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Fixed income long-read

Helicopter money: manna or poison pill?

- (Un)conventional policy measures are exhausted and ineffective
- Helicopter money: remedy that is worse than the disease
- Portfolio implications would be negative for bonds

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Central banks are doing everything they can to keep the global economy going. Now that their traditional measures are exhausted, governments may well consider going to the next level and hand out 'helicopter money' as a last remedy.

What's the problem?

Today's world is stuck in a situation of low growth and low inflation. The typical response from governments and central banks is monetary or fiscal expansion. But conventional and unconventional monetary measures by central banks, such as lowering rates, buying large volumes of bonds (quantitative easing) or even controlling the yield curve (Japan), are exhausted or are increasingly less effective. The potential to lower interest rates is limited, with rates close to or even below zero. The effectiveness of quantitative easing (QE) has been questioned and for the ECB there is only a limited amount of purchasable bonds left to buy. The vast amount of bonds that central banks have bought hamper market functioning given the shortage of high grade collateral - not to mention the fact that central bank balance sheets have already increased very significantly.

'It's no longer merely a theoretical option'

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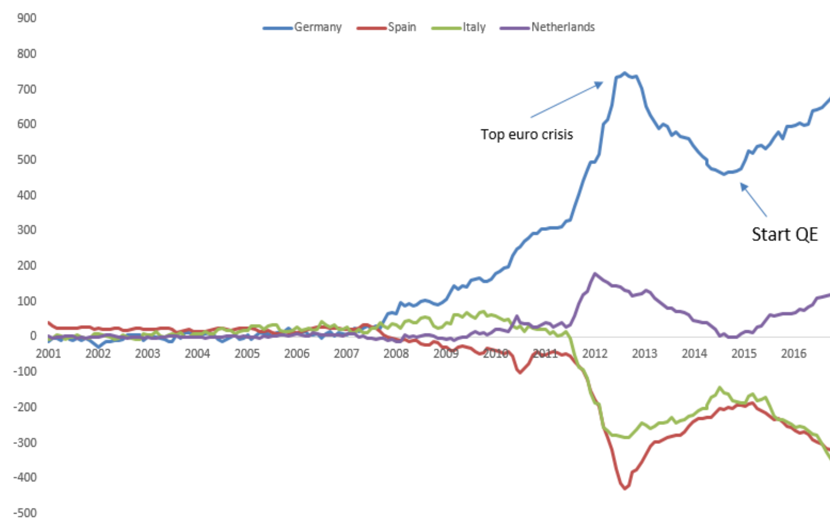
Besides the more technical bond market related issues, QE has other negative external effects. The extreme low yield environment caused by QE has significant ramifications for funding ratios of pension funds, causing either cuts in (future) pensions or higher current contributions. Furthermore, both in the US and in Europe monetary policy is gaining a more prominent position in the political debate, given the wealth distribution effects of QE. Critics say that, rather than stimulating consumer spending, QE has primarily led to asset price inflation. The property markets in London, Frankfurt and Amsterdam, for example, have witnessed very significant price increases in the last couple of years.

Lastly, it's relevant to take into account that the unconventional monetary policy measures which started in 2014 caused an increase in the Target2 imbalances between euro area countries. Target2 is the settlement system for euro payment flows between (central) banks in the euro area.

Figure 1 | Target2 imbalances (EUR bn)



Source: Euro Crisis Monitor, ECB, Robeco

Figure 1 shows that both Germany and the Netherlands have claims against the euro system (the system of all national central banks plus the ECB) of approximately EUR 700bn (EUR 9000 per capita) and EUR 100bn(EUR 6000 per capita). Since especially Italy but also Spain have a liability against the euro system of approximately EUR 300bn each, the future cost of the northern countries in the event of a euro breakup will be very significant[1]. This negative external effect of QE is not often mentioned. The earlier significant rise in Target2 imbalances (2008-2012) was caused by deposit flights from the south to the north of Europe during the

[1] For information related to Target2 imbalances; http://www.eurocrisismonitor.com/

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euro crisis. According to Bundesbank Governor Weidmann[2], the rise in imbalances since the start of QE (2014) has been aggravated by e.g. the Italian central bank buying Italian bonds from domestic and foreign bond holders, which replace these bonds with north European (German) bonds or other north European assets.

