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Ready to do whatever it takes? The legal mandate of the European Central Bank and the economic crisis

Daniel Wilsher

Abstract: To complement the 'no shared liability' rule and public deficit limits, the Maastricht agreement gave the European Central Bank a narrow remit to focus on price stability. Crucially, as a 'non-sovereign' central bank, it was that the ECB would act as lender of last resort in the event of market panics. The neo-liberal orthodoxy at the heart of EMU held that moral hazard and inflationary risks militated against anything resembling 'illegal monetary financing'. Following monetary union, markets underpriced risks and encouraged bubbles but sentiment rapidly reversed during the crisis. With bail-out funds limited and austerity failing to improve debt spreads, sovereigns became illiquid. For Bank officials, an uncontrolled large bank or sovereign default rightly became synonymous with the end of monetary union itself. The ECB was forced de facto to expand its mandate to support the banking sector and then, more reluctantly, sovereigns facing loss of access to bond markets. Ultimately this improved market sentiment but it jarred with the ECB's own neo-liberal economic perspective. Uncomfortable with its interventions, the Bank has continued to stress its legal limitations and acted to deepen Eurozone commitments to austerity and structural reform packages. The ECB's actions, whilst safe-guarding the single currency in the short-run, cannot however substitute for the deeper political and banking union that may be necessary to create stable and democratic Eurozone governance.

Introduction

'Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.' (Mario Draghi, ECB President, 26 July 2012)¹

Given the serious threat posed by the Eurozone financial crisis, it is perhaps surprising how far alleged limits imposed by the Maastricht treaty have been cited by politicians, commentators and ECB officials in debates about appropriate action to resolve it.² Law has however always been central to the methodology of European integration.³ As is well-known, the Euro was conceived of as a purely monetary not fiscal union (this latter term being understood to refer to some shared debt issuance and a substantial federal budget). To assuage fears over the loss of the inflation-control provided by the Bundesbank, the European Central Bank (ECB) was given strong independence and a narrow mandate to focus upon price stability. Eurozone members were legally obliged to adhere to fiscal targets without any automatic federal transfers, a common banking union or a designated sovereign lender of last resort to maintain their solvency in bond markets. Unsurprisingly, during the period 1999-2007 legal mechanisms to enforce

¹ Speech given at the Global Investment Conference in London, text available at www.ecb.int/press/key/date/2012/html/sp120726.en.html (last accessed 25th March 2013)

² Ruffert, M., 'The European Debt Crisis and European Union Law' (2011) 48 CMLRev 1777-1806

³ Mattli, 1994

fiscal discipline tuned out to be weak and instead financial markets were relied upon to price debt to reflect underlining budgetary fundamentals. The neo-liberal view was indeed that, so long as the ECB remained aloof, markets would correctly allocate resources to rebalance the Eurozone economy.

This paper considers the evolving position of the ECB. It argues that, whatever the legal arguments, a sovereign central bank is the only body that can ultimately secure the stability of both private and public debt markets. The crisis forced an expansion in the ECB's remit that was largely shaped by political and economic factors, not law. Indeed, given the complexity and unpredictability of events during the crisis, no legal rule could have met every exigency. Central banks act in this sense *sui generis*, a fact tacitly accepted by the ECB. As each new phase of the crisis emerged, the ECB gauged the appetites of the respective political actors: the ability of debtor countries to deliver given levels of austerity and the willingness of creditor nations to provide loans to sovereigns. At least until the Cyprus bail-out of April 2013, the ECB showed a cautious willingness to bridge political gaps by ensuring banks had liquidity (to safeguard credit markets) and reducing sovereign bond spreads (to maintain debt serviceability).

Whilst the Maastricht drafters' original idea of a narrowly-focused central bank, has been partially eclipsed by events, the ECB has continued to refer to the so-called 'ban on monetary financing' throughout the crisis. This was however never a legal rule but more a reflection of the liberal economic doctrine of moral hazard avoidance. This idea, directed at preventing a crisis occurring, became problematic once financial panic set in. To re-establish bonds as 'risk-free' required clear promises by the ECB but these clashed with its own belief that moral hazard would result, removing pressure for austerity and structural reform. The ECB has therefore not uncomplicatedly offered accommodative monetary policy to its government(s) - like the contemporary Bank of England or the US Federal Reserve - by unconditionally providing liquidity and targeting low long-term interest rates. Rather it has become a key political actor, conditioning its emergency measures on the introduction of new Eurozone legal rules on fiscal discipline, economic surveillance and compliance with Troika programmes. To this extent, despite all the accusations of abuse of power leveled against it, the ECB has endorsed the narrow monetary model of Maastricht. It has not pressed for new democratic federal structures to create a deeper political and budgetary union; rather its strong endorsement of 'temporary' deflationary Troika programmes further weakens Eurozone democracy and growth prospects.

The Origins of the Crisis

It is widely agreed now that the crisis revealed that the legal order of the single currency allowed unsustainable imbalances to build up.⁴ Economic evidence shows that under-regulated capital markets in Europe reflected global trends toward excessive risk-taking. In addition, the Eurozone experienced internal trade imbalances: trade surplus countries saved more than they could invest domestically and trade deficit countries absorbed the

⁴ Barnes, S., 'Resolving and Avoiding Unsustainable Imbalances in the Euro Area' (2010) OECD

excess. Much of this capital flow however took the form of highly liquid securitized debt, not long-term foreign direct investment. Whilst some capital was employed to raise the productivity of 'catch-up' countries, it also funded public deficits, consumption booms and asset bubbles.⁵ Credit spreads narrowed across the Eurozone as markets appeared to believe that the legal irrevocability of the single currency meant that devaluation and default risks were negligible. Astonishingly, despite their very different debt and deficit profiles, the spreads for 10-year government bonds converged such that on 4 July 2006, in relation to the bench-mark German bund, the risk premium was only 0.31% for Greece and 0.30% for Italy. After the crisis hit private credit markets, capital repatriation began. In the absence of cheap private capital, a hard budget constraint returned to banks in deficit countries. The subsequent collapse in asset prices, banking sectors and economic activity felt in these countries created or worsened budget deficits. There appears to have been an implicit assumption by market actors up until late 2009 that the Eurozone would, despite the limited nature of Maastricht, underwrite its Members (through the ECB, common bonds or a bail-out fund) to secure banks and debt servicing. When Greece was only reluctantly supported, worsening public debt profiles triggered a flight to safety and a sovereign debt panic spread across the Eurozone.

The Maastricht framework was of course designed deliberately to deny large-scale fiscal support to Eurozone members. In addition, a political narrative developed identifying 'profligate' behaviour in Southern Europe as the cause of the crisis. Finally, liberal economic thinking promoted by core countries, the European Commission and the ECB has consistently emphasized the pre-existing legal framework requiring austerity supported by liberalising structural reforms. As a result, the political response since 2010 has been piece-meal, with rescue funds being raised only in response to a succession of sovereigns being shut out of access to bond markets. The amounts of direct financial support have been modest and have been dwarfed by the large and diverse range of opaque transfers made through the European System of Central Banks (ESCB).⁶ Cheap loans to banks spared sovereigns the social and economic costs of sudden bank failures. Eurozone members with trade deficits were able to maintain imports and fund private sector capital flight. There has been no traditional balance of payments crisis like that which forced the non-Eurozone Baltic Republics into drastic austerity to maintain parity with the Euro.

Centrifugal forces have however constantly threatening to overwhelm centripetal dynamics: austerity-fatigue led to fears of default, exit and devaluation by nations in deep recession, whilst the direct burden on taxpayers of bail-outs (concealing the indirect benefits to the banking system) and fear of currency debauchment prompted voices in stronger nations to consider abandoning the non-compliant in favour of a smaller monetary union. To date, however, political leaders have lacked any vision for a new economic

⁵ Eichengreen B, 'European monetary integration with the benefit of hindsight', (2012) 50 *JCMS* 123-136.

⁶ The ESCB balance sheet showed that between January 2007 and March 2013 lending to euro area banks increased from €440 billion to €990 billion whilst direct holdings of securities rose from €78 billion to €605 billion. By contrast, the central rescue fund of the Eurozone, the European Stability Mechanism, will see €80 billion of capital phased in over five years.

constitution to replace Maastricht. During the acute phase of 2010-12, avoiding an uncontrolled default or currency exit was the key objective. The fear of a new Lehmann Brothers-style shock was profound. Thus modest fiscal transfers and tepid ECB bond-buying were combined with demands for structural reform and austerity to restore economic 'fundamentals'. As capital flight persisted and Southern European sovereigns found refinancing increasingly costly, the ECB came under greater economic and political pressure to openly support sovereign bond markets.

