Has Euro area monetary policy become redistribution by monetary means?

'Unconventional' monetary policy as a hidden transfer mechanism

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Abstract

This article takes an unconventional perspective on Eurosystem monetary policy by asking what kind of redistributive effects it might have had. Any monetary policy can have redistributive effects as it alters the environment in which economic agents, households and companies, operate. Some benefit and some stand to lose from decisions by the central bank. However, monetary policy generally does not aim at redistributive implications; indeed, in the Euro area context it does not have a mandate to do so. Against this background it is not irrelevant how the large number of Eurosystem monetary policy measures during crises should be assessed. The article claims that in particular the government bond purchase programmes by the Eurosystem and massive liquidity support to banks could have had redistributive elements even in a prominent role. The Eurosystem has become the final guarantor of the Member States in trouble and their banking sectors, even re-inforcing the link between the two. This focus has potentially pushed the Eurosystem to neglect its primary objective but also its broader implications for the Euro area economy and societies more generally.

Introduction

It is no secret that, since 2007, the European system of central banks (the Eurosystem) has taken a number of 'unconventional' monetary policy measures, including large-scale acquisition of sovereign bonds of Euro area countries in secondary markets. Less noticed, but equally relevant, is that the Eurosystem has at the same time made extensive 'unconventional' use of some parts of its standard operational framework. This is the case with the massive and long term refinancing operations of 2011 and 2012, through which one trillion euros were injected into the Euro area financial system.

In this article, I consider whether 'unconventional' monetary policy, as designed and implemented by the Eurosystem, has or has not pushed the Eurosystem to act *beyond* its powers and to go *beyond* what its mandate requires, and in the process *potentially* compromising its independence, vis-à-vis both Member States and financial institutions. In particular, I will consider whether some of these policies have resulted in *hidden* transfers, either to Member States or in favour of particular actors within the financial sector. In each and every occasion on which it acts, the Eurosystem produces *arguments* to justify the decisions involved. From a standpoint *internal* to the reasoning of the argument, these claims seem persuasive enough. However, the more the measures deviate from the well-designed and thoroughly analysed standard monetary policy 'template', in brief, the more 'unconventional' monetary policies become, the stronger the reasons to assess the measures from a perspective broader and more comprehensive than that used by the Eurosystem itself. For those and other related reasons, it seems pertinent and necessary to consider whether the arguments put forward by the Eurosystem are persuasive enough, or, on the contrary, whether good reasons exist to conclude that the Eurosystem has acted either *beyond its powers* (*ultra vires*) or *in a way contrary to what its independence requires*, or both. This in a nutshell is the very purpose of this article: to determine whether the line of reasoning of the ECB holds when tested against this set of comprehensive arguments.

The article is structured in three parts. In the first part I present a concise description of the history and policy tools of the Eurosystem , with a view to providing readers less familiar with European central banking with the background knowledge necessary to make sense of the subsequent parts of the argumentation. In the second part I reconstruct Eurosystem monetary policy since 2007 and evaluate its distributive consequences, and in particular the potential distributive effects of (1) the issuance of banknotes; (2) the provision of liquidity to financial institutions; (3) the payment system of the Euro area, the so-called 'TARGET2'; (4) the provision of emergency liquidity assistance to financial institutions (and in actual practice, to national financial systems); and (5) the acquisition of sovereign bonds. The third part holds the conclusions, where I consider what the distributive implications of Eurosystem policy tell us about *what kind* of central bank the European Central Bank actually is, and what kind of *community of debt* the Euro area has come to be through the decisions and reforms taken in the name of containing and overcoming the crises.

I. The Eurosystem

A) Composite, quasi-federal structure

The Eurosystem[1] is the Euro area central banking system. Despite the fact that most public discussion and indeed a good deal of legal scholarship assumes that the European Central Bank, with headquarters in Frankfurt, effectively runs European monetary policy, the fact of the matter is that the ECB is but the tip of a quasi-federal central banking system, of which national central banks are also fundamental parts.

Not only is the composite character of the Eurosystem closely related the composite character of the European Union as a whole, but also the quasi-federal design of the Eurosystem results from a fundamental decision at the core of the constitutional design of the Eurozone, namely the strict separation of national responsibilities for public debt (the 'wall of separation' between national exchequers, as codified in Article 125 TFEU). As a result, NCBs have retained separate, independent legal personality and autonomous operative capacities regarding most if not all monetary policy operations (for example, the actual buying of sovereign debt in secondary markets has mostly been undertaken by national central banks in actual operative terms). Indeed, the assets and liabilities of NCBs remain strictly separated.

Precisely because the distinction between the Eurosystem, the ECB and NCBs is fundamental, in this article I use Eurosystem, and not ECB, when I intend to refer to the whole structure, and not only to its 'central' component.

B) Key roles of the Eurosystem

The Eurosystem is in charge of defining and implementing monetary policy in the Euro area (Art. 127 TFEU). The ECB is granted the exclusive competence to issue legal tender. This equips the ECB with (potentially) unlimited monetary resources that are the basic condition of the effectiveness of monetary policy.[2] The actual monetary policy instruments form an interlinked combination.

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[1] The Eurosystem consists of the ECB and national central banks of the Euro area countries. It is the preferred term for Euro area monetary policy function. It has the same decision-making body as the ECB, in the shape of the Governing Council. This can create some confusion, as decisions of the Eurosystem are formally decisions by the ECB. In this article, the Eurosystem is used unless the issue relates only to the ECB and not the whole central banking function of the Euro area.

[2] Modern central bank money is a central bank liability towards its holders which is generally not backed up or redeemable by gold or foreign currency reserves. It is simply backed up by a promise. In many modern polities, including the Euro area, this promise boils down to the central bank keeping the purchasing power of money relatively stable. This is not incompatible with the fact that the value of money is generally determined in terms

Firstly, The Eurosystem imposes on banks an obligation to hold minimum reserves at NCBs. This creates a demand for central bank financing. Secondly, the demand for short-term funding by banks is fulfilled by means of refinancing operations. Every week, the Eurosystem holds an auction in which it provides short-term money to banks. This is then linked to the third element of the monetary policy framework: official interest rates. The money that is provided to banks is basically charged the official interest rate, the interest rate on main refinancing operations. In normal times, the actual interest rate is defined by banks' bids at auction, called the variable rate auction. When the market mechanism cannot be trusted, the interest rate is fixed. In addition to short-term policy refinancing operations, the Eurosystem has also typically conducted longer term refinancing operations, mainly for three months. Through this operational framework the Eurosystem has been able to influence the interest rate prevailing in the interbank money market and overall liquidity in the financial markets, while still respecting the principle, enshrined in Article 127 TFEU in line with Article 120 TFEU, to operate in full compliance with the principle of an open market economy with free competition. In that regard, a couple of elements are critical: the Eurosystem should affect the pricing of various market segments with extreme caution; and its own operations should rely on market pricing as much as possible. Furthermore, the criteria set for accepting collateral (the guarantees the banks put forward when obtaining refinancing) are of the essence. All Eurosystem lending to banks should be protected by sufficient collateral. Operationally, refinancing takes place through the NCBs, but the conditions including collateral requirements are uniform. Until 2007 some country variation in collateral requirements was possible as a transitional system, but that was ended at the same time as the new payments system, the TARGET2 system, was launched.

The Eurosystem or its constituent NCBs were assumed to act as a lender of last resort for banks. However, this was not formally acknowledged until the Eurosystem published some general guidelines for provision of Emergency Liquidity Assistance (ELA). This was to be implemented by NCBs (under the control of the ECB but at national risk).[3] The purpose, rather obviously, was indeed to

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relative to the purchasing power of other currencies (in their turn also anchored to the credibility of the policies of their central banks).

[3] The Eurosystem procedure for granting emergency liquidity assistance (ELA) has been specified by the ECB Governing Council. The main guidelines were claimed to have been in place since 1999 and more recently the ECB has published an undated note to underline the applicable procedure. The decision on ELA is a national one, but according to Art 14.4 Statute the ECB has the responsibility to restrict an ELA operation if it interferes with the objectives and tasks of the Eurosystem. Decisions are taken by a majority of two-thirds of the Governing Council votes. For this, the ECB needs to be informed of ELA operations within two days after the operation is carried out. The information includes all the relevant details on, e.g., counterparties, amounts, collateral, and interest rates. However, prior approval is required if ELA exceeds a pre-set threshold.

establish a means of assisting banks which, even if prima facie not insolvent, lacked eligible collateral at their disposal, and as a result, could not obtain liquidity through standard refinancing operations.[4]

It is common knowledge that the Treaties guarantee the independence of the Eurosystem in the pursuit of its tasks. Such independence[5] is aimed at ensuring that the Eurosystem serves the collective interest of the Euro area and cannot be influenced by partisan political aims or financial interests that could stand to benefit from Eurosystem decisions. At the same time, it is important to notice that independence is premised on central bankers acting on the basis of its best expert knowledge in defining and conducting monetary policy and its objectives. Among other things, this requires that the Eurosystem acts within and in line with the mandate given by the Treaties, being very careful not to overstep its mandate, for example by taking decisions that have relevant effects on issues other than monetary policy. In other words, the Eurosystem has to act in ways coherent with a limited legitimacy basis, and in particular, keeping constantly in mind that the grant of power to design and implement monetary policy to an independent central bank is an exception to the general rule of democratic legitimation of power that consequently has to be constructed narrowly.[6]

II. Unconventional monetary policy and unconventional uses of standard monetary policy instruments

A central bank (a central banking system in the case of the Euro area) is not isolated from the rest of the economy or society at large. If this social interconnection is clear in *ordinary times*, it becomes impossible to miss in extraordinary times, and even more so during emergencies. In particular, the ability to issue unlimited amounts of money equips the central bank with tools to solve potential liquidity problems in the economy. These powers have been frequently used in the past, with central banks stepping in as lenders of last resort for both states and banks. It has been a core feature of

[4] See www.ecb.europa.eu/mopo/ela/html/index.en.html.

[5] Many regard the ECB as having been modelled on the German Bundesbank. See for example, K. Dyson, 'Economic policy management: catastrophic equilibrium, tipping points and crisis interventions', in S. Green, W.E. Paterson (eds.), *Governance in Contemporary Germany: The Semisovereign State Revisited* (Cambridge University Press, 2005), 115-137; J. De Haan (ed.), *The History of the Bundesbank: Lessons for the European Central Bank* (Routledge, 1997); A.S. Posen, 'Lessons from the Bundesbank on the Occasion of Its 40th (and Second to Last?) Birthday', (1997) *Institute for International Economics Working Papers 97-4*, available at http://tinyurl.com/guf2kkg.

[6] A point made in exemplary fashion by the German Constitutional Court. See BVerfGE 89, 155.

modern central banks to act as lenders of last resort for (solvent) private banks. [7]At the same time, central banks have often been forced to act as the ultimate funder of the government, with occasional adverse impact on price stability. [8]

There is no doubt that times have been far from ordinary in the Euro area since 2007. In such a context, the Eurosystem has made ample use of its powers as part of the effort to contain and overcome the crises. This has resulted in massive operations of refinancing Euro area banks and the acquisition of large amounts of public (and to some extent corporate) debt from financial markets.

Eurosystem reactions to the crises could be seen as a continuum, where individual measures could be analysed in relation to the unfolding of the crises but also in relation to earlier measures. Having said that, an element of sobriety in the assessment is required by the fact that all Eurosystem actions were taken in situations that evolved most rapidly. In the following the measures are analysed in broadly chronological order. The economic and constitutional perspectives are complemented by analysis of the distributional consequences of the measures, so as to determine whether hidden transfers were involved.

A) Transferring money through demand-driven issuance of banknotes?

The first policy tool to be analysed is the power to issue legal tender. As a central bank, the Eurosystem has the exclusive right to issue legal tender in the Euro area. The Governing Council of the ECB authorises the issuance of banknotes, which are then distributed by NCBs.[9] The issuance of

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[7] This is sometimes referred to as the Bagehot rule, stating that a central bank should lend to solvent banks unlimited amounts of liquidity at penalty interest rates and against full collateral.

