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Macroeconomics US Inflation

An MMT response on what causes inflation

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This week in testimony to the Senate Banking Committee, Jay Powell, Chairman of the Federal Reserve, offered a verdict on modern monetary theory. "The idea that deficits don't matter for countries that can borrow in their own currency I think is just wrong," he said. It was a victory for the movement, of sorts: modern monetary theory is now unavoidable. It now must be addressed in a committee hearing of the US Senate.

It's an idea being contested right now on finance and economics Twitter, which sounds like a silly thing to say but is not, because the people who read and write econ Twitter are the people who explain economics in newspaper articles and academic papers for the rest of the world.

Which is how yesterday we got an emai from three MMTers: Scott Fullwiler, Professor of Economics at the University of Missouri, Kansas City; Rohan Grey, a Doctoral Fellow at Cornell Law School; and Nathan Tankus, Research Director of the Modern Money Network. They wanted a chance to respond to several recent articles, our piece on how the US financed the second world war among them. Here, in their own words:

For two decades we and our like-minded colleagues have been putting forward the idea that a monetarily sovereign country like the United States with debts denominated in its own currency and a floating exchange rate cannot "go broke". We have been writing about this and all the myriad implications this has for macroeconomics under what has come to be known as Modern Monetary Theory.

Excitingly, last month representative Alexandria Ocasio-Cortez brought attention to our views when she said that MMT should be "part of the conversation". This set the economics and finance media ablaze with renewed commentary. In a major step forward, the broad consensus of these pieces in a series of outlets has been to agree with my colleagues and I that the only limit on government spending is inflation. The acceptance of this crucial tenet of MMT is very welcome and new. It was not too many years ago that throughout the economics press it was commonplace to present MMT as a wild new theory and speak in worried uncertain terms about the possibility that bond markets would refuse to buy US treasury securities, causing a debt crisis. We are thrilled to move past this stage in the public macroeconomic debate.

Unfortunately, while the press has been willing to agree with this major proposition, it has not been willing to follow its implications. Josh Barro writing in *New York Magazine* particularly articulates what seems to be the emerging response to MMT in the press:

> If the government prints and spends money when the economy is at or near full employment, MMT counsels (correctly) that this will lead to inflation, and prescribes deficit-reducing tax increases to reduce aggregate demand and thereby control inflation. See how we have ended up back where we started? Whether you take a Keynesian view or an MMT view, if the government spends more, it's likely going to need to tax more, sooner or later. [...] Whatever the Federal Reserve's demerits, the idea of depending on Congress to pass surplus-generating tax increases in order to keep the economy stable and prevent runaway inflation gives me hives.

Contrary to Barro's assertions, we have not "ended up back where we started." MMT's approach to budgeting and designing a macroeconomic policy framework for a Green New Deal with price stability is radically different from current Congressional practice and there are no other modern proposals like it.

First, when we suggest that a budget constraint be replaced by an inflation constraint, we are not suggesting that all inflation is caused by excess demand. Indeed, from our view, excess demand is rarely the cause of inflation. Whether it's businesses raising profit margins or

passing on costs, or it's Wall Street speculating on commodities or houses, there are a range of sources of inflation that aren't caused by the general state of demand and aren't best regulated by aggregate demand policies.

Thus, if inflation is rising because large corporations have decided to use their pricing power to increase profit margins at the expense of the public, reducing demand may not be the most appropriate tool. The recent controversies over rising housing rents and drug prices demonstrate that we need alternative tools in place to manage the power of big business and ensure their pricing policies are consistent with public purpose. The experience of the last decade inadvertently reflects the potential strength of alternative inflation-fighting tools, as one of the reasons inflation has remained below target for the past ten years is legislated cuts to medicare and medicaid payments.

Because of the pricing power of big companies, whichever administrative agency or agencies is responsible for managing aggregate demand should not be responsible for overall inflation on its own. It should either share joint responsibility for keeping inflation on target with other agencies responsible for regulating business pricing power or new price indices should be constructed that exclude concentrated markets where prices are clearly acyclical.

Second, we do not believe that any and all inflation that does result from excessive demand can and should be addressed by higher taxes. This is a distortion of our view, as years of publications can attest. When MMT says that a major role of taxes is to help offset demand rather than generate revenue, we are recognising that taxes are a critical part of a whole suite of potential demand offsets, which also includes things like tightening financial and credit regulations to reduce bank lending, market finance, speculation and fraud.

Assessing the potential inflationary effect of new spending proposals also requires seriously assessing how underutilised our existing resources are. This requires detailed, expert analysis from a range of industry analysts; not just statistical regressions on aggregate economic data by macroeconomists.

At the same time, we must also confront the fact that the fossil fuel, real estate, defense, and financial industries are too large, too dirty, and eat up too much of our national resources. They must be shrunk one way, or another. Thus, another way to offset excessive demand pressure is to tighten environmental and other forms of regulation,

which would disemploy people and resources in those industries, and free them up to be redeployed in green production as part of the broader economic transformation of the Green New Deal. Our current political leaders tend to oppose such an approach on the grounds that demand is limited and jobs are a rare, scarce commodity, so each existing job must be preserved at all costs. MMT allows us to recognise that the government can commit to real full employment. We can instead focus on increasing the quality of jobs and ensuring our economy generates prosperity for everyone.

