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# SPECIAL REPORT

May 27, 2019

# The Long And The Short Of MMT


RESEARCH TEAM

**Chen Zhao**
Chief Global Strategist

**Tony Boeckh**
Editor-in-Chief

**David Abramson**
Senior Strategist

**Yan Wang**
Chief EM & China Strategist

**Harvinder Kalirai**
Chief Fixed Income & FX Strategist

**Jackie Huang**
Senior Research Analyst

**Xiaocen Wang**
Senior Research Analyst

**Henry Wu**
Head of Quantitative Research

**Isabelle Ng**
Senior Research Analyst

**Kevin Yulianto**
Research Analyst

**Haaris Aziz**
Research Analyst


*Dear Clients,*

*Today we are publishing a special report titled "The Long And The Short Of MMT" by Tony Boeckh, Alpine Macro's Editor-In-Chief. Modern Monetary Theory (MMT) is a politically-charged topic that could easily cause controversies, and yet, it is such an important issue that we all must confront. Tony has taken a very objective approach in looking at the various aspects of MMT. He is not shy to point out why MMT's policy prescription has some merits, but also warns about the potential danger if it is in the hands of populist politicians. Tony has provided a framework for investors to think about MMT in the context of debt, excess savings and economic policy, and has made a serious effort to explore how all of these issues tie up and interact with financial markets. I trust you will find this piece interesting, provocative and insightful.*

**Chen Zhao**
*Chief Global Strategist*

I read Kevin Muir's "The Macro Tourist"[1] regularly and almost always there are insights and little gems that one does not see very often. Recently, he has been writing a lot about the so called Modern Monetary Theory ("MMT") and why we should pay attention to it. He stresses the point that we should all drop our prejudices and look at what it's about with an open mind.

This sparked my interest because I have to admit that I had, and still do have, a lot of prejudices and deep skepticism about MMT. History shows us repeatedly that economists and governments always try to find a new theory to fit whenever the current facts are inconvenient. That in itself is not a bad thing because a lot of economic theory is useless and often does not help to understand the real world.

1 "The Macro Tourist" is an excellent and free blog associated with East West Investment Management.

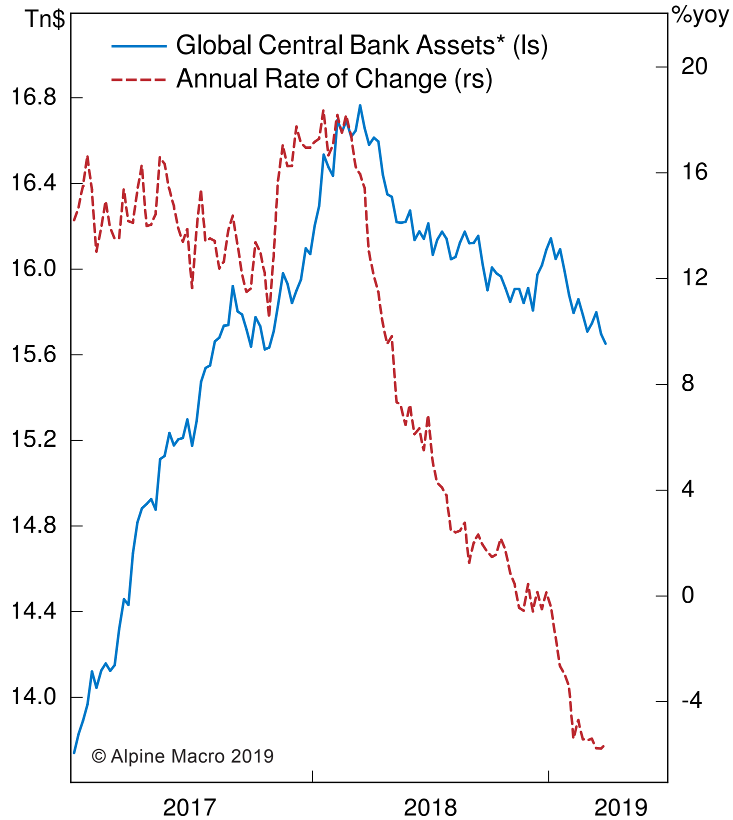
It seems to me that it is not modern (think John Law and the Mississippi Bubble circa 18th Century), not primarily about monetary policy but rather fiscal policy, and not really a theory but a policy polemic for deflationary times. But having said that, I think that looking at the world through MMT eyes gives you a different take on what is going on out there. We need to think about what is likely to happen, not whether it is good or bad. Kevin, being an investment guy, always approaches everything through the lens of what it means for the markets.

## What Is MMT?

The core principle of MMT in simple terms is that, for any country, there are only two constraints on monetary and fiscal policy — inflation and availability of real resources. This assumes, of course, a sovereign (not necessarily independent) central bank and a floating exchange rate. Italy, for example, cannot resort to MMT because it has neither.

We live in a world of very low inflation and even deflation in some places. Whatever its cause — ex-ante excess global savings, technology, globalization, or massive debt-to-GDP ratios, etc. — it does not really matter. The fact is that price inflation continues to undershoot central bank targets in spite of the over $16 trillion in asset purchases by the Fed, Bank of England, ECB, Swiss National Bank and Bank of Japan since the Great Financial Crisis (GFC). Important countries like Japan and most of the EU are dealing with zero inflation or even deflation. No constraint there.

