

## Careful MMT Fan, the US is NOT Japan

*Greg Anderson, CFA, PhD - Global Head of FX Strategy*

### Why MMT Matters

- With all the major exchange rates trapped in narrow ranges, we're left to debate the issues that could cause the next major (10% or greater) move in the broad USD. Presumably the next turn in the USD index will drive everything else.
- The 2020 Presidential election is still 18 months away, so it shouldn't be a 'theme' for markets yet. But although it may be a bit soon to trade the election, this election appears that it *may* have a facet that could trade in the FX market in a big enough way to move the USD by 10%.
- The facet of which I speak is the potential for the US to adopt a much more aggressive fiscal/monetary policy mix that Bernie Sanders advocated during the 2016 election and that many Democratic Party candidates are advocating now. That policy mix goes by the name of Modern Monetary Theory or MMT.
- In a nutshell, MMT is a combination of expansive fiscal policy financed by the printing press (technically central bank government bond purchases or private debt assumptions).
- MMT is controversial enough that if its probability of happening were to rise to somewhere around 30%, the FX market would probably begin to trade the theme. That could easily happen over the next 12 months.
- Even though we're in the very early stages with this topic, MMT has already drawn very strong responses from many of the leading economists of our time. The concept has its fans, who think it could accelerate growth and finance the resolution of student debt. However, it also has its haters, who fear that it will lead to an inflation-depreciation spiral like that endured by the Weimar Republic prior to WWII and like those recently seen in Venezuela and Zimbabwe.

### MMT and Japan

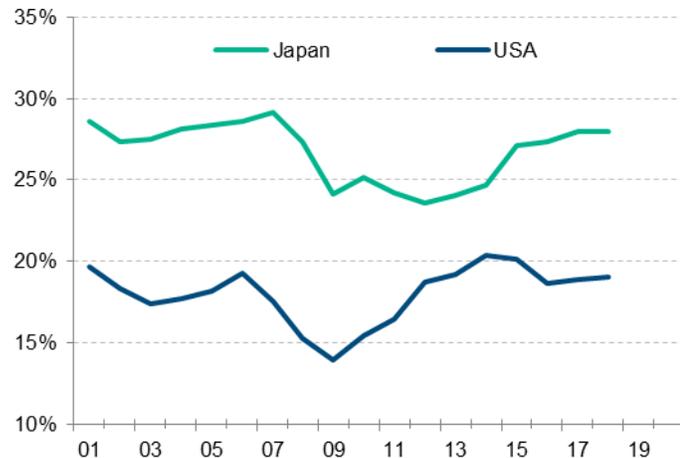
- Advocates of MMT will tell you that it is already being successfully employed by Japan. Moreover, even opponents of MMT have acknowledged that Japan has successfully managed its economy over the past decade with MMT principles (see [this Forbes article](#) for example).
- For their part, Japanese officials have denied that what they are doing is MMT (see [Bloomberg article on Abe's MMT denial](#)). However, we would argue that Japan is doing more or less what MMT advocates are calling for in the US. Japan has been running a substantial fiscal deficit and then financed it via central bank purchases of government bonds.
- The outcome for Japan thus far has been fairly positive. Unemployment is at 25-year lows. The government's net debt is shrinking. The BoJ has had no problem keeping the 10Y JGB rate at 0.0%. The biggest shortcoming is that inflation has yet to arrive at the BoJ's 2.0% target, but it's probably a lot closer than it would have been if Japan were not running a fiscal deficit that is financed by the BoJ.
- So given the positive outcome in Japan, it seems perfectly reasonable to debate whether a more aggressive use of the same principles might work in the US.
- The purpose of this article is NOT to kill the debate; it's worth having. However, the debate needs to be carefully framed to avoid going down wrong paths. The most dangerous path of all is the assumption that what works in Japan would automatically work in the US. The two economies are fundamentally VERY different.

### The Contrast Begins with the Savings Rate

- Although both the US and Japan are advanced economies, they are very different in terms of their savings rates. Almost by their very nature, Japan is a high savings society and the US is a low savings society.
- As shown in [Figure 1](#), the IMF's estimate of Japan's national savings rate in 2018 was 28%. The IMF's estimate for the US is 19%. Although there has been a drift lower in Japan's household savings rate and a drift higher in the US's, total savings rates (including the household, government and business sectors) have been quite stable for both countries. There is a consistent 9% gap.
- The data underneath the IMF's calculations may not be completely comparable and we recognize that. There is another way to calculate the 'savings' of an economy. Subtract what it consumes from what it produces. That metric, by accounting identity, is the current account balance.

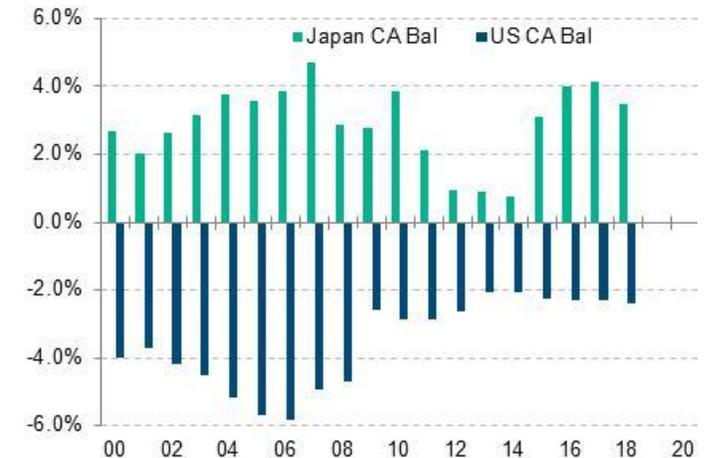
- Although it has stabilized at a much lower deficit than we saw earlier this century, the US's current account balance has been in perpetual deficit for more than a generation, while Japan's has been in surplus, as shown in [Figure 2](#). This underscores the point of this section. Japan is a saver/producer economy where the US is a consumer economy.

