Charles Goodhart and Rosa Lastra*

The Changing and Growing Roles of Independent Central Banks Now Do Require a Reconsideration of Their Mandate

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Abstract: In this paper, we analyse why the changing and growing roles of independent Central Banks now do require a reconsideration of their mandate.

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1 Introduction

In this paper, we analyse why the changing and growing roles of independent Central Banks now do require a reconsideration of their mandate.

There are several lines of argument for such a reconsideration, not all of which we can cover in this paper, but the subject is relevant and topical. So, we are delighted to contribute to the symposium issue in the *Journal of Accounting, Economics, and Law: A Convivium* edited by Matthias Thiemann around the main arguments and proposals of Eric Monnet's book on Democracy and Central banking (to be published English by Chicago University Press in 2023). We agree that with central banks having

***Corresponding author: Rosa Lastra**, Professor, Sir John Lubbock Chair in Banking Law, Centre for Commercial Law Studies, Queen Mary University of London, London WC2A 3JB, UK,
E-mail: r.lastra@qmul.ac.uk
Charles Goodhart, Emeritus Professor, London School of Economics and Political Science, London WC2A 2AE, UK

a wider mandate, and at the same time their confidence in being able to control inflation coming under greater question, the issue of how central banks should be held accountable is gaining ever more traction. Eric Monnet's proposal for a Credit Council is an interesting way of providing a further mechanism of accountability in the light of the expanded set of tools of the ECB – including the prospect of financing the green transition[1] – and in line with the need to provide greater democratic legitimacy, though in the UK the tripartite group of the Bank of England, HM Treasury and the [now defunct] Financial Services Authority (FSA) proved rather a disaster.

One issue that is currently coming to the fore is that renewables, solar and wind, are far more sensitive to the cost of capital than fossil fuels, since their input is free and the cost of construction (i.e. capital), represents almost the total cost. So there is a strongly put argument from the green side that, in order to get to net zero quicker, we should subsidise the capital cost of building renewables. The suggestion is then made that the central bank should be prepared to provide such a subsidy, rather along the lines of the ECB's Targeted Longer-Term Refinancing Operations, TLTROs.[2] The response to that, however, is that any such decision is inherently political. If the politicians should want that, they should change the mandate of the central bank. The central bank could, and should, not do it off its own bat. We do not, however, pursue this further in this paper, though we come back to the issue of expanded central bank mandates in Sections 3 and 4.

Instead, in Section 2, we review the context of the then current economic theories and macroeconomic background which led at the end of the 1980s and the beginning of the 1990s to the adoption of a combination of more independent central banking, with operational independence and a mandate for achieving an inflation

1 See *inter alia* https://www.ecb.europa.eu/ecb/climate/html/index.en.html.

At Stefan Ingves' farewell conference in Stockholm in January 2023, there was an interesting interaction between Fed Chairman J. Powell declaring that the Fed would not get involved in climate change issues while at the same time Isabel Schnabel of the ECB stated that ECB would continue to provide support for green initiatives. The FT ran an editorial on these divergent approaches at https://www.ft.com/content/30da304d-5a82-439c-b767-3ed6dec6f8c0 The impact of climate change on central banking (comparing the statutory goals of the European Central Bank, the US Federal Reserve System and Bank of England) is analysed by one of us, Rosa Lastra, in an article co-authored with Christina Skinner on "Sustainable Central banking" forthcoming in the Virginia Journal of International Law, Vol. 61, 2023.

2 For further information see https://www.ecb.europa.eu/mopo/implement/omo/tltro/html/index.en.html. The targeted longer-term refinancing operations (TLTROs) are Eurosystem operations that provide financing to credit institutions. By offering banks long-term funding at attractive conditions they preserve favourable borrowing conditions for banks and stimulate bank lending to the real economy. A first series of TLTROs was announced on 5 June 2014, a second series (TLTRO II) on 10 March 2016 and a third series (TLTRO III) on 7 March 2019.

target (IT), as a means of maintaining price stability. We explain how the underlying economic conditions led to the operation of such a system being rather different, and quite a lot easier, than had been initially expected.

