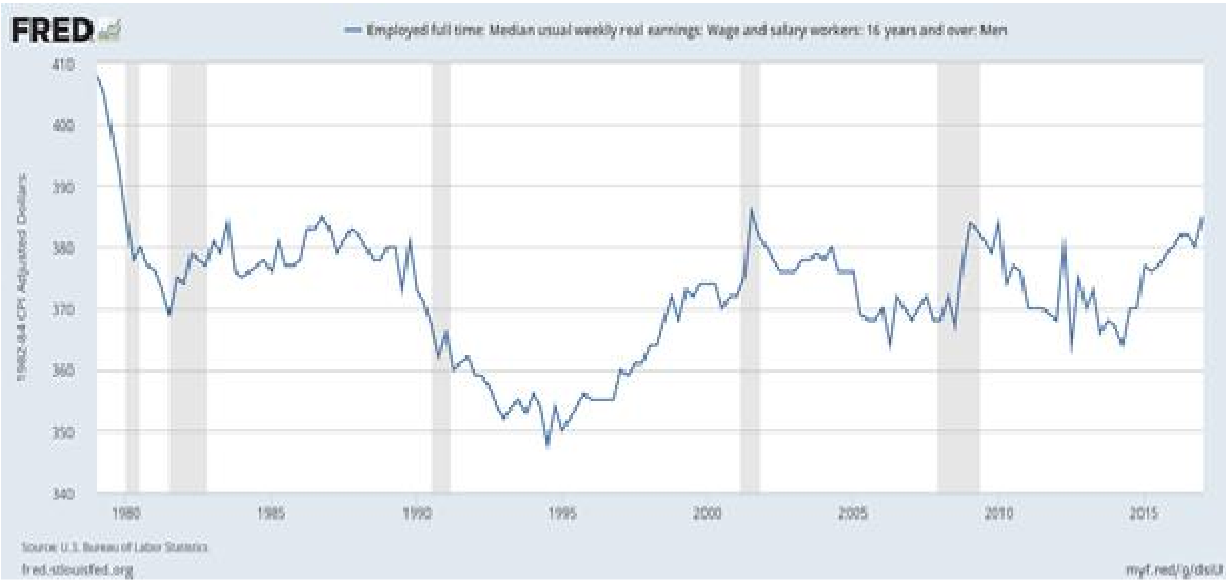
The Fed Becomes a Demoralizing Embarrassment

The U.S. Federal Reserve is tightening its noose on the U.S. economy, despite being below its 2% PCE inflation target, and despite the sluggish wages that define the American job scene: real hourly wages are down in Q1 (the latest reading) and are up 3.1% in the last 10 years.

However, the picture may be even sourer. As the chart of real median weekly earnings for males aged 16 to 64 shows, for nearly four decades real earnings has been flat to down, and such workers make less today than in 1979.



Even with the slow-footed recovery of eight years, and the current 4.3% unemployment rate, there are presently about 1.2 people looking for work in the U.S., for every job opening.

Of the droopy labor market, the Fed opined in the latest Beige Book that, “Labor markets continued to tighten, with most Districts citing shortages across a broadening range of occupations and regions.”

And now this, courtesy of the regional San Francisco Fed, which also finds staff to pontificate on the national economy: “The labor market has further strengthened and appears to be at or even beyond full employment.“

The Fed and its sinecured staff suggest that a 4.8% unemployment rate, up from the current 4.3% unemployment – that is, when about 1.5 people are seeking work for every job opening–is the bare minimum tolerable unemployment rate.

How does the Fed settle on the ideal of 4.8% unemployment?

The unemployment rate in Japan is 2.8%. There are 1.34 job openings for every job hunter, and still no inflation.

What should the employee-class in the United States make of this? Real wages have been soft for 40 years, and now the central bank says the national labor market is "beyond full employment."

If the Fed is correct, then the U.S. cannot deliver higher living standards to employees, not now, and not in the last 40 years.

Conclusion

More dole and trade adjustments and Ivanka Trump-inspired paid maternity leave is not the path to higher living standards for Americans. A Fed that targets NGDPLT, and preferably errs on the high side, would be a big step in the right direction.

Orthodox macroeconomists and globalists have been making a case that open borders for immigration and rising trade deficits are in fact raising U.S. living standards, and that the Trumpsters are economically illiterate to suggest otherwise.

But the globalist promise appears somewhat hollow given 40 years of flat-to-down real weekly earnings, and in fact trade deficits are probably accelerating house price appreciation (due in large part to property zoning), according to a New York Fed study.

When empirical observations fly in the face of theories, what to do?

To remain relevant, orthodox central bankers and modern-era macroeconomists need to revise what is prominently discussed and treated by policy. The Phillips Curve is dead, but housing shortages and higher housing costs are rampant.

If what central bankers and national policy-makers promise is more of the same—more decades of higher house prices and stagnant wages—then who can blame the voting public for choosing something other than globalism and free enterprise?

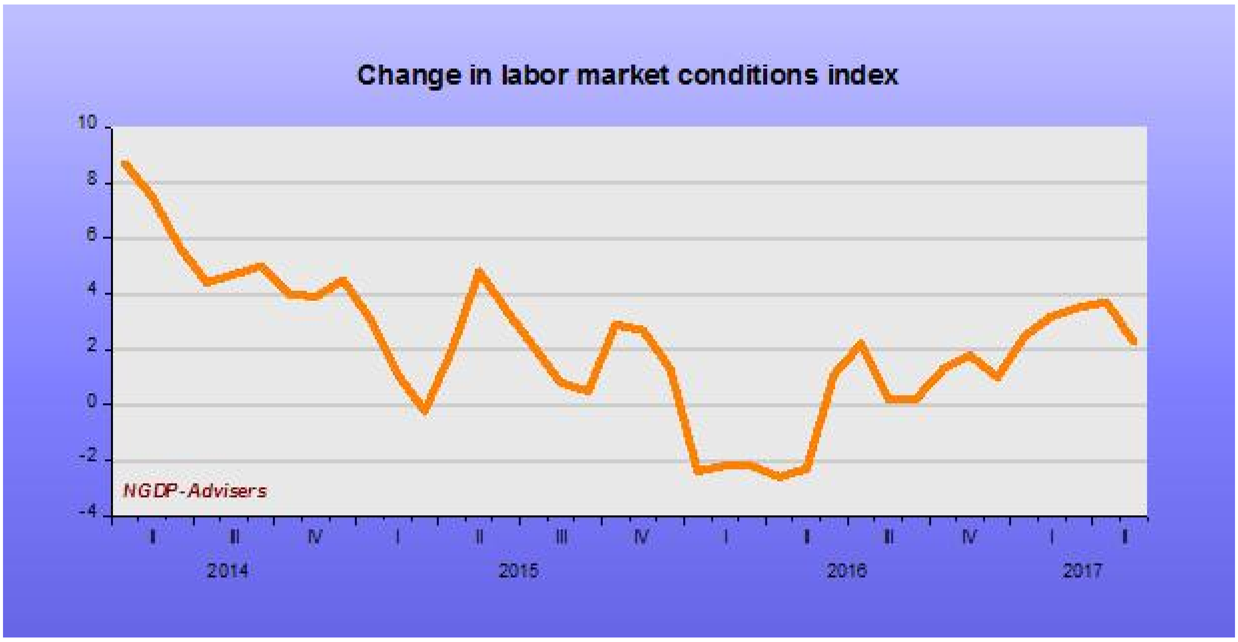
The three finalists in 2016 for the U.S. presidency in the last election were Donald Trump, Bernie Sanders and Hillary Clinton.

Think about that.

For investors, there remains the possibility the Fed, obsessed with 2% inflation and fleeting bumps in wages will choke off this long but weak expansion.

