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This time it is for real – the ECB's accountability amidst rampant inflation

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Abstract

The accountability of the European Central Bank (ECB) is a complicated issue, as it is constitutionally located at a particular intersection of constitutional and international law and as a central bank it has features of both regulatory administration and also of the conduct of economic policy. It is suggested that a key element is that the ECB's responsibility to maintain price stability could be seen as a form of accountability mechanism through which it is ultimately accountable to the people for delivering to them on the promise that money can be trusted as a means of payment and a store of value. The article discusses how the new roles and strategy of the ECB as well as its enormous balance sheet could affect its ability to maintain credibility as a constitutional inflation-fighting central bank. The critical context is the first inflation shock that the ECB is facing since its establishment, where the actions and communication of the ECB will form the means to maintain the trust of the public.

Keywords

European Central Bank, monetary policy, inflation, accountability, EU law, monetary policy transmission, quantitative tightening, price stability, financial stability

1. Introduction

The accountability of public administration is an important but also complex issue, whereby any general accountability theories always need to be complemented with features arising from both the specific constitutional setting and also the type of administration in question. The accountability of the European Central Bank (ECB) takes these complications to the extreme. The EU public administration and its institutions are located at a particular intersection of constitutional and international law. At the same time, central banks have always had a special position within the public

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administration, as they have features of both regulatory administration and also of the conduct of economic policy. While the former is often seen as strict application of law, the latter is perceived as policy-making, and hence they have different accountability mechanisms (in economic terms rules vs. discretion).[1] Furthermore, many features of central banks are functionally similar to private sector (banking), which also forms their main daily counterpart. To increase the complexity further, some central banks, including the ECB from 2014 onwards, also supervise the banking sector.

This article takes due note of the broader forms of accountability, but mainly as necessary background. It also mentions the key features that arise from the ECB's unique nature as an EU institution within a complex multitier administration and multilevel (democratic) accountability model.[2] However, the focus of this article is on the special responsibility that stems from the central bank nature of the ECB, which could also be seen as a form of accountability mechanism. The core claim is that the ECB, like any other (independent) central bank of a liberal society (economy), could be seen as ultimately accountable to the people for delivering to them on the promise that money can be trusted as a means of payment and a store of value. This assumes that the credibility of a central bank in achieving its inflation target and its accountability (responsibility) for maintaining price stability are intrinsically linked. They could be seen as two sides of the same coin. In the case of the ECB, this mechanism could be even more pronounced compared to other major central banks, as it enjoys an exceptional sphere of discretion and independence. This should give it more credibility in maintaining price stability to begin with, but if it were to lose it, the same independence could actually make credibility more difficult to regain. Actually, focusing on the ECB's credibility could be seen to reinstate the original economic-constitutional premises of the ECB that has given away to other and perhaps more progressive aims and objectives of the ECB during the last decade of exceptionally limited inflationary pressures. I confess that my background as a central bank economist leads me to consider these other aims and objectives as conditional on the ECB's ability to maintain inflation expectations anchored at a low level.

In other words, this article discusses the ECB's price stability objective first and foremost as a responsibility of the ECB towards the people of the euro area, for which it is held accountable by the public trust in the currency as a means of payment and a store of value. Clearly, such a definition of accountability is complementary to more traditional forms of accountability. This direct accountability mechanism could be seen as the missing link between the ECB's extreme independence and its weak forms of political and judicial accountability. Incidentally, the means of accountability of the ECB for its primary objective is a timely topic, because inflation, the archenemy of central banks at least since the end of Keynesian heydays, has proven to be much more alive than many had thought or hoped for. In early 2021, inflation started its upward trajectory, which has increasingly become a political and economic problem and begun to challenge the credibility of most major central banks. For the ECB that is facing its first ever inflation shock, this raises important questions concerning its relationship with the euro area public.

1. The title of a famous article by F. Kydland and E. Prescott, 'Rules Rather than Discretion: The Inconsistency of Optimal Plans', 85 *Journal of Political Economy* (1977).
2. F. Scharpf, 'Legitimacy in the Multilevel European polity', 1 *European Political Science Review* (2009) and F. Scharpf, 'Legitimacy Intermediation in the Multilevel European Polity and Its Collapse in the Euro Crisis', 12/6 *MPIfG Discussion Paper* (2012).

I will start by discussing some notions of central banks' accountability models, in particular the case of the ECB and its peculiarities as a supranational and constitutionally independent central bank. A key argument is that the ultimate accountability benchmark of the ECB could actually be the euro area public's trust in euro currency as a means of payment and a store of value. In contrast to any other areas of the EU, the ECB has a direct and measurable link to the general public through the euro and this could explain or even legitimize its exceptional independence from EU and Member States' political power. The analysis then moves from theoretical observations to the current inflationary pressures, which could threaten the credibility of the ECB. I will argue that thanks to its constitutional position and overriding price stability mandate, the ECB should be well equipped to deal with the inflation shock. However, the analysis of the ECB's new monetary policy strategy from 2021 leads to more mixed results, particularly as it increased the flexibility of the ECB and arguably gave it new goals and aims. As we shall see, the more flexible and multifaceted ECB model with its potential benefits in other areas could impose challenges to the new strategy to become the basis of its communication and accountability towards the general public and the financial markets for maintaining price stability.

