Seven reasons why the Fed won't follow the EC

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WASHINGTON (Reuters) - The U.S. Federal Reserve is in no hurry to follow Europe down the interest rate-hike trail and probably won't budge from its ultra-easy policy stance until inflation and employment draw nearer to its goals.

The European Central Bank's well-telegraphed rate hike on Thursday may be the first of several this year as high oil costs drive consumer prices above the ECB's target.

A vocal minority within the Fed's policy-setting committee has been making its case for raising the benchmark U.S. overnight lending rate by as much as three-quarters of a percentage point by the end of the year.

Judging from comments coming from Fed Chairman Ben Bernanke and close allies such as New York Fed President William Dudley, the hawkish wing won't have its way. Both have said the economy is still too weak to stand on its own and needs Fed support.

Most leading economists think the Fed will remain on hold through 2011, according to a Reuters poll of primary dealers -- the large financial institutions that do business directly with the Fed.

Here are seven reasons the Fed will likely stay on hold.

1. The United States endured a deeper recession than Europe did. Unemployment more than doubled, touching 10.1 percent in late 2009. Compare that with the euro zone, where unemployment rose by a relatively modest 40 percent during the slump.

The U.S. jobless rate has come down by a full percentage point since November, but at 8.8 percent it remains well above the level the Fed considers normal -- around 5 or 6 percent.

"The old analogy that the Federal Reserve removes the punch bowl just when the party gets going doesn't apply here because, well, there is no party," said **Bernard Baumohl,** chief global economist at the Economic Outlook Group in Princeton, New Jersey. "There's not even a balloon in sight."

2. The Fed's inflation-fighting credibility is considered iron-clad while the 10-year old ECB's nerve has yet to be tested. Would it really submit the euro zone to a recession in order to stamp out inflation as the Fed did in the 1970s?

The ECB made a similar inflation-fighting stand in 2008, when oil prices approached $150 a barrel. However, it reversed course just a couple of months later when the Lehman Brothers bankruptcy touched off a global panic.

"This is eerily reminiscent of the summer of 2008," said Michael Hanson, an economist for Bank of America-Merrill Lynch.

3. The ECB has a single mandate to fight inflation. The Fed has two goals, price stability and full employment.

The latest reading on the Fed's preferred price index showed it was up just 1.6 percent year over year, a shade below the central bank's comfort zone. Europe's inflation rate was running at 2.6 percent.

As for full employment in the United States, most economists think it will take at least three more years of strong job growth to close the labor market gap.

Another concern for the Fed is that rising oil prices will sap consumer spending, which is the driving force behind the U.S. economy. Retail sales have been resilient so far, but consumer confidence has taken a hit.

4. ECB officials focus on headline inflation, which covers all prices. U.S. officials focus on underlying "core" inflation, which strips out volatile goods like gasoline and food. The ECB has a specific numerical inflation target, something that Bernanke has expressed support for in the past but the Fed has never officially adopted.

The Fed views core inflation as a better indicator of where future inflation will be. If the ECB focused on core, it might not be in such a rush to hike.

U.S. inflation excluding food and energy rose by just 0.9 percent year over year in February, according the Fed's favored gauge. That's not far from the record low of 0.7 percent hit in December.

5. European workers have more power to demand wage increases than U.S. workers, who are less likely to belong to unions and bargain collectively with employers. As a result, price rises translate more quickly into inflation in Europe and inflation is harder to beat back.

Last week's U.S. jobs report showed hourly earnings were flat in March, and they have been for four of the past five months. That means real earnings -- adjusted for inflation -- are falling, giving American consumers less buying power and curbing economic growth.

Euro zone wages rose 1.4 percent in the fourth quarter, the most recent period for which data is available.

6. History: several generations of Europeans are scarred by memories of hyperinflation in the 1930s that led to the rise of fascism and the Second World War.

American folklore harks back to the trauma of the economic downturn of the

Great Depression, when unemployment topped 20 percent and bread lines stretched for blocks.

Bernanke is a scholar of the Great Depression, and believes the Fed's mistakes prolonged the suffering by tightening before the economy had healed.

7. There is considerable doubt among economists about whether rate hikes in the United States or Europe will be effective in cooling oil prices, which are the primary driver of the current bout of inflation.

The two main causes behind the oil price spike are strong emerging market demand and concern about supply disruptions stemming from unrest in the oil-producing Arab world. Higher borrowing costs in Europe and the United States won't address either of those issues.

Bernanke has said this episode of inflation is likely to be "transitory".