International Money and Banking: 7. The Fed and the ECB

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A Closer Look at the Fed and ECB

Before describing in detail how they implement monetary policy, here we will describe in some detail how the Federal Reserve System and the Eurosystem of central banks are organised. We will focus on the following.

1. **Legal Mandates**: What are they required to do by law?
2. **Organisation**: Who takes the decisions and how?
3. **Banking Supervision**: What is the level of involvement in overseeing the banking system?
4. **Political Independence and Accountability**: What is their relationship with politicians and how accountable are they?
5. **Meetings**: How do their meeting work?
6. **Communications**: How do they communicate their decisions to the public?

We will then discuss their *monetary policy operational strategies*—how they implement monetary policy, in the next lecture.

Legal Mandates: The Fed

- The legal framework within which the Fed operates has evolved gradually over since its initial founding in 1913.
- Originally set up primarily as lender of last resort to prevent banking crises, the Fed did not do a good job as preventing the banking problems of the 1930s.
- With the setting up of the modern Federal Reserve Board of Governors in Washington DC, the Fed's performance improved, and with the banking system largely stable after the 1930s, over time, monetary policy became its main responsibility. Banking stability has now come to the fore again.
- The most important legislation is the 1978 Full Employment and Balanced Growth Act (known as the Humphrey-Hawkins Act) which requires the Fed to meet a number of objectives including
  1. A high level of employment.
  2. Stable prices (i.e. low inflation).
  3. Moderate long-term interest rates.

Legal Mandates: The ECB

- The legal basis for the single monetary policy of the Euro area was set in the 1993 Maastricht Treaty.
- Despite media focus on the ECB in Frankfurt, the common monetary policy is really set by the so-called Eurosystem, i.e. the ECB plus the national central banks (NCBs) of the member countries.
- Unlike the Fed, the Eurosystem has a clear primary goal. The Treaty states: "the primary objective ... shall be to maintain price stability"
- The Treaty then states that the Eurosystem "without prejudice to the objective of price stability ... shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives ... laid down in Article 2."
- Article 2 mentions as objectives "a high level of employment, sustainable and noninflationary growth, a high degree of competitiveness and convergence of economic performance."
- The ECB itself interprets "price stability" to mean "inflation close to but below 2 percent per annum."

Organisation: The Fed

- Need to distinguish the Federal Reserve System from the Federal Open Market Committee (FOMC) which makes the monetary policy decisions.
- The System consist of a central management board in Washington (the Board of Governors) and 12 regional Federal Reserve Banks.
- The System works together to carry out functions such as printing of currency and management of intra-bank payments, with much of this decentralised to the Reserve Banks.
- The FOMC:
  1. Consists of 12 members: The 7 members of the Board of Governors, the President of the New York Fed, and four other regional district Bank presidents, who sit on the committee on a rotating basis.
  2. Is chaired by the Chairman of the Federal Reserve Board, currently Janet Yellen. Its Vice-Chairman is the President of the New York Fed, currently William Dudley.
  3. Usually meets 8 times a year but sometimes holds emergency meetings by conference call.
- Open market operations are carried out by the New York Fed.

Organisation: The ECB

- The ECB is run by its six-member Executive Board. Its President is Mario Draghi and its Vice-President is Vitor Constancio.
- Monetary policy decisions are taken by the *Governing Council* of the ECB. This consists of the Executive Board and the Governors of each of the (currently 19) participating national country central banks. So the Governing Council has 25 members.
- This is important: The Irish Central Bank hasn't "given up" monetary policy to the ECB. It actively participates in making Euro-area monetary policy.
- The Governing Council meets to consider monetary policy every six weeks. (They also hold separate meetings on other issues.) The meetings usually (but not always) take place at the ECB's building in Frankfurt.
- Open market operations are carried out by all participating central banks.
- Like Fed districts, national country central banks print currency and operate payments systems. Unlike the Fed, many other tasks carried out largely by the Federal Reserve Board in Washington are de-centralized in the Eurosystem, e.g. forecasting, production of statistics, monitoring of public finances.