Indeed, the concluding remarks will address the communication of the ECB as the key forum for its accountability towards the people of the euro area. This communication should be understood broadly, and even could be labelled as the real monetary dialogue with people and financial markets of the euro area that complements the formal monetary dialogue between the ECB and the European Parliament (EP). With such a reading, the ECB's decisions and their reasonings have their primary counterpart in the perceptions and expectations of the public and financial markets. And now this communication faces enormous challenges, if the inflation process shows signs of becoming more self-sustained. Consequently, the ECB's communication needs to address two new pressing issues, namely, why the ECB's forecasts failed to detect the sustained inflation process and how its historically large balance sheet, resulting mainly from the legacy of quantitative easing policies, is taken into account in assessing the current monetary policy stance and the conduct of monetary policy going forward. Through this real monetary dialogue with the people of the euro area, the ECB needs to convince the public of its narrative of being willing and able to get inflation under control. A well-planned communication strategy complemented by clear and decisive actions is the way forward, while paying due respect to the other side of the dialogue, the public's perceptions and expectations.

2. Accountability and inflation-targeting central banks

Before moving to the analysis of the current situation, the necessary background is set out by outlining the general accountability of the ECB as a central bank with a primary objective of price stability. Considering the ECB as both a constitutional and an economic institution highlights two interlinked sides for its accountability: a constitutional law perspective and the general economic rationales related to the inflation-targeting central bank model.

A. The ECB's accountability and price stability

The accountability of the ECB has been a topic worthy of academic research over the last decade, where two recent key inputs include Fromage et al (2019) and Dawson (2023), although the issue was actively debated at the start of the euro.[3] The ECB is a unique institution, largely outside the reach of the political power, but also extremely well protected against changes to its statutes (practically requiring the unanimity of the EU Member States for the most provisions). Such an independence has been explained by the importance of the actual independence of the German Bundesbank as well as by the mainly Anglo-Saxon literature on central banks that stressed independence as a means to solve the time-inconsistency problem of modern central banks that issue fiat money.[4]

Under these circumstances, the theoretical models to assess the ECB's accountability have divided accountability into various forms. *Political accountability* could be defined as being held accountable by the main relevant political power of a given polity. In the case of the ECB, this has been formally mainly towards the European Parliament and in practice more towards the EU Council (Eurogroup). The latter has acted as the main counterpart for the ECB, particularly during the crisis, providing an accountability forum for politically sensitive issues. The accountability of the banking supervision function adds further complications to political accountability, as transparency has a more limited role due to secrecy issues and as the rationales (if any) for independence differ from monetary policy. However, the questions related to banking supervision remain outside the scope of this article.

Judicial accountability reflects the constitutionally protected position of the ECB. As the ECB was made independent from political influence by virtue of Article 130 TFEU, it was left to judicial accountability to delimit the ECB's actions to the areas that were conferred to it and also to ensure that its measures respected EU law more generally (including their proportionality). However, the hopes attached to the judicial process of the CJEU in delimiting and constraining the ECB, and thereby protecting the areas of economic policy-making that were not conferred to the ECB,[5] abated with the landmark cases concerning the ECB's more adventurous policy programmes (*Gauweiler* and *Weiss* cases) and the EMU economic governance more generally (*Pringle* case).[6] The CJEU was clearly reluctant to take a major role in defining the substantive content of the common monetary policy or in defining stricter borderlines

3. D. Fromage et al, 'ECB Independence and Accountability Today: Towards a (Necessary) Redefinition?', 26 *Maastricht Journal of European and Comparative Law* (2019) and M. Dawson (ed.), *Substantive Accountability in Europe's New Economic Governance* (Cambridge University Press, 2023). The key earlier interventions include, for example, J. de Haan and L. Gormley, 'The Democratic Deficit of the European Central Bank' 21 *European Law Revie* (1996), p. 95; F. Amtenbrink, *The Democratic Accountability of Central Banks: A Comparative Study of the European Central Bank* (Hart Publishing 1999) and W. Buiter, 'Alice in Euroland' 37 JCMS (1999), p. 181.
4. I discussed this background thoroughly in K. Tuori, *The Eurosystem and the European Economic Constitution: A Constitutional Analysis of Common Central Banking Before and During the Crisis* (University of Helsinki, 2017). This exceptional element was also noted in the judgment on the Maastricht Treaty by the German federal constitutional court in FCC Maastricht judgment BVerfGE 89, 155.
5. On the earlier discussions, see, for example, R. Smits, *The European Central Bank – Institutional Aspects* (Kluwer Law International, 1997); K. Dyson and K. Featherstone, *The Road To Maastricht. Negotiating Economic and Monetary Union* (Oxford University Press, 2000); H. James, *Making the European Monetary Union* (Belknap Press of Harvard University Press, 2012); F. Amtenbrink and J. de Haan, 'The European Central Bank: An Independent Specialized Organization of Community Law – A Comment', 39 *Common Market Law Review* (2002); and O. Issing, *The Birth of the Euro* (Cambridge University Press, 1998).
6. Case C-62/14 *Gauweiler and Others*, EU:C:2015:400; Case C-493/17 *Weiss and Others*, EU:C:2018:1000; Case C-370/12 *Pringle*, EU:C:2012:756.

between monetary policy and other areas of economic policy that have remained as responsibilities of the Member States.[7]

Administrative accountability can be a major element of the accountability mechanism, particularly within the executive, where an actor would be held accountable within (public) administration mainly according to hierarchical and other administrative lines.[8] However, unlike most other central banks, the ECB and also National Central Banks (NCBs) are detached from the general executive with regard to the conduct of monetary policy, and hence the scope for administrative accountability is limited. Naturally, the ECB remains accountable for accounting issues (including to the European Court of Auditors), but this plays a minor role in the conduct of monetary policy.[9] Furthermore, the internal relations within the ESCB (Eurosystem) could be described as a form of accountability whereby the NCBs could be held accountable by the ECB.

