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The Evolution of Modern Monetary Theory

Student Research Internship Report

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Modern Monetary Theory (MMT) is a concept that seems relatively new when it comes to economic theories. It peaked in popularity in 2019, when Alexandria Ocasio-Cortez supported the use of MMT to fund the Green New Deal. However, MMT has its roots embedded in theories that have stood the test of time, and has been widely discussed in academic circles before the term was officially coined.

Money takes on multiple roles in the economy- it acts as a medium of exchange, a unit of account, a store of value, a delayed form of reciprocal altruism, a mode of payment, etc. Alfred Mitchell-Innes views money as a standard for deferred payment, a debt-relation between two parties, specifically the taxpayer and the government. In Credit Theory of Money, he says that the creation of money is simultaneous to the creation of debt, since the government requires money in order to create money. Each taxpayer acquires a portion of the debt of the government and redeems or cancels it via tax. Thus, according to Mitchell-Innes, the purpose of taxation is redemption of government debt. Moving forward to 1986, Minsky builds on this and compares the creation of money to that of a balance sheet operation, since it is simultaneously an asset to the creditor as well as a liability to the debtor. He argues that the issue lies not in the creation but in the acceptance of money.

In 1924, The State Theory of Money by Friedrich Knapp overhauled the metallist view of money with an opposing theory known as chartalism. According to the metallists, money was a commodity like any other. Money, back in the days, was minted from a precious metal like gold, and had an intrinsic value independent of its use as a currency, which made it a suitable middleman during the barter system, relying on the principle of 'double coincidence of wants'. However, metallists were unable to explain the concept of fiat money (a government issued currency not backed by a commodity like gold, i.e., money as we know it today), and how society at large agreed to commonly accept it as a means of exchange. Knapp says that fiat money is valuable because taxes are paid with it- known as the chartalist view. Payment of taxation links us to Mitchell-Innes view of redemption of government debt. Chartalists believe the government to be the centre for all money creation, since it can authorize any commodity- be it gold, paper, or even stone, to be permitted as legal tender. Due to the very nature of chartalist theory, i.e., its inherent property of viewing money to be accepted by both parties (taxpayer and government), there

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is an automatic creation of a creditor and a debtor. This creation of a debt-relation coincides with Minsky's views of creation of money to be a balance sheet operation.

In 1947, deriving from the works of John Maynard Keynes, principles of effective demand and chartalism, Abba Lerner came up with the heterodox macroeconomic theory of functional financing after World War II. It is an interventionist ideology, advocating for deficit spending to reduce unemployment and most importantly, highlighting that money is a creature of the state. It cannot be self-regulated. The theory promotes the balancing of supply and demand at full employment, rather than balancing the budget. Thus, according to Lerner, the purpose behind taxation is to control consumer spending, not to fund public projects, since any government which has a monopoly on its fiat currency can create as much money as it needs to. The myth that taxpayers' money is required in order for a nation's economy to function was busted.

MMT recognizes any transaction between a government body and a non-government (private) body to be a vertical transaction. It uses the sectoral balances approach laid out by Wynne Godley in 1996. The government has an account with the central bank where it can spend or receive money in the form of taxes. Any deficit in the government budget means there is a surplus in non-government sectors, since money has been deposited into non-government bank accounts. On the contrary, taxation means a surplus in the government account and a deficit in the non-government account.

As we can observe, the formation of the modern monetary theory was inevitable. Since the onset of the 21st century, theories and ideas along the lines of creation of money and taxation had been formulated. In 2008, Bill Mitchell and Joan Muysken officially used the term Modern Monetary Theory to explain how a country having a monopoly on the production of its fiat currency can create money out of thin air in order to fund any projects, without needing to collect taxes. The only obstacle in the way of government spending are labour and raw materials. As we move forward in time, more blogs and books are being published on Modern Monetary Theory, and economists as well as the common man are challenging the notions of government debt and taxation which have prevailed since their onset.

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