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The ECB's Mandate and Legal Constraints



Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies

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Abstract

This paper considers how the ECB can implement its mandate in the current crisis conditions and the legal constraints that exist on its actions. The current position of the euro area economy means the threat to meeting the ECB's primary objective of price stability stems from the possibility of a long period of below-target inflation. This means the ECB should consider a wide range of stimulative policies that would help it meet both its primary and secondary objectives. The ECB, however, will be constrained by the ECJ's interpretation of the monetary financing clause and its ability to meet its primary objective (and its independence) could be threatened by the recent German constitutional court judgement which is flawed in both its legal and economic analysis.

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LIST OF ABBREVIATIONS

BVerfG	Bundesverfassungsgericht
ECB	European Central Bank
ECJ	European Court of Justice
NBER	National Bureau of Economic Research
PEPP	Pandemic Emergency Purchase Programme
PSPP	Public Sector Purchase Programme
TEU	Treaty on the European Union
TFEU	Treaty on the Functioning of the European Union

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EXECUTIVE SUMMARY

- **This paper considers how the ECB can implement its mandate in the current crisis conditions and the legal constraints that exist on its actions.**
- **Price stability is the Eurosystem's primary objective.** However, **the Eurosystem is also legally obligated to support economic policies of the Union**, provided this support does not prejudice its primary objective.
- **In recent years, the ECB has fallen short of meeting its self-defined price stability target of inflation being close to but below 2 percent.** And the current state of the euro area economy means the threat to meeting its primary objective of price stability stems from the possibility of a long period of below-target inflation.
- **The evidence on the behaviour of inflation over the past 25 years also gives the ECB room to pursue policies that previously would have been considered illegal.** Economists have less certainty now than they did when the ECB was founded about exactly which factors determine inflation. Evidence suggests that neither low unemployment rates nor rapid expansion of the monetary base necessarily lead to high inflation.
- **This means there are many new actions the ECB could take to both meet its primary and secondary objectives.** Actions that support the economic policies of the Union and stimulate the economy can move inflation back to its target level and help the ECB meet its primary objective. Tools to constrain inflation during a recovery are also available.
- **The ECB, however, will be constrained by the ECJ's interpretation of the monetary financing clause.** Actions that could be considered legal via a literal reading of the EU Treaties are likely to be ruled illegal due to ECJ's interpretation of Article 123 of the Treaty on the Functioning of the European Union (TFEU).
- **The ECB's ability to meet its primary objective is also threatened by the recent German constitutional court judgement** which is flawed in both its legal and economic analysis.
- **The German constitutional court's distinction between monetary and economic policies is unjustified.** Its position on the proportionality of the PSPP programme has little legal justification and the economic analysis underlying its decision is also highly flawed.
- **The ECB does not have to respond to the German constitutional court but it should be relatively easy to provide a convincing explanation** that the PSPP represents a proportionate response to economic conditions, thus allowing the continuation of a shared monetary policy across all euro area Member States.

1. INTRODUCTION

The Eurosystem's primary objective, as laid down in the EU Treaties, is the maintenance of price stability. However, the Eurosystem is also legally obligated to support economic policies of the European Union, provided this support does not prejudice its primary objective. In recent years, the ECB has fallen short of meeting its self-defined price stability target of inflation being close to but below 2 percent. With the appointment of a new ECB President, there was an increasingly active discussion through late 2019 and early 2020 about whether the ECB could legally take a wider range of actions to support the general economic policies of the EU consistent with supporting the EU's objectives but without threatening price stability. For example, Christine Lagarde highlighted various ways in which the ECB's could use its financial regulatory tools to support the move to a carbon-neutral economy.¹ The strategic review of the ECB's monetary policy that is being undertaken this year will address some of these questions.

With a profound global economic crisis underway, it seems likely that the ECB will continue to fall short of its price stability target over the next few years, with high unemployment and weak demand likely to depress prices. The global economy collapsing at a record pace has already led to a slump in energy prices, which will have a significant effect on headline inflation over the next year or so.

In this situation, there are strong economic and legal arguments for the ECB to consider using a wide range of tools, including some that it has not yet considered, to stimulate the European economy. Such stimulus would both support its primary objective of restoring price stability but also fulfil its requirement to support the general policies of the Union.

Despite this apparently strong economic and legal case for taking substantial and decisive action, the ECB is likely to be constrained in fighting the new global economic crisis by legal restrictions. These restrictions partly stem from the clear wording of some articles in the Treaty but they also stem from how the European Court of Justice (ECJ) interprets these articles and from legal challenges to the scope of the ECB's monetary policy by the Bundesverfassungsgericht (the German constitutional court), most notably its judgement of 5 May 2020. This judgement has the potential to threaten the independence of the ECB and its ability to pursue both its primary and secondary objectives in a shared and co-ordinated fashion.

