

Dr. Mike Walden: Are We Looking At A Test On Modern Monetary Theory ?

By Administrator

Wednesday, 24 March 2021 10:28 - Last Updated Wednesday, 24 March 2021 10:35

Although the main principles of economics were established decades ago, the discipline is constantly evolving. One of the most recent contributions has been a new field called “behavioral economics.” Here, scholars have developed ideas explaining why – in some cases – individuals appear to go against their own self-interest in making choices. I have found the insights of behavioral economics exceedingly useful. Apparently, so too has the economics profession, as several leaders in the field have won Nobel Prizes in recent years. There’s been another new development in economics that focuses on decisions impacting the big – or “macro” – economy rather than the individual – or “micro” – economy. The new development is termed “modern monetary theory,” or MMT. I’m sure the creators of MMT hope it will be as successful as behavioral economics. And they may not have to wait long because a big test of MMT could be approaching.

The main focus of MMT is on federal borrowing. Traditional economic theory states the federal government can pay for its spending in three ways. It can tax income away from households and businesses to fund the spending. Or, it can borrow money from private sources to pay for spending. Last, the federal government can borrow funds from the country’s central bank, the Federal Reserve.

With the first method, the costs of the spending are immediately paid by taxpayers. When borrowing from private sources, there are two costs. The first is regular interest payments on the loans, and the second is payment of the principal (the amount borrowed) when the term of the loan ends, unless the loan is refinanced.

With the third method – borrowing from the Federal Reserve – there is a unique aspect. When you or I pay taxes, we are sending money we’ve earned to the government. Similarly, if we willing loan money to the federal government because we want to include federal investments, called Treasury securities, as part of our investment portfolio, we are again using money we’ve earned.

But when the Federal Reserve loans money to the federal government, it is not using money the central bank has earned. Instead, the Federal Reserve uses money it has created. That’s right, the Federal Reserve has the unique ability to print money, although in today’s economy the creation is done digitally.

In the past, the Federal Reserve was careful about how much money it created for fears of sparking faster increases in prices, that is, higher inflation. In fact, there’s been substantial research from numerous countries showing a link between faster money creation and higher inflation.

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But now enter MMT. MMT questions the assumption of an automatic link between money creation and inflation. Specifically, MMT says if the government spending financed by newly created money makes the economy more productive – thereby leading to faster economic growth and more jobs and income – then the inflation rate won't rise. In addition, a larger economy will make debt payments more affordable for the federal government.

In short, MMT supporters see government spending backed by newly created money from the Federal Reserve as a way to unleash the economy's potential by investing in projects like infrastructure, education, and research.

Interestingly, MMT has the same goal as another macroeconomic theory, "supply-side economics" (SSE). Both ideas seek to increase the growth of the economy. But the ideas use opposite approaches. MMT uses increased government spending, debt, and money creation to boost the economy, whereas SSE lowers tax rates to motivate more private spending and investments.

SSE was applied as recently as 2017 when federal tax rates were cut to jump-start a sluggish economy. As you might expect, economists differ over whether the policy was successful.

Now we may be looking at a test of MMT. Over the past year the federal government has authorized \$6 trillion to be spent addressing Covid-19 and the resulting recession. Of the funds raised to date for this spending, the majority has come from the Federal Reserve. There will likely be more proposals forthcoming for additional federal spending, in areas like infrastructure, energy and climate, reductions of college student loans, and a basic income for households. If these proposals become reality, and if most of the financing comes from the Federal Reserve, then this will be a big, big test of MMT.

One of the things I like about being a professional economist is there's never a dull moment. Economists are constantly developing and debating new ideas about how the economy works and can be improved. Modern monetary theory is the latest in these ideas. Will MMT work, or will it fail? Soon, we may have a test to help us decide!

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