# FUNDAMENTALS

## Modern Monetary Theory: are deficit hawks an endangered species?

A once-fringe economic theory has been embraced by liberal politicians at the same time as traditional budget hawks have been in retreat. Its rise has potentially radical implications for inflation and investors.

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Decades into an era of declining inflation and falling interest rates, political calls for balanced budgets and fiscal restraint now seem quaint if not completely antiquated. Where longstanding defenders of 'responsible' central banks and austerity have not fallen silent, they have in some cases now reversed their positions entirely.

This is not merely a case of conservative politicians deciding that spending limits and prudence are inconvenient now that they are in power. As may be expected, loud calls for the government to unleash its fiscal power have also come from liberals, most notably Democrats in the US including Congresswoman Alexandria Ocasio-Cortez.

### THE QUIETENED HAWKS

**Bob Corker**, then a Republican US Senator, on fiscal responsibility: "The American people today are not interested in it" (May 2018)

**Olivier Blanchard**, former chief economist at the International Monetary Fund: "High public debt is bad, but may not be catastrophic" (January 2019)

**Mick Mulvaney**, Director of the Office of Management and Budget in the US and a prominent former hawk, when asked about deficits: "Nobody cares" (February 2019)

**Ken Rogoff**, credited with laying the intellectual foundations for austerity politics: "To be frank, it has never been remotely obvious to me why the UK should be worrying about reducing its debt-GDP burden, given modest growth, high inequality and the steady (and largely unexpected) decline in global real interest rates" (February 2019)

**Larry Kudlow**, White House economic adviser: "There's no reason to obsess" about the budget deficit (March 2019)

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One of the more formal articulations of such thinking about fiscal stimulus has become known as Modern Monetary Theory (MMT). While there are multiple – often contradictory – interpretations of MMT, the rejection of conventionally 'sound' government finances is a central tenet. The idea is that governments which issue debt in their own currency can never have a financing problem – they can't run out of money like an individual or a company can, because they can always create more of their own money – so the only real limit on their budgets is the inflation that could be stoked by unlimited spending.

MMT's proponents thus argue it follows that, as inflationary pressure is not currently elevated, governments are not yet constrained and could be spending more, regardless of debt and deficit levels.

Whether or not MMT ever becomes government policy in any meaningful sense, it is clear from the rhetoric on both sides of the political spectrum that the shackles put around the public purse when austerity was being preached are being loosened.

Indeed, insofar as MMT is defined simply as railing against supposedly 'undue' limits on government spending, it merely aligns its advocates with the recommendations of several mainstream economists who have long argued against fiscal restraint – decidedly non-fringe characters like Joseph Stiglitz and Paul Krugman, both Nobel laureates. And, as highlighted already, deficit hawks are falling silent on the other side of the argument. Concurrent with the rise of voices pushing for stimulus, then, the number and influence of those pulling for austerity and balanced budgets have diminished.

**Figure 1: Trending interest in modern monetary theory**


Source: Google

Welcoming higher spending and worrying less about deficits seem to us to be part of a larger trend, namely that the longer economies go without generating significant inflationary pressure, the more convinced that mainstream opinion becomes that we can spend more.

## PUMPING UP INFLATION

This shift in the politics of government spending makes us much more confident that we will see more government spending, and also more inflationary pressure. How much more inflation is priced in by the market will depend on the inflation-targeting policy framework that accompanies these expected expanded fiscal deficits.

The extent of this inflationary pressure will largely be a function of the monetary policy employed at the time. When policymakers have a credible inflation target, more fiscal spending means that we would expect a country to achieve that target. But with MMT, the inflation implications are potentially much greater.

In fact, as it is most commonly interpreted, the MMT framework leaves very little role for monetary policy. It instead asserts that fiscal policy should be used to smooth the natural ups and downs of the economic cycle.

One important feature of this switch is that while the direct impact of monetary policy on aggregate economic demand is somewhat nebulous, increased fiscal spending does have a direct impact on aggregate demand.

