THE DEFICIT MYTH AND MODERN MONETARY THEORY REVISED: THE CANADIAN VERSION

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Contents

The appendixes are related but not directly tied to my critique of the Deficit Myth and MMT.

Appendix 1- The graph of annual household net savings, federal budget, and current account balance from 2000 to 2017 helps to visualize the relationship between private, government, and the foreign sectors.

Appendix 2- The graph of debt to disposable income from 1990 to 2018 shows Canadians growing private debt burden.

Preface

The Deficit Myth is an apt title and the book dispels many concerns the general public has about federal government deficits. Stephanie Kelton and other Modern Monetary Theorists (MMT) must be given credit for challenging deficit hawks and austerity advocates. They have moved the conversation of deficits to thinking like a deficit owl. Federal deficits can mean that more money is available to the general public. MMT have also proposed a locally oriented job guarantee program for those that want to work funded by the federal government (employer of last resort). They also establish that Government debt is not the same as household debt. Although maybe, the most important contribution MMT has made is opening up a conversation about where money comes from. When people realize that money first comes into existence by simple keystrokes on a computer the next question should be who controls that privilege and who benefits from it.

I was hoping that Stephanie Kelton would clean up some of MMT precepts with the publication of her new book "the Deficit Myth Modern Monetary Theory and the Birth of the People's Economy." Albeit, it remains consistent with Modern Money Theory A Primer on Macroeconomics for Sovereign Monetary Systems 2nd edition. It's ironic that Kelton uses this quote by Mark Twain; "It ain't what you know that gets you into trouble. It's what you know for sure that just ain't so." Unfortunately, this quote directly applies to MMT.

How do you build a false premise? Create an over simplified model and lead people down a path dictated by linear logic. Kelton lays out a path analogous to debunked mainstream economic theories like the Kuznets curve or the Laffer curve just to name a couple, all theories that MMT reject and rightly so.

What is interesting is that you don't need any of MMT descriptive analysis in order to endorse their prescriptive proposals. However, the false assumptions and pretzel logic used to arrive at their conclusions bares closer examination. The following is an analysis of the descriptive rather than the prescriptive aspects of MMT.

Explanatory Note:

The red texts are passages from "the Deficit Myth Modern Monetary Theory and the Birth of the People's Economy" and "Modern Money Theory A Primer on Macroeconomics for Sovereign Monetary Systems 2nd edition. Kindle Edition" that I find objectionable. From Stephanie Kelton's book I will simply give the page number as a reference, for Randall Wray's book a location number. My criticism of MMT and the Deficit Myth will be focused on several precepts made by MMT and Stephanie Kelton, the Implication that all currency in circulation is issued by the federal government, taxes don't pay for anything, taxes create a demand for the currency, Warren Mosler's improbable story, imports are a benefit, exports are a cost, and the national debt poses no financial burden.

1. Is All Currency in Circulation Issued by the Federal Government? No!

Its starts with this absurd statement, MMT radically changes our understanding by recognizing that it is the currency issuer—the federal government itself—not the taxpayer, that finances all government expenditures. Taxes are important for other reasons that I will explain in this book. But the idea that taxes pay for what the government spends is pure fantasy (p. 3). Although Kelton admits that this core idea seems outlandish she asserts that it is descriptively accurate (p. 3).

The confusion starts by completely ignoring the role that privately owned commercial banks play in creating digital money which can be exchanged for currency (paper money) and gives the reader the false impression that the government creates all the money in circulation, which couldn't be further from the truth. Secondly, the premise that government pays for its own expenditures, which leave taxes hanging and grasping for meaning. I will get into the meaning MMT has of taxes later on. The government can fund its own expenditures but most of the time it doesn't.

Currency (paper dollars) is established by the government and the public acceptance of it. It is a convenient medium of exchange that allows commerce to flourish. Of all the things that can be criticized in mainstream neoclassical textbooks this isn't one of them. The definition of money as medium of exchange, store of wealth, and a unit of account are just fine. It is a completely unnecessary intellectual exercise to take it into deeper waters and in terms of the prescriptive aspects of MMT useless. However, if you really want to go back to the dark ages when kings imposed metal money or a currency of some type on the proletariat and then taxed them, go talk to David Graeber or better yet read his book Debt The First 5000 Years which is a great read by the way.

MMT takes as its starting point a simple and incontrovertible fact: our national currency, the US dollar, comes from the US government, and it can't come from anywhere else—at least not legally (p. 17).

