# Economics 101

## "Helicopter Speech" – 10 years later

**Foreword:**

This autumn we commemorate the 10th anniversary of the famous helicopter speech given by Ben Bernanke. We take this occasion to review this controversial paper that is so often cited by financial market experts.

In his *Deflation: Making Sure "It" Doesn't Happen Here* (*) then Fed-member Bernanke, who became chairman in 2006, outlined unconventional tools available to a central bank to stimulate aggregate demand once policy rate falls to zero percent.

In November 2002, when his essay got published (rates stood well-above 0%), it was largely recognized as an open mouth policy maneuver with the aim to give investors' confidence to return to risky assets after more than two years of stock market decline.  The paper was well-timed as it marked almost the bottom of the bear market. In the following five years the S&P 500 index doubled and everything seemed to be fine…

By spring 2007, however, the housing bubble started bursting and in the following months policy rates were slashed to zero. Still, despite record low Fed fund rates the financial system continued to suffer from extreme instability and economic indicators began to drop sharply going into summer 2008 - the time was finally ripe to implement the unconventional tools discussed in November 2002.

In the following five years Mr. Bernanke made use of many of those exceptional measures with the aim to:

1) repair the financial system and stabilize financial markets during (2007-2009)
2) prevent deflation by pushing up consumer price inflation as they temporarily dropped below zero percent on a year-on-year basis (2010).

In the following we will pass review all the programs implemented thus far and will describe the two tools left in Mr. Bernanke's arsenal.

**Facts:**

Dr. Bernanke made clear in his legendary essay that central banks should take measures that prevent from falling into deflation and, should it nevertheless happen, he proposed how to cure it.

Concretely, in the *preventing* –section the paper says:
*First, the Fed should try to preserve a buffer zone for the inflation rate, that is, during normal times it should not try to push inflation down all the way to zero.*
As we know by now, the Fed chairman has convinced his FOMC colleagues to implement a "price stability level" that got fixed at 2% (announced January 25, 2012). In other words, 2% annual inflation means price stability; but that means also that inflation rates below 2% are viewed as deflationary and needs to be "addressed"…

*Second, the Fed should take most seriously…its responsibility to ensure financial stability in the economy.*
Concretely, he talked about the link between violent financial crises leading to "fire sales" of assets impacting negatively aggregate demand and, in the following, the general price level. During the current financial crisis the US central bank did indeed offer services to financial institutions under stress – using programs called, e.g., TARP the Fed took over risky assets from banks, brokers and other financial institutions that were otherwise not sellable or at massively lower prices only.

*Third,…, when inflation is already low and the fundamentals of the economy suddenly deteriorate, the central bank should act more preemptively and more aggressively than usual in cutting rates.*
In July, 2007 the Fed Fund rates stood at 5.25% - by November 2008 this key policy rate got basically lowered to zero percent (0,25%). Mission accomplished, again.

As the *preventing*-section above perfectly matched Mr. Bernanke's promises made in late 2002, let's now analyze the *curing*-part of deflation:
In this paragraph, he first delineates that under a fiat (paper) money system a central bank should always be able to generate increased nominal spending and inflation. He states *"…But the U.S. government has a technology, called a printing press … that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation…the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services…"*. (Because of this particular paragraph his essay was titled "Helicopter Speech").

In the following, he then lists and explains still other policies at the Fed's disposal to prevent or cure deflation. These are:

- ✓ Expanding the scale of its asset purchases (implemented)
- ✓ Expanding the menu of assets that it (Fed) buys (implemented)
- ✓ Lowering rates further out along the Treasury term structure (implemented)
- ✓ Committing to hold the overnight rate at zero for some specific period (implemented)
- ✓ Using existing authorities to operate in the markets for agency debt (implemented)
- ✓ Attempting to influence directly the yields on privately issued securities through lending against assets deemed eligible as collateral using the discount window (implemented)

but also:

- o Announcing explicit ceiling for yields on longer-maturity Treasury debt (not yet implemented)
- o Buying foreign government debt (not yet implemented)

So, let's then discuss in more details the two bullets left.

