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The Fiscal- Monetary Nexus:

A paradigm shift or a
return to normal?

- Do deficits still matter?
- YES!
- But not the way we've been taught to believe
- We're taught to think of a governments as financially constrained
- Spending > income is "fiscally irresponsible"
- Deficits OK in emergency
- But fiscal path needs to be "sustainable"
- Can't assume savers will lend indefinitely
- Borrowing costs must eventually rise
- May trigger solvency crisis
- Responsible governments "pay for" their spending

What is Changing?



A New Fiscal Era? The White House Budget

Proposes \$6T in
gov spending
(rising to \$8.2T by
2031)

WH projects
deficits > \$1.3T
throughout the
next decade

Fully offset—“paid
for”—over 15 years

Leaves deficit of
\$1.8T in 2022

Debt/GDP rises to
117% by 2031

Unemployment
falls to 4.1% by
next year and stays
< 4% thereafter

Inflation never
rises above 2.3%

Fed only gradually
hikes

So, trillion-dollar
deficits are here to
stay!

Is That Cause for Alarm?

MMT rejects the idea that deficits are evidence of “overspending”

Tells us to look to inflation for evidence of overspending

Pretty hard to conclude that Biden is overdoing it if inflation stays near 2% over the next decade

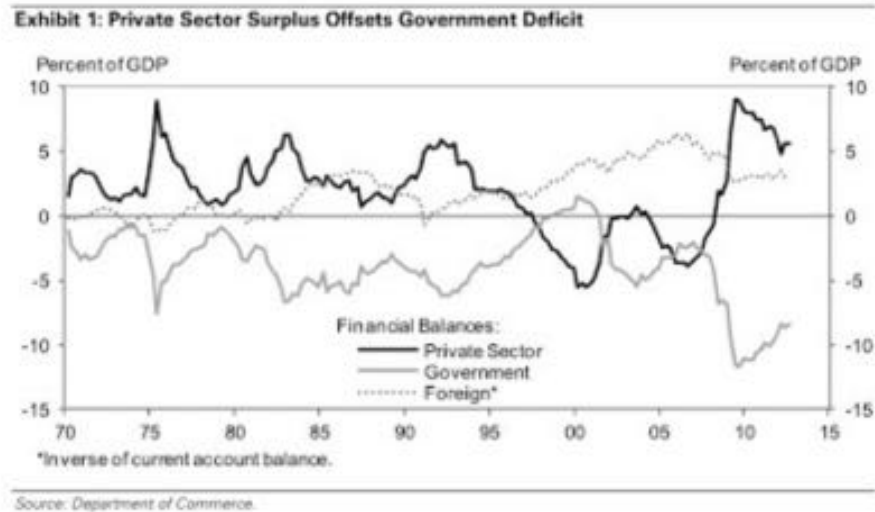
Truth is, deficits are perfectly normal and almost always necessary to maintain a good economy

Put simply, someone has to spend more than their income—i.e. deficit spend—or the output doesn't get sold

This is just accounting!

How Deficits Matter

“The world’s most important chart.” ~Jan Hatzius, 2012

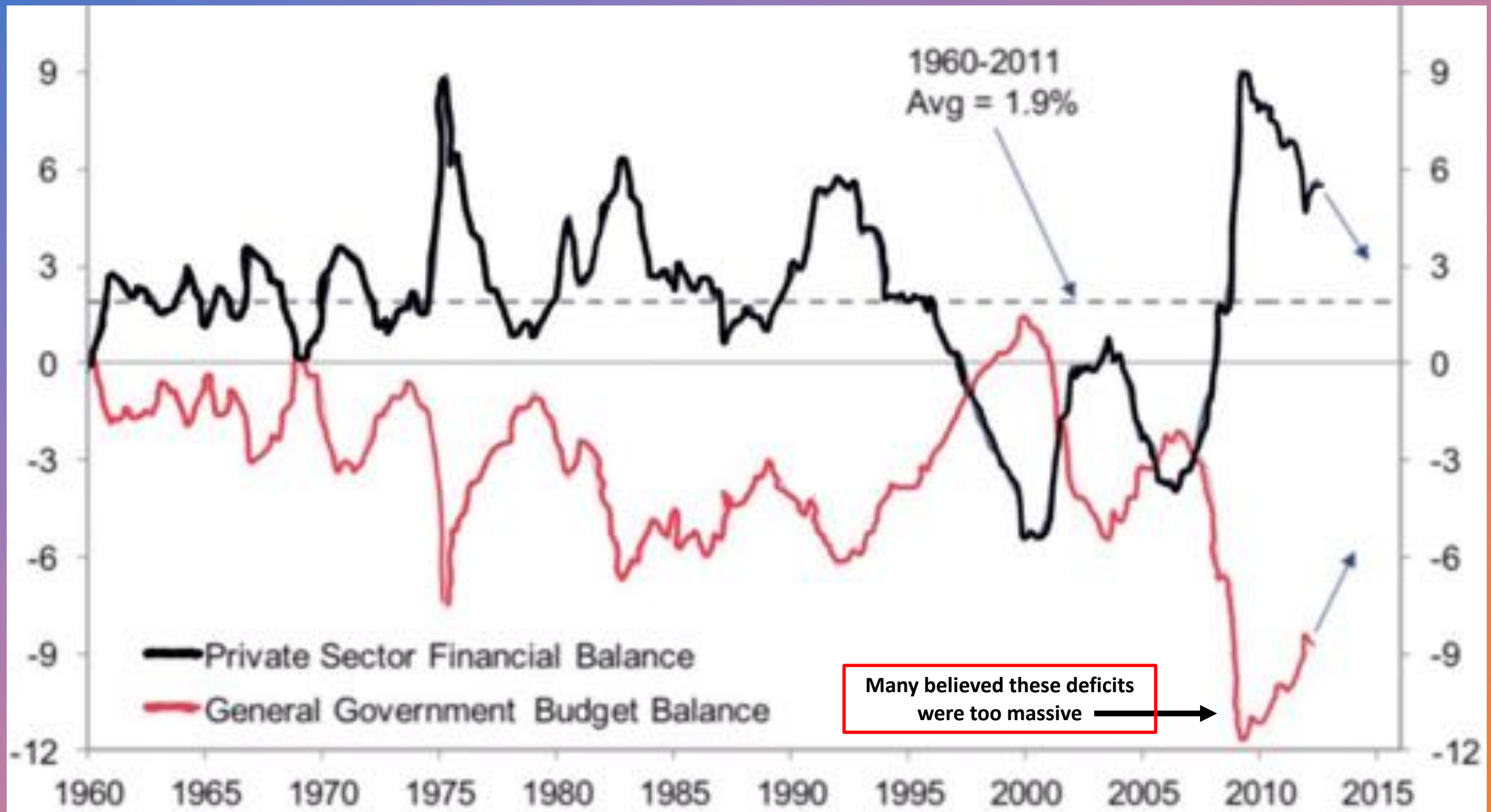


Source: Goldman Sachs (2012) "The US Economy in 2013-2016: Moving Over the Hump" via [Business Insider](#)

"The chart demonstrates a critical economic concept: Government deficits (the grey line) are essentially the mirror image of private sector savings (the dark black line). When the private sector tries to save money aggressively (as happened during the crisis) the government deficit will inevitably explode (as happened). Periods associated with small government deficits (such as the late '90s) are associated with extreme private sector leveraging.

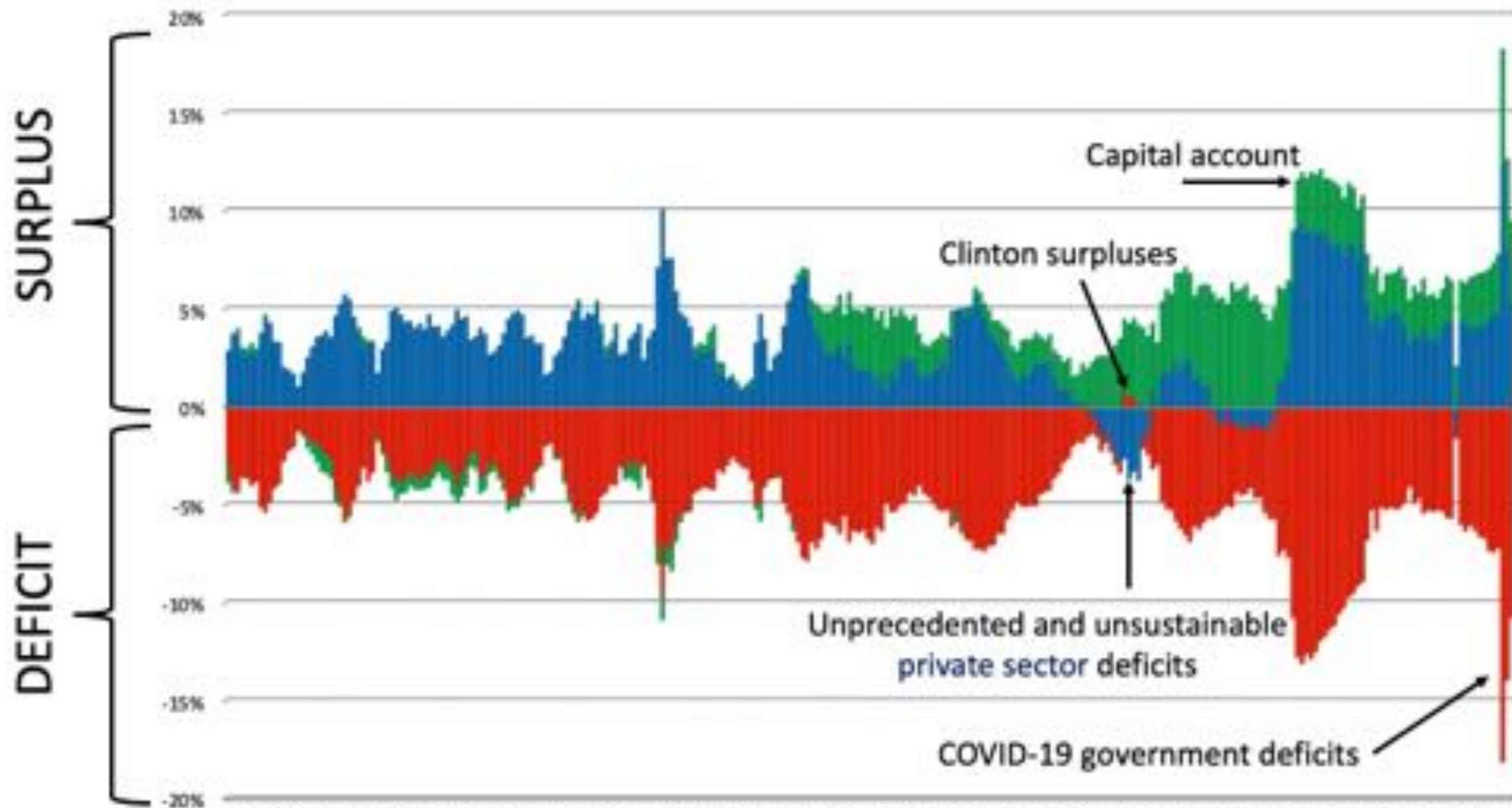
The key to understanding the economy, and forecasting growth, is to think about which sectors are increasing and decreasing their savings."

