

HOW TO REVERSE A DEFLATION: HELICOPTER BEN NEEDS TO DROP SOME MONEY ON MAIN STREET

Ellen Brown, September 8th, 2010
http://www.wefofdebt.com/articles/bernanke_helicopters.php

The Fed is proposing another round of "quantitative easing," although the first round failed to reverse deflation. It failed because the money went into the coffers of banks, which failed to lend it on. To reverse deflation, the money needs to be funneled directly to state and local economies.

In 2002, in a speech that earned him the nickname "Helicopter Ben," then-Fed Governor Bernanke famously said that the government could easily reverse a deflation, just by printing money and dropping it from helicopters. "The U.S. government has a technology, called a printing press (or, today, its electronic equivalent)," he said, "that allows it to produce as many U.S. dollars as it wishes at essentially no cost." Later in the speech he discussed "a money-financed tax cut," which he said was "essentially equivalent to Milton Friedman's famous 'helicopter drop' of money." You could cure a deflation, said Professor Friedman, simply by dropping money from helicopters.

It seems logical enough. If there is insufficient money in the money supply (deflation), the solution is to put more money into it. But if deflation is so easy to fix, then why has the Fed's massive attempts to date failed to do the job? At the Federal Reserve's Jackson Hole summit on August 27, Chairman Bernanke said he would fight deflation with his whole arsenal, including "quantitative easing" (QE) – purchasing longterm securities with money created on a computer. Yet since 2008, the Fed has added more than \$1.2 trillion to "[base money](#)" doing just that, and the economy is still in a serious deflationary spiral. In the first quarter of this year, the money supply actually [shrank](#) at a record annual rate of 9.6%.

Cullen Roche at [The Pragmatic Capitalist](#) has an answer to that puzzle. He says that as currently practiced, quantitative easing (QE) is *not* really a money drop. It is just an asset swap:

"[T]he Fed doesn't actually 'print' anything when it initiates its QE policy. The Fed simply electronically swaps an asset with the private sector. In most cases it swaps deposits with an interest bearing asset."

The Fed just swaps Federal Reserve Notes (dollar bills) for other assets (promissory notes or debt) that can quickly be turned into money. The Fed is merely trading one form of liquidity for another, without raising the overall water level in the pool.

The mechanics of how QE works were revealed in a remarkable segment on [National Public Radio](#) on August 26, describing how a team of Fed employees bought \$1.25 trillion in mortgage bonds beginning in late 2008. According to NPR:

"The Fed was able to spend so much money so quickly because it has a unique power: It can create money out of thin air, whenever it decides to do so. So . . . the mortgage team would decide to buy a bond, they'd push a button on the computer – 'and voila, money is created.'

"The thing about bonds, of course, is that people pay them back. So that \$1.25 trillion in mortgage bonds will shrink over time, as they get repaid. Earlier this month, the Fed announced that it will use the proceeds from the mortgage bonds to buy Treasury bonds – essentially keeping all that newly created money in circulation. The decision was a sign that the Fed thinks the economy still needs to be propped up with extraordinary measures."

"Extraordinary measures" was a reference to Section 13(3) of the Federal Reserve Act, which allows the Fed in "unusual and exigent circumstances" to buy "notes, drafts and bills of exchange" (debt instruments) from "any individual, partnership or corporation" satisfying its requirements. The Fed was supposedly engaging in these extraordinary measures to "reflate" the money supply and get credit flowing again. Yet the money supply continued to shrink. The problem, as Roche explains, is that the dollars were merely being swapped for other highly liquid assets on bank balance sheets. That this sort of asset swap will not pump up a collapsed money supply has been shown not only by the Fed's failed experiments over the last two years but by two decades of [failed QE policy](#) in Japan, an economy which remains in the deflationary doldrums. To reverse deflation, it seems, QE needs to be directed somewhere else besides the balance sheets of private banks. What we need is the sort of helicopter drop described by Bernanke in 2002 – one over the towns and cities of the real economy.

There is another interesting lesson suggested by two decades of failed QE: it *might* actually be possible for the government to "print" its way out of debt, without triggering the dreaded hyperinflation long warned of by pundits. Swapping dollars for debt hasn't inflated the circulating money supply to date because federal debt securities already serve as forms of "money" in the economy.

