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A Critical Reappraisal of Modern Monetary Theory

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ABSTRACT

This paper critically evaluates Modern Monetary Theory (MMT), acknowledging its insights into sovereign currency mechanics while exposing fundamental flaws in its theoretical assumptions, institutional analysis, and policy prescriptions. It argues that MMT's core tenets, particularly regarding unlimited deficit spending, the role of taxation, central bank independence, and the dynamics of private credit, are incomplete and often misleading. This paper introduces an alternative framework: the Sovereign Wealth and Thermodynamic Monetary Framework which aims to re-anchor money to tangible assets, emphasize the entropic consequences of unchecked fiat issuance, and propose a more robust approach to monetary governance and sustainable development that is applicable across diverse national contexts.

Keywords: Modern Monetary Theory, Sovereign Wealth Theory, Central Bank Independence, Endogenous Money, Financial Entropy

1. Introduction

Modern Monetary Theory (MMT) has emerged as a significant heterodox macroeconomic theory, challenging conventional views on fiscal and monetary policy that have long dominated economic discourse (Wray, 2015). MMT posits that sovereign governments, by virtue of issuing their own fiat currency, possess the unique ability to fund public expenditures through money creation without facing traditional budgetary constraints, such as the need to "tax before they spend" or to borrow from private markets (Mosler, 2010; Bill, 2011). Proponents argue that the only true constraint on government spending is inflation, which accelerates once the real

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resources of the economy (labor, capital, natural resources) are fully utilized (Kelton, 2020). This perspective has gained considerable appeal, particularly among those seeking solutions to austerity measures and advocating for policies aimed at achieving full employment and public welfare (Mitchell & Mosler 2024).

This paper contends that MMT's theoretical edifice is built upon several fundamental misconceptions and overlooks critical institutional, international, and systemic realities (Palley, 2019). The paper introduces an alternative framework, the Sovereign Wealth and Thermodynamic Monetary Framework, which offers a more grounded and sustainable approach to monetary governance. The proposed framework recognizes the real economic, institutional, and thermodynamic constraints on monetary policy, in order to create a path towards more resilient and globally applicable economic management (Luo, 2024).

2. Discussion

The Illusion of Unlimited Deficit Spending and the Money-Value Disconnect

A cornerstone of MMT is the assertion that a sovereign government, as the issuer of its own fiat currency, can never "run out of money" and can always finance its spending by simply creating new currency, constrained only by the availability of real resources and the risk of inflation (Mosler, 2010). This view implies an almost boundless capacity for government expenditure, suggesting that fiscal deficits are not only sustainable but can be actively used to achieve full employment without traditional financial limitations.

However, a critical distinction must be drawn between "printing money" and "printing value." While a government can indeed technically issue currency, it cannot create real economic value ex nihilo (Drumetz & Pfister, 2021). Money, in its essence, serves as a claim on real goods and services, and its ultimate purchasing power is derived from the productive capacity, labor, and tangible assets of the nation (Fisher, 2006). When government spending is not matched by a corresponding increase in real output or productive capacity, the inevitable consequence is inflation, currency devaluation, and a corrosive loss of public trust in the currency's stability and future purchasing power (Dornbusch et al., 1995). This represents a potential erosion of the fundamental social contract that money embodies, which is a promise of future access to real goods and services (Drumetz & Pfister, 2021). The long-term stability and acceptance of a currency are thus intrinsically tied to the health and productivity of the underlying real economy, rather than simply the government's technical capacity to issue it.

Besides, MMT often treats the government and its central bank as a single, consolidated entity, simplifying their balance sheets and operational interactions. This assumption, while convenient for accounting, fundamentally disregards the institutional and legal separation that exists

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between fiscal (treasury) and monetary (central bank) authorities in virtually all modern economies (Fullwiler, 2017). In practice, governments typically must borrow from either central banks or private financial markets to fund their expenditures. Central banks, far from being mere extensions of the treasury, operate with distinct mandates (Buiter, 2014).

Re-evaluating the Role of Taxes: Debt Transfer, Collateral, and Social Control

MMT posits that the primary function of taxation is not to fund government spending, but rather to manage aggregate demand, control inflation, and create demand for the fiat currency itself. From this perspective, governments are seen to "spend first and tax later."

