Modern Monetary Theory Is Not a Recipe for Doom

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Economics

There are no inherent tradeoffs between fiscal and monetary policy.

By
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There's no science to it.

Photographer: Saul Loeb/AFP via Getty Images

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Paul Krugman first wrote about modern monetary theory on March 25, 2011. He last wrote about MMT in a two-part series on February 12-13*, *see below* 2019. Although he's had almost a decade to come to terms with the approach, he is still getting some of the basic ideas wrong.

This matters for two reasons: one, because people listen to Paul Krugman, who won the Nobel economics prize in 2008, and, two, because the approach he is discussing is at the heart of how to design economic policies that affect millions of Americans. I'd like to try to move the conversation forward by addressing his concerns.

He begins by saying, "MMT seems to be pretty much the same thing as Abba Lerner's 'functional finance' doctrine from 1943." Krugman then sets out to critique Lerner's functional finance, which he says "applies to MMT as well."

It's actually not correct to say that modern monetary theory is pretty much the same thing as Lerner's functional finance. MMT draws insights and inspiration from Lerner's work — including his "Money as a Creature of the State" — but the American academics who are most associated with MMT would argue that the contributions of Hyman Minsky and Wynne Godley are at least as important to the project, and probably more so. So, a critique of functional finance is not a critique of MMT but a critique of one component part of the broader macro approach.

But let's go ahead and examine what Krugman thinks MMT — er, Abba Lerner — gets wrong. For those who aren't familiar with Lerner's approach, here's the thumbnail version: The government should use its fiscal powers (spending, taxing and borrowing) in whatever manner best enables it to maintain full employment and price stability. Basically, he's saying Congress, not the Federal Reserve, should have the dual mandate.

Lerner abhorred the doctrine of "sound finance," which held that deficits should be avoided, instead urging policymakers to focus on delivering a balanced economy rather than a balanced budget. That might require persistent deficits, but it might also require a balanced budget or even budget surpluses.

It all depends how close the private sector comes to delivering full employment on its own. In any case, the government should focus on inflation and not worry about deficits or debt, per se.

Krugman says there are two problems with Lerner's thinking and, by extension, MMT. "First, Lerner neglected the tradeoff between monetary and fiscal policy."

Specifically, Krugman complains that Lerner was too "cavalier" in his discussion of monetary policy since he called for the interest rate to be set at the level that produces "the most desirable level of investment" without saying exactly what that rate should be.

It's an odd critique, since Krugman himself subscribes to the idea that monetary policy should target an invisible "neutral rate," a so-called r-star that exists when the economy is neither depressed nor overheating. For what it's worth, research suggests the neutral rate "may be flat-out wrong," and Fed Chairman Jerome Powell has admitted that the Fed has been too cavalier in relying "on variables that cannot be measured directly and which can only be estimated with great uncertainty."

But Lerner wasn't trying to use interest rates to optimize the economy. That was a job for fiscal policy. He argued that the government should be prepared to spend whatever is necessary to sustain full employment *without raising taxes or borrowing*.

Unless it risked creating an inflation problem, Lerner wanted the government to cut taxes or spend newly issued money and just leave it in the economy. But he also understood that this could cause interest rates to "be reduced too low…and induce too much investment, thus bringing about inflation."

For that reason, Lerner suggested that the government might want to sell bonds in order to mop up excess money (reserves) to the point that the short-term interest rate rose enough to prevent excessive investment. Otherwise, the low interest rates brought about by rising deficits might "crowd in" more investment spending and overheat the economy. In other words, Lerner had a completely different way of thinking about the relationship between deficits, interest rates and the purpose of 'borrowing.'

He was worried about the potential *crowding-in* effects of fiscal policy, not the *crowding-out* effects Krugman believes are part of an inherent tension—tradeoff—between fiscal and monetary policy. Lerner understood that deficits could drive interest rates *down* and spur too much investment, thus his support of bond sales to maintain higher interest rates. In this way, borrowing was not about financing deficits but hitting some desired interest rate. MMT agrees and makes the same point.

Krugman's other objection is that Lerner "didn't fully address the limitations, both technical and political, on tax hikes/or spending cuts" as a means of fighting inflation.

