ECB's Independence: No Longer a Golden Bullet?

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Abstract

In the aftermath of the financial crisis of 2007-2009 the European Central Bank (ECB) proceeded to the reinterpretation of its mandate to overcome the strict constraints of the Maastricht Treaty and create a variety of mechanisms that stabilised the euro area. Scholarly literature has focused on the mandate-stretching of the ECB pointing to constraints on its independence, but so far, has avoided to question the appropriateness and relevance of the concept.

This paper argues that the mandate of the ECB and the level of its independence are inextricably linked. Drawing on the framework of sociological institutionalism, this paper turns to the cultural environment of the Eurozone to examine the 'Sound Money' ideas that legitimised the original organisational framework of the Economic and Monetary Union. It then traces the evolution of these ideas after the financial crisis that legitimised the adapted mandate of the ECB as a superior organisational form. It is shown that the emergence of the 'financial stability' and 'macroeconomic stability' beliefs undermine the sharp division of responsibilities between the monetary and the fiscal authorities, thereby challenging the principle of central bank independence. It is suggested that a partial restriction of the bank's independence fits better its revised mandate. The paper employs the method of organisational discourse analysis to examine the construction of new meanings within the Eurozone and their impact on the organisational setting.

Introduction

On 12 March 2020, ECB's President, Christine Lagarde, was stressing in a Press Conference that 'we [the ECB] are not here to close spreads. This is not the function or the mission of the ECB. There are other tools for that, and there are other actors to actually deal with those issues' (ECB, 2020a). The Financial Times were writing about a 'dangerous slip-up' (Jones, 2020), while national capitals were becoming increasingly nervous (Reuters, 2020). Less than a week later, the ECB announced the €750 billion Pandemic Emergency Purchase Programme (PEPP) targeting the purchase of public sector securities. The ECB noted that 'any risks to the smooth transmission of its monetary policy in all jurisdictions of the euro area' would not be accepted (ECB, 2020b). The U-turn confirmed that a decade of crises has substantially transformed the mandate of the ECB. In the past few years, scholarly worked became increasingly engaged with the issue of ECB's mandate stretching. Some scholars approached this evolution as normalisation (Chang, 2020), while others expressed skepticism due to the ditching of the Maastricht model (Sinn, 2018). A strand of the literature became preoccupied with the constraints that the new policy tasks of the ECB pose on the bank's independence. This paper attempts to approach the issue from a different angle, seeking to take a step back and examine the effects of the ECB's evolved mandate on the appropriateness of the Central Bank Independence (CBI) principle.

The argument promoted is that the evolution of ECB's mandate fundamentally undermines the legitimacy of its independence. To do so, the paper explores the evolution of the underlying economic policy beliefs of Eurozone policymakers adopting a sociological institutionalist approach. CBI is not treated as a given but as the organisational reflection of particular 'Sound Money' economic policy beliefs shared in the Eurozone at the time of its creation: price stability and the credibility of monetary policy. It is shown that the emergence of 'financial stability' and 'macroeconomic stability' after the financial crisis of 2007-2009 undermined the social logic of delegation of monetary policy to an independent institution. Subsequently, the paper discusses the challenges that the new beliefs raise for the organisational setting of the ECB underlining significant incompatibilities.

The rest of the paper unfolds as follows. Section I briefly summarises the scholarly work on the evolution of the mandate of the ECB and its effect on the bank's independence. Section II introduces the sociological institutionalist approach of the paper and the methodological parameters. Section III provides the analysis of the original Sound Money beliefs of the EMU and their organisational reflection on the independence of the ECB. Section IV proceeds to the analysis of the evolution of the Sound Money beliefs after the financial crisis guiding the unconventional policy initiatives of the ECB. Section V presents the challenges to the concept of Central Bank Independence posed by the evolution of Eurozone beliefs. Section VI summarises the discussion.

ECB's Mandate Evolution & Independence

The mandate stretching of the ECB after the financial crisis of 2007-2009 is well-documented in the literature (Scicluna, 2018; Sinn, 2018; Högenauer and Howarth, 2019; Chang, 2020; Heldt and Mueller, 2021). Inter alia the Bank has engaged in the supervision of financial assistance to member states with financial difficulties, launched monetary programmes that circumvented the Maastricht Treaty's monetary prohibition to sovereigns, and undertook the macroprudential supervision of credit institutions. Scholars have moved on to examine the various constraints posed by the de facto expansion of the ECB's mandate on its cherished independence (Beukers, 2013; Eijffinger and Hoogduin, 2018; Tuori, 2019; Mabbet and Schelkle, 2019; Bozina Beros, 2019; Tesche, 2019). The identification of political, legal, policy and accountability ramifications led them to raise concerns about the Bank's legitimacy. With few exceptions (Tesche, 2019), scholarly work has refrained from reflecting on the appropriateness of ECB's independence in the post-crisis environment.

The value and continued relevance of the ECB's independence cannot be taken for granted. As Kathleen McNamara (2002) has shown twenty years ago, the functional arguments for the delegation of authority to central banks conceal the existence of a social logic of delegation of a particular cultural environment. Previous work on the EMU has linked the establishment of the independent ECB with the 'Sound Money' ideas of the Eurozone's social environment (Dyson,

1994: 233-238; 2000). Given that the financial crisis can be described as a ‘crisis of ideas’ challenging the dominant economic orthodoxy (Blyth, 2013: 43), an analytical turn to the economic ideas within the Eurozone can reveal whether the social logic of delegation is still preserved.

