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THE ECB INDEPENDENCE UNDER THREAT

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Introduction

The great success story in macro-economic policy making over the past four decades has been the attribution to central banks of independent powers to achieve price stability – defined in practice by a low rate of inflation, say around 2 per cent. In the new monetary framework, independence has been linked inextricably to the narrow mandate on the control of inflation. By the early 2000s, most central banks in advanced countries, as well as many more in emerging countries, had formally adopted inflation targeting as their main operational objective, including the European Central Bank (henceforward the ECB), the Bank of England and the US Federal Reserve (which has a dual mandate, also encompassing "maximum employment").

However, developments since the great financial crisis of 2008-09 have compromised the simplicity of the monetary policy framework, leading to expanded involvement of the central banks in the markets for public and private securities, with inevitable large effects on borrowers' incentives. The relationship between monetary policy and the measures to address financial instability is a main issue that acquired fresh prominence following the great financial crisis – leading to the development of a new policy framework to address macro-economic stability that was formally entrusted to national governments but that entailed large areas of overlapping with monetary policy powers.

Moreover, the purchase of large amounts of government securities raised fresh questions about the interaction between monetary and fiscal policies, notably within the European monetary union, where the prohibition for the central bank to help the financing of public sector deficits is a key pillar of the monetary constitution. The related involvement in macroeconomic policies affecting the distribution of income became a further source of criticism of central bank independence.

However, the case for central bank independence remains strong as long as the short time horizon of macro-economic government policies maintains alive the risk of inflation surprises for financial investors. This is especially true in the European monetary union, where fiscal policies remain firmly in national hands. This conclusion is even stronger if – as argued by Goodhart and Pradhan (2020) – the long economic depression with low inflation that followed the great financial crisis was an expression of underlying economic forces that have run their course.

However, ECB independence is inconsistent with the present overreach of the institution into the economic policies of the member states, a function for which the ECB is not accountable. Therefore, we argue that ECB powers must be brought back to the original Treaty design of strict separation between monetary policy and all other economic policies. To this end, it is also necessary to disentangle the ECB from its involvement in member states' fiscal policies by first of all drastically reducing its government securities portfolio, bringing it down to the size required to manage monetary policy interventions.

In order to do this, we propose to gradually transfer a large share of these securities to the European Stability Mechanism (ESM), which would then become a true debt agency for the European Union. The ESM liabilities would also become the safe asset required to provide the euro financial system with a well-functioning unified money market.

The structure of the paper is as follows. Paragraph 2 describes the theory underpinning central bank independence. Paragraphs 3 and 4 review the ECB's legal setup and its evolution over the decade following the great financial crisis. Paragraph 5 discusses the main decisions by the European Court of Justice (ECJ) on Treaty limitations of ECB powers. Paragraphs 6 and 7 describe the monetary policy quagmire created by the new Transmission Protection Instrument requiring the central bank to intervene to stabilize the government securities markets of some euro area member states from the possible adverse consequences of restrictive monetary policy. Paragraphs 8 and 9 illustrate our proposals to remedy the current policy overreach of the ECB and reestablish appropriate institutional conditions for monetary policy independence from fiscal policy.

Central Bank Independence with Multiple Mandates

A theoretical case for entrusting monetary policy with an inflation mandate to an independent central bank is predicated on its efficacy in eradicating inflation expectations by removing fears of inflation surprises engineered by policy makers to gain popularity in the short term – thus overcoming the famous problem of time inconsistency of optimal policy (the classical references are Kydland and Prescott 1977 and Barro and Gordon 1983). Rogoff (1985) ingeniously suggested that the central bank commitment to low inflation could be resolved by appointing a “conservative” central banker to manage the central bank – with conservatism defined as an inflation preference lower than that of politicians and the public at large.

Over time, this approach appeared increasingly attractive, following the successful experience of some central banks (e.g., the Central Bank of New Zealand and the German Bundesbank) which managed to keep inflation down in the years of runaway inflation that followed the breakdown of the fixed exchange rate system in the 1970s, as well as to reduce the volatility of both prices and output. Lower inflation and reduced volatility of prices and output have in turn seemingly allowed to tame economic distortions and improve resource allocation, bringing the economy closer to its efficient frontier and setting the basis for the “great moderation”, the long and steady economic expansion in the US and the world economy of the ensuing two decades (Bernanke 2004, Blanchard and Simon 2001, IMF 2012, Draghi 2018).

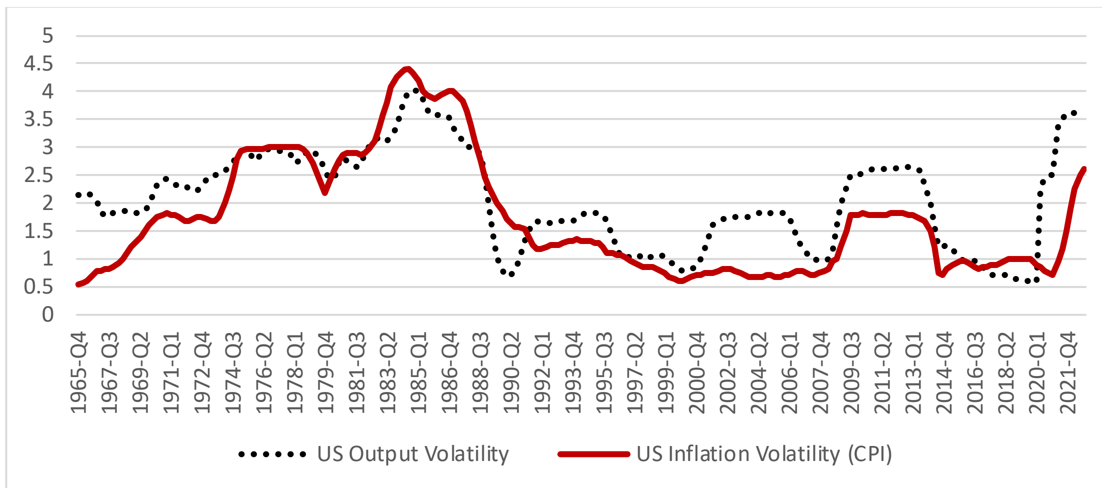
A key ingredient underpinning the new monetary policy framework is that inflation volatility and output volatility seemingly move together, rather than with inverse correlation (as Stiglitz 1998 had erroneously believed). Therefore, by reducing inflation and inflation volatility, monetary policy would also contribute to moderating output volatility (Chart 1).[1] Alesina and Summers (1993) provided authoritative empirical support both to the (long-term) neutrality of money and the low output costs of tying the hands of monetary policy. Their straight conclusion is that “central bank independence reduces the level and variability of inflation but does not have either large benefits or costs in terms of real macroeconomic performance”.

In the economic literature, political independence is the degree of influence that elected politicians have over the central bank and encompasses appointment and dismissal procedures of central bank officials, the presence of government representatives in central bank decision-making bodies, and the controls over potential conflicts of interest for central bank officials. Operational independence, on the other hand, is the ability of the central bank to move its instruments, such as the discount rate or reserve requirements, to achieve monetary policy goals. A key requirement for operational independence is the prohibition of financing government deficits, which protects the central bank from any obligation to provide funding at the expense of its ability to control inflation (Balls et al 2018).

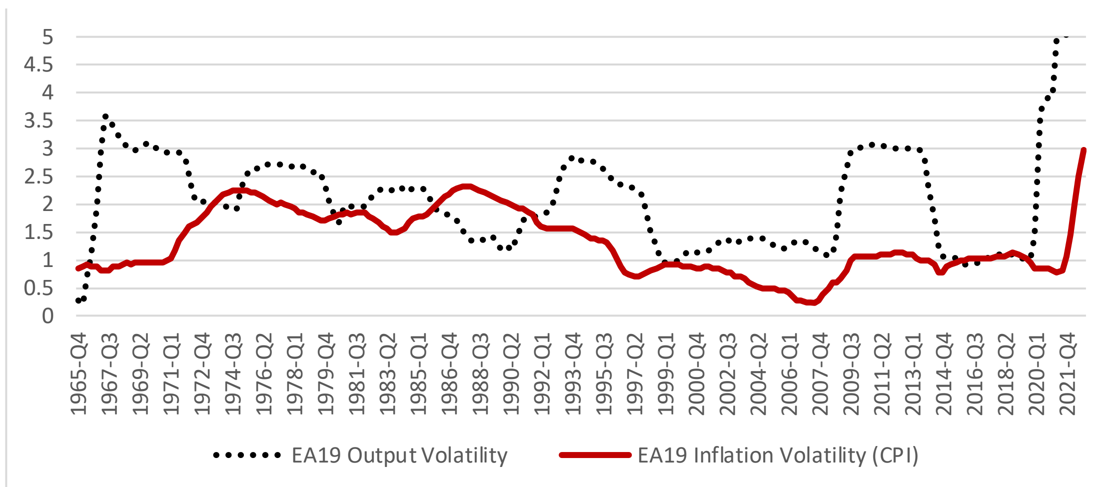
[1] Blanchard and Gali (2007) showed that, in the New Keynesian model, nominal wage rigidity weakens the “divine coincidence” between output and inflation volatility – meaning that restrictive monetary policies will have some output costs, at least temporarily.

Figure 1. Output volatility and Inflation volatility (%, 1965-2022)

A. United States



*B. Euro Area**



Source: OECD

Note: Output Volatility is the twenty-quarter rolling standard deviation of quarterly real GDP growth.

Inflation Volatility is the twenty-quarter standard deviation of the quarterly inflation rate (CPI for both US and EA).

** EA19 data refers to Germany until 1991. EA19 does not include Croatia.*

Independence was mostly posited as *instrument* independence, i.e., the freedom of the central bank to set its operational instruments without any government interference in the pursuit of an inflation target set at the political level. The argument against *goal* independence is that in a democracy the ultimate goals of monetary policy should be decided by elected authorities, while only the conduct of monetary policy in the pursuit of those goals should be free from political control (De Haan and Eijffinger 2016, Bernanke 2010).

