ADVISOR PERSPECTIVES

Arresting Disinflation Will Require Taking up the Slack

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of Northern Trust

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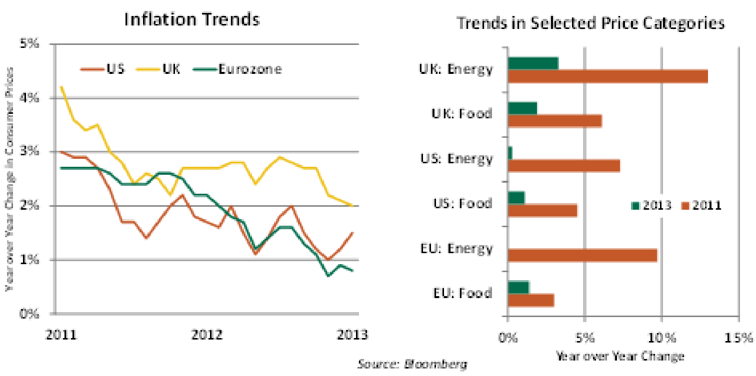
> - Arresting disinflation will require taking up the slack
> - Estimates of the U.S. output gap remain substantial
> - The U.S. achieves budget peace but still faces long-term fiscal challenges

The term "slacker" refers to those who lay about while others are being industrious. Kind of like your children taking it easy on the couch while mom and dad are out shoveling the most-recent 10 inches of snow.

Few would accuse the world's central bankers of being slackers in this sense, given the hard work they've put in over the past five years stabilizing markets and trying to lay the groundwork for a lasting recovery. But the concept of slack seems to be driving their decision-making. And it may explain differences in performance across key markets.

At the moment, developed economies are wrestling with inflation that has fallen well below desired levels. The deceleration is especially prominent in categories that make up large shares of the consumer price index. Food, energy and shelter costs are rising at a far slower pace than they were two years ago.



Those hoping that disinflation will prove more transitory are banking on the likelihood that energy price inflation will not fall another 10% over the next two years and that food prices will stabilize. Both European Central Bank (ECB) President Mario Draghi and Federal Reserve Chair Janet Yellen highlighted this expectation in their most-recent public remarks. Both have also been comforted by longer-term inflation expectations (measured by surveys and market implications) that remain close to the 2% target shared by the two central banks.

But where the fortunes of key markets diverge is in the degree of unused capacity that is present. Until economic growth returns to its potential level on a sustained basis, this resource slack will not be reduced and inflation will be held down.

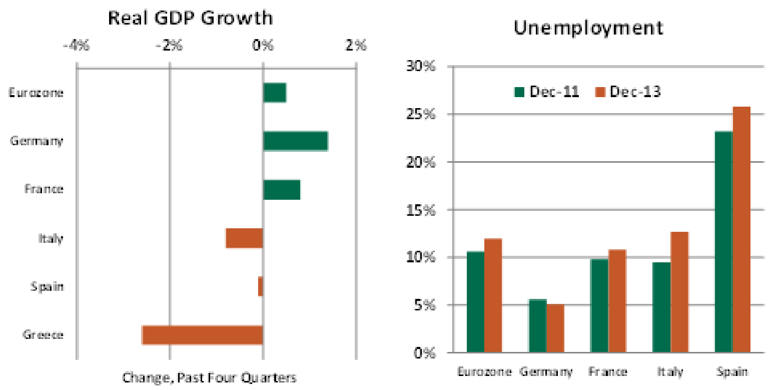
Bank of England (BoE) Governor Mark Carney focused on this concept in his inflation report this week. Carney shared an expectation that increases in the British price level are likely to trend below target for much of the next two years. One reason for this is the level of slack that remains in the U.K. economy, even as growth has gained momentum.

In light of this, the BoE's Monetary Policy Committee (MPC) is not contemplating a rise in interest rates, despite the drop in British unemployment to a point just above the level targeted in forward guidance. Instead of rebasing its unemployment target, the MPC opted to rebase its communication. Going forward, the group will monitor a series of factors (18 of them!) that attempt to gauge the degree of economy's spare capacity.

It will be interesting to see whether the Federal Reserve will consider adopting a similar rubric, given the approach of American unemployment to the central bank's target. In her Congressional testimony this week, Yellen cautioned against exclusive reliance on the jobless rate, noting that a broader range of variables provides a more-complete report card on progress toward the Fed's dual mandate.

