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An MMT perspective on the US crisis

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1. Extraordinary times

These are extraordinary times. The pandemic triggered the worst economic crisis since the 1930s, and arguably, the worst in history. Economies are enduring massive contractions with unemployment at obscene levels. As a standalone event, this crisis offers all the elements of any of the major tragedies in human history.

The only reasonable conclusion, as evidenced by the substantial increase in official unemployment and the rise in the BLS U6 broader measure of labour underutilisation is that the fiscal support has been grossly inadequate and poorly targeted.

The benefits of the US government's fiscal package flowed disproportionately to corporations and left millions of workers exposed to income loss and financial disaster. The main action has come from the Federal Reserve's decisions to purchase government bonds in large quantities and to provide other liquidity support.

But another way of viewing the pandemic is that it is exposing the unsustainability of the neoliberal era in terms of economic policy and the underlying economics that guide that policy. Nowhere is that more obvious than in the United States.

The last several decades have been marked by a reliance on household debt for growth with lax oversight of financial markets justified by the 'efficient markets' theorem, which in lay terms, amounted to a denial that financial markets can act irrationally and misallocate investment funds. At the same time, government policy has been biased towards austerity and dominated by a reliance on monetary policy. The mainstream macroeconomists were so smug that their principle economic models did not include a financial sector. The Global Financial Crisis was a rehearsal for the folly of that approach. And the scale of the damage now, as we deal with an existential health crisis, is further demonstrating why this approach is an inadequate guide to stable and inclusive growth.

The way out of the crisis, which addresses the health challenges, the socio-economic consequences and the underlying climate crisis, that has been pushed to the back of our attention, will thus require an orthogonal shift in policy thinking driven by a paradigm shift in economic theory.

The latest Eurostat data shows the European Union contracted by 11.9% in the second quarter 2020, while the euro area was down 12.1%. Italy's output shrank by 12.4% Spain, down 18.5%, France by 13.8%, Portugal by 14.1% and Germany, the largest European economy contracted by 10.1%. Unemployment rates are rising as output shrinks (Eurostat, 2020).

Similarly, the US economy contracted by 9.5% in the June quarter, the largest quarterly contraction in recorded history. Consumption expenditure declined by 10.1% in real terms and business investment by 17.4%. The collapse in consumer expenditure was concentrated in services (-22.6%), which reflected lockdowns and the unwillingness of consumers to continue normal practices (BEA, 2020).

The consumer outlook is negative. The Conference Board Consumer Confidence Index ((2020) rose in June, but as the infection rate has accelerated, the July figure declined from 98.3 to 92.6. This was accompanied by a massive decline in the *Expectations Index*, which signals short-term consumer estimates of income and labour market prospects – down to 91.5 from 106.1.

The future is not looking optimistic.

Several major US companies are laying off thousands (for example, Boeing, AT&T, Hilton, HSBC, Linked-In, etc and many companies have disappeared forever.

Conversely, Amazon, Apple and Facebook have boomed with shifts to home office setups and on-line shopping. These shifts will not be temporary. Firms will start rationalising expensive office space and the decline in bricks-and-mortar retailing will accelerate. Both trends have serious implications for the viability of commercial real estate, which was already in trouble before the pandemic.

The human tragedy is exemplified by the 54 odd million people that have filed for unemployment insurance since early March. While the weekly claims started to decline as the lockdowns eased, they have risen again with 1.4 million filing in the last week of July. The insured unemployment rate has also risen (11.6%) (Department of Labor, 2020).

The socio-economic crisis is global and will worsen as nations around the world endure the emerging second wave of the virus. Renewed lockdowns are already occurring in various nations as hospital systems face being overwhelmed and death rates remain high.

The politicians started with the V-shaped (hibernation) presumption, while they 'flattened the curve'. The reality is different. This will be a long-drawn out crisis and many companies will fail to 'get to the other side', leaving a residual of high unemployment.

Capitalism is now on state life support. The 'market' will not provide the cure.

There is also a growing disconnect between movements in the booming US equity markets and the real economy, after the former fell sharply in mid-February. This is partly because the 'tech stocks' have boomed (as above). But there is also a raw optimism that consumer spending will rebound strongly into 2021. If this sentiment is wrong and the real economy takes much longer to recover on the back of larger second waves, then the equity markets will eventually come to grief.

To avoid an extended period of grief, the age of irrational worry about fiscal deficits and public debt ratios will have to give way to a new era of large, continuous deficits supported by the monetary capacity of the Federal Reserve.

