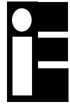 THE EUROPEAN INSTITUTE

The Independence and Regulatory Roles of the U.S. and European Central Banks Get a Fiery Political Trial

By J. Paul Horne

As the "Great Recession" recedes, the aftershocks of public anger are exploding with a political passion not seen since the Great Depression.. In this tumult, knives are out for the two leading central banks – the U.S. Federal Reserve (the Fed) and the European Central Bank (ECB), the agencies responsible for monetary policies underpinning the world's most important economies and markets.

On January 28, Fed Chairman Ben Bernanke won Senate confirmation for a second four-year term by surviving a populist revolt. The 70-30 – the smallest majority ever for a Fed Chairman – was only gained thanks to immense pressure from the White House. The battle illustrates the furies unleashed against the monetary authorities in the U.S. – and to some degree, in the 16-nation euro zone and its European Central Bank, headed by Jean-Claude Trichet.

The two central banks stand accused on two counts. The first is that their lax supervision of the financial markets led to the financial crisis that detonated first in the U.S. in August 2007 Work has already begun on investigating the causes of this crisis, and the independent and non-partisan Financial Crisis Inquiry Commission (FCIC) will report its findings next December – just after the U.S. Congressional elections. Already it is clear that regulators in the complex U.S. system, including the Bernanke-led Fed, failed to diagnose and defuse the growing systemic risk that ultimately threatened the global financial structure.

The second, more debatable, charge against the two central banks is that they were slow to lower interest rates as the crisis snowballed. It took 16 months after the 2007 crisis began for the Fed to cut its key target rate in December 2008 from 5.25 percent to 0.25 basis points. Similarly, the ECB's key rate was slashed from 4.25 percent in August 2007 to one percent by May 2009. Once rates had been cut to these lowest-possible levels, critics charge, the Fed and ECB "erred" in the opposite direction and exceeded their statutory authority by using "quantitative monetary easing" facilities to inject massive amounts of liquidity into virtually all financial markets.

Federal Reserve Facilities in Response to the Financial Crisis

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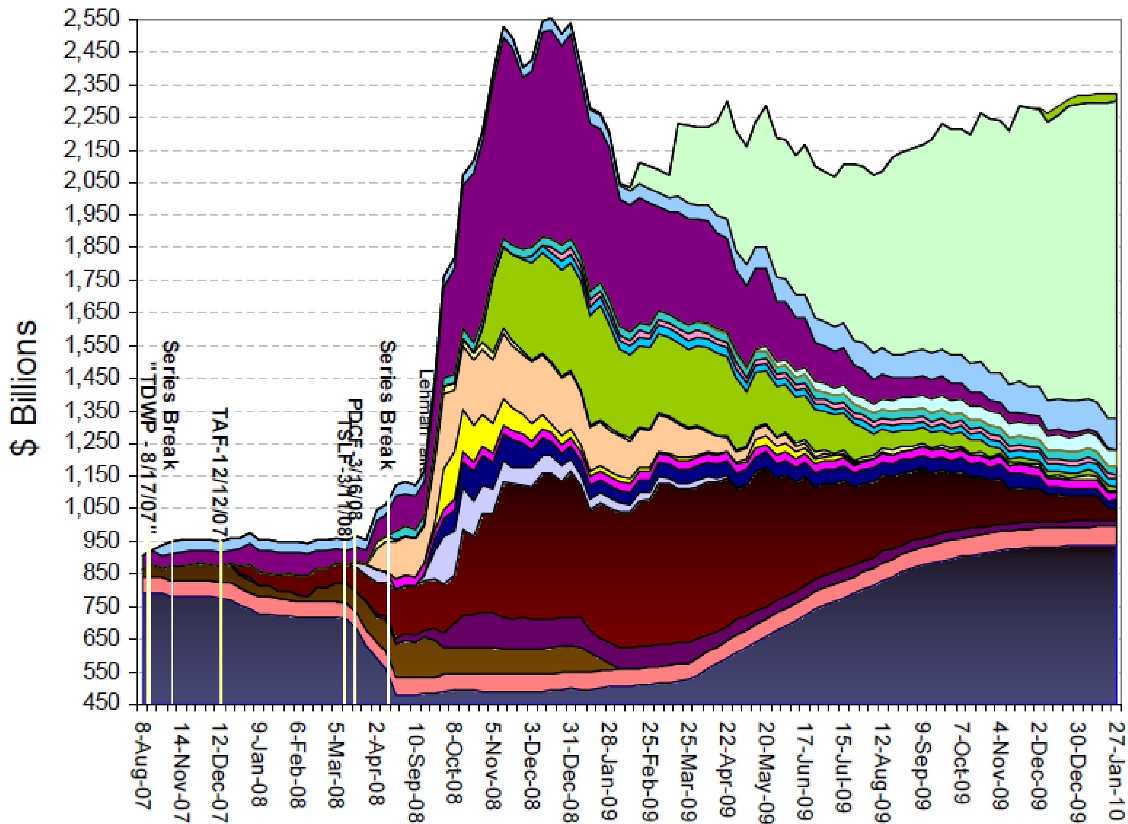

