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The European Central Bank's Securities Markets Programme: Why a Necessary Response to the European Debt Crisis Should Come to an End

Peter Doely

Note

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The European Union Member States ("Member States") created the European Central Bank ("ECB") to provide price stability to the eurozone. The ECB is highly independent because central bank independence is directly correlated to providing price stability. In order to preserve the ECB's independence, the Treaty on the Functioning of the European Union ("TFEU") provides legal safeguards. One safeguard is a prohibition on the ECB purchasing government bonds directly from Member States. This safeguard helps to ensure that the ECB does not monetize the debt of Member States, and it helps to preserve the distinction between monetary policy and fiscal policy.

In early 2010, the finances of several Member States, most notably Greece, were in dire straits and investors began to doubt those countries' ability to repay their debts. Government bond yields for those countries began to rise precipitously. In addition to other European efforts to quell the crisis, the ECB implemented the Securities Markets Programme ("SMP") in order to drive down the yields for those countries' bonds and provide liquidity to the securities markets. The SMP involved the ECB purchasing government bonds from secondary markets.

The ECB claims a legal basis for the SMP by characterizing it as necessary for monetary policy. The ECB reasons that the SMP is necessary to reestablish order in dysfunctional markets and to preserve its transmission

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mechanism for monetary policy. Critics have claimed that the SMP has been a Trojan horse for fiscal policy. The ECB, they claim, is primarily concerned with helping to relieve the debt burden of potentially insolvent governments, and that acting for such reasons is an implicit breach of the prohibition on debt monetization.

This Note examines the monetary and fiscal justifications for the SMP and discusses whether it compromises the ECB's independence. Part I examines the legal and economic bases for the ECB's independence and the events that necessitated the SMP. Part II compares the plausible monetary and fiscal reasons for the SMP. Finally, after examining options for modifying the ECB's ability to act, this Note concludes that the Member States should limit the amount of government bonds that the ECB is able to purchase in order to safeguard against debt monetization, to preserve ECB independence and to ensure the ECB fulfills its mandate of price stability.

I. THE ECB, THE EUROPEAN MEMBER STATES, AND THE CRISIS

In 1992 European Member States signed the Treaty on European Union ("TEU") and created the European Economic and Monetary Union ("EMU").[1] This Treaty[2] established the framework of the European System of Central Banks (the "ESCB"), including the ECB and central banks of Member States.[3] In addition, it laid out the ESCB's responsibilities in the EMU:

> The primary objective of the European System of Central Banks (hereinafter referred to as 'the ESCB') shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the

1. Treaty on European Union, Feb. 7, 1992, 1992 O.J. (C 191) 1.
2. For ease of reference, this Note will use the Consolidated Version of the Treaty on European Union, Mar. 30, 2010, 2010 O.J. (C 83) 13 [hereinafter TEU]. This Note will also use the Consolidated Version of the Treaty on the Functioning of the European Union, Mar. 30, 2010, 2010 O.J. (C 83) 47 [hereinafter TFEU] and Protocol (No 4) on the Statute of the European System of Central Banks and of the European Central Bank, Mar. 30, 2010, 2010 O.J. (C 83) 230 [hereinafter ECB Statute].
3. TFEU art. 4(2)(a).

> Treaty on European Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119.[4]

First and foremost, the ECB should "maintain price stability."[5] In order to maintain price stability, a central bank must keep inflation at a low and consistent level.[6] This is desirable because it allows participants in the economy to plan and invest in the future with an accurate idea of the return on their investments. This stability promotes sustained and smooth economic growth.[7] If price stability is maintained, the ECB is also able to "support the general economic policies in the Union,"[8] though this goal is distinctly secondary.[9] Member States, not the ECB, are responsible for determining and implementing their economic policies.[10]

As a means to price stability, the Member States made the ECB what some have called "the world's most legally independent central bank."[11] There is a strong connection between the insulation of central bankers from political pressure and price stability.[12] Because inflationary pressure

4. TFEU art. 127.

5. *Id.*

6. *See* FREDERIC S. MISHKIN, THE ECONOMICS OF MONEY, BANKING, AND FINANCIAL MARKETS 388–89. (2d ed. 1989). The ECB has interpreted the price stability mandate to require inflation under 2% in the medium term. Press Release, Governing Council of the European Cent. Bank, A Stability-oriented Monetary Policy Strategy for the ESCB (Oct. 13, 1998), *available at* http://www.ecb.int/press/pr/date/1998/html/pr981013_1.en.html.

7. *See* MISHKIN, *supra* note 6.

8. TFEU art. 127.

9. *See, e.g.*, Jean-Claude Trichet, President, European Cent. Bank, Introductory Statement with Q&A at Frankfurt am Main (Mar. 6, 2008), *available at* http://www.ecb.int/press/pressconf/2008/html/is080306.en.html ("We have one needle in our compass, which is price stability.").

10. *See* TFEU art. 120 ("Member states shall conduct their economic policies . . . .").

11. KARL KALTENTHALER, POLICYMAKING IN THE EUROPEAN CENTRAL BANK 70 (2006).

12. *See* DAVID HOWARTH & PETER LOEDEL, THE EUROPEAN CENTRAL BANK: THE NEW EUROPEAN LEVIATHAN? 119 (2003) ("Most empirical studies have shown that countries with independent central banks achieve substantially lower rates of inflation than countries in which the central bank is controlled directly by the government."); Patrick Deller, *The European System of Central Banks: Quo Vadis?*, 21 HOUS. J. INT'L L. 169, 197–98 (1999) ("[T]he independence of central banks is a prerequisite to the achievement of

can lead to higher economic activity and employment in the short term, inflation can work to the short term advantage of governments.[13] Thus, those who answer to an electorate are more likely to encourage inflation because elections occur in the short term. If they do, as a result inflationary pressure creates uncertainty for market participants and discourages investment.[14]

Politicians may also pressure the central bank to alleviate sovereign debt already accrued through a process called "debt monetization."[15] This is a process through which the central bank directly or indirectly purchases sovereign debt, which replaces securities in the market with currency, increases the monetary base and may lead to inflation.[16] This process relieves the government of debt in two ways: first, all payments it makes to the central bank for its debt are then circulated back to the government, and second, inflation reduces the real value of the sovereign debt.[17] Therefore, debt monetization also allows politicians to spend without incurring the pushback from direct taxation, or it may act as an escape valve if the country is threatening default.[18]

A. CENTRAL BANK INDEPENDENCE

Central bank independence is divided into three categories: political, personal and financial.[19] A direct and unequivocal prohibition of anyone influencing the ECB's decisions ensures its political independence.[20] Personal and financial

stable prices.").

13. *See* Mishkin, *supra* note 6, at 577-81.

14. *See id.*, at 388–89, 577–81.

15. *See id.*, at 364–66, 568–76, 581–83.

16. *Id. See also* HOWARTH & LOEDEL, *supra* note 12, at 133. Even if debt monetization should be viewed relative to inflation expectations, *see* Daniel L. Thornton, *Monetizing the Debt*, 14 ECONOMIC SYNOPSES 1, FEDERAL RESERVE BANK OF ST. LOUIS (2010) *available at* http://research.stlouisfed.org/publications/es/10/ES1014.pdf, this is still the process through which a central bank would finance government spending.

17. *See* Thornton, *supra* note 16.

18. *See* Narayana Kocherlakota, President, Federal Reserve Bank of Minneapolis, Remarks on Central Bank Independence and Sovereign Default at the Sovereign Debt Seminar (Sept. 26, 2011) *available at* http://www.minneapolisfed.org/news_events/pres/kocherlakota_speech_Sept-26-2011.pdf.

19. *E.g.*, HOWARTH & LOEDEL, *supra* note 12, at 128–36. The terminology for categorizing elements of independence varies. *E.g.*, Deller, *supra* note 12, at 201–02 (referring to political independence as "institutional independence").

20. *See* TFEU art. 130.

independence act to reinforce political independence by preventing politicians from removing officials or withholding funding in reaction to an unpopular decision by the central bank.[21] Long tenures and removability only for cause protect ECB officials' personal independence.[22] Though Member States initially capitalized the ECB with five billion euros, it now operates off the revenue provided by its monetary operations which preserves the ECB's financial independence.[23]

Another aspect of financial independence is how easily governments can force central banks to monetize their debt.[24] Generally, the more restrictive governments' access to central bank credit is, the more independent central banks are.[25] For instance, there may be legal restrictions on the amount of debt that the central bank may purchase, the maturity of the debt, whether the debt is collateralized, the interest rate paid relative to market rates, whether the central bank is allowed to purchase sovereign debt on the primary market or the reasons for which the central bank can purchase debt.[26] Ideally, an independent central bank should not be allowed to purchase government bonds because a central bank "can easily bypass the prohibition on deficit financing" by purchasing government

21. *See* HOWARTH & LOEDEL, *supra* note 12, at 130–32, n. 89; Deller, *supra* note 12, at 202–06.

22. The Executive Board Members' terms are eight years, TFEU art. 283(2), and national central bank governors will have at least five year terms, HOWARTH & LOEDEL, *supra* note 12, at 131. In addition, an Executive Board member may only be excused if they are no longer able to fulfill their duties or if they have been found guilty of serious misconduct. ECB Statute art. 11(4).

