

The Quantitative Easing Policies (QE) During Recessions and The Monetary Policy Issues Especially Still the Relevance of The Money Supply

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Abstract

This short article discusses the economic background under which the Quantitative Easing (QE) policies have been initiated by the major central banks of the advanced countries in the world. The QE was initiated by the major central banks because the conventional 'inflation targeting policy through short term interest rates policies were found to be ineffective in fighting the recession of the years 2008-2009, as the short term interest rates had already reached a floor and the central banks could not reduce the rates further down. This might have been due to the 'Keynesian Liquidity trap'. Then the central banks resorted to buying the long-term assets such as the bonds, the mortgage securities and selling or pumping the money to the public, financial institutions and the households. We have discussed the operation and working of these QE policies in the USA, the U.K, Europe, and Japan. We have also evaluated the effectiveness of the QE policies in those major countries and economies. Our assessment has been by and large very positive about the QE policies; however, there have been some distributional effects, which have reduced the intended effectiveness of the QE policies in those countries. Further, the conventional money supply, either the narrow money, M1, or the broad money supply, M3, are found to be empirically very important to judge the effectiveness of the monetary policy especially during the recessions of 2008-2009.

Keywords: Monetary Policy Rules, Inflation Targeting, Quantitative Easing, Money Supply, GDP, Liquidity, Distributional Effects, Recession

1. Introduction

Shortly before he became Chairman of the Federal Reserve Board in 2006 Bernanke wrote: 'By allowing persistent declines in the money supply and in the price levels the Federal Reserve of the late 1920s and 1930s greatly destabilized the U.S. economy. Equipped with this historical lesson, Bernanke and other Central Bankers were determined to avoid this mistake when the crisis hit in 2008. The Fed announced its first asset purchase program in November 2008, and by March 2010, Fed bought \$1.25 trillion of mortgage-backed securities (MBS), \$200 billion of agency debt, and \$300 billion of long-term securities, totaling 12 per cent of the US GDP in 2014.

In the UK QE has come in three bites. The Bank of England (BOE) injected £ 200 billion of electronic money into the British economy between March 2009 and January 2010 (QE1), and £175 billion between October 2011 and November 2012 (QE2, and QE3), making £375 billion in all or 22.5% of 2012 GDP. The majority of its purchases were of highly liquid gilts, though the Bank also brought commercial paper and corporate bonds. After the Brexit vote in June 2016, the BOE decided to resume QE in August. For the European Central Bank (ECB), repo operation known as the long-term refinancing operations (LTROs), designed to refinance banks, remained its main source of balance sheet expansion until it started its asset purchase program.

In March 2015, the ECB started to buy €60 billion of the euro-area public debt per month. A year later, this amount was increased to €80 billion, and the high-grade corporate bonds become eligible for purchase. This amount dropped back to €60 billion in April 2017, and to €30 billion in January 2018. For each of the three central banks, the scale of their balance sheet expansion was unprecedented. Three strong arguments backed the QE: the first was that they were simply an extension of the 'the Open Market Operations' or the QE was unconventional and the technique was never used outside Japan until then.

There is a pretense that QE does not involve permanent expansion of money supply as the bonds can be sold back in principle and the money supply be got back and thus reduced. The second argument is that fiscal policy has been disabled in the very first six months of the crisis of recession. And the conventional monetary policy has been constrained by the zero bound of short-term interest rates in a liquidity trap situation. The third argument is ideological that monetary expansion was preferable to public investment, since it is claimed to avoid the role of government in the allocation of capital.

1.1. How was QE Meant to Work?

Explains the expected real balance effect by invoking Fisher's *Santa Clause*: agents who find themselves with excess real money balances, spend the extra money balances by increasing their purchases [1]. The cumulative attempts by the recipients to get rid of their money balances raises all prices to a level at which the desired ratio of money holdings to expenditure has been restored. Thus, a stable demand for real balances is brought into equilibrium with increased supply of money through a rise in nominal income. How much this rise in nominal income will be shared between output and prices depend on the output gap. How much extra money will Santa Clause need to spray around the community to achieve a given inflation target? In the Fisher's theory the answer was given by money multiplier: the amount of new bank loans which can be created by an increase in reserves (base money) in a fractional banking reserve system.

