BRIEFING

Developing a pandemic emergency purchase programme

Unconventional monetary policy to tackle the coronavirus crisis

SUMMARY

The Treaty on the Functioning of the European Union specifies the maintenance of price stability in the euro area as the primary objective of EU single monetary policy. Subject to that, it should also contribute to the achievement of the Union's objectives, which include 'full employment' and 'balanced economic growth'. Responsibility for the conduct of monetary policy is attributed to the Eurosystem, which carries out its tasks through a set of standard instruments referred to as the 'operational framework'. To tackle the financial crisis, the Eurosystem has complemented its regular operations by implementing several non-standard monetary policy measures since 2009.

The first strand of these measures had the primary objective of restoring the correct functioning of the monetary transmission mechanism by supporting certain distressed financial market segments, playing an important role in the conduct of monetary policy. A second strand of non-standard measures was aimed at sustaining prices and fostering economic growth by expanding the size of the Eurosystem balance sheet through massive purchases of eligible securities, including public debt instruments issued by euro-area countries. Net purchases were conducted between October 2014 and December 2018, after which the Eurosystem continued to simply reinvest repayments from maturing securities to maintain the size of cumulative net purchases at December 2018 levels. Due to prevailing conditions, however, in September 2019, the European Central Bank (ECB) Governing Council decided to recommence net purchases in November of the same year 'for as long as necessary to reinforce the accommodative impact of its policy rates'.

The spread of the coronavirus in early 2020 has impaired growth prospects for the global and euro-area economies and made additional monetary stimulus necessary. In this context, the ECB has increased the size of existing asset purchase programmes, and launched a temporary, separate and additional pandemic emergency purchase programme (PEPP).

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In this Briefing

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Introduction

Article 127 of the Treaty on the Functioning of the European Union (TFEU) states that the primary objective of single monetary policy is to maintain price stability, which is defined as a yearly increase in inflation[1] for the euro area of below, but close to 2 %. Responsibility for pursuing this policy is attributed to the Eurosystem, which comprises the European Central Bank (ECB) and the national central banks (NCBs) of the Member States whose currency is the euro. Article 127 adds that, 'Without prejudice to the objective of price stability', the Eurosystem shall also 'support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union'. These include, among other things, 'full employment' and 'balanced economic growth'. The Eurosystem carries out its tasks through a set of instruments referred to as the 'operational framework'. They consist of open market operations,[2] standing facilities[3] and minimum reserve requirements for credit institutions.[4]

In addition, the European Central Bank (ECB) has implemented several non-standard monetary policy measures to complement the regular operations of the Eurosystem since 2009. A substantial part of these measures has the primary objective of restoring the correct functioning of the monetary transmission mechanism[5] by supporting the market for certain financial instruments, which play a decisive role in the conduct of monetary policy. Besides that, a second strand of non-standard measures implemented by the Eurosystem is aimed at achieving monetary stimulus, i.e. increasing liquidity in the economy to sustain prices and foster growth by expanding the size of the Eurosystem's balance sheet.

Securities markets programme

The outbreak of the financial crisis in 2008 put the euro-area banking system under stress and particularly affected banks' covered bond market. This is why the ECB decided in 2009 to intervene to support this market segment by implementing two different purchase programmes: the covered bond purchase programme 1 (CBPP1) and 2 (CBPP2).

With the beginning of the European sovereign debt crisis in early 2010,[6] certain primary and secondary markets for government bonds also began to dry up. These increased the risk of impairing the transmission mechanism, due to the link between government bond interest rates and the costs of borrowing in the economy (interest rate channel), the crucial role government bonds play in repurchase transactions[7] (liquidity channel) and the potential impact of the price of government bonds on banks' balance sheets (balance-sheet channel).

To address the malfunctioning of the market segments concerned and to restore an appropriate monetary policy transmission mechanism, the ECB announced the securities markets programme (SMP). This consisted of targeted purchases in the secondary markets of euro-area public and private bonds that showed a collapse in prices and a subsequent increase in interest rates, in an era when the ECB had drastically lowered key interest rates. The SMP aimed to increase the price of bonds concerned, so as to reduce their interest rates and bring them more into line with the general development of market interest rates and the ECB's monetary policy impulses. Under the programme, the Eurosystem purchased about €220 billion of Greek, Irish, Portuguese, Italian and Spanish government bonds and held them until they matured. To ensure the programme did not engage in a form of 'quantitative easing', the ECB sterilised[8] its interventions by offering selling banks interest-bearing deposits, on a weekly basis, for an amount equal to the amount of government bonds it purchased.

According to an ECB study, the programme led to 'stabilisation in markets as well as to an immediate and substantial decline of government bond yields'. Indeed, relative to German government bonds (*Bunds*), Greek ten-year spreads tightened more than 400 basis points (bps), i.e. 4 %, on 10 May 2010. When the ECB expanded the SMP to Italian and Spanish debt in August 2011, both countries' ten-year yields fell some 100 bps relative to *Bunds*.

