Understanding Modern Monetary Theory

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Amid concerns about rising debt, lower growth, declining rates, and easier money, an obscure and heterodox branch of economic theory is gaining traction. Here's a guide to what investors should know.

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Although the unprecedented steps taken by leading central banks may well have saved the world from a repeat of the Great Depression 10 years ago, the economic orthodoxy behind that rescue is under attack. Now a radically new method of economic management called Modern Monetary Theory (MMT) has become a major topic of discussion among politicians, business leaders, economists and financial market practitioners in the United States and beyond. In the process it has captured an expanding fan base on the political left, which means investors will be hearing a lot more about it between now and the 2020 Presidential election.

MMT draws upon multiple strands of economic thought. Chief among them is the notion a government that can print its own money need never default on debt denominated in that currency. This means such a country can, and indeed should, run substantial and persistent budget deficits at near-zero cost and hence without fear of the consequences, especially when inflation is low. In fact, it can buy goods and services without issuing debt, or even raising taxes, in the first place. In contrast to orthodox thinking, MMT suggests because of the way in which money is created, higher deficits tend to put downward pressure on interest rates. It is only where governments choose to sterilize the impact of any deficit spending by issuing bonds – something MMT sees as unnecessary – that interest rates may rise.

The Pushback

Unsurprisingly, the economics establishment that has gone largely unchallenged for so long has been scathing in its criticism. Federal Reserve (Fed) Chairman Jerome Powell told a congressional hearing the concept of MMT was "just wrong" and scoffed at the idea the dollar's status meant the U.S. deficit did not matter.[1] Harvard professor Kenneth Rogoff labelled MMT, "Modern Monetary Nonsense."[2] Interestingly, left-of-center economists have been just as critical. Former Treasury Secretary Larry Summers described it as the new "voodoo economics",[3] while Paul Krugman, a Nobel prize winning Keynesian, complained its devotees change the rules on a whim.[4]

Unlike Krugman, Stephanie Kelton, a former advisor to Democratic Senator Bernie Sanders, sees little or no ability to substitute monetary policy for fiscal policy. She argues that in a slump, cutting interest

rates is “weak tea” against depressed profit expectations.[5]

In fact, Krugman would concede that as interest rates approach the so-called zero lower bound, the trade-off between monetary and fiscal policy begins to disappear. Where Krugman and Shelton differ is in explaining what happens when the economy is not in a liquidity trap.

For Krugman, since the economy is already operating at full capacity, either inflation will begin to rise sharply, or the central bank will be forced to hike interest rates to prevent the economy overheating. In his view, this will in turn cause private-sector investment to be “crowded out”.

By contrast, Kelton thinks raising interest rates “does little to quell new activity”. Her conclusion is that governments should wrest control of the economy back from central banks, since fiscal policy is a more direct method of regulating economic activity than monetary policy. Interest rates should simply be set at a low level, or even zero, and left there.

What About Debt?

Mainstream economists such as Krugman say a second major problem with MMT is that it fails to address the potential problem of snowballing debt. For them, if a country’s real economic growth rate does not exceed the inflation-adjusted cost of servicing its debt, it must run a primary budget surplus to keep its debt-to-GDP ratio stable.

As Krugman wrote in *The New York Times*: “I’m not arguing against an ambitious (fiscal) agenda. But heterodox monetary theory won’t let you avoid the reality that this agenda will have to be tax-and-spend, not just spend.[6]

For Kelton, however, preventing a “doomsday scenario” is not difficult. All the monetary authority needs to do is ensure interest rates are below the country’s growth rate. She cites Japan as a prime example. Even with a debt ratio she says may well rise to 300 per cent one day, “rates sit right where the Bank of Japan sets them”, meaning the government can “easily” sustain its primary deficit.[7]

Economic Theory’s Inflation Problem

One of the main arguments advanced by conventional economists against MMT is that the policies it advocates risk much higher inflation. As Summers wrote in his critique of MMT: “It is not true that governments can simply create new money to pay all liabilities coming due and avoid default... past a certain point, this approach leads to hyperinflation.”[8]

