MODERN MONETARY THEORY

Nicholas Dolasinski

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Introduction

Roughly a half century into the Great Leveraging, a trend which promoted greater utilization of lending within the global economy, our society's desire to borrow appears unquenched as discussions around Modern Monetary Theory have garnered mass attention in the past few years. As we will discuss, Modern Monetary Theory is progressive policy which calls for the use of Fiscal Policy as a steering wheel for the economy as well as larger government spending on social programs all using funds the government essentially loans itself. In the following pages I will review the origins of Modern Monetary Theory before providing an argument in favor or Modern Monetary Theory followed by an analysis of this argument and finally concluding with a number of other criticisms raised surrounding MMT.

Functional Finance

Before we discuss how current academic literature foresees the potential feasibility and ultimate consequences of MMT, we must review what Modern Monetary Theory is and the macroenvironment currently spurring public interest around the subject.

As Craig Medlen and Zelin Chen (2023) point out in their review of Modern Monetary Theory's origins, MMT contends with common budgeting practices refusing to accept the claim that, "A government with a sovereign currency needs to solicit funds from the public first in the form of taxes and borrowing before the government can spend"[1]. Instead, to accumulate the funds necessary to employ a certain fiscal policy, the central bank for the nation's government

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[1] Medlen, Craig, and Zelin Chen. "Modern Monetary Theory in Historical Perspective". Journal of Economic Issues. Association of Evolutionary Economics. March. 2023. 242

can purchase government bonds, as they are issued, with freshly “printed” money that was not in circulation prior to the purchase. In doing this, monetary policy essentially supports fiscal policy allowing fiscal policy to operate in a prolonged deficit. Of course, certain conditions must apply for a government to have the ability to entertain Modern Monetary Theory including the ability to issue and regulate the value of their free-floating currency and the ability to issue debt denominated in that currency[2]. When these conditions apply, a government can theoretically meet any short-term debt requirements and is only bound by the continued survival of the currency and the governing body on top of the physical limits of the finite resources being used. As we will discuss in later sections, these assumptions may be seriously threatened by the prolonged implementation of Modern Monetary Theory at a large scale. However, before we do so, we will first review the origins of Modern Monetary Theory through the lense of Medlen and Chen 2023 and the various ways MMT differs from similar policies. This is a critically important exercise as MMT has yet to be executed in its proposed form forcing us to rely on the history of similar policies, economic theory, and fundamental economic principles to analyze this wishful policy.

Despite what its name suggests, the fundamental principles behind Modern Monetary Theory are not new at all. MMT as we know it today is a close relative to Functional Finance, a theory developed by Abba Lerner in the early 1950’s[3]. Functional Finance essentially advocated for the utilization of government spending (fiscal policy) to control the speed of the economy using funds financed through a similar type of self-feeding monetary policy [4]. However, while Functional Finance and MMT employ relatively similar methods of financing, the purpose

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[2] Kravchuk, Robert S. “Post-Keynesian Public Budgeting and Fiannce: Assessing Contributions from Modern Monetary Theory”. Wiley-Blackwell. Public Budgeting and Finance. 2020. 96
[3] Medlen, Craig, and Zelin Chen. “Modern Monetary Theory in Historical Perspective”. 242
[4] Medlen, Craig, and Zelin Chen. “Modern Monetary Theory in Historical Perspective”. 243

behind these policies and the macroenvironment in which they are supposed to be implemented are substantially different. According to Medlen 2023, Functional Finance was necessary because markets were inherently instable and thus "Prone to deep depression and inflation without any definitive way to self-correct"[5]. As a result, it is the government's duty to act as a "steering wheel" for the economy, as Lerner put it. Lerner's primary concern with Functional Finance was the possibility that it could cause a positive feedback loop of hyperinflation. To Lerner, there were two primary drivers of inflation: demand push inflation propelled by consumers' fear over prices being higher tomorrow and cost push inflation which is primarily a result of wage inflation[6]. We can imagine that in Lerner's world, demand push inflation could be mitigated with greater government investment which ultimately increases suppliers. Unfortunately, wage push inflation was a much trickier concept for Lerner to solve. One can imagine that with the government spending under a Functional Finance framework, workers might be incentivized to continue to demand wage growth beyond the nation's productivity growth as the government continues to spend more in an effort to combat inflation. It is important to remember that Lerner developed this theory in the early 1950's. During this period, workers controlled a great amount of power over their wages and working conditions relative to the modern workforce because of the widespread union representation that existed in specific industries which dominated American employment. The manufacturing sector, for example, employed roughly 40 percent of nongovernment, non-agriculture workers in the US in 1950 of which 58% were union members[7]. As of 2019, only 10 percent of the labor force worked in the manufacturing sector with 9.4 percent of those participating in a union[8]. Outside of decreasing union participation, there exist a