In fact, Lerner actually had quite a lot to say about this. Here's the opening sentence to an entire chapter on the subject in his 1951 book "The Economics of Employment": "We have now concluded our treatment of the *economics* of employment, but a word or two must be added on the *politics* and the *administration* of employment policies in general and of Functional Finance in particular" (emphasis in original).

Here's Krugman's concern: What if lawmakers made policy the way Lerner thought they should, and it put us in a situation where somewhere down the road, we ended up with a debt-to-GDP ratio of 300 percent, and an interest rate that is higher than the growth rate?

Krugman says, "to stabilize the ratio of debt to GDP would require a primary surplus equal to 4.5 percent of GDP." And then he wonders how we're going to get there. "Are we going to slash Medicare and Social Security?"

I have three responses.

Since interest rates are a policy variable, all the Fed has to do is keep the interest rate below the growth rate (i

Rather than presenting this as a problem for functional finance, Krugman should be wondering why the Fed would ever maintain an interest rate that would put the debt on an unsustainable trajectory. I don't believe it would. If i>g, then debt service grows faster than GDP, which Krugman argues would be inflationary.

So his hypothetical scenario begs the question: Why would an inflation-targeting Fed permit i>g with a debt-to-GDP ratio at 300 percent?

Japan serves as a pretty good example here, with a debt ratio that might well rise to 300 percent one day. Meanwhile, rates sit right where the Bank of Japan sets them, and the government easily sustains its primary deficits.

Second, if we're so obsessed with debt sustainability, why are we still borrowing? Remember, Lerner didn't think of borrowing as a financing operation. He saw it as a way to conduct monetary policy – that is, to drain reserves and keep interest rates at some desired rate — as I explained here.

But the Fed no longer relies on bonds (open-market operations) to hit its interest rate target. It just pays interest on reserve balances at the target rate. Why not phase out Treasuries altogether? We could pay off the debt "tomorrow."

If that seems too extreme, why not restrict duration to three-month T-bills so interest rates always sit within a hair of the overnight rate? And if we wanted to embark on a World War II-like mobilization for a Green New Deal, Congress could instruct the Fed to cap interest rates the way it did during the actual mobilization for WWII. In other words, there are many ways to deal with the technical and administrative problems that concern Krugman.

Finally, Krugman, like most of the economics profession, appears to assume that the short-term interest rate is the only tool available to the Fed to slow the economy. MMT disagrees, and many central banks around the world do, too.

As just one possible alternative, the Fed could raise margins of safety on lending, such as lower maximum loan-to-value or debt service-to-cash flow ratios. Less credit would be extended, consistent with the Fed's goal of slowing the economy, while the interest rate on the national debt would not rise. A potential benefit to raising margins of safety, compared with raising short-term rates, is that credit extended could come with reduced risks of default.

Where does that leave us? Paul Krugman and I agree on a great many things, but we come at certain questions from a fundamentally different place.

He believes there are inherent tradeoffs between fiscal and monetary policy. Outside of the so-called liquidity trap, Krugman adopts the standard line that budget deficits crowd out private investment because deficits compete with private borrowing for a limited supply of savings.

