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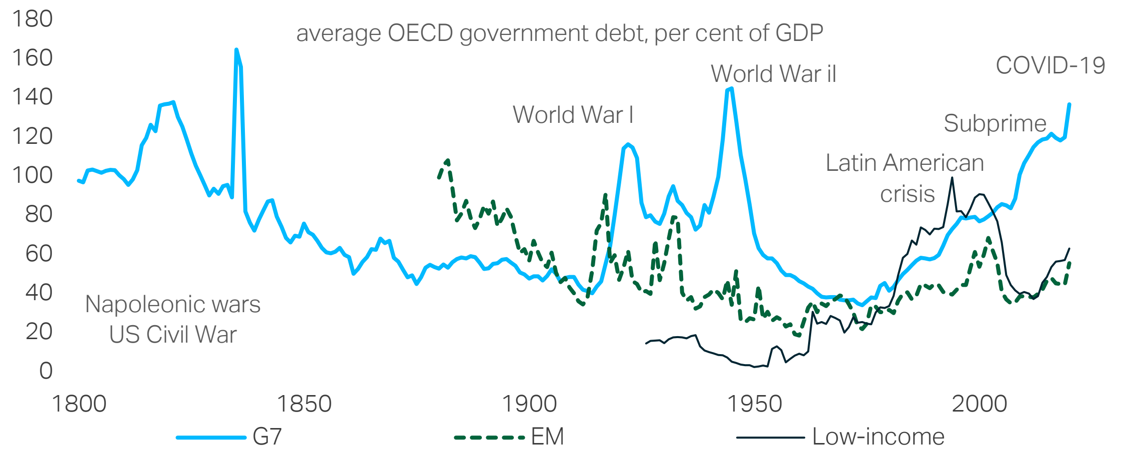
Macro Picture

HOW WE PAY FOR IT

Dario Perkins

The "how do we pay for it?" question is back. After the 2008-09 crash, governments tried the 'orthodox' approach of budget consolidation with monetary stimulus. This delivered a decade of stagnation. MMT urges us to take a more 'unorthodox' approach to COVID-19. These ideas offer an escape from the current slump, but risk a future of high inflation and financial repression.

Chart 1: A brief history of public debt



Source: IMF debt database, IMF forecasts for 2020, TS Lombard

BUDGET BLOWOUT

The fiscal response to COVID-19 caused budget deficits to widen to historic levels. Consumer spending plunged, so governments tried to absorb large corporate deficits in an attempt to prevent mass bankruptcies and unemployment. With public debt set to exceed 100% of GDP across the OECD, some politicians are already worrying about long-term fiscal sustainability.

AUSTERITY RULED

After the 2008 crisis, there was a broad consensus in favour of fiscal consolidation. Learning from previous episodes, the authorities adopted an "orthodox" approach to debt reduction, reliant on public austerity and monetary stimulus. They avoided more radical options such as write-downs and financial repression because they didn't want to upset the bond vigilantes.

MMT PROMISES

Government austerity contributed to a decade of stagnant incomes, widening inequality and populism, which has empowered more radical ideas about government financing – especially Modern Monetary Theory (MMT). MMT is helpful in the current context because it offers a way to escape secular stagnation, but it could deliver a future of high inflation and financial repression.

HOW WE PAY FOR IT

COVID-19 triggered the most aggressive fiscal expansion since the Second World War, with most developed nations running historically large budget deficits during the first half of 2020. There is no doubt these actions were necessary. As governments shut-down their economies and households slashed their discretionary spending, the global corporate sector suffered a massive decline in revenues. To prevent permanent depression-levels of unemployment and mass bankruptcies, the public sector needed to absorb what would otherwise have been a dangerously wide corporate deficit. Governments did this by temporarily (they hoped) taking on the dominant corporate expense – the wage bill – either directly via public furlough schemes (as in Europe), or indirectly via unemployment insurance (as in the US). Governments also worked with central banks to provide cheap loans and low-cost funding. There is no doubt the macro outlook would have been considerably grimmer if policymakers had not reacted so forcefully. Yet, with the immediate sense of emergency gone, there is now a growing number of politicians who are keen to withdraw this policy support. Public debt is set to exceed 100% of GDP in the US and across the OECD, which is causing a degree of anxiety about the long-term sustainability of the public finances. The question "how do we pay for it?" is making an untimely comeback.

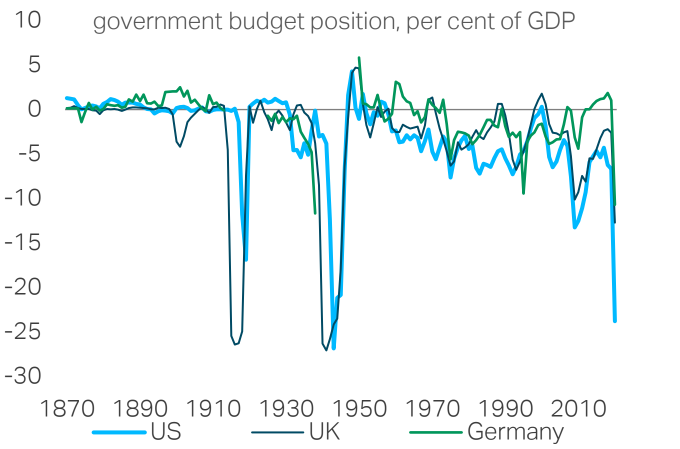
The last time we faced this much unease about the state of the public finances, governments all over the world embarked on large and ultimately self-defeating "austerity" programmes. A decade ago, in the aftermath of the financial crisis, "mainstream" economists and officials spent a considerable amount of time worrying about the dangers of large public debts. They thought excessive government borrowing would undermine economic growth and looked at history to guide their efforts in trying to rectify the situation. History shows governments have been able to reduce big public debts in two main ways: (i) the "orthodox" approach, which is to run primary surpluses, introduce structural reforms and hope easy monetary policy can support the budgetary adjustment; and (ii) the "unorthodox" approach, which is to default on the debt either directly in the form of write-downs, or indirectly via unanticipated inflation, wealth taxes and financial repression. Fearing the "bond vigilantes" – and with misplaced confidence in the power of monetary policy (even at the zero bound) – the authorities opted for the orthodox approach. But rather than emulate the successful budget consolidations of the 19th century, they came closer to repeating the UK's disastrous experience with post-WW1 austerity. The 2010s saw one of the weakest global expansions in history, with bond yields sinking to 700-year lows.

The dismal macro performance of the last decade has radically shifted the debate about fiscal policy, at least in the economics profession, bolstering the ideas of Modern Monetary Theory (MMT). MMT claims, as long as governments have "monetary sovereignty", they face no direct funding constraint. The authorities can always use their central bank to provide fiscal spending power, which means inflation should be the only constraint on their actions – not the level of debt or size of the deficit. This idea is not new – economists have always known governments could issue high-powered money rather than long-term bonds, though they discouraged such behaviour because they worried about 'rollover risks'. Yet, according to MMT, there is no rollover risk because the bond vigilantes do not exist and central banks can pin interest rates at zero forever (as long as they abandon their independence). If inflation rises, the fiscal authorities should raise taxes, cut spending, or look to other ways to slow the economy, such as direct restrictions on private lending and price controls. What should investors make of these ideas? MMT is helpful in the current context, where the lower bound constrains monetary policy and there is a risk of premature fiscal tightening. Though radical, these ideas provide a route out of secular stagnation. But, from a historical perspective, MMT could end up like the classic "unorthodox" policies of the past – using inflation and financial repression to reduce the debt.

1. BUDGET BLOWOUT

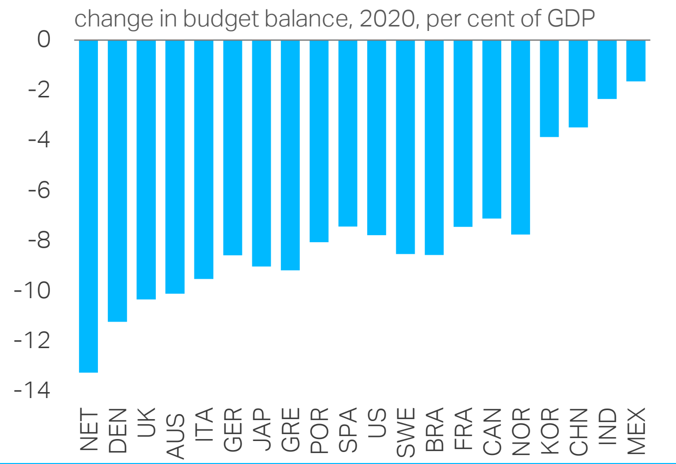
At the start of the year, there were already widespread calls – at least among economists – for a large fiscal expansion. The global economy had slowed and central banks, running out of ideas about how to stimulate a recovery, seemed set to keep undershooting their inflation targets, perhaps indefinitely. Yet few governments seemed prepared to act. The IMF's Fiscal Monitor, which provides a regular update on budget plans all over the world, expected only a modest easing in fiscal policy during the next few years, which would not be sufficient to move the dial on global growth or inflation. Even China, which had been the one large economy prepared to use its state balance sheet to reflate demand during the 2010s, had reached the limit in terms of what it was prepared to do, embracing weaker GDP rather than launch another massive stimulus programme. Then the world learned about COVID-19 and the fiscal outlook changed - radically.

