Weekly Economic Commentary

February 28, 2014

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of Northern Trust

- **The sensitivity of emerging markets complicates the Fed's exit plans**
- **Raising the minimum wage is not the only way to aid low-income workers**
- **Brazil's economy is faltering as the World Cup approaches**

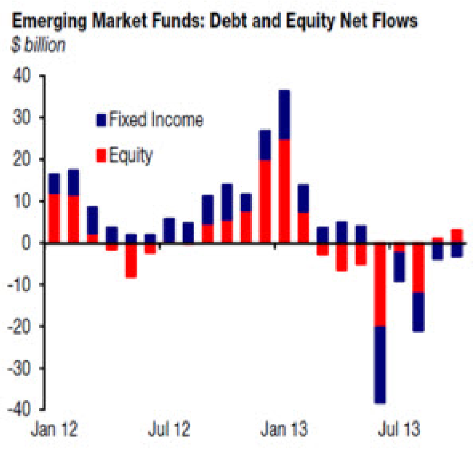
I studied French in college. My professor was partial to existentialists, who felt that life was essentially meaningless and absurd. Enlightenment occurred only when one accepted that fact.

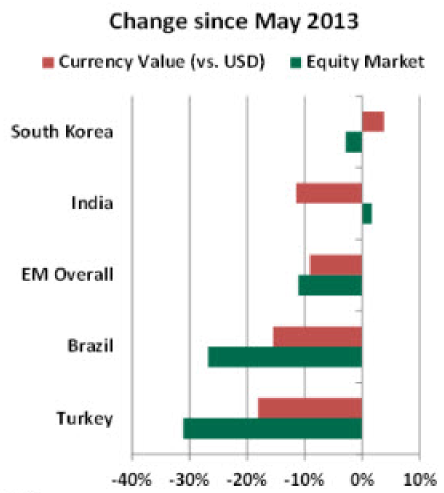
While there were many more uplifting books we might have read (Barbar? Le Petit Prince?), we were forced to tackle "No Exit," a play by Jean-Paul Sartre that centers on three characters locked into a room for eternity. It leaves the reader in a pretty dark mood.

I was thinking back to that tome recently as I contemplated the exit strategy that lies ahead for central banks. The mere mention of cutting back on accommodation has created dark moods in developed and emerging markets alike. Does this reaction reflect addiction to cheap credit that will need to be broken at some point? Or is there something more subtle at play that should inform the pace and design of the process?

It's been more than five years since the Fed began applying unconventional tools, quantitative easing chief among them. While other central banks have followed suit, none have gone to quite the same length. And because the Fed's work influences capital flows worldwide, its actions have been much more far reaching.

One way quantitative easing is supposed to work is by encouraging those parked conservatively in low-yielding assets to take a few more risks in exchange for higher returns. Some of the resulting portfolio reallocation ended up in emerging markets.





Source: IIF

In some cases, this was done directly by investors. In other cases, hedge funds engaged in "carry trades" by borrowing in dollars and investing overseas. The recipients of this capital were happy to have it; in many cases, it was deployed to local projects intended to facilitate economic growth.

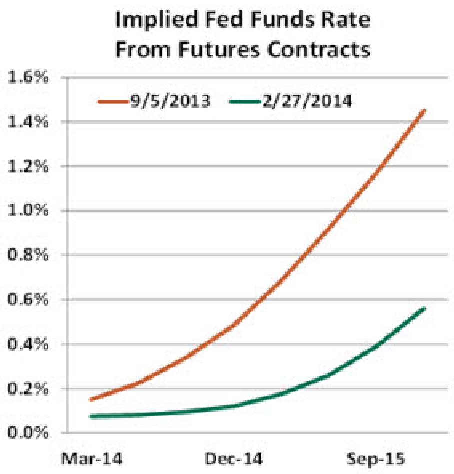
But what comes in can also go out. And when the Fed mentioned the possibility of tapering last May, the exodus began. The result was severe retreat in currency values and equity markets in a series of emerging nations. At some points, the retreat was somewhat indiscriminate. But of late, investors have become more nuanced in their consideration. Countries with stronger reserve positions, budgets and trade flows are being favored.

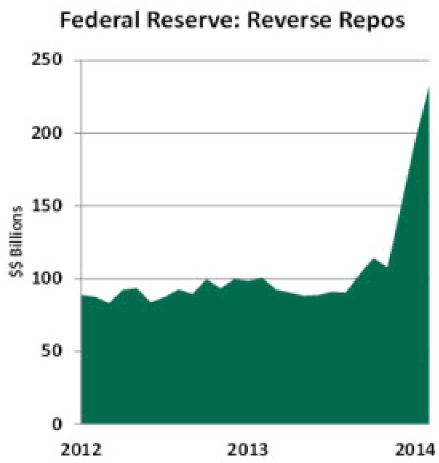
To be sure, problems endemic to some emerging markets may be a bigger cause of their difficulty than anything the Fed might do. And the apparent slowing in China's economy has also been a factor. But policy makers in the G-20 recently urged the Fed to proceed with caution. Raghuram Rajan, governor of India's central bank, has been particularly vocal on this front.

