Northern Trust

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Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

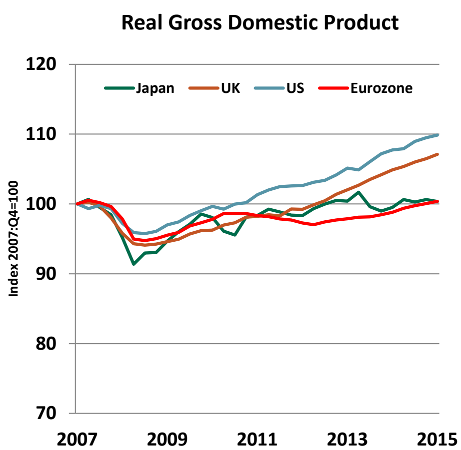
Carl R. Tannenbaum
Chief Economist
312.557.8820
ct92@ntrs.com

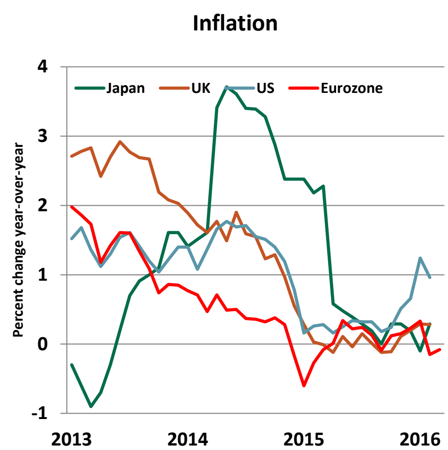
Asha G. Bangalore
Economist
312.444.4146
agb3@ntrs.com

- **Should Central Banks Call in the Helicopters?**
- **The Fed's Dot Charts Are Misunderstood**
- **Breaking Up Banks Could Threaten Financial Stability**

For the past eight years, major central banks used unconventional monetary policies to promote economic growth and lift inflation. But success is incomplete on these fronts, and there is an active debate about whether forward guidance, negative interest rates and quantitative easing (QE) remain potent. It may be time for "helicopter money."

The Federal Reserve and the Bank of England can point to gains in output and employment to validate the use of QE. But inflation remains below target in both countries. More recently, the European Central Bank (ECB) and the Bank of Japan adopted negative interest rates in addition to QE to stimulate economic activity and boost inflation to match their mandates. The early returns on those efforts have not been overly encouraging.





Source: Haver Analytics

Concern remains that central banks are running out of tools to increase aggregate demand. And so central banks have been open to new strategies. That's where helicopter money comes in.

Professor Milton Friedman coined the term "helicopter drop" in a 1969 essay to describe how central banks could print money and distribute it to citizens to correct a deflationary situation. (The helicopter, hovering over eager consumers, was a metaphoric delivery mechanism.) In a 2002 speech, then-Fed Governor Ben Bernanke suggested using helicopter money as a means to correct a deflationary situation.

In its purest form, helicopter money involves the central bank sending checks to households. Households deposit the checks at banks. Banks present the checks at the central banks and their reserves increase.

The advantage of a “helicopter” program is that households receive money directly. Given propensities to spend, this could have a pronounced impact on consumption. At times, tax cuts have been distributed directly to households, prompting important amounts of additional spending. “Helicopter” programs might be similarly beneficial.

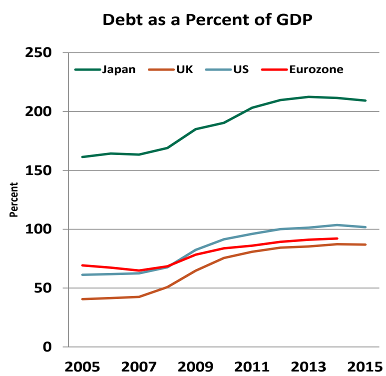
Giving money directly to consumers would maximize spending gains.

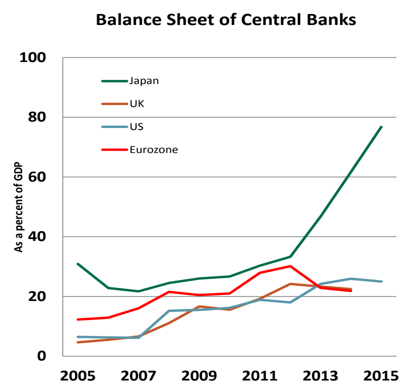
This strategy has an important advantage over quantitative easing. QE reduces bond yields, lowers borrowing costs, and encourages spending through an enhanced wealth effect. Ultimately, though, the influence on consumption and output is much less-direct than would be the case with a direct infusion of reserves to household accounts.

Unfortunately, there are operational and legal problems with helicopter strategies. Distributing checks to all households would be an operational challenge. In most countries, central banks do not have the legal authority to send out checks to citizens. For example, all members of the eurozone would have to agree for the ECB to implement this strategy. Congress would have to authorize the Fed to undertake such a plan.