23. ECB Statute art. 28(1); *Capital Subscription*, European Central Bank, http://www.ecb.int/ecb/orga/capital/html/index.en.html (last updated Dec. 28, 2011).

24. HOWARTH & LOEDEL, supra note 12, at 133. These types of limitations have been called "the most relevant of institutional guarantees of central bank independence." ANAND CHANDAVARKAR, CENTRAL BANKING IN DEVELOPING COUNTRIES 227 (1996). *See also supra* notes 13–16 and accompanying text.

25. *See* Alex Cukierman, Seven B. Webb & Bilin Neyapti, *Measuring the Independence of Central Banks and Its Effect on Policy Outcomes*, 6 WORLD BANK ECON. REV. 353, 357 (1992).

26. *See, e.g.*, John W. Head, *Lessons from the Asian Financial Crisis: The Role of the IMF and the United States*, 7 KAN. J.L. & PUB. POL'Y 70, 86–87 (1998); Cukierman, Webb & Neyapti, *supra* note 25, at 359 (providing metrics based on different levels of restrictions to each of these criteria); Robert Sparve, *Central Bank Independence Under European Union and Other International Standards*, *in* LEGAL ASPECTS OF THE EUROPEAN SYSTEM OF CENTRAL BANKS 269, 279–80 (2005) (noting the ECB electing not to use the IMF's recommendation of prohibiting quasi-fiscal activities).

bonds on the secondary markets.[27] However, purchasing sovereign debt or using sovereign debt as collateral, which may result in the debt being acquired by a central bank, is often necessary to implement monetary policy and is largely seen as unproblematic as long as quasi-fiscal operations are prohibited.[28]

Article 123 of the TFEU creates the clearest barrier to debt monetization for the ECB:

> Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States *shall be prohibited*, *as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments*.[29]

The TFEU clearly prohibits the direct purchase of Member States' sovereign debt by the ECB,[30] but it is silent as to when the ECB may purchase that debt from the secondary markets.

The Treaty likely only prohibits direct purchase of Member State debt because the ECB may need to hold that debt in order to implement monetary policy. The ECB primarily uses open market operations to implement monetary policy.[31] Through

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27. PETER BOFINGER, MONETARY POLICY: GOALS, INSTITUTIONS, STRATEGIES, AND INSTRUMENTS 214–15 (2001). *See also* HOWARTH & LOEDEL, *supra* note 12, at 133.

28. *See The Eurosystem's Instruments: Open Market Operations*, EUROPEAN CENTRAL BANK (last visited Nov. 12, 2012), http://www.ecb.int/mopo/implement/intro/html/index.en.html#operations (describing the open market operations of the ECB, which include refinancing operations – for which collateral must be pledged – and fine tuning operations – for which the ECB may directly purchase sovereign debt from the secondary market; open market operations are aimed at manipulating the money supply, i.e. implementing monetary policy). Prohibiting quasi-fiscal activities can be prohibited by explicitly limiting what actions the central bank may take. *See* Tonny Lybek, *Central Bank Autonomy, Accountability and Governance: Conceptual Framework*, INT'L MONETARY FUND 7 (Aug. 18, 2004), http://www.imf.org/external/np/leg/sem/2004/cdmfl/eng/lybek.pdf.

29. TFEU art. 123 (emphasis added).

30. *Id.*

31. ECB Statute art. 18; FRANCOIS NAUDIN, THE EUROPEAN CENTRAL BANK: A BANK FOR THE 21ST CENTURY 187–90 (2000).

these operations the ECB engages with banks to buy, sell, lend and borrow claims and marketable instruments.[32] When the ECB extends credit to banks, the banks must provide "adequate collateral."[33] Because the ECB has stringent criteria for what constitutes "adequate collateral," few marketable instruments qualify.[34] Of these, "the best available tier one asset is local sovereign debt."[35] In addition, the ECB through "fine tuning operations" buys and sells outright marketable instruments including sovereign debt.[36] Therefore, by engaging in these operations the ECB may acquire sovereign debt through default or purchase.

B. ECONOMIC RESTRAINTS FOR EUROPEAN COUNTRIES

The Member States exclusively determine the economic policies of the EU with guidance from the Treaties between the Members.[37] Member States, however, foresaw that irresponsible economic policies of individual Member States could have implications for the whole EU. For example, if a Member State accrues too much debt and threatens to default, other Member States or an EU institution, such as the ECB, may need to rescue that Member State in order to preserve stability in the EU.[38] To avoid such a situation, the TEU dictates that "Member States shall avoid excessive government deficits."[39] The Member States empowered the European Commission to monitor the development of the budgetary situation in each Member State.[40] Protocol No. 12, annexed to

32. ECB Statute art. 18(1).

33. *Id.*

34. *See* NAUDIN, *supra* note 31, at 192–94. The categories of eligible market assets, as laid out by the ECB, include: central government securities, regional government securities, uncovered bank bonds, covered bank bonds, corporate bonds, asset backed securities and other marketable securities. EUROPEAN CENTRAL BANK, COLLATERAL DATA (Oct. 9, 2012), *available at* http://www.ecb.int/paym/pdf/collateral/collateral_data.pdf?8b7bd994d87f09679e7665319d2e8ea5. *See generally*, *Collateral*, EUROPEAN CENTRAL BANK (last visited Nov. 12, 2012), http://www.ecb.int/paym/coll/html/index.en.html.

35. *See* NAUDIN, *supra* note 31, at 194.

36. *The Eurosystem's Instruments: Open Market Operations*, *supra* note **Error! Bookmark not defined.**.

37. TFEU art. 120.

38. For example, the ECB could monetize that country's debt. *See* HOWARTH & LOEDEL, *supra* note 12, at 133; Kocherlakota, supra note 18. *See also supra* notes 15–18 and accompanying text.

39. TFEU art. 126(1).

40. TFEU art. 126(2).

the TEU, limits public debts and deficits to 60% of GDP and an annual rate of 3% of GDP respectively.[41] To give these provisions teeth, the EU implemented the Stability and Growth Pact (the "SPG").[42] The SPG is made up of a preventative arm, which requires Members States to report their fiscal outlook to the EU,[43] and a dissuasive arm, which gives the EU the ability to warn and sanction non-compliant Member States.[44]

The Treaty and the SGP, however, failed to keep the Member States' fiscal houses in order. Facing sluggish growth and excessive deficits,[45] the Member States elected to amend the SGP rather than comply by its provisions.[46] The ECB voiced concern that the SGP's new impotence would "undermine confidence in the fiscal framework of the European Union ("EU") and the sustainability of public finances in the euro area Member States," as well as the price stability of the EU.[47] Nonetheless, the ECB's warnings to Member States went largely unheeded, and the Member States amended the SGP so that it would have little power to constrain the Member States.[48]

41. Protocol (No 12) on the Excessive Deficit Procedure, Mar. 30, 2010, 2010 O.J. (C 83) 279.

42. Resolution of the European Council on the Stability and Growth Pact, 17 June, 1997, 1997 O.J. (C 236) 1 (EC).

43. *See* Council Regulation 1466/97 of 7 July 1997 on the Strengthening of the Surveillance of Budgetary Positions and the Surveillance and Coordination of Economic Policies, 1997 O.J. (L 209) 1 (EC).

44. *See* Council Regulation 1467/97 of 7 July 1997 on Speeding Up and Clarifying the Implementation of the Excessive Debt Procedure, art. 2, 1997 O.J. (L 209) 6 (EC). If the EU decided to sanction a Member State, the Member State will be required to deposit a sum, ranging from 0.2% to 0.5% of its GDP with the ECB, and if the its deficit was not reduced, the deposit woud be forfeited. *Id.*, at arts. 11–16; KALTENTHALER, *supra* note 11, at 98.

45. *See* KALTENTHALER, *supra* note 11, at 98–99. *Compare Real GDP Growth Rate*, EUROSTAT, - http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00115 (last updated Nov. 10, 2012), *with Government Deficit/Surplus, Debt and Associated Data*, EUROSTAT, http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=gov_dd_edpt1&lang=en (last updated Oct. 26, 2012).

46. KALTENTHALER, *supra* note 11, at 101–02.

47. Press Release, European Cent. Bank, Statement of the Governing Council on the ECOFIN Council's Report on Improving the Implementation of the Stability and Growth Pact (Mar. 21, 2005), *available at* http://www.ecb.int/press/pr/date/2005/html/pr050321.en.html; KALTENTHALER, *supra* note 11, at 99.

48. KALTENTHALER, *supra* note 11, at 99.

C. SOVEREIGN DEBT CRISIS

The EU, like much of the world, suffered through a deep recession starting in 2008.[49] While the entire EU was still working to regain traction, Greece in early 2010 revealed that the size of their deficit was much larger than it had previously disclosed.[50] This disclosure, combined with Greece's already substantial debt, led market participants to question Greece's ability to repay their debt. As a result, yields on Greek bonds began to rise precipitously in April 2010.[51] Investors' fears also led to increased yields on government bonds from countries that either had very high debt levels and a weak recovery, such as Portugal, or had been particularly ravaged by the recession, such as Spain and Ireland.[52] Indeed, in the summer of 2011, the yields on both Spain and Italy's bonds rose dramatically as investors began to fear they would not be able to pay their debts.[53]

For governments already struggling to accelerate their economies and collect tax revenue, raising bond yields posed another burden: in order to continue borrowing from lenders, these countries had to pay a risk premium of higher interest rates on the debt.[54] However, increasing interest rates to compensate for investors' fear of default actually increases the likelihood of default.[55] If it costs a country more to borrow

49. *See Real GDP Growth Rate*, *supra* note 45.

