The post Covid-19 new normal, a time for the decidedly abnormal: an opportunity for modern monetary theory?

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With governments daily announcing ever more extensive economic support packages, fiscal and other rules discarded, and monetary policy about as easy as it could conceivably be, the macroeconomic paradigm prevailing across Europe has been transformed. The questions now are what next and how will matters evolve as the Covid-19 economic crisis abates? A much-discussed answer has been modern monetary theory (MMT), an approach to macroeconomic policymaking that had already gained considerable traction prior to the pandemic.

The proposition at the heart of MMT is beguilingly simple: because governments are in the privileged position of controlling the issue of currency, even when delegated to an 'independent' – a point of contention – central bank, they can increase spending without having to raise taxes, simply by ordering the central bank to 'print' money, which it can do at virtually zero marginal costs.

The approach became especially prominent in the US where it was espoused by many on the left of the Democratic Party, not least Bernie Sanders and Alexandra Ocasio-Cortez, with the latter saying in an interview with Business Insider, pre-pandemic, it needed to be 'a larger part of our conversation'. Stephanie Kelton, one of the leading and most publicly visible advocates of MMT, captures its essence in the title of her book, published in 2020 *The Deficit Myth: Modern Monetary Theory and How to Build a Better Economy*. In her view, 'the idea that taxes pay for what the government spends is pure fantasy' (for the main arguments at stake, see Annex Table).

MMT has, however, proved to be a red rag to the bull of mainstream economists, attracting not just analytic criticism but considerable derision. For Willem Buiter and Catherine Mann, past and current chief economists of Citi, 'what's right is not new, what's new is not right, what's left is too simplistic'. Larry Summers has been especially scathing, resurrecting the term he used to denigrate the supply-side policies of the Reagan era: 'voodoo economics'. As the opening line of a *Financial Times Alphaville* comment observes, 'MMT is a theory that people love to love, and love to hate'.

It has certainly garnered far more attention than other supposedly 'heterodox' approaches, such as Post-Keynesianism, even prompting some of the latter's proponents to admit to envy. Even so, before Covid-19, MMT and the tribe of economists who developed and advocated it, were generally regarded more as a radical, even eccentric curiosity, than as a credible alternative macroeconomic paradigm. However, with the world facing policy challenges so far out of the ordinary, it is reasonable to ask a double question: can MMT be the basis for policies to foster a recovery from the severe downturn induced by the pandemic and in what way would its prescriptions differ from those already being implemented or under consideration?

This policy note considers whether it is a plausible basis for macroeconomic policy today, while also asking how it would make a difference. The potential applicability of MMT to recovery in the Eurozone is then assessed, and concluding comments complete the note.

Does MMT make sense in a severe downturn?

There are three certain outcomes from how the economic crisis is unfolding. The first is a substantial rise in public sector debt because of the extensive, and entirely justified, actions by governments to cushion the blow of lockdown. Second, workers will face unemployment or under-employment because of the combination of economic activities in hibernation and employers having to retrench. In what might seem to be an oxymoron, the third certainty is that there will be uncertainty about the future trajectory of economies. All of this poses a profound policy challenges to economists. Is debt to be avoided or encouraged? Is printing money a better option rather than saddling the next generation with liabilities? Is all this public spending bound to stoke-up inflation or, in these exceptional conditions, is the argument hollow?

The Roosevelt 'New Deal' in the 1930s was lauded as a break with the discredited thinking of the recent past on how to counter a severe depression, but it is instructive to examine how it unfolded. However, Price Fishback, in a comprehensive article on fiscal and monetary policy during the 1930s Great Depression in the US, shows that the common perception of the Roosevelt New Deal as a massive fiscal stimulus (in stark contrast to the policies of his predecessor, Hoover) is inaccurate. Hoover's administration undoubtedly made egregious policy mistakes, although the Federal Reserve is painted as the greater culprit, but it massively increased public spending between 1929 and 1933. Roosevelt then gave a further large boost to federal spending. However, both the Hoover and Roosevelt administrations sought to finance the higher spending mainly by raising taxes; as he notes: between them, they 'raised the federal debt as a percentage of GDP by 28 percentage points, from 16 per cent in 1929 to 44 per cent in 1939'. The economic effects of the pandemic are, arguably, quite like the 1930s, and it may be that currency issue would reinforce the response.

