

MODERN MONETARY THEORY, OR MAGICAL MYSTERY TOUR?



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IN A NUTSHELL

- Some claim that modern monetary theory upends conventional economic thinking but others remain unconvinced. And it is not hard to see why.
- Ignoring the difference between monetary and fiscal policy and the trade-offs between them, oblivious to resource constraints, heedless of the tensions between private and public resource allocation, it suffers from obvious shortcomings.

Modern monetary theory (MMT) is all the rage. It is certainly sparking heated debate. But what exactly is MMT? Proponents claim it is a revolutionary paradigm that upends conventional economic thinking and the gratuitous shackles it imposes on public budgets. Others are less convinced. Indeed, MMT seems a rather inchoate doctrine, an amorphous set of tenets, many ill-defined and poorly grounded. Where its precepts are sound, they are conventional; yes, debt-financed government spending and tax cuts can help revive economic activity when private demand is depressed – nothing terribly "modern" about that. And when MMT purports to sail new seas, it starts to take on water, heedless of the difference between monetary and fiscal policy, and of the tradeoffs between them, oblivious to resource constraints, blind to the tensions between private and public resource allocation, betraying reason, evidence, and the most elementary economics in promising a fiscal free lunch, manna from heaven.

But the shortcomings of MMT should not give license to the debt curmudgeons – those who warn incessantly of impending fiscal doom. Their jeremiads seem overwrought, especially for a country like the United States, where the government has considerable latitude to borrow – not unlimited, not without tradeoffs and costs, but considerable. That fiscal space is most essential when the private sector is on its heels and monetary policy is constrained, as in the aftermath of the Great Recession. But even now, some prominent voices contend that a bit more borrowing to finance targeted government investment might be beneficial (despite the costs and tradeoffs), because private credit

demands are still relatively subdued, global savings plentiful, and interest rates low. Others counter that such a fiscal stance would be imprudent at this juncture, potentially stoking inflation, diverting resources better employed privately, exacerbating an already-challenging longer-term debt trajectory, and limiting the fiscal space needed to counter the next downturn. The debate is well reasoned though, falling firmly within the bounds of credible economic discourse – unlike much of the nebulous orthodoxy of MMT.

DO GOVERNMENT DEFICITS MATTER?

The short answer, according to MMT, is rarely. For a country that issues debt solely in its own currency, and controls its own monetary policy, government deficits only become problematic, according to MMT, if they are run when the economy is fully utilizing its resources. Then, and only then, are deficits to be curbed, lest they push up inflation. Short of that, the government should set the budget deficit to whatever level is necessary to ensure full employment. That ought to be the overarching focus of fiscal policy, according to MMT. And since full employment has rarely been achieved, at least on MMT's reckoning, their doctrine implies that deficits have been too small, insufficient to enable the economy to realize its potential. Even now, many MMT proponents claim that there remain idle resources in the U.S. economy that could productively be employed if the government adopted a more accommodative fiscal stance.

It is perfectly reasonable to debate where an economy's resource limits may lie. No one knows for sure. And a case could be made for using fiscal policy to probe those limits,

¹For a sampling of some of the recent debate between MMT and its critics, see: <https://www.nytimes.com/2019/02/25/opinion/running-on-mmt-wonkish.html>
<https://www.bloomberg.com/opinion/articles/2019-03-01/paul-krugman-s-four-questions-about-mmt>
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to test whether additional productive resources could be called forth and sustained. Though this strategy carries risks, those risks have to be weighed against the possible benefits of helping the economy realize a greater potential. A sensible debate to have.

