WEEKLY ECONOMIC COMMENTARY

Northern Trust

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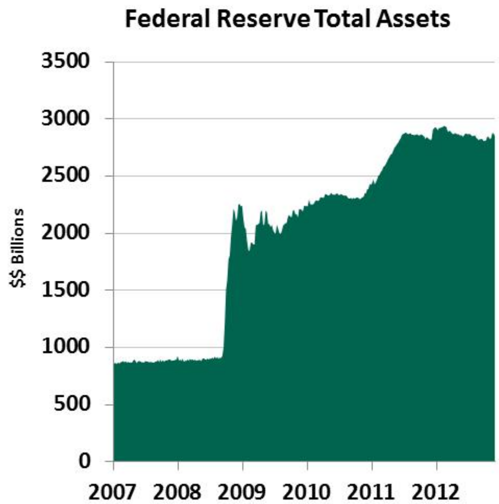
- **What are the margins of monetary policy?**
- **The November job report showed only modest improvement**
- **Japan continues to struggle, with a change of government on the horizon**

After several years of pushing the boundaries of monetary policy, the world's leading central banks may be approaching the natural limits of their influence. As they do, the comparison of marginal benefit to marginal cost becomes increasingly important. This tradeoff, and strategies to contain potential costs as they arise, have been at the center of recent monetary policy discussions in the US and Europe.

In the US, the Federal Open Market Committee (FOMC) will conduct its final meeting of the year next week. The key decision facing the group will be what to do after "Operation Twist" sunsets at the end of 2012. Under this program, the Federal Reserve has been selling short-term Treasury securities and buying long-term Treasury securities in an effort to keep downward pressure on long-term rates.

If "Twist" is allowed to expire, it would represent a tightening of monetary policy. Based on comments from a plurality of Fed officials over recent weeks, that is not an outcome that most are ready to support with unemployment still elevated. We therefore expect the FOMC to charter an outright purchase program of long-term Treasury securities in the range of $45 billion monthly, roughly comparable to what they have purchased this year. This will continue the expansion of the Fed's balance sheet, which is on its way to exceeding $3 trillion.



Source: Federal Reserve, Bloomberg

Each extension of the Federal Reserve's quantitative easing (QE) program renews the debate over its efficacy and the potential risks it might kindle. It's hard to know with precision how much the Fed's efforts have helped the US employment situation, since many factors bear on the labor markets. But there is a growing sense that the benefits of QE are diminishing, and that headwinds to job creation may be too substantial for the Fed to overcome. There is little that the US central bank can do to clear the uncertainty posed by the approach of the fiscal cliff, for example. Policy constraints on housing are the province of other agents in Washington. Consumer balance sheet repair, even for those with steady jobs, is hard to accelerate.

To some, the Fed is facing a bit of a liquidity trap, pushing on a string in an effort to stimulate activity. If pressing ahead produces more modest benefits, they will have to be weighed against potential costs that might manifest themselves over time. Inflation is one possible consequence, although both current and expected inflation in the US seem very well behaved. The formation of asset bubbles is another, although none are on the horizon at the moment.

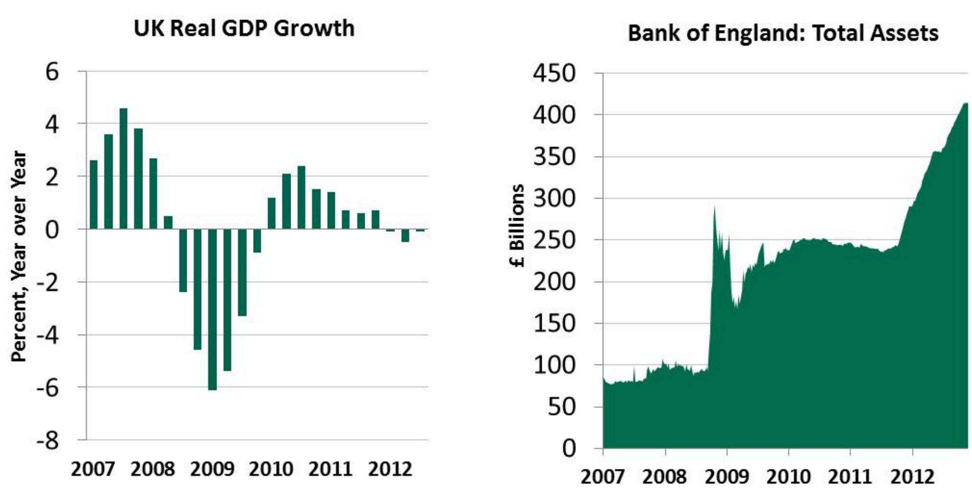
The FOMC is likely to press ahead with QE, despite increasing signs of diminished potency.

