VOICE

# The Death of the Central Bank Myth

For decades, monetary policy has been treated as technical, not political. The pandemic has ended that illusion forever.

BY ADAM TOOZE
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In Europe, a ruling by the German Constitutional Court that the European Central Bank (ECB) failed to adequately justify a program of asset purchases it began in 2015 is convulsing the political and financial scene. Some suggest it could lead to the unraveling of the euro. It may be difficult at first glance to understand why. Yes, the purchases were huge—more than 2 trillion euros of government debt. But they were made years ago. And the points made by the court are arcane. So how could a matter like this assume such importance?

The legal clash in Europe matters not only because the ECB is the second-most important central bank in the world and not only because global financial stability hinges on the stability of the eurozone. It also brings to the surface what ought to be a basic question of modern government: What is the proper role of central banks? What is the political basis for their actions? Who, if anyone, should oversee central banks?

As the COVID-19 financial shock has reaffirmed, central banks are the first responders of economic policy. They hold the reins of the global economy. But unlike national Treasuries that act from above by way of taxing and government spending, the central banks are in the market. Whereas the Treasuries have budgets limited by parliamentary or congressional vote, the firepower of the central bank is essentially limitless. Money created by central banks only shows up on their balance sheets, not in the debt of the state. Central banks don't need to raise taxes or find buyers of their debt. This gives them huge power.

How this power is wielded and under what regime of justification defines the limits of economic policy. The paradigm of modern central banking that is being debated in the spartan court room in the German town of Karlsruhe was set half a century ago amid the turbulence of inflation and political instability of the 1970s. In recent years, it has come under increasing stress. The role of central banks has massively expanded.

In much of the world, notably in the United States, this has engendered remarkably little public debate. Though the litigation in Germany is in many ways obscure, it has the merit of putting a spotlight on this fundamental question of modern governance. Faced with the hubris of the German court, it may be tempting to retreat into a defense of the status quo. That would be a mistake. Though it is flawed in many ways, the court's judgment does expose a real gap between the reality of 21st-century central banking and the conventional understanding of its mission inherited from the 20th century. What we need is a new monetary constitution.

Central bankers gather for a G-7 meeting in Washington in April 2004, including (from left) David Dodge of the Bank of Canada; Christian Noyer of the Bank of France; Jürgen Stark of the Bundesbank; Jean-Claude Trichet of the European Central Bank; Alan Greenspan of the U.S. Federal Reserve; Toshihiko Fukui of the Bank of Japan; Mervyn King of the Bank of England; and Antonio Fazio of the Bank of Italy. STEPHEN J. BOITANO/LIGHTROCKET VIA GETTY IMAGES

**The proud badge worn by modern central bankers is that of** independence. But what does that mean? As the idea emerged in the 20th century, central bank independence meant above all freedom from direction by the short-term concerns of politicians. Instead, central bankers would be allowed to set monetary policy as they saw fit, usually with a view not only to bringing down inflation but to permanently installing a regime of confidence in monetary stability—what economists call anchoring price expectations.

The analogy, ironically, was to judges who, in performing the difficult duty of dispensing justice, were given independence from the executive and legislative branches in the classic tripartite division. With money's value unhooked from gold after the collapse of the Bretton Woods system in the early 1970s, independent central banks became the guardians of the collective good of price stability.

The basic idea was that there was a trade-off between inflation and unemployment. Left to their own devices, voters and politicians would opt for low unemployment at the price of higher inflation. But, as the experience of the 1970s showed, that choice was shortsighted. Inflation would not remain steady. It would progressively accelerate so that what at first looked like a reasonable trade-off would soon deteriorate into dangerous instability and increasing economic dislocation. Financial markets would react by dumping assets. The foreign value of the currency would plunge leading to a spiral of crisis.

Under the looming shadow of this disaster scenario, the idea of central bank independence emerged. The bank was to act as a countermajoritarian institution. It was charged with doing whatever it took to achieve just one objective: hold inflation low. Giving the central bank a quasi-constitutional position would deter reckless politicians from attempting expansive policies. Politicians would know in advance that the central bank would be duty bound to respond with draconian interest rates. At the same time as deterring politicians, this would send a reassuring signal to financial markets. Establishing credibility with that constituency might be painful, but the payoff in due course would be that interest rates could be lower. Price stability could thus be achieved with a less painful level of unemployment. You couldn't escape the trade-off, but you could improve the terms by reassuring the most powerful investors that their interest in low inflation would be prioritized.

