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The age of reason?

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The age of reason?

Abstract

At age 25, the euro has been a historical success, but it has not yet reached an adult stage. The ECB has made much progress and can do more on its own. Its next monetary policy strategy, to be announced in 2025, is an opportunity that should not be missed. Much more is needed from member governments, which are still reluctant to grant the ECB what it needs to become a normal central bank.

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LIST OF ABBREVIATIONS

ECB	European Central Bank
EU	European Union
EMU	European Monetary Union
ESM	European Stability Mechanism
FOMC	Federal Open Market Committee
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
PEPP	Pandemic emergency purchase programme
OMT	Outright Monetary Transactions
QE	Quantitative easing
SSM	Single Supervisory Mechanism
SURE	Support to mitigate Unemployment Risks in an Emergency
TPI	Transmission protection instrument
US	United States

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EXECUTIVE SUMMARY

- **The European Monetary Union (EMU) has been a historical success**. It has defied sceptical predictions and it has withered severe crises, both internal and external. Yet, a number of shortcomings have been left dangling and remain threatening. The next monetary policy strategy review provides an opportunity to deal with them, even though many measures to be adopted lay beyond the ECB's authority.
- **Because the common currency limits the ability of member countries to deal with shocks, improving risk sharing is a necessity**. Fiscal policies can do more and better, but they also interact with monetary policy. Limited progress is largely explained by the risk of moral hazard, but this risk can be mitigated through appropriate arrangements.
- **The financial markets allow for private sharing, but they remain ineffective**. Completing the banking union and the capital markets union stand to make an important contribution to risk sharing. Progress depends on member governments but it is held up for protectionist reasons.
- **The ECB can provide an important degree of risk sharing by lending in last resort to both governments and financial institutions**. Little by little, it has moved toward lending in last resort to governments but a few more steps need to be taken to normalise this procedure, essentially by removing conditionality.
- **It has taken more than decades for the ECB to formally adopt the expected inflation targeting strategy that most other central banks adopted much earlier**. Unfortunately, this strategy rests on forecasts, which have been seriously wrong in recent years. While the strategy remains the state of the art, all central banks must define how to apply it when forecasts have become highly imprecise.
- **The ECB's own response so far has been to produce scenarios**. Hopefully, its next strategy will go further than this communication tool. It will also have to accept that, in a situation of high uncertainty, forward guidance is not desirable and even counterproductive.
- **There are no 100% safe assets in the euro area**. The absence of safe assets undermines the financial markets and the international role of the euro. It also explains the contagion that plagued many countries during the sovereign debt crisis. One solution is that the ECB become a lender of last resort to governments. Other proposals have been suggested, but they face the risk of moral hazard that such a commitment would create. The ECB could break this logjam but issuing its own debt instrument that could be used routinely for open market operations.
- **The ECB started with the narrow objective of price stability, but it has added a few more objectives**. It has accepted responsibility for financial stability, including by becoming the supervisor of banks considered as systemically significant. More recently it has added some responsibility regarding climate change. The content of this responsibility is not precisely defined, however. Climate change policies are the realm of governments, not of the ECB, which calls for a clarification.
- **Most of the existing shortcomings remain in place because member governments have failed to act for the last 25 years**. They hamper the ECB and they represent a continuing threat to the euro.

1. INTRODUCTION

Twenty-five years ago, many observers were doubting that the euro could work and even survive for long. In 2011, a bit more than ten years ago, many thought that the moment of truth was happening as it was rumoured that the German Finance Minister advocated that Greece should be pushed out of the European Monetary Union. It did not happen. It is now accepted widely that the euro is here to stay. The overwhelming majority of EMU citizens use the common currency every day without thinking about it. The euro is a historical success.

However, the success is not total. Mistakes were made, leading to a major sovereign debt crisis, which was poorly managed. During the ensuing years, the European Central Bank (ECB) failed to bring inflation to its target. Then, since 2021, inflation has vastly exceeded the target. In an interview with the Financial Times on 4 September 2023, President Lagarde has indicated that the ECB must be "open about the limits of what we know, the areas where we have missed the mark, and what we are doing about it".[1] In addition, the construction of EMU is still an unfinished business. The banking and capital market unions are still on the drawing board. The fiscal discipline regime, which is undergoing a new reform, is far from satisfactory. Lingering fears remain that high public debts in several countries may face renewed attacks from financial markets. Some countries, which have refused to join in, still do not seem keen to adopt the euro. The decision-making process involves the 26-large Governing Council with a monthly rotation to limit voters to 21. Even so, this is an unwieldly large group open to untold national interferences.

The latest ECB statement on its monetary policy strategy was published at an inconvenient time, in mid-2021, just when inflation was reaching high levels, which undermined the assertion that "the new strategy is a strong foundation that will help guide us in the conduct of monetary policy in the years to come".[2] A new strategy review announced for 2025 will have to deal with both lasting shortcomings and with the unexpected inflation surge.

As the institution that oversees the ECB, the European Parliament might wish to produce a list of precise questions that the review ought to consider. This paper intends to suggest some possible avenues for the forthcoming review. It is important to stress that many major issues lie beyond the responsibilities of the ECB and yet directly affect its actions and the results of its actions. As an independent institution, the ECB cannot systematically raise questions or even suggest solutions that belong to the EU and its member governments. However, a strategy review may create an opportunity to evoke the need for parallel thinking.

The next section revisits the 25 years since the creation of the euro. It focuses on the shortcomings that ought to be addressed. Section 3 proposes a list of issues that the strategy review needs to address. The last section briefly concludes.

