Intelligence MEMOS

From: Mark Zelmer

To: Policymakers in Ottawa

Date: April 12, 2021

Re: **BEWARE THE SEDUCTION OF MODERN MONETARY THEORY**

The massive increase in government spending in Canada and around the world in response to COVID-19 has been accompanied by the siren song of Modern Monetary Theory, the fashionable economic thesis that predates the pandemic.

We need to turn a deaf ear to MMT's song as we begin to emerge from the acute phase of the pandemic.

Now that inflation concerns are beginning to stir, it is hard to imagine governments raising taxes or cutting spending anytime soon to keep inflation in check – yet that's how MMT advocates would control inflation. The theory postulates use of traditional fiscal policies rather than the customary monetary tools of interest rates and liquidity measures to stem inflation while maintaining full employment.

MMT is very seductive, as I point out with my co-author, Farah Omran, in our recent C.D. Howe Institute paper. It acknowledges the need for inflation control but is not so keen to leave that task with central banks.

MMT proponents believe central banks are too quick to raise interest rates to contain inflationary pressures, typically doing so before the labour force is fully employed, thus denying many people the opportunity to obtain meaningful jobs and financial security. Instead, MMT puts the onus squarely on ministers of finance to accomplish the twin tasks of achieving full employment while controlling inflation.

This would be a step backwards. Canada's economic performance, and hence our standard of living, have benefited tremendously over the past 25 years from having an explicit inflation target and tasking the Bank of Canada with conducting monetary policy in pursuit of that target.

History has shown that central banks deliver better inflation control than governments. Keeping the Bank of Canada focused on inflation control gives savers everywhere more confidence that their investment returns in Canada are less likely to be eroded by inflation than if inflation control is left to government policymakers who have to balance many competing policy priorities.

Part of MMT's allure is that it does get a few things right. It is correct in saying there is no magic debt-to-GDP ratio for the federal government: much depends on what borrowed money is used for. It is also correct in saying that when the economy is operating below its full potential, government debt denominated in Canadian dollars does not necessarily crowd out private investments. And, finally, it's also true that government debt does not pose a credit risk for investors when the issuing government controls the monetary printing press. A Canadian government that can print Canadian dollars will always be able to pay off its Canadian dollar debt.

But it is not true, as MMT implies, that governments can issue debt with impunity.

Both Canadian and foreign investors can move money around the world with the click of a mouse. Unless they believe government borrowing is likely to be used in a way that generates future income to service it, they may begin to worry that some of their returns from investing in Canada could be offset by a depreciation of the Canadian dollar relative to other currencies.

The interest rate and exchange rate gyrations of the early 1990s are a good reminder of what can happen if we stray too close to those rocky coasts. Permitting the Bank of Canada to continue buying the federal government's debt and keep interest rates low risks dislodging our inflation-control anchor after the economy recovers. It would be tantamount to placing monetary policy in the hands of government policymakers who, given their other priorities, are less likely to be willing to keep inflation under control.

So as we approach the next federal budget we need to make sure that any additional government debt will be used in ways that generate the means to service it.

It might be thought there is safety in numbers, given that Canada is in the same boat as other countries emerging from the acute phase of the pandemic. But our businesses and households are more indebted than those in other countries, and foreign investors are acquiring a larger share of our debt. This is increasing our exposure to the shifting winds of market perceptions about how our economic fortunes will evolve in future. While we have been able to navigate these winds so far, we should think twice before compounding our growing private debt load with more public indebtedness.

Canadians have benefited from low inflation with economic growth for more than a generation. We should stay that course.

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A version of this Memo first appeared in The Financial Post on April 6, 2021.