Will the helicopters take off?

Having helicopters drop money will hardly help central banks achieve their inflation targets.

Even after years of close to zero interest rate policy and several rounds of quantitative easing, several central banks are struggling to push up inflation. Recently some central bank economists have been referring to “helicopter money” as an interesting concept, indicating that this is being discussed as a potential new weapon in the campaign for higher inflation.

What is helicopter money? Can it help push up inflation? And what is the likelihood of the helicopters taking off?

Helicopter money refers to an untraditional way of funding budget deficits. Deficits are traditionally financed by issuing government debt to the private sector. The state uses helicopter money as financing if it instead borrows from its central bank. Many people think of helicopter money as ‘money printing’. This is misleading. What happens is that the central bank increases its balance sheet. On the assets side, the central bank adds a loan to the government. On the liability side a corresponding amount is deposited in the government’s account. The government uses these deposits to cover the deficit.

Contrary to how it might sound, helicopter money is not a sure-fire recipe for inflation. At any rate it is highly unlikely to be an accurate tool for obtaining inflation that is in line with the central bank’s inflation target.

First, there is barely any difference between borrowing from the market and borrowing from the central bank. Regardless of how the government finances its deficit, it ends up with a higher debt to the private sector. Why is this?

When the government spends its new deposits, the deposits flow from the government’s central bank account to accounts in the central bank that are owned by private banks. Since the government owns the central bank, private sector central bank deposits are part of the government’s overall debt to the private sector. Thus in the case of helicopter money, the government issues debt to the same extent as when it issues bonds in the market. The only difference between government bonds and central bank deposits is that the interest rate on bonds is typically fixed while the interest rate on central bank deposits is floating. Hence the choice between helicopter money and bond issuance impinges on the interest rate risk profile of the government’s overall debt to the private sector.

Whether helicopter money will result in higher inflation depends on whether the market thinks such a policy lowers the probability that the government will keep its fiscal house in order.

A government can run large deficits and accumulate a lot of debt and still have the market’s trust, if the private sector is convinced that expenditure and tax levels over time are adjusted sufficiently to service the debt. If, however, the private sector does not think that the government will properly manage its finances over time, they will try to dispose of their government assets by buying more real products, such as goods and services. The increased demand for goods and services pushes up inflation until the real value of the state’s liabilities has dropped to a suitable level.

The high inflation recently seen in Russia is likely due to a lack of trust in government finances. A sharply falling price of oil and adverse repercussions of foreign adventures decreased tax revenues. Putin and his gang were likely not seen as capable of ensuring that the government could honour its obligations at the initial price level. This resulted in a sharp increase in inflation, which was for a time was in the double digits.

Supporters of helicopter money seemingly believe that if the state camouflages part of its debt as central bank deposits, they can obtain some of the same type of inflation.

The idea is that the private sector might come to think that the government is only going to stand by its traditional debt, i.e. that the government will pursue a fiscal policy that neglects the fiscal implications of debt owed to the private sector via the central bank. If, so, the private sector deems the fiscal stance as unsound and inflation increases as purchases of goods and services accelerate.

I think this approach underestimates the market’s ability to understand public finances. Why shouldn’t households and firms understand that it does not make any difference to the government finances whether the state borrows from the market or from the central bank? And why shouldn’t they expect politicians to service entire government debt?

I don’t think democratically elected governments in developed economies can credibly commit themselves to only servicing their overt debt. I think it is safe that to assume that the private sector expects their politicians to behave responsibly in the long run. If so, households’ savings will increase if the government resorts to helicopter money. They must save to pay higher future taxes (or to compensate for lower public transfers). And if this is the case, the private sector willingly holds the augmented government debt and helicopter money has no impact on inflation.

But let us assume that the trick works and the authorities manage to make the public believe that central bank debt is not government debt. It does not follow that the state hits the bull’s eye of the inflation target.

No one has attempted a fiscal policy that is deliberately somewhat unsustainable. How much money will be crammed into the helicopters? Authorities will grope around in the dark, and there is a big risk that inflation will be higher than the inflation target.

As I see it, it is likely that an attempt to use helicopter money will either have no effect on inflation, or the effects will be far too strong. I think that when the authorities have mulled over these questions, they will come to the same conclusion. Hence I don’t think we will see monetary helicopters on the horizon.

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