THE WALL STREET JOURNAL.

WEDNESDAY, MAY 15, 2013

Bring on the 'Helicopter Money'

By DANIEL J. ARBESS

The economic recovery remains sluggish and uneven. Stock-market investors are benefiting while most everyone else struggles with subpar economic growth, wage stagnation, tight credit and poor job prospects. And with the rest of Washington gridlocked, the Federal Reserve's quantitative easing is the only economic policy game in town.

This makes the rising criticism of the Fed's policies especially significant. Any immediate "tapering off" of asset purchases would be an acknowledgment by the central bank that its policies are becoming counterproductive, not that the economy is in the clear. Yet there may be another financing tool that the Fed can use to help Washington re-engage in the fight against potential deflation.

Presently, the Fed is buying government bonds from banks; the banks are supposed to use the new money to lend more to private borrowers who invest the funds in new or growing enterprises. But the economic problem today is not the supply of credit—it is the lack of demand. Monetarists call this "pushing on a string."

After taking steep losses during the financial crisis, many households are repairing their "balance sheets" and in no mood to take on more debt. Willing borrowers, on the other hand, often fail to satisfy tighter post-crisis lending standards. So the Fed's new money stays in the financial sector chasing returns and, the Fed itself says, risking new bubbles as bond yields compress to record lows and equity valuations threaten to rip ahead of real economic and earnings growth.

Fiscal policy has become a headwind to the recovery, as higher payroll taxes and rising health costs take a bite out of household disposable income. Meanwhile, Washington's ongoing failure to pass coherent tax and regulatory policy keeps corporations from productively investing the $2 trillion sitting on their balance sheets.

Monetary impotence plus fiscal paralysis equals an inadequate recovery: GDP growth of around 2.5% is barely outpacing the 1.8% nominal inflation rate. Stock markets have recovered all of the $10 trillion lost in the recession, but homeowners are still $5 trillion underwater. According to the Pew Research Center, the highest-earning 7% of the population saw their net worth grow by 28% between 2009 and 2011, while overall the net worth of the remaining 93% of Americans dropped by 4%.

Were it not for the "wealth effect" brought about by the robust stock markets, the economy might not be growing at all. But the increased spending by investors hasn't boosted overall consumption enough to offset declines in the private-investment and government-spending components of GDP, both of which remain way below trend. Deflation is still a threat.

Government action remains necessary to help broaden participation and strengthen the recovery. The economy needs tax cuts, smart, job-providing government investments and corporate tax incentives to stimulate private investment. Yet there is no responsible budgetary headroom to finance these initiatives with more debt.

There is another possible solution. A decade ago in a widely noted speech, Ben Bernanke, then a Federal Reserve governor, encouraged Japan to finance tax cuts with money printed by the central bank and credited directly to the budgetary arm of the government without issuing any more interest-bearing debt. This idea was first proposed by Milton Friedman in 1948, who likened it to a "helicopter drop" of money for combating deflation. Today "helicopter money" is more politely called "overt monetary finance."

The Fed has already printed about $2.5 trillion of new money. Overt monetary finance might offer a more direct way to channel that money into the economy than trying to push debt through banks to the private sector. Such an approach would bypass the credit channel and send cash straight to the Treasury, where it would be deployed as directed by Congress.

The Fed would be making the equivalent of an equity investment in the Treasury, which is important because it is prohibited by law from directly buying Treasury debt. This mechanism might offer an optimum combination of fiscal and monetary stimulus without increasing private or public debt.

Seriously? Overt monetary finance does sound like a free lunch that could easily get out of hand, with Congress tempted to throw budgetary discipline to the wind. The risks of eventual inflation are obvious, even if the immediate goal is in fact to stimulate some inflation.

These risks need to be carefully analyzed, but they seem manageable. The Fed would remain independent and decide itself how much money to create by reference to strict and closely monitored employment and inflation targets.

Congress would have to fit its fiscal programs into the available funding envelope, instead of trying to tell the Fed how much to fund. Congress and the executive would also have to develop smart fiscal initiatives like tax relief that spur long-term job creation instead of gimmicks like "cash for clunkers." Once growth and inflation approach targets, the Fed would effectively redeem its investment in the Treasury by increasing reserve requirements, just as it says it might do as it exits from its current policy of quantitative easing.

Overt monetary finance is only a crisis-fighting tool. Once the economy stabilizes, the nation's elected leaders must find a responsible way to correct the nation's long-run budgetary imbalances.

Meanwhile, the Fed is loudly voicing it exasperation at the failure of fiscal policy makers to help in the fight to avoid deflation. "Helicopter Ben" hasn't resorted to overt monetary finance yet, but expect to see the idea attracting more attention at the Fed if real economic growth doesn't quicken very soon.

Mr. Arbess is a hedge-fund manager and partner at Perella Weinberg Partners.