Northern Trust

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- **Looking Past the Olympic Carnival**
- **Time to Shift the Monetary Policy Goal Posts?**
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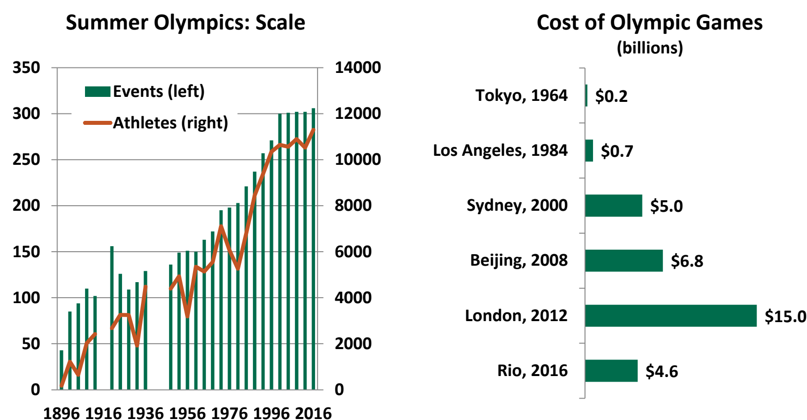
I have always wanted to be an Olympian. I wrote my eighth grade term paper on the ancient Olympics, during which governments and armies halted armed conflicts so the competition could take place. I devoured modern Olympic histories, from accounts of Baron de Coubertin's efforts to revive the Games to the unique stories that emerge every four years.

Sadly, my swimming times never got anywhere close to the qualifying standard. (Even at my best, Michael Phelps would have defeated me by almost a full length of the pool in a 200-meter race.) So I've had to be satisfied with enjoying the Olympics as a spectator. The recently closed Games in Rio did not disappoint; the performances of Simone Biles, Usain Bolt, Mo Farah and Joseph Schooling (who won Singapore's first-ever gold medal) were particularly inspiring. Ryan Lochte… well, that's another story.

The Brazilian hosts had their moments as well, winning the men's volleyball and soccer tournaments, the latter of which ended dramatically with Neymar's penalty kick that sent the nation into rapture. Now that the Olympics are over, what lies ahead for Brazil? On an economic front, it may be hard for the country to match its sports programs' success atop of the medal stand.

Growing substantially from the first modern Olympics in 1896, which included just 34 events contested by 241 athletes from 14 countries, this year included 306 events and 11,303 competitors from 207 countries. The cost of the Games has also risen greatly; while arriving at specific accounting figures is challenging (Rio spent almost $20 billion, but that figure includes related public construction in addition to the direct cost of the Olympics), the long-term trend is clear.



Sources: Wikipedia, Oxford Olympics Study

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There are economic attractions to hosting the Olympics. New transit lines, additional housing and improved infrastructure constructed for the Games all benefit society for decades after the event. Newly constructed sports venues can be transitioned to regular use. Increased tourism and commerce can accrue from an enhanced global image. (Economic impact studies attempting to quantify this are challenging to assemble and often bear the bias of their sponsors.)

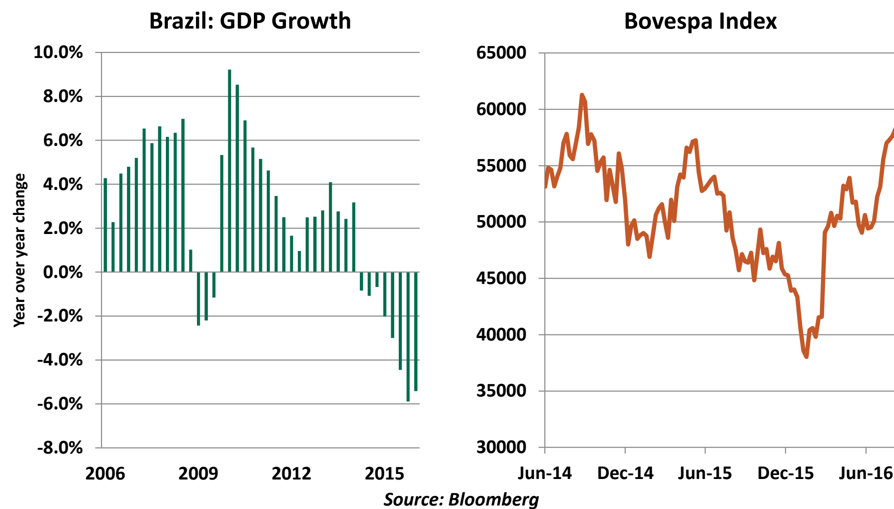
These benefits must be weighed against the costs. Fees for Olympic television rights and sponsorships have skyrocketed, but the International Olympic Committee (IOC) keeps most of these. Candidate cities must pledge to cover any financial shortfall from the Games, and several recent Olympics have left host countries with big bills. Montreal recently made the final payment on debt it assumed for the 1976 Summer Games, which nearly bankrupted the city.

