ADVISOR PERSPECTIVES

Modern Monetary Muddle

June 29, 2020

by Michael Edesess

The debate over the much-touted and much-criticized modern monetary theory (MMT) is the murkiest I have ever been involved with, short of secondary school debates about the existence of God. But I finally see it clearly. Incredible as it may sound to nearly all observers – once they learn what MMT says – its basic economic tenets are agreed to by most knowledgeable economists. The dispute is not really over its core economic model; it is over fears of its perceived political implications.

Neither MMT's critics, however, nor its advocates have the temerity to dwell on the ultimate source of those fears.

What does MMT say?

Stephanie Kelton is the author of the book, *The Deficit Myth*, which was published June 9. Her book has generated a great deal of interest and controversy, and has recently been a *New York Times* bestseller.

Dr. Kelton is a professor of economics and public policy at the State University of New York at Stony Brook and was chief economist on the U.S. Senate Budget Committee (serving the Democrats) from 2015 to early 2016. She was an advisor to the Bernie Sanders 2016 and 2020 presidential campaigns. (I interviewed Professor Kelton in an *Advisor Perspectives* podcast that you can listen to here.) In her book, she explains the MMT basics. I will now give a brief synopsis of them.

To put it in a very small nutshell, MMT rejects the (TAB)S model of the federal budget in favor of the S(TAB) model.

So what are the (TAB)S and S(TAB) models?

The (TAB)S model says that Taxes And Borrowing precede Spending. That is, for the federal government to spend money, it must first collect taxes or borrow to cover the spending. Most people can relate to this model because it is similar to what enables a household, a business, or a state or city government to spend. You can't spend the money if you don't have it. First you have to borrow it – or earn it – or if you're a state or city government, collect it in taxes.

But the federal government's budget doesn't work like a household budget. Dr. Kelton, when she was chief economist for the Democrats on the U.S. Senate Budget Committee, discovered that none of the senators who sit on this powerful committee seemed to realize that. The difference is that the federal government, unlike a household, or a business, or a state or city government, is the issuer of the currency, not just a user of it.

The issuer of a currency – the federal government – operates not under the (TAB)S model but under the S(TAB) model. What does that mean? It means that the federal government Spends first, then it may, or may not – it doesn't need to – Tax And Borrow later.

This should be intuitively obvious to everyone. The federal government *creates* the currency. It's the issuer. It doesn't get it from anywhere or anyone, it makes it. If you make it, you don't need to tax or borrow to get it.

And since the U.S. left the gold standard in the early 1970s, it can create as much of it as it wants – there's no constraint.

Except, of course, inflation. So MMT, according to Kelton, focuses on inflation, not on balancing the federal budget. Specifically, it focuses on whether we have enough resources to employ the amount of dollars that the federal government issues.

If we don't have enough idle resources to put to use, there will be too many dollars chasing too few resources and we will have inflation. And that's where taxes come in. To prevent that inflation, the government needs to absorb some dollars, which it can do by raising taxes.[i]

But as long as we have resources that aren't being fully utilized – reflected, for example, in unemployment figures – the government can issue more money to employ those resources for productive purposes. It has no need to get that money by taxing or borrowing, it can just create it.

What do the critics say about this?

In a May 29, 2019 column, *Financial Times* chief economics commentator Martin Wolf addressed MMT and its perceived shortcomings. In that column, Wolf allowed that, “Modern monetary theory … is analytically correct, so far as it goes.”

He then uses up most of the column space restating, at some length, the tenets of MMT – basically the ones I described above – again concluding that, “This analysis is correct, up to a point.”

So what does Wolf mean by saying, “so far as it goes,” and “up to a point”? We’ll come to that shortly. But recognize that MMT’s basic claims, those that are likely to be the most shocking to the average observer – i.e. that the federal government has no need to tax or to borrow money to pay for its spending, or to balance its budget – are correct, according to one of the world’s most respected economic commentators.

Now let’s look at a highly critical review of Kelton’s book in the *Wall Street Journal* by University of Chicago economist John H. Cochrane. Its tagline is, “At least Bernie Sanders believes spending depends on tax revenue.”

So you might think that Cochrane is going to say that it’s nonsense that the government can spend without taxing or borrowing.

