Comment

MMT: new wine in old bottles or 'voodoo economics'?

- *Modern Monetary Theory (MMT) is attracting considerable attention, especially on the left.*
- *It purports to provide macro policymakers with additional degrees of freedom.*
- *At MMT's core are some common-sense truths, but in reality, it offers little that is new.*
- *Converts to MMT tend to gloss over the challenging practicalities of its application.*
- *It is probably best viewed as a policy agenda for periods of acute demand deficiency.*

The pursuit of modernism

MMT is gaining support, especially on the political left

Modern Monetary Theory (MMT) is a contemporary, increasingly fashionable, heterodox doctrine of economic thought. It is captivating many on the political left, who consider that traditional macroeconomic frameworks have been found wanting, especially in the aftermath of the 2008 Global Financial Crisis.

Much like early-1980s Laffer Curve 'supply-siders', MMT's disciples are often near-messianic in tone, while somewhat vague in exposition.[1] They are prone to presenting their ideas as a pathbreaking, revolutionary, approach to economic analysis and management, that can free policymakers from the shackles of fiscal and monetary orthodoxy.[2]

In an era characterised by income and wealth inequality, burgeoning populism, and political polarisation, MMT could exert a profound influence on the macroeconomic policy debate.

It purports to free policymakers from orthodox constraints …

Accordingly, in this piece we seek to present, in a technocratic, apolitical way, a guide to the analytic content of MMT, and the conditions under which it could, or could not, be usefully applied in policymaking.

Nuts and bolts

The essential elements of MMT can be summarised as follows:

- A government that creates its own money generally need not, and will not, default on debt denominated in its own currency.
- A government deficit is necessarily mirrored by an equivalent private sector surplus.
- Monetary policy is relatively ineffective in a slump: fiscal policy is more powerful.
- A government can buy goods and services without the need to collect taxes or issue debt.
- Through money creation, interest costs can be constrained. Indeed, a substantial and persistent budget deficit can be financed at low, if not near-zero, cost.
- Government spending and money creation need be limited only to the extent that employment becomes 'over-full' and encourages inflation.
- Inflation, should it arise, can readily be controlled by higher taxation and bond issuance to remove excess liquidity.

Thus, the core inference and contention of MMT is that the budget deficit and public sector indebtedness should be allowed to adjust to the level necessary to secure full employment.

… allowing them to pursue more radical policies

In turn it is suggested that this goal should be achieved through a government-sponsored blanket jobs guarantee, which would act as an automatic stabiliser. When private sector jobs were plentiful, government spending on the guarantee would be lower, and vice versa.

Alternatively, full employment could be achieved by large-scale spending on infrastructure, climate change, and the environment, such as via a 'Green New Deal' – all financed, if necessary, by the central bank.

Nothing new under the sun

In reality, it embodies little that is new …

The truth about MMT is more complicated and less trailblazing than its supporters suggest. Closer inspection reveals a methodology that has its roots firmly in the past, and in particular in early 20th century chartalism,[3] and initial Keynesian thinking. Indeed, it looks very much like the 'Functional Finance (FF)' gospel preached by Abba Lerner in the late 1930s and 1940s.

Lerner was a Russian-born British economist who worked alongside both Hayek at the London School of Economics and Keynes at Cambridge, before emigrating to the US, and teaching at a number of top universities. Always something of a maverick, albeit a brilliant one, Lerner's

… and smacks of A. P. Lerner's 'Functional Finance' doctrine

macroeconomic philosophy can be distilled down into the notion that, so strong is the economic, social, and moral case for achieving high employment and relative price stability, policymakers should not be unduly fussy about how they go about it. Policies should be judged on their ability to achieve these goals, rather than on notions of 'soundness' or compliance with the dogmas of traditional economics. What matters is maintaining an adequate flow of total expenditure; and if that means that the boundaries between monetary and fiscal policy become increasingly blurred, then so be it.[4]

Keynes recognised MMT's shortcomings in the 1940s

Lerner considered that, if the direct financing of budget deficits by the central bank was the only option left to boost aggregate demand and keep output in line with potential, then it should be actively and robustly employed. Interestingly Keynes, while certainly prepared to be radical, was cautious about Functional Finance. By the early 1940s Keynes was a senior Treasury official, and intimately involved in the practicalities of financing the war and planning for peace. Operating very much in the real world, he believed that policy should be measured, steady, consistent, and credible.

Hence, while Keynes acknowledged Lerner's brilliance, and expressed sympathy for the logic of his framework of thought, he saw FF more as a pedagogic device than as a basis of a rigorous policy programme. He considered that Lerner lacked practical judgement and intuition, and paid insufficient heed to what he described as the public's 'allergy to extremes'.

Perhaps most importantly, Keynes feared FF's potentially damaging effects on debt sustainability and private sector confidence, and the risk it presented for inflation.[5]

Common sense meets the real world

MMT does contain some fundamental economic truths …

Whatever its intellectual heritage, MMT, like FF, is at a basic level, little more than an expression of a macroeconomic judgement and a political reality. High unemployment and excessive inflation are ills best avoided, and which almost all politicians want to minimise. Hence, government policy should prioritise their prevention. In the process, policymakers may need, *in extremis*, to be inventive in how they combine monetary and fiscal policy to achieve these goals.

At the same time, it is also clear that over recent years government investment has been neglected in many economies; inequality is now a burning social and political issue that urgently needs to be addressed; and, even though historically-high public debt is often portrayed as a serious constraint, that the constraints on fiscal expansion are much reduced when interest rates are close to zero.

