Globalism, Monetary Policy, Housing Prices and Trade Policy

The viewpoints of the world's macroeconomists are becoming anachronisms, not updated for a global economy and housing costs.

For starters, there are some storm signals out there in monetary-land; notably Far East investors are fearful of capital flight.

"U.S. rate hikes have sorted emerging markets into winners and losers as investors pull capital from particularly unstable countries, though steep dollar debts may soon drag even Southeast Asia—fairly healthy so far—into the losers' circle," reported the Nikkei Asian Review.

"The gap between key South Korean and US interest rates will widen further if the US Federal Reserve raises its key rate again this week, a move that would rekindle worries of capital outflows," reported The Korean Herald. Seoul stock markets have been drooping, despite the best news on North Korea in decades.

Of course, the 1997 Asian Financial Crisis was precipitated in part by higher US interest rates, which drained capital out of SE Asia.

The Hong Kong Monetary Authority matched the recent Fed rate hike, a move that may cramp that city's famously expensive and capital-eating property markets, although the People's Bank of China did not.

The concern in Beijing is that the China economy is already cooling too much. The Sino rulers evidently will rely on capital controls to prevent money flight.

About 70% of global economies have central banks that peg to Fed in one way or another, Mercatus Center scholar David Beckworth has posited. Embedded in the past, the Fed appears intent on raising interest rates preemptively to fight non-existent US inflation, courtesy of the propeller-plane era Phillips Curve.

That higher interest rates in the West could siphon money out of entire economies is not yet blinking on monetary-policy radar screens in Washington.

Hopefully, the globe's capital glut will lessen the impact of the

Fed's resolve to obtain higher unemployment rates in the US.

Housing Prices

Housing prices are runaway in so many nations that Nobelist and Yale scholar Robert Shiller recently authored a article entitled, "Why Do Cities Become Unaffordable?"

From Australia, to Hong Kong, to New Zealand, to America's West Coast, to Canada to London and all of Great Britain, housing has become unaffordable for the employee-class. In contrast, in much of the same developed world, wages have been stagnant for a couple generations.

The flow of capital to nations that run current-account trade deficits is cited in a Fed paper as a large reason for exploding house prices. Obviously, restrictive zoning is a primary factor as well.

A shocking headline from Hong Kong A huge amount of capital gets absorbed by static (in terms of supply) and unproductive housing markets, globally, as noted by Adair Turner, former Chairman of the Financial Services Authority in Great Britain and a monetary policy scholar. Housing markets become defined by towering leverage.

Another shocker: Houses and residences in the US are worth $31.8 trillion by recent measure, reported Zillow. The market capitalization of US stocks is about $30 trillion.

Where are America's macroeconomists on this trade imbalance, leveraging, and housing-price explosion issue? Mostly mute.

Trade Policy

Global free trade is a positive and has largely been obtained, although certainly fingers can be pointed at the OPEC cartel or mercantilist China.

Indeed, the American consumer may wonder if he or she can buy anything manufactured in the USA, from computers to smart-phones, household wares to clothes, to wide-screen TVs.

A Yank can buy an American-built pick-up truck, but then he is told that Nixon-Reagan era protectionism can be blamed for that. Meanwhile, Ford and GM are said to be giving up on US sedan production, and Ford wants to move more jobs to Mexico.

But let Trump suggest what are essentially wrinkles in trade policy, and more than 1000 US economists will sign a public letter, which as Bloomberg put it, “invokes the Great Depression.” The old canard that the (essentially toothless) Smoot-Hawley Act caused the global Depression (and not tight money?) is dragged out for a gullible US public to consume.

To repeat, “free trade” is a good idea, but whether the managed, taxed, subsidized and regulated trade of today is “free” is a basic question. Besides that, Trump-era protectionism pales next to the Nixon and Reagan days, and no global recession was triggered back then.

But the world did encounter a Global Financial Crisis and Great Recession after the 2008 property price collapse—which followed Fed tight money policies.

Conclusion

Investors and citizens must think for themselves, as expert economist consensus is increasingly outdated, or off-topic. Unfortunately, the whipsaw of expensive housing and dead wages is not going to encourage the public to believe in free enterprise or even bona-fide free trade.

Western economists need to come to grips with what causes unaffordable cities, dead wages and Great Recessions. More pontificating on the merits of tight money and free trade is not an addition to the conversation.

For investors, a tricky situation. Global assets and property are fully priced, and the Fed is tightening up (with the encouragement of most economists), and taking up to 70% of the world’s economy with it. The good news is that Bank of Japan and the People’s Bank of China appear to be charting independent courses.

Yet, declines in global property values are sometimes self-feeding, and banks globally are heavily exposed. Capital flight tends to breed capital flight.

Cures, if a recession hits? Central banks still have not even yet broached the taboo topic of money-financed fiscal programs, meaning that option is off the table. Interest rates are still moderate, so central banks will have scant ammo by lowering rates. There seems to be no consensus that QE works. Whether the Fed would even go to QE unless pushed remains a question.

The US government is already running huge deficits for as far as the eye can see. More fiscal stimulus may not be forthcoming.

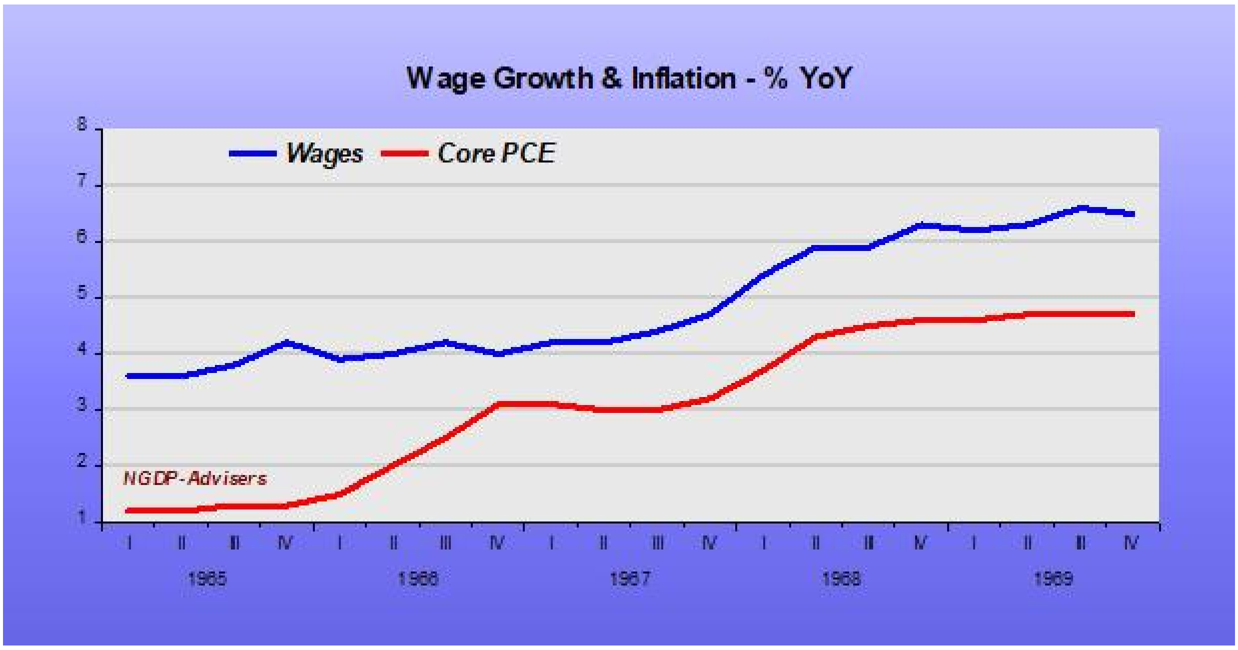
Plenty for investors to be concerned about.

