

The Fed & the ECB

Their regional structures are strikingly similar, but important differences remain

BY JOHN A. WEINBERG

After a long period of feudal rule by the shoguns, imperial rule returned to Japan in 1863. The emperor sought to outfit the nation with the institutions of a modern state. His attempt to modernize the military is what brought Tom Cruise's character to the country in the recent film, *The Last Samurai*. A less cinematic part of the emperor's reform program was the founding of the Bank of Japan, to centralize and govern the issue of currency.

From the perspective of the 21st century it may seem only natural that a central bank should be considered an integral part of a modern state. But that wasn't always the case, and even at the time when the Bank of Japan opened its doors for business, such institutions were not universal. For

20th century, as colonial power receded and the number of sovereign states grew. By 1997, the world's group of central banks numbered 172. One could even argue that recent decades have witnessed a new era in which central banks' visibility among economic and government institutions has reached new highs.

The Federal Reserve's success at achieving and sustaining low inflation under the Chairmanships of Paul Volcker and Alan Greenspan has brought heightened public attention to this country's central bank. Another recent phenomenon has been the efforts by a number of countries to strengthen their monetary institutions. Notably, the late 1990s saw major revisions to the laws governing the Banks of England and Japan.

The Founding of the European Central Bank

The focus in this period was the refinement of the relationship between a country's central bank and its government. This focus reflects a growing appreciation of the importance of central bank independence. Since all central banks are created by the authority of a nation's government, no central bank is really totally independent. Still, the ability of central banks to exercise independent judgment in their pursuit of monetary and financial stability has grown considerably in many countries.

An independent central bank is free to make its own decisions without direct government intervention in the control of such monetary policy instruments as the interbank interest rate. At the same time, the central bank is typically accountable to the government for the



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The Euro sign is illuminated in front of the European Central Bank (ECB) in downtown Frankfurt, Germany.

instance, with the closing of the Second Bank of the United States in 1836, the United States was without a central bank until the founding of the Federal Reserve System in 1913.

When the Fed was founded, the United States joined a club of 20 countries with central banks. This number rose rapidly in the second half of the

European Union (EU) Member States in the European System of Central Banks (ESCB)

- Austria*
- Belgium*
- Cyprus
- Czech Republic
- Denmark
- Estonia
- Germany*
- Greece*
- Finland*
- France*
- Hungary
- Ireland*
- Italy*
- Latvia
- Lithuania
- Luxembourg*
- Malta
- Poland
- Portugal*
- Slovakia
- Slovenia
- Spain*
- Sweden
- The Netherlands*
- United Kingdom

*EU states that have adopted the Euro and participate in the implementation of monetary policy for the Euro area

results of monetary policy. This arrangement is a far cry from the origins of many central banks, which started as banks for the government, with a main mission of facilitating war finances.

The crowning event of this wave of central bank developments was the creation in 1998 of the European Central Bank (ECB). The ECB is unique in that it is the first supranational central bank, serving a community of sovereign states. An institution of this kind would not have been thinkable in an earlier time when central banks were thought of more as arms of the government treasury than as independent monetary institutions.

The ECB's creation raises new questions about central bank governance. Just as a consensus was emerging about the importance of independence for a national central bank, the ECB came along and upped the ante. Now the issue is the relationship between a central bank and multiple governments, as well as the relationships among governments in the operations of the European monetary system.

The other unique aspect of the ECB is that it did not simply replace the national central banks of its member countries. Rather, the ECB was placed at the center of the European System

of Central Banks. In this regard, the ECB's closest precedent is the Federal Reserve System.

Like the ECB, the Fed is a system of central banks, with 12 regional Banks and central authority resting with the Board of Governors. In the Richmond Fed's 1999 Annual Report, economist Marvin Goodfriend examined the similarities and differences between these two institutions, and discussed how their shared decentralized structure helps build credibility in the pursuit of price stability.

The Makeup of the Eurosystem

The European System of Central Banks (ESCB), or "the Eurosystem," came into being when many of the nations of the European Union (EU) decided to adopt a common currency, the Euro. If these nations were going to abandon their national currencies in favor of a single, continent-wide currency, they needed a new institutional framework for controlling the supply of money over the Euro area. The Eurosystem is made up of the 12 national central banks in the Euro area (see chart) and the ECB.

The terms Eurosystem and European System of Central Banks are sometimes used interchangeably, but they actually refer to two slightly different entities. While the Eurosystem includes only those countries that have adopted the Euro as their common currency, the ESCB includes all 25 member nations of the EU. Three countries — Denmark, Sweden, and the United Kingdom — were parties to the original treaty that established the Euro and the ECB but have so far elected not to give up their national currencies. In addition, the 10 countries that joined the EU in 2004 — many of them part of the former Soviet bloc — have not yet adopted the Euro.

Only those countries that are part of the Eurosystem participate in the formation and implementation of monetary policy in the Euro area. The broader ESCB provides a forum for cooperation among all the central banks in the EU on a number of issues.

It is, for instance, one of the means by which the 25 member nations coordinate their efforts in bank supervision and regulation.

