More Quantitative Easing will be a sign of real trouble ahead [1]

Written by **Dr Eamonn Butler** [2] | Monday 14 January 2013

Fund manager and commentator Liam Halligan argues [3] much the same as we do in a paper by Robert Miller due out later this month ? that the first bouts of Quantitative Easing might have been wise, but any more could prove highly destructive.

The argument actually goes back to Hayek, who of course devoted many years of his career to the study of boom-bust cycles. These cycles, he concluded, start with the central bank easing credit ? say, by keeping interest rates too low. That makes loans and mortgages cheaper, so householders buy bigger houses and businesspeople invest more on plant and equipment. But at the same time, low interest rates put off savers, and the funds needed for all this investment dry up. There is a crisis, and then a painful recession as investments are written off, house prices fall and productive equipment is sold for scrap.

What Miller explains elegantly in his forthcoming paper is how the banks amplify both the boom and the subsequent bust. That is because of the 'fractional reserve banking' system. When you pay money into your bank account, the bank keeps only a tiny amount on hand and lends out the rest to businesses. When those businesses buy equipment (say) from their suppliers, the suppliers pay that money into their account too. The bank keeps only a tiny amount on hand and lends out the rest to... well, you get the idea, it's a spiral. In fact, if the banks keep on hand just 3% of each deposit (as the Basel rules allow), then your original £100 turns into £2,219 of deposits after just 36 cycles. And when things turn sour and they start those same loans, exactly the reverse happens.

So the banks can create money out of thin air ? and destroy it again ? exaggerating the boom and the bust. That is why the Bank of England and the Fed reached for Quantitative Easing to repair the sudden post-crisis fall in the quantity of money. In so doing, they might well have saved us from a damaging depression.

So if Quantitative Easing can stop us going down, can more of it float us upward? No, says Hayek. In the boom, people invested their capital in the wrong places. More money will not do any good until productive assets are re-shuffled into more realistic uses. It just prolongs the problem. So if you see the authorities reaching for Quantitative Easting again, you can be sure that things are going to get worse, not better.

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