**Figure 1: US and Japan Total National Savings Rates for the 21<sup>st</sup> Century (IMF Methodology)**



Sources: IMF, Bloomberg, BMO CM

**Figure 2: US and Japan Current Accounts as a %age of GDP in the 21<sup>st</sup> Century**



Sources: Bloomberg, BMO CM

### The Currency Dynamics of Debtors are Different than the Dynamics of Creditors

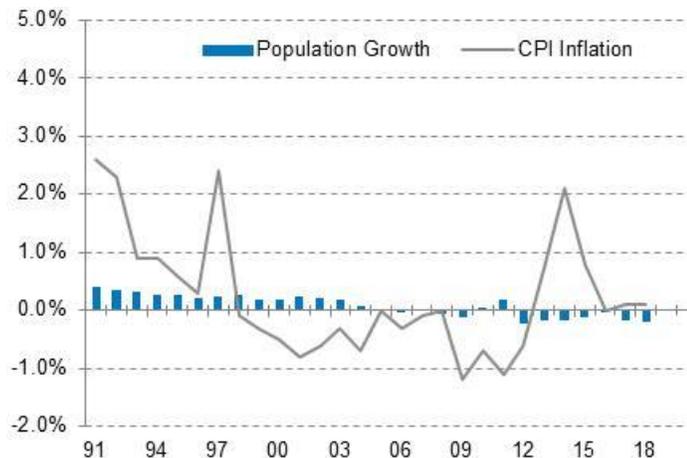
- As a result of many years of current account surpluses, Japan is a creditor. Its net international investment position (NIIP) is an extraordinary surplus of roughly 65% of GDP.
- As a result of many years of current account deficits, the US is a debtor economy. Its NIIP is a deficit of roughly 45% of GDP.
- The general rule of thumb is that creditor currencies appreciate during crises because investors tend to bring international assets home. For example, the JPY appreciated by about 15% against the USD during the 2008-2009 period. JPY even appreciated in the wake of the Tohoku earthquake/tsunami/meltdown disaster.
- Because JPY appreciates during crises, the inflation impulse from the passthrough is negative. This means that the BoJ can ramp up QE during a crisis without worrying about inflation. And if the BoJ is ramping up QE, the Japanese government can increase its fiscal deficit without worrying about falling into a depreciation-inflation spiral.
- Debtor currencies tend to depreciate in crises, although the US is somewhat unique due to being the current numeraire currency. We think it is a mistake to think that the US's numeraire status couldn't change relatively quickly. There may not be an obvious replacement among national currencies, but the US embracing MMT may be all it takes to usher in a new regime where a gold-backed crypto currency becomes the ultimate reserve and unit of account.
- As a result of the US's net debtor status, the whole world would worry about a depreciation-inflation spiral being the potential result of ramping up QE if the dollar weren't 'special' due to being the numeraire. As it stands, the USD *may* be able to retain its 'special' status in the next global crisis and that *may* allow the US to get away with a whole lot more MMT than any other debtor, but doubt should and does exist.

### The Next Issue is the Population/Inflation Dynamic

- Slowing population growth is a near-global feature. This is an important economic issue for a number of reasons. One of them is the impact of population growth and urbanization on inflation. Rising populations in large cities makes land scarce, and that drives up real estate prices. Rising real estate prices spur generalized inflation through a wage-price spiral as workers demand raises and firms raise good prices.
- Japan has been dealing with a shrinking working-age population for 20 years. Overall population peaked in 2011 and is now 1.5% below the peak. It should be no surprise that Japan has seen very little inflation over the past decade, as shown in [Figure 3](#).

- Thanks largely to immigration; the US still has a growing labour force. Labour force growth is slowing along with inflation as shown in [Figure 4](#), but the US's population is still growing at about a 0.7% per annum clip. No wonder that US inflation has averaged 1.6% per annum over the past 10 years while Japan's has averaged 0.3%.
- Due to the US's labour force growing 1.0% per annum faster than Japan's, a 2.0% inflation target is a whole lot more realistic for the Fed than it is for the BoJ. So where it would take a whole lot of MMT to get Japanese inflation to 2.0%, it wouldn't take very much at all to get the US's inflation rate above target.

**Figure 3: Japan Population Growth and Core CPI**



Sources: Bloomberg, BMO CM

**Figure 4: US Population Growth and Core CPI**



Sources: Bloomberg, BMO CM

### The US Debt Market is Harder to Bribe than Japan's

- Although the financial structures of both economies are evolving towards each other, Japan and the US are still substantially different in that regard.
- Japan is a smaller economy with a financial sector oligopoly. The financial system is dominated foremost by banks and there are only a few large pension fund managers and insurance companies.
- The US's financial structure is consolidating, but it is still much larger and it is much less bank-centric. The US's fixed income and equity markets have many more participants. Although the big participants are institutional, those institutions need to fear the loss of retail investor money, which can migrate more easily in the US than in Japan.
- Small groups are relatively easier to steer than large groups (ask the ECB President about that). Japan's fixed income investor base is much easier to talk into holding under-compensated government bond positions or taking on new positions than the US's. And again, Japan doesn't need to convince foreign fixed income investors to stay. The US does. As a net debtor, the US needs to bribe foreigners with a positive interest rate. Foreigners can't be treated differently; that positive interest rate must be paid to domestic investors as well.

### Equilibrium Interest Rates Make Japan's Government Debt Free but the US's Isn't

- The BoJ has a target overnight interest rate below zero and a target 10Y bond rate of 0.00%. Both targets have proven credible over a span of years. That means that the Japanese government can borrow for free. Whether debt is 100% or 200% or 500% of GDP, if the interest rate can be maintained at 0.00%, then government debt is free. Given Japan's high savings rate and net creditor status through its NIIP surplus, Japan may not be able to get to a 500% debt ratio, but 200% clearly wasn't a problem.
- Even when the Fed's target rate was 0.00% to 0.25% and the Fed had an active QE program, the US's 10Y bond yield never dipped below 1.30%. That means that US government cannot borrow for free.
- As subdued inflationary expectations have taken the inflation premium out of the long end of the bond curve, the US has seen its long-term interest rate decline. And that makes a constant debt/GDP ratio much less expensive. An interest rate of 4% combined with a debt/GDP ratio of 50% yields a government interest cost of 2.00% of GDP. But so does a 2% interest rate crossed with a debt/GDP ratio of 100%. This is precisely how the US government's interest cost has remained in the 1-2% range even as the debt/GDP ratio has doubled over the past decade.