Analytical Framework

This paper turns to Eurozone’s social environment to examine the adaptation of the ECB’s mandate. It does so by employing the theoretical framework of Sociological Institutionalism (SI). Following the seminal work of DiMaggio and Powell (1991), Meyer and Rowan (1991) and Scott and Meyer (1991), the paper endorses the view that formal institutions and the people that populate them are embedded in social structures that exert deep and lasting effect on them. Organisational change is understood as compliance to evolving cognitive frameworks.[1] As Kathleen McNamara notes, ‘the choice of organizational form is linked to social processes that legitimate certain types of institutional choices as superior to others’ (McNamara, 2002: 59). Legitimacy emanates ‘from conforming to a common definition of the situation, frame of reference, or a recognizable role, or structural template’ (Scott, 2008: 61). SI focuses on the components of culture, namely the cognitive elements of social environments. Cognitive elements refer to ‘the shared conceptions that constitute the nature of social reality and the frames through which meaning is made’ (Scott, 2008: 57). The sociological institutionalist analysis of policy change begins with the exploration of taken-for-granted understandings within a given organisation’s social environment and proceeds to the examination of the organisational adaptations promoted by the participants in the organisation as they attempt to comply with the cognitive framework. Previous sociological institutionalist work on the Eurozone has identified the existence of shared economic policy beliefs at the time of its creation (McNamara, 1998; Dyson, 2000). This paper proceeds to a more thorough exploration of the intellectual origins of

[1] Sociological institutionalists use the term ‘organisational change’ to describe the change of the formal institutional setting. The term ‘institutional change’ refers to the change of the cognitive framework. For them, institutions are the elements of the social environment, such as schemas, typifications, taken-for-granted understandings (Hall and Taylor, 1996).

these elements in the economic literature before analysing the emergence of new economic policy beliefs in the aftermath of the financial crisis.

Considering methodology, the application of organisational discourse analysis (Phillips and Oswick, 2012) is employed to analyse the constitution of Eurozone's social environment and the construction of taken-for-granted understandings. 73 official organisational documents were collected and analysed, including 48 Monthly Bulletins/ Economic Bulletins and 21 Executive Board Speeches.[2]

The Sound Money Beliefs Behind EMU's Original Framework

My argument in this section is that the independence of the ECB is the organisational reflection of particular 'Sound Money' beliefs that prevailed in the social environment of the EMU at the time of its establishment. The 'primacy of price stability' and the 'credibility of monetary policy' guided Eurozone officials to delegate monetary policymaking to the ECB and shield it from any political influence.

The Primacy of Price Stability

The central Sound Money belief at the time of the creation of the EMU was the primacy of price stability. The latter was the intellectual offspring of two schools of economic thought: monetaristm and ordoliberalism. Not every major school of economic thought adhered to the primacy of price stability. A notable exception was the Keynesian school, which used to be the dominant economic doctrine in Europe during the period of embedded liberalism (from the end of the Second World War until the 1970s). The Keynesian approach considered unemployment as the primary social problem and was preoccupied with the attainment of full employment. Keynesians perceived the market system as intrinsically unstable rejecting its ability to

[2] As this paper is work in progress, data from semi-structured interviews with Eurosystem policymakers will be included in the analysis. As a result, the conclusions are only tentative and may be adjusted considerably in later versions of the paper.

automatically equilibrate to full employment (Samuelson, 1946). Self-interested individuals guided by animal spirits were expected to engage in excessive saving aggravating the procyclical tendencies of the economy as a whole leading the economy to the underutilisation of resources or even to economic depression. Due to the built-in flaws of the market system, Keynesianism endorsed state intervention to achieve economic stabilisation: government spending would be used to maintain a high level of employment. The role of monetary policy was to assist in the fine-tuning of the economy (Papandreou, 1972: 9-11). In this context, monetary policy's basic task was to maintain the interest rates low to facilitate the servicing of the government debt and stimulate aggregate demand. Inflation was a necessary evil. Keynesianism claimed that there was a trade-off between inflation and unemployment. Reducing the level of unemployment justified the tolerance of a higher rate of inflation.

The emergence of Monetarism represented an intellectual counter-revolution to the post-war Keynesian revolution (Johnson, 1971). Monetarists insisted on the inherent value of price stability. In this vein, they prioritised the fight against inflation against other policy objectives, such as the achievement of full employment. Monetarists accepted that 'inflation is always and everywhere a monetary phenomenon' (Friedman and Paden, 1983). In other words, they anticipated that inflation was caused by a rapid increase in the quantity of money. Therefore, they assigned to monetary policy only one task: to control the increase in the quantity of money. This prioritisation of the fight against inflation was inextricably linked to the monetarists' wider view about the market system. The latter was perceived to be inherently stable. Any source of instability originated from governmental efforts to intervene in the economy. The basic requirement for the achievement of equilibrium was a stable monetary framework. For monetarists, the adoption of a monetary stability framework entailed only a temporary rise of unemployment, which would abate after the initial period (Friedman, 1972). In any case, employment was rejected as a criterion of monetary policy with Monetarists embracing the idea that each economy presented a natural rate of unemployment (Friedman, 1968). Any attempt by the monetary authority to reduce unemployment below the natural rate was dismissed as futile.