[1] https://www.ft.com/content/afe704e3-291c-4a06-8106-b235955970e2

[2] https://www.ecb.europa.eu/home/search/review/html/index.en.html

2. LESSONS FROM THE PAST

2.1. Fiscal-monetary interactions

2.1.1. Macroeconomic coordination

Fiscal and monetary policies are very different macroeconomic instruments. They pursue different objectives, a narrow one for monetary policy (price and financial stability) and broad ones for fiscal policy. Yet, through different channels, they both impact the levels of activity and employment, and therefore inflation. This often leads to suggestions that they ought to be coordinated in order to avoid that they undermine each other's effects on inflation. However, coordination rarely occurs. While inflation is the main focus of central banks, it is merely a by-product of government actions. As long as inflation is low, governments may indeed ignore it, to some degree at least. If coordination between one government and one central bank does not come naturally, it is especially difficult to achieve in the euro area where the ECB operates along 20 governments in countries with varied macroeconomic conditions.

As it strives to keep inflation close to its target, a central bank is expected to systematically raise its interest rate when inflation rises and, conversely, to lower interest rate when inflation declines. Coordination would require that fiscal policy turns contractionary when inflation rises and expansionary when inflation declines. Since, in normal times, inflation and the level of activity move in the same direction, coordination would require that both policies be countercyclical. The empirical evidence is that central banks informally follow the Taylor rule,[3] which prescribes raising the interest rate when expected inflation exceeds its target and when the output gap – the difference between actual and trend gross domestic product (GDP) – is positive, and conversely (while also adjusting for expected inflation). This is indeed countercyclical. The left-hand chart in Figure 1 shows the evolution of the euro area's output gap from 2000 to 2023 along with the change in the ECB interest rate. Until 2012, the interest rate moves in a clear countercyclical fashion. Then it is kept unchanged at its lower effective bound irrespective of the cyclical fluctuations. It starts rising in 2022, resuming its countercyclical pattern.

Governments can also smooth economic fluctuations, with an eye to limit variations in unemployment. This tends to happen automatically through the fiscal multipliers, whereby tax income rises during boom years, which improves the balance budget, and conversely during low activity years. But governments may also wish to use discretion to reinforce the effects of the fiscal multipliers. The evidence is that discretionary fiscal policy in the euro area has been slightly procyclical or acyclical since the euro was launched.[4] This is illustrated in the right-hand chart of Figure 1, where discretionary fiscal policy actions are measured as the change in the cyclically adjusted budget balance, which nets out the effect of the fiscal multiplier. A key exception is the post-COVID-19 year 2022, when a strong fiscal policy expansion reinforced the timid reaction of the ECB and contributed to the inflation surge.

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[3] For example: Bernanke (2015), Coibion and Gorodnichenko. (2012), Leeson et al. (2012) and Orphanides (2003).

[4] The result was first established by Fatas and Mihov (2010) and confirmed since, see e. g., Eyraud et al. (2017), Larch et al. (2020), Afonso and Tiago Carvalho (2021) or Gootjes and de Haan (2022).

Figure 1: Cyclical behaviour of monetary and fiscal policies

Source: European Commission, AMECO on line.

Notes: The output gap is the difference between actual and trend GDP, in % of GDP. Monetary policy actions are measured as the change in the short-run interest rate relative to the previous year. Fiscal policy actions are measured as the change in cyclically adjusted budget balance measured as a % of the GDP. All variables are annual averages.

2.1.2. Risk sharing through markets

The fundamental argument against a monetary union is that an individual member country cannot use its own monetary policy when it faces an adverse disturbance. But it still can use its fiscal policy. The enhanced importance of fiscal policy, however, means that it should be strongly countercyclical, which has not happened for many reasons, including the restrictions imposed by the Stability and Growth Pact (SGP).[5] The effects of the disturbance can be mitigated if other mechanisms come into play. This is the idea of risk sharing, whereby countries help each other. In principle, market mechanisms already exist:

- If workers are mobile, they can move away from a country where unemployment is rising.
- If their own country's financial institutions come under stress because of the adverse disturbance, consumers and firms can borrow in the same currency from financial institutions in other countries.

Reviewing the available evidence, Kalemli-Özcan and Martin (2019) note that, in comparison with the United States (US), labour mobility is low within the euro area and financial transfers, both public and private, are too limited to allow for adequate risk sharing. Ferrari and Rogantini Picco (2023) find that risk sharing has actually declined in the periphery countries after the creation of the euro because the financial market flows have not offset the loss of monetary policy.[6]

The weakness of these mechanisms means that there is a need to public interventions. Borrowing and lending by national governments is an option but the previous section suggests that it has not been working so far because fiscal policies have been, at best, acyclical. The next section examines what can be done in emergency situations. Here we note that proposals for less extreme situations have been made but rejected so far, largely because of moral hazard consideration. The proposals include a European-level fiscal capacity or a permanent version of the Support to mitigate Unemployment Risks in an Emergency (SURE) programme put in place at the time of the COVID-19 pandemic.

[5] In addition to the limits to budget deficits and public indebtedness, Fátas (2019) has shown that underestimates of potential GDP has led the Commission to require excessive austerity during the 2010s.

[6] They define the periphery countries as Greece, Ireland, Italy, Portugal, and Spain.

2.1.3. Central bank backstops during emergencies

While collective public risk sharing has not been accepted for normal fluctuations – and is deemed forbidden by the Treaties – each of the two major crises that the EMU has faced have led to innovative actions. These actions were designated as temporary, but more emergencies are bound to unexpectedly occur, so lessons can be learned from the experience so far.

When the sovereign debt crisis started in 2010, the predominant view was the ECB should not bail out governments under threat, as stipulated by Article 125 of the Treaty on the Functioning of the EU. This was seen as a crucial condition to ensure the independence of the ECB and to eliminate the threat of inflation. The same article also precluded support from other Member States. Yet, it was reinterpreted in 2012, when Greece was on the verge of being forced to leave the euro area, which raised fears potential contagion to other countries. The result was the creation of the European Stability Mechanism (ESM) for collective lending. In order to assuage opposition by some countries, including Germany, the ESM was not allowed to offer grants. It could only lend, initially at a punishing interest rate eventually lowered, and under very strict conditions.

