EuroPOLIS

Independence versus unlimited Power

Has the European Central Bank become a source of financial instability?

By Markus C. Kerber[1]

Abstract

In the following account, I shall outline a sceptical view of the ECB's policy and its institutional role. By pursuing profligate policies and exerting increasingly substantial supervisory powers, the ECB has significantly contributed to the potential instability of the financial system and to the degradation of its reputation in certain countries like the Netherlands and Germany. To fuel this thesis, the balance of the ECB measures since 2010 will be examined.

Moreover, the ECB is confronted with a growing academic controversy regarding its policy which have not achieved the desired effect. As the most indebted member states of the Eurozone want the ECB's policy of zero interest rates and capital market distortions by QE to be pursued, the ECB categorically ignores all attempts at critical academic dialogue and refuses for the time being to elaborate on an exit strategy. On the contrary on July 25th 2019 the ECB announced the tasking of all relevant ECB working groups to create proposals for a new chapter of unconventional policy. On September 12th 2019 the ECB even took the decision to

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This article is a tribute to Prof. Dr. *Friedrich Kübler* (1932-2003) whose enquiries into law and economics have stimulated the author ever since he read his textbook on corporate law as a student in the seventies. *Kübler* was unique, as he represented an academic transatlantic bridgehead, importing many ideas from Pennsylvania to Germany.

The author is grateful to George Selgin's thought-provoking essay which has amplified this idea, although Mr. Selgin has never analysed the ECB policy. See Selgin, The Independent Review, v. 14; Spring 2010 pp. 485-496.

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decrease the deposit floor rate further and to restart net purchase of public bonds at a monthly rate of 20 billion Euros.[2] Meanwhile, the ECB has received unsolicited proposals to revolutionize monetary policy by putting investment facilities at the disposal of national budgets, in addition to the eye-catching measure of making ECB credits directly available to consumers.[3]

Outline

[2] See press release https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.mp190912~08de50b4d2.en.html

[3] Blackrock Investment Institute; Dealing with the next Downturn, August 2019

1. Introduction

Central Banks base their monopoly power and their independence from democratically processed decisions by claiming that it would be the unalienable ambition of each central banker to keep the financial system afloat. Long-sightedness, expertise, independence from parliamentary control or even from elections therefore represent, according to the discourse of central bankers, the institutional prerequisites of achieving the sacred goal of balancing the economy between low inflation and high employment. As the only lender of last resort, central banks dispose of all lesser prerogatives in order to prevent collapse, to master crisis and thus to guarantee the sustained equilibrium of the financial system. In Constitutional Law as well in institutional economics these prerequisites of independence are still, though critically, supported. However *Tucker's* comparison of central bank power with armed forces and the law courts is in itself a misconception.[4] Law courts in western democracies apply law which has been generated in a democratic legislative process. Their independence correlates to the democratic legitimacy of law. Armies are not allowed to act on their own. Their intervention – the use of violence in military action –is subject to a democratic

[4] Paul Tucker, Unelected Power, Princeton University Press 2018

consent either by the head of the government or by Parliament itself. Even in the field of tactical operations democratically legitimate instances assure accountability by procedural checks and balances such as reporting. Central banking does not consist of applying law but of achieving nationwide, different objectives vaguely defined by law. Their claimed independence from democratic legitimation correlate to a strictly limited mandate. The difficulty starts however when - as the European Central Bank (ECB) postulates- in order to achieve the objectives of its mandate, the central bank necessarily generates repercussions in political fields out of its remit such as fiscal policy.

The presumption of independence from governments and from other democratically elected bodies is regularly repeated by the President of the European Central Bank (ECB) and his closest colleagues in the Executive Board. The representatives of the Bundesbank and, in particular, its president in abstracto do share that belief. They are right in asserting that the ECB's independence, enshrined since the Treaty of Maastricht in Art.130 TFEU, is a result of their political lobbying. Until now, no serious academic opinion has hinted at the problematical correlation between independence and the purely national status of all central banks except for the ECB. Therefore, the question whether the independence of supranational central banks can work in the same manner is a legitimate one.[5] The empirical balance of the ECB's policy and its institutional development raise the question of whether independence is the appropriate and sufficient condition to guarantee the central bank's respect for the goals and limits of its mandate. The sacred independence of the ECB[6] has factual and formal features which distinguish the institution from all other National Central Banks (NCBs):

[5] As may be seen from the concept of independence claimed by the European Commission, the historical development is ambivalent: What had been beneficial at the beginning of the ECC to enforce Community Law, has meanwhile turned into the curse of inflating competences which strive for centralization and freedom from the rule of law. See Kerber, Positionen und Argumente im Kampf mit Brüssel, Luxemburg, Berlin. Stuttgart 2017, p. 23 f. 253 f.

[6] See Art. 130 TFEU.

- The electoral system in the governing council is based on the principle of "one person one vote". Should there be, from the perspective of institutional economics, equivalent voting rights for members representing countries as different in size as Germany, France, Italy and Spain on one hand, and Luxembourg, Estonia, Malta and Lithuania on the other? Is sound policy likely to be generated by a Central Bank where managerial power and financial liability are so unevenly distributed? Can good governance be expected if countries of Germany's size lose their power to vote in the Council during certain periods?[7] In other words: will the discrepancy between operational control and economic liability as the most striking institutional feature of the ECB promote policies which are either reluctantly borne by some major countries or even overtly rejected by the populations of these ECB member states? These questions point to a consistently underestimated difference between the independent NCBs and the ECB. Whereas an independent NCB cannot afford not to demonstrate its independence in the daily political battle, rallying national opinion behind its position, the ECB continues its policy irrespective of national public opinion.[8] The lack of a European public sphere proves to be advantageous for the ECB which reduces its accountability to the level of occasional press conferences by the President and its Vice-president.[9] Until now, the ECB's President has attempted in vain to persuade the German public of the merits of his policy.[10]

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[7] See the Rotation of voting rights in the Governing Council of the ECB, ECB Monthly Report, July 2009, p. 100 ff.

[8] The Public Sector Purchase Programme (PSPP) was praised by France's President Hollande as "courageous" and rejected by the German general public. Several plaintiffs have even challenged the PSPP in the Constitutional Court. Cf. Von Stein et. Alia Case 2 BvR 980/16. See for more details: Kerber, Positionen und Argumente, Stuttgart 2017 p.172 f.

[9] The latter being reduced to the role of a caddy, whereas the President sets the discourse by a magisterial prose which is indifferent to any dissenting opinion.

[10] Their bottom line view is that Germany has been subjected to marginalization by the ECB: two key positions have been allocated to French representatives. Benoît Coeuré is in charge of all open market operations including the Public Sector Purchase Programme (PSPP) and Danièle Nouy was responsible for banking supervision. As usual and to say the least, France is well represented in international organisations.

Draghi's communicative *suada* clearly proves his fear of losing what the Bundesbank never lost before the Economic and Monetary Union (EMU) started: the German people's trust. Despite *Draghi's* succession of personal interviews designed to win them over, the German general public is far from being convinced.[11] Of particular note was Draghi's "explanation" that the Asset Purchase Programme (APP) – quantitative easing which formerly qualified as unconventional – had now become part of the "normal tool box". This assertion amounted to a form of autocratic accountability which until now has not been claimed by any central banker in Germany.

- Whereas the citizens of a country remain the principals of their NCBs despite its independence, the ECB has no clear principal and therefore is stepping up its institutional powers beyond what is compatible with its monetary mandate. This is clearly confined to price stability through monetary policy.[12] Additionally, as monetary matters are highly complex and banking supervision is by definition discreet, there are no countervailing powers of public opinion which could penetrate the natural opacity of the ECB measures.

- To summarize the preliminary analysis, it is evident that the particular status of institutional independence of the ECB[13] is a problem and not the remedy

Further details: Kerber, City A.M., More QE could damage the Eurozone beyond repair, 23th November 2015.

[11] The appearance of the ECB President in the German Bundestag was first contested because Draghi invited him and then put him on the lowest institutional level, a facultative hearing in the Bundestag's Commission for European Affairs.

[12] See Art. 127 I and Art. 282 II, compare in detail Waldhoff in: Siekmann (Hrsg), EWU, Kommentar zur Europäischen Währungsunion, Tübingen 2013, Art. 127 Rz.7.

[13] Kerber: Spielmacher der Wettbewerbsverfälschung? Anmerkungen zur Rolle der EZB auf den Kapitalmärkten, ORDO, Jahrbuch für die Ordnung von Wirtschaft und Gesellschaft 2012, Lucius & Lucius, Stuttgart 2012, p.63-84.; Der permanente Ausnahmezustand, Ifo-Schnelldienst, Heft 67, 06/2014, p. 03-25; Kommissarischer oder souveräner Diktator? – Eine staatsrechtliche Einordnung des Handelns der EZB, Zeitschrift für das gesamte Kreditwesen 67. Jahrgang, Heft 7-2014, p. 358-362.

for widely-known and academically discussed temptations of monopoly power to create money.[14] This intrinsic problem of the ECB could be mitigated by the strictest adherence to its mandate. However, the extensive interpretation of the range of its mandate and its formal enlargement entail serious consequences, mainly in the form of conflicting interests.

Although endowed only with an extremely limited mandate, the ECB and its leading staff employ the same discourse, hinting at their 'beneficial saviour' measures during the crisis of 2007/2008 as well as the unconventional measures since 2010. This discourse is reinforced by the – legally contested[15] though factually existing – supervisory powers of the ECB since the implementation of the Single Supervisory Mechanism (SSM) in November 2014 followed by the Single Resolution Mechanism(SRM) and the Single Resolution Fund (SRF).

In the following account, I shall portray a radically different view. Despite pursuing exceptional policies and gaining more supervisory powers, the ECB seems to have lost the capacity to autonomously steer monetary policy whilst still having impact on capital markets unless the ongoing programs were prolonged and enlarged. These will now restart on November 1st 2019 despite the very limited achievement of inflation targets ever since the PSP/CSPP was implemented in 2015. The collateral effect of the enormous distortion of competition on capital markets[16]– perhaps intentionally sought by the ECB –is the chief feature of its policy and clearly beyond its mandate. As a research agenda it is intriguing to find out whether this policy has significantly contributed to the potential instability of the financial

[14] Brennan/Buchanan: The Power to Tax, Analytical foundations of fiscal constitution, Cambridge University Press 1980 p. 111f. Hayek, The Constitution of Liberty, University of Chicago Press, 1960 p.324-337. His focus is however on inflationary worries.

[15] See the constitutional complaint against the banking union in the German Constitutional Court: 2 BvR 1685/14 as well as 2 BvR 2631/14. After the ruling by the German Constitutional Court on July 30th 2019 a documentation will publish the most important writs of the procedure lasting almost 5 years. See Kerber/von Stein, Finanzstabilität oder Bankenunion ?, Marburg 2019

[16] And claimed for by market players, particularly in the covered bond market.

system. In point of fact, that policy has already led to the degradation of the ECB's reputation in certain member countries of the Eurozone like the Netherlands and Germany. That loss in reputation, on the long run, could bring into question its policy-authority.

To delve further into the relationship between financial stability and the ECB's policy, one has to primarily examine the concept of financial stability before analysing the balance of the ECB measures since 2010.

2. The concept of financial stability

The concept of financial stability is a normative one which is related to the macroeconomic idea of equilibrium.[17] The legal reference to that normative concept can be found in Art. 127 section 5 TFEU which orders that the ECB "shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system."

How far the ECB's operational responsibility for financial stability goes, is a controversial legal issue[18] which cannot exhaustively be considered at this stage. Apart from this open legal and thus normative question, the economic discussion of *financial stability* deserves a short description as the concept is widely debated[19]. What is to be understood as *financial stability* for the purpose of this paper can be summarized as follows:

[17] Cf. Felderer/Homburg, Makroökonomik und Neue Makroökonomik 7.Auflage Berlin, Heidelberg, New York, 1999, S.12 ff. with a precise definition of the concept of equlibrium in all its – however economic –facets.

