PART 1

Design Flaws of the European Monetary Union?

1

Does the ECB Care about Inflation?

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My title might seem like an extraordinary question: what can I possibly mean by 'does the ECB care about inflation?' If I disclose my answer is 'no', the question and answer might, indeed, seem completely crazy – and so uninteresting. In this chapter, I will try to persuade the reader otherwise, or at least create a sense that the European Central Bank (ECB) has a problem it must somehow seek to reduce, if not solve.

I am going to unpack the question, point towards some evidence in a rather loose way, and offer an explanation for my answer. Partly, something really has gone wrong in advanced-economy central banking. Partly, the ECB's extraordinarily pivotal role in the European project pulls it in conflicting directions. The first is curable both in principle and in practice, although I do not mean to imply it would be easy given where the advanced-economy central banks as a whole find themselves. The second might be curable in theory but it is hard to see how – absent severe social dislocation, which could lead anywhere – Europe will find a way through the massive challenges presented by the serious constitutional deepening that is necessary to release the ECB into the community of regular central banks.

1. Unpacking the Question of whether the ECB Cares about Inflation

Very obviously the ECB cares somewhat about inflation. Almost everyone does, so I do not mean to ask whether the ECB cares about inflation at all. The

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question makes sense only in the context of the ECB's treaty-based objective, which (paraphrasing) is first and foremost to maintain price stability, and subject to that, to support wider EU economic policies.[1]

The question, then, is not whether the ECB cares about inflation a bit; nor whether it gives inflation a much higher weight in trade-offs with other goods. Rather, it is whether the ECB is consistently directed to achieving price stability as a *necessary precondition* for turning to other things at all. That means expectations of medium to long-term inflation being anchored to the 2 per cent target, and, furthermore, that anchor being secure.

Does the ECB care about inflation in that sense? No, it does not – or, perhaps more accurately, for an extended period over recent years the ECB talked and set policy as though it did not. In this, the ECB was not alone among the major central banks, so part of what I have to say – about the contingent perils of gradualist policy, and about policy-makers' incentives – will concern advanced-economy central banks in general. But there is also a very important constitutional point about the ECB in particular, which I will discuss in the final part of this chapter.

2. Circumstantial Evidence that the ECB and Some Other Major Central Banks have not been Prioritising Inflation

During the 1990s there was something approaching a revolution in the practice of monetary policy. At its centre was a massive increase in transparency: transparency about objectives, policy settings, and, perhaps above all, in explanations of policy settings. Transparency fostered both economic efficiency and accountability. Policy-makers were supposedly tied to the mast by exposing themselves to scrutiny.[2]

But the notion that pellucid explanations of policy-makers' reasoning are supposedly the norm might be questioned if the explanations end up being elusive or even misleading. I fear we were close to that during much of 2021–22, and

[1] Under Art 127 of the Treaty on the Functioning of the European Union (TFEU), 'Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union'. Contrary to commentary among economists, this is not a straightforward lexicographic objective (of the kind the Bank of England has). A plausible reading of the treaties is that anything done by the ECB, including in pursuit of the second objective, needs to be permissible under the first objective; and that anything done under the second objective involves supporting EU policy, and so cannot involve the ECB making discretionary choices on EU policy. For such a reading, see the following article by the current ECB General Counsel: Chiara Zilioli and Michael Ioannidis, 'Climate Change and the Mandate of the ECB: Potential and Limits of Monetary Contribution to European Green Policies' (2022) 59 *CML Rev* 363. As such, the word 'objective' (used in the French as well as the English version of the treaty) is somewhat misleading.

[2] Tucker, *Unelected Power* 420–24.

perhaps even in 2020. Before getting to those points about presentation, here are some broad-brush background facts, together with some observations on them.

In 2020, in response to the economic shock brought by the Covid-19 virus, the main central banks massively increased quantitative easing (QE) at the same time as governments provided badly needed fiscal support to families and businesses. In effect, we had money-financed fiscal stimulus. But, even at the time, it was not clear why additional monetary accommodation was warranted. After all, a good deal of the economy's productive capacity (aggregate supply) was shutting down. Of course, it was sensible to stabilise government bond markets when the seriousness of the pandemic dawned on people in the spring of 2020. But that warranted a market-maker of last operation that could be unwound when markets stabilised, not long-lasting additions to QE. It was almost as though central banks had forgotten that they can purchase government bonds for different purposes, and not all of them are QE, which should be thought of as monetary policy stimulus to aggregate demand.[3] Meanwhile, the financing costs available to credit-worthy governments via the bond markets were, due to forward rates being below any plausible long-term equilibrium for nominal rates, much better than those they instead took on via the fixed-to-floating rate swap delivered by ever-expanding QE.[4]

In 2021, when the US government enacted a new massive fiscal stimulus package, the Federal Reserve continued to add to its own monetary stimulus – as did the other major central banks. Putting it mildly, it was not easy to understand why the pace of QE – ie, the pace of incremental additions to monetary stimulus – should be maintained notwithstanding the scale of injection of demand from the federal government. And for other central banks, the enormous size of the US meant that the prospect of the US economy overheating was obviously relevant to their own deliberations.

In 2022, there was a very sharp rise in energy prices due to Russia's war on Ukraine (and OPEC's choice not to increase supply to stabilise prices). The main central banks initially maintained low policy rates and continued to add to QE. They said the rise in headline inflation from the cost shock would be temporary. That is, of course, correct for shocks to the price level, just so long as there are no second-round effects on inflation expectations, affecting wage- and price-setting.

