Running on MMT (Wonkish)

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Opinion

With everything else going on, I really don't want to spend time arguing with the Modern Monetary Theory people; after all, we agree on basic policy issues right now, and they are never likely to have as much destructive influence as the deficit scolds. But the MMT people think they have an argument with conventional Keynesians like me, and as long as they're out there claiming that standard macroeconomics is all wrong, I guess we need to respond.

Now, arguing with the MMTers generally feels like playing Calvinball, with the rules constantly changing: every time you think you've pinned them down on some proposition, they insist that you haven't grasped their meaning. So I was glad to see Stephanie Kelton responding to my attempt to clarify my problems with the doctrine in a way that seems to make at least some key differences in view clear.

The problem is that I don't understand her arguments at all. If she's saying what I think she's saying, it seems just obviously indefensible. If I try to explain that, will I be told again that I just don't get it? Are we still playing Calvinball after all?

Well anyway, let me describe a bit more analytically one of my key problems with MMT, and what I understand to be Kelton's response.

A key proposition of Abba Lerner's doctrine of "functional finance," which is in turn a large part of the MMT doctrine, is that the appropriate size of the budget deficit can be determined by how big it needs to be to ensure full employment. What I argued was that while this is true when monetary policy is constrained by the zero lower bound, it isn't true when the central bank has room to move interest rates.

Figure 1 illustrates my point. Suppose that the Fed or its equivalent in another country can set interest rates, and that a lower interest rate leads, other things equal, to higher aggregate demand. Then at any given point in time there is a downward-sloping relationship between the interest rate and GDP, as shown by the lines IS1, IS2, IS3.

Figure 1CreditPaul Krugman
Image

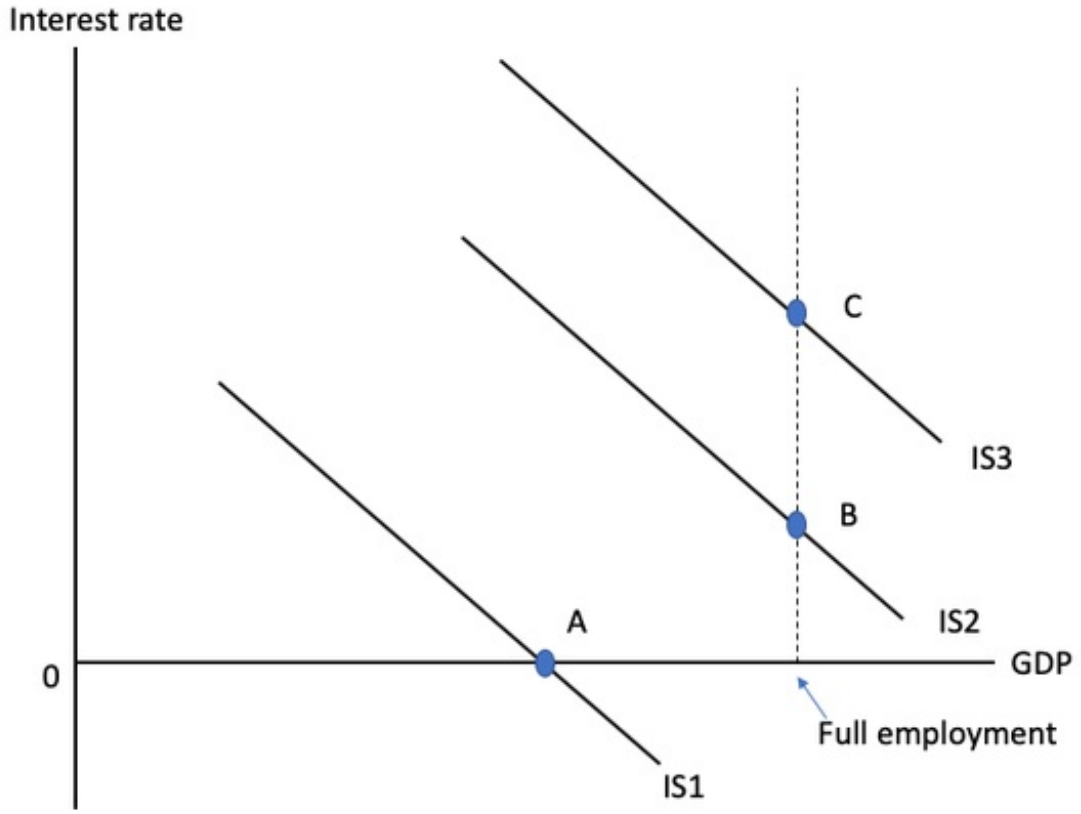

Figure 1CreditPaul Krugman

Suppose that the current aggregate demand schedule is IS3. Then the central bank can set the interest rate so as to achieve full employment, getting the economy to point C.

Now suppose that the government were to cut spending, shifting the aggregate demand schedule down to IS2. Need this create unemployment? No: the central bank can still get us there by cutting interest rates, getting the economy to point B.

So we've just refuted the claim that the required size of the budget deficit can be determined by the need to achieve full employment; as long as monetary policy is available, there is a range of possible deficits consistent with that goal. The question then becomes one of tradeoffs: would the things the government could buy with a higher deficit be worth the lost private investment due to a higher interest rate? Often the answer will be yes. But there *is* a tradeoff.

Now, this breaks down when the interest rate required to achieve full employment goes negative. If fiscal policy is contractionary enough that it pushes the aggregate demand schedule down to IS1, we end up at point A, well short of full employment. And this case has been all too relevant over the past decade! But it's not always the way things work.

OK, so this seems clear to me, and hard to argue with. But Kelton does argue with it, or at least I think she does.

First, she suggests that the neutral or natural interest rate – which is defined as the interest rate consistent with full employment given everything else – does not exist. What does she mean by that? I think she means that it's hard to determine, or maybe that it's unstable, which are defensible claims. But the analysis I've just given doesn't depend on the natural rate being either easily estimated or stable over time. In fact, I never mentioned the natural rate in the previous post. All we need is that the central bank be able to move rates, and that these rates affect overall spending.

So what purpose does claiming that the natural rate is a meaningless concept serve? It looks to me like sophistry – word games intended to confuse what should be a simple issue. Maybe that's uncharitable, but I truly don't see the point otherwise.

Second, and more important, Kelton seems to claim that expansionary fiscal policy – in Figure 1, policy that pushes the IS curve out from IS2 to IS3 – will lead to lower, not higher interest rates. Why?

It seems as if she's saying that deficits necessarily lead to an increase in the monetary base, that expansionary fiscal policy is automatically expansionary monetary policy. But that is so obviously untrue – think of the loose fiscal/tight money combination in the 1980s – that I hope she means something different. Yet I can't figure out what that different thing might be.

Now, the fiscal-monetary tradeoff isn't the only place where I have problems with MMT. But it's a place where Kelton has laid down a very clear marker, saying something that I think I understand – and which also seems to be quite wrong.

So let's be clear here: Are MMTers claiming, as Kelton seems to, that there is only one deficit level consistent with full employment, that there is no ability to substitute monetary for fiscal policy? Are they claiming that expansionary fiscal policy actually

reduces interest rates? Yes or no answers, please, with explanations of how you got these answers and why the straightforward framework I laid out above is wrong. No more Calvinball.

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