Outright monetary transactions

Nevertheless, the period from late 2011 to early 2012 was tumultuous, with a proposed Greek referendum on the EU financing package and government crises in both Greece and Italy, as well as Standard & Poor's downgrading of nine euro-area sovereigns in January 2012 and lowering of 16 Spanish banks' credit rating in April of the same year. The uncertainty created – and which Greek elections in spring 2012 did not dissipate – resulted in government bond yields of a number of euro-area countries reaching new heights and beginning to incorporate a risk that some Member States would exit the economic and monetary union (EMU) and redenominate their public and private liabilities in a reborn national currency. Against this background, the ECB sent a strong signal to the markets, with its President declaring that the ECB was ready to do 'whatever it takes' to preserve the euro. This was followed shortly after by the announcement of a new programme under which the ECB was ready to intervene via outright monetary transactions (OMTs), along with NCBs, in the secondary sovereign bond markets of euro-area Member States. Following the Governing Council decision of 6 September 2012 to initiate OMTs, the SMP was terminated.

The main elements of the OMT programme were the following:

- strict and effective conditionality attached to an appropriate European Financial Stability Facility (EFSF) / European Stability Mechanism (ESM) precautionary or macroeconomic adjustment programmes;[9]
- transactions under the programme would be focused on sovereign bonds with a maturity of between one and three years;
- no ex-ante quantitative limits were set on the size of OMTs;
- the Eurosystem accepted the same (*pari passu*) treatment as private or other creditors with respect to bonds issued by euro-area countries and purchased by the Eurosystem through the programme;
- the liquidity created through the programme would be fully sterilised;
- Lastly, for transparency reasons, aggregate holdings under the programme and their market values would be published on a weekly basis.

Ross et al. note further that Member States should have regained access to private capital markets, defined as successfully placing a bond offering with a ten-year maturity; and have borrowing costs elevated beyond what should be normally justified by underlying economic fundamentals. Altavilla et al. attempted to quantify the financial and macroeconomic impact of OMT announcements in four euro-area countries: Germany, France, Italy, and Spain. According to their findings, the mere announcement that the Eurosystem might engage (under specific conditions) in OMTs had a sizeable impact on financial markets. Indeed, such announcements led to a decrease of about 200 bps in the two-year government bond rates in Italy and Spain, while leaving German and French bond yields for comparable maturities largely unaffected. Secondly, their evaluation suggests that OMT announcements have statistically significant and economically relevant effects on credit, as well as on economic growth in general, in Italy and Spain, with relatively limited spillovers in France and Germany.

Asset purchase programme

During 2014, inflation in the euro area, even net of the most volatile components such as energy and food, fell significantly below the definition of price stability, and economic activity gradually lost momentum. The risks of a decoupling of inflation expectations and the start of a deflationary spiral increased.[10] The ECB Governing Council repeatedly reduced the official rates by bringing the refinancing operations rate close to zero and the deposit facility rate to negative values. In June of the same year, the Governing Council also announced the launch of targeted longer-term refinancing operations (TLTRO) – aiming in essence to provide banks with cheap long-term credit against adequate collateral, to allow them to use this liquidity to increase the credit granted to the real economy. Another two rounds, in March 2016 and March 2019, followed this first round of TLTROs.

In September 2014, the Governing Council launched an asset purchase programme (APP) consisting of buying asset-backed securities resulting from the securitisation of bank loans to businesses and households (asset-backed securities purchase programme, ABSPP) and bank covered bonds (CBPP3). In contrast to the SMP, this intervention bore a monetary stimulus, aimed at promoting lending to the real economy and sustaining prices and growth through an increase in the size of the Eurosystem balance sheet.

In January 2015, the Governing Council deemed the monetary stimulus achieved through the monetary policy measures adopted between June and September 2014 to be insufficient. Although it had contributed significantly to reducing private-sector financing costs, and in particular the lending interest rates applied by banks to businesses, the overall amount of liquidity injected into the economic circuit was lower than expected. Inflation expectations continued to signal a return to values close to 2 % only over a very long-term horizon.

For these reasons, the Governing Council decided to extend the APP to public debt instruments, by launching the public-sector purchase programme (PSPP). It also increased the size of the APP to €60 billion per month and announced that it would run until at least September 2016 and in any case until inflation in the euro area became consistent with the monetary policy objective. In December 2015, the Governing Council further reduced the deposit facility rate with the Eurosystem and strengthened the APP by formally extending its duration until March 2017 (or longer if necessary) and expanding the range of eligible public securities. The Governing Council also announced that the repayments on matured securities purchased under the APP would be fully reinvested, for as long as necessary.

Under the PSPP, the Eurosystem purchased eligible marketable public debt securities[11] on the secondary markets, from eligible counterparties,[12] under specific conditions. In particular, so as not to hinder the market price formation process, purchases should meet an issue share limit (initially 25 %, subsequently increased to 33 %) per single eligible marketable security under the programme,[13] and an aggregate limit of 33 % of each issuer's total outstanding securities.