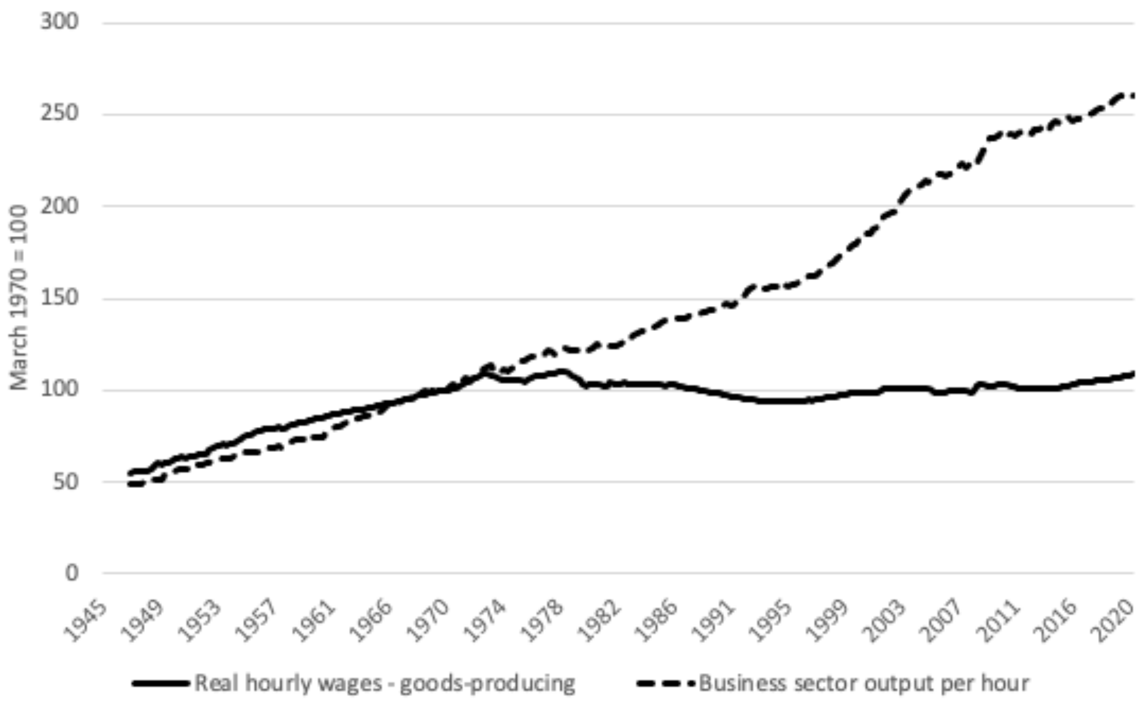
The problem for most nations is that governments 'penny pinched' on the fiscal support that accompanied the lockdowns. This not only exacerbated the economic losses, but, created the vicious cycle where political pressure led to premature easing of the lockdowns, which then fuelled the infection rate, and magnified the economic losses.

2. The slippery slope

The US economy hasn't functioned in a sustainable manner for several decades.

A characteristic since 1980 has been the growing productivity-real wages gap (see Figure 1). Economic growth no longer generates upward mobility. Real pay used to grow in line with productivity growth, which allowed for broad increases in material living standards and consumption growth without high levels of indebtedness.

Figure 1 Real wages and productivity, USA, March 1945 to June 2020



Source: US Bureau of Labor Statistics (2020).

Since the late 1970s, several factors have contributed to real wages growing by just 6.1%, while output per hour has grown by 137 per cent (BEA, 2020). For example, the influx of women into the workforce created excess supply conditions, which employers used to restrain wages growth, while exploiting a better educated workforce using better technology to stimulate productivity growth. Fiscal austerity, particularly at the State-level over this period also made it hard for workers to make real wage gains.

The promised ‘trickle down’ has not eventuated and wealth and income inequality has risen substantially as a result. This has forced households into increasing indebtedness to maintain consumption standards. There was a lull after the sub-prime mortgage binge that caused the GFC, but since the refinancing began in 2013, mortgage originations have growth strongly. The Federal Reserve Bank of New York (2020) shows that U.S. household debt reached record levels ($14.5 trillion) in late 2019, with mortgage debt surging on the back of strong refinancing. It is true that the origination credit scores are higher than before the GFC. It remains the case that households are increasingly exposed to insolvency risk.

More and more households will go under if the government doesn’t significantly expand cash support. Loading debt onto household balance sheets while eschewing public debt is an unsustainable growth strategy.

