

Krugman's Macroeconomics Is No Match for MMT

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Economics

The Clock Runs Down on Mainstream Keynesianism

Paul Krugman's macro framework is leading him astray.

By

[Stephanie Kelton](#)

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Running on MMT time.

Photographer: Krisztian Bocsi/Bloomberg

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So-called "finance twitter" buzzed as the tension between mainstream Keynesian analysis and MMT was put on display. Krugman then took to Twitter with a series of tweets calling my analysis "[a mess](#)" and declaring

MMT to be “a losing game.” He also reminded us of his own record when it comes to “denouncing austerity policies.”

I want to address what Krugman claims I got wrong and also compare the record.

I argued that deficits put *downward* pressure on interest rates. Krugman says I got that wrong. The standard line – Krugman’s line – is that deficits normally lead to *rising* interest rates. I argued that deficits actually put downward pressure on the interest rate and that policymakers have to fight against this natural gravitation by doing something to prevent the overnight rate from dropping toward zero. This is really just basic supply and demand.

It helps to break the argument into a two-part thought experiment. First, think about what happens if the government is running huge budget deficits. As I explained, these deficits would result in a massive injection of reserves into the banking system. *Unless something is done to prevent it*, banks will scramble to offload the excess funds in the overnight market. But with massive supply and no demand for these balances, the overnight bid heads toward zero.

Krugman stops the story here and claims I’m wrong because we can see, empirically, that the monetary base doesn’t increase with the debt. This is because he’s not recognizing that *something is done* to prevent the base from permanently increasing.

What is done? The government is coordinating its deficit spending with bond sales, thereby doing a reserve drain (selling bonds) along with a reserve add (deficit spending), so that the newly injected reserves are quickly transformed into newly added Treasuries. The bond sales are done to coordinate the impact so that the government’s fiscal operations don’t leave the banking system with a larger monetary base (and lower interest rates).

But this is fighting against the gravitational effects on the interest rate. Deficit spending pushes down on the overnight rate, and bond sales pull it back up. When bond sales are perfectly coordinated with deficit spending, the opposing forces cancel out, leaving the monetary base looking stable as Krugman’s graph shows.

To finish the thought experiment, consider what would happen if Congress decided to dispense with Treasury auctions and simply allow budget deficits to supply the system with base money instead of Treasuries. Clearly, that would drive the overnight rate to zero. If it wanted to, the Fed could still achieve a positive overnight rate, simply by paying “interest on reserve,” or IOR, balances. That, too, would be fighting against the natural tendency for rates to go to zero.

I understand why this makes no sense to Krugman. The crude, IS-LM interpretation of Keynes demonstrates that, under normal conditions, an increase in deficit spending will push up interest rates and lead to some crowding-out of investment spending. There is no room for a technical analysis of monetary operations in that framework. For Krugman, the model is simple but useful.

He used the same model to fight the deficit scolds, who were pushing austerity during the Great Recession. (And he deserves credit for being on the right side of that debate!) But his defense of deficits was always contingent on being in a depressed economy, where he argued that monetary policy had become largely powerless (a flat LM curve) due to the zero lower bound (ZLB) so fiscal policy needed to do more to help the economy recover. Now that the economy has escaped the ZLB, Krugman has returned to warning that "deficits matter again." In his words:

What changes once we're close to full employment? Basically, government borrowing once again competes with the private sector for a limited amount of money. This means that deficit spending no longer provides much if any economic boost, because it drives up interest rates and 'crowds out' private investment.

He then goes on to say that "by crowding out investment," deficit spending "will somewhat reduce long-term economic growth."

This follows directly from his model, and these are the arguments I disputed in my most recent reply. Our differences derive from our different analytical frameworks: Mainstream Keynesian versus MMT.

Krugman calls MMT "a losing game," and he urges us to remember "all those articles I wrote" over the previous years.

I sampled those articles, and here's some of what I found.

On Social Security, he asks, "Where is the crisis? Just over the horizon." And then he warns, "While the present generation of retirees is doing very nicely, the [Social Security] promises that are being made to those now working cannot be honored."

He called our nation's finances "a fiscal train wreck" and confessed, "I'm terrified about what will happen to interest rates once financial markets wake up to the implications of skyrocketing budget deficits."

He insisted that the U.S. faces, "a looming fiscal crisis," adding, "the only question now is when foreign investors, who have financed our deficits so far, will decide to pull the plug."

He mused about the potential for accelerating inflation under quantitative easing, writing that the Fed is, "printing \$1 trillion of money, and using those funds to buy bonds. Is this inflationary? We hope so!"

He asked, “couldn’t America still end up like Greece?” answering, “Yes, of course. If investors decide we’re a banana republic whose politicians can’t or won’t come to grips with long-term problems, they will indeed stop buying our debt.”

And he puzzled over the different interest rate environments in Japan and Italy, asking, “Why are the interest rates on Italian and Japanese debt so different?” confessing, “I actually don’t have a firm view. But it seems to be an important puzzle to solve.”

No economist is going to get everything right. But the odds of getting things right improve dramatically when you’re working with a macro framework that doesn’t lead you astray. The IS-LM framework is a gadget that will often align with sensible real-world analysis. It may perform better than a stopped clock, but it is no match for MMT.

