The Death of Modern Monetary Theory

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The last two years have provided an empirical test of Modern Monetary Theory (MMT), the idea that a government can borrow indefinitely in its own currency with no fear of bankruptcy. Stephanie Kelton is the cheerleader for testing the limits of fiscal prudence – I reviewed her book in late 2020. MMT doesn't prescribe limitless spending. It is axiomatic that bankruptcy in one's domestic currency can always be avoided by printing money – having the central bank finance debt issuance – so there's nothing insightful about that. MMT holds that the economy's capacity to produce goods and services without generating inflation is the true limit.

Even MMT's most basic assertion, that non-inflationary consumption financed with debt is harmless, fails cursory scrutiny. Suppose Congress voted a giant July 4th party with the world's biggest ever fireworks display funded by issuing 30 year bonds. MMT doctrine would allow this consistent with the inflationary limit. Most would find this absurd. Borrowing to finance transfer payments such as Medicare and social security, as we do now, is an equally indefensible passing of a burden to later generations for no benefit to them.

Fiscal policy has looked very MMT-like since Covid struck, so Kelton and other supporters have been gamely trying to manage the message. A year ago, Kelton appeared on a Bloomberg podcast titled, "How M.M.T. Won the Fiscal Policy Debate." By last July, she was describing surging inflation as "temporary…growing pains." Now even the NYTimes is expressing mild skepticism.

More recently, Kelton is distancing MMT from current fiscal policy, arguing that the former can't be evaluated from the latter. She argues that deficit spending requires a CBO-like assessment to determine whether it will be inflationary, and that faithfully adhering to the economy's speed limit will allow a country to maximize its non-inflationary spending.

It's a bit like NAIRU (Non-Accelerating Inflation Rate of Unemployment). Central Bank utopia is keeping the economy close to NAIRU as much as possible. It doesn't happen – not just because economic surprises inconveniently intrude, but because central bankers never know exactly where NAIRU lies. It's only ever possible to identify it in hindsight, when the absence of inflation suggests more employment slack than anticipated, or rising wages demonstrate the opposite.

Wage increases that outstrip improvements in productivity are believed by most economists to be a necessary pre-requisite for inflation to become embedded and no longer "transitory" (to use Jay Powell's now discredited term). Without knowing where NAIRU is, it's impossible to know how close the economy is to running at full capacity, and therefore to gauge the inflation risk.

Government policy already aims to keep the economy moving at close to its speed limit. The Fed's mandate is to seek maximum employment consistent with stable prices.

MMT is no more than a statement of the obvious masquerading as a profound theory.

Kelton argues that the spending limits to fiscal policy should be set by the CBO scoring the budget based on whether it would generate inflation or not. We should keep borrowing and spending up until the inflationary point. Calculating the deficit impact of a budget is complicated, but forecasting the inflationary result is a giant step farther. Although the CBO isn't charged with the task Kelton would set them, the Federal Reserve is.

The Fed concluded that the March 2020 CARES Act ($2.2TN), the December 2020 Consolidated Appropriations Bill ($900BN) and the completely irresponsible March 2021 American Rescue Plan Act ($1.9TN) were not going to cause inflation. The Biden White House also believed this last dollop of fiscal profligacy wouldn't be inflationary, even though Covid vaccines were already being administered to older Americans by the time it passed.

The Fed went even further and deemed the fiscal response inadequate to the economic challenge, because they maintained their own stimulus via rock-bottom interest rates and partial debt monetization.

It must be obvious to all that government forecasts of continued moderate inflation were dead wrong. Forecasting is hard, although prudent risk management would have seen the Fed curbing their ultra-accommodative stance a year ago, as we noted at the time. On February 23 last year, Jay Powell said, “At this point, the Federal Open Market Committee is seeking inflation running moderately above 2% for some time.” Following the most recent CPI report showing inflation since then at 7.5%, and 6.0% excluding food and energy, it looks like job done.

Why does Kelton think a CBO inflation analysis would have reached a different conclusion than economists in the White House and the Fed?

In case it isn’t already clear what a wealth-destroying philosophy Kelton promulgates, a recent blog post lists her favorite pre-emptive measures to smooth economic cyclicality and includes the following gem: “Instead of allowing millions of people to fall into unemployment each time the economy falters, workers could transition into a public service job that replaces some or all of their lost income.”

To what useful employment would such a Federal program direct former MMT economists, of which there is already a surplus?

Negative real interest rates have allowed the continued explosion of Federal indebtedness to occur with relatively little pain. MMT has nothing to say on this, but there are $TNs dedicated to fixed income with no need of a return on capital, simply a return of capital. Central banks, sovereign wealth funds, pension funds and others are enabling hitherto unseen levels of US debt accumulation.

If there is an inefficiency to be exploited, it is this excessive supply of cheap financing. The case for testing spending limits rests with the low cost of debt, not some idea that if we could only forecast inflation accurately, we could reach our full economic potential.

MMT was bunk when it was still just a theory. Now that it’s received a full empirical test, savers are left to deal with the consequences.

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