There Be Dragons: The Myth of The Deficit Myth (23/07/20)

Who trusted God was love indeed
And love Creation’s final law -
Tho’ Nature, red in tooth and claw
With ravine, shriek’d against his creed -

No more? A monster then, a dream,
A discord. Dragons of the prime,
That tare each other in their slime,
Were mellow music match’d with him.

O life as futile, then, as frail!
O for thy voice to soothe and bless!
What hope of answer, or redress?
Behind the veil, behind the veil.

Alfred, Lord Tennyson: In Memoriam A.H.H

As a student of monetary history and as someone who advises savings institutions, your author is particularly interested in Modern Monetary Theory (MMT) and its implications. To further understand it I read Randall Wray’s Modern Money Theory early this year and have just finished reading the newly published The Deficit Myth by Stephanie Kelton. Apart from the numerous errors in both monetary theory and financial history that these books contain, there is something much more concerning - a complete refusal to discuss what impact MMT will have on savers. I was certainly hopeful that Stephanie Kelton, schooled as she is in the work of Wynne Godley, would have to discuss how this largest of stocks might be impacted by, and react to, this new flow of money that MMT creates. However, this subject is entirely avoided in The Deficit Myth, as it is by Randall Wray as well. It is this silence that likely betrays the true intent of the project, at least as it pertains to savers.

There are probably two differing explanations as to why the impact of MMT on the stock of savings is avoided in The Deficit Myth. One would be the author is so besotted by her ‘new’ approach to creating money flows, something that seems very old indeed to monetary historians, that she simply forgot to mention how this new policy might impact savers. That would be a very difficult thing to forget, and quite an oversight in assessing the economic impact of a policy, but I suppose it’s possible. The other reason might be that she knows the likely consequences of these policies on the stock of savings, but deems it politically astute not to mention those consequences.

Having read The Deficit Myth I can only conclude that it is the latter motivation which drove the decision to ignore any public analysis of the impact on savers from MMT. Yet another book analysing the impact of the new MMT money flow without any reference to how this might impact shifts in stocks, particularly the stock of savings, cannot be accidental. So why the silence on the impact of MMT on savers? In hope of answer or redress this report looks behind the veil of MMT.

Having previously described financial repression as a policy that is designed to ‘steal money from old people slowly’, it is very clear why MMT proponents would prefer not to mention the implications for savers from their policies. What politician would endorse a policy that is designed to destroy savings, given the socio-political devastation that such destruction has wrought historically? Perhaps, more importantly, what savers would choose to subject their savings to such theft when it would be possible to move money out of a jurisdiction pursuing a MMT/financial repression policy? As the old saying goes
'slowly, slowly catchy monkey' and you, as a fiduciary responsible for the savings of millions, are that monkey. For MMT to succeed, you must not be alerted to the policies necessary to fix savings in place as the MMT monetary medicine is administered. The only conclusion on the reticence of MMTers to acknowledge that savings move between asset classes and out of currency zones, must be that they foresee a time when they are not allowed to move. The acceptance that savings can move destroys much, perhaps all, of the MMT analysis so there must be a policy, yet to be disclosed, that prevents such movement. You heard it here first, monkey!

Stephanie Kelton has lofty and often admirable goals, and interestingly they are goals that have already been achieved in many countries, but not the USA. These goals for greater equality, public healthcare, etc. have all been achieved without any resort to MMT. They have been reached by choices on fiscal policy enacted through legislation passed by democratically elected governments. In short, there is ample evidence that Kelton’s goals can be achieved with the use of the existing policy tools.

If she regards achieving those aims as success, then many democratically elected governments have achieved that success without any recourse to MMT. Thus, much of the book explains how fiscal policy can achieve key political goals - and who can argue with that as they have achieved such goals elsewhere? If all Skelton argued for was the same fiscal policies that had achieved her preferred social goals elsewhere, then every saver would be well prepared for the consequences of those policies. However, for some reason, while listing the achievements of other governments through fiscal policy choices her book is about… well, let Kelton explain:

‘MMT takes as a starting point a simple and incontrovertible fact: our national currency, the US dollar, comes from the US government, and it can’t come from anywhere else - at least not legally…… It’s not something households, businesses, or state or local governments can do. Only the federal government can issue our currency. Everyone else is merely a currency user.’

