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Dialogue Modern Monetary Theory / Mainstream

This (fictional) dialogue between a proponent of modern monetary theory (MMT, in black) and a mainstream economist (in blue) aims to briefly introduce MMT and the issues at stake.

- Due to global warming, it is necessary to build a new energy system and promote innovation. And everyone should be entitled to a job from the state (paid at the minimum wage). And...
- How much would it cost?
- We'll find the money.
- Where?
- We'll print it.
- What?!
- A country that has its own currency always has enough currency as it only has to print it. In fact, it doesn't even need to print: money today is electronic, all you have to do is click. If there is someone in the Federal Department of Finance with a finger, then there will always be enough money.
- Unbridled money creation leads to inflation, or even hyperinflation.
- What about the creation of money by commercial banks to finance the private sector? You don't seem to be complaining about that. Yet, according to your logic, it would also create inflation.
- Of course. But commercial banks are not unbridled. They remain cautious because when they lend (and therefore when they create money), they take the risk of not being repaid. Moreover, to stabilise prices and the economy, the central bank is typically led to offset fluctuations in the monetary creation of commercial banks.
- The numerous financial crises cast serious doubts on the prudence of commercial banks. Furthermore, as you will soon understand, it is not the central bank's role to stabilise prices and the economy. This is a matter of fiscal policy. But to return to the so-called inflationary impact of money creation: central banks have created a lot of money without causing inflation.
- It's really rather peculiar. First, there would have been deflation without the intervention of central banks. Above all, central banks currently have difficulty injecting money into the goods and services market on a sustainable basis because this money tends to return immediately to them in the form of commercial bank reserves or ends up on the financial markets. But in normal times, prices increase when there is more money to buy a given quantity of goods and services.
- Inflation is rarely a monetary phenomenon. Prices increase when demand is too high in relation to supply. And it is not that money ends up on the financial markets, rather it is injected there from the outset when the central bank buys securities. It is therefore logical that this increases the prices of securities rather than goods and services. But whatever the reason, the facts show that low inflation is compatible with the impressive monetary creation that has taken place. It would therefore currently be possible to finance public expenditure by monetary creation without generating inflation.
- Inflation may only be delayed until this money returns to the goods and services market. When you feel richer because the securities you hold have increased in value, you also spend more on goods and services. Moreover, you want to inject money through public spending, which will directly create inflation. In any case, this wouldn't be sustainable. Look at Zimbabwe. Their enormous monetary creation led to hyperinflation.
- In Zimbabwe, there was a decrease in supply following the reorganisation of agricultural land ownership. This led to a shortage and this imbalance was further

exacerbated because the government sought to spend more than its economy could produce. Clearly, this creates inflation.

- So you propose to finance public spending by creating money only until there is full employment.
- Public spending is always financed by money creation. But when there is full employment, monetary creation generates inflation. To avoid this, money must be withdrawn from economic actors.
- The central bank should therefore pursue a restrictive policy with its right hand to compensate for the expansive policy it pursues with its left by financing public spending through money creation?
- The central bank sets the interest rate which, in my opinion, has little impact on the economy. It can of course use quasi-fiscal instruments to modify the money supply, but it is then preferable for the government to assume this responsibility. The state can withdraw money in circulation through taxes or by issuing bonds.
- So we agree: In case of full employment, the state must finance its expenses through taxes and borrowing.
- Not at all. Financing is always done by monetary creation. It is already being done by monetary creation in all countries. Taxes and bond issues are used to withdraw money in circulation. They may also have other objectives. Taxes can be used to reduce inequalities or, like the CO_2 tax, to discourage behaviour that is considered bad. Issuing bonds should stabilise interest rates but they are not instruments for financing public expenditure.
- That is a very odd way of explaining things. But however we may put it, we agree that in a situation of full employment, the total amount of taxes and government loans must be equal to its expenses.
- Yes, but we may disagree on the share to be financed by taxes versus public bond issues. You will probably tell me that the state should not run deficits when the economy is doing well, or even should generate surpluses to compensate for the debts generated in times of crisis. But the level of public bonds issued (versus tax) in a situation of full employment must be set to ensure macroeconomic balance. The public budget balance is the counterpart of the private balance: if the private sector wants to have a financial surplus, then the state must have a deficit since the balance is globally zero.
- It could just as easily be argued that the private sector must generate a surplus because the state is in deficit. This accounting identity says nothing about causality.
- If the private sector asks for securities that the state does not provide, then this will lead to an increase in the price of bonds and a decrease in interest rates. Public bond issues serve to stabilise prices on the financial market or to stabilise interest rates, which amounts to the same thing (and the quantity of public bonds should of course not fall below the need for safe assets of financial markets), while the total amount of "public bond issues + taxes" must be equal to that of public expenditure in the event of full employment to avoid inflation. It must be understood that bond issuance is not used to finance public spending, but to achieve other aims. This means, for example, that it may sometimes be desirable to issue bonds to stabilise interest rates, even in a situation of budget surplus.
- Stabilising interest rates is the central bank's job. Moreover, this accounting identity is only correct in a closed economy.
- In the past, the US Treasury has sometimes been very helpful to the central bank in stabilising interest rates.[1] In an open economy, it is indeed a little more complicated