MONETARY POLICY GETS SHORT SHRIFT

But where MMT starts to run aground is in its (mis)handling of monetary policy. Yes, deficit spending can help restore full employment if private demand is in a funk, but so can monetary stimulus. And there is a tradeoff between the two, a policy choice that MMT blithely ignores. Put simply, the more monetary accommodation is deployed, the smaller the fiscal deficit is necessary to recovery. To be sure, there may be times when monetary policy is less effective, in rare cases perhaps nearly impotent; when an economy is in a classic liquidity trap, with interest rates stuck near zero, unconventional monetary tools blunted, and normally interest-sensitive spending unresponsive. Then, fiscal policy needs to carry the load. But those are extreme conditions, far from the norm that MMT suggests. Historically, monetary policy has almost always had traction – even in the aftermath of the financial crisis and Great Recession, the U.S. Federal Reserve (Fed) was able to support recovery. Fiscal stimulus is rarely if ever the only game in town. There is a choice between monetary and fiscal (or some combination of the two). And a tradeoff that MMT insouciantly disregards. The terms of that tradeoff hinge in part on the downsides of fiscal deficits; in particular, that they can crowd out private investment by absorbing private saving, driving up interest rates and thereby offsetting some of their lift to demand. The more crowding out, the less effective fiscal stimulus becomes, and the more monetary policy needs to do the heavy lifting of reviving demand. Crowding out may be more salient at some times than others, depending on private saving and investment inclinations, interest elasticities, and so on. It may not be a terribly binding constraint right now, for example (though some would demur). But to dismiss crowding out categorically, wave it away as at most a minor consideration, even sidestep it entirely, failing to acknowledge the tradeoffs it engenders between fiscal and monetary policy, is to dispute time-tested economic reason and evidence.

CONFLATING MONETARY AND FISCAL POLICY

Yet MMT goes even further out on a ledge. Positing not only that crowding out is negligible, that fiscal deficits do not put upward pressure on interest rates, but that they actually lower them. Not that fiscal deficits tend merely to coincide with lower interest rates (because they are both often associated with weak private demand); this is generally true and well known. No, MMT argues that deficit spending actually causes interest rates to decline. How? Here is where MMT blurs the boundaries between fiscal and monetary policies. If the Treasury spends more than it collects in taxes

(essentially writing more checks to the public than it receives), reserves are added to the banking system, and all else equal, this puts downward pressure on the fed funds rate (and other short-term interest rates), potentially driving them to zero. True enough. But the deficit spending has to be financed; within the confines of what we term fiscal policy, this is done by selling U.S. Treasuries to the public. As the deposits of those who purchase the Treasuries are debited, reserves are drained from the banking system, exactly offsetting the reserves added by deficit spending, leaving the federal funds rate unaffected. But MMT argues that this is a choice; that the deficit spending need not be financed by selling Treasuries. Consider, they suggest "... what would happen if Congress decided to dispense with Treasury auctions and simply allow budget deficits to supply the system with base money (reserves) instead of Treasuries. Clearly that would drive the overnight rate to zero."²

Yes, but this would require Congress to take back the authority for monetary policy it has delegated to the Fed. Short of that, Congress cannot "dispense with Treasury auctions;" they are necessary to finance deficit spending. Once Congress passes a budget that authorizes spending in excess of revenues, it is essentially with the same stroke of the pen authorizing Treasury auctions to fill the gap, and the net effect of these two conjoined actions on reserves and overnight interest rates is nil. Deficit spending does not increase reserves and lower the federal funds rate, because that spending does not exist independent of Treasury borrowing.

Perhaps MMT is subliminally hinting that Congress ought to abolish/amend the Fed, and retake direct responsibility for monetary policy. Then, Congress would be able to finance deficit spending with reserves instead of Treasuries, and that would indeed put downward pressure on overnight rates. But that would essentially be a monetary financing of a fiscal deficit – not a direct result of the fiscal stance itself, and something that under our current system cannot occur. Only Fed policymakers can set the level of reserves, can make monetary policy.

Of course, they do so to achieve the mandate Congress has authorized (full employment and price stability). And Congress could, in principle, fold up the Fed and take back that task for themselves. But if they wanted to reach the same goals, they would face the same economic choices and constraints confronting the Fed. They could not just willy-nilly finance deficits with reserves without regard to the effect such financing might have on the mandated objectives. And there are good reasons Congress has delegated these tough monetary policy choices – to insulate them from political pressures, and enable appointed, non-political decision makers to focus on the economy's longer-term health and stability. Under this system, Congress cannot choose to accommodate deficit spending with monetary policy; it has ceded that policy to the Fed, and mandated that it be made

²<https://www.bloomberg.com/opinion/articles/2019-03-04/krugman-s-macroeconomics-is-no-match-for-mmt>

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with eyes unwaveringly focused on achieving the dual-mandate objectives.