However, if the money multiplier is unknown or leaky, how much original base money is needed is unknown. For example, the excess could be automatically be extinguished by the repayment of the bank loans, or through what it comes to the same thing, by the purchase of income yielding financial assets from the banks, leaving the quantity of money (deposits) the same [2]. In his *Treatise on Money*, Keynes identified this slip that money will be utilized to buy existing assets, apart from his theory in the *General Theory* that the demand for money or liquidity will become infinitely elastic. These considerations led Keynes to conclude that that the only secure way to get new money spent in a slump was for the state to spend it itself.

1.2. How the Bank of England expect QE To Work in Practice?

The BoE specified two main transmissions channels from reserves to spending: The first was **the Portfolio Substitution channel**; the second was **the Bank Funding channel**. According to the bank

lending channel, as a result of QE the banks would get a large amount of reserves. This would induce them to reduce the rate of interest they charge for loans, and their loan portfolio would enlarge. The spending of the loans would expand the economy. However, in practice the BOE did not much believe in the bank lending channel as only 30 % of the government securities were purchased from the banks. Given the impairment of the bank balance sheets, and the collapse in the confidence of the borrowers, there was not much scope for bank lending.

The BOE put its main hope, like the FED, but unlike the ECB, **in the Portfolio rebalancing or the substitution effect**. This was to be activated by the buying of government bonds from the private investors such as pension funds and insurance companies. So far as the investors regard the corporate bonds and equities as close substitutes to the government bonds than money we expect them to re-balance their portfolio in favor of these assets, if their money holdings are boosted by the temporary bond purchases by the BOE. This would tend to put upward pressure on the prices of these assets.

The BOE reasoned that a policy aimed at reducing the excess demands for bonds would cause to switch investors not to cash but to financial assets like equities, which promised higher returns, though riskier returns. The increase in their paper wealth would encourage them to spend more. The desire for riskier assets would go up, but there would be no leakages from the circular flow of money. **In addition the BOE discovered the announcement effect**. The announcements will give rise to 'forward guidance' which makes long-term commitments of the policy makers to keep low rates

2. An Assessment of QE

The effect on real GDP has not been directly clear. The Portfolio Rebalancing channel is supposed to work by depressing the yields of gilts. If QE successfully raised equity and corporate bond price, we might expect firms to raise more money from the capital markets. The QE reduced yields and the borrowing costs of the government, and raised equity indices such as that of FTSE, Euro Stoxx50, and the German Dax. However, the QE failed to stimulate bank lending. While commercial bank reserves at the BOE (narrow money) rose dramatically from €30 billion in March 2009 to over €300 billion by the end of November 2013, the annual rate of growth of bank lending fell from 17.6 per cent to negative in September 2010. The private sector was increasing its savings. The banks were less willing to lend and the households and firms were less willing to borrow. The consensus view is that the modest recovery in the UK banks' lending in 2012 was mostly due to the government subsidizing program, which were fiscal in nature. The failure of QE to revive bank lending has led to even more unconventional policies. In January 2017, the ECB started taxing 'excess reserves' held by the banks in order to encourage them to lend.

2.1. The Signaling Channel

This hypothesis asserts that the market prices react to "news" rather

than to the actual events. But the central Banks's announcements may be subject to the law of diminishing returns. The market participants might have become much astute. As a consequence, the QE2 seemed to have less effect compared to QE1.

Through all the above channels, the injections of the narrow money (M1) was supposed to influence the movement of broad money and through broad money growth in nominal GDP.

2.2. Broad Money Effects

Broad Money is largely synonymous increase with bank lending. But as the bank reserves went up the bank lending fell the presumed relationship between narrow money and the broad money never occurred smoothly during the QEs. The multiplier never emerged because the decrease in velocity of circulation of narrow money offset of QE. Tim Congdon stated, "I accept that the growth of money in the QE has been much lower than I had been hoping for", "Nevertheless it has stopped a much worse recession."

