Macro Picture

A NEW SUPERCYCLE RUNNING ON MMT

Dario Perkins

MMT has not only transformed the fiscal debate, it is also having an (indirect) effect on monetary policy. It might even provide the space/opportunity for a new “supercycle” in the macro-political regime, which has reached a critical inflection point. While the bears warn about a fiery 1970s-style endgame, the influence of MMT could actually deliver a superior fiscal-monetary policy mix.

Chart 1: The end of Neoliberalism?

Source: Bichler, Shimshon and Nitzan, Jonathan. (2016)

INFLECTION POINT

While MMT has declared victory in the debate about fiscal policy (especially in the US), it seems endogenous to where we are headed in the broader macro-financial “supercycle”. As in the 1930s, monetary superiority is giving way to fiscal dominance, threatening the end of “neoliberalism”. MMT could be the “software” for creating a new form of Capitalism (4.0).

MMT VICTORY

Every policy supercycle contains the seeds to its own destruction and MMT is no different. While MMT analysis is appropriate for an environment of chronically low inflation and near-zero interest rates – something mainstream economists had forgotten – it could run into trouble if the inflation backdrop fundamentally changes and the authorities need to raise interest rates.

FISCAL DOMINANCE

The bears argue MMT-type thinking will eventually recreate the policy disasters of the 1970s. This is a reasonable endgame but it could be decades away, especially as secular inflation pressures are weak and we still have independent central banks. In the meantime, the popularity of MMT is actually a good thing – it will produce a less deflationary policy mix in the years ahead.

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A NEW SUPERCYCLE RUNNING ON MMT

In a recent podcast, the influential MMTer Stephanie Kelton claimed victory in the debate about fiscal policy, suggesting the US Congress was now taking her advice. Other commentators also sense a "regime shift" in macro policy, claiming we have reached the end of the Neoliberal era. While these declarations are premature – both in the US but especially in other parts of the world – there has long been a certain inevitability to MMT's success. The idea that fiscal policy must take over from monetary policy has been increasingly obvious for years, especially given the perversity of the macro policy mix we have had since the Global Financial Crisis. Nominal bond yields at 700-year lows were a clear signal something had gone wrong. As we explained in a previous Macro Picture, policy-stabilization efforts have been retracting the long historical "supercycle", with the recent era of secular stagnation putting the authorities back where they were in the 1930s. Not to take anything away from MMTers, but there has been a degree of "endogeneity" to their success. We can also place the policy supercycle into a series of macro-financial-political regimes since the late-19th century, the "three phases of Capitalism". While some pundits were surprised there wasn't a "regime change" after the 2008-crash, there was no clear alternative to neoliberalism. Today, MMT provides the "software" for a new paradigm.

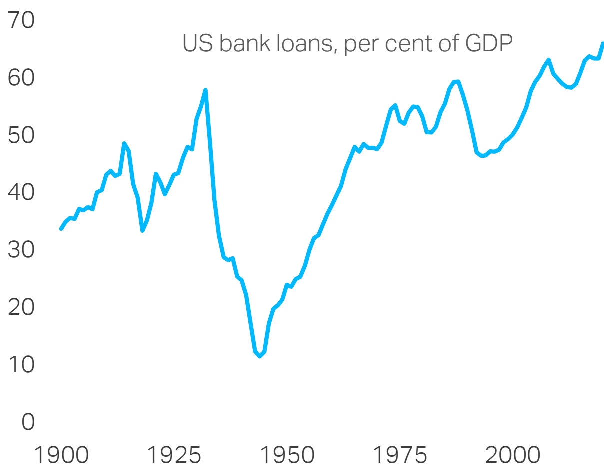
Mainstream economists love to point out "there is nothing new in MMT". When interest rates are zero, all MMT's big macro claims should be uncontroversial even for traditionalists – monetary policy will struggle to reflate the economy, bond and "money" financing are equivalent (so QE is meaningless), there is no "crowding out", and fiscal policy must take over. But the mainstream had forgotten this analysis and has spent the last decade assuming the zero-rate environment would be temporary. Not only has MMT always been on the right side of these debates (which makes Kelton a sort of modern day Milton Friedman), but, thanks to the COVID-19 response, MMT now has unambiguous evidence to show fiscal policy is highly effective (with no serious side effects). While MMT can provide the intellectual rationale for a new form of Capitalism (Capitalism 4.0), it is going to take more than the creation of new fiscal/monetary policy space to get there. It will be crucial to monitor what happens to other institutions and broader political trends in the years ahead. Will there be a Reagan/Thatcher for Kelton's Friedman? While some commentators believe President Biden has already adopted this role in the US – proving more radical than anyone could have imagined before he entered office – the situation in the rest of the world is murkier (especially in jurisdictions that are less amenable to MMT-style thinking).

The big thing about the macro-financial supercycles is that they ultimately sow the seeds of their own destruction. Overly powerful trade unions played this role in the "mixed economy" of the1970s, while unsustainable debt expansions destabilized Capitalism 3.0. A pivot to "full MMT" could suffer a similar fate, by giving elected politicians too much responsibility for inflation. MMT analysis is sound when interest rates are zero but we should also expect activist fiscal policy to create a tendency for inflation and interest rates to rise. Some investors (particularly those who remember the 1970s) believe this "time inconsistency" problem will inevitably lead to stagflation and financial repression. Back in the 1970s, when fiscal deficits were often "unfunded", the authorities had to fight inflation by any means other than raising interest rates – which led to serial policy errors. It is possible MMT will set us down a similar path. But because secular inflation trends remain weak and labour-market institutions are totally different to the 1970s, such an "endgame" could be many years – perhaps even decades – away. More important, the influence of MMT is still (mainly) confined to fiscal policy rather than monetary policy. If central banks retain their independent, a "romance" with MMT (rather than a full marriage) would be a positive development, both for finance and the real economy. We certainly face a more sensible policy mix (and perhaps even a less toxic political situation) than during the Capitalism 3.0 era.

1. INFLECTION POINT

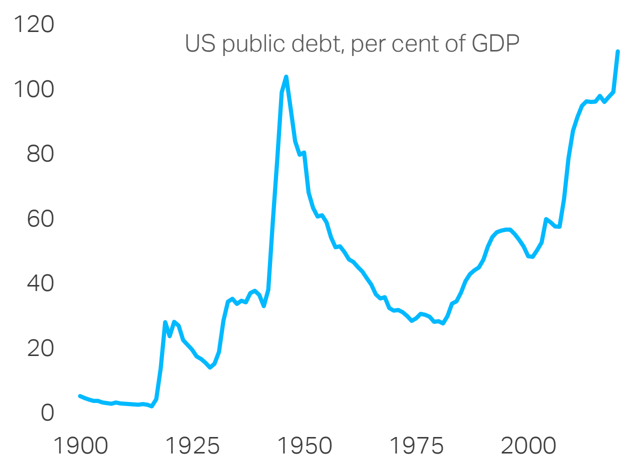
Last summer, after Stephanie Kelton published her influential book "the Deficit Myth", I told TS Lombard clients it could be the most influential economics volume in a generation. This view wasn't based on MMT's underlying analysis, which had been in the public domain for a number of years, but rather the timeliness of the message combined with Ms Kelton's natural ability to distil complex ideas into an appealing public narrative. Pretty soon, even sports celebrities and rap musicians were expressing their appreciation for MMT ideas. As a public-facing economist, Kelton is reminiscent of Milton Friedman, or rather an "anti-Freidman" given she holds an entirely opposite macro-political philosophy. But, while MMT has gained momentum with the publication of The Deficit Myth, this is a revolution in macroeconomics that has looked inevitable for some time. Even before COVID-19, we had identified a long "supercycle" in macro policy, showing how – over the last century – the pendulum had swung several times between extreme fiscal and monetary dominance, with the world again primed for another fundamental regime switch.