It soon became clear that the ESM could not stop the crisis for one good reason. When the financial markets start panicking, they use huge resources to make bets that can overwhelm any pre-announced support. The unique feature of central banks is that they are the only public actors that can make unlimited commitments since they can create as much money as needed. This is why the ECB ended up making its celebrated announcement of "whatever it takes", which soon stopped the crisis. To be sure, because of Article 125, the ECB had to be juridically careful, which resulted in two features. First, it stated that the purpose was not to finance an ailing country but to maintain the transmission of monetary policy, a fig leaf to dispel the controversial nature of lending in last resort. Second, the ECB subjected its unlimited commitment to ESM-style conditions.

When the COVID-19 pandemic started in 2020, similar developments took place. The European Commission promptly suggested two transfer mechanisms, which were accepted. The first one was the SURE programme, which supported unemployment insurance. The second one was NextGenerationEU, which combined grants and loans under detailed conditions. Both programmes have been funded by collective borrowing whereby the Commission issued EU bonds to be financed by member countries and new own resources.[7]

Financial markets remained generally calm during and after the COVID-19 pandemic period, so there was no emergency from that side. One reason is that the ECB – and most other central banks as well – acted pre-emptively and promptly restarted quantitative easing (QE). The ECB also worried of different budgetary impacts of the COVID-19 pandemic. To that effect, it developed two more instruments that provided backstops for national public debts. The Pandemic Emergency Pandemic Programme (PEPP), adopted at the outset of the COVID-19 pandemic, allowed for some flexibility in the purchase of national public debts. The Transmission Protection Instrument (TPI), announced in 2022 when interest rates started to be raised, is subject to less exacting conditions The Transmission Protection Instrument (TPI), announced in 2022, at the start of the ECB normalisation cycle, is subject to less exacting conditions, tailored to the prevailing situation, as explained in Wyplosz (2022). With the TPI, the ECB is getting closer to accepting its role as lender in last resort, but not quite yet. Other central banks are understood to be unconditionally ready to act as unlimited lender of last resorts to their governments. The restrictions that the ECB has put in place are needed to avoid legal litigations, which have occurred anyway, as explained in Section 3.2. These limits are a consequence of the multinational nature of the EMU, which creates the risk of moral hazard. Conditionality is a way of alleviating this risk.

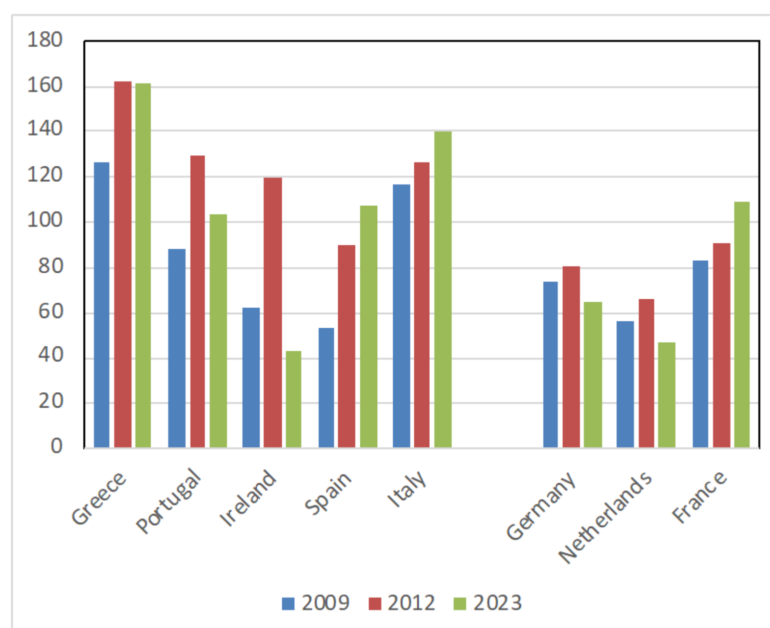
[7] Eurobonds are examined in Section 3.3.

2.1.4. Fiscal policy and financial market dominance

Moral hazard is a key concern among the "frugal" countries of Northern Europe. They fear that the "spendthrift" countries of Southern Europe could see systematic emergency external support – by the ESM, or any other similar arrangement, or the ECB – as a precedent, which would encourage them to relax unpopular policies like tax increases or spending cuts. Within the EMU, moral hazard primarily concerns fiscal discipline and banking regulation, supervision and resolution. These concerns are referred to as fiscal policy dominance and financial market dominance, respectively.

The "frugal countries" concerns have been confirmed by the public debt crisis of 2010. The crisis erupted in Greece, spread to Portugal and Ireland, then Spain, and threatened to affect Italy, possibly France.[8] Figure 2 displays these countries' public debts for the pre-crisis year 2009, the end-crisis year 2012 and the most recent year (2023). The figure also shows the debts in two "frugal" countries, Germany and the Netherlands. Two sorts of crisis occurred. First, two countries, Greece and Portugal, already had high public debts when the global financial crisis erupted. Second, Ireland and Spain started off with low debts but then had to rescue their banking systems at great budgetary cost, which suddenly resulted in rapidly growing public debts. Note that Italy and France were in the high-debt danger zone but escaped. Importantly, since then, the frugal countries (Germany, the Netherlands, joined by Ireland) have brought their public debts back down, but the others did not. This is often seen as a proof of moral hazard.

Figure 2: Gross public debts in selected countries (% of GDP)



Source: European Commission, AMECO on line.

