AQUILA

Flash

Helicopter money – Highly dangerous

Even though central banks are pursuing a monetary expansion with no historical parallels, the world economy can't manage to grow faster than 3%. Given this, the demands from various quarters that central banks ratchet up the pace of monetary expansion are scarcely surprising. But there are also widespread doubts as to the effectiveness of the policies that have so far been followed and some economists now argue for an even more radical approach, with respect to both fiscal and monetary policy. Proposals include the unlimited expansion of the money supply, the provision of "helicopter money" and a ban on the use of cash. We believe all these proposals are highly dangerous. The repeated flooding of markets with liquidity will render interest rates useless as a tool for steering capital flows. Cost free money is money whose value is questionable. It's only a short step from here to a loss of confidence in paper or central bank money. Once trust in paper money is lost, a return to a barter economy or a monetary reform threatens. Given the risks of a loss of confidence in cash, investors should focus on "real assets" and avoid "nominal assets".

The world economy can't manage to grow faster than 3%.

Since 2008, the world's central banks have undertaken over 500 measures of monetary easing. Even so, the world economy has not managed a better than 3% growth rate. Indeed the US seems to be the only major robust economy. As for the Eurozone, one has to question just how strong its current expansion would be without the supports of a weak currency, low oil prices and an increasingly activist ECB. Meanwhile, the recent flow of disappointing data on Japan casts doubt as to whether that economy has managed to grow at all in the third quarter. China is still an engine for growth but one with fading momentum. Unsurprisingly, fears as to the strength of the global economy have plagued markets since mid-August.

The ECB and BoJ are set to ratchet up their pace of monetary expansion.

In this environment, the calls from various parties for a ratcheting up of the monetary expansion are scarcely surprising. And the central banks have already started to respond. Thus Mario Draghi in the ECB's latest press conference stated that the Eurozone's central bank would not hesitate to use all the monetary tools at its disposal. Similar comments have come out of the Bank of Japan recently. Our assessment, that the ECB might extend its QE program to 2,500 bn. euros worth of bond purchases and allow it to run for an extra 2 years, was recently supported by Standard & Poors. Regarding the Bank of Japan, comment tends to focus on whether the next ratcheting up of monetary expansion will be announced this October or next April. Meanwhile, there is increasing comment that the policies pursued thus far are inappropriate as they will not stimulate investment in the real economy. It is therefore not surprising that some economists now propose much more drastic measures of fiscal and monetary expansion in order to prevent the global economy from sliding into another recession.

Some see salvation for the world economy in Helicopter money.

Renowned money manager Bill Gross says that, given their disappointing experiments with monetary policy, governments should now focus on fiscal policy as the way to breathe life into the world economy and to push up price levels. The fact that budget deficits are already groaning under the weight of debt service charges is seen as no barrier to a shift in this direction. Mr. Gross suggests the combination of tax cuts and increased public spending. Central banks would be forced to cover the additional government borrowing through purchases of government bonds. Thus the balance sheets of the central banks would be permanently raised by an unlimited quantitative easing. Meanwhile Willem Buiter, Chief Economist at Citigroup says only Helicopter money can save the world from impending recession. The idea of Helicopter money, which should be dropped on us all like Manna from Heaven, goes back to the monetarist economist Milton Friedman, who thought it could boost both consumer spending and inflation. Elsewhere, Harvard Professors Larry Summers and Kenneth Rogoff argue for a ban on cash so that the negative interest rate policies now being pursued by various central banks would have more leverage.

Money which has no cost is money with no value.

All these smart ideas revolve around the notion that something can be conjured out of nothing. If they were coming from individuals of no particular standing one might be able to write them off easily as worthless. The fact that respected experts are making such suggestions is highly disturbing. We view all the ideas outlined above as extremely dangerous. An even greater flooding of the markets with liquidity will render interest rates useless as a tool for steering capital flows. The resulting misallocation of capital could have consequences that include allowing an obsolete capital stock to stay in place and the development of asset bubbles which sooner or later have to burst. Money which has no cost is very close to money which has no value. It's easy to imagine a loss of confidence in paper, or central bank, money. Once that happens, the way is open to the return of a barter economy or monetary reform.

Given the risk of a loss of confidence in central bank money, investors should focus on real assets.

We fear that circumstances could force the world's central banks down the path of unlimited quantitative easing and Helicopter money. Admittedly, investors might at first react positively if current policies of QE were to mutate in this direction. But we believe that any resulted gains in the financial markets would be temporary. Given the risks of a loss of confidence in paper money, investors should now favor real assets over nominal ones.

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