[8] When a central bank finances a government by buying the sovereign bonds issued by it, private sector holdings of longer-term government bonds are replaced with short-term public liabilities, central bank money. Similarly, when a central bank buys private sector assets by issuing central bank money, private sector assets holdings change from private to public ones. Holdings of private assets are replaced by central bank money. Following the German tradition, this role of financier of the government was excluded from the ECB and the NCBs in the Maastricht Treaty.

[9] On the basis of Article 128(1) TFEU and Art. 16 of the Statute of the ECB, the Governing Council of the ECB authorises the issuance of banknotes, which are distributed by national central banks. See Decision of the European Central Bank on the denominations, specifications, reproduction, exchange and withdrawal of euro banknotes (ECB/2003/4), OJ L 78, 20.3.2003, 37-42.

banknotes and of money in electronic form generates both seigniorage and income (as the money issued can be invested).[10]

The crux of the matter is how seigniorage income is distributed among Euro area states. Could a hidden redistribution of resources have occurred through an asymmetric 'appropriation' of monetary income?

Demand for banknotes during the crises has been anything but stable. Some correlation has existed between a given country experiencing serious fiscal difficulties and an increase in the demand for cash in that country. This was clearly the case in Greece. At the (many) times at which Greece's fate as a Euro area member was in doubt, cash hoarding became widespread. This demand for banknotes was duly met by the Eurosystem by means of authorising the distribution of large amounts of cash by the Greek Central Bank. [11] Did this imply a *hidden transfer* to Greece?

The answer is negative, and for two reasons. Firstly, it should be noted that the amount of notes distributed by each NCB always accommodates the actual demand for banknotes, which varies from country to country, depending on cultural patterns affecting the preference for cash or the use of credit cards. [12]Secondly, and decisively, the issuance of banknotes is part of the common monetary policy function similar to refinancing operations. Although the actual operations are executed by the NCBs, it is a common function where *monetary income* is pooled and then allocated to the NCBs (and thus, at the end of the day, to Member States) on the basis of their share in ECB capital.[13] NCBs that have issued fewer banknotes are compensated by calculating a risk-free return on banknotes issued.[14]

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[10] The total stock of issued banknotes in circulation exceeds 1.1 trillion euro. The ECB publishes figures monthly in ECB Euro banknotes and coins statistics. See http://sdw.ecb.europa.eu/reports.do?node=1000004112.

[11] For example, in Greece, banknotes in circulation amounted to less than 7 bln euros when it joined the EMU in 2001. That increased steadily to reach 14 bln just before the crisis in 2008, reflecting economic activity but also low inflation, which reduced the cost of holding cash. Since the outbreak of the crisis, the amount has doubled again to 28 bln euros.See www.bankofgreece.gr/Pages/en/Statistics/monetary/monetary.aspx. The increase has been surprisingly steady with monthly increases above 1 bln only in Oct 2008, Jan 2009, Dec 2014 and Jul 2015.

[12] In some states, the public use primarily debit and credit cards for payments with less need for banknotes.

[13] That is based on the population and GDP (in technical terms, in accordance with the paid-up capital of the ECB subscribed by each Member State; this amount is directly proportional to population and GDP, ex Articles 32 and 29 of the ECB statute). Decision of the European Central Bank on the allocation of monetary income of the national central banks of Member States whose currency is the euro (ECB/2010/23), OJ L 35, 25.11.2010, 17-25.

[14] Formally the difference in liability base and earmarked asset times the reference rate. Art 3 of Decision of the European Central Bank on the allocation of monetary income of the national central banks of Member States whose currency is the euro. Cf. https://www.ecb.europa.eu/ecb/legal/1001/1013/html/index.en.html.

This entails that the issuance of notes has not led to discretionary transfers of liabilities between the Member States.[15] For example, in June 2011, the Bank of Greece had issued 36.6 bln euros of banknotes, although its allocated share of issuance was 21.9 bln euros. Consequently, it had to compensate for the yield of the 14.8 bln euros for the central banks that were issuing less than their share. Germany has been by far the largest issuer of banknotes and therefore the Bundesbank has been forced to make the largest compensation.[16]

Additionally, it must be said that the concern that the ECB would start to print money at will does not, in a literal, physical sense constitute a realistic fear.[17]

B) Targeted Redistribution through TARGET2?

a) TARGET2 polemics

Any modern monetary union requires financial infrastructures through which payments across the whole monetary area can be settled, enabling people not only to have the same currency in their pockets (or in their credit cards) but also to actually make use of it to buy goods or services across borders, or to engage in economic activities across the monetary area as a whole.

A European payments system (known as 'TARGET') was introduced in 1999. This system linked the national payment systems of the Euro area countries.[18] A new and more integrated system, TARGET2, was phased in by steps in 2007 and 2008. The decision to move to TARGET2 was hardly controversial at the time. However, TARGET2 did become a source of much controversy once the financial and fiscal crises hit Europe. At that point, TARGET 2 came to be regarded by some authors as a conduit for

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[15] The earmarked assets related to the note issuance liability could give rise to some implicit transfers, but generally the discretion on these investments is limited.

[16] See for example, J. Whittaker, 'Eurosystem debts, Greece, and the role of banknotes', (2011) *MPRA Paper No. 38406*, available at http://tinyurl.com/hgyqxde, p. 2.

[17] An increase in the circulation of banknotes in one country may signal an expectation that the country could be leaving the Euro area, triggering a hoarding of euro banknotes as 'hard currency' with which to avoid the foreseeable loss of value of the 'reborn' national currency). This may well have consequences (and serious one) if the Euro area should eventually break up, but that is a separate (if highly relevant) issue.

[18] TARGET was intended to facilitate safe transfer of large payments, particularly monetary policy related payments.

hidden transfers between Euro area states. Unsurprisingly, debate was especially intense in Germany, on account of the Bundesbank holding by far the largest positive balance in TARGET 2.[19]

In a nutshell, the claim is as follows. The interbank market came to a grinding halt in September 2008. Banks with excess liquidity deposited large amounts of money with NCBs instead of lending it in the interbank market for a higher interest rate, which was regarded as too high a risk to run in the aftermath of the sudden collapse of Lehman Brothers. As will be discussed at some length in Section 3, the Eurosystem stepped in by providing the liquidity that banks claimed to require. As a result, large private sector capital balances (reflected in the interbank money market) were replaced by intra Eurosystem balances (reflected in TARGET2). The moment at which the crisis moved from financial to fiscal, the argument was made that TARGET2 imbalances reflected a redistribution of resources from 'core' to 'periphery', which would become tangible the moment the Euro area broke up. 'Prudent' states were bound to end up bearing the costs of the 'profligacy' of 'reckless' states via TARGET2 (See Graph 1).

Even if less headline grabbing, two further issues have been raised. The first is that liquidity provision by the Eurosystem has been so massive and unqualified that it has contributed to hiding actual solvency problems. The second is that the abundant availability of central bank financing has contributed to the replacing of private credit with public credit and paradoxically contributed to the persistent dysfunctionality of the Euro area interbank markets.[20]

b) Assessment

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[19] H.-W. Sinn and T. Wollmershaeuser, 'Target Loans, Current Account Balances and Capital Flows: The ECB's Rescue Facility', *NBER Working Paper* No. 17626, 2011, available at http://tinyurl.com/jc6twmv; now (2012) 19 *International Tax and Public Finance*, 468-508; H. –W. Sinn, 'Fed versus ECB: How Target debts can be repaid', *VoxEU.org*, March 2012, available at http://tinyurl.com/zoeltuf.

[20] An important issue concerning the TARGET2 related to the currency redenomination risk. Some evidence showed that banks, particularly, outside the Euro area, became worried about the possibility of the Euro area break-up. As a risk protection, they reduced their asset and liability mismatches in individual Euro area countries. This mismatch was corrected by selling assets (local government bonds) in troubled countries and increasing local liabilities including loans from the local NCB. To the extent that this effect was substantial, it was temporary by nature and should have halted and reversed as the risk of Euro area break-up diminished. S.G. Cecchetti, R.N. McCauley and P. McGuire, 'Interpreting TARGET2 balances' (2012) *BIS Working Papers No 393*, available at http://tinyurl.com/be4oke4, 9-10.

The truth of the matter is complex, but it seems to me that it should be kept in mind that liquidity provision is a typical central bank function which could not but be expected, in times of crisis, to be discharged in such a way as to counterbalance extreme conditions in interbank markets.
Having stated that, much then depends on the analysis that is regarded as most accurate of the *causes* of TARGET2 imbalances. The dominant view is that TARGET2 balances mostly reflect changes in capital accounts. When private capital flows were reversed, official flows needed to counterbalance that effect. No automatic link exists between current account deficits and negative TARGET2 balances, nor do they automatically reduce central bank lending to banks in surplus Member States. Critically, large surpluses should not be seen as a risk exposure for NCBs, but rather an intra Eurosystem payments feature that if it is visible is because of the structure of Target 2, in particular the existence of separate NCB accounts.[21] To put it differently: if the Eurosystem had only one balance sheet, no imbalances would exist.

The critical view is that TARGET2 imbalances were mostly a reflection of deeper real economy imbalances within EMU and even caused by it. Since EMU was launched in 1999, massive trade imbalances cumulated between core and peripheral countries, mainly driven by large and increasing current account deficits in peripheral countries. These deficits came (to a considerable extent) hand in hand with flows of credit moving in the opposite direction to goods and services. This credit took the form of interbank lending and also purchases of government bonds of the peripheral countries. During the crisis the earlier private sector lending from the core (Germany) was replaced by capital exports through the Eurosystem that showed up in TARGET2 balances.[22] From this perspective, the Eurosystem is a transfer mechanism that forces NCBs in *surplus* countries to lend to *deficit* countries.[23] And even worse, it is claimed that Eurosystem monetary policy has been captured by the need to maintain this capital transfer system.[24]

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[21] See, Cecchetti, McCauley and McGuire, above, n. 20; W.H. Buiter, E. Rahbari and J. Michels, 'The implications of intra-euro area imbalances in credit flows', (2011) *Centre for Economic Policy Research, Policy Insight No. 57*, available at http://tinyurl.com/jydwsh9.

[22] In addition to the current account explanation, the proponents of this approach also acknowledge the substantial impact of capital flight in some cases such as Ireland and Italy. See for example Sinn and Wollmershaeuser, above, n. 19.

[23] C. Fahrholz and A. Freytag, 'Will TARGET2-Balances be Reduced again after an End of the Crisis?', (2012) *Working Papers on Global Financial Markets.* No. 30, http://tinyurl.com/gtzyr2q, 17-18.

[24] The TARGET2 system could be used to eliminate differences in government bond yields, A country that is running persistent current account deficits could afford to have a negative TARGET2 balance up to the limit of the collateral of its financial institutions that would be accepted by the ECB. As the list of collateral had been

Graph 1

The institutional and even constitutional issues related to TARGET2 are complicated by the large number of economic assumptions involved. However, the correct focus of constitutional assessment of these questions is the underlying monetary policy framework and instruments. It is important not to lose from sight that TARGET2 cannot but be seen (and assessed) as the payment system supporting monetary policy. A good many of the institutional and constitutional concerns are thus reflected on TARGET2, but the ultimate cause is to be sought in actual monetary policies and their effects.

c) Interim Conclusion

It is safe to say that the initial claim that a full positive balance of the Bundesbank would constitute a risk for Germany was an overstatement. All monetary losses to NCBs resulting from monetary policy operations would generate a liability on the side of the ECB. Hence, any Bundesbank claim on the ECB, would be covered by the ECB, if needed through capital calls on its owners.[25] As long as the Euro area 'survives', any losses stemming from the common monetary policy would be covered by all the Member States, if needed, not only by the state registering a positive balance in TARGET2.

