HSBC Global Research

8 October 2020

# Future Saviour or False Prophet?

## Modern Monetary Theory (MMT) examined

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Economics - Global

- Supporters of MMT think government debt doesn't matter
- It's a seductive conclusion given the fiscal impact of COVID-19
- But is this the real world? No, it's just fantasy


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**Modern Monetary theory: what is it?**

Proponents of modern monetary theory believe that governments can and should fund public spending simply by printing money. They regard government debt as no more than interest-bearing cash. In their world, inflation should be controlled not by central banks but, instead, by changes in the government's fiscal stance. Taxes are really not necessary, at least for the purposes of financing public spending.

**What does it mean today?**

Quite simply, MMT proponents think there is no limit to how much government debt should rise so long as inflation remains under control. Admittedly, this only applies to nations with power over their own printing presses (and, thus, not to individual members of the Eurozone). It means, however, that there should be no debt "hangover" when COVID-19 is finally brought under control.

**Too good to be true?**

Frankly, yes. Throughout history, governments have found the temptations of the printing press irresistible. Central banks are granted independence for a reason: their independence reduces the chances of political expediency trumping long-term economic stability.

**Six claims, six mistakes**

MMT proponents claim that their approach is the equivalent of shifting from Ptolemy to Copernicus. It's a bold boast. Close examination of six of their key arguments suggests, however, that it is also a shallow boast. Ultimately, government finances *are* constrained, most obviously through changes in interest rates or currency values. All governments compete for resources in a global market place. Yes, government borrowing can be "funded" through printing money in a bid to keep interest rates low but, other things equal, currency depreciation is then likely to lead to higher import prices, squeezing real household incomes.

**There is no free lunch**

In general, changes in government borrowing trigger relative price adjustments. These changes, in turn, lead to offsetting economic effects elsewhere. In truth, MMT is less a journey from Ptolemy to Copernicus but, rather, a trip in the opposite direction.

*This is a redacted version of the report published on 08-Oct-20. Please contact your HSBC representative or email [AskResearch@hsbc.com](mailto:AskResearch@hsbc.com) for information.*




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# Future saviour or false prophet?

- Rapidly rising government debt…
- …may be attracting lots of scary headlines…
- …but supporters of MMT think we should just relax. They're wrong

## What is MMT?

**From Ptolemy to Copernicus and back again**

One of the more obvious economic consequences of the COVID-19 pandemic is much higher levels of government debt. We have written elsewhere that such large increases – at least for the major developed economies − are most commonly seen during wartime[1]. We have also noted that, in the aftermath of war, government debt eventually comes back down again, at least when expressed as a share of GDP (chart 1). Sometimes – notably in the 1950s – this can happen virtuously, via a strong acceleration in income growth (and, hence, a rapidly falling debt/GDP ratio). On other occasions – after the Napoleonic Wars, after the First World War – the decline may be linked to higher taxes, increased austerity, inflation or default[2]: in other words, a whole heap of economic pain (King, S, *Borrowing from the Future: Lessons from the pre-COVID-19 past*, HSBC, 1 June 2020).

**1.British government debt through the ages**


Source: Bank of England, ONS

[1] Japan's "lost decades" experience – and, for other countries, the aftermath of the Global Financial Crisis – are good "peacetime" examples

[2] The UK suffered from both higher taxes and austerity (contributing to the 1926 General Strike); Weimar Germany and Austria succumbed to hyperinflation after the First World War; much of Latin America defaulted in the 1930s.

An alternative view – from proponents of Modern Monetary Theory (MMT) – suggests we really have no need to worry about high and rising domestic currency-denominated government debt. So long as governments have access to a printing press, high debt levels are an irrelevance. In that sense, the US and the UK have the advantage over members of the Eurozone, each of which has surrendered its monetary sovereignty.