Chart 2: Echoes of the 1930s



Source: MacroHistory database, TS Lombard

Chart 3: Back to post-WW2 govt debts

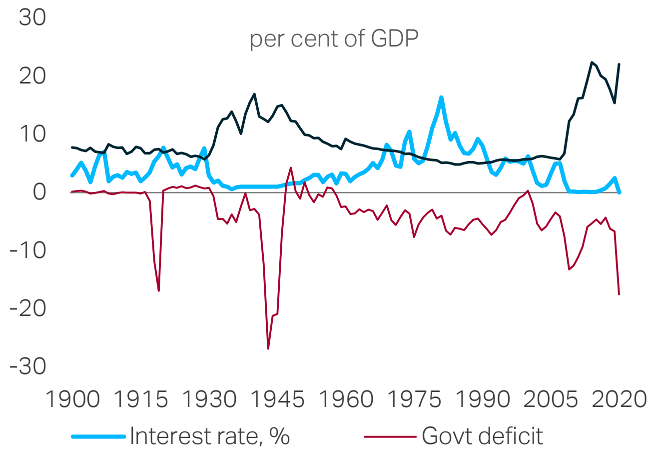


Source: MacroHistory database, TS Lombard

The "supercycle" turns

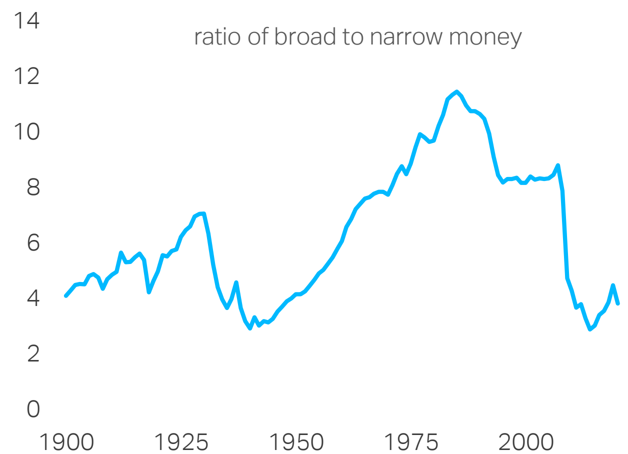
We can trace the policy supercycle from the end of World War I, which saw the rigid Gold Standard replaced with the more flexible Gold Exchange Standard. Until then, the monetary system significantly constrained what policymakers could do. Sure, financial panics were frequent, but there was no sustained monetary expansion (beyond the discovery of new gold supplies, such as New World gold in the 1500s). Inflation was effectively white noise. This changed in the 1920s, when the authorities – particularly on the monetary side – gained significantly more discretion. (As the BIS puts it, the global credit system became "more elastic".) The consequences of this new regime were profound, with the authorities in the US (and in some other countries) inflating an unprecedented credit bubble, which burst spectacularly in 1929. While monetary policy was dominant in the 1920s, by the mid-1930s it was clear that it had no solution for a serious Depression. This is when Alvin Hansen's idea of secular stagnation first appeared, together with the metaphor of monetary policy "pushing on a string". The authorities could pull the string to drag inflation lower, but they couldn't push on it to reflate a chronically weak economy. Fiscal policy had to take over – which is what happened during/after WWII.

Chart 4: The long fiscal-monetary supercycle



Source: MacroHistory database, TS Lombard

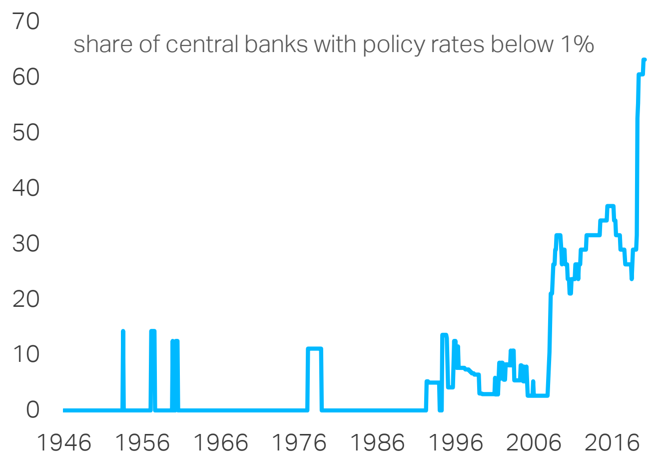
Chart 5: Banks stopped lending (like the 30s)



Source: MacroHistory database, TS Lombard

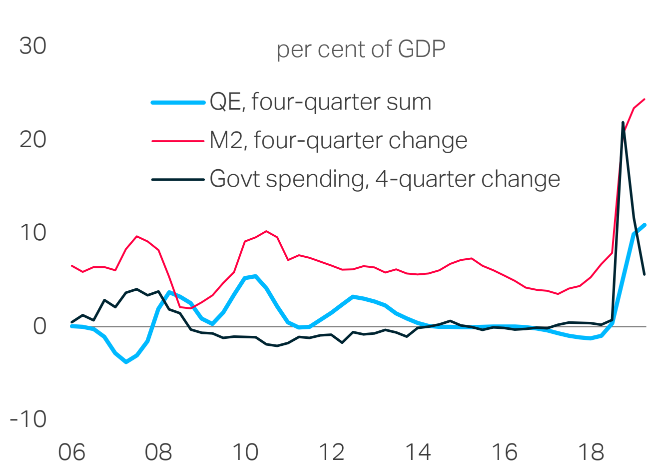
The extreme confidence in monetary policy of the 1920s was eventually replaced with an excessive faith in fiscal policy. Central banks were subservient to governments after WW2 and interest rates were relegated to the role of supporting the public debt. It isn't surprising this policy mix would eventually lead to the inverse of what happened in the 1920s – with inflation replacing deflation as the dominant problem. Eventually, of course, fiscal policy would become just as ineffective as monetary policy had been in the 1930s. Keynesian economics had no answer for 1970s stagflation. What works better against high inflation? Monetary policy. So the 1980s produced another regime change in policy, with monetary tools gaining traction, taming inflation and then completely taking over. Governments made their central banks independent, to lock in this new disinflationary era, with fiscal policy relegated to an untrustworthy secondary role (at best). Though the regime of monetary dominance was remarkably successful until the 2000s, it became clear that stimulating the economy via debt accumulation created severe underlying (often latent) imbalances – by the mid-2010s, secular stagnation was back.

Chart 6: A world at the lower bound



Source: BIS, TS Lombard

Chart 7: The COVID "romance" with MMT



Source: FRED, TS Lombard

Macro-political regimes

Investors have a tendency to see the world through the prism of macro stabilization tools, but the relative importance of fiscal and monetary policy – together with the underlying macro

environment in which they operate – is jointly determined with the broader political climate. In recent years, several academic studies and influential books have analysed macro policy as part of a sequence of deep macro-financial "regimes", identifying three main phases of Capitalism:

(i) the pre-World War I era, which combined the Gold Standard with "corporatism"

(ii) The "mixed economy" that followed World War II (the "Golden Age");

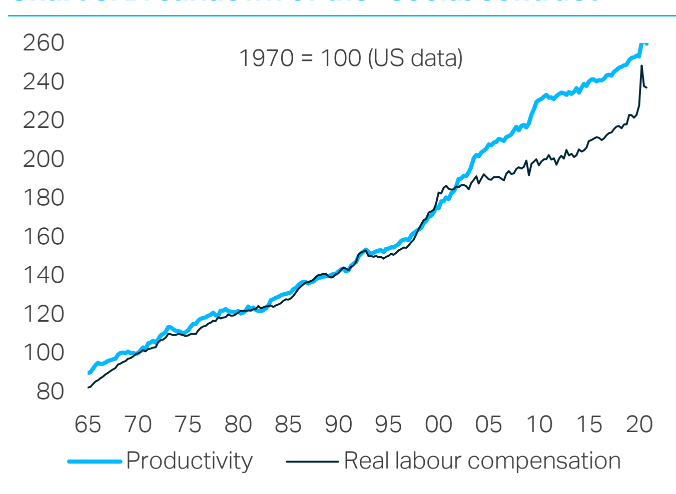
(iii) Post-1980s "Neoliberalism", which gained traction with Reagan, Thatcher etc.

