The "modern theory of money" – is it useful?

by Xavier Ragot

A heated debate is currently taking place in macroeconomics. The change in US economic policy following the election of Joe Biden has sparked debate over what to expect from "Bidenomics". The debate has seen radical Keynesian proposals being promoted by the "modern theory of money" (MMT). This movement advocates massive stimulus packages and the monetization of public debt. This post discusses the MMT proposals through a review of two recent books that have recently appeared in French: **Stephanie Kelton, *The deficit myth* (**John Murray, 2020**)** and **Pavlina Tcherneva, The case for a job guarantee** (Polity, 2020).

Before criticizing MMT, we should briefly summarize its proposals: the first key idea is the promotion of monetary policy in the service of fiscal policy. MMT supports the systematic purchase of public debt by central banks, the so-called *fiscal dominance* of monetary policy, in order to allow for an increase in public spending. For economists, fiscal dominance is opposed to *monetary dominance*, which defends the idea that the primary role of monetary policy should be to control inflation and leave the financing of public expenditure and debt to taxation.

The second proposal is the promotion of the state as the employer of last resort. The state should be in charge of providing jobs that are useful to the public to all unemployed people, i.e. a public employment service to avoid falling into poverty.

The rather benign criticism of the modern theory of money offered here can be summarized as follows: it is difficult to see anything really new. MMT is not really a theory of money, nor is it modern, though it does stimulate debate!

Should public debts be financed by money?

First of all, let's not deny ourselves the pleasure of acknowledging that Stephanie Kelton's book is a good mainstream economics book, and a lively and controversial introduction to macroeconomics. The book is of course not perfect, but prior to any criticism, let's first note that it is a pleasure to read. Stephanie Kelton's thesis is that money creation is carried out on behalf of states, for countries such as the United States or Great Britain that do not belong to monetary unions. In these countries, the state can ask the central bank to buy up as much public debt as it wants by creating money: it is the state that sets the statutes of its national central bank.
This monetary sovereignty allows the state to finance policies, with the only

constraint being inflation. For MMT, monetary policy should serve fiscal policy, which should manage inflationary risks by stabilizing aggregate demand. This approach is interesting because it evokes certain economic truths, or simply accounting truths. Let’s consider a couple of these before offering some criticism.

The first is that public debt is held by someone: a state’s debt is someone else’s wealth. Consequently, it makes no sense to write that “we” are indebted because the state is indebted. On the contrary, we are enriched by the public debt we hold on the state. The impact on our wealth depends not on the debt itself, but on how the financing of the debt interest is distributed. This way of thinking leads to restoring the accounts of agents. When the state issues debt, other actors hold it, and will receive the interest on the debt and the eventual repayment of the principal. Public debt therefore contributes to the formation of other actors’ wealth.

The value of Stephanie Kelton’s book is that it presents these accounting relationships in a lively and polemical manner, directly attacking politicians in the US who do not understand these macroeconomic realities. Indeed, it should not be assumed that there is a broad understanding of these macroeconomic features. In France, there are still people who believe that the public debt represents “indebtedness to future generations", which makes little sense, as has been discussed [elsewhere](). Stephanie Kelton's fight on behalf of macroeconomics is therefore salutary, and much remains to be done.

The second accounting truth is more interesting for the public debate. In our economies, central banks belong to states that have a monopoly on issuing central bank money, such as the banknotes, coins and currency held by banks. By force of law, this money cannot be withheld from transactions. The existence of cryptocurrencies will not significantly challenge this monopoly in the near future. Furthermore, we can expect a vigorous response from the states aimed at ensuring their central bank's control over the issuance of money. This public monopoly holds in the euro area as well, even though the European Central Bank "belongs" to different states. However, overall money creation is for the benefit of the states. So how does a macroeconomist think about all this? At an abstract level, the state can finance itself either by issuing public debt or by issuing money. The latter possibility is called "seigniorage" in the economic literature, because it stems from the monetary sovereign's monopoly on issuance. This general view is taken for granted in monetary economics. For example, the standard textbook on monetary economics devotes an entire chapter to it (see chapter 4 in Carl Walsh, *Monetary Theory and Policy*, MIT Press). The fact that government debt is held by non-residents does not change the logic, as they are paid in the national currency. As long as inflation is low and not very volatile (and that is the point!), the national currency is accepted in the exchange. The problem with monetary financing is that it can create destabilizing effects and generate inflation, which reduces household purchasing power, with complex effects on inequality. Predictable inflation is nowadays said to be a public good, because it allows people to avoid unpredictable fluctuations in their income.

So there are really no new theories in MMT. In my opinion, the importance of this “theory” is rather different, and does not involve convincing the macroeconomist or the monetary theorist. The point is to promote an alternative economic policy, stimulating activity through higher public debt and the eventual monetization of public debt, while accepting a higher inflationary risk. The book defends the historic post-WW2 economic orientation, so-called traditional Keynesian policy, which involved drawing on fiscal tools to achieve full employment, even if this leads to moderate inflation. In doing this Stephanie Kelton rehabilitates Abba Lerner who, from the 1940s onwards, promoted policies that would later be described as Keynesian, and which he called *functional finance*. Abba Lerner emphasized that his contribution was to show the coherence of Keynesian thought: the aim of economic policy is full employment, the means are public debt and money creation, and, because of the possibility of issuing money, the risk is inflation and not the unsustainability of public debts. In 1943, he presented his conception in fourteen pages written in a very accessible form. The history of inflation in the 1970s showed that the use of these policies to revive economies with production constraints (linked to oil at the time) could lead to high and volatile inflation. Clearly identifying a demand shock is necessary to control inflation.