These general means and categories have been utilized to elaborate many sides of the ECB's accountability. In this already quite extensive literature, some positive results concerning the ECB's accountability have been found, but most research points to considerable gaps as well. In general, it could also be added that the ECB has been broadly accommodative towards findings concerning these gaps, and it has made efforts to remain accountable. For example, the monthly press conferences and also the far more extensive written accounts of the past and future monetary policy go well beyond the requirements of its Statute. However, with hindsight it could be claimed that the research on the ECB's accountability, while acknowledging the ECB's unique features as a central bank and as an EU institution, has remained rather theoretical and even detached from reality as long as the inflation environment has remained very benign. That is to say that the ECB has not been held accountable for its main role and objective of maintaining price stability for the simple reason that price stability has not been a major issue due to the benign global price environment. Arguably the most widely discussed issues with respect to price stability have related to deflation threats that the ECB itself has used as justifications for its asset purchases.

I would claim that it is the *public accountability* that has been the missing link in the accountability models for the ECB that would be needed to rationalize the whole EMU model with an extremely independent central bank that is only weakly accountable towards the polity, judiciary or administration for failures in meeting its objectives. Indeed, even if the ECB had caused massive inflation through policy mistakes, there would be no political, judicial or administrative means to force it to follow its mandate, as its independence protects it from any sanctions or even attempts to force it to reconsider its policies. However, this obvious gap can be filled by the ultimate accountability mechanism of public trust in the money that the ECB is issuing. This additional accountability mechanism could then explain the ECB's independence as something else than a grave deviation from the democratic accountability. Such a reading of the ECB's accountability would point toward a narrow model of central banking, as this accountability towards the public cannot cover other central bank objectives than price stability. Next, we discuss the economic rationales before assessing what this means in the current situation.

7. See, for example, F. Amtenbrink and R. Repasi, 'The German Federal Constitutional Court's Decision in Weiss: A Contextual Analysis' 45 *European Law Review* (2020), p. 757 and M. Markakis, *Accountability in the Economic and Monetary Union: Foundations, Policy, and Governance* (Oxford University Press, 2020), esp. Ch 8.
8. M. Bovens, R. Goodin and T. Schillemans (eds.), *The Oxford Handbook of Public Accountability* (Oxford University Press 2014) provides the multitudes of the definitions.
9. This was well explained in the *OLAF* case (Case C-11/00 *Commission of the European Communities v. the European Central Bank*, EU:C:2003:395) and the following discussion, for example, R. Goebel, 'Court of Justice Oversight Over the European Central Bank: Delimiting the ECB's Constitutional Autonomy and Independence in the OLAF Judgment', 29 *Fordham International Law Journal* (2005), and F. Amtenbrink and J. de Haan, 'The European Central Bank', 39 *Common Market Law Review* (2002).

B. Back to basics – inflation shocks as a classic central bank test

The inflation shock of 2021–22 was a novelty in 21st-century central banking, although inflation had been one of the key features of central banking of the second half of the 20th century. Indeed, persistent inflation was the epitome of the last decades of the Keynesian economic policies in the 1960s and the 1970s that led to the shift in the macroeconomic policy-making and governance in the 1980s.[10] At the European level, substantial inflation differentials continued well into the 1980s and were also the key causes for frequent disruptions in the EMS/ERM currency arrangements.[11] Even relatively small but persistent inflation differentials led to substantial losses of competitiveness that made the quasi-fixed exchange rate arrangements fundamentally unstable.

It was therefore at the heart of the new EU monetary policy framework to fight high and variable inflation that was perceived as one of the most destabilizing phenomena for the euro area. An inflation shock has the ability to disturb the economic and financial stability of the euro area not only from a short-term but particularly from a medium-term perspective. In particular, inflation differentials can cause major malfunctions for the whole euro area, as they can cause sustained competitiveness problems for individual Member States, barring other adjustment mechanisms suggested by the theories on optimal currency areas.[12] In particular, the euro area did not begin as an optimal currency area due to limited labour mobility and rigid wages and prices more generally. Unfortunately, there is limited evidence that the first two decades of the euro would have improved the situation markedly.[13] It could therefore be argued that the high (and thus also variable) inflation periods still contain large risks for the euro area particularly if such periods are prolonged and lead to persistent differences in inflation patterns.

At a general level, inflation shocks or inflation scares have been discussed extensively in economics as part of the path toward disinflation and even the 'Great Moderation'.[14] Among the key findings was that people adjust their inflation expectations depending on various factors, of

10. K. Tuori, *The European Central Bank and the European Macroeconomic Constitution: From Ensuring Stability to Fighting Crises* (Cambridge University Press, 2022).
11. The European Monetary System (EMS) was launched in March 1979 as a form of deeper currency cooperation within the Community. At the heart of the system was the Exchange Rate Mechanism (ERM), which specified the fluctuation margins between Member States and how they needed to intervene if margins were reached. The system also included a prevention mechanism whereby a country in trouble would need to take action (interest rates and fiscal policy adjustments). See R. Mundell, 'The European Monetary System 50 Years after Bretton Woods: A Comparison Between Two Systems', tenth edition of the 'Incontri di Rocca Salimbeni' meetings, 1994.
12. Starting already with the classics of optimal currency area, see J.M. Fleming, 'Domestic Financial Policies under Fixed and Floating Exchange Rates', 9 *IMF Staff Papers* (1962) and R. Mundell, 'Capital Mobility and Stabilization Policy Under Fixed and Flexible Exchange Rates', 29 *Canadian Journal of Economic and Political Science* (1963).
13. This could be visible in most criteria for the OCA, including labour mobility. In addition, a recent study by D. Kunovac, D. Palenzuela and Y. Sun, 'A New Optimum Currency Area Index for the Euro Area', *ECB Working Paper Series* 2730 (2022) concluded that: 'Our results indicate that OCA conditions in the euro area have not progressed significantly, even though common symmetric shocks have gained prominence as a driver of the business cycle in the euro area countries. The progress has been slow and was most importantly disrupted by the especially the sovereign debt crisis starting in 2011 in addition to other crises.'
14. The recent focus on deflationary problems may have led to forgetting some of the key economics in the area, for example, in A. Orphanides and J. Williams, 'Inflation Scares and Forecast-Based Monetary Policy', 8 *Review of Economic Dynamics* (2005); C.J. Erceg and A. Levin, 'Imperfect Credibility and Inflation Persistence' 50 *Journal of Monetary Economics* (2003); V. Gaspar and F. Smets, 'Monetary Policy, Price Stability and Output Gap Stabilisation', 5 *International Finance* (2002); M. Goodfriend, 'Interest Rate Policy and the Inflation Scare Problem: 1979–1992', 79 *Federal Reserve Bank of Richmond Economic Quarterly* (1993).

