*The Empirical and Institutional Limits of Modern Money Theory*

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*Abstract*

Modern Money Theory (MMT) economists acknowledge a number of empirical and institutional limitations on the applicability of MMT to macroeconomic policy, but they have not attempted to explore these empirically nor have they adequately addressed their implications for MMT’s main macroeconomic policy proposals. This paper identifies some of these important limitations, including those stemming from modern international financial markets, and argues that they are much more binding on the policy applicability of MMT than many of MMT’s advocates appear to recognize.

JEL Codes: E58; E61; E62; F42

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*Introduction*

Modern Money Theory (MMT) has recently gained a significant amount of attention. This has stemmed largely from the “shout-outs” it has received from prominent progressive politicians such as Alexandria Ocasio-Cortez. MMT’s recent appearances in the news and social media have also drawn a variety of criticisms from economists of various stripes. Though much of the previous debate about MMT has concentrated on theoretical and doctrinal issues, less seriously discussed have been those MMT monetary and fiscal policy proposals that have attracted the attention of progressive politicians and activists.[[2]](#footnote-2)

The recent appeal of MMT is understandable. For almost forty years, neo-liberal economic theory and policy has dominated macroeconomic policy with its focus on balanced budgets, austerity and the elevation of “independent central banks” to focus on inflation to the virtual exclusion of all other goals, including full employment­. (e.g. Epstein and Yeldan 2009; Pollin 2003). In this world, neo-liberal economics was used as a justification for macroeconomic policies that tolerated high unemployment, and government budgets that starved important public investments and social programs for the poor and working class. Mainstream Democrats in the US and similar politicians in Europe and elsewhere also adopted this approach, with devastating results on our economies and the livelihoods of many people (Blyth 2013). Austerity for the working class and riches for the rich also helped to fuel the rise of the right in the US, Europe and elsewhere.

MMT theorists were not the first or only economists to criticize neo-liberal austerity economics. Keynesian and heterodox economists more generally have been pushing back against this cynical and destructive policy and ideology for decades (See the articles, for example in Dymski, Epstein and Pollin 1993; Palley various; Blyth 2013; Galbraith 2012). But, MMT has gained many adherents by putting this anti-austerity argument on a whole new plane by claiming that, in principle, government spending never has to be paid for and is typically implemented by a mere stroke of the monetary pen. This way, MMT has recently been able to capture a large amount of attention in the progressive debate. Naturally, along with this positive attention, MMT has come in for a good deal of criticism from some economists including from prominent heterodox economics.[[3]](#footnote-3) This debate is for the most part a healthy one, as new ideas must be vetted thoroughly, especially if they are going to guide public policy.

Here I focus on the monetary and fiscal policy recommendations promulgated by MMT advocates.[[4]](#footnote-4) Roughly speaking, as developed by Randall Wray, Stephanie Kelton and others, MMT’s macroeconomic approach amounts to Abba Lerner’s “functional finance” approach with a twist of “sovereign money” and “debt monetization” (Lerner 1943). For them, the main goal of fiscal and monetary policy is to maintain full employment without (excessive) inflation. Their point about sovereign money is that governments do not need to save or levy taxes to “pay for” goods and services because all they need to do is print their sovereign currencies and use this money to acquire them. In fact, when the central bank and the treasury are institutionally connected, this money payment happens automatically, according to MMT. But, in the case of the U.S., and other countries, as Lavoie (2013) points out, these policies are not automatic but amount to deliberate decisions by the Federal Reserve to monetize Treasury debt since the Federal Reserve charter prohibits the Fed from directly lending to the U.S. government.

What then is the role of monetary and fiscal policy? The “functional finance” claim is that the role of “taxes” and “borrowing” should be to drain spending from the economy when necessary to prevent excessive inflation, not to “finance” spending, per se. MMT advocates add that the proper target of monetary policy should be to keep interest rates very low in the long run, (even zero) while fiscal policy should be adjusted when necessary to maintain full employment and moderate inflation. According to MMT, any level of sovereign debt is sustainable in the narrow sense that the issuers of sovereign money will never need to default on its debt; they just need to print more money to service and even repay the debt if necessary.