**Chart 1** **QE And QT**




*Sum of Fed, BoJ, ECB, BoE and SNB

On the real resource side, we don't seem to face a problem either, probably because of a combination of technology, globalization, pressure to deleverage and a lingering pool of underemployed people as a result of the 2008 Great Recession. Most commodities, excluding oil, are quite plentiful, with low and falling prices.

The prescription then for MMT'ers in this world is to continue to expand fiscal deficits (hopefully productively with such things as infrastructure spending, tax cuts, etc.) and let central banks play a passive role of accommodation by continuing to buy as much of the growing government debt as necessary so as to keep interest rates very low, as long as inflation stays down. This is basically what has been going on since 2008.[2]

When the important central banks and governments have not followed this prescription in recent years, there has been trouble for the economy and stock prices. **Chart 1** shows that the five most important central banks' aggregate assets peaked in January 2018 at close to 20% p.a. and fell below zero a year later. The Fed actually started to shrink its balance sheet at the end of 2015, leading to a soaring dollar, shrinking global liquidity and a global growth slump. In addition, China has tightened its fiscal and monetary policy three times since 2009: in 2011, 2015 and 2018 and each time, the Chinese economic growth caved in, negatively affecting global manufacturing and causing commodity prices to collapse.

Every time Japan has tried to retrench fiscally, its economy slides into "technical recessions". The German government pursued orthodox fiscal policy by running a 1.5% fiscal surplus, which in no small part has driven the economy into stagnation and contributed to weakness in the rest of Europe.

The U.S. has had a different experience in recent years because the Trump fiscal stimulus kept the economy strong through 2018 and is still having an effect, although diminishing. The economy may have begun to slow as domestic demand grew at a mere 1.4% annualized rate in Q1, but the picture is still mixed as fiscal thrust remains large going into 2019 due to delayed tax rebates.

However, the inverted yield curve and other measures of liquidity in the U.S. (discussed later) suggest a weakening economic outlook ahead. Price inflation in the U.S. peaked around mid-2018, Japan is back to deflation and European inflation is way below the central bank target. China's inflation has also undershot the target by a significant margin.

In short, the backdrop for the world economy is still very deflationary. Central banks can, and do have, an impact when they tighten, and the time lag seems shorter than before. This means that central bank action is not symmetrical. When they ease, there is not much, if any, stimulus. We all know that monetary policy works through lower rates inducing more business and consumer spending, and generally raising asset prices, which improves balance sheets. When rates are zero, there is nothing left for inducement, and hence monetary policy is often described as "pushing on a string".

This is where MMT comes into play as a policy prescription:

First, it says that central banks should never tighten. They must keep interest rates close to zero and remain passive through the cycle.

Second, because central banks cannot stimulate, fiscal policy has to do the heavy lifting.

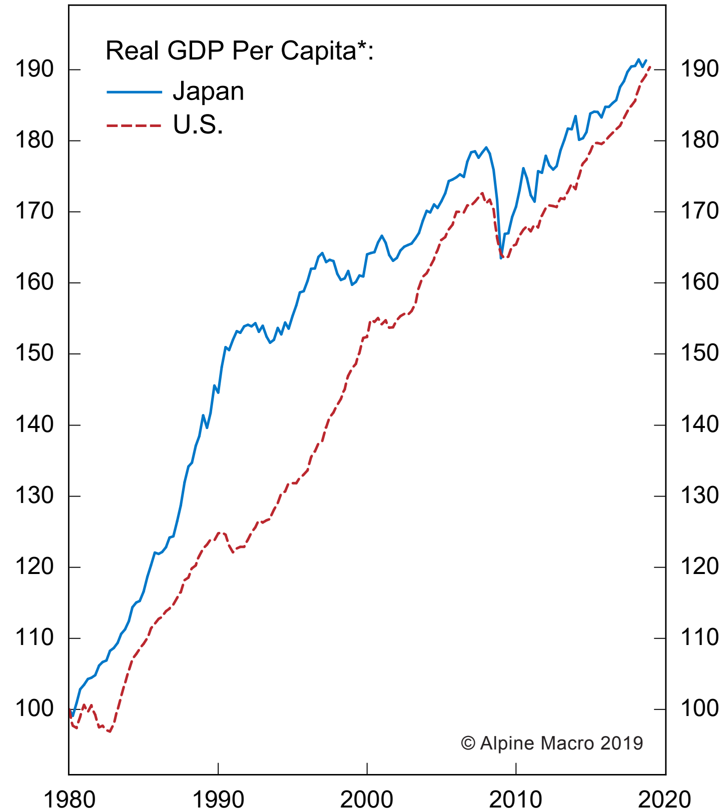
Third, bigger deficits and rising government debt are the only way for the public sector to offset the over-saving problem in the private sector.

