The Fed and ECB: A Tale of Diverging Paths

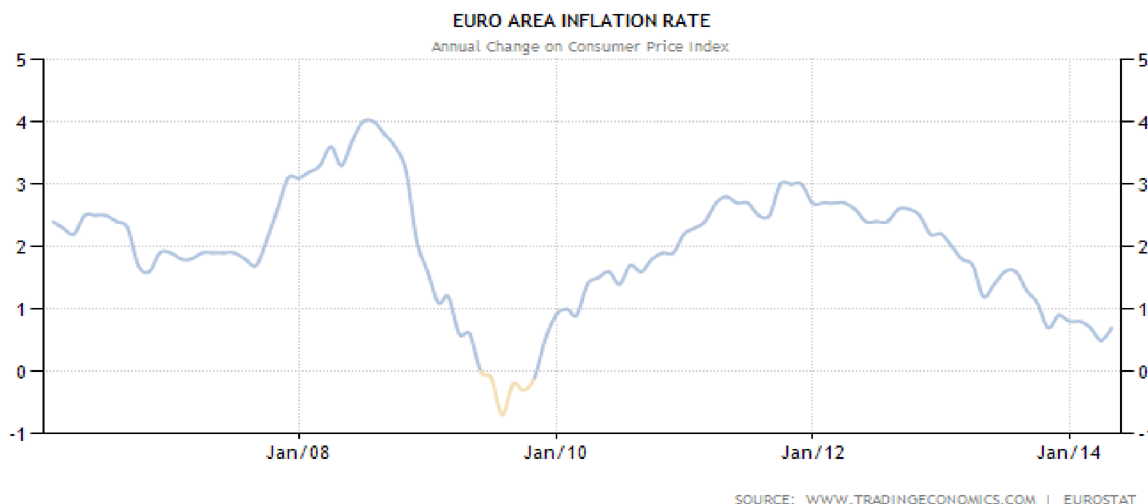
On the surface, the Fed and ECB would seem to be facing the similar predicaments. Inflation is below their desired targets and still falling and unemployment is unacceptably high. Yet the Fed continues to exit its experiment with QE while the ECB has yet to begin. A closer look, though, reveals that the two central banks are out of sync on more than just their approach to asset purchases. Namely, the ECB currently has higher real interest rates and tighter liquidity than the Fed, in large part because deflation is becoming embedded in the European psyche, whereas Americans are beginning to see a light at the end of the disinflationary tunnel. If these divergent sentiments prove correct, we will face several more years of asynchronous monetary policies and their consequences for currency markets.

Dangers of Deflation. One of the many dangers of deflation is the possibility of perverse behavior. Consumers may postpone purchases in hopes of getting lower prices in the future. It pays to save, not spend. Recession then perpetuates itself. Expectations of falling prices become self-fulfilling. And central banks are ill-equipped to combat the downward spiral.

This cycle contraction and falling prices often is perceived as having roots in self-fulfilling negative expectations on inflation. The Fisher equation (i = r + E(inflation)) summarizes the this phenomenon: the nominal interest rate is the sum of the real rate and inflation expectations. As long as expected inflation is stable, a central bank can gauge the degree of monetary restraint and its effect on the economy. However, when inflation is so low that households and businesses begin to expect an outright decline in the price level (E(inflation)<0) , behavior begins to change. The central bank loses its compass and the ability to help borrowers and debtors by setting nominal rates below inflation because of the zero lower bound to policy rates. Monetary policy becomes ineffectual as more deflation translates into higher real interest rates.

The ECB: Too Tight and Too Late. Despite a slight uptick in April, euro area inflation shown in Figure 1 remains close to the lower bound of the ECB's forecast. Unlike 2009 when a sharp drop