~Jan Hatzius, 2012



Many believed these deficits were too massive

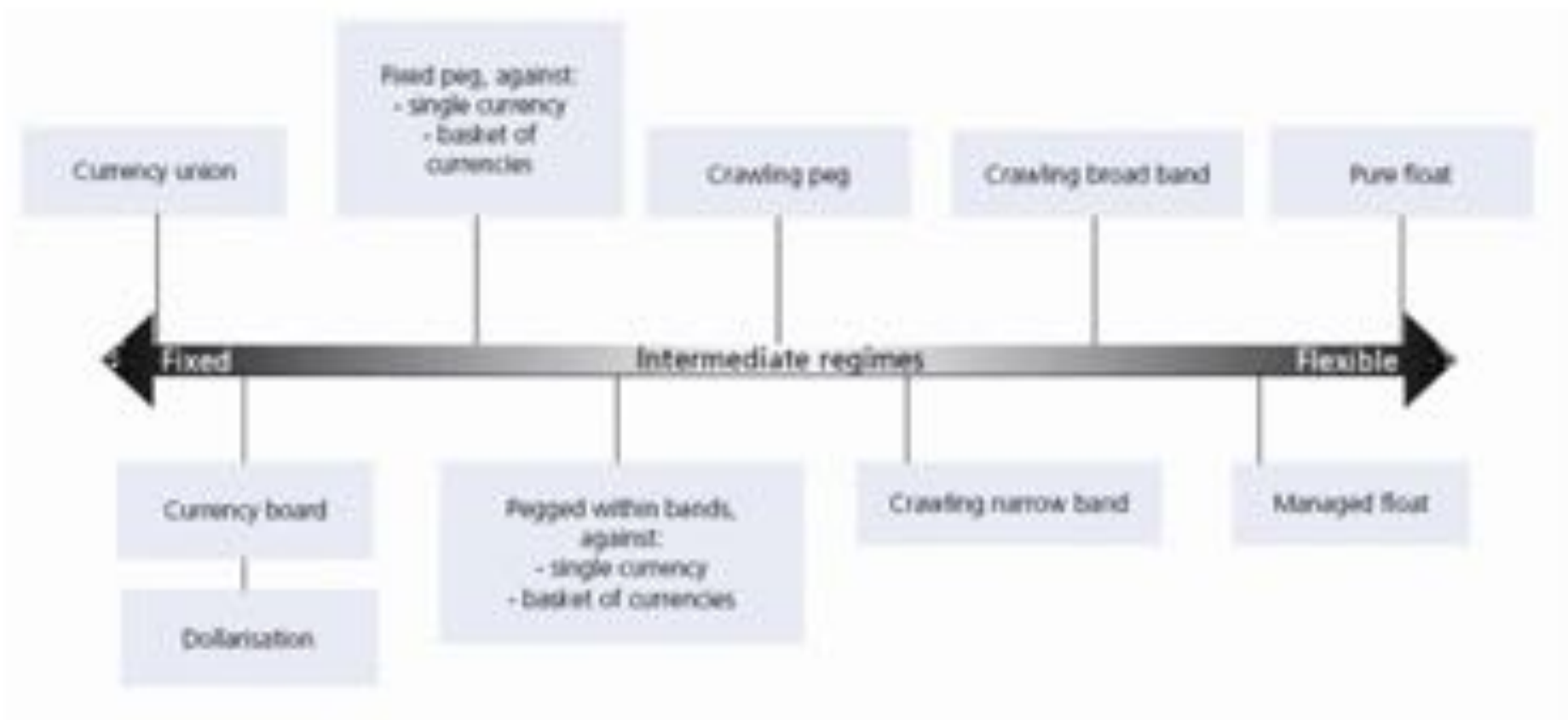
Sector Financial Balances as a % of GDP, 1952q1 to 2020q4





Where Does MMT Apply?

Spectrum of Monetary Sovereignty



The United States is a national state which has a central banking system, the Federal Reserve System, and whose currency, for domestic purposes, is not convertible into any commodity. It follows that our Federal Government has final freedom from the money market in meeting its financial requirements.

January 1946

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Taxes for Revenue Are Obsolete

By Beardsley Ruml

Chairman of the Federal Reserve Bank of New York

Mr. Ruml read this paper before the American Bar Association during the last year of the war. It attracted then less attention than it deserved and is even more timely now, with the tax structure undergoing change for peacetime. His thesis is that given (1) control of a central banking system and (2) an inconvertible currency, a sovereign national government is finally free of money worries and need no longer levy taxes for the purpose of providing itself with revenue. All taxation, therefore, should be regarded from the point of view of social and economic consequences. The paragraph that embodies this idea will be found italicized in the text. Mr. Ruml does not say precisely how in that case the government would pay its own bills. One may assume that it would either shave its expenses out of the proceeds of taxes levied for social and economic ends or print the money it needs. The point may be academic. The latter end of his paper is devoted to an argument against tax-

tions, the obvious answer is likely to be a superficial one. The obvious answer is, of course, that taxes provide the revenue which the government needs in order to pay its bills.

It Happened

If we look at the financial history of recent years it is apparent that nations have been able to pay their bills even though their tax revenues fell short of expenses. These countries whose expenses were greater than their receipts from taxes paid their bills by borrowing the necessary money. The borrowing of money, therefore, is an alternative which governments use to supplement the revenues from taxation in order to obtain the necessary means for the payment of their bills.

A government which depends on loans and on the refunding of its loans to get the money it requires for its operations is necessarily dependent on the sources from which the money can be obtained. In the past, if a government persisted in borrowing heavily to cover its expenditures, interest rates

Monetary Sovereignty Means



Government can afford to purchase whatever is for sale in its domestic unit of account (including all unemployed labor)