Traditionally, political-economy analysis assumed exogenous events – such as the oil shocks in the 1970s – caused the world to switch between these three regimes. But a fascinating recent paper by Dafermos, Gabor and Michell (2020) suggests something deeper has been going on. Channelling Hyman Minsky, they argue that the capitalist system is fundamentally unstable, which forces the authorities to design institutions and "thwarting mechanisms" to try to manage and ultimately reduce this instability. In line with other recent work – such as Blyth and Matthijs, (2017) – the configuration of these institutions ultimately depends on the balance of power between different "interests", especially labour versus capital (see Table 1). When labour is dominant, we end up with institutions designed to ensure full employment. When capital is in charge, the focus is on keeping inflation low. But the whole system is reflexive – institutions affect economic outcomes and economic outcomes, in turn, alter the balance of power.

Chart 8: Capitalism 2.0 and 3.0

Source: Dafermos, Gabor and Michell (2020)

Chart 9: Breakdown of the "social contract"



Source: BEA,BLS, TS Lombard

Supercycle instability

In the Dafermos et al model, the supercycle arises because the effectiveness of the "thwarting mechanism" ('customs, institutions or policy interventions') needed to restrain capitalism naturally diminishes over time, as economic agents learn to game the system. There is an "endogenous erosion" of their potency, which eventually produces a tipping point. In the 1970s, for example, powerful trade unions – necessary to ensure full employment – eventually undermined the wage-price setting process. In the 2000s, the power of the financial sector eroded financial regulation and created dangerous macro imbalances. The system experiences a systemic crisis once the thwarting mechanisms are no longer sufficient to constrain the dynamics of the business cycle[1]. At that point, there is a power struggle, which eventually

[1] Based on Minsky's analysis, the Defermos et al model has two cycles: (i) a shorter-term business cycle (the "basic cycle"), which depends all short-run and medium-run economic fluctuations generated by the interactions between financial and real factors, and (ii) a long-term "super cycle", which reflects the effectiveness of thwarting mechanisms.

produces new institutions and an alternative policy regime. This reconfiguration of thwarting mechanisms reshapes the supercycle, hardwiring powerful macro ideas into new policy regimes.

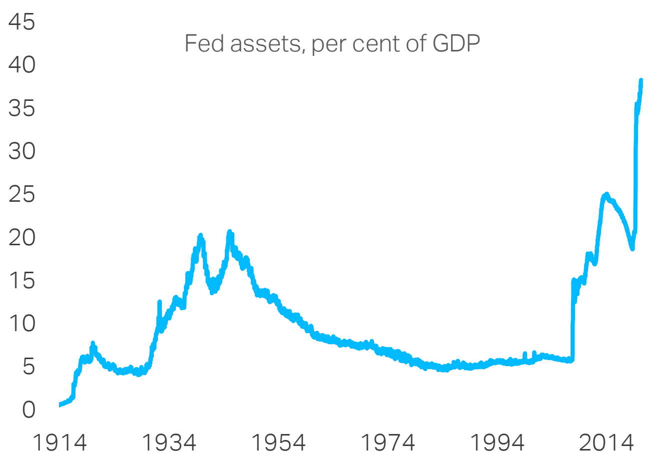
Table 1: Post-WW2 policy regimes

	Capitalism 2.0	Capitalism 3.0
Policy Target	Full employment (or low unemployment)	Price stability (or low inflation)
Policy outcomes	Positive inflation	Secular disinflation
	Labour share at historic highs	Capital's share at historic highs
	Corporate profits low/stagnant	Wages low or stagnant
	Inequality low	Inequality high
	Markets mostly national	Markets globalized
	Trade unions strong	Trade unions weak
	Finance weak and immobile	Finance strong and highly mobile
	Central banks weak and politicized	Central banks strong & independent
	Legislatures strong	Legislatures weak

Source: Based on Blyth and Matthijs, (2017)

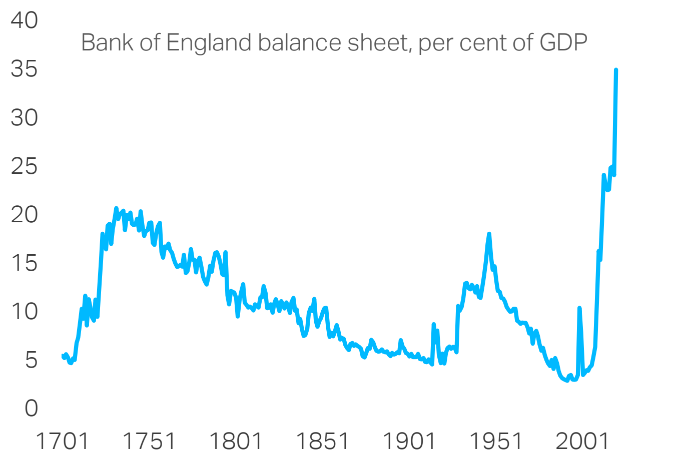
Defermos et al create a “macrofinancial stability index”, which they use to identify four phases of the supercycle: expansion, maturity, crisis and genesis (Chart 8). During the expansion phase, newly introduced thwarting mechanisms are highly effective, delivering strong economic growth and broad social/financial stability. Short-term recessions occasionally disrupt activity but thwarting mechanisms prevent a systemic crisis. Eventually, however, economic agents learn how to adapt to the new institutional environment, innovating to increase their profits. This reduces the effectiveness of thwarting mechanisms. Further, when the authorities introduce mechanisms to reduce one source of instability, they might create new problems – for example cutting interest rates to alleviate a recession might create inflation or encourage private debt. And once the effectiveness of these mechanisms starts to decline, the supercycle enters its maturity phase. Economic growth might continue but the macro-financial stability of the system diminishes. The next recession will lead to a more serious crisis, triggering wider social instability.