which the credibility of the central bank's inflation objective is an important one and the actual inflation another. If, as was seemingly the case for a long time also in the euro area, the central bank is seen as fully credible in maintaining, and, in case of deviations, returning to, price stability, temporary deviations in inflation do not cause inflation expectations to rise. If, on the other hand, the inflation target is seen only as one among many targets or if the central bank is seen unable to reduce inflation quickly for fear of political interventions or of causing financial instability, the public might adjust its inflation expectations upwards. Under these circumstances, an observed increase in actual inflation is a test for the central bank's credibility, as it causes the public to reconsider and analyse the credibility it assigns to the central bank's price stability objective.

Consequently, an increase in inflation can be seen as the start of communication between the central bank and the public (including financial markets). It calls for the central bank to react in such a manner that the public becomes convinced of its ability and willingness to ensure price stability over the medium term, which then determines the inflation pattern the public expects. How the public sets and adjusts its inflation expectations remains an important part of monetary economics. Some theories stress rational expectations, whereby an independent central bank with a sole low inflation target would suffice to convince people of low inflation going forward. Other theories point to a learning process whereby people adjust their expectations gradually based on observed inflation and also central bank's reactions to any deviation therefrom.[15]

The main elements of an inflation-targeting central bank were developed in the 1980s and 1990s. They include the importance of central bank credibility with a clear inflation target and central bank independence, a medium-term perspective focusing on inflation expectations, and also guiding the public's and financial market's expectations through transparency and signalling. In this setting, central bank accountability is often perceived as a means to achieve credibility and even equalled to transparency. If the central bank is fully credible concerning its ability and determination to keep (or reduce) inflation at the target level, the general public and financial markets will act accordingly, which guarantees well-anchored inflation expectations and a low inflation environment. By and large, this has been the monetary policy setting in the main economies after the disinflation period of the 1980s and early 1990s, where the conduct of monetary policy relied on adjusting official interest rates to steer the economy and inflation expectations towards the chosen inflation target. If the output gap was estimated to turn positive or similarly unemployment rate was expected to fall below NAIRU[16] level, the central bank would increase its policy rate to prevent rising inflation. The important assumption was that with cyclical tools, such as monetary policy, the policymakers could not achieve sustained reduction in unemployment below its natural rate, which in turn is dependent on structural factors.[17]

As these elements were introduced, the inflation levels declined globally. In the heyday of the 'Great Moderation', the focus on maintaining low inflation also reduced economic fluctuations and provided a generally benign economic environment. All the main central banks were perceived credible with regard to their ability and willingness to maintain price stability. However, whether

15. The topic has been discussed extensively, starting from emergence of rational expectations. See for example, T. Sargent, *Rational Expectations and Inflation* (Harper and Row, 1986) or, concerning the euro area policy-making, O. Issing et al., *Imperfect Knowledge and Monetary Policy* (Cambridge University Press, 2006).
16. Non-accelerating inflation rate of unemployment is a common concept in macroeconomics. See for example, M. Goodfriend and R. King, 'The New Neoclassical Synthesis and the Role of Monetary Policy', in *NBER Macroeconomics Annual 1997* (MIT Press, 1997).
17. This largely removed the Keynesian trade-off between low inflation and high employment.

this ‘Great Moderation’ should be attributed to the new economic and political setting remains an open question, as does the question of how much the new policy setting contributed to the build-up of excesses, including extensive lending and risk-taking, that led to the Great Financial Crisis (GFC) globally and the series of crises in the euro area. In any case, the GFC changed central banking thoroughly, at least temporarily. The discussion on central banking became more diverse, and particularly financial stability became an important objective, with a somewhat unspecified relation with price stability. In addition, the objectives of central banks have continued to expand with climate change and even broader social progress, particularly during the Covid-19 pandemic. Importantly, this discussion and even the actual changes in central bank practices have mainly occurred without major constitutional changes. Hence, the overall setting in central banking was relatively unsettled when the old archenemy, inflation, returned in 2021, which will be the focus of the next section.

3. The ECB and its price stability objective 20 years after

The 1990s consensus of an inflation-targeting central bank is still the model that best characterizes the formal central bank setting in major economies, making price stability the main objective of central banks, although perhaps less unconditionally than before. Among major central banks, the ECB (and the whole Eurosystem) is constitutionally exceptionally well positioned to maintain price stability, as its clear price stability objective as well as its institutional safeguards, including independence and prohibition of public sector finances, were designed on the basis of the 1990s consensus on inflation-targeting monetary policy. However, while the constitutional position and all the key Treaty (and Statute) provisions of the ECB have remained intact, the actual situation is different from the first decade of the euro. The policy measures of the ECB during and after the GFC have been perceived to have other aims and objectives, including financial stability and even supporting Member State public finances, which might not fit squarely with the model of a pure inflation-targeting central bank.

