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It's a Wonderful (MMT) World!

Modern Monetary Theory (MMT) has received a good deal of attention recently. While only scratching the surface, this article seeks to identify the main ideas of MMT and to assess its credibility by exploring recent economic history. Of course, it makes sense to finish with suggested ALM responses if implementation becomes more widespread.

MMT aims to raise the real economy to primacy over the financial markets and to do so through the fiscal policy levers of spending and taxation. If the economy is operating below potential, as measured by employment slack and idle capacity, the Federal government would increase spending. Ideally, this spending would be directed towards infrastructure that enhances the productivity of the economy, but not necessarily so. It may take the form of a job guarantee which directly addresses employment. On the other hand, were the economy to overheat based on an acceleration of inflation beyond a set threshold, taxes would be raised to throttle back growth. It is precisely because the private economy needs government-issued money to pay its taxes that MMTers contend that money gains legitimacy. Since the government controls the issuance of money, it cannot default on its debts because it can issue whatever it needs to pay off borrowings. This is critical and separates countries like the United States which issues its own currency from countries that use a currency controlled by others. America is not Zimbabwe nor is it Venezuela. In this formulation, federal government deficits and traditional monetary policy become secondary. In fact, MMT proponents argue that there is little distinction between a deficit funded by debt and one funded by debt monetization. They further argue that the equilibrium real policy rate is zero, placing even more emphasis on inflation as the critical variable to control.

Prominent commentators have raised objections to MMT while others have suggested the environment since the Great Recession validates at least part of the theory. By looking at recent economic history, we may be able to see where it has

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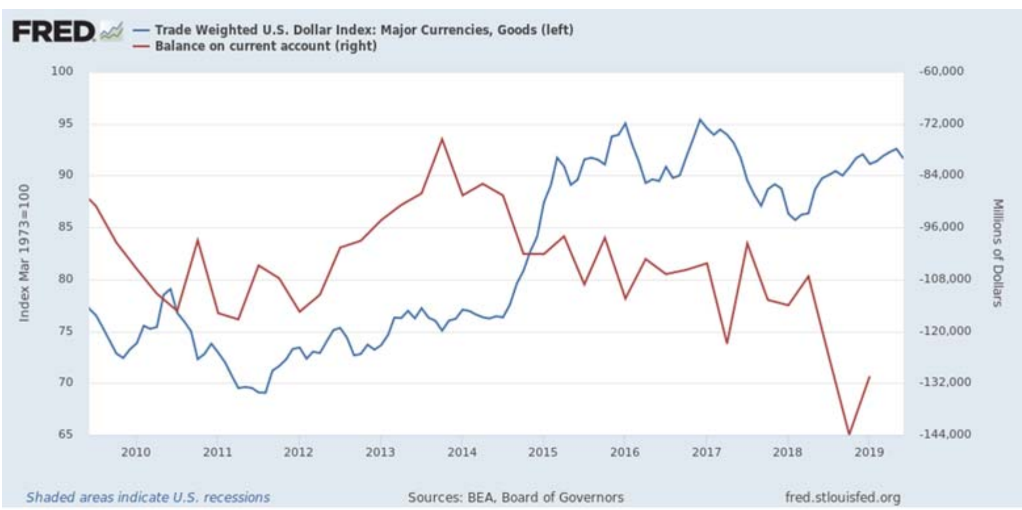
been accurate along with why we may not want to buy in entirely.

Let's start with the idea that deficits cause inflation. In the United States, we have been running deficits of a substantial nature for as long as I can remember with only a few surpluses sprinkled in. And yet, inflation has been on a general downtrend for at least thirty years. Ditto for Japan, which has seen an even higher level of government deficits and debt coupled with even lower inflation and interest rates. Neither has the European Union been a paragon of fiscal probity. European fiscal deficits have been the norm, but inflation has not. Furthermore, interest rates are low or negative across the continent. In all of these cases, the central banks involved resorted to purchasing the debt issued by the governments. Many warned against quantitative easing (QE) as a set-up for inflation and even hyper-inflation. The evidence to date suggests those concerns were misplaced.

