Stephanie Kelton on Modern Monetary Theory

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Erik: Joining me now is bestselling author Professor Stephanie Kelton, widely known both as an expert on modern monetary theory and I would say even more so as one of the most active promoters of modern monetary theory in the public policy arena. Dr. Kelton, thank you so much for joining us, the book of course is called "The Deficit Myth: Modern Monetary Theory and the Birth of the People's Economy".

So I want to dive right in to the six myths that you bust in the book and talk about the first one which is that for years and years we've had this debate in public policy, where everybody says, okay, we've got too much debt. The political left says that's because we're not taxing the rich enough and the political right says it's because we're spending too much. But both sides historically have generally been willing to agree that expanding the national debt is a big problem, you got to balance the budget.

You say, that's not really true, particularly for monetary sovereigns like the United States that control their own currency. So why that distinction? And why is it a myth that it's important to pay for what we spend or what the government spends through taxes?

Stephanie: First, thanks for having me on and so let's just jump right into the very last question that you asked. This idea that governments have to pay for things and the way that I was taught when I was a graduate student studying economics and the way that the vast majority of students today are taught that the government faces a budget constraint.

Governments have choices when it comes to how to pay for their spending, that a government can pay for it spending with tax revenue. And if they need to spend more or wish to spend more than one option is to raise taxes to come up with the money in order to pay for that additional spending.

The other option is that governments can borrow, and so they can go to savers and they can borrow to finance the spending that way. And then the third option, which is the one that quickly gets buried under the rug, is the recognition, well, of course, sovereign government and if it has its own currency it could always print money and pay the bills that way.

And so there is this menu of options, three choices, which one will the government choose to pay its bills? And MMT comes along and says, wait a minute, if we look operationally at how government finance actually works, we learn we discover that there's really only one way to pay that all government spending. I'm talking federal government spending, so for a government like the US or the UK or Australia or Japan, that there is only one way to pay that all government spending is indeed already and only ever paid for financed with new money creation.

There's no other way for it to work and so once you get that recognition, once you kind of arrive at that point, then you sort of scratch your head and say, well, then what are the taxes and bond part? What's that about? And it took me a while to get to that point, I think the first or second peer reviewed article that I ever published was titled "Do Taxes and Bonds Finance Government Spending?" because, again, as a graduate student I was taught that's exactly what they do.

And it was only later when I encountered the work of Warren Mosler that I began to question my own understanding of how government finance works. And then after a period of months really working my way through this stuff and the mechanics of government finance.

I was able to persuade myself that I had the ordering the sequencing wrong, and that the government spends new money into existence. And only after it has spent those dollars into existence are they then available to either pay taxes or buy government bonds.

Erik: Now, let's go a little bit deeper on those taxes and bonds because what a lot of people would say is, well, if you figured out that there's kind of a magic source of income here and we don't need those taxes. Let's eliminate taxes and never have them again, because we don't need taxes, we can print new money. But the study of MMT says actually taxes are very important, but maybe for an unobvious reason pertaining to inflation. So why do we still need taxes?

Stephanie: Okay, well, remember I just want to go take one tiny step back and just sort of reassert the point that it's not that we can print money. It's that there is no other way for the government to spend but to create new money as it's been so its newly created digital dollars, and there's no other way for it to work.

And so your question is a very good one, so once you recognize that the government spends its currency into existence, then you say, well, then why do we have to pay any taxes at all? Why not just let the government spend and forget the tax piece, which, by the way, is exactly what Congress has been doing.

Let's just take the cares act as one example, the biggest relief package that has so far gotten through both the House and the Senate and signed into law that was $2.2 trillion. And that bill was Congress writing what we in the DC beltway circles call a clean bill, in other words, it was not offset the spending was not offset. The Congress said, listen up fed, we are ordering up $2.2 trillion, get ready, because you're going to carry out the payments that we have authorized on behalf of the US Treasury, that's how it works.

