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MMT (Modern Monetary Theory): What Is It and Can It Help?

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What Is It?

MMT is an approach to understanding/analyzing monetary and fiscal operations, and their economic and economic policy implications, that focuses on the fact that governments create money when they run a budget deficit (so they do not have to borrow in order to spend and cannot "run out" of money) and that pays close attention to the balance sheet mechanics of monetary and fiscal operations.

Can It Help?

Yes, because at a time in which the developed world appears to be "running out" of conventional monetary and fiscal policy ammunition, MMT casts a more optimistic and less constraining light on the ability of governments to stimulate aggregate demand and prevent deflation. Adopting an MMT lens, rather than being blinkered by the current conceptual and institutional orthodoxy, provides a much easier segue into the coordination of monetary and fiscal policy responses that will be needed in the next major economic downturn.

Some context and background:

- The current macroeconomic policy framework is based on a clear distinction between monetary and fiscal policy and assigns the primary role for "macroeconomic stabilization" (full employment and price stability and latterly usually financial stability) to an independent, technocratic central bank, which uses a "flexible inflation-targeting" framework.
- Ten years after the Global Financial Crisis and Great Recession, major central banks are far from having been able to re-stock their monetary policy "ammunition," government debt levels are high, and there is much hand-wringing about central banks being "the only game in town" and concern about how, from this starting point, central banks and fiscal authorities will be able to cope with another serious downturn.
    - The Federal Reserve's target range for the federal funds rate is now 1.75-

2%, after peaking at 2.25-2.5% in this interest rate tightening cycle and the Fed has stopped shrinking its balance sheet with banks holding $1.373 trillion of excess reserves (the pre-crisis benchmark would have been about zero).

  - The European Central Bank (ECB) recently cut its main deposit rate to minus 50 basis points (bp) and announced it will soon restart its asset purchase program, at the rate of €20 billion per month. The ECB's balance sheet is now about 2.2 times its size when the ECB announced the details of its expanded asset purchase program in January 2015.
  - The Bank of Japan (BOJ) operates a framework called "Quantitative and Qualitative Easing (QQE) with Yield Curve Control," in which the short end of the yield curve (the policy rate) is pegged at around minus 10bp and the yield on 10-year JGBs (Japanese Government Bonds) is pegged at around zero percent and the BOJ commits to continue to expand the monetary base, principally by buying large amounts of JGBs, until it more than achieves its 2% CPI (consumer price index) inflation target. The BOJ's balance sheet is now 3.5 times larger than it was when it announced the first iteration of QQE in April 2013.

- There is a growing debate in academic and financial market circles about the need to rethink the macroeconomic policy framework, particularly to allow for greater coordination of monetary and fiscal policy.
- Such thinking in official circles, however, remains close to taboo, with reviews taking place in the context of the existing framework.
  - The Fed announced in November 2018 a major Review of Monetary Policy Strategy, Tools, and Communication, to report its findings in the first half of 2020, but, as far as I can make out, despite an extensive and much-publicized "listening tour," it is not conferring with the Administration or Congress with a view to taking input from them.
    - The topic of this year's Jackson Hole conference was "Challenges for Monetary Policy," not "Challenges for Monetary and Fiscal Policy."
  - The ECB has announced a similar review of its monetary policy strategy, to be undertaken by incoming president Christine Lagarde in conjunction with the Governing Council.
    - At its last meeting, the ECB Governing Council called on euro area governments "with fiscal space [to] act in an effective and timely manner," and in his press conference ECB President Draghi stated

that “there was unanimous consensus, unanimity, …that fiscal policy should become the main instrument” and that “now it’s high time I think for the fiscal policy [sic] to take charge”.

- But, as long as the euro area is a monetary union without a fiscal union, macroeconomic policy is operating with one hand tied behind its back.

