Abenomics Is Working?

Japan has put together a string of five straight quarters of real growth, along with declining unemployment and minute amounts of inflation. Some have recently termed Abenomics "a big success."

If so, then worth noting is that Abenomics' "three-legged stool" of fiscal reform, less regulation and expansive monetary policy has so far been carried out on one appendage: monetary policy.

The foundation, buttresses and keystone of Abenomics has been quantitative easing. Japan's economic resuscitation can be laid at the feet of the Bank of Japan (BoJ), their central bank.

The BoJ

For the record, the BoJ has an open-ended program to buy 80 trillion of yen ($700 billion) a year, in an economy variously rated at between one-quarter to one-third the size of the U.S. economy. Not only that, the BoJ has vowed to buy 10-year Japanese government bonds (JGBs) whenever the yield rises above 0%.

In pursuing its QE program in recent years, the BoJ has purchased about 43% of outstanding JGBs.

I doubt there was a Western economist on the planet 10 years ago who would have predicted the BoJ could buy back nearly half of Japan's famously large national debt, with only positive consequences.

So the Japanese government now owes a ton of money to itself, and in less than 10 years it will owe the lion's share of national debt to itself.

The discussions about Japan's level of indebtedness has become a variant of "Mobius-strip" economics. The Mobius strip obviously has two sides—until you run your finger along the surface and discover only one side. Japan's national debt is disappearing, perhaps becoming monetized.

Macroeconomists disagree on this point of monetization, and it might require metaphysicians to untangle. No matter, Japan's taxpayers are no longer on the hook, at least effectively. Japan is still in borderline deflation, btw.

Labor

Arguably the foremost accomplishment of Abenomics and the BoJ has been the creation of robust and healthy job markets to Japan, which by the standards of Western orthodox economists are “tight”

In fact, there is little or no wage inflation in Japan. Real wages in March 2017 are down 0.8% YOY.

There is also little unemployment, as measured at 2.8%, even as labor participation rates rise. Japan’s labor market is another positive feature of BoJ’s policy. As I have often said, if we want voters to embrace free enterprise, shouldn’t “tight” labor markets be a goal?

Austerity?

Along with a dearth of regulatory reforms (to be expected in any democracy), Abenomics has hardly curtailed Japan’s chronic national budget deficits.

This from The Japan Times: “Based on that [upbeat] scenario, the government expects to issue ¥34.37 [about $300 billion] trillion in new bonds in the next fiscal year [2018], down 0.2 percent from the initial fiscal 2016 budget. It will still rely on debt to pay for 35.3 percent of its expenditures.” The paper laments growing military and social welfare outlays.

Financing one-third of the national budget by issuing IOUs is hardly reform or austerity.

I happen to be a fan of smaller and balanced federal budgets in the United States, but the emergence of QE and helicopter drops as policy tools blurs the distinction between fiscal and monetary. And what means “national debt” if it can be liquidated through QE, with only positive results?

Should a developed nation in general run budget deficits, which are then paid down by QE in times of recession?

Conclusion

Japan remains inexplicable by Western orthodox macroeconomics. They run large trade surpluses, they run large federal budget deficits, they conduct massive QE, they have robust labor markets—and live in borderline deflation. Their national debt is disappearing. It is worth noting Japan has much looser property zoning that the United States.

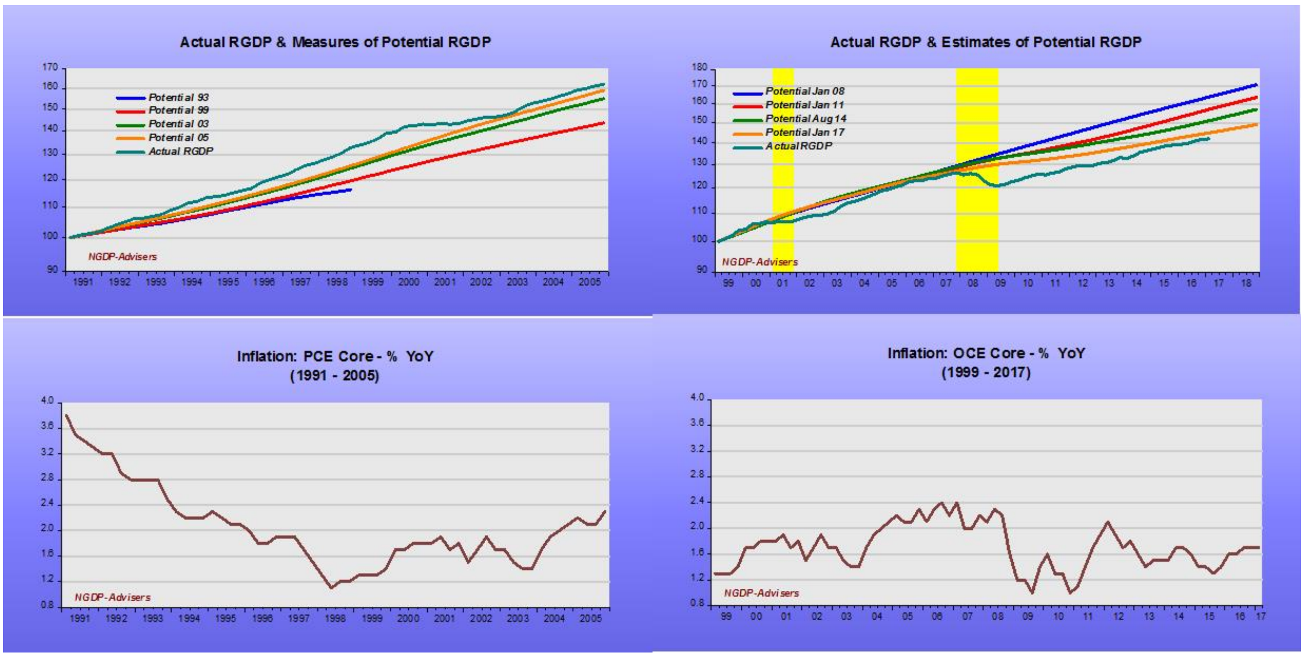
There may be valuable lessons in Japan for the United States. Perhaps more QE and tighter labor markets—and a reduction in property zoning—can bring about more prosperity to the United States.