Chart 10: Historic Fed intervention



Source: Federal Reserve, TS Lombard

Chart 11: UK data show even longer history



Source: Bank of England, TS Lombard

Table 2: The three phases of Capitalism

	Features	Sources of instability
Capitalism 1.0	Gold standard limited policy discretion	1930s Depression – market didn't "self-correct"
	Unfettered corporate power (globalization & industrial revolution)	Mass unemployment
	Labour as a simple commodity	People demanded protection - extremism
	Few social safety nets, no unions etc.	World War II
Capitalism 2.0	Mixed economy – balance of power between big corporates and labour	Trade unions became too powerful, especially after OECD productivity slowed
	Companies made big LT investments	Eurodollar destabilized global capital markets and made the Bretton Wood unsustainable
	Government direction, big infrastructure	Stagflation – no Keynesian solution
	Workers paid full productivity, which in turn supported demand for industry	
Capitalism 3.0	Deregulation	Rapid private debt accumulation
	Finance moves to capital markets	Volatility in asset prices
	Emergence of securities-based credit system	Rising inequality and populism
	Rollback of the State	Low growth and weak investment
	Globalization and digitization	(Secular stagnation)
	Independent central banks	

Sources: Dafermos, Gabor, Michell (2020), Lonergan and Blyth (2020), TS Lombard

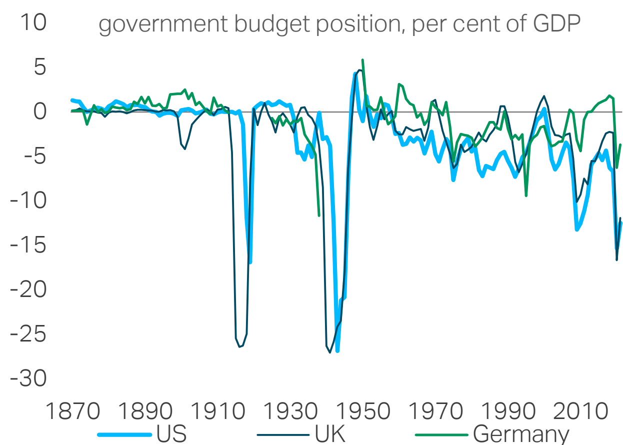
Have we reached the tipping point?

Back in 2009, there were lots of commentators warning about a "crisis for capitalism". Some thought the banking crash would trigger widespread social tensions, forcing a new regime ("Capitalism 4.0"). While there were political strains throughout the 2010s – populism, Brexit, Trump, euroscepticism etc. – the full "regime change" never happened. Instead, governments adopted austerity and central banks tried QE, pushing the old system to even greater extremes and widening wealth/income inequalities. Part of the problem was a collective lack of imagination – nobody could imagine a serious alternative to Capitalism 3.0 ("neoliberalism"). In part, this was because the subprime crisis came as a total shock to the establishment, breaking the Great Moderation, a long period of uninterrupted growth and prosperity. The response to COVID-19 has been radically different. Today, there is a broader feeling that the old "system" is broken and no expectation that the situation will improve with a *laissez-faire* government attitudes. The popularity of MMT is also significant – for the first time in a generation we have a clear alternative to neoliberal economics. While MMT enthusiasts say they are merely offering a "tool" to understand the economy, it is clear MMT is the blueprint for an entirely different institutional "software" and – ultimately – a way to shift the balance of power from "capital" to "labour".

2. MMT VICTORY

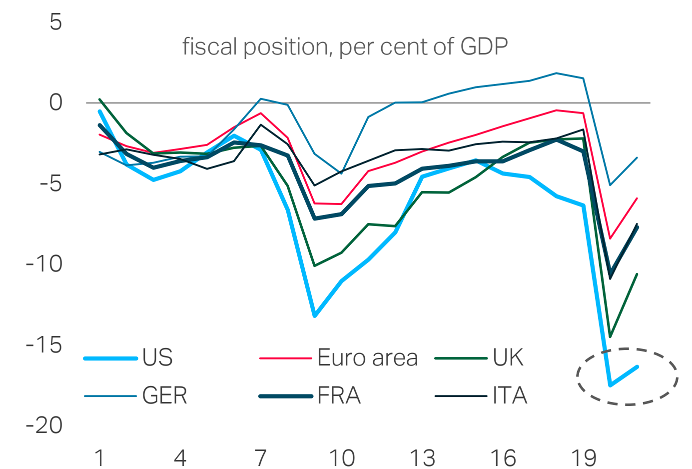
The attractive thing about MMT – beyond its promise that "we can have nice things" (a quote from Kelton's book, which appears alongside a vast fiscal wish list) – is that its proponents have got all the big macroeconomic calls correct over the past decade (while mainstream economics has struggled). When, for example, central banks first announced QE and some pundits were worried about inflation, MMT economists rightly pointed out that these policies were largely inconsequential, because QE just swapped one government liability for another. It helped that MMT employed a more modern and sophisticated understanding of how the banking sector worked, which was something mainstream economists had struggle with. MMT enthusiasts didn't fall into the trap of believing newly issued central-bank reserves would trigger an inflationary surge in bank lending because they realized the standard "money multiplier" was a fiction of economics textbooks. Banks make lending decisions based on expected returns, not the supply of "loanable funds". If anything, the money multiplier actually operates in reverse, with banks creating deposits and deposits requiring additional reserves. With interest rates at the zero bound and QE ineffective, MMT rightly questioned the potency of monetary policy.

Chart 12: Massive fiscal response



Source: MacroHistory database, OECD, IMF, TS Lombard

Chart 13: US has done the most



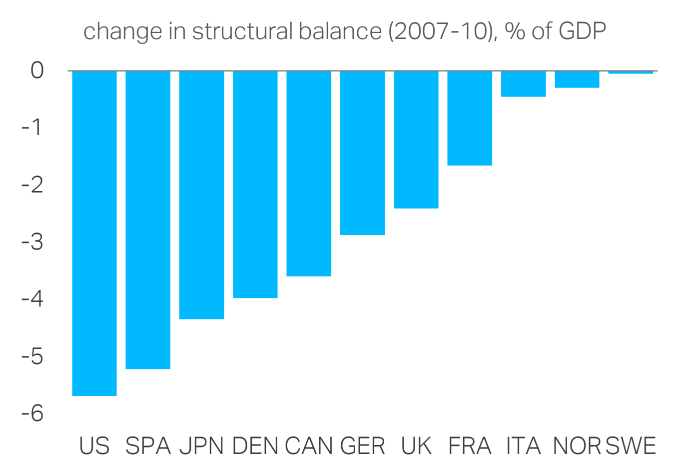
Source: IMF Fiscal Monitor, TS Lombard

QE, euro crisis, no bond vigilantes – MMT got everything right

MMT gained further traction during the euro crisis, which was also a difficult period for many mainstream economists. The distinction between "currency users" and "currency issuers" is central to MMT analysis. If the government (which includes the central bank) is the monopoly supplier of cash – it is a currency issuer and has full "monetary sovereignty" – MMT analysis shows it can never run of money. The central bank can always create new funding for its Treasury, either by printing bank notes (as in the past) or crediting the government with cash directly. Consider an example where the government wants to spend $1 trillion. It could either issue $1 trillion in bonds, or it could use its central bank to create the money electronically. MMT argues there is no reason to issue bonds, other than because these bonds allow monetary policy to operate in a specific way – which isn't strictly necessary. When the government spends this $1 trillion (on unemployment insurance, military equipment or whatever), the cash finds its way into the private sector, which will increase the reserves in the banking system. MMT stresses an important point: the increase in reserves will cause short-term interest rates to

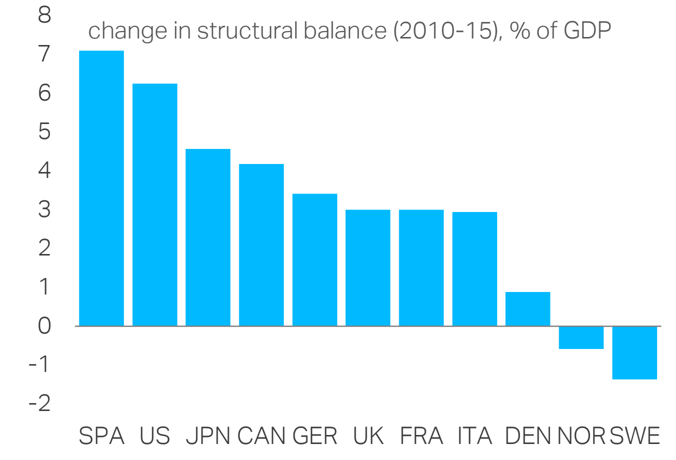
DECLINE[2]. This means there can be no "crowding out" and no chance of the government "running out of money". The only genuine concern is that it might ultimate cause inflation. So the true constraint on policy depends on the real resources of the economy, the amount of "slack".

