



Modern Monetary Theory

Where does money come from?
Where does it go to?



No kangaroos

- Don't jump to your own conclusions
- **Very, very, very contentious**
- Don't argue with conclusions, argue with the assumptions and logic
- Listen to what I say, not what you imagine I say



Institutions

- Central Banks vs Treasury Departments
- Laws, MOUs, HOAs
- Bond markets

- All very important, but only conventions

Modern Monetary Theory



- There ain't no theory
- Stock/flow consistent analysis of money and credit flows
- Watch carefully – I won't make many assumptions
 - Unlike almost all other analyses of money



Credit creation

- I'm a bank and lend you \$1bn
 - \$1bn asset – IOU
 - \$1bn liability – account that you can draw down
 - Books still balance

You buy something

- If your counterparty banks with me then I shift the liability to them
- If ctpy banks with XYZ then reserve acct transfer occurs
- Apart from leakage into newly created cash, the \$1bn is always in the banking system
 - As a whole the banking system doesn't need to borrow money to finance its lending



**As a whole the banking
system doesn't need to
borrow money to finance
its lending**

lending creates its own deposits



What brakes exist?

- Regulators
- Capital requirements
- Risk management
- Market
- Shareholders
- Board
- Auditors
- Rating Agencies

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GET REAL!

- Take a look at UBS
- There were no brakes until the balance sheet imploded
- Evidence based theory



Banking is fundamentally unstable

- When we are all happy we keep dancing till the music stops
- When the music stops, we are depressed, we all do nothing

Ideas and Jargon!

- These credit arrangements are called horizontal transactions
- There is no creation of net credit
- No net saving of financial assets is possible
 - Real assets may increase
 - Financial assets match with liabilities



What are vertical transactions?

- I'm from the government, I'm here to help you
- Jargon:
 - Banks have reserve accounts (RA) with RBA
 - Govt payments and receipts operate through RAs – these are the vertical transactions
 - RAs and physical cash are High Powered Money (HPM)
 - Sovereign states issue their own money and have a floating currency



Fiat Money

- Net Government transactions:
 - Buying goods and services
 - Collecting taxes and fees
- Neutral Government transactions
 - Borrowing – exchanges one government obligation for another

Net Government Financial Transactions

- Buying goods and services
 - Creation of HPM by increasing RAs by price of goods
- Collecting taxes and fees
 - Destruction of HPM by decreasing RAs by amount collected



Where does the HPM go?

- Nowhere!
- For accounting purposes you might have a Government account
 - This is purely for show, nothing exists in the account

Net financial assets

- When governments **spend** money they **create** net financial assets in the private sector
- When governments **collect** money they **destroy** net financial assets in the private sector
 - Government deficits create net financial assets
 - Government surpluses destroy net financial assets



Three corollaries

- Taxes aren't revenue raised for government consumption
- Money to pay taxes comes from government spending
- A string of government surpluses will exhaust private savings, eventually leading to higher private debt levels



How should we discuss budgets?

- Sovereign governments can always pay their bills by creation of HPM
 - Default is never necessary
- Governments don't have to finance spending
- The effect on the economy is real
- Is government spending consistent with economic activity?



Real activity

- Government spending uses real goods and services
- If these are fully utilised then more government spending will increase prices
- If underutilised then more government spending may not affect prices



