Confluence Investment Management

Weekly Geopolitical Report

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The Geopolitics of Helicopter Money: Part 1

Since the 2008 Financial Crisis, developed economy central banks have been implementing a series of unconventional policy measures, including quantitative easing (QE), zero interest rate policy (ZIRP) and negative interest rate policy (NIRP). Although these measures likely prevented a deeper financial calamity, such as a repeat of the Great Depression, these actions by the central banks have not led to a strong economic recovery. In particular, inflation rates have remained very low and growth sluggish. The lack of growth is partly to blame for the rise of populist movements in the U.S. and Europe.

Economists and other market analysts have pondered whether the central banks have effectively "run out of ammo." In terms of conventional and some unconventional policies, the answer is probably yes. It is hard to imagine how additional QE could boost any of these economies, and the impact of NIRP has, thus far, been mixed.

However, there is one remaining policy tool that is virtually guaranteed to lift inflation and would almost certainly boost growth. Using monetary policy to directly fund fiscal spending, formally called "monetary funded fiscal spending" (MFFS) and often referred to by its more colloquial name, "helicopter money," remains within the policymakers' tool boxes. However, it is a potentially dangerous policy that is appropriate only in the most extreme circumstances.

This topic has geopolitical importance because of current global integration. Although nations generally are given some latitude in setting domestic monetary and fiscal policy, MFFS would likely have a significant impact on foreign exchange markets. If the policy is perceived as a deliberate attempt to weaken one's currency, it could trigger protectionist policies and bring about a "currency war."

In Part 1 of this report, we will describe MFFS and barriers to its use. In Part 2, we will examine two historical examples when forms of it were implemented, Japan during the 1930s and the U.S. during WWII. In Part 3, we will note some observations from the historical record and look at the likelihood of MFFS being deployed in today's world, focusing on which nation is most inclined to use it. As always, we will conclude this series with expected market ramifications from MFFS.

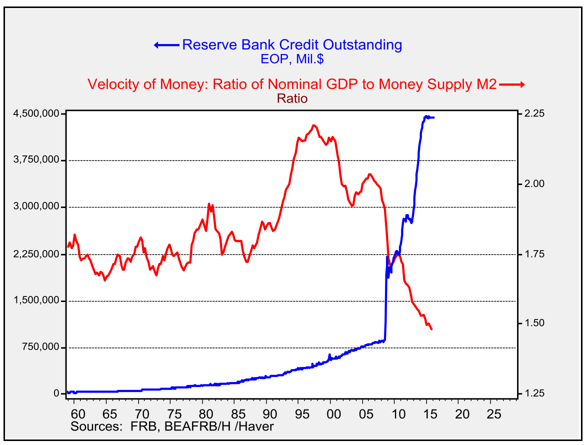
Helicopter Money

Both Milton Friedman and John Maynard Keynes described how central banks never lose their ability to stimulate an economy if they are willing to employ an aggressive enough policy. Under conditions of deflation and severe underutilization of productive capacity, policymakers can spur spending through monetary debasement. Keynes suggested that governments could hide printed currency in abandoned mines and allow people to go find it. The new money would be spent, using up the excess capacity and eventually triggering inflation, which would lead to even more spending as households and businesses speed up purchases to avoid future price increases.

Milton Friedman's description is where the "helicopter" comes in:

> *Let us suppose that one day a helicopter flies over the community and drops an additional $1,000 in bills from the sky, which is, of course, hastily collected by members of the community.*[1]

To some extent, it does beg the question…how is MFFS different from QE? After all, if we are assuming the quantity theory of exchange is operative (which is M*V=P*Q), then it is possible that increasing the money supply might only lead to falling velocity. In fact, this is exactly what has occurred in the U.S. with QE.



Note that as the Federal Reserve's balance sheet has expanded, velocity has declined. Essentially, the monetary base the U.S. central bank created was simply held within the banking system, neither increasing demand significantly nor leading to rising price levels.

The difference between MFFS and QE is that the former directly funnels purchasing power to businesses and households via government fiscal actions, while the latter works through the banking system. With QE, the central bank purchases assets from the banking system in exchange for cash. This action has three effects. First, it increases the level of liquidity in the banking system and, under normal circumstances, should lead to more lending. Second, the buying of financial assets tends to lift their prices and the rise in asset values would normally make businesses and households feel "richer" and lead to more spending due to the wealth effect. Third, the expansion of the money supply, *ceteris paribus*,[2] would tend to depress the QE nation's exchange rate, which would usually boost exports and cut imports, lifting GDP.

