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FED SHADOW

Fed vs ECB -- the ECB Wins

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The euro's run may be ending as the Fed starts acting more like the ECB.

Update to strategic view

US DOLLAR: The euro's new highs against the dollar are unlikely to be sustained, as the Fed increasingly adopts less inflationary approaches more like the ones the ECB has employed throughout the credit crisis.

[see Investment Strategy Dashboard]

The persistent strengthening of the euro versus the dollar -- now having cracked $1.60, up nearly 20% since the outbreak of market turmoil last summer, and about 10% just since January -- reflects the contrasting approaches of the Fed and the European Central Bank in responding to the crisis. While the Fed has chosen the broad path of easy money, the ECB has held firm to a more disciplined policy course, and now is contemplating the possibility that higher rates might be needed to confront an unwelcome rise of reported inflation. But we think the rise in the $/€ exchange rate is unlikely to be sustained, as the Fed's new facilities for dealing with the credit crisis come increasingly to look like what the ECB has been doing all along. The Fed has lots of catching up to do, as does the dollar with respect to the euro, but at least the Fed is getting started. Its new approach to providing a liquidity backstop to strained financial institutions is taking out much of the perceived need for further rate cuts, amid signs that the expectations environment is turning toward the possibility of rate hikes beginning before year end (futures markets now give about a 40% probability to a rate hike at the October FOMC meeting).

The Fed's new liquidity facilities have helped defuse the credit market panic, but they didn't come soon enough to avoid what will surely prove to be some costly consequences of its initial panicked rate-cutting response. The Fed's no holds barred easing episode didn’t prevent the collapse of one of Wall Street's most venerable institutions, Bear Stearns. And while the Fed's new facilities will likely serve to avoid the worst-case inflation outcome arising from a continued open-ended easing exercise, there's not much question that an inflation breakout is already underway.

By contrast, the ECB has charted a course that has allowed it to keep its sights trained on price stability while thus far avoiding anything resembling the Bear Stearns catastrophe. The Europeans have from the outset of the credit market turbulence treated it as an impaired-asset problem giving rise to solvency and default-risk issues -- which do not lend themselves to a broad-brush monetary policy response. The ECB has been a ready and aggressive provider of liquidity, regularly pumping hundreds of billions of euros into the European interbank market in

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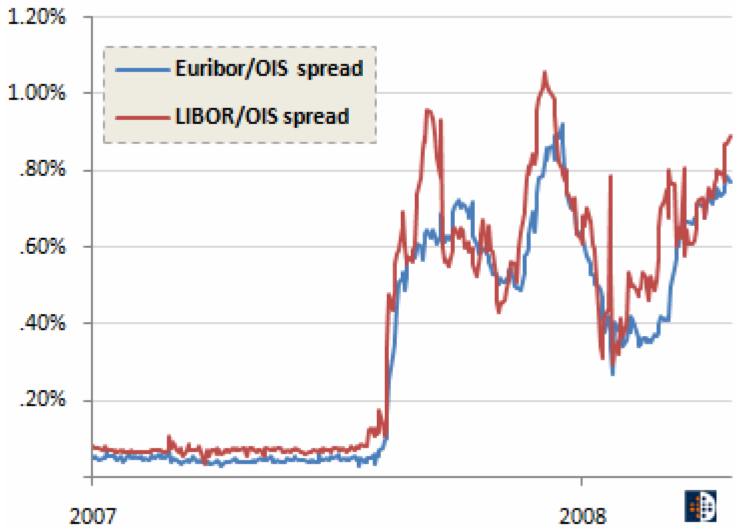
endeavoring to relieve the stresses. These liquidity injections are effected through temporary open market transactions so that, over time, their net effect on overall liquidity levels is essentially nil.