The ECB as Lender of Last Resort to the Private Sector

The ECB has come to be the key actor during the crisis. This is for four reasons: first, it is relatively immune from political or legal challenges to its decisions; second, Member States, struggling to get national parliaments (and taxpayers) to pay directly for bank and sovereign bail-outs, have acquiesced in the ECB providing 'off-balance sheet' funds that do not feature in their national budget figures; third, its legal remit has turned out to be rather more flexible than previously imagined; fourth, the interconnectedness of the European capital markets meant that, regardless of the intentions of the Maastricht drafters, a form of lender of last resort came to be seen as essential in practice.⁷

It is, with hindsight, surprising how little attention was given to the issue of financial stability in all the debates surrounding the design of the ECB.⁸ Discussion focused upon fact that growth and employment were not made core objectives of the ECB. Instead, the primary duty on the European System of Central Banks (ESCB) comprising the ECB and the national central banks was to maintain price stability. Importantly, unlike most national central banks, the ECB had no duty to maintain financial stability but only to 'contribute to the smooth conduct of policies' of national banking regulators who still retained ultimate responsibility for prudential supervision of Eurozone banks. There was no explicit legal restriction on the ECB acting as lender of last resort to the *private* as opposed to the public sector. It was clear however that the ECB was not as well-suited to fulfill such a role compared to national central banks whose ultimate source of funding is the monopoly power of taxation held by a sovereign state. National central banks cannot become insolvent so long as their state is solvent.⁹ This also works in reverse: so long as it is denominated in national currency, a national bank can buy up

⁷ This has been predicted by commentators in advance of the Euro. See Folkerts-Landau, D. and Garber, P. (1992) 'The European Central Bank: a Bank or a Monetary Policy Rule' NBER Working papers series, No.416.

⁸ J Pisani-Ferry, 'Only One Bed for Two Dreams: A Critical Retrospective on the Debate over the Economic Governance of the Euro Area' (2006) 44(4) JCMS 823-44 for a discussion of the actual debates.

⁹ Strictly speaking, the economic consensus is that a central bank cannot become economically insolvent in the sense of being unable to pay its liabilities, because it holds the monopoly on issuance of new currency. See W Buiter, (2008) 'Can Central Banks go Bust?', Centre for Economic Policy Research Policy Papers No.24 who rightly argues that unless they hold large volumes of foreign-denominated liabilities, then central banks can always print money to recapitalize because their hidden assets include the net present value of seigniorage revenues which they can raise by creating inflation. This solution might however be incompatible with the central bank's primary goal of price stability in which case recapitalisation by the sovereign is the only option to enable it to continue to fulfil its mandate.

unlimited amounts of public debt to ensure that its government's debts are serviceable.

The ECB by contrast remained reliant upon the limited capital provided at the outset by its shareholders – the Eurozone central banks (and their governments) - on the basis of the contribution formula agreed at Maastricht.¹⁰ It had no sovereign guarantee backed by Member States' taxation systems to protect it from financial difficulty.¹¹ This was perhaps inevitable given that the Eurozone remained a collection of sovereign states not a federal government. As Goodhart foresaw, however, this made the ECB closer to the International Monetary Fund than a national central bank; if its capital became stretched due to a rescue operation it would have to appeal to all Eurozone governments for further injections with all the attendant political complexities this might bring.¹² There is no provision in the Treaty for any such recapitalization. In principle, this design limited the ECB's ability to engage safely in the kinds of lending and money creation typical of a lender of last resort.

The issue of lender of last resort did not however arise at all for the ECB during the years 1999-2006. When the crisis began in 2007, however, it was already received wisdom amongst central bankers that the tight monetary policy of 1929-31 that had caused widespread bank failures must be avoided. The classical role of the lender of last resort is to lend freely but only to solvent entities against good collateral. The aim is to support the illiquid not to bailout the insolvent but distinguishing between the two is very difficult in a crisis. Particularly after the collapse of Lehman Brothers in September 2008, the ECB interpreted its own mandate to include ensuring financial stability. The fact that the initial burden was felt across the *whole* Eurozone inter-bank credit market left the ECB with greater legal and political flexibility to act and prevent a chain of banking failures.¹³

It used both standard measures, cutting its main policy rate, and 'non-standard' measures, initially in the form of unlimited loans of up one year and even outright purchases of bank debt securities. As regards loans, the ECB Statute merely states that collateral provided be 'adequate'. The ECB Guideline on Monetary Policy Instruments determines which assets are 'eligible'.¹⁴ This may be amended by simple majority vote and it is here that the real power of the ECB Governing Council to manage the Eurozone crisis has been located. Agreeing to accept an asset class as eligible collateral creates economic implications not just for the many banks holding such assets, but also their governments, their citizens and taxpayers across the

¹⁰ The largest capital contributions are Germany at 19%, followed by France 15% and Italy 14%.

¹¹ See Statute of the European System of Central Banks and of the European Central Bank, Article 28 where the original capital was set at a modest €5 billion and Article 33(2) 'In the event of a loss incurred by the ECB, the shortfall may be offset against the general reserve fund of the ECB and...against the monetary income of the relevant financial year...'

¹² Goodhart, C., 'Myths about the Lender of Last Resort' 227-245, in Goodhart, C. and Illing, G., *Financial Crises, Contagion, and the Lender of Last Resort*, (2002) Oxford University Press.

¹³ Quaglia, L., Eastwood, P. and Holmes, 'The Financial Turmoil and EU Policy Co-operation in 2008, (2009) 47 Annual Review JCMS 63-87.

¹⁴ European Central Bank, 'Guidelines of the European Central Bank of 31st August 2000 on monetary policy instruments and procedures of the Eurosystem,' ECB/2000/7, Chapter 6 sets out the guidelines for eligible collateral which 'must meet high credit standards....the ECB takes into account...available ratings by market agencies'(6.2).

Eurozone. The Maastricht treaty however left such decisions entirely up to the discretion of the national central banks and the ECB Executive Board that make up the Governing Council. These votes are governed by 'one member, one vote' on this issue, rather than any weighting of votes by capital contribution. In fact, despite some German members' dissents, there has been a remarkable degree of consensus on the Governing Board.

Although liberal economists worried about the moral hazard of protecting bank creditors, there was however no immediate doubt raised about the legality of the ECB acting as lender of last resort to the private sector during 2007-9. The ECB had been seen to pass its first real test. The ECB reassured the potential critics that the quality of the assets it had taken onto its balance sheet was sound and that there was little credit risk for its shareholder Member States. Indeed by summer 2009, the ECB President was already promising an exit strategy through winding down of the Bank's liquidity support whilst urging Member States to 'prepare and communicate ambitious and realistic fiscal exit and consolidation strategies...'¹⁵ This mirrored the Commission's recommencement of procedures to restore the fiscal benchmarks of the Stability and Growth Pact across the Eurozone. For, markets however, as we shall below, the return to 'business as usual' for sovereigns was disturbing because it indicated that there was in fact no willingness to pool liability at Eurozone level; the Maastricht model remained the only one on offer despite very poor growth outlooks and heavy deficit burdens.

Thus, despite early optimism that use of its balance sheet would be temporary and confined to 'classic' private liquidity provision, the ECB has since been forced to continue providing credit to European banks on a large scale. As the crisis developed from 2010 into one enveloping sovereigns, the fate of banks and their sovereigns became entwined: in the absence of a Eurozone banking union to force bank recapitalisation whilst sharing the cost, bank creditors began to fear for banks' solvency. Weak sovereigns beget weak banks and vice versa. The ECB officially relaxed its collateral standards to allow banks to post junk status sovereign bonds in return for liquidity.¹⁶ The ECB showed that, at least until the Cyprus crisis of April 2013, for financial stability reasons, it did not wish to see a major bank fail. It has however at times refused to provide credit directly to banks unable to offer even this level of collateral. This power to cut off funds to private banks was briefly used on two occasions in respect of Greek banks; in February 2012 when Greek sovereign bonds were technically in default for one week and could not be used as collateral and later, in May 2012, when Greece had a caretaker government and the ECB refused credit to four banks due its increased fear that the government was going to default. On these occasions however Greece was still allowed to grant its banks Emergency Liquidity Assistance (ELA) to avoid insolvency.¹⁷ This is an inherent power of central banks to

¹⁵ Trichet, J-C., 'The ECB's enhanced credit support' Keynote address at the University of Munich, 13 July 2009.

¹⁶ Decision of the European Central Bank of 6 May 2010 on temporary measures relating to the eligibility of marketable debt instruments issued or guaranteed by the Greek Government. (ECB/2010/3).

¹⁷ Emergency Liquidity Assistance is the inherent power of the national central banks to create money through loans to their banks. It must be notified to the Governing Council of the ECB but can only be

create liquidity by making loans to solvent banks in return for poorer quality collateral. The Irish, Greek and Cypriot central banks have used this extensively. In the case of default, the risk lies with the national central bank.

The legal constraints on ELA are opaque but ultimately lie with the ECB Governing Council which may -by 2/3 majority - veto a proposed loan of ELA if it will 'interfere with the tasks and objectives of the ESCB' (Article 14.4 ESCB Statute). This is ambiguous but the ECB has indicated its opinion to the effect that such funds must only be granted to solvent institutions and must be repaid rapidly.¹⁸ The concern is that if banks receive central bank money (which does not form part of the national debt) the sovereign in effect benefits by monetary financing of its activities in breach of the Maastricht prohibition on such financing. The legally correct approach to *insolvent* banks is to recapitalize them from central funds - which does feature as increased government debt. Thus the ECB monitors carefully all ELA to ensure it is truly a valid loan which is being repaid.

