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The crisis: a tale of two monetary policies

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The European Central Bank and the Federal Reserve are facing similar problems but pursuing different policies. The ECB has been raising interest rates while the Fed has been cutting them. The overnight federal funds rate is now 2 per cent while the corresponding ECB rate is 4.25 per cent. Which central bank is doing the right thing? Or could they both be?

Inflation is a significant problem in both the eurozone and the US, with a headline consumer inflation rate over the past 12 months of 4 per cent in the eurozone and 5 per cent in the US. Both economies are also facing declining economic activity with falling employment and lower industrial production.

The sharp rise in the prices of energy and food during the past 12 months will undoubtedly spill over into higher prices for other products in both the US and Europe. The primary challenge for both central banks is to limit this inflationary shock to a one-time pass through, avoiding the rise in wages that would occur if employees attempted to offset the decline of their real incomes. It was that futile wage-price spiral that drove inflation rates in the 1970s to double-digit levels. Preventing a repetition of that requires convincing the public that today's high inflation rate will soon decline.

Despite the similar problems faced by the two central banks, there are important differences that justify their separate strategies. The contrast between the ECB's mandate to achieve price stability and the Fed's "dual mandate" to balance the goals of price stability and employment is not just an accident of legislative history but a reflection of fundamental differences between the two economies. Those differences make it more difficult to tame inflation expectations in Europe and therefore require the ECB's tougher policy.

The role of trade unions is the most important difference. Only 7.5 per cent of US private sector employees are union members and they are concentrated in automotive, airline, construction and other depressed industries. In contrast, more than 25 per cent of employees in the European Union are members of trade unions and in some EU countries the wages set in union contracts are automatically extended to other companies in the same industry.

Because of this union power, the ECB must persuade union members and their leaders that it is determined to bring inflation down to its target level of less than 2 per cent. The ECB's tough stance and exclusive emphasis on price stability is crucial to shifting inflation expectations and persuading unions to accept the rise in food and energy prices without pressing for offsetting wage gains.

In contrast, the Fed does not have to worry in the same way about union power and collective bargaining. Wage setting is decentralised and wage contracts do not have the formal links of wages to inflation that intensified the wage-price spiral of the 1970s.

Differences in the inflation histories also influence today's appropriate policies of the ECB and the Fed.

Although Americans remember the double-digit inflation of the late 1970s and early 1980s, there has been no US experience similar to the earlier hyperinflations in Germany and other EU countries. The ECB pursues a tough inflation target policy to persuade Europeans that there is not even a small probability of returning to those conditions.

Finally, the ECB recognises that it is still a very young institution that must prove to the European public that it will follow the successful anti-inflation tradition of the German Bundesbank. But a decade of relatively good performance is not a reliable guide to the future. The ECB is only now facing its first challenge of imported high inflation and the expanding membership of the European monetary union is bringing new voting representatives to the ECB whose views are yet to be tested. The power of Europe's unions, its history of hyperinflation and the need to develop credibility for a young institution all justify the ECB's tough stance. Because the Fed does not have these problems but faces a potentially serious recession, it is prepared to gamble that the weakness in US employment and the general decline in economic activity will prevent a wage-price spiral without further increases in the interest rate. If food and energy prices remain at today's level and wage costs do not accelerate, the overall consumer price index inflation will decline by next year to an annual rate of less than 3 per cent. I think the Fed's current interest rate strategy makes sense but would be too risky for the ECB.

The writer is professor of economics at Harvard University