

# QUANTITATIVE EASING AND THE GREAT RECESSION

Did US Federal Reserve's aggressive monetary policy, and in particular quantitative and credit easing, pull its economy from the brink of a second Great Depression?

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The Great Depression of the 1930s was caused by a simultaneous contraction in credit and money supply. Deleveraging reduces the velocity of money. According to Fisher's equation ( $M*V = P*Q$ ), at any given money supply a reduction in the velocity of money would lead to either a decline in nominal prices (deflation) or output, or both. Hence increasing money supply should stabilise GDP.

Central banks have little control over credit markets. But they can certainly influence money supply. Could better use of monetary policy have prevented the Great Depression of the 1930s? Yes, say two celebrated historians of the Depression, one of whom is none other than Ben Bernanke, current chairman of the US Federal Reserve (the other is of course Milton Friedman). During the Great Depression the Federal Reserve was constrained by the gold standard in driving up money supply to counteract deleveraging. Rather fortuitously, one of these economists was at the helm of the US Federal Reserve just as the world stood on the brink of a second Great Depression in 2007-08.

This time round the US Federal Reserve was ahead of the curve. It started monetary easing even when policy makers elsewhere were still combating inflation. Deflation was perceived as the greater danger that lurked just beyond the inflationary horizon. As the threat of deflation crystallised with the credit freeze, US mon-

etary policy became aggressively zero bound. The Bank of England and the European Central Bank followed in its wake as the Great Recession unfolded.

The limits of monetary policy were tested in the 1990s during the banking crisis in Japan when interest rates became zero bound following repeated cuts. The Bank of Japan continued to pump liquidity by buying government treasury bonds in what came to be known as quantitative easing. Central banks had long been accommodating fiscal policy through purchase of treasury bonds. However, used as a purely monetary policy tool following zero bound short-term interest rates was a Japanese innovation.

Quantitative easing could not stimulate the Japanese economy back to former levels of growth. There was, therefore, no proof that it was the way out of a liquidity trap. It could nevertheless be argued that Japanese trend growth itself was declining consequent on structural and demographic shifts.

This did not deter Ben Bernanke from testing his theories during the recent financial crisis. Quantitative easing on the epic scale envisaged by Ben Bernanke virtually amounted to dropping money on the economy by the aerial route, and had earlier earned him the epithet "Helicopter Ben". The US Fed embarked on aggressive quantitative (purchase of treasury bonds) and credit (purchase of private securities) easing on a scale unmatched even by the Bank of Japan in the nineties.

After retreating for six quarters the US

economy is back on the path of growth, albeit tepid and below trend, as is to be expected in the case of balance-sheet recessions. Did aggressive monetary policy, and in particular quantitative and credit easing, pull the economy from the brink of a second Great Depression? This is, at present, a matter of conjecture, and a lively subject for future research. There are, however, at least three reasons to doubt its efficacy.