The situation could be different if the Euro area broke up. Much would depend on the concrete form and timing of the breakup. However, a large part of the collateral held by the Eurosystem (covering its lending to banks and mostly to banks established in countries experiencing fiscal crises or major difficulties) consists of government bonds of the very countries experiencing fiscal crises or major difficulties. If the breakup of the Euro area were caused by those countries defaulting on their debt, or caused them to do so, then substantial losses for countries with positive TARGETt2 balances would be unavoidable. Furthermore, it would be likely that capital would flee from the troubled countries for some time, thereby increasing the cost for countries with large and increasing TARGET2 claims on the ECB.

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extensively enlarged, the troubled country would be completely excluded from private capital markets before the limits were reached, as was the case with Greece.

[25] See for example, C. Jobst, M. Handig and R. Holzfeind, 'Understanding TARGET2: The Eurosystem's Euro Payment System from an Economic and Balance Sheet Perspective', (2012) *OeNB Monetary Policy and the Economy*, http://tinyurl.com/hlph2ar, pp. 81–91, and also J. Ulbrich and A. Lipponer, 'Balances in the TARGET2 payments system – A problem?', (2012) *CESifo Forum*, available at http://www.cesifo-group.de/portal/pls/portal/docs/1/1213644.PDF, 73–76.

It could be concluded that TARGET2 balances as such do not constitute a transfer mechanism so long as the Euro area does not break up. TARGET2 balances should not to be taken to reflect intra-state debt or risk exposures. These imbalances merely render painfully visible some even structural economic trends such as permanent current account deficits. But the *real* problem lies not with TARGET2, but with the actual developments registered by Target 2. Indeed, the underlying causes of TARGET2 balances are the ones triggering the imbalances.[26]

It follows that, were the Euro area to break up, the conclusions just stated would have to be drastically revised. It is not an unlikely scenario that some or even quite a few Member States would default on their debt during the process of 'unmaking' the Euro area. Consequently, state liabilities towards a redundant Eurosystem could be defaulted on as well. In such an eventuality, any claim on the Eurosystem could have relatively low value. This would have self-evident implications in terms of distribution of liabilities.

C) 'Unconventional' refinancing: Cui prodest?

a) The different shapes of 'unconventional' refinancing of financial institutions

As already pointed out, a key instrument for implementing common monetary policy is the refinancing of financial institutions. By means of lending to banks, the Eurosystem can impose its official interest rate as the base interest rate on financial markets, as well as steer liquidity in the banking sector.

The volume and nature of refinancing operations has been everything but ordinary since the beginning of the crises. In particular, three different phases in the transformation of refinancing operations from instruments of standard to unconventional monetary policy can be distinguished: aa) moderate injections of liquidity (2007-8); bb) unconventional injections of liquidity (2008-2011); cc) massive injections of liquidity (2011 onwards). All three phases are individually addressed below.

The different forms of 'unconventional' refinancing operations elicit different sets of constitutional questions, and in particular three of specific importance. First, whether the scale and nature of refinancing operations has resulted in capital allocation in the Euro area being determined by the Eurosystem itself, not proceeding through competitive markets as required by the Treaties. Second, whether the Eurosystem has subsidised the operations of some financial institutions. Third, whether

[26] This is also vocally stated as this 'highlights a huge lack of transparency that exists as regards the terms and conditions of portfolio investment and lending decisions of the ECB' in Buiter, Rahbari and Michels, above, n. 21, p. 13.

the design of unconventional refinancing operations was not intended to, or could not but result in, an indirect means of financing (some) Euro area states.[27]

aa) Moderate injections of liquidity (2007-2008)

The first indications of the upcoming financial crisis manifested themselves in the course of 2007, when some banks and particularly some business models in the banking sector started to show clear signs of vulnerability. Both the US sub-prime markets and the widespread 'banking model' on borrowing short and lending long (i.e. short-term funding through interbank markets) proved to be unsustainable in the long run. As a result, the Euro area interbank markets started to experience difficulties. The very foundation of the interbank money market, namely trust in the capacity of other banks to repay their loans, was undermined.[28]

The Eurosystem responded with a series of measures to counter these developments by increasing liquidity, so as to ensure that solvent but temporarily illiquid banks could retain access to market funding. The first concrete decision, which can be regarded as constituting the symbolic start of crisis government, was taken in August 2007. That day the Eurosystem offered Euro area financial institutions unlimited overnight credit at a fixed rate.[29] This was a highly exceptional measure, on account of the unlimited credit provided, and its very provision at a fixed rate, not at a rate resulting from competitive bidding among banks. Still, it was a very short-term measure (overnight financing), intended not so much as a ground-breaker for unconventional policy, but rather as symbolic, signalling the extent to which the Eurosystem was ready to go, with the hope that such signalling by itself would contribute to calm down worries.[30]

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[27] I will not focus on purchases of covered bonds and other private bank securities. Even if they could be regarded as part of the refinancing of financial institutions, it seems to me that purchases of banking securities, even if part of the measures undertaken to contain and overcome the crises, is a rather orthodox decision, which is less risky than actual lending to banks, as the Eurosystem can choose the securities it wished to buy and is compensated for the risk in the form of an even substantial interest rate spread vis-à-vis government bonds.

[28] What complicates analysis of the initial response to the financial crisis is that the transition to the first single collateral framework and later TARGET2-securities system took place in parallel. On 8 March the GC of the ECB decided that it was feasible to go ahead with TARGET2-Securities, and a list of measures were taken which also affected collateral policy. The TARGET2-securities project was officially launched on 17 July 2008.

[29] See for example, ECB Introductory statement with Q&A with Jean-Claude Trichet, President of the ECB, (6 September 2007), Frankfurt am Main, (available at www.ecb.europa.eu/press/pressconf/2007/html/is070906.en.html).

[30] Banks used the possibility by taking as much as 95 bln euros of extra overnight liquidity, perhaps a sign of more worries to come. See ECB Monthly Bulletin (October 2010), available at http://tinyurl.com/jxu8l9x, 63-65.

Indeed, this highly unconventional start was followed by months of markedly restrained Eurosystem policy. The Eurosystem limited itself to increasing the liquidity it injected in regular and longer-term (three-month) auctions.[31]

This policy assumed that some additional liquidity was needed to assuage doubts about the solvency of the Euro area financial system. Still the Eurosystem could be said to have been rather phlegmatic in its approach. It was assumed that the difficulties amounted to doubts caused by imported fears, resulting from developments in the US, and unrelated in fundamental terms to the performance of Euro area banks and financial markets.[32] Uneasiness on the side of financial institutions was to be welcomed, as long as it resulted in a healthy reassessment of risks.

It should be added that not only were the actions of the Eurosystem only moderately 'unconventional', but all refinancing operations were still competitive, as the interest rate was defined by competitive bids from banks.[33]However, the Eurosystem did state that the auction rate would be close to the refinancing rate.[34] It can thus be concluded that the design of the first unconventional refinancing operations was still shaped by the aim of maintaining the 'market conformity' of operations (in line with Article 127 TFEU).[35]

As a consequence, Eurosystem influence on the market mechanism increased but remained under check. The Eurosystem assumed more risks, but this was regarded as necessary to ensure liquidity did not dry up due to dynamics external to the European economy and financial sector. Moreover, these additional risks were kept in check. Decisions were premised on the basis that the assumption of new risks allowed the continued operation of the interbank market, thus preventing systemic risks for the

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[31] On 27 August a supplementary 3-month LTRO of 40 bln euros; on 6 September a supplementary (again 3-month) LTRO with no pre-set amount (75 bln euros), but with variable rate. On 8 November two new supplementary LTROs as variable rate tenders, each with a pre-set amount of 60 bln euros that were renewed with somewhat different amounts and lengths on 7 February, 28 March and 31 July 2008.

[32] One of the key events was the disclosure by Bear Stearns, a major US investment bank, of major losses of value by two hedge funds investing in so called sub-prime loans. These events started the more familiar story of surprise losses by investment bank-led hedge funds related primarily to the US real estate markets. These losses subsequently led to a realisation that many risks were heavily underestimated and hence undercapitalised. As a consequence, banks' ability to trust one another was questioned and led to malfunction of the interbank market, a major source of funding for the banking sector.

[33] With the exception of the 9 August overnight operation mentioned earlier.

[34] ECB Monthly Bulletin, October 2010, above, n. 30, 64-65.

[35] The only truly ad hoc measure was acting as agent for the US Fed by using Eurosystem collateral and hence with Eurosystem risk.

whole sector. Most significantly, the ECB explicitly remained aloof from emerging discussions over measures explicitly aimed at shoring up the solvency of banks (something which could not but involve state aid in one way or the other).[36] This helped the ECB to remain in a position where it could claim that it retained its institutional independence, for the simple reason that 'unconventional' liquidity support was not mixed up with indirect solvency support or, even worse, indirect public financing.

B) Unorthodoxy unleashed (2008-2011)

The financial crisis deepened in September 2008 with the collapse of Lehman Brothers. It was a shock to the confidence of market actors (and consequently to the overall levels of trust in capital markets) that a bank of Lehman's size was allowed to fall rather than being rescued by public authorities.[37] Hence banks' ability to trust one another was eroded to an extent unforeseen in the short history of modern banking. If Lehman, a bank regarded as too large to fail, had *actually failed*, then *any other bank* could fail as well. The realisation of this fact led to the interbank market freezing, and in general, financial markets coming close to a systemic meltdown. Many banks found themselves in an extremely difficult situation, because they had adopted a business model that made them highly dependent on short-term refinancing in financial markets. Consequently, the drying up of interbank funding would have led to large-scale reductions and withdrawals of lending, fire-sale of assets and other panic actions that could transform a liquidity crisis into a solvency crisis and hence an economic crisis. Europe was very badly hit. Many European banks had in their balance sheets significant amounts of assets that had played a major role in the collapse of Lehman, and the banking sector was bery important for the Euro area financial markets and hence also for the European economy.

Along with other central banks, the Eurosystem was forced to react quickly and forcefully to avoid the European economy rapidly entering a downward spiral. Firstly, the Eurosystem relaxed its collateral

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[36] In the case of a German bank failing over US subprime liabilities, Trichet stated in a press briefing on 2 August 2007, available at https://www.ecb.europa.eu/press/pressconf/2007/html/is070802.en.html: 'I will not add anything to what has been said by the German entities concerned themselves, by the authorities and by Axel Weber', making it very clear that the ECB had nothing to do with a bank failure in a euro area country.' And even more explicitly on responsibility concerning Fortis Bank at a press conference on 2 October 2008, available at https://www.ecb.europa.eu/press/pressconf/2008/html/is081002.en.html: 'And in a period when it appears that the situation calls for government responsibility, I confirm that we judge it appropriate that governments take up their responsibilities. I think they did well in the case you mentioned, they did well in other cases, including in this country: I confirm that I think the government did well in Germany.'

[37] This surprise was probably made bigger by the fact that Bear Stearns had been rescued only six months earlier through a sale to JPMorgan Chase that was facilitated by financial assistance from the NY Federal Reserve.

policy.[38] The list of assets accepted as collateral was expanded dramatically, lowering the quality of eligible collateral in Eurosystem credit operations.[39] This enabled an increase in refinancing through the normal operational framework, but also considerably increased the riskiness of Eurosystem monetary policy. From 2008 onwards, only roughly one tenth of collateral in the Eurosystem comprised safe government bonds, while asset-backed securities and non-marketable assets increased to 40% in 2008.[40]

Secondly, the refinancing of banks was made more automatic, less market driven; at the same time, the maturity of lending operations was increased. The main refinancing tenders were conducted at fixed rates and providing the full amount bank bid for. The exception became the rule. [41] Banks were effectively guaranteed all the credit they needed.[42] Furthermore, dollar liquidity[43] was provided by means of using Eurosystem collateral and hence at the credit risk of the Eurosystem.[44]

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Graph 2

[38] Paradoxically, the ECB had even introduced some changes to make the collateral policy slightly stricter to take into account the increased risks in the banking markets.

