

## Aspects Regarding the Organization and Activity of the Federal Reserve System and the European Central Bank

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### Abstract

*The Fed and the European Central Bank (ECB) are two key institutions on the global financial markets. The areas of action of these institutions cover approximately 36% of the world economy. Thus, a topic which tackles institutions such as the Fed and the ECB is and will continue to be a relevant subject.*

*The aim of this paper is to identify the similarities and differences between the two institutions, the guidelines and the adopted strategies. Last but not least, the measures adopted in 2020 in the context of the COVID-19 pandemic will be presented.*

*The objectives of the research are: the comparison of the main pillars on which the activity of the two institutions is based. The objectives, structure and organization, responsibilities and monetary policy instruments will be analyzed comparatively.*

**Key words:** Fed, ECB, monetary policy, money market

**J.E.L. classification:** D60, E24, G28, H11

### 1. Introduction

Since their establishment and up to the present, central banks have played major roles in state, regional and even global politics. Although they were originally created for a variety of reasons - to collect funds for a war, to prevent possible financial crises and to stimulate business or to ensure and maintain price stability, today their role is to manage the monetary policy of the area in which they act in correlation with the legally defined objective (s).

Our research is concentrated on the following central banks: the Federal Reserve System and the European Central Bank. The two institutions are currently relevant worldwide, which is why they have been chosen for our research. Even if the Fed acts on the US territory, the decisions taken influence the interest rate and the exchange rate of the US dollar. The ECB is a supranational institution which conducts the monetary policy for the entire Euro area. The single European currency and the US dollar are the most widely used currencies in the world, which is why this topic is of great interest.

Neither of the two institutions was established among the first central banks in the world. Riksbank is the world's oldest central bank. The Fed was established in 1913, when there were already 20 other central banks.

The number of central banks increased exponentially after World War II, as a result of the decolonization and after the 1990s, along with fragmentation of the Soviet Union and the dividing process of the states in Central and Eastern Europe. In 1997 there were already 172 central banks.

The European Central Bank was set up on 1 June 1998, having as its predecessor the IME. The ECB became the supreme monetary authority for the Euro area on 1 January 1999.

The roles of the central banks have changed a lot from the time of their establishment to the present day. The monetary policy has become a major responsibility of a central bank.

## 2. Literature review

The U S' economy is the largest in the world as measured by nominal GDP, in 2019. (\$21.43 trillion). The biggest contributor to that GDP is the economy's service sector which includes finance, real estate, insurance, professional and business services, and healthcare (Bureau of Economic Analysis, 2020).

The euro area with a GDP of \$18.292 trillion (nominal; 2019), \$18.377 trillion (PPP; 2020) according to Eurostat (2020) and the USA make up over 35% of the world economy. That explains why there are numerous studies on the Fed and ECB in the specialized literature. Hereinafter, we will refer to some of them.

The ECB's global position, as well as its monetary policy instruments were presented and analyzed extensively by Issing O., Gaspar, Angeloni & Tristani in 2001. The structure and organization of the ECB, its governing bodies were presented and its independence, responsibility and transparency were analyzed. ECB is an independent bank. Independent means that it is immune to the interests of the governments, it is not subordinated to any EU institution and is only accountable to the European Parliament, according to its responsibilities and sole objective: ensuring and maintaining price stability. All these desiderata were also recorded in the Maastricht Treaty's amendments. ECB is preoccupied about Euro area risk-free interest rates: measurement issues, recent developments and relevance to monetary policy. In Europe banks align with both the international standards and requirements imposed by the European Commission in a legislative context. (Georgescu, Radu, 2015)

There is a large number of structural policies that could significantly improve the functioning of the euro area (Section 3.1). For some of these policies responsibility lies at the national level, while for others agreements at the euro area or EU level are needed. Increased product and labour market flexibility, including flexibility in the allocation of labour and capital across firms, sectors and regions, would make it possible to limit economic costs (e.g., in the form of higher unemployment or lower wages) arising from relative price or supply shocks (Masuch, Anderton, Setzer, Benalal, 2018).

Eyalar R. C (2020) analyzes the differences between the objectives of the FED and the ECB and how these have been reflected in the monetary policy decisions adopted by the 2 institutions in various economic cycles. Other researchers have investigate the extent to which the United States and the countries of Europe have achieved economic convergence of their corporate sector (Valsan, Druica, 2020).

