ZAIS Insights

MMT is flawed

June 2019

Bernhard Eschweiler, PhD
Senior Economic Advisor

Bernhard advises ZAIS on macroeconomic risks and prospects related to credit markets and is a regular contributor to ZAIS Insights

MMT is flawed

- Modern Monetary Theory (MMT) may not be a short-lived fashion
- The promises of MMT are tempting in an environment of low growth and inflation
- But MMT risks bloating the government and jeopardizing the foundations of policy control and flexibility
- Recent episodes of quantitative easing (QE) are good examples of a well-functioning fiscal and monetary policy mix and not proof that MMT may work
- However, QE is no panacea and does not guarantee government debt sustainability

The current debate around MMT (see box for a short primer below) suggests this theory could be viewed as a short-term hype that will be over after the US elections. We fear that MMT will be around for longer.

Over the last ten years, the below average growth and inflation performance, and the associated policy challenges, have created room for unconventional policy prescriptions like MMT.

As inequality and frustration with globalization increases, MMT becomes a tempting policy panacea for populists on the left as well as on the right of the political spectrum.

In our view, however, the promises and recommendations of MMT seem vague. Moreover, there is little empirical evidence that MMT may work.

For instance, the German experience during the first half of the 20th century is probably the most horrific example of debt monetization going wrong.[1]

In another instance, some MMT supporters like to point to Canada post World-War II as a positive example, but this ended in crisis with Canada joining the Bretton Woods System in 1962.[2]

Finally, there are more recent examples of debt-monetization in Latin America that have ended badly. [3]

The case against MMT

We do not intend to dive into the academic debate about the novelty and theoretical foundation of MMT.

In our view, MMT is not suitable as a general policy framework for many reasons:

- In general, we believe it is better to have two independent policy areas (fiscal and monetary) than just one (only fiscal), both in terms of control and of effectiveness and flexibility.
- Fiscal policy takes longer to adjust than monetary policy. It relies more on direct real economic interventions and less on incentives. Therefore, adjusting fiscal policy to keep the economy balanced risks creating more dislocations.
- Under MMT, as the sole stabilizer of the economy, the government is likely to take over more and more tasks, bloating its size and role in the economy.
- Historically, the government has a mixed track record deciding over resource allocation in the economy. This could result in more inefficient investments as the investments risk becomes less efficient, while the share of government investments increases.

A short MMT primer

Although called a monetary theory, MMT essentially claims that attaining non-inflationary full employment is a fiscal policy issue that uses the government's ability to issue "fiat money".

Under MMT, the government issues money to fund its expenditures (i.e., monetizes its debt). When the economy is below full employment, the government steps up the monetization of fiscal spending to boost growth.

Taxes are levied to limit inflation (i.e., curb growth when the economy exceeds full employment) but not to fund expenditures, per se.

According to MMT, interest rates can be fixed at zero since the government can issue money for free and fiscal policy already does the job of attaining non-inflationary full employment.

MMT has three preconditions:

- The government issues debt only in its own currency (this guarantees that the government cannot go bankrupt, as it can always issue more money to fund its expenditures and service its debt)
- The currency is not tied to gold or any other commodity, currency or asset (i.e., the currency must be free-floating)
- Monetary operations are integrated with fiscal policy (there could be a separate central bank, but it is not independent and is effectively only for implementing fiscal policy.

- Demand-side fiscal policies like MMT are not well suited to deal with structural or supply-side issues like labor market rigidities, regulatory and tax distortions, the effects of globalization, the IT revolution or demographics. Demand-side fiscal policies could make these problems worse and generate negative side effects, for example with overly rigid labor laws that may reduce the incentives to work.
- The creation of money to fund fiscal spending is difficult to divide between different levels of government. The result would be a further strengthening of the central government versus state and local governments.
- People accept paying taxes in exchange for government services. However, taxing people solely to curb their spending could undermine the public's tax morale and reduce compliance rates.
- Fixing interest rates at zero would reduce the ability to manage liquidity in the banking and financial system. This could result in asset bubbles as well as boom-bust cycles and lead to capital flight and sharp currency depreciation.
- Inflation dynamics are complex; they involve expectation changes and time lags that may be difficult to manage with simple adjustments to fiscal spending and taxes.
- Last, but not least, the political economy is different from the "text-book" government. Political players have other priorities like getting re-elected and not just the altruistic interest of balancing the economy. MMT would create the risk that the printing press will be abused, causing not just inefficiencies, but also higher inflation that could end in hyperinflation.