50. *Times Topics: European Debt Crisis*, N.Y. TIMES, http://topics.nytimes.com/top/reference/timestopics/subjects/e/european_sovereign_debt_crisis/index.html (last updated Sept. 19, 2012).

51. *See id.*; *Greece Govt. Bond 10 Year Acting as Benchmark*, BLOOMBERG, http://www.bloomberg.com/quote/GGGB10YR:IND/chart (last updated Sept. 21, 2012).

52. *Times Topics: European Debt Crisis*, *supra* note 50; *see also Portuguese Government Bond 10YR Note Portugal PL*, BLOOMBERG, http://www.bloomberg.com/quote/GSPT10YR:IND/chart (last updated Sept. 21, 2012); *Spanish Government Generic Bonds - 10YR Note*, BLOOMBERG, http://www.bloomberg.com/quote/GSPG10YR:IND/chart (last visited Sept. 21, 2012); *Ireland Government Bonds 10 Year Note Generic Bid Yield*, BLOOMBERG, http://www.bloomberg.com/quote/GIGB10YR:IND/chart (last updated Oct. 11, 2011) (demonstrating the increased bond yields in these countries).

53. *Times Topics: European Debt Crisis*, *supra* note 50; *see also Italy Govt Bonds 10 Year Gross Yield*, BLOOMBERG, http://www.bloomberg.com/quote/GBTPGR10:IND/chart (last updated Sept. 21, 2012); *Spanish Government Generic Bonds - 10YR Note*, *supra* note 52.

54. *See* Derek Thompson, *What is the 'Contagion Effect'?*, THE ATLANTIC (May 18, 2010, 9:35 AM), http://www.theatlantic.com/business/archive/2010/05/what-is-the-contagion-effect/56858/.

55. *Id.*

money, it is more likely that the country will not be able to borrow enough to meet their current liabilities. The potential contagion in other countries compounded the crisis, and a series of defaults threatened to bring the EU to its knees in early 2010.[56]

D. European Response to the Sovereign Debt Crisis

In order to quell market fears and prevent defaults, the IMF and European Member States created a financial safety net for Greece which Greece then tapped into in late April 2010.[57] In addition, the leaders of the Member States agreed to create the European Financial Stability Facility ("EFSF") on May 9, 2010.[58] The purpose of the EFSF is "to preserve financial stability of Europe's monetary union by providing temporary financial assistance to euro area Member States if needed." Member States committed €780 billion to the EFSF.[59]

In conjunction with the creation of the EFSF, on May 10, 2010 the ECB acted to stabilize financial markets by launching the Securities Market Programme (the "SMP").[60] The SMP allowed the ECB to purchase sovereign debt from public and private securities markets in order to drive down interest rates to provide depth and liquidity to those markets.[61] In addition to providing liquidity to government bond markets, the ECB also 'sterilized' its purchases by absorbing an amount of liquidity from the economy which was equal to the amount of government bonds purchased.[62]

56. "Contagion" refers to the investor paranoia that if one country defaults on their debt promises, more countries will. *Id.*

57. *Timeline: Euro Zone Debt Crisis*, REUTERS (June 10, 2010, 10:24 AM), http://www.reuters.com/article/2010/06/10/us-eurozone-events-idUSTRE6593G320100610.

58. Council Regulation (EU) No 407/2010 of 11 May 2010, Establishing a European Financial Stabilisation Mechanism, 2010 O.J. (L 118) 1; *About EFSF*, EUROPEAN FINANCIAL STABILITY FUND, http://www.efsf.europa.eu/about/index.htm (last visited Oct. 11, 2011). The lending capacity of the EFSF is currently €440 billion.

59. *Frequently Asked Questions*, EUROPEAN FINANCIAL STABILITY FUNDFUNDFACILITY, 1 (Sept. 10, 2012), http://www.efsf.europa.eu/attachments/faq_en.pdf.

60. *The ECB's Response to the Financial Crisis*, ECB MONTHLY BULL. 59, 72 (Oct. 2010) [hereinafter *The ECB's Response to the Financial Crisis*].

61. *Id.*

62. The ECB sterilizes by opening seven day deposits to banks. *See The ECB's Response to the Financial Crisis*, *supra* note 60, at 73. *See also* Complete data set of *History of All ECB Open Market Operations*, EUROPEAN CENT. BANK, http://www.ecb.int/mopo/implement/omo/html/

The SMP led the targeted government bond yields to drop, temporarily abating tensions.[63] During the course of the SMP, the ECB has purchased bonds from Greece, Italy, Portugal, Spain and Ireland in order to curb rising yields on those countries' bonds.[64] As of August 20, 2012, the ECB has purchased €211.5 billion under the SMP.[65] During the lifetime of the SMP, there has been speculation from market participants that the ECB will continue to act as long as markets exert pressure.[66]

Member States have also signed two new treaties in order for the EU to be better equipped to deal with such crises: the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union ("Treaty on Stability")[67] and the Treaty Establishing the European Stability Mechanism ("Treaty Establishing ESM").[68] The Treaty on Stability reinvigorates the fiscal oversight of Member States and again gives the EU the ability to levy sanctions against delinquent Member States.[69] The Treaty Establishing ESM creates a permanent rescue fund to replace EFSF and acts as a lender of

top_history.en.html (last visited Oct. 29, 2011); *Summary of Ad Hoc Communication*, EUROPEAN CENT. BANK, http://www.ecb.eu/mopo/implement/omo/html/communication.en.html (last visited Oct. 29, 2011).

63. *The ECB's Response to the Financial Crisis*, *supra* note 60, at 73.

64. Paul Carrel, *ECB Says Will "Actively Implement" Bond-Buying*, REUTERS (Aug. 7, 2011, 5:53 PM), http://www.reuters.com/article/2011/08/07/us-crisis-ecb-idUSTRE7762PE20110807. *See also, e.g.*, *Greece Govt Bond 10 Year Acting as Benchmark, supra* note 51; *Ireland Government Bonds 10 Year Note Generic Bid Yield*, *supra* note 52 (depicting the rising bond yields in Greece and Ireland in chart form).

65. *See ECB Eurosystem Securities Market Program*, BLOOMBERG, http://www.bloomberg.com/quote/ECBCSMP:IND/chart (last updated Sept. 14, 2012).

66. *See* Jack Ewing & Raphael Minder, *Stocks Surge as a Fed Statement Sinks In: Central Bank Props Up Spain and Italy, for Now*, N.Y. TIMES, Aug. 10, 2011, at B.1 ("They will do whatever it takes because they will be forced to . . . .").

67. Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, Mar. 2, 2012, *available at* http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf [hereinafter Treaty on Stability].

68. Treaty Establishing the European Stability Mechanism, Feb. 1, 2012, No. D/12/3, *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=DOC/12/3&type=HTML [hereinafter Treaty Establishing ESM].

69. *See, e.g.*, Treaty on Stability, *supra* note 67, art. 8(2).

last resort to distressed Member States.[70]

A combination of efforts from the European Governments, the IMF and the ECB has prevented any outright defaults by European governments or meltdowns in the European markets. There is little doubt that such actions helped to stave off the pain that would have resulted from a disorderly breakdown of European public finances. Furthermore, the ECB has vigorously defended the legality of the SMP. Yet there has been a growing dissent that the ECB, while helping save the markets in the short term, has overstepped the boundaries of its power and engaged in debt monetization. This, critics argue, has also undercut price stability and the independence upon which the ECB and the European economies depend.

II. LEGALITY AND IMPLICATIONS OF THE SMP

The SMP had the effect of driving down yields in the markets for select government bonds.[71] Lower bond yields have both fiscal and monetary implications. A fiscal implication is that those governments are able to borrow money at a lower interest rate.[72] This has aided those governments in staying solvent. A monetary implication is that those government bond markets moved more freely which enabled the ECB to use those markets to implement its monetary policy effectively.[73] The ECB's motivation in implementing the SMP will therefore

70. *See generally* Treaty Establishing ESM, *supra* 68, art. 23–24 (outlining the dividend policy and establishment of a reserve fund).

71. *The ECB's Response to the Financial Crisis*, *supra* note 60, at 72.

72. *See supra* notes 51–64 and accompanying text.