However, the impact of QE and ZIRP has been far less than anticipated, mostly because of the drop in velocity. Why has velocity been so weak? The most obvious reason is that banks have not lent much of the injected reserves. However, it is not easy to separate the demand and supply effects. For example, households have been deleveraging and have been slow to increase borrowing. Businesses have increased their borrowing recently but most of the funds have been used for mergers or equity repurchases. The economic impact of business borrowing has been dampened because new investment spending has lagged. In other words, demand for loans has been weak. At the same time, banks have been reluctant to lend, restricted by post-Financial Crisis regulations. Asset values have clearly increased, with QE and

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[1] Friedman, Milton. *The Optimum Quantity of Money*. Chicago: Aldine Publishing Company, 1969. Ben Bernanke repeated this concept in a 2002 speech without referencing Friedman, assuming that his audience would surely remember that the idea originated with his more famous predecessor. Unfortunately for Bernanke, his audience was not as familiar with the history of this economic thought as he presumed, and from that point forward, Mr. Bernanke has been labeled with the moniker "Helicopter Ben."

[2] Latin phrase meaning "all other factors held constant."

low interest rates helping to create bull markets in equities and credit markets, but the benefits have mostly accrued to the wealthy, who lack the numbers to dramatically boost overall consumption.

The lack of potency surrounding QE and ZIRP has led the ECB and BOJ, along with some smaller central banks, to engage in limited NIRP. So far, the results have been less than impressive. We suspect this is because NIRP is stressful for the financial system. Much of the financial system is based on intertemporal interest rate spreads—banks borrow short-term and lend long-term—to function. Negative interest rates make it very difficult to generate profitable spreads.

This lack of potency has led an increasing number of economists to postulate that MFFS may be necessary to jump-start the developed world economy.

In theory, MFFS would bypass the financial system and put money directly in the hands of households and businesses. As Milton Friedman's above example postulates, the receivers of cash would be inclined to spend at least some of this windfall which would boost spending and growth.

In practice, MFFS requires coordination of both monetary and fiscal authorities. In the developed world, there is an institutional division between monetary and fiscal policy. Monetary policy affects the economy by manipulating interest rates and financial conditions. Some central banks are also required to manage the exchange rate. Most modern economies, worried about political interference in the setting of interest rates, have created conditions that give the central bank independence from the government. Fiscal authorities are given the mandate of managing government spending and tax policy. Fiscal policy includes spending on public goods (courts, roads, public safety and external security), income maintenance (transfer payments and health care) and the incidence of revenue raising (the areas to be taxed, e.g., income versus consumption, user fees, etc.).

Since the Reagan/Thatcher revolutions, there have been deep fundamental disagreements in many Western nations over the proper role of government actions in the economy. These disagreements have mostly ended the use of discretionary counter-cyclical fiscal policy. Managing the business cycle has mostly become the sole responsibility of the central banks. Unfortunately, at the zero bound, monetary policy becomes less effective but, due to the current institutional structure, monetary authorities tend to lack the necessary political mandate to perform what is essentially fiscal policy. In other words, it is theoretically possible for the central bank to put money directly into household or business accounts; practically, that isn't possible in Western democracies.

Because of these institutional constraints, MFFS would require the monetization of fiscal spending. Essentially, a government would engage in fiscal stimulus—examples include tax cuts, transfer payments or infrastructure spending. Instead of raising taxes or issuing bonds to fund the spending, the fiscal authority would simply acquire the funding from the central bank. This action would lead to a permanent rise in the money supply. In a closed economy operating at full utilization of productive capacity, inflation would result. If the economy is operating below full capacity, or the economy is open, the injection of liquidity would increase spending and imports, and would almost certainly lift domestic and international economic growth. Essentially, spending would rise without increasing the government's debt.

All this sounds fairly painless. However, there are three good reasons why policymakers are reluctant to deploy this weapon.

1. Once employed, the temptation for politicians to use MFFS on a regular basis will increase. There have been numerous historical examples of hyperinflation. All of them have been partly due to direct central bank funding of fiscal spending. Fiscal authorities, facing budget constraints, have found it hard to resist the easy use of debt monetization once it has been used. What might start out as an emergency measure could become standard procedure, leading to uncontrolled inflation.

2. The central bank almost certainly gives up its independence. Under MFFS, the fiscal authority can demand the central bank fund its spending, a clear violation of independence. All central banks get their mandates from the government and only an agreement with the government can make a bank independent. Central bank independence was not all that common until the Reagan/Thatcher revolution, which was partly a response to high inflation. Central bankers tend to view independence as something that was hard earned and would be loath to give it up under less than dire circumstances.

3. The nation using MFFS may see its currency decline sharply and other nations may react to offset the impact of currency appreciation. These measures may include implementing MFFS themselves, putting up tariff barriers or intervening in the currency markets to raise the value of the currency of the country implementing MFFS. Simply put, deploying MFFS may very well cause global financial problems.

Using this background information, next week we will examine two historical examples of MFFS.

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Confluence Investment Management LLC

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