Modern Monetary Theory Is Voodoo Economics Redux

Elliot Eisenberg, Ph.D.
GraphsandLaughs, LLC

There is currently widespread frustration with the performance of the global economy. Traditional policy approaches are not delivering the economic results they have in the past. In the US, Millennials are poorer, have lower incomes, marry less often, and have fewer children than the generations before them. In Europe, the rise of previously fringe parties is unmistakable as voters express their frustrations with the status quo at the ballot box. All this has led to the rise of Modern Monetary Theory (MMT), a set of ideas that reflect a significant and unfortunate break with previous orthodoxy.

During the late 1970s, a similar economic malaise gave rise to supply-side economics popularized by Arthur Laffer. It began with the age-old observation that taxes had important incentive effects and that, in conceivable circumstances, tax cuts could raise revenue. That said, from these two well understood underpinnings, it grew into the ludicrous idea that tax cuts would always pay for themselves. In the 1980 presidential primaries, future President George H.W. Bush called this idea "voodoo economics" and in the following decades this doctrine did substantial damage to the US economy and has largely short-circuited meaningful debate about taxes.

Now comes MMT, which, like supply-side economics, makes a good observation, that fiscal policy needs to be rethought in an era of low real interest rates, but then stretches it into a ludicrous claim that massive deficit spending on job guarantees can be financed by central banks without any burden on the economy. At a moment of deep economic and political frustration, some fringe wing of the out-of-power party is again offering the proverbial economic free-lunch as a politically attractive way out of a fiscal bind. Regrettably, MMT is flawed at many levels.

First, it promises that by printing money the government can finance deficits at zero cost. Not true! The government in fact pays interest on money it creates as it becomes reserves held by commercial banks and the Fed pays interest on reserves. Second, contrary to MMT, governments cannot simply print money to pay bills and avoid default. Looking back at developing nations that have employed MMT demonstrates that beyond a certain point printing money leads to hyperinflation. Third, MMT conveniently assumes an economy that does not trade with other nations. Regrettably, money printing will result in a collapsing exchange rate that will in turn boost inflation, raise long-term interest rates, encourage capital flight and reduce real wages.

And it is not only in emerging markets where MMT has played out badly. France in the early to mid-1980s and West Germany in the late 1980s employed what now would be called MMT but both nations had to reverse course. Separately, the UK and Italy both had to be bailed out by the IMF in the mid-1970s because of an excessive reliance on inflationary finance.

Supply-side economics was an unreasonable extension of valid ideas. To that end, few support a return to the very high marginal tax rates that prevailed before the tax reform of the 1980s. Similarly, in an era of very low inflation, and of real interest rates of close to zero, we can and should carefully reconsider our traditional views of federal borrowing; they need at a minimum a careful and thoughtful rethink.

That said, when something sounds too good to be true, as was the case with supply-side economics, and is the case with MMT, it's important to make this clear to improve debate and hopefully prevent us from making another costly and unnecessary economic policy mistake.

Elliot Eisenberg, Ph.D. is President of GraphsandLaughs, LLC and can be reached at Elliot@graphsandlaughs.net.
His daily 70-word economics and policy blog can be seen at www.econ70.com.