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Money and Debt: Are Central Banks "Borrowing" From Modern Monetary Theory?

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The fiscal and monetary responses to the COVID crisis have led to unprecedented public deficits and money printing. These policy prescriptions seem to agree with those of Modern Monetary Theory (MMT), a heterodox macroeconomic theory that emphasizes the (almost) unlimited spending potential of developed markets (DM) governments. **But while the policy reactions to the crisis could seem to vindicate MMT, mainstream adoption of the latter has not arrived.** Three facts show that central banks have not veered towards MMT: (1) inflation is still their core focus, (2) they have not lost their independence and (3) their COVID-era rules and tools are still mostly "conventional".

1. Inflation is the main disagreement

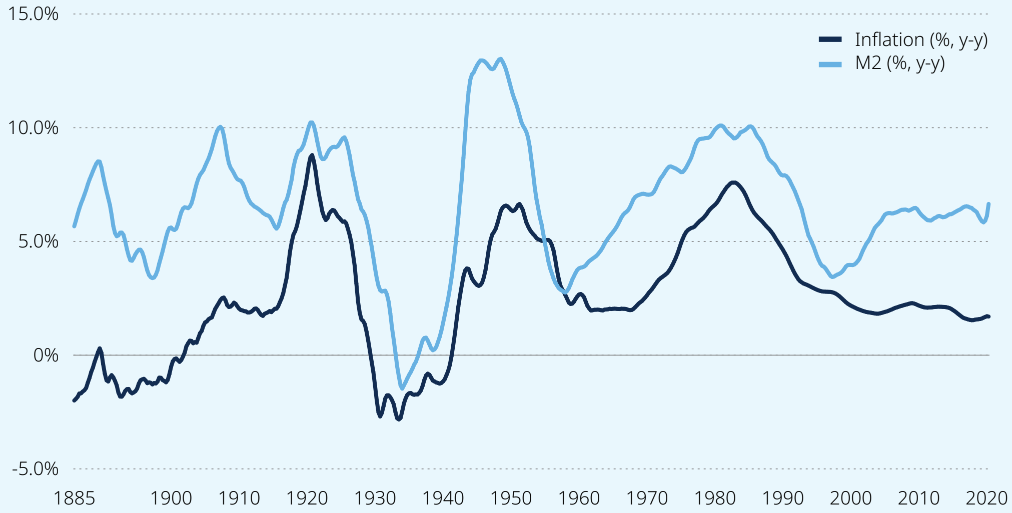
MMT's headline thesis is that a government of a country with its own currency need never explicitly default on its debt. It can finance ever-increasing deficits by having its central bank print money and buy interest-free government bonds directly from the treasury, thus generating cash reserves from which the government can finance its day-to-day spending. MMT's emphasis on the idea that governments should not worry about explicit default has undoubtedly been a positive contribution to public policy, shifting politicians' focus from the risk of short-term debt defaults to more important issues. The almost catastrophic "debt-ceiling" crisis of the second Obama administration could have been averted if policymakers had realized that fiscal space was not an issue in the short-run. But this insight is not unique to MMT. Since long before the origination of MMT, economists from both sides of the political spectrum have agreed that explicit default can be avoided. The controversial part of MMT is around what happens in the long-run when governments rack up money-financed debt.

In conventional economics thinking, money-financed spending invariably leads to inflation. Because productive capacity is constrained by scarce resources – e.g., labour, capital, land, natural resources – governments must outbid the private sector that would otherwise be using these resources to produce private goods. In the end, they end up paying higher prices proportional to the new money created, generating an inflationary spiral. So even if the government does not explicitly default on its debt obligations, long-run inflation forces an implicit default, with government debt becoming worthless for lenders. MMT proponents argue that while inflation is not theoretically impossible, it is very unlikely since economies have tons of unused productive capacity, or "slack". To them, inflation should not be a primary concern. If it eventually becomes one, fiscal authorities – not central banks – can deal with it.

Central banks certainly do not think that inflation is an afterthought. Almost every DM central bank has an inflation target as its core objective. The loose money policies we have seen since the global financial crisis (GFC) have been aimed at getting inflation up. The US Fed, the rare DM central bank to have a dual mandate, did Quantitative Easing (QE) in large part because inflation was below its target. In fact, stubbornly low US inflation is in part explained by the Fed's success at stabilizing inflation in the past. Central banks still expend great resources at monitoring inflation expectations, to make sure they do not become unanchored and cause inflation to spiral out of control. In addition, Fed and Bank of Canada officials still bring up neutral interest rates and output gaps as arguments in their press conferences, two measures that are of little relevance in an MMT framework in which economies have unobserved slack.