It was a model that rested on a series of assumptions about the economy (there was a trade-off between inflation and unemployment), global financial markets (they had the power to punish), politics (overspending was the preferred vote-getting strategy), and society at large (there were substantial social forces pushing for high employment regardless of inflation). The model was also based on a jaundiced vision of modern history and more or less explicitly at odds with democratic politics: first in the sense that it made cynical assumptions about the motivations of voters and politicians but also in the more general sense that in the place of debate, collective agreement, and choice, it favored technocratic calculation, institutional independence, and nondiscretionary rules.

Bundesbank President Karl Blessing lays the cornerstone for the new Bundesbank building in Frankfurt, Germany, in November 1967. ROLAND WITSCHEL/PICTURE ALLIANCE VIA GETTY IMAGES

This conservative vision legitimated itself by reference to moments of historical trauma. The German Bundesbank founded after World War II in the wake of two bouts of hyperinflation—during the Weimar Republic and the aftermath of Germany's catastrophic defeat in 1945—was the progenitor. The U.S. Federal Reserve made its conversion to anti-inflationary orthodoxy in 1979 under Paul Volcker's stewardship. The mood music was provided by President Jimmy Carter's famous speech on the American malaise compounded by global anxiety about the weakness of the dollar after repeated attempts by the Nixon, Ford, and Carter administrations to stabilize prices through government-ordered price regulations and bargains with trade unions and businesses. Democratic politics had failed. It was time for the central bankers to act using sky-high interest rates. That ending inflation in this way would mean abandoning any commitment to full employment, plunging America's industrial heartland into crisis, and permanently weakening organized labor was not lost on Volcker. There was, in that famous phrase of the era, no alternative.

By the 1990s, an inflation-fighting, independent central bank had become a global model rolled out in post-communist Eastern Europe and what were now dubbed the "emerging markets." Along with independent constitutional courts and adherence to global human rights law, independent central banks were part of the armature that constrained popular sovereignty in Samuel Huntington's "third wave of democracy." If the freedom of capital movement was the belt, then central bank independence was the buckle on the free-market Washington Consensus of the 1990s.

For the community of independent central bankers, those were the golden days. But as in so many other respects, that golden age is long gone. In recent decades, central banks have become more powerful than ever. But with the expansion of their role (and their balance sheets) has gone a loss of clarity of purpose. The giant increase in power and responsibility that has accrued to the Fed and its counterparts around the world in reaction to COVID-19 merely confirms this development. Formal mandates have rarely been adjusted, but there has clearly been a huge expansion in reach. In the American case, where the extension has been most dramatic, it amounts to a hidden transformation of the state, indeed of the U.S. Constitution, that has taken place in an ad-hoc way under the pressure of crisis with precious little opportunity for serious debate or argument.

Conservative economists watch in horror as the paradigm of the 1990s has come apart. Won't a central bank that intervenes as deeply as modern central banks now do distort prices and twist economic incentives? Does it not pursue social redistribution by the back door? Will it not undermine the competitive discipline of credit markets? Will a central bank whose balance sheet is loaded with emergency bond purchases not fall into a vicious circle of dependence on the stressed borrowers whose debts it buys?

These concerns are at the root of the drama in Germany's constitutional court. But to know how to respond to them, we need to start by doing what neither the German court nor the ECB's defenders have so far done, namely to account for how the familiar model of central bank independence has come apart since the 1990s.

The eurodollar options pit at the Chicago Mercantile Exchange erupts on Dec. 19, 2000, after a Fed announcement that it saw economic risk tilted toward a downturn rather than toward inflation. SCOTT OLSON/AFP VIA GETTY IMAGES

**The assumptions about politics and economics that** anchored the model of the independent central bank in 1980s and 1990s were never more than a partial interpretation of the reality of late 20th-century political economy. In truth, the alarmist vision they conjured was not so much a description of reality as a means to advance the push for market discipline, away from both elected politicians and organized labor. In the third decade of the 21st century, however, the underlying political and economic assumptions have become entirely obsolete—as much because of the success of the market vision as its failures.

