“It’s the Economy’s Real Resources, Stupid”: A Brief Inquiry into Modern Monetary Theory

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I. Introduction

Modern Monetary Theory (MMT) picks up with our course’s recent direction of studying monetary and fiscal policy jointly. The generally-accepted distinction between these two policy levers is that monetary policy is concerned with inflation and output stabilization, while fiscal policy is concerned with the impacts of changes in spending and taxes. MMT breaks from the idea that taxes and bonds finance government spending. This zero-sum notion is central to our established understandings and policy actions. MMT provides an alternative or “heterodox” descriptive synthesis of the macroeconomy, and then effectively throws the ball into what we would currently consider FP’s court with policy recommendations, reenvisioning the role of our monetary policy tools. First, I will attempt to capture the main points of Modern Monetary Theory, highlighting contrasts to mainstream macroeconomic theories. I will conclude with a couple critiques of MMT which I find salient and highlight areas for further research and consideration.

II. Overview

The crux of Modern Monetary Theory (MMT) is the concept of *monetary sovereignty*: the ability of a nation to issue its own nonconvertible (fiat) currency and borrow only in that currency. Monetary sovereignty is what undergirds MMT’s rebuttal of the typical “household” model of budgeting. Mainstream theorists and policymakers understand the government as a currency-user which must collect money in the form of taxation or debt issuance (selling bonds) *in advance* of a purchase. MMT contrasts this view by framing the government as the sole currency issuer, which may theoretically produce as much money as it desires to fund policies. When understood as a fiat-currency monopolist, the government is the origin of all currency, which it functionally "spends into existence" *prior* to any tax collection or bond sales. Hence, government spending is bound not by what money it can collect back from taxes or debt sales to finance policies, but rather by the limits of the economy's real resources. We can consider fiscal policy (spending or taxation) as the government controlling the money supply.

"So the government can just rack up infinite debt as long as its deficits aren't inflationary? What about debt default?" This is a really important question and MMT's answer opens up a whole new set of possibilities for the monetarilysovereign nation.

The U.S. arm of monetary policy, the Federal Reserve, issues bank reserves that are functionally interest-bearing dollar-denominated liabilities. The US Treasury conducts fiscal policy with the issue of treasury bills and bonds, also dollardenominated. It's important that most forms of government debt are denominated in dollars. Nominal debt is only a promise to a certain number of dollars in the future. The "real liability" (what dollars can buy) depends on price level. From a mainstream macro perspective, we can say that the fiscal authority controls the backing that gives liabilities value, which essentially means that the the credibility of the government being good on its promised payments is contingent on fiscal (taxation/spending) decisions, namely the ability of the government to turn a primary budget surplus at some point. Conventional understanding would suggest that fiscal policy basically ought to ensure government debt is "risk-free", meaning that that government debt does not grow to a point where those who would hold it (private entities and foreign entities) begin to doubt the government will make good on its promises to pay it off. However, a government that issues debt denominated in its own currency is in a different situation than from that of a private borrower whose ability to pay off debt actually could have a limit. For the government, debt is a promise only to deliver "*more of its own liabilities"* (Woodford, 2000 per Tcherneva, original emphasis) in the form of dollars (functionally like liabilities which don't pay interest). The end result of this statement is that any monetary sovereign cannot default on its debt because it can always monetize it. "There is thus no doubt about the government's technical ability to deliver what it has promised" (ibid), so there is not any hard limit to the amount of debt a government can take on.

If the government has no total borrowing limit, what constraints do exist? Remember, the government isn't "collecting back" money from taxes or bond issuance in order to spend; any government spending can be paid for with the creation of money. How do we determine the appropriate level of spending? Per Deborah D'Souza's synthesis of MMT, "spending shouldn't be determined by deficit levels, but by whether or not spending is keeping the economy at full employment and at a reasonable level of inflation" (Investopedia, 2020) - sounds a lot like the dual mandate.

Inflation is what manifests when spending surpasses the economy's real resource capacity. Specifically, we run into what is often termed "demand-pull inflation" in Keynesian theory. Real resources become increasingly scarce as an economy moves closer to its full employment limit. It becomes harder for businesses to increase their supply in response to more spending. Aggregate demand for goods and services is rising more rapidly than the economy's productive capacity can accommodate. When the economy hits 100% full employment, *any* additional spending is inflationary. Hence, a Modern Monetarist definition of "overspending" has no relationship to a budgetary deficit and may even occur during a state of budget balance, or even surplus. It's related only to inflation, which itself is a function of the strain on an economy's real productive capacity.