[39] The decision was quickly made in the form of Regulation (EC) No 1053/2008 of the European Central Bank on temporary changes to the rules relating to eligibility of collateral (ECB/2008/11), OJ L 282, 25.10.2008, 17-18, because it amended, albeit temporarily, the Guideline of the European Central Bank on monetary policy instruments and procedures of the Eurosystem (ECB/2000/7), OJ L 310, 11.12.2000,1-82. It needed to be directly applicable throughout the Eurosystem and hence the Guideline of the European Central Bank on temporary changes to the rules relating to eligibility of collateral (ECB/2008/18), OJ L 314, 25.11.2008, 14-15 was adopted.

[40] See ECB Monthly Bulletin, (October 2010), above, n.30, 69.

[41] For example, on 7 May 2009 the ECB announced for the first time a schedule of one-year auctions with fixed rate and full allotment, so a considerable lengthening of maturity.

[42] This was emphasised by a covered bond programme through which the ECB would buy bank-issued securities in both the primary and the secondary markets. Officially the decision was made on 2 July 2009, see Decision of the European Central Bank on the implementation of the covered bond purchase programme (ECB/2009/16), OJ L 175, 4.7.2009, 18-19. The aim of the programme was to support a 'specific financial market segment that is important for the funding of banks and that had been particularly affected by the financial crisis.' In more concrete terms, the programme was set up to facilitate some countries' financial markets, where bank funding was effectively based on covered bonds rather than short-term interbank financing.

[43] The first in the series of decisions was taken on 26 September 2008 and was a coordinated measure with other central banks.

[44] On 13 October, these weekly dollar auctions were conducted on a fixed rate full allotment basis.

It is important to underline that during this second stage of the crisis, the general perception was that the financial crisis was hitting all Euro area states rather symmetrically. The decisions, when criticised, were not so treated on account of their constituting *hidden* transfers between states; but rather because they were benefiting the banks disproportionately; indeed, because they were at odds with market allocation of capital.

The market situation appeared to calm down towards the end of 2009 and early 2010. Hence, on March 4th 2010 the Eurosystem decided to accelerate the phasing-out of its non-standard operational measures with the announcement of a likely ending to conducting its main refinancing operations at fixed rates with full allotment in the latter half of 2010. In April 2010, the Eurosystem decided to return to variable rate tenders in regular longer-term refinancing operations. There were also hints of a speedy return to the *standard*, more demanding rules concerning collateral. However, somewhat illogically, government debt instruments were excluded from these more demanding rules for collateral, and the Eurosystem was criticised for bending the system to include Greek government bonds.

C) Unorthodoxy unbound (2011-?)

The Greek fiscal crisis put an end to any expectations of a quick return to 'normality' in the Euro area. What started as a Greek issue became in a matter of months a massive fiscal crisis affecting the Euro area as a whole with severe repercussions also for the common monetary policy. The Eurosystem went into full 'unconventional' mode, particularly in terms of refinancing policy.

Firstly, the Eurosystem made a radical decision on its collateral policy. Notably, convoluted negotiations led to a complicated 'bilateral' but coordinated scheme through which the Member States of the Euro area, together with the IMF, provided financial assistance to Greece in April 2010.[45] In parallel to this decision, the Eurosystem changed its collateral policy regarding bonds issued by the Greek government. No minimum credit rating threshold would apply. The Eurosystem argued that, after assessing the 'programme' against which provision of financial assistance was conditioned, the conclusion was that the existence of the agreement rendered the Greek bonds adequate collateral. The ECB as part of the troika, so the argument went, had assessed the Greek adjustment programme and also considered it appropriate from a risk management perspective. In other words, the ECB's position in the negotiations leading to the programme of financial assistance gave it sufficient information and confidence in Greek government finances: 'We had to be consistent with this judgement as regards the

[45] See for example K. Tuori and K. Tuori, *The Eurozone Crisis – A Constitutional Analysis* (Cambridge University Press, 2014).

eligibility of the Greek government bonds.'[46] The decision applied not only to all outstanding sovereign bonds, but also to all new debt instruments issued by the Greek government.[47] The same policy was followed when Ireland[48] and Portugal became recipients of financial assistance from the Euro area.[49]

Secondly, the length of refinancing operations was radically increased, making them rather intrusive from the perspective of allocation of capital by markets. This is perhaps dramatically illustrated by the two three-year refinancing operations decided at the end of 2011, and implemented in late 2011 and early 2012.[50] The operations were conducted as fixed rate auctions with full allotment, and totalled nearly 1015 bln euros. These auctions fundamentally changed the picture of the Eurosystem's involvement in the banking funding, both with regard to the maturity composition but also with regard to country exposure (see Graph 2). It is difficult to dissociate such extremely unconventional refinancing operations with the serious difficulties that Spain and Italy, as well as Spanish and Italian banks, started to experience in the summer of 2011.

After the long term refinancing operations just mentioned (hereinafter, **LTROs**), Eurosystem funding to the Euro banks doubled to 1.2 trillion; moreover, this funding consisted to a rather large extent of longer-term financing, with Italian, French and Spanish banks being clearly overrepresented. In relative terms, banks in Greece and Ireland also remained heavily over-represented. At the same time, banks in Germany that in normal times represented a substantial share of the total, were nearly non-existent.

b) Interim Conclusion

[46] ECB Introductory statement with Q&A with Jean-Claude Trichet, President of the ECB, 6 May 2010, Frankfurt am Main, available at www.ecb.europa.eu/press/pressconf/2010/html/is100506.en.html.
[47] Decision of the European Central Bank on temporary measures relating to the eligibility of marketable debt instruments issued or guaranteed by the Greek Government (ECB/2010/3), OJ L 117, 11.5.2010, 102-103.
[48] ECB Press Release, 'ECB announces the suspension of the rating threshold for debt instruments of the Irish government', 31 March 2011, available at https://www.ecb.europa.eu/press/pr/date/2011/html/pr110331_2.en.html.
[49] ECB Press Release, 'ECB announces change in eligibility of debt instruments issued or guaranteed by the Portuguese government. This suspension will be maintained until further notice', 7 July 2011, available at https://www.ecb.europa.eu/press/pr/date/2011/html/pr110707_1.en.html.
[50] ECB Press Release, 'ECB announces measures to support bank lending and money market activity', 8 December 2011, available at https://www.ecb.europa.eu/press/pr/date/2011/html/pr111208_1.en.html. In addition the ECB halved the reserve ratio from 2% to 1% and also relaxed collateral availability further by including for example bank loans on the list.

The main proclaimed aim of Eurosystem 'unconventional' refinancing operations was to avoid the major shocks of the subprime crisis, the collapse of Lehman Brothers and later the Greek fiscal crisis from compromising the functioning of the European financial sector.[51] The Eurosystem injected liquidity to ensure the financial sector remained functional. Three observations are pertinent.

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Firstly, the unconventional Eurosystem refinancing policy aimed at ensuring the continued functioning of the European interbank market. To achieve that goal, however, it went so far as to act as a stand-in for the interbank market when it guaranteed unlimited funding to banks as long as they had collateral, while at the same time relaxing the rules applying to collateral. The Eurosystem also started direct purchases of covered bonds. The resulting expanded role of the Eurosystem in the Euro area banking market is visible in the evolution of the balance sheet of the Eurosystem. Eurosystem consolidated loans to, and securities by, Euro area residents were 560 bln in July 2007, then 1080 bln in July 2009 and finally reaching 1780 bln euros in March 2012. Hence the Eurosystem's exposure to Euro area financial markets increased more than threefold in the five years following 2007.

Secondly, it could be doubted whether Eurosystem collateral policy remained compliant with Article 18.1 of its Statute requiring collateral to be 'adequate'. While all legal concepts are subject to interpretation, it should be kept in mind that Eurosystem lending to banks takes place with a risk-free interest rate. Consequently, the safety requirements should be more stringent than with private banks. Otherwise, and as was probably the case, a 'relaxed' collateral policy can lead to a reduction of market discipline and consequently hamper the functioning of the market, which the Eurosystem should foster according to Article 127 TFEU in conjunction with Article 120 TFEU, as already noted. Against this background, the expansion of collateral by including less reliable government bonds and also bank-created assets could have increased moral hazard problems, as banks in trouble could take further risks in an attempt at gambling their way out of problems, at the risk (and eventual expense) of the Eurosystem. The extent and the way in which Eurosystem operations affected banking behaviour will hopefully be a subject of intensive studies.

Thirdly, the policy decisions taken by the Eurosystem had two major distributive consequences. Massive injections of liquidity at very low and fixed rates, in almost unlimited amounts, and subscribed asymmetrically by financial institutions came dangerously close not only to a subsidy to financial institutions, but even worse, *benefited some banks more than others*. The 'subsidy' character

[51] Evidently, the fact that banks could not trust each other also reflected distrust of financial supervision in Europe. Without going into too much detail, it was clear that some supervisory solutions like the transition of potentially problematic assets including some government bonds from application of the mark-to-market accounting principle to hold to the maturity principle of the banking book were elementary in increasing distrust in the system.

of the policy is closely dependent on the fact that the Eurosystem tolerated use of liquidity to acquire sovereign bonds, resulting in a *safe profit*, at least as long as the Eurosystem could guarantee the irreversibility of the Euro area. Indeed, the *simultaneous* change in collateral policy represented a strong incentive to buy sovereign bonds, which were eligible as future collateral. This borrowing from the Eurosystem to invest in bonds made economic sense for each bank in the short term, but from an aggregate and long-term perspective reinforced the link between the solvency of the banking sector and sovereign creditworthiness. The deadly mutual embrace between banks and financial institutions became tighter (and was characterised in public discourse, not without reason, as a 'kiss of death').[52] Moreover, the fact that banks invested heavily in government bonds most likely contributed to the worsening of mistrust between banks.[53]

In addition, massive injections of liquidity created the conditions under which banks borrowed massively from the Eurosystem to acquire sovereign bonds, in most cases issued by the governments of the countries in which they were established. The operations created a powerful incentive to invest in government bonds of *some states* , and hence the refinancing was made use of in rather asymmetrical ways by financial institutions within the Euro area.

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Looking at some evidence on developments in the Member States with two examples, clear evidence is available that the funding structure of some banks was clearly influenced by Eurosystem policy while the scale of their investment in 'national' government bonds increased after they became beneficiaries of the injection of liquidity by the Eurosystem. This is plainly illustrated by the transformation of the balance sheets of Greek banks. When Greece joined the EMU, the largest deposits were overnight deposits, but the importance of slightly longer deposits increased dramatically. Before the crisis, overnight deposits increased from 60 bln to 90 bln euros in the middle of 2008 while short term deposits increased from 28 bln to140 bln euros in early 2009, becoming a critical form of funding for Greek banks. It was these deposits of up to two years that most explicitly signalled the state of public trust in banks (or lack thereof) in Greece. They started to decrease in late 2009, with the speed of the decline accelerating in the first half of 2010 in the run up to the first economic programme, and again in early summer 2012. In particular, between December 2014 and July 2015 the amount of deposits

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[52] Charlemagne, 'The kiss of life, or of death?', *The Economist,* 19 October 2012, available at www.economist.com/blogs/charlemagne/2012/10/eu-summit-2.

