Modern Monetary Theory

VOODOO ECONOMICS GETS A RUN

Background

SBS News ran a report last week publicising the visit to Australia of US economist, Stephanie Kelton.[1] Professor Kelton worked on Bernie Sanders' 2016 presidential election campaign and advocates an apparently novel framework for macroeconomic management known as 'Modern Monetary Theory' or 'MMT' for short.

What is MMT?

Proponents of MMT believe that governments can create full employment simply by spending more money and that budget deficits do not matter because countries with their own 'fiat' currencies – such as Australia, the United States, Canada and the UK – can print their own money and so can never 'run out of' the ability to spend. It is only when economies have reached full employment that spending may need to be wound back to avoid pushing demand beyond supply and causing inflation. It is for this reason that contrary to the entire mainstream economics profession, MMTers believe that it is fiscal policy (government taxation and spending) that controls inflation rather than monetary policy (central bank manipulation of the money supply and interest rates).

MMT gained popularity in the post-GFC years, particularly in the US and the UK where unemployment reached double-digit levels and remained stubbornly high even as official interest rates were pushed to zero and central banks engaged in large-scale purchases of government-backed bonds through 'quantitative easing', also known as 'QE' and more popularly as 'printing money'. Unemployment never rose that high in Australia, and now is back to 5% here and down to around 4% or less in the US and UK. This makes it somewhat ironic that MMT is gaining some traction now, a point to which we will return.

The wheat in MMT...

As with most seductive ideas, there is a grain of truth in MMT. When unemployment is high and central banks are reluctant or constrained in their ability

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1 SBS News, "A radical plan to give every Australian a job who wants one is gaining momentum": https://www.sbs.com.au/news/a-radical-plan-to-give-every-australian-a-job-who-wants-one-is-gaining-momentum

to stimulate the economy, mainstream economics supports the proposition that government spending can raise aggregate demand and boost employment. In the post-GFC years in the US and UK, when interest rates were at zero and central banks were engaged in successive rounds of QE – in a seemingly vain attempt to 'push on a string' – more government spending may have helped. This is not to say that fiscal policy is the best tool for counteracting recessions; monetary policy is a far more flexible and effective instrument for stabilising the economy. Our 2016 bulletin on Nominal GDP targeting contended that in contrast to the views often expressed in the press, independent central banks are never 'out of ammunition'. Even at zero rates, central banks retain a powerful arsenal of policies they could deploy to stabilise spending if determined to do so. Further, as Nobel Prize winning economist Milton Friedman and former US Federal Reserve chairman Ben Bernanke said, the prevailing level of interest rates is a poor guide to the stance of monetary policy. Nevertheless, in depressed conditions and with self-restrained central banks, mainstream economists agree that government spending can work.

...And the chaff

But it is under the hood that MMT falls apart, undermining any reason to have faith in its more unconventional prescriptions. MMTers believe that higher government spending can always solve unemployment, while higher taxes can always solve inflation, and that monetary policy is next to irrelevant. This flies in the face of the last half-century of economic thinking and led Berkeley economist and President Clinton's Treasury deputy assistant secretary, Brad DeLong, to quip that MMT was neither modern, monetary, nor a theory.

The clearest counterexample to these key MMT propositions is Japan, which has run large and consistent budget deficits since the early 1990s and yet failed to keep inflation even at 1% per annum. It has only been recently – interestingly during a phase of tighter fiscal policy – that the Bank of Japan acting in concordance with Prime Minister's Shinzo Abe's 'Abenomics' has actively targeted inflation and managed to hit 1% inflation without relying on indirect tax increases to get there. Meanwhile, despite smaller budget deficits, unemployment has fallen from over 4% in 2013 to less than 2.5% now.

Numerous other examples at odds with MMT are available. Inflation in Australia fell rapidly in the early 1990s despite a large budget deficit that continued expanding until 1993.

By way of comparison, US budget deficits under President Reagan rose through the early 1980s from around 2.5% of GDP to 5% of GDP, yet inflation fell. The budget deficit under President Trump was 3.5% of GDP in 2017 and is forecast to be 4% of GDP this year; yet US inflation remains at around 2% per annum. Any government that took MMT seriously would be risking a major destabilisation of its economy.

Putting voters on the couch

All of this raises the question of why is MMT becoming popular, and more intriguingly, why now? To be fair, one could say the same of the Trump and Brexit phenomena, both of which occurred at a time when the US and British economies, respectively, had largely recovered from the GFC. Perhaps the most frequently-cited economic reason is a slowing of average economic growth since the turn of the century, combined with the decline of manufacturing industry and a rise in inequality. These outcomes have, in turn, been variously put down to factors such as the growth of 'crony capitalism', an increase in firms' market power (including but not limited to the domination of the big tech companies), and weaker unions. These ideas are continuingly being debated and economists do not know whether and to what extent each of these is responsible for the voter malaise in many English-speaking countries. It is equally possible that non-economic reasons for the post-Clinton/Blair/Howard rise in populism will prove to be correct.

For now, the lesson from the growing prominence of MMT for all countries including Australia is twofold. First, monetary policy should focus laser-like on providing stable inflation – or better still, stable growth in nominal GDP – so as to allow the economy to reach full employment without the need for fiscal experimentation. Second, elected governments should expend their energies and political capital on supply-side reforms that boost productivity and economic growth, enlarging the pie and enabling them to better satisfy voters' wants. The first lesson has been partly waylaid in Australia by a Reserve Bank that has preoccupied itself with an inchoate conception of 'financial stability' rather than its inflation target. The second lesson, unfortunately, appears to have been mislaid entirely.

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