MACRO COMMENT

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The New Reality Show: *Real Economists of the Ivory Tower*

Principal Plot: **Inflation Is Not Proceeding from Large Scale Money Growth as Monetarists Would Expect. Keynesians Are Not Providing a Complete Enough Explanation to Laymen as to Why That Is So. Frustration and Name-Calling Ensues.**

And a Subplot: **Warren Buffett Walks into a Bar. . . .**

Over recent months, an intense debate between two opposing schools of economics has reached a crescendo. The relationships—at least in print—among members of the so-called saltwater school of economists (those leaning towards Keynesian fiscalism, and more-managed forms of capitalism) and economists in the freshwater or Chicago school (broadly favoring less-regulated, free-market economies with an emphasis on monetary matters) has never been overly warm. But the degree of name calling and apparent unwillingness to find common ground has come to a head since the beginning of the year—especially following the U.S. economic profession's annual conference the first weekend after the New Year's break.

With the World Economic Forum at Davos on tap for this week, providing yet another occasion to read tea leaves and tout theories, it is a good time to consider whether polarization of opinion isn't as much of a problem as polarization of income and wealth in the developed world. Is the almost complete absence of consensus among mainstream economists yielding drama but paralyzing decision?

To my view, the answer to the foregoing is a decisive yes. So, I have decided to tackle the issue with a bit of humor, together with my own explanation of the underlying problems and suggestions for how to go about reaching a very elusive meeting of great minds.

The debate as it proceeds each week in what I now title *Real Economists of the Ivory Tower* provides an often amusing diversion for its wonkish audience—but I am afraid it will never be successful mass entertainment.

Its cast—Paul, John, Robert, Brad, Simon, Scott, Tyler, and others—can fling their credentials and arguments at one another, but if you don't know who I am referring to in this sentence, I doubt you would DVR the series. (Fortunately, we all have a guy named Mark—who happens to be a new colleague of mine in our work at The Century Foundation—to keep everyone honest, so you can always head over to his invaluable blog if you miss any episodes.)

Economist cat fights, alas, seem never to involve sex. There's money, but no bling. And the typical insults run the gamut from "you weren't listening during Econ 101" to "you are so out of it that you can't even understand what I am saying."

That economists don't understand what each other are saying, of course, comes as no surprise to laymen—as everyone else can't understand them either.

So, with that in mind, and as technical as the subject matter may be (this is, actually, a *serious* essay), I'll do my best to present in plain language the problem that is the source of the foregoing drama. For more advanced readers, I will provide a somewhat unconventional explanation of a possible middle ground that I will call, for now, an Exogenous Supply Incongruity (so named as to make certain no one understands me either until they read on).

The Synopsis to Date

In the major nations of the developed world—first in Japan, over a period of nearly two decades, then in the United States, beginning in 2008, and now (however reluctantly) in Europe—monetary authorities (central banks) have been massively increasing the portion of the money supply over which they have direct influence in an effort to revive their economies. In a conventional cyclical downturn, it is received knowledge that looser money encourages additional economic activity (spending, investment, employment, etc.) by making money cheaper and discouraging saving/hoarding.

Cheap and ample money would also encourage lending, and thereby would be expected to increase broad money supply—and, ultimately, to induce inflation across economic sectors.

In response to economic collapse, central banks have now gone well beyond conventional methods of expanding money supply, including purchasing investment assets (typically government issued or insured) in the open markets and pushing cash out to the sellers of those instruments, in the expectation that they will do something with that that cash to improve economic activity. This action is known as *quantitative easing,* which is a fancy term for what desperate central banks must resort to when they've already dropped short-term interest rates to essentially zero (the so-called zero lower bound, beyond which conventional monetary policy is obviously useless).

A limited amount of re-inflation itself is generally regarded as being a net positive to the recovery of an economy, especially after a debt binge such as we experienced in the 2000's. The principle concern in this regard, however, is not to induce runaway inflation—something that is bad for a whole host of reasons that I do not need to go into here (especially because a majority of Euro-American economists and politicians appear to be preternaturally so afraid of inflation that one must assume that they all must know exactly why that is—or perhaps not, but I digress).

In any given developed nation, along with inflation, one would expect to see the value of that nation's currency fall in relation to those of others that are not experiencing similar rates of inflation—thus furthering inflation in imported goods and making the inflating economy more competitive relative to those other countries. One would also then expect interest rates to rise in order to maintain levels of real (inflation adjusted) returns, thus getting things off the zero bound and back to normal.

