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Modern Monetary Theory

By Max J. Rudolph, FSA CFA CERA MAAA

On April 9, 2014 the CFA Nebraska Club hosted Dr. Stephanie Kelton to share her thoughts on Economic Theory. My apologies to Dr. Kelton if I don't get it right, and as usual I will make some additional comments based on my current thoughts on economic theory. Note that I have recently read Code Red by John Mauldin and Currency Wars by James Rickards so this will clearly influence my comments.

MMT – What's Different?

Surprisingly, very little. I went to this CE event hoping to hear a new theory that could overcome our own cognitive biases, and the politicians. At the end of the talk someone summed up the talk by referring it to a modified Keynesian approach, and I think they were right. I had read a paper Dr. Kelton recently recommended by L. Randall Wray of the Levy Economics Institute of Bard College. It is working paper number 658, last updated in March 2011. It is an easy read, but I found myself struggling to really see anything new.

The United States, and all other developed countries (and probably all countries) work with a fiat currency (since 1971 when Nixon took the US off the gold standard). Some would argue that a floating currency not locked with a physical commodity will eventually blow up given that politicians will never make the tough choices. The fact that we have only been off the gold standard for a relatively short period of time means there is little historical evidence to know how various risks and events will interact. Large deficits funded by a central bank creating money from a computer keyboard seem bad to me, but Kelton is not as worried. To me this only works if the US is willing to default on its debt owed to foreign investors (in our case owed to Japan and China).

I want to focus on several specific comments she made.

- After 45 minutes she made a point that I think matters. Deficits can be okay if spent on the right things. Infrastructure that helps future GDP growth is good. Bailing out banks, probably bad. I agree.
- Her statement that "capitalism runs on sales" is true, but we ran out of time so I did not get a chance to ask the obvious question – with future government outflows so heavily weighted to entitlements and non-productive uses like health care and pensions to seniors, how can this work on a practical level?
- She seems to differentiate between inflation and partial government default, but I believe they are equivalent in their net impact.
- She did not talk about how the dollar as reserve currency impacts her analysis. I think it is a key assumption.

- If the Federal Reserve Bank continues to print money, at some point it is no longer a risk free loan to the lender. Countries can and do go bankrupt.
- Her analysis focuses on relative changes from current status. I think this is true if we were in a stable state. I don't think this is true today, and I don't think you can make that assumption at any point in time. We just don't know. Mean reversion is like a pendulum, never converging to a specific point but spending about the same amount of time on both sides of a targeted, perhaps intrinsic, value.
- Economists are forced to accept the current accounting regime as what matters, and I don't blame Kelton for this. But I think there are problems with the current system that does not charge an economic price for something like polluting fresh water. We also can pay someone to repeatedly dig a hole and fill it in, and it counts in GDP even though society is no better off (and don't get me started about having two sides of a balance sheet when a portfolio could include assets AND liabilities).
- She asserted that our standard of living improves with imports, but then made a comment right as she finished up that exports were the best thing ever. I think this is because she is working from the G+I+X = S+T+M (spending from Government, private Investment and Exports matches Saving, Taxes and Imports).

Final Comments

In the Reinhart/Rogoff book, *This time is different*, their data shows that deficits matter when they get large enough. The write up after any collapse seems to say that it happened slowly, then quickly. Right now the US consumer has improved their personal balance sheet as the government has allowed the Fed to pay for deficit spending. It's worse in other countries, so the dollar as reserve currency will likely strengthen near term. Only when someone, anyone, gets their fiscal house in order will the US continue its race to the bottom. Currently it is very hard to keep up with Japan and the EC.

The first slide of Dr. Kelton's presentation is an old quote from a master, Mark Twain. *"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."* This immediately reminds me of Donald Rumsfeld of known knowns fame. In my view Twain is referring to a known unknown!

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