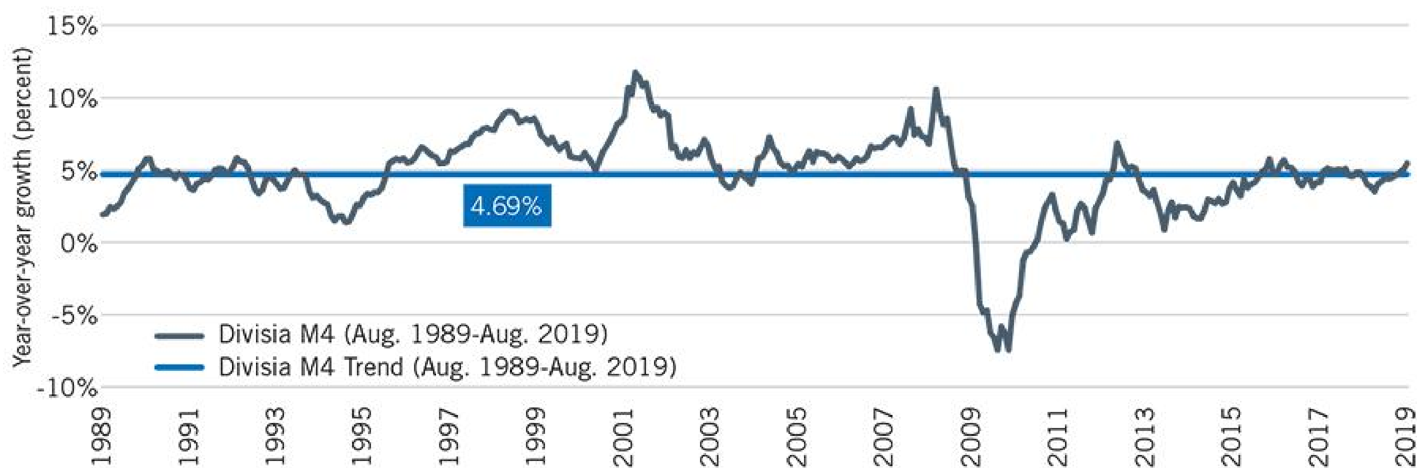
Part of the problem with this line of reasoning is that the same arguments were widely advanced when QE commenced in late 2008. Yet more than a decade on, the high inflation predicted by many has failed to materialize despite massive monetary stimulus. In the United States at least, this is largely explained by the deep liquidity trap the economy fell into during the financial crisis, and the subsequent impairment of the credit-creation process.

While central banks primarily control narrow measures of the money supply, it is privately-owned banks which primarily influence broader measures of money. As the chart below shows, it wasn’t until 2011

that the annual growth rate of a broad measure of the U.S. money supply turned positive as households stopped deleveraging. Furthermore, since that time broad money growth has been subdued by historical standards.

Even so, MMT-ers concede boosting spending with the economy at full capacity can lead to inflation, but they contend this can be easily quelled by raising taxes or issuing bonds to remove excess liquidity.

US Broad Money Supply Annual Growth Rates



Note: Divisia M4 is a broad aggregate, including negotiable money-market securities, such as commercial paper, negotiable CDs, and T-bills.

Assessing Hyperinflation Risks

As for those who cite the example of Weimar-era Germany, or more recently Zimbabwe, when pointing out the dangers of MMT, they omit some crucial points.