This statement implies that all the money in circulation must first be issued by the government which is false. However, does MMT really mean only the federal government issues both digital money and hard currency? MMT must because further arguments suggest that before one can pay taxes the government must issue that money. As a given, the majority of us pay our taxes in digital money both in the US and Canada, more on that later.

The US Constitution grants the federal government the exclusive right to issue the currency.1 As the Federal Reserve Bank of St. Louis put it, the US government is "the sole manufacturer of dollars."2 The term monopoly refers, of course, to a market in which there is only one supplier of some copyright product. Since the federal government is the sole manufacturer of US dollars, we can think of it as having a monopoly over the dollar itself. It's kind of like a being given a super copyright (one that never expires) over the ability to make additional copies of the dollar. It's an exclusive power, articulated by our founders. It's not something households, businesses, or state and local governments can do. Only the federal government can issue our currency. Everyone else is merely a currency user (p. 17-18).

The above statements are only true when referring to banknotes while ignoring digital money and I believe this is the most serious flaw in the MMT descriptive analysis. The majority of the money in circulation in both the US and Canada is digital, which can be converted into hard currency at your local bank. In Canada approximately 97% of all money in circulation was created by privately owned commercial banks through the issuance of loans and the other 3% is hard currency (paper money). The implication that the government creates all the money in circulation leads to S(TAB) government spending currency into the economy followed by taxes and borrowing. Again, the majority of digital money in circulation is created by privately owned commercial banks through the loans process, not the government!

More statements implying the government spends before taxing and borrowing:

S(TAB): spending before taxing and borrowing. By Mosler's reasoning, the government doesn't go around looking for someone else to pick up the TAB, it just spends its currency into existence (p. 23).

It occurred to him that before the government could subtract (debit) any dollars away from us, it must first add (credit) them. He reasoned that spending must have come first, otherwise where would anyone have gotten the dollars they needed to pay the tax (p. 24)?

He began by referring to the US dollar as "a simple public monopoly." Since the US government is the sole source of dollars, it was silly to think of Uncle Sam as needing to get dollars from the rest of us (p. 24).

The implication that the government is the only entity that can produce digital dollars continues to be reinforced. It is the private sector or namely privately owned commercial banks that create the majority of digital money in circulation, not the government!

Workers are paid with digital money that entered the economy from a commercial bank through the issuance of loan somewhere down the line of many transactions (infinite regression if you will, a term used in the book). You might ask where did the commercial bank get the digital money from? The answer is nowhere; they simply typed numbers into a database and thereby created brand new digital money exchangeable with the currency of the land.

In Canada paper money is printed by the Canadian Bank Note Company then sold to the Bank of Canada (BoC). The Bank of Canada then exchanges the banknotes at face value for digital entries into accounts that commercial banks hold with the BoC and enjoys seigniorage in the process.Whenever a loan is issued by a privately owned commercial bank and accepted by a debtor the money supply expands and is not contingent on any funds from the government. In Canada we don't even have reserve requirements and haven't since July of 1994, which means not even hard currency issued by the Bank of Canada is required to leverage loans. Rather capital adequacy requirement ratios are used to backstop the amount of loans that private banks can issue although they do not fully constrain it. https://progressivemoney.ca/money-creation

In fact, as of March 26, 2020, there are no reserve requirements for all depository institutions in the U.S. https://www.federalreserve.gov/monetarypolicy/reservereq.htm . Essentially the US system is the same as ours where banks are required to keep a certain percentage of capital on their books at all times (supposed to). There is an excellent article by John Carney on what really constrains bank lending in the US, albeit the most important aspect of limits to lending is the last highlighted item. In his conclusion, he writes, "But under current procedures, these restraints do not arise from a hard limit on the amount of reserves in the system. They arise from the costs of lending, which is conditioned by (a) the interest rate targeted by the Fed, (b) regulatory and market capital requirements and the market price for bank capital, (c) by back-office administrative and hedging costs of lending, and (d) the credit-worthiness and credit-hungriness of borrowers. https://www.cnbc.com/id/46970418

