Helicopter money: A cure for what ails the euro area?

SUMMARY

'Helicopter money', or 'helicopter drops' of money, generally refers to a non-standard monetary policy tool used in deflationary conditions. It can be understood as a permanent increase in the nominal stock of fiat base money at lowest nominal interest rates. Some experts call for its use in the euro area, arguing that the interest-free distribution of additional money to the private sector would increase consumption and investments, and help jump-start the EU economy.

In practical terms, there are different proposals for distributing helicopter money, which may entail fiscal policy measures, such as government bonds, or printed-money-financed tax relief for private households. Some empirical studies show that tax rebates have had positive macroeconomic effects in certain countries.

Helicopter money is also criticised, however. Some experts argue that it would have a negative impact on public sector (or central bank) balance sheets. Others say it may prompt indebted euro-area countries to pull back from unpopular fiscal and structural reforms. Helicopter money, it is argued, could also undermine the stability of the euro, by triggering 'runaway' inflation or reducing the incentive to work.

There are also questions about the legality of helicopter money. Some experts believe it is permissible under EU law, citing Article 20 (Other instruments of monetary control) of the Protocol on the European Central Bank's statute. The Bank has a rather reluctant stance, arguing that the very idea runs counter to Article 123(1) of the Treaty on the Functioning of the European Union, which prohibits the direct financing of public expenditure.

In this briefing:

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Glossary

Liquidity trap: A situation in which prevailing interest rates are low and savings rates high. Consumers choose to avoid bonds (which have an inverse relationship to interest rates) and keep their funds in savings, because of the prevailing belief that interest rates will soon rise.

Quantitative easing (QE): A strategy used by central banks to increase the supply of money by, for example, purchasing bonds. In the euro area, the ECB has translated this strategy into an expanded Asset Purchase Programme (APP).

Ricardian equivalence: An economic theory developed by David Ricardo in the 19th century that suggests that when a government tries to stimulate demand by increasing debt-financed government spending, demand remains unchanged. This is because the public will save the extra money in order to pay for future tax increases that it anticipates will be needed to pay off the debt.

Zero Lower Bound (ZLB): The lowest percentage of owed principal that a central bank can set, e.g. a 0% nominal interest rate. As the interest rate approaches the zero bound, the effectiveness of monetary policy as a macroeconomic tool is reduced.

Background

The ongoing financial crisis has led to stagnation in the EU, and in some euro-area countries in particular. Several experts have advocated helicopter money as a way of jump-starting the economy by combatting deflationary tendencies and boosting investment. One of the first and most prominent advocates of helicopter money in recent years was the former chairman of the United States (US) Federal Reserve, Ben Bernanke. In a speech to the US National Economists' Club (November 2002), Bernanke warned of deflation, and suggested helicopter money as one means to boost the economy.

The discussion on helicopter money is highly relevant in the EU where, since 2013, the European Central Bank (ECB) has struggled to effectively tackle low inflation, despite cutting its main interest rate and introducing quantitative easing. Quantitative easing has raised asset prices and caused the euro to depreciate, but the new money has failed to stimulate inflationary expectations. In addition, the euro area is facing a decline in investments and considerable GDP output gaps.[1] This is where helicopter money could help, say its advocates. There are many different views on what the consequences of introducing helicopter money would be, however. This raises questions about its practicability, benefits and legality.

Definition and understanding of helicopter money

There is no common definition or understanding of the term 'helicopter money'. Generally speaking, helicopter money, or helicopter drops of money, is a non-standard monetary policy tool that involves distributing large sums of money to the public in order to stimulate the economy during deflationary periods.

The notion of helicopter money goes back to US economist and Nobel Prize Laureate Milton Friedman (1912-2006), who has been the most influential academic representative of the idea of monetarism. According to monetarist principles, there is a causal relationship between the money supply and economic growth. This theory underlines the importance of a steady increase in the money supply for sustainable economic growth, and of maintaining price stability. Central banks can control price levels by increasing or decreasing the supply of money. In the case of an economic downturn that does not respond to adjustments in the interest rate, monetarism suggests that the central bank should abandon its tight monetary policy and expand the supply of money. In doing so, the national bank avoids a credit squeeze and provides sufficient liquidity to markets and consumers.[2] In this context, Friedman used his famous analogy of a helicopter: 'that one day a helicopter flies over our hypothetical long-stationary community and drops additional money from the sky'. According to Friedman, the final equilibrium of money supply and demand will be a nominal income (that has increased by the amount of money dropped by the 'helicopter') with precisely the same flow of real goods and services.[3]

Milton Friedman's words on 'helicopter money' (1969)

'In our hypothetical world in which paper money is the only medium of circulation, consider first a stationary situation in which the quantity of money has been constant for a long time, and so have other conditions. [...] Let us suppose, then, that one day a helicopter flies over our hypothetical long-stationary community and drops additional money from the sky equal to the amount already in circulation. ... The money will, of course, be hastily collected by members of the community. [...] If everyone simply decided to hold on to the extra cash, nothing more would happen. ... But people do not behave in that way. [...] It is easy to see what the final position will be. People‘s attempts to spend more than they receive will be frustrated, but in the process these attempts will bid up the nominal value of goods and services. The additional pieces of paper do not alter the basic conditions of the community. They make no additional productive capacity available. ... Hence, the final equilibrium will be a nominal income [that has doubled] ... with precisely the same flow of real goods and services as before.'