[18] Cf. Christoph Keller/ Siekmann, *Kommentar zur Europäischen Währungsunion*, Tübingen, 2013 Art .18 Rz. 106 which straightly rejects a competence of the ECB for financial stability; the report by the Bundesbank on Financial Stability is interesting and intriguing. 2016: cf. Bundesbank Finanzstabilitätsbericht 2016, Frankfurt 2016 p.16 ff. " Umfeld begünstigt Aufbau von Risiken".

[19] See Schinasi, Defining Financial Stability, IMF Working Paper WP/04/187 October 2004. See as well Bundesbank, Finanzstabilitätsbericht 2017 p. 7 f., 108 f.

Financial stability comprises the functioning of the banking system for lending and settlement purposes. In as much as these two fundamental functions are threatened by miscellaneous circumstances, financial stability is at stake. Obviously a risk overload of banks as well as a significant amount of non-performing loans could create such a danger. Additionally, abundant liquidity in banks' balance sheet seeking high yields could add to the disproportionate risk which turns out to be unsustainable for a significant number of banks. The further impact of an increasingly negative deposit floor rate makes the business of banks more difficult than ever before. As for regulatory reasons they are not free to deposit the abundant liquidity with other partners than the ECB, that unavoidable placement becomes a continuous and growing source of losses. These are only partially compensated for, by fees and "punitive interest rates". It has become a striking feature of the years since 2007/2008 that although being formally and factually more involved in providing financial stability, ECB contributes to a growing instability of a growing number of banks. The ECB's President showed awareness of the problem at an ECB Watcher Conference, by making a notable allusion to compensatory measures in favour of banks by TLTRO III.[20]

The ECB's obligation in that field is therefore neither to create incentives for risky trading activities due to abundant liquidity nor to reward banks for lending to corporate or private debtors who are unable to provide adequate collaterals. However the ECB claims a wide margin of powers to define what are *adequate* collaterals in the sense of Art. 18 N° 1 of the ECB Statutes.[21]

In more general terms it could be argued that any monetary policy incentive to suspend the market mechanism or to distort competition on the capital and lending

[20] See the technical features made public on June 6th 2019 : https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190606~d1b6e3247d.en.html

[21] See Keller in Siekmann, EWU Kommentar zur Währungsunion Tübingen 2013 Art 18 EZB Satzung N° 237 However the Guidelines of ECB on the implementation of the Eurosystem monetary poilicy framework of 19 December 2014 (Offcial Journal of the EU of 2.4.2015 L 91/3) have replaced the requirement of *adequacy* by eligibilty.

market is incompatible with the ECB's responsibility for financial stability. It should be remembered that the system of undistorted competition is considered by the TFEU as the pillar of economic order[22] and thus of financial stability (art. 119 sect. I TFEU , Art. 3 Nr. 1 a. TFEU, the protocol on Competition annexed to the TEU being an integral part of the Treaty). As the ECB has been given – though legally disputed and challenged in Court[23] – full supervisory responsibility for the banks of the Eurozone and, naturally, to be their lender of last resort, its operational range of interventions is clearly defined and could be in potential conflict with the priority objectives of monetary policy. Therefore, its responsibility for financial stability equates to a commitment to abstain from measures which, through the distortion of competition, clearly endanger the – sustained - equilibrium of the financial system. The TFEU relies upon undistorted competition as a pillar of economic and financial stability, using the benefits of competition as a countervailing power against statal interventions and corporate abuses of market power.[24]

Before judging the ECB's policy under this aspect, I propose to take a closer look at the measures which have so far been taken on behalf of monetary policy.

3. <u>The chronology of strategic crisis policy since 2007</u>

a. Securities Markets Programme and Covered Bonds Purchase Programme

In 2009 and a year prior to the Greek crisis, the ECB initiated a Covered Bonds Purchase Programme (CBPP). This was followed in 2011 by a second CBPP. Both

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[22] Mestmäcker/ Schweitzer, Europäisches Wettbewerbsrecht, München 2014 Rz. 26 ff.

[23] Cf. The complaint of several German plaintiffs in the German Federal Constitutional Court as of July 2014, a case ruled on July 30th 2019. See the constitutional complaint against the banking union in the German Federal Constitutional Court: 2 BvR 1685/14 as well as 2 BvR 2631/14.

[24] Cf. Art. 119 TFEU ; Mestmäcker/Schweitzer, Europäisches Wettbewerbsrecht, 3.Aufl. München 2014 § 3 Rz. 65 f.

programmes led to an ECB balance sheet enlargement of 76.4 billion Euros. These two Covered Bond Purchase Programmes have now become obsolete because most of the bonds have matured. In May 2010 Greek government bonds and, as a consequence, Irish and Portuguese government bonds were declared fully eligible collateral bonds for the ECB-credit-operations.

This extraordinary measure of declaring fully eligible government bonds issued by the states which were likely to fail was for the Greek case only suspended during the repurchase programme from 2nd March 2012 onwards. Since the ECB's decision as of 22.6.2016 the Euro-System considers Greek state bonds again eligible for repo-operations as well for the purchase programme.[25]

The Securities Markets Programme (SMP) led to a relatively modest position of sovereign debt within the ECB balance sheet which, according to the Bundesbank figures, amounts to 210 billion Euros.[26]

Apart from these exceptional measures which in the meantime have been replaced by monetary tools of another dimension, it will be outlined in the following discussion that steady qualitative easing is a striking feature of the ECB crisis policy.

b. Continual opportunistic qualitative easing

Qualitative easing, in contrast to quantitative easing, concerns the easing of requirements to the nature and robustness as well as the terms of collaterals accepted in credit operations with the central bank. It leads to a risk structure of the active side of the balance sheet which is clearly different from what it was before.

[25] Cf. ECB decision as of 22.6.2016 https://www.ecb.europa.eu/press/pr/date/2016/html/pr160622_1.en.html.

[26] The Bundesbank's expert opinion of December 21st 2012 to the German Constitutional Court, p. 2 in the OMT procedure.

In contrast to qualitative easing, quantitative easing as implemented by the CBPP and SMP led to the lengthening of the balance sheet of the central bank by outright purchases of sovereign debt.

As to the importance of the collateral framework for central banking, *Bindseil* deserves to be quoted:

> "Collateral availability is the ultimate constraint to accessing to central bank credit. In this sense, it is difficult to overstate the importance of the collateral framework for monetary policy and financial stability. Unencumbered central bank-eligible collateral is potential central bank money, dependent on the rest of operational framework, as banks can swap it more or less easily into actual deposits with the central bank."[27]

The process of systematic qualitative easing began in December 2011 and was continued in February 2012.[28] In general it led to an easing of the general eligibility criteria from A to –Investment grade (BBB) which, in terms of collateral quality, comprises completely different asset classes. Parallel to this easing process, the ECB authorized the national central banks of the euro-system to ease eligibility criteria for collateral operations even further. Seven central banks (France, Austria, Spain, Italy, Greece, Portugal, and Ireland) have used this authorisation for further easing without explaining their reasons.[29] It has been taken into account, however, that the process of steady qualitative easing has gone hand in hand with increasing haircuts.[30] Nevertheless the process of crisis-inducing qualitative easing has reversed the important process of unifying collateral eligibility criteria summarised

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[27] *Bindseil*, Monetary Policy Operations and the Financial System, 2014, p. 108. Bindseil is the Director General of Market Operations reporting to Benoît Coeuré, member of the ECB Executive Board.

[28] See *Kerber*, Spielmacher der Wettbewerbsverfälschung? Anmerkungen zur Rolle der EZB auf den Kapitalmärkten, Ordo Bd. 63, 2012, p. 63 ff.

[29] See for the details: *Kerber*, Ordo 63, S. 63 ff. as well as Eberl/ Weber, ECB Collateral Criteria:

A Narrative Database 2001–2013, Ifo-Working paper 174, Februar 2014.

[30] *Hoffmann*, Die EZB in der Krise – Eine wesentliche Analyse der Sondermaßnahmen von 2007 bis 2012, (Diss.) Berlin 2015 pp. 94 ff.

in the single list. The Euro-System had worked hard to unify eligibility criteria leading in 2007 to a unified single list.[31] The credo underlying the elaboration of a single list is as follows:

No single currency without a single list of clearly defined eligibility criteria.

The consequence, otherwise, is that the differentiated approach of national central banks in the field of collateral policy would be a source of distorted competition between banks in member states of the European Monetary Union. This is why the decentralisation of eligibility criteria for collaterals as decided by the ECB in December 2011 could lead further to an uncontrolled allocation of risk and to a distortion of competition among the banks within the Eurozone.

Apart from the fundamental aspects of the Treaty's goal of undistorted competition[32], neither the European Central Bank nor the national central banks of the members of the European Monetary Union are authorised to modify the eligibility criteria in a discretionary way. However this is clearly ignored by influential practitioners and academics. Although *Bindseil* rejects the idea of uncollateralized central bank credit, he agrees that unsecured lending would require sophisticated lengthy risk assessments incompatible with prompt monetary operations[33]. He does not seem to realize that Art. 18 of the ECB-Statute clearly requires "adequate collaterals" for all credit operations. In as much as the ECB eases eligibility criteria in an unlimited way for credit operations, it triggers off a process of eroding this postulate of risk adequacy. Central bank money is no longer given to banks upon conditions which correspond to the requirements of ownership economics.[34]

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[31] Ibid.

[32] See Art. 119 TFEU, Art. 51 TEU with Protocol No. 27 of the Lisbon Treaty on competition and the single market.

[33] *Bindseil*, (2014) p. 112

[34] Compare to *Sauer*, Die sich auflösende Eigentumsbesicherung des Euro, Ifo Schnelldienst 16/2011, S. 58 ff. Even in case of ELA (emergency liquidity assistance) the ECB is a lender of last

Qualitative Easing does not only concern the easing of eligibility criteria for securities already qualified as eligible. It also operates through the enlargement

of collateral-listing by adding new securities and other assets. Normally, central banks as well as the ECB only accept credit operations in exchange for marketable securities. In the framework of qualitative easing, the ECB enlarged the list of securities in a dubious manner. It declared as eligible collateral:

- marketable securities in non-Euro denominated securities (without ABS and retail loans),
- marketable bank bonds on non-regulated markets (RMBD),
- consortial credit lines in Euro with a public guarantee,
- Retail Mortgage based debt,
- term deposits (although term deposits are in the strict sense of the word not a security). In as much as term deposits are accepted as collaterals by the ECB, it will be unable to sterilize quantitative easing measures by asking banks to subscribe to term deposits because these term deposits can immediately be handed in to the central bank in exchange for new central bank money.

A Bundesbank director made critical academic comments about the lax trend of enlarging eligibility criteria according to Art. 18 of the ECB statutes.[35]

Bindseil provides the quantitative figures of collateral availability within the Eurosystem. He points out that banks' assets account for roughly 32 trillion Euros.

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resort only on condition that the credit operation is secured by adequate collaterals. As can be seen from the Greek financial crisis in summer 2015, the stock of available collaterals limited the amount of emergency assisstance. See in general: Heinsohn/Steiger, Ownership Economics(translated and edited by Frank Decker), Routledge Frontiers of Political Economy 2013 p.83 f.

[35] Keller in Siekmann(Hrg.), EWU Kommentar zur Währungsunion, Tübingen 2013 Art. 18 N° 271 f in particular see N° 339

In 2012 assets of 14 trillion were accepted as eligible collateral with 5 trillion of eligible collateral post haircut.[36]

Qualitative easing is therefore the most striking feature of the ECB policy, though unknown to the wider public. That " policy " of opportunistic qualitative easing is a major case of distorted competition and as such a source of financial instability because securities are deemed by the ECB's decision to be adequate and thus eligible repo–operations although their adequacy remains doubtful after the review of its risk and its marketability. It is therefore not too surprising that the ECB's decision as of June 22nd 2016 to requalify Greek sovereign bonds as eligible for purchase operations by the Eurosystem has not provoked any outcry of protest although that country largely depends on transfers from the EU to assure its solvency.

