A Beginner's Guide to MMT

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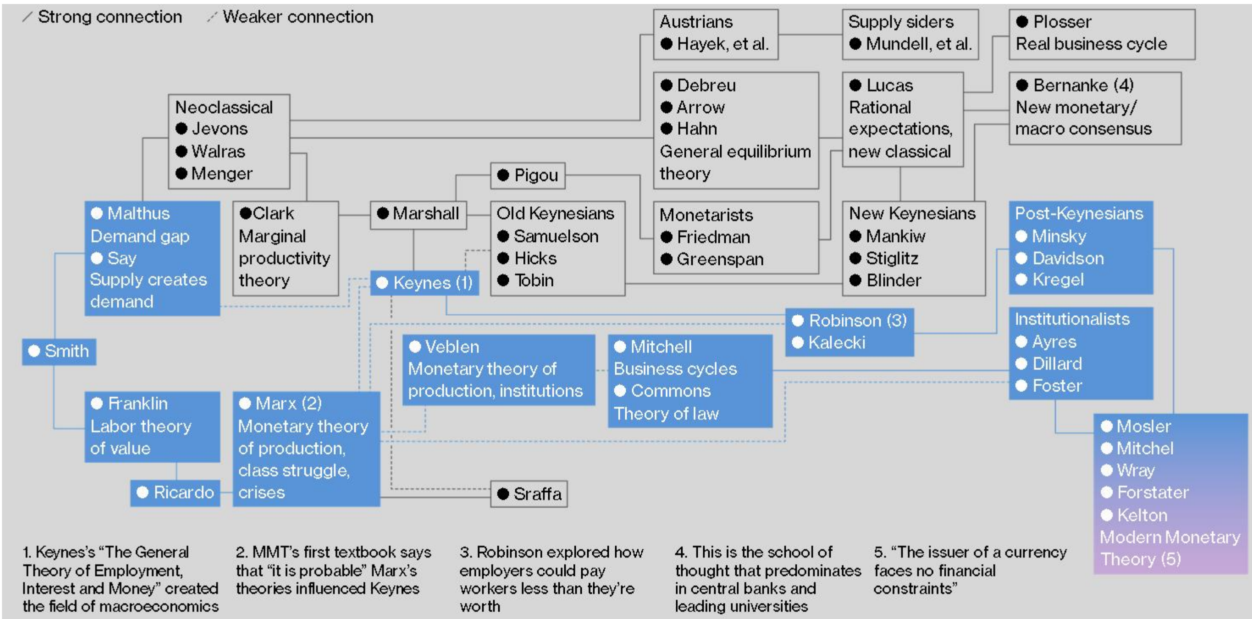
There's a lot of debate swirling around Modern Monetary Theory—some strident. Its critics call it a hot mess. "MMT has constructed such a bizarre, illogical, convoluted way of thinking about macro that it's almost impervious to attack," Bentley University economist Scott Sumner claimed recently on his blog. MMT's proponents say it's the critics who are impervious to reason—"part of a degenerative paradigm that has lost credibility," says Australian MMTer William Mitchell.

Stephanie Kelton is an MMT proponent who was an economic adviser on Bernie Sanders's 2016 presidential campaign.

This state of confusion isn't good because Modern Monetary Theory, once confined to blogs and a handful of colleges including the University of Missouri at Kansas City, suddenly matters. In the U.S., the left wing of the Democratic Party is citing MMT to make the case for massive federal government spending on a Green New Deal to wean the U.S. off fossil fuels and fund Medicare for All. It's virtually certain that MMT will be dragged into the debates of the 2020 presidential race. So the time is right for a semi-deep dive into Modern Monetary Theory—what it is, where it comes from, its pros and its cons.

Fortunately, the first academic textbook based on the theory was published in February. The 573-page tome, titled simply Macroeconomics, is by Mitchell, an economist at the University of Newcastle in Australia; Randall Wray of Bard College in Annandale-on-Hudson, N.Y.; and Martin Watts, an emeritus professor at Newcastle. This article is based on the textbook as well as academic papers and blogs by MMTers and their critics.

Modern Monetary Theory's Lineage



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A good place to start is with a simple description that you can carry in your pocket: MMT proposes that a country with its own currency, such as the U.S., doesn't have to worry about accumulating too much debt because it can always print more money to pay interest. So the only constraint on spending is inflation, which can break out if the public and private sectors spend too much at the same time. As long as there are enough workers and equipment to meet growing demand without igniting inflation, the government can spend what it needs to maintain employment and achieve goals such as halting climate change.

If you've absorbed that much, you're already ahead of a lot of the critics. Because MMT is associated with the Left, some people assume it favors soaking the rich to pay for social programs. In fact, MMT breaks with liberal orthodoxy by saying that while taxes on the wealthy are good for lessening inequality, they aren't essential to pay for government spending. Another misconception is that MMT says deficits never matter. On March 13 the University of Chicago Booth School of Business published a survey of prominent economists that misrepresented MMT that way, leaving out its understanding that too-big deficits can cause excessive inflation. The surveyed professors roundly disagreed with MMT as described. MMTers cried foul.

