An Investor's Rough Guide To Modern Monetary Theory

Will Denyer
wdenyer@gavekal.com

By now you've probably heard a fair amount about Modern Monetary Theory, or MMT as its supporters and critics both call it. Even if you haven't been paying much attention, you have probably caught some of the buzz. You may have watched a video in which an MMT enthusiast—Bernie Sanders advisor Stephanie Kelton perhaps, or hedge funder Warren Mosler—appears to turn conventional economic wisdom on its head. And you've almost certainly come across an excoriating rebuttal from one of MMT's many opponents, who range from Nobel laureate Paul Krugman to Fed chief Jay Powell.

But in all probability, you aren't feeling very much wiser. Although there is plenty of heat on either side of the debate, there has been remarkably little light. The purpose of this paper, then, is neither to promote nor to criticize MMT, but simply to examine its precepts, explore whether it really does bring anything new to the table, and to outline some of the implications should it ever be applied as practical policy. In short: what is all the fuss about?

MMT rests on the insight that a sovereign's spending need not be limited to what it can tax or borrow...

At its core, MMT is the recognition that government spending is not constrained by how much the government can tax or borrow—at least not if the government has independent control of its own money-printing press and no obligation to maintain a fixed exchange rate, whether against gold or another fiat currency. In these terms, therefore, the US federal government is not constrained, but the governments of California, say, or Italy, are.

Print and spend

Where governments qualify, MMTers say policymakers can—and should—print and spend as much money as necessary to achieve their policy goals. This should involve the Keynesian manipulation of aggregate demand to achieve full employment and a targeted rate of inflation. But it could also include long term projects like public healthcare, a universal basic income and a "Green New Deal". In other words, MMTers subscribe to the socialist economist Abba Lerner's assertion—put forward in the 1940s under the banner of "functional finance"—that the government should use all its tools, and use them as much as necessary, to achieve its goals. If that means running large fiscal deficits or devaluing the country's currency, so be it.

...although, ultimately there may be a limit in terms of available resources

While they acknowledge no constraints on government spending in nominal terms, MMTers do recognize that there may be real constraints in terms of resources. Take labor, for example. The government can pay public employees as much as it wants (with no nominal limit). But it cannot employ more people than exist. And to the extent that government employment draws labor away from private sector jobs, there will be opportunity costs.

In practical policy terms, the conclusion is this: the government should print and spend as much money as it sees fit, and employ as many real resources as are available, and which the government thinks it can utilize better than the private sector, either on a temporary or on a permanent basis.

The distinction between money and wealth

When thinking about MMT, it is important to distinguish between money and wealth. What the government injects into the private sector through printing and deficit spending is money. It is not wealth, nor is it anything that might be construed as wealth, such as "savings". The intention here is not to discredit MMT, but to clarify an important distinction.

MMT proponents sometimes say that the only way for the private sector to save is for the government to spend more than it takes in. This is true if you define "saving" narrowly as the net accumulation of government money. Some MMTers are quite clear that this is exactly what they do mean. But others sometimes seem to suggest that the only way for the private sector to accumulate wealth is for the government to run deficits and inject new money into the economy. At least, this is how some commentators have interpreted their views. If the MMTers do believe this, they are wrong.

If I own US$5 and a railroad, then my wealth is US$5 and a railroad. It is not just US$5. The government can influence both the nominal and real value of wealth, for better or worse. But it is not the only source of wealth. If I spend a day making a tool—a chisel, say—that is valued by the market, then I have increased my wealth to US$5, a railroad and a chisel, without the government doing anything. The same applies to the country as a whole. Money is a useful economic good, valued by the market, and so part of the total wealth of both a person and country. But it is not all of it.

This brings up another quibble that can be raised about some MMT literature: exactly why money is an economic good. MMT proponents focus exclusively on money's use as a means for settling tax liabilities. They even go so far as to call the US dollar nothing more than a US tax credit (Mosler is especially fond of this characterization). It is certainly true that paying tax bills is one of money's key uses. And it is important to remember the government has a monopoly on the legal use of violence, which it can—and does—use to force people to pay taxes in the currency of its choosing. This makes it very hard for other potential forms of money to compete and to achieve widespread adoption (this is one of the main reasons to be skeptical about the potential of Bitcoin; see **Bitcoin: Money Or Bust**). But settling tax liabilities is by no means the only, nor even the primary, use of money. It also tends to be quite useful in private transactions.

If the government prints more money than the private sector wants, the private sector will ascribe a lower value to money

If the resulting amount of printing and deficit spending injects more money into the private sector than the private sector has demand for—for what Ludwig von Mises would have called "money balances" and what modern commentators might refer to as "working capital"—then the private sector will value each unit of this money less. The flipside of this coin is a rise in prices—inflation.