The ECB has used negotiations around ELA on several occasions to ensure compliance with its views on Eurozone economic governance. Decisions on ELA in fact became linked to bail-out packages. Thus in 2010, during its bail-out negotiations, when Ireland said that it was going to allow Anglo-Irish, an insolvent bank, to default and write-off bond holders, the ECB and the European Commission opposed this. As a condition for the bail-out, they insisted that Irish banks instead use ELA to pay-off their creditors. The problem was, as a result, that Irish taxpayers had to honour the large government debts on onerous terms ('promissory notes') which had previously been pledged as security for the initial grant of ELA. In effect, Irish taxpayers were indirectly bailing out reckless creditors, mainly banks in France, Germany and the UK, who had bet on Ireland's property bubble persisting. The ECB feared that a default would bring about another Lehman Brothers-style shock.¹⁹

The perception of risk had changed by 2013 when Cyprus, faced with huge bank recapitalisation costs (caused by the earlier Greek debt write-down), was negotiating its bail-out. The parameters had largely been set when German parliamentarians refused to authorise sufficient bail-out funds to protect all depositors (many of whom were Russian nationals). With no agreement forthcoming, the ECB forced the issue when it ruled that the central bank of Cyprus could no longer grant ELA to Laiki bank because it was insolvent and needed to be run down unless it was substantially recapitalised by the government. Without ELA, the bank would have been pushed into liquidation within days. This forced Cyprus to accept the terms of the Troika package which necessitated that depositors in the country's two main banks bore losses of up to 60% on their savings.

overturned by a two-thirds majority. It is resorted to when the collateral offered by banks is less than adequate for the ECB. Germany, Ireland and Greece have all used it extensively and, although its terms and conditions are opaque, the Governing Council has never refused to endorse it.

¹⁸ ECB Convergence Report, May 2008, 24.

¹⁹ In 2013, the Irish government, facing huge repayment costs, sought ECB permission to withdraw these promissory notes and replace them with less onerous long-dated sovereign bonds. The ECB acceded, even though this was in effect a write-off of government debt held by the Irish central bank, and hence technically a form of 'illegal' monetary financing.

This was a milestone because it saw the ECB, for the first time since 2008, actually use its legal powers over money issuance to impose write-downs on the private sector and, in effect, force a large bank to close. The use of legal limits on liquidity provision also meant that Cyprus had to agree to a package of austerity set out by the Troika in order to avoid immediate default. This however raised fresh doubts over the status of depositors' funds across the Eurozone and opened up the possibility of future capital flight in the absence of a functioning Eurozone banking union to guarantee deposits.²⁰ The ECB seems to have believed that Cyprus would not leave the Eurozone because it would face severe budget cuts, bankruptcies and depositor losses in any event. Additionally, the Cypriot government, faced with a bank run, was forced to introduce capital controls which prevented cross-border payments. Cypriot euros were no longer the same as those in other Eurozone members; the 'single' currency was in effect suspended. The management of the Cypriot bail-out confirmed that there was no implicit Eurozone guarantee for depositors fearful about bank or government solvency.

The ECB as Lender of Last Resort to Sovereigns

The need for central banks (or international lenders like the IMF) to act as lender of last resort to sovereigns is accepted by many economists and policy-makers.²¹ Panics in bond markets can cause illiquidity and drive up yields creating solvency problems. Unlike for banks, the solvency of nations is however a largely political - not economic - question. Here it is important to distinguish between nations borrowing in their own sovereign currency from those which issue loans in a foreign currency or tie their domestic currency to gold or dollars. The former can always, at some risk of inflation, monetarize their liabilities by borrowing from their central bank. Sometimes this may involve the central bank simply crediting the Treasury with funds; most governments instead create a 'rule' that they should at least issue bonds which are then bought by the central bank in volume to control interest rates.²² By contrast, for 'non-sovereign' nations seeking foreign currency from an international lender of last resort, 'solvency' is measured by assessing the extent of their political ability to impose given levels of austerity. As stated above, the Maastricht agreement was predicated on limiting the ECB's capacity (or willingness) to act as lender of last resort to sovereigns. Eurozone members facing a fiscal crisis could only seek direct loans from the IMF (and later, the Eurozone rescue funds) with conditionality attached. This meant

²⁰De Grauwe P, 'The New Bail-in Doctrine: a recipe for banking crises and depression in the eurozone', (2013) CEPS Commentary, 4th April argues that depositors are not like normal creditors of banks because their funds are part of the payments system inherent to the economy. In weaker economies, the risk of bailing-in depositors is likely to cause depressions as capital flees in the face of solvency fears. For another view see Gros D, 'The meaning of Cyprus: towards a banking union?', (2013) CEPS Commentary, 8th April who argues that successful bailing-in will bring forward a true banking union with deposit guarantees for smaller savers.

²¹ Fischer, S., (2002) 'On the Need for an International Lender of Last Resort' in Goodhart, C. and Illing, G., *Financial Crises, Contagion, and the Lender of Last Resort*, Oxford University Press.

²² For an explanation of how governments may simply print money to finance themselves see Lerner A, 'Functional finance and the federal debt' (1943) In *Selected Economic Writings of Abba P. Lerner*, (1983) New York University Press.

that, in giving up their currencies, the Eurozone members became like developing countries who borrow in foreign currency.

This was unsurprising as it was a key philosophical tenet of those drafting the Maastricht treaty that monetary financing of public debts must be prevented. The German experience of the Weimar hyperinflation was allied with the wider European experience of the inflationary 1970s. As the European Monetary Institute, the precursor to the ECB, put it: 'Historical as well as recent experience has shown that a monetary policy oriented towards price stability may be jeopardized by the involvement of central banks in financing government budgets'.²³ Thus, in addition to providing strong guarantees of central bank independence from political interference, Article 123 TFEU actually banned the ESCB from both providing credit facilities to public bodies and also the 'purchase *directly* from them....of debt instruments' (Italics added). This was confirmed in Article 21 of the ECB Statute.²⁴ European central bankers at the time believed that this 'very clearly provided that the central bank is not allowed to finance the deficit in the public sector'.²⁵ As well as combating inflation, the prohibition would help to prevent moral hazard. The European Commission believed that only an absolute prohibition clause could persuade the markets that no solidarity measures would be undertaken.²⁶

Despite these ideas, the so-called 'no bail-out clause' did not however outlaw purchases of government debt in the *secondary* market. It was foreseen that it might be necessary to buy up such debt to provide liquidity as part of traditional open market operations. To this extent, there was therefore never an absolute ban on such purchases. Rather, it was the *purpose and effect* of such purchases that had to be reconciled with the overriding duties of the ESCB. The legal position rested upon complex questions of interpretation. Whilst there was a widespread political and economic belief that the ECB should not 'monetarize public debt', some sovereign debt purchases would not fall within this concept. Indeed, as the ECB's remit has expanded *de facto* to include ensuring financial stability, sovereign debt purchases to secure this end, rather than to finance government spending *per se*, would arguably be lawful.

The ECB first tested the legal limits of Article 123 in May 2010, when, as part of the overall bail-out package of austerity and structural reform, it revealed that it had agreed to buy €40 billion of Greek sovereign debt (at a large discount) on the secondary market. This was explained on that basis of 'severe tensions in certain market segments' which were 'hampering the monetary policy transmission mechanism.' At the same time it announced that it was beginning a Securities Market Program to buy up securities rather than simply hold them as collateral to support loans to banks. The voting procedure in the Governing Council on this issue, again, is not weighted by

²³ European Monetary Institute, (1994) Annual Report.

²⁴ Protocol (No. 4) On the Statute of the European System of Central Banks and of the European Central Bank C 115/230 OJ

²⁵ Otto-Pohl, K., 'The Philosophy of central banking: a panel discussion' in F Capie, F., Goodhart, C., Fischer, S., and Schnadt, N., The Future of Central Banking (1994) Cambridge University Press. Otto-Pohl was Governor of the Bundesbank at the time.

²⁶ European Commission, (1990) 'One money, one market: an evaluation of the potential benefits and costs of forming an economic and monetary union' European Economy 44.

capital contribution but rather proceeds by simple majority.²⁷ Axel Weber and Jurgen Stark, the German members of the Council voted against the decision purchase of Greek bonds on the grounds that it was outside the ECB's legal remit.

The exact purpose of these purchases remains unclear: the Governing Council did not explain how they contributed to either the primary legal mandate of achieving price stability or its emerging role to protect financial stability. Of course, the risk of Greece defaulting and leaving the Euro would have presented a massive financial shock. Similarly, contagion spreading to other sovereigns from Greece might have led to deflation and bank failures across the Eurozone. The ECB might have openly referred to such systemic risks. The purchase of Greek bonds from a down-graded sovereign that would certainly have defaulted apart from the bailout package was risky. There were grave doubts (subsequently vindicated) about Greece being able to achieve debt sustainability. Even with the ECB being part of the Troika, Greece persistently failed to comply with its adjustment programme. It seems most likely that the ECB was seeking to share the burden with the Eurozone members who faced political constraints on the size of their bail-out contributions. In the absence of clarification, it was open to critics to say that the purchases were simply illegal attempts to support Greek public finances.