Banking Supervision: The Fed

- The U.S. has a highly complex system of banking regulation.
- The Fed directly supervises large bank holding companies, other national banks are supervised by the Office of the Comptroller of the Currency in the U.S. Treasury Department, while smaller state-chartered banks are supervised by the Federal Deposit Insurance Corporation (FDIC).
- Recent years have seen an expansion in the Fed's role in supervision.
  - The 2010 Dodd-Frank act abolished the Office of Thrift Supervision ("thrifts" are building societies) and gave the Fed supervision of thrift holding companies.
  - A new interagency Financial Stability Oversight Council (FSOC) to monitor risks to the financial system has been set up. The Fed is one of the council's members and plays an important role in stress testing the U.S. banking system.
  - Dodd-Frank specifically assigned the Fed responsibility for supervising non-bank financial institutions whose safety and soundness the FSOC determines to be important to the overall financial system. (AIG being the kind of nonbank institution they have in mind.)

Banking Supervision: The ECB

- Euro area member states have differed in how they have handled banking supervision. Some have had national central banks perform this task while some have had separate agencies.
- In June 2012, the euro area heads of state agreed to allow the common "bailout fund" the European Stabilisation Mechanism, to make investments in under-capitalised European banks.
- As a condition for this agreement, it was decided that the ECB would become the "single supervisory mechanism" (SSM) for banks in the euro area.
- The ECB took on this role in late 2014 and is currently directly supervising 126 banks, representing 82% of all bank assets in the euro area. Other banks will continue to be supervised by the national authorities but the ECB can decide at any time to exercise direct supervision of any one of these credit institutions in order to ensure consistent application of supervisory standards.
- In preparation for taking over as supervisor, the ECB published a *comprehensive assessment* of banks it directly supervises. This involved a risk assessment, an asset quality review and a stress test.

Political Independence and Accountability: The Fed

- The Fed's decisions are not subject to Congressional approval or Presidential veto, so in this sense it is politically independent.
- However, its legal mandates could be changed at any time by Congress and members of the FOMC are appointed by the President.
- Fed Governors are appointed to 14 year terms, so once they are appointed, they don't need to worry too much about pleasing Congress or the White House. (Though often, Governors are appointed to "see out" someone else's 14 year term, so in practice their renewal can come up quicker.)
- The Chairman of the Board—while serving a 14-year term as Governor—is subject to presidential re-appointment every four years, which needs to pass the House and Senate. Janet Yellen's four-year term ends in October and my bet is she won't be serving another term.
- The Humphrey-Hawkins act requires the Fed to deliver a bi-annual report to Congress including forecasts for output and inflation. After this report, the Chairman also needs to testify before Senate and Congressional committees and answer questions.
- By current international standards, the Fed is not very independent.

Political Independence and Accountability: The ECB

- The ECB is a highly independent central bank.
- Its legal mandate is set by the Maastricht Treaty and would be almost impossible to change.
- ECB Executive Board appointments made by "common agreement" by the Prime Ministers and Presidents of the participating countries.
- Executive Board members are appointed to non-renewable 8-year terms. National country central bank Governors must have terms of at least 5 years.
- Members of Governing Council need to make decisions based on Euro-area considerations and cannot consult with politicians.
- The Maastricht Treaty forbids politicians in member countries from seeking to influence decisions of ECB.
- ECB must prepare an annual report for the European parliament and the President appears four times a year at its Committee on Economic and Monetary Affairs.

Independence from Fiscal Authorities

- Recall that high inflation often stems from central banks being pressurised by governments to print money to finance budget deficits. The European Central Bank was set up with safeguards designed to prevent if from financing deficits.
- Article 123 of the European Treaty states "*Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States ... in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments.*"
- However, there is nothing preventing the ECB or Eurosystem NCBs from purchasing bonds of euro area governments in the secondary market. The ECB has done this in the past via its Securities Market Programme (SMP) and will be doing so again as part of its QE programme.
- The Fed is also prohibited from direct purchases of Treasury bonds but has engaged in large-scale purchases of these bonds on secondary markets in its QE programme.