Further, even when there were reserve requirements, empirical research initiated by Basil Moore (1979, 1983, 1988a, 1997, 2001) and later independently corroborated by numerous researchers, including Kydland and Prescott (1990), confirmed a simple operational observation about how banks actually operate, made in the very early days of the monetarist controversy, by the then senior vice-president of the New York Federal Reserve, Alan Holmes. The 'Money Multiplier' model assumes that banks need excess reserves before they can make loans. The model process is that first deposits are made, creating excess reserves, and then these excess reserves allow loans to be made, which create more deposits. Each new loan reduces the level of excess reserves, and the process stops when this excess has fallen to zero. But in reality, Holmes pointed out, banks create loans first, which simultaneously creates deposits. If the level of loans and deposits then means that banks have insufficient reserves, then they get them afterward – and they have a two-week period in which to do so. In contrast to the Money Multiplier fantasy of bank managers who are unable to lend until they receive more deposits, the real-world practicality of banking was that the time delay between deposits and reserves meant that the direction of causation flowed, not from reserves to loans, but from loans to reserves. *Source: Revised And Expanded Edition Debunking Economics The Naked Emperor Dethroned/Steve Keen/2011/Zen Books Ltd./page #308*

2. Taxes Don't Pay for Anything. Huh?

Are you ready? Your taxes don't actually pay for anything, at least not at the federal level. The government doesn't need our money. We need their money. We've got the whole thing backward (p. 23)! (Who has got what backwards?) Okay, if taxes don't pay for anything what are they for? Warren Mosler says, "It wants to provision itself," (Translation, the government wants to get stuff for itself) he replied. "The tax isn't there to raise money. It's there to get people working and producing things for the government (p. 24)."

Let's break down this nonsensical statement. How does the government get people working and producing things for the government without money? The answer is they can't, implying that the government spends this money into existence before it gains revenue through taxation. Okay, the tax isn't there to raise money, so what is it for? The tax in and of itself somehow gets people working? As you can see, one must employ some heavy duty pretzel logic in order to glean any meaning from the above statement. Kelton continues to use language throughout the book to drive home the false assumption that taxes don't pay for anything.

If the US government buys some bulldozers from Caterpillar Inc. and hires some American workers to build a bridge, dollars will flow into the US private sector bucket as the government makes those payments. American workers and (most) US businesses also pay federal taxes, so Uncle Sam subtracts some of those dollars away from the private sector bucket (p. 132).

Notice the way this statement is worded, instead of saying taxes are used to pay for bulldozers the government pays for them first and then subtracts the taxes. It's analogous to looking at a glass of water and trying to determine if it is half full or half empty. Essentially they are the same thing which kind of makes sense until further examination reveals where taxes come from, us. MMT creates an unnecessary paradox, does government spend first before taxes can be levied or are taxes paid before government can spend. What also adds to the confusion is that the government can spend first if the political will was there to use the money creation process and sometimes does. The reality is that most government expenditures are paid for by revenue collected through taxation. So don't be confused there is no paradox!

The Canadian Government uses (IFRS) International Financial Reporting Standards and stocks and flows can be determined by examining balance sheets of the various financial sectors. Every year the federal government publishes its annual report through the Department of Finance which catalogues all revenues (taxes included) and expenditures.

https://www.canada.ca/en/department-finance/services/publications/annual-financial-report/2019.html

3. Taxes Create a Demand for the Currency

The tax is there to create a demand for the government's currency (p. 25). People go to work in order to survive and thrive and need currency to do that, taxes are the very last thing on their list of priorities. Survival trump's the need to pay taxes even if you might go to jail. The following are some examples that counter MMT assertion that taxes drive money. One is the use of cash in the underground economy, where people use the currency precisely to avoid paying taxes. Two, is the use of local currencies to encourage commerce within a community. An example of a successful local currency from my home province of British Columbia is Salt Spring Island dollars https://saltspringdollars.com/all-about-salt-spring-dollars/. Third, is the introduction of Bitcoin and other cryptocurrencies that can be used to hide wealth and thereby avoid taxes. As Kelton continues attempting to illustrate the point that taxes are there to create a demand for government currency we get Warren Mosler's improbable story.

4. Warren Mosler's Improbable Story

The whole point of his story is to support his assertion that governments must spend currency into existence before it can be taxed S(TAB), thereby creating a demand for it. However, the majority of money (digital) in circulation is not created by the government; it's created by privately owned commercial banks. Taxes are there to create a demand for government currency (p. 26). Rather, digital money which can be converted into currency is used to pay taxes the way most people believe it works, or in MMT parlance (TAB)S.

Warren tells his kids that he will pay them for chores with his business cards. However, the business cards cannot be exchanged for anything. Then he has the epiphany? Did he not realize that the kids would recognize that the cards were worthless? After the epiphany he tells his kids you still don't have to do any chores but takes away the TV privileges, use of the swimming pool, and trips to the mall. In order to access these privileges the kids will now have to do chores to receive the new currency to purchase these privileges which he calls a tax.