Empirical evidence has confirmed a strong negative correlation between inflation and operational independence of the central bank while, at least in advanced economies, goal independence has seemingly played a lesser role in taming inflation (Cukierman 2008, De Haan and Eijffinger 2016). At least to an extent, this result probably reflects the fact that legal and institutional arrangements change more slowly than output and inflation, and therefore their mutual relation is less readily detected with regression analysis. However, in advanced economies the societal commitment to low inflation is often implicitly embedded in institutional arrangements, meaning that the autonomous empirical role of instrument independence in taming inflation is probably overestimated. Tellingly, formal legal independence arrangements, including restraints on removing central bank governors, are more frequent in emerging countries, where the societal consensus on low inflation often is weaker.

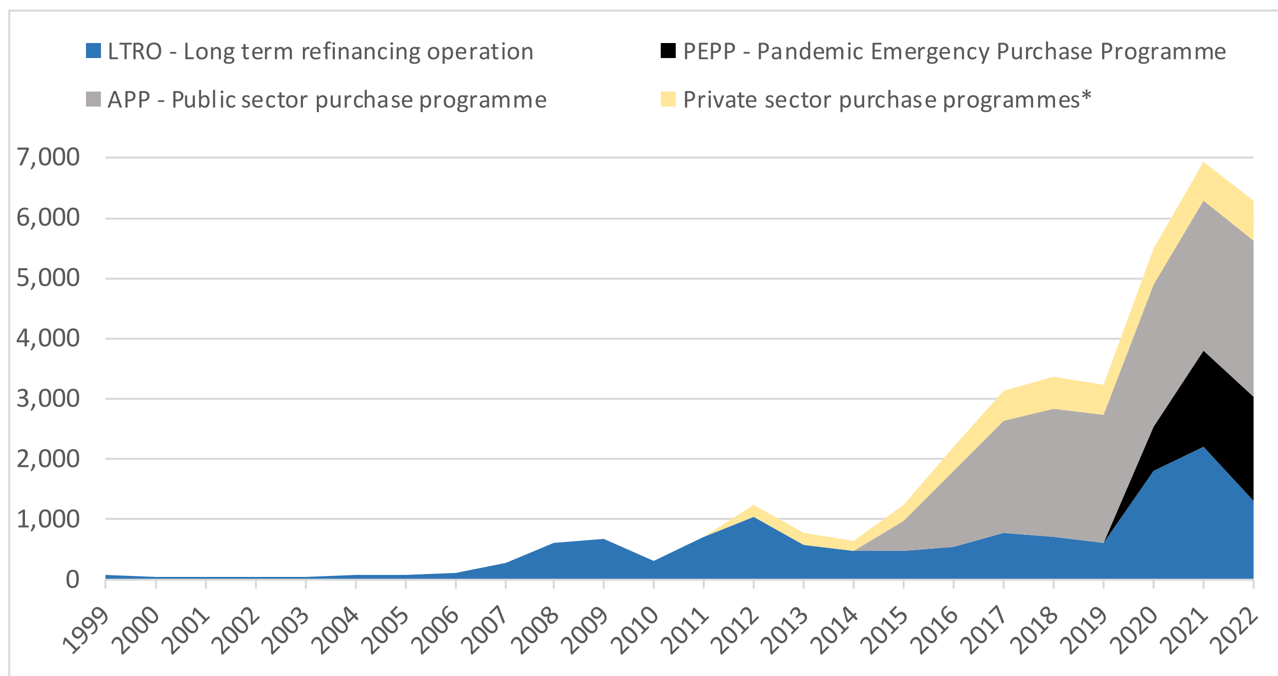
Central banks' freedom to vary their operational instruments has entailed considerable discretion, de facto settling the long-running dispute between rule and discretion in favour of the latter. The main reason has been the inability to find a stable relationship between the final policy goals (inflation and output) and monetary and credit aggregates, which has undermined the case for simple monetary rules as originally advocated by Milton Friedman (1968).

The adoption of inflation targeting by central banks resolved the issue, with independence closely linked with a requirement of full transparency to the public at large not only about policy decision-making but also of underlying economic analysis and forecasts over inflation and output (Dall'Orto et al. 2020). Formally, central banks have been made accountable to the parliaments that had legislated their independent powers and the inflation goal, e.g., Congress in the US and Parliament in the UK. The ECB, whose statute was set up by the Treaty of Maastricht, was made accountable to the European Parliament, the only elected (and hence truly federal) body amongst European institutions, which under the Treaty exercises political oversight of the Commission and all European agencies, including the ECB.

Clarity and transparency about central banks' policy goals and the reaction to be expected by the central bank to unforeseen events also play an important role in enhancing the effectiveness of policy by helping households and firms anticipate central bank actions, thus reducing uncertainty and amplifying the effects of monetary policy on long-term rates (Bernanke 2010). A high standard of transparency about decision making was set by the US Federal Open Market Committee, the Bank of England, and the ECB. These arrangements typically entail: (i) release of a written statement after each meeting explaining policy decisions; (ii) publication of the minutes of the meetings shortly after the meetings (within a few weeks); (iii) full publicity about the central bank policy instruments, balance sheet and the economic analysis and data underpinning policy decisions. The ECB pioneered the practice of holding a press conference after each meeting of the Governing Council to help clarify its decisions and their motivations.

Developments since the great financial crisis of 2008-09 have compromised the simplicity of the monetary policy framework, leading to expanded involvement in the markets for public and private securities, with inevitable large effects on borrowers' incentives (Chart 2).

Figure 2: The ECB balance sheet: asset purchase programmes and LTRO (billion euro, 1999-2022)



Source: ECB.

** This indicator includes private sector purchase programmes under APP (Corporate Sector, Covered Bond 3, and Asset-backed securities) and Security Market programme.*

There were two main changes in the implementation of monetary policy: first, the central banks had to step in as market makers of last resort; second, once the policy rates hit the zero lower bound (in early 2009), with quantitative easing their action expanded to altering the risk components of the main assets, including government bonds, corporate bonds, and mortgage bonds, hence coming much closer to steering credit to specific sectors (Tucker 2018).

The relationship between monetary policy and the measures to address financial instability is a main issue that acquired fresh prominence following the great financial crisis (IMF 2012; Balls et al. 2018). It became common wisdom that monetary policy had overlooked the implications for systemic stability of financial market imperfections and the swelling size of the non-bank financial sector. Financial innovation in improving access to credit and promoting the diversification of risk had been seen as beneficial regardless of its effects on risk-taking and balance sheet exposure to credit and interest rate risk. The new perception[2] set up a separate policy framework for macro-prudential supervision.[3] Macro-prudential tools include capital requirements and buffers, forward-looking loss provisioning, liquidity ratios, and prudent collateral valuation.

A careful review of macro-prudential policy tools and their effect is provided by Smets (2014). The empirical evidence on their effectiveness is inconclusive, also due to the limited period of application of

[3] In the EU the establishment of the European Systemic Risk Board took place in 2010, following a recommendation of the Larosière Report.

the new framework. In general, macroprudential tools may doubtless exercise a restraining effect on excessive credit expansion and asset prices, but in some cases did not prevent the accumulation of systemic risks. One aspect that may not help their effectiveness is that the responsibility for macro-prudential measures has been fragmented between various regulators and supervisors, which has not helped coherent application.[4] Another is that monetary policy may have large effects on risk taking and systemic exposure, especially in the environment of large debt accumulation where we are now living. In other words, the instruments of monetary policy and macro-prudential stability may not be sufficiently independent of each other. To the extent that financial stability is made an explicit goal of monetary policy, there is a risk of financial dominance, that is the risk that consideration of financial stability of sectors or categories of intermediaries may weaken the pursuit of the main goal of price stability.

These developments have fuelled reactions of opposite sign. On one hand, there are those who think that central banks have grown too powerful. Some analysts have argued that independence is less needed when the goal is to raise inflation rather than lower it since in this case there is no inflation bias to be dealt with. Policy failures were also feeding criticism of central bank independence: in 2022-23 it became apparent that inflation was coming back in earnest, and the main central banks had failed to detect the shift in underlying price pressures, admittedly in an environment of extreme uncertainty, due to shortcomings in their forecasting models.

However, the case for central bank independence remains strong as long as the short time horizon of macro-economic government policies maintains alive the risk of inflation surprises for financial investors.

This conclusion is even stronger if – as argued by Goodhart and Pradhan (2020) – the long economic depression with low inflation that followed the great financial crisis was an expression of underlying economic forces that have run their course. The main aspect of relevance here is the changing equilibrium in world labour markets. In the authors' view, the integration of China and Eastern European countries into the world labour market in the 1990s had led to an excess supply of (unskilled and semi-skilled) labour in advanced economies, and hence to an excess of savings over investment, which had structurally depressed wages and interest rates over the ensuing two decades – even raising concern of secular stagnation (Summers 2020). Under this interpretation, the improvement in monetary policy frameworks that have been described may still claim some merit for promoting a stable economic environment, but persistent excess supply stands out as a main factor in fostering low inflation. Nowadays, as the excess supply of labour is steadily reabsorbed by demographic trends (aging), the risk of excess demand fuelled by fiscal policies is likely to return as a constant feature of our economic systems; hence central bank independence will continue to be needed to credibly eliminate inflation surprises.

There are, however, reasons to fear that, as inflation pressures return in advanced economies, the political and social consensus that had so far sustained central bank independence may weaken. First, harsh restrictions may become necessary to tame inflation, which in the meantime has become entrenched in our "core" economic variables. Second, we have moved into a highly uncertain world in which central banks' economic forecasting models have failed to foresee the strength of underlying price pressures, leading to monetary policy decisions taken "meeting by meeting" based on inflation

[4] The recent strains in the US mid-sized banks (Spring 2023) confirm this conclusion. As it turned out, mismanagement and wanting prudential oversight were more important in explaining the failures of the Silicon Valley and First Republic banks than possible failures of the macro-prudential rules. Cf. Board of Governors of The Federal Reserve System, Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank, April 2023.

data. Central banks' credibility may be weakened by central banks' inability to indicate a reliable future path of inflation.

Finally, central banks' new mandate to protect financial stability is much less apt to a clear and simple definition as for the goal of price stability (2% inflation), raising fresh questions on the accountability of central banks. As has already been mentioned, the ECB has gone as far as to create a mechanism for limiting adverse spreads over government securities of high-debt eurozone members. The new tools deployed by the ESCB have raised fresh challenges to central bank independence. These include the changed balance of power between fiscal and monetary policy, in an environment of global debt hang-over; the risk to financial independence posed by the enormous increase in central bank balance sheets; and the claims for greater political accountability of institutions that may undertake measures involving substantial redistributive effects than traditional monetary policy (Mersch 2017, Jones et al. 2021).

