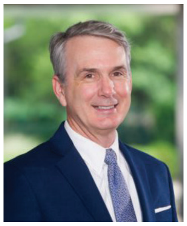
WHITE PAPER

MODERN MONETARY THEORY
AN INTRODUCTION FOR BEGINNERS



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PRINCIPAL

I would forgive the reader of this for not knowing what Modern Monetary Theory ("MMT") is or even why I would be writing about it. Theories about economies and how they do or should work are much more complex than the basic macroeconomics most of us may have taken in school. The 2020 presidential election will probably make MMT a bigger topic in much the same way that Ronald Reagan and supply side economics did in the 1980's. Why? Because it is the only theory of money supply and spending that can support the ten or eleven digit price tags of the promises being made by politicians.

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Before I get into any real specifics, I should set some expectations. First, I am neither a supporter nor a critic of MMT, so my goal is not to change your mind if you have an opinion or create an opinion for you. MMT is also a fairly complex theory and this introduction will not make you an expert! But it should highlight for you its basic ideas and help you understand why it is popular today with both economists and politicians. However, there are still many questions related to whether it really explains modern economies that have the ability to "print" their own money.

Some theory is necessary to address what has become a very large problem in many modern economies and certainly in the U.S. Deficit spending has become the new normal and new stimulus or new social mandates are being considered with very large price tags. It seems that "trillions" is the new "billions" when we talk about government spending.

- The 2020 election has included health care as a key component among the Democratic presidential candidates. Based on two independent estimates, a Medicare for All bill would cost at least $32 trillion over the next 10 years[1].
- The American Action Forum estimates the Green New Deal, which is a series of mandates and funding that would look to address inequality, healthcare and climate change, would cost more than $50 trillion over the next 10 years[2].
- The chart below by the Congressional Budget Office shows the deficit for FY 2019 to be nearly $900 billion and will grow to more than $1 trillion annually by 2029, which represents more than 4% of the total gross domestic product each year.

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[1]Committee for a Responsible Federal Budget, February 27, 2109; The Urban Institute and Commonwealth Fund, October 16, 2019
[2]American Action Forum, February 25, 2019

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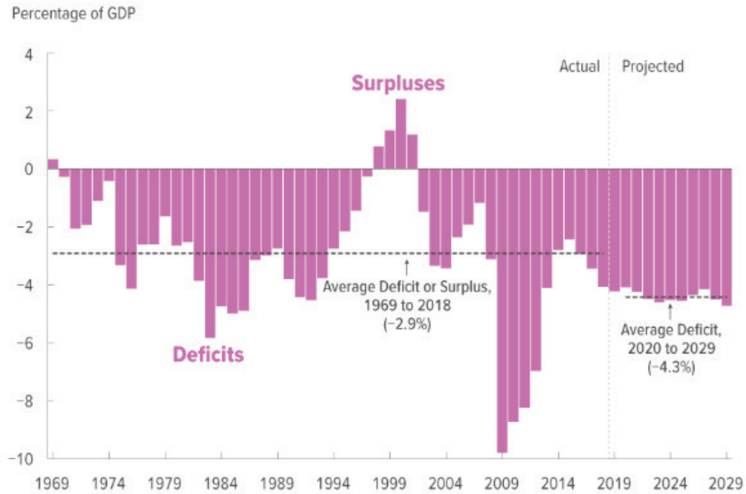

Source: Congressional Budget Office

Paying for all of this is not possible with the current approach of growth and taxes. MMT presents a possible theory for addressing what politicians seem to want in a way that does not destroy the economy.

MMT in its current form has been around for about 20 years, with papers being published in the late 1990's. Its origins, however, go back to the early 20th century. MMT is a theory that attempts to explain the world we experience. It is not something that is easy to prove, like a math problem. Economies are complex things, with lots of people and government making decisions and interacting. The outcomes of all that activity are things like employment, interest rates, inflation, and growth. Just like Copernicus attempted to explain how stars and planets behave in the heavens, MMT is trying to explain what we see in terms of economic activity and what actually causes those things. Copernicus had an uphill battle because people of his time believed things were already explained and the stars and planets all revolved around the Earth; that is what they saw. MMT also has an uphill battle when it tries to explain things in a world that has famous economists who believe they have already explained the workings of money and interest rates and inflation. MMT attempts to combine many of these theories into a comprehensive model that includes a "modern" fact: today, most governments have the power to make money without needing gold or silver or anything tangible behind them. We call that fiat money.

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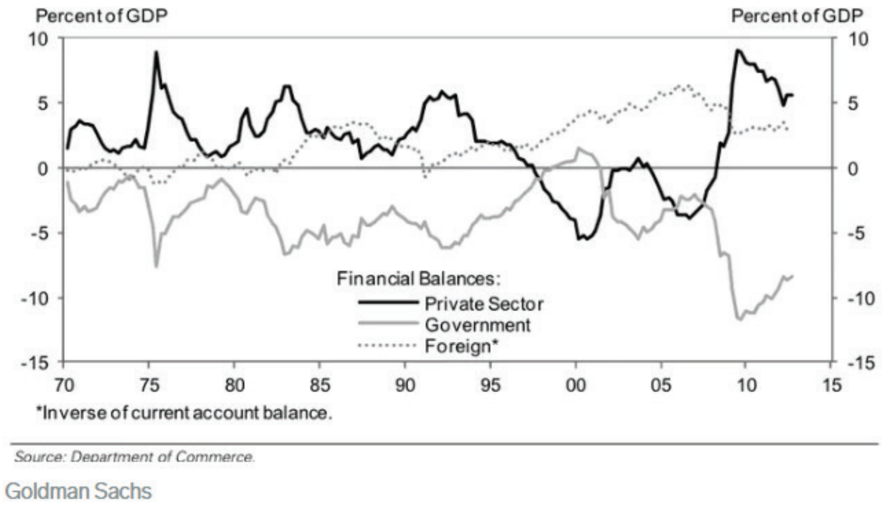
When you or I want to buy something, we need to have money to complete the purchase. We get that money either by earning it, borrowing it, or by some sort of gift. This fact requires us to have a sense of balance in how we conduct our monetary affairs. Expenses or spending are limited to the sum of our earnings and borrowings. MMT points out that governments don't have to work like that. While they can both earn (in the form of taxes) and borrow, they also have another alternative, which is to print money. In fact, they have to! It is by printing money in the first place that an economy starts to function, since money is necessary to allow for transactions between all of its participants. Money is the lubricant that allows the engine to run.