‘… the government doesn’t go around looking for someone else to pick up the TAB, it just spends its currency into existence.’

‘When the government spends more than it taxes away from us, we say the government has run a fiscal deficit. That deficit increases the supply of green dollars.’

Perhaps Kelton deliberately uses the term ‘currency’ rather than money to confuse, thus avoiding the simple fact that most money creation, at least since the eighteenth century, is the product of commercial banking balance sheet expansion and has nothing to do with government fiscal deficits. We have just seen a spectacular example of this in the rush by commercial banks to lend during COVID-19 and the ensuing massive jump in the growth of broad money. These things did not happen during QE when central banks laboured hard to boost the growth in broad money. So the private sector has just created a huge amount of money. The government has very clearly not just spent its money into existence, but it has been created by an expansion of commercial bank balance sheets.

That is an ‘incontrovertible fact’ that is inconsistent with the ‘incontrovertible fact’ that is the very basis of MMT. The government does not spend its currency into existence and a deficit does not increase the supply of dollars. That is not how money is created. With money created primarily by commercial banks, and the government deficit funded by an existing stock of savings, this description of how the monetary system works is palpably wrong. It’s either a fundamental error or a necessary conceit to justify why MMT will work. Kelton has an opinion on that:

‘The problem we have today is that economic policy is often prescribed by people who, despite holding advanced degrees in Economics, possess no real understanding of how our monetary system works.’

It really seems that Kelton believes she sees something no one else can see. As she appears not to see the role of fractional reserve banking in the money creation process, one can determine how she comes to such revolutionary conclusions on money creation. I think on this issue it’s best just to ignore
her assessment of how money is created, as it’s so clearly wrong, and focus on MMT as her policy by which it should be created. Of course, by doing so this does avoid the tricky issue of how one ends the money creating capabilities of fractional reserve banking and the impact for private sector access to credit. Perhaps that’s why the current money creation process is fictionalized as a product of fiscal deficits, but really who knows why she comes to such a conclusion. On this topic, as with so much more on the impact on the private sector, The Deficit Myth is silent.

Have MMTers simply not noticed that most money is created by the fractional reserve banking system, or is there a reason why they want to ignore this fact? This is the problem (or omission) that occurs throughout this work and also Wray’s seminal piece, and it is hard to believe that such statements spring entirely from ignorance. As it stretches credulity to its limits that these authors would not know their description of money creation is so wrong, one has to assume that it has been deliberately mis-stated.

In the opinion of your author, it is deliberately mis-stated for the important reason that most of the rest of the reasoning around MMT falls down if we admit for a moment that private sector institutions do play a huge role in creating money and also allocating savings. The fact is that MMT means ultimately both those functions pass to the state with massive negative consequences for those savers who see their asset allocation mandated by the needs of government, rather than expected future returns.

That is the ‘incontrovertible fact’ that must not be revealed and that spurs the mental gymnastics necessary to ignore the role of the private sector in both creating money and shifting the stock of savings to fund the public and private sector. Those roles have to be abolished for the new flow of money called MMT to work its supposed magic, but it is important not to disclose this. To be fair to the authors, it is difficult to reveal the full consequences of a new economic policy when its success largely results in the secrecy of its methods. Savers and commercial bankers must not know what is coming and so they are simply left out of the analysis. Kelton openly admits to be furthering ‘our cause’, but at whose price that cause is delivered is the price that dare not speak its name. It is at the price of savers.

So let’s pretend that money will be created in the way that MMT suggests, which must entail ending the fractional reserves banking system, with the plan being to fund whatever the government wants by the creation of new money. Of course there does have to be a limit on the use of this newly created money:

‘If the CBO and other independent analysts concluded it would risk pushing inflation above some desired inflation rate, then lawmakers could begin to assemble a menu of options to identify the most effective ways to mitigate that risk.’

With monetary policy abolished and replaced by fiscal spending as the tool of money creation, policy makers will have to control inflation via alterations in fiscal policy. The Congressional Budget Office (CBO) will advise on this, and our elected representatives will identify effective ways to take effective measures, presumably by a tightening of fiscal policy, to control inflation. No level of required inflation is recommended by The Deficit Myth that would trigger such CBO conclusions, nor are the ‘effective’ ways of controlling inflation through fiscal policy elaborated.