The Fed´s ‘model’ is screwed up

In Powell’s Fed Could Clear Up a Few Mysteries Puzzling Investors, we read:

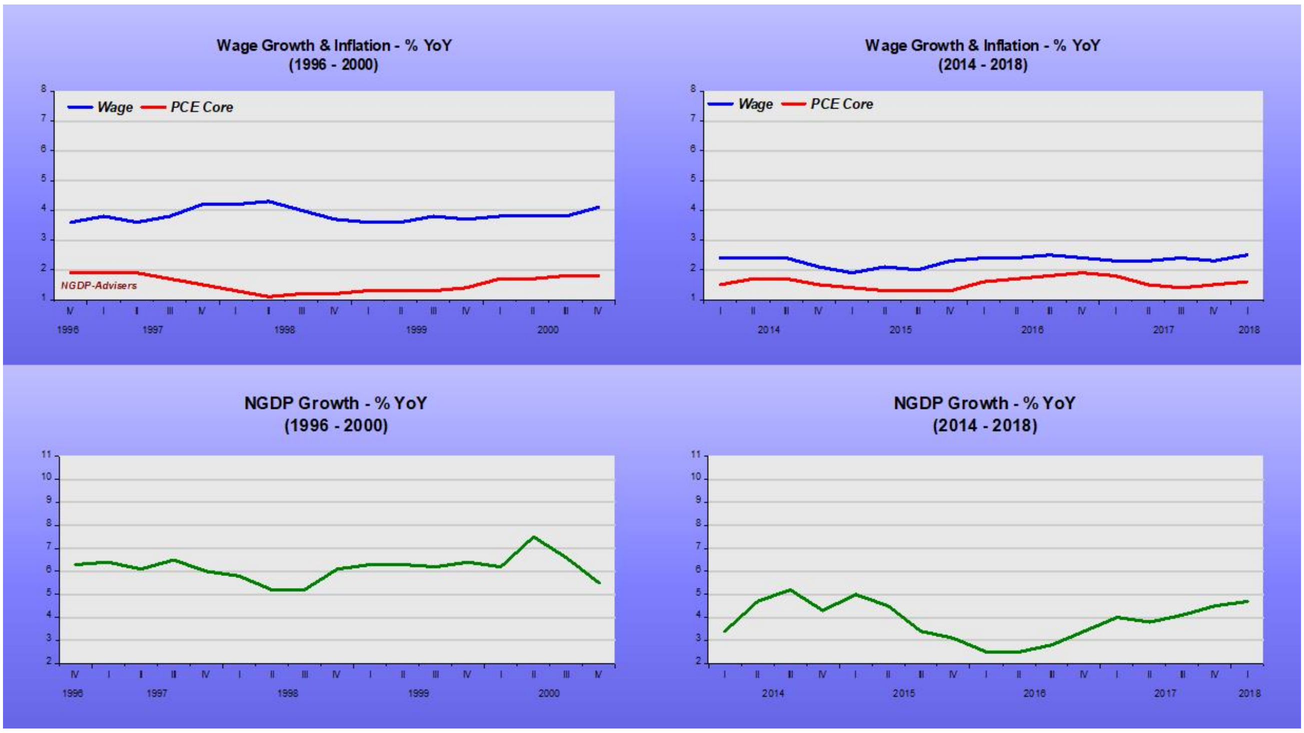
> The Fed says unemployment is already running below the level that can be sustained in the longer run, **but wages are crawling higher rather than taking off**. What’s more, job growth hasn’t slowed down as much as you might expect in an economy with a big worker shortage.

Fortunately, inflation is not a wage phenomenon. On the contrary, it is inflation that drives up wages. The late 1960s makes that clear. Note that wage growth only picks up after inflation has almost tripled!



Comparing the late 1990s and the last four years, you see that inflation is pretty much the same, while wage growth is significantly higher in the late 1990s.

Why? In the late 1990s, stable NGDP growth was higher, so the economy was more ‘enticing’. For some reason the Fed has decided that the economy has to be kept restrained, so it keeps NGDP growth stable at a significantly lower level. Wages ‘obey’.



When ‘good’ is ‘terrible’

The headline: **The Fed’s Biggest Dilemma: Is the Booming Job Market a Problem?**

