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Industry Note
Industry Update

FINANCIALS RESEARCH

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MMT 101

KEY TAKEAWAYS

While sometimes caricatured as arguing that governments can borrow without limit because they can always money-print their way out of debt, MMT offers a more meaningful framework. Specifically, its base prescription is for a permanent policy of zero interest rates and the use of fiscal policy, including a job guarantee, to stabilize aggregate demand.

Surprisingly, this prescription is more consistent with stable prices than might appear although it does require the embrace of some counter-intuitive notions: that fiat money is more rooted as an instrument of state power than means-of-exchange, and that the role of bond sales is to support interest rates not finance budget deficits.

However, MMT is vulnerable to inflation policy error given that fiscal, and particularly tax, policy can be politicized. It responds by arguing that the conventional framework is vulnerable to employment policy error because of reliance on conceptual constructs that can be hard to pin down. For example, the 'natural' rate of unemployment is acknowledged to have been over-estimated so that monetary policy has embedded higher involuntary unemployment than necessary for stable prices.

This is no small matter, and MMT takes the view that 'unemployment is always a greater problem than inflation'. In other words, MMT is making a different trade-off between the costs and risks of policy error than the conventional framework. Given the human and macroeconomic toll of unemployment, it deserves a thoughtful hearing.

Ratings

Industry View:	Neutral

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MMT 101

The base prescription of MMT is a permanent policy of zero interest rates and stabilization of aggregate demand through fiscal policy including a job guarantee. Warren Mosler, an early champion, notes that 'with a permanent zero-percent rate policy … the trick is to cut taxes or increase spending just enough to keep the economy humming along at full employment'. By implication, the other trick is to raise taxes or reduce spending – both public and, through credit regulation, private – to mitigate demand-pull inflation.

MMT makes the case for a zero-rate policy by observing that, as a monopoly issuer of a fiat currency required to pay taxes, government can set interest rates wherever it wants; in this context, 'fiat' means that the currency is not convertible at a fixed rate to any other asset. Bill Mitchell, who coined the term MMT, comments that 'our preferred position is a natural [interest] rate of zero, no bond sales [and] then allow fiscal policy to make all the [demand] adjustments … it is much cleaner that way'. Bond sales are not needed in a zero-rate environment (absent self-imposed constraints such as no-overdraft limits on Treasury's account at the Fed) since, as Warren Mosler puts it, 'the point of securities sales is to support interest rates not to finance expenditures'.

This bears some explanation. As a matter of monetary operations, untaxed (i.e. deficit) spending is *money-financed*: Treasury instructs the Fed to credit the 'reserve' account that is required of a member bank to settle its customers' tax liabilities. To the extent deficit spending creates reserves above the amount banks need for liquidity and regulatory purposes, it increases supply in the interbank lending market and so suppresses overnight interest rates. A government with a positive rate target must then drain excess reserves which is the role of bond sales (since the Fed debits the reserve account of the buying bank and credits its securities account).

Today, of course, central banks use interest rates as a policy instrument. The claim is that higher interest rates reduce aggregate demand, and hence price pressure in the goods market, because investment and savings are affected both directly and through rate-sensitive channels such as the stock market; and vice-versa for lower rates. Paul Krugman argues that a framework such as MMT which forswears the use of interest rates, and relies on the budget deficit to achieve full employment, loses the ability to make an important trade-off: '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.'

However, the use of rates as a policy instrument requires a policy signal, and MMT decries reliance on unobservable parameters such as the natural rates of unemployment and interest rates (at which the economy purportedly finds an equilibrium with full employment and stable prices). Its concerns are shared among mainstream figures with Governor Tarullo arguing, remarkably, that *the Fed does not have a working theory of inflation* because of dependence on 'conceptual constructs' and Chair Bernanke commenting that 'the Phillips curve [and, by extension, the natural rate of unemployment] is probably still the best general framework for thinking about inflation … *the problem is using it in a practical way*.' MMT avoids these constructs altogether through a job guarantee so that 'you know that the government has spent enough … when the last person has walked into the job guarantee office'.

In limiting deficit spending, MMT insists that government faces an *inflation* constraint not a *budget* constraint. In other words, government policy should be judged by how it serves the public purpose (in promoting full employment and price stability) rather than against deficit and debt ratios. Stephanie Kelton, author of 'The Deficit Myth', likes to say that *inflation, not deficits, is evidence of overspending*. And MMT notes that government has nothing to fear from bond vigilantes since the central bank can always outbid them, but thereby becomes vulnerable to caricature as advocating profligacy because 'all government debts can be paid by printing money.'

In fact, MMT takes fiscal sustainability seriously and does not advocate spending beyond the productive capacity of the economy; rather, it makes a different judgement than the conventional framework around the risks and costs of policy error. Through regulating aggregate demand primarily through fiscal tools, without either reference to deficit/debt ratios or the use of interest rates, MMT implicitly accepts the scope for inflationary policy error. However, it rejects the scope for employment policy error through poorly specified model parameters such as the natural rates of unemployment and interest rates. These model errors are not small. Congresswoman AOC points out to Chair Powell that unemployment of 3.7% in July 2019 was nearly two percentage points below the Fed's estimate for the natural rate of unemployment of 5.4% in early 2014 while 'inflation is no higher today than it was 5 years ago'.

With a US labor market of ~165mm, the difference represents nearly 3mm people. Given the human and macroeconomic toll of unemployment, this is shocking. Bill Mitchell argues 'unemployment is always a greater problem than inflation … there is nothing ideological in the statement that [macroeconomic] losses from unemployment dwarf those associated with inflation … [and these] are just the tip of the iceberg … the personal, family, and community losses are very large and persist across generations'. Furthermore, the job guarantee acts as an automatic fiscal stabilizer and, through its wage rate, an anchor for private-sector pay and hence more general price levels: 'if the private sector is inflating, a tightening of fiscal and/or monetary policy shifts workers into the fixed-wage job-guarantee sector to achieve inflation stability without unemployment.'

All that said fiscal, and particularly tax, policy can be highly politicized so that the chance of policy error may be greater under MMT than under the conventional framework where a central bank uses interest rate tools and, at least in theory, acts as an 'independent agency that makes decisions based on the best available evidence and analysis, without taking politics into consideration'. Yet the acknowledgement that the Fed has substantially overestimated NAIRU and so implemented policy consistent with higher unemployment than strictly necessary for stable prices is disturbing. As Keynes said many years ago in a different context, 'it may seem very wise to sit back and wag the head … but while we wait, the unused labor of the workless is not piling up to our credit in a bank, ready to be used at some later date … it is running irrevocably to waste … it is irretrievably lost.'

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