This paper discusses these issues as follows. In Section 2, I outline the case for the use of large-scale and innovative stimulus and whether the ECB's primary objective of maintaining price stability restricts its ability to do so. I argue that the persistent weakness of inflation in modern advanced economies, our limited understanding of the inflation process and the tools the ECB has available to it to reverse course should inflation increase, together all provide a case for unprecedented stimulus. Section 3 discusses the issues relating to the monetary financing clause in the Treaty and how this clause has been interpreted by the ECJ in a way that places more restrictions on the ECB than a literal reading of the Treaties would imply. Section 4 discusses the legal challenges to the scope of the ECB's monetary policy set out by the German Constitutional Court and argues these challenges are based on a skewed interpretation of the Treaty, flawed economic arguments about the negative impact of asset purchase programmes and an inaccurate assessment of how the ECB Governing Council has taken and communicated its decisions.

One theme worth flagging about the discussion in this paper is that while any detailed discussion of the policies the ECB can adopt must rely both on economic analysis (addressing how the ECB's actions affect the economy) and legal analysis (addressing what it can legally do), it is increasingly the case that key issues sit at the intersection of economic and legal analysis. For example, it is

¹ See Lagarde (2020).

unfortunately common to see proposals from economists that the ECB should take actions which it is legally constrained from actually doing. However, I believe a more important constraint on the ECB's actions in the current crisis is likely to be the use of flawed economic analysis by courts assessing the legality of its policies.

2. CONSTRAINTS DUE TO THE PRIMARY OBJECTIVE

The key legal article outlining the ECB's legal mandate is Article 127 of the current Treaty on the Functioning of European Union (TFEU). This is repeated in full below:

"The primary objective of the European System of Central Banks (hereinafter referred to as 'the ESCB') shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119."

Article 3 of the Treaty on the European Union (TEU) states:

"The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance."

Taken together, these articles mean there is a legal obligation on the ECB to act to promote full employment and other social goals such as improvements in the quality of the environment — provided the actions taken to support those goals do not endanger price stability.

But how would we know if an action endangered price stability? The Treaty is silent on this issue and rightly so. The factors that determine prices are the domain of economics rather than law. And it would be nice if the scientific evidence on the factors determining aggregate price stability were clear. But, unfortunately, the current state of science on the factors determining inflation is probably as uncertain as I can remember it being during my professional economics career (much of which I have spent analysing and researching the inflation process). In the rest of this section, I will point out two influential theories about the determinants of inflation which have proved to be unreliable and then discuss the implications for the ECB's policy options.

2.1. The Money supply and inflation

A historically important school of thought in economics is monetarism. Associated with Nobel prize winner Milton Friedman, the basic idea of monetarism is that "inflation is always and everywhere a monetary phenomenon" as Friedman (1963) put it. This school of thought believed that the price level would ultimately be proportional to some measure of the money supply such as M1 (which measures currency in circulation plus checking deposits). Monetarists also believed the central bank could maintain control over the money supply via its control over the monetary base (which is currency in circulation plus the reserve accounts that commercial banks hold with the central bank).

Monetarism's practical influence on central banking peaked in the late 1970s and early 1980s when central banks in the UK, US and elsewhere shifted their policies to focus on meeting targets for the growth rate of the money supply. While this period did see high rates of inflation tamed, monetarism was largely abandoned in the mid-1980s as being an impractical methodology that generated volatile interest rates and that relied on a correlation between money supply growth and inflation that was generally weak.

Monetarism still maintained some influence in European policy circles up to the founding of the ECB and the ECB's original monetary policy strategy featured a "prominent role for money." Specifically, a reference value for M3 was set at a 4.5% annual rate and this figure was used to calculate a "monetary

overhang". This measured the cumulative difference between actual M3 growth and the reference value, with higher numbers supposedly representing risks for medium term inflation.

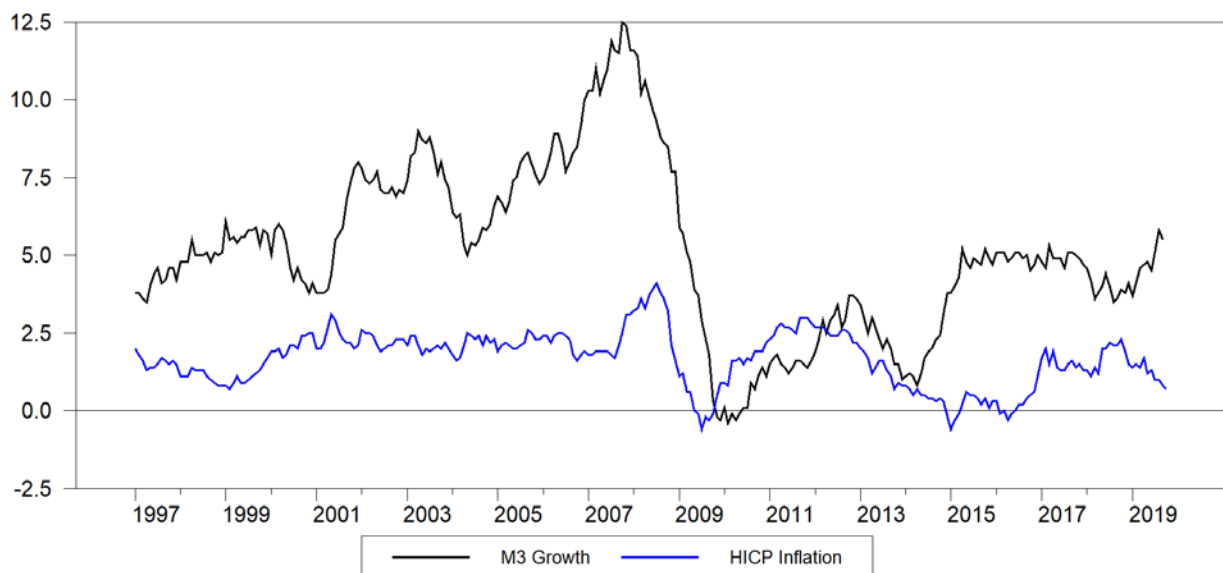
The early years of the ECB did nothing to suggest that the prominent role for money was a useful part of the monetary policy strategy. Money growth steadily exceeded price inflation and a surge in money growth during 2001 was not matched by any contemporaneous or subsequent increase in inflation (see Figure 1). Analysis of the money supply was given a lower emphasis after the 2003 review of monetary policy strategy, with no further reference being made to the monetary overhang variables. The evidence in the years since 2003 has not improved the case for its existence. As Figure 1 shows, money growth has outstripped inflation in almost every year of the ECB's existence, often by a large amount, and there is no statistical evidence that it works as a useful leading indicator of inflation.

