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Can Quantitative Easing Fund Green Jobs?

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In our August 2010 Policy Briefing Paper, "G20 Surrenders to the Money Traders," we discussed how central banks have the option of creating money out of nothing through what is known as "quantitative easing" or QE for short. In that paper, we note that the US Federal Reserve created US$1.2 trillion in 2008 through QE. It used that money to purchase toxic assets from private financial firms anxious to offload their holdings of subprime mortgage-backed securities. At the time, we had no idea that a new round of quantitative easing, known as QE2, would meet with so much resistance.

In this Briefing Paper we discuss why QE is getting a bad rap in many quarters and explore whether there might be a better way to use this little known tool of monetary policy to address unemployment by funding green jobs.

Quantitative easing is a monetary policy tool used by central banks to increase the money supply in order to stimulate economic activity. When the newly created liquidity is used to buy government securities held by private financial firms its has dubious benefits for working people. However, this Briefing Paper will argue that there are other options for using money created through QE.

Current Debate on QE2

The current debate on QE2 revolves around the US Federal Reserve's decision to create $600 billion of new money to purchase long-term Treasury bonds from banks or other financial institutions. These purchases are supposed to drive up bond prices and lower their yields – in effect lowering interest rates. In theory, the new liquidity and lower long-term interest rates will enable the private banks to make more loans to customers thus boosting the US economy and creating jobs.

However, few expect QE2 to lead to significant new investments in the real economy. US banks already hold substantial sums on their balance sheets, but customers are not lining up to borrow. Due to high unemployment and stagnant real wages, few families will apply for consumer loans. As Canadian Labour Congress economist Andrew Jackson notes: "QE … is not going to have a big impact so long as business is unwilling to invest, households are paying down debt, and banks are already flush with cash."[1]

Some vocal critics allege that the Fed is likely to provoke hyperinflation if it keeps on "printing" too many new dollars through data entries on electronic balance sheets. These determined inflation fighters seem unaware that the current danger is still deflation, i.e., falling prices, not runaway inflation. They also underestimate the determination of the Fed to start shrinking money supply were inflation to return.

Other critics of this round of QE, including former Federal Reserve chairman Alan Greenspan, accuse the Fed of deliberately weakening the value of the US dollar by increasing the money supply.[2] While the US dollar did decline on news that the Fed was contemplating another round of QE, it is important to note that it was already weakening against other major currencies. Large US trade deficits embolden currency speculators to bet against the greenback. When this happens the Canadian "loonie" tends to rise in value, making exports more costly and leading to a loss of manufacturing jobs in Canada.

Speculators Invest Abroad

If the private firms that sell their Treasury bills to the Fed use the proceeds to lend to hedge funds for speculative investments in stocks, commodities, foreign bonds or currencies, then QE will do little to enhance domestic demand in the US. Some of the newly available money will likely enter the "carry trade" where investors borrow money in the US at low interest rates and make short-term investments in other countries where they can earn higher returns.

Finance Ministers and central bank governors in the emerging markets have a legitimate concern as they worry about a destabilizing flood of hot money into their economies. Hence some Southern countries, such as Brazil, are pre-emptively instituting capital controls to stem the inflows.

Some fear that the US is trying to export its crisis to other countries much as it did in 1971 when President Richard Nixon suspended convertibility of the dollar into gold and imposed a 10% surcharge on imports. One of the fallouts from the "Nixon shocks" was a devaluation of the dollar and an effective default on a portion of US foreign debt since payments were made in dollars that were worth less than those originally borrowed.

Reflecting on the earlier use of QE to bail out private financial firms by taking over US$1.2 trillion of toxic debt, Paul Quintos, a researcher with IBON Foundation in the Philippines, accuses the Fed of favouring the interests of finance capital over workers. By lowering interest rates and printing more dollars via QE, Quintos says the Fed is putting "more money into the hands of finance capitalists [while failing] to spur investment in the real economy, generate jobs and lift people out of poverty."[3]

From the above description it might appear that QE is always a wrongheaded measure doomed to failure. But could the problem be that the Fed's error is not that it is creating money out of nothing but that it is channelling that money to the wrong entities?

What if Central Banks Were to Spend Instead of Lend?