New Tasks for the ECB

The ECB is a young institution, and its credibility was inevitably subject to hard scrutiny in its early years, especially since it had to stand against the performance of its main predecessor in the eurozone, the Deutsche Bundesbank, which had hitherto set the standard for good central banking. The challenge was complicated by the specific institutional structure of the eurozone, where the single monetary policy would coexist with separate national economic and fiscal policies.

The Treaty on the Functioning of the European Union (henceforth the TFEU) established the European System of Central Banks (ESCB), consisting of the ECB and the national central banks (NCBs) of countries participating in the euro area, and assigned to the ESCB the "primary objective" to maintain price stability. To this end, the Treaty gave the ESCB the core task of defining and implementing monetary policy (Article 127 TFEU).

Independence of the ESCB – which amounts to effective insulation from national and EU political processes – is guaranteed by Articles 130 and 282(3) of the TFEU. Article 130 prohibits the ECB and its national central banks from taking instructions from any other public institution, European or national, in performing their tasks. Article 282(3) provides that the ECB "shall be independent in the exercise of its powers and in the management of its finances". This provision makes the ECB independent also in the management of its budget – which is possible because monetary policy generates sufficient resources to pay for its operations and generate a profit, which is distributed to national central banks in proportion to their share in the ECB capital, and eventually returned by them to national treasuries.

Independence only applies when the ESCB and the ECB are "exercising their powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and the ECB" – which boils down to the main goal of maintaining price stability. When there is no conflict with this main goal, the ESCB "shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union".

As a further safeguard against political pressures, it is also prohibited for the ESCB to provide monetary financing to government bodies or agencies of any type at the European and national level, as well as to purchase directly from them their debt instruments. This provision does not preclude the ESCB from purchasing government securities in the secondary market, albeit with certain additional safeguards to be described later, opening the door for the so-called quantitative easing policies in the 2010s.[5] As a

[5] Central bank independence is also protected by rules on the required personal qualifications of the members of the Executive

further safeguard against political pressures, it is also prohibited for the ESCB to provide monetary financing to government bodies or agencies of any type at the European and national level, as well to purchase directly from them their debt instruments. This provision does not preclude the ESCB to purchase government securities in the secondary market, albeit with certain additional safeguards to be described later, opening the door for the so-called quantitative easing policies in the 2010s.[6]

Independence entails a suspension of normal oversight and accountability of an important public administration, the ESCB, which is entrusted with a narrow mandate of a technical nature, i.e., to achieve price stability. Transparency and accountability are therefore essential complements of independence. Transparency requires the clear communication of monetary policy goals and the underlying analysis of inflation developments so as to make private agents fully aware of ongoing decisions – thus also facilitating their supportive reactions in achieving inflation goals. An important event in this process is represented by the written statement announcing the monetary policy decisions of the Governing Council and the press conference that follows their meetings.

Accountability is achieved by ex-post explanation and justification of the monetary policy course and its impact, as required by the Treaty – including the presentation of reports to the European Parliament, the European Council, and the European Commission on an annual and quarterly basis, the willingness of executive board members to explain their actions and decisions before the competent parliamentary committees, and the response to queries from members of the European parliament.

A main addition to the responsibility of the ECB was decided in June 2012 by the European Council as part of a new drive towards the Banking Union and covered the prudential supervision of credit institutions. This decision was taken under Article 127(6) of the TFEU which explicitly provided the possibility for the Council to confer to the ECB specific tasks in this domain; it was formally adopted in October 2013 with Council Regulation n. 1024/2013 establishing the Single Supervisory Mechanism (the SSM Regulation). The new tasks were entrusted to a separate structure within the ECB, the Supervisory Board, with specific provisions to prevent possible interferences with monetary policy, including separate reporting lines and strict restrictions on the exchange of information between the two organizational structures (cf. Article 25 of the SSM Regulation).

However, under Article 127(6) of the TFEU, the SSM was not (and could not be) established as a separate legal entity but as a new legal task of the ECB. Accordingly, the ultimate responsibility for the decisions of the SSM was entrusted to the Governing Council of the ECB, under a no-objection procedure which allows the Governing Council to send back the decision to the Supervisory Board for reconsideration. For cases in which the Governing Council did not agree with proposals by the Supervisory Board, the ECB was required to set up a Mediation Panel entitled to settle such disagreements, if requested by a national authority. The competent authorities of a concerned member state can also make a request for mediation.

Article 19 of the SSM regulation defines the degree of independence of the ECB in the performance of the new tasks. It establishes that the "ECB and the national competent authorities acting within the

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Board and by their long term of office (8 years). They are also protected from arbitrary dismissal by the ESCB Statute. Similar protection applies in principle to national central bank governors, although in practice this has not impeded harsh treatment and dismissal in some member countries of the euro area, after the governor came in conflict with the government (Demetriades 2020).

SSM shall act independently"; a stricter requirement of independence is set for the members of the supervisory board and the steering committee, which "shall act independently and objectively in the interest of the Union as a whole and shall neither seek nor take instructions" from Union and national institutions and from any other private body. This last specification is meant to prevent possible conflicts of interest arising from the inevitably close relations between supervisors and supervised banks. The SSM also has its independent budget financed by fees applied to supervised banks.

The question has arisen as to whether the independence provisions for the SSM differ from those for the ECB in their monetary policy tasks. The straight answer has been provided by the ECB itself (Mersch 2017): the ECB independence is set by the Treaty and thus is part of the Union constitutional law, which takes it outside the possible scope of Union legislation; the SSM independence, on the other hand, is provided by secondary law which may be changed with ordinary legislative procedure. Furthermore, while they must "act independently", there is no explicit prohibition for the ECB and the national competent authorities within the SSM to accept instructions, reflecting the fact that in some member states the national competent authorities are bound by the directives of the respective ministries. Indeed, in performing its supervisory tasks, the ECB must respect European and national laws regulating the matter. Finally, the principle of personal independence only applies (weakly) to the Chair, Vice-Chair, and ECB representatives in the Supervisory Board, under different specific rules for dismissal, and not to the national representatives in the Supervisory Board.

In sum, in its supervisory tasks, the ECB may not be fully shielded from external influences, while to an extent its discretion in the use of supervisory tools is subject to the legislative and regulatory powers of Union and national legislators. The possibility of conflict between the monetary policy of the ECB and its supervisory responsibilities in case of a crisis of a major bank, possibly involving its resolution, cannot be ruled out. Yet the arguments for removing banking supervision from the ECB tasks seem on the whole unconvincing, mainly in view of the need to preserve the central bank's close oversight of banks in the protection of monetary and financial stability (Whelan 2012).

As was already recalled, a main shared conclusion of the analyses undertaken after the great financial crisis of 2008-09 was that micro-prudential supervision, that is the individual surveillance of financial institutions, is insufficient to prevent the buildup of systemic risks in the financial system, and that therefore a new domain of supervision, macro-prudential supervision, was needed to monitor and contrast the accumulation of systemic risks, especially arising from the interconnectedness of large financial institutions worldwide. Formal proposals to this end at the EU level were included in the Larosière Report published in 2009, which wanted to entrust important responsibilities in this domain to the ECB.[7] This recommendation was not followed through by the European Council, which for [8] (including the possible fiscal repercussions of macro-prudential tools) took the view that macro-prudential supervision in the EU should be managed primarily at the [9][10]

In 2010 the European Parliament and the Council of the EU adopted a Regulation (n. 1092/2010 of 24 November) establishing a European Systemic Risk Board (ESRB), which was charged with monitoring systemic risks and making recommendations for tackling them effectively to the Council as well as

[7] The Report of the High-Level Group on Financial Supervision in the EU, published in Brussels on 25 February 2009.

[10] Under the SSM Regulation, the ECB has power to raise requirements for capital buffers than applied by the national competent authorities or national designated authorities of participating Member States, countercyclical buffer rates and apply more stringent measures aimed at addressing systemic or macroprudential risks at the level of credit institutions.

national authorities. The ECB was to ensure the secretariat of the ESRB and provide it with analytical, statistical, logistical, and administrative support. The Board was to include representatives from the ECB (President and Vice-President), the central bank governors of the EU, the Chair of the Financial Services Authorities (EBA, ESMA, and EIOPA), and experts from the scientific committee; it was to be chaired, in its first five years of existence, by the President of the ECB. Over time, however, the ESRB has failed to gain influence and its reports, albeit of excellent quality, have not played a significant role in the evolution of financial regulation – be that for lack of legal powers or weak relevance of its recommendations in a more stable financial environment. The tight organizational connection to the ECB, however, may backlash onto the ECB's reputation in case of new bouts of instability, where it would not be easy to distinguish macro-determinants, remaining under member states' remit, from micro-determinants under the remit of ECB supervision.

The last strand of new competencies falling upon the ECB was related to the establishment in 2012 of a new crisis management instrument, the European Stability Mechanism (ESM), tasked to provide financial assistance to euro area countries in severe financial distress. Under the Treaty establishing the ESM, the latter may provide financial assistance to member states conditional on the adoption of macroeconomic adjustment programmes designed and monitored by the Commission "in liaison" with the ECB. These programmes played a major role in managing the debt-related financial crisis within the euro area in 2010-12. While the ECB always maintained that its role was that of a junior partner providing technical support, on a number of occasions it appeared to play a more significant role.

For instance, the Irish crisis in 2010 was seemingly the direct result of the stand taken by the ECB against any form of sovereign debt restructuring, which forced the Irish government to provide its full guarantee for all banking losses and, hence, to seek financial assistance from the ESM. There is ground to argue that the letter sent by Trichet and Draghi to the Italian government in September 2011 was instrumental in precipitating the downfall of Berlusconi and its substitution with Mario Monti two months later.

