An MMT perspective on current inflation

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Based on:

- Is It Time for Rate Hikes?: The Fed Cannot Engineer a Soft Landing but Risks Stagflation by Trying *Public Policy Brief* No. 157, April 2022, Nersisyan & Wray

and

- Still Flying Blind after All These Years: The Federal Reserve's Continuing Experiments with Unobservables, *Public Policy Brief* No. 156, December 2021, Papdimitriou & Wray

Does MMT Ignore Inflation?

- MMT has always emphasized that real resources limit spending.
  - Spending more than our real capacity can be inflationary.
- Need to “resource” spending rather than “finance” it.
  - E.g. real resource accounting for GND, BBB, etc.
- Functional approach to taxation – withdraw demand to prevent inflation.
  - Not all taxes are created equally.

But Didn't We Try MMT? Covid Relief = Printing Money → inflation?

Mainstream

- Inflation is a demand side problem
- Slow growth is a supply side problem
- Before Covid, secular stagnation due to problems on supply side
- Now: excessive Covid relief caused demand side problem

Reality

- Inflation is a supply-side problem
- Chronically insufficient agg. demand during 50 years of Neoliberalism → depressed domestic investment
- Came to rely on imports/supply chains
- Supply collapsed during Covid → deepest recession since Great Depression
- Covid response: $Trillions led to fastest recovery ever; but spending not well-targeted

Continuing Supply Side Problems

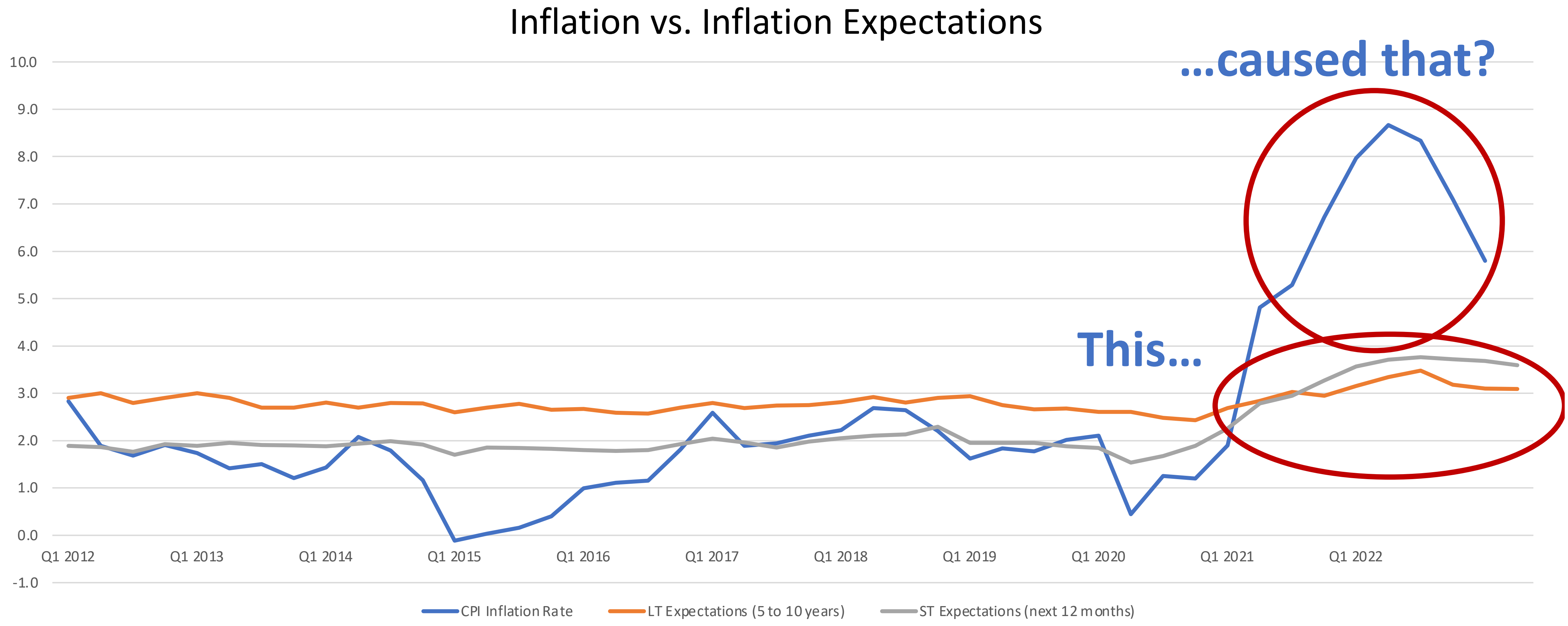
- Powell correct response: patience
- Covid disruptions continued far longer than expected
  - Bungled response to Covid
  - Just in time production; neoliberal supply chains broken; China lock-downs
  - Price gouging
  - Ukraine war
- All conspired to produce high inflation
- Problem is not Covid relief—it ended months ago
  - First round saved; second round spent (but on select items)
- Tax revenue boomed, sucked demand out of economy
  - Fed currently adding to headwinds created by fiscal policy

The View from the Fed

Abandoned Friedman's Quantity Theory—the idea that money causes inflation.