Chart 14: After easing policy in response to GFC



Source: OECD, TS Lombard

Chart 15: Governments adopted austerity



Source: OECD, TS Lombard

The big thing about the euro crisis was that it showed what can happen when governments give up their monetary sovereignty. The likes of Greece and Italy could run out of money and did become victims of the bond vigilantes precisely because they couldn't rely on their central banks (now consumed by the ECB) to "print money". Many mainstream economists struggled with this basic point, which is why they failed to understand the 2010-13 market crisis. Worse, once the likes of Greece suffered serious financial calamities and spiraling bond yields, some economists mistakenly applied the logic of "currency users" to "currency issuers". They warned that the US might "turn into Greece" and that UK gilts were "sitting on a bed of nitroglycerin". These faulty narratives stuck and became the reason for adopting disastrous austerity policies across the developed world from 2010 onwards. MMT (again rightly…) pointed out that the combination of overly tight fiscal policy and ineffective monetary policy would compound secular stagnation, a policy mix that would eventually push nominal bond yields down to 700 year lows. The austerity error became even clearer when governments eventually loosened their budgets, starting with Trump's stimulus after 2017. Far from resurrecting the bond vigilantes, yields eventually settled at new historic lows. And then COVID-19 struck, which forced the biggest fiscal expansion since WW II. Did governments struggle to fund themselves? Not at all.

MMT is the new "software" but politics dominates

With the experience of the last decade discrediting mainstream economics and MMT gaining traction, there are parallels with the death of Capitalism 2.0 and the emergence of monetarism. Keynesian economics, which had dominated the period 1945-1970 had no answer to the most serious macro issue of the time – stagflation. So Milton Friedman's monetarism – which had correctly predicted stagflation – eventually took over. The question today is whether MMT can enjoy the same level of dominance going forwards, perhaps with Stephanie Kelton playing the

[2] Before the financial crisis, back when the Fed operated a 'corridor' system, the central bank would prevent this from happening by altering the supply of bonds in the economy – it would "mop up" the reserves by issuing bonds. This, according to MMT economists, was the main reason governments needed to issue bonds in the past – the central bank required these bonds so that it could operate monetary policy by manipulating the level of short-term interest rates.

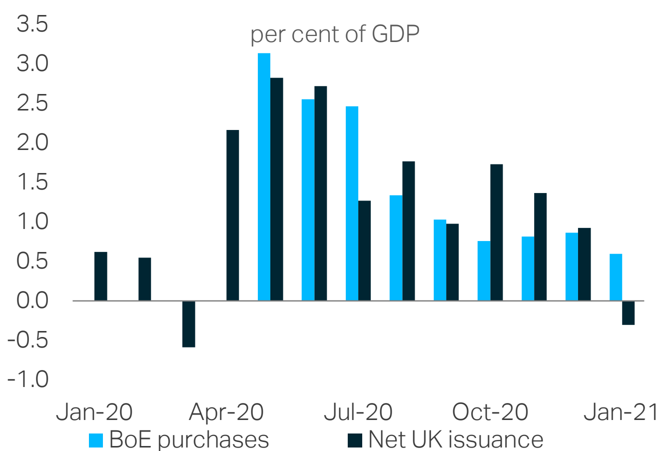
role of (the anti) Milton Friedman. Like Friedman, Kelton is a brilliant salesperson, able to express herself in a way most people (even politicians!) can understand. Ultimately, of course, the influence of MMT will come down to politics. Back in the late-1970s/early 80s, there was a political revolution primed to embrace monetarist/neoliberal ideas, with a population that had endured serious economic crises, and compelling new leaders – Ronald Reagan in the United States and Margaret Thatcher in the UK – who promised a brighter future, free of "Big Government" inefficiencies. Who is going to be the Reagan/Thatcher to Kelton's Friedman?

A gentle inflection point

A new macro-financial regime (Capitalism 4.0) requires a political revolution equivalent to what happened in the 1980s (or the 1930s). It needs to fundamentally shift the balance of power between workers and capital. MMT-type thinking can provide the "software" for this new regime (to use the term that Mark Blyth and Eric Lonergan adopt in their brilliant "Angrynomics" book) – by resetting policy objectives and creating the required fiscal/monetary policy space – but an attractive economic theory alone isn't going to be enough. Nobody knows for sure whether this is going to happen – or, if it did, how quickly such changes could transform the macrofinancial climate – but there are certainly signs we have reached a gentle inflection point. The clearest evidence comes from the United States, where various commentators now believe President Biden is playing the role of an unlikely political revolutionary (unlikely because, as Ezra Klein points out, it contradicts everything we thought we knew about Congressman Joe Biden).

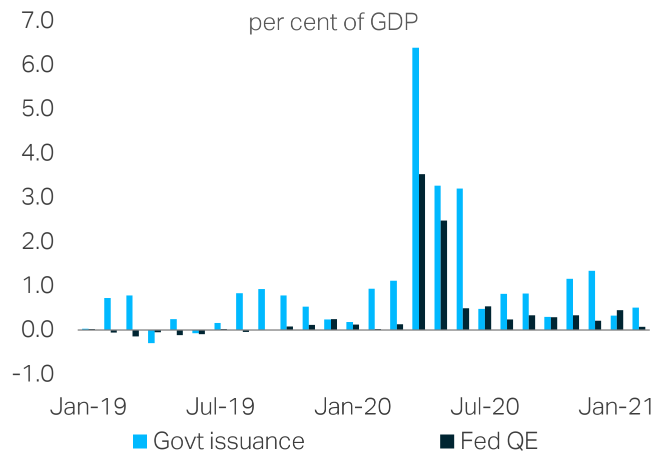
According to Klein, President Biden's radicalism reflects a combination of factors: (i) A shift in the Democrats' political objectives, with the party now prepared to push policies it believes will be popular with US citizens rather than bipartisan ideas that are acceptable to Republicans; (ii) the emergence of a new (younger) generation of advisers/staff who have grown up in an era of secular stagnation/inequality and do not share the babyboomers' fear of 1970s-style inflation/ Big Government; and (iii) an administration that no longer listens to mainstream economists (such as Larry Summers), a major break from previous Democrat governments. According to Klein, "the backdrop for this administration is the failures of the past generation of economic advice. Fifteen years of financial crises, yawning inequality and repeated debt panics that never showed up in higher interest rates have taken the shine off economic expertise". Finally, many pundits believe 2010s populism has been a major wakeup call for the likes of President Biden, who are desperate to avoid another Trump-style "strongman" taking control of US policy.

Chart 16: BoE is "coordinating" policy?



Source: Bank of England, ONS, TS Lombard

Chart 17: US coordination less obvious



Source: US Treasury, Fred, TS Lombard

The argument for a "regime change" in US politics is gaining traction – perhaps it is overdue – but the issue is far from settled. President Biden has a thin majority in the senate and the midterms in 2022 will be a critical first test for any "new paradigm". If the democrats lost control, as Obama did in 2010, the prospects for US policy would look very different. Remember also that the politics of agreeing fiscal stimulus in 2020-21 were relatively straightforward because there was nobody to blame for COVID-19 (a big contrast to the 2008 crisis) and governments were forcing people to stay at home. They had no alternative.[3]. The situation will become trickier once the pandemic is over and the economy has fully reopened. Yet, if the early experience of "Bidenomics" is successful it could empower the President to go even further. This would greatly enhance the prospects for a genuine "paradigm shift", both in the US and elsewhere. We might even see a version of Bidenomics in Europe, especially if the region is slower to recover from the current recession (as seems likely, with politicians not doing enough to support the economy).