Most of the revenue generated by the Olympics is kept by the IOC.

For authoritarian regimes, these outcomes raise few protests. But for democratic nations, the public debate over whether the Olympics represent money well spent is more active. Boston, which was nominated by the United States Olympic Committee to be the American candidate city for the 2024 Summer Games, withdrew from consideration after local groups raised objections. The list of prospective suitors for each Olympiad seems to be shrinking.

This has led to proposals that the Olympics might better be held at one of a limited set of rotating sites with established facilities and infrastructure. That would certainly make fiscal sense, but the competition to be among the favored would be especially keen. The IOC selection process has already been the subject of corruption on a number of occasions, and the size of the stakes if that proposal succeeds might bring out the worst in the delegates.

When Brazil was awarded the 2016 Games seven years ago, the country was ascending. The economy had been expanding and the Brazilian real had doubled in value against the U.S. dollar. Foreign investment was flowing in and Brazil seemed poised to join the upper echelon of developing nations.



Source: Bloomberg

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Since 2009, unfortunately, times have soured. The end of the commodities "super-cycle" diminished Brazil's leading industries. Unemployment has risen from less than 5% at the beginning of 2015 to more than 11% today. The country has never been known as a bastion of fiscal responsibility and its debt position has worsened dramatically. A massive corruption scandal led to the impeachment of the president.

Brazil's markets have recovered, but the economy has not.

On the bright side, investors seem to sense that the worst is over. Brazil's stock market has rebounded this year – up nearly 70% versus an 8% return across global markets. However, the economy remains firmly in recession and government finances are a mess; a lot of difficult policy work will be required to correct what ails the economy. The Brazilian spirit of *gambiarra*, or last-minute improvisation, worked well for the Olympics but may not be sufficient to address long-term challenges.

The divisions between Brazil's rich and poor have grown deeper. The lack of basic services like sanitation, health care and security placed the Olympic costs under a particularly strong microscope. The excitement surrounding the Games certainly took people's minds off their problems for a fortnight. Yet those problems will remain long after the athletes have left, and Brazil may struggle to sustain the positive feeling generated by the Olympics.

As many will recall, Chicago was among the bidders for the 2016 Summer Games. Some people feared a financial disaster and were glad the city was eliminated in the very first round of voting. I was not one of them. I was hoping to jump into the Olympic pool just in time to win the gold medal I always dreamed of. The years in prison would have been worth it.

Upping the Ante

John Williams, president of the Federal Reserve Bank of San Francisco, recently suggested raising the inflation target of the Federal Reserve from the current 2% to perhaps 4%. In doing so, he joined a small but growing chorus of voices calling for a change in the existing monetary policy framework across the developed world.

The basic logic of raising the inflation target goes like this: Weak economic performance and prospects have lowered the "neutral" real rate of interest, and raising the inflation target would lead central banks to keep the nominal rate of interest higher during stronger times. This would give monetary policy makers greater room to pursue deeper policy rate cuts to stimulate economic demand during difficult times.

Allowing inflation to run a little hot would lower the probability of hitting the zero lower bound, the point at which monetary policy loses potency. Greater room to use interest rate policy would reduce the need to implement further unconventional monetary policy measures and fiscal activism – central bank balance sheets are already swollen and public debt levels remain high in the developed economies.

This idea is not new. It was floated in 2010 by the chief economist of the International Monetary Fund, Olivier Blanchard. Back then, the economic slowdown then seemed to be a temporary phase and the potential risk of unmooring inflation expectations was an overriding concern. Six years hence, the idea has gotten a lot more traction.

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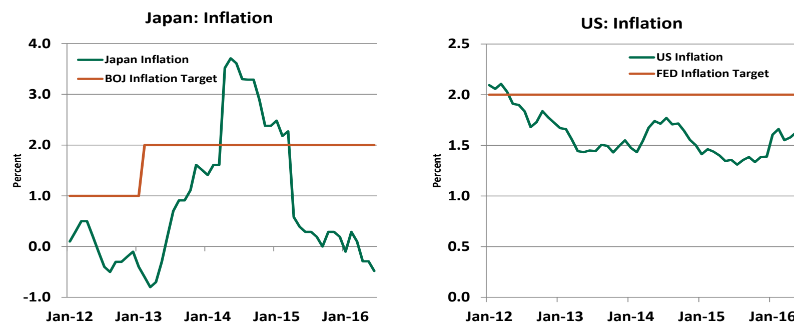
The “hawkish” case against raising the inflation target could be dismissed as generals fighting the last war. The primary concern of the new era is not the potential for prices to spiral out of control; instead, developed nations are struggling to generate normal levels of inflation. It is true that rich countries have higher price levels and therefore need low inflation to remain globally competitive.