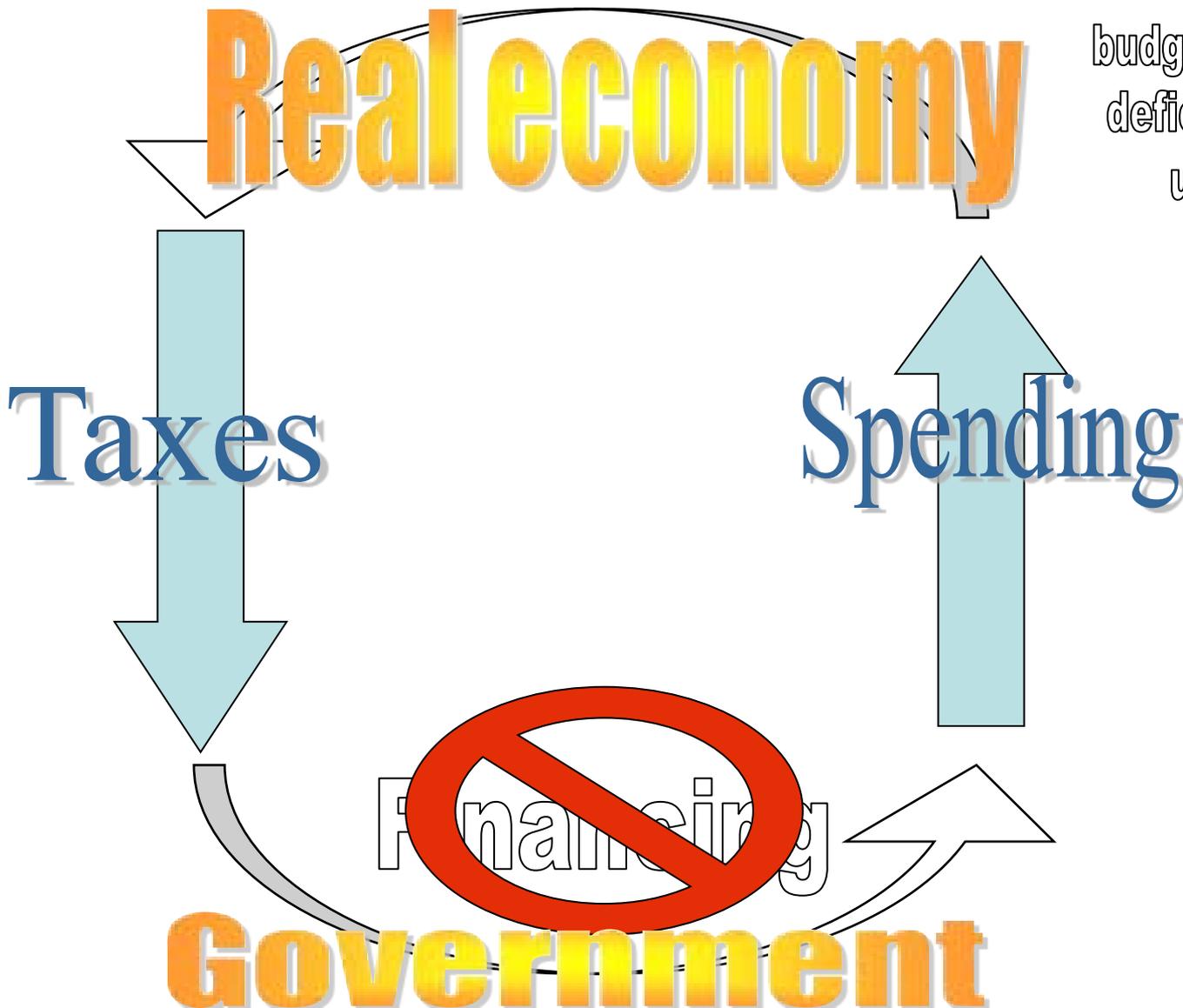
Too low economic activity

- Underutilised resources
- Possible Government action:
 - Increase spending
 - Reduce taxation, fees
 - Increase deficit
 - Create net financial assets



Too high economic activity

- Possible Government action:
 - Reduce spending
 - Increase taxation, fees
 - Reduction in deficit, maybe even run a surplus
 - A surplus may destroy net financial assets created during previous cycle



The debate on budget surplus or deficit should be up here ...

... not down here

Government borrowing

- Government surpluses increase RAs
- If Reserve Banks pay target interest rate on RAs then no great problem
- Government borrowing trades RA HPM for longer maturity asset
 - No decrease in net government liabilities
 - Equivalent to entering a fixed-for-floating interest rate swap with RB
 - Except for credit risk on fixed receiver



Corollary for Borrowing

- Sovereign governments don't have to borrow
- Government borrowing is a service to banks to help them with risk-free maturity profile structuring

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Relax

Take a deep breath



What's the point?

- Almost all arguments on government deficits are plain wrong
- They're usually based on gold standard thinking
- We've been off the gold standard for 40 years



What's the point? (ii)

- If we don't debate properly we'll reach very sub-optimal policies
- Individual and corporate actions may be driven by the wrong argument



Example

- Japan's position is in line with MMT
- High government deficit with underutilised resources means:
 - Low interest rates
 - Possible deflation
 - No problem with borrowing



Conclusion

- What is the risk to your firm of having the wrong understanding of money and credit?
- What is the risk to government policy of wrong understanding?
- How can we change the debate?