ALPHA SOURCES

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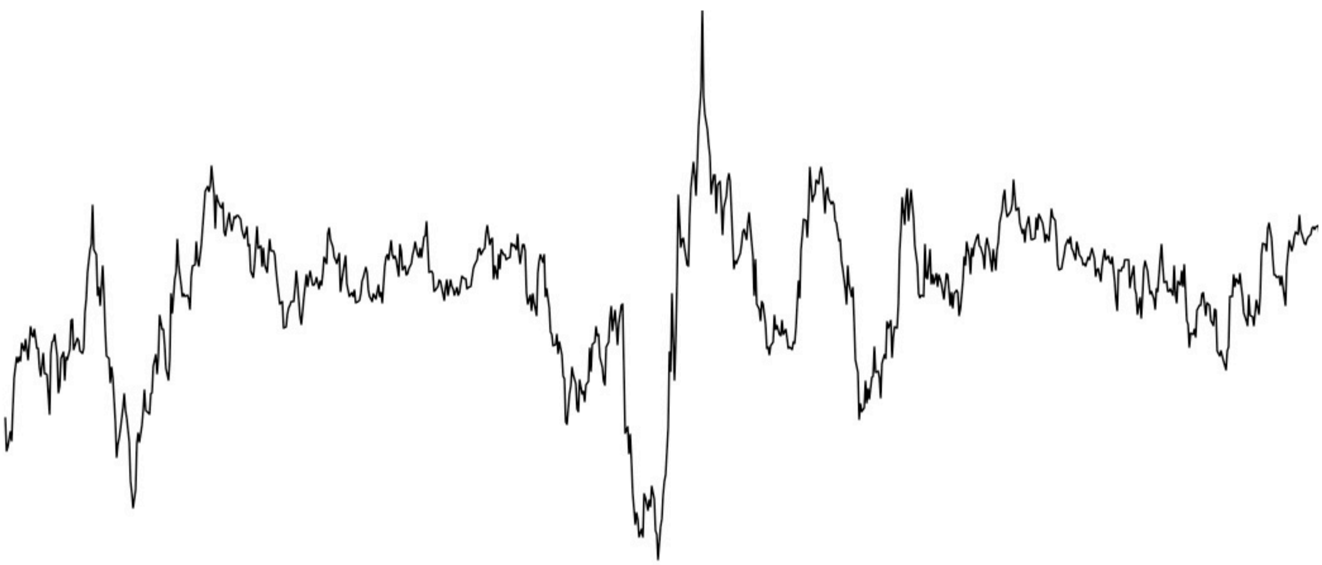

THE *REAL* MACRO WARS

I am still not entirely sure whether Noah Smith, a U.S. Economist and prolific blogger, is a converted MMTer or not. But I do know that he is doing a great job in describing the *discourse* around this newfound holy grail of macroeconomic policymaking. In my attempt to label MMT as "Woke Economics", I leaned on some of Noah's earlier pieces on this, and now he is back with his invocation of the new Macro Wars. The stage, according to Noah, is the recent fiscal relief bill in the US, prompting even otherwise pro-stimulus economists to push back. Oliver Blanchard and Lawrence Summers both suggest that $1.9T might be too much of a good thing, while Krugman is sticking to his Keynesian ethos, arguing that Biden's bill really is 'disaster relief', a position that Noah seems to agree with. Replying specifically to Noah's recent post, he argues that Keynesianism won the theoretical battle a decade ago, leaving only "cranks, charlatans and WSJ Op-ed writers" on the other side. Tyler Cowen chimes in, pointing out that Biden's post-election fiscal stimulus push has as much to do with populism as it has to do with careful application of Keynesian macroeconomics. As it turns out, this is a position I have a lot of sympathy for.

The context for this debate will be well known to many of my readers, but it's sometimes a good idea to set the stage all the same. If you want the long version, you should take a detour to my long-form essay on fiscal policy, here, but for the short version, we can fast forward to the idea that MMT is now in charge.

To re-cap, MMT lobs a hand grenade at two of the central assumptions of standard neoclassical macroeconomics. **First**, MMT proposes that the government does not operate under a hard budget constraint, and **secondly,** it suggests that NAIRU—the adverse inflationary consequences of sustained budget deficits—is non-existent or at worst, a dim and distant trivial constraint.