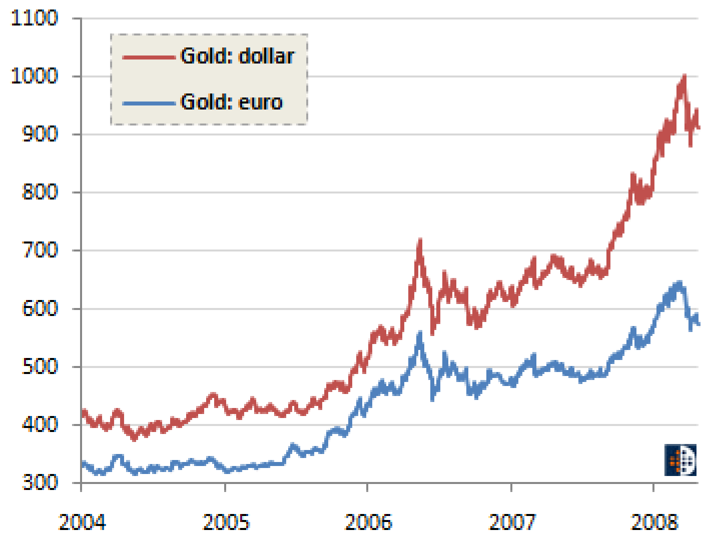


The proof that the Fed's rate-cutting hasn't outperformed the ECB's approach is that, today pressures in the short term funding markets are remarkably similar in the US and Europe. . The three-month LIBOR/overnight indexed swap (OIS) spread, measuring the gap between the current interbank rate and overnight rate expectations, stands at nearly 90 bp, up about 30 bp in the past month. This spread measures the difference between what banks charge each other for taking the risk of an outright three-month loan, versus the alternative of a synthetic three-month commitment to a sequence of virtually riskless overnight loans.. The long-run average for this spread is less than 10 bp, suggesting the market continues to experience an unusually highdegree of counterparty risk. In Europe, the three-month Euribor/OIS spread is slightly narrower, about 80 bp, although it has nearly doubled since early last month. One would think that if the Fed's rate-cutting approach had been an appropriate response to the credit market dislocation, these spreads would be considerably lower in dollar-based markets than in euro-based markets, where rates were never cut. The fact that they're not suggests that, in large measure, the Fed has been providing an ineffective monetary solution to a non-monetary problem.

The Fed has done the most to contribute to a healing process with its creation of various targeted liquidity mechanisms, particularly its Primary Dealer Credit Facility, providing discount window access to Wall Street investment banks in the wake of the Bear Stearns implosion last month. This has gone a long way toward relieving the atmosphere of fear and panic that was shutting down the broad capital market's capacity to bear risk, and in the process putting the economy in severe peril. Since then, a host of indicators are consistent in signaling that the market's risk appetite is being restored. One, the Merrill High Yield Index spread, has narrowed by nearly 150 bp since its peak above 860 bp on March 17, which was the first market day following news of the Bear Stearns collapse.

So the Fed had the tools at its disposal to counteract the worst strains of the credit market turbulence without resorting to its aggressive easing response -- but it failed to use those tools until forced to do so as an emergency response. The ECB used the right tools from the outset. One advantage the ECB had is that, for the purposes of access to the lender of last resort function, there has never been a distinction between investment banks and deposit-taking banks in Europe as there has traditionally been in the US, dating to the Glass-Steagall strictures of the Great Depression. Because there has never been a question about whether there would be a lender of last resort to backstop European investment banks if need be, there was no risk that there wouldn't be such access in a potentially systemic crisis, thus sustaining a critical level of confidence. That certainty of a backstop was absent in the US, and the resulting lack of confidence surely led to the run on the bank that destroyed Bear Stearns. Furthermore, until last month, the Fed attempted to create confidence by continuing to cut rates, but ended up undermining confidence by repeated application of ineffective monetary tools to address a fundamentally non-monetary problem. If the Fed had made a more timely decision to open the discount window to investment banks, as was made possible by repeal of Glass Steagall in 1999, not only would Bear Stearns still likely be an operating entity but the Fed probably would have avoided cutting rates to such an accommodative extreme that a significant inflation price likely will ultimately be paid for this episode of ultimately pointless monetary largesse.

Another element is that the ECB is also bound by a single-objective mandate: sustaining price stability. The Fed's dual mandate -- price stability and maximum employment -- has offered a convenient rationalization for its policy choices since last September. Earlier, Fed chief Ben Bernanke would often observe that there was really no conflict between the two mandates -- that maximum sustainable growth and employment depended on securing price stability. But such wisdom has been absent in this policy cycle as he has sought to rationalize that the Fed is responding to its "dual mandate," when in fact it had until last month thrown any concern with price stability to the wind, for the sake of stabilizing the credit market.



While political pressures are bearing down on the ECB to provide some relief from the appreciating euro, this is not a likely option. There is open discussion among ECB council members about whether the bank's current 4% overnight rate target is high enough to bring down inflation -- at 3.5%, Europe's year-on-year CPI is well above the 2% top end of the ECB's target. Many analysts point to rising energy and food prices as being a significant contributor to inflation, as if these are exogenous factors outside the realm of policy. But while European monetary policy has appeared firm relative to an exceptionally easy Fed, it cannot in any way be considered tight. In fact, the euro has also lost considerable ground relative to gold -- the euro gold price is up about 75% the past three years, a significant loss in purchasing power, even though over the same time the dollar gold price has more than doubled. We think the decline in the real value of the euro is largely attributable to dollar weakness. In practical terms, it's nearly impossible for a competing central bank to entirely offset spillover effects when the country at the center of the global trading and financial system is pursuing a weak currency policy. That's how a US-centered inflation problem gets transmitted globally, as occurred in the 1970s. And a problem it is. While the ECB frets about 3.5% CPI inflation, in the US it is even higher, at 4.0%. As we said at the outset, the Fed has a lot of catching up to do.

BOTTOM LINE: The euro's nearly 20% appreciation against the dollar since credit market turmoil broke out last summer may be close to reaching its end, provided that this Fed easing cycle is also close to its termination point, with a move toward reversing the rate cut cycle beginning in the foreseeable future. The Fed is finally starting to adopt a policy approach that the ECB has utilized throughout the credit crisis. The ECB understood from the beginning that impaired assets of financial institutions would pose significant insolvency risk, and that this was a situation amenable to a liquidity policy response, not a monetary policy response.