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Financial Follies: Fiscal Stimulus and Modern Monetary Theory in the Era of Quantitative Easing and Zero or Negative Interest Rates

Last week, I explained how Federal Reserve (Fed) balance sheet expansion could send 10-year Treasury yields toward zero over the next few years. While that notion may seem far-fetched to some, my point was to highlight why quantitative easing isn't a panacea for trying to safeguard economic growth from a downturn. The same holds true for fiscal stimulus or more abstract principles like Modern Monetary Theory (MMT). With that in mind, let's set out to debunk their growing popularity in the U.S.

Conventional economic wisdom is that monetary policy has done the heavy lifting in terms of reviving economic growth. Now that policy rates are low or negative and balance sheets have expanded, all we need is some fiscal stimulus to keep an economy from turning down into recession. Outgoing European Central Bank President Mario Draghi reinforced this dogma in what may have been his last interview as the incumbent with the *Financial Times*. Draghi left with a parting shot, chastising Germany and its northern European neighbors, the region's de facto economic growth engine, for not spending enough. Draghi's dogmatic protestations are nothing new. Except, his dogma is flawed.

Let's look to the U.S. to test his hypothesis

We've already established the challenges around managing expanding central bank balance sheets when policy rates are negative or near zero. Add deficit spending and the problems are compounded. The U.S. now has fiscal deficits approaching \$1 trillion annually, brought on by tax cuts to corporations and well-off individuals. The ability for the market to absorb the additional government debt has reached its limit, at least when the Fed's balance sheet is shrinking. We saw this in the recent ructions in the overnight financing markets. If the Fed did not step in with overnight and term facilities, these new liabilities would be challenging to finance.

So, deficit-financed fiscal stimulus and expanding central bank balance sheets need to go hand in hand. The central bank can then limit yields rising by buying the government debt. However, the longer-term problem—improving economic growth that stimulus is meant to solve—actually becomes worse.

Additional government debt and the need for central bank intervention slows spending and investment by the private sector—which is where real growth and productivity occur. So fiscal stimulus may not be the panacea central bankers hope it will be; in fact, deficit-financed stimulus would just drive government yields lower as structural growth and productivity decline.

What next if fiscal stimulus won't help

But what if the central bank balance sheets keep expanding to fund the fiscal deficits? Or better yet, why not have the central bank just buy newly issued government liabilities directly and disperse the proceeds directly to the taxpayers or finance the pet projects of the political establishment? Now, we're entering the world of MMT. I candidly admit that the "real world" MMT would move Treasury yields off zero as inflation expectations rise rapidly, but the relevant currency—the domestic economy's store of value—would markedly depreciate. As we mentioned in a previous [MMT blog](#), there would be consequences for inflation and the currency by printing more

money to pay off local- and hard-currency debt. Just ask Argentines.

Central bankers and politicians would be wise to consider the recent warning from Oliver Bäte, the chief executive of Allianz, "The politicians and the regulators have told us they fixed the banking system and insurance system in terms of this negative spiral of financial sector risk morphing into sovereign risk and [looping] back. It is the biggest non-truth that exists."

Aren't negative and near-zero rates and expanding balance sheets just a manifestation of this truth?

Folly, indeed!

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