All the above considerations also refer to the topics which preoccupied us in our research.

## 3. Research methodology

The two brand institutions which are the subject of this paper are less comparable with other such entities. That is why the comparative analysis was chosen for our research. As a type of qualitative research, it has the advantage of being, on the one hand, easily understood and, on the other hand, replicable. In addition, the qualitative analysis is suitable for the study of a limited number of cases.

Some researchers claim that the comparative analysis is a bridge which connects the gap between the two opposite edges. The study will assess comparatively: the organization, policies and measures tackled in the current period.

Polland (2003) performs a comprehensive analysis of the structure and functioning of the two institutions ever since their establishment. This article examines modern central banking with a focus on the world's two most prominent central banks — the Fed and The ECB. It examines the structure and appointment process of the key policymakers at the central banks. Next, it highlights the tasks of those banks, focusing on the monetary policy process (Poland, 2003).

Braun (2016) analyzes the two institutions from the perspective of public's confidence in the legitimacy of the central banks. "Financial upheaval and unconventional monetary policies have made money a salient political issue. [...] How central banks cope with this ambiguity depends on the monetary situation" (Braun, 2016).

In ECB’s case, monetary policy decisions are unique to the entire euro area and apply uniformly in all the states that have adopted the single currency. However, the impact of these measures differs from country to country and from region to region.

Hereafter, we will compare the two central banks in order to identify the main differences and similarities between the ECB and the Fed in terms of organization and monetary policy.

The COVID-19 crisis has created an unprecedented situation for the institutions to be in. That is why the special measures adopted by the two entities were also tackled in the research.

#### 4. The Fed vs. the European Central Bank. Organization and structure

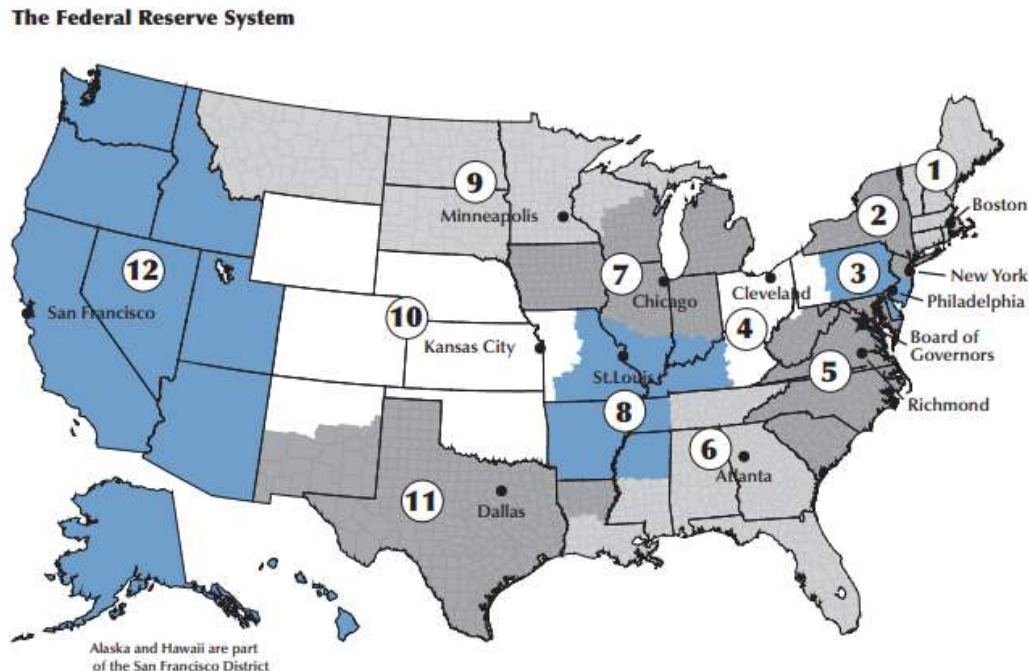
The Fed has the following structure:

- ✓ The Board of Governors has the role of overseeing the entire system and is responsible for the monetary policy;
- ✓ 12 regional banks with the role of supervising and examining the commercial banks which are members of the Fed;
- ✓ Member banks, all the national banks and all state banks which choose to be its members.