Ordoliberalism was another school of economic thought that endorsed the primacy of price stability. The main concern of the Ordoliberals was the establishment of a market system of

unrestricted competition with a workable price mechanism (Eucken, 1952/1982: 116). In contrast to other branches of liberal thinking (including Monetarism), Ordoliberals rejected the idea that the market system could spurt out as a result of the free interaction of market forces and denied that such a system could be inherently stable. The concentration of private economic power was perceived as a permanent source of instability threatening the market system (Vanberg, 2014). While Ordoliberals accepted the need for state intervention, they denounced the unprincipled discretionary intervention of Keynesianism. Therefore, Ordoliberals promoted the idea of an 'economic constitution' providing order to the economy. This term did not only refer to the formal institutions but included the informal traditions and conventions guaranteeing the preservation of the competitive order. Walter Eucken, one of the founders of the Ordoliberal school, included price stability in his proposed six constitutive principles safeguarding the viability of the market system (Eucken, 1952/1982: 116-118). Eucken noted that price stability was necessary for the price mechanism to maintain its steering function. Acute fluctuations of the value of money would entail significant distortions in the market: creation of profits from inflation rather than economic activity and the devaluation or revaluation of debts in comparison to assets. Eucken stressed that price stability would need to be accompanied by the automaticity of the function of the monetary authority due to the propensity of the decision makers to accept high inflation.

The primacy of price stability belief determined the organisational structure of the EMU at the time of its creation. The Treaty included the unqualified prioritisation of preserving price stability over other policy objectives asserting the trust of the monetarists in the inherent value of price stability: '[t]he primary objective of the ESCB shall be to maintain price stability' (TEC, Article 105). The Governing Council of the ECB confirmed the monetarist logic behind the EMU's policy design. In its first Monthly Bulletin, the ECB acknowledged that 'the Eurosystem assigns a prominent role to money', thereby endorsing the monetarist view that inflation is a monetary phenomenon (ECB, 1999a: 19). The organisational reflection of this notion was the establishment of the first of the two pillars of the so-called stability-oriented monetary policy strategy of the Eurosystem to achieve the primary objective. By setting a reference value for the growth of the broad monetary aggregate (M3), the Governing Council signaled its adherence to the core

monetarist tenet that the quantity of money was the ultimate cause of inflation (ECB, 2000a: 40). Practically, however, the fist pillar was employed purely as an analytical instrument and did not affect the execution of monetary policy (ECB, 2000a: 41; Galí, 2002: 51-59; Gaspar, Masuch and Pill, 2002: 83-84). In this sense, the first pillar functioned as a symbolic reminder of the monetarist foundations of the EMU.

Another monetarist concept that became embraced by the ECB at an early stage was that the preservation of price stability was the best contribution that the monetary authority could make to the real economy (ECB, 1999b: 39-40). As the first President of the ECB explained, '[b]y fulfilling its primary objective of maintaining price stability, the ESCB will *automatically* also support the general economic policies in the European Community (…), namely growth and employment' (Duisenberg, 1998, my emphasis). In so doing, the ECB de facto ignored its secondary mandate included in the Treaty, according to which

> Without prejudice to the objective of price stability, the ESCB shall support the General economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2
>
> (TEC, Article 105)

The ECB interpreted the secondary mandate as a potential danger to the achievement of price stability (ECB, 1999b: 41). In this way, the Governing Council justified the effective abandonment of the secondary objectives and the exclusive concentration of the bank to the attainment of price stability. In parallel, the ECB defined unemployment as a problem 'overwhelmingly structural in origin' to be addressed through an increase in the flexibility of labour and goods markets (ibid). In other words, the Governing Council rejected the Keynesian view regarding the use of monetary policy to fine-tune the economy and tame unemployment. Instead, the ECB embraced the monetarist notion that unemployment was not the responsibility of monetary authorities and that only the economic authorities had the obligation to act by promoting structural reforms.

Credibility of Monetary Policy

The second Sound Money belief that dominated the social environment of the EMU was the credibility of monetary policy. The seminal article of Kydland and Prescott (1977) highlighted how the expectations of future policy actions affected the current decisions of economic agents. The two economists exposed the suboptimality of time-consistent policy decisions: selecting the best policy for the current situation results in higher inflation, as the private economic agents have already taken decisions (based on a different set of expectations) that can no longer be affected by policymakers. Kydland and Prescott concluded that the existence of the time consistency problem pointed to the limitation of discretionary policymaking via the adoption of policy rules. Barro and Gordon (1983) followed up by conceptualising the credibility conundrum for monetary policy arising from the time consistency problem. The existence of monetary policy rules increased the incentives of the monetary authority to cheat (renege on commitments) in order to achieve better economic results. However, the gains from sudden inflation shocks could be repeated only if private economic actors could be systemically deceived. As economic agents adjust their inflationary expectations, such systematic deception cannot occur. In Barro and Gordon's words, 'the cost of cheating today involves the increase in inflationary expectations for the future' (1983: 108). The two economists stressed the significance of enforcement: the mere existence of rules was not enough as a lack of enforcement would still lead to a loss of credibility.