Chart 2: The fiscal war on COVID-19



Source: OECD, MacroHistory, TS Lombard

Chart 3: Massive fiscal response



Source: OECD Economic Outlook

Two world wars and one global pandemic

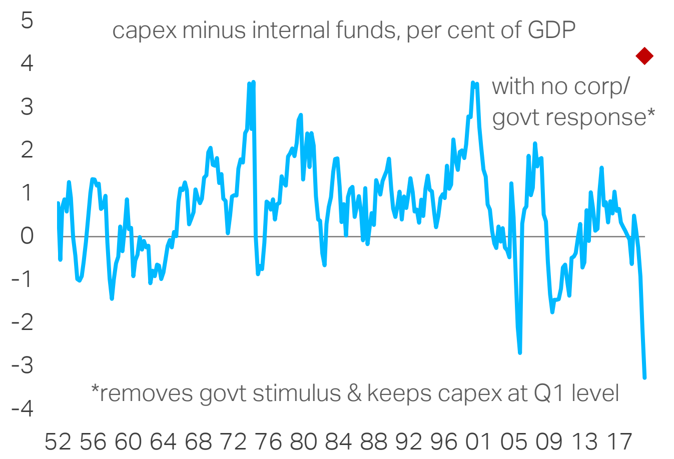
Charts 2 and 3 show the OECD's latest estimates for budget deficits in 2020, using the MacroHistory database to provide historical context. The fiscal response has been massive, with most governments spending around 10-20% of their annual GDP, similar to what happened during the two World Wars. Public debt is surging, set to rise above 100% of national income in the US and across the OECD. And our charts include only the first-year increase in their national debt; but governments are likely to be running huge fiscal deficits for at least the next two years, which could propel the OECD's liabilities above previous highs. What explains this radical fiscal response? Part of it, of course, reflects "automatic stabilizers". As the authorities shut down their economies and consumers slashed their spending, tax revenues naturally evaporated and government spending inevitably increased, especially in areas such as health provision (dealing with the pandemic) and social security. But the larger part of the response was discretionary – governments provided a massive stimulus because they wanted to prevent a depression.

Absorbing private-sector losses

While the authorities realized they could do nothing to prevent a short-term collapse in GDP, especially while they were shutting down businesses and forcing people to stay at home, they understood these actions would have a profound impact on business revenues. The aim was to ensure these effects were temporary, which meant they had to make sure the lockdowns didn't trigger mass bankruptcies or encourage companies to permanently lay off their workers.

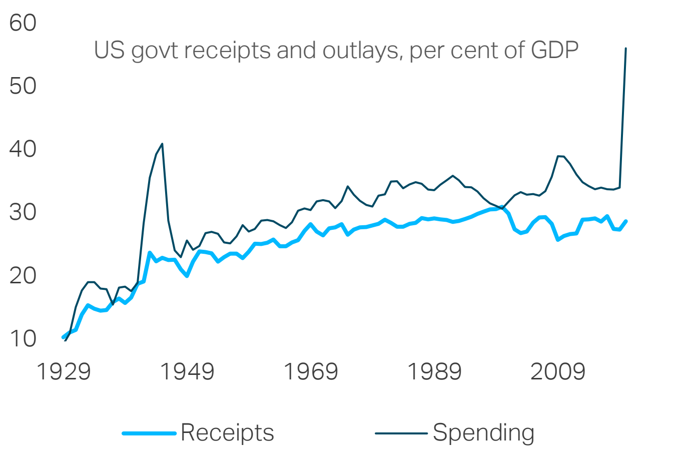
Governments did this by "socializing" the corporate sector's most important cost – its labour. The authorities in most countries either encouraged businesses to move workers into official furlough schemes, or pushed them into temporary unemployment, while topping up incomes.

Chart 4: Corporate sector faced large deficits



Source: TS Lombard estimates based on Fed data

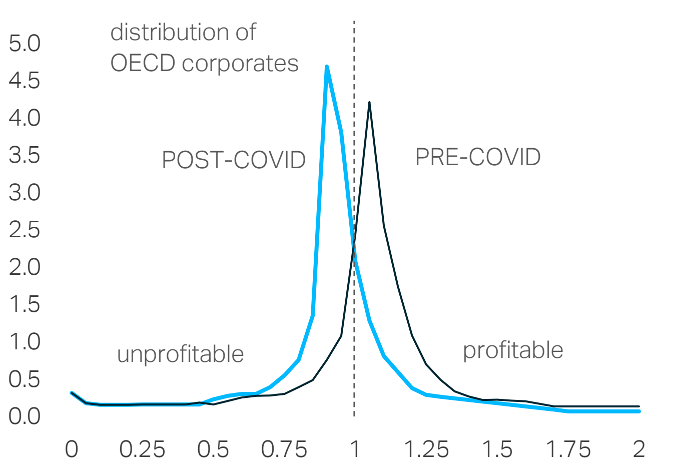
Chart 5: Government absorbed private deficit



Source: FRED, BEA, TS Lombard

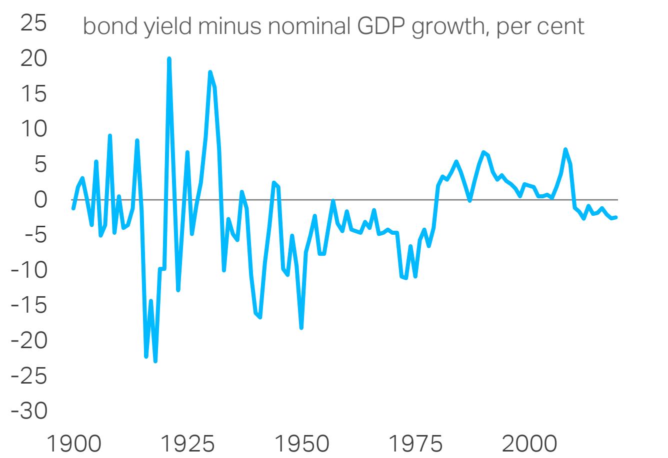
While we don't yet have flow-of-funds data for Q2, there is no doubt government policy provided critical support. For the United States, our estimates – based on Q2 NIPA profits and nominal capital spending – suggest the corporate sector was probably in surplus during the first half of the year, even as revenues collapsed. This compares to what would have been one of the largest corporate financing gaps in history, had companies not been able to slash their labour costs by moving their workforce onto temporary unemployment and freezing their capital expenditure (Chart 4). Bankruptcies data in the US have deteriorated but the situation would have been far worse without government support. The Chicago Fed, estimated that 25% of US companies would run out of cash by Q3. Most other developed nations were in a similar situation. BIS analysis showed the majority of OECD companies would be operating at a loss.