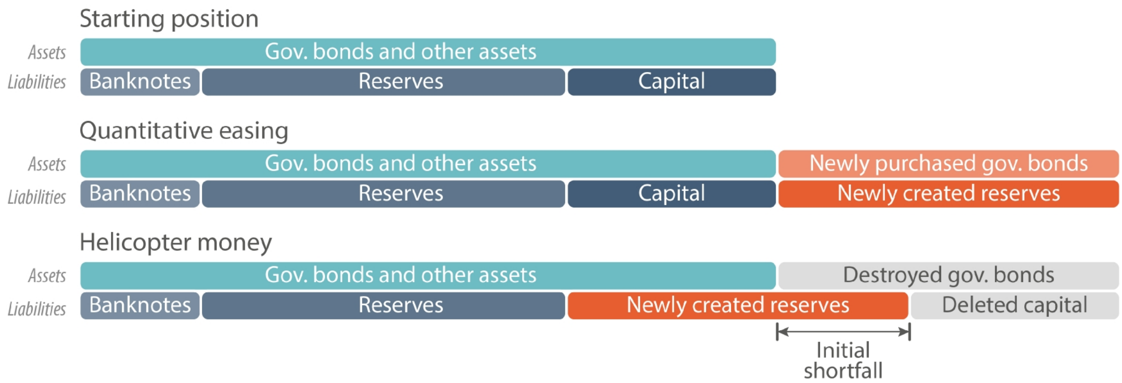
Today's experts interpret helicopter money in a more technical way. According to Bernanke, a tax cut financed by creating money (for example, through incremental purchases of government debt) is essentially equivalent to Friedman's helicopter drop.

Buiter's interpretation is the following: 'A helicopter drop of money is a permanent/irreversible increase in the nominal stock of fiat base money with a zero nominal interest rate, which respects the intertemporal budget constraint of the consolidated Central Bank and fiscal authority/Treasury – henceforth the State. An example would be a temporary fiscal stimulus (say a one-off transfer payment to households, as in Friedman’s example), funded permanently through an increase in the stock of base money.' Buiter says that helicopter money is very similar to quantitative easing, as it permanently increases the stock of base money through an irreversible open market purchase by the central bank of non-monetary sovereign debt held by the public.[4]

However, there are differences between helicopter money and quantitative easing. According to Wren-Lewis, quantitative easing creates money when interest rates are at their zero lower bound (ZLB). Nonetheless, that money can be taken out of the system later if need be by selling the assets that quantitative easing buys. The main difference may be that, while helicopter money also puts money into the system at the ZLB, it does so 'in a much more effective way than quantitative easing', because it does not have to be paid back, which means there is no need for central banks to put it into reverse.

Cumming makes similar arguments. While quantitative easing is reversible by its very nature, helicopter money is not. Quantitative easing involves buying government securities by creating reserves. The balance sheet therefore expands. In order to make the monetary stimulus permanent, the central bank has to cancel the newly purchased government securities. Cumming uses a central-bank balance sheet to illustrate the difference between quantitative easing and helicopter money and their effects (see Figure 1).

Figure 1 – Comparison of quantitative easing and helicopter money on a central bank balance sheet



Source: Cumming, F., *Helicopter money: setting the tale straight*. Data adapted by EPRS.

However, the effects of helicopter money through, for example, sovereign bond-financed tax cuts or higher public spending may be cancelled out if aggregate demand remains unchanged. This could happen, for instance, if forward-looking households respond by saving the additional money to pay for future tax increases (anticipated as necessary to pay off the debt resulting from quantitative easing or helicopter money) – a reaction known as Ricardian equivalence.

Implementation, empirical evidence and arguments

There are a variety of ideas on how to implement helicopter money. According to Cumming, a modern helicopter drop would be a joint operation between a government and a central bank: 'First, the government would carry out a bond-financed tax cut or spending programme to transfer resources to firms and households. The central bank would then simultaneously buy the equivalent amount of government debt in the secondary market in exchange for reserves; in a manner that would be observationally similar to the quantitative easing programmes that some central banks have conducted to date.'