Kenneth Rogoff (1985) addressed the credibility of monetary policy by promoting a different solution from the adoption of a strict rule: the delegation of monetary policy decisions to an inflation-averse central banker. His influential paper exposed the superiority of a discretionary monetary policy regime vis-à-vis the rigid constraints associated with the setting of fixed monetary targets, as the latter impeded the monetary authority's response to supply shocks. Rogoff found that this regime would lead to substantially lower average inflation but noticed that there was a trade-off: lower inflation would come at the cost of inferior economic performance. The main precondition for the success of the delegation approach was the independence of the central bank, so that it could concentrate on the stabilisation of inflation rather than the stabilisation of employment. During the late 1980s and throughout 1990s the concept of central bank independence (CBI) took off and became embraced by vast strands of the economic

literature. Gros and Thygesen (1990; 1998: 490-496) pointed out the links between political independence of the monetary authority and low inflation. Grilli et al. (1991) and Alesina and Summers (1993) argued that there was no real trade-off between inflation and output in the case of CBI with the benefits of lower inflation far outweighing possible drawbacks. Cukierman (1994) stressed the inflationary bias of politicians underlining the good record of highly independent central banks, such as the Bundesbank and the Swiss National Bank, in maintaining price stability. Alesina and Gatti (1995) linked CBI with lower output variability as the result of the elimination of electoral uncertainty.

The literature proceeded to the clarification of the concept of central bank independence (de Haan, 1997; Papadia and Ruggiero, 1999). CBI was composed of three distinct dimensions: personnel independence, financial independence and policy independence. Personnel independence had to do with the appointment of bank governors by the government. Long tenures, job security and appointment on the basis of strict professional standards were seen as prerequisites for CBI. Also, conditions of employment for lower ranked officials would only be determined by the bank governors. Financial independence referred to the abstention from the financing and the management of the government debt. Policy independence included the monetary authority's freedom to select the final monetary policy goals and the freedom to select the policy instruments to pursue those goals.

The credibility of monetary policy belief had a profound impact on the organisational setting of the EMU. The Governing Council of the ECB adopted a quantitative definition of the primary objective and included it in the stability-oriented monetary policy strategy of the Eurosystem (ECB, 1999b: 39-50). According to this definition, price stability was identified as the year-on-year increase of prices below but close to 2%. The ECB clearly linked the announcement of the quantitative definition of price stability with the enhancement of the credibility of its monetary strategy. By making a public commitment regarding the targeted level of inflation, the ECB sought to limit its discretion and anchor the expectations of the economic agents in line with the rules-based approach to the time-inconsistency problem (ECB, 2005). While the practice of adopting a quantitative definition of price stability was employed by a number of central banks at the time, it was not a policy decision adopted universally, as the Federal Reserve and the Bank of Japan

refrained from providing such numerical targets and insisted on qualitative definitions (Duisenberg, 2001).

However, the most important organisational reflection of the credibility belief was the delegation of monetary policymaking to the European Central Bank and the national central banks of the Eurozone member states (together forming the Eurosystem). The ECB was established as an independent central bank embodying all the features that had been identified by the literature as essential for the preservation of the distance between the politicians and the monetary authorities. In particular, the ECB projected personnel independence as appointments of high-level officials were for long tenures and removal was difficult (Gros and Thygesen, 1998: 492). Also, staff issues were the responsibility of the Executive Board (Protocol, Article 37). Financial independence was secured via the inclusion of the monetary financing prohibition in the Treaty (TEC, Article 103). The ECB was precluded from directly acquiring debt instruments of national governments, EU institutions or any other regional public authority. Policy independence was guaranteed as the ECB was granted full discretion over the selection of policy instruments. At the same time, while the ECB appeared to dispose limited discretion regarding the selection of policy goals, given that price stability was clearly determined as the primary objective of monetary policy by the Treaty, in practice the ECB retained considerable freedom to define the content of price stability (de Haan, 1997). Indeed, the quantitative definition of price stability was not a Treaty requirement but was chosen by the Governing Council of the bank. Similarly, the effective abandonment of the secondary objectives (see above) reflected the flexibility of the bank to interpret its mandate. The ECB acknowledged the link between the credibility of monetary policy and its delegation to the Eurosystem in its very first Monthly Bulletin: '[t]his institutional independence allows the Eurosystem to pursue price stability in an appropriate medium-term framework and thereby significantly enhances the credibility of monetary policy' (ECB, 1999b: 40-41).

The independence of the ECB became a legal provision included in the Treaty (TEC, Article 107). The monetary authorities were not allowed to seek guidance or take instructions from any other EU institution or national government. What distinguished the ECB from any other central bank, however, was the legal rank of its statute. Whereas the legal framework of other central banks

could be amended by the respective government or parliament, the Statute of the ECB was included in a Treaty Protocol effectively acquiring constitutional quality (Gros and Thygesen, 1998: 492-496; Papadia and Ruggiero, 1999: 69). Its amendment would require the unanimous approval by the member states and a complex ratification process. Such a high procedural threshold meant that the ECB was shielded against any political coalition seeking to influence the bank's policy by threatening to overturn its independent status.