73. The ECB, as the sole issuer of Euros, determines the short term interest rate for the European money market through its open market operations, standing facilities, and minimum reserve requirements for credit institutions. *See* Jean-Claude Trichet, President, European Cent. Bank, Speech at the 38th Economic Conference of the Oesterreichische Nationalbank: The ECB's Response to the Recent Tensions in Financial Markets (May 31, 2010), http://www.ecb.int/press/key/date/2010/html/sp100531_2.en.html [hereinafter The ECB's Response to the Recent Tensions]. The ECB then relies on functioning credit markets to affect the cost of credit for consumers, the amount of economic activity and, thus, price levels. *Id. See generally The Implementation of Monetary Policy in the Euro Area*, EUROPEAN CENT. BANK, Feb. 2011, at 5, 9–13, *available at* http://www.ecb.europa.eu/pub/pdf/other/gendoc2011en.pdf (presenting the operational framework for the Eurosystem's monetary policies and procedures); *Transmission Mechanism of Monetary Policy*, EUROPEAN CENT. BANK, http://www.ecb.europa.eu/mopo/intro/transmission/html/index.en.html (last visited Oct. 29, 2011) (depicting a flow chart demonstrating the process through which monetary policy decisions affect the economy).

largely depend on which results it has been trying to effectuate and which results were simply ancillary.

For legal observers therein lies the problem: depending on which motivations and outcomes the ECB intended in implementing the SMP, its actions are more or less legally dubious. The ECB was explicitly created to determine and implement monetary policy in order to maintain price stability.[74] At the same time, Member States are to determine and implement economic, or fiscal, policies.[75] It is true that the Member States opted not to ban the ECB specifically from engaging in fiscal activities[76] and that the ECB may support the "general economic policies in the Union" if it does not threaten price stability.[77] However, the structural separation of monetary and fiscal responsibilities in the TEU[78] and the ECB's insistence that it acts solely for monetary reasons[79] are strong indicators that the ECB may not act for fiscal reasons. If so, the ECB may have overstepped the powers the Member States ceded to it and violated the TEU.

A. THE SMP AS MONETARY POLICY

The ECB has insisted that the SMP is a tool of monetary policy on three grounds: first, it complies with the letter of the Treaty, second, it is necessary to implement monetary policy, and third, the ECB has continued to maintain price stability.[80]

74. TFEU art. 127(1)–(2).

75. *Id.*, art. 120 ("Member States shall conduct their economic policies").

76. This would have provided a clearer boundary. *See* Lybek, *supra* note 28, at 7 ("The potential for quasi-fiscal activities should be eliminated in the central bank law, which can be done by explicitly prohibiting activities that are not provided for under the act . . . .").

77. TFEU art. 127. Therefore, while not entirely banned from engaging in such activities, the ECB is significantly limited in its ability to support governments in a direct or individualized way.

78. *See id.*, art. 120–26 (economic policy) and *id.* art. 127–33 (monetary policy). *See also* TFEU art. 127 ("The primary objective of the European System of Central Banks (hereinafter referred to as 'the ESCB') shall be to maintain price stability. *Without prejudice to the objective of price stability*, the ESCB shall support the general economic policies in the Union . . . .") (emphasis added).

79. *See* Trichet *supra*, note 9 ("We have one needle in our compass, which is price stability.").

80. *See, e.g.*, Jürgen Stark, Member of Exec. Bd., European Cent. Bank, IMFS Distinguished Lecture: Central Banking after the Financial Crisis (Feb. 21, 2011), http://www.ecb.int/press/key/date/2011/html/sp110221.en.html [hereinafter Central Banking after the Financial Crisis]; The ECB's Response to the Recent Tensions, *supra* note 73.

In addition, some members point to the ECB's restraint in the size and duration of the SMP to demonstrate its monetary purposes.[81]

i. The Treaty's Text

The ECB primarily exists to maintain price stability.[82] The ECB is charged with "defin[ing] and implement[ing] the monetary policy of the Union,"[83] and the ECB is empowered to make "decisions necessary for carrying out the tasks entrusted . . . under the Treaties . . . ."[84] In order to do this, the ECB under the ECB Statute is able to "operate in the financial markets by buying and selling outright . . . claims and marketable instruments."[85] Except for transactions which the Member States prohibited the ECB from engaging in, such as directly purchasing government bonds,[86] the Member States in the letter of treaties have granted the ECB a great deal of latitude in establishing and implementing monetary policy.

It remains unclear what boundaries exist for the ECB while acting under the auspices of monetary policy. This is in part because "[t]he European Central Bank . . . is loath to acknowledge any limitations on its monetary policy arsenal."[87] Despite this, some ECB officials have publically described the impetus for the SMP and some reasons for its necessity. These reasons, they argue, establish that the SMP is a tool of monetary, not fiscal, policy; if it is a tool of monetary policy, then the SMP is a legitimate tool for the ECB to use.

ii. Necessary for Monetary Policy

In May 2010, the ECB, along with the rest of the world, observed tensions and volatility in the financial markets.[88] The ECB identified the European debt markets, particularly the

81. *See* Central Banking after the Financial Crisis, *supra* note 80.
82. TFEU art. 127(1).
83. *Id.*, art. 127(2).
84. *Id.*, art. 132(1).
85. ECB Statute, *supra* note 1, art. 18(1).
86. TFEU art. 123(1).
87. Ewing & Minder, *supra* note 66.
88. Jean-Claude Trichet, President, European Cent. Bank, Introductory Statement at the Hearing at the Economic and Monetary Affairs Committee of the European Parliament (June 21, 2010), http://www.ecb.int/press/key/date/2010/html/sp100621.en.html [hereinafter Introductory Statement].

sovereign debt markets, as the epicenter of the tension.[89] The ECB saw an increasing risk that the markets would become so impaired by the volatility that the ECB's transmission mechanism for monetary policy would no longer be able to function.[90] Without being able to implement monetary policy, the ECB would not be able to maintain price stability.

Then-President of the ECB, Jean-Claude Trichet, identified three channels for monetary policy which malfunctioning government bond markets were impeding.[91] First, there is the price channel.[92] Because the price of government bonds influences the price of non-government credit, the soaring interest rates on government bonds can raise the price of non-government credit. [93] If the interest rates rise enough because of these risks, it may overwhelm the changes in interest rates that the ECB is trying to establish for purposes of monetary policy.[94] Second, there is the liquidity channel.[95] Government bonds play an important role as collateral in the money market, the point of contact between the ECB and credit institutions.[96] If there is a chance that banks will not be able to trade government bonds, interest rates will increase and trading will slow, which may impede monetary policy transmission.[97] The final channel is the balance sheet channel.[98] If government bonds' yields are higher, then by definition the bonds' prices are lower.[99] With less capital, banks may extend less credit; again, the less money that flows through the financial system, the less effective the transmission of monetary policy.[100]

Because of the importance of government bond markets in these channels, the ECB argues that it would not be able to implement monetary policy or maintain price stability without

89. *Id.*
90. *Id.*
91. The ECB's Response to the Recent Tensions, *supra* note 73.
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.*
97. *See id.*; Introductory Statement., *supra* note 88.
98. The ECB's Response to the Recent Tensions, *supra* note 73.
99. *When Yield Goes Up, Price Goes Down*, YAHOO! FINANCE (last visited Sept. 20, 2012), http://finance.yahoo.com/education/bond/article/101195/When_Yield_Goes_Up_Price_Goes_Down.
100. The ECB's Response to the Recent Tensions, *supra* note 73.

action.[101] Therefore, it is necessary for the ECB to moderate dysfunctional markets with the SMP.[102] Because the ECB's treaty powers are unequivocal about its responsibility to implement monetary policy and maintain price stability[103] and the ECB is allowed to purchase bonds from the secondary market,[104] the ECB argues that it has the legal authority to implement the SMP in order to fulfill its mandate.[105]

The ECB's argument concerning the implementation of monetary polic is compelling in some respects, but ultimately unsatisfying. It is true that if the ECB is going to implement monetary policy, it needs to have functioning mechanisms through which it can transfer its policies into the economy at large. Given the importance of sovereign debt markets, they likely play an important role in this transfer. However, there is scant limiting principle in the ECB's explanation. Seemingly, the ECB is asking for carte blanche to implement new programs provided their justifications are based on ensuring its ability to implement monetary policy. Such wide authority could allow the ECB to act for any reason as long as its nominal reason is monetary policy. If they do act for other reasons, for example to prop up fledgling Member States, the ECB would exceed the power ceded to the ECB by the Member States.

iii. Sterilization and Price Stability

Although the Treaty requires the ECB to define and implement monetary policy, it also requires monetary policy to be oriented toward the ECB's primary mandate: price stability.[106] When the ECB buys sovereign debt with euros, it is injecting money in the economy. When the ECB increases the monetary base, it could cause inflation to rise over the ECB's target, potentially altering its monetary stance and jeopardizing price stability.[107]

The ECB insists that is not engaged in quantitative easing or debt monetization and that price stability maintains it primary focus despite the SMP.[108] This is because the ECB

101. *Id.*
102. *Id.*
103. TFEU art. 127(1)–(2).
104. *See id.*, art. 123; ECB Statute art. 18(1).
105. The ECB's Response to the Recent Tensions, *supra* note 73.
106. TFEU art. 127(1)–(2).
107. *See* The ECB's Response to the Recent Tensions, *supra* note 73.
108. *Id.*

sterilizes every euro it injects into the economy through the SMP by removing euros from the economy in an equal amount.[109] Because sterilization prevents the SMP from increasing the amount of euros in the economy, the ECB's monetary stance as a whole, it argues, remains unaltered.[110] Sterilization also lends credibility to the ECB's commitment to price stability, which critically reassures investors.[111]

Critics of the SMP are skeptical about the effectiveness of the ECB's sterilization because the ECB has also pursued a very accommodating monetary policy throughout the lifespan of the SMP. The ECB has offered unlimited loans through its refinancing operations as another non-standard measure to support liquidity.[112] If a bank deposits money with the ECB, as part of the ECB's sterilization efforts, and then is able to take out a loan the next day from the ECB, critics argue that the sterilization is not effective.[113] If the banks want more credit, and by extension allow an increase in the monetary base, they are free do so.

iv. A Limited, Emergency Measure

Jürgen Stark, formerly of the ECB's executive board,

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109. *See The ECB's Response to the Financial Crisis*, *supra* note 60, at 73. When ECB purchases sovereign debt through the SMP, it increases the amount of euros in the economy. By having banks deposit an equal amount of euros through weekly liquidity absorption operations, the ECB is decreasing the amount of euros in the economy by an equal amount so that the SMP will have a net-neutral effect on the money supply. *See Liquidity Analysis: Monetary Policy Portfolios*, EUROPEAN CENTRAL BANK, http://www.ecb.int/mopo/liq/html/index.en.html (last visited Nov. 12, 2012).