Clearly, the severity of the current downturn in much of Europe and North America has induced massive policy responses, a number of which – not least the massive 'Biden' recovery package and his promise of a further huge outlay on infrastructure investment – are consistent with MMT propositions, but that is not necessarily the same as policy motivated by a conversion to MMT. Monetary policy is at, or very close, to the effective lower bound (ELB) – distinguished from the zero lower bound only because some central banks have resorted to negative interest rates. The Fed and the Bank of England have ramped up purchases of assets, as has the ECB through the Pandemic Emergency Purchase Programme (PEPP).

A new interaction between fiscal and monetary policy is undoubtedly being shaped and will be a key strategic issue for macroeconomic policymaking. For example, in the UK, government borrowing has been facilitated by these monetary measures. Mainstream economists would generally approve: thus, according to Willem Buiter, 'monetized increases in public spending or tax cuts is an appropriate policy response under such extraordinary conditions. So long as interest rates are stuck at the ELB, cash disbursements will not be inflationary'. At a news conference during the 2019 spring meetings of the IMF and World Bank in Washington. Christine Lagarde, while asserting that MMT is 'no panacea' has conceded that it can be helpful in averting deflation, the latter clearly a greater risk at a time of severe contraction – or, as in Japan, of prolonged stagnation – of the economy.

What is much less clear is whether the fiscal responses enacted by so many governments since the pandemic hit would have been different if MMT had already become the policy paradigm. Nersisyan and Wray stress that MMT is not about 'helicopter drops of cash or having the Federal Reserve finance government spending through rebooted quantitative easing'. Instead it 'provides an analysis of fiscal and monetary policy applicable to national governments with sovereign, nonconvertible currencies' in which the idea of a public sector budget constraint is rejected because a government with a sovereign currency cannot run out of money.

In practice, governments have not allowed budget constraints to deter them and have allowed deficits and debts to surge, in the knowledge that markets are not penalising them. Central banks have accommodated them, but there is a clear sense that this is temporary. MMT would have meant using currency issue to finance the exceptional spending, but with uncertain consequences and no time limit, provided inflation remained quiescent. Some, such as Peter Bofinger, argue that 'the theoretical core of MMT can be easily reconciled with standard macroeconomic principles' and he implies that it makes sense in current conditions, although he warns that too big a dose could turn it from a cure into a poison.

Moreover, the promise of herd immunity from the roll-out of the various Covid-19 vaccines is widely expected to see a rapid bounce-back in economies, leading to a winding-down of extraordinary measures. An assessment of whether MMT makes sense would then revert to arguments made in pre-pandemic times about whether it is macroeconomically sustainable.

Could MMT work in Europe?

Most of the debate on whether MMT can offer a radical new approach to policy has focused on the US where – overlooking the doubts about whether it would be advisable – many accept it could be attempted. This prompts the question of whether the country has distinctive attributes or whether others could also adopt a similar macroeconomic policy. In particular, how workable might it be in the EU and, specifically, the Eurozone, again irrespective of whether it is a good idea?

Here the problem is twofold. First, the ECB is legally constrained by the terms of the treaty, and even if it found a way to provide the financing MMT requires, it would be sure to be hauled before the European Court of Justice, as has happened with complaints emanating from Germany, especially, relating to much less radical policies. Second, the ECB is not like the Fed or the Banks of England or Japan in one crucial respect. It is a supranational institution, dealing with a diversity of national fiscal authorities, rather than a single finance ministry at the supranational level.

In principle, if a currency fulfils the four criteria explained by L. Randall Wray, it could fund its public spending by issuing more money. These boil down to an independent, sovereign currency and its use for all government transactions. The real-world test is whether those dealing with governments would have sufficient confidence in the stability of the currency to accept it in exchange for their labour, products or services. MMTers acknowledge that the onset of inflation would set a limit and there are numerous examples across the world and over the centuries of governments debasing the currency to create ever more money.

Plainly, the US dollar has the 'exorbitant privilege' – as Valéry Giscard d'Estaing portrayed it – of being the preeminent global reserve currency, enabling it to conduct monetary policy almost exclusively to meet domestic objectives, irrespective of any consequences for those holding and using dollars elsewhere. Increasing the supply of dollars will therefore have an impact on other countries, eroding the value of their holdings of dollars and creating incentives to diversify. If done so to excess, the US dollar could lose its lustre, although this would be a slow process in the absence of a convincing alternative. As Otmar Issing puts it: if US policy-makers wanted to close the door to foreign capital and harm the status of the world's supreme reserve currency, introducing MMT would be a sure way to do it'.