Chart 6: OECD corporates running at a loss



Source: BIS estimates

Chart 7: Public debt sustainability metrics



Source: TS Lombard

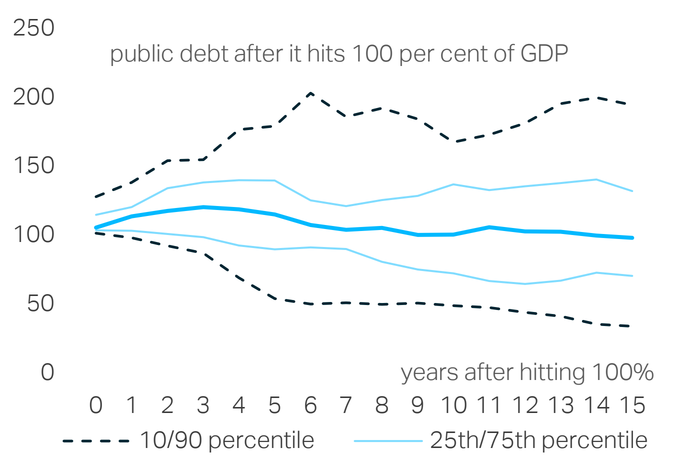
Now the urgency is gone

While the budgetary response to COVID-19 was commendable, it was obvious the authorities needed to take action. Politicians of all persuasions were in agreement. Now the situation is getting trickier. Even as infection rates remain high and we face further waves of the pandemic, there are some who are worried about the enormous fiscal costs associated with these interventions. Some politicians are even concerned that the "generosity" of the fiscal response might be holding back the economic recovery, by discouraging people from working and preventing a necessary reallocation of resources. Should the government continue to support sectors of the economy that might never recover? This means the consensus for aggressive fiscal action has shattered, giving way to divisions along ideological lines, as politicians debate the wisdom of continued interventions. And there is one question that is starting to dominate the debate about the fiscal response to COVID-19: *"How are we going to pay for it"?*

Fiscal sustainability?

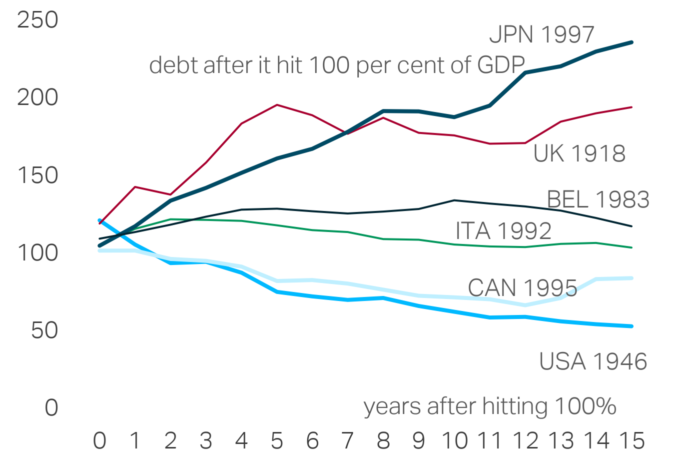
In reality, we almost never "pay back" the national debt. Instead, the traditional approach to assessing fiscal sustainability is to look at how the ratio of public debt to GDP is set to evolve – is it stable, declining, or set to explode higher? There is some simple arithmetic than can help. Debt evolution depends crucially on three variables: the size of the primary balance (i.e. excluding interest payments) and the difference between the governments' borrowing costs (the bond yield) and nominal GDP. If, for example, the interest rate is zero and trend nominal GDP growth is 3% (r-g = -3), any primary deficit smaller than 3% of GDP will stabilize debt. Before the pandemic, most countries experienced borrowing costs well below their growth rates, which suggested they had untapped "fiscal capacity". While governments will violate this debt sustainability condition in 2020-21, since deficits have swelled far in excess of "r-g", much of this deterioration is temporary and their budget positions should improve automatically as the recovery continues.

Chart 8: What happens at 100% of GDP debt?



Source: IMF World Economic Outlook, October 2012

Chart 9: Mixed picture through history

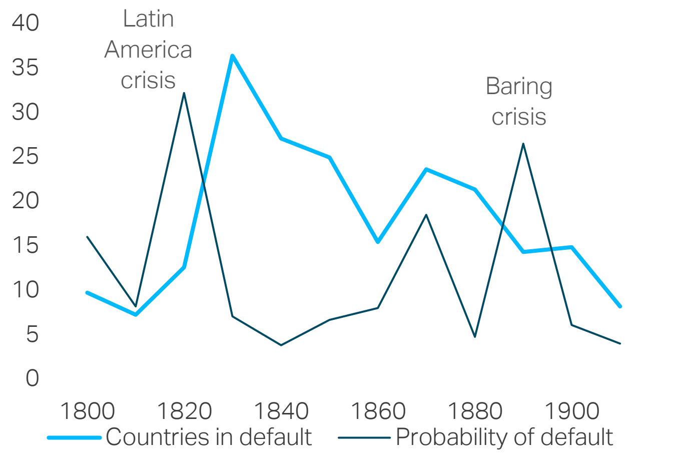


Source: IMF World Economic Outlook, October 2012

2. AUSTERITY RULED

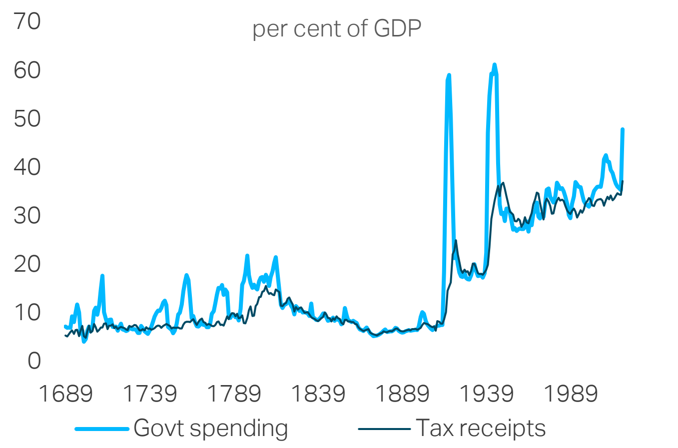
The "how are we going to pay for it?" debate is eerily reminiscent of the budget anxieties that appeared not long after the subprime crisis. Like COVID-19, the 2008 financial crash delivered a powerful shock to the public finances. As soon as the economy started to recover, politicians everywhere looked for ways to put their national debt back on "a sustainable trajectory".

Chart 10: Regular defaults in the 1800s



Source: Eichengreen et al (2019)

Chart 11: Long history of UK fiscal policy



Source: Bank of England, TS Lombard

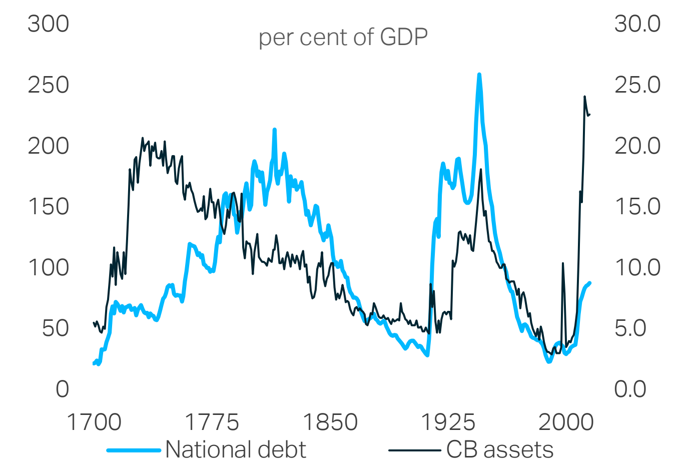
Mainstream economists must share the blame for the "austerity" that followed. Back in the early 2010s, there was a clear consensus that argued high levels of public debt were dangerous. It wasn't just Reinhart and Rogoff (2010) who claimed government debts in excess of 100% of GDP could lead to a persistent economic slump, others – including at the IMF and the OECD – pushed the same policy advice. Meanwhile, economic historians published detailed accounts about how governments had managed to reduce their national debts in the past. In short, there was a widespread presumption that debt needed to be forced onto a downward trend and history showed that policymakers only had two main routes to achieving this:

(i) The "unorthodox" approach: Default on the debt, either directly by write-downs, or indirectly via unanticipated inflation, financial repression and wealth taxes;

(ii) The "orthodox" approach: tighten fiscal policy with the aim of generating persistent primary surpluses, while trying to support growth through expansionary monetary policy and (ideally) structural reforms designed to lift supply potential;

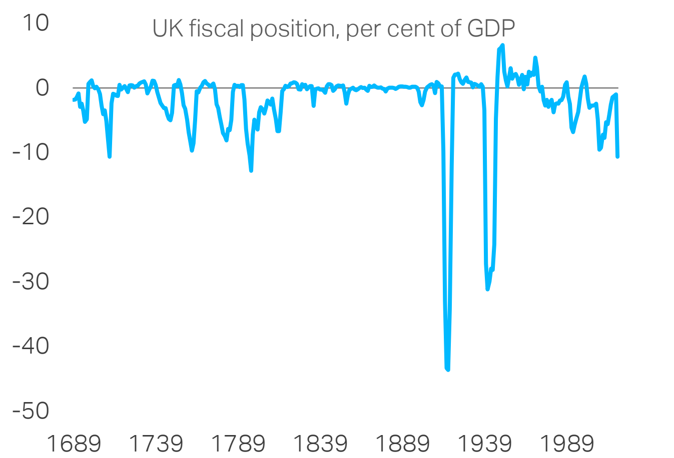
Given this choice, it is not surprising the politicians opted for the "orthodox" approach of budget consolidation. Outright default seemed impossible, not least because – despite a series of close calls (especially for the UK in 1956, 1967 and 1976) – there had been no examples of a large

