QE, negative rates, helicopter money… What tools will the Fed use for the next recession in the United States?

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Fears about a possible recession in the United States have revived questions about the toolkit that the Fed could use in this case: negative rates, forward guidance, large-scale asset purchases, helicopter money… In this paper, we take stock of the evolution of the debates. In the event of a recession, the Fed should probably use the same tools as during the last decade (QE, forward guidance) but at a time when the central bank's independence is threatened, it remains relevant to look at measures such as than negative rates and helicopter money.

Despite a clear improvement in labor market conditions in the United States over the decade 2010-2019 and a historically accommodative monetary policy of the Federal Reserve (Fed below), inflation has remained low compared to what we could have waited. In October 2017, outgoing Fed vice-chairman Stanley Fischer even said: "We don't know what's going on with inflation."

However, the Fed had lowered its fed funds target range to 0 / 0.25% in December 2008 and left it at this level until December 2015. The concept of neutral rate, or even short-run equilibrium real rate, makes it possible to understand why the fact that the key rate has been at zero for a long period did not allow a rebound in growth and inflation as strong as expected. This rate, below which the real short rate is accommodative and above which it is restrictive, has been estimated between 0 and 1% over the last decade, whereas it was between 2 and 3% during the previous decade[1]. The reason for this decline is largely due to the decline of potential growth, itself partly caused by demographic factors (population ageing). As a result, the zero interest rate policy has had less impact than one might have expected in the past.

In a seminal paper from 2004[2], Vincent Reinhart and Ben Bernanke, president of the Fed between 2006 and 2014 and master-thinker of central bankers over the past two decades, indicated "*three strategies for stimulating the economy at an unchanged level of the policy rate*":

1) providing assurance to investors that short rates will be kept lower in the future than they currently expect, (what is now known as forward guidance),

2) changing the relative supplies of securities in the marketplace by altering the composition of the central bank's balance sheet

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[1] See the Laubach & William's estimates on the New York Fed's website.

[2] Bernanke B. and V. Reinhart, 2004, « Conducting Monetary Policy at Very Low Short-Term Interest Rates ».

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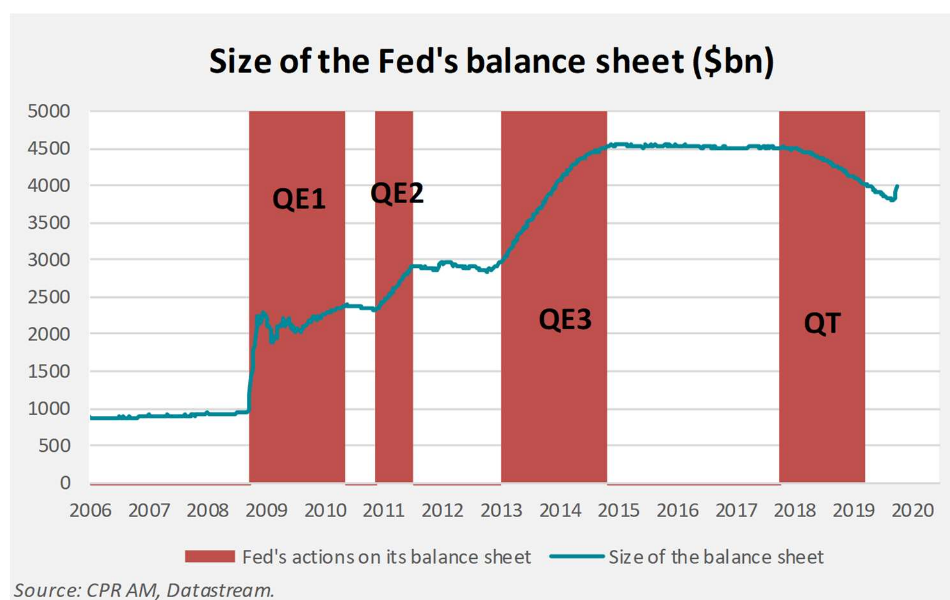
3) increasing the size of the central bank's balance sheet beyond the level needed to set the short-term policy rate at zero (what is now known as quantitative easing, QE, or quantitative easing).