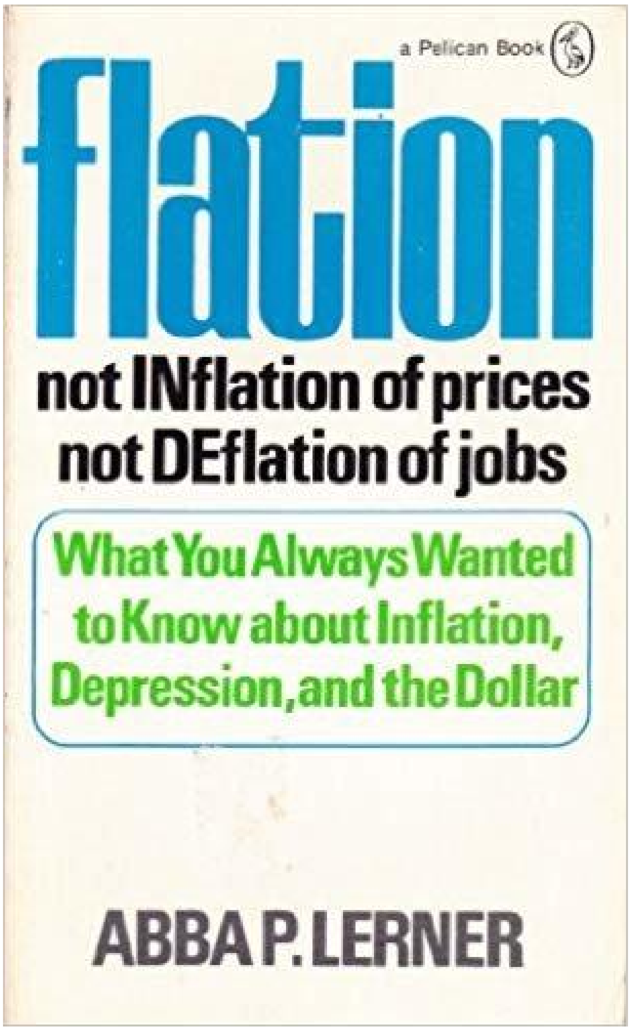
The MMT framework rejects this, since government deficits are shown to be a source (not a use!) of private savings. Some careful studies show that crowding-out can occur, but that it tends to happen in countries where the government is not a currency issuer with its own central bank.

This seems like a disagreement we should be able to resolve either empirically or intuitively. But who knows? As Lerner wrote, "a man convinced against his will retains the same opinion still."

What's Wrong With Functional Finance? (Wonkish)

nytimes.com/2019/02/12/opinion/whats-wrong-with-functional-finance-wonkish.html

Paul Krugman, *The New York Times*, February 12, 2019



Well, it looks as if policy debates over the next couple of years will be at least somewhat affected by the doctrine of Modern Monetary Theory, which some progressives appear to believe means that they don't need to worry about how to pay for their initiatives. That's actually wrong even if you set aside concerns about MMT analysis, which is something I'll write about in a companion piece. But first it seems to me that I need to set out what's right and what's wrong about MMT.

Unfortunately, that's a very hard argument to have – modern MMTers are messianic in their claims to have proved even conventional Keynesianism wrong, tend to be unclear about what exactly their differences with conventional views are, and also have a strong habit of dismissing out of hand any attempt to make sense of what they're saying. The good news is that MMT seems to be pretty much the same thing as Abba Lerner's "functional finance" doctrine from 1943. And Lerner was admirably clear, making it easy to see both the important virtues of and the problems with his argument.

So what I want to do in this note is explain why I'm not a full believer in Lerner's functional finance; I think this critique applies to MMT as well, although if past debates are any indication, I will promptly be told that I don't understand, am a corrupt tool of the oligarchy, or something.

OK, Lerner: His argument was that countries that (a) rely on fiat money they control and (b) don't borrow in someone else's currency don't face any debt constraints, because they can always print money to service their debt. What they face, instead, is an inflation constraint: too much fiscal stimulus will cause an overheating economy. So their budget policies should be entirely focused on getting the level of aggregate demand right: the budget deficit should be big enough to produce full employment, but no so big as to produce inflationary overheating.

This is a smart take, and at the time he wrote – coming off the 1930s, with a reasonable expectation that the economy would lapse back into chronic weakness once the war was over – was a much better guide to policy than conventional fiscal thinking. And it also looks pretty good in today's world, where we once again had a long period of depressed demand despite zero interest rates and still look pretty fragile. Indeed, it looks vastly better than the "Eek! We're turning into Greece!" panic that dominated policy discussion for much of the 2010s.

So what are the problems? First, Lerner really neglected the tradeoff between monetary and fiscal policy. Second, while he did address the potential problem of snowballing debt, his response didn't fully address the limitations, both technical and political, on tax hikes and/or spending cuts. Introducing these limitations makes debt potentially more of a problem than he acknowledges.

From a modern perspective, "Functional finance" is really cavalier in its discussion of monetary policy. Lerner says that the interest rate should be set at the level that produces "the most desirable level of investment," and that fiscal policy should then be chosen to achieve full employment given that interest rate. What is the optimal interest rate? He doesn't say – maybe because through the 30s the zero lower bound made that point moot.