Source: Chart courtesy of Cumberland Advisors, Inc.

Criticism of the Fed began slowly soon after the financial crisis started, but escalated into public anger as household wealth was amputated by steep market declines, homes were repossessed and unemployment soared. Voters were enraged at seeing banks recover rapidly (thanks to massive bail-outs with taxpayer funds), start reporting record profits and bonuses for their executives – while refusing to lend to job-creating businesses. It has become a political firestorm for U.S. politicians ahead of elections in November. Alarmed, they are trying to divert voters' wrath by attacking the "money men" in the banking and financial industries and also in calling for changes at the two central banks, which are usually above the fray.

This populist strategy, driven by leaders' fears that the economic backlash is jeopardizing their whole political agendas and indeed their hold on office, is fueling calls in Washington and European capitals to revamp the two central banks' charters of independence. A parallel theme in both the U.S. and Europe focuses on proposed post-crisis rules for the monetary authorities and regulators responsible for banking and financial entities. There is an expert consensus that a sensible new global regulatory framework is essential if the world is to avoid another financial meltdown.

But the recent populist earthquake has unleashed tremors that threaten to lead to legislative and regulatory overkill and changes in the statutory independence of the Fed and the ECB, subjecting monetary policy to political pressures and also vesting some regulatory authority over financial institutions in new supervisory systems or agencies.

If any changes curtail the ability of these two banks to set interest rates and determine overall monetary policy independently of governments, it would reverse a fundamental lesson, hard-learned over past decades on both sides of the Atlantic: that politicians cannot be entrusted with management of monetary policy. This is especially true when economic circumstances require the central bank to tighten credit conditions in order to cool an accelerating economy before it overheats. This sound economic move is usually a politically unpopular step – described as "taking the punch bowl away just as the party is getting going." But history demonstrates that the bitter medicine administered by central banks and regulators is essential to avoid the speculative bubbles that cause financial crises and recessions. The discipline is needed to promote growth in national wealth in real terms.

The current fervor for zealous regulatory reform may end up producing little real restraint on private-sector banking. The financial "masters of the universe" often seem to feel that they are paid so much because of their wiles in circumventing any governmental constraints. Moreover, their lobbyists have mounted a high-pressure campaign to block more stringent legislation. But the debate itself may well cause collateral damage by undermining consensus about the need for independent central banks. Some euro zone leaders, such as Italian Prime Minister Silvio Berlusconi, French President Nicolas Sarkozy and even Luxembourg's centrist Prime Minister Jean-Claude Juncker have called for shifts in the balance of power to favor of the political leaders in the euro zone at the expense of the ECB. (Their position is echoed by non-euro zone Europhobes such as British Conservatives, who are likely to govern after parliamentary elections this spring) and Czech Republic President Vaclav Klaus.

These leaders accuse the ECB of failing to prevent Europe's financial crisis – even though the ECB is <u>not</u> statutorily responsible for regulating the banking and financial sectors. (Their disregard of the facts is paralleled by their readiness to disregard logic: they also criticize the euro zone's single monetary policy as being too constraining for a bloc of countries with such widely different economic conditions.) In contrast to these political grievances, history already suggests that both the Fed, led by Bernanke; and the ECB, under Trichet, performed brilliantly and audaciously, after the financial crisis began in August 2007. They used all the resources at their disposal, both to preserve the financial system from collapsing and to attenuate the economic recession.