If the desired amount of printing and deficit spending causes a desired amount of inflation, perfect. If inflation is too low or negative, then MMTers say the government should print and spend even more. After all, while there is an obnoxious zero bound problem with stimulating nominal growth by manipulating interest rates, there is no such problem with using fiscal stimulus.

Is the US government really printing money when it spends?

Is it really true, as the MMTers insist, that the government conjures money out of thin air whenever it writes a check to pay for its spending? Ultimately yes, but it's complicated—perhaps by design. MMT literature sometimes suggests that when Congress decides to spend, the Treasury simply prints new money and injects it into the private sector. This is not technically how things work. But actually it may be a helpful way to think about today's monetary system, abstracting away a lot of the mechanical details. Again, the intention here is to clarify, not to discredit MMT.

For the nerds, what actually happens today is that Congress first decides how much to spend and tax. If the Treasury's account is bare and it needs to make a payment as instructed by Congress, then the government issues new treasury securities in order to borrow the money from the private sector. This temporarily reduces the money supply outside the Treasury's account, which is not counted as part of the economy by either MMTers or official money supply measures.

This is what MMTers mean when they say the Treasury simply "shreds" the money it receives when borrowing or taxing. In reality, the Treasury keeps the dollars in its account until it needs them to make another payment (seldom very long). When the government makes payments, it injects money back into the private sector. This is what the MMTers mean when they say the government injects new money whenever it spends (there is some debate about whether the Treasury's accounts should really be excluded from the money supply, but again, that's not one for today).

So far so good, but nowhere in this description of the process has the government actually printed any brand new money. The government temporarily pulled some existing money out of the private sector, and later returned it. As a result, the money supply was only reduced temporarily. It was very quickly brought back to its former level.

How does brand new money get created? The simplest way, under the current system, is for the Fed to buy up the debt securities that the Treasury just issued. Whether it does so directly, or via a few privileged members of the financial sector called primary dealers, is a minor detail (although not to the primary dealers). A more roundabout method involves commercial banks working in coordination with the Fed and Treasury to create money.

Details aside, MMT is correct that the government ultimately has the ability to create as much money as it wants, and that it can direct as much of that new money as it wants into government spending programs. It may do so by involving the banking system, but this is optional. In fact, some MMTers argue the main purpose of involving the banks is to make the whole print-and-spend operation (or the print-borrow-spend operation, which is effectively the same thing) so complex and confusing that the population doesn't understand what is going on right under its nose.

Others see it as a subsidy to the bankers; or part of an elaborate system of checks-and-balances designed by ideologues to restrain government spending. However, the MMTers argue that none of these reasons is justifiable. In their view, the government should print and spend freely, out in the open. If policymakers achieve good results they should be proud of their decisions; if it not they should change course.

If the desired amount of printing and spending causes inflation to get too high, the government can take some of the money back out of circulation, either by taxing, which withdraws the money for an indefinite period, or by borrowing, which is a temporary withdrawal of money that is eventually returned to the private sector plus interest.

Borrowing and tax are used to manage monetary policy, not to fund spending

MMT makes a big deal out of the fact that taxes and borrowing are potentially useful government tools for managing monetary policy and steering the redistribution of wealth. But they are not required to "finance" government spending in any traditional sense.

How much of a change really?

So, MMT restates some old ideas from Keynes and Lerner and offers an interesting way to think about how the existing US fiscal and monetary system operates. But if its proponents put it into practice, would it really represent such a big change? Outlined below are some of the key policy changes often advanced by leading MMT proponents. Each merits a full report in its own right, but for now some brief remarks will have to do.

MMTers believe spending is a better way to manage aggregate demand than manipulating interest rates

- **More Keynesian deficit spending.** The US government has long employed Keynesian deficit spending during periods of economic slack. This has taken the form both of "automatic stabilizers" such as unemployment checks, and *ad hoc* stimulus bills. MMTers would like the government to do more. They see such spending as a more effective way to stimulate aggregate demand than interest rate manipulation by the Fed, especially when interest rates hit the zero bound. In this respect, MMTers are no more or less dangerous than your average unabashed Keynesian.

- **The establishment of a "job guarantee" or "transition jobs" program.** MMT enthusiasts suggest that, instead of just sending out unemployment insurance checks, the government should offer "transition jobs" to the unemployed, effectively acting as the economy's employer of last resort. There would be several advantages to such a program. Since these transition jobs would be open to all people at all times, the pay they offer could substitute for the current regulatory minimum wage.

  In addition, one of the main reasons private employers are often reluctant to hire unemployed people is that they cannot call up candidates' current employers to check if they have been showing up to work every day, on time, clean, sober and ready to get on with the job. If the government offers transition jobs, it not only gets some output in return for the checks it would have written anyway to the unemployed, it also creates an employment track record for the otherwise out-of-work, making them more attractive to private employers.

