Modern Monetary Theory: An Austrian Interpretation of Recrudescent Keynesianism

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Outline of Presentation

- Overview of the Austrian school
    - Capital based macroeconomics
    - Sustainable growth
    - Unsustainable growth (Austrian Business Cycle Theory)
- Argues that MMT’s enhanced version of “old school” Keynesianism
    - Massive idle resources
    - Supremacy of fiscal policy over monetary policy and the private sector
- MMT’s financing of Treasury deficits would ***not*** lead to an Austrian Business Cycle but instead general economic stagnation
    - Increase in government spending increases time preferences
    - Increase in government spending leads to general waste
    - Higher taxes to combat inflation also increases time preferences

What is the Austrian School of Economics?

- Heterodox school of thought
  - Founders Austrian: Ludwig von Mises (1881-1973) and F.A Hayek (1899-1992)
- Heyday in the 1930s and 1940s:
  - Socialist Calculation Debate
    - Theory of Economic Calculation
  - Keynesian Revolution
    - Austrian Business Cycle Theory

Capital Based Macroeconomics

- Capital based macroeconomics, not labor based (Keynesian) or money based (Monetarist)
  - Time preferences (premium on present consumption) determines interest rate
  - Interest rate coordinates economic activity across the temporal structure of production

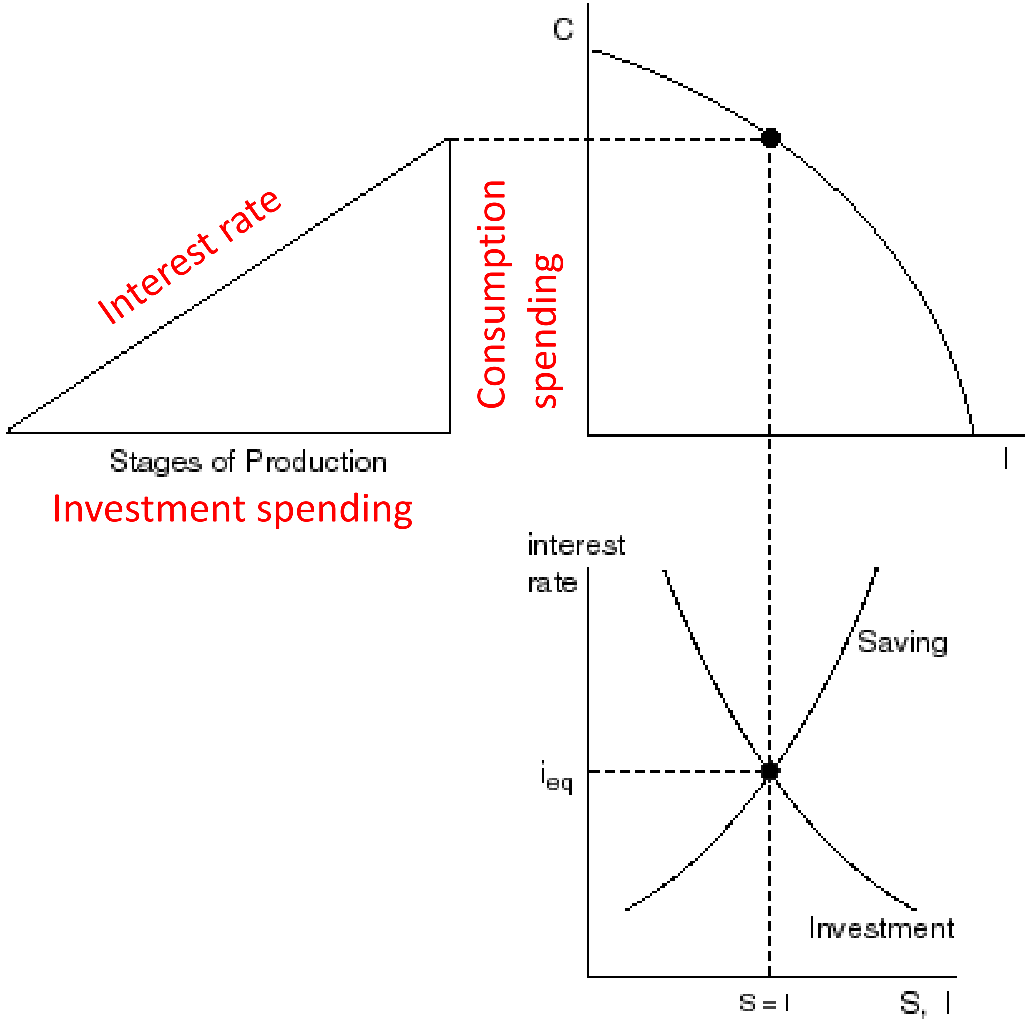


Figure 9.7: A Capital-Based Macroeconomic Framework

Sustainable growth

- When time preferences fall:
  - Increase in investment and shift to long term production
  - Economic growth and long term supply of consumer goods increases
- When time preferences rise:
  - Exact opposite (economic stagnation)