Government does not need to tax or borrow in order to spend



Borrowing is optional



The interest rate paid on government bonds is a policy variable



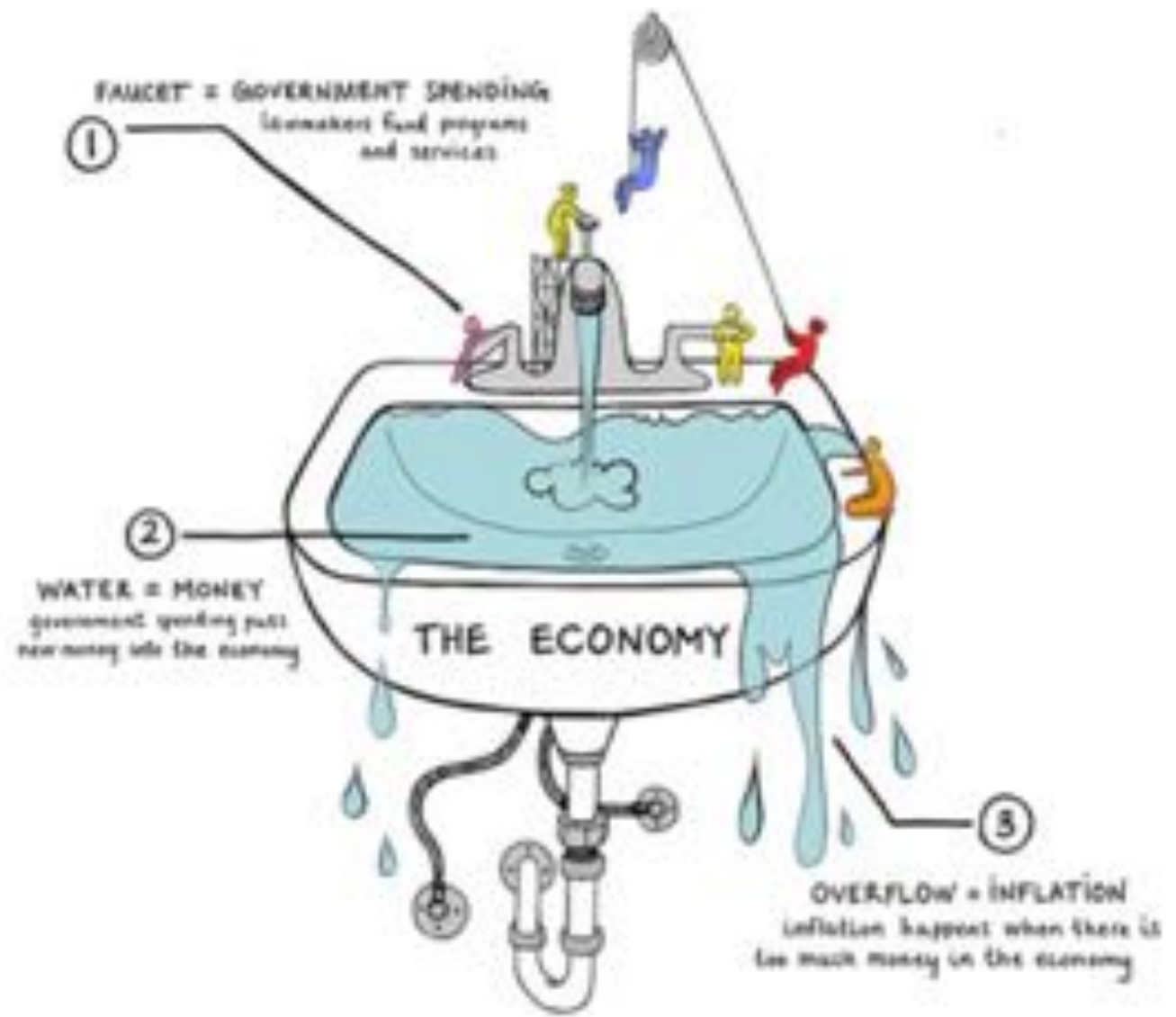
A solvency crisis is impossible as long as it borrows in its own currency



Inflation is the relevant constraint when it comes to spending limits

Monetary Sovereigns Face *Real* Spending Constraints

- Relevant constraint is inflation, not solvency
- No one has a good model of inflation
- QTM
- Phillips Curve
- Inflation expectations
- Supply constraints matter



Evaluating the constraints on government spending

MMT

		Is the economy fully employed?	
		Yes	NO
Does the nation enjoy monetary sovereignty?	Yes	Real	None
	NO	Financial/Real	Financial

Evaluating the constraints on government spending

MMT

Is the economy fully employed?

YES

NO

Does the nation enjoy
monetary sovereignty?

YES

Real

None

NO

Financial/Real

Financial

Evaluating the constraints on government spending

MMT

Is the economy fully employed?

YES

NO

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YES

Real

None

NO

Financial/Real

Financial

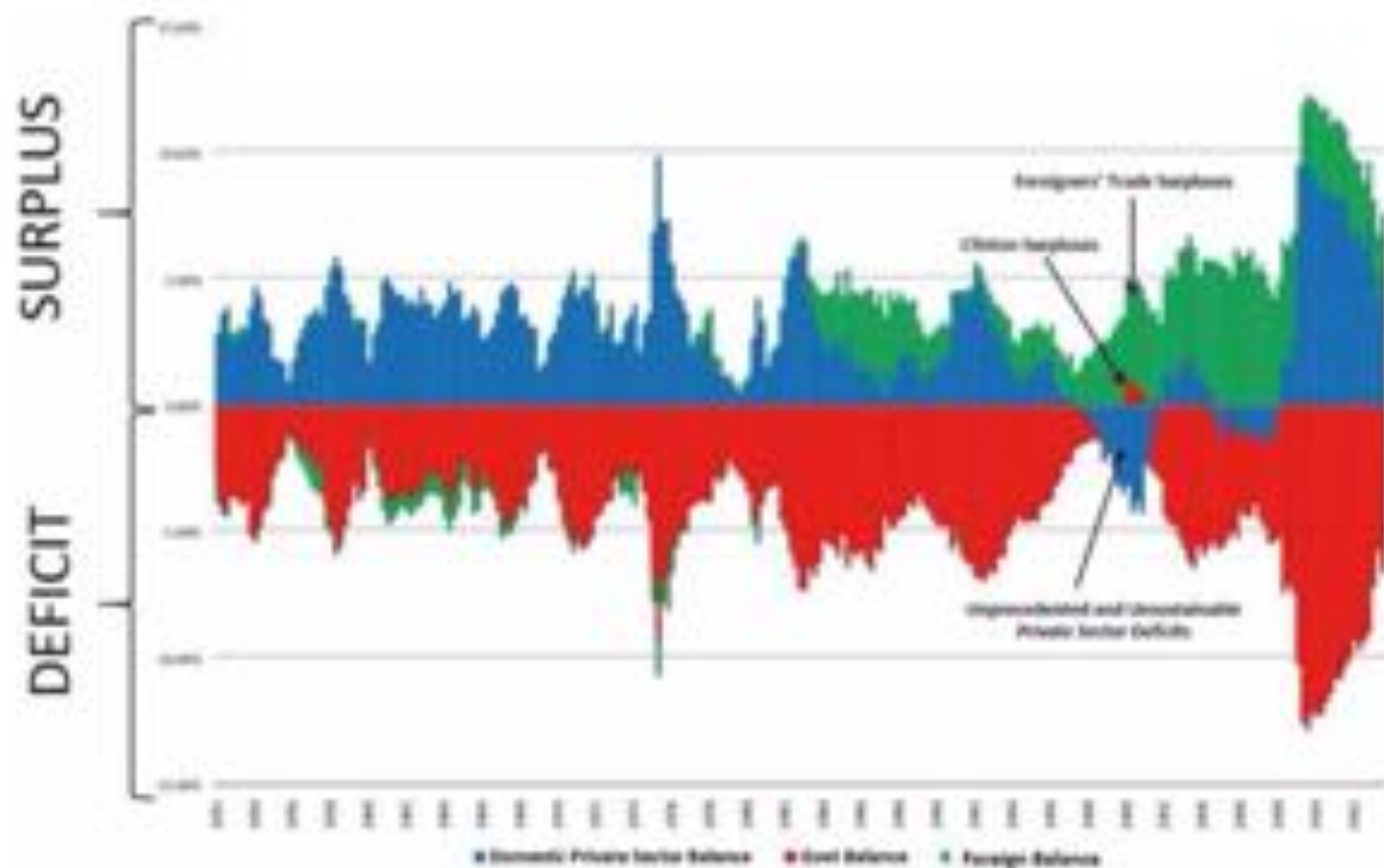
Evaluating the constraints on government spending

MMT

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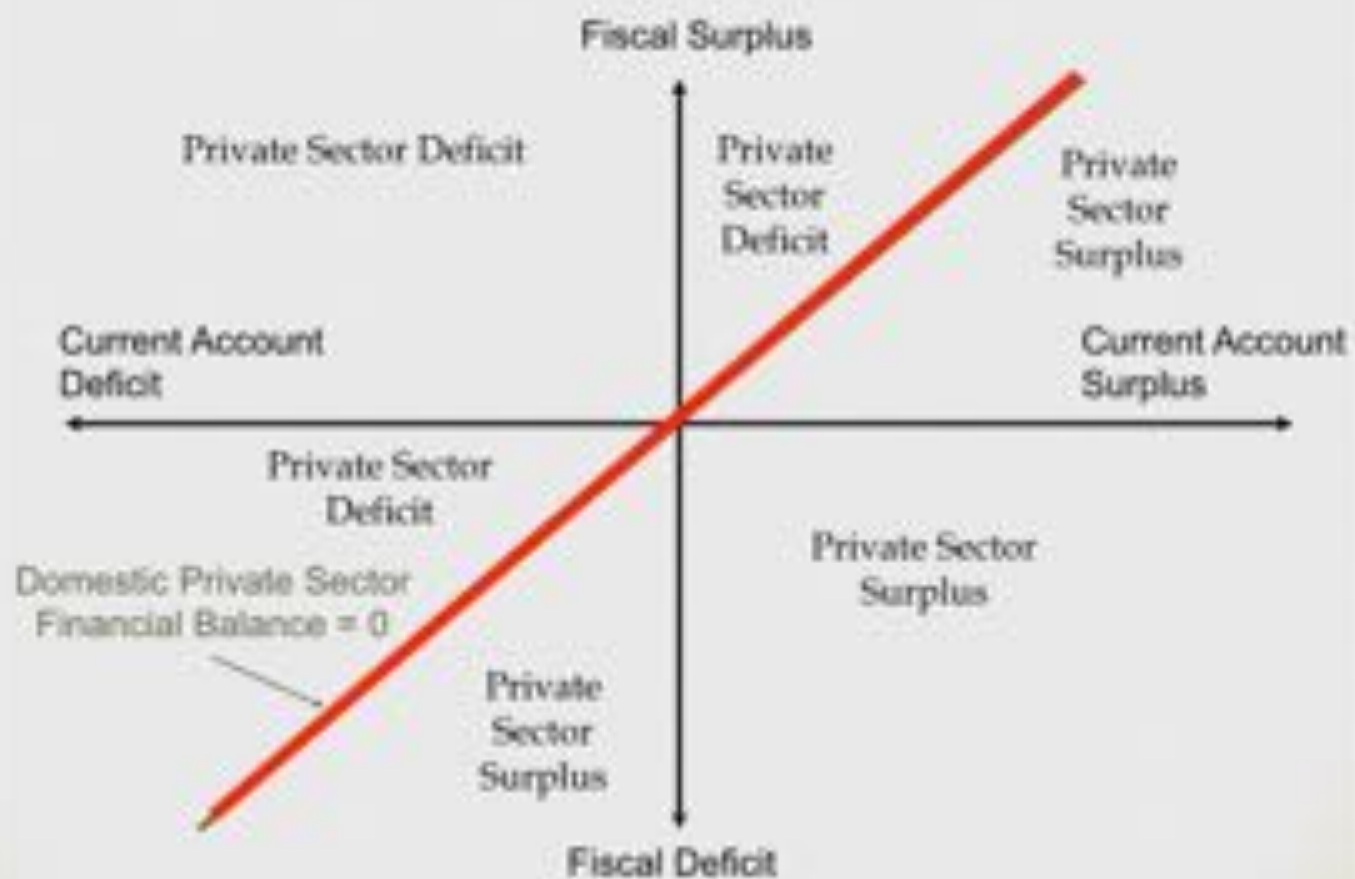
True For *Any* Country