MMT allows the government to act as the economy's employer of last resort

  For sure, all kinds of slippery slope arguments against transition jobs spring to mind. The program could easily swell way beyond its originally intended size and scope. Instead of simply employing idle labor, it could suck resources away from the private sector and drive up labor costs for businesses. But if these risks can be managed—a big "if"—there are attractive aspects to the idea which could help it become reality.

The government can also get a lot smarter about funding public healthcare

- **Smarter welfare spending.** Sanders and other democratic socialists want the government to provide public healthcare for all. Mosler and the MMTers suggest introducing vouchers as part of the scheme to reduce the overuse and overpaying problems inherent in third party payer programs. They propose giving each person US$5,000 in healthcare vouchers at the start of every year. Of these US$1,000 will be preventative healthcare vouchers, and US$4,000 general purpose healthcare vouchers. The exact amounts can be debated, but the idea is that the preventative vouchers are use-it-or-lose-it. They must be spent during the year, or they expire worthless. This feature should encourage spending on preventative healthcare such as screening.

  The general purpose vouchers are intended to cover basic services such as visits to the doctor. If a recipient does not use them all, the remainder are paid out at the end of the year in cash. The idea here is to discourage unnecessary use of the public healthcare system. And should a patient exhaust all his or her general purpose vouchers, "Medicare for all" kicks in to cover the additional spending. This is not the place to debate the merits of public versus private healthcare. But if the government is to adopt a public system, such a voucher scheme might well help to reduce overuse and overpaying.

In general MMT favors much higher public spending...

- **More public spending in general.** Most MMTers believe the government does not spend as much as it should in general. Their assumption is that this is because some policymakers and voters failed to get the memo that the US has dropped the gold standard and is not constrained by its ability to tax or borrow. They appear to disregard the notion that people might realize the government could spend more, but don't believe that it should. There are plenty of reasons to think that the government should practice restraint in spending: to avoid the inefficient allocation of resources, inflation, perverse incentives and the unfair redistribution of wealth, to name just a few. But these are concerns that the MMTers do not appear to share in any high degree.

...while some MMTers advocate an end to government bond issuance

- **No more government bond issuance.** This may come as a surprise. MMTers argue that the government should do as much deficit spending as it wants. But prominent proponents of the theory also maintain that the government has no need to "finance" its spending by issuing debt securities. They argue it might be better if the government stopped issuing bonds altogether, or limited itself only to issuing three-month T-bills.

  Why? MMT proponents offer conflicting views. Some MMT literature suggests the reason is to get the government out of the business of manipulating the shape of the yield curve by adding or subtracting demand for loanable funds at various maturities—as it currently does when it issues treasuries, pays off debt, or buys and sells treasury bonds via the central bank and its agents.

  But although free marketeers might think this a refreshing example of MMT proponents suggesting less, not more, manipulation of markets, free market enthusiast should not get too excited.

MMT proponents appear to favor full-scale financial repression...

Some MMTers, and maybe all, want to replace treasury securities with term deposits at the Fed. These would not just be the one-week term deposits that already exist, but a full panoply of terms from one-year, through five-years, to 10-years and so on. These long term deposits would be functionally similar to treasury bonds, but with one critical difference: the interest rates would be set by the government, not settled by the market (not even by a manipulated market, like the current treasury bond market). So the end result would be to give the government even more control over interest rates on government-guaranteed assets and over the yield curve in general. Add regulations forcing private savings into these accounts, and the government will be all set to exercise full-scale financial repression—by holding down real interest rates.

- **ZIRP forever.** MMTers say the Fed should not support short term interest rates. When the government prints and spends freely, it will drive interest rates down to zero. The Fed (and the government in general) should not soak up excess money in order to raise overnight rates above zero. Risk-free assets with little or no lock-up period should not pay any interest. If they did, it would be a subsidy to the financial sector, which should be stopped.

...to forward their desired public spending programs, while keeping inflation in check

This raises the question how the fractional reserve banking system would be discouraged from creating money hand over fist, potentially fueling high inflation. MMTers suggest that inflation can be kept in check using other tools, whether tax hikes, spending cuts, or bank regulation. The details of the MMTers' proposed agenda for banking system reform are somewhat obscure, but they appear to involve a sizable dose of interest-rate-setting and regulation aimed at suppressing real rates and directing money toward the government—or financial repression as it's generally known.

Conclusion

As MMT gains traction in Washington, the foreign exchange market may vote against the US dollar and in favor of alternatives

Modern Monetary Theory is—at the very least—a thought-provoking way to look at the current system in a new light. Some of the suggested reforms might be positive. But on the whole, MMT calls for Washington to print and spend more than it already does. It also calls for more, not less, downward manipulation of interest rates. There remains a great deal of uncertainty about how and to what extent these ideas will influence policy in the years to come. But as MMT gains increasing attention in Washington—which it undoubtedly is doing—the foreign exchange market may well respond to the heightened uncertainty by reducing its bid on the US dollar and US dollar assets, and increasing the bid on alternatives such as gold and the renminbi.