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[5] Medlen, Craig, and Zelin Chen. "Modern Monetary Theory in Historical Perspective". 244
[6] Medlen, Craig, and Zelin Chen. "Modern Monetary Theory in Historical Perspective". 245-246
[7] Medlen, Craig, and Zelin Chen. "Modern Monetary Theory in Historical Perspective". 248
[8] Medlen, Craig, and Zelin Chen. "Modern Monetary Theory in Historical Perspective". 248

number of other trends which have greatly reduced the bargaining power of employees and firms such as globalization, widespread automation, and a growing number of firms/suppliers generally. So, as we can see, the ability for firms and workers to endlessly demand higher prices and wages has decreased overtime alongside labor and firm power.

Lerner ultimately abandoned Functional Finance's original form before a meaningful reduction in firm and labor power occurred. In its place stepped Monetary Policy and the use of Open Market Operations as we know them today. In the United States, Open Market Operations are used to set and maintain the federal funds rate as well as to grow or shrink the central bank's balance sheet which ultimately changes the monetary base within the economy. The U.S. Federal Reserve strategically employs this policy to satisfy its dual mandate: price stability with maximum employment. This dual mandate was adopted as a part of the Federal Reserve Act of 1977 replacing fiscal policy's need to guide the economy as Lerner initially called for[9].

Thus far we have discussed what Modern Monetary Theory, Functional Finance, and Open Market Operations are, how they are related, and how the economy has evolved in favor of the previously disregarded Functional Finance spurring conversations today around Modern Monetary Theory. We will now review a few factors which differentiate MMT from Functional Finance which must be addressed before advocating for such a policy given the changes in the macroenvironment.

There notably exist stark differences between MMT and Functional Finance in the proposed utilization/employment of these funds within the economy. On top of the advocating for the use of fiscal policy in place of monetary policy like in Functional Finance, Modern Monetary Theory has also been used as an argument in support of many progressive policies

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[9] "Overview: The History of the Federal Reserve". Federal Reserve History. Federal Reserve Bank of St. Louis. September 2021.

such as the Green New Deal, more subsidized or free tuition, free health care, and a job guarantee to name a few[10]. A common theme here seems to be a prioritization of the use of these funds rather greater concern being placed on the method of the financing required. In other words, MMTers seem to focus on the question “How can we pay for this?” rather than asking “Why should we pay for this and is it worth the cost?”. This makes complete sense as some of the loudest MMT advocates have been politicians seeking to further their agendas. According to Medlen 2023, Lerner was more concerned with the interest rates associated with a financing decision than many current MMTers are[11]. This is further supported by Lerner’s argument that “An economist is concerned only with the means and not the ends”. That is not to say that Lerner did not care about the ultimate employment of the funds created just that he prioritized their ultimate consequence for the health and speed of the broader economy which is a direct factor of both the means of financing and the employment of the funds. Lerner himself proclaimed that “Functional Finance is in one sense the last thing for a government to think about. The government must first of all decide on all the other reasons for buying various things or taxing certain activities or for applying any of the other instruments of fiscal policy”[12]. Asides from the differences in the reasoning behind the increased government deficit, there also exist critical differences in the limits of these policies. As you will recall, Lerner viewed functional finance as a necessary tool to keep the economy from spiraling and thus applied certain laws to the utilization of its funds: “To fiscally adjust spending to just the right point where full employment coexisted with minimal inflation”[13]. The contradicting nature of these two guiding mandates in practice would have restricted the levels of debt the government hypothetically would have held,

[10] Medlen, Craig, and Zelin Chen. “Modern Monetary Theory in Historical Perspective”. 250
[11] Medlen, Craig, and Zelin Chen. “Modern Monetary Theory in Historical Perspective”. 250
[12] Medlen, Craig, and Zelin Chen. “Modern Monetary Theory in Historical Perspective”. 244
[13] Medlen, Craig, and Zelin Chen. “Modern Monetary Theory in Historical Perspective”. 244

when implementing functional finance, in the same way the dual mandate currently keeps open market operations in check. Modern Monetary Theory, on the other hand, has no obvious or agreed upon guiding mandates or binding limits given its proposed utilization as both a stabilizing tool and a method of financing expensive and progressive projects leaving its utilization at the discretion of politicians if it is ever to be implemented in its current popularly proposed form.

