The term quantitative easing first entered popular language during the 2008 Global Financial Crisis. Central banks, specifically the US Federal Reserve (FED) and the Bank of England (BoE), tried to provide stimulus to their economies by buying securities from banks, with a goal to reduce monetary conditions and, thereby, induce an increase in lending and promote economic activity.

As interest rates fell to zero, the Fed began QE1 in November 2008 with a $600 billion purchase of mortgage-backed securities (MBS). It did this by creating new credit in its own account and then exchanging this for the MBS held by the banks. The purpose of this was threefold: to improve bank balance sheets, raise the price of securities (and therefore reduce interest rates along the yield curve) and stimulate new borrowing.

Japan
This was not an entirely new policy, as Japan had been engaged in the same process for more than 10 years, though with limited success. The Bank of England followed suit in March 2009 and started buying UK government bonds and a limited amount of other high-grade assets.

The initial impact was felt in the asset markets with the price of stocks, bonds and commodities all rising. In fact, rising commodity prices were seen as an unwelcome side effect of QE, given that QE was supposed to boost lending and, therefore, economic activity, specifically new jobs.

Banks were supposed to be lending these excess reserves, not speculating in financial markets. The reality was that banks had no interest in lending and businesses and consumers had little interest in borrowing.

The central bankers had failed to note that they were in the middle of a huge debt bubble and that trying to offer new debt into a market saturated with the stuff was hardly going to be a winner.

There is no doubt QE helped restore confidence to the financial markets and, as a side effect, helped steady the global economy. Whether it actually worked in the manner it was supposed to, is debatable.

As Bank of England governor Mervyn King stated when giving evidence to the UK Treasury Committee on QE, “I can’t guarantee that it (QE) means that bank lending will rise, but what I do believe is that it won’t fall as far as it might otherwise have done”.

In terms of impact, the US bailout of the auto industry had more success with more than a million jobs saved. While the financing aspects were contentious, the outcome has been positive. As President Obama’s aides noted, direct government funding enabled the auto industry to survive and this would not have happened if it had been left to the market.

Direct stimulus
Setting aside the merits of saving the US auto industry, what was crucial and different about this policy was that it involved direct stimulus into the real economy, where people are employed to make products.

As Nouriel Roubini noted, the US government would have been better off just spending the new credit used for QE directly into the economy [instead of handing it to the bankers].

He suggested, in a co-authored 2011 paper, that there should be a massive infrastructure rebuild ($1.2 trillion) in the US, which would create jobs and lay the foundation for “a more efficient and cost-effective economy”.

He further noted that the crisis had been exacerbated by “inadequate action” by policymakers who had an “inadequate understanding of what ails us”.

It’s clear that policymakers have not stepped back and tried to understand both the causes and outcomes of the crisis. In a debt-deflating environment,
no amount of new debt is going to help the problem. Until the bad debt has been cleared, new investment is unlikely to happen and the economy dies a slow death.

One option that hasn’t been considered, as Roubini alludes to, is to actually stimulate the real economy directly; i.e. the economy that produces real goods and services. Governments can actually print new money and spend it directly into the economy through infrastructure projects. This way, the money directly supports real economic activity, in a way that QE was supposed to do but never did.

The Sustento Institute proposed this type of policy in 2011, immediately after the 22 February Christchurch earthquake.

Cash injection
A direct injection of $5 billion of new money was suggested, as a way of financing new and necessary infrastructure for the rebuild of the city. At that time, this was calculated to save around $200 million a year in financing costs and avoid further increases in government debt.

Ironically, the Minister of Finance, Bill English, rejected this on the grounds that it may cause “an adverse combination of high inflation, arbitrary wealth transfers and a loss of confidence in the creditworthiness of New Zealand”. His response supports Roubini’s position that policymakers simply do not understand the problem.

In the case of New Zealand, Bill English seems to be quite happy to keep borrowing money and worsening the financial position of the country.

As has been seen, inflation is non-existent in a debt deflating economy. Of course, any new injections of new money must be carefully monitored and be at a level that is not likely to cause over stimulation of the economy.

As Willem Buiter, a former external member of the Bank of England’s Monetary Policy Committee notes, an injection of base money “even in huge amounts, need not become inflationary ever”.

Buiter goes on to state that “any inflationary increase impact of the enlarged stock of base money on the stock of bank credit or broad money can be neutralized by either raising bank reserve requirements, or by raising the remuneration rate on excess reserves held by banks”.

Monetary dialysis
Therefore, inflationary concerns can be set aside when this double-sided process is undertaken. This type of intervention has been called ‘monetary dialysis’, where clean money comes into the system (newly minted e-notes) and replaces or causes a reduction in debt money (bank credit) in order to keep the money supply at a prescribed level.

The key is that the process is managed within the same framework that current monetary conditions are dealt with. No new legislation is required and the process can begin immediately.

The RBNZ is already developing a new suite of macro-prudential tools and will be well placed to manage this policy shift.

In this process, all the objections raised by the English are dealt with. Infrastructure is rebuilt, people are employed, goods and services are provided, inflation is stable and money is saved, as there are no financing costs incurred.

This really is the ultimate point: it’s not about not having enough money, it is whether you have surplus labour (unemployment) and resources (capacity in the economy).

This was the stark lesson of the Great Depression and it’s incredible that it still hasn’t been properly understood.

As to the creditworthiness of New Zealand, it is more likely that this will improve, as the overall level of debt falls and the productive economy recovers. What’s not to like about that?

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The Sustento Institute is an independent policy development organization based in Christchurch. Its purpose is to develop policy solutions that lead to a more sustainable society.

On the web: www.sustento.org.nz