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Modern Monetary Theory: An Austrian Interpretation of Recrudescent Keynesianism

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Abstract Modern monetary theory (MMT) argues that governments can never go bankrupt because they have the power to print money to finance budget deficits. Consequently, debt monetization can achieve virtually any government objective desired. This paper uses Austrian economics to argue that MMT suffers from the flaws of all forms of Keynesian economics, particularly the original version of the 1930s and 1940s. MMT fails to understand capital-based macroeconomics and how government policy affects the temporal structure of production. MMT also neglects the importance of profit and loss accounting compared to government allocation of resources. The Austrian school argues that traditional New Keynesian countercyclical monetary policy results in a credit-induced boom and bust (Austrian business cycle theory) by injecting new money into private sector loans through the banking sector. However, Austrian analysis demonstrates that MMT's monetary policy to monetize government deficits and increase the money supply through government spending will instead lead to secular economic stagnation and a stunted capital structure. Overall, the policy prescriptions of MMT are far more dangerous than traditional New Keynesian policies.

Keywords Modern monetary theory · Keynesian economics · Austrian economics · Debt monetization

JEL B22 · B25 · B53 · E52 · E63

Introduction

The 2008 financial crisis and the weak economic expansion of the 2010s generated a renewed interest in macroeconomic theory and policy. In both public and academic

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forums economists discussed and debated mostly orthodox concerns in neoclassical and New Keynesian economics: the efficacy of traditional countercyclical monetary policy, government deficit spending and debt-to-gross domestic product (GDP) ratios, and the costs and benefits of financial regulation. However, many economists also focused on the ideas of heterodox macroeconomic schools of thought, most recently the policy proposals of modern monetary theory (MMT).

MMT refers to a collection of theories regarding the government's role in regulating the money supply and the proper fiscal and monetary policies it should practice (Mitchell et al. 2019; Wray 2015). While it is called modern, many of its central ideas are actually quite old and formerly associated with the chartalist school of thought in the early twentieth century. Essentially, MMT stresses that money is whatever the government wants it to be because only the government can decide what to accept as payment for taxes. Furthermore, the government can never go insolvent because it can always print money to pay off its debts and finance new budget deficits. MMT advocates policy proposals different from the prescriptions of traditional macroeconomics. While the New Keynesian consensus advocates countercyclical policy through an independent central bank, proponents of MMT prefer that the central bank monetize government deficits and play a secondary role to fiscal policy. If excessive monetary expansion leads to high inflation, then the government can simply raise taxes to reduce spending in the economy.

Economists have recently commented on MMT from critical perspectives (Palley 2015a; Palley 2015b). Discussion has also occurred in popular outlets because MMT's biggest influence is through the blogosphere (DeLong 2019; Hummel 2019; Krugman 2019; Murphy 2019). The most prominent comments are from the New Keynesian perspective and only criticize various aspects of MMT rather than the core theoretical assumption: the government needs to provide a heavy-handed dose of fiscal and monetary intervention in the economy in order to improve economic activity. This is because MMT is ultimately a branch of Keynesian economics.

In contrast to MMT, Austrian economics is a different heterodox school of thought that received increased attention during the 2008 financial crisis and immediate aftermath. The Austrian school emphasizes entrepreneurial profit and loss accounting and capital-based macroeconomics. Capital-based macroeconomics investigates how changes in time preferences and monetary policy affect the temporal structure of production. Capital-based macroeconomics business cycle theory, otherwise known as Austrian business cycle theory (ABC), argues that expansionary monetary policy artificially lowers interest rates and generates an unsustainable business cycle. Austrian economists have previously criticized Keynesian economics for failing to properly appreciate economic calculation and the distortionary effects of fiscal and monetary policy.

