SUERF
THE EUROPEAN MONEY AND FINANCE FORUM

SUERF Policy Note
Issue No 67, April 2019

What is „Modern Money Theory“ (MMT)?

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JEL-codes: E02, E42, E50, E58.

Keywords: Money, Monetary theory, Legitimacy, Governance, Monetary financing.

In the US, the views of a school of economic thought known as „modern money theory“ (MMT) have received considerable attention in recent economic policy debates. The core message of MMT is to stress room of manoeuvre for economic policy resulting from monetary financing of government deficit spending. It has contributed to a debate about the roles, potential and relationship among the state, the central bank and the private sector in the economic system. While MMT's claim that it offers a mere description of how money works is misleading, its main contribution is to direct attention towards often neglected monetary implementation issues and their connection to economic policy priorities.

In the US, the views of a school of economic thought known as „modern money theory“ (MMT) have received considerable attention in recent economic policy debates. The core message of MMT is to stress room of manoeuvre for economic policy resulting from monetary financing of government deficit spending. It has contributed to a debate about the roles, potential and relationship among the state, the central bank and the private sector in the economic system. Prominent economists like Krugman[1], Rogoff[2], Summers[3] and Powell (Fed)[4] have publicly taken a

[1] https://www.nytimes.com/2019/02/25/opinion/running-on-mmt-wonkish.html

[2] https://www.project-syndicate.org/commentary/federal-reserve-modern-monetary-theory-dangers-by-kenneth-rogoff-2019-03/german

[3] https://www.bloomberg.com/news/articles/2019-03-05/summers-slams-mmt-as-fallacious-as-economics-battle-heats-up

[4] https://www.bloomberg.com/news/articles/2019-02-26/jay-powell-is-no-fan-of-mmt-says-the-concept-is-just-wrong

critical stance with regard to the theory. Recently, European media have started to pick up the debate.[5]

MMT criticises a number of widely held economic policy assumptions:

- Money must be held scarce by the central bank, inter alia by denying public sector access to central bank financing, to prevent inflation.
- The public sector is financed by taxes and government debt. Government indebtedness has to be kept moderate to avoid a funding crisis on government debt markets. The function of markets for government debt is to impose discipline on economic policy.
- Government expenditure for goals like full employment is subject to these constraints.

MMT criticises that these assumptions neglect the following key aspects of the actual working of the monetary system:

First, in countries like the US, new money is created by the central bank in exchange against government securities.

Second, if government expenditure leads to increased economic activity in a situation of underemployment, growth of the money supply can be accompanied by new economic activity without inflation.

New interpretation of current institutional mechanisms

MMT draws quite far reaching conclusions from these observations:

In the view of MMT, because government enforces payment of taxes in national currency, governments have an unshakeable domestic monopoly on money that allows the unlimited use of national currency as a policy instrument (Wray 2011, 8).

According to MMT, if markets lose trust in government debt sustainability or dictate unacceptable conditions for government finance, the central bank can step in and grant finance to government on a permanent basis without problems by buying new government debt.

The fact that central banks issue money backed by government debt, and that central banks are subject to a public mandate is perceived by MMT as an argument that government and central banks can be considered as a single consolidated entity in terms of institutional mission and balance sheet (Tymoigne and Wray 2013, 27). Central bank independence, rules prohibiting direct government financing, and the separation of government and central bank balance sheets are regarded by MMT as superfluous and misleading.

Because new money is issued against government securities on a regular basis in countries like the US, MMT views public deficits as indispensable for money even entering the private sector. Government deficits are therefore perceived as money creation, and taxation as absorption (destruction, withdrawal) of money (Bell 2001, Wray 2012, 52). This implies a reversal of the traditional perspective, according to which governments have to raise money through taxation and debt before they spend.

Correct observations…

MMT draws attention to institutional details of the monetary framework and monetary policy implementation that are neglected in both folk theories of money and many macroeconononomic models. Whereas many people (including economists) associate money creation with Santa Claus throwing cash from a helicopter on an economy trading around a fixed supply of resources, MMT proposes to take a closer look at actual operating procedures.