In Section 3, we describe how a variety of developments led to the accretion of several additional objectives for central banks beyond price stability: financial stability, crisis management, and climate change.

In Section 4, we go on to discuss how Covid, and the measures used to counter that, and the Ukraine War have both put further pressure on central banks, and also have led to the need to refashion the relationship between the Treasury (Ministry of Finance) and the central bank.

Then in Section 5, in the light of the developments that we have outlined in Section 2 through 4, we argue that the separation of the operations of monetary and fiscal policies needs reconsideration and, perhaps, reformulation. We recommend a new institutional arrangement that recognizes that the tools must be coordinated without undermining the virtues of central bank independence (CBI).[3]

2 The Early Years of CBI and Inflation Targetry

The initial move to CBI and IT at the end of the 1980s in New Zealand did not come about as a conscious revision of monetary policy, but rather as a by-product of a more general need to provide a clear set of objectives to which the public sector, nationalised, industries could be held accountable. In the previous decade, the then Prime Minister of the National Party, Sir Robert Muldoon, had intervened, often massively, in industrial matters, with very mixed results. The incoming Labour Party, with Prime Minister Lange, and Finance Minister Roger Douglas, wanted to abandon political interference into these industries. In order to do so, they wanted to provide each of these industries with a clear, and if possible quantifiable, objective to which the CEO would be held accountable. In the course of this process, it was realised that the central bank, the Reserve Bank of New Zealand, was among the list of such publicly-owned nationalised companies. So the question then arose, 'Exactly what was the objective of the RBNZ?' After a certain amount of discussion, it became generally agreed that the objective of a central bank must be price

3 See also Moutot (2020) and Dabrowski 2021.

Dabrowski warns of the danger that rising public sector debt ratios and quantitative easing (QE) could enhance the risk of fiscal dominance over monetary policy. Now that inflation has spiked, while governments in Europe have had to extend fiscal deficits to offset the cost of living crisis, caused by the Ukraine war, we would contend that risk has come so closely into effect that steps should be taken to manage and reformulate the relationship between fiscal and monetary policies, without abandoning central bank independence (CBI).

stability, and with a floating exchange rate, this meant internal domestic price stability. How is this to be quantified? By having an inflation target. This was originally set as lying between 1 and 4%. There were then, as subsequently, a range of arguments, which need not be rehearsed here, for setting the inflation target at a small positive rate, rather than at zero.[4]

So, the origin of CBI and IT in New Zealand owed relatively little to the then currently fashionable macroeconomic theories. Nevertheless, this institutional move fitted extremely well into several current theoretical positions as well as with the general view that the more independent central banks in Germany and Switzerland had performed better in the previous stagflation. There were two in particular. The first was the argument about time inconsistency (Kydland and Prescott), and its related empirical associate, the idea of the political business cycle.[5] The general idea was that politicians would claim always to want to maintain price stability. But because expansionary (monetary) policy would raise output first, with inflation only following with a lag, there would be a tendency for the politicians to over-expand in the run up to an election, and then be forced to step on the brakes when the subsequent inflationary pressure emerged.

The emphasis on the role of an inflation target, if reasonably successfully achieved, to anchor expectations, and thereby assist in returning inflation to target with less need for strong policy action, was less in evidence at that time than later, but was still considered important in some quarters, especially among the more theoretical economists espousing rational expectations.[6]

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4 One of the authors of this paper, Goodhart, was an external adviser to the RBNZ during this period. He also advocated having an incentive payments programme, so that the Governor's remuneration should depend on how closely the target was achieved. This was discussed, but, rightly, rejected on presentational and PR grounds. Thus there was a fear that there could be headlines in the following form, 'Governor raises his own pay by NZ$ 5000 by throwing 5000 people out of work!'. Goodhart (2010) provided an account of the adoption of inflation targetry in his 2010 paper on 'The political economy of inflation targets: New Zealand and the UK'. The best and most comprehensive account of this development is to be found in Singleton, Grimes, Hawke, and Holmes (2006), *Innovation and Independence: The Reserve Bank of New Zealand, 1973–2001*.