Anyway, what actually happens at least much of the time – although, crucially, not when we're at the zero lower bound – is more or less the opposite: political tradeoffs determine taxes and spending, and monetary policy adjusts the interest rate to achieve full employment without inflation. Under those conditions budget deficits do crowd out private spending, because tax cuts or spending increases will lead to higher interest rates. And this means that there is no uniquely determined correct level of deficit spending; it's a choice that depends on how you value the tradeoff.

What about debt? A lot depends on whether the interest rate is higher or lower than the economy's sustainable growth rate. If rg you do have the possibility of a debt snowball: the higher the ratio of debt to GDP the faster, other things equal, that ratio will grow. And debt can't go to infinity –

it can't exceed total wealth, and in fact as debt gets ever higher people will demand ever-increasing returns to hold it. So at some point the government would be forced to run large enough primary (non-interest) surpluses to limit debt growth.

Now, Lerner basically acknowledges this point. But he assumes that the government always can and will run these surpluses as needed. He dismisses any concern about the incentive effects of high tax rates; certainly Very Serious People grossly exaggerate these effects, but they're not completely imaginary. And he says nothing at all about the political difficulty of achieving the required surpluses, yet such difficulties seem likely to be central if debt gets to very high levels.

A numerical example may help make the point. Imagine that one way or another we get up to debt equal to 300 percent of GDP, and that r-g = .015 – the interest rate is 1.5 percentage points above the growth rate. Then stabilizing the ratio of debt to GDP would require a primary surplus equal to 4.5 percent of GDP.

That's not impossible: Britain ran surpluses that big for several decades after Waterloo. But it's a lot to ask of a modern polity. Are we going to slash Medicare and Social Security? Are we going to impose a value-added tax, not to finance new programs, but simply to service the debt? It's possible, but you do have to wonder whether the temptation to engage in some form of financial repression/debt restructuring/inflation would prevail. And more to the point, investors would wonder about that, pushing r-g even higher.

The bottom line is that while functional finance has a lot going for it, it's not the kind of axiomatically true doctrine that Lerner – and, I think, modern MMTers – imagined it to be. Deficits and debt can matter, and not just because of the effects of deficit spending on aggregate demand.

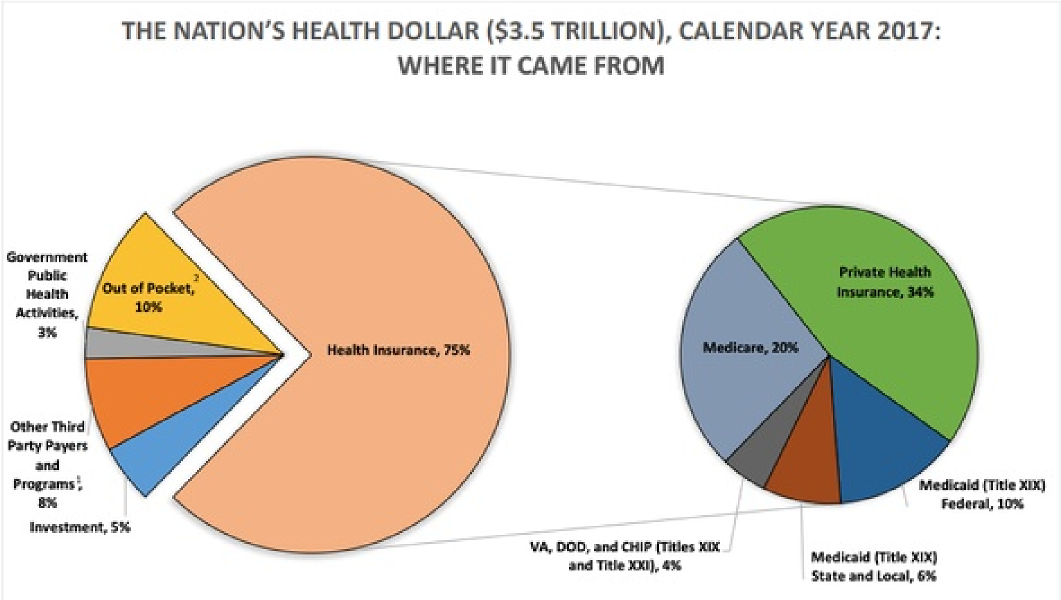
That said, I don't think these objections are all that central to the budget issues facing progressives in the near future. You don't have to be a deficit scold or debt-worrier to believe that really big progressive programs will require major new revenue sources. But I'll explain that in my next post.