Chart 12: UK "monetary financing"



Source: Bank of England, TS Lombard

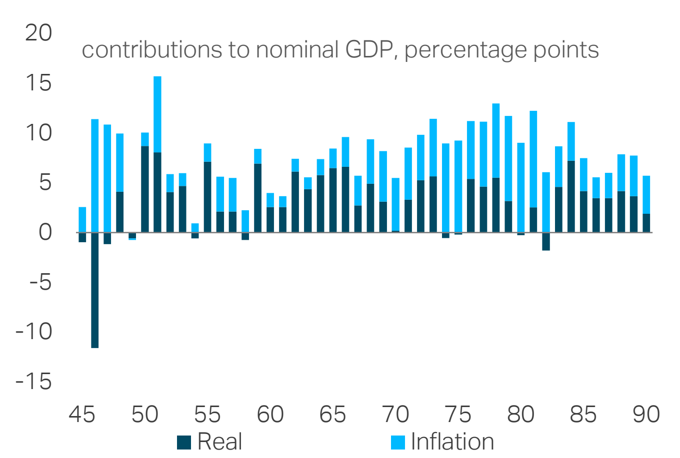
Chart 13: History of UK fiscal deficits



Source: Bank of England, TS Lombard

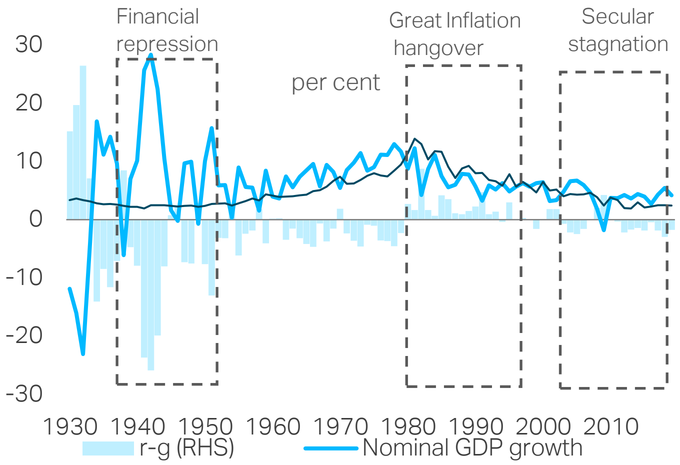
developed nation writing-down its national debt since the Second World. The bond vigilantes would surely punish such behaviour, perhaps cutting the government off from international markets for years to come. In fact, the historical record shows plenty of examples of government default before the 1940s, including throughout the 1800s, and especially around the two World Wars, but those write-downs were focused on intergovernmental liabilities and mainly happened during extreme political crises. The most famous examples included Germany, France, Italy and Greece defaulting on the massive debts they owed to the United States after the end of World War I (which, in Germany's case, included ill-conceived war reparations).

Chart 14: US nominal boom after WW2



Source: BEA, TS Lombard

Chart 15: Financial repression helped

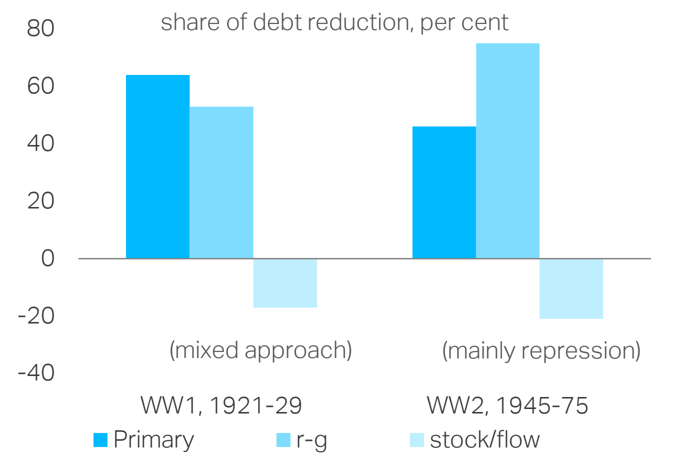


Source: MacroHistory, TS Lombard

Avoiding financial repression

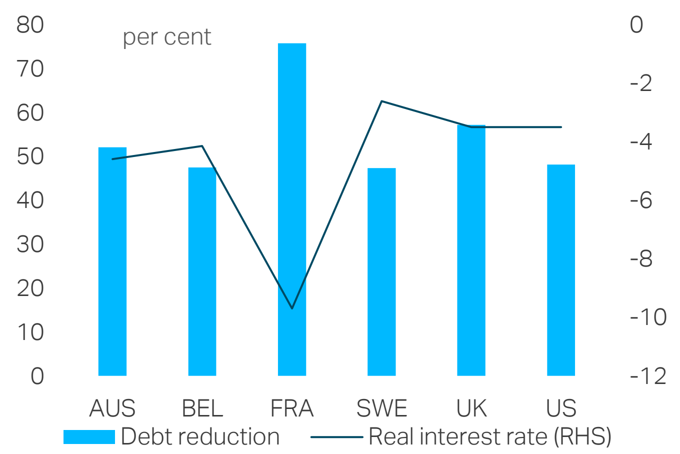
Hard defaults were unthinkable in the 2010s, while governments were also reluctant to go down the route of 'indirect' write-downs such as trying to generate inflation in order to reduce the 'real' value of their obligations. Yet there was overwhelming evidence to show the authorities had used financial repression in the past, especially after World War II. Recall the "arithmetic" to public debt, which allows us to decompose movements in the debt-GDP ratio into contributions from the size of the primary budget balance and the difference between bond yields and

Chart 16: How they financed the wars



Source: Eichengreen et al (2019)

Chart 17: Financial repression after WW2

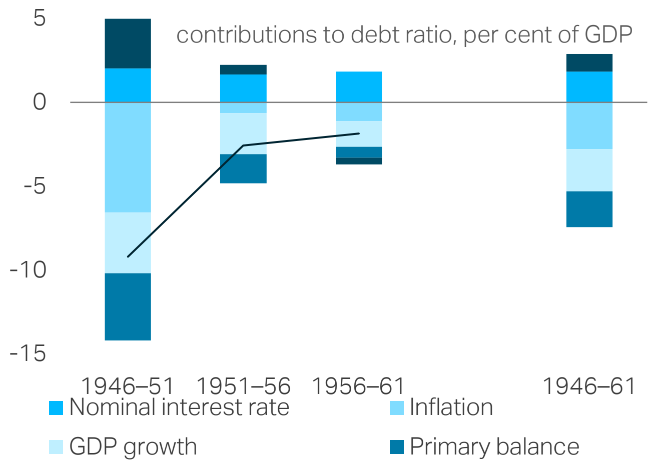


Source: Reinhart and Rogoff (2015)

nominal GDP growth (plus a residual[1]). If the authorities can lift nominal growth rates substantially above their borrowing costs, either by creating unanticipated inflation or by using their central banks to intervene in bond markets, they can reduce their debt ratios even without introducing painful 'austerity' programmes. Studies that used this arithmetic to analyse previous debt cycles showed that 'financial repression' accounted for much of the debt reduction that took place between 1945 and 1970s, in contrast to what had happened before and after World War I (where governments had focused more on raising taxes and running budget surpluses).