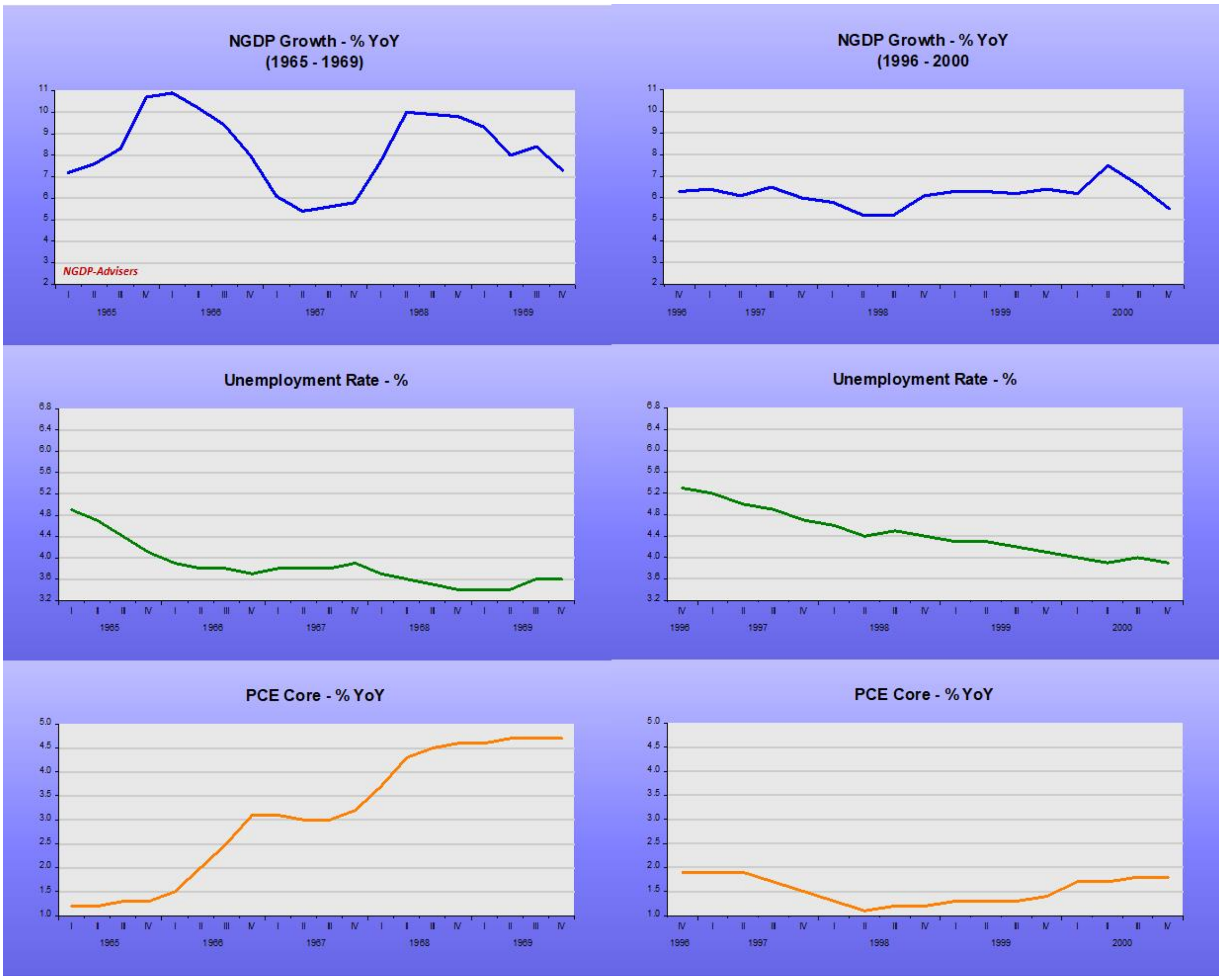
Snipets:

> No question looms larger for Federal Reserve Chairman Jerome Powell than this: How low can the U.S. unemployment rate safely go?
>
> Only twice in the past half-century has unemployment fallen to its current rate of 3.8%—for a few years in the late 1960s and for one month in 2000.
>
> The ’60s episode spurred years of soaring inflation that

would take a decade for policy makers to corral. The latter coincided with a technology bubble that, when it burst, caused the 2001 recession.

It seems low unemployment is ‘terrible’, out of which no good can came!

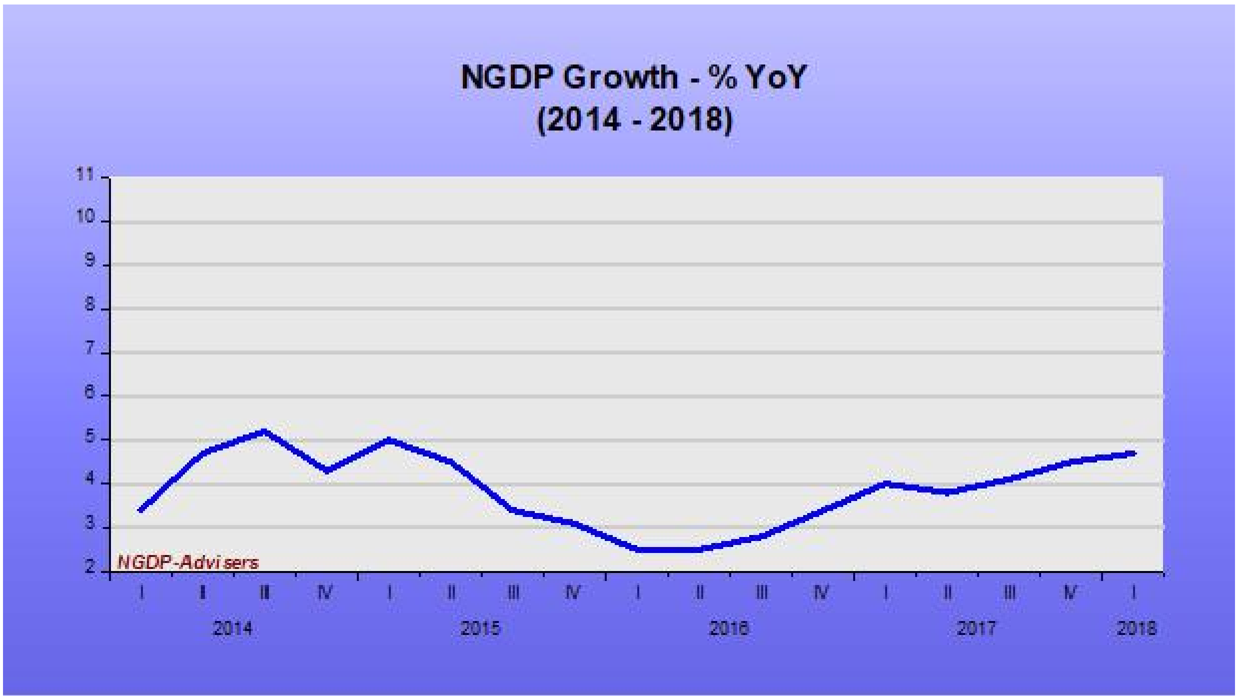
Let´s review the episodes, where the charts illustrate.



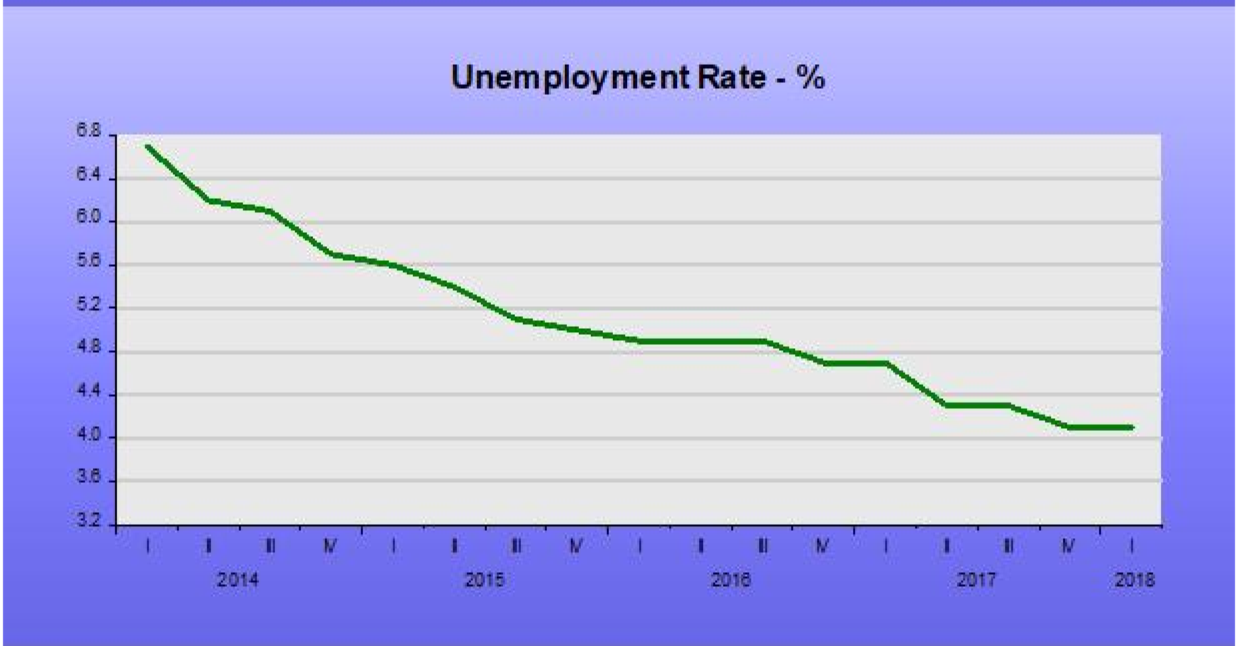
In all cases, unemployment is falling/low. In the late 1960s, inflation was on an upward trend. That´s not due to low unemployment, but the result of an expansionary monetary policy gauged by nominal spending (NGDP) growth, which was high and erratic.