Crucially, the idea that there is a strong relationship between prices and the monetary base controlled by central banks has been tested in an extreme "natural experiment" and been found to be false. When the Federal Reserve began its quantitative easing programme in 2010, a group of prominent Republican economists wrote an open letter to Fed Chairman Ben Bernanke warning him not to pursue a programme of expanding the monetary base via large-scale asset purchases. They believed that "*The planned asset purchases risk currency debasement and inflation.*"² In practice, despite an enormous increase in the monetary base (a four-fold increase over a short number of years) there was no evidence of any corresponding escalation of prices. Indeed, throughout the period since 2010, inflation in the US has been relatively low, often below the Federal Reserve's preferred 2 percent rate. Similarly, the expansion in the monetary base that has occurred in the Eurosystem since the ECB began its Asset Purchase Programme has not triggered any increase in inflation.

So the idea that there is a link between the monetary base and inflation has been tested about as thoroughly and clearly as any proposition in macroeconomics can be and it has been found to be false. Its failure partly reflects the weakness of the monetarist idea that there should be a strong relationship between the monetary base and the broader money supply (i.e. a stable money multiplier) but it also reflects the absence of a reliable relationship between money growth and inflation.

² The letter can be found at <https://www.hoover.org/research/open-letter-ben-bernanke>.

Figure 1: M3 growth (black) and HICP inflation (blue)



Source: Data from ECB Statistical Data Warehouse.

2.2. The Phillips curve

With monetarist ideas about the determination of inflation are widely believed to be of limited use, central bankers have largely turned to the Phillips curve as the framework they use when thinking about inflation.

The original Phillips relationship between inflation and unemployment, as documented by A.W. Phillips in his famous 1958 paper, is no longer considered accurate: Many years of data across many countries fail to report a robust statistical relationship between inflation and unemployment. However, central bankers still rely heavily on another idea of Milton Friedman's — the expectations-augmented Phillips curve. Friedman (1968) put forward the idea that the public's *inflation expectations* were the key determinant of actual inflation outcomes and thus macroeconomic policymakers needed to convince the public to expect low inflation. In addition, however, Friedman believed the state of the labour market affected inflation, with low unemployment rates stimulating wages and prices so that below a certain level of unemployment inflation would tend to rise above expected levels. However, he viewed this as a short-run relationship: Ultimately, inflation expectations would adapt over time so that there was no long-run relationship between inflation and unemployment.

