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Modern Monetary Theory – can it help with economic problems or is it just another Magic Money Tree?

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Key points

> Modern Monetary Theory reminds us that monetary financing of government spending need not be inflationary if there is spare capacity in the economy.

> But it suffers from a number of problems: it implies there is always some sort of free lunch; it underestimates the costs of large-scale public employment programs; and it underestimates the difficulties politicians have in turning off monetary financing once inflation has returned.

> Arguably much of the same can be achieved by independent central bank QE and fiscal stimulus but without the key pitfalls of MMT.

> For investors, the interest in MMT is another sign that the risks around inflation may shift from the downside to the upside on a five to ten-year horizon.

Introduction

For some years now Modern Monetary Theory (MMT) has been gaining prominence as a solution to the perceived failure of traditional economic policies to achieve full employment & meet inflation targets, despite at or near zero interest rates. MMT has been given added impetus by the hit to economic activity from coronavirus. And with even Reserve Bank of Australia Governor Philip Lowe referring to it in question time after an address last week, it's clearly hit the big time. Its supporters seem to claim it will solve many of our economic problems. But its detractors see it as just another simplistic economic theory with plenty of problems. In fact, Governor Lowe said, "there's actually not much monetary, not much modern and not much theory in it. It's really a series of propositions about fiscal policy." So can it help or is it just another fad like monetary targeting? Its easy to get bogged down in the details of MMT, so I will keep it simple.

What is MMT?

Modern Monetary Policy has a number of key propositions:

1. The government can just keep spending until it meets its objectives – whether that's traditional macroeconomic objectives like boosting inflation or full employment, or conceivably everything else including reducing inequality, dealing with climate change and more affordable housing.
2. Many MMT supporters advocate a government job guarantee in the form of community work programs that are paid at the minimum wage which can be dialled down once full employment is reached and then dialled up again if needed.
3. Rather than raising taxes or issuing debt, government spending can be financed by the government directing its central bank, eg, the RBA in Australia, to print the money and give it to the government to spend, subsuming monetary policy into fiscal policy.
4. As long as there is spare capacity in the economy in the form of unemployment and underutilised factories, monetary financing of government spending should not be inflationary.
5. Worries about budget deficits and sovereign debt are overblown if the government borrows in its own currency – so the government can just print more money to finance itself and service its debts and there is no risk of a currency crisis.
6. It also contends that a government that issues its own currency can borrow at any interest rate it wants and that all government spending can be financed by debt or money printing – but these are a bit way too whacky for me!

Monetary financing of government is not new

So MMT basically advocates using printed money from the central bank to directly finance government to spending, which boosts the economy. This concept is not new. From university economics in the early 1980s, I remember the equation that:

Government spending = Tax + bonds + money printing

Which basically means that government spending can be financed by taxes, the issuance of more debt or the printing of more money. Of course, in the early 1980s in developed countries, the financing of government spending by printing money (beyond growth in the money supply consistent with growth in the economy) was and has remained out of fashion because it was seen as inflationary following the hyperinflation in the Weimar Republic in 1920s Germany, the experience of the late 1960s and early 1970s where expanded welfare and Vietnam War spending was partly financed by money printing and given the experience in many South American countries with money printing and hyperinflation. At the back of most economists' minds is the Quantity Theory of Money that states:

M times V = P times T

where M = money supply, V = its velocity of circulation in the economy, P = prices and T = transactions or real GDP. V and T were thought to be constant in the short term so an increase in money supply would lead to an increase in prices, ie, inflation.

So given this and the experience with high inflation at various times, the monetary financing of government spending has been seen as a no no! And this has been reinforced by the separation of monetary and fiscal policy in Australia and many countries, with central banks being made independent.

MMT does provide some useful insights or reminders

Of course, the experience over the last decade has highlighted the already well-known failings of the quantity theory of money – put simply there are different forms of money and its speed of circulation in the economy (or V) is not constant. For example, quantitative easing (QE) led to an increase in the money supply in Europe, the US and Japan last decade but it was narrow money (like cash and bank reserves) not credit and the circulation of money through the economy slowed so there was not much, if any, increase in inflation. This was contrary to some hard money fanatics who claimed that QE would lead to hyperinflation. But it didn't even get us back to most central banks' inflation targets of around 2% p.a.

MMT reminds us, via Proposition 4 above that, as long as there is spare capacity in the economy, using printed money to finance public spending should not be inflationary. This is consistent with the experience of last decade which was characterised by spare capacity globally and taken together with a fall in the velocity of circulation of money in the economy explains why inflation did not take off despite QE boosting the money supply.

But it also explains why Zimbabwe and Venezuela have had a different experience – they boosted their money supply to finance government spending but as there was no spare capacity this just led to hyperinflation as too much money chased too few goods.