5 Kydland & Prescott, 1977, and Nordhaus, 1975 and 1989.

6 For a compilation of the literature on rational expectations (including the seminal work by John Muth on "Rational Expectations and the Theory of Price Movements," originally published in 1961 in *Econometrica*) see Lucas and Sargent 1981, https://www.jstor.org/stable/10.5749/j.ctttssh5.

Although the new classical economics based on rational expectations and continuously clearing markets, had greatly influenced academic economists by this time, it had virtually no influence on those in charge of policy decisions. The gap between theoretical economics and political economy had widened, and still remains wider than usual. See, for example, Blinder (2022) and Blanchard et al., 2022.

The second main theoretical argument in support of CBI and IT depended on the belief in a vertical medium and longer run Phillips Curve. This implied that monetary policy measures would only affect output in the relatively short-run. In the medium and longer term, monetary measures could only affect nominal, not real, variables. So, the best that monetary policy could do in the longer term would be to maintain price stability. Indeed, the long-run Phillips Curve might even be backwards bending, in the sense that maintained inflation would actually reduce output because of the various distortions involved and efforts to avoid that. This argument has been nicely set out by Harold James in his Tawney Lecture in the *Economic History Review*, 2022:

> The linked arguments of the late twentieth century about the monetary policy framework of disinflation – central bank independence and the adoption of an inflation target – were predicated on the belief in the long-term verticality of the Phillips curve.[7] No amount of inflation could, in the long run, affect output or productivity. All that would occur was that the bad sides of inflation – its equivalence to a regressive tax, its distortion of market signals – would be more and more apparent. The literature initially developed on the basis of an appreciation that establishing firm commitment mechanisms was an essential element in the establishment of policy credibility.[8] This approach emphasised the contractual element of the position of central banks, and consequently focused on the explicitly defined terms of contracts or laws establishing central banks. Monetary policy in a very precisely delimited way could be delegated by politics to a particular body of experts.[9] The idea was backed by theoretical academic work that modelled the effect of a 'conservative central banker'. It seems that the authors of this literature had in mind the behaviour of a real-life figure, the commanding figure of Paul Volcker.[10]

The fact that CBI and IT fitted in so nicely with the current dominant macroeconomic theories, and also that in the early years of the Great Moderation worked so well, led to this institutional structure becoming effectively dominant world-wide. That said, however, the experience, both of the early years, and indeed subsequently, was really rather different from what might have been initially expected. In the first place, the 'time inconsistency' and 'political business cycle' arguments implied that central banks would frequently, if not generally, act in a way that would make them unpopular with Ministers of Finance. In practice this rarely happened. Not perhaps surprisingly, since their independence was always subject to the good will of the government, central banks almost always refrained from raising interest rates in the immediate run-up to elections. But more generally over the decades from the 1990s to 2020, there was a sizeable long-term trend decline in nominal interest rates. This allowed Ministers of Finance to adjust fiscal policy in

7 Rogoff (2007), 'Impact of globalization'.

8 Kydland and Prescott, 'Rule rather than discretion'; Barro and Gordon, 'Rules, discretion and reputation'.

9 See Tucker (2019), *Unelected power.*

10 Rogoff (1985), 'Optimal degree of commitment'.

such a way that public sector deficits and debt ratios continuously increased without any increase in debt service ratios. Rather than being at loggerheads, central banks and Ministers of Finance became the very best of friends most of the time.

Second, the vertical Phillips curve largely disappeared from sight. Instead, what happened was that the Phillips curve appeared to become ever more horizontal, thereby seemingly allowing the central bank to run the economy at ever hotter levels without any danger of subsequent inflation. Similarly on this front, central banks and Ministers of Finance appeared to become best friends, rather than enemies.

In short, the separation of policymaking between an independent central bank and a politically determined fiscal policy never got seriously tested before 2021.