But, fueled by anger that "Wall Street plays while Main Street pays," fierce debate over statutorily independent monetary authorities is probably inevitable. In the U.S., it may have a silver lining: it may provide the first real opportunity in many decades to overhaul an ad hoc and rickety regulatory system that has regularly failed to prevent speculative bubble-and-bust cycles. In the euro zone, there is a chance that the debate could actually have some beneficial effects if it clarifies (and widens) the ECB's mandate to pursue monetary strategies beyond the narrow agenda of just protecting price stability only. And it could be useful in determining what institution (right now, it is not the ECB) should have regulatory authority over the European banking system.

On the political defensive, White House and Congressional Democratic leaders are leaning toward a populist strategy: in his State of the Union address in late January, President Barack Obama suggested an agenda that could hit the big banks with taxes in the form of levies

on their transactions or balance sheets; restrictions on proprietary trading (using deposits to speculate in a bank's own account), limits on their market share and restrictions on executive compensation. Such measures – based on ideas from former Fed Chairman Paul Volcker, who is now a key Obama adviser – seem most likely for the "bailed-out banks" that used taxpayer money to surmount the crisis. Some similar measures are being enacted in Europe. Sweden, for example, has a "bank tax," introduced in 2009, that imposes a 0.036 percent tax on banks' final balance sheets. (Taxing balance sheets rather than transactions makes it harder for bank companies to escape to tax havens.) This tax has already produced budget revenues equal to one percent of Swedish gross domestic product.

More broadly on regulatory reform, rather than give the ECB an additional role as a cross-border regulator, Brussels and EU governments prefer a gradualist and pragmatic approach to regulatory changes. This approach reflects the realistic need to take account of the sensitivities of national regulators responsible for the banking (and insurance) industry. In contrast to the situation in the U.S., these are still largely national since European banks are only slowly consolidating across EU border.

Histories of these two Banks in the Tumult

Indeed, reactions to the recession and the *furore* about reforms have thrown into high relief the fundamental differences between the Fed and the ECB, starting with their mandates, statutory powers and the political environment within which they work.

The Fed is statutorily independent in making monetary policy but must report to Congress on its success in achieving dual mandates: maintaining price stability and maximizing economic growth and employment. Through the 12 regional Federal Reserve banks, the Fed also has regulatory authority over the nation's most important banks but not all U.S. banks. It also has emergency powers, which it has used aggressively and creatively since the start of the financial crisis. The Fed does not coordinate its monetary policy with the administration – at least not officially in normal times. And fiscal policy – taxing and spending – is subject to Congressional approval of legislation proposed by the White House and administered by Executive departments.

While the Fed is often responsively attuned to the U.S. political leadership's overall political and economic agenda, it most definitely does not have responsibility for the government's fiscal policy. Of course, it may have to adjust monetary policy to deal with the consequences of fiscal policy decided by Congress. In fact, Fed chairmen and ECB President Jean-Claude Trichet often complain publicly about fiscal policy problems – for which they are not responsible and cannot solve but are often blamed.

Nor is the Fed required to finance whatever the Treasury wants to borrow, i.e. by "printing money". If the Fed does not increase the money supply as Treasury borrowing rises, then interest rates must rise. Unless there is an alternative supply of capital from foreign savers who buy the additional Treasury debt, meaning that we finance our deficit with foreign savings. This is precisely what has happened since the early 1980s, boosting both our national and foreign debts. This can complicate the Fed's job as when Bernanke complained in early 2005 (just before

he succeeded Fed Chairman Alan Greenspan) about a "global savings glut" – much of it pouring into U.S. asset bubbles such as bundled real-estate mortgages and complex financial paper such as credit-default swaps. The Fed can, however, be faulted for not working harder to neutralize that inflow of foreign credit which inflated our asset bubbles. In the euro zone, the ECB was powerless to prevent the extensive issuance of euro-denominated government debt by EU countries; now some of these capitals are finding it difficult to refinance their debts and deficits that have swollen during the recession.

In practice, of course, the Fed is somewhat vulnerable to political pressures. Theoretically, Congress could legislate a fundamental change in the Fed's statute. And the rough ride Bernanke had on the way to his Senate confirmation may have hurt his political credibility, making it more difficult for him to lead the Fed with as much autonomy and authority as he would like. But Bernanke has proven himself tough enough to ride out the storm of anti-Fed criticism and lead the central bank effectively. The main question facing him is whether Congress is willing to change the Fed's statute.