On that latter front, the Federal Reserve may have altered its thinking. Alan Greenspan often noted that diagnosing bubbles is very tricky business, and that traditional monetary policy was a poor tool for deflating bubbles in any case. These observations, combined with his belief in market discipline, led to a "hands off" policy when it came to asset market excesses.

Ben Bernanke, however, leaves the door a bit more open to central bank responses in these cases. In a 2002 speech, then-Governor Bernanke suggested that supervisory powers, as opposed to monetary approaches, might be employed effectively to curb excesses. In particular, he mentioned capital requirements based on stress tests as one means to this end. Ten years later, stress tests have been codified as a supervisory requirement for many banks.

All of this is not to say that the Fed can head off any potential consequences of too much quantitative easing. But it is to say that a new set of unconventional tools could be used to curb the risk of the unconventional tools currently in use.

The Bank of England (BoE) opted this week to keep its benchmark interest rates the same, and to keep its program of quantitative easing on hold. These decisions were taken in spite of fresh forecasts that were less optimistic.



Sources: UK Office for National Statistics, Bank of England, Bloomberg

The BoE had allowed its own QE program to close at the end of October after purchasing £375 billion ($600 billion) of government bonds. As a percentage of Britain's GDP, this effort was actually more sizeable than the one undertaken by the US Fed. The UK Monetary Policy Committee has apparently concluded the program had reached the limit of its effectiveness.

Last month, the Chancellor of the Exchequer surprised many by naming Mark Carney, the Governor of the Bank of Canada, to a similar post at the Bank of England. (Some of my British

Supervisory powers are an essential wrench in the central banker's tool kit.

partners noted that the appointment, while very surprising, was nowhere near as shocking as the appointment of an outsider to lead the national soccer team in 2001.) Perhaps one reason for the selection is that Carney is deeply involved in financial stability work, and might make best use of the bank supervisory powers which are returning to the British central bank. As noted above, these might be employed effectively to limit any unpleasant side effects of quantitative easing.

The European Central Bank also concluded its meeting this week with a call to gain supervisory authority over all of the continent's banks. In his post-meeting remarks, ECB President Draghi highlighted the importance of these powers to the quest for economic stability. Bringing transparency to credit intermediaries, and ensuring that they are capitalized to a level that would support renewed growth, will be essential to addressing the Eurozone's challenging environment.

Having the supervisory authority under the same roof as the monetary authority supports the exchange of information that is critical to steering economic activity. It may also allow a level of policy coordination that could be exceptionally useful in a post-QE world.

Some might note that, as a former central banker, I could be accused of thinking that additional oversight from the official sector is the cure for everything. Yet if central banks can use their various wiles to prevent credit excesses before they occur, everyone is better off.

