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FED SHADOW

# Bernanke's Test

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**The ECB challenges the Fed to clean up its own inflationary mess.**

When Fed chairman Ben Bernanke spoke last month about the inflationary implications of dollar weakness, it was already apparent that the European Central Bank, viewing the euro-area inflation data with growing alarm, was seriously contemplating a near-term tightening -- which risked pushing the dollar into another interval of decline against the euro (see "The Bernanke Awakening" June 5, 2008). With the ECB's rate hike today, this has now come to pass. Growing expectations for ECB action had already helped push the euro back near its all time highs around $1.60 posted in April, so today's decline likely reflects some knee-jerk "sell on the news" position shifting, and may prove short-lived. Also, today's euro decline may be due to the interpretation that the ECB is not as firmly committed to further hikes as had previously been thought. Either way, the ECB's posture imposes a severe test on Bernanke. If the dollar weakens from here, Bernanke would have to prove that his remarks last month were intended as something more than lip service to the notion that the Fed was cognizant of the task of securing currency stability. And if the ECB is signaling that it doesn't intend to risk slowing the European economy for the sake of fighting an inflation that it may fairly regard as imported from the US, then Bernanke would be forced to clean up his own inflationary mess. We think these factors should be considered as tilting the scales toward the initiation of rate hikes in the not too distant future.

| Update to strategic view |
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| **FED FUNDS:** Our call for an August rate hike is now contingent on Bernanke passing a critical test of credibility. He must dare to begin to normalize rates now made all the more absurdly low by today's ECB hike. We want to believe he will pass this test, but he has disappointed before -- which would mean that rate hikes won't begin till later in the year when incoming growth and inflation data finally force Bernanke's hand. |
| [see Investment Strategy Dashboard] |

But that presumes a lot, especially in the wake of last week's FOMC statement, which was roundly derided as a weak-kneed attempt to balance the recognition of rising inflation risks against ongoing concerns about the strength of the economy and stability of financial markets (see "Bond Wish, Stocks Worry" June 26, 2008). The dollar was not mentioned in the statement. In the following days, the price of gold shot up by more than $50, and the dollar weakened against the full basket of G6 currencies, not just the euro.

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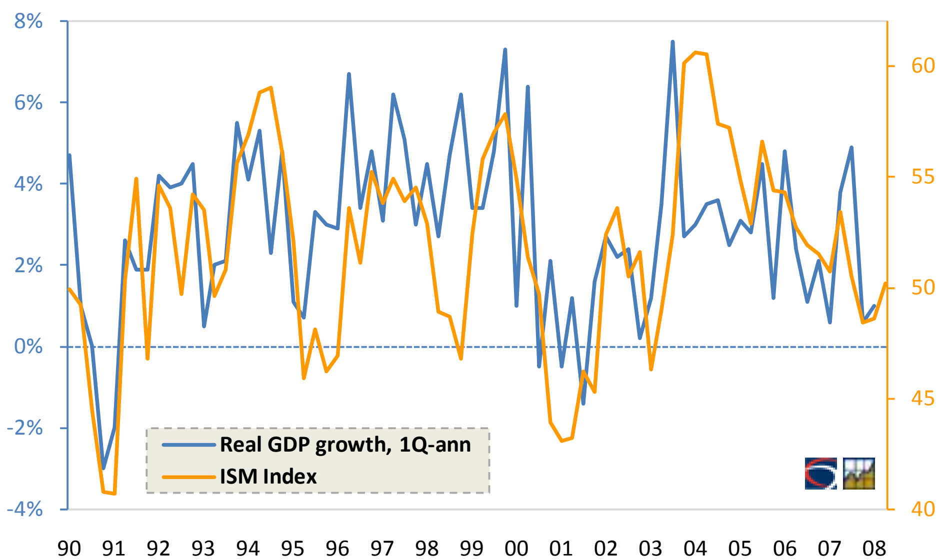
We have been willing to give Bernanke and the Fed the benefit of the doubt, viewing last week's statement -- at least in its recognition of the signs of mounting inflation risk -- as a marginal shift toward hawkishness. But there's no question that the markets didn't see it that way --the markets are now testing Bernanke's inflation-fighting resolve, and in our view he faces irreversible damage to his credibility should he fail that test. Clearly, the fate of the dollar, upon which rests not only the inflation outlook but prospects for equities and potentially the economy as a whole, is at the front line of this testing process (see "Fail-Safe" July 2, 2008).

Bernanke must be pondering the implications of the fact that the ECB was compelled to tighten even with its overnight policy rate having been maintained for the last year at double the present fed funds target of 2%. Fact is, while the euro has appreciated by some 35% against a deteriorating dollar the past three years, that still hasn't been enough to keep the real value of the euro from eroding significantly. The euro price of gold is up some 65% over this time. That's far better than the dollar's 120% decline in terms of gold, but it means Europe cannot completely avoid the global inflation breakout being transmitted by the Fed's mismanagement of the dollar. At this point, the inflation being experienced in the dollar and the euro areas is roughly equal -- about 4% year-on-year. But unless the Fed moves in expeditious fashion to restore equilibrium and root out the inflationary impulses now embedded in the system, dollar inflation will significantly outpace that of the euro in the medium to long term.

The ECB has an important institutional advantage enabling it to move quickly when inflation threats are looming: it has a single mandate to maintain price stability. Technically, the Fed is bound by statutory language directing it to pursue a "dual mandate" of price stability *and* maximum sustainable employment. Bernanke articulated in his very first speech as Fed chairman the correct view that these two objectives don't really conflict, and that price stability is critical to maintaining maximum employment -- or growth. In the recent policy cycle, however, he regularly referred to the "dual mandate" as imposing a policy framework requiring the Fed to balance its objective for price stability against growth. Essentially, it became an important part of the Fed's rationale for pursuing an easy money policy course.




Today's employment report showing a loss of 62,000 nonfarm payroll jobs -- the sixth consecutive decline -- would figure to factor in on the side of restraining the Fed from swift action to move rates higher, although employment is a lagging indicator. The ISM non-manufacturing index, coming in slightly below breakeven at 48, could also give pause. We don't dismiss indicators suggesting the economy is still struggling to break out of its recent slowdown. Certainly, there remain risks in the current landscape to restoration of trend-rate growth, including the continued escalation of oil prices and impairment of credit markets. But the central bank can not avoid facing the reality that the longer it delays moving policy back toward equilibrium, the more it will end up having to tighten eventually to accomplish the task, and the greater the risk of long-term economic damage. Further, by any normal benchmark such as the Taylor rule, today's rates are simply too low -- they could be raised considerably with the spirit of merely normalizing, without actually "tightening" (again, see "Fail-Safe").

We were particularly encouraged this week by the ISM manufacturing index moving back above the breakeven levels, at 50.2. Among the universe of indicators, the manufacturing index is probably the most reliable coincident gauge of overall real growth, as can be seen in the chart on the previous page. While the ISM never sunk to levels consistent with recession, its rebound the last four months is a highly positive sign that the worst is past, and the economy now is likely on path to a return to trend growth rates by year-end.

**BOTTOM LINE:** The ECB's rate hike is putting some added, and likely unwanted, pressure on Ben Bernanke. With his speech last month, he signaled that the Fed is aware of the inflation risks arising from currency weakness, implying that the Fed would act to redress the dollar's extended depreciation. Now that the ECB has acted first to tackle the inflation problem also besetting the European economy, the ball is in Bernanke's court. Either he makes good on his words last month, or suffers a potentially irreparable loss of credibility.