Investment Perspective

IS MODERN MONETARY THEORY A PANACEA OR A TRAP?

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You may have heard the term "Modern Monetary Theory" (MMT) recently in the financial media or in political discussions. If not, it is likely you will in the months ahead. Investors should pay close attention to these discussions. Why? Because progressive politicians are embracing it as a means of increasing social spending without imposing taxes. To its advocates, MMT also offers the promise of reducing or reversing the contribution to income inequality and wealth inequality of current conventional monetary policy. However, historical experience with policies similar to MMT has resulted in periods of high and volatile inflation, which is detrimental to real returns of stocks and bonds, and thus, the financial plans of savers and investors.

In this issue of Investment Perspective, we will describe the tenets of MMT, why it has been gaining popularity, some weaknesses in the arguments supporting it, and the risks it poses for the U.S. economy and investors, foreign or domestic.

MMT Explained

MMT is an unorthodox way of examining the monetary policy framework of sovereign nations, which leads to the startling conclusion that they are not constrained by their revenues when it comes to setting spending levels. You read that correctly. According to MMT, sovereign nations do not need to collect taxes or issue debt securities for spending. Instead, they can print as much money as they need because they are the monopoly issuers of their own currency. MMT challenges beliefs about the nature of money and the importance of budget deficits. MMT advocates say mainstream beliefs about money, taxes and debt are holdovers from the gold standard, and are inaccurate and unnecessary.[1]

Advocates for MMT, such as Professor Stephanie Kelton of Stony Brook College, who is one of its leading proponents, describe it as looking at monetary and treasury operations through a different lens. First, she makes the point that spending is the source of inflation, not printing money, as is argued by monetarists. Next, she notes that in reality, government spending always comes first, then taxes and borrowing follow to pay for it. Votes by legislators authorize the spending.

Countering arguments that the government should be constrained in its spending just as households are, she notes that the federal government is not like a household because the government creates its own fiat currency, and has the sole legal authority to do so. It should not be constrained by arbitrary budgeted spending limits. The risk of inflation does impose limits on its spending, and that risk increases when spending exceeds the economy's capacity of available resources such as labor, capital, commodities, etc. Professor Kelton believes that Congress is the proper governmental body to make these judgements about spending levels rather having an independent, unelected body, do so. She admits that there are no precise measures of an economy's productive capacity, but that inflation is the critical indicator of that capacity. The fact that inflation is currently under control indicates to MMT advocates that there is potentially significant unused productive capacity in the U.S., and that government spending can safely be increased. If inflation were to trend higher, Congress would need to act to keep it under control. According to MMT, this would be done through taxation.

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MMTers view the role of taxes differently than do mainstream economists. Rather than being considered the tool for raising revenue to fund government expenditures, taxes are to be used to remove money from the economy when it is becoming overheated. In effect, fiscal policy is expected to serve as an economic stabilizer just as the Federal Reserve's monetary policies do currently via control over bank reserves and short-term interest rates. The objective of maintaining full employment and controlling inflation would be shared, according to Kelton, but in truth would largely fall to Congress, with the Fed having little power.[2] In fact, according to an article in Bloomberg Businessweek by Peter Coy, Katia Dmitrieva and Matthew Boesler, MMTers consider the natural interest rate in a world of fiat currencies to be *zero*, and that any higher rate is a giveaway to the investor class.[3] Apparently, everything we have learned about the time-value of money, and its critical role in allocating finite resources is not valid. Professor Kelton adds that previous Fed chairpersons have commented that federal policymakers should have better economic stabilizers, so under MMT, monetary policy will not have to bear all the burden of smoothing out economic cycles.[2]

What about federal deficits? Professor Kelton notes that mainstream economists are not viewing deficits in the proper context. A government deficit is always offset by a surplus somewhere else in the economy, such as the private sector. There are surplus private sector savings invested in government securities offsetting the government deficit. This raises the question about U.S. Treasury securities owned by foreign governments, such as China. Why does China hold these securities? It is because we have a large trade deficit with them. The trade deficit provides China with a huge supply of U.S. dollars which they naturally prefer to have in interest-bearing securities rather than in idle cash.[2] Not every nation is in the enviable position to fund its budget or trade deficits with foreign savings, but the U.S. can do so because the U.S. dollar is recognized as the world's reserve currency. It holds this position because of the wealth and financial strength of the U.S. and its well-regulated financial markets.

