

## Bernanke and Trichet: Comedy or Tragedy?

Recent comments by the heads of the Federal Reserve and European Central Bank moved the markets. Federal Reserve Chairman Benjamin Bernanke spoke plainly and clearly and yet was nearly universally misunderstood, but the market tended to like what it thought he was saying. In contrast, ECB President Jean-Claude Trichet was perfectly understood and investors did not particularly like what he said.

Bernanke spoke at a monetary conference in Spain. He said he wanted to discuss three things: place recent developments in the context of long-term factors, trace how those factors impact the market and the economy, and finally discuss the Fed's response.

The copy of the text of his remarks ran about 22 paragraphs, and the dollar per se was mentioned just three times, all within the last section in which Bernanke discussed how the Fed responded and is responding to those forces weakening the economy as well as elevating price pressures and all within one paragraph.

The first mention of the dollar was to state the obvious: working with the US Treasury, the Federal Reserve continues to carefully monitor developments in the foreign exchange market. This is neither a new initiative nor a change in stance. The Federal Reserve closely follows market developments daily. By citing the Treasury, Bernanke was also paying homage to the division of labor over US dollar policy—it is set by the Treasury Department, not the central bank.

The second mention of the dollar was an identification of the factors that have weighed on the dollar. Here Bernanke did not cite the current account deficit, a conventional explanatory variable. Nor did he cite the diversification of central bank reserve or sovereign wealth funds that others have cited. Instead, he noted that the challenges the US economy faced had generated some downside pressure on the dollar. In turn, he acknowledged that the decline in the dollar “contributed to the unwelcome rise” in import and consumer prices. In this context, Bernanke said the Fed was attentive to the implications of this for inflation and inflation expectations.

This seems largely consistent with the shifting risk-assessment at the Federal Reserve, which had already signaled somewhat greater concern about the upside risks to inflation than the downside risks to growth. Essentially, policy makers would like currency values to move in a direction consistent with policy (that is the fundamental benchmark that officials seem to refer to when they say currency markets should reflect fundamentals). When growth concerns dominate, a weaker currency is not objectionable. When inflation concerns move into ascendancy, a stronger currency is more desirable.

The third and final mention of the dollar was a reiteration of the Federal Reserve's mantra: over time, the commitment to the dual mandate of “price stability and maximum sustainable employment”, the flexibility of markets, and its innovative and productive prowess will ensure “the dollar *remains* strong and stable” (our emphasis).

In the Q&A session, Bernanke's audience pressed him a bit more on the dollar. Here too he was clear. First, a good part of the dollar recent decline was the unwinding of previous gains. This seems to play down the significance of that decline. Second, he opined that the impact of the dollar on commodity prices has been “relatively modest.” This also appears to diminish the importance of the dollar's decline and counters those who suggest the Fed's supposed elevated concern was because the weak dollar was driving commodity prices higher. Lastly, he opined that the dollar was fairly stable in the face of the recent run-up in oil prices.

Again, there was nothing that shows a shift in policy or some kind of commitment to intervene or in other ways support the dollar directly. While some claim that his comments were pointed and a break from Fed custom, we would conclude the opposite. Contrary to some press reports, like the Financial Times where the title of a story was “Why Fed chairman spoke out about the dollar” (June 4<sup>th</sup>, news analysis by Krishna Guha), or other observers claiming that Bernanke was glib, he did not did not speak about the dollar. The dollar was included briefly in his largely academic discussion of the economy. If he did not mention the dollar, it would have been a glaring absence. It is only prudent to consider the currency's impact on inflation in general and imported inflation in particular.

Arguably, a more compelling explanation for the dramatic rise in the dollar was the short-term momentum players, who the media all too often seems to think are the only market participants, were reading the news in a way that justified their positions. However, two days later, the ECB laid any such hopes to rest.

After leaving rates on hold, ECB President Trichet explained that it was in a heightened state of alertness about inflation and that a rate hike next month was possible. It was possible, not a certainty, because the ECB does not pre-commit to rate adjustments. In Q&A, when asked why the ECB did not hike rates, Trichet replied that it had to prepare the market by first going to a heightened state of alertness. Apparently, to be forewarned is to be forearmed.

Policy has been on hold since last June, when it hiked its key rate 25 bp to 4.0%. At the conclusion of recent ECB meetings, Trichet has indicated that the decision was unanimous. This time the decision was by consensus, implying that some were calling for a rate hike. At the same time, Trichet released the new staff forecast which included upward revisions to inflation forecasts for this year and next, and this also helped drive home the heightened inflation concerns. Shortly after Trichet's remarks, Bundesbank President and ECB board member Axel Weber, one of the more vocal hawks, warned that the ECB would follow up its words with action.

Taken together, Trichet and Weber have all but indicated that the ECB will most likely raise rates next month. This now has to be the base case view. What can change this in the coming weeks is not weakness in real sector data. Trichet's remarks assume the strong Q1 growth will not be sustained. Inflation data, broadly understood, is now likely to receive both policy maker and investor attention.

Sometimes market participants confuse what they personally may think policy makers *should* do with what they are likely to do. To be sure, a rate hike would seem to be unnecessarily aggressive and will aggravate the challenges that lie ahead for the eurozone economy. With price pressures largely emanating from food and energy, in order to get headline inflation down to acceptable levels, the ECB appears willing to risk a recession.

Even if the systemic risk to the global financial system has been reduced, banks' and insurance companies' balance sheets have deteriorated and many are trying to raise cash. The rate hikes, or even the dramatic backing up in European rates, will make these efforts more difficult and likely prolong the convalescent process.

The one country that seems to draw the most benefit from higher rates will be Germany. Over time it has done a better job at containing unit labor costs and is easily the most competitive economy. A day after Trichet's comments, the Bundesbank revised up its German growth forecast to 2.25% this year from the 1.9% forecast made at the end of last year. Other countries who share the euro will be further strained. In the past, they would be able to devalue to restore price competitiveness, but this path has been effectively closed. Divergence rather than convergence may be a growing theme. German asset markets will likely outperform rest of Europe. As the region's economic slowdown gains momentum in H2, look for the critics to become more vocal. A Sarkozy-Berlusconi axis within the euro-zone is likely.

In conclusion, Trichet has trumped Bernanke in part because Bernanke was not announcing a new policy. Trichet clearly was. These developments suggest that although the dollar may have bottomed against half of the G7 and many emerging markets, the bottom being carved out against the euro will likely be more protracted than previously anticipated. It changes the trajectory, but not, in our view the underlying direction. In respect to these changes, we have lifted our year-end forecast for the euro from \$1.44 to \$1.47.

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