Fed Chair Janet Yellen testified this month that it is nearly impossible to set American monetary policy in a manner that addresses all of the world's challenges while remaining faithful to its domestic mandate. Unless and until a feedback loop from emerging markets threatens U.S. growth, tapering will proceed apace.

Yet the Asian crisis of 1998 certainly garnered a lot of attention from U.S. policy makers, and the linkages of commerce and capital between mature and developing economies are much deeper now than they were then. So recent developments in emerging markets cannot be viewed as entirely exogenous to U.S. performance.

In recent months, the Fed has made it clear that its withdrawal from accommodation was going to be very slow. These statements have successfully steered expectations of interest rate hikes to a much more modest level.





Source: Bloomberg

Further, the Fed has begun revealing how it might transition from tapering to reducing reserves. The Fed has established a fixed-term reverse repo facility that essentially borrows cash from banks using the securities on its balance sheet as collateral. The program remains small, but has grown quite a bit so far this year.

We think that the reverse repo program is going to be a central component of the Fed's work to normalize monetary conditions. It has the benefit of withdrawing reserves from the banking system without selling securities before they mature. The size of the program can be recalibrated regularly, depending on market conditions, which will also help the Fed control the pace of exit in a manner that suits everyone.

The application of reverse repos will also force us to think differently about the level of short-term rates and their impact on economic activity. As opposed to the traditional strategy of modulating the Federal funds rate, Yellen has said that repo rates may become the new target of monetary policy. We'll be writing more about this in coming months.

At some level, I am still troubled by calls from emerging markets for the Fed to hold off on its tapering. Many have substantial problems of their own making, which the Fed should not dignify by keeping market liquidity at unhealthy levels.

But we've had many recent examples where innocent bystanders are harmed by the bad behavior of others. Strategy that reduces potential contagion can be seen as an investment in ongoing financial stability.

The signature line from "No Exit" is "L'enfer, c'est les autres." Hell is … other people. No matter how developed nations might try to distance their policies from the problems of emerging markets, we're all at the same table together. And we're going to be there for a very long time to come.

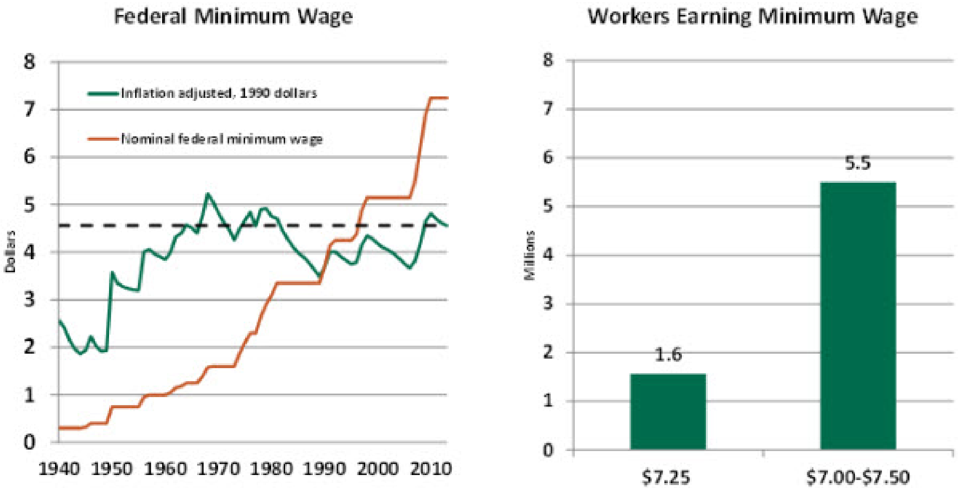
Minimum Wage – What's the Controversy All About?

There has been a visible increase in the frequency of editorials and opinion pieces pertaining to the federal minimum wage. The main thrust of proponents is that a higher minimum wage would stimulate spending and lower income equality. Opponents point to the potential for job losses if labor costs are forced higher.

The evidence on the impact of a higher minimum wage is mixed. The Fair Labor Standards Act of 1938 instituted the federal minimum wage, which currently stands at $7.25 per hour. The Bureau of Labor Statistics estimates that 5.5 million workers were compensated within 25 cents of this level in 2012, which is about 4% of total nonfarm employment. A large percentage of minimum wage employment is concentrated in the food preparation industry, followed by sales-related jobs.