The uselessness of the concept of potential output

The concept of potential output is one of the Fed´s “guiding lights”. Unfortunately, it doesn´t “illuminate” anything but dependence on it can cause grave policy mistakes.

It seems, as illustrated in the charts below, that “potential” output is always “chasing” actual output. In the 90s and first half of the 00s, actual output was always above potential, so potential was constantly revised up. Since the crisis, actual output has always been below potential, so potential has been revised down!

Adding information on inflation, the result is the opposite of what should be expected. In the 90s, with actual output way above potential, inflation was falling! More recently, with actual output below potential, inflation has remained low and stable.



By using unobservable quantities – potential output, natural rate of unemployment and natural/neutral interest rates – as guides to policy, the Fed has done enormous harm, with the economy remaining stuck in a "long depression".

With their view that the economy is close to potential, they are eager to tighten policy. The consequence will not be pleasant!

Eric Rosengren Ignores Property Zoning To Throttle Prosperity

Eric Rosengren is the Boston Fed President, and a man who has publicly fretted at the construction cranes populating his home city. True, property values have been soaring in the Boston market—witness nearby Newton, Mass., where an average home sells near a cool million. Boston is a city and region infamous for stipulations on property development, from minimum lot sizes to excruciating permitting for commercial development.

Rosengren may wish to ponder whether a noose on supply is what drives Boston property values higher, and not national prosperity.

When he had a vote on monetary policy (as a rotating member of the Federal Open Market Committee) Rosengren resolutely voted for rate hikes last year, warning of an overheating economy. Nary a week goes by now that Rosengren does not reiterate his sentiments.

We have this doozy from Rosengren in March, as reported by Reuters: "Eric Rosengren…said the 'sharp' rise in apartment prices in particular may signal financial instabilities that interest rates, which are only gradually rising, may not be able to contain."

Of course, presently national core CPI sans shelter is actually deflating, and up 0.8% YOY.

The latest core PCE (the Fed's preferred measure of inflation) also deflating presently, but YOY is up 1.6%.

And Boston? Core CPI there is up 2.1%, pulled by "with higher shelter costs being the main driver of the increase…." reports the BLS.

Boston

"Property sales volume may have peaked, but prices continue to rise due to limited inventory."—That is how commercial real estate brokerage Colliers International sized up the Boston property market in Q1 2017.

The Colliers review of the Boston market is one any other city would die for, with tech employment growing, law firms hunting space, the local schools highly rated and a mass-transit system that hustles 1.3 million riders around every day.

The problem is Boston does not have the housing and commercial property to handle the demand, and that is spiking prices. An economist might suggest the solution is to build more.

And Rosengren's solution? One can Google "Eric Rosengren" and "property zoning" and come up with nothing. His solution is to cut demand.

Property Values, Zoning And Trade Deficits

So we have a central bank, in this case the U.S. Federal Reserve, contemplating monetary policy in a world of artificially inflated property values.

The problem is complicated by the fact that the U.S. runs large and chronic trade deficits, and that also tends to spiral property prices north—a finding of the Fed itself, but one which no Fed official has ever mentioned. In short, foreign capital pours into U.S. real estate. The same thing is happening in Australia, Canada, Great Britain. Yes, a house in Sydney will set you back $1 million, and the middle-class can no longer afford to buy a house in Great Britain.

Conclusion

The Fed is fighting chimeras, and myopically at that. True, the Fed does not control property zoning in Boston or anywhere else, nor can it shrink the trade deficit.

But rather than define solutions for policymakers—for example, suggest methods by which federal inducements could cut property zoning, or create "free development zones" in cities, or suggesting a raise in trade tariffs (yes, heresy)—instead the Fed continues to operate as if kneecapping labor markets is the only policy course. It is certainly the Fed's favorite policy.

As if on cue, on May 9 Reuters reported that, "Rosengren, in a speech that reiterated concerns about high U.S. real estate prices, said the current jobless rate at 4.4% has already fallen below his 4.7% estimate of 'natural employment.'"

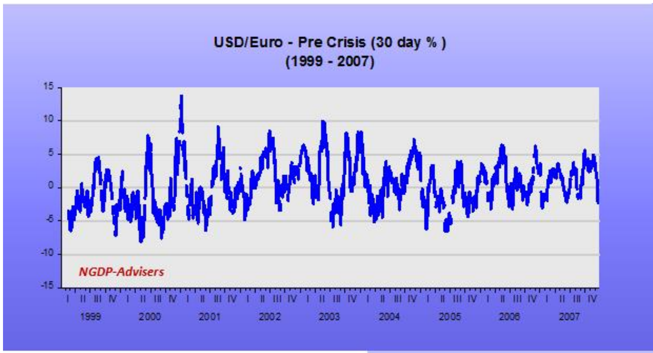
For investors, 2017 thus remains a tricky year. The Fed appears ready to eviscerate labor and suffocate the economy to throttle real estate prices. With a yawning trade deficit and ubiquitous property zoning, that will take some throttling. Overkill is possible, perhaps likely eventually.