The problem today is that, not only have conventional and extreme/unprecedented forms of monetary easing failed to restart brisk growth in developed economies, but massive monetary growth has not resulted in sustainable inflation, either. To be sure, there have been spikes in U.S., U.K., and European inflation (and slowing deflation in Japan—which is how you need to measure things over there), but they have arisen from *expectations* that quantitative easing would surely result in sustained inflation—not the actual thing itself.

And when inflation failed to materialize on a sustained basis in the United States (primarily because wages refused to track inflation in commodity and other goods to which excess liquidity flowed in an attempt to shelter money from expected inflation), the dollar refused to devalue. Instead of causing interest rates to rise, U.S. policy to date has seen interest fall to historically low levels in anticipation of not inflation, but rather—if anything—deflation.

All of this has, understandably, sent the freshwater crowd into a defensive tizzy of the sort you might hear from the religious right in response to taunts like "God is dead." (Of course, the gods of the Chicago school are dead, which is unfortunate, because I'd love to hear Friedman and Hayak chime in on all of this.)

Trying hard to make the facts on the ground fit into theories and models that freshwater economists have spent their careers studying and advancing is a tough business under the current circumstances. Not only are they up against the dreaded zero bound, and the arguments from the other side regarding the existence of a "liquidity trap" (in which excess liquidity tends to exacerbate matters), but the failure of the economy in the first place can be arguably laid at the doorstep of the freshwater crowd, following a quarter-century of road-testing various forms of the supply side-oriented consumerism they directly or indirectly advocate.

The dramatic foil for the supply-siders is provided by demand-oriented Keynesian economists, and so-called New Keynesians, who for that same twenty-five-year period have been forced to endure the slings and arrows hurled at them from colleagues whom they still regard as contrarian newcomers. Full disclosure: while I am one-quarter of Austrian lineage (a joke about . . . well, too complicated, let's just say I think there is some degree of moral hazard in "free money"), the other three-quarters of my economic orientation is very much Keynesian. But I am doing my best to be evenhanded here, even critical with respect to those with whom I otherwise agree.

The dramatic conflict in our new reality show: it is hard to ignore that aggregate U.S. and global demand is inadequate to foster a robust recovery. Even the supply side/monetarists agree. The issue is how to address that imbalance (and its related imbalances).

Thus far, and I am deliberately over-simplifying, the fiscalist Keynesian response has been a lot of "I told you so" combined with calls for governments to spend more money on direct employment to drive demand (I have made similar calls—without, I hope, any vindictive rejoinders). It is also suggested that governments borrow as necessary to finance that spending, on the theory that long-term interest rates have never been lower, excess labor has not been more abundant since the Great Depression, and there is a pretty good history of government spending serving to re-prime private sector economic activity.

The position of the saltwater school is thoughtful, pragmatic, and often quite insightful with regard to the flaws in the arguments of the Chicagoans. But the debate has stalled, partly because instead of persuading and finding common ground, the obvious (at least to me) victor is seeking its intellectual spoils. I am a businessman first and a writer on macroeconomics second, and while this stuff may be par for the course in academia, we are not getting the deal done. We are not finding the consensus necessary for those with less knowledge (our political leaders) to be able to trust that there is one, and adopt it.

"Call Rewrite!"

So, as much as the drama of *Real Economists of the Ivory Tower* can be entertaining in a sophomoric sense (and it is terribly funny), I'd like to take a shot at coming up with a new treatment that might result in the show getting better ratings. It involves the "coastal" economics crowd doing the following:

- Acknowledging, whenever possible, that there is a slew of monetarist thought that, when I was first studying economics thirty-six years ago, was still fringe and has since become an accepted part of New Keynesian thought—just so laymen don't think that Keynesians regard the Chicago folks as a lower form of humanity.

- Conceding that the freshwater school is populated with brilliant mathematic economists and theoreticians who, while they may have gotten some inputs wrong and assumed some important things away, developed brilliant formulae all of which work as a mechanical matter.

- Agreeing that more than just a little of what the other side posited might have worked wonderfully in a totally closed economic system. Who cares if such a system doesn't really exist, this is theory we're talking about (no one was really supposed to actually road-test it on the world's largest economy). *And everyone deserves a free pass for not factoring in the end of socialism and the sudden entry into the free market of some 3.5 billion people, thus completely changing the global macroeconomic paradigm* (see what I wrote about that, with Roubini and Hockett, here).

