# Modern monetary theory and asset markets

- **MMT changes assumptions, constraints and priorities versus conventional economics**
- **Not surprisingly, MMT also has very different implications for asset prices**
- **MMT could affect asset prices by Q1-2020 if a progressive has a chance of winning the White House**
- **MMT may be applied cyclically if a severe recession hits, with friendlier asset-market implications**

## We may all be modern monetary theorists down the road

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Modern monetary theory (MMT) argues that government spending and taxation should be the main tools to achieve non-inflationary full employment, relegating monetary policy to a passive, secondary role and viewing the fiscal deficit *per se* as irrelevant. What we call the 'strong' form of MMT is meant to shape policy on an ongoing basis, during business up-cycles as well as down-cycles. The 'weak' form would only apply during severe downturns.

A strong form of MMT is unlikely to be applied unless economic policy shifts sharply to the left. It would probably have a large negative effect on equities, but also push nominal rate and inflation expectations sharply higher, as monetary policy would become largely passive and subordinate to fiscal policy. This would be USD-negative (possibly strongly so). For smaller developed-market (DM) economies and in EM, we think strong MMT would have an even stronger negative impact on currencies.

A weak form of modern monetary theory (MMT) may well be applied in the next major US downturn, and other countries will likely be tempted as well. We think it would be more effective in raising inflation expectations and nominal rates than other proposals that central banks are now considering. If implemented in the US and other developed markets, it would likely boost the exchange rate in the short term but have more ambiguous implications over the medium term. Investors are likely to be sceptical of its implementation in emerging markets.

The strong form of MMT has the following characteristics:

- The government uses spending as the major tool to achieve employment and other economic and social goals
- Spending on socially productive infrastructure, environmental projects and human capital is prioritised
- The central bank is not independent – it prints money to finance government spending
- Taxes are adjusted to prevent overheating or inflation

The underlying assumptions are: (1) monetary policy is relatively ineffective, and (2) government spending boosts employment and production, but lowers interest rates when accompanied by monetary expansion. Policy objectives are full employment, socially desirable spending projects, and improved income and wealth distribution.

The weak form of MMT has the following characteristics:

- Government spending is supported by permanent balance-sheet expansion during severe economic downturns, when monetary policy has maxed out in terms of stimulus
- The objective is to raise output and inflation expectations
- Outside of crisis times, the standard policy framework would apply

MMT is not currently affecting asset-market pricing because its application looks too remote. It may become more relevant in the US in Q1-2020 if a progressive is one of the leading Democratic presidential contenders, and emerge more strongly as a policy option in Q3-2020 if such a candidate appears likely to win. Elsewhere in developed markets, we think it would take a political sea change – perhaps in response to the ongoing economic and political dissatisfaction – for strong MMT to be implemented. Barring such developments, strong form MMT is unlikely to have a significant impact on asset markets. Weak form MMT could come into focus quickly if activity is not responsive to monetary stimulus in a downturn.

***MMT discussions tend to ignore incentives and efficiency***

Most discussions of MMT do not touch on asset prices. If MMT were the prevailing policy framework, asset-market signals would likely become less important (bye-bye, Fed put). Public spending priorities would play a much bigger role in allocating resources than price signals would. This may not be so important when MMT is used to provide temporary cyclical stimulus, but it could have large distortive effects if MMT were to become the main policy tool.

There are multiple forms of MMT; not all correspond to the descriptions above. Some precursors to MMT were more focused on macroeconomic stabilisation, and less on income distribution and using government spending to prioritise social goals.

MMT discussions often focus on money creation and the role of money in the economy. We set this aside and focus instead on how MMT expects policy makers to behave. The central bank essentially accommodates government spending by printing money and accumulating government debt. We analyse how asset markets might respond.

## Asset-market implications of ‘strong’ MMT

While we think the weak form of MMT is more likely to be adopted, we discuss the strong form first because it is what is usually referred to when discussing MMT.

### Equity prices would likely fall

We think equity prices would come under pressure, inflation expectations and nominal rates would rise, and the USD would fall in case of ‘strong’ MMT implementation in the US.

***Socially productive investment is a priority***

MMT gives much prominence to social goods and their provision by the public sector. The supply-side benefits of low taxes are not discussed much, and room for inefficiency in public-goods provision is largely ignored. The focus appears to be full employment and socially productive investment, rather than production efficiency.