The ECB's OMT Plan

- Interest rates on Spanish and Italian government debt reached very high levels in summer 2012, as many investors feared that they would be following Greece and defaulting on their debt.
- To ease fears, Mario Draghi announced an "Outright Monetary Transactions" programme in September 2012. This differs from the previous SMP plan.
  1. The plan involves the purchase of shorter-dated (under three years) government bonds of countries that have agreed an adjustment programme with the European Stabilisation Mechanism (ESM). As of yet, no OMT purchases have actually been made.
  2. No ex ante limits are placed on the size of purchases and ECB will announce how much it has purchased and a breakdown by country,
  3. The Eurosystem would rank equally with other creditors.
- Some officials, such as Bundesbank president, Jens Weidmann, feel that programmes like the OMT run counter to the spirit the "no monetary financing" prohibition.
- The German Constitutional Court has said they believe the bond purchase programme runs counter to European law and referred it to the European Court of Justice but the ECJ did not agree.

How Do the Meetings Work? Fed

- We have lots of information about how FOMC meetings work because full transcripts of the meetings are made available with a five year-lag. See the link on the website.
- So we know that the meetings work as following:
  1. The meetings start with staff presentations on recent developments in financial markets and the domestic and international economy.
  2. The Board staff's forecasts for the US economy are discussed.
  3. There is a roundtable discussion which includes the regional bank presidents discussing economic conditions in their district.
  4. Then they have coffee!
  5. Then the Chairman gives his assessment and makes a recommendation for which policy to adopt and (perhaps more importantly in recent years) how the FOMC statement should be worded.
  6. They have a discussion and then vote on the Chairman's proposal. If a member doesn't agree with the majority decision, they can record a dissent along with a brief explanation for why they disagreed.

How Do the Meetings Work? ECB

- What about ECB Governing Council Meetings? Since 2015, the ECB has been publishing "accounts" of these meetings.
- These accounts describe the briefings the Council received on financial and economic developments and provide a general account of the discussion, without naming attributing statements to individuals. It's not clear whether these accounts have played much role in clarifying the ECB's monetary policy communications.
- In relation to voting, until the last few years, we were told that all decisions were unanimous. We know that has not been the case in recent years but voting results are not released (if they are taken at all).
- The accession of Lithuania to euro membership brought the number of countries to 18, and this triggered a new voting system in 2015. Euro area countries are divided into groups according to the size of their economies and their financial sectors. To determine which national central bank Governor belongs to which group, a ranking will be established. The Governors from countries ranked first to fifth – currently, Germany, France, Italy, Spain and the Netherlands – share four voting rights. The other 14 share 11 voting rights. The Governors take turns using the rights on a monthly rotation.

Communications: The Fed

- After each meeting, the FOMC issues a statement. In addition to announcing the decision, it gives an assessment of economic conditions and the risks for inflation. The details of the vote are given.
- There has been a significant increase in the transparency of the FOMC. Prior to 1994, no statements were issued at all; prior to 1999 no statements were issued unless the target funds rate was changed; and in recent years the statements have become more detailed.
- In particular, the statements of recent years regularly contained communications describing how long the Fed planned to keep rates at zero. Since first raising rates in December 2015 the Fed has been saying it "*expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate.*"
- Detailed minutes of the meeting are released a few weeks later. In 2011, the Fed Chairman began to give press conferences after some FOMC meetings.
- In addition to congressional testimony, FOMC members regularly use public speeches to outline their views in relation to monetary policy.

Communications: The ECB

- After each monetary policy meeting, the Governing Council issues a statement which is read out by the ECB President at a press conference.
- The statement details the basis for the decision in terms of the ECB's announced monetary policy strategy. It describes the results of its *economic analysis* and its *monetary analysis*.
- Then the President takes questions from journalists, a very demanding task. Press conferences see Draghi bombarded with tricky questions about developments in specific countries and with questions about how far ECB is willing to go with its bond-buying.
- These press conferences are an interesting insight into the world of "central-bank-speak". ECB Presidents are generally determined to stay "on-message" and provide the intended guidance to financial markets.
- Transcripts and webcasts of the press conferences are available online. For those of you interested in the ECB, I strongly recommend checking them out (see the link on the webpage).
- Governing Council members also give speeches on a wide range of topics.

Recap: Key Points from Part 7

Things you need to understand from these notes.

1. Legal mandates of the Fed and ECB.
2. Organisational structures of the Fed and ECB.
3. Banking supervisory responsibilities of the Fed and ECB.
4. Political independence and accountability of the Fed and ECB.
5. Independence of the Fed and ECB from fiscal authorities.
6. Details of how the ECB's OMT programme is supposed to operate.
7. How the Fed and ECB meetings work.
8. Communications strategies.