- Budget is always “in balance”
- Fiscal deficits can be too big or too small
- Private sector deficits are unsustainable

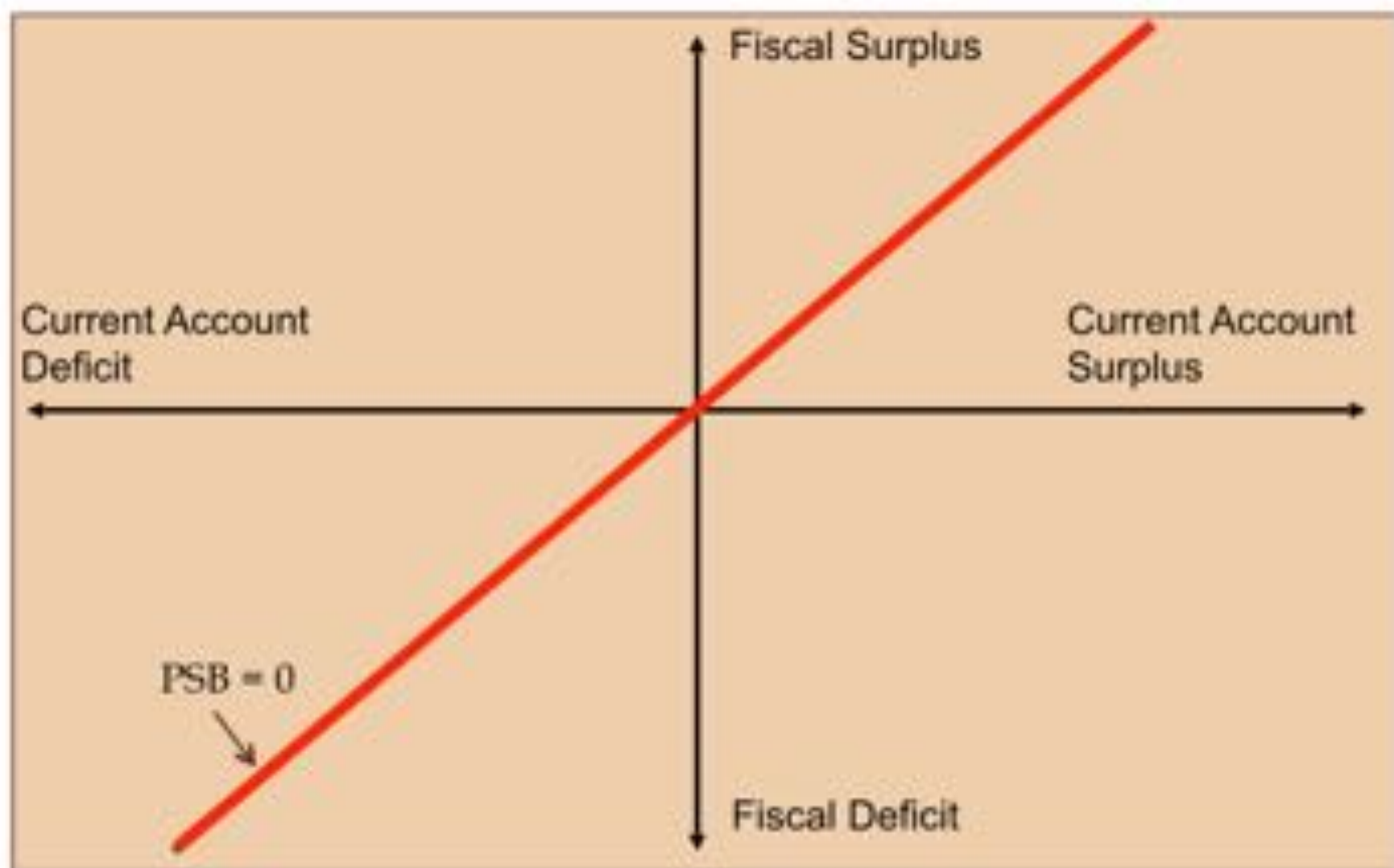


Defining Sustainable Space

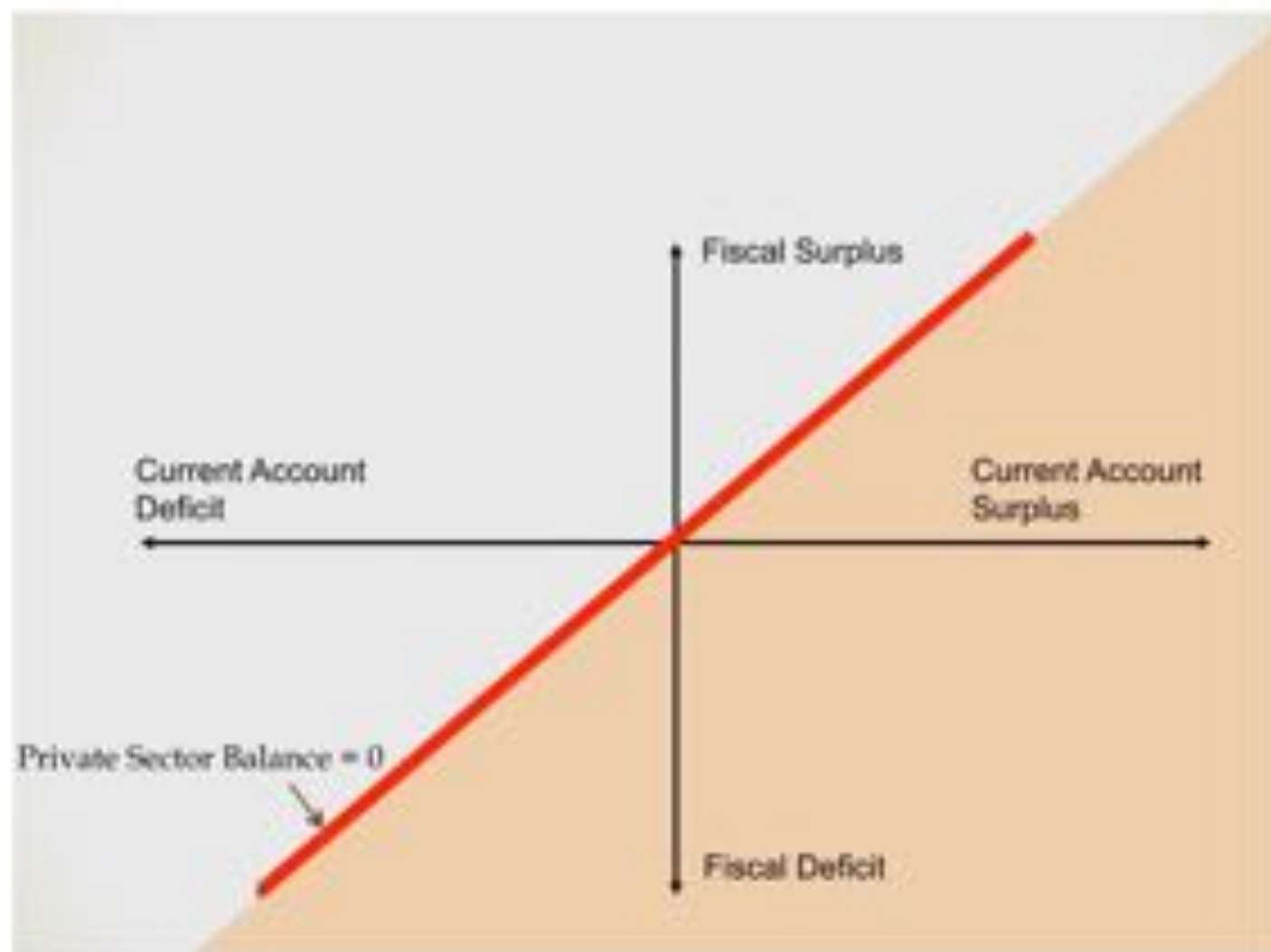
The Financial Balance Model



*Available
Space Facing
a Monetary
Sovereign*



*Sustainable