In contradistinction to the household debt vulnerability that led to the GFC, the main vulnerability as present is the rapid increase in non-financial corporate debt, which has risen by 58 per cent since its pre-GFC peak (September-quarter 2008) (Federal Reserve Bank St Louis, 2020). While borrowing costs remain low, the sheer scale of the debt exposure in the face of the dramatic negative pandemic shock will surely stretch the capacity of many businesses to stay afloat. Around 30 per cent of corporate debt exposure is low quality leveraged loans, which in July experienced the highest default rate since the GFC (S&P Global, 2020). If the equity markets falter then we would expect this default rate to escalate rapidly.

3. The required policy response

The challenges ahead are many.

The climate crisis demands major public investment in green technologies to reduce carbon usage.

The health crisis exposed by very high per capita Covid death rates requires major investment in the public health care system (Medicare for All).

Pay stagnation has to be reversed and focusing on corporate tax breaks, increasing interest rates or free trade deals are ill-advised. Reducing debt exposure (especially student debt) will be an important component in building a more equitable society. Major public investment projects should also set higher wage norms that the private sector has to respond to.

The federal government should encourage tighter lockdowns and increase its financial support to workers who are disadvantaged. The pandemic has not impacted evenly across socio-economic groups and is exposing the dramatic inequalities in America.

The working class has been forced by economic circumstance to continue working despite the health risk, while middle- and upper-income workers have been able to ‘work from home’. The spillovers of the infected continuing working are massive and will only be reduced through better government support to low income workers.

Importantly, there was no reason for unemployment to rise significantly. The Federal government should aim to sustain true full employment, in part, by introducing guaranteed employment to disadvantaged communities and increasing the federal minimum wage substantially.

How to pay for all that?

4. The failure of mainstream macroeconomics

Mainstream economists will predict rising inflation, rising government bond yields, higher taxes as a result of this policy agenda. There will be moral tales about leaving higher tax burdens for grandchildren. All these predictions are erroneous.

Donald Trump threw a ‘cat among the (deficit and debt phobia) pigeons’ through his willingness to spend freely. He also blew cover when he stated in 2016: “This is the United States government … you never have to default because you print the money …”

Nations have been badly served by the mainstream, which essentially advances a ‘fictional’ world that serves the interests of some at the expense of the many.

There are many examples. During the GFC, as fiscal deficits reached new heights, economists claimed there would be capital losses on government bonds. Further, as more central banks followed the Bank of Japan's lead and engaged in quantitative easing programs, accelerating inflation was predicted – the standard ‘printing money’ myth - which biased investment portfolios towards inflation hedges. Neither prediction was realised, and significant profits were foregone because of this faulty mainstream advice. Bond markets can never overpower the financial capacity of the Treasury and the central bank.

Further, the mainstream insistence has been that monetary policy should dominate counter-stabilisation policy (‘inflation first’ strategies) with discretionary fiscal policy biased towards running surpluses. The problem is that monetary policy (interest rate changes and quantitative easing) has proven to be ineffective as a stimulus force. Conversely, fiscal policy (spending and taxation) directly impacts on aggregate spending in the economy and the result of the fiscal austerity bias, has been growth stagnation, elevated levels of labour underutilisation and subdued inflation rates. Wages growth is flat, and households have accumulated record levels of debt making financial stability more precarious.

Central bankers responded to low inflation and growth stagnation, by progressively cutting interest rates, to the point where negative rates are not uncommon. In turn, we are now seeing negative yields on long-term bonds in many jurisdictions. The stifled public infrastructure development has restricted low-risk, productive investment opportunities for investment funds.

Large pension funds are now facing increasing maturity mismatch as returns on assets have become compromised. As a consequence, they are taking riskier investment positions to increase earnings given their contractual liabilities and increasing their insolvency risk.

5. Modern Monetary Theory (MMT) - the emerging paradigm

MMT is a lens through which policy makers could obtain a better understanding of the monetary system and the capacities of currency-issuing governments. And by linking institutional reality with behavioural theories, it can provide a more coherent framework for implementing the very necessary policy responses needed to protect the U.S. economy.

Most choices that are couched in terms of 'budgets' and 'financial constraints' are, in fact, just political choices.

MMT exposes the false analogy between an income-constrained household and the currency-issuing government. Households use the government's currency and always have to finance their spending choices.

There are no intrinsic financial constraints on a currency-issuing government, only real resource and political constraints. They can purchase whatever is for sale in their own currency including all idle labour desiring work. Mass unemployment is a political choice.

It also makes no sense to talk about a suite of MMT policies. We have to overlay our MMT understanding with our values to define a set of policies. MMT is politically agnostic.

In terms of the policy agenda noted above, MMT allows us to address the 'how to pay for it' canard and illustrate why inflation and interest rates are likely to remain low despite the required increase in the Federal Reserve's balance sheet.

