Modern Monetary Theory: Voodoo Economics?

"There's no such thing as a free lunch."

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Modern Monetary Theory (MMT) has been a topic *du jour* of late, and has formed the backdrop for some of the U.S. Democratic candidates' proposed economic policies.

With global interest rates still near all-time lows and tepid economic growth, it's not surprising that proponents of MMT have come forward. Democratic representative Alexandria Ocasio-Cortez put forth the "Green New Deal" via MMT in an effort to achieve a range of economic and environmental goals without raising taxes.

But what exactly is MMT? Essentially, it's the belief that governments can spend money to stimulate growth by printing money, at no expense, when interest rates are near zero, inflation is low, and the economy has the capacity to expand. The basic idea is not new; it's a specific case of economist John Maynard Keynes's proposed use of countercyclical deficit spending to stabilize the economy. However, MMT is implemented when monetary policy is ineffective (i.e., when the economy is in a liquidity trap[1]).

MMT *Can* Make Sense

While many economists have questioned the ability of a government to spend endlessly via money printing and not have the consequences of higher inflation, there does appear to be some validity to MMT. Deficit spending is warranted in an economy where (i) infrastructure is collapsing, (ii) the cost of government borrowing is lower than the returns on government investments, and (iii) when investment spending by the private sector is restrained.

[1] A liquidity trap is a situation in which low interest rates are no longer an effective way to stimulate the economy.

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The current economic environment, with aging demographics, makes MMT attractive. Quantitative easing in many ways was an example of MMT, where the U.S. government's fiscal spending was met with monetary policy that substituted debt issuance with cash. Japan has also, over the last 20 years, partaken in a form of MMT deficit spending. Neither of these cases has yielded higher inflation.

While Ocasio-Cortez's Green New Deal was rejected by the Senate, President Trump recently announced a joint agreement with Democratic congressional leadership for a US$2 trillion investment in infrastructure. If passed, the risk of higher inflation from stronger growth could increase materially.

Several gauges of the current economy are giving mixed signals. Academic measures of potential growth show that the U.S. and Canada are near or at full potential, with the output gap closed and unemployment hitting record lows. However, wages and salary growth remain weak.

If the current economy is near full potential, is fiscal spending warranted? Can we maintain economic growth with no cost?

In March, Federal Reserve Chair Jerome Powell stated in his U.S. Senate testimony that "[t]he idea that deficits don't matter for countries that can borrow in their own currency is just wrong". Most economists would likely agree: there's no free lunch!

Ultimate Gauge of Fiscal-Deficit Spending is its Effect on Inflation

We believe the adage "the dose makes the poison" is relevant here. A strong dosage of excessive fiscal spending (deficits) will eventually lead to the poisonous effect of higher inflation, via the printing of money to finance the spending. However, a balanced approach to deficits (a weak dosage), even if taken continuously over the long run, may not necessarily lead to higher inflation.

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