2 Kevin Muir has pointed out that hard core MMT proponents would have some esoteric differences with my interpretation which is meant to avoid complex technicalities. For example, they say that governments don't need to buy debt, governments spend first and don't have to borrow and that money creation is endogenous, not exogenous, i.e. central bank engineered.

In other words, with the private sector always saving more than its desired investment, the public sector needs to always dissave to make up the gap, or nominal GDP would fall.

MMT'ers would say, "go for it, where is the problem?" We can look at Japan, perhaps, for some guidance. The gross government debt-to-GDP has risen progressively to 240% and left many who shorted JGBs with big stomach aches. In fact, **Chart 2** shows real per capita income for Japan and the U.S. since 1980. While Japan had a slower growth than the U.S. in the 1990s and 2000s, it was entirely due to a stagnant labor force. If you adjust for the slower growth of Japan's labor force, the experience of the two countries is also about the same over the past 20 or 30 years. So, again, where is the problem?

**Chart 2** Per Capita GDP: Japan Vs U.S.




*Both series are rebased to Jan 1980 = 100

## What Are The Concerns?

Trump is the first MMT president/administration in U.S. post-war history and there are plenty of MMT supporters in the Democrat-controlled House. In fact, MMT was coined by Elizabeth Warren and Alexandria Ocasio-Cortez, so both the White House and Congress have bipartisan support for this. The voices to counter this are weak, in good part because it is probably appropriate, given the deflationary environment we are in and the widespread concern among the middle and lower classes over their declining economic status.

However, I worry that MMT, in the hands of politicians like Donald Trump or Bernie Sanders, is a bit like letting children play with matches. Trump has attempted to appoint lackeys to the Federal Reserve Board, but so far his attempts have been thwarted. Should the next president come from the Democrat side, the situation could be even worse because many presidential hopefuls are socialists who simply want to spend. The longer policymakers can get away with monetizing deficits and spending beyond their means, the more they will do. Isn't every populist's dream to be able to throw money to the masses to buy support?

There is another thought that is articulated by Lacy Hunt.[3] He theorizes that rising government debt-to-GDP ratios in today's world are

3 Lacy H. Hunt, Ph.D, Executive Vice President and Chief Economist of Hoisington Investment Management Co.

associated with lower, not higher, interest rates and inflation (**Chart 3**). Debt-funded traditional fiscal stimulus does seem to be fleeting when debt is already very high.

It is very difficult to buy this thesis. Lacy Hunt is essentially saying that the growing supply of government debt acts perversely and pushes up bond prices (i.e. rates down), contrary to traditional bond market analysts.

I don't buy this notion as it mixes up cause and effect and ignores the fact that it is excess savings that drive down interest rates, forcing the government to dissave and borrow from the public. In Japan's case, for example, the government has not dissaved enough to offset private sector excess savings, a key reason Japan has suffered deflation.[4]

## Three Core Macro Principles

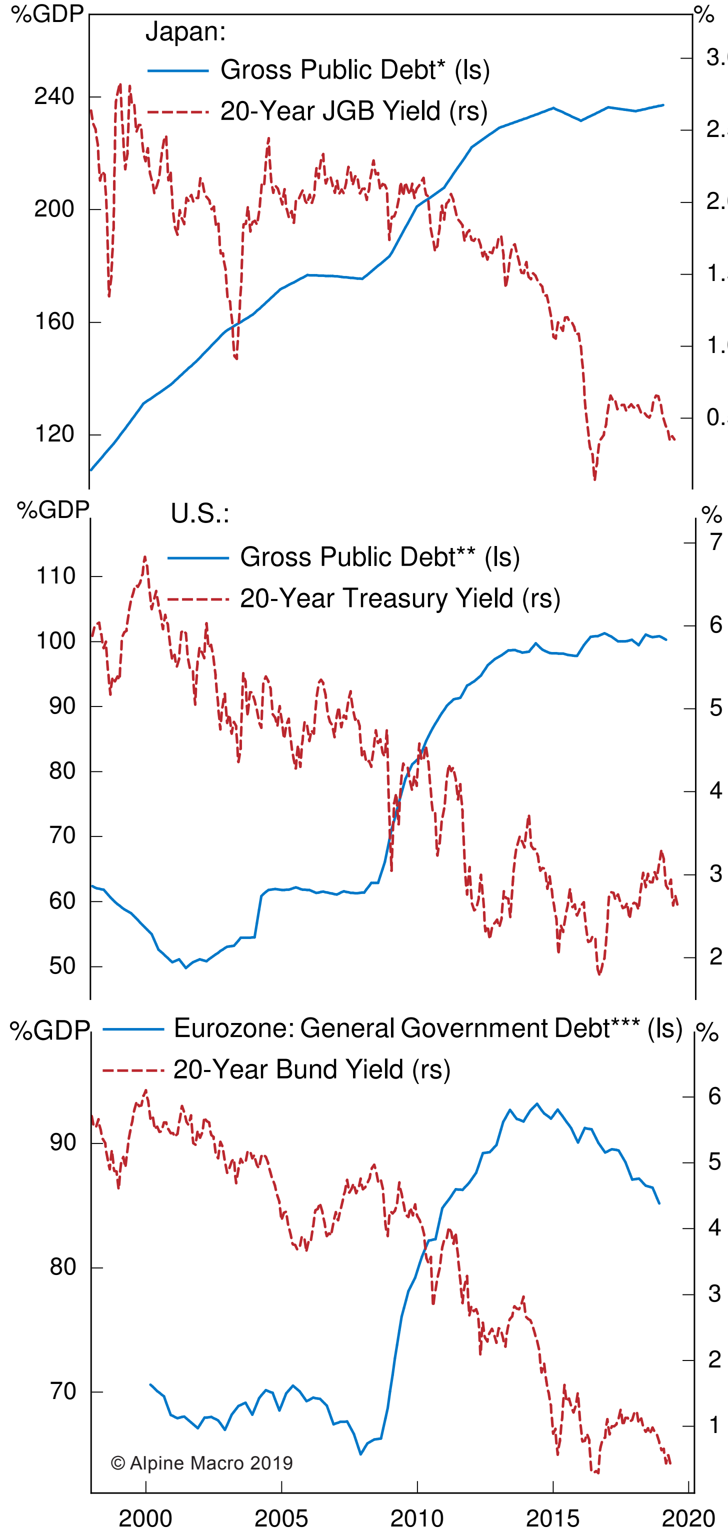
There are three core macro principles that have always seemed self-evident.

