ulm university universität ulm

International Summer Program

8 July 2010

ECB & Fed
A comparison

Agenda – ECB and FED Comparison

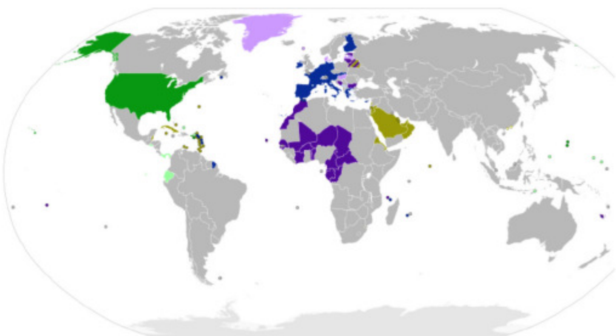
- **Introduction**
- **European Central Bank**
- **Federal Reserve System**
- **Summary: ECB and FED**
- **Excursus: Other Central Banks**


Central Banks

A **central bank**, **reserve bank**, or **monetary authority** is the entity responsible for the monetary policy of a country or of a group of member states. It is a bank that can lend money to other banks in times of need. Its primary responsibility is to maintain the stability of the national currency and money supply, but more active duties include controlling subsidized-loan interest rates, and acting as a lender of last resort to the banking sector during times of financial crisis (private banks often being integral to the national financial system). It may also have supervisory powers, to ensure that banks and other financial institutions do not behave recklessly or fraudulently.

Most richer countries today have an "independent" central bank, that is, one which operates under rules designed to prevent political interference. Examples include the European Central Bank and the Federal Reserve System in the United States.

Direct Influence of Euro and US-Dollar in the world



English:
- Eurozone, the originator in control of the euro
- External adopters of the euro
- Currencies pegged to the euro
- Currencies pegged to the euro within a narrow band

- United States, the originator in control of the US dollar
- External adopters of the US dollar
- Currencies pegged to the US dollar
- Currencies pegged to the US dollar within a narrow band

Note that the Belarusian ruble is pegged to the Euro, Russian Ruble and U.S. Dollar in a currency basket.

Key Characteristics

	€-15	EU-27		
Population (millions)	319	495	302	128
GDP (PPP, € trillions)	8.9	12.6	12.0	3.7
GDP per capita (PPP, € thousands)	27.8	25.4	39.6	29.0
Share of world GDP (PPP, %)	16.1	22.7	21.3	6.6
Exports (goods and services, % of GDP)**	22.6	14.2	11.8	18.4
Gross fixed capital formation (% of GDP)	21.7	21.2	18.7	23.3
Gross saving (% of GDP)	22.5	20.8	13.4	29.6

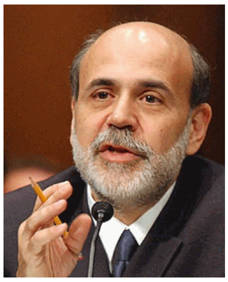
* 2007 ** The figure for the euro area excludes Cyprus and Malta
Sources: for euro area and EU: ECB, Eurostat, national data, IMF and ECB calculations; for the United States and Japan: national sources, IMF.

© EUROPEAN CENTRAL BANK

Central Bankers

Jean-Claude Trichet

President of the European Central Bank



Bernard Bernanke

Chairman of the Federal Reserve

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ECB – History (see ECB History Video)

1944 – 1973
Collapse of the Bretton Woods System

1972 – 1979
First attempt of European monetary cooperation: Snake in the Tunnel

European Monetary System (EMS)

4 Stages:

Stage 1: 1979 – 1983
Stage 2: 1983 – 1987
Stage 3: 1987 – 1992
Stage 4: 1992 – 1993

Treaty on the European Union

3 Stages:

Stage 1: 1990 – 1994
Stage 2: 1994 – 1999
Stage 3: Since 1999

Video Source: http://www.ecb.int/ecb/educational/movies/history/html/index.en.html

ECB - Motivation

Quote of the second Article of the of the Treaty on the European Union of March 25th, 1957, where it says that it is the purpose of the union:

… to promote economic and social progress and a high level of employment and to achieve balanced and sustainable development, in particular through the creation of an area without internal frontiers, through the strengthening of economic and social cohesion and through the establishment of economic and monetary union, ultimately including a single currency in accordance with the provisions of this Treaty…

