



MORNING BRIEFING

July 8, 2020

Modern Monetary Theory: In Theory & In Practice

Check out the accompanying [chart collection](#).

(1) Meet Stephanie Kelton. (2) A manifesto for the people's economy. (3) A champion of big government. (4) Resource allocation debate: government vs markets. (5) The magic of printing money. (6) Fiscal policy should take the lead in creating full employment. (7) Economic deficits matter more than budget deficits. (8) MMT is the New Deal on steroids. (9) Fighting inflation by raising taxes. (10) Public service jobs for all. (11) The Wiz is a Utopian. (12) Big-government politicians on both sides of the aisle embrace MMT. (13) Trump administration unites fiscal and monetary policy in MMT alliance to fight the GVC.

(I) MMT Description: Meet Professor Kelton. Stephanie Kelton is the most vocal proponent of Modern Monetary Theory (MMT) today. She is a former chief economist on the US Senate Budget Committee and professor of economics and public policy at Stony Brook University. Her June 2020 book, [The Deficit Myth: Modern Monetary Theory and the Birth of the People's Economy](#), reads like the MMT movement's manifesto. Melissa and I have written about MMT before (see [here](#) and [here](#)). Kelton's new book provides us with more to write about both her theory and her policy prescriptions.

Kelton argues that the federal government can and should run large budget deficits as long as inflation remains subdued. MMT opponents' main objection is that the theory provides a blank check for the government to get much bigger. It provides the government with too much power to allocate resources. Free-market capitalists believe that markets do a much better job of doing so than politicians and bureaucrats. Kelton clearly disagrees; but before we go there, let's dive into her theoretical description of MMT:

(1) *Printing press.* The central premise of MMT is that the US federal government, as the exclusive issuer of its sovereign currency (i.e., the US dollar), can "print" money without limit. It can do so as necessary to service or to pay down the public debt. It follows, therefore, that there is no well-defined limit on deficit-financed government spending unless and until inflation heats up.

Kelton notes: “Both the US Treasury and its fiscal agent, the Federal Reserve, have the authority to issue the US dollar. This might involve minting the coins in your pocket, printing up the bills in your wallet, or creating digital dollars known as reserves that exist only as electronic entries on bank balance sheets” (p. 17).

The power of the monetary printing press is not limited to the US. Any country that issues and borrows in its own currency also has the power of MMT.

(2) *Inflation*. Importantly, Kelton acknowledges that government budget deficits only matter if they cause inflation. That happens when real resources in the economy are strained by “overspending,” which causes inflation. The clear implication is that federal government deficits can balloon until they cause inflation to heat up. In Kelton’s world, the federal government budget deficit clearly is too small if there is any unemployment, a sign of underutilized resources.

MMT maintains that the federal government can achieve both full employment and stable inflation with an appropriate amount of deficit-financed spending. But what happens when the economy hits the wall of full utilization of resources, causing inflation to heat up? Any additional government spending beyond full resource utilization is inflationary. But never fear: MMT theorizes that inflation can easily be taxed away (as discussed in the section below)!

(3) *Fiscal policy matters more*. The old-school Keynesian concept of running budget deficits during recessions and surpluses during expansions is so yesterday. Even modern-school Keynesians have long abandoned any notion of fiscal discipline during good times. New-school MMTers reject the Keynesian belief—held by central bankers around the world—that a certain amount of unemployment is necessary to keep inflation stable. That concept is often referred to as the “natural rate of unemployment” (NAIRU). MMT advocates dismiss NAIRU given their stance that it’s possible to balance full employment (i.e., literally zero unemployment) with stable inflation. If done right, the theory goes, MMT can take the resources that are underutilized in the private sector and put them to work in the public sector.

From an MMT point of view, “we should rely on adjustments in taxes and spending (fiscal policy) rather than interest rates (monetary policy)” to balance our economy (p. 63). Kelton argues, as Keynesians do, that fiscal policy is better equipped for this task than monetary policy, mainly because the Federal Reserve cannot *force* borrowing to boost spending; it can

only reduce the cost of borrowing. Fiscal spending directly targets areas of the private sector that need a boost.

(4) *Accounting for MMT*. MMT is based on an accounting identity, as every surplus (deficit) in one sector of the economy is offset by a deficit (surplus) in another sector of the economy. There are three “buckets” in the economy: the public sector, the private sector, and the foreign sector. The financial balance for any of these sectors at a given time all must total to zero. As Kelton observes: “Fiscal surpluses suck money out of the [private] economy. Fiscal deficits do the opposite” (p. 96).

Fiscal deficits also serve to keep the US private sector from falling into a deficit when the foreign sector runs at a surplus, Kelton maintains. More specifically, “the government must run budget deficits that *exceed* the US trade deficit” (p. 134). The US consistently runs a trade deficit with the foreign sector as it imports more than it exports, bringing in goods and services and sending US dollars abroad.

