Modern Monetary Theory is not a recipe for doom

There are no inherent tradeoffs between fiscal and monetary policy.

By Stephanie Kelton
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Paul Krugman first wrote about modern monetary theory on March 25, 2011. He last wrote about MMT in a two-part series on February 12-13, 2019. Although he's had almost a decade to come to terms with the approach, he is still getting some of the basic ideas wrong.

This matters for two reasons: one, because people listen to Paul Krugman, who won the Nobel economics prize in 2008, and, two, because the approach he is discussing is at the heart of how to design economic policies that affect millions of Americans. I'd like to try to move the conversation forward by addressing his concerns.

He begins by saying, "MMT seems to be pretty much the same thing as Abba Lerner's 'functional finance' doctrine from 1943." Krugman then sets out to critique Lerner's functional finance, which he says "applies to MMT as well."

It's actually not correct to say that modern monetary theory is pretty much the same thing as Lerner's functional finance. MMT draws insights and inspiration from Lerner's work — including his "Money as a Creature of the State" — but the American academics who are most associated with MMT would argue that the contributions of Hyman Minsky and Wynne Godley are at least as important to the project, and probably more so. So, a critique of functional finance is not a critique of MMT but a critique of one component part of the broader macro approach.

But let's go ahead and examine what Krugman thinks MMT — er, Abba Lerner — gets wrong. For those who aren't familiar with Lerner's approach, here's the thumbnail version: The government should use its fiscal powers (spending, taxing and borrowing) in whatever manner best enables it to maintain full employment and price stability. Basically, he's saying Congress, not the Federal Reserve, should have the dual mandate.

Lerner abhorred the doctrine of "sound finance," which held that deficits should be avoided, instead urging policymakers to focus on delivering a balanced economy rather than a balanced budget. That might require persistent deficits, but it might also require a balanced budget or even budget surpluses.

It all depends how close the private sector comes to delivering full employment on its own. In any case, the government should focus on inflation and not worry about deficits or debt, per se.

Krugman says there are two problems with Lerner's thinking and, by extension, MMT. "First, Lerner neglected the tradeoff between monetary and fiscal policy."

Specifically, Krugman complains that Lerner was too "cavalier" in his discussion of monetary policy since he called for the interest rate to be set at the level that produces "the most desirable level of investment" without saying exactly what that rate should be.

It's an odd critique, since Krugman himself subscribes to the idea that monetary policy should target an invisible "neutral rate," a so-called r-star that exists when the economy is neither depressed nor overheating. For what it's worth, research suggests the neutral rate "may be flat-out wrong," and Fed Chairman Jerome Powell has admitted that the Fed has been too cavalier in relying "on variables that cannot be measured directly and which can only be estimated with great uncertainty."

But Lerner wasn't trying to use interest rates to optimize the economy. That was a job for fiscal policy. He argued that the government should be prepared to spend whatever is necessary to sustain full employment *without raising taxes or borrowing*.

Unless it risked creating an inflation problem, Lerner wanted the government to cut taxes or spend newly issued money and just leave it in the economy. But he also understood that this could cause interest rates to "be reduced too low...and induce too much investment, thus bringing about inflation."

For that reason, Lerner suggested that the government might want to sell bonds in order to mop up excess money (reserves) to the point that the short-term interest rate rose enough to prevent excessive investment. Otherwise, the low interest rates brought about by rising deficits might "crowd in" more investment spending and overheat the economy. In other words, Lerner had a completely different way of thinking about the relationship between deficits, interest rates and the purpose of 'borrowing.'

He was worried about the potential *crowding-in* effects of fiscal policy, not the *crowding-out* effects Krugman believes are part of an inherent tension—tradeoff—between fiscal and monetary policy. Lerner understood that deficits could drive interest rates *down* and spur too much investment, thus his support of bond sales to maintain higher interest rates. In this way, borrowing was not about financing deficits but hitting some desired interest rate. MMT agrees and makes the same point.

Krugman's other objection is that Lerner "didn't fully address the limitations, both technical and political, on tax hikes/or spending cuts" as a means of fighting inflation.