However, taxes function as a crucial mechanism for transferring government liabilities to the population. When governments incur debt by borrowing from central banks or financial markets through the issuance of bonds, these instruments represent future claims on state revenue (Bell, 2000). Taxes are therefore not merely a tool for price stability; they constitute the fundamental *collateral base* for public borrowing. The state's ability to levy taxes guarantees the solvency of its liabilities, effectively making the productive labor and wealth of its citizens the ultimate asset backing government debt. This means that public debt, when incurred, is ultimately serviced by future taxation, representing a transfer of burden onto the population, often without explicit transparency or accountability.

Secondly, beyond their role in debt transfer, tax revenues provide the government with essential liquid assets, enabling it to meet its obligations without resorting to excessive borrowing or direct money creation (Polackova, 1998). This liquid asset base provides fiscal flexibility and reduces dependence on financial markets. Moreover, taxation plays a vital disciplinary and legitimizing role within the monetary system. Governments demand that taxes be paid in their own unit of account, thereby compelling economic agents to accept, circulate, and value that specific currency. This process acts as a powerful form of sovereign control and ensures the national acceptance and legitimacy of the currency. The act of paying taxes in the national currency links economic activity directly to state legitimacy and the social contract, extending its function far beyond mere inflation control to encompass fundamental power dynamics and intergenerational wealth transfer (Tcherneva, 2016).

Institutional Independence: Central Banks, Treasuries, and the Global Banking Cartel (BIS)

MMT's theoretical framework often assumes a "consolidated government sector," where the central bank and treasury operate as a single, unified entity (Florio, 2019). This simplification, however, obscures the complex institutional realities of global monetary governance.

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In practice, central banks, such as the US Federal Reserve, the European Central Bank (ECB), or the Reserve Bank of India (RBI), operate with significant institutional and operational independence from elected governments (Goodman, 1991). These institutions are entrusted with the critical responsibilities of controlling currency issuance, setting monetary policy, and managing foreign reserves. Their mandates often prioritize financial stability, price stability, and maintaining creditor confidence over direct government spending or broad employment targets. This independence is frequently enshrined in law, as exemplified by India's 1949 RBI Act, which, despite nationalizing the central bank, maintained its operational autonomy (Mohan, 2006).

Crucially, MMT largely underestimates or entirely overlooks the pervasive influence of the Bank for International Settlements (BIS) (Tarullo, 2008). Headquartered in Basel, Switzerland, the BIS functions as a "bank for central banks," playing a pivotal role in coordinating global monetary policy and enforcing international banking standards, such as the Basel norms. Central banks, including the RBI, are members of and, in effect, accountable to the BIS, not solely to their national governments. This accountability profoundly undermines MMT's assumption of unfettered sovereign monetary control. The BIS's influence is instrumental in ensuring central bank independence from national governments and aligning global monetary policy with the broader interests of the international banking cartel (Felsenfeld & Bilali, 2004).

A level of supranational governance that significantly limits national monetary autonomy. The global financial system is not merely a collection of independent sovereign states but a hierarchical network where the BIS, alongside institutions like the IMF and World Bank, exerts substantial influence through technocratic policy recommendations and crisis lending conditions. This cartelized structure means that even nominally nationalized central banks operate within a globally enforced framework that prioritizes monetary orthodoxy and creditor confidence. Consequently, true monetary sovereignty, as conceptualized by MMT, is largely a myth for most nations, as their fiscal and monetary choices are constrained by this global hierarchy, rendering MMT's prescriptions globally inapplicable.

The Primacy of Private Credit and Endogenous Money

MMT primarily focuses on government money creation and public spending as the main drivers of the money supply (Mosler, 2010), often understating or neglecting the dominant and frequently more volatile role of private credit in modern economies.

As extensively demonstrated by post-Keynesian economists such as Steve Keen and Hyman Minsky, commercial banks are the primary creators of money in modern economies (Pettifor, 2017). They create money endogenously when they issue loans, a process that expands the

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money supply independently of government deficits (Keen, 2011). This endogenous money creation is a powerful mechanism for monetary expansion and economic activity.

However, the unchecked expansion of private credit inherently fuels asset bubbles, encourages speculative investment, and ultimately leads to financial crises. The 2008 global financial meltdown serves as a stark example of how an overreliance on private credit can generate systemic instability. MMT fails to adequately integrate endogenous money theory and the inherent risks of debt-driven instability, asset bubbles, and debt cycles into its macro framework. In doing so, it mirrors the same oversight that blinded many mainstream economists and central banks in the lead-up to the 2008 crisis (Meng, 2023). The stability of a modern economy is far more dependent on the prudent management of private credit than MMT acknowledges.