[53] The LTRO also deepened the differences between the banking sectors in creditor and debtor states. As the funding rates in monetary policy operations were the same, the difference in credit risk led to a situation where Eurosystem lending to creditor countries' banks was not appealing while it was seemingly highly lucrative for some banks in debtor countries.

for up to two years shrank by more than 45 bln euros in deposits up to two years.[54] This is a clear example of capital fleeing Greece amid worries over continued membership in the Euro area. The resulting gap in banks' funding was filled by both Eurosystem funding through refinancing operations and Bank of Greece funding through emergency liquidity assistance. Spain provides further confirmation of this trend. At the end of 2009 banks owned less than 170 bln euros worth of government bonds. However, that increased to 274 bln euros by the end of 2012, and stood at 321 bln in September 2015, more than a quarter of all outstanding government debt.[55]At the same time, banks' balance sheets and particularly deposits were declining. Even worse, this happened when some big Spanish banks had to be recapitalised with funding from the European Financial Stability Facility, on account of their patently being on the brink of collapse due to decapitalisation.[56]

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In conclusion, the bank lending of the Eurosystem was, by and large, in line with the role that central banks are expected to fulfil in a financial crisis. However, the size of the massive three-year refinancing operations of 2011 and 2012, and the relaxation of collateral policy did not contribute to normalisation of the situation. Both operations increased the exposure of the Eurosystem towards the troubled countries. Indeed, the massive LTROs were subscribed in a disproportionate fashion by Italian and Spanish banks, which moreover tended to use their government bonds as collateral. At the same time, it could be argued that the operation resulted in a subsidy for banks established in Italy and Spain (at the same time that the creditors of these banks clearly benefited). In this regard, refinancing operations could be said to have come close to constituting hidden transfers, directly benefiting some Member States (by means of easing access to credit, and reducing the costs of borrowing) and some financial institutions (those established in countries experiencing major fiscal crises), while indirectly benefiting the creditors of the financial institutions and the states mentioned, which were, to a far from negligible extent, financial institutions from Euro area core countries.

It would indeed be worth researching where the supply of government bonds came from. Naturally, part of the supply was new issuance by Member States with increasing deficits. However, a substantial part most likely came from private investors who were already holding bonds. Holdings of large

[54] The largest monthly declines were in April 2010, May and June 2011, October 2011, May and June 2012. The largest peaks, however, took place in December 2014 and January 2015 as well as June and July 2015. See Greek contribution to Euro area monetary aggregates from www.bankofgreece.gr/Pages/en/Statistics/monetary/monetary.aspx .

[55] Cf. www.bde.es/webbde/es/estadis/infoest/a0603e.pdf and www.statista.com/statistics/270411/national-debt-of-spain/.

[56] It could be stressed that while government bonds have a zero risk-weight in supervisory calculations, they hold even considerable risks that need to be taken into account in actual risk management and thereby reduce the amount they can lend for other purposes.

amounts of government bonds were transferred to banking sectors functioning under implicit and even explicit government guarantees and being funded by the Eurosystem. In this situation, any defaults on government bonds could have had dramatic and unexpected repercussions and they had to be prevented at any cost.

D) Emergency Liquidity Assistance

a) The asymmetric nature of the crises and the demand for ELA

Given the massive amount of liquidity injected by the ECB since 2007, in the terms discussed in the previous section, it could somehow be expected that not much need would have arisen for *additional* liquidity assistance to European financial institutions. However, the crisis had been so deep (and so asymmetric) that emergency liquidity assistance nonetheless played a key role in the unfolding of the Euro area crisis.

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At least four instances of emergency liquidity assistance have been documented:

- assistance provided to bail out Hypo Real Estate in 2008,[57]
- assistance to Irish banks in 2010,[58]
- assistance to Cypriot banks in 2013,[59]
- and assistance to Greek banks on several occasions, crucially in 2012 and 2015.

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b) General features of ELA

[57] Within days of the fall of Lehman Brothers, the German bank Hypo Real Estate came close to the brink. Hypo's model was based on very short-term interbank funding (as had been that of Northern Rock, an early European but non-Euro area casualty). Hypo ended up being nationalised. The process was facilitated by ELA provided by the Bundesbank. See, M. Buder, M. Lienemeyer, M. Magnus, B. Smits and K. Soukup, 'The rescue and restructuring of Hypo Real Estate', (2011) 3 *Competition Policy Newsletter Number*, available at http://ec.europa.eu/competition/publications/cpn/2011_3_9_en.pdf, 41-44.

[58] The Irish financial sector was hit very early by the crisis. A two year full guarantee provided by the Irish state only bought time. In the fall of 2010, ELA by the Irish Central Bank became the only means of keeping the Irish banks afloat. This assistance was approved by the ECB. The ECB even conditioned, more or less openly, its approval on the Irish government requesting financial assistance, and on the same government guaranteeing all ELA financed lending to Irish banks.

[59] In 2013, during the critical days preceding the (difficult) agreement on financial assistance to Cyprus, the ECB approved a grant of ELA from the Bank of Cyprus to Cypriot banks. Again, approval was subject to the condition of the Cypriot government signing an assistance programme.

Before considering the Greek case in some detail, it is perhaps pertinent to refer to two general features of the provision of emergency liquidity assistance during the crisis.
Firstly, emergency liquidity assistance appears to have been granted at a higher interest rate than normal refinancing. Even if the exact figures have not been published,[60] several sources converge on reporting that the interest rate was somewhere between 100 and 175 basis points higher that the official interest rate.[61]

Secondly, emergency liquidity assistance has been rather controversial because of the conditions attached to it, and the degree to which the ECB not only controlled the provision of assistance, but also made use of that control to impose decisions and outcomes hard to regard as falling within its sphere of competence. Thus, in the case of Ireland and Cyprus, there is also evidence that the ECB actively conditioned emergency liquidity assistance on the national government requesting financial assistance from the Euro area.[62] This presented both governments with a major dilemma. Either they assented (even against their own will) to request assistance, or they risked seeing their financial systems come dangerously close to the brink by slow asphyxia. Moreover, it seems that the ECB put pressure on Ireland to use taxpayers' money to bail out all the creditors of Irish banks, a decision it might not have otherwise taken.[63]

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c) The Greek case

The Greek case stands apart, though, and consequently deserves more detailed analysis. Emergency liquidity assistance has been provided several times to Greek banks. The first time was presumably in 2011, when the Eurosystem excluded some Greek banks from normal refinancing operations by

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[60] Central banks do not generally publish the use of ELA or its amounts. In the Eurosystem, it appears on the NCB's balance sheet, but is often hidden under some residual item so that risks to taxpayers' money remain unclear.
[61] U. Bindseil and P. König, 'TARGET2 and the European sovereign debt crisis', (2012) 45 *Kredit und Kapital*, 135–174 mention a figure of 100 basis points above marginal lending rate. Reuters put up a range 100-150 basis points, see M. Jones, 'Factbox: What is ECB Emergency Liquidity Assistance (ELA)', *Reuters,* 22 June 2015available at www.reuters.com/article/2015/06/22/us-eurozone-greece-ela-factbox-idUSKBN0P21XH20150622).
[62] V. Boland and P. Spiegel. 'ECB threatened to end funding unless Ireland sought bailout', *Financial Times*, 6 November 2014, available at https://www.ft.com/content/1f4ed1fa-65ac-11e4-aba7-00144feabdc0.
[63] 'Report of the Joint Committee of Inquiry into the Banking Crisis', January 2016, available at https://inquiries.oireachtas.ie/banking/.

hardening collateral policy.[64] The ECB became more accommodating in August 2012, resulting in an expansion of short-term Greek sovereign debt that could be used as collateral. In effect, this was perceived to be pure financing of the Greek government.[65] Immediately after the election of a new Greek government in February 2015, the Eurosystem no longer accepted Greek government bonds as collateral.[66] The decision was said to be grounded on renewed worries about the continued membership of Greece in the Euro area, presumably due to policy proposals by the new government. This forced Greek banks into requesting ELA again from the Greek central bank.

d) Interim Conclusions

Improper use of ELA could result in subsidising specific financial institutions, as well as indirectly financing governments (through the intermediation of 'assisted' banks that in turn buy government bonds). Moreover, the Eurosystem may use ELA as a means of exerting pressure on national governments to take decisions regarded as necessary by the Eurosystem. Furthermore, use of this type of financial leverage on Member States can affect the relationship between governments and central banks in the longer-term too. The underlying national decisions often have profound effects on the various groups in society. These effects, difficult as they may be, are still acceptable results of the national political process but less so when they are deemed to be dictated by a supra national central bank. In the case of Ireland, a parliamentary inquiry was conducted, leading to explicit censuring of the ECB on account of the undue pressure that the Irish Parliament is persuaded the ECB exerted on the Irish government. The report quoted Finance Minister Michael Noonan as saying that ECB President Trichet had told him a 'bomb would go off in Dublin' if the government went ahead with a haircut of some claims on the Irish banks. Similarly, there are grounds to conclude that the relationship between the ECB and the Greek political system became extremely strained. The transparency of ELA operations was limited, to a far from irrelevant extent, as a result of the ECB form of 'constructive ambiguity'. That approach not only makes assessment and comparison of ECB operations rather difficult, but is also highly problematic in terms of ensuring the ECB remains accountable for its actions.

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[64] See 'Bank of Greece Annual Report 2011', available at http://www.bankofgreece.gr/Pages/en/Publications/GovReport.aspx?Filter_by=8&Year=2011, 25-26.

[65] See M. Martin, 'ECB saves Greece from bankruptcy by securing emergency loans-paper', *Reuters*, 3 August 2012, available at www.reuters.com/article/2012/08/04/us-ecb-greece-idUSBRE87302P20120804.

[66] Decision 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), OJ L 53, 25.2.2015, 29, available at https://www.ecb.europa.eu/ecb/legal/pdf/oj_jol_2015_053_r_0010_en_txt.pdf.

E) Securities purchases by the Eurosystem

a) Between lender of last resort and quantitative easing *à l'européenne*

The crises not only pushed the Eurosystem into uncharted waters in terms of refinancing financial institutions. A major pillar of its 'unconventional' decisions boiled down to selective acquisition of government bonds (that is, bonds of only *some states*), an utterly unprecedented policy.

In this section, I consider the three main programmes through which the Eurosystem has acted: the Securities Markets Programme (SMP), launched in May 2010 and phased out in September 2012; the Outright Monetary Transactions programme (OMT), announced in September 2012 but never implemented, even if at the core of well-known litigation before the German Constitutional Court and the European Court of Justice; and the Public Sector Purchase Programme (PSPP)(launched in 2015, and still ongoing in its different variations.

aa) Securities Markets Programme

The Securities Markets Programme (SMP) was announced on May 2010. It formed part of a larger (and inter-institutional) package aimed at addressing severe tensions in financial markets[67] that also included the establishment of two institutions that made up a European Monetary Fund of sorts, or what is the same, an institutional structure equipped with the financial means to provide financial assistance to Euro area states in fiscal difficulties.[68] It soon became clear that the SMP simply meant the Eurosystem acquiring bonds of troubled Euro area states. It bought first Greek bonds, but later also Irish bonds (from the fall of 2010), Portuguese bonds (from mid-2011), and, finally, Spanish and Italian bonds (from August 2011).

The launch of the programme was a surprise. Only two working days earlier President Trichet had denied that the Governing Council would even have discussed such a measure. Trichet argued that the quick change of heart was justified by the acute malfunctioning of some segments of the euro area bond markets. That may well have been so, but it is also a fact that in those forty eight hours the EU Council had decided to establish the twin funds to provide financial assistance to states and in that

[67] Formally the SMP was established by Decision of the European Central Bank establishing a securities markets programme (ECB/2010/5), OJ L 124, 20.5.2010, 8-9.

[68] The European Financial Stability Mechanism and the European Financial Stability Facility, forerunners of the European Stability Mechanism.

way preserve financial stability in Europe.[69] The sequence of decisions makes it difficult to avoid wondering whether the SMP was evidence of the Eurosystem bending to political pressure. These doubts were reinforced, rather than dispelled, by some Eurosystem central banks apparently leaking information on the programme and questioning the soundness of the decision establishing the SMP.[70] In this regard, it is important to notice that the risk involved in acquiring sovereign bonds is much higher than that resulting from holding the same bonds as collateral (something that the Eurosystem has done from the start). Holding collateral is a *guarantee* against the insolvency of the debtor. Only if both the bank being refinanced through the Eurosystem and the Member State issuing the bond become insolvent would the Eurosystem suffer an economic loss. In contrast, since the Eurosystem holds bonds directly, it is exposed to losses if the state issuing them becomes insolvent, which was deemed quite likely by market pricing in the case of Greece.

