Retro and Modern Monetary Theory

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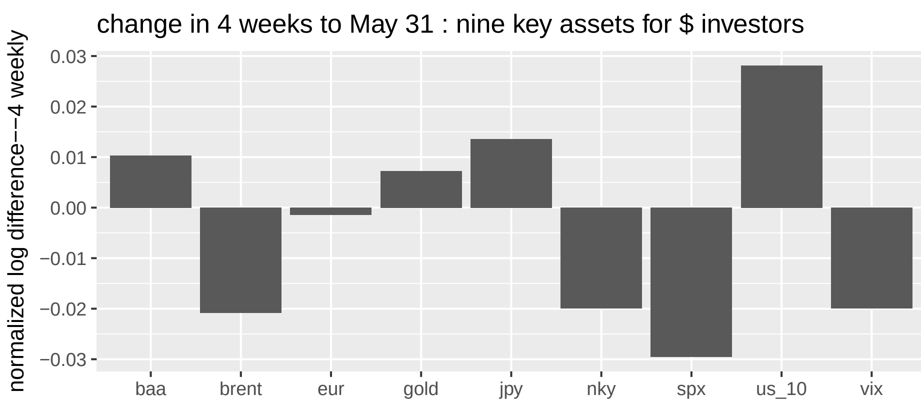
Bond yields moved down sharply as equity prices started down again. We have been in a sustained rotation from stocks into the safest available bonds for several months.

Other risk markets, including some emerging markets, have weakened in line with the core markets. In currencies, the Yen and Swiss Franc were stronger

Oil prices turned down, as did copper, in line with the growing recession risk projected by investors and implied by the falling bond yields.



A Weak Rebound Investors understandably seek to limit their considerable downside risk in stocks by shifting to bonds, but their actions are pushing a bigger rally in bonds, and lower yields, than justified.

Safe government bonds are in such great demand that riskier paper has not seen the same drop in yields. So, a measure of the widening of risk spreads is the mechanical consequence of the great move into safe bonds.

As risk aversion continues to dominate headlines, investors become groggy with the antics of Mr. Trump. Some of these, including a possible major disruption of global trade patterns with tariffs and sanctions, cannot be good for long term projections, and real investment.

In the UK, the collapse of the Mays government opens up her conservative party to a take-over by radical Brexiteers who may be capable of a highly disruptive no-deal exit. In that case sterling could be far lower, so investors began to price the possibility.

Modern Monetary Theory... Sometimes dismissed as gibberish, "Modern Monetary Theory" (or MMT) is clearly different from today's standard academic theory. Rooted in the decidedly non-academic ruminations of a money market trader, it starts by considering the legal requirement that banks hold reserve balances at the Federal Reserve against deposits. Shortage of these required balances, supplied by the Fed's open market operations (at that time), was the key that determined how high interest rates for the fed funds market and then the rest of the economy would go.

Arguing by strained analogy, this trader extended the model to the broader economy. All money base, is required by law, he claims, to make all government tax payments. [1] In this way, he claims the economy, employment, and prices are put under **downward** pressure by higher taxes and less public spending, supposing always that money demand, like reserve requirements, is mostly independent.

After decades of academic disinterest, the approach finally gained scattered converts, a blogging community, and the approval of several Democratic politicians. It also turns out that the main conclusion were all there already in the economics literature of the the 1940's. At that time, the wartime control economy brought out the potential for a widely administered economy, in the US as elsewhere. Keynesian economics was a by-product of that time, but others described a more general theory of social control in war-time.

After the war, an hysterical push to roll back the control state developed, starting in the US. Seemingly overly-attractive and dangerously socialist acceptance of public administration was rejected. In particular, Keynesian approaches that included active public spending programs became a political target. Eventually, anti-Keynesian theoreticians latched on to Monetarism as an alternative approach that promised the advantages of automatic macro control without the heavy hand of discretionary government. Today's "Modern Monetary Theory" has actually turn that monetarist effort completely on its head, because it comes back to the conclusions of the war-years under the verbal guise of a monetary, or minimal control, theory.

