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Modern Monetary Theory: The Federal Reserve, Inflation, and the US Dollar

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In July 2020, GFMI delivered a virtual seminar on Modern Monetary Theory (MMT). One of the questions posed to the audience was "Does too much money in the financial system, as measured by the monetary base, M1 or M2, cause inflation?" Nearly 70% of the respondents believed it did. This perspective aligns with the more orthodox or traditional line of economic theory. MMT advocates would think otherwise. This article briefly looks at MMT, the Fed's movement toward the merging of monetary and fiscal policy, inflation, and the value of the greenback.

Modern Monetary Theory (MMT) Revisited

Some of the main features of MMT are:

- A government that creates its own money need not and will not default on debt denominated in its own currency.
- A government can buy goods and services without the need to collect taxes or issue debt.
- Deficits can be financed at low or near-zero cost through money creation.
- Government spending and money creation should be allowed to adjust to the level necessary to secure full employment without inflation.
- Should inflation arise, it can be controlled by increasing taxes so that the public has less money to spend.
- Government deficit spending need not compete with the private sector for scarce savings and so it will not crowd out private investment.
- It rejects the fine-tuning approach to monetary policy.
- "Policy space" created by MMT should be used by government to create permanent structural programs such as a Job Guarantee to secure full employment.
- Central Bank policy should target zero or near-zero overnight interest rates.
- Combining the above two bullet points implies greater consolidation of Treasury and Central Bank operations.

The Federal Reserve

The Fed has traditionally used reserve requirements, open market operations, and the discount window to manage the amount of reserves in the financial system (for more information and background, read Federal Reserve Tools: Past and Present). In 2008, Quantitative easing (QE) was introduced and the Fed starting paying interest on reserves. The rescue packages for COVID-19 have left no doubt about the merging of monetary and fiscal policy. On May 13, 2020, Scott Pelley of *CBS 60 Minutes* interviewed Jerome Powell, Chair of the Federal Reserve. Here is an excerpt from the interview:

PELLEY: Fair to say you simply flooded the system with money?

POWELL: Yes. We did. That's another way to think about it. We did.

PELLEY: Where does it come from? Do you just print it?

POWELL: We print it digitally. So as a central bank, we have the ability to create money digitally. And we do that by buying Treasury Bills or bonds for other government guaranteed securities. And that actually increases the money supply. We also print actual currency and we distribute that through the Federal Reserve banks.

PELLEY: In terms of size, Mr. Chairman, how does what the Fed is doing right now compare to the unprecedented action it took in 2008?

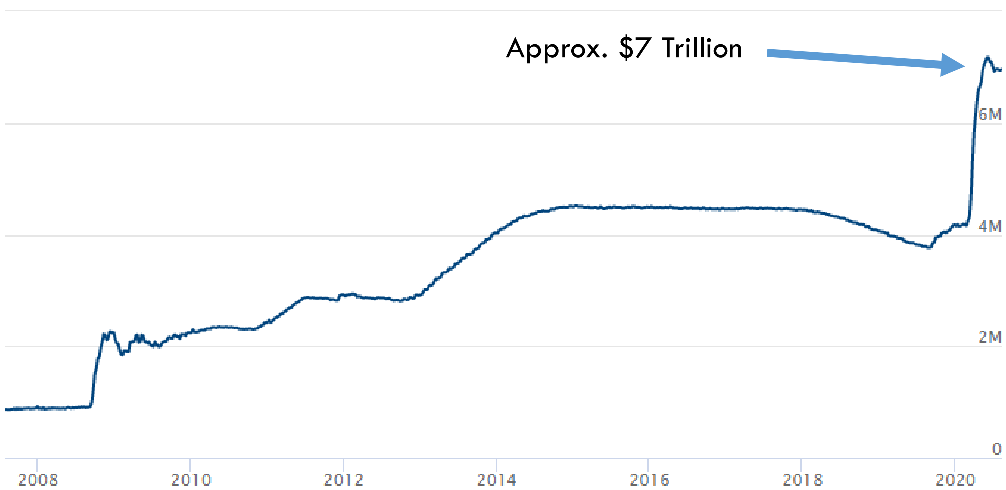
POWELL: So the things we're doing now are substantially larger. The asset purchases that we're doing are a multiple of the programs that were done during the last crisis. And it's very different this time. In the last crisis, the problems were in the financial system. So they were providing support for the banking system. Here, really, the problems are in what we call the real economy, actual companies that make and sell goods and services. And what's happening to them is that many of them are closed or just not having any revenue.

