Funding the Future

What is modern monetary theory?

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I this morning's video, I argue that you can’t discuss macroeconomics without knowing about modern monetary theory. So, what is it all about? In this longer-than-usual video, I offer my explanation.

https://www.youtube.com/watch?v=1_vNAY2Nrm0?si=KUqJAtxrJ63YpQLy

The audio version is here:

https://www.podbean.com/player-v2/?i=7x4rh-16c6be6-pb&from=pb6admin&share=1&download=1&rtl=0&fonts=Arial&skin=8bbb4e&font-color=&logo_link=episode_page&btn-skin=ff6d00

This is the transcript:

What is modern monetary theory?

You cannot take part in discussion about economics these days without hearing the term modern monetary theory come up, and it's important to understand what it is because a great deal that is said about MMT, as I will refer to it throughout this video, is complete nonsense.

Some of its supporters don't help MMT by making claims about it which are entirely unfounded and even untrue. And almost everything that is said about it by its opponents is, let's be honest, largely a work of fiction, because they want to, for reasons that are not apparent to me, deny the truth implicit within it.

There is, in fact, very little about MMT that is either very radical, new, or unusual. It is simply a description of the way in which money is created and used by central government in a modern modern fiat currency economy.

Now I am aware that I've already used a number of terms that are quite complicated. For example, ‘how money is used’. We must remember that money is debt, and debt is created by bank lending.

We must also remember that fiat currency is not backed by any form of asset. It is not linked to gold or silver or anything else. It is simply a government promise to pay that gives a fiat currency its value.

And what we're talking about is how money of that type is created by the government and how that money created by the government functions within the economy of which we're all a part.

Most of the time, most of economics tries to ignore this issue. It pretends, in many cases, that money hardly exists, which is quite absurd.

Because, of course, money does not only exist, but the existence of money and the management of money is a major part of the management of the economy. So, to have a theory which explains how money works is really important, and that's what MMT does, and that is why I think it is core to the understanding of macroeconomics.

So, having said all that, as a preamble, let's talk about how this thing works.

MMT says that a government that has its own central bank and its own currency, which in a country like the United Kingdom would be the Bank of England and the pound sterling, and with that currency being internationally acceptable, which we know the pound sterling is, then that government need neither tax nor borrow before spending because its entire government expenditure can be funded by new money creation by its central bank acting on its behalf with the government then being indebted to its central bank for the sum that it's expended.

Let me put that another way. The government can simply tell its central bank, “please make a payment” to whoever the government wishes, and the central bank is required to mark up the government's overdraft to make the payment, and there does not need to be any money there to allow the payment to take place, because the mere process of increasing the overdraft does in itself create the money that the government wants to spend into the economy.

And that is the core idea at the heart of MMT.

Now, a government that borrows in this way from its own central bank need never repay the debt it owes to that central bank for one very good reason, and that is because it owns the bank in question and therefore the bank in question has no effective claim against the government.

But there's a much better reason why it need not make the repayment of at least some of that money which has been created, because the money made in that way then becomes the money supply of the jurisdiction for which the government is responsible. And one of the ways in which we can even identify that a jurisdiction or state exists is that a government is able to put into place in that geographic location the currency that it declares to be legal tender.

So, of course, it has to make sure that if it's declared a currency to be legal tender, there must be enough of it available. And by the process of spending money into existence to support its programmes, hopefully mandated by a democratic election, then a government can create the money supply that allows that economy to undertake the transactions which will sustain it.

So, it does not have to repay all that debt. And this is a critical point to understand.

That said, it cannot obviously not clear some of that debt. The reason why is that if you kept on making new currency forever, you would end up with hyperinflation. That obviously is totally unwise. And modern monetary theory, MMT, clearly understands that fact.

And so, it says there is one fundamental tool that exists to make sure that the government can control inflation. Anybody who says that MMT is not interested in inflation has clearly missed the point about the theory, because in fact MMT is obsessed by inflation and how to control it But what it says is that the major control instrument that we have to stop inflation occurring is taxation because tax takes the money that the government has created as a result of it spending it into existence and brings it back into the central treasury where it is cancelled.

If you look at a banknote, it says on it, I promise to pay the bearer on demand the sum of five pounds, or whatever. That promise is fulfilled by accepting that note in settlement of your tax liability. When the tax liability is paid, it is finished. It is complete. It is cancelled. You haven't got another liability.

So, so the fact is that paying tax cancels your liability to the government and in exactly the same way as repayment of a bank loan cancels the money that was created when a bank loan was advanced, so paying tax cancels the money that the government has put into existence by reason of its spending.

