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# WEEKLY ECONOMIC COMMENTARY

**IN THIS ISSUE:**

- **Cost Of Living Rooms**
- **NATO By The Numbers**
- **Global Tax Deal: Unfinished Business**


Global Economic Research
50 South La Salle Street
Chicago, Illinois 60603
northerntrust.com

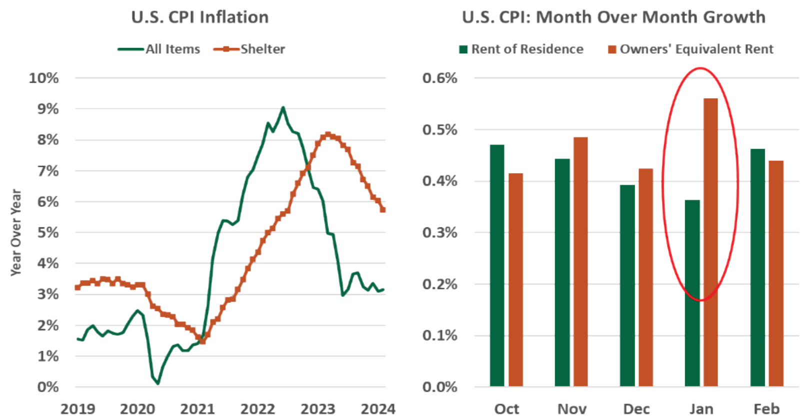
**Carl R. Tannenbaum**
Chief Economist
312-557-8820
ct92@ntrs.com

**Ryan James Boyle**
Chief U.S. Economist
312-444-3843
rjb13@ntrs.com

**Vaibhav Tandon**
Chief International Economist
630-276-2498
vt141@ntrs.com


The importance of the housing market has led us to focus on it across many dimensions. We have discussed its short supply, the role of mortgages as a defense against inflation and promises of greater residential investment. Today, housing has captured our attention as a consequential and frustrating driver of inflation.

Shelter costs followed headline inflation up in this cycle, but have remained stubbornly elevated even as most other components improved. The majority of U.S. households own their homes; in the consumer price index (CPI), their monthly costs are captured by a concept called owners' equivalent rent (OER). The measure is theoretical; it does not use actual house prices or interest rates, which combine to drive mortgage costs. Its impact on inflation is significant, as OER represents over 25% of the CPI basket (and combined with rent, the shelter category exceeds 35% of the CPI).




*Sources: Bureau of Labor Statistics, Haver Analytics*

High housing inflation is casting more attention on these measures, and a divergence in their growth rates in January was alarming. The rent and OER indices usually move in tandem, as they are closely related. In January, the two measures grew at starkly different rates.

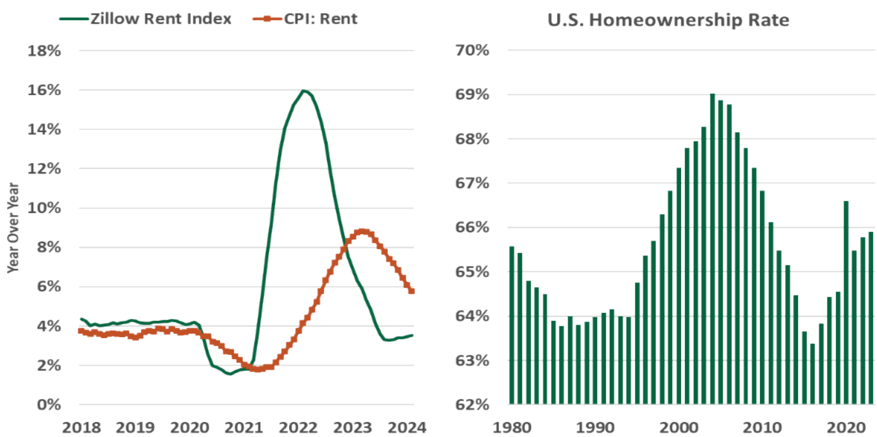
As part of routine annual benchmarking, the weights in the OER formula were rebalanced to add 5% more weight toward single-family detached housing. Rents on these units have been growing more rapidly than they have for apartments, which created the jump in inflation. The weights are now fixed for the year ahead, and further divergence is unlikely—at least, until the next reset.

The surprise was magnified after the Bureau of Labor Statistics (BLS) emailed a more detailed explanation to a subset of "super user" economists who had inquired about the surprise. The BLS then clarified that no new information was contained in the message.

The episode highlights the current sensitivity to housing as we grapple with the outlook for inflation. After collapsing in 2020 and then recovering, the CPI measure of rents is growing almost twice as fast as alternative indicators of asking rents (such as the Zillow index shown in the chart). Economists have been expecting the two to converge, but the process has been slow.

The measures use different reference sets, which may explain the different trajectories. Indices published by Zillow or Redfin draw from listed vacancies on their own portals, often large buildings under professional management.