110. *See id.*; The ECB's Response to the Recent Tensions, *supra* note 753.

111. *See* The ECB's Response to the Recent Tensions, *supra* note 73 (explaining how sterilization confirms the ECB's commitment to price stability, and how credibility is essential in maintaining price stability).

112. Ansgar Belke, *Driven the by Markets? ECB Sovereign Bond Purchases and the Securities Market Programme*, Directorate General for Internal Policies, Policy Dept. A: Economic and Scientific Policies, Economic and Monetary Affairs (June 8, 2010), at 7. *See also* Tracy Alloway, *Sterilised and Scandalised*, FT.COM/ALPHAVILLE (May 18, 2010, 8:15 AM), http://ftalphaville.ft.com/blog/2010/05/18/233726/sterilised-and-scandalised/.

113. *Lecture by Markus C. Kerber: The ECB Under Fire*, OPEN EUROPE (Oct. 12, 2011), http://www.openeurope.org.uk/Article/Page/en/LIVE?id=1660 [hereinafter *ECB Under Fire*]. The ECB has also failed to fully sterilize the SMP on several occasions, *see* Jana Randow, *ECB Fails to Sterilize Bond Purchases With Deposits*, BLOOMBERG (Feb. 1, 2011), http://www.bloomberg.com/news/2011-02-01/ecb-fails-to-sterilize-bond-purchases-for-third-time-since-program-began.html, though the infrequency with which this has occurred indicates that it is not a major concern as of now.

focused on defining the SMP as a temporary measure to ensure that the SMP was not being used for fiscal purposes. He insisted that "the ECB has entered a terrain in which it should not stay longer than absolutely necessary" and that the SMP would be phased out as soon as it has resolved the dysfunction of the government bond markets.[114] Stark argued in February 2011 that the temporary nature of the SMP, as well the "clearly limited scope and scale of our outright purchases in securities markets . . . has also mitigated any blurring of monetary and fiscal responsibilities."[115]

Stark subsequently resigned because of the expansion of the SMP in August 2011, [116] indicating that the ECB's prudence and self-restraint may not have been sufficient to contain the SMP. Indeed, other ECB officials, including Trichet, have been reticent to point out specific limitations in duration or size of the SMP.[117] In the three months following reactivation of the SMP in early August 2011, the value of government bonds on the ECB's balance sheet has increased by €100 billion, compared to the €75 billion accumulated in the fifteen preceding months.[118] As a result of such actions, analysts and bank insiders believe that the ECB can legally go as far as it wants in purchasing government bonds.[119]

Professor Marcus Kerber, who filed a lawsuit against the ECB over the SMP in September 2011, echoes the concerns by Stark.[120] Professor Kerber insists that continuing to justify the SMP under the premise of emergency action is disingenuous. He stated that there are no permanent emergencies and that the ECB has in effect assimilated the SMP into its standard monetary policy.[121] Because the ECB has only justified the SMP as an emergency measure, Kerber argues, it is now overstepping what it is legally allowed to do.[122]

114. Central Banking after the Financial Crisis, *supra* note 80.

115. *Id.*

116. Marc Jones, *ECB's Spent 14 bln Euros on Bonds Ahead of Stark Exit*, REUTERS (Sept. 12, 2011), http://www.reuters.com/article/2011/09/12/ecb-bonds-idUSEAP50OC3520110912.

117. *See* The ECB's Response to the Recent Tensions, *supra* note 75 (explaining that the SMP is "time-bound in nature" but not actually specifying a time limit).

118. *ECB Eurosystem Securities Market Program*, *supra* note 65.

119. Ewing & Minder, *supra* note 66.

120. *ECB Under Fire*, *supra* note 113.

121. *Id.*

122. *Id.*

B. THE SMP AS FISCAL POLICY

Critics of the SMP claim the ECB is inappropriately blurring the line between fiscal and monetary policy.[123] Despite the ECB's insistence that the SMP was created only for monetary purposes, it has also had substantial fiscal effects.[124] The TEU was constructed to preserve a very high level of independence for the ECB,[125] and that independence as formulated in the Treaty demands that fiscal and monetary policies should be separate.[126] Structurally, the TFEU demonstrates this by providing separate spheres for the two realms of policy – Member States create fiscal policy and the ECB creates monetary policy[127] If the ECB implemented the SMP for fiscal reasons, it may have exceeded its legal power.

Critics of the SMP have put forward two main arguments that the SMP is in violation of the Treaty on European Union. First, the Treaty's prohibition on purchasing sovereign debt directly from Member States is meant broadly to prohibit debt monetization. As debt can be monetized on the secondary as well as the primary markets, it makes little difference if the ECB buys sovereign debt from the primary or secondary markets if its purpose is debt monetization. Second, there is a great deal of evidence that the motivation for the SMP was primarily to provide support to beleaguered governments; it was a fiscal act.

i. The Purpose of Article 123

Article 123's prohibition on direct government bond purchases by the ECB is not an end unto itself but an effort to restrain central bank support for government spending.[128] Making the prohibition applicable only to purchases of government bonds on the primary market was an imperfect solution to preventing debt monetization because debt

123. *See, e.g.*, Axel Weber, President, Deutsche Bundesbank, Keynote Speech at the Shadow Open Market Committee (SOMC) Symposium: Monetary Policy After the Crisis: A European Perspective (Oct. 12, 2010), *available at* http://www.bis.org/review/r101018a.pdf?frames=0.

124. *See supra* notes 51–64, 73–75 and accompanying text.

125. *See supra* notes 19–36 and accompanying text.

126. *See supra* notes 11–18, 24–28 and accompanying text.

127. *See* TFEU art. 120–26 (economic policy) and art. 127–38.

128. *See generally supra* notes 11–18, 25–36 and accompanying text (discussing how politicians can pressure a central bank to support government spending through debt monetization).

monetization can still occur by purchasing government debt from the secondary market.[129] ECB officials themselves acknowledge that outright purchases of government bonds could be the beginning of debt monetization, even on secondary markets.[130] Although a general prohibition on purchasing any government bonds would have been more effective at preventing debt monetization,[131] such a provision was not practicable because of the need to use sovereign debt in implementing monetary policy.[132]

Former German President Christian Wulff, among others, has suggested that Article 123's prohibition must be understood as a prohibition against debt monetization in a broader sense and not strictly against debt monetization through direct purchases of government bonds.[133] He stated that "this ban only makes sense if those responsible don't circumvent it with comprehensive purchases on the secondary market."[134] This sentiment is in accord with the idea that when independent central banks purchase government bonds from secondary markets, they still should do so exclusively for monetary and not quasi-fiscal purposes.[135]

Acknowledging that it is possible to monetize sovereign debt on secondary markets and that outright purchasing of sovereign debt is the first step to do so, it is therefore possible that the SMP is a program that is monetizing debt. If the Article 123 is understood as a broader prohibition against debt monetization, the ECB would therefore be in violation of the Treaty.

ii. Fiscal Motivation

There is no smoking gun from ECB officials that demonstrates that the SMP was created for fiscal reasons. In fact ECB officials have consistently couched the SMP in terms of monetary policy.[136] However, the way in which the ECB used

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129. *See* Bofinger, *supra* note 27.

130. Stark, *supra* 82 ("[O]utright purchases of government debt . . . might be perceived as a first step towards a monetisation of government debt.").

131. *See supra* text accompanying notes 24–28.

132. *See supra* text accompanying notes 31–36.

133. Paul Carrel, *German President Questions Legality of ECB Bond Buys*, REUTERS (Aug. 24, 2011), http://www.reuters.com/article/2011/08/24/ecb-germany-bonds-idUSL5E7JO15720110824.

134. *Id.*

135. *See* Lybek, *supra* note 28, at 7.

136. *See* The ECB's Response to the Recent Tensions, *supra* note 73

the SMP in conjunction with fiscal events and institutions indicates that the ECB acted for fiscal reasons.