Each reader will have their own opinion as citizens as to whether government should control the supply of money as part of fiscal policy. However, as representatives of savers, it will be very obvious very quickly to you that law-makers would face extreme political pressure in trying to rein in spending or raising taxes as part of their attempt to control inflation. Their failure to curtail fiscal policy from the mid-1960s is why a move to the independence of central bankers was eventually endorsed from the late 1970s onwards. Savers will demand higher interest rates, given the risks of higher inflation associated with such a radical shift in money creation to politicians. Recognising that interest rates also rise, The Deficit Myth partially lifts the veil on what has to befall savers in the MMT world.

‘It can’t lose control of its interest rate. As Fulwiller observed, interest on the national debt is a “matter of political economy”, meaning that policy makers can always overrule market sentiment.’
‘Indeed, that’s exactly what the Federal Reserve did during and immediately after World War II, and it’s what the Bank of Japan is doing today.’

‘There’s nothing inherently dangerous about offering a safe, interest-bearing way for people to hold on to dollars. If we choose to live with ’em, we should come to grips with the fact that the thing we call the national debt is nothing more than a footprint from the past.’

‘In spite of what most economists say, there’s simply no pre-ordained relationship between fiscal deficits and interest rates…. A little history will prove the point. From 1942 until 1947, the Federal Reserve - at the behest of the Treasury Department - actively managed the government’s borrowing costs. Even as spending to fight World War II drove the federal deficit to more than 25 percent in 1943, interest rates trended lower.’

‘…a government that borrows in its own sovereign currency can always maintain the critical condition for sustainability (\( r < g \)). It never has to accept a market rate of interest.’

The statements above make it very clear what the outcomes for savers are from MMT. The nominal growth rate of GDP will be forced above the yield curve. Unless MMT manufactures some major jump in real growth, it is clear that the move in the growth rate above interest rates will involve a move to much higher rates of inflation. Throughout that process the yield curve will be capped. This \( r < g \) equation is financial repression - pure and simple.

MMT believes that investors will continue to hold these ‘safe, interest-bearing’ securities, despite the fact that they would see their real value decline every year. Yes, this was all achieved from 1942 to 1947, but Kelton simply fails to mention that the policies associated with its success were - rationing, price controls, credit controls, capital controls and enforced purchases of government debt. Yield curve control was indeed possible within the strictures of what was a de facto command economy. It’s not a great advertisement for MMT but, as ever, the consequences of the policy are either forgotten or deliberately ignored; your analyst suspects deep down, it is the latter.

Because the MMT world is one of flows, and which ignores stocks, it cannot see that the market reaction to such a policy is to put the entire stock of Treasuries to the new buyer of those instruments. Glorifying in the impact of each new drop of fresh monetary snow, the theory has to assume that the massive stock of already created money and savings does not turn into a dangerously shifting avalanche triggered by the greater weight of money. As it is very hard to believe that MMTers have just forgotten this fact, we once again have to postulate that MMT must include policies further down the line in which the private sector is compelled to own these investments.

The ability to keep \( r \) less than \( g \) is the key element of financial repression, and also the clear recommendation of Kelton’s book. MMT is financial repression but in its written expression clearly seeks to pull its punches on the impact on savers, and thus hopefully succeed in corralling savers into the killing pens of fixed-interest securities. One has to look hard in The Deficit Myth to divine any guide as to how \( r \) is kept above \( g \) while allowing savers the freedom to choose their own investments. However, there is a hint as to one policy that would prove useful in utilizing such monetary sovereignty:

‘In addition to South-South trade agreements, developing countries need to return to regulating financial transactions across borders. They may not be able to implement the classical form of capital controls that ruled Bretton Woods and relied on global cooperation but they can certainly do better than they are now.’

‘In other words, regulating international capital flows shouldn’t be looked at as a short term “stop-gap” measure, but a permanent policy to help nations reach higher and higher degrees of monetary sovereignty.’

A resort to capital controls in pursuit of monetary independence is admitted in The Deficit Myth. While Kelton foresees it as a policy for developing countries, it is clearly a policy that is on the table should
MMT implementation trigger the scale of capital outflow from the US that is all but inevitable. What other policies will be necessary to lash savers to the deck during MMT are not revealed in *The Deficit Myth*.

