



Modern Monetary Theory and Policy

By Stan Veuger

January 2019

Proponents of so-called Modern Monetary Theory emphasize that governments can always avoid defaulting on existing obligations denominated in a currency they themselves create. In many instances, they extrapolate from this correct observation to sweeping claims about the proper size of government and the role of monetary and fiscal policy. To the extent that these claims go beyond those of mainstream monetary doves, policymakers would be unwise to rely on them.

Over the past few years, so-called Modern Monetary Theory (or Money) Theory (MMT) has attracted mainstream attention (e.g., Krugman 2011; Helm and Goldmark 2018) and support from a number of economists and observers, including perhaps most notably Stephanie Kelton of Stony Brook University, an adviser to Sen. Bernie Sanders' presidential campaign.

Renditions of MMT range from the panacean to the tautological, but certain common elements recur. The basic theoretical foundation of MMT is straightforward and undisputed: Governments that can create a given currency can always meet nominal obligations in that currency. No matter how great outstanding government debt is, the government can always create more currency through a keystroke instead of being forced into involuntary default (Wray 2010, 2012).

The centrality of this claim to MMT thinking manifests itself in two ways. First, MMT writing focuses significantly more on balance sheets and the mechanics of money creation than mainstream macroeconomics does, and there is effectively no focus on formal models of agents making (constrained) optimal choices based on their preferences. The goal of these extensive accounting exercises is not always entirely clear, beyond emphasizing that net debt in the world is always zero, a direct implication of accounting identities. This is where MMT writing comes closest to

the tautological. Second, there is little focus on topics such as long-term economic growth or dynamic optimization, perhaps because these topics do not lend themselves as well to discussions dominated by the inherently static tools of double-entry bookkeeping.

Where MMT moves beyond accounting identities is when it moves closer to prescriptive territory. It is here that MMT writing usually develops a split personality of sorts that largely reflects different concerns of audiences it seeks to address.

On the one hand, MMT writing radiates ambition. A common proposal is for a federal job guarantee that would entail the federal government's direct employment of millions of additional workers (Wray 2012), and many MMT supporters have also embraced Medicare for All proposals à la Sanders' plan. Both types of plans would involve significant new federal spending.

MMT supporters downplay the cost of such spending by pointing toward the impossibility of bankruptcy of a government that creates the currency in which such spending is done. Taxation is not a strict prerequisite for spending, they argue correctly, as government spending can exceed government revenue. It is the ability to impose taxes in the future, they say, that gives a fiat currency its value and that makes workers and firms willing to accept money in exchange

for goods and services. They then extrapolate from the fact that governments can meet existing obligations by creating more currency to the claim that governments can use newly created money to mobilize the resources required to implement extensive new social programs. It is through this extrapolation that MMT proponents manage to present their ideas as the panacea for our economic conundrums.

On the other hand, MMT proponents are usually less outspoken when it comes to the consequences of such spending and such programs as we move past the very short term. To be sure, they recognize that our resources are scarce. But they are not worried about the primary concern of mainstream macroeconomists when confronted with a plan to monetarize large amounts of social spending: rising inflation. Their response follows two separate tracks (Helm and Goldmark 2018).

First, much like mainstream monetary-policy doves, they argue that the US economy is nowhere near full capacity. Inflation is therefore not a concern. Second, recognizing that this is at best a temporarily valid response and at worst a misreading of the state of the macroeconomy, they reveal the second key feature of their macroeconomic policy framework: Instead of using fiscal policy to manage the government's real activities, they propose using it to manage the price level.¹ Were inflation to become a threat, taxation would be used to "remove" money from the economy and eliminate upward pressure on prices.

In effect, what MMT proponents argue for is a complete role reversal in the macroeconomic policy mix, with fiscal policy taking on the role of monetary policy in securing price stability. The political advantage of this switch is obvious: It front-loads the benefits of social spending while delaying its costs. This is politically convenient because it postpones both the full realization of aggregate costs and discussions of their zero-sum (or negative-sum) distributional implications.

In this sense, the proposal is not different from common policy practice: Governments at all levels

have taken on sizable unfunded liabilities, redistribution is often executed through regulation as opposed to spending and taxation, and the recent Tax Cuts and Jobs Act was significantly debt-financed. The unifying theme is always to reduce the salience of the costs involved while highlighting the benefits.

What sets the proposal apart from common practice is the political risk associated with implementing this role reversal in the policy mix. Under the new policy framework, maintaining price stability would become the task of the fiscal authority. This is currently the US Congress, where electoral pressures often make it difficult for policymakers not to choose short-term gains over avoiding long-term pain. It is for that reason that most developed economies have moved decisively toward a system of central-bank independence over the past few decades.

It is hard to imagine that elected officials would find it easier to maintain price stability through fiscal policy than they did when they directly implemented monetary policy. If anything, the direct distributional implications of fiscal-policy changes are both starker and more salient. Perhaps MMT proponents have a new institutional framework in mind as well, though that is far from clear (e.g., Tymoigne and Wray 2013). But the most obvious alternative—an independent fiscal-policy authority—is both less desirable and less feasible than an independent central bank precisely because of the political nature and distributional implications of tax policy changes.

In short, what MMT proponents have in mind is twofold: (1) increased social spending financed solely through the creation of new money, in which the hope is that inflation will not rise, and (2) if inflation does rise, tax increases to manage the price level. If successful, this second step would presumably lead to significant income redistribution, a key goal of most MMT proponents. If unsuccessful for the reasons discussed above, and to the exact extent that MMT is substantively different from dovish mainstream macroeconomics, hyperinflation becomes a real risk.

¹ There are occasional hints (e.g., Wray 2012, 259) that the wages set in a national job guarantee program would help stabilize prices, but it is not clear how and why this would work.

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