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Some observations on MMT: what's right, not right, and what's too simplistic

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Abstract

Three observations on modern monetary theory (MMT): (1) What's right is not new—Consolidating public finance, whether it's held on a balance sheet of the Fed or held on the balance sheet of the fiscal authority, is the appropriate strategy to understand debt burdens and debt sustainability even as the independence of the Fed relative to its role in the fiscal space is a legitimate topic of discussion. The monetary authority has a monopoly over the issuance of its own currency, and in addition the currency issuer gets seigniorage. (2) What's new is not right—The notion that somehow deficits need to precede tax payments is not necessary. It is not right to argue that public debt is not a future burden, or that the zero lower bound is a natural state. Moreover, sovereigns can default, in numbers of ways, including inflating away obligations or depreciating the currency. (3) What's left is too simplistic—there is complacency with regard to the exorbitant privilege; there is evidence in auctions of some digestion problems of large fiscal deficits. Importantly, MMT lacks a financial sector, yet financial intermediation and markets are central to the how much monetary accommodation boosts the real economy or asset prices. Boosting the latter could worsen inequality. Finally, MMT does not address choices or quality of fiscal policy, which would affect the real economy, inequality, and asset markets.

Keywords MMT · Modern monetary theory · Exorbitant privilege · Monetary economics

I appreciate the opportunity to come to NABE's annual meeting to talk about modern monetary theory. Most of you know that I never go anywhere without charts. But I did not bring any because I only need the aggregate demand, aggregate supply diagram, and we all know that one. Keep that in your mind as we talk about modern monetary theory.

Today I will draw on a short piece written with my colleague, Willem Buiter available on Citi's public-facing GPS website (https://www.citivelocity.com/citigps/modern-monetary-theory-mmt/). We begin with a summary of what we see as the fundamentals of MMT: A sovereign nation with its own currency can issue abundant public debt in that currency. It cannot go broke. The only limit to the amount of public debt issuance is inflation. In response, we argue three points about MMT: What's right is not new, what's new is not right, and what's left is too simplistic.

To start, what's right in MMT is not new. Consolidating public finance, whether it's held on a balance sheet of the Fed or held on the balance sheet of the fiscal authority, is, from an economic perspective, the appropriate strategy to understand debt burdens and debt sustainability.

The independence of the Fed relative to its role in the fiscal space is a legitimate topic of discussion. There've been times in the USA where the Fed was institutionally independent but wasn't terribly independent when it came to supporting the objectives of the fiscal authority. So, institutional independence is not a formal consideration when it comes to the basic concept of debt sustainability and the consolidation of public finance. So, MMT is not new from this perspective.

The second point where MMT is right but not new is with regard to whether the monetary authority has a monopoly over the issuance of its own currency. We agree, and in addition the currency issuer gets seigniorage, which can be used to offset the fiscal budget deficit. We calculate it's about 0.3% of GDP or $64 billion, although could be about twice that, say $100 billion or so. Seigniorage reduces your

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fiscal deficit, that is, increases your fiscal space. There are other ways that monetary policy can open up fiscal space, for example by reducing the cost of sovereign borrowing. So MMT's points about monopoly and seigniorage are right, but not new.

What about where MMT is new but not right? The first point is that somehow you need to have deficits in order to create money so that people can pay taxes later, e.g., deficits precede tax payments. We don't think that that's right and it doesn't make any sense. But I also think it's a small point.

The next point asserted by MMT is that public debt is not a future burden. We don't agree with this. The empirical evidence for this assertion—that government spending or tax cuts pay for themselves, with interest—is not there. So, it is not right to claim that, as a rule, undertaking deficit finance, whether it be through a tax cut or by additional spending does not pose a burden to future generation.

MMT is not the only school that asserts this magic that a fiscal deficit will pay for itself. Supply siders have said this for a long time about tax cuts. We find it interesting that two different ends of the ideological spectrum have come around to agree with each other. Different instruments at work—tax cuts vs spending—but both have deficit financing pay for itself, with interest. There is no evidence; neither are right.

The third place where we think that MMT is new, but not right, is the notion that the zero lower bound is a natural state—there is a gravitational pull that is resisted by the Fed. For the zero lower bound to be a natural state for the economy—now imagine your aggregate supply, aggregate demand diagram—this is only true if the aggregate supply response in the economy that comes from the monetized fiscal strategy is always greater than the aggregate demand response. If you don't have the aggregate supply response always greater than that of aggregate demand, then you will get either crowding out or inflation or some combination. A corollary to this ZLB-as-a-natural-state is that money is not neutral in the long run. It's not neutral in a very specific way: The aggregate supply consequences of monetary financing of fiscal deficits overwhelm the aggregate demand response. This is a pretty strong combination, and we think it is not right.

A fourth element that's new but not right is that the sovereign will never default. Our definitions of default have become a little bit more flexible over time. You can inflate away your obligations. That's not exactly a default but it's not exactly what people thought they were going to get when they bought the bonds. We can talk about reprofiling, where we issue new bonds at different maturities and change the contract terms and so forth. Whether this is default or not is a matter of terminology and contract law, but we also think MMT is not right to say that the sovereign will never default.

What's too simplistic about MMT? The first is the exorbitant privilege assumption: That the USA can always issue debt into the marketplace, and there will be no macroeconomic consequences of that continuous issuance.

We have mounting evidence that this assumption is not right. The bid-to-cover ratios for the 10-year and the 30-year bonds have declined. The ratio of the stop-through (more demand for the bonds after the auction than at the auction) to the tail (there's a discount after the auction as compared to the auction price) also has fallen. More auctions have tailed recently particularly the 30 year, the 5 year, and the 6 month. So there's evidence of some erosion of the exorbitant privilege, which is a key element of modern monetary theory.

A second simplistic view in MMT is that there's no financial sector (although our other macro-models, such as IS-LM and AS-AD also, are missing a financial sector). However, with the abundant monetary issuance under MMT, the financial sector may come to play an increasingly important role. Specifically, does the money creation get transmitted through the financial sector to the real economy, or is it captured in the financial sector leading to increased asset prices? The implications of those two different destinations are quite dramatic.

So that summarizes what's right is not new, what's new is not right, and what's left is too simplistic.

I'll conclude by arguing that this discussion of MMT is missing some key topics. None of the macro-theories talk about income or wealth distribution and how that can be affected by both monetary and fiscal policy. Considering MMT, given that wealth is not evenly distributed, if monetized fiscal deficits raise asset prices more than bolster the real economy, MMT would worsen the wealth distribution. Finally, MMT itself does not address fiscal choices. Whether a tax cut or additional spending, it is the fiscal choice—what the deficit is financing—not the monetization of it, that matters the most.

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