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The Applicability Analysis of Modern Monetary Theory System to Government

George Guanghao Luo[1,a,*]

[1]Shanghai American School, Shanghai, China
a. George02px2026@saschina.org
**corresponding author*

Abstract: Modern Monetary Theory (MMT) has become a significant alternative to traditional economic thought, challenging conventional views on fiscal and monetary policy, particularly regarding government debt and deficits. MMT challenges traditional economic frameworks by advocating for the government's sovereign currency-issuing power to achieve full employment and stabilize the economy without necessarily triggering inflation. This paper explores the origins and development of MMT, highlighting key contributions by economists such as L. Randall Wray, Stephanie Kelton, and Warren Mosler. The study examines the application of MMT principles in countries like the United States and Japan, analyzing the outcomes of MMT-like policies during periods of economic crisis. Through a comparative analysis of fiscal and monetary policy, the paper argues that MMT offers a viable framework for achieving economic stability and full employment, though it also raises concerns about inflation and long-term fiscal sustainability. The findings also emphasize the importance of strategic policy integration in a globally interconnected economic landscape. Furthermore, this comprehensive analysis aims to contribute to the broader dialogue on how governments can leverage economic theories like MMT to navigate complex financial environments.

Keywords: Modern Monetary Theory, Fiscal Policy, Monetary Policy, Economic Stability.

1. Introduction

Modern Monetary Theory (MMT) represents a major shift from conventional economic theories, especially in how it handles fiscal and monetary policy. Emerging in the 1990s and championed by economists such as L. Randall Wray, Stephanie Kelton, and Warren Mosler, MMT challenges conventional wisdom that emphasizes the dangers of high government debt and deficits. Instead, MMT posits that sovereign governments, by virtue of issuing their own currency, have the ability to fund public expenditures through money creation without relying on taxation or borrowing, constrained primarily by inflation rather than solvency [1-3]. Over time, MMT has evolved from a niche academic theory into a broader economic school of thought that has gained attention, especially during periods of economic crisis. This paper explores the origins, key proponents, and the practical implications of MMT, focusing on how fiscal and monetary policies are coordinated, the impact on global economic stability, and the response to shocks from uncertainties.

The paper is structured as follows: 1) Introduction to Modern Monetary Theory (MMT), including its origins and key proponents such as L. Randall Wray, Stephanie Kelton, and Warren Mosler. 2)

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Analysis of the practical application of MMT principles in Japan and the United States to examine the effects of MMT-like policies on their economies. 3) Comparative analysis of fiscal and monetary policies, emphasizing MMT's unique perspective on their coordination and effectiveness. 4) Conclusion discussing the implications of these findings for future economic policy and the ongoing debates surrounding MMT.

2. Overview of Modern Monetary Theory

2.1. Origin and History of Modern Monetary Theory

Modern Monetary Theory (MMT) originated in the 1990s, formulated by economists including L. Randall Wray, Stephanie Kelton, and Warren Mosler. They argued that sovereign governments can finance spending through money creation rather than borrowing or taxation, challenging traditional views that emphasize the dangers of high government debt and deficits. Over the past few decades, MMT has gained attention as an alternative approach, particularly during economic crises, as it emphasizes the full use of resources and the minimization of unemployment rather than focusing solely on debt levels.

MMT has evolved from a niche academic concept into a significant economic school of thought that challenges traditional macroeconomic policies. Originating in the early works of economists such as Warren Mosler, who laid the groundwork with his insights in "Soft Currency Economics," MMT argues against conventional views on fiscal policy and monetary operations. This theory fundamentally disputes the need for governments that issue their own currencies to balance their budgets in the same manner like businesses and households. Instead, it suggests that governments can create money to fund public spending and achieve full employment, constrained only by inflation [1, 3].

The theoretical expansion of MMT was significantly advanced by L. Randall Wray and Stephanie Kelton, among others, who have both authored numerous works that articulate and advocate for the principles of MMT. Wray's book, "Understanding Modern Money: The Key to Full Employment and Price Stability," and Kelton's contributions, particularly on the fiscal operations in a sovereign monetary system, have been instrumental in shaping the modern understanding of MMT. These contributions have clarified the role of taxes and bond issuance in managing an economy, emphasizing that a sovereign currency issuer does not operate under the same financial constraints as currency users [4]. Through these scholarly works, MMT offers a fresh perspective on economic policy, especially regarding employment, stability, and growth, challenging entrenched fiscal orthodoxies and suggesting new possibilities for economic governance.