The credibility belief led to the establishment of a particular organisational principle within the EMU: the *sharp division of responsibilities* between the monetary and budgetary spheres (Gros and Thygesen, 1998: 549). The so-called 'Maastricht Assignment' sought to provide the right incentives to monetary policymakers by insulating them from the social and political pressures arising from the management of economic policy. This principle went one step further than CBI. The ECB was not allowed to engage into an explicit or 'ex ante' coordination with fiscal authorities as this would entail a potential decrease of accountability and transparency, thereby endangering the credibility of monetary policy (Gaspar, Masuch and Pill, 2002: 78-80). In this context, there was little scope for macroeconomic coordination in the EMU (Issing, 2002a; Winkler, 1999). Monetary authorities could only take part in a dialogue with fiscal authorities with the aim of exchanging information but were obliged to avoid making any commitments that could undermine the pursuit of the primary objective (ECB, 2000b: 52). Fiscal authorities had to align their policies with the monetary policy decisions of the ECB. Coordination could only be conducted implicitly or 'ex post' with the fiscal authorities internalising the expectations for inflation. The sharp division of responsibilities fitted well with the ordoliberal idea of an indirect state intervention in the economy via the economic constitution (Gros and Thygesen, 1998: 549).

The Post-Crisis Evolution of Sound Money Beliefs

My argument here is that the outbreak of the financial crisis of 2007-2009 led to the evolution of Sound Money economic policy beliefs within the Eurozone. Price stability was no longer *the* core economic policy belief of Eurozone policymakers but became flanked by two newly emerged beliefs: financial stability and economic stability.

Financial Stability

Before the financial crisis of 2007-2009 financial stability was not a major consideration of Eurozone policymakers. The monetarist intellectual influences led decision-makers to trust the efficiency of financial markets (Krugman, 2009; see, also, Fama, 1998; Mishkin, 1978). Major financial instability was unthinkable in a world of rational agents avoiding systematic mistakes and prices reflecting economic fundamentals (De Grauwe, 2013). While asset bubbles were known to have negative repercussions for economic activity, mainstream economic thinking did not accept that central banks had an informational advantage vis-à-vis market participants (Mishkin, 2011: 17-19). ECB's Issing noted characteristically

> With regard to asset prices any central bank intervention would imply that the central bank has the ability to detect a bubble in real time. I myself have often made the argument that *the central bank has no comparative advantage over market participants* to dare such a judgement (Issing, 2003, my emphasis)

In this context, financial stability was considered to be a byproduct of price stability (De Grauwe and Gros, 2009: 2; De Grauwe, 2018: 199; Issing, 2002b). Following this logic, EU-level provisions for the prudential supervision of banks and the stability of the financial system were very weak: the ECB was tasked to support the competent national authorities acting as a forum (ECB, 2000b: 61-64). The misalignment of jurisdictions of the (centralised) monetary policy and the (decentralised) banking supervision policy was rather uncommon (Howarth and Loedel, 2005: 96-98). While the prospect of the ECB acting as a Lender of Last Resort (LoLR) was dismissed as unrealistic (Padoa-Schioppa, 1999), the possibility of the ECB facing pressures to select a more accommodative monetary policy to support the balance sheets of private banks seemed to have contributed to the institutional detachment between monetary policy and prudential supervision (Eichengreen, 1993: 1343-1345). Again, the prioritisation of the attainment of the primary objective appears to have enhanced the insulation of the monetary authority from other tasks, which are usually performed by central banks.

The financial crisis of 2007-2009 shattered the policymakers' illusions about the efficiency of the financial markets. The collapse of the US subprime mortgage market in 2007 was transformed into a credit crunch by 2008 as uncertainty about the exposure of banks to unsafe assets led to intensifying solvency concerns and the concomitant freezing of interbank markets (IMF, 2008). The financialisation of capitalism in the US and the EU and the adoption of securitisation practices by the banks in both sides of the Atlantic in the pre-crisis period had increased the interconnectedness of the financial markets (Lapavitsas, 2011; Eubanks, 2010). After the bankruptcy of Lehman Brothers in September 2008, Eurozone banks were very quickly faced with similar solvency concerns due to their exposure to unsafe assets. In response, banks engaged in an accelerated deleveraging process to improve their balance sheets. The International Monetary Fund (IMF) was noting the existence of a 'negative feedback loop between the economy and the financial system' and stressed the need for the timely recapitalisation of European banks by the governments to rebuild confidence in the financial system (IMF, 2008). The governments of the Eurozone took measures to support the banking systems (guarantees for bank liabilities, capital injections and asset support schemes) that had a substantial impact on public finances (ECB, 2009a: 68-74; 2009: 98-100; 2015a: 74-87).

The ECB participated in the coordinated response to the financial crisis that was formulated by the Euro area leaders in October 2008. The ECB undertook the commitment to provide adequate liquidity to financial institutions and improve the conditions for the refinancing of banks (Council, 2008a). A few days later, the ECB enacted the 'enhanced credit support' scheme moving beyond the use of interest rates (ECB, 2010a: 67-69). As the financial crisis transformed into a sovereign debt crisis in 2010 and Eurozone peripheral countries started facing increasing borrowing costs, the ECB launched the Securities Markets Programme (SMP) with the aim to 'restore depth and liquidity in malfunctioning segments of the debt securities markets' (ECB, 2010b: 24). A number of economists pointed out that this measure effectively constituted an indirect means for the management of member states' public debt by the ECB (Buiter and Rahbari, 2012; Sinn, 2018).[3] Arguably, the ECB was addressing the feedback loop between sovereign and bank credit risk that

