Money Reimagined: How a Dangerous Idea Could Work

Michael J. Casey

August 14th, 2020

The Cato Institute's George Selgin recently quipped that economists who are neither gold bugs nor advocates of Modern Monetary Theory (MMT) are distinguished on Twitter by their relatively low follower numbers (himself included).

The joke, for which I owe a hat tip to Nathaniel Whittemore's podcast interview with Selgin on The Breakdown, seems especially relevant right now. Demands for COVID-19 fiscal stimulus are driving an increasing number of liberals to embrace MMT's no-limits position on government spending while hard-money conservatives, disdainful of government expansion, are pouring money into gold as a hedge against runaway inflation and general monetary breakdown. As both extremes garner all the attention, it's difficult for nuanced, middle-ground voices to be heard.

But that middle position is exactly where I'm going with this column, inspired by having just read "The Deficit Myth," the influential new book by MMT's most prominent advocate, Stephanie Kelton.

You're reading Money Reimagined, a weekly look at the technological, economic and social events and trends that are redefining our relationship with money and transforming the global financial system. You can subscribe to this and all of CoinDesk's newsletters here.

Some of my words might attract scorn from the bitcoin community's "digital gold bugs," who tend to view MMT's suggestion that governments ignore deficits and manage spending by printing money as crazy talk. Unlike them, I think MMT's take on the relationship between government and money is essentially accurate and that it's a useful point of understanding in our ongoing debates over how best to deliver economic stimulus in the COVID-19 era.

But I'm also going to say that, within the current analog financial system, MMT's policy prescriptions would be a recipe for disaster. Without the discipline of fiscal responsibility, especially without the political accountability of having to fund spending with unpopular taxes, what's to stop sovereign money issuers from doing what they've done through history and debasing their currency?

As per the arguments in last week's newsletter about Argentina, the very act of removing fiscal constraints would undermine the thing that matters most for a currency to function: trust.

The bigger question, then, is what can be done to enhance trust so that unencumbered government spending can be appropriately deployed to encourage sustainable economic prosperity for all citizens. How might cryptocurrency and blockchain tools help?

Uncle Sam can't go bankrupt

Kelton and her colleagues get some things right.

To start with, they convincingly demonstrate the budget of a sovereign, currency-issuing government is incomparable to that of, say, a household or a company. There is no way for a government to go bankrupt, not in the literal, legal sense. And if its debts are owed in its own currency, there is no reason to expect they won't be repaid, at least in nominal terms.

That basic but important insight exposes the common misconception that governments are constrained by a fixed pool of resources that can only be increased through taxation or borrowing. MMTers say the unique sovereign power of currency issuance renders the idea of nominal funding limits false. Thus, they show the harm done by rigid rules such as balanced-budget requirements and debt ceilings.

Kelton argues this misconception stems from traditional economics, which frames the sequencing of government fiscal activity backwards. Taxation is not a mechanism for raising funds for future expenditures but a way for a government to compel people to use the currency that its spending initially brought into existence. Taxation assigns utility, and therefore value, to the currency, she argues.

Using the acronyms "TAB(S)" and "S(TAB)," Kelton argues the sequencing is not "taxing and borrowing precede spending" but "spending before taxing and borrowing." No longer conceived as fundraising tools, taxation and debt issuance should instead be viewed as policy levers for managing income distribution, influencing borrowing rates in credit markets and moderating the overall flow of money in the economy.

The third of those goals is critical, MMTers say, because governments must respect the "inflation constraint," the one thing they view as a real, tangible limit on government expenditure.

Far from approaching inflation with reckless abandon, MMTers are obsessive about it. They insist governments be singularly focused on preventing a destructive acceleration in prices from undermining a currency's store of value and hurting savers at the expense of borrowers.

Fine in theory but in practice?

So much for theory. The core problem with MMT, as I see it, is that all state agencies, not just central banks, now have to be trusted to fight the inflation bogey. They must measure it, predict it and preemptively stop it. That's easier said than done.

More important, they have to be properly incentivized to do so. Because governments are currently sitting on a mountain of rising debt (see the Global Town Hall below), they're incentivized to encourage inflation, not fight it. Because debt payments are fixed in nominal terms while incomes and tax revenue vary with changing prices, inflation inherently helps the borrower (in this case the government) and hurts the lender (bondholders.)

Having inflation as the only constraint exacerbates a principal-agent misalignment. It's bad enough that government leaders and lawmakers already inoculate themselves from political pressure through gerrymandering and other forms of voter disenfranchisement. Now, without the duty to raise taxes to pay for their spending and with the opportunity to inflate away their debt obligations, it's easy to imagine a further dereliction of their public duty.