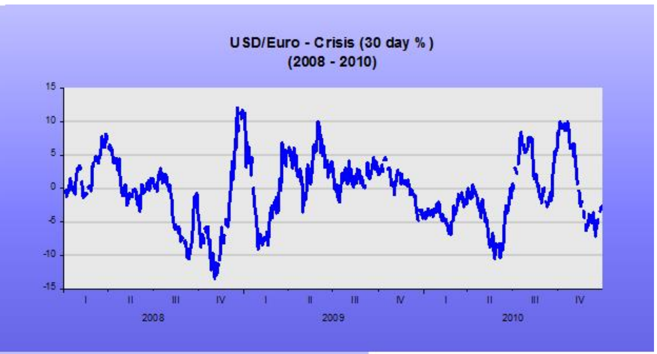
For the past six years, the USD/Euro Exchange rate has been less volatile than ever before

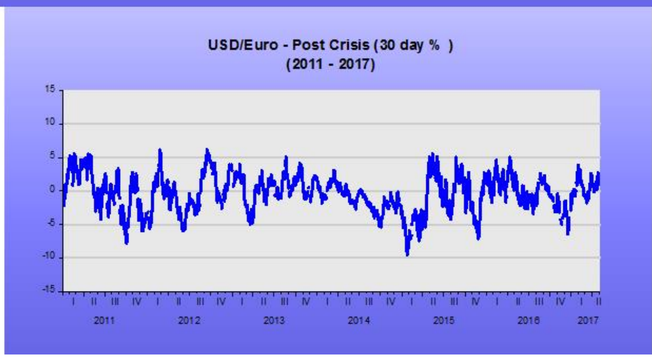
Some think not:

> It's the most important price in the world: How many U.S. dollars does it take to buy one euro? The exchange rate between the two largest world currencies affects profits and financial conditions around the globe—***and it has been dangerously unstable for more than a decade***. Since 2007, the dollar-euro rate has swung up or down by about 20% no fewer than eight times. Exchange rates that gyrate this much produce crisis and weak economic growth, while undermining the case for free trade.

The chart depicts three episodes since the birth of the Euro:







The "gyrations" have been "small", as has growth!

The FOMC thinks it´s coaching a "major league" economy

In a recent speech, Loretta Mester gave the impression the FOMC is dealing with a "robust or major league" economy. Excerpts from her speech, where the highlighted "descriptions" convey that view follows. She´s not alone. On the same day, San Francisco Fed president John Williams said: *"Now that we've gotten the monkey of the* ***recession off our backs****, we have the* ***luxury*** *of being able to look to the future."*

Mester:

> **The Economic Outlook**
>
> The economic expansion turns eight years old next month. It got off to a ***slow start*** from a very weak place, but now this expansion is one of the ***longest*** on record.
>
> In my view, the underlying fundamentals supporting ***continued expansion*** remain sound. These fundamentals include accommodative monetary policy and financial conditions, improved household balance sheets, and ***strength***

in the labor market that has led to increases in personal income.

Economic growth

Despite the strong fundamentals, GDP growth in the first quarter was weak. At this point, I'm not taking much of a signal about future growth from that reading; there are reasons to think this was a ***transitory*** slowdown.

Business activity and investment are ***starting to strengthen*** after being quite subdued last year and through much of the expansion.

Labor markets

As the economy has added jobs, the unemployment rate has moved down. It stood at 4.4 percent in April, less than half its peak of 10 percent in late 2009 and at the lowest reading achieved in the previous expansion.

In addition, the labor force participation rate has been essentially stable for the past three years. So relative to the downward trend, the stability we've seen in participation is ***actually another sign of strength in the labor market***.

For much of the expansion, wage growth has been ***subdued*** compared to what we've experienced in other expansions. Still, we have seen a ***gradual acceleration in wages over time as labor market conditions have strengthened.***

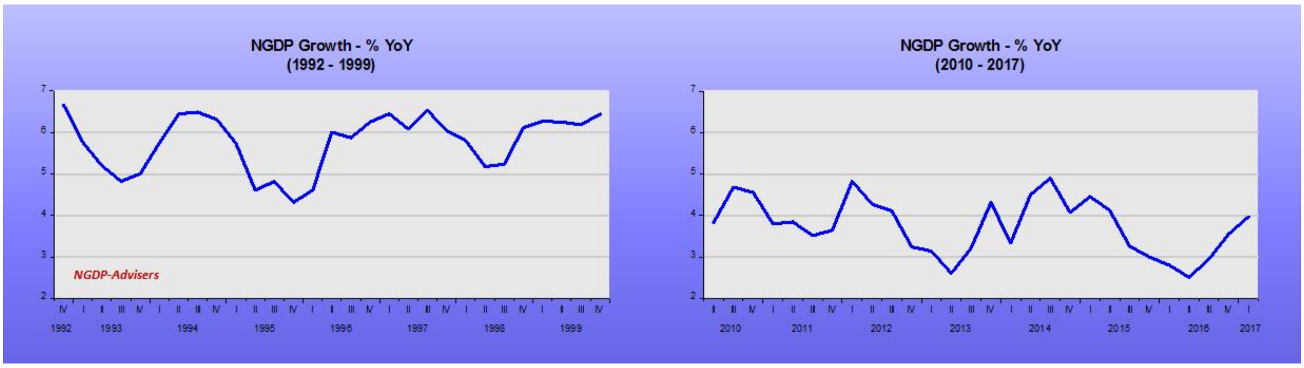
On balance, we've seen a sustained cyclical recovery in labor markets since the Great Recession. From the standpoint of the cyclical conditions that monetary policy can address, I believe we have ***achieved the maximum employment part of the Fed's monetary policy mandate.***

