The QE3 fantasy [1]

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The monetary authorities are at it again ? trying to defy reality. In Europe, the ECB has thought up a new wheeze, called Outright Monetary Transactions, by which they can buy up the debts of bankrupt eurozone countries without (they hope) causing too much grumbling among the Germans who will ultimately pay for it. In the US, the Fed has just announced a new quantitative easing (QE3) plan to buy up mortgage debts in order to keep long-term interest rates down and make homeowners happy ? well, as happy as they could be after a 20%-30% slide in the value of their properties.

Lots of economists are popping up on TV screens in Europe and America to say how wise these new moves are. Well they would, wouldn't they? Most economists work for banks and big companies or big financial firms. All this new government money is very welcome in such quarters. It goes directly into bidding up the price of financial assets, mortgages and shares, including the shares of the banks themselves.

I supported the early rounds of QE on good monetarist grounds. It is one of the oddities of fractional reserve banking that banks can actually create money. At the stroke of a pen, they can create loans that their customers then deposit in other banks, allowing those banks to create more loans...and so on. During the financial crash, the banks were caught like rabbits in the headlights, and clamped down on their lending. The politicians and regulatory authorities added to the contraction, telling the banks not to make so many risky bets. As a result the amount of money around fell sharply. But money affects everything in the exchange economy: it is critically important, and you do not want to see it falling sharply like that. So the Bank of England needed to fill the gap. As long as the Bank is prepared to cut back sharply again, should the economy start booming once more (though the chance of a rapid bounce-back seems to be receding somewhat).

The Fed's latest $40bn-a-month boost to the mortgage market is just a fraction of its earlier monetary boost, of course. So whatever good or harm it will do might be limited. But what exactly is it intended to do? The effect, of course, will be to keep down long-term interest rates, which one might hope makes life easier for businesses that want to invest and grow. But the immediate and strongest effect will be to shore up the US housing market, and making it easier for people to get housing loans and buy houses. Wait a minute, though...is that not exactly the thing ? or at least, a large part of the thing ? that got us into this mess in the first place? Cheap credit that encouraged people to borrow more than they could afford and boost house prices beyond any commonsense level? When are our authorities actually going to face reality?

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