ADVISOR PERSPECTIVES

Weekly Economic Commentary

November 1, 2013

by Team
of Northern Trust

> - The public needs to move beyond its bad feelings toward financial institutions
> - Should we modify the price stability mandate of central banks?
> - The Fed offers no surprises

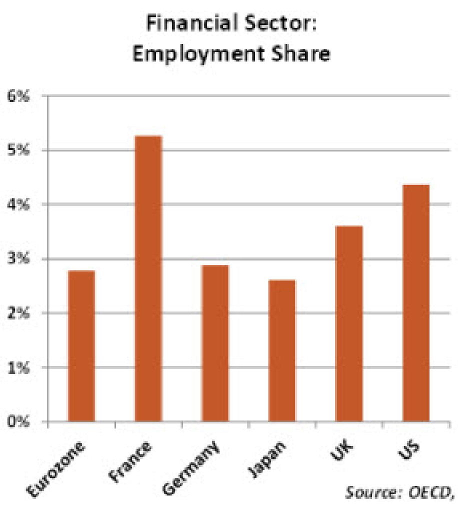
The financial crisis took a terrific toll in many places and at many levels. Among the casualties was my reputation. Up until 2007, I was among the “evil bankers that caused the mess;” thereafter, I was one of the regulators that offered bailouts to the miscreants. It mattered little to my critics that I was a small cog in two very big machines.

I’m back to banking now, but the vitriol surrounding our industry has scarcely abated in the past five years. According to U.S. public opinion polls, only Congress is held in more contempt than bankers, hardly a source for comfort. Recompense is still being extracted from leading financial institutions. And there remain calls to put more financial executives in jail for their misdeeds.

At some point, though, policy-makers and the public are going to have to find peace with the financial sector. The futures of these agents are inextricably intertwined, and a good portion of the lingering bad feeling is based on misunderstanding. Fortunately, there are signs that all sides want to move on.

The demonization of finance has a long history. From the expulsion of money changers from the temple in the New Testament, to the nefarious depictions of creditors in literature (Shylock in “The Merchant of Venice”) and film (Mr. Potter in “It’s a Wonderful Life”), to President Obama’s recent characterization of bankers as “fat cats,” the industry has been a near-constant target of scorn. Stereotypically, bankers take pounds of flesh from hard-working folks and award themselves big bonuses. Periodically, their bad judgments crash markets and leave taxpayers holding the bag.

Yet these characterizations miss several broad truths. First, banks provide incomes for many workers, and relatively few of them are richly compensated. Employment in financial services is significant but has waned importantly since 2008.



Source: OECD, Haver Analytics, Bloomberg

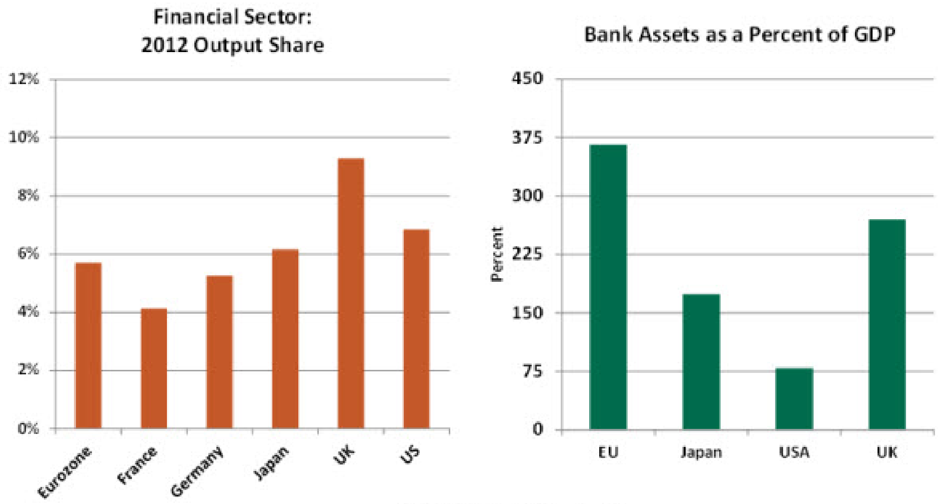
Some might say that we had too many people working in this sector, but the loss of these jobs has been damaging.

At the level of chief executives, pay-for-performance is an issue that goes beyond the financial services industry. There are myriad industrial firms whose leaders were handsomely paid even while producing disappointing results. Further, the compensation of senior officers at large banks is now the subject of increasing scrutiny from regulators and boards.

