

The European Central Bank, The Federal Reserve System and the Challenge of Inflation

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Abstract

Worldwide, inflation is one of the most used terms when discussing the economy and beyond. Inflation is the indicator that governments, the population, financial entities, investors and not least monetary authorities are interested in.

Since central banks have price stability as their main objective or not, they act through monetary policies when necessary. Monetary decisions in the Eurozone and the United States - as financially important regions - influence other economies.

This paper focuses on the study of the evolution of the inflation rate in these two cases because of the importance of the subject. It will be found that inflation can also be a challenge for these large financial entities – Federal Reserve System and European Central Bank.

Key words: central bank, inflation rate, FED, ECB

J.E.L. classification: G01, G20, G21, G24, G30, E50

1. Introduction

The Federal Reserve System (FED) is the central bank of the United States of America.

European Central Bank (ECB) is one of the most important central banks in the world. It is the central bank for the entire euro area. It oversees more than 120 banks with significant impact in the area.

Double-digit inflation in recent years has made monetary policy and monetary policy interest rates a topic of interest to all participants in economic and financial life.

2. Theoretical background

Central banks have common functions that derive from specific objects. There are situations where the objective is single or others where we find multiple objectives. In the USA, Switzerland or Japan the central bank declared several objectives. In the case of EU countries, the central bank's objective is one: to ensure and maintain price stability. The stated strategy of these European countries is: inflation targeting.

The Fed conduct monetary policy to promote the goals such: maximum employment, moderate long term interests rate, stabile prices.

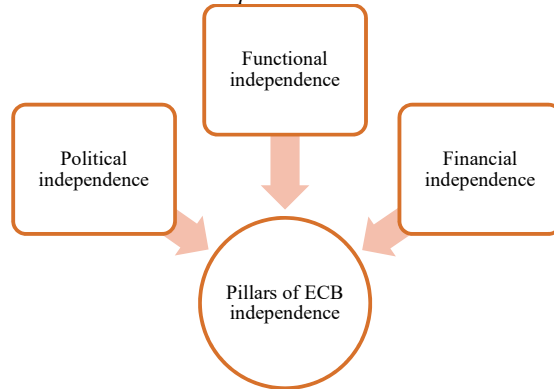
Central banks in the US and the euro area, through their monetary policy instruments, act in the financial market and have responsibilities that have effects on the global economy.

In the case of the Reserve Bank, the basic purpose of monetary policy is to ensure that, over time, the expansion of money and long-term credit will be adequate for the long-term needs of a growing economy under stable price conditions. The bank participates at all times in achieving the nation's economic and financial goals through its potential to influence money and credit in the economy. In short, it seeks to tailor its policies to combat deflationary and inflationary pressures. And, as a lender of last resort, it has the task of using the policy tools at its disposal in an attempt to avoid national liquidity crises as well as financial panics.

The European Central Bank provides currency surveillance and monitors price developments throughout the euro area; is considered an independent central bank (most in the world). The pillars that underpin its activities.

The Bank's objective is to maintain price stability. The single objective is to bring inflation to just below 2% over the medium term. It is achieved through monetary policy, which involves controlling inflation and maintaining the stability of the value of the euro.

Figure no. 1. Pillars - ECB independence



Source: Own design

Whether we are talking about the Fed, the ECB or another central bank, it is well known that the benchmark interest rate has a major impact on the economy. The monetary policy interest rate indirectly influences the lending rate. A monetary tightening leads to a decrease in the volume of credit in the banking sector, even if there is a lagged response. (Dawood, 2019)

3. Research methodology

Monetary policy is far from the only influence on the economy. Fiscal policy, i.e. the federal government's tax and spending policy, has a particularly important impact on the demand for goods and services and, by extension, on credit market conditions. Exogenous price shocks, such as the huge increases in oil prices in the 1970s or the sharp increases in agricultural prices, affect the price level. High inflation creates large imbalances in an economy. It means a decrease in the value of money, which implies an increase in the prices of goods and services. Deflation means the opposite - falling prices.

The Fed's mandate is to maintain a business and population-friendly climate where price stability creates the conditions for interest rates to be at average level.

In this paper we will analyse the evolution of the inflation rate from two major regions: The eurozone and United States. The decisions of these major central banks being the strongest are felt in all countries that have trade, financial links with the Eurozone and the USA. The rhetorical question is: In which countries are the effects of inflation NOT felt in these large areas?

