

Global Macro Views – The End of the MMT Illusion

November 3, 2022

Robin Brooks, Managing Director & Chief Economist, rbrooks@iif.com, @RobinBrooksIIF

Jonathan Fortun, Economist, jfortun@iif.com, @EconChart

Jack Pingle, Associate Research Analyst, jpingle@iif.com, @JonathanPingle



- Modern Monetary Theory (MMT) was all the rage two years ago.
- At the time, global interest rates were low amid record fiscal deficits, ...
- feeding the illusion that fiscal space is limitless for advanced economies.
- The illusion of limitless fiscal space has ended abruptly in recent months.
- UK attempts to sharply increase debt issuance ended in market turmoil, ...
- while the BoJ yield cap in Japan has led to unprecedented Yen devaluation.
- Italy's rising dependence on the ECB is another example of the same thing.
- Fiscal space is a scarce and valuable resource to be used sparingly.

Modern Monetary Theory (MMT) was at its zenith two years ago. Issuance of government debt had sky-rocketed globally and yet interest rates remained low, feeding the illusion that fiscal space – the ability to run up debt without adverse consequences for the bond market or the currency – is limitless. That illusion has come to an abrupt halt in 2022. We have [warned](#) of the lack of fiscal space on the Euro periphery and especially Italy for over a year, noting that low bond yields – thanks to the ECB – just mean that the most flexible class of investors – foreigners – sell their holdings, which we see increasingly for Italy. The same underlying dynamic is at work in Japan. Government debt is high, but yields are artificially low due to BoJ yield curve control (YCC). The fiscal risk premium, which would ordinarily show up in higher bond yields, is instead showing up in the currency, with unprecedented Yen depreciation in recent months. UK efforts to sharply increase debt issuance in the September mini budget are another example. The reality is that fiscal space is a [scarce](#) and valuable commodity to be used sparingly, the opposite of the MMT zeitgeist that has been so influential in recent years.

Exhibit 1: Debt levels were rising before COVID, ...

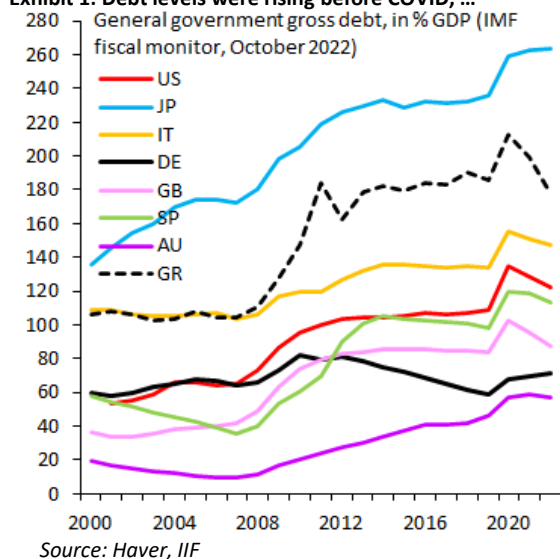
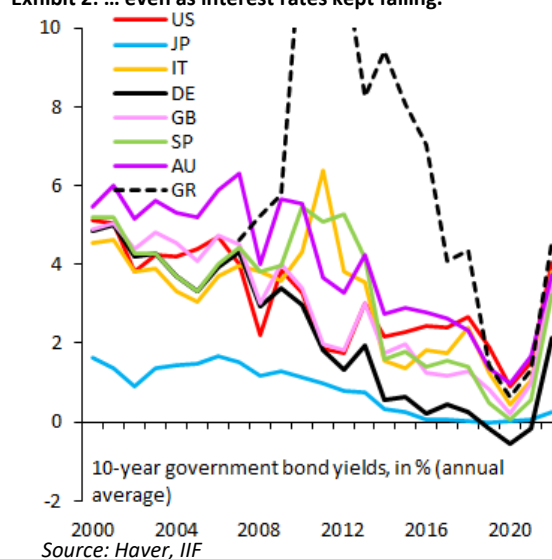
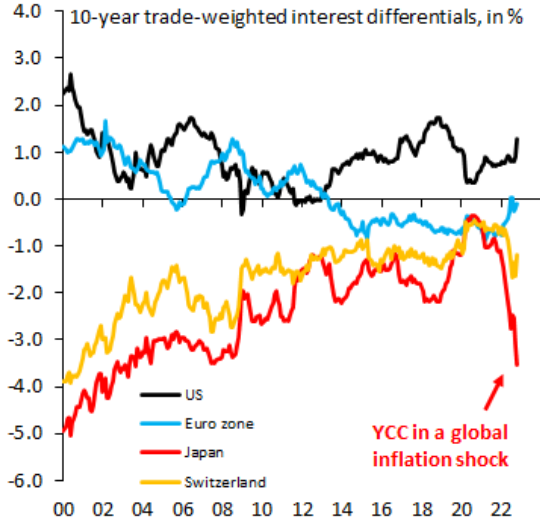


Exhibit 2: ... even as interest rates kept falling.