Workers in some areas are a little better off. Minimum wages in 21 states and the District of Columbia exceed the federal level; 11 states adjust their minimum wages automatically with inflation. About half of all workers live in states where the applicable minimum wage is greater than $7.25 per hour.

The minimum wage has been raised periodically, with the most recent hike coming in 2007. From a starting point of $5.15 per hour, the target was raised in three steps; the increase of 40% was among the largest in history. But even after this improvement, minimum wage has failed to keep pace with inflation over the long term. In purchasing power terms, someone earning the minimum wage is no better off than they were 40 years ago.



Sources: Haver Analytics, BLS, CBO

To its supporters, raising the minimum wage would correct for this deficiency and stimulate spending. The initial pinch on profits, which might tend to reduce hiring, could be recouped by the additional spending that higher pay would allow. Opponents point to the elevated youth unemployment rate and low levels of labor force participation among young people, and suggest that raising required pay would leave these people on the sidelines.

Evidence on the employment impact of a higher minimum wage is mixed. Recently, the Congressional Budget Office (CBO) examined the consequences. The CBO estimates that establishing a minimum wage of $10.10 would translate to reduced employment by about 500,000 jobs but it would lift 900,000 people out of poverty and raise income by $2 billion. The impact on job losses and income is smaller in the case of the $9.00 option. The bottom line of these two options is consistent with the Econ 101 lesson that instituting a minimum wage results in an increase in unemployment.

However, there are other investigations pointing to the absence of a decline in employment following a hike in the minimum wage. The latter result is most likely the case if employers aim to prevent employee turnover and seek other ways to offset the increase in wage costs.

There may be another way to achieve the same aim. The Earned Income Tax Credit (EITC) helps low income workers in a different manner. The amount of earned income credit is determined by earned income, marital status and the number of children in the family. The Center for Public Policy and Priorities estimates that in 2012, the EITC lifted 6.5 million people out of poverty.

However, the EITC program is biased toward families with children. At the current federal minimum wage, full-time employment would result in compensation of $15,080 per year. However, a single person with no qualifying children would not qualify for EITC, because the cut-off compensation for qualification is $14,590.

Broadening the EITC might have an impact similar to a minimum wage increase, with fewer potential drawbacks. Because this is an election year, and because income inequality is getting a lot of attention, expect to hear much more on these alternatives as November approaches.

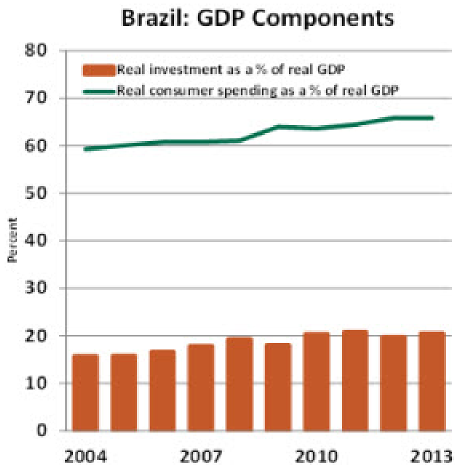
Brazil – Watch Domestic Economic Fundamentals

Brazil is the host of the World Cup this summer and the Olympics in 2016. The odds favor Brazil to win this summer's football challenge. Unfortunately, the odds on the Brazilian economy are not that good.

Brazil narrowly missed a recession in 2013, with a 0.7% increase in real gross domestic product (GDP) during the fourth quarter after a 0.5% decline in the third quarter. The 2.3% gain in real GDP in 2013 beats the 1.0% increase seen in the prior year. But the pace of real GDP growth was significantly higher before the global financial crisis of 2008 when Brazil earned a special spot in investors' portfolios.

The outlook for 2014 is challenging. First, entrenched inflation has led the Brazilian central bank to tighten seven times since April 2013, taking the policy rate to 10.75%. Surely, tight monetary policy is not the medicine to remedy soft growth.

Second, the Brazilian economy is a consumer-spending model, unlike several other emerging markets where exports and/or investment are the engines of economic growth. The share of consumer spending in GDP has shot up nearly five percentage points since 2008. The consumer driven model resulted in a sharp increase of the household debt-servicing ratio to nearly 23% in early-2012; the ratio declined to 21.5% in 2013 but it remains elevated. This imbalance is not a positive development.



Source: Haver Analytics

Third, investment spending has held steady at roughly 20% of real GDP in the past six years. The share of investment spending as a percentage of GDP in Brazil is one of the smallest in the region and among its peers in emerging markets. Robust capital formation is necessary to strengthen the fundamentals of the economy.

Brazil's external balance sheet is strong, with low external debt, low short-term external liabilities and a large stock of foreign exchange reserves. But this will be threatened if pro-growth investment policies are not put in place. Investors are likely to place a very cautious bet on the Brazilian economy, particularly with elections scheduled for later in the year.