- Directly connected with the point above, ceasing to refer to the problem as an insufficiency of aggregate demand (which is a relative concept in any event). After all—even the word *demand* makes the folks who live near inland lakes see red (and fear a new New Deal lurking nearby). Instead, let's go over to the dark side and frame matters as an excess of supply of labor, capacity, and capital—relative to aggregate *D-word*. It's more than optics—as it has the added benefit of being true (hint, this is the "Exogenous Supply Incongruity" I mentioned earlier—it just means too much stuff from other places). See, Keynesians can talk about supply too!

Finally, there's that matter of why the monetary "inflationistas" are not seeing things clearly. Yes, there is that little wonky thing about assuming the velocity of money is a constant—which anyone on the coasts knows is untrue, because we can sit at the ocean and watch the waves to contemplate how amplitude, frequency, and velocity are all variables (sorry—really wonked-out joke).

But bit of humor helps the medicine go down my friends! And that leads us to, Episode 1:

Warren Buffett Walks into a Bar. . . .

. . . And he's forgotten his wallet but really craves a beer. So he sidles up next to me at the bar and takes a cocktail napkin and writes an IOU on it for $5 (its Omaha, prices are lower than here in Manhattan) so I will buy him the beer. While it is Warren Buffett, and I therefore might want to just frame the napkin as a collectible, let's assume that I take his IOU because he is, well, loaded, and for the purposes of this argument has nearly infinite credit.

The cocktail napkin is basically what is known as fiat currency (assuming it's not a forgery). Warren just created money out of what I would otherwise have used to wipe the salt from the bar nuts off my fingers. After all, he got his $5 worth of beer, he still has his $5, I gave the barkeep my $5 and I have the napkin. There is now $5 more in the world, made out of what otherwise would have been crumpled up tissue (less the $0.01 value of the napkin itself if you want to get all technical).

Now, you're saying "no, the IOU is a loan, it is credit, not money." But for the purposes of our story, we are regarding Warren as a *de facto* money printing press, not only because he has so much money and makes so much more of it every day that he might as well be one, but because of the fact that, like any issuer of fiat currency, the ability to get it accepted as a means of exchange (much less as a reserve for storage of wealth) is dependent on the magnitude of the economy backing the entity that is doing the issuing.

You probably see where I am going—but if you don't, then pull out of your pocket the crumpled U.S. dollar bill you've got jammed in there and have a read up top where it says "Federal Reserve Note." Our money is—of course—a note from the Fed promising to pay you with, well, another note just like it.

Oh, I forgot to tell you—Warren didn't offer me interest on his cocktail napkin IOU, and neither does the Fed's currency.

Greatest deal on earth—the Fed can "drink all the beer" it wants and pass around pieces of paper with no interest that are only redeemable for other pieces of paper. Moreover, when it creates dollars and uses them to buy notes that actually pay interest (like U.S. Treasury Bonds), it can—in theory—make infinite profits.

Unfortunately, the Federal Reserve actually does have an "owner" that has given it a small amount of actual capital (not that it needs it—since it prints the currency and can always print more). That owner is the U.S. government, the Treasury of which takes the Fed's profits (called "seigniorage," although the word used to mean something else entirely, but is held onto in order to make economists less understandable) and guarantees the solvency of the Fed.

Back to Warren. He is a very generous person and keeps writing cocktail napkin IOUs to buy everyone in the bar round after round. You might think that Buffett's Beer Binge would have resulted in the barkeep's ability to raise prices. After all, the bartender can also take those IOUs from people who were handed them by Warren—so the bar quickly fills with a lot of "money."

But let's assume that jobs are scarce and some patrons merely hold on to the napkins and leave the bar. If the barkeep tries to raise the price of his goods, he finds that there are a lot of other bars in the neighborhood craving customers, and that there simply aren't enough patrons to go around and support all the bars adequately—despite the plentiful stock of literally paper money. In fact, there are so many bars with so many empty tables that many of them run extended happy hours at deep discounts.

Over time, even though our fictional Warren has gotten into the habit of buying everything with cocktail napkin IOUs, and they are used for the purchase of many goods, there are still way too many goods and way too little wage income in Omaha (this of course is a fictional Omaha—Nebraska is enjoying an energy and agricultural boomlet right now, but I've got to take my gazillionaires where I find them).