[3] The distinct purposes include to stimulate aggregate demand (monetary policy); to provide emergency financing to government; to stabilise bond markets; to provide liquidity to those selling the bonds; and to relieve pressure (inventory risk) on intermediaries. The second to the fifth each entails moral hazard. Each of the five also needs its own regime and governance. See Stephen Cecchetti and Paul Tucker, 'Understanding how central banks use their balance sheets: A critical categorisation' (*VoxEU*, 1 June 2021) https://cepr.org/voxeu/columns/understanding-how-central-banks-use-their-balance-sheets-critical-categorisation.

[4] The debt swap is effected when QE is combined with central banks paying their policy rate of interest on the totality of reserves, not merely the marginal euro (dollar, pound) of reserves, which is all that is necessary to implement standard monetary policy. See Paul Tucker, 'Quantitative Easing, Monetary Policy Implementation, and the Public Finances' *Institute for Fiscal Studies Green Budget 2002* ch 7.

Of course, Covid-19 and the war on Ukraine presented extraordinarily difficult circumstances for macroeconomic policy-makers. But it is – and, at the time, was – striking that only from the middle of 2022 did the major central banks cease adding to QE and start raising their policy rates in earnest.[5] Since, at least in some countries, the aftermath of the pandemic seems to have brought a contraction in labour-market participation, entailing a lower path for aggregate supply (AS), that gradualism raises puzzling questions about the central banks' conjunctural judgements and policy strategies.

2.1. Presentation: Elisions, Obscurities and Risks

The main point of recalling that history is to examine monetary-policy explanations and transparency. The first surprising thing was that, when the change in policy stance eventually began, we were encouraged by the main central banks to think that they were *tightening* policy in the face of inflationary pressures. Indeed they were. But it seems likely that policy was still stimulating aggregate demand for a good part of 2022. For example, in a January 2023 interview, ECB policy-maker Philip Lane said: 'We're not yet at the level of interest rates needed to bring inflation back to 2 per cent in a timely manner.'[6] One might reasonably ask why not; why would the ECB choose to set its policy rate at a level it thought inadequate to achieve its target? An answer might be framed in terms of uncertainty and the balance of risks, looking ahead.

Elsewhere in this rich and instructive interview, Lane says: 'The debate about the exact timing [of starting to tighten policy] is misplaced.' As a general proposition, that makes sense. But it applies in particular situations only if inflation expectations are *securely* anchored to the target, so that there is zero need for pre-emptive action in order to avoid seeming complacent. By stipulating that the debate was misplaced, a senior policy-maker perhaps seemed to assume victory was assured.

Anyway, for months and months policy was tightened by central banks in the sense of being less loose, but not in the sense of restraining aggregate demand. That involved an elision of *changes* versus *levels*.

But there is one more thing. Lane underlined that in February 2022, the ECB 'signalled a faster pace of reduction of asset purchases'. Read or heard quickly, that

[5] As I understand it, the Bank of England stopped making QE purchases in late 2021 and commenced selling QE gilts roughly a year later; the Fed stopped QE purchases in March 2022, and started sales a quarter later; and the ECB stopped expanding their QE portfolio in July 2022, but reinvested redemptions until spring 2023, since when they have partly reinvested redemptions.

[6] Interview with Philip R Lane, Member of the Executive Board of the ECB, conducted by Martin Wolf, *Financial Times* (London, 17 January 2023) www.ecb.europa.eu/press/inter/date/2023/html/ecb.in230117~1ab0df6f3d.en.html. I must underline, given that I draw a lot from this interview, that Lane is unquestionably expert in these matters. I choose his remarks precisely because, in this interview and elsewhere, he is articulate and there is little risk that he does not understand what he is saying.

too might sound like tightening, but it isn't even that. Its meaning becomes clear if the sentence is translated into an equivalent proposition on interest rates: 'interest rates have been cut by X basis points per meeting, but now we are going to cut rates by smaller amounts at each meeting'. In other words, still cutting; and, back in the world of QE, still adding to the stimulus. So, I suppose, that is a second elision. Or, at least it looks that way unless further stimulus was warranted by new adverse shocks to aggregate demand (AD), or by news that older adverse AD shocks still working their way through the economy were bigger than previously grasped and outweighed any contraction in AS. But in that case, why not say so?

All that is noteworthy because one of the two big things about monetary policy is *getting the sign right*: to be restraining demand when one judges one needs to slow spending growth to maintain inflation in line with the target; and to be stimulating demand when necessary to achieve the target. To continue stimulating demand was substantively odd in my view. That is because it risked adding domestically generated inflationary pressures to the effects on headline inflation from the external cost shocks, and so raised the probability of unwelcome second-round effects in inflation expectations. Writing in spring 2023, it seems likely that this is becoming visible in the US, and perhaps elsewhere.

That takes us back to the demands of a norm of transparency, seen as a route to both efficiency and legitimacy, via accountability and discipline (including internally within central banks as concrete organisations). Given the complex combination of shocks affecting inflation, they have needed to publish their best-guess decompositions of excess inflation (relative to target) in terms of the effects of external terms-of-trade shocks (notably the energy price increases) and drivers of any domestically generated inflation, including adverse internal AS shocks (eg, to labour supply) and monetary conditions. Even if, for illustrative purposes, 80 per cent of the roughly peak 8 percentage point (pp) overshoot was attributable to the external cost shocks, the residue attributable to domestically generated inflation (20 per cent of 8pp: 1.6pp) would probably rank as the biggest overshoot since the regime of flexible inflation-targeting was introduced a quarter of a century ago.[7] (At least in the US, 80 per cent seems unrealistically high, underlining the point.)

