PANOECONOMICUS, 2021, Vol. 68, Issue 3, pp. 405-414
Received: 09 May 2020. Book review

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The Deficit Myth: Modern Monetary Theory and How to Build a Better Economy

by **Stephanie Kelton**

John Murray Publishers, 2020.

According to the title, this book is about a theory (a monetary one) and about a policy proposal (improvement of resource allocation and speeding up economic growth, with perhaps some redistribution). According to Stephane Kelton, the author of the book, it is about widespread myths and the way that these myths can be overcome. It is Modern Monetary Theory (MMT), humbly referred to as a Copernican revolution by the author, that will dispel all these myths. Just for the record, these myths are conventional wisdoms, insights accepted by most academic economists worldwide, all mainstream economists, and virtually all decision-makers, wither elected representatives or civil servants in the central banks and ministries of finance. So, all of them are wrong and MMT and its representatives are right.

Nonetheless, being in the minority, or rather alone, does not necessarily mean that you are wrong. The majority opinion is not necessarily right only because it is held by the majority. After all, Nicolaus Copernicus was (almost) alone when he made the scientific revolution. So, it is necessary to consider the insights of the MMT, the arguments that those insights are based on, and the evidence that supports them to see whether that theory is superior in explaining reality. At the end of the day, the purpose of economic theory is to explain reality, to identify causality relations, and to enable us to understand why people behave the way they do. In line with that purpose, economic theory builds models (these days usually formal ones), based on some working assumptions, carefully checking the internal consistency of these models, and then the findings (theoretical hypotheses) are submitted for rigorous empirical testing, usually by econometric (regression) models. If the reader expects MMT to be something along these lines, he/she would be gravely mistaken.

Instead, Stephany Kelton discloses MMT insights as a batch of six myths that are ostensibly debunked by it. First the individual myth is spelled out and then follows the MMT insight labelled as “reality”. But before the myths and “realities” are considered, the author makes a bold 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. […] the idea that taxes pay for what the government spends is pure fantasy" (p. 11). After that, the reader who is a mainstream academic economist starts to contemplate Flat Earth Theory (FET) as a counterpart of the MMT in some other segments of human creativity. Nonetheless, what is more important is the political collateral to this bold statement. "That's because Congress has the power of the purse. If it really wants to accomplish something, the money can always be made available. If lawmakers wanted to, they could advance legislation – today – aimed at raising living standards and delivering the public investments in education, technology, and resilient infrastructure that are critical for our long-term prosperity. Spending or not spending is a political decision" (p. 13). If the last sentence is true, and that is seemingly the essence of MMT, then there is no way to explain the behaviour of elected officials, as all of them have strong incentive to spend more, as that increases the probability of them being re-elected. There is vast political economy literature on the analysis of the patters elected politicians' propensity to spend, including constitutional economics and election business cycles theory, but there are no findings that elected officials constrain themselves from spending. It would be paradoxical, taking into account re-election incentives. The author is absolutely silent about that: no explanation whatsoever is provided.

If that fundamental paradox is neglected, for the sake of argument, then the MMT should be reviewed by analysing the author's ostensible myth busting exercise. The Myth #1 is that "The federal government should budget like a household" (p. 22). Of course not, according to the author, and the key insight labelled as reality is "Unlike a household, the federal government issues the currency it spends" (p. 22). Of course, the insight that the government with monetary sovereignty issues money is true. Of course, the fiat money of the modern government is not based on any countervalue, such as gold during the time of the gold standard, and there is no compulsory convertibility for that money. Of course, this modern paper money is nothing but a financial instrument (IOU – I owe you) with non-negotiable amount and zero maturity, which the government is free to issue, i.e. "print" the currency however much it likes. These findings are true, trivial, and well known, even beyond academic economists. They are not theory at all, but all of them together do not disqualify the proposition that the government should budget like a household.