In the other instances, inflation was low and stable. Again, not because of low unemployment, but the outcome of stable NGDP growth.

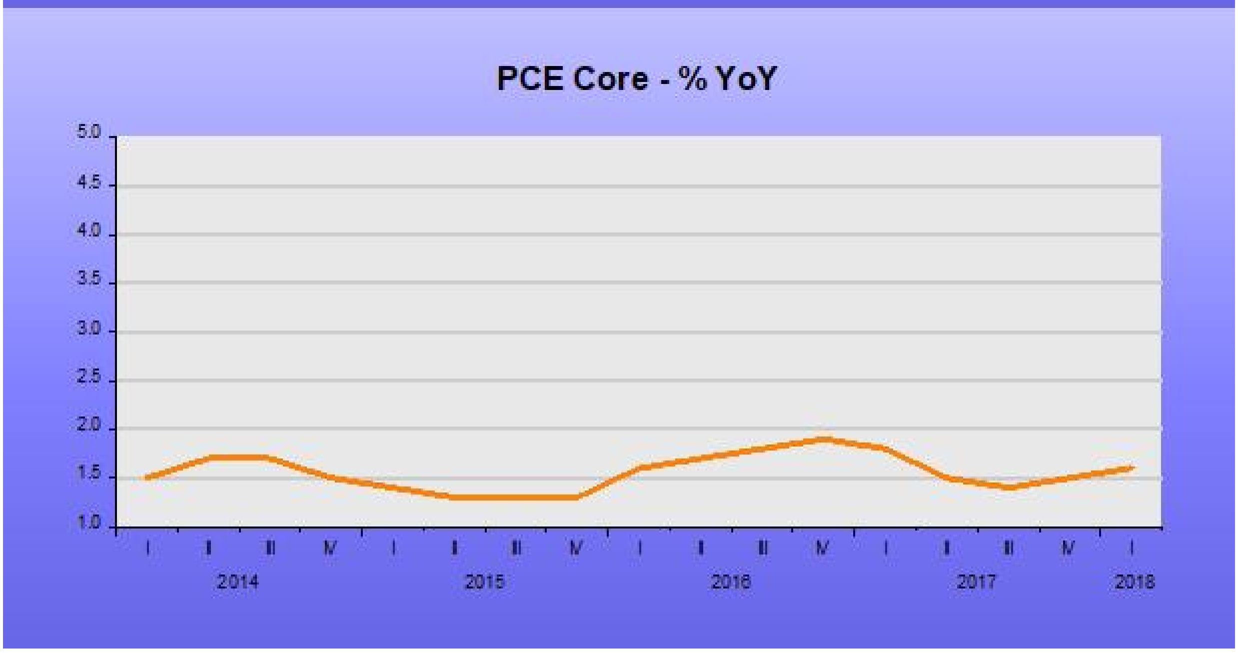
In the most recent episode, NGDP growth is maybe too low, especially given that the Great Recession was the outcome of a drastic fall in the **level** of spending, and subsequent spending **growth** never made up for that drop, keeping the economy in a depressed state.



NGDP Growth - % YoY
(2014 - 2018)
NGDP-Advisers
2014
2015
2016
2017
2018



Unemployment Rate - %
2014
2015
2016
2017
2018



PCE Core - % YoY
2014
2015
2016
2017
2018

Bottom Line: If the Fed worries about "low" unemployment, it will tighten monetary policy. Even if a recession is not called, the economy will weaken further.

The US Federal Reserve Perfects the Art of Cluelessness

"Construction in the residential market remained solid, though the shortage of labor and intense price pressures for building materials continued to act as headwinds."

The above paragraph is from the May 30 Beige Book, the Fed's periodic wrap up of economic conditions in its 12 districts.

Can you guess which of the 12 districts the Fed is describing? Dallas, perhaps?

No, the above is the Fed's most-recent synopsis of housing markets in the Fed's San Francisco 12th District, which is the West Coast.

What is odd about the Fed's resolute myopia is that there is a broad, bright-red common thread that runs from San Diego to Los Angeles to San Francisco, to Portland to Seattle: Property zoning and other regulations prevent residential construction. In even a merely good economy, rents and house prices are exploding. Vast portions of Los Angeles and Seattle (56% and 69% respectively) are zoned for single-family detached housing only, and NIMBYism is run riot in other neighborhoods.

The Fed devotes not a jot to the foregoing, but copiously covers "labor shortages." Remember the price signal, and supply and demand? The Fed has evidently forgotten.

But there is more.

The median house-price in Seattle is now $820,000. The average apartment rent in San Francisco, as of April 2018, is $3552.

Shrewd econo-detectives might have an inkling to worker availability on the West Coast: It is too expensive to live there, mostly due to housing costs. Nearly half of San Francisco Bay Area residents plan to leave, citing housing costs.

Inexplicably, these obvious observations about the West Coast economy are absent in the Fed Beige Book. But why?

Regulatory Capture?

About one-half of US commercial bank loan volume is extended on real estate, and in America that means zoned real estate. Un-zoning property would mean declines in property values, and possibly spell trouble for banks, who have borrowed short to lend long. In other words, the US financial system is deeply wedded to and even dependent on the artificial market scarcity created by property zoning. Free enterprise? What has that to do with it?

One might posit this industry dependency is why the Fed is so acutely concerned about labor rates, and so mute on rising housing costs.

Outlook

For investors, the outlook is much as it has been for several years. The Fed is tight, and will get tighter, and has promised to do so. The Fed even recently declared the "sustainable" rate for US real GDP growth is 1.8%.

