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Beyond the Inflation Regime Collapse

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At some point, ever-lower rates will fail to stimulate the economy, and the current monetary regime will likely be abandoned when this becomes the prevailing view, as we noted in "The Death of the Inflation Regime." But what happens then?

Collapses of monetary regimes tend to come in tumultuous times. Two world wars ended with the fall of the gold standard. The collapse of Bretton Woods led to a world of floating-rate regimes. When this current inflation-targeting regime is eventually disrupted, we may see a similarly radical shift in thinking.

Monetary regimes have generally paved the way for higher inflation and more active fiscal policy, and this will likely be the case as the inflation-targeting regime comes to an end.

The last time the United States saw a shift from monetary to fiscal policy was the end of Bretton Woods. At that time, President Richard Nixon pushed U.S. Federal Reserve (Fed) Chair Arthur Burns to take a steady position of low rates in the face of higher government spending causing ever-rising inflation.[1]

Until very recently, we've heard central banks grumble that governments are not stepping up to the plate to

provide stimulus.[2] With unprecedentedly low rates and enlarged balance sheets, central banks argue, they have clearly done what they can to rescue the economy.

It is now time for governments to do their part and they seem amenable to reciprocate. There is a widespread perception that as long as central banks can be trusted to keep rates low, the resulting higher government debts will be cheap to finance.

After World War II, low rates on government debt were used to shrink the debt burden. Today, on the contrary, they serve as an excuse for more deficit spending. Some policy makers have started flirting with approaches such as modern monetary theory (MMT), which some see as allowing the government to spend at will by simply printing more money.

According to MMT, the government need not worry about deficits or imposing taxes as long as interest rates and inflation are on target. In an MMT world, the interest rate is set at zero and the government achieves this rate and steady inflation by changing how much money it spends, how much it taxes the economy, and by issuing and buying back bonds.

The central bank has no independence and functions as a vehicle for the government as it prints money and buys or sells treasuries. MMT thus transfers the responsibility for inflation and rate targeting from the central bank to the government.[3]

A commitment to something like MMT would spell the end of the current inflation-targeting regime, by explicitly shifting dominance from monetary to fiscal policy. Before government spending crowds out private investments, such a shift can spur a period of higher economic growth.

However, the distortions of such a system will inevitably destroy wealth and asset values in the long run.

In addition, a zero target rate and high government spending would likely (eventually) introduce a period of higher inflation, which would eventually need to be tamed by a radical shift back to monetary policy dominance with growth-suppressing rate hikes similar to what the United States saw with Paul Volcker.

Before we start stressing out about such a nightmarish repeat of history, we can at least note that there are some other proposals for more fiscal policy activity that suggest a less scary future than MMT.

Some proposals floating around go under the label of “helicopter money,” which are based on the belief that governments are better than central banks at raising inflation expectations since they can make more credible commitments to print money.

One version of helicopter money is a big check from the central bank to the treasury to spend at will. Another is massive new government investment projects financed by central bank money.[4]

Government investments in infrastructure and the like should, in theory, be more productive than massive government jobs programs, which followers of MMT espouse. However, they also have a much longer lead time than people often assume, and thus a less immediate effect on GDP.

Followers of MMT advocate for perpetual government programs likely to convince people of the government's commitment to spending and, hence, inflation. Instead of Keynesian countercyclical fine-tuning, it comes with a perpetual tangle of government spending and wage guarantees.

Helicopter money can be perceived as more temporary and can increase inflation only if the government commits to continuing to pump new money into the system. People are forward-looking and, if there is an expectation that the government will offset the spending today with taxes or borrowing in the future, they will save instead of consume, thus counteracting the inflationary effect of the newly created money.[5]

MMT and helicopter money both rely on continuous flows of government spending. This contrasts with a traditional view of economic stimulus as a temporary measure in times of recession that must be compensated for by contractionary surplus policies when the economy is booming.

But it would be a continuation of the trend toward the more persistent stimulus we have seen under inflation-targeting and the seemingly perpetual stimulus many central banks have provided since the great recession.

Next up: The inevitable abandonment of the current monetary regime.

1 Bianchi 2012; Meltzer.
2 Examples include: Australian Central Bank Governor Philip Lowe: "Government and business should use record low interest rates to invest more" (link); "European Central Bank President Mario Draghi said the institution can do more if needed to boost inflation, and repeated his call for euro-area governments to support this effort with fiscal spending" (link).
3 Tymoigne and Wray 2013.
4 Coppola, Frances. The Case For People's Quantitative Easing. Polity; 1 edition (September 3, 2019); https://www.mercatus.org/bridge/podcasts/10212019/frances-coppola-macroeconomics-helicopter-drops.
5 The thesis that government spending is not stimulative if people believe that they will somehow have to pay for it is the so-called "Ricardian Equivalence," first proposed by David Ricardo (David Ricardo, "Essay on the Funding System" in *The Works of David Ricardo*. *With a Notice of the Life and Writings of the Author* by J.R. McCulloch, London: John Murray, 1888.).

Download the white paper below to see the full list of references.

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Part 1: Navigating the Low-Rate Environment
Part 2: Nothing Natural About Low Rates
Part 3: Why Rates Are Low
Part 4: Where Is the Inflation?
Part 5: The Death of the Inflation Regime
Part 7: Rates: Lower for Longer
Part 8: 6 Negative Consequences of Low Rates

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