If a politician says it should, like Margaret Thatcher did in the statement "We know that there is no such thing as public money. There is only taxpayer money" (p. 26), then the author's response is the question: "Was it an innocent mistake or carefully crafted statement designed to discourage the British people from demanding more from their government?" (p. 26). In other words, anyone that questions MMT wisdom, anyone who does think that the government should budget like household, anyone who subscribes to this normative proposition is either ignorant or a liar. It is just a great academic discourse!

Nonetheless, the book reveals the theoretical foundation of MMT. It is a contribution by Warren Mosler (2012), who is considered by the author to be the father of MMT. The bottom line of the foundation is Mosler's insight about taxes. "The tax isn't there to raise money. It's there to get people working and producing things for the government. […] The tax is there to create a demand for the government's currency. Before anyone can pay the tax, someone had to do the work to earn the currency" (p.

30). And the evidence for this insight is the way Mosler brought up his kids. His way to obtain services from his children (tidying up their bedrooms, the kitchen, and the yard) was to "pay" them in his business cards, a kind of fiat money, without any intrinsic value. The only value these cards have for the kids is that when they are "paid" back to the father, they were allowed to watch TV, use of the swimming pool, or trips to the mall. This story is the theoretical foundation of MMT and its crucial insight that "Taxes are there to create a demand for government currency" (p. 32).

This theoretical underpinning of the MMT is flawed for several reasons. First, from a methodological standpoint, inductive generalisation based on a single case is a cognitive error. Second, Mosler made a mistake in his children's upbringing: one step too many. There was no need for his fiat money, as he had coercion power within the household, and he could have made a straightforward proposal: either you tide up your bedroom or there will be no watching TV tonight. The main feature of the state is its coercion power, the Weberian "monopoly on legitimate use of force". This power has been used to extract value from economic agents under its jurisdiction in different ways throughout history: fiat or any other money was not necessary for various in-kind or labour tributes, or landed gentry covering the costs of military operations with the resources of their private armies[1]. Third, there is no doubt that money has a few more functions than paying taxes: it is a general medium of exchange, unit of account, and store of value, as pointed out by Frederick S. Mishkin (2007). It is quite convincing that these functions of money have been lingering around the market since the beginning of the exchange of commodities and production factors and that money is a typical bottom-up economic institution (Avner Greif 2006). Accordingly, there is no way do unequivocally decide who and for what exact reason created the institution of money. So much for the theoretical underpinning of the MMT.

There is no doubt that a government with monetary sovereignty can issue, i.e. "print" as much currency as it likes, but there is a consequence – inflation. Modern economics, whose insights were instrumental in the reduction of inflation around the world, consider inflation a monetary phenomenon and these considerations are based on the quantitative theory of money – prices are proportional to the money supply. None of that is important for the author as she considers Myth #2 "Deficits are evidence of overspending" (p. 46). Not at all, the reality is "For evidence of overspending, look to inflation" (p. 46). In short, for Stepanie Kelton, inflation is a fiscal phenomenon.

Now, how to deal with it? "The economists behind MMT recognize that there are real limits to spending, and that attempting to push beyond these limits can manifest in excessive inflation. […] In fact, we argue that it is possible to use *true* full employment to help stabilize prices" (p. 62, italics in the original). This is something new to a trained economist: there is no Keynesian trade-off between unemployment and inflation, let alone friction in the labour market, but a win-win situation: both full

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[1] The history of non-monetary tributes to the state/ruler provides empirical evidence against the theoretical hypothesis of chartalism and its leading author Georg Friedrich Knapp (1905) that money was created by the state to enable taxation of economic agents, especially taking into account that fiat money is basically a 20th century invention, with a metallic standard of some kind having previously been the rule in monetary affairs.

employment and stable prices. How on (flat) Earth would that be accomplished? "MMT recommends a federal job guarantee, which creates a nondiscretionary automatic stabilizer that promotes both full employment and price stability" (p. 65). So, that is the magic wand. Good to know.