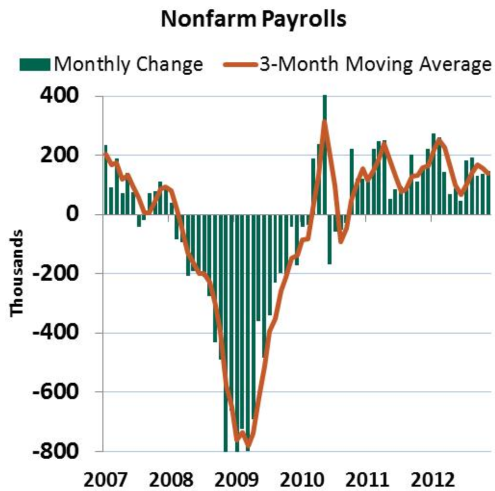
Little Impact of Sandy in the November Job Report

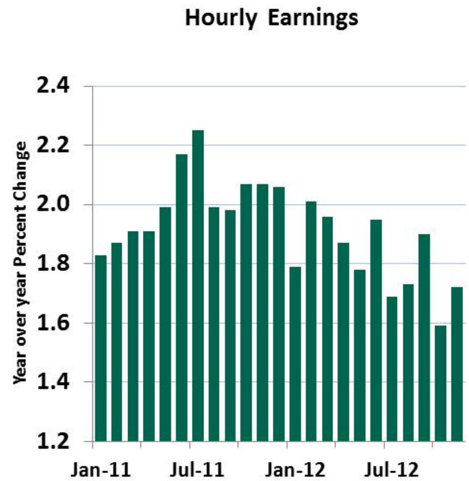
The Labor Department announced this morning that the US unemployment rate fell to 7.7% in November from 7.9% in the prior month. This is the lowest unemployment rate since December 2008. The broad measure of unemployment, which includes those seeking full-time jobs but working part-time and those marginally attached to the labor force in addition to the officially unemployed, stood at 14.4% in November vs. 14.6% in the previous month and it is down from 15.6% a year ago.

Prior to the publication of today's report, there was speculation about the impact of Hurricane Sandy on the November employment data. The Bureau of Labor Statistics has pointed out that the "survey response rates in the affected states were within normal ranges" and Hurricane Sandy "did not substantially impact the national employment and unemployment estimates."

Digging more deeply into details, the decline in jobless rate came about because the labor force declined sharply (-350,000), after an expansion of close to one million in the September-October period. As a result of a reduction in the labor force, the participation rate edged down two notches to 63.6% during November.

Nonfarm payrolls advanced 146,000 in November, nearly matching the year-to-date average of 151,000 and the 2011 average of 153,000. There were downward revisions to job estimates for September and October resulting in a loss of 49,000 positions, largely a reduction of government jobs. The total workweek was unchanged and the monthly increase in hourly earnings was small, suggesting that consumer spending will not advance at a robust pace.





Recovery in the US labor market remains modest.

Source: Bureau of Labor Statistics, Haver Analytics

Essentially, today's news points to a very gradual mending of labor market conditions, which will continue to remain on top of the Fed's list of major concerns. In early 2013, the Fed is likely to make available a threshold of the jobless rate which it deems consistent with a higher Federal funds rate. Recent remarks of Fed Presidents show thresholds of unemployment rate ranging from a low of 5½% to a high of 7¼%, suggesting that choosing a consensus target will require some careful conversation.

Another Year, Another Japanese Prime Minister

It's been a little over a year since Yoshihiko Noda took over as Prime Minister in Japan, so that can only mean one thing—it's time for another prime minister. Following a tense year in which Noda was criticized for stalling after promising to call elections "soon" in August, the Prime Minister was finally forced to dissolve parliament and send voters to the polls on December 16 in order to avoid the Japanese version of the fiscal cliff.