- The respective efficacy of monetary and fiscal policy has been a contentious issue at the heart of macroeconomics since its inception, almost defining the subject, and has involved contributions by such luminaries as Wicksell, Keynes, Hicks, Hayek, Lerner, Friedman, Samuelson, Minsky, Lucas, Sargent, Kydland/Prescott, and more recently views of such prominent economists as Bernanke, Blanchard, Blinder, Furman, Krugman, Rogoff, and Summers.
  - At every stage, developments in macroeconomic theory have informed and influenced the evolution of macroeconomic policy frameworks.
- Paralleling and partly overlapping with this mainstream macroeconomic tradition has been a series of contributions by more “heterodox” thinkers, which have culminated in recent years in an approach or body of work known as “Modern Monetary Theory”.
  - MMT has as its antecedents such strands as Knapp’s chartalism or “state theory of money,” Mitchell-Innes’s “credit theory of money,” Lerner’s “functional finance,” Moore’s “endogenous money” or “horizontalist” approach, and Godley’s balance-sheet-consistent approach, and more recently has been developed and popularized by such writers as Fullwiler, Forstater, Kelton (nee Bell), Mitchell, Mosler, and Wray.
- For many years, MMT was in the shadows or on the fringes, viewed from a mainstream academic and policy perspective, but in recent years MMT has come to popular attention and an active (and sometimes acrimonious) debate has raged in the blogosphere between mainstream economists and MMTers
  - An important trigger for this to happen appears to have been prominent MMT scholar Stephanie Kelton’s becoming an economic advisor to the campaign of 2016 Democratic presidential candidate Bernie Sanders.
- MMT is often seen as an idea of “the left,” which complicates the academic and policy debate and can make it susceptible to being dismissed.
  - I prefer to focus on the economic merits of MMT insights and arguments and their policy implications, and leave politics out of the picture.
  - In my view, positive analysis should come first and inform normative

(policy) analysis, which itself can be (but usually isn't) conducted in an apolitical way.

Some key ideas/insights from MMT (my rendering)

- Even if set up differently in institutional terms, it is helpful to view the central bank and the treasury, that is, the monetary authorities and the fiscal authorities, as being two parts of a single consolidated government.
    - The central bank (typically) serves as the fiscal agent of the government or the banker to the government.
    - "Monetary" and "fiscal" policy are two aspects of the same thing – the ability of the government to create, regulate and redistribute money – or what I have termed "two sides of the same sovereign coin."
        - Notice that a Federal Reserve Note (a banknote) is a liability of the Federal Reserve but is signed by the Secretary of the Treasury and the Treasurer of the United States (two different Treasury officials).
    - Monetary and fiscal operations are intertwined.
        - In change terms, a simplified central bank balance sheet can be written as: $\Delta A = \Delta R + \Delta BK + \Delta GD$, where A is total assets, R is reserves (deposits of banks), BK is banknotes (cash held by the public), and GD is government deposits. R and BK comprise what is called the monetary base.
        - Rearranging to show what influences reserves, $\Delta R = \Delta A - \Delta BK - \Delta GD$.
            - When $\Delta A = \Delta BK = 0$, $\Delta R = - \Delta GD$, that is, reserves increase when the government runs a budget deficit and decrease when the government issues bonds (because the former causes government deposits to fall and the latter causes them to rise).
- Governments create money when they spend and create money in net terms when they spend more than they take in as tax (and other) revenue, that is, when they run a budget deficit.
    - Governments do not need to raise money, by taxing the public or issuing bonds, in order to spend it. Sovereigns cannot run out of (their own) money (they may run out of other countries' money).
    - The purpose of taxing and issuing bonds is to facilitate the monetary policy operations of the central bank (drain reserves) and help modulate aggregate demand and, in the case of taxing, to help create demand for government money, since the public needs to acquire government IOUs

(money) in order to extinguish their tax liabilities.

  - ✧ Not much is written on a Federal Reserve Note, but this bit is key: "This note is legal tender for all debts, public and private."