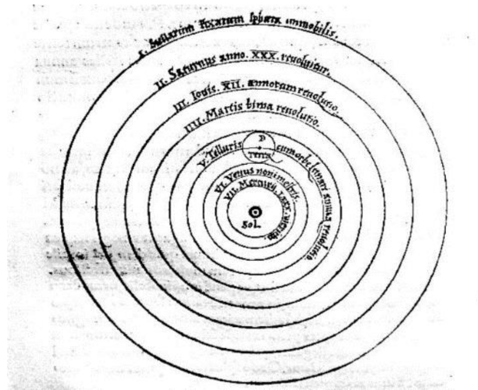
It is easy to see why MMT has become so popular with those politicians seeking easy answers to life's economic complexities: after all, it appears to suggest (i) there is no financial constraint on how much governments can borrow and (ii) as such, government spending can potentially rise a long way, particularly given that, in recent years, inflationary risks have been either dormant or non-existent.

MMT supporters are not afraid of making big claims. As Stephanie Kelton, a leading MMT exponent and former Chief Economist on the US Senate Budget Committee, notes in her book, *The Deficit Myth*[3], MMT might prove to be the economic equivalent of shifting from Ptolemy to Copernicus (charts 2 and 3). The "father" of MMT – Warren Mosler – has guru status among his many followers. There are now MMT textbooks – notably *Macroeconomics* by Mitchell, Wray and Watts – for those who hope to embrace a different kind of economics. To its detractors, however, MMT is simply known, disparagingly, as the "magic money tree".

**2. The Ptolemaic Earth-centric solar system**


Source: Wikimedia Commons

**3. The Copernican Sun-centric solar system**



Source: Wikimedia Commons

The starting point for MMT is the idea that governments with access to a printing press, unlike households and companies (and members of the Eurozone), cannot run out of money. They are currency "issuers", not currency "users". As such, they cannot default. Adherents also argue that – *in extremis* – there is no need for governments to raise taxes. Money required for spending purposes can simply be printed (which is exactly what happens in some countries in the event of war or pandemic). From a financial perspective, the budget deficit is, thus, an irrelevance.[4]

The only macroeconomic constraint is inflation. For supporters of MMT, limitations on government ambition are "real", not financial, determined by the productive potential of an economy (in that sense, MMT foundations are not so different from those of mainstream economists using standard output gap analysis, even though that approach has had, at best,

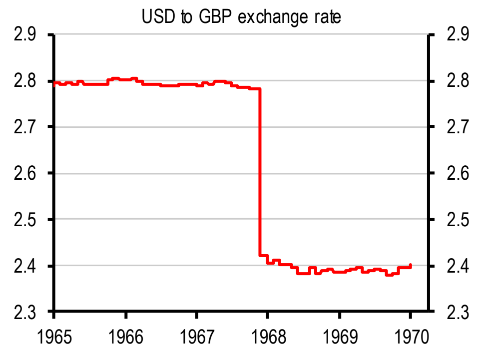
[3] Kelton, S., *The Deficit Myth: Modern Monetary Theory and How to Build a Better Economy*, John Murray Press, London, 2020
[4] The "father" of MMT is Warren Mosler, author of *Soft Currency Economics II: What Everyone Thinks They Know About Monetary Policy Is Wrong*, first published in 1993. Of course, if EVERYONE is wrong, then it's difficult to see who could be right.

limited success in recent years: in the words of Ehnts and Mosler, "Inflation is not caused by increases in monetary aggregates per se")[5]. During booms, public spending should be restricted (thereby limiting inflationary pressures) while, during recessions, it should be raised (thereby restraining deflationary pressures)[6]. Some adherents of MMT argue that governments should offer a job guarantee scheme. For anyone wanting work, a job will be provided because, put simply, the money is always available. If, during recessions, the private sector is unable to produce enough jobs, the public sector should mop up the slack. Indeed, in the absence of financial constraints, there is a moral duty to do so (even if the wage level for such workers is tricky to specify).[7]

MMT adherents are deeply suspicious of the role of monetary policy and, indeed, the economic framework used by the majority of central banks. As Kelton notes, "to put it crudely, the Fed uses unemployed people as its primary weapon against inflation" and "monetary policy has limited potency. It works mainly by driving consumers and businesses into debt". Using fiscal policy to stabilise the economy makes much more sense because, unlike currency-using consumers and companies who can too easily go bust, governments can cover their "debts" by printing money (indeed, Treasuries and the like are regarded as being no more than interest-bearing money, the equivalent of having cash in a savings account). In a call to arms, Kelton demands that "we must end the cruel and inefficient practice of relying on democratically unaccountable central bankers to target the "right" mix of inflation and unemployment. To build an economy for the people, responsibility for maintaining employment and income security must become the responsibility of elected representatives of the people".