This is fundamental to the understanding of MMT. The primary tool for the control of inflation is not the interest rate, which you would believe if you listened to neoclassical economics and neoliberal economics and its belief in the use of interest rates through independent central banks to achieve this role. Instead, taxation is the fundamental tool to control inflation, and therefore fiscal policy is primary in modern monetary theory.

The secondary role of tax in the government's funding cycle is to provide the government-created money of a jurisdiction with value in exchange. Now, this is a little more complicated to understand, but let's be honest, if you were given a five-pound note and you had no idea what it was, or you were in Fiji at the time with no opportunity to exchange it into local currency, then that £5 note would, for all practical purposes, be entirely worthless to you.

But, if you're in the UK, that £5 note, which would be worthless somewhere else, does have value. And the value is created by the fact that the government will accept your money in exchange for tax liabilities owing.

Now, in the UK at present, well over a third of most people's income is, in some way or other, going to eventually be paid in tax. It won't all be paid in income tax, some will be paid in national insurance, some will be paid in VAT, some in alcohol duties, or tobacco duties, or car duties, or road fund licences, or whatever else it might be. But ultimately, significant amounts of money are going to be paid in tax.

And because trade gives rise to tax liabilities, those undertaking trade in the UK will always use the pound as their chosen instrument for trading, because they don't want to take the exchange risk of waiting with dollars or whatever it might be, to not know what those dollars or whatever else they might be will be worth on the day when they have to pay their tax and, therefore, they will trade using pounds because that way they minimise their exchange risk. But that means that by requiring that tax be paid the government forces its currency into use in the economy so that people use it. As a corollary the government gets control of the economy by having management of the currency.

This is fundamental to macroeconomic control of an economy by a government. And MMT is the only economic theory that really has an explanation of how that value is created.

Once those roles of tax have been fulfilled, then tax can have other roles. It can, for example, deliver economic, social, regulatory, and inequality agendas on behalf of the government. And that is something that every government around the world usually wants to undertake. They wish to promote some activities, they wish to discourage others, and tax is incredibly useful for that. But what I stress is that that is a further role of tax, which has nothing to do with revenue raising. It has everything to do with supporting other government agendas, which is a quite different objective. And this has to be fully understood. But it does make tax one of the most powerful instruments for delivering policy by any government anywhere, and in my opinion, MMT explains this.

So what else does MMT say? Most importantly, what it says is that if the situation that I have described exists, then the government does not need to balance its income and expenditure. In fact, what it also says that in most situations, that balance would be thoroughly undesirable.

For example, if the government has a growing economy, and a modest but controlled inflation, then the expansion of its money supply is essential. And that expansion of the money supply is best delivered by running government deficits.

It follows, like night does day, that this is what a government should do to make sure there is sufficient money in existence to let the economy grow. But that shortfall is not something that creates a risk to the economy as a whole. In fact, it is essential to ensure that there is cash in existence.

What is more, there is no reason to why the government then has to borrow any money back. It could just run an overdraft at the Bank of England or whatever its central bank might be if we're talking about in another country and that would meet the purpose just as well. In in other words, a government in this situation never needs to borrow from financial markets.

That is because a government of this sort can always borrow instead from its central bank. It has no dependency on financial markets as a consequence. For anyone to pretend that there is such a dependency is claiming a falsehood. It does not exist.

And we know it doesn't. In the case of the UK, when we faced crises in 2008/9 and in 2020/21, the government created hundreds of billions of pounds of new cash to meet its own needs. It did it by effectively borrowing from its own central bank using the quantitative easing process, which does end up with this situation arising. And it did not need to go to the financial markets to say “please fund furlough” or whatever else it might have been. That didn't happen. The government does not need to borrow from financial markets.

But, having said that, the government might well wish to offer a savings facility to banks and to other financial institutions within the jurisdiction who wish to save with the safest investment. institution that is available within the country as a whole, and that is the government. The government is always the safest place to save money in a country like the UK, and that's for one very simple straightforward reason.

The government can always repay its debts. It is the one and only organisation that can do that, and as a consequence, large companies banks, pension funds and others are very keen to save using government bonds because that is the one asset that they can rely upon to always be repaid when nothing else is guaranteed in that way, including, in their case, any deposits that they might hold at a bank because only the first £85,000 of the sums that they hold on deposit are guaranteed, which in the case of many of these organisations will be a totally insignificant amount. Therefore, the government can, and very often does, provide this facility, but it has to be understood for what it is.