Beyond money being an object, there is an issuer behind contemporary money that gives guarantees with regard to its value. Central bank money creation is a balance sheet operation, where the central bank swaps liabilities with counterparties in the financial sector. Government securities are the regular asset class backing central bank monetary liabilities in countries like the US and UK. In the euro area‘s collateral framework, private securities have traditionally played a more important role. As part of their stabilization efforts in reaction to the Global Financial Crisis, most central banks, including those of the US and the UK, purchased both public and private sector securities. All of these assets finance economic activity with potentially (but not necessarily) positive macroeconomic results.

[5] http://bruegel.org/2019/02/on-modern-monetary-theory/; *The Economist* February 16, 2019.

In recent years, the role of most central banks in markets for public sector securities has increased as a result of asset purchase programmes, giving rise to a discussion on the appropriate division of labour among institutions and the influence of central banks on long-term interest rates.

Definitely, instrument independence of central banks should not give rise to an isolated view neglecting interactions of monetary policy with other actors and policy instruments in creating macroeconomic effects.

...but excessive expectations, misleading generalisations and misinterpretations:[6]

How does money creation and government finance function in reality? Government raises finance by taxing the private sector in exchange for government spending on public services. On top of that, as long as its creditworthiness remains intact, the public sector can issue liabilities on domestic or global markets, in exchange for receiving money from the private sector.

Public sector securities purchased by commercial banks can be exchanged against new money from the central bank according to conditions set by the central bank (tender procedures, interest rate, criteria for acceptable collateral, duration etc.) in view of its monetary policy goals. By creating money, the central bank builds up liabilities against the private sector, backed by assets (in the case of the US these assets are usually government securities).

Commercial banks create non-cash balances for their customers by building up liabilities against the public and private sector, in tandem with acquiring claims against counterparties (cash and claims on the central bank, claims on credit customers, securities from the public and private sector). They settle their liabilities with central bank money.

MMT relies on an alternative presentation and interpretation of these relationships, based on analytically absorbing the central bank balance sheet in a consolidated view of the public sector and selectively ignoring a number of aspects of the money creation process.

Central bank and public sector

In the MMT view, the central bank is an addendum to the public sector that does not have its own interface with the private sector. In this perspective, new money only enters the private sector via government expenditure.

The process in which the public sector sells securities to the private sector which then can be exchanged by commercial banks at the central bank for new money is perceived by MMT as a superfluous detour which only serves to obfuscate the basic mechanism („new money is created against government debt“) and can be ignored. Money creation is presented as an internal affair of the public sector (as simultaneous creation of two kinds of IOUs by the same issuer, which in the end do not create any net obligation for the issuer), with new money only entering the private sector through government deficit spending. Money flowing from the private to the public sector as a result of taxation and sale of government securities are regarded as money destruction. MMT regards this as tool to absorb excessive money in order to control inflation, not as a means to finance the public sector (Wray 2012, 52). After all, MMT sees the public sector as financed by money creation.

Back to war finance?

What MMT presents as a description conflates contemporary institutional reality with historical cases, where the public sector centralizes economic governance in the face of existential threats, resulting in a shift of the weight given to different economic policy objectives in favour of resource mobilisation by government. This is typically the case during and after war. In these circumstances, direct public sector access to the central bank to finance activity is part of a broad set of measures to direct economic production, control prices and international capital movements. Outside such an environment and accompanying measures, the relationship between central bank and government is characterized by other priorities and requirements.

Government debt markets are the main field of operation for central banks due to their superior liquidity, and central banks can also support their liquidity in times of stress to secure financial stability. But limiting central bank acquisitions of

[6] Weber 2018, Chapter „MMT“, 193-207.

government securities to the secondary market is intended to make it harder for the public sector to bypass markets (in issuing securities) and parliament (in approving taxation and debt) and give in to the temptation to risk the quality of national currency by having easy access to monetary financing.