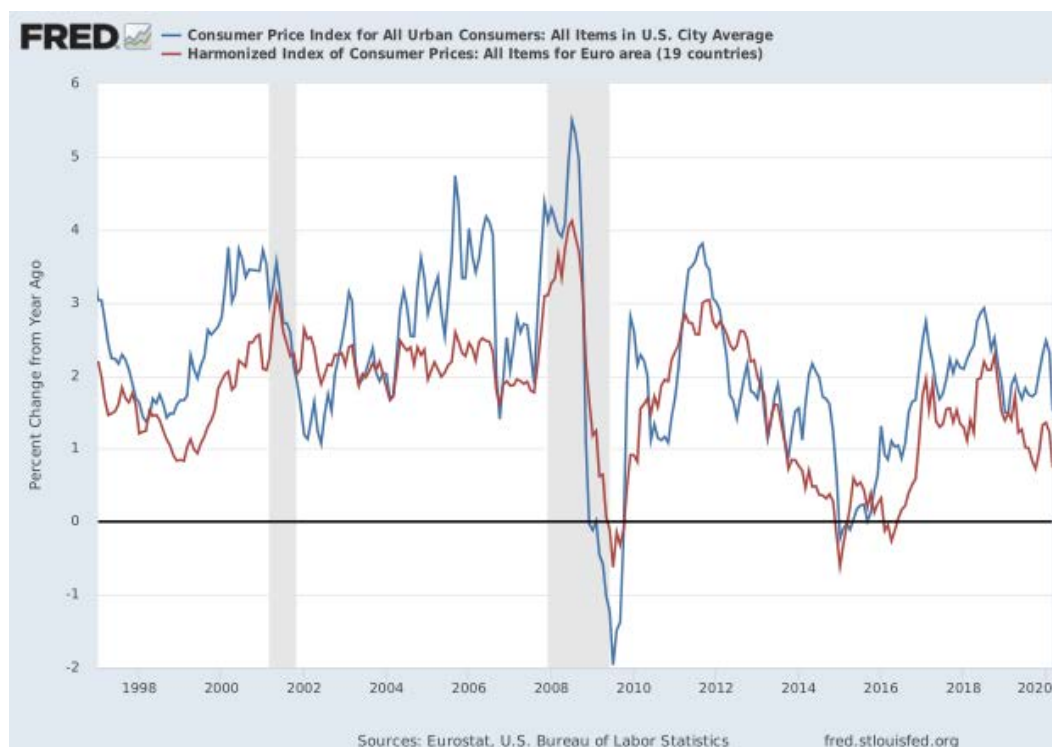
This is the framework that most modern central banks have used when modelling and forecasting inflation. Econometric models of inflation tend to rely on the recent behaviour of inflation to proxy for inflationary expectations and then to also include measures of "slack" in the economy, such as unemployment rates or output gap measures. These models view inflation as likely to pick up when the economy grows strongly for a sustained period of time, resulting in low unemployment rates.

The problem for this framework is that the evidence in favour of it has considerably weakened over the past 25 years. There does seem to be evidence that inflation declines when there is a recession. Figures 2 and 3 show inflation and unemployment in the US (the blue lines) and the euro area (the red lines) since 1997. The shaded bars represent the NBER-approved official dates for recession in the US. These charts show that inflation fell in both the US and the euro area during both the "dot com"

recession of 2001 and during the “great recession” of 2008/09. They also show how, having picked up during 2010/11, inflation slumped again in the euro area during and after the “double dip” recession of 2012, as the unemployment rate climbed to 12 percent in 2014.

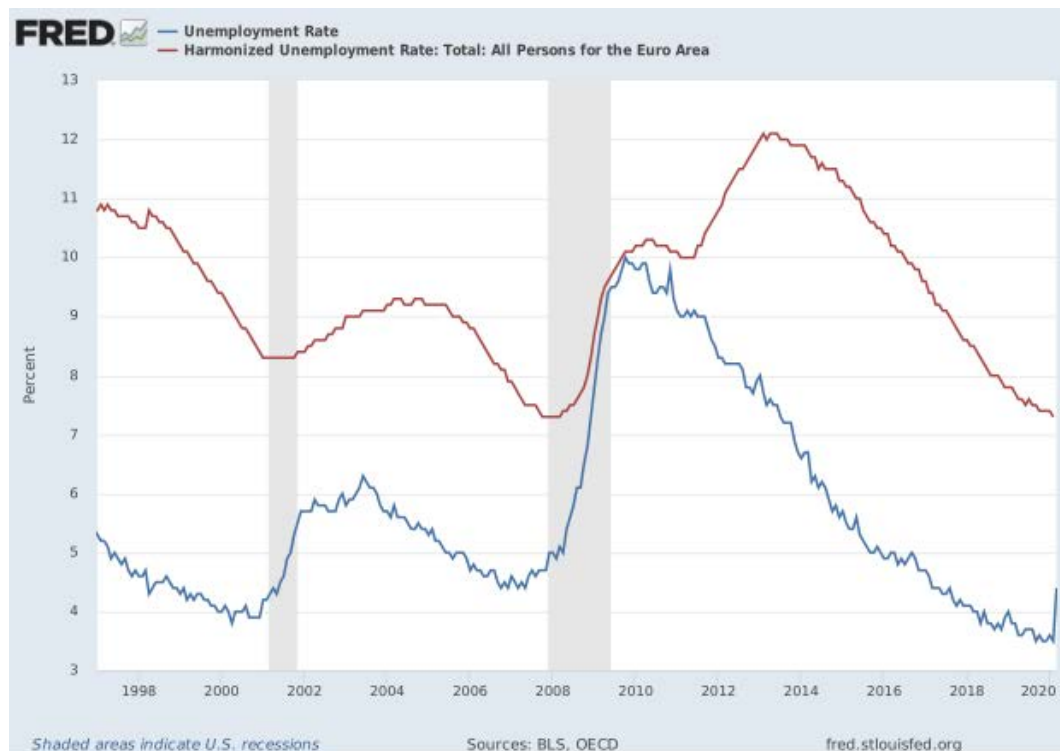
While these patterns roughly conform to the predictions of an expectations-augmented Phillips curve model, the evidence for low unemployment rates triggering higher rates of inflation seems much less strong. In each of the last three global expansions, inflation has remained calm despite unemployment reaching relatively low rates, particularly in the US where the unemployment rate reached below 4 percent in 2019 without triggering any increase in inflation.

Figure 2: US CPI inflation (blue) and euro area HICP inflation (red)



Source: Federal Reserve Bank of St Louis, FRED website.

