

Keep the money flowing to stave off deflation

Print

By Tim Congdon

Published: July 8 2009 19:53 | Last updated: July 8 2009 19:53

Has “**quantitative easing**” been a success or a failure? Should it be dropped, continued or expanded? With base rates virtually as low as they can go and therefore no longer effective as an instrument to boost the economy, the **Bank of England**’s views on QE have become a central talking point.

As the Bank governor, **Mervyn King**, explained in March, the purpose of QE was to increase “the amount of money that’s held by the wider economy”. The thinking was that extra money “would influence decisions to spend directly” as well as “decisions to re-allocate assets which might increase the value of those assets”. It would lead people “to feel better off and, hence, to spend”.

On this basis we must assess QE on two fronts: its effect on the rate of money growth and its knock-on effect on the wider economy.

In later briefings the Bank made its objective more precise. The M4 money measure (which includes most bank deposits held by households and companies) had stopped growing in late 2008, as banks restricted credit and their customers repaid loans. M4 threatened to contract in 2009 if nothing was done, aggravating the economic downturn. The Bank’s hope was that QE would restore M4 growth to an annualised rate of 5 per cent.

These are early days, but the available data show that the first part of the policy is working according to plan. Unfortunately, there is an irritating but important complication. Money aggregates have in this cycle been subject to a serious distortion. The banks’ creation of “conduits”, “special purpose vehicles” and the like since 2004 led to artificial expansion of deposits, complicating the interpretation of the money supply statistics.

The Bank now publishes an M4 series with this distortion stripped out. In the second half of 2008 it was falling by about 0.5 per cent a month. Deposits held by companies were particularly badly affected, dropping by about 1 per cent a month, a similar rate of decline to that in America’s Great Depression. But in the three months to May 2009 – in other words, the first three months of QE – the annualised rate of growth of M4 was 4.3 per cent, only a tad beneath the target of 5 per cent.

QE has therefore stopped the contraction of money, exactly as it was supposed to do. What about the effect of higher money growth on the economy at large?

Too many commentators have forgotten the intense despondency of January and February 2009. Informed observers judged that the government and the Bank were clueless about how to respond. As Martin Jacques put it in the *New Statesman* in February: “The political and business elites are flying blind. This crisis has barely started and remains completely out of control.”

But the darkest hour was just before the dawn. The start of QE in early March coincided almost precisely with an abrupt improvement in nearly all macroeconomic indicators.

In early 2009 most fund managers shared the prevailing pessimism and were running high levels of cash relative to their total assets. But now the prospect was for £150bn of new cash being added to total money holdings, with much of it initially passing through insurance companies and pension funds as they sold gilts to the Bank. The investment outlook was suddenly transformed.

Fund managers tried to commit money to bonds, equities, commercial property and other assets, but to a large extent they were buying and selling from each other at rising prices. Within a few weeks share prices were up 30 per cent, while the commercial property market showed signs of stabilising.

Most important of all, both business surveys and actual indicators of spending have strengthened dramatically since early March. While there is room for debate about how much of the improvement should be attributed to QE rather than other measures, Mr King has surely been justified in hoping that QE would make people feel better off (or at any rate less worse off) and hence would encourage them to spend more (or at least to cancel plans to spend less).

So far QE has been an almost unqualified success. If M4 growth shows signs of slipping beneath the 5 per cent number, the Bank should have no hesitation in expanding its **gilt purchases**. The priority must be to ensure that the quantity of money continues to rise, so keeping the menace of deflation at bay.

The writer is chief executive of International Monetary Research