- Unless MMT can lead to a similar reduction in interest rates (that likely occurred due to demographic factors), any increase in the debt/GDP ratio will lead to the interest cost being a bigger burden on society and a bigger drag on economic growth in the case of the US.

### **Bringing it all Back to Home**

- We presume the market does or will see the difference between the US and Japan the same way we do. Japan can get away with a fairly large amount of MMT. The US can't get away with nearly as much.
- As a result of this perception, if we get to a spot later this year where every single realistic candidate for the Democratic nomination is talking up MMT, then this will be a negative for the USD as soon as H2 of this year.
- If the Democratic frontrunner and eventual nominee is an MMT advocate, then MMT is likely to be the FX market's #1 theme in calendar 2020. Now may be a bit early to get in front of that, but it's something to think about while we're stuck in a seemingly endless range.

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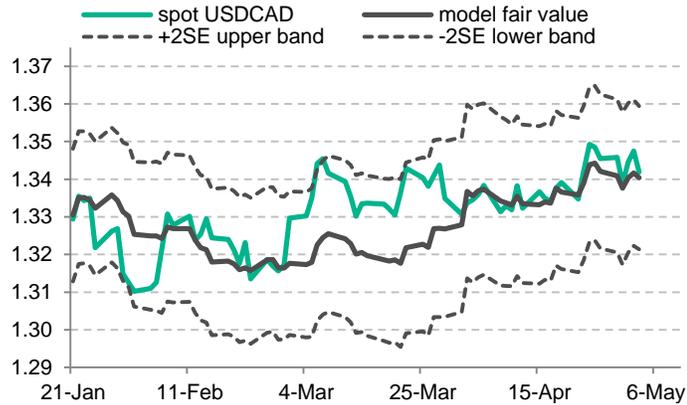
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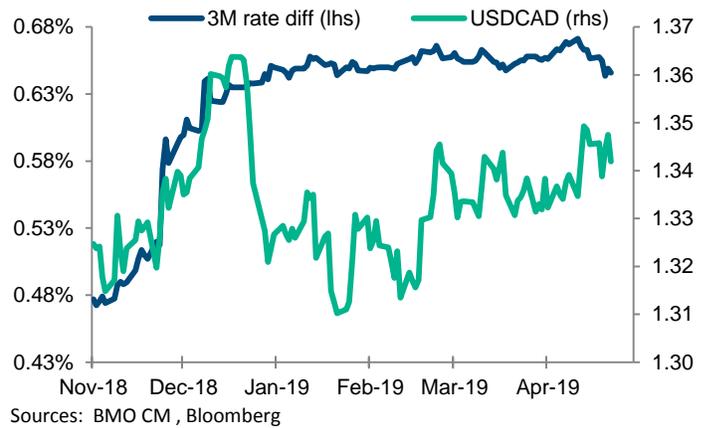
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### Additional FX charts

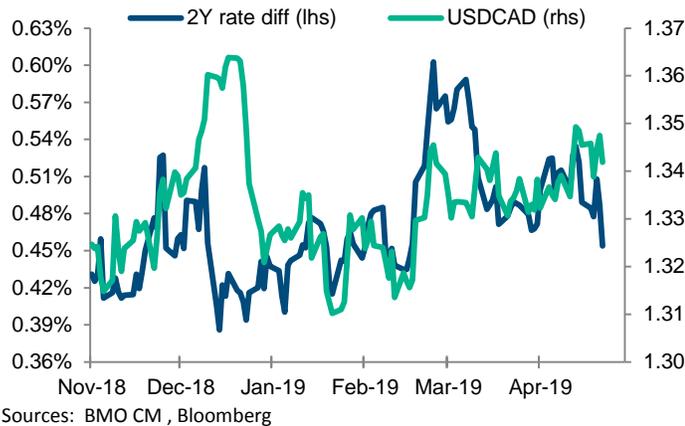
**USDCAD spot and BMO model's financial fair value**



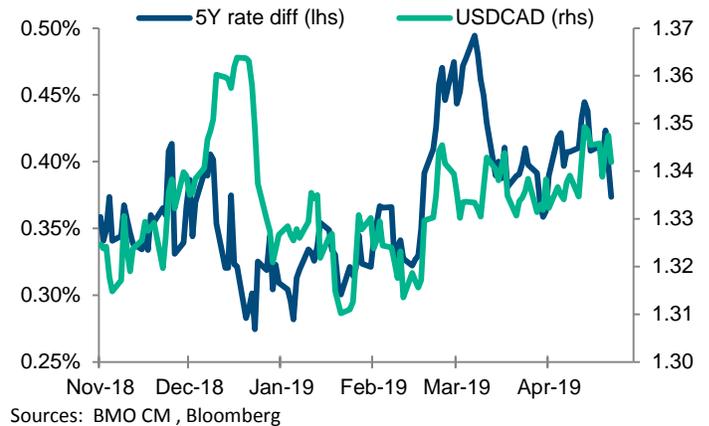
**USDCAD and the 3M OIS interest rate differential**



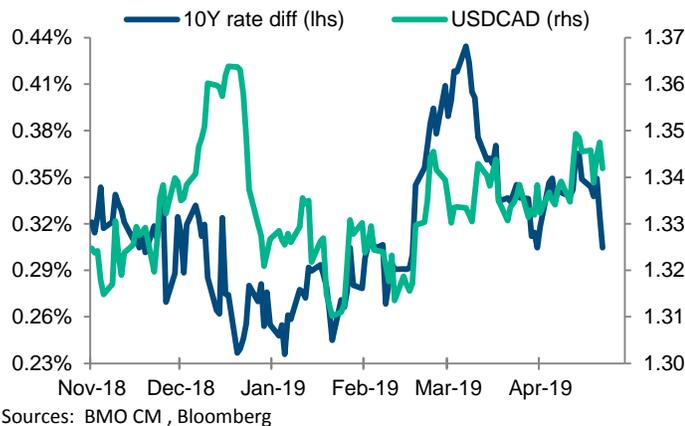
**USDCAD and the 2Y swap rate differential**