Figure 3: Unemployment rates in the US (blue) and the euro area (red)

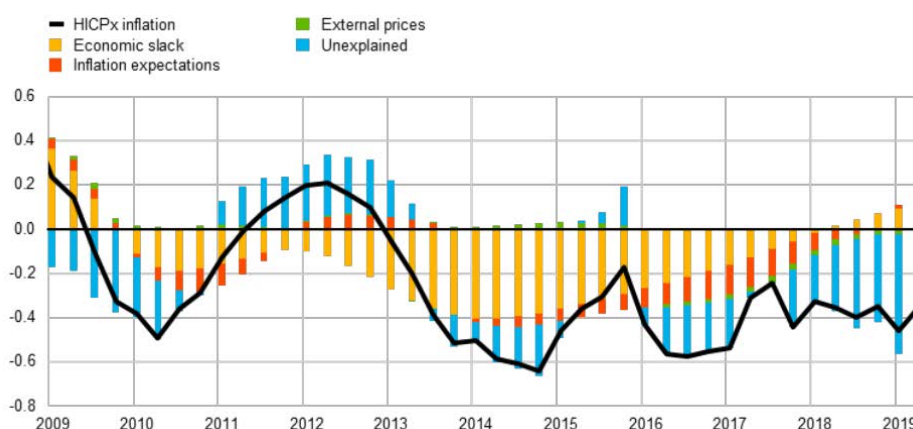


Source: Federal Reserve Bank of St Louis, FRED website.

To get a sense of how Phillips curve models have failed to understand recent inflation developments in the euro area, Figure 4 repeats a chart from a new ECB working paper by Eser et al. (noting that ECB chief economist Philip Lane is part of the et al.). The chart provides a historical decomposition of the factors that the ECB's econometric models believe were determining inflation — as measured by deviations in HICP inflation excluding food and energy from its historical average — including an “unexplained” component. Rather than use just one model, the authors reported averages across 780 different Phillips-curve style specifications, so this gives a fair sense of what the typical empirical model believes has been happening with inflation in the euro area. The chart shows that at most points in time, a significant element of inflation cannot be explained by the models. Most notably, the key component determining the persistent low inflation of recent years is “Unexplained”!

To summarise, while economists rely on Phillips curve relationships to forecast and to give monetary policy advice, their answer as to why inflation has been so stubbornly low in recent years is “We don't know”. One possibility, as discussed by Blanchard (2016) is the inflation expectations have become “anchored” at low (and falling) levels and this anchoring has offset the positive effect on inflation of falling unemployment. But this theory doesn't get us too far since it doesn't tell us how inflation expectations become anchored or what would cause them to become de-anchored. In terms of the ECB meeting its price stability target of inflation close to 2 percent, it seems the greater risk for now is that the current deep recession will drive inflation well below target and cause inflation expectations to move well below the ECB's target rate.

Figure 4: ECB decomposition of HICP inflation excluding food and energy (minus its historical average value)



Source: Eser, Karadi, Lane, Moretti and Osbat (2020).

2.3. Economics and the primary objective

Given Article 127's statement of a clear obligation for the ECB to consider price stability as its prime objective, this article provides the most obvious grounds for ruling out various monetary policy options. Any policy the ECB undertook that prejudiced the pursuit of its price stability would be illegal. However, I think this argument cannot be used against the ECB's current asset purchase programmes. We have seen already that very large asset purchase programmes have not triggered significant inflation. And if these programmes do have a positive effect on inflation then, as of now, implementing them is consistent with the price stability objective, since the ECB is currently failing to meet its own target of inflation close to but below 2 percent.

Indeed, in the current circumstances, it is likely that the ECB could implement various completely new initiatives that would not threaten price stability and would support the economic goals of the EU as set out in Article 3 of TEU. For example, as I discussed in Whelan (2019), the ECB could consider providing long-term low-cost loans to the European Investment Bank to finance a large programme of investments aimed at moving towards a low-carbon economy. Article 3 of TEU explicitly mentions environmental concerns. The ECB should also be willing to consider more aggressive monetary policy options such as a more negative deposit rate, a greater use of tiering of reserves, providing more supports for the mortgage market, equity purchases and even programmes to encourage banks to make zero or negative interest rate loans to businesses affected by the COVID-19 crisis.

Each of these options will be greeted by some as "obviously illegal" based on the opinion that they undermine the ECB's primary objective. But the evidence cited here suggests there is little economic science behind such calls. Moreover, if additional stimulus measures taken by the ECB did manage to generate an economic recovery that then produced additional inflation, the ECB has lots of tools it can use to slow the economy and reduce inflation, most notably raising its deposit rate and ceasing asset purchase programmes. So should the ECB overshoot its 2 percent target in the next few years, it has the ability to reverse course with its stimulus measures.