The programme started off immediately, and during the first two weeks the Eurosystem bought 26.5 bln euros worth of bonds.[71] The programme was more or less put on hold in July 2010, then reactivated with large-scale purchases from August 2011 onwards. In early 2012, the amount peaked at 220 bln euros. Later the Eurosystem revealed the composition of SMP purchases. The largest holdings were in Italian, Spanish and Greek government bonds.[72]

Table 1 SMP holdings	(31 December 2012)
Issuer country	Outstanding amounts EUR billion
Ireland	14.2
Greece	33.9
Spain	44.3
Italy	102.8

[69] At the meeting governor Trichet had been highly vocal stressing the need for a European based rescue solution.

[70] In an interview with *Börsen Zeitung* the next day, Bundesbank governor Weber stated: 'Der Ankauf von Staatsanleihen birgt erhebliche stabilitätspolitische Risiken' [The purchase of government bonds carries olitical stability risks] and he also made known that he had opposed the decision. Apparently some other unnamed senior level bankers from the Bundesbank even raised the suspicion that Trichet was simply trying to save French banks from incurring large losses on Greek government debt, (W. Reuter, 'German Central Bankers Suspect French Intrigue', (31 May 2010), *Spiegel Online* (available at http://www.spiegel.de/international/europe/ecb-buying-up-greek-bonds-german-central-bankers-suspect-french-intrigue-a-697680.html]).

[71] The Eurosystem did not give any indication of the total volume it expected to use for the purchases, but it provided weekly *ex post* information on the amounts it sterilised.

[72] ECB Press Release, 'Details on securities holdings acquired under the Securities Markets Programme', 21 February 2013, available at https://www.ecb.europa.eu/press/pr/date/2013/html/pr130221_1.en.html.

Portugal	22.8
Total	218

The ECB provided two main justifications for the SMP. Firstly, the SMP was necessary to ensure the proper transmission of monetary policy decisions. If the interest rates at which Euro area states borrow money in financial markets diverge 'excessively', then the interest rates at which banks are able to borrow become fragmented: the actual rate paid by each bank being conditioned by the country in which it is established. This could lead to a wider fragmentation of interest rates in the Euro area, rendering Eurosystem decisions on interest rates ineffective (as the actual rates would be more conditioned by conditions occurring in each state than by decisions of the ECB itself). By trying to preserve 'depth and liquidity' in security markets, the Eurosystem could prevent 'excessive' divergences in bond rates, which were said to be 'irrational' (and thus endogenous to markets and market functioning) because they stemmed from irrational fears of a Euro area breakup.[73] Indeed, the decision establishing the SMP was explicitly grounded on Art 127(2) first indent TFEU, which assigns to the ECB the task of defining and implementing monetary policy.[74] Secondly, purchases under the programme were to be 'sterilised'; or, what is the same, the Eurosystem compensated the acquisition of bonds by sales of other assets, so that monetary conditions would not change.[75]

The reasoning of the ECB has been contested on two main constitutional grounds. Firstly, many contested the actual nature of the programme. While the ECB claimed that this was monetary policy as usual, only the circumstances were extraordinary, critics claimed that the ECB was engaging in economic policy by other means, and consequently overstepping its mandate. A programme such as the SMP was easier to explain on the grounds of its economic and fiscal implications than on the basis of monetary policy effectiveness.

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Secondly, the programme had an impact (to the extent that it was effective) on the rates at which the Member States whose bonds were acquired borrowed money. The ECB claimed that this was a secondary and contingent effect of the programme. Critics found this a disingenuous argument,

[73] ECB Press Release, 'ECB decides on measures to address severe tensions in financial markets', 10 May 2010, available at https://www.ecb.europa.eu/press/pr/date/2010/html/pr100510.en.html.

[74] Cf. Art. 12.1 second subparagraph, as well as Arts 3.1 and 18.1 of the ECB Statute. It is interesting to notice that, *a contrario,* the measure was neither presented as contributing to supporting general economic policies (Art 127(1) TFEU) nor as part of the smooth conduct of policies pursued by the competent authorities relating to prudential supervision of credit institutions and the stability of the financial system Art 127(5) TFEU.

[75] The sterilisation aim was largely symbolic, coming at a time at which the ECB had moved to full allotment in its bank lending operations.

because the ECB could not but actually intend a result which was forbidden by Article 123 TFEU (and indirectly Article 125 TFEU). In particular, the SMP decision refers to the Treaty prohibition only indirectly, by excluding primary purchases of 'eligible marketable debt instruments issued by the central governments or public entities of the Member States'. However, the decision refrains from discussing how the programme would comply with the prohibition. Indeed, compliance seems to depend on a very narrow and formalistic reading of Art 123 TFEU. As a result, the SMP raises the question: what type of government bond purchases were meant to be allowed with the formulation of Art 123 TFEU and the Council regulation?[76]

It is hard to contest that purchases under the SMP were indirect funding of Member States in a situation where markets were increasingly unwilling to finance some Euro area Member States. The purchases were intended to affect the market pricing of the assets, signalling the Eurosystem's assessment that bond yields had reached levels that could not be backed up by economic fundamentals. For Greek government bonds this was also a clear failure, if not worse. Greek finances were such that it was clear beyond doubt to most sensible observers that there was no interest rate at which Greece could be lent more money before the debt burden was cut. The market were not irrational, not *ex ante* nor *ex post*. Not only did the purchases fail to have a sustained impact as the Greek economic situation kept turning worse, but even the credibility of the ECB's ability to make accurate economic assessments was hampered.

The programme also fundamentally altered the relationship between the Eurosystem and the debtor countries. As the purchases changed the holding of those securities from private to public hands, the Eurosystem became a long-term holder of public sector bonds in those countries. Furthermore, the Eurosystem announcement that its bond holdings would have a preferential position among creditors kept them outside the Greek debt restructuring in 2012. This reduced the amount that Greek debt was cut in the restructuring, put other holders of debt in a worse position and potentially had a detrimental effect on the future of the Greek government bond markets. The winners of the SMP were those that were able to sell bonds to the Eurosystem. Hence, Eurosystem purchases were part of the massive transformation of Greek government debt from privately owned to publicly owned that has already resulted in enormous factual losses for Euro area taxpayers, even if nominal losses have been rejected.

It was possible that something similar was happening to Italy and Spain. The negative dynamics of the SMP could have started a similar spiral if the share of Eurosystem purchases in addition to other

[76] Council Regulation (EC) No 3603/93 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b (1) of the Treaty, OJ L 332, 31.12.1993, 1-3.

European measures had increased to a level where they would have had a detrimental effect on the position of private investors. As a first step, they did affect the relationship between the ECB and Italy and Spain, as demonstrated by the letters to the governments of Italy and Spain.

bb) The Outright Monetary Transactions Programme (OMT)

If the SMP was the stepchild of the first peak of the Euro area fiscal crisis, the OMT was an orthodox measure aimed at tackling its second peak. In the summer of 2012, fears of a potential euro area break-up became rampant. The rates at which the Italian and the Spanish governments borrowed money increased again, particularly compared to German rates. Given the size of public debt in Spain, and even more so in Italy, the Euro area lacked the actual means to provide financial assistance to either country, even less so to both of them at the same time.

Commented [A12]: IT and ESP banks? Governments?

On 26 July 2012 ECB president Draghi stated that:

'To the extent that the size of these sovereign premia hamper the functioning of the monetary policy transmission channel, they come within our mandate', to which he added '[w]ithin our mandate, the ECB is ready to do whatever it takes to preserve the euro, believe me, it will be enough.'[77]

Words like these needed to be followed by some serious action. The OMT programme was announced on 6 September 2012. The press release only sketched the main features of the programme. The full programme has never been published in detail nor (consequently) has it been implemented legally or in practice. According to the press release, government bonds would be purchased on secondary markets under specified conditions. The main condition was that the issuing Member State should be subject to a programme of financial assistance under the European Stability Mechanism. The Eurosystem was to buy shorter-end bonds, with a maturity of between one and three years. Most crucially, there was no *ex ante* quantitative limit to the purchases that the Eurosystem would be willing to make. Furthermore, the Eurosystem would accept the same treatment as private creditors.[78]

OMT was presented as reflecting the fundamental commitment of the Eurosystem to provide funding to governments facing 'undue constraints' in their market financing. Moreover, the OMT was clearly aimed at contributing to the funding of the governments as long as they were under a financial assistance programme. In that regard, it was intended to be supportive of financial assistance

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[77] See for example, www.bloomberg.com/news/articles/2012-07-26/draghi-says-ecb-to-do-whatever-needed-as-yields-threaten-europe.
[78] ECB Press Release, 'Technical features of Outright Monetary Transactions', 6 September 2012, available at http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html.

programmes, to the extent that the mere possibility of OMT being implemented reduced the need for direct assistance from the ESM (and thus from other Member States).

Of the broad range of Eurosystem measures, the OMT programme is the one that has been legally tested. The German Constitutional Court made a preliminary reference to the ECJ questioning the legality of the OMT programme.[79] The reference revolved around the question whether the OMT programme was a monetary policy measure or a means to ensure financing of the Member States at Euro area risk. In this context only a few remarks must suffice. The ECJ approved OMT on two bases. First, the Eurosystem claimed that it was needed to achieve the objective of monetary policy: price stability. Claims of other potential influences were not substantially addressed. Second, OMT was deemed to use instruments that were applicable for monetary policy, namely purchases of securities. To the extent that these two criteria are also to be applied in the future to decide whether a measure is part of the Eurosystem mandate or not, it is very difficult to think of anything that would be excluded: the ultimate carte blanche for the Eurosystem.

Putting the narrow legal assessment aside, discussion of the OMT as a transfer mechanism needs to be based on speculative assumptions, because it was never used. This has not prevented the Eurosystem from declaring the OMT programme a success, on the basis that it would have put an end to frivolous speculation on the breakup of the Euro area and as a result would have brought interest rates on bonds more in line with economic fundamentals. This was achieved without buying any bonds: a crime without a victim, or a bluff that was not called? Most likely a little bit of both. Had the programme been activated and the Eurosystem acquired a substantial amount of shorter-term bonds of a Member State, this would have implied a major transfer in favour of the country in question. Implementation of OMT would have changed the composition of the holdings of public sector debt from relatively short-term debt of one Member State to very short-term debt of the Eurosystem. Private holdings of government debt would have been replaced by public holdings by the Eurosystem.

Commented [A13]: Meaning unclear: please review.

Graph 3

Legally a difficult question was: how could a constitutional norm have been breached if no action was taken? In economic terms it is not particularly difficult to understand that, if the announcement was credible, it increased the mutual responsibility element in Euro area bond pricing. The perceived risk of safe government bonds before the announcement should have increased. At the same time, the Eurosystem announcement gave an implicit guarantee on the Italian and Spanish government bonds, and their riskiness should have decreased. The impact on inflation expectations is more difficult to

[79]See The Federal Constitutional Court Press releases nos. 29/2013 (19 April 2013) and also the final rulings 2 BvR 2728/13, 2 BvR 2729/13, 2 BvR 2730/13, 2 BvR 2731/13, 2 BvE 13/13 (21 June 2016).

assess. For example, while the announcement could have reduced economic uncertainty in the troubled countries, it could have done the opposite in countries such as Germany.

cc) Purchases on Secondary Markets of Public Sector Assets (Public Sector Purchase Programme)

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In January 2015,[80] the ECB Governing Council announced the Public Sector Purchase Program (PSPP).[81] This was a completely new programme not only with unprecedented features, but also on a massive scale. The Eurosystem was to buy public sector assets (mainly bonds) of all Euro area states (at least, of all Euro area states found as qualifying for that purpose).[82] An exact amount of bonds would be bought every month. It was initially announced that the programme would run at least from March 2015 to September 2016. In March 2016 the programme was prolonged to March 2017[83]and in December 2016 it was further prolonged at least until the end of December 2017, but from April 2017 onwards monthly purchases are scaled down to 60 bln euros.[84]

On such a basis, it was not far-fetched to regard the programme as the Eurosystem equivalent of the quantitative easing programmes launched by other major central banks after the financial crisis. In terms of the assets that can be bought under PSPP, they include debt securities (bonds) issued by Euro area central governments, certain agencies established in the Euro area such as Kreditanstalt für Wiederaufbau as well as certain international or supranational institutions located in the Euro area such as the EIB and ESM. Moreover, bonds have to be eligible as collateral under Eurosystem rules[85]

[80] The January meeting was preceded by a surprisingly explicit public discussion. The decision was anticipated by the media, financial markets and even other central banks. This provision of information was at least partly intentional and used to direct expectations such as Draghi's statement that the Eurosystem balance sheet should return to the level of early 2012. These expectations put pressure on the ECB Governing Council to make the highly contested decision in favour of a large-scale government bond purchase programme.