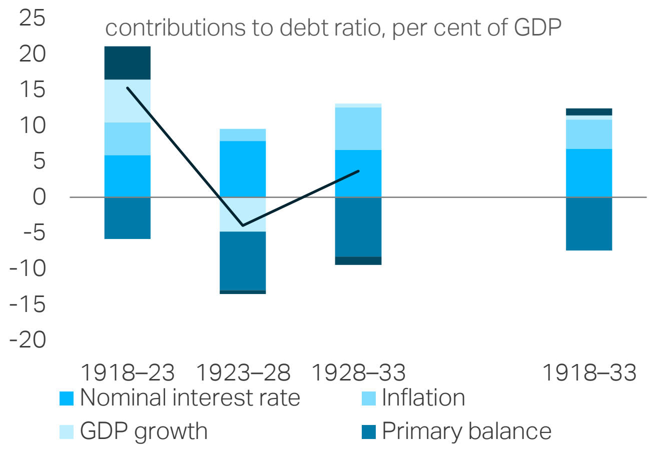
Despite its role in "paying" for World War II, no serious economist proposed financial repression as a way to deal with the debt left over from the financial crisis. There were good reasons for this. First, it was clear post-conflict rebuilding had contributed to the boom in nominal GDP growth after the 1940s, conditions that would be impossible to replicate in the 2010s. Most countries needed massive reinvestment in their productive capacity, while military personnel had to be reintegrated into labour markets, causing a huge increase in supply potential. New wartime technologies had also boosted productivity, particularly when redeployed for non-military purposes. And there was a rapid increase in the population (the Baby boom). While there were occasional bursts of inflation, this supply-side boom meant central banks didn't have to work particularly hard to supress government borrowing costs. The Federal Reserve, for example, only had to defend its yield caps briefly in the early1950s – during the Korean War – and was then able to withdraw from intervening in bond markets without causing yields to spike higher.

Chart 18: US used financial repression



Source: IMF World Economic Outlook, October 2012

Chart 19: UK tried austerity after WW1



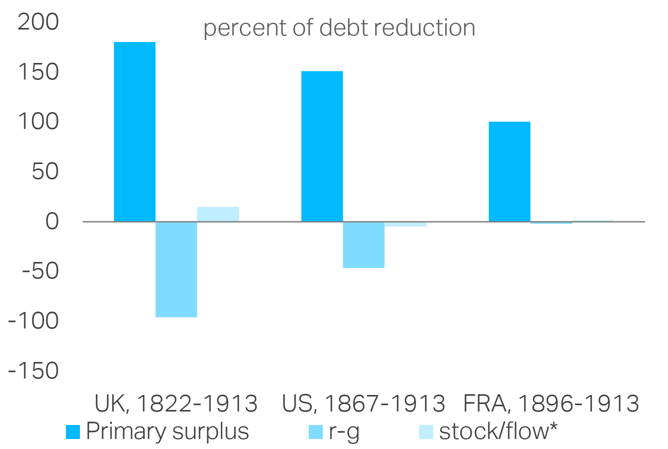
Source: IMF World Economic Outlook, October 2012

The second objection to financial repression in the 2010s was that it had only worked in the post WW2 era because capital markets were closed and the banking sector was heavily regulated. Regulatory restrictions included interest-rate ceilings and reserve requirements on banks, prudential floors on pension fund assets (forcing them to hold government securities), caps on bank deposit rates, and restrictions on cross-border FX transactions. Meanwhile, to quote from Barry Eichengreen, the international bond markets were "quiescent and demoralized". These conditions made it relatively easy to apply an inflation or "wealth tax" on markets, which is what financial repression amounts to. Investors held government bonds after the 1940s partly out of patriotic duty, but also because the financial alternatives were limited – banks couldn't pay higher interest rates on savings, capital controls prevented the purchase of foreign bonds and

[1] The residual is the so-called stock-flow adjustment, which can also include writedowns, privatizations and other one-off adjustments in the level of government debt that are not otherwise captured by the budget arithmetic. .

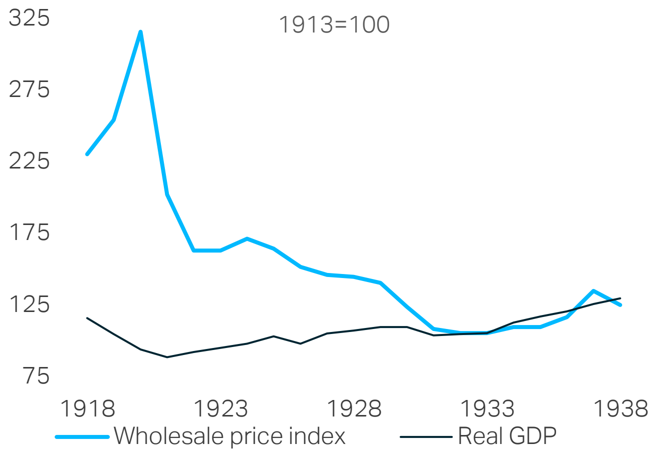
high commissions made the equity market unattractive. Policymakers had no interest in trying to recreate these conditions in the 2010s, especially as a larger share of advanced economy debt was held by non-residents, with a lower share in domestic banks. There was no "captive" investor base. Worse, taxing the financial system would compound financial stability risks and undermine the cherished independence of central banks (which was still sacrosanct back then).

Chart 20: "Sound Finance" in the 1800s



Source: Eichengreen et al (2019)

Chart 21: UK austerity caused deflation



Source: IMF World Economic Outlook, October 2012

Lessons from the "sound finance" period

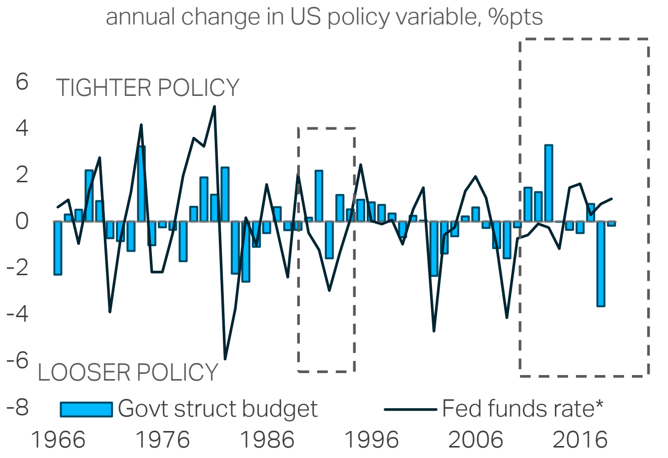
Since the consensus believed public debt had to be reduced after the financial crisis and there was no appetite for the "unorthodox" approach involving dangerous writedowns, the only option was austerity. In some case, of course, this was ideological. UK and US politicians, for example, looked back fondly on the successful fiscal consolidations of the Thatcher and Clinton eras. This contributed to an overly bullish view about what fiscal consolidation might entail. Yet there was also an earlier period in economic history that suggested austerity could work – specifically the large debt reductions that had happened before the 20th century – such as in Britain after the Napoleon conflicts, the US response to its Civil War and in France during the late 1800s. These had been fiscal adjustments based almost entirely on tax increases and budget surpluses, rather than defaults and financial repression. Even when governments had resorted temporarily to "monetary financing", by suspending the convertibility of their currencies into gold and "printing money", budgetary arithmetic showed seigniorage hadn't been a big part of the adjustment.

Too optimistic about monetary stimulus

The pre-Twentieth Century version of austerity reflected the interests of the people who made the decisions, especially the dominance of the "creditors" (the wealthy) in Parliament and the Congress. Perhaps we can levy the same accusation at politicians in the 2010s (or even today…). Yet it is also true the consensus had too much faith in the power of monetary policy to offset the impact of fiscal tightening. As we pointed out in previous research, this was an era of total monetary dominance, where most economists believed central banks had the tools to support the macro economy, even with interest rates close to the lower bound. Policies such as QE, officials claimed, could provide a powerful stimulus (perhaps too powerful – remember those worries about hyperinflation and dollar debasement!), which would reduce the fiscal multiplier to zero, providing a full monetary offset. Some economists went further, claiming austerity could end up being stimulative because it would reduce long-term interest rates and prevent the "crowding out" of private spending. These ideas became particularly popular in the euro area.