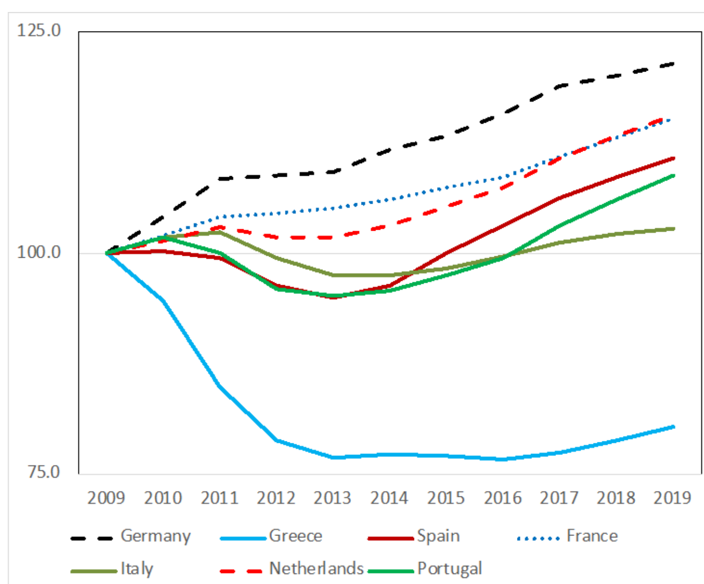
The first sort of crisis illustrates fiscal policy dominance. The countries saddled with high debts in effect forced the hands of the ECB to act as lender of last resort. The second sort of crisis, a case of financial market dominance, occurred when governments were forced to raise their debts to prevent a banking meltdown, which in turn forced the ECB to act as lender of last resort. As noted above, heavy conditionality was imposed in an effort to limit the moral hazard.

8 It also affected Cyprus for idiosyncratic reasons.

Heavy conditionality was costly, however. The rescued countries were obligated to pursue fiscal austerity just as they were trying to recover from the impact of the global financial crisis. As can be seen in Figure 3, Greece, Portugal and Spain[9] suffered several years of negative growth and, at best, ended up with a modest recovery by 2019, the last year before the COVID-19 pandemic crisis. In fact, in that year, the Greek GDP was still 14.6% below its 2009 level.

Another lesson is the "doom loop" phenomenon. As explained in Brunnermeier et al. (2016), European banks hold large amounts of their own government debts. When a country's debt comes under market pressure, its banks suffer large losses, which leads the government to provide support, further increasing the debt. Alternatively, the crisis starts with one or more large banks and results into stressed public debt and then further bank losses. This embrace between a government and its banks is dangerous and may lead to the combination of fiscal dominance and financial dominance. It could have been hoped that the adoption of a common currency would have led to a diversification of public debt holdings by banks. It did not, even after the debt crisis. A commonly cited reason is the lack of effective banking and capital markets unions.

Figure 3: Real GDP (Index: 100 = 2009)



Source: European Commission, AMECO on line.

Note: The "virtuous" countries are represented with dashed lines. France, an intermediate country, is represented with a dotted line.

In the end, the debt crisis brought together two issues that have bedevilled the euro area from the start, and still remain unsolved:

- The need for deeper risk sharing to compensate for the loss of monetary policy at the national level. If the market does not provide adequate private risk sharing, governments and the ECB may be forced to intervene.
- The risk of moral hazard that pits countries against each other and undermines risk sharing. Rules and conditions, which aim at mitigating moral hazard, hamper private risk sharing and prevent the effective use of fiscal policies at both the national and euro area levels.

[9] Spain refused to be bailed out to avoid the conditions that would have been requested. Nevertheless, it had to adopt austerity. Ireland is not shown because it underwent a sharp recovery and the highest growth performance in the euro area when it started to benefit from the presence of several US high-tech headquarters.

2.2. The monetary policy strategy

2.2.1. Inflation targeting

Inflation became elevated in the 1970s in most developed economies largely because monetary policy was still poorly understood. Ever since inflation has been eradicated in the 1980s, central banks have gradually adopted one variant or another of the inflation targeting strategy. Over time, the strategy has been refined and most central banks have converged to similar arrangements. They announce a target and use the short-term interest rate – the policy rate – to drive inflation toward the target. They are guided by the Phillips curve which provides a view on what determines inflation.

When the ECB came into existence, it did not adopt the inflation targeting strategy, opting instead for a two-pillar strategy. As a nod to the most successful central bank, the Bundesbank, its strategy combined a monetary analysis borrowed from the Bundesbank, which asserted that inflation was driven by the rate of money growth, and an economic analysis that bore some resemblance with the inflation targeting strategy. The combination was unwieldy. It rested formally on two different instruments, the rate of money growth that corresponded the monetary analysis, and the interest rate implied by the economic analysis. The role of money growth was then increasingly seen as outdated and the two instruments were often at odds with each other.[10] In practice, the ECB was moving toward the inflation targeting strategy, as the Bundesbank had done in the last years before the euro. The ECB defined price stability, which is its key mandate under the Treaty of Maastricht, as the range between 0% and 2%, but avoided calling it a target.

The ECB first reviewed its strategy for the first time in 2003, four years after the launch of the euro. It reaffirmed its commitment to the two-pillar strategy, but it signalled that it used the monetary analysis for the long run and the economic analysis for the medium run, understood to be the time it takes for monetary policy to achieve its effects. Implicitly, the interest rate became the only instrument and the ECB followed the inflation targeting strategy. Officially, however, it refused to adopt that strategy.[11] The definition of price stability was changed to "close to, but below 2%", recognising that too low an inflation rate could push the interest rate instrument to its zero lower bound.

It took nearly two decades until the second review that was announced in 2021. The ECB finally accepted the inflation target strategy. The target was set at 2%, with symmetric margins of tolerance. The former monetary analysis, renamed as the monetary and financial analysis, now was geared toward financial stability, not to monetary policy proper. Unfortunately, the review was announced just as inflation started to rise to levels unseen since the 1990s.

Meanwhile, most central banks had moved from the initial inflation targeting strategy to an *expected* inflation targeting strategy. Because today's monetary policy action affects inflation with a variable lag of more than one year, possibly two years or more, it is logical to target future inflation. Closely related to the strategy, once central banks look ahead, they can think about their decisions on the policy interest rate over the policy horizon. It is natural then for them to communicate their intentions through forward guidance. Although the ECB review did not mention this subtle shift of the inflation targeting strategy, its publications and forward guidance have made it clear, even before the review, that it was guided by its forecasts of future inflation.

