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"Modern" Monetary Theory

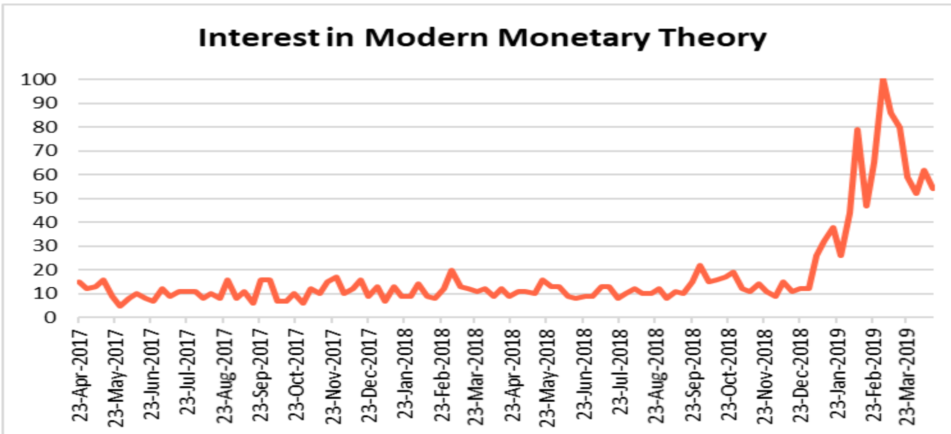
History is replete with episodes of abuse of the power to print money. In fact, the advent of central banking and paper money systems in the 17th century was quickly followed by the failure of the world's first de-facto government bank, Sweden's Stockholms Banco founded in 1656, after only seven years of issuing dramatically more notes than it held in underlying collateral. Not long after that, John Law, an economic advisor to the French Duke of Orleans, helped engineer the Mississippi Bubble in the early 18th century, a financial scheme that allowed the government to print a large amount of fiat currency that ended in financial collapse. France, unfortunately, did not learn its lesson well and repeated the episode 80 years later during the French Revolution.

France's failed experiments with fiat money systems made such an impression on one of history's greatest playwrights, Wolfgang von Goethe, that he included aspects of them in his famous play, *Faust*. In return for worldly knowledge and pleasure, the young scholar, Faust, sells the devil, Mephistopheles, his soul. The two have a number of different experiences together including an episode in designing a new monetary system. In the scene, Faust and Mephistopheles visit the court of an emperor who has depleted his treasury's gold reserves by throwing too many extravagant parties. At a loss for what to do next, the emperor is approached by Mephistopheles who suggests a new way to solve their spending problems. Instead of waiting for new gold to be mined to fund the court's lifestyle, Mephistopheles suggests the treasury simply issue promissory notes for the value of the gold the emperor will surely mine in the future. The emperor and his treasurer quickly agree. As the emperor states, "I'm sick and tired of how and when/We're short of money so make it, then." Goethe's eloquent rendition of the government's proclamation is quoted below:

"To all whom it concerns, let it be known:
Who hath this note, a thousand crowns doth own.
As certain pledge thereof shall stand
Vast buried treasure in the Emperor's land.
Provision has been made that ample treasure,
Raised straightway, shall redeem the notes at pleasure."

As can be expected, the dramatic increase in the government's money supply does not solve the regime's problems as the emperor spends even more and his empire eventually succumbs under the weight of inflation and economic disaster.

Fast forward to today and many of the leading academic and political minds are discussing the merits of a similar policy. Modern Monetary Theory (MMT) has increasingly grabbed the headlines and attention of the media, political figures, academics and money managers. A Google analysis of leading search trends highlights the recent dramatic increase in interest in the concept.



Source: Google Trends,Worldwide (observed as of April 18, 2019)

MMT posits that the United States (and other countries who issue debt in their own currency) can essentially print money to pay off its debt and fund its deficit spending without negative consequences. Proponents of the theory highlight the fact that recently expanded government deficits have not led to higher inflation and interest rates as was predicted by traditional economists.

Therefore, instead of cutting spending to rein in deficits, the theory postulates that the government can spend even more in order to jump start the economy's animal spirits and generate greater economic growth. We have been profligate so far and there is little sign of inflation, so why not spend even more? And if inflation does return, MMT proponents believe the government will have the tools, the wisdom and the willingness to manage the situation sustainably.

Evidence is accumulating that previous monetary policy adjustments such as quantitative easing and negative interest rates are now becoming either ineffective (a lack of inflation or sustainable economic growth) or detrimental (a rise in income inequality). To counter this, politicians and policy makers are looking for new types of monetary alchemy and MMT looks a likely candidate. What politician wouldn't want to come into elections with a policy that allows them to pay for everything they promise to voters? What company management wouldn't want to see the value of their options increase incessantly? What voter wouldn't prefer to work less yet receive more benefits?

While we do not believe a move to this type of monetary policy is imminent, our sense is that a contraction in the economy accompanied by a large drop in the stock market could be the impetus to take the policy off the shelf. The impact on an investor's portfolio and our investment strategy, should MMT be implemented, could be significant. Not only would stocks likely initially trade at higher multiples than in the past, arguing for greater equity allocations relative to bonds at first, but one would need to prepare for the eventual result of such policies – potentially much higher inflation. Allocations to real assets, including gold, would then need to be a larger part of one's portfolio and companies would need to be tested for the impact of higher inflation on their business models. Bond values would likely erode via inflation in this scenario which would argue for a lower weighting.

It remains to be seen if the current whispers of Mephistopheles build to a rallying cry and eventual action by our policy makers or if this is simply an academic, thought-provoking exercise. But given the potential impact on our clients' portfolios, it is one we will be monitoring closely.

Chris Olson and Gautam Dhingra
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