(5) *Changing the rules*. For years, Congress has followed three main rules when it comes to the federal budget: PAYGO, the Byrd Rule, and the deficit ceiling. In 2018, Congress, led by Speaker Nancy Pelosi (D-CA), reinstituted PAYGO to “demonstrate their commitment to good, old fashioned household budgeting” (p. 22). With PAYGO, federal borrowing to finance new expenditures is not permitted. So lawmakers must cover any new spending proposals with revenue from new taxes. Under the Byrd rule, on the Senate side, deficits can increase, but not beyond a 10-year budget window. Finally, the debt ceiling puts a legal limit on the allowable federal government debt. Kelton points out that while these rules may be politically useful, they are completely artificial. She says: “Because all of these constraints were imposed by Congress, they can all be waived or suspended by Congress” (p. 38).

(II) MMT Prescriptions: It’s All About Power. Kelton promotes lots of controversial policy prescriptions based on MMT. “The question is,” she writes, “How do we want the federal government to *use* its great power? ... Can we trust Congress to make the right choices, at the right time, making productive choices when there is fiscal space and exercising the necessary restraint as resources become scarce?” (p. 237). She clearly is all for bigger government with more power.

Kelton’s reader can easily detect her political leanings. She is decidedly for the policies of Representative Alexandria Ocasio-Cortez (D-NY and Green New Deal proponent) and Senator

Bernie Sanders (D-VT; universal healthcare). She writes against the policies of President Donald Trump (China trade), former President Bill Clinton (budget surplus), and former President Barak Obama (recession response). Her agenda focuses on how the nation's real resources should be allocated by government programs rather than how extensive and big those programs should be or how they should be financed. Here's more:

(1) *Real deficits*. Kelton contends that, rather than focusing on the fiscal deficit, politicians should focus on the real deficits in our economy. According to Kelton, these deficits can be addressed with fiscal policies (and spending) as follows: a good-jobs deficit (a minimum standard of living), a household-savings deficit (free higher education and affordable childcare), a healthcare deficit (insurance for all and more real healthcare resources), an education deficit (retire all student debt), an infrastructure deficit (fix it), an inequality deficit (taxes and redistribution). Clearly, Kelton advocates replacing Adam Smith's invisible hand with Uncle Sam's hugely visible one.

(2) *Taxing & redistributing*. As we see it, one of the major flaws of MMT is that excessive spending that causes inflation would have to be offset with higher taxes for the private sector. Kelton herself admits that if the government wants to boost spending in a targeted area, it may "need to remove some spending power from the rest of us to prevent its own more generous outlays from pushing up prices" (p. 33). One way to create this room is through higher taxes. Taxes are also a "powerful way for governments to alter the distribution of wealth and income" (p. 33). Governments can also use taxes "to encourage or discourage certain behaviors" (p. 34).

(3) *Federal jobs guarantee*. "Capitalist economies chronically operate" without "enough combined spending (public and private) to induce companies to offer employment for every person who wants to work," Kelton writes (p. 56). She adds: "There isn't a capitalist economy on earth that has found a way to eradicate the business cycle" (p. 65). Kelton argues that MMT could be used to get the economy to full employment and smooth the business cycle.

Kelton envisions a "universal right of employment" whereby a "Public Service Employment (PSE) program" would offer "paid work at a living wage" of \$15 per hour "with a basic package of benefits that include health care and paid leave" (p. 249). "Think of it" as binders on a shelf "filled with a wide variety of available jobs." Enough jobs to "allow people with different skills and interests to walk in without a job and walk out with one that fits them." The program would be focused on utilizing workers to build a "care economy" oriented around our aging society.

This remarkable program would automatically stabilize fiscal spending to where it needs to be to balance full employment with stable inflation. When the economy hits a recession (or recovers), the PSE program ramps up (or down). This raises some obvious questions. If people are content with their government job, why would they leave? What about workers who say they want to work but are routinely absent? How do you address structural problems like mismatches between the government's skill needs in a particular region and their availability in the local job market?

(4) *The Wizard of Oz*. MMT reminds Kelton of the end of the classic 1939 film *The Wizard of Oz*, when Dorothy discovers that she always had the power to return home simply by clicking the heels of her red shoes three times. Kelton uses this analogy to describe the power of MMT, which has always been there, in her opinion. But remember, the story was all a bad dream Dorothy had after getting hit on the head. Free market capitalists might exclaim: "Pay no attention to the professor behind the curtain!"

(III) MMT Utopia: Free-for-All. Kelton's views must strike many conservatives as unrealistic. They must see her as another Utopian promising Heaven on Earth—a people's economy where everything is provided for free thanks to MMT.

But whether one is for MMT or against it, Kelton's book leaves no doubt about what MMT is all about: It's an agenda for more big government and higher taxes. She probably would welcome the opportunity to be Treasury Secretary if the Democrats win the White House in November. Ironically, her views already are reflected in the current Republican administration's fiscal policymaking! Consider the following:

(1) *Huge federal deficits*. At the beginning of 2018, the Trump administration lowered taxes and agreed to an increase in government spending. The result was a massive upward revision in the federal budget deficit and debt projections of the Congressional Budget Office (CBO) ([Fig. 1](#) and [Fig. 2](#)). Last year, the CBO projected that deficits would exceed \$1.0 trillion every year from 2020 to 2030. By the end of this period, the CBO projected that the public debt would be close to 100% of nominal GDP, up from 79.2% during 2019.

