Preparing for the Next Round of Intimidation

Johan Van Overtveldt
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*Though rarely making headlines in major media outlets, the **European Central Bank** (**ECB**) is becoming a focal point of discussion among **European political leaders**. This is not only due to the urgent need to make appointments for the three top jobs within the ECB but also to the more than minor possibility of major upheaval in the **bond markets** of certain **EU member states**.*

European heads of state and prime ministers have a lot on their plate these days. Besides pressing domestic problems—such as governmental paralysis, looming election victories for extremist parties, rising social unrest, industrial depression, and/or increasingly unmanageable public finances—there are also major issues to be tackled urgently at the **European Union** level. Support for **Ukraine**, **Russia's** ever more threatening cyber activities, the **EU's** huge competitiveness problem, and the contours of the next seven-year **EU budget**, the so-called **Multiannual Financial Framework** (**MFF**), are among the most urgent of these **EU "hot potatoes."**

Hardly less urgent, however, are a few crucial appointments, of which those at the European Central Bank (ECB) are the most important. **Christine Lagarde**, the current ECB president, announced she will step down in February of next year, eight months before her term would formally end. Early in January 2027, **Isabel Schnabel**, the **German** member of the ECB's Executive Board responsible for market operations, will leave the

ECB for the IMF in Washington. Last but not least, the ECB's chief economist, **Philip Lane**, will exit the Frankfurt euro fortress in May next year.

Berlin Wall Revisited

The departure of Lagarde, Lane, and Schnabel means that the individuals in the three most crucial posts at the ECB will be leaving their respective positions in a few months' time. At the recently held **ninth European Political Community meeting in Dublin**, the gaping void in the ECB's top ranks was discussed informally but without conclusive results. The most often heard comment is that disagreement within the German government coalition is the major hurdle to reaching a compromise on the ECB. As with so many other policy issues, Chancellor **Friedrich Merz's CDU/CSU Christian Democrats** stand eye to eye with **Finance Minister Lars Klingbeil's Social Democrats** in the discussion on the ECB appointments.

The two main contenders for Lagarde's position are **Klaas Knot**, former president of the Dutch central bank, and **Pablo Hernández de Cos**, currently general manager at the Bank for International Settlements (BIS) and former governor of the Spanish central bank. Knot is generally considered to be the more hawkish of these two contenders. **There is, however, a persistent rumor in European corridors that the Germans have not given up on their ambition to see a German president at the ECB's helm.** Many in Berlin consider it more than Germany's right to finally obtain that position after four non-Germans have served as ECB president since the start of the common currency in 1999: **Wim Duisenberg (**Netherlands), **Jean-Claude Trichet** (France), **Mario Draghi** (Italy), and **Christine Lagarde** (France).

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For the two other ECB top jobs—chief economist and the one overseeing market operations—several names are circulating. There is **Markus Brunnermeier**, the German

top academic economist currently teaching at Princeton University. The two others are French economists. **Laurence Boone** was formerly the OECD's chief economist and now heads corporate and investment banking in France for banking group Santander. The second French contender is **Agnès Bénassy-Quéré**, currently vice president of the Banque de France.

The puzzle is complicated not only because of the wall between the coalition partners in **Berlin** but also because visions on monetary policy and central bank management differ substantially between, broadly speaking, the **northern countries of the EU** and the **southern ones**. The former tend to be more strict and orthodox (often referred to as hawkish), while the latter are much less so and more open to monetary experimentation (often referred to as dovish). Choosing Knot inevitably means that at least one, if not both, of the other two positions would need to go to candidates from southern countries. If de Cos steps into Lagarde's shoes, then northerners would be first in line for the two other positions. And, as always within the EU, the job shuffling at the ECB will ultimately also be related to decisions in other files, such as the MFF. Decision-making within the EU almost always has a touch of higher math to it.

Intimidating Everybody

Much is at stake here given the many uncertainties and potentially complicated situations the ECB will most probably be facing in the near and medium-term future. Most interesting in this context was a quote from an unnamed French official closely involved in these discussions in the Financial Times of November 12. Referring to talks going on between French President Macron and German Chancellor Merz, this French official argued that "**it is important to have both a balance and a shared vision, not just regarding the individuals involved, but also *the ECB's mission today and its objectives in the current context***" (my italics).

The last part of the quote is crucial. On the website of the ECB, the institution's mission is defined as follows: "**The main objective of the Eurosystem is to maintain price stability: safeguarding the value of the euro. The European Central Bank is responsible for the prudential supervision of credit institutions located in the euro area and participating non-euro area Member States, within the Single Supervisory**

Mechanism, which also comprises the national competent authorities. It thereby contributes to the safety and soundness of the banking system and the stability of the financial system within the EU and each participating Member State."

