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Modern Monetary Theory, an unconventional take on economic strategy

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About 11 years ago, James K. “Jamie” Galbraith recalls, hundreds of his fellow economists laughed at him. To his face. In the White House.

It was April 2000, and Galbraith had been invited by President Bill Clinton to speak on a panel about the budget surplus. Galbraith was a logical choice. A public policy professor at the University of Texas and former head economist for the Joint Economic Committee, he wrote frequently for the press and testified before Congress.

What’s more, his father, John Kenneth Galbraith, was the most famous economist of his generation: a Harvard professor, best-selling author and confidante of the Kennedy family. Jamie has embraced a role as protector and promoter of the elder’s legacy.

But if Galbraith stood out on the panel, it was because of his offbeat message. Most viewed the budget surplus as opportune: a chance to pay down the national debt, cut taxes, shore up entitlements or pursue new spending programs.

He viewed it as a danger: If the government is running a surplus, money is accruing in government coffers rather than in the hands of ordinary people and companies, where it might be spent and help the economy.

"I said economists used to understand that the running of a surplus was fiscal (economic) drag," he said, "and with 250 economists, they giggled."

Galbraith says the 2001 recession — which followed a few years of surpluses — proves he was right.

A decade later, as the soaring federal budget deficit has sharpened political and economic differences in Washington, Galbraith is mostly concerned about the dangers of keeping it too small. He's a key figure in a core debate among economists about whether deficits are important and in what way. The issue has divided the nation's best-known economists and inspired pockets of passion in academic circles. Any embrace by policymakers of one view or the other could affect everything from employment to the price of goods to the tax code.

In contrast to "deficit hawks" who want spending cuts and revenue increases now in order to temper the deficit, and "deficit doves" who want to hold off on austerity measures until the economy has recovered, Galbraith is a deficit owl. Owls certainly don't think we need to balance the budget soon. Indeed, they don't concede we need to balance it at all. Owls see government spending that leads to deficits as integral to economic growth, even in good times.

The term isn't Galbraith's. It was coined by Stephanie Kelton, a professor at the University of Missouri at Kansas City, who with Galbraith is part of a small group of economists who have concluded that everyone — members of Congress, think tank denizens, the entire mainstream of the economics profession — has misunderstood how the government interacts with the economy. If their theory — dubbed "Modern Monetary Theory" or MMT — is right, then everything we thought we knew about the budget, taxes and the Federal Reserve is wrong.

Keynesian roots

"Modern Monetary Theory" was coined by Bill Mitchell, an Australian economist and prominent proponent, but its roots are much older. The term is a reference to John Maynard Keynes, the founder of modern macroeconomics. In "A Treatise on Money," Keynes asserted that "all modern States" have had the ability to decide what is money and what is not for at least 4,000 years.

This claim, that money is a "creature of the state," is central to the theory. In a "fiat money" system like the one in place in the United States, all money is ultimately created by the government, which prints it and puts it into circulation. Consequently, the thinking goes, the government can never run out of money. It can always make more.

This doesn't mean that taxes are unnecessary. Taxes, in fact, are key to making the whole system work. The need to pay taxes compels people to use the currency printed by the government. Taxes are also sometimes necessary to prevent the economy from overheating. If consumer demand outpaces the supply of available goods, prices will jump, resulting in inflation (where prices rise even as buying power falls). In this case, taxes can tamp down spending and keep prices low.

But if the theory is correct, there is no reason the amount of money the government takes in needs to match up with the amount it spends. Indeed, its followers call for massive tax cuts and deficit spending during recessions.

Warren Mosler, a hedge fund manager who lives in Saint Croix in the U.S. Virgin Islands — in part because of the tax benefits — is one proponent. He's perhaps better know for his sports car company and his frequent gadfly political campaigns (he earned a little less than one percent of the vote as an independent in Connecticut's 2010 Senate race). He supports suspending the payroll tax that finances the Social Security trust fund and providing an $8 an hour government job to anyone who wants one to combat the current downturn.

The theory's followers come mainly from a couple of institutions: the University of Missouri-Kansas City's economics department and the Levy Economics Institute of Bard College, both of which have received money from Mosler. But the movement is gaining followers quickly, largely through an explosion of economics blogs. Naked Capitalism, an irreverent and passionately written blog on finance and economics with nearly a million monthly readers, features proponents such as Kelton, fellow Missouri professor L. Randall Wray and Wartberg College professor Scott Fullwiler. So does New Deal 2.0, a wonky economics blog based at the liberal Roosevelt Institute think tank.