[3] Carpinelli and Crosignani (2021) make a similar argument in relation to the Long-Term Refinancing Operations (LTROs) that were launched in 2011.

eventually emerged as a result of the governments' initial decision to bailout the banks (Acharya, Dreschsler and Schnabl, 2014).[4] What is certain, is that crucial monetary policy decisions were not taken any more with the sole aim of preserving the stability of prices but were concentrating on a much more acute problem: the survival of the euro area against uncontrolled market fluctuations. Ironically, the turmoil of the markets ended with a measure that was announced but never activated: the Outright Monetary Transactions (OMT) (De Grauwe and Ji, 2013; Fratzscher et al., 2016). OMT enabled the ECB to purchase unlimited amounts of government bonds in secondary markets. In so doing, the ECB signaled its unwavering commitment to preserve the integrity of the euro area (Draghi, 2012).

The financial crisis of 2007-2009 revealed that private economic activity in the financial markets could be the source of trouble forcing the ECB policymakers to evolve their thinking regarding the issue of financial stability. ECB President Trichet expressed eloquently his frustration with market participants:

> one of the main reasons for the lack of preparation had its basis in the widely held view that regulation should not stifle financial innovation and that markets knew best and could – for the most part – regulate themselves adequately. The turmoil has shown how complacent and misleading this attitude was.
>
> (Trichet, 2009)

By May 2009, the ECB was underlining the role of 'unreasonable market expectations' in the instigation of financial turmoil (ECB, 2009c: 75-90). According to this approach, segments of the financial market, driven by excessive optimism about technological progress, would form unreasonable market expectations that once they were not met would lead to a sharp decline of investment and the depreciation of asset prices. The bank admitted that the scale of the crisis

[4] An early account of the negative repercussions of the ECB's increased liquidity provision on sovereign debt can be found in Lapavitsas et al. (2010: 359-361).

proved that asset price misalignments could no longer be disregarded in the formulation of monetary policy:

> The current financial crisis calls into question the wisdom of ignoring unreasonable expectations embedded in asset prices and may call for a reinforcement of strategic mechanisms *beyond a quantitative price stability objective*.
>
> (ECB, 2009c: 90, my emphasis)

The acknowledgement of unreasonable market expectations undermined the monetarist assumptions about market efficiency and opened the way for the return of Keynesian ideas. Keynes had conceived the notion of 'animal spirits' to describe the waves of optimism and pessimism affecting economic activity (De Grauwe, 2011). In such a world, the central bank is expected to play a more active role to stabilise output by monitoring asset prices and adopting strategies that prevent the emergence of bubbles ('lean against the wind') (De Grauwe, 2008). Price stability was not enough to ensure financial stability. ECB President Trichet confirmed that the ECB has evolved its thinking regarding the relationship between price stability and financial stability:

> The 2008/2009 crisis has also demonstrated that price stability is a necessary though *insufficient* precondition for financial stability
>
> (Trichet, 2010: 18, my emphasis)

ECB's revised monetary stability strategy of July 2021 confirmed the evolution of economic policy beliefs within the bank. The new strategy highlighted the medium-term orientation of monetary policy enabling the Governing Council to incorporate 'other considerations relevant to the pursuit of price stability', such as 'financial stability' (ECB, 2021: 81). The ECB acknowledged that 'financial stability is a precondition for price stability' (2021: 85) and undertook the task to monitor financial vulnerabilities and imbalances. By considering the preservation of financial stability as a distinct (secondary, if not comparable) objective, the ECB is faced with a trade-off

(Smets, 2014; Praet, 2011). Ensuring financial stability would come at the price of a less credible strategy for the pursuit of price stability.

Macroeconomic Stability

The financial crisis of 2007-2009 led to the emergence of another economic policy belief within the Eurozone environment: macroeconomic stability. In the aftermath of the bankruptcy of Lehman Brothers and the ensuing sharp downturn of the economic activity, the monetary policy's limitations in relation to economic stabilisation became evident. In this context, the economists of the IMF started contemplating the use of discretionary fiscal policy as a remedy to the slowing economic activity (IMF, 2008: 159-196). Following the adoption of fiscal stimulus packages in the United States and Japan, the European Commission proposed a European Economic Recovery Plan (EERP) in November 2008. According to the Plan, the Member States would proceed to a coordinated budgetary expansion (1.2% of EU GDP), while extra EU funding would become available (o.3% of EU GDP). The purpose of the Plan was to '[s]wiftly stimulate demand and boost consumer confidence' thereby supporting employment (European Commission, 2008: 5). The Commission proposed a counter-cyclical macroeconomic response to the crisis via the use of discretionary public spending. The EERP became approved by the European Council in December 2008 (Council, 2008b).

The ECB approached the EERP with considerable skepticism. In December 2008, the ECB was noting that '[e]xperience has shown that policy activism has only led to the accumulation of fiscal imbalances and has not helped to solve the underlying economic and structural problems' (ECB, 2008: 76 Dec). In March 2009, ECB's veiled criticism of the Plan gave way to a more open rejection of the logic behind fiscal stimulus. The ECB repeated the monetarist discourse regarding discretionary fiscal policy:

> Not all measures are clearly linked to the root of the current economic problems or can be implemented quickly. Some measures may reflect political compromises rather than economic considerations. Government intervention also carries the risk of

> distorting the behaviour of economic agents and undermining an efficient allocation of resources
>
> (ECB, 2009d: 77)

The Bank supported the quick reversal of fiscal expansionism and the return to sound fiscal policies to preserve the credibility of the fiscal framework (ECB, 2009d: 80-81).