The Federal Reserve Labor Market Conditions Index Drops Again

The Federal Reserve's Labor Market Conditions Index for May was released this week, and it is still hewing to pattern of general decline observed for the last three years.



Yet at the end of May, the same central bank said in its signature Beige Book report that, "Labor markets continued to tighten, with most Districts citing shortages across a broadening range of occupations and regions."

My economic training tells me that labor shortages in a growing national economy, with corporate profits at all-time highs, would result in stiff wage hikes.

Oddly enough, in the first quarter of 2017 real compensation fell, the latest quarter for which figures are available. But that was one quarter, and a single reading does not a story tell.

Taking a longer view, real compensation per hour has risen by 3.1% since the first quarter…of 2007. In 10 years, real wages are up 3.1%.

Anecdotes

It is sad enough when the blogosphere recites anecdotes, husbanding stories about, say, the car lot in Jaspar, Alabama that cannot find salespeople at even at $10,000 per month. $120k a year to sell cars? Call me "Bama," 'cause I am buying a toupee and moving south.

But when a central bank places credence in anecdotes or business grousing as the foundation for monetary policy, one gets a serious sinking feeling.

The numbers are just not there that wages are rising, and the anecdotes—well, here are some anecdotes from Indiana, a state where there is an official 3.2% unemployment rate, which is lower than the national average of 4.3%.

According to the job-listing service Indeed.com, the average wage offered for a server in a restaurant in Indiana is $9.46 an hour. The average for an assembler in production is $11.08 per hour. The average job ad for an Indiana construction worker is $13.45 an hour. This is in a state with "tight" labor markets.

Conclusion

For whatever reasons, the Fed appears intent on raising interest rates and possibly selling a few trillion dollars in bonds in the coming seasons. With no hard national numbers to paint a picture of rising wages and inflation, the central bank is reduced to citing subjective observations of business enterprises in contact with district banks, who report "labor shortages." One might expect such governance in the colonial Philippines, but it is a demoralizing embarrassment in present circumstances.

For investors, it may be the best that can be hoped for is more slow growth, while most asset classes appear fully priced. The central banks and economies of Japan and mainland China may become locomotives, thus averting global recession. It is not sure footing ahead.

A veritable "festschrift" on a (new & higher) inflation target

After building-up for several years, the view that the Fed should increase its inflation target has "boomed".

The progression:

2010, 2014, 2016, 2017A, 2017B, 2017C

The July 1996 FOMC Meeting witnessed an extended discussion of inflation targeting. Interestingly it was Janet Yellen and Laurence Meyer´s first FOMC Meeting. Interesting because they are the two strong Phillips Curve adepts!

What I found of greatest interest in the discussions was Greenspan´s intervention (on page 72):

> "The discussion we had yesterday was exceptionally interesting and important. ***I will tell you that if the 2 percent inflation figure gets out of this room, it is going to create more problems for us than I think any of you might anticipate."***

Interesting exchange (pages 50/51):

YELLEN. Mr. Chairman, will you define "price stability" for me?

> CHAIRMAN GREENSPAN. Price stability is that state in which expected changes in the general price level do not effectively alter business or household decisions.
>
> YELLEN. Could you please put a number on that? [Laughter]
>
> CHAIRMAN GREENSPAN. I would say the number is zero, if inflation is properly measured.
>
> YELLEN. Improperly measured, I believe that heading toward 2 percent inflation would be a good idea, and that we should do so in a slow fashion, looking at what happens along the way. My presumption based on the literature is, as Bob Parry summarized it, that given current inaccurate

> measurements, heading toward 2 percent is most likely to be beneficial.

Flash forward to 2014: "Of Kiwis and Currencies: How a 2% Inflation Target Became Global Economic Gospel":

> Yet even as the idea of a 2 percent target has become the orthodoxy, a worrying possibility is becoming clear: What if it's wrong? ***What if it is one of the reasons that the global economy has been locked in five years of slow growth?***
>
> Some economists are beginning to consider the possibility that 2 percent inflation at all times leaves central banks with ***too little flexibility to adequately fight a deep economic malaise***.

And today: "One simple action the Fed refuses to take could make its policies a lot more powerful"

> There is an easy step officials at the Federal Reserve could take to ***improve their ability to fight the next recession***, but policymakers are deeply reluctant to go there: raising the central bank's 2% inflation target.
>
> That's because with inflation chronically undershooting the Fed's goal and interest rates still below 1%, they worry the central bank may not have much room to ease monetary policy further the next time the economy runs into trouble.

"Too little flexibility/constrained ability" is the standard argument put forth by all proponents of a higher inflation target.

The Letter to the Federal Reserve Board signed by 22 prominent economists on June 8 argues that:

> One of these key parameters is the rate of inflation targeted by the Federal Reserve. In years past, a 2 percent inflation target ***seemed to give ample leverage with which the Fed could lower real interest rates***. But given the evidence that the equilibrium interest rate had fallen substantially even prior to the financial crisis, and that

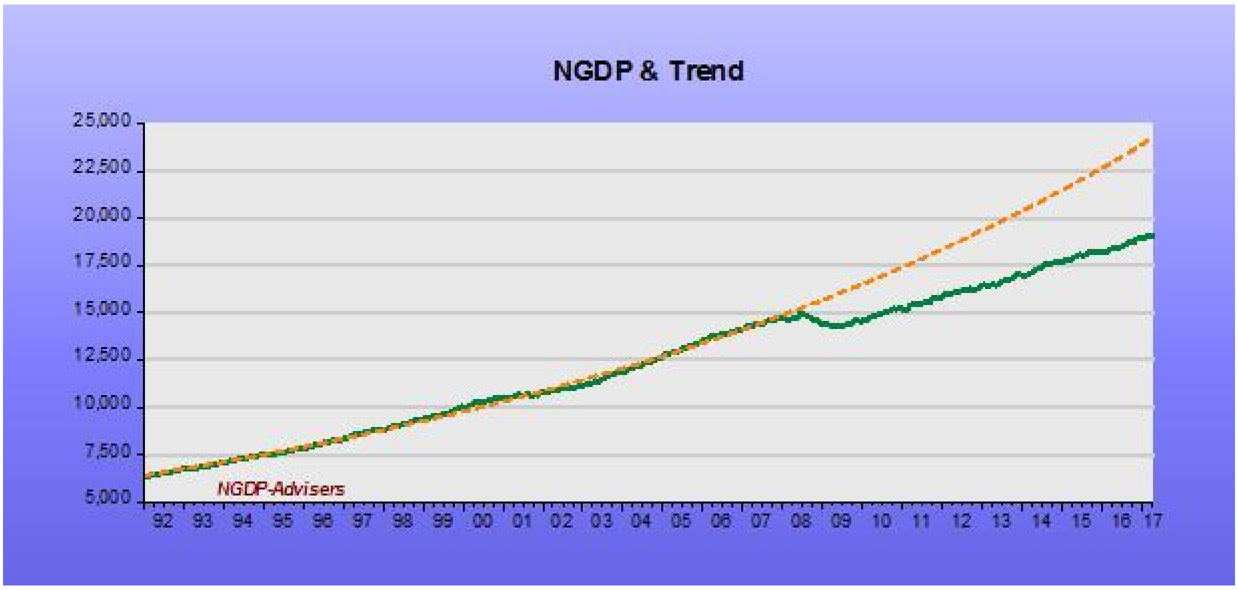
> the Fed’s short-term policy rate remained at zero for seven years without sparking any large acceleration of aggregate demand growth, a reassessment of this target seems warranted.