While, as one policy-maker rightly pointed out to me, any such (staff) decompositions would be model-based, that is irrelevant to the unavoidability of policy-makers making such judgements themselves (ideally drawing on multiple models) in order to set policy, and their duty (given the transparency norm) to publish them. Also, while the opinions of different policy-makers within

[7] I have chosen 80% for my illustration mainly because (for mysterious reasons) people are fond of 80/20 splits, and also because Bank of England governor Andrew Bailey attributed 80% of the target overshoot in Britain to external cost shocks when testifying to the Westminster parliament during 2022. See Larry Elliot, '"Apocalyptic" food prices will be disastrous for world's poor, says Bank governor' *The Guardian* (London, 17 May 2022) www.theguardian.com/business/2022/may/16/apocalyptic-food-prices-will-be-disastrous-for-worlds-poor-says-bank-governor.

any jurisdiction's monetary committee might reasonably differ, that is not an argument against transparency, because it is hard for any of them to explain their votes without resort to at least implicit judgements on what has been driving the high inflation outturns.

2.2. What Might Explain the Elisions?

Of course, my own various substantive judgements, implied above, might easily be mistaken. But if, contrary to my view, the ECB's judgement was that policy needed to stay accommodative – and, even more important, that its policymakers were correct to want to carry on adding to the stimulus until mid-2022 – then the transparency norm, supposedly central to the 1990s' revolution, demanded that central bank policy-makers say so in terms, and defend that important judgement. That did not happen. There are various candidate explanations for this, but with some obscurity about which would be favoured by the policy-makers themselves.

One possibility is that, at least during the first part of 2022, the main central banks carried on believing their 'transitory inflation' story well after they stopped pressing it in public. That would have had to be based on a judgement that the energy price rises had delivered a cost shock but there had not been any change in nominal trends (and so in underlying inflationary pressures). It would also mean that when they said they were 'tightening', they did not have any plan for policy to be tight (in levels terms). The immediate point here is not that such a diagnosis and decision would definitely have been a mistake – a separate question – but, rather, that the apparent lack of candour about the (conditionally) intended stance of policy would have been a mistake.

A second possible explanation is that central bankers understood they were still stimulating aggregate demand but thought any excess demand would have a negligible effect on inflation. That might have reflected a view that the so-called Phillips Curve had not merely been mislaid (a serious practical problem) but, much more important, no longer captured any kind of reliable economic relationship; in other words, that there was no longer any meaningful constraint on the path of demand relative to the path of the economy's productive capacity. If so, that view needed declaring in terms, and defending.

A third, and perhaps more realistic, possibility is that the main elision – between *changes* in short-term interest rates and their *level* – arose because policy-makers have come to think they can rely on expectations of *future* policy settings to do the work of bringing the economy back into balance. This draws on the true belief that it is the entire yield curve that matters. As Lane rightly said in his Financial Times interview: 'After all, the yield curve jumps in anticipation of what we are expected to do and we've also proven an ability to move quickly.'

But on dissecting that main elision, we are reminded that it is the expected and realised path of *real* rates not of *nominal* rates that matters to the stance of monetary policy (and much more). Thus, policy-makers might have judged that, even in conditions of excess demand, it was ok for the prevailing (instantaneous) *nominal* policy rate to deliver a negative *short-term real* rate provided that market expectations (embodied in the yield curve) of *future* policy-rate settings would bear down on aggregate demand because the implied *path* for *real* interest rates – ie, after taking account of expectations of the path of inflation itself – would be high enough to do so. This kind of gradualism can be thought of as choosing to maintain negative real rates today, while signalling the prospect of positive short real rates tomorrow, and eventually real rates high enough to restrain AD. It is a strategy or plan that might appear to suit everyone, since it might reduce volatility in the economy and also in financial markets.

But, to work, that kind of policy strategy depends heavily on the expected profile for inflation and, more specifically, on the central bank being trusted to deliver on the inflation target. In other words, to repeat a central point, it relies on the anchor both holding and being secure. While dynamic stochastic general equilibrium (DSGE) models – and their outputs served up by technically proficient staff – might be used in ways that effectively encode credibility through a presumption of securely anchored inflation expectations, policy-makers themselves should not habitually inhale that addictive assumption.[8] These are points about people or, more accurately, about people and processes, and so about organisational fitness.

The root point is that *central bankers are themselves the nominal anchor*. Routinely relying on market expectations to do the heavy lifting is a risky strategy, entailing much more volatility down the road if economic agents have come to harbour scepticism about policy-makers' willingness to be unpopular in order to deliver inflation back to target, and hence to maintain medium-term inflation expectations in line with the target. Sometimes (not always) policy needs a down payment, to show you mean it; ie, to show more than that you will get round to restraining demand eventually. When that is so is a matter for policy-makers' judgement. It is a judgement they need to be open about and cogently defend, but most importantly one they need to remember they must make.[9]

It matters enormously for this reason. If ever the anchor does slip, it will be damn hard to know how far it has moved. That means it will be hard to know the rate of inflation expected in the future, which in turn means it will be hard to know the level of real rates currently and prospectively. Bluntly, it will be hard to

[8] Technically, this involves running the model with a reaction function for the policy rate that delivers inflation in line with the target, and minimises the costs of economic volatility, and so on. But if, in the real world, inflation expectations have slipped or are not securely anchored – meaning the expectations–formation process has changed in some way – then the necessary reaction function will be different, and probably not known ex ante.