Even more relevant appears the role played by the ECB in the negotiations of an ESM programme with the Greek government. In February 2015, the ECB withdrew recognition of Greek sovereigns as eligible collateral for ECB loans, having determined that the Greek government no longer complied with a European Union/IMF programme.[11] This left emergency liquidity assistance (ELA) as the only channel of official finance open to Greek banks. Then, in June 2015 the ECB decided to cap access to ELA by Greek banks, which led to a bank holiday of various weeks that cornered the Greek government in their negotiations with the Commission. While these decisions were doubtless taken by the ECB in the exercise of its own powers regarding[12][13]

The European Court of Justice was called in to rule on the consistency of some of its interventions with the TFEU, notably in regard to the establishment of the OMT programme in September 2012 (Case C-62/14) and the decision to intervene in secondary markets to purchase public sector securities (C-493/17). An important decision by the Court was also adopted on the compatibility with the EU Treaty of the establishment of the ESM. Before turning to a discussion of these decisions, it seems appropriate to briefly recall some aspects of the twin crises of 2088-12 which have affected profoundly the mandate

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[11] Decision (EU) 2015/300 of the European Central Bank of 10 February 2015 on the eligibility of marketable debt instruments issued or fully guaranteed by the Hellenic Republic (ECB/2015/6).

[13] In their Press Communiqué of 28 June 2015, the Governing Council announced that their deliberation had been taken "following the decision by the Greek authorities to hold a referendum and the non-prolongation of the EU adjustment programme for Greece"

of the ECB.The European Court of Justice was called in to rule on the consistency of some of its interventions with the TFEU, notably in regard of the establishment of the OMT programme in September 2012 (Case C-62/14) and the decision to intervene in secondary markets to purchase public sector securities (C-493/17). An important decision by the Court was also adopted on the compatibility with the EU Treaty of the establishment of the ESM. Before turning to a discussion of these decisions, it seems appropriate to briefly recall some aspects in the twin crises of 2088-12 which have affected profoundly the mandate of the ECB.

From the Collapse of Lehman Brothers to "Whatever it takes".

In its early years, the ECB was successful in the pursuit of its primary goal of price stability and hence in establishing its credibility (Hartman and Smets 2018). Average inflation in the euro area over its first twenty years of existence was about 1.7 per cent, and its moving average fluctuated closely around 2 per cent until the sovereign debt crisis, after which it fell to a historic low of 0,7 per cent at the beginning of 2016, only slowly recovering afterward.

The financial crisis following the collapse of Lehman Brothers in September 2018 opened the way to various non-standard measures, matching sharp interest rate reductions (effectively, 400 basis points from October 2008 to May 2009) with various measures to enhance the provision of liquidity to the banking system in response to the collapse of bank intermediation – including the expansion of eligible assets for the provision of collateral in ECB refinancing operations and the reduction in the minimum rating for eligible collateral, as well as and new facilities for longer-term refinancing and the provision of dollar liquidity. The first programme for outright bond purchases – the Covered Bond Purchase programme – was started in July 2009. Expansionary fiscal policies were also agreed at the G-20 summit in November 2008 and led to expansionary fiscal support in the European Union of around 1.5 per cent of GDP. Euro area financial institutions were also supported by massive capital injections, liability guarantees, and asset support, amounting (ex-post) to some 15 percent of the area GDP. Announcements by the policy authorities had been double that amount.

These measures were effective in restoring confidence and turning GDP growth into positive territory by the end of 2009. By 2010 headline inflation rose back to about 2 per cent. The key features of the measures above mostly explaining their success was the consensus on their necessity and the ensuing swift concerted action. This consensus broke down in the ensuing phase, leading to the euro area sovereign debt crisis.

The detonator was the Greek debt crisis, opened by the Greek government's revelation in October 2009 that their public sector data on debt and deficit has been misreported for years. While European governments agreed to put together a rescue package for Greece, this elicited a wave of mistrust in the financial conditions of many other euro area countries where public debt had increased substantially – notably Cyprus, Ireland, Portugal, and Spain. The heightened risk of losing market access pushed these countries into an adjustment programme supported by the new crisis management facility – the European Financial Stability Mechanism (EFSM), later turned into the ESM (eventually established by the European Council in 2013). However, rather than subsiding, financial tensions persisted and in 2011 extended to Italy and France. They were fuelled by a growing perception that disagreement between the member states over the source of the crisis could end up forcing one or more member states out of the euro area. Redenomination risk had been born.

During the winter of 2010-11 the European Council, following the interpretation whereby the crisis was generated by excessive public debts in some countries, approved various legislative measures to strengthen fiscal discipline, including the Six Pack and the Two Pack (Micossi and Peirce 2014). Under the latter provisions, eurozone member states are required to submit their draft budgets to the European Commission before they are adopted by national parliaments, and the Commission may ask for revisions if it considers that the draft budget is at risk of breaching the stability and growth pact (SGP). Moreover, with the Fiscal Compact,[14] promoted by Mario Draghi to help meet German concerns about

[14] The Treaty on Stability, Coordination and Governance of the Economic and Monetary Union, signed by euro area members on 2 March 2012 and entered into force on 1 January 2013.

fiscal discipline, eurozone members committed to adopting national budgetary rules, preferably at a constitutional level, binding them to a balanced budget, including automatic corrective measures in case of breach of the SGP medium-term objectives. Under these rules, the cumulated impact of budgetary slippages on government debt would have to be considered in designing corrective measures.

A further step to restore confidence, taken by the European Council in June 2012, was the project for the Banking Union entailing the transfer of banking supervision to the ECB, the establishment of a resolution authority to handle terminal bank crises, and cross-border deposit insurance. While the first two pillars of the banking union were approved swiftly, deposit insurance was shelved indefinitely due to widespread concerns about the large exposure of some banking systems to national public debts (notably in Italy).

And yet, financial instability did not subside until President Draghi's announcement, in July 2012, that the ECB would do "whatever it takes" to preserve the euro. Something was missing in the measures brought forward by Union legislators, and that was the willingness of the ECB to act as lender of last resort in government securities markets of euro area member states. This issue has deep roots in the architecture of the euro area that must be spelled out.

As well explained by De Grauwe (2011), by entering the euro its members relinquished control of their national currency, while the euro would not be available to provide lending of last resort to national debt markets without permission from the ECB Governing Council. This entails that, unless the ECB decides to step in, a loss of confidence by international investors may generate a self-fulfilling confidence crisis in national debt markets and drive the country into default.

The problem was compounded, in the events leading to the euro area sovereign debt crisis, by the widespread reading of the mounting financial tensions as a consequence of excessive public debts and deficits – even if empirical evidence did not broadly conform to such interpretation, with the notable exception of Greece (De Grauwe and Ji, 2012). This created strong resistance to providing financial support to the countries under strain unless they preliminarily agreed to adopt severe adjustment programmes to contain their public sector deficits and curb public spending. The publicly voiced disagreement by the main euro area policymakers on the sources of the crisis only helped aggravate financial tensions.

Thus, the ECB was only permitted to intervene after the countries under pressure within the euro area had adopted fiscal deflationary packages designed to assuage creditor countries (as reflected in Target2 balances within the ECB), and bank prudential supervision was moved to the ECB to overcome the alleged capture of national regulators by the banks. Only then President Draghi was allowed to announce that the ECB was ready to act to save the euro with its Outright Monetary Transactions (OMT) programme. The press Communiqué of 2 August stated the main purpose of OMT quite clearly: "risk premia that are related to fears of the reversibility of the euro are unacceptable". However, in their subsequent press communiqué of 6 September, the ECB also stated that a necessary condition for activation of the OMT would be "strict and effective conditionality attached to an appropriate European Financial Stability Facility/ESM macroeconomic adjustment programme". Accordingly, they stated, the Governing Council would consider OMT to the extent that "they are warranted from a monetary policy perspective as long as programme conditionality is fully respected and terminate them … when there is non-compliance with the macroeconomic adjustment or precautionary programme ".

Thus, the conceptual distinction between financial instability stemming from country fundamentals and financial instability generated by the very architecture of the euro area was not yet firmly established within the Governing Council – which played it safe by imposing conditionality as a pre-condition for government bond purchases. It may be noted, nonetheless, that at that time the ECB followed in its operations the so-called *separation* principle, meaning that the conduct of monetary policy was focused on setting policy rates dictated by the price stability goal, while market operations were undertaken to ensure that market turbulences would not hamper the transmission of policy rates to the economy (Hartman and Smets 2018). Therefore, the conceptual basis for distinguishing ECB measures based on their different goals was already there.

The distinction became explicit much later, after the return of inflation and the monetary policy turned into restrictive territory, with the introduction of the TPI to shield high-debt members of the euro from the unwanted adverse effects of monetary restriction on interest rate spreads across the euro area.

At all events, in the Summer of 2012, the announcement of the OMT succeeded in calming market tensions without any interventions by the ECB. This seemingly confirmed that financial instability was driven by investors wanting to test the resilience of the euro as such, due to its specific architecture. The credibility of the ECB response was founded on a fresh commitment by the members of the euro area that no one among them would be allowed to fall out of the system, as all key policymakers within the euro had concluded that, once the door was opened to let one member's currency exit the euro, it would be most difficult to close it again.

The Powers of the ECB under Three Decisions by the European Court of Justice

The ECJ was called in to rule on the consistency with the TFEU of some ECB "unconventional" measures, notably regarding the establishment of the OMT programme in September 2012 and the decision to intervene in secondary markets to purchase public sector securities. An important decision by the Court was also adopted on the establishment of the ESM that among other things clarifies the allocation of tasks between the ESCB and the ESM in tackling financial instability. We can now turn to examining these important decisions.

Outright Monetary Transactions

The Outright Monetary Transactions (OMT) is a programme of government bond purchases in the secondary markets of euro member states that have subscribed to an EFSM/ESM adjustment programme "to the extent that they are warranted from a monetary policy perspective as long as programme conditionality is fully respected" (cf. ECB press communiqué of 6 September 2012). They may also be activated for member states already under an adjustment programme "when they will be regaining bond market access". As has been recalled, the announcement of OMT was effective in calming market tensions, and no market interventions were undertaken by the ECB.

With its preliminary ruling on the decisions of the Governing Council of the ECB on monetary transactions by the ESCB in the government bonds market (Case C-62/14, Gauweiler et al.), taken in response to questions raised by the German Constitutional Court, the ECJ has established important principles regarding the domain of action of monetary policy and the attendant separation from other economic policies not belonging to the ESCB.