And we're trying to do what we can to get them through this period where they're perfectly good companies that have had, you know, sound financial condition as recently as February, but now they have no business. And they have fixed costs. So we're trying to help them get through that period.

Source: https://www.cbsnews.com/news/full-transcript-fed-chair-jerome-powell-60-minutes-interview-economic-recovery-from-coronavirus-pandemic/

Whether looking at the Fed's balance sheet (Figure 1) or the amount of US Treasuries purchased over a specific time frame (Figure 2), The Fed's QE is here to stay.

Figure 1 – Fed's Balance Sheet as of August 12, 2020



Source: https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm

Figure 2*

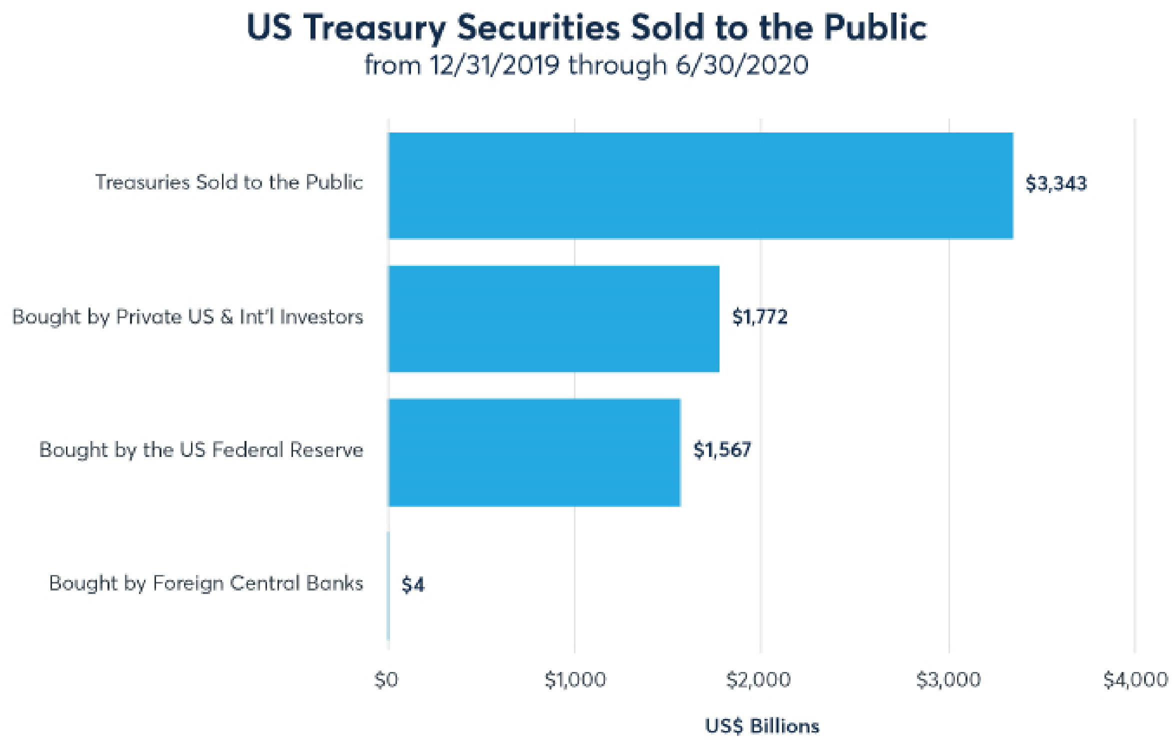


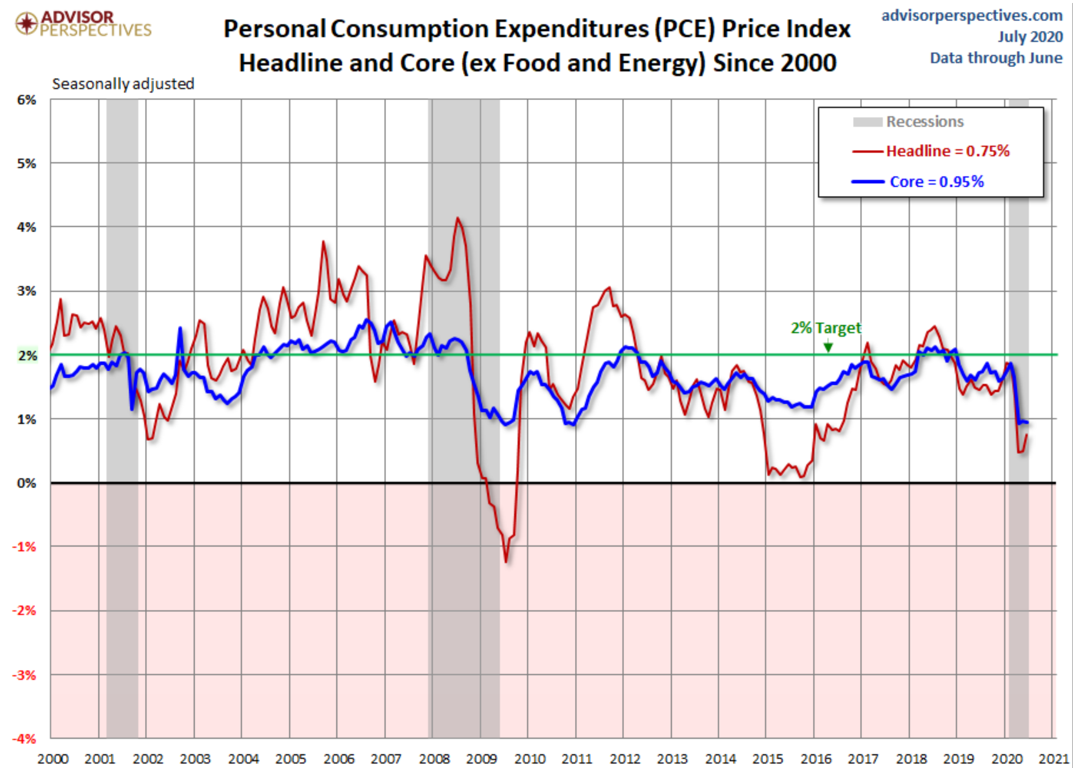
Chart Created by CME Group Economics.
Source: Federal Reserve and US Treasury.

* Implications of US Borrowing $3 Trillion in H1 2020 by Bluford Putnam
https://www.cmegroup.com/education/featured-reports/implications-of-us-borrowing-3-trillion-in-h1-2020.html

There are plenty of variables in the future to determine how much more the government will need to borrow including the recovery, GDP, state and local revenues (11 municipalities have defaulted on their debt so far in 2020), and unemployment. But one thing is certain, MMT has entered the mainstream.