Recently the findings of *Nyborg* after a research internship with the ECB have thrown even more critical light on the importance and the inconsistency of the ECB's collateral policy.[37]

His research focus is on the most "open secrets" of central banks in general and ECB collateral policy in particular. His findings have two merits:

First he explains the significance of collateral policy as a major part of monetary policy instead of restricting collateral policy to the aspects of providing waterproof guarantees for the ECB and the Euro system.

Secondly he explains that collateral follows the main stream of monetary policy: when banks are pampered by the ECB in general through full allotment or long-term refinancing operations for 3 years, collateral policy has to follow.

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[36] *Bindseil* (2014) p. 109: see also, Bindseil's explanations on maintaining and enlarging the collateral basis as a buffer in the financial crisis to overcome funding risks of banks, p.179.

[37] Nyborg, Collateral Frameworks: The open Secrets of Central Banks, Cambridge University Press 2017

Nyborg reveals by empirical evidence the predisposition of the ECB, to change collateral categories and in particular the eligibility requirements without giving plausible reasons.

Furthermore, he explains in detail the increases and decreases of "haircuts". Haircuts should depend on liquidity, risk, duration and residual maturity as well as the coupon type (fixed or variable). Nyborg does not question why counterparty risk is not considered[38].

Neither can he explain why in the case of reverse floaters there is a 25% hair cut.[39]

In the text, Nyborg quantifies how much French and Italian banks have benefitted from the inclusion of unsecured bank debt[40] trading on unregulated markets. He interprets that form of collateral policy as indirect bailing out of banks.

A particular issue of collateral policy is eligibility without conforming to the minimum requirements (BBB). In that case, government guarantees help to meet the eligibility criteria. Nyborg reveals to which extent Italy has had recourse to that practice.[41]

"To get a sense of the size and impact of these guarantees, data on the individual securities and issuers were collected from Bloomberg for August 15, 2013 and May 28, 2014. With respect to the former date, of the 325 Italian securities with central government guarantees, 294 could be found on Bloomberg. For each of these securities, Bloomberg was used to find the rating of the issue and the long-term issuer rating. I then used the procedure described in Table 6.1 and discussed above in order to determine the rating that would have applied without the guarantee."

[38] Cf. Nyborg Ibid p. 64-78
[39] Cf. Nyborg Ibid p.79
[40] Nyborg Ibid p.177
[41] Nyborg Ibid p.139

To sum up, collateral policy as conducted by ECB is volatile instead of constant. It is biased by the liquidity interests of banks instead of providing adequate guarantees, and it is opaque instead of transparent.

c. Lax handling of Emergency Liquidity Assistance

The title of this subchapter refers to Art. 14 section 4 of the ECB-Statute which allows the national central bank to give individual emergency liquidity assistance (ELA) to the national banking sector unless a 2/3 majority in the ECB council has vetoed such a measure. The amount of 161 billion Euros granted to banks by national central banks of the Euro-System clearly shows the quantitative significance of ELA during the ECB crisis policy. No central bank decision in the field of ELA has ever been vetoed by the ECB council. However in the case of Ireland, the ECB has indicated to the national central bank of Ireland that it would be unhappy with its possible ELA measures.[42] ELA measures are vague as far as their conditions are concerned. The borderline between illiquidity and insolvency is difficult to define. In practice, ELA has always been given as a perpetually revolving credit, contrary to its *telos* of a transitional liquidity support.

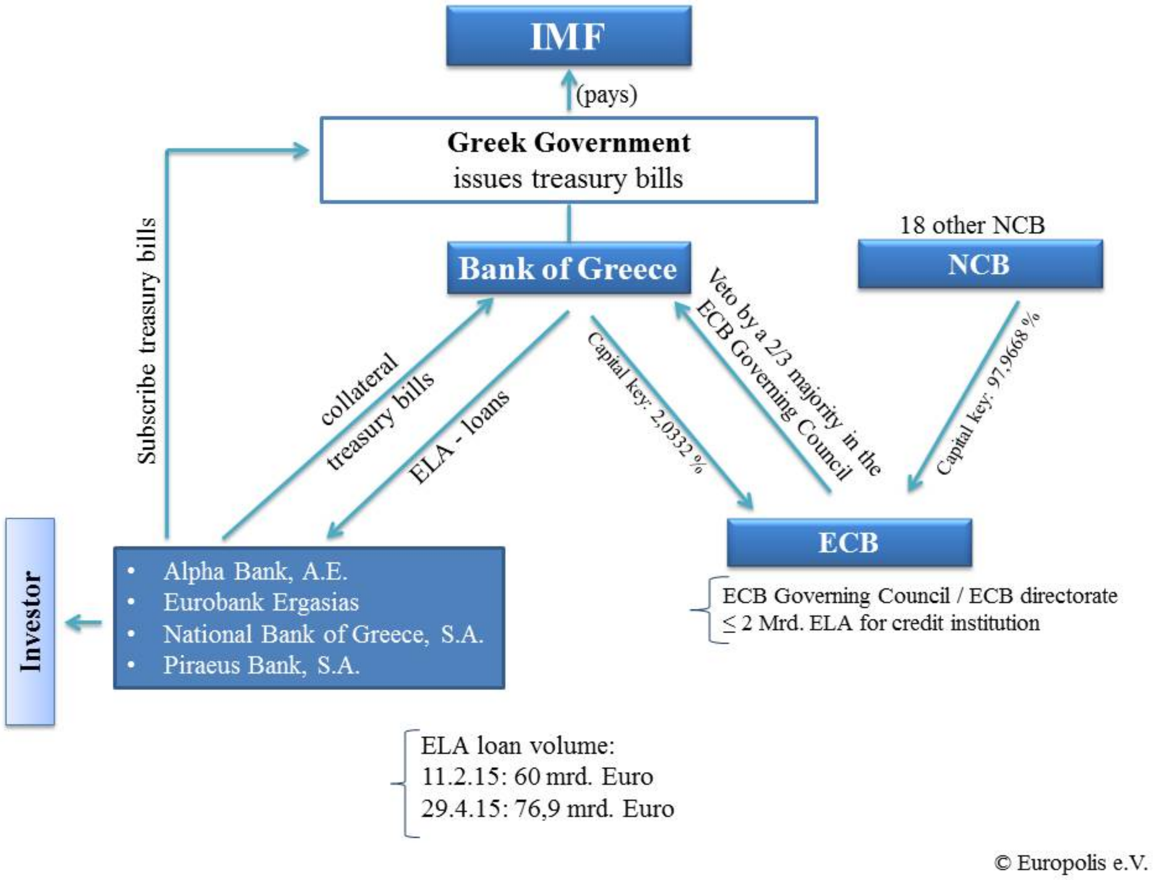
The handling of the Greek banking sector from the end of 2014 till summer 2015 reveals the pitfalls of the ECB being in charge of both banking supervision through SSM and monetary policy comprising the role of the Euro system as a lender of last resort. After the Tsipras government had come into power, Greece’s standing on the domestic and international markets steadily deteriorated. The announcement of credit claims against socially weak debtors to be given up by Greek banks on instruction by the government provided evidence even to the less knowledgeable Greek saver that under these conditions, the stability of the Greek banking system could not be sustained. The increasing exodus of deposits from Greek banks to safe

[42] In Ireland, shadowy ELA funds were used by the Central Bank to prop up Irish banks from 2008, a move that rapidly accelerated into tens of billions of euro in secret loans.

harbor countries was not only the logical consequence but perhaps – as *Sinn* argues[43] – the intended effect of the Greek government's policy of blackmailing the Euro-creditor states with financial chaos. Despite the entire period from the end of 2014 until summer 2015, the head of the ECB banking supervision *Danièle Nouy* kept reassuring the public by asserting that the Greek banks were still solvent whilst huge amounts of ELA credits were given by the NCB of Greece to the major four banks of the country. [44]

The apparent contradiction between ELA credits to Greek banks amounting to a peak of about 90 billion Euros in summer 2015 and the SSM's discourse of "still solvent" Greek banks can be explained by the unavoidable dilemma of the ECB. If Greek banks were no longer solvent, the ECB as banking supervision would have to state their 'failing or likely to fail' status, provoking the immediate intervention of the Single Resolution Mechanism in Brussels in charge of bank resolution. Additionally, the statement of Greek banks as being 'failing or being likely to fail' would have entailed a controversial discussion within the Governing Council of the ECB as ELA is unequivocally prohibited in a case of banking insolvency. Although the 2/3 majority of its members was clearly in favour of continued ELA provided to Greek banks, the ECB as a "rule based institution" would have been at odds to explain its omission of vetoing the pursued ELA practice by the NCB of Greece. The organized institutional opacity of the ECB action throughout 2015 demonstrates the striking conflict between responsibility for monetary policy and supervisory commitments.

[43] See *Sinn*, Die griechische Tragödie, ifo Schnelldienst, Sonderausgabe vom 29.5.2015.
[44] See Kerber, Wehrt Euch, Bürger ! 2nd edition, Munich 2017



The discretionary, simultaneous assessment of solvency by *Danièle Nouy* and the apparent reluctance to liquidate Greek banks refutes not only the official discourse on the *telos* of the banking union as a framework enabling market exit of credit institutions. Additionally, it proves the crucial normative deficit of the SSM: Neither the statement of qualifying a bank as "failing or likely to fail" nor the subsequent liquidation by the SRM is understood as compulsory. Letters to *Danièle Nouy* and to President *Draghi* focusing on this lacuna have not been answered or have received evasive explanations. However, the commitments of SSM and SRM can be made an object of a complaint lodged at the European Court of Justice (ECJ).[45] Only if through litigation the commitments of SSM and SRM are clarified by the ECJ, will the banking sector no longer be fuelled by the taxpayer. Unfortunately

[45] See Art. 265, 340 TFEU.

however, Greek banks had received a credit line of up to 25 billion Euros from the ESM to be allowed – as in the past – to remain a continuous element of financial instability. The practical effect of ELA and SSM is an encouragement for governments, such as Greece, to abuse undercapitalized credit institutions for state financing and social gifts in order to transfer the costs of that policy to the ESM financed by tax payers. How can it any longer be argued by the ECB that such a practice is aimed at achieving financial stability and enhancing fiscal responsibility?

In Italy meanwhile the features of the banking crisis are different but even more alarming. Three banks – one of them, Monte dei Paschi di Siena, being N° 3 in Italy – after failing to raise fresh capital in the markets, have been recapitalised by the government.[46] Before the end of 2016 the Italian government has been authorised by the national parliament in the form of a *decreto-legge* to raise the necessary funds on the market (in other words increase Italy's gross debt) to recapitalise the banks in trouble. The loophole in the regulation on bank resolution (BRRD) used for that purpose presupposes that banks are not insolvent and allows under this prerequisite "precautionary recapitalisation" by member states. The ECB has invited the Italian government to have recourse to that escape clause(Art. 32 4. And Art. 56 BRRD Directive) by claiming all these banks concerned were solvent. Even the European Commission has exempted that massive state aid by the Italian government from the control provided by Art. 107 TFEU. Thus the Italian government has increased its gross debt to avoid the liquidation or at least the unwinding of a bank of such central political importance as Banca Monte dei Pasqui.[47] The creditworthiness of the banking union and the reputation for unbiased assessment by the ECB and Commission have been heavily endangered by this case

[46] Soon after that case Banca Carige, a regional bank of significant size in Genova, followed a similar procedure.