Similar purchases were however made at the time of the subsequent Irish and Portuguese bail-outs. Further interventions to buy Italian and Spanish bonds occurred during market stresses in summer 2011, this time without any Troika program to enforce austerity and reform. Whilst these purchases did, at least for a time, reduce bond yields on government debt across the Eurozone, the uncertainty surrounding the legal basis and intention behind them satisfied no-one: markets were insufficiently reassured whilst hawkish critics still alleged that the Maastricht settlement was being undermined by the ECB. The only route to legally challenge the ECB's decisions is however through direct annulment proceedings. *Locus standi* is reserved to the EU institutions and Member States who have privileged access.²⁸ Any hint of such a challenge would of course bring financial chaos such that no Member State would be likely to commence it. In the event, Weber and Stark later resigned from the ECB Executive Board because of what they saw as its illegitimate actions.

Much more important in practice even than the direct bond purchases was the Governing Council's decision, apparently taken as part of the bail-out, to suspend its collateral rules. Banks could continue to obtain short-term credit by posting Greek sovereign debt even though this had been down-graded to junk status by ratings agencies.²⁹ The ECB took similar steps as part of the bail-out packages in relation to Ireland and then Portugal. Without such loans, these banks would have failed and their sovereigns would have

²⁷ See Statute of the European System of Central Banks and of the European Central Bank, Article 10.

²⁸ Article 263 TFEU.

²⁹ Decision of the European Central Bank of 6 May 2010 on temporary measures relating to the eligibility of marketable debt instruments issued or guaranteed by the Greek Government. (ECB/2010/3). Article 1 simply states that the 'minimum requirements for credit quality thresholds...shall be suspended.' Article 2 confirms that 'Such assets shall constitute eligible collateral...irrespective of their external credit rating'. This was also applied to bank loans guaranteed by the government. Similar decisions were made for Irish and Portuguese debt.

had to exit the Eurozone to restart their banking systems with national currency. Creditors in other Member States, particularly Northern European banks, would have borne substantial losses. Public spending cuts would have been more painful than the austerity packages agreed with the Troika of IMF, ECB and European Commission. The ECB's generous credit facility therefore suited both the stronger Eurozone members and the countries needing bail-outs. This was a political decision that had potential distributional consequences: it allowed banks and weaker sovereigns to put risks onto Eurozone taxpayers as a whole, who would in practice, if not in law, have to recapitalize the ECB in the event of it suffering losses.

The ECB became a major creditor to Eurozone governments, holding €212 billion of sovereign bonds by May 2012. In addition, the ECB had made over €2 trillion in loans backed by collateral (often sovereign bonds) from peripheral countries. As noted above, the ECB has only limited capital and its own financial independence was arguably put at risk.³⁰ In December 2010 its request for an increase in its capital from €5.76 to €10.76 billion was granted by the Member States. Its overall balance sheet had by that time grown to nearly €2 trillion. Because of its own potential losses and fears for the European banking sector generally, the ECB strongly resisted any sovereign debt restructuring for peripheral countries. Until the Cyprus bail-out of 2013, it repeatedly insisted that all public and private debts be honored. This was most obvious when the Irish government was persuaded to continue to guarantee most of its banks' debts in 2010. Legal, economic and political doubts about the ECB's actions also grew during 2010-11 amongst sections of German opinion. In response, the ECB pressed Member States to put in place a clearer and permanent legal mechanism (beyond the temporary European Financial Stability Mechanism created in 2010) to make loans to Eurozone members in difficulty.

The European Council therefore agreed in December 2010 to amend the Article 136 TFEU to permit for the first time, not a system of fiscal transfers, but the establishment of a stability mechanism to be activated if indispensable to safeguard the *stability of the euro area as a whole* (italics added). The subsequent European Stability Mechanism (ESM), although endowed with lending capacity of up to €700 billion, requires recipients to comply, in principle, with a comprehensive macro-economic adjustment program in every case. There is no power for the ESM to simply buy up debt in the primary or secondary markets without strings attached and become a lender of last resort. If it were given a banking license it could however borrow from the ECB by posting as collateral the bonds it purchased on primary markets. This would mean it could leverage itself against its capital base to become much larger. The German government has however persistently refused to permit the ESM being given a banking license even though the limited size of the ESM troubled financial markets and weaker sovereigns.

Significantly the ECB itself issued a legal opinion stating that funding ESM would breach the monetary financing prohibition ('one of the basic pillars of the legal architecture of EMU both for reasons of fiscal discipline ...and in order to preserve the integrity of the single monetary policy as well as the

³⁰ Ruparel, R. and Persson, M., 'A House Built on Sand? The ECB and the hidden cost of saving the euro', Open Europe, June 2011

independence of the ECB').³¹ The Germany Constitutional Court noted this with approval when declaring German ratification of the ESM to be in compliance with the Maastricht Treaty principles.³² As regarding lending to the ESM, Governor Draghi said that people risked 'destroying the credibility of [the ECB] by asking it to behave outside the limits of its mandate.'³³ The textual argument regarding the ECB and ESM relationship is in fact inconclusive: Article 123(1) speaks of a ban on lending to 'Union institutions, bodies, offices or agencies.' Article 123(2) however allows the ECB to lend money to 'publicly owned credit institutions' which could include the ESM. There is a precedent here in that the European Investment Bank, a wholly-owned public body of the EU, has received loans from the ECB. It is considered a 'credit institution'.³⁴ The real concern driving the attempt to constrain the ESM was likely the deep philosophical fear of moral hazard and resistance to creating a lender of last resort for sovereigns with largely unlimited funds.

National Politics, the ESCB and the Balance of Payments

In 2011, a different source of controversy surrounding the ESCB emerged as data was presented by German scholars about intra-Eurozone capital movements occurring via the inter-bank payments system. These critics argued the ECB accounts showed forced loans on a vast and uncontrolled scale from, inter alia, the Bundesbank to the periphery.³⁵ The ESCB payments system ensures that all private bank transfers are settled. This takes place in accounting terms through transfers by national central banks to and from the ECB. When a Spanish consumer buys a German car, for example, the consumer's bank asks the national bank of Spain to transfer the funds. After making the transfer, the national bank of Spain has a debit on its balance at the ECB. The Bundesbank then creates funds in the German seller's bank account. The Bundesbank then has a credit for this amount in its account at the ECB. These accounting entries at the ECB are called TARGET2³⁶ balances. They are recorded as public exports of capital from Germany to Spain in balance of payments data. Before the crisis, such transfers of liquidity from the periphery to the core were largely re-financed by private-sector bank loans from surplus countries. Thus, Northern Europe's trade surplus entailed a trade deficit in the South which was funded by a capital account surplus provided by Northern banks' cross-border lending. The TARGET2 balances were therefore insignificant.

As fears of possible bank failure developed, cross-border loans were called in and Southern European depositors began to move large sums to safer countries like Germany. Current account deficits also continued to be run for some time. With peripheral banks increasingly shut out of private credit markets, there was no longer any capital inflow to offset the outflows

³¹ Opinion of the European Central Bank of 17 March 2011, 2011/C 140/05, Para 9.

³² [\[207\] 2 BvR 1390/12 and others, decision of 12 September 2012.](#)

³³ Introductory Remarks, ECB, Monthly meeting 5 July 2012.

³⁴ Gros, D. and Mayer, T., 'Refinancing the EFSF via the ECB' (2011) CEPS Commentary.

³⁵ Sinn, H. and Wollmershauser, T., 'Target Loans, Current Account Balances and Capital Flows: The ECB's Rescue Facility,' CESifo Working Paper No.3500, 24 June 2011

³⁶ See European Central Bank Guideline on the Trans-European Automated Real-Time Gross Settlement Express Transfer system (TARGET2) ECB/2007/2.

appearing in the TARGET2 balances. To continue operating peripheral banks had to refinance themselves and meet minimum reserve requirements. These reserves came, as we have seen, through unlimited cheap loans from the ECB or Emergency Liquidity Assistance. As a result of these trends, TARGET2 balances at the ECB grew rapidly. By August 2012, the Bundesbank credits at the ECB peaked at €751 billion (up from €25 billion in 2006) which largely matched the debits of the Irish, Spanish, Greek and Italian central banks. There is no obvious limit to the size of these balances: so long as the banking system in the periphery has eligible collateral then they can continue to grow.³⁷

Before these developments, the national character of balance of payments data within the Eurozone had been seen as unimportant. Since 2011 however, critics have argued that TARGET2 balances are like forced loans from the central banks of Germany, the Netherlands, Finland and Luxembourg without repayment terms or collateral. This interpretation has rightly been strenuously rejected by the ECB and the Bundesbank.³⁸ TARGET2 balances do not take the legal form of loans; rather they are merely accounting entries that reflect the pattern of cross-border private sector bank payments. The profits and losses from the operations of the ESCB are distributed between its Members based upon their capital contributions not their TARGET2 balances. If the ECB simply made loans directly to commercial banks, rather than using national central banks as agents, there would be no such accounting entries at all.