Not only the effectiveness of central banks is questioned, the same holds for fiscal authorities. Even if the latter are willing to taper austerity measures, they can't, as fiscal policies are already stretched to limits. Public debt-to-GDP ratios have increased rapidly, for example, and are closing in on post-war highs. In addition, at least in theory, EU countries have to respect the stability and growth pact, which caps the member states' debt-to-GDP ratio at 60% and the budget deficit at 3%.

Figure 2 | Public debt-to-GDP ratio of advanced economies

Source: Historical Public Debt Database, IMF, Barclays Research

This leaves two other options. The first is helicopter money and will be discussed in the following paragraph. And the last option is; the do-nothing option. Or in other words, accept that both economic growth and inflation are lower than average. This option is discussed in the penultimate paragraph.

What is helicopter money?

It's a response which is both monetary and fiscal in nature and which has been dubbed 'helicopter money' by Milton Friedman in his 1969 publication 'The optimum quantity of money'. Helicopter money is a form of fiscal spending by a government, which is financed directly by its central bank. This means the government does not have to raise taxes or issue

[2] OMFIF Commentary, Target-2 imbalances rise again, F.Westermann, April 2016

debt to fund spending. The money that is given should be perceived by the recipient as an asset. Or to put it differently, the money should be perceived as a gift and not as a liability.

Instead of being given to banks, the money is made available to the government or directly to the general public. Helicopter money can take the shape of tax rebates, handing out cash to the public, increased public spending on for instance infrastructure, or central banks writing off their holdings of government bonds. Cutting out banks from the equation is an important difference with QE, since with QE central banks can do no more than hope that the extra liquidity that is provided via QE is lent out by banks to the real economy. The difference between QE and helicopter money is summarized in the table below.

Table 1. Quantitative Easing vs Helicopter Money

	Quantitative Easing	Helicopter Money
Central Bank balance sheet	Temporary change	Permanent change
Coordination with Fiscal Agent	Possible	Explicit
Use of money supply	To banks	To gov/ general public
Risk of high inflation	Muted	Higher
Risk Central Bank independence	Muted	Higher
Economic effect	Indirect	Direct

Source: Robeco

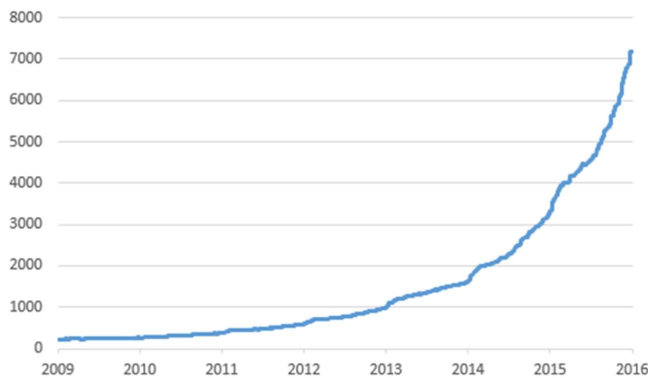
So what's the downside?

Handing out free money does come at a risk, though, the main one being creating high (or even hyper) inflation. In the past 100 years there have been several examples were helicopter has actually been used in practice and all of them have led to hyperinflation. A recent example is Venezuela. The financing of government expenditures via the printing press resulted in the following outcome:

- 3000% growth in M2 money supply since 2009 (66% per year); this compares with 54% growth (6.5% per year) for the Fed and 30% (4% per year) for the ECB
- 480% year-on-year Consumer Price Index (CPI) inflation in 2016 (IMF estimate)
- GDP growth of -2% on average since 2013

Other little uplifting examples that might make one hesitant to resort to helicopter money were the Weimar Republic (1919-1933) and Zimbabwe.

Figure 3 | Total amount of money (M2) in circulation in Venezuela (bn local currency)



Source: Bloomberg

Canada did apply a halfway version of QE and helicopter money, as the Bank of Canada bought **directly** from the government up to 25% of government bonds between 1935 and the early 1970s. However, the catch here is that the loans from the central bank to the government had to be paid back, which means there is not a **permanent** increase in money supply. Therefore, the Canadian example does not qualify as helicopter money and has more resemblances with QE, as QE also has a temporary effect on the money supply. The fact that Bank of Canada directly purchased bonds from the government is an important distinction as with QE bonds are purchased in the market. The Canadian stimulus package is deemed successful as inflation hardly ever exceeded 5% and the country enjoyed a long period of relatively stable and high growth.