The dangers of inflation are familiar. Inflation is a continuous rise in the price level. If prices begin to rise faster than most people's incomes, this constitutes a loss of purchasing power and this can lead to a decline in the real standard of living of a populus. MMT's theory of inflation doesn't conflict with the typical economist distinction between "cost-push" and "demand-pull" types of inflation and understanding the different forms of inflationary phenomena helps to clarify MMT's inflation-control policy approaches. From James R. Barth and James T. Bennett's "Cost-push-versus Demand-pull Inflation: Some Empirical Evidence"(1975):

> "... cost-push advocates assert that the source of rising prices is not excess demand but rather market power that permits either wages to be raised by strong labor unions, which results in price increases as wage costs are passed on to the consumer, or prices to be increased directly by oligopolistic firms ...
>
> demand-pull adherents assert that the cause of inflation is an increase in money demand or too much money chasing too few goods"

Current monetary policy seeks to control inflation (all types) by manipulating the short-term nominal interest rate, effectively influencing the price of credit and thus indirectly regulating the amount of money that consumers and businesses may spend into the economy. The Federal Reserve is tasked with the pursuit of maximum employment and stable prices, but it is unable to spend money into or tax money out of the economy.

Current monetary policy is predicated on acceptance of a certain "natural rate" unemployment. From Keynesian theory, we can see that expanding the money supply would trigger more spending and thus lower unemployment as businesses would need to hire more workers to accommodate higher demand. But, as Milton Friedman theorized, below a certain level of unemployment, any attempt to increase the money supply would cause inflation to rise faster than paychecks. The dual mandate was designed to prevent desire for minimal unemployment from causing the Fed to increase the money supply too rapidly or ad infinitum, leading to skyrocketing price levels. It's a significant problem that the natural unemployment rate is only calculable retrospectively, once we see that inflation is accelerating with any further decline in unemployment. In practice, the Fed observes the labor market for evidence of wage acceleration (considered a prelude to higher inflation) and tightens interest rates before the inflation can occur.

Modern Monetary theorists see multiple ways of reducing inflationary pressures in the economy. Basically, while the Taylor rule guides current monetary policy to adjust the interest rate in order to manage the macroeconomy, MMT instead favors a "functional finance" (Lerner, 1943) approach. In response to demand-pull inflation, MMT states that the government may deploy targeted tax increases in order to repress demand. Basically, just as the Taylor rule says to adjust the interest rate to manage the macroeconomy; functional finance says to manage the budget position to do this. Economist Stephanie Kelton puts it like this:

> If the government wants to boost spending on health care and education, it *may* need to remove some spending power from the rest of us to prevent its own more generous outlays from pushing up prices. One way to do this is by coordinating higher government spending with higher taxes so that the rest of us are forced to cut back … in order to create room for government spending. That can help manage inflationary pressures by balancing the strain on our economy's real resources.

Kelton also frames taxes as a useful policy tool for other reasons: Taxes enable a government to continually provision itself with real things (roads, bridges, hospitals, military, court system, etc.) without exercising explicit force over people. Imposition of a tax motivates people to spend some of their time working in order to acquire the currency in which the tax is denominated. As just said, MMTers see taxation as a way to manage inflation by reducing the amount of money that people have to circulate through the economy. Taxation is also a way the government can alter the distribution of wealth and income. Furthermore, taxation is also still a way to internalize externalities by encouraging or discouraging certain behaviors. For all these reasons, even if the government has the ability to "print money", if you will, in order to finance any expenditures, the government still has reasons to tax people.

MMTers acknowledge that "there are a range of sources of inflation that aren't caused by the general state of demand and aren't best regulated by aggregate demand policies" (Financial Times, 2019). This is where the targeted taxation mentioned above would fail, but the existence of some automatic fiscal stabilizer - namely, the MMT Jobs Guarantee proposal - could still help manage inflationary risk.

The economy's real resources (labor, capital, etc) are fully utilized only when the economy hits full employment. Hence, MMT also contests the very notion of a natural level of unemployment. Per Kelton, "Because they accept the concept of an inherent tradeoff between inflation and unemployment, the Fed is forced to think in terms of how much unemployment to keep in the system as a sort of insurance policy against inflation"(p.54). Modern Monetary Theory rejects the use of a "buffer stock" of unemployment and instead proposes a sweeping fiscal policy action in the form of a federal jobs guarantee. Per economist Bill Mitchell, "Under a Job Guarantee, the inflation anchor is provided in the form of a fixed wage (price) employment guarantee"(2010). MMT frames a job guarantee as a nondiscretionary automatic fiscal stabilizer, which promotes both full employment and price stability, by creating more jobs as people need them, but not continuing to spend greater amounts once the economy reaches full employment. Per Mitchell, again, "However, if the government is buying a resource with zero market bid (the Job Guarantee workers) and moving resources from the inflating sectors to the fixed price sector then inflation control is possible – no matter the origin"(ibid).