The Board of Governors was established as a government agency. The President appoints the seven governors with the approval and consent of the Senate, which enables the Administration and the Congress to influence the Fed by appointing the seven members to the council. The full term in office in the Board is 14 years and governors may be appointed at any time of the term. Appointments are made in installments, with a term expiring every 2 years. Two of the members hold the position of Chair and The Vice.

The banks of the Fed are responsible for issuing money and controlling the money supply of the U.S. dollar. The number of Federal Reserve Districts is equal to the number of regional banks, i.e., 12.

Figure no. 1: The territorial coverage of Fed’s Regional Banks



Source: Fed

Within the ECB, the main decision-making bodies are the Governing Council, the Executive Board and the General Council. The Governing Council is the most important decision-making body. The Executive Board comprises 6 members with different mandates. The governors of the central banks in the euro area, as well as the 6 are members of the Governing Council.

Among the main responsibilities of the ECB's Governing Council (G. C.) are: making decisions on ECB's interest rates and adopting decisions to ensure the performance of the tasks entrusted to the Eurosystem.

The ECB Executive Board is elected once every 8 years and has a President, a Vice-President and four other members.

The responsibilities of the committee include:

- Preparing Governing Council meetings;
- Managing the day-to-day business of the Bank;
- Implementing the monetary policy for the euro area
- Exercising the powers assigned by the G.C.

The General Council comprises the President and the Vice-President of the ECB and the governors of the Central banks of the EU Member. The General Council can be regarded as a transitional body, and the Statute stipulates its dissolution once all EU member states have joined the single currency.

Figure no. 2: The euro area



Note: Only the countries which are marked in blue are members of the Eurosystem

Source: ECB

## 5. Measures taken by the Fed and the ECB during the COVID-19 pandemic

This situation created by COVID-19 brings atypical tools on the stage of economic and monetary policies.

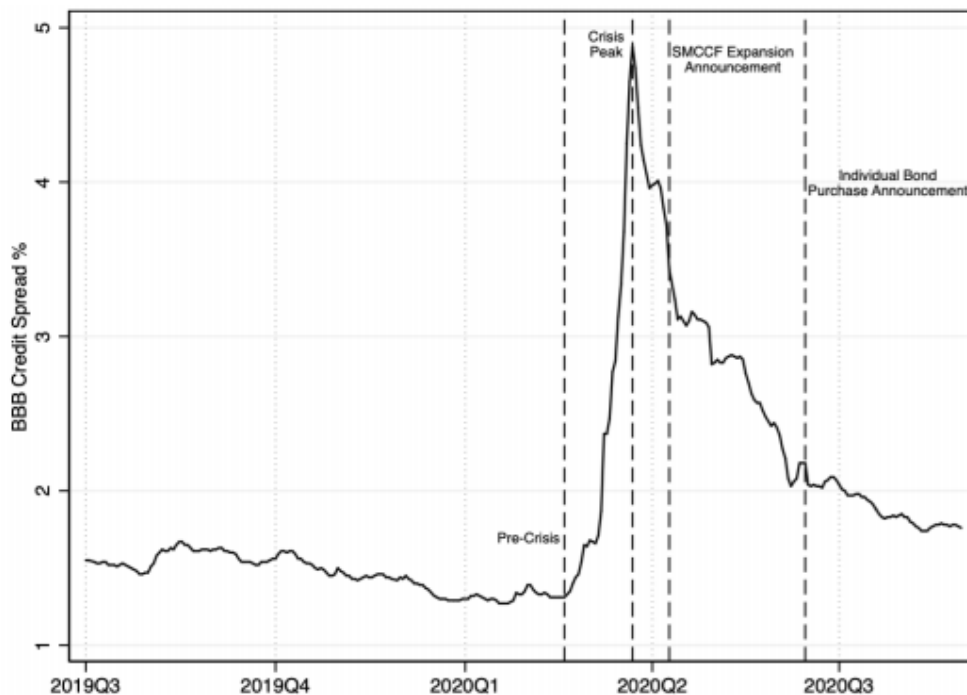
Thomas Flangan and Amiyatosh Purnanandam elaborate on this subject in *Corporate Bond Purchases After COVID19: Who Did the Fed Buy and How Did the Markets Respond?*. Next, we will present the measures taken by the two central banks in order to fight and limit the negative economic consequences generated by the COVID-19 pandemic.