[47] See the TV investigation „ Tod eines Bankers" shown by ARTE. It reveals the full amount of the cover up.

of trilateral collusion.[48] However in the Tercas-Case the ECJ overruled convincingly the Commission's assertion that the rescue of a bank by a private banking recapitalisation mechanism could be considered as a case of state aid.[49]

d. Since September 6th 2012: OMT

Although never implemented and thus remaining the announcement of an intention, the ECB declares OMT[50] to be the most efficient measure of declaratory policy in its existence. The announcement of unlimited purchase of state bonds from countries hit by critical markets has been in the meantime given legal clearance by the ECJ. In its preliminary ruling as of June 16th 2015 (Case C-62/14) the Court – following the recommendation of the Advocate General[51] and according to Art. 267 of the TFEU – confirmed OMT as fully compatible with Art. 119, 123, 127 and Art. 17-24 of the ECB statutes. The court qualified OMT as being within the range of monetary policy in opposition to the views presented by the plaintiffs and the German Federal Constitutional Court, who argued that OMT does not only border on fiscal policy but clearly means measures reserved for fiscal and thus national policy.[52] What is remarkable about the ECJ's preliminary ruling is its method of determining whether the ECB was still within the limits of its mandate.

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[48] Quite early Paulina Pzrewoska, Finance Watch Policy Brief October 2014 p. 7 had foreseen such an adverse development

[49] See ECJ Cases T-98/16, T-196/16, T-198/16.

[50] See press release, Technical features of Outright Monetary Transactions, ECB, 6th September 2012.

[51] See Court of Justice of the European Union, Opinion of Advocate General *Cruz Villalón* delivered on 14 January 2015, Case C-62/14. Veröffentlicht unter http://curia.europa.eu/juris/document/document.jsf;jsessionid=9ea7d2dc30d5cf3d03b96ca84a2fa261ce6c60f937d4.e34KaxiLc3qMb40Rch0SaxyKbhr0?text=&docid=165057&pageIndex=0&doclang=de&mode=lst&dir=&occ=first&part=1&cid=47329.

[52] Bundesverfassungsgericht, 2014 - 2 BvR 2728/13 conformed to the supremacy of ECJ's ruling but left sufficient loopholes for the Bundesbank to resist the ECB's application of OMT: see: https://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/DE/2016/06/rs20160621

> “The Court has held that in order to determine whether a measure falls within the area of monetary policy it is appropriate to refer principally to the objectives[53] of that measure.”[54]

Through this interpretation, the ECJ has paved the way for the complete empowerment of the ECB. Whatever the ECB does in whatever field, the bank will remain within the limits of monetary policy in as much as it can argue that its measure has monetary objectives. Whether that ruling reduces the ECB compliance with the TFEU to a journalistic effort remains to be seen.

As, however, there is no denial of the impact of OMT on the economic policy of Eurozone countries, the Court had to be cautious in order not to leave an open flank to its critics:

> “Indeed, a monetary policy measure cannot be treated as equivalent to an economic policy measure merely because it may have indirect effects on the stability of the euro area.”[55]

After making its ruling waterproof in terms of defining the ECB competence, the question of distorting markets through a single big investor by making unlimited purchases was left open. As a matter of fact, even if the ECB does not underwrite issues on the primary market, its readiness to operate unlimited purchases on the secondary market would necessarily produce an impact on the underwriting behaviour for the primary issue. The underwriter could be sure to sell to the single investor -the ECB - making the operation equivalent to the underwriting on public issues prohibited by Art. 123 TFEU.[56] The safeguards, offered by the ECB to prevent

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http://curia.europa.eu/juris/document/document.jsf;jsessionid=9ea7d2dc30d5cf3d03b96ca84a2fa261ce6c60f937d4.e34KaxiLc3qMb40Rch0SaxyKbhr0?text=&docid=165057&pageIndex=0&doclang=de&mode=lst&dir=&occ=first&part=1&cid=47329.

53 Underlined by the author.

54 ECJ 16.6.2015 (Case C-62/14) N° 46.

55 ECJ 16.6.2015 N° 55.

56 ECJ 16.6.2015 N° 104.

the conditions of issue of government bonds from being distorted by the certainty that these bonds would be purchased after being issued by the ECB, gave satisfaction to the ECJ. The ECB simply promised to ensure that a black out period is observed between the issue of a security on the primary market and its purchase by the ECB on the secondary market.[57]

When on June 21th 2016, the German Federal Constitutional Court had to rule on OMT in the light of the ECJ's decision, the Constitutional Court did not challenge the ruling by its Luxembourg colleagues but instead gave a stunning interpretation of the ECJ's ruling: As soon as the OMT programme no longer meets certain requirements – in particular exposes the Bundesbank to the risk of losing all or part of its equity– Bundesbank would be obliged to withdraw immediately from the program. So the German Constitutional Court, though pledging allegiance to the ECJ has returned to the battle field through the back door by claiming the sovereign right to reinterpret the ECJ's conditional clearance on OMT.[58]

For the time being the verdict by the German Constitutional Court has not brought about immediate consequences. It will however be referred to when the QE programme goes on despite the insignificant increase of both inflation and growth, thus leading the Bundesbank to a unique risk exposure through continued bonds purchases. In view of the restart of net asset purchases on November 1st 2019 announced on September 12th 2019, the Constitutional Court will hopefully take this important fact into consideration when finalising its ruling on PSPP/CSPP in the near future.

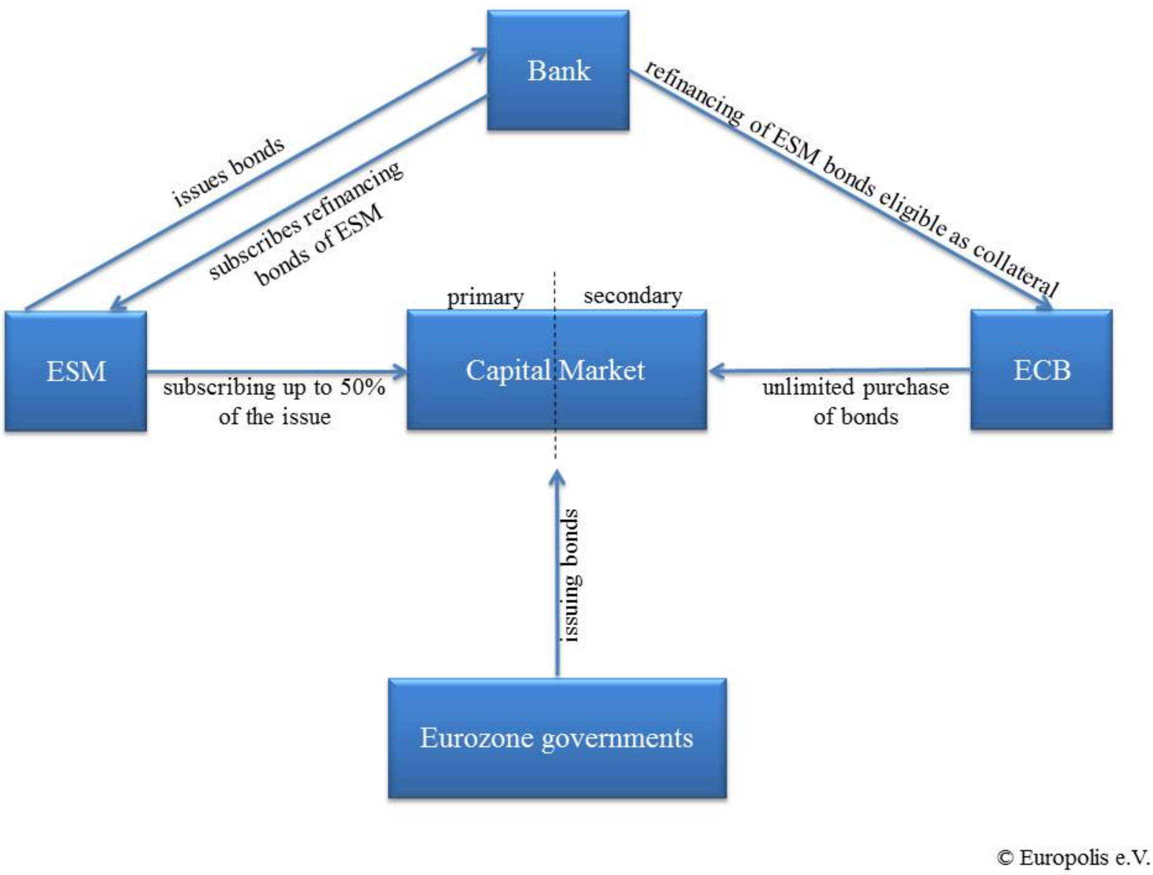
In response, the ECB quite understandably welcomed the ECJ's ruling because it allowed the expansion of its mandate by simply declaring its intentions to be of a

57 ECJ 16.6.2015 N° 106.

58 https://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/DE/2016/06/rs20160621 _2bvr272813.

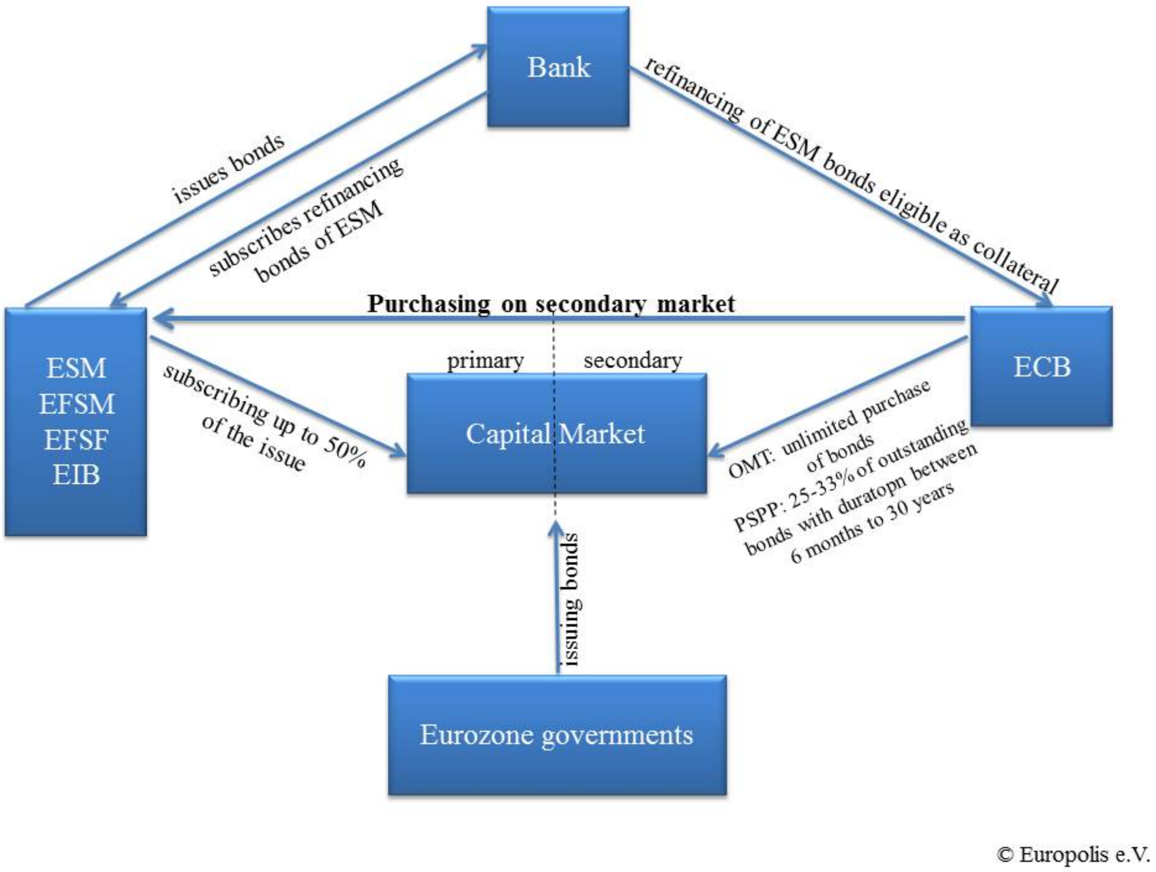
monetary character.[59] But that is not all. The scale of market distortion enabled by the ECJ only becomes apparent if OMT is added to the activity of ESM which can, in its own right, underwrite up to 50% of an issue as precautionary measure on the primary market.