The US Dollar Privilege and MMT's Global Inapplicability

MMT's theoretical framework is heavily predicated on the unique experience of the United States, a country that enjoys what economists term "exorbitant privilege" as the issuer of the world's primary global reserve currency. This unparalleled status grants the US several structural advantages, including the ability to run persistent trade and fiscal deficits without facing immediate balance-of-payments constraints or severe currency depreciation (Lee, 1996). The global demand for US debt and the dollar's role in international trade and finance effectively subsidize US deficits and provide a buffer against inflationary pressures.

This "exorbitant privilege," however, does not extend to the vast majority of other countries. Nations lacking reserve currency status are severely constrained by the need to actively manage foreign exchange reserves, external debt, and import reliance. If these countries were to attempt MMT-style policies of extensive deficit spending, they would face immediate and severe consequences, including rapid currency devaluation, capital flight, and imported inflation due to their dependence on foreign goods and energy. Historical examples vividly illustrate these risks: countries like India, Argentina, and Turkey have experienced severe balance of payments crises when deficits led to capital flight and currency collapse (Calvo, 2000). India's 1991 gold pledge crisis, where it had to physically ship gold to foreign creditors to secure emergency funds (Naylor, 1996), serves as a stark historical reminder that even a large, nominally sovereign nation could not simply "print its way out" of foreign currency obligations; it needed foreign currency, which it could not create domestically.

Furthermore, MMT proponents have claimed that a government can simply offset a trade deficit with public deficit spending to maintain full employment (Mitchell & Mosler, 2024). This argument breaks down in open economies. Trade deficits fundamentally involve a net outflow of real resources such as goods, energy, and capital. Public spending, unless strategically targeted at

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import substitution or increasing productivity for exports, will likely worsen the deficit, drain foreign reserves, and cause further currency devaluation. In many developing nations, essential imports like energy, technology, and food mean that monetizing domestic demand simply raises prices without increasing supply. The geopolitical asymmetry inherent in the global monetary system means that MMT's universal application of its principles ignores this fundamental hierarchy. For non-reserve currency nations, deficit spending without real economic backing directly impacts foreign exchange reserves, leads to imported inflation, and can trigger capital flight. Consequently, MMT's policy prescriptions, if adopted by most countries, would likely lead to severe economic instability, currency crises, and increased external dependency, rather than the promised full employment and prosperity.

Misunderstanding Inflation Dynamics

MMT's approach to inflation often assumes a relatively straightforward dynamic: inflation arises when aggregate demand exceeds the economy's real productive capacity, and it can be easily managed through fiscal tools like taxes or spending cuts. This perspective primarily focuses on demand-pull inflation.

However, inflation in modern, globally interconnected economies is a far more complex phenomenon driven by a broader set of factors not solely related to demand. These include significant supply-side shocks, such as sudden spikes in oil prices or disruptions in global supply chains (as vividly demonstrated during the COVID-era pandemic), speculative bubbles in asset markets, and energy crises (Stiglitz et al., 2022). The 1970s stagflation, characterized by high inflation and high unemployment, and recent supply shocks, are clear examples where demand suppression alone proved inadequate to curb inflationary pressures.

Moreover, in many nations, particularly those heavily reliant on imports, currency depreciation directly triggers cost-push inflation. This is especially true for essential goods like energy, food, and industrial inputs, whose prices rise in local currency terms as the domestic currency weakens. Deficit spending under such conditions would exacerbate inflation rather than benignly fostering employment. MMT's toolkit for inflation management is thus too narrow, potentially leading to ineffective or even counterproductive policies in the face of non-demand-driven inflationary pressures.

Bonds, Reserves, and the Mechanics of Money Creation

In practice, governments do not directly "print" money and inject it into the economy. Instead, they typically hold accounts at the central bank, and *all expenditures must be settled through those accounts*. Therefore, for the treasury to spend, it must either (a) have sufficient reserves already in its central bank account, or (b) acquire those reserves by borrowing from the banking

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system (primarily via bond sales) *prior* to initiating expenditure. This sequence is critical: spending requires prior access to reserves.

