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The Fed and the Great Virus Crisis
Edward Yardeni, Melissa Tagg
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Free Money Theory

The Wizard of Oz

We live in surreal times. In Chapter 1, we compared them to the TV series *The Twilight Zone*. However, a more apt comparison would be with the land that Dorothy and her dog Toto visited in the movie *The Wizard of Oz*. When a tornado ripped her house from its foundation, causing it to crash-land in Oz, she emerged safe and sound, looked around in wonder and famously marveled, "Toto, I've a feeling we're not in Kansas anymore."

The analogy with Oz was recently provided by none other than the Wizard of MMT, Professor Stephanie Kelton. In her June 2020 book *The Deficit Myth: Modern Monetary Theory and the Birth of the People's Economy*, she wrote: "Like Dorothy and her companions in *The Wizard of Oz*, we need to see through the myths and remember once again that we've had the power all along."[128]

Kelton was referring to Dorothy's power to go back home to Kansas simply by clicking the heels of her ruby-red slippers three times. Similarly, Kelton believes that the US government has always had the power to run huge budget deficits and should be doing so now to cure all our ills. As a result of the GVC, her theory took on a life of its own. Governments around the world spent massively on stimulative deficit-financed fiscal policies to offset the recessionary forces unleashed by the GVC. Central bankers provided ultra-easy monetary policies to allow the resulting deficits to be financed at record low interest rates.

Until 2020, MMT was an offbeat school of thought. As we noted in the Introduction, it isn't modern, isn't monetary, and isn't a theory. We prefer to call it "Free Money Theory." Its advocates argue that when sovereign governments borrow in a national currency that they alone issue, that debt has no risk of default, as the governments can always print more money to make good on future promises. MMT suggests that governments can borrow without limits until inflation becomes a problem. Inflation becomes a problem only when resources become so constrained that prices rise.

As described in Chapter 2, on Friday, March 27, four days after the Fed's QE4ever announcement, Trump signed the CARES Act. It provided $2.2 trillion in rescue programs for the economy, including $454 billion for the US Treasury to provide as capital to the Fed to make $4 trillion in loans through various SPVs. In other words, the US federal government implemented an untested theory on a grand scale.

Kelton is one of the most vocal proponents of 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 book reads like the MMT movement's manifesto.

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 allocating resources than politicians and bureaucrats. Kelton clearly disagrees; but before we go there, let's dive into her theoretical description of MMT.

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."[129]

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.

Kelton contends 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. Kelton believes that 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!

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" or "Non-Accelerating Inflation 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.[130] 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.

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. According to MMT, there are three main "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."[131]

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."[132] 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.

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, or "Pay As You Go," to "demonstrate their commitment to good, old fashioned household budgeting."[133] 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."[134]

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?"[135]

Kelton's readers can easily detect her political leanings. 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. 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.

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." 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." Governments can also use taxes "to encourage or discourage certain behaviors."[136]

“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.[137] She adds: “There isn’t a capitalist economy on earth that has found a way to eradicate the business cycle.”[138] 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.”[139] “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 remarkably ambitious 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?

Kelton’s book leaves no doubt about what MMT is all about: It’s an agenda for more big government and higher taxes. Kelton’s views must strike many conservatives as unrealistic and utopian. Proponents of free market capitalism might exclaim: “Pay no attention to the professor behind the curtain!”

For now, the central banks continue to pour liquidity into global financial markets. Fiscal policymakers have joined the stimulus party, resulting in the global implementation of MMT, i.e., massive fiscal deficits financed by massive quantitative easing. Kelton has won the debate, for now, on the heels of the GVC. Nevertheless, recall that The Wizard of Oz was all about a bad dream Dorothy had after getting hit on the head.

TINA Plus MMT

A trillion here, a trillion there adds up to serious money. In MMT’s dreamland, taken to the extreme, government deficits are bottomless pits. If they can be financed so easily with easy money without boosting inflation, why do we bother collecting taxes? We would be big advocates of MMT if our taxes were cut to zero. Let’s give it a try! Why not? Anything is possible in Oz.

While MMT hasn't boosted inflation, as measured by consumer prices, so far, it certainly has boosted asset inflation, potentially fueling the Mother of All Meltups (MAMU), which potentially could set the stage for the Mother of All Meltdowns (MAMD). In recent years, many stock market bulls have argued that "there is no alternative" to stocks because bond yields have been so low. TINA (There Is No Alternative) made even more sense after the Fed and the Treasury embraced MMT at the end of March 2020. The stock market equation from March 23—at least through this writing in January 2021—has been TINA + MMT = MAMU.

Endnotes

[128] Stephanie Kelton, *The Deficit Myth: Modern Monetary Theory and the Birth of the People's Economy* (New York: PublicAffairs, 2020), page 13.
[129] Kelton, page 17.
[130] Kelton, page 63.
[131] Kelton, page 96.
[132] Kelton, page 134.
[133] Kelton, page 22.
[134] Kelton, page 38.
[135] Kelton, page 237.
[136] Kelton, pages 33-34.
[137] Kelton, page 56.
[138] Kelton, page 65.
[139] Kelton, page 249.