

**WAKING UP IN RECOVERY, PART 1:
LESSONS BEHIND US, CHALLENGES AHEAD**

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HOST: Paul Kasriel, award-winning chief economist of Northern Trust, is one of the most respected economists in the financial community. In Part One of this series, Paul shares his views on the state of the economy, the headwinds we face, and future engines for global growth.

DOUG: Thanks for joining me.

*Paul Kasriel
Chief Economist,
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PAUL: My pleasure.

DOUG: Looking back over the past year, we have been through one of the largest economic meltdowns in recent memory. What do you see as the key lessons coming out of that period?

PAUL: Well, one of the things I think we have to learn is that the Federal Reserve can't control everything, and that sometimes when it tries to control everything it leads to the kind of meltdown we had. Alan Greenspan was of the view that he could let a bubble run. He might not have said that he helped create it – other people might say that – but that he could always come to the rescue after the bubble burst. And he was able to do that once but not twice. But I think we need to learn that the Federal Reserve should be more neutral in its approach to its job. The Federal Reserve should not be there to smooth out every bump in the road for Main Street or Wall Street. And if we have the Fed acting in a more neutral way, we would likely not see these asset bubbles develop – we saw two of them within ten years – and we wouldn't see prices of goods and services run away either. So we need a more humble Fed. I think investors need to learn. They need to do their homework. You don't get something for nothing. In that respect, I am talking about the rating agencies. The rating agencies are paid by the issuers of bonds – the borrowers – not by investors. And investors thought



they were getting something for nothing in these ratings. They need to do their own credit research or hire someone to do that. We need the regulators to actually use the authority they have been given. I suspect that, had various regulators done that, they could have stopped a lot of the abuses that were taking place.

DOUG: How do you see the state of the economy now? You have talked about coming out of this period and looking at perhaps a jobless recovery, what is your overall assessment?

PAUL: Well, the worst is over and I really believe that an economic recovery has set in. But I believe it will be a very uneven and on average subpar recovery for at least a year and maybe a little bit more. There still are significant headwinds the economy faces and one area in which that is apparent is in the financial sector. The financial sector has been stabilized but there is another problem coming, that is commercial mortgage losses and probably more losses related to credit card debt and auto loan debt. The financial sector, while many players are adequately capitalized today, six months or a year from now, with these additional losses coming, may be undercapitalized. And without capital the private financial sector cannot create credit in a normal way. And history tells us when that sector is not functioning in a normal way the overall economy doesn't. So that is one area. Another is households. Households are having to readjust, not to a new normal, but to the old normal. That is, spending less than they earn. And that doesn't necessarily mean that total spending in the economy has to go down. But there are periods of adjustment here, so that is going to take time. And unfortunately I think we are going to have another jobless recovery much like the prior two recoveries were jobless recoveries. This one may be even worse. There are three reasons why I think the labor markets are going to be slow to come back. Number one, I just don't think the economy is going to grow fast enough to reemploy all of the millions of people who have lost their jobs and employ new people coming into the workforce. Number two, the workweek is at a record low level of 33 hours. I think normally the workweek is 40 hours; it is 33 hours on average now. So as businesses see a pickup in demand, they can accommodate that demand simply by extending the workweek of their current workforce. And third, we are going through some structural changes in the economy. As I mentioned, consumers are going to start to spend less relative to their income and certain areas are not going to come back for a long time. Car and truck sales; in 2006 we were selling 17 million units of cars and trucks and

now we are selling a little bit more than 9 million. It's going to be a long time before we get back to 17 million, and that means that some of those unemployed autoworkers probably will never find employment again in that sector. And there are other sectors like that as well.

DOUG: What is the implication for the global economy? Because the U.S. consumer has long been the engine of global growth.

PAUL: Well, we are going to see, I think, a shift in emphasis for a lot of emerging market economies more toward domestic demand. We have seen the Chinese government embark on a fairly aggressive fiscal stimulus program. We are seeing rising numbers in the middle class in these emerging economies and typically when you get into that category you tend to consume more, spend more. And so I think the emerging markets, the developing economies, are going to be where most of the action is over the next ten years. And I think in those economies, we are going to see a gradual shift to more domestic demand, and I think that is actually going to lead to a shift in the composition of output and demand in our economy, away from as much consumer spending and housing – they'll still be big, but not as big – and more toward exports and capital spending and research and development to support those export industries.

HOST: Thank you for joining us. If you'd like to read more of Paul's commentary, please log on to northerntrust.com/econtrarian.

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