Their followers have taken to the theory with great enthusiasm and pile into the comment sections of mainstream economics bloggers when they take on the theory. Wray's work has been picked up by Firedoglake, a major liberal blog, and the New York Times op-ed page. "The crisis helped, but the thing that did it was the blogosphere," Wray says. "Because, for one thing, we could get it published. It's very hard to publish anything that sounds outside the mainstream in the journals."

Most notably, Galbraith has spread the message everywhere from the Daily Beast to Congress. He advised lawmakers including then-House Speaker Nancy Pelosi (D-Calif.) when the financial crisis hit in 2008. Last summer he consulted with a group of House members on the debt ceiling negotiations. He was one of the handful of economists consulted by the Obama administration as it was designing the stimulus package. "I think Jamie has the most to lose by taking this position," Kelton says. "It was, I think, a really brave thing to do, because he has such a big name, and he's so well-respected."

Wray and others say they, too, have consulted with policymakers, and there is a definite sense among the group that the theory's time is now. "Our Web presence, every few months or so it goes up another notch," Fullwiler says.

A divisive theory

The idea that deficit spending can help to bring an economy out of recession is an old one. It was a key point in Keynes's "The General Theory of Employment, Interest and Money." It was the chief rationale for the 2009 stimulus package, and many self-identified Keynesians, such as former White House adviser Christina Romer and economist Paul Krugman, have argued that more is in order. There are, of course, detractors.

A key split among Keynesians dates to the 1930s. One set of economists, including the Nobel laureates John Hicks and Paul Samuelson, sought to incorporate Keynes's insights into classical economics. Hicks built a mathematical model summarizing Keynes's theory, and Samuelson sought to wed Keynesian macroeconomics (which studies the behavior of the economy as a whole) to conventional microeconomics (which looks at how people and businesses allocate resources). This set the stage for most macroeconomic theory since. Even today, "New Keynesians," such as Greg Mankiw, a Harvard economist who served as chief economic adviser to George W. Bush, and Romer's husband, David, are seeking ways to ground Keynesian macroeconomic theory in the micro-level behavior of businesses and consumers.

Modern Monetary theorists hold fast to the tradition established by "post-Keynesians" such as Joan Robinson, Nicholas Kaldor and Hyman Minsky, who insisted Samuelson's theory failed because its models acted as if, in Galbraith's words, "the banking sector doesn't exist."

The connections are personal as well. Wray's doctoral dissertation was advised by Minsky, and Galbraith studied with Robinson and Kaldor at the University of Cambridge. He argues that the theory is part of an "alternative tradition, which runs through Keynes and my father and Minsky."

And while Modern Monetary Theory's proponents take Keynes as their starting point and advocate aggressive deficit spending during recessions, they're not that type of Keynesians. Even mainstream economists who argue for more deficit spending are reluctant to accept the central tenets of Modern Monetary Theory. Take Krugman, who regularly engages economists across the spectrum in spirited debate. He has argued that pursuing large budget deficits during boom times can lead to hyperinflation. Mankiw concedes the theory's point that the government can never run out of money but doesn't think this means what its proponents think it does.

Technically it's true, he says, that the government could print streams of money and never default. The risk is that it could trigger a very high rate of inflation. This would "bankrupt much of the banking system," he says. "Default, painful as it would be, might be a better option."

Mankiw's critique goes to the heart of the debate about Modern Monetary Theory — and about how, when and even whether to eliminate our current deficits.

When the government deficit spends, it issues bonds to be bought on the open market. If its debt load grows too large, mainstream economists say, bond purchasers will demand higher interest rates, and the government will have to pay more in interest payments, which in turn adds to the debt load.

To get out of this cycle, the Fed — which manages the nation's money supply and credit and sits at the center of its financial system — could buy the bonds at lower rates, bypassing the private market. The Fed is prohibited from buying bonds directly from the Treasury — a legal rather than economic constraint. But the Fed would buy the bonds with money it prints, which means the money supply would increase. With it, inflation would rise, and so would the prospects of hyperinflation.