Given that governments have the power to print money, MMT reverses the traditional belief that governments should look at their finances the same way a household or a business does. A government does not need to start with revenue and borrowings to decide how much it should spend. **Its starting point should be spending enough to ensure the overall economy has full employment.** Creating work, and therefore income, for everyone puts the economy on an initial solid footing, helping to maximize the potential of the overall economy to produce and consume. That level of spending can then be funded by taxes or borrowing or simply by creating money, or some combination of those three items.

This fact highlights a key component of MMT. The overall economy needs to be balanced, not the individual participants; surplus for one part of the economy is the deficit for another participant. That seems like both an obvious statement and also one that is hard to get our minds around. If the government runs a deficit, which is more spending than it has revenue, the rest of the economy receives that spending as income and it creates for them a surplus. A way to look at that is in the chart below, created by showing the total spending and capital investment of the U.S. Government and the U.S. private sector. The positive value of the private sector, its surplus, comes from the



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negative value or deficit of the government. Since we are a global economy, there is some foreign investment and trade activity that is included in this in order to balance everything. In essence, government deficit spending has created the surplus that the U.S. private sector has enjoyed for decades. The government has been able to run this deficit by borrowing the difference between taxes and spending, but MMT says that some or all of that deficit could come from printing money.

At this point, many of you are scratching your heads. Doesn't printing money create inflation? This doesn't seem right. For most of us, we have Milton Friedman to thank. His work on the quantity of money seems to be in direct conflict with the idea of printing money. Both Friedman and MMT believe that you can get a benefit from printing money in the short term with no inflation. Friedman believed that in the long-run, though, an increase in the money supply would lead to an increase in price levels, or inflation. MMT says that as long as the increase in money is in keeping with the overall potential of the economy, there is no inflation in the long-run either. The objective is to print the right amount of money, not too much or too little. MMT tells us that taxes are the way to help with that.

Randy Wray, one of the modern proponents of MMT, describes government spending, money creation and taxes with an analogy. Imagine the economy overall as a sink, which can hold some amount of water. Water is money; the economy needs some amount of water in order to handle all of its transactions and investments. The addition of water into the sink, from the faucet, is the creation of money by the government in order to fund new spending for programs and services. When the funding occurs too quickly, you have water spilling over the sides of the sink, and this represents inflation. According to MMT, inflation occurs when there is too much money in the economy, which comes from government spending and printing faster than the economy can handle it. Taxes are the drain in the sink. As an economy pays taxes, it has the effect of removing money from the system. This reduces or eliminates the spillage of water and moderates inflation. So, tax policy is the process of working the sink stopper, ensuring there

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is enough water in the sink to handle the needs of the economy and when there is too much or not enough, moderating or increasing taxes to fix the water level. So, MMT believes it is not the creation of money through spending that should be the main concern of government but rather the application of tax policy. Spending should help keep the sink full and by extension everyone fully employed.

It is easy to see why candidates and current politicians are quick to include MMT into their thinking and funding explanations. In fact, based upon my point above about the deficit, we are already experiencing some form of MMT today. The government spends more money than it brings in and inflation continues to be at levels the Federal Reserve thinks are too low rather than too high. We have all been taught that being prudent, spending only what you make and using borrowings very judiciously are the hallmarks of fiscal maturity. However, that has not been the case for our government for decades. And it hasn't been the case for most developed governments. MMT attempts to explain what is happening in the real world.

In the U.S. today, the Treasury worries about the level of money and the Federal Reserve worries about employment and inflation. In an MMT world, those duties would shift to the Congress in the form of total spending and taxes to control inflation. The Treasury or the Federal Reserve would be responsible for helping to implement the monetary part of those decisions. Our current deficit spending is funded by borrowings, which today sit at more than $22 trillion. MMT points out that some or all of that debt could be retired by simply printing more money to pay it off. We call that monetizing the debt. There have been some MMT economists that have suggested that Japan is already there, though the current Prime Minister and the head of the Bank of Japan both disagree. In any case, MMT presents a plausible theory about money and spending and the way that governments who can print their own money could potentially consider another approach to fiscal decisions besides balancing revenue and spending.

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Governments can print money because they have a monopoly to do so. That monopoly is provided to them by the people they govern. When the governed lose trust, there is no amount of printing that can earn that back. I think one of the things that makes most of us uneasy about MMT is the fact that we don't have an answer to that question. All of this is possible because of the strength of the U.S. economy and the strength of the dollar as a reserve currency for the world. But we have seen through history other reserve currencies that have met their demise as people lost faith and confidence. Athens, Rome, Constantinople, Florence, Amsterdam, Madrid and London over the course of history have experienced the power and decline of being the center of the global economy.

There isn't a final word to MMT or any economic theory. As time passes, we may find other theories that explain the complexity of our world better. Or we may try an existing theory and see what works or what doesn't. There will always be a desire to be able to spend more than we make. Let's hope that process can be done prudently regardless of the theory that attempts to explain it.

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