This paper analyzes MMT from the Austrian perspective. It argues that the core ideas and policy proposals of MMT are nothing new but are simply repackaged Keynesian proposals from the 1930s and 1940s. As a result, MMT fails to incorporate capital-based macroeconomics and comparative institutional analysis which demonstrate the superiority of the market's allocation of resources compared to government allocation. However, Austrian reasoning also shows that the debt monetization policies of MMT will lead to different outcomes than the traditional policies of New Keynesian theories. While expansionary monetary policy by an independent central bank increases

the money supply through the banking sector and leads to a cyclical boom and bust, debt monetization increases the money supply through the government sector and does not cause a business cycle. Instead, it simply leads to economic stagnation because it increases time preferences and capital consumption.

Capital-Based Macroeconomics

Austrian economics is a heterodox school of thought that emphasizes the importance of entrepreneurship and capital structure. A core tenant of the Austrian school is capital-based macroeconomics, subsumed under the general Austrian theory of economic growth and development (Garrison 2006; Manish and Powell 2014; Skousen 2015; Cochran 2015). Capital-based macroeconomics differs from the currently dominant New Keynesian macroeconomics, which is a combination of the older Keynesian and monetarist economics that focused on the labor market, the money supply, and nominal spending (Snowdon and Vane 2005). Instead, capital-based macroeconomics analyzes the interrelationship between time preferences, the interest rate, and the structure of production. In particular, it analyzes sustainable growth caused by decreases in time preferences and unsustainable growth from credit expansion.

When time preferences fall, the premium on present consumption drops and actors spend less on present consumption and instead invest in future consumption. Through present value discounting, the lower interest rate on the loanable funds market increases the profitability of long-term production (the higher orders) relative to short-term production (the lower orders). Entrepreneurs devote more scarce resources to producing long-term capital goods, which lengthens the structure of production and increases the supply of future consumer goods. If time preferences remain permanently lower, the economy sustainably grows and is able to maintain higher standards of living. On the other hand, the exact opposite happens if time preferences rise. People devote a greater proportion of their income to present consumption and the higher loan interest rate decreases the comparative profitability of long-term production. Although entrepreneurs produce more consumer goods now, their decreased devotion to maintaining and building up the capital stock reduces the economy's capacity to produce for future consumption and the structure of production shortens. The economy permanently shrinks (Rothbard 2009).

Capital-based macroeconomics combines both of these insights to develop a theory of unsustainable growth, also known as ABC theory. Unsustainable growth occurs when there is government intervention in the form of expansionary monetary policy via the banking sector, most commonly through a central bank. When the central bank practices expansionary monetary policy, it encourages fractional reserve banks to engage in credit expansion and increase the money supply. The credit expansion manifests as an increased supply of loanable funds and the loan interest rate decreases. While the increased credit expansion looks identical to a fall in time preferences, the similarities are only superficial because the increase in the money supply does not actually increase savings in the economy. In fact, it reduces savings because the artificially low interest rate incentivizes individuals to save less while at the same time

businesses are encouraged to borrow more. Higher order production and prices increase and economic growth goes up.

However, because time preferences remain constant, individuals have not decreased their consumption and released resources that can be used for new higher order production. In fact, as described above, they tend to increase consumption. The structure of production is lengthening at the same time actors' spending patterns cause it to shorten. The economic boom is unsustainable because the central bank must increase its rate of monetary expansion in order to prevent the increased time preferences from redirecting resources away from the newly embarked upon higher-order investment projects. However, the increased growth rate in the money supply increases the rate of inflation. If the process continues indefinitely, the higher rates of inflation will lead to hyperinflation and a destruction of the currency. The central bank must either increase the rate of monetary expansion and generate higher rates of inflation or engage in contractionary monetary policy. While contractionary monetary policy wrings out inflation, it also reduces credit expansion to the higher orders and reveals the unprofitability of the long-term investments, now known as malinvestments. The result is a sudden bust, which leads to a decrease in production and resource employment in the higher orders and an economic recession.

During the recession, entrepreneurs must redirect scarce resources away from the higher orders, where current time preferences make their employment unprofitable, and channel them into the lower orders where they are profitable to use. Only after this readjustment process can the economy sustainably grow again (Rothbard 2009).