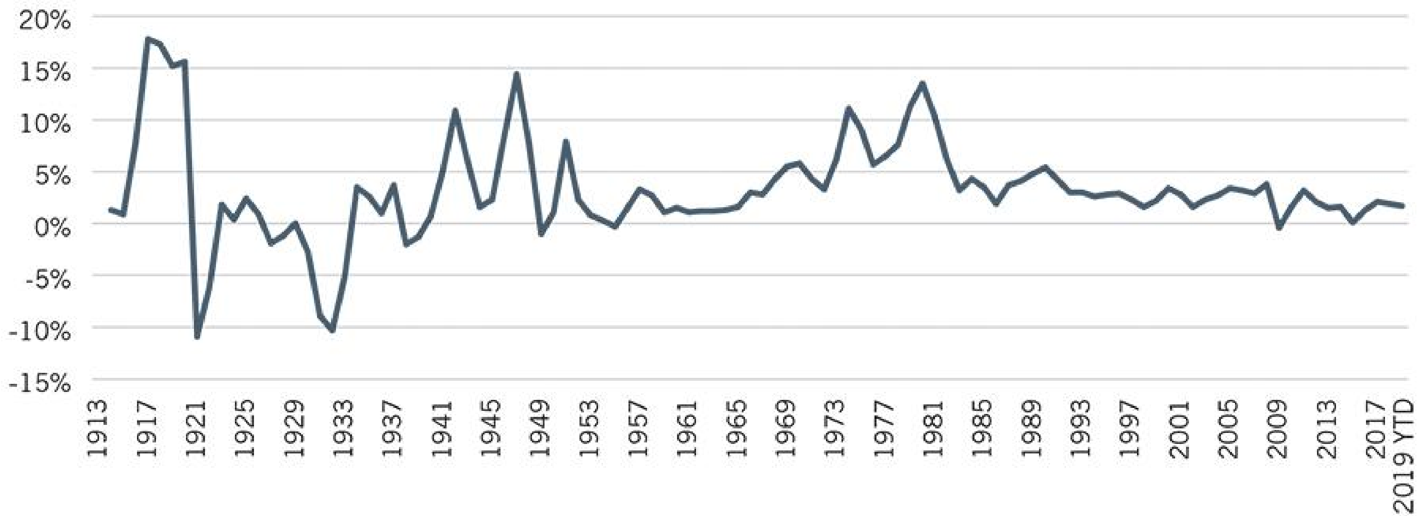
For instance, Germany's situation in the 1920s was unique. Already saddled with huge debt following World War I, the country was then told to pay huge reparations to the Allied powers. That crippled the economy, forced the country to print banknotes to acquire the gold or foreign currencies it needed, and ultimately led to the mark collapsing and hyperinflation. As for other episodes of hyperinflation, they have usually been caused by major wars or other disruptive supply shocks.

Having said that, even if one concedes there is considerable uncertainty as to what causes inflation, it seems likely U.S. Representative Alexandria Ocasio-Cortez's proposed Green New Deal to wean the United States off fossil fuels or Sanders' plan to provide Medicare for all and free college tuition would be highly inflationary. Regardless of funding proposals, given their sheer scale and the fact there is little spare capacity in the U.S. economy, it seems hard to argue otherwise. But it is worth noting that U.S. inflation 40 years ago was 13.3% (see chart below).

Policymakers are in a bind. With interest rates at record lows in much of the world 10 years into a global economic rebound, they find themselves in an extremely uncomfortable position. While the Fed may have a little room for maneuver with interest rates currently around 2.1%, other central banks are all but out of conventional ammunition, particularly with the drawbacks of quantitative easing and negative rates becoming ever more apparent. Should the world head back towards recession, there is a growing likelihood governments will adopt a more interventionist fiscal stance. Some politicians may feel they have nothing to lose by printing money to finance increased spending.

Is Inflation Dead?

Inflation May Be Subdued Now, But Here's Its Track Record Since the Federal Reserve Was Created



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Prior to joining Aviva Investors, David Nowakowski was a director at Barings with responsibility for idea generation and scenario analysis for Fixed Income portfolios with a particular focus on currency, rates and credit strategies, as well as contributing to firm-wide macroeconomic views. Beforehand, he held numerous roles in investment management in New York and London, including Lazard Asset Management and The Rohatyn Group. He was also senior director of research at Roubini Global Economics, and has advised sovereign and corporate clients during his time at Citigroup/Salomon.

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1. Jerome Powell Says the Concept of MMT Is 'Just Wrong', Bloomberg, February 26, 2019
2. Kenneth Rogoff, "Modern Monetary Nonsense," Project Syndicate, March 4, 2019.
3. Lawrence Summers, "The left's embrace of modern monetary theory is a recipe for disaster," Washington Post opinion piece, March 4, 2019.
4. Running on MMT… Trying to get this debate beyond Calvinball, New York Times opinion piece by Paul Krugman, February 25, 2019.
5. "Paul Krugman Asked Me About Modern Monetary Theory. Here Are 4 Answers," Bloomberg opinion piece by Stephanie Kelton, March 1, 2019.
6. Paul Krugman, "How Much Does Heterodoxy Help Progressives?," The New York Times, February 12, 2019.
7. Stephanie Kelton, "Modern Monetary Theory Is Not a Recipe for Doom," Bloomberg, February 21, 2019.
8. Summers, op. cit.

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