Modern Monetary Theory
July 10, 2019

Modern Monetary Theory is a strain of macroeconomic thinking that stresses the legal tender aspect of fiat money issued by a sovereign government and that has recently drawn attention for seeming to suggest a means of financing ambitious government spending programs, such as the Green New Deal or free college education.

It is difficult for someone like me who is not immersed in MMT to summarize its key tenants. Part of the problem is that MMT combines many different ideas, old and new, some mainstream and widely accepted and some more obscure or controversial. These are presented by MMT supporters as a more accurate depiction of how the economy works than mainstream macroeconomics. But when mainstream economists disagree with an MMT argument or observation - or even when they agree but question its importance to the analysis – a common response is "you don't understand." Furthermore, those who identify as MMT economists emphasize – or downplay - different features of MMT; so generalizations do not apply to all. Thus, a critique of one MMT economist's arguments may lead to a rejoinder from another with a different focus.

With those qualifications, here is my understanding of the key features of MMT and potential risks to widespread acceptance.

<u>Money's special legal tender status</u>

A common thread in MMT is that fiat money is uniquely in demand because it is used to pay taxes to the issuing sovereign government. Because households and businesses must pay taxes, they will always accept the sovereign's fiat money in exchange for goods and services. It follows then that a sovereign government that borrows in its own currency cannot go bankrupt, as it can always issue new money to pay its obligations. However, in the MMT framework, borrowing is not necessary; the government can finance itself through seigniorage – or the creation of base money (reserves and currency.)

MMT economists acknowledge that high rates of government spending and the associated growth in the money supply can lead to inflation. At full employment, the potential for "too much money chasing too few goods" can impose a limit on government spending and the expansion of the money supply. However, the appropriate response is not tighter monetary policy in the form of higher interest rates. Rather, in response to "demand pull" inflation, MMT economists see the appropriate remedy as higher taxes. Higher taxes reduce the public's money balances, thereby curbing expenditures and the upward pressure on prices.

It should be noted that some MMT economists are doubtful about the dangers of demand pull inflation. Some think inflation is more likely to come from supply side forces and, thus, they see a role for price controls and regulatory interventions.

Fiscal policy would also be the government's primary tool for dealing with economic downturns. Some MMT economists are currently working on developing a government jobs program that would function as an automatic stabilizer and kick in to provide employment in a recession.

Monetary Policy

MMT economists generally do not see monetary policy as effective in stabilizing the economy. In particular, they do not believe that saving and, more crucially, investment respond strongly to interest rates. Investment is driven more by expectations of future profitability and "animal spirits," and lower interest rates will not necessarily be stimulative.

Central banks can and do set interest rates. But since fiscal policy is the preferred choice for stabilization, interest rates do not have to play that role and should be low. MMT economists do not give much credence to the Fisher effect, which argues that nominal interest rates will incorporate expectations of inflation.

With fiscal policy stabilizing the economy, there is no need for independent monetary policy and MMT economists commonly consolidate the central bank and the rest of government.

Government deficits and net private savings

MMT economists devote a lot of attention to the identity linking government deficits or surpluses, on the one hand, and net private savings and net imports (or capital flows.) In national income accounting, domestic output equals income; so
$(T-G) + (S-I) + (M-X) = 0$
where T is taxes, G is government expenditures, S is private saving, I is investment, M is imports and X is exports and
domestic output $(Y) = C + I + G + X – M$ and consumption $(C) = Y - S - T$.
In equilibrium, net private saving (positive value for S-I) must be balanced by a government deficit (negative value for T-G) or a trade surplus (exports exceed imports.)
This is the "Keynesian Cross" from introductory economics texts and is not, in itself, controversial. It is an accounting identity, not a policy statement. It can be used to justify expansionary fiscal policy to offset a shortfall in investment (S-I is positive.) But it can also justify expansionary monetary policy to close the gap between S and I.

However, MMT economists seem to view a positive value for S-I as a normal state, in need of an offsetting government deficit. They also seem to view a positive S-I as desired by households and businesses as it allows them to acquire fiat money and build financial wealth. In contrast, most mainstream economists would see an increase in investment activity (I) and an expansion in the economy's productive capacity as the key to improving economic well-being.

MMT in the current environment

The weak performance of many countries after the 2008 financial crisis has focused attention on MMT. In discussions of causes and possible responses to sluggish economic growth and below-target inflation rates, macroeconomists have raised ideas that sound very similar to those in MMT. Prominent mainstream economists have argued that the natural interest rate – the rate associated with full employment and stable inflation – has fallen and may even be negative, leading to a long-term shortfall in investment relative to saving. They have debated the pros and cons of helicopter money – financing government expenditures or tax cuts through a one-time permanent expansion of the money supply – as an appropriate response. MMT pushes these ideas further: monetary policy is ineffective for stabilization purposes, not just now with rates close to zero, but generally. Government spending can – and should be – financed by an increase in the money supply, not just once but as a general rule.

Real world experience

MMT proponents see Japan's experience as validating their approach. Following a real estate and stock market bust in 1990, the government of Japan tried to stimulate the economy with a very aggressive program of fiscal expansion, financed by debt. The central bank also increased the money supply, although not sufficiently in the eyes of many U.S. economists as real growth remained sluggish. The ratio of Japanese government debt to GDP increased dramatically.