[1] "Overall, the Treasury helped drain up to $610 billion of reserves in October and November 2008 via the TT&L [Treasury tax and loan accounts: accounts of the Treasury at private banks] transfers and the SFP bills [Supplementary Financing Program: The program consists of a series of Treasury bill auctions, separate from Treasury's current borrowing program, with the proceeds from these auctions maintained in an account at the Federal Reserve Bank of New York. Funds in this account serve to

but let's take the United States: The rest of the world lends them money. If the private sector in the United States wants a surplus, it means that the state must be in deficit.

- Well, we are not exactly on the same page when it comes to situations where there is full employment, and I have the impression that it will be even worse when there is unemployment.
- When there is unemployment, public spending (even financed by money creation) does not cause inflation. Public expenditure could therefore be financed by monetary creation (without subsequently withdrawing this currency through taxation or bond issuance) until it leads to full employment.
- You talk as if there were only two situations: either we have full employment or we don't. In reality, we gradually move from one to the other, like in the Phillips curve.
- OK. We can imagine a gradual transition to full employment where some sectors achieve full employment before others.
- In this case, money creation generates inflation before full employment is achieved in all sectors.
- Yes, except if the state buys goods and services from sectors where there is not full employment. This can also be understood from a practical point of view: as long as public expenditure reactivates unused factors of production (e.g. unemployed people), it increases production. The additional use of goods and services by the state then does not occur at the expense of the private sector; there is no real crowding out.
- But this is only possible if demand is too low to use all existing production capacity. This happens during demand crises. MMT's recommendations are nothing more than usual Keynesian policy.
- Yes, but we will see that this is the usual situation. However, I would first like to clarify one thing: If there is unemployment, or more precisely if the economy is far enough from full employment, then public spending could be financed by monetary creation without creating inflation. But it can sometimes still be useful for the government to take on debt (even in times of crisis when there is no risk of inflation) to meet private demand for securities. Issuing securities then serves a monetary objective: to stabilise the interest rate.
- Anyway, how can we withdraw the surplus money after a crisis?
- In general, it is not necessary for the state (central bank included) to withdraw more money than it creates. It is usually enough to no longer increase the money supply too much.
- This would involve reducing public spending financed by money creation after a crisis and knowing politicians, it's not that easy.
- It's not surprising that a stimulus package should stop after a crisis. And with the "Job guarantee" programme that we are proposing, public spending to provide all those who request it with state employment paid at the minimum wage will automatically decrease with the end of the crisis. This programme is an automatic stabiliser that increases public deficits in times of crisis and reduces them in times of boom. In addition, taxes automatically rise during boom periods (this is usually the main source of changes in the public deficit).
- What if you still have to withdraw excess money?
- To withdraw money that we will destroy, all we have to do is borrow or tax. It should be noted that private individuals can also destroy money when they repay their debts.

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drain reserves from the banking system]." Tymoigne E. (2014), Modern Money Theory, and Interrelations between the Treasury and Central Bank: The Case of the United States, Journal of Economic Issues, Vol. XLVIII No. 3.

But in any case, we should not only think about transitory crises; many countries are constantly in a situation of underemployment.

