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MODERN MONETARY THEORY IS POPULIST BUT NOT CREDIBLE

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The theory suggests the state can spend endlessly to meet its goals, the fiscal deficit can simply be financed by printing money, and if inflation does not break out, it can keep doing this

I welcome the response of Sashi Sivramkrishna to my column “The inexplicable allure of Modern Monetary Theory [MMT]". At the very least, his response adds to a healthy debate on an important topic of macroeconomics. He says that MMT should be carefully studied; that we need not blindly stick to the mainstream paradigm and dismiss heterodox theories like MMT. This point is well taken. Indeed, my column quoted several mainstream contemporary economists and policymakers, who were responding with an open mind to the somewhat viral spread of ideas related to MMT. It is spreading mainly in the US, which is experiencing the anomaly of vastly expanded fiscal and monetary policy, coupled with very low inflation. For the past decade, the size of its central bank’s balance sheet has quadrupled, and interest rates have stayed near zero. Why is there no inflation when money supply has increased so much? Does this negate conventional theory? Not really, and for that you need to reach back to Keynes and his theory of the liquidity trap. In such a situation, no amount of cutting interest rates or increasing money supply can kick-start private investment. Pessimistic beliefs get interlocked and investment freezes. Sounds familiar? That’s when expansionary fiscal policy is effective, even if it means employing people to dig ditches and fill them up. The fiscal impact is immediate, and the multiplier effect on gross domestic product (GDP) can be much greater than one. This Keynesian insight has stood the test of time, albeit with caveats about the size and sustainability of the fiscal deficit and public debt. It acts as an automatic stabilizer, since deficit expansion is counter-cyclical: It goes up during a recession, but contracts when the economy and tax collections boom. In some ways, the MMT crowd rallying behind presidential candidate Bernie Sanders seems to be echoing Keynes’ prescription. But they insist that MMT is not simply a rehash of old Keynesian ideas. A recent book by Lance Taylor argues that MMT is just a melange of vintage fiscal ideas of Keynes, Abba Lerner and Wynne Godley, coupled with a Chartalist theory of fiat money. The MMT folks refute this, and claim that it is different, and both more subtle and complex.

Stripped of its outward trappings, the core idea of MMT is that governments need not tax or borrow in order to spend. That’s because “money" is a monopoly creation of the state, and it becomes a means of exchange only because the state insists on taxes paid with fiat money. The state never “runs out" of money because it can always print more. Unlike households and firms, governments do not have budget constraints, and the only limit to government spending is the point at which inflation kicks in. That’s when the government should sell bonds, mop up extra money, and curb the rise of prices. The people who receive these bonds, and their grandchildren are “twice blessed", because they will be able to redeem these bonds and also benefit from the infrastructure and other public goods built with that bond money.

So, by implication, MMT recommends that governments should keep spending until we achieve full employment and low moderate inflation. In the Indian context, MMT folks would advocate massive spending on education, health, infrastructure, and a universal basic income. The only hitch is a massive increase in the deficit and debt. But they don’t care about public debt. It is of no consequence, they say, because the state can always forgive its own debt, or print new money to pay off old debt. Conventional economics would call this a great Ponzi scheme. An axiom of orthodox economics is that “there is no free lunch".

MMT proponents and Sivramkrishna point to the case of Japan, with 250% of GDP as debt but no sign of fiscal distress or inflation. It has actually suffered near complete GDP stagnation for three decades. But its per-capita income—and hence, standard of living—keeps rising since its population is shrinking. Its debt is almost wholly domestically-owed, so the left pocket owes money to the right pocket. It is one of the richest countries in the world, and to that extent, MMT suffers from rich-world tinted lenses. Try experimenting with huge fiscal spending on free healthcare and education, and other freebies in a developing country like, say, Venezuela. Oh wait.

There are other anomalies. In August 2011, the US lost its AAA sovereign rating. By conventional theory, this should have led to a sell-off of government bonds, but the opposite happened. Does this disprove conventional theory? Of course not. The downgrade highlighted macro fears round the world, and the knee-jerk risk aversion of investors resulted in a massive flow of funds toward US bonds, which are considered a safe haven.

The MMT folks are mostly driven by a desire for better macroeconomic solutions to such travails as a stagnant median household income, low-quality jobs, crumbling infrastructure and big lacunae in education and health. But it is still dangerous to assume that we can spend our way out of the current slowdown, and ignore not just the risks of inflation and crowding out (or private investment), but also of unsustainable finances. MMT is populist and appeals to politicians, but that does not make it right.

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