

The left's embrace of modern monetary theory is a recipe for disaster

Lawrence H. Summers – Washington Post – 4 Mars 2019

We've seen this movie before.

There is widespread frustration with the performance of the economy. Traditional policy approaches are not delivering hoped-for results. A relatively unpopular president is loathed to an unusual extent by a frustrated opposition party that lost the previous presidential election while running a pillar of its establishment. And altered economic conditions have led to the development of new economic ideas that reflect a significant break with previous orthodoxy.

And now, these new ideas are being oversimplified and exaggerated by fringe economists who hold them out as offering the proverbial free lunch: the ability of the government to spend more without imposing any burden on anyone.

During the late 1970s, this was the story of supply-side, Laffer-curve economics. It began with the valid idea that taxes had important incentive effects and that, in conceivable circumstances, tax cuts could raise revenue. It grew into the ludicrous idea that tax cuts would always pay for themselves, and this view was then adopted by a frustrated extreme wing of a major political party.

George H.W. Bush was right during the 1980 presidential primary campaign to call such thinking "voodoo economics." In the decades following, that doctrine did substantial damage to the U.S. economy.

Modern monetary theory, sometimes shortened to MMT, is the supply-side economics of our time. A valid idea — that traditional fiscal-policy taboos need to be rethought in an era of low real interest rates — has been stretched by fringe economists into ludicrous claims that massive spending on job guarantees can be financed by central banks without any burden on the economy. At a moment of economic and political frustration, some in the more extreme wing of the out-of-power political party are seizing on the possibility of a free lunch to offer politically attractive ways out of economic difficulty.

Modern monetary theory is fallacious at multiple levels.

First, it holds out the prospect that somehow by printing money, the government can finance its deficits at zero cost. In fact, in today's economy, the government pays interest on any new money it creates, which takes the form of its reserves held by banks at the Federal Reserve. Yes, there is outstanding currency in circulation, but because that can always be deposited in a bank, its quantity is not controlled by the government. Even money-financed deficits cause the government to incur debt.

Second, contrary to the claims of modern monetary theorists, it is not true that governments can simply create new money to pay all liabilities coming due and avoid default. As the experience of any number of emerging markets demonstrates, past a certain point, this approach leads to hyperinflation. Indeed, in emerging markets that have practiced modern monetary theory, situations could arise where people could buy two drinks at bars at once to avoid the hourly price increases. As with any tax, there is a limit to the amount of revenue that can be raised via such an inflation tax. If this limit is exceeded, hyperinflation will result.

Third, modern monetary theorists typically reason in terms of a closed economy. But a policy of relying on central bank finance of government deficits, as suggested by modern monetary theorists, would likely result in a collapsing exchange rate. This would in turn lead to increased inflation, increased long-term interest rates (because of inflation), risk premiums, capital fleeing the country, and lower real wages as the exchange rate collapsed and the price of imports soared.

Again, this is not just theory. Numerous emerging markets have found, contrary to modern monetary theory, that they could not print money to cover even their domestic currency liabilities. The same is true of industrial economies. The Mitterrand government in France in 1981 and the Schröder government in Germany in 1998 began with MMT-type approaches to policy and were forced to reverse course. The British and Italians both had to call in the International Monetary Fund during the mid-1970s because of excessive reliance on inflationary finance.

Supply-side economics was an unreasonable extension of valid ideas; few today advocate the top corporate tax rate of 46 percent and rates above 50 percent for a substantial swath of taxpayers that prevailed in the late 1970s. So, too, in a new era when the Fed chairman thinks that neutral real interest rates are well below 1 percent, we can approach federal borrowing with much less trepidation than we have traditionally.

But for neither the right nor the left is there any such thing as a free lunch. It's the responsibility of serious economists, whatever their political party, to make this clear.