Concerning the purchase allocation, the bulk (about 90 %) of the total value of eligible marketable debt securities purchased under the programme consisted of securities issued by central governments and recognised agencies, while the remainder was composed of securities issued by eligible international organisations and multilateral development banks. To ensure the effectiveness of the PSPP, the Governing Council provided that the Eurosystem would make securities purchased under the programme available for lending, including repurchase operations.

NCBs purchased 92 % of the total market value of purchased eligible securities – according to the ECB's capital key,[14] while the rest was purchased directly by the ECB. A specialisation criterion was applied according to which each NCB is the primary purchaser on the secondary market of its own country, while the ECB purchases securities from each jurisdiction. This has limited the PSPP risk-sharing to the purchases conducted by the ECB.

Finally, transparency was an important element of the APP. In this respect, the Eurosystem undertook to publish the book value of securities held under its purchase programme under the open market operations section and the total book value of the securities held, in the commentary of its consolidated weekly financial statement. In addition, it published the weighted average residual maturity by issuer residence of its holdings under the purchase programme on a monthly basis, separating international organisations and multilateral development banks from other issuers.[15]

In March 2016, the ECB increased the APP to €80 billion per month and added a new component, the corporate sector purchase programme (CSPP). Under the CSPP, the Eurosystem purchased securities issued by non-bank corporations (corporate bonds) in both the primary and the secondary market.

The Eurosystem continued with its unconventional monetary policy in 2016 and 2017. At its 26 October 2017 meeting, the ECB Governing Council decided that, as of January 2018, monthly net asset purchases would be halved to €30 billion until the end of September 2018, or beyond. As of October 2018, it further reduced the amount of its monthly purchases under the expanded APP to €15 billion. It finally halted net asset purchases at the end of 2019, but only temporarily.

Between January 2019 and October 2019, the Eurosystem fully reinvested the repayments from maturing securities held in the APP portfolios, with the aim of maintaining the size of cumulative net purchases under each component of the APP at their respective December 2018 levels. However, due to prevailing conditions, on 12 September 2019, the ECB Governing Council decided that 'net purchases will be restarted under the Governing Council's asset purchase programme (APP) at a monthly pace of €20 billion, as from 1 November 2019. The Governing Council expects these to run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates'.

The APP is similar in many respects to the 'quantitative easing' programmes launched earlier by the United States Federal Reserve System, the Bank of England and the Bank of Japan.

According to an ECB report, the APP has provided a substantial improvement in financing conditions via several transmission channels, and each individual policy measure, being part of a package of policy measures, has benefited from reinforcing synergies. First, the APP would have direct consequences on the yields of the public and private securities subject to the programmes, leading to an improvement in credit supply conditions and stimulating investments ('interest rate channel'). Second, the increase in liquidity and the reduction of interest rates would favour the depreciation of the euro exchange rate ('exchange rate channel'); this would contribute to raising inflation, avoid the embedding of deflation expectations and provides an additional stimulus to economic activity. Third, investors could use additional liquidity to rebalance their portfolio towards other financial assets not directly affected by central bank interventions, thus transmitting the monetary impulse to a wide range of private-sector financing instruments ('portfolio readjustment channel'). Fourth, the increase in the value of household wealth induced by the increase in the prices of financial assets, and in view of real ones, would lead to greater growth in consumption ('wealth channel'). Finally, the announcement of a significant expansion of the size and composition of the Eurosystem's balance sheet would contribute to increasing public confidence ('channel of trust'), stimulating consumption and investment, and to supporting inflation expectations ('channel of expectations of inflation').