2.2. Key Proponents of Modern Monetary Theory

Modern Monetary Theory (MMT) has several key proponents who have significantly shaped its development and dissemination. This paper summarizes some of the most influential figures in MMT:

L. Randall Wray is a pivotal figure in the development of Modern Monetary Theory, offering deep insights into the nature of money and its relationship with economic policy. His seminal works, such as "Understanding Modern Money: The Key to Full Employment and Price Stability," provide a robust framework for how modern monetary systems operate, advocating for policies aimed at maintaining full employment. Wray's research emphasizes the sovereign capacity of governments to issue currency and manage economies, challenging traditional views on fiscal sustainability and deficit spending [4].

Stephanie Kelton is renowned for her ability to translate the complex ideas of MMT into accessible strategies for economic and social policy. In her influential book, "The Deficit Myth: Modern Monetary Theory and the Birth of the People's Economy," Kelton debunks common misconceptions

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about government deficits and fiscal responsibility, suggesting that a deeper comprehension of modern monetary mechanisms can lead to policies that are more effective and fairer. Her work is crucial for policymakers and laypersons alike, reshaping debates on government spending, taxation, and economic priorities [5].

Warren Mosler stands out in the MMT community for his practitioner's insight into the workings of financial markets and fiscal policy. His book, "Seven Deadly Innocent Frauds of Economic Policy," tackles prevalent economic fallacies from an MMT perspective, offering a compelling argument for reevaluating our approach to economic policy. Mosler's practical experience in finance enriches his academic contributions, making his work particularly valuable for understanding the real-world application of MMT principles [3, 6].

Bill Mitchell's work in Modern Monetary Theory is characterized by a strong focus on the socio-economic implications of monetary and fiscal policies. His co-authored paper, "Full Employment Abandoned: Shifting Sands and Policy Failures," critically examines the decline of full employment as a primary goal in economic policy. Mitchell advocates for the use of sovereign monetary capabilities to address unemployment and social inequities, promoting an MMT framework that aligns economic policy with broader social goals [7].

Scott Fullwiler's contributions to MMT involve a detailed examination of central banking operations and the mechanics of currency use in the economy. His paper, "Modern Central Bank Operations–The General Principles," outlines the operational realities faced by modern central banks under the lens of MMT, illustrating the flexibility central banks have in managing the economy. Fullwiler's analytical approach provides a crucial technical foundation for understanding how monetary policy can be effectively leveraged to achieve macroeconomic stability and growth [8].

Each of these scholars has enriched the discourse around Modern Monetary Theory through their rigorous analysis, practical insights, and policy recommendations, offering diverse perspectives on how governments can harness their monetary systems to foster economic well-being.

3. Countries That Have Applied Modern Monetary Theory and Its Effects on Them

Although no country has officially adopted MMT as its guiding economic framework, several nations have implemented policies that align with MMT principles. Japan and the United States are two prominent examples where fiscal and monetary policies have occasionally reflected MMT ideas, especially in times of economic crisis.

3.1. Japan: A Case Study in MMT-like Practices

Japan is often cited as a country that has applied MMT-like strategies, particularly in response to its prolonged economic stagnation since the early 1990s. Following the collapse of its asset price bubble, Japan pursued aggressive fiscal policies, characterized by high government spending aimed at stimulating growth and combating deflation. The Bank of Japan undertook substantial monetary easing, including almost near-zero interest rates and extensive purchases of government bonds—reminiscent of MMT's call for expansive fiscal measures with a support of a cooperative central bank.

Despite Japan's national debt exceeding 230% of its GDP, inflation has remained low, and the country has not faced a debt crisis. This outcome challenges traditional economic theories that predict high inflation and potential default in the face of such high debt levels. However, Japan's economic growth has been modest, and the country continues to struggle with structural challenges, such as low productivity and aging population. Critics argue that while Japan's policies have prevented a deeper economic downturn, they have not led to robust economic growth, raising questions about the long-term sustainability of MMT-like practices [9].

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3.2. United States: Fiscal Responses to Crises

The United States provides another example of MMT-like policies. During and after the 2008 financial crisis and the COVID-19 pandemic, the United States also implemented MMT-like policies. For instance, in response to the 2008 crisis, the U.S. government enacted substantial fiscal stimulus measures, including the American Recovery and Reinvestment Act (ARRA). This injected a substantial amount of funds into the economy to boost demand and generate employment opportunities. The Federal Reserve implemented unconventional monetary policies, such as quantitative easing (QE), in which the central bank bought large amounts of government securities to reduce interest rates and stimulate economic activity.

During the COVID-19 pandemic, the U.S. government deployed significant fiscal stimulus packages, which encompassed direct payments to citizens, increased unemployment benefits, and aid for businesses. Furthermore, the Federal Reserve increased its balance sheet through the acquisition of government bonds and other securities to sustain liquidity within the financial system. These measures align with MMT's guidance that governments should employ fiscal policy to uphold economic stability and ensure full employment, especially during crises.