The Keynesian Revolution and Modern Monetary Theory

The macroeconomics ushered in by the Keynesian Revolution is very different than the capital-based macroeconomics outlined in the previous section. This macroeconomic system does not emphasize how the interest rate coordinates capitalist entrepreneurs to follow profit and loss signals and engage in production over time. Instead, Keynesian macroeconomics concentrates on an aggregative framework that conceals the interrelationships of the capital structure and treats the interest rate as a variable that governments can manipulate in order to achieve desired policy objectives (Boettke and Newman 2017).

The Keynesian Revolution was named after its prominent expositor, John Maynard Keynes, and the influence of his writings (Keynes 1964). Although Keynes proclaimed that he was changing macroeconomics, he actually contributed relatively little to the then currently dominant neoclassical paradigm. His two theoretical contributions were the underemployment equilibrium and the liquidity trap. Keynes used both theories to argue that *laissez faire* (wage cuts) and expansionary monetary policy would not cure a recession. Instead, the only solution was expansionary fiscal policy. To the extent monetary policy is used, Keynes wanted it to finance budget deficits either directly through debt monetization or indirectly by lowering borrowing costs (Boettke and Newman 2016).

The true revolution of Keynes was not necessarily in economic theory but in how economists, politicians, and public policy advisors treated his prescriptions as an antidote to the stagnation of the 1930s amidst the Great Depression (Boettke and Newman 2017). The Keynesian Revolution convinced economists that the market

economy was inherently unstable and saturated with idle resources seemingly free from any restriction of scarcity. Moreover, its holistic aggregative framework and liquidity trap theory emphasized the supremacy of consumption and government spending at the expense of savings and market forces. Public policy was transformed away from limited government to active fine tuning. Fiscal policy could now achieve any policy objective by tapping into a near limitless supply of unemployed resources. Instead of balancing budgets, politicians were given the "open sesame" to engage in unprecedented intervention and deficit spending greased by easy money. The Austrian economist Murray Rothbard previously described the Keynesian Revolution's impact on economic and political thinking in the 1930s and 1940s:

> "Governments as well as the intellectual climate of the 1930s were ripe for such conversion. . . . along came Keynes, with his modern 'scientific' economics, saying that the old 'classical' economists had it all wrong: that, on the contrary, it was the government's moral and scientific duty to spend, spend, and spend; to incur deficit upon deficit, in order to save the economy from such vices as thrift and balanced budgets and unfettered capitalism; and to generate recovery from the depression. How welcome Keynesian economics was to the governments of the world!" (Rothbard 1992, p.184).

It was in this environment that the tenets of this old school Keynesianism were allowed to flourish. Governments can print money and run budget deficits to stabilize the disorderly market economy (Hansen 2003; Lerner 1970). The conclusions and interpretations of Keynes were cleaned up and synthesized with the neoclassical paradigm to create the Neo-Keynesian synthesis of the 1950s (Samuelson 1997). Neo-Keynesians added the formal theory of the investment trap and used it to argue that fiscal policy is a definitively superior countercyclical tool compared to monetary policy. In addition, Neo-Keynesians believed that governments could permanently reduce the rate of unemployment because there was a permanent tradeoff between inflation and unemployment (Salerno 2001; Boettke and Newman 2016; Boettke and Newman 2017).

The inflationary problems caused by Neo-Keynesian policy prescriptions in the 1960s and 1970s led to the development of New Keynesian economics in the 1980s, which has dominated macroeconomic discussion ever since. New Keynesian macroeconomics argues that absent a liquidity trap, monetary policy is more effective than fiscal policy and there is only a temporary tradeoff between inflation and unemployment. New Keynesian economics takes a step back from the crude post-scarcity world imagined by the Keynesian Revolution by grounding its theories in microeconomic reasoning and recognizing the limits of monetary and fiscal policy. Monetary policy no longer focused on facilitating fiscal policy and budget deficits but instead on managing interest rates and nominal spending in order to mitigate the business cycle (Snowdon and Vane 2005).