Concluding:

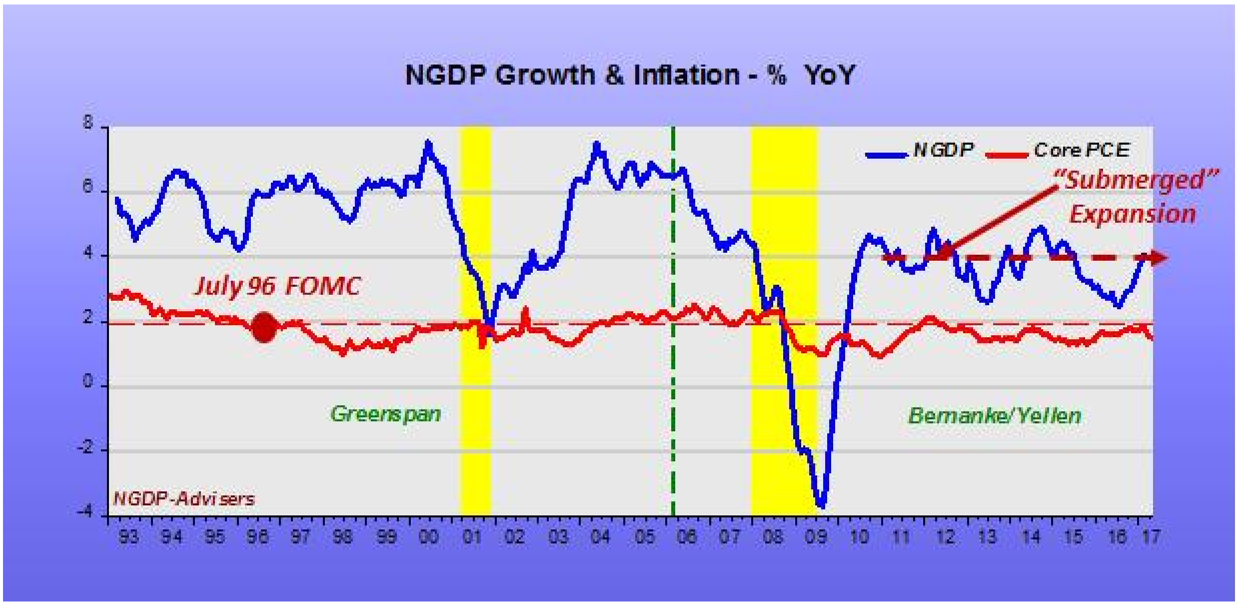
> Economies change over time. Recent decades have seen growing evidence that developed economies have ***harder times generating faster growth in aggregate demand than in decades past***. Policymakers must be willing to rigorously assess the costs and benefits of previously accepted policy parameters in response to economic changes.
>
> ***One of these key parameters that should be rigorously reassessed is the very low inflation targets that have guided monetary policy in recent decades***. We believe that the Fed should appoint a diverse and representative blue ribbon commission with expertise, integrity, and transparency to evaluate and expeditiously recommend a path forward on these questions. We believe such a process will strengthen the Fed as an institution and its conduct of monetary policy, and help ensure wise policymaking for the years and decades to come.

The Letter implicitly shows that what we all want is not a higher inflation target, but a higher ***level*** of aggregate demand (nominal spending or NGDP), and possibly a higher ***growth rate*** of aggregate demand.

The first chart below is very clear on that point. Aggregate demand fell off the trend path and there was no effort made to engineer a recovery, i.e. put the economy back on the path. All we´ve experienced is a “submerged” expansion!



The next chart clearly indicates that what the economy lacks is faster growth in aggregate demand, to enable a higher trend path of spending.



To get aggregate demand to a higher ***level***, the Fed should increase nominal growth. Once a higher (adequate) level of demand is attained, a decision can be made on the appropriate growth rate going forward.

Over the quarter century depicted in the charts, core PCE inflation has remained low and stable. From 1993 to 2005, it averaged 1.9%. From 2006 onwards it averages 1.7%. Note that when the July 1996 FOMC Meeting that discussed inflation targets took place, core PCE was 1.9%!

Therefore, the big change has been in how the Fed has managed aggregate demand. Adequately before 2006 and poorly thereafter. Note how NGDP growth wanes as soon as Bernanke takes over, crashing in 2008 when the Fed reacted strongly to the increase in headline PCE inflation following the 2007-08 oil shock.

The wage/NGDP ratio explains all the movement in the unemployment rate. When NGDP tanks in mid-08, wage stickiness causes a strong rise in the ratio. Unemployment shoots up. When NGDP growth picks up, even if along a "submerged" expansion, unemployment comes down together with the wage/NGDP ratio. When the ratio stabilizes after mid-2015, so does the unemployment rate.

I have a hard time understanding why the concept of inflation targeting, plucked from thin air in New Zealand almost 30 years ago, remains as the only viable alternative for monetary policy. It is ironic to see prominent economists now arguing, after a long (and successful) battle to contain inflation, that it will be "good" to increase the desired inflation rate!

On the other hand, the idea that the Fed should target nominal spending (some favored level targeting while others favored growth targeting) has been around since at least the 1950s (Clark Warburton, Leland Yeager). In his 1977 Nobel Lecture, James Meade said:

> Earlier I spoke of 'price stability' as being one of the components of 'internal balance'. Yet in the outline which I have just given of a possible distribution of responsibilities no one is directly responsible for price stability.

> To make price stability itself the objective of demand management would be very ***dangerous***. If there were an upward pressure on prices because the prices of imports had risen or because indirect taxes had been raised, the maintenance of price stability would require an offsetting absolute reduction in domestic money wage costs; ***and who knows what levels of depression and unemployment it might be necessary consciously to engineer in order to achieve such a result?***

Flash forward thirty years to 2007 and the "danger" materializes under Bernanke´s Chairmanship of the Fed. This mostly happens because Bernanke was known as an ardent defender of inflation targeting and would likely act accordingly (As most IT central banks did).

This is likely what Greenspan had in mind when he warned "***I will tell you that if the 2 percent inflation figure gets out of this room, it is going to create more problems for us than I think any of you might anticipate".***

Later in his Lecture, James Meade said:

> I have told this particular story simply to make the point that the choice between fiscal action and monetary action must often depend upon basic policy issues which should certainly be the responsibility of the government rather than of any independent monetary authority.
>
> **Perhaps the best compromise is an independent monetary authority charged so to manage the money supply and the market rate of interest as to maintain the growth of total money income on its 5-per-cent-per-annum target path, after taking into account whatever fiscal policies the government may adopt**.

Later the nominal income-targeting concept was favorably discussed by Bennett McCallum in the 1980s and by Mankiw and Robert Hall in the early 1990s.

And since the Great Recession intervened, Nominal Income Level Targeting has been the banner hoisted by Scott Sumner.

Low unemployment: Root of all evil?

Yes, according to this piece: "Other Times Unemployment Has Been This Low, It Didn't End Well"