Whatever the nature of TARGET2 balances, they reflected a breakdown in the inter-bank funding market across the Eurozone. The risks began to be considered too great for the private sector to advance funds. In order to avoid bank failures, the ECB stepped in as lender of last resort. This enabled private creditors, particularly in the UK, Netherlands, France and Germany, to exit some positions in peripheral assets and transfer the risks to the Eurozone public through TARGET2. The ESCB has extensive reserves of gold and foreign exchange to meet any losses. In the worst case scenario of a major country leaving the single currency (and taking its collateral with it) then Eurozone members would probably recapitalize the ECB. This allowed Northern banks to escape their bad investments but at the cost of socializing the risks of sovereign default without using the official lending channel under

³⁷ There was around €13 trillion eligible collateral in the Eurozone at the end of 2011 (ECB, 2012). The critics would like to prevent these balances from growing by legal changes to the ESCB. Under the US Federal Reserve system regional banks must clear their balances annually by providing hard assets such as gold certificates or government bonds to those in credit. It is argued that then TARGET2 imbalances would not have been able to continue to grow as peripheral central banks ran out of such assets. This interpretation of the US system is generally rejected by most commentators on the basis that the rebalancing occurs as an accounting entry through reallocation of the portfolio of assets held by the Federal Reserve amongst all the regional banks. The system does not prevent regional payments imbalances persisting year on year. See Buiter, W., Rahbari, E., and Michels, J., (2011) 'The Implications of the intra-euro area imbalances in credit flows' Policy Insight No.57, Center for Economic Policy Research.

³⁸ See Weidmann J, Guest Contribution to Frankfurter Allgemeine Zeitung, 13th March 2012. http://www.bundesbank.de/Redaktion/EN/Standardartikel/Press/Contributions/2012_03_13_weidmann_FAZ_FD.html (accessed 26th April 2013). Bundesbank Monthly Bulletin, March 2011, 34-35 for a detailed explanation.

the ESM.³⁹ These sums are less obvious to taxpayers and do not appear on national debt figures. Nevertheless, the alternative of refusing to continue granting credit to peripheral banks would likely have led to pan-European banking failures through both direct losses and contagion. Banks would then have to be recapitalized by their sovereigns (including French and German banks exposed to the periphery). If national central banks could no longer create fresh reserves for their banks, then the single currency would then cease to exist at all because euros in peripheral states could not be used to make cross-border transfers.⁴⁰ This was first seen in the case of Cyprus in April 2013 which had to impose of capital controls following the ECB's refusal to permit further liquidity for Laiki bank.

The Fiscal Compact and the Widening Crisis in Sovereign Debt Markets

By summer 2011 speculation had re-emerged within the single currency: instead of currencies, sovereign debts and private banks were the targets. Even domestic depositors in the periphery began to move their money to banks in core countries. Contagion spread to large sovereigns like Italy and Spain, both considered too large to bail out with the existing rescue funds. There had never been any previous doubt about the solvency of such countries. But with national central banks' barred from buying public debt to control yields and calm markets, illiquidity was transforming into insolvency⁴¹. The weakening in sovereign debt markets had a feedback onto banks in those countries who were large holders of sovereign debts. Peripheral banks could no longer raise long-term debt at reasonable rates. At the same time as their share prices were falling, the banks were also under pressure to raise more capital to meet Basel III regulatory requirements.

Throughout this period the ECB came under increased pressure to cap yields by buying more Italian and Spanish public debt. Upon his appointment in November 2011, however, the new ECB President Mario Draghi very clearly stated that acting as lender of last resort to sovereigns was outside the legal remit of the ECB.⁴² Nevertheless, within a month, he said that the ECB might take further action if politicians acted to establish 'a new fiscal compact' that would 'enshrine the essence of fiscal rules and ...ensure that the latter become fully credible, individually and collectively'.⁴³ He argued that 'confidence works backwards: if there is an anchor in the long term, it is easier to maintain trust in the short term.' The established ECB view was that fiscal indiscipline was a major cause of the crisis.⁴⁴ It had long

³⁹ Homburg, S., 'Notes on the TARGET2 dispute' CESifo Forum 2012. Accesible at <http://www.cesifo-group.de/portal/page/portal/ifoHome/b-publ/b2journal/30publforum/ PUBLFORUM12>

⁴⁰ Merler S and Pisani-Ferry J, 'Sudden stops in the Euro area', Bruegel Institute, March 2012.

⁴¹ Gros, D., 'Speculative Attacks within or outside a Monetary Union: Default versus Inflation (what to do today)' 16 November 2011, CEPS Policy Brief no.257

⁴² 'Gaining credibility is a long and laborious process. Maintaining it is a permanent challenge. But losing credibility can happen quickly – and history shows that regaining it has huge economic and social costs.' Draghi, M, 'Continuity, Consistency and Credibility', Introductory remarks, at the 21st Frankfurt European Banking Congress "The Big Shift", Frankfurt am Main, 18 November 2011

⁴³ Draghi, M., Introductory Statement, 1 December 2011, Hearing before the Plenary of the European Parliament on the occasion of the adoption of the Resolution of the ECB's 2010 Annual Report.

⁴⁴ European Central Bank (2012), Annual Report 2011.

argued for deeper constitutional fiscal commitments - principally a German-style debt brake – not just a modified Stability and Growth Pact, to ensure a credible institutional framework for both a return to sound public finances and the smooth functioning of EMU.⁴⁵ Financial markets believed that the ECB was about to abandon its reluctance to cap sovereign bond yields as part of a grand political bargain with the Fiscal Compact as the *quid pro quo*.

In December 2011 the Eurozone members agreed to the new Fiscal Compact which promised cuts in structural deficits to 0.5% of GDP alongside more automatic enforcement. The ECB's initial response was not however in the sovereign debt markets; rather it gave unlimited volumes of three-year loans to the European banking sector at 1% interest rates. This Long-Term Refinancing Operation program was taken up on a vast scale (around €1 trillion) by banks desperate for liquidity. Again, the ECB continued to accept a wide range of collateral. Although, there was no direct purchase of government debt, it is probable that the ECB hoped that banks might buy their sovereign's debts – with a carry-trade giving 4-5% on Italian or Spanish bonds – driving down yields and rebuilding bank capital. This was the first program launched by the ECB engaging in fresh deposit-creation without draining liquidity elsewhere - true 'money printing'. This was again a concern for German opinion which saw here signs that the ECB might be losing sight of its primary goal of price stability in an effort to secure financial stability.

The ECB rightly continued to deny that these actions amounted to illegitimate monetary financing of public debt.⁴⁶ Although they indirectly helped governments - by preventing bank failures and lowering yields - they remained in form private loans aimed at maintaining financial stability. The LTRO program did however bind domestic banks closer to their sovereigns. As foreign investors sought to exit, domestic banks bought up their sovereigns' debts. This increased banks' vulnerability to shocks through any write-downs in their sovereign assets. It is clear that a crucial collapse in the market for much sovereign and bank debt in Europe can be dated to this period. Foreign investors were faced with default and exit risks that were no longer negligible. Furthermore, the holders of Greek public debt had been twice forced into large write-downs in order to protect official lenders like the ECB and EFSF from any losses on their loans. This precedent suggested that future rescue operations might lead to further heavy private sector losses on other sovereign debts.⁴⁷ The assets in Europe perceived to be risk-free had narrowed to the government bonds of strong Northern Eurozone countries.

Yields on Spanish and Italian debt fell initially following LTRO but rose again to dangerous levels of around 6-7% in summer 2012 whilst Germany could borrow at under 2%. In light of continued doubts from the private sector about the Eurozone remaining intact, TARGET2 balances had continued to grow, despite the LTRO program, with Bundesbank credits peaking in August 2012 - reflecting continued repatriation of funds and the beginnings of

⁴⁵ Schuknecht, L., Moutot, S., Rother P., and J Stark, J., 'The Stability and Growth Pact: Crisis and Reform,' ECB, Occasional Paper Series, No.129, September 2011

⁴⁶ See interview with Mario Draghi conducted by the Financial Times, 14 December 2011 in Frankfurt where he said that this is 'obviously not equivalent to the ECB stepping-up bond buying.'

⁴⁷ The ESM treaty did not mandate 'private sector involvement' but does require an assessment of debt sustainability and write-offs where this is considered to be the only means of restoring solvency. See Article 14.

domestic deposit flight from Spain. Spain was faced with the immediate problem of funding large-scale bank recapitalisations. In June this required an ESM sovereign loan of €100 billion because a direct recapitalisation of banks was said by Northern European countries to be illegal under the ESM Treaty. Thus, the Fiscal Compact combined with the LTRO programme had failed to restore financial stability. The continued refusal of the ECB to cap sovereign debt yields directly allowed markets to spread contagion from clearly insolvent sovereign debtors like Greece to solvent countries like Spain and Italy. It thus increased the likely cost of future rescue packages and deepened the austerity needed to pay interest bills, driving some towards insolvency.⁴⁸ However with the lending capacity of the EFSF (and its successor ESM) now fixed and limited by the Bundestag at around €700 billion, this was not large enough to provide immediate funding for the bigger sovereigns in the Eurozone.