It is easy to forget the benefits of independent monetary policymaking in times of persistent below-average growth, inflation and interest rates.

However, we see no compelling benefits of MMT that outweigh the progress made under independent monetary policymaking since the break-up of the Bretton Woods system.

This is especially significant, since the last 10 years have shown that monetary policy is able to adjust even when conventional operations become less effective.

QE is not the same as MMT

MMT supporters like to view recent episodes of QE in the US, Japan and the Euro-area as proof that debt monetization is already becoming a reality and is successful.

In our judgment, non-standard monetary operations like QE are legitimate and effective under specific circumstances, e.g., when demand is suppressed by private deleveraging and credit impairments that render traditional monetary policy operations ineffective.

We believe adopting QE in the US, Japan and the Euro-area were the right decisions at the time and the results, so far, seem on balance to be positive.

However, we think it is wrong to say that QE in the US, Japan and the Euro-area adhered to the MMT prescriptions.

QE was not used to facilitate the expansion of fiscal policy. On the contrary, QE was used to create room for fiscal consolidation.

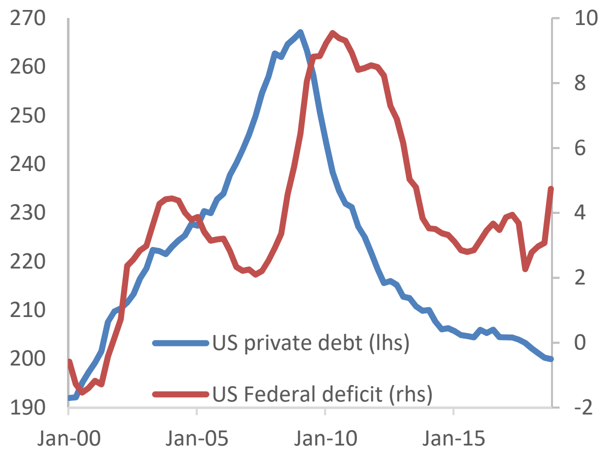
Fiscal deficits and debt levels soared during and immediately after the crisis and reached unsustainable levels.

Yet growth was not sufficiently strong for a self-sustaining recovery, as private-sector deleveraging was not finished.

Chart 1, below, shows the US private deleveraging experience, which lasted nearly 10 years. However, fiscal policy ran out of steam a few years after the crisis as the budget deficit reached 10% of GDP.

Chart 1: US private debt and federal deficit

% of GDP both scales



Source: Federal Reserve Bank of St. Louis[4]

With policy rates around zero, central banks adopted QE to lower long-term interest rates and boost asset prices.

This was meant to safeguard the recovery and provide governments the opportunity to consolidate their fiscal balances. Indeed, while central banks boosted their holdings of government debt, governments themselves reduced their deficits (Table 1).

Table 1: QE and budget deficits

% of GDP

	QE Period	Chg. in gov. debt held by central bank	Chg. in gov. budget deficit
USA	2010-15	8.0	-6.0
Japan	2013-19	65.9	-5.8
Euro-area	2015-18	19.2	-2.0

Source: St. Louis Fed, BoJ, ECB and IMF [5]

True, central banks struggled to get inflation back up to target, but deflation has been avoided as inflation stayed positive and unemployment declined (Table 2).