The questions posed by the German Constitutional Court were the following:

(i) Whether the OMT decisions fell within the mandate of the ECB;
(ii) Whether they infringed the prohibition of monetary financing of Article 123 TFEU.

The ECJ confirmed that the ECB monetary policy competencies comprise selective government bond-buying to preserve the singleness of monetary policy through a properly functioning transmission mechanism. Thus, the ECB is empowered to intervene to correct the fragmentation of financial markets, which is a specific feature of the euro area linked to national rules and oversight practices that may endanger the smooth transmission of monetary policy, in the face of potentially self-fulfilling redenomination risks (on this cf. the Introductory Statement by Mario Draghi to the ECB press conference of August 2nd, 2012).

According to the Court, "the objective of safeguarding an appropriate transmission of monetary policy is likely both to preserve the singleness of monetary policy and to contribute to its primary objective, which is to maintain price stability" (Case C-62/14, para. 47). Furthermore, they found that "in order to

achieve the objectives of the ESCB and carry out its tasks … the ECB and the national central banks may in principle operate in the financial markets by buying and selling outright marketable instruments in euro" – which is one of the policy instruments provided for by primary law (para. 54; cf. Zilioli 2016 for a discussion of the decision). At all events, it appeared to the Court that sufficient safeguards had been built into OMT to ensure that "it will not, in practice, have an effect equivalent to that of a direct purchase of government bonds from public authorities and bodies of the member states" (para. 107).

The Court also found that that, although OMT may have favorable consequences for the financing conditions of the public deficit of the member states, the features of the programme "preclude the possibility" that OMT creates an incentive for member states to dispense with fiscal consolidation thank to the financing opportunities generated by the programme (para. 120). The Court confirmed, specifically, that the conditionality attached to the OMT programme does not make it an economic policy programme but is solely there to ensure that the monetary policy measures will not undermine the discipline of economic policies followed by the member states.

It should be noted, in this regard, that, following the financial crisis of 2008-09, the ECB had been acting to moderate financial instability in sovereign bond markets for some time, as sovereign debts rose vigorously to cushion the economic fallout of the post-Lehman financial crisis. Ample provision of liquidity to the banking system was complemented, in May 2020, by a new sovereign bond purchase programme, the Securities Market Programme (SMP). The programme, however, did not impress investors, probably because of mixed signals by the ECB, which at least initially wanted to keep the monetary policy stance unchanged and, as a consequence, was fully sterilizing the liquidity effects of its government purchases (Hartman and Smets 2018). In addition, the crisis of the two largest Irish banks in 2010 fed fears of more banking instability to come.

Thus, OMT was the strong act required to halt mounting financial speculation, which up to that point had been unmet by monetary policy tools, owing to disagreements within the Governing Council, and indeed the European Council itself, on the sources of instability. The twin decisions to enact the Fiscal Compact, in March 2012, and the Banking Union, in June 2012, were the preconditions allowing Draghi to use its monetary instruments to preserve the euro, which in all likelihood would have otherwise broken down.

Seen in this light, OMT was much more than technical measures to restore the transmission of monetary policy. It was the decision to let the central bank act without preset limits as a lender of last resort in selected government bond markets to break destabilizing speculation set in motion by the prospect that one member state may be allowed to exit the euro. The announcement of this momentous change in monetary policy management was sufficient to restore confidence, without any need for actual interventions, by "dispelling unjustified fears about the breakup of the euro" (para. 76 of the Gauweiler decision) – thus confirming that it was indeed a change of regime.

At the same time, the decision confirmed that the ESCB must refrain from intervening in the domain of economic policy and that its measures must be restricted to monetary actions designed to preserve the transmission of monetary policy and foster price stability. Whether subsequent actions undertaken to counter financial instability are consistent with these limits seems open to question, as will be discussed.

The Expanded Asset Purchase Programme

In January 2015 the Governing Council of the ECB decided to expand its asset purchases in the secondary markets to include government and other public sector assets – with its new PSPP programme – because of various developments that appeared to entail the risk of price deflation in the euro area while at the same time, the room to change interest rates was constrained by having reached the effective lower bound on policy rates. Monthly purchases were initially set at 60 billion per month and were repeatedly recalibrated given economic and monetary conditions, until net purchases were terminated

at the end of June 2022 and reinvestments of maturing securities were halted in July 2023. At that time Eurosystem holdings under the asset purchase programmes amounted to about euro 3.153 trillion, out of which about euro 2.5 trillion were public sector securities. From that moment onwards, monthly redemptions would ensure a reduction of total holdings at an average yearly pace of about Euro 300 billion, entailing a continuing involvement of the ESCB in the government securities markets of the member states for several decades.

With its decision on Weiss and others (Case C-493/17), the ECJ confirmed that the ESCB asset purchase programmes fell within its monetary policy mandate and that it did not "reduce the impetus of the members states to follow a sound budgetary policy". The Court accepted that the efficacy of the programme depended on a large volume of government bonds being purchased by the ESCB in the secondary market, and also that the programme may entail that the ESCB hold the bonds on a lasting basis and reinvest the amounts repaid at maturity (para. 90).

The Court also took note that in case of any loss of a national central bank related to the programme, the only losses to be shared within the Eurosystem would be those generated by securities issued by eligible international organizations, while the ESCB has not adopted any rule providing for the sharing of losses suffered by a national central bank on its holding of national government bonds (para. 97). According to the Court, the possibility that national central banks may incur losses on the government securities issued by its national government does not hamper the independence f the ECB as appropriate risk limitation measures are provided for by the programme, and at all events the risk of losses is inherent in any open market operations.

However, eligible securities would need to have a minimum credit quality assessment (credit quality Step 3) in the Eurosystem's harmonized rating scale or, if not, they would have to be issued or fully guaranteed by a member state government under a financial assistance programme in respect of which the credit quality requirement had been suspended by the Governing Council. This provision was to become important in connection with the Greek financial assistance programme, when a lack of agreement between the Greek government and the European Commission in the financial assistance programme review led to the exclusion of Greek public securities from eligible securities in ESCB purchase programmes.

Here the dividing line between monetary policy measures and measures that may provide undue support to the fiscal policy of a member state becomes especially thin, as the risks involved with national securities holdings by the national central banks will be affected asymmetrically by monetary policy once the latter shifts into restrictive territory, with interest rate spreads widening against high-debt countries. At that point, the borderline between rising debt costs related to systemic financial market tensions and costs related to weak national budgetary policies becomes difficult to disentangle.

More broadly, the question arises as to what extent the Court decision covers the interventions by the ESCB in managing national debt securities independently of the monetary policy requirements that had led to their purchase. An open-ended allowance for the ESCB to operate in the national government securities markets outside of well-defined monetary policy requirements would probably stretch the ECJ decision beyond its intended scope.

The Consequences of the ESM

To establish the ESM, the European Council adopted an amendment of Article 136 TFEU, which by a new Comma 3 authorized the member states of the euro area to "establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole." The new mechanism was seen as a complement to various economic policy regulations adopted to strengthen the economic governance of the Union in 2011 and was decided with the specific objective of managing financial crises that might arise despite the new economic policy framework. What is sometimes overlooked is that the ESM was originally conceived to address the same kind of instability that eventually led the

ECB to its announcement that it was ready to do "whatever it takes" to preserve the euro. Accordingly, it was endowed with a rich panoply of instruments that notably included the possibility of purchasing members' debt instruments in the primary and secondary markets (cf. articles 17 and 18 of TESM).

With its judgment in Case C-370/12 (the Pringle decision), the Court has clarified that the decision to establish the ESM formalized a distinct function of preserving the financial stability "of its member states and the euro area as a whole" that fell already within the powers its member states, which had now decided to formally entrust that function to a separate institution. The justification for the new mechanism was that the strong financial interrelations between its members within the euro area entail a strong risk of contagion when one or more of them are at risk of losing market access for their debt instruments.

While the new comma 3 of Article 136 TFEU does not create new powers, the creation of a new institution does affect the distribution of policy functions between existing institutions, including the ESCB. Indeed the Court decision clarifies that the goal of preserving financial stability within the euro area is "clearly distinct" from the goal of maintaining price stability, which is the primary task of monetary policy (para. 56). One critical point of contact, however, that may arise between the ESM and the ESCB concerns purchases of government securities.

The identification of a separate function related to financial stability, which is entrusted to the ESM, opens the way to a further step in the organization of financial policies of the eurozone, namely, to make the ESM the eurozone debt management agency by transferring to it the national sovereigns held by the ESCB. In this manner, the eurozone would achieve full separation between the monetary and economic policy domains, and all encumbrance of the ESCB due to its large holdings of national sovereigns would be eliminated.

The ESM Treaty assigns new tasks to the ECB, including the task of assessing the urgency of stability support and, "in liaison" with the Commission, assessing the requests for stability support, negotiating the MoU detailing the policy conditionality, and monitoring compliance with the MoU. This decision led to the ECB's participation in the "troika" managing the financial assistance programmes of the EFSM/ESM. Moreover, the TESM also provides that ESM decisions to intervene in the secondary market "to address contagion" shall be taken based on an analysis of the ECB "recognizing the existence of exceptional financial market circumstances and risks to financial stability" (Article 18(2)).

The Court acknowledged that the member states had the power to entrust these new tasks to the ECB (and to the European Commission) while concluding that these tasks do not entail any power to make decisions of their own (para. 161) and do not alter the essential character of the powers of the ECB – which will act in this domain based on its duty to support the general economic policies of the Union.

On this, a different opinion had been expressed by advocate general Crus Villalòn in his opinion on the Gauweiler case. In his view, the active part played by the ECB in the course of financial assistance programmes may detract from the monetary policy nature of OMT – to the extent that the purchase of government bonds becomes an instrument to enforce the policy conditionality.

The Court did not follow this view and saw policy conditionality as a positive factor to avoid the risk that OMT could weaken the incentives to follow a sound monetary policy. An elaborate defense of the ECB's role in the Troika is provided by Zilioli (2018). However, she acknowledges that the ECB should not take decisions that require democratic legitimation. In his opinion on Pringle, advocate general Kokott's main concern was to argue that the ECB was under no obligation to perform the tasks allocated to it by the ESM treaty, while at the same time stressing the ECB obligations in view of the principle of sincere cooperation.