- Early 1990s embraced New Monetary Consensus and **Taylor Rule**:
  - Expectations of inflation cause inflation… but how?
  - Policy works by controlling expectations… but how?
  - Control expectations through "forward guidance"… but how?
  - Move the fed funds rate to move the "real rate" to the "natural rate"
- **Tarullo**: Fed has no theory of inflation;
- **Rudd:** "Nobody thinks clearly, no matter what they pretend… even the goofiest opinion seems wonderfully clear, sane, and self-evident."
- Papadimitriou and Wray: 1994, 1996, 2021: **Flying Blind**
  - Focusing on triple unobservables: inflation expectations, real rates, natural rates
  - Policy is reduced to Psy-Ops: Psychological gamesmanship "to influence emotions, motives, and objective reasoning"

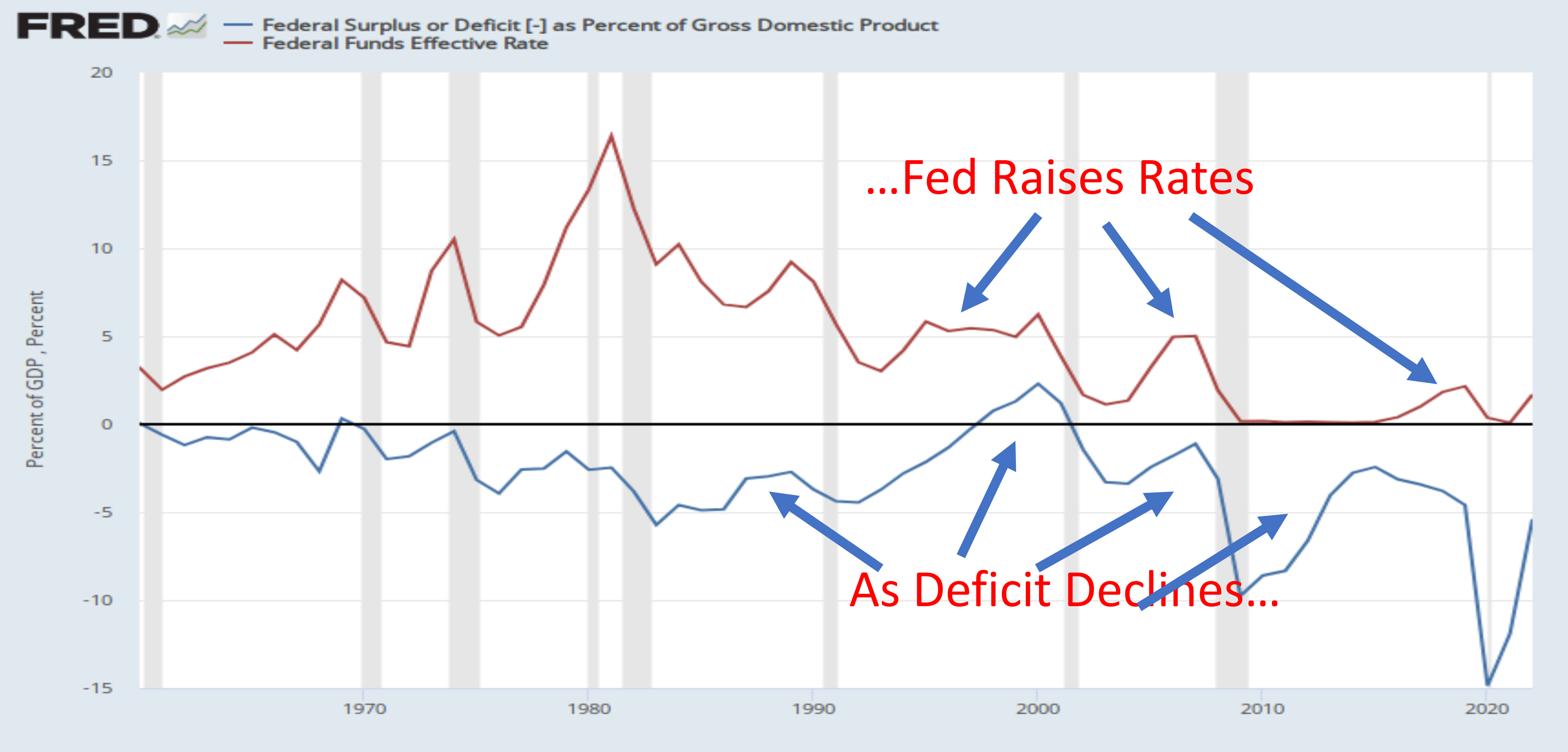
Expectations Cause Inflation? Or Do They Converge to Reality?