Space for a
Monetary
Sovereign*



Three Ways To Keep the Private Sector in Surplus

Run

Run a government deficit *and* a trade surplus

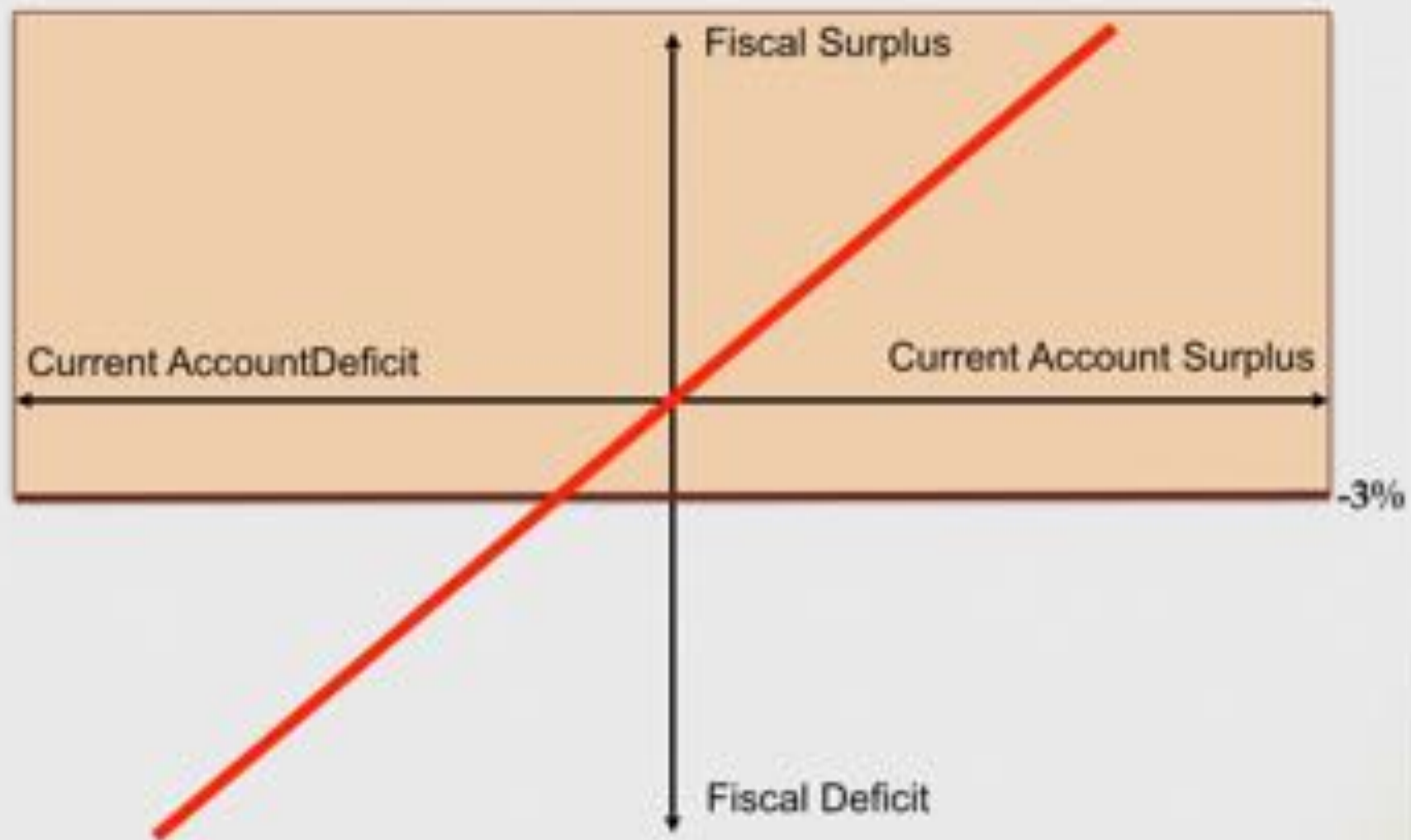
Run

Run a government deficit $>$ trade deficit

Run

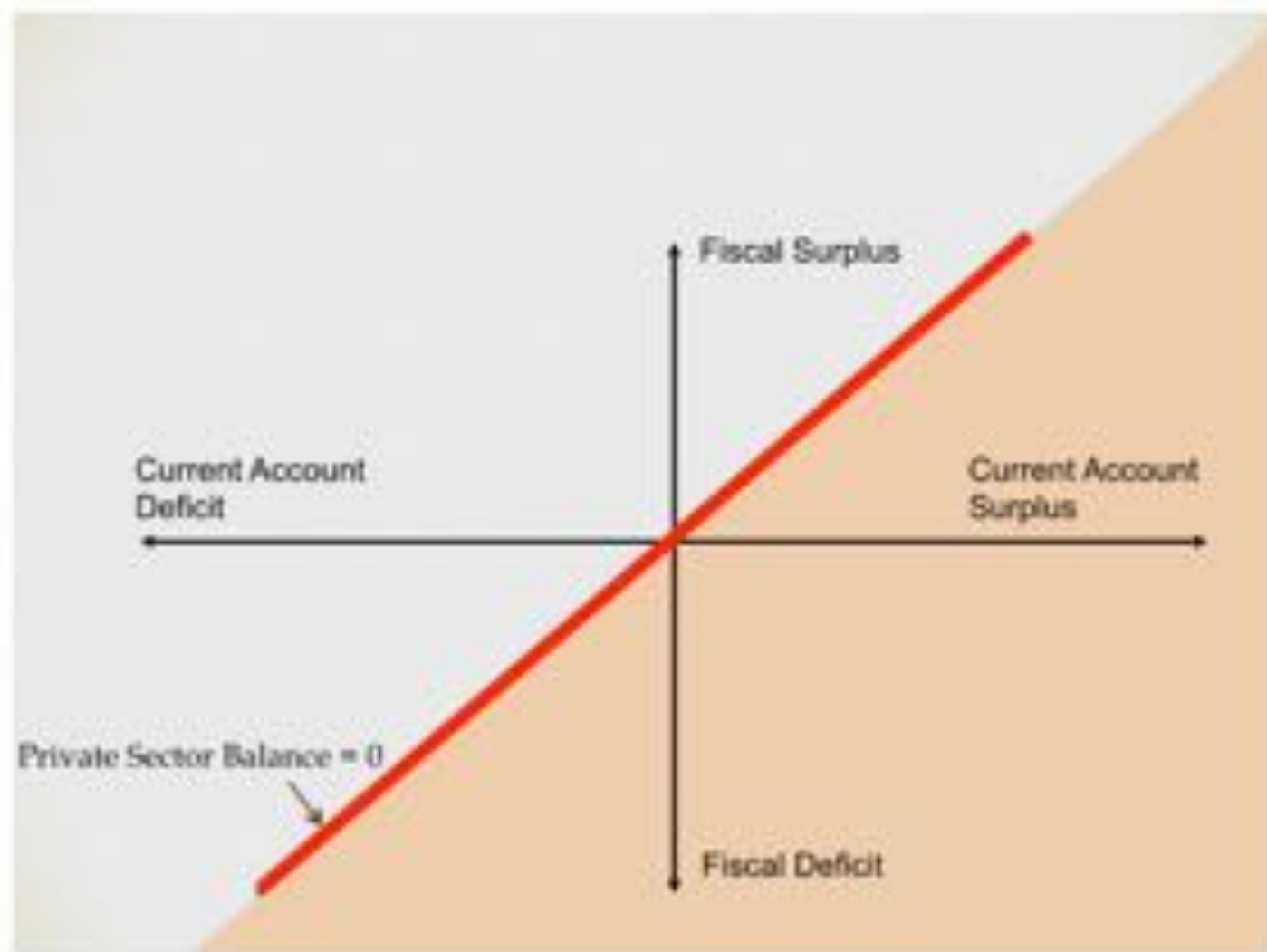
Run a trade surplus $>$ government surplus