A first important measure adopted by the Fed was the purchase of individual corporate bonds on the secondary market by SPV (Special Purpose Vehicle). This instrument was financed by the Treasury and the FED.

The infusion of capital at company level aims to avoid bankruptcies and reduce the number of unemployed people. However, the measure of purchasing bonds issued on the secondary market is not very effective, as it is very unlikely that it will be able to supplement the support provided to cover the financing need also of the other companies as long as the market does not bounce back (Flangan, Purnanandam, 2020).

On 9 April 2020, the expansion of the SMCCF program was announced, with the inclusion of high-yield corporate bonds in its scope.

Figure. no 3 BBB Bond Credit Spread During COVID-19 Crisis



Source: ICE BofA BBB US Corporate Index Option-Adjusted Spread from FRED

Figure 3 shows the evolution of BBB credit during the crisis caused by COVID-19. On the Y axis we have represented in percentage points the degree of credit spread, and the dotted lines correspond to several periods, respectively: the end of the pre-crisis period (February 19), the peak credit period (March 23), the time of the SMCCF Extension announcement (April 9) and the time of the individual bond purchase announcement (June 15).

Another measure adopted by the FED in March 2020 to fight the negative effects on the economy generated by the COVID-19 crisis was to reduce the monetary policy rate in the USA by 0.5% (from 1.5- 1.75% to 1-1.25%).

Following the COVID-19 crisis, the ECB also envisaged many measures to secure long-term monetary policy. On March 18, 2020, the Governing Council decided to launch an asset purchase program targeting both public and private sector securities valued at 750 billion Euros (Pandemic Emergency Purchase Program).

Also, in March of the same year, the Council decided to reactivate the swap agreement with Danmarks Nationalbank and increased the maximum amount to be borrowed to 24 billion Euros. In April 2020, a set of measures was approved with the intention of temporarily relaxing collateral constraints, thus facilitating their availability to Eurosystem's counterparties participating in liquidity-providing operations.

On the other hand, the interest rate for the main refinancing operations and for the facilitation of marginal loans or deposits remained at the same level (0.0%, 0.25%, -0.5%) until a robust convergence of the inflation of almost 2% is observed, but in decrease.

One of the main medium-term effects of the economic crisis generated by COVID-19 is supposed to be the gradual intensification of total inflation, based on the hypothesis of keeping HICP inflation, exclusively energy and food products, at a low level (1.2% in 2023).

## 6. Conclusions

The study that we have conducted shows that the two analyzed institutions have points in common, but also have both similarities and differences. The differences refer both to the functioning and organization of the decision - making structures for monetary policy, and to the objectives and the strategic plan of the two institutions.

Both are responsible for monetary policy, monetary issuance, and controlling the money supply. Both are independent institutions, although we can say that the ECB has a higher degree of independence through its Statute and structure. Although both are central banks, the Fed is more centralized and less independent. The statement is validated by the fact that the right to issue currency and regulate its value rests, by constitution, with the United States Congress.

The Fed has multiple objectives and responsibilities regarding consumer credit and long-term interest rates as opposed to the ECB which has a single goal: maintaining price stability.

The economic and financial structure of the euro area does not resemble that of the USA. That is why the adopted policy measures are different and have zonal effects.

On the other hand, both institutions emphasize the transparency of the decision-making process and the facilitation of the communication of these economic decisions to the public and to market participants.

Given the ECB's objective, the review of the monetary policy's strategy has known an unforeseen delay due to the COVID-19 pandemic. After stopping the effects of the pandemic, a comprehensive analysis is expected of the variables which may influence the objective of setting prices in the medium term.

On the other side of the ocean, the US central bank outlines a new strategic framework for monetary policy and medium and long-term objectives, which will bring important changes in the ranking of the objectives assumed by the FED.

Although we are in the midst of implementing measures to fight the effects of the COVID-19 pandemic we can say that the analysis is just starting and we intend to continue to monitor the monetary phenomena in the two areas of interest.

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