'Whatever it takes'? The Outright Monetary Transactions Program for Sovereigns

A new phase in the crisis had developed. The LTRO could neither remove underlying bank insolvency nor stabilize sovereign bond markets. Just as the Fiscal Compact had been used to justify the LTRO programme in late 2011, the Eurozone leaders' next important agreement in June 2012 provided support for the next dramatic step taken by the ECB. The Eurogroup apparently agreed in principle to create a 'banking union' ostensibly to break the 'vicious circle between banks and sovereigns'.⁴⁹ When looked at more closely this involved merely a shift in supervisory power from national bank regulators to the ECB in respect of larger banks; there was no agreement on forcible bank closures or sharing deposit protection or bank re-capitalization costs for historic losses. This would have been a form of fiscal union creating shared liability whilst limiting national policy autonomy pertaining to the banking sector (an autonomy cherished by all Eurozone members in this most highly political field). The most that was contemplated was a possible future authorization for the ESM (by treaty amendment) to directly recapitalise banks, rather than increasing sovereign debt further.

Nevertheless, the June agreement was hailed used by the ECB President on 26 July 2012 as a major step toward a deeper 'financial union'. In words quoted the world over, he said that the single currency was 'irreversible' and that '[w]ithin our mandate, the ECB is ready to do whatever it takes to preserve the euro...' Whilst markets came to focus upon the second part of this historic phrase, the reference to the ECB's mandate were not idle. This was made clear in September when the actual details of the new Outright Monetary Transactions ('OMT') program to replace the failed SMP were laid out: it was up to Member States and the ESM, not the ECB, to instigate and follow austerity and structural reforms before they could expect central bank

⁴⁸ Buiter, W. and Rahbari, E., 'Why Does the ECB not put its mouth where its money is? The ECB as lender of last resort for Euro area sovereigns and banks' 27 February 2012, Global Economics View, Citibank, Economics Department Working Papers, No.827.

⁴⁹ Euro Area summit statement, 29 June 2012 available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf (accessed 20 April 2013).

support. Whilst the markets were strangely euphoric, the ECB had apparently drawn a red line ruling out further bond purchases without Troika programmes.

The OMT program was officially justified by Governor Draghi on a new and distinct basis from the SMP, namely that the sovereign interest rates in the periphery were elevated in part because the market was imposing a currency 'convertibility' premium based upon a mistaken belief that some Euro members might exit. Once again, the Bank's primary intention was said not to be to finance governments but to disavow private sector actors of doubts on this issue. The ECB would buy up unlimited amounts of short-dated sovereign bonds to eliminate this risk premium. Furthermore, the Bank would no longer claim seniority over other creditors.

These two steps were hugely significant but once again the Bank feared the moral hazard problem and free-riding by debtor nations. It decided that bond market support would only be available to successful graduates *coming out* of an ESM/Troika programme, in the process of regaining market funding. The ECB also explicitly failed to say that it would cap bond yields at any particular rate, leaving governments uncertain as to the point at which the ECB would stop intervening. Finally, the ECB would sterilize all such purchases by removing liquidity equal to that injected. These steps were all designed to reassure core countries fearful about indiscriminate 'monetary financing' of the periphery but also because the ECB had lost faith with its own ability to press for reforms informally by using bond purchases alongside discrete negotiations. The OMT was agreed unanimously by the Governing Council, including the German member on the Executive Committee; the sole dissent came from the President of the Bundesbank who announced this was too close to inflationary and illegal monetary financing of government debt. The German government however openly endorsed the legality and prudence of the OMT.⁵⁰

The financial markets however ignored all the caveats. Without any country having to accept its onerous terms, the mere announcement of the new policy dramatically reduced spreads on short-term and longer-term sovereign debt for all periphery countries, whether inside or out Troika programmes. For Italy and Spain, the fall was around 2-3 percentage points, allowing for the rollover of debt on politically tolerable terms. TARGET2 balances also improved markedly with Bundesbank credits falling by 20% to reflect private investment flowing back to the periphery and improved export performance.⁵¹ The ECB had shown that merely stating that it could, on certain conditions, use its unlimited deep pockets was enough to stabilize sovereign bond markets.

As De Grauwe and Ji show, the previous orthodoxy from the ECB and the Commission that only austerity would reduce spreads, was contradicted by the evidence. The greatest austerity, in Greece, had in fact produced the biggest rise in spreads before OMT. After the OMT announcement, countries

⁵⁰ Chancellor Merkel referred to the ECB's actions as securing financial stability. Any potential legal constraint posed by the views of the German Constitutional Court has also not been brought to bear on the ECB. In its ESM ruling the Court said that the ECB could not lawfully make loans to the ESM but it did not comment on the previous bond-buying programmes even though asked to do so. 2 BvR 1390/12 and others, decision of 12 September 2012, 245-247.

⁵¹ See Bundesbank TARGET2 balance of €588 billion at 31st March 2013.

with the highest initial spread saw the greatest reduction in spreads.⁵² Thus Greece saw its borrowing costs fall by 10 percentage points. The markets' response indicated that the existence of a lender of last resort, not reductions in the level of debt or deficits along pathways ordained by the Commission was crucial to calming market panics over sovereign bond yields. The ECB had always accepted that market judgments on sovereigns reflected rational assessments of the 'fundamentals' of debt size, deficit and growth. In fact the evidence suggests that during 2000-8 markets moved in a wave of optimism on the belief that default and exit were unthinkable by driving down sovereigns spreads below their fundamentals. Then, during 2008-12, faced with the Eurozone's lack of commitment to support sovereigns, markets swung towards pessimism by driving spreads above the underlying fundamentals.⁵³ The ECB's announcement of the OMT programme stemmed the irrational panic, something that countries with their own central banks (but worse debt profiles) had not experienced.

Has the ECB Ever Engaged in 'Illegal Monetary Financing'?

Even before the OMT programme, there had been allegations that the European Central Bank had engaged in 'illegitimate deficit financing'. Because legal arguments are viewed as trump cards over economic and political considerations, they often carry great power. Essentially, it has been alleged that, apart from its early liquidity provision for banks in 2008-9, the ECB's actions have breached the Maastricht treaty. The legal argument is however very weak. As noted above, Article 123 TFEU only prohibits the ECB from extending credit to sovereigns or buying government debt in the *primary* market. So why did it ever become accepted that Maastricht clearly banned 'deficit financing'? The answer lies in three further features of the Treaty. First, the ECB's monetary policy mandate, particularly maintaining price stability, took legal priority over the Bank's support for wider economic policy. Second, the 'no shared liability' clause in Article 125 made clear that neither the Union nor its Member States assumed liability for sovereign debts other than their own; markets should price debt accordingly. This, combined with the obligation to avoid excessive deficits in Art 126, aimed to ensure Eurozone members remained solely responsible for their own fiscal policies and subject to market discipline. It was widely assumed that these arrangements must mean that the ECB could not (lawfully) circumvent this goal directly by engaging in large-scale sovereign debt purchases or indirectly by supporting weak banks. And yet it is clear that there never was a rule of law governing the matter. It would be more accurate to say that the 'spirit' - rather than the letter - of Treaty pointed against the ECB acting as a lender of last resort.

And yet, in May 2010, this is just what the ECB had appeared to do in the case of Greece, to be followed by further interventions in respect of Ireland, Portugal, Italy and Spain. The OMT program put such interventions on a transparent and formal footing with the trigger being a entry into a Troika

⁵²See de Grauwe P and Ji Y, 'Panic driven crashes in the Eurozone and its implications' Vox, 21 February 2013, <http://www.voxeu.org/article/panic-driven-austerity-eurozone-and-its-implications> (accessed 20 April 2013).

⁵³ See de Grauwe P and Ji Y, 'Mispricing of sovereign risk and multiple equilibria in the Eurozone' (2012) CEPS Working Document No.361.

programme under the ESM. ECB Presidents have nevertheless always publicly accepted that they work within legal constraints and that deficit financing is illegal. The difficulty has been to pin down exactly where the parameters of legality lie. There is no agreed definition on when a central bank is engaging in 'deficit financing'. The classic case, in which a Treasury simply sent its invoices to be paid for by the central bank, is rare. Certainly hyperinflations have only generally arisen in such cases, which obviously does not fit the ECB's situation. Without such a definition, however, the legal argument has no place to go. The critics have yet to agree on a definition themselves, rendering their attacks less convincing.

Given that no single legal opinion has set it out, what can we glean from the ECB's stance over recent years as to where it thinks the legal boundaries lie? The picture is not straightforward, given the complexity of the issues. The most important factor emphasized has been the ECB's *intention* in purchasing debt (or extending credit) rather than the fact of having done so. It is a very Catholic idea at heart; the double effect doctrine holds that, where one's intentions are good, this may justify causing a known bad if that is an unavoidable and minimally harmful means to secure an overall good. With the creation of the Long Term Refinancing Operation of over €1 trillion to the banks in 2011-12, the ECB accepted that these funds would be used to support sovereigns by buying up their bonds. It rightly argued that this was however an indirect effect and did not amount to illegitimate financing.

Under the more controversial Securities Markets Programme, the ECB's argued its goal was to repair the 'broken transmission mechanism' in peripheral countries; lowering effective interest rates in countries where they were elevated above the ECB's target rate. This was rendered less objectionable, by withdrawing from circulation money equal to that spent to counter the allegation of 'printing money'. Finally, the sovereigns supported were each under the supervision of the Troika, including the ECB itself, so giving a measure of control over the national treasury regarding austerity and reform. Any easing of fiscal pressures on sovereigns was portrayed as a by-product which could not be considered remotely within any definition of 'illegitimate deficit financing.' The subsequent difficulties with the Greek bail-out revealed that, even within a Troika programme, the ability of external bodies to ensure the restoration of public finances was limited in the face of recession and resistance.