The possible collusion between the ECB, ESM, Eurozone governments and, of course, banks under the OMT regime is illustrated in the diagram below.



[59] See press release, ECB Governing Council takes note of court ruling on OMT, ECB, 18 th June 2015.

Since the implementation of PSPP (QE[60]) the diagram has to be modified because the ECB can directly purchase securities issued by divers European institutions. Could this be compared to a new Ponzi Game ?[61]



In the current context, the concept of a neo-Ponzi game may be understood in a figurative way as a perpetual chain of raising and refinancing funds by players who,

60 Cf. more details under 3.h.)

61 See https:// en.wikipedia.org/wiki/Ponzi_scheme for more information on Charles Ponzi,the namesake of that fraudulent investment system ever since known as the Ponzi game.

though formally independent, are factually interdependent and will do their utmost to bail out each other. It could work in the following manner:

If the economy of a Eurozone member state is at odds with the markets and interest rates for its public debt issues begin to rise “abnormally”, the ESM would be free to intervene even before a national programme with strict conditionalities has been concluded. Precautionary provisions allow the ESM to underwrite up to 50% of a government issue on the primary market. As the ECB according to the features of the OMT-Programme could effectively purchase an unlimited amount of funds, the ESM can always find a buyer for its debt portfolio. Banks in full knowledge of this institutional understanding which suspends market forces will consequently be willing to underwrite the governments’ issues hand in hand with the ESM. If ever their portfolio of public debt begins to become a financial burden, they will be in the happy position of finding an ultimate buyer due to the PSPP, the ECB and the Euro system. Even if the banks end up in a high-risk situation such as potential illiquidity or insolvency, the ESM may assist within the framework of its direct bank recapitalization programme still in force.[62] Alternatively, the ECB may abstain from vetoing ELA provided by the respective national central bank.[63] As a final recapitalization instrument for banks, the ESM cannot give without taking. The refinancing of ESM-loans to countries and banks requires underwriting by international investors, namely banks which themselves refinance the purchase of the ESM instruments by submitting them to the ECB as eligible for repo-operations.

The collusive relationship between the above mentioned players will work as long as the chain does not break. The chain breaking incident which brings any Ponzi game to its end is difficult to foresee. But the ESM funds are limited and banks’ appetite for benefits is unlimited, whilst none of the problematical Eurozone governments is

[62] The direct bank recapitalisation programm is supposed to be replaced by a back stop ESM grants to SRB. ESM’s direct recapitalisation programm-born briefly after the creation ESM – has always been legally disputed.

[63] See graphic N° 1.

ready to step forward towards an improved fiscal balance. Finally, the ECB is not a homogeneous body, but a disparate arena of dissenting opinions and diverging interests. Focusing the lens of the public eye on the ECB is the most effective means of widening the discussion of problematical ECB policy issues.

Are we witnessing the beginning of a neo-Ponzi game initiated by the ECB and certain governments in the name of euro-rescue and financial stability? The fact that the ECB has allowed itself to buy issues from EIB, ESM, EFSM and EFSF up to 50 % of the outstanding issue is alerting prudent observers.[64]

e. June 2014: Funding for Lending

The target longer term refinancing operation (TLTRO) which was decided in June 2014 is another significant step of continued crisis policy. It intervenes quite clearly in the individual risk-taking of commercial banks by submitting the credit operation of the central bank to a particular form of a credit policy operated by commercial banks. Legal acts underlying the credit operations are of July 7/29/2014 and the first operation of that kind led to a credit request of only 64 billion Euros within the framework of the TLTRO programme. Clearly, banks do not appreciate the microeconomic risk assessment by the ECB. Apart from that, the macroeconomic debate on whether a central bank should operate its credits on tight microeconomic conditionalities is controversial. It has been particularly argued that TLTRO encourages banks to borrow at negative rates and to keep the liquidity.[65] However, this controversy may be left aside in this context because the programme in terms of volume has turned out to be macro-economically insignificant. However TLTRO II

[64] Cf. Decision by ECB on April 18th 2016 (O.J. L 121/24 of 11..5.2016) concerning the modification of decision EU 2015/774.

[65] See the critical Bruegel Paper ECB TLTRO 2.0 http://bruegel.org/2016/03/ecb-tltro-2-0-lending-at-negative-rates/

programme, the effects of which remain still to be examined[66], has been announced in 2016 and in 2019 TLTRO III is taking shape.[67]

f. September 2014: Covered Bonds Purchase Programme III + ABS

On September 4th and 5th, 2014 the President of the ECB announced outright operations for a new covered bonds purchase programme of a volume up to 500 billion Euros. He clearly indicated that the ECB would be ready to purchase ABS securities but only in the senior tranche, leaving thus the problem of who would take the risk for the equity and mezzanine tranche. Discussions with the governments led nowhere and as a consequence the European Investment Bank examined the conditions of taking over that remaining part of the risk. Generally it was expected that these final steps of the third covered bonds purchase programme and an ABS security programme would only pave the way for an immense new step in quantitative easing at the beginning of 2015. From a constitutional perspective renowned academics have severely criticized the programme as an ultra vires-act, amounting to a measure in conflict with the mandate of the ECB.[68]

To summarize the above, one must emphasise that the outright purchase of securities until PSPP has been of limited importance. Problems come from the very low and declining interest rates, hand in hand with the full allotment of requested credits for banks. The qualitative easing, however, is extremely problematical in the long term not only because of the distortion of competition but for the credo of a monetary union. Compared to the long term refinancing operation (Hauptfinanzierungsgeschäft) the ECB is suspending or reducing the minimum legal reserve as well as enlarging the refinancing operations, which have remained

[66] In June 2016 several plaintiffs filed a constitutional complaint including TLTRO II . Cf Cf. Von Stein et. Alia Case 2 BvR 980/16.

[67] See the Technical features announced on June 6th : https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190606~d1b6e3247d.en.html; see the slight modifications in the ECB press release on September 12th 2019

[68] *Murswiek*, Das ABS-Ankauf Programm der EZB, Stiftung Familienunternehmen, München 2015.

marginal. However outright purchases of state bonds by national central banks are fast increasing in volume.[69]

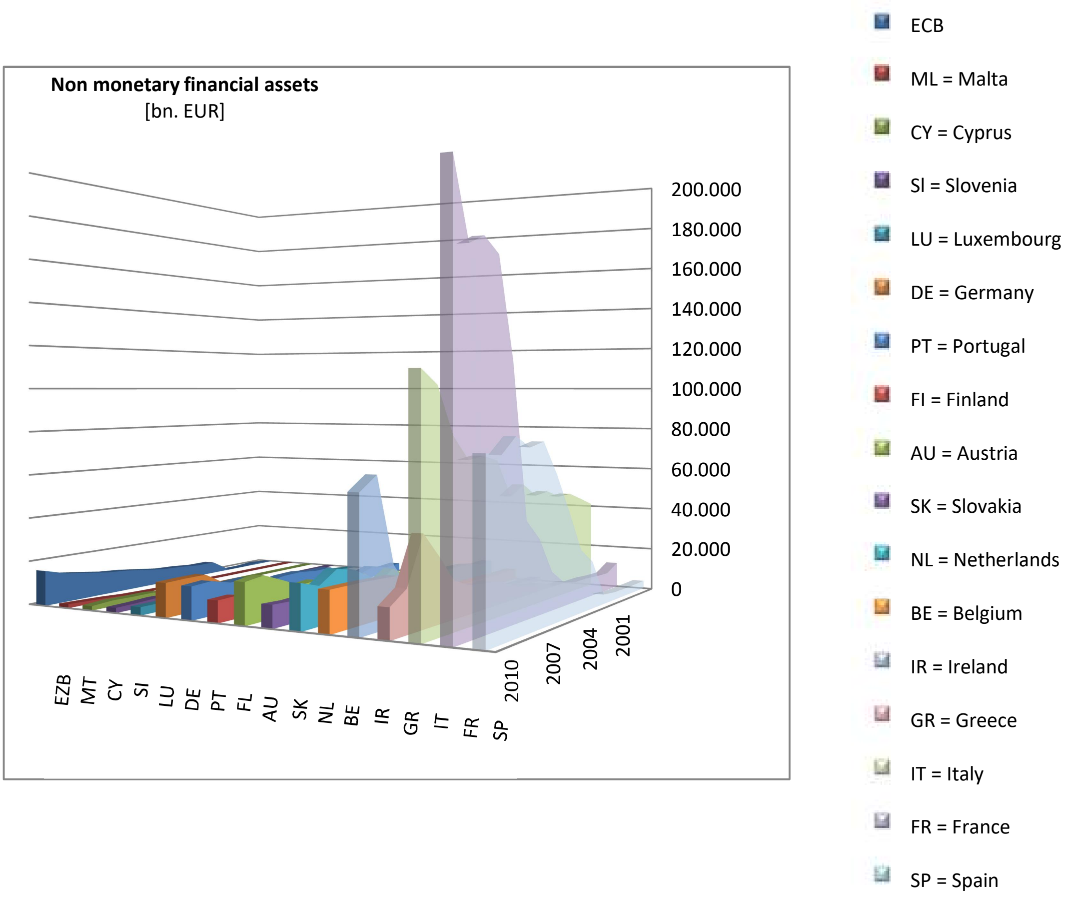
g. Non-monetary policy measures by NCBs: The Achilles heel of the European System of Central Banks

In a confederalist system of central banking, the national central banks remain the lenders of last resort and maintain their ultimate competence for printing money. Article 14/4 of the statute of the ECB clarifies that national central banks in the European system of central banks remain free to conduct their affairs in as much as non-monetary issues are concerned.[70] This freedom, however, can be vetoed by a two-third majority of the ECB council if the policy conducted by a national central bank puts into danger the implementation of the European monetary policy.
This relative freedom of national central banks in the euro system might finally turn out to be one of the Achilles heels of the whole system. Unobserved by the public, throughout the crisis beginning in 2007 the national central banks of crisis countries within EMU have enormously increased their purchases of state bonds issued by their home countries and put it under the item of "non-monetary financial assets" in their balance sheet. In his dissertation *Daniel Hoffmann* has quantified the amounts of financial asset of non-monetary nature. Until the end of 2012, France's national central bank has accumulated a position of 236 bn Euros, Italia's

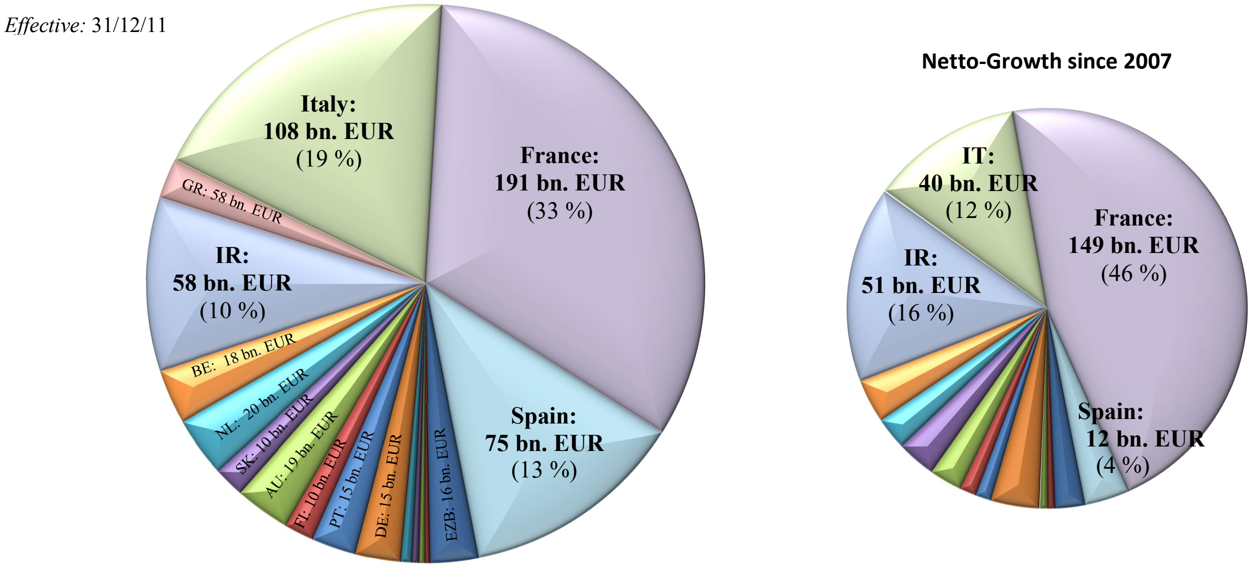
[69] The most dangerous tendency is rooted in complementary qualitative easing by national central banks. As a consequence, sooner or later the shareholders of the ECB will be aware that the ECB holds securities in its balance sheet with a worse risk than the ECB itself. Cf. For further details 3.g.)