The issue was temporarily superseded by the lack of interventions under the OMT. However, it arguably came back to prominence in connection with three subsequent interventions by the ECB:

(i) When President Trichet's opposition to bank debt restructuring forced Ireland to guarantee all bank liabilities and as a consequence be obliged to request financial assistance from the ESM;

(ii) When President Trichet wrote letters together with national central bank governors to the governments of Italy and Spain, in September 2011, detailing the economic policies deemed necessary for central bank support; the leak to the press of the Italian letter arguably led to the fall of the Berlusconi government and its substitution with the Monti government, which was much more willing to follow sound budgetary policies:

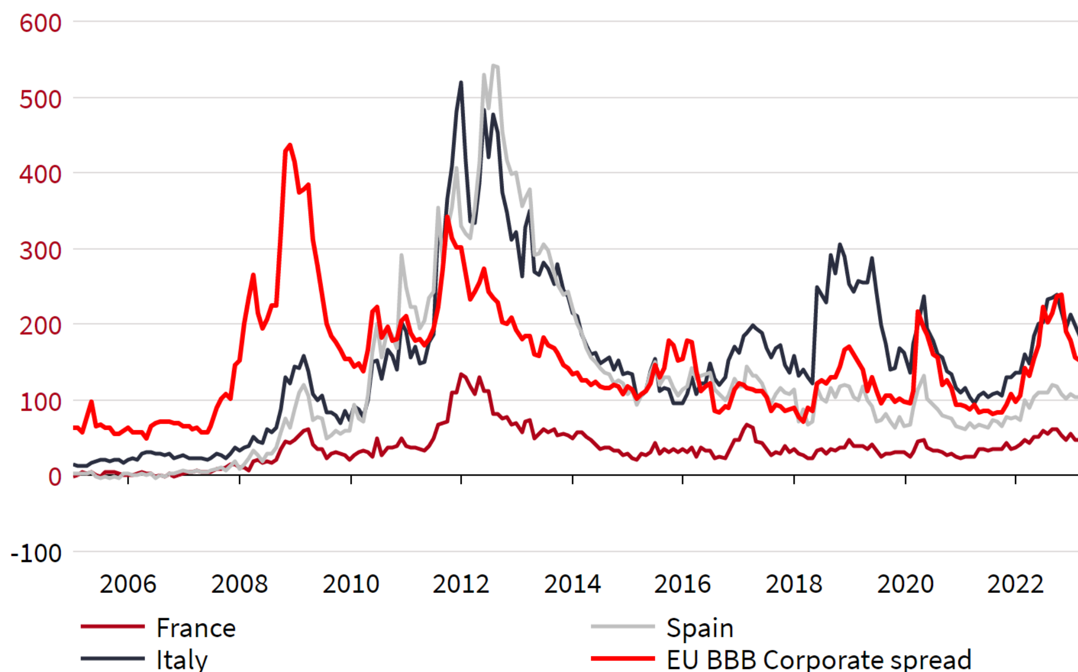
(iii) When the ECB decided to use its powers to cap emergency liquidity assistance to Greek banks by the central bank of Greece, leading to a protracted bank holiday that undercut the Greek government's negotiating position in the financial assistance programme under discussion with the European Commission.

Because of these developments, one may concur with Zilioli's conclusion that the role in the Troika assigned to the ECB by the ESM Treaty was per se not in conflict with its primary monetary policy competence – but serious questions arise on the consistency of ensuing ECB actions with those legal principles.

The Transmission Protection Instrument

When monetary policy turned into restrictive territory in the Spring of 2022, interest rates on member states' government securities started to diverge, with stronger increases in high-debt countries (Chart 3). On 21 July the ECB approved a new operational instrument, the Transmission Protection Instrument (TPI) "to counter unwarranted market dynamics that pose a serious threat to the transmission of monetary policy across the euro area" (ECB Press release, 21 July 2022).

Figure 3: 10Y sovereign spreads and BBB Corporate 5Y spread (Basis point)



Source: Bini Smaghi

Specifically, the TPI will allow the Eurosystem to undertake secondary market securities purchases – without prespecified limits – in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals. More precisely, the TPI will be activated "to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy"; and, second, the Eurosystem will purchase securities in jurisdictions experiencing a deterioration of financing conditions "not warranted by country-specific fundamentals".

Flexibility in the composition of euro area government securities purchases across jurisdictions was already possible under the Pandemic Emergency Purchase Programme (PEPP), to counter any undesirable tightening of financial conditions in some member states. It was usefully applied in the early stage of PEPP until the narrowing of inter-country interest rate spreads (and the approval of large fiscal support to break the deflation) made it unnecessary. At that time, however, a separation between financial stability concerns and monetary policy objectives was not an issue, as the economy was amid a large deflationary shock.

The situation was different when monetary policy turned restrictive in June 2022; at that time, a negative inflation surprise in the US triggered sharp and unjustified movements in sovereign bond markets, raising fears of self-reinforcing dynamics. The need to manage financial market instability and prevent market fragmentation with a separate instrument alongside monetary policy tools became manifest. Such an instrument entails that the central bank provides ample liquidity to the euro area

financial system with targeted and temporary interventions, when needed to preserve financial stability and a smooth transmission of monetary policy. Purchases would be undertaken so as not to entail a persistent impact on the monetary policy stance. The ECB also specified that the principal instrument ("the first line of defense") to counter risks to the transmission mechanism would be the pandemic emergency purchase programme (PEPP). The difference between the two programme is of course selectivity, which under the first programme would allow to intervene in specific markets experiencing distressed conditions.

The stated underlying issue is one of liquidity and not one of solvency. The TPI proved useful in maintaining orderly financial market conditions while monetary policy turned increasingly restrictive (Schnabel 2023).

Eligibility criteria require the ECB to assess whether the relevant member states pursue "sound and sustainable" fiscal and macro-economic policies, based on an extensive set of criteria that include:

(i) Compliance with the EU fiscal framework, notably including the country not being subject to an excessive deficit procedure;
(ii) The absence of severe macro-economic imbalances;
(iii) Fiscal sustainability, that is the trajectory of public debt is sustainable;
(iv) Sound and sustainable macroeconomic policies, including compliance with the policy commitments undertaken within the Recovery and Resilience Facility and with the European Commission's country-specific recommendations under the European Semester.

The assessment of eligibility conditions will be undertaken by the ECB by considering the economic assessments of the European Commission, the ESM, and other economic and financial institutions, notably regarding debt sustainability analysis. Central bank independence entails of course that the judgment on the eligibility criteria would belong exclusively to the Governing Council.

As may be seen, the TPI represents a quantum leap in the policy oversight of the ECB over its member states and the ability to influence their policies, entailing in practice the possibility of calling into question their entire macro-policy decisions when their financial markets come under stress. The instrument has not been activated, as had happened with the OTP, its announcement managed to tame country-specific tensions related to monetary tightening. Should it become necessary to use it, the close contact between monetary and fiscal policy required to permit its use would no doubt raise serious questions.

Overcoming the Monetary Policy Quagmire

As has been described, in recent years the ECB has taken up increasing responsibilities in managing the economy, including measures that have brought its actions close to the border between monetary and economic policies in the enforcement of common policy prescriptions in certain member states. Moreover, specific concerns have been raised on the effects of monetary policy on income and wealth distribution, leading to requests for greater political accountability of the central bank on this ground to elected bodies such as the European Parliament.

There is little doubt that multiple objectives may threaten central bank independence, as they are likely to generate difficult trade-offs when the objectives come into conflict with the fundamental goal of price stability. While trade-offs may exist between price stability and distributional objectives, inequality cannot be unambiguously measured as it has many dimensions (e.g., consumption, income, and wealth inequality). Furthermore, available evidence, while often inconclusive, indicates that monetary policy has weak effects on inequality (Bonifacio et al. 2021).

The main value of central bank independence has been to provide unambiguous success in taming inflation, and there is little doubt that this policy goal is best guaranteed by leaving it in the hands of an independent central bank, as national governments are likely to respond to different short-term incentives. However, there is a serious question as to whether the current policy responsibilities of the central bank, as they have evolved over the past fifteen years of economic and financial turmoil, should be seen as a satisfactory equilibrium or whether instead they should be reviewed to return to a stricter delimitation.

The exceptional financial instability of the past 15 years has led to a massive expansion in the size of the ESCB's balance sheet. Its total assets and liabilities, including the balance sheets of national central banks of the euro area, stood at the end of 2022 at about euro 8 trillion, or over half the euro area GDP; the Eurosystem's securities held for monetary policy purposes rose close to euro 5 trillion, or about one-third of the euro area GDP. Out of this total, about one-half, or some euro 2.5 trillion, were represented by government securities of the euro area member states. In the year ending in July 2024, the total redemptions over those securities amounted to about Euro 300 billion; with a similar rate of yearly re-demptions, it would take about 16 years to run down those securities holdings – always provided that such a rate of redemption would not interfere with the required provision of liquidity to the banking and financial system over time.

The fact is that such a large portfolio of government securities may bring the monetary and fiscal policy dimensions too close for comfort. More in general, the question arises as to whether the ESCB should keep upon itself the task of managing those securities to ensure stable financial market conditions in their markets.

Three implications stand out in this regard. The first one, which we may call encumbrance, boils down to the fact that the ECB may find itself in an uncomfortable position, were it is required again to provide strong monetary support to the economy (Issing 2023). Fresh massive purchases of securities may well distort the functioning of capital markets by restricting unduly the supply of certain securities, notably including government securities of some issuers available in smaller quantities.

The second implication was apparent when the ECB monetary stance turned restrictive in the Spring of 2022, with interest rates rising more steeply in the securities markets of high-public debt countries. The ECB responded swiftly with the establishment of its new TPI tool, which was effective in taming the emerging divergences in interest rates.

However, as restrictive monetary policy is likely to continue for some time, the return of selective pres-sure on the government securities of high-debt countries may not be excluded. Over time, persistent monetary restriction is bound to weaken the sustainability of high government debts. At that time, the ECB's ability to intervene would be predicated on its assessment that the country or countries involved

were running stable financial policies and respected all common policy recommendations. Thus, the ECB would find itself in the uncomfortable position of either refusing to activate the TPI in the presence of rising financial tensions in certain markets or having to indicate appropriate policy adjustments in the relevant countries. Financial investors would no doubt become aware of tensions and disagreements in policy discussions between the ECB and the governments involved.

