

Why quantitative easing won't work

By MoneyWeek Editor [John Stepek](#) Mar 05, 2009

Mervin King: Let the virtual presses roll.

Interest rates were already at a record low. Now they really can't go much lower. The Bank of England cut the bank rate in half today, with another half-point cut to 0.5%.

One of the many pundits currently clogging up my email inbox with comments on the cut says that it will "actively encourage business and consumer confidence." I think this is a bit of a leap. Interest rates can't go much lower. The only other country that's ever had 0% interest rates in recent decades is Japan, and it's been practically impossible to make money there ever since. That doesn't inspire confidence in me.

But the Bank didn't just cut rates. It's now started on the next phase of the great western monetary experiment – quantitative easing (QE). So what does this mean – and will it help?

QE is basically just printing money. You don't do it with ink and paper, you do it electronically, but it has the same effect. More on that in a moment, but first the theory behind it.

Broadly speaking, we are in recession because there's not enough money circulating around the economy. This depends on two things: the amount of money available (the money supply), and the rate at which it is changing hands (the money multiplier).

Having cut interest rates to the bone to try to tempt people with cheap money, the Bank is now targeting the amount of money that's actually out there. It has been given permission by the Treasury to buy up to £150bn of assets, £50bn of which is dedicated to private sector assets, and the other £100bn to government bonds.

And the Bank has said today that it will buy £75bn of assets over the next three months, the majority of which will be spent on medium and long-term gilts.

Where does the money come from? The Bank just creates it out of thin air. If you're thinking that this sounds pretty unusual, then you'd be right. As John Hardy at Saxo Bank points out: "The most interesting aspect of this is the announcement that the BoE will be purchasing government debt, as this represents outright debt monetisation, which can be considered one of the most desperate forms of money printing by a central bank. Not even the US Fed has taken this step yet, though it has declared that it is considering the effects of doing so."

So what's the aim? Well, the assets are bought from the commercial banks that hold them. So you're swapping assets for cash. The hope is that the banks then feel more free to lend money to homes and businesses.

Will it work? There are a couple of problems. The banks – in their distinctly frail condition – may decide to hoard any cash raised from QE rather than lend it out. So the extra money may not even be offered to people and businesses.

If they do offer more loans, people may not want to take them. The housing market is a good example. Even if 100% loans were to make a return to the market (highly unlikely), that bubble has now burst. House prices are falling at 18% a year, according to the Halifax. Why would you buy a house now? So pumping in all this money may have no or little effect - if there's no demand for more debt, then you can jack up the supply as much as you want and it won't matter.

But what if it does work? Well, then you have a whole new set of problems. The ultimate aim of QE is to encourage inflation. But inflation isn't an easy thing to control. Policy makers reassure us that they'll stuff the genie back in the bottle once growth returns to the economy. But given their performance so far, and given that this is new territory for monetary policy, what makes

us think that they will somehow be much better at managing monetary policy this time round?

And given that this is an artificial stimulus, even if it works, what's to say that the economy won't just collapse again when the printing press is turned off?

The recession is the result of us taking on too much debt. We need to get that out of the system; ultimately, that means we need to build up our savings. QE and rate-cutting are at best a distraction and at worst a positive hindrance to this process. Anyone with debt is now focused on paying it off in case they lose their job - any spare income they get will go towards paying down their debts. Meanwhile, cutting interest rates is striking fear into those who want to see their savings grow - instead of spending more money, they'll try to save even harder to keep ahead of inflation.

If you aren't convinced that this is counter-productive, just look at Japan. 20 years of government spending and central bank fiddling to prop up the economy; and yet, it could be one of the countries that suffers the most painful decline this year.

There's no quick solution to this slump. And the longer we keep trying to find ways to simply wave a magic wand and make everything go back to the way it was in 2006, the longer it'll take us to escape from the mire.