Available
Space for
EMU
Countries

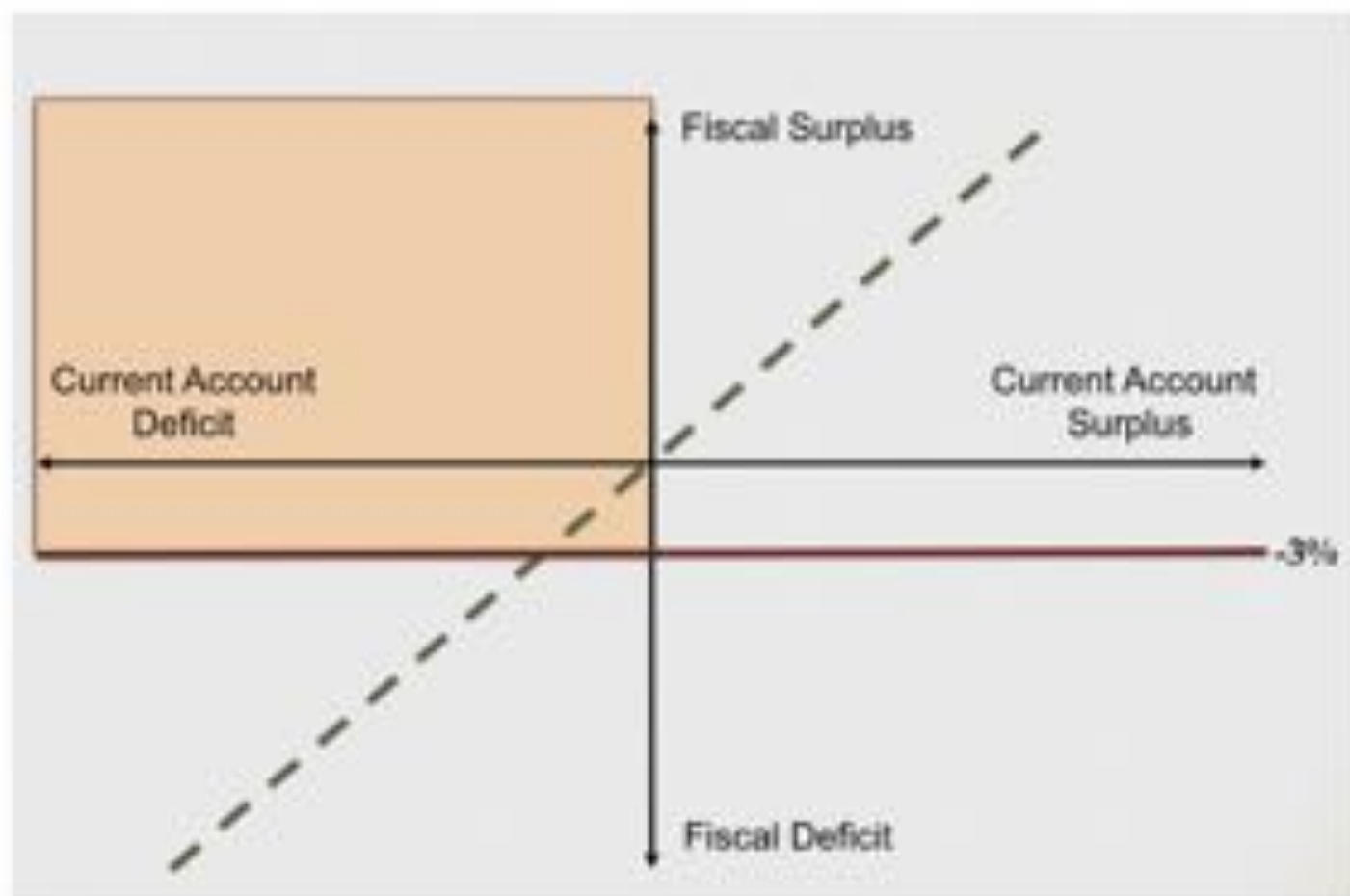


Reminder:

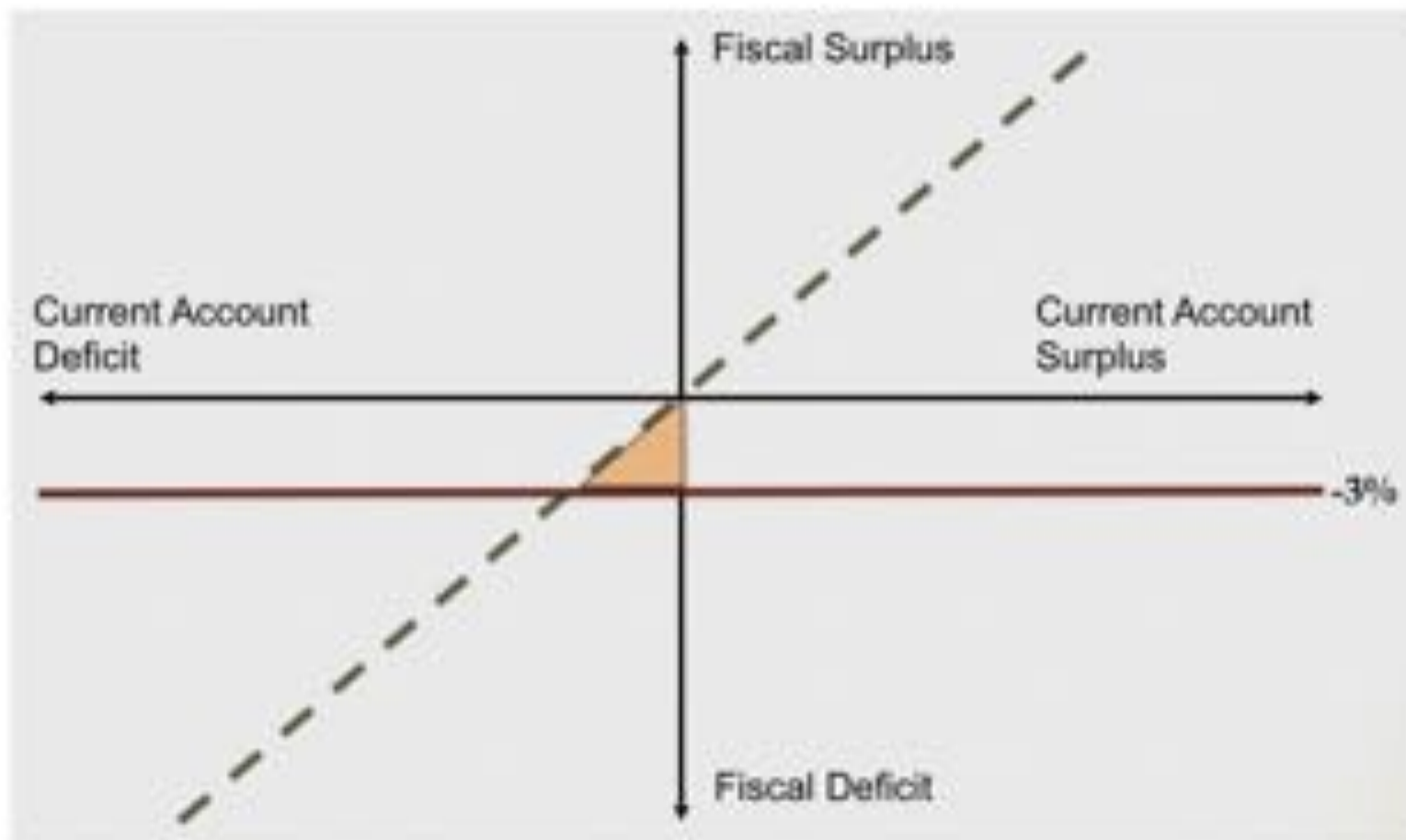
*Sustainable
Space for
U.S., U.K,
Japan*



Available Space
for EMU
Countries with
Trade Deficits



Sustainable
Space for EMU
Countries with
Trade Deficits



STABILITY AND GROWTH PACT

Countries in Excessive Deficit Procedure (corrective arm)

Countries not in Excessive Deficit Procedure (preventive arm)