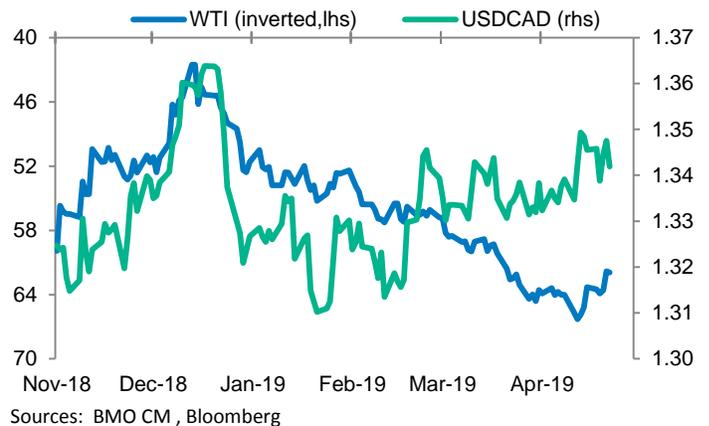
**USDCAD and the 5Y swap rate differential**



**USDCAD and the 10Y swap rate differential**

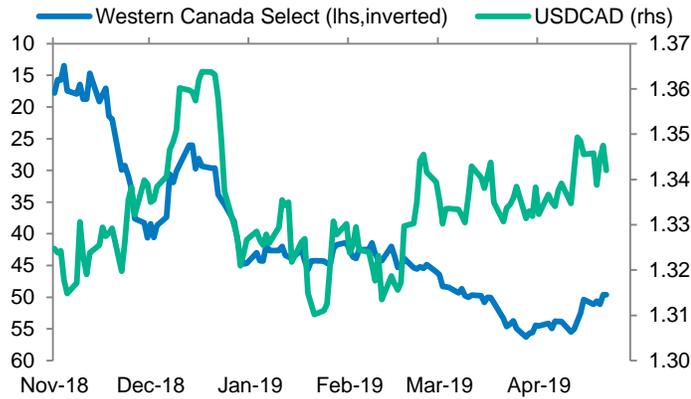


**USDCAD and front-future WTI crude**



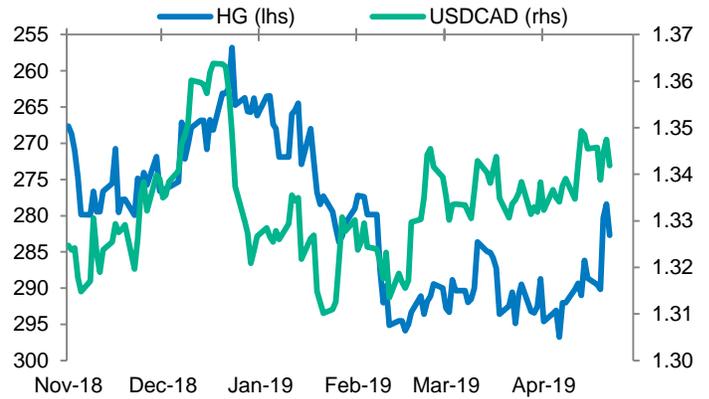
### Additional FX charts

#### USDCAD and spot WCS-grade crude



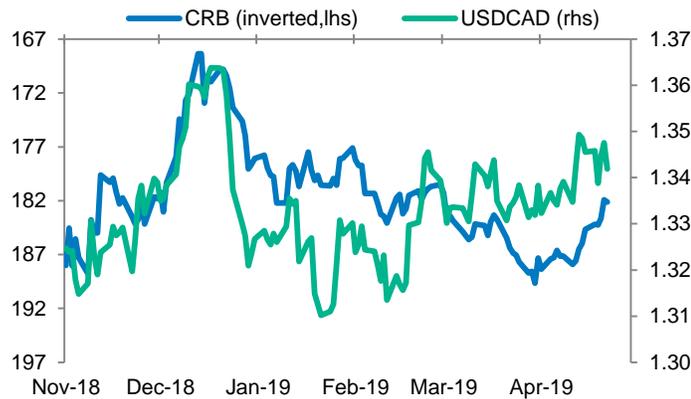
Sources: BMO CM, Bloomberg

#### USDCAD and front-future copper



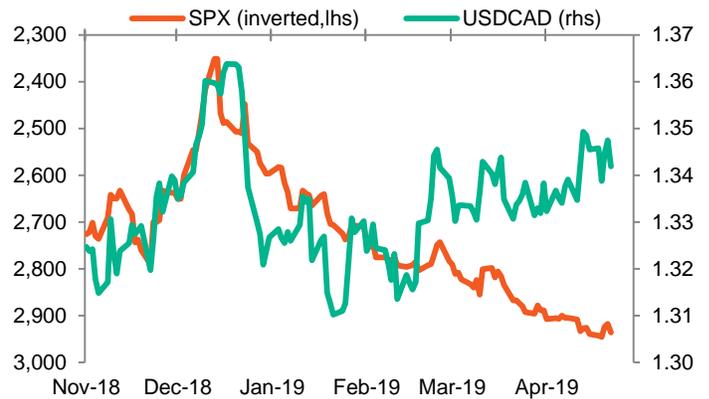
Sources: BMO CM, Bloomberg

#### USDCAD and the CRB commodity price index



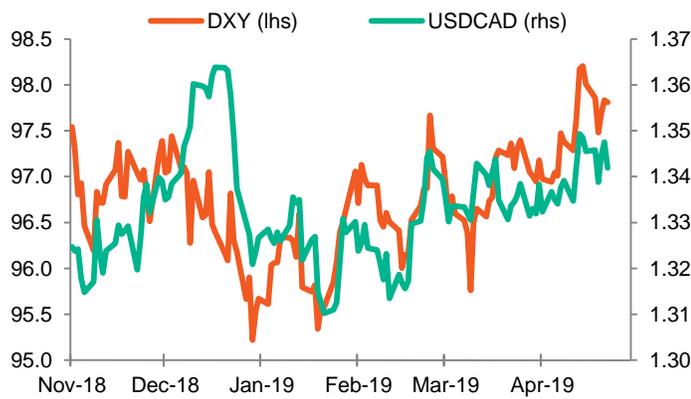
Sources: BMO CM, Bloomberg

