Central Banks Grapple With Competing Forces

Europe, U.S. Chart Different Courses As Economies Recover and Prices Rise

By BRIAN BLACKSTONE And JON HILSENRAITH

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The ECB, preparing for a policy meeting Thursday, is poised to become the first central bank among the world’s large, developed economies to raise interest rates since the world fell into deep recession in 2008.

The Federal Reserve is carrying on its easy monetary policies, keeping short-term interest rates near zero and pumping extra money into the economy by buying government bonds. An increasingly intense debate has broken out within the U.S. central bank about when to raise rates.

The central banks’ divergent policies will have enormous effects on economic growth, inflation and financial markets. The stakes are high for both banks. If the ECB is wrong in moving rates higher now, it could choke off economic growth in the euro zone. If the Fed is erring on the side of easy money, it could let U.S. inflation take off, damaging the domestic economy.

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This comes as other major central banks are pursuing their own varying approaches. The People’s Bank of China on Tuesday raised its policy rate by a quarter percentage point, continuing a phase of interest-rate increases in the world’s fast-growing emerging economies that began earlier but that many economists say has been too timid.

The Bank of Japan, shaken by natural disasters and a nuclear crisis, is preparing for a policy meeting Wednesday and Thursday at which it is considering new easy-money measures that would direct low-interest loans through banks to crisis-hit areas. The Bank of England, which also meets Thursday and is wrestling with both high inflation and the risk of recession, is expected to stay on hold but faces mounting pressure to stem rising consumer prices.

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The central bank faces a deepening divide between its prosperous northern members of Germany, Austria and the Netherlands—where inflation is starting to take hold—and its southern counterparts, where more economies are struggling. This divide will be on display when the European Central Bank meets Thursday, with many ECB officials pressing for a rate increase now to deter inflation. The Fed, on the other hand, is betting it can afford to let a nascent U.S. recovery—still challenged by a slumping housing market, thrifty consumers and high unemployment—run a while before trying to slow it down.

Managing the exit from easy-money policies could be more fraught than usual. Central banks have to decide both when to start the process, and how to do it. Minutes from the Fed's latest meeting in March, released Tuesday, gave hints of the brewing debate within the Fed about the economic outlook and its policy course.

The Fed decided to continue a $600 billion bond-buying program, known as quantitative easing, but "a few members" thought the Fed might need to reduce the program. The minutes also showed Fed officials had an extended discussion about the outlook for inflation, in which they tried to make sense of higher prices for oil, grains, metals and other commodities. Though Fed Chairman Ben Bernanke expects the broader inflation impact of higher energy prices to be muted, some Fed officials are eager to start moving to contain it.

The U.S. consumer price index was up 2.1% in February from a year earlier, though another measure preferred by the Fed was slightly lower. Excluding the volatile food and energy sectors, the index was up 1.1%. Euro-zone inflation was 2.6% in the 12 months ended in March. It was up 1% for February when food and energy prices were excluded.

"Inflation has probably bottomed out in the U.S. and from this point on will probably start to move higher," James Bullard, president of the Federal Reserve Bank of St. Louis, said in an interview Tuesday. He wants to cut the Fed's bond-buying program to $500 billion at its meeting at the end of this month, but he's in the minority.

Mr. Bernanke said Monday that he thinks commodity price pressures will prove transitory. He added that if he's wrong and consumer prices rise more broadly than he expects, he'll act to stamp it out.

Although the Fed hasn't yet decided when to start tightening, the debate has begun over how to do so. Some Fed officials, including Mr. Bullard, want the Fed to sell off its stockpile of Treasury securities as a first step toward tightening, rather than pursue the traditional course of raising short-term interest rates, a proposal where he is again in the minority.

With the ECB moving toward tighter policy and the Fed staying easy, the U.S. dollar could be heading for continued declines as investors seek higher-returning holdings elsewhere, said Bruce Kasman, chief global economist for J.P. Morgan. The dollar is down 3% against a broad currency basket of 10 other currencies since the beginning of the year and down 24% from a decade ago, though it has been weaker before, including in July 2008 and in the early 1990s, according to Fed data.

The divergence among central banks is a test of their credibility. The ECB is betting a rate increase now will prove its anti-inflation mettle and might help it avoid more draconian increases in borrowing costs later. ECB officials are expected to signal that the bank's main lending rate one-quarter percentage point to 1.25% at the meeting Thursday. The euro hit five-month highs against the U.S. dollar this week.

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If ECB President Jean-Claude Trichet is wrong, higher interest rates could unnecessarily punish Europe's fragile economies, such as Greece, Ireland, Portugal, and Spain, while a rising euro could trim German exports by making them more expensive on world markets.

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weaker southern countries, plus Ireland, where unemployment is high and economic growth sluggish.

The Bank of England is expected to hold short-term interest rates steady Thursday at 0.5%. The U.K.'s consumer price inflation, at 4.4%, is relatively high, but its economy contracted in the fourth quarter and shows scant signs of having recovered solidly in the first quarter. Reflecting the conflicting economic signals, the BOE policy board is divided three ways, with a majority behind steady rates, some members pressing for rate increases, and one backing more stimulus.