Were not subject to an in-depth review in 2019

No imbalances

Imbalances

Excessive imbalances

Excessive imbalances with corrective action

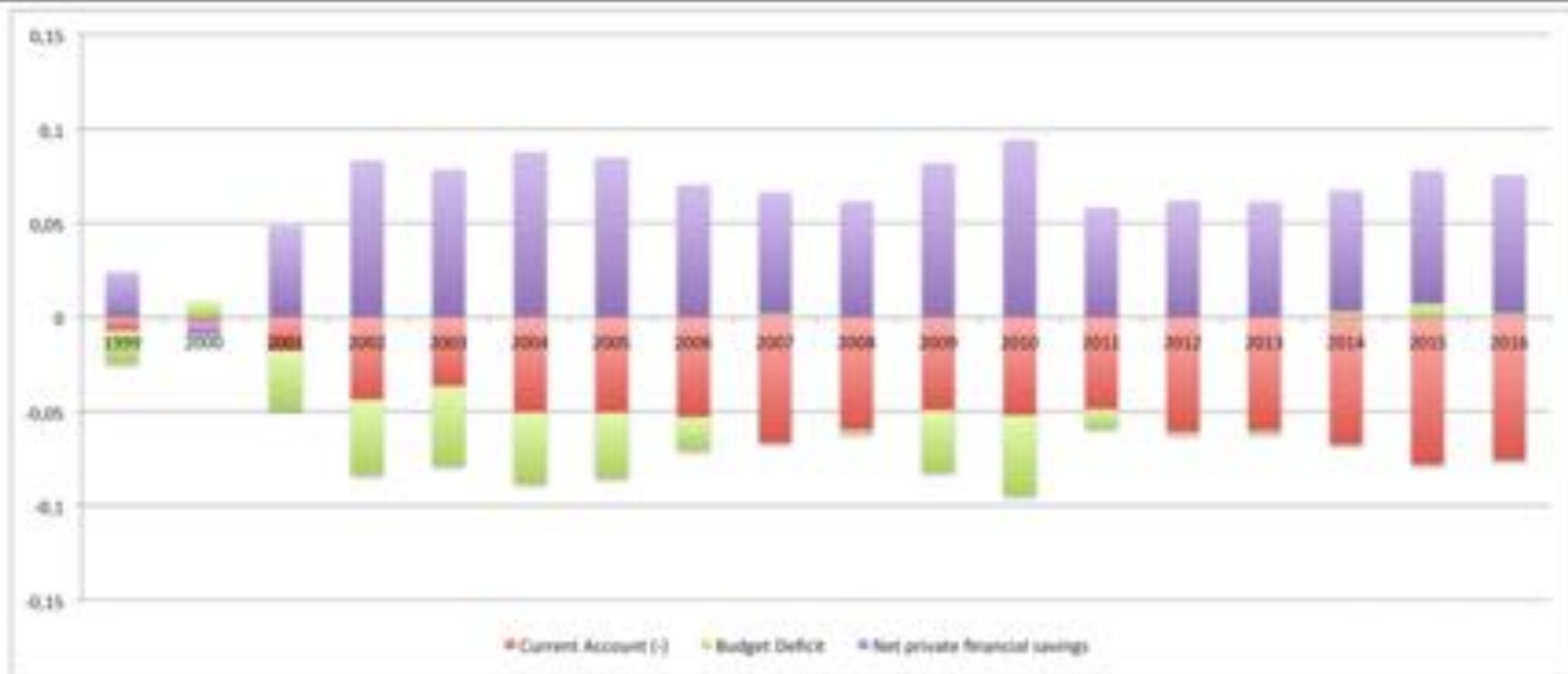


= euro area

Trade Surpluses Become Vital for Survival

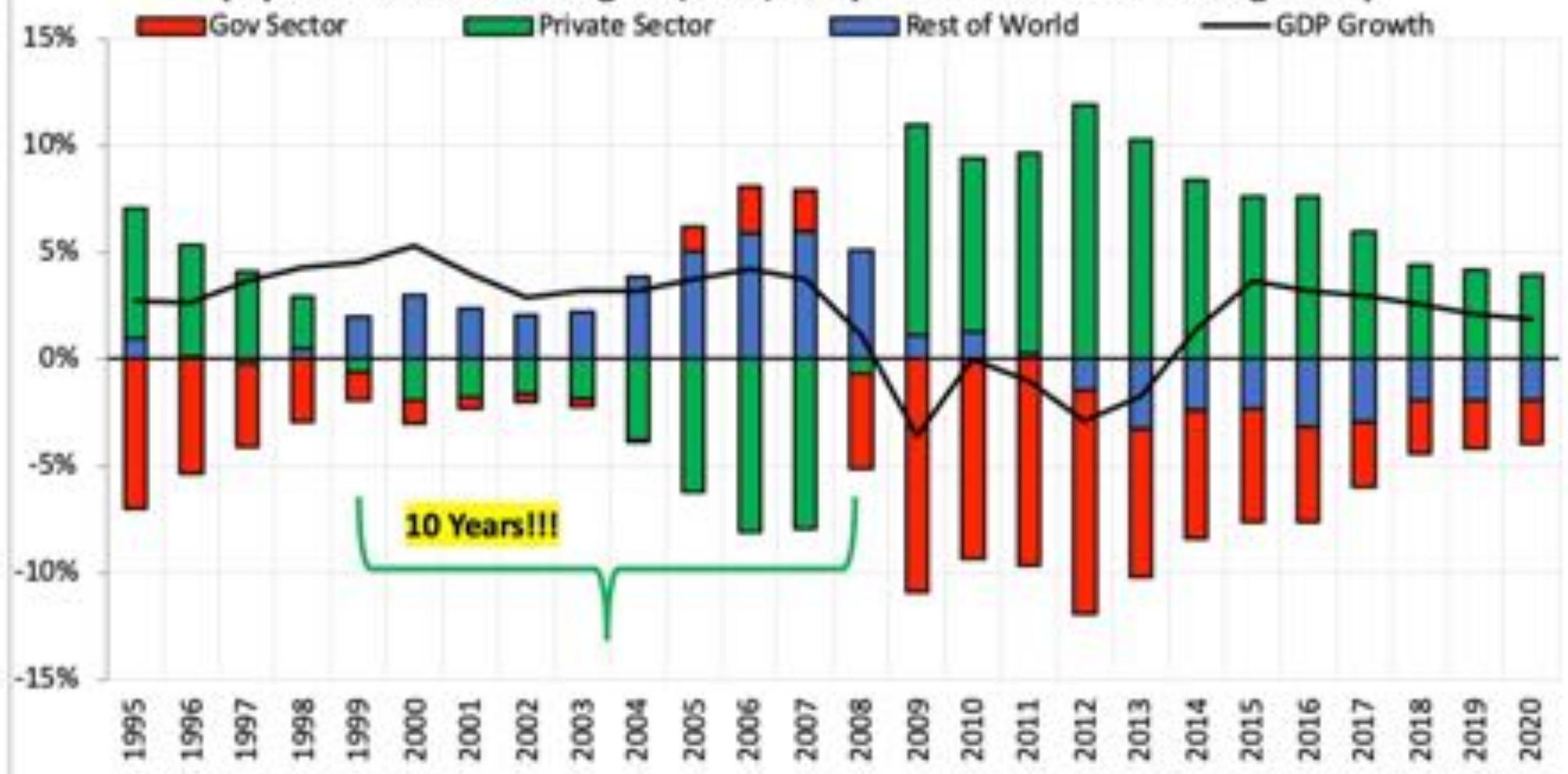
MACROECONOMIC IMBALANCES PROCEDURE

Germany's Entire Private Surplus Depends on Current Account Surplus



Sectoral Balances for Spain

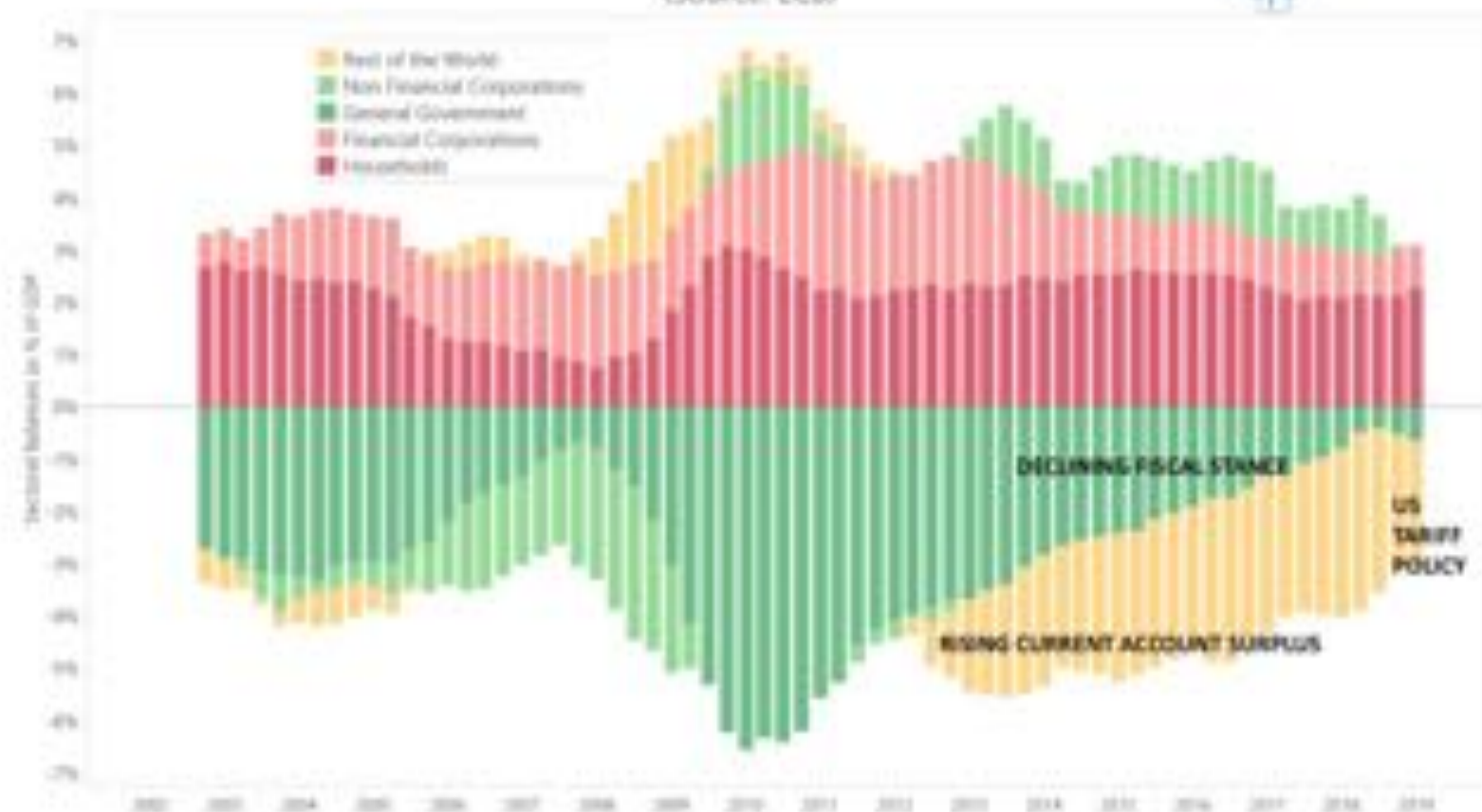
(represented as sector's gains/GDP, compared to real GDP annual growth)



Euro Area Vulnerable to Trade Shock

Euro Area: Sectoral balances (2003-2019)