Professor Kreber described the SMP as fiscal policy, specifically as it applied to Italy.[137] Kreber offered two pieces of evidence for this: the communication between Trichet and Italian Prime Minister Berlusconi and the sheer amount of support given to Italy through the SMP.[138] The communication was a letter sent by Trichet and then-ECB Governing Council Member, now-ECB President, Mario Draghi to the Italian Prime Minister.[139] In the letter, the ECB outlined fiscal steps that it viewed as essential for Italy.[140] The Italian government's compliance with the ECB's demands resulted in the ECB reactivating the SMP on a very large scale to relieve the market pressure on the Italian bond market.[141] In other words, Kreber argues, the ECB threatened to discontinue giving the Italian bond market buoyancy in order to force Italy to comply with its demands for specific fiscal measures.[142] This cause-and-effect relationship between fiscal policy and the SMP demonstrates that the SMP was implemented for fiscal reasons.[143] In addition, the ECB's use of the SMP as a carrot for Italian budgetary reform represents an indirect but real foray by the ECB into establishing a Member State's fiscal policy.[144]

The relationship between the EFSF and the SMP also suggests the SMP has fiscal motivations. ECB officials have characterized the SMP as a "bridge" until the EFSF has more financial ability to intervene.[145] Yet, the EFSF was set up

("However, we have not gone beyond the goal of re-establishing a more correct transmission of our monetary policy. We have not changed our monetary policy stance . . .").

137. ECB Under Fire, *supra* note 113, at (11:33).

138. *Id.* at (14 :20).

139. *Id.* at (11 :52).

140. Mario Draghi & Jean-Claude Trichet, *Trichet e Graghi: Un'azione Pressante Per Ristabilire la Fiducia Degli Investitori*, ECONOMIA (Sept. 29, 2011), http://www.corriere.it/economia/11_settembre_29/trichet_draghi_inglese_304a5f1e-ea59-11e0-ae06-4da866778017.shtml.

141. *See* ECB Under Fire, *supra* 113.

142. *See id.* at (12:00).

143. See id. at (14:20).

144. *See id* at (12:00).

145. *Weidmann Warns of the Consequences of Soft Restructuring in Greece*, EUROINTELLIGENCE (May 26, 2011), http://www.eurointelligence.com/eurointelligence-news/archive/single-view/article/eu-commissioner-becomes-first-official-to-warn-about-greek-exit-from-the-eurozone.html ("The eurosystem has acted in a phase when the fiscal

explicitly "to safeguard financial stability in Europe by providing financial assistance to euro area Member States."[146] The SMP and the EFSF are both used to purchase bonds in tumultuous sovereign debt markets, but only the EFSF can purchase sovereign debt on the primary market.[147] However, the difference between primary and secondary market purchases matters little in practical terms in distinguishing between fiscal and monetary motivations because either may be used to implement fiscal policy.[148] Because the EFSF is used to save Member States and the SMP and the EFSF work in very similar ways, the SMP is also likely a creature of fiscal policy.

Given the similarities between the SMP and the EFSF, the ECB's insistence that it is not legally able to support the EFSF indicates the SMP may have been improper. For example, the French government among others suggested that the EFSF attain a banking license so that it could borrow money from the ECB.[149] However, this suggestion was rejected both by Germany and the ECB.[150] The Bundesbank President, Jens Weidmann, rejected the idea specifically because such lending would have amounted to monetary state financing.[151] Trichet agreed that ECB leveraging of the EFSF would be 'inappropriate.'[152] Given the similarities between the SMP and

policy was unable to act. By doing so it built a bridge."); *see* Valentina Za, *ECB Should Stop Bond Buys Once EFSF Bolstered-Constancio*, REUTERS (Oct. 10, 2011), http://www.reuters.com/article/2011/10/10/ecb-bonds-constancio-idUSL5E7LA15W20111010.

146. *About EFSF, supra* note 58.

147. The ECB's Response to the Recent Tensions, *supra* note 75; *About EFSF, supra* note 58.

148. Jack Ewing, *Lending a Hand to Banks, but Not to Nations*, N.Y. TIMES (Nov. 14, 2011), *available at* http://www.nytimes.com/2011/11/15/business/global/as-european-nations-teeter-only-lenders-get-central-banks-help.html?_r=3&pagewanted=1&hp.

149. Mark Deen & Gabi Thesing, *Baroin Says ECB Role Bolstering EFSF Remains 'Best Solution'*, BLOOMBERG BUSINESSWEEK (Oct. 19, 2011), http://www.businessweek.com/news/2011-10-19/baroin-says-ecb-role-bolstering-efsf-remains-best-solution-.html.

150. Annika Breidthardt & Luke Baker, *Options Left for Leveraging EFSF Do Not Involve ECB*, REUTERS (Oct. 21, 2011), http://www.reuters.com/article/2011/10/21/us-eurozone-efsf-leverage-idUSTRE79K64820111021.

151. Eva Kuehnen & Annika Breidthardt, *ECB Should Stay out of EFSF Leveraging: Buba Chief*, REUTERS (Sept. 17, 2011), http://www.reuters.com/article/2011/09/17/us-ecb-leveraging-idUSTRE78G17B20110917.

152. Jeff Black & Jana Randow, *Trichet Says Not 'Appropriate' for ECB to*

the EFSF, it is hard to explain why the ECB's involvement in the EFSF is inappropriate while implementation of the SMP is not.

III. THE ECB AT A CROSSROADS

Now that the European Union has moved beyond the most acute dangers of the debt crisis, the European Union needs to ensure that such an event does not occur again. The debt crisis was a fiscal event; Member States borrowed to a point where investors doubted their ability to repay their debts.[153] This doubtraised interest rates on government borrowing and threatened government defaults which in turn necessitated action by the ECB.[154]

The ECB's response to the sovereign debt crisis was necessary to prevent a meltdown of the European economy.[155] When the crisis erupted in early 2010, no European entity could shoulder the burden of unsound government spending with as much credibility or speed as the ECB.[156] Without the SMP to quell market fears, widespread default by major European governments was a real possibility.[157]

Now the ECB is at a point where it needs to define its role in future crises. As one ECB official stated, "[I]f a central bank comes under pressure in times of crisis, and succumbs to that pressure, it is very unlikely to exit from such extraordinary measures in a timely manner. This may unanchor inflation expectations . . . ."[158] Not only may the ECB not exit its crisis measures in a timely manner, but by acting to prevent the fiscal collapse of Members States, it has signaled to Member States that it will act if needed. The knowledge that the ECB will and can act to drive down bond yields of targeted countries significantly weakens each Member State's incentive to follow a prudent fiscal course. If the market demands too high a risk premium from a Member State, the ECB will counter. So, given

Leverage EFSF, BLOOMBERG (Oct. 6, 2011), http://www.bloomberg.com/news/2011-10-06/trichet-says-financial-market-tensions-may-slow-expansion.html.

153. *See* Thompson, *supra* note 54.

154. *Id.*

155. *See supra* notes 49–68 and accompanying text.

156. *See supra* notes 49–68 and accompanying text.

157. *See supra* notes 49–68, 151–153 and accompanying text.

158. Jürgen Stark, Mem. ECB Exec. Bd., European Central Bank, Speech at the 13th Annual Emerging Markets Conference 2011: The Global Financial Crisis and the Role of Monetary Policy (Sept. 24, 2011).

the ECB's *willingness* to act, it is necessary to examine whether the ECB's *ability* to act should be modified.

This Note identifies three possible ways forward. First, the ECB could continue to muddle along, skirting the line between monetary and fiscal policy. Second, the Member States could eschew the strict division between monetary and fiscal policy by revising the ECB's mandate allowing the ECB to concern itself equally with both price stability and economic growth. This legitimizes tools such as the SMP to some extent. Finally, the solution endorsed by this Note: the ECB's ability to intervene in government debt markets could be limited so as to adhere more strictly to the principles laid down in the TFEU.

A. THE MEMBER STATES' CURRENT FISCAL CONTEXT

Changes have been put in place in order to prevent another crisis. Two major breakdowns in the European Monetary Union allowed the debt crisis to occur. First, the oversight system of the SGP and "peer pressure" from other Member States failed to force other Member States to keep sound public finances.[159] Second, bond market participants failed to demand sufficiently varying risk premia from euro zone countries based on an assessment of each country's financial situation.[160] With pressure from other Member States and the markets failing to materialize, some Member States did not implement structural change, accumulated large debts and their potential defaults threatened the European financial system.

After the debt crisis, pressure on Member States to take a prudent approach to their finances has ratcheted up. Member States reinvigorated the SGP to give oversight of each other's finances more teeth.[161] Member States signed the Treaty on Stability which allowed stiffer penalties for excessive debts or

159. Peter Praet, Mem. ECB Exec. Bd., Lecture at the International Center for Monetary and Banking Studies: Monetary Policy at Crisis Times (Feb. 20, 2012), *available at* http://www.ecb.europa.eu/press/key/date/2012/html/sp120220.en.html.