Another important drawback from helicopter money is that the central bank's independence is at stake, as the government and the central bank will need to cooperate closely. Also, as helicopter money will eat into the central bank's capital, the public's trust in the central bank as well as the value of money may start to sag. It remains to be seen whether this process can be controlled. A government needs to be strong enough to stop helicopter money once it's no longer required, a challenge that may be especially hard to meet in election times.

And lastly, helicopter money causes a permanent increase in money supply and therefore cannot be turned back. Experimenting with helicopter money is therefore a dangerous policy option with the only real-life examples having very poor outcomes.

Is it effective?

As helicopter money directly impacts spending, it is more powerful than QE. The actual effectiveness is determined by the way in which it is implemented. Is additional government spending targeted at growth enhancing projects, or just at financing general government spending? If money is handed to the public, will it be spent or saved? It is important that the

money goes where it's needed most and that it is actually spent rather than saved. There are however ways to address this, a simple option being to issue vouchers with an expiry date. This is the theory, and according to e.g. Willem Buiter, helicopter money will always boost aggregate demand[3]. But to refer again to Venezuela, since 2009 the country is going through a very deep recession and is suffering from hyperinflation. As often theory is very different from practice.

Reality check

Talking about the pros and cons of helicopter money is far from a theoretical exercise, as both IMF and ECB have explicitly hinted at further cooperation between fiscal and monetary policy and that helicopter money is even part of the monetary toolbox according to the ECB:

"A first priority is a coordinated effort to raise growth. The G20 agreed that this will require making full use of all policy levers – monetary, fiscal and structural – individually and collectively."
IMF Managing Director Christine Lagarde; Press release to G20, September 5, 2016

"As emphasized repeatedly by the Governing Council,…, other policy areas must contribute much more decisively, … all countries should strive for a more growth-friendly composition of fiscal policies."
ECB president Mario Draghi; Press conference, October 20, 2016

"All central banks can do it", said Praet. "You can issue currency and you distribute it to people. That's helicopter money. The question is, if and when is it opportune to make recourse to that sort of instrument which is really an extreme sort of instrument."
ECB Executive Board member Praet; La Repubblica, March 18, 2016.

It is not to say that helicopter money is around the corner, but evidence is building up that the discussion on helicopter money is becoming more mainstream. The above remarks from both the IMF and the ECB should be seen as the canary in the coal mine.

Nothing wrong with lower growth and low inflation

Economic textbooks would reason that deflation will result in ever further postponing of consumption. But even for Japan, in practice there is no proof that deflation has such an effect on consumption. And is 2.0% that much better than 0.5% inflation, if the only way to get there is via a policy instrument which may be difficult to control?

We would advocate to refrain from helicopter money. The negative effects are far more prominent than the few possible positive effects. Central banks should accept that the

[3] The Simple Analytics of Helicopter Money: Why It Works – Always. W. Buiter, 2014

difference between 0.5% and 2% is minimal, and understand that they have no influence on determining external factors like the oil price, imported deflation or structural developments like ageing. And for fiscal policy, the ever increasing debt-to-GDP ratios (figure 2) cannot continue forever. Greece and Italy are perfect examples. And speaking of low growth, or even a recession, recessions do have an important function, as they result in an economic reset. As Winston Churchill said: "No crisis should go to waste".

Portfolio implications: unfavorable for bonds

Should helicopter money ever become reality it potentially has far reaching effects on fixed income portfolios. Although helicopter money will not cause a further increase in the debt ratio, the steep rise in inflation will have negative effects on bonds. The country that will be the first to start with helicopter money will debase its currency, which could lead to international tensions. The same goes for companies, where helicopter money would only postpone the inevitable, i.e. a much-needed restructuring of over-indebted companies, and would do little more than keeping zombie companies alive. The process of creative destruction will stop, where defaults and start-ups are very much needed. This will have negative implications for longer term profitability. Credit spreads will rise with rising interest rates and high leverage.

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