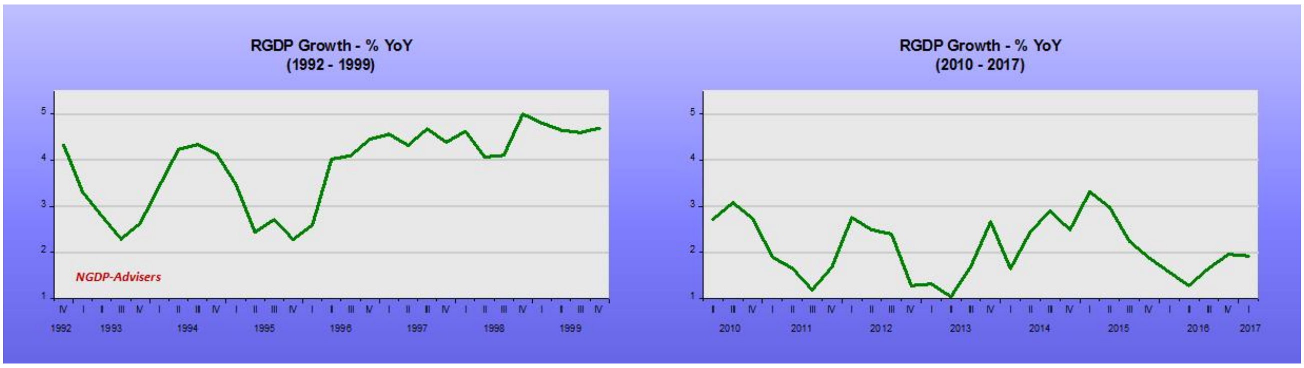
Inflation

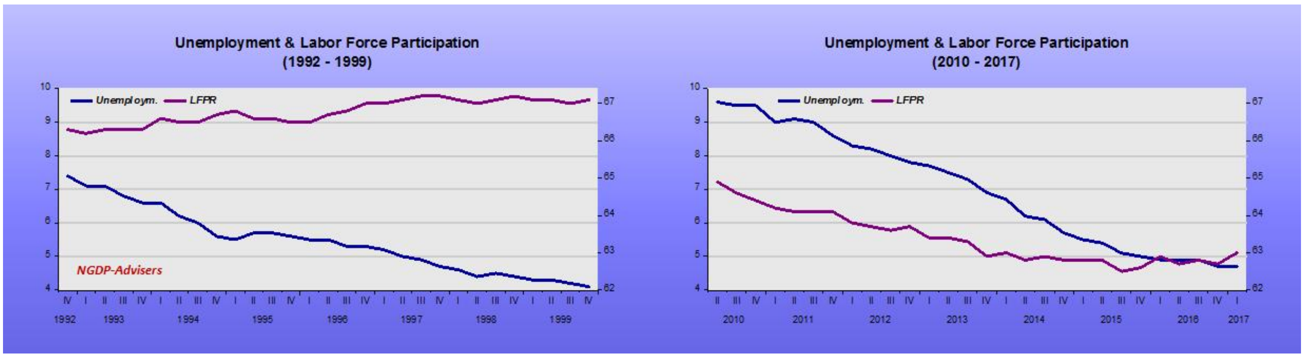
The other part of the Fed's dual mandate is price stability. For some time, inflation has been running ***below*** the Fed's 2 percent goal, but over the past two years, ***inflation has been moving up.***

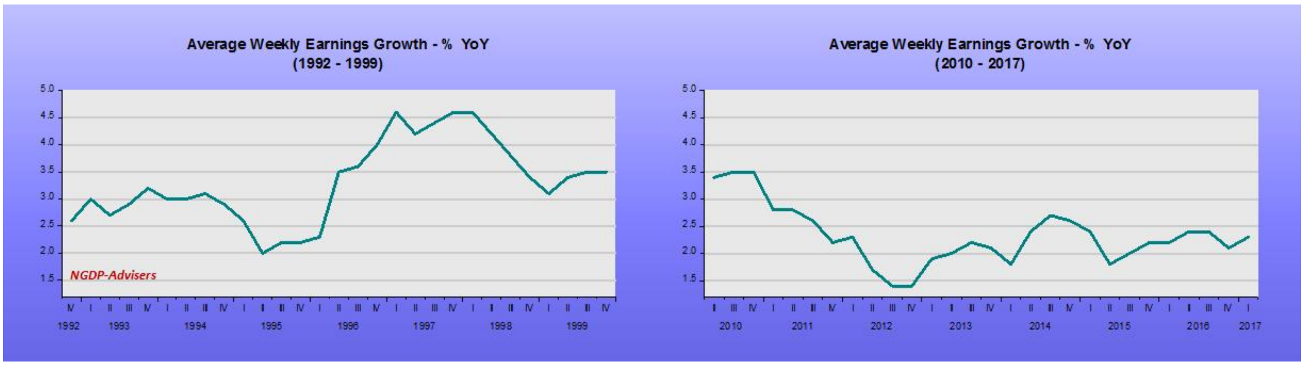
> Measured year-over-year, ***headline*** PCE inflation stood at 1.8 percent in March, ***up from under 1 percent a year ago***.
>
> In determining where inflation is relative to our goal, we need to look through ***transitory movements*** in the numbers, both those below and those above our goal, and focus on where inflation is headed and where it will be maintained on a sustained basis.
>
> With appropriate adjustments in monetary policy, I believe the conditions are in place for a sustained return over the next year or so to our symmetric goal of 2 percent inflation. These conditions include the firming in inflation that we’ve seen over time, reasonably stable inflation expectations, continued strength in the labor market, and growth expected to be at or slightly above trend.
>
> **Monetary Policy**
>
> Appropriate adjustments in monetary policy are those that will sustain the expansion so that our longer-run goals of price stability and maximum employment are met and maintained. In my view, we ***have met the maximum employment part of our mandate and inflation is nearing our 2 percent goal***.
>
> If economic conditions evolve as anticipated, I believe ***further removal of accommodation*** via increases in the federal funds rate will be needed. It will help avoid a build-up of risks to macroeconomic stability that could arise if the economy is allowed to overheat and risks to financial stability, should overly low interest rates encourage investors to take on excessively risky investments in a search for yield.
>
> It will put monetary policy in a ***better position*** to address whichever risks, whether to the upside or downside, are ultimately realized.