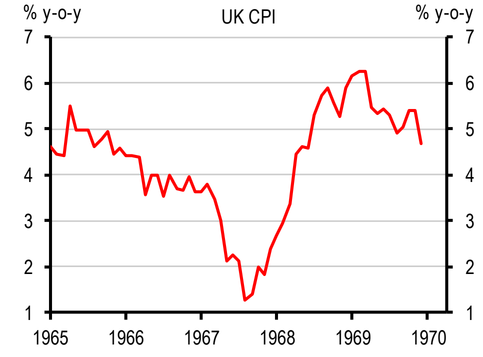
Ultimately, according to MMT supporters, a currency-issuing government can afford to buy whatever is for sale in its own unit of account. (which is a claim rather similar to British Prime Minister Harold Wilson's infamous "pound in your pocket" speech associated with sterling's 1967 devaluation[8], charts 4 and 5).

**4. Sterling plummeted in 1967…**




Source: WR/Reuters

**5…and inflation soared**




Source: OECD

[5] See *https://braveneweurope.com/dirk-ehnts-warren-mosler-a-euro-zone-proposal-for-fighting-the-economic-consequences-of-the-coronavirus-crisis*.

[6] For critics, this introduces an unacceptable cyclicality into public spending. For supporters, the so-called "automatic stabilisers" are simply turbocharged.

[7] Standard macroeconomic concepts such as the non-accelerating inflation rate of unemployment (NAIRU) are dismissed out of hand, even though MMT supporters recognise that economies cannot grow indefinitely at rates above productive potential. To be fair, NAIRUs are near enough impossible to observe. Still, that doesn't alter the fact that any sensible policymaker has to be aware of economic trade-offs.

[8] Specifically, Wilson said ""From now on, the pound abroad is worth 14% or so less in terms of other currencies. That doesn't mean, of course, that the pound here in Britain, in your pocket or purse or in your bank, has been devalued."

Advocates of MMT are remarkably confident regarding their claims. Yet, when their arguments are examined properly, it quickly becomes apparent that, beyond what is obviously true, too much of what they claim is a triumph of hope over reality. Rather than offering a Copernican revolution, MMT threatens to take us back to the Dark Ages.

## Six claims…and six mistakes

**Claim No.1: Currency-producing governments cannot go bust**

When a government defaults, it fails to pay its creditors. They are left out of pocket. MMT advocates are correct in arguing that a currency-issuing government doesn't have to default on domestic-currency-denominated debt (according to Ehnts and Mosler, "Government's ability to pay is not an issue"[9]). The alternatives, however, amount to much the same thing. Raising wealth taxes, for example, has roughly the same impact as a default: those who have savings suddenly discover that those savings – post-tax – are now worth a lot less. Allowing inflation to rise delivers roughly the same outcome. So long as interest rates don't rise at the same pace – and a government in control of the printing press can more or less guarantee that they won't – the real value of cash savings (and savings in the form of government bonds) will fall in value. It is a default in all but name. History is replete with examples of such behaviour: kings and queens (the currency issuers) were always tempted to debase the coinage in an attempt to "print" money to fund military endeavours while, for merchants, coin clipping was a good way of (fraudulently) increasing claims on others' real resources.

**Claim No.2: "Their red ink is our black ink"**

Any macroeconomist knows about the so-called sectoral balances. In essence, all economies have four "sectors" – households, corporates, government and "the rest of the world" – that are either in surplus or deficit with one another. By definition, the balances of the four sectors must add up to zero. MMT advocates suggest that bigger budget deficits imply bigger surpluses elsewhere and, thus, that such deficits are always funded ("their red ink is our black ink"). This is tautologically the case but, as such, totally lacks any useful insight. Accountancy is not the same as economics.[10]

Any analysis of the sectoral balances has to answer questions related to "how" and "why". For starters, a budget deficit can increase in size either intentionally via tax cuts or increases in public spending (which may lead to higher interest rates) or "by accident" thanks to, say, an unexpected recession which leads to lower government revenues and higher benefit payouts (and, other things equal, lower interest rates).

