# Economics

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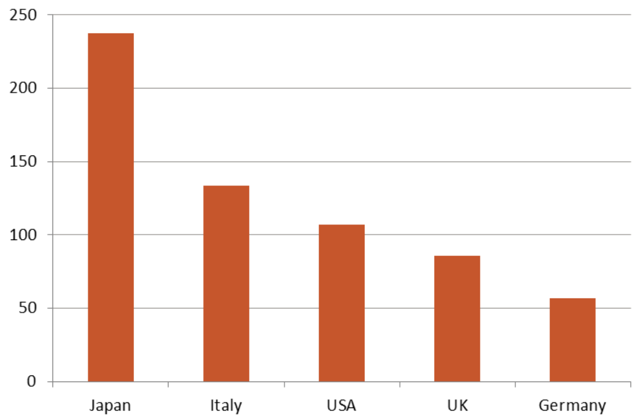
# Modern monetary theory: no magic bullet

- **Can the economic problems of our time be solved by a new monetary theory?** The so-called "modern monetary theory" (MMT) has been attracting attention in the US for some time, because it questions proven economic principles and is being championed by prominent US politicians on the left. The debate is no longer limited to the US, but has been taken up by experts in Germany, Europe and Australia. So, what is behind MMT?
- **According to MMT, the central bank and its monetary policy become the extended arm of the state.** A thrifty state is no longer necessary because it can finance itself directly through its central bank and by creating new money. According to conventional theory, such a policy would pose a considerable risk of inflation.
- **However, recent central bank policy could be interpreted in such a way that the feared danger of inflation does not arise in practice, and the propositions of MMT are validated.** Massive bond purchase programmes have made leading central banks important creditors of their own countries. The Bank of Japan already holds more than 40% of its own government's bonds without any significant consumer price inflation in Japan.
- **In this context, some are calling for the high levels of government debt held by central banks to be simply cancelled; however, we consider MMT implications of this nature to be extremely dangerous.**

**Public debt in percentage of GDP**




*Source: Fiscal Monitor (2019)*

## Key macro reports

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So-called modern monetary theory (MMT) has been attracting media and political attention for some time, and has won prominent supports on the US left in particular. Some of these see it as a way to tackle obstacles to growth and cancel the immense levels of national debt, especially in industrial nations. The debate is no longer limited to the US, but has been taken up by experts in Germany, Europe and Australia. So, what is behind MMT?

## The basic framework of the theory

A central tenet of MMT is that countries with their own currency do not have to worry about debt. They will always be able to meet financial obligations denominated in their own currency, as the money they need can be provided by their central bank. The rising money supply could at worst lead to inflation and a weak external value of the own currency.

Under this model, the central bank loses its independence and acts as an extended arm of fiscal policy by handing its money-creation monopoly to the state. The money supply is then no longer controlled only by the key interest rate and central bank interventions, but also by the state's expenditure and income. If the state's expenditure exceeds its revenues (government deficit), the money supply is increased (expansive fiscal policy). If, on the other hand, revenue exceeds expenditure, the money supply is reduced (restrictive fiscal policy).

In such a system, taxes serve only as an instrument for controlling the money supply and as a measure for redistributing income and wealth. Their function of financing the state budget, on the other hand, is superfluous, since the state finances itself through its own central bank and thereby creates new money – ie whenever it wants to make additional expenditures.

Issuing government bonds also serves only to adjust the interest rate, which according to MMT would otherwise be zero in a fiat money system (ie one that is not backed by real assets such as gold). The financing function on the one hand, and the disciplining effect of the state's capital market dependency on the other, are thus removed from the equation.

## MMT as the heir to Keynes?

The theory is basically a development of Keynesian views. A central statement of Keynesian theory is that, although individuals are able to "save their way" out of a crisis, not all economic actors can do so at the same time. What makes sense from a microeconomic standpoint can lead to ruin in macroeconomic terms. Due to declining demand, the economy can slide into recession or, in the worst case, even depression.

The Keynesian solution is that, in such times, the state must take countermeasures and strengthen macroeconomic demand by borrowing and thus, for example, increasing investment ("deficit spending"). In good times, the state should then reduce the resulting deficit through higher tax rates. The Keynesian signature of MMT is thus recognisable, even though MMT gives the state much more far-reaching powers than just recommending that it borrow heavily in times of a downturn. Even direct state financing should be possible. In the event of overheating, the additional money should be removed via taxes or issuing bonds.

Experience shows, however, that even in times of economic recovery, politicians – often for reasons of self-interest (eg a desire to be re-elected) – tend to hesitate to raise taxes in order to reduce government deficits and debts. Tax increases are usually accompanied by a decline in popularity and therefore endanger the career and power prospects of professional politicians. In this case, the national debt would not escalate, but the rising money supply would drive up inflation rates and weaken the exchange rate of the country's own currency.