The Fed and the BoE can feel confident in the likelihood that inflation will gradually move back toward target. The ECB, however, cannot say the same. This is because growth in the eurozone has been very slow; even the encouraging growth in fourth quarter gross domestic product (GDP) falls well short of long-term potential.

As a result, Europe continues to create spare capacity, most notably in its labor markets. This will tend to keep downward pressure on wages and prices there.



Sources: Bloomberg, Haver Analytics

While the continent seems much further from financial crisis than it was two years ago, most countries are enduring sluggish growth and deep disinflation. Draghi, during his press conference last week, consequently was asked to explain why the eurozone is not Japan.

The ECB president has promised "decisive action" to deal with any advancing threat of deflation, but it remains very unclear what that action would be. Barred from monetizing national debts, the ECB has been very limited in its ability to conduct quantitative easing. The Outright Monetary Transaction (OMT) program, announced in summer 2012, was thought to be a potentially promising avenue, but it remains in a certain degree of legal limbo. (Consideration of the program's permissibility was passed from German courts to European courts last week.)

Further, countries that request inclusion in the OMT program must agree to "conditionality" that could be quite onerous. So it is not clear that anyone is eager to apply for OMTs, even if they are deemed legal.

The ECB really has very few options as it tries to reverse disinflation.

One possibility that might prove more promising longer-term would be ECB purchases of assets or asset-backed securities, which would put reserves into the economy and ease leverage constraints faced by banks. But it would take a while to build such a program to critical mass, and assets delivered to the market would have to be valued at appropriate discounts. And the question of what assets to buy, from what countries, could be politically complicated.

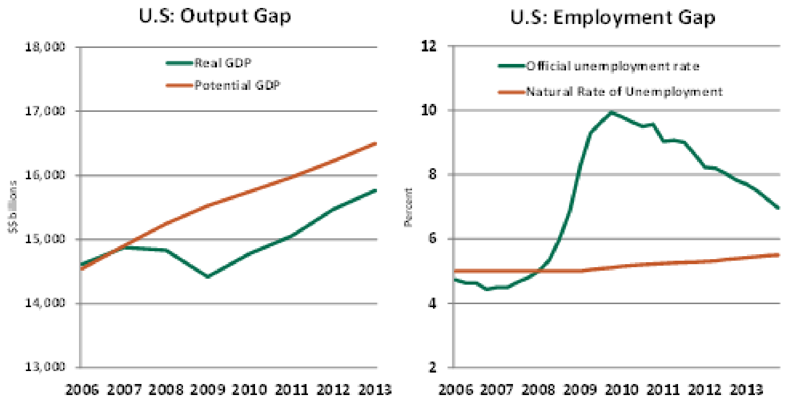
In sum, we're going to be hearing a lot more about slack in the world's economies, and central banks are going to be working hard to reduce it. Until they do, inflation will be taking it easy.

Closing the Gap?

So exactly how much slack remains in the American economy? The Great Recession ended in June 2009, and the U.S. economic recovery is approaching its fifth anniversary. Frequently, the question comes up about the status of the economy in relation to its potential capacity. The Congressional Budget Office's (CBO) semi-annual report on the budget and economy helps to answer this question.

The CBO's estimate of real potential GDP is the benchmark that enables a comparison with actual real GDP to assess the size of any "output gap." Real GDP has risen roughly 11% from its low in December 2007 versus a 20% increase on the fifth birthdays of the last six expansions.

As a result of the slow recovery, the U.S economy is operating roughly 4.5% below its potential capacity. The CBO estimates that the gap between actual and potential GDP will be closed only in 2017.



Sources: BEA, BLS, CBO, Haver Analytics

The decline in the unemployment rate to 6.6% of late from 10% in October 2009 would have been more meaningful if the participation rate had advanced instead of maintaining a downward trend. Based on the CBO's estimate, the unemployment rate is 1.1% above the estimated level of full unemployment (5.5%), but functionally, the gap may be much larger. An upward-trending participation rate would have resulted in a higher unemployment rate and a larger employment gap.