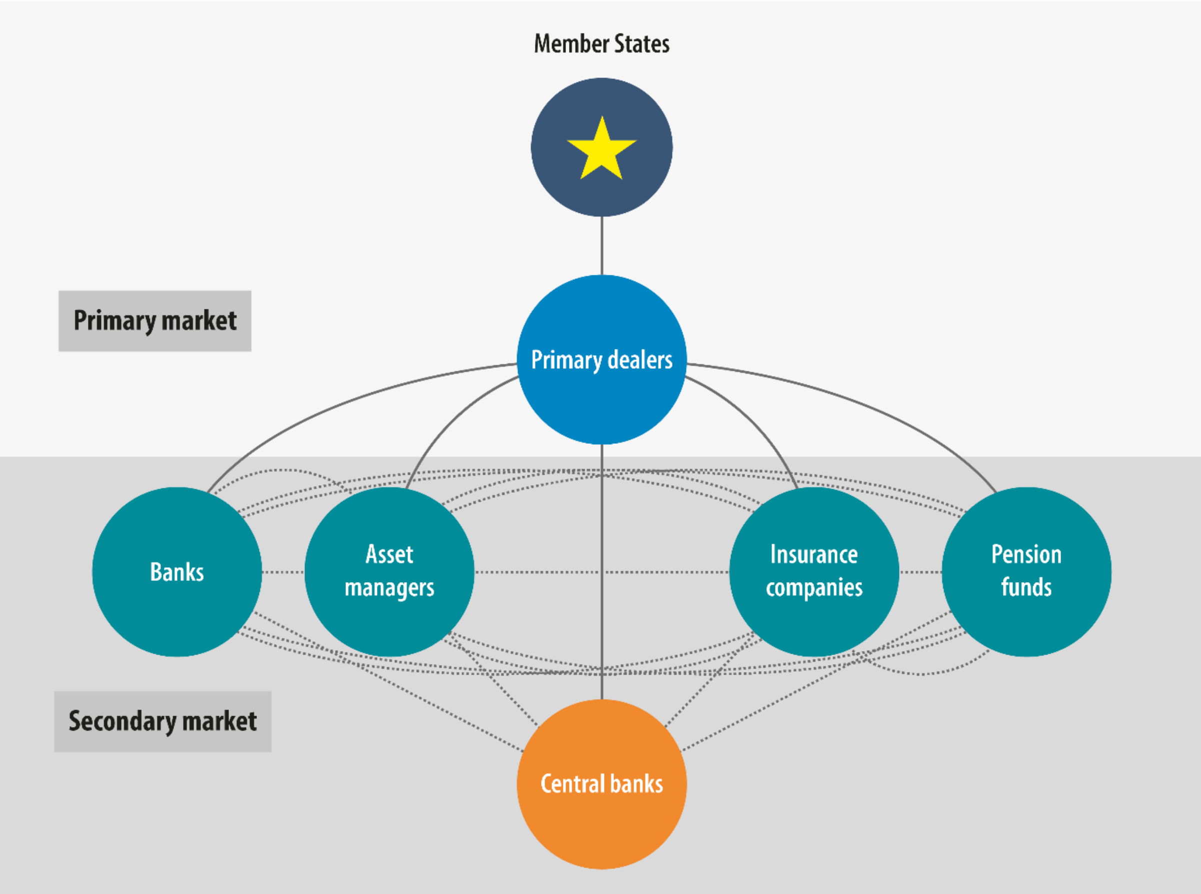
In their 2017 paper, Bua and Dunne find that rebalancing effects were mostly aimed at assets issued outside the euro area and were not large. The authors also find that significant effects could only be noticed after the pace of purchases was increased. They therefore suggest that the choice of programme scale may be crucial. Lastly, but not less importantly, the authors note that continued flow towards non-euro-area assets, despite euro weakness, suggests a reluctance on the part of investors to bet on growth at the levels of risk perceived at the time. This, according to them, provides another perspective on the role asset-purchase programmes play in delivering inflation: at that point, at least, it seemed that the market view was that inflation would more likely be achieved through imported inflation rather than through risk-taking, lending and issuance of new debt and equity by non-financial corporations or banks.

Using an event study approach, Urbschat and Watzka estimate different asset price channels by quantifying the cumulative decrease of spreads and by running event regressions for several euro-area countries. Focusing on the signalling channel, they find that the effects in yield and spread reduction were most pronounced for the initial announcement on the PSPP, but declined afterwards for additional announcements. The authors note that possible explanations for this are the declining degree to which the ECB surprised markets and the increasingly burdensome institutional set-up of the purchase programme.

Possible effects of the public-sector purchase programme on TARGET2 imbalances

Sovereign debt instruments are issued by governments (directly or through specific agencies) on the primary market, where in most cases they are purchased by primary dealers, i.e. banks or other financial institutions which are authorised to trade securities with a government subject to certain legal and operational requirements. Primary dealers then negotiate these instruments with each other or sell them to other institutional investors (including banks, insurance companies, pension funds, savings managers, etc.), thus creating the secondary market in which the ECB and the NCBs of the Eurosystem conduct purchases in implementation of the various asset purchase programmes.

Figure 1 – Simplified representation of the primary and secondary market for public debt securities



Source: EPRS.

Payments deriving from the negotiations carried out on both the primary and secondary markets are settled in TARGET2. TARGET2 is the real-time gross settlement (RTGS) system for euro payments between banks in the euro area, owned and operated by the Eurosystem. Payment orders submitted to TARGET2 are processed and settled in 'central bank money', i.e. money that commercial banks hold in an account with a participating NCB and that participating NCBs handle in their own accounts with the ECB. When the banking system in one participating Member State registers more payment outflows than inflows, its NCB accumulates a TARGET2 liability to the ECB. In contrast, if the banking system faces more inflows than outflows, the respective NCB acquires a TARGET2 claim towards the ECB. TARGET2 balances therefore mirror the cumulative net payment flows within the euro area.

