

The Fed and ECB: The Hubris of Small Differences?

The two major central banks, the Federal Reserve and the European Central Bank, meet next week. The neo-conservative Robert Kagan argued that in international affairs, Americans are from Mars and Europeans are from Venus. Many financial market participants appear to have taken this to heart and extended the application from diplomats to monetary officials.

Most observers seem to place emphasis on three differences between the Fed and ECB. The conventional view begins with the fact that the Federal Reserve has two mandates, full employment and price stability, while the ECB's only mandate is price stability. Next, they say the ECB has a formal inflation target while the Fed's has an informal comfort level. Lastly, it is noted that the Fed's inflation focus is on the core rate, which excludes food and energy, while the ECB targets headline inflation.

While there seems to be some validity to this view, these differences are more apparent than real. The Fed does, for example, have two mandates, but the way in which it interprets results in a similar mandate as the ECB. To those that think the Fed has two masters, the Fed has explained that there really is only one: price stability is necessary to achieve full employment.

A distinction without much of a difference is the issue of informal and formal inflation target. The ECB has repeatedly overshot its inflation formal inflation target more or less since it became responsible for the region's monetary policy. For their part, many Fed officials have acknowledged that US inflation is above their comfort zone. Operationally there appears to be little substantive difference between a formal and informal inflation target.

One of the considerations is accountability. There is little. The BOE is an exception. If inflation is sufficiently over its target, then it writes a letter (once a quarter) to explain itself. The absence of a legislative or executive recourse when the formal target is violated is more suggestive of an informal target, regardless of how it is marketed. Both the ECB and Fed desire price stability, which is defined in practical terms as the level of price increases that do not impact business or investment decisions.

There has been much debate about the validity of looking at prices stripped of energy and food, especially during this commodity shock. But the Fed's interest in core inflation is often exaggerated. It is true that many Fed officials have indicated a preference for looking at the deflator of core personal consumption expenditures. Officials also look at other measures of inflation, such as surveys of inflation expectations and the 5-year by 5-year forward inflation breakeven (a function of the difference of the Treasury's Inflation Protected Securities forward and the conventional Treasury forward curve). In addition, a number of officials have noted the acceleration of headline consumer prices. The Federal Reserve and ECB stance seems at most to be a marginally different emphasis.

On another level of analysis, there does appear to be a structural difference between the two central banks. The ECB board has a small core and large representation of the heads of the member central banks. The Federal Reserve in contrast has evolved to have a larger board and less influence for the regional presidents.

However, for a number of reasons (some political and some coincidental), the regional presidents have become more important on Federal Reserve Open Market Committee. Normally there are seven governors on the Federal Reserve Board who vote at the FOMC meetings, including the chairman. Five presidents from the Fed's districts have voting powers on the FOMC. Four of the five are decided on a formal rotating basis, while New York maintains a permanent spot amongst the regional contingent.

However, beginning in the June FOMC meeting and continuing at the August 5th meeting, the governors and presidents are at parity with 5 votes each. Two governors are missing. One has been confirmed recently (Elizabeth Duke from Virginia) but has not taken up her responsibilities yet as she is still making the transition. Some reports suggest that she might not be prepared to vote at the Oct meeting either.

In addition, Governor Mishkin is stepping down and the August meeting will be his last. In addition, Governor Kroszner's term has expired. He has been nominated for another term, but Congress has failed to confirm the appointment. Under the rules, however, Kroszner is permitted to remain a voting member until he has been confirmed or his successor has been named.

The point is that Senate Democrats are holding up the confirmation process in what appears to be largely partisan politics, hoping that the next president will be from their party. These obstructionist tactics are undermining the finely tuned balance by allowing the Board of Governors to lose their majority on the FOMC.

Several regional presidents, including Dallas Fed President Fisher (formerly of Brown Brothers Harriman) and Philly Fed President Plosser, are holding up the hawkish wing of the FOMC. It will be recalled that Fisher dissented at the June meeting, instead favoring an immediate rate hike. He also had previously opposed the last part of the rate cut cycle.

It is possible that the regional Fed presidents flex their muscles. However, this appears unlikely. Ultimately, James Madison's insight in Federalist 10 has stood the test of time. The great regional diversity in the US can prevent permanent majorities. The regional presidents are not a homogenous group. They do not vote as a bloc. Indeed, many regional presidents, like the presidents of the NY Fed, the San Francisco Fed and the Minnesota Fed, seem to be quite content with the FOMC's policy decisions.

Back in late June, the market had thought it quite possible that the Fed would hike rates next week. Such ideas have faded in the light of day. The market now recognizes practically no chance of an August hike. Economic data released since the last FOMC meeting probably did nothing to change Fisher's mind about the need to hike rates, but it probably did nothing to convince the FOMC of an urgency to join Fisher, though at most fellow hawk Plosser might have joined Fisher.

We never thought August was a likely timeframe for the first rate cut. Instead we looked forward to September. With some measures of inflation moderating, like employment labor costs, and the core PCE deflator in Q2 GDP and inflation expectations measured by the 5-year 5year forward and the University of Michigan long-term inflation survey, within the context of still serious financial stress, rising unemployment and tentative growth, the FOMC likely sees little urgency to move quickly.

Often observers confuse what they think the Fed *should* do with what the Fed is *likely* to do. To be clear then, we think that the current Fed funds target rate is well below zero in real inflation adjusted terms, which is appropriate for an emergency or contracting economy. A 25 bp rate hike will not have any perceptible material economic impact, would keep the real rate below zero, but it would represent a step toward re-building the Fed's anti-inflation credentials and would also help to support the US dollar. We think the Fed should and will adjust monetary policy earlier in the cycle than it often did under the Greenspan Fed.

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