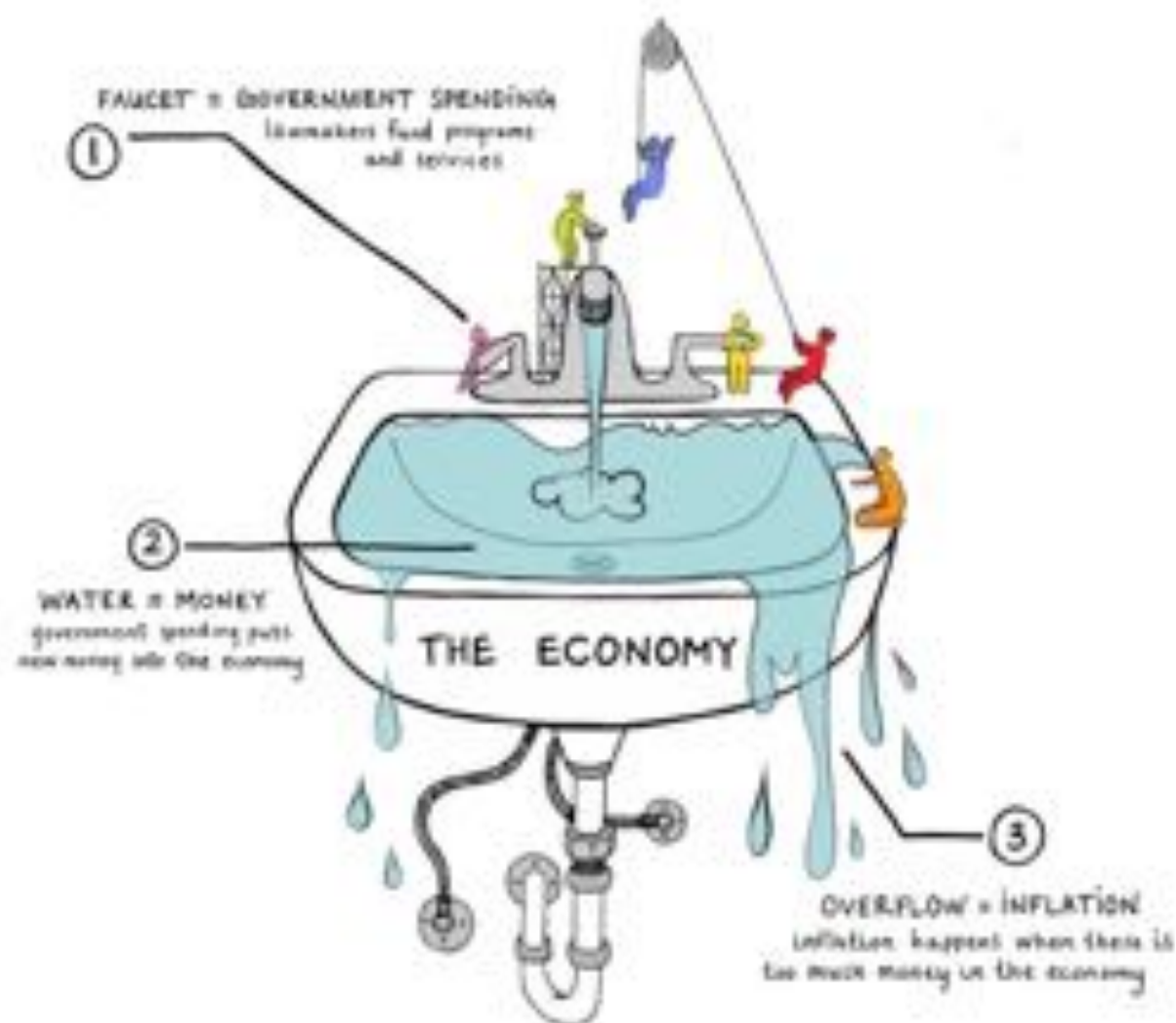
(Source: ECB)



On Inflation

- MMT is about **replacing** an *artificial* budget constraint with a *real resource* constraint—i.e. inflation
- **Supply constraints** matter
- No inherent **tradeoff** between inflation and unemployment
- Full employment is a better **price anchor** and **automatic stabilizer**
- Building and maintaining capacity is part of an **anti-inflation** program

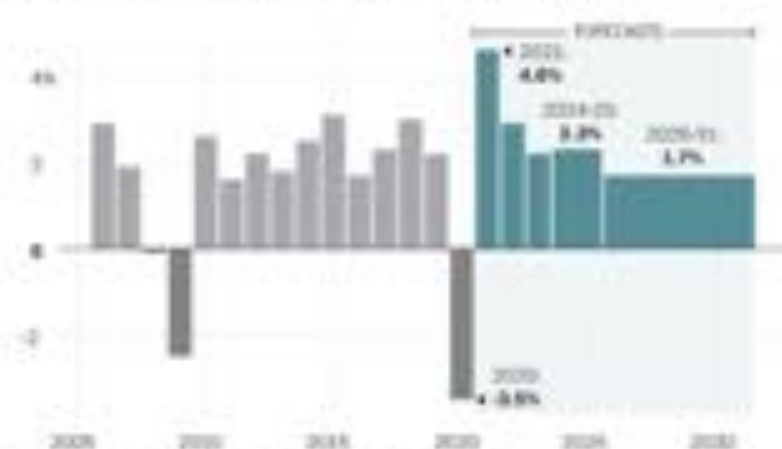
MODERN MONETARY THEORY



Debating Relief and Recovery Spending

Economic growth forecasts

Annual change in gross domestic product, adjusted for inflation

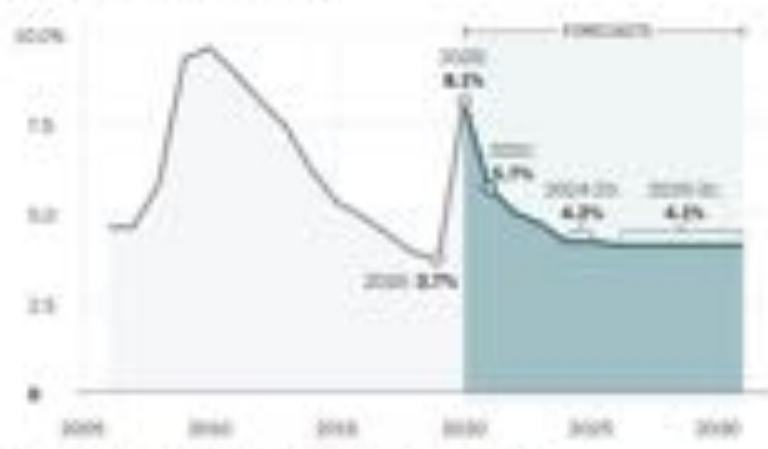


Note: Forecasts for 2024-2025 and 2026-2027 are multiyear averages.
Source: Bureau of Economic Analysis; Congressional Budget Office

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Unemployment rate forecasts

Average U.S. unemployment rate



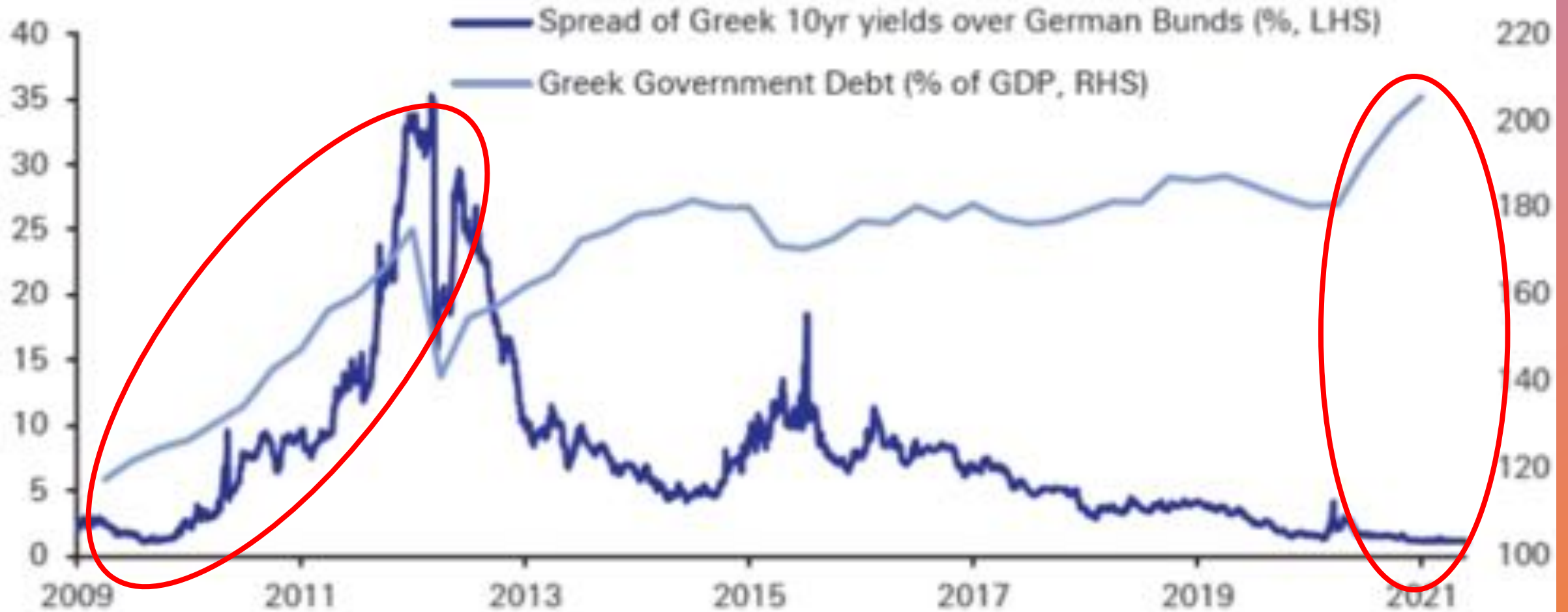
Note: Forecasts for 2024-2025 and 2026-2027 are multiyear averages.
Source: Bureau of Labor Statistics; Congressional Budget Office

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THANK YOU

Figure 1: Greek 10-year spreads over bunds and government debt



Source : Bloomberg Finance LP, Deutsche Bank

Reduction in Federal Funds Rate During Recession