Then the Great Virus Crisis (GVC) hit at the start of this year. In March and April, four laws were enacted in response to the 2020 coronavirus pandemic. They included lots of programs

to support workers and businesses. The 12-month federal budget deficit jumped to a record \$2.1 trillion through May, as outlays soared while revenues plunged ([Fig. 3](#) and [Fig. 4](#)).

On April 13, the Committee for a Responsible Federal Budget stated: “Our latest projections find that under current law, budget deficits will total more than \$3.8 trillion (18.7 percent of GDP) this year and \$2.1 trillion (9.7 percent of GDP) in 2021. We project debt held by the public will exceed the size of the economy by the end of Fiscal Year 2020 and eclipse the prior record set after World War II by 2023.”

(2) *Another round of support.* These projections almost certainly underestimate deficits, since they assume that no further legislation is enacted to address the crisis and that policymakers stick to current law when it comes to other tax and spending policies. In a June 30 briefing, Senate Majority Leader Mitch McConnell promised to “stay on the schedule that I announced earlier in the year” for making a decision in July on the next stimulus bill, and by extension, if that contains another stimulus check. He has also warned that the next relief package will also be the last. White House Chief of Staff Mark Meadows on Monday said he expects the Trump administration and lawmakers to hammer out another coronavirus stimulus package within the next two to three weeks before Congress’s August recess, with President Donald Trump backing both another round of checks to taxpayers as well as a payroll tax deduction.

(3) *QE4Ever.* In his February 26, 2019 congressional [testimony](#) on monetary policy, Fed Chair Jerome Powell trashed MMT and rejected the idea that the Fed ever would help combat the impact of spiraling deficits by keeping interest rates low. Specifically, Powell said, “The idea that deficits don’t matter for countries that can borrow in their own currency I think is just wrong.” Furthermore, “US debt is fairly high to the level of GDP—and much more importantly—it’s growing faster than GDP, really significantly faster. We are going to have to spend less or raise more revenue.” During his congressional testimony, he refused to cross the border between monetary and fiscal policies: “And to the extent that people are talking about using the Fed—our role is not to provide support for particular policies,” Powell said. “Decisions about spending, and controlling spending and paying for it, are really for you.”

What a difference a GVC makes! On Monday, March 23, the Fed announced QE4Ever, an open-ended commitment to buy Treasuries and mortgage-backed securities. By the end of the week, Friday, March 27, President Trump signed the \$2.2 trillion CARES Act, which provided \$450 billion for the Fed to support \$4 trillion in loans to Main Street.

Now Powell is all for MMT all the time, or at least until there is a vaccine. In his April 29 [press conference](#), he crossed the line, mentioning the word “fiscal” 11 times. A central theme of his comments was that “[t]his is the time to use the great fiscal power of the United States ... to do what we can to support the economy and try to get through this with as little damage to the longer-run productive capacity of the economy as possible.” He implied that the Fed would do everything possible to enable more fiscal stimulus.

That all adds up to MMT. Kelton has won the debate, for now, with the assistance of the GVC.

CALENDARS

US: **Wed:** Consumer Credit -\$15.5b, MBA Mortgage Applications, EIA Crude Oil Stocks. **Thurs:** Initial & Continuous Jobless Claims 1.375m/18.950m, Wholesale Inventories -1.2%, EIA Natural Gas Inventories, Bostic. (DailyFX estimates)

Global: **Wed:** UK Supplementary Budget, China CPI & PPI 2.5%/-32.% y/y, European Commission Forecasts, Guindos, Buch. **Thurs:** Germany Balance of Trade €5.2b, Eurogroup Meeting, Buch. (DailyFX estimates)

GLOBAL ECONOMIC INDICATORS

Germany Industrial Production ([link](#)): May data show industrial output rebounded, though like factory orders, the gain was below expectations. Germany’s headline production—which includes construction—jumped 7.8% (vs 10.0% forecast) after sliding 24.8% over the two months through April, with manufacturing up 10.4% and down 29.7%, respectively, over the comparable periods. Excluding construction, May’s rebound was stronger, climbing 9.7% after a two-month slide of 28.8%. The resumption of car production provided a big boost to May production, though output was still a sizeable 19.0% below its pre-crisis level. Of the top four Eurozone economies, Germany’s lockdown was the least severe, since it never mandated factories close—though companies did stop production in some areas. Here’s a snapshot of movements in the main industrial groupings over the past three months: capital goods (+27.6% in May & -43.1% during the two months through April), consumer durable goods (+17.1 & -27.8), intermediate goods (-0.1 & -19.9), and consumer nondurable goods (-1.4 & -13.2). Looking ahead, June’s Ifo business survey showed expectations within the manufacturing sector advanced at its strongest rate on record—jumping 55.8 points during the two months through June to 0.0—an encouraging sign.

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