However, MMT takes macroeconomic theorizing back to the days of the Keynesian Revolution (Wray 2015). Similar to Keynes, MMT reinvents the wheel by presenting much of contemporary mainstream macroeconomic theorizing in a new system of equations and accounting identities. Even Paul Krugman, one of the most prominent New Keynesians active in public forums of discussion, described their reasoning akin

to "Calvinball," a fictional game in the comic *Calvin and Hobbes* where the rules are made up as the game progresses (Krugman 2019). However, MMT goes much further than reinventing the wheel. After showing that governments can never go bankrupt because they can always finance their deficits with expansionary monetary policy, a statement no economist would really disagree with, MMT argues that governments should run massive budget deficits financed through debt monetization in order to reduce unemployment and stimulate real GDP. Debt monetization would occur through expansionary monetary policy that increases bank reserves and allows banks to increase the money supply by purchasing new government securities (Wray 2015). Since the problems of inflation are minimized or assumed to be nonexistent, MMT implicitly conceptualizes a post-scarcity world with widespread unemployment of labor and other resources. To the extent that inflation ever becomes a problem, the government can raise taxes to reduce inflation (Wray 2015). This type of reasoning and recrudescence of old school Keynesianism now provides the "open sesame" for modern day politicians and policy advisors to propose enormous increases in fiscal intervention and government spending. One only needs to slightly modify Rothbard's earlier remarks by substituting Keynes and Keynesian economics with MMT to have them apply to the late 2010s and early 2020s.

A Capital-Based Macroeconomic Analysis of Keynesian Economics and MMT

According to the Austrian school, Keynesian economics and its policy prescriptions, whether of the old school Keynesianism, Neo-Keynesianism, New Keynesian, or MMT variety, are all misguided. Their central errors are differences in degree and not in kind. All types neglect the interrelationship between time preferences and the structure of production. They treat the interest rate not as a coordinative mechanism that spontaneously arranges activity on the marketplace but a tool governments can manipulate. Governments are superior to entrepreneurs on the market in terms of estimating opportunity costs of resources because they direct production according to broad measures of social benefits and costs that voluntary exchange and the price system cannot provide.

Austrians stress that government spending is not superior to private spending. In fact, government spending is inferior precisely because its decisions are not based on profit and loss earned in competitive markets. Governments cannot operate on a business basis because they have access to tax revenue and can forcibly block out competition. They are unable to configure the employment of scarce resources according to voluntary consumer desires and instead tend to misallocate and waste resources. As a result, when governments spend money, whether on military, infrastructure, education, welfare, or something else, it is equivalent to consumption spending on behalf of the politician or bureaucrat. Higher government spending is tantamount to an increase in time preferences, which shortens the structure of production. In fact, this increase in time preferences occurs twice if government spending is funded through higher taxes because higher taxes also increase time preferences by reducing savings. Government spending and taxation both increase time preferences (Rothbard 2009).

It becomes clear that according to the Austrians, expansionary fiscal policy is not the solution to a recession because it is not based on economic calculation and cannot redirect resources into avenues consistent with the societal rate of time preference.

Instead, higher government spending only aggravates the adjustment process by requiring a further shortening of the structure of production. Austrians recommend contractionary fiscal policy in the form of a decrease in government spending in order to decrease consumption spending and incorporate more resources into private sector production.[1]

While the Austrian critique of fiscal policy applies to both New Keynesian and MMT, the two most recent versions of Keynesianism, there are important differences in regard to their monetary policy proposals. As explained earlier, New Keynesians favor independent expansionary monetary policy practiced by a central bank that lowers interest rates and increases the money supply through the banking sector in order to get an economy out of a recession. Their goal is to increase spending by channeling new loans to consumers and businesses. In this framework, if the central bank stimulated credit expansion by purchasing government debt, it is debt purchased on the secondary market. These open-market purchases increase bank reserves and facilitate credit expansion to businesses. This method does not finance current government deficits, although it may indirectly help the government service debt by lowering borrowing costs. The capital-based macroeconomics outlined earlier shows that this New Keynesian expansionary monetary policy artificially lowers interest rates and creates an unsustainable boom. Instead of expansionary monetary policy during a recession, Austrians favor a cessation of credit expansion and even outright contractionary monetary policy in order to speed up the readjustment process (Rothbard 2008a).