## Political and economic reception of the MMT concept

So far, the theory has found particular support on the left wing of the US Democratic Party. Prominent representatives in this camp include Congresswoman Alexandria Ocasio-Cortez, who is at the beginning of her political career, and Stephanie Kelton, economics professor and former campaign advisor to Bernie Sanders.

Ocasio-Cortez hopes that the implementation of the monetary policy concept will lead to the realisation of the "Green New Deal" and health insurance for everyone. The financing of these projects is the primary problem that could be solved by the ideas of MMT. Like leading supporters of MMT, Ocasio-Cortez also demands a state job guarantee. Bernie

Sanders, who also advocates job security, could even make the theory become an electoral issue because of his proximity to its supporters, thus triggering a broad social debate about the Federal Reserve's new monetary policy orientation. Should the monetary policy of the US Federal Reserve be put to the test, other central banks could hardly escape such debates.

Some Democrats, however, are opposed to the concept, rejecting it, or at least criticising it in part. Former Treasury Secretary Larry Summers, for example, recently described MMT as "voodoo economics", while Federal Reserve Chairman Jerome Powell, Nobel Prize winner Paul Krugman and former IMF Chief Economist Ken Rogoff are also critical.

## How far are we from an MMT world?

It seems that MMT experiments are already being conducted in some countries without the feared consequences that critics are warning us about. Japan has been trying to combat deflationary trends since the 1990s. Nevertheless, the Japanese economy is dominated by moderate growth and low inflation expectations. Europe has found itself in a similar situation for some years now.

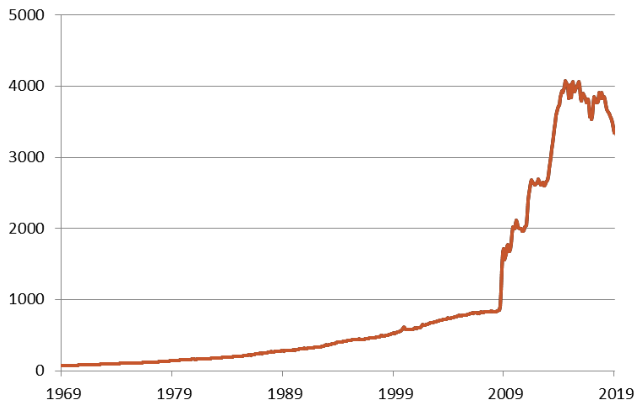
The Bank of Japan has now become Japan's most important bondholder and holds around 40% of the total bond volume in its own books. And with the announcement of unlimited bond purchases, the end has apparently not yet been reached – the de facto unlimited direct government financing would thus not be standing in the way in Japan. Despite the very expansive monetary policy, there is no escalating consumer price inflation at all.

German government bonds are already indirectly adding considerable sums to the books of the EU's central bank system. The current volume is around 500 billion euros. Measured against Germany's total debt of around 2 trillion euros, that already equates to c25%. The ECB recently signalled its willingness to return to a more expansionary monetary policy, and a new bond purchase programme is likely. The stock of government bonds held in the Eurosystem would then continue to rise.

The Canadian central bank is even allowed to legally provide the government with central bank money to some extent by default. The feared consequences for consumer prices have so far failed to materialise. However, the very limited amount of direct capital resources must also be taken into account.

Since abandoning the gold standard, the Fed's monetary base has risen steadily and strongly over the last decade (see chart). Significantly higher inflation has not been accompanied by a sharp increase in the money supply since 2009.

**Monetary base of the US Federal Reserve in billions of US dollars, 1969 to 2019**




*Source: Federal Reserve (2019)*

Even if consumer price inflation has not risen as feared, the situation is different for asset prices. International stock indices rose in parallel with the launch of various purchase programmes and a generally loose monetary policy. In addition, real estate prices have risen sharply, especially in urban agglomerations, including in Germany.

The increased money supply has therefore not led to the feared rise in consumer prices, but it does have an influence on the rise in asset prices. For central banks, this can be a desirable transmission channel for monetary policy decisions, but it can also be an undesirable side effect of monetary policy that has to be corrected later.

## Should the central banks simply abolish escalating public debt?

There have been occasional calls recently for central banks simply to delete government debt from their books. Given the high levels of government debt, some observers believe that such debts are no longer repayable anyway. Japan's debt, for example, is approaching 250% of GDP.

Such a step would represent a radical departure. The credibility of the central banks and the entire monetary system would be shaken. Central banks do not act in an economic vacuum and they must adhere to certain economic rules. For example, they have a balance sheet with an asset side and a liability side that must correspond in value. The bonds that a central bank buys are on the assets side. If these were deleted, ie written off at a stroke, there would be a considerable difference between the assets and liabilities sides. This is especially true for the Japanese central bank, which in this case would write off 40% of Japan's total national debt.

The depreciation of assets is tantamount to a loss. In the case of the volume mentioned, this would far exceed the equity capital of the central bank. It would therefore be consumed completely and the difference between the two sides of the central bank balance sheet would still not be closed. In order to remedy this situation, the central bank would introduce an adjustment item on the assets side. This would in fact be negative equity.