3. CONSTRAINTS DUE TO THE MONETARY FINANCING CLAUSE

Beyond questions about how to interpret the primary and secondary objectives of the ECB, there is one clear restriction on its actions: Article 123 of TFEU which prohibits monetary financing. The first (and key) part of this article is repeated in full below:

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

This article makes clear what is illegal for national central banks: Directly providing money to national governments by purchasing bonds from them or providing them with a credit facility. But it also makes clear that indirect secondary market purchases of these bonds are legal. It isn't surprising that the Treaty says this. The classic textbook example of a monetary policy in which the central bank increases the money supply is an open market purchase of a government bond. To outlaw this would have required ruling out an important monetary policy tool.

So secondary market purchases of government bonds by the Eurosystem are legal. This could be interpreted as meaning that all secondary market purchases of government bonds by the Eurosystem are legal: They are not illegal, so that must mean they are legal right? The reality, however, is not quite so clear. The ECJ and national courts interpret European law not in a *literal* way but a *purposive* way, i.e. they consider what the original purpose of the legislation was rather than restricting themselves to precisely what the specific words say.

To give an example of why such an approach is reasonable, consider the case of pure monetary financing, where a national central bank simply creates money and gives it to the central government. Technically, you could argue that the Treaties do not outlaw this. They outlaw buying bonds directly from governments or giving them loans but they don't mention the idea of just giving them money without any requirement to return it. However, the ECJ would interpret such a proposal as clearly at odds with what the authors of Article 123 had in mind when they drafted it. The purpose of the article was clearly to avoid using the money creation powers of central banks to directly finance government spending. It appears the drafters of the Treaty didn't imagine there would ever be discussions of monetary financing via a direct transfer of money rather than bond purchases or loans, so they did not mention this possibility, but it is impossible to imagine they would have approved of such a policy.³

For this reason, Article 123 can place limits on ECB's actions such as asset purchase programmes if courts view these actions as running counter to what the article was intended to achieve. For example, the applicants in the *Weiss* case ruled upon by the ECJ in December 2018 appeared to think that the purpose of Article 123 was ensure that central banks could not make it easier for governments to run deficits and so the PSPP, by lowering yields on government bonds and thus reducing interest costs, must be illegal.

Sensibly, the ECJ rejected this argument, noting:

³ Worth noting, however, is that it is legal for national central banks to remit their profits back to their national governments. The Eurosystem's accounting procedures have led to them retaining much of their economic profits stemming from increases in the value of their assets via the process of booking an essentially fake liability called "revaluation accounts". I suspect a revision of those policies and a return to central governments of this money would be legal. This would allow the Eurosystem to remit about 4 percent of euro area GDP to governments.

“the conduct of monetary policy will always entail an impact on interest rates and bank refinancing conditions, which necessarily has consequences for the financing conditions of the public deficit of the Member States”⁴.

In other words, it can't be possible that a monetary policy programme is illegal just because it lowers interest rates and thus lowers the cost of government borrowing.

That said, the ECJ's interpretation of Article 123 does place some restrictions on asset purchase programmes and may restrict the ECB's plans for its EUR 750 billion Pandemic Emergency Purchase Programme (PEPP). Specifically, the ECJ interprets Article 123 as intended to encourage member states to follow a “sound budgetary policy”. This phrase is used 11 times in the *Weiss* judgement, with the first and key reference being as follows (paragraph 107):

“the ESCB must build sufficient safeguards into its intervention to ensure that the latter does not fall foul of the prohibition of monetary financing in Article 123 TFEU, by satisfying itself that the programme is not such as to reduce the impetus which that provision is intended to give the Member States to follow a sound budgetary policy”.

While not placing explicit limits on the PSPP, the *Weiss* judgement points to a series of features of the PSPP that the ECJ views as implying the policy is not undermining sound budgetary policy. For example, the ECJ cite the explicitly temporary nature of the programme, the fact that ECB is leaving a “blackout period” of time from when a bond is issued to when it can be bought by the Eurosystem and the lack of certainty that any private owner of a sovereign bond can have as to whether they can at some point sell their bond to the ECB. Finally, and perhaps most importantly, the *Weiss* judgement noted that the Eurosystem had decided not to purchase more than 33% of a particular issue of bonds of a member state or more than 33% of the outstanding securities of one of those governments.

This latter point is important because with the introduction of the new PEPP, the ECB has indicated that it is no longer going to stick within these limits. This suggests legal challenges to PEPP on monetary financing grounds may be more likely to succeed at the ECJ.

The legal issues surrounding these issuer limits are subtle. The one-third limits are designed to prevent the Eurosystem from obtaining a “blocking minority” position if a country proposes a debt restructuring which its bondholders then vote on via a Collective Action Clause (CAC). There are concerns that failure to use a blocking minority to prevent debt restructuring could be viewed as illegal monetary financing, since this would involve money created by the Eurosystem being ultimately used to write down the debt of a member state.

In its OMT judgement (paragraph 126), the ECJ acknowledged that purchasing bonds involved the Eurosystem taking on risk:⁵

“although the lack of privileged creditor status may mean that the ECB is exposed to the risk of a debt cut decided upon by the other creditors of the Member State concerned, it must be stated that such a risk is inherent in a purchase of bonds on the secondary markets, an operation which was authorised by the authors of the Treaties, without being conditional upon the ECB having privileged creditor status.”