#### USDCAD and the S&P 500



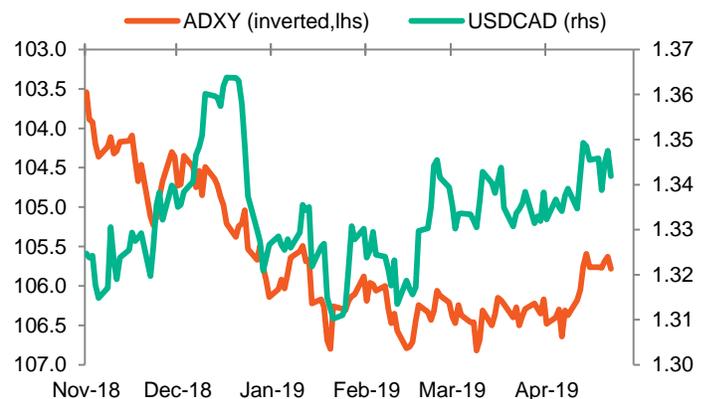
Sources: BMO CM, Bloomberg

#### USDCAD and the DXY dollar index



Sources: BMO CM, Bloomberg

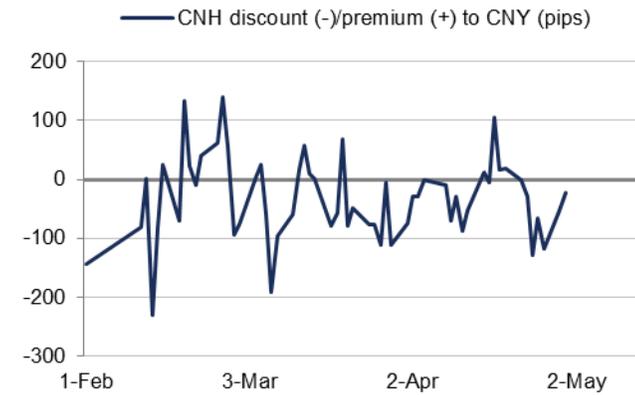
#### USDCAD and the ADXY Asian currency index



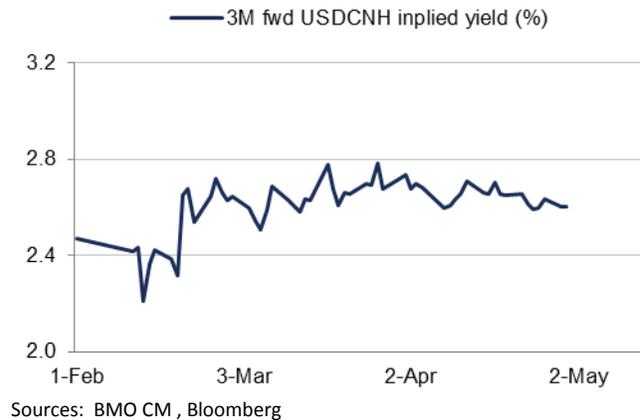
Sources: BMO CM, Bloomberg

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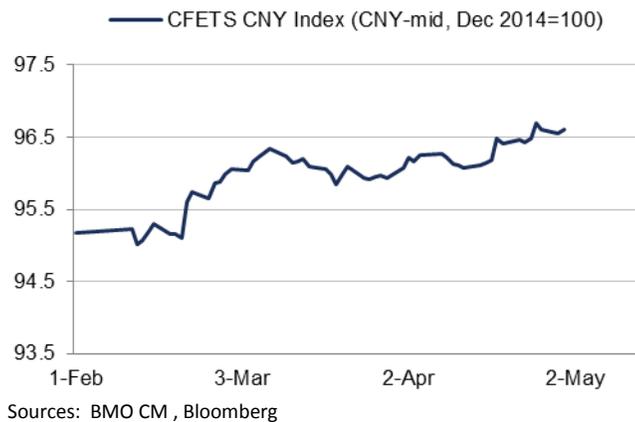
#### Spot USDCNH/USDCNY differential



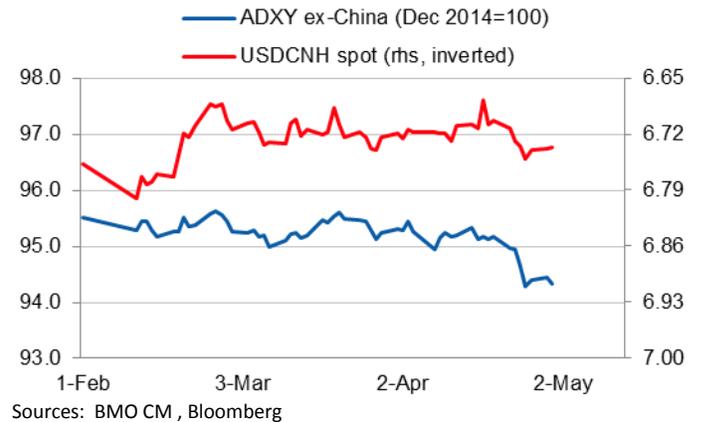
#### 3M forward USDCNH implied yield



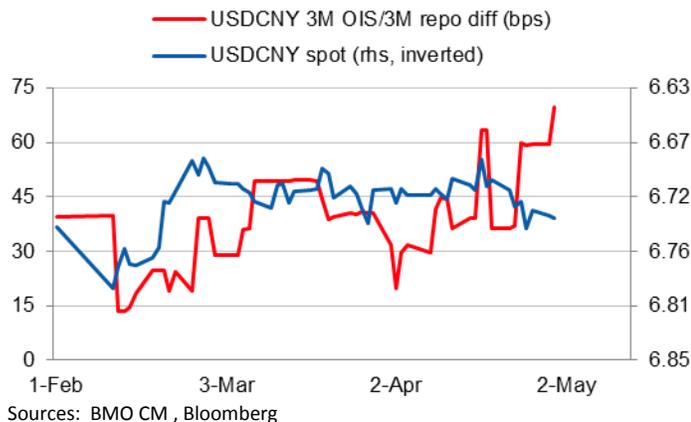
#### CFETS CNY Index (-90 calendar days)