The legacy of the quantitative easing in the forms of the PSPP and PEPP programmes could be the most problematic going forward.[18] It remains an open question how the euro area Member States’ economies and financial markets might react if and when by far the largest owner of government bonds starts a large-scale reduction of its holdings. In addition, the new tasks and objectives other than price stability could complicate the inflation reduction task of the ECB, because it is possible or even likely that the new situation gives rise to conflicts of interest between objectives.[19] The ECB’s new monetary policy strategy of 2021 and also the legal practice of the CJEU might add complications as they have arguably increased the area of discretion for the ECB. Consequently, the general public might have started to see the current ECB as a more political than a constitutional central bank, which would complicate its task of reducing inflation and keeping the inflation expectations low. Against this background, it is pertinent to discuss first how we could detect changes, if any, in the ECB’s credibility for maintaining price stability. At the same time, we can simplify the assessment of the current situation into a battle between two

18. Public sector purchase programme (Decision ECB/2015/10 of 4 March 2015) and Pandemic emergency purchase programme (Decision ECB/2020/17 of 24 March 2020).
19. Good discussion and largely the ECB’s perspective on the issue could be found in C. Zilioli and M. Ioannidis, ‘Climate Change and the Mandate of the ECB: Potential and Limits of Monetary Contribution to European Green Policies’, 59 *Common Market Law Review* (2022).

narratives: the ECB as a credible and determined inflation-targeting central bank or the ECB as a more political and engaged central bank.[20] We can also discuss how the ECB could ensure that it is seen as the former rather than the latter.

A. Evidence on the credibility of the ECB

Turning to whether the ECB is still considered credible in maintaining (or returning to) low inflation, this needs to be observed from various indicators. One particular issue is the impact of the ECB's inflation forecasts that failed to detect the seriousness of inflationary pressures, as the ECB's first reaction to increased inflation in 2021 was to declare it temporary and transitory. This approach has been criticized as 'wishful thinking', and could have impacted the ECB's credibility. For example, the former Chief Economist of the ECB, Otmar Issing, has pointed to the failure to react early to rising inflation.[21] However, it is less clear that the failure or at least a delay in necessary reactions was caused by other objectives or policy goals of the ECB, which, in turn, would be most harmful for its credibility. It could also be noted that most other central banks made similar forecasting mistakes. The US Federal Reserve was the first major central bank to become alerted to the new situation, and it continues to stress the difficulty of forecasting and its reliance on 'data-dependent' monetary policy, which is far from the ideal type of forward-looking central bank discussed earlier. Therefore, the ECB's failures in assessing the inflation situation correctly could be blamed on the difficult circumstances, and the public is hardly questioning the ECB's ability more generally, which is positive for the credibility of the ECB going forward.

Interestingly, in many countries the public seems to blame local politicians more than the ECB for the increased inflation. It is even surprising how few commentators in national media blame the ECB for the persistently high inflation, although the ECB's raison d'être is to maintain price stability. Naturally, many other parties might affect the inflation outlook, but it is the ECB that is responsible. This requires further research into whether it indicates a major dis-embeddedness of the ECB that could be a double-edged sword. It makes the ECB's life easier in the short term, but at the same time it could increase costs of achieving price stability in the euro area going forward. How could the ECB be credible in maintaining inflation, if it was not perceived accountable or even criticized for not achieving it?

From these descriptive notions, it is interesting to turn to more observable variables concerning the ECB's credibility and inflation expectations. One key source is the market information on the euro area bond markets, in particular on inflation-indexed bonds. Starting with market expectations of future inflation, the *inflation-linked swap rates*[22] show that inflation expectations have increased both in the short term but also in the longer term. Indeed, both 2-year and 5-year inflation expectations spiked upwards in the first half of 2022 and also the 5/5 rate increased initially but later

20. The political role of the ECB has been raised, for example, in F. Amtenbrink, 'The European Central Bank's Intricate Independence versus Accountability Conundrum in the Post-Crisis Governance Framework', 26 *Maastricht Journal of European and Comparative Law* (2019) and K. Tuori, 'Expert, Stakeholder or Just Politician? New Roles of European Central Bank' (Helsinki Collegium for Advanced Studies, 2013).
21. https://www.bloomberg.com/news/articles/2023-03-05/ecb-policy-pioneer-issing-warns-of-more-inflation-shocks-to-come#xj4y7vzkg. Also, O. Issing, 'The European Central Bank – Still Waiting for Godot?', *Politico*, 24 May 2022.
22. Without getting very technical, these rates refer to market rates on inflation-linked interest rates that are defined in interbank markets, and could be considered generally active and liquid markets. Comparing inflation-linked rates and nominal rates results in inflation expectations (and risks) inherent in nominal rates.

declined to close to 2%. This 5/5 rate refers to expected 5-year forward inflation rate five years from now. In that period, starting from 5 years in the future, none of the current cyclical factors should have any impact. It thus measures the underlying and non-cyclical credibility of the central bank's inflation target by excluding the impact of current issues.

Perhaps most alarmingly, market measures of inflation risks have increased the most, and have remained quite elevated. Particularly, the likelihood of inflation exceeding 2.5% over the next 5 years has increased markedly, while the likelihood of deflation at that time has vanished to zero.[23] However, the potential problem with market information, particularly on government bonds yields, is that they have been heavily influenced by central bank purchases, which reduces their information content significantly (and perhaps also their ability to warn against inflation risks).

