

The central banker's *Brahmastra*

QE may have outlived its effectiveness. Is it time to drop money from helicopters, as Milton Friedman and Ben Bernanke once argued?

ALOK SHEEL

It has long been known that the limits of conventional monetary policy are reached when interest rates are lowered to the zero bound, inflation rates drop, the output gap grows, and there is still little demand for credit. This is the liquidity trap into which Japan fell in the 1990s, as did much of the developed world in the wake of the recent global financial crisis.

In such circumstances, central banks may be constrained to resort to unconventional monetary policy — expanding money supply not only through the discount window, but also through purchase of long-term government assets (quantitative easing, or QE) and/or private assets (credit easing, or CE). This can neutralise the sharp decline in the money multiplier owing to rapid deleveraging in a financial crisis. The liquidity injections are also expected to stimulate growth by stimulating both investment (by keeping the cost of credit cheap) and consumption (through the wealth effect of appreciating asset prices).

The signal triumph of QE and CE during the recent financial crisis was in having forestalled deflation. Milton Friedman advanced the theory, in his monumental *A Monetary History of the United States 1867-1960*, that it was the US Federal Reserve's failure to pump in large amounts of liquidity to counter deleveraging, and the consequential decline in the money multiplier, that led to deflation and the Great Depression of the 1930s. On Friedman's 90th birthday in 2002, the current Chairman of the Federal Reserve — Ben Bernanke, another authority on the Great Depression and then a Fed governor — acknowledged that it was indeed the Fed that was responsible for the Great Depression.

Bernanke was perhaps less than fair to those at the helm of the Fed in the 1930s. The US was on the gold standard, and could not, therefore, print currency by fiat. The US went off the gold standard for a while in the 1930s, following which it was able to inject more liquidity into the financial system, and this helped to stabilise the financial system.

The post-War Bretton Woods system, however, restored the gold standard, which continued right up to President Nixon's announcement in 1971 that the value of the dollar would no longer be linked to gold but to, well, the dollar! QE is a monetary tool of the fiat currency era, since there is now no limit on



BINAY SINHA

how much currency can be created.

The first real-life experiment with QE was done by Japan following the financial crisis triggered by the collapse of the real estate boom in the 1990s. The Japanese experiment, however, could prevent neither deflation nor recession. Bernanke famously argued that this was because Japan's QE was far too timid. In hindsight, in the light of the much more aggressive QE by the Fed, and consequential better outcomes, this appears to be a valid argument.

This "bond-financed tax cut" has, however, spectacularly failed in countering the liquidity trap. Most of the liq-

uidity pumped into financial markets is simply coming back to the Fed as bank deposits — which are now at record levels, and still rising.

Monetary policy transmission channels remain broken. The wealth effect of asset appreciation has not translated into consumption demand; low borrowing costs have failed to stimulate investment; the tax on savings has slowed deleveraging; spillovers have fuel fears of currency war and distorted commodity and gold prices.

"Helicopter drop" has never been tried so far — too small a bank cheque might be saved by households, and too large could unanchor inflationary expectations

So, would a "money-financed tax cut", where the central bank simply injects freshly minted money into the economy directly — say by mailing cheques to households or to the Treasury, instead of purchasing Treasury or private assets — work, as recently argued by Lord Adair Turner? This is the famous "helicopter drop" (HD) of Friedman, advocated so strongly by Bernanke some time ago that he has been known as "Helicopter Ben" ever since.

This is a fair question. In several respects, the outcomes of QE and HD are similar; but their differences are also crucial. First, there is a permanent increase in money supply, which is a downside. But excessive liquidity can always be mopped up by the central bank when the money multiplier normalises with the return of private demand through allocation of new treasury bonds directly to the central bank. Second, in this manner, the central bank can bypass the financial system, where transmission channels are broken, and provide liquidity directly to the end user.

In such a situation, the central bank would operate something like a cross between Santa Claus and a retail bank. Imagine this: Santa Claus dressed as a smart retail banker with a scholarly backpack, rather than in the familiar red and white garb with a sackful of toys slung over his shoulder; he is piloting a helicopter in choppy weather instead of being driven through freshly laid snow on a sleigh by Rudolph; and he is dropping bank cheques, instead of toys assets, down the chimney into the state treasury and/or stuffing peoples' Christmas stockings.

HD has never been attempted so far. Central bankers can go where none has gone before, the final monetary frontier. As such, HD is perhaps the final arrow in their monetary quiver — and strapped, as it happens, to the back of a person whose name is indelibly linked with this arrow.

Why has this arrow not been used so far, despite the very limited success with QE and CE? Instead, the burden of stimulus seems to have shifted back to long-discredited fiscal policy — by its very nature too political to be an effective and sustainable stabilization tool. Is this possibly because of a lurking fear that HD could be akin to the "*Brahmastra*" — the proverbial double-edged weapon of last resort of Hindu mythology capable of extensive collateral damage? Too small a cheque might be saved by households. But too large a cheque could completely unanchor inflationary expectations. Or, worse, if the central bank, usually perceived as a conservative and stabilising institution, is now seen to be a technology incubator, it might drive the fear of God into households regarding the future of fiat currency itself, making them reach for you-know-what — more gold.

The writer is secretary of the Prime Minister's Economic Advisory Council. These views are his own