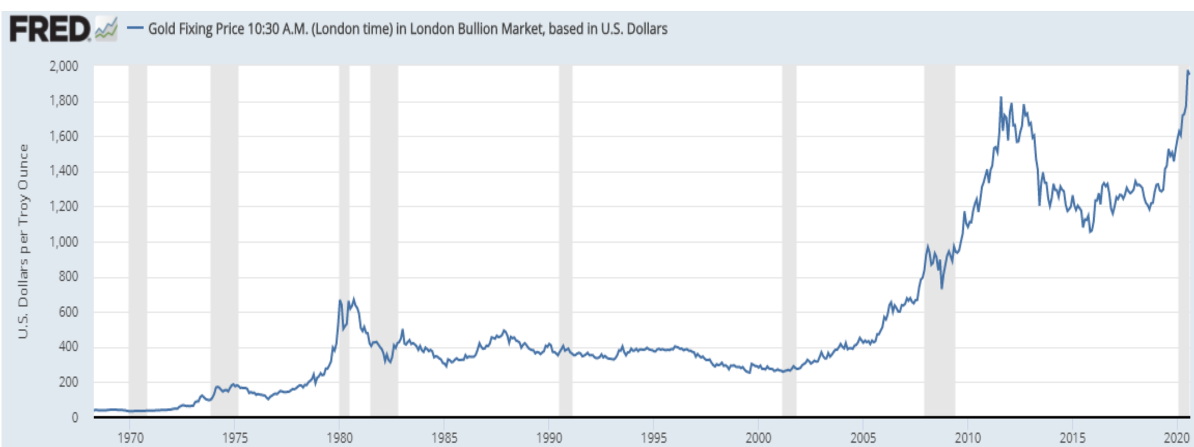
Inflation

Inflation still remains below the Fed's Target of 2% as shown in the following graph:



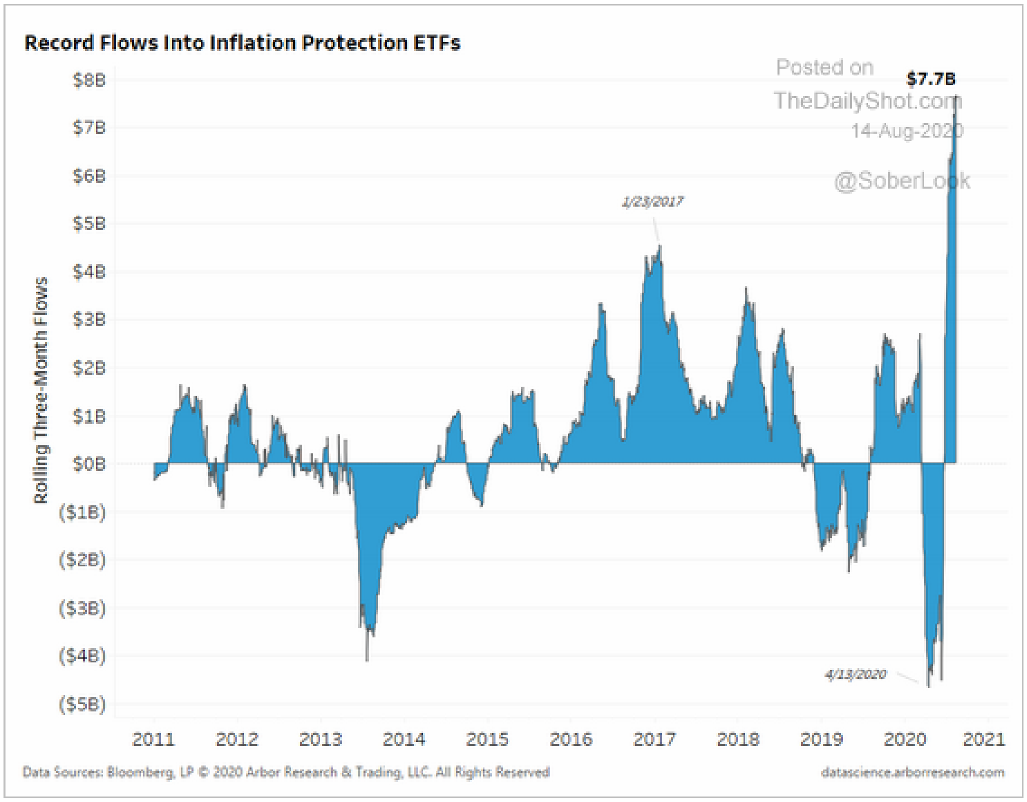
Source: https://www.advisorperspectives.com/dshort/updates/2020/07/31/pce-price-index-june-headline-core

But the traditional inflation hedge, gold, continues to move up:



Source: ICE Benchmark Administration Limited (IBA), Gold Fixing Price 10:30 A.M. (London time) in London Bullion Market, based in U.S. Dollars [GOLDAMGBD228NLBM], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GOLDAMGBD228NLBM, August 14, 2020.

