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Understanding helicopter money

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Abstract

What are the policy tools in times of economic crises? What are the tools that governments and central banks have against the coronavirus crisis? This article briefly explains how several types of monetary policy can currently work, placing an emphasis on a form of helicopter money directed to affected firms. The proposition is that this type of monetary policy should be avoided in general, but it might yield beneficial results in the current European economy.

The direct effect of the crisis is the drop in demand and production (including supply chain) and firm revenue caused by the lockdown. This is what we currently experience. The indirect and, perhaps more important, effect is that a lasting lockdown will cause a surge in unemployment (business will lay off workers) with concurrent losses in income.[1] This will push the global economy into a deep recession. The key economic policies available to reduce the length of the recession are fiscal and monetary expansion.

Fiscal expansion

The governments increase public spending by issuing new debt. This is also the case if there is a new Eurobond or Coronabond. This is a nice development toward European integration and could be a nice test for the future. The current problem with this type of policy is that countries' government debt will be expanding and we know that most of the countries severely hit by the virus already have a national debt close to or higher than 100% of their GDP. Increased debt will generate a vicious spiral of higher government bond rates (as we saw during the Global Financial Crisis) and a new debt crisis will emerge with adverse economic effects in the medium- to long-run. Of course, this will be less so in the case of Eurobonds: those will have a lower interest rate for the southern countries.

Monetary policy

Monetary policy takes three general forms. Conventional expansionary monetary policy implies the Central Bank (ECB) cutting interest rates so that investment and consumer spending rises. However, central bank rates have already been at very low levels (at the zero lower bound for

[1] Of course this is a simplified approach to what is happening, for the shake of brevity.

several years), so that conventional monetary policy will not work. This leaves the options of quantitative easing (QE) and debt monetization (DM).

Would QE work during the coronavirus crisis?

QE is the process via which the Central Bank issues money to purchase financial assets (from banks). It can have a positive effect in the current situation by strengthening banks' financial position and reducing the risk of bank runs. However, it is unlikely that banks will significantly expand their lending activity to businesses, at least not until the medical emergency ends. Businesses, especially small and medium-sizes enterprises (SMEs) have stopped operating and this increases their risk of redundancies and the risk of default. QE is expected to have a positive effect after the quarantine ends (or even after the medical crisis ends via an effective treatment) and of course QE lowers the pressure on sovereign bond yields (which is important if governments decide to issue new debt to finance their fiscal expansion).

Would debt monetization work in the coronavirus case?

DM is the process via which the ECB issues money to purchase government bonds. Debt monetization will have a positive effect (as long as the funds will be put to good use) given that European fiscal austerity has been abandoned for the current year. The ECB will buy government debt (in the form of bonds) and will return the interest to the countries' treasuries. The problem with this type of monetary policy is that government debt will be inflated (as is the case with fiscal expansion) and we know that most of the countries severely hit by the virus have a national debt close to or higher than 100% of their GDP. Inflated debt might increase government bond spreads for the countries with already high levels of debt (as we saw during the Global Financial Crisis).

Helicopter money and its drawbacks

This is the process of the ECB printing money that goes directly to the public (a money drop). Thus, the governments do not write this in their budget and government debt does not expand. In normal times, helicopter money should not be an option. There are five important reasons for this.

1. A money drop to the public cannot raise productivity in the short term. It will only increase consumption and the price level.
2. More liquidity in the system alongside very low interest rates may trigger a search for yield mechanism, whereby the equilibrium risk levels (especially financial risk) is higher. This creates economic bubbles that burst into recessions.
3. The domestic currency will significantly devaluate resulting in economic power loss for the domestic citizens.
4. Quite importantly, implementation of helicopter money probably implies a transfer by the ECB to governments and then "fiscal policy" from governments to the public. Fiscal policy in Europe is with the national governments. This is not just semantics: fiscal policy is inherently controlled by democratic institutions and certain European governments can block the policy on the basis of institutional fears (e.g., fears that the ECB will lose its independence or that this type of fiscal expansion is centrally planned).
5. The ECB's balance sheet will expand without holding a meaningful asset (one with market value). This implies seigniorage: the ECB is foregoing holding an asset with market value by holding an asset with no market value and increased liabilities. Having a bloated ECB

balance sheet of that sort is mostly uncharted waters for economics: it might matter or it might not.

