October 2020

Modern Monetary Theory Explored

“There’s nothing to prevent the federal government from creating as much money as it wants.”

Alan Greenspan

Household matters

Before I dig into MMT – this month’s topic – I would like to point your attention to the megatrend page on our website. As you can see, we have identified a total of six megatrends. One of those – about the debt supercycle – was until very recently called The End of the Debt Supercycle but, as you can see, the name has changed. It is now called Last Stages of the Debt Supercycle.

The logic behind this change is straightforward. Some of our clients have long argued (with some right) that “The End ...” is not a trend but rather the end. I honestly do not know precisely when this debt supercycle will collapse, but I do know (for all the reasons mentioned in prior Absolute Return Letters) that we are in the very last stages, hence the name change. Although our (well-meaning) clients have raised this issue for a while, my decision to write about MMT made me think of it again, and I should emphasise that it is indeed possible that an MMT framework in central banking, if introduced more widely, could extend this debt supercycle.

One of the classic signs that we are approaching the end of this debt supercycle is slowing productivity and GDP growth. I often come across those who argue that this will all be sorted out when the next wave of the digital revolution takes off. Inventions like AI in advanced robotics, IoT and other new digital technologies will see to that.

In a recent research paper which is only available to ARP+ subscribers (see here), I pointed out why you cannot necessarily make such an assumption. Also, we are about to publish a megatrend paper on climate change and, later this month, we plan to publish part V of our research paper on investing in natural resources in an increasingly digital world. That paper will summarise my earlier findings from parts I–IV and, most importantly, it will provide our
thoughts on how an investment in natural resources should be structured going forward. All that will require a subscription to ARP+, though.

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What is MMT?

Modern Monetary Theory (MMT) is a rather unconventional economic concept – at least if you are a classically trained economist as I am. That said, over the years, I have learned that, every now and then, it pays to think out of the box, so I am willing to take a closer look MMT is defined as a ...

“heterodox macroeconomic theory that describes currency as a public monopoly and unemployment as evidence that a currency monopolist is overly restricting the supply of the financial assets needed to pay taxes and satisfy savings desires.”

In other words, in MMT theory, there are three key variables – the currency, the level of unemployment and public debt. Admittedly, public debt is only referred to indirectly in this definition, but there is a hint – read the following sentence again: “... a currency monopolist is overly restricting the supply of the financial assets ...’. This is a roundabout way of saying that governments can spend as they desire, as long as they only borrow in their own currency. If required, they can simply print more money to pay off debts.

MMT maintains that inflation is effectively the result of too much public debt, but that unemployment is the result of not enough public debt in an economy. By printing more money, you can raise demand and thus eradicate unemployment, and you can continue to do so until you have full employment. Only when inflation rears its ugly head should you change tack. You then raise taxes to neutralise the purchasing power you created with the earlier money printing.

MMT has been discounted by most (but not all) mainstream economists as fanciful thinking by left-wing leading fantasists. Take Bernie Sanders – about the most radical left-wing the Americans can come up with these days. Although he has never (publicly) acknowledged the validity of MMT, Stephanie Kelton – one of his closest advisors during his recent election campaign – certainly has.

Ms. Kelton, economic professor at Stony Brook University in New York, is actually one of the leading proponents of MMT. Maybe it is her link to Bernie Sanders that is causing critics to call MMT fanciful thinking by left-wingers,
but the reality is that Donald Trump is also flirting with MMT – see for example [link to Reuters article].

Having said that, Donald Trump is seemingly busy trying to get Judy Shelton appointed to the Federal Reserve Board. Ms. Shelton is known for advocating a return to the gold standard, and you may wonder (as I do) how she could possibly function in an MMT-friendly US central bank regime? The gold standard is about as far away from MMT as you can imagine. Maybe the story in Reuters is simply untrue? Maybe Donald Trump doesn’t see the engrained conflict? Maybe something completely different, but it is a fact that he desperately wants Ms. Shelton on the board of the Fed. Interesting times!

**Why write about MMT now?**

MMT is, according to a small but growing number of policy makers and economists, the ultimate solution to all our problems, but thinking of money in a new and very different way is nothing new. Already in 1905, George Friedrich wrote a book called *State Theory of Money*, in which he argued that money is a creature of law rather than the commodity it was (and still is) widely perceived to be. Only in March 2019 did anyone publish anything remotely academic on MMT, though – see [link to article here].

I don’t think I have ever expressed any views on MMT before but have decided I can no longer sit on the fence. Whether I approve of it or not, my sixth sense is telling me it’s coming. In fact, one could argue it’s already here. With so much unfinanced public spending since the breakout of the Coronavirus crisis in March, don’t we already have *de facto* MMT in some countries?