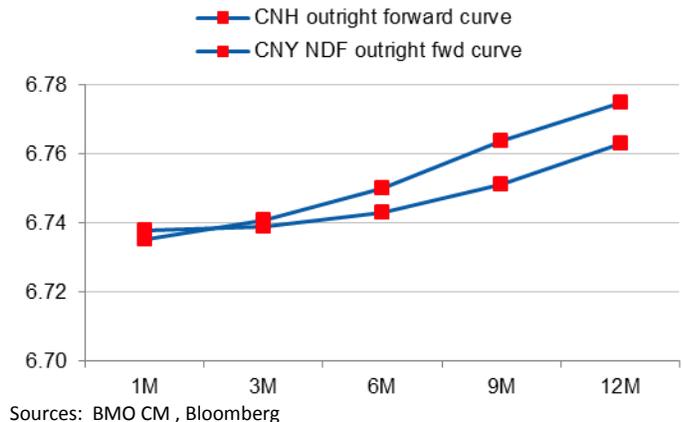
#### ADXY Index (ex-China) vs USDCNH spot



#### USDCNY spot vs USD-CNY 3M rate diff

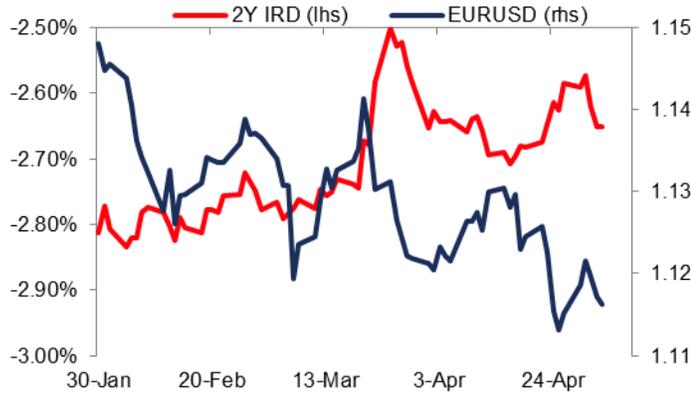


#### USDCNH and USDCNY NDF outright fwd curves



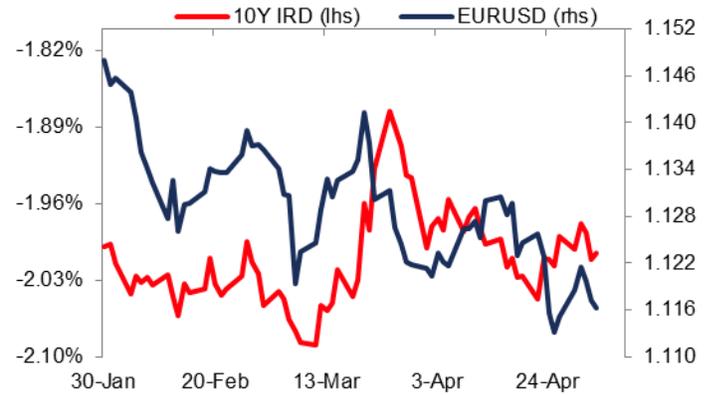
### Additional FX charts

**EURUSD and its 2Y swap rate differential**



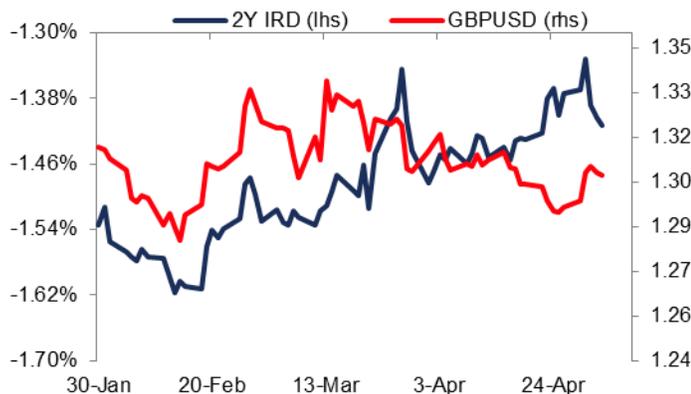
Sources: BMO CM , Bloomberg

**EURUSD and its 10Y swap rate differential**



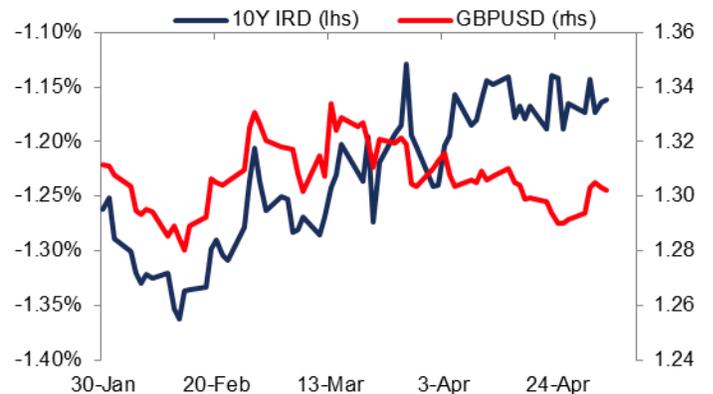
Sources: BMO CM , Bloomberg

**GBPUSD and its 2Y swap rate differential**



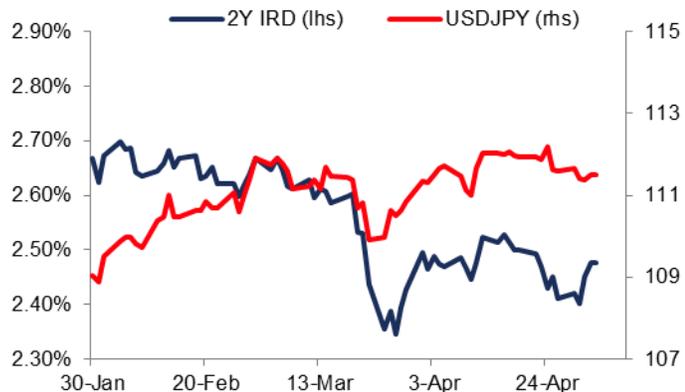
Sources: BMO CM , Bloomberg

**GBPUSD and its 10Y swap rate differential**



Sources: BMO CM , Bloomberg

**USDJPY and its 2Y swap rate differential**



Sources: BMO CM , Bloomberg

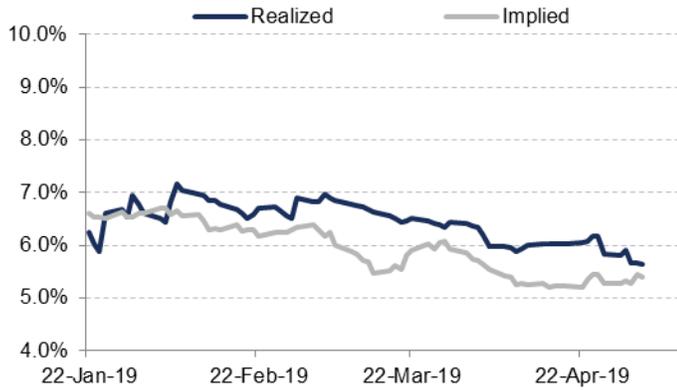
**USDJPY and its 10Y swap rate differential**



