Northern Trust

WEEKLY ECONOMIC COMMENTARY

February 20, 2015

Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Carl R. Tannenbaum
Chief Economist
312.557.8820
ct92@ntrs.com

Asha G. Bangalore
Economist
312.444.4146
agb3@ntrs.com

Ben Trinder
Analyst
44.20.7982.2517
bt424@ntrs.com

- **The Bank of England Sets Out Principles for Viewing Inflation**
- **Where Is the Energy Price "Dividend?"**
- **The "Audit-the-Fed" Movement Is Misguided**

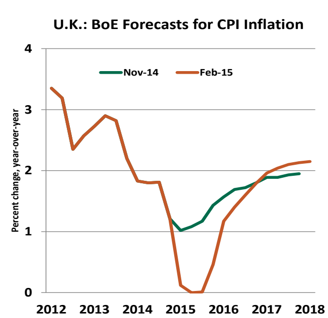
The dramatic retreat in the price of oil and other commodities has muddied the waters for those trying to assess inflation. The world's central banks, most of which are charged with meeting an inflation target, are among those struggling to gain adequate visibility.

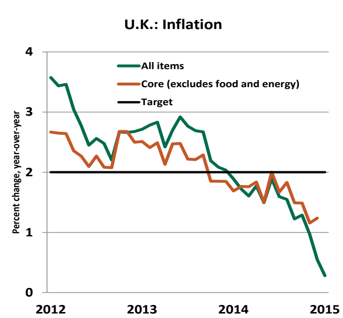
Recently, Bank of England (BoE) Governor Mark Carney laid out some interesting principles to help "look through" current distortions and arrive at the correct perspective. By separating transitory factors from those that are more permanent and drawing a distinction between good disinflation and bad disinflation, he offered a framework for others to follow.

January data on prices for the United Kingdom showed that the headline inflation level was again dragged downward by lower oil and food prices. The increase in Britain's overall consumer price index (CPI) now stands at a record low of 0.3% over the past year. This reading is likely to turn negative, perhaps as early as next month. Similar developments are being seen in other economies, to a greater or lesser degree.

The BoE fully expects a brief spell of overall deflation and yet does not seem concerned. During the press conference following the quarterly inflation report last week, Carney stressed his belief that a brief period of lower prices is unambiguously good for the British economy and that the United Kingdom is far from falling into pernicious deflation wherein consumer purchases are consistently delayed. How has he arrived at this conclusion and why is the bank seemingly so relaxed?

Firstly, the bank has broken down the CPI into its component parts and studied each individually. An interesting statistic raised during the press conference was that 68% of the components of the U.K. CPI basket are still rising in price, which is in line with historic averages. Further, the year-over-year rate of core inflation (which excludes energy and food prices) rose to 1.4% in January. These are hardly signs of a deflationary spiral.





Sources: Bank of England, Haver Analytics

Secondly, Carney was very careful to distinguish between a temporary fall in the oil price and widespread price changes across the economy, at which point a “good price fall” would become a “bad price fall.” In the former case, a limited period of falling prices for some items adds to consumption and economic momentum. Estimates suggest there is now an extra £10 billion in the British economy that can be spent on goods other than petrol, which will boost growth. And as this occurs, prices will resume a more normal pace of increase.

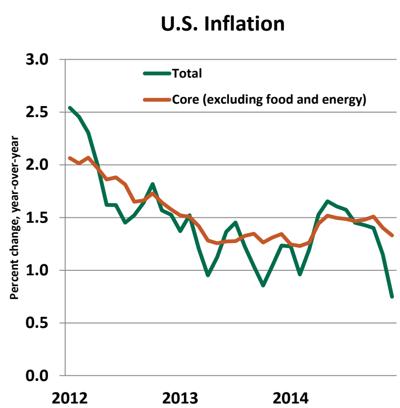
A little bit of deflation isn’t a bad thing; a lot of deflation is.

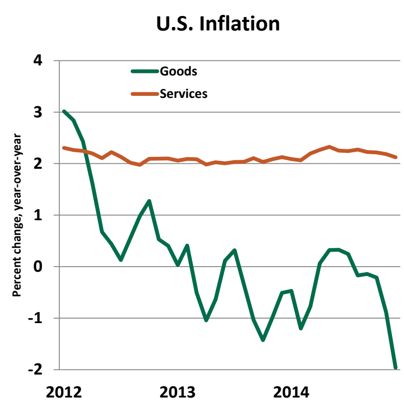
Thirdly, Carney outlined the underlying strength of the economy as a strong check against broad deflation. In this regard, he pointed to continued declines in unemployment, which he suggests could fall to 5% over his forecast period. The BoE was bullish when it came to wage growth, upping its forecast to 3.5% for 2015. If the cost of labor rises at this rate, a drop in the overall CPI would be very unlikely.

