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Modern Monetary Mishegoss

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May 10, 2021

The Yiddish word *mishegoss* is often translated as "craziness," but it's a peculiar kind of craziness: It's the kind that has its own single-minded internal logic even if it makes no sense to disinterested observers. A cocky baserunner may try to swipe third base in order to get closer to scoring a run; but when his team is behind by two runs in the ninth inning, that's just *mishegoss*. Likewise an investor who holds nothing but large-cap stocks; sure, stocks do better than bonds over time, but the small incremental return of being 100% in stocks in comparison to being 75% just isn't worth the large incremental volatility. That too is just *mishegoss!*

Modern Monetary Theory has become popular among politicians and investors. It says that federal government spending need not be constrained by tax revenues because the government can just print more money without fear of igniting inflation or a debt spiral. That's music to the ears of legislators who want to spend trillions of dollars but don't want to raise taxes to pay for it.

Not to put too fine a point on it, but Modern Monetary Theory is *mishegoss.*

To see why an MMT-based regime won't end well, it helps to understand the reasoning behind the theory. If a sovereign government controls its own currency (i.e., the U.S. and Japan but not any Eurozone countries), then it cannot be forced into insolvency because it can always "print" more money to satisfy its debts. In other words, the national government can always refinance its ever-increasing debt by selling new bonds to a willing market. The U.S. has been doing this for years, and adherents argue that recent experience proves the theory: Persistently low interest rates indicate that Treasury bond investors don't fear a possible default or inflationary spiral.

There's a fiscal element to MMT, too. In introductory economics classes, college frosh are taught that the government must choose among different spending priorities because its tax revenues are limited by political factors; voters will cast out legislators who raise taxes too much. Thus the famous "guns or butter" debate that has been rehearsed in thousands of lecture halls over the years. MMT changes the formulation to "guns *and* butter," and wins the hearts of free-spending legislators everywhere.

The argument is that MMT allows a sovereign government to inject more money into the economy through spending than it withdraws through taxes; it is inherently a catalyst to faster growth as the multiplier effect takes hold.[1] If the bond markets don't penalize a government through higher interest rates, why *not* spend more money and boost economic growth?

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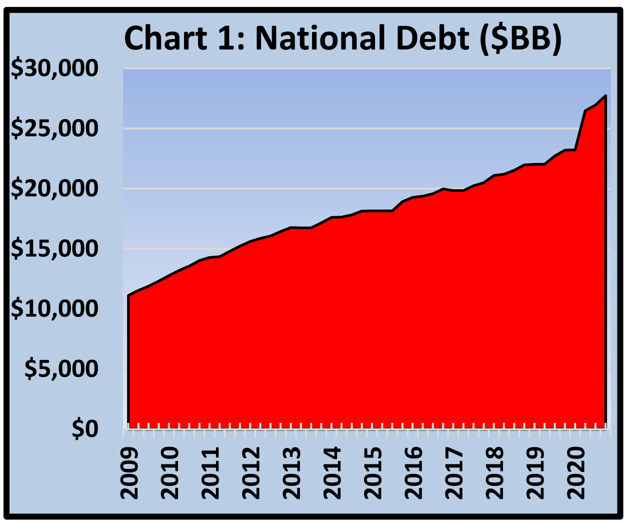
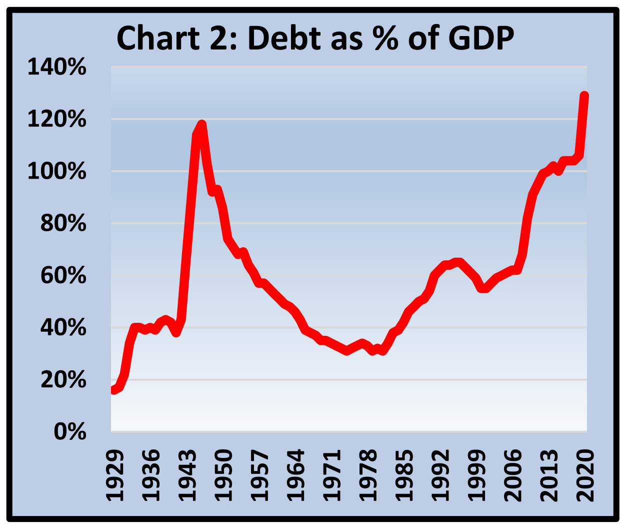
[1] When the government spends money, the economy grows by more than the amount of money spent; as government largess ripples through the economy, its effect is multiplied several times. Different spending programs have different implied multipliers: Infrastructure investment has a comparatively large multiplier, for example, while payroll at foreign military bases carries a much smaller multiplier.