In Abba Lerner, we find the clearest case for the logic of a war-time control economy. In his work, Lerner found that money is a state creation, without any necessary reference to gold or any other anchor.[2] He also argued that the right way to think about effective public administration is in terms of finding how much public spending is required to hit national objectives, like a stable price level and low unemployment. This is regardless of deficits and is exactly the lesson the MMT crowd has drawn, without the tortured analogies.

Lerner argued that if public spending ever grew too large, any incipient inflation could be countered with cuts in spending and higher taxes. There can never be an excess debt in the sense that the inflation rate will never be allowed to rise too fast or the private sector permanently crowded out of capital markets. He called this "Functional Finance". Basically, he thought that a modern economy is almost always dominated by administered functions, and politicians who see this will prosper. To quote Lerner: "Like any other mechanism, Functional Finance will work no matter who pulls the levers. Its relationship to democracy and free enterprise consists simply in the fact that if the people who believe in these things will not use Functional Finance, they will stand no chance in the long run against others who will."[3] Indeed.

Today's MMT takes one a little extra twist, by arguing for a public jobs program. Since employment is a political objective, why not target it directly? As long as fiscal policy is responsive to rising and falling inflation risk, and fully in control, what can be the harm?

[1] Mosler, W."Mosler Economics/Modern Monetary Theory: The Currency as a Public Monopoly", Course Materials, *University of Bergamo*, 19 March 2014

[2] Lerner, A. "Money as a Creature of the State", *The American Economic Review*, Vol. 37, No. 2, Papers and Proceedings of the Fifty-ninth Annual Meeting of the American Economic Association (May, 1947), pp. 312-317

[3] Lerner, A. "Functional Finance And The Federal Debt", Social Research, *The Johns Hopkins University Press*, Vol. 10, No. 1 (February 1943), pp. 38-51

...Can be Useful in Elections. Of course, the state cannot be the main source of sustained economic change. Ask residents of the ex-Soviet Union, or Cuba, or Venezuela today. So the idea of aiming public policy at the unemployment rate by simply hiring the unemployed, as the MMT crowd and Lerner before them called for, has risks. In particular, who can assure us the "employment" offered is productive work and comparable to the effort called for private sector work? The jobs actually offered will have to be limited.

Lerner also claimed, as do today's MMT proponents, that public debts owned to one's own nationals cannot be a threat. One sector's debt is another sector's asset and it all washes out. Maybe, but that works best when interest rates do not compound debts faster than the rise in debt service capacity for any one sector. Luckily, low rates today mean debt to GDP levels can be stabilize easily. That was very much **not** the case in the 1970's when widely adopted Keynesian polices led to higher commodity prices, inflation, and sharply higher interest rates. So I am not sure ignoring public debt is correct under all circumstances. Certainly, public spending has to be subject to reduction when inflation looms.

To be complete, a fiscal policy-centered apparatus would have to include an independent board to set spending levels according to an impartial judgment of current economic conditions. Replacing what the Fed now does with modulating interest rates, that would curtail legislative control of taxes and spending. It is doable, but would mean an enormous institutional change in the both the US and Europe.

As an aside, the MMT crowd has a special distaste for the European Monetary Union. Because that system is founded on a partial political solution that locks down each nation into limited budget deficits, nations cannot use fiscal policy freely in seeking full employment. From the point of view of MMT theory, the flaw is fatal. Indeed, warm Italian interest in MMT thinking has led the newly invigorated Lega party to push for a new fiscal deal in Europe using these ideas.

Extreme? Yes. But, our current condition, fairly considered, is hardly less extreme. Originally a hands-off and impartial monetarism has morphed into central bank interest rate setting, and from there into vast balance sheet operations. In fact, pointing central bank bond-buying policy at asset valuations to support demand, to the lopsided collateral benefit of our richest citizens, is so radical a policy it could never have been adopted if spelled out clearly in advance. And yet that policy is exactly where we are today in the absence of more active fiscal policies.