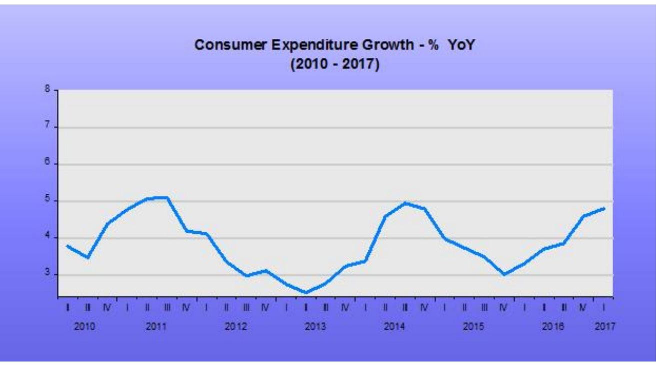
The panel below provides compelling evidence that what the FOMC is dealing with certainly cannot be described as “major league”. The “Great Recession” “transformed” a “major league” economy into a “little league” economy which, if treated as “major league”, will not “survive” for long.











The Reserve Bank of Australia Ponders "Financial Instability". House Prices Soar Amid Trade Deficits; RBA In Straitjacket?

"If the **Reserve Bank** was still retaining its narrow focus on keeping inflation between 2 and 3 per cent per annum, it would be **cutting interest rates** at its May meeting," opined the ***The Sydney Morning Herald*** a couple of days ago.

Instead, the Reserve Bank of Australia (RBA) opted to do nothing at its May meeting. Although doing nothing for a central bank is sometimes akin to "doing nothing" when you see burglars enter a neighbor's house.

At any rate, ***The Sydney Morning Herald*** added, "The domestic economic is growing, but still weak. And the currency is still high—factors that some say should lead the RBA to cut rates."

So why the timidity? Why does not the RBA cut rates?

“Financial instability”—that is, soaring house prices, and fear of a bubble-pop.

RBA Governor Phillip Lowe has publicly fretted about “dealing with the mess in five years’ time when the housing market pops,” said the Sydney paper.

Housing

It is huge and yet largely un-discussed challenge for many central banks, certainly the Federal Reserve, the RBA and the Bank of England. How to respond to soaring house prices (into which so much bank-lending is poured) but soggy economies?

It is a topic that orthodox macroeconomists revile, but in fact large trade deficits appear to skyrocket housing prices in nation after nation. The New York Fed published a paper to that effect, which was then updated and also published in the prestigious Journal of Money, Credit & Banking.

As embracing “free trade” and even genuflecting to huge trade deficits is required of proper U.S. macroeconomists today, the above papers have been resolutely ignored.

Thus, a policy challenge snarls before central bankers. Property zoning and trade deficits are not likely to change. But to hold interest rates “low” will send housing prices to the moon. The average house in Sydney now retails north of $1 million. In Great Britain, the middle-class can no longer buy housing, a situation mirrored in large parts of the West Coast and Northeast of the U.S.

The Unpopular Solutions

Macroeconomists and central bankers in Australia, Great Britain and the U.S. must come to terms with this new reality of trade deficits, property zoning, soaring house prices and monetary policy. The craft of macroeconomics must be conducted not in theory, but accepting the facts on the ground.

Property zoning has become a macroeconomic issue, certainly of greater importance than the minimum wage, or whether there is a tariff on Canadian lumber. The macroeconomics profession needs to say so, and else offer increasingly worthless advice to policymakers.

Unless trade deficits and property zoning are tackled dead on, vast swathes of the English-speaking publics may come to conclude (and many already have) that “free trade” or worse, even “free enterprise” are but games rigged to benefit a propertied and financial class.

Would they be entirely wrong?

For investors in companies in the English-speaking world, proceed cautiously. The central banks must learn to either live with higher inflation, or suffocate growth. And macroeconomists need to abandon orthodoxy—at least in present-day context—the least likely outcome of all.

Wolfgang Schauble – the most dangerous politician in Europe

For all the column inches spilled on Le Pen, Farage, AfD, Willders, etc. etc. by far the most dangerous politician in Europe is the one who has both huge influence and completely wrong-headed ideas about monetary policy. That man is Wolfgang Schauble, Germany’s long-standing and powerful Finance Minister.