- From Milton Friedman, we all learned that "inflation is always and everywhere a monetary phenomenon". Friedman was always on the side of rules as discretionary policy frequently led to either inflation or deflation.

- Keynes taught us that fiscal deficits were appropriate when the economy was depressed but should be offset by surpluses when the economy recovered, to prevent a persistent rise in government debt-to-GDP ratios.

4 Richard Koo has been making this point for some years. See his book, *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession* (John Wiley & Sons, 2008).

**Chart 3** Rising Debt And Falling Rates




*Source: World Bank
**Source: Federal Reserve
***Source: ECB

- Evsey Domar and Walter Ellis showed that a persistent trend of rising debt-to-GDP would lead to a doomsday situation causing a self-feeding spiral and inevitable collapse.

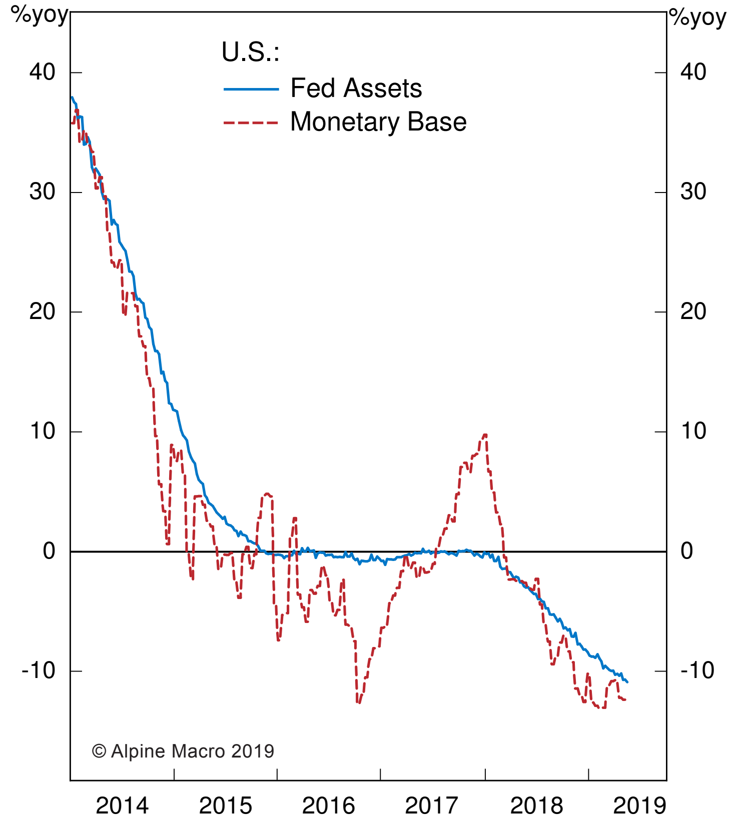
Over the 10 years since the GFC, the world seems to have made a mockery of Friedman and Domar, but vindicated Keynes so far on the right policy prescription for economic slumps, but we have not yet seen the end of the story on rising debt-to-GDP ratios.

Central banks have pursued unbridled monetary expansion, adding over $16 trillion to their balance sheets but inflation is lower than 10 years ago. Keynesian policy (e.g. TARP, China's RMB4 trillion stimulus package in 2008 and huge budget deficits from Europe to Japan prior to 2010) has certainly undercut the depth and severity of the economic contraction during and after the GFC. Without that, we would have had a similar liquidation spiral as in the 1930s. Public sector debt-to-GDP has soared from the U.S. to China to Japan, and yet, bond yields are either at zero or extremely low.

There has been no evidence of "crowding out" whatsoever, in spite of the fact that Keynes' policy prescription of massive public sector dissaving continued well after most economies recovered from the GFC. Keynes would have said that there should have been much smaller deficits or surpluses depending on the country, but this has been ignored.