Table 2: Unemployment rate and inflation

Percent

	Unemployment rate			Latest inflation rate
	Peak time	Peak level	Latest level	
USA	Oct-10	10.0	3.8	1.9
Japan	Jul-09	5.5	2.5	0.5
Euro-area	Feb-13	12.1	7.8	1.4
France	May-15	10.6	8.8	1.2
Germany	Jul-09	7.9	3.1	1.3
Italy	Nov-14	13.1	10.7	1.0
Spain	Jun-13	26.3	13.9	1.3

Source: OECD[6]

In fact, the US and Japan are essentially at full-employment, while some parts of the Euro-area lag behind.

The average growth performance of this expansion was low compared with previous cycles, but that should not be surprising given the private deleveraging pressures.

On the other hand, this cycle is already the second longest and could soon become the longest post-war expansion.

In our view, the combination of fiscal and monetary policies have done a good job avoiding deflation and safeguarding the recovery given the extraordinary challenges created by the crisis and the subsequent private deleveraging. Moreover, the extended period of QE has given fiscal policy some room to consolidate.

QE is no panacea, either

In our view, QE is appropriate under special circumstances, but not all the time.

The risk with QE is that governments may become too comfortable with a monetary policy that maintains low interest rates, and so may ignore their own budgetary responsibilities.

When this is the case, central banks may become too compliant and the final outcome could be similar to MMT.

It is too early to judge, but the recent slippage in fiscal balances in the US, parts of the Euro-area and Japan, with the simultaneous calls for more monetary stimulus, may be seen as first warning signs.

More information

As always, we are available to discuss our views with you. Please contact your client relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com.

---

[1] Robert L. Hetzel; German Monetary History in the First Half of the Twentieth Century; Federal Reserve Bank of Richmond Economic Quarterly Volume 88/1 Winter 2002. Also Andrea Sommariva and Giuseppe Tullio; German Macro-Economic History 1880-1979; St. Martin's Press, New York, 1987; ISBN 0-312-32588-6.

[2] Josh Ryan-Collins; Is Monetary Financing Inflationary? A Case Study of the Canadian Economy, 1935-75; Levy Economics Institute of Bard College; Working Paper No. 848, October 2015.

[3] Sebastian Edwards; Modern Monetary Theory: Cautionary Tales from Latin America; Hoover Institution; Economics Working Paper 19106, April 25, 2019.

[4] Federal Reserve Bank of St. Louis https://fred.stlouisfed.org/categories), see below:

Board of Governors of the Federal Reserve System (US), Nonfinancial corporate business; debt securities and loans; liability, Level [TCMILBSNNCB], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/TCMILBSNNCB, June 12, 2019.

Board of Governors of the Federal Reserve System (US), Households and nonprofit organizations; debt securities and loans; liability, Level [TCMILBSHNO], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/TCMILBSHNO, June 12, 2019.

Board of Governors of the Federal Reserve System (US), Domestic financial sectors; debt securities and loans; liability, Level [DODFS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DODFS, June 12, 2019.

Board of Governors of the Federal Reserve System (US), Federal government; net lending (+) or borrowing (-) (financial account), Flow [FGLBAFQ027S], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FGLBAFQ027S, June 12, 2019.

U.S. Bureau of Economic Analysis, Gross Domestic Product [GDPA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GDPA, June 12, 2019.

[5] Board of Governors of the Federal Reserve System (US), U.S. Treasury securities held by the Federal Reserve: All Maturities [TREAST], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/TREAST, June 12, 2019.

U.S. Department of the Treasury. Fiscal Service, Federal Surplus or Deficit [-] [MTSDS133FMS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MTSDS133FMS, June 12, 2019.

U.S. Bureau of Economic Analysis, Gross Domestic Product [GDPA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GDPA, June 12, 2019.

JP. Cabinet Office, Gross Domestic Product for Japan [JPNNGDP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/JPNNGDP, June 12, 2019.