2.3. The Effect on Output and Unemployment

The BOE estimated the level of real GDP was boosted by 1.6 to 2 per cent by the QE. The QE was able to lift up the inflation rate and the output levels more effectively in US than in UK and Euro zone. However, the research question remains whether it was, as the monetarists argue that if the QE injected money, created increased inflationary expectation, which lifted up the spending and output levels, or as Keynesians argue that the QE lifted up the spending and output levels, which lifted the inflation expectations? Targeting inflation presupposed that inflation governed output. Most people would spend more because they expected the prices to go up. This is how the real balance effect was supposed to work.

But Keynes reversed the causality: it was people's spending more which caused the prices to go up. Therefore, the target should have been output and not inflation, and the tool should have been fiscal policy and not monetary policy sell [3]. The Bank's failure to boost inflation (except perhaps possibly in the first bout of QE, was due to a deficiency of aggregate spending. The period 2008-16 demonstrated no better correlation between money (narrow or broad) and inflation. Keynesian conclusion is that the inability of QE to get inflation up to target in the medium term was due to the government's failure to get output up to the trend in the short-term. This was true not only just of the U.K., but also of Japan, where the Bank of Japan failed to achieve the target 2 % inflation

2.4. Distributional Effects of QE

The effects of QE were supposedly distributionally neutral, though the balance of advantage went in favor of the rich. Therefore, the QE increased the concentration of wealth in the hands of the few. But the richer households have as much lower marginal propensity to spend, that is they spend a lower portion of their new income than the poor people. So, it will have less impact on aggregate demand.

3. The Comparison between USA and Euro Zone

There is a general agreement that QE was more successful in

the United States than in the UK, and less successful in the Euro zone than in either. The broad explanation for these discrepancies is that there was more 'stimulus' in the United States from both monetary and fiscal policies than in the U.K and Euro zone; and more 'stimulus' from the monetary policy in the U.K than in the Euro zone. The FED's QE program was overwhelmingly targeted at the most distressed parts of the financial system and purchased riskier mortgage backed securities, whereas the BOE bought only virtually Treasury gilts. However, one cannot segregate this 'bigger bang per buck' from the simultaneous \$ 800 billion fiscal stimulus enacted by President Obama in February 2009.

The Euro was afflicted with two original sins -the disconnect between fiscal and monetary policy and its neo-liberal monetary constitution The European Central bank (ECB) was technically debarred from buying government debt. So, the monetary response to the crisis has been 'too little and too late'. Its first response was even to increase interest rates in July 2008 and it only arrived at QE on the UK and US scales only in 2015. Whereas in the UK monetary policy was used deliberately to offset the effects of fiscal austerity, in the EU there was no such offsetting action from the ECB. Unlike U.K and USA the Euro zone suffered from double digit depression until 2015. ECB's rules forbade it from holding more than a third of any specific bond issue, or more than a third of any country's debt. Even in February 2008, the ECB thought that the problem was inflation.

4. Conclusions About QE Effectiveness and That 'The Money Supply Has Not Withered Away 'and Still Relevant for The Implementation of Monetary Policy

The conclusions are thus: "QE promised to boost output by raising the rate of inflation while being neutral on distribution. In fact over five years (2011-16) it failed to get inflation up to target; it had, at best, a weak effect on output; and it was far from being distributionally neutral [4]. After 9 years of emergency money ,the financial system remains dangerously dependent on debt. "The first generation of monetary reformers – Fisher, Wicksell, the early Keynes -believed passionately that the way to prevent booms and slumps was to keep the price level stable. QTM seemed to give the monetary authority a scientific basis for doing this. They were unwilling to entrust the monetary policy to governments.

The main dispute at this stage concerned the transmission mechanism from money to prices. This involved the very nature of money: was it cash or credit? For Fisher, money was cash: control of base money or narrow money was key to control of prices. However, even at that time most transactions were financed by credit, there need to be a determinate relationship between money and credit, which was measured in the monetary multipliers. This was the view of also Friedman, Milton, and American monetarists. But Wicksell saw money as credit, and not as cash [5]. The key to the control of money supply was credit control. This could only be done by regulating the price of credit or interest rates -the terms on which banks made loans. The early Keynes was a Wicksellian. And the central banks' policy in the early years of this century with its reliance on Taylor rules of monetary policy and inflation

targeting owed more to Wicksell than to Fisher or Friedman. However, Wicksell raised a troubling problem for those who relied on monetary therapy alone to keep prices steady.