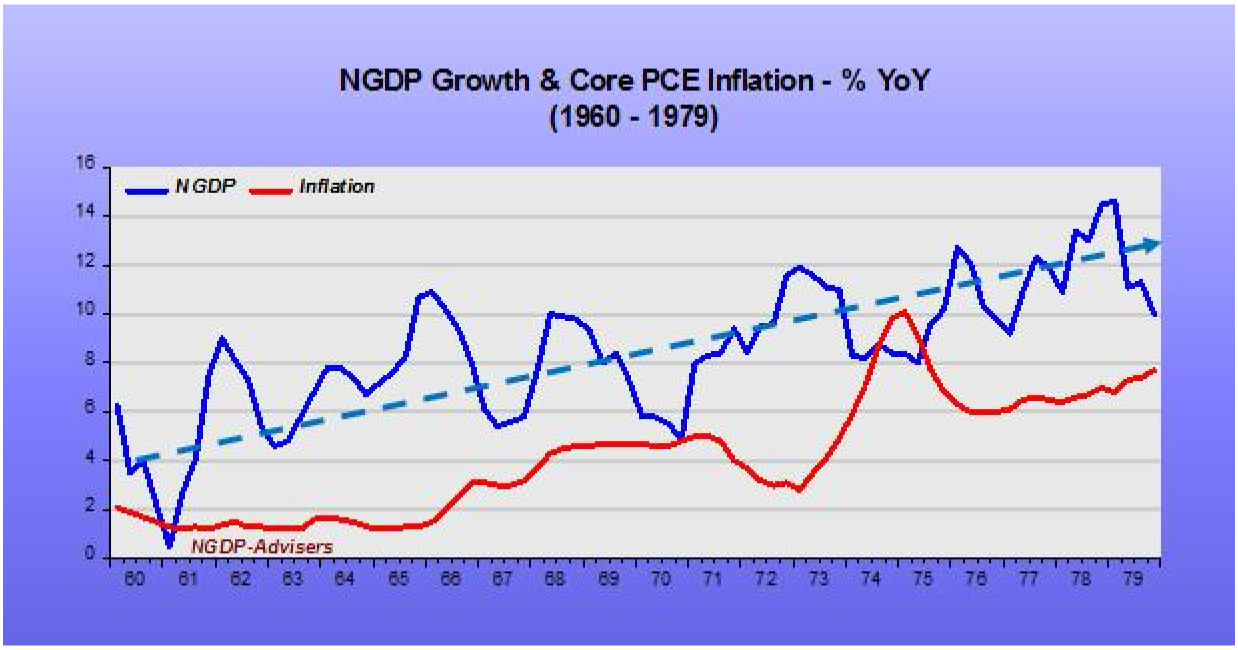
> There have been only three fleeting periods in the past half-century when the U.S. unemployment rate was as low as it is today.
>
> This would be cause for celebration but for one disturbing fact: in hindsight, each period was associated with boiling excesses that led to serious economic trouble.
>
> Low unemployment of the late 1960s preceded an inflation spiral in the 1970s. The late 1990s bred the Dot-com bubble and bust. The mid-2000s saw the buildup and collapse of U.S. housing.
>
> While there is reason to believe today's economy isn't boiling over as in the past, those episodes call for caution.
>
> "It's not a matter of superstition, it's a matter of being mindful of the history of what such a low unemployment rate usually is followed by," said Michael Feroli, chief U.S. economist of J.P. Morgan Chase & Co.

By episode:

1.

> While initially a welcome development, ***low unemployment in the 1960s laid the groundwork for a buildup of wage and price pressures***, spurred on by low interest rates and aggressive government spending programs.
>
> The unemployment rate dropped to 4.3% in September 1965 and then below 4%. Today's unemployment rate, also at 4.3%, could drop below 4% in the next year if it maintains its present trajectory.

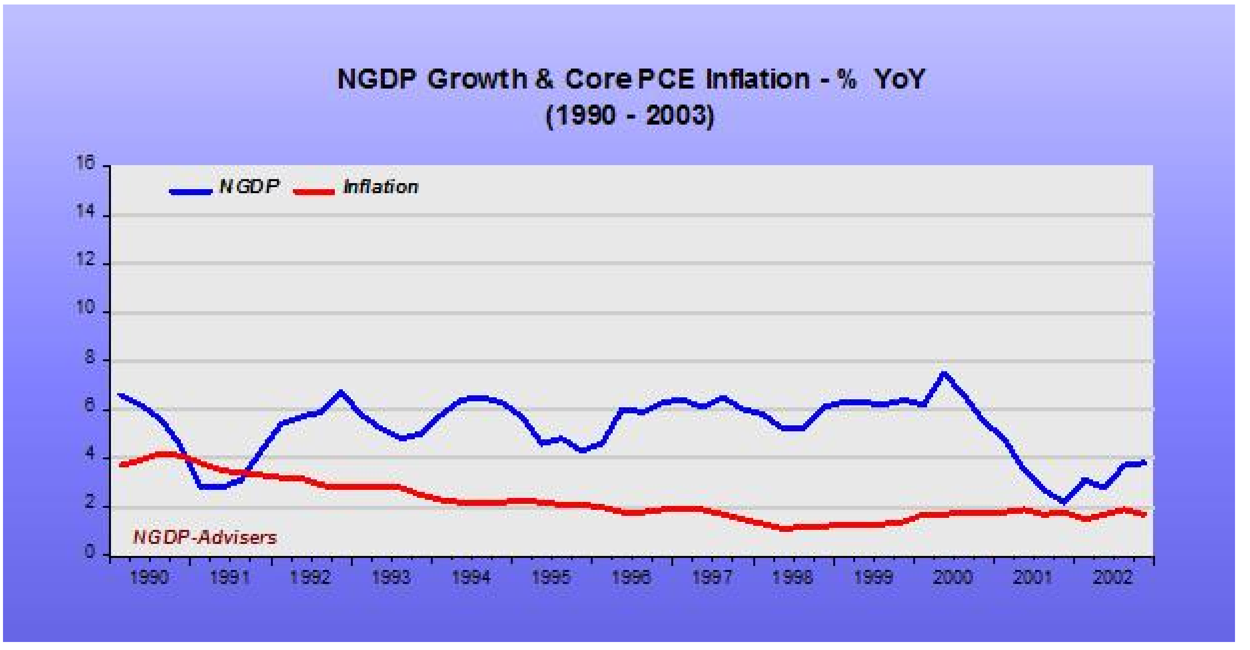
Low unemployment did not lay the groundwork for anything. As the chart illustrates, the rise in inflation was the child of “irresponsible” monetary policy that put nominal spending growth on an upward trend.



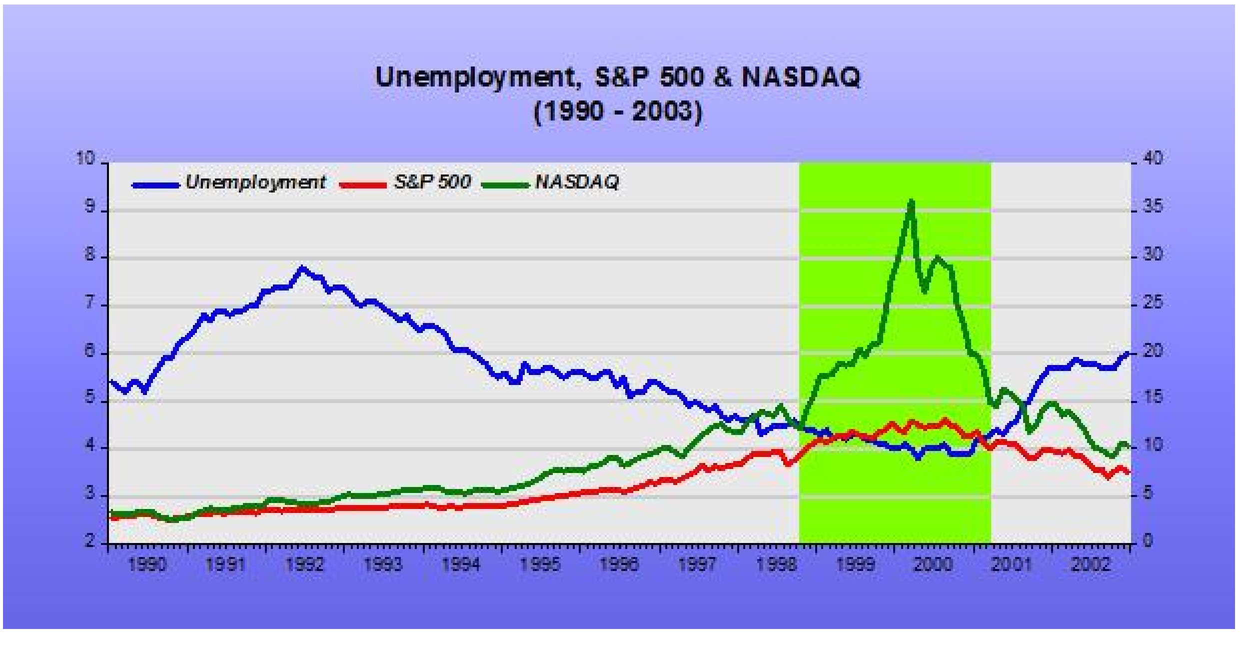
2.

