The Debate about MMT Should Focus on the Role of Effective Demand, Not Debt Sustainability

A comment on N.G. Mankiw's "A Skeptic's Guide to Modern Monetary Theory"

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MMT has recently attracted a lot of attention in the media and to a lesser extent in mainstream academic economics (see for example Krugman's intervention and debate with Kelton on twitter and online newspapers). At the AEA Meeting in San Diego, in two days from now, N.G. Mankiw will present his "guide" on MMT, which he has published on his blog. With this little note, I hope to clarify the set of assumptions that underlie the disagreement between MMT and mainstream economics and thereby convince the reader that the debate should focus less on debt sustainability issues and the quantity theory of money and more on the role of effective demand. The two views indeed diverge in two key dimensions: i) they make a different diagnostic regarding the degree of slack on the labor market and distance to full-employment ii) they hold different beliefs about government spending multipliers.

Diverging Views on the Role of Effective Demand

Let's start with the budget constraint of a government. If *b* is the ratio of government debt over national income, i, π, g the nominal interest rate, the rate of inflation and the growth rate of real national income, d the ratio of government primary deficit over national income, then the change over time of the ratio of government debt over national income is given by

$$\dot{b} = (\mathrm{i} - \pi - g)\, b + d$$

The fundamental question at the core of the ongoing debate between MMT and the mainstream regards the medium and long-term implications of an increase in the government deficit, *d*, for the ratio of government debt to national income, *b*. *The answer to this question depends on how the interest rate, the inflation rate and the growth rate of output, (i, pi, g), as well as the path of future d react to the current increase in the deficit, d.* And this is where the two camps have different views.

The MMT view consists in saying that

(i) *i* doesn't react because the central bank intervenes on the money market to maintain the nominal rate at its target level by buying government bonds or providing liquidity to banks
(ii) *g* increases significantly in the short and medium-run (MMTers assume a high multiplier)[1]
(iii) π doesn't increase in the short and medium run (MMTers assume that the economy is in a state of under-unemployment, and that inflation would start to increase only when competition for workers start pushing wages up or when unions' bargaining power is strong).

[1] Government spending also have long-run effects on the growth rate of output if additional resources are devoted to the education and health of the workforce, on the quality of infrastructures, on research and development, etc…

The conclusion of this set of assumptions is that when the government increases its deficit, and the monetary policy accommodates it, output increases *permanently*, generating additional fiscal revenues in the medium run, keeping public debt on a sustainable path and without any increase in inflation. Another conclusion is that, given how far we are from full employment, one can run such a policy for some time without making government debt unsustainable and triggering inflation.

The mainstream view differs between the short-run where neo-keynesian mechanisms dominate and the medium-run where neo-classical mechanisms dominate. It says that

(i) g increases temporarily and modestly (they assume a low Keynesian multiplier)
(ii) π increases as the economy is pushed beyond its natural or full capacity level of production by the increase in aggregate demand (they assume that the economy is fluctuating around its full-employment level)
(iii) in the medium run, the real rate of interest i- π is pinned down by the equilibrium between saving and investment decisions
(iv) in the medium-run the price level is pinned down by the money supply.

The conclusion of this set of assumptions is that when the government increases its deficit, and the monetary policy accommodates it, there is a *temporary* increase in output and inflation, because the economy is pushed above its natural level. Therefore, the ratio debt over GDP increases, which has to be financed by an increase in taxes. In the medium-run, policies aimed at increasing effective demand are ineffective.