So over time, in the midst of such excess supply, the price of beer and other goods actually falls.

And, wouldn't you know, for that original $5 cocktail napkin, I can eventually buy two deeply discounted beers instead of one. Measured in beer, then, the value of my napkin has increased, despite the fact that Warren has gone on a tear and issued napkins like mad, and despite the fact that maybe folks might be worried about napkins' continued efficacy as a means of exchange and a reserve of wealth. But, as I said earlier, Warren is the richest guy out there, and his fortune vastly exceeds the billions of cocktail napkins he's issued—so who else's cocktail napkins are you going to want to hold or accept?

The Denouement

Ultimately, the foregoing storyline shows us that the dilemma is not about the creation of nearly endless (or potentially endless, in the case of the Fed) amounts of fiat currency. It is also not about the credit of the issuing entity if the fortune (or size of economy) underlying that issuer is large enough.

Whether or not inflation will ensue from creating fiat money, whether that money will rise or fall in relation to other currencies, and whether the issuer's affiliated fiscal entity (treasury) will need to pay more or less to borrow is, I believe, ultimately an issue of the relative purchasing power of the currency, which—in the country of its issuance—is a function of supply and demand, both internally and globally.

We are not living through "ordinary times"—the developed world is no longer an island unto itself. The imbalances and instabilities that are associated with the continuing absorption of labor in the post-socialist emerging nations, and the excess capacity and capital generated thereby, make the correlation of classical forms of economic thinking with the facts and circumstances prevailing around the globe very difficult, if not impossible.

The United States, the United Kingdom, and Europe are in a slump, not only as the result of the bacchanalia of borrowing over the past decade, but also because we are met with extraordinary competition at lower prices. Accordingly, our goods/services pricing, and asset value complex, is being naturally driven downward as the outcome of relatively simple supply and demand calculus.

Whatever re-employment we are slowly experiencing in the United States is occurring because wages here are becoming increasingly globally competitive. The dollar is stronger, and medium- and long-term interest rates are lower because the purchasing power of the dollar (domestically) is either growing or is not deteriorating as quickly as it was.

If we wish to continue down the path of global re-competitiveness and domestic re-employment, the foregoing must continue. And it must continue in the face of more emerging population being drawn into the global free market each year, until a combination of emerging market demand and a more competitive developed world sufficiently resolves present imbalances. That is the only way we can continue to add jobs, and it involves a very long, painful, and destabilizing path.

It is therefore reasonable that, if wages are low and becoming lower, borrowing is cheap, and we have plenty we could be doing to improve our economy; for example, we should consider making our infrastructure more competitive while soaking up some of the excess domestic labor with government-stimulated jobs to take full advantage of our resources.

The experience of Japan, which was faced with the rise of the Asian Tiger economies after its own credit bubble burst two decades ago (and then again with the rise of the BRIC nations a decade later), is highly instructive. Japan has maintained its surplus current account and net exporter status (with a few slips along the way) by enduring now-decades of on-again, off-again deflation in wages, prices, and assets. Its globally low borrowing costs and its strong currency reflect the impact of such deflation in the form of higher real returns and greater purchasing power, respectively, to the holders of its government bonds and the Yen.

And here's the punch line. One doesn't need to trash the entire freshwater body of work to accept that the facts on the ground have shifted dramatically. Supply-side and broader monetarist views do have a place in the debate. Even the so-called Laffer Curve (which is really an illustration originally made by Keynes) has some legitimacy if governments begin to tax incomes too heavily—although that is certainly not the case today.

Let's go back to blaming the communist world (for having terminated itself), if that's what we need to do to get to a sufficiently directive consensus among economists. The followers of Keynes should be magnanimous in victory, not just because it's the right thing to do, but because what makes them right are the very global facts that few of them saw coming either (fair is fair).

We have an entire edifice of Euro-American policy and political thought that has been keyed in to arguments (supply enhancement, shrinking government spending, and trickle-down hypotheses) for a quarter century that simply have little application today—despite the theoretical elegance thereof. And until there is some agreement among leading economists that the world has changed and we need to suspend this now-ancient debate for a period (as we would, for example, in a military conflict that threatened our nations), the economics establishment will be of little practical use to governance or to our peoples.

That is the reality of this "show."

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