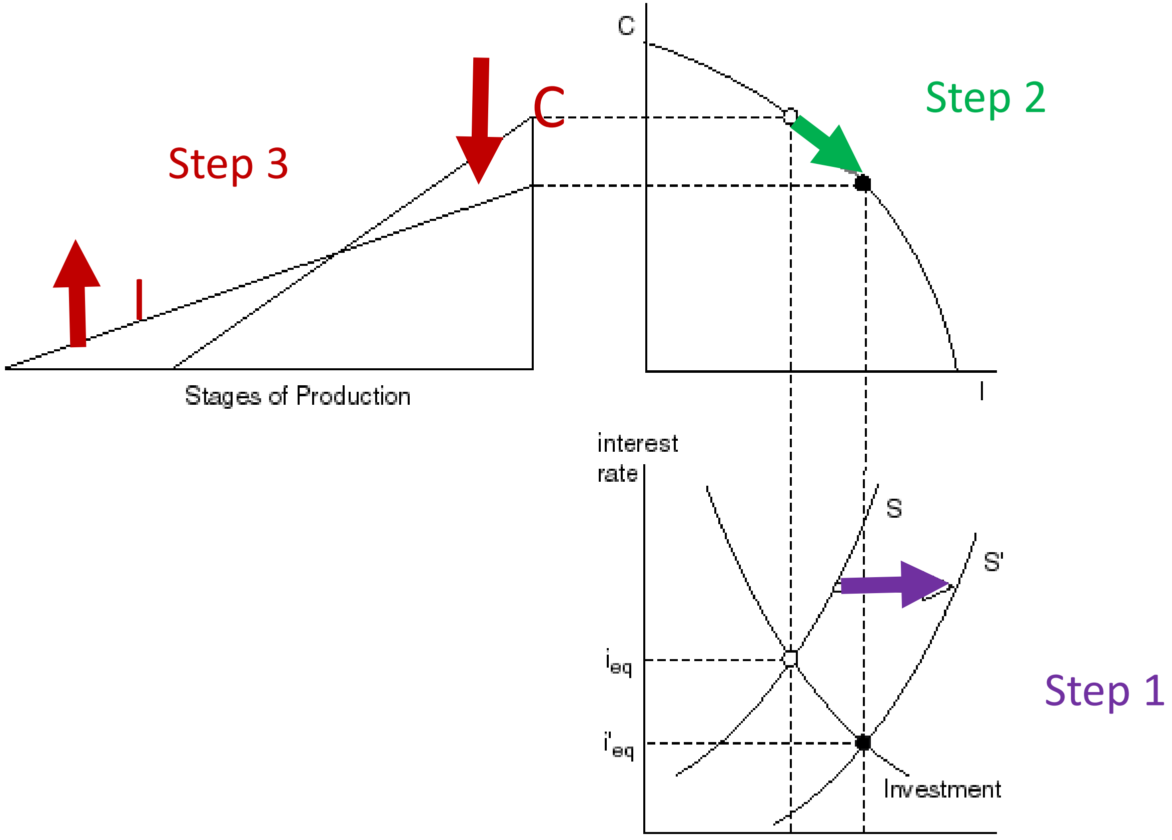


Figure 9.8: Saving-Induced Economic Growth

Sustainable growth

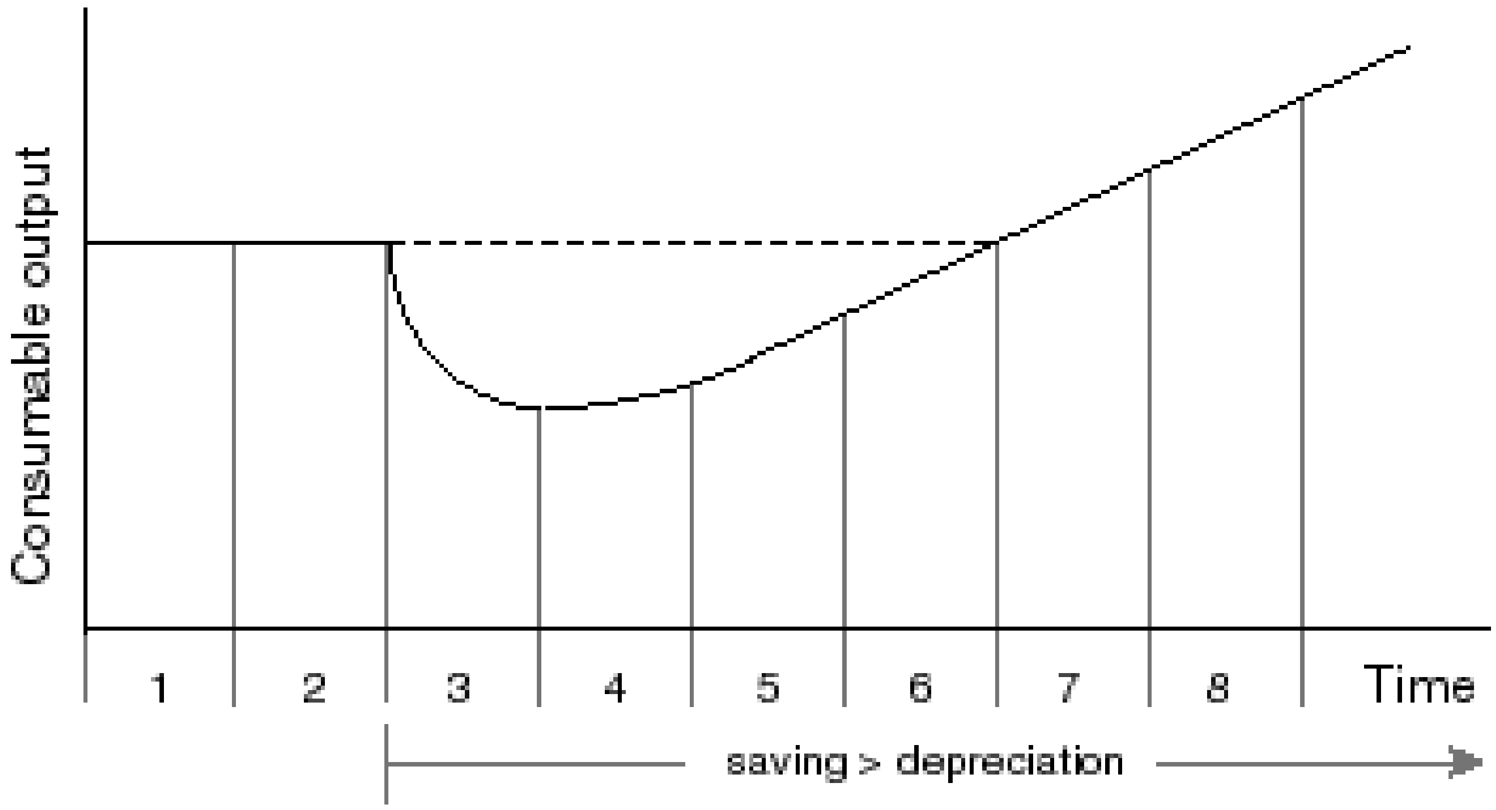


Figure 9.2: A Possible Temporal Pattern of Consumable Ouput

Unsustainable growth: Austrian Business Cycle Theory

- When central banks engage in expansionary monetary policy:
  - Increase in investment and shift to long term production ***while*** time preferences increase (unsustainable)
  - Decrease in savings and increase in overconsumption