And there are record flows into Treasury Inflation Protection Securities or TIPS via ETFs:



Source: @benbreitholtz

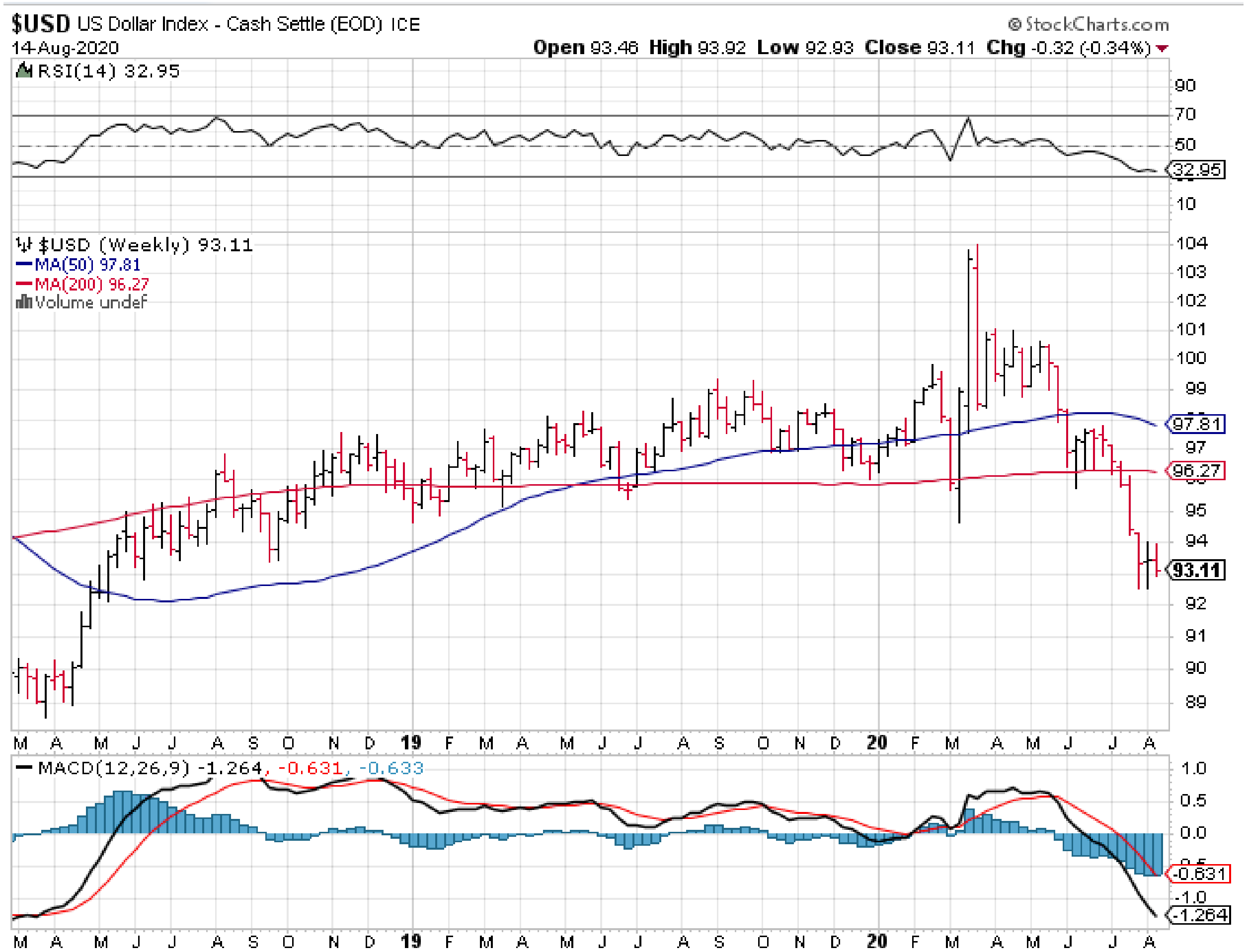
Source: The Daily Shot 8/14/2020

US Dollar

Interest rate differentials, or the forecast of interest rate differentials, play a major role in the value of the USD. The Fed's forward guidance of keeping the Fed Funds in the 0.00 – 0.25% range for some indeterminable time frame, would appear to favor other currencies. Fed Funds Futures are pricing this range all the way out to the April 2022 contract! One major reason to hold USDs is because of the higher rates in the US. That no longer seems to be the case. Some believe the massive explosion in debt is debasing the USD.

Technically speaking, the dollar is in a downtrend, as is evident in the following charts. The first chart shows the Euro vs. the USD, and the second chart shows the ICE US Dollar Index.

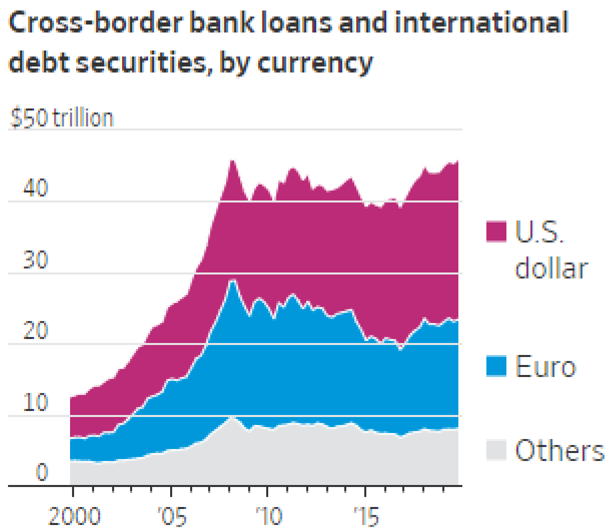
Source: https://stockcharts.com/h-sc/ui?s=$EURUSD



Source: https://stockcharts.com/h-sc/ui

In the dollar's favor:

- Some 88% of all currency trades involve the USD (BIS Foreign Exchange Turnover in April 2019).
- Much of international trade is invoiced in USD.
- Many commodities are priced in dollars including gold, oil, and (yes) coffee (I am not sure it matters what coffee is priced in, as many of us would still drink it)!
- The strong preference for dollar funding (see the following chart).



