JULY 2020

THOUGHT LEADERSHIP:

COVID-19 AND THE MAGNIFICENT MONEY TREE

INTRODUCTION

In response to an administrative error that led the Australian Government to overstate the bill of its JobKeeper plan by A$60 billion dollars, Treasurer Josh Frydenberg made the following comment in late May in the wake of the discovery of the error:

'This will reduce the government's borrowings by $60 billion. With the nation's debt bill already standing at $650 billion and all new spending initiatives during the pandemic are debt-financed, any opportunity to keep Australia's debt as low as possible is welcomed.'[1]

Despite pressure to use the 'extra' $60 billion to extend the scope and duration of the payment scheme or to direct the funds to other struggling industries, Frydenberg instead focused on the fact that the error meant that the government would not need to borrow as much to support the Australian economy through this difficult period. This response from the Australian Government shows its dogged focus on the size of its debt. Getting the budget '*back in black*' was part of the Liberal Party's 2019 election campaign, and pre-COVID-19, Treasury's forecasts indicated that the budget would be in a surplus position for each of the next four years.

Traditionally, government debt is considered to be finite. Running large fiscal deficits year after year will mean that at some point, government debt will get so large that the government will be forced to default. Or, even if they are able to avoid the default scenario, the cost of servicing the outstanding debt will plague future generations. As such, governments are often thought to be fiscally responsible if they can deliver budget surpluses as it means they are able to reduce the size of the outstanding government debt. In fact, pre-COVID-19, Frydenberg had argued that Australia's low government debt to GDP ratio meant that the country would be better equipped than more indebted countries to deal with future economic crises.

Along comes COVID-19. Global governments have been forced to shutter much of their economies to stem the virus spread. In turn, they have spent with little to no restraint over the past several months, in an effort to put their economies on life support. The quantum of fiscal spending is unprecedented, far outstripping the Global Financial Crisis (GFC). Governments' financial positioning before COVID-19 has seemingly had little to no impact on their ability to unleash enormous fiscal support packages.

[1] Refer to JobKeeper Gaffe Bonus To Help Rein in Debt: Frydenberg, The Australian, 24 May 2020

When the dust settles on the simultaneous health and economic crises, governments will be forced to take stock of their much higher debt levels, and assess what this means for their current and future public finances. Through the conventional economic lens that suggests high debt levels are dangerous and unsustainable, governments may face some tough choices. Will they be forced to run sizable surpluses over years or decades, generated through higher tax rates or less government spending? No elected official will want responsibility for implementing a period of fiscal austerity after COVID-19's economic hardship.

Modern Monetary Theory (MMT) turns this conventional economic thinking on its head. Despite its name, MMT is less a theory and more a different coloured lens to view the inner workings of the economy and the fiat monetary system through. MMT proponents argue governments who are monetary sovereign (issue their own currency) can print as much money as needed, to never default on their debt. As such, governments can stop their fixation on deficits and debt. Government spending should ebb and flow with economic cycles, and taxation should be used to keep inflation in check. Central banks' role also changes, from an independent body to the government's execution arm that keeps interest rates on government bonds at or close to 0%.

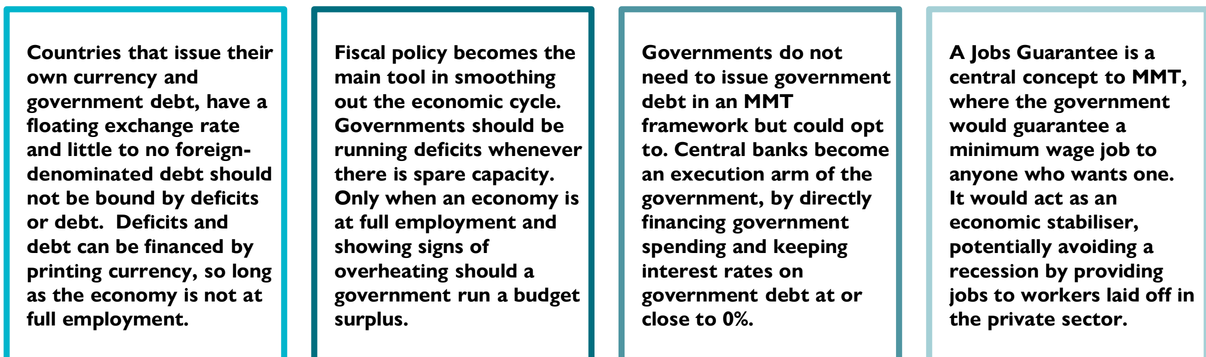
In examining the response to COVID-19, and going back further to the response to the GFC, perhaps subconsciously or because they are faced with no other choice, governments are already starting to see the economy through an MMT lens. Specifically, on the brink of a global recession, governments have spent without restraint. Central banks are financing government spending by purchasing significant volumes of government debt as part of their asset purchase programs, and are maintaining interest rates at or close to 0%.