So, this is an example of Congress committing to spending money it did not have, it's just what it has is the power of the purse it can commit to spending $2.2 trillion. And the Fed as the government's fiscal agent will carry out those payments by changing the numbers in the appropriate bank account. So for people who got that $1,200 stimulus check, the way that the money got into your account is that the Federal Reserve and the bank that you bank at change the numbers upward in your account.

And so there was no pairing of higher taxes to go along with this, so why do we sometimes increase taxes? Why do we have taxes at all? So in the book, I go into a lot of detail on this, if you wanted to start up a currency from scratch then a tax or something like it fees, fines. Also, other obligations governments impose to get a population to put a population of people in a position where they need to earn the state's currency in order to settle their tax or other obligation to the state.

And we could talk a lot about this, but we don't have time, so I'll just say that one reason for taxes is that they allow governments to start up a currency from scratch. Once that currency has been started up and now people are accustomed to having this currency around, they begin making their own payments and transacting in that currency. And the government can use the tax lever to pull some of those dollars back out of our hands.

So taxes are important, because they're one way that the government can reduce the purchasing power of all the other spenders in the economy. So if the government wants to come in and do a big ambitious infrastructure project and spend trillions of dollars into the economy. It might be worried that spending trillions of dollars could push prices higher, could lead to inflationary pressure.

And to offset or mitigate the inflationary pressure, it matches up some of its new spending with higher taxes. So it makes room for the government to be able to spend those dollars into the economy without creating inflationary pressures. Taxes are important because they allow government to pull a lever if it's interested in rebalancing the distribution of wealth and income.

You say, I'm going to put this new tax on or push this existing tax higher because I think the distribution of wealth and income has become so extreme that we want to try rebalance things. So governments use taxes for things like that, and then finally you can use taxes to incentivize or disincentivize behavior in the economy.

So gas tax, carbon tax, earned income tax credit, I mean, you can work it both ways to try to get people to do or not do certain things. So lots of important reasons for taxes but in MMT, the one way that we do not think of taxes is as a source of revenue to pay the government's bills.

Erik: Now, I know that one of the ways that you do think about taxes in MMT is as a preventive measure to overcome the tendency of that spending to bring about inflation. What I haven't seen addressed and maybe I just haven't read enough about it is, wait a minute, inflation tends to be a vicious cycle with a long lead time.

That has to do with inflation leading to inflation expectations, leading to acceleration of velocity of money, and it feeds on itself and once it gets going, it's hard to break it. So it seems to me like I worry about whether, how do you know the taxes enough to prevent that cycle from starting and how do you break out of that cycle. If some of the money that's being created through MMT by the government financing more of its spending just by printing new money does start to lead to that widespread inflation?

The other problem that I have understanding this inflation argument is at least some people, and maybe this is the politicians as opposed to the MMT scholars are saying, well, it's really what we have to do to prevent the inflation, we've got to tax the rich specifically. Tax the rich, well, wait a minute, the rich are the people whose spending habits are not really directly impacted by their tax burden and their inflation because they've got enough assets that they can continue spending.

So how do you overcome the potential of creating a vicious cycle of inflation? Is it just taxes? Or are there other measures that MMT uses to overcome that inflation risk?

Stephanie: Okay, so let me start by saying there's a terrific, short, accessible piece, but your audience is very smart so they can handle the higher order stuff. There's a piece in the Financial Times that was coauthored by three MMT scholars and I think the title of the piece is something like "How MMT Thinks About Inflation" or "How MMT manages inflation". Something along those lines, people can find it because I wouldn't have time to do it all justice here.

But look, okay, let's start by recognizing that inflation, as you say, is a dynamic process, it is a continuous increase in the price level, it's not a one off. It's a complex phenomenon, there isn’t economist on Earth who can write down for you a model of inflation that will apply in all times across, space and time, nobody can do it.

The Federal Reserve, Daniel Tarullo, who was a Fed Board of Governors member, he rolled off the board of governors and went out. And one of the early speeches he gave just made huge headlines, because he went out and he said, the Fed does not have a working model of inflation, we don't know.

So I know that economists, I'm one, wave their hands around and use the phrase inflation expectations, but I'll be honest with you, it's pretty much baloney. It's what we hide behind when we run out of realistic things to say.