Sources: BMO CM , Bloomberg

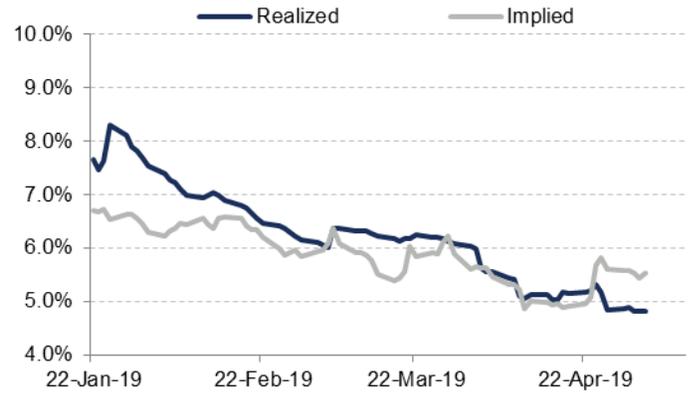
### Additional FX charts

#### USDCAD 3M realized and implied volatility



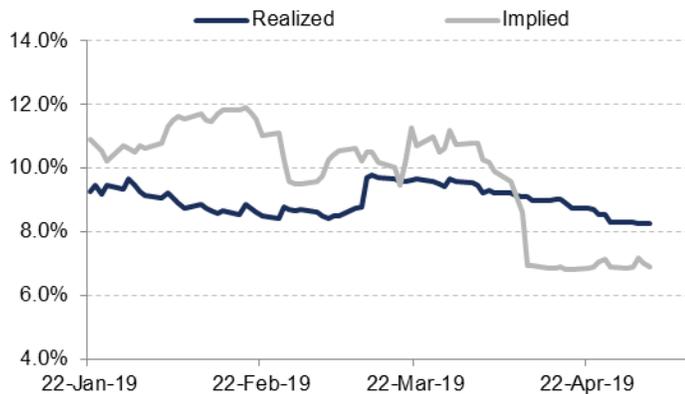
Sources: BMO CM , Bloomberg

#### EURUSD 3M realized and implied volatility



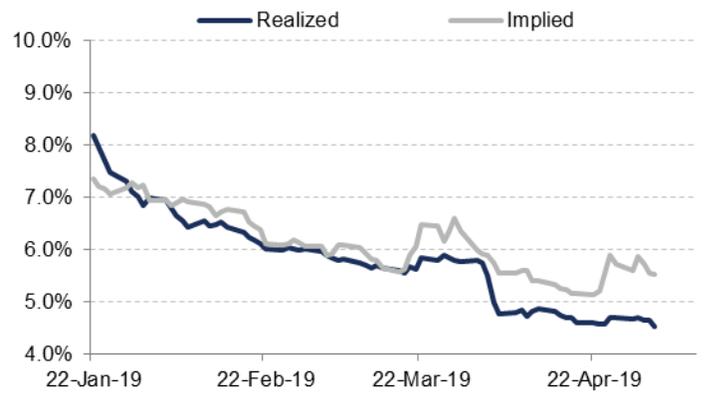
Sources: BMO CM , Bloomberg

#### GBPUSD 3M realized and implied volatility



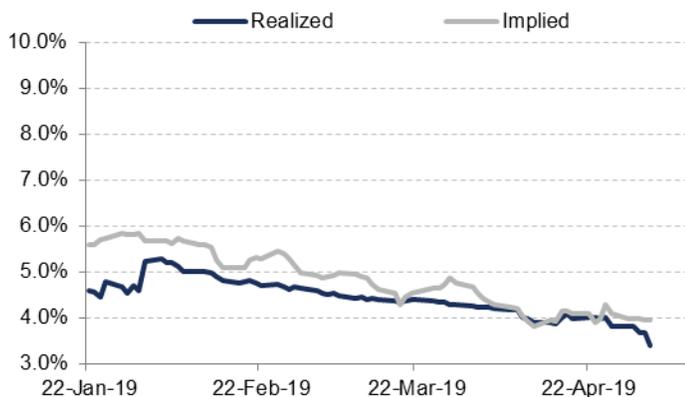
Sources: BMO CM , Bloomberg

#### USDJPY 3M realized and implied volatility



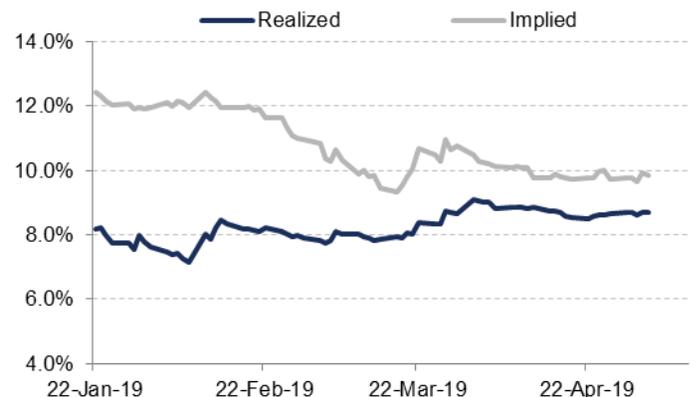
Sources: BMO CM , Bloomberg

#### USDCNH 3M realized and implied volatility



Sources: BMO CM , Bloomberg

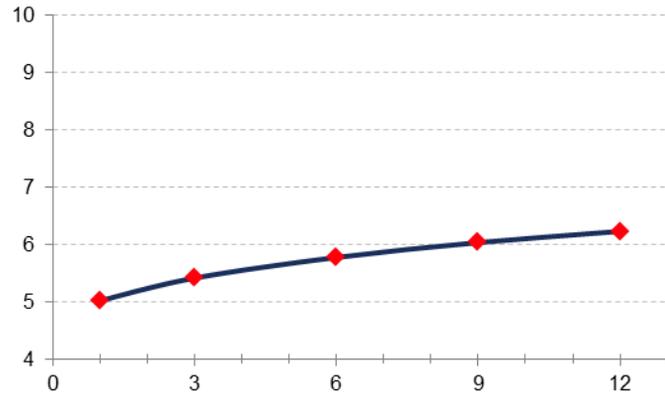
