Modern monetary nonsense

By Kenneth Rogoff
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A number of leading progressive US politicians advocate using the Federal Reserve's balance sheet to fund expansive new government programs. Although their arguments have a grain of truth, they also rest on some fundamental misconceptions, and could have unpredictable and potentially serious consequences.

Just as the US Federal Reserve seems to have beaten back blistering tweets from President Donald Trump, the next battle for central-bank independence is already unfolding. And this one could potentially destabilize the entire global financial system.

A number of leading US progressives, who may well be in power after the 2020 elections, advocate using the Fed's balance sheet as a cash cow to fund expansive new social programs, especially in view of current low inflation and interest rates. Prominent supporters of this idea, which is often referred to as "Modern Monetary Theory" (or MMT), include one of the Democratic Party's brightest new stars, congresswoman Alexandria Ocasio-Cortez. Although their arguments have a grain of truth, they also rest on some fundamental misconceptions.

Fed Chair Jerome Powell could barely contain himself when asked to comment on this new progressive dogma. "The idea that deficits don't matter for countries that can borrow in their own currency I think is just wrong," Powell insisted in US Senate testimony last month. He added that US debt is already very high relative to GDP and, worse still, is rising significantly faster than it should.

Powell is absolutely right about the deficit idea, which is just nuts. The US is lucky that it can issue debt in dollars, but the printing press is not a panacea. If investors become more reluctant to hold a country's debt, they probably will not be too thrilled about holding its currency, either. If that country tries to dump a lot of it on the market, inflation will result. Even moving to a centrally planned economy (perhaps the goal for some MMT supporters) would not solve this problem.

On Powell's second point, that US debt is already high and rising too fast, there is far more room for debate. True, debt cannot rise faster than GDP forever, but it may do so for quite a while. Today's long-term, inflation-adjusted interest rates in the US are about half their 2010 level, far below what markets were predicting back then, and far below Fed and International Monetary Fund forecasts. At the same time, inflation has also been lower for longer than virtually any economic model would have predicted, given current robust US growth and very low unemployment.

What's more, despite being at the epicenter of the global financial crisis, the US dollar has become increasingly dominant in global trade and finance. For the moment, the world is quite content to absorb more dollar debt at remarkably low interest rates. How to exploit this increased US borrowing capacity is ultimately a political decision.

That said, it would be folly to assume that current favorable conditions will last forever, or to ignore the real risks faced by countries with high and rising debt. These include potentially more difficult risk-return tradeoffs in using fiscal policy to fight a financial crisis, respond to a large-scale natural disaster or pandemic, or mobilize for a physical conflict or cyberwar. As a great deal of empirical evidence has shown, nothing weighs on a country's long-term trend growth like being financially hamstrung in a crisis.

The right approach to balancing risk and reward is for the government to extend the maturity structure of its debt, borrowing long-term instead of short-term. This helps to stabilize debt-service costs if interest rates rise. And if things get really difficult, it is far easier to inflate down the value of captive long-term debt (provided it is not indexed to prices) than it is to inflate away short-term debt, which the government constantly has to refinance.

True, policymakers could again resort to financial repression, and force citizens to hold government debt at below-market interest rates, as an alternative way of reducing the debt burden. But this is a better option for Japan, where most debt is held domestically, than for the US, which depends heavily on foreign buyers.

Having the Fed issue short-term liabilities in order to buy long-term government debt turns policy 180 degrees in the wrong direction, because it shortens the maturity of US government debt that is held privately or by foreign governments. Contrary to widespread opinion, the US central bank is not an independent financial entity: the government owns it lock, stock, and barrel.

Unfortunately, the Fed itself is responsible for a good deal of the confusion surrounding the use of its balance sheet. In the years following the 2008 financial crisis, the Fed engaged in massive "quantitative easing" (QE), whereby it bought up very long-term government debt in exchange for bank reserves, and tried to convince the American public that this magically stimulated the economy. QE, when it consists simply of buying government bonds, is smoke and mirrors. The Fed's parent company, the US Treasury Department, could have accomplished much the same thing by issuing one-week debt, and the Fed would not have needed to intervene.

Perhaps all the nonsense about MMT will fade. But that's what people said about extreme versions of supply-side economics during Ronald Reagan's 1980 US presidential campaign. Misguided ideas may yet drag the issue of US central-bank independence to center stage, with unpredictable and potentially serious consequences. For those bored with the steady employment growth and low inflation of the past decade, things could soon become more exciting.

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