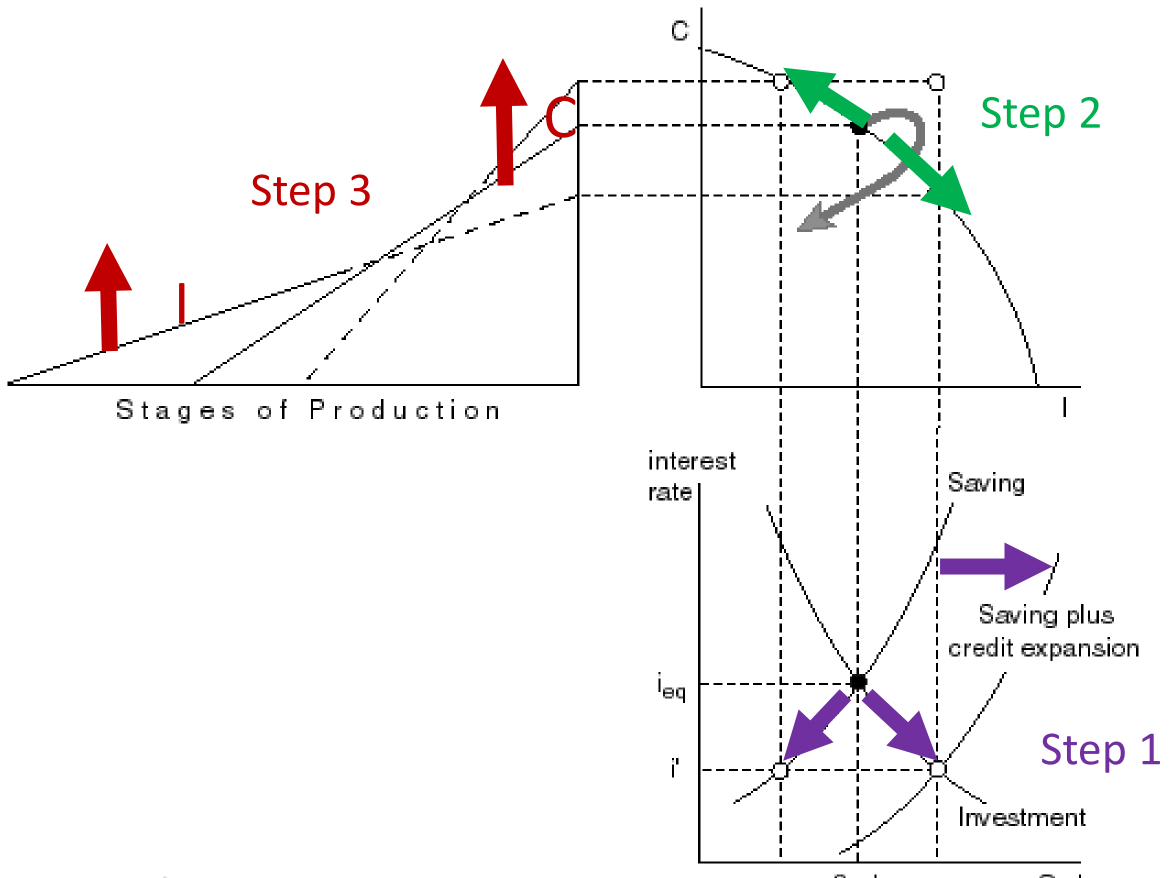


Figure 9.10: A Policy-Induced Boom and Bust

Unsustainable growth: Austrian Business Cycle Theory

- When central banks engage in expansionary monetary policy (cont.):
  - Requires increase in credit expansion (inflation) or contractionary monetary policy (recession)
  - Solution: increase in savings and reallocation of investment to short term production