3 Evolution of Central Bank Objectives

In this section we describe how a variety of developments led to the accretion of several additional objectives for central banks. Some of these developments were unforeseen, as in the case of the need for central banks to play closer attention to financial stability issues in the aftermath of the GFC. In some part, the relative success of central banks in meeting their inflation targets during these years meant that they were thought to be able to achieve other objectives, in addition to their inflation target and price stability.

Central banks are creatures of history. Their mandates have been adjusted over time since the first central banks – the Riksbank and the Bank of England – were established in the 17th century. From war financing to stable money and sound banking (in modern parlance, monetary and financial stability), the evolution of central bank objectives and functions is characterised by a dynamic character.

The emphasis on price stability (in itself a narrow mandate) should be understood in the historical context of the latter part of the 20th century. As indicated in the earlier section with regard to New Zealand, from the early 1990s a consensus developed around a “central banking model” in line with the Tinbergen rule – of one agency (the central bank), one primary objective (price stability) and one main instrument (interest rate policy).[11] This became the norm: from the EU Member States that signed the Maastricht Treaty to many countries that revised their central

11 The relationship between the monetary aggregates and nominal incomes had become unstable in the 1980s, leading central banks to focus on interest rate control, rather than monetary supply control. That preference was reinforced when many monetarists, mainly in the USA, predicted, incorrectly, that a massive expansion in the monetary base in 2009 would lead to an equivalent sharp rise in inflation; see Blinder (2022) and Bernanke (2022).

bank laws, often based on IMF recommendations. In the U.S., the history dates from the 1970s—and arguably the 1950s—with a *de facto* understanding of the primacy of price stability relative to maximum employment (even though during the pandemic the latter goal was frequently invoked, as pointed out in Lastra and Skinner).[12]

The narrow-mandate central banking *model* was based on the notion of monetary independence in order to control inflation. This *model* facilitated accountability, preserved the legitimacy of a technocratic agency, and safeguarded the much cherished independence that ensures credibility in monetary policy.

But the consensus around this *model* started to splinter with the global financial crisis – a Black swan event in the words of Nassim Taleb, 2011. Central banks faced unprecedented challenges – e.g., the complex dynamics between monetary, fiscal, and sovereign debt policies and the renewed emphasis on financial stability – and, acting as 'crisis managers', started using an ever increasing range of unconventional tools of monetary policy and facilities for emergency liquidity assistance. Once interest rates had reached the zero lower bound (ZLB), and central banks resorted to QE operations, the size of most developed central banks' balance sheet started to expand without any clear limit.

While price stability was easily defined and targeted (as we observed in Section 2), the same cannot be said about financial stability. The latter is a broad and discretionary concept often more identifiable in its negative dimension (of what is instability or the materialization of systemic risk) than in positive terms. Furthermore, and distinct from price stability whose pursuit is the domain of independent central banks, financial stability is a shared responsibility with the Government and other supervisory agencies, and with other authorities at different levels of governance (national, regional and international).[13] Indeed, financial stability is a goal that nowadays transcends geographic boundaries and institutional mandates. In addition, there are also multiple instruments to achieve this goal while the pursuit of the goal of price stability relied upon one instrument: interest rate policy.

The role of central banks as crisis managers further expanded and acquired new contours during the COVID crisis and in the responses to the pandemic, which

12 Lastra and Skinner (2023). 'Sustainable Central Banking' forthcoming as an article in the Virginia Journal of International Law, Vol. 61.

13 The Financial Stability Oversight Council (FSOC) in the US is a good example of the multiple authorities involved in the pursuit of financial stability. The FSOC is made up of 10 voting members under the chairmanship of the Secretary of the Treasury (the other nine member are the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the Bureau of Consumer Financial Protection, the Chair of the SEC, the Chair of the Commodity Future Trading Commission, the Chair of FDIC, the Chair of the Federal Housing Finance Agency, the chair of the National Credit Union Administration, and an independent member with insurance expertise) and five nonvoting members.

led to a very close cooperation between central banks and fiscal authorities in the announcement of exceptional measures of economic and monetary support. But the ever expanding use of QE programs for reasons beyond the original intent of QE in 2009 to 'unclog' the bank lending channel[14] points towards 'fiscal dominance' and monetary finance.[15]

The "tragedy on the horizon", quoting Mark Carney, is the most recent challenge for central banks. In Carney (2015) described climate change with these words, lamenting that it fell outside "the horizon of technocratic authorities, like central banks, who are bound by their mandates." For a more nuanced view see Lastra and Skinner (2023).