[81] The formal decision was taken and published in March 2015 and execution measures were initiated shortly afterwards.

[82] ECB Press Release, 'ECB announces expanded asset purchase programme', 22 January 2015, available at https://www.ecb.europa.eu/press/pr/date/2015/html/pr150122_1.en.html.

[83] ECB Introductory statement to the press conference (with Q&A), with Mario Draghi, President of the ECB, 10 March 2016, Frankfurt am Main (available at www.ecb.europa.eu/press/pressconf/2016/html/is160310.en.html. On 3 December 2015, the Governing Council decided that regional and local government issuers are also eligible for the PSPP, REFERENCE.

[84] ECB Press Release, 'Monetary Policy Decisions', (8 December 2016).

[85] Guideline of the European Central Bank on monetary policy instruments and procedures of the Eurosystem (ECB/2011/14), OJ L 331, 14.12.2011, 1-95.

equivalent to the lowest level of investment grade rating from the main rating agencies.[86] Lower ratings are possible if the securities are issued under a financial assistance programme and the credit quality threshold is suspended by the Governing Council.[87]Hence, although formally limited to relatively high quality public sector securities, the programme can in effect be used to buy any government bonds in the Euro area to the extent deemed appropriate by the ECB Governing Council. [88]

Very importantly, the PSPP programme contains relative but not absolute limits on bonds by reference to both the bond issuer, both in relative terms to other states, and in terms of the total outstanding debt of each state: 33% of the debt with a remaining maturity between 2 and 30 years at the time of purchase [89] and the specific issue. The limits aim to prevent imbalances in terms of the nationality of the bonds being acquired and the degree to which it distorts the bond market, which is further supported by the condition that bonds cannot be bought immediately after issuance: the so-called 'blackout' period. [90] Different rules apply to debt issued by states under a financial assistance programme.[91]

The most striking feature of the programme is its size and length. The PSPP together with the two earlier programmes totalled first 60 bln monthly, which was raised to 80 bln, of which the large

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[86] This credit assessment refers to the Eurosystem credit assessment framework (ECAF) that supplements credit rating agencies. See www.ecb.europa.eu/paym/coll/risk/ecaf/html/index.en.html for more information. The Eurosystem credit quality step 3 is equivalent to the lowest level of investment grade rating from rating agencies.

[87] Art 3(2)c of Decision (EU) 2015/774 of the European Central Bank on the secondary markets public sector asset purchase programme (ECB/2015/10), OJ L121, 14.5.2015, 20-24.

[88] The decision and later communication has left open what will happen to purchased bonds should they lose their eligibility for the programme. Given the absence of any specific stipulation in this regard, it may be the case that bonds will continue to be held by the Eurosystem even if downgraded to junk bond status.

[89] Art 3(3) of Decision 2015/774, above, n. 87.

[90] According to the Decision, the Governing Council determines time and maturity limits before and after any bond issue during which purchases are not permitted in bonds that could be seen as close substitutes to primary issues.

[91] Preamble (6), Art 5 (1) and Art (2) of Decision 2015/774, above, n. 87. The eligibility of those securities is based on successful implementation of the conditions set in the MoUs agreed between the Troika and the Member State, controlled by periodic reviews. Hence, as a rule purchases should be conducted during a period of two months after each successful review. It could be claimed that purchases of bonds issued by a financial assistance recipient country are the most vaguely stipulated in the ECB decision, and the case for actual secondary market activity could be fairly difficult to make. In practice, speculation on the Eurosystem purchase has led to some extreme movements in the Greek government bond markets.

majority is on the PSPP.[92] The programme is now intended to be carried out at least untilthe end of 2017 and 'in any case, be conducted until the Governing Council sees a sustained adjustment in the path of inflation,'[93] The total asset purchase programme is expected to reach 1.8 trl euros of which 1.5 trl in PSPP. By the end of January 2017, the Eurosystem had bought more than 1.3 trl bonds only in the PSPP.[94]

Commented [A15]: This will need updating

Table 2 Breakdown of debt securities under the PSPP

31 January 2017	Monthly net purchases	Cumulative monthly net purchases
Austria	1.97	35.168
Belgium	2.489	44.325
Cyprus	0	248
Germany	17.713	321.658
Estonia	0	65
Spain	8.789	159.122
Finland	777	22.07
France	14.24	255.107
Ireland	547	19.109
Italy	12.302	221.907
Lithuania	70	2.332
Luxembourg	10	1.752
Latvia	39	1.353
Malta	29	836
The Netherlands	4.021	71.846
Portugal	688	25.298
Slovenia	160	5.095
Slovakia	334	8.489
Supranationals	7.185	148.413
Total	71.362	1.344,194

Source: ECB

The programme entails a peculiar limited risk-sharing between national central banks (contrary to what was the case with the SMP and the OMT).[95] Only 20% of the risks are shared and the remaining

[92] No exact amounts have been communicated except informally. See D. Goodman, L. Meakin and E. Nelson, 'The What and Why of ECB Bond Buying; For How, Watch This Space', *Bloomberg Markets*, 22 January 2015, available at www.bloomberg.com/news/articles/2015-01-22/the-what-and-why-of-ecb-bond-buying-for-how-watch-this-space.

[93] Preamble (7) to the Decision 2015/774, above, n. 8, p. 20.

[94] See www.ecb.europa.eu/mopo/implement/omt/html/index.en.html.

[95] The reason for the limited risk-sharing was to 'mitigate the concerns that many participating countries in the Euro area have about the unintended fiscal consequences of potential developments in the future'. The

80% are at the risk of the Member States, in proportion to the amount of bonds that have been bought. The bonds under risk-sharing are those of European institutions purchased by a selection of NCBs and bonds purchased by the ECB.[96] The ECB holding has increased to 186 bln euros of which 121 bln consisted of government bonds by the end of January 2017.[97]

Commented [A16]: Update?

Limited risk sharing is very unusual for common monetary policy and could be seen as evidence that the programme results in monetary transfers. It also reflects a compromise within the Eurosystem. On the one hand, the indivisible nature of the common monetary policy would demand that there are no country divisions On the other hand, quantitative easing programmes elsewhere have focused on the least risky assets. That way, the central bank does not unnecessarily affect the price mechanism in financial markets. In the case of the Eurosystem, that would have meant basically mainly German and Dutch government bonds as well as some bonds issued by European institutions. From this perspective, the purchase of government bonds of countries with lower creditworthiness is a distortion in favour of the less creditworthy Member States. The transfer mechanism nature of the PSPP is hence a fairly complex issue. Use of central bank money to purchase government bonds substantially changes the structure of public sector liabilities. However, limited risk-sharing means that liabilities are not mostly supranationalised, only made of shorter maturity. The cost of liability fundamentally changes, particularly with regard to Member States that have a lower credit rating. The main underlying risk relates to the massive increase in the quantity of money, which contains the risk of inflation regardless of the benign inflation environment at the moment. Should the inflation risk be realised, the transfer nature of the Eurosystem QE programme would have new, even dramatic, features.

b) Interim Conclusions

Selective acquisition of bonds could not but raise major concerns, to the extent that it was at the very least rather close in economic if not formal terms to *financing* those states whose bonds were being bought (something precluded by Art. 123 TFEU). The acquisition of sovereign bonds by the Eurosystem is likely to have had an impact on the actual rate at which the given Member State actually borrowed in financial markets, and, consequently, on the terms under which sovereign bonds were acquired. It is thus hard to escape the conclusion that the ECB provided an indirect subsidy to the states whose bonds it acquired. The flip side of this subsidy was, moreover, assumption of the risk stemming from these bonds by the Eurosystem (a risk thus borne, at the end of the day, by all Euro

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limitations to risk-sharing were hence presented as the ECB's concession to worries that unconventional monetary policy measures could turn into actual fiscal transfers between Member States.

[96] ECB Press Release, 'ECB announces expanded asset purchase programme', above, n. 82.

[97] http://sdw.ecb.europa.eu/reports.do?node=1000005533.

area states). This policy may lead to a systematic collapse of the independence of the central bank, and disturb the institutional balance of the role of the Eurosystem towards the Member States: A balance that, it should be kept in mind, was being further compromised by the role played by the ECB in the design, implementation and monitoring of financial assistance programmes, to which reference has already been made. This is so because holding Member State government bonds makes the Eurosystem dependent on the conduct of fiscal policy by that state, something that may result in the central bank trying to explicitly or implicitly influence the Member State in question. Indeed, some would claim that the letters sent by the President of the ECB to the Spanish and Italian governments at the very same time that the Eurosystem started to buy their bonds constitutes evidence that this risk is more than theoretical.

Conclusions – Eurosystem central banking as a (hidden) transfer mechanism?

This article is part of a special issue which focuses on whether and to what extent the EU could be characterised as a community of debt. The contribution of this article to that inquiry is the analysis of whether the 'unconventional' monetary policy of the Eurosystem has actually transformed the Euro area into a community of debt, and if so, in what sense, through which means, and with which constitutional implications. The starting premise was that monetary policy can have distributional consequences, but independent central banks such as the Eurosystem should avoid intentional transfers. The question that followed from that premise was whether the unconventional policy triggered by the manifold European crises has or has not resulted in (hidden) monetary transfers.

In three cases, I found that it would be far-fetched to conclude that redistribution through monetary policy has taken place. Firstly, this is clearly the case on what concerns the issuanceof bank notes. While the relative number of notes in circulation in different Euro area states has changed even substantially since the beginning of the crises, the very norms that allocate seigniorage among the Member States ensure that this cannot be used to affect allocation of burdens and benefits within the Euro area. Secondly, emergency liquidity assistance seems also not to have resulted in any significant transfers, because the said assistance has been provided in respect of the principle of national financial liability. Nonetheless, I pointed (and I will be back to this briefly) that the way the Eurosystem has been going aboutemergency liquidity assistance (most clearly in the Irish and Greek cases), raises far from minor constitutional concerns. Thirdly, the massive imbalances in the Eurosystem payments system (Target 2) can be persuasively argued to be a telling symptom of the underlying structural problems of the Eurozone design, but do not in themselves constitute hidden transfers. The payment system of a monetary union cannot but reflect the highly problematic trade and current account balances fostered by the terms under which EMU was established and proceeded for its first decade, as well as the role played by the Eurosystem in striving to prevent its collapse since the beginning of the crises, in particular through massive and markedly asymmetric refinancing of financial institutions. The big caveat to this conclusion is that were the Euro area to break up (especially if this break up came together or resulted in several states defaulting), the outstanding claims by the 'surplus countries' towards the ECB could lead to substantial financial losses.[98]

Rather less clear-cut is the assessment of the three programmes of purchase of government bonds. The programmes had different aims and consequences. Firstly, the SMP programme was explicitly aimed at altering the market perception of the solvency of *some* Euro area states. In operative terms, this entailed replacing private holdings of government bonds with public holdings, and in the process shifting contingent risks to the Euro area as a whole (via the Eurosystem). The Eurosystem, even if formally only through acquisitions in secondary markets, became a creditor (and far from an insignificant one) of *some* Member States. The direct and immediate distributional consequences seem hard to miss. Secondly, the OMT followed from ECB President Draghi's promise that the Eurosystem would do whatever it took to save the euro, but it can be explained by the failure of the SMP as well. Even if never implemented, the OMT announcement signalled that the Eurosystem was ready to buy unlimited amounts of short to medium term government bonds of Member States experiencing fiscal difficulties as long as those states were undergoing adjustment programmes (that is, receiving financial assistance from the ESM subject to strict conditionality. From the transfer perspective, it tied Member States' creditworthiness together. If the Eurosystem could in practical terms take over even all the government debt of a Member State to a common euro area liability, the risk premia of the lower creditworthiness countries should decline and the opposite take place with regard to high creditworthiness countries. A convoluted but rather material transfer cannot but ensue. Thirdly and finally, the PSPP, or rather quantitative (and qualitative!) easing à la Eurozone, resembled some of the QE programmes activated by other major central banks in the aftermath of the financial crisis of 2007-2009, but there were also some important differences, some of which were directly related to the peculiar constitutional setup of the Eurosystem (what the Eurosystem has been buying is national public debt in amounts proportional to the share of each state in the ECB capital), and in particular, to what was assumed national responsibility for public liabilities requires (only 20% of the bonds

[98] The likelihood of that event, together with the outstanding exposure, gives an indication of the risk exposure of the surplus countries (Germany), which, unsurprisingly, are those standing to suffer higher immediate losses in the case of a breakup.

acquired are 20% of the risk is bore collectively)The full effect of the PSPP programme remains to be seen. The so-called portfolio rebalancing effect was expected to be its main mechanism for influencing the economy, pushing other asset prices up with the capital given by the Eurosystem to buy the government bonds.. This has resulted in a factual transfer to the current owners of these assets, and in relative terms worsened the position those aiming at long-term investments such as houses. This monetary policy-induced redistribution between the haves and have nots seems particularly hard on younger generations These government bond purchase programmes have relatively clear redistributive implications, at least economically.