MMT would use its newfound source of spending to provide a means of stabilizing employment with a federally funded, locally administered job guarantee. Government would employ more people in recessions than in expansions to create a counter-cyclical force as was done during the Great Depression. The plan envisions government-employed workers moving back to the private sector when the economy strengthens. A goal of MMT is to create an automatic stabilizer to reduce the size and impact of economic downturns.[3]

Opposing Arguments

There is plenty of debate around MMT, which was once only discussed only in blogs and a handful of colleges. Critics call it a hot mess. Wall Street sometimes derides it as Magic Money Tree. The debate over MMT now matters, as it will almost certainly become a factor in the 2020 presidential race. We will discuss that in more detail in the last section.

There are several weaknesses in the arguments for MMT, and we will address some of them below. In general, mainstream economists argue that the correct parts of MMT are not new, and the new parts are not correct. As an example of the former, the statement that printing money is not inherently inflationary but spending it can be is nothing more than saying the velocity of money can vary, and it tends to do so in a pro-cyclical manner. This is not a new concept.

The arguments favoring the abandonment of budget constraints and the use of deficits to tap unused economic capacity raise a number of questions and concerns, including:

- If Congress is to set spending based on assumed economic capacity of the nation, what information or guidance will be used to set the spending limits? Professor Kelton notes that there are no foolproof measures of economic capacity. It seems likely that Congress will be dealing with much uncertainty and will end up considering other factors in taxation decisions besides what is best to control inflation.

- If inflation and interest rates head higher, can we be confident that Congress will make timely, unpopular adjustments in taxes to reduce inflation expectations? Critics argue that using fiscal policy to steer the economy is a proven failure, due to the lags in legislative action, and the tendency to use taxation for social engineering, rather than for sound economic purposes.

- Given the inherent conflict between politics and sound financial policies, how likely is it that global bond and currency markets will maintain confidence in the U.S.'s finances with a neutered central bank? Given the greater government spending capacity MMT would offer under loose or no budget constraints, can Congress be expected to make sound decisions over the allocation of limited resources, as is done quite efficiently in the private sector? MMT critics point out that using the Federal Reserve to do the Treasury Department's bidding was used in World War II, but was permanently ended in 1981 because leading economists warned that a subservient central bank would result in inflation racing upward.[3]

- There is much evidence that increasing the government's role in resource allocation has negative implications for economic growth, productivity and real wage increases. Could this financing scheme threaten the U.S.'s status as the world's reserve currency? Put another way, would China and other creditor nations remain willing to hold a massive amount of U.S. dollars if Congress was responsible for keeping inflation under control, rather than the Federal Reserve? These are questions that MMT advocates avoid or dismiss.

An additional problem with MMT is the argument that deficits do not matter because they are offset by surpluses (savings) elsewhere in the economy. This ignores the fact that those savings are the source of private investment, otherwise known as capital spending (capex). Syphoning off private savings from productive use, such as for capex, into generally less productive pork-barrel spending projects will have negative consequences for long-term economic growth. The more private savings are redirected into government securities, the less remaining savings there will be for private investment, which is always the true engine of sustainable real wage growth and rising living standards. Fewer savings for private investment tends to push interest rates higher, and causes fewer investment projects to be economically feasible, which is harmful to long term economic and wage growth. However, MMT has an unconventional response to this interest rate warning. It states that when the government spends more, the private sector gets the money and deposits it in the banking system. With more money in the banks, and no increase in demand for it, interest rates will fall, not rise. That is, unless the government chooses to soak up that money by selling bonds, which is not required in an MMT world where selling treasury securities or raising taxes is not necessary. To spend money, the central bank, under the control of the treasury, can pay for everything just by creating more electronic money.