The untrammelled use of fiscal policy as the primary tool for controlling the economic cycle does not come without potentially adverse side effects, however. For a start, fiscal policy unavoidably requires a government to choose where to increase – and, in reality, probably decrease – spending. When it comes to the decisions about increasing spending, governments may allocate resources less efficiently than market-driven forces. And then when it comes to decreasing spending – or, alternatively, increasing taxes – to reign in excess demand and contain inflationary pressures, it is immensely difficult for a government to take money away from people one way or the other while maintaining its popularity.

## DISCRETION REQUIRED

One solution put forward to this issue is the greater use of a mechanism known as automatic stabilisers. This refers to government spending that increases automatically – that is, without any need for any legislative authorisation – when growth falls and conversely decreases automatically when growth rises.

Within an MMT framework, a jobs guarantee would lead to a large expansion of automatic stabilisers. For many disciples of MMT, unemployment is a policy choice: a government that controls its own currency can theoretically buy all goods and services sold in that currency, which includes labour. So if there is unemployment, it can be argued that the government is choosing to allow it by not 'buying' that pool of labour.

Under a jobs guarantee, then, government-funded employment at a minimum wage would be offered to anybody willing to work, although they would not be obliged to take up that offer. In an economic downturn, this would obviously provide a substantial stimulus directly to those in most need; lower interest rates, in contrast, are a far less direct route to helping boost employment and consumption.

But then in market booms, employees would be likely to move from their government-guaranteed job at minimum wage into higher-paying work in the private sector. This would automatically reduce government spending, without necessarily having a detrimental impact on people's income or public-sector services. In this way, government spending would act counter cyclically, increasing in recessions and declining in recoveries.

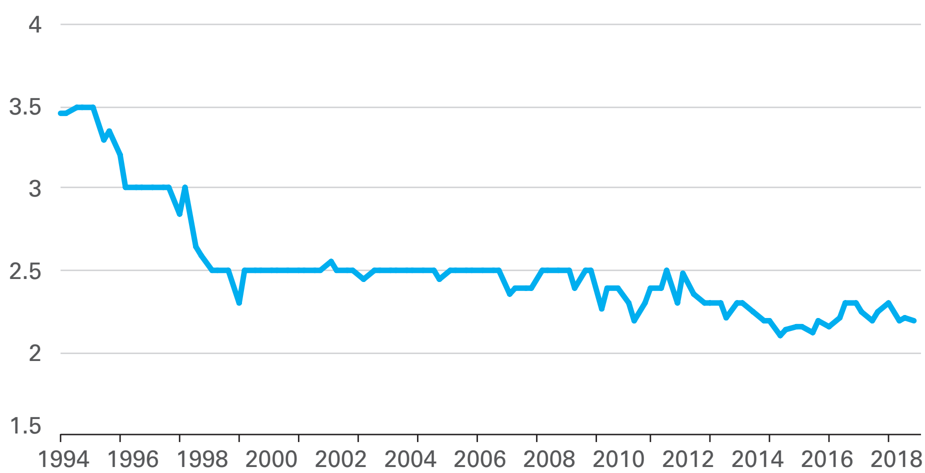
However, even with such automatic stabilisers, MMT would probably still require some problematic 'discretionary' tax increases and/or spending cuts. The modern state is simply too vast and complex to adhere to neat economic models. The process of setting national budgets would therefore remain cumbersome and political, as exemplified by every US budget negotiation in recent memory. As previously noted, it is immensely difficult for a government to take money away from people one way or the other while maintaining its popularity.

Monetary-policy operations were made independent of central government precisely in order to remove this political bias and introduce more credibility to inflation targets, a method that has proved successful so far. Removing the credibility that surrounds the current inflation-targeting regime would likely result in greater market volatility in the future.

## ANCHORS AWEIGH?

With this in mind, it is worth reviewing the experience of the past two decades, during which time inflation expectations have become increasingly anchored on central banks' targets.