Climate change as a catalyst, even in Europe

Climate change is the potential catalyst for a political regime change, which could fundamentally reshape the macro-financial landscape. Not only is it the centre piece of what the US administration is trying to do, but it features prominently in MMT policy initiates/advice. Environmental damage is, of course, the classic market failure/ "externality" that requires government intervention, especially given neoliberalism's apparent failure to address this problem. Now, the scale of the potential climate disaster, and the speed at which it must be solved, demands a different role for the government. This catalyst is especially important in Europe, where the growing popularity of the Green Party in Germany has the potential to kill the fiscal conservatism that has guided German politics (via CDU-CSU dominance) since the early 2000s. A CDU-Green block, which seems likely ahead of September's elections, could exclude public investment from Germany's zero deficit rule, allowing a massive expansion in government spending over the next decade. By declaring a "war on climate change", Germany could unleash a powerful policy stimulus, not only domestically but across the whole of the euro area.

MMT-enthusiasts are reluctant to apply their ideas to the euro area because governments have given up their monetary sovereignty. Yet with the ECB desperate to reflate the region and engaged in massive (increasingly "green-friendly") QE, there is certainly an emphasis on governments across the euro area to do more to try to revive their depressed economies. So far, most European governments have been reluctant to take up this opportunity and have done less than required, even during the COVID-19 crisis. Fiscal policy has diverged sharply with the United States, especially over the past six months. Even the much-celebrated Recovery Fund, which was widely acclaimed to be a "Hamiltonian moment" for the euro area is explicitly a one-off, presumably because the region has been unable to shake off its eternal worries about "moral hazard". Yet a shift in German politics could help to address these failures, especially if it produces new flexible fiscal rules that will allow governments to invest in green infrastructure.

China abandoning MMT?

Ironically, the one part of the world that has come closest to MMT policy prescriptions in recent times – China – seems to be falling out of love with these policies. The Chinese authorities massively expanded their state balance sheet after the global financial crisis, adding more than 30% pts of GDP to the world's aggregate debt ratio. In an era of secular stagnation, this made China the dominant driver of the global industrial cycle, with every short-term swing in the

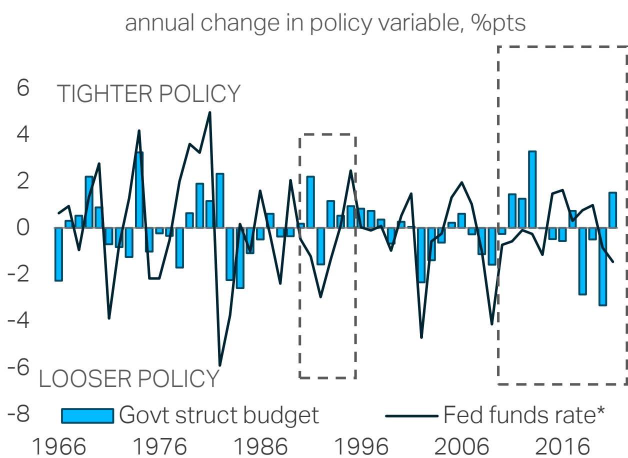
[3] Kelton is right that politicians confuse public finances with the constraints on households. The public do too, which is why austerity was accepted. But politicians are also fickle and "the deficit" is sometimes no more than a convenient excuse not to approve additional government spending ("we would love to do X but we simply can't afford it").

nation's domestic policy cycle guiding broader gyrations in world trade and international investment spending. Yet, just as the rest of the world is becoming more willing to use fiscal instruments to boost demand, the Chinese authorities seem reluctant to continue down this route. Worried about turning into the next Japan, with public and private debts that are too large, China now seems determined to damp its medium-term credit expansion, accepting weaker trend GDP growth rather than risk compounding acute vulnerabilities in its banking sector[4].

3. FISCAL DOMINANCE

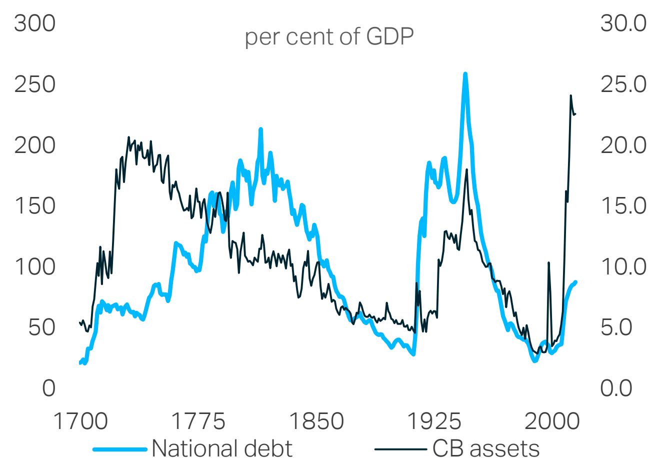
The growing popularity of MMT and its potential to provide the institutional software for a totally new macro-financial regime is making some investors uncomfortable. They worry that it has set us on a policy path that leads back to the macroeconomic chaos of the 1970s. Just as Neoliberalism (our Capitalism 3.0) recreated the broad macro conditions of Capitalism 1.0 (i.e. deflation and inequality), a new regime of "interventionist" governments (let's call this Capitalism 4.0) might meet a similar fate to Capitalism 2.0 (fiscal dominance and stagflation). Indeed, all the most bearish financial pundits have suddenly become "inflationistas", abandoning their previous perma-deflation views. We agree stagflation is a long-term risk – like every policy regime, MMT relies on "thwarting mechanisms" that could become ineffective over time. And in the case of MMT, this points firmly in the direction of an inflation bias. But any stagflationary endgame is not inevitable and could be many years (even decades) away, especially if it takes time for MMT to extend its influence beyond fiscal/monetary policy and fundamentally alter the balance of power between workers and capital (via e.g. deglobalization and trade unions). In the meantime, the popularity of MMT-type thinking should be a good thing – it will improve the macro policy mix.

Chart 18: The 2010s policy mess



Source: OECD, TS Lombard

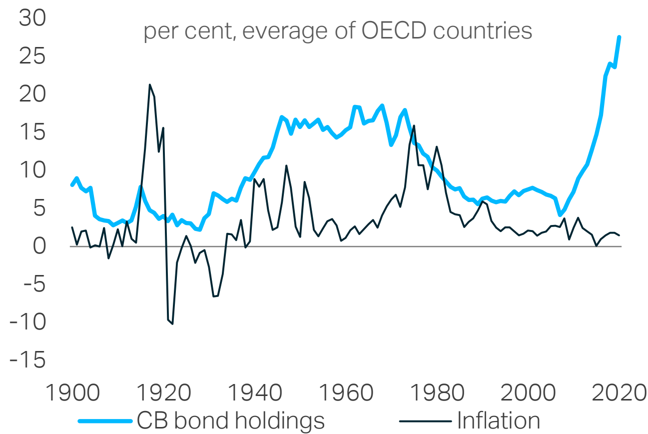
Chart 19: History of UK "debt monetization"



Source: Bank of England, TS Lombard

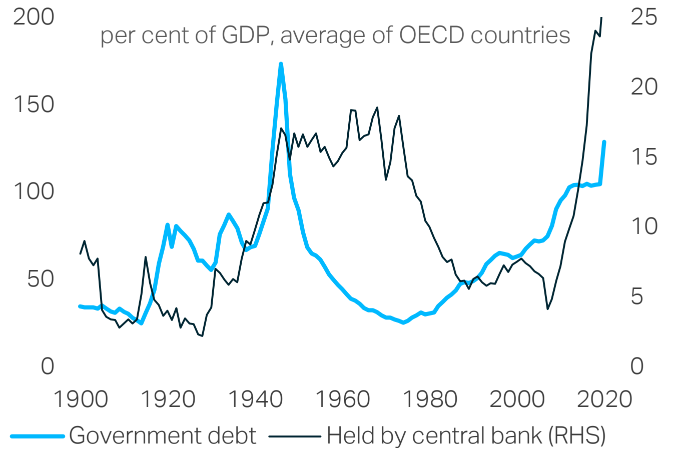
[4] In principle, much of the debt accumulation since 2008 has been on "private" balance sheets. But the distinction in China is murky, with state-owned banks lending to state-owned enterprises. In reality, the government has simply been shifting public debt around different sectors of the economy, giving it different (largely artificial) labels.