However, this would not happen quickly because of the extent to which holders of dollar denominated assets – not least China's massive official reserves – are 'locked-in'. At the other extreme, a newly created country with weak institutions embarking on MMT would rapidly be in trouble. In between, Japan has been close to following MMT for some time, as has the UK in its response to the pandemic, with the Bank of England financing much of the exceptional spending by the government. Purists will argue that this is not strictly MMT because the government continues (successfully) to issue bonds, but as Olivier Blanchard said in a 2019 event at the Peterson Institute, currency issue and debt are effectively the same if the interest rate is zero.

In Europe, where economies are relatively more open (especially the smaller ones), it will be hard to contain the leakage of additional government spending across borders, as the well-documented episode of the Mitterrand public spending surge in France in the early 1980s demonstrated. A concerted action, with countries boosting spending simultaneously, could mitigate this risk, but would face formidable political economy obstacles, as has been shown repeatedly when initiatives involving cross-border spending in Europe are put forward.

The Eurozone, however, is manifestly different. In international finance, the euro is the second global currency, has a powerful central bank which has shown its capacity to act decisively when faced with crises ('whatever it takes'), and has been willing to 'stretch' its mandate, for example in how it introduced what, in effect is quantitative easing. But the ECB does not have a fiscal policy counterparty in the same ways as the Fed has with the US Treasury. Instead, the Eurozone has to deal with nineteen independent fiscal authorities and, further complicating matters, the nineteen lack a credible mechanism for coordinating their action. In addition, the other institutions at EU level, let alone in the Eurozone, do not hold sway over the ECB as MMT envisages. In short, there is no mechanism for instructing the central bank to print money and, in the terms Wray describes for a sovereign currency, no Eurozone member state has one.

There is an answer, namely to endow the EU level with a Treasury and allow it to determine spending in the member states. But no-one who knows how the EU works can seriously believe this is a realistic prospect even over an extended time-horizon. The slow progress on the many aspects of economic governance generally agreed to be needed to complete economic and monetary union should be recalled, making it hard to imagine steps as radical as MMT would entail. There are also strongly entrenched national differences, reflecting the fact the EU is some way short of being a state.

It might be argued that change could be accelerated by the pandemic which, notably, has brought forth a massive (and rightly applauded) response in the form of the *Next Generation EU* package, to be funded by direct borrowing by the EU level. Experience of how the EU functions suggests a borrowing capability of this sort is quite likely to remain as an EU policy instrument, even though the agreement to establish it describes it as temporary. While it could become an opportunity for MMT-type policies – again abstracting from whether or not they are desirable – acute institutional obstacles would have to be overcome, even in the unlikely event that the political will were there.

A first is that abandoning central bank independence as a cornerstone of EMU governance seems implausible, and it is hard – impossible even – to conceive of a pathway to do so, especially in the face of the inevitable opposition from Germany and other creditor states. Second, MMT would require a coherent supranational fiscal authority to be created and for it to have the political capacity to steer spending. Although the US suffers from 'pork-barrel' politics in shaping spending allocations, the problem would be orders of magnitude greater in the EU, as anyone acquainted with the almost surreal politics of agreeing the EU budget knows. The underlying problem is simply explained: the EU is not a political union and being one is a pre-condition for deficit spending as a standard tool of macroeconomic management, the NGEU innovation notwithstanding.

Conclusion

While exceptional times call for exceptional measures, it is important to distinguish between the cases for actions designed specifically to respond to the sharp downturn resulting from the pandemic and for the longer-term recasting of macroeconomic policy. MMT has looked like a credible solution and has gained obvious traction as governments introduce ever larger support packages. In contrast to just a few years ago, when austerity ruled, the idea of being constrained by financial markets concerned about widening deficits seems implausible. Some of the immediate actions taken by policymakers are, undeniably, consistent with MMT, though also with more conventional policy.

Among its advocates, Stephanie Kelton is especially articulate, energetic and telegenic, but there is a strong streak of populism underlying her message, alongside too little discussion of pitfalls. As one especially acerbic reviewer of her book, Robert Wenzel (author of a short book debunking MMT), put it 'from start to finish, it is extremely difficult to find anything positive to say about Stephanie Kelton's new book'. In another, Terence Burnham is more nuanced, observing in reply to his own rhetorical question: 'the answer is that we do not know if MMT is correct'. He goes on to suggest 'MMT is probably going to end in financial disaster. That being said, all the naysayers (including me) predicted collapse sooner. So, for now, MMT rules the world'. In his review of Kelton's book, John Cochrane concludes with the damning statement 'skeptics have called it "magical monetary theory." They're right'.