Moreover, budget deficits and public debt has blown out dramatically from where they were at the time of the budget austerity obsession early last decade (the deficit blow out seemed to be the central issue in Australia's 2013 election!) without major consequences. This seems to line up with the MMT assertion that worries about budget deficits and public debt are overblown for countries that borrow in their own currency.

And using government spending to employ unemployed workers also has merit. In fact, it's standard Keynesian economics.

But what are the problems with MMT?

But while MMT provides some useful insights it has big problems:

- First, it gives the impression there is always some sort of free lunch. That the central bank can just print money – like some sort of Magic Money Tree – and all economic problems can be solved. But as an old friend of mine used to repeatedly remind me, "you can't make something out of nothing." Of course, in the current environment of high unemployment and inflation below target, there perhaps is a bit of a free lunch if more government spending financed by money printing can result in full employment and boost inflation back to target. But contrary to what some MMT supporters imply, the economy is not always in a position of spare capacity.
- Second, the traditional concern about budget deficits and rising public debt is not always overblown. When the economy is strong, it can cause overheating as the competition for workers and funding can push up wages, prices and interest rates "crowding out" more productive private sector activity. Budget deficits and high public debt are not a problem now as there is spare capacity, economies are not overheating and interest rates are low but this won't always be the case.
- Third, MMT underestimates the costs and low productivity associated with large scale public employment programs. This has been evident in the failure of "work for the dole" schemes in Australia to make much headway.
- The more fundamental problem with MMT is that governments may have trouble turning off the monetary and fiscal stimulus when spare capacity is used up and inflation hots up. Not only is it hard to get the timing right economically, but it's compounded by politicians in government having an incentive to keep the stimulus going to get re-elected. Politicians risk becoming addicted to the flow of money from the central bank's Magic Money Tree, resulting in wasteful government spending and eventually high inflation or hyperinflation. And once the inflation genie gets out of the bottle, it's hard to get it back in as we saw in the 1970s.

This is precisely why central banks are independent of politicians.

What's the difference between QE and MMT?

Normally central banks implement monetary policy by changing interest rates. But when interest rates have fallen to zero, central banks have been turning to boosting the quantity of money. And this is called quantitative easing (or QE). QE involves a central bank printing money and using that money to buy government and private sector securities that have already been issued or to lend directly or via banks to pump cash into the economy.

Quantitative easing is more indirect than what is advocated by MMT as it involves using printed money to buy bonds that have already been issued into the secondary market. It can help the economy by lowering long term borrowing costs (as the bond buying pushes up bond prices which pushes down their yield and so pulls down fixed mortgage rates as well), by pushing down the currency (as its supply goes up) and by forcing investors in government bonds into more risky assets like shares, which increases the availability of funds in the economy and pushes up asset prices resulting in a positive wealth effect.

Some would say it's the same thing as monetary financing as the bond holders who have sold their bonds to the central bank then have more scope to directly buy bonds off the government. But central banks and MMT supporters would say it's not the same as the central bank is not being directed in doing this by the government and it's not directly financing the government as the bonds held by the central bank still have to be paid back at maturity just as if the bonds were held by say a bank.

So QE as currently practiced is not really MMT or helicopter money – which would see a central bank directly give money to the government to spend.

But of course, QE is aiding the government's stimulus program by helping to keep bond yields down. And unlike in the period of quantitative easing seen in the US and Europe last decade, which was accompanied by fiscal austerity, exploding budget deficits today provide a vehicle for the increased money supply to add to spending in the economy. So QE today is likely to be more potent than last decade when it occurred at a time of fiscal austerity which led to an environment akin to driving a car with one foot on the accelerator and the other on the brake.

In this sense, despite all the differences, QE may achieve the same thing as MMT – but because it's controlled by an independent central bank, it avoids the pitfalls of MMT which sees politicians left in charge and at greater risk of leaving the punchbowl at the party for too long for political reasons.

What does it all mean for investors?

For now, spare capacity is massive which is keeping inflation is below target and so there is plenty of room for big budget deficits and this may remain the case for a while – so interest rates could remain low for several years. This has the effect of bidding up the value of other assets as investors continue to search for more attractive yields than what's offered by bank deposits and bonds.

But the combination of massive quantitative easing and fiscal spending along with increasing talk of MMT highlights that policy makers are increasingly focussed on taking more risks with inflation. This has also been highlighted by the recent move by the Fed and RBA to shift from raising rates pre-emptively ahead of a forecast rise in inflation – to only raising them when actual inflation is back at target. Inflation has moved in decades long cycles and so too have attitudes to it. After the deflation of the 1930s, the focus was on full employment and taking risks with inflation. But after inflation got out of hand in the 1970s, the focus was on keeping it down with inflation targeting and independent central banks. Now the inflation of the 1970s is long forgotten and so the focus is shifting back to full employment. Ultimately the combination of ultra-easy monetary policy, huge budget deficits and a retreat from globalisation will add to the risk of an eventual pick-up in inflation - but at this stage this looks like something to be wary of on a five to ten-year horizon, but not right now.

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