160. *Id.*

161. *See* Council Directive 2011/85/EU of 8 November 2011 on Requirements for Budgetary Frameworks on the Member State, 2011 O.J. (L 306) 41; Regulation 1175/2011 of the European Parliament and of the Council of 16 November 2011, 2011 O.J. (L 306) 12 (EU); Regulation 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the Effective Enforcement of Budgetary Surveillance in the Euro Area, 2011 O.J. (L306) 1 (EU); Council Regulation 1177/2011of 8 November 2011, 2011 O.J. (L306) 33 (EU).

deficits.[162] Markets now discriminate more dramatically between bonds from different Member States.[163] Provided that neither Member States nor markets become lax in exerting pressure, such actions should provide a solid basis to prevent another crisis. In the case that these actions are not enough, Member States have assigned the Treaty Establishing ESM to take over the EFSF's function as lender of last resort permanently, as a "firewall" to ensure all Member States remain solvent.[164]

B. Option One: The Status Quo

The ECB could continue to implement the SMP on an ad hoc basis as it has done since the beginning of the crisis. Such an approach has proven to prevent default and contagion by giving the ECB some latitude to reassure markets that it will act when needed.[165] It also allows the ECB nominally to remain faithful to its mandate of price stability by insisting that the SMP is a temporary, emergency measure to ensure it is able to implement monetary policy and provide price stability.[166] This approach relies on the prudence of the ECB and does not require any revision of its powers or responsibilities.

The status quo, however, is not the preferred choice because it perpetuates the ambiguous nature of the ECB's role in times of crisis. While such a course would effectively split the baby between the proponents and opponents of the SMP, it is an answer that is satisfactory for neither. Instead, as the SMP has exemplified, such a path does not provide sufficient reassurance for markets or confidence in the ECB's commitment to price stability.

On the one hand, the SMP appears to have compromised the ECB's commitment to price stability because it was likely implemented in order to prevent Member States' defaults. The ECB's ability to preserve price stability depends crucially on its independence.[167] Its independence, in turn, depends on Member

162. *See* Treaty on Stability art. 8.

163. *Compare Greece Govt. Bond 10 Year Acting as Benchmark, supra* note 51, *with German Government Bonds 10 Yr Dbr*, BLOOMBERG (last visited Mar. 22, 2012), http://www.bloomberg.com/quote/GDBR10:IND/chart.

164. Treaty Establishing ESM art. 39–40.

165. *See* Thompson, *supra* note 54.

166. Ewing & Minder, *supra* note 66.

167. *See supra* notes 11–18 and accompanying text.

States not being able to force the ECB to take action.[168] This includes Member States not being able to force the ECB to purchase government bonds because of potential insolvency.[169] When the ECB acted to preserve Member States from defaulting, it acted in response to political decisions by those Member States, undermining its independence and potentially its price stability.

On the other hand, the SMP was likely less effective than it could have been in easing tensions in the short-term.[170] With prominent critics, such as the Bundesbank, voicing concerns over the SMP's legality, some investors were skeptical that the ECB would deploy its limitless balance sheet and fully act as a backstop to Member States threatened with default.[171] As a consequence, investors demanded higher risk premia than they may have if there were no doubt that the ECB would purchase unlimited amounts of bonds.[172] While providing some buoyancy, the status quo has not prevented as much nervousness as an unbridled intervention into government bond markets by the ECB would have.

C. OPTION TWO: EXPAND THE ECB'S MANDATE

The second option is to expand the ECB's mandate and allow it to pursue economic goals as a coequal goal with price stability. This option would involve balancing the economic imperatives of the EU against price stability and would allow the ECB to intervene in bond markets explicitly for economic reasons as is the case in other major economies.[173] A dual

168. *See supra* notes 11–28 and accompanying text.

169. *See* Kocherlakota, *supra* note 18.

170. *See* James Wilson, *Bundesbank Squares up to ECB's Draghi*, FINANCIAL TIMES (March 1, 2012), http://www.ft.com/intl/cms/s/0/eb335298-63be-11e1-8762-00144feabdc0.html#axzz1pa55qxck.

171. *See id.*

172. Simon Kennedy, *Italy Bond Attack Breaches Euro Defenses As Crisis Worsens*, BLOOMBERG (Nov. 10, 2011), http://www.bloomberg.com/news/2011-11-09/italy-bond-attack-breaches-euro-s-defenses-as-region-s-contagion-worsens.html; *see generally* Ewing, *supra* note 154.

173. *See, e.g.*, 12 U.S.C. § 225(a) (2010) ("The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."); *Reserve Bank Act 1959* (Cth) s 10(2) (listing the central bank's goals as: the stability of the currency of Australia, the maintenance of full employment in Australia; and the economic prosperity and welfare of the people of Australia); s*ee also* Joe Weisenthal, *LOOK:*

mandate would free the ECB to pursue policies, such as the SMP, that may unmoor inflation expectations to some degree but would also give confidence to investors that the ECB will backstop precarious markets and prevent Member States from defaulting.[174] Given that preventing default of Member States or languid economic growth within the EU are certainly economic goals of the Member States,[175] tools such as the SMP would then more comfortably fit within the ECB's mandate and may be viewed as legitimate.

Giving the ECB express authority to intervene in the markets to prevent default or stimulate growth would likely help to improve the short-term economic stability in the EU. By knowing the ECB will intervene if needed, markets will likely be less prone to large fluctuations because market participants will be more confident that the ECB's limitless balance sheet will provide a backstop to rising bond yields. Having the ECB use its balance sheet as a tool for fiscal stability is an approach that has worked to a limited degree through programs such as the SMP.[176] It is also an approach that has been encouraged by some Member States and other major economies, such as the United States, in the context of the ECB providing funding to the EFSF, but this approach was subsequently rejected as exceeding the ECB's mandate.[177]

Such an approach would be an overt affirmation of what commentators and market participants already assume will happen. Many commentators believe that because the ECB is the only credible backstop to Member States defaulting, it will need to expand the role it is already playing in purchasing bonds.[178] Some market participants are testing the ECB's

There's One Solution For Europe, Everyone Knows What It Is, And If It Doesn't Happen, There Will Be A Collapse, BUSINESS INSIDER (Nov. 16, 2011, 8:00 pm), http://www.businessinsider.com/how-to-save-the-eurozone-2011-11 ("Every other major economy in the world [besides the EU]: Japan, the UK, the US, China, etc. has a central bank that funds the government.").

174. Kennedy, *supra* note 172.

175. TFEU art. 127.

176. *See supra* notes 60–68 and accompanying text.

177. *See, e.g.*, Deen & Thesing, *supra* note 149; Rainer Buergin & Jonathan Stearns, *Germany Rejects Using ECB to Lift EFSF Rescue-Fund Firepower*, BLOOMBERG BUSINESSWEEK (Sept. 17, 2011), http://www.businessweek.com/news/2011-09-17/germany-rejects-using-ecb-to-lift-efsf-rescue-fund-firepower.html.

178. Jack Ewing, *Lending a Hand to Banks, but Not to Nations*, N.Y. TIMES (Nov. 14, 2011), *available at* http://www.nytimes.com/2011/11/15/business/global/as-european-nations-

willingness to purchase unlimited amounts of government bonds.[179] So, moving from tacitly accepting the responsibility for stabilizing financial markets and encouraging growth in the short-term to explicitly accepting this responsibility may amount more to a change in rhetoric than to a shift in policy.

This Note chooses not to endorse this approach for two reasons. First, the TFEU clearly contemplates a division of fiscal and monetary policies.[180] The reason for this division is to preserve the independence of the ECB and maintain price stability.[181] This was the deal brokered by the Member States as part of the grand bargain in creating the EU. The Member States wanted fiscal decisions to be made by the Member States. Leaving fiscal decisions with the Member States ensures that those making such decisions are, appropriately, politically accountable. It provides long-term confidence to markets by ensuring price stability. Therefore, the ECB's singular adherence to price stability should be maintained.

Second, allowing the ECB to backstop struggling countries still threatens the ECB's independence. Such an approach puts great confidence in the revamped fiscal oversight that has transpired since the debt crisis and effectively removes the market discipline imposed on Member States through different interest rates for different Member States.[182] Politicians and market participants would ideally have a long memories and act diligently to ensure budgetary discipline, especially given the recent structural changes regarding accountability between Member States. However, knowing that there is a safety net may encourage Member States to slip back into complacency and take on more debt than they are able to service.[183] If debt loads are too burdensome because of deficits, Member States could force the ECB to take action again. If the ECB is so forced

teeter-only-lenders-get-central-banks-help.html?_r=3&pagewanted=1&hp; Andreas Cremer, *Euro Zone Hangs on ECB Bond Buying, Krugman Tells Handelsblatt*, BLOOMBERG (Nov. 10, 2011), http://www.bloomberg.com/news/2011-11-10/euro-zone-hangs-on-ecb-bond-buying-krugman-tells-handelsblatt.html; Simon Kennedy, *Italy Bond Attack Breaches Euro Defenses As Crisis Worsens*, BLOOMBERG (Nov. 10, 2011), http://www.bloomberg.com/news/2011-11-09/italy-bond-attack-breaches-euro-s-defenses-as-region-s-contagion-worsens.html.

179. *See* Ewing & Minder, *supra* note 66.

180. *See* TFEU arts. 120–26 (economic policy) and arts. 127–33 (monetary policy).

181. *See supra* notes 11–17, 24–36 and accompanying text.

182. *See supra* note 167–170.