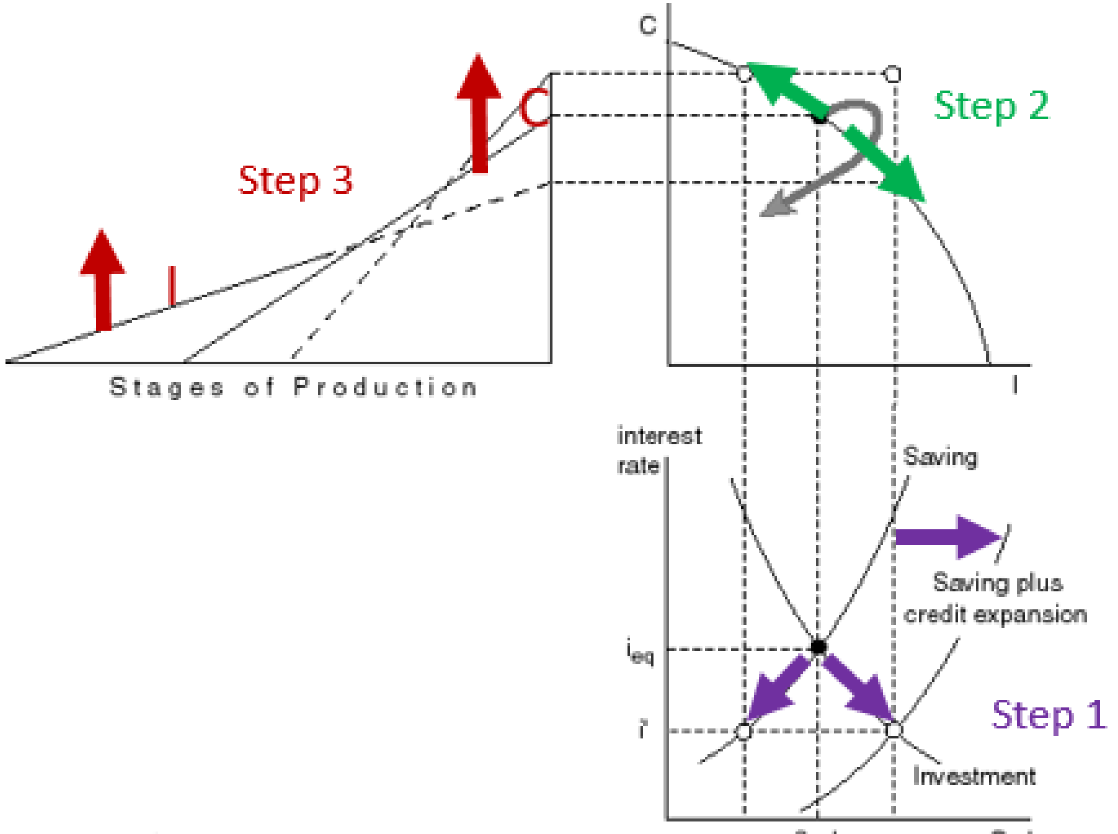


Figure 9.10: A Policy-Induced Boom and Bust

Unsustainable growth: Austrian Business Cycle Theory

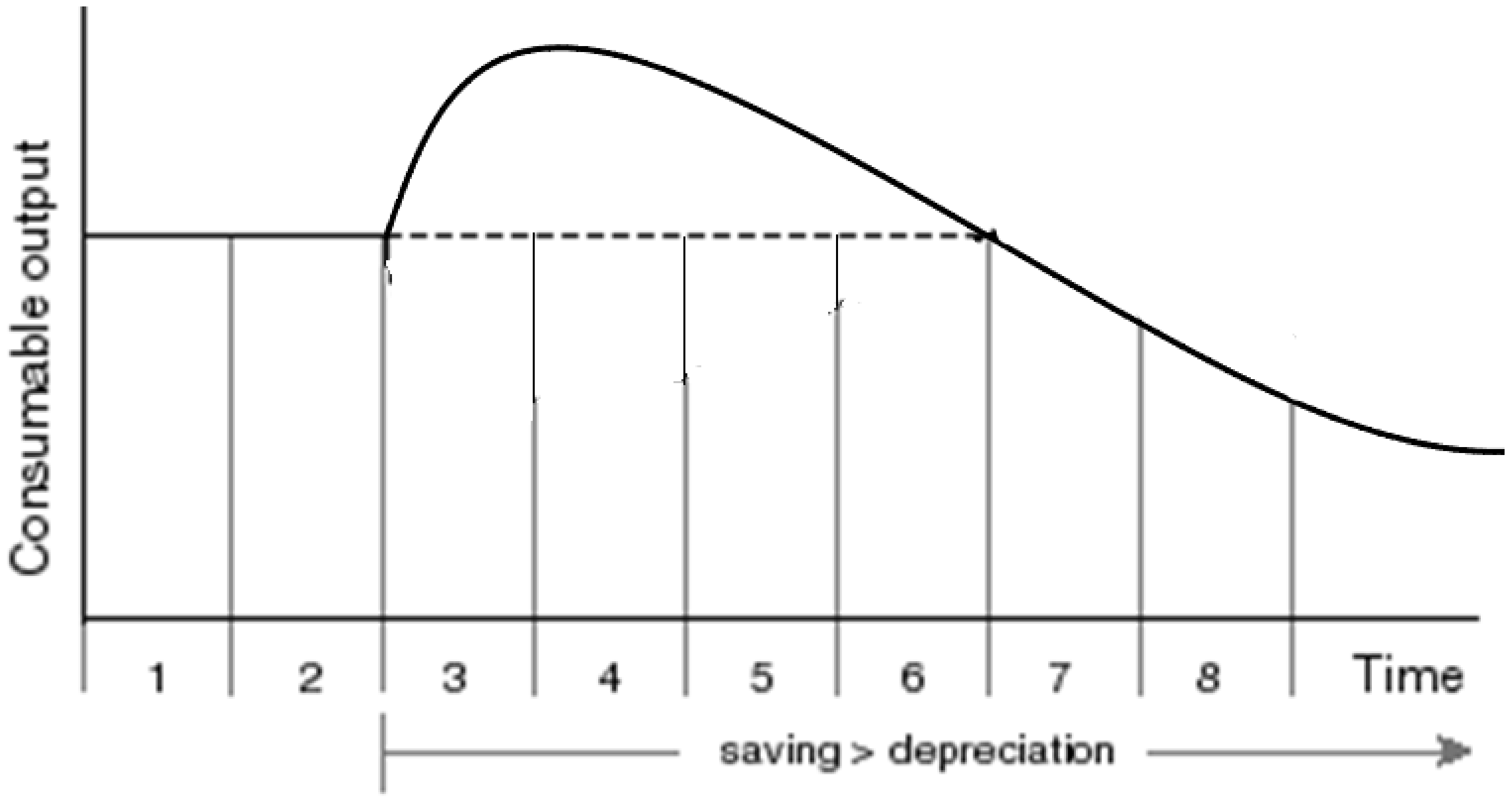
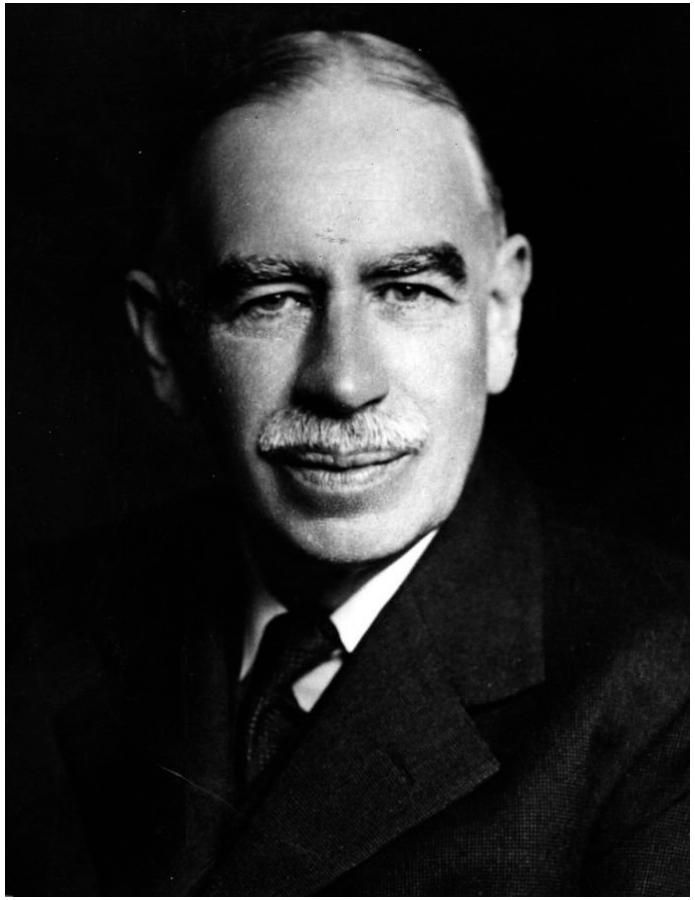


