TD Asset Management

Modern Monetary Theory + 20 Minutes
= New Thinking

Modern Monetary Theory:
A 10,000-foot View

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At a Glance

- Modern Monetary Theory (MMT) is an economic policy aimed at addressing stagnant economic demand and growing financial instability within society.
- MMT could change inflation expectations, moving away from a 'lower for longer' interest rate environment.
- MMT is a natural response to rising economic imbalance and aims to redistribute economic benefits more equally across society.

Modern Monetary Theory, has become a common discussion topic within U.S. policy circles and has seemingly been embraced by several high-profile Democratic politicians. But there is also a vocal opposition to this theory, who ardently advocate against its premise. Highly regarded economists and financial experts have all categorized the theory as "nonsense". They simply don't see sound economic principles behind it.

In this paper, TD Asset Management ('TDAM'/'We') will provide a brief explanation of MMT and its underlying tenets. We will speak to the proposed merits of this economic theory and explore its potential shortcomings. Finally, we will examine the practical implications of implementing MMT in terms of its effects on the macro environment and different asset classes.

MMT Simplified

Without delving into technicalities, we have condensed MMT into a few key points.

Seeking a balanced government budget is not always a good policy goal when the entire economic system is considered.

Countries that can freely issue debt and have a floating exchange rate should not be bound by deficit or debt, because they can always finance it by printing currency; as long as it is within some natural limit.

Governments should more forcefully apply their fiscal tools to smooth out the economic cycle. Fiscal stimulus should remain in place until the output gap is closed; adjusting only after reaching full employment. The countercyclical use of fiscal policy does not necessarily generate excessive inflation.

As we can see on the left, some elements of MMT significantly deviate or even oppose conventional economic thinking. Views such as "finance debt by printing money" and "seeking a balanced budget is not always a good policy goal" are heresy to mainstream economist. In a nutshell, MMT gives government much more freedom to spend. **But does MMT really make sense? And what is the potential downside of MMT?**

Reasonable elements in MMT

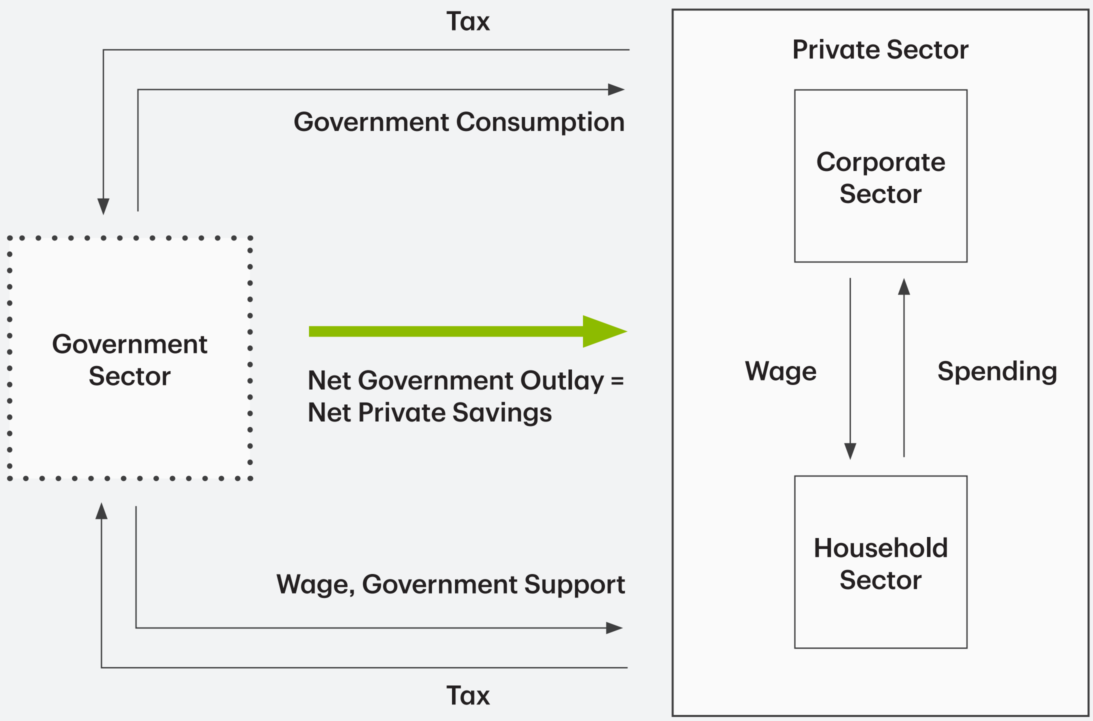
MMT cannot gain popularity with pure hype. There are some reasonable elements in MMT. Detailed below are two reasonable arguments that we believe support MMT.