Source: WSJ.com https://www.wsj.com/articles/fed-federal-reserve-jerome-powell-covid-coronavirus-dollar-lending-economy-foreign-currency-11596228151?mod=searchresults&page=1&pos=10

- The Feds central bank currency swap lines during the initial COVID outbreak demonstrated the world's reliance on dollar funding

These last two bullet points are probably the main reason that the dollar's immediate future as the world's reserve currency will not be going away any time soon. Longer term, it is certainly a major question.

Conclusion

The Fed's massive actions have ushered in the era of MMT. The merging of fiscal and monetary policy appears to be here to stay. Although they have good intentions, the Fed's actions have distorted capital flows and valuations, let alone the reliance on an unproven economic theory. I suspect that Adam Smith is rolling over in his grave.

Resources

C. A. E. Goodhart, “The Continuing Muddles of Monetary Theory: A Steadfast Refusal to Face Facts”, Financial Markets Group, London School of Economics, Working Paper, 2009.

R. Jones and J. Llewellyn, “MMT: old wine in new bottles or ‘voodoo’ economics?”, Comment, Llewellyn Consulting, April 2019.

Tymoigne, E., and L. R. Wray (2013), “Modern Monetary Theory 101: A Reply to Critics”, Levy Economics Institute of Bard College Working Paper 778.

L. Randall Wray, “From the State Theory of Money to Modern Monetary Theory: An Alternative to Economic Orthodoxy”, Levy Economics Institute of Bard College, Working Paper No. 792, March 2014.

