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NY Dinner Notes
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Drobny and BNP hosted a dinner in NY. Some of the analysis was tough going, but it got a many participants rather excited, and I'm certainly one of them. Many questions remain, but several important things were clarified.—Andres Drobny

This was an evening of high theory. Professor Stephanie Kelton led a discussion of what has become known as Modern Monetary Theory (MMT). Kelton is a leading proponent of this framework of analysis, which is still in its infancy but has grown in stature in this period of deflationary dangers, zero rates and QE. MMT stands in stark contrast to traditional macro theory, as the role of money creation by the government takes center stage. A key element of the analysis is to differentiate between **users** of currency, largely the private sector, and the **monopoly issuer** of currency, which is the Government. This differentiation leads to an understanding of a crucial difference between fiat currency regimes and alternative currency systems based on some outside anchor (eg, most notoriously gold but also the Euro, see below). MMT also advocates increased fiscal activism and downplays monetary activism. In some senses, then, it stands as a polar opposite to monetarism. The MMT framework also provides a powerful lens to understand current developments raises some powerful market implications.

To understand the method, start by assuming a world of full employment and full capacity utilization. When a country faces a real resource constraint, then inflationary pressures can become a genuine and immediate danger. In such circumstances, monetary policy can arguably have an important role to play is dampening excess private sector demand. As discussed during the dinner, such policy would effect private sector spending decisions by raising the price banks receive for the excess reserves they hold at the central bank, thus inducing them to lend less and park more cash with the central bank, or ask for higher returns from lending thus raising the cost of investment.

However, fiscal fine tuning could also accomplish this task. The MMT framework argues for this approach. They are fiscal activists. This doesn't necessarily mean that the size and role of the state varies. That's a separate and highly political issue. Instead, such fine tuning could be accomplished through varying tax rates, using an instrument such as payroll taxes in the US (or VAT in Europe). Kelton is involved in a project of creating a fiscal analogue to the Taylor rule for monetary policy to help pinpoint the appropriate level of an instrument such as the payroll tax rate or VAT rate needed to achieve full employment at any given moment. She also advocates creating a FED-like agency for fiscal fine tuning, and downgrading the role of the Federal Reserve. Controversial proposals, no doubt. And, in a world that is running close to full employment and capacity, it is tougher to make the case that fiscal activism dominates monetary activism.

But, of course, few countries today face genuine resource constraints. The opposite is true. Much of the world is plagued by excess capacity, zero rates, and deflationary rather than inflationary pressures. In such circumstances, monetary policy might help limit deflation, one participant noted, but it may not be enough to reflate an economy. The central bank can reduce the rate it pays on excess reserves to zero, or buy longer term assets to reduce long term interest rates. But, as we've witnessed over the past several years (and much longer in Japan), such policies cannot force banks to lend more. In a world facing deflation and excess private sector savings, zero rates and QE can fail to reflate an economy. Kelton went further and argued they are destined to fail, but that does not seem crucial to the story.

It's in a deflationary environment where the strengths of the MMT framework are most evident. After a debt bubble bursts, monetary policy may become impotent. This explains why Japan never recovered despite QE after they tightened fiscal policy when they raised the consumption tax back in 1997. Big mistake. MMT advocates fiscal activism by adjusting the government deficit, rather than relying on monetary stimulus. Again, tax rate changes are emphasized since they are likely to have a quick and immediate impact on private sector (disposable) income levels.

This all stems from a simple accounting identity. Assume that the trade deficit is zero; to simply things at first. Then divide the economy into private and public sectors, who behave differently because the balance sheet pressures they face are different. In a fiat currency regime, the government sector can always fund itself by creating more reserves. Private agents face a genuine budget constraint. But, by the accounting identity, if one sector is in surplus (or deficit), the other must be in deficit (or surplus).

The sum of the deficits and surpluses in the two sectors must be zero. In a fiat currency system, the government has the freedom to accommodate changes in private sector behavior by adjusting its budget deficit and self funding if it chooses as a means to cushion the effects on output, growth and inflation rates. And, failure of the government to offset the private sector's savings desires actually creates a headwind which frustrates the objectives. If the government doesn't act decisively to an increased desire by the private sector to save (eg, deleveraging), it is effectively starving private sector activity because in a fiat money system, it's the government (and not the central bank) that creates new liabilities for the private sector to own.

So, at any level of income, if the private sector decides to save more (eg, deleveraging), the public sector will by definition, by an accounting identity, end up saving less (the government deficit rises or surplus falls). In an ideal world where the fiscal authorities are competent, efficient and proactive, then an innovation in private sector savings would be matched by an instantaneous shift in the tax rate, producing an equal and opposite response in the public sector. Income would remain stable. A key policy proposal that stems from MMT, then, is to keep monetary policy steady and adjust the tax rate to limit economic fluctuations. And, this argument seems to be especially relevant in a world of private sector deleveraging, zero rates and QE.