"You can't just fund any level of government that you want from spending money, because you'll get runaway inflation and eventually the rate of inflation will increase faster than the rate that you're extracting resources from the economy," says Karl Smith, an economist at the University of North Carolina. "This is the classic hyperinflation problem that happened in Zimbabwe and the Weimar Republic."

The risk of inflation keeps most mainstream economists and policymakers on the same page about deficits: In the medium term — all else being equal — it's critical to keep them small.

Economists in the Modern Monetary camp concede that deficits can sometimes lead to inflation. But they argue that this can only happen when the economy is at full employment — when all who are able and willing to work are employed and no resources (labor, capital, etc.) are idle. No modern example of this problem comes to mind, Galbraith says.

"The last time we had what could be plausibly called a demand-driven, serious inflation problem was probably World War I," Galbraith says. "It's been a long time since this hypothetical possibility has actually been observed, and it was observed only under conditions that will never be repeated."

Critics' rebuttals

According to Galbraith and the others, monetary policy as currently conducted by the Fed does not work. The Fed generally uses one of two levers to increase growth and employment. It can lower short-term interest rates by buying up short-term government bonds on the open market. If short-term rates are near-zero, as they are now, the Fed can try "quantitative easing," or large-scale purchases of assets (such as bonds) from the private sector including longer-term Treasuries using money the Fed creates. This is what the Fed did in 2008 and 2010, in an emergency effort to boost the economy.

According to Modern Monetary Theory, the Fed buying up Treasuries is just, in Galbraith's words, a "bookkeeping operation" that does not add income to American households and thus cannot be inflationary.

"It seemed clear to me that . . . flooding the economy with money by buying up government bonds . . . is not going to change anybody's behavior," Galbraith says. "They would just end up with cash reserves which would sit idle in the banking system, and that is exactly what in fact happened."

The theorists just "have no idea how quantitative easing works," says Joe Gagnon, an economist at the Peterson Institute who managed the Fed's first round of quantitative easing in 2008. Even if the money the Fed uses to buy bonds stays in bank reserves — or money that's held in reserve — increasing those reserves should still lead to increased borrowing and ripple throughout the system.

Mainstreamers are equally baffled by another claim of the theory: that budget surpluses in and of themselves are bad for the economy. According to Modern Monetary Theory, when the government runs a surplus, it is a net saver, which means that the private sector is a net debtor. The government is, in effect, "taking money from private pockets and forcing them to make that up by going deeper into debt," Galbraith says, reiterating his White House comments.

The mainstream crowd finds this argument as funny now as they did when Galbraith presented it to Clinton. "I have two words to answer that: Australia and Canada," Gagnon says. "If Jamie Galbraith would look them up, he would see immediate proof he's wrong. Australia has had a long-running budget surplus now, they actually have no national debt whatsoever, they're the fastest-growing, healthiest economy in the world." Canada, similarly, has run consistent surpluses while achieving high growth.

To even care about such questions, Galbraith says, marked him as "a considerable eccentric" when he arrived from Cambridge to get a PhD at Yale, which had a more conventionally Keynesian economics department. Galbraith credits Samuelson and his allies' success to a "mass-marketing of economic doctrine, of which Samuelson was the great master . . . which is something the Cambridge school could never have done."

The mainstream economists are loath to give up any ground, even in cases such as the so-called "Cambridge capital controversy" of the 1960s. Samuelson debated post-Keynesians and, by his own admission, lost. Such matters have been, in Galbraith's words, "airbrushed, like Trotsky" from the history of economics.

But MMT's own relationship to real-world cases can be a little hit-or-miss. Mosler, the hedge fund manager, credits his role in the movement to an epiphany in the early 1990s, when markets grew concerned that Italy was about to default. Mosler figured that Italy, which at that time still issued its own currency, the lira, could not default as long as it had the ability to print more liras. He bet accordingly, and when Italy did not default, he made a tidy sum. "There was an enormous amount of money to be made if you could bring yourself around to the idea that they couldn't default," he says.

Later that decade, he learned there was also a lot of money to be lost. When similar fears surfaced about

Russia, he again bet against default. Despite having its own currency, Russia defaulted, forcing Mosler to liquidate one of his funds and wiping out much of his $850 million in investments in the country. Mosler credits this to Russia's fixed exchange rate policy of the time and insists that if it had only acted like a country with its own currency, default could have been avoided.

But the case could also prove what critics insist: Default, while technically always avoidable, is sometimes the best available option.