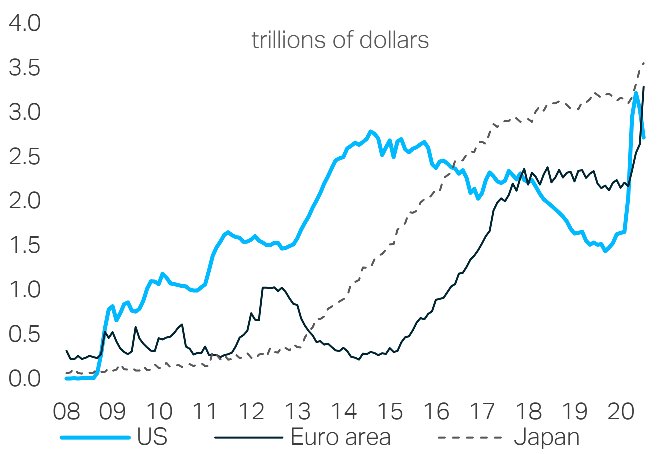
The 2010s optimism about monetary was misplaced. The mix of tight fiscal policy and loose monetary policy produced the weakest economic expansion in modern history. Most central banks continuously undershot their inflation targets and yields slumped to 700-year lows, clear evidence the policy mix was wrong. If, as the IMF had claimed, the authorities believed monetary stimulus could prevent a repeat of what happened in the UK after WW1 – where the government's obsession with austerity and being on the Gold Standard delivered an unnecessary episode of high unemployment and deflation – they were sorely mistaken. Instead, the whole world suffered a milder version of that same malaise. QE was a poor substitute for interest rate cuts – it just swapped one low yielding financial asset for another – especially where there was limited appetite in the private sector to accumulate debt (unlike what happened during the Thatcher and Clinton eras). In fact, by the time the COVID-19 pandemic struck, a decade later, even the central bankers had lost confidence in the potency of monetary policy.

Chart 22: Unhelpful policy mix in 2010s



Source: OECD, TS Lombard, *includes shadow rate

Chart 23: Massive QE didn't help

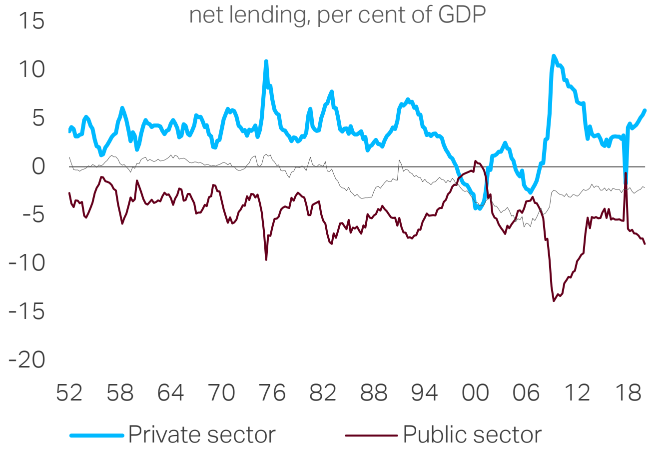


Source: National sources, TS Lombard

3. MMT PROMISES

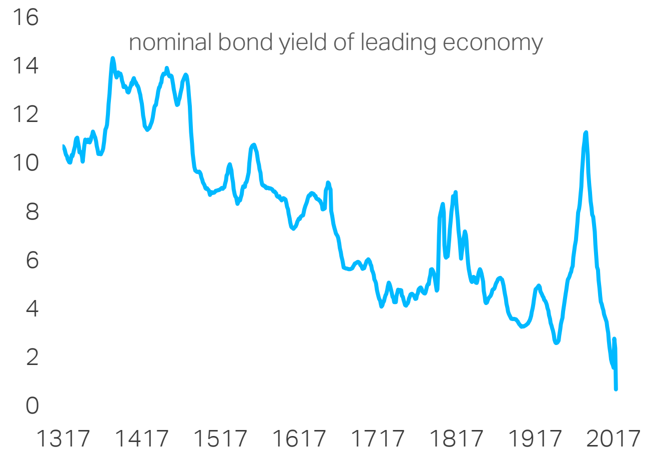
The history of public debt can provide clues about what might happen next. In the 2010s, the authorities tried what historians called the "orthodox" approach to fiscal consolidation: they tightened their budgets and tried to offset this austerity with loose monetary policy. The result was chronic income stagnation, widening inequality, booming asset prices and dangerous populism. Yet, if high levels of public debt are really something we need to worry about – as many politicians still believe – we now have an even bigger problem than we had a decade ago. So, do we face another decade of austerity, or is it time to try something different? Modern Monetary Theory (MMT) now provides this alternative. MMT economists argue the size of the fiscal deficit, or the level of public debt, is largely irrelevant and should not be the objective for government policy. There is no nominal limit on the amount governments with "monetary sovereignty" can spend, the only constraint is on real resources (i.e. inflation). In short, MMT urges us to abandon the "orthodox" approach to public debt and try the "unorthodox". With Stephanie Kelton's book topping summer charts, these ideas seem to be gaining traction[2].

Chart 24: MMT's favourite chart



Source: Federal Reserve, TS Lombard

Chart 25: History of nominal bond yields



Source: Bank of England

What is MMT?

The core of MMT concerns how government-issued fiat money relaxes the financial constraint on the public sector and opens space for policy. MMT analysis usually starts with a description of the origins of money because this sets up its main narrative about how the private sector "needs" public spending, rather than the government needing to raise taxes and issue bonds. This is the classic "chartalist" interpretation, which claims money has value only because people need it to pay their taxes. Rather than think about budget deficits as an indication that the government must raise cash from the private sector, MMT argues this way of thinking is backward – the government has to spend in order to provide the money people require to pay their taxes. After all, if the government (which includes the central bank) is the monopoly supplier of cash, how can it ever run of money? While it is unusual for economists to talk about the government's role in this way, chartalism actually has a long tradition. Yet mainstream economists accept there are other reasons why money is desirable, including its properties as a store of value, a unit of account and a medium of exchange – MMT tends to downplay these.

Governments can't run out of money

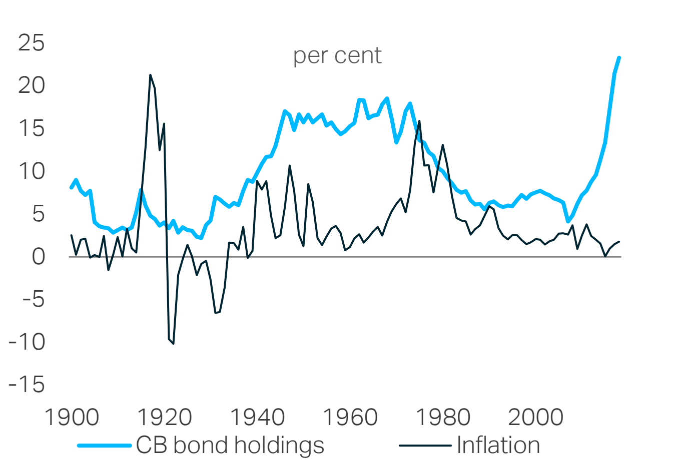
While the precise origins of money are debatable, they are not essential to MMT's main policy prescriptions – the most important of which is that there is no need for governments to raise taxes or issue bonds in advance of spending because central banks can create all the money they need electronically (i.e. print money). This means the public sector does not face the same financial constraint as households and businesses – it has monetary sovereignty. The ability to print money also means governments who issue debt in their own currency never need to default – the central bank can always cover whatever expenses the public sector incurs, including interest on past borrowing. This sounds controversial but it is largely a matter of accounting. Economists have always recognized that governments can "fund" themselves with either high powered money or governments bonds. To quote Thomas Palley, "the critical

[2] Critics like to accuse MMT of not being "new" but this is something its proponents admit. Fullwiler, Kelton and Wray describe it as: 'integrating the insights of Knapp's (1924) state money approach (also called chartalist and adopted by Keynes (1930; 1914)), the credit money view of Innes (1913, 1914), Lerner's (1943, 1947) functional finance approach, Minsky's (1986) views of banking, and Godley's (1996) sectoral balance approach'. Plus a Job Guarantee Programme.

question is not whether a government can finance spending without taxes. Everybody knows it can. The question is about the macroeconomic consequences of doing so. And should governments do it"? Mainstream economists have discouraged money financing, not because they didn't know it was possible, but because they believed it was dangerous.