In fact, Lerner actually had quite a lot to say about this. Here's the opening sentence to an entire chapter on the subject in his 1951 book "The Economics of Employment": "We have now concluded our treatment of the *economics* of employment, but a word or two must be added on the *politics* and the *administration* of employment policies in general and of Functional Finance in particular" (emphasis in original).

Here's Krugman's concern: What if lawmakers made policy the way Lerner thought they should, and it put us in a situation where somewhere down the road, we ended up with a debt-to-GDP ratio of 300 percent, and an interest rate that is higher than the growth rate?

Krugman says, "to stabilize the ratio of debt to GDP would require a primary surplus equal to 4.5 percent of GDP." And then he wonders how we're going to get there. "Are we going to slash Medicare and Social Security?"

I have three responses.

First, "there is a devil in the interest rate assumption," as economist James K. Galbraith has explained. Preventing a doomsday scenario is not difficult. As Galbraith explains, "the prudent policy conclusion is: keep the projected interest rate down." Or, putting it more crudely, "It's the Interest Rate, Stupid!"

Since interest rates are a policy variable, all the Fed has to do is keep the interest rate below the growth rate ($i<g$) to prevent the ratio from rising indefinitely. As Galbraith says, "there is no need for radical reductions in future spending plans, or for cuts in Social Security or Medicare benefits to achieve this."

Rather than presenting this as a problem for functional finance, Krugman should be wondering why the Fed would ever maintain an interest rate that would put the debt on an unsustainable trajectory. I don't believe it would. If $i>g$, then debt service grows faster than GDP, which Krugman argues would be inflationary.

So his hypothetical scenario begs the question: Why would an inflation-targeting Fed permit i>g with a debt-to-GDP ratio at 300 percent?

Japan serves as a pretty good example here, with a debt ratio that might well rise to 300 percent one day. Meanwhile, rates sit right where the Bank of Japan sets them, and the government easily sustains its primary deficits.

Second, if we're so obsessed with debt sustainability, why are we still borrowing? Remember, Lerner didn't think of borrowing as a financing operation. He saw it as a way to conduct monetary policy – that is, to drain reserves and keep interest rates at some desired rate — as I explained here.

But the Fed no longer relies on bonds (open-market operations) to hit its interest rate target. It just pays interest on reserve balances at the target rate. Why not phase out Treasuries altogether? We could pay off the debt "tomorrow."

If that seems too extreme, why not restrict duration to three-month T-bills so interest rates always sit within a hair of the overnight rate? And if we wanted to embark on a World War II-like mobilization for a Green New Deal, Congress could instruct the Fed to cap interest rates the way it did during the actual mobilization for WWII. In other words, there are many ways to deal with the technical and administrative problems that concern Krugman.

Finally, Krugman, like most of the economics profession, appears to assume that the short-term interest rate is the only tool available to the Fed to slow the economy. MMT disagrees, and many central banks around the world do, too.

As just one possible alternative, the Fed could raise margins of safety on lending, such as lower maximum loan-to-value or debt service-to-cash flow ratios. Less credit would be extended, consistent with the Fed's goal of slowing the economy, while the interest rate on the national debt would not rise. A potential benefit to raising margins of safety, compared with raising short-term rates, is that credit extended could come with reduced risks of default.

Where does that leave us? Paul Krugman and I agree on a great many things, but we come at certain questions from a fundamentally different place.

He believes there are inherent tradeoffs between fiscal and monetary policy. Outside of the so-called liquidity trap, Krugman adopts the standard line that budget deficits crowd out private investment because deficits compete with private borrowing for a limited supply of savings.

The MMT framework rejects this, since government deficits are shown to be a source (not a use!) of private savings. Some careful studies show that crowding-out can occur, but that it tends to happen in countries where the government is not a currency issuer with its own central bank.

This seems like a disagreement we should be able to resolve either empirically or intuitively. But who knows? As Lerner wrote, "a man convinced against his will retains the same opinion still."

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