Japanese Government debt by holder/Bank of Japan http://www.stat-search.boj.or.jp/ssi/cgi-bin/famecgi2?cgi=$nme_a000_en&lstSelection=PF02

Japan general government net lending/borrowing from IMF World Economic Outlook database https://www.imf.org/external/pubs/ft/weo/2019/01/weodata/index.aspx

Euro area (changing composition), Eurosystem reporting sector - Securities of euro area residents denominated in euro, Euro - Euro area (changing composition) counterpart (ILM.W.U2.C.A070000.U2.EUR); Data Source in SDW: http://sdw.ecb.europa.eu/quickview.do?org.apache.struts.taglib.html.TOKEN=104d2024449314690f421a32a5a8df71&SERIES_KEY=123.ILM.W.U2.C.A070000.U2.EUR&start=&end=&submitOptions.x=0&submitOptions.y=0&trans=N&periodSortOrder=ASC

Gross domestic product at market prices - Euro area 19 (fixed composition) - Domestic (home or reference area), Total economy, Euro, Current prices, Non transformed data, Calendar and seasonally adjusted data (MNA.Q.Y.I8.W2.S1.S1.B.B1GQ._Z._Z._Z.EUR.V.N); Data Source in SDW: http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=320.MNA.Q.Y.I8.W2.S1.S1.B.B1GQ._Z._Z._Z.EUR.V.N&periodSortOrder=ASC

Euro area 19 (fixed composition) as of 1 January 2015 - Net lending (pos) / net borrowing (neg) - Balance (Credits minus Debits) - counterpart area: World (all entities, including reference area, including IO), counterpart sector: Total economy, Current prices, Standard valuation based on SNA/ESA - Domestic currency (incl. conversion to current currency made using a fixed parity) (GFS.Q.N.I8.W0.S13.S1._Z.B.B9._Z._Z._Z.XDC_R_B1GQ_CY._Z.S.V.CY._T); Data Source in SDW: http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=325.GFS.Q.N.I8.W0.S13.S1._Z.B.B9._Z._Z._Z.XDC_R_B1GQ_CY._Z.S.V.CY._T&periodSortOrder=ASC

[6] OECD Harmonized unemployment rate, % of labor force: https://data.oecd.org/unemp/harmonised-unemployment-rate-hur.htm

OECD Inflation (CPI), annual growth rate (%) https://data.oecd.org/price/inflation-cpi.htm

Important Information

Confidentiality.

The information presented herein has been prepared and provided by and is confidential and proprietary to ZAIS Group, LLC, ZAIS Group (UK) Limited and their affiliates and subsidiaries (collectively, "ZAIS"). Accordingly, this material is not to be reproduced in whole or in part or used for any purpose except as authorized by ZAIS, is to be treated as strictly confidential and is not to be disclosed directly or indirectly to any party other than the recipient. By accepting receipt of this document, the recipient agrees to comply with this restriction and confirms its understanding of the limitations set forth in these disclaimers.

Source of Information.

Unless otherwise noted, the source of information for the charts, graphs, and other materials contained herein is ZAIS. The charts, tables, and graphs contained in this document are not intended to be used to assist the reader in determining which securities to buy or sell or when to buy or sell securities. Additional information is available upon request.

Nature of Information Provided.

This information has been prepared solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or instrument or to participate in any trading strategy which may or may not be made available. Any such offer of securities would, if made, be made pursuant to definitive final private offering documents, which would contain material information not contained herein (including certain risks) or material that differs from the information contained herein and to which current and prospective investors are referred. Any decision to invest should be made solely in reliance upon such private offering documents. In the event of any such offering, this information shall be deemed superseded, amended and supplemented in its entirety by such private offering documents. Information contained herein does not purport to be complete and is subject to the same qualifications and assumptions, and should be considered by investors only in the light of the same warnings, lack of assurances and representations and other precautionary matters, as disclosed in an applicable private offering memorandum and subscription agreement. No representation or warranty can be given with respect to the terms of any offer of securities conforming to the terms hereof. There is no guarantee that the strategies set forth herein will be successful. The information should only be considered current as at the date specified herein and is subject to change at any time and without notice. Statements made herein that are not attributed to a third party source reflect the views and opinions of ZAIS.

Opinions.

