MMT=TANSTAAFL

Modern monetary theory may have a place in helping fuel economic activity, but if practised recklessly, the costs could easily outweigh the benefits.

By David Stonehouse

In 1966, Robert Heinlein wrote The Moon is a Harsh Mistress, widely acknowledged as one of the greatest science fiction novels of all time. Part of the plot involves the false notion that the moon has inexhaustible resources for humans to exploit. The book helped popularize the phrase TANSTAAFL: There ain't no such thing as a free lunch.

Another acronym that has gained popularity recently is MMT, or Modern Monetary Theory. The doctrine espoused by a growing list of U.S. politicians, including presidential hopeful Bernie Sanders, claims that policymakers can spend as much money as required to achieve their goals (i.e., run fiscal deficits) and finance that spending by printing money (i.e., quantitative easing) as long as the country has independent control of its currency and monetary policy.

On the surface, it may appear as though MMTers have hit upon the proverbial free lunch and given the current backdrop of high income inequality and low interest rates, it may well continue to gain favour. But in reality, modern monetary theory is more complex and several constraining factors could rein in its promise over time.

That's not to say there aren't positive aspects to the theory. To start with, deficit spending since the financial crisis has contributed to U.S. GDP growth without much downside impact, at least so far. Although the notion that persistent deficits can be good goes against conventional economic wisdom, proponents of MMT have been emboldened by the past decade of unprecedented fiscal and monetary stimulus, which has helped fuel the country's recovery from the financial crisis without causing the runaway inflation that many had been predicting.

As such, modern monetary theory is seen by some as a funding panacea to a more utopian society supporting everything from full employment and a universal basic income to comprehensive public healthcare and more robust environmental initiatives. To be sure, budget deficits can be prudent policy in certain circumstances. They can boost economic activity with little near-term cost. These actions can help close output gaps and stimulate economies that are struggling to revive animal spirits following a financial crisis. Spending can be directed toward productive initiatives such as infrastructure or education, and also assist social welfare programs like healthcare.

Indeed, it can be argued that the U.S. has already been employing a form of MMT over parts of the past decade when deficit spending approved by U.S. Congress and implemented by the U.S. Treasury coincided with quantitative easing executed by the U.S. Federal Reserve. Some observers question the need to increase spending ten years into an expansion with unemployment at 50 year lows. However, the labour force participation rate remains 4% below its peak in the U.S, skill mismatches suggest that training and education could reduce under-employment, and aging infrastructure desperately needs upgrading – all factors which suggest there may be room for more growth.

Perhaps the most advanced and concrete example of MMT-like policies has been Japan, where Abenomics has involved a more explicit budget deficit program financed in large part by QE from the Bank of Japan. In sum, it can be argued that MMT is happening to a degree, may be working to some extent, and has some runway to be employed more aggressively without dire consequences, at least in the near term.

However, all but the most vehement supporters of the unorthodox theory realize that, taken too far, MMT could have serious negative ramifications for the economy.

First, there is the dilemma of higher interest payments as deficits grow ever larger. The more that governments need to spend on servicing their debt, the less they have to allocate to other more beneficial areas of the budget, including many of those espoused by MMTers. This "crowding out" occurs even when rates are as low as they are today.

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The annual interest payment on the U.S. national debt, for example, is greater than US$300-billion and is projected to triple to more than US$900-billion over the next decade, according to the Congressional Budget Office. This will represent up to 13% of the federal budget a decade from now, surpassing spending on both Medicaid and national defense. In response to this constraint, MMTers might simply advocate printing money to cover interest payments, or maintaining interest rates at or near zero to minimize these costs. However, these decisions lie within the purview of the Fed.

Second, true MMT involves not just deficit spending, but the coordination of fiscal and monetary policy. As noted before, there have been points in time earlier this decade that fiscal deficits and quantitative easing have been employed concurrently, but in recent years the Fed's balance sheet has stopped expanding, and over the past year and a half has actually been shrinking through quantitative tightening. MMTers argue that the Fed can finance a virtually unlimited amount of spending by buying Treasury bonds issued to cover the interest payment problem noted above, but unless the Fed proves willing to monetize the debt, congressional budget limits and rising interest costs will continue to squeeze government spending on other programs.

The Fed is fiercely protective of its independence and is unlikely to engage in monetization under normal circumstances, but rather would do so only if there is clear evidence that the economy is in serious trouble. It will be very difficult to coordinate congressional deficit spending with Fed easing policy on a prolonged basis unless the Fed loses its independence. This risk may be more significant than many believe, given rumblings from various quarters in the U.S. political system (ironically for different reasons), but the bar is likely high for such an outcome.

The third potential constraint is the possibility of inflation finally rearing its head. While MMTers point to the past decade of price stability as validation, most concede that future spending would have to be curtailed (or taxes raised) should prices rise too aggressively once economic slack is eliminated. In addition, large amounts of money printing could also boost inflation as a result of substantial currency depreciation, leading to a loss of purchasing power. That's not something to be overly concerned about in the current situation, they contend, but the challenge is knowing when it's time to put on the brakes in order to keep inflation at bay. The eventuality of inflation is the primary fear of many in the anti-MMT corner.

This tendency for human greed to mess up even the best-laid plans is the fourth concern. Politicians are notorious for succumbing to the temptation of instant gratification at the expense of longer term benefits. Once Pandora's box is open, it can be extremely difficult to close again: the government may find it nearly impossible to wean itself off deficits (and inflation). Look no further than the introduction of income taxes in Canada in 1917, which were portrayed as just a "temporary" measure to finance war spending, or the difficulty the Fed faced in taming inflation when Paul Volcker was chairman from 1979 to 1987.

An even more fundamental challenge to unlimited government spending is the scarcity of resources in the economy. Modern economies need public sector spending for essential services when the private sector is unable or unwilling to undertake those activities, or when society deems it preferable for the government to do so (e.g., armed forces, portions of education, health care, water utilities, fire departments, etc.). However, as Adam Smith's invisible hand concept taught us, and based on the struggles of most centrally planned societies, the public sector generally allocates capital less efficiently than the private sector. While some government spending such as infrastructure can be productive, often it is allocated to less productive programs, which may in part explain why developed countries whose governments represent a large portion of GDP tend to be slower growing. In fact, this constraint may be the ultimate guard rail for MMT to contend with.

The key, then, is for governments to formulate reasonable budgets that prioritize productive opportunities without spending beyond the economy's resource limits. There still appears to be some runway for further non-inflationary spending in the U.S., but eventually the government will hit this limit if it persists in running large deficits, even if they're financed with the support of the Fed. Whether it's construction workers needed to support a bulked-up infrastructure bill or doctors and nurses to facilitate an increase in healthcare spending, at some point, there won't be enough people in the workforce to put that extra money to work, or the spending may be misdirected to areas where it's not productive (e.g., building bridges to nowhere due to a surplus of workers with construction skills while there's a chronic shortage of STEM workers).

Ultimately, modern monetary theory presents a challenge to long-held economic beliefs that cannot be ignored and could plausibly be implemented on a larger scale in the years to come.

But while higher government deficits and substantial quantitative easing have clearly provided some boost to the U.S. economy and financial markets over the past decade, MMT has its limits, and left to run amok could result in long-term costs (inflation, misallocation of resources, eroded productivity) that far exceed the benefits. There truly is no free lunch.

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