This is because there has not been any problem as a result of central bank monetization of debt

**Chart 4** **U.S.: Is Money Too Tight?**




as the world has remained very deflationary, with interest rates on government debt at extremely low levels.

This experience appears to have totally refuted standard macroeconomic theory and policy, making it almost impossible to argue against the principle tenets of MMT. So, the gate has been and remains wide open.

Populists like Donald Trump and many Democrat presidential hopefuls can easily argue for the need to have much lower interest rates and increased fiscal expenditures, lower taxes and larger deficits with little coherent opposition.

**Chart 5** U.S.: A Flat Yield Curve And Slowing M2

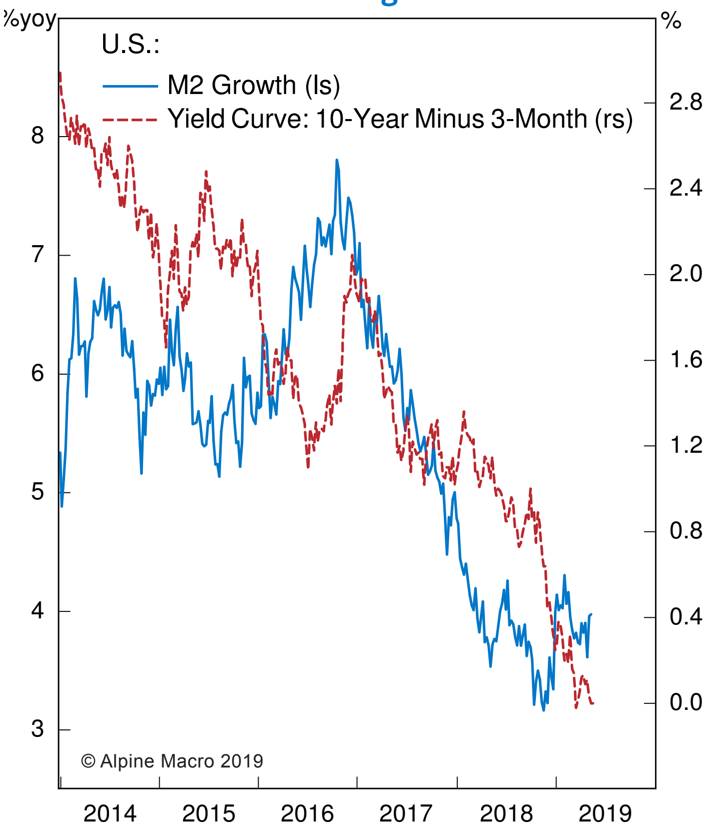
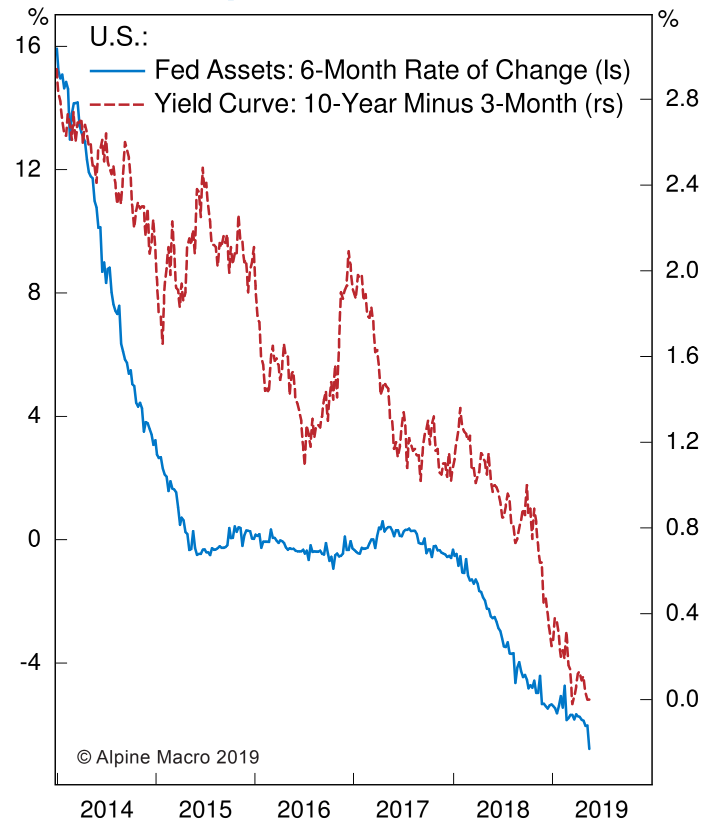



