MMT and the quantity theory of money

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Time and again, I am being told at present that money creation — which is what Modern Monetary Theory (MMT) quite correctly says happens every time the government spends money — must always lead to inflation because, so those making the claim suggest, there is a direct relationship between the quantity of money in the economy and the value of money in relation to the goods and services that it might buy. This, they say, means that when the quantity of money increases, the value of that money falls, giving rise to what we call inflation as a result.

The logic behind this claim is based on the so-called "quantity theory of money", promoted by someone who might be considered one of the earliest neoliberal economists, [Irving Fisher], who was writing more than a century ago, and who might fairly be called the godfather, if not the founder, of monetarism.

The problem with Fisher's claim is that, like a great deal else within neoclassical and neoliberal economics, what it suggests is wrong. To explain this, I have added the following entry into the glossary associated with this blog, in the hope that this explains why the claims made about Modern Monetary Theory are incorrect.

This has, of course, to be the case because, in fact, MMT has explained what has been happening in our economy for more than 50 years now, and there have been no occasions within that period when inflation has been created by an excessive money supply, with all inflationary episodes being capable of explanation by one of the following:

* External supply shocks, for example, with regard to oil, war, or the reopening from Covid.

* The failure of international relations in monetary policy, for example, with regard to the European Exchange Rate Mechanism or global financial crises.

Quantity Theory of Money

The quantity theory of money (QTM) claims there is a direct and proportional relationship between the money supply and the general price level in an economy. It is most famously expressed by the identity:

MV = PT

Where:

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M = the quantity of money in circulation

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V = the velocity of circulation, or how quickly money moves between transactions

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P = the average price level

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T = the number of transactions (or sometimes real output)

This equation is an identity: it is suggested that it must always balance because it describes what money does. The controversy comes with the theory attached to it.

From the late nineteenth century onwards, economists, most notably **Irving Fisher, argued that V** and **T** are constant in the short term. That assumption implies that if governments or central banks increase **M**, then **P** must rise in proportion. In other words, Fisher claimed that inflation is always a monetary phenomenon. Milton Friedman later made this claim the foundation of monetarism in the 1970s. It was used to justify austerity, the shrinking of government, and the deregulation of finance.

However, the theory fails when tested in the real world:

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Velocity is not constant: in fact, it is highly volatile and collapses in crises, as it did in 2008 and did again during Covid, meaning that huge increases in the money supply often do not translate into inflation.

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Output is not fixed. Economies can expand production when demand rises. If more money supports the production of more real goods and services, prices need not increase.

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Banks create most money through lending; governments have a role, but it is often a lesser one, most especially in the post-cash era. Loans expand the money supply when issued, and shrink it when repaid. QTM says very little about this, which is a fundamental flaw in its argument.

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Inflation frequently arises from non-monetary causes, whether they be supply shocks, wage suppression, profiteering, energy price spikes, or the exploitation of market power; all of these play significant roles.

QTM's most significant flaw, however, is its reverse causality. Instead of excess money causing inflation, it is inflation, driven by real-world constraints and power dynamics, that most often forces money supply to expand to keep the economy functioning.

Nevertheless, the theory remains popular with those wanting to limit the role of government. It provides a simple-sounding cautionary tale, suggesting that spend too much, and inflation will punish you. But simplicity is not truth. Modern Monetary Theory shows that what matters is real resources, and not arbitrary limits on money. Money is a tool we issue to mobilise the productive capacity we already possess.

Inflation is undoubtedly a challenge, but it requires real economic solutions, and not outdated monetary dogma. Those who offer that dogma always have one true agenda, which is to constrain the role of government within society.

Comments