…to assert its identity on the international scene, in particular through the implementation of a common foreign and security policy including the progressive framing of a common defence policy, which might lead to a common defence, in accordance with the provisions of Article 17…

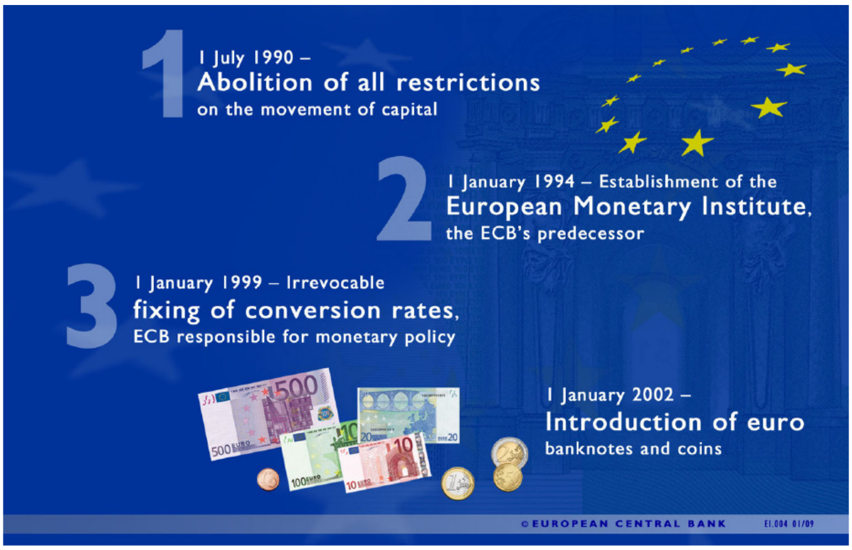
Signing of the Treaties of Rome

The idea if European Integration occurred first shortly after the end of World War II, when Sir Winston Churchill spoke of “establishing some kind of United States of Europe” in 1946.

Process of European Integration

Preparation of Economic and Monetary Union (EMU)

Three stages to EMU



Convergence Criteria

Government finance

Annual government deficit:

- Government deficit must not exceed 3% of GDP
- If not, it is at least required to reach a level close to 3%.
- Government debt: The ratio of gross government debt to GDP must not exceed 60%

Exchange rate:

- Applicant countries should have joined the exchange-rate mechanism (ERM II) under the European Monetary System (EMS) for 2 consecutive years and should not have devaluated its currency during the period.

Inflation rate:

- No more than 1.5 percentage points higher than the three lowest inflation member states of the EU.

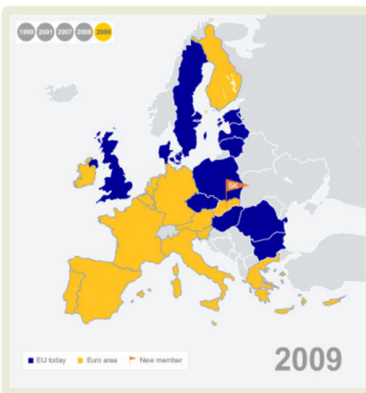
Long-term interest rates

- The nominal long-term interest rate must not be more than two percentage points higher than in the three lowest inflation member states.

Purpose of setting the criteria: Maintain the price stability within the Eurozone even with the inclusion of new member states.

Eurozone

Map of Euro Area 1999-2009



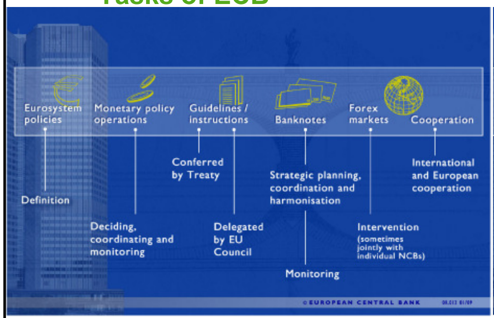
Source: http://www.ecb.eu/euro/intro/html/map.en.html