How does it work, according to Stephanie Kelton? The government announces the wage for anyone who is looking for work but unable to find the employment, and they will be employed in the public sector. When a better opportunity comes around, the worker moves to the private sector for a higher wage. "The idea is to task people with useful work that is valued by the community and to provide compensation for that work in the form of a decent wage and benefit package" (p. 69). Well, the reader can see the rationale for this scheme and how, in principle, it can provide full employment, irrespective of all the misallocation of resources and distortions in the labour market, some of which are demonstrated by Thomas I. Palley (2015). But how on (flat) Earth will the scheme prevent inflation and enable price stability, as specified by the author?

The author steps forward with the new idea – taxation as inflation control. To sum up many pages with long descriptions (because this book is all about descriptions) the idea is that legislators should tax economic agents to control inflation. In short, taxes should be used to sterilize excess money issuing and to control the supply of money. That is possible, according to the quantitative theory of money, but only if tax revenues are used solely to soak up excess liquidity and not for public expenditures. So, it will be two channels of monetary policy: one is issuing currency and increasing money supply, done by the central bank, and the other is taxation and removing money from circulation, done by the legislators. Is this balancing act feasible? Theoretically, yes[2]. There is, however, an extremely low probability that it will be achieved once, an even lower probability that will be performed regularly, at even if it is performed it will be with huge associated costs. The monetary policy is about swift and decisive moves to address the inflationary expectations, that is what is effective. Taxation procedure is time consuming, strongly influenced by political economy, so the decisions will be too late and too little[3]. Furthermore, it is unclear how the trigger inflation rate, the one that would start the withdrawal of liquidity by taxation, would be specified. From another viewpoint, such taxation would inevitably disrupt the financing of long-term projects already approved in the budget (Otmar Issing 2020).

The other issue is that the author believes that inflation occurs only with full employment. "If the government tries to spend too much into an economy that's already running at full speed, inflation will accelerate" (p. 12). The problem is that this belief is not supported by facts. One of these facts is the stagflation in the 1970s, a situation of both high inflation and substantial unemployment. This situation is not

[2] If that happens, if all new money is to be soaked up in taxes to avoid inflation, then, as pointed out by John H. Cochrane (2020), the structure of MMT will be undermined, as the public spending is ultimately paid for with the taxes. Furthermore, inflation is effectively taxation, undermining real purchasing power of economic agents. So, there is a transfer of resources from economic agents to government without proper tax mechanism.

[3] Illustration of than kind of sluggishness is the way how the TARP (Toxic Assets Repurchasing Program) Bill has been processed by the US Congress in the time of the 2008 Great Financial Crisis and unprecedented urgency in the financial history (Ben S. Bernanke, Timothy F. Geithner, and Henry M. Paulson 2019).

mentioned in the book. Nor is monetary stabilisation, which is carried out by independent central banks, focused to price stability. If the historical facts do not fit in the normative story, it seems that the strategy of the author is just to keep them out of the book. The approach is like the Flat Earth Theory: when ships disappear from sight beyond the horizon, just do not mention it. And of course, photographs taken from spacecraft are faked. Earth is flat because it is not curved under my feet. That is enough, both for FET and MMT.

The Myth #3 is about sovereign debt. The myth is that "One way or another, we're all on the hook", and the reality according to the author is: "The national debt poses no financial burden whatsoever" (p. 76). Well, the reader is not surprised by such a way of thinking by the author after the way the two previous myths have been ostensibly debunked. The mechanism is clear. The government with monetary sovereignty, whose debt is nominated in national currency, can print enough money to purchase all the debt financial instruments (primarily bonds) and the debt can be eradicated literally in a day. Yes, that can be done. That is exactly what Weimar Germany did with the hyperinflation its government created in 1923. It was even not the objective of the German government, which was focused to the Ruhr occupation crisis and funding coal miners' wages in the region, but the outcome was the obliteration of the domestic debt (Mark De Broeck and Harold James 2019). Yes, that can easily be done with inflation, devastation of financial assets (bond) issued by the government, ultimately owned by households, and ruined the government's reputation as a borrower in financial markets.