But what, in fact, does Cochrane say? He says, “True, the federal government can spend any amount by simply printing up the needed money (in reality, creating bank reserves). True, our government need never default since it can always print dollars to repay Treasury bonds.”

Again, though critical of MMT in other ways, Cochrane agrees with its basic premises. His critical review is littered with sentences that start out with phrases like, “She starts well…” … “Again, she starts correctly…”

As with Wolf’s assessment, of course, there’s always a “but.” And we’ll come to that.

But first, one more indication that Kelton’s basic claims – the truth nobody on the Senate Budget Committee seems to realize – are routinely accepted by knowledgeable economists. Let’s turn to an example that she gives in her book.

In 2005 Paul Ryan, who was then Speaker of the House of Representatives and a balance-the-budget “hawk,” called as a witness then-Federal Reserve Chairman Alan Greenspan, a known economic conservative. Ryan expressed concern that there was a financial crisis facing Social Security (a pay-as-you-go system) and that it could become insolvent. He therefore expected support from Greenspan for his scheme to help balance the budget by privatizing Social Security.

According to Kelton, “Ryan asked the witness [Greenspan] whether he agreed with that assessment. As the witness began to answer the question, Ryan’s face lost all color. It wasn’t the answer Ryan was looking for.”

What was Greenspan’s answer? “I wouldn’t say the pay-as-you-go benefits are insecure,” he said, “in the sense that there’s nothing to prevent the federal government from creating as much money as it wants and paying it to somebody.”

In spite of Congress’s blanket ignorance, the truth is widely understood among economists that the federal government can create as much money as it needs, without taxing or borrowing, and without balancing its budget.

Let’s go a little further with Professor Kelton’s proposals

This claim, that the federal government can create as much money as it wants or needs, without counterbalancing taxation or borrowing, is the cornerstone of MMT – and it is undeniable.

But Kelton says a little more than that. One of her main points is that what the Federal Reserve does – trying to set the interest rate at a point that will achieve the “natural rate of unemployment” – is not the best way to tackle unemployment, because it still leaves some resources underutilized.

She believes that instead of the Fed trying to balance unemployment and inflation through the monetary mechanism, Congress should be doing it through the fiscal mechanism. In particular, Congress could ensure that all human resources are utilized – i.e. that there is zero unemployment – by providing a jobs guarantee. If all resources are engaged by minting enough dollars to pay for them – but not more – then inflation will not take off.

It’s important to separate this MMT claim from the more basic ones, those that are agreed to by other economists. Otherwise the debate gets too muddied.

Now let’s come back to the critiques.

Inflation, inflation, inflation

One of the most vehement critiques of MMT comes from Larry Summers, formerly Treasury Secretary and president of Harvard University. His opinion piece about MMT, titled, “The left’s embrace of modern monetary theory is a recipe for disaster,” was published in *The Washington Post* March 5, 2019.

His chief complaint was that, “contrary to the claims of modern monetary theorists, it is not true that governments can simply create new money to pay all liabilities coming due and avoid default. As the experience of any number of emerging markets demonstrates, past a certain point, this approach leads to hyperinflation.”

But of course, Kelton says that the *central* concern of MMT is inflation – especially as opposed to balancing the budget.

Nevertheless, all of the critiques – Summers’s, Wolf’s, Cochrane’s, and even Paul Krugman’s, which I’ll come to in a moment – are concerned that embrace of MMT will cause too much inflation.

Why is that, when Kelton says that the purpose of MMT is to provide a framework for ensuring that too much money is not chasing too few resources, thus avoiding inflation, while also employing those resources as fully as possible?

Because those critics don’t believe it. They don’t believe MMT’s efforts to control inflation by funding full employment – but not more – will work. For example, Martin Wolf says, “it is hard to know where ‘full employment’ lies. Excess demand may exist in some sectors or regions, and deficient demand elsewhere. Full employment is a highly uncertain range, not a single point.”

But then couldn’t you fine-tune things by observing and adjusting? Cochrane rejects Kelton’s suggestions about how Congress could tell if there is slack in the economy. He says, “Really her answer is: Don’t worry about it.”

