FINANCIAL REVIEW

Opinion

The theory that's too good to be true

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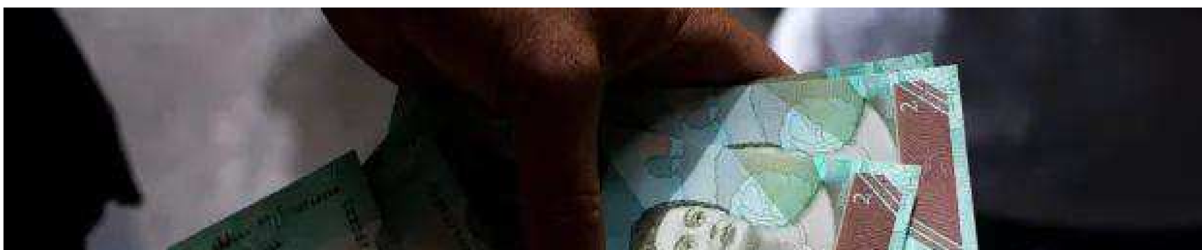
There is currently a popular debate on how to stimulate economies that are stuck with low productivity, low real interest rates and a large amount of public debt. Proponents of an old idea in new clothes – modern monetary theory (MMT) – argue that central banks can solve all these problems by simply buying the large amounts of government debt and increasing the money supply. Advocates argue the stimulus to demand would cause firms to unleash investment and a long sustainable economic expansion would follow. This can only be described as a classic free lunch.

The idea of free lunches has a long tradition in policy debates. Free lunches are politically popular and have recurred many times in the 20th century and before. The experience with all economies that have swallowed this particular free lunch, is it is very costly and it can take a long time before the contradictions eventually causes a disastrous outcome.

The basic problem with MMT is it has been tested by countries and the result has always been hyperinflation, massive social and economic destruction and a crisis followed by more conventional economic policies being imposed. All existing experience – Venezuela today, Zimbabwe in 2008; Yugoslavia in 1994; Hungary in 1946; Greece in 1944; Wiemar Germany in 1923 – demonstrate the large costs.



New devalued bank notes on issue in Venezuela, 2018.

It is possible traditional economics has missed something? Is it possible this time really is different?

When a government spends more than the revenue they generate, the budget deficit that results is usually financed by issuing government debt. The debt of the government is a promise to repay lenders at some time in the future. This can be done by eventually cutting spending relative to taxes or by raising taxes relative to spending.
Most taxes are transparent such as income or profit taxes but the usual tax that eventually finances large and persistent fiscal deficits and exploding government debt is the inflation tax. This is the decline in the value of real money balances in the hands of the public because prices rise more quickly than the printed money on issue. It happens when central banks print large amounts of money in excess of the capacity of the supply side of the economy to produce the additional goods. More money chasing a limited supply of goods leads to rising prices on those goods.

Someone must pay

John Maynard Keynes was an advocate of money financed fiscal expansions to smooth the business cycle. There is a reasonable argument to smooth fluctuations in private demand with government demand financed by temporarily printing money. The problem with the MMT is it is seen as a way to raise the growth rate in the economy in the face of persistent fiscal deficits and high-levels of debt for no apparent cost.

The reality is that eventually someone must pay for fiscal deficits – but the long lags from implementing money financed, persistent deficits and the eventual crisis it creates, makes it a tempting proposition for politicians. I know of no example of a country that has started down the path of money financed fiscal deficits and then

been able to transition back to more conventional policies once the economy enters a new long-term growth path.

There are plenty of examples where printing money to solve a fiscal debt problem hasn't worked. There are no examples, that I am aware of, where the approach of proponents of MMT has worked. It is a theory with no practical relevance.

The fundamental problem in the global economy in 2019 is a complex mix of many factors including: adjustments to demographic slowdowns; a decline is productivity growth; threat of trade wars; a real concern about the scale of public and private debt in the global economy which imply that someone has to pay taxes in the future to fund these debts. It is difficult to see how printing money to replace excessive government borrowing can do anything to improve these fundamental problems and it is likely to make things worse.

There is a good argument for governments to temporarily finance investments that earn a much higher rate of return than the current low and negative real interest rates. There is also a role for governments to smooth business cycles. These arguments are completely different to the ideas being proposed by advocates of modern monetary theory that printing money to replace the huge quantities of government debt in the world economy is a free lunch.

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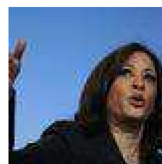

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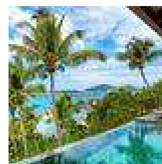

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