Modern Monetary Theory says the world still hasn't come to terms with the death of the gold standard in 1971, when President Richard Nixon declared that the dollar was no longer convertible into gold. In the modern era of "fiat" currency, MMT says, the U.S. and other big economies no longer need to worry about having enough gold to back their paper money, so they're free to print however much they need.

"I think we are being visited by a presence from Mars today"

MMT claims to be the legitimate heir to the theories of Britain's John Maynard Keynes, who created the field of macroeconomics during the Great Depression. Keynes coined the term "paradox of thrift." His insight was that while any single household can dig itself out of a hole by cutting spending when its income falls, the economy as a whole cannot. One household's spending is another's income, so if everybody cuts back, no one gets paid. What you get then is a depression—a situation only government can fix because, unlike the private sector, it can afford to spend freely, putting money in people's pockets and thus getting the economy back on track.

In MMT's reckoning, Keynesianism was gutted in the following decades by successors such as Paul Samuelson, who unrealistically tried to make economics like physics, playing down the role of fundamental uncertainty. MMTers haven't endeared themselves to the mainstream by referring to that school of thought as "bastard Keynesianism," a coinage of the late British economist Joan Robinson.

MMT also draws on the "functional finance" work of the Russian-born British economist Abba Lerner, who wrote in the 1940s that government should spend what's required to achieve its goals, deficits be damned. Later, Britain's Wynne Godley developed the concept of sectoral balances, which focuses on the accounting truth that when the government runs a deficit, the nongovernment sector must run a surplus, and vice versa.

Starting in the 1990s, the budding movement coalesced with the financial and intellectual support of Warren Mosler, a hedge fund manager who lives in the U.S. Virgin Islands and has interests ranging from politics to catamaran design. It ran into skepticism. When Mitchell presented the ideas at an economic conference, he recalls, the first comment was from a man who said, "I think we are being visited by a presence from Mars today."

MMT rejects the modern consensus that economies should be steered primarily by the raising and lowering of interest rates. MMTers believe that the natural rate of interest in a world of fiat money is zero and that pegging it higher is a giveaway to the investor class. They say tweaking interest rates is ineffectual because businesses make investment decisions based on prospects for growth, not the cost of money.

MMTers argue that economies should be guided by fiscal policy—government spending and taxation. They want a nation's central bank to do the bidding of its treasury. So when the treasury needs money, the central bank accommodates it with a keystroke—creating base money from thin air by crediting the treasury's checking account. The new textbook says that today, governments "tend to run unduly restrictive fiscal policy stances so as not to contradict the monetary policy stance."

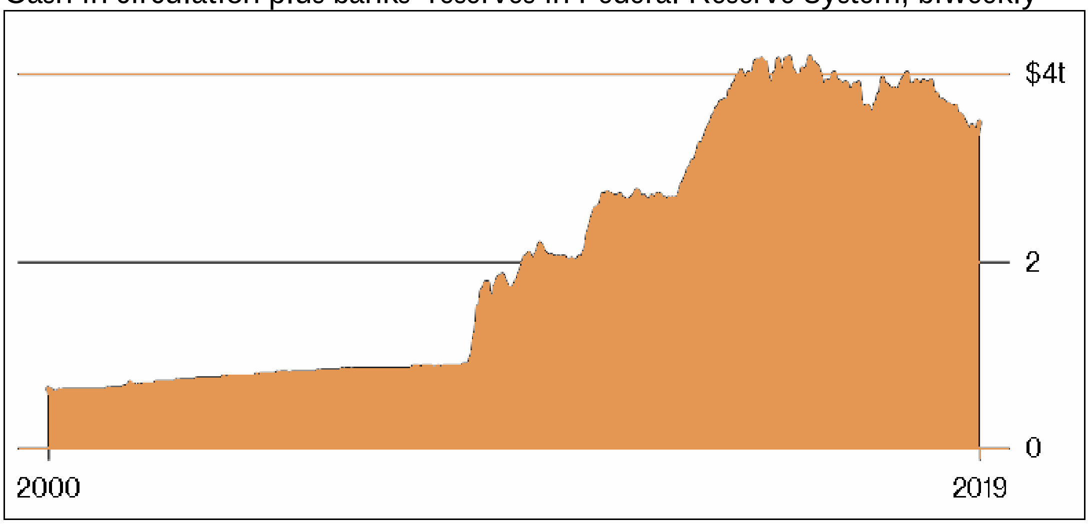
MMT says that, contrary to appearances, banks don't make loans out of deposits. Rather, they make loans based on the demand for borrowing, then the borrowers stash the proceeds in the bank. Anyone they write a check to simply makes a deposit in another bank. The bottom line is that loans create deposits rather than deposits creating loans. This is one aspect of MMT that even some conservative central bankers—including those at Germany's Bundesbank—agree with.

To stabilize employment, MMT would add a federally funded, locally administered job guarantee. Government would employ more people in slumps than in booms. Pavlina Tcherneva of Bard College's Levy Economics Institute is refining the plan. Representative Alexandria Ocasio-Cortez, the Democratic Socialist from the Bronx who's in her first term in Congress, supports the job guarantee and says MMT should be "a larger part of our conversation."