While no one doubts the importance of taking climate change adaptation and mitigation strategies seriously into account, the question arises: what is the best distribution of tasks between political authorities (in charge of taxation, expenditure, legislation and regulation) and depoliticised independent agencies with narrower mandates and more limited tools? And how to guard against the dangers of politicisation and conflicting mandates?

In the new mode or model of central banking, central banks have been entrusted with multiple and broader objectives (price stability, financial stability, climate change), additional functions (macroprudential policy and crisis management in addition to monetary policy, acting as lender of last resort (LOLR) and supervision and multiple powers or tools.

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14 https://www.bankofengland.co.uk/-/media/boe/files/speech/2009/mervyn-king-to-cbi-dinner. Mervyn King stated in 2009: "There is a fine dividing line between helping to oil the wheels in markets which are temporarily impaired, and artificially supporting markets".

15 Fiscal dominance can be defined as a condition wherein central banks deviate from their mandate to maintain price stability (by achieving their inflation target), in order to help finance, and cheapen, the debt sales of the Government, again see Dabrowski (2021). Financial dominance is similarly said to occur when a central bank deviates from its mandated objective in order to support fragile financial markets.

For a comprehensive explanation and critique of QE in the UK, US, EU and Japan, see the report of the House of Lords, Economic Affairs Committee, 'Quantitative Easing: a dangerous addiction?' 16 July 2021 - HL Paper 42, at https://committees.parliament.uk/publications/6725/documents/71894/default/. One of us, Lastra, acted as Specialist Adviser to the House of Lords in this inquiry. QE was first introduce in Japan in 2001. In the UK, the original intent of QE (2009) was to 'unclog' the bank lending channel to the private sector and to increase the money supply. The website of the Bank talks about two transmission mechanisms: (1) by creating this 'new' money, the Bank aims to boost spending and investment in the economy by making it cheaper for households and businesses to borrow money and (2) the 'wealth effect' since QE can stimulate the economy by boosting a wide range of financial asset prices. (See https://www.bankofengland.co.uk/monetary-policy/quantitative-easing). Lord Turner referred in his evidence to the Committee referred to a 'third transmission mechanism': "lubricating a fiscal expansion" (monetary financing) while Daniela Gabor told the Committee: "QE has fiscal spill-overs that are poorly theorised and poorly understood".

A broader central banking agenda is more susceptible to politicization. In his oral evidence, Otmar Issing told the Economic Affairs Committee during the House of Lords QE inquiry that “central banks have come closer to political decisions during the financial crisis and now in the context of the pandemic”. If we add climate change and environmental sustainability to the mandates of central banks, these dangers will surely have increased, and with them the potential damage to the reputation and credibility of central banks in the pursuit of their primary goal of price stability.

The problem with credibility is that it is laborious to construct and easy to destruct as the recent crisis in the UK clearly evidences. If central banks overstep their mandates, or are perceived to do so, they lose credibility and endanger their legitimacy. This not only threatens the effectiveness of monetary policy but can also undermine the general trust in the commitment of the central bank to fulfil its mandate of keeping inflation under control.