We can only note that the three recommendations of the paper by Bernanke and Reinhart were followed to the letter by the Fed over the years which followed, with the implementation of a forward guidance policy having taken several forms, three operations of QE (QE1, QE2, QE3) and the "Operation Twist" (sale of short maturity securities to buy long maturity securities). These operations were also implemented under the direction of Bernanke himself. The central banks of the other major developed countries have adopted similar measures.



Source: CPR AM, Datastream.

Since Bernanke's departure from the Fed in early 2014, the Fed has made five rate hikes under the leadership of Janet Yellen and four rate hikes under the leadership of her successor Jerome Powell. The Fed has even started to reduce the size of its balance sheet in October 2017 (what is known as *Quantitative Tightening*), by not reinvesting a fraction of the securities it holds when they mature. In 2019, concerns about a possible US recession, which would have been partially caused by the trade war initiated by the Trump administration against several countries and in particular against China, as well as a sharp drop in long-term expectations have led the Fed to undo some of the monetary tightening undertaken in 2017/2018. Thus, the Fed lowered its fed funds target range three times in 2019 (to 1.50 / 1.75%), stopped its balance sheet reduction (QT) policy and even started buying assets again since October, mainly to relieve tensions on the interbank markets[3].

Given the low level of key rates, a debate is taking place on the tools that the Fed could mobilize in the event of a possible recession in the United States. In terms of new tools, Ben Bernanke had already outlined some options in 2016 in a series of articles[4]:

• Setting the fed funds in negative territory (like what the ECB and the Bank of Japan have done),

• Targeting long-term interest rates (similar to the Yield Curve Control implemented by the BoJ),

• Helicopter money.

In September 2019, Donald Trump has indicated that he wanted to see the Fed move its key rate into negative territory. A few days later, the Fed chairman Jerome Powell ruled out the idea of the Fed

[3] $60bn of T-bills per month through Q2 2020.

[4] Bernanke B., 2016, «What tools does the Fed have left? », Blog de la Brookings Institution.

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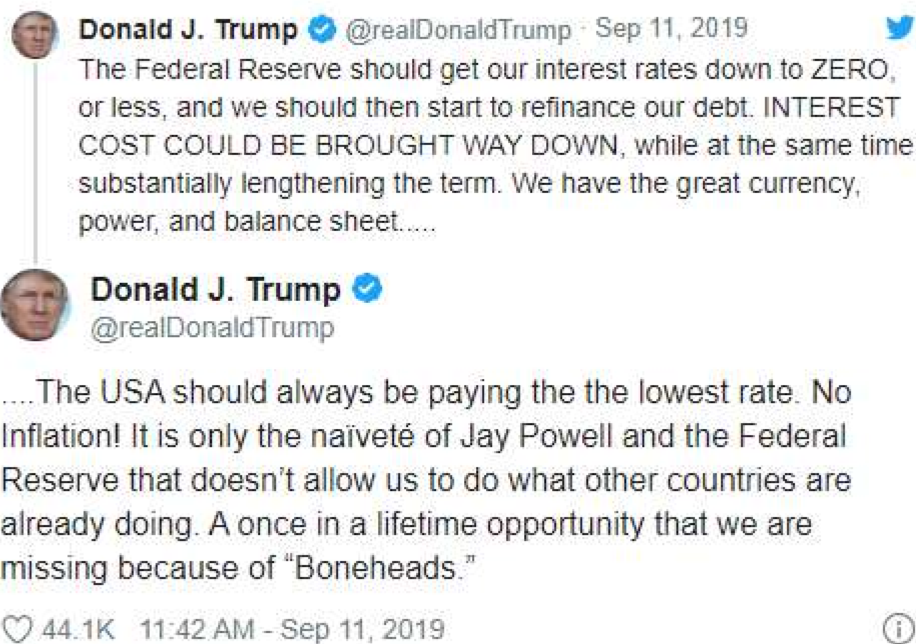
implementing a negative rate policy in the future and explained that the Fed would use QE and forward guidance policies in the event of a recession: « *I think if we were to find ourselves at some future date again at the effective lower bound—again, not something we are expecting—then I think we would look at using large-scale asset purchases and forward guidance. I do not think we'd be looking at using negative rates. I just don't think those will be at the top of our list* ». The minutes from the 2019 Fed monetary policy meetings suggest that asset purchases could be much larger in the next recession than during the past decade. Nonetheless, FOMC members are studying possible new tools that the Fed could use in this scenario as part of their strategic review.