In this month's article, we provide a refresher on the economic principles of MMT, and explore why COVID-19 has brought MMT squarely into the spotlight. We highlight the aspects of the recent fiscal and monetary policy response to COVID-19 that make MMT seem an increasingly conceivable (or perhaps, inevitable) economic policy framework going forward. This discussion is the first of two articles on the subject. Next month, we will discuss the investment implications a shift towards MMT could have.

A Crash Course on MMT

We first wrote about MMT in September 2019, providing a detailed summary of the main policy dynamics, including differences between MMT and more mainstream economic theory. As a refresher, Figure 1 describes the main policy features. Importantly, only countries that issue their own currency and have limited foreign-denominated debt can consider MMT as part of their policy frameworks. This rules out countries within the eurozone (do not issue their own currencies) and most emerging market countries (large volumes of foreign-denominated debt).

Figure 1 – Overview of Modern Monetary Theory

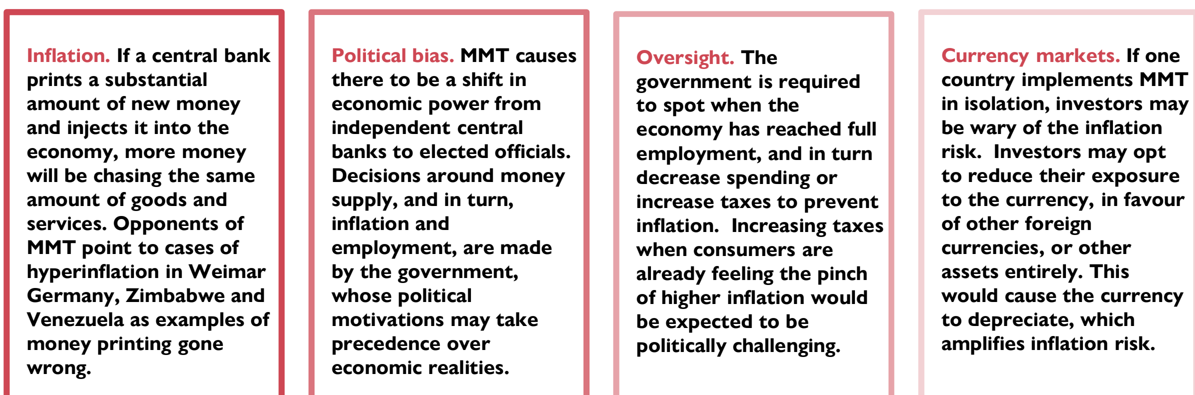


Over the past several years, MMT has surged in popularity, largely because of Elizabeth Warren's and Bernie Sanders' presidential campaigns, and support from US Congresswoman Alexandria Ocasio-Cortez. These left-leaning politicians floated MMT as a possible way to fund their very expensive social and environmental platforms. However, criticism of MMT has been ample, including from mainstream economists of all political stripes.

Larry Summers, former US Treasury Secretary, called MMT '*fallacious at multiple levels*', '*a recipe for disaster*' and '*voodoo economics*'. Current Chair of the Federal Reserve Jerome Powell said that MMT is '*just wrong*'.

Why does MMT evoke such harsh criticism? Figure 2 highlights some of the most controversial issues and risks.