Since 2021 developed countries started to question monetary stimulus as inflationary pressures emerged. Some central banks announced major changes, a situation referred to as the ‘normalization’ of monetary policy (Panetta, 2022). The problem is that inflation soon became unexpectedly very high in most advanced economies.[16] This happened at a time in which central banks had accumulated large debt holdings through QE and the two alternative methods of tightening policy, namely to raise the level of official short rates or to sell the asset holdings (Quantitative Tightening or QT) back into the market (or let them run off at maturity without replacements), are not always in sync. For example, the instrument announced by the ECB in July 2021 to address bond market fragmentation, the so-called Transmission Protection Instrument (TPI), if activated, would controversially imply more asset purchases at a time of surging inflation in the eurozone (Bernoth et al., 2022). In the UK, the support by the Financial Policy Committee of the Bank of England of the pension fund industry, in response to the dysfunction in the gilt market following the mini-Budget announced by the then Chancellor Kwasi Kwarteng in September 2022, was the first time that the Bank had intervened via QE in the financial markets for reasons of financial stability. The Bank was purchasing gilts at the same time as the Monetary Policy Committee was setting out the

16 As noted *inter alia* by Reinhart and Graf von Luckner 2022: “Inflation has come faster, spiked more markedly, and proved to be more stubborn and persistent than major central banks initially thought possible. After initially dominating headlines in the United States, the problem has become a centerpiece of policy discussions in many other advanced economies (AEs). In 15 of the 34 countries classified as AEs by the International Monetary Fund’s World Economic Outlook, 12-month inflation through December 2021 was running above 5%. Such a sudden, shared jump in high inflation (by modern standards) has not been seen in more than 20 years. Nor is this inflationary surge limited to wealthy countries.” See also Charles Goodhart at https://www.worldfinance.com/strategy/is-inflation-here-to-stay.

importance of QT on the monetary policy side for price stability considerations (Aikman and Barwell, 2022).

4 Covid, Ukraine and Other Current Problems

The record shows, as demonstrated by Goodhart & Pradhan (2020), that when the last two crises have struck, first the Global Financial Crisis and then Covid/Ukraine, central banks have tended in both cases to underestimate considerably the speed and strength of recovery that subsequently occurred. Since these crises were in several ways unique, and there were elements, such as the availability of effective vaccines for Covid that could hardly be forecast in advance, such errors were not, perhaps, surprising. Moreover, labour markets remained much tighter, even after the arrival of these vaccines, than had been expected, so the sharp rise in inflation in the second half of 2021 was not predicted.[17] And then, of course, came the Ukraine war in early 2022, providing a huge adverse supply shock particularly for Europe and the UK. Meanwhile, in the US the expansion of both fiscal and monetary policies went far further than necessary, given the advent of such vaccines.

There remains a division, however, between two opposite understandings. On the one side, those who believe that once, and when, the Ukraine shock disappears, other supply frictions fall away, and cuts in living standards force more of the aged back into work, inflation may return quite quickly to target (within an underlying context of remaining disinflationary and lower for longer). On the other side, there are those, like ourselves, who believe that the labour market tightness will persist for sufficiently long to require interest rates to be raised to levels that will bring about such a recession and reduction in output that pressure will be placed on central banks to soften their policies before the inflation target is regained.

17 Monetarists, such as Tim Congdon and John Greenwood in the UK, (personal email correspondence), also claim that the surge in inflation in 2021 could, and should, have been predicted from the prior spike in (broad) money growth in 2020. How might one reconcile the limited connection between money and nominal incomes during the Great Moderation with a revived relationship during the recent Covid crisis? One answer could be that in normal times, e.g. when the broad monetary aggregates are growing somewhere between 1% and 8% per annum and nominal incomes between 2 and 6%, the frequent fluctuations in financial developments, and monetary velocity, tend to obscure any underlying relationship. But when monetary growth is extreme, say negative or above 10% p.a., it *is* a signal that needs, at the least, careful examination and (public) explanation, even if not countervailing action. Tim Congdon is making just such a proposal. There is also now a small literature testing whether extreme fluctuations in (broad) monetary aggregates are linked to similar fluctuations in nominal incomes and inflation, whereas minor fluctuations in money have no discernible relationship with nominal incomes and inflation, see Papadia and Cadamuro (2021), De Grauwe and Polan (2005), and Borio, et al. (2023).