Even under a dictatorship this would not be a very reflective model of how taxes are imposed on a population. In the story it isn't mentioned that the kids are already receiving everything they need to thrive in the world, food, shelter, clothing, education, and hopefully Warren's love and it is all free! If he really wanted to replicate the real world his kids would have to do chores for all of the previously mentioned items. In essence, his kids would be his slaves or indentured servants if you will. Working for food, shelter, and clothing, would he still call this a tax?

What if the kids rebelled and decided not to do any chores and create their own currency? The kids get together and decide they are not going to give hugs to their father anymore unless they get to watch TV or are allowed to indulge in any of the other restricted activities. The kids create their currency out of paper and every time they watch TV, use the swimming pool, or go on trips to the mall they give their father a validated signed bill denominated in hugs redeemable upon presentation. Would the kids call this a tax?

Warren Mosler's improbable story as written in Kelton's book:

To illustrate his point, he told me a story about the time he sat his kids down and told them he wanted them to do their part to help keep the place clean and habitable. He wanted the yard mowed, beds made, dishes done, cars washed, and so on. To compensate them for their time, he offered to pay them for their labor. Three of his business cards if they made their beds. Five for doing the dishes. Ten for washing a car and twenty-five for tending to the yard work. Days turned into weeks, and the house became increasingly uninhabitable. The grass grew knee high. Dishes piled up in the sink, and the cars were covered in sand and salt from the ocean breeze. "Why aren't you doing any work?" Mosler asked the kids. "I told you I would pay you some of my business cards to pitch in around here." "D-a-a-a-ad," the kids intoned. "Why would we work for your business cards? They're not worth anything!" That's when Mosler had his epiphany. The kids hadn't done any chores because they didn't need his cards. So, he told the kids he wasn't requiring them to do any work at all. All he wanted was a payment of thirty of his business cards, each month. Failure to pay would result in a loss of privileges. No more TV, use of the swimming pool, or trips to the mall. It was a stroke of genius. Mosler had imposed a "tax" that could only be paid using his own monogrammed paper. Now the cards were worth something. Within hours, the kids were scurrying around, tidying up their bedrooms, the kitchen, and the yard. What was once considered a worthless rectangular calling card was suddenly perceived as a valuable token. But why? How did Mosler get the kids to do all that work without forcing them to do any chores? Simple. He put them in a situation where they needed to earn his "currency" to stay out of trouble. Each time the kids did some work, they got a receipt (some business cards) for the task they had performed. At the end of the month, the kids returned the cards to their father. As Mosler explained, he didn't actually need to collect his own cards back from the kids. "What would I want with my own tokens?" he asked. He had already gotten what he really wanted out of the deal—a tidy house! So why did he bother taxing the cards away from the kids? Why didn't he let them hold on to them as souvenirs? The reason was simple: Mosler collected the cards so the kids would need to earn them again next month. He had invented a virtuous provisioning system! Virtuous in this case means that it keeps repeating (p. 24-26).

5. Imports are a Benefit and Exports are a Cost

In her book Kelton only briefly mentions these assertions. As with other precepts in Stephanie Kelton's book it has its origins in Modern Monetary Theory 2nd edition written by L. Randall Wray. In real terms, exports are a cost and imports are a benefit from the perspective of a nation as a whole. The explanation is simple. When resources, including labor, are used to produce output that is shipped to foreigners, the domestic population does not get to consume that output or use it for further production (in the case of investment goods). The nation bears the cost of producing the output, but does not get the benefit. On the other hand, the importing nation gets the output but did not have to produce it. For this reason, in real terms net exports mean net costs, and net imports mean net benefits MMT (loc. 4652).

After making this statement Wray follows it with a list of caveats softening the assertion from the perspective of the producer, employee, and the nation's interests.

First, from the perspective of the producer of output, it does not matter who buys the produced goods or services; the firm is equally happy selling domestically or to foreign buyers MMT (loc. 4652).

Second, net exports add to aggregate demand and increase measured GDP and national income. Jobs are created to produce goods and services for export. True, labor and other resources that would have been left idle are now employed; workers who would not have received a wage now get income; owners of firms who would not have sold output now receive profits. Yet, if the produced output is sent abroad, there is no extra output for domestic residents to purchase. Further, there can be a "multiplier": the new workers spend wages and producers sell more, generating jobs in the private sector to produce output sold domestically as the economic "pie" grows MMT (loc. 4666).