There is also an important assumption made when MMT advocates defend the use of deficit spending with loose or no budget constraints. The assumption is that financial markets will always cooperate. Perhaps because the U.S. has gone through an extended period of very low interest rates, it is assumed that deficits cannot cause higher rates, perhaps because of the argument made in the previous paragraph. The recent example in Italy shows this may not always be true, as there are other possible catalysts for rising rates. Last year, the Italian government proposed larger deficits in defiance of the European Union, and the bond market reacted with sharply higher interest rates on Italian debt, sending Italy into recession. MMT advocates may argue that the U.S. is different because of its reserve currency status, but then they are making the case that the U.S.'s privileged status makes deficit spending possible, not the fact that government can print all the money it needs to pay interest on the debt.

Why Take MMT Seriously?

Advocates of Modern Monetary Theory have two goals. One is to provide an alternative description of how government financing operations actually work, and they make points that are quite valid. It is true that governments which have the ability to issue their own currency face different financial situations than those of a household or business, at least in the short term. It is quite simple for governments to issue currency to pay for their spending. It happens quite frequently.

The second goal is to convince us that the ability to issue fiat currency provides an ability to spend and issue currency to a much greater extent than is currently considered prudent. We are asked to trust that Congress can find, monitor and stay within spending limits that do not threaten rampant inflation. MMT advocates are convinced that the U.S. has not come close to reaching these limits and that the nation's needs, including those related to income inequality, environmental protection and healthcare can be met without painful consequences.

Professor Kelton believes the tide is turning in favor of support for MMT as policymakers recognize that monetary policy does not have adequate tools to spur growth. She sees greater coordination between central banks and fiscal authorities as "almost certainly the wave of the future."[4] She predicts that central banks will not openly admit they have lost their independence, but "at the end of the day, they're going to be accommodating fiscal."[4] It seem clear that she is speaking of the evidence in the U.S. in which President Trump and both parties in Congress express no concern over rising deficits, and Trump demands that the Fed stop quantitative tightening and cut the fed funds rate.[5]

We expect to hear the arguments for and against MMT as the 2020 presidential campaign gains momentum. MMT provides an enticing framework for political candidates to promise almost unlimited government spending with no negative effects on living standards and the variables that influence them. One can foresee how some of the credible arguments surrounding MMT might be used to promote the more extreme ideas such as taxes being unnecessary to fund spending, and that hugely expensive items such as single-payer healthcare are feasible, because taxes do not fund spending. Investors should be alert to these messages, and how the candidates who espouse them are received by voters. We believe the market implications of these ideas are very significant.

About Our Author

Richard Chauvin, CFA is an investment director at Hancock Whitney Bank, where he is responsible for investment research and strategy and serves as a portfolio manager for high net worth personal and institutional clients. Richard has been in the banking industry for over 30 years, with 2 years as a member of the Hancock Whitney team. Prior to joining Hancock Whitney, he spent 10 years as the Chief Investment Officer at Capital One and three years as a Senior Portfolio Manager at Hibernia Bank. Richard has a Bachelor's Degree and a Master's in Business Administration from Louisiana State University, and he holds the Chartered Financial Analyst designation.

Sources:

[1] www.investopedia.com

[2] Information is from a presentation on June 26, 2019 by Professor Kelton which was hosted by Strategas Group. Kelton is a leading expert on MMT and a former Chief Economist on the U.S. Senate Budget Committee. She served as an advisor the Senator Bernie Sanders 2016 presidential campaign.

[3] Bloomberg Businessweek, "Warren Buffett Hates it. AOC Is for It. A Beginner's Guide to Modern Monetary Theory", March 21, 2019.

[4] www.bloomberg.com; "MMT's Kelton Sees Central Banks Quietly Yielding to Governments" by Yuko Takeo and Mashahiri Hidaka; July 18, 2019.

[5] Tweet by Donald Trump (@realDonaldTrump), April 30, 2019.