Second, economies cannot thrive without financial intermediaries matching savers and borrowers. The banking network forms a kind of circulatory system for the world economy; if sclerosis sets in, business activity will be constricted. And a heart attack could be fatal for all.

The burdens of past losses and regulatory uncertainty still hinder credit extension at many points on the globe. In Europe, bank conservatism has led to credit contraction, while in the United States, debt capital markets are a shadow of what they once were. As a consequence, small business formation has waned, and housing markets continue to struggle.

Third, banking is a key strategic sector for many countries. By serving a global set of clients, the scale of the financial industry in many places is significantly larger than gross domestic product (GDP).



Sources: ONS, Haver Analytics

Finance is, therefore, a key service export for many nations where banks are the subject of both pride and prejudice. It is, at times, hard to reconcile the two. It remains difficult for many people to accept, but the support given to banks during the 2008 crisis was really support for societies as a whole. Had aid not been extended, the destruction of jobs and wealth would have been far more substantial. These points have perhaps not been as well made as they might have been; but then again, they are points that some people simply do not want to acknowledge.

And it might be fair to observe that, to the extent that there are Wall Street banks that were deserving of blame, they were not the only bad actors on the stage. How might we assign contributory negligence to those who speculated on real estate or who over- utilized the equity in their homes? Or to legislators who built structural fiscal problems that only became apparent when the economic tide went out? Or supervisors who had the opportunity to step in a bit earlier and opted not to do so? While it is convenient to concentrate blame, it should more properly be shared.

Of late, it appears that peace talks are progressing. Mark Carney, governor of the Bank of England (BoE), gave a key address last week in which he took a somewhat conciliatory tone toward the financial sector. Declaring the BoE "open for business," he highlighted the congruent interests between supervisors and the supervised. This was taken as a bit of a break from the tone taken by his predecessor, whose mistrust of bank motives was well-documented.

In the United States, work is proceeding to settle many of the remaining grievances left over from the crisis. Negotiations have been difficult, but the movement toward accord signals a desire on both sides to move on.

None of this narrative should be taken as blanket forgiveness for the actions of banks and bankers. Some may well deserve the scorn they have received. But to those who want more executives thrown in prison, the reality is that much of what went on was bad judgment and not illegal activity. And fortunately for us all, poor choices are not always criminal.

A friend once told me that forgiveness is a gift that you give to yourself. It took a while for that to sink in, but I've found it to be true. If we can embrace that spirit as we think about the role of finance in our lives, we will all be better off.

Price Stability – Time for Symmetric Definition

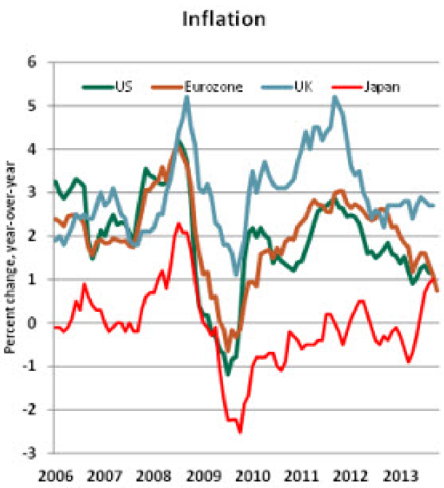
Lackluster economic growth, non-threatening inflation, large balance sheets and fiscal austerity in several major economies have left central bankers with a tough challenge. Consequentially, some are suggesting the unthinkable: that tolerance of higher inflation may create a path to self-sustained expansion. A recent New York Timesarticlecited Professor Kenneth Rogoff's recommendation of 6% inflation for the United States to pull out of the soft-growth quagmire.

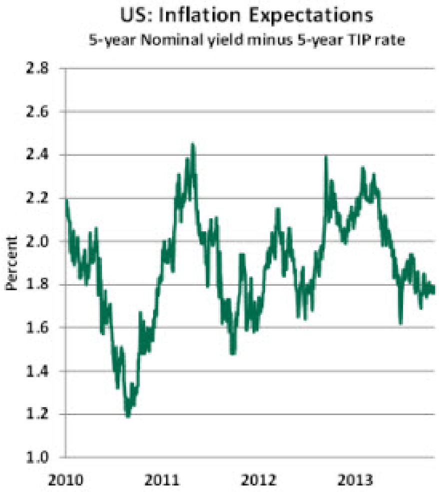
This, in our opinion is an unsuitable alternative. Guiding markets to understand that inflation exceeding the current target is a temporary strategy and designing monetary policy to get the economy back on track from the elevated inflation path are simply bridges too far.

Our concern is more on the other side. Should there be a targeted range for inflation, which includes some minimum guidance level? With price level increases falling in many parts of the world, this idea deserves consideration.

