Opinion **Global Economy**

What you need to know about modern monetary theory

MMT does not win much respect from economists, but investors should pay attention

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Modern monetary theory (MMT), and its intellectual predecessors, have been somewhat obscure and unconventional branches of economics for many decades, but they have recently gained much more prominence. This column provides a basic catch up for those who have not been paying attention.

MMT has become relevant because it seems to "explain" some of the key events in the post-crisis era, including the persistence of zero interest rates and very low global inflation. Lately, it has also provided a convenient justification for those on the political left who favour a large fiscal expansion in order to finance climate policies, universal healthcare and a public sector job guarantee for unemployed workers (see, for example, the Green New Deal promoted in the US by freshman Democratic congresswoman Alexandria Ocasio-Cortez).

Does the doctrine make any sense? MMT has several different strands, some of which are inconsistent with each other and with established conclusions from more

Many mainstream economists (see Paul Krugman, Lawrence Summers and Kenneth Rogoff) think that MMT is deliberately made obscure because it is nothing more than "modern monetary nonsense". It is often described as a questionable extension, made by fringe economists, of a doctrine that may be partially true, but only in extreme circumstances. I tend to agree with that.

Nevertheless, MMT does have one main tenet that is relevant to the current global economic situation and is hard to refute completely. This states that the public sector in a modern advanced economy should never face the need to default on its sovereign debt in its domestic currency, whatever the size of its outstanding debt or its budget deficit. This is because such a government can always instruct its central bank to print enough domestic banknotes to service or repay any quantity of public bonds that have been issued.

Bank notes, or banks' interest-free liquid deposits at the central bank, are assets of the private sector, but in no genuine sense are they liabilities of the state, since they cannot be swapped for any other assets. In the last resort, the government can exchange pieces of paper, which are in infinite supply at zero marginal cost, for goods and services produced by the private sector, and assets owned by them.

This proposition dates back to the work of Abba Lerner on "functional finance" in the 1940s. Regarded with suspicion by John Maynard Keynes (as an excellent summary of MMT by Llewellyn Consulting makes clear), it was subsequently long forgotten.

I remember a conversation immediately after the financial crash in 2008 in which I suggested to a very senior G7 government official that it was possible to cover a burgeoning budget deficit by printing money, thus avoiding any immediate upward pressure on government bond yields. He was extremely surprised. This, of course, was before quantitative easing had begun.

Ever since former UK prime minister Margaret Thatcher proclaimed in her compelling conference speech in 1983 that "the state has no source of money other than money which people themselves earn" and "there is no such thing as public money", politicians around the world forgot that, while the private sector is indeed mainly responsible for creating real economic resources, the state can actually produce as much money as it wants.

But that of course is subject to the limit that it can only create the amount of money that is consistent with its inflation objective. Even MMT enthusiasts (mostly) accept that an inflation constraint can limit this "exorbitant privilege" to print money.

The basic economics of all this are explained in an important recent article by Willem Buiter and Catherine Mann, released by Citigroup. The essential conclusion is that MMT's central tenet applies only when the economy is stuck in a deep recession, with interest rates at the effective lower bound of zero. When this condition applies, the private sector's demand for money becomes infinite, and the government can finance large and persistent deficits without necessarily facing an immediate constraint.

This does not apply in the US today. Furthermore, there are other factors to take into account.

The financial markets may panic at the extent of money creation, at which point risk premia on private and public debt might explode. With long-term interest rates above the growth rate of the economy, debt would be unsustainable in the long run, unless the government eventually runs a surplus on its non interest budget. In addition, the exchange rate would probably collapse, taking the economy away from the zero lower bound. Once this happens, the standard rules of macroeconomics would apply.

Money printing is anyway limited by the private sector's willingness to hold cash, which is far from infinite. Mr Buiter and Ms Mann conclude that, in normal times and consistent with the 2 per cent inflation target, the appetite to hold money rises at 0.7 per cent of gross domestic product per year. If the government prints more than that relatively small amount to fund its deficit, inflation could follow, though many factors other than the money supply would be relevant here.

These arguments imply that investors should distinguish sharply between two states of the world in which the ideas of MMT might be implemented.

- When economies are stuck at the zero lower bound, like Japan and the eurozone today, MMT could persuade governments and central banks to be less worried about debt constraints when considering expansionary fiscal policy, financed by money creation. Within limits and bolstered by institutional reforms to maintain confidence, this might restore healthy levels of demand more quickly.
- However, when an economy is operating normally, and especially when it is close to full employment, MMT should not be used to justify money financed deficit increases, such as those to finance the Green New Deal. In fact, the results could be highly inflationary and financially destabilising. These are the conditions that apply in the US and UK

In summary, MMT is not a "get out of jail" card for populist politicians who want to ignore the established constraints of macroeconomics. When the economy is near full employment, investors should see it as a red flag for the markets.

Letters in response to this column:

All MMT advocates recognise constraints exist / From Phil Armstrong, University of Southampton Solent and York College, UK

No economy has operated 'normally' for more than a decade / From Professor Richard Murphy, City, University of London, UK