Whereas the prime objective of the ECB, i.e., price stability, is quite clear and unequivocal, the second part of the mission description leaves a lot of room for interpretation in terms of when action by the ECB is required (or not) and what that action might look like. In the present context of heightened geopolitical uncertainty and increasing tensions on worldwide financial markets, the answers needed to tackle major issues that might arise for the monetary authority have the disturbing characteristic of having to become more specific. This is especially so given the mounting turmoil on bond markets. **James Carville**, political advisor to **American President Bill Clinton**, claimed in 1994 that if reincarnation were possible, "**I would like to come back as the bond market. You can intimidate everybody.**" More than three decades later, this metaphor remains highly relevant, as even **President Trump** had to accept early in April 2025. After announcing his Liberation Day trade tariff assault on the rest of the world, the bond market reacted viciously negatively, obliging Trump to hastily and chaotically backpedal on his tariff war "voodoo."

With rising spreads within the euro area—meaning increasing differences between the longer-term bond yields of, on the one hand, Germany and, on the other hand, other euro area members—bond markets are once more intimidating (almost) everybody within the euro area. Since escalating interest rates make the budgetary situation of several euro area member states increasingly difficult to keep under control, the odds of a crisis erupting around the financiability of outstanding and new government debt increase in parallel. The increasingly visible incapability of some euro member governments to get a grip on future budgetary trajectories obviously adds to the potentiality of future crises in the bond market.

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Of course, the ECB will not allow such a crisis to lead to an implosion of the whole euro area construct. But the larger the member state that may come under serious attack if and when the **bond markets** have had enough, the more impressive and comprehensive the **ECB's interventions** will have to be. The ECB can activate its **TPI** (Transmission Protection Instrument) program, but that requires conditionality to be imposed on the country in trouble. Will that be possible? Will the ECB have to step outside its existing arsenal of intervention tools? There is more than passing attention to these questions these days, not only within the ECB but also in higher political circles. Nobody says it aloud, but the fear of a most disturbing financial crisis waiting just around the corner is very much present.

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Back to Basics

The current discussions regarding the ECB's role within the more general macroeconomic and political reality in the EU and its member states must also be seen in a context broader than the actual threats and potential crisis situations. What can politicians expect from central banks? Does it make sense, as many commentators have been doing over the past two decades, to argue that central banks have become the "**only game in town**"? This last claim boils down to the assumption that whatever problem arises in the economy, and even beyond, central bankers can and will take care of it.

Two most interesting pieces of research have popped up concerning these questions. Researchers at the **Dutch Erasmus University** analyzed **385 parliamentary and presidential elections** in **18 countries** between **1900** and **2020**. The main conclusion of this analysis is that political pressure on central banks to switch to easy money policies does not lead to election victories for incumbents. Research at the **German Kiel Institute for the World Economy** reveals, on the basis of analysis of 365 elections, that inflation

surprises almost systematically lead to substantial electoral gains for extremist, anti-system, and populist parties.

The conclusion deriving from this research and from what we see in the real world—think the **Democrats' tsunami** in the **US midterms**—seems rather obvious. Politicians should leave central bankers alone, and central bankers should focus foremost on **price stability**. Of course, given their responsibility for financial stability, central banks also have to intervene to avoid and correct financial crises. Those interventions should, however, not be inspired by fiscal or other needs of the political world. On the contrary, the political world has to take its part of the responsibility for avoiding financial crises seriously. Central bankers are definitely not "**the only game in town**." If **price stability** concerns necessitate higher interest rates, fiscal authorities should assume this and not beg central banks not to raise interest rates. After decades of jostling around with policy objectives and responsibilities, we have come full circle: monetary authorities have to safeguard **price stability**, and fiscal authorities (governments) bear full responsibility for the health of public finances.

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Politicians and monetary authorities should be very much aware that the **bond markets** are watching in an ever more critical mood. The conclusion **Robin Wigglesworth** draws in his magnificent recent book ***A Fabulous Debt: The Epic Story of How Bonds Built the Modern World*** holds more than ever: "**The bond market is the world's cleverest economist, its best political analyst, its most prescient strategist, and its finest scientist ... Its only real ability is to raise the cost of your debt, or to refuse to lend altogether. Yet in a world that increasingly depends on debt as the dominant fuel of economic growth, this is an awesome power.**"