According to some commentators, the implementation of the PSPP considerably contributed to the increase in TARGET2 imbalances registered between 2015 and 2018. During the European sovereign debt crisis of 2009-2010, TARGET2 imbalances rose substantially due to a loss of confidence in banks in vulnerable euro-area countries and doubts about the capacity of EMU. This resulted in capital flight from vulnerable countries to perceived safer countries, such as Germany and the Netherlands. TARGET2 imbalances mirrored these outflows and thereby became indicative of banks' funding stress in vulnerable countries. To finance the capital outflows, these banks increased their recourse to Eurosystem refinancing and therefore their cumulative liabilities. As the intensity of the crisis decreased, the recourse to Eurosystem refinancing operations by banks and TARGET2 imbalances gradually declined.

However, these imbalances increased again between 2015 and 2018, and only began reducing steadily later on. That leads to a supposition that, in this case, the imbalances are due to the uneven way in which the liquidity injected by the Eurosystem through its PSPP was distributed among national banking systems against the background of persistent fragmentation and risk perception within the euro area. The mechanism would be the following: under the PSPP, the Eurosystem purchased bonds from institutional investors through banks; the investors selling to the Eurosystem received a credit on the deposit account with their banks; at the same time, these banks accrued credit on the current account with their NCB. Many of the institutional investors selling under the PSPP hold deposits at banks in euro-area countries with the highest perceived creditworthiness. This also applies to third-country investors who have set up their subsidiaries in the euro area. As a result, purchases from non-domestic sellers made by NCBs from countries that are more vulnerable led to an increase in bank deposits in countries such as Germany, Luxembourg and the Netherlands. This mechanism would have resulted in an increase in TARGET2 deficits for the former NCBs and an increase in the positive TARGET2 balances for the latter.

According to this reading, rising TARGET2 imbalances would mirror the distribution of the liquidity created by the PSPP across the euro area. It has been argued that in a well-functioning monetary union, the liquidity created by the PSPP would be proportionally distributed between the banking systems of participating Member States, and not lead to TARGET2 imbalances. The increase in TARGET2 imbalances instead show that risk perceptions and fragmentation have not yet disappeared.

In an official bulletin, the ECB itself highlights the linear relationship between liquidity injected into the euro-area financial systems through the purchase of government bonds and the corresponding increase in TARGET2 imbalances. Other commentators acknowledged the validity of this analysis, but at the same time argued that the impact of the PSPP on TARGET2 balances was the result of the purchase specialisation criterion mentioned above, and that imbalances would not increase if purchases were carried out exclusively by the ECB.

On a different path, others found that the aggregated data seem to contradict the mechanism just seen above, at least in the case of Italy and Spain. In these countries, in fact, the public debt is largely held by residents, therefore the purchases made under the PSPP should not have generated cross-border payment flows as large as those registered in the TARGET2 balances. According to this view, to understand what happened in Italy and Spain, TARGET2 imbalances should be reinterpreted as the result of movements in the balance of payments reflecting a recomposition of residents' portfolios towards assets other than government bonds and bank bonds, which could have been favoured by the asset purchases and the liquidity injections made by the Eurosystem.

Pandemic emergency purchase programme

By the end of 2019, preliminary results for the year and two-year projections pointed towards muted growth for the euro area and the EU as a whole. This has worsened considerably with the spread of the coronavirus, which constitutes a major shock to the growth prospects of the global and euro-area economies and has heightened market volatility. The ECB's initial decision to tackle the crisis by adding only €120 billion of net purchases in the PSPP to be concluded in 2020, and some unfortunate comments during the press conference, led to divergences between the sovereign bonds yields of euro-area countries not seen since 2012. This induced the ECB to further intervene by establishing the temporary pandemic emergency purchase programme (PEPP) as separate from – and in addition to – the aforementioned net purchases under the APP, with an envelope of €750 billion, later increased to a total of €1 350 billion. The aim of the PEPP is to 'counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the outbreak and escalating diffusion of the coronavirus'.

Purchases started on 26 March 2020. Under the PEPP, the Eurosystem central banks started to conduct purchases of eligible marketable public debt securities;[16] corporate bonds and other marketable debt instruments;[17] covered bonds;[18] and asset-backed securities.[19] The eligibility criteria for the PEPP are the same as under the corresponding programmes that constitute the APP. In addition to the asset categories eligible under the APP, the programme includes a waiver of the eligibility requirements for securities issued by the Greek government. It further shortens the minimum eligible remaining maturity to 70 days (the maximum eligible remaining maturity remains at 30 years and 364 days). Non-financial commercial paper is also now eligible for purchases both under this programme and the CSPP.

Purchases will be carried out under the programme to the extent deemed necessary and in a manner proportionate to counter the threats posed by the extraordinary economic and market conditions on the ability of the Eurosystem to fulfil its mandate. Net asset purchases under the PEPP will be terminated once the ECB Governing Council judges that the coronavirus crisis phase is over, but in any case not before the end of 2020. They will also be conducted in a flexible manner, allowing for fluctuations in the distribution of purchase flows over time, across asset classes and among jurisdictions.[20] The allocation of cumulative net purchases of marketable debt securities is guided, on a stock basis, by the capital key of the NCBs.[21]

To boost the effectiveness of this exceptional decision, the consolidation of holdings applicable in the PSPP[22] will not apply to the purchase programme's holdings.[23]

The aggregate book value of securities held under the PEPP will be published on a weekly basis. PEPP monthly net purchases and cumulative net purchases will be published on a monthly basis.