The qualification is that the Fed does not want to trigger another 2008-style property collapse, a result it did not anticipate when it tightened the US into the Great Recession. Not for nothing that Fed Chair Jerome Powell has lately discussed softening the 2% inflation target.

Unfortunately, in divining prospective Fed policy, one not only has to ponder macroeconomics, but also institutional biases and compromises. In the end, the Fed practices politico-economics.

Invest accordingly.

Keynes; "The difficulty lies, not in the new ideas, but in escaping from the old ones"

An old idea never relinquished is the one that sees inflation as a cost phenomenon, or the result of "cost-push."

A recent op-ed by Peter Hooper, managing director and chief-economist of Deutsche Bank Securities, and more significantly a 26-year veteran of the Federal Reserve Board in Washington, DC, provides a good illustration.

According to him, "*the Trump administration doesn't seem concerned about this. It has taken at least six actions that have either actually or potentially boosted inflationary pressures. As a result, it has risked making our next economic downturn more severe*."

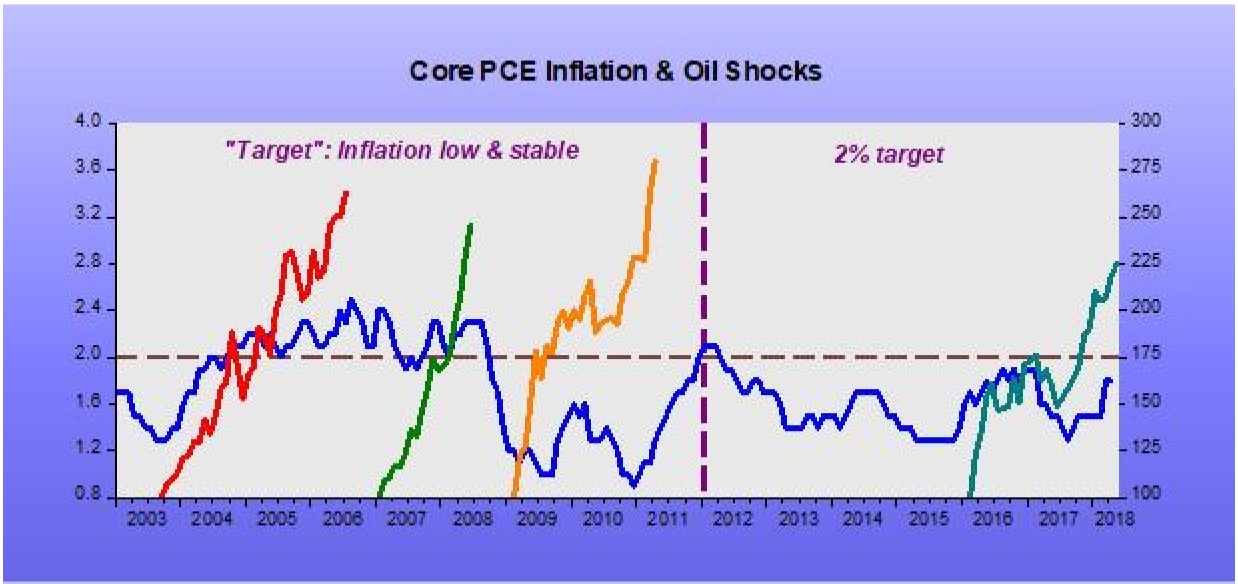
The first is the "classic" Phillips-Curve reasoning:

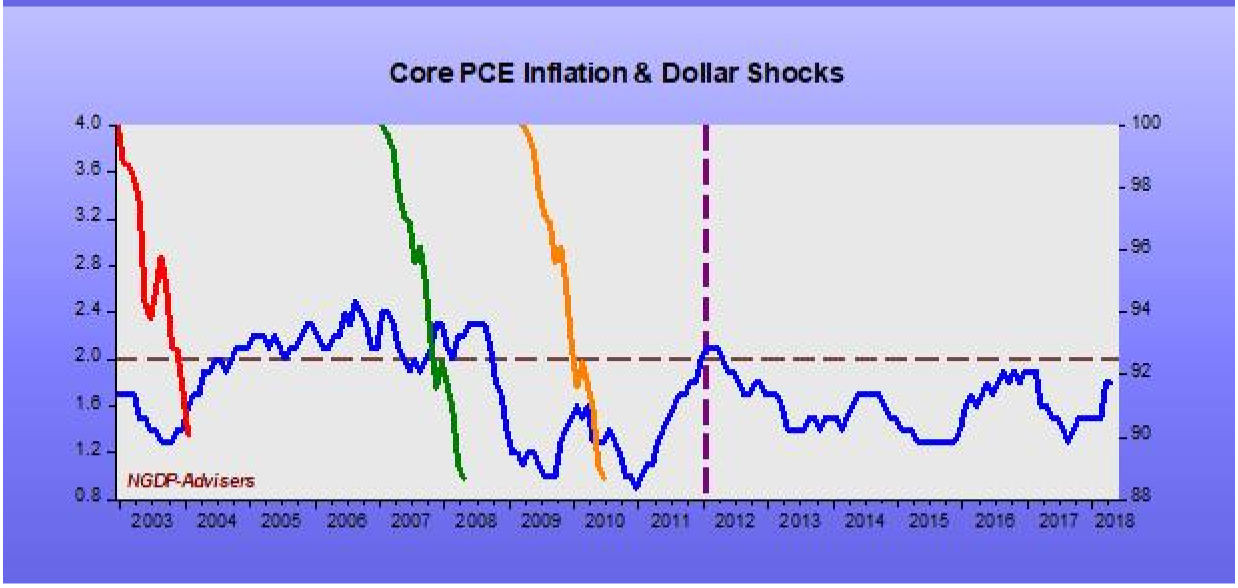
Historical experience – and recent evidence at the state level – indicates that the further unemployment drops below NAIRU, the higher wages and price inflation go up.

The others include, "weak dollar policy", "hospital inflation" due to rollbacks in the ACA, Trumps "trade wars", the repeal of "net neutrality rules" and "withdrawing from Iran´s nuclear agreement which will increase oil prices".

Curiously, despite spending more than a quarter-century at the heart of monetary policymaking, Peter Hooper does not think monetary policy has any role in inflation. In fact, he implies that the Fed is powerless to control inflation, which is all "cost-push."

The charts below show PCE core inflation and instances of oil and dollar shocks. In those instances, oil prices more than double in a relative short period and the dollar falls by 10% or more.





To all, inflation said: “My dear, I don´t give a damn”.