As Henry Thornton had already noted, there were two interest rates needing attention. The first was the Bank rate, and the structure of commercial banks' interest rates dependent on it. The other was the 'natural' or 'equilibrium' rate of interest -the expected rate of return on investment. The task of the central bank is to keep the market rates equal to the natural rate. This was the point of entry for Keynesian revolution. As Keynes has seen it the key element of volatility in the market economies was not the fluctuations in the price levels but in the natural rate of interest. So according to Keynes, the policy should be directed not to the stabilization of prices but to the stabilization of investment, and the fiscal policy had to be the main instrument of demand management, since it was spending, and not money which needed to be managed.

The economic collapse of 2008-2009 showed that that the monetary policy directed to a single aim of price stability not enough to maintain economic stability. The economy collapsed though price level was stable. However, QE was an attempt to apply Friedman's lessons of the Great Depression as learned by Bernanke to a situation where nominal interest rates had reached their zero bound. Preventing a collapse in money supply was achieved by the 'unconventional monetary policy' of QE. Pump enough cash into the economy and the extra spending it produced would soon lift it out of the doldrums. But the critics argue that the QE took no account of the investment demand [6]. The recipients of the central Banks's cash either did not spend it sufficiently, or did not spend on currently produced goods, so the broad money =bank deposits fell, even as narrow money expanded. In the language of the Keynes's Treatise on Money, the money got stuck in 'the financial circulation'.

The crisis left the relationship between fiscal and monetary policy unresolved. The monetary policy was perhaps overburdened. It was expected to push output and prices. The critics point out that the QE meant to boost output instead boosted the portfolios of the wealthy. The fiscal policy was difficult to be used due to high levels of fiscal deficits in many of these countries [7]. Irving Fisher, Ralph Hawtrey and the monetary reformers of the 1920s recommended to use monetary policy to prevent the oscillations of the business cycle.

And there is a criticism against the QE that, it biases the distribution of income and wealth towards the rich classes whose marginal propensity to spend is relatively lower. The foregoing has been answered by the monetarists that a capitalist economy has a range of mechanisms by which the arbitrage between different asset markets prevents prices and yields in one class having out of line with prices and yields in another. However, it is also a fact that the monetarists have no exact idea how much money they will need to pump into an economy to lift it out of recession. And it is debatable if the private sectors desired holdings of cash balances is independent of business cycle.

Therefore, it seems that ultimately the relationship between money, prices, and output, is an empirical question. Also, another important empirical observation very recently made by is that during 2008-09 recession, when aggregate demand and prices were falling, why a large effort by the Federal Reserve system to create money through QE did not succeed much in stopping the falling prices? There is another channel of transmission of QE through 'portfolio substitution' which induces the substitution from the long-term government bonds to money but from the government bonds to corporate bonds and equities which is said to increase the prices of corporate bonds and equities and create 'a wealth effect' [8].

But how the QE affected spending? Was the wealth effect empirically strong in affecting positively spending? Or the increase in the corporate bonds 'and the equities' pries only created a financial bubble? Ultimately, were prices of output still falling during 2008-09 recession as documented by Ireland (2025) despite the QE? We will notice in our further discussion that the experience of 2020 recession and the QE effect was much different as the growth of broad money was increasing and the prices were also increasing then. In any case the 'inflation targeting 'through 'monetary policy rules based on the short- term interest rates failed during the recent recessions of 2008-09 and 2020, and the central bankers had to fall back on the ideas of monetarism of Fisher and Friedman by implementing the QE.

In their recent study using quarterly data for the sample period from Q2 2000 to Q1 2024, employing the statistical tools, the cointegration analysis and the Vector error Correction models, established that there is a statistically significant long-run demand function for real narrow money for India [9]. Therefore, the money has not withered away despite financial innovations, and the monetary aggregates should be again recognized as important monetary policy indicator variables in the monetary policy formulation and implementation.

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