Confluence Investment Management

Weekly Geopolitical Report

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Modern Monetary Theory: Part I

In recent weeks, Modern Monetary Theory (MMT) has become a hot topic of discussion. Given the level of controversy, we want to provide our take on the theory. One could wonder if this topic is appropriate for a geopolitical report. We are using this report to examine MMT because, in our opinion, its rise reflects the continued shift in the equality/efficiency cycle; essentially, MMT is yet another signal that we are seeing the waning days of efficiency and moving into the dawn of equality.[1] The equality cycle is not just a U.S. phenomenon but affects most developed economies. And, if the U.S. is affected by MMT then it will impact other economies as well. In addition, MMT could have a profound effect on the dollar's reserve currency status, which will have repercussions for the global geopolitical situation.

MMT is a heterodox economic theory, somewhat related to Post-Keynesian economics. Its epicenter is the University of Missouri at Kansas City (UMKC). The current popularizers of MMT are three professors, Stephanie Kelton and Mathew Forstater, who teach at UMKC, along with L. Randall Wray, who teaches at the Levy Economics Institute of Bard College, another school that supports MMT. These colleges are not part of the "saltwater" or "freshwater" colleges that have been at the center of economic debates over the past four decades.[2] Instead, MMT represents a new paradigm.

Historical figures who are considered part of the "family tree"[3] are Georg Knapp, Mitchell Innes, John Maynard Keynes, Abba Lerner, Hyman Minsky and Wynne Godley. Keynes is well known; Minsky had his "moment" during the Great Financial Crisis. The rest of these names are rather obscure.

I started studying MMT a couple of years ago and must admit the theory seemed rather odd the first time I read about it. However, as I went through the theory, I was reminded of a useful bit of advice I received in graduate school. I was taking a graduate level course on Marx; the professor must have realized I was struggling with the material and he was kind enough to call a meeting with me. Essentially, he suggested that if I took the class simply searching for a reason to reject Marxism as a system then I would never really learn it. Instead, he suggested I keep an open mind and suspend judgment so I could learn the material. He assured me that although he would prefer I become a Marxist, it wasn't likely to happen, and he was right—I didn't. But, I did keep an open mind and learned Marx. The lesson from that situation is that an effective way to learn something that is completely outside the scope of the norm is to suspend judgment, work to understand the principles and fairly decide the strengths and weaknesses of the theory. I would urge readers to adopt this position if they are interested in the theory.

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[1] For a discussion of this cycle, see WGRs, Reflections on Inflections: Part I (1/7/19) and Part II (1/14/19).

[2] https://www.nytimes.com/1988/07/23/business/fresh-water-economists-gain.html

[3] http://www.levyinstitute.org/pubs/wp_792.pdf

My goal in this report is to describe MMT, treating the theory as descriptive. Much of the popularity of MMT is coming from Left-Wing Populists[4] who are using the theory in a prescriptive manner. Vitriol on both sides has been increasing.[5] *Ad hominin* attacks have become the order of the day. It is my intention to examine the key elements of MMT and the potential policy ramifications, and let the reader decide what to think. However, more importantly, even if the theory proves to have flaws (and all do), it may not matter. MMT may not be correct but it will be useful in shifting the economy toward equality and away from efficiency.

This is an important topic and we will cover it in a series of four installments. In Part I, we will begin with origin narratives—how orthodox and MMT explain money. Part II will lay out the principles and consequences of MMT. Part III will examine the importance of theoretical paradigms in the equality/efficiency cycle. Part IV will discuss potential flaws of MMT and finally, as always, we will conclude with market ramifications.

Origin Narratives

Origin narratives are stories that underpin human beliefs. They normally describe events that are thought to have occurred in the past that explain why something is the way it is today. Origin narratives cannot be established by history; instead, they usually suggest that conditions that exist today are part of long-term actions by our ancestors. These actions give credence to current beliefs.

In the orthodox tradition, the origin of money[6] developed from barter.[7] At some point, people traded items with each other. However, barter is clunky—it requires a coincidence of wants that may be difficult to find. Over time, people began to use items that were considered universal for exchange. Because of their rarity, precious metals have historically been used for money.[8]

This narrative postulates that money developed organically as a medium of exchange. If money is created by the decisions and actions of individuals, then banks obtain money (deposits) through private saving. Governments can only acquire money through taxes after money is created by exchange. In the orthodox model, money is a veil for exchange and doesn't affect real economic variables.

The MMT narrative is state-centric. Money has value because the state creates it to buy goods and services. In essence, money comes from government issuance. People use money because it can meet the state's demand for taxes. Banks cooperate with the government by facilitating the transfer of money from government to taxpayers. The government doesn't need to tax its citizens to raise money; it creates it, *ex nihilo*.

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[4] For a description of our views on the categories within democracies, see WGRs, Reflections on Politics and Populism: [Part I](#) (7/16/18) and [Part II](#) (7/23/18).