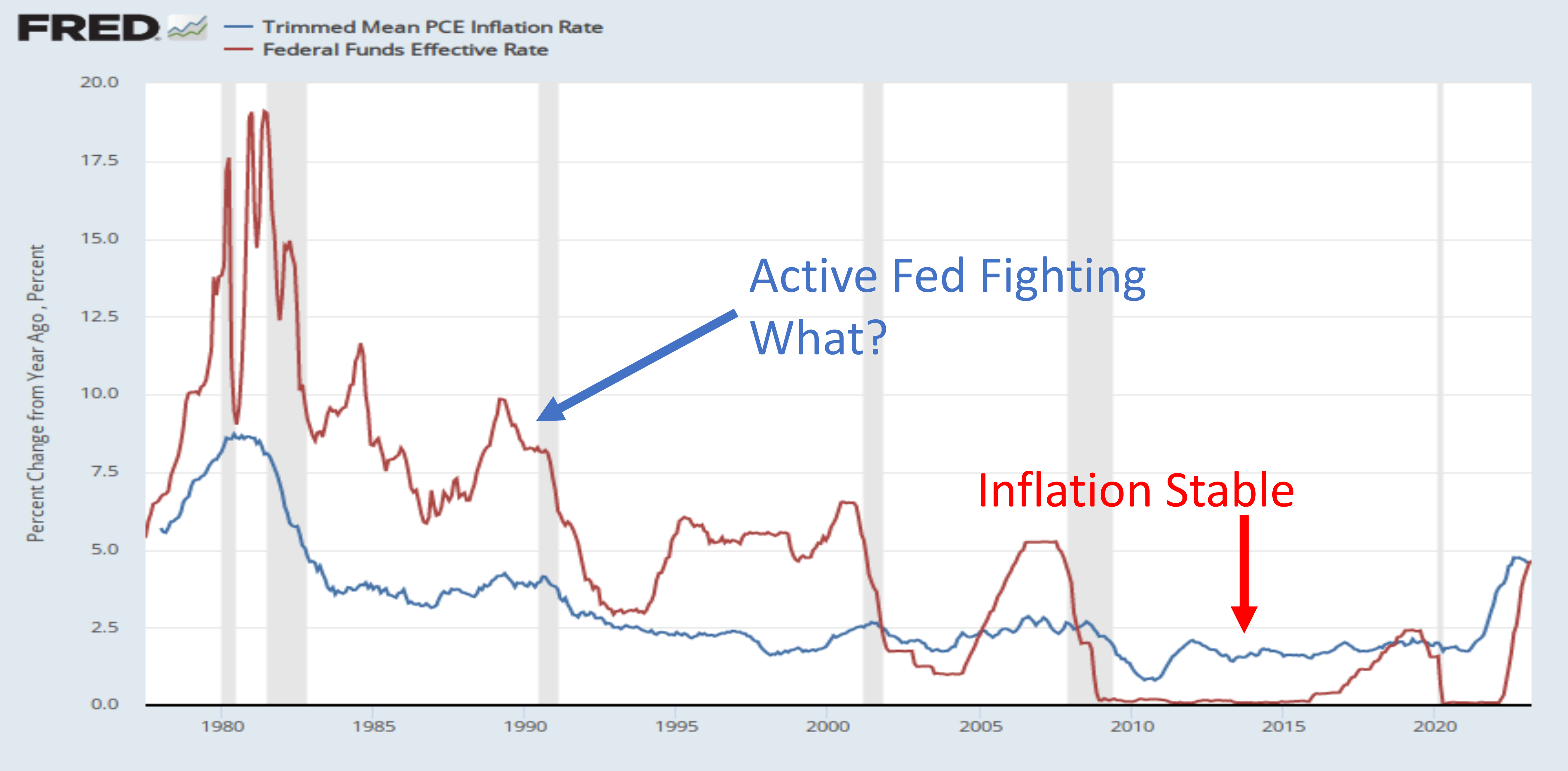
But Central Banks Have to Take-Way the Punch Bowl, Right???