However, in relation to issuer limits, the key phrase here that suggests CACs may raise a legal issue is “a debt cut decided upon by the other creditors.” By focusing solely on a “debt cut” imposed on the

⁴ See <http://curia.europa.eu/juris/document/document.jsf?jsessionid=0EB01E126001D811CB91BDF8D53798F6?text=&docid=208741&pageIndex=0&dodang=EN>.

⁵ See <http://curia.europa.eu/juris/document/document.jsf?text=&docid=165057&pageIndex=0&dodang=EN>.

Eurosystem by other creditors, it could be interpreted that the ECJ has implicitly assumed that, once given the opportunity to vote on a potential restructuring, the ECB would be legally required to use a blocking minority position to prevent a debt restructuring.

This raises questions about why the ECB has decided to exceed the one-third issuer limits. The ECB could decide to focus its purchases on bonds issued prior to 2013, when CACs became standard in euro area sovereign debt contracts. Also, should a CAC-driven restructuring ever become a likelihood, the Eurosystem could sell enough bonds prior to the restructuring to get below the blocking minority limit. It would be likely that losses would be incurred on these sales but it would avoid the ECB taking a conscious decision to agree to a debt restructuring. In any case, it is unclear whether CACs would actually be the mechanism employed by future governments to restructure debt.⁶ For example, the Greek government restructured its debt via a unilateral act of the Greek parliament, and this may be the approach taken by future European governments when defaulting on debt.

To summarise, while the ECB can argue that the Treaty does not prevent it from making unlimited secondary market purchases of sovereign bonds and that issues to do with restructuring can be dealt with later (and are less likely to happen because of its interventions), the legal situation is that the ECJ's views on the meaning of Article 123 are going to restrict how far the ECB can go with asset purchase programmes.

From a practical policy perspective, this suggests the ECB needs to start thinking about new and innovative ways that it can stimulate the economy by assisting the private sector, rather than continually expanding its purchases of public sector debt.

⁶ See Gelpern and Gulati (2013) for a sceptical discussion of euro area CACs from two of the leading academic experts on sovereign debt law.

4. CONSTRAINTS DUE TO THE LIMITS OF THE ECB'S MONETARY POLICY MANDATE

A final set of constraints on the ECB could stem from there being legal restrictions on how far its mandate to conduct monetary policy prevents it from taking certain kinds of actions. Most prominently, the idea that the ECB's monetary policy mandate restricts it from pursuing various policies has been promoted by the Bundesverfassungsgericht (BVerfG) in its judgements of recent years, most notably its 5 May 2020 response to the ECJ's *Weiss* judgement.

This section discusses the idea that the ECB's mandate to implement monetary policy necessarily restricts it from carrying out actions such as the PSPP, first focusing on the BVerfG's distinction between monetary policy and economic and then focusing on the legal and economic issues underlying the BVerfG's 5 May 2020 judgement.

4.1. Monetary policy versus economic policy?

The EU Treaties gives the Eurosystem the responsibility for monetary policy in the euro area. The Treaties also point out that national governments can co-ordinate economic policies. These statements have been taken by some to mean that the ECB cannot pursue economic policies because it can only pursue monetary policy. I have worked in and commented on central banking issues since 1997 but the first time I ever heard of this idea was in the BVerfG ruling on the OMT programme in January 2014.⁷ Paragraph 39 of the ruling including the following:

"The European Central Bank may only support the general economic policies of the Member States (Art. 119 sec. 2, Art. 127 sec. 1 sentence 2 TFEU; Art. 2 sentence 2 ESCB Statute). It is not authorised to pursue its own economic policy. If one assumes – subject to the interpretation by the Court of Justice – that the OMT Decision is to be qualified as an independent act of economic policy, it manifestly violates this distribution of powers."

As an economist the idea that monetary policy and economic policy are different things strikes me as strange. Indeed, I never thought I would have to write the following sentence in one of these briefings: *Monetary policy is part of economic policy.*

Every monetary policy decision the ECB takes — whether they be altering its various policy rates, making loans to banks, purchasing assets, changing collateral rules or communicating about future policies — have economic effects on firms, households and governments. Indeed, the BVerfG position raises the question of how they think the ECB is supposed to meet its primary objective of price stability. Is it supposed to magically conjure up price stability without taking actions that affect the economy? While we don't fully understand the factors that determine aggregate inflation, it is clear that prices generally respond to the underlying forces of supply and demand in the economy.

Thankfully, the ECJ recognises that monetary policy decisions must, by their nature, have real economic effects. Paragraph 66 of the *Weiss* judgement states:

"in order to exert an influence on inflation rates, the ESCB necessarily has to adopt measures that have certain effects on the real economy, which might also be sought — to different ends — in the context of economic policy. In particular, when the maintenance of price stability requires the ESCB to seek to raise inflation, the measures that it must adopt to ease monetary and financial conditions in the euro area for that purpose may entail an impact on the interest

⁷ This is available at https://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2014/01/rs20140114_2bvr272813en.html.

rates of government bonds because, inter alia, those interest rates play a decisive role in the setting of the interest rates applicable to the various economic actors”.

This is a clearly argued and convincing case from the highest authority on European law. One might have hoped that this spurious distinction would no longer feature in important legal cases involving the ECB. Alas, that did not prove to be the case.