To summarize, the disagreement is located in two places: (i) the strength of the government multiplier (MMT assumes it is high, mainstream isn't so optimistic), and relatedly (ii) the degree of under-employment (MMT thinks the economy is structurally far below full-employment). These differences are well-exemplified by two literatures Mankiw himself quotes. On the one hand, the old Keynesian tradition of fixed-price equilibrium (Barro and Grossman, 1971; Malinvaud, 1977) formalized the idea of excess supply on both the labor and goods markets and the new Keynesian literature which allow for sticky prices and demand-led fluctuations around the neo-classical full-employment equilibrium. MMT is unambiguously closer to the former tradition and mainstream macroeconomics to the latter.[2] I would also argue that it is not difficult to relate and reinterpret the insights from MMT in a new keynesian framework. But one has to enter a world of either coordination issues/multiple equilibria, or of liquidity trap and downward nominal rigidities.[3]

The Focus of the Debate so Far: Sustainability and Monetization of Public Debt

Much of the discussion on MMT has focused on two other questions related to the sustainability of government debt which I quickly address now. First "Is there a limit to the increase in government debt?" MMTers and mainstreamers would agree that the government might find itself in a difficult

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[2] Although I like Mankiw's idea to use the disequilibrium – fixed-price general equilibrium or neo-keynesian - and new keynesian literatures to put the current debate between MMT *vs* mainstream into perspective, I strongly disagree with his conclusion that "MMT is akin to new Keynesian analysis." I wonder whether Mankiw meant to write "neo-Keynesian" not to confuse it with "new Keynesian".

[3] I commit to a detailed presentation of such a reconciliation in a later blog post. For coordination issues, I refer the reader to, for example, Cooper and John (1985), or Farmer and Platonov (2006). For downward nominal rigidities, see Schmitt-Grohé and Uribe (2013).

situation should the ratio debt over national income reach very high level. But from the point of view of MMTers, (i) additional government spending would boost output and government revenues, such that government debt would *ex post* remain on a sustainable path; (ii) government debt sustainability *should not* be prioritized over the objective of full-employment and over productive investments by the government (*e.g.* Green New Deal), (iii) the government can always monetize its debt if issuing bonds becomes too expensive. This leads me to the question of monetarization and inflation.

Second, “Is there a limit to the monetization of debt and is it going to be inflationary?“ MMTers would say that (i) inflation is primarily governed but by the degree of slack on the labor markets (and other inputs markets, such as oil),[4] and not by the quantity of money (ii) the share of government debt that is monetized only determines the nominal interest rate through the portfolio preferences of private agents,[5] and that (iii) when inflation comes back, the government should close its deficit to cool the economy down.[6]

These arguments don’t entirely resolve the issue of insolvency. Monetization can resolve liquidity problems, by addressing coordination issues on financial markets[7]. Monetization is also a way to transfer risks from bonds’ holders to currency holders, and therefore to spread the risks among more numerous and less attentive investors. But ultimately, when a very high government debt is monetized, the confidence in the currency, the most important of all institutions in a decentralized markets economy, tends to erode: households, firms, financial intermediaries try to get rid of their monetary holdings by either spending them or shifting their portfolios towards real assets, locally or abroad. This flight away from money is nothing else than a self-fulfilling inflationary spiral. Externally, it means a sharp depreciation of the exchange rate. This is exactly the recent Argentinian scenario.

Conclusion

To conclude, I wish this short note could contribute to move the focus of the debate between MMTers and mainstreamers away from whether the quantity theory of money is true. It would be more fruitful if the debate could now move on to the following disagreements: i) the different diagnostics regarding the degree of slack on the labor market and the distance to full-employment; ii) the different beliefs regarding the level of the keynesian multipliers, and the ability of public spending to generate enough growth in output and fiscal revenues to “finance itself”; iii) the different policy priorities and sense of urgency regarding full-employment and productive public investments.

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[4] This argument brings us back to the premise that our economies are far from a situation of full-employment. To the risk of repeating myself, this is in my view the most important and underappreciated assumption of MMT.

[5] An implication is that at the zero lower bond, government bond and central bank liability are strictly equivalent forms of public debt.

[6]MMT would also say that creating a little bit of inflation by keeping the economy at full-employment wouldn’t be very harmful to the economy. Many indeed argue that the rate of inflation in advanced economies is too low (which leaves little space for effective interest cut by the monetary authority, and impedes real wages adjustments in a world where nominal wages are downward rigid) and that the cost of moderate inflation might have been overstated (Nakamura and Steinsson, 2018).

[7] As the ECB’s OMT has done for government bond markets of Southern European states.