- When Government spends too much, the CB must reduce demand?
  - Too much government spending increases the deficit and the debt, raising interest rates and causing inflation!
- But: The Fed raises rates going into recession!
- But: The Fed raises rates as the deficit falls!
- But: The Fed raises rates even when there is no inflation!
- Interest rates are determined by monetary policy, not by deficits!
- Government deficit/debt need not cause inflation!
- Our high inflations are always driven by the supply side!

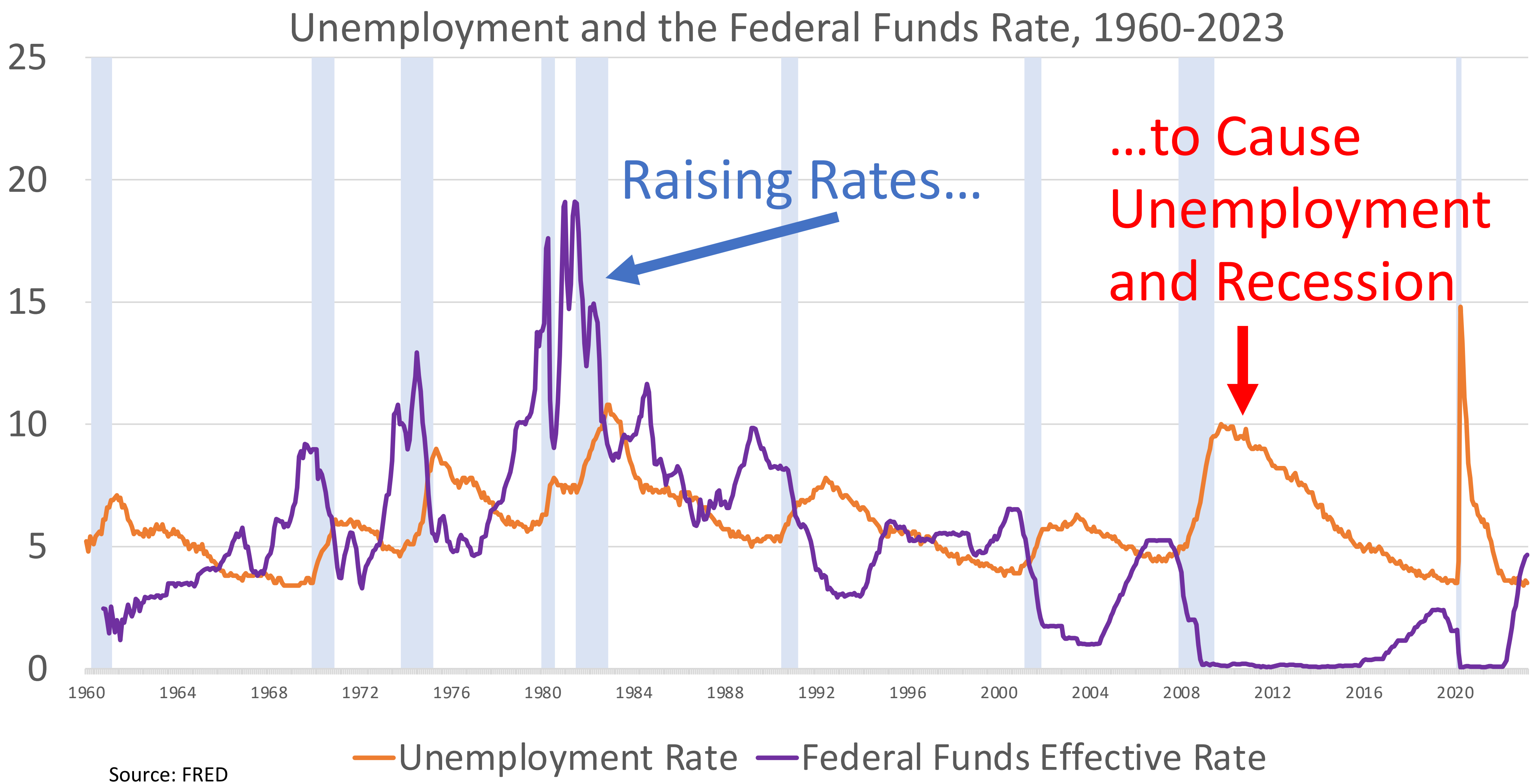
Fed Always Adds To Fiscal Headwinds: Raises Rates as Deficit Falls