**Chart 6** U.S.: QT And Yield Curve




## Financial Indicators

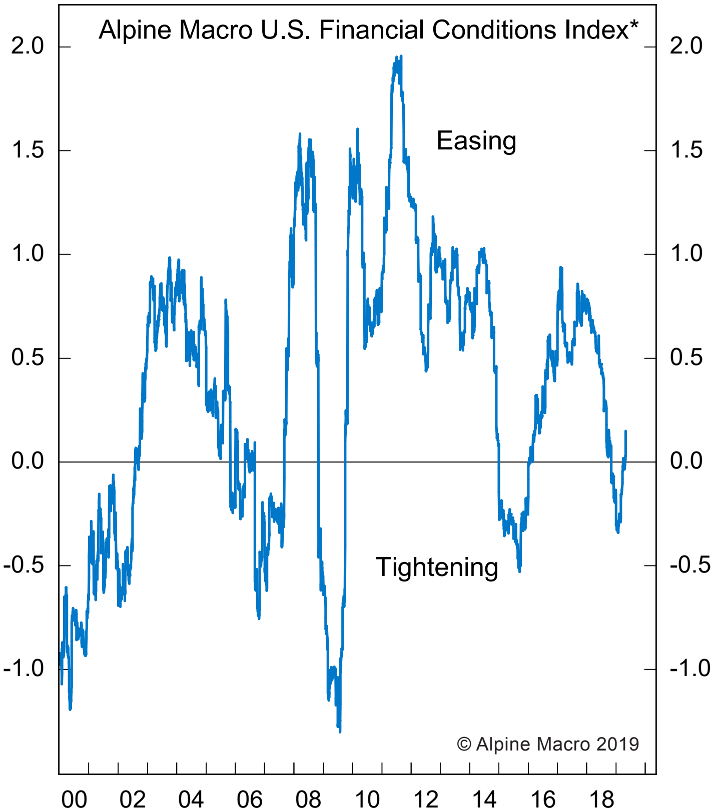
Since the Fed first stopped adding to its balance sheet and then began to shrink it, liquidity in the U.S. has tightened, perhaps too much.

**Charts 4, 5** and **6** show that, with the transition from QE to QT in the U.S., both the monetary base and money supply (M2) have weakened substantially, the yield curve has flattened and even inverted. Alpine Macro's financial conditions indicator fell significantly into negative territory although it has recovered more recently (**Chart 7**).

The U.S. dollar has been stronger than expected, usually an indicator of liquidity tightness. Perhaps most important is the impact that Fed tightening has had on shrinking global liquidity, as shown in **Chart 8**. All of this, in turn, has occurred in conjunction with slowing global growth. As such, there are legitimate concerns that money is too tight.

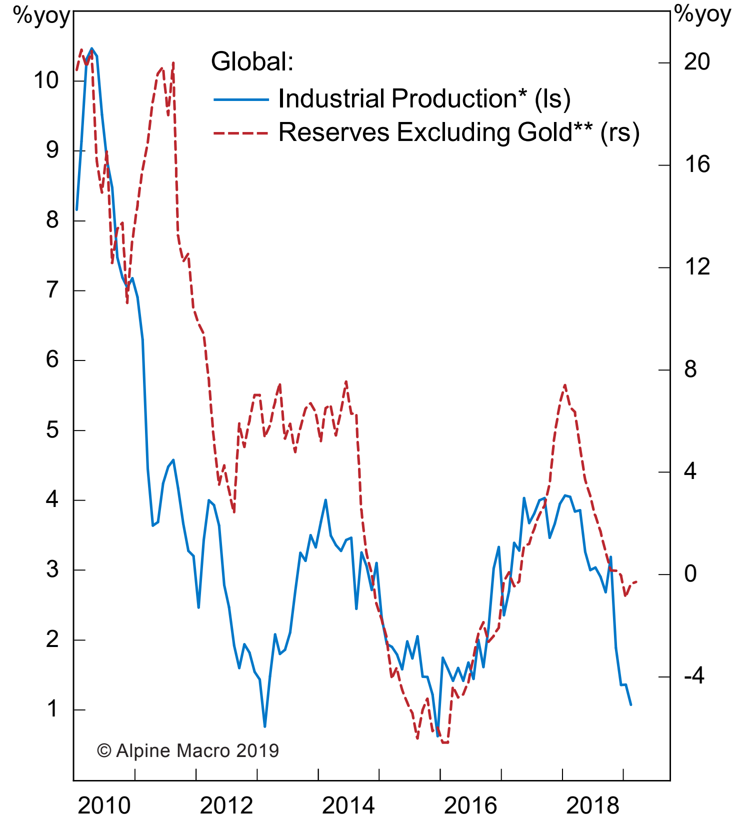
On the fiscal side, the current situation shows that, with the U.S. economy very close to full employment (or above, according to the CBO), federal government deficits, currently at 4%

**Chart 7** U.S. Financial Conditions Index




*Based on the yield curve, trade-weighted dollar and stock market; standardized

**Chart 8** Slowing Global Liquidity: Weakening Global Growth




*Source: Netherlands Bureau for Economic Policy Analysis (CPB)
**Source: IMF

of GDP, are expected to more than double to 9.3% by 2049, based on CBO projections (**Chart 9**). Federal debt[5] is projected to rise from 78% to 147% of GDP over the next 30 years (**Chart 10**).