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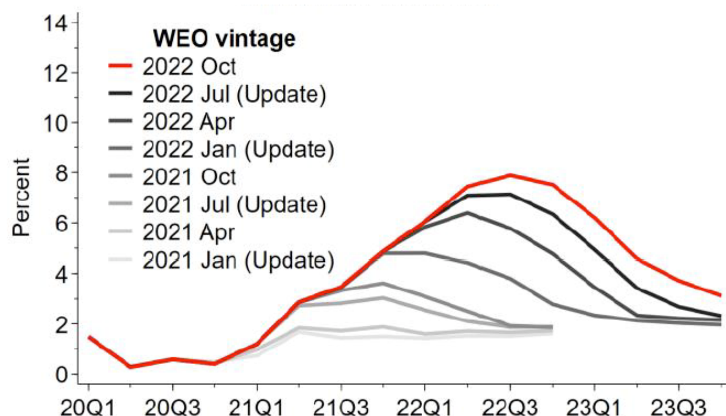
[10] Schnabel (2023) rejects the claim by insisting (2021) that the rise in inflation after the COVID-19 pandemic has been a consequence of the massive injection of liquidities under QE.

[11] In presenting the policy review, President Jean-Claude Trichet stated that *"the two-pillar framework, in conjunction with the medium-term orientation of the ECB's monetary policy conduct, has over time become the hallmark of the ECB's strategy. These features, among others, distinguish the ECB's strategy somewhat from the approaches implemented by some other central banks, in particular from inflation-targeting strategies"*. (Speech of November 2003; https://www.ecb.europa.eu/press/key/date/2003/html/sp031120.en.html).

Unfortunately, one reason why most central banks have shared the misery of the inflation surge is that their forecasts have been widely off the mark since the end of the acute phase of the COVID-19 pandemic. Figure 4 presents the usually consensual forecasts produced by the International Monetary Fund (IMF) twice a year, looking at average inflation in the advanced economies. Since early 2021, forthcoming inflation has been underestimated by a large margin. The underlying economic situation has been so unusual by historical standards that the models used by central bank staff could not capture the evolution of the situation. At the present time, they are all grappling with this unprecedented difficulty.

Figure 4: Inflation forecasts and outcome in advanced economies



Source: Koch and Noureldin (2023).

Notes: The latest information available at publication time is shown in red. WEO=World Economic Outlook.

2.2.2. Forecasts and forward guidance

While we currently worry about the inflation surge, it is also helpful to examine what happened following the global financial crisis. In many developed economies, inflation dropped below the targets. The central banks lowered their interest rates and reached the 0% level, but inflation did not respond as intended. A few of them, including the ECB, decided to bring their interest rates into negative territory, to no avail, an unprecedented situation. They then undertook to create massive amounts of liquidity, another unprecedented procedure called QE, and it did not work either, as explained in Wyplosz (2013). During this period, their forecasts dutifully predicted a rise of inflation toward target. This led them to produce forward guidance that pledged to keep the policy interest rate unchanged, i.e., "low for long". Forward guidance was also trying to influence the public's expectations, and ultimately actual inflation itself.

There is a long history of forecasts that did not conform to eventual outcomes. The ECB has now admitted that its forecasts have been consistently erroneous since early 2021 (Chahad et al., 2022). This admission presents the ECB with a major challenge, having endorsed in its strategy review the expected inflation targeting strategy. Yet, the ECB stuck with the "low for long" statement up until it reversed its policy stance and raised the policy rate. At that stage, President Lagarde indicated that *"we are not offering forward guidance of any kind"*.[12] Indeed, forward guidance is inconsistent with systemic forecast errors.

[12] Press conference following the July 2024 decision to start raising the interest rate. https://www.ecb.europa.eu/press/pressconf/2022/html/ecb.is220721~51ef267c68.en.html

The same inconsistency is at play at the time of writing. The rapid decline in inflation during the second half of 2023 has raised the possibility that the ECB could start cutting the policy interest rate in the first half of 2024 and yet it keeps repeating that it plans to keep it "high for long". Yet, any such statement is immediately followed by an insistence that the ECB decisions are shaped by incoming data, for example at the Monetary Dialogue of November 2023 when President Lagarde indicated that *"our future decisions will ensure that policy rates are set at sufficiently restrictive levels for as long as necessary. The appropriate level and duration of restriction will continue to be determined in a data-dependent manner."*[13]

The ECB is not alone to face this predicament. Many central banks and international organisations repeatedly have produced wrong forecasts since the recovery from the COVID-19 pandemic. As noted above, the ECB has acknowledged its errors, as did the IMF (Koch and Noureldin, 2023). Similarly, most central banks still provide forward guidance only to be proved wrong and forced to make decisions inconsistent with past statements. All are rethinking this aspect of the expected inflation targeting strategy.

2.2.3. Inflation surge after COVID-19

The inflation surge represents a major failure of monetary policies. Inflation increased far above the targets because of a series of unprecedented shocks. Four questions arise:

- Could these shocks have been foreseen?
- Could their impact have been measured?
- Could central banks have acted more appropriately?
- Is this episode a rebuke of the inflation targeting strategy?

The main causes of the surge are relatively well established by now (Bernanke and Blanchard, 2023). Some could have been foreseen. Restarting economies after a long period of paralysis due to the pandemic could not happen fast, thus restraining supply at a time when consumers were eager to catch up with previously suppressed spending, using their accumulated savings and supported by highly expansionary policies. With supply chains now global, worldwide transports could not deliver goods once they came out of production lines scattered all over the word. On the other hand, the energy crisis that followed the Russian invasion of Ukraine and the sanctions imposed as a retaliation were truly unpredictable.

Given the unprecedented nature of these shocks, precise measures of the shocks and of their impacts were going to be highly imprecise, at best. Yet, most professional public and private forecasters were unwilling to acknowledge the limitations.