MMT: Functional Finance Blended with Government Spending

As we have seen, Modern Monetary Theory draws inspiration from Abba Lerner's Functional Finance with a few key differences including the economic environment in which the theories are being advocated for as well as the purposes behind the policy and the ultimate limits, or lack thereof, that these mandate's place on the proposed policies. In reviewing the published literature surrounding Functional Finance and Modern Monetary Theory it becomes increasingly apparent how uncoordinated and unagreed MMT supporters are when it comes to the ultimate purpose for using monetary policy to support fiscal policy. Some, like Abba Lerner discussed above, see the policy tool as a way of steering the economy towards the same ends monetary policy currently controls the economy. Others prefer to use Modern Monetary Theory as a financing tool for progressive policies without a real understanding of how this would be employed alongside or in replacement of monetary policy. And some, like Joelle Leclaire 2023, call for a combination both despite the two interests which may potentially fight against one another for prioritization. We will now take a look at Leclaire's argument in favor of MMT as Functional Finance with the addition of financing new policies and will discuss its various shortcomings before diving into the potential consequences of abusing Modern Monetary Theory.

In 2023, Joelle Leclaire wrote an academic review on the potential for MMT to be employed in the current macroenvironment using an extremely similar line of thought to that of Abba Lerner in the early 1950s. Immediately, Leclaire 2023 claims that MMT can be used in the presence of inflation driven by supply chain bottlenecks, like the inflation seen in the three years following the COVID-19 pandemic[14]. She then separates the drivers of inflation into demand pull or cost push in the same manner as Abba Lerner, arguing that in times of supply blockages, government targeted spending/investment can be used to increase suppliers and reduce inflation. She correctly understands that government spending can both increase inflation by adding to demand pull while also reducing inflation by alleviating cost push[15]. She argues that strategically using MMT to reduce inflation is preferential to the traditional policies which combat inflation by slowing the economy through raising interest rates and increasing taxation. The reason for this being the lack of hardship experienced by workers and consumers in combating inflation using MMT method (or Functional Finance as we know it) relative to slowing the economy by reducing demand and increasing the costs of investment/production which in turn increases unemployment[16]. Again, similar to Lerner's Functional Finance objectives, Leclaire also calls for MMT to be used to keep interest rates low and thus firm investment high alongside MMT's use in ensuring price stability[17]. Leclaire explains that government spending results in new firm and worker bank deposits which increases bank reserves and subsequently lowers lending rates.

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[14] Leclaire, Joelle. "Fiscal and Monetary Policy for difficult times: MMT solutions". European Journal of Economics and Economic Policies. August 2023. 357
[15] Leclaire, Joelle. "Fiscal and Monetary Policy for difficult times: MMT solutions". 359
[16] Leclaire, Joelle. "Fiscal and Monetary Policy for difficult times: MMT solutions". 360
[17] Leclaire, Joelle. "Fiscal and Monetary Policy for difficult times: MMT solutions". 362

Finally, Leclaire departs from Lerner's Functional Finance by also advocating for some of the programs commonly linked to modern MMT proposals like the job guarantee program. She sees greater unionization and a job guarantee program as productive towards increasing price stability as these concepts offer a floor for worker wages.

Leclaire's and other MMTer's recommendations are ultimately of little value as their thought process is significantly flawed. First of all, both Leclaire and other MMTers pin their conclusions on several bold claims including the idea that government spending is not correlated with inflation or higher interest rates. To prove this, Leclaire simply looks at government spending overlayed with interest rates and inflation over time without controlling for any potentially disrupting factors or considering that monetary policy has been used as the primary steering wheel for the economy artificially influencing inflation and interest rates since the implementation of the dual mandate in the 70s[18]. Additionally, she stands with modern MMT proposals in recommending a job guarantee program to further stabilize prices. She and other MMTers do not discuss, however, how this and other spending recommendations might increase labor power and thus the cost push inflation which ultimately destroyed Lerner's theory of Functional Finance in the mid to late 20th century.

Arguments against MMT

We have discussed the origins of MMT in Functional Finance, why Functional Finance failed, and why it was ultimately replaced with monetary policy and Open Market Operations as we know it today. We then reviewed a newer argument (MMT) calling for a combination of

[18] Leclaire, Joelle. "Fiscal and Monetary Policy for difficult times: MMT solutions". 358 and 363

Functional Finance's fiscal dominance with greater government spending and found that the logic behind this argument was significantly flawed. We will now conclude our analysis with a discussion of a few of the common arguments against MMT.