The Textbook Money Multiplier Model . . . And Why It Is Obsolete

Beginning with some definitions, "[quantitative easing](#)" is explained in *Wikipedia* like this:

"A central bank . . . first credit[s] its own account with money it has created *ex nihilo* ('out of nothing'). It then purchases financial assets, including government bonds, mortgage-backed securities and corporate bonds, from banks and other financial institutions in a process referred to as open market operations. The purchases, by way of account deposits, give banks the excess reserves required for them to create new money, and thus a hopeful stimulation of the economy, by the process of [deposit multiplication](#) from increased lending in the fractional reserve banking system."

"Deposit multiplication" is the textbook explanation for how credit expands as it circulates through the economy. In the textbook model, banks must retain "reserves" equal to 10% of outstanding deposits (including deposits created as loans). With a 10% reserve requirement, a \$100 deposit can support a \$90 loan, which gets deposited in another bank, where it becomes an \$81 loan, and so forth, until a \$100 deposit becomes \$1,000 in credit-money.

The theory is that increasing the banks' reserves will stimulate this process, but both the Federal Reserve and the Bank for International Settlements (BIS) now concede that the process has not been working in the

textbook way. (The BIS is "the banks' central bank" in Basel, Switzerland.) The futile effort to push more money into bloated bank reserve accounts has been compared to adding more apples to shelves that are already overstocked with apples. Adding more reserves to a banking system that already has more reserves than it can use has *no* net effect on the money supply.

The failure of QE either to increase bank lending or to inflate the money supply was confirmed in a March 24 paper by Federal Reserve Vice Chairman [Donald L. Kohn](#), who wrote:

"The huge quantity of bank reserves that were created [by quantitative easing] has been seen largely as a byproduct of the purchases [of debt instruments] that would be unlikely to have a significant independent effect on financial markets and the economy. This view is not consistent with the simple models in many textbooks or the monetarist tradition in monetary policy, which emphasizes a line of causation from reserves to the money supply to economic activity and inflation."

The textbook model is obsolete because banks don't make lending decisions based on how many reserves they have. They can always get the reserves they need. If customers don't walk in the door with new deposits, the bank can borrow deposits from other banks, something they can now do at the very low Fed funds rate of .2% (1/5th of 1%). And if those deposits are not available, the Federal Reserve itself will supply the reserves. This was confirmed in a [BIS](#) working paper called "Unconventional Monetary Policies: An Appraisal", which observed:

"[T]he level of reserves hardly figures in banks' lending decisions. The amount of credit outstanding is determined by banks' willingness to supply loans, based on perceived risk-return trade-offs, and by the demand for those loans. . . .

"The aggregate availability of bank reserves does not constrain the expansion [of credit] directly. The reason is simple: . . . in order to avoid extreme volatility in the interest rate, *central banks supply reserves as demanded by the system*. From this perspective, a reserve requirement, depending on its remuneration, affects the cost . . . of loans, but does not constrain credit expansion quantitatively. . . . [A]n expansion of reserves in excess of any requirement does not give banks more resources to expand lending. It only changes the composition of liquid assets of the banking system. *Given the very high substitutability between bank reserves and other government assets held for liquidity purposes, the impact can be marginal at best.*"

Again, one form of liquidity is just substituted for another, without changing the overall level in the pool.

If bank reserves do not constrain bank lending, what does? According to the BIS paper, "the main . . . constraint on the expansion of credit is minimum capital requirements." These capital requirements, known as "Basel I" and "Basel II," were imposed by the BIS itself. It is interesting that the BIS knows that the main constraints on bank lending are its own capital requirements, yet it is talking about [raising](#) them, in an economic climate in which lending is already seriously impaired. Either the BIS is talking out of both sides of its mouth, or its writers don't read each other.

A Solution to the Federal Debt Crisis?

Another interesting aside arising from all this is the suggestion that the government *could* actually print its way out of debt – it could print dollars and buy back its bonds -- *without* creating inflation. As Roche observes:

"[Quantitative easing] in time of a balance sheet recession *is not actually inflationary at all*. With the government merely swapping assets they are not actually 'printing' any new money. In fact, the government is now essentially stealing interest bearing assets from the private sector and replacing them with deposits. . . . [T]his policy response would in fact be **deflationary – not inflationary.**"

Roche concludes, "the *inflationistas* have been wrong and the USA *defaultistas* have been horribly wrong." The "inflationistas" are the pundits screaming that QE will end in hyperinflation, and the "defaultistas" are those insisting that the U.S. must eventually default on its debt. Representing both camps, for example, is [Richard Russell](#), who writes:

"In my opinion, the **US MUST default on its debt**. There are two ways to default. One is simply to renege on the debt. . . . The other way to default on the debt is to **inflate it away**. I'm absolutely convinced that this is the path that the US will take. If the US inflates enough, then over time (many years) the devalued dollar will tend to reduce the power of the debts."