There are obvious questions about the viability of MMT macro policies: what would be their impacts on inflation, exchange rate instability, interest rates, financial instability, investment and economic growth? What, ultimately, are the limits and constraints on MMT macro policy? How broadly, if at all, do these views apply across the world and over time?

My conclusion is that, when one takes into account substantial empirical and institutional literature that has studied these issues, the applicability of MMT policy proposals appears to be more limited than its advocates recognize.

To start, even though MMT advocates claim that its macroeconomic framework applies to all countries with “sovereign currencies”, there is significant evidence that it does not apply to the vast majority of such countries in the developing world that are integrated into modern global financial markets. As is well-known, in the modern world, these countries are subject to the vagaries of international capital flows, including “sudden-stops”. The problem is that, in light of these flows, these countries have limited fiscal and monetary policy space, surely insufficient to conduct MMT prescribed monetary and fiscal policies for full employment. Wray argues that that flexible exchange rates would provide sufficient policy space for these countries to undertake MMT macro-policies. Occasionally he briefly mentions capital controls but these are not seriously discussed as a complementary policy.[[5]](#footnote-5) But, I argue that a careful survey of the empirical evidence casts grave doubts on the effectiveness of flexible rates for giving policy autonomy or insulating these countries from the vagaries of global financial flows. This problem is worse for countries that cannot borrow in their own currencies, but it also applies to small open countries that are able to borrow in their own currencies. The upshot is that the number of countries to whom MMT might apply is quite limited, likely, only countries that issue their own internationally accepted currency.

Even for those countries that issue their own international currencies, the sustainability and “exploitability” of the international role is not absolute. The country that has the greatest fiscal and monetary space is the United States, which issues the predominant key currency, the US dollar. Whereas Wray has written that the predominance of the dollar is not something we will need to worry about in our lifetime, historical and empirical evidence suggests that key currency positions usually weaken over time, perhaps even rapidly and dramatically.[[6]](#footnote-6) This is especially true when there are competing currencies with both a “will” and a “way” to achieve key currency status. China (and to a lesser extent, the Euro zone) are competitors in this sense. Despite the current strength of the US dollar, there is nonetheless significant evidence of a move to a multi-currency system in which dollar holders can more easily switch out of the dollar if perceived significant, problems arise, such as high exchange rate instability, excessive inflation, or default threats. In such a world, the ability of the US government to exploit the dollar’s “exorbitant privilege” to sustain very large debt levels or sustained low interest rates has limits. To be sure, these limits are uncertain, but history suggests that the US cannot completely ignore them, even in “our” lifetime.

But even if the dollar’s role continues indefinitely thereby creating space to implement MMT macro-policies, that doesn’t mean that the US should actually do so. The MMT proposed policy amounts to an “America First” macroeconomic policy. While it is traditional for the US (and other countries) to ignore the impacts of their macroeconomic policies on the rest of the world, presumably a progressive approach to policy would adopt a more internationalist perspective. There is significant evidence that there are substantial spillover effects of US monetary policy on emerging market and developing countries that are transmitted largely through the dollar’s predominant international role. These spillover effects can be highly destabilizing if the Federal Reserve pursues excessively loose or tight monetary policy without any consideration of their impacts on developing countries. For example, as Jane D’Arista (2019) shows, the low interest rates of the Greenspan era helped to generate dangerous levels of dollar denominated leverage in emerging markets which contributed to the spread of financial crisis in 2007-2008. A more internationalist, progressive approach to macroeconomic would take these impacts into account. At a minimum, to address these impacts, MMT analysts would have to evaluate institutional arrangements such as capital controls, and financial regulations to mitigate these negative impacts. With few exceptions, these receive at most only a cursory mention in their work.[[7]](#footnote-7)