Contemporary academic contributions in the field of debt sustainability (Xavier Debrun et al. 2020) have demonstrated that the burden of debt depends on many things, such as the nation's economic growth rate, the interest rate that the debtor is paying, conditions for funding, i.e. refinancing of the debt, etc. But the bottom line is that if there is a non-negative real interest rate that the government is paying, then there is at least some burden. This is a trivial insight based on common sense, not on sophisticated economic analysis, because there is no need for such. The author refers to Oliver Blanchard (2019) and his analysis that there is no debt crisis in the US and other economies as long as the interest rate (r) is below the GDP growth rate (g), a rather standard condition for debt sustainability. Nonetheless, the future is uncertain, so Blanchard simply points out no one knows what the future will bring regarding the relation between the two variables. But the author emphasises that Blanchard does not recognises "that a government that borrows in its own sovereign currency can always maintain the critical condition for sustainability ($r < g$). It never has to accept a market rate of interest" (p. 90). Nonetheless, this finding is true only in the case that two necessary conditions are fulfilled: (a) that the government borrows exclusively from the central bank; and (b) that the central bank is not independent. But this very case is a blueprint for inflation disaster. Evidence supporting this statement exists both in macroeconomic theory and economic history, such as the Austria-Hungary inflation episode in 1918 and beyond.

Is there any other reason, apart from inflation (which is not a real threat according to MMT economists), why the US government does not buy out all its bonds, all the US Treasury bonds, and eradicate its sovereign debt? The reason, according to author, is that these bonds and open market operations of them enable the US central bank, the Federal Reserves (Fed), to manage the interest rate. Without the US Treasury bonds, "the Fed would need to find some other way to set interest rates" (p. 96). This is simply not true, because a way already exists and it is called discount loans to the banks, i.e. borrowing from the Fed, or borrowed reserves. These loans appear on the liability side of bank's balance sheet and on the asset side as the liquidity they provide as reserves. The interest rate charged to the banks for these loans is at discount rate; it is set by the Fed, and it is a crucial mechanism of monetary policy as it is a basic interest rate, a basic cost of borrowed capital. No market interest rate can be below the discount rate (that would be irrational) and market rates move up and down with it. This is the reason why announcements on the updates of the Fed discount rate make headlines. This is monetary economics 101 and it is missing from a book that is ostensibly about monetary theory. Modern or otherwise.

Myth #4: "Government deficits crowd out private investment, making us poorer" (p. 100), and reality according to the author is that "Fiscal deficits increase our wealth and collective savings" (p. 100), whatever "collective savings" may mean. In this stage of the book the reader is rather bored with all the counterintuitive and unsubstantiated findings of the author, without providing any empirical evidence to support them. Considering the crowding-out myth demonstrates that the basic logic of economics is disregarded in this book – a logic that is deeply based on the concept of alternative allocation of resources and opportunity costs of allocation decisions. It is rather simply and indisputably logical that resources that are used in one way are crowded out from some alternative use. According to the basic macroeconomic accounting balances, in a closed economy the fiscal deficit must be funded by household savings – there is no other way. And also, the savings segment that funds the fiscal deficit cannot be allocated to private investments.

The author tries to convince the reader that the fiscal (government) deficit means nongovernmental surplus. But this finding is true and trivial: macroeconomic balance must be achieved. What is missing are the consequences of this balance. Yes, the aggregate demand and consumption will grow as consumer disposable income increases. So, what?! The crucial question is not about the consumption, but rather about crowding out investments. Investments are funded from savings and if there is a deficit it must be funded from the very same savings, therefore the fiscal deficit crowds out investments. The author refers to William Vickrey, Nobel Prize winner, and his view that well targeted deficit "will generate added disposable income, enhance the demand for the products of industry, and make private investment more profitable" (p. 124), but the problem is there will be no investments, however profitable they may be, as the savings are used to fund the deficit. It crowds out private investments. Period!