Using the folklore of macroeconomics, MMT presents the world as one in which policymakers have the luxury of forever operating in an IS/LM model—which, remember, does not include prices—and complete control over interest rates, if not the printing press itself.

MMT assumes a policy setup in which the LM curve is either controlled by an accommodating independent central bank—sound like anyone you know?—or that governments control it outright. A flat LM curve will do the trick too, but the point is simple enough. **In an MMT framework, the government have full control of *both* the IS and LM curves.** For those not well versed in this model, this implies that the government can expand output at a constant interest rate, indefinitely.

To the extent that a (vertical) supply curve and inflation lurk somewhere in the future as a threat, via the AD/SAS model, the functional finance underpinnings of MMT promise swift action if inflation does rear its head, either in the form of tighter policy of price controls.

On that background, Noah's Macro Wars suddenly seem a bit fake. It is difficult to deny MMT its victory on this particular field of battle. I agree with Noah that there is a *theoretical* joust to be had over how long a benevolent social planner can print money to create jobs and welfare without running up against a vertical supply curve and inflation. This discussion is concerned with the formulation of a robust *dynamic* theory of inflation, and how such inflation is measured in the first place

But it is important to remember that the imprisonment of Keynesian macroeconomics in the 1970s was, to a large extent, based on an *empirical* indictment. After all, stagflation proved Keynes wrong, prompting economists to seek new paradigms, both theoretically and politically.

Over time, however, the empirical shackles tying down IS/LM and demand-side fiscal stimulus have corroded. Krugman is absolutely right to point this out. The foundation for the re-emergence of Keynesian macroeconomics was laid after the Financial Crisis. The puzzlingly flat Philips curve, and the increasingly non-binding constraint of NAIRU, have provided increasingly fertile ground for old-school Keynesianism to return. We shouldn't be surprised that it is now muscling its way into actual policymaking via the re-discovery of MMT and Functional Finance even if it took a GDP destroying pandemic to push it over the line.

As much as I enjoy a debate about the inflation-generating abilities of budget deficits, I suspect the real wars lie ahead. Allow me to recycle some content.

MMT lends itself to the interpretation of the world in which the government can achieve just about any economic outcome it wants, and that it can do so without being subject to any constraints. It works on paper, kind of, but it quickly runs into a number of obstacles in the cold light of reality, chiefly of which is the question of the distribution of the funds, when to stop lining people's pockets if at all, and the implications for currencies in a world of free capital mobility. As I have said on numerous occasions, MMT's proponents are either unaware of this or they're not being honest about what they really want, which is to say a specific distributive outcome and (much) less capital mobility.

Tyler Cowen brushes up against the first part of this story with the idea that the new U.S. Administration's fiscal push is partly populist. But there is a potentially more nefarious and divisive political economy in play. Raising the bar to the point at which the government has the means and duty to create jobs and monetary welfare for everyone is a wonderful idea. It is also, however, naïve in the extreme. We need to ask who gets the money, how much and in what proportion to their neighbors? These are real and relevant questions and they're all subject to *political* choice. Biden's *Build Back Better* plan is seeped with promises to combat racial and gender inequities. These are noble pursuits, but what does it mean in the context of an unconstrained benevolent fiscal planner? Will black and Latino families in Los Angeles get a bigger cheque than white families in the Appalachia? I can't quite figure out how far the Biden presidency intends to go, but I do know that it is a potential tinderbox in U.S. society such as it is. News that the new US administration intends to raise taxes is a more trivial version of this dilemma, though it is a paradox all the same. Why raise taxes, if money is a public good?

The issue with MMT and capital mobility is two-fold as far as I can see. First, not all currencies are made equally sovereign—in a world of capital mobility—implying that not all countries have the benefit of unconstrained deficit spending. Secondly, and following from the first, MMT requires capital controls; Wray (2012):

"(...) all countries in Lerner's time adopted strict capital controls. In terms of the "trilemma" they had a fixed exchange rate and domestic policy independence, but did not allow free flow of capital."

In principle, there is nothing wrong with this position, though you would think that those favoring such a policy would be open about it. As with the politics of distribution, they haven't come clean about their preferences just yet. The *real* macro wars over fiscal activism and MMT haven't even started.