It is partly because of these strong fundamentals that the BoE changed its inflation forecast looking ahead to 2018. CPI growth is set to remain around zero for the rest of this year, but once temporary effects have dissipated and slack in the economy has been reduced, inflation could rise faster than previously anticipated, to just above the 2% target at the end of 2017.

Taking this longer view is the proper perspective for those setting monetary policy. By publishing a higher level for the end of the forecast period, the governor may be subtly trying to change market expectations for a rate hike by shifting focus away from what is happening to prices now and toward the solid recovery.

Other central banks are also attempting to look through temporary price effects. The most recent minutes of the Federal Open Market Committee and the first minutes from the European Central Bank (ECB) governing council meeting reflected concerns about persistently low levels of inflation, prompted in part by the energy price correction.





Source: Haver Analytics

Forecasts from the Federal Reserve have consistently reflected an expectation that inflation is on its way back toward the long-term target of 2%. If the benefits of low prices for some products add to existing economic momentum, the price level should resume a normal rate of increase after this transitory period of muted growth. And similar to the case in the United Kingdom, service-sector inflation (which makes up 62% of the U.S. CPI) is on a normal track.

The dynamic in the eurozone is more complicated. The ECB proceedings reflected concern that a widening share of goods and services is showing price declines, and underlying economic momentum is insufficient to serve as a check against deflation. As a result, the minutes note that "(T)he Governing Council was not in a comfortable position to 'look through' price shocks, even when they originated on the supply side."

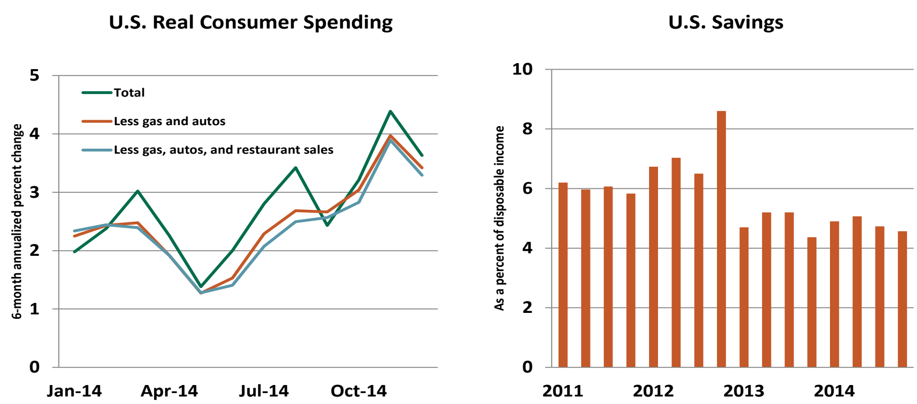
In sum, the inflation construct offered by Governor Carney last week may prove to be a very valuable British export to the rest of the world. One also hopes that Britain's strong economic performance will prove valuable to its neighbors in Europe.

Oiling the Gears of Consumption

Crude oil prices have declined by more than 50% since June 2014, and gasoline prices in the United States are down roughly 22%. It is widely expected that the benefit from lower gasoline prices should translate into higher consumer spending on other items. Analysts are slicing and dicing data to look for signs of this oil price dividend.

U.S. real consumer spending advanced at a robust 4.3% annualized pace in the fourth quarter, a solid reading that is a testimony to improved economic fundamentals. But the weakness in December and January retail sales after excluding gasoline purchases has many wondering if consumers are saving energy cost reductions for a rainy day.

Gasoline expenditures account for roughly 5% of overall nominal consumer expenditures, a non-trivial amount. Historical experience indicates that lower gasoline prices have immediate and lagged effects on consumer spending.



Source: Haver Analytics

At first, consumers increase gasoline purchases when prices fall, and this is visible in recent data. In the June-December 2014 period, real gasoline sales rose 3.9%. Households are also inclined to buy new cars, with a preference for bigger vehicles, when gasoline outlays make up a smaller part of the budget. Recent car sales numbers support the view that the reduction in gasoline prices boosted car sales, especially for larger models.

Savings from lower energy prices are being spent cautiously — for now.

Looking at consumer spending beyond fuel and transportation, data indicate that restaurant sales, a discretionary purchase, recorded the largest six-month increase since 2006. But outside of these primary categories, spending has maintained a more modest upward trend.

Household preferences may be leading to frugality — for now. Personal saving as a percent of disposable income held nearly steady on an annual basis in 2014, while quarterly numbers point to a drop in savings. Many families still have some work to do to pay down debt and rebuild savings, and this may be holding back their willingness to spend their energy cost windfall.

Further, the Permanent Income Hypothesis posits that consumers have a long-term trajectory in mind when they allocate their budget. In this context, if the recent drop in oil prices is seen as a transitory event, a portion of the resulting savings may not be spent. On that front, the University of Michigan Consumer Sentiment survey shows households expecting a 25% increase in gasoline prices during 2015.

