EURIZON SLJ
ASSET MANAGEMENT

'*Financial Climate Change*' and the increased risk of storms

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Analysing macro is fun these days, because nobody knows what the right answers are; but making market calls is more challenging, not only because nobody knows what the right answers are, but because the distribution of the possible outcomes is far from normal or unimodal. We are in many ways suffering from a 'financial climate change,' whereby various structural factors have made financial storms more likely, in my view, that traditional models such as the Phillips Curve have become highly inadequate in capturing the most important macro tensions.

In particular, this 'financial climate change' is related to inflation targeting, in the context of major structural changes, including demographic changes, sometimes disruptive technological advances, and of course globalization. The use of unconventional tools was initially justified by unconventional objectives (credit crunch related to the Great Financial Crisis), but has since been justified on conventional grounds (inflation being 0.3% lower than the target).

Thoughts on...Modern Monetary Theory (MMT)

There is more talk about Modern Monetary Theory (MMT) and ideas like the MMT of cooperation between the fiscal authorities and central banks to artificially generate demand and inflation. There are plenty of market participants and policy makers who support what used to be an unthinkable idea. In the absence of crises, this exceptional emphasis on taking extreme actions to eke out a small increase in inflation is stunning to me. Most people know that globalization and technological changes have been disinflationary. This is 'good deflation' that central banks dismiss, on the notion that lower inflation limits the scope for future monetary easing, due to the zero lower bound.

MMT is the idea that a large fiscal program and large fiscal deficits and debts could be monetised with little consequences if inflation is low. In other words, proponents of MMT (Profs Kelton – an advisor to Senator Bernie Sanders), (L. Randall Wray, and Bill Mitchell – who coined the term MMT) and (Senator Elizabeth Warren) support large social programs and generally expansionary fiscal policies through all parts of the business cycle, with the fiscal deficits financed by money printing. They argue that fiscal deficits don't matter when the country in question can issue its own currency, and therefore can always issue enough currency to buy the sovereign debt.

The increasing popularity of MMT is in part a result of Japan's experience of two decades of fiscal deficits averaging 6% of GDP (and as high as 10% of GDP), with little obvious consequences. Its popularity is also a reflection of the polarised politics in the US on the appropriate size of the social programs and how to fund them.

The key arguments against the MMT include the following:

1. Many countries can issue their currencies, including Russia and Argentina. But they have still chosen to default on their debt. The reason has to do with the trade-off between inflation and fiscal financing and shifting the burden of adjustment to foreign holders of the sovereign bonds.
2. Many EM economies have pursued this very strategy, only to see their currencies collapse, because investors who don't like these bonds also tend not to like the currencies. To stabilise the currencies, interest rates would need to be raised, which would further exacerbate debt sustainability.
3. Many DM economies have pursued this very strategy, including the Mitterrand government in France in 1981 and the Schroder government in Germany in 1998[1].

They all had to reverse their policies.

This idea that there is a big free lunch to be had will likely remain enticing to politicians. The Fed, which has thus far made all of the arguments to justify maintaining unconventional and easy monetary policies, will have a hard time resisting becoming an unwitting participant to an MMT program: when the decision is made to run large fiscal deficits and large social programs, the Fed will have little choice but to comply by conducting QE to keep interest rates low.

[1] 'The left's embrace of modern monetary theory is a recipe for disaster', Larry Summers, March 4, 2019.

https://www.washingtonpost.com/opinions/the-lefts-embrace-of-modern-monetary-theory-is-a-recipe-for-disaster/2019/03/04/6ad88eec-3ea4-11e9-9361-301ffb5bd5e6_story.html?noredirect=on&utm_term=.96de708d9f0f

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