Many of the policy responses to the pandemic include actions consistent with MMT, but as an overall package the approach is not only unproven – having never really been tried – but needs to show how a stimulus financed by currency issue could be phased-out. It is not enough for MMT proponents to describe a process of tax increases without delving into the political economy of how the brakes could be applied to an overheating economy.

In short, though tempting, the case for MMT is not – or not yet – sufficiently persuasive to justify the switch of paradigm and institutional transformation it would require, especially in Europe. Greg Mankiw, who tried to relate MMT to mainstream thinking, drawing on the Mitchell at al book which provides one of the most complete exposition of MMT, makes the point succinctly:

> 'I should admit that I found the task of figuring out MMT to be vexing. As I studied it, I was often puzzled about what precisely was being asserted. I hasten to add that the problems I had could have been of my own making. Perhaps after forty years in the profession, I am too steeped in mainstream macroeconomics to fully appreciate MMT. I raise this possibility because MMT proponents may say that I missed the nuances of their approach'.

As the former Australian Prime Minister, Malcolm Turnbull, once said: 'when politicians offer you something that sounds too good to be true, it's always worth taking a careful second look'.

PRE-COVID, IN FAVOUR OF MMT	PRE-COVID, HOSTILE TO MMT	WHAT STEPHANIE KELTON SAYS	SINCE COVID, IN FAVOUR OF MMT	SINCE COVID, HOSTILE TO MMT
MMT is not about Congress ordering the Fed to use its “balance sheet as a cash cow.” Rather, it is about understanding how monetary operations actually work, how interest rates are set, and what economic powers the US government has – Jamie Galbraith	I have not really seen a carefully worked out, you know, description of what is meant by MMT, what you are mentioning. It may exist, but I have not seen it. I have heard some pretty extreme claims attributed to that framework, and I do not know whether that is fair or not. But I will say this: The idea that deficits do not matter for countries that can borrow in their own currency I think is just wrong – Jerome Powell	There is a doctrine among mainstream economists that …the government can take more of the economy’s financial resources, but only at the expense of lost private investment. This means that running budget deficits has at least some downside. Paul Krugman is a believer in this doctrine. I‘m not.	If you haven’t started worrying about deficits don’t start, if you have started, stop – Jamie Galbraith	Basically, most of the claims of “modern monetary theory” are true; and we are already doing them. We’ve been doing them for the last fifty years, and more. If that’s the case, what’s the point of MMT? The point — this is pretty common in economics — is to provide a justification to do something silly, since its hard to justify silly things if you named things in plain terms – Nathan Lewis (for Forbes)
The greatest achievement of MMT so far has been to disprove the idea that there is no alternative to neoliberal ideology – Louis-Philippe Rochon	[MMT] takes ideas that have a little bit of validity and extends them to a grotesque point where they defy the laws of arithmetic – Larry Summers	The deficit is this barrier both mental and – in a sense – real, that prevents us from getting better economic policy	The danger conjured up by MMT critics, that high deficits could lead to inflation, is very unlikely in the case of the Covid-19 crisis – Peter Bofinger	The path to painless cost-free state financing is an illusion – Otmar Issing
We had a hard time making progress in economics or in policy circles. Bill, Warren, Mat Forstater and I used to meet up every year or so to count the number of economists who understood what we were talking about. It took over decade before we got up to a dozen. – L Randall Wray	MMTers are messianic in their claims to have proved even conventional Keynesianism wrong, tend to be unclear about what exactly their differences with conventional views are, and also have a strong habit of dismissing out of hand any attempt to make sense of what they’re saying – Paul Krugman	Governments aren’t like households because governments issue the currency. And households are what we want to think of as users of the currency …. The government’s cheques never bounce	Modern Money Theory (MMT) has been thrust into the spotlight again, as numerous governments around the world respond to the pandemic. Unfortunately, those invoking MMT misrepresent its main tenets – Yeva Nersisyan and L. Randall Wray	It is not a theory because the appropriate size of the government budget deficit and how much money to print depend entirely upon the context of the decision – Mervyn King