[70] 14.4 statute of the ECB: National central banks may perform functions other than those specified in this Statute unless the Governing Council finds, by a two-third majority of the votes cast, that these interfere with the objectives and tasks of the ESCB. Such functions shall be performed on the responsibility and liability of national central banks and shall not be regarded as being part of the functions of the ESCB.

central bank's position amounted up to 112 bn Euros. Spain's Banco de España shows a position of 64 bn Euros, not to forget Ireland with a position of 56 bn Euros and Greece with an amount of 102 bn Euros.[71]



[71] Daniel Hoffmann, Die EZB in der Krise – Eine Analyse der wesentlichen Sondermaßnahmen von 2007-2012, Berlin 2015, p. 179 ff.



Source: Daniel Hoffmann, die EZB in der Krise – Eine Analyse der wesentlichen Sondermaßnahmen von 2007-2012, Dissertation, Berlin 2015, p.244.

Confronted with these figures by journalists at a press conference in Frankfurt am Main on 3rd December 2015, the ECB President *Mario Draghi* was allegedly aware neither of the existence of such net financial assets in the balance sheet of national central banks, nor of their amount.[72] A storm in the press was the answer to this confession of apparent ignorance by the ECB's head. Moreover, the suspicion was growing that certain national central banks were conducting a national program of quantitative easing which had not been authorized by the governing council of the ECB. Additionally, the agreement of November 14th of net financial assets signed by all members of the Euro system had been kept confidential until that day. Due to the pressure of the Deutsche Bundesbank, which published its monthly report in

[72] Draghi's answer: "ANFA purchases are entirely a matter for national central banks. They decide on their investment policy in complete independence. Often it's very hard to understand the purposes as to why they buy certain bonds. Often, for example, very often it's for their pension funds".

"Some of them communicate, by the way, and some others don't. You have central banks that don't tell anything about ANFA, so you wouldn't be able to know how many bonds they purchased. So the question that you may have about ANFA should be asked to the national central banks."

March 2016, the ECB made the essence of the agreement public. The ECB was also concerned about not giving the public the impression that the creation of money by national central banks is uncontrolled by the ECB and that national central banks have been conducting a parallel quantitative easing program. Taking into account the enormous amount of purchases which have accumulated since 2007, the impact on monetary policy cannot be disputed. Therefore the situation remains that national central banks, in particular that of France, have abused their relative autonomy and the ECB had several times modified its releases on the agreement of net financial assets to assure the markets.[73]
Doubts, however, persist and reveal the institutional inconsistency of a system in which countries with problems on sovereign debt markets keep using national central bank prerogatives to stabilize their domestic bond market.

h. The most recent revolution: PSPP/CSPP

In January 2015 the ECB announced its intention to pioneer in the field of quantitative easing. In March 2015 the Public Sector Purchase Programme was published and since June 2016 the monthly volume of the programme was increased from 60 to 80 bn Euro[74] including, for the first time, corporate bonds with an investment grade. The purchase of corporate bonds is operationally left to a consortium of NCBs.[75] But the common liability of the Eurosytem is accepted – for the first time. Let us look at the striking results:

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73 https://www.ecb.europa.eu/press/pr/date/2016/html/pr160205.de.html.

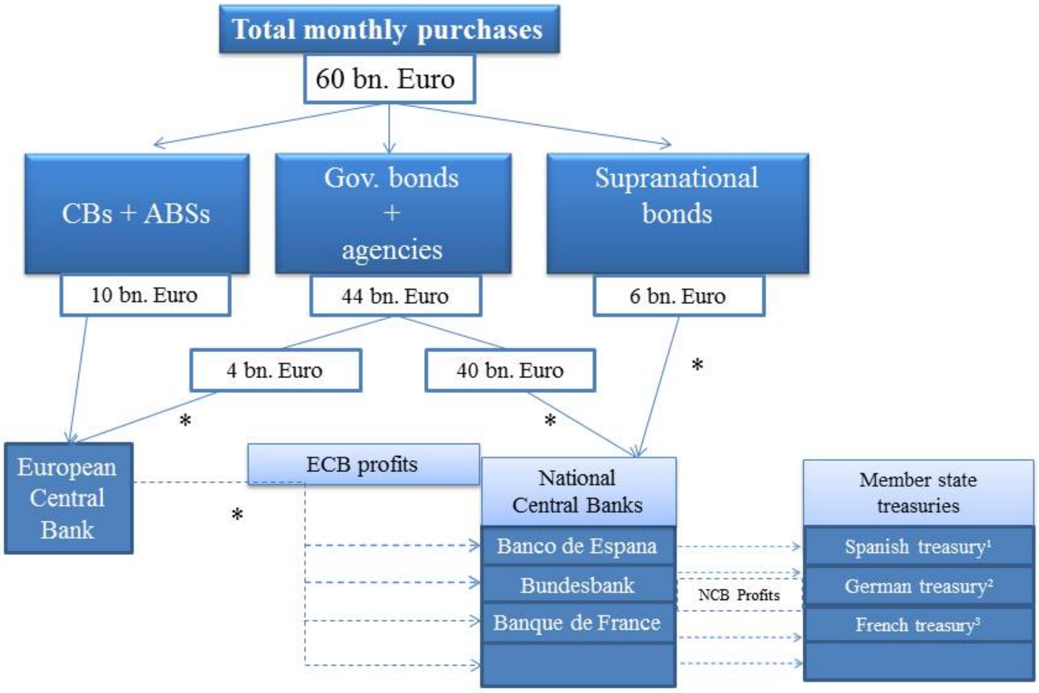
74 The decrease of net purchases to 30 bill. Euro till September 2018 was decided in the meantime. Teh programme of net purchases is due to expire on December 31st 2018.

75 Cf. Publication of ECB's decisions: Decision (EU) 2015/774 as of March 4th 2015 (J.O. L 121/20 as of May 14th 2015); Decision (EU) 2015/2101 as of November 5th 2015 (j.O. L 303/106 as of November 20th 2015; Decision (EU) 2015 /2464 as of December 16th 2015 (J.O. L.344/1 as of DEcember 30th 2015; Decision (EU) 2016/702 as of April 18th 2016 (J.O. L.121/24 as of May 11th 2016; Decision on the implemenation of the corporate sector purchase programme as of June 1st 2016; Decision as January 11th 2017 (J.O. L 16/51 as of 20th January 2017).

- Interest rates for corporate bonds with investment grade have gone down significantly.
- International corporations, even though they do not have their headquarters in the Eurozone, have created special financial vehicles within the Eurozone to raise funds being immediately transmitted to their central cash pool to serve financing outside the Eurozone.
- NCBs purchase not only on the secondary market but are entitled to underwrite as well up to 70% of the primary market issue of corporate bonds.

As a matter of fact only NCBs focus on corporate issues of their home countries as the empirical analysis of the first monthly purchases clearly prove.

Allocation of monthly asset purchases by the Eurosystem



* According to capital key
1 Tesoro Público
2 Bundesrepublik Deutschland Finanzagentur GmbH
3 Agence France Trésor

The German Constitutional Court in a ruling from 18 July 2017 requested the European Court of Justice for a preliminary ruling to answer 5 key questions as to the compatibility of PSPP and CSPP with the TFEU and in particular Art.123, 127, 130 TFEU. In its reasoning the German Constitutional Court lays bare substantiated doubts about that compatibility but clearly leaves the answers to the ECJ. A ruling of December 11th 2018 has confirmed the conformity of ECB's purchase programme without answering the question of financial liability being qualified as "illicit".

In its audience on July 30th/31st 2018 the German Constitutional Court listened to various experts of monetary policy and gave all attorneys the chance to legally qualify the ECJ's ruling. The final ruling in the pending case in view of renewed QE will have a lasting impact on ECB's *marge de manoeuvre* although its president claims not to be accountable to a German Court. The reinvestment policy of the PSPP/CSPP and the problem of mispricing due to artificially driven demand for bonds[76] are recent features of the disputed PSPP/CSPP which the Court will have to consider as well as the restart of net asset purchases in November 2019.

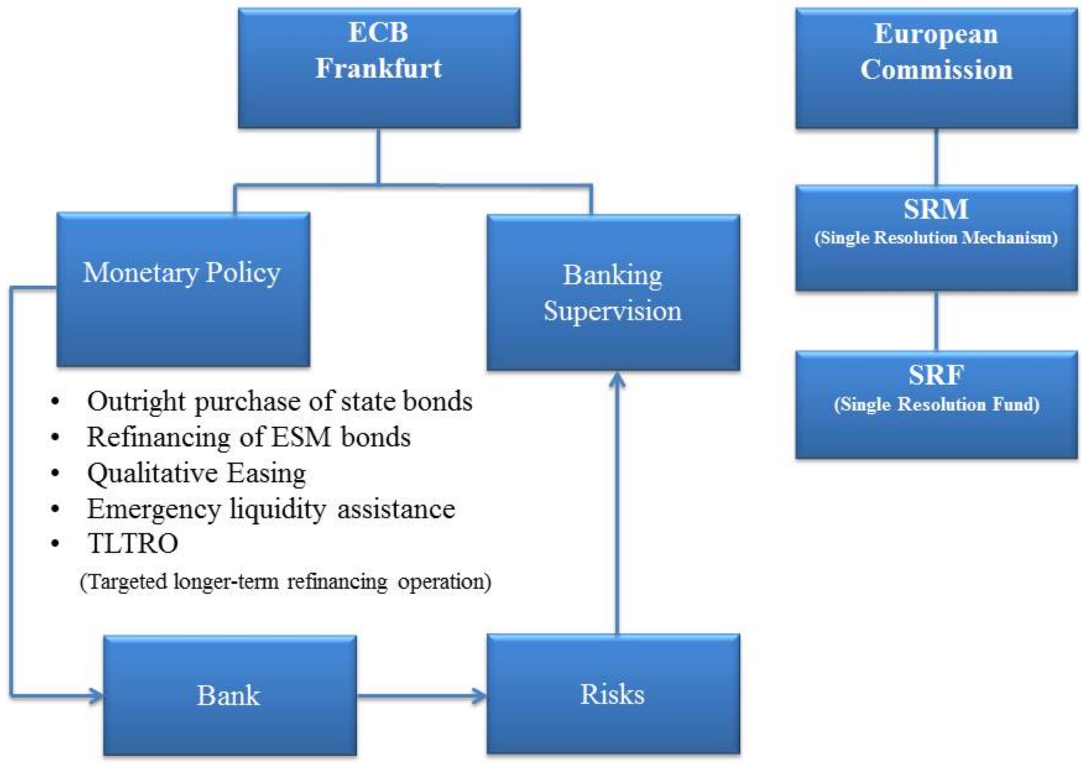
4. "Fulfilling European Monetary Union": ECB becomes the omniscient banking supervisor (SSM)

Since 4th November 2014, the ECB has become the single supervisory mechanism (SSM) throughout the Euro-Zone for the countries of the European Union as well as those which have opted to cooperate with the ECB in the field of banking supervision.

a. Conflicts with monetary policy: Setting the fox to watch the geese?