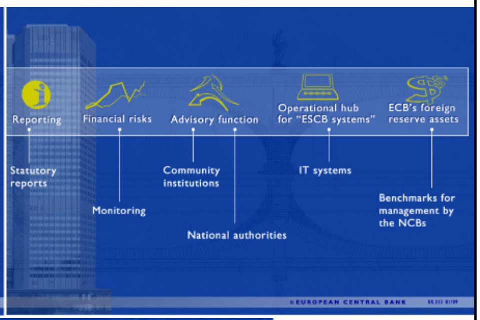
EU members in the euro-zone (16 countries)	EU members in the non-euro zone (9 countries)	EU members with an opt-out (2 countries)
January 1, 2002	Sweden	United Kingdom
Germany		Denmark
France	**Joined in 2004**	
Spain	Czech Republic	
Italy	Estonia	
Ireland	Latvia	
Finland	Lithuania	
Portugal	Hungary	
Austria	Poland	
Belgium		
The Netherlands	**Joined in 2007**	
Greece	Bulgaria	
Luxembourg	Romania (expect in 2014)	
January 1, 2007		
Slovenia (Joined in 2004)		**Applicant countries**
January 1, 2008		Turkey
Cyprus (Joined in 2004)		Croatia
Malta (Joined in 2004)		Macedonia
January 1, 2009		
Slovakia (Joined in 2004)		