Chart 20: Coordination not naturally inflationary



Source: IMF, TS Lombard

Chart 21: Back to the 1940s regime

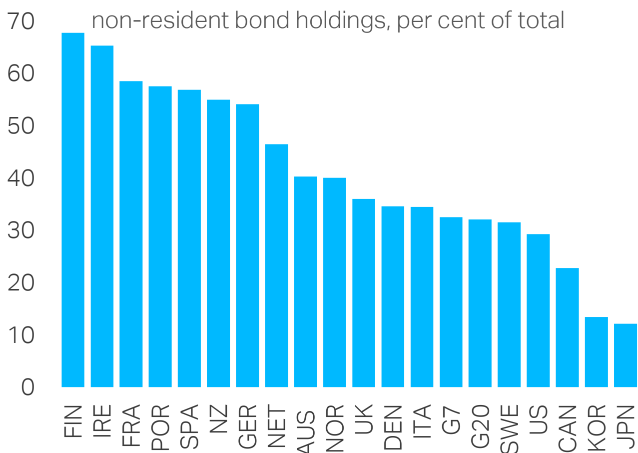


Source: IMF, TS Lombard

MMT is mainstream at zero rates

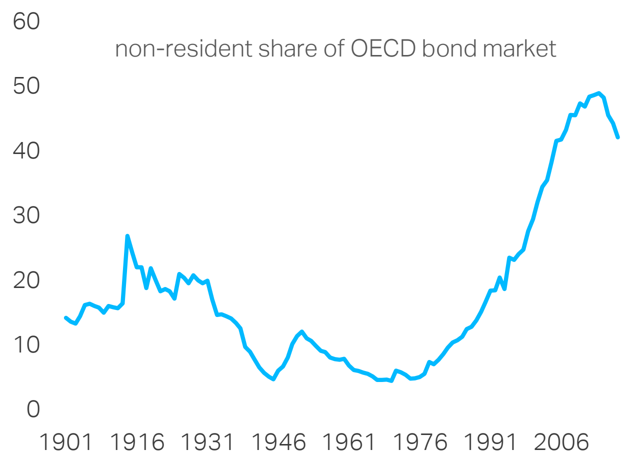
The success of MMT over the past decade arguably reflects a specific set of macro conditions, rather than a new "universal" set of economic rules that are applicable in all states of the world. In the language of mainstream macro, the fundamental issue is the equilibrium interest rate – the rate consistent with stable inflation – has been close to zero for many years. Had mainstream economists recognized this development in real time, which they failed to do, they should have been making the same forecasts (and giving similar policy advice) as the MMTers. With interest rates at zero, monetary policy becomes less effective, there is no difference between debt and money-financed government deficits, and the case for large-scale fiscal stimulus becomes overwhelming. There is also no crowding out and no risk of bond vigilantism. In short, in a world of secular stagnation, MMT and mainstream macroeconomics should be indistinguishable.

Chart 22: MMT doesn't apply to all?



Source: IMF fiscal Monitor

Chart 23: Headed back to financial repression?



Source: IMF, TS Lombard

Where the controversy comes from

The controversy with mainstream economics is not whether governments *can* fund themselves at zero rates indefinitely, but rather whether this is something they *should* try to do. By creating bank reserves rather than bonds ("unfunded" rather than "funded" deficits), the government is effectively borrowing overnight rather than issuing long-term securities. This

doesn't matter when the equilibrium interest rate is zero but it could become important if/when the equilibrium interest rate increases. Mainstream economics calls this a "rollover risk". The worry is not that a government with monetary sovereignty will struggle to fund itself (but rather that this will cause a difficult dilemma for the monetary authorities. Central banks will either have to exert their independence and raise interest rates (which will have fiscal consequences) or suppress public-sector borrowing costs and allow inflation to overshoot. There is also a risk governments will eventually exert their power over the central bank, rescinding their independence. This all sounds academic, but it is actually relevant to the situation we face to today. By conducting massive QE operations, central banks have already shortened the maturity of (consolidated) government liabilities, creating a (sort of) rollover risk in the public finances[5].

While MMT analysis works well in a world of zero interest rates, the mainstream complaint is that it becomes dangerous in a scenario where interest rates need to move higher. Extreme forms of MMT get around this problem by effectively deactivating monetary policy and preventing the central bank from responding. In the purist MMT world, central banks forfeit their independence and focus instead on capping public-sector borrowing costs by keeping interest rates at zero. So who fights inflation? MMT argues monetary policy is not an effective tool for keeping consumer prices down and puts more emphasis on other government agencies and tools – notably regulation, restrictions on credit availability and fiscal policy. Ideally, the fiscal authorities would make their tax and spending decisions subject to a strict inflation constraint, which would prevent the economy from overheating even with perma-zero interest rates – especially if they introuced powerful automatic stabilizers such as MMT's flagship Job Guarantee (JG) proposal. A JG scheme would produce a natural tightening in fiscal policy as the labour market "heated up".

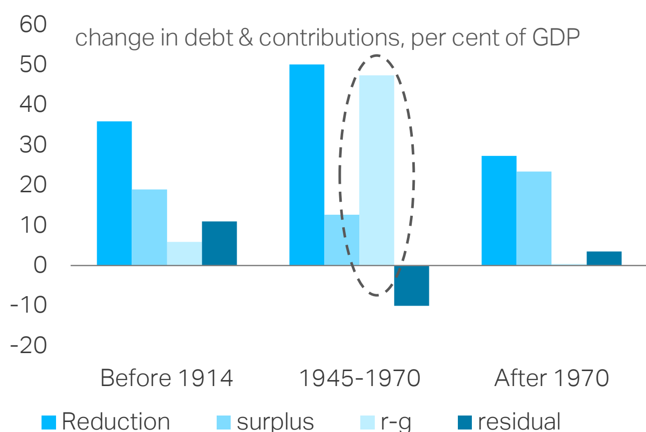
MMT has an inherent inflation bias

Many economists – and older investors – are worried that governments that adopt pure MMT software will have an inherent inflation bias because politicians will not be able to restrain themselves once they get a taste for large public spending. This, after all, was one of the most important policy lessons of the 1960s/1970s and the bedrock of the neoliberal consensus that gave us independent central banks and an emphasis on balanced budgets. In its most extreme forms, MMT only holds when interest rates are zero but the act of following MMT policy recommendations would actually cause the equilibrium interest rate (r*) to rise. In this sense, we can already see how Capitalism 4.0 – like previous policy regimes – would incorporate a new policy software with inherent "bugs". In fact, there is even an argument that MMT is really just an excuse for governments to "inflate away" the debt they have accumulated over the past decade. This is consistent with our historical review of large public debts and how governments paid for previous crisis that were similar in magnitude to COVID-19. We showed there were broadly two main approaches – the "orthodox" (austerity and structural reforms) and the "unorthodox" (inflation, default and financial repression). The decisions that were made depended on which groups (creditors or borrowers) in society governments were representing. Before the First World War (our capitalism 1.0) and during the neoliberal regime (Capitalism 3.0), the creditors