[76] Loriana Pelizzon, Marti G. Subrahmanyam, Davide Tomio, Central Bank driven Mispricing , working paper Nr 226 edited by SAFE Research Center 29 Oct 2018

All observers - including particularly the Bundesbank- agree that the current monetary policy pays heed to the fiscal situation of Eurozone governments as well as the financial needs of banks. The measures in the past and those additionally announced in the fields of quantitative and qualitative easing have led to an abundant and probably redundant amount of liquidity in the markets, which is looking for a placement with high yields. This is a highly risky situation and one cannot deny the fact that the ECB is the major source of that risk. The question is therefore legitimate: How can the ECB as a single supervisory mechanism act independently from its role as a monetary policy agency? Moreover the potential collusion with ESM and thus the banking sector remains as critical as described under 1.c.[77]



[77] See Graphic N° 1.

b. Overaccumulation of liquidity and Europe-wide deposit insurance?

The ECB seems reluctant to discuss the structural financial instability generated by its policy of zero interest rates, generous qualitative easing and sustained quantitative easing. *Draghi* and the diverse instigators of that policy must fear that the continued abolition of interest as a price for lending, the lax policy on collaterals and the distortion of competition on bond markets in the segment of 2 to 30 years[78] will lead to an over accumulation of liquidity in the balance sheets of credit institutions. That liquidity - though obtained by banks under conditions free from any competition- will seek easy and high returns.[79] That is why it will remain uncertain if all that liquidity will flow into the traditional lending business, which in Europe remains important for corporate finance. In fact, corporate lending would entail lengthy bargaining with debtors and generate only moderate long term profits. Investing liquidity into risky bonds issued e.g. by Thailand or Uruguay is therefore a more challenging option, in as much as it does not entail any capital requirement. The scale of new risks to be accumulated in the near future can readily be envisaged.

This is why the ECB not only supports but promotes the integration of all Eurozone deposit insurances[80] to ensure that in case of failing bank insolvencies, the depositors of the banks will not queue up either to be reimbursed by the banks or by the national tax payer. The ECB is aware that particular problematic countries are short of fiscal resources to meet a second banking crisis. It is therefore understandable that *Draghi* very recently gave weight to the Commission objective

[78] Meanwhile on December 9th 2016 the ECB Council has even decided to purchase bonds with a duration of no less than one year ; cf https://www.ecb.europa.eu/press/pressconf/2016/html/is161208.en.html.

[79] Which will be transferred to the ECB.

[80] See Speech by *Draghi* "One year of ECB Banking Supervision" at the ECB Forum on Banking Supervision, 4th November 2015, Frankfurt, also: Proposal for a Regulation of the European Parliament and the Council (Regulation (EU) N° 806/2014) to establish a European Deposit Insurance.

of making all existing deposit insurances liable for each other through a reinsurance scheme.[81] He is followed by his unconditional academic supporters in academia.[82]

That approach is fundamentally flawed because such a scheme would allow banks in countries without any or with an insufficient deposit insurance to benefit from countries with well-established deposit insurance systems. That would inevitably create adverse incentives and thereby distort competition: banks in countries with no deposit insurance would have a cost advantage. The deposits of their clients would be protected without any financial contribution of the savers. This 'free of charge' protection would incentivise these banks to attract depositors by means of attractive interest conditions. Depositors could thus put their funds anywhere, irrespective of the sustainability of the bank's business model. Contrary to the spirit of the banking union aimed at treating banks as potentially exiting the market, an institution such as the ECB effectively underwrites the integrated deposit insurance throughout the Eurozone. The counterproductive impact on financial stability is palpable. For an observer of market logic, this is an astonishing state of affairs.

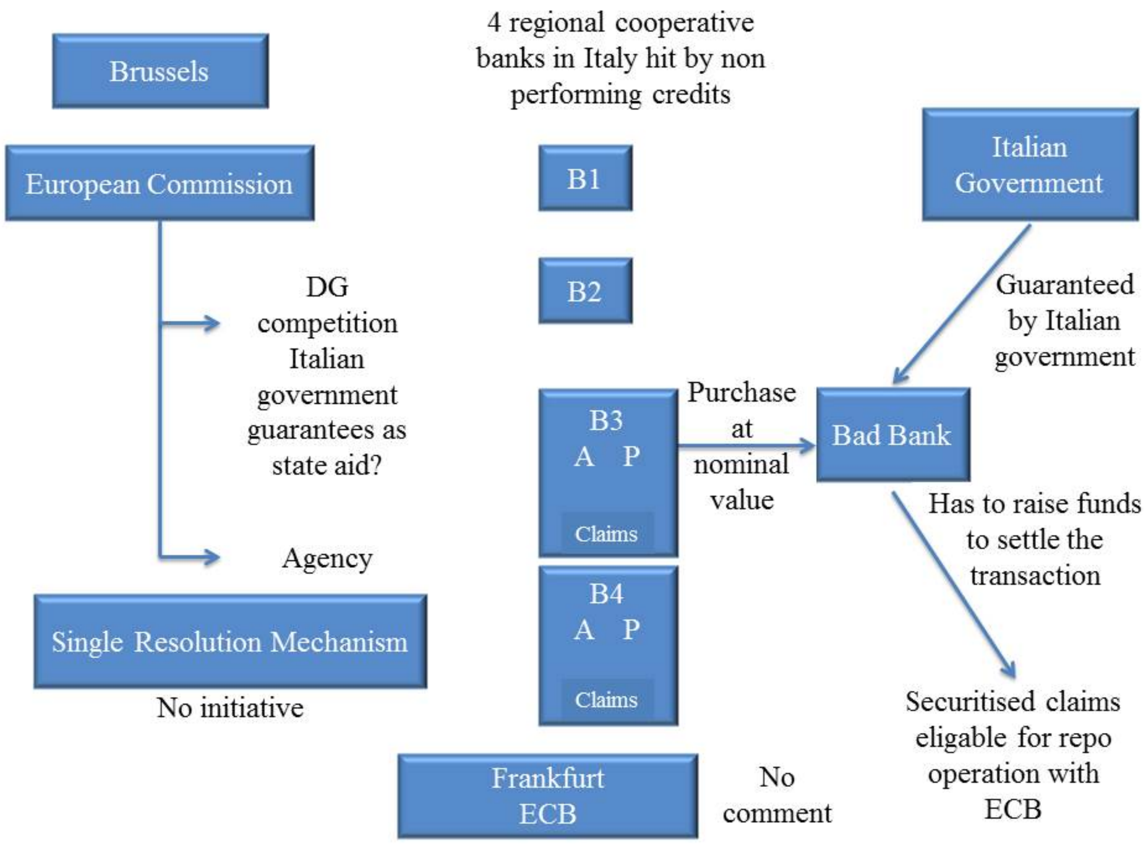
Germany is for the time being opposed to the Commission's project, fearing a political backlash against the idea that her accumulated funds could be used to guarantee the deposits of savers in other European countries.[83] Would Germany expect the same solidarity from others in Europe if her own funds proved insufficient ? Such an expectation might prove to be more illusion than reality. What could Germany expect from Austria, Slovakia or even Finland? The reality is that some countries have a strong longing for European deposit insurance as they are more vulnerable than others.

[81] http://www.ecb.europa.eu/ecb/legal/pdf/en_con_2016_26_f_sign.pdf;

[82] Isabel Schnabel, The Regulation of Sovereign Exposures, 5th DIW Lecture on Money and Finance, Berlin 21st August 2019

[83] In particular the German savings banks (Sparkassen) and the cooperative sector (Genossenschaftsbanken) offer fierce resistance in view of their own deposit insurance autonomously financed by their deposit clients.

Let us take a closer look at the situation of the Italian banking sector as well as the European Commission's initiatives so far:



The ECB, a driving force behind integrated deposit insurance, has not only escaped the public eye but illustrated its anticompetitive stance as well as its resolution to avoid banks' market exit. The intervention of the ECB in the context of the Italian banking crisis will reveal its fundamental attitude because Banca d'Italia's governor has already postulated publicly the qualification of securitized non-performing loans from Italian banks as eligible for repo operations.[84]

5. The "prisoner's dilemma" of the ECB:

So far the inflation target has not been reached despite the heavy arms of quantitative easing leading to an overall stock of bonds of 2,6 trillion Euro in the balance of the Eurosystem. Additionally, in spite of unique financing conditions, symptoms of fading growth are gaining the upper hand. Instead of revising the appropriateness of the ECB's tools, " new monetary instruments" are being discussed under the benevolent auspices of the ECB. Moreover to prove its institutional authority weakened by academic and political critique of its deficient policy, the ECB announced the restart of net asset purchases as an open ended programme.

However reality is incontrovertible: the ECB's non-standard monetary policy has led the central bank into a trap. So far the ECB has not demonstrated that its policy has been successful in achieving with proportionate means at reasonable risk the fixed target of inflation. There is only an uneven economic upswing in the economy from one country to another in the Eurozone. But that upswing does not necessarily correlate with the ECB's policy and it is now fading away.

Despite that setback, the ECB's board and its council continue to take risks which are disproportionate compared with the objectives sought. Enlarging the balance sheet of the eurosystem brings the central banks of the Eurozone into even deeper dependence on the banking sector and its willingness to increase lending activities. There may come a point where crisis measures will not remain exceptional but

[84] See interview of Ignazio Visco with the Börsenzeitung in Summer, 2016. Kerber, Die Draghi Krise, München 2018 S. 30ff

become perpetual,[85] simply because banks, governments and their financial needs dominate the ECB and not *vice versa*.

So far the ECB has given time to governments in order to get reform under way for both public and private sectors. That is, fiscal rebalancing (stable public budgets) and restoring the competiveness of their enterprises. But that time credit has led most of the governments, particularly the French, to the fallacy that they can simply refuse unavoidable reforms.[86] Again the ECB is now dependent on governments who request a wider range of exceptional measures and a longer if not perpetual endurance of these measures.

a. Judging the effects of the policy hitherto

If the performance of the ECB's crisis policy is judged in an objective way, it is apparent that for the time being, there is a growing discrepancy between the vitality of the financial markets until now and the state of the real economy. The real economy continues to be sluggish in some countries and buoyant in others whereas financial markets, despite volatilities, are extremely euphoric and have led indices for CAC 40, Dow Jones, etc. to record levels.

Contrary to Trichet who despaired of the lack of affection showed to him and his policy by the markets, *Draghi* seems to be widely accepted by them. For the time being, *Draghi* uses that positive attitude of the markets to deliver. He is considered by the markets to be the man who will make the kind of monetary policy which supports their interests. The question, however, is how long that will last. The probable answer is: " until the expectation of the market no longer matches

[85] This was suggested by former Board member and vice-president Constancio

[86] So far President Macron has not executed any of the promised cuts of 60 billion Euro in France's expenditure.