THE FED IS NOT A PIGGY BANK

Short of abolishing the Fed, could Congress simply instruct the Fed to buy the Treasuries needed to finance deficit spending, as some MMTers advocate? And would not this enable the Treasury to finance those deficits without cost (since the Fed remits the interest it earns back to the Treasury)? After all, the Fed did buy lots of Treasuries in the aftermath of the financial crisis and Great Recession. But that was a monetary policy decision, aimed not at financing deficits but at achieving the price stability and full employment goals; purchases were halted and (partially) reversed when no longer deemed consistent with those goals. If Congress required the Fed to buy Treasuries to finance deficits, that would indeed increase reserves and potentially drive overnight rates to zero. But if Fed policy-makers reckoned that to be incompatible with their objectives, they would hold the line on the interest they pay on reserves, preventing overnight rates from falling, despite the surfeit of reserves (because no one would lend those reserves at a rate below what they could get from the Fed). And this would negate much if not all the cost saving to the government (as the Fed paid out much of what it earned on Treasuries as interest on reserves). In short, the Fed cannot be the Treasury's piggybank – not without abrogating its monetary policy role.

PRIVATE VS. PUBLIC INVESTMENT, RESOURCE ALLOCATION, AND SUPPLY SIDE ISSUES

MMT also focuses almost exclusively on fiscal policy's role in managing aggregate demand – ignoring its potential impacts on efficiency, resource allocation, and the economy's supply side. For example, as part of their case for using fiscal policy to ensure full employment, MMT calls for a public option of a federally-funded job guarantee, but with nary a mention of what this might mean for economic efficiency and optimal resource allocation. If people currently employed in the private sector were lured into these jobs, and their tasks were set by government officials unresponsive to market forces, might not efficiency be compromised?

More broadly, is the public sector as likely as the private to be effective in allocating resources? In some areas (e.g., certain types of infrastructure, basic scientific research), a public hand may be beneficial, even essential, but in many (most) other realms, the discipline of private capital markets and atomized decision-makers pursuing their best interests will likely drive the most efficient use of resources, maximizing the economy's potential. Though "supply-siders" may overstate the case, there is reason to

fear that an increasing share of an economy's resources directed by government (whether financed by taxes, MMT-style borrowing, or regulation), will impinge on growth potential and efficiency. Yet MMT barely entertains the possibility. A glaring omission.

DEBT

Finally, there is the matter of government debt. Can it grow larger and larger without consequence? It obviously cannot exceed total wealth. And problems are likely to ensue long before that. Government debt cannot rise indefinitely relative to the gross domestic product (GDP) without at some point squeezing private, productive resources and provoking concerns about debt sustainability. Trouble is, these thresholds are not known in advance, and are apt to vary across time and place. Countries that issue debt solely in their own currency and control their own monetary policy have much more runway than ones that do not. The United States has more still, as the dollar remains the global reserve currency, without any credible rival on the horizon, backed not only by an independent monetary policy, but a stable government with a long history of honoring its debt obligations, deep and well-functioning capital markets, the rule of law, and a vibrant, innovative economy. And with the economy's real growth rate running above the real interest rate on Treasuries, the United States does not even have to run surpluses on its primary budget (i.e., before accounting for interest payments) to stabilize the debt-to-GDP ratio; modest primary deficits would do the trick (albeit not the outsized ones running right now). Still, there are undoubtedly some configurations of debt and growth dynamics that would worry investors, causing them to push up Treasury rates, perhaps even back above the country's growth rate – not because they fear default, but inflation and currency depreciation to avoid default. This would severely limit the government's fiscal room for maneuver, raising the costs of debt service, and reducing resources available for other priorities. Though not an imminent threat, it is naïve to assume it can never happen.

CONCLUSION

Ah, to live in a world without resource constraints and trade-offs. Where MMT's hopes could be realized. But sadly, we inhabit a less bountiful place, a world of limited resources. And MMT cannot change that.

GLOSSARY

Accommodative

The aim of an **accommodative** monetary policy is to support the economy by means of monetary expansion.

Federal funds rate

The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

Financial crisis

The **financial crisis** refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

Fiscal policy

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Great Depression

The **Great Depression** was the deepest and longest-lasting economic downturn in the history of the Western industrialized world.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Liquidity trap

Liquidity trap describes a situation where conventional monetary policy has lost its potency.

Monetary policy

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

Primary budget surplus

A **primary budget surplus** is a surplus of government revenues over expenditure before interest payments on debt.

Real interest rate

The **real interest rate** is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

Reserve currency

A **reserve currency** is a foreign currency held in significant quantities by central banks and international financial institutions. Foreign currency reserves allow a country to pay off its international debt obligations or boost its currency's value.

Treasuries

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

U.S. dollar (USD)

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.

United States Congress

The **United States Congress** is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

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