Figure 2: Risks Associated with MMT



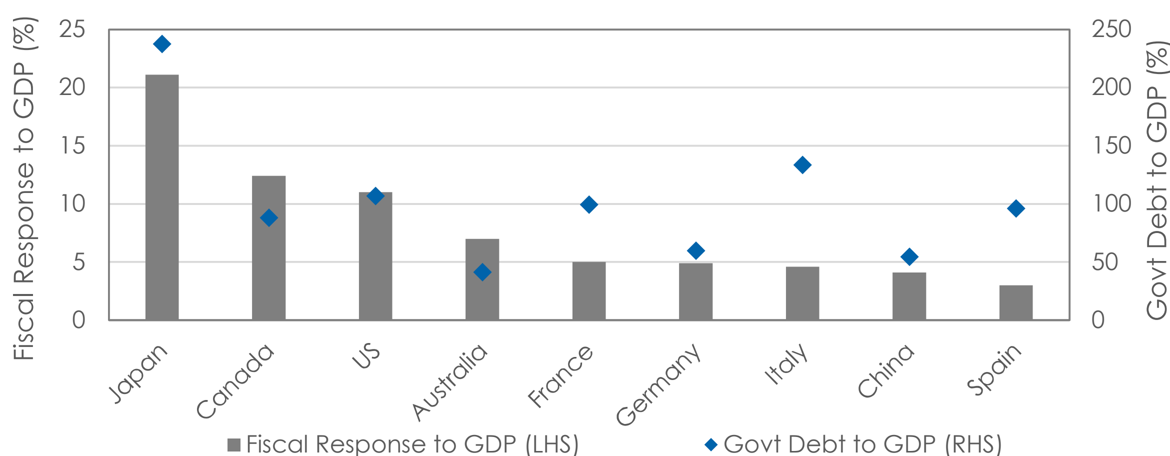
SHUTDOWNS & STIMULUS

Typically, when governments announce large fiscal stimulus initiatives, they often need to describe how they will fund these projects, whether through tax hikes, spending cuts or by borrowing. The nature of the COVID-19 pandemic, especially the need for extraordinarily swift responses from governments to funnel cash to households, businesses and markets, meant that governments only had time to consider one option – the fiscal support would be financed by issuing debt.

Levels of government indebtedness pre-COVID-19 had little bearing on how much governments have spent in support of their economies. It quickly became clear that the primary constraint on spending was political, not financial. Chart 1 shows the size of the fiscal response size from select developed market countries as a proportion of pre-COVID-19 GDP, as well as government debt to GDP ratios as at end-2019. Note the fiscal response illustrates only the additional government spending (wage support, public investment, subsidies to businesses, etc.) and does not include the impact of payment deferrals (such as deferrals of taxes and social security contributions) that some countries implemented.

Countries within the EU are more constrained in terms of government spending as they are part of the Stability and Growth Pact which requires each member state to implement fiscal policy that remains within the limits on government deficit (3% of GDP) and debt (60% of GDP). As such, European governments have been more reliant on payment deferrals, which is not captured in Chart 1. Importantly, countries within the eurozone are not monetary sovereign, so they cannot simply print currency to fund targeted fiscal initiatives.

Chart 1: Fiscal Response and Government Debt to GDP Ratios



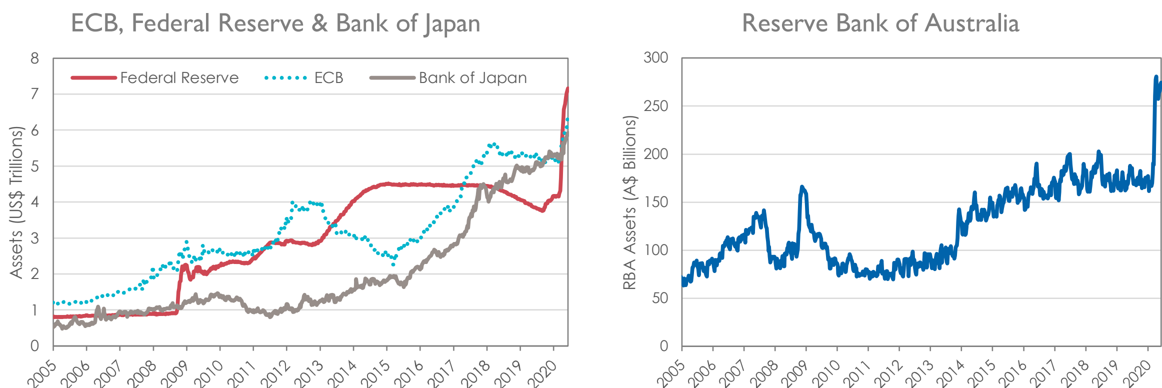
Source: IMF, OECD, Whitehelm Advisers, as of 1 July 2020

The response from central banks was also swift and sweeping, slashing interest rates to 0% or close to. However, monetary policy has been the main game in town in smoothing out the economic cycle and supporting asset markets since the GFC. As such, cash rates had little room to move lower in response to COVID-19. The Fed's cash rate was in the target 1.50-1.75% per annum range at the start of 2020, while the Bank of Japan and European Central Bank (ECB) started with negative deposit rates.