The same risk-sharing principles apply for the PEPP as for the APP. That means that the private-sector asset purchases under PEPP will be fully risk shared, while for the public sector purchases only the ECB's share (as well as purchases of securities issued by European institutions) will be subject to risk-sharing. The public-sector purchases that are carried out by NCBs will remain not subject to risk-sharing.

As noted by Blanchard and Pisani-Ferry, the PEPP can evidently constitute a channel for (partially) mutualising the cost of the coronavirus crisis. The authors acknowledge there are 'good reasons why part of the burden of tackling the pandemic should be mutualised among EU members, but it would be more appropriate to do so in a more transparent way through explicit budgetary and financial channels'. So far, no agreement has been reached on such schemes.[24] Nonetheless, they note that 'the PEPP is not a hidden budgetary mechanism. At a time when investors are prone to nervousness, its main purpose is to prevent the convergence of expectations on a bad, self-fulfilling crisis equilibrium. Such action serves the interest of all the members of the eurozone'.

ECB Executive Board member Fabio Panetta argued that the implementation of the ECB's securities purchase programmes would be facilitated by an adequate joint European fiscal response to the crisis, increasing the effectiveness of monetary policy.

Alongside the PEPP, on 12 March 2020, the Governing Council also decided to conduct additional LTROs on a temporary basis, under a fixed rate full allotment procedure, to provide immediate liquidity support to banks and act as a backstop to possible deterioration of money market conditions. On the same date, TLTRO III conditions were further eased, along with a temporary reduction of applicable interest rates (as low as -0.75 %) for all operations outstanding during the period between June 2020 and June 2021. On 30 April 2020, the Governing Council decided to further ease TLTRO III conditions for operations by bringing forward the start of the lending benchmark assessment period by one month (to 1 March 2020) and by reducing applicable interest rates (as low as -1 %) for the period between June 2020 and June 2021. On 30 April, the Governing Council also decided to conduct a series of seven pandemic emergency longer-term refinancing operations (PELTROs) to provide liquidity support to the euro area financial system and ensure smooth money market conditions during the pandemic period.

Is the PEPP legal?

Siekmann notes that, while a substantial amount of sovereign debt from selected Member States was purchased during the pre-OMT programmes, the outcry was relatively mild and the judiciary did not object in substance.[25] This changed following the announcement of the OMT programme, when a group of German citizens brought an action before the German Federal Constitutional Court. On 14 January 2014, the German court suspended the proceedings and, for the first time, referred certain questions to the Court of Justice of the European Union for a preliminary ruling. On 16 June 2015, the European Court of Justice delivered its decision in the *Gauweiler* case, in essence considering the programme to be compatible with EU law. The Federal Constitutional Court ruled a year later (21 June 2016), upholding – among other things – that the programme did not contravene the German Constitution and that the Bundesbank could participate. Following this judgment, a series of plaintiffs brought another case before the Constitutional Court in 2017, regarding the legality of the public-sector purchase programme. This new case became known as the *Weiss* case. In essence, both cases revolved around the questions of whether the decisions of the ECB fell within the scope of its mandate (and therefore observed the division of competences between the EU and the Member States, or failed to do so), and whether they infringed the prohibition against monetary financing. Individuals also argued that those decisions infringe the principle of democracy laid down in the Constitution of the Federal Republic of Germany and thereby undermined German constitutional identity.

In a March 2020 paper, Grund notes that in these recent cases, three criteria were established for a given ECB bond-purchase programme to be considered permissible by the Court of Justice of the EU:

- *Compliance with the ECB's mandate*. Here, the Court focuses in particular on the objectives of the measure. In *Gauweiler*, the Court confirmed that a programme aimed at preserving the transmission mechanism of monetary policy is likely to contribute to the ECB's price stability objective (and, as such, can be considered within the ECB's mandate).
- *Proportionality to the objective*. Under EU law, the proportionality requirement states that a monetary policy measure by the ECB is suitable and necessary to fulfil the price stability objective. With regard to suitability, the author notes that, as long as the measures adopted by the ECB are not obviously misguided from an economic standpoint, they are suitable to achieve the price stability objective. With regard to necessity, he notes that the measures proposed must not go manifestly beyond what is necessary to achieve the objective. A useful benchmark in this verification of proportionality is the limits and safeguards that each programme contains to ensure proportionality. When assessing the PSPP, the CJEU considered the following safeguards as sufficient: that the ECB's purchases were not selective, that they were temporary, limited in size and risk, that they were subject to purchase limits per issue and issuer and lastly, that the bonds purchased were subject to stringent eligibility criteria.
- *Compatibility with the prohibition of monetary financing*. Here, the Court of Justice checks that the ECB does not purchase bonds on the secondary market that would have an equivalent effect to that of a direct purchase of bonds by Member States, and that the ECB ensures there are sufficient safeguards to keep incentives to following a sound budgetary policy in place.