Buiter suggests implementing helicopter money by way of close cooperation between the central bank and the treasury: 'There would be a one-off cash transfer to all eligible households by the Treasury. The Treasury funds these payments by selling Treasury debt to the Central Bank, which credits the account held by the Treasury with the Central Bank (which is not normally counted as part of the monetary base).' Buiter argues that as the Treasury pays out the cash to the eligible households, its account with the Central Bank would be drawn down.[5]

Lonergan broadly agrees, but is more explicit about how the idea could be implemented in the euro area. The ECB should announce a targeted longer-term refinancing operation (TLTRO) programme, through which it would provide perpetual, zero-interest loans to banks. In turn, banks would have to extend these loans on the same terms to the public in euro-area countries. According to Lonergan, members of the public would be able to apply for a loan up to a specified maximum per adult, say €600. Banks could provide the loan in the form of a deposit, a cheque, or cash. He also argues that at zero interest rates, this process 'has no net impact on the ECB’s balance sheet' since accounting liabilities (such as bank reserves) would rise by the same amount as assets (such as perpetual loans). According to the author, this process is 'clearly legal' under EU law. It would be in line with the ECB's main objective of meeting price stability or, more precisely, of maintaining the inflation rate below, but close to, 2% over the medium term. Lonergan maintains that this would preserve the ECB's independence, since there would be no role for national treasuries or government spending.

Muellbauer makes a similar proposal, but with specific estimates of GDP output. His suggestions include providing all workers and pensioners who have a social security number, or who are on the electoral roll, with a €500-per-adult 'hand out' or payment from the ECB. The Member States could help to distribute the additional money. Muellbauer believes that helicopter money would have not only a macroeconomic effect[6] – for example, by increasing the GDP of Spain, Portugal and Greece by between 1.1 and 2%, and that of Germany by 0.5% – but also a political one, as it would reduce resentment towards the EU institutions and in particular the ECB.

The positive macroeconomic effects of tax rebates have been observed in other countries. In 2001 and 2008, for instance, there were tax rebates in the US. A study from 2006 analysed the 2001 rebate. One of its main conclusions is that 20-40% of the rebate was spent in the quarter in which the cash was received, and about another third in the following quarter. A study of the 2008 tax rebate concluded that 'households spent 12-30% (depending on specification) of their payments on nondurable goods during the three-month period of payment receipt, and a significant amount more on durable goods, primarily vehicles, bringing the total response to 50-90% of the payments'. In a study of the 2009 'tax bonus' in Australia, it turned out that around 40% of the bonus was spent in the quarter it was received.

There are also arguments made against helicopter money, however. During the February 2016 Monetary Dialogue Preparatory Meeting in the European Parliament's Committee on Economic and Monetary Affairs, Stefan Kooths of the Kiel Institute for the World Economy stated in a presentation that helicopter money could be seen as a (radical) policy instrument to enhance the effectiveness of quantitative easing. According to him, helicopter money may end up bypassing the credit channel to inflate away debt overhang, which would result in the transformation of the euro into a pure fiat money system.

Muellbauer in his piece also lists arguments against helicopter money, although he does not find them persuasive. Besides the legal aspects (see next section), there is concern about the costs of helicopter money, and its increasing impact on the public sector (or central-bank) balance sheet. In addition, there is the question of moral hazard: highly indebted euro-area Member States may pull back from unpopular fiscal and structural reforms. Furthermore, helicopter money could undermine the stability of the currency and weaken the incentive for the unemployed to work.

Legal aspects of helicopter money

Legal questions relate not only to EU law, but also to how the concept of helicopter money is interpreted – whether it is seen as monetary or fiscal policy – and to the role and mandate of central banks.

Buiter argues that independent central banks issue the fiat base money and have some operational independence (concerning inflation targets, for example). However, they do not act as fiscal principals (for example, by carrying out public investment). They do not levy taxes or pay overt subsidies to other domestic economic entities.[7] Government bonds held by the central bank are usually counted as part of the public debt. A government can recapitalise its central bank by either raising taxes or selling more of its own debt. Economists call this 'fiscal backing' for the central bank. Therefore, it makes no difference whether the central bank cancels the sovereign bonds it buys or holds them indefinitely, because the state and its treasury is the beneficiary and owner of the central bank. The state/treasury receives the central bank's profits and is responsible for its losses.

In this context, Bibow argues that handing out banknotes, or making transfers into deposits held by the public 'constitutes not monetary policy, not even unconventional monetary policy, but plain and simple fiscal policy'. And Grenville notes that independent central banks can only exchange one asset for another, they do not have a mandate to give money away. Such a decision would be subject to a budget-approval procedure. Therefore, central banks cannot produce helicopter money on their own – fiscal policy-making must also play a role.