Central banks have been forced to resort to extraordinarily robust asset purchase programs (or quantitative easing (QE)). The depth and breadth of QE has been unprecedented, and eclipses that implemented during the GFC. The Fed is currently running an open-ended program across fixed interest asset classes, including, remarkably, high yield debt. The ECB's asset purchase program is currently targeting €1.35 trillion, and not slated to end until June 2021. The Reserve Bank of Australia (RBA) has even embarked on its first foray into QE, by purchasing short-dated Commonwealth and semi-government bonds. Chart 2 presents the dramatic increase in the volume of assets for selected central banks.

The messaging around the purpose of this monetary stimulus differs across central banks. For example, the Fed's open-ended asset purchase program currently involves purchasing a set amount of assets per month, an amount deemed sufficient to ensure government bond yields remain low across the yield curve. Alternatively, the RBA has adopted a yield curve control approach (YCC), where it sets an explicit 0.25% per annum target for the yield on three-year government bonds. The RBA then buys the amount of government bonds necessary to maintain the target yield. The Bank of Japan adopted YCC in 2016, targeting a 0% yield on its 10-year government bond. Regardless of the exact framework in place, the point is to ensure that interest rates across the yield curve are very low.

Chart 2: Central Bank Assets, 2005 – 2020



Source: Bloomberg

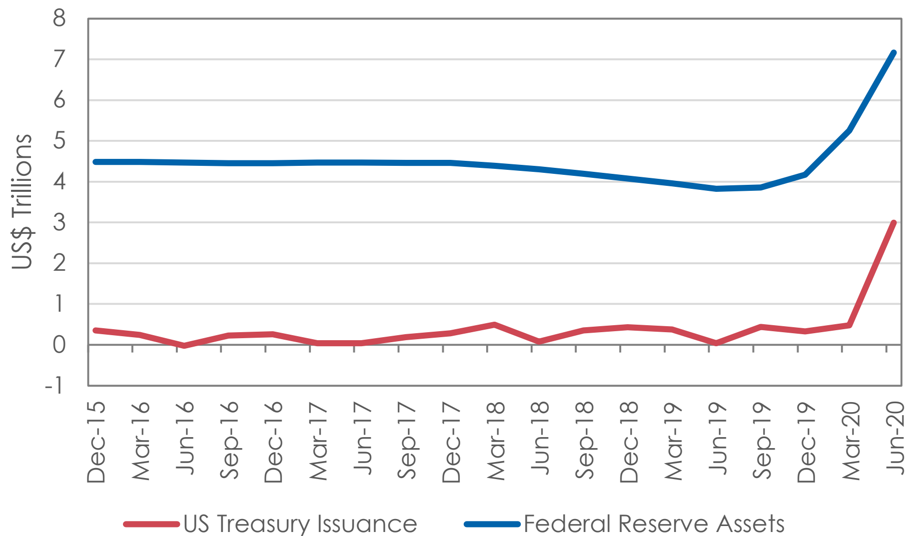
Is This MMT?

MMT economists argue that the government should smooth out the economic cycle by implementing extensive and targeted fiscal policy measures when the economy is showing signs of distress. They also argue that central banks should finance government spending, either by printing money for the government to spend directly or by buying the necessary amounts of the government debt issued to finance the spending. While this is a simplification of MMT's intricacies, does it sound similar to what is taking place now?

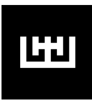
Governments' COVID-19 responses have been targeted, marked by creating new or boosting existing safety nets for those who are most vulnerable to the impacts of the shutdown. Only political considerations restrained the fiscal response, not financial ones – pre-crisis levels of indebtedness had little bearing on how much a government could or was willing to spend.