1 The world is already adopting de-facto MMT!

While media coverage of MMT has only recently been in vogue, it has been in action for a long time. The symbolic sign of MMT is the central bank financing of the government, which has intensified in the post financial crisis era and is evident in most economies. For example, Bank of Japan holds more than 40% Japanese government bonds and has maintained the 10-year government financing cost at approximately zero percent. Other central banks are moving in the same direction, but to a lesser degree. And almost all central banks have institutional arrangements to remit profits back to their governments. If this is not direct financing of the government, what is! if most central banks are already doing this, why refrain from incorporating it into the actual policy framework?

2 Long term fiscal deficit should not be demonized

There is a long-held belief among some policymakers that government deficits are bad and should always be avoided or eliminated. Even in mainstream economics, where temporary fiscal deficit is allowed, a long-term neutral fiscal policy (i.e. over a long period of time, deficits average out to zero) is always the desirable outcome. MMT poses a different perspective, arguing that one sector's savings is another sector's debt. If the private sector seeks net positive savings, then it is natural for the government sector to accumulate a deficit. In a simplified closed economy, as shown in the chart below, we map out the cash flows (black arrows) between different sectors of the economy. For example, money flows from the corporate sector to the government in the form of taxes. At the same time, there are inflows made to the corporate sector in the form of government consumption. If we aggregate the corporate and household sectors into one private sector and only look at the net cash flow (bold green arrow) between the government and private sector, private sector net positive savings has to come from net government spending. Even when we loosen the conditions to a more realistic setting, the general principle still applies.



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Downside of MMT

MMT is a controversial theory and does have several potential downsides. The biggest two are:

1 MMT could create distortions in the incentive system

While MMT enables government to spend more, it does not incentivize politicians to spend more wisely and every penny misspent can have its long-term economic consequences. That's why researchers generally advocate an independent fiscal process, taking power out of politician's hand and giving it to a technocratic body. But the probability of this happening is slim. History tells us that it often takes repeated crises to reach political consensus and set up this type of institutional arrangement. Without depleting the power of monetary policy first, it can be extremely hard to have the right setup for MMT policy.

2 MMT could destabilize inflation expectations and weaken confidence in money

It is generally perceived that money will lose its value when it is printed to finance spending. People could simply refuse to play this "printing game" and switch to other currencies and alternatives. When that happens, currency could devalue, which could in turn push inflation higher and form a self-fulfilling prophecy. History suggests that once the expectation of stable inflation is lost, it can be hard to restore.

The big picture

Every major economic theory is born to solve the problems of its time. In the 1920s, when the private sector struggled to generate enough demand, Keynesian theory was born to enable governments to play a bigger role. From the 1950s to the 1970s following World War II, too much "fiscal monetization" and shortage of supply triggered runaway inflation, which was mitigated by the modern inflation targeting framework.

From the 2000s onwards, lack of demand and financial instability have been the new problems on the macro landscape. Both are deeply rooted in the over-reliance on monetary policy and inflation targeting framework. MMT is intended to address those issues.