First and foremost, the fight against inflation was won. Indeed, it was won so decisively that economists now ask themselves whether the basic organizing idea of a trade-off between inflation and unemployment any longer obtains. For 30 years, the advanced economies have now been living in a regime of low inflation. Central banks that once steeled themselves for the fight against inflation now struggle to avoid deflation. By convention, the safe minimal level of inflation is 2 percent. The Bank of Japan, the Fed, and the ECB have all systematically failed to hold inflation up to that target. It was the desperate efforts of the ECB to ensure that the eurozone did not slide into deflation in 2015 that led to the drama in the German courtroom last week. The ECB's giant bond purchases were designed to flush the credit system with liquidity in the hope of stimulating demand.

Long before the lawyers starting arguing, the economics profession has been scratching its head over this situation. The most obvious drivers of so-called lowflation are the spectacular efficiency gains achieved through globalization, the vast reservoir of new workers who were attached to the world economy through the integration of China and other Asian export economies, and the dramatic weakening of trade unions, to which the anti-inflation campaigns, deindustrialization, and high unemployment of the 1970s and 1980s powerfully contributed. The breaking of organized labor has undercut the ability of workers to demand wage increases. This lack of inflationary pressure has left modern central banks unconcerned about even the most gigantic monetary expansion. However much you increase the stock of money, it never seems to show up in price increases.

Nor is it just the economics that are haywire. Whereas the classic model assumed that politicians were fiscally irresponsible and thus needed independent central banks to bring them into line, it turns out that a critical mass of elected officials drank the 1990s Kool-Aid. In recent decades, we have seen not a relentless increase in debt but repeated efforts to balance the books, most notably in the eurozone under German leadership. Contrary to its reputation, Italy has been a devoted follower of austerity, leading the way in fiscal discipline. But so has the United States, at least under Democratic administrations. Politicians campaigned for fiscal consolidation and debt reduction instead of promises of investment and employment. In the agonizingly slow recovery from the 2008 crisis, the problem for the central bankers was not overspending but the failure of governments to provide adequate fiscal stimulus.

Rather than obstreperous trade unions and feckless politicians, what central bankers have found themselves preoccupied with is financial instability. Again and again, the financial markets that were assumed to be the disciplinarians have demonstrated their irresponsibility ("irrational exuberance"), their tendency to panic, and their inclination to profound instability. They are prone to bubbles, booms, and busts. But rather than seeking to tame those gyrations, central banks, with the Fed leading the way, have taken it on themselves to act as a comprehensive backstop to the financial system—first in 1987 following the global stock market crash, then after the dot-com crash of the 1990s, even more dramatically in 2008, and now on a truly unprecedented scale in response to COVID-19. Liquidity provision is the slogan under which central banks now backstop the entire financial system on a near-permanent basis.

To the horror of conservatives everywhere, the arena in which central banks perform this balancing act is the market for government debt. Government IOUs are not just obligations of the tax payer. For the government's creditors, they are the safe assets on which pyramids of private credit are built. This Janus-faced quality of debt creates a basic tension. Whereas conservative economists anathematize central banks swapping swap government debt for cash as the slippery slope to hyperinflation, the reality of modern market-based finance is that it is based precisely on this transaction—the exchange of bonds for cash, mediated if necessary by the central bank.

One of the side effects of massive central bank intervention in bond markets is that interest rates are very low, in many cases close to zero, and at times even negative. When central banks take assets off private balance sheets, they drive prices up and yields down. As a result, far from being the fearsome monster it once was, the bond market has become a lap dog. In Japan, once one of the engines of financial speculation, the control of the Bank of Japan is now so absolute that trading of bonds takes place only sporadically at prices effectively set by the central bank. Rather than fearing bond vigilantes, the mantra among bond traders is “Don’t fight the Fed.”

Central bank intervention helps to tame the risks of the financial system, but it does not stem its growth, nor does it create a level playing field. While high-powered fund managers and their favored clients hunt for better returns in stock markets and exotic and exclusive investment channels like private equity and hedge funds, thus taking on more risk, more cautious investors find themselves on the losing side. Low interest rates hurt savers, they hurt pension funds, and they hurt life insurance funds that need to lock in safe long-term returns on their portfolios. It was precisely that constituency that was the mainstay of the litigation in front of the German constitutional court.

A woman jumps on a table, throwing papers and confetti and calling for an “end to the ECB dictatorship,” as she disrupts a news conference in Frankfurt on April 15, 2015. DANIEL ROLAND/AFP VIA GETTY IMAGES

The plaintiffs and their lawyers blame the central bank for pushing interest rates down, benefiting feckless borrowers at the expense of thrifty savers. What they ignore are the deeper economic pressures to which the central bank itself is responding. If there is a glut of savings, if rates of investment are low, if governments, notably the German government, are not taking up new loans but repaying debt, this is bound to depress interest rates.