Finally, perhaps he most far-reaching hidden transfer mechanism has taken the form of provision of liquidity to financial institutions through Eurosystem refinancing operations. The Eurosystem has become a substitute for the interbank money market, by means of providing practically unlimited funding to financial institutions at low rates, and with relaxed collateral requirements. The degree to which financial institutions used the liquidity offered by the Eurosystem was far from homogeneous across the Euro area. The result was that the Eurosystem as a Euro area collective liability assumed particular risks in ways unrelated to any set criterion, and even risking its independence vis-à-vis states as well as financial institutions. In the first phase, roughly from 2007 to 2009, the extent to which financial institutions took Eurosystem liquidity was only asymmetric to a limited extent. From 2009 to the end of 2011 asymmetry was plain to see, and the unconventionality of the policies was similarly higher. From the end of 2011, liquidity in massive amounts for a three-year period with a marked asymmetric pattern of allocation of such liquidity pushed unconventionality to its limits.

During this evolution, the borderline between liquidity provision and solvency support became increasingly blurred and three-year funding was hard to distinguish from a subsidy, ensuring not only liquidity to solvent but illiquid banks, but creating the conditions under which insolvent banks could try to resurrect themselves, mainly by buying high-yielding government bonds of the states where the banks were established A worrying sign in this regard was that most of the new funding by the Eurosystem ended up being used to purchase securities, government bonds of troubled Member States, rather than in providing credit to companies and households. . This resulted in asymmetric pattern in refinancing financial institutions hand in hand with an asymmetric pattern in (indirect) refinancing of Euro area states. Three major economic effects followed. Firstly, the fate of Euro area states and Euro area banks became more closely intertwined. Secondly, the exposure of the Eurosystem to the fate of banks and Euro area states increased. Thirdly, the programme altered the pattern of holding bonds, but did not have any relevant impact on non-financial investment or economic activity.

At the time of writing, participation of the Eurosystem in the euro area economy has reached levels that were unforeseen at the time the Maastricht Treaty was drafted and signed, and for that matter, when EMU was launched. It is certainly the case that the crises which the Euro area has confronted are serious and challenging. It is hard to contest that the Eurosystem was called upon to play a major role in governing the crises and in particular in preventing panics that were in the making on several occasions during the last decade. However, the persistence and depth of unconventional monetary policy can hardly be explained only by reference to recurrent panics, or for that matter, by reference to deeply asymmetric information requiring the Eurosystem to step in.

Before concluding on how the measures have affected the Euro area as a community of debt, some economic and societal implications of the unconventional monetary policy needs to be mentioned that could affect the assessment of these measures.

First, unconventional Eurosystem monetary policy could actually have impaired the functioning of the markets that it was trying to restore. There is no room for market determination of interest rates at which banks obtain funding if the Eurosystem continues to provide unlimited funding at a zero interest rate. In this regard, excessive provision of funds has slowed down the 'normalisation' of the banking markets, instead of contributing to it. Banks established in Euro area countries with fiscal difficulties are still dependent on Eurosystem funding instead of interbank markets. After the initial shock, the banks could have done a number of things to regain access to market funding. They could have increased the amount of their own funds, which has been used but only as a last resort and often in insufficient amounts. They could have reduced the level of risk by means of, for example, selling risky government bonds. The final option would be to go out of business. All these options have been used to considerably more elsewhere than in the Euro area, where troubled banks continue to resort to refinancing from the Eurosystem, at worst with increased risk-taking. Too simplictic analysis should be avoided, however, The 'unconventional' injections of liquidity were initially aimed at preventing solvent banks from being unable to access funding and preventing banking panics is an appropriate albeit exceptional function of central banks. The crucial point is when injections of liquidity, often below reasonable market prices, changes from prudent central banking to a major subsidy and a hindrance to the functioning of the markets. As the new banking supervisor, the ECB is even more interwoven to the situation in the banking sector.

Second, in addition to the transfer considerations and constitutional problems involved in selective acquisition of government bonds discussed above, the PSPP PSPP programme is likely to have other profound and unclear effects on Euro area economies and societies. Central bank money has been created with the explicit purpose of influencing the market pricing of government bonds with a result that financing conditions for Euro area governments have become considerably, even excessively, loose. At the same time other asset prices have increasedwith massive (unrealised) capital gains. Not as a result of investments, innovations or entrepreneurship, but simply as a result of this Eurosystem policy raising questions concerning the proper role of any central bank, at least concerning the immediate distributional impacts and its intergenerational implications. Paradoxically, the PSPP purchases have actually increased TARGET2 imbalancesas bonds purchased by the PSPP have come from domestic non-financial actors and the cash is seemingly being invested *abroad*. It could be guessed that the ECB did not see PSPP leading to capital flight.

Ultimately with all these complications and unintended implications of the measures, the final broader question is the ability of the Eurosystem to keep focusing on its primary objective. It is likely to be more than tested in the near future. Even if the link between the PSPP and inflation was unclear to begin with, it cannot be excluded that massive creation of central bank money makes future inflation unpredictable, if not uncontrollable.

Finally, on the specific perspective of what kind of community of debt can we say the Euro area has become? One aspect is the aforementioned use of liquidity as a Community means of solving problems. It has increased Community liability over the Euro area banking sector. And with the link between banks and states in trouble becoming more vicious, not least because of the very liquidity provision, use of liquidity has also become a designated mechanism for solving fiscal problems.

Indeed, one of the most paradoxical issues in the whole process of Eurosystem measures to combat the crisis, is the responsibility over Member States. Already, when ECB President Trichet excluded default by a Euro area state, the ECB in effect started to assume some responsibility over Member States' debts. The paradox is that Greece defaulted anyway, with probably a higher cost for its citizens and remaining creditors. In the meanwhile, the Eurosystem had worsened the link between Member States and their banks, a problem that it began to solve by assuming a more explicit role as the ultimate financier of the Member States (OMT) and by becoming the ultimate market-maker of the Member States' bond markets (PSPP).

The result is a situation where the central bank has an enormous balance sheet, the banking sector is afloat with liquidity, and institutional responsibilities within the Community are as blurred as ever. The liquidity creation has been used to solve problems stemming from insolvent banks in some Member States as well as for Member States' problems in obtaining market financing. Hence the Euro area as a community of debt is based on liquidity creation by the Eurosystem. This leads to very strange forms of debt relations that are likely to surprise us with new implicationsin the future.

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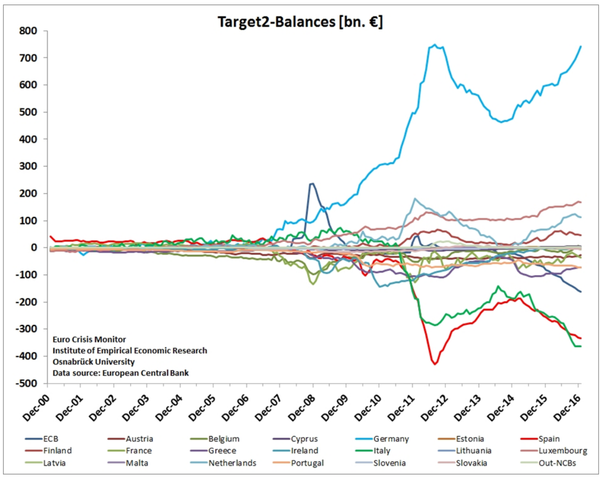
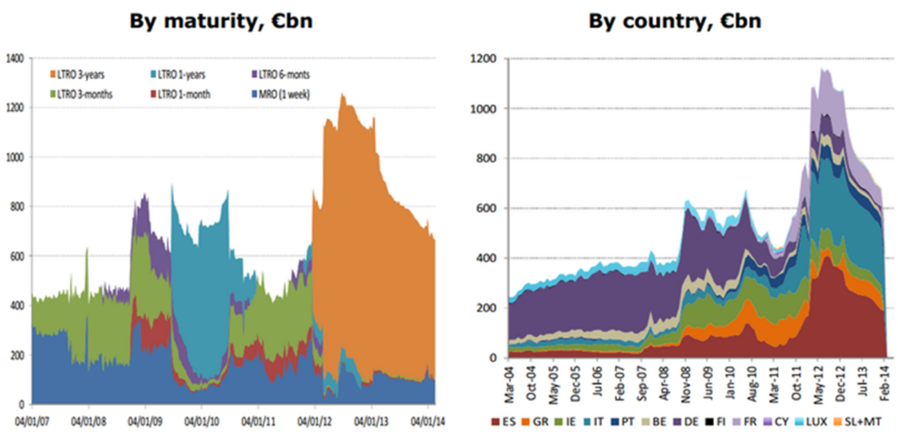
Graph 1

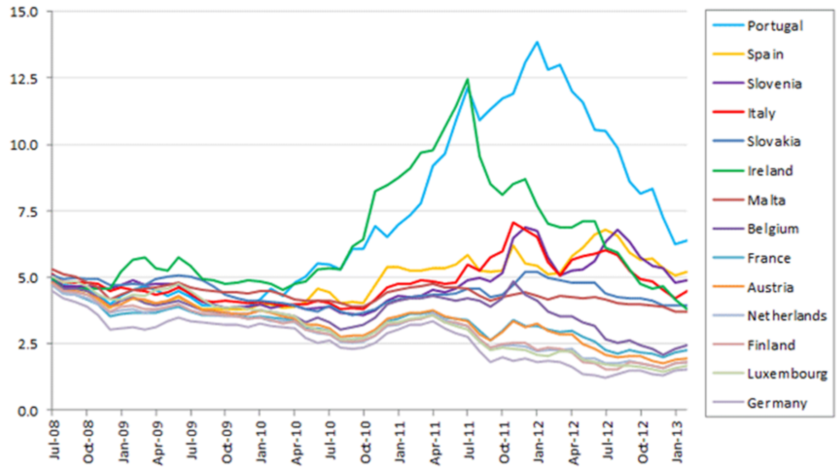


Source: ECB Data, modified by http://www.eurocrisismonitor.com/

Graph 2



Source: http://bruegel.org/2014/07/the-not-so-unconventional-monetary-policy-of-the-european-central-bank-since-2008/



Source: WTO, https://www.wto.org/english/news_e/pres13_e/pr688_e.htm