Inflation targeting works when central banks set an objective and commit to a monetary policy consistent with that goal. Ideally, businesses and individuals find the central bank’s pledge to be credible and set their inflation expectations accordingly. This anchors long-term average inflation to the target. Thus, belief in the central bank’s ability to meet the target is essential for this framework to function.

If central banks were starting over with a clean slate today, some might agree with Williams and pick 4% instead of the current 2%. But given that central banks have been unable to meet even the 2% target satisfactorily since the Great Financial Crisis, can we really expect them to meet a higher target? Raising the target now would simply set the central banks up to fail, compromise their credibility and unhinge inflationary expectations.

Best to meet existing goals before setting new ones.



Sources: Thomson Reuters, FRED

Consider the case of Japan. Despite having failed to meet its 1% inflation goal, the Bank of Japan (BoJ) set a target of 2% in January 2013. Although a temporary rise in inflation resulted from energy prices and a sales tax hike, the shift in inflation target has been a failure despite the massive expansion in the BoJ’s balance sheet and negative policy rates. The Japanese economy is back in deflation this year.

The Fed’s performance in meeting the current inflation target would inform expectations on its ability to meet the new one. Therefore, trying for a higher inflation target (or any other targeting options, like nominal GDP) will make sense only when the current target is successfully achieved. This subject is sure to arise during the meeting of global policy makers and academics at Jackson Hole, and it will be interesting to see if any conclusions are reached.

Policy and Theory from Jackson Hole

Fed Chair Janet Yellen’s much awaited speech on August 26 had two segments – a short discussion of near-term Fed monetary policy and an extended reflection of longer-term issues. The former is of greater interest for markets.

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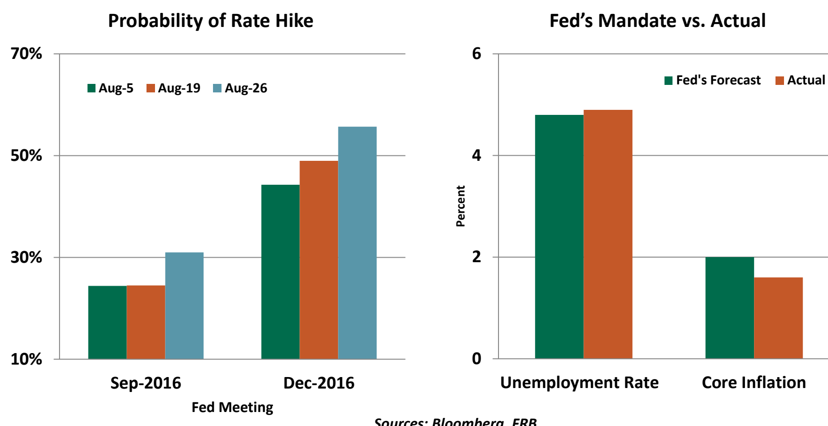
Yellen mentioned that the "case for an increase in the federal funds rate has strengthened in recent months." She noted that the U.S. economy is on the cusp of meeting The Fed's goals of "maximum employment and price stability." But her remarks did not allude to timing of the next move. She added the usual caveat that Fed policy actions are data dependent.

A Fed hike in 2016 is very probable.



Sources: Bloomberg, FRB

The federal funds futures market raised expectations about rate increases by only a small measure soon after. The August employment report will likely play a big role at the September Fed meeting, after which the Fed's new economic forecasts will be available and a press conference will take place. Whether members of the Federal Open Market Committee (FOMC) have changed their near-term and long-term expectations of monetary policy will be visible from the dot chart.

The second part of the speech was a comprehensive discussion of the longer run policy issues. Doubts about the course of near-term monetary policy, caused by the article John Williams published last week, were removed. He suggested a higher inflation target (see comments above) should replace the current one. Chair Yellen noted: "I should stress, however, that the FOMC is not actively considering these additional policy tools and frameworks, although they are important subjects of research." She expressed complete faith in The Fed's current policy tool kit and its effectiveness.

There is a lively debate underway about the long-run equilibrium interest rate. Members of the FOMC view the long-term federal funds rate as 3%, down 125 basis points from the Fed's first-published forecasts in 2012. After adjusting for the Fed's inflation target, the real rate would be 1%.

Yellen opined on this issue and mentioned that the real rate is close to zero by some calculations. She indicated "it could remain at this low level if we were to continue to see slow productivity and high saving." This implies the Fed believes the path of monetary policy tightening will be gradual.

Slow and steady Fed remains our conclusion. A September move is possible but a December change is more likely.

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