However, as time goes on and the sense deepens that gasoline prices will remain lower for longer, gains in consumer expenditures should be more prominent. This would follow the lagged pattern seen in past oil price corrections. If gasoline prices eventually reflect the full correction in crude oil prices, this would also be an accelerant for the economy.

These considerations are included in our forecast of consumer spending for 2015, with the first half showing a stronger performance compared with the latter part of the year. The benefit from lower oil prices is here, but the size is smaller than expected — for now.

So while cheap gas has not produced a very substantial change in consumer behavior yet, this remains an important upside factor in the outlook for 2015.

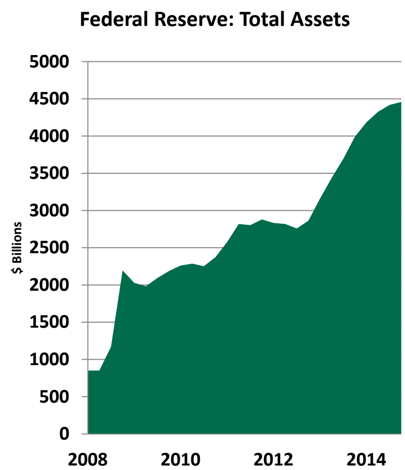
Audit This

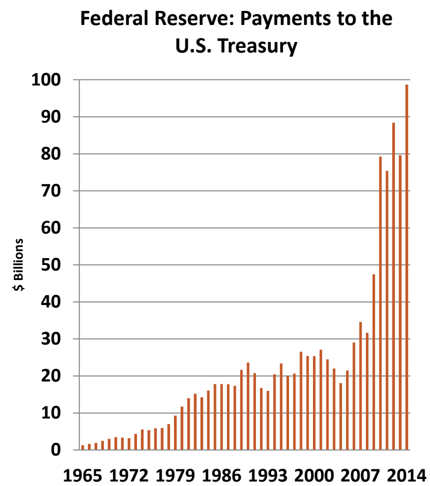
I sit on the same floor as our audit department. It's a bit nerve-wracking; I am always in fear that one of its members will notice something questionable on my desk and demand a lengthy explanation. Broadly speaking, though, I have immense respect for my partners across the hall; events over the past 25 years have clearly demonstrated the importance of their discipline to the financial system.

Nonetheless, I am adding my voice to the expanding chorus that stands against the "audit-the-Fed" movement. The proposal is a thinly veiled attempt by some in Congress to meddle in monetary affairs, cloaked in the false tunic of the public interest.

The Federal Reserve has attracted a lot of attention since 2008. The series of steps taken to stabilize the financial system and re-establish economic expansion pushed the envelope of central bank authority. As one reflection of this, the Federal Reserve's balance sheet remains more than five times larger than it was prior to the Global Financial Crisis.

As the owner of about 14% of all U.S. Treasury securities and 24% of U.S. agency-backed mortgage bonds, the Fed has also been generating sizeable cash flow, well beyond what is needed for its functioning. The excess is remanded to the Treasury Department, a practice that produced nearly $100 billion for federal coffers last year.





Sources: Bloomberg, Haver Analytics

If Congress is interested in transparency, it should start with a look inward.

Such powers and such sums certainly warrant appropriate oversight. To that end, the Federal Reserve is already audited on a number of fronts. Its financial statements are reviewed by one of the "Big Four" accounting firms, and its operations are reviewed by the General Accounting Office (GAO). Having participated in some of the GAO exercises while working at the Fed, I can attest to their depth and objectivity.

Of course, it is not the bookkeeping or the process reviews that interest the Fed's critics in Congress. Instead, they would like to expand legislative oversight of monetary policy by retrospectively reviewing central bank decisions and the outcomes they produced.

Aside from the bald politics of the proposal, the concept has serious flaws. Decisions made in real-time under uncertainty are hard to judge *ex post* when all is clear. Further, monetary policy works with long and unpredictable lags; choosing an appropriate time line for review is, therefore, difficult. And finally, economic outcomes are the product of a wide series of domestic and international policies over which the Fed has only limited control.

Structurally, the independence of central banking is a very sacred tenet in the financial world. Excessive government involvement in the process can stress short-term outcomes over long-term goals and raises the prospect of the central bank monetizing public debt. There have been numerous past and present examples from around the world that illustrate these dangers.

Over the past generation, the Federal Reserve has become progressively more open in explaining its actions. Next week, Fed Chair Janet Yellen will deliver the Fed's semiannual monetary report to the Congress, one of a series of regular efforts to keep the public fully informed.

She is far too polite to be so direct, but many of us would cheer if she parried the calls for greater accountability by turning the mirror back on those who would question her. Now *that's* an audit I'd like to see.