The Arrival of Modern Monetary Theory

Famously known as the "dot.com" period in the 1990s, an impeccable combination of accommodative monetary policy and technological innovation produced U.S. GDP growth rates surpassing even those of the mid-1980s expansion. At its zenith, the new economy joy ride brought forth suggestions that the woes of economic cyclicality were possibly no more. Alas, the business cycle proved itself irrepressible and the slowdown hit big time. Moreover, ever since 2000 the U.S. has yet to achieve even one year of the higher GDP growth rates notched in the 1990s.

The economic underperformance of late versus those glory days from over 20-years ago has brought forward a host of policies to stimulate growth and address growing inequality. One such idea gaining interest in the conversation of economic egalitarianism is Modern Monetary Theory or MMT. Let's unpack MMT's tenets, look back at economic history to appraise comparable efforts, and consider the investor's response amidst an inflationary environment spurred by growing deficit spending.

What is MMT?

Economist Stephanie Kelton outlined the details in her 2020 volume, "The Deficit Myth." MMT seeks to empower elected officials with the fiscal tools to create an economy geared to help all people with the government taking the lead allocating resources. Like the U.S. government pouring its means into landing a man on the moon, MMT suggests that the same kind of determination can be harnessed to address broader challenges.

Sovereign entities – such as the United States, Japan, and Australia – are "currency creators" that MMT economists maintain can never go broke, ceteris paribus. Government budgeting can consequently move away from the traditional paradigm of pursuing a balanced budget, a virtue that MMT finds illusory. Plus, they note that several large scale government programs are already perpetually funded irrespective of identifying legitimate ways to pay for them.

If currency creators like the U.S. cannot go belly-up, these governments can and should aggressively deficit spend to stimulate economic fairness. Within the MMT model, deficits are not problematic so long as they don't fuel harmful levels of inflation. If an inflationary upswing needs some tamping down, progressive taxation or slowing down the pace of spending should be enough to do the trick.

MMT furthermore advocates enacting a federal jobs guarantee serving as an employment back stop when the private sector runs into trouble. This mechanism would also set a minimum wage for public sector employees that could serve as a baseline for employee remuneration across the entire economy.

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What can history teach us?

Though the phraseology sounds novel, MMT is simply financial engineering applied to the implementation of fiscal policy. The pages of economic history offer us the ability to conduct a learned critique of MMT because some of MMT's proposals have been implemented previously.

Weimar Germany, Zimbabwe, and Venezuela are some of the most notorious examples of unfettered government spending running afoul. Kelton is aware of them for sure, but dismisses the three catastrophes as almost being irrelevant in the discussion. She also highlighted Argentina's substantial employment and spending efforts to prop-up the economy from over 20-years ago but doesn't address the subsequent debt default in 2001 as the hoped for economic progress faltered.

A key principle of MMT is for the capacity of a country to function autonomously in order to deploy fiscal policy on a colossal, top-down basis. So perhaps the aforementioned economic calamities don't apply here because they were too dependent on other countries.

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However, there was a state that had the necessary components favored by MMT: the Soviet Union or U.S.S.R (Union of Soviet Socialist Republics). Its currency was the ruble and everybody was given a job accompanied by wages or work credits to exchange for goods. When the economic archives could officially be studied following the downfall of the Soviet Union, the data showed ballooning deficit spending just prior to its demise in 1991. Maintaining autonomy wasn't a problem for decades as the Soviet state was absurdly resource rich, and the military built-up a stock pile of armaments to defend its borders.

Despite the Soviet's promising set-up, its economic fortunes continuously lagged the gains made in the United States from the 1940s onward. For example, by 1990 U.S. GDP per capita was just over $20,000 while Soviet per capita GDP amounted to around $5,000.[1] One historian noted:

> *"It [the Soviet Union] was a shortage economy, in which producers had little incentive to economise on inputs and constantly sought to employ more workers…This tended to generate excess consumer demand at established prices and therefore queues, shortages, unintended savings and black markets."* [2]

While the story of the Soviet economic expiry is widely available, there's no mention by Kelton about it in her book. When so much of the Soviet economic model mirrors the proposals of MMT, and was a currency creator that did go bankrupt, the advocates for such sweeping economic policy owe it to the world to explain why "it's different this time."