A private-sector company in such a situation would either have to be recapitalised immediately or declared bankrupt. Not so a central bank, because it cannot actually go bankrupt, on account of its money-creation monopoly. Similar scenarios have already happened to several central banks in history. One example is the Bundesbank, which reported negative equity in 1973 due to a massive revaluation of its currency reserves.

The consequence of such a situation is that during this period the state has to forgo the profits of its central bank, which would otherwise be expected annually and which it generates by creating money ("seigniorage"). These profits must instead be used to gradually reduce the balancing item and gradually help the central bank regain positive equity capital.

In addition, the credibility of a central bank would be damaged, as it would be difficult to explain to the public why private economic players have to budget properly, while the central bank – to put it simply – can print its way back to health. This could give rise to political demands that someone should be held responsible for the mismanagement, even if the nature of a central bank means that this is not necessary. In the end, the owner of the central bank could be asked to pay again: ie the state, whose debts were supposed to be cancelled in the first place.

## Outlook

MMT tries to give the economic debate a different perspective. As a method of analysis, it may well be suitable for questioning and reinterpreting certain models. However, its implications for political practice are dangerous.

Confidence in the monetary competence of states, which are (often) led by elected governments and therefore by politicians who depend on the approval of their voters, must be viewed critically. Because of the normative guidelines for action, MMT sees itself not only as a tool for analysis, but also as a source of advice on fundamental economic policy decisions.

Politicians could be tempted to make inefficient investments, to be imprudent and to waste money. The issue of self-interest – the desire for popularity and re-election – also raises questions about politicians' consistency with regard to monetary policy; such consistency would be indispensable for money supply control within the framework of MMT. Moreover, the power of governments would be considerably enhanced if central banks were deprived of their independence by being integrated into the structure of the state.

In view of the less than successful monetary policies of numerous central banks as well as the worldwide escalation of public debt, MMT presents itself as a possible solution. Advocates see the concept as a political panacea offering a financial solution to the pressing problems of our time. Anyone who wants to prescribe MMT to the world's leading economies as a remedy for their troubles should, however, not ignore the problems mentioned. The concept is likely to do more harm than good in the long term.

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| | |
|---|---|
| Patrick R. Trucchio | +1 646 949 9027 |

**CAPITAL GOODS**

| | |
|---|---|
| Andrew Buscaglia | +1 646 949 9040 |

**INDUSTRIAL MATERIALS**

| | |
|---|---|
| Paretosh Misra | +1 646 949 9031 |

**REAL ESTATE**

| | |
|---|---|
| Nate Crossett | +1 646 949 9030 |
| Connor Siversky | +1 646 949 9037 |

**SOFTWARE & IT SERVICES**

| | |
|---|---|
| Gal Munda | +1 646 949 9021 |
| Joshua Tilton | +1 646 949 9036 |

**TECHNOLOGY HARDWARE**

| | |
|---|---|
| Andrew DeGasperi | +1 646 949 9044 |

## ECONOMICS

| | |
|---|---|
| Mickey Levy | +1 646 949 9099 |
| Roiana Reid | +1 646 949 9098 |

## EQUITY SALES

**SALES**

| | |
|---|---|
| David Alonso | +1 415 802 2523 |
| Albert Aguiar | +1 646 949 9218 |
| Jason Cantrell | +1 415 802 2523 |
| Daniel Claeys | +1 646 949 3144 |
| Nate Emerton | +1 617 292 82 11 |
| Kelleigh Faldi | +1 617 292 8288 |
| Ted Franchetti | +1 646 949 9231 |
| Rich Harb | +1 617 292 8228 |
| Zubin Hubner | +1 646 949 9202 |
| Jessica London | +1 646 949 9203 |
| Anthony Masucci | +1 646 949 9217 |
| Ryan McDonnell | +1 646 949 9214 |
| Emily Mouret | +1 415 802 2525 |
| Peter Nichols | +1 646 949 9201 |
| Kieran O'Sullivan | +1 617 292 8292 |
| Rodrigo Ortigao | +1 646 949 9205 |

**CRM**

| | |
|---|---|
| Alexandra Angove | +1 646 949 9211 |
| Sammy Chea | +1 646 949 9241 |

**CORPORATE ACCESS**

| | |
|---|---|
| Michelle Backmann | +1 646 949 9215 |
| Adriane Klein | +1 617 292 8202 |
| Olivia Lee | +1 646 949 9207 |

**EVENTS**

| | |
|---|---|
| Meridian Della Penna | +1 646 949 9208 |
| Laura Hawes | +1 646 949 9209 |

## SALES TRADING

| | |
|---|---|
| Ronald Cestra | +1 646 949 9104 |
| Mark Corcoran | +1 646 949 9105 |
| Michael Haughey | +1 646 949 9106 |
| Christopher Kanian | +1 646 949 9103 |
| Lars Schwartau | +1 646 949 9101 |
| Donato Tierno | +1 646 949 9109 |