[9] For similar sentiments, expressed differently, see former Bank of England governor Mervyn King, 'The King Canute Theory of Inflation' (*Bloomberg*, 24 November 2021) www.bloomberg.com/opinion/articles/2021-11-24/central-banks-should-abandon-the-king-canute-theory-of-inflation, based on Mervyn King, 'Monetary Policy in a World of Radical Uncertainty' (Institute of International Monetary Research, Annual Public Lecture, London, 23 November 2021).

judge whether monetary conditions are stimulating or restraining demand, and by how much.[10] Once in that situation, the policy-maker would have to make a best guess, and then wait and see. If they were unlucky and medium-term inflation expectations had risen by more than they guessed, then further tightening would become necessary to restore the anchor. But precisely because in that situation there would be growing uncertainty about medium-term expectations and increasing nervousness about credibility, the policy-makers would still not be confident about quite how high nominal interest rates would need to go.

This means that when monetary policy-makers occasionally go out of their way to say, speaking in general terms, that bringing inflation back down from above target is easier than getting inflation up from below target when the policy rate is stuck at the Zero Lower Bound (ZLB), they are not wrong as a general matter, but something is being obscured (a third elision). Namely, that if the anchor slips, they would not know how big and painful a recession would be needed to restore it.

Those were the implied stakes when, in late February 2023, the president of the New York Fed, who is vice chair of the Federal Open Markets Committee, said 'our job is to make sure we *restore* price stability' (emphasis added).[11] That was not the same as saying that inflation is too high and must be brought down but that underlying nominal trends remain consistent with price stability; and, given the speaker's experience and credentials, I discount the possibility that the vice chair misspoke. Instead, the word 'restore' plainly implied that price stability needed to be restored; ie, that, along the way of operating a gradualist rate strategy, the anchor had slipped. By contrast, in Lane's slightly earlier *Financial Times* interview, he carefully stressed that euro area inflation expectations were still anchored. That matters enormously, because any plausible justification of the ECB's own gradualist strategy has depended on exactly that.

2.3. The Hazards in 'Forward Guidance'

Much of that discussion is related to the phenomenon known as 'forward guidance', on which there is more to be said (not all of it good) than can be managed here.

[10] Of course, that judgement includes assessing where the actual and yield-curve implied risk-free real rate (r) is relative to the neutral real rate (the notorious r*) that prevails when the economy is, broadly speaking, in balanced equilibrium. But while r* is never directly observable, for a quarter of a century central bankers and others have been able to measure r with confidence. When the anchor is slipping, that becomes a lot more difficult. The sheer scale and persistence of QE has, meanwhile, probably distorted signals from bond yields, which in more normal times act as an independent (albeit erratic) conscience for monetary policy-makers by pricing expected inflation and inflation risk premia (compensating for uncertainty about future inflation) into nominal bond yields. I do not discuss here the effects of so-called quantitative tightening (QT) on this or on the other issues I explore.

[11] *Reuters*, 'Fed is "absolutely" committed to 2% target, Williams says' (22 February 2023) www.reuters.com/markets/us/fed-is-absolutely-committed-2-inflation-target-williams-says-2023-02-22.

First, it is vital to distinguish between, on the one hand, what has come to be known as Odyssean forward guidance when policy rates are stuck at the ZLB and, on the other hand, statements about future policy when nominal rates are no longer stuck at the ZLB, casually known as Delphic. That vital distinction has been blurred, elided or for a while just junked.

In Odyssean mode, the policy-maker is trying to commit to keep policy rates low for too long; ie, beyond the point of economic recovery and a return of underlying inflation to (or above) target. But the same sounds and scribbles – 'forward guidance' – have come to be employed habitually when, freed from the ZLB constraint, policy-makers are merely talking about what they are going to do. The first is a commitment, the second a prediction, and so they obviously do not have anything like the same analytical grounding. This fourth elision, moreover, is costly because policy-makers' unqualified predictions about their future choices are unreliable, not for any nefarious reason but because they do not know what is going to happen in the world. They do not know which known risks will crystallise, and which shocks will take them completely by surprise (unknown unknowns).

That being so, I would urge policy-makers to talk less about themselves, and more about the economy: about the economic outlook, with its many uncertainties, and about whether they judge the risks to the outlook for growth and for inflation to be symmetric or skewed, and why.

I urge that partly because Delphic guidance can impair the quality of decision making. Guidance of either variety cannot work unless there is a stable super-majority in a policy committee. If Guidance issued today is vulnerable to being dropped or changed at a future meeting because, say, just one member has changed his or her mind, and that possibility is widely understood, the initial guidance (now lower case) will be given little weight. Indeed, Odyssean Guidance is, in practice, absolutely pointless without a stable super-majority.

But after years of Odyssean Guidance, it was hard for financial market participants and others to grasp that Delphic Guidance is different. They found that hard because central bankers and their closest commentators continued to use the words 'forward guidance'. Same words, same meaning, yes? No.

