Modern Monetary Theory: Endless debt with no consequences?

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Larry Randall Wray thinks it could all be so easy. For 25 years, the American economist has been researching a formula to combat unemployment, recessions and social inequalities. Modern Monetary Theory is the name of his approach. MMT for short, it goes back to the State Theory of Money, a 100-year-old idea from the economist Georg Friedrich Knapp that promises the possibility of letting debts add up without remorse.

What sounds like a miracle actually makes perfect sense at first glance. For as long as a country is in debt in its own currency, it cannot go bankrupt. If revenues are down, they can always be funded by the central bank and countries should be allowed to spend as much money as they want. Even the Second World War showed what "economic miracles" could emerge from catastrophe. "It was the basis for the economic miracle that we call the golden age of capitalism," says Wray.

Mr. Unpopular among economists

Yet with his ideas Wray is considered an economic outsider. Together with the hedge fund manager Warren Mosler, he tried for years to make his theory acceptable. But for most economists, simply printing money to finance debt sounded too reckless.

"We're definitely misunderstood," says the 66-year-old Wray, who believes that false theses have contributed to the poor image of MMT.

US trade deficit surges to 10-year high

Among the theory's opponents are some of the biggest economists in the world. Paul Krugmann, economics Nobel laureate and *New York Times* columnist, has repeatedly railed against MMT. Ken Rogoff, former chief economist of the International Monetary Fund (IMF), has described it as nonsense and quackery.

The US Federal Reserve has also criticized the theory. "The idea that deficits don't matter for countries that can borrow in their own currency, I think, is just wrong," said Fed chief Jerome Powell in February in front of the US Senate's banking committee.

Even America's left wing, which is usually open to higher public debt, is having a hard time with the idea. In a guest commentary for *The Washington Post*, Lawrence H. Summers, former economic adviser to Barack Obama and finance minister under Bill Clinton, described MMT as "voodoo economics" and a "recipe for disaster."

MMT-like policies are, after all, essentially responsible for hyperinflation in Latin American countries like Venezuela where, according to the IMF, prices have risen 10 million percent in recent years.

Pushing and pulling

Yet both sides agree that fiscal policy must move back into the center of US politics. It is true that US President Donald Trump passed a comprehensive tax reform at the beginning of 2018. But its promised impact is only slowly trickling down to taxpayers.

One big side effect of the tax cuts though is reduced government income. America is known for big deficits, but now currently at nearly a trillion dollars, the American government is deep in debt. Tax cuts and rising social spending have put a massive burden on the US budget, experts say. Only MMT can straighten that out again, say its proponents.

At the core of the theory is a change in financial and monetary policy. While countries usually finance themselves through taxes and the central bank prevents inflation, Modern Monetary Theory calls for a role reversal. The central bank would take on the role of lender. In other words, it would finance the government and create capital when money is needed. In this way it would be able to increase debts unhindered to boost investment in the country and avoid recessions.

The theory has become especially popular among the left wing of the Democratic Party since the election of Donald Trump. Both Bernie Sanders and Alexandria Ocasio-Cortez, who are campaigning to become the next president, advocate some ideas of Modern Monetary Theory. It is supposed to provide the economic basis for their expensive social programs.

In addition to extensive job guarantees and the "Green New Deal," Ocasio-Cortez wants to introduce universal health insurance. That would cost several trillion dollars annually and lead to higher government deficits. But according to MMT supporters, that won't be a problem backed with MMT and its printing presses.

Side effects on all sides

The wild reasoning of some MMT advocates has caused irritation among many economists. "They oversell the theory," says George Selgin, director of the Cato Institute's Center for Monetary and Financial Alternatives. It is true that countries should not have to worry about being able to pay their debts because they can always print enough money. But this is not without risks. That's why countries have "to worry about the inflationary consequences of paying off those debts by abusing its money," says Selgin.

Scott Sumner, a professor at George Mason University, also sees "nasty side effects" with MMT policies. "Some adherents of MMT advocate financing new projects with debt, which I think is a bad idea," he says. Today's deficits would become a burden for future generations. Instead he argues for a progressive consumption tax to support the American economy.

It's not that MMT supporters are blind to the dangers of their own theory. Many admit that there really is a limit to debt and money creation. "We know that there is some chance that it's going to be inflationary," says Wray in an effort to clarify things.

Although the US dollar is currently a strong currency, if inflation increases MMT fans will have an answer. "We may need to impose some taxes … to reduce consumer demand," says Wray, though so far he has failed to ask how ordinary citizens would react. "What we're going to do is we're going to ramp up your retirement pay and we're going to increase social security benefits." But again, this would be financed with debt. Perhaps none of this will be needed, as prominent cases demonstrate.

Looking east

The first example is the US itself. Because even though government debt is extremely high, inflation has not picked up. In February, it even dropped to its lowest level since September 2016. The proportion of voters, who see the reduction of the government deficit as the top priority, is also steadily declining.

The second example comes from Japan where the central bank has been experimenting with elements of MMT for some years now. With the help of the central bank printing presses, the government wants to put the highly indebted, demographically shrinking country on a sustainable growth path.

The Bank of Japan has therefore been buying mountains of securities that make quantitative easing programs elsewhere look small. Still inflation has remained historically low. How long the central bank can continue with its purchase program without losing credibility remains to be seen. It's an exciting experiment that may pave the way for MMT — or it may bury the theory forever.