The result of this combination of economic, political, and financial forces is an economic landscape that, by the standards of the late 20th century, can only seem topsy-turvy. Central bank balance sheets are grotesquely inflated, yet prices (except for financial assets) slide toward deflation. Before the COVID-19 lockdown, record low unemployment no longer translated into wage increases. With long-term interest rates near zero, politicians nonetheless refused to borrow money for public investments. The response of central bankers, desperate to prevent a slide into self-sustaining deflation, is to reach again and again for stimulus.

In the United States, at least in this respect, the election of Donald Trump as president helped restore a degree of normality, if with a perverse edge. Egged on by Republicans in Congress, his administration has shown no inhibition about huge deficits to finance regressive tax cuts. Apart from anti-immigrant rhetoric, Trump's winning card in 2020 would be an economy running hot. In 2019, the Fed seemed to be headed into the familiar territory of weighing when to raise interest rates to avoid overheating. Chair Jerome Powell certainly did not appreciate the president's bullying against rate hikes, but at least the Fed was not lost in the crazy house of low growth, low inflation, low interest rates, and low government spending that the Bank of Japan and the ECB had to contend with.

Since the 1990s, the Bank of Japan has engaged in one monetary policy experiment after another. And driven by the profound crisis in the eurozone under the leadership of Mario Draghi, the ECB embarked on its own experiments. These efforts proved effective in delivering a measure of financial stability. They made central bankers into heroes. But they also fundamentally altered the meaning of independence. In the paradigm that emerged from the crises of the 1970s, independence meant restraint and respect for the boundaries of delegated authority. In the new era, it had more to do with independence of action and initiative. More often than not, it meant the central bank single-handedly saving the day.

Whereas in most of the world this was accepted in a pragmatic spirit—it was reassuring to think that someone, at least, was in charge—in the eurozone it was never going to be so easy. The way that Chancellor Helmut Kohl's government sold German voters on the abandonment of the Deutsche mark was the promise that the ECB would resemble the Bundesbank as closely as possible. It was barred from directly financing deficits, and, in the hope of limiting undue national influence, it had limited political accountability. Its narrow mandate was simply to ensure price stability.

This was always a gamble, which depended on the willingness of the Italians and French, who also had a voice in the euro system, to go along. Their financial elites pushed for a common currency in part because they were looking for a restraint on their own undisciplined political class—but also because they were gambling that as members of the eurozone they would have a better chance of bending European monetary policy in their direction than they would if their national central banks were forced to follow the Bundesbank by the pressure of bond markets. In the early years of the euro, the compromise worked to mutual satisfaction. But it was always fragile. Once the financial crisis of 2008 forced a dramatic expansion of the ECB's activity, buying both government and corporate bonds, intervening to cap the interest rates paid by the weakest eurozone member states, pushing bank lending by complex manipulation of interest rates, conflict was predictable. This tension exploded in the German Constitutional Court last week.

People wearing face masks walk in front of a big euro sign in front of the European Central Bank headquarters in Frankfurt on April 24. YANN SCHREIBER/AFP VIA GETTY IMAGES

**For the majority of financial opinion, the ECB's growing** activism is broadly to be welcomed. It is the one part of the complex European constitution that actually functions with real authority and clout as a federal institution. Though grudging in her public support, Chancellor Angela Merkel has rested her European policy on a tacit agreement to let the ECB do what was necessary. Allowing the ECB to manage spreads—the interest rate margin paid by weaker borrowers—was easier than addressing the question of how to make Italy's debt-level manageable. But a recalcitrant body of opinion in Germany has never reconciled itself to this reality. For them, the ECB serves as a lightning rod for their grievances about the changing political economy of the last decade. They blame it for victimizing savers with its low interest policy. They blame it for encouraging the debts of their Southern European neighbors. Exponents of the old religion of German free market economics regard cheap credit as subversive of market discipline. All in all, they suspect the ECB of engaging in a policy of redistributive Keynesianism in monetary disguise, everything that Germany's national model of the social market economy was supposed to have ruled out. For these Germans, the ECB is an opaque technocratic agency arrogating to itself powers that properly belong to national parliaments, barreling down the slippery slope to a European superstate. And, for them, it is anything but accidental of course that it is all the creation of a Machiavellian Italian with trans-Atlantic business connections, Mario Draghi.