This is a seductive argument. It leads to the conclusion that a nation's economic growth is limited only by its human and physical resources, supplemented by its prowess in trading with other nations. Until those limits are reached, inflation would be unlikely because there would still be slack capacity available.

MMT adherents can look to the experience of the past year as vindication of their ideas. Government spending ballooned following the pandemic's onset, leading to unprecedented expansion of the national debt, as shown in the charts below. Chart 1 shows the steady rise in federal indebtedness over the past decade, and the sudden acceleration in 2020 after the CARES Act and other legislation were enacted. Chart 2 compares the federal debt to GDP over nearly a century, showing that the current debt/GDP ratio has hit an all-time record, surpassing even the WWII spike.[2]

Despite this gigantic increase in spending, both interest rates and inflation have remained low, suggesting that investors are simply not worried about the long-term implications of this real-world experiment in MMT. The recently enacted American Rescue Plan and President Biden's two new legislative initiatives (the Jobs and Families plans) push the concept even further.





Source (both charts): Treasury Department

So where is the *mishegoss*? The whole of Modern Monetary Theory hinges on two critical assumptions: First, that investors will always want to buy government bonds, and that they will always accept low interest rates because there is essentially no risk of default; and second, that government spending will always stop short of creating inflation because the wise sages in Congress will know when the economy is hitting its capacity limits as determined by labor and resource availability. Sadly, these assumptions are both wrong.

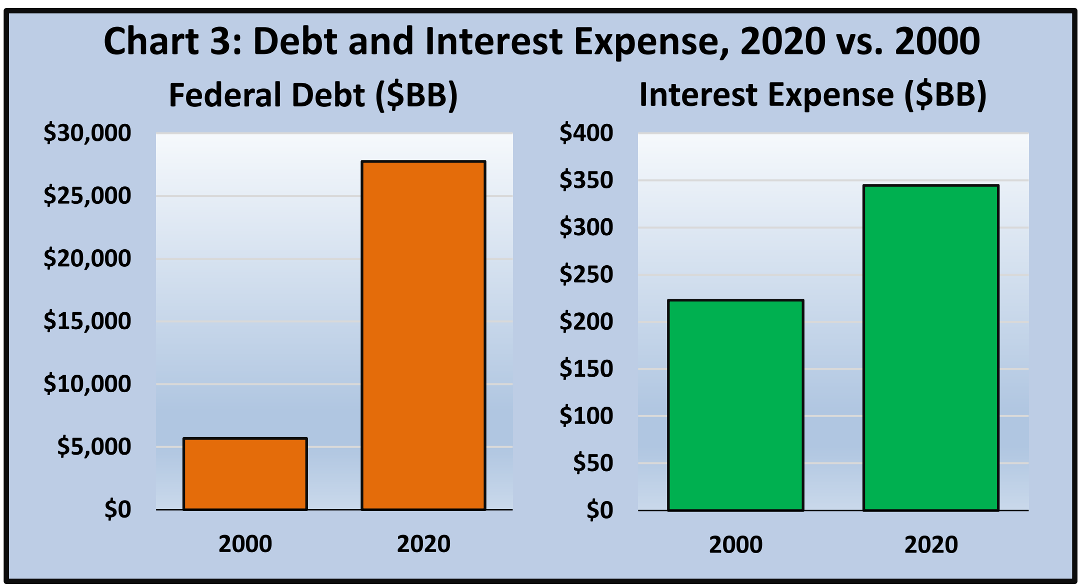
[2] It's worth noting that debt/GDP fell steadily from 1947 to 1970, a period that nostalgic economists remember as having sustained 4% GDP growth. Far be it from me to suggest that perhaps falling debt/GDP didn't hinder GDP growth as MMT theorists would suggest, but the numbers don't lie. Of course, many other factors were also at play during that period, including the rapid influx of women into the workforce, much higher immigration rates, and the higher birth rate of the baby boom years.