All that's needed for inflation to set in is the wrong message. If people believe their government is going to become profligate, their inflation expectations will get baked into preemptive price rises, creating a self-fulfilling prophecy.

The issue, again, comes down to trust. It may well be a myth, per Kelton, that "taxing and borrowing precedes spending." But that story serves a purpose if it helps people retain trust in their government. After all, as the historian Yuval Harari explains, it's our capacity to tell stories and organize ourselves around them – not the veracity of those stories per se – that allowed homo sapiens to build civilization and take over the world.

An alternative

This risk of trust failure means an MMT approach is not viable within our current system of government. It would invite the kinds of monetary problems suffered by Venezuela, Zimbabwe, Argentina and Turkey into relatively stable economies such as the U.S.

But what about in an era of central bank digital currencies? Perhaps CBDCs could offer more transparency and accountability to MMT-guided policymakers, allowing them greater expenditure leeway within the bounds of the inflation constraint.

The rich data generated by a digital monetary system could help officials better estimate money supply, demand and, importantly, velocity (the rate of exchange) – all factors that contribute to inflation but are traditionally hard to measure.

Further, blockchain-based smart contracts could be instituted to automate monetary policy adjustments according to changes in these data inputs.

Of course, those automated systems could be overridden by the central bank, most easily if the CBDC is based on a closed, single-authority model. But if the systems are audited by a third party, perhaps by the International Monetary Fund, central banks and the government institutions they answer to would face a difficult political backlash if they were shown to be abandoning the model.

In return for the policymaking freedom that MMT affords them, bolder governments might even adopt permissioned or even permissionless blockchains to lock in these contractual systems and demonstrate their commitment to protecting the value of their currency.

So, you see, interesting ideas can still flourish in the middle path between the extremes.

Bitcoin's luster grows

By Galen Moore, CoinDesk senior research analyst

Bitcoin has never looked more like "digital gold" than it does now.

Consider: Despite the popularity of the "gold 2.0" narrative, for most of its recent life bitcoin has shown a negative correlation with the price of the yellow metal.

Bitcoin vs. gold.Source: Is Bitcoin a Safe Haven? CoinDesk Research, August 2019

If that surprises you, it shouldn't. Bitcoin is a risk-on asset, a venture bet on a future technology that most people in the world have never used. Unlike most such investments, bitcoin is fairly liquid. It makes sense that in times of crisis, it's one of the first things sold to raise cash.

That's what happened in March, apparently, and bitcoin's safe-haven narrative took a hit. Following March 12, bitcoin started to show a stronger correlation to gold. It also moved in tandem with U.S. stocks. "In a crisis, all correlations go to one." (If you're sick of hearing that line repeated, you're not alone.)

Look what's happened in the past two months. Bitcoin's positive correlation to gold is stronger and more consistent than it has ever been, at any time in the past. And its correlation to the S&P 500 is falling back into non-correlated territory.

Source: FactSet/CoinDesk

It's one thing to say bitcoin has potential as an inflation hedge. It's another to be actually looking hard for the inflation hedge with the highest potential earnings out there. Notably, this week, as overbought gold saw a correction, bitcoin held strong. The rest of Q3 will either jumble bitcoin's "digital gold" narrative again, or will solidify bitcoin (market cap $216 billion) as a contender against gold, an asset that has a valuation in the trillions.

Global town hall

PRAYING FOR BENIGN INFLATION. Whatever you make of MMT, demand for fiscal discipline constrains a government's ability to maneuver during challenging economic times. In a note to investors this week, David Kelly, J.P. Morgan Asset Management's chief global strategist, laid it out in stark terms. Predicting a ballooning in U.S. fiscal deficits from $984 billion last year to $3.5 trillion in 2020 and $3 trillion in 2021, Kelly forecast total federal debt would swell from 79.2% of GDP to 106.5%, "just below the 108.2% of GDP peak reached in 1946 as the U.S. government faced the colossal debt racked up in fighting World War II."

Kelly demonstrated how sensitive those debt numbers are to changes in economic conditions. He first described a relatively benign scenario in which continued low inflation allows the Federal Reserve to maintain its easy monetary policy and sustained economic growth restores government tax collections. If nominal GDP growth runs at 5% over the next decade, fiscal deficits are kept below $1 trillion, and interest rates on federal debt stays around 2%, the debt-to-GDP ratio would drift down to a 93.3%, Kelly wrote.

