Modern Monetary Theory Delusions

By Charles Lieberman, PhD
A hot debate has erupted over “modern monetary theory” (MMT), which promoters allege justifies an increase in government deficit spending to pay for the Green New Deal and other programs. The government would issue as much debt as needed to raise funds, and the Federal Reserve (the Fed) would buy the debt by printing the money. MMT proponents claim there would be no adverse consequences because the debt is denominated in dollars and the Fed can print as many dollars as required.

One vocal and visible MMT promoter is Stephanie Kelton, former chief economist of the Senate Budget Committee for the Democratic minority staff, a former senior advisor to Bernie Sanders, and a professor of economics at Stony Brook University. Kelton has argued that any country engaged in MMT doesn’t have a deficit problem unless it has an inflation problem; she states that running very large deficits does not lead to rising inflation (Helfand 2019; Malter 2019). Kelton notes that because the U.S. government can print its own money to meet any obligation (the Fed would do the printing and buy the Treasury’s newly issued debt), it is not possible for the U.S. government to ever become insolvent. This is true, but others believe that dire consequences will ensue.

Kelton’s argument stands on the basic view that increased government spending is desirable to fight high unemployment, even when that spending creates a deficit. This basic view is held by Keynesians and has been mainstream for many years. But Kelton goes further by maintaining there is no limit to the size of the budget deficit that can be run as long as there is no inflation problem—and she sees no link between too much federal spending and inflation. She calls such a link “hard to believe.” Others, however, believe that MMT misses the inevitable link between too much federal spending, printing money, and inflation.

THE SOMETIMES TRAGIC HISTORY OF DEFICIT FINANCE

The legal ability to print money has long been held exclusively by government, despite the best efforts of counterfeiters. Economies need currency with which to conduct business transactions. In supplying money to their economies, governments enjoy seigniorage, which is the difference between the face value of money, such as a $10 bill, and the cost to produce it. Governments can print currency at little cost and use it to buy goods and services for the government beyond whatever tax revenues they can impose on their economies. And for the most part, governments have handled this ability to print money fairly responsibly. But they can and have gone overboard with severe adverse consequences.

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With one notable exception, every time governments have printed money copiously to pay bills, the result was rising inflation and, in the extreme, hyperinflation. Two egregious examples are the Weimar Republic and its hyperinflation in Germany in the 1920s and Zimbabwe in 2008–2009. Both printed vast, seemingly unlimited quantities of money to finance government spending, but they paid for this behavior with runaway inflation. Recently, Venezuela, which is experiencing eroding oil revenues, has managed its deficits by printing more money, and its inflation rate has risen from around 800 percent annually in 2016 to an estimated 1–million percent in 2018. These are the extreme examples trotted out to explain why printing money is economically dangerous.

More moderate versions are more common, with lesser but still problematical results. When Italy and France had their own currencies, both economies continually suffered from higher inflation than the rest of Europe. They found it difficult politically to pay for their high level of government spending with taxes, so they made up the difference by printing money and tended to have higher inflation than their neighbors. These higher inflation rates weakened their currencies.
to offset the rise in domestic prices and to maintain competitiveness. Neighboring governments resented that the French and Italians were always weakening their currencies in order to maintain their competitiveness to sell goods. So, the Europeans pressed to adopt a single currency that would make competitive devaluations a thing of the past. Indeed, when the Italians and French pegged their currencies to the rest of Europe, their higher rates of inflation killed their competitiveness and they suffered high unemployment even when they chose to run larger government budget deficits.

Some Latin American countries, such as Argentina and Brazil, also have chosen to fund budget deficits by printing money to pay for their spending. These episodes also ended badly. Bonds issued in their own currencies required ever higher interest rates to compensate investors for rising inflation, so these governments resorted to issuing bonds in foreign currencies, such as the U.S. dollar. But the international investment community’s appetite for Latin American bond issues in the U.S. dollar was sated when foreign investors worried they’d never be repaid. A buyer’s revolt resulted in a financial meltdown in Latin America in the 1980s, because those governments could no longer fund their deficits.1

Even the United States has succumbed to this temptation. In the 1960s, when Lyndon Johnson sought to finance “guns and butter” spending on Great Society programs and also pay for a war in Vietnam, inflation surged. The Fed imposed historically high interest rates in order to squeeze inflation out of the U.S. economy and bring down federal deficits.