Would helicopter money work in the current economic state and how?

I think that in the current framework helicopter money is an option. Let me explain what the format should be and why.

1. The optimal is that the ECB makes treasury deposits to countries based on a simple algorithm, calculating the coronavirus economic costs and the size of the economy. This can happen by governments issuing perpetual bonds with zero maturity and interest. Such bonds will have a book value (to be included in the ECB's balance sheet) but zero market value. The ECB's balance sheet will expand. The biggest advantage at the current economic state is that governments will not write this in their budget and thus the government debt will not expand. Thus, there will not be increased sovereign risk from this policy. There will of course be an increase in debt from other fiscal policies and lower GDP.

2. The governments should then direct the funds to firms, so that unemployment will not rise. Funds directed to households would not work because households cannot boost demand while in quarantine. The funds should be enough to minimize job losses for the next 2-3 months until the quarantine ends and other types of monetary policy become effective. This is the only proposed form of helicopter money to take place: the ECB must state that this is only a one shot to help with the exogenous shock and will not happen again. This statement must be explicit and credible.

Further, the governments must make sure that funds will be used efficiently and in the formal sector.

Would the five problems of helicopter money emerge in the current economic state?

1. Inflation is currently decreasing and as of March it is 0.7% in the Eurozone. This is unlikely to be a problem in the short-term given the current loss in consumption.
2. Increased appetite for risk will not kick in until the end of the quarantine. There is unwillingness to take financial risk in this economic state.
3. Other important countries will likely implement similar policies. Thus, euro devaluation is unlikely to be very large, especially as euro is the second "safe heaven" after the USD. Of course, some devaluation will happen.
4. The fact that helicopter money is in fact a fiscal policy (financed by monetary policy) is still a problem. But at this time, we should care more about rising unemployment due to a completely exogenous shock and not so much about who conducts fiscal policy. If the ECB has major problems to overcome, then the money drop can take place via the banking system and not the treasuries. The banks can then send the money to businesses and governments should monitor that firms do not lay off employees.
5. The expanded ECB's balance sheet is a real problem, as there is much uncertainty for both academics and policy makers about this issue. Supposedly, this can create increased risk and bubbles. Prominent economists (e.g., Jordi Gali) are suggesting that this is just a drop in the ECB's capital and will not have real economic implications. We need more theoretical considerations and empirical facts to decide on this issue.

Why do some countries oppose it?

Mainly for reasons under point 4. Helicopter money in the proposed form is essentially a fiscal transfer. And fiscal policy is in the remit of the sovereign countries, not the ECB. This is important for countries that saved and can refinance their debt at negative interest rates. It is like giving away their economic model for something that is a free lunch (of course, as explained helicopter money has costs and is not a free lunch). For the U.S., this is less of a problem as one government can work with one central bank. In Europe, prudent countries who can finance the fiscal expansion needed are unwilling to transfer fiscal power to the ECB and to other national governments. To me, the main problem is point 5. There is uncertainty about the effect of increasing the size of ECB's balance sheet.

Conclusions

Helicopter money is a fiscal policy financed by monetary policy. Policy makers should not resort to helicopter money in normal times. The current economic shock started as an exogenous shock, in the sense that it had nothing to do with preexisting policy and the economic environment. However, its transmission is endogenous to health policy and economic policy, as we are seeing that some countries hurt more than other countries. The first line of defense against shocks is always the own country's fiscal strength. However, in the current state, it seems that in Europe there are clear benefits stemming from a one-shot money drop, directed to firms to preserve the economy from short-term unemployment (that will cause longer-term adverse effects). At least we need to consider this one drop seriously.

PS. Shortly after writing this piece, the Bank of England essentially initiated a helicopter drop. Interesting times for monetary policy, tough times for the world.