Certain information contained herein represents ZAIS's current reasonable opinion and is based on unaudited and forecast figures which have been derived from multiple sources and have not been subject to specific due diligence. The information has been provided in good faith but is not guaranteed and is subject to uncertainties beyond ZAIS's control and should not be relied upon for the purposes of any investment decision. ZAIS makes no representations or warranties and accepts no liability whether in contract, tort or otherwise for (1) the information not being full and complete, (2) the accuracy of any opinion, (3) the basis on which any comparison has been drawn or the facts selected to make such comparison and (4) the assumptions underlying any opinions. ZAIS does not undertake to update its opinions. No opinion of this nature can be, and this information does not purport to be, full, complete, comprehensive or to contain all relevant information. Statements made herein that are not attributed to a third party source reflect the views and opinions of ZAIS.

Forward-Looking Statements.

These materials may contain statements that are not purely historical in nature but are "forward-looking statements". In some cases, you can identify forward-looking statements by terms such as "anticipate," "believe," "could," "estimate," "expect," "intend," "may," "plan," "potential," "should" and "would" or the negative of these terms or other comparable terminology. These forward-looking statements include, among other things, projections, forecasts, estimates or hypothetical calculations with respect to income, yield or return, future performance targets, sample or pro forma portfolio structures or portfolio composition, scenario analysis, specific investment strategies or proposed or pro forma levels of diversification or sector investment. These forward-looking statements are based upon certain assumptions, some of which are described herein. Prospective investors are cautioned not to place undue reliance on such statements. No representation is made by ZAIS as to the accuracy, validity or relevance of any such forward-looking statement and the recipient agrees it is solely responsible for gathering its own information and undertaking its own projections, forecasts, estimates and hypothetical calculations. Actual events are difficult to predict, are beyond ZAIS's control, and may substantially differ from those assumed. All forward-looking statements included herein are based on information available on the date hereof or such date specified and ZAIS does not assume any duty to update any forward-looking statement contained herein. Some important factors which could cause actual results to differ materially from those in any forward-looking statements include, among others, the actual composition of the investment portfolio, any defaults to the investments, the timing of any defaults and subsequent recoveries, changes in interest rates, changes in currency rates and any weakening of the specific obligations included in the portfolio. Accordingly, there can be no assurance that estimated returns or projections can be realized, that forward-looking statements will materialize or that actual returns or results will not be materially lower or higher than those presented. The value of any investment, and the income from it, may fall as well as rise. Accordingly, there can be no assurances that an investor will receive back all or any of the original capital invested. Further, the eligible investments may be leveraged and the portfolio of eligible investments may lack diversification thereby increasing the risk of loss.

ZAIS Group (UK) Limited. ZAIS Group (UK) Limited is a company registered in England with number 08908933 and whose registered office is c/o Dixon Wilson, 22 Chancery Lane, London WC2A 1LS, United Kingdom. ZAIS Group (UK) Limited is authorized and regulated by the Financial Conduct Authority in the United Kingdom. ZAIS Group (UK) Limited's authorization by the FCA does not imply a certain level of skill or training. Investors will not benefit from the rules and regulations made under the Financial Services and Markets Act 2000 for the protection of investors, nor from the Financial Services Compensation Scheme in the United Kingdom. Nothing herein excludes any liability which ZAIS is not permitted to exclude by applicable law.

ZAIS Group (UK) Limited. ZAIS Group (UK) Limited is a company registered in England with number 08908933 and whose registered office is c/o Dixon Wilson, 22 Chancery Lane, London WC2A 1LS, United Kingdom. ZAIS Group (UK) Limited is authorized and regulated by the Financial Conduct Authority in the United Kingdom. ZAIS Group (UK) Limited's authorization by the FCA does not imply a certain level of skill or training. Investors will not benefit from the rules and regulations made under the Financial Services and Markets Act 2000 for the protection of investors, nor from the Financial Services Compensation Scheme in the United Kingdom. Nothing herein excludes any liability which ZAIS is not permitted to exclude by applicable law.

Regulatory Registrations and Authorizations. ZAIS Group, LLC's registrations with the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC"), and ZAIS Group (UK) Limited's authorization by the United Kingdom's Financial Conduct Authority ("FCA"), does not imply a certain level of skill or training.