The ECB came under some pressure to accept losses on its Greek bond purchases when private sector bond-holders suffered write-downs in March 2012. It refused on pragmatic grounds arguing it was a senior creditor like the IMF. Later, the ECB said that it would be actually be *illegal* deficit financing for it to voluntarily agree to write-offs of its bond purchases. This is because it would result in a 'transfer' of funds on a permanent basis to the Greek sovereign. The same debate took place when, in February 2013, Ireland applied to restructure its own promissory notes (held by the Central Bank of Ireland as collateral for loans to Anglo-Irish bank). This time however the ECB effectively allowed Ireland to write-down its debts to enable it to

better manage its exit from the Troika programme.⁵⁴ Thus the even the 'no sovereign write-off' criteria is not entirely certain.

In July 2012, when Governor Draghi said he was willing to do 'whatever it takes' to save the Euro it sounded like the prelude to dispensing with legal constraints on ECB action. Again however the details of the Outright Monetary Transaction programme revealed that the ECB's new intention was to eliminate the irrational 'break-up' premium on peripheral sovereign bonds. Moreover, although unlimited purchases were contemplated, recipients had to be under a Troika programme, thus removing the ECB's previous flexibility to intervene in a more discrete and discretion manner. The complex nature of the OMT arrangements, which were created by the ECB's officials, cannot be considered a legal 'interpretation' of Article 123. Instead they constitute a culmination of the ECB's political and economic policy position based on experience during the crisis. The OMT programme sought to secure the Euro by balancing moral hazard against austerity-fatigue and limits to bail-out funds. At one level, it suggested that the ECB had decided to leave political negotiations to the politicians; it would only intervene once they had reached agreement on the terms of a bail-out and it was being complied with. The OMT would however make such negotiations easier in that it guaranteed that countries emerging from bail-outs would be given ECB support to keep market rates capped at levels consistent with an irreversible monetary union.

By always defining its intentions in terms of 'monetary policy', the ECB has deflected the legal attack upon it. Any definition of illegitimate deficit financing must indeed consider the intention of the central bank in creating liquidity. The ECB has no doubt many intentions when it undertakes monetary policy but it has always cloaked these in a manner sufficiently linked to monetary policy as to shield it from any (unlikely) legal consequences. The ECB's actions in sovereign debt markets have indeed been far more restrained than those of the US Federal Reserve or the Bank of England. Both of the latter continue to argue that they are engaged in monetary, not fiscal, policy through quantitative easing. Importantly the Bank of England has purchased around 1/3 of UK government debt whilst still not being criticized by the Commission for breach of Article 123 (which also binds it). Its stated purpose is to increase liquidity to drive down wider interest rates (and thereby avoid undershooting the inflation target) not to support government finances. It has maintained that these purchases are temporary and will be reversed by resale to the public at some point.⁵⁵ Importantly this means, that as a matter of EU law, UK government debt cannot lawfully be cancelled, although this has been mooted by some as a partial solution to UK indebtedness.⁵⁶ During

⁵⁴ The complexity of the arrangements between the Irish government, its central bank, Anglo-Irish bank and its successor the Irish Bank Resolution Corporation was such that the ECB may have felt that the real nature of the write-down would not be apparent. For a detailed account see Whelan K, 'Ireland's Promissory Note Deal', 11 February 2013 at <http://www.forbes.com/sites/karlwhelan/2013/02/11/irelands-promissory-note-deal> (accessed 20 April 2013).

⁵⁵ See interview with Charlie Bean, Deputy Governor for Monetary Policy, Bank of England accessible at <http://www.bankofengland.co.uk/monetarypolicy/Pages/qe/askqa.aspx> (last accessed on 16th April 2013).

⁵⁶ See Adair Turner, Mansion House speech, 11th October 2012 at <http://www.fsa.gov.uk/library/communication/speeches/2012/1011-at.shtml> (accessed 25th April 2013).

the crisis, the UK has had a debt and deficit profile worse than that of weaker Eurozone members like Spain.

The ECB cannot seriously be accused of having broken any rule of law within the Maastricht Treaty through its reluctant and conditional actions during the crisis. The possibility of a Eurozone break-up, something generally impossible in a sovereign state, has had implications for the ECB and the Eurozone members. It is clear that because this very possibility was allowed to emerge during 2010-12, panicking markets over-reacted. If a break-up had occurred then some of the ECB's purchases and loans had gone bad, it would need recapitalization by the remaining Eurozone members. In addition, the remaining Member States would lose paper assets in the form of TARGET2 loans. It is not clear that they would however suffer real economic harm because their central banks could simply create new money.⁵⁷ Furthermore, the actions of the ECB allowed Northern European banks to avoid losses that would otherwise have required their taxpayers to recapitalise them. Overall therefore, it is not clear that the actions of the ECB have cost taxpayers anything or that a 'transfer union' has covertly been created, rather the opposite is likely to be the case.

Politics, Law and Moral Hazard

With the legal constraints on the ECB being more imagined than real, what have been the political and economic factors influencing its actions? During the first period of the crisis 2007-9, the ECB's assumption of lender of last resort facilities was politically acceptable to most Eurozone states. There was *general* failure of liquidity in *private* debt markets. The benefits of ECB intervention could not be seen to accrue to particular sovereigns, although German banks were principal beneficiaries. Since 2010, however, political attention has focused upon peripheral sovereign debt markets. As is common, the banking crisis was a catalyst for a marked worsening in fiscal positions, particularly in countries which had experienced property booms.⁵⁸ In Northern European political discourse, these difficulties were no longer seen as general to the Eurozone but reflected particular political failures in Greece, Spain, Portugal and Italy which required national policies of austerity, reform and wage cuts. The political logic resonated with the orthodoxy about Maastricht not constituting a transfer union. For a long time, ECB endorsed this thinking by refusing to underwrite sovereign debt yields which market fears had caused to sharply diverge.

Alongside these political dynamics, important German economic opinion of the Hayekian and ordo-liberal schools argues that reasserting the law on fiscal and monetary discipline was crucial to secure economic

⁵⁷ De Grauwe P and Ji Y, 'What Germany should fear most is its own fear: an analysis of Target2 and current account imbalances' (2012) CEPS Working Document No.368 which argues that Target2 credits are not a source of real wealth backing the currency in Germany but merely paper claims whose destruction would not change the real value of German residents' assets in any break-up of the Eurozone so long as inflation were controlled upon any redenomination of the currency. The deposit flight to Germany from peripheral states means that the Bundesbank would have to decline to convert foreign deposits for fear of stoking inflation.

⁵⁸ Fischer, S., (2002) 'On the Need for an International Lender of Last Resort' in Goodhart, C. and Illing, G., Financial Crises, Contagion, and the Lender of Last Resort, Oxford University Press.

adjustment.⁵⁹ This would force all banks, both in core countries and the periphery to realize their losses, although core countries would of course be better placed to recapitalize their own banks. This ultimate 'grundnorm' of the single currency, allowing market mechanisms to work, was challenged by the ECB's adoption of its new role to safeguard financial stability.⁶⁰ Whilst price stability was maintained, liberal economic critics argued that the vast liquidity provided by the ECB had created an illegitimate transfer union, increased moral hazard and impeded market adjustments. The private lender of last resort function has morphed into a political discretion to prop up weak banks and, indirectly, their governments. Continuing to extend such credit merely increased the risk of a larger collapse in the future. The ECB should re-establish strict rules on the collateral and thus curb money creation not backed by sound assets. This has echoes of the gold standard approach to money and prices. Certainly, the imposition of tighter limits upon money creation would be deeply deflationary and would thus force down wages and prices in the periphery of the Eurozone economy. But this might also lead to the banking failures and debt/deflation dynamics that central bankers have identified as causing the Great Depression and the collapse of the gold standard. The single currency might well break-up.

For the ECB, restoring market mechanisms in finance, whilst economically attractive in theory, was unacceptably dangerous. It fought to protect financial stability whilst pushing for the economic adjustments it felt were necessary to remove imbalances. Direct exposure by French and German banks to securities in the periphery remained significant. Any banking default by a major player⁶¹ might well lead to contagion across the whole European banking sector. Similar results would ensue from an uncontrolled sovereign default. Sovereigns and their banks remain weak. The continued provision of liquidity however prevents the dramatic price and wage falls that are the preferred method of rebalancing for the *ordo-liberal* school. The only other adjustment mechanism available under Maastricht arrangements was through the enforcement of the Stability and Growth Pact targets. Nevertheless, the ECB has consistently seen adherence to the Fiscal Compact as the only way to exit from its open-ended lender of last resort functions.⁶²

In this regard, although the Fiscal Compact formally reaffirms law as a key element to European integration, in practice political processes continue to dominate the austerity and reform agenda. Creditor Member States, the European Commission and the ECB seek to reform struggling Member States *outside the legal framework* of the EU Treaties. This new system of politics at the heart of the Eurozone represents a significant shift away from the rule of law and democracy that has dominated the single market

⁵⁹ CESifo Forum 2012. Accesible at <http://www.cesifo-group.de/portal/page/portal/ifoHome/b-publ/b2journal/30publforum/PUBLFORUM12>

⁶⁰ Sauter, W., 'The Economic Constitution of the European Union' (1998) 4 Colum. J Eur L 27 at 43-56. Herdegen, M., 'Price Stability and Budgetary Restraints in the Economic and Monetary Union: the Law as Guardian of Economic Wisdom' (1998) 35 CML Rev 19.