Subscribers will know that such policies are many and dangerous and outlined in *Capital Management in An Age of Repression* (3Q 2020). A study of the 1945 to 1979 period reveals that policy makers play a game of whack-a-mole with savers who are constantly trying to escape the inflation tax that MMT/financial repression brings. That game leads to more and more administrative measures to whack the mole until there is little of the private sector left. That’s a dialectic which is not discussed in *The Deficit Myth* either - once again, in case it frightens savers and causes them to bolt.

Of course, there are numerous consequences for savers from other recommendations in *The Deficit Myth* but these are very much the standard consequences that savers are used to from the operation of fiscal policy. The most striking thing about the book is that probably all of its goals can be achieved without resort to MMT at all! While eschewing the need to tax the wealthy - something very different from savers - in order to finance new spending, the book does have certain recommendations on the subject of taxation:

‘Feigning dependence on those with incredible wealth sends the wrong message, making them appear more vital to our cause than they actually are.’

‘There is a strong case to be made for taxing the rich, and we need to do it. But we need to do it strategically, recognizing that the purpose of the tax is not to pay for government expenditures but to help us rebalance the distribution of wealth and income because the extreme concentrations that exist today are a threat to both our democracy and to the functioning of our economy.’

This is straight fiscal policy, and it will be up to the people to either endorse or not endorse through the ballot box. It has the advantage of being honest and directed, and openly decided and enforced. It is just the sort of policy that MMT is not. MMT aims to take money from savers, whether rich or not; and given the obfuscation around its consequences in *The Deficit Myth*, it is not one to be fully explained to, or endorsed by, the electorate. It is an attempt to impose an inflation tax on savers and redistribute wealth without an open discussion - at least that is what one must conclude from the reading of a book that simply refuses to discuss the implications for savers of MMT’s implementation.

In a recent interview Raghuram Rajan described MMT as ‘absolute nonsense’. Of course, that is what it does look like, but this is because its proponents cannot bring themselves to reveal the nature of the capture of private savings necessary to make the theory work as they propose. In the opinion of your analyst, the apparent theoretical failings, necessary to disguise its intent, make it look like ‘absolute nonsense’; actually, it is much more dangerous than that.

John Maynard Keynes, no slouch as an economist or in using fiscal policy for public good, had a warning for those who would seek to use monetary policy to redistribute wealth in a society:

*Lenin is said to have declared that the best way to destroy the capitalist system was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become ‘profiteers’, who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished, not less than of the proletariat. As the inflation proceeds and the value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery. Lenin was certainly right. There is no subtler, no surer means of over-turning the*
existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and it does it in a manner which not one man in a million is able to diagnose.

The Economic Consequences of The Peace, 1919

Savers must be in no doubt that the aim of MMT is to redistribute wealth in an economy without full democratic endorsement and, crucially, in an arbitrary form. While many large and better-informed savers will successfully dodge the new inflation tax, many smaller and less-informed investors will see the purchasing power of their savings undermined. It will achieve a form of wealth distribution, but almost certainly not the intended form.

As history shows, it is most likely to fall most heavily upon that section of society which has heretofore supported the rule of law, democracy and property rights. Destroying their savings - their buffer against uncertainty - usually leads to their endorsement of that dangerous political extremist who, under the guise of bringing certainty, destroys liberty and often peace. Perhaps the dream before the monster!

When one looks at the goals that Kelton describes in her book as ‘our cause’, nothing could be further from her intentions than to facilitate such a destructive political shift. Her goals can be met without resort to MMT but that would require overt political endorsement for a much more active fiscal policy, as once enjoyed by FDR, for example. Sound money can be compatible with such goals, and democratic endorsement for achieving them through fiscal policy can and has been achieved both in US history and now elsewhere in the world.

The Solid Ground has been writing about financial repression for many years and advising subscribers on how to maintain the purchasing power of their savings in such a repression. MMT is financial repression, red in Tennysonian tooth and claw, and the irony is that it not only destroys savings but, alas, also ‘the cause’ which Kelton so passionately believes in. Thus ultimately it is the aim of MMT to hide its modus operandi in pursuit of a consequence that its proponents do not understand must destroy its goals.

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O for thy voice to soothe and bless!
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