For the body of opinion that had always been suspicious of the euro, Draghi's commitment to do "whatever it takes" in 2012 was the final straw.

The Alternative for Germany (AfD) emerged in 2013 not originally as an anti-immigrant party but as a right-wing economic alternative to Berlin's connivance with the antics of the ECB. As the AfD has consolidated its position as the anti-establishment party of right-wing protest above all in eastern Germany, its agenda has shifted. But Bernd Lucke, one of the founders of the AfD who has since left the party, was among the plaintiffs whose case the German constitutional court decided last week.

Meanwhile, Germany's influential tabloid *Bild* pursued a campaign amounting to a vendetta against Draghi, picturing him last September as a vampire sucking the blood of German savers. And even the Bundesbank leadership, both current and emeritus figures, has not been shy about associating itself with public opposition to the expansive course of the ECB. Defending the strength of the euro against the spendthrift, inflationary ways of Southern Europe played well with the patriotic gallery. But so long as Merkel preferred to cooperate with the ECB's leadership, that opposition remained marginalized. What has thrown a spanner in the works are the well-developed checks and balance of the German Constitution guarded by the Constitutional Court.

The German Constitutional Court, based in modest digs in the sleepy town of Karlsruhe, has an activist understanding of its role within the German polity, presenting itself as "the citizens' court" unafraid of upending the political agenda on issues from the provision of child care or means-tested welfare benefits to the future development of the European project. Since the 1990s, the court has been a vigilant check on unfettered expansion of European power. It makes the argument on the basis of defending democratic national sovereignty, insisting on its right to constantly review European institutions for their conformity to the basic norms of the German Constitution.

Each progressive expansion of ECB activism has thus stirred a new round of legal activism. Announced in 2012, Draghi's instrument of Outright Monetary Transactions, an unlimited bond-buying backstop for troubled eurozone sovereign debtors, was challenged by a coalition of both left-wing and right-wing German plaintiffs. It was not until the summer of 2015 that the court finally and grudgingly ruled it acceptable.

When Draghi finally launched the ECB into large-scale bond buying in 2015, of the type that both the Fed and Bank of Japan had embarked on years before, it too immediately triggered a new round of litigation. In 2017, the court gave a preliminary ruling but referred the case to the European Court of Justice (ECJ). In December 2018, the ECJ declared the program to be in conformity of the European treaties. But the German constitutional judges were not satisfied with the reasoning of the ECJ and held hearings in 2019. After months of deliberation, Karlsruhe was supposed to issue its judgment on March 24, but that was postponed a week beforehand due to the coronavirus pandemic.

That turned out to be opportune because financial markets in March were in crisis. Between March 12 and 18, as the ECB failed to calm the waters, the interest paid by Italy for state borrowing surged. Thanks to massive intervention by the ECB, they have since cooled. Christine Lagarde's ECB has promised to make an additional round of purchases in excess of 700 billion euros, with more to come if necessary. To calm the markets, what was needed was discretion and largesse—precisely what the German critics of the ECB feared most and had criticized so incessantly in the 2015 bond-buying program.

The judges of the German Constitutional Court in Karlsruhe arrive to give their ruling on the European Central Bank bond-buying program on May 5. SEBASTIAN GOLLNOW/DPA/AFP VIA GETTY IMAGES

**This made the judgment from Karlsruhe on the 2015** program even more significant. What might the ruling on Draghi's quantitative easing (QE) signal for possible action against Lagarde's crisis program? How might the court influence the course of debate in Germany? The initial hearings in 2019 had not sounded favorable to the ECB. The selection of expert testimony by the court was conservative and biased. The court had given full vent to the protests of smaller German banks about the low interest rates that ECB policy permitted them to offer savers. It was as though the court had summoned oil companies, and oil companies only, to give evidence on the question of carbon taxes.

For all the anticipation, the judgment has come as a shock. The question that has ultimately proved decisive is a seemingly conceptual one concerning the distinction between monetary policy and economic policy. The German Constitutional Court declared that the ECB, in pursuing its efforts to push inflation up to 2 percent, had overstepped the bounds of its proper domain—monetary policy—and strayed into the area of economic policy, which the European treaties reserve for national governments.