The same paradox arises here that was already evident with OMT. The TPI works smoothly as long as it is not used; the process of activating it, which would notably involve raising questions of policy conditionality, would likely excite financial instability rather than tame it.

The last implication of the large holdings of government securities by the ESCB is that it creates a large area of potential interference between monetary policy and national fiscal policies, as governments become increasingly aware of their direct exposure to the ESCB. This could result in concrete threats to central bank independence.

On a broader perspective, one wonders whether it is wise for the euro area central bank to try and retain the powers to influence national policies gained during the past fifteen years which, as has been described, on occasion was stretched out into the slippery ground of policy enforcement on behalf of the European institutions – with and without the existence of an ESM programme.

In this regard, it appears that the room opened by the ECJ to the ECB scope of action was stretched improperly well into the domain of enforcement of policy conditionality – as most notably happened in the case of the ECB cap on emergency liquidity assistance to Greek banks in June 2015. The same also happened, albeit with a lower intrusiveness in national decision making, when the Irish government was forced to provide full backing to the liabilities of its two largest banks, in 2010; or when the letters to the Spanish and Italian governments by the president of the ECB, cosigned by national central bank governors, led to a harsh policy package for the banks in one case and the change in government in the other.

The ECB has much to gain from extricating itself from excessive proximity to national policy making, as it would strengthen its legitimacy and the effectiveness of its monetary management by freeing it from any threat of policy conflict. If it could relieve its budget of the encumbrance of its members' government securities, it would also free itself from possible criticism that its massive bond purchases have held down interest rates for bonds issued by highly indebted member states, thus reducing pressure on those governments to consolidate their public budgets.

In the transition to a new equilibrium, striking the right balance between interest-rate policies and quantitative tightening will not be easy. But as a general guide in its decision-making, the ECB should stay focused on its primary mandate of maintaining price stability – which is the best way to ward off possible future threats to its independence generated by its policy overreach. I will present in the next paragraphs a proposal that may accelerate the disposal of the ECB portfolio of government securities, and thus strengthen its freedom of action.

A New ESM Facility to Purchase Sovereign Bonds from the ESCB

Micossi (2020) and Avgouelas and Micossi (2021) have proposed to set up a new facility at the ESM to enable it to gradually acquire the sovereigns held by the ESCB and then renew them for as long as needed to avoid any destabilizing effects of their redemption on national public debt markets.

Under their proposal, these purchases would be financed by the EMS by issuing its liabilities, which under appropriate arrangements would become the long-sought-after eurozone safe asset, open to European and international investors. This would also pave the way for a larger role for the euro as a reserve instrument in the international financial system.

An important feature of this scheme is that it would eventually separate the monetary responsibility for the lending of last resort in the eurozone sovereign debt markets from the fiscal responsibility of

ensuring the orderly rollover of sovereign debts that were acquired by the ESCB (on this cf. also Martin et al. 2021).

Avgouleas and Micossi (2021) had originally envisaged that the new ESM intervention would operate within the existing system of the precautionary credit lines provided for by Article 14 of the EMS Treaty. However, the precautionary credit line is a credit to a Member State, adding to its net debtor position. On the other hand, buying sovereigns in the secondary market does not affect the financial position of the Member States concerned – except perhaps by changing the risk features of those sovereigns – as the ESM and the ESCB would be trading securities that are already outstanding.

A different approach is therefore in order. Fortunately, this is already provided on its own by Article 18 TESM, whereby "the Board of Governors may decide to arrange for operations in the secondary market in relation to the bonds of an ESM Member, in accordance with Article 12.1." Article 12.1 in turn provides that "if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States, the ESM may provide stability support to an ESM Member subject to strict conditionality, appropriate to the financial instrument chosen." Here, the general purpose of safeguarding the stability of the euro area *as a whole,* as well as that of its Member States, finds explicit recognition. The reference in the ensuing sentence to *an individual* Member State in no way precludes that this type of assistance be granted simultaneously to all the eurozone Member States. In this approach, the ESM would gradually purchase over some years a large share of the government securities held by the ESCBs. These purchases would represent a portfolio investment justified by the overriding goal of preserving the financial stability of the eurozone. The sovereigns would be purchased at market price.

An alternative to our gradual purchase programme that has been suggested by Martin et al (2021) would be a one-shot swap of sovereign assets held by the ESCB with a corresponding amount of new ESM liabilities issued all at once. However, this approach would not result in the 'one-shot' creation of a large market for ESM liabilities, since all ESM freshly issued liabilities would end up in the belly of the ESCB, which could only release them slowly in a thin market (at present total ESM liabilities circulating in financial markets amount to about euro 100 billion) and would still be constrained by the need to not perturb monetary conditions with its open market sales.

Moreover, a question may arise as to whether the ECB may conduct such a bulk operation exclusively with the ESM that is not likely at market terms (cf. Article 18 of the ECB Statute). A gradual purchase programme that entails small transactions in each case would not be exposed to this objection, as the two institutions could trade between themselves based on an observable market price that would not be influenced by their trades.

As to the conditionality to be applied when a Member State's sovereigns are acquired by the ESM, Article 18.3 TESM refers to a memorandum of understanding (MoU) to be drawn as specified in Article 13.3 (as amended by the recent reform). [15] The question arises, in this regard, as to whether it wouldn't be appropriate to refer instead to the new provisions for the precautionary credit lines contained in (amended) Article 14 and the new Annex III, notably with its reference to 'eligibility criteria' to be continuously monitored (by the ESM Managing Director and the European Commission, in liaison with the ECB) which however would normally not entail a macro-economic adjustment programme.[16] In any

[15] Amato et al. (2023) have similarly proposed to create a European Debt Agency (EDA) to rollover government debts; the price of EDA loans would be anchored to fundamental economic variables, thus fostering fiscal discipline.

[16] In line with Article 14 precautionary financial assistance, Annex III provides that for countries in full compliance with the eligibility criteria, boiling down to full compliance with the SGP and the excessive imbalances procedure, a letter of intent will suffice, while for those not meeting some of these criteria, but 'whose general economic and financial situation remains strong and whose government debt is sustainable', an MoU as specified by (amended) Article 13.3 will be required.

event, two general criteria would have to be always respected as a pre-condition for participation in the scheme, namely that: (a) there is a threat to the financial stability of the euro area as a whole or of its Member States; and (b) the public debt of countries participating in the purchase scheme would be "sustainable".

A final question that must be confronted at this stage is whether the ESM would be legally able to issue the very large liabilities required by our proposed scheme. While limits have been set by the Eurogroup and the Board of Governors for total lending[17], and total credit under individual facilities, no such limit exists presently either for the purchases of Article 18 or the total liabilities to be issued as a counterpart by the ESM – provided that the former are not seen as a loan to the Member States. Appropriate caps could of course be set by the Board of Governors to govern ESM security issues year by year in line with the purchase programme. A separate issue that needs to be tackled is whether a limit to purchases and liability issues is required in proportion to the ESM capital, notably given the need to preserve its Triple-A rating.

On the Compatibility of the New ESM Facility with EU Law

Under our proposal, the ESM would purchase public debt securities from the NCBs, acquired before and during the pandemic, that the ESCB should divest once their monetary policy justification is exhausted. We will now examine whether such an operation can be carried out without modifying the Union and ESM Treaties. [18]

Based on general principles of international and European law, the establishment of the ESM and its operations are lawful as long as they do not conflict with the provisions of EU law. This was confirmed by the ECJ in the Pringle judgment[19]. The provisions of the TFEU to be mainly taken into consideration, as indeed in Pringle, are Articles 127 (giving the ECB exclusive competence in monetary policy), 125 (prohibiting the Union and its Member States from assuming the obligations of another Member State – the *no-bailout* provision) and 123 (prohibiting any monetary financing of the Member States by the ECB and NCBs).

Any conflict with Article 127 TFEU may be ruled out immediately. By purchasing sovereigns from the ECB, the ESM pursues non-monetary financial stability objectives, and at all events, these purchases only entail a change in the portfolio composition of the ESCB. As has been discussed, repercussions on financial conditions may be brought about by the ESM security issues to finance these purchases, but the ECB possesses the instruments to offset them as required by monetary policy. There may also be repercussions on price trends, but these are secondary effects with respect to a clearly stated economic policy operation. The exclusivity of the ECB in monetary policy is therefore not affected (Pringle, para. 93-98).

Conflict with Article 125 TFEU also does not arise. As stated in Pringle (para. 129-147), Article 125 is not intended to prohibit any form of financial assistance to a Member State, provided two conditions are met: that the beneficiary state remains solely responsible for its obligations, and that assistance prompts the Member State to implement sound policies. In our case, the debtor of the sovereign bonds

[17] The Eurogroup statement of 30 March 2012 set an overall ceiling for the combined ESM/EFSF *lending* at EUR 700 billion, out of which the maximum lending volume of the ESM was set at 500 million. However, as we have argued, this ceiling would not apply to sovereign purchases under Article 18 to the extent that these purchases cannot be seen as ESM loans.

[18] This paragraph draws heavily on the arguments developed by Tosato (2021).

[19] Judgment 27.11.2012, case C-370/12, specifically paragraphs 99-107.

remains the State that issued them; only the creditor changes, passing from the ECB to the ESM. On the other hand, the preventive and continuous assessment of compliance with the eligibility conditions of the new credit line, created to support ESM purchases, guarantees virtuous behaviour throughout the euro area. Those two conditions therefore appear to be fully satisfied.

Violation of Article 125 must also be ruled out from another point of view. The purchase of the securities may result in losses for the ESM, market gyrations, or debt restructuring by the issuing state. Losses may also arise from any ESM loan or other operation. When this happens, the losses must be borne by the ESM capital. In such cases, it may be necessary to ask the Member States for a supplementary capital payment and a state may fail to provide it. As set out in Article 25.2 TESM, the missing share is provisionally covered by the other Member States, but the obligation of the defaulting state remains valid. Therefore, as clearly explained in the Pringle judgment (paragraphs 144-146), even in this case Article 125 would not be breached.