To start with, the persistence of low interest rates in the past decade does not reflect the classic free market theory of price as the meeting point between willing *economic* buyers and willing *economic* sellers. Because of persistent Federal Reserve intervention in the bond markets, we can't reasonably assume that the price of Treasury debt sends a signal about its riskiness.

Through its four episodes of quantitative easing (the last of which is still ongoing), the Federal Reserve has acted as a *non-economic* buyer, purchasing bonds with the explicit intent of driving interest rates down. Indeed, whenever the Fed slowed its purchase activity, long-term interest rates jumped almost immediately. (Remember the "taper tantrums" in recent years?)

The Fed has purchased roughly one-quarter of all Treasury debt issued over the past decade. Take away the Fed's fat thumb on the scale, and interest rates would be a lot higher – and hence the cost to the Treasury of trillion-dollar deficits would be much higher as well. This could easily threaten to undermine the basic assumption of MMT, namely that governments can't go broke.

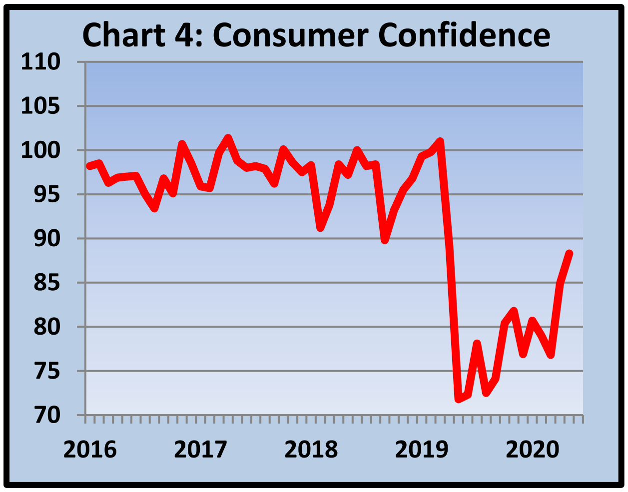
Consider what has happened just in the past two decades. Since 2000, the national debt has nearly quintupled, from $5.7 trillion to $27.7 trillion, while the net interest expense (in dollars) on that debt has grown by only about one-third in the same period (Chart 3).



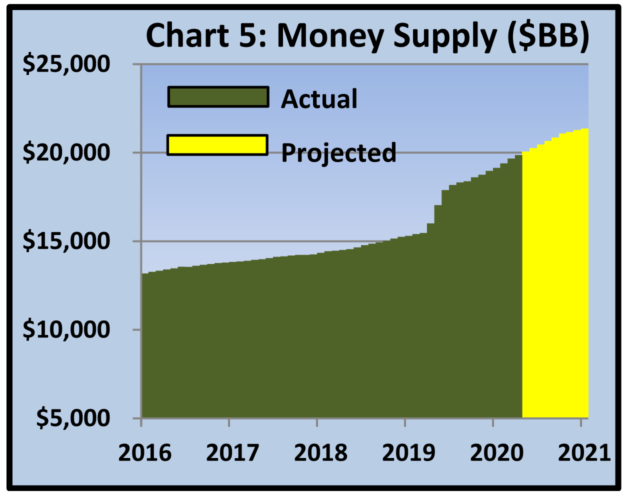
Source: Treasury Department

How is it possible that debt has grown at a rate so much faster than the interest expense on that debt? As interest rates fell over this two-decade period, Uncle Sam benefited by replacing high-priced older debt with lower-coupon new issuance. But if the Fed ever takes its thumb off the scale, the leverage works in the opposite direction: Treasury might be faced with paying higher coupons on rising debt loads, causing interest expense to skyrocket even faster than the debt itself. The Congressional Budget Office has estimated that debt service costs could triple within a half-decade under such a scenario. MMT assumes this won't happen, but it might – and if it does, bond investors may start shunning Treasury debt. If no one wants to buy government debt because the debt service costs are so high, the MMT house of cards comes tumbling down.

The second core assumption of MMT is also open to question. It suggests that Congress will know when to turn off the spigot before it spurs more demand than our resources can satisfy. But the link between spending and demand is indirect. The intervening variable is human emotion, which can be measured by consumer confidence surveys, purchasing manager index data, and bank reserves.