This is by no means an obvious distinction. It was originally built into the treaties both to protect national prerogatives and to ensure that the ECB's focus on price stability was shielded against any improper meddling by parties that might prioritize concerns like unemployment or growth. Making this distinction is one of the central dogmas of the German school of economics known as ordoliberalism. But once monetary policy reaches any substantial scale, it in fact becomes meaningless.

The ECJ in Luxembourg reasonably took the view that the ECB has fulfilled its obligation to respect the boundary by justifying its policy with regard to the price objective and following a policy mix typical of modern central banks. It is this casual approach on the part of the ECJ to which Karlsruhe objects. The ECJ waived the case through without assessing the proportionality of the underlying trade-off, the German Constitutional Court thundered. In doing so, it had failed in its duty and acted *ultra vires* —beyond its authority. It was thus up to the German court to adjudicate the issue, and it duly found that the ECB had not to its satisfaction answered the economic concerns raised by the court's witnesses. The ECB too was therefore found to have overstepped its mandate.

Since the German court does not actually have jurisdiction over the ECB, the ruling was delivered against the German government, which was found to have failed in its duty to protect the plaintiffs against the overreaching policy of the ECB. As Karlsruhe emphasized, its judgment would not come into immediate effect. The ECB would have a three-month grace period in which to provide satisfactory evidence that it had indeed balanced the broader economic impact of its policies against their intended effects. Barring that, the Bundesbank would be required to cease any cooperation with asset purchasing under the 2015 scheme.

The judgment was delivered to a court room observing strict social distancing, though the judges did not wear face masks. Chief Justice Andreas Voßkuhle, whose 12-year term at the court ends this month, noted that the ruling might be interpreted as a challenge to the solidarity necessary to meet the COVID-19 crisis. So he added by way of reassurance that the ruling applied only to the 2015 scheme. There is no need, therefore, for any immediate change of policy. The markets have so far taken the intervention in stride. But the Karlsruhe decision is, nevertheless, shocking.

It is a spectacular challenge to European court hierarchy. Instead of merely assessing the conformity of the ECB's policies with the German Constitution, the German court arrogated to itself the right to evaluate the conformity of the ECB actions with European treaty law, an area explicitly left to the ECJ. This will surely play into the hands of those in Poland and Hungary who are determined to challenge the common norms of the European Union. It did not take long for Poland's deputy justice minister to signal his enthusiastic support for the Karlsruhe decision. This may end up being the case's most lasting effect.

But it is spectacular also for another reason. In challenging the ECB to justify its QE policy, the German court has put in question not just a specific policy but the entire rationale for central bank independence. What is more, it has done so not only formally but substantively. It has exposed the political and material basis that lies behind the norm of independence.

The claim that the ECB overstepped the bound between monetary and economic policy is, as an abstract proposition, not so much a scandal as a tautology. Only in an ordoliberal fantasy world could one imagine monetary policy working purely by way of signaling without it having an impact on the real economy. Indeed, to affect real economic activity by lowering the cost of borrowing is precisely the point of monetary policy. Far from failing to consider the economic impact of its monetary policies, this is precisely what the ECB spends its entire time doing.

Nevertheless, by harping on this seemingly absurd distinction the court has in fact registered a significant historic shift. The shift is not from monetary to economic policy but from a central bank whose job is to restrain inflation to one whose job is to prevent deflation—and from a central bank with a delegated narrow policy objective to one acting as a dealer of last resort to provide a backstop to the entire financial system. The German court is right to detect a sleight of hand when the ECB justifies an entirely new set of policies with regard to the same old mandate of the pursuit of price stability. But what the German court fails to register is that this is not a matter of choice on the part of the ECB but forced on it by historical circumstances.

Cutting through the legalese and abstruse arguments, the complaint brought to the court by the plaintiffs is that the world has changed. Europe's central bank was supposed to be their friend in upholding an order in which excessive government spending was curbed, wage demands and inflation were disciplined, and thrifty savers were rewarded with solid returns. The reality they have confronted for the last 10 years is very different. They suspect foul play, and they blame the newfangled policies of the ECB and its Italian leadership. Rather than taking the high ground, recognizing the historical significance of this crisis and calling for a general reevaluation of the role of central banks in relation to a radically different economic situation, the German Constitutional Court has made itself into the mouthpiece of the plaintiffs' specific grievances, linked those to an expression of fundamental democratic rights, and mounted a challenge to the foundation of the European legal order.