The Fed and the Eurosystem

On its face, the monetary policy setup of the Eurosystem is quite similar to the Federal Reserve System. The key policymaking body is the Governing Council, which is comparable to the Fed's Federal Open Market Committee (FOMC). The Governing Council is made up of the Governors from the 12 national central banks and the six members of the ECB's Executive Board. Since they represent the distinct economic perspectives of their individual countries, the national central bank governors play a role similar to that of the presidents of the 12 regional Federal Reserve Banks. Similarly, the Executive Board is like the Fed's Board of Governors. The members of both of these Boards are government appointees.

As one might expect, the appointment process for members of the ECB's Executive Board is a little more complicated, given the need for the multiple national governments to make a coordinated decision. In the United States, the President makes Board appointments with the consent of the Senate. ECB Board members, on the other hand, are appointed through the consent of the heads of all 12 of the national governments.

While the makeup of the Fed's and Eurosystem's policymaking committees are similar, there is a difference in how they vote on monetary policy decisions. The FOMC has 12 voting members at any given meeting. The seven members of the Board of Governors vote at every meeting, as does the president of the New York Fed. The other 11 Reserve Bank presidents vote on a rotating basis, with four voting in any given year. In the Eurosystem's Governing Council, all the members vote all the time. As a result, decisionmaking power is more decentralized in the Eurosystem.

The relationship between the ECB and the national central banks in the

Eurosystem is also different from the relationship between the Reserve Banks and the Federal Reserve Board of Governors. The Board of Governors exercises general supervisory authority over the Reserve Banks. For instance, the Board approves the appointments of Reserve Bank presidents and directly appoints a third of all Reserve Bank directors. The ECB does not have the same sort of central authority in the Eurosystem. In fact, the governors of the national central banks have ultimate control over the staff of the ECB. Such decentralized control was useful in getting the many countries that make up the Euro area to agree to give up their own monetary sovereignty.

Finally, responsibility for the safety and soundness of a member country's banking system lies primarily with that country's national government and central bank. So the ECB does not take a direct part in bank regulation or in the provision of emergency credit to banking institutions. This is different from the Fed, where the Board has ultimate responsibility for bank supervision, together with the other federal bank regulatory agencies. The Reserve Banks implement bank supervisory and regulatory policy, but they do so under "delegated authority" from the Board.

Despite their differences, the Eurosystem and the Federal Reserve play a fundamentally similar role. Each provides a unified monetary framework for a large, diverse, and integrated economy. In addition to the formulation and implementation of monetary policy, both systems also provide infrastructure for the clearing and settlement of interbank payments, facilitating the integration of commercial and financial activity over wide geographic areas. In the case of the Eurosystem, the ECB's "TARGET" system links the interbank payment mechanisms of the national central banks.

Of course, the most significant similarity between the two institutions is their regional structure. According to Goodfriend, this brings distinct benefits. Perhaps most important, the regional structure can enhance credi-

bility. Credibility is important, because it enables a central bank to better manage the public's expectations regarding inflation. Managing expectations, in turn, facilitates the achievement of price stability.

Historically, central banks have sometimes come under political pressure to stray from price stability, often to help finance government deficits with inflationary monetary policy. The diffusion of power in a system of regional central banks like the Fed or the Eurosystem, says Goodfriend, "makes it more difficult for outside pressure to be brought to bear on a central bank."

After presiding over high and variable inflation throughout much of the 1970s, the Federal Reserve faced the daunting task of credibly claiming that it could achieve the goal of price stability. But over a long period beginning in the 1980s, the Fed brought inflation down and kept it low in a way that convinced the public that earlier inflationary policies were unlikely to return. The ECB and the Eurosystem, by definition, came into being without such an institutional history. So in order to establish credibility as an inflation fighter, it had to do so through other means. Its founding document, the Maastricht Treaty, states that the primary objective of the Eurosystem will be to maintain price stability. This is a less ambiguous mandate than has ever been given to the Fed.

It's important to note, though, that however credibility is established, the dispersed power of the regional structure should help in its preservation. This is true for both the Federal Reserve System and the Eurosystem.

The regional structure also allows a central bank to have a significant presence in the diverse areas served by the common monetary policy. This regional presence has many beneficial effects. Contact with and knowledge of regional economic conditions permit diverse perspectives to enter policy deliberations. And the regional presence also makes it easier for a central bank to communicate with and explain its policies to a

wide set of participants in the economy. Specialized regional knowledge can also be useful for monitoring conditions in the banking industry to help make prudent decisions about the provision of emergency central bank credit to private financial institutions.

The Future of Supranational Central Banks

Should we think of the design of the Eurosystem as a conscious attempt to mimic the Federal Reserve, the way Japan's creation of a central bank in the 19th century was directly modeled on European central banks of the time? Probably not. Given the distinct political and institutional histories of the countries involved, the regional structure adopted was probably the only practical way to link the countries in a unified monetary system. The similarities seem to follow naturally from the comparable size and diversity of the U.S. and EU economies. Perhaps, as other regions experience growth and economic integration, and as the economies of other large nations continue to grow, we will see more entries into the ranks of regional systems of central banks. **RF**

READINGS

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