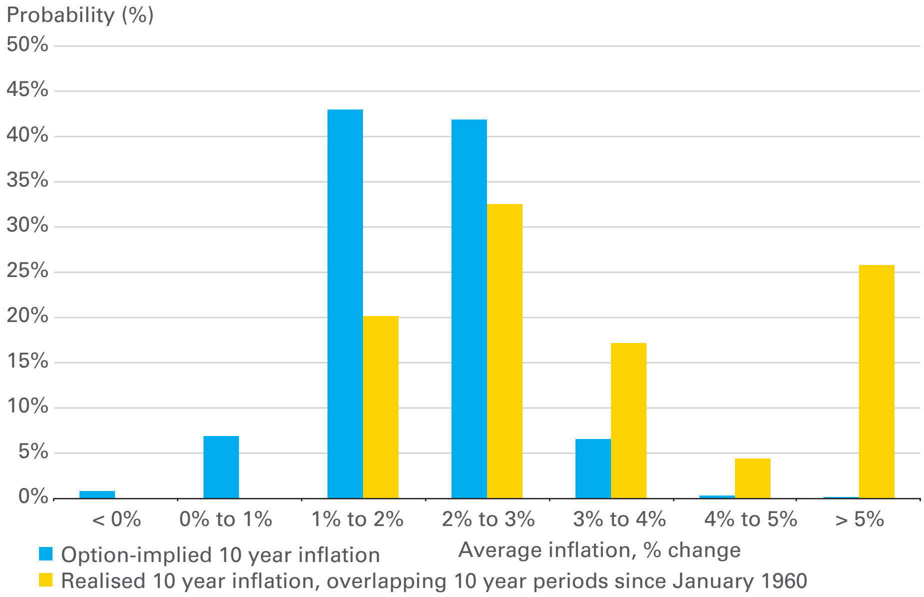
**Figure 2: Sustained drop in inflation expectations since mid-90s**




Source: Bloomberg, Philadelphia Federal Reserve

In more recent years, as interest rates have fallen toward their lower bound and inflation has consistently undershot expectations, the market-implied probabilities of different inflation outcomes have become more skewed.

**Figure 3 : No market worries about even moderately higher inflation**




Source: BBG, LGIM calculations, July 2019

What does this mean in the context of an emerging political consensus that embraces larger deficits? We would expect this new policy landscape, rid of hawks, to help inflation expectations converge back into the centre of that distribution chart.

However, if it was decided more explicitly that fiscal policy should replace monetary policy as the primary tool for controlling economic cycles – in other words, that politicians should supplant central bankers at the wheel of the economy – we would expect a much more dramatic re-pricing of inflation expectations.

## LET'S GET FISCAL

As memories of higher inflation and higher interest rates fade, conviction in the need for fiscal restraint is dwindling. The arguments against wider deficits and higher national debt are becoming quieter.

The US election season seems poised to focus the market's attention on the prospects for increased fiscal spending due to the more radical policy agenda of some of the Democratic candidates – not just in their association with MMT, but in campaigns for single-payer healthcare, free higher education, the Green New Deal, and so on.

This phenomenon isn't limited to the US, though. Similar dynamics also exist in the UK, with calls for significantly increased spending and radical changes to the Bank of England's mandate.

As larger deficits become more likely than they have been over the past few years, this is likely to translate into increased aggregate economic demand. The extent to which there is an associated increase in inflationary pressure will depend on the credibility of central banks' inflation-targeting framework.

## WHERE NEXT?

In previous work, we've looked at where the local institutional dynamics make it easier to enact more radical fiscal and monetary policy. We concluded that it looks easier in the UK than in the US, and easier in the US than in the Eurozone.

We want to take this line of thinking further, looking more closely at the political dynamics. Specifically, can we learn something from comparing the experience of Japan with that of the US?

Japanese nominal GDP growth has been stagnant for decades, and yet the government there has never looked to abandon the appearance of fiscal discipline. By comparison, among the major developed markets, the US has had the least experience of low economic growth and low interest rates and is nonetheless already talking about MMT.

What could explain the difference? Does Japan's position as a large net creditor mean that it doesn't need to be concerned about being able to pay the bills of an aging population? Is it that politics is much more stable in Japan because the distribution of assets is much more equitable? Or is it something completely different?

These are questions that we will explore in forthcoming pieces. First up, inequality.

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