When central banks create money, they need not use it to purchase assets from private financial institutions. They have the option of lending it directly to various levels of government – federal, provincial, state, or municipal – for job-creating investments in areas such as public transit or clean energy. Andrew Jackson notes: "The total amount of QE2 comes to about $2,000 per US citizen. … [The Fed] could have helped finance state budgets in deficit, avoiding the pending decimation of public services, and could have … [extended] expiring unemployment benefits for many long-term unemployed."[4]

As Keith Newman writes, QE "would be more effective if targeted at municipal and state bonds" lowering the costs of their investments in new infrastructure. "With respect to Canada," Newman adds, "our federal government should increase spending to increase demand in the economy and put the unemployed back to work to build a better country. It should target improvements in public transportation, the rail system, social housing, social programs, etc."[5] In addition, the Bank of Canada has the option of lending to the provinces for similar investments.

When central banks lend money to governments the interest they earn goes back into the national Treasury minus only the banks' operating expenses. This is true even for the privately-owed US Federal Reserve as it is for the Bank of Canada.[6]

Spending on real assets such as alternative energy sources or rail lines need not be inflationary if the money is used to purchase new goods and services, especially at a time of low private demand for the same goods. In addition, spending on local procurement for local projects avoids a destabilizing effect on foreign countries through currency speculation or the carry trade.

What is needed then is a type of QE that gives priority to investments in a productive and sustainable economy rather than favouring financial speculation.

Inflation Can be Contained Without Government Cuts

Critics of QE often argue that it is inflationary regardless of the circumstances under which it is initiated. They say that creating more money when there is a fixed amount of goods and services available will eventually lead to inflation. What this critique fails to acknowledge is the fact that private banks create new money every day whenever they make new loans. An alternative view explained in our KAIROS background paper on the Economics of Sustainability is that money creation should be a public, and not a private, function.

In the current debate on QE2 many critics of the Fed's action not only assume that it will inevitably lead to inflation but also assume that the only alternative for fighting inflation is to cut back on government spending. However, there is another option for curtailing a too rapid growth in money supply if indeed it does contribute to inflation. Governments have the option of raising the reserve requirements for private

banks, that is, the amount of money banks are required to retain in cash to cover any withdrawals clients may choose to make. Higher reserve requirements would constrain the private sector's ability to create new money by limiting the rate at which banks issue new loans.

As Martin Wolf writes in the *Financial Times*: "The essence of the contemporary monetary system is creation of money, out of nothing, by private banks' often foolish lending. Why is such privatisation of a public function right and proper, but action by the central bank, to meet pressing public need, a road to catastrophe? When banks will not lend and the broad money supply is barely growing, that is just what it should be doing. … If the worst came to the worst, [the Fed] could just raise reserve requirements."[7]

Wolf notes that many of the Federal Reserve's critics advocate moving to 100% reserve banking. For example, ecological economist Herman Daly argues that we should gradually move away from the fractional reserve system where most of the money supply is created by private bank lending. Daly asserts that "Under the existing fractional reserve system the money supply expands during a boom, and contracts during a slump, reinforcing the cyclical tendency of the economy." [8]

The alternative is to treat money as a public utility where "the profit (seigniorage) from creating … and being the first to spend new money … would accrue to the public rather than the private sector."[9] Under a public system the required level of reserves that private banks must keep with central banks would be raised gradually to 100%. Commercial banks would then make their income by lending savers' money and from service charges on checking accounts. Daly points out: "Lending only money that has actually been saved by someone … would prevent such debacles as the 'sub-prime mortgage' crisis."[10] The result would be a smaller, more stable financial system and an economy oriented to employing people to produce real goods and services in harmony with the limits of the ecosphere.

France Calling for a New International Monetary System

Some critics of QE2 allege that future repeated rounds of QE will drive down the value of the US dollar, effectively allowing the US to default on a portion of its huge foreign debt.

To address such an eventuality we must look beyond the somewhat narrow debate on QE2 to wider issues involving calls for a new international monetary system. Political economist Duncan Cameron reminds us that France, which is taking over the chair of the G20 for 2011, "has an agenda for broad international monetary reform. … France may have a right wing government, but it has a long record of opposition to U.S. financial dominance of the world economy, one worth studying and understanding."[11]

Indeed this history includes President Charles de Gaulle's denunciation of the USA's ability to print money to spend abroad as an "exorbitant privilege." In an August 25, 2010, speech to ambassadors at the Elysée Palace, President Nicolas Sarkozy laid out his plans for the French presidency of the G20, noting that reform of the international monetary system would be his first priority. "We must … consider the suitability of an international monetary system dominated by a single currency in a now-multipolar world," Sarkozy said.[12] While conceding, "We are nowhere near establishing the global currency that Keynes proposed with the Bancor," Sarkozy suggested that the decision taken at the 2009 London meeting of the G20 to endorse an exceptional allocation of the International Monetary Fund's Special Drawing Rights set a precedent.