⁶¹ Note that Cypriot banks were not well-integrated into the financial system relying mainly upon Russian and domestic depositors for their funds with only small levels of senior debt held by banks.

⁶² Schuknecht, L., Moutot, S., Rother P., and J Stark, J., 'The Stability and Growth Pact: Crisis and Reform,' ECB, Occasional Paper Series, No.129, September 2011

hitherto.⁶³ The previous balancing of market opening against other values no longer applies to weaker states faced with severe budgetary problems; instead, structural reform, liberalization and austerity must emerge from negotiations with creditors. The ECB had limited faith in this process which remains largely political. The persistent failure of Greece to implement its Troika program, leading ultimately to default, alongside reluctant reforms in Italy and Spain, caused the ECB to maintain limits to its sovereign debt purchases. As noted above, it is not part of an integrated central bank and government.⁶⁴ It was therefore exposed to potential losses on its bonds that would have destroyed its limited capital-base with no guarantee of recapitalization.⁶⁵ Even the planned Fiscal Compact, with its greater 'automaticity' of sanctions, did not on its own convince the ECB to restore its bond purchases.⁶⁶

Only when forced by markets in summer 2012 did it announce a clear path for Eurozone members to receive unlimited bond market support. The pre-condition was compliance with Troika programmes and regaining access to bond markets. In this way the ECB strongly endorsed the austerity and structural reform model as the path to growth. It also meant the ECB no longer trusted Eurozone members to follow this path through exhortation alone. The Court of Justice also endorsed this model its judgment in the *Pringle* case where it expressly said that the purpose of Article 125 was to ensure that Eurozone members 'remain subject to the logic of the market.'⁶⁷ Action by the EU institutions (including the ECB) or Eurozone members through which incentives to conduct a 'sound budget policy' is diminished are illegal. The Court endorsed the ESM system only to the extent that it would impose conditions 'such as to prompt Member States to implement a sound budgetary policy.'⁶⁸ Thus, for the ECB and the CJEU, moral hazard avoidance is at the heart of the Maastricht settlement. Market discipline is the norm and conditionality is the panacea for exceptional deviations from this. It is this lack of trust that makes the ECB unique: for 'normal' central banks moral hazard must be ignored; they are servants of their state and must not let their Treasury default. They must hope that politicians will adopt the right steps to restore fiscal sustainability. The only possible limit on their lender of last resort function would be if it resulted in inflation in breach of their mandate.

Both the ordo-liberal and the ECB's fiscal disciplinary perspectives are at odds with broader mainstream economic opinion that argued that the failure to establish at the outset a clear lender of last resort within the Eurozone was a serious problem.⁶⁹ The ECB appeared to believe for a long time that

⁶³ Ruffert, M., 'The European Debt Crisis and European Union Law' (2011) 48 CMLRev 1777-1806

⁶⁴ Buiter (2009) above.

⁶⁵ Belke A, 'How much fiscal backing must the ECB have? The Euro Area is not the Philippines' (2010) German Institute for Economic Research, Discussion Paper 996, at <http://ideas.repec.org/p/diw/diwwpp/dp996.html>.

⁶⁶ Buiter, W. and Rahbari, E., 'Why Does the ECB not put its mouth where its money is? The ECB as lender of last resort for Euro area sovereigns and banks' 27 February 2012, Global Economics View, Citibank, Economics Department Working Papers, No.827.

⁶⁷ Case C-370/12 *Pringle v Government of Ireland*, judgment of 27 November 2012, para.135.

⁶⁸ Above, para.136.

⁶⁹ de Grauwe P and Ji Y, 'Mispricing of sovereign risk and multiple equilibria in the Eurozone' (2012) CEPS Working Document No.361.

markets were fully rational in pricing in risk of default and exit and only government austerity could change them. The whole purpose of a lender of last resort is however to alter market expectations. Ironically, the announcement of the OMT, even with all the conditions attached to it, was enough to radically change market sentiment and remove the pressure for austerity. The ECB has thereby lost, for the time being, the ability to ensure the very austerity and structural reforms that it apparently demanded by linking the OMT to Troika programmes. To this extent the risk of moral hazard, so long feared by the ECB, has already come about. The response of Keynesians is to argue that the whole logic of austerity was always misguided and that democratic politicians, not unelected officials, are legitimate to question this economic model. Recent economic evidence indeed suggests that the economic consensus at the heart of the Eurozone on the need for and benefits of short-term austerity is misguided.⁷⁰

Reliance on a lender of last resort could not substitute for the failure by the Eurozone to agree on a new democratic model of economic governance directed at restoring growth and sharing the burden of fiscal adjustment in return for necessary structural reforms. In this respect, the ECB's stance has been incoherent: it should either have committed from the outset to be an unconditional lender of last resort (forcing the politicians to agree on new mechanisms to eliminate moral hazard) or it should have declined to do so in the absence of such structures. Instead it sought to solve the moral hazard problem itself when it had neither the tools nor the legitimacy to do so.

Conclusions

The legal structure set up at Maastricht failed to insulate Eurozone members and taxpayers from fiscal transfers. Integrated capital markets, far from disciplining governments and private borrowers, proved to be the primary transmission mechanism. Capital markets found the single currency too credible and believed that devaluation and default risks were negligible. Cross-border lending took on excessive risk, fuelling bubbles and raising unit labour costs in the periphery. When credit markets froze in 2008, whilst the Treaty did not explicitly mandate it, the ECB expanded its remit to include maintaining financial stability by providing vast liquidity to banks. This prevented mass bank failures across all Eurozone members and allowed creditors to exit risky positions. This was however viewed by most commentators as a legitimate exercise in the classic lender of last resort function.

After 2010, however, the crisis became identified with weaker sovereign borrowers and their banks. Although it did buy some government bonds, the ECB declined to act openly as a lender of last resort to sovereigns, preferring to indirectly channel funds through banks. It argued that legal constraints bound it and instead pushed for both larger bail-out funds and a tougher legal regime over fiscal discipline. ECB officials remained convinced that austerity and structural reforms, not debt write-offs and growth, were

⁷⁰ Blanchard O and Leigh D, 'Growth forecast errors and fiscal multipliers', (2013) IMF, Working Paper 13/1 which confirms that budget cuts produce larger reductions in GDP than previously thought. Herndon T, Ash M, Pollin R, 'Does high public debt consistently stifle economic growth? A critique of Reinhart and Rogoff' (2013) PERI, University of Mass. Working Paper series No.322.

crucial for rebalancing. Austerity did not improve fiscal sustainability however and default and exit risks came to be seen as non-negligible, causing losses in market confidence that pushed up the required level of fiscal tightening.

Critics rightly argued that the ECB's drawing of a stark distinction between sovereign and private credit was flawed both legally and economically. For ordo-liberals, loose money for banks had merely delayed bank insolvencies, impeded wage adjustment in the periphery and indirectly exposed European taxpayers to increasing volumes of risky assets.⁷¹ On the other side, Keynesian critics said that the failure to cap sovereign debt yields for solvent Member States endorsed market contagion, worsened the crisis and necessitated levels of austerity that lacked political credibility. Faced with political limits on both bail-out funds and austerity, the ECB eventually relented and committed to unlimited sovereign bond purchases for countries *emerging from successful* Troika programmes. The effect on financial markets was extraordinary; *all* peripheral sovereigns were able to refinance at affordable rates. For all its efforts to avoid this, the ECB may have inadvertently recreated the moral hazard problem.

Despite being a constant point of reference throughout the Eurozone crisis, the so-called 'law' against funding sovereigns was in reality never precise enough to constitute a legal rule. Central banks, including the ECB, being political organs fundamental to the survival of nations (and currencies), must operate largely beyond the reach of law as conventionally understood. Indeed, the ECB has used the very uncertainty of its legal mandate as a flexible tool both to reassure its North European critics and to discipline struggling peripheral nations seeking its largesse. In the hands of the ECB, the 'law' means more or less what the Bank says it means, and it has used this power to try to mould the Eurozone in its preferred image. Thus, throughout the crisis, the ECB has always championed the existing Maastricht model and pressed for deeper legal commitments to austerity and structural reform. Its interventions were reluctant deviations from the discipline of the market. To the extent that bond markets were calmed, the ECB may have prevented an immediate exit by one or more Eurozone members but delayed the necessary longer-term political agreements on debts write-offs, common bond issuance, shared budgetary responsibility and bank resolution systems. Furthermore, moral hazard is a real danger with politicians in weaker countries. Without the development of broader pan-Eurozone democratic structures to commit to growth, burden-sharing and structural reform, the system will remain very unstable, with long-term austerity a fragile form of governance.

⁷¹ 'A bit more courage to let the market processes run their course would have saved the ECB the huge problems posed by the stock of dubious collateral it now has to live with.' (Sinn and Wollmershauser, 2011) 36.