

Steering past the sirens: central bank independence and the role of credibility

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Check against delivery

Distinguished governor, excellencies, colleagues, ladies and gentlemen,

It is a great honour to address you today at the 10th Annual Research Conference of the National Bank of Ukraine, jointly organised with Narodowy Bank Polski.¹ Let me express my regret that we cannot meet in person in Kyiv due to **Russia's continued unjustified war against Ukraine**. And yet, despite this enormous challenge, Ukraine stands firm. Your endurance on this journey deserves our deepest admiration and support. And we stand firmly with Ukraine – slava Ukraini!

Dear ladies and gentlemen,

There are myths and legends that have guided and motivated human beings for millennia. In my speech today, I would like to draw on one that is widely known and despite its age very topical. It tells the story of a difficult journey. That legend is **Homer's Odyssey**.

In a famous passage of *The Odyssey*, Ulysses learns how to steer his ship past the sirens – dangerous creatures that draw sailors to their doom. Ulysses must tie himself to the mast of his ship to escape the temptations of the sirens' song. Hearing the song would forever divert him from his quest to reach home. For the same reason, Ulysses tells his crew to plug their ears with wax. He also orders them never to untie him, however much he begs. The operation succeeds because the safety measures effectively limit Ulysses's ability to act on his temptation.

In my remarks, I would like to use this metaphor to explore **how monetary policy can successfully steer past "today's sirens" – complex supply shocks** that might tempt policymakers in central banks and governments to embrace an "easy" way out that is usually more costly overall than responsible action.

1 Before the sirens sing

Homer dedicated roughly sixty lines to describe how Ulysses was put to the sirens' test. It only took Christopher Nolan a couple of minutes in his recent movie to recount the same episode. But we economists are particularly known for our gift for brevity. Several decades ago, we began to refer to the underlying challenge using only two words: **time inconsistency**.

Time inconsistency is one of the most fundamental challenges in public policymaking. It involves a simple question: How do you make a promise credible when you may later have reasons to break it? If

¹ I am grateful to Alex Grimaud and Kilian Rieder for their input and help in preparing this speech.

households and firms anticipate that a public policy commitment is not going to hold, this belief will shape their expectations and actions. Any attempted commitment then becomes ineffective.

Central bank independence is the textbook solution to the challenge of time inconsistency in the case of monetary policymaking. Governmental interference could loosen monetary policy's commitment to price stability. Democratic societies therefore hand monetary policy to an independent institution. This keeps price stability out of day-to-day political bargaining. Hence, central bank independence helps people predict how the central bank will react to future economic developments.

Yet central bank independence is not the same as central bank **credibility**. Credibility cannot be engineered by an institutional arrangement alone. Credibility is a belief about how the central bank will behave in the future. An independent central bank can lose credibility if its decisions no longer look consistent with its mandate. So: independence only creates the conditions for credible commitment. Central bank behaviour determines whether that commitment is eventually credible.

2 Introducing today's sirens

When are the temptations greatest to go back on a past commitment? Ulysses's story gives a clear answer. We are most tempted when staying on course feels most costly, or when deviating looks most rewarding. Tied to the mast, Ulysses begs loudest for release precisely when he first hears the sirens' song. In monetary policymaking, the sirens' song resounds whenever honouring the commitment to price stability involves difficult choices.

Today, **supply shocks** represent some of the most tempting sirens in the realm of central banking. When demand is running ahead of the economy's capacity, tighter policy reduces both demand pressure and inflation. The direction of travel is clear. Supply shocks are different. A negative supply shock raises prices while reducing productive capacity, real income and activity. Monetary policy cannot reopen a pipeline or add a barrel of oil to world supply. The loss is real and our actions to bring down inflation can add to the initial economic pain.

Supply shocks are the "perfect storm" for central bank independence. Governments face pressure to cushion losses in purchasing power, protect employment and prevent otherwise viable firms from failing. The central bank, meanwhile, must watch a different risk: that the initial price increase spreads into wages, broader price-setting and expectations. The worse the shock, the stronger the case for governments to cushion it – and the stronger the case for the central bank to stop inflation from spreading. A severe supply shock therefore creates a genuine possibility of **disagreement between government and central bank, or at least: a potential contradiction between the monetary policy stance and the fiscal policy stance**.

