The European Central Bank has finally launched a policy of quantitative easing (QE). The key question at this stage is whether Germany will give the ECB the freedom of maneuver needed to carry out this monetary expansion with sufficient boldness.
Though QE cannot produce long-term growth, it can do much to end the ongoing recession that has gripped the eurozone since 2008. The record-high stock-market levels in Europe this week, in anticipation of QE, not only indicate growing confidence, but are also a direct channel by which monetary easing can boost both investment and consumption.

But some observers, such as Nobel Laureate Paul Krugman and former US Treasury Secretary Larry Summers, continue to doubt whether QE can really be effective. As Krugman recently put it, a "deflationary vortex" is dragging down much of the world economy, with falling prices causing an inescapable downward spiral in demand. The World Bank and International Monetary Fund seem to agree, as both recently lowered their growth forecasts a few notches.
Pessimists argue that the world economy suffers from an insurmountable shortage of aggregate demand, leading to a new "secular stagnation." Monetary policy is seen to be relatively ineffective, owing to the notorious zero lower bound (ZLB) on nominal interest rates. With policy interest rates near zero, the argument goes, central banks are more or less helpless to escape the deflationary vortex, and economies become stuck in the infamous liquidity trap. In this scenario, the demand insufficiency feeds on itself, pushing down prices, raising real (inflation-adjusted) interest rates, and lowering demand further.
This perspective has been prominent among Keynesian economists in the United States and the United Kingdom since 2008. Krugman argues that Japan was only the first of the major economies to succumb to chronic deflation, back in the 1990s, and has now been followed by the European Union, China, and most recently Switzerland, with its soaring franc and falling prices. The US, in this view, remains near the vortex as well, prompting the Keynesians' repeated calls for more fiscal stimulus, which, unlike monetary policy, is seen by the pessimists to be especially efficacious at the ZLB.
In my view, the pessimists have exaggerated the risks of deflation,

which is why their recent forecasts have missed the mark. Most notably, they failed to predict the rebound in both the US and the UK, with growth rising and unemployment falling even as deficits were cut. Without a proper diagnosis of the 2008 crisis, an effective cure cannot be prescribed.

The pessimists believe that there has been a large decline in the will to invest, something like the loss of "animal spirits" described by Keynes. Even with very low interest rates, according to this view, investment demand will remain low, and therefore aggregate demand will remain insufficient. Deflation will make matters worse, leaving only large fiscal deficits able to close the demand gap.

But the causes of 2008's deep downturn were more specific, and the solutions must be more targeted. A large housing bubble preceded the 2008 crisis in the hardest-hit countries (the US, the UK, Ireland, Spain, Portugal, and Italy). As Friedrich Hayek warned back in the 1930s, the consequences of such a process of misplaced investment take time to resolve, owing to the subsequent oversupply of specific capital (in this case, of the housing stock).

Yet far more devastating than the housing bubble was the financial panic that gripped capital markets worldwide after the collapse of Lehman Brothers. The decision by the US Federal Reserve and the US Treasury to teach the markets a lesson by allowing Lehman to fail was a disastrously bad call. The panic was sharp and severe, requiring central banks to play their fundamental role as lenders of last resort.

As poorly as the Fed performed in the years preceding the Lehman Brothers' collapse, it performed splendidly well afterward, by flooding the markets with liquidity to break the panic. So, too, did the Bank of England, though it was a bit slower to react.

The Bank of Japan and the ECB were, characteristically, the slowest to react, keeping their policy rates higher for longer, and not undertaking QE and other extraordinary liquidity measures until late in the day. Indeed, it required new leaders in both institutions – Haruhiko Kuroda at the BOJ and Mario Draghi at the ECB – finally to set monetary policy right.

The good news is that, even near the ZLB, monetary policy works. QE raises equity prices; lowers long-term interest rates; causes currencies to depreciate; and eases credit crunches, even when interest rates are near zero. The ECB and the BOJ did not suffer from a lack of reflationary tools; they suffered from a lack of suitable

action.
The efficacy of monetary policy is good news, because fiscal stimulus is a weak instrument for short-term demand management. Ironically, in an influential 1998 paper, Krugman explained why. He argued at that time, and rightly in my view, that short-term tax reductions and transfers would be partly saved, not spent, and that public debt would multiply and create a long-term shadow over the fiscal balance and the economy. Even if interest rates are currently low, he noted, they will rise, thereby increasing the debt-service burden on the newly accumulated debt.
With all major central banks pursuing expansionary monetary policies, oil prices falling sharply, and the ongoing revolution in information technology spurring investment opportunities, the prospects for economic growth in 2015 and beyond are better than they look to the pessimists. There are rising profits, reasonable investment prospects for businesses, a large backlog on infrastructure spending almost everywhere in Europe and the US, and the opportunity to finance capital-goods exports to low-income regions, such as Sub-Saharan Africa, and to meet the worldwide need for investment in a new, low-carbon energy system.
If there is a shortfall of private investment, the problem is not really a lack of good projects; it is the lack of policy clarity and complementary long-term public investment. European Commission President Jean-Claude Juncker's plan to finance long-term investments in Europe by leveraging relatively small amounts of public funds to unlock large flows of private capital is therefore an important step in the right direction.
Obviously, we should not underestimate the capacity of policymakers to make a bad situation worse (for example, by pressing Greek debt service beyond the limits of social tolerance). But we should recognize that the main threats to growth this year, such as the unresolved Greek debt crisis, the Russia-Ukraine conflict, and turmoil in the Middle East, are more geopolitical than macroeconomic in nature. In 2015, wise diplomacy and wise monetary policy can create a path to prosperity. Broad recovery is within reach if we manage both ingredients well.