Currently, the Federal Reserve has a dual mandate of price stability and full employment, while price stability is the single obligation of most other major central banks. Operationally, the price stability mandate translates into maximum inflation readings, with ranges built in to allow some flexibility.

Essentially, these major central banks have crafted asymmetric price stability mandates, with concern only on the upside. Yet deflation was a legitimate threat in the United States following the financial crisis in 2008 and again in 2010. These situations led to the first two rounds of large scale asset purchases. Recent inflation numbers of the United States and eurozone suggest that the current disinflationary trend could translate to deflation if business momentum softens. Inflation expectations are also on the decline. Japan only recently emerged from a crippling deflation that lasted most of the past two decades.





Source: Haver Analytics

Extending John Makin'sproposalfor the Fed, all central banks would do well to define price stability in a symmetric manner to make provisions for not only inflation but also deflation. The net benefit of this modification is they should be able to manage inflation expectations and prevent a significant setback to economic activity with fewer changes to near-term policy announcements.

In this context, it is noteworthy that the Fed showed just this sort of symmetry in its May 1, 2013, policy statement. (*'The Committee is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes."*) The September policy statement alluded to concerns about the disinflationary trend.

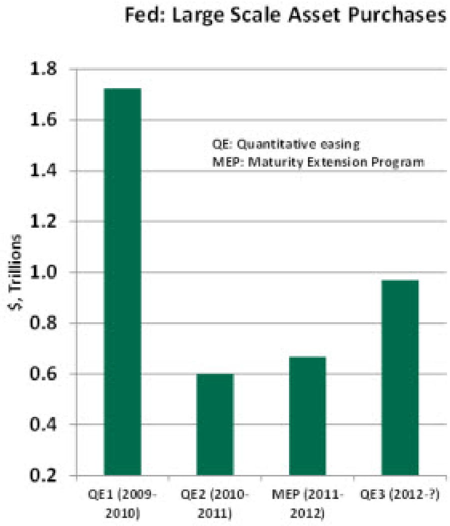
An explicit lower bound for inflation should become part and parcel of central bank monetary policy mandates. While inflation has been the bigger threat for most of the past generation, the potential for price declines deserves equal billing in the current environment.

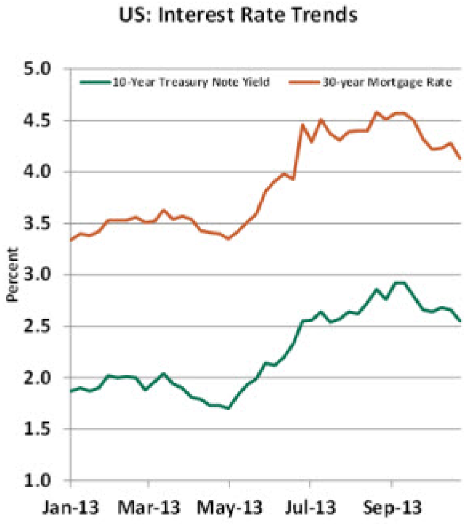
Fed Opts to Stay the Course; Incoming Data Hold the Key

The Federal Open Market Committee (FOMC) stood pat at the October 29-30 meeting. No surprises here: the Fed will continue to purchase $85 billion in securities each month, taking its balance sheet close to $4 trillion by year-end. Kansas City Fed President Esther George cast the lone dissenting vote. She remains concerned about asset purchases increasing the risk of financial imbalances and an increase in long-term inflation expectations.

The Fed continues to see the current status of fiscal policy as a hurdle to economic growth despite the re-opening of the federal government. Congress has to meet the December 13 deadline with a compromise on total federal government spending for fiscal year 2014. In addition, the current Continuing Resolution that funds government operations expires on January 15. In light of these deadlines, the Fed's unease about fiscal policy stands justified.

The Fed's assessment of the labor market in September was unchanged at this week's meeting. Given that interest rates have declined since the September decision not to commence tapering of asset purchases, the Fed eliminated that statement citing tightening financial conditions as restraining economic growth.





Source: Federal Reserve Board, Haver Analytics

Although hints about the timing of a reduction in asset purchases were absent in the policy statement, we are fairly confident that discussion of the topic will feature prominently when minutes of the meeting are released in three weeks. The group continues to monitor labor market conditions, benefits and costs of asset purchases, and the stability of the financial system.

The December FOMC meeting will likely be far more interesting than the one just finished. By then, we'll have a clearer picture of employment, and there will be a press conference to allow the chairman to provide more guidance on what might be ahead.

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