From the practical to the philosophical, take a few moments to reflect upon the concept of money. It's more important than you might at first think when evaluating the impact of MMT policies.

Governments that are too casual in creating and spending money expose their economies to more risks than otherwise. Money in due course ultimately represents a unit of wealth creation exchanged between two entities that are confident the transaction is mutually beneficial. The benefits come from increased utility be it an experience like a vacation or an investment into an asset that generates greater returns in the future.

The simplest way to assess the breakdown of the confidence in transacting is the emergence of higher inflation and the development of unsanctioned markets such as what transpired in the Soviet Union, Zimbabwe, and Venezuela. But there's another critical question to ask, why were there ever fewer goods produced in these economies?

If money is debased and no longer credibly represents the wealth created by its citizens, incentives to produce and innovate become casualties which eventually asphyxiates total economic output. MMT seemingly disregards this crucial role that money expresses amongst members of society. Should people lose confidence in the fiat currency so much so that it becomes worthless, citizens will abandon it in favor of something else that holds its value.[3]

Taking Action

Today, I suggest the U.S. has already embarked on an MMT-like path with respect to government spending. The tax-cuts in 2017 plus the fiscal stimulus deployed in response to COVID-19 have pushed the Federal budget deficit to 19% of U.S. GDP, the highest since World War II when it surpassed 25% of GDP. Regardless of your views, higher levels of government spending in combination with an economy about to go back to work full-time squarely points to higher inflation in the future.

Across the board, we hear a growing chorus of companies experiencing significant price increases for inputs such as a lumber, energy, chemicals and agricultural products. The charts for these commodities unmistakably confirm the anecdotes.

To position your portfolio for this higher growth, higher inflation environment, a 3-5% allocation to commodity-linked investments in a diversified manner is appropriate. There are other assets to keep in mind like Treasury Inflation-Protected Securities (TIPS) in your fixed income allocation (5-10%) and real estate. Your home, though illiquid, likely represents your largest inflation hedging asset. Making improvements to it, assuming you can find the skilled labor and materials for a fair price these days, plays into the theme of rising inflation. In terms of equities, emerging markets have historically performed very well for U.S. investors during runs of higher inflation. Our models call for all investors to have some EM exposure ranging from the conservative allocation at 2% to 10% for the more aggressive investor who has a longer-term time horizon.

Big picture, the discussions around MMT have once again raised the question as to how society can provide the daily necessities for the masses yet offer the opportunities to gain the rewards of laissez-faire capitalism. As that debate continues, another era of big government spending is upon us, the likes of which has not occurred relative to the size of our economy in decades. Investors know from history that such actions initially lead to reawakened growth and then higher levels of inflation following thereafter. Prepare accordingly.

The Arrival of Modern Monetary Theory Continued

Summary

- *Modern Monetary Theory or MMT has been popularized in discussions about economic egalitarianism. MMT suggests that a combination of both federal deficit spending and enacting a national job guarantee can position the economy favorably.*

- *Though the phraseology sounds novel, MMT is simply financial engineering applied to the implementation of governmental fiscal policy for spending and taxation.*

- *Historically, countries that embarked on an MMT-like approach have incurred difficulties in containing inflation and maintaining a suitable level of economic output.*

- *An era of big government spending is upon us, the likes of which has not occurred relative to the size of the U.S. economy in decades. Inflation-sensitive assets like commodities, TIPS, residential real estate and emerging market equities are suitable investments in the current environment.*

[1] *Philip Hanson, "The Rise and Fall of the Soviet Economy," p. 244.*
[2] *Hanson, p.88.*
[3] *See this quarter's Research Review,* "When Money Destroys Nations - How Hyperinflation Ruined Zimbabwe, How Ordinary People Survived, and Warnings for Nations that Print Money."