The effects of these policies in the U.S. have been inconsistent. On one hand, the strong fiscal and monetary actions helped prevent a more severe economic downturn and facilitated a relatively quick recovery in several industries. On the other hand, these efforts also resulted in a significant increase in national debt, raising concerns about the long-term fiscal well-being of the country. Additionally, the rapid economic recovery, coupled with supply chain disruptions and labor shortages, contributed to the highest inflation rates seen in the U.S. in decades, sparking debates about the risks associated with such expansive fiscal policies [9].

In summary, while elements of MMT have been applied in various contexts, the outcomes have varied, and the long-term impacts continue to be debated. The experiences of countries like Japan and the United States suggest that MMT principles can be effective in preventing economic downturns and promoting recovery, but they also raise important questions about inflation, debt sustainability, and the limits of fiscal policy.

4. Discussion

4.1. Comparison analysis

Fiscal policy and monetary policy represent the primary methods used by governments and central banks to shape a country's economic landscape. While these methods generally support each other, they have separate functions and ways they influence the economy. MMT provides a distinctive viewpoint on the application and efficacy of these policies, questioning conventional economic models.

Fiscal Policy: Fiscal policy entails decisions on government spending and taxation, directly influencing aggregate demand through adjustments in government expenditures or tax modifications. For instance, in a recession, a government could raise infrastructure spending or reduce taxes to stimulate economic growth, leading to job creation and higher consumption. On the other hand, in times of economic overheating, the government may decrease spending or raise taxes to temper the economy and curb inflation.

Under traditional Keynesian economics, fiscal policy is crucial during downturns but is typically constrained by concerns about national debt and budget deficits. The general principle is to run deficits during recessions and surpluses during expansions, thereby managing the economy's cyclical nature.

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Monetary Policy: Monetary policy, overseen by a nation's central bank, mainly focuses on regulating the money supply and interest rates to affect economic conditions. By reducing interest rates, central banks lower the cost of borrowing, which encourages both businesses to invest and consumers to spend, thereby stimulating the economy. Alternatively, increasing interest rates can temper an overheating economy by making borrowing costlier, which in turn slows spending and investment.

Monetary policy is often viewed as a more flexible tool than fiscal policy because it can be adjusted more quickly and is less subject to the political process. Traditional economics often emphasizes monetary policy as the primary means of controlling inflation and stabilizing the economy.

MMT's Perspective on Fiscal and Monetary Policy: MMT places a greater emphasis on fiscal policy over monetary policy as the main mechanism for managing the economy. Advocates of MMT contend that a sovereign nation that prints its own currency is not bound by the same financial limitations as businesses or households [2]. Consequently, they argue that the government should utilize fiscal policy, particularly through government spending, to attain full employment and regulate economic fluctuations.

According to MMT, monetary policy plays a secondary role and is often seen as less effective in stimulating the economy, especially in situations where interest rates are already low. MMT suggests that relying on interest rate cuts to stimulate demand is inefficient compared to direct government spending. This is because lower interest rates might not always result in increased borrowing and investment if businesses and consumers hold a pessimistic outlook on future economic prospects.

MMT elevates fiscal policy to the primary method for managing the economy, advocating for the government to actively utilize its spending power to drive demand and ensure full employment. Monetary policy, while still important, is relegated to a supportive role, mainly focused on maintaining financial stability rather than being the central mechanism for managing economic cycles.

This reorientation challenges the conventional wisdom and raises debates about the sustainability and risks associated with such an approach, particularly concerning inflation and the potential erosion of central bank independence [10].

4.2. Coordination, alignment, and improvement

The interaction between fiscal and monetary policy can be complex, with each policy potentially complementing or counteracting the other [2, 10]. According to Charles Wyplosz in his paper "Fiscal Policy and Monetary Policy: Restoring the Boundaries," effective economic management requires clear boundaries and coordination between these policies. For instance, should a government implement an expansionary fiscal policy (such as increasing spending or reducing taxes) while the central bank enacts a contractionary monetary policy (such as raising interest rates), the policies could neutralize each other's effects, leading to suboptimal outcomes. Wyplosz emphasizes the importance of delineating these roles to avoid such conflicts and ensure that both policies work towards the same economic goals [11].

Coordinating fiscal and monetary policy is crucial, especially during economic crisis, as highlighted in Benjamin M. Friedman's analysis in "Monetary Policy, Fiscal Policy, and the Efficiency of Our Financial System." During the 2008 financial crisis, the simultaneous use of expansionary fiscal policy (through stimulus packages) and accommodative monetary policy (through quantitative easing and low-interest rates) played a pivotal role in stabilizing economies. This coordination helped prevent deeper recessions by ensuring that fiscal stimulus was supported by easy monetary conditions, which amplified its impact on economic recovery. Friedman's work demonstrates that, in times of crisis, the effectiveness of one policy often hinges on the supportive stance of the other [12].