When the government issues bonds, these are purchased by various entities. While the central bank *can* purchase government debt, it generally does *not* buy new government debt directly from the treasury in primary auctions under normal conditions. When central banks do acquire government bonds through quantitative easing programs, it is typically *after* the fact, through open market operations (OMOs) in secondary markets. OMOs are designed to manage system liquidity and control short-term interest rates by buying or selling *existing* securities. This mechanism is distinct from direct fiscal monetization.

A significant and growing portion of government bonds is purchased by the "non-bank public," which includes a diverse range of Non-Bank Financial Institutions (NBFIs) such as asset managers, insurance companies, broker-dealers, and hedge funds. These entities represent a massive and increasingly influential pool of capital that actively participates in government bond markets. Their involvement further complicates the MMT narrative of direct government money creation, demonstrating that government borrowing is intermediated through a broad and complex financial market, not solely through the central bank.

The balance sheet effects of these transactions are also crucial. When private banks purchase government bonds, it is primarily an asset swap on their balance sheets (a decrease in reserves is offset by an increase in bond holdings). When the government subsequently spends, reserves increase at the recipient's bank, and deposits increase for the payee. Crucially, the overall money supply (deposits) increases *only if commercial banks create new deposits* through their lending or asset swap activities, not simply because the government has spent. This highlights that the expansion of the broader money supply is largely a *private sector-driven mechanism*, a point consistently underweighted by MMT.

The Sovereign Wealth and Thermodynamic Monetary Framework

Our Sovereign Wealth and Thermodynamic Monetary Framework argues that while money is indeed a legal and institutional construct, it cannot function sustainably without being explicitly anchored to *real assets*, national productive capacity, and the genuine sovereignty of its people.

Money should be issued by the State and not the Central Bank. Monetary issuance must be explicitly linked to tangible value and real resources. This includes a nation's labor force, land, energy reserves, productive capacity, and even its cultural heritage. The creation of fiat money without a corresponding increase in such real backing introduces "monetary entropy" as a measure of disorder and potential instability within the financial system. Consequently, governments should issue currency only against measurable productive capacity or verifiable

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sovereign collateral, ensuring that money reflects embedded productive value rather than speculative issuance.

A broader definition of economic value is required moving beyond the narrow confines of Gross Domestic Product (GDP). True national wealth and economic well-being extend to human development indicators such as education, health, knowledge, and ecological integrity.

Monetary Energy and Entropy: Understanding Systemic Disorder and Financial Collapse

Within this framework, "monetary energy" refers to the system's capacity to mobilize resources, both real and financial, through flows of credit, taxes, and government spending. Conversely, "monetary entropy" is introduced as a measure of disorder, complexity, and distributional variance within the financial system. It quantifies the number of ways financial assets and liabilities can be arranged across economic agents.

Credit creation, a primary driver of economic activity, simultaneously acts as an entropy amplifier. It enables a greater number of transactions, generates increasingly complex balance-sheet combinations, and can encourage speculative behavior, thereby expanding the potential configurations of the system. When the rate of credit creation outpaces the economy's capacity for repayment or real output, monetary entropy rises, increasing systemic fragility. This dynamic can be formalized through an entropy equation: $dS(t)/dt = \alpha C(t) - \beta\delta(t)$, where α represents the entropy increase coefficient from credit creation, $C(t)$ is the rate of credit issuance, β is the entropy compression factor from defaults or wealth concentration, and $\delta(t)$ is the default rate. This model suggests that maximum entropy precedes systemic fragility, and financial collapse often follows periods of excessive complexity. This mirrors the lead-up to the 2008 global financial crisis, where excessive credit generated high-leverage structures and systemic fragility, culminating in massive deleveraging and a collapse of monetary entropy.

MMT, by assuming that government spending benignly adds "net financial assets," overlooks the entropic consequences of each new unit of fiat money or credit. Each new unit increases configuration complexity and requires future servicing (via taxation or inflation). Crucially, the increase in monetary entropy is not easily reversible. When defaults rise, or liquidity dries up, the system does not smoothly revert to a previous stable state. Instead, it enters a "phase transition," akin to a liquidity trap or debt deflation, where market participants hoard cash, monetary velocity collapses, asset values fall, and the system enters a rigid, low-entropy, low-mobility regime. This phenomenon has historical precedents, such as Japan's "lost decades".