About the Author: Kenneth Kapner

Ken Kapner, CEO and President, started Global Financial Markets Institute, Inc. (GFMI) a NASBA certified financial learning and consulting boutique, in 1998. For over two decades, Ken has designed, developed and delivered custom instructor led training courses for a variety of clients including most Federal Government Regulators, Asset Managers, Banks, and Insurance Companies as well as a variety of support functions for these clients. Ken is well-versed in most aspects of the Capital Markets. His specific areas of expertise include derivative products, risk management, foreign exchange, fixed income, structured finance, and portfolio management. He has been a Risk Management Advisor to a Mutual Fund's Board of Trustees and has served as an Expert Witness using knowledge of derivatives, trading and risk management.

Prior to starting GFMI in 1998, Ken spent 14 years with the HSBC (Hong Kong and Shanghai Banking Corporation) Group in their Treasury and Capital markets area where he traded a variety of instruments including interest rate derivatives, spot and forward foreign exchange, money markets; managed the balance sheet; sat on the Asset Liability Committee; and was responsible for the overall Treasury activities of the bank. He later headed up HSBC's Global Treasury and Capital Markets Product training for two years in Hong Kong. Specifically, his responsibilities included developing new courses and delivering courses to traders, support staff and relationship managers. In New York, he established a training department for the firms' Securities Division where he was in charge of the MBA Associates Program, continuing education and Section 20 license.

He has co-authored/co-edited seven books on derivatives including *The Swaps Handbook and Understanding Swaps.*

Publications and Articles

Articles

2019 3-Month SOFR Futures
2019 LIBOR Schmibor: What's Next? SOFR Part I and Part II
2018 VIX, Volatilities, and Exchange Traded Products
2018 Settlement Risk and Blockchain
2017 Electronic Trading and Flash Crashes – Part I and Part II
2016 The Long and Short of IT: An Overview of XVA
2016 The Long and Short of IT: An Overview STACR and CAS
2016 The Federal Reserve Tolls: Past and Present
2016 The Perfect Storm: October 2008
2016 Interest Rate Swap Futures: An Introduction
2014 Risk Reversals

2002 Futures Magazine, Doing Your Homework on Individual Equity Futures (Co-written with Robert McDonough)

Blog

Ken also edits and writes for the GFMI Blog.

Books

1996 Como Entender Los Swaps, (co-author: John Marshall), published by CECSA (a Mexican publishing firm). This is a translated edition of our book Understanding Swaps, but with adaptations to fit the Mexican markets. (289 pages)

1993 The Swaps Market: 2nd edition, Kolb Publishing, 288 pages (co-author: John Marshall, copyright 1993). This book is directed to the graduate business student.

1993 Understanding Swaps, John Wiley & Sons, 270 pages (co-author John Marshall, copyright 1993). This book is directed to the practitioner market and is published as part of Wiley's Finance Series.

1993 1993-94 Supplement to the Swaps Handbook, New York Institute of Finance, a Simon & Schuster Company, 494 pages, (co-authors John Marshall and Ellen Lonergan, copyright 1993). This book is directed to a practitioner audience and is a supplement to The Swaps Handbook. My role was largely that of editor.

1991 1991-92 Supplement to The Swaps Handbook, New York Institute of Finance (Simon & Schuster Professional Information Group), 300+ pages (co-author: John Marshall copyright 1992). This book is directed to a professional practitioner audience and is an annual supplement to The Swaps Handbook.

1990 The Swaps Handbook: Swaps and Related Risk Management Instruments, New York: New York Institute of Finance, a Simon & Schuster Company, 543 pages. (co-author: John Marshall). This book is directed to derivative product professionals.

1988 Understanding Swap Finance, Cincinnati: South Western publishing Company, 155 pages. (co-author John Marshall, copyright 1990). This was the first academic text published on the swaps markets.

Affiliations

International Association of Financial Engineers Board of Advisors – 1994 - 2010
Global Association of Risk Professionals
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