An underlying problem has come into view. Monetary policy restricts inflation by tightening interest rates and reducing demand. Almost by definition, central banks cannot increase supply. But both the reduction in demand and output and the increase in interest rates will worsen the overall fiscal deficit, perhaps quite severely. Given the already historically very high public sector debt ratios, such increases in deficits can easily lead investors to worry about the sustainability of such debt. The recent, September/October 2022, potential collapse in the UK gilts market, after an unfunded mini budget involving large tax reductions, provided a pertinent empirical example of this syndrome. What this means is that an attempt to rely on monetary policy alone to combat inflation, and thereby return to the inflation target, under present circumstances will not, and cannot, succeed unless it is complemented with an appropriate fiscal policy that can reassure investors of debt sustainability. The implication is that central banks now cannot, by themselves, achieve their mandated objective of price stability, unless fiscal policy is under adequate control. This immediately puts the separation, always less than it superficially appeared, between an independent central bank and a politically determined fiscal policy under much greater pressure than in the earlier years. We explore how the enhanced need for complementary between monetary and fiscal policy might lead to a change in the central bank mandate in the next and final Section. (Also see Biondi, 2018).

5 Reconsidering the Separation Between Monetary and Fiscal Policy

Ever since the adoption of central bank independence (CBI) and, with it, inflation targetry (IT) in the early 1990s, the operations of monetary and fiscal policies have been formally separated. We argue that such separation needs reconsideration and, perhaps, reformulation.

Thus, when setting the instrument(s) of monetary policy, the relevant Monetary Policy Committee in each country, and especially its Chair, has to take fiscal policy as given, and is not supposed to express any criticism of such policy, at least in public. In the discussion in *Central Banking*, between Daniel Hinge and Christopher Sims, 'On modelling the inflation surge' (26 October, 2022), the following exchange took place:

> Hinge – You mention that central bank models are often criticised for failing to predict the latest shock .... Do you see that as a failure of the models?
>
> Sims – I think to some extent it is a failure (...). In fact, monetary policy can fail to have the usual effects if it is not accompanied by these required fiscal changes. Fiscal policy must, at least

> eventually, contract somewhat in response as inflation rises. We're now in a situation where the debt is so much bigger that the effects of interest rates on the budget are bigger by a large factor.

In so far as the shocks hitting the economy were primarily demand shocks, the stabilization of prices, i.e. hitting the inflation target, would as a generality, also lead to the achievement of a stable equilibrium output gap, a 'divine coincidence'. In that case, fiscal policy need not concern itself with problems of macroeconomic stabilisation, but could focus instead on issues relating to resource allocation and income distribution. In looking forward to prospects for future fiscal deficits and changes in the public sector debt ratio, the relevant body in charge of doing this, such as the Congressional Budget Office in the USA, or the Office for Budget Responsibility in the UK, could assume that inflation would be held to target in future years, and with that nominal and real interest rates held stable, and preferably low, as in recent years. By the same token, the officials in the Treasury (Ministry of Finance) and their political masters have been supposed to make no comment or criticism about the conduct of monetary policy, although this has not prevented opposition politicians from criticising the central bank.

This formal separation worked really quite well until recently, apart from the view that the Global Financial Crisis arose partly as a result of inadequate financial supervision, which was largely, in many countries, also the job of the central bank. That said, central banks reacted quickly and effectively to that downturn. Moreover, inflation from the 1990s until 2021 remained extraordinarily close on average to target. And, apart from the GFC, the output gap was generally kept low. After a period of successful growth during the Great Moderation, growth overall became somewhat disappointing, but this could hardly be blamed on monetary policy, or the separation of policies.

But in the last couple of years, the context, and with it the separation of policies, has become much more difficult to sustain. First, the recent shocks, both the Covid pandemic and even more acutely the Ukraine war, have been clearly, in large part, supply shocks rather than demand shocks. This makes the conduct of monetary policy much more difficult, because tightening on demand in the face of a supply shock will make the decline in output even worse. There will have to be a trade-off between recession and bringing inflation down, and that tradeoff is surely political.