Thus there is a lot at stake, and hence, the policy inferences of MMT need to be considered seriously. At the very least, they do not compare unfavourably with calls for fiscal and monetary rectitude that are grounded either in narrow accounting logic or myopic adherence to the quantity theory of money. Judgements on the appropriateness of a policymaking framework cannot usefully be made without regard to the state of the business cycle, or the strength of private-sector animal spirits.

The devil is in the detail

As always, however, the devil is in the detail. And the cheer-leaders for MMT are inclined to skate over many of the technical and political complexities of their prescriptions. For example:

1. MMT, like FF (and in common with much US-led analysis) is based implicitly on a closed-economy model. It makes no allowance for the possibility of monetary expansion causing the exchange rate to fall rapidly.
2. MMT overlooks the potential for monetary expansion and an extended period of low interest rates to create the conditions for domestic financial instability, excess, and perhaps disaster.
3. MMT's disciples pay little attention to the structural component of unemployment, which is unlikely to prove responsive to stimulus of demand and, more likely, raise inflation. In the real world, full employment is a dynamic phenomenon, and the inflation process is continual: transition to a state of inflation at full employment is not the obvious and discrete process that MMT portrays.
4. They say little about the effects on wealth distribution of a reliance on monetary finance.
5. They ignore the fact that interest is regularly paid on the new money that is created in the form of reserves held by the commercial banks at central banks. Hence, even entirely money-financed deficits cause public sectors to incur debt.

… but its disciples gloss over many practical issues

6. They ignore the vexed issue of moral hazard. The disruption of the connection between government decisions on the size of its budget deficit and the willingness of the private sector to fund that deficit at interest rates that it deems reasonable destroys at a stroke one of the most important disciplines the market imposes on politicians. And with that discipline swept away, the door is open to irresponsible fiscal policies, and a plethora of crack-pot schemes.
7. Finally, it is inescapable that debt accumulation cannot go on indefinitely; and public sector debt ratios are already historically high. In the limit, total liabilities cannot exceed total wealth and, as the debt burden escalates, inducing people to hold it will require ever-higher returns. Much depends on whether the average interest rate payable on debt is higher or lower than the economy's sustainable growth rate. If it is lower then the level of government debt is of less consequence. But if it is persistently higher, then debt will snowball.

   Hence, at some point a government would be obliged to run a large enough primary budget surplus to stabilise debt growth. And this could involve dramatic tax increases or public expenditure cuts, which are politically unpalatable, if not impossible, to deliver.

Special case rather than general theory

MMT's policy prescriptions are best suited to depressions

As ever, Keynes was a fount of wisdom. In our judgement the overwhelming conclusion to be reached is that of Keynes: resort to the policy prescriptions of MMT is appropriate only in exceptional situations, where economies are far from full employment, deflationary pressures are in evidence, and interest rates are at the zero bound.

In short, MMT is a policy polemic for chronic demand deficiency. And even then, robust checks and balances would need to be put in place before an MMT-inspired remedy could be safely implemented. For example:

a. MMT prescriptions would best be applied within the context of an explicit inflation, price level, or nominal GDP target framework, and all the transparency that goes with it.
b. The ultimate decision to go down this route should be put in the hands of an independent central bank's policymaking committee, rather than a government.
c. Resort to direct monetary financing would need to be ring-fenced by law, and confined to a specific amount over a specific period – say 3% of GDP over 3 years. It should be finite, albeit extendable if necessary.
d. Rather than financing tax cuts or subsidies, which can exert an immediate impact on a government's popularity, it would be better to concentrate on funding a specified range and number of capital projects, such as public infrastructure, which would add to the economy's productive potential and could subsequently be at least partially sold back to the private sector.

But even then they should be heavily circumscribed

e. Macroprudential policy should be primed to address financial market over-exuberance.
f. Income and wealth inequalities should be monitored, and if necessary counterbalanced by supplementary, alternative, policy action.
g. As a show of good faith, it might also make sense to combine the stimulus with the announcement of a programme of structural reforms that would be applied over a number of years, and which would help to render the subsequent expansion more durable.

Watch fors

- Growing espousal of MMT by the leadership of left-of-centre political parties.
- Broadening support for the tenets of MMT during the next recession.
- Growing backing for blanket job guarantees to address income and wealth inequality.
- Revision of central bank mandates to facilitate monetary finance.
- Application of MMT policy prescriptions without the needed checks and balances.■

[1] Vice-President George H.W. Bush famously referred to President Ronald Reagan's attraction to Lafferism as 'Voodoo Economics'.

[2] The most vocal proselytisers of MMT include Warren Mosler, L. Randall Wray, Stephanie Kelton, Bill Mitchell, and Pavlina Tcherneva.

[3] Chartalism is a phrase ascribed to Georg Knapp, a German economist who published The State Theory of Money in 1905. He argued that money originated with states' attempts to direct economic activity rather than as a spontaneous solution to the problems with barter or as a means with which to tokenize debt, and that fiat currency has value in exchange because of sovereign power to levy taxes on economic activity payable in the currency they issue.

[4] Lerner. A.P. (1943). *Functional Finance and the Federal Debt.* Social research, 38-51. Also, Jones. R. and Llewellyn.J., 2014. *Towards 'Functional Finance'.* Llewellyn Consulting Comment. 13 November. Available on request.

[5] For a full description of the sometimes-heated debate between Keynes and Lerner in the 1940s, see Aspromourgos. T., 2014. *Keynes, Lerner, and the Question of Public Debt.* History of Political Economy 46:3. *link*

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