The BLS draws from consumers' reported expenditures; their housing costs encompass a much wider variety of property types. Most homeownership is of single-family detached homes, which are less likely to be listed on large rental data aggregation platforms. Further, rentals on detached homes are rare, making it difficult to calculate the OER.




*Sources: Zillow, Bureau of Labor Statistics, Census Bureau, Haver Analytics*

**Housing costs may not ease as quickly as we had hoped.**

All of this casts some doubt over the notion of when and whether shelter costs will moderate. The outlook for housing remains a story of strong demand and constrained supply. The prices of and rents on property will continue to be supported by tight labor markets and a growing population; we are still in need of places to live.

Bringing shelter costs under control will be vital to holding down inflation and managing expectations. When shelter is excluded from the CPI, we find that price growth has been below 2% for nine months in a row. The housing line is one of the first we look at when new inflation data comes out; we expect that it is the same way within the Federal Reserve.

The forces holding up shelter prices, like a growing population and longer lifespans, are good problems to have. But until the stock of dwellings catches up with demand, the high cost of housing will remain a burden.

## The Case For The Defense

I'm writing from London this week, where Sherlock Holmes famously chased clues and criminals. There is a Sherlock Holmes museum here, and one can take a walking tour to visit sites that featured prominently in his adventures.

Believe it or not, Holmes used cocaine to focus his mind. The drug was commonly prescribed in Victorian England for a range of maladies; a seven percent solution was administered. That dosage became the title of a 1974 novel, an homage to Sir Arthur Conan Doyle in which Holmes and Watson foil a villain intent on inciting war in Europe.

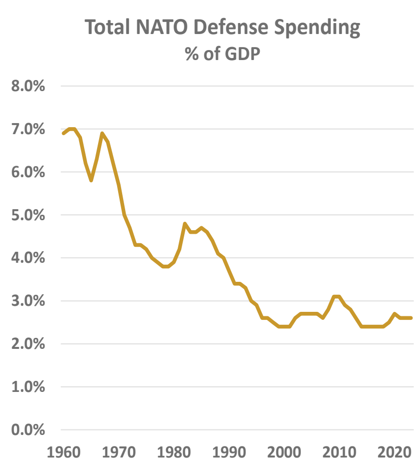
In the modern era, a two percent solution has been used to avoid war in Europe. The two percent refers to the fraction of gross domestic product (GDP) that signatories to the North Atlantic Treaty Organization (NATO) are expected to spend on defense. Not all countries are in compliance with this expectation, which has become a sticking point between members and a risk to economic activity.

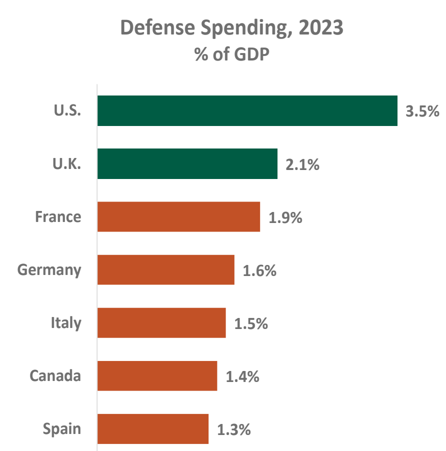
National security and prosperity are inextricably linked. Threats raise risk premia and divert resources from civilian to strategic applications. The potential for disruption can lead to outmigration of both people and capital. Investment horizons are curtailed amid the possibility of war, hindering long-term development.

**Defense spending in Europe needs reinforcement.**

NATO was formed in 1949 to coordinate defense among Western Allies. After collaborating during World War II, Western Europe and the Soviet Union found themselves in a Cold War. NATO was formed with twelve countries, whose union served as a counterweight to growing Soviet influence in Eastern Europe. With the continent rebuilding, the United States provided the lion's share of defense spending for NATO in its early years.

At the height of the Cold War, NATO defense spending as a share of members' GDP was three times higher than it is today. As détente took hold in the 1970s, and as the fall of the Berlin Wall approached in the 1980s, Western countries were able to reap a "peace dividend." The fraction of GDP devoted to security by NATO members has been fairly constant for the past 20 years.




*Source: NATO*

In the wake of Russia's annexation of Crimea in 2014, NATO adopted the 2% rule to ensure sufficient financial commitment to security. That goal was to be reached over a ten year period. As of last year, only 11 of the 32 member countries met this objective; some important European names fell short. That is not a good position to be in with Russian aggression increasing.

In recent years, gaps in NATO defense spending have become more of an issue with the United States, which is facing a deteriorating fiscal position. Some have suggested that European countries have gained competitively by using resources for development instead of deterrence. The situation is certain to be a focus during the 2024 U.S. presidential campaign.

The challenge is that national budgets in Europe are also stretched. The updated growth and stability pact is limiting fiscal freedom. Annual shortfalls will once again be capped at 3% of GDP, leaving little room for more defense spending. Europe's governments are also seeking to engineer a successful energy transition and modernize technology, all while dealing with the collective costs of aging populations. The calculus is very difficult.