Second, from the time of the GFC onwards, monetary policy was not able by itself to bring inflation back up to target and to maintain a satisfactory level of output by itself without the assistance of expansionary fiscal policy. This was very largely due to the effective lower bound (ELB) to nominal interest rates. As a result, the fiscal deficit increased sharply, and the public sector debt ratio widened abruptly during the years from 2008 onwards, to levels that had previously only been seen during the special occasion of wars. Unlike wars, which can be expected to end, the further

projections of deficits and public sector debt were that they would continue to expand sharply over the foreseeable horizon, at least to 2050 under present policies, largely driven by the medical and other public sector expenses of looking after an increasingly aged population. But, before the last couple of years, such a projection of ever-expanding public sector deficit and debt caused little alarm. The reason for that was that growth despite being quite anaemic, at little over one percent per year, was nevertheless higher than interest rates, which were historically exceptionally low both in nominal and real terms. With nominal growth greater than nominal interest rates, with the latter near zero, the continuing sharp rise in the public sector debt ratio led to no increase whatsoever in the debt service ratio, since the fall in interest rates offset, more or less exactly, the rise in public sector debt, see Blanchard (2019).

But all this depended on the underlying context remaining disinflationary. Now that we have an inflationary upsurge, and one that may continue because of a growing shortage of those of working age, while the ranks of the aged increase, the context for monetary policy has become much more difficult, see Goodhart and Pradhan (2020). Trying to restrain demand sufficiently to bring inflation back down to target, would inevitably weaken tax revenues and raise certain expenditures, e.g. unemployment benefits, thereby worsening the primary deficit, while at the same time the sharp rise in interest rates, now much higher than growth, would lead to a, potentially massive, increase in the debt service burden. As clearly evidenced by the market response to the Kwarteng mini-budget, this could well bring issues of debt sustainability for almost any advanced economy back into focus, even including the USA. The very large subsequent increase in the borrowing requirement could cause the sovereign debt market to become unhinged. A sharp, especially if disorderly, rise in long-term public sector debt yields, would then just make things worse, so the central bank might be forced to step in (again) to monetise the debt. And that, in turn, would mean that the pressure to maintain the inflation target could no longer be maintained.[18]

In other words, the central bank can no longer expect to successfully meet its mandate for price stability without the support of an appropriate degree of fiscal retrenchment. So our conclusion is that the prior degree of separation between monetary and fiscal policy can no longer be maintained. And we need to reconsider

18 We could consider the time scale of the return to the inflation target with the ability of the Treasury (Ministry of Finance) to adjust such time scale as well as the definition of the target, taking into account other variables currently not included such as housing and/or the effects of worsening deficits and debt ratios.

Megan Green writes in the FT on 1st November 2022, “There’s one inflation gauge that bucks the trend” about benefits of the New York Fed’s underlying inflation gauge (UIG), an index that looks at moves in prices, the labor market, financial markets and the real economy.

the institutional structure in order to enable an appropriate degree of coordination between the two arms of policy. How that may be done – via amendments to remit letters, changes in the nature of the consultations (from informal to formal), staff exchanges, scope of the work of OBR/CBO or other arrangements – needs to be carefully considered to preserve the virtues of central bank independence, and should be the subject of further work.[19]

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19 Though Eric Monnet advocates a Credit Council, in our opinion, a revised mandate would combine clarity and accountability.

See also Allen 2022. Allen argues that the way in which the Bank of England is organised has become outdated and that the Bank of England needs to be re-organised to eliminate the arbitrary distinction between monetary policy and financial stability. He argues that the separation of decision making among the various bodies within the Bank of England – the Monetary Policy Committee, the Financial Policy Committee and the executive management of the Bank – has become anomalous and he advocates a radical simplification of the Bank of England's management structure in the interests of more efficient decision making and greater transparency. He proposes that the Bank of England should in future be managed by a single board, including members recruited outside the Bank's regular staff, mandated to meet the Bank's objectives for both price stability and financial stability, and empowered to decide what operations the Bank should undertake in financial markets. (The objectives of the Bank would remain unchanged).

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