Supply shocks are also tricky for another, less obvious reason. It is crucial that households, firms and markets believe that the commitment to price stability will survive difficult moments. Suppose people expect the central bank to be overruled, or to back down under pressure. Then that expectation can feed into wages and prices before any conflict even starts. Countering these expectations appears to call for even stronger commitment. However, stronger commitment does not always mean more forceful action. If the supply shock is temporary and expectations remain anchored, excessive tightening can simply add a heavier recession to an existing loss. Even the classic theory does not call for a central banker who cares about nothing but inflation. If taken too far, monetary conservatism can eventually produce excessive volatility in employment and output.

For monetary policy, supply shocks therefore create two risks at once. Too little commitment, and temporary inflation can propagate. Too little flexibility, and monetary policy can unnecessarily amplify a real shock. The central bank needs enough independence to embrace an uncomfortable trade-off – and enough judgement to know which trade-off it is actually facing. In *The Odyssey*, Ulysses seems aware of this dual risk. He makes sure the ropes around him are tightly bound. Yet, while he plugs the ears of his crew, he does not blindfold them: someone needs to be able to watch out for shallow water.

Supply shocks occurred long before *The Odyssey* was written. Today, however, we are likely to face these disturbances much more frequently than over the past decades. Climate change and geopolitical tensions are on the rise. Supply shocks can hit overnight. Or they can build slowly, as production networks, energy systems or labour markets change. As monetary policymakers we may have to spend more time in an uncomfortable position: sitting on board of the ship of state, looking at governments – or even ourselves – screaming for release from the mast. Fortunately, only figuratively so...

3 Reading the winds

How can we make sure to overcome the temptations of today's sirens? Reaching a correct and timely **diagnosis** is a crucial **first step**. Ulysses anticipates his desires. He orders the crew to tie him even tighter if he starts calling for release. As monetary policymakers our task is arguably more complicated. We do not have the benefit of divine advice.

On the one hand, supply shocks can hide very different inflation processes. The “energy shock” in 2022 due to the unjustified Russian invasion of Ukraine did not pose the same monetary policy problem for the ECB as the “energy shock” in 2026. In 2022, inflation was already high and accelerating, supply bottlenecks were broad and demand was strong. In 2026, inflation started much closer to target. Demand was weaker. The composition of the energy shock was different. And there was initially less evidence of broad second-round wage effects.

On the other hand, there are no simple recipes for addressing supply shocks. “Looking through” can at times be the right response. But a small, temporary price rise is one thing. A large, lasting shock that feeds into wages, prices and expectations is another. The relevant question is whether the shock is beginning to shape the process that will determine inflation tomorrow. Supply shocks require a careful policy judgement about their size, persistence and propagation.

To arrive at the right diagnosis, central bank independence is key. Central bank independence should protect the process by which our diagnosis is formed. I call this **process independence**. It matters because political pressure is *usually* much subtler than a blunt demand to cut rates no matter what. The first independent monetary policy decision is often not what interest rate to set, but how to interpret the economy. As central bankers, we should prick up our ears when some are just a little too quick to call a shock “temporary” or “unlikely to trigger second-round effects”. Diagnosis must never precede **analysis**. Here, as monetary policymakers, we have a great advantage. We can draw on a vast body of knowledge. The expertise and research of our staff are invaluable.

4 A regime, not an isolated action

Now, diagnosis is only half the battle when we deal with supply shocks. Credible commitment also requires **behaviour in line with the commitment**. Note that this is very different from saying that

credibility depends on a *specific* course of action. Credibility cannot mean that everyone knows our next interest rate decision. In an uncertain economy, we often do not know it ourselves. The right monetary policy decision may change as the diagnosis changes.

Instead, credibility rests on the **policy regime** that produces our actions: the objectives this regime protects, the constraints it respects and the actions people expect when circumstances change. A well-functioning macroeconomic policy regime stands on **several pillars**.

The first is a **common goal** across different policy branches. Monetary and fiscal policies ultimately have to fit together. A central bank may be legally independent and entirely serious about price stability. However, if the rest of the policy framework makes that commitment impossible to sustain, the statute alone cannot solve the problem. Central bank independence can delegate authority, but it cannot make incompatible goals compatible. What matters is whether the state's other promises stay consistent with price stability when stress arrives.

Second, the policy regime also has to be expected to survive when keeping it becomes costly. In other words, the regime has to be **durable**. A monetary policy commitment to price stability is credible when households, firms and markets believe that hard times may change our response – but not our objective.

This brings me to the third pillar. **New evidence** can require a new diagnosis. The diagnosis has to remain open to the incoming data, competing models, internal disagreement and public challenge. Our expertise is not in avoiding error. That would be impossible. It is in recognising it and correcting course. Importantly, changing the diagnosis when the evidence changes is not at all the same thing as changing the objective. Later in my speech I will discuss in more detail how to distinguish disciplined revision from drift.