As for Krugman, he and Kelton carried out a running public exchange last year in the pages of *The New York Times* and *Bloomberg*. Much of that debate is too technical to be covered here, but one of Krugman’s main arguments baffles me.

In an article with the tagline, “Their agenda still needs to be tax-and-spend, not just spend,” Krugman argues that if Medicare for all means replacing private insurance with free public coverage, you need offsetting revenue.

But let’s look at it from the MMT perspective – would replacing private insurance with free public coverage make more intensive use of resources than leaving things as they are? Would it mean too much money chasing too limited resources? No, it would replace one resource with another, in fact probably the same one – many of those who work in the private health insurance field might instead work for the government.

Krugman seems to be missing Kelton’s point.

Why do the critics think that belief in MMT will fuel inflation and why are they so worried about it?

Notice that Summers’s warnings focus on the hyperinflation that occurred in emerging markets where governments promised too much and gave too much to their constituencies.

One of Kelton’s main proposals is to take the task of balancing inflation against resource exploitation (i.e. employment) away from the Fed and give it to Congress. Congress would decide whether there is slack in the economy. It would decide whether to make use of that slack by spending more, without regard for whether that spending is “covered” by taxes. If there were no slack at all and the economy was tightly wound, then Congress would decide whether to mop up the excess dollars by raising taxes. It would do this, of course, by drawing on expert advice, for example from the Congressional Budget Office. But that advice would not be couched in terms of balancing the budget, but in terms of determining the extent to which national resources were fully utilized and inflation was emergent.

The critics are freaked out by two things.

In her book, Kelton devotes a lot of pages to waxing optimistic about all the things we could do once we realize that the spending doesn’t have to be paid for by additional taxes. This raises fears that those who embrace MMT will, in fact, go on a spending bender, exceeding the available resources and causing inflation – just as in Summers’s developing countries like Argentina, Brazil, and Zimbabwe.

The deeper issue

But there is an even more basic issue raising those fears. They don't trust Congress to make the appropriate adjustments. Would Congress, observing that – or being advised that – the economy was overheating therefore raise taxes to mop up the excess dollars, as MMT advocates? Would it restrain itself from spending programs once Congresspersons had to deal with lobbyists for various programs who had learned that MMT tells you that you don't have to raise taxes to do it?

No, they don't trust Congress to do that – in fact they don't trust democracy to do it. And for good reason.

Democracy has a Tragedy of the Commons problem. A Tragedy of the Commons is, for example, a fish pond shared by many anglers, each of which, in their own self-interest, catches as many fish as they can, with the unfortunate collective result that the pond gets fished out.

If each person votes his or her own financial interest, they will vote for more government spending and less taxes. But collectively, it will cause too much spending chasing limited resources – hyperinflation.

The current structure of the U.S. government is one that dodges this problem, but it requires believing a fiction. It requires that Congress – and its constituencies – believe the budget has to be balanced, and it requires an undemocratic committee of elites, the Federal Reserve, to manoeuver, however inefficiently, to keep inflation in check.

Any threat to that arrangement is dangerous. To keep the unwashed masses from prevailing upon – or electing – a government that tries to provide all things to all people, as in a populist state, we must perpetuate the fiction that all new expenditures must be immediately paid for by new taxes. And we must delegate the management of the supply of money not to a democratic process, but to a quasi-authoritarian government arm, the Fed.

Kelton recognizes this tension and raises the question of whether we can trust Congress to properly allocate resources. But she does not provide a clear answer.

Nor do the critics of MMT. They believe – but can't say directly – that such power leads to disaster.

Economist and mathematician Michael Edesess is adjunct associate professor and visiting faculty at the Hong Kong University of Science and Technology, chief investment strategist of Compendium Finance, adviser to mobile financial planning software company Plynty, and a research associate of the Edhec-Risk Institute. In 2007, he authored a book about the investment services industry titled The Big Investment Lie, *published by Berrett-Koehler. His new book,* The Three Simple Rules of Investing, *co-authored with Kwok L. Tsui, Carol Fabbri and George Peacock, was published by Berrett-Koehler in June 2014.*

[i] The collection of taxes has another purpose, especially when a government first issues a currency: namely, to force the citizenry to use it. Dr. Kelton explains this not only in her book but in a recent *New York Times* opinion piece.