Compared to the monetary policy toolset, MMT primarily works through the fiscal channel, which can create very different effects on the economy and markets. In a monetary policy driven environment, policymakers must lower the interest rate and/or increase money supply to support the economy. The impact on the asset market tends to be strong and immediate, but the impact on the real economy tends to be slow and indirect, often through long and uncertain transmission channels. In other words, monetary policy benefits the asset owners first, before the positive effect gradually flows to the population at large. At the late stage of the debt cycle (which is where we are now), the divergence of the two effects can become even greater. Affected by heavy debt burden, additional monetary easing may not translate into strong real consumption, but the impact on financial asset is still positive, as evidenced by the quantitative easing (QE) effect[1]. This means that monetary policy tends to create asset inflation, but not necessarily real inflationary pressure in the economy. Fiscal policy operates in a very different way. In fiscal policy, government hands money directly to corporations and households, which results in a direct increase of spending power. This certainly can have a positive impact on financial assets too. For corporations, this means less tax and more profit, which in turn could drive stock prices higher. For households, the improvement in income could translate to more spending and more corporate revenue, therefore supporting higher stock prices. But the key difference is that fiscal policy benefits the real economy as much as the asset markets during the transmission process. The fiscal support can help prop up the aggregate demand and lead to a more stable interest rate, therefore helping to contain asset bubbles. In short, fiscal policy tends to create more consumption related inflationary pressure than asset inflation, which counters the weakness of the monetary toolset. Given the structural weakness we are facing today, MMT does seem to move in the right direction.

Lastly, viewed from a political economics perspective, we believe MMT is also an inherent requirement of populism. The root of populism stems from the fact that labor's share of income has gradually declined for the last two decades. The middle class in the U.S. was hollowed in the globalization wave as their incomes have deteriorated despite a growing economy. Monetary policy tools could not effectively redistribute the economic benefit and was helpless in addressing average workers' problems. MMT is a natural economic policy response to the broader populist trend. If those economic imbalances still exist, discussions around MMT will continue.

[1] Quantitative easing, also known as large-scale asset purchases, is a monetary policy whereby a central bank buys predetermined amounts of government bonds or other financial assets in order to inject liquidity directly into the economy.

Implications

As an asset manager, our focus is not on providing a defense or rebuttal for MMT, but on preparing for any potential policy changes. After all, even the wrong policy may be implemented if it gains enough political backing. The question we ask ourselves is if a moderate version of MMT becomes reality, what are the potential investment implications?

1. **The economy will recover much faster and we can break out of the "New Normal" regime** If MMT works as expected to create a synchronization between fiscal and monetary policy, it is not hard to project that policy stimulus can work much more effectively at the bottom of the economic cycle. The economy can recover much faster and quickly return to a normal growth trajectory. The sustained low growth environment or "New Normal" as we call it, can be upended. This is great news for equities.

2. **The "lower for longer" interest rate environment will change** If interest rates are a natural reflection of nominal growth, a faster recovery means that interest rates can break out of their secular downtrend. If government debt is viewed as the outcome of increased corporate and household savings, it could be subject to less fiscal constraints. The result could be an economy that is less sensitive to interest rate changes which in turn can allow rates to increase. The potential change in inflation expectation created by MMT could also cause interest rates to overshoot to the upside. On a shorter time-horizon, this is mildly bearish for fixed income. But on a longer time-horizon, investors can enjoy higher yields without moving up the risk curve. Separately, interest rates also serve as a key input for equity valuation multiples. For equities that have gone up in multiples, but do not provide enough earnings growth, they could be subject to pressure.

3. **Structural imbalances will improve** If populist demand is better met through MMT policy, structural imbalances such as income inequality could improve. Fiscal spending on education and retraining may even increase productivity and boost long-term economic potential. All these changes could result in a less polarized political environment and provide political stability. Again, this is a long-term positive for equities.

Policy debate on MMT is far from over and will most certainly continue into the foreseeable future. Like any major policy shift, there can be significant road blocks and hidden traps to the implementation of MMT. But if you believe in MMT, there is one clear positive: the policy space we actually enjoy might be much more than what the conventional view would suggest. So, investors have reasons to be less concerned about the limited economic policy options available for the next downturn and more hopeful about the long-term return potential of their portfolios. ■