In addition to these difficulties, reserves (liabilities of the central bank) created by helicopter money do not have a corresponding asset. Therefore, the way to get around this problem is for helicopter money to work as a money-financed fiscal expansion. This could be achieved if fiscal authorities initiated a tax cut and issued new debt to finance this policy action. The central bank would purchase the new debt and pledge to hold it for a very long period of time.

This would be critical to managing the expectations of consumers, who might not react as freely if they suspected that their newfound bounty would ultimately be rescinded or reduced by subsequent monetary restrictions. (The offset to this would be tax increases on the fiscal side.) Pledging to hold the acquired securities for a lengthy interval would also reduce the chances that long-term interest rates would increase as a result of an expanding fiscal deficit.





Source: Haver Analytics

Politically, helicopter programs would require close coordination between the legislature and the central bank, which won’t be easy to secure. Central banks were founded to issue currency, prevent bank panics, and be the lenders of last resort. Over time, though, the monetary mandate has expanded to include correcting episodes of deficient demand, which tests the border between fiscal and monetary policy.

Most major economies are strapped with high levels of debt, leaving central bankers to navigate weak economic circumstances on their own. As politicians struggle to balance austerity and growth during challenging times, central banks have felt the need to be more aggressive.

Critics note that helicopter money amounts to a conflation of monetary and fiscal policy which can reduce the perceived independence of central banks. Further, helicopter money (like any extreme monetary expansion) can result in higher inflation that is not desirable. Central banks with strong credentials on this front, like the Fed, might be in the best position to attempt a helicopter strategy.

Advocates of helicopter money point out that central banks can contain these risks by placing limits on how much banks can lend and raising reserve requirements of banks to curtail inflation if it appears. Central bank communication that monetary finance is designed to fight deflation and meet the inflation mandate is critical for public perceptions in this case.

Helicopter money may be the next unconventional policy tool.

There is precedent for central banks to take a more active role. The Federal Reserve helped fund WWII expenditures through monetary finance and provided direct credit to private corporations during the post-war period. It did produce higher inflation for a short period (in the former case), but it kept growth on track.

Should developed nations fall back into recession sometime soon, including helicopter money as part of a central bank's toolkit is not a bad option. It may not be time to send the whirlybirds into the air, but it might not be a bad idea to ensure that the rotors are ready.

Deceived by Dots

Pointillism is a style of painting developed 130 years ago in which the artist covers the canvas with dots of paint. Studied closely, the outcome appears to be a confusing array; viewed from a distance, though, a clear image emerges.

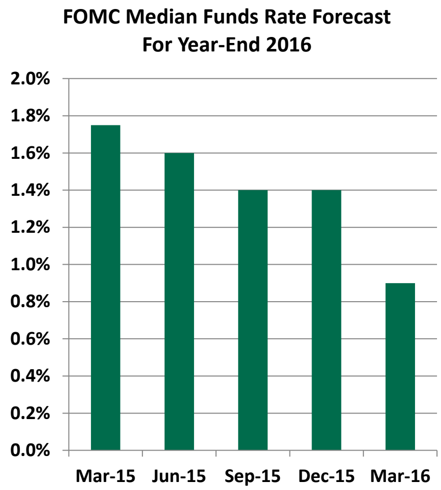
I would guess that relatively few traders spend their time contemplating Georges Seurat's *oeuvre*, but they do seem obsessed with another kind of dot plot: the one the Federal Reserve releases each quarter that offers a forecast of how short-term interest rates might progress.

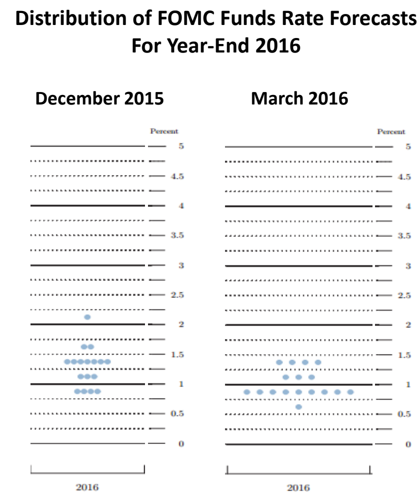
The dot chart was introduced in 2012, a year after the Federal Open Market Committee (FOMC) began publishing a set of consensus forecasts each quarter. It was novel because it was the first time the outlooks of individual participants in a central bank meeting were made visible.

Over the past year, the dot chart revealed a steady decline in expectations for Fed tightening. At the conclusion of last month's FOMC meeting, market participants were quick to seize on the 50 basis point decline in the median of projections for year-end 2016. Through the dots, analysts suggested that the Fed was signaling a much more-gradual approach.