Two recent events have prompted me to write about MMT today. On the 27th August, on the opening day of this year’s Jackson Hole symposium, Fed Chairman Jerome Powell presented a radical new US monetary policy framework. Since the 1990s, inflation targeting has been at the centre of monetary policy, not just in the US but pretty much everywhere across the OECD. That is no longer the case.

Although Powell said that the Fed will still target average inflation around 2% over the longer term, by using those words he implied that the Fed won’t necessarily take action if inflation overshoots the previous target of 2%. Having said that, subsequent comments from members of the Federal Reserve Board suggest they do not agree precisely when to take action. Whereas some have admitted not knowing the answer (yet), those who quantified their answer came in with numbers from around 2.5% to about 3%. I have not yet seen anybody suggesting the Fed should sit on its hands if (when) annual inflation is in excess of 3%.

Powell then launched an even bigger surprise. Going forward, he said, full employment shall be one of the Fed’s three main objectives, and it probably wasn’t a coincidence that he mentioned full employment before mentioning the other two objectives – stable prices and moderate long-term interest rates. You can read [Jeremy Powell’s speech here](#).

One little detail requires some further explanation. Powell never actually used the term “full employment” in his speech – a term favoured by MMT subscribers. He chose to call it “maximum employment”. The difference is
subtle but important. Full employment implies that the rate of unemployment is 0% and, for a number of reasons, that will never happen. Maximum employment, on the other hand, is unquantifiable which provides the Fed with plenty of latitude in terms of how the new policy tool is handled.

In his speech, Powell argued that the weakening link between the rate of employment and inflation – i.e. the flattening of the Phillips curve – justifies this change in monetary policy (Exhibits 1a–1b). An interesting question – a question raised by almost nobody – is therefore whether Powell’s speech was an early sign that US monetary policy is in the process of converting to MMT? The combination of Powell’s speech and virtually limitless spending during the Coronavirus crisis could be a sign of that, but it is still too early to draw any conclusions.

Exhibit 1a: The original Phillips curve (1861–1957)
Source: A. Phillips, DWS

Exhibit 1b: The Phillips curve over various time periods
Source: A. Phillips, DWS

The other event that has prompted me to write about MMT now is, as the Economist recently pointed out (see here), the ongoing shift in mainstream thinking towards government debt, i.e. how much debt can an otherwise well–run country afford? Most economists have been brought up in the Keynesian school, i.e. were told – and believed – that governments should always keep government debt well below 100% of GDP.
Although the current health crisis has driven governments all over the world to smash that barrier almost as if nobody had ever heard of it, in reality, government debt-to-GDP in the average advanced economy passed 100% a long time ago – almost 15 years ago to be precise (Exhibit 2). As you can see, the average advanced country is now more indebted that at the peak of the previous debt supercycle – the end of World War II.

![Graph showing government debt as % of GDP](image)

**Exhibit 2:**  Government debt as % of GDP  
*Source: Wall Street Journal*

Of the major OECD countries, the first to break the 100% barrier in this debt supercycle was Italy in the mid–1990s, but it didn’t take Japan long to join the party. Today, Japan is by far the most indebted country with no less than 200% government debt-to-GDP, and a classically trained economist like me wonders how they get away with all that debt?

They are admittedly handling it well, but the fact that Japan has no external deficits (the trade account and the current account are both positive) as well as the support from two exogenous factors – hardly anyone outside Japan holds Japanese government bonds in size and the Yen is not a reserve currency to any significant extent – have supported the Japanese approach.

The combination of those three facts have made it a great deal easier for the Japanese to manage 200% debt-to-GDP. In the context of MMT, what is important here is that Japan's ability to manage all that debt has probably driven other countries to conclude that, if Japan can do it, so can they, but it may not be that simple for the reasons just mentioned.

**MMT vs. traditional economics**

MMT differs from classic Keynesian economics in (at least) two important ways. For starters, in traditional economics, printing money to solve a country's problems is always a bad idea. I spent 5½ years reading economics at Copenhagen University and not once in those 5½ years was I told that printing money more or less freely could ever be accomplished without serious consequences (Zimbabwe anyone?). MMT, on the other hand, maintains that printing money should be deployed as an economic tool to stimulate demand in order to reach full employment, and that it can be
accomplished without devaluing the currency or leading to unwarranted inflation.

Secondly, classic economic theory maintains that a government should always balance its books over a full economic cycle. Running a deficit in lean times serves to stimulate demand when the economy needs it the most, but that should be addressed by running a corresponding surplus during good times. MMT, on the other hand, maintains that governments can spend freely at all times so long as inflation is under control.