The ECB's views regarding the appropriateness of employing discretionary fiscal policy for macroeconomic stabilisation have gradually evolved. In 2014, ECB's President pointed out that a growth-friendly fiscal policy was essential for the support of demand and the reduction of high unemployment after a prolonged Eurozone recession (Draghi, 2014). In 2015, ECB's President together with the Presidents of the European Council, the European Commission, the European Parliament and the Eurogroup issued a report envisaging a Fiscal Union with a euro area treasury, but more importantly, promoting the idea of a 'mechanism of fiscal stabilisation for the euro area as a whole' in the medium term (European Commission, 2015). In 2016, the ECB followed up this report by discussing the concept of an appropriate aggregate euro area fiscal stance and describing the necessary features of such a macroeconomic stabilisation function (ECB, 2016: 68-87). The logic behind this intellectual shift is related to the constraint posed to monetary policy by the so-called 'zero lower bound': when interest rates are approaching zero, monetary policy can no longer stimulate demand (Giavazzi, 2016). A reduction of interest rates below zero cannot function as economic agents can choose to hold money rather than interest-bearing assets (Gerlach and Lewis, 2014). In such a case, the only available instrument for cyclical stabilisation is fiscal policy (Ubide, 2019; Corsetti et al., 2019). The Vice-President of the ECB confirmed this change of approach towards discretionary fiscal policy:

> when policy rates are close to the lower bound, fiscal policy becomes more effective in stimulating aggregate demand
>
> (de Guindos, 2019)

In this context, the reform of the Eurozone's fiscal framework with the establishment of a dedicated centralised fiscal capacity assisting with macroeconomic stabilisation appeared as the natural way forward.

The policymakers' evolved thinking regarding the use of discretionary fiscal policy seemed to have a tangible impact on their monetary policy decisions. In January 2015 the Bank decided to use its balance sheet to purchase public sector securities as it launched the Public Sector Purchase Programme (PSPP) (ECB, 2015b: 76). The programme, also known by the term 'quantitative easing', constituted a de facto monetary financing mechanism of Eurozone governments (van Lerven, 2016: 241; Eijffinger and Hoogduin, 2018: 170). In reality, the ECB became involved in the management of public debt enabling the Eurozone governments to adopt more accommodative fiscal policies (Corsetti et al., 2019). Indeed, the aggregate fiscal stance of the euro area, which had been contractionary for several years, turned expansionary after 2015 (Zoppè and Gotti, 2021).

The emergence of the macroeconomic stabilisation belief undermined the monetarist foundations of the EMU. Keynesian ideas were partially revived. The zero lower bound constraint, which led Eurozone policymakers to change the direction of policy, had been initially conceptualised by Keynes as part of the so-called liquidity trap (Krugman, 1998; 2009; Goodfriend, 2000). For monetarists, a liquidity trap was impossible. However, the provision of liquidity by the ECB through various programmes was not enough to increase output significantly after the recession proving the validity of the concept. Similarly, the Keynesian concept of the paradox of thrift, whereby excessive saving by private economic actors results in a reduction of production and employment had been equally dismissed as irrelevant for modern economies (Thies, 1996). The fact that ECB's President used it to explain the weak economic activity in the Eurozone signified its relevance:

> A main driver of the weak outlook at present is heightened uncertainty, which is triggering 'paradox of thrift' behaviour in parts of the private sector. Uncertainty encourages higher saving which compresses demand and incomes, which in turn feeds back

> into more uncertainty and lower, not higher, saving. Fiscal policy can break this vicious circle since, with its greater multipliers, it can push incomes and income expectations higher.
>
> (Draghi, 2019)

The significance of the above shift to Keynesian economic thinking was that this school of economic thought has established the inadequacy of monetary policy to stabilise the economy under certain conditions emphasising the value of fiscal intervention (Seidman, 2012).

ECB's revised monetary policy strategy reflected the evolution of beliefs described above. The ECB formally admitted that '[f]iscal and other policies are important for macroeconomic stabilisation, especially in the proximity of the effective lower bound' (ECB, 2021: 83). Discretionary fiscal policy was no longer perceived as a threat to the credibility of monetary policy, but as a necessary complement:

> By contributing to macroeconomic stabilisation, countercyclical fiscal policy amplifies the effectiveness of monetary policy.
>
> (ECB, 2021: 83)

Consequently, the simple and unqualified prioritisation of price stability gave way to a more complex combination of objectives that inevitably involved trade-offs. Taking into account the issue of macroeconomic stability in the formulation of monetary policy entailed a consideration of other factors, such as the level of unemployment. Yet, as the ECB acknowledged, paying attention to employment might require a toleration of higher inflation in the short-term:

> the medium-term orientation provides flexibility to take account of employment in response to economic shocks, giving rise to a temporary trade-off between short-term employment and inflation stabilisation without endangering medium-term price stability.
>
> (ECB, 2021: 81)

Challenging ECB's Independence?