Exhibit 7



Turning to America's current account, we experienced a general narrowing of the deficit from 2009 to 2014 while the dollar increased in value. However, since then, the current account has plunged further into negative territory, but the dollar continued to advance. This evidence puts another vote in the MMT column (see Exhibit 7).

Given the empirical support, why is opinion so divided on the merits of MMT? There are two flavors of objections — one consists of alternative explanations of the facts while the other focuses on temporal differences.

One possible explanation for the lack of inflation is that DDT killed it. Not DDT the pesticide, but DDT: debt, demographics, and technology. One could argue that the increased level of debt itself has slowed the economy, limiting inflation. Instead of acting as a fillip to growth, it has acted as an obstacle by diverting funds to repayment instead of expansion. Demographic trends suggest that as the population gets older, it saves more and spends less. The increased use of technology in both production and online retail can be cited as undermining pricing power.

Another alternative explanation involves increased wealth inequality. The idea is that it has put the benefits from a growing economy in the hands of those who invest rather than spend. So while deficits and debt have increased, the supply of savings has grown even faster.

I would point out that rather than discredit MMT, these alternative explanations actually bolster the idea that fiscal policy can be far more expansionary than it has been without traditional economic consequences. However, a more telling caveat zeroes in on the time differences between actions and results. Perhaps the impact of deficits and monetization of debt has simply not yet appeared. It puts me in mind of the fellow who falls off the Empire State Building and manages to text his wife as he passes the 50th floor, "So far, so good." We know how that ends.

We are left with the fact that recent economic history not only supports MMT, but an objective review of the situation indicates that we are already living in an MMT world. Both Japan and the Eurozone have resorted to monetizing debt because rates are already at or below zero. In the United States, our government deficit has jumped even as the economy has continued to grow, and inflation has faded rather than accelerated. Politicians, and more importantly the public are unconcerned with either deficits or the resulting debt issuance. While there is a possibility that the benefits are front-loaded, and we will still have to pay the piper at some point in time, until there is evidence of sustainable inflation, the right course of action is to expect low rates to persist and head even lower on signs of economic weakness.

Whether MMT is formally adopted or not, it is likely that the Federal Reserve will experience the same problem that has bedeviled other developed market central banks: what to do when the zero-rate bound is met. Another round of QE is likely, but the last few rounds did little to boost the real economy as opposed to financial markets. That suggests that fiscal policy will come to the fore and that the Fed is likely to purchase much of the debt issued. With rates at or below zero, this is effective monetization.

How should a bank proceed if this scenario is deemed likely? Bank liability structures consist of both non-maturity deposits and term deposits/ borrowings. The former are constrained by the zero bound and effectively bear operating rather than interest costs. That makes them long-term in nature. Adding term assets is the only way to offset the risk of falling rates on these liabilities. For liabilities which come due at or near market rates, the best strategy is to shorten term to be able to renew the funds at lower rates. Paradoxically, paying a higher rate for a shorter term may very well be the best strategy given the current point in the rate cycle. This transports the inverted yield curve from the public markets to the consumer space.

Longer-term, the variable to watch is inflation. Even if MMT is adopted in full to support spending, it is hard to believe that a future Congress and White House will raise taxes to limit inflation. However, even if they don't, we can expect that the market will do it for them. This could easily result in a spike in term interest rates. While that is likely to eventually moderate the economy and inflation, it can be an uncomfortable interlude if too many long-term assets are held. In this case, the logical option to pursue is Treasury Inflation-Protected Securities (TIPS**)**. Timing of the switch to TIPS is, of course, provisional, but shifting from traditional fixed-rate assets to those protected against inflation should be pursued once the spread between the two falls below a set threshold. I would recommend 1%.

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