As they bumped into those contradictions, leading central banks, very much including the ECB, tried to escape from their predicament by emphasising that policy would be 'data dependent'. And so, by God, it should be, because it is only by analysing an eclectic set of data – official statistics on the real economy, the monetary aggregates and other indications of nominal trends, surveys, anecdote – that one has any hope of making tolerably sound judgements about the economic outlook. It is a practice where policy-makers need to spend a lot of their own time scrutinising the conjunctural data, and thinking about how they fit together given various possible understandings (models) of how the economy works.

But policy-makers are finding it hard to stick to a (second-order) promise of being data dependent, which, under any ordinary understanding, would mean not making decisions until they have received all the data due out before the next formal policy meeting. That precludes revealing *before* a meeting what will be decided at that meeting, which, to pick only one example, is what the ECB seemed to do when, in mid-February 2023, it said that the policy rate would be raised by 50 basis points at the meeting to be held roughly a fortnight later.[12] In other words, policy seemed to be decided before all the data were in, so it was not easy to be convinced that policy choices depended wholly on the data, as not a few commentators pointed out at the time.

What, I think, may be going on here is partly the corrosive habit-persistence after years of forward guidance to which I have already alluded, but also partly a mode of making policy decisions via *negotiations* among members rather than collective *deliberation*. If anything akin to negotiation is the main mode of operation, a policy committee's leader(s) would rationally want to announce a deal once they have clinched one they can live with. This, I should say, is how the Fed seems to have operated at times over the past decade, and I hardly think it has more to recommend it there than in Europe. The underlying problem might be that both committees are too big, and that regional Fed presidents in the US and national governors in Europe have learned that, if the leader(s) wants consensus or at least a big majority, regular members can advance their own preferred policy by, in effect, negotiating via public speeches and interviews.

Anyway, it seems to me that continuing to use 'forward guidance' to imply that policy will only gradually reach the point of restraining demand can sometimes amount to deferring necessary action. That would be an exercise in hope: the technical hopes of staff seduced by DSGE models in the service of the political hopes of policy-makers interested in promising, say, inclusive growth (a worthy objective for elected politicians using their fiscal instruments).

While that predicament was perhaps most obvious at the Federal Reserve, there seemed to be an element of it at the ECB too. On both sides of the Atlantic, a previous generation would have quickly raised the policy rate to be restrictive in order to maintain the anchor, and might by the time of my writing (spring 2023) even have reached the point of beginning to ease the degree of restraint on demand. Instead, we might only now be entering the phase of restrictive policy.

The interesting question about this apparent shift in sentiment towards taking risks with inflation is, why? What can have induced independent policy-makers to loosen the binds that lie at the heart of their existence?

[12] Andrew Langley, 'ECB's Lagarde Reaffirms Intention for Half-Point March Hike' (*Bloomberg*, 15 February 2023) www.bloomberg.com/news/articles/2023-02-15/ecb-s-lagarde-reaffirms-intention-to-hike-by-half-point-in-march.

3. Incentives: Making Central Bank Independence Work

That vital question brings us to incentives, and hence the conditions for independence to work at all. The standard argument is rooted in the time-inconsistency problem made famous, analytically, by Finn E Kydland and Edward C Prescott.[13] The argument is plausible enough intuitively: even assuming that elected politicians consistently prioritise the electorate's aggregate welfare, they will sometimes exploit any short-term trade-off between economic activity (or jobs) and inflation, leading to higher medium-term inflation expectations without improving long-run output. When features of the real world are introduced – notably, the tendency of politicians to flip flop in their policy preferences – the arguments for not leaving monetary policy in elected hands are fortified.

There is also a different kind of argument for independence – a constitutional one. Since the monetary levers are always latently instruments of taxation (through surprise inflation or deflation), the last people who should hold them are the members of the elected executive (prime ministers, finance ministers, and so on) as that would violate one element of the separation of powers that lies at the heart of constitutional democracy: that taxation should be approved by a representative assembly of some kind.[14]

But those are both arguments – welfarist or constitutionalist – for not leaving executive government free to run monetary policy. They say nothing about why delegation to an independent body will work. Take, for example, a Rogoffian conservative central banker: why wouldn't the politicians appoint someone who looked 'conservative' but, when it came to it, wasn't, because in fact they were an ally of the politician. Or take a Walshian contract: why would the politician choose to enforce the contract against the erring central banker if the politician benefitted from the economic and credit boom; and since the politician might not enforce the contract, why wouldn't inflation expectations reflect that?[15] Both prescriptions are vulnerable to the time-inconsistency problem merely being relocated, as pointed out many years ago by the late Ben McCallum.[16] This poses a challenge to Larry Summers' important statement at the beginning of the 1990s that 'institutions [can] do the work of rules, and monetary rules should be avoided; instead, institutions should be drafted to solve time-inconsistency problems.'[17]

[13] Finn E Kydland and Edward C Prescott, 'Rules Rather than Discretion: The Inconsistency of Optimal Plans' (1977) 85 *The Journal of Political Economy* 473.

[14] Tucker, *Unelected Power* 287–92. When I first discussed this with the late Alberto Alesina, he was kind enough to say that he had not come across this argument before, and agreed with it.

