

Fed Utd vs. FC ECB: A round-table discussion on the different crisis management styles of the two central banks. With Roger Kubarych (Unicredit Global Research) and Marco Annunziata (Unicredit) held on Wednesday, March 19, 2008, from 12:30-2:15pm.

To borrow the football metaphor, the result was a score draw with both teams conceding goals and missing golden opportunities. In a penalty shootout, the ECB would have clinched the game. The first speaker said bluntly the Federal Reserve did not manage the crisis as well as it should have done, could have done, or will do. Perhaps denying his American background, he said the ECB had done better job, albeit not by much. The epicentres of the crisis had been Wall Street, London and Switzerland and where there had been euro area crises such as SocGen they were *sui generis*. In terms of liquidity it spotted banks like Germany's IKB and SachsenLB early and prevented a solvency problem.

So what should the Fed have done? The speaker said the one central bank that should have seen the problem was the Fed. He said one Wall Street bank had alerted the Fed to problems at New Century Financial but at a secret meeting no one wanted co-ordinated action. Mortgage securitisation was too lucrative to abandon. If only someone at the Fed had said out loud that there might be a problem. The SEC meanwhile was absent without leave.

But the Fed is responsible for enforcing the Bank Holding Company Act but it didn't do that job – no one at the Fed had heard of a SIV. Early 2007 was the point of maximum effectiveness for action. Since then it has done well at damage control but is still playing catch-up. Using an American football analogy, the Fed has thrown three Hail Mary passes - forward passes made in desperation but little chance of success - in the form of rate cuts. If the Fed is lucky it will only have to cut another 25 basis points – if unlucky at least 75bp. It will be interesting to see if banks use its new lending facilities. He said they would include big “haircuts” but said would be rolled over. For Wall Street the key is to work out how to unbundle the CDOs at the root of the crisis. One member said this would require more capital as they were so highly leveraged. The speaker agreed, saying the mark-to-market write-downs were an acknowledgement of that deleveraging was needed.

He said the Fed had sent a clear signal it was worried it was pushing on a string and that someone else – the US Treasury – needed to intervene. This could be in the form of a more permanent Resolution Trust Corporation-style facility than the Fed's 28-day facility. In other words it

would be the Treasury taking on the dodgy assets. The speaker said that rather than try to value these assets and cause panic, the Treasury should instead provide the funding it deems each bank needs. In exchange for taking the risk, the US taxpayer would take the benefits of the eventual recovery.

The speaker said it is wrong to see the ECB as complacent. Economic data is strong not only in Germany – where businesses are more worried by inflation than the strong euro – but also in states such as Italy. Europe is more exposed to Asia and commodity prices than to the US. Should the ECB really be more worried about growth falling to trend levels of 1.5% than inflation hitting 3.3%, wage pressures rising and core inflation pushing up? In fact the Fed is being reckless with inflation and will cut rates to 1% to avoid having to face the music. It risks losing the rewards of the Great Moderation of the previous two decades. Even the Fed now publicly acknowledges worries over inflation.

There is a philosophical struggle between the ECB that is angry at what it sees as the Fed's jeopardising inflation; while the Fed sees the ECB as complacent or downright stupid – why does it not buy some insurance, they ask? However the speaker admitted the ECB was behind the curve to some extent. Growth will slow as, even though Europe is not as exposed to subprime, the shock to the financial system was global. Expect the ECB to cut rates by mid-2008. As far as liquidity was concerned he was not - there was a huge gap between the two although the ECB had perhaps been more proactive. Spanish banks would be in serious trouble otherwise.

One member asked what would have happened if subprime hadn't been invented. Surely there would simply have been another investment craze. And isn't the point that the ultimate cause is central banks cutting rates too low and creating excessive liquidity? The second speaker said the ratio between US incomes and house prices had rung alarm bells yet inflation measures ignored housing. That prompted one speaker to ask what the Bank of England should do given UK price/earnings ratios. The first speaker said it should have tightened policy earlier. But if a crash is underway the second speaker said it must to cut interest rates, especially as there may be more nasties lurking in the bank sector. He said the BoE showed a mixture of complacency, arrogance and incompetence. It had stood by when banks needed more liquidity. It had said publicly it would not rescue badly managed banks – and then bailed out Northern Rock.

What does the future hold? The second speaker said it would feature a return to the fight against inflation and a battle to restore central bank credibility. A big question would be whether we can resolve global imbalances without a long period of stagnant growth. The first speaker pointed out that during the period of strong US growth, 2 percentage points came from housing – building, renovating and trading it. Take that away and growth will be anaemic. It will be hard for the US to achieve even average growth rates. He feared two malevolent trends under a Democrat Congress and possibly White House. The first was a return to protectionism and calls to renegotiate NAFTA – a very real prospect. The second was more frequent intervention by the government in areas such as energy to the annoyance of the rest of the World. Normally one would look to the White House to block these. But both candidates for the Democrat nomination have been banging those drums. Very worrying indeed.