In a depression, recession calls are even harder to make

The flattening of the yield curve has generated heated discussions about a coming recession. Some like Bullard, for example, caution the FOMC´s appetite to raise rates. Others like Deutsche Bank, say yield curve flattening belies strong growth outlook for U.S:

> “The risks of overheating and inflation are much higher than the risks of a recession. And the irony of this discussion is that the low level of long rates, and hence, the flatness of the curve, is increasing the probability of

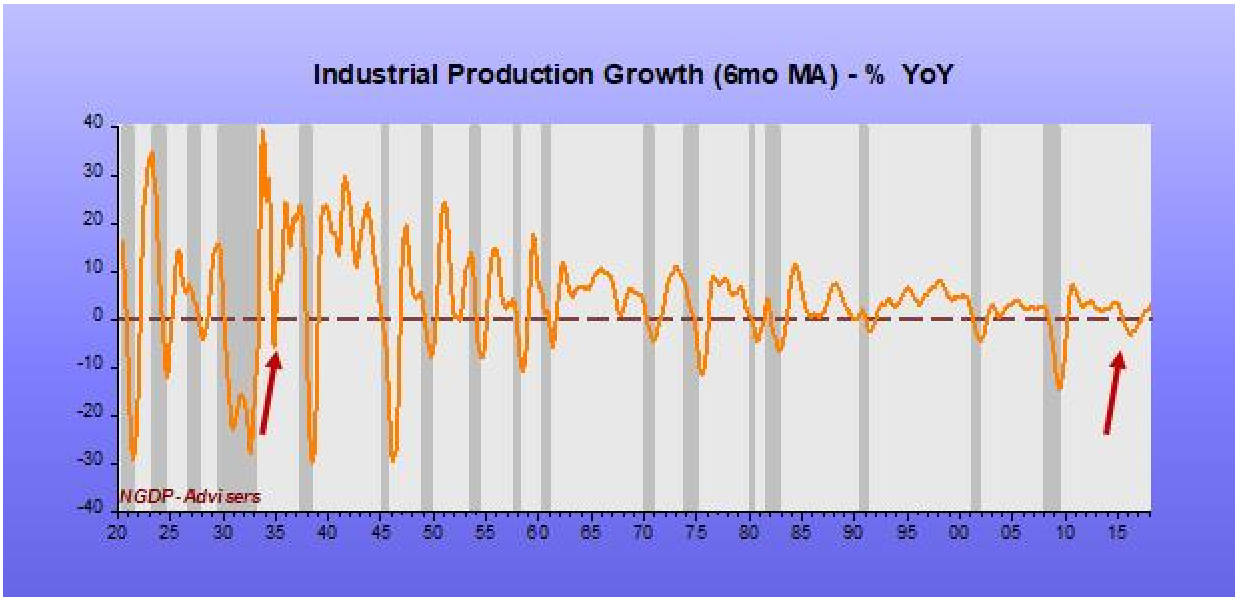
overheating even further.

Lower long-dated yields keep financial conditions loose, heightening the risk of an upsurge in growth, not a slump."

These opposing views only confirm the idea that predicting recessions is a "fool´s game".

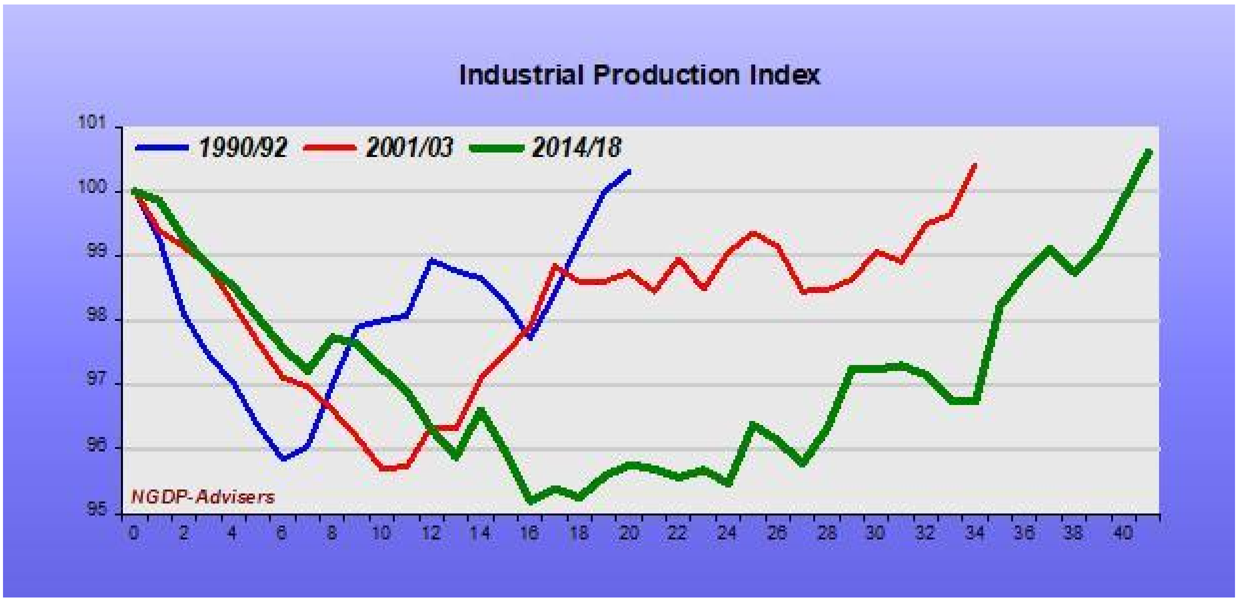
Usually, it takes a long time, frequently more than one year, for the NBER, the official business cycle dater, to say a recession has occurred. It is useful, therefore, to have on hand a good lagging indicator of recessions since it may indicate a recession has begun sometime before, and ahead of the official NBER call.

One such indicator is the 6-month moving average of industrial production growth. As the chart indicates, for the past 100-years only once before it gave a false positive, a negative reading on industrial production growth that was not followed by a recession call.



The 1934 false positive signal reflected the N.I.R.A interventions. What does the more recent 2015/16 false positive signal reflect?

From looking at the chart below, which graphs industrial production around the 1990/91 and 2001 recessions and what transpired in 2014/18, it is hard to fathom why there was no recession call in 2015/16.



My conjecture is that in an already weak or depressed economy, a further weakening does not necessarily result in a recession.

The charts below depicting nominal spending (NGDP) growth illustrate. In both cases, NGDP growth falls to similar levels, but the drop is much higher in 2000/03 than in 2014/18. In addition, in both cases, industrial production goes back to the initial level when spending growth returns to the initial level.

Bottom line: In the depressed state the economy finds itself, a recession will only be called when nominal spending growth drops significantly, probably to negative levels. We have to hope the Fed does not repeat the mistake of 2008 (or 1937). If it doesn´t, the economy will continue to chug along the depressed path it has travelled since 2010, unless it changes the framework to NGDP Level targeting.