Central banks have also been doing their part, by financing government spending through sweeping QE programs, and by maintaining interest rates at or close to 0%. They have made it very clear that interest rates will remain at or close to 0% for an extended period of time. Central banks continue to claim that they are not directly financing the government because they typically buy government debt on secondary markets. However, they have been the largest purchaser of the newly issued government bonds, with the coinciding increase in the Fed's balance sheet and volume of US Treasury issuance shown in Chart 3.

Chart 3: US Treasury Issuance and Federal Reserve Assets, 2015 - 2020



Source: US Treasury, US Federal Reserve



We have seen a high degree of cooperation between governments and central banks in their policy responses to COVID-19. This marks a dramatic shift from uncoordinated efforts since the GFC, where monetary policy has largely been relied on to support economic growth, despite central bankers' pleas for more government fiscal support. However, an important difference between what we are currently seeing and MMT is the way that the relationship between the central bank and the government is being defined to the public.

The mainstream belief is that central banks need to remain independent from government. They should be focused on using the tools available to meet economic targets and not succumb to political influence. Furthermore, independence between the two bodies is considered one of the most important drivers of confidence in a country's bond market. Not having independence could mean that the central bank would be pressured to increase money supply because of short-term political motivations. Any hint of runaway inflation caused by politically motivated money printing will likely send shockwaves through a country's bond market, as expectations for inflation increases will cause bond yields to increase, and bond prices to fall.

The more recent entanglement of monetary and fiscal policy illustrates that the line that divides governments and central banks is blurring. Since the GFC, central banks have seemingly had one eye on inflation targets and the other eye squarely on ensuring asset market stability. In this latter pursuit, central banks appear willing to expand balance sheets to whatever size necessary. Reframed from an MMT angle, central banks were willing to purchase a significant portion of the debt that governments needed to issue to fund fiscal deficits.

The entanglement of the monetary and fiscal policy responses is not always made explicit to the public, however. Governments are not making it easy to understand that one arm of the government (the central bank) is the majority buyer of the bonds being issued by another arm (Treasury). Rather, governments want to maintain confidence in the current policy frameworks, and keeping the public in the dark about who is funding government debt seems to be part of that.

WILL MMT BE FORMALLY ADOPTED?

If governments are already embracing many aspects of MMT, will it be formally adopted as part of the economic policy framework? Some advocates of MMT, including Australian economist Bill Mitchell who is responsible for giving MMT its name, point out that it is not actually a matter of adopting MMT, rather it is a matter of changing the way we think. In a blog post from 23 March 2020, Mitchell wrote:

'MMT is not a new regime that we will shift to. That is a fundamental mistake in understanding that many people fall into. A government does not suddenly 'apply' or 'switch' or 'introduce' MMT. Rather, MMT is a lens which allows us to see the true (intrinsic) workings of the fiat monetary system.'[2]

So, what will be the catalyst for viewing the global economy through an MMT lens?

Politics

In the current economic and political climate, it is hard to foresee how governments are ever going to embark on austerity to rein in government debt. The economic recovery from COVID-19 is likely to be long and winding, and governments are likely to have to implement many more rounds of fiscal support before they can even start thinking about fiscal surpluses. In the case of Australia's growing government debt, former Treasurer Peter Costello recently made the following comments with regards to expectations that the debt could reach A$1 trillion:

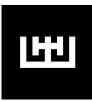
'I don't think you'd pay back a trillion dollars. You can't pay back any of it until you turn a budget surplus, right? That's the first point. And then how many budget surpluses would you need to pay that back? Twenty? Twenty in a row? Can you imagine that?'[3]

Governments will face political backlash if they start to tighten their belts too soon, or ever. Consider the United States. One of Donald Trump's many campaign promises during the 2016 presidential election was to eliminate US government debt over an eight year period. At the time, US government debt was around US$19 trillion. Almost four years later, US government debt stands at US$25 trillion. If President Trump is re-elected in November, will he kick off his second term by hiking taxes or decreasing government spending, to ensure an improvement in the country's fiscal positioning? President Trump's track record suggests this is unlikely, even without the pandemic backdrop.

Alternatively, if Joe Biden gets elected, will his first order of business be to tighten the purse strings? With either election result, we are more likely to see an increase in US government debt as expensive campaign platforms get actioned and COVID-19 fiscal support continues. If under pressure to grapple with paying off the monstrous debt loads, politicians may favour a more politically appealing framework of not worrying about paying off the debt at all.