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Collateralized Loan Obligations Are Riskier Than Most Realize

Finance

The Bomb That Blew Up in 2008? We’re Planting Another One

Collateralized loan obligations may look safe but they pose risks that are poorly appreciated.

By

[Satyajit Das](#)

3 mars 2019 à 01:00 UTC+1



Investors are blinded by higher returns.

Photographer: Adrian Dennis/AFP

Satyajit Das is a former banker, whom Bloomberg named one of the world's 50 most influential financial figures in 2014. His latest book is "A Banquet of Consequences" (published in North America and India as "The Age of Stagnation"). He is also the author of "Extreme Money" and "Traders, Guns & Money."

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5:26

Financial markets have short memories. Of late, they've convinced themselves that collateralized loan obligations (CLOs) are much safer instruments than the collateralized debt obligations, or CDOs, on which they're based and which helped precipitate the 2008 crisis. They're wrong -- and dangerously so.

Current CLOs outstanding globally total around \$700 billion, with annual new issues of over \$100 billion. That's broadly comparable to subprime CDO volumes in 2008. Both Bank of England Governor Mark Carney and former Fed Chair Janet Yellen have warned about potential risks; [regulators in Japan](#), where banks have been big CLO buyers, are particularly concerned.

The structure of CLOs is economically similar to CDOs. Each pools multiple loans to create synthetic, bond-like investments. Investors buy a slice (or tranche) of the underlying interest and principal cash flows of the portfolio.

A defined order of which investors get repaid first and which bear the most losses allocates risk differentially.

High-risk CLO equity pieces, which are unrated, are first in line for losses and last for repayment. Less-risky subordinated or mezzanine pieces, typically rated anywhere between BBB and B, rank ahead of equity. Low-risk senior pieces, typically rated A or better, rank first for payments and only bear losses if the equity and subordinated pieces are completely wiped out.

CLOs, like CDOs, are designed to increase the leverage on a portfolio of debt. In other ways, CLOs are indeed set up to be safer. Rather than mortgages, subprime or otherwise, they repackage corporate loans, primarily leveraged loans, as well as consumer credit such as automobile loans. Investors in better-rated tranches have greater protection than they would have in CDOs, as higher levels of losses are required before they lose money.

Until recently, they could also rely on the fact that the banks structuring these packages had to retain a minimum amount of the riskiest securities to ensure that they had skin in the game, better aligning their interests with those of investors. The kind of dodgy innovations we saw in 2008 (remember CDO Squared?) haven't recurred.

Nevertheless, many risks remain. How safe or not CLOs are is contingent on several factors: the credit quality of the underlying loans -- as judged by the risk of default and the extent of loss if there is a default -- as well as the correlation between default and losses within the portfolio.

Several aspects of this risk aren't well-understood. The credit quality of the leveraged loans which underlie the bulk of CLOs is poor, typically not investment-grade. Borrowers are highly leveraged. The loans increasingly have minimal investor protection, with over 70 percent lacking any covenants that would allow monitoring of financial condition and early intervention to manage problem borrowers. This exacerbates the risk of higher losses.

Investors assume that the portfolios are safer because they're diversified. Yet, relative to mortgages, corporate-loan portfolios typically are made up of fewer and larger loans, which increases concentration risk. Leveraged loans are highly sensitive to economic conditions and defaults may be correlated, with many loans experiencing problems simultaneously.

Even buyers of high-quality tranches, who may be insulated from actual losses, face the possibility of mark-to-market writedowns, where the current value of securities declines. Relatively minor losses could impact such investors by reducing the protection for higher tranches and triggering rating downgrades. Similarly, general problems in credit markets, where margins increase, will decrease values.

Where investors are leveraged, falling values will result in margin calls. Hedge funds invested in riskier tranches will face withdrawal of funding and redemptions. Some investors, such as mutual funds, may be forced to sell because of loss or rating triggers.

Japanese banks, which have bought up to 75 percent of AAA CLO tranches and perhaps one-third of all CLOs, finance their holdings by borrowing dollars and euros in the inter-bank markets. Losses may create difficulties in rolling over funding, leading to a liquidity squeeze. As in 2008, that would accelerate declines in prices.

As we saw last December, problems with CLOs may result in a contraction of credit. CLOs purchase 50-60 percent of all leveraged loans, just as CDOs funneled funds into mortgages. The demand from CLOs has underpinned decreases in the price of credit and looser lending terms.

In the case of a downturn, the risk is that CLOs will create adverse feedback loops. Banks will be stuck with unsold inventories of underwritten loans. Falling prices, rising spreads and tightening credit availability will cause credit markets to seize up. Tighter credit will feed into the real economy, setting off losses, selling and price declines. Fears about the financial position of banks and investors will create contagion as depositors refuse to fund banks and investors demand their money back.

There are too many parallels to 2008 for comfort. Investors, many with uncertain expertise and weak holding power, have increased their exposure in the search for higher returns, which can be as high as 20 percent for the riskiest equity pieces. Bankers have aggressively underwritten leveraged loans and structured CLOs, earning around \$2.8 billion last year. Built into this speculative episode, like its predecessors, is a euphoric flight from reality and a blindness to risks that continue to rise.

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