With the 10-year checkpoint approaching, 18 of the 32 NATO countries say that they will meet the 2% requirement. That represents an improvement, but it also represents only 56% compliance. If peace and prosperity are to be preserved, Europe will want to do better.

Perhaps we can borrow a magnifying glass from Sherlock Holmes to find clues on where funding can be found in national ledgers. Hopefully, the solution will be…elementary.

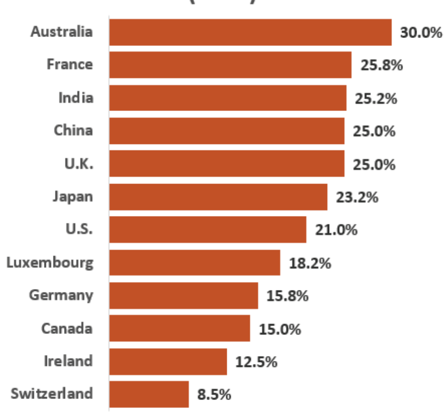
## Taxing Problem

Following a decade of debate, over 130 nations agreed to a Global Minimum Tax for large multinational corporations (MNCs) in 2021. At the time, it was deemed a momentous achievement that would prevent a race to the bottom in corporate tax rates. Three years later, the deal is stuck in political paralysis.

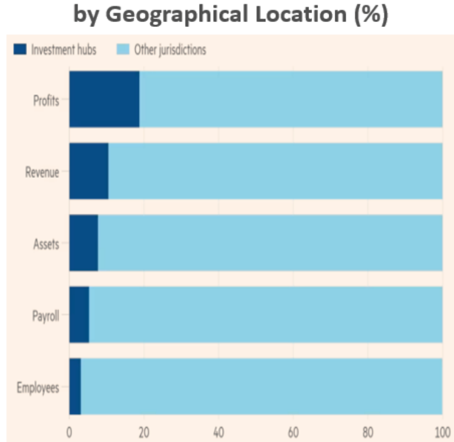
The agreement contains two pillars. Pillar One changes where large corporations pay taxes. MNCs would pay taxes in jurisdictions where they conduct a substantial amount of business or where their products are sold, even if they do not have a physical presence in those markets. Pillar Two focuses on the introduction of the global minimum tax of 15% for companies with consolidated group revenues of more than €750 million per year.

The new system is aimed at minimizing opportunities for profit shifting, and ensuring that the largest corporations pay taxes both where they do business and at home. Research shows that U.S. businesses accumulated an estimated $1.2 to $1.4 trillion in profits in low-tax jurisdictions from 1998 to 2018.

**Corporate Income Tax Rate (2023)**




**Profits Multinationals Earned by Geographical Location (%)**




*Sources: OECD, FT; Investment hubs are low-tax countries or tax havens*

**A historic agreement is at risk of becoming another major economic flashpoint.**

Corporate taxes are a source of revenue for development objectives, energy transition and infrastructure modernization. The international tax reform was expected to provide a more level playing field and increase fiscal intake. According to the Organization For Economic Co-operation and Development (OECD), which led the discussions around the agreement, the global minimum tax policy will reduce under-taxed profits by around 80%. The OECD estimates that the reform would lead to an increase in annual tax revenue of up to 8.1%, or $192 billion globally.

After delays and disagreements, the draft of the multilateral treaty for Pillar One was published only recently (October 2023). The progress on Pillar Two has also been slow. Only 36 nations have implemented the deal or have new rules in process thus far. These include the U.K., Norway, Australia, South Korea, Japan and Canada. Even nations like Ireland, Luxembourg, Switzerland and Barbados, which were seen as tax havens or investment hubs, have levied the 15% minimum tax on profits of large corporations.

However, the deal continues to face obstacles in other major economies like the United States, where Congress has been unable to ratify the agreement. The loss of sovereignty and ability to cut taxes is a point of great contention; the U.S. could withdraw from the deal entirely if Republicans prevail in this year's elections.

**Even if the U.S. does not adopt the global minimum tax, U.S. firms will pay more in taxes overseas.**

In January 2024, the European Commission initiated infringement proceedings against nine European Union (EU) member states for not implementing the global minimum tax. Non-compliance could lead to an escalation to the EU Court of Justice and potential financial penalties. Several developing market signatories are pushing for a bigger and legally binding role of the United Nations amid concerns over their interests.

Not every nation stands to benefit from the standardization in international taxation. Investment hubs which have had corporate tax rates below 15% or have used corporate tax breaks to attract foreign investments will be among the biggest losers, as MNCs will likely relocate profits and investments. American corporations have benefited from lower corporate tax rates in European economies like Ireland. They now face higher tax payments, even without the ratification of the deal in the United States, as many European nations have already adopted the reforms.

A U.S. opt-out will likely fragment the global tax system and could trigger trade or tariff fights. The deal will boost tax revenue for developing economies, but the gains will be relatively small and won't be enough to meet their sustainable development goals without raising their domestic taxes.

All these developments suggest that broad implementation of the 2021 agreement is still some way off. This potential symbol of cooperation has become a source of friction in an already fragmented world.