Fed rate hikes aren't closely associated with inflation



Fed Raises Rates when Unemployment Bottoms



Source: FRED

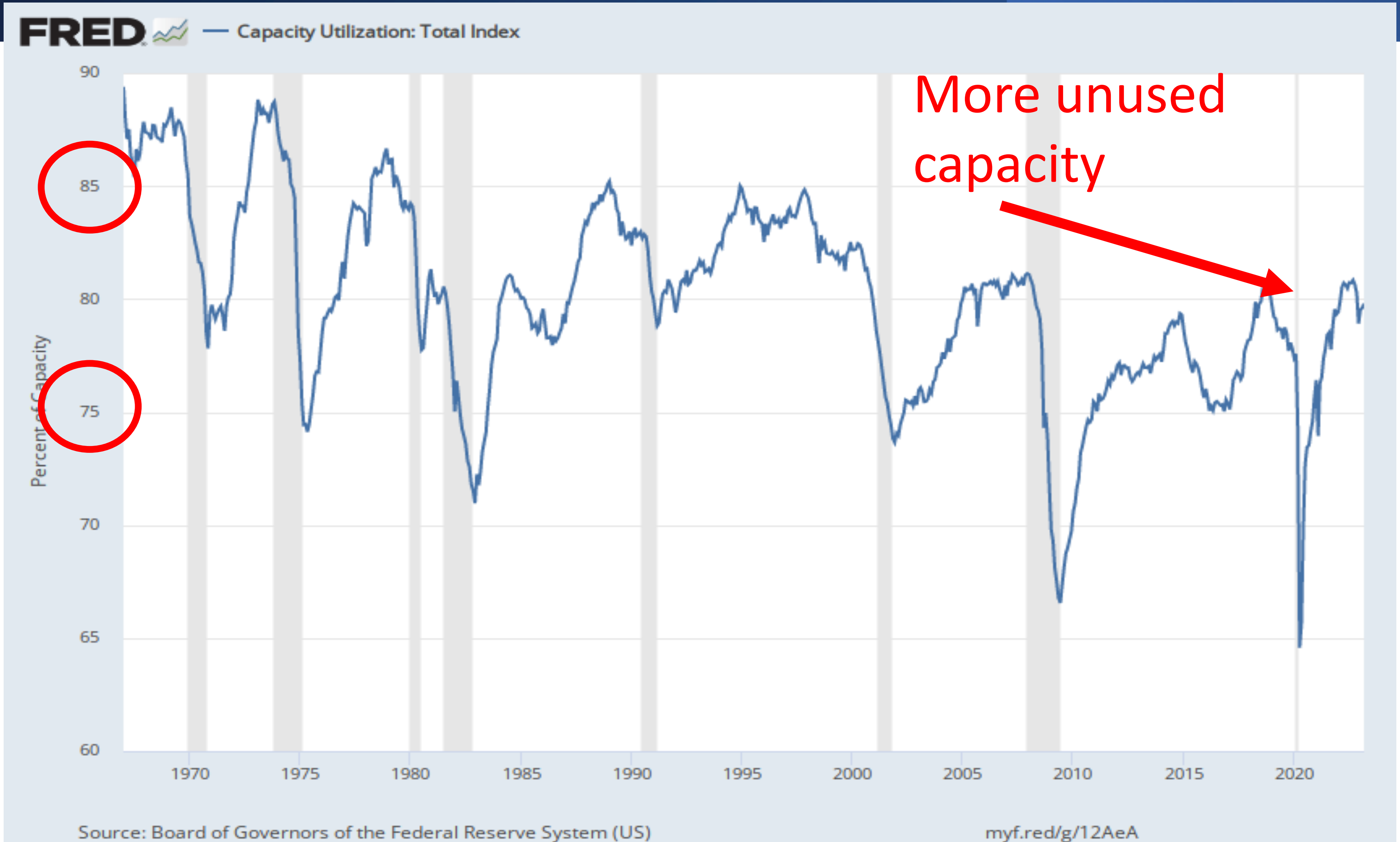
What is the Source of Current Inflation?

- Oil, Food, Shelter—as always!
  - Imputed rentals have become biggest source: 2% points; energy now down sharply
- Price gouging, rising markups. Some idiosyncratic sources such as cars.
- Now food (oil with a lag) and services (higher wages to attract workers?)
- No evidence of W-P spiral
- Patience was the best policy; raising rates not helpful:
  - spending not interest sensitive; consumers don't borrow to finance fuel, food, etc.
  - hurts supply of housing, especially rental units;
  - cost feed-through; interest income
- The answer to supply-side inflation is not to reduce demand but to increase supply (Build Back Better).