All this of course is idealized. A repost at the dinner was that fiscal activism can be very political and is rarely quick and efficient, especially in a democracy. That, in fact, was part of the original argument by Milton Friedman for advocating stable fiscal and more activist monetary policy back in the 50s and 60s!

Another worry that was expressed is that fiscal activism at best controls nominal income, not real income. That actually isn't necessarily correct, except at or near full capacity. And, this complaint applies equally to fiscal or monetary activism. If inflation pressures are relatively non-existent, then successful policy activism, whether monetary or fiscal, will have a powerful effect on real incomes. It is largely after the policy achieves success, and the economy nears full capacity, that inflationary pressures are likely to emerge, limiting the ability of the authorities to push up real incomes and growth. That's the issue of an exit strategy – after the policy has succeeded. (With MMT, you just raise the tax rate; we'll see what they do if QE succeeds.)

Several participants were also concerned about default risk that arises from a permanent government budget deficit (assuming the private sector always wants to save some of its income, which itself proved a controversial issue). It was pointed out that, in a fiat currency regime, the government cannot be compelled to default (though they can choose to) since they can always self finance. The Russian default, the Argentina default, Greece, and most others over the centuries catalogued in the famous Reinhart and Rogoff pieces of a few years ago, are virtually all related to non-fiat currency regimes. This seemed to surprise several in the audience.
OK, this is the bare bones of the theory, and again it's in its infancy. But, what about the implications? Some are really powerful, especially in a world characterized by deleveraging and deflationary pressures.

Start with Japan. Kelton argued that Japan is the perfect example of how zero rates and QE failed to generate recovery. Pumping reserves into the banking system did not lead to more lending. A fire may now be lit in Japan precisely because the authorities look set to use additional instruments, fiscal stimulus and currency depreciation, to directly generate more demand and spending on Japanese produced goods. It's the switch from exclusive reliance on monetary activism that is the source of more hope in Japan these days. And, because the yen is a fiat currency, fears that upward pressure on JGB yields from fiscal stimulus are overblown since the government, as the issuer of currency, can self fund the stimulus. Again the risk of higher rates, according to MMT, comes if and only if the policy succeeds in generating growth and ultimately an end to price deflation.

Or take the Eurozone. Kelton's PhD was on this topic and warned of trouble ahead. There's still a mess.
The countries abdicated their monopoly power to issue currency and self fund. That is now controlled at a supranational level. Yet fiscal policy is conducted at the national level. So, these countries have a built in financing problem. The Euro system imposes on the fiscal authorities of each country a budget constraint akin to that faced by agents in the private sector (or US states). There is no equilibrium for this system, she argued.

Instead, what you introduce is exposure to default risk. The MMT model correctly predicted high volatility in Eurozone bond spreads, and warns of sustained default risk.

Moreover, the system leaves the authorities little room to accommodate changes in private sector behavior. Instead, they are forced into 'leaning with the wind' fiscal policies, as private sector deleveraging by definition pushes up the public sector deficit which, because they have no ability to issue currency and self fund, leaves the fiscal authorities no option but to try and cut that deficit. Everyone attempting to cut their deficits at the same leads to depression. And, to wide and volatile bond spreads.

Kelton argued that although the ECB has helped limit solvency risk in the Eurozone, they cannot do anything to resolve this underlying tension. It was a stark warning that the recent calming effect of ECB actions, and the narrowing of spreads, could well be short lived. There doesn't seem to be a serious recognition of the underlying problem. And how Germany will ultimately deal with the seemingly interminable transfer payment problem that they face with the system. The joke at the dinner was that Germany may be in the penthouse suite, but they are still living in the same roach motel!

And, then there's the US. Notice how the overall growth rate of the economy has decelerated on trend as fiscal stimulus has been withdrawn. Despite expanded QE. Now, a good test of this theory may be coming, since fiscal tightening is now in process at a time when some economic acceleration might be taking place. The MMT would suggest caution on optimism that the US recovery has reached sustainability unless, of course, there is enough fuel that comes from new sources of private sector growth such as the shale oil revolution. Then fiscal tightening would serve to accommodate increased private sector spending in a healthy fashion.

MMT is in its early stages of development and there are many issues, questions and unresolved conundrums that arise. One of them is this view that interest rates should remain constant and that the fiscal deficit be adjusted (via taxes) to accommodate shifts in private sector savings behavior. An extreme version of this view is that interest rates should be set at zero.

There's a simple problem with this, and a deeper one. The simple problem is whether this stability idea applies to nominal or real rates. If it's nominal, then this implies that, unless the fiscal authorities get it exactly right, inflation will produce variations in real interest rates that may prove highly undesirable. A 2% interest rate across the yield curve has very different implications if inflation is at zero or at 10%. And, if the implication is that the real rate be kept constant, then this would imply a substantial amount of volatility in nominal rates, which could also be problematic. This needs to be worked on and is why some may prefer a hybrid approach to policy and macro analysis (guilty!).