A wider budget deficit may be offset by an increase in the "rest of the world" surplus, which is simply another way of saying that the home country ends up with a wider balance of payments current account deficit. The rising "black ink" in this case is neither household nor corporate savings but, instead, savings from the rest of the world: in that sense, it is not "our" black ink, but someone else's. It's just not possible for a government unilaterally to demand that the rest of the world increases its supply of savings to the home nation (unless there is, *ex ante*,

[9] See https://braveneweurope.com/dirk-ehnts-warren-mosler-a-euro-zone-proposal-for-fighting-the-economic-consequences-of-the-coronavirus-crisis

[10] To be precise, MMT supporters suggest that money "printed" by the central bank and then given to the government is then given to the "people" in the form of, say, a tax cut. That money then enters the banking system in the form of higher deposits (assets) for the "people" (and thus higher liabilities for the banks). As the "people" are now deposit-rich, they effectively have higher savings. In the event that they spend those savings, however, there may well be a negative impact on the balance of payments. There is no escaping the tautological logic of the sectoral balances.

unlimited global demand for the home nation's currency, an unlikely event). In this case, something else will have to change to encourage the higher inflows.

One possibility is a rise in domestic interest rates compared with interest rates elsewhere. This, however, will also tend to dampen domestic private demand by placing either upward pressure on household saving or downward pressure on investment: in this case, additional government borrowing may "crowd out" private demand. Another possibility is a decline in the exchange rate to make domestic assets cheaper in the eyes of foreign investors. Again, there is a cost: foreign goods are now more expensive priced in the "home" currency: prices rise relative to wages, making consumers worse off. Put another way, their "red ink" becomes our problem. Government borrowing changes relative prices (of capital or of domestic versus foreign goods) and, as such, will trigger a response from households, firms and the "rest of the world". There is no free lunch.

**Claim No.3: Government spending doesn't need taxes**

MMT supporters are willing to concede that taxes can help in the redistribution of income and wealth or in the discouragement of "sinful" behaviour but their underlying belief is that, from a revenue-raising perspective, taxes are simply not necessary. The government, with its monopoly power over the issuance of the currency, has no need to raise revenues via taxes. It can just issue additional currency (but only enough, apparently, to reduce unemployment to scarcely anything while keeping inflation at bay, the economic equivalent of finding the Holy Grail).

MMT adherents do, however, make what might be described as a "weak case" for taxation relating to the provisioning of public services. In what might be described as a *Through the Looking Glass* moment, MMT supporters argue that it is easier for governments to hire health workers, teachers and the military if those same workers have to pay taxes in the home currency (In the words of Ehnts and Mosler, "Tax liabilities create sellers of goods and services desiring Government currency in exchange"[11]). Public workers would, apparently, not turn up for work and earn, say, US dollars or British pounds if they didn't have to pay some of those dollars or pounds back to the IRS or HMRC. It is, apparently, the obligation to pay tax that encourages them to earn dollars or pounds in the first place.

In reality, taxes do, in fact, play a crucial financing role. The fundamental difference between the government sector and other sectors of an economy is the government's coercive power to raise taxes. The reason why government bond yields are typically lower than, say, the yields on equivalent corporate bonds is not because of access to a printing press but, instead, because of the government's ability to confiscate other people's money. A company that is making a severe loss cannot reduce that loss by imposing taxes on everyone else. A government can. A worker that receives a pay cut cannot force others to make up the difference. A government can.

Seen this way, taxes matter far more than the printing press. Should an incompetent government abuse the printing press, or should the public fear a government is about to do so, the risk is that the currency collapses in value. The velocity of circulation rises, the stock of money surges and inflation starts to accelerate. The public can then reject the currency altogether. In the early 1980s, for example, Israel succumbed to hyperinflation. As it did so, the economy became increasingly dollarized. Menus were priced in dollars, bills were paid in dollars, shops sold goods in dollars. Why own rapidly depreciating shekels – even if taxes had to be paid - when dollars held their value? And why hold shekels to pay future taxes when it was more profitable to hold dollars and convert them to shekels later on at a much more advantageous exchange rate?

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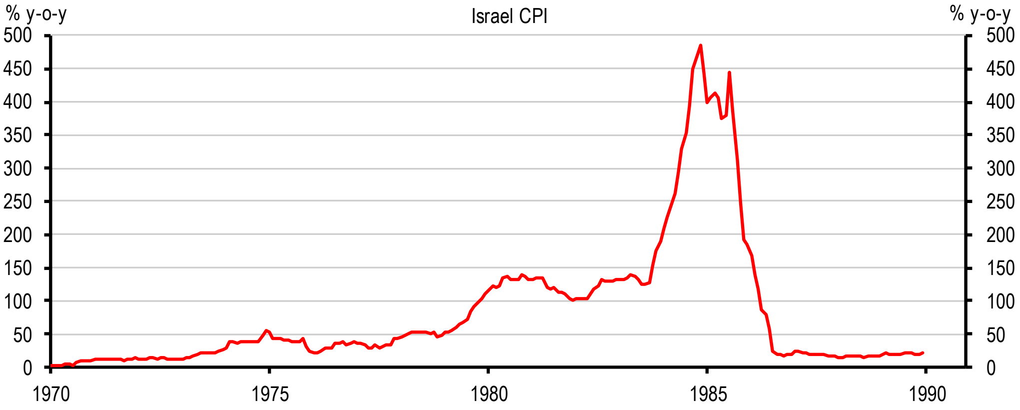
[11] https://braveneweurope.com/dirk-ehnts-warren-mosler-a-euro-zone-proposal-for-fighting-the-economic-consequences-of-the-coronavirus-crisis

**6. In the 1980s, Israelis gave up on inflationary shekels**




Source: Bank of Israel

**Claim No.4: Fiscal deficits enlarge the private sector's savings**

This is a variant of the "red ink/black ink" argument. The idea is simple. In a closed economy, government borrowing by definition must be matched by non-government saving. And, as governments with access to printing presses don't tend to default, whereas "currency using" households and companies can do so, a nation that increases its government borrowing must, by definition, lower its default risk. Seen this way, the risk of financial crises is reduced.

A supposed proof of this idea comes from the late-1990s. The US economy was booming. Private sector debts were rising. At the same time, the Clinton Administration was delivering budget surpluses. According to Kelton, "the government's surpluses were siphoning away a portion of our financial savings…fiscal surpluses rip financial wealth away from the rest of us, leaving us with less purchasing power to support the spending that keeps our economy going."

The implication is that, had the Clinton Administration delivered budget deficits rather than surpluses, the rest of the US economy would have been forced back into surplus, thereby reducing the risk of economic calamity. This confuses cause with effect. In hindsight, the late-1990s economic boom generated higher than expected tax revenues, leading in turn to a dwindling budget deficit and, eventually, a series of budget surpluses. Had the Clinton administration opted, instead, for bigger deficits, the economic boom would have been even larger, paving the way for an even more painful crash thereafter. And, in all likelihood, the "savings" would have had to come from abroad, in the form of a larger balance of payments deficit.

Indeed, the idea that the government alone is best placed to run deficits represents a peculiarly skewed view of how an economy typically functions. To understand why, consider an economy in which there is no government at all. The likelihood is that households will save (in other words, they will be in surplus) while companies will borrow (they will be in deficit). The reason is obvious. Companies exist precisely because they are better able to make use of household savings than the households themselves. Risks are pooled, economies of scale – in terms of both production and sales – are created and, in time, everyone ends up a little bit better off. Admittedly, governments can also play the borrowing role typically played by companies but, as the Soviet economic system so usefully demonstrated, an economy is unlikely to thrive in the absence of corporate risk taking. Meanwhile, if companies want to borrow more than households want to save, they can do so via the rest of the world (in which case, the country in question will have capital inflows and, hence, be running a current account deficit: the impact on interest rates, in turn, will depend on the perceived rate of return in the home country relative to what is on offer elsewhere).

**Claim No.5: The control of inflation should be given to elected officials via fiscal policy, not unelected monetary technocrats via monetary policy**
This claim partly stems from the idea that central bankers in effect hold the unemployed hostage in a bid to keep inflation under control. Elected officials, answerable to voters, would apparently do no such thing. Instead, they would simultaneously keep inflation under control while reducing unemployment to virtually nothing.

To be fair, some aspects of this claim are reasonable. If governments insist on giving central banks multiple – and sometimes conflicting – objectives (low inflation, full employment, financial stability etc), the technocrats running central banks will have to assess trade-offs, a process which is inherently political and which should, at the very least, be open to public scrutiny. If central banks have cut interest rates to zero and, as such, have run out of conventional ammunition, there is a powerful argument to be made in favour of using proactive fiscal policy.

MMT supporters, however, go a lot further. They claim that fiscal policy is the only game in town partly because monetary policy works in fundamentally perverse ways: in the words of Mosler, "what's called Fed tightening by increasing rates may increase total spending and foster price increases, contrary to the advertised effects of reducing demand and bringing down inflation"[12]. Yet it is difficult to see why fiscal policy can credibly be used as a stabilising force. Consider, for example, the electoral timetable. The desire to stoke up an economy ahead of an election is, for many politicians, impossible to resist. Jam today, however, may lead to asset price bubbles and inflation tomorrow. The case for central bank independence is, in part, an argument to keep the electoral urges of politicians under control.

MMT supporters can also be inconsistent with regard to the effectiveness of monetary policy. On the one hand, they want to argue that monetary policy works in the wrong direction (Mosler: "higher interest rates may impart an expansionary, inflationary bias"[13]) but, as we've already seen, they also want to claim that low interest rates can lead to too much in the way of private debt. The lack of nuance in this approach is striking.

In truth, monetary policy works through a variety of channels: *inter alia*, it has an impact via asset prices (lower rates and quantitative easing lead to more demand for risky assets, making their owners feel wealthier and making it easier to raise funds on capital markets); via the exchange rate (other things equal, lower interest rates will lower the value of the exchange rate, boosting exports while raising import prices); via debt service costs (for any given level of debt, lower rates will reduce monthly repayments, boosting disposable real income); and via the yield curve (for given long term rates, lower short term rates will boost the profitability of lending by banks engaged in maturity transformation: yield curve control can lower borrowing costs for a range of long-term capital raisers). There are times when central bank powers are in danger of waning – most obviously when interest rates have dropped to zero, or below – but that is not an argument to suggest that central bankers have served only to damage our economic prospects.

**Claim No.6: MMT frees governments from binding financial constraints**
MMT proponents make a great deal of the claim that, once freed from budgetary and monetary constraints, it's possible for nations to enjoy economic freedoms denied to others. There is some truth in this. If a nation pegs its currency to another nation's currency, it will have to adhere to that country's monetary policy choices. If a nation "dollarizes", it will have to accept the policies of the Federal Reserve, even if the Fed has no interest in (and, for that matter, no responsibility for) the dollarized economy. If a nation throws in its lot with other members of the

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[12] See White Paper, MMT, at
*https://docs.google.com/document/d/1gvDcMU_ko1h5TeVjQL8UMJW9gmKY1x0zcqKIRTZQDAQ/edit*

[13] Ibid.

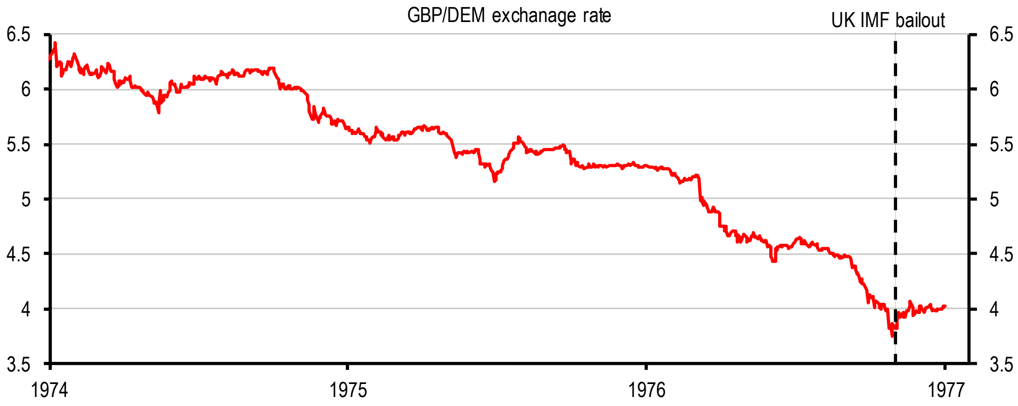
eurozone, it will lose its monetary independence and, as Greece has discovered, could be plunged into an economic crisis from which there is no easy escape.

Yet, when it comes to economic policy, few countries choose to “go it alone”. Most prefer to be constrained one way or the other, largely because “going it alone” leads to all sorts of temptations (and, for that matter, external shocks) that, in turn, might negatively impact both borrowing costs and currency levels. The same, of course, is true within countries, one reason why those seeking independence for Scotland have been so coy about their future monetary plans. Would Scotland be part of a sterling area, a euro area or would it embark on a monetary journey into the unknown?

To be fair, some countries can cope with independence more easily than others. The US has deep and liquid capital markets, a large domestic economy, a relatively low trade exposure to the rest of the world and, to boot, can boast the world’s dominant international currency. As John Connally, President Nixon’s combative Treasury Secretary, warned in 1971 as the Bretton Woods exchange rate system was on the verge of collapse, “The dollar is our currency, but it’s your problem”. If international transactions are mostly conducted in dollars, it helps if you happen to be the world’s monopoly issuer.

Yet countries ticking the “independence” box don’t always have it so easy. The UK attempted to kick start its economy in the early 1970s with what became known as the Barber boom, a fiscal stimulus package designed to bring down unemployment and increase the chances of a Tory victory in the forthcoming General Election (in the event, they lost). A combination of inflationary wage demands, a collapse in the value of the pound and the 1973 oil price shock put the economy (and sterling, chart 7) into a downward spiral that, in 1976, led Denis Healey, the Labour Chancellor of the Exchequer, to call in the IMF. It was a funny kind of independence.

**7. Sterling fell and fell, prompting an IMF bailout in November 1976**




Source: Deutsche Bundesbank

In the early 1980s, the combination of tight monetary policy − designed to bring inflation under control − and loose fiscal policy − thanks to the desire of the Reagan administration to take on the “Red Menace” of the Soviet Union − led to screamingly high US interest rates. It was a good example of where a political fiscal imperative trumped the “cyclical” fiscal role beloved of MMT supporters. For Reagan’s detractors, the result was a series of global imbalances and severe economic pain for those nations – mostly in Latin America – which had previously borrowed in dollars and were unable to cope with a suddenly much more bracing financial environment. For Reagan’s supporters, the willingness to borrow in an effort to boost America’s military capacity accelerated the end of the Cold War. At the end of the day, politicians are unlikely to limit fiscal policy to a macroeconomic stabilisation role: they have much bigger fish to fry.

Many countries, meanwhile, simple don't have the capacity to "go it alone", partly because of the danger of what might loosely be described as contingent liabilities. In the absence of capital and exchange controls, anyone in theory can raise funds in foreign currency. In recent years, for example, many emerging companies have borrowed in dollars or euros rather than in their domestic currency in order to take advantage of lower interest rates. Yet in the event that the domestic currency suddenly plunges in value, the ability of those companies to repay their foreign debts declines. The government is then faced with a choice: let the companies go bust or, alternatively, bail them out. In the world of MMT, this is easily done: simply print money. In the real world, you might end up with Venezuela.

## Conclusions

It is perfectly reasonable to question conventional economic thinking. After all, economic outcomes in recent years have been less than satisfactory (at least when judged against both consensus forecasts and those from the major "official" national and international forecasting bodies). Economic growth has been lower than expected, productivity gains have been paltry, inflation has been too low, inequality has risen and isolationism is resurgent. To suggest that all (or indeed any) of this can be fixed with a quick wave of a modern monetary wand is, however, a triumph of simplistic hope over complex economic reality. Yes, politicians and policymakers have got things wrong, most obviously their persistent failure to understand the true nature of financial bubbles. Yet the world is a complex place, where people's livelihoods are determined not just by macroeconomic policy but also by technology, globalisation, regional inequalities and relative educational attainment. Modern monetary theory rightly asks important questions. Unfortunately, it hasn't come up with the right answers. Benjamin Franklin's aphorism still stands: "in this world, nothing can be said to be certain except death and taxes".

# Disclosure appendix

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1 This report is dated as at 08 October 2020.

2 All market data included in this report are dated as at close 06 October 2020, unless a different date and/or a specific time of day is indicated in the report.

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