Draghi's capacities to conduct monetary policy due to restrictions and the protests of other board members". [87] Protest against the decision on September 12th was heard of from some of its members after the ECB-Council's decision which – surprisingly enough -took place without formal vote. With the expiration of Draghi's mandate the special relationship between the ECB-President and the market becomes obsolete. The new ECB President Lagarde whose expertise as economist is less reassuring than that of her predecessors will have to try hard to re-establish something equivalent.

b. The normative consequence of ongoing crisis policy: no balance of powers or the omnipotence of monetary policy

It became very apparent in the public audience of the ECJ on October 14th 2015 that the Commission and the European Central Bank claim to define the range of the ECB's mandate clearly by connecting it with the ECB's intention to conduct monetary policy. The definition of prerogative powers according to subjective elements is inherently dangerous. A war of aggression remains a war of aggression, even if the aggressor purports to only act in self-defence. Ever since the ECJ's ruling on OMT, the ECB has claimed absolute power to reinvent its mandate by prolonging and enlarging its extravagant policies. Since December 8th 2016 we knew that PSPP would not only go on until March 2017, but would also be pursued after September 2017. [88] Since then the amount of monthly net purchases had been reduced to 30 billion Euros. On June 13th, the ECB Governing Council announced that from October the net purchase would be reduced to 15 billion to expire definitely by the end of 2018. However ECB's Draghi clarified that the QE

[87] See Markus C. Kerber, Die Draghi Krise, Was die Europäische Union für Italien plant und von Deutschland bezahlen lässt, München 2018

[88] However, the volume of monthly purchases will be limited to 60 bn Euros. Afterwards the ECB was purchasing monthly 10-20 bn Corporate Bonds on the markets till December 31sr 2018.

programme would remain in force and all income from the Eurosystems purchase would be reinvested in an open ended manner. In fact, the amount of reinvestment from April 2018 to April 2019 was roughly 140 billion Euros. But not only factually has the APP now become

“ part of ECB’s” tool box”. Draghi officially admitted that APP” remains now a normal instrument to monetary policy.” The decision on September 12th 2019 to restart net asset purchases of bonds leaves the impression of an erroneous dictator who despite the evidence of the inappropriateness of his policy measures prescribes more of the drug which has turned out to inefficient and judged dangerous, merely to reinforce his authority and to protect his power against rational doubt. As dictators who evidently fail in their decisions, are extremely reluctant to admit error, their power becomes extremely dangerous. If Madame Lagarde is unwilling and incapable to attempt a new beginning, she will be trapped by Draghi’s past and ECB policy will take an even more dangerous turn.

It remains uncertain whether in the pending cases against the ECB and its QE-programme, the German Federal Constitutional Court will give clearance to the renewed purchase policy. After getting a preliminary ruling from the European Court of Justice in 2019 and an audience in the Federal Constitutional Court on July 30th/30st 2019 the public is expecting a final ruling which will pay tribute to the perspective of renewed net asset purchases decided by ECB with effect on November 1st 2019.

c. The crowding out effect : the ECB without strategic reserve

If an army is at war, its fundamental strategic guideline is to maintain a strategic reserve in all circumstances. According to Clausewitz[89], a strategic reserve has to be kept to be able to act decisively in a crucial strategic moment. [90]

[89] Clausewitz, On War, book III, Chapter 13, Penguin p.284ff.

“A reserve has two objects which are distinct from each other, namely, first, the prolongation and renewal of the combat, and secondly, for use in case of unseen events.”[91]

Does the ECB have a strategic reserve after all its war against “deflation” and the “dysfunctioning of transmission channel” of monetary policy?

Taking into account the uniquely immense volume of bonds purchased since March 2015, it cannot only be argued that such a non-standard policy is not sustainable in the long run without generating results in terms of growth and inflation which are proportionate to its risks and side effects. But the ECB’s quantitative easing (PSPP) has led to the limitation of bonds eligible for purchase according to the ECB’s eligibility criteria. As yields have come down due to QE, fewer bonds are available on the market which bear at least -0,4 interest. Additionally the ECB excluded in its decisions as of March 2015 bonds with maturity of less than two years and was reluctant to purchase more than 33% of the outstanding issue. Although the volume monthly net purchases of 30 billion Euro continued till October 2018 and then came down to monthly 15 billion Euros to expire at the end of the year, the crowding out-effect will remain a significant issue because all net proceeds from the ECB’’s purchases will be reinvested in an open ended manner.

Perhaps the eligibility criteria will have to be adjusted as a function of the future “emergency situation”. In December 2016 the ECB already eased eligibility criteria:

- Bonds with a yield below interest rates for ECB’s deposit facility “ will be permitted to the extent necessary”: is ECB obliged to incur losses ?
- The maturity range was broadened by decreasing maturity for eligible securities from two years to one year.

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90 The Ostheer - the German Army deployed in Russia since 1942 - missed that moment in the Summer of 1943 in the battle of Kursk when Hitler, instead of breaking the Russian front by throwing in its reserves, withdrew his troops and deployed them on the Italian front. According to *von Manstein*, the most sophisticated of the German fieldmarshalls, throwing in the strategic reserves of the German *Panzerarmee* would have struck the Red Army by such a surprise that Kursk would have become a German victory.

91 Clausewitz, ibid.

For the time being the ECB does not have the courage to alter the 33% limit because that would have made it a party in any potential future debt restructuring. If after November 1st 2019 purchasing becomes difficult because the crowding out process continues, the ECB will be sooner or later at odds finding eligible securities for its QE. The question of the strategic reserve is therefore left wide open. The loss of parameters of action for ECB becomes practically apparent in the light of the necessary exit from unconventional monetary policy. Unless the deteriorated situation in Italy leads the ECB to update or even to enlarge its non standard policy which would lead to an institutional conflict, ECB was expected to prepare an exit. As a matter of fact, the inflation rate currently is at 1.9% which conforms with the ECB's target. Instead of making an announcement on the manner of its exit ECB creates the expectation of renewed and amplified QE. As already mentioned that process goes hand in hand with unsolicited proposal by the investment industry for monetary instruments going clearly beyond the ECB's mandate.[92]
That will immediately bring the market value of the purchased assets significantly down. All investors with portfolios incurring losses would have to write down the portfolio's market value. It remains to be seen whether those investors have sufficient buffer in their balance sheet to absorb the amount of losses.

d. Endgame: Collapse or reform of the Eurozone by parallel currencies

If the ECB's crisis policy is going to be perpetuated as standard policy and even enlarged, that could endanger financial stability, distort pricings of bonds and finally lead – as all distortions of competition -to the collapse of the whole Euro-System.

[92] Blackrock Investment Institute, Dealing with the next downturn, August 2019 p.12

If exit from that policy does not find an advocate we have to ask: Is a reasonable reform of the Eurozone still possible ? Which institutional reforms should be envisaged ?How could parallel currencies facilitate that process ?. An operational plan exists.[93] Despite the ups and downs of the Greek crisis, the public is not yet ready for fundamental changes. The issue of exiting the ECB policy, however, is under discussion. The German Institute of Industrial Economics (Institut der Deutschen Wirtschaft, a research organization of the Confederation of German industry) formulated a plan five years ago at the request of the German insurance organization for the exit of crisis policy both in terms of quantitative and qualitative easing and in terms of zero interest policy. That plan presupposes a significant upswing in the European economy and a slight increase of inflation. [94] Both conditions have been fulfilled.

For the time being, the ECB's policy is the major source of financial and institutional instability. Let us sum up the most striking features of the phenomenon of central bank induced instability:

- The ECB has become an indispensable market maker.[95] The influence of its zero interest policy[96] combined with qualitative easing and a purchase programme for public bonds is being enlarged by further quantitative easing (QE II). The ECB has accustomed bond markets to its purchase practices as a big investor with unlimited resources which systematically distorts competition. Due to QE, Portugal, Spain and Ireland have been put into a position to make short term bond issues at negative interest rates. Thus they

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[93] Kerber, More monetary competition, Stuttgart 2015. The Second largely accomplished edition is now available. Cf Edition europolis www.europolis-online.org.

[94] http://www.gdv.de/wp-content/uploads/2015/03/IW-Studie-Niedrigzinsumfeld-06-2014.pdf.

[95] Comparable to the Fed from 2008, *Merhling,* The New Lombard Street: How the Fed Became the Dealer of Last Resort, 2010.

[96] See the negative effects described by Schnabl: Der Weg in die Nullzins-und Hochverschuldungsfalle (2013)

https://www.econstor.eu/handle/10419/94500 have received the wrong message from the market. Neither their budgetary situations nor the overall state of their economies could explain such a favourable treatment. Other problematic countries like France have been encouraged to cherish the illusion that their budget will be balanced without any adjustment of current spending practices. Therefore the ECB has outmanoeuvred itself. The central institution of the Eurozone for sovereign monetary policy has ceased to be sovereign. The ECB depends now, more than ever before, on the will for reform in the Eurozone member states as well as on the continued expectation of the markets that unconventional monetary policy will go on.

- The loss of operational parameters for monetary manoeuvring goes hand in hand with enhanced freedom of the ECB from normative, institutional and wider political limitations. The ECJ's ruling as of June 16th 2015, as well as that of December 11th 2018, irrespective of its conditional application by the German Federal Constitutional Court[97], is claimed by the ECB to be a general empowerment to continue or even enlarge "unconventional policy". Auditions at the European Parliament (EP) are used by the ECB President to prove his institution's sense of accountability, although nowhere in Europe is there less opposition to the ECB than in the EP. The claim of the EP's President to show the relevance of this – highly unrepresentative – institution[98] goes hand in hand with the ECB's ambition to receive parliamentary clearance to improve its image in the general public. One must stress the fact that the ECB's accountability before the EP is not only an illusion, but contrary to the principle of a central bank's independence from the volatile sphere of a pseudo-democratic institution. Within the ECB,

[97] Cf. BVerfG ruling as of 21.6.2016

[98] In the Lissabon ruling the Bundesverfassungsgericht(German Constitutional Court) has qualified the European Parliament as ineligble for constituting a democratic government as it lacks democratic representation.Cf.Bundesverfassungsgericht June 30th 2009: BVerfGE 123, 372 ff.

Draghi's audition in an EP Committee is universally considered to be more of a symbolic gesture than an act of genuine accountability.

- The loss of parameters of action for the ECB becomes particularly apparent in the light of imminently expected and endlessly postponed zero interest rate policy and the impossible netselling of bonds from a state bond laden balance sheet of the Eurosystem. If ever the ECB/Eurosystem sold bonds in significant quantities, writeoffs would become immediately necessary for institutional investors. The hour of truth will come and face investors with a difficult accounting challenge. As the value of purchased assets both in bonds and stocks will be adversely affected, all investors trading in these assets have to operate an immediate write off to market value. It remains to be seen whether investors will have enough equity to buck such an adverse market development entailed by a tailored increase of interests and net asset sale by the ECB. If not the Single Resolution Mechanism will have a historic chance to prove its functionality as systemic shock absorber.

- But the most dangerous dependence results from the ECB's reliance on the banking sector. Cherished and pampered by the ECB, the credit institutions, particularly in Italy, continue their reluctance to provide the real economy with credit. Instead they benefit from the advantages of monetary policy to invest in equity markets as well as in hazardous debt instruments. Their risk is the most worrisome heritage of the ECB's policy. If they fail, the system could collapse irrespective of a Single Resolution Mechanism because the SRM cannot liquidate more than one medium sized bank at once for lack of funds in the SRF. Therefore I fear that the ECB has become a prisoner of its central banking debtors. Have the credit institutions become the masters of monetary policy? Are they the new sovereigns in the word of finance? The ECB has done its utmost to increase its dependence on a banking sector continuously uninterested in the lending business.

A sober review of the ongoing ECB policy proves that it has been amplifying the amount of structural risk in financial sector by a policy which so far has not reached any of its objectives. The ECB's claim to mutualize individual banking risks cannot conceal the fact that ECB has itself become a major risk and, thus, a source of instability. Therefore we face the beginning of a fundamental debate about the limits of central banking power. [99] That will clearly mark the end of confusing institutional independence with unlimited powers of the ECB.

[99] Cf. Schnabl, The Failure of ECB Monetary Policy from a Mises-Hayek Perspective, January 2017.

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