[5] https://www.washingtonpost.com/opinions/the-lefts-embrace-of-modern-monetary-theory-is-a-recipe-for-disaster/2019/03/04/6ad88eec-3ea4-11e9-9361-301ffb5bd5e6_story.html?utm_term=.005b59ccc535

[6] Money performs three basic functions: it is a medium of exchange, a unit of account and a store of value.

[7] Any standard Money and Banking economics course textbook will do for exposition, see: Chandler, Lester, and Goldfeld, Stephen. (1981). *The Economics of Money and Banking* (8th ed., original copyright 1948). Philadelphia, PA: Harper & Row (pp.5-14).

[8] Wray, L. Randall. (2012). *Modern Money Theory: A Primer on Macroeconomics for Sovereign Monetary Systems* (2nd ed.). New York, NY: Palgrave Macmillan (pp.162-163).

Banks don't need deposits from the private sector to issue loans; they get reserves from government spending (when the government spends, it puts money into the accounts of producers it buys from and creates reserves). The central bank then manages the level of reserves to meet its interest rate goals. In MMT, money is primarily a unit of account and secondarily a medium of exchange.

The key point about origin narratives is that they are not definitively provable. Strictly speaking, they are *a priori synthetic* statements of belief.[9] Although there will be attempts to historically prove origin statements, in reality, the "proof" is never strong enough to sway everyone.

Instead, the discussion of origin narratives comes down to persuasion. Unfortunately for the organic barter narrative, there is nothing that is naturally money, including precious metals.

> *Anyone who begins the study of money with a belief that there is some one thing that is "by nature" money and has been used as money at all times and in all places will find monetary history very disconcerting, for a most heterogeneous array of things have served as circulating media…the variety of things that have served as money is reflected in our language. For example, the word pecuniary, meaning "monetary," comes from the Latin pecus, which means "cattle," while salary derives from the Latin word for salt, salarium. Similarly, the expression "to shell out," meaning "to pay," reflects the early use of shells as money.*[10]

[9] For details on such statements, see WGRs, Thinking about Thinking: Part I (8/15/16) and Part II (8/22/16).
[10] Op. cit., Chandler and Goldfeld, p.12

Although precious metals are often thought to have intrinsic value, upon review, such metals only become money because they are accepted as such. Precious metals are rather rare, thus their supply is limited. And, as Marx noted, because precious metals have limited value as commodities, they are less likely to be consumed and are therefore useful as money.[11] Perhaps the weakest argument for the orthodox narrative is the answer to the question that commonly comes up in Money and Banking courses, "Why do we accept fiat currency?" The answer is that fiat money has value because we generally accept it. MMT argues that the need to pay taxes is a much more cogent reason for accepting fiat money.[12]

The state-centric narrative argues that even precious metals only become money with a state stamping; in other words, the sovereign stamps his image on the coin and it becomes acceptable as legal tender.[13] The state-centric narrative is based on the concept that money is linked to debt. Money can relieve the debtor of his burden.[14] In the ancient marketplace, a state-stamped coin became the government's way of signaling dominance over the market.[15] The state-centric narrative also makes the point that, in Roman times, the state-stamped coins ***were not valued by weight***.[16] By not putting a value to weight, the emperor could determine the value of each coin. In other words, the state determined the nominal value.

[11] Marx, Karl. (1973). *Grundrisse: Foundations of the Critique of Political Economy*. New York, NY: Vintage Books (p.166).
[12] Op. cit., Wray, pp.152-153
[13] Ibid, Wray, p.163
[14] Ibid, pp.163-164
[15] Ibid, p.165
[16] Ibid, p.168

The primary weakness of the state-centric narrative is that just because a nation dictates a legal tender doesn't mean citizens will use it as such. In other words, they may provide the state currency for tax obligations but demand other money for private transactions. Such outcomes occur during times of hyperinflation.

So, in the end, where does this leave us? Although it is impossible to definitively prove which origin narrative is true, we can say that modern economies are driven by the state-centric narrative. No industrialized nation backs its currency with precious metals or provides conversion to metals upon demand. The Bank of England published an influential report in 2014 pointing out that modern banks don't act as intermediaries, taking deposits and making loans. Instead, banks make loans and create money; reserves in the banking system are determined by the level of loans, while the central bank applies the interest rate on reserves to set a price and thus control their size, to a greater or lesser extent.[17]

However, even if the state-centric narrative best describes the current monetary system in the developed world, origin narratives are important for the human reaction to policy. In other words, regardless of how things might actually work, our beliefs are tied to origin narratives and thus guide how we see the world. Therefore, the visceral reactions seen on both sides of the orthodox and heterodox debate are, to a great extent, tied to these origin narratives.

If one ascribes to the orthodox viewpoint, government is less important, money is organically created and banks are not special in the economy. If one ascribes to the heterodox position, the government is the source of money, which is an instrument of sovereignty. Banks and the financial system are special. Politically, if one is skeptical of government, the orthodox position on money will likely be appealing, whereas one who generally views government as a friendly force will find the heterodox position comforting.

Part II
Next week, we will publish the second of four installments in which we examine the principles and consequences of MMT.

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[17] https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2014/money-creation-in-the-modern-economy