[2] Refer to http://bilbo.economicoutlook.net/blog/?p=44547

[3] In an interview with Alan Kohler on ABC's 7.30 on 21 June 2020



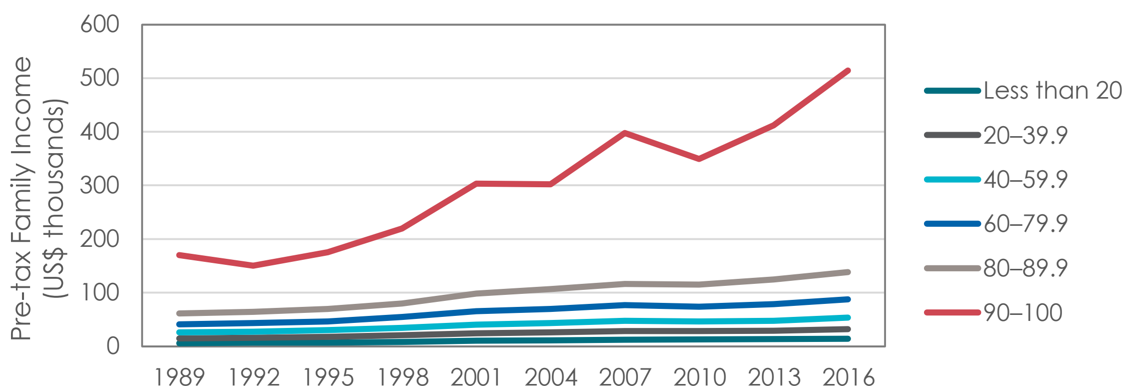
Inequality and Social Unrest

Relying on monetary policy to stimulate the economy has had disproportionate benefits for the wealthy, and little to no impact on the poor. Furthermore, any austerity measures to rein in government debt levels are most likely to weigh heaviest on the poorest segments of society. We are already seeing sweeping and impactful protests driven by marginalised sectors of American society. If governments try to implement austerity measures to rein in government debt or maintain a monetary policy status quo, we may see a high degree of civil unrest centred around wealth and income inequality.

The post-GFC and pre-COVID era of relying predominantly on monetary policy to support the economy has been incredibly beneficial for asset markets, but any benefit to the real economy has been muted and lagged. Depending on the stage of the economic cycle, the divergence between the benefit for asset owners and the real economy fluctuates. Late in the economic cycle, where private (households and businesses) debt levels are very high, monetary policy easing is unlikely to materially impact consumption, but asset prices will rise anyway. This results in asset inflation, but not price inflation. The reliance on monetary policy has primarily lined the pockets of the wealthy (those with the most exposure to asset markets), but it has been of little benefit to everyone else. Chart 4 shows the worsening income inequality in the US.

MMT economists argue that fiscal policy is well-suited to redistribute economic benefits more equitably across income and wealth distributions because it can be better harnessed to target the real economy. In an MMT policy framework, central banks would support governments to implement fiscal spending that directly targets households and businesses, with the end game being to increase spending power. But fiscal policy does not leave asset markets out in the cold. Corporations would benefit from increased consumption, lower tax rates and more profit, which would push up stock prices. Increased awareness of the current system's flaws may lead to a level of social unrest that demands real change. Seeing the economy through an MMT lens could strike a better balance between benefits to the real economy and to asset markets.

Chart 4: Pre-Tax Family Income in the United States by Income Distribution, 1989 - 2016



Source: US Federal Reserve – Survey of Consumer Finances, Whitehelm Advisers

Financial Markets

Financial markets may dictate a push towards MMT, or another monetary and fiscal policy framework.

