THIRD WAY

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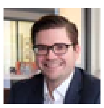
What Is MMT, and Why Isn't It Practical?



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Neither political party has a monopoly on fringe economic theories. For the far right, supply-side economics promised prosperity would trickle down to everyone if government just got out of the way. Supply-side provided a convenient theoretical basis for conservative Republicans to both promote their agenda and argue that they would help the economy more than Democrats. It sounded too good to be true—and it was.

Enter a new far-flung theory, this time from the far left. Modern Monetary Theory (MMT) promises that we should stop obsessing over how to pay for policies such as Medicare for All, a federal jobs guarantee, a universal basic income, free college—anything really. Imagining a world without federal budget constraints is politically attractive to some progressives because they've rightfully felt short-changed by blatant Republican hypocrisy. Republicans screamed about the national debt when Obama was in office trying to save the economy from the great recession, and then passed a huge tax cut for high-income and wealthy individuals and corporations in the midst of an economic expansion.

But just as supply-side failed to live up to its expectations, MMT also is littered with issues. In this memo, we unpack what MMT is, its pitfalls, and note how thinkers from the far left to the mainstream left have come out against the theory.

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TWEET THIS

What is MMT?

Modern Monetary Theory takes a nontraditional approach to explain how governments, specifically large ones like the U.S. who issue their own currency, can finance spending and investment. Its two main tenets are:

- Governments with monetary sovereignty (i.e. the ability to print money and borrow in their own currency) are always solvent and can afford to buy anything in their own currency. Debt and deficits are not constraints, inflation and actual available resources are.

- Taxes should not be viewed as a way to reduce inequality or raise revenue. Instead, they should be used as a way to take money out of the economy and curb inflation.

Therefore, proponents of MMT believe that there are no traditional budget constraints on spending because a monetarily sovereign government can always print more money to finance its debt. They argue that since the government creates money, there is no reason that a government cannot simply print more money if it chooses. If inflation occurs because of that, the government should use higher taxes or lower spending—both which take money out of the economy and therefore curb inflation. [1]

In essence, instead of the Federal Reserve regulating the money supply to manage the competing demands of economic growth, full employment, and modest inflation, that role would be left up to Congress and the White House through taxation and federal spending policies that have the effect of reducing or increasing the money supply.

MMT is often pejoratively attacked as only saying that deficits do not matter. The most visible expert on MMT, Stephanie Kelton, clarifies: "Of course, there are real limits to what can be done. No country can commit to large-scale infrastructure investment unless it has the available labor, machinery, concrete and, steel. Trying to spend too much will cause an inflation problem. The trick is to adjust the budget to make efficient use of the people, factories and raw materials we have." [2]

What are Some Potential Pitfalls for MMT?

If MMT sounds too good to be true, that's because it is. All progressives want to devote additional funding to a series of sectors, from health care and education, to economic security and the environment, so the theory carries an obvious appeal. But MMT is riddled with pitfalls.

1. It assumes politicians will easily raise taxes and cut spending.

Under an MMT regime, policymakers would need to respond to inflation by doing two of the most unpopular things ever: *raising* taxes and *cutting* spending.

With MMT, if inflation starts to get out of control, money needs to be pulled out of the economy either by taxing people more or spending less. Raising taxes is, of course, historically difficult in America. For example, the last time Congress passed a meaningful increase in the payroll tax was in 1993 when the earnings limit was repealed for the Medicare portion of FICA. [3] The last Republican president to sign a tax increase into law was President George H.W. Bush in

1991.[4] With one party adamantly opposed to increasing taxes, it seems like a fantasy to believe that politicians would approve a tax increase while people's earning power is being eroded by inflation. On the spending side, do we see Democrats actually cutting spending and taking an ax to things like national parks, food inspection, and health care services? They shouldn't have to—and they won't.

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TWEET THIS

Further, the current political system moves painfully slow. People rightfully blame gerrymandering, primary challenges, the filibuster, and a host of other political issues. But the end result is the same: depending on Congress to react as quickly as the Fed currently does takes a lot of faith. We can easily imagine divided government's paralysis to fight inflation—Republicans refusing to raise taxes and Democrats refusing to cut spending.

2. It ends our central non-political economic manager.

The Federal Reserve provides an important macroeconomic safety net for the country. And it is able to play the role of an independent steward in the economy free, or mostly free, from political intrusion. For example, in the wake of the Great Recession, Congress worked to provide stimulus to bring the economy out of the tank. But it wasn't enough. Fortunately, the Federal Reserve stepped in to help the economy through the fiscal policy doldrums in 2011 and 2012.