- The demand crisis that causes this underemployment is when people want money rather than goods and services. Once enough money has been put into circulation, the demand crisis disappears.
- In certain circumstances, the demand for money seems insatiable (see the massive injection of money during quantitative easing). And you know that even mainstream economists are considering the possibility of a lasting demand crisis (secular stagnation).
- It may well be that the real interest rate that would equalise savings and investment is so negative that it is not possible to achieve this, given the effective lower bound of the nominal interest rate.
- The problem is more profound. If your explanation were correct, all you would have to do to escape a crisis would be generate inflationary expectations that are strong enough. In reality, this wouldn't be enough.
- Of course this would be enough because it is the real interest rate that matters. It is equal to the nominal rate minus the anticipation of the inflation rate. So even with an strict floor for the nominal rate, it is possible to obtain a real rate as negative as desired by generating sufficiently high inflation expectations. The current difficulty in countries like Japan is to generate these inflationary expectations.
- Imagine if a central bank could convince people that it would increase inflation. The players will therefore anticipate an increase in the nominal interest rate that will result in a loss in value of the securities. This will encourage them to hold cash rather than securities. They will prefer to waive any interest to avoid this capital loss. We therefore cannot escape insufficient demand.
- This is true: it is not enough to generate inflationary expectations, it is still necessary to convince people that nominal interest rates will not rise. All that is required is for the central bank to conduct a sufficiently expansive monetary policy.
- It must convince people not only that the short-term interest rate will not rise (or not by too much), but also long-term rates. This assumes that the central bank also buys and sells long-term bonds. And indeed in Japan this doesn't work, which is no surprise as the weakness of demand is due to an ageing and shrinking population, not to interest rates. The mistake is to believe that it is the adjustment of the interest rate that makes it possible to equalise savings and investment.
- In a closed economy, savings inevitably equal investment.
- Yes, but this happens through the adjustment of GDP, not the interest rate. Indeed, savings and investment depend not so much on the interest rate as on the economic situation. GDP that equalises savings and investment, and thus equalises the supply of and demand for goods and services, may be lower than full employment GDP. Such unemployment is not necessarily an extraordinary situation, but can be a lasting one as long as the state does not intervene. There is every reason to believe that we are facing a continuing demand crisis, which could be the new norm. Whatever the reason for a sustained weakness in demand, Keynes' recommendations to combat demand crises then apply in the long term. It is a matter of constantly supporting demand through public spending.
- I don't think we're in a secular stagnation. But it is true that if this were the case, a sustainable Keynesian policy could be justified. Except that here we have been talking about a closed economy. In an open economy, new elements must be taken into account. Therefore, if this economy suffers from a weakness in foreign demand, the possibility for the state to fill the gap is limited insofar as those who produce for foreign markets cannot always produce goods and services that the state could require.

- Indeed. Another problem that arises when we take into account the existence of other countries is that a country that has taken on debt in a foreign currency (which it cannot create) can go bankrupt.
- What's more, the impact of money creation on the exchange rate must also be taken into account. In particular, depreciation would have an inflationary impact through the increase in import prices.
- Price increases should not be confused with inflation. A depreciation episode doesn't in itself imply a continuous increase in prices. Moreover, I'm not convinced that an increase in the money supply leads to a sharp depreciation of the currency and even less that it translates into a sharp increase in the price of imports. Importers do not necessarily adjust the price of the imported products they sell to final consumers according to exchange rate variations, at least not to the same extent (incomplete pass-through).
- A continuous increase in the money supply will eventually lead to a continuous depreciation which will result in a continuous increase in import prices and thus contribute to inflation, although in the short term the impact on the exchange rate may be masked by other sources of volatility and if importers do not immediately adjust their prices.
- In the event that money creation generates inflation through imports, this will simply have to be taken into account.
- We have some differences, but perhaps we are not so far apart from each other as one might imagine at first glance.
- Above all, we disagree on whether the conditions are currently met under which public expenditure financed by pure money creation would produce neither inflation nor a real crowding-out effect.
- And we assess differently the risk that politicians will not be disciplined enough to stop creating money when these conditions are no longer met. This has implications for the confidence that can be placed in them and the importance of ensuring the independence of the central bank.

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