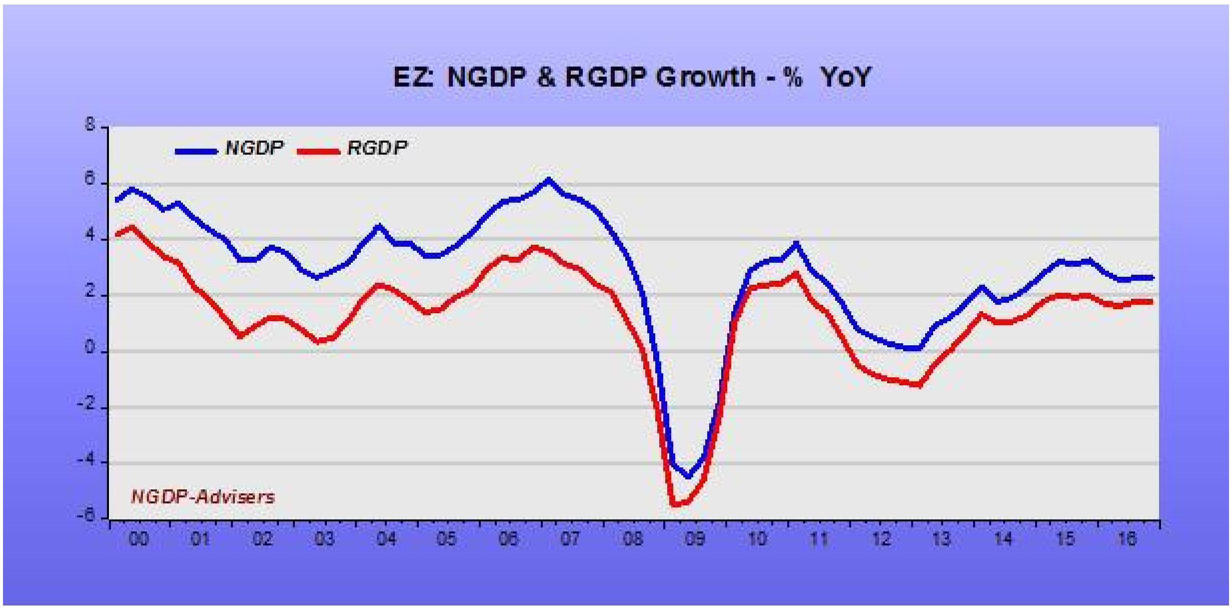
At the fringes of last week’s IMF meeting, he was reported to be pressing for an end to the ECB’s QE as in his analysis:

> *“It is encouraging undue risk-taking, political complacency, capital misallocation and asset price bubbles”.*

To be fair he has consistently complained about QE but has let it go ahead without too much trouble.

The worry is that his new view is coinciding with that of several senior ECB Board members who increasingly think that the Euro economy is now responding and it will soon be time to end QE. Just by discussing the end of QE they automatically blunt its effectiveness. But are they right about the economy? If not they will cause the Euro economy to slow.

The evidence is that Euro Area NGDP is way below the levels it should be and has thus dragged down RGDP too. The successful period" of NGDP growth averaged 4% and RGDP around 2%. "Inflation" or the "implied deflator" therefore averaged around 2% also. Putting aside the lost levels, RGDP may be averaging almost 2% but it is a huge struggle as NGDP growth cannot get over 3%, leading to less than 1% inflation and negative interest rates.



Germany dominates the EU and even more dominates the Euro Area. And Schauble is a huge voice given his position in Germany. If he really thinks there is "undue risk-taking, political complacency, capital misallocation and asset price bubbles" with these anemic growth numbers then Euro Area is in for big trouble.

Instead of "Banking Rules", Fischer should be concerned with "Monetary Policy Rules"

According to Stan Fischer, it wasn´t the Fed´s fault:

> "We seem to have forgotten that we had a financial crisis, which was ***caused by behavior in the banking and other parts of the financial system, and it did enormous damage to this economy***," Fischer told CNBC's Sara Eisen in the lobby of the International Monetary Fund, responding to a question about the potential rolling back of Dodd-Frank rules.
>
> "Millions of people lost their jobs. Millions of people

> lost their houses," Fischer said. "This was not a small-time, regular recession. ***This was huge, and it affected the rest of the world***, and it affected, to some extent, our standing in the world as well. We should not forget that.
>
> "The strength of the financial system is absolutely essential to the ability of the economy to continue to grow at a reasonable rate, and taking actions which remove the changes that were made to strengthen the structure of the financial system is very dangerous."

And is "on track" to repeat the mistake:

> On another issue, Fischer said he believes the Fed ***still will hike rates three times in 2017***, despite recent signs of a slowing economy.
>
> Fischer attributed much of the slowness, both in the economy and the inflation rate, to ***seasonal factors that will go away as the year progresses***.
>
> "We're feeling that way and so far haven't seen anything to change that," he said during an interview from the sidelines of the joint meeting of the International Monetary Fund and World Bank. ***"But we are dependent on what happens in the economy***, and we're not tied to three."

Interestingly, all "unwanted" things "will go away" in time, just like "inflation has been low due to ***temporary*** effects of low oil prices".

By saying the Fed "is dependent on what happens in the economy", Fischer misses the more relevant part of the equation, that "the economy is Fed-dependent". Early last year we identified the following loop (or trap):

[market-strengthening -> Fed tightening talk -> market weakening -> Fed backing off -> market strengthening -> Fed tightening talk -> …]

It seems the Fed is unable to "break-out"!

Did That Canary Just Topple Over?

Over at the always-trenchant Idiosyncratic Whisk, blogger Kevin Erdmann has again parsed the U.S. CPI release, and finds that shelter costs (as measured) are suddenly cooling.

Of course, one month does not a trend make. But then we have indices that show that U.S. commercial property values topped out last August.

Yes, the last time commercial property prices topped out was July of 2007. (If the graph is too small to read, go to link).

House prices appear to be rising still, though at a slower rate by various indices. On a per-square-foot basis, house prices in the U.S. have not budged since May of last year. That could be important, suggesting that houses now selling are larger, and the middle-class is dropping out of the market.

Déjà vu?

Of course, economic history rarely repeats itself exactly. The U.S. Federal Reserve is still inflation-phobic and price-centric, but inflation is lower than in 2008, perhaps lessening the ardor of the Fed's gang of monetary vigilantes.

If shelter costs do moderate, the U.S. PCE index will likely move to near zero or even below, perhaps enough to sate the Federal Open Market Committee (now sans former Philadelphia Fed President Charles Plosser, who often rhapsodized about deflation, or Dallas Chief Richard Fisher, who grew grumpy when wages in Texas rose above the inflation rate).