The restructuring of the Eurozone's stability paradigm after the financial crisis of 2007-2009 challenges the legitimacy of the ECB's independence. As it was explained above, the independence of the ECB was linked to the original Sound Money paradigm of the EMU that underpinned the Maastricht organisational setting. The delegation of monetary policymaking to the ECB was legitimised by specific economic policy beliefs that dominated the Eurozone social environment at the time of its creation. The primacy of price stability justified the unwavering fight against inflation and the neglect of other economic policy objectives. The need to guarantee the credibility of monetary policy in the face of what economists identified as the problem of time consistency legitimised the insulation of the monetary authority from social and political pressures. The policy options regarding the independence of the ECB were the organizational reflections of the above ideas.

The emergence of new economic policy beliefs in the Eurozone social environment after the financial crisis of 2007-2009 led to the restructuring of the Sound Money paradigm. Price stability lost its preeminence. Eurozone policymakers reckoned that the Eurozone needed to pursue a combination of objectives beyond the stabilisation of inflation. Securing financial stability and macroeconomic stability meant that the design and execution of monetary policy became a much a more complex process. The ECB is now faced with a trade-off that involves the balancing of competing interests and has significant redistributive effects. In other words, monetary policymaking acquired an inevitable political dimension that is a far cry from the one envisaged in the Maastricht model. The organisational setting of the ECB is no longer fit-for-purpose. Accountability on the basis of reference values and targets makes little sense, given that the ECB is obliged to pursue multiple objectives. Financial independence is now irrelevant as the ECB has been obliged to participate in the management of sovereign debt to fight solvency concerns and facilitate government spending to increase demand. At the same time, discretion in the selection of policy goals exacerbates legitimacy concerns due to the lack of a procedure for the representation of conflicting political interests. In turn, the lack of any other mechanism of

political representation increases the incentives for politicised appointments in the ECB Governing Council, thereby defeating the very purpose of personnel independence.

The evolution of economic policy beliefs in the EMU also affects the coordination of the ECB with the fiscal authorities. The sharp division of responsibilities established by the Maastricht assignment and the concomitant ex post coordination made sense when the ECB was exclusively focused on the stabilisation of inflation. Under that regime, the ECB could select the appropriate policy without taking into consideration the plans of the fiscal authorities. As the ECB is now involved in the management of public debt and has a significant role to play in sustaining financial stability, a closer coordination with fiscal authorities is necessary. This reality was acknowledged early on by the ECB (Praet, 2011). Indeed, the ECB has been actively engaged in the management of fiscal coordination in the past decade. It is also a central part of the regulatory supervision of financial institutions (Bozina Beros, 2019; Howarth and Quaglia, 2013). Yet, these developments prove that the reality of policymaking in the EMU has led to the relativisation of the concept of central bank independence.

Conclusion

This paper has shown that the evolution of Eurozone's 'Sound Money' beliefs after the financial crisis of 2007-2009 undermined a fundamental organisational principle of the EMU: the independence of the ECB. In contrast to other studies examining the adaptation of the ECB's mandate during the decade of crises, which point to constraints on the independence regime of the ECB, the findings of this study suggest that the very logic of delegation is called into question. Indeed, the emergence of 'financial stability' and 'macroeconomic stability' beliefs led to the veiled reorganisation of the ECB's interaction with national governments. The revised monetary strategy of 2021 proves that the reinterpretation of the ECB's mandate is not a temporary arrangement but a permanent feature of the evolving monetary regime.

The above findings beg the question whether a more radical reform of the EMU is necessary, potentially including Treaty amendments. The legal acknowledgement of the complex role of the

ECB would align the legal framework with the reality of the ECB's current activities, shield it against legal challenges, but most importantly, enhance its legitimacy in the eyes of the public and important stakeholders. By pretending that the ECB pursues only one objective, price stability, the ECB is obliged to conceal from the public the complex trade-offs that it has to face, when taking monetary policy decisions. While the Bank has managed to navigate through the various crises adequately, preserving the financial stability of the Euro area and facilitating the use of discretionary fiscal policy for macroeconomic stabilisation, the inevitable outcome of its evaluation will be that of policy failure, if its function is judged only on the basis of the attainment of the inflation target. This can have important repercussions for the legitimacy of the ECB in some constituencies highly sensitive to the stabilisation of inflation, such as the German public and the German institutions. Also, as the ECB expands its objectives with the consideration of climate change aspects (Zilioli and Ioannidis, 2022; Battiston et al., 2021), it will become increasingly difficult for the ECB to continue linking its activities to the preservation of price stability in its public communication (see also, Lokdam, 2020).

In this context, a partial restriction of the ECB's independence in the Treaty framework can have advantageous effects for the Bank. A process of democratic authorisation of the Bank's policy objectives every few years would imbue the selected policy mix with legitimacy. This could take the form of a formal approval of medium-term policy targets (proposed by the Governing Council) by the European Parliament and the Council. In this way, the Bank will gain the freedom to adjust its medium-term policy targets to fit the economic conditions. In parallel, it will retain the flexibility to pick the necessary policy instruments to achieve its objectives mitigating pressures over the justification of every single instrument. Also, the restriction of financial independence would give the Bank more freedom to legitimately support sovereigns without devising questionable policy explanations that could face legal challenges. In sum, a less independent ECB can be much stronger.

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