"What about the bond market? So far, MMT sounds like a set of fiscal policy recommendations." As far as I understand, this is a valid take. If the government

can manufacture its own currency, it seemingly wouldn't need to borrow it back. Government borrowing is the issuing of bonds. Kelton's explanation is that the government indeed doesn't need to borrow; it sells bonds to support interest rates. Issuance of bonds is another way of offsetting inflationary pressures from government spending, rather than a way to finance spending. MMT economist Pavlina Tcherneva writes,

> Any sale or purchase of securities is done only to provide an interestbearing alternative to non-interest bearing reserve accounts. These are transactions that *support the overnight interest rate and do not finance government spending*. The government, consolidating the Treasury and Federal Reserve, has unlimited dollars at its disposal (2002, Original emphasis).

MMT essentially says the government sells bonds in order to hit its overnight interest rate target. In the United States, the Federal Reserve influences the overnight rate through open-market operations, resulting in a rigidly fixed overnight rate and then the longer-term rates reflect market sentiment about the expected future path of the short-term policy rate. The typical notion is that in turn, the overnight rate affects the level of inflation. MMT considers the existence of bonds, which MMT progenitor Warren Mosler calls "savings accounts at the Fed" (quoted by Kelton, 2020), a policy choice, rather than something the government is required to do.

Indeed, many MMTers contest that the current policy regime's assumption that lower interest rates lead to higher demand is questionable because demand forces can be insensitive to interest rate changes. In essence, they don't believe that interest rate policy is particularly effective at allowing the central bank to "steer" the economy. Hence, some MMT economists propose the "abolition" of the bond market - in other words, the government would stop issuing bonds and let the overnight rate just be 0%. The implementation of this is rather fuzzy and not even a consensus among MMTers; for instance, Kelton doesn't support the so-called "retiring" of government bonds.

III. Critiques of MMT

As many economists note, these MMT ideas I've attempted to capture are not actually that "modern" or new; it's the rhetorical synthesis of these things and the policy recommendations that are more novel. For instance, the monetary sovereignty concept is grounded in a theory called Chartism (Mitchell-Innes, 1914) or "endogenous money theory" and doesn't inherently run counter to mainstream monetary theory.

Paul Krugman has written multiple critiques of MMT, one of which where he essentially claims that MMT is comparable to trying to "extract too much from seigniorage". Alberto Bisin picks up this critique in his December 2020 JEL review of Stephanie Kelton's book. He writes

> It is correct that the government is not a household because it has monopoly of the currency. Not only is this argument correct, but it also has important consequences: it takes us directly to seigniorage and it might take the more sophisticated among us to the fiscal theory of the price level. It does not break, however, the conclusion that "the government must tax more to spend more" (p. 20), unless we play with the word tax, excluding seigniorage from the realm of taxes.

I also think Bisin's critique that while any monetary sovereign can always monetize its debt, "this does not imply that the consequences of monetizing the debt, in real terms for bondholders, are much different from those of a literally defaulted-upon debt"(Bisin, 2020) is valid and merits further consideration. Krugman also takes issue with the fiscal/monetary blending of MMT. He writes of one of Kelton's arguments "It seems as if she's saying that deficits necessarily lead to an increase in the monetary base, that expansionary fiscal policy is automatically expansionary monetary policy". Truly, I can't really figure it out either. I have to continue reading carefully.

IV. Conclusion

Just as the Fed currently faces a dual mandate of stable prices and "full" employment, MMT conceives of a hybrid monetary-fiscal policymaking apparatus which is equipped to monitor/control demand-pull inflation by increasing taxation(functionally the same as manipulating money supply), and figuring out how to target that taxation so it actually succeeds in reducing the amount of money being spent in the economy. For example, unilaterally taxtargeting the most wealthy might not succeed at quelling inflationary pressures, because they're not actively spending the vast majority of their money, so there would need to be a mobilization of economists to determine these things.

Additionally, MMT seems to suggest that rather than the government budget constraint which we modeled in class is more of an ideological constraint and that the "real" constraint would be an inflation constraint. I cannot yet parse the the quantitative work related to establishing these models, but from what I gather it's a common critique among macroeconomists that Modern Monetary Theory is currently more an amalgamation of descriptive theory and policy recommendations than a robust empirical framework, pointing to a need for more quantitative work. Pavlina Tcherneva is one MMT economist who is doing this work and I would point to both her paper "Monopoly Money: The State as a Price Setter"(2002) as a starting point and also perhaps the criticism of that paper written by Noah Smith entitled "Examining an MMT Model in Detail"(2019).

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