4.2. Proportionality and the PSPP

On 5 May 2020, the BVerfG ruled that ECJ's *Weiss* ruling was not sufficient for it to be willing to declare the PSPP to be legal.⁸ They declared that the element of the ECJ's ruling relating to the proportionality of the PSPP was *“not comprehensible”* and thus the judgement was *ultra vires*. It instructed the Bundesbank to stop participating in the implementation and execution of the PSPP in three months' time *“unless the ECB Governing Council adopts a new decision that demonstrates in a comprehensible and substantiated manner that the monetary policy objectives pursued by the PSPP are not disproportionate to the economic and fiscal policy effects resulting from the programme.”* In the absence of this demonstration, the Bundesbank was instructed to sell all of the bonds it purchased as part of the PSPP.

In my opinion, this judgement is legally flawed, relies centrally on poor economic thinking and makes claims about ECB decision making and communications that are clearly false. I will discuss each of these issues in turn in the next three sub-sections.

4.2.1. Legal issues

The key legal argument put forward by the BVerfG against the *Weiss* ruling was that it did not assess whether the PSPP satisfied the so-called principle of proportionality. Specifically, the BVerfG's judgement begins with the (in my view spurious) distinction between economic and monetary policy and cites the principle of proportionality as follows (paragraph 138):

“As the economic policy effects of the PSPP are disregarded completely, the application of the principle of proportionality by the CJEU cannot fulfil its purpose, given that its key element – the balancing of conflicting interests – is missing. As a result, the review of proportionality is rendered meaningless.

Relying on the principle of proportionality to distinguish between monetary policy and economic policy (Art. 5(1) second sentence and Art. 5(4) TEU) implies that a programme's effects can render it disproportionate.”

In relation to the ECB's decision-making, the BVerfG outlined some supposed negative economic effects of the PSPP and declared (in paragraph 176):

“It would have been incumbent upon the ECB to weigh these and other considerable economic policy effects and balance them, based on proportionality considerations, against the expected positive contributions to achieving the monetary policy objective the ECB itself has set. It is not ascertainable that any such balancing was conducted, neither when the programme was first launched nor at any point during its implementation. Unless the ECB provides documentation demonstrating that such balancing took place, and in what form, it is not possible to carry out an effective judicial review as to whether the ECB stayed within its mandate.”

⁸ The judgement can be found at https://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2020/05/rs20200505_2bvr085915en.html;jsessionid=90CEC341BE6D2AD9E28476F1320EEA14.2_cid370.

I believe the BVerfG have adopted a skewed interpretation of the principle of proportionality and asked the ECB to behave in a way that runs counter to its obligations under the Treaty.

The two Treaty articles the BVerfG claim to be crucial to their judgement are as follows. Here is Article 5(1) TEU:

"The limits of Union competences are governed by the principle of conferral. The use of Union competences is governed by the principles of subsidiarity and proportionality."

And here is Article 5(4) TEU:

"Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties."

The institutions of the Union shall apply the principle of proportionality as laid down in the Protocol on the application of the principles of subsidiarity and proportionality."

So Article 5(1) TEU just states that the proportionality principle must be used and Article 5(4) TEU defines what the principle means. For the various institutions, the principle means that it cannot exceed what is necessary for it to fulfil the objectives of the EU Treaties they have been charged with achieving.

From the perspective of the ECB, the objective it has been asked to achieve is price stability and the accepted definition of this is inflation close to but below two percent. Was the PSPP excessive to what was necessary to achieve this goal? We already know the answer to this is a clear "No". Despite an enormous purchase programme, the ECB's policies did not return the inflation rate to its target level. Purely by appeal to the Treaty's definition of proportionality, the programme cannot be described as disproportional.

Moreover, the ECB can point to the fact that programmes of this type have been adopted in the past by other central banks when they had reached lower limits on policy rates and wished to meet their inflation targets. If this was a programme that only the ECB had enacted and no other central bank had implemented, it might give pause for thought as to whether the policy was somehow disproportionate but this is clearly not the case.

The BVerfG clearly has a different view of what the proportionality principle means. They believe that *"the balancing of conflicting interests"* is a key element. I am unsure why they believe this. It is true that academic debates about proportionality often discuss the role that can be played by balancing of interests.⁹ However, the word "balancing" is not mentioned in Article 5 of TEU nor is it mentioned in the Protocol of the application of the principles of subsidiarity and proportionality.

Indeed, perhaps uniquely among all the European institutions, a "balancing" test is explicitly not something the ECB can do. It has a primary objective – price stability – and it is not supposed to "balance" this against other economic goals. It can consider those goals but only if they are not preventing it from meeting its price stability goals. As such, it is legitimate for the ECB to take actions that have negative economic effects provided these actions move the economy close to achieving price stability.

The BVerfG may not have considered quite how much the ideas underlying their judgement have the potential to undermine the ECB's independence and its ability to achieve its primary objective. While the negative consequences of asset purchase programmes mentioned by the BVerfG are either mild or illusory (see below), there are clearly times when the ECB's actions to maintain price stability will

⁹ See, for instance