In fact, we could say that Mr. Trump's initial implied promise to use infrastructure spending in case of an economic downturn was really out of the MMT playbook. By bolstering business and investor confidence even if not a penny was actually spent on construction, it was surprisingly successful. Later on, an oversized and unnecessary tax cut and spending program bolstered the economy again in 2018, by more than I expected. So what we are really seeing in MMT is the intellectual organization of ideas that Mr. Trump has already been implementing. It works, for Democrats or Republicans, in the sense that you can only get elected by supporting it, as Lerner long ago suspected.

So, Modern Monetary Theory is not modern, not mainly about money, and definitely not gibberish. Indeed, it may be a factor in global markets in the years to come. Its adoption without full safeguards also poses a risk of reflation and sudden exit from the long period of low inflation we have been in.

Amid Tariff Risks. We are recovering more slowly than I expected from the global supply chain flash-crash of early this year. For me,this crash was due to the conjunction of China's New Year holiday with a pause in earlier Chinese over-production meant to beat US tariffs, and a related pause in the the build-up of US inventories. But continued solid services activity around the world supports the hypothesis that we just saw a serious but still limited shock in the global inventory cycle involving mainly manufactured goods.

In the US, inventory and export gains held up GDP growth even in the face of a deep slide in demand. Underlying consumption was weakened by delayed tax returns and falling farm incomes, housing is only slowly recovering from higher mortgage rates in 2018, and investment spending may be held down by the collapse in shipments of Boeing 737 Maxi planes. Some of these factors should reverse later in the year in the absence of a credit crunch and the unpredictable and far reaching responses that often follow. Still, the weakness in capital goods shipments shows the accumulating harm to businesses struggling to adapt to intensifying threats of US trade sanctions against China, and also Iran, Venezuela, and now Mexico. Whether a manufacturing-centric inventory cycle turns into an economy wide event will remain in the balance.

Elsewhere, European production has stabilized at a low level after the global supply chain shock. Production adjustments were felt across the Eastern European supply chain, particularly in Czechia's car assembly sector. In the UK, the continued Brexit saga has led to a marked short-fall in investment spending by companies understandably unclear about their future operating environment. But, pro-cyclical fiscal spending remains inevitable on the continent, as Italy's Lega will be pushing for it in the European Legislature, using using parts of Modern Monetary Theory for support. As in the US, the European manufacturing pause has not been followed by job losses yet, which should support incomes, stabilizing these economies by mid-year.

A Chinese recovery after the Lunar New Year, when reflationary measures should have kicked in, has been disappointing. Export orders and other indicators all show the sustained harm of tariff wars on exports and the continuing downturn in car sales at home. Apartment sales, on the other hand, seem to be holding up and steel production keeps increasing. Unsold car inventories will be hanging over production, and a similar excess could be developing in housing, all of which may yield several quarters of continued weakness in these areas. Meanwhile, efforts to wring out financial excess while not triggering a deeper recession continue. Recently a provincial retail bank failed, with only a portion of (smaller) deposits guaranteed. A slowing economy will always expose weak lending, sometimes suddenly, and the policy seems to be to enforce educational losses to correct future lending behavior. But this central bank seems to have all the instruments to react smoothly and quickly to stop a wider panic from developing.

A sudden and joint industrial adjustment, across an unusually large range of nations is something new for global markets. But a shock limited to the global inventory cycle should pass. Testing our luck at the same time, however, we have Mr. Trump trying out a range of sanctions weapons against a broad range of real and imaginary enemies around the world, all of which could seriously disrupt economic structures and investment spending plans.

Despite the immediate risks, I remain of the view that the real danger for financial market disruption comes from another bond market sell-off. Of course, the opposite has been happening as bonds advance with the fall in equities. But if we turn out for any reason to pass through this test without a full recession, and with rising prices now beginning to build in the global system, a wrenching change in bond valuations will be coming that could close bond markets, triggering broader credit fears.

I find the recovery with inflation case comes one step closer with the adoption of Modern Monetary Theory. By turning upside down many long-adopted principles of macro-management this theory could take us right back to the Keynesian public overspending of the 1970's if not handled with great care.