There is finally a true myth on the list, Myth #5 "The trade deficit means America is losing". Of course, America is not losing, and the deficit is sustainably funded by America's capital account surplus, but the author soon reintroduces the idea of full employment by introducing federal job guarantee, repeating the bulk of the things already stated in previous chapters. The bottom line is that globalization took jobs from Americans and that the unemployment created this way should be tackled with the previously mentioned guarantee scheme. It seems that the author considers unemployment the main if not the only problem in American society and the evil that must be thoroughly eradicated – zero tolerance towards unemployment. According to the author, referring to "MMT economist" Pavlina Tcherneva (2017), "unemployment resembles an epidemic: like a virus, it affects other people nearby, resulting not only in lost income but higher mortality and suicides rate and permanent decline in well-being" (pp. 133-134). The problem with this reasoning is twofold. First, the unemployment rate in the US is rather low. Before the outbreak of the COVID-19 pandemic it was below 4% and, after the pandemic caused surge to almost 15%, but at the time of writing this review it had dropped to around 6%. Second, unemployment is not permanent, it is temporary – it is not the same 4%, 6% or 15% of the workforce that are unemployed all the time. Some people are fired, some unemployed people find a job, not the same one. So, the basic reasoning of "MMT economist" Tcherneva is flawed: something that is moderate and temporary cannot produce such profound effects like higher mortality and suicide rate. These profound changes have been thoroughly investigated by Anne Case and Agnus Deaton (2020), who, based on the findings of decades long research, demonstrated that it is the quality of the jobs in America and level of the wages that matter, not the unemployment. Low quality jobs have crowed out high quality jobs. Due to globalisation, the US working class lost its high quality, unionised, well-paid jobs in manufacturing to low-quality, frequently temporary, low salary jobs in the service industry, as they cannot get high quality jobs in the service industry due to their low human capital. In short, the full employment by the federal job guarantee, recommended by the author, will not solve the problem of the rising mortality rate and "death of dispair" – because unemployment is not the origin of it. So much for the MMT policy proposals.

The final myth in the book is about entitlements. Myth #6: "'Entitlements' programs like Social Security and Medicare are financially unsustainable. We can't afford them anymore" (p. 155). According to the author, the reality is: "As long as the federal government commits to making the payments, it can always afford to support these programs". Well, this time the reality is – real. As the author points out "These are *federally funded* programs. The money can always be there" (p. 157, italics in the original). This is true. The only problem that is not mentioned in the book is the costs of that funding. Conspicuously, the word "costs" is missing from the book. The readers wonders what kind of economics book it is if costs are almost not mentioned in it.

The last two chapters supposed to be policy oriented. The one under title "The Deficits that Matter" is a shopping list of the troubles/challenges Americans face today, which should be sorted out. These troubles are, for some reason, labelled as deficits. Hence, according to the author, there are: good jobs deficit, savings deficit (actually it is about pensions), healthcare deficit, education deficit, infrastructure deficit, climate deficit (*sic*), and, finally, democracy deficit. All these deficits will be resolved through investments that will be funded, of course, by printing money, only the democracy deficit will be solved by Robin Hood style taxation, which will curb the political power of the rich.

The last chapter, according to the title, is about building a better economy. The reader wonders how that will be achieved. How will we (at least the Americans) step into a new, better world? What does MMT have to offer? According to the author, it is crucial that we ask the right question, and that is where MMT steps in. "It teaches us to ask not 'How will you *pay* for it?' but 'How will you *resource* it?'" (p. 233, italics in the original). Well, in a market economy resource allocation is done by the pricing mechanism and at the end of the day, someone has to pay these prices (p. 233) Hence there is equivalence in those two questions. The question "How will you resource it?", without reference to paying, is a question relevant only for Soviet style allocation of resources – economic planning; in short, a question for Stanislav Gustavovich Strumilin and his Gosplan colleagues. The reader has some doubts whether the author is aware of the implications of the sentences that have been written in the book.