- It is wrong to treat the government as akin to a household in terms of having a money budget constraint.
  - ➢ The government does not need to balance its books or repay its debts in the way that a household does.
    - ✧ From the national accounting identities, at a global level (for simplicity and to make the point most clearly), the following identity holds: $S - I + T - G = 0$, where S is private sector savings, I is private sector investment, T is net tax revenue (net of transfers) and G is government spending, all on a real GDP basis. Rearranging, $S - I = G - T$, which says that net private sector savings equals (that is, must equal) the government's budget deficit. If the people of the world want to save more than they invest (either directly or through the corporate sector) governments in aggregate must run a budget deficit, such deficit providing the financial asset that the public uses to transfer its purchasing power through time, a very handy thing to be able to do.
  - ➢ Government macroeconomic policies should be based on "functional finance," not "sound finance," principles. That is, the goal of monetary and fiscal policy is to ensure full employment and price stability, so that everyone who wishes to work and obtain purchasing power can do so and so that the value of that purchasing power is maintained over time. The tail (arbitrary fiscal targets) should not wag the dog (social welfare).
  - ➢ The constraint that governments face lies in the real economy: injecting too much purchasing power into the economy, relative to available resources, will lead to inflation.
- Bank do not "use" deposits to "make" loans; rather banks create deposits when they lend. Nor can banks "lend out" their reserves (deposits at the central bank).
  - ➢ There is no mechanical money multiplier from central bank reserves to the money supply (cash and bank deposits).
    - ✧ Before central banks started to pay interest on reserves (from around about 2008), they had to drain any excess reserves (reserves in excess of those needed because of minimum reserve requirements, set by the central bank) if they were targeting a positive policy rate

(otherwise the non-remunerated excess reserves would have forced the policy rate to zero).

- Bank deposits come from three places (in usual order of importance):
  - Banks making loans (“inside money”).
  - Governments running budget deficits (“outside money”).
  - Central banks acquiring assets from the public (either to make sure banks have enough reserves or to do quantitative easing).
- Bank deposits are convertible into central bank money (banknotes) at par.
  - Banks and the government are joined at the hip in money creation.

How MMT Can Help

- An increasing number of academics, policymakers and market practitioners worry that central banks will not have enough “monetary ammunition” and governments enough “fiscal space” when (not if) there is another serious economic downturn. An MMT perspective shows that these concerns are largely a product of the institutional makeup of the existing macroeconomic policy framework, which is designed to solve the problem of governments abusing their access to the “printing press” and generating too much aggregate demand and triggering runaway inflation as a result.
  - This framework works well when the threat to full employment and price stability is “from above” – too much aggregate demand and too much inflation. But it is poorly suited when the threat is “from below” – too little aggregate demand and not enough inflation (disinflation or deflation).
  - Then, a framework that facilitates and encourages monetary and fiscal policy coordination and joint mobilization, a la so-called “helicopter money,” would work better. An MMT-way of looking at the world makes such policy prescriptions much easier to conceptualize and accept than the mainstream way, steeped as it is in the notion of strict separation of monetary and fiscal policy.
- Take QE (quantitative easing). QE, when it involves the central bank buying government debt securities (the usual case), is best viewed as a debt refinancing operation of the consolidated government, in which the consolidated government, acing via the central bank, retires government debt securities and refinances them into central bank money. From an MMT perspective, QE can be viewed as merely returning things to the more “primitive” state before the government issued debt securities to soak up the

reserves generated by its budget deficit, what I have termed the "Monetary Garden of Eden." QE blurs the lines between monetary and fiscal policy because the distinction is moot to begin with.

- But there is a crucial difference between government debt securities and reserves: the former have to be repaid whereas the latter do not. The consolidated government, if there is the proper coordination between the monetary and fiscal authorities, can at will expunge the default risk associated with government debt securities.
    - This suggests that "limited fiscal space" is an artifact. Unlimited QE can provide unlimited fiscal space, but only if the central bank sees it that way. Central bank independence in such circumstances can be an impediment.

Further reading/references

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