While still historically high, that "might be sufficient to sustain the confidence of global investors in both U.S. government debt and the value of the dollar," he allowed. On the other hand, if nominal growth runs at just 4%, fiscal deficits average $2 trillion, and average rates are at 4%, federal debt would reach 133.6% of GDP, "requiring an even tighter fiscal policy at the end of the decade."

This serious debt challenge is repeated across every large industrialized country. It may well be the trigger for an entirely new global financial and economic order to

DEJA VU ALL OVER AGAIN. At 10:10 p.m. ET on Wednesday this week, I looked at CoinDesk's home page and read its "right rail" column of headlines: "Uniswap's August Volume Topples July $1.76B Record in Less Than Two Weeks"; "Decentralized Finance Frenzy Drives Ethereum Transaction Fees to All-Time Highs"; "Deposits in 'Monetary Experiment' Meme Token YAM Break $460M"; "What Today's Robinhood Rally Has in Common With the Last Crypto Boom"; "Token Sales are Back in 2020."

Boy, the DeFi mania of this moment sure feels like a flashback to the earlier crypto boom, which, as most readers would remember, pushed tokens to sky high prices before a brutal crash and reckoning in 2018. But which year? I suggested it looked like 2017 in a tweet, but others disagreed. "I feel like this is 2016 … 2017 is next year and I am already bracing myself," tweeted Unchained Podcast host Laura Shin. A day later, after YAM's fundraising spectacle was ended by a bug rendered its unaudited protocol inoperable and destroyed $60 million in value, it was like 2016's DAO attack all over again. Meanwhile, with banks like Goldman Sachs investing in blockchain development and talking of launching their own tokens, it felt more like 2015. Whatever year we're in, this rollercoaster sure is addictive.

A MIND CHANGED. Hidden in one of the biggest crypto news items of the week was a dramatic about-face. When business intelligence leader Microstrategy announced it would now treat bitcoin as its "primary reserve asset" and had moved $250 million out of cash and into the cryptocurrency, the bold move was forcefully justified by CEO Michael J. Saylor: "We find the global acceptance, brand recognition, ecosystem vitality, network dominance, architectural resilience, technical utility, and community ethos of Bitcoin to be persuasive evidence of its superiority as an asset class for those seeking a long-term store of value. Bitcoin is digital gold – harder, stronger, faster, and smarter than any money that has preceded it." Seven years ago, his views were different. In a tweet from December of that year, one that – bless him – he has never deleted, Saylor wrote, "#Bitcoin days are numbered. It seems like just a matter of time before it suffers the same fate as online gambling." As Bitcoiners like to say, "at first they ignore you, then they criticize you, then they invest $250 million."

Relevant reads

The Federal Reserve Is Experimenting With a Digital Dollar. This year, the voices from those calling on the Fed to explore the introduction of a digital dollar have grown considerably louder. Now, finally, as Nikhilesh De reports, Fed governor Lael Bainard admits to what, in some respects, was an open secret: it has been quietly experimenting with digital currency technology for a number of years.

Why It's Time to Pay Attention to Mexico's Booming Crypto Market. As readers of this column will know, I believe one of the most important trends in crypto is the accelerating adoption in the developing world, a story that is playing out in different ways for different reasons in different countries. It is satisfying to see, per this illuminating report from Sandali Handagama, that Mexico is joining that trend on the backs of a use case that has long been considered a solid one for that country and many others with large diasporas of emigres: remittances.

What Bitcoin Can Learn From Gold About Staying 'Clean'. CoinDesk columnist J.P. Koning offers a brilliant analogy, describing a potentially bifurcated bitcoin market that differentiates "clean" coins that have gone through exchanges' and custodians' "know-your-customer" (KYC) compliance from "dirty" ones that haven't to the two-tiered state of the gold market. Read it, if for nothing else, for its rich insights into the long-lasting traditions of the age-old bullion trade.

BitMEX to Mandate ID Verification for All Traders as Maverick Exchange Ends Wild Ways. Speaking of KYC, it is coming to the wildly successful crypto derivatives platform BitMEX. Zack Voell reports on the taming of an exchange that has long enjoyed a Wild West reputation.
Epic Games Blasts Apple's 'Anti-Competitive' Payments Practices in Lawsuit. Watch this space. Per Danny Nelson's report, Epic Games, maker of Fortnite and a behemoth in the gaming

market, is launching its own epic fight against the behemoth of device makers, Apple. It matters to the crypto world, not only because the lawsuit alleges that Apple’s restrictions on bitcoin payments curtail innovation, but also because it underscores the gatekeeping power of centralized platforms and helps make the case for decentralization.