

## **Monetary Policy During the Recession**

The Bank of Canada and the Bank of England have reduced their overnight lending rates to very low levels. The Federal Reserve Bank in the United States is maintaining its overnight lending rate between 0-0.25%. At these low interest rates, one might think, there should be overwhelming demand for credit. However, under current economic conditions, individuals and firms are reticent to borrow, and banks (with balance sheet problems of their own) are not willing to lend, since they are trying to “repair” their balance sheets, in light of losses from credit defaults.

This situation has led many central banks to embark on, or think about embarking on (in the case of the Bank of Canada) what is described as “quantitative easing”. In this approach, the central bank increases the supply of money, in the hope that this increased liquidity will stimulate economic activity. However, in several countries’ cases, quantitative easing is being implemented through increases in the supply of money by lending to banks, which banks are merely using these funds to repair their balance sheets, “lend” the funds back to the central banks at positive interest rates, and not lend the increased money supply to the business and industrial sectors.

When interest rates are low, when lenders will not lend, and when borrowers will not borrow, monetary policy has lost much of its usual effectiveness. Hence the effort to provide the financial system with a boost, in the form of quantitative easing. This policy, however, is only going to have an effect if the increased money supply ends up in the hands of spenders, who will then stimulate economic activity.

The Bank of Canada alludes to a quantitative easing policy by which it will use newly created money to buy corporate bonds, and perhaps even common stocks. In contrast, the Federal Reserve in the United States and the Bank of England, are proposing to use quantitative easing mainly to buy up government bonds, thereby reducing long-term bond yields in the long-term bond market. This, again, in the hope to stimulate borrowing by businesses. The Bank of Canada approach could have the advantage of by-passing banks, which are not inclined to lend, since they are having more difficulty than usual in assessing which economic players are credit-worthy.

Quantitative easing is, however, nothing more than “printing money”: central banks buy bonds by creating new money. This policy raises the possibility that inflationary problems could emerge in the future, as the increased money supply enters the economy. The problem with this policy is that it is very difficult to fine tune, in order to pull the economy out of recession, in a way where the effect of the increased money supply and availability of credit can be removed as the economy recovers, without sparking a major inflation.

To see why this problem arises, note that when most workers in an economy are employed, and production is at capacity, only so much money is needed in the economy to facilitate transactions. Indeed, even at lower output levels, when some unemployment

## **Monetary Policy**

**Christopher J. Nicol**

*Appeared in the Lethbridge Herald, April 9, 2009*

exists, and when there is some spare productive capacity, it is not easy to increase output quickly, using the less than fully employed capacity. If there is a sharp increase in the amount of money in circulation, new output cannot be produced at all, or quickly, so the increased demand for goods and services (from increased money in circulation) merely drives prices upwards (inflation emerges).

As an economy is recovering, the “excess money” used to get the economy moving needs to be removed in such a way as not to damage the recovery. However, if the excess money is not removed at the appropriate rate, prices can rise quite quickly. In the coming months, as we hope to see the world economy recover, it will be important for central banks to keep a close watch on the potential for emerging inflation, as a result of the increase liquidity (money) which has been introduced, and which will ultimately have to be removed.

*Christopher J. Nicol, Ph.D.,  
Professor of Economics, University of Lethbridge*

*March 20, 2009*