The spending programme envisioned by MMT advocates could generate large productivity gains through infrastructure and human capital investment, to the benefit of equity investors. Advocates may argue that a richer economy would benefit equities – but this is not a priority and may be a lucky (yet unlikely) outcome. We think the most likely scenario is that the combination of government-directed spending and higher rates discussed below would produce an environment for asset markets that is not equity-friendly.

*Some MMT discussions emphasise income distribution*

Among MMT advocates, a major criticism of post-financial crisis monetary policy is that it generates asset-price inflation, which has negative consequences for wealth distribution without being effective in restoring full employment. Under MMT, government spending and taxation are seen as rebalancing income and wealth distribution, with equity prices in the background. Implicit in many (but not all) discussions of MMT are higher taxes on income, wealth and capital gains, which would likely weigh on equity prices.

## Rates would probably go higher

*Many MMT advocates see the central bank as a passive buyer of government debt*

While MMT should theoretically result in lower rates, we are sceptical of this claim; we think misaligned incentives and inefficient implementation would likely result in higher inflation and rates than MMT advocates promise. Higher rates would be another factor weighing on equities.

According to MMT advocates, government spending accommodated by the central bank increases money supply and lowers rates. Increased supply of money from the central bank prevents the added government demand from creating a liquidity shortage that would push up rates This contrasts with conventional theory, where crowding out, higher inflation and possibly higher risk premia lead to higher rates.

The MMT optimism on rates does not ring true with bond vigilantes, most academics or central bankers, although this may partly reflect how deeply embedded the conventional view of rate determination is. MMT appears to have more than enough policy instruments – spending, taxes and interest rates – to achieve its goal of non-inflationary full employment. Even if we assume two goals – full employment and an optimal level of infrastructure, human and environmental capital investment – there are enough policy tools to achieve both.

*MMT assumes vigorous use of fiscal policy, giving policy makers more options*

But for MMT to be effective, fiscal and tax policy need to be centralised and flexible (in contrast, conventional analysis assumes passive fiscal and tax policy, with monetary policy the only tool available). In principle, fiscal and tax policy could be set to achieve all the MMT goals. Monetary policy on its own is viewed as largely ineffective under MMT; the best it can do is accommodate the increased spending.

MMT advocates claim that higher taxes would avert inflationary pressure. The key point is that the fiscal deficit – the difference between spending and revenue – is not economically important under MMT. What matters is that spending and taxation be at the right levels to generate full employment without inflation. Advocates argue that their theoretical models are consistent and can generate macroeconomic equilibrium and low inflation outcomes similar to conventional models.

In practice, however, two questions arise: (1) whether the required level of taxes is so high as to discourage work effort and investment, and (2) whether the political willingness to raise taxes to avoid inflation will be there. The willingness to raise taxes on middle- and lower-income households if spending exceeds the revenue generated by taxing the wealthy is uncertain. And raising taxes could damage work incentives. There are many historical experiences of high spending, inadequate taxation, high inflation and low productivity growth.

*It may be hard to raise taxes, even if required for stabilisation*

We are sceptical that MMT, as applied in practice, is sufficiently disciplined to remove the risk of higher inflation driven by spending and an accommodative central bank., There is also a risk that savings will be wasted if investment is politically driven, resulting in a shortage of quality-adjusted investment. We think the most likely outcome of 'strong MMT' is that misaligned incentives and inefficient implementation would result in more inflation and higher rates than advocates promise. That said, nothing precludes a positive outcome. A fortunate combination of economic parameters and implementation could yield a positive result; we just do not think this is likely.

Even if MMT can ultimately lead to lower inflation and rates, the initial market reaction would likely be sceptical. We would expect both risk premia and inflation expectations to rise, possibly sharply, until clear evidence emerged that outcomes were better than feared.

### FX also under pressure

We suspect that the same risk and inflation premia that lead to higher yields would weaken the currency – possibly sharply – if higher risk premia are the dominant market reaction. This would almost certainly be the case for EM currencies, with investors sceptical on disciplined implementation. It would likely also apply to the USD and other DM currencies if evidence accumulated that rates of return to capital investment were falling.