For a while, it was possible to imagine that the recovery would occur without inflation. Deeply impressed by a decade of inflation below target, most central banks were actually relieved to see this period come to an end. In addition, they were concerned that the recovery could be accompanied by financial instability, hence the resumption of QE and the unwillingness to contemplate an end to their decade-old highly expansionary stances. The rapid decline of inflation occurred in the last quarters of 2022, before the monetary tightening started in late 2021 (Federal Reserve) and mid-2022 (BCE) could deploy its effect. It suggests that, maybe, the central banks were right when they in initially saw the surge as temporary. Still, given how expansionary policy had been until then, the central banks could

[13] https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp231127~a4af2f4e28.en.html

have normalised their policies – both the interest rate and QE – as the recovery was taking hold, as suggested in Wyplosz (2021). This could have resulted in a lower and earlier inflation peak.

At any rate, inflation targeting remains the best strategy. So far at least, no better one has been suggested. Implementation must be fine-tuned, however. The surge has shown that inflation forecastscan be unreliable sometime. The ECB's statement that its decisions are "*data-dependent*" is highly sensible but then the rest of the procedure must be amended correspondingly. This includes the publication and use of forecasts, the renunciation to forward guidance and a more open and "humble" communication of internal deliberations.[14]

2.2.4. Mission creep

Early on, the ECB indicated that its mandate assigns an overriding priority to the objective of price stability. This is in line with the *time-honoured Tinbergen principle* that there should not be more policy objectives than there are instruments (Tinbergen, 1956). In addition, the ECB considered that, as an independent public institution, it must be accountable and saw as necessary to have a single and measurable objective. Once many objectives are accepted, it argued, the central bank may need to make trade-offs between them, which unavoidably involves debatable value judgements. The 2003 review upheld the primacy of this objective.

However, during the public debt crisis, the ECB focused on financial stability and waded into lending in last resort, as explained in Section 2.1. Next, it has been assigned the responsibility for supervision of significant banks and is the home for the Single Supervisory Mechanism (SSM). Finally, since the early 2020s, the ECB has accepted a responsibility in dealing with climate change. The 2021 strategy review underwrites this evolution as follows:

> *"These objectives include balanced economic growth, a highly competitive social market economy aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. The Eurosystem shall also contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system."*[15]

Following the global financial crisis, central banks in most developed countries have accepted some responsibility for financial stability and have recognised that there are circumstances when they must act as lender in last resort. Thus, the ECB is not alone in expanding its objectives. Yet, they all face a number of issues.

Regarding the Tinbergen principle, the ECB notes that it has expended its toolbox with QE and lending in last resort. This still leaves a larger number of objectives than available instruments. In addition, the multiplicity of objectives also opens up the accountability issue. In several countries, dealing financial stability and lending in last resort are subject to agreement with the national Treasury. This is not the case for the ECB. It may even be impossible to achieve because it would require making arrangements with 20 distinct Treasuries.

The ECB is careful to note that climate change is primarily the responsibility of governments, but it then lists many actions. Some are just bookkeeping, like incorporating the effects of climate change on inflation, growth, or financial stability. It is also "tilting" its own portfolio by disposing of corporate

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[14] President Lagarde is quoted in the *Financial Times* of 4 September 2023 as saying "*humility in how we communicate is key to fostering trust*".

[15] "The ECB's monetary policy strategy statement". https://www.ecb.europa.eu/home/search/review/html/ecb.strategyreview_monpol_strategy_statement.en.html

bonds issued by polluting firms and it adjusts its collateral requirements. Officially, this is good prudential precaution but, in effect, these measures implicitly tax brown assets. Of course, fighting climate change is a major challenge, but so are many other structural issues like employment, inequality or long-run growth. Central banks explicitly avoid being involved in these policy areas for fear of being drawn into actions that are usually considered as lying outside their scope because they have redistributive effects and, therefore are subject to political judgements. At stake is the independence of central banks.

3. ISSUES FOR THE NEXT POLICY STRATEGY REVIEW

3.1. Uncertainty and forecasting

The immediate challenge, for all central banks, is to rethink the inflation targeting strategy. During reasonably stable periods, the expected inflation version has been successful, but when the situation makes it impossible to forecast inflation with sufficient precision, the challenge is acute, for three main reasons.

First, because monetary affects the economy, and therefore inflation, with long and variable delays, today's actions must aim at tomorrow's conditions. There is no shortcut, monetary policy must be forward-looking, with a horizon that can expand to 3-5 years.

Second, when setting the nominal interest rate, central banks must think about the real interest rate (the nominal rate less expected inflation) because it is the real rate that affects the economy. Here again, there is no shortcut.

Third, precisely because expectations are central to monetary policy, central banks naturally wish to influence them and keep them anchored to the target. This is what forward guidance is largely about. Obviously, the central banks cannot simply state that they are unable to foresee the future evolution of inflation.

It has emerged that the range of situations when forecasts are too imprecise is much wider than initially thought. In fact it has been the scale during the whole period since the global financial crisis. Yet, expected inflation targeting is the best strategy known so far and no superior strategy has been suggested. The ECB is well aware of this challenge. It has started to publish scenarios, which are designed to include the best and worst cases and an intermediate one. This is a good approach as far as communication is concerned, but it leaves out the decision-making process.

The Federal Reserve's response has been to publish the "dot plots" which displays the anonymous expectations of the individual members of the decision-making Federal Open Market Committee (FOMC). The latest dot plot, from December 2023 is shown in the right-hand chart of Figure 5.[16] It shows that over the policy-relevant horizon, individual members of committee harbour significantly divergent expectations. This is how it should be in the current period of high uncertainty. It is also a representation of how decisions are made since each member of the FOMC votes on the basis of her expectations. It is also a good communication instrument. Importantly, it avoids the contradiction between the tendency to use communications to affect expectations and the risks of losing credibility when the forecasts are found to have been wrong. Finally, at the level of individual members, this procedure is fully in line with the expected inflation targeting strategy.