Stiglitz Commission Called for New Reserve System

If Sarkozy is serious about the establishment of a new monetary system he should look beyond G20 debates and consider the proposals contained in the report of the Commission of Experts on Reforms of the International Monetary and Financial System tabled in the United Nations on September 21, 2009. The Commission, chaired by Joseph Stiglitz, describes some of the problems associated with the current global reserve system's dependence on the US dollar. The current system is plagued by instability and an inability to guarantee full employment. It suffers from "an inflationary bias associated with excess dollar liquidity… [that leads to the] eventual erosion in the value of dollar assets."[13]

Furthermore, the existing system is inequitable "because it results in developing countries transferring resources, typically at low interest rates, to the developed countries … in particular to the United States. … This transfer has increased over time due to the realization by developing countries that large foreign exchange reserves are their only defense in a world of acute financial and terms of trade instability."[14] As we noted in our Briefing Paper Number 19 Financial Crisis An Opportunity for a New Global Order when developing countries lend money from their foreign exchange re-

serves to Northern treasuries at low interest rates and borrow it back at higher rates they suffer net losses amounting to as much as ten times the value of all Official Development Assistance.

The Stiglitz Commission points out that the current system also has costs for the US as it must run huge current account deficits in order to supply liquidity to world markets. "The demand for global reserves has led to increasing current account deficits in the United States that have had adverse effects on U.S. domestic demand."[15] Hence the Commissioners argue that the US itself would benefit from a new global reserve system that is not dependent on the "vagaries of the economy and politics of a single country."[16]

The Commission concludes that a new reserve system could be managed in one of two ways. It could be overseen by a deeply transformed International Monetary Fund, using its Special Drawing Rights as a universal reserve currency. SDRs are in fact a type of *fiat* money created out of nothing to provide liquidity for world markets. In this sense they are analogous to the new money created by national central banks through QE. But the Commission notes that this would be feasible only if the IMF were to undergo fundamental reforms. Alternatively, the Stiglitz Commission suggests that a new Global Reserve Bank could be created to oversee an international currency.

While a full discussion of how a new international reserve system might function is beyond the scope of this Briefing Paper, these observations show that bold reforms are indeed possible. The world does not have to be held hostage to the vagaries of US monetary policy.

Conclusion

Creating money out of nothing need not invariably lead to hyperinflation. In fact the private banks do it every day through their loans. The creation of money should be a public function in keeping with public needs. Properly allocated, QE can play a role in funding investments in clean, renewable energy and creating local jobs without disrupting other economies.

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KAIROS: Canadian Ecumenical Justice Initiatives unites eleven churches and religious institutions in work for social justice in Canada and around the globe.

Endnotes

[1] Andrew Jackson. "QE2" The Progressive Economists Forum at http://www.progressive-economics.ca/2010/11/11/qe2/

[2] Alan Greenspan. "The eurozone's stark lessons for the G20." *Financial Times*. Nov. 10, 2010.

[3] Paul Quintos. "The Currency War is a Class War." *Resist newsletter*. IBOB International: Quezon City, Philippines. October, 2010.

[4] Andrew Jackson. Op. cit.

[5] Keith Newman comment on Andrew Jackson. Op. cit.

[6] When the Federal Reserve was originally established in 1913 by powerful Wall Street bankers, it kept all of its profits to itself. However, during the 1960s the Fed underwent a reform due to pressure from members of Congress led by Congressman Wright Patman. Henceforth it began to remit its earnings to the US Treasury. See Ellen Brown. "Thinking Positively: How 'Quantitative Easing' May be Harnessed for the Public Good." March 30, 2009 at http://www.webofdebt.com/articles/bernanke.php

[7] Martin Wolf. "The Fed is right to turn on the tap." *Financial Times*. November 9, 2010.

[8] Herman Daly. *Beyond Growth: The Economics of Sustainable Development.* Boston: Beacon Press. 1996. Page 9.

[9] Ibid.

[10] Ibid.

[11] Duncan Cameron Comment on Andrew Jackson. Op. cit.

[12] Nicolas Sarkozy. Speech to 18th Ambassadors' Conference. Elysée Palace. Paris: Présidence de la République. August 25, 2010.

[13] Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International monetary and Financial System. New York: United Nations. September 21, 2009. Chapter 5, Paragraph 4.

[14] Ibid. Chapter 5, Paragraph 21.

[15] Ibid. Chapter 5, Paragraph 23.

[16] Ibid. Chapter 5, Paragraph 30.