Finally, **traceability and transparency** matter. Households, firms and markets do not observe the central bank's reaction function directly. They infer it from what the central bank says and, above all, from what it does. Over time, they form a view of what makes policymakers patient and what makes them act. They need to understand what kind of evidence changes the decision. A policy framework can be perfectly coherent internally and still fail to anchor expectations if nobody outside can work out how it operates.

Ulysses and his crew successfully steer past the sirens in large part because they are united by a common goal that keeps them disciplined: reaching home. Moreover, the ship does not suddenly change direction when it approaches the sirens' island – though, it did at other instances, but these are other stories in *The Odyssey*... The crew has no reason to believe that their diagnosis was wrong: deviating would have catastrophic consequences. And the crew knows about these consequences precisely because Ulysses openly shared the information with his comrades.

5 The economics of being believed

Taken together, these aspects can be summarised as framework guidance: framework guidance refers to the set of principles, objectives, rules, and communication practices that guide how a central bank makes monetary policy decisions and explains them to the public. In times of frequent supply shocks proper framework guidance is even more important. It has economic value.

So far, I have talked about credibility as though it were mainly a reputational asset – something central banks naturally prefer to have. But credibility can have very concrete **economic value**.

While our journeys may be slightly less extreme than a lost decade, risking our credibility as policymakers can have **tangible consequences**. Let me highlight three here:

First, credibility influences how much monetary force is needed to bring inflation back under control following a supply shock. If households and firms believe that the central bank will ultimately deliver price stability, they have less reason to build a temporary shock into wages, prices and longer-term expectations. The **Volcker disinflation** in the United States at the end of the 1970s and the beginning of the 1980s illustrates just how expensive the loss of credibility can be for a central bank. After a decade of high inflation, the new commitment to price stability was initially not taken at face value. Households, firms and markets waited to find out whether the Federal Reserve would persist once the recession deepened and political pressure intensified. These doubts were a key reason why disinflation was so costly.

The underlying **economic argument** is straightforward. A supply shock first raises headline inflation. If central bank credibility is weak, households and firms treat that increase as the beginning of a broader inflation process. Wage demands adjust, firms expect other firms to reprice, and the shock becomes more persistent. With strong credibility, the same initial shock is more likely to remain a relative-price adjustment. Less movement in medium-term expectations and fewer second-round effects follow. A credible central bank therefore needs to tighten less to stabilise inflation after a supply shock. Household and firm expectations do part of the stabilising work. By helping to build the conditions for credible commitment, central bank independence can make some difficult decisions less costly. The more often supply shocks hit, the more relevant this argument becomes.

A related second advantage of high credibility is that it can buy **valuable time** for the central bank. Distinguishing between a temporary disturbance and a persistent supply shock is tricky. In this context, it is both good and bad news that credibility does not have to be rebuilt from zero every time a new shock arrives. The reputation that has been created or depleted in the previous episode carries over into the next one. In other words, returning inflation to target does more than close yesterday's problem. It replenishes the credibility that gives policy room to deal with tomorrow's problem intelligently.

Finally, there is also a third, perhaps less obvious benefit of credibility. After a major shock, households and firms already have enough to work out: what will happen to energy costs, wages, demand, competitors' prices, fiscal support or the exchange rate. A credible monetary regime removes one additional question from that list: Has the **inflation regime** itself changed? Credibility prevents each new shock from becoming a referendum on the monetary regime. That makes everyone's life simpler. People can deal with the shock without also having to guess what the central bank wants.

6 When flexibility becomes drift

To recapitulate: In response to supply shocks, credibility is a precious good. It buys us flexibility and creates room to respond differently and efficiently to different shocks. However, I must emphasise that this room is not unlimited. This is the point I would like to discuss next.

Used well, flexibility can reinforce credibility by showing that different actions still serve the same objective. Used as a one-way excuse for delay, it does the opposite. The term "supply shock" cannot become another way of saying "inflation to which monetary policy need not respond." In short, flexibility needs **discipline**.

Let me first rule out **two tempting but unsatisfactory ways** to provide that discipline:

- A **first option** is a mechanical rule. Yet, no central bank can write the exact optimal response to every future war, pandemic, financial disruption or technology shock into one equation. Even for the known unknowns this is impossible.
- A **second option** is fixing an interest rate path in advance. Such forward guidance may have some merit at or close to the effective lower bound. Yet, in uncertain times, any projected path should depend on the outlook. If the outlook and the underlying data change, rates must change with them.