[15] Kenneth Rogoff, 'The Optimal Degree of Commitment to an Intermediate Monetary Target' (1985) 100 *Quarterly Journal of Economics* 1169. Carl E Walsh, 'Optimal Contracts for Central Bankers' (1995) 85 *American Economic Review* 150.

[16] Bennett T McCallum, 'Two Fallacies Concerning Central Bank Independence' (1995) 85 *American Economic Review* 207.

[17] Lawrence Summers, 'Panel Discussion: Price Stability: How Should Long-term Monetary Policy Be Determined?' (1991) 23 *Journal of Money, Credit and Banking* 625.

How, exactly, can institutions do the work of rules? What does that depend on? After all, the relocated commitment problem afflicts even the Kydland-Prescott paper's advocacy of rules: why would anyone stick to the rule? Identifying a well-crafted rule that would be best (even optimal) if people stuck to it is not much use if, once humans are allowed in, it will be set aside.

3.1. Prestige and Esteem, but for What?

Here we can turn to insights on incentive-compatible institutions. If delegation to unelected central bankers is to do its work (and so be worth any legitimation convolutions), it needs somehow to harness the incentives of the regime's stewards, and their political overseers, who are all flesh and blood men and women.

Illumination comes, I think, from some papers by the late Alberto Alesina and Guido Tabellini.[18] They posit a choice between a politician (who targets aggregate welfare) and a technocrat (who is motivated by the esteem accruing to them if they are seen successfully to deliver a delegated mandate). Armed with that distinction, it becomes rational to delegate some kinds of task to the technocrat. The authors say something about the particular conditions that must hold for that to make sense in certain fields (eg, a time-inconsistency problem), but do not step back to address the wider necessary preconditions for the economy of esteem to do its work. I attempted to do that in *Unelected Power*.[19]

One precondition is that the political society must be capable of bestowing esteem; an apparently innocuous point that has some punch. If the only measure of prestige in a particular society is, say, wealth or perceived closeness to the ruler, delegation is not going to work. This precondition amounts, therefore, to a society needing to have multiple sources of prestige if monetary independence is to work (a point that I suspect does not find its way into International Monetary Fund (IMF) recommendations to a good chunk of the world).

A second precondition, which gets close to the bone today and opens up an illuminating perspective on central banks taking on more and more functions, is that appointed central bank leaders need to care (a lot) about the prestige accrued from delivering the mandate, or foregone if they do not. Milton Friedman was half onto something, but not what he thought, when in the early 1960s he claimed that 'the two most important variables in [central bankers'] loss function are avoiding accountability on the one hand and achieving prestige on the other'.[20] What he

[18] Alberto Alesina and Guido Tabellini, 'Bureaucrats or Politicians? Part I: A Single Policy Task' (2007) 97 *American Economic Review* 169.

[19] Tucker, *Unelected Power* chs 5 and 6.

[20] Letter from Milton Friedman to Stan Fischer, quoted in Stanley Fischer, 'Rules versus Discretion in Monetary Policy' in Benjamin M Friedman and Frank H Hahn (eds), *Handbook of Monetary Economics*, vol 2 (Amsterdam, Elsevier Science Publishers, 1990) 1155–84, 1181.

missed is that, in some circumstances, exposing oneself to accountability can help sharpen incentives, and so offers a route to prestige.

At this point, it is useful to unpack where those personal returns might come from. There are two main sources: professional esteem from a dispersed community of current and former central bankers, monetary economists and other specialist commentators; and, separately, wider public prestige from the political community itself (households as voters, but also the business and financial communities). Delegation works to harness central bankers only if they do care about such esteem and prestige.

Now imagine a central banker who has a public reputation for combatting, say, climate change and inequality, and other social-justice causes. Maybe if (steady state) inflation rises under their watch, they will not care much about ignominy among those who do care about price stability (the *Bild* newspaper in Germany, say) because their standing in the world is buttressed by their social-justice credentials. And maybe, in our thought experiment, they do not much care about the opinion of former central bankers and monetary economists since they have never really been part of that professional-cum-epistemic community. Alternatively, imagine a central banker whose key constituency of political supporters cares most about lax regulation that permits their donors to thrive: a kind of libertarian conservatism. In either case, and plenty of others, the harness is not going to be tight enough to underpin the warrant for delegating responsibility for price stability.

Put more broadly, delegation is unlikely to work as well as expected (or at least hoped) if office holders have access to alternative sources of esteem and prestige. Since the public interest depends on incentivising them to stick to and deliver the central bank's mandate, they have to desire prestige for and from *that*.

That poses a challenge if someone arrives in office already enjoying prestige (for something else), or gains it while in office for something other than sticking to and delivering the mandate (eg, for intervening in political issues or a devotion – genuine or apparent – to good causes). Somehow, the political community needs to put that prestige on hold, so as to orient the prestige-seeking office holder to the mandate. Whether that is realistic might turn, I suggest, on the attitudes of the relevant professional community, and on public attitudes toward that professional community. If the office holder craves professional esteem, the harness might bite notwithstanding pre-existing stardom. If not, and if the public do not think much of the professional community ('economists', with the word spat out in a certain way), then the harness will be loose. In those circumstances, the best that can be hoped for is that office holders care whether their prestige will be in jeopardy in the longer run if they screw up.

Ironically, and maybe tragically, here we are back to short-termism. Delegation to an insulated agency in order to sidestep the costs of political short-termism will struggle to work if the office holders are motivated by short-term prestige (sometimes casually termed celebrity).