Additionally, central banks and other institutions often collect survey information on inflation expectations, from both the general public, professional forecasters and financial market participants that play complementary roles in defining inflation expectations. The evidence from professional forecasters indicates that the broad consensus does not see a major shift in the euro area longer-term inflation expectations: both 2 years ahead and 5 years ahead, inflations have increased only moderately and are still close to 2%.[24] Admittedly, these forecasters have been quite poor in forecasting as of late, and it is relatively unlikely that such forecasts would be the first to signal major deviations in the future path of inflation. Interestingly, consumer expectations have been more alert, particularly on the future path of inflation, although particularly mean (as opposed to median) expectations always have a strong upward bias.[25] The mean (average) expectation are thus pushed upwards by a reasonably large minority that sees substantial inflation and inflation risks ahead of us.

On the basis of this indicative information, it is difficult to draw strong conclusions on how much of the ECB's credibility is at stake. The market information is still relatively calming, although even small movements in wrong directions need to be taken seriously, as credibility is hardly a linear concept. In addition, the ECB is still the main actor in the marketplace, and hence it affects particularly government bond market pricing and market information directly. I would argue that the most alarming issue is that the blame for high inflation by the public and media seems to have multiple addressees, thereby limiting the ECB's 'ownership' of the matter even if its constitutional responsibility is clear. Naturally, Member State economic policy also can and even should affect inflation, particularly if national inflation deviates from the euro area average, but the responsibility for the euro area price stability lies first and foremost with the ECB. Next, we will turn our attention to the ECB's actual policy choices and their communication going forward.

B. Old situation – new circumstances

The increase in inflation, and also the more limited increase in inflation expectations, is a classic situation for central banks. Although the last two decades saw very limited inflationary pressures in the major economies, inflation is still the main threat against which the statutes of most major central banks were designed. The ECB is a case in point with its very anti-inflationary statute and broader constitutional setting, and hence it should be in a very good position to convince the

23. Banca d'Italia Occasional Paper 712
24. www.ecb.europa.eu/stats/ecb_surveys/survey_of_professional_forecasters/html/table_hist_hicp.en.html.
25. www.ecb.europa.eu/stats/ecb_surveys/consumer_exp_survey/results/html/ecb.ces_results_march_2023_inflation.en.html#_Inflation_expectations_three.

public that it is willing and able to maintain price stability over the medium term. Two complications could be considered, however; namely, its balance sheet and its new strategy.

The main completely new element in the current situation is the size of the ECB's (formally the Eurosystem's) balance sheet, as there is limited historical precedent for central banks that issued money to buy assets worth well in excess of 50% of the GDP without causing substantial inflation.[26] Before the balance sheet expansion, the ECB could change its monetary policy stance relatively quickly and mostly with limited structural impact on financial markets. Now the situation is different, as the ECB is by far the largest holder of government bonds, with a balance sheet twice the US Federal Reserve's in relative terms. Since 2015, the purchases (by issuing central bank money) have had a manifold impact on the euro area economy and particularly on all the asset prices. It thus remains to be seen what the impact of a quantitative tightening will be.

Indeed, the procedure for monetary policy tightening and its impact on financial markets remains work in progress. The ECB needs to decide how the policy tightening is balanced between short-term interest rates and balance sheet reductions. The US Federal Reserve chose to signal its tightening first with the Fed Funds rate in March 2022[27], which was soon followed by a reduction plan for its balance sheet.[28] The ECB's monetary policy tightening started in July 2022 with raising the official interest rates. The balance sheet was reduced first by an automatic reduction of Covid-19-related lending to banks barring any new measures. The reduction in government bond holdings waited until March 2023 with a relatively modest initial rate of 15 billion euros monthly, and from June ceasing to reinvest maturing bonds.[29] As a reflection of the concerns that this could affect the government bond markets negatively, the ECB has added some safeguards, including the continuous reinvesting of the more flexible PEPP fully until the end of 2024 (!) and introducing the Transmission Protection Instrument (TPI). [30]

The euro area monetary policy transmission mechanism has become even more complicated, as the Member States' financial structures are likely to react differently to various monetary policy tightening measures. The ECB's government bond sales could have a minor impact on some Members States that in turn are strongly affected by the increased official interest rates, while in other Member States the impacts could be the opposite. Furthermore, liquidity in the euro area also remains excessive according to the ECB,[31] as shown by the TARGET2 imbalances. Hence, the ECB's balance sheet is still enormous and the path for its reduction raises many questions, making it difficult to assess even when the overall ECB's monetary policy stance turns sufficiently restrictive. The ECB's dominant role in the euro area financial markets since 2015, with its extremely lenient financing conditions and zero interest rates, has most likely created many excesses in financial markets that will become more apparent when financing conditions normalize. It is thus not known how far the ECB can tighten its monetary policy before any serious financial instability occurs, similar to the failing Silicon Valley Bank in the US. Furthermore, it is difficult to assess how quickly and how broadly such a financial instability would reduce inflationary pressures.

26. In mid-2022, the Eurosystem balance sheet was almost 70% of the euro area GDP. See, for example, www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230327_1_annex~7ace3bf661.en.pdf.
27. www.federalreserve.gov/monetarypolicy/files/monetary20220316a1.pdf.
28. www.federalreserve.gov/monetarypolicy/files/monetary20220504a1.pdf.
29. www.ecb.europa.eu/press/pr/date/2022/html/ecb.mp221215~f3461d7b6e.en.html and www.ecb.europa.eu/press/pr/date/2023/html/ecb.mp230615~d34cddb4c6.en.html.
30. ECB Press Release, 'The Transmission Protection Instrument', 21 July 2022.
31. www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230327_1_annex~7ace3bf661.en.pdf.