On the other hand, proponents of MMT argue that the central bank should not engage in independent monetary policy but instead act as a subservient auxiliary to fiscal policy by financing budget deficits through debt monetization. Debt monetization, such as what happened during the U.S.'s involvement in World War II, occurs when government increases spending, runs a deficit, and then forces the central bank to increase bank reserves and allow commercial banks to purchase new government debt. This method monetizes the debt because the new money funds the government's deficit (Rothbard 2008b). In this scenario, the money supply does not increase through the banking sector and private sector borrowing. Rather, the government is the first entity to spend the new money. This type of monetary expansion does not cause an ABC because the new money does not first enter the loanable funds market and increase loans to businesses. On the contrary, the government spends the money through expansionary fiscal policy (Mises 2008; Rothbard 2011). MMT's debt monetization program only shortens the structure of production (Salerno 2019).

Debt monetization leads to a boom-and-bust business cycle only to the extent that the central bank finances the government deficit by directly purchasing all of the new securities. While this increases the money supply through government spending, it also increases bank reserves which banks can use to subsequently increase credit expansion through business loans. This leads to an additional increase in the money supply through the private sector loanable funds market and sets in motion an ABC (Rothbard 2008b).

[1] For examples of fiscal austerity in the form of reduced government spending improving economic activity, see Alesina et al. (2019). As the authors point out, the harmful type of austerity is through increases in taxes, which Austrians also do not support.

This is not to say that the debt monetization policy of MMT is better, or less bad, than the independent monetary policy of New Keynesianism. In fact, it is far worse because, instead of creating a boom-and-bust business cycle that has some positive growth, the debt monetization just causes the economy to stagnate and permanently lowers living standards. This stagnation is aggravated after the higher inflation from the monetization leads to capital consumption and further increases time preferences. In order to combat the higher inflation, MMT recommends raising taxes. However, higher taxes reduce the supply of savings and increase time preferences yet again. The higher taxes will also most likely not even reduce inflation because politicians will use the additional revenue for more government spending (Rothbard 2009). The result of MMT's debt monetization is only higher time preferences, a shorter production structure, and decreased economic prosperity. Although the comparison is exaggerated, it is similar to the difference between a capitalist and socialist economy. Socialist economies do not suffer from the business cycle because they are perpetually in recession and cannot achieve any real economic growth without the use of external prices, foreign aid, and black markets (Mises 2008). Employing the debt monetization policies of MMT pushes a capitalist market economy closer to a centrally planned socialist economy, with all the related consequences.

Conclusion

MMT is repackaged old school Keynesian economics. It asserts the supremacy of fiscal policy over independent monetary policy and private spending. Debt monetization is the preferred tool governments can use to accomplish a wide array of policy objectives. By convincing the world one can assume away scarcity, the basic cornerstone of all economic reasoning, MMT's impact on modern day economists, politicians, and policymakers is similar to that of Keynes and the Keynesian Revolution in the 1930s.

Austrian economics and capital-based macroeconomics demonstrates that unlike the independent monetary policy advocated by New Keynesians, the debt monetization program of MMT will generally not lead to an ABC. Instead, it will only increase time preferences and shorten the structure of production at the expense of living standards. Furthermore, the higher inflation from the monetary expansion and the increase in taxes that will be advocated to reduce inflation will only further accentuate the problem. MMT will lead to a general decline in living standards and a decay in economic activity.

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