The EU Treaties also have a bearing on quantitative easing and helicopter money, with Article 123(1) of the Treaty on the Functioning of the European Union (TFEU) often quoted in this context: 'Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as "national central banks") in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments'.

Buiter takes a dim view of Article 123(1) TFEU. He maintains that it 'deprive[s]' the euro area 'of the one policy instrument – a temporary fiscal stimulus permanently funded by and monetized by the Central Bank – that is guaranteed to prevent or cure deflation, "lowflation" or secular stagnation. It is time for Article 123 to be scrapped in its entirety if the euro area does not wish to face the unnecessary risk of falling into any of these traps'.[8]

Muellbauer, on the other hand, argues that 'nothing in Eurozone law forbids the ECB from undertaking such an independent action', since the ECB is independent of governments. He maintains that the ECB implementing his idea of a €500-per-adult-citizen direct hand-out would clearly be monetary policy and not fiscal policy. The liquidity trap and a citizens' dividend were among the topics discussed at a conference on 'Quantitative easing for people' held in the European Parliament in February 2016. There, Lonergan argued that helicopter money would essentially be a form of 'people's quantitative easing', and would resemble a kind of a targeted longer-term refinancing operation by the ECB for households. This policy would be in line with Article 20 of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank. Article 20 is named 'Other instruments of monetary control' and states, inter alia, the following: 'The Governing Council may, by a majority of two thirds of the votes cast, decide upon the use of such other operational methods of monetary control as it sees fit...'.

It is true that the ECB has broad discretion in the conduct of monetary policy, as emphasised by the Court of Justice of the EU in its judgment on Outright Monetary Transactions (OMT). However, the official statements of the ECB on helicopter money suggest a rather ambivalent stance towards it.

ECB Vice-President Vítor Constâncio struck a cautious note in December 2015: 'The original idea of helicopter money refers to the direct financing of public expenditure. That is not an option for us. That is not something that we are considering.'

During the ECB press conference in March 2016, the question of whether helicopter money is part of the ECB toolbox (either in the form of direct financing of public investment, for example the European Investment Bank, or in the form of direct money to consumers) was raised. ECB President Mario Draghi answered as follows: 'We haven't really thought or talked about helicopter money. It's a very interesting concept that is now being discussed by academic economists and in various environments. But we haven't really studied yet the concept. Prima facie, it clearly involves complexities, both accounting-wise and legal-wise, for our view, but of course by this term "helicopter money" one may mean many different things, and so we have to see that.' This statement is interesting insofar as Draghi sounded more reluctant on helicopter money during the Monetary Dialogue with the European Parliament in September 2015. There he said that 'we should also not underestimate the legal aspects that would apply to the euro area and to the ECB, so one should ask the question whether this helicopter money is consistent with the Treaties and so on'.

Outlook

The idea of helicopter money can be understood and implemented in different ways. Provided that there is no Ricardian equivalence, helicopter money could be effective in stimulating aggregate demand and higher inflation and it could be a cure for what ails the euro area. But in addition to questions about its legality, helicopter money has a political dimension. Bibow, for instance, raises questions about democratic legitimacy: 'Who would want unelected central bankers to be in charge of taking such a decision; even if it may well be the right one?'

Another reason why independent central banks are cautious about helicopter money is that they want an asset that they can later sell after the economy recovers. As Wren-Lewis states, quantitative easing gives them that asset, but helicopter money does not: 'The nightmare is not the current position of deficient demand, but a potential future of excess inflation that they are unable to control.'

Woodford has offered a possible solution to this dilemma. He suggests a policy that could deliver the same effect as helicopter money, but would preserve the traditional separation between monetary and fiscal policy. His proposal focuses on a version of flexible inflation targeting whereby the central bank commits future monetary policy to a permanently higher nominal target (than the 2% inflation target over the medium term), such as the path of nominal GDP. This would also include permanent increases in the monetary base via fiscal transfers, but the central bank would not be involved in making transfers to private parties.

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Endnotes

[1] On this topic, see the EPRS briefing on secular stagnation, Gustaf Gimdal and Cemal Karakas, February 2016.
[2] On monetarism and its use by the European Central Bank, see the related EPRS briefing, Cemal Karakas, July 2015.
[3] While the size of the money base would increase, the amount of goods and services would remain the same. This would gradually lead to the desired higher inflation rate.
[4] Buiter, W. H., *The Simple Analytics of Helicopter Money*, p. 1.
[5] Ibid., p. 36.
[6] For the calculation of the figures, see Footnote 6 in Muellbauer, J., 'Combatting Eurozone deflation: QE for the people', CEPR's Policy Portal, 23 December 2014.
[7] Buiter, W. H., op. cit., p. 35.
[8] Ibid., p. 40.

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