5. **How can the Eurosystem become (and remain) independent?** …

**Introduction**

A large body of literature has emerged in recent years on the importance of central bank independence. This literature has influenced greatly the design of the European Central Bank and has given rise to institutional changes in several countries aimed at making their central banks independent.

The argument for giving independence to central banks rests on the benefits that such independence can bring to the conduct of monetary policy and thus to the credibility of the institution. Credibility can be defined as the extent to which market participants believe that the central bank will achieve its goals. If a central bank is independent, it can conduct monetary policy with the aim of achieving its primary objective. If it is not independent, it can be subject to pressures to pursue other goals. Indeed, monetary policy can be directed at different and at times conflicting objectives, such as price stability and economic growth.

The effectiveness of monetary policy depends on agents’ expectations. Monetary policy is most effective in the area of inflation when agents perfectly anticipate it; it is most effective on real economic variables, such as output or employment, when agents do not fully anticipate the intentions of the authorities. If monetary policy is aimed at controlling inflation, the central bank should act in a way that allows agents to anticipate its actions. If, on the contrary, monetary policy aims at stimulating output and employment, the central bank should ‘surprise’ economic agents and renege on pre-announced commitments. This dilemma is well understood by economic agents. If agents believe that the central bank pursues, or is pressed to pursue, a growth and employment objective, rather than price stability, they will suspect the central bank of conducting a
more expansionary, and thus more inflationary policy than announced. Inflation expectations will be revised accordingly, with potentially negative effects on real economic activity.

One way to resolve the time-consistency dilemma is to prohibit the central bank from pursuing a growth and employment objective. Monetary policy should be directed only at price stability and conducted separately from other economic policies. To achieve its goal, the central bank has to be entrusted with the necessary independence. Incentive-compatible contractual arrangements can be designed to provide the central bank with independence of action and accountability of results.\(^2\)

The pressures exerted on the ECB during its early days, in particular by the German government, to cut interest rates provides an excellent illustration of this problem. Had the ECB not been given an independent status, it would have been forced to adopt a more expansionary monetary policy with a view to stimulating growth and employment, even at the cost of higher inflation. Long-term interest rates could have increased substantially, mirroring a rise in inflationary expectations.

Empirical research has confirmed that independent central banks on average deliver a better performance in terms of price stability, without incurring any additional costs in terms of output variability.

The Maastricht Treaty has been inspired by this analytical framework and the Statute of the ESCB and of the ECB has been drafted with a view to entrusting the latter with the highest possible degree of central bank independence. Independence does not depend only on statutes and laws, however, but on a series of factors that are internal and external to the central bank. Furthermore, as indicated in Chapter 1, the Eurosystem has a rather peculiar construction. It is made up of the ECB and the NCBs, both of which are in principle independent. However, NCBs can conduct a series of activities "outside" the Eurosystem, for which independence is not required.