The failed QE experiments in Japan and the U.S. suggest, however, that there is a third alternative. Printing dollars to pay the debt (referred to by Russell as "inflating the debt away") might actually eliminate the debt *without* creating inflation. This is because federal bonds and Federal Reserve Notes are interchangeable forms of liquidity. Government securities trade around the world just as if they were money. A \$100 bond represents a claim on \$100 worth of goods and services, just as a \$100 bill does. The difference, as Thomas Edison said nearly a century ago, is merely that "the bond lets money brokers collect twice the amount of the bond and an additional 20%, whereas the currency pays nobody but those who contribute directly in some useful way. . . . Both are promises to pay, but one promise fattens the users and the other helps the people."

The Fed's earlier attempts at QE involved swapping \$1.25 trillion in mortgaged-backed securities (MBS) for dollars created on a computer screen. As noted in the NPR segment, many of those securities have come due and have gotten paid off, putting cash in the Fed's till. The Fed now proposes to use this money to buy long-term Treasury debt rather than MBS. That means the Fed will, in effect, be buying the government's debt with dollars created on a computer screen. The privately-owned Federal Reserve is not actually an arm of the federal government, but if it were, the government would thus be printing its way out of debt – just as Helicopter Ben proposed in 2002. Recall that he said, "*the U.S. government* has a technology, called a printing press" – the U.S. government, not the central bank that has done all the QE to date.

Running the government's printing presses to pay its bills has not seriously been tried since the Civil War, when President Lincoln saved the North from a crippling war debt at usurious interest rates by printing [Greenbacks](#) (U.S. Notes). [Other countries](#), however, have tested and proven this model more recently. They include Germany, which pulled itself out of a massive financial collapse in the early 1930s by printing a form of currency called "MEFO bills"; and Australia, New Zealand and Canada, all of which successfully funded public works in the first half of the twentieth century simply by advancing the credit of the nation. China, Malaysia, Guernsey, Jersey, India, Argentina and other countries have also revived their economies at critical times by this means. The U.S. government could do this too. It could print dollars (or type them into electronic bank accounts) and spend the money on the sorts of local public projects that would put people back to work and get the economy rolling again.

How to Reverse a Deflation: Do a Helicopter Drop on the States

The government *could* pay its bills by issuing Greenbacks as Lincoln did, but it probably won't, given the current deadlock in Congress. Today only the Federal Reserve Chairman seems to be in a position to act unilaterally, without asking anyone's permission. Chairman Bernanke could execute his own plan and generate the credit needed to get the economy churning again, by aiming his "quantitative easing" tool at the states. After all, if Wall Street (which got us into this mess) can borrow at .2%, underwritten by the Fed as "lender of last resort," then state and local governments should be able to as well. Chairman Bernanke could credit the Fed's account with money created *ex nihilo* (out of nothing) and swap it for state and municipal

bonds at the Fed funds rate.

A "state" might not qualify as an "individual, partnership or corporation" under Section 13(3) of the Federal Reserve Act, but a state-owned bank would. [Bruce Cahan](#), an attorney and social entrepreneur in Silicon Valley, California, proposes that the Fed could diversify its role by buying long-term bonds in existing or newly-chartered state-owned banks. These banks, which would have a mandate to serve state and local communities, would more quickly and accountably lend for in-state purposes than private banks do now. They could be required to use accepted transparency accounting standards to trace how the proceeds of their loans flowed into the economy. Local needs would thus determine how best to jumpstart and keep alive businesses and households that the "too big to fail" megabanks no longer want to fund on fair credit terms. Adding a state-owned bank would also bring competition to regional banking markets such as that of the San Francisco Bay area, which are now dominated by out-of-state megabanks. By funding state-owned banks, the Fed could inject "liquidity" where it is most needed, in local markets where workers are hired and real goods and services are sold.

Ellen Brown is an attorney and the author of eleven books. In [Web of Debt](#), her latest book, she shows how the Federal Reserve and "the money trust" have usurped the power to create money from the people themselves, and how we the people can get it back. Her websites are [webofdebt.com](#), [ellenbrown.com](#), and [public-banking.com](#).

[Home](#) | [Also by Ellen Brown](#) | [Links](#) | [Contact Us](#) | [Order Now](#)  [SHARE](#)

Select Language

Powered by  **Translate**

Site by Phoenix Development.

© Copyright 2007 Ellen Brown. All Rights Reserved.