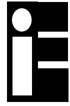 THE EUROPEAN INSTITUTE

Powers of the U.S. Federal Reserve and the European Central Bank
By J. Paul Horne

To put into perspective possible structural changes for the Fed and ECB, it is useful to look at their origins. The Federal Reserve Board today describes itself as "an independent entity within the government," whose Chairman is appointed by the U.S. President, subject to Senate confirmation. The Fed, while statutorily independent, must nevertheless report to Congress on price stability and economic growth in the context of its monetary policy. It does not have to obey Congress, but it does listen carefully, mindful that the legislative branch has the ultimate power to alter the Federal Reserve Act. The Fed also has emergency powers, used aggressively since the financial crisis began in autumn 2007. It consults with the Treasury and the White House, but, as explained above, has no direct responsibility for fiscal policy.

Unlike the ECB, the Fed is also responsible for: supervising and regulating major banking institutions to ensure the soundness of the banking and financial system; protecting individual consumers' credit rights; maintaining the financial system's stability and containing systemic risk in financial markets. However, it shares supervisory and regulatory responsibilities for domestic banking institutions with the Office of the Comptroller of the Currency (OCC) (part of the Treasury), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (in the Treasury) at the federal level; and with the 50 state banking departments.

In contrast to the Fed's birth in crisis, the ECB had its origin in the Maastricht Treaty of 1992, after much debate during a long period of European prosperity and after a political singularity: the fall of Soviet Communism and reunification of Germany. The ECB was possible because the process of European union had succeeded well enough in trade and political cooperation for political leaders to move toward closer, and irreversible, integration. The key political leaders at the time (Kohl, Mitterrand and, at least initially, British Prime Minister Thatcher) had realized that it would be impossible to persuade politicians to relinquish control over taxing and spending. They thus agreed on the Single European Act of 1987 which provided for majority voting on key objectives such as the completion of the Single Market and set up tighter monetary integration that would culminated in the 1992 Maastricht Treaty. Remarkably, European leaders agreed to make monetary policy independent of politicians, to unify member countries' interest-rate structures and to replace national currencies with the euro.

The EU's single monetary policy began by making all central banks statutorily independent in those countries that agreed to participate (the U.K., Sweden and Denmark opting out). The "euro governments" then had to meet stringent "convergence criteria" for inflation, long-term interest rates, budget deficits and debt-to-GDP ratios. By some miracle, the euro countries were certified by the European Commission to have met these targets in time for the "financial euro" to be used from January 1, 1999, and from which date all financial transactions were denominated in euro. The ECB, which had begun operating in June 1998, supervised the transition, and took over monetary policy-making

from the national central banks. Euro banknotes and coins hit the streets on January 1, 2002, with very few problems, apart from an inflationary "rounding up" effect as national currency prices were converted into euros.

There is no doubt that the ECB and euro mark a revolution in European monetary history. This was due largely to the ECB being independent and focused solely on price stability, Germany's primordial condition for the Bundesbank being subsumed into the ECB. The conservative German view of long-term economic policy also led the EU to agree, in 1997, on a "Stability and Growth Pact" (SGP) designed to ensure that politicians managed fiscal policy prudently. The SGP requires that EU member states' fiscal policies be monitored by the European Commission (EC) and the EU Council. Euro zone members must continue to respect the stringent "fiscal convergence" criteria that qualified them to join the euro zone.

Governments infringing these rules are formally warned by the EC. If they do not rectify their fiscal turpitude, the EC can levy significant fines on those governments. Unfortunately, neither the SGP nor the Maastricht treaty made mention of the difficulty of correcting cyclical and structural fiscal deficits during recessions or weak economic growth. Ironically, it was Germany and France who were the first countries to breach the agreed ceiling on fiscal deficits – three percent of gross domestic product. This led to a revision of the SGP rules so that a euro zone country is now judged on its cyclically-adjusted public deficit and debt, the duration of its recession or sub-trend growth; and factors affecting national productivity.

The Maastricht Treaty also created a European System of Central Banks (ESCB) of the original EU members, with the ECB as the central bank for the euro zone. This system works builds on the national central banks, with their long-established relationships their own national banking and credit communities and their knowledge of their own countries, languages and cultures. The ESCB and the ECB's situation is thus similar to the Federal Reserve System's dependence on the expertise of its 12 regional banks.

Unlike the Fed, however, which has clear regulatory and supervisory responsibility for the private banks belonging to its 12 regional member banks, there is an ambiguous European regulatory structure. The ESCB and ECB have a "coordinating responsibility" but not direct supervisory authority over European banks, which continue to be regulated by national regulatory authorities. This explains why the ECB, unlike the Fed, gets unfairly blamed for failing to prevent the financial crisis. Nevertheless, the ECB is required to monitor conditions in the ESCB and the private banking system and warn national regulators of potential risks. Although the ECB seems not to have done this effectively before the crisis, it did move to inject massive liquidity into the euro interbank markets to counteract the crisis. And, like the Fed, it expanded its balance sheet from around €1 trillion when the crisis began up to around €2 trillion at the height of the crisis.

In the aftermath of the crisis, European policy makers are considering a gradual broadening of the ECB's role in overall European economic policy-making. To broaden its mandate, attention is focused on a long-ignored point in the ECB's statute which states that "without prejudice to the objective of price stability, the ESCB shall support the general economic policies … contributing to… the objectives of the Community" --

meaning sustainable, non-inflationary economic growth and high employment. If this interpretation is accepted, the ECB could assume a dual mandate like the Fed's.

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