1 Central Bank – 16 National Central Banks (NCB)

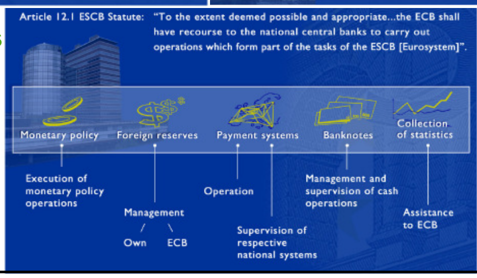
ECB Independence

Tasks of ECB



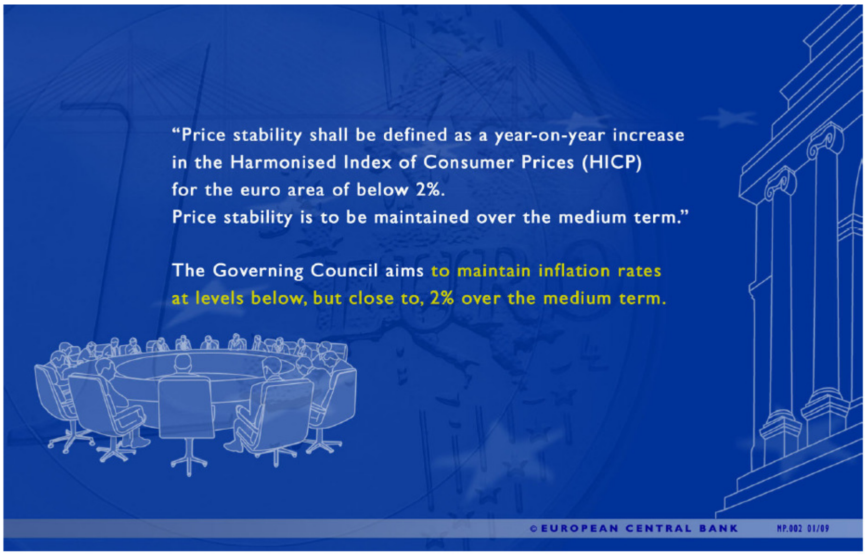


Tasks of NCBs

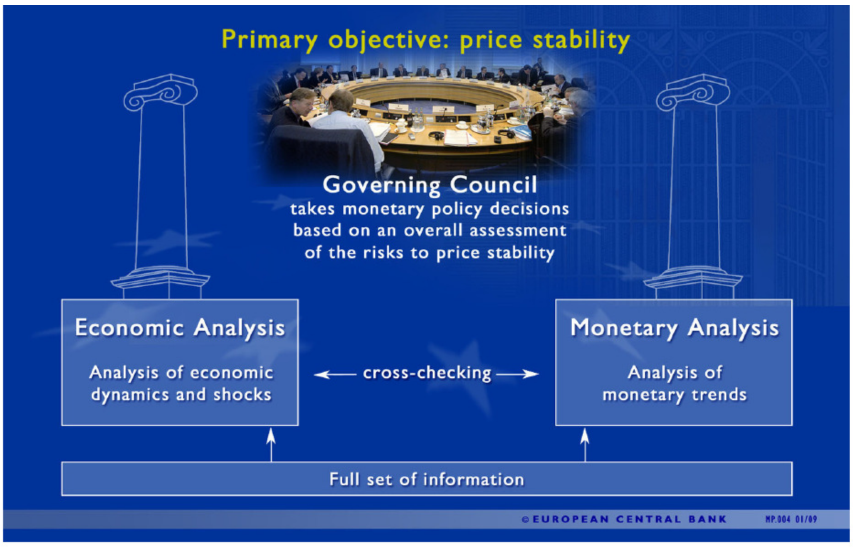


Primary Objective: Price Stability

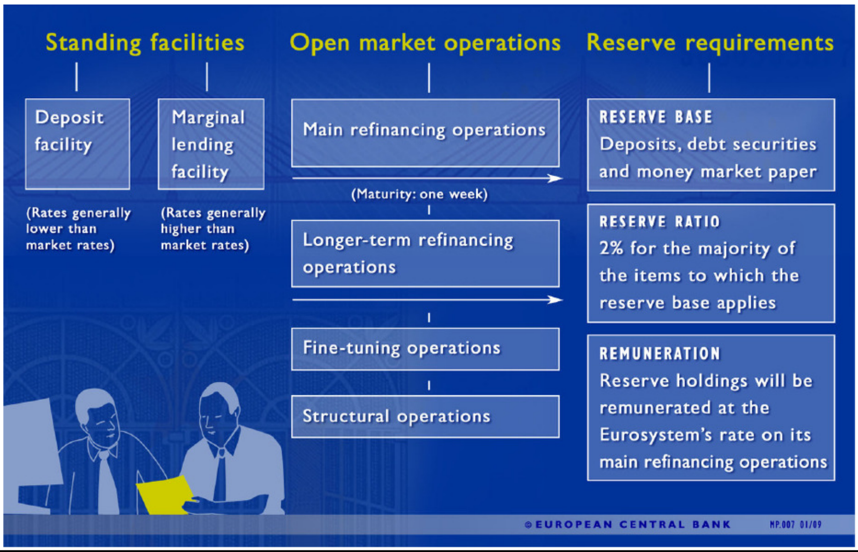
Definition: Price Stability



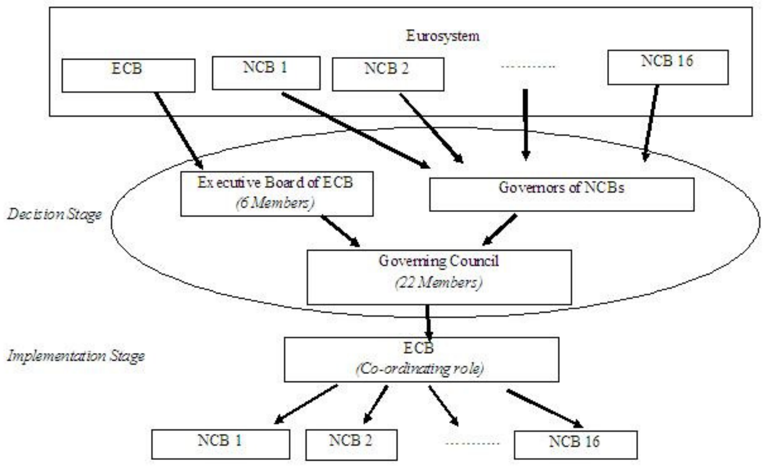
ECB's Monetary Policy Strategy



Monetary Policy Instruments



Organizational Framework of the Eurosystem



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The Federal Reserve System: Origins

- 1870 to 1907:
  US had 21 financial panics
- Anatomy of 19th century bank panics:
  - Crop Failure ⇒ Loan Default
  - Loan default damaged rural bank
  - Rural bank withdrew deposits from city bank
  - Financial difficulties spread