Another obvious caveat is that producing output for foreigners can be in a nation's economic and political interests for a variety of reasons MMT (loc. 4686).

However, somehow MMT arrives at the conclusion from the perspective of a nation as a whole it is best to pursue full employment at home, and let the current account and budget balances adjust. That is far better than the usual strategy, which is to pursue a trade surplus in order to get to full employment MMT (loc 4701) which I agree with.

Given all the caveats and depending on the time and need of a nation one must ask who objectively considers what is in the nations its best interest? Are exports really a cost? For example, in Canada we are gifted with many natural resources, more than we can consume. By taking advantage of unused natural resources many Canadians consider exports a benefit. Whether imports are a benefit and exports a cost to a nation is purely a subjective exercise. Why speak in absolutes when there is none? Imports and exports can be both a benefit and a cost depending on your perspective.

6. The National Debt Poses no Financial Burden

The national debt poses no financial burden whatsoever (p. 75). This is not true in Canada approx. 7% of our federal taxes are used to service the national debt.
https://www.canada.ca/en/department-finance/services/publications/annual-financial-report/2019.html

However, it is true that we do not need to worry about the actual debt instruments themselves. Currently, the Bank of Japan (BoJ) holds approximately 50 percent of all Japanese government bonds (p. 93) and the Bank of Canada (BoC) is doing the same thing right now. The BoC has created over 375 billion dollars https://progressivemoney.ca/videos-and-updates to purchase government securities through various programs since mid March of this year 2020. Essentially, neutralizing government debt because if the BoJ or the BoC hold these debt instruments to maturity, working as the government's bank they simply write off the debt because it is owed to themselves. This is where most people get confused because they don't understand how government debt is financed and the dual role that central banks play in the process https://progressivemoney.ca/our-national-debt . People in general can only relate to debt based on their own personal experience with it. Household debt must be paid back whereas government debt does not if held by its own central bank.

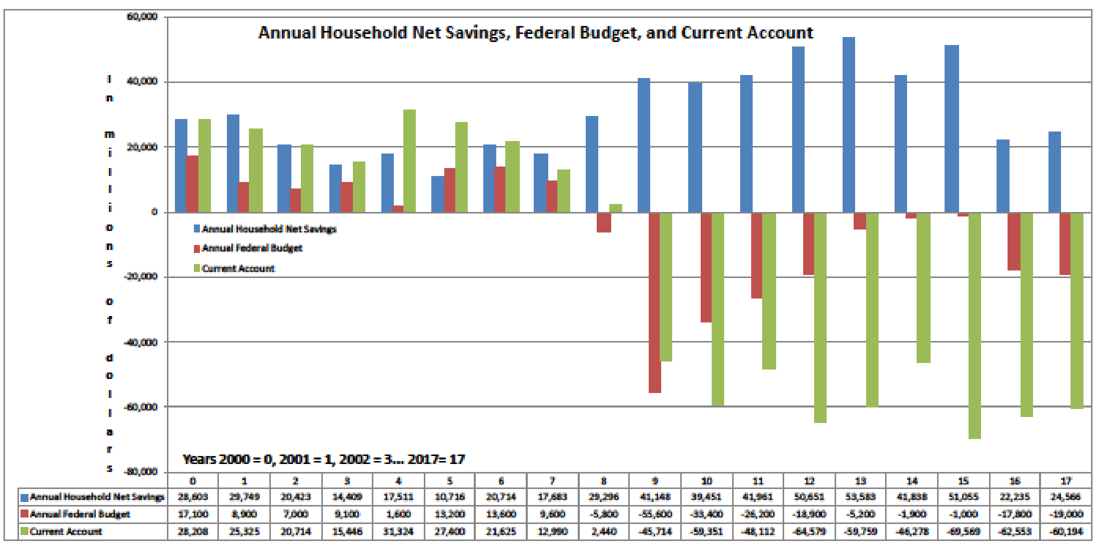
In the book Kelton says that selling bonds are done to support interest rates, not to fund the government (p. 87). When Bonds and Treasury bills are first tendered they do help fund government expenditure. In addition, when securities are bought and sold in overnight trading it's done to support interest rates, so they do both https://progressivemoney.ca/our-central-bank .