Further, our current economic situation is one of low inflation and low-interest rates. This is because markets trust the Federal Reserve and, as a result, businesses and individuals have well-anchored inflation expectations (i.e. they think inflation is going to be low and stable). Under MMT, however, the Fed's role would be upended. A shift in strategy and relationship to inflation would have an uncertain effect on individuals' and businesses' inflation expectations. And possibly more dangerous during economic downturns, we would move from having both monetary and fiscal policy tools to only having fiscal ones.

Why does MMT require the Fed to get out of the way? Because the Fed currently has a dual mandate of full employment and stable prices. The Fed's toolbox to help manage the dual mandate is, primarily, changing short-term interest rates and buying and selling publicly traded bonds.

Currently increasing the deficit can raise interest rates in two ways:

1. The Treasury must auction significantly more bonds, which results in higher demanded interest rates in the marketplace.

2. Inflationary pressure from larger deficits would, under current practice, provoke monetary tightening (higher interest rates) from the Fed.

Higher interest rates generally put the brakes on economic activity. To solve the challenges higher interest rates create – including a possible interest financing spiral – MMT generally says that the Fed will be tasked with keeping interest rates low by making the federal government, through the Fed, the consistent (if not the primary) purchaser of bonds. This is a different mission for the Fed than it has now. The Fed would no longer be tasked with intervening to keep prices stable because it would be too busy buying bonds. Bond purchases by the Fed generally increase inflation. Thus, the Fed would no longer be an independent manager of the economy. And as we explained above replacing monetary policy with fiscal policy has its challenges.

3. It destroys foreign confidence in America's finances.

The United States has control over its currency because we are the largest open economy and everyone wants to do business with us. Currently, foreign investors own about $6.4 trillion (40%) of the $16 trillion in publicly held U.S. debt. The largest two individual holders are Japan and China. [5]

Holders of U.S. debt (in the form of treasuries) expect stability in value, a return from their investments, and the ability to be paid back. MMT blows that up. Bondholders would no longer be assured a return on their investment, and it will no longer be as desirable for our creditors to hold U.S. debt. The recent ability of foreign investors to soak up the increasing supply of U.S. marketable debt has helped prevent a run-up in interest rates that could have damaged the recovery from the great recession.

Why does this matter? Well, a flight of foreign creditors destabilizes U.S. international trade because inherently less demand for U.S. assets will weaken the exchange rate of the U.S. dollar, possibly severely. And a weaker dollar would further provide inflationary pressure from higher import prices.

What are People Saying About MMT?

Because of issues surrounding MMT, thinkers from the far left to the mainstream left have come out against the theory and issued warnings. For example:

- Paul Krugman in *The New York Times*: "And debt can't go to infinity – it can't exceed total wealth, and in fact as debt gets ever higher people will demand ever-increasing returns to hold it. So at some point the government would be forced to run large enough primary (non-interest) surpluses to limit debt growth." [6]

- Noah Smith in *Bloomberg*: "Let's think in terms of real resources — not dollars, surpluses and deficits, but cars, pizzas, hours of labor. It seems clear to me that unless we have unused resources in the economy — idle workers and idle factories — that a government deficit can't increase real output. At the end of the day, real output is what we care about — you can't eat dollars, but you can eat pizzas. And if the U.S. economy is indeed nearing full employment, it means that there aren't many unused resources lying around — and hence, the real benefit from deficits seems low. This is just standard Keynesian economics." [7]

- Matt Bruenig in People's Policy Project: "The real point of MMT seems to be to deploy misleading rhetoric with the goal of deceiving people about the necessity of taxes in a social democratic system. If successful, these word games might loosen up fiscal and monetary policy a bit in the short term. But insofar as getting government spending permanently up to 50 percent of GDP really will require substantially more taxes in the medium and long term." [8]

- Larry Summers in *The Washington Post*: "...contrary to the claims of modern monetary theorists, it is not true that governments can simply create new money to pay all liabilities coming due and avoid default. As the experience of any number of emerging markets demonstrates, past a certain point, this approach leads to hyperinflation." [9]

- Doug Henwood in *Jacobin*: "MMT's lack of interest in the relationship between money and the real economy causes adherents to overlook the connection between taxing, spending, and the allocation of resources." [10]

ENDNOTES

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