

Much ado about Modern Monetary Theory

As governments dig deep to fund Covid-19 support, the alternative macroeconomic approach known as "modern monetary theory" (MMT) has captured the public imagination in places such as the United States.

BY JANICE HENG



PHOTO: AFP

It suggests that governments can increase money supply and manage the resulting risk of inflation through other means such as taxation.

But can Singapore draw any inspiration from this?

A closer look suggests that even if there is a case to be made for MMT – which remains a large "if" – its relevance to Singapore is necessarily limited.

How is MMT meant to work?

The broad argument behind MMT is that deficit financing will not have negative repercussions when there is excess slack in the economy.

– Ramkishen S. Rajan, Yong Pung How Professor, Lee Kuan Yew School of Public Policy (LKYSPP), National University of Singapore

With excess slack – that is, no inflationary pressures – central banks can finance deficits with infusions of liquidity. Interest costs can be kept low to encourage private sector spending.

Why can't Singapore do this?

Massive increases in domestic liquidity would cause currency depreciation, which is incompatible with Singapore's exchange-rate-based policy. MMT is more applicable to economies that control the domestic quantity or price of money – that is, interest rates – and where most of the debt is domestically held.

The impossible trinity

An economy can only have two out of these three:

Free capital flow



Sovereign Monetary policy

Fixed exchange rate

If a country sets a higher interest rate than the world rate, for example, capital would flow in and push the currency up. The central bank would either have to impose capital controls, or give up its ability to set the exchange rate.

What about other economies?

Even economies whose currencies are recognised as being among the world's reserve currencies may not be able to implement MMT.

I don't expect MMT to work outside of the top three economies – US, eurozone, China – if at all. Economies outside of these three, especially in Asia and other developing markets, are prone to capital outflows when debt spirals out of hand.

– Howie Lee, economist, OCBC

As a global financial centre, Singapore has to allow for free capital mobility.

A large economy like the US will choose independent monetary policy as their economy is driven largely by consumption and investment, with a relatively small role for exports and imports.

Singapore is different. We are a small, open economy – most of our consumption and investment is imported. If you stimulate consumption, you stimulate imports. But we want to stimulate our own production, which is exports.

– Yip Sau Leung, associate professor, Nanyang Technological University

So Singapore chooses to control the exchange rate, as the effect of exchange rates on output and inflation is more important.

What about deficit financing in general?

One obstacle to deficit financing – under MMT or otherwise – is that the Constitution prevents the Singapore government from running a deficit over its term of office.



Another practical constraint to MMT lies in Singapore's dependence on foreign investment, which means that it can ill afford to lose the confidence of investors.

– Chow Hwee Kwan, Professor of Economics and Statistics (practice), Singapore Management University (SMU)

Given how connected Singapore is to world trades and international financial systems, the types of government spending and fiscal practices that MMT advocates may mean excessive volatility in Singapore's currency and prices that are difficult to control.

– Huynh Bao Tan, senior lecturer, SMU



If it ain't broke...

If nothing else, the discourse over MMT has shifted the debate away from being too fiscally hawkish, suggesting that there may be scope for significant deficit-financed fiscal expansion, at least in periods of low interest rates and significant idle capacity.



This is quite a major intellectual shift from just a decade ago when the focus, even with the recession induced by the Glocal Financial Crisis, was about ensuring fiscal sustainability and there being strict limits to the size of public debts and deficits.

– Prof Rajan, LKYSPP



But the central MMT argument – that governments are not faced with financial constraints, only resource constraints – is likely to be seen as too radical.



There is too much at stake - jobs, livelihoods, political and social stability - to attempt an untested MMT theory on any present economy, much less a well-oiled economy like Singapore. It is not so much fiscal prudence that is holding back MMT, but the complete change of mindset required.

– Mr Lee, OCBC