The ECB, on the other hand, is more insulated from voters' ire. For one thing, it is a work in progress that only began operations on June 1, 1998. After years of wrangling between EU member states, the Maastricht Treaty, narrowly adopted in 1992, mandated the new ECB that started business in 1998 to manage monetary policy independently in those countries using the new single currency, the euro. Unlike the Fed's double mandate, the ECB has a single statutory objective: price stability, with a medium-term inflation target of two percent. Euro zone governments are expressly forbidden from interfering with the work of the ECB, its Governing Council and 16 member central banks. As in the U.S., fiscal policy, spending and taxing, is the responsibility of national parliaments and governments. Independence means that neither the Fed nor the ECB is required to adjust monetary policy to suit government fiscal policies. Instead, the Fed and the ECB tighten (or loosen) monetary policy when either central bank judges that prevailing economic circumstances are leading to inflation (or deflation).

There is a nominal political voice, which theoretically the ECB is required to heed: euro zone countries' finance ministers, the so-called Eurogroup, which provides non-binding guidance to the ECB on member governments' overall collective economic objectives. When the ECB was being organized, France forced Germany and other EU nations to agree that this advisory political body be set up. The ECB has dutifully listened to the Eurogroup politicians but only infrequently follows their advice if it conflicts with their own assessment.

Recently, perhaps feeling guilty about its failure to prevent the financial crisis, however, the ECB is now providing more information about its monetary deliberations and operations to EU political institutions such as the European Parliament and the European Commission – transparency that ECB critics wish to see enhanced. Politicians such as Sarkozy and Juncker also are calling for an enhancement of the role of the Eurogroup of finance ministers.

Political Economics of Current Crisis

Ironically for an institution divorced from governments' fiscal policy, the ECB is today facing a major challenge caused by the national budgetary disasters by political mismanagement in Portugal, Ireland, Italy Greece and Spain – the euro zone's so-called PIIGS. Aggravated by the recession, these countries' long-running and worsening budget deficits now average between eight and 12 percent of their gross domestic products – multiples of the ceiling of three percent by the Growth and Stability Pact of the European Monetary System. Yet despite pressure from other euro zone countries, these governments may be politically unable or unwilling to rein in their deficits.

Their debt-to-GDP ratios exceed 100 percent already, so bond market "vigilantes" and traders are alarmed and forcing the PIIGS to pay higher and higher yields to sell their bonds to borrow money. Markets worry that the major EU governments, or the IMF, may have to bail out Greece and the others. If so, ECB monetary policy might have to take into account the potential inflationary impact of increased borrowing of the euro zone governments, as well as the economically restrictive impact of higher borrowing rates for the problem countries. But the ECB's Trichet emphasizes that the ECB has no direct responsibility, nor the means, for resolving the PIIGS government deficits. Moreover, Greece, Ireland and Spain together represent only 16 percent of the euro zone's aggregate gross domestic product (and 12 percent of the EU's) and therefore should be manageable, even though they are responsible for most of the euro zone's most problematical sovereign debt.

For the moment, however, the PIIGS crisis is the gravest threat yet faced by the euro and the ECB. When the European Monetary System was founded, the EU was economically strong (in contrast to the current weakness), but even then the founders correctly foresaw that the politicians, not central bankers, would be the most difficult to discipline. Ironically, of course, the ECB has used all the levers at its disposition to help maneuver the euro zone out of the current economic slump. There is no "EU government" to set overall fiscal policy, spending and taxation across all 27 EU countries or the 16 euro zone countries. So the ECB does not have direct fiscal-policy interlocutors as the Fed does in the administration and Congress. As desirable as an "EU government" might be for improved fiscal governance, it has been almost impossible to visualize the political leaders giving up their powers for deciding spending and taxation in their own countries to a Brussels-based administration. The current "PIIGS problem" may give EU leaders a useful push in the right direction of at least trying to coordinate budgetary policies in the euro zone (and possibly the EU) to avert major fiscal crises.

In practice, European politicians who attack the ECB and its independent monetary policy usually do so for national political reasons rather than a desire to restructure the ECB. Any serious attempt to do so would reopen a politically fraught and fundamental debate about EU integration among all the member countries. None of these governments dares to restart the titanic battles entailed by all such major moves toward European union, most recently the Lisbon Treaty. The ECB's statutory independence could not be altered without the unanimous agreement of the 27 EU governments, and Germany, whose Bundesbank served as the model for the ECB, would never accept an attack on ECB independence. Battling inflation is part of all Germans' DNA after their experiences with hyperinflation in the 1920s.