MMT challenges a core principle of conventional economics, which is that an increase in budget deficits will tend to raise interest rates, all else equal. Just the opposite, it says, sounding a bit like the White Queen from Alice in Wonderland. When the government spends more, the private sector gets the money and puts it in the banking system. With more money in the system and no increase in demand for it, interest rates will tend to fall, not rise, MMT says. That is, unless the government chooses to soak up reserves by selling bonds, which it doesn't have to do.

Big Pump

Cash in circulation plus banks' reserves in Federal Reserve System, biweekly



Data: Federal Reserve Bank of St. Louis

The reason the government doesn't need to sell treasury securities, or levy taxes, to spend money is that the central bank, under the control of the treasury, can pay for everything by conjuring up electronic money. In MMT's ideal world there would still be taxes, but their main purpose, aside from lessening inequality, would be as "offsets" to keep inflation under control. Taxes would drain just enough money from consumers and businesses so total spending in the economy won't be excessive.

It's tempting to view MMT's conception of fiscal policy as essentially similar to that of the mainstream—"Hey, they believe in taxes, too!"—but that's not quite right. MMTers hold that inflation isn't primarily the result of excessively strong growth. They blame much of it on businesses' excessive pricing power. So before trying to choke off growth to kill inflation, they would try to break up monopolies and stop banks from making too many loans. "The more actively we regulate big business for public purpose, the tighter the full employment we can achieve," three MMTers wrote in a letter to the Financial Times' Alphaville column that was published on March 1.

With that formula, it's no wonder that MMT has loud critics on Wall Street, where it's sometimes derided as Magic Money Tree. What's more surprising is how much flak the school of thought is taking from liberal economists who'd appear to be natural allies, such as Larry Summers, the former Treasury secretary and former Harvard president. Summers has been making the case that wealthy nations are suffering from "secular stagnation" and require permanently high levels of stimulative deficit spending by governments to keep them out of recession, which is similar to what MMT argues. Yet in a recent Washington Post op-ed, Summers called MMT "fallacious at multiple levels."

Summers and others may be worried that MMT will give a bad name to their more conventionally dovish views on deficits. "As long as they're out there claiming that standard macroeconomics is all wrong, I guess we need to respond," Paul Krugman, the Nobel laureate who is a professor at City University of New York Graduate Center, wrote on his New York Times blog.

MMT's critics argue that trying to use fiscal policy to steer the economy is a proven failure because Congress and the president rarely act quickly enough to respond to a downturn. And they say politicians can't be relied upon to impose pain on the public through higher taxes or lower spending to squelch rising inflation. MMTers respond that they also oppose fine-tuning and instead want to use automatic stabilizers—including the jobs guarantee—to keep the economy on track.

MMT's detractors are skeptical of the idea that the treasury and central bank should work in concert. The Federal Reserve did the Treasury Department's bidding during World War II, but that "overdraft" privilege was used spottily thereafter and permanently ended in 1981—precisely because economists warned that a subservient central bank would allow inflation to race out of control. They're also dubious of the jobs guarantee, arguing that if the government's wage for guaranteed jobs is too low it won't do much to help unemployed workers or the economy, while if it's too high it will undermine private employment. Tcherneva's plan calls for $15 an hour. MMT envisions that government-employed workers would move back into the private sector when the economy strengthened, but that means some government functions would no longer be performed. In an email, Wray said the cyclical fluctuations in government employment are manageable.

Critics of MMT reject its reassurance that a country with its own currency doesn't need to worry about deficits. After all, it's been proven that a nation that loses the confidence of the world's investors will see its currency plummet. As recently as 1976, the U.K. was forced to appeal to the International Monetary Fund to stabilize the value of sterling. Wray said the U.K.'s mistake was trying to peg its currency to the dollar and the crisis eased when it allowed the pound to float.

Other disagreements are harder for laypeople to parse. There are complicated arguments over how interest rates are determined and whether the government and private sectors compete for savings, for example. Mainstream economists argue that the correct parts of MMT aren't new and the new parts aren't correct. But MMTers point out that the establishment hasn't covered itself in glory in recent years—largely failing to foresee the global financial crisis a decade ago, for instance. Paul McCulley, the former chief economist of bond giant Pacific Investment Management Co., says that though he's "not a card-carrying MMTer," he believes it offers a "robust architecture for a fiat currency world."

In any case, the new textbook gives MMT a good slingshot. Samuelson, in the preface to the 1990 edition of his best-selling principles book, wrote, "I don't care who writes a nation's laws—or crafts its advanced treaties—if I can write its economics textbooks." Stephanie Kelton, an MMTer who was the economic adviser on Vermont Independent Senator Bernie Sanders's presidential campaign in 2016 and is a Bloomberg Opinion columnist, sees the tide turning. In presentations, the Stony Brook University economist likes to flash up a quote that says, essentially: First they ignore you, then they laugh at you, then they fight you. Then you win.