QE and the RICH

Poor old 'quantitative easing' (QE). Has there ever been an important economic policy that has been more thoroughly misunderstood and misjudged? TIM CONGDON

The rationale of QE is simple and can be explained in a few paragraphs. But much confused nonsense has been written about it, and that nonsense has led to foolish and unjustified criticism.

Did QE stop the Great Recession turning into the Great Depression?

Standard theory and a great deal of evidence argue that the demand to hold money balances is stable. This stability of the money demand function means that changes in the quantity of money and nominal national income are roughly equi-proportionate in the medium and long runs.

In other words, a change of a certain percentage in the quantity of money is accompanied by a change of more or less the same percentage in nominal national income.

Data from many countries over long periods of time show that this assumption is not silly, even if the short-run relationship between money and income is problematic.

Given these facts, most sensible people would accept that steady expansion of the quantity of money ought to be one aspect of macro-economic policy. They might have doubts and reservations about the emphasis to be placed on this principle, but almost everyone would surely endorse the view that stability in money growth is preferable to instability.

Unfortunately, in late 2008 and early 2009 many leading economies, including the UK, were close to a monetary disaster. If nothing had been done, the quantity of money was about to collapse by hundreds of billions of pounds.

Indeed, the prospective rate of decline, of about 1 per cent a month (or 10 per cent a year), was similar to that seen in the USA's Great Depression of 1929 to 1933, when the quantity of money went down by over a third in under four years.

The reasons for this parlous state of affairs are debated. Some 'experts' blame the banks for having too much risk in their balance sheets, and so being in danger of 'going bust' and failing to repay depositors in full.

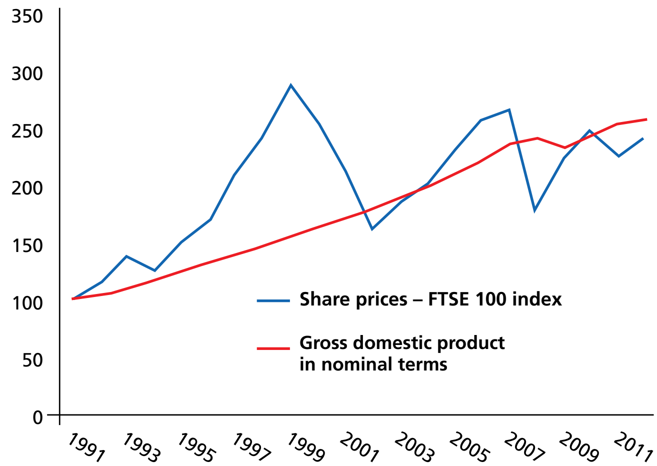
Others say that banks were solvent throughout the crisis, and that they were obliged to shrink their loan portfolios and securities holdings only because of a sudden and misguided tightening of bank regulation which began in October 2008. But, whatever the precise cause of the trouble, a big fall in the quantity of money was imminent.

Fortunately, the creation of money by the state is easy. All that is required is for the government or the central bank to borrow from the commercial banks, and to use the proceeds of the loans to purchase anything (government securities, tanks and planes, old boots) from the non-bank private sector.

QE IS PART OF MONETARY POLICY AND MONETARY POLICY CANNOT IN THE LONG TERM CHANGE SO-CALLED "REAL VARIABLES" SUCH AS THE DISTRIBUTION OF INCOME BETWEEN LABOUR AND CAPITAL

The effect of the purchases is to increase the bank deposits held by the private sector agents. People and companies can write cheques against the deposits, which are therefore

Share prices and national income (1991=100)



money, and the new money balances can then circulate an indefinitely large number of times.

In essence, QE was and remains nothing more than the large-scale creation of money by the state. In the particular case of the UK, since early 2009 the amount involved has been about £400 billion.

Sure enough, in detail the mechanics of QE and the analysis of its effects can be hugely complicated. But the heart of it is that it caused the quantity of money to be about £400 billion – or roughly between 15 per cent and 20 per cent – higher in mid-2013 than it would otherwise have been.

Even allowing for some technical caveats, an unambitious conclusion is that nominal national income today is over 10 per cent above the level at which it would have been without QE.

Furthermore, QE did stop the Great Recession becoming the Great Depression that was threatening in early 2009.

QE and asset prices

It would be nice to think that QE would be given three cheers by the commentariat. However, that is not at all the case.

Many pundits give it one cheer for stopping a worse economic downturn, but say that it rescued the bankers, and bankers are wicked and undeserving by definition. Well-known columnists such as Liam Halligan in *The Sunday Telegraph* claim that QE is the last refuge of banana republics and bankrupt empires, and that it foreshadows hyperinflation. Another boo has come from critics who assert that QE gave an artificial boost to asset prices and was therefore biased in favour of the rich.

According to Merryn Somerset Webb in an article ("A policy that stigmatises the well-off") in the *Financial Times* on 12th October, in the aftermath of QE: "those with money have simply bid up prices of existing assets". The further consequences have been that QE "has pushed down the purchasing power of the general population and devastated their savings".

But QE is part of monetary policy and monetary policy cannot in the end change so-called "real variables" such as the distribution of income between labour and capital, or the valuation of some capital assets relative to others.

It must be admitted to Merryn Somerset Webb that asset price fluctuations are far more volatile than national income and that short-run changes in asset prices are partly attributable to movements in the quantity of money.

But, in the long run, the real value of corporate and property assets depends on savers' preferences, not on monetary variables. Since the beginning of UK equity investment on modern professional lines in the early 20th century, the quantity of money and the level of national income have increased a very large number of times, but the valuation of equities has changed relatively little.

Because of the cyclical volatility of the stock market, share prices were depressed in early 2009, with the FTSE 100 index down at its worst point, in March, to a low of 3512. That was little better than half the all-time peak FTSE 100 figure of 6930 at the end of 1999. Since early 2009 the stock market has moved back towards the all-time peak, but never quite made it.

The figure shows that share prices and nominal national income have risen by more or less the same over the last 20 years taken as whole, but the year-by-year fluctuations have been much greater for share prices.

The recovery in the stock market between early 2009 and today was partly due to the increase in the quantity of money due to QE. This can be agreed.

Without QE the quantity of money and the UK equity market would have been much lower, and the recession would have been more intense than it was. This can also be agreed.

But QE cannot be blamed for the surge in share prices back towards the 1999 peak, since QE had not at that stage been invented.

Tim Congdon's
Money and Asset Prices in Boom and Bust
is available for free download at:
www.iea.org.uk/publications/research/money-and-asset-prices-in-boom-and-bust

Moreover, despite all this alleged favouritism of public policy towards the rich, the level of UK share prices today is lower than it was over a decade ago.

More generally, although asset prices are affected by monetary policy in the course of one business cycle, monetary policy cannot affect the real level of share prices, or income and wealth distribution, across a number of business cycles.

Further, it needs to be emphasised that QE has been good for demand, output and jobs, and the extra employment has been of greatest benefit to the poor.

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