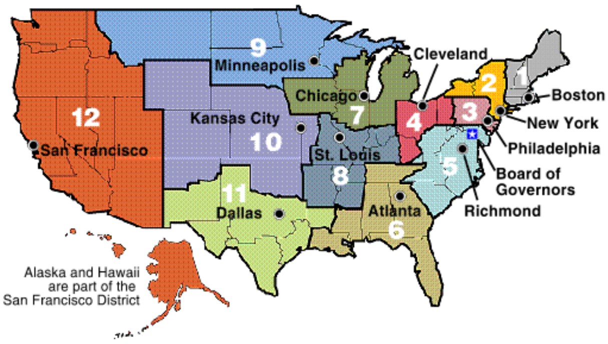
The Federal Reserve System: Origins

- Panic of 1907 – must be a better way.
- Federal Reserve Created in 1914

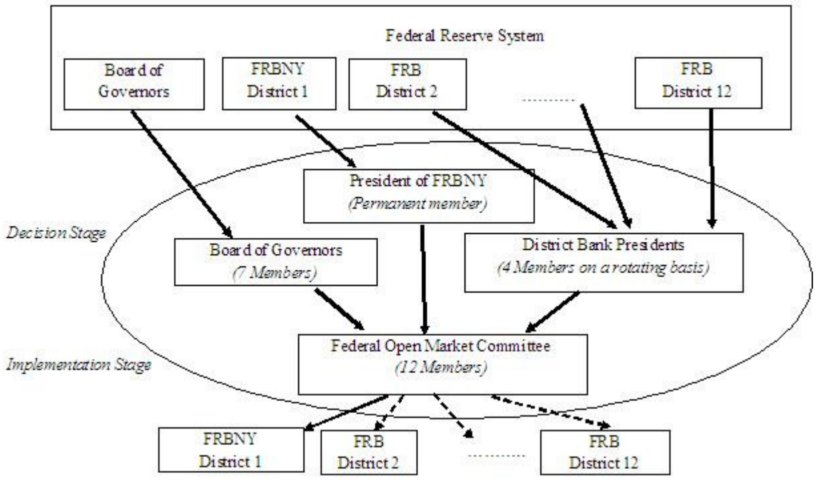
The first Federal Reserve Board, 1914

The Federal Reserve System: Federal Reserve Banks

12 Districts:
- Each is a Private Non-Profit Organizations and Chartered Banks
- Owned by commercial bank "members"
- Overseen by both
  - Board of Directors
  - Board of Governors in Washington



Organizational Framework of the Federal Reserve System



The Federal Reserve System: The Board of Governors

Structure

- 7 Governors including a Chairman and Vice Chairman
- Serve 14 year terms

Functions

- Analyze financial and economic conditions
- Administer credit protection laws
- Supervise and regulate the Reserve Banks
- With Reserve Banks, regulate and supervise the financial system
- Collect and publish statistics

The Federal Reserve System: Federal Open Market Committee

FOMC Membership:
- 7 Governors
- President of the Fed Reserve Bank of NY
- 4 of the remaining 12 Reserve Bank Presidents in rotation

Function:
- Set the Federal Funds Rate

Mechanics of the FOMC

Meet 8 times a year in Washington
Before the Meeting
- Beige Book:
  - Current Business conditions
  - 2 weeks prior to meeting
- Green Book:
  - Forecast prepared by the Board staff
  - Thursday Prior to the meeting
- Blue Book:
  - Policy Options prepared by Board staff
  - Saturday Prior to meeting

Released at 2:15pm
- Target interest rate
- Brief statement of Committee’s view of current economic conditions
- Balance of risks statement
- The vote

The Federal Reserve System: What the Reserve Banks Do

- Government's Bank
  - Issue currency
  - Maintain the Treasury's account
  - Manage the Treasury debt
- Bankers' Bank
  - Hold Reserve Deposits
  - Operate the Payments System
  - Make Discount Loans at the Discount Rate
  - Supervise and regulate financial institutions
  - Collect Data

New York Fed Only:

- Auction Treasury Securities
- Foreign Government Services
- Monetary Policy Operations
- Fedwire: Large Value Interbank Funds Transfer System

Federal Reserve Bank of NY: The Cash

- Largest in the world
- Only robots go in
- 3 stories high and the size of a football field.
- Holds 5400 pallets of currency each 160 shrink-wrapped blocks of 4000 notes

The Fed's Role in the Payments System

- **Supply Cash**
  Over $800 billion outstanding in 2007
- **Checks**
  Over 100 million per day
- **Interbank Payments & Fedwire**
  600,000 to 650,000 transactions per day valued at nearly $4 trillion in 2007

The Fed's Role in the Payments System: The Fedwire

- Banks regularly make payments expecting to be paid by someone else later in the day.
- System has substantial interdependence
- Runs on reserves – the balances commercial banks hold at the Federal Reserve
- Reserve balances are used an average of **400** times a day!