Its willingness to assume this role no doubt reflects its resentment at the usurpation of its supremacy by the ECJ. The decision reflects in this sense a concern to defend German national sovereignty. But it also reflects the cognitive shock of failing to come to terms with the role of central banks in a radically changed world. What this starkly reveals is the limits of existing modes of central bank legitimacy—including the narrative of central bank independence—at the precise moment at which we have become more dependent than ever on the decisive actions of central banks.

To see the head-turning effect of this ruling, imagine an alternative history. Imagine a citizen's court like that in Karlsruhe convening sometime in the mid-1980s in the United States to evaluate whether or not Volcker's Fed had adequately weighed the economic impact of its savage interest rate hikes on the steelworkers of the Rust Belt. Or, only slightly more plausibly, imagine a hearing in the Spanish or the Italian constitutional court on the question of whether or not their governments were remiss in not demanding to see the reasoning that justified the ECB's decision in 2008 or 2011 to raise interest rates just as the European economy was sliding into first one and then a second recession. Were German concerns about inflation at those critical moments weighed against the damage that would be done to the employment opportunities of millions of their fellow citizens in the eurozone? Would Karlsruhe have heard a case brought on those grounds by an unfortunate German citizen who lost his or her job as a result of those disastrously misjudged monetary policy moves?

Of course those decisions were criticized at the time. But that kind of criticism was not considered worthy of constitutional consideration. That was merely politics, and it was the duty of the central bank, and a measure of its independence, to override and ignore such objections.

Flags of the European Union and Germany hang in front of the court in Frankfurt on May 5, the day the German Constitutional Court pronounced its judgment on billion-euro purchases of government bonds by the European Central Bank. SEBASTIAN GOLLNOW/PICTURE ALLIANCE VIA GETTY IMAGES

**The political impact of the court ruling has been revealing.** On the German side, the business council of Merkel’s Christian Democratic Union immediately expressed its support for the court. So too did a spokesperson for the AfD. Friedrich Merz, a possible right-wing successor to Merkel, let it be known that he now considers the German government bound to exercise a precautionary check on any further expansion of the ECB’s range of action.

The reaction of the European Commission and the ECB was no less immediate. They closed ranks around the ECJ. The clear message they sent was that they are bound by Europe’s common law and institutions. After a few days of deliberation, the ECB declared with supreme understatement that it takes note of the judgment from Karlsruhe but intends to ignore it since the ECB answers to the European Parliament and the European court, not the German Constitutional Court. The ECJ ruled in December 2018 on the asset purchase program at the request of the German court. There are no do-overs. The case is closed.

This leaves the German government and the Bundesbank in a tight spot. The German government, for its part, often goes for years without fully implementing the Constitutional Court’s most ambitious judgments. The Social Democrat-led Finance Ministry in Berlin, which cultivates its image as an advocate of pro-European policies, has played down the decision. The neuralgic point will be the Bundesbank. It is both a German agency, answerable to the Constitutional Court, and a member of the euro system—and thus bound by the statutes of the ECB.

An open and irresolvable conflict between the Bundesbank and the Constitutional Court on the one side and the ECB on the other would compound the tensions already being felt within the eurozone over the issue of the funding of the emergency response to the COVID-19 crisis. Resentment in Italy and Spain toward Germany is already at a high pitch. One might take the German court's call to limit and balance the ECB's expansion as a call to, instead, expand the reach of European fiscal policy. The ECB has made precisely that argument itself. But unfortunately the same political forces in Germany that brought the case to the Constitutional Court also stand in the way of a major move toward fiscal federalism.

Given the economic conservatism and hubris of the German court and the prospect of a string of challenges from across the EU by even more unfriendly forces, a strong stance from the European side is to be welcomed. But it would be regrettable if the ECB responded to the quixotic German onslaught against the realities of 21st-century central banking by itself retreating into a defensive bunker.

A placard with "capitalism is more dangerous than the coronavirus" is seen at a demonstration in Cologne, Germany, on May 1.
YING TANG/NURPHOTO VIA GETTY IMAGES

If it was not already evident, the COVID-19 shock has made clear beyond a shadow of a doubt that both the political and economic circumstances out of which the original model of central bank independence emerged have changed, not just in Germany or Europe but around the world. This renders the classic paradigm of inflation-fighting independence obsolete and has thrown into doubt models of narrow delegation. To address the new circumstances in which the real problems are the threat of deflation, the stability of the financial system, and the passivity of fiscal policy, the ECB, like all its counterparts, has indeed been pursuing a policy that goes well beyond price stability conventionally understood. In fact, in Europe the ECB is the only agency engaged in economic policy worthy of the name. Given the limitations of its mandate, this does indeed involve a degree of obfuscation. Despite itself groping in the dark, the Karlsruhe decision has helpfully put a spotlight on the ECB charade.