Inflation is a determinant of investment decisions, the efficiency of economic activities, the determination of financial risks, etc.

In view of the mandate of the two central banks presented on inflation, we will analyse its evolution in the two major areas of global financial interest: the U.S. and the euro area. The importance of this analysis also lies in the links between the banking system, monetary policy and the fiscal system. The effects on the economy and the causal relationship between the three has been the subject of extensive scientific work. (Lipară & Dănilă, 2015).

4. Findings

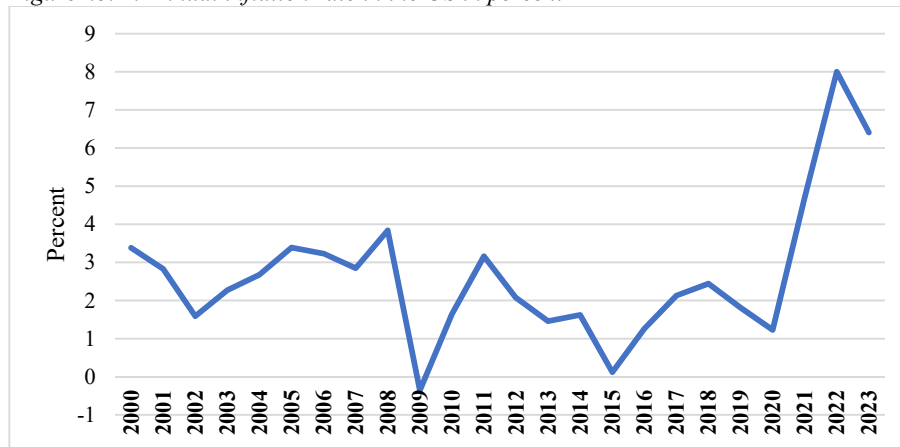
4.1. Analysis of the inflation rate in the US

Monetary policy decisions are taken at FOMC meetings. At each stage, the Committee clarifies in a public statement how it interprets its monetary policy objectives and the principles that guide its strategy for achieving them. A very important point to note about the Bank is that the monetary policy objective is to maintain price stability and effective control of inflation.

Federal Reserve policymakers assess changes in inflation by monitoring several different price indices. A price index measures change in the price of a group of goods and services. The Fed considers several price indexes because they track different goods and services and are calculated differently.

Therefore, these indices can send different signals about inflation.

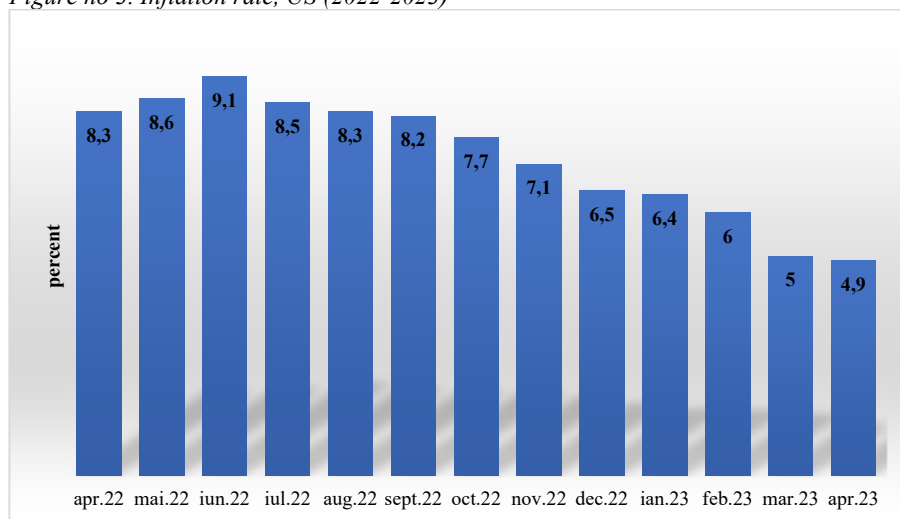
Figure no. 2. Annual inflation rate in the US in percent



Source: Own processing of data published by the Fed

In the United States, inflation was 3.38% in 2000. Since then, inflation has fluctuated around 3%. In 2021, as a result of the Covid-19 pandemic, the annual inflation rate reached 4.70%. A year later, it peaked at 8%. In April 2023 inflation stood at 4.9%.