Figure 9.2: A Possible Temporal Pattern of Consumable Ouput

Keynesian Revolution

- Main contributions of John Maynard Keynes (1883-1946) to mainstream economic theory
    - Underemployment equilibrium theory (wage cuts may not cure a recession)
    - Systematized liquidity preference theory and liquidity trap theory (monetary policy may not cure a recession, fiscal policy needed)

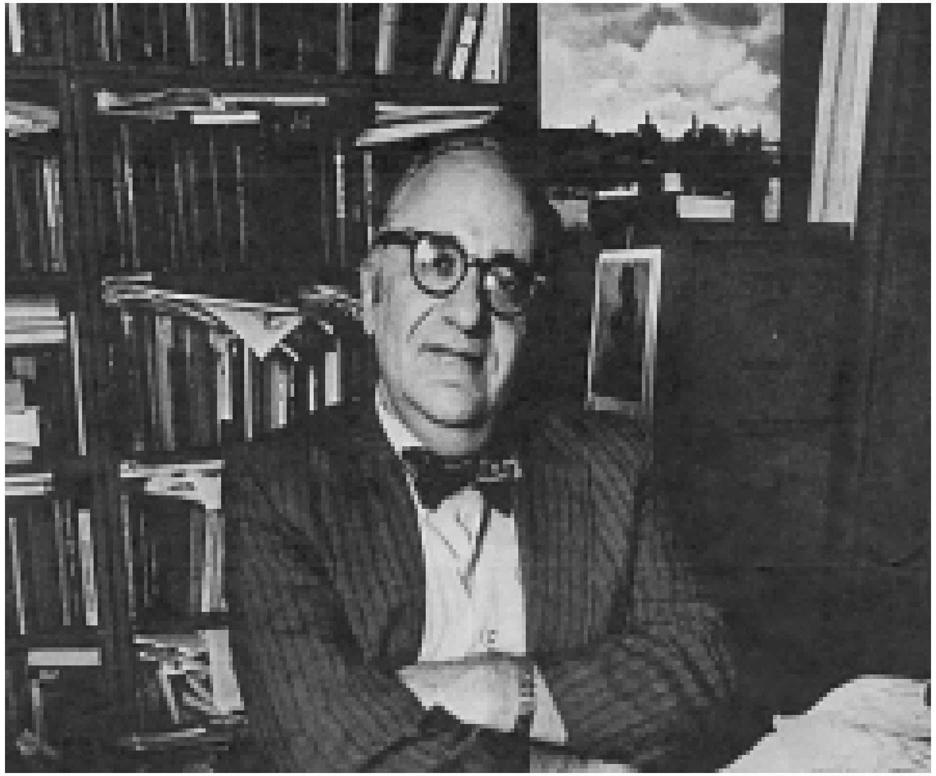


Consequences of the Keynesian Revolution

- As interpreted by the public, politicians, and intellectuals:
  - Market economy unstable and saturated with idle resources, economy can be described in a few simple aggregates (Y=C + I + G)
    - Consumption and government spending emphasized, savings downplayed
  - Government should be activist and constantly fine tuning the economy to mitigate unemployment
  - Politicians can run deficits (but have little incentive to run surpluses)

Austrian economist on the consequences of Keynes

- “Governments as well as the intellectual climate of the 1930s were ripe for such a conversion. Governments are always seeking new sources of revenue and new ways to spend money, often with no little desperation; yet economic science, for over a century, had sourly warned against inflation and deficit spending, even in times of recession. <u>**Economists . . . were the grouches at the picnic, throwing a damper of gloom over attempts by governments to increase their spending**</u>. . . .”



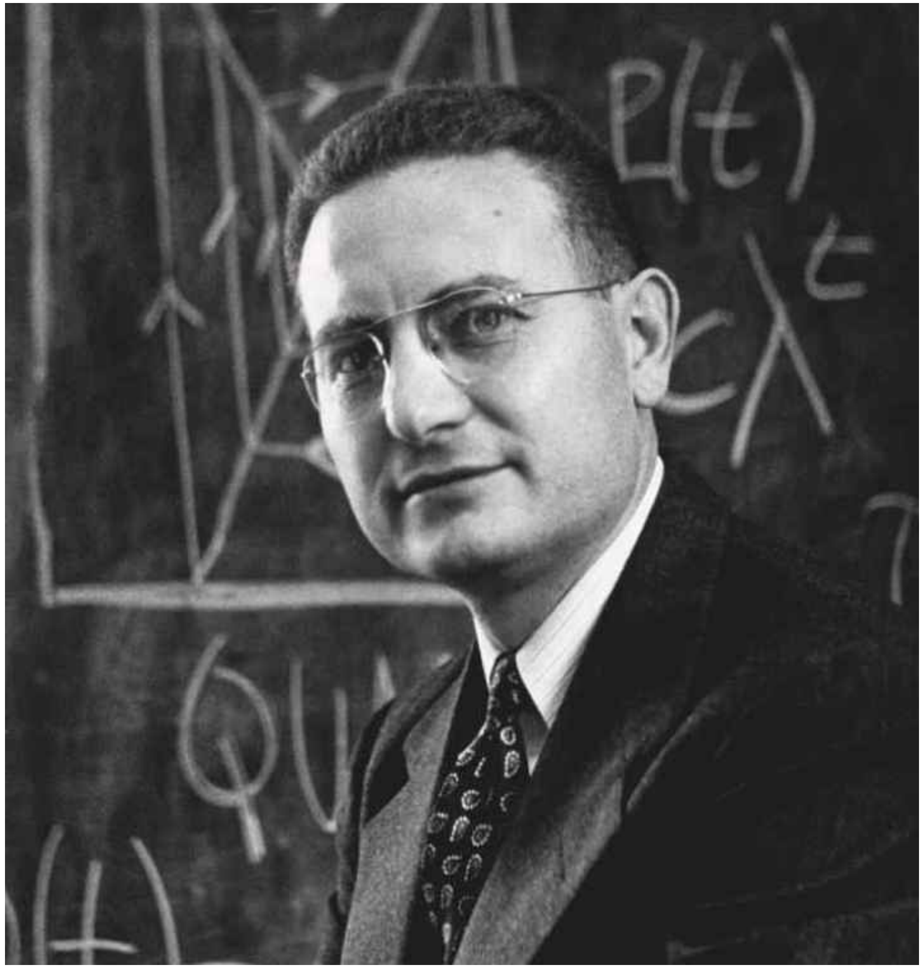
Murray Rothbard (1926-1995)

Austrian economist on the consequences of Keynes (cont.)

- “Now along came Keynes, with his modern ‘scientific’ economics, saying that the old ‘classical’ economists had it all wrong; that, on the contrary, ***<u>it was the government’s moral and scientific duty to spend, spend, and spend; to incur deficit upon deficit</u>***, in order to save the economy from such vices as thrift and balanced budgets and unfettered capitalism; and to generate recovery from the depression. ***<u>How welcome Keynesian economics was to the governments of the world</u>***!”