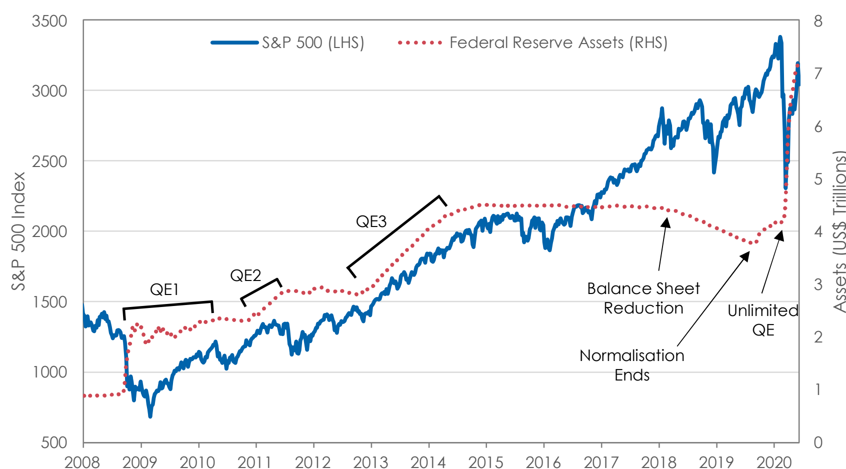
Consider the Fed's challenge when it tried to embark on a period of monetary policy normalisation over the past five years. The 'taper tantrum' at end-2015/early 2016 was triggered by a mere 0.25% increase in the Fed's cash rate (from its 0% lower bound), and a discussion about reducing the size of its balance sheet. Then, in 2018 when the Fed did embark on reducing its balance sheet, equity markets again sold off aggressively. The Fed temporarily had its federal funds rate in the target range of 2.25-2.50% in 2018, before market conditions forced it to ease monetary policy again in 2019. Chart 5 shows the relationship between the size of the Fed's balance sheet and the S&P 500 index.

Central banks' difficulty in normalising monetary policy has only been exacerbated by COVID-19. The Fed was having trouble reducing the size of its balance sheet when it was half its current size. How are central banks ever going to meaningfully increase interest rates or reduce balance sheets without causing pandemonium in markets? Furthermore, with conventional monetary policy already at its limit, and unconventional monetary policy packing less of a punch, improving labour market outcomes, stimulating inflation and increasing interest rates while also maintaining stability in asset markets seems inconceivable. A change to the economic framework that fundamentally changes the way monetary policy and fiscal policy interact may be inevitable.

A change in the economic policy framework du jour would not be unprecedented. Keynesian theory rose in popularity when the private sector struggled to generate adequate demand in the 1920s, which led to governments playing a bigger role in the economy. The modern inflation targeting framework was implemented to prevent runaway inflation like that in the 1970s and 1980s. We are currently seeing the monetary policy framework reaching its limits and discussion around what its successor will look like.

So, an explicit push towards MMT, or some other framework may not be a matter of if, but when. This is not just a COVID-19 story. The global pandemic is not going to be the root cause of a shift in the economic framework used by governments around the world. Rather, it is more likely to be the straw that broke the camel's back.

Chart 5: Federal Reserve Balance Sheet and S&P 500 Index



Source: IFM, Bloomberg, Whitehelm Advisers

CONCLUSION

Current policy settings – where central banks do much of the heavy lifting by stimulating economies through conventional and unconventional monetary policy means – are starting to tire. Not only do central banks have little to no ammunition left, the current framework has led to plenty of undesirable outcomes, including asset bubbles and worsening inequality. While not officially accepting this stance, governments and central banks are starting to transition towards a different framework – one where their independence from each other is fuzzier, where central banks print money to support the government in its policy initiatives and where deficits and debt levels are less important. Officials continue to deny they are embarking on MMT, but COVID-19 has lifted the hood on the direction that we may be headed.

Any official change to the economic framework employed by central banks and governments requires a new configuration of economic policy, including redefining the relationship between governments and central banks. The government would have to determine new targets and constraints. Is it purely an inflation target, or does the government also consider unemployment rates, asset price stability and wage growth? Importantly, the government would need to ensure it has proper oversight on fiscal processes, given that elected officials may be incentivised to spend money carelessly, which can have long-term economic consequences (most notably, hyperinflation).

Central banks need to determine their new role. Is it purely to act as an execution arm of the government in which it buys the government debt issued with newly created money? Or is purchasing other assets included in its mandate? The answers likely depend predominantly on the government's new economic mandate, but the scope of assets that the central bank purchases would have profound implications for the relative performance of assets across sectors and asset types.

In this month's article, we have discussed the current landscape, including why the COVID-19 crisis has likely expedited a push towards an implicit or explicit transition towards MMT. We expect this will have a variety of implications for investors – including considering what a heavier reliance on the printing presses will mean for inflation expectations, debt markets and currency markets. We will continue to look at MMT in next month's article, focusing on implications for asset markets and investment strategy.

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