In this complex situation, the role of the ECB would need to be one of clarity and guidance. Presumably, various scenarios have been extensively modelled by the ECB, but the communication and perhaps also reliability of such models remains modest. The exceptionally uncertain starting point combined with an unclear path towards price stability makes the communication very difficult. In central bank language, this lack of certainty is expressed as policy being data-dependent, which is now used also by the ECB following the example of the US Federal Reserve. This is the setting in which the ECB would need to communicate, and become accountable, by using its new monetary policy strategy as a guide.

4. The reviewed strategy and the fight of narratives – a true monetary dialogue

The ECB's credibility in maintaining price stability is being currently tested, if not fully challenged. This increases the importance of the ECB's actions going forward, which are complicated by the unusual or even unique monetary circumstances going into a tightening cycle. Before discussing the role of the ECB's communication with the public and financial markets as the ultimately accountability forum of the ECB, a few elements of the ECB's new monetary policy strategy need to be discussed.

A. The ECB monetary policy strategy changed more than first appeared

The starting point for the ECB's communication on monetary policy is its monetary policy strategy that has just been updated from its original version from 1998 (with a moderate revision in 2003).[32] The ECB strategy review followed the trends in global central banking started by the US Federal Reserve.[33] The main theme was that the operational environment for central banks was seen to have changed through declined neutral interest rates. Lower neutral interest rates leave less room to cut interest rates to counteract downside risks to inflation (deflation risks). As a consequence, the conduct of monetary policy relying solely on setting official short-term interest rates may have lost some of its efficacy. Also in practice, most major central banks had resorted to asset purchases as a complementary monetary policy tool, including the ECB since 2015.

The new ECB strategy was announced in July 2021[34] with a subdued reception in the media and financial market commentators. It was largely seen as formalizing the existing changes in the framework for monetary policy. A clear change was an increase in the numerical definition of price stability from 'below but close to 2%' to 2% over the medium term, which aimed at providing slightly more room for interest rate changes within the positive interest rate territory. Although the ECB did not use the term 'average' inflation rate, it continued to outline the idea that deviations should balance each other out over the medium term. What this means in practice requires further communication from the ECB.

32. ECB press release, 'A Stability-oriented Monetary Policy Strategy for the ESCB', 13 October 1998, www.ecb.europa.eu/press/pr/date/1998/html/pr981013_1.en.html and ECB press release, 'The ECB's Monetary Policy Strategy', 8 May 2003, www.ecb.europa.eu/press/pr/date/2003/html/pr030508_2.en.html.
33. US Federal Reserve Statement on Longer-Run Goals and Monetary Policy Strategy (August 2020), www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications.htm.
34. www.ecb.europa.eu/home/search/review/html/ecb.strategyreview_monpol_strategy_statement.en.html.

The new strategy also formalized asset purchases as a more regular part of monetary policy, particularly to overcome the zero-bound interest rates constraint. Terminology-wise asset purchases are now non-standard monetary policy instead of unconventional monetary policy. Hence, QE is now a more conventional measure than before but still used only when the standard monetary policy of setting short-term interest rates is deemed insufficient. Finally, the strategy review discussed broader economic aims and also potential consequences of monetary policy. In particular, the strategy review addressed the means to incorporate climate change measures to the conduct of monetary policy, although it left open whether climate change mitigation was a formal (secondary) objective.

Indeed, the ECB's other objectives include supporting the general economic policies in the EU, as defined in Article 127(1) TFEU, but this never had an independent role nor was it explicitly referred to. The review did not take a stand on whether this objective should be defined explicitly, as the procedure of defining the general economic policies in the Union was not addressed in the Treaty. This question has received some academic attention lately that, at an extreme, even obliged the ECB to support various policies at the EU level.[35]

In conclusion, the new ECB strategy still maintains the price stability objective at the centre, though while stating that it takes it as given rather than making the case of the benefits of price stability, as was the case in the original strategy. The main change is the increased flexibility: the inflation target is no longer an upper boundary but a point target, with somewhat unclear communication as to the path from deviations. The previous communication that a prolonged deviation on one side could be followed by deviations on the other side is presumably still valid. Flexibility is also increased as to the instruments of monetary policy, whereby interest rates and asset purchases are on a more equal footing than before. In addition, the broad list of other aims and objectives, including financial stability, climate change and even balanced economic growth, potentially gives the ECB more flexibility in selecting the most appropriate policy and instrument mix. However, this increased flexibility could also be perceived as a complication for the ECB's communication and particularly for its accountability.

B. The ECB's communication and the fight between narratives

I argued above that in the inflation-targeting model of central banking, the key aim of the central bank is to become credible in its commitment to maintain price stability. The ECB was deemed to be in a particularly good position to convince the people of its ability and willingness to achieve low inflation, because of its constitutional 'overkill' of not only giving priority to price stability but also adding the objective with various constitutional safeguards.[36] Accordingly, euro area citizens who set their inflation expectations in their longer-term contracts and wage negotiations could rely on the ECB to ensure price stability going forward. However, as the last decade relativized many of the Treaty provisions concerning the monetary policy framework, this could complicate the ECB's task in convincing the people. As mentioned above, the new ECB strategy might have added to this uncertainty with its multiple flexibilities.

35. J. van 't Klooster and N. de Boer, 'What to Do with the ECB's Secondary Mandate', 61 *Journal of Common Market Studies* (2023) and J. Baquero Cruz, 'Karlsruhe and its Discontents', *European University Institute LAW Working Paper* 202 (2022). As mentioned before, these views are not fully shared by the ECB staff, as in C. Zilioli and M. Ioannidis, 59 *Common Market Law Review* (2022).