> Unemployment returned again to 4.3% in January 1999. This time the inflation rate remained below 2% and it seemed that, unlike the late 1960s, the economy wasn’t overheating.
>
> But asset prices—the stock market in particular—soared after what had already been a long climb. The Dow Jones Industrial Average shot above 10000 for the first time in March 1998. Highflying tech companies commanded billion-dollar valuations with no profits to report. In hindsight, an internet bubble grew out of control.

Illustrating again: Inflation remained low and stable because monetary policy was “responsible”.



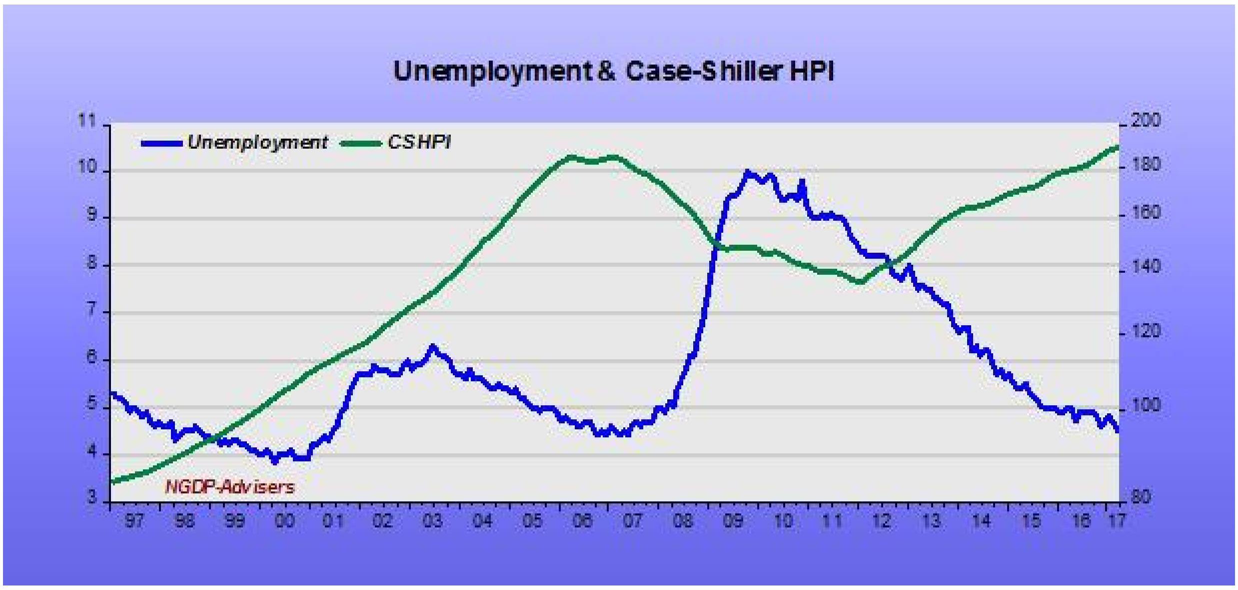
It wasn´t asset prices that soared, but the Nasdaq in particular. Strong productivity growth and the siren song of technology companies were the “culprits”, certainly not low unemployment (and low inflation).



3.

Unemployment fell back to 4.4% by October 2006. It coincided with a home- price boom that happened even though broader inflation measures remained stable. When home prices fell, a financial sector deeply exposed to mortgage credit collapsed and the economy entered the longest and deepest recession since the Great Depression.

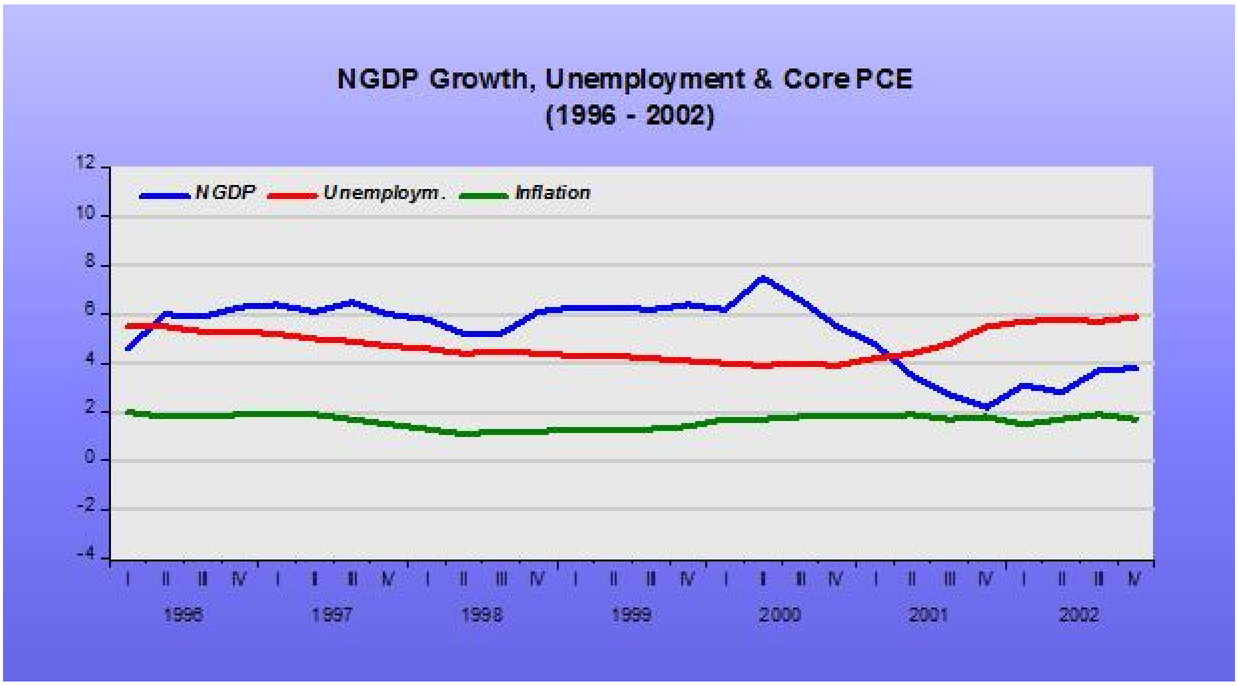
A “coincidence” is just that. But the statement is not even true. Booming house prices had begun almost ten years earlier. When unemployment fell to 4.4% house prices had already peaked. The house price boom was the consequence of many things, among them distorted public policy leading to moral hazard. Certainly not a consequence of low unemployment.

