



Market Volatility in Japan: A Verdict on Abenomics?

Adam S. Posen says the market turmoil in Japan may actually be a sign that Prime Minister Abe's economic policies are working.

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Steve Weisman: The markets in Japan have been in turmoil and some critics are saying it's a reaction to Abenomics—the economic policies of Prime Minister [Shinzo] Abe. Adam Posen, president of the Peterson Institute for International Economics, is watching Japan closely. This is Steve Weisman. Adam, first, how serious is this volatility and is it a reaction to Abenomics?

Adam Posen: I think the answer is: the volatility needs to be watched but it's nothing serious yet, and the extent to which it's a comment directly on Abenomics is vastly exaggerated. I'm just back from Tokyo where I actually met with the Prime Minister and other senior officials, so let me declare my loyalty of sorts to their attempts to get Japan out of deflation before I talk.

But, in terms of the impact of the volatility, part of what's happened is the Bank of Japan has stopped buying everything in sight, moving instead to buying the long end of the Japanese Government Bond Curve. And private sector individuals have stopped being so terrified that they only hold very short and cash-type instruments. In other words, part of the reason you have volatility, not all, but part of it is a reflection of the fact that things are getting better.

Some people are taking risks. They're not all terrified into doing nothing but holding cash. The Bank of Japan is actually moving towards reflation rather than damping down the volatility of the economy. So, volatility in and of itself, if it persists and grows, is not a good thing, but part of the reason we have the volatility is that healing is underway.

Steve Weisman: Markets go up; markets go down when markets function.

Adam Posen: Exactly.

Steve Weisman: Let's reprise for a second what Abenomics is. It's basically, you mentioned reflation, but there are several instruments toward that end, including monetary fiscal policy, restructuring, other steps. What of these have been undertaken, and which are having the most success in your view?

Adam Posen: Abenomics is a three-part program. There is a monetary part which is already underway and has been undertaken and I believe is having success. That's essentially the Bank of Japan, as I said, buying things that are less like cash, buying longer-term government bonds, and committing to buying as much as it takes to get Japan out of deflation. We're already seeing the benefits of that for Japan. It's reflected in the exchange rate, but it's reflected primarily in this movement in interest rates. The real interest rate in Japan has gone way down as my colleague, Joe Gagnon, has pointed out, and that is a sure sign that inflation expectations are rising.

We're starting to see movement in some prices and wages as well in Japan; movement up in a way that we haven't seen for a very long time. So, the monetary arrow which has been shot is working and they should stick with it.

Steve Weisman: Why should inflation prospects bring interest rates down? Isn't it normal to expect the opposite?

Adam Posen: Depends on the situation. We're talking about the difference between real interest rates and nominal interest rates.

Steve Weisman: Okay.

Adam Posen: I am talking now about real interest rates, which is the rate that you're paying on your contract or on your government bond, minus the rate of the inflation that you're experiencing.

Steve Weisman: Got it.

Adam Posen: Right now, the inflation and expectations of inflation are moving up faster than the nominal rate. The coupon you're paying on these bonds is moving up. So, the real rate, which is the difference between the two, is declining. Over long periods of time or when people expect inflation to get out of hand, it usually does work the other way. The nominal interest rate moves faster than the real rate. It goes up more than 1 for 1 with inflation pretty quickly. In Japan, because they've been in deflation off and on essentially for the last 17 years, it's much slower. There were people who were doubting that they could get inflation expectations up at all, and so expectations are moving faster than the market is going to move.

Steve Weisman: There are some international dimensions to this, namely some anxiety in markets around the world; in emerging markets. How is that connected to Japan?

Adam Posen: It's part of the broader issue that, on the one hand, every country that expands its monetary policy—whether through quantitative easing or cutting interest rates when your interest rates are above zero—tends to depreciate its currency against other countries. That's happened for the US, for the UK, and has now happened over the last few months for Japan. The G20—the major world economic powers—has agreed that that's OK as long as you're doing it to reflate your own economy; you're doing it through domestic means.

Steve Weisman: Right.

Adam Posen: You're not directly selling off other people's currencies. And, so far at least, the Japanese Government and the Bank of Japan have not been doing that. But, we've got two other things going on. One is, people are beginning to worry that the Fed is going to stop printing as much money as it's been doing, and maybe even start tightening policy in the foreseeable future -- not tomorrow, but in six months, 12 months, 18 months.

Steve Weisman: The US Fed, right?

Adam Posen: The US Federal Reserve. And that would tend to draw money out of the emerging markets. All this money that went sloshing into the emerging markets because you had bonds there that were yielding 5 percent, 6 percent, 7 percent, when bonds in US and Japan were yielding 0 percent to 1 percent or 2 percent.

Steve Weisman: Another factor is the renewed risk about those markets, too?

Adam Posen: Well, it all goes together. A number of these countries—including Brazil, Mexico, Turkey, South Africa, a variety of countries in Eastern Europe, notably Ukraine -- got lots of capital inflow; lots of money leaving the US, Japan, Europe over the last few years because the returns were higher in those countries and because prospects looked really bad, particularly in Europe, but also in Japan and the US. Now, the relative prospects are looking better in the US and the gap in returns is shrinking because interest rates seem to be going up in the

US and elsewhere. So, the money is flowing out.

For countries that are well prepared and didn't waste the money that flowed in or didn't get bubbles in their real estate markets with outside investors flowing in, which they couldn't necessarily do anything about, that's OK. But, if you did waste the money and you racked up debt or you did, through no fault of your own, end up with a bubble in your biggest cities' real estate market-

Steve Weisman: Which some did.

Adam Posen: Which some did, then the money pulling out can cause a crash. And so that's why people are starting to get worried now, and the Japan move, in my view, is a contributing part, but only a part of this broader retrenchment, that money is flowing out of the major emerging markets back towards the US.

Steve Weisman: If Japan and the US and—some day in the next couple of years—Europe start to move in more positive directions economically, is that necessarily bad for emerging markets?

Adam Posen: Usually, it's good news for emerging markets, particularly when the US-

Steve Weisman: Because they can-

Adam Posen: Particularly when the US expands, because the US tends to import a lot.

Steve Weisman: Right.

Adam Posen: For any given amount of growth, we tend to eat a lot of foreign stuff.

Steve Weisman: And, our deficit is going up-

Adam Posen: And, the trade deficit goes up in accordance. That means other people are growing as a benefit from the US growth; and that's part of the reason why other countries, including China and Japan and Korea, supported the US doing quantitative easing because, on net, even if the currency moved, it's better to have a growing US in the end that sucks in more trade.

The problem is not so much anytime of Europe waking up, but in the short term, over the next one to ten months, of the US improving a lot, Japan potentially improving a lot and then this money flowing back out of the countries I mentioned earlier. And then in very short term they're caught short. They have to pay a bunch of debts, real estate prices go down. It's a version of what we've seen before in Southern Europe a few years ago, in Latin America in the past.

Steve Weisman: Are you worried about any kind of crisis in any of these countries?

Adam Posen: The word crisis just keeps going around. I'm certainly worried about a shock and a contraction. The Governor of the Central Bank of Mexico—Agustin Carstens, who is very much a wise man on all these issues—has been warning for the last couple of years that not only his government, but governments in a lot of comparable countries, had to prepare ahead for when this day came. And it looks like it may not be this week, but sometime soon this day is coming. Especially for certain countries, they've got accustomed to having easy credit from abroad, buying their bonds, good tax revenues from inflated real estate prices; this is going to come as a shock.

Steve Weisman: OK. Thanks, Adam.

Adam Posen: Thank you, Steve.