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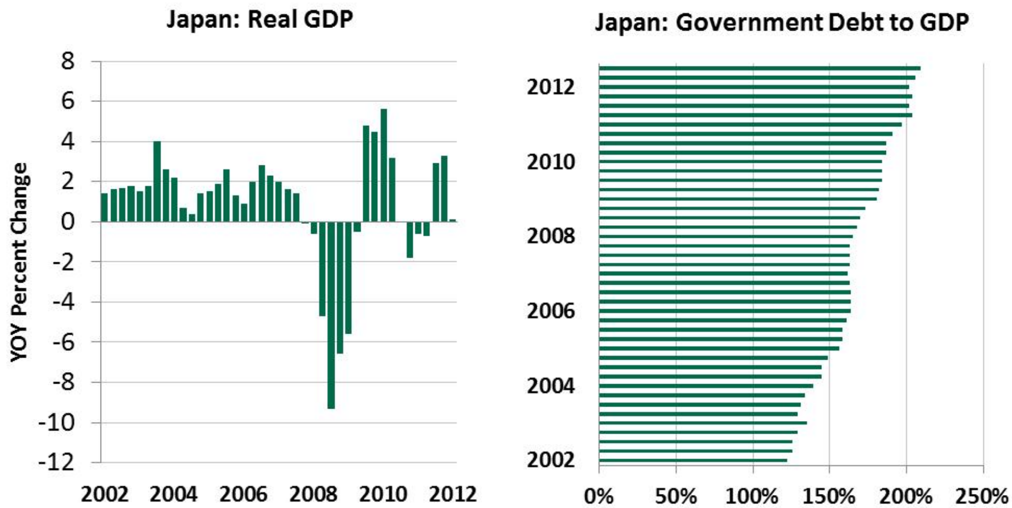
Shinzo Abe, who had an unremarkable turn as PM in 2007, will almost certainly be the next Prime Minister. Mr. Abe will certainly have his hands full as Japan slides towards a recession in the fourth quarter. Soft global demand, the stubbornly high yen, and a de facto boycott of Japanese goods by Chinese consumers have taken the steam out of the economy in the second half of the year.



Source: Bank of Japan, Bloomberg, Haver Analytics

Reconstruction efforts in the Tohoku region, site of the Fukushima reactor, have proceeded more slowly than anticipated, but increased spending should ensure that Japanese growth is positive on an annual basis in 2012 and 2013. However, the incoming government will be tasked with finding the consistent growth that has eluded the country.

Japan's "lost decade" has now lasted twice that long.

The winners of the election will have the opportunity to control appointments to the three most senior posts in the Bank of Japan (BoJ). The outgoing Governor Masaaki Shirakawa has been harshly criticized for lackluster attempts at easing—especially when compared to his Eurozone and US counterparts—as well as the inability to defeat deflation. Following the LDP's return to power, monetary policy is expected to become more aggressive and substantive.

The winning party will also inherit the controversy surrounding the use of nuclear power plants. Currently all but two of the nation's 48 nuclear reactors are offline, as authorities bow to public opposition. The impact on businesses is higher utility costs and the need for flexible production hours to work around consumption restrictions. The increasing cost of operating in a nuclear-free Japan may be the final straw in pushing some enterprises to other locations, including South Korea and China.

The trade account has also been impacted as increased energy imports have combined with decreased exports to send the balance negative. The days of persistent Japanese trade surpluses are gone.

A perennial issue, with which the LDP is already well versed, is the demographic deficit on the island. People are living longer at the same time that the working age population is due to shrink as a result of falling birthrates. Young women are reluctant to hop off the corporate ladder to have children, while corporations in Japan, Inc. are slow to change a business culture that is not wired to deal with working mothers. Immigration, the other traditional option for countries with low birthrates, is currently not an option in a country which values its relative homogeneity.

The demographic deficit discussion holds the key to the most pressing question for Japan-watchers: when will Japanese yields rise? A sovereign with debt levels above 200% of GDP wouldn't normally have some of the lowest yields in the world. Japanese pension funds will gradually start paring back holdings of Japanese government bonds as they require more cash to pay benefits. As that occurs, yields will become more susceptible to global investor sentiment.

Japan's "lost decade" has now lasted almost twice that long, with annual real GDP growth averaging less than 1% over the past 20 years. Policy failures on the fiscal and monetary front have contributed to this outcome, and the study of this experience may be what keeps the Federal Reserve driving forward with its quantitative easing program. One can only hope that the Japanese eventually learn from their own experience.