Monetary & Fiscal Policy shouldn´t mix

Sweden´s finance minister thinks it should:

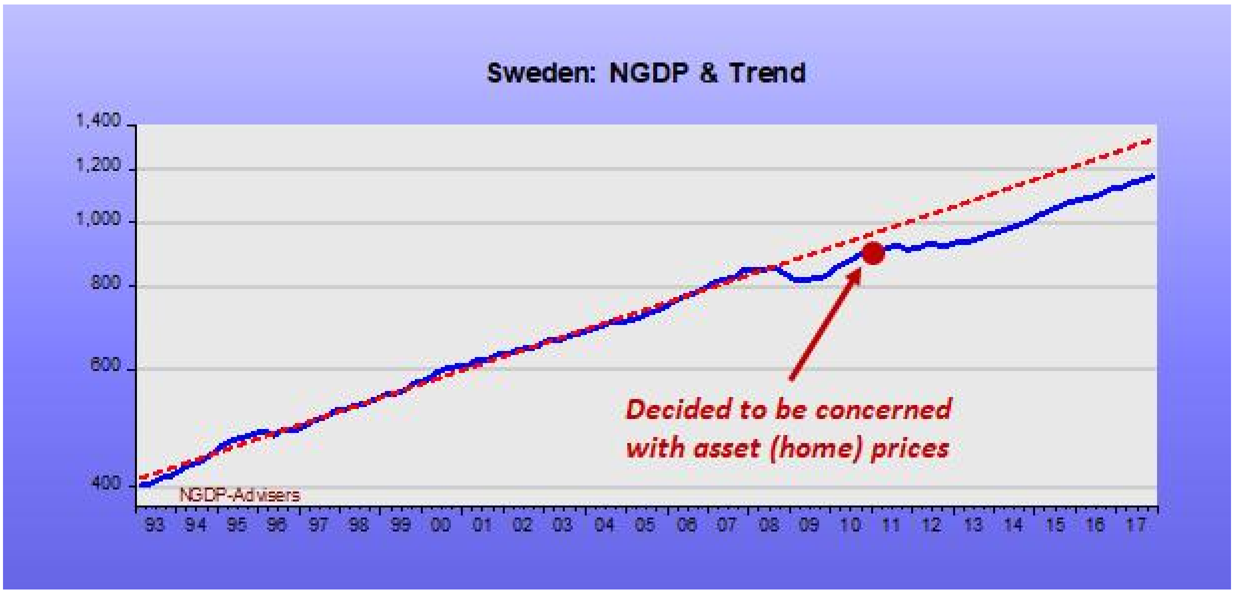
> Sweden's finance minister said it's time to look deeper into the framework of central bank independence.
>
> In an interview on Thursday in Stockholm, Magdalena Andersson argued that more research and discussion will be needed on how central banks and governments can coordinate policy responses in a crisis situation.
>
> "Looking back on the wave of reforms that made central banks independent, it's obvious today that it wasn't well thought through," she said. "There might be situations when fiscal and monetary policy need to work together in a way that's not possible under the present regulation.''

She goes on to say:

> Sweden, for example, already has a stability council comprised of the Riksbank, the Financial Supervisory Authority and the debt office, which could serve as a forum, according to Andersson.
>
> "Then you can discuss whether that is sufficient or not," she said. "I'm not ready to suggest any new policy suggestions, but it's a research field where I would like to see more research.''

It´s ironic that Sweden was doing better than most advanced countries central banks, until it decided that it should be concerned with asset (home) price bubbles in late 2010.

The chart shows that the situation, which was on a good "track", deteriorated significantly once monetary policy turned contractionary and NGDP growth relented.

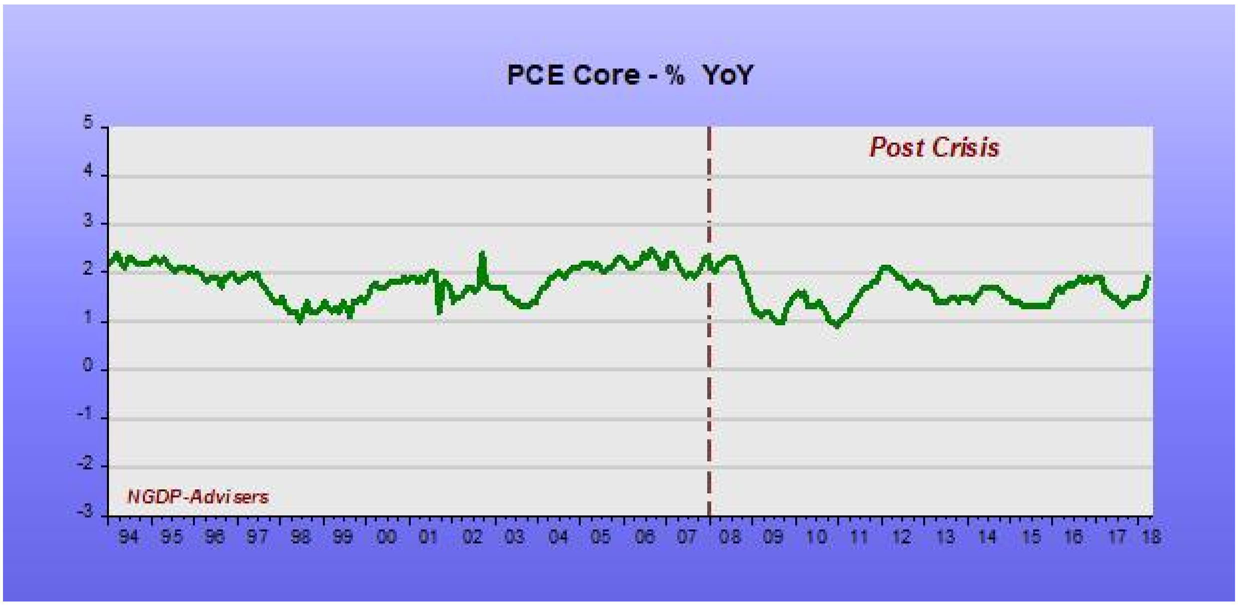


It would be much better if she showed concern about the Riksbank choosing an improved monetary policy framework, and not try to bring fiscal policy into the mix.

‘Splitting hairs’ on inflation

When inflation remains low and stable for as long as it has, people get “worried” and start looking for signs that show that cannot be true.

The chart below shows inflation of the core variety (which abstains from volatile elements to better show the inflation trend) for the past quarter century.



Then, the ‘dumb views’ proliferate. A recent one is telling:

> Inflation has been a **puzzle** in the U.S. economy for years, failing to move up much when the unemployment rate tumbled. To resolve the puzzle, it helps to look at the U.S. as two economies: **one for goods, another for services**.
>
> The goods economy has been transformed by trade and technological innovation over several decades, giving consumers access to inexpensive products made in foreign countries or automated factories. The services economy has been more sheltered from international competition and technological change. You can’t hire cheap Chinese labor to serve you pizza or a robot to teach your ninth-grader English.
>
> Because of those differences, inflation behaves differently in the two economies.
>
> “You can have technological innovations that lower the price of TVs, but our technology for, you know, haircuts doesn’t change as much,” says Michael Feroli, the chief U.S. economist at JPMorgan.
>
> The **divergence** between goods and services price inflation is especially important now because of the unusual behavior of consumer prices.