Later Keynesians take a step back

- Neo-Keynesians (1940s and 1950s)
  - Investment trap theory (monetary policy subordinate to fiscal policy)
  - Permanent tradeoff between inflation and unemployment
- New Keynesians (1980s and 1990s)
  - Monetary policy more effective than fiscal policy unless at zero lower bound
  - Temporary tradeoff between inflation and unemployment



Austrian Analysis of Keynesian Economics

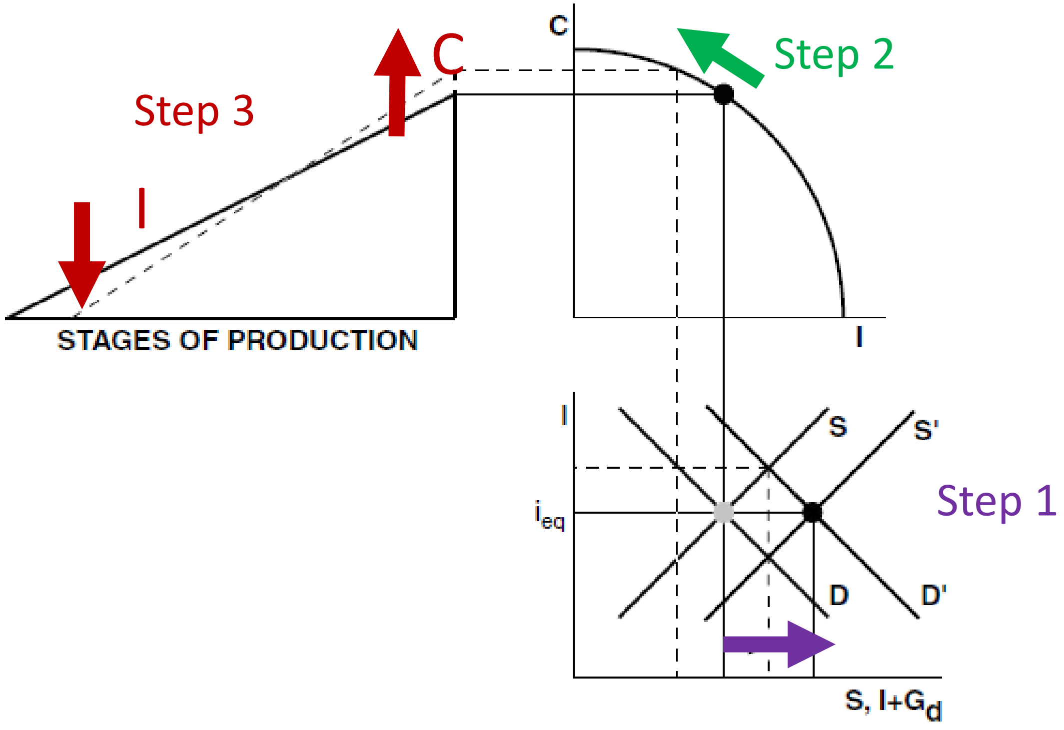
- Expansionary monetary policy ineffective because it sets in motion Austrian Business Cycle Theory
  - Expansionary monetary policy **via the banking system** leads to unsustainable growth
- Countercyclical fiscal policy ineffective because it increases time preferences and results in economic stagnation
  - Government spending not based on economic calculation (consumption), also siphons off savings away from private sector

Austrian analysis of Modern Monetary Theory

- Basic policy prescription of Modern Monetary Theory:
  1. Government runs deficits to pay for various programs
  2. Central bank monetizes debt from the Treasury (directly buys bonds)
  3. If inflation ever becomes a problem, Congress raises taxes
- Crude Keynesianism repackaged and augmented
  - Massive idle resources
  - Supremacy of fiscal policy over monetary policy and the private sector
  - Politicians can spend to hearts’ desire

End Result: general economic stagnation

- To the extent central bank pays for programs by directly monetizing debt:
  - It simply raises time preferences and does not lead to a business cycle
    - New money not injected into credit markets
  - Problem is exacerbated when taxes are raised to later combat inflation
    - Taxes increase time preferences



MMT monetized deficit spending

MMT is nothing new, repackaged old school Keynesianism—paraphrased Rothbard

- “Governments as well as the intellectual climate of the ***[2020s]*** ***[are]*** ripe for such a conversion. Governments are always seeking new sources of revenue and new ways to spend money, often with no little desperation . . . Now along came ***[Modern Monetary Theory]*** . . . saying that 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 . . . How welcome ***[Modern Monetary]*** economics ***[is]*** to the governments of the world!”