3.2. Independence's Achilles Heel: Esteem and Prestige for Too Much

That economy-of-esteem account of the preconditions for effective monetary delegation opens a window onto how independence can be undermined. Here is how I put it in a piece for the IMF a few years ago (before headline inflation took off):

> It is important to remember that there have always been enemies of independence. Within a rich repertoire for undoing an economy's monetary constitution, they can deploy two broad strategies, each with obvious and opaque variants.
>
> One way to bring central banks to heel is through appointments. As seen recently in the United States, that is not easy when favored candidates fall well short of the normal credentials. More troubling are appointees who seem reasonable, excellent even, but turn out to be discreetly committed allies of leading politicians. The most famous case, also during turbulent times, is the former Fed chairman Arthur Burns, a leading economist who put Richard Nixon's 1972 reelection prospects ahead of the Fed's statutory mandate. No one should think that was the last example of a political outrider occupying the monetary corridors.
>
> The other way to undermine independence is through a change in mandate. The crude variant involves simply voting to compromise or repeal the central bank law. That isn't easy, because it is highly visible. The subtle, almost paradoxical, strategy gives the central bank *more* responsibility – so much so that any decent official would feel duty bound to consult political leaders on how to use their extensive powers. The more central banks acquiesce (even revel) in the 'only game in town' label, the easier it becomes for politicians to give them more to do, and so undo them.[21]

My analysis in *Unelected Power* suggested (but, given subsequent developments, I now feel did not bring out sufficiently) that those two strategies are intertwined. Independence is undermined by widening the mandate and appointing someone who cares more about those other causes (or, more accurately, other sources of prestige) than about the respect and standing that would come from delivering monetary-system stability.

3.3. Application to the ECB

When applied to the ECB, this leads to some reasonably clear conclusions. First, ECB policy-makers should not seek any credit for supporting any EU policies (under the ECB's second objective). Moreover, whenever supporting EU policies, it would be important to explain publicly why particular actions fit under the secondary treaty objective, and why the ECB was not making important

[21] Paul Tucker, 'On Central Bank Independence', *Finance & Development* (IMF, June 2020) www.imf.org/en/Publications/fandd/issues/2020/06/paul-tucker-unelected-power-on-central-bank-independence.

discretionary choices about the substance of EU policy or on how it bears on the ECB's operations. Second, and conversely, ECB policy-makers need willingly to impale themselves on medium-term inflation expectations being securely anchored to the 2 per cent inflation target.

And yet, it is more complicated than that, and here my tone will shift.

4. Why the ECB has the Hardest Job Among Advanced-Economy Central Banks

There is something distinctive about the ECB, uncomfortably so. It is both more and less than a normal central bank.[22]

4.1. Not a Regular Central Bank

The most obvious difference between the ECB and most of its notional peers is that it is not established by ordinary legislation (passed by the EU Council and Parliament, and revisable by them) but, rather, through a treaty among the EU's many member states (each with their own local ratification process, some involving national referenda). In practice, therefore, the ECB's independence is as deeply entrenched as it is possible to get. As I have argued elsewhere, this implies that the ECB's functions ought to be even more narrowly constrained; ie, more constrained than the regimes for central banks granted independence by ordinary legislation.[23] While legislators in the US, UK and Japan can alter the terms of their local monetary regime if the Fed, Bank of England or Bank of Japan stretch themselves too far in some perceived way, that is not feasible in Europe and so the binds need to be stricter from the start.

In its enthusiasm to pursue wider functions – sometimes, but not always, carefully wrapped in the language of providing 'support' for the EU's other policies and goals – the ECB cuts against this important condition for sustained legitimacy: not only its own, but that of the EU institutions more generally.

4.2. Deep Entrenchment Combined with Incomplete Economic Government

But the differences between the ECB and its ostensible peers run deeper than the degree of its constitutional entrenchment, with profound implications. Unlike

[22] This section draws on Tucker, *Unelected Power* 393–94.

[23] Paul Tucker, 'How the European Central Bank and Other Independent Agencies Reveal a Gap in Constitutionalism: A Spectrum of Institutions for Commitment' (2021) 22 *German Law Journal* 999.

those central banks serving national or federal democracies, the euro area's central bank does not work alongside a counterpart fiscal authority, let alone one elected by the people.

Appearing to recognise this, the EU's treaty-makers sought to substitute discipline for discretion by enshrining a legal principle of 'no bail outs' for member states participating in the monetary union. When it came to pass, however, that proved to be mere parchment. While member state governments had short-term incentives to sign up to 'discipline', they did not have more enduring incentives to abide by or enforce their agreement. So when the euro area faced an existential crisis, the lack of confederal fiscal capabilities in elected hands left the ECB as the only institution that could keep the currency union from shattering.

It is important to be clear about what this means: the ECB became the existential guarantor of the European project itself. Not merely a mighty citizen, but *the* essential citizen, the economic sovereign – a lot more than a normal central bank.[24]

4.3. Central Banking's Grand Dilemma Writ Large

Here we confront an especially problematic version of central banking's grand dilemma. In its standard form, this is the problem of the Stackelberg (sequential-move) game inscribed into the relations between a monetary authority and an elected fiscal authority. Even where policy-makers share the view that an adverse economic shock is best met with a combination of fiscal and monetary stimulus, the fiscal policy-maker has strong political incentives to do nothing – thereby avoiding the short-term political costs of carrying with them cabinet, donors, party base etc– safe in the knowledge the central bank will strive to do more within the limits of its mandate.

