There is quite a lot of fuss in the economics pages of newspaper today about a new report on quantitative easing from the House of Lords Economics Affairs Committee. So I went and read the report in question.

The report, if I might summarise it, has three conclusions.

First, whilst they acknowledge that QE might have been important in 2009 in saving the economy from collapse they do not know what it is doing now, or why it has been doubled and they worry that it has imply been funding the government as in the last year or so QE has been almost exactly tracked government bond issues. They think the government might be addicted to QE.

Second, they do not know how QE impacts the economy precisely, and doubt the Bank of England does either, but are very worried that it might cause inflation. They are not sure how QE can be unwound but think that doing so might have impact on inflation for reasons that are not clear, but nonetheless want a plan for that unwinding even though they acknowledge that no government has ever done that.

Third, they are worried that because (they claim) the bank reserve accounts created by QE must have bank base rate paid on them the cost of government borrowing could rise quickly in the event that bank base rate rose in response to QE.

Having read that lot I despaired, more than a little. How is it that the House of Lords, which is supposed to be a repository of wisdom, seems to know so little on something as important as economics? Let me offer some responses.

First, the purpose of QE is simple. Its function is to inject government created money into the economy to provide liquidity when that liquidity is not available elsewhere, and most especially from bank lending, as it would not have been but for government action in the last year. In the process it is, alongside tax and borrowing, part of the macroeconomic funding cycle for government. This is not surprising, or a case of wonderment as to purpose: it is a simple statement of fact. Their Lordships still cannot get their heads around the fact that the government can create money at will, but that is precisely what a government might do. And unless they want to undo money creation and create liquidity crises you don’t unwind QE, which is why no one has.

Second, the impact of that spending is appraised in two ways. The first is to consider what might have happened without it. Since QE simply funds government deficits it is not independent of those deficits in that case. To appraise QE the question to be asked is not whether QE funding was well used, but whether the government spent wisely when incurring a deficit. Their Lordships simply asked the wrong question in that case. If they could have imagined the economy surviving the last year without a deficit they would have been decidedly isolated in that opinion. If they could have imagined tax funding that deficit last year they would have simply been wrong. So the only actual question that they should have asked is whether or not the borrowing capacity to fund that deficit existed, created (as it would have been, of course) by the quantum of the deficit in the first place, since all deficit spending does by definition create new money. The answer is that it might have done, but the necessary credit in the banking system would have been removed, with potential disastrous impact on liquidity, and in itself that answers the Lord’s question as to why QE had to be used. Money creation was the only option.

Third, regarding inflation, there is no evidence that the government’s deficit has created inflation. It can be argued that the government’s withdrawal of support for business now will do so. It can also be argued that its failure to control Covid now might be inflationary. Both create severe supply chain disruption risk and that will be inflationary. But the deficit itself did not: there were resources to buy and for the government to therefore expend funds on and in that case to do so is not an inflationary act.

Nor is further QE an issue now if (and this is a big if) the government gets its planning for the economy together to provide the central direction required to ensure that key issues (the effectiveness of the NHS, getting track an retrace right, support for education and a Green New Deal) are addressed. If, however, it leaves matters to the random chance of a chaotic and even collapsing market place the impact could be inflationary. This, then is down to choice.

And finally, there is QE and whether it will increase the cost of government debt. Here their Lordship’s lack of imagination is staggering. Just think about this. The government created new money that it, in effect, they gifted to the clearing banks as funds they could deposit to increase their financial security by substantially increasing the resources that they hold with central government. But because of this act of generosity we are now told that the government must cut its spending or else the cost of servicing debt that it is claimed is owed to banks who did nothing to earn it will increase. Litreally, the argument is that the government must pay the finance sector for the fact that the government created money to ensure its security. This is, of course, absurd. And there is a simple answer to the problem, in any case. It is that the deposits in question can be described as special reserves and can have their own interest rate, quite separate from bank rate, and if the latter has to change (and I doubt it will for years, but that’s another issue) then the interest rate due on the central bank reserve account balances created by QE can remain at 0.1%. And in that way the whole threat to government funding is resolved. It was really not that hard to work out how to do that.

My suggestion is that their Lordships redo their homework and reissue their report. They asked the wrong people the wrong questions and got the wrong answers. If ever there was a case of ‘do again and resubmit’ this was it.