Price stability will stay a focus of central banks – even after 10 years of low inflation – because they were the ones who had to do the heavy lifting last time inflation escalated (Figure 1). In the US, the Fed had to aggressively raise rates to counter the high inflation generated in part by government funding of the US military efforts in the Vietnam war. The Fed has not forgotten about the possible dangers of inflation, even if they have not veered their heads for a few decades. Inflation is hard to forecast. When it emerges – as it did in a major way in the 1970s – it's typically unanticipated, coming in too abruptly for gridlocked fiscal authorities to deal with.

Figure 1. | US inflation has trended with the money supply since 1885
(10-year averages)



Notes: Inflation is GNP deflator growth. Data for 1885-1983 is from Robert J. Gordon, "The American Business Cycle: http://data.nber.org/data/abc/. Data for 1885-2020 is from the BEA (inflation) and the Federal Reserve (M2), both via Bloomberg.

2. Central banks are still independent

MMT's core policy of money-financed spending relies on the collaboration of governments and central banks. Governments need a guarantee that bank reserves will indefinitely flow to their Treasury. There is no sign that central banks have entered into this type of contract, explicitly or implicitly. Donald Trump's criticism of Fed Chair Jay Powell in 2018-2019 for keeping rates too elevated highlights the continued separation between the monetary authority and government.

To be clear, an erosion of this independence is certainly possible in the future. With ballooning public debt levels (Figure 2), governments could progressively increase the pressure on central banks to maintain favorable borrowing conditions. And with elected officials having the last say, independence is far from permanent. But in 2020, there is no concrete sign that central banks have sacrificed their macro stabilization mandate to finance public debt in the long run.

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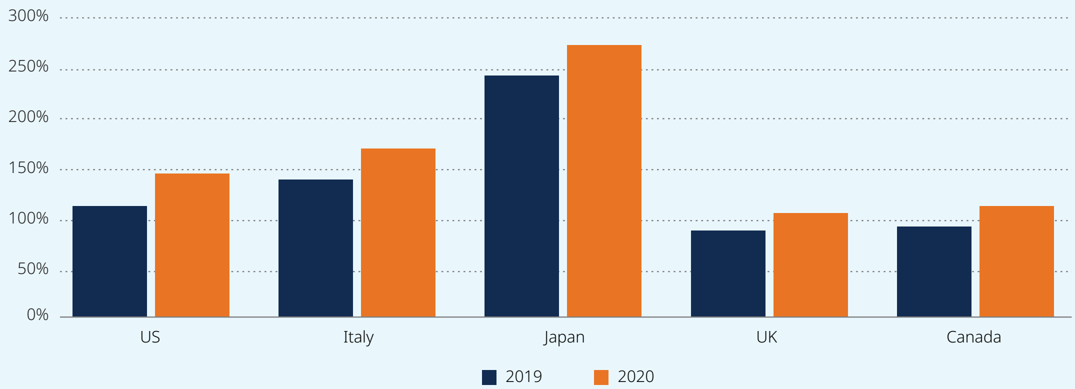
Figure 2. | Surging debt could put pressure on central bank independence
(Gross general government debt as a share of GDP)



Notes: General government debt as a share of GDP, IMF estimates, June 2020.

3. Monetary rules and tools in the COVID era are mostly "conventional"

Finally, while central banks around the world have ramped up their interventions in the last 6 months, the tools they employ and the rules they follow are clearly distinct from those advocated by MMT. Large-scale bond purchasing programs like QE are materially different from MMT's preferred debt-financing tools. First, under QE, central banks buy bonds from the secondary market rather than directly from the government. Second, and most importantly, central banks sell the bonds before they mature. Hence governments must eventually raise taxes to pay back its borrowing. **While QE may tend to lower yields on public debt in the short-run, spending is ultimately financed through taxes, the original sin of MMT.**

Past weeks have also seen some central banks revise their policy rules. At its Jackson Hole Symposium on August 27, the Fed announced it was changing the inflation targeting portion of its mandate to an average inflation rule. Average inflation targeting is far from a ground-breaking policy and has been advocated by many orthodox economists since the GFC. The mandate tweak has arguably boosted the status of the employment portion of the Fed mandate, but the objective is still macroeconomic support, not public debt relief. The day before, the Bank of Canada held its Monetary Policy Framework Renewal Conference. Speakers from across the academic and policy communities exposed their views on an optimal monetary framework. None of them spoke of MMT, nor proposed public debt financing as a potential monetary framework.

Orthodox monetary policy in a time of crisis can be mistaken for MMT. But scratching beneath the surface, it is clear that MMT still has a long way to go before it is adopted by central banks. And if that time comes, the impetus will likely come from elected officials rather than central banks themselves.

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