183. *See* Ewing & Minder, *supra* note 66.

to take action, it cannot be acting independently. This would undermine a bedrock principle of monetary policy.

D. Option Three: Limiting the ECB's Ability to Intervene in Markets

The third option is to limit the ECB's ability to intervene in markets with tools such as the SMP and thereby firmly limit the ECB's ability to engage in quasi-fiscal activities. Such an approach would preserve the division between monetary and fiscal policy as envisioned by the framers of the TEU. While not providing the short-term stability offered by option two, limiting the ECB would help to reaffirm the independence of the ECB and anchor price stability to encourage long-term growth.

i. Proposed Limitations

Member States should restrict the ECB's ability to engage in quasi-fiscal activities by limiting the amount of sovereign debt the ECB is able to hold; the ECB should also permanently end the SMP as soon as the ESM is operational. This restriction should not affect government bonds used as collateral by banks engaged in open market operations with the ECB. It should allow the ECB to engage in fine-tuning operations by outright sale and purchase of government bonds on a scale consistent with conventional fine-tuning operations. This restriction would leave the ECB with full discretion to determine the appropriate monetary policy and implement it using its standard tools, but it would also significantly limit the ECB's ability to make targeted interventions into government bond markets.

This restriction would be a supplementary provision to Article 123's prohibition on debt monetization and would reestablish the ECB's commitment to price stability. As Article 123 prohibits the ECB from engaging in debt monetization through the primary markets,[184] this new restriction would restrain the ECB from engaging in debt monetization through the secondary markets. In implementing this measure, the Member States would remedy an imperfection in the original prohibition on debt monetization: the ECB is currently able to monetize debt by purchasing government bonds on the secondary market.

184. TFEU art. 123.

Unlike reformation of the ECB's mandate, this solution would enlist markets to impose discipline on Member States. Removing the ability for the ECB to intervene on a large scale in government bond markets will send a strong signal to market participants that they must diligently evaluate each Member State's finances and set that State's interest rates accordingly. Pricing government bonds in such a way will allow each Member State to borrow in accordance with the soundness of their finances. While the newly implemented fiscal restraints and oversight within the EU will hopefully prove effective, this solution will employ the markets as an additional means to exert pressure on Member States.

ii. Ending the SMP

The ECB should transfer the balance of the SMP to the ESM when the ESM is operational. The ESM will have a sufficient balance sheet,[185] and the ESM was created explicitly to prevent the insolvency of Member States. As laid out in the Treaty, the ESM is meant "to mobilise funding and provide stability support . . . to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States."[186] In other words, the ESM is structured to be the firewall that the SMP was previously. It should be employed for that purpose.[187]

In addition, the responsibility for backstopping potentially insolvent Member States is more appropriately reposed with the Member States. As laid out in the TFEU, fiscal policies are the responsibility of the Member States.[188] Deciding whether to intervene in government bond markets and preventing the default of Member States has reverberating implications for other Member States. When an EU institution takes on the debt of a Member State, all members of the institution will suffer a loss in the case of that Member State's default. Because of potential fiscal implications for each of the Member States and their electorates, such decisions should be left to the

185. Compare the current holdings by the ECB under the SMP, *ECB Eurosystem Securities Market Program*, *supra* note 65 (€218 billion as of March 22, 2012), with the lending capacity of the ESM, Treaty Establishing ESM art. 41 (€500 billion).

186. Treaty Establishing ESM art. 3.

187. Kennedy, *supra* note 178.

188. *See* TFEU art. 120.

politically accountable governmental bodies. In addition, when extending credit through the ESM, Member States may attach conditions to the loans.[189] The ability formally to tie an extension of credit to structural and budgetary changes for a Member State provides more accountability and transparency than informal conditions that the ECB may require.[190]

iii. Potential Concerns

Some question exists as to how much debt the EFSF/ESM can shoulder because of its finite balance sheet.[191] Such uncertainty may make market participants nervous and may put short-term stability in question. However, while market stability is a concern, it should not prohibit taking this step. The reasons such concerns should not be prohibitive are both fundamental to the nature of the EU and practical in light of the ESM and the ECB's resistance to large scale intervention.

This proposal is laid out as a way to preserve the fundamental division contemplated in the TFEU, not to salve markets. That division was made to ensure the ECB's independence, price stability and the Member States' long-term fiscal discipline. Market confidence in the ECB stems from its infinite balance sheet,[192] but if the ECB was actually to employ that balance sheet it could undermine its independence and price stability. Such action would therefore likely exceed the level of power and responsibility ceded by the Member States to the ECB in the formation of the European Union. Efforts to continue reserving to the Member States those powers they intended not to cede should therefore trump short-term market demands.

From a more practical perspective, the ESM should be able to handle the amount of government bonds that have been acquired by the ECB through the SMP.[193] It is possible that the new measure would exacerbate the demand put on the ESM because the belief that the ECB would intervene if needed

189. Treaty Establishing ESM art. 12 ("Such conditionality may range from a macro-economic adjustment programme to continuous respect of pre-established eligibility conditions.").

190. *See supra* notes 143–148 and accompanying text.

191. Willem Buiter, *EFSF Needs Bigger Bazooka to Maximise Its Firepower*, FINANCIAL TIMES (Oct. 31, 2011), http://www.ft.com/intl/cms/s/0/c4886f7a-03d3-11e1-bbc5-00144feabdc0.html#axzz1ckfBgwG5.

192. *Id.*

193. *Id.*

would no longer exist and the volatility in government bond markets could increase. However, this concern should not be overstated. Public questioning of the SMP's legality has tempered market participants' expectations that the ECB will use its balance sheet.[194] While the current state of the government bond markets reflects some expectation that the ECB will intervene, that expectation is tempered by the ECB's resistance to further intervention.[195] Therefore, the change in short-term stability resulting from the ESM, not the ECB, being responsible for intervention may not be as pronounced as some would expect.

iv. Adherence to the TFEU's Principals

This solution stays in line with the broad principles of the TFEU. In constructing the EMU, Member States gave the ECB one primary mandate: price stability.[196] The Member States retained for themselves their fiscal policy.[197] To preserve the ECB's independence, and hence price stability, fiscal and monetary matters are insulated from each other through provisions such as the prohibition on monetary financing.[198] Given these guiding principles, a limit on the amount of sovereign debt the ECB may purchase would help to preserve its independence and price stability by removing the legal ambiguity.

In addition, the ECB would likely welcome this limitation on their ability. Just as the ECB has demonstrated that it will respond when needed to preserve the EMU,[199] it has also demonstrated that it will not work outside the letter of the Treaty.[200] Commentators have noted that the ECB is uncomfortable with the SMP and looks forward to its discontinuance.[201] European Central Bank officials have stated

194. Wilson, *supra* note 170.

195. *See* Gabi Thesing, *ECB Seeks to Shed 'Uncomfortable' Bond-Buying Duty: Euro Credit*, BLOOMBERG (Feb. 2, 2011), http://www.bloomberg.com/news/2011-02-03/ecb-seeks-to-shift-uncomfortable-bond-buying-to-rescue-fund-euro-credit.html.

196. TFEU art. 127.

197. *Id.* art. 120.

198. *See supra* notes 11–36 and accompanying text. *See* Lybek, *supra* note 28, at 7 (advocating a prohibition for central banks on quasi-fiscal activities).

199. *See generally supra* notes 60–68 and accompanying text.

200. *See supra* notes 84–89 and accompanying text.

201. *See* Gabi Thesing, *ECB Seeks to Shed 'Uncomfortable' Bond-Buying Duty: Euro Credit*, BLOOMBERG (Feb. 2, 2011),

that it should not allow the program to continue longer than necessary.[202] Just as ECB officials supported handing over the task of capping yields to the EFSF,[203] it will likely welcome handing it over to the EFSF's successor, the EMS.

IV. CONCLUSION

This Note has described the motives and the purposes of the SMP in regards to the ECB's independence and mandate. The TEU granted the ECB a very large amount of independence, most notably for this Note through the prohibition on debt monetization. However, having been confronted by the European sovereign debt crisis, the ECB had to implement the SMP in order to keep sovereign debt markets functioning. Although the ECB has always described the SMP in terms of monetary policy, there are plausible fiscal motivations for the SMP. Through ambiguity in the Treaty, the ECB has been able to stave off greater crisis in the euro zone. However, the current lack of limits on the SMP, the questionable effectiveness of the ECB's sterilization of the bond purchases and the ready fiscal explanation of the SMP threaten to compromise the ECB's independence and adherence to price stability. The more appropriate organ to deal with potential Member State insolvency is the ESM. Therefore, this Note suggests limiting the amount of government bonds that the ECB may purchase and transferring the balance of the SMP to the ESM. This will put further legal restrictions on the ECB's ability to monetize debt which will reaffirm the ECB's independence and commitment to price stability, as well as allow market pressures to instill discipline in government fiscal policy.

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http://www.bloomberg.com/news/2011-02-03/ecb-seeks-to-shift-uncomfortable-bond-buying-to-rescue-fund-euro-credit.html.

202. Central Banking after the Financial Crisis, *supra* note 82 ("[T]he ECB has entered a terrain in which it should not stay longer than absolutely necessary.").

203. *See* Thesing, *supra* note 201.