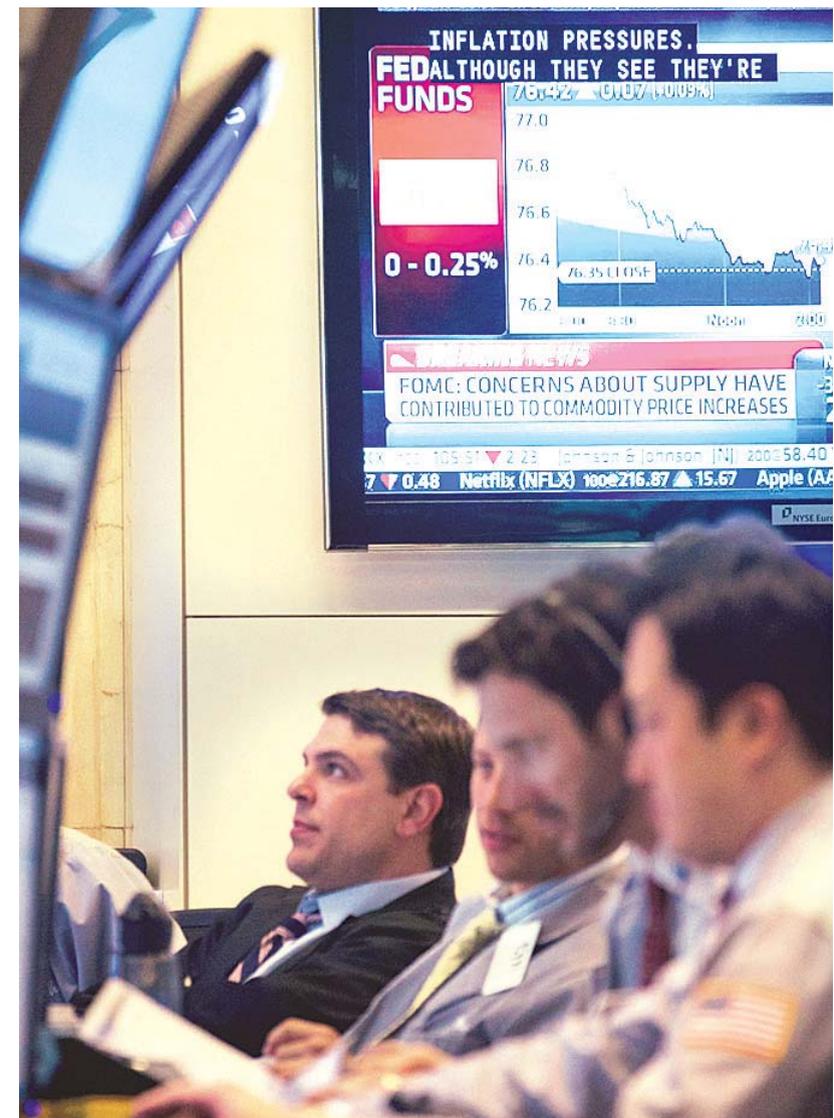
First and foremost, instead of expanding credit, much of the fiat money created by the Federal Reserve found its way back to the Fed through a sharp and continuing increase in the voluntary holdings of depository institutions. While one can quibble whether the problems lie more on the supply or demand side, this strongly suggests that quantitative easing is no way out of a liquidity trap. Instead of stimulating the domestic economy, the flood of liquidity is spilling into emerging markets and inflating asset and commodity prices. Neither has quantitative easing devalued the dollar to the extent that the US could export its way out of low growth and unemployment, perhaps because of its reserve currency status.

Second, while monetary policies might influence the investment behaviour of firms, the extent to which they influence consumption and savings by households is arguable. This behaviour is culturally specific and very sticky. The predilection of US households to borrow, and of the Swabian housewife to save, is legendary. Investment behaviour is ultimately de-

pendent on the consumption patterns of households and overseas demand that drive animal spirits. The response of US households to their damaged balance sheets is to sharply increase savings, which have risen from a low of 1.5-2.5 per cent of personal disposable income in 2004-2006 to almost six per cent at present. Since the post-war average is closer to 10 per cent, the savings rate could continue to rise consequent on balance sheet repair and regulatory tightening. Easy monetary policy is not inducing households to consume more.

Third, the rise in personal savings and fall in investment was countervailed by government dissavings that pushed up the budget deficit from 1.2 per cent of the GDP in 2007 to 8.9 per cent in 2010. This dramatic fiscal expansion, unparalleled in peace time, may be propping demand. It is at, at present, difficult to separate the effects of monetary and fiscal policies in counteracting extreme recessionary conditions. Indeed, it is argued that the firewall between the two has broken down, and that the two have become virtually indistinguishable.

Monetary policy is currently crippled by the monetary trap deriving from the breakdown of transmission channels. Have central bankers now flogged monetary policy beyond limits, just as governments had earlier done with fiscal policy? And will this excess, like the fiscal excesses of the seventies, eventually lead to inflationary outcomes? Would central banks be able to suck out the excess liquidity before it is too



late? This could prove tricky if trend growth has indeed drifted lower, and the phenomenon of "jobless growth" persists. Headline inflation in the US is rising, although core inflation continues to be low. Neither loose monetary policy before the crisis, nor loose monetary policy after the crisis, could drive core inflation upwards, even as asset and commodity prices boomed. But this could simply be the tail-

end of the "good deflation" deriving from globalisation, in particular the integration of China and India into the global economy. Why consumer price inflation is much higher in EMEs is another issue, but they are also growing at near trend and their inflation measurement is different.

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