To respond by doubling down on a defense of independence may be inevitable in the short run. But this too will run its course. The more constructive response would be to advocate for a wider mandate to ensure that the central bank does indeed balance price stability with other concerns; the bank's second objective should surely be employment and not the interests of German savers. But an open debate about the range of the ECB's mandate would be a step forward for European politics. The politics of treaty adjustment are not easy, of course. It will take political courage. But the demand itself should not be presented and dismissed as outlandish. After all the Fed has a dual mandate. Alongside price stability, it is enjoined by the Humphrey-Hawkins Act to aim for the maximum rate of employment possible. As the history of the Fed attests, this is far from being a binding commitment. But since 2008 it has provided the Fed with the latitude necessary to expand its range of activities.

That expansion of activity has in large part been a matter of technocratic discretion. The point of pushing for a discussion of a widening of the ECB's mandate should be the opposite. The aim should be to encourage a wide-ranging discussion about the wider purpose of central banks. Again, the U.S. example may be an inspiration. The Fed's dual mandate is, somewhat surprisingly, a legacy of progressive struggles fought in the 1960s and 1970s—specifically, by the civil rights movement under Coretta Scott King's leadership—to force social equity to the top of the macroeconomic policy agenda. This may seem far-fetched, but progressives cannot shrink from the challenge. They should not allow themselves to be held prisoner to the 1990s mystique of central bank independence.

Two new issues make this pivotal in the current moment. One is the financial legacy of the COVID-19 crisis, which will burden us with gigantic debts. The balance sheet of the central bank is a pivotal mechanism for managing those debts. The other issue is the green energy transition and the need to make our societies resilient to environmental shocks to come. That will require government spending but also a reorientation of private credit toward sustainable investments. In that process, the central bank also has a key role. The current mandates require those concerns to be shoehorned in by way of arguments about financial stability. It is time for a more direct and openly political approach.

The independence model emerged from the collapse of the Bretton Woods system and the need to anchor inflation during the Great Inflation of the 1970s. The huge range of interventions currently being pursued by global central banks have emerged out of the crises of a globally integrated financial system. They have been enabled by the absence of inflationary risk. They have succeeded in staving off catastrophe for now. But they lack a positive purpose and updated democratic grounding.

We value price stability, but for better and for worse the forces that once made it an urgent problem are no longer pressing. That objective alone is no longer sufficient to define the mandate of the most important economic policymaking agency. Financial stability is essential, but the current incestuous relationship between central banks and the financial system tends, if anything, to underwrite and encourage dangerous speculation by a self-enriching elite. Meanwhile, slow growth, inequality, and unemployment are at the root both of many of our social ills and by the same token the problem of the debt burden—how we manage government debt depends crucially on how rapidly the economy is growing. Finally, we can no longer deny that we confront fundamental environmental issues that pose a dramatic generational challenge for investment.

These are the policy challenges of the third decade of the 21st century. Money and finance must play a key role in addressing all of them. And central banks must therefore be at the heart of policymaking. To pretend otherwise is to deny both the logic of economics and the actual developments in central banking of recent decades. We should also acknowledge however that this expansion stands in tension with the current political construction of central banks and particularly the ECB. Defining their position in terms of independence, strictly delimited mandates, and rules limits their democratic accountability. That was the explicit intention of the conservative reaction to the turmoil of the 1970s.

If Europe wants to escape the impasse created by the German court ruling, in which one countermajoritarian institution checks another at the behest of a resentful and self-interested minority, we need to step out from this historical shadow. Doing so is no doubt hedged with risks. But so too is attempting to patch and mend our anachronistic status quo. Half a century on from the collapse of Bretton Woods and the emergence of a fiat money world, 20 years since the beginning of the euro, it is time to give our financial and monetary system a new constitutional purpose. In so doing, Europe would not only be laying to rest its own inner demons. It would offer a model for the rest of the world.

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**Adam Tooze** is a history professor and director of the European Institute at Columbia University. His latest book is *Crashed: How a Decade of Financial Crises Changed the World*, and he is currently working on a history of the climate crisis. Twitter: @adam_tooze