Explicit ceiling for yields on longer-maturity Treasury debt:
A ceiling on interest rates of US Treasuries notes and bonds (or even GSE's) would be seen by investors as a free put-option on prices (call on rates). Even though yields would stay low in nominal terms, bond investors would be attracted to buy those debts close to the ceiling's fixed rate in an environment of a positive yield curve – as a result the Fed would most likely not even need to buy large amounts of such papers, very similar to what happened from the early 1940s to 1951. The PIMCOs of this world and other astute fixed income investors would find ways to offer bond strategies delivering return even higher than the ceiling; as an example, one could borrow short and invest long on a leveraged basis as to improve returns. Also, corporate bonds offering better yields than Treasury would attract investors' interest, pushing down rates for private debts closer to the ceiling over time.

From the perspective of borrowers (companies) the better visibility for future refinancing conditions would incite them on aggregate to make better use of their accumulated cash hoardings – returning money to shareholders (share buy-backs or dividends) or re-invest into their core businesses come to mind. Some other firms would even use the low borrowing conditions to leverage business or their balance sheets. All in all, a rather bullish scenario for equity investors.

A new dimension of this policy response should arise the day when inflation rate will surpass the official rate ceiling, resulting in negative real interest rates. Carmen M. Reinhart and M. Belen Sbrancia well-described in *The Liquidation of Government Debt* (**) the process and implications of negative real interest rates respectively the wealth transfer from creditors to debtors, better known as "Financial Repression".

Then, at the latest, those who still hold cash or have access to credit will start consuming or investing as to avoid a loss in purchasing power of money. The velocity of money would accelerate rapidly.

Buying foreign government debt:
The possible purchase of foreign denominated assets (government debt or others) on behalf of the Fed is in our opinion the real monetary policy bazooka. That's because buying foreign government debts goes with an equivalent amount of US Dollar selling, sending a clear message to financial markets: "Washington" follows a *weak dollar policy*!

Let's assume the Fed would announce the purchase of foreign government debts for the counter value of USD 500billions. The US central bank would need to buy those various currencies in the open market to pay for the assets it transacts. Simultaneously, as to finance those bonds it would need to sell freshly printed US dollars in the FX-market. Without any doubt that would send the Greenback lower within hours. (An even more aggressive approach would be the purchase of foreign currencies only, as further to the increase in US dollars in circulation, those foreign currencies would disappear from the market, making them less available. At this stage such a double-whammy strategy seems rather unlikely as, if non-coordinated with the other foreign currency countries, it would be viewed as the classical "beggar your neighbor" policy.)

Buying foreign denominated assets directly lowers the dollar exchange rate against competing economic blocks or countries. US produced goods and services become cheaper internationally, leading to increased exports. Simultaneously, imports would get more expensive boosting domestic final demand at the expense of imports. Very quickly corporations would start hiring people to increase investments and production.

**Looking forward:**

Thus far, Fed chairman Bernanke proved to be very determined with respect to the implementation of unconventional tools presented 10 years ago in his "Deflation: Make Sure it Doesn't Happen Here".

Today with financial market stability restored and price inflation close to its own defined target, can the Fed sit back and be complacent?

Our answer to that question is clearly "no" and we point to another highly important task the US central bank finds in its own mission statement(***): "…*conducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment."* (emphasis added) Undoubtedly, this is the key topic at the Federal Open Market Committee. At many occasions this year already the Fed chairman and other members stated that the unemployment rate stays at unacceptable high levels.

To sum it up, the Fed acknowledges its responsibility to help improving the unemployment situation but questions the repeat of previous programs because of their diminishing returns. Based on this information it seems almost obvious that the Fed chairman would propose to his colleagues the implementation of the two bullets left from his "2002-arsenal": the fixing of a Treasury yield ceiling and/or the purchase of foreign government debts.

Especially the purchase of foreign government bonds would send a shock wave through financial markets and give a very strong signal to US-domestic and international businesses that products *"Made in USA"* would be supported by a weak dollar policy going forward. Job perspectives would rise almost overnight.

Should one of these measures be implemented (maybe announced at the upcoming Jackson Hole meeting) we would expect another risk-on period with clear investors' preferences for real assets: among others, we would anticipate precious metals and, in particular, mining shares to outperform on an absolute and relative basis just like in the 2008-09 period. US export-oriented companies and multinationals should also be considered, although on a USD-hedged basis only.

Get mentally prepared for the unexpected!

CH-Nyon, August 2012-ug

References:
(*) http://www.federalreserve.gov/boarddocs/speeches/2002/20021121/default.htm
(**) www.imf.org/external/np/seminars/eng/2011/res2/pdf/crbs.pdf
(***) www.federalreserve.gov/aboutthefed/mission.htm