[5] Currently, we have a "floor system" in monetary policy – central banks pay interest on bank reserves, which they can adjust in order to move a broader set of interest rates. In this operating framework, the MMT proposal for cash-financing means the government would effectively be borrowing OVERNIGHT. This is because reserves are a liability of the central bank, which is part of the government. If the central bank eventually raised interest rates, the debt servicing costs of the government would start to increase (via lower remittances). We get the same dynamics with the combination of government deficits and QE, which have been a feature of policy over the past decade. When the central bank buys government bonds, it adds reserves to the bank system and – as long as it continues to pay the IOER – this action effectively shortens the maturity of the government's liabilities, transforming long-term debt into overnight lending. If the government spends $1 trillion and the central bank conducts $1trillion in QE, we get the same result as if the government funded itself with $1 trillion in overnight bills.

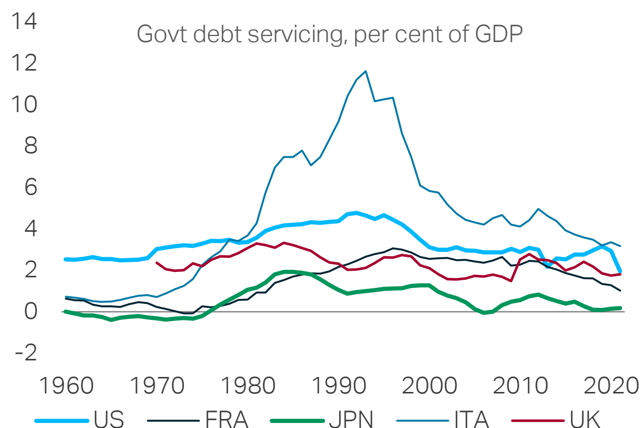
dominated policy and the authorities went down the austerity route. MMT, in contrast, aims to take us down the unorthodox route – an endgame of inflation and financial repression.

Chart 24: This is how we "paid for" WW2



Source: TS Lombard estimates

Chart 25: Public sector debt servicing



Source: OECD Economic Outlook

How we (really) pay for it

For mainstream economics, public-debt sustainability is a matter of arithmetic, the difference between debt servicing costs ("r") and nominal GDP ("g"). When "r" is less than "g", debt is on a declining trend. On this basis, a charitable interpretation of MMT is that it would aim to deliver fiscal sustainability by using government investment to raise "g" relative to "r." Large public infrastructure programmes could, for example, raise national output with relatively little impact on inflation, while trying to "run the economy hot" would boost participation and revive productivity. But there is also a more pessimistic interpretation, which claims MMT is just an attempt to achieve debt sustainably by raising inflation (lifting nominal GDP) while "repressing" financial markets, holding down interest rates and effectively imposing a "wealth tax" on investors. A fascinating podcast with Ian Macfarlane, the former Governor of the RBA, shows how MMT software might end in policy chaos. Macfarlane explains what went wrong in the 1970s, with a focus on the dangers of unfunded deficits. He argues central banks were slow to respond to inflation because they were reluctant to raise interest rates. Instead, the authorities tried to control inflation by other means, relying instead on direct price/income/credit controls and regulations that forced financial institutions to hold government bonds even if they made losses in real returns. It is not an exaggeration to say recent MMT advice on inflation – which comes from a similar desire to suppress borrowing costs – has eerie similarities with the way central banks conducted monetary policy after WW2. MMT is trying to recreate Capitalism 2.0.

Stop worrying about the endgame!

The inherent inflation bias in MMT suggests investors are right to identify stagflation as the potential "endgame" for this new policy regime. If MMT provides the "software" for Capitalism 4.0, inflation and "fiscal dominance" are the obvious "bugs" in the system that will eventually lead to instability. Yet it is also important to remember that any rerun of the 1970s is not inevitable and could, in fact, be many years (perhaps even decades) away. This is because the influence of MMT has (so far) been confined to the way the mainstream thinks about fiscal policy. It hasn't yet spread to other institutions and policy settings. Trade unions are weaker than in the past, international competition/technology continues to restrain wage demands (and prices are no longer just a markup on costs) and – crucially – central banks have retained their independence.

Even the "victory" of MMT in fiscal policy isn't totally ensured (or applicable at the global level). Of course, it is possible these things will change over time – creating a genuinely new Capitalism 4.0 regime – but this is far from inevitable (and unlikely to happen quickly). Paul McCulley summed the situation up nicely when he said policy is experiencing "a romance not a marriage" with MMT. We might end up with a "marriage" but we are definitely not there yet.

In the meantime, rather than worrying about stagflationary "endgames", there are reasons to think the popularity of MMT could be a "good" thing for both financial markets and the real economy. Confined to fiscal policy (with monetary policy staying in the hands of independent central banks) we are likely to see a better policy mix than at any point since the global financial crisis. Fiscal policy will become more expansionary – on average, but especially during recessions – while monetary policy adopts a secondary rule, sticking to what it does best – anchoring inflation expectations. This is unambiguously a superior policy mix compared to what happened during the 2010s, where governments were excessively worried about their budget positions and central banks couldn't counteract this because QE was ineffective and the lower bound prevented them from reducing interest rates. It should deliver both stronger economic growth and less inequality, which would tackle some of the severe political – and ultimately market – risks that have appeared over the last decade. We actually have a chance to tame the historical supercycle in fiscal-policy dominance by allowing both tools to focus on what they are good at. Sure, MMT ultimately wants to swing the pendulum too far (towards fiscal policy), but that is a problem for the future – it is not something investors should worry about today.

Bottom line

MMT is claiming victory over mainstream macro, with politicians no longer worried about whether they can afford a more "interventionist" approach to supporting their economies. Certainly, the debate about the size of fiscal stimulus in the US is happening on "MMT terms" with the mainstream worrying about the inflation consequences of government spending rather than "crowding out" or the "bond vigilantes". While the MMT "victory" is less apparent outside the United States, it is possible that a successful Biden administration – combined with the existential threat from climate change – will transform the fiscal narrative elsewhere. We have long felt there is a degree of inevitability about this transition to a "new regime", especially as we retrace the long historical supercycle in macro policy, which has seen the world oscillate several times between fiscal and monetary dominance. Some commentators thought this transition would take place after 2008 but, with the financial crisis coming as a complete shock to the establishment, there wasn't a clear alternative to post-1980s neoliberalism.

Today, these alternatives exist. If MMT is to provide the "software" for a new macro-financial regime, it comes with obvious bugs – which the bears have correctly identified in an inherent inflation bias. But we think now is not the time to worry about the "endgame" or an eventual "repeat of the 1970s". As long as MMT's influence is mainly confined to fiscal policy, while central banks retain their independence, we are facing a much healthier policy mix than the one that only compounded the secular stagnation of the late-Capitalism 3.0 era. Not only would this boost average economic growth, it might start to tackle inequality – the cause of increasingly toxic political trends and a serious threat to the long-term stability of financial markets. We might even discover that Wall Street and Main Street can learn to co-exist. Gradually shifting the balance of power back to "labour", if it happens, won't necessarily destabilize capital markets.