What is Helicopter Money, WIll It Work and What Are The Risks?

What is Helicopter Money?

There is still much confusion over what exactly ‘helicopter money’ means. In 1969, Milton Friedman coined the term in an extreme example to illustrate a point.

“Let us suppose now that one day a helicopter flies over this community and drops an additional $1,000 in bills from the sky, which is, of course, hastily collected by members of the community. Let us suppose further that everyone is convinced that this is a unique event which will never be repeated.” (Milton Friedman, “The Optimum Quantity of Money,” 1969)

In practical terms, helicopter money would require the central bank or some other branch of government to with the authority to create money, to fund the national debt precisely through the creation of money; debt monetization. As such a more precise name for ‘helicopter money’ is Monetized Fiscal Policy (MFP).

What is the difference between QE and MFP?

In QE, the central bank buys government bonds from private investors who had bought the bonds, ultimately from the government. In MFP, the central bank buys bonds from the government. The difference seems almost academic.

So far, QE has been undertaken in the US, UK and Eurozone without deliberately targeting a budget deficit. To the contrary, countries undertaking QE have tended to at least attempt fiscal responsibility. From a prudential management viewpoint this is sound policy but from an economic growth viewpoint this is somewhat self-defeating. When the problem is not undersupply of credit but deficient demand, monetary policy drives interest rates down with low impact on growth. This has been supported by data.

MFP involves operating a fiscal deficit, either in the form of tax cuts or investment spending which is subsequently funded by the central bank. The stimulus effect comes not from lowering interest rates and providing credit or liquidity, but in directly augmenting demand. Output rises directly as a result of the fiscal expansion. Whether or not the capital infusion circulates or gets saved is a separate matter. If the economy is facing deficient private demand it may take some time for inflationary effects to spur private demand.

What are the risks of MFP?

A distinction is often made between debt financed and money financed fiscal policy. This distinction is a very fine one and is not well defined. Proponents of MFP prefer to think of the debt purchased by the central bank as permanent, or written off. The central bank not only buys the bonds of the government but that debt is either perpetual or the central bank promises to maintain its balance sheet through refinancing these bonds in perpetuity. The accounting pedant would consider this debt outstanding and not written off, but that it had a perpetual buyer of last resort. In effect the central bank becomes the lender of last resort to the state, as much as a lender of last resort to the commercial banks. There are risks associated with this role.

We have seen how difficult it has been to wean an economy off QE. The Fed is the least accommodating of the major central banks yet its balance sheet has not shrunk since 2014 despite an end to its asset purchase program. The Fed continues to maintain a 4.5 trillion USD balance sheet by reinvesting coupons and maturing principal.

We have seen also how difficult it is to wean economies off low interest rates. The Fed had planned on a gentle path of rate hikes as early as mid 2015. It has managed one rate hike Dec 2015. The next one may come before Godot. Targeting unusually low interest rates distorts the single most important price in the economy, the price of money, leading to misallocation of resources, and encouraging overcapacity which may ultimately be disinflationary while impairing the profitability and solvency of the banking and insurance industry.

There is a tangible risk that MFP once implemented is accelerated. The experiences of QE and ZIRP have shown the economy’s propensity for chronic dependence on analgesics. Since the central bank acts as lender of last resort to the state, accelerations of MPF can damage confidence and lead to a run on the assets and currency of the country.

How should the money be spent? This is a difficult question in the best of times. Most developed world economies could do with infrastructure upgrades. Better funding of medical and social insurance programs would be welcome. However, public spending is to a great extent a political matter, less so an economic one. The risk that spending is inefficient and does not make a sufficient return on investment, not to the state alone but to society, is high. Also, fiscal spending tends to be sticky upwards, meaning that it is later difficult to cut back when MFP is no longer required. In fact it would increase the probability that MFP once begun would be perpetual.

Tax cuts are another channel for MPF. Here too, the consideration will likely be more political than economic. Given the explicitly unnatural nature of permanently financing a tax rebate by monetization, the design of MFP specific tax structure will likely be highly politicized and contentious.

Unanswered questions following MFP

Since the central bank is the lender of last resort to the state it is reasonable to ask what is the capital position of the central bank, how liquid and solvent is the central bank.

What is the balance sheet of the country? What are its assets and liabilities? Is it well defined?

What happens if the central bank’s accounts were consolidated into the country’s balance sheet?