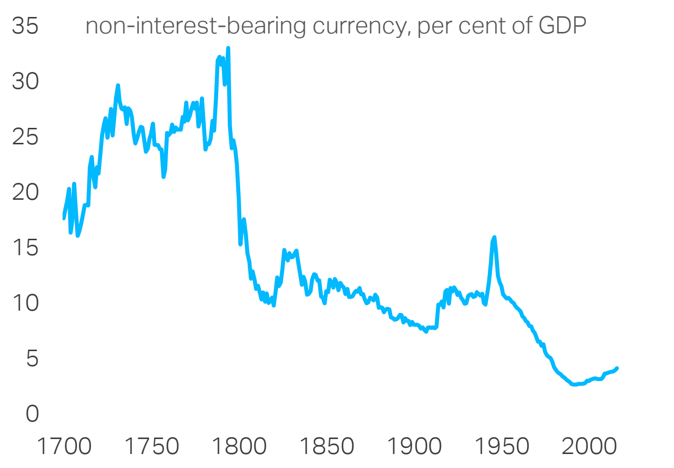
Let's run through an example of how money financing works, based on this paper by the three most prominent MMT economists. Suppose the government wants to spend $1 trillion. It could either issue $1 trillion in bonds, or it could use its central bank to credit its account. MMT argues there is actually no reason to issue bonds, other than because these bonds allow monetary policy to operate in a specific way – which MMT believes is unnecessary. When the government spends this $1 trillion (on unemployment insurance, military equipment or whatever), the cash will find its way into the private sector, which will increase the reserves in the banking system. MMT stresses an important point: the increase in reserves will naturally cause short-term interest rates to DECLINE. Before the financial crisis, back when the Fed operated a 'corridor' system, the central bank would prevent this from happening by altering the supply of bonds in the economy – it would effectively "mop up" the reserves by issuing bonds. This, according to MMT economists, was the main reason governments needed to issue bonds in the past – the central bank required these bonds so that it could operate monetary policy by manipulating the level of short-term interest rates. This analysis is an important departure from the idea that government spending will naturally cause interest rates to rise, "crowding out" private spending[3].

Chart 26: Money financing not inflationary?



Source: IMF, TS Lombard

Chart 27: A risk to monetary financing



Source: Bank of England, TS Lombard

Currently, of course, we have a floor system in monetary policy – central banks pay interest on bank reserves, which they can adjust in order to move a broader set of interest rates. In this operating framework, the MMT proposal for cash-financing means the government would effectively be borrowing OVERNIGHT. This is because reserves are a liability of the central bank, which is part of the government. If the central bank eventually raised interest rates, the debt servicing costs of the government would start to increase (via lower remittances). Incidentally, we get the same dynamics with the combination of government deficits and QE, which have been a feature of policy over the past decade. When the central bank buys government bonds, it

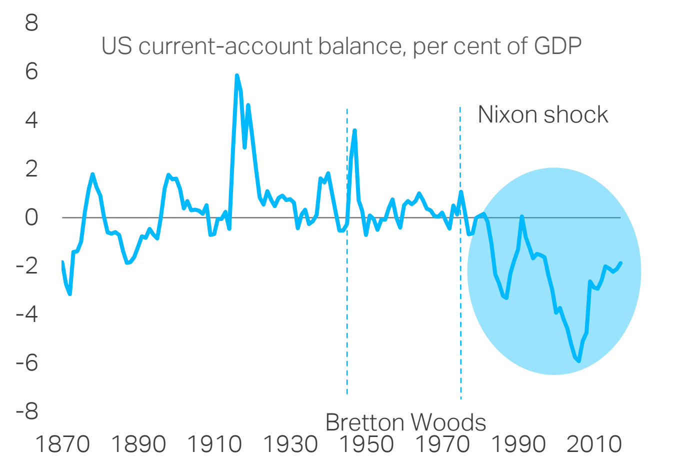
[3] MMT rejects the "loanable funds" model of banking, which assumes there is a fixed supply of funds available for lending to businesses and the public sector. This means there is no crowding out, where a government bid for extra borrowing would otherwise increase the cost of capital for the private sector, discouraging business investment and home loans.

adds reserves to the bank system and – as long as it continues to pay the IOER – this action effectively shortens the maturity of the government's liabilities, transforming long-term debt into overnight lending. If the government spends $1 trillion and the central bank conducts $1trillion in QE, we get the same result as if the government funded itself with $1 trillion in overnight bills.

Inflation is main fiscal constraint?

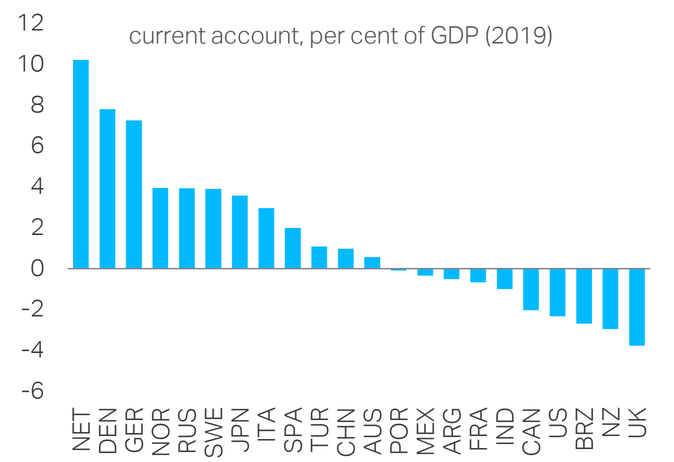
At the zero bound, where the central bank has no intention of raising interest rates, there is indeed no difference between bond-financed government spending and bill/reserve funded fiscal deficits. (Which is also why QE becomes a meaningless asset swap). Yet a difference emerges when we bring inflation into the story because an independent central bank would eventually want to raise interest rates, causing the government's liabilities to increase. MMT gets around this problem by deactivating monetary policy and preventing the central bank from responding. In an MMT-based policy world, central banks must forfeit their independence and their role is now focused on capping public borrowing costs. So who fights inflation? MMT claims the focus must shift primarily to fiscal tightening, direct price controls, regulatory changes and even restrictions on the supply of credit – basically anything other than interest rates! In fact, if these other measures can deliver an economy that is always at full employment – never too hot or too cold – the natural rate of interest is zero. And in a perma-zero world where governments are able to keep inflation under control, all forms of public funding are the same.

Chart 28: The world needs US deficits



Source: Macrohistory database, TS Lombard

Chart 29: But what about other nations?



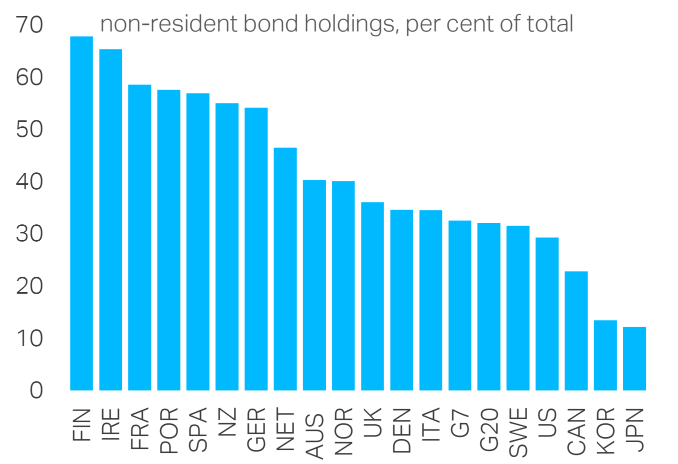
Source: OECD

Mainstream economists have always discouraged monetary financing and urged governments not to fund themselves at short-term maturities. They were concerned about "rollover risk", the pressures that would emerge if interest rates started to rise. This wasn't just about the danger of the bond vigilantes. As Reinhart and Rogoff explained a decade ago "Though governments that issue debt in domestic currency can never be forced into technical default by markets, they are, still vulnerable to inflation risk and to nominal interest rate spikes should inflation expectations become unanchored". In fact, it has always been recognized that there might be a trade-off between rollover risk and central-bank independence. In the case where inflation targeting is too rigid, the country faces rollover risk because the central bank is not able to print money as needed to prevent a rollover crisis. In the case where there is no anti-inflation commitment, the country avoids rollover risks entirely, but is faced with a high, time consistent inflation. The question is whether MMT can make central-bank independence irrelevant by finding alternative ways to control inflation – of whether MMT ideas are a 'special case' at the zero bound.