Based on the above, Grund is of the view that the PEPP meets the three criteria the Court of Justice of the EU has established for checking the legality of monetary policy measures: it is compliant with the ECB's mandate, as it aims to address malfunctioning in the smooth transmission of monetary policy signals across the currency area triggered by the sudden end to economic activity, thereby undermining the single nature of monetary policy; it is proportional because bond purchases are restricted to €1 350 billion, are limited in time to periods of malfunctioning monetary policy transmission channels, are not selective, are limited to securities with stringent eligibility criteria, and are subject to a limited loss-sharing arrangement; and, lastly, it complies with the monetary financing prohibition, as it has no equivalent effect to bond purchases on primary markets and it does not incentivise Member States to pursue 'unsound' budgetary policies.[26]

In May 2020, there were significant developments in this area: despite the CJEU ruling that the PSPP was lawful, the German Federal Constitutional Court challenged the CJEU's standard of proportionality review and asserted that it had thus acted *ultra vires*. According to the GFCC, the CJEU's approach of disregarding the actual effects of the PSPP in its assessment of the programme's proportionality, and to refrain from conducting an overall assessment and appraisal in this regard, does not satisfy the requirements of a comprehensible review as to whether the Eurosystem and the ECB are observing the limits of their monetary policy mandate. As a result, the GFCC ruled that the CJEU judgment has no binding force in Germany.

The matter was temporarily settled in July: following the publication of the deliberations in the ECB's Governing Council, as well as documents supplied to the German Parliament (which concluded that the ECB had indeed completed a proportionality check and thus complied with the judgment), the Bundesbank took the view that the court's demands had been met and that it will continue to take part in European Central Bank asset purchases.

In the future, however, Kyriazis notes that, as a matter of substance, while the GFCC said about the PSPP that it 'did not find a violation of the prohibition of monetary financing of Member State budgets', this was because of the long list of limits and conditions attached to it. Those elements are missing from the PEPP, and the clarification of the GFCC that its judgment 'does not concern any financial assistance measures taken by the European Union or the ECB in the context of the current coronavirus crisis' may be seen as an indication that plaintiffs are free to challenge the new programme.

Volker Wieland and Helmut Siekmann propose a compromise under which the ECB tweaks its future asset purchases, by making the question of proportionality part of the strategy review of the Eurosystem's monetary policy launched and publicly announced by the Governing Council on 23 January 2020.

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ENDNOTES

[1] Inflation is the general increase in level of prices for goods and services. It is measured by the rate at which the average price level of a basket of selected goods and services in an economy increases over a given period. For the definition of inflation in the euro area, reference is made to the Harmonised Index of Consumer Prices (HICP)

[2] Open market operations are the most commonly used tool for managing the liquidity situation in the market and signalling the Eurosystem's stance on monetary policy. The main open market operations are: (i) main refinancing operations (MROs), i.e. regular, open market, reverse transactions executed by the Eurosystem for the purpose of providing banks with appropriate liquidity; (ii) recently introduced longer-term refinancing operations (LTROs), i.e. regular, open market operations, executed by the Eurosystem to provide long-term liquidity to the banking system; (iii) fine-tuning operations (FTOs), which are carried out on an ad hoc basis and aim at increasing or decreasing liquidity in the money market and at steering interest rates, to smooth the effects of unexpected liquidity fluctuations in the market; (iv) structural operations, executed at the initiative of the ECB to adjust the structural position of the Eurosystem vis-à-vis the financial sector.

[3] Standing facilities are monetary policy operations which aim to provide and absorb overnight liquidity and signal general monetary policy stance. Contrary to open market operations, which are initiated by the ECB, standing facilities are initiated by the banks. Two standing facilities are available: (i) the marginal lending facility, which allows banks to borrow overnight funds from their NCBs, against eligible collateral; and (ii) the deposit facility, which allows banks to make overnight deposits with their NCBs.

[4] All euro-area banks are required to hold a certain amount of minimum reserves on current accounts with their respective NCBs. These amounts are calculated in relation to specific items on the banks' balance sheets, such as deposits. According to the ECB, by means of those reserves, central banks are able to stabilise money market interest rates by giving institutions an incentive to smooth the effects of temporary liquidity fluctuations, and also to create or enlarge the need and demand of banks for central bank credit. This need, in turn, gives the ECB the possibility to steer money market rates through open market operations, since the ECB allocates liquidity to the banks at a price that matches its policy intentions and therefore influences the money market interest rates.

[5] The transmission mechanism is the process through which monetary policy decisions affect the economy in general and the price level in particular. More information about the transmission mechanism of monetary policy can be found on the European Central Bank's dedicated webpage.