Mainstream economists claim that the US government has to fund its spending via taxation, bond issuance, or 'money printing', which all have negative consequences (taxes distort behaviour, bonds drive up interest rates, and money finance is inflationary). As a result, fiscal deficits are largely eschewed.

MMT rejects this analysis.

First, government spending is facilitated by central banks typing in numbers to bank accounts. New currency is spent into existence. There is no spending 'out' of taxes or out of bond sales. All the elaborate accounting structures and institutional processes, which make it look as though tax revenue and/or debt sales fund spending, are voluntary smokescreens. They are designed to impose political discipline on government spending.

In March 2009, the US program 60 Minutes asked Federal Reserve Chairman Ben Bernanke: “Is that tax money that the Fed is spending?” He replied: “It’s not tax money. The banks have accounts with the Fed … we simply use the computer to mark up the size of the account ...”

The same applies for all government spending.

Second, all government and non-government spending carries an inflation risk. If nominal spending growth outstrips the productive capacity of the economy, then inflationary pressures will emerge.

Consider two scenarios facing a monetarily sovereign nation, like the US – which issues its own currency, floats it on foreign exchange markets, does not borrow in foreign currency and sets its own interest rate.

In the first scenario – a fully employed economy - government spending is not financially constrained. But, if it competes for productive resources with the non-government sector, then inflationary pressures will arise.

To increase its use of productive resources, but avoid inflationary pressures, the government has to deprive existing users and ‘free up’ resources for transfer into the public sector. Taxation is one policy option because it reduces non-government purchasing power and creates real resource space which the government can spend into without creating inflation. The taxes do not provide any extra financial capacity to government.

In the second scenario, idle productive resources can be brought back into productive use with higher deficits. There are no constraints – financial or resource – on such government spending. The responsibility of government in this case is to spend up to full employment.

Do bond sales reduce the inflation risk of public spending?

Mainstream economists claim that if central banks just credit bank accounts on behalf of governments (erroneously called ‘money printing’) without bond issuance, then accelerating inflation will result. The risk is lower with bond issuance because, allegedly, rising interest rates ‘crowd out’ private spending. But these conclusions are not ground in the foundations of a fiat monetary system nor banking reality.

First, the crowding out story is based on Classical loanable funds doctrine, which claims that competition for a finite pool of ‘savings’ from government bond sales drives up interest rates and damages interest-sensitive non-government spending. John Maynard Keynes exposed the fictions of this story in the 1930s by showing that saving is a function of income and rises with net government spending.

The mainstream also claim that bank lending is constrained by deposits (reserves). But in modern banking, loans create deposits. Banks will extend credit to any credit worthy customers knowing they can always get reserves from the central bank to satisfy payment system demands. Banks do not loan out reserves. There is no scarcity of ‘savings’, squeezed by government debt auctions.

Second, what happens when government issues debt? Fiscal deficits generate excess reserves, which influences the way the central bank manages monetary policy. It has only two choices if its desires to maintain a positive policy target rate: (a) it can offer a return on excess reserves, or (b) it can drain the excess via open market operations. Otherwise, it loses control of its policy target as banks try to rid their excess reserves in the interbank market which drives the short-term rate down to zero. So, without an open market operation or the functionally equivalent interest support, the interest rate is biased downwards when there are fiscal deficits.

Further, when the government issues bonds to match the deficit, the central bank marks down reserve accounts and marks up a 'treasury debt' account. There is no reduction in bank deposits created by the fiscal deficits. The bond sales do not alter the net worth in the non-government sector. Only the asset portfolio composition held in the non-government sector changes.

Why would that alter the inflation risk inherent in the spending?

It is clear that funds used to purchase the bonds are not currently being 'spent' on goods and services. Thus, bond sales do not ordinarily reduce non-government spending. And the funds to purchase the debt came from past deficits that had not yet been taxed away by government and were 'left' in the non-government sector as accumulated net financial assets.

History supports the MMT depiction. Over the last three decades, central banks have significantly expanded their balance sheets through the purchase of government bonds as a strategy to prevent deflation. The strategy was driven by recourse to the erroneous mainstream notion that injecting reserves would increase the money supply and trigger inflation – too much money chasing too few goods! The strategy failed.

While these bond-buying programs have effectively been funding fiscal deficits, there were no inflationary consequences because spending was not pushed beyond the real resource constraints that MMT places at the centre of its analysis of the constraints on government spending.

6. Conclusion

With elevated fiscal deficits and continuing central bank public debt purchases, it is highly likely that inflation and interest rates will remain low for the indefinite future as the world struggles to come to terms with the health crisis and its drawn out aftermath.

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