It's a savings facility. It is not in any shape or form a borrowing facility. Because it doesn't need to borrow from these organizations, it is providing them with a safe place to save.

So, where are we? We have a government which is in the position to control inflation without the use of interest rates. We can, instead, use tax rates to control inflation, or we can vary the scale of the deficit because that stimulates or reduces the scale of economic activity, which in turn has a consequence for the level of inflation within it, and the government could also, if it wished, reduce it. use credit controls to commercial bank lending to control inflation, but MMT does describe a situation where if inflation is a priority and inflation management is always a matter of concern in macroeconomic thinking, then this can be delivered without the use of interest rates because MMT suggests that it would be wise to run a low effective interest rate policy within any economy.

There are a number of reasons for doing so. Firstly, that of course minimizes the interest rate obligations that the government will incur by providing a savings facility to whoever uses its banking facilities. In other words, the interest paid on government bonds, or on National Savings and Investments accounts, will be reduced to the minimum possible, which the government would appreciate.

Secondly, of course, to provide a low interest policy provides the best possible environment for investment, because investment is not funded by savings, it is funded by borrowing, and if borrowing is cheap, the amount of money that will be invested in productive capital within an economy will rise, and the result is that we will get growth if that is the government's objective.

So whether growth is the objective or not, low interest rate policies still pay. And third, having a policy which minimizes the interest rate paid within an economy reduces the amount of money that is reallocated upwards by the payment of interest on things like mortgages, and that reduces inequality, which must be a government goal in any sensible environment where an economic balance is sought as an outcome from macroeconomic policy.

All of this then means that a government can have one other objective, and that is full employment. This is possible inside an MMT environment because what a government that is planning for inflation can do, which any government that is subscribing to MMT will be doing, will be to say that if there are underused resources within its economy it can seek to put those resources to use without the risk of inflation arising.

So if, for example, there are people who are underemployed or unemployed in the country, a government can pursue full employment, which would put those people to work in a way that could not create inflation because they are at present sitting out of work. Putting them to work cannot create inflation.

But this policy, if properly understood within the context of MMT, means that if there is no capacity to put extra resources to work and the government still tries to spend, it cannot achieve that objective unless one of two things happens. One would be inflation, because it would bid up the price of labour or other assets, or alternatively, it must increase taxation.

Now, it doesn't increase taxation in that situation to actually raise revenue, and that is an incredibly important point to make. What it does do is increase taxation to make sure that these resources are not going to be bid for in the private sector, because the state wants to use them in the public sector. And this, as a matter of fact, is another use for taxation. It effectively removes resources from use within the private sector so that the state may buy them at a reasonable price. And that is part of macroeconomic management because we know that the state and the private sector must work together to achieve all economic outputs and, therefore, this balancing act is essential, but it is a balancing act that has to be carefully planned to make sure that inflation does not result.

There could be a guarantee of full employment within an MMT economy. I am not wholly convinced that is necessary, nor do I see it is a necessary balancing act to say everybody must have work if they want it. I think that that is a desirable outcome. I don't see it as an essential outcome. I will differ with some MMT economists on that point. They call this a job guarantee. I think it is something that a government may wish to do as a policy objective. I do not see it as core to MMT. Every single other thing that I have described within this video is, however, I think core to MMT.

Now, I am well aware that this has been quite a long and quite complicated video. There is a whole written version of this available as well, and we will provide the link below this video so you can download it from the Funding the Future website, because I have addressed this issue in several ways over quite a long period of time.

But understanding MMT is really important if you are to get your head around the way in which the macroeconomy really works. There is nothing that I have said that is either particularly radical, or unusual, or even challengeable.

In other words, this is the way that central banks agree that money works within the economy.

This is the way that every economist of any repute now agrees that money is created.

This is a way in which everybody knows inflation can be managed.

It does challenge the idea of independent central banks and their control of interest rates, and their control of inflation using interest rates, but that apart, MMT does very little which is radical, or different, or unusual.

It is simply a form of post Keynesian economics that says that with careful management of money, we can achieve the goal that any economy should try to fulfill. And that is full employment. If ensuring that the well-being of people is delivered by guaranteeing them work to the greatest possible degree that a government can, and that becomes the aim of any government, then MMT makes sense for it to follow.

If you want to run an economy without guaranteeing full employment, by all means, run the central bank using interest rates to control inflation and take the risk that there will always be unemployment as a buffer whilst it overheats or underheats the economy through the use of interest rate policy.

But, if people come first, so does MMT, and that is why it is so important.