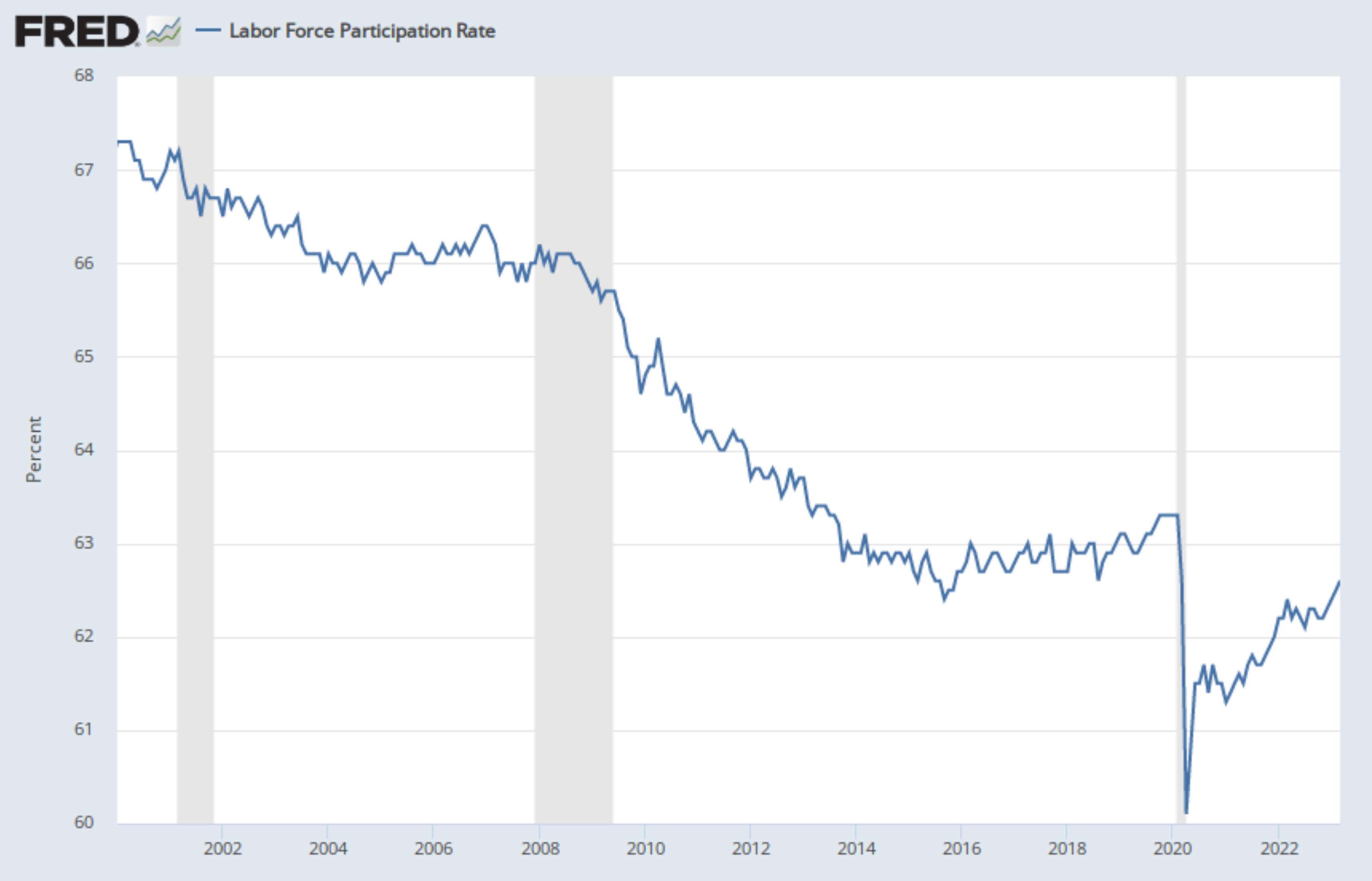
Demand Has Not Outstripped Capacity

- Well within potential capacity that could have been expected
- In spite of low measured unemployment, labor markets are not excessively tight
- Sales are not above normal
- PCE inflation is on a downward trend; core is below 5% already