Conclusion

The most serious flaw in Stephanie Kelton's book is ignoring the role that commercial banks play in issuing digital money in the currency of the land. Kelton implies that the federal government is the sole issuer of currency both digital and paper. It follows that the government must first spend money into the economy before people can pay taxes or borrowing can occur, in MMT parlance they use the acronym S(TAB). The reality is that digital money is created by commercial banks through the loans process, not the government! Normally taxing and borrowing by government follows (TAB)S. However, if the government had the political will to create money and spend it into the economy it could. MMT analysis leads to another absurd assertion that taxes don't actually pay for anything on the federal level. I have covered what I believe to be the most important blunders, other MMT concepts are less critical in their descriptive analysis. It is my sincere wish that Stephanie Kelton and other MMT reevaluate their descriptive analysis and continue to pursue their prescriptive proposals.

Appendix 1

The graph of annual household net savings, federal budget, and current account balance from 2000 to 2017 helps to visualize the relationship between private, government, and the foreign sectors.



	0	1	2	3	4	5	6	7	8
Annual Household Net Savings	28,603	29,749	20,423	14,409	17,511	10,716	20,714	17,683	29,296
Annual Federal Budget	17,100	8,900	7,000	9,100	1,600	13,200	13,600	9,600	-5,800
Current Account	28,208	25,325	20,714	15,446	31,324	27,400	21,625	12,990	2,440

	9	10	11	12	13	14	15	16	17
Annual Household Net Savings	41,148	39,451	41,961	50,651	53,583	41,838	51,055	22,235	24,566
Annual Federal Budget	-55,600	-33,400	-26,200	-18,900	-5,200	-1,900	-1,000	-17,800	-19,000
Current Account	-45,714	-59,351	-48,112	-64,579	-59,759	-46,278	-69,569	-62,553	-60,194

Data used for graph:

Annual Financial Reports of fiscal years 2000/01 to 2017/18 of the Government of Canada:
https://www.canada.ca/en/department-finance/services/publications/annual-financial-report.html

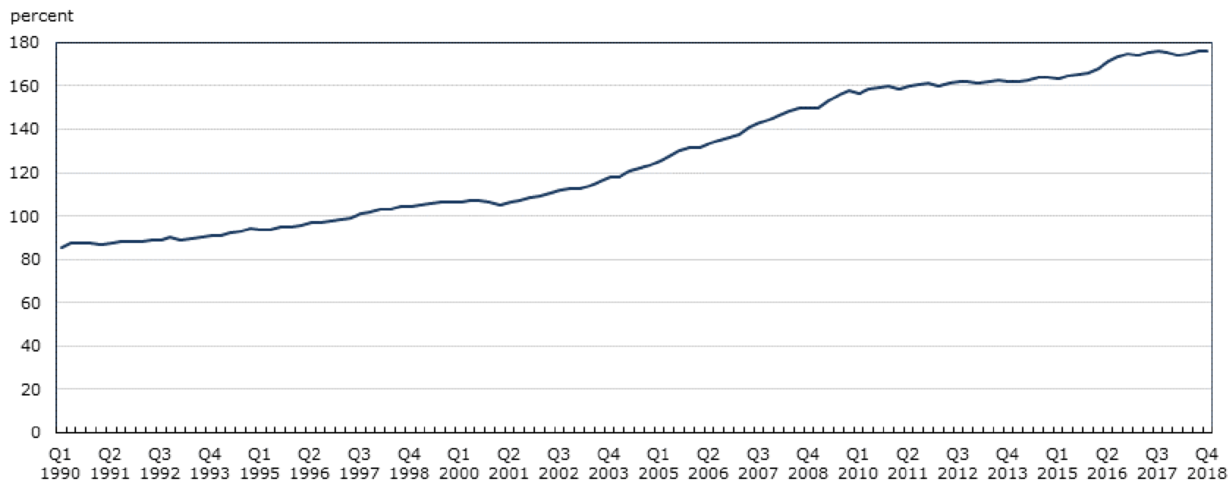
Distributions of household economic accounts, income, consumption and saving, by characteristic. Refer to household net savings, income, consumption and savings, all levels selected https://www150.statcan.gc.ca/t1/tbl1/en/cv.action?pid=3610058701#timeframe

Total current account: https://www150.statcan.gc.ca/t1/tbl1/en/cv.action?pid=3610001401

Appendix 2

The graph of debt to disposable income from 1990 to 2018 shows Canadians growing private debt burden.

Chart 1
Debt-to-disposable income ratio of households, first quarter (Q1) of 1990 to fourth quarter (Q4) of 2018



Source: Statistics Canada, *Table 38-10-0235-01 Financial indicators of households and non profit-institutions serving households, national balance sheet accounts.*