The framework also draws upon the Second Law of Thermodynamics, which dictates that energy conversion always involves some dissipation. Applied to money, this means that fiat issuance without real asset or labor backing introduces financial entropy but does not guarantee value

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creation; it may instead cause misallocation of capital, speculative booms, and ultimately, value destruction. Thus, fiat money behaves not like a frictionless public utility, but like a "high-entropy fuel" since it powers the system temporarily but leaves behind systemic disorder and rising instability unless carefully managed within real resource constraints. The Third Monetary Law, a concept within this framework, posits that as economic activity approaches zero, entropy collapses, leading to liquidity traps, zero velocity, and mounting defaults. This provides a robust theoretical basis for understanding why financial systems are inherently unstable if credit is not managed within real resource and entropic constraints. It shifts the policy focus from merely managing demand to actively managing systemic complexity and preventing entropic overload, making it crucial for financial stability.

Table 1 illustrates the core analogies between thermodynamic concepts and their monetary counterparts, making the abstract concept of "monetary entropy" more concrete and understandable.

Table 1: Thermodynamic Concept to Monetary Analogy

Thermodynamic Concept	Monetary Analogy
Energy (Q)	Credit and government spending
Work (W)	Productive investment or asset creation
Internal Energy (U)	Aggregate liquidity and monetary base
Heat Loss / Waste	Interest payments, defaults, deadweight losses
Entropy (S)	Financial disorder, inequality, instability
Temperature (T)	Monetary velocity or credit activity
Closed system	Autarkic or constrained economy
Open system	Real-world economy with debt, trade, institutions

From Fiat Abstraction to Asset-Backed Currencies

True monetary sovereignty requires a currency backed not just by legal fiat, but by *tangible national wealth*. This means a nation's currency strength and its ability to act autonomously are directly tied to its control over real resources and its capacity to generate value, not just its ability to print money.

This framework calls for a shift towards asset-anchored currencies. A key policy mechanism proposed is the **National Resource-Backed Currency (NRBC)**, where currency issuance is indexed to a dynamic basket of national assets, such as mineral reserves, arable land, energy capacity, and labor productivity. This ensures that money reflects embedded productive value

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and reduces vulnerability to foreign exchange shocks. Such proposals align with contemporary academic and geopolitical discussions around asset-backed digital currencies and resource-based common currencies, particularly in the context of de-dollarization efforts. The detailed mechanism of a commodity currency board, where banknotes are issued against warehouse certificates guaranteeing physical resource availability, provides a concrete example of how this can be implemented with transparency.

We also propose the establishment of a **Sovereign Monetary Treasury (SMT)**. This restructured institution would be responsible for issuing currency *directly*, bypassing traditional bond markets or central bank operations, but guided by strict rules of value-backing, public investment benchmarks, and thermodynamic risk limits. This material basis of national power encourages policies that foster internal resource mobilization and real wealth creation as the ultimate foundation for monetary stability and independence. It suggests that national power and economic resilience are built upon tangible assets and productive capacity, and not merely financial abstractions.

Policy Implications and the Path Forward

Intervention is necessary to:

- **Prevent Entropic Collapse:** Large-scale government spending and liquidity injections are vital to prevent a complete freeze of economic activity and a further rise in defaults. This is not about arbitrary money creation but about restoring monetary "energy" to a system that has entered a low-energy, low-entropy state, thereby preventing a deeper, irreversible systemic breakdown.

- **Re-anchor Value:** Unlike MMT, which might imply broad-based spending, this framework emphasizes directing crisis spending strategically towards real asset creation, critical infrastructure, and human capital development. This re-anchors the currency to tangible value and productive capacity, preventing the intervention from merely inflating financial assets or exacerbating speculative bubbles.

- **Fulfill the Social Contract:** The state's intervention is also a fulfillment of its fundamental social contract, mitigating widespread human suffering and maintaining societal cohesion during periods of extreme economic distress. This leverages the state's unique position as the ultimate guarantor of the currency's value, which is ultimately backed by the future labor and assets of society.

- **Strategic Debt Restructuring and Entropy Management:** Crisis interventions should not simply expand debt indiscriminately. Instead, they must include active strategies for

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debt restructuring and entropy management, distinguishing between productive credit that facilitates real economic activity and parasitic credit that fuels speculative excess.

Future research directions should focus on empirically testing the proposed entropy metrics in various financial systems, developing detailed economic models for National Resource-Backed Currencies, and exploring the institutional pathways for central bank reform that balance independence with democratic accountability. By moving beyond the abstractions of MMT and embracing a more grounded understanding of money and value, policymakers can foster more stable and sustainable economic futures.

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