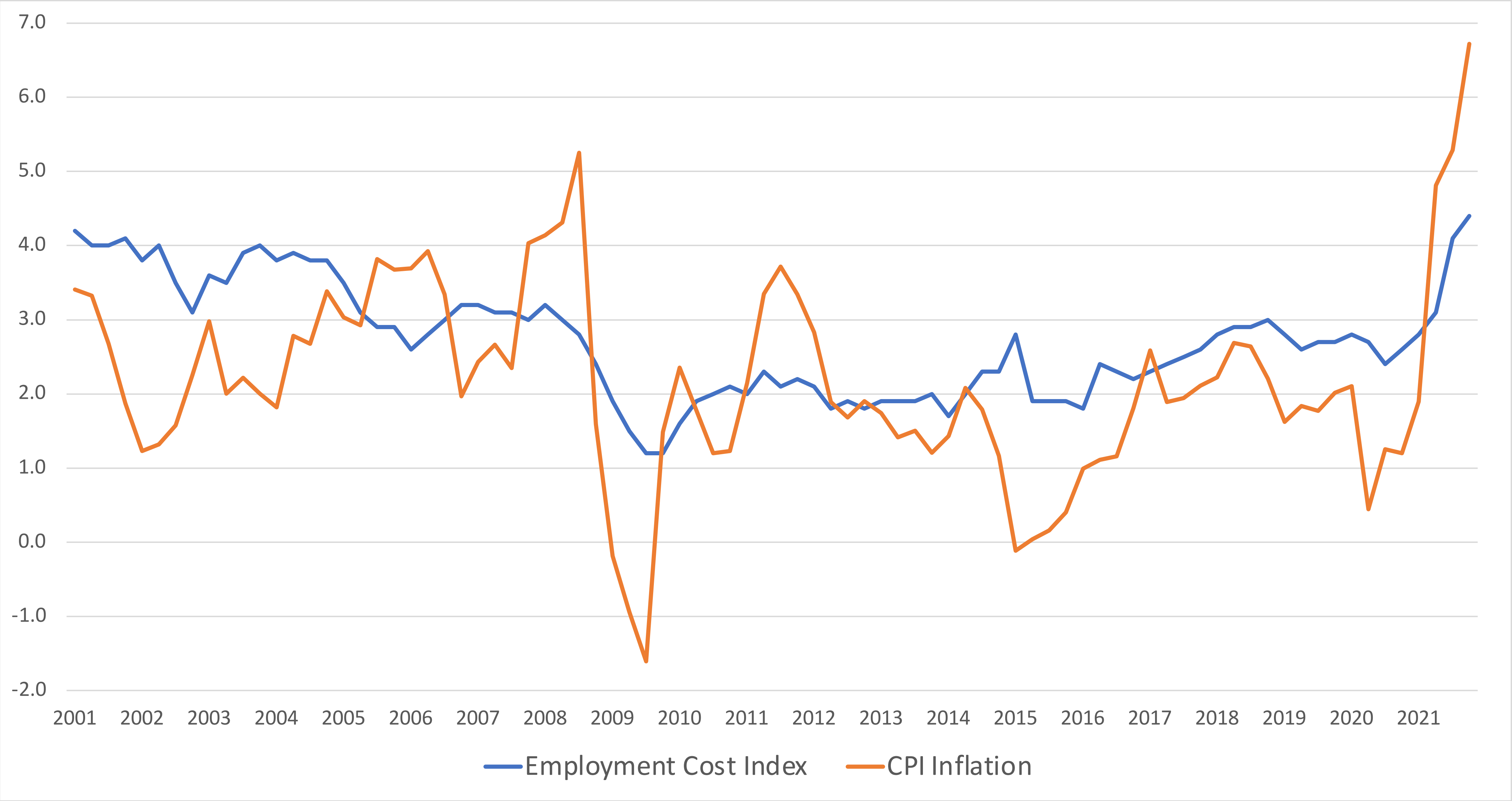
Capacity Utilization Rates: No evidence of excess demand