One thing the two schools very much agree on is the need to stimulate economic growth right now, as COVID-19 destroys demand left, right and centre. Having said that, pedestrian economic growth is not at all a new phenomenon. In the 75 years that have passed since World War II ended, real GDP growth in the OECD has been in a declining trajectory (Exhibit 3). The ongoing pandemic has not exactly made it any easier, but the writing was already on the wall long before COVID-19 struck.

![Diagram of Real GDP growth](image)

**Exhibit 3:** Real GDP growth (5-year moving average)  
*Source:* Wall Street Journal

The government’s power to ‘print’ money is another area where the two theories agree. However, the two schools disagree in terms of how that power should be utilised. MMT subscribers argue that governments can always print the amount of money needed to pay its bills, whereas Keynesians argue that just because they have that power to print, they shouldn’t always use it (Zimbabwe?).

Apart from those points, I have (at least) one big problem with MMT which has to do with the shape of the Phillips curve which I discussed earlier. MMT is essentially founded on an assumption that the Phillips curve will stay flat forever, and I am not so sure about that. Take for example the case of globalisation, which I strongly suspect has contributed to the flattening of the Phillips curve in recent years. What will happen if, as a result of climate change, our younger generations turn their backs on globalisation and demand more local produce? Could the Phillips curve begin to steepen again as a result?
As far as the US is concerned, being the premier reserve currency of the world allows you to get away with one or two things that other countries wouldn’t. If interest rates begin to rise and the US government suddenly finds itself in a pickle in terms of honouring its obligations without printing ad libitum, the US dollar could lose its status as the favoured reserve currency, which could have rather dramatic implications for an economy which runs with substantial external deficits.

Furthermore, I would argue that MMT supporters ignore the critical nature of credibility in economic and political circles. Allow me to repeat one of my opening lines:

*Only when inflation rears its ugly head should you begin to worry. You then raise taxes to neutralise the purchasing power you created with the earlier money printing.*

In other words, only if the free money printing causes inflation to rise, should governments take action but, whereas monetary policy is controlled by (mostly) credible central bankers, tax policy is controlled by (mostly) non-credible politicians. Governments typically don’t react quickly enough and, when they finally do react, it is often too late.

**My verdict**

There is actually not much, if any, new economic theory embedded in MMT so, to use the word *theory* is probably a step too far. Rather, for the most part, it is a modern interpretation of classic economic theory, but let’s put that point aside, as it is less relevant. What good could MMT do?

It goes without saying that, if inflation can be kept under control, MMT could become a very powerful economic tool, but that is indeed a very big *if*. It is no secret that, amongst Keynesians, there are many budget hawks, i.e. those who believe that a government should always seek to balance its books, although such a strategy would do immense economic damage in difficult times. Therefore, at the very least, MMT is an important antidote to all the hawkish budget talk.

If MMT becomes the primary policy tool, public deficits will unquestionably grow much bigger which will, sooner or later, begin to affect inflation. Taxes will probably not be raised enough (or quickly enough) to offset the inflationary impact, turning it into a slippery slope. As I have learned, smart governments use fiscal deficits to stimulate demand during economic downturns. Not-so-smart governments allow fiscal deficits even during the best of times. Does anyone remember Gordon Brown? He was a master of that.

In my humble opinion, the problem of subdued economic growth should be addressed in a very different way with the focus instead being on reducing the rising gap between rich and poor. The top 0.1% in society control a larger and larger share of total wealth (Exhibit 4), and that has negative implications for economic growth. Exhibit 4 is a little long in the tooth and covers the US only but rest assured – the top 0.1% everywhere has increased its share of total wealth further over the last 7-8 years.

Before I get 150 angry emails, accusing me of being a communist, you should know that I am a firm believer in capitalism but in a version of capitalism that
I call responsible capitalism. In that version of capitalism, you also look after the weak in society, and the weak are indeed having a tough time at the moment.

![Graph showing wealth share in the US, 1913-2012.](image)

**Exhibit 4:** Top 0.1% wealth share in the US, 1913–2012

*Source: Berkeley*

From an economic point of view, as the rich get richer and the poor get poorer, consumer spending is negatively affected. This is because the marginal propensity to consume is lower, the wealthier you are. The top 0.1% only spend a fraction of their capital on consumption every year, whereas the poorest 50% spend virtually everything. Therefore, as the rich get richer and richer, economic growth slows down and MMT does nothing to address that.

*Niels C. Jensen*

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