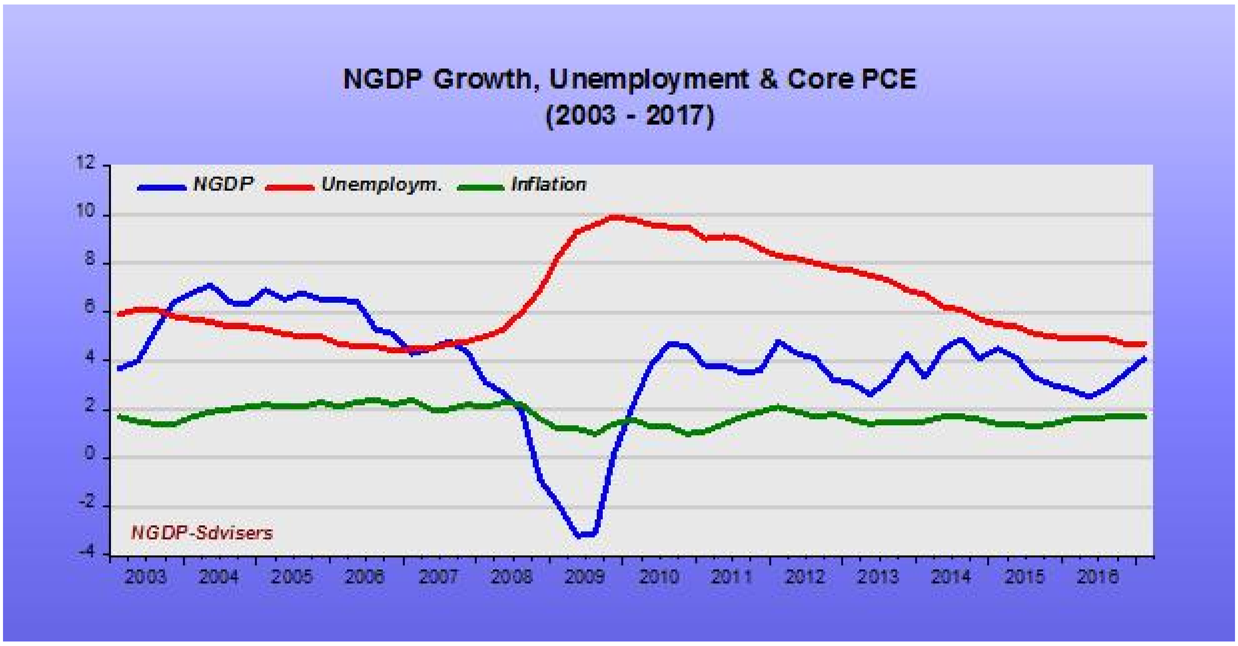


The conclusion “throws the argument away”!

> ***There is no telling how long this low unemployment period will last***. Previous episodes of low unemployment went from a few months to several years with no predictable regularity or end. Still, the broader historical lesson looms: ***Eventually, these low unemployment cycles end***.

Yes, they do end, but only when, given low inflation, monetary policy becomes “inadequate” or, in the extreme, “irresponsible”. The charts illustrate.





Global Monetary Policy Flounders On The Rocks Of Property Zoning?

The listed Henderson Land Development recently paid $3 billion for a parking garage in Hong Kong, a price made only somewhat less jaw dropping by the fact the plot of land allows for a 465,000-square-foot development.

If Henderson were to conjure up a medium-sized office tower for free in Hong Kong, it would still have to sell it for $6,450 a square foot just to break even. By way of comparison, a class A office tower on Chicago's Magnificent Mile with a 22,000-square-foot Apple store on the ground floor just sold for $370 million, or $487 a square foot.

That's not all; Hong Kong house prices have about doubled since 2011.

Not surprisingly, the Hong Kong Monetary Authority is concerned, and on June 1 cut the allowable cap for construction finance to 40% of site value and 80% of construction cost, with the overall limit reduced to 50% of the expected value of completed properties.

In short, the HKMA's is moving to restore "financial stability" and tame property prices, but also inevitably and ultimately cut the supply of built property. Restricting the supply of a good is an odd way to lower the price of a good.

Of course, Hong Kong is but an amplification of land prices in many global or attractive cities. The average house in Sydney is now $1 million, and the middle-class is boxed out of housing in Great Britain. The average one-bedroom apartment in Los Angeles rents for $1,730. Vancouver is placing new fees on foreign ownership, joining much of Australia in trying to tamp down foreign capital inflows into property. Meanwhile, the ordinary commuter suburbs of Boston's yesteryear now have million-dollar barrier-to-entry hurdles.

And in every nation with soaring property values, central banks are raising the monetary noose—but sadly, that's a suffocation strategy that will throttle all industries and employees, not just real estate. See 2008.

In every case of high property prices, there is a better solution than monetary suffocation: End property zoning, and let free markets rule. Expand supply.

Yet orthodox macroeconomists continue to advocate monetary and trade policies as if banking and finance had not become an adjunct to the zoned-property industry, and as if heavy foreign capital inflows do not often exacerbate property price booms. (A recent Fed paper concluded current account deficits lead to skyrocketing house prices.)

Yet the topic of property zoning might as well be taboo.

And as if on cue, the Fed’s Beige Book on the national economy came out on May 31, and at least four times mentions “labor shortages.” The Fed summary reads in part, “Labor markets continued to tighten, with most Districts citing shortages across a broadening range of occupations and regions.”

There are now about 1.4 people looking for work in the United States for every job opening. Real labor compensation in Q1 was up 1.3% YOY.

The words “property zoning” or “housing shortages” do not appear in the Beige Book report.

Conclusion

It is a curiosity of our time that orthodox macroeconomists and central bankers in developed nations call for embracing tighter money and enduring widening trade deficits, when both penalize the macro economy, given slow growth and ubiquitous property zoning. Tight money but trade deficits will restrict the supply of built property and increase the demand for investable property at the same.

For investors, this makes for a tricky game. The current low-growth picture may be the best that can be hoped for. The risk remains that global central banks, led by the Federal Reserve Board, will bring about even lesser growth rates and possibly stagnation

It would help if central banks engaged in nominal GDP level targeting, which might help dodge false signals sent by artificial property markets and international capital flows. For now, the Fed is acutely attuned to inflation and labor markets.

Unpleasant rumblings in EUR land

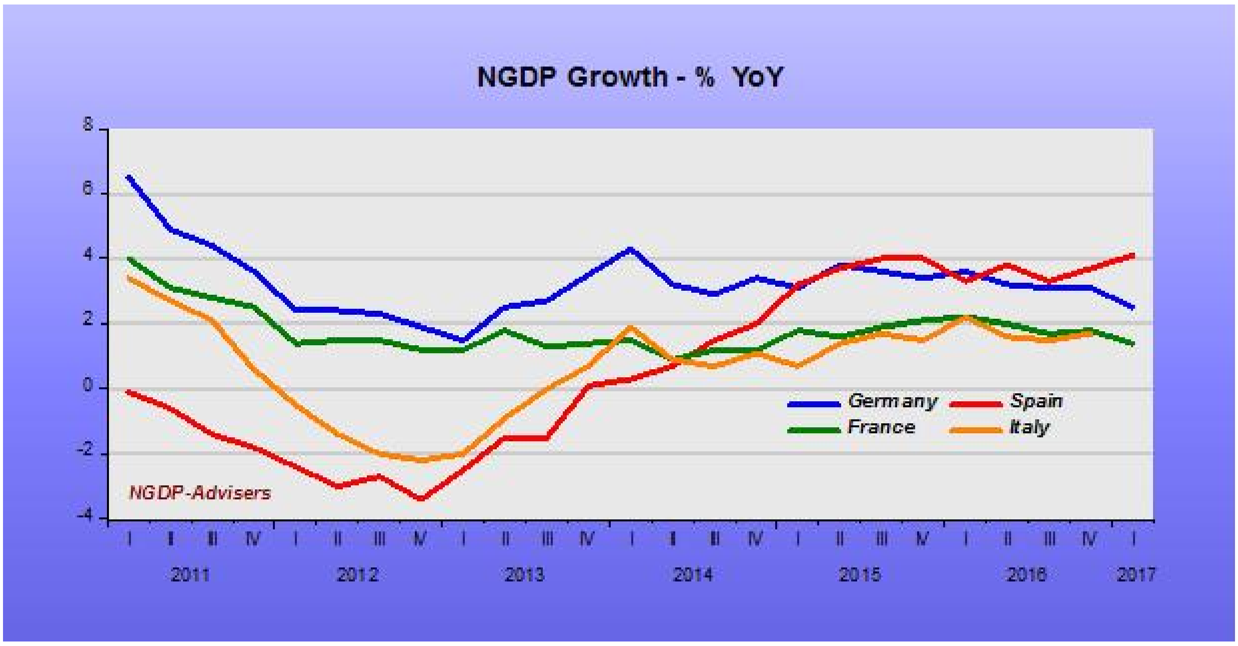
As some debate raged in the corridors of the ECB about both Draghi’s successor and over when and how to end the QE for the EUR, the common currency remained strong, helping keep the USD weak.

