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INVESTMENT MANAGEMENT

Beware Modern Monetary Theory: An Opinion on Risks

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Modern Monetary Theory (MMT) represents a structural change in how we think about money, inflation and asset prices. It is an increasingly popular narrative that is widely discussed in the markets today. While the current debate is immediately unlikely to have a significant impact on asset prices, it has the potential to affect the future of economic policy in a way that may present longer-term risks.

As a basic breakdown of a complex topic, MMT can be understood in basic form to be the opposite of fiscal austerity. Fiscal austerity is the notion that a country's deficit—or rather, its deficit/GDP ratio—matters. This ratio is akin to a default-risk level. MMT, by contrast, suggests that the deficit/GDP ratio is less important because as long as a country can print its own money, it can pay off its debts in perpetuity and without problems. In this theory, the creation of money by the government is what directs economic activity.

In its original formulation in 1905, this was called "chartalism," from the Latin *charta,* meaning token. While the first "M" in MMT stands for "modern," the theory is also referred to as "neo-chartalism" by those with a taste for economic history. There is nothing modern about it.

Under standard monetary policy, the Fed uses interest rates to affect the value of money. Lower rates mean cheaper money and an accommodative policy, while higher rates make money more expensive and lead to monetary tightening. By contrast, under MMT, the government would take over responsibility for the Fed's dual mandate of price stability (inflation) and full employment. It would change the value of money through a combination of the printing press and taxation. Printing more would direct economic activity (easing) and increased taxation would drain money out of the system (tightening).

MMT is seeing a resurgence in popularity largely due to the belief that the global economy is in a "liquidity trap"—i.e., that interest rate policy as a tool to stimulate the economy is broken. In a liquidity trap, lower rates, no matter how low, will not stimulate growth, will not spur economic activity and will not increase employment. One of the explanations of why MMT has gained so much attention lately is "because it is a policy polemic for depressed times,"[1] and there is indeed some validity to the liquidity trap argument. Japan's 0% rate policy, the ECB policy rates at -0.40%, low real rates of growth, secular stagnation and so on all act as cases in point. In situations like this, the fiscal side of the economy needs to step up.

Can MMT work? As Yogi Berra eloquently explained, "In theory, there is no difference between theory and practice. In practice there is." In theory, MMT can work. In practice, we believe it is very unlikely to. In theory, economic activity can be controlled by politicians through fiscal spending, if they spend when appropriate and reduce spending when appropriate—much like the way the Fed hikes and cuts interest rates. In practice, however, politicians (of any party) tend to become drunk with the power of the printing press and tend to invest and spend in inefficient projects. This generally leads to inflation rising.

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– Yogi Berra

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Expectations of rising inflation due to MMT would have an impact on investing by potentially decreasing the value of cash flows in the future. The discount rate would thus be expected to rise and the present value of assets would fall. Financial assets, which were inflated under QE, would likely suffer, but real assets could benefit.

This would take time, however. During the first few years of MMT, the potential impact may be similar to that of a fiscal stimulus, to the benefit of GDP. If—or when—the markets sense this spending is mismanaged, it could lead to higher inflation and hurt financial assets. This is the general narrative today.

In our view, MMT is a risky economic experiment. It increases the size and the role of government in economic activity, despite overwhelming historical evidence that governments tend to be inefficient users of capital in comparison to the private sector. Under current monetary policy, the Fed simply sets the price of money and lets the "animal spirits," innovation and efficiencies from the private sector take over. While this system is not perfect, we believe it is better than MMT, as MMT is very likely to create inflation and erode asset prices in the long term.

The key question becomes *when*? In its early stages, MMT could generate positive results, as it looks similar to fiscal stimulus. Those gains could mask the longer-term deleterious impact of higher inflation and eroding asset values. In other words, MMT could fool us in the short term.

Despite being based on shaky economics, MMT's appealing politics have the potential to turn it into a real risk. If the U.S. or global economy falls into a recession, MMT may look like a good alternative in a time of economic stress as it provides a large fiscal impulse that seemingly works significantly better than lowering interest rates.

At the moment, the debate over MMT in the markets will only have marginal, if any, impact on asset prices and inflation. In our view, however, its growing popularity does present a longer-term risk that we will be watching closely, and we will adjust our portfolio positioning accordingly.

[1] *Palley, Thomas, Modern money theory (MMT): the emperor still has no clothes*, 2014.

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