In his 2022 academic review of concerns regarding MMT implementation, Guillaume L'oeillet shows that MMT prioritizes full employment over price stability[19]. This conclusion is in line with those that we have made regarding Functional Finance and the type of MMT proposed by Leclaire 2023 whereby MMT tends to propel wage push inflation. L'oeillet goes on to discuss the potential for MMT in its currently proposed form to cause hyperinflation. This inflation would be driven by both demand pull and wage push for the same reasons we disregarded Leclaire's conclusions. L'oeillet adds to this conversation by revealing potential issues with MMT's utilization of taxes to slow the economy in the event of this inflation. He correctly identifies that MMTers lack a benchmark for an acceptable level of employment as well as a plan for the type and the target of these taxes on top of how to curb redistributive effects[20]. L'oeillet also points to the likelihood of currency depreciation in the event of global unwillingness to continue to purchase government assets as its deficit grows and fiscal strength subsequently deteriorates[21]. It is also well documented that MMTers advocate for the use of monetary policy as both a financer of the Modern Monetary Theory and to artificially keep interest rates low keeping the government's cost of debt low. L'oeillet discusses how this may incentivize abnormal risk-taking investment behavior on top of potentially aiding in the creation of asset

[19] L'oeillet, Guillaume. "Modern Monetary Theory: Misconceptions, Real Limitations, and Blind Spots. A review of criticisms.". Revue D'Economie Financiere. October 2022. 224
[20] L'oeillet, Guillaume. "Modern Monetary Theory: Misconceptions, Real Limitations, and Blind Spots. A review of criticisms.". 230
[21] L'oeillet, Guillaume. "Modern Monetary Theory: Misconceptions, Real Limitations, and Blind Spots. A review of criticisms.". 230

bubbles both of which ultimately threaten the stability of the entire financial system[22]. Outside of potentially creating asset bubbles in the host country, there is potential for MMT to cause significant side effects in other areas of the world. Another paper by Andreas Hoffmann, written in 2014, uses empirical data from emerging markets (using Brazil, Russia, India, China, Turkey, Poland and Indonesia) from 2009 to 2014 to show the unintended effects of sustained low interest rates in advanced economies on developing ones[23]. He finds that the low interest rates in the advanced economies incentivized riskier investment behavior particularly in emerging markets where there were high growth rates causing asset bubbles in those emerging markets[24]. Additionally, those emerging markets' governments tended to follow the policy behavior of advanced economies leading them to also lower their interest rates which in turn exasperated the risk-taking behavior and subsequent asset bubbles[25]. Finally, L'oeillet raises concerns regarding the use of Modern Monetary Theory funds to finance an assortment of progressive fiscal policies without a common objective or limiting ceiling for these expenditures which are entirely at the discretion of politicians[26]. He further discusses concerns regarding the potential for pre or post-election pro inflationary incentives for politicians seeking favor amongst the general public[27]. Again, without any formal limits to the acceptable level of government spending and debt or mandates by which to judge the appropriateness of a fiscal decision under MMT, there exists a great likelihood for political abuse of the blank check which MMT provides.

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[22] L'oeillet, Guillaume. "Modern Monetary Theory: Misconceptions, Real Limitations, and Blind Spots. A review of criticisms.". 232
[23] Hoffmann, Andreas. "Zero-Interest Rate Policy and Unintended Consequences in Emerging Markets". The World Ecnomy. 2014. 1367
[24] Hoffmann, Andreas. "Zero-Interest Rate Policy and Unintended Consequences in Emerging Markets". 1379
[25] Hoffmann, Andreas. "Zero-Interest Rate Policy and Unintended Consequences in Emerging Markets". 1385
[26] L'oeillet, Guillaume. "Modern Monetary Theory: Misconceptions, Real Limitations, and Blind Spots. A review of criticisms.". 235
[27] L'oeillet, Guillaume. "Modern Monetary Theory: Misconceptions, Real Limitations, and Blind Spots. A review of criticisms.". 236

Conclusions:

As thoroughly documented, the macroeconomic factors which ultimately killed Functional Finance before it was tested have become increasingly irrelevant over time. This trend, alongside higher levels of government debt, have reignited questions around the feasibility of Functional Finance but with a twist. Many advocates of Modern Monetary Theory support more government spending on nuanced policies on top of the use of fiscal policy in place of monetary policy. A few examples of new policies which could be financed using MMT include the Green New Deal, universal healthcare, more free tuition, and a job guarantee[28]. As we discovered, this addition to functional finance reelevates concerns regarding wage push inflation as they provide workers with greater wage negotiating power. We also reviewed how Modern Monetary Theory fails to answer a number of important critiques such as the likelihood of asset bubble development, riskier investment decisions, and inflation driven by policy misuse to name a few. Ultimately, Modern Monetary Theory in its currently proposed form cannot replace monetary policy without creating a number of serious side effects with unknowable conclusions for the American economy. In order for MMT to be seriously considered economists must either change its purpose refocusing MMT to exclusively on guide the economy like functional finance, implement some kind of contradicting mandate caping MMT's use like the FED's dual mandate, or implement some kind of policy mix wherein MMT is relied upon exclusively as a last case scenario policy option to combat stagflation resulting from supply side bottlenecks.

[28] Medlen, Craig, and Zelin Chen. "Modern Monetary Theory in Historical Perspective". 250

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