[6] By then, markets were expecting a possible Greek sovereign default. Ireland, Portugal, Spain and Italy were also facing difficult economic situations (a housing crisis evolved into a financial crisis in Spain and Ireland, there was high public debt in Italy, and slow growth and increasing debt-to-GDP ratio in Portugal).

[7] Corradin and Maddaloni note that repos are used by bond market participants either to finance long bond positions, by borrowing liquidity, or to initiate bond short positions, by borrowing the underlying asset. Transactions in the cash market are therefore often accomplished by market participants through complementary transactions in the repo market. The repo market is pivotal to ensuring market liquidity and funding availability and changes in repo rates and haircuts have important implications for asset pricing and financial stability.

[8] 'Sterilisation' is a term used to explain the procedure under which money is removed from the money market so that the monetary base does not increase as a result of an intervention.

[9] The ECB specified that such programmes can take the form of a full EFSF/ESM macroeconomic adjustment programme or a precautionary programme (enhanced conditions credit line), provided that they include the possibility of EFSF/ESM primary market purchases. The involvement of the International Monetary Fund (IMF) shall also be sought for the design of the country-specific conditionality and the monitoring of such a programme.

[10] The ECB economic and monetary analysis published in December 2014 observed that 'The risks surrounding the economic outlook for the euro area are on the downside ... [the analysis confirms] the need to closely monitor the risks to the outlook for price developments over the medium term and to be prepared to provide further monetary policy accommodation, if needed'.

[11] That is, euro-denominated marketable debt securities issued by central governments of a Member State whose currency is the euro, recognised agencies located in the euro area, international organisations located in the euro area and multilateral development banks located in the euro area. The remaining maturity of those securities at the time of purchase by the ECB or a national central bank should be between 2 and 30 years. Moreover, for the securities to be eligible, (a) the issuer or guarantor of the marketable debt securities should have at least one public credit rating provided by an external credit assessment institution, or, (b) the securities should be issued or fully guaranteed by the central governments of euro area Member States under a financial assistance programme.

[12] These are credit institutions established in the euro area, which hold minimum reserve on accounts with the ECB and NCBs in pursuance of single monetary policy objectives. Those counterparties must be financially sound and be subject to at least a form of harmonised EU supervision by national authorities. Lastly, they need to fulfil operational criteria specified in the relevant arrangements applied by the respective NCBs. The decision added 'any other counterparties that are used by Eurosystem central banks for the investment of their euro-denominated investment portfolios' to the above.

13 Individual securities are identified through the international securities identification number (ISIN).

14 The capital key specifies the share of the ECB's capital attributable to each of the NCBs.

15 Decision (EU) 2015/774 of the European Central Bank of 4 March 2015 on a secondary markets public sector asset purchase programme (ECB/2015/10).

16 See Article 3 of Decision (EU) 2020/188 of the ECB. On top of these criteria, marketable debt securities must have a minimum remaining maturity of 70 days and a maximum remaining maturity of 30 years at the time of their purchase by the relevant Eurosystem central bank. Also, Greek government euro-denominated marketable debt securities will be eligible for purchases under the purchase programme, provided they comply with the criteria for purchases as set out in Article 3(4) of this decision.

17 See Article 2 of Decision (EU) 2016/948 of the ECB.

18 See Article 3 of Decision (EU) 2020/187 of the ECB.

19 See Article 2 of Decision (EU) 2015/5 of the ECB.

20 In particular, the purchase allocation may be adjusted under the purchase programme to allow for fluctuations in the distribution of purchase flows, over time, across asset classes and among jurisdictions.

21 As referred to in Article 29 of the Statute of the European System of Central Banks.

22 Article 5 of Decision (EU) 2020/188.

23 Decision (EU) 2020/440 of the European Central Bank of 24 March 2020 on a temporary pandemic emergency purchase programme.

24 See Delivorias A. and Stamegna C., Joint debt instruments: A recurrent proposal to strengthen economic and monetary union, European Parliamentary Research Service, Briefing, April 2020.

25 This is not to say that there were no other court cases relative to European integration. Indeed, as Schiek notes, 'The [OMT] ruling continues a line of Federal Constitutional Court case law which resulted from the fact that from 1993, when the Treaty of Maastricht introduced the common currency, each step towards further EU integration has been challenged before this court'. To make his point, he cites several important rulings, e.g. for the Maastricht Treaty, Germany's entrance into the EMU, the Constitutional Treaty, or the financial support for Greece in 2010.

26 The author holds the view that the PEPP, like the PSPP, would not amount to direct assistance to Member States because 'it enshrines both programme's safeguards, including a blackout period, the possibility of ad hoc deviations in the allocation of securities bought under the PEPP, the purchase of securities across the entire yield curve, and the restrictions on the publication of granular information on Eurosystem bond holdings'. With regards to the question if the programme undermines incentives for sound budgetary policies, Grund notes, that the activation of the general escape clause under the Stability and Growth Pact can be seen as a signal of the agreement across the political spectrum that the appropriate response to the current economic shock is an expansionary fiscal policy.

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