The book that is about MMT vividly demonstrates several things. First and the most important one is that MMT is not a theory. In the words of the author "MMT is … a description of how a modern fiat currency works" (p. 232). A theory is much more than a description. As already pointed out in this review, it is about explanation, about causality and, in economics, about incentives and behaviour. A theory makes hypotheses – prediction that can be empirically tested. MMT produces no predictions, so its findings cannot be empirical tested.

Furthermore, the standard of explication of the MMT theory is far from the minimum academic standard. There is no analysis of causality, there is no coherent logical structure "expressed in a direct, clear way, from head to toe" (Alberto Bisin 2020), just declarations of the "reality" which stands for truth and a notion that everyone who does not agree with the "reality" is either ignorant or a liar. The evidence provided are silly ready-made word processor cartoons. For a trained economist, this is a lamentable reading.

Since this book is not about economics, let alone about economic theory, the question is what is this book about. Bisin (2020) justifiably suggest that the book, as well as MMT, is merely a rhetorical exercise. The evidence for that can be, for example, found in the suggestion that the sovereign debt should not be called debt, because it associates people to the household debt and that makes confusion. "Perhaps we should start by giving it another name" (p. 99). Well, the success of economics as a science is based, among other things, on Popperian methodological nominalism – a convention about the term, so economist can understand each other irrespectively of whether they agree with each other. In the recent academic debates on sovereign debt various arguments have been exchanged, but all participants are debating about the same issue. The rhetoric recommended in this book would ruin that.

Taking that into account, it is hard to believe that this book is aimed at academic economists, trained professionals[4]. So, who is the target audience? At whom is this book directed. A speculation can be made that this book is a contribution in politics. A self-serving paragraph from the beginning of the book, with an unqualified statement from the author, provides some evidence of this[5]. "MMT gives us the power to imagine a new politics and a new economy. It challenges the status quo *across the political spectrum* with sound economics, and that is why it is generating so much interest

[4] There are people who disagree with this view. Hans G. Despain (2020) that this book is a triumph. "Kelton's book archives a revolution in political economy" as her achievement is "Copernican" (p. 5).

[5] There are other self-serving statement in the book like, for example: "I decided the owl would make a good mascot for MMT because people associate owls with wisdom" (p. 76).

around the world from policy makers, academics, central bankers, finance ministers, activist, and ordinary people" (p. 19, italics in the original). Irrespective of whether this statement is true or not, it is "the political spectrum" that is in italic, not academics or central bankers.

One could even go a step further and consider this book as a contribution in populist politics. An easy solution has been suggested; a magic wand for all difficult problems – printing money. As Cochrane (2020) pointed out, this is Magical Monetary Theory. Furthermore, this simple and straightforward solution has not been applied yet because of the elites, who are either ignorant or non-benevolent. For one reason or the other they do not see an obvious solution.

Modern populism is across the political spectrum. What a pity that the people who stormed the US Capitol on 6th January 2021 do not read books, just blogs and text messages. They could have subscribed to the MMT. Why not – this is addressed to them: "With MMT's tools, we can restore full employment and tight labor markets, helping return bargaining clout to workers" (p. 209). And a wild guess would be that most of them believe in the Flat Earth Theory (FET).

Perhaps, the most ironic political slogan in the book is: "We have nothing to lose but our self-imposed constraints" (p. 20). A sad echo of "Workers of the World unite! You have nothing to lose but your chains!" Nonetheless, the reader should not worry much. Most probably, there will not be millions of dead, storming of palaces, civil wars, revolutionary terror, and cultural revolutions. The worst-case scenario would be – printing money, whatever the technical term that will be used. After all, this is the 21st not the 19th century.

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