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MMT suggests policymakers have more ammunition than they think

Modern Monetary Theory, known as MMT, challenges conventional macroeconomic policy thinking; it has been dismissed by mainstream economists and policymakers variously as obvious, wrong, and dangerous. But it is time to take MMT insights seriously.

Monetary and fiscal policy settings in much of the developed world, stretched by responses to the Global Financial Crisis and Great Recession, are far from being returned to normal. Policymakers worry that they will not have enough "ammunition" to fight the next economic downturn, when it comes. An MMT lens reveals that the government *always* has the fiscal and monetary wherewithal to fight a recession.

The essential insight of MMT is that governments *create* money when they run a budget deficit, because they inject more purchasing power into the economy (by their spending) than they withdraw (in taxes): they can't "run out" of money. This seems to turn conventional thinking on its head: don't governments have to *raise* money in order to spend it? Isn't that what taxes and government debt markets are for?

Under the current framework strictly separating monetary and fiscal policy, this is indeed how things work. It is precisely because governments can create money at will, and risk causing runaway inflation as a result, that in the latter part of the twentieth century they tied their hands against being able to do so. Central banks were given "independence" in order to be able to put a check on governments' money creation. MMT reminds us that this state of affairs is self-imposed, not God-given.

The central bank is the banker to the government as well as to the banking system. If it allowed the government's account with it to go into overdraft (without limit), budget deficits would never have to be "financed" by the government issuing bonds; rather those deficits would just show up as newly created central bank reserves and bank deposits. This is essentially how quantitative easing works: government debt securities, which were issued to soak up the reserves created by the budget deficit, are turned back into central bank money.

Adopting an MMT view suggests that policymakers' concerns that they will have limited policy ammunition in the next economic downturn are misplaced. True, government debt levels remain high and the balance sheets of major central banks remain "bloated" by QE. The Fed's policy rate appears to have peaked in this cycle at an underwhelming 2.25-2.5%.

But when the economy falls into a Keynesian state of insufficient aggregate demand and its flipside of high unemployment, can it be that policymakers are rendered impotent because monetary policy has "run out of ammunition" and "fiscal space is limited"? An MMT perspective suggests not.

Such confidence-sapping hand-wringing reflects the constraints of the current policy framework, constraints that were put in place to solve a very different problem: the need to keep the government's hands off the printing press lest it spend too much and trigger high inflation. But the very loosening of these constraints can provide the policy ammunition economists lament is lacking. MMT brings glad tidings.

The reaction of mainstream economists to MMT coming out of the shadows and having its day in the sun has generally been hostile and dismissive. As a heterodox school of economic thought, MMT has been around for a couple of decades and, admittedly, has taken its fair share of potshots at the mainstream. Now that the mainstream has woken up to the existence of MMT, and feels under attack, it is not too surprising that its knee-jerk reaction is to respond in kind. But this is not productive for anyone.

The insights of MMT gel well with much emergent mainstream academic and policy thinking. There is much lamenting in policy circles of central banks being "the only game in town". Notable economists such as Olivier Blanchard, Paul Krugman and Lawrence Summers argue that the world may have entered an era of structurally low real interest rates, providing much more scope for fiscal policy to be mobilized than previously assumed.

Japan's experience provides a laboratory lesson too. After years of QE, the Bank of Japan now holds almost half of government debt securities outstanding and since September 2016 has been pegging the ten-year yield on government bonds at around zero percent. Yet the inflation rate remains doggedly below the BOJ's 2 percent target. Japan's problem is not that policymakers lack ammunition – it is that they act as if they do. That is the only way to explain why, spooked by a government debt to GDP of about 237%, they are about to put the fiscal brakes on again.

It is time to fundamentally rethink the conventional macroeconomic policy framework in preparation for future economic downturns. Monetary and fiscal policy need to be better aligned and coordinated so that they can be mobilized quickly and effectively when needed, and in the right combination. MMT can play a useful role in that debate. But economists on both sides have to put down their rhetorical pitchforks first.

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