In addition, we must recognise that the Green New Deal is about creating new resources over the medium term, which will in turn expand green output to further accelerate the decarbonisation process. This is not our current approach. Instead the Congressional Budget Office continually defines potential capacity down from what it actually is, creating a vicious self-fullfiling cycle defined by low productivity and lost output. To address this failure, the Congressional Research Service (as well as other budget advisory organizations) will need to be enlarged to do the analysis necessary to find the right mix of inflation offsets that best move forward the task of decarbonizing our economy. There is no alternative if we are going to succeed at averting climate change.

Regardless of which policy tool is used in a particular context, demand management in general needs to lean much more heavily on the appearance of bottlenecks in specific industries instead of simply tracking changes in a general price index. The immediate signs of bottlenecks are large and sustained rises in unfilled orders for specific goods and services. Preventing shortages is after all what demand management is first and foremost about and price indices are misleading policy targets when they include factors that are insensitive to demand and would be counterproductive to manage with demand. The more actively we regulate big business for public purpose, the tighter the full employment we can achieve and the more resources we can devote to the Green New Deal while preserving price stability.

Third, when we *do* advocate using tax increases to address inflationary pressure, we are not suggesting that Congress attempt to raise taxes in real time *after* inflation has already emerged. Indeed, our approach is precisely intended to *avoid* a situation in which Congress merely spends without paying attention to inflation dynamics until it is too late. Thus, we argue varying tax rates and other inflation offsets

should be included in the budgeting process *from the outset*. In our approach, an MMT-informed Congressional Budget Office would produce detailed reports of how specific spending or lending proposals would increase demand and which sectors and regions would be most affected, and would monitor inflationary pressures closely to determine the appropriate policy response based on specific conditions. This would be a radical improvement over the current CBO scoring process, which looks only at dollar values in aggregate, and treats all sources of revenue as equal. This crude approach can easily lead to mistaken conclusions, like that Elizabeth Warren's wealth tax could adequately "pay for" large spending proposals, when in reality, such a tax would not be likely to reduce overall demand by very much in the areas that the new government spending would be directed towards (even if it was still desirable from an equity standpoint).

Beyond an improved Congressional budgetary process, there are well-established approaches to policymaking that can assist us in managing inflationary risks. For example, we have long recommended strengthening automatic fiscal stabilisers. Indeed, our principal policy recommendation is a Job Guarantee (which is part of a Green New Deal) which automatically creates more jobs as people need them, but does not continue to spend greater and greater amounts once the economy reaches full employment. Other ways we can strengthen automatic stabilisers include savings policies and no longer indexing tax brackets or indexing them to an inflation target instead and introducing more tax brackets so that as incomes rise faster than the inflation target a higher percentage of income is progressively taxed. With these tools there is much less need to rely on day-to-day discretionary decision making like is currently the case with the Federal Reserve's management of interest rates.

That said, we are not against one or more agencies being given additional tools to collectively manage demand on a discretionary basis. It is unclear where this myth came from but it doesn't come from our extensive publication record- in academic journals or in the blogosphere. One of us long ago suggested in the Financial Times the goal of delegating responsibility for day-to-day demand management to an independent agency was a good one but that the Federal Reserve was the wrong agency. As we said then:

> Whereas Bernanke only hinted at the need for a fiscal partner, former Fed Chairman Marriner Eccles openly

> advocated the use of fiscal policy as the most effective way to fight both unemployment and excessive inflation. In the depths of the Great Depression, Eccles pushed for a payroll tax cut, calling it 'the most important single step that can be taken' to stimulate consumer buying power. Years later, just prior to the near tripling of US war expenditures, Eccles urged lawmakers to raise the payroll tax in order to stave off an inflationary episode. Indeed, as his Special Assistant made clear in the following letter, Eccles considered adjustments in fiscal policy (in this case an increase in the payroll tax) to be 'the most effective anti-inflationary means of reducing purchasing power.

Commenters are not wrong that some of these proposals and tools will be controversial. What is ignored by this criticism is the fact that our current approach of managing inflation on the backs of a very indebted and underemployed public is also controversial. Indeed, the Federal Reserve has historically been a conservative institution biased against full employment. To ensure the Green New Deal creates and maintains true full employment, we will need a new macroeconomic framework that brings in many currently excluded institutions and stakeholders, and abandons our reliance on interest rate adjustments as a primary tool for stabilising demand.

Modern monetary theory has a range of policy implications that bring us to an entirely different policy world, rather than back where we started. A Green New Deal must include some mixture of the policy instruments we've laid out if it successfully plans a new green full employment economy with price stability. Budgeting the traditional CBO way will focus attention on the wrong issues and fail to offset the inflationary potential of this necessary new spending. As we've said, there are a number of taxes -- especially on the rich -- which offset much less GND spending than their dollar amounts would imply. This does not mean that we shouldn't tax the rich -- they are too rich. It just means Congress needs to look elsewhere if they're going to fully offset the inflationary potential of this spending. We can afford a Green New Deal and we can accomplish it as well. We just need the right policy tools to make sure it's successful.