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 Jerome Powell. Its Vice-Chairman is the President of the New York Fed, currently John Williams.
  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 Christine Lagarde.
- Monetary policy decisions are taken by the **Governing Council** of the ECB, comprising the Executive Board and the Governors of each of the (currently 19) participating national central banks (NCBs). 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 takes place at the ECB's building in Frankfurt with one "away day" per years in another member state.
- Monetary policies operations are largely carried out by the NCBs.
- Like Fed district banks, NCBs 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).
- The period after the global financial crisis saw 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 was 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.

Banking Supervision: The ECB

- Euro area member states have historically 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 119 banks, representing over 80% 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 supervised and works with the European Banking Authority to publish annual **stress tests** of these banks.

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.
- 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 it 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 (i.e. from other investors) as the ECB has done with its "Asset Purchase Programme", i.e. 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.

Capital Keys and Their Influence on the Eurosystem

- In many of its operations, the role of individual national central banks (NCBs) is determined by their "capital key".
- This is the share of the ECB's initial stock of capital that is contributed by each country in the EU.
- The NCBs shares in this capital are calculated using a key which reflects the respective country's share in the total population and gross domestic product of the EU. These two determinants have equal weighting.
- Capital keys are used in various ways
    1. The Eurosystem's profits and losses on its monetary operations – including those from the printing of banknotes – are allocated to NCBs according to capital share.
    2. The ECB's Asset Purchase Programme operates in a decentralised way with the amount of assets purchased by NCBs proportional to their capital key.
- Ireland's capital key is 1.65% but Ireland still has one of the 25 votes at the Governing Council. In this sense, Ireland is "punching above its weight"

Pooling and Reallocating Monetary Income

- The Eurosystem pools its monetary income (the net interest income it earns from its monetary policy operations) and reallocates it so that, on net, each member ends up with a share corresponding to their capital key,
- The Eurosystem monetary income (i.e. the net income earned on Eurosystem monetary policy operations) is determined by measuring the actual annual income that derives from the earmarkable assets held against its liability base.
- The key earmarkable assets are lending to euro area credit institutions related to monetary policy operations denominated in euro and securities held for monetary policy purposes.
- Example: For the Central Bank of Ireland, the difference between the monetary income pooled by the Central Bank and that reallocated to the Central Bank is recorded as "Net result of pooling of monetary income" in the Profit and Loss and Appropriation Account.
- In 2018, the Central Bank pooled €182.8 million in monetary income and was reallocated €201.3 million.

Example: Pooling and Reallocating of Monetary Income

	2018 €000	2017 €000
Monetary income pooled	*(182,861)*	*(152,861)*
Monetary income reallocated	*201,276*	*177,902*
Net Receiver of Monetary Income (Note 20)	**18,415**	**25,041**

Source: Central Bank of Ireland 2018 Annual Report

Eurosystem Sharing of Seigniorage Revenues

- Commercial banks have to pay their local NCB to receive a cash delivery. This payment takes the form of a reduction in the bank's deposit account with its NCB.
- Because banknotes can be produced at a tiny fraction of their face value, this means the production of banknotes earns large profits for central banks.
- To ensure profits from printing of banknotes (known as **seigniorage**) are shared fairly across the union, the Eurosystem shares these revenues according to a "banknote allocation key", which allocates 8 percent of the revenues to the ECB and the other 92 percent to NCBs in proportion to their capital key.
- Some NCBs produce more banknotes than would be warranted by their capital key, so these NCBs record an "intra-Eurosystem liability related to the allocation of banknotes" while the other NCBs record a positive entry, with the total summing to zero.
- At the end of 2018, the Central Bank of Ireland had an intra-Eurosystem liability related to the allocation of banknotes of €18.25 billion. This was tiny, however, compared with the Bundesbank's liability for the same item of €401 billion.

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, argued the OMT programme ran counter to the spirit the "no monetary financing" prohibition.
- The German Constitutional Court adjudicated that the OMT programme ran 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 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 19, and this triggered a new voting system in 2015. Euro area countries were divided into groups according to the size of their economies and their financial sectors. 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.
- For most of the past decade, the statements described how long the Fed planned to keep rates at zero, and then changed to describing its plans to raise interest rates. Having cut rates twice in 2019, the Fed's current "forward guidance" is effectively neutral, pointing out that what happens next depends on how the economic data come in.
- 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 and under Chairman Powell moved to have them after each meeting.
- 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 the President asked 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—you can find them on the class 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. How the Eurosystem shares monetary income and seigniorage profits.
7. Details of how the ECB's OMT programme is supposed to operate.
8. How the Fed and ECB meetings work.
9. Communications strategies.