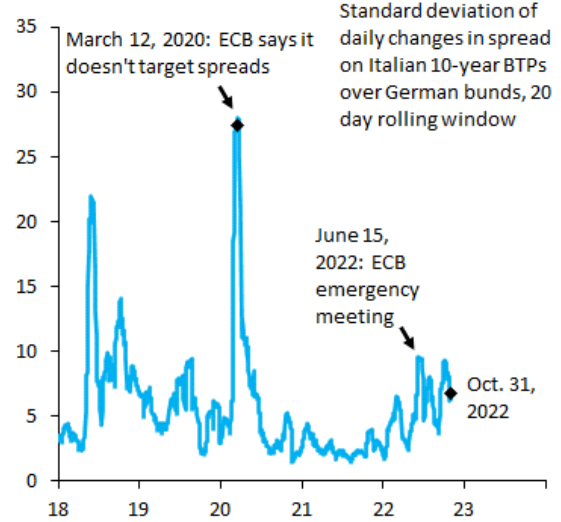
Government debt had been rising steadily for many years even before COVID (Exhibit 1), yet interest rates were falling and – amid massive COVID debt issuance – remained low (Exhibit 2). This conundrum sparked debate on whether fiscal space in advanced economies is in fact limitless, making it possible to fund things like a universal basic income cheaply. The illusion of limitless fiscal space got a reality check in 2022. Japan had been a favored MMT talking point, given that it has been able to sustain high debt levels at low rates of interest. However, this year's inflation shock and global rise in interest rates exposed the risks to this high debt equilibrium: as global interest rates have risen, the fact that YCC has pegged Japan's yields at low levels has meant that rate differentials moved sharply against Japan (Exhibit 3), sending the Yen into an unprecedented devaluation spiral. This illustrates that a central bank can suppress the fiscal risk premium in the bond market, but – if it does that – the risk premium just shows up in currency devaluation.

Exhibit 3: The MMT illusion burst in 2022, ...



Source: Haver, IIF

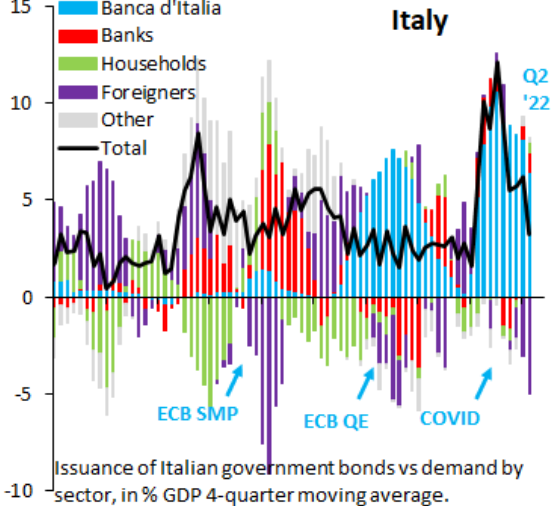
Exhibit 4: ... given mounting bond market stress.



Source: Haver, IIF

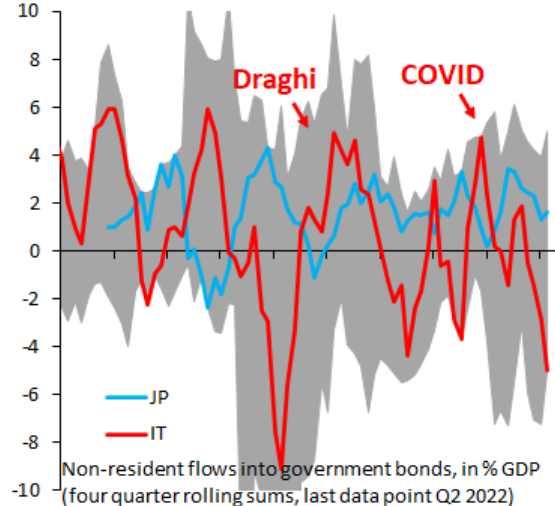
[Italy](#) is another example of the same thing. The spread on Italian government debt over Bunds has stayed low amid rising global yields and volatility is low (Exhibit 4), thanks to the ECB – indirectly – absorbing the bulk of net new debt issuance (Exhibit 5). However, ECB actions do not eliminate the fiscal risk premium, they merely suppress it. As a result, Italy is seeing record selling by foreigners, who are unencumbered by regulatory capture and thus highly mobile (Exhibit 6). 2022 is a reminder that fiscal space is a scarce and valuable resource to be used sparingly, the opposite of the MMT zeitgeist that has been so influential in recent years.

Exhibit 5: Italy's reliance on the ECB has grown, ...



Source: Haver, IIF

Exhibit 6: ... even as foreigners are selling BTPs.



Source: Haver, IIF