Figure 1



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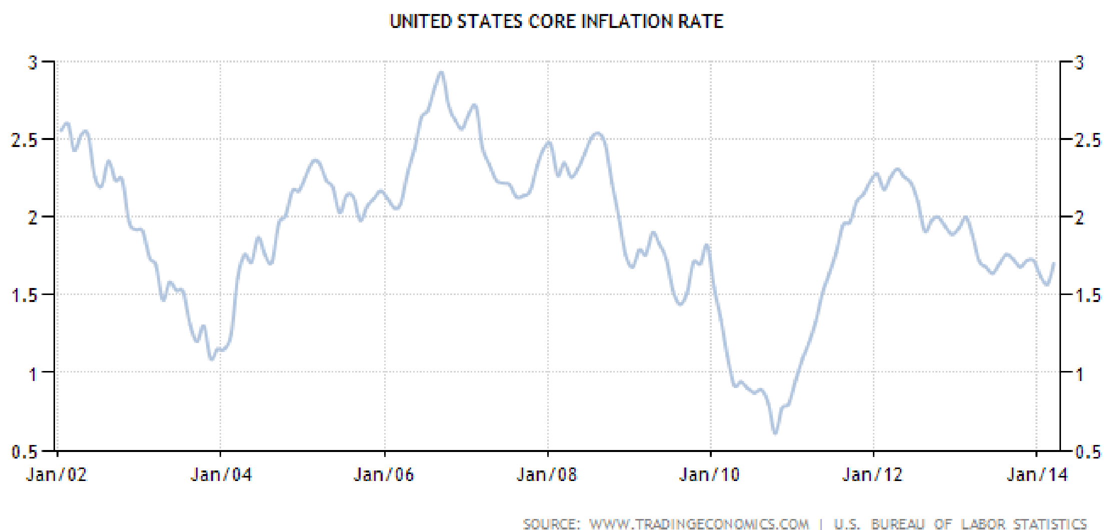
in energy prices was viewed correctly to be transitory, today's low inflation is perceived to be more permanent as evidenced by pricing of 10y swaps. Namely, since this latest slide in EU inflation began in September 2013, the inflation premium embodied in the 10y swaps has moved in concert with with slide in inflation itself – a disturbing trend that does not show any confidence in the ECB's ability to reach its inflation target anytime soon and raises the risk of further currency-driven disinflation. Mr. Draghi has cited the two conditions for ECB action as either 1) inflation falling below the ECB's lower forecast bound or 2) an "unwarranted tightening of monetary conditions". One cannot rule out the possibility that currency markets will force the ECB to translate its talk into more aggressive action by appreciating the euro further, which would be a self-fullfilling prerequisite for both of Draghi's conditions.

The Fed: Staying the Course. By contrast, 10y US inflation swaps show no such correlations as inflation expectations have remain remarkably stable at around 2% despite a steady decline in core inflation (Figure 2) and repeated warnings from the Fed that inflation is too low. Americans apparently have some faith that the Fed aggressive easing and asset buying has nipped deflation in the bud. The recovery, howver halting, now is entering its sixth year. Employers are hiring and more househoulds report an improvement in their economic well-being than at any time during the past five years. For the first time in this expansion, commercial credit is expanding as banks have eased credit standards for corporate loans as many companies have made progress in deleveraging balance sheets, which bodes well for capital spending.

Figure 2



In short, enough is going right for the Fed to stay the course in tapering asset purchases. At today's meeting, the FOMC cut its purchases another $10 billion to $45 billion. At this rate the Fed will end QE altogether either at the FOMC meeting in September of October at the latest. Now that credit is flowing again, there will not be any pauses or slowing in the exit, nor is there likely to be much dithering in normalizing rates beginning in 2015. As the Fed's research shows, the only reliable lead indicator of booms and busts is a change in bank lending standards which

tend to anticipate major changes in the business cycle by one to two years. By that metric, the Fed may not be able to wait and see as long as it might like.

Implications. The bottom line is that the Fed and ECB are destined to chart opposite courses over the next few years at minimum. The Fed's exit from QE is on autopilot now that banks are beginning to monetize their vast excess reserves on the Fed's balance sheet by extending mortgages, credit lines and loans. Even though we are nowhere near the credit boom, the Fed has a lot of wood to chop before US monetary policy will be considered 'neutral' again. A graceful exit is by definition a gradual one and is best spread over many years.

Pundits who have expected that Fed tapering would lead to a quick appreciation of the USD are likely to be disappointed for a while longer, especially with respect to the euro. The ECB simply has not been able to deliver a Fed-like infusion of liquidity or much deleveraging of the financial sector. Monetary conditions actually have tightened over the past several months and the euro has appreciated in concert. Indeed, it seems unlikely that the euro will revert toward fair value until either the ECB actually delivers s version of QE or the Fed signals its first rate hike. Neither of those appears likely until 2015.

In the interim, the specter of deflation in Europe should not be ignored. Investors who were quick to snatch up the high yields offered by the periphery countries might want to reconsider how long their wish to hold that debt. Debt burdens inexorably grow in countries whose nominal interest rates exceed nominal GDP growth, unless of course they also are running large primary budget surpluses. Few European countries meet these requirements for stabilizing debt burdens even after the recent compression in periphery spreads. The reason is that nominal GDP growth in general has declined even more than nominal interest rates. The road to deleveraging will be long and arduous as long as Europe's real interest rates and exchange rate stay high.

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30 April, 2014