Shifting views of policy challenges, instruments and priorities

Since the global economic and financial crisis, where central banks played a key stabilizing role, a debate is ongoing about whether a return to pre-crisis views of what can be considered normal can be expected or justified, including the role of central banks. Or, if on the contrary we face continuing severe challenges to the sustainability, prosperity and fairness of the economic system, creating pressure to adapt institutional arrangements (including the mission and division of labour among economic institutions) to shifting priorities among policy goals.

This debate is the main explanation for the current interest in MMT. Institutional arrangements reflect policy choices with regard to economic policy trade-offs. MMT may currently fail as an accurate description of the status quo, but it may function as a tool to readjust perceptions, contributing to an adjustment of institutional realities to ultimately fit its descriptions.

MMT stresses that „taxes drive money“ (Wray 2012, 275). Tax authority is an important anchor behind network effects among private sector participants that support general acceptance of national currency in any currency area, as long as the national currency's quality does not deteriorate too much compared to available alternatives among foreign currencies. But that does not mean that general domestic currency acceptance is an automatic result of despotic imposition by government. Tax authority, like currency acceptance, requires legitimacy. By granting independence to the central bank and giving a clear mandate including price stability, the public sector sends a signal - in an environment of liberalised capital movements and potential currency competition - that it will not lightheartedly sacrifice monetary stability in a potential conflict with government finance objectives. MMT ignores this aspect because it is based on the belief that currencies are unilaterally imposed by government on the private sector through tax authority based on the state's monopoly on violence, and do not require legitimacy in order to be accepted. Taxation is also seen as key and effective in containing inflation.[7]

In a transnational currency area like the euro area, which comprises more than one member state, and all members retaining most aspects of fiscal sovereignty, private securities traditionally play a larger role in monetary policy than in countries like the US, and prohibitions against purchase of government securities on primary markets are strongly instituted. This is a result of political compromise and is intended as a signal to significant stakeholders among currency users. It can also be regarded as a measure to avoid conflicts around questions regarding which member state is able to access direct monetary financing to which extent under which circumstances (even purchases on the secondary markets after 2010 were subject to quotas and dispute).

The public sector‘s room of manoeuvre with regard to national currency depends on their rank in the international hierarchy of currencies. Definitely, the USA as issuer of the world's number one international currency do have greater room than other states. The lower the status of a currency in the international hierarchy, the greater the risk of a government debt crisis leading to a currency crisis.

To restrict a discussion of fiscal rooms of manoeuvre to monetary financing is a narrowing of the debate. Taxes can be raised and many governments, supranational entities and public development banks have additional room for debt financed spending. Pointing out monetary financing capacities may be a bargaining chip in a political debate intended to revive fiscal policy paralyzed by political deadlock, but it is certainly not the only possible route for economic policy, and does not come without trade-offs.

Reforming money?

MMT is part of a broad post-crisis tendency to perceive the reform of money as a key avenue to fix the economy's fault lines. Various ideas for monetary reform can be distinguished by their position with

[7] See Mehrling 2000 and Skidelsky 2018, 26 and 246. In some of their lengthier writings, MMT scholars acknowledge the contingency of tax authority and currency choice, but do not consider it relevant beyond rare special cases (Wray 2012, 54; Fullwiler et al. 2012, 20).

regard to two fundamental questions: First, which dimension of money is key? Here, approaches focusing on money as a scarce object differ from approaches focussing on money as the liability of an issuer. Second, who should create and govern money? Here, approaches favouring centralized governance can be distinguished from approaches favouring decentralized governance.[8]

	Money as liability of	**Money as an object**
Centralized	MMT	Sovereign Money aka „Vollgeld“
Decentralized	Regional Currency	Bitcoin

One common feature of these proposals is that they tend towards an isolated view of money as the key steering tool for directing the economy. They tend to neglect that institutional arrangements for the creation and governance of money are interrelated with institutional arrangements governing the economy in general. Neither money nor the economy in general are run purely by either the private or the public sector. Regardless its flaws, one may hope that public attention for MMT may contribute towards a debate resulting in a more enlightened understanding about the mechanisms and trade-offs involved in institutional arrangements involving money and economic policy.

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[8] Weber 2018, 100.

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