Of course, the Fed was also late to prevent the inflation surge because it erred on the side of prudence. The left-hand chart of Figure 5 shows that, in June 2021, a large majority of FOMC members did not expect that they would raise the policy rate later. A key reason is that most central bankers initially assumed that the surge would be transitory. In this case, according to the accepted doctrine, the correct policy response is not to make monetary policy tight. The verdict is out on whether it was a wrong assumption.[17]

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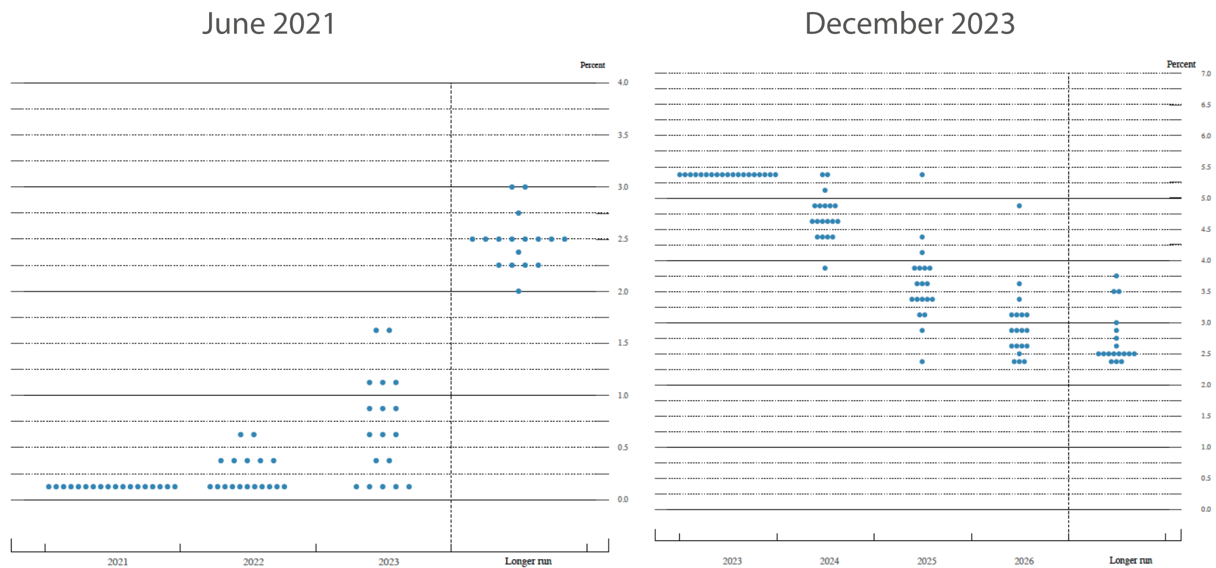
[16] The document also publishes a large number of statistics about the Committee members' expectations concerning GDP growth, the unemployment rate as well as various measures of inflation. The Committee is composed of 17 members, 12 of which vote on a rotating basis.

[17] Even so, coming out of the pandemic, monetary policy was strongly expansionary and it was time to make it neutral. For a discussion, see Wyplosz (2023).

Figure 5: FOMC: dot plots



Source: Summary of Economic Projections. Federal Reserve Board. https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20201216.pdf; https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20231213.pdf.

This raises the question about the way the forecasts are produced. In most central banks, this is the task of the staff, which uses different models. The established models were, and still are, unable to make reliable forecasts in the presence of unprecedented shocks that are not included in the history that provide statistical information. This is another lesson that needs to be fully addressed. The ECB is well aware of this risk.

Decision-makers should have incentives to disagree from staff projections and, if need be, from one another. While the FOMC meets over two days, the Governing Council of the ECB meets over a dinner and a morning. With 26 members, it also is too large a body to conduct in-depth debates. In addition, the ECB has established a tradition of seeking consensus within the Governing Council which, reportedly, hardly ever takes votes. Individual positions are careful hidden from public view, unless some members express their positions in the media. The fear initially was that disagreements by national governors might lead to a politicisation of monetary policy. As the ECB reaches the age of 25, it might time to abandon these fears. Four separate measures would greatly improve the situation:

- Reduce the size of the Governing Council by giving up on the one-country-one-member principle, along the lines suggested by Burda (2013).[18] This would require a Treaty change.
- Hold longer meetings when monetary policy decisions are made.
- Having every monetary decision be effectively decided by a vote, as prescribed in the Treaty.
- Publishing the forecasts of all members of the Governing Council.

3.2. Lending in last resort

Until the global financial crisis, lending in last resort used to be treated as a secret weapon to avoid creating moral hazard. Now that the crisis has shown that the advanced economies are not immune to

[18] The idea to form a policy making committee by grouping all member countries into a reasonably small number of constituencies, each with one representative and one vote.

financial crises, lending in last resort is part of central bank toolboxes. The ECB has already announced three programmes: Outright Monetary Transactions (OMT), PEPP and TPI, which involve lending in last resort in the sense that they set no limit to its interventions and can be used to defend specific countries. However, these programmes fall short of international standards.

First, elsewhere, the central banks stand ready to lend unconditionally in last resort to their governments, even though they are usually not allowed to directly lend in normal times. There is no doubt that the central banks would intervene should public debts come under heavy market pressure in the US, the UK, Japan and other developed countries. This certainty has a powerful stabilising effect. In the euro area, the existing programmes involve conditions that must be met by the governments. For some countries at least, there is no certainty.

Second, in most countries, there is an agreement that protects the central bank from bearing losses when it acts as lender in last resort to commercial banks or other financial institutions. No such agreement exists in the euro area. It would have to be signed by all member countries, at least those that wish to benefit from ECB interventions.