But the ECB faces this problem on a giant scale almost unknown to regular central banks.[25] Since there is no conventional fiscal authority for the euro area, it finds itself synthesising one, under the rubric of monetary policy, whenever the economic–financial pillars of the Union are crumbling.

Thus, the 'grand dilemma' becomes gruelling, leaving the ECB with a job immeasurably more difficult than that of its supposed peers. Because the ECB's independence is so deeply entrenched, its functions should (normatively, ie, given Europeans' deep political values) be tightly constrained. Because it lacks a fiscal counterpart, the opposite is inevitable in practice. The deep value of constitutional propriety and the imperative of preserving the people's welfare meet in headlong

[24] The language 'economic sovereign' echoes the notorious and morally repugnant Carl Schmitt, who argued that the actor who declares a state of exception is the true sovereign, and that that is always the executive branch of government (as the only 24/7 branch).

[25] I include the qualification 'almost' because the Federal Reserve faces a diluted version of the predicament given Congressional sclerosis.

collision. Both in terms of constitutional politics and quotidian politics, therefore, the ECB's greatest challenge is to navigate itself back toward the proper role of technocratic trustee for monetary-system stability.

It is hard to see how that can be accomplished without a deepening of the economic union – to some degree of fiscal union – in ways that are unpalatable for some member states. For constitutionalists, the choice lies between living with an overmighty central bank (underpinning a fragile currency union through its quasi-fiscal powers) or, alternatively, returning technocracy to its proper place but within a deeper economic union built on incentive-compatible foundations.

Meanwhile, the ECB's leaders, knowing they are the emergency cavalry, are not incentivised to be pre-emptive against inflation in a single-minded 'no risks with the anchor' way, because they must always consider whether an abrupt tightening of monetary and credit conditions could bring about a crisis among euro area members with cyclical or structural financing vulnerabilities.[26] It puts the ECB beyond any normal conception of a central bank, landing its leaders with a quite extraordinarily difficult job.

5. Summing up

The central background thought behind this chapter is the following: *inflation, meaning persistent inflation, is always and everywhere a political economy phenomenon*.

Friedman's famous statement about inflation being always a monetary phenomenon is true, but lies one step forward from the underlying problem. At the time of writing in spring 2023, we do not yet know whether the high inflation of recent years will persist or, if inflation does fall back, whether it will settle in line with or above target. If it does remain above target, the roots of the predicament will lie in flawed incentives: in the incentives of the monetary regime's designers, or of the regime's central banker stewards, or of those who appoint those stewards, or of those who oversee the stewards, or even of commentators, or some complex combination of some or all of those. We wait and see (and of course hope).

Given that basic proposition, the chapter's morphology of central bankers' incentives and interests underlines the importance of some welfare-oriented principles for the design of independent central banks. First, their functions and responsibilities must be as narrow as possible, as otherwise their leaders have too many routes to esteem and prestige. I believe the mandate should be

[26] Perhaps the new instrument for handling fragmentation crises, the Transmission Protection Instrument, will alter this dynamic, which would be a major achievement since, among other things, it would remove the shackles on monetary policy. But one could imagine that policy-makers might still be cautious about imposing monetary-policy shocks via sharper tightenings because until there is a crisis, they cannot be sure the new tool will work as intended. These are, to be clear, weighty judgements.

monetary-system stability, which includes the stability of the private part of the monetary system, but not more.[27]

Second, they need objectives that can be understood and tracked by interested members of the public, so that their personal ambitions cannot be achieved by self-declaratory success. Precisely because the price-stability objective is framed as a quantified target for inflation (typically 2 per cent), observers can see that outcomes have been miles away from target, and the central bankers have accordingly been taking a lot of public heat, personally. Although one takes zero pleasure in observing this, that shows that that part of the regime is working as intended.

In a way, it has been a reminder to central banks in general, and the ECB in particular, to attend to the core of the mandate: achieving price stability via a secure anchor for medium-to-long-term inflation expectations. The single-mindedness which that demands will, however, continue to be tested by the need for vigilance regarding the stability-cum-integrity of the euro area itself.

That is because, as was understood by many from its founding, the designers of Europe's monetary union faced conflicting incentives they could not reconcile: to push the European project forward by introducing a single currency, but not to push it so far forward that, via establishing some kind of fiscal union, a political union loomed around the next corner before the peoples of Europe clearly wanted or could support it. The upshot is a fragility that the ECB's leaders have to remember, and navigate, every second of every day.

So, the answer to my headline question is: 'No, the ECB is not focused above all else on maintaining price stability, and that is a bad thing, but how could things be otherwise after everyone realised that the ECB is the de facto emergency fiscal authority the European project's architects understandably hesitated to create elsewhere.'

That mitigation is not a licence to branch out beyond central banking, or to be casual about shocks to underlying inflationary trends. But it does introduce a constraint that is not faced by other central banks. Given the geopolitical situation, the last thing the West needs is another euro area crisis.[28]

Finally, it should be stressed that it is easier to make these various judgements as an observer than as an actor. But perhaps that is why, at least in aspiration, they might be of some slight use to those carrying such great responsibilities in such extraordinary times.

[27] Tucker, *Unelected Power* ch 20.
[28] See Tucker, *Global Discord* part V.