The global recession following the 2008 financial crisis and an earthquake, tsunami and nuclear power plant meltdown in Japan in 2011 resulted in further increases in Japan's deficit spending and expansionary monetary policy. Particularly after 2012, the Bank of Japan embarked on a program of massive purchases of government debt, effectively shifting much of it from the private sector to its own balance sheet. Yet despite a correspondingly huge increase in the monetary base, inflation and interest rates remain low. Indeed, inflation is below the central bank's target of 2 percent. Meanwhile the unemployment rate is very low and real GDP per capita continues to expand.

Many observers have been puzzled that Japan's high ratios of government debt to GDP and decades of expansionary monetary policy have not resulted in higher interest rates and rising inflation. Japan's debt is denominated in yen and held domestically, increasingly by the central bank. Japanese officials deny that they are following an MMT agenda. One important difference is that despite decades of large government deficits and expansionary monetary policy, the ratio of government expenditures to GDP is still relatively low for an advanced country. Taxes, while also low, have been increasing and some analysts believe they are sufficient to make Japan's debt "sustainable."

While Japanese authorities reject comparisons of their policies to MMT, Sebastian Edwards points out that the rhetoric of leaders in several Latin American countries, and more recently, Turkey, justifying higher government spending financed by expansionary monetary policy, is similar to the arguments of MMT economists calling for large increases in U.S. spending to address climate change, student debt burdens and other problems. In Latin America, the initial results of expansionary policies were often favorable; but continued pursuit of these policies led to inflation, currency depreciation and financial crises.

Problems in Latin America were generally compounded by borrowing in foreign currency, and MMT economists stress that their assertion about the impossibility of default applies only to countries borrowing in their own currency. However, only a relatively few countries are able to borrow globally in their own currency. And even if countries do not have substantial debt in a foreign currency, they may still need to acquire foreign currency to acquire sophisticated investment goods in international markets. Foreign suppliers, unlike domestic, have no tax obligation requiring them to accept a currency that is losing its value.

<u>Comments</u>

The ideas behind MMT are not new. That fiscal policy can play an important role in economic stabilization goes back to the 1930s if not before. The current emphasis on monetary policy for stabilization purposes is largely due to the delays and controversies associated with enacting spending increases and tax cuts. With fiscal policy, winners and losers are clear; not so with monetary policy. More crucially, the attraction of seigniorage as a financing mechanism has long been recognized. There is no payback obligation, as with debt, and the distortions from an inflation tax may be less than from other forms of taxation.

But is seigniorage too attractive? Will the temptation to increase government spending lead to an excessive expansion in the money supply and high rates of inflation? That some see MMT as suggesting a financing mechanism for the Green New Deal and other very large – permanent - increases in government spending is worrisome. (In contrast, advocates of helicopter money emphasized that these were one-time interventions intended to lift the economy out of the doldrums; not a means of financing spending indefinitely.) One reason for favoring debt issuance over seigniorage to finance government is that the interest rate provides a warning signal of building inflationary risks.

Countries that have greatly expanded government spending, however financed, have often been lulled by good initial results to pursue these policies to the point of inflation and financial crisis. As noted, Latin America provides examples.

The United States is in a unique position. It borrows in dollars and internationally traded products are commonly priced in dollars. MMT economists seem optimistic that this will always be the case. But while the United States borrows in dollars, much of its debt is held by non-U.S. investors. If inflation were to rise sharply and the dollar to fall in value, these foreign investors are likely to demand much higher interest rates. The fact that so many traded goods are denominated in dollars is simply a convenience; if the dollar were no longer a relatively stable benchmark, the market would find alternatives.

And do we think there are no alternatives to the dollar domestically? MMT economists stress the role of the domestic currency as legal tender and the requirement that it be used to pay taxes. But a viable economy also needs a medium of exchange. If the currency loses its value, people will develop alternatives – even if they continue to make tax payments in the domestic currency. In some Latin American countries that experienced runaway inflation and a collapsing domestic currency, private parties shifted to using the dollar. Black markets and barter also became more prevalent. Today, the emergence of cryptocurrencies raises the possibility of a parallel universe where much of the private sector transacts in private currencies while exchanges in fiat money are limited to transactions with the government.

References

Edwards, Sebastian. 2019. "Modern Monetary Theory: Cautionary Tales from Latin America." Hoover Institution, Economics Working Paper 19106 https://www.hoover.org/sites/default/files/research/docs/19106_edwards.pdf

Henwood, Doug. 2019. "Modern Monetary Theory Isn't Helping." *Jacobin* magazine https://jacobinmag.com/2019/02/modern-monetary-theory-isnt-helping

Hummel, Jeffrey Rogers. 2019. "Interpreting Modern Monetary Theory." *EconLib's Featured Article collection.* Apr 1 2019. The Library of Economics and Liberty. https://www.econlib.org/library/Columns/y2019/Hummelmonetarytheory.html

Matthews, Dylan. 2019. "Modern Monetary Theory Explained." *Vox.* April 16, 2019. https://www.vox.com/future-perfect/2019/4/16/18251646/modern-monetary-theory-new-moment-explained

Skidelsky, Robert. 2019. "The Case for a Guaranteed Job." *PS OnPoint.* Aug 1, 2019. https://www.project-syndicate.org/onpoint/the-case-for-a-guaranteed-job-by-robert-skidelsky-2019-08?barrier=accesspaylog

Wikipedia. "Modern Monetary Theory."
https://en.wikipedia.org/wiki/Modern_Monetary_Theory
Accessed June 6, 2019.

Wray, L.Randall. 2014. "From the State Theory of Money to Modern Money Theory: An Alternative to Economic Orthodoxy." Levy Economics Institute of Bard College, Working Paper No. 792.
http://www.levyinstitute.org/pubs/wp_792.pdf