Third, the initial ruling the German Federal Constitutional Court that OMT is incompatible with German laws has created legal uncertainty. Asked by the German court for its opinion, the European Court of Justice next ruled that OMT is legal. The German Federal Constitutional Court accepted this ruling but issued some conditions. A few years later, the Public Sector Purchase Programme, one branch of QE but not a lending in last resort programme, was again rejected by the German Federal Constitutional Court, and maintained by the European Court of Justice.

Lending in last resort is not an option. The ECB must be able to conduct emergency interventions when public debts or financial institutions face acute difficulties. Inventing a new programme whenever new potential risks emerge, each with its own set of ad hoc conditions, is not sustainable. The ECB must make the case for becoming a full-blown lender in last resort because central banks are the only institutions that can face up to panicky financial markets thanks to their unique ability to ”do whatever it takes”.

3.3. Safe euro assets

In every advanced economy, the financial system is based on the existence of safe assets, the government's public debt. Safety is provided by the certainty that the central bank will do "whatever it takes" when and if doubts emerge. In the euro area, there is no 100% safe asset because, as explained by de Grauwe (2012), the member countries do not have a central bank of their own. It follows that, say, the German and Italian debts are fundamentally different financial instruments, even if they are labelled in the same currency. The absence of safe assets undermines the financial markets and the international role of the euro. It also explains the contagion that plagued many countries during the debt crisis. This has led to a substantial debate about the need to issue safe euro assets.[19] This debate has led to several proposals.

The challenge is to limit moral hazard. Low debt countries understandably do not want their public debts to be identical to those issued by highly indebted governments. Indeed, it would result in an identical interest rate, presumably higher than those they face, and they could be directly affected in the event that a new debt crisis erupts. At the opposite end, the high debt countries frequently call for mutualising at least parts of all public debts, if only to avoid the risk that monetary policy is not transmitted homogenously across the euro area. In addition, the existence of a large market for safe

[19] This debate and the proposals are summarised in Leandro and Zettelmeyer (2019). See also European Commission (2018).

eurobonds would strengthen the European financial markets and enhance the international role of the euro (Ubide, 2023).

Several of these proposals aim at reconciling clearly opposite views while recognising the potential advantages of safe eurobonds. In fact, eurobonds already exist. The borrowings of the ESM and those incurred by the Commission to finance SURE and NextGenerationEU are guaranteed by all Member States but, in principle, they correspond to exceptional borrowings, with no growth potential. Some further progress seems possible.

Public bond issuance is a matter for national governments, not the ECB. Still, the ECB can issue its own debt. As it routinely conducts open market operations with banks to create (or absorb) money, it swaps cash against bonds. The bulk of these bonds are public. It could instead swap cash against its own debt instruments, call them ECB bills. Over time, ECB bills could become the main – or only – asset traded on the open market. They would circulate among banks and fulfil some of the objectives assigned to eurobonds by the proposals: they would be a safe and joint liability of all central banks part of the Eurosystem. It would also be a powerful tool to ensure the proper transmission of monetary policy since the banks would put up the same collaterals as they trade with the ECB. Moreover, it would go a long way to dissolve the doom loop (presented in Section 2.1.4). Indeed, they would carry a lower rate than government bond yields because of the Eurosystem guarantee, and banks would need to hold them in sufficient quantities to deal with the ECB.

3.4. Climate change

As pressure is growing on governments to make the momentous decisions required by climate change, there have been many suggestions that the ECB ought to make its own contribution. This may seem natural given the central bank's apparently unlimited resources. However, using these resources in financial emergencies is one thing, using them steadily for non-monetary purposes is another. Its new collateral framework and purchases of corporate sector assets lay in a grey zone as it may be seen as trying to favour green assets, as noted in Section 2.2.4. Even though the ECB has been careful to emphasise the governments' responsibility and to outline actions that are mostly dealing with financial risk, its statements are ambiguous enough not to discourage further pressure. It should clarify what it will not do.

3.5. Financial market integration

The ECB, the European Commission and most observers have long been calling for completing the banking union and the capital market union. This is another requirement for the smooth operation of the euro area as well for reaping the benefits of the Single Market. Unfortunately, this is a decision that belongs to governments, which disagree mostly for protectionist reasons. The ECB can only keep repeating the need for decisive progress on an issue that affects monetary policy, financial stability and risk sharing.

4. CONCLUSION

The last strategy review was issued at an unfortunate time, just before the inflation surge. The ECB has now announced a new review in 2025. The previous review took the long-hoped step of embracing the expected inflation strategy, which it had informally practiced for quite some time. An unprecedented level of uncertainty has temporarily hampered the strategy, unfortunately, not just at the ECB but in many other central banks as well. In addition, the TPI represents a welcome but partial step towards accepting its responsibility as lender in last resort to government, leaving open the question of lending in last resort to banks. The TPI also deals with the doom loop, but not decisively. At stake is the need for safe euro assets, to which the ECB can make a useful contribution by issuing its own debt instrument. Finally, climate change is an explicit issue addressed in the 2021 review but too many ambiguities remain. The ECB should eschew mission creep.

Some of these issues require approval by member governments, but they directly affect the sustainability of the euro. As such, they belong to the ECB mandate. As noted by Eichengreen (2019), the member governments are a long way from agreeing to adequate responses. For institutions as for individuals, age 25 is the age of adulthood. It is striking that major issues have been lingering for so long, many of them since the launch of the euro. As a comparison, it may be useful to remember that the US Federal Reserve, which was created in 1913 at a time when the federal government was relatively feeble, suffered from many related weaknesses. It took the Great Depression for the US authorities to pass, 20 years later, the Banking Act of 1933, which still applies. The learning curve was steeper in the US than in EMU. Since its adulthood must be blessed by the parents, the ECB could use its strategy review to nudge them.

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At age 25, the euro has been a historical success, but it has not yet reached an adult stage. The ECB has made much progress and can do more on its own. Its next monetary policy strategy, to be announced in 2025, is an opportunity that should not be missed. Much more is needed from member governments, which are still reluctant to grant the ECB what it needs to become a normal central bank.

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