MMT gets a lot right

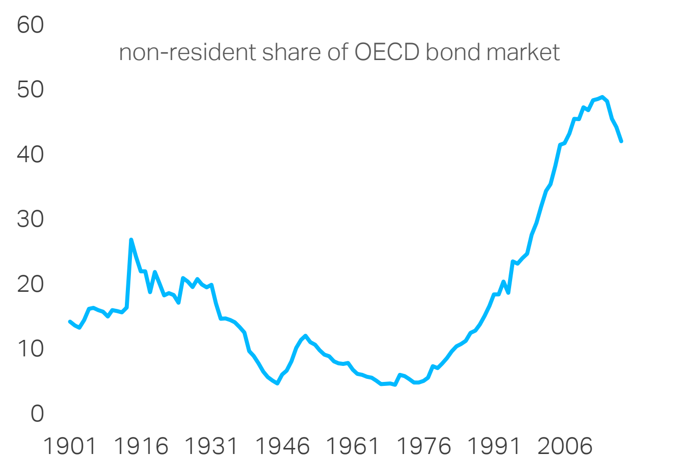
The consensus has been quick to attack MMT analysis. Yet its proponents have got many of the big issues "correct" over the last decade and they deploy tools that have always played a role in the way TS Lombard has approached macroeconomic analysis, including Wynne Godley's "sectoral balances"[4]. MMT was correct, for example, to highlight the financial dangers of EMU membership for countries giving up their "monetary sovereignty". It was also on the right side of the austerity debate, pointing out that governments should not try to reduce their deficits during a 'balance sheet recession', when the private sector was intent on raising its saving rate. Many mainstream economists could also learn from the MMT approach to banking, which is more sensible than the outdated models still included in most standard textbooks. MMT understands there is no "money multiplier", adopting instead an "endogenous money" view of banking, which realizes that banks make loans (based on a variety of criteria/metrics) by creating deposits and central banks supply the reserves they need (i.e. the money multiplier in reverse). This gave a better guide to QE than traditional monetary analysis, where some predicted hyperinflation.

Chart 30: Will we need capital controls?



Source: IMF Fiscal Monitor, 2019

Chart 31: And a reversal of globalized markets?



Source: IMF, TS Lombard

Above all, MMT provides the correct diagnosis for the post COVID-19 era, especially for a world that was already struggling with secular stagnation even before the pandemic. Now is not the time to worry about the size of the public debt and embark on new rounds of austerity. If the likes of Stephanie Kelton – who is incredibly persuasive – can convince the world's politicians to embark on a multi-year fiscal stimulus programme, this will be a beneficial outcome. Yet there are risks associated with MMT-type thinking and it is important that investors understand these risks, especially as they could have an important bearing on the longer-term macro outlook.

The dangers of MMT

While there is no doubt the world needs large-scale fiscal support, MMT threatens to take the new era of "fiscal dominance" too far. This makes it both an effective solution to secular stagnation and a threat to long-term stability. Years ago, Paul Krugman famously claimed the

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[4] MMT sometimes uses sectoral balances in a misleading way. For example, its proponents are fond of Chart 24, which they argue shows government deficits always "cause the private sector to save more". This inference can lead to some odd policy conclusions, such as Clinton's budget surpluses in the 1990s caused the Dotcom bubble. But the mirror image in Chart 24 is simply an accounting identity, it tells us nothing about causation. If the government is borrowing, another sector has to do the lending. As for the Dotcom bubble, it seems likelier that the boom in the private sector boosted government receipts, causing the surpluses!

authorities needed "credibly irresponsible" policies to deal with a liquidity trap. Governments had to commit to massive stimulus and serious inflation in order to break deflationary psychology. MMT comes closer to meeting these requirements than anything we have seen so far. But in doing so, it also includes the seeds to its own destruction. To explain, we see several problems:

(i) Vagueness of monetary sovereignty: MMT says any country with "monetary sovereignty" can always print money to fund its deficits. But it doesn't specify exactly what this means. Countries that share a common currency, such as the euro, clearly don't have sovereignty. There are also a bunch of countries that borrow externally in dollars, including many Emerging Markets, which MMT rightly excludes. But what about nations with large current-account deficits such as the UK? Or even countries that have balanced trade positions but import vital goods and services, such as food and medicine. MMT-type policies could cause a plunge in their exchange rates, which might generate inflation even without full employment. Obviously these issues are less threatening for the US, which is the world's reserve currency, but – over time – could MMT ideas also undermine dollar hegemony?

(ii) Losing the "nominal anchor" of CB independence: MMT would abandon the independence of central banks, relying instead on fiscal policy and various price controls to fight inflation. Yet we know from history that governments have often struggled to tighten their budgets when faced with inflation, especially around election time. This was, after all, the reason most countries strengthened the independence of their central banks after the 1970s – they didn't stumble on this framework by accident but rather because the previous regime ended in rampant inflation. MMT hopes to provide a new nominal anchor by introducing a Job Guarantee scheme. The government would offer, as a right of citizenship, a job at minimum wage with benefits, working in the public sector or a non-profit, to any adult who wants one. When the labour market is tight, people would move out of the JG scheme into private jobs, which would lead to an *automatic tightening* in fiscal policy. Yet the JG might not be politically feasible and the labour market is not the only source of inflation.

(iii) High-powered money vs bonds: MMT argues there is no difference between high-powered money and government bonds. This is true in a liquidity trap, which is why MMT has seemed so prescient over the last decade. But it might not be true in other states of the world. In fact, monetary financing creates "latent spending power", which could become a problem if central banks are no longer allowed to raise interest rates. Once a government injects non-interest-bearing currency into an economy (the "classic" helicopter drop) it cannot reverse the policy. In our example where the government spends $1 trillion to stimulate the economy, this cash injection becomes helicopter money if the central bank holds interest rates at zero even with higher inflation, allowing seigniorage to pay off the debt. MMT also ignores the role of inflation expectations. Again, this might be appropriate for a liquidity trap, but expectations could behave quite differently in an economy starting to "overheat".

(iv) Perma-zero interest rates: MMT argues the authorities should set interest rates at zero and – to the extent they want to use monetary policy at all – focus on price and credit controls instead. But policymakers tried these same tools in the past, especially in the 1970s, with limited success. The UK government, for example, abandoned "quantity" controls on money/credit in 1980 because it believed these only postponed the need to raise interest rates – they were not a substitute. More generally, MMT proponents want to deactivate monetary policy because they believe interest rates no longer have an influence on aggregate demand and consumer prices. But they have forgotten the "string" analogy. History shows the authorities cannot "push" on interest rates to get inflation higher, but there have been plenty of episodes where they have successfully "pulled" on interest rates to force inflation down. Permanently deactivating monetary policy seems dangerous.

In previous research, we noted the "supercycle" in macroeconomic policy, where – over the last century – the authorities have oscillated between supreme faith in monetary policy and total confidence in fiscal policy. They pushed one set of tools to the extreme, abandoned them, and adopted the alternative array of instruments instead. Monetary-policy dominance caused asset price bubbles and overleverage in the 1930s, a deflationary trap that required a fiscal solution. Fiscal dominance took over, ending with stagflation in the 1970s. Because monetary policy was able to force inflation lower through the 90s, we repeated a second era of monetary dominance. Now, after 30 years+ of complete faith in monetary policy, we are on the brink of a second era of fiscal dominance. Even the central banks say they cannot hit their targets without fiscal help.

We can do better than MMT

MMT threatens to repeat this pattern all over again, deactivating monetary policy, withdrawing central-bank independence, and relying excessively on fiscal instruments. When MMT economists stress the need for quantity restrictions on credit/banking, price controls, yield caps and even barriers to the mobility of international capital, it sounds as if they want to totally recreate the policy framework and macro environment that existed after the Second World War. They even have a "war on climate change" to take the place of actual military conflict. Based on what we know about the public finances after WW2, we can also make inferences about what MMT might mean for the management of the public debt. We are likely to "pay down" the debt through some combination of higher inflation and financial repression, which could be a messy outcome for financial markets. Yet, in principle, we should be able to do better than simply repeat the "on-off" policy oscillations of the past. How about a policy framework that leveraged up the depression-busting power of fiscal policy when it is needed, like today, without compromising the inflation-fighting credibility of monetary policy? We need a co-ordinated approach.

Bottom line

Governments everywhere introduced a massive fiscal response to COVID-19 in an effort to prevent mass bankruptcies and depression-levels of unemployment. Deficits widened dramatically as the public sector absorbed huge income losses in the private sector. There is no doubt this gave the global economy the best opportunity to rebound once the pandemic was over. Yet, despite a recovery that remains patchy and incomplete, worries about how to pay for the crisis have already returned. Some politicians are anxious to tighten their public finances, reminiscent of what happened not long after the 2008-09 global financial crisis. Back then, most mainstream economists supported the "orthodox approach" to reducing the debt, which relied on cutting the deficit and using monetary policy to try to offset the fiscal adjustment. Yet the long period of austerity failed, producing a decade of macroeconomic stagnation and deteriorating politics. This experience has emboldened more radical economic ideas, notably MMT. While fiscal activism is welcome – indeed necessary – MMT threatens to take us down the classic "unorthodox" route to debt reduction, namely via inflation and financial repression.