And people who should know better utter complete nonsense:

> A number of factors could rouse goods prices from their slump, economists say. President Donald Trump threatened last month to impose tariffs on up to $150 billion worth of goods imported from China, the U.S.’s largest trading partner, raising fears of a trade war. Mr. Trump’s decision this month to reinstate sanctions on Iran, a major oil producer, has helped send prices for crude to the highest levels since late 2014. A depreciation in the dollar due to large fiscal deficits or other concerns could make imports more expensive.
>
> “That would be **messy**,” said Vincent Reinhart, a **former Fed official** and the chief economist at Standish Mellon Asset

Management. “They should actually now be concerned about **too much inflation** because the thing that is costly to adjust (services inflation)…is already above the goal.”

Inflation is a rise in the overall level of prices. Relative price changes have no bearing on inflation, which is a monetary (not price or unemployment) phenomenon.

The chart below depicts the ‘split’ of overall core inflation between goods (or flexible) prices and services (or sticky) prices over the same 25 years.

Why, pray, should the Fed be concerned about “too much inflation”?

The source of inflation is nominal spending (determined by monetary policy). With subdued but stable nominal spending growth, you ‘reap’ subdued and stable inflation.

Does anyone believe the Fed is set to raise nominal spending growth?

The Federal Reserve Genuflects Again to 'Sustainable" 4.7% Unemployment Rates, and 1.8% Real GDP Growth Rates. Investor Beware.

The US Federal Reserve wants a higher rate of unemployment, at least from reading missives from the San Francisco branch. And slower economic growth.

In its May 10 "Fed Views", the San Francisco branch posits that 4.7% is the lowest "sustainable" unemployment rate, and 1.8% the maximum "sustainable" real GDP growth rate.

"We estimate 2.8% GDP growth in 2018, a full percentage point above our estimate of the long-run sustainable growth rate," reports the SF Fed.

They add, "We expect unemployment to decline further this year and through 2019, and remain below our estimate of the long-run rate of 4.7% for some time."

At 4.7% unemployment, there are about 1.3 to 1.4 people actively looking for work for every job opening. Thus the US central bank believes only when supply of labor exceeds demand is the labor situation "sustainable."

Fed's View Obsolete?

Of course, if there is such a thing as a "sustainable" rate of unemployment (and by whose metric?), it certainly must be highly variable, depending on culture, time and nation. In Japan, there are 159 job openings for every person seeking work at latest count, yet the problem in Japan remains a central bank that cannot hit its inflation target of 2%.

Evidently, the Fed does not brook the idea that perhaps recent decades have changed what is "sustainable" unemployment, or maybe even that the idea is weak to begin with, relying on an increasingly dubious "Phillips Curve" that posits lower unemployment leads to higher inflation.

And are Americans really to believe that US GDP must move into the slow lane, and permanently, to proceed with "sustainable" growth?

The SF Fed Solution

Fear not. The SF Fed posits the one solution to the permanently anemic economy that it forecasts and believes must bring about is…higher labor participation rates, but only for women. That is, women with children.

"Over the past two decades," says the SF Fed, "participation rates for Canadian women with a college degree have increased, and rates for Canadian women with a high school diploma have stayed the same. American women of both levels of educational attainment instead have reduced their rates of participation in the labor force over the same period."

The SF Bank adds, "However, one likely key to the story is the mix of policies in Canada aimed at providing employment protection for parents, and expansions of parental leave with income support."

Conclusion—Investor Beware

Yes, increased (mandated?) unemployment leave for parents is the ticket to more-robust US economic growth. Even as the Fed tightens the screws en route to a higher, 4.7% unemployment rate and slower, 1.8% real GDP growth. Or so says the SF Fed.

Macroeconomics in the US, as practiced, more and more resembles politics in drag. The SF Fed missive is exemplary not for macroeconomic insights, but for marrying SF-PC with Fed-PC.

Funny, I thought higher wages (perish the thought), or lower taxes on wages might encourage labor force participation, on the carrot side. On the stick side, lower unemployment benefits, or delayed Social Security retirement benefits. A phase-out of Veteran's Administration pensions and disability payments is another worthy option.

I have even fantasized that higher wages and strong aggregate demand might spur greater investment in plant and equipment, raising productivity. You know, like the 1990s.

Unzoning property along the West Coast, to enable workers to live near job creation, is another worthy idea.

Investor beware. The central bank wants more unemployment and slower economic growth. And mandated parental leave benefits.

Did The Bank of Japan Throw In the Towel? Has QE Flopped?

Under Governor Haruhiko Kuroda, the Bank of Japan has pursued a relatively strong quantitative easing program, and applied negative interest-rates on a large portion of bank deposits.

The Japanese central bank buys 10-year Japanese government bonds (JGBs), when rates rise above 0%. The BoJ has also become the largest buyer of equities in Japan, though its purchases of ETFs. The central bank's short-term policy rate is 0.1%, and the BoJ buys about $730 billion in bonds every year. The BoJ owns about 45% of the entire stock of JGBs.

By the pedestrian and ossified standards of central-bankers, Kuroda is a tiger.

But two weeks ago Kuroda, in some regards, tossed in the towel. The Bank of Japan, which has had a receding timeline to hit a meek 2% inflation target (IT), has abandoned the fiscal 2019 (through March of 2019) target date for hitting even that low bar.

Japan, by orthodox macroeconomic metrics, remains a puzzle.

For example, there are 159 job openings for every 100 job hunters, Japanese officials recently reported. The economy has been growing mildly in the last couple of years, around 1.3%, although Q1 may come in flat. The Japan CPI core in March was up only 0.9% YOY, and the yen is stronger against the US dollar than a year ago.

So Kuroda, in postponing yet again a target date for hitting 2% inflation, may be admitting that QE and low interest rates alone will not bring Japan to its IT 2% or strong GDP growth.

Upshot: Bring in the Choppers?

The outlook is edgy for Japan.

The Market Monetarists (a tribe to which I belong) generally support QE, and have thought that if a central bank does enough QE, it should work. But with the BoJ owning 45% of JGBs, and becoming a major shareholder though ETF purchases, and with labor conditions historically tight…one has to wonder if QE can turn the tide in Japan. If not now, when?

Even if QE eventually works in Japan, could any other central bank muster the resolve to be as tough as Kuroda & Co.?

Can one imagine the Fed being as persistent?

QE has been the topic of numerous academic and central bank studies, most of which conclude QE is weak tea. Certainly, the US “recovery” from the Great Recession has been sluggish (or as Marcus Nunes points out, still lacking compared to former trend-lines) while Europe, under the ECB-QE program, has also limped along,

Given the stalling nature of inflation and the economy of Japan, one must ponder if money-financed tax cuts, aka helicopter drops, are a sensible next step for Tokyo.

And when recession comes again to the West, should central bankers go to 1) QE, or 2) QE plus government deficits (a lot like money-financed fiscal stimulus), or 3) bald-faced money-financed fiscal stimulus?