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WHY INVESTORS ARE GOING TO HEAR A LOT MORE ABOUT MMT

Chris Bedingfield

Modern Monetary Theory (MMT) has been gaining attention in recent months – some positive and some not so positive.

Over the next few years, investors can expect to hear a lot more about MMT. So what is it, and why should they care?

MMT is not a policy

First and foremost, MMT is not a policy or a theory – in many ways, its name is its biggest weakness. It is a fact-based, empirically supported framework of the modern (post gold standard era) monetary system.

At its core, MMT is a framework and detailed description on how the monetary system actually works across most developed countries. Indeed, those of us living in Australia (and the US, UK, Canada, Japan or New Zealand) are already living in an MMT world.

So if MMT is nothing more than a description of the system, how is it different to mainstream economics?

Currency issuer vs currency user

Distinguishing between a currency issuer and a currency user may sound like a fairly esoteric concept, but in fact it goes to the heart of MMT – and explains issues that have otherwise baffled mainstream economists.

For instance, in 2011 economist Paul Krugman famously asked why there was such a difference between Japanese and Italian interest rates. He noted Japan's government debt dwarfed that of Italy – yet Japanese interest rates were always zero, while Italy (and most of Europe) was suffering from a sovereign debt crisis.

MMT recognises countries that issue their own currency – such as the governments of Australia, US, Japan and the UK – cannot inadvertently become insolvent. Of course, that doesn't mean they will never go broke. But insolvency is a political choice, not economic. For example, the debt ceiling in the USA is a political constraint, not an economic constraint.

Likewise, whether Australia's deficit is $10 billion or $100 billion, the debt will never force interest rates higher or condemn Australia to an economy similar to Greece. There will always be a buyer of its bonds.

However, currency users – including countries such as Italy, Portugal and Greece, as well as businesses and state and local government – are no different to a household. Like a household, Italy does not have its own currency-issuing central bank, and therefore can 'go broke'.

The quote

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Recognising that money is not a constraint for government, many critics jump to the conclusion that adherents of MMT believe deficits don't matter, and therefore the entire framework is garbage. Yet there are many papers over the years in which MMT academics clearly acknowledge deficits have always mattered – just not the way people traditionally think.

The MMT framework understands that while money may buy any good or service in an economy, it doesn't guarantee that good or service will be available. That is, the constraint on unlimited net government spending isn't financial, but rather the availability of real resources in the economy. And while a country like Australia or the USA can never run out of its own currency, it can run out of labour, energy, food or water.

Taxing vs spending

Mainstream economic literature says that governments can only spend from revenue raised.

The insight from MMT is that the spending comes first, only to be taxed later. That is, tax dollars do not fund government spending, but government spending funds tax dollars.

Some critics misinterpret this concept, claiming that by not requiring taxes to fund the budget, MMTers are advocating that governments simply force their own central bank to fund government spending directly. They argue this risks the independence of central banks, turning them into political tools and discrediting their role in the economy, causing foreign investors to flee – and thus rendering the local currency worthless.

Such a criticism generally reflects a poor understanding of how the Treasury, central bank, commercial banks and bond issuance interact on a daily basis. In Australia, the central bank already assists in funding the government and has been doing so for decades. This is due to the institutional, regulatory and policy framework of the Australian financial system.

Not convinced? Data shows US interest rates continue to fall, despite higher levels of government debt.

When confronted with such data, critics often suggest the USA is different, as the US dollar is the world's 'reserve currency'. But if that's true, why do we have the same dynamic in Japan, the UK and even Australia?

The recognition that spending comes first has profound implications.

It means net government spending creates a net non-government surplus (or financial assets inclusive of bonds). That is:

> Net government deficits = household savings + company savings + foreign savings.

This can be empirically shown via the sectoral balances over time.

Taking this a step further, there is a very strong link between net government spending and household savings.

The fact that the government is moving closer to surplus at the same time household savings approach zero is not a coincidence: its accounting. If the government wants household savings to increase, it must run a larger deficit.

MMT and the role of taxation

If Australia is not fiscally constrained (but resource constrained), why are our schools and hospitals underfunded? Why do we have any unemployment? What is the role of charity? And why do I have to pay taxes if they don't actually fund government spending?

Under MMT, taxes play a vital role in the economy – but not for financing the government. They serve two purposes:

1. They reduce the purchasing power of the private sector, which frees up resources in the economy so the government can purchase goods and services in a non-inflationary way to meet its social and political objectives. For example, this may include ensuring there is enough labour for a standing army, judicial system and schools.
2. They give the currency value. Critics of fiat currencies like the US or Australian dollar argue that since 'going off the gold standard', there is nothing supporting the value of the modern currency other than good faith.

If that faith ever vanished (which some suggest is inevitable), the value of the currency will be destroyed. Hence 'hard money' advocates suggest gold is the only true form of money and will always be a store of value; and more recently, cryptocurrency advocates offer the same argument.

From an MMT perspective, requirement for citizens to pay taxes creates demand and therefore an intrinsic value for the currency. For example, try to pay your taxes at the ATO with gold and your payment will be rejected. The ATO will only ever accept AUD to satisfy any tax liability. Alternatively, try not paying your taxes at all and you will end up in jail.

The price of engaging the Australian economy is the requirement to pay tax. There are historic precedents that support this notion of tax creating demand for fiat currency from diverse periods, including the colony of Massachusetts in the late 17th century and British colonies in Africa in the 1800s. Most failures of this system generally stemmed from overspending or weak taxation collection system (i.e. deficits do matter).

From an MMT perspective, the role of tax and the strict manner in which it is collected gives rise to underlying demand for the currency.

Does MMT = Zimbabwe, Venezuela, Weimar republic? (No)

MMT critics are quick to try and draw parallels to economies that succumb to hyperinflation, suggesting this is a result of 'implementing MMT' (which, as we know, is not something that can be implemented).

Understanding the role of inflation is central to the

MMT framework. In fact, MMT was one of the very few schools of thought that correctly predicted Quantitative Easing would not cause inflation. And as we have noted, deficits do matter from an MMT perspective, since too much spending crowds out real resources in the economy, resulting in price inflation.

Furthermore, the economic history of hyperinflation rarely begins in an economy operating at full employment – more often than not; hyperinflation is a result in the collapse of the productive capacity of the economy.

Why you are going to hear a lot more about MMT?

MMT is nothing more nor less than an accurate description of how the monetary system works. To summarise:

- There is a difference between a currency issuer and a currency user.
- A currency issuer (like Australia, USA, Japan, etc.) can never inadvertently become insolvent. There are no financial constraints for the federal government.
- The constraint on any government is the availability of real resources in the economy and therefore inflation. Deficits do matter.
- Taxation does not fund the government. Net government spending has to occur before it can be taxed.
- However, taxation plays a critical role in the modern economy – a robust and enforceable tax regime gives rise to intrinsic demand for the currency.

Much has been written about MMT of late. A lot of it has been dismissive, but this 'new' idea is not going away any time soon. Those who criticise it without detailed understanding and research may need to do some backtracking in the years ahead. FS