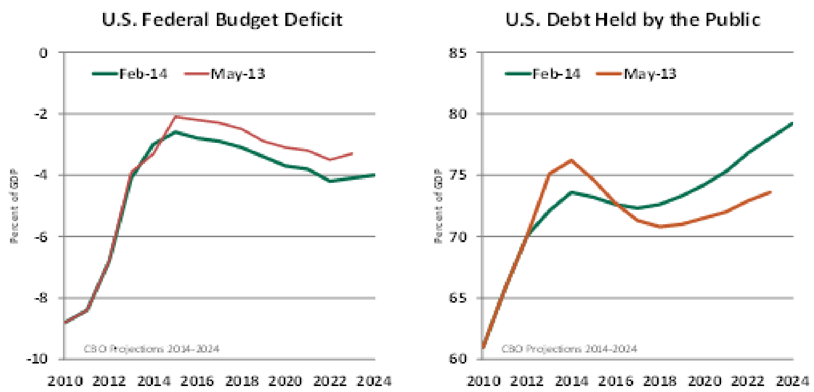
Against this backdrop, Fed Chair Yellen's remark about examining a broad set of indicators to arrive at an assessment of the economy is fitting. And the persistence of output gaps justifies remaining accommodative long after growth accelerates.

Fiscal Checkup of the United States

This week's passage of the Temporary Debt Limit Extension Act averted another round of debt ceiling brinkmanship. The bill suspends the debt limit until March 15, 2015, allowing the government to continue borrowing without a cap until that date. Congress acted responsibly to avoid unnecessary market uncertainty and volatility. However, there are large and important fiscal challenges to address.

The CBO's latest semi-annual economic and budgetary outlook is a good place to start in order to appreciate the magnitude of the problem. In the very near term, there is some encouraging news on the federal budget, but the trajectory for the next decade is the crux of the concern.

Starting with the positive, the federal budget deficit under current law is estimated to shrink to $514 billion in fiscal year 2014 from $680 billion in 2013 and $1.4 trillion in 2009. The budget deficit would be 3.0% of GDP in 2014. A further reduction of the budget deficit to $478 billion, or 2.6% of GDP, is estimated for 2015.



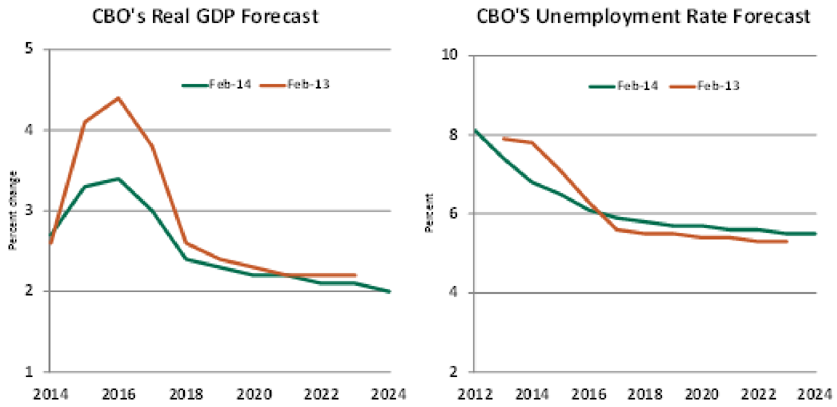
Source: CBO, Haver Analytics

Deficits are projected to maintain an upward trend for most of the 10-year period, however, and result in a larger debt as a percent of GDP. The discretionary component of federal government spending is estimated to decline in the next 10 years relative to the size of the economy to such an extent that it works out to be the lowest percentage of GDP since 1940.

But the second component – mandatory outlays – is the main culprit. Aging of the population, health insurance costs and interest costs on federal debt are the main factors driving the projection of spending. The broad contours of this story are not new.

The latest CBO exercise indicates that the fiscal situation worsens despite an improving economy, spending cuts and tax increases put in place recently. Deficits climb from under 3.0% in 2015 to 4.0% by 2024 and the debt level is projected to stabilize through 2017 and reach 79.2% of GDP in 2024.

CBO's notable downward revisions to projections of the economy's future performance result in lower revenues in the next 10 years. The weaker growth forecast lowered estimated income and payroll taxes. The new economic projections explain a significant part of the increased deficits.



Source: CBO, Haver Analytics

The federal budget is vastly sensitive to economic conditions. Slow growth weakens the budget outlook. The CBO estimates that if real GDP growth each year turns out 0.1 percentage point lower than the CBO forecast, the cumulative deficit would be $311 billion higher by 2024.

The current level of federal debt and projections of it 10 years hence are not an immediate call for the Coast Guard to rescue a sinking ship. Excessive debt slowly erodes the foundation of the economy. A critical time will come when the economy literally cannot support its own level of spending, and then it can topple over. Robust political will to prevent such a situation and address the imminent fiscal problems will be necessary to keep the United States sailing toward a prosperous future.

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