Draghi has been such a relative force for good at the ECB, boldly implementing QE and other measures to achieve the unachievable target of “less than but close to” 2% inflation that he will be missed if he goes. Sure, he hasn’t campaigned at all for a more sensible flexible inflation target, at least not publicly. He has slightly reinterpreted it as a sustainable inflation rate of “less than but close to” 2% – which could mean above 2% for a while, just like the Bank of England.

While his flexibility is very welcome, it may not survive his going. Such is the power and prestige of the ECB President that discretionary policy is still the order of the day. A potential successor is Jens Weidman, a German who seems to have little grasp of monetary economics just as Draghi’s hugely damaging predecessor, Trichet. Mrs Merkel, Weidman’s sponsor, has again talked of the EUR as being too weak, as local German economic conditions are apparently more important than those for the EUR area as a whole.

Even German economic conditions seem spurious as a reason to want to tighten monetary policy for the EUR.

Germany’s nominal GDP growth weakened considerably in 2017Q1. Last week’s figures showed that YoY growth rate dropped to 2.5% and the QoQ (not annualised) was a meagre 0.35%. France had already reported similarly weak numbers indicating that for the EUR region as whole NGDP growth will have slipped back to 2.5% or so – lately, Germany is usually the average, as faster Spain often offsets slower France and Italy.



Yes, interest rates should be banned from monetary policy discussions

At the Mercatus Center, Thomas Raffinot has an important working paper:

> According to the conventional view, low interest rates are associated with "loose" monetary policy, leading to higher inflation, whereas high interest rates are associated with "tight" monetary policy, leading to lower inflation. ***Interest rates, however, are unreliable indicators of monetary policy***: low interest rates could be the outcome of tight monetary policy just as high interest rates could be the outcome of loose monetary policy.
>
> In "Interest-Rates-Free Monetary Policy Rule," economist Thomas Raffinot reassesses the stance of monetary policy based on a forward generalization of the Taylor rule ***without reference to interest rates***. Using this new proposed rule as a yardstick, Raffinot evaluates the stance of monetary policy in the eurozone and the United States and argues that tight monetary policy explains (1) the historical collapse in nominal GDP in both regions during the Great Recession and (2) the slow recovery that followed despite the period's low interest rates.

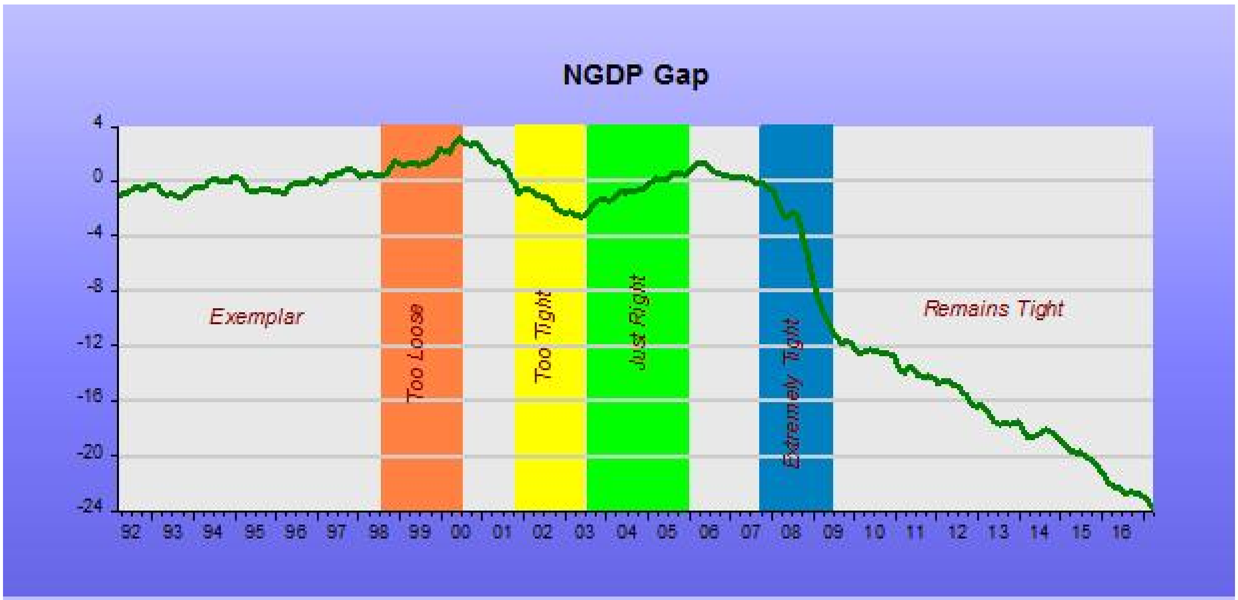
This is a welcome advance. Interest rates should be "banned" from monetary policy decisions and discussions. As 2008 showed, the consequence can be tragic! However, there is still something amiss because Raffinot finds that:

> The ***ex post analysis reveals that monetary policy in the United States was too loose from 2004 to 2007 but has been too tight since 2008***. The ***real-time analysis fails to show that monetary policy was too loose from 2004 to 2007, but it does show that monetary policy was too tight in 2008 and subsequent years.***

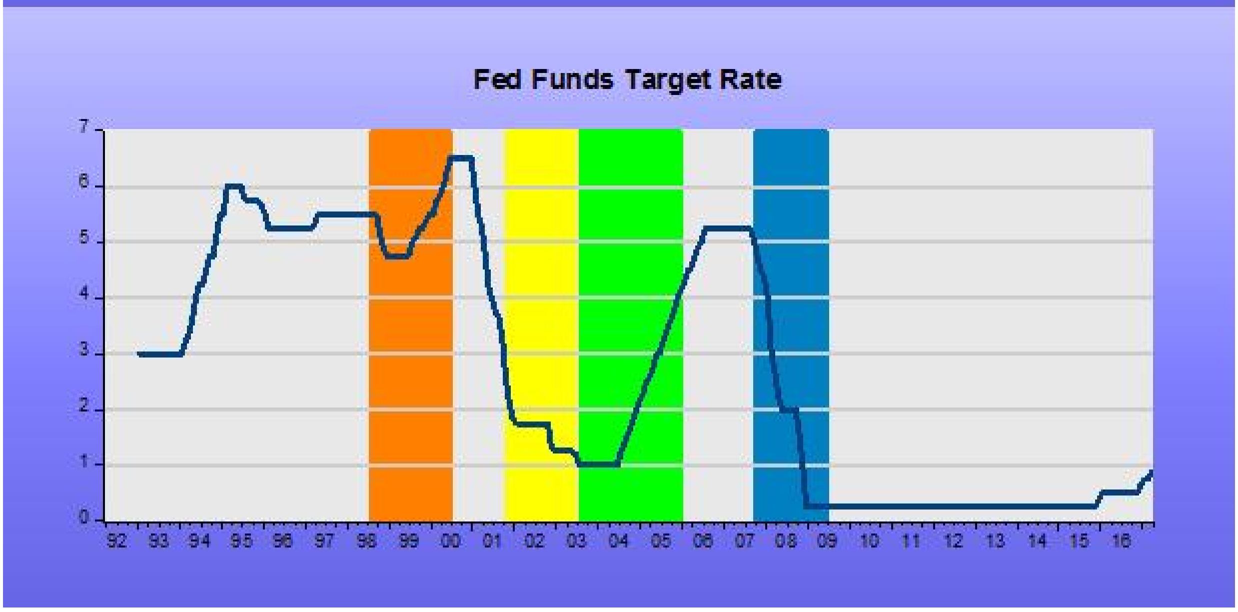
It´s interesting to observe that Raffinot´s real-time analysis ***fails*** to show that monetary policy was too loose from 2004 to 2007.