MMT advocates might argue that their proposed low US interest rates and expansionary fiscal policy would facilitate growth in developing countries by reducing the cost of capital for these countries and generating more export demand, so that the spill-overs would be good, not bad. While there might be some truth to this, by itself, this claim ignores the highly speculative nature of modern international financial markets. A careful analysis of the impact of low, long term interest rates shows that in the absence of strong financial regulations domestically and internationally, the impact is likely to be the accumulation of high leverage, asset bubbles and financial instability. Yet MMT theorists talk very little in the context of their proposed macroeconomic policies about the necessary role of financial regulations and capital account regulations in channeling funds productively and limiting financial crises. In short, this relative lack of attention to financial instability and financial regulation in the context of their proposed monetary and fiscal policy is a key example of their relative inattention to institutional and empirical constraints on the macroeconomic policies they propose.

As I mentioned earlier, much of MMT’s policy appeal stems from the strong perception that MMT implies that progressives with programmatic plans do not need to discuss the costs of these programs or how they are going to be “paid for”. But even within the framework of MMT itself, this claim of a free lunch is incorrect. Recall that MMT theorists recognize that at or around full employment, further economic expansion could lead to an increase in inflation and if this fiscal and monetary expansion were pushed too far, inflation could accelerate. In this world, at full employment, MMT theorists argue that the government would have to raise taxes or cut private or other public spending in order to make room for new fiscal initiatives. This is no free lunch. Yet, MMT advocates have not emphasized this point in a systematic way to their would-be followers. I believe this presents a serious danger to progressive politicians and policy advocates.[[8]](#footnote-8)

In what follows, I elaborate on several of these points, focusing on the international points related to developing countries. For a broader critique and more details, please see my book, *What’s Wrong With Modern Money Theory; A Policy Critique* (Palgrave, 2019).

*MMT Policy is Relevant, at best, to Only a Few Countries: Those with Significant International Currencies*

MMT advocates argue that MMT style policy applies to any country with a sovereign currency, though they acknowledge that small open economy countries from the Global South might have less policy space generally than large rich countries (see, for example, Wray 2012, chap. 3, 5, and 6). Wray argues, furthermore, that the key to MMT policy in smaller or poorer countries with sovereign currencies is to operate a flexible exchange rate. (see, for example, Wray 2012: 129 and chap. 6).

Unfortunately, these claims do not appear to be backed up by rigorous empirical work.[[9]](#footnote-9) The empirical work suggests that contrary to MMT claims, many economies with sovereign currencies are forced to stop well short of full employment because of financial speculation and “sudden stops” of capital from international capital markets. This is true in regimes of both fixed and flexible exchange rates. These results strongly suggest that, to the extent that MMT theory applies, it applies only to countries that issue important international currencies. A broader literature, which I will briefly discuss toward the end of this section, do address how non-key currency countries can enhance their policy spaces, but this requires a set of institutional innovations such as broader central bank policies, capital management techniques, and other policies.[[10]](#footnote-10) While heterodox economists have studied these institutional constraints and institutional alternatives for decades, as far as I know, the only MMT advocate who has looked at these issues carefully is William Mitchell. In my view, if MMT is going to be relevant to developing countries, then these issues need to be put more firmly on their research agendas.

*Sudden Stops and Speculative Exchange Rate Crises Even before the Time of Emerging Markets*

*Crises*

Countries with open capital markets are subject to hot money inflows and outflows, surges and “sudden stops”. (See, for example, Akyuz 2017). Surges, or “hot money inflows” are associated with increased liabilities on the balance sheets of local borrowers, instability in exchange rates, and difficulties managing liquidity conditions. Such inflows can often lead to over-valued exchange rates, current account deficits, and then rapid capital outflows and sudden-stops, leaving local financial institutions and businesses with debts that are hard to service and repay (see Taylor 1991, Chapter 6 for a classic model of this cycle).

These problems are exacerbated for countries that are not able to borrow internationally in their own currencies.[[11]](#footnote-11) MMT theorists would say that these countries do not have fully sovereign currencies. Yet, many of the same problems beset developing countries that can borrow in their own currencies. In both cases, when capital flies out and the exchange rate depreciates, the local value of international debt increases, making it difficult for institutions in these countries to service their debts. Such excessive debts can have damaging impacts on investment, productivity and employment. It can also lead to bankruptcies. Note that many of these countries are those with sovereign currencies.