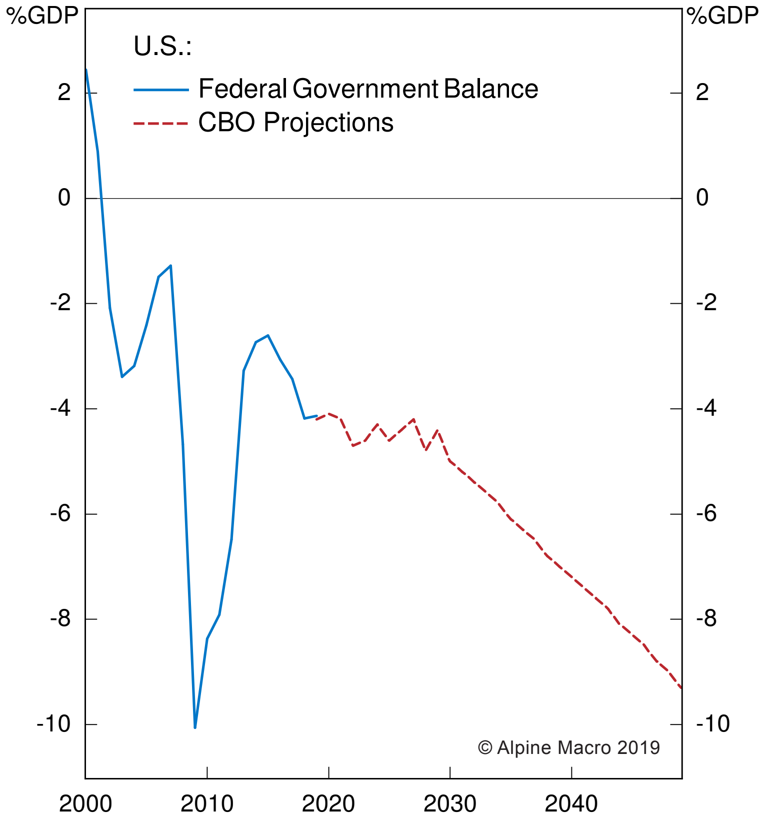
This assumes no recessions and does not include the huge federal unfunded liabilities or state and local government debt. Of course, we should always treat this kind of projection with a grain of salt, but the key point is that both the Republicans and Democrats are seriously discussing a $2 trillion infrastructure package, unfazed by the debt and deficit numbers.

This again is a consequence of the post-GFC environment in which huge deficits and rising debt levels have had no apparent side-effects for inflation and interest rates and the relative ease of governments financing themselves.

If we are right that the U.S. economy will soften in the prelude to the 2020 election, we can certainly expect President Trump to increase his attacks on the Fed. As well, there is a big incentive for both parties to try to get an infrastructure package agreed to.

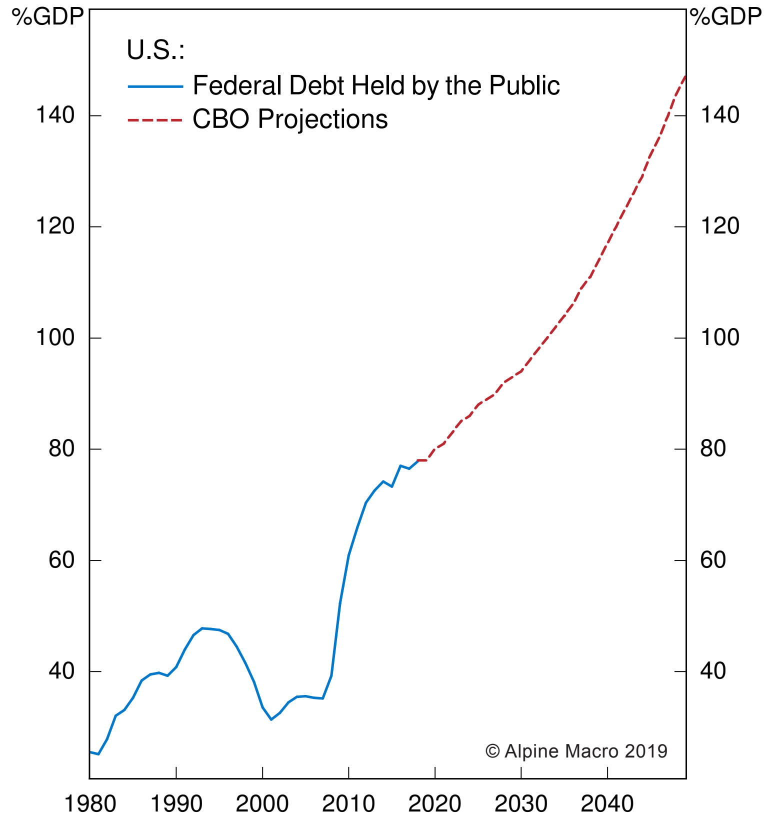
5 This measure is Federal debt held by the public, which excludes debt held by the Federal reserve and other federal agencies.

**Chart 9** U.S. Fiscal Deficit And Projections




Source: Congressional Budget Office (CBO)

**Chart 10** U.S. Federal Debt And Projections




Source: Congressional Budget Office (CBO)

## Conclusion

Everyone should be very interested in MMT. The U.S. government has already practiced MMT in principle, and the Japanese government has applied the MMT doctrines for decades. What is developing now is that a number of politicians and academics are trying to make it into a theory with which to guide economic policy.