It is worth noting the ECB has performed very credibly since 1999 in setting and explaining monetary policy in the 16 euro zone countries, maintaining price stability (which has resulted in record low nominal and real interest rates since 1999) and shepherding the single euro currency. Thus the ECB is arguably, along with the euro, the EU's greatest success and provides the monetary glue that holds the often politically fractious Euro zone countries together – a fact not lost on European politicians.

As for regulation of the banking and financial sectors, the ECB has no statutory responsibility for regulating banks or other major financial institutions. It does, however, have a responsibility to carefully monitor banks and financial institutions, and to signal potential problems to national regulators.

THE REFORM AGENDAS IN THE U.S. AND THE EU

In autumn 2009, the European Commission proposed comprehensive legislation for new supervisory institutions that would cover all EU and euro zone banks and non-bank financial entities. The scope and rapidity of the commission's proposals are remarkable. Taken together, they amount to a proposed supervisory structure that is more comprehensive and coordinated across the 27 EU countries than anything on the table in Congress. Could the EU leapfrog the U.S. in developing this framework?

It seems unlikely: any reforms must be approved by the EU Council of Ministers, i.e. by member governments, and such unanimity is not a foregone conclusion, even with the new post-Lisbon Treaty voting-system. EU member governments have a long tradition of defending national turf. Although European leaders often call, rhetorically, for the bank to be more aggressive in promoting job growth, they are primarily posturing for their domestic electorates. They know they have virtually no chance of pushing through changes in an institution as crucial as the ECB. This state of affairs is probably an asset for Europe since it means European national politicos cannot derail key policies and institutions for petty political reasons.

The European Commission has put forward its own reform blueprint which incorporates the recommendations of the De Larosière report, published in February 2009. In the wake of the financial crisis, the Commission requested a group of European "wise men", led by Jacques De Larosière, the former governor of the Bank of France and head of the IMF, to make recommendations for financial regulation across EU borders. The EC's final proposal calls for a European System of Financial Supervisors (ESFS) and three new European Supervisory Authorities (ESA) to work across EU borders. Existing national supervisory authorities responsible for banking, financial securities, insurance and employee pensions would be transformed into the three ESAs: a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA) and a European Securities and Markets Authority (ESMA). This authority would have direct supervision over credit rating-agencies in the EU.

The commission in Brussels also proposes the creation of a European Systemic Risk Board (ESRB): it would work closely with the ESFS to identify systemic risk and then act through the ESAs to correct systemic problems. It is an ambitious, comprehensive package. It may pass while in the U.S., reform still faces political stalemate and strong lobbying by the financial industry.

Since successfully declaring “war on inflation” in 1979 as Fed Chairman, Paul Volcker, head of President Obama’s Economic Recovery Advisory Board, has had a consistent record of speaking frankly in public. In the *New York Times* on January 31, 2010, Volcker offered an agenda for reform that emphasized: higher capital and liquidity requirements for banks; better official supervision of financial institutions; improved risk management and oversight by banking company boards; revamped accounting procedures for financial institutions; and international cooperation on the supervision and regulation of international finance, including the new-fangled “derivatives.” The Fed, he insisted, should have the responsibility of assessing systemic risk in the financial system and recommending action to deal with it.

Regulation of large U.S. insurance companies, now limited to State regulators, should be reviewed from a national perspective, according to Volcker, who voiced serious concern about the “moral hazard” that occurs when banks are allowed to become “Too Big To Fail” – a situation that, perversely, encourages them to engage in excessive risk-taking. It enriches them while they succeed, and they run no risk of being in “hazard” because they know taxpayers must bail them out when they get into trouble, as they surely will. Volker urged the creation of a “resolution authority,” a Federal agency to intervene quickly when a “systemically critical capital market institution is on the brink of failure.” The agency would arrange an orderly liquidation or merger of the institution in a way that laid most of the loss at the door of shareholders, management and creditors – not taxpayers asked to put up funds for a bail-out.