Figure no 3. Inflation rate, US (2022-2023)



Source: Own processing of data published by the Fed

As can be seen, over the period 2022-2023, inflation has fluctuated widely. This can be seen in graph 3.2., which mirrors the evolution of the inflation rate. In April 2022, the inflation rate was 8.3%, peaking at 9.1% in June 2022. Although down from a peak of 9.1% in the summer of 2022, the inflation rate remains well above the Fed's 2% target. It stood at 4.9% in April 2023.

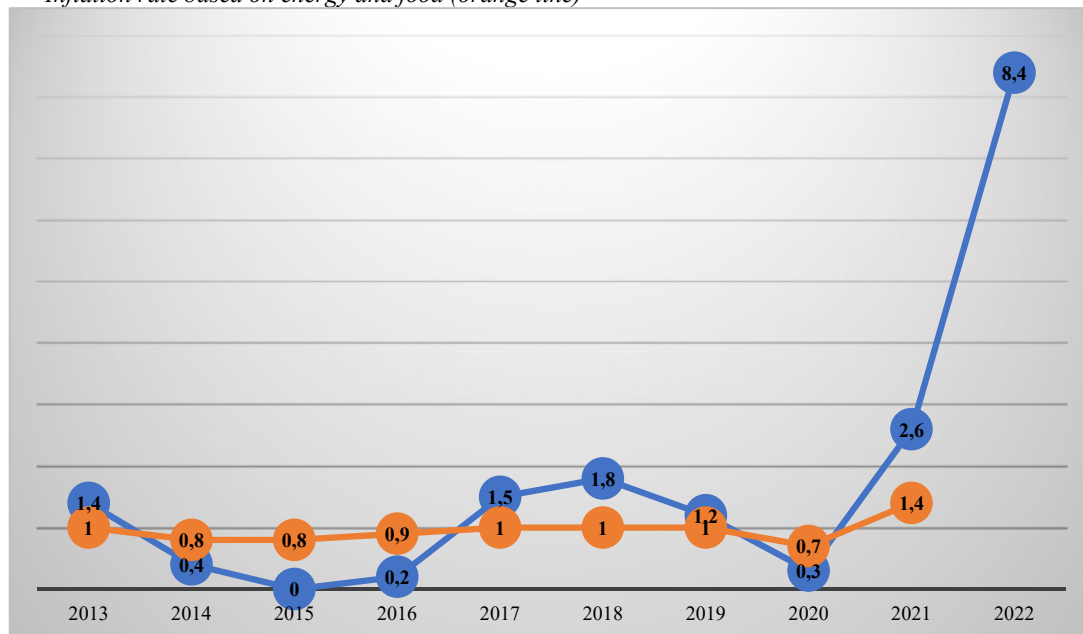
The FOMC believes that low and stable inflation at a rate of 2%/year, as estimated by the annual change in the personal consumption expenditures price index, is the best way to achieve the dual mandate.

4.2. Inflation rate in the euro area

ECB policies are implemented in all Member States of the Monetary Union. The ECB's decisions apply to all these countries. Given the Bank's single objective, we will look at inflation developments in the euro area.

This inflation rate is regularly reported by the ECB, so we can analyse the evolution of this macroeconomic indicator.

Figure no. 4.
Total inflation rate in the euro area (blue line)
Inflation rate based on energy and food (orange line)



Source: Own processing of data published by the Fed

The year 2022 was the year in which the annual inflation rate reached the highest level in the whole period under review, namely 8.4%, significantly higher than the 2.6% in 2021. This increase is driven in the first part of the year by the consequences of the COVID-19 pandemic, and then the invasion of Ukraine by Russia played the most important role. Russia invaded Ukraine on 24 February which resulted in an energy crisis, which contributed to the rise in inflation. Russia decides to cut off gas exports to some EU countries, prompting the European Council to largely suspend the use of Russian gas.

In the last quarter, gas prices fell thanks to savings made at EU level. During the year, the ECB, of course, took measures to try to lower the inflation rate, which included raising interest rates, a measure that had not been taken previously at the ECB for 11 years. This measure failed during the year to keep the inflation rate below 2%, which made the final decision for 2022 to further increase interest rates until inflation reaches the desired target.

In 2021, the inflation rate increased from 0.3% in 2020 to 2.6% in 2021, significantly higher than the ECB's target. This increase was largely due to the pandemic.

The COVID-19 pandemic has had a profound impact on people's lives but also on economies around the world. Globally, many businesses and enterprises have had to reduce their operations or even suspend their activities due to measures taken by the authorities, involving social distancing, travel restrictions and even quarantine.

