

DWIGHT ASSET MANAGEMENT COMPANY LLC

NOT ALL CENTRAL BANKS ARE CREATED EQUAL Why We Should Be Concerned

On June 1, 2008, the European Central Bank (ECB) celebrated its tenth anniversary. We take this opportunity to reflect on what impact this institution has had on the Federal Reserve System and its monetary policy.

In the past, we took it for granted that the United States alone could determine its fate regarding domestic monetary policy. As the dollar replaced the British pound as the dominant reserve currency in the post-World War II era, the Federal Reserve emerged as the most powerful central bank in the world. The Fed effectively controlled monetary policy in the United States, and it either directly or indirectly influenced the monetary policies of smaller, otherwise independent central banks. The arrival of the European Central Bank and the euro, along with the ECB's approach to monetary policy over the past decade, has eroded the Fed's leadership position and has posed a significant risk to its global dominance among central banks.

Conflicting Mandates

It is important to remember that not all central banks are created equal. Very few central banks have mandates which mirror that of the Fed. This might not have held much significance in the past, but it may well change the way the Fed can maneuver in the future. The Federal Reserve is entrusted with setting U.S. monetary policy, and operates to promote the goals of price stability, maximum employment and moderate long-term interest rates. In contrast, the European Central Bank's mission is very clearly defined as that of the "gatekeeper" whose main task it is "to maintain the euro's purchasing power and thus price stability in the euro area" (ECB 2008).

While it was hardly the first time that the ECB chose to follow a different (and we might say independent) way of addressing its economic and monetary concerns, many observers were nonetheless puzzled when the bank decided to hold

rates steady last summer. Despite the Fed's decisive actions to counteract the potential impact of the credit market crisis on the U.S. economy, its European counterpart remained rather passive. As the Fed aggressively cut its key lending rate starting in June 2007 by a total of 325 basis points, the ECB supplied ample liquidity to the financial system to avert a cash crunch, but kept its key lending rate unchanged at 4%. Some questioned their sanity at the time, but the ECB affirmed its inflation-fighting credibility during this challenging period.

A Different Frame of Mind

Although some perceive the ECB to have an obsession with price stability, it is important to remember that this concept is firmly anchored in the psyche of Europeans. Price stability is particularly important to Germans as they recall, from either direct experience or history lessons, the hyperinflation that occurred during the Weimar Republic in 1923 and also in the aftermath of World War II. These are the events that ultimately led to the creation of the Bundesbank, the German central bank that is now a part of the ECB, and the deutschmark, Germany's postwar currency. In the years after its creation, the Bundesbank's non-nonsense approach toward price inflation earned the admiration of central bankers around the globe and resulted in the stability of the deutschmark. With the European Union's desire to replicate the success of Germany's postwar central banking system, the deutschmark and the Bundesbank served as blueprints for the euro and the European Central Bank. Thus the Bundesbank certainly helped overcome the angst of Germans, who had to give up their beloved deutschmark.

The task of the European Central Bank is obviously not without some challenges. After all, the ECB currently represents fifteen different countries, some



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of which have very diverse economic cycles and tax codes. Additionally, some member nations are struggling to preserve national autonomy. In this context, it comes as no surprise that in the face of a global economic downturn, countries like Germany, France, and the Netherlands show relatively resilient economic growth while other nations, like Ireland and Spain, have suffered greatly from the combination of a contracting economy and a monetary policy that is too restrictive for their needs.

We think that we are witnessing a corrective phase. As a result of the convergence of their economies, economic policies, and currencies leading up to the launch of the euro, countries like Ireland, Italy, and Spain profited from a long period of cheap money and historically low interest rates relative to their pre-euro local currencies. For Ireland and Spain, this low interest rate environment sparked an unprecedented construction and employment boom, which has now come to an abrupt end.

Shifting Regimes

The European Central Bank is not shy about pointing to its independence when responding to critics, and until recently has repeatedly proved to be spot-on when formulating the appropriate monetary policy. While we are not suggesting that the euro is about to replace the U.S. dollar as the main world reserve

currency (at least not yet), the stewardship of the ECB might have set the stage for the emergence of the euro as a premier global reserve currency. The recent weakness of the U.S. dollar has supported calls for a second reserve currency, and the euro appears to be ready to fill that role, creating a potential predicament for the Fed.

When the ECB shifted gears after its policy meeting on June 5 and put the market on notice for a potential rate hike in July of this year, the Federal Reserve quickly mirrored its hawkish anti-inflation rhetoric. On July 3, the ECB adhered to its warning and increased the key lending rate by 25 basis points to 4.25%. This raises a question about what options the Fed might have now and in the future if and when the ECB signals a series of rate hikes while our economy is still in need of a more accommodative policy. If the Fed stands idly by, there is a risk that the U.S. dollar will weaken further and exacerbate the U.S. inflation problem. Alternatively, a tighter policy would probably deepen the economic downturn.

The arrival of the ECB as a major player among central banks clearly changes the game, creating the potential for a catastrophic policy error on this side of the Atlantic or the other. We will be watching this closely. ■

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