The notable exception to large budget deficits without rising inflation is Japan, where the debt to gross domestic product ratio is about 2.5, well above the U.S. ratio of about 1.0. Yet Japan has been in recession or experienced rather little growth for more than two decades. It also has a shrinking population as well as a highly acquiescent population that seeks order and favors existing institutions. Workers don’t strike for higher wages in Japan. Redundant workers aren’t fired; they are given dead-end jobs with nothing to do. It isn’t clear that any other nation could mimic the Japanese economy, assuming it wished to do so. Regardless, we haven’t yet seen how Japan’s huge budget deficit will play out.

**THE CASE FOR AND AGAINST MMT**

Kelton’s argument seems to be based on the observable fact that the U.S. government is running a large budget deficit today without experiencing worrisome rising inflation. MMT advocates don’t seem to offer any explanation of what does cause inflation, and Kelton rejects outright the possibility that inflation may increase in response to large budget deficits albeit with a lag. MMT adherents also claim that if inflation were to increase, then government could prevent a surge by raising taxes. That may be true in theory, but in practice, governments raise or lower taxes when such action is politically expedient, not when it is most appropriate for the economy.

Inflation results when demand for goods and services exceeds supply, so rising prices are required to offset the difference. For example, consider an economy with $19 trillion in demand that is producing $19 trillion in goods when the government chooses to increase its spending by $1 trillion financed by printing money. There is now demand for $20 trillion of goods and services, but only $19 trillion is being produced. There are two possible outcomes. The first is that the economy expands more quickly so output increases to meet that higher level of demand. This is feasible when unemployed workers can be hired to increase output. In this case, deficit spending may be desirable. Indeed, this is precisely when Keynesians argue that fiscal stimulus should be used to help the economy get back to full employment quickly following a recession.

The second possibility is that the excess demand drives up inflation. The gap between $20 trillion in demand and $19 trillion in supply can be closed by a 5-percent price increase across the board, so that the $19 trillion in supply is repriced to cost $20 trillion. This situation arises when the economy is already at full employment, hiring is difficult because unemployed labor is scarce, and

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**Figure 1**

<table>
<thead>
<tr>
<th>Year</th>
<th>Unemployment Rate</th>
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<tr>
<td>1950</td>
<td>2</td>
</tr>
<tr>
<td>1960</td>
<td>3</td>
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<tr>
<td>1970</td>
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<td>2000</td>
<td>11</td>
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the effort to hire drives up labor costs and inflation, as suggested by figure 1. But the story does not end with this simple outcome. Demand was at $20 trillion before the 5-percent increase. Once prices rose, buyers paid $20 trillion, but only got $19 billion in inflation-adjusted goods and services, and the government got $1 trillion of that total. Consumers were frustrated in their effort to buy the goods they wanted. Before the government added that $1 billion to the spending stream, consumers were spending $19 trillion and getting $19 trillion. Once the government stepped in to buy $1 trillion worth of goods, consumers got only $18 trillion of goods, because inflation squeezed them out of the market for the $1 trillion of goods bought by the government. Even so, the increase in inflation almost certainly increased wages as well as prices. With more cash in their pockets, consumers might now try to buy $20 trillion instead of $19 trillion. But adding in the government spending, we now have $21 trillion in demand chasing a higher-priced $20 trillion in supply. Rinse and repeat and we get recurring, accelerating inflation. That’s how 5-percent inflation turns into 10 percent and 20 percent and hyperinflation, unless spending retrenches. As long as the government provides more money to pay for its own spending, it validates the general rise in demand and prices will keep rising. The simple fact that the government chose to print more money doesn’t increase the actual supply of goods and services. Those goods and services simply get repriced to cost more to equate supply with demand.

So, what determines which of the two outcomes may occur? (In reality, some of both is likely to occur, but to simplify the analysis, only the two extreme outcomes are being considered.) The key determinant of whether printing money to pay for new government programs creates inflation is whether the economy has the capacity to increase output. When unemployment is already low and labor is scarce, printing money causes inflation because the economy is constrained from producing more goods and services. That condition exists today. An increase in U.S. government deficit spending now would add to demand, but because labor is scarce, increasing the supply of goods to meet that higher level of demand likely would run into bottlenecks. In this case, excess demand can be met only by marking up the price of supply—inflation—so that supply can match up with demand once again.