How Much Does Heterodoxy Help Progressives? (Wonkish)

nytimes.com/2019/02/12/opinion/how-much-does-heterodoxy-help-progressives-wonkish.html

13 février 2019

Health care is a big fiscal dealCreditCMS



Health care is a big fiscal dealCreditCMS

The center-left is feeling ambitious these days, and it's a heartening thing to see. Anything can happen politically, but it looks at least possible that in 2021 there won't just be unified Democratic control of Congress and the White House, but control by a much more consistently progressive party than was the case in 2009. Maybe America can finally get truly universal health care, policies that really tackle inequality, and more.

But you don't have to be a deficit scold to suggest that progressives should be thinking about how to pay for their policies. So it's a source of mild concern that I keep hearing that heterodox economics — specifically Modern Monetary Theory — says that we don't have to worry about where the money will come from, that because we have a printing press deficits don't matter.

Now, I am not a fan of MMT, which is basically Abba Lerner's "functional finance," which while clever missed some possibly important things. I explained all of that in a previous post. But the truth is that none of this matters much for the issue at hand. Even if you're a committed Lernerite, even if you think that debt never matters, the sheer scale of what progressives would like to accomplish means that there will have to be tax hikes to pay for most of it.

In other words, this isn't mainly about theory; it's about arithmetic.

To see what I mean, consider the biggest ticket on progressives' wish-lists: Medicare for All. This could mean different things, and if it's basically allowing private-sector buy-in then there's no problem. But if it means replacing private insurance with free public coverage, you need offsetting revenue.

Why? In 2017, private insurance paid about a third of America's medical bills — $1.2 trillion, or 6 percent of GDP. Having the government pay those bills directly, without a revenue offset, would therefore be a spending increase — a fiscal stimulus — of 6 percent of GDP.

Suppose — as MMTers tend to assume — that interest rates nonetheless didn't rise. Then this stimulus would have a multiplier effect, probably raising GDP, other things equal, by 9 percent.

Unemployment would fall somewhat less than this, because tighter labor markets would pull more people into the work force. That's why "Okun's Law," the relationship between growth and changes in unemployment, has a slope less than 1 — usually estimated at around 0.5, although when I run the regression on recent data I get around 0.8. But even so, to increase GDP by 9 percent we'd have to see the unemployment rate fall by more than 4 points, that is, go negative — which of course isn't possible.

And don't tell me that we can pull lots of people who were previously out of the work force into employment; Okun's Law already takes that effect into account.

But if the economy can't expand as much as a multiplier says it "should" after an unfunded introduction of Medicare for All, what would happen? Inflation. Big time. Either that or the Fed would have to raise interest rates by a lot, crowding out a lot of private investment. That might be justifiable if the public spending itself takes the form of investment, say infrastructure. It's less defensible if it's for social insurance, no matter how pressing the need.

And if you think that the magic of heterodox monetary thinking somehow means that deficit spending is never inflationary, or crowding out never happens, or something, you don't understand the functional finance that MMT advocates themselves claim underlies their doctrine.

Now, I am *not* saying that we can't afford Medicare for All, just that it would have to be paid for with new taxes. You can certainly argue that most people would come out ahead, because those taxes would end up being less than the insurance premiums they and/or their employers currently pay. In fact, that's probably true. Whether you could convince people to trade their private coverage for public insurance is another question, but that gets into political judgment rather than economics.

The point for now, however, is that rejecting conventional concerns about debt doesn't actually do very much, if anything, to make paying for progressive initiatives look easier. Even if you consider debt a meaningless number, the size of the things progressives are proposing means that pursuing those initiatives without an offsetting increase in revenue would create a lot of inflationary pressure. There needs to be new revenue to achieve what progressives, myself included, want to achieve.

Again, I'm not arguing against an ambitious 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.