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Improving the coordination between fiscal and monetary policies requires consideration of both immediate economic conditions and the establishment of a framework to promote long-term stability [2, 10]. The paper by Antonio Fatás and Ilian Mihov, "The Macroeconomic Effects of Fiscal Policy," suggests that when these policies are well-aligned, they can mitigate the amplitude of economic cycles, reduce uncertainty, and foster sustainable growth. For instance, maintaining a balanced approach where fiscal policy is countercyclical (i.e., it counteracts the business cycle) and monetary policy is focused on maintaining price stability can lead to more predictable and stable economic environments. By linking these policies through a shared understanding of economic conditions and goals, governments and central banks can enhance their overall effectiveness, reducing the risks of policy conflicts and enhancing the capacity to handle both short-term fluctuations and long-term growth objectives.

4.3. Future outlook

Future monetary policy implementation faces the challenge of adapting to an increasingly complex and interconnected global economy. The principles guiding this evolution must account for the dual objectives of supporting macroeconomic growth and effectively managing global uncertainty shocks. This paper aims to provide valuable insights into how these principles can be developed.

Flexibility and Responsiveness.

One of the fundamental principles for future monetary policy is the need to be more adaptable and responsive to evolving economic conditions. Benjamin M. Friedman’s analysis in "Monetary Policy, Fiscal Policy, and the Efficiency of Our Financial System" emphasizes that monetary policy must be adaptable, particularly in times of financial crises. Central banks must be prepared to deploy a range of tools beyond traditional interest rate adjustments, such as forward guidance and emergency lending facilities as well as quantitative easing. These tools are important for stabilizing financial markets and supporting economic activity during times of great uncertainty. This flexibility is crucial for dealing with the unpredictable nature of global shocks such as financial crises, pandemics, or geopolitical events [12].

Coordination with Fiscal Policy.

Effective future monetary policy requires close coordination with fiscal policy to achieve macroeconomic stability and growth. As highlighted in Charles Wyplosz’s "Fiscal Policy and Monetary Policy: Restoring the Boundaries," the interaction between these two policies can either enhance or undermine their effectiveness. In times of global uncertainty, such as during the COVID-19 pandemic, the coordinated use of expansionary fiscal policies (like stimulus packages) alongside accommodative monetary policies (like asset purchases and low-interest rates) has proven essential for mitigating economic downturns. Moving forward, this coordination should be institutionalized, ensuring that monetary and fiscal policies are aligned and mutually reinforcing, particularly when responding to global shocks [11].

Inflation Management and Expectations.

Managing inflation and anchoring inflation expectations remain critical tasks for future monetary policy, especially in a globalized economy where shocks can quickly spill over across borders. The work by Antonio Fatás and Ilian Mihov on "The Macroeconomic Effects of Fiscal Policy" underscores the importance of a stable macroeconomic environment for sustained growth. Central banks must maintain credibility in their commitment to controlling inflation, even while adopting unconventional policies. This might involve clear communication strategies that guide public and market expectations, ensuring that temporary measures to counteract shocks do not lead to long-term inflationary pressures.

In conclusion, the principles for future monetary policy must be rooted in flexibility, coordination, credible inflation management, and an understanding of global financial dynamics. These principles

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will be critical in guiding central banks as they navigate the challenges of promoting macroeconomic growth while managing the risks posed by an increasingly interconnected and uncertain global economy.

5. Conclusion

Modern Monetary Theory (MMT) offers a transformative perspective on how governments can leverage their fiscal and monetary capabilities to achieve economic stability and growth. As demonstrated by the experiences of countries like Japan and the United States, MMT principles have been informally applied during times of economic crisis, leading to both successes and challenges. While these applications have shown that expansive fiscal policies, supported by accommodating monetary measures, can prevent deeper recessions and promote recovery, they also raise concerns about long-term inflation and debt sustainability. The coordination between fiscal and monetary policy, as emphasized by MMT, is crucial for managing economic cycles effectively, particularly in a globally interconnected economy where uncertainty shocks are increasingly common.

However, the mixed outcomes observed in different contexts underscore the importance of cautious and well-coordinated implementation. Although MMT supports a more prominent role for fiscal policy in promoting economic growth and achieving full employment, it also highlights the need for strong institutional frameworks to manage potential inflationary pressures and maintain economic stability. As global financial systems become more integrated, the principles outlined in MMT and their application must be carefully tailored to address both domestic and international challenges. Moving forward, the debate on the viability and risks associated with MMT will continue to shape the discourse on fiscal and monetary policy, particularly in an era marked by frequent economic disruptions and uncertainties.

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