Assessing the FED's Structure

Independence from Political Influence

- Long terms
- Irreversible Policy Decisions
- Budgetary Independence

Decision-making by Committee

- 12 voting members

Two events provide the foundation for Fed independence:

1. In 1935 political appointees were removed from the FOMC
2. In 1951 President Truman supported the Fed's refusal to purchase Treasury securities that the Secretary of the Treasury requested they buy

Assessing the FED's Structure

Clearly Stated Objectives

- Fed's mandate is this vague statement

"The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

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Summary – ECB and FED

	Eurosystem	Federal Reserve System
Established/ Made independent	1998	1914
Monetary policy decision-making body	Governing Council, comprising 22 members: the ECB Executive Board (6 members) and the Governors of the 16 NCBs of the Eurosystem	Federal Open Market Committee (FOMC),12 members: 7 Board Governors, President of the New York Fed, and 4 of the 11 other reserve banks FedPresidents on rotating basis; 19 participants
Appointment of policy makers	President and Governing Council members appointed for 8 years by national governments; ratified by European Parliament	Governors (14 year terms)/Chairman(4 year term) appointed by the President and approved by the Congress; Bank Presidents selected by Bank directors (largely local banking/ business community)
Independence from political influence	Yes. Enshrined in the Maastricht Treaty	Yes. Fed is a "creature of the Congress" and must report regularly, but enjoys substantial independence by long-standing tradition

	Eurosystem	Federal Reserve System
Monetary policy objective(s)/ Mandate	Price stability is the primary objective as set in the Maastricht Treaty. The ECB has quantified this as medium-term inflation goal of "below but close to 2%"	Multiple objectives: to promote maximum employment, price stability, and moderate long-term interest rates. Price stability not defined, but widely viewed as 1-2% comfort zone (skewed toward upper portion) for core PCE inflation
Monetary policy strategy	Two pillar strategy. First pillar focuses on shorter-term economic and pricedevelopments ("economic pillar"); Second pillar focuses on longer-term inflation outlook based on monetary analysis	Focus on economic forecasts; rates adjusted to optimise expected outcomes and minimise risks of deviating from those outcomes (factoring in costs of those deviations). Preference forgradualism unless risks dictate more aggressive action
Decision-making style	Consensual, with the President assuming the role of moderator; dissents are rare	Consensual (less so under Bernanke than Greenspan), with Chairman clearly first among equals. Dissents are infrequent, multiple dissents are very rare
Role of monetary aggregates and asset prices	Both play a significant role	Neither plays a significant role independent of their effects on growth and inflation

	Eurosystem	Federal Reserve System
Accountability and transparency	a. Immediate press conference after Council meetings with introductory statement and Q&A (2:30 pm local time) b. Annual Report to EU institutions and presentations to the European Parliament c. Monthly Bulletin published d. Speeches	a. Immediate announcement following the FOMC, with voting record (2:15 pm local time) b. Meeting minutes three weeks later c. Full transcripts of meetings five years later d. Frequent speeches by FOMC participants e. Semi-annual monetary policy report to Congress; other hearings

Conclusion

Rule-based = one response to every economic situation	Discretionary = come to a decision case-by-case
+ consistency + plausibility + predictable + quick decisions !?	+ flexible + best reaction !?
ECB & € - a new central bank and currency - a heterogeneous area	Fed & $ - an established central bank and currency - a homogeneous area

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Bank of Canada

- Founded in 1934
- Directors are appointed by the government for three-year terms, and they appoint a governor for a seven-year term.
- A governing council is the policy-making group comparable to the FOMC.
- In 1967, ultimate monetary authority was given to the government. However, this authority has never been exercised to date.

Bank of England

- Founded in 1694
- The “Court” (like Fed’s Board of Governors) consists of the governor, two deputy governors (five-year terms), and 16 nonexecutive directors (three-year terms).
- The Monetary Policy committee compares with the U.S. FOMC, consisting of the governor, deputy governors, two other central bank officials, plus four outside economic experts.
- The Bank was the least independent of the central banks, until 1997, when it was granted authority to set interest rates.
- The government can step in under “extreme” circumstances, but has never done so yet.

Bank of Japan (Nippon Ginko)

- Founded in 1882
- The Policy Board sets monetary policy, and consists of the governor, two vice governors, and six outside members. All serve five-year terms.
- The Bank of Japan Law (1998) gave the Bank considerable instrument and goal independence.
- Japan’s government can exert authority through its budgetary approval of the Bank’s non-monetary spending.