A continuation of the deflationary environment and middle-class Americans' concern for jobs and real income gains will continue to be very supportive of the populist MMT agenda.

As a result, it will be a tough uphill battle arguing against MMT policy prescriptions. Almost everyone believes that central banks no longer have much ability to stimulate. This also supports the MMT approach.

The timing of a more aggressive implementation of MMT policies, however, remains uncertain but the directional effects of such policies are pretty clear as far as the U.S. economy is concerned.

More fiscal stimulus is bullish for economic growth and stock prices, potentially bearish for bonds, bullish for the dollar, but ambiguous for commodity prices and real assets: Strong growth is bullish for commodities but a stronger dollar usually depresses them, and the net impact is hard to tell.

It could well trigger the long-awaited rotation into small-cap, value and even commodity stocks at the expense of growth and high dividend stocks, but this reversal could continue to remain elusive for a while longer.

However, speculative interest in loss-making tech, cannabis, etc., stocks could continue but these areas are highly risky and will eventually get trashed.

MMT in populist hands is dangerous. If politicians get addicted to MMT, a prolonged public sector spending spree could become a source of rising inflation leading to a blow-up in the bond market. This is not an immediate concern, but investors should not lose sight of this longer-term potential risk.

Moreover, it should be kept in mind that a key component of MMT is that, in a situation of full employment and rising inflation, taxes should be raised to restore balance. This is in fact in total conflict with mainstream Republicans and virtually all populists.

As Paul Krugman has said (and he is no right-wing economist), seigniorage — the ability of governments to acquire real resources by printing money — eventually comes to an end when abused. At that point, inflation will start rising again and potentially set in motion the fiscal doomsday model of a catastrophic upward spiral in the government debt-to-GDP ratio.

**Tony Boeckh**
*Editor-in-Chief*

**Alpine Macro**, founded in 2017, is an independent global investment research firm based in Montreal, Canada. We focus on the analysis of major macro economic forces and specialize in forecasting the direction of global financial markets, while providing actionable recommendations on investment strategy and asset allocation.

## Our Leadership

**Chen Zhao, Founding Partner and Chief Global Strategist** From 2015 to 2016, Chen was Co-Director of Macro Research at Brandywine Global Investment Management. Prior to Brandywine Global, Chen spent 23 years at BCA Research. As a Partner, Managing Editor and Chief Global Strategist, Chen developed and wrote BCA's China and Emerging Markets publications in the 1990s. Chen became the firm's Chief Global Strategist in the 2000s and was the author of BCA's flagship publication, Global Investment Strategy from 2005 to 2015. He holds an MA in economics from the Central University of Finance and Economics, was a visiting scholar at the University of Illinois at Urbana-Champaign and pursued post graduate studies with a PhD candidacy at McGill University.

**J. Anthony Boeckh, PhD, Founding Partner, CEO & Editor-In-Chief** Tony was previously Founder, Chairman, Chief Executive and Editor-In-Chief of Montreal-based BCA Research for 34 years. He authored The Great Reflation (Wiley) in 2010 and was publisher of, among others, the Bank Credit Analyst, a monthly big-picture analysis of the U.S. and global economies and financial markets. He is a founding trustee of the Fraser Institute in Vancouver, British Columbia — an economic "think tank" dedicated to free market principles. Tony has a PhD in Finance and Economics from the Wharton School, University of Pennsylvania, and a B.Com. from the University of Toronto.

**David Abramson, Partner and Senior Strategist** David was a Macro Strategist holding a variety of senior roles at BCA Research. Most recently, he was Chief U.S. Strategist and also Director of Research for the firm. During his tenure at BCA Research, David launched and managed the European Strategy and Commodity & Energy Strategy services. In addition, he was the Managing Editor for the Foreign Exchange Strategy and the China Investment Strategy services. He has taught international finance to MBAs at McGill University for 20 years, and is on the Client Committee of the Kenneth Woods Portfolio Management Program at Concordia University.

**Yan Wang, Partner and Chief Emerging Markets and China (EMC) Strategist** Prior to Alpine Macro, Yan spent 15 years at BCA Research, as Managing Editor and Chief Strategist for BCA's China Investment Strategy service, and played a major role in formulating BCA's view on the Greater China region and emerging Asia. Prior to joining BCA, he spent six years as an equity analyst in China and Hong Kong. Yan holds an MBA in Finance from McGill University, an M.A. in Economics from Tianjin Institute of Finance and a B.A. in Finance from Nankai University. He also holds the CFA designation.

**Harvinder Kalirai, Partner and Chief Fixed Income & Currency Strategist** Before joining Alpine Macro, Harvinder spent a decade with BCA Research, where he headed the firm's Foreign Exchange Strategy service from 2008 to 2016 and Daily Insights from 2016 to 2018. Prior to BCA, Harvinder was Head of Currency Management at CIBC Global Asset Management. Previously, he held various positions at State Street Global Markets, including Senior Macro Strategist (London), Head of Currency Research, Asia-Pacific (Sydney), and Senior FX Strategist (Boston). Harvinder began his career at the Bank of Canada in 1995 with an MA (Economics) and a BCom (Finance) from McGill University. He also holds the CFA designation.