#### USDMXN 3M realized and implied volatility



Sources: BMO CM , Bloomberg

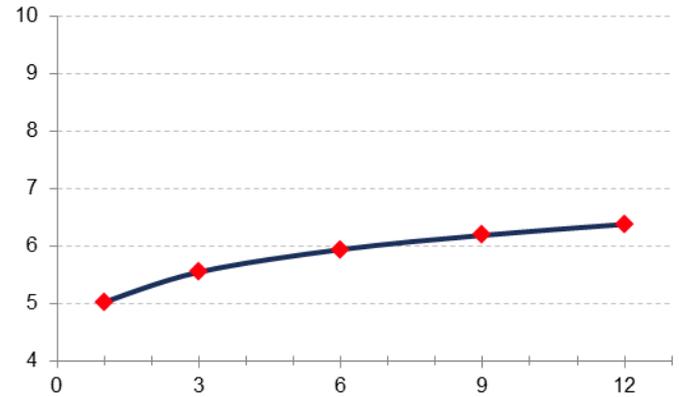
### Additional FX charts

#### USDCAD implied vol curve



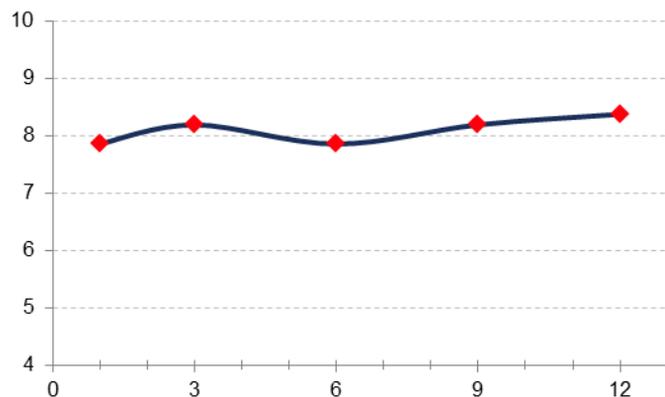
Sources: BMO CM , Bloomberg

#### EURUSD implied vol curve



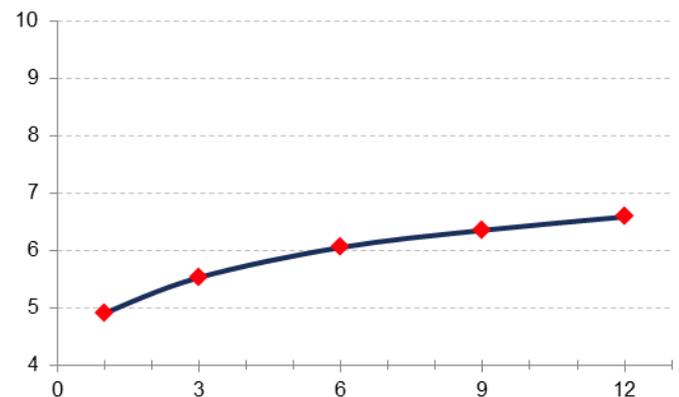
Sources: BMO CM , Bloomberg

#### GBPUSD implied vol curve



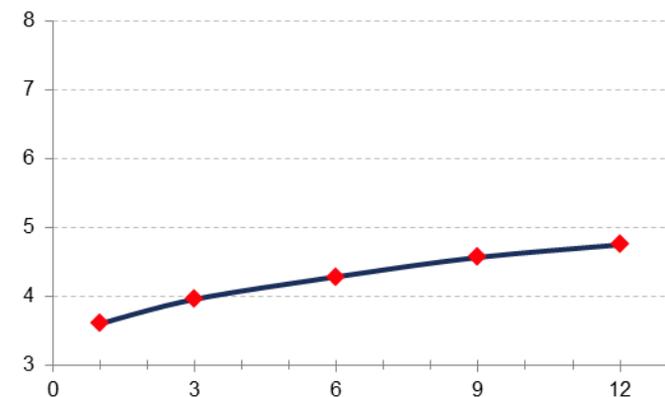
Sources: BMO CM , Bloomberg

#### USDJPY implied vol curve



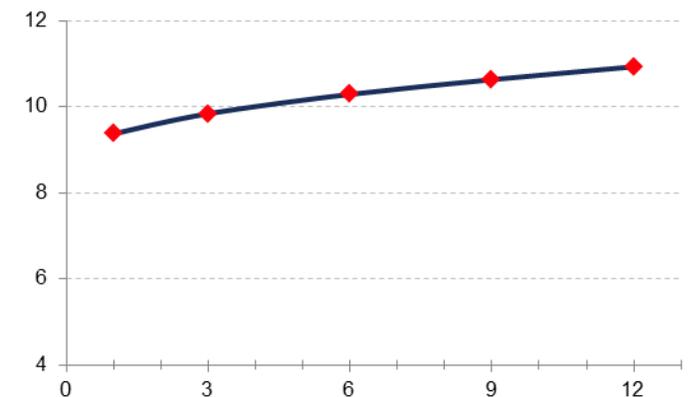
Sources: BMO CM , Bloomberg

#### USDCNH implied vol curve



Sources: BMO CM , Bloomberg

#### USDMXN implied vol curve



Sources: BMO CM , Bloomberg

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