This economic theory and historical experience are precisely why many economists criticized the Trump administration’s late 2017 tax bill, which injected incremental spending into an economy already enjoying low unemployment. Most economists expected the tax cut to prove inflationary. The very fact that it has not resulted in a surge in inflation has been taken up by MMT proponents as evidence to suggest it won’t and shouldn’t be expected to do so.

Proponents of MMT probably take comfort from the fact that government deficit spending has increased and inflation has not increased significantly, as yet. Indeed, it is the breakdown in the historical relationship between unemployment and inflation, known as the Phillips Curve, that has provided some credibility to their claims that printing money to finance debt need not result in rampant inflation (see figure 2). But this is a very weak reed on which to build the case for MMT. For one thing, MMT advocates offer no alternative theory or explanation for what causes higher inflation and none of them would argue explicitly that the laws of supply and demand have been repealed, which happens to be the underlying economic foundation for the Phillips Curve. Implicitly, if growing labor scarcity does not cause rising labor costs and higher inflation, supply and demand don’t matter. Now that’s really hard to believe.

Moreover, nothing in economic theory suggests that inflation must surge immediately in response to larger government budget deficits. Market reactions and adjustments to changing economic conditions can take some time. So, the risk today is for inflation to increase because of this deficit spending. And this would occur whether or not the increased supply of bonds is bought by the Fed. There’s simply too much demand chasing goods, and if the Fed printed more money, the Fed would be pouring gasoline on the fire.

**WHY HAS INFLATION BEEN MUTED?**

Some of the credit for keeping inflation contained surely goes to the Fed, which has been vocal about keeping inflation...
around its 2–percent target and maintaining its high level of credibility. But Fed officials understand perfectly well that an unemployment rate that is already below full employment could cause higher inflation at any time. In this politically charged environment, Fed officials are reluctant to raise interest rates until higher inflation becomes visible. If they raise rates to prevent rising inflation, critics will argue they are preventing growth from continuing. Indeed, President Donald Trump has criticized Fed Chair Jerome Powell for raising rates over the past year, and MMT proponents are also critical because they’d like to finance their social programs. The Fed gets little credit for inoculating the economy against a problem that isn’t visible, as yet. So, the Fed has acquiesced and will tolerate some rise in inflation at least until everyone sees higher inflation as an emerging problem.

The Fed also is operating within the context of a U.S. economy that is performing quite well, while many foreign economies are struggling. Strong demand here can be satisfied, at least in substantial part, by importing the difference. Using the example above, if there’s $20 trillion in demand but only $19 trillion being produced in the United States, we can always import $1 trillion to make up the difference, at least for a while. For a global economy struggling to grow, it is simply a godsend for those struggling economies to be able to sell more products to the United States. In fact, the overall U.S. trade deficit has increased even as the United States has become an exporter of crude oil and natural gas after many years of being a major importer, as shown in figure 3.

Rising imports can delay our domestically brewed inflation pressures, but they can’t overcome them. As the United States runs larger trade deficits, we are supplying the global economy with ever–larger quantities of dollars. Sooner or later, this dollar supply will turn into a dollar glut, which will drive down the value of the dollar and increase the price of imported goods to U.S. consumers.

Looking ahead, standard neoclassical economic theory suggests that the ongoing decline in the unemployment rate will become an ever–greater bottleneck in the economy that will lead to higher inflation. Theory is extremely clear on this point, even if it is incapable of providing much insight with regard to timing. Assorted pressures are likely to keep the Fed from acting in anticipation of such an outcome. And the fact that some Fed officials would prefer a period of inflation above 2 percent to make up for a period of inflation below 2 percent ensures that the Fed will not react either pre–emptively or quickly to a rise in inflation. MMT lacks a sound basis in theory and there is plenty of historical precedent to indicate that it is bad policy. If adopted by the government as policy, it is likely to lead the nation to experience more inflation than we would otherwise.

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ENDNOTE

REFERENCES

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