The real risk is that the present-day dead-in-the-water property prices are the start of a bona fide real-estate price decline, which will provoke much less lending on property. There is a huge dose of self-fulfilling prophesies in real estate, as when lenders pull back then property values fall, which then scares lenders into lending less, etc. Property lending is powerful conduit for new money to enter the economy. When the real-estate pipe is shut off, the Fed can compensate—but doing so forcefully enough is a challenge for inflation-obsessed central bankers.

Conclusion

As we saw in 2008, there are macroeconomic effects when property markets crater, especially if the Fed leans the wrong way and kneecaps the economy at he same time.

Property values are high presently, especially in those regions where the artificial supply constraints of property zoning prop up prices. In the commercial property world, "cap rates" are low.

The U.S. macroeconomic community and Fed policy-makers have little interest in property zoning and only flagging interest in the connection between real-estate lending and macroeconomic performance.

For investors, that means antennae must be up high.

A Fed engineered Ice-Age

In The Economy May Be Stuck in a Near-Zero World, Justin Wolfers posits:

> If the Fed can't cut rates as much as required to fight a slowing economy, then recessions will become more common and more painful. It suggests an urgent need to reconsider how we will counter the next bout of bad economic news, preferably before it arrives. If monetary policy won't be enough, perhaps fiscal policy will be. Certainly, this is no time for complacency.
>
> In a nutshell, the American economy appears to have changed in a way that ***undermines the effectiveness of monetary***

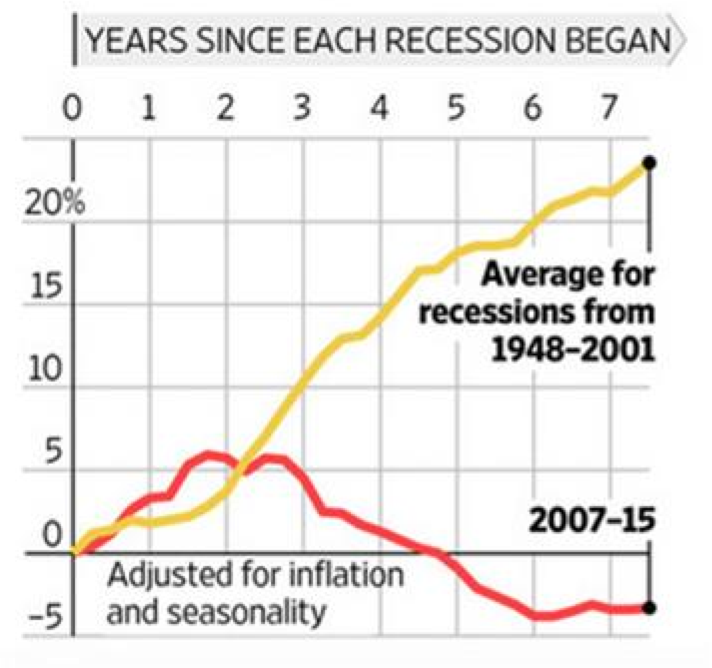
policy but not fiscal policy, which may need to be wielded more actively.

Nothing new there. Two years ago the WSJ wrote: U.S. Lacks Ammo for Next Economic Crisis, where they question the capacity of even fiscal policy to come to the rescue:

> Many economists believe relief from the next downturn will have to come from fiscal policy makers not the Fed, a daunting prospect given the philosophical divide between the two parties.
>
> Republicans doubt federal spending expands the economy, and they seek to shrink rather than grow government. Democrats, meanwhile, say government austerity hobbles the economy, especially in a downturn.

At the time, Kevin Drum posted:

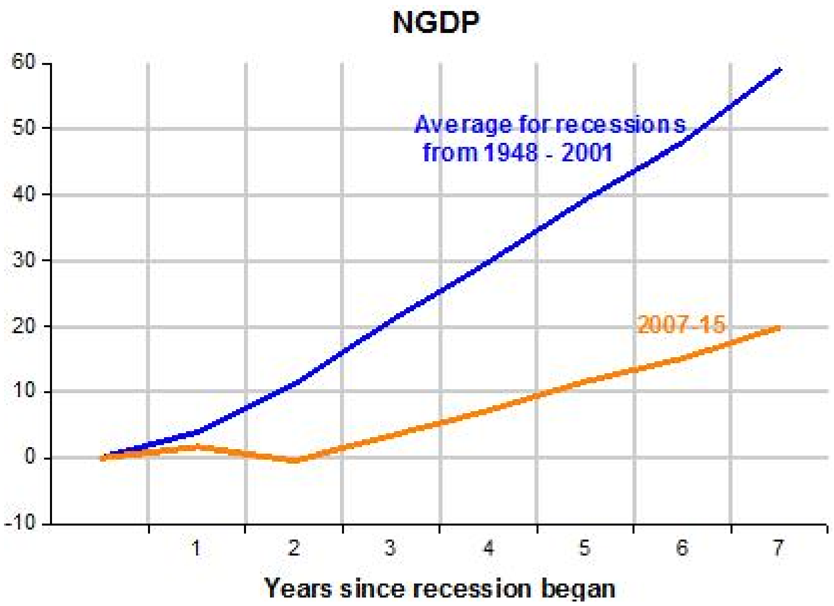
> I don't really have any good hook for posting this chart, but it's one of the ***most important ones you'll ever see***. It's from the *Wall Street Journal* and it shows total government spending (state + local + federal) during the recession and its aftermath:



> For about a year following the Obama stimulus, total

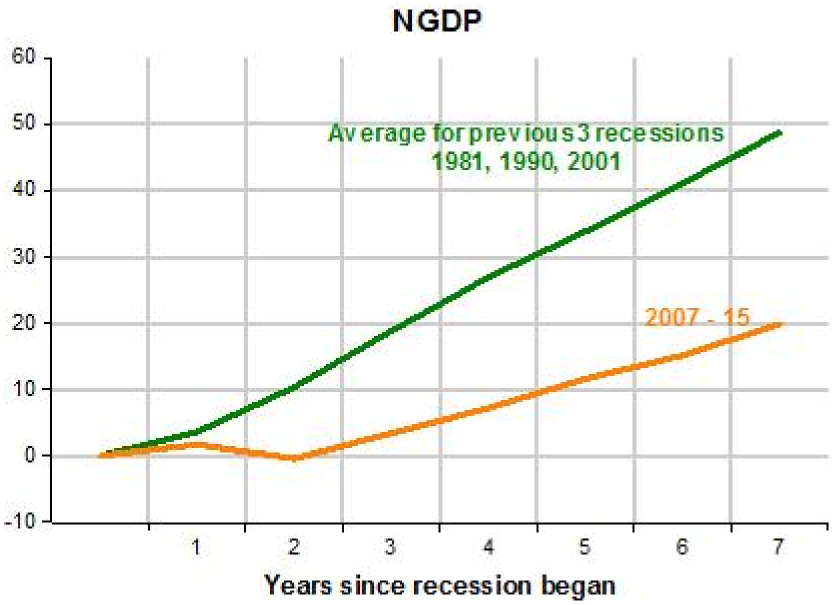
> spending was a bit higher than average for recession spending. But after that, spending fell steadily rather than rising, as it has after every previous recession. The result: a sluggish recovery, persistent long-term unemployment, and anemic wage growth.

However, let´s not be too quick to "idolize" fiscal policy. The chart below compares Aggregate Nominal Spending (NGDP) on the same basis.



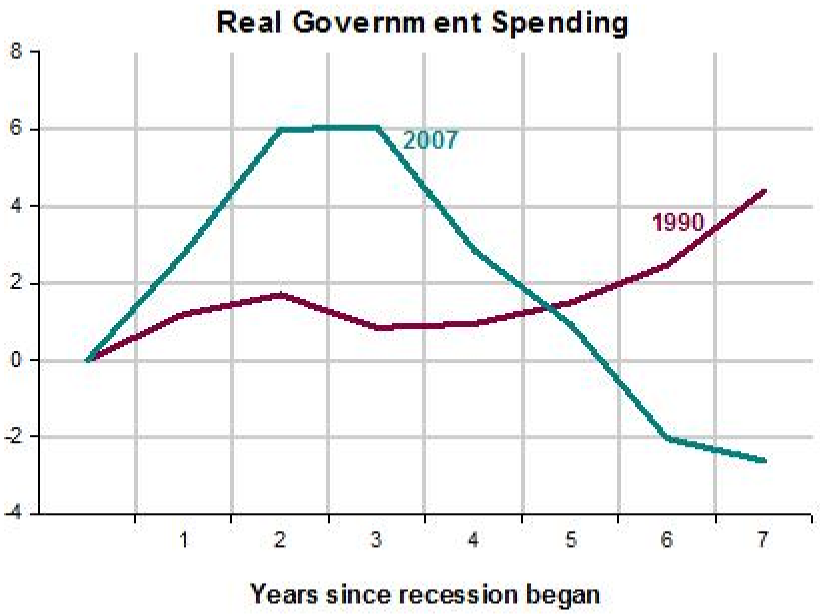
While spending went negative for the first two years of this recession, it never faltered on the other occasions.

One might argue that in many other instances inflation went up a lot. Therefore, the next chart compares NGDP for the noninflationary occasions, considering only the previous 3 recessions/recoveries. The pattern is the same.



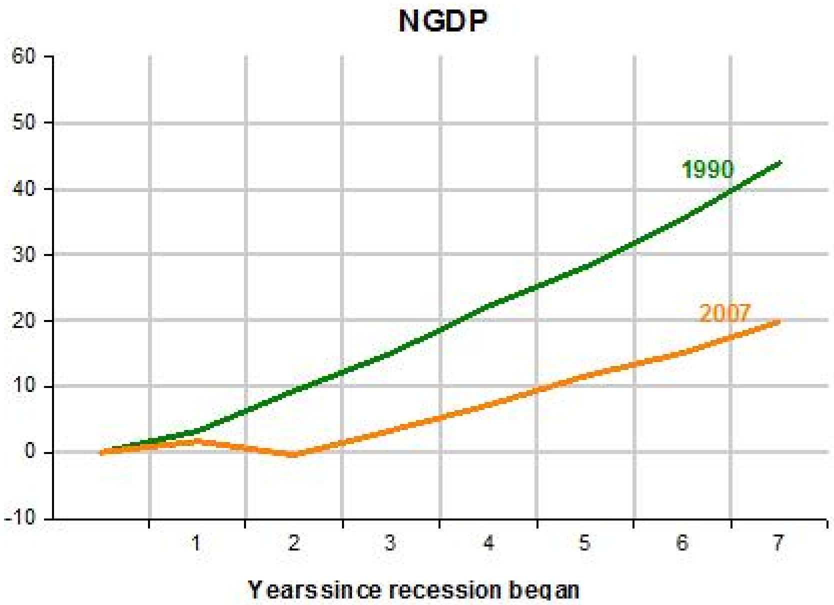
The least one could say is that you also have to consider monetary policy. This time around, both fiscal and monetary policy have been tight!

How can we distinguish their relative “guilt”? The next chart compares fiscal policy (government spending) in the 1990 and 2007 episodes.



Initially, fiscal policy was significantly more expansionary in the present episode, although this expansion has been weaker throughout.

Now, contrast nominal spending in the two episodes.



Maybe monetary policy really trumps fiscal policy!