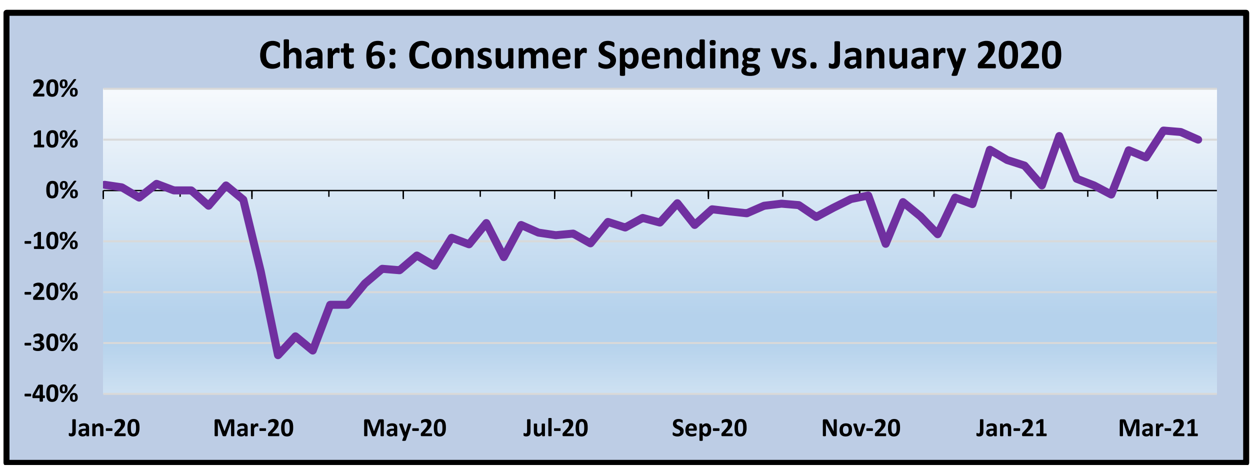


Source: University of Michigan Survey



Source: Federal Reserve

Chart 4 shows that confidence plummeted at the onset of the pandemic, while Chart 5 shows that the money in circulation skyrocketed. If MMT held true, that vast increase in the money supply would have spurred spending, but it just didn't happen. Instead, as Chart 6 indicates, consumer spending remained subdued for nearly a year before rising vaccination rates finally pulled consumers out of their funk.[3] The evidence is clear: Congress wanted to boost consumer spending through the pandemic, but consumers were in no mood to spend; contrary to Modern Monetary Theory, spending follows confidence, not bank accounts.



Source: www.tracktherecovery.org

[3] The same effect played out with business spending and investment, as corporate balance sheets bulged with cash from PPP loans but actual expenditures followed business confidence south.

MMT also doesn't take into account what could happen when consumer confidence finally does recover. The sharp recovery of confidence in the past two months, in combination with rising vaccination rates, was closely correlated with a sharp acceleration in consumer spending as shown in Charts 4 and 6. Spending is already running about 10% above pre-pandemic levels; as the economy continues its reopening process and more people return to work, it is possible that consumer spending may accelerate even faster, beyond what our human and physical resources can sustain. If that happens, it seems doubtful that Congress or the Fed could reverse course quickly enough to avert overheating the economy.

Like many economic and investment fads before it, Modern Monetary Theory appears to work; its adherents are feeling quite smart today. Like other investment and policy fads before it,[4] MMT will likely continue to work just fine until some unexpected catalyst causes it to fail suddenly and spectacularly. That may not happen for months or years. But when we do reach that point, MMT proponents might empathize with Gnarls Barkley in lamenting their *mishegoss*:

> *I remember when I lost my mind*
> *There was something so pleasant about that place*
> *Yeah, I was out of touch*
> *But it wasn't because I didn't know enough*
> *I just knew too much*
> *Does that make me crazy? Possibly.*

From the bottom of the financial crisis in 2009 through the onset of the pandemic in 2020, Congress and the Fed successfully fostered growth and tempered the amplitude of the normal business cycle. That stability fell apart during the pandemic. The great challenge facing the nation today is to get the economy back to steady growth without triggering a new and more volatile boom / bust pattern.

[4] Remember the Nifty Fifty of the late 1960s? Portfolio insurance in 1987? How about the dot-com revolution in the late 1990s? History is filled with seemingly brilliant economic or investment ideas that worked quite well until they got too big and imploded.