I would argue that discipline is most effectively provided via **a clear and understandable reaction function and with its transparent communication**. A clear reaction function ensures that changes in economic conditions lead to policy changes according to a stable logic. People need to understand which aspects of the economy matter for our monetary policy decisions, and how those aspects change the appropriate response. A clear and understandable reaction function is how policy can remain adaptable without becoming arbitrary.

In the case of the ECB, rate decisions depend on the inflation outlook and the risks surrounding it. We look closely at incoming data, at underlying inflation and at how strongly our policy is transmitted. Our approach is data-dependent, moves meeting-by-meeting and does not pre-commit to any rate path. While there is always uncertainty about the next decision, there is no uncertainty about the principles behind our decisions. Unfortunately, this will not tell you where rates should be six months from now. But it describes the shock as best as we can: how strong, how long and how far it may spread. And it explains what developments would make us move one way rather than another. That is what state-contingent policy should look like: The decision can change as the state changes, while the principles governing the action remain recognisable.

7 Voice and control

I have argued that central bank independence creates the conditions for credible commitment. Credibility in turn allows for well-disciplined flexibility in response to supply shocks, based on a clear and understandable reaction function. I would like to add one final point to this chain of reasoning. The foundation of our disciplined flexibility – central bank independence – is a **sign of trust** from society. That trust comes with special responsibility. Let me highlight **three core features** of this responsibility.

First, I would like to emphasise that independence does not place a central bank outside the **democratic order**. Independent central bankers do not appoint themselves, write their own mandates or define the boundaries of their own authority. Those choices belong to the political and legal order, to democratically elected representatives and thus, ultimately, to every single one of you.

Second, the more judgement an independent central bank exercises, the more **explanation** it owes. If policy is allowed to respond differently to different shocks, outsiders need to be able to tell whether a change in policy reflects a genuine change in the diagnosis or simply a change in preference. Explanation is not a public-relations add-on. It is part of what makes an independent decision both accountable and open to correction.

Third, independence cannot mean the absence of voice for the wider society in our decision-making processes. Governments will criticise. Parliaments should scrutinise. Researchers and economists should challenge our diagnosis. Citizens certainly do not owe a central bank automatic trust. As central bankers, we need to **listen to scrutiny** to improve where appropriate, while remaining insulated from direction. It

is telling that Ulysses ties himself to the mast but remains the only one able to hear. Driven by curiosity and eager to learn, he actively exposes himself to the sirens' song.

8 Through the storm

In principle, my remarks apply to all central banks, but in Kyiv, they are anything but abstract. Your endurance gives the questions I have been discussing today a very concrete meaning.

Let me take a brief break from economics and acknowledge what actually sits behind those words. **Russia's unjustified war** against Ukraine has imposed extraordinary human and economic costs on the Ukrainian people. The courage and determination with which Ukrainians have defended their country deserve our admiration. And, as a central banker, I have particular admiration for the staff of the National Bank of Ukraine, who have kept the monetary and financial system functioning throughout the full-scale invasion. That is not simply a case study in adaptable policy. It is an institutional achievement under circumstances none of us would wish to face.

In Ukraine, the distinction between a stable objective and adaptable instruments has been tested under extreme conditions. You have had to conduct monetary policy through war, destruction of productive capacity, attacks on the energy system, enormous fiscal needs, exchange-rate pressure and radical uncertainty. No serious monetary framework could have treated such an environment as business as usual. The key policy challenge is to keep confidence in price stability while everything else changes: the environment, the instruments, the way you operate. The NBU has withstood all adversarial forces.

Extraordinary circumstances require coordination. In fact, the harder the circumstances, the more important it is that the fiscal and monetary sides of the state remain jointly credible: able to support the war effort today without creating doubt about the monetary regime tomorrow.

9 Reaching the destination

Let me come back to the more general case and conclude. Ulysses understood that some future choices had to be constrained. But not every choice can be settled in advance. The monetary policy response must adjust when the economy, when the circumstances change. Different shocks can require different decisions. New evidence can change the underlying diagnosis. Uncertainty can change the appropriate path of interest rates. And yet all this flexibility requires discipline. The monetary policy objective must remain durable and our reaction function clear.

This is where central bank independence matters; where it matters most. It protects our commitment to price stability from short-term pressure without freezing the decisions needed to honour it. A credible central bank is therefore not one that always takes the same action. It is one whose different actions can still and will be understood as serving the same objective.

To close, may we as decision-makers in monetary policy all have the wisdom of Ulysses in that moment: to hear the sirens' song and learn from it, but to pass safely beyond their island.

Thank you.

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