There is substantial empirical evidence in support of these channels and problems. Eichengreen, Hausmann and Panizza (2003: 16) demonstrate that developing countries are much more volatile in their capacity to service their debt compared to advanced countries. If a country's debt is denominated, let us say in US dollars, its capacity to service its debt will depend on the value of its GDP in US dollars. Given the volatility of exchange rates, which is typically between 2 to 3 times higher in developing countries, a typical developing country with these constraints would face volatility of around 13 percent whereas a developed country without them would face volatility of around 2.7 percent per annum. Eichengreen, Hausmann and Panizza further argue that the volatility of the real exchange rate is a concern not only for short-term debt. The authors show that the volatility of movements in the five-year moving average of the real multilateral exchange rate is also very high; indeed, it moves for more than 60 percent in an average developing country. Hausmann (2003), on the other hand, shows that countries unable to borrow in their own currencies have lower evaluations of solvency as it intensifies the dependence of debt service on the movements of the exchange rate, which may be subject to crises and crashes due to its volatility. Further empirical evidence on the ability to borrow abroad in local currency is presented by Hausmann et al. (2001) and Bordo and Flandreau (2001). These two papers show that the set of countries that can borrow internationally in their domestic currency is quite limited, mainly to G-3 countries, with a few surprises such as Poland, South Africa, and Taiwan. The Bank for International Settlements (BIS) similarly documents that outstanding international debt securities are denominated in only four currencies, namely the US dollar, the pound sterling, the Euro and the Japanese Yen (quoted in Jeanneret and Souissi, 2016: 202).

No matter what the underlying cause is, the prevalence of high-interest rates limits fiscal expansions by lowering the sustainability of even *domestic* debt issued in the country’s own sovereign currency. Indeed, there is significant evidence that most developing countries are unable to issue domestic currency debt at reasonably low interest rates. Most of the time, developing country governments have to offer high yields to make their bonds more attractive, even in their own countries. For instance, an IMF study shows that in a sample of 65 low-income countries, domestic debt, which only represent 21 percent of total debt absorbs 42 percent of the total interest bill.

*Do Flexible Exchange Rates Provide The Solution?*

Wray (2012) argues that the solution to these problems for developing countries with sovereign currencies is to adopt flexible exchange rates. But flexible exchange rates do not appear to do the job by themselves.[[12]](#footnote-12)

There is an enormous literature on the issue of the possible insulation properties of flexible exchange rates. This literature is not uniform. Some empirical studies suggest that flexible exchange rates do provide some insulation properties for developing countries (see for example, Klein and Shambaugh 2015). But even these find that this protection is far from complete. The preponderance of evidence, on the other hand, is that, in the age of massive capital flows and financial openness, flexible exchange rates provide very little, if any, monetary or fiscal policy autonomy or insulation properties for developing countries and emerging markets. (See for example, Montecino 2018; and Hofmann and Takats 2015In short, flexible exchange rates are no panacea for MMT policy in the developing world -- not even close – even for countries that can borrow in their own currencies.

*“America First” Monetary Policy and Its Costs*

Developing country economies have always been subject to the vagaries of financial decisions made by “center” countries, including the United Kingdom and in later years, the United States (e.g. Kindleberger 1978). Diaz-Alejandro (1985) famously tied these center-induced financial crises to center country financial conditions and financial liberalization on the periphery. Epstein (1981), among others, identified the dramatic Volcker interest rate hikes as sending dangerous shockwaves that would generate financial crises in Latin America and abroad, causing significant problems for many economies. Thus, the financial conditions and monetary policy in the center countries have driven financial conditions in the periphery for decades and this is especially true now.

A great deal of empirical research demonstrates that the multiple and leading international roles played by the dollar is a key channel through which the Federal Reserve monetary policy is a dominant force that spills over to the financial conditions in much of the rest of the global economy. These spillover effects impact the richer countries (see for example, McCauley 2015) but their impacts are larger on so-called “emerging market” economies. At the same time, these economies have fewer tools of coping with these spill-overs. (Akyuz 2017; D’Arista 2019).