MMT advocates might argue that low rates and stronger demand arising from accommodative monetary policy will weaken the currency – and they might see this as positive. If running the economy hot leads to stronger demand pressure and higher rates (contrary to MMT expectations), the currency may appreciate at least initially. If the ultimate outcome is inefficient capital allocation and higher inflation, depreciation is likely.

*Domestic investors may want out, and foreign investors may not want in*

Our longer-term concern is that if the productivity of capital is low and if public priorities lead to misallocation, domestic investors will want to get their capital out and foreign investors will not want in. A structurally weaker financial account needs to be offset by equivalent current account strength to stabilise the currency. If the implementation of a social investment programme raised demand but weakened productivity growth, the external balance could fall rather than rise. Real exchange rates fall under these conditions to maintain current and financial account balance. If nominal inflation picked up, nominal exchange rate depreciation could be sharp. Such an outcome could also compromise the USD's reserve currency status.

FX-positive scenarios under 'strong' MMT would include the following: (1) final demand is strong and the economy runs hot enough to firm up rates, but not hot enough to push up risk and inflation premia; and (2) efficient provision of social, human and environmental capital raises productivity and competitiveness. However, we think these outcomes are unlikely, and if they did occur, they would be serendipitous.

## Asset-market implications of 'weak' MMT

### MMT as a cyclical tool

*A weak version of MMT may be very effective in a severe downturn*

A weak form of MMT may well be applied in the next significant downturn. By "weak form of MMT" (as outlined above), we mean that that the central bank turns to a form of helicopter money after exhausting conventional monetary stimulus tools relatively quickly. If it becomes clear that balance-sheet expansion (and forward guidance and average inflation or price level targets) are not enough to spur growth, the central bank will encourage the government to spend and issue debt that the central bank will purchase. It makes no difference if the central bank buys in the primary or secondary market, as long as it indicates an intention to keep the balance sheet permanently large.

*Fiscal and monetary expansion, combined with permanent balance-sheet expansion, is a powerful tool*

The key difference between this prospective policy and past recent monetary stimulus is that the monetary expansion fuels spending directly, not by lowering short and long-term rates or trying to raise inflation expectations. This leaves the impact on asset markets ambiguous. Monetary expansion on its own has (theoretically) unambiguous effects on rates, liquidity and the exchange rate.

Weak-form MMT intersects with money-financed fiscal expansion in that monetary and fiscal policy combine to get the economy out of a downturn. Spending can be used for socially positive projects, but there is nothing to stop the central bank from financing consumer spending. The idea is that spending plus money printing will generate either real spending or inflation (which would give real rates more room to fall).

### Impact on asset markets

Using policies that resemble MMT to exit cyclical downturns is likely to be far more asset market-friendly than using MMT as a long-term policy framework. In a severe downturn, policy makers want inflation and inflation expectations to move higher; they are less concerned about long-term incentives and productivity and more focused on aggregate demand.

*'Weak' MMT in response to a severe downturn would be asset market-friendly*

Such a scenario – where unemployment is persistent and monetary policy tools have been exhausted – is characterised by short- and long-term rates close to zero, weak equity markets and probably a weak currency, with a heavy risk premium on rates and equity prices. From such a low starting point, MMT-like policies would likely have a positive impact on asset markets.

In these circumstances, central bank-financed fiscal policy has a doubly desired impact – it raises activity and inflation expectations. These may not be desirable outcomes if the economy is already at full employment, but if the risk is to the downside, higher activity and higher inflation expectations are desired. Such a programme would push both rates and equity prices higher, and the currency would probably strengthen as well.

The asset-market response would be largely driven by reduced risk premia. The rates back-up and currency appreciation would be less than if fiscal policy were used after monetary policy was exhausted. Under conventional policy, government debt owed to the public would increase, and investors would expect a degree of crowding-out and be concerned about public debt levels down the road. The advantage of central bank-financed spending over conventional fiscal policy, which is funded out of private-sector savings, is that the currency and rates markets are unlikely to move to limit the impact of the stimulus, provided there is confidence that the financing would stop with recovery.

***It may be tempting to keep applying stimulus for too long***

A weak form of MMT may be the most asset market-friendly policy at the bottom of a recession, and could effectively pull the economy out of recession. But it would not necessarily be market-friendly at the middle or top of the business cycle.

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