36. The substantive developments are more thoroughly described in K. Tuori, *The European Central Bank and the European Macroeconomic Constitution: From Ensuring Stability to Fighting Crises*.

Against this background, it could be argued that since the latter half of 2021, the ECB has been involved in the battle of narratives that in the short term defines the path of inflation expectations and in the longer term defines the type of central bank the ECB is perceived to be by the general public and financial markets. The main options for narratives could be described as (1) the ECB remains both willing and able to maintain price stability as its primary objective and would not hesitate to engage even in unpopular measures to ensure a return to price stability (constitutional ECB); or (2) the ECB is slow and hesitant in fighting inflation because it is engaged in areas that could conflict with price stability (political ECB). Naturally, this is a simplification that serves the purpose of highlighting the factors that could be relevant for defining the public and financial market perception of the ECB going forward.

The constitutional and inflation-fighting ECB is still the benchmark model. For most of its existence, the ECB has been able to maintain inflation at a low level, broadly in line with its initial definition of price stability of below 2%. Also, as mentioned earlier, the main longer-term inflation expectations still seem to be anchored relatively well around 2% inflation. However, for the constitutional ECB model to persist, a few issues would need to be addressed. First, the ECB needs to convince the public that its late reactions to rising inflation and its insistence on its temporary nature did not reveal a neglect or wishful thinking on its part, but rather reflected a very difficult forecasting environment. Second, the ECB needs to convince the public and financial markets that it is able to tighten monetary policy sufficiently without causing major damage to the economy and even more so to financial stability. Third, the ECB would benefit from showing that it can reduce its enormous balance sheet and particularly government bond holdings without causing chaos in financial markets or public financing of the Member States. These three interlinked issues could be described differently, but they ultimately check whether the ECB can convince the public that it is able to reverse its key policies, should that be deemed necessary for restoring price stability.

The second narrative of a political ECB is currently mainly a risk rather than a likely outcome. However, given the downsides related to this risk, it is pertinent to ask what the main causes for this narrative to gain traction are. Arguably, first and foremost, a perception of the ECB's inability to bring inflation down in a relatively timely manner would question its ability or willingness to act decisively. This would be made worse by a perception that the ECB is prioritizing other goals over price stability, such as financial stability, public financing or climate change mitigation. Fortunately, these other goals and the price stability objective are generally not seen to be in conflict, neither by professional forecasters, by participants nor by the ECB itself. However, given the expanded role of the ECB in the euro area financial markets and particularly in government bond markets, a conflict of objectives cannot be excluded. For example, it is foreseeable that the ECB could see major disruptions in some sections of the euro area financial markets, while it would still be required to tighten monetary policy. In particular, if the ECB was too cautious with its balance sheet reduction, because it was perceived to know something alarming concerning banks or public finance, this could be detrimental to its credibility as a constitutional inflation-fighting central bank.

Looking forward, and assuming that two such broad narratives are battling out, the question is which one is likely to get an upper hand. The relevant factors include external as well as internal ones. From an economic-constitutional perspective, the internal ones are of most interest, because they link the actions of the ECB to its constitutional setting. However, the external ones could act as the inputs that force out reactions from the ECB. The main external factors could include first a general easing of the inflationary situation. This could be a combination of an easing of global supply side inflationary pressures and the impact of the US Federal Reserve policies on the global demand inflation. Alternatively, a slightly more difficult external factor would be that of global inflationary pressures becoming more persistent, should the secular disinflationary (globalization) trend be coming to an end. Finally, the most difficult external situation could relate to a potential boom-and-bust in the financial and real estate market, initially caused by the central bank liquidity creation, which could lead to major financial instabilities without reducing inflation substantially.

These external factors could be seen as tests for the ECB's accountability as a constitutional central bank that would reveal the ECB's current internal factors through its reactions. Particularly, if the external factors revealed conflicts between objectives and tasks, it would be the reactions of the ECB that would define the overall outcome. These revealed internal factors would define the longer-term outcome for the ECB as a constitutional central bank. The first internal factor would be the ECB's communication on its responsibility over price stability. This is where the new strategy and its flexibility increase complexity, alongside the expanded list of other responsibilities the ECB could be perceived to have taken over. As inflation rose strikingly above the ECB's quantitative definition of price stability and as the inflationary process became more sustained already, this communication or even accountability is essential. The second, and even more complicated, issue would be a clear conflict between the objectives, whereby the ECB would potentially need to distance itself from tackling financial instability or public finance problems in Member States. Should the inflation expectations find their way into longer-term bond yields, this choice between objectives is largely imaginary; the ECB can hardly achieve financial stability without price stability.

5. Conclusions

This article has argued that the accountability model of the ECB is only partial if it excludes the ECB's accountability over provision of price stability to the people of the euro area. That is seen as the ultimate accountability of the ECB that also makes it different from other parts of public administration. Furthermore, this accountability is currently at play as the inflation has exceeded any definitions of price stability. The ECB is facing a test whether it is considered the constitutional central bank with the primary (and overriding) objective of price stability or whether public and financial markets should see it more as a political central bank with multiple goals and objectives. I argue that the narrative of constitutional central bank is still strong but being tested. Moreover, the gravity of the test depends on the ECB's reactions as well as on external factors. The new, more flexible monetary policy strategy and the ECB's enormous balance sheet make its communication more complicated. The ECB would need to emphasize its accountability for providing the euro area with price stability and a long planning horizon; this accountability toward the public would feed its credibility. The stakes could hardly be higher when the ECB engages in a true monetary dialogue with the euro area citizens.

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