No conflict also arises with Article 123 TFEU. As pointed out by the ECJ (again in Pringle, paragraphs 125-127), the prohibition contained therein is specifically addressed only to the ECB and the NCB and therefore does not apply to the ESM. Apart from this observation (which is at any rate diriment), our scheme does not entail any monetary financing of sovereign debts. The ESM buys sovereign bonds from the ECB that the latter has purchased on the secondary market. This does not constitute monetary financing – provided that the ECB's purchases have complied with the conditions set out in the Gauweiler (16.06.2015, case C-62/14) and Weiss (11.12.2018, case C-493 / 17) judgments[20]. The non-existence of an 'upstream' monetary loan by the ESCB *a fortiori* excludes the notion that it can be envisaged for 'downstream' purchases by the ESM.

It is worth noting, finally, that the distinction between purchases by the ESM relating to 'pandemic' securities and other ECB purchase programmes is irrelevant to the legality of ESM purchases as the grounds for compatibility with EU law are the same. The element of 'solidarity' that characterizes the former can be relevant from a political standpoint, but not juridically. Therefore, the ESM interventions that we are proposing are fully compatible with Articles 127, 125, and 123 TFEU, regardless of the type of securities involved.

On the Compatibility of the New ESM Facility with the ESM Treaty

The ESM was established to safeguard the stability of the euro area through financial support interventions in favour of Member States under financial stress (Article 3 TESM). Two main forms of intervention are envisaged: loans to Member States that are already in serious financial difficulty (Article 16 TESM) and precautionary credit lines to prevent such a situation from occurring (Article 14 TESM). In addition, Article 18 provides that the Board of Governors may arrange for operations in the secondary market concerning the bond of an ESM member.

ESM support is subject to specific conditions (conditionality), some general, and others relating to the specific form of intervention. As already mentioned, the former includes the existence of a risk to the

[20] In these judgments, adopted following a preliminary ruling by the German Constitutional Court, the ECJ legitimised the ECB's two programmes entitled the Public Sector Purchase Programme (PSPP) and Outright Monetary Transactions (OMT), but at the same time required that their implementation be adequately motivated, especially with regard to the principle of proportionality (Gauweiler, para. 66-92; Weiss, para. 71-100). The ECJ also established that the purchase of sovereign bonds by the ECB takes place in such a way as to exclude any circumvention of the prohibition pursuant to Article 123 TFEU (Gauweiler, para. 66-92; Weiss, para. 101 et seq.). The Karlsruhe Court conformed, albeit with reservations, to the Gauweiler judgment (Decision 11.06.2016), while it rejected the Weiss judgment, which was deemed lacking on the point of proportionality (Decision 5.05.2020).

stability of the euro area as a whole (and attendant risk of contagion) and the sustainability of the public debt of the beneficiary states (Article 13.1 TESM). The latter range from a macroeconomic adjustment programme, in the case of loans, to continuous compliance with eligibility criteria, in the case of precautionary credits (Article 12.1 TESM)[21]..

In our current version, we have envisaged that the ESM intervenes to strengthen the financial stability of the euro area through the secondary market facility in Article 18 TESM. There seem to be no preclusions in this sense in the TESM, which considers credit lines as flexible instruments, not bound to particular purposes. They can therefore be used to address various situations which could jeopardize the stability of the euro area. This has been done recently to allow the financing of anti-Covid health expenses (Board of Governors, Decision 5.05.2020), without any objections being raised to the absence of specific conditions for access to the facility (except for its use to combat the health emergency).

Under our proposal, the ESM sovereign purchases could eventually rise to 20-25 % of the euro area GDP, or some EUR 2.5-3 trillion. To do so, the ESM would have to issue a similar amount of its liabilities, thus leveraging its capital – which is about EUR 705 billion – by a factor between 3.5 to 4.3. We must now determine whether this is legally possible under the TESM, as well as whether this would be compatible with the ESM retaining its Triple-A rating. We will argue that both questions can be given a positive answer.

On the legal matter, the TESM is clear on the fact that total loans under the ESM and EFSF (until the latter is wound down) cannot exceed EUR 500 billion capital (Article 39 TESM), and in addition that any losses on these loans will be fully covered by ESM reserves, paid-in capital, and called-in capital (Article 25). Accordingly, ESM liabilities under these provisions would not be allowed to rise beyond the total ceiling for lending and the maximum leverage would be well below unity.

The situation, however, appears quite different with respect to our proposed facility. The reason is that in this case, the ESM would not borrow *to lend* but to acquire other securities (Member States' sovereigns). Therefore, its liabilities would rise in line with the securities accumulated on the asset side of its balance sheet. Since these securities are the public debts of its Member States, they may deem to be of the highest quality – and indeed fully safe as long as we can believe that no Member State would be allowed to go into default (as this could wreak havoc to the eurozone financial system and perhaps endanger the very survival of the euro itself).

On this, suffice to recall that during the Greek debt restructuring process by the EFSF in 2017-18, the cost of the operation was charged to the Greek state (in the form of an extra interest charge over interests due by Greece on the loans) and the ESM bore no losses. The ESM constantly refers to this precedent in their presentations to financial investors to solicit their investments in ESM bonds.

In sum, these considerations point to the conclusion that the ESM capital would amply suffice to cover any possible loss due to debt restructuring by a Member State; that the implicit conditions of full coverage of ESM of losses set in the TESM would be satisfied; and that even in this case the ESM would not be allowed to suffer any losses. The likelihood of any event such as a default by a large euro area Member State would in all likelihood be rather slim, given its potentially disruptive effects on the euro itself.

The same considerations apply in regard to the financial impact of ESM sovereign purchases on the rating of its liabilities. Since the risk of default of even the weakest of all Member States is tiny, then

[21] We should recall that Article 14.1 TESM provides for two types of precautionary credit lines: the Precautionary Conditioned Credit Line (PCCL) and the Enhanced Conditions Credit Line (ECCL). The two credit lines differ in the financial status of the beneficiary states (less sound in the case of an ECCL) and in the consequent nature of the conditionality (stricter for the ECCL). The eligibility conditions for access to the PCCL and ECCL are specified in Annex III of the TESM.

the Triple A rating of the ESM would not be threatened. Further reassurance on this score would come from the conditionality attached to those purchases, which entails the continuous monitoring of the economic policy eligibility conditions contained for each Member State in its letter of intent or MoU conditioning the activation of the facility.

The ESM Management Mandate

A further question to be decided would be under what mandate the ESM would operate in managing the members' government securities. A first aspect to be decided in this regard would be whether the ESM would be asked to run down its portfolio of government securities as they come to maturity, or to reinvest the reimbursements. Under the first approach, the ECB would have to manage the monetary impact of redemptions, while under the second the sovereign holdings would continue to be rolled over indefinitely. This latter option would make the ESM facility permanent, opening the way to the creation of a true debt management agency of the EMU.

Were the latter option followed, then a further question would arise as to whether the ESM would be asked to intervene to maintain orderly market conditions in those markets, mitigating the impact of selective financial socks affecting individual government securities markets. Under this course, the ESM would assess the proper course of national policies of member states involved, so as to verify the continuing compliance with common economic policies, and therefore provide support only when financial shocks appeared unrelated to national fundamental variables, as has been described above under the ECB's TIP. Were the member state's policies found to be diverging from required common economic policies, the member state would need to act in agreement with the European Commission so as to restore its eligibility conditions for access to the ESM facility. The ESM facility would thus evolve into a mechanism of enforcement of common economic policies. Such an evolution would need to be formalized as a new policy arm of the revised Growth and Stability Pact.

Conclusions

There is little doubt that the ECB singlehandedly rescued the euro from outright collapse with its interventions in the Summer of 2012 and that it played a paramount role in restoring decent economic growth in the ensuing years with its unconventional monetary policy instruments. At the same time, it appears that on occasion these enhanced responsibilities led the institution to trespass the separating line between monetary policy and the broader domain of economic policies.

The paramount examples include the decision to force Ireland to guarantee all bank liabilities and, as a consequence, be obliged to request financial assistance from the ESM in 2010; the letters sent by President Trichet to the governments of Spain and Italy in September 2011, detailing the economic policies deemed necessary for central bank support; the decision by the ECB to cap emergency liquidity assistance to Greek banks by the central bank of Greece in 2015.

Moreover, the large purchases of government securities undertaken to stabilize euro area financial markets have entailed cumbersome legacies for the exercise of ECB powers. The first one, which we may call encumbrance, is that the ECB may find itself in an uncomfortable position, were it required again to provide strong monetary support to the economy. Fresh massive purchases of securities may well distort the functioning of capital markets by restricting unduly the supply of certain securities, notably including government securities of some issuers available in smaller quantities.

The second implication was apparent when the ECB monetary stance turned restrictive in the Spring of 2022, with interest rates rising more steeply in the securities markets of high-public debt countries. The ECB responded swiftly with the establishment of its new TPI tool, which was effective in taming the emerging divergences in interest rates. However, as restrictive monetary policy is likely to continue for some time, the return of selective pressure on the government securities of high-debt countries may not be excluded. Since activation of the TPI is predicated on an assessment that the country or countries involved respected all common policy recommendations, the ECB could find itself in the uncomfortable position of either refusing to activate the TPI in the presence of rising financial tensions in certain markets or having to indicate appropriate policy adjustments in the relevant countries.

The last implication of the large holdings of government securities by the ESCB is that they create a

large space of potential interference between monetary policy and national fiscal policies, as governments become increasingly aware of their direct exposure to the ESCB. This poses a concrete threat to central bank independence that would be challenged.

The ECB has much to gain from extricating itself from excessive proximity to national policy making, as it would strengthen its legitimacy and the effectiveness of its monetary management by freeing from any threat of policy conflict stemming from its intrusion into the domain of national economic policies. Accordingly, the ECB should be brought back to its original mandate of maintaining price stability – which is the best way to ward off possible future threats to its independence generated by its policy overreach.

In order to facilitate the return to a strict separation between monetary powers and all other economic policies, we have proposed a scheme to transfer the excess holdings of government securities by the ECB to the ESM, through a programme whereby the ESM would gradually purchase those securities and issue its own liabilities in exchange. These liabilities, issued against the government debt of euro members, would be the long-sought safe asset of the euro area; they would also offer the basis for a large and liquid money market where the ECB could operate with its open market operations. The full separation between monetary and fiscal policies within the euro area would be reestablished.

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