The European Central Bank is committed to maintaining price stability and supporting economic activity throughout the delicate and difficult period caused by the SARS-CoV-2 virus by implementing a series of monetary policy measures to support the economy. These measures included, among others, cutting interest rates, providing additional liquidity to the banking system and increasing asset purchases.

In 2020 there was a drastic drop in the inflation rate from 1.2% in 2019, 1.8% in 2018 to 0.3% in 2020. This drop was largely due to the start of the pandemic. All the restrictions imposed by the new pandemic, including export restrictions, led to a fall in demand.

Falling prices of metals, oil, agricultural products, but most importantly energy products led to the 0.9% gap compared to 2019 and 1.5% gap compared to 2018 in the 2020 inflation rate.

In 2019, 2018 and 2017 the inflation rate experienced minor fluctuations caused mostly by energy and food prices. Thus the inflation rate increases from 1.5% in 2017 to 1.8% in 2018 and then falls to 1.2% in 2019.

In period 2014-2016, the inflation rate fluctuates, also slightly, with 2016 rising to 0.2% from 0.0% in 2015, and 2015 falling from 0.4% in 2014. However, in 2014, the inflation rate fell to 0.4% from 1.4% in 2013, also due to energy and food prices.

However, the year 2022 remains remarkable as the inflation rate reached its highest percentage in the period under review, namely 8.4%.

Central banks have specific functions and tasks. These derive from their role as well as from the objectives set. Since a sound financial structure is a key ingredient of an effective monetary policy and a growing and prosperous economy, monitoring inflation is a central bank objective. While the Federal Reserve has been entrusted with several functions and objectives, including inflation targeting, the ECB has a single objective: to ensure and maintain price stability.

In the euro area, the year 2022 brought double-digit inflation, which is an all-time high. The month with the highest rate of 10.6% was October. In January was at its lowest, 5.1%, and by October it gradually increased to double its value. In November it falls by 0.4% to 10.1% and by the end of the year it falls to 9.2% in December. As a multi-state area it is obvious that the area rate is determined by the rates of the Member States. Looking at their rates shows that the gap between the minimum and the maximum of the area countries is more than 15 percent.

In February 2023, Luxembourg is the country with the lowest inflation rate in this month, i.e. 4.8%, but the percentages remain high for most countries. Latvia has the highest percentage at 20.1%, significantly higher than in previous years. Following Estonia with 17.8%, Lithuania with 17.2%, Slovakia with 15.5%, Croatia with 11.7% and Australia with 11%, these 6 countries out of 20 are the countries with inflation rates above 10% in February 2023.

5. Conclusions

All banking systems operate in the presence and under the supervision of a central bank. Although there are similarities, the objectives, instruments and degree of independence are different.

It is accepted that the United States has an independent central bank, but theoretically less than the ECB. This is true because the Federal Reserve's decisions do not have to be confirmed by the President or any other government institution. However, it is still subject to congressional oversight and must operate according to the government's economic and fiscal policy objectives.

The analysis of the annual inflation rate between 2000 and 2023 in the US revealed that the historical maximum was reached in 2022 and the minimum in 2008 due to the financial crisis.

Looking at the rates of the euro area countries in February 2023, the range of fluctuation is large, i.e. between the minimum of 4.8% in Luxembourg and the maximum of 20.1 in Lithuania.

Even if they are general to the evolution of inflation and the mandate given, central banks' decisions have short and medium-term effects on commercial banks' strategies. They will adapt their systems, products and services and adjust their prices. (Cerchia & Zaif, 2019). Implicitly there are knock-on effects in the real economy.

Public confidence in central bank decisions is an important issue because it has been found that an accepted measure is easier to implement. Periods of rising or falling confidence alternate over time under the influence of major events. It is found that during the pandemic period confidence in the ECB changed. (Van der Cruiser and Sammarina, 2022).

A survey of the Dutch public to analyse trust in the central bank confirmed the link between right-wing ideology and public trust in the ECB. (Brouer & Haan, 2022)

One can talk about chain reactions and even a vicious circle: if inflation is high and rising, the central bank intervenes and raises the monetary policy interest rate. Commercial banks will increase the price of credit, which will lead to an increase in the cost of finance for economic agents and hence to an increase in the prices of the products and services they offer, at least in the first instance, and hence a further increase in inflation. On the other hand, the increase in prices in the economy, together with the increase in the credit rates of the population, may lead to a decrease in consumption. Will this happen? This is the question we want to reflect on and answer in a future study.

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