Now the White House must soon decide how to reconcile Volcker’s views with two different bills in the Democrat-controlled Congress for regulatory reform. The Senate bill, sponsored by Christopher Dodd, chairman of the Banking Committee, would create an entity similar to the “resolution authority” and also a new super regulatory agency to supervise all federally-chartered banks and financial institutions. By eliminating the regulatory powers of the Fed, OCC, FDIC and other federal regulatory agencies, it would make way for this super regulator headed by the Treasury Secretary. By consolidating regulatory authority for virtually all U.S. banks, Dodd’s legislation would, in effect, prevent U.S. financial firms from shopping for the most lenient regulator. The Fed would be marginalized. (Dodd’s proposal would be the most radical regulatory reform since the Roosevelt era during the Depression. A landmark of that period was the Glass-Steagall act separated regular banks from investment banks borrowing capital to plough into ventures proclaimed. That ban was repealed in 1999, allowing big investment houses such as Goldman Sachs to buy up banks on Main Street and speculate with their assets.)

Dodd, who is highly critical of the Fed’s failure to prevent the crisis, also wants to restrict the Fed to setting monetary policy and reduce its power to monitor day-to-day bank transactions, hence its ability to fine tune monetary policy. This Congressional attack on the Fed’s independence was unexpectedly amplified in November 2009 in the other house of Congress,

when a large bipartisan majority of Representatives, backed a proposal by a libertarian Texas Republican Representative Ron Paul to pass a "Federal Reserve Transparency Act." The bill calls for the Fed's monetary policy-decisions and relations with foreign monetary authorities – a much broader category than its "accounts" – to be "audited" by the Government Accountability Office (GAO), an agency controlled by Congress. Current legislation exempts the Fed from such politically-motivated audits. Fed critics like Paul ignore the considerable transparency to which the Fed is already subjected. Its accounts are audited regularly by the GAO, and the Fed Chairman and other Fed officials testify frequently before Congressional committees on monetary policy and the Fed's economic forecasts.

The other major regulatory reform bill in the House was put forward by Massachusetts Representative Barney Frank, head of the Financial Services Committee. The Frank bill is at odds with Dodd's proposal because it would overhaul supervision of financial markets but protect the Fed's independence and expand its supervisory powers to allow it to oversee all the largest banks and non-bank financial institutions. It would also increase the Fed's authority to monitor systemic risks in the financial sector. The White House (including Volcker) are more closely attuned to the thinking of Frank than of Dodd, whose position has weakened since the announced in November, when faced with disastrous polling declines, that he will not stand for re-election in this year's election.

The main problem facing the Obama administration's efforts to reform the U.S. regulatory structure is not so much reconciling the Volcker, Dodd and Frank approaches, but persuading Congress to approve legislation at all. Obama no longer disposes of a filibuster-proof "super-majority" in the Senate, so any proposal must make some concessions garner support from some members of the Republican opposition. Yet it is not clear what reforms are sought by the Republicans, if any.

Political and economic rivalries between the U.S. and the EU may also retard a solution to the reform of international supervision and regulation structures. Many American politicians and financial leaders (often inspired by Europhobes in The City in London) have long regarded the EU and ECB as an ill-conceived political project condemned to fail because of perceived European structural, economic and political problems. Such observers seem to neglect the reality that the EU is now 52 years old, has a population of 500 million and accounts for nearly one-third of world GDP. Signs that the EU is trying to move to an EU-wide supervisory structure suggest that the euro zone may be ready for slow but real economic recovery...hopefully one without a risk of another major financial crisis.

As for the U.S., it faces an uphill road for efforts at reorganizing and unifying the splintered financial regulatory structure. Not only is anti-regulatory ideology a major obstacle, but the financial lobbies are lavishly funded and influential enough to neuter most significant reforms, despite voter anger. If Congress fails to reconcile and approve a compromise reform including the best of Volcker's and Frank's proposals before this spring, campaign posturing prior to the mid-term elections in November will probably block any significant reform. Even then, however, Bernanke can be expected to defend the Fed's independence and be pre-emptive in dealing with incipient bubbles. Other U.S. regulators, under the Obama administration, can be counted on, too, to be more proactive in policing the financial industry. This outcome would be a very small

benefit compared to the toll of the crisis. Such modest gains, however, certainly would not be as bad as some extremely misguided populist remedies such as those proposed by Dodd and Paul. Incremental regulatory reforms such as those urged by Volcker and Frank would be far probably better than the unstable status quo.

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