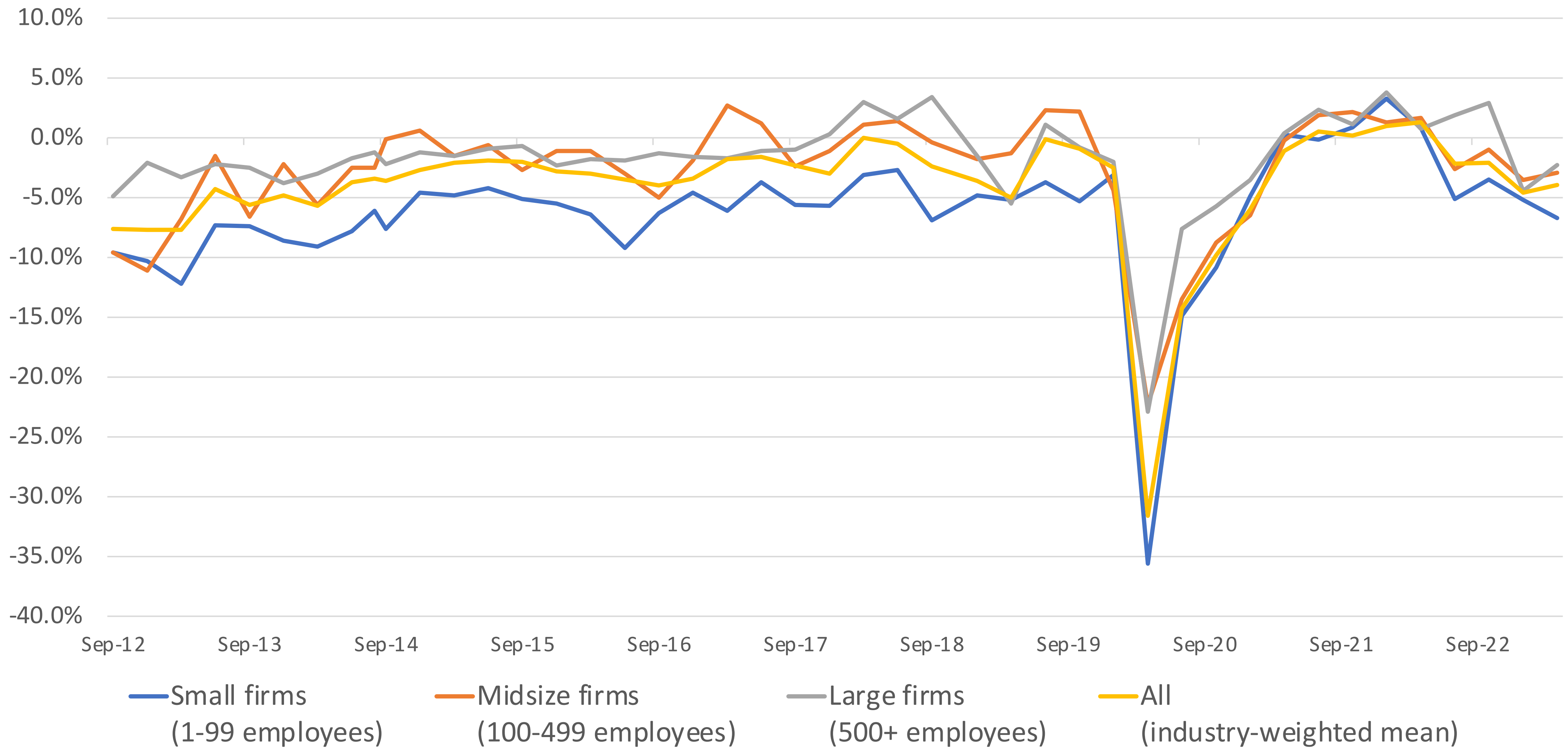
Labor Force Participation Rate: Tight Labor Market?



Employment Cost Index versus Inflation



By What Percent Are Sales Above/Below 'Normal"?



Source: Federal Reserve Bank of Atlanta

Inflation and the Fed

- The Fed has taken credit for the low inflation in the U.S. (since Volcker).

Reality, due to:

- Globalized supply chains, cheap labor, low costs of regulations and taxes abroad.
- “Just-in-time” production, low or no inventories.
- Austerity/stagnating demand – jobless recoveries.
- These same factors that tamed inflation have come back to bite.
- Volcker given credit but raised rates >20% causing a deep recession, a series of financial crises, a decade of lost development in Latin America, and full recovery took 25 years.

“I'm aware of no major example in which the Central Bank reacted with excessive speed to inflation and a large cost was paid,” says @LHSummers

Fed’s Latest Projections

- “Under appropriate monetary policy”, Americans can now expect to be 3% poorer at the end of 2023 compared to what had been projected before the pandemic.
  - And to remain permanently worse off in the years that follow.
- Compared to June 2021 projections, real GDP in 2023 has been marked down 5.5%.
  - Worse than the hit from the pandemic itself!
- Policymakers now expect unemployment rate to rise to at least 4.4% by the end of 2023.
- Powell: “we ***need*** to have” a sharp slowdown in growth—Fed officials would accept a lot of economic “***pain***”.
- That “pain” is spreading ‘round the world already. Others must follow Fed rate hikes to minimize pressure on exchange rates and thus inflation.

Conclusion

- MMT has not ignored inflation – it has always emphasized real resource constraints.
- Pandemic policy was not MMT policy.
- Current inflation not really demand driven – gov't "stimulus" is long finished.
- Fed can't do much about Inflation, anyway; it's not a monetary phenomenon.
- Fiscal policy more appropriate – address bottlenecks, invest in particular sectors (e.g. housing, energy), punish price gougers with tax hikes.