There are, however, a couple of problems with that conclusion. First, the leadership of the Fed has no ability to use the dots as a signaling mechanism; the entries from individual contributors are published unadulterated. Secondly, medians are simply mid-points: if two dots had moved down in December and two dots had moved up in March, the medians would have been identical. So this is hardly a seismic change.

Far too much attention has been paid to a minor piece of Fed guidance.





Source: Federal Reserve

Finally, some dots vote and some dots don't. And some dots should be bigger than others, because some FOMC contributors are more important than others.

Observers of impressionist work know it is best not to look at the art too closely. Fed watchers could learn a lesson from them.

The Big (Bank) Picture

Policymakers around the world are debating the ideal scale of financial institutions. There is a popular sentiment that is smaller is safer, but the exact opposite may be true. And European regulators may be demonstrating why.

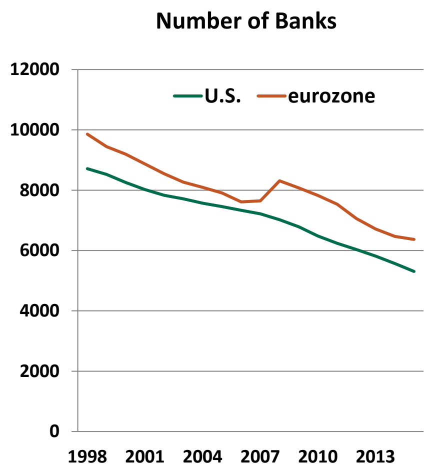
Banking worldwide has been consolidating for a very long time. The number of commercial banks in the United States has diminished by almost two-thirds in the last 30 years, and Europe has followed a similar pattern. At one time, this was viewed as a very positive development: small banks whose business was concentrated in a country, region or industry were more at risk than institutions that had better diversification. Economies of scale, especially in technology, realized through combinations should lower costs and provide platforms that can foster innovation.

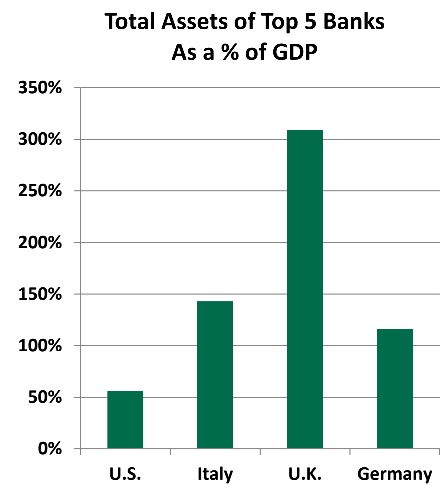
But as banking became more concentrated, national and international economies became more reliant on the largest intermediaries. And as these intermediaries became increasingly interconnected, the health of the global financial system became bound up in the health of big banks. This made it difficult for supervisors to close them down during adverse circumstances.

"Too big to fail" has been the subject of two books (and one movie), and fixing moral hazard has been a focus of post-crisis regulation. But the pace of reform has frustrated some. Neel Kashkari, the new president of the Federal Reserve Bank of Minneapolis, used his first official address to propose "breaking up large banks into smaller, less connected, less important entities." That sounds simple enough, but the devil would lie into the details. Among the critical questions would be:

- How big is too big?
- Would "big-ness" be defined simply by asset size or by dominance in a particular business line or region? Would it be defined domestically or globally?
- How would prospective divestitures be redistributed? How would shareholders be compensated for forced dispositions?
- What unintended consequences would ensue?

Believe it or not, making big banks smaller may make the system less resilient.





Sources: Federal Reserve, ECB, The Clearing House

If not designed intelligently, a breakup of megabanks could increase systemic risk instead of reduce it. Lending portfolios and business lines within a firm would become less-diverse. And while supervisors might think they can handle the failure of a more modestly sized institution without incident, the potential for shock and contagion in that event would remain high.

European banking seems to be moving in an opposite direction. In Italy, a large bank merger was consummated last month at the behest of the prime minister and the ECB. The consolidation is viewed as a means to strengthen the Italian financial sector, which continues to struggle with credit problems and has fared poorly in the ECB's stress tests.

The key to the transaction was the ECB's insistence that the combined organization strengthen its capital levels. These added reserves serve two purposes: they stand ready to absorb losses that might emerge from the lending portfolio, and they reduce the chance that the government (or by inference, taxpayers) would have to offer a costly bailout. With more of their own money at risk, shareholders would presumably make wiser choices.

Broader capital bases and regular stress testing for big banks are not European creations; they were imported from the United States. Risks consolidated in a large organization may be easier to secure with tight controls on capital and liquidity. So while it may be viscerally tempting to mandate the breakup of banks, the system may be safer if we leave them large.