Again, there is nothing radically new here in the United States, where the central bank's mandate is to ensure low inflation and maximum employment. It is in the euro area that this statement implies a profound change, as the ECB's sole mandate is price stability, not economic activity. Making changes to the ECB's mandate is an old topic that is mentioned in passing, and dealt with at greater length here in the wake of the 2008 financial crisis.

Let us turn now to a critique of the book. The limit on debt monetization or monetary financing of public expenditure is inflation, as the author reminds us. However, nothing precise is said about the link between economic policy and inflation. Yet this link is essential to properly calibrate the amount and the format of the stimulus package in the US, and which we need to develop in Europe. The ECB holds around 23% of France’s public debt. How far can we go? What are the economic and social costs of higher inflation? How can we ensure that inflation expectations do not rise dangerously?

This subject has been studied extensively from various angles: the relationship between economic activity and inflation, the famous Phillips curve, for example, covered in a recent article here. The relationship between the quantity of money and inflation has also been analysed extensively, for example here. To understand the effects of inflation, it is necessary to study in detail who holds money and why, which we do here.

The work of Stephanie Kelton and the MMT economists carefully avoids citing the work of other approaches in order to foster the appearance of a new school of economic thought. At this point, however, that is not the case. Stephanie Kelton’s book is a good introduction for those who want to learn about the macroeconomic policy debate through topical issues from a polemical angle. But MMT has to be criticized for its relative macroeconomic naivety and empirical weakness.

The second revendication of the MMT authors is the promotion of a job guarantee for all employees. This second aspect is independent of the macroeconomic management of aggregate demand and the financing of the public deficit. It concerns the residual part of underemployment that exists in the business cycle. The proposal set forth by Pvalina Tcherneva is simple: it consists of proposing an additional tool, an offer of public jobs paid at least at the minimum wage (which Pvalina Tcherneva wants to increase to $15 for the United States). These jobs would not be compulsory, but would constitute a universal right for the whole population. They would be linked to training, accreditations and apprenticeships, with the goal being that when those employed in these jobs leave they should be suited to find a job in the private sector. According to the author, these jobs are not intended to compete either with public employment with identified objectives or with private employment, which responds to a solvent demand.

The French reader will find these jobs familiar: they could be subsidized jobs in the non-market sector, which we know can boost the returns on employment, when the qualification achieved is effective, as is shown in evaluations. The proposal is to make the number of such jobs endogenous through the demand of workers over the cycle. While a deep-going reform of the training and apprenticeship system is necessary, the proposal of a counter-cyclical use of this type of job is interesting and already in partial use.

Paradoxically, perhaps, the interest is in thinking not an opposition to the market economy, but a policy of stabilization, which gives rise to radical criticism of MMT! The cyclical employment deficit is compensated for either by vigorous and potentially inflationary management of aggregate demand or by a policy of generating public jobs. These Keynesian policies are developed within the so-called post-Keynesian approach, which is one of 50 shades of Keynesianism (neo-Keynesian, historical Keynesian, post-Keynesian, circuitist, etc.).

MMT, post-Keynesianism, and Joe Biden's new economic policy

We are witnessing a profound change in US economic policy with plans for investment stimulus packages, higher taxes on corporations and wealthier households, and a plan to increase the federal minimum wage, all with an accommodating central bank that seems to have little concern about short-term inflationary pressures. These developments are in line with the MMT recommendations (without taking up all the recommendations). One legitimate question is to identify the role of this school of thought in these developments. This can only be answered imperfectly, as the mysteries of economic policy are so obscure, sometimes for the decision-makers themselves.
The MMT proposals were first taken up by Bernie Sanders, who leads the left wing of the Democratic Party and whose economic adviser for the 2016 campaign was Stephanie Kelton. As a result, the proposals have become

part of the
American economic debate.

However, one can trace a completely different
intellectual genealogy of the change in US economic policy,
from either the
neo-Keynesian or Keynesian stream, and this seems to me to be
more realistic.
The work of Paul Krugman on the liquidity trap in Japan, of
Lawrence Summers on secular stagnation, and of Olivier
Blanchard on the role of multipliers (among many others) have
for several years now led to developments within the IMF and
the OECD in a much
more Keynesian direction. These developments are independent
of MMT, which
presents fewer empirical proposals than some of the work cited
here. Thus,
Biden's economic turn seems to me to be much more imbued with
the pragmatic
experience of the real world than with a new "alternative"
body of theory. What
is described as pragmatism is in fact above all an empirical
approach to
economic mechanisms, in a context of low interest rates that
give states a new capacity for debt.

European lessons?

To conclude, what are the lessons for Europe of MMT
(and the Keynesian turn in US policy)? The expansionary use of
fiscal policy
and the monetary financing of public deficits can of course
take place only at
the level of the euro area, as it is the central banks of the
Eurosystem that
have the monopoly on issuing money. The problem therefore is
not so much
economic as political. The different economic situations in

the euro area are giving rise to different requirements for a recovery. Germany’s economy is stimulated by strong external demand due to a favourable internal exchange rate. Germany’s public debt is expected to be around 65% in the coming quarters. The Italian economy is experiencing weak growth and a public debt of 160%. More than any theoretical debate, it is this economic and political divergence that is paralysing Europe. The judicious use of European recovery packages can bring about re-convergence and job creation, but that is another matter.