In November 2019, Lael Brainard, a Board Governor, expressed some interest for the targeting of long-term interest rates, with the idea of establishing a cap for short to medium maturity rates. A few months earlier, the chairman and vice-chairman of the Board, Jerome Powell and Richard Clarida, had indicated their interest in this type of measure. Note that the Fed has already used this type of policy from 1942 to 1951[5]. While fixed quantities of securities are purchased under QE, the quantities of securities purchased under a rate targeting policy are not determined in advance. The objective is qualitative and not quantitative. In the *Yield Curve Control* policy of the Bank of Japan, the 10-year rate is the target.

The idea of helicopter money is not new. Already in 1969[6], Milton Friedman had provocatively described an emergency mechanism to restart inflation: throwing banknotes at the population from helicopters, making sure that everyone is convinced that this event would not be repeated afterwards. This idea has been brought up to date by Bernanke since a speech in 2002[7], which earned him the nickname of *Helicopter Ben*. Several formulations of this policy are possible. In the most common of them, the fiscal stimulus financed by monetary creation, the US government would increase the deficit (to stimulate demand, either by more spending or by tax cuts) and the Fed would finance this increase in deficit either 1) by crediting the account the Treasury has at the the Fed, or 2) by purchasing the new bonds issued by the Treasury. In either case, the Fed would commit that this monetary creation would be permanent. This induces a major difference with QE operations, for which the Fed has shown with QT that the central bank money created could be destroyed later.

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[5] "Treasury-Fed accord", Federal Reserve History.
[6] Friedman M., 1969, « The Optimum Quantity of Money ».
[7] Bernanke B., 2002, « Deflation: Making Sure "It" Doesn't Happen Here ».

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One of the advantages of a fiscal stimulus financed by monetary creation rather than by debt issuance (which is conventionally done) is that it avoids the problem of 'Ricardian equivalence' (when the fiscal stimulus financed by debt does not have the expected effects because households and businesses anticipate that an increase in the deficit today will be offset by an increase in taxes tomorrow).

On the other hand, one of the biggest difficulties of a helicopter money policy would be that a high degree of cooperation between the government and the Fed would be required to determine the amounts at stake. This could jeopardize the Fed's independence in the long run (in this regard, Donald Trump's repeated criticism of the Fed calls for caution). Improperly controlled and excessive use could prove disastrous. This is in large part why economists working on this policy warn that it must remain exceptional. In the case of the Fed, another problem would arise since the reserves held by the banks would increase sharply and permanently, but the Fed would pay interest on them, which would complicate any rate normalization afterwards and would make necessary the creation of other mechanisms.

In conclusion, in the event of a recession in the United States, the Fed should give priority to large-scale asset purchases and a return of the forward guidance. The form of asset purchases could differ from previous episodes possibly with the targeting of long-term interest rates, or even the introduction of a ceiling for these. The use of negative rates and a helicopter money policy is unlikely in the immediate future in the United States. However, their use cannot be ruled out, especially at a time when the independence of central banks is under threat.

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