Modern monetary disasters

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The experience of Latin America should serve as a clear warning for today's Modern Monetary Theory enthusiasts. In a variety of countries, and at different times, fiscal expansions that were financed by printing money spun catastrophically out of control.

Modern Monetary Theory (MMT), a seemingly new approach to economic policy, has become a hot topic, gaining support from leading US progressives such as presidential candidate Bernie Sanders and Democratic Representative Alexandria Ocasio-Cortez. But MMT enthusiasts should heed lessons learned in Latin America, where policies based on similar ideas inevitably ended in economic catastrophe.

According to MMT's supporters, the US Federal Reserve should print large amounts of money to finance massive public infrastructure projects, along with a "job guarantee" program aimed at ensuring full employment. A major increase in public-sector debt, MMT backers claim, does not represent a danger for a country that can borrow in its own currency, as the United States can. This unconventional view has been criticized by Keynesians and monetarists alike. Many respected academic economists, including Paul Krugman, Kenneth Rogoff, and Larry Summers, say that MMT makes little sense. In response, MMT supporters argue that the theory's critics do not fully understand how a modern monetary economy works. According to influential MMT advocates such as Stephanie Kelton, governments in countries with their own national currency, such as the US, do not face hard budget constraints because they can simply print more money to finance higher expenditures. Assessing the merits of MMT is difficult, for two reasons. For starters, its supporters have not provided a unified, detailed description of how the model is meant to work. As Krugman recently wrote, MMT backers "tend to be unclear about what exactly their differences with conventional views are, and also have a strong habit of dismissing out of hand any attempt to make sense of what they're saying." In addition, MMT supporters have offered hardly any inkling of how the policy might function in practice, especially in the medium and long term. Yet the approach is not unprecedented. MMT, or some version of it, has been tried in several Latin American countries, including Chile, Argentina, Brazil, Ecuador, Nicaragua, Peru, and Venezuela. All had their own currency at the time. Moreover, their governments – almost all of which were populist – relied on arguments similar to those used by today's MMT supporters to justify huge increases in public expenditure financed by the central bank. And all of these experiments led to runaway inflation, huge currency devaluations, and precipitous declines in real wages.

Four episodes in particular are instructive: Chile under President Salvador Allende's socialist regime from 1970 to 1973; Peru during President Alan García's first administration (1985-1990); Argentina under Presidents Néstor Kirchner and Cristina Fernández de Kirchner from 2003 to 2015; and Venezuela since 1999 under Presidents Hugo Chávez and Nicolás Maduro.

In all four cases, a similar pattern emerged. After the authorities created money to finance very large fiscal deficits, an economic boom immediately followed. Wages increased (helped by substantial minimum-wage hikes) and unemployment declined. Soon, however, bottlenecks appeared and prices skyrocketed, in some cases at hyperinflationary rates.

Inflation reached 500% in Chile in 1973, some 7,000% in Peru in 1990, and is expected to be almost ten million percent in Venezuela this year. In Argentina, meanwhile, inflation was more subdued but still very high, averaging 40% in 2015.The authorities responded by imposing price and wage controls and stiff protectionist policies. But the controls did not work, and output and employment eventually collapsed. Worse still, in three of these four countries, inflation-adjusted wages fell sharply during the MMT-type experiment. In the periods in question, real wages declined by 39% in Chile, 41% in Peru, and by more than 50% in Venezuela – hurting the poor and the middle class. In each case, the central bank was controlled by politicians, with predictable results. In Chile, the money supply grew by 360% in 1973 alone, helping to finance a budget deficit equivalent to an astonishing 24% of GDP. In Peru in 1989, money growth was 7,000%, and the fiscal deficit exceeded 10% of GDP. In Argentina in 2015, the deficit was 6% of GDP, with the annual rate of money creation surpassing 40%. And Venezuela currently has a deficit of 32% of GDP, with the money supply estimated to be growing at an annual rate of more than 1,000%. As inflation increased in these countries, people greatly reduced their holdings of domestic money. But because governments required taxes to be paid in local currency, it did not completely disappear. Instead, the speed at which money changed hands – what economists call "velocity of circulation" – increased dramatically. No one wanted to be holding paper money that lost 20% or more of its value every month. When the demand for money collapses, the effects of money growth on inflation are amplified, and a vicious circle develops. One serious consequence is that the currency depreciates rapidly in international markets. MMT supporters conveniently ignore the simple fact that demand for local money declines drastically when its value tumbles. Yet this is perhaps one of the theory's biggest weaknesses, and one that makes it extremely risky for any country to implement. The experience of Latin America should serve as a clear warning for today's MMT enthusiasts. In a variety of countries, and at very different times, fiscal expansions that were financed by printing money resulted in an uncontrollable loss of economic stability. Economic-policy ideas are often as dangerous in practice as they are flawed in theory. MMT may be a case in point.

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