The deeper problem, or missing piece, takes us back to the Swedish 'Austrian' theorist, Knut Wicksell. His model ties the monetary and real economies by comparing the (real) rate of profit on physical capital to the (real) rate of return on money. Booms occur in his model when the rate of profit rises above the cost of borrowing. Slumps occur when either the cost of borrowing is pushed up above the rate of profit, or when the rate of profit starts to fall, say after a debt-based investment boom.

The MMT approach of keeping interest rates steady and varying the fiscal deficit in response to such events seems to miss Wicksell's main point, that a flexible monetary policy helps, however haphazardly, to stabilize investment trends. If the MMT proposals are adopted, then what prompts a revival of profits and investment after a slump in private sector spending? Simply time, to allow capital to decay and become obsolete, which would serve to raise the rate of return on new vintage if capital equipment? That sounds woefully inadequate and slow. There has to be a way to accommodate a profits cycle, and promote renewal within the framework. Something between the extremes of monetarism—which suggests that the capitalist system will self-regulate and the Government need to just let the system adjust on its own and avoid big monetary mistakes—and MMT - which suggests that the fiscal policy can be adjusted to accommodate changes in savings behavior and monetary policy should remain stable—still needs to be found. But, in the meantime, while this fascinating new model is developed by its proponents, we can still glean powerful economic and market implications from this evolving theoretical framework.

Please note, these comments represent my own personal interpretation of the proceedings and MMT theory. Additional comments, suggestions, and especially clarifications and corrections would be gladly received and reported.

Favorite Trades of Participants:

SG 1: **Buy US swap spreads:**
SG 2: **Buy high quality US stocks:**
SG 3: **Buy Euro/SFr:**
SG 4: **Buy EMG FX vol:**
SG 5: **5-30 fwd steepeners in Euro:** ECB will be looser than currently priced
SG 6: **Buy AUD bonds:**
SG 7: **Sell long dated gilts:**
SG 8: **Buy Euro/HUF risk reversals:**
SG 9: **Buy precious metals (gold and silver):** Central banks will not take foot off gas.
SG 10: **Buy EMG vol generally:**
SG 11: **Buy zero cost risk reversals in S&P:**
SG 12: **Buy mortgage convexity/gamma:** A play on the impact of higher Treasury yields
SG 13: **Buy late 2015/2016 calendar spreads in eurodollar contracts:**
SG 14: **Buy vol in FX and Rates in Eurozone:** Europe is a false equilibrium and mkt underpricing potential range of outcomes.
SG 15: **Buy short duration EMG assets:**
SG 16: **Sell Canadian Homebuilders:**
SG 17: **Sell AUD:**
SG 18: **Buy USD:**
SG 19: **Buy USD vs CAD:**

SG 20: **Buy USD vs CAD & GBP:**
SG 21: **Buy USD vs JPY and NKY:** Just getting started and NKY owners need to hedge.
SG 22: **Buy USD vs AUD and NZD:**
SG 23: **Buy CMS cap 9mths 30yr 310-330 spread and sell 350:** Pay 5c to make potential 30 on upward grind in US rates. Assumption is Europe won't h it systemic risk.
SG 24: **Pay 5yr 5yr fwd KRW swaps:** Asian rates are anomalously low.
SG 25: **Buy USD/Yen:** BoJ will succeed, long way to go.
SG 26: **Buy risk assets:**
SG 27: **Buy Mexican homebuilders:** Price is right, Mexican gov't just issued supportive policy/guarantee program.
SG 28: **Sell Sterling & Buy USD/Yen:**

Professor Stephanie Kelton is Associate Professor and Economics Department Chair at the University of Missouri-Kansas City and a Research Scholar at both the UMKC Center for Full Employment and Price Stability and the Levy Economics Institute in NY. In 2011, she was invited to serve on a panel of experts to help Sen. Bernie Sanders (I-Vt.) draft legislation to reform the Federal Reserve alongside Nobel Prize winner Joseph Stiglitz, Jeffrey Sachs, Robert Reich, James K. Galbraith, Dean Baker, and Robert Johnson.

Dr. Kelton is an active blogger at New Economic Perspectives and has published dozens of articles in professional journals including the Journal of Economic Issues, the Cambridge Journal of Economics, the Journal of Post Keynesian Economics, the International Journal of Political Economy, the Review of Social Economy, and Challenge Magazine. She is listed in Who's Who in the World and was the recipient of a Rotary International Scholarship to study in Cambridge, England. Her book (edited with Edward J. Nell), The State, The Market, and the Euro: Metallism versus Chartalism in the Theory of Money, is available through Edward Elgar Press.

Andres Drobny

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