Yellen Riding U.S. Growth Veers From Draghi as EU Stalls

By Simon Kennedy and Jeff Kearns - Aug 23, 2014

The world’s two most powerful central bankers are nearing a transatlantic gap in monetary policy as the Federal Reserve debates raising interest rates while the European Central Bank signals more stimulus.

The potential for divergence was on display yesterday as Fed Chair Janet Yellen and ECB President Mario Draghi outlined differing economic outlooks to international counterparts in Jackson Hole, Wyoming. The U.S. unemployment rate stands at 6.2 percent compared with 11.5 percent in the euro area.

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Yellen said with their labor markets healing, U.S. central bankers are shifting to debating when “we should begin dialing back our extraordinary accommodation.” By contrast, Draghi said officials “stand ready to adjust our policy stance further” while adding that investor bets on the bloc’s inflation have “exhibited significant declines at all horizons” in August.

“U.S. monetary policy is leaning toward tightening in 2015, and, if you believe futures markets, policy in Europe is on hold until well into 2017,” said Alan Ruskin, head of foreign exchange strategy for Group of 10 countries at Deutsche Bank AG in New York, “Draghi’s talk was pretty consistent with that view.”

Such a split puts investors on the alert for a multi-track world of monetary policy almost six years since central banks began uniting around record-low interest rates to rescue their economies from recession. A break between the U.S. and ECB in interest-rate paths will likely create more foreign-exchange volatility as interest-rate differentials widen, Ruskin said.

Labor Slack

In her remarks yesterday, Yellen said deciding when she’ll be satisfied with the progress in the labor market won’t be easy to determine.
“The labor market has yet to fully recover,” Yellen said in her speech at the Kansas City Fed’s annual conference held near the Teton Range of the Rocky Mountains. While the five-year expansion has put more Americans back to work, “a key challenge is to assess just how far the economy now stands from attainment of its maximum employment goal.”

Her comments echoed the message from minutes of the July Federal Open Market Committee meeting, which showed officials growing more aware that the job market looks healthier. She said policy makers will have to consider a “wide range” of indicators to make that assessment, adding that there’s “no simple recipe” for deciding when to raise rates for the first time since 2006.

**Draghi’s Dovishness**

Draghi, meanwhile, gave his strongest indication yet that ECB officials aren’t finished with measures to stave off a Japan-style stagnation.

“The Governing Council will acknowledge these developments and within its mandate will use all the available instruments needed to ensure price stability over the medium term,” he said in remarks that weren’t included in the prepared text distributed by the ECB.

The 18-nation economy stalled in the second quarter and unemployment remains near a record high. Draghi made his remarks days before a report is predicted to show euro-area inflation slowed to 0.3 percent this month, a fraction of the ECB’s goal of just below 2 percent and the weakest since October 2009.

Draghi’s concern is that the malaise prompts investors, consumers and companies to pull back spending in anticipation of even weaker inflation, tipping Europe into a deflationary spiral that will be harder to reverse.

**Japan, Canada**

Other central bankers meeting at the economic symposium sounded in no hurry to tighten monetary policy. Bank of Japan Governor Haruhiko Kuroda told reporters that the BOJ will keep monetary policy easy until price stability is achieved and would adjust it if inflation fell short, while Bank of Canada Governor Stephen Poloz said in an interview that his labor market has “quite a bit of room to grow.”

In the U.S., while inflation is rising closer to the Fed’s goal of 2 percent, Yellen didn’t indicate much concern that it will accelerate too quickly.

The ECB’s main refinancing rate will remain almost unchanged by the end of 2015, increasing to 0.16 from 0.15 percent, according to the average estimate of 40 analysts surveyed by
Bloomberg. By contrast, the U.S. federal funds target rate is expected to rise to almost 1 percent from its current range of zero to 0.25 percent, according to a separate survey of 76 analysts.

‘Multi-Speed World’


“Central banks are no longer on the same side anymore,” he said. “Chair Yellen’s main challenge was how quickly should she lift her foot off the accelerator,” while Draghi “has the opposite problem -- how much should he step on the accelerator and when.”

Stocks remained lower after Yellen and Draghi’s remarks. The Standard & Poor's 500 Index declined 0.2 percent to 1,988.4 at the 4 p.m. close of trading in New York after reaching an all-time high the previous day. The yield on the 10-year Treasury note was little changed at 2.40 percent.

Yellen also emphasized the need for flexibility: If progress “continues to be more rapid than anticipated,” a rate increase could come sooner than currently expected and further increases could be more rapid, she said. Conversely, if the Fed’s goals of full employment and stable prices remain elusive, policy would be more accommodative.

U.S. Outlook

U.S. policy makers in June projected that the benchmark interest rate would rise sometime next year. They have kept the rate close to zero since December 2008, and expect to end their third round of asset purchases in October.

Draghi made no mention of quantitative easing in his speech, instead highlighting steps the ECB is already taking to bolster the economy. The central bank cut interest rates to record lows in June, and will next month start a round of cheap funding for banks linked to loans to the real economy.

The ECB is also “fast moving forward” with a program for buying asset-backed securities, and the euro area should benefit from a weaker currency, he said. The euro slid to an 11-month low against the dollar yesterday.

The ECB’s Governing Council next meets to set monetary policy on Sept. 4 in Frankfurt. It has so far avoided QE amid political and logistical concerns over how such a program would be carried out.
Draghi intensified pressure on European governments to play their part, saying “it would be helpful” if those with room to ease fiscal policy did so.

“We need action on both sides of the economy: aggregate demand policies have to be accompanied by national structural policies,” Draghi said. “We should not forget that the stakes for our monetary union are high.”

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