No helicopter drops of cash from the Fed
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Can monetary policy do more to support a listless economy? Weak data and concerns about a possible double dip in the United States and Europe have brought this question to the fore.

With the interest rate instrument already pushed to the limit, Federal Reserve chairman Ben Bernanke has been urged to use the unconventional balance sheet instruments sometimes called quantitative easing (QE). Paul Krugman has even revived the memorable suggestion of Milton Friedman that the Fed should carryout a "helicopter drop" of money.

In 2002 Bernanke (then just a Fed member, not its chairman) argued that the Fed, in the face of disinflation, ha other effective policy options once interest rates had been lowered to zero. He even raised the possibility of a helicopter drop. So what options are available to central banks now when interest rates are close to zero?

Some commentators see QE as simply adding more cash (base money) to the system. Friedman certainly thought in those terms: "more money" would "chase more goods", boosting demand as it was multiplied through the credit creation process.

Monetary policy, however, no longer works like this (if it ever did).

In normal circumstances, base money is "demand determined". A central bank would not increase base money beyond the normal demand for it, because the excess money would drive down the rate of interest – the principal instrument of monetary policy. But if the policy interest rate is already at zero, it is possible to expand base money without upsetting the interest rate setting, since it can't go lower.

The extra base money, in itself, won't do much to boost demand and economic activity. It will simply build up in the balance sheets of the commercial banks because they are already doing as much lending as they want to.

That said, there might still be a positive effect from expanding money. Any such effect will come not from the extra base money, but from the counterpart transactions when the central bank carries out open market operation. A central bank doesn't give away its cash: it exchanges base money for an asset held by the public. Just what assets it buys will determine how effective QE is.

The obvious candidate is government bonds, the traditional form of open market operation. The Bank of England's QE operations have bought a quarter of the total stock of government bonds. This is also what the Bank of Japan did in its QE in 2001-2004.

But this has little effect on bond yields. The yield curve is anchored by the term structure of interest rates: bond yields are roughly equal to the expected short-term interest rate over the life of the bond. Thus the shape of the yield curve depends more on what the market thinks the future policy rate will be, rather than on the volume of bonds bought by the central bank. A credible Fed promise to keep interest near zero for longer would have more impact.

In any case US bond yields are already low: two-year bonds are paying well under 1 per cent, so there is not much room to fall. There is no clear evidence, either from Japan or the UK, of any significant impact on economic activity from the massive QE operations there.

The US has already shown a more powerful version of QE. Since October 2008 the Fed has spent more than $US 1 trillion buying private sector securities – much of it the sort of debatable-quality securities that funded the excessive housing lending in the first place. The Fed's purchases aimed to revive the liquidity in the mortgage securities market and provide continuing funding for housing.

Let's hope that the Fed has bought securities that are basically sound but were unfairly penalised in the market funk after the Lehman collapse. But even if the Fed makes some losses, these operations will have served the function of getting this market going. Thus this approach is likely to prove an effective, if risky, option. If the Fed has bought well, it will also prove profitable.

But QE in the US might now have been pushed to its useful limit. Voices in Congress are arguing that enough has been done and markets should be left to find their own equilibrium.

What, then, about the famous helicopter drop? While Bernanke did discuss the idea in his 2002 speech, he mad a clear distinction between this approach and the other QE options. In normal open market operations the Fed gets something in return for its cash: bonds or private securities. It doesn't just push money out the door.

Governments, on the other hand, sometimes do a helicopter drop in the form of cheques sent out to the general public. Even Australia did this. And it works. But it's not monetary policy – it's fiscal policy. Fiscal policy requires the full governance processes. Policy can't bypass the legislature by getting the central bank to do a stimulus that Congress will not authorise.

Monetary policy is given independence and a degree of freedom from the legislature because it is usually a fairly technical operation, best left to the technicians. But a helicopter drop, or sending out cheques to the general public, clearly needs full legislative constraints, and the central bank is not the vehicle for it.

Other members of the Fed board are, at best, lukewarm about the idea of further QE. They have not articulated their concerns very explicitly but they understand the general point that central banks need to keep a tight rein over their funding of government spending. They certainly aren't going to be pushing any money out the helicopter doors.

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