This outsized impact of US monetary policy on macroeconomic conditions in the rest of the world, and especially in developing countries, would seem to call out for a more globally oriented monetary policy on the part of the Federal Reserve. At the minimum, it would suggest the need for consultation and cooperation between the Fed and other monetary authorities. But such coordination and cooperation is spotty, at best.[[13]](#footnote-13)Certainly, a progressive macroeconomic policy can do better than this, can it not?

Conclusion

In my view, MMT advocates need to grapple more seriously with the empirical evidence that bears on their proposals and on the institutional limits to their applicability. I have emphasized here primarily the empirical and institutional limitations that emanate from the nature of modern international financial markets. I have argued that MMT advocates have not adequalely addressed the implications of these markets, including the key role of the dollar, shadow banking, and international capital flows, for the viability of their macroeconomic policies.[[14]](#footnote-14)

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2. For MMT’s recent popularity among some progressive politicians see Guida (2019) and Holland and Bosesler (2019). Among the recent well-known mainstream economic critics are Lawrence Summers 2019, Fed Chair, Jerome Powell (McCormick, 2019) and Kenneth Rogoff, 2019. Doug Henwood has recently criticized MMT from the left (Henwood, 2019) while James Galbraith has come to MMT’s defense (Galbraith, 2019). For important contributions to the earlier, more academic, theoretical debates see Mehrling (2000), Palley (2015a, 2015b) and Lavoie (2013). Wray (2012) is a classic presentation and defense of MMT. [↑](#footnote-ref-2)
3. See the references in footnote 1 above. [↑](#footnote-ref-3)
4. I am aware that there is a debate within MMT circles about whether MMT should exclusively focus on “descriptive” issues or should also address “normative” ones. (Wray 2012). Galbraith (2019) defends MMT, for example, by arguing that it is mostly a descriptive theory, not a policy one. My paper focuses on the validity of key policy and political messages of MMT so I focus on the normative claims. For a summary of these see Wray (2012, chap. 6). In this paper I will not address various doctrinal or theoretical issues concerning the nature of “sovereign money”, the role of money vs. credit, and so forth, except insofar as these address the specific focus of this paper. [↑](#footnote-ref-4)
5. See Wray’s cursory mentions on pages 139, 211, 216. As another example, in his discussions of macro policy in Tunisia, Kaboub focuses on flexible exchange rates and does not sufficiently address capital controls. (Kaboub 2007, 2012) [↑](#footnote-ref-5)
6. See Wray (2012: 72) [↑](#footnote-ref-6)
7. As an exception, see some of Bill Mitchell’s work cited in the bibliography. [↑](#footnote-ref-7)
8. Only very recently, perhaps in response to critiques such as this, have MMT advocates begun to address these trade-offs. See, for example, Nersisyan and Wray (2019); for further discussion of this and all the material in this article see Epstein (2019b). [↑](#footnote-ref-8)
9. Esra Nur Uğurlu prepared an excellent literature review from which much of the material of this section is drawn. I also thank Adam Aboobaker and Juan Antonio Montecino for his helpful comments on this section. [↑](#footnote-ref-9)
10. “Key currency” countries are those that issue major international currencies. [↑](#footnote-ref-10)
11. For some strange reason, the mainstream of the economics profession refers to this state of affairs as “original sin”: a bizarre practice of blaming the victim dressed up in biblical garb. [↑](#footnote-ref-11)
12. See also Kaboub (2007; 2012). [↑](#footnote-ref-12)
13. During crises this cooperation and consultation tends to increase. The Federal Reserve’s extensive international lender of last resort actions through extending swap lines and coordinated interest rate declines are cases in point; but most emerging and poor countries were not included or consulted in these actions. [↑](#footnote-ref-13)
14. For an elaboration of these and related arguments, see Epstein, 2019b. [↑](#footnote-ref-14)