Loose monetary policy pre crisis has been a conventional argument, initially proposed by John Taylor, for whom monetary policy was too easy in 2002-2005.

I believe his real time analysis for the pre-crisis period is correct. The charts provide visual but compelling evidence, when the stance of monetary policy is gauged by NGDP growth, in particular by the NGDP gap relative to its trend path, that monetary policy was “just right” in 2004-2007 and “too tight” (not “too loose”) in 2002-03.


NGDP Gap
Exemplar
Too Loose
Too Tight
Just Right
Extremely Tight
Remains Tight
4
0
-4
-8
-12
-16
-20
-24
92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16


NGDP Growth - % YoY
8
6
4
2
0
-2
-4
NGDP-Advisers
92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16


Fed Funds Target Rate
7
6
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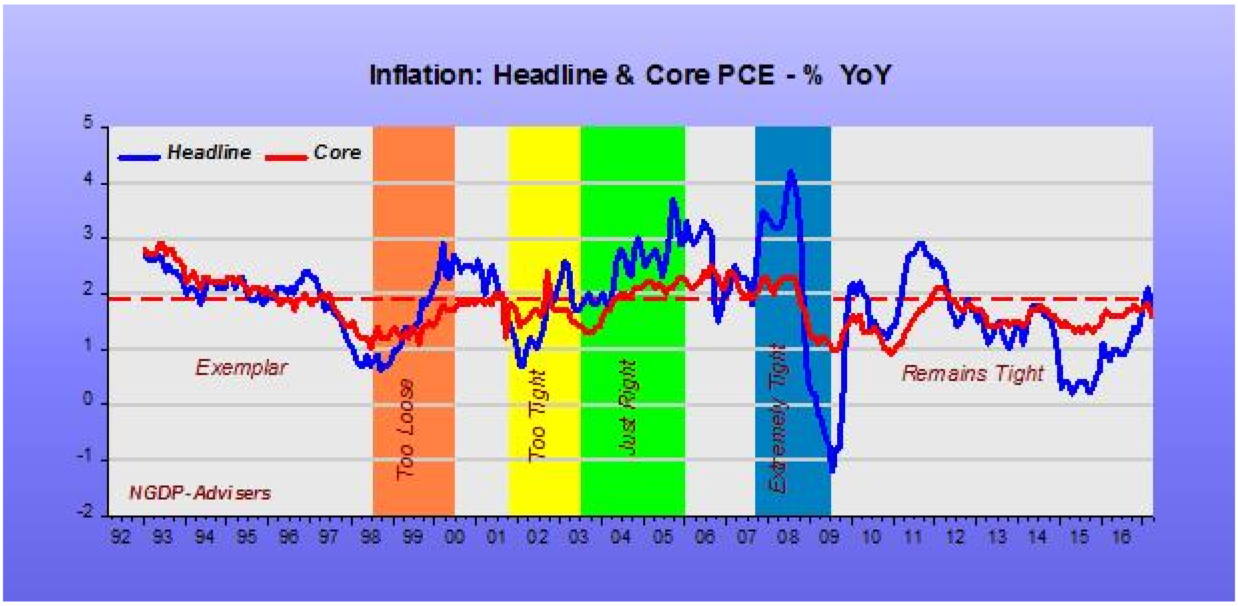
3
2
1
0
92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16



It appears monetary policy was too loose at the closing of the millennium. That can be explained by the Fed´s focus on inflation, especially of the headline variety. In the late 1990s, the US economy was buffeted by a positive productivity shock. The outcome is a rise in real growth and a fall in inflation (both headline and core).

By reacting to the “too low” inflation, the Fed caused nominal instability, with NGDP climbing above trend.

The Fed, then, overcorrected and monetary policy became too tight. In mid-2003, the Fed appropriately eased monetary policy. The NGDP gap closed and core inflation moved to the (then implicit) 2% target. Headline inflation was “high” and variable, moving in tandem with the oil shocks that took place from 2003 to 2008. The Bernanke Fed, in particular, was very worried about headline inflation going into the crash.

As you can see, after 2007 monetary policy became “extremely tight” and has remained tight ever since. NGDP growth turned positive, but was never enough to close the gap. Note that in 2014, the Fed tightened further, with the gap widening faster. In mid-2016, the Fed “relaxed” the monetary policy stance, but more recently has again reverted to its preferred “tightening stance”!

Note that the FF rate, the Fed´s policy rate, was most of the time providing misleading information about the stance of monetary policy!

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.

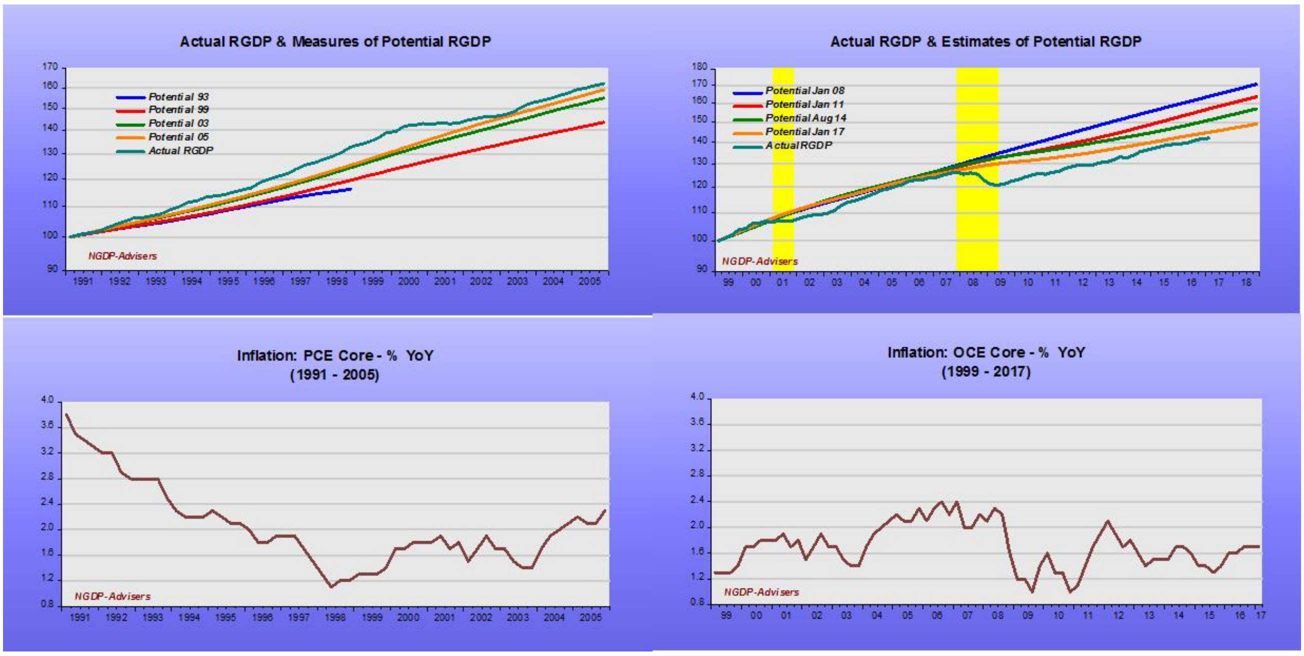
There may be valuable lessons in Japan for the United States. Perhaps more QE and tighter labor markets—and a reduction in property zoning—can bring about more prosperity to the United States.

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.