So once upon a time, there was a quantity theory of money and man, you could write that equation down, everybody could see it. And you said, inflation happens because velocity is constant, and the real economy tends to full employment.

And once you apply a little calculus to the quantity theory to the equation of exchange, then you know that inflation is always in everywhere, a monetary phenomenon. Money supply growth rate accelerates, inflation will accelerate to the same degree, well, that's clearly silly and wrong. And you know, we have decades of experience with QE where people who relied on that thinking expected quantitative easing to drive inflation or possibly hyperinflation.

Of course, it didn't do any of that, then you had the Phillips Curve and you say, well, it's the Phillips Curve, that's the model I'll write down and that's my inflation model. Well, listen, nobody believes this stuff anymore and you can expectations augment the Phillips Curve all you want, and it still isn't workable.

So I don't believe that we should think of inflation as something that happens because expectations become unanchored and people formulate ideas about where prices are headed, and then it becomes self fulfilling. That's just silly stuff that we make up, I think we need to be more serious than that, price has changed, because producers raise prices, people change prices. They don't just happen and they certainly don't just happen across all categories of consumer goods, so let's think a little bit harder.

If I go down stairs after this interview, and I hope this doesn't happen, but if I go downstairs and find my basement is flooded, I don't just run to one part of the house and say, oh, I have to stop the flooding in the basement. I don't know what caused the flooding in the basement, I don't know if a kid left a faucet running if a toilet overflowed, if a pipe burst, if you know the dishwasher is leaking, I got to find the source of the problem.

And I think that's the way we in MMT think about inflationary pressures, you have to look under the hood, you have to go to what is driving that headline price inflation. I'll give you just one quick example, the supreme court's going to take up the case on the Affordable Care Act that's going to happen soon. And there is a chance that the Supreme Court will say the ACA is unconstitutional, and provisions like protections against pre existing conditions that could go away some of the cost controls around medical reimbursements and prescription drug prices and so forth.

That cost containment that could go away and people who look at the US experience in recent years post ACA compared to the years immediately before the Affordable Care Act passed. People say, listen, the Affordable Care Act took us a long way toward constraining inflationary pressures in this period, because there were all these controls.

Now, let go of all that stuff, imagine that health insurance companies are free to raise premiums and price discriminate based on pre existing conditions and pharma companies can be more aggressive with prescription drug prices and so forth. You can easily imagine, headline inflation ticking up for those reasons, now, how would you fight that? I mean, would it make sense to say raise taxes in order to combat that kind of inflationary pressure? I think that's crazy.

But would it make sense to say the Fed should raise interest rates to fight now that's equally crazy? So when I talk about inflation, and when we in the MMT scholarly community talk about it, it's a much more nuanced conversation. Because you have to recognize that, there are things you can do on the regulatory side. There are a lot of non fiscal doesn't have to do with cutting government spending or raising taxes, ways to deal with inflationary pressure, but you got to know what's causing it.

Erik: I want to move on to what you actually have identified as the next myth in the book, which would also be the feedback that you'd probably get from a lot of people who would say, look, what you're talking about doing here amounts to stealing from future generations. You're just scribing away without having to raise taxes, which makes it more politically viable for the government to spend more money that we don't have and increase the national debt. That's going to have to be paid off someday by our children and grandchildren, that's immoral. Why is that a myth?

Stephanie: Well, it's a myth because none of it makes any sense whatsoever. I mean, I'm sorry, I'll just be as kind of upfront and candid as I can, I think that's just really silly. And I know that it's common, and I know that people repeat it and I know that sometimes serious people repeat these kinds of things.

So this falls right back into the household analogy, right back into that trap of thinking like government as a household. And when we use words, like borrowing, like paying it back, calling this thing the dead, we are falling back into that household trap. The Federal Government's nothing like a household, it doesn't operate its budget like a household.

So here's just one example, okay, when the government runs a deficit, it matches up the deficit spending by selling treasuries, right. We know that and that's something it chooses to do not something it must do. The government sovereign government doesn't need to borrow its own currency from anyone in order to spend but the government currently matches up its deficit spending with bond sales.

So what happens? So the government spends $100 into the economy, taxes let's say $90 back out, we say the government has run a deficit, we look at it as a shortfall. That's not a shortfall, this government's the scorekeeper for the dollar, right? It's adding 100 and subtracting 90, somebody gets 10 points, that's those $10.

Now the government comes along and says, well, because I ran a deficit I'm going to sell these treasuries, which means the government is going to subtract back out the $10 and replace them with 10 treasuries. So what the way that I look at it isn't that the government is borrowing in any meaningful sense. If I go to a bank for a loan and I sit down with the loan officer I don't plop the money down on the desk in front of the loan officer and then ask for the loan I came there because I don't have the money, that's why I'm there to borrow.

The federal government is the issuer of the currency, it doesn't borrow because it doesn't have the money. What it's doing is first supplying its currency and then transforming those dollars into a different financial instruments into US Treasuries. So it's allowing us to hold dollars that amplify themselves over time, that those are amplifying dollars. Why? Because they pay interest.

So I look at the treasuries as a form of payment, not a form of debt, there's nothing being borrowed, there's something being paid out. And when the Treasury matures, when the bond matures, it simply converts back into its original form, it converts back to the currency form.

So paying it back quote, unquote involves nothing more than shifting funds from one account at the fed a securities account into what's effectively a checking account, a reserve account at the Fed. That's all the more complicated it is to quote, unquote pay it back, but I think that we have a communications problem. We don't have a debt problem, we just have chosen very unhelpful words to narrate what's actually taking place?

Erik: Well, if we don't think of it in terms of actual debt and as you say we can just print the money in order to pay expenses. And it's only a convenience that we happen to articulate that through a debt transaction, at least in the current system.

Well, hang on a second, doesn't printing that money dilute the value of the money that everyone who owns money has? And therefore, isn't it really a form of tax on the wealth of everyone holding dollars?

Stephanie: So look, it isn't a simple thing. I know a lot of people think just in somehow in their heads there's this supply and demand framework. And that if you have more supply of anything, then that automatically pushes prices down, the value of the thing goes down, but no, I mean it depends what happens with those dollars.

So first, every deficit is good for someone, in financial terms, the government's deficit is a deposit, it is a financial contribution to some other part of the economy. Now, every deficit is good for someone, but deficits do different things, for whom? Who gets that contribution? And what is it being used to accomplish somewhere in the economy?

So if the government's making investments in infrastructure and education and R&D, those are the three categories where economists by and large agree that you get the greatest long term benefit from that kind of spending. In other words, if you're worried about the value of the dollar going down over time because the government is spending. How about recognizing that certain kinds of government spending, actually improve long term productivity and boost potential real wealth real output.

So no, there's no simple, if the government spends more than the value of the currency goes down. You can have a much stronger economy as a consequence, and a much stronger currency along with that,

Erik: Professor Kelton, I haven't gotten even to all six myths in the book but I want to jump ahead because I know you've got a very tight scheduled today and just a couple more minutes for us. I think that your voice, you're extremely articulate, you're very persuasive in your arguments, I won't be at all surprised if you replace Janet Yellen as the most influential woman in the history of Finance.

Let's pretend that that comes true, what do you want to be remembered for changing? How does the world or particularly the US government need to change if you were in charge and applying MMT to make the world a better place?

Stephanie: Well, boy, Eric, look I get frustrated by the nature of the debates that that take place in this country and around the world. And I think, for me, a lot of this is just gratuitous suffering, it is just the worst kind of suffering because we have the capacity to do better, and to do better by our fellow Americans to do better by others.

And if we can improve economic life for millions of people, without creating harm, why wouldn't we do that? And so I would like to see us begin to have a better debate, without reference to the sort of things we've been talking about some of these myths, that we can't do x, y and z because there's no money to do it. We can't do these things because China won't lend us the dollars, we can't do these things because the future generations are already too burdened by debt.

I want to clear through all of that and get us to a place where we have a more constructive, fruitful, national debate about what our priorities are, what is the proper role of government? What programs are we collectively willing to support? And in terms of our nation's real resource capacity, what can we afford to do?

And so if we could just get to the point where we start having the debate on the right kind of playing field with the with the right limits in mind, that's sort of what I'm after. I don't have greater ambitions in a sense then trying to help to open up space to have that better debate.

Erik: One of the myths that you have in the book is entitlement programs like Social Security and Medicare are financially unsustainable. We don't have time to get into that but I just want to ask, what is the constraining factor? And obviously, if we really can't afford those things, we can print money.

Why stop with social security and medicare? Why not have a Mercedes and maybe a private jet for every single citizen, there's got to be some reason to stop. Is it just the risk of inflation? Or are there other constraints?

Stephanie: Well, I mean, there are political constraints, but the relevant constraint is inflation, it is our nation's real resource capacity. It's how many people do you have that are of working age and capable of working and producing in the economy? How many factories, buildings, machines, what are your raw materials, what is your state of technology, you'll combine all of the real resources you have and that tells you what you're capable of domestically.

And then the US has the good fortune of also being able to tap productive capacity in other parts of the world because the rest of the world is willing to produce for us. They will accept the dollar and we can have access to some of their productive capacity to so with respect to seniors. If we want to care for seniors in a way that makes us proud to call ourselves Americans, we say we have this retirement security system in place called Social Security.

People are always talking about how it's unsustainable, we're going to have to make tough choices and cut benefits or test the program so that everybody doesn't get to benefit from Social Security, that's all wrong. I mean, Alan Greenspan told us how wrong that was years ago testifying before Congress under oath.

When he got a question from then Congressman Paul Ryan who said, look, Social Security is going broke, we got to do something about this, don't you agree, Mr. Chairman? And Greenspan leaned into the microphone and I thought he gave the most brilliant and honest answer. And he said to Paul Ryan, I don't agree, he said, there is nothing about the way the system is set up today that is financially unsustainable.

His exact words were, "There's nothing to prevent the federal government from creating as much money as it wants and paying it to someone". Okay, that is the first point he made, but the second point is the really important one. He said, the question is, how do you set up a system which assures that the real assets are created, which those benefits are employed to purchase.

And what he meant is that we have changing demographics and the demographic changes have been underway for a long time. On average, everyday in America 10,000 people hit the age of 65, okay, they can move into retirement if they want to at that point. And Greenspan said basically we're being left with a shrinking population of people to produce the stuff, to actually kick out the goods and services in the economy and a growing population of retirees.

If we continue to mail checks, or deposit digital dollars in their bank accounts, those seniors can turn around and spend that money into the economy competing with all other spenders in the economy. So for Greenspan, like every central banker in the world, inflation is the thing you worry about.

And Greenspan's looking at this and saying, how do we know that in the future 10-30 years from now when those checks go out the US is going to be a productive enough economy, to produce all the goods and services that both seniors and the current working population want and need. If that's the case, if we are productive enough, there's no problem keep the system running, you can even make it more generous.

The risk is, if we are not a productive enough economy going forward, then all we end up with is more intense competition for a dwindling pool of real goods and services and hence an inflation problem. So it seems to me the fight over Social Security should be about which political party has a better plan to increase the probability that in 10-30 years we are a productive enough economy.

To be able to kick those goods and services out to allow seniors to have a sustained standard of living in retirement and to raise living standards for working people going forward. We just need a productive enough economy, we ought to argue over who has the best economic platform to get us there.

Erik: Professor Kelton, I know that we've already gone past the hard stop in your schedule, I can't tell you how much we appreciate a terrific interview listeners. The book is "The Deficit Myth" by Professor Stephanie Kelton. It's also available in audiobook form narrated personally by Professor Kelton Stephanie, anything you want to add before I let you go?

Stephanie: No, I mean, like everybody probably listening, waiting on pins and needles to see whether Congress is going to come through with another relief package, that's kind of the thing that weighs on my mind right now.

Erik: Well, I can't thank you enough for a terrific interview Patrick Ceresna and I will be back as MacroVoices continues right after this message from our sponsor.