MMT taboo by Roger Bootle of the ToryGraph

https://www.telegraph.co.uk/business/2019/04/29/taboo-should-broken-extreme-circumstances/

You may know the quip about the Holy Roman Empire that regularly causes Fred and his friends down the Dog and Duck to convulse with laughter. “There are three things to remember about the Holy Roman Empire: it wasn’t Holy, it wasn’t Roman and it wasn’t an Empire.”

I am reminded of this by the burgeoning interest in an approach to economic policy known as Modern Monetary Theory (MMT). There are three things to remember about MMT: it isn’t modern, it isn’t really monetary, and it isn’t a theory. Nevertheless, Fred and his friends better take notice of it because it may be about to enthuse a politician or two near them, with potentially dangerous consequences.

The story so far. In the wake of the Global Financial Crisis (GFC), governments and central banks were able to stabilise the economy by a combination of fiscal relaxation and loose monetary policy, including Quantitative Easing (QE). But this fiscal relaxation left a legacy of huge government debt that subsequently prompted many governments to tighten fiscal policy.

There are serious worries that, with debt so high, governments will not be able to respond to a future economic downturn by relaxing fiscal policy again.

The essential idea of MMT is that, for countries that issue their own money, orthodox financial restraints should no longer be accepted. For, even if the yields on government bonds are not immediately driven up by an expansionary fiscal policy, there is the risk that this will happen subsequently, thereby causing a major increase in the cost of funding the debt. This would eventually force governments into unpalatable action – perhaps involving the slashing of government spending and/or increasing taxes.

Admittedly, low interest rates make it possible to sustain higher debt – while they last. But they may not last. Accordingly, high debt is risky and it is right for governments to be fiscally cautious and to reduce deficits and aim for a lower ratio of debt to GDP when they can.

Meanwhile, although there is scope for more QE, this doesn’t exactly appeal either. This policy has boosted asset prices and thereby mainly benefited the rich, while causing significant distortions to the economy. Moreover, it is not clear that recent bursts of QE have done much good. The banks have largely sat on the money.

This is where MMT comes in. The essential idea is that, for countries that issue their own money, orthodox financial restraints should no longer be accepted. If extra government spending was financed by printing money, there wouldn’t be any need for a rise in interest rates on government bonds, either now or in the future. And the increase in the money supply delivered in this way would be more effective than ordinary QE, because the extra money would land up directly in households’ and companies’ bank accounts. They would be more likely to spend it than banks are to lend it. So, you can see why MMT appeals to thinkers on the Left. Suddenly, it is a case of “Debt: where is thy sting?”

But does MMT make sense? The answer is that it all depends. For a start, this policy of money-financed increases in government spending is not as novel as you might think. It corresponds to the idea of so-called “helicopter money”. This term derives from the imagined use of a helicopter to drop dollar bills on the population, which first appeared in an article by the great American monetarist Milton Friedman in 1969. But in the Thirties, Keynes had suggested something similar when he advocated workers being employed to bury bottles containing Bank of England notes, for other groups of workers to be employed to dig them up again.

Interestingly, this “helicopter money” idea is not so different from policies that have been pursued recently in a number of countries. A drop of “helicopter money” amounts to a combination of an increased government deficit (caused by higher spending and/or lower taxes), funded by issuing new bonds, and a policy of QE under which the central bank buys the new bonds. The net result is a money-financed increase in government borrowing.

There is a slight difference, though. In the conventional case the extra debt still exists and at some point, the central bank may return it to the markets, at which point the danger of the government having to pay much higher interest rates on its debt re-emerges. This risk may act as a restraint on governments. Moreover, the prospect of this happening at some stage may conceivably inhibit the private sector from responding to the policy by increasing its spending, such that this type of expansionary policy is less effective than one where debt never has to be redeemed or sold to the markets.

Can such a policy of money-financed government spending be supported? In some circumstances, it can. If we find ourselves in a really serious downturn and conventional measures don’t offer any prospect of success, then it would be defensible to ward off an economic disaster by implementing a money-financed fiscal expansion.

But there are severe risks attached to such an approach. The constraints imposed by the debt markets have a definite utility. They restrain governments’ natural tendency to spend and borrow willy-nilly. If those constraints are not present, there will be next to no defence against both rampant inflation and an extreme waste of resources by a public sector no longer inhibited by the perceived need to husband money carefully.

This is why there has been such a taboo surrounding the direct monetary financing of governments. In view of the painful experience of hyperinflation during the interwar Weimar Republic, and again at the end of the Second World War, this taboo has been not just obeyed but actively fostered by the German Bundesbank. It has framed the legal restraints on the European Central Bank.

Taboos may seem irrational but in our imperfect world they can serve a useful function. The point is not that they can never be broken but rather that they should only be broken in extreme circumstances. Tell Fred.

Roger Bootle is chairman of Capital Economics

Sub-panel

How does quantitative easing work?
Since the financial crisis, policymakers have looked for new ways to support their economies.

One of the tools they have leaned on has been quantitative easing, or QE.

Central banks, like the Federal Reserve, European Central Bank and the Bank of England, have created new money to buy financial assets.

QE is sometimes known as ‘money-printing’. But in reality, no hard cash is actually created and most of us will never see it.

Instead, a central bank is able to digitally create money, which is then deployed to purchase things like government debt in the form of bonds.

QE helps lower the yield investors can get from these ‘safe assets’.

In doing so, it makes them less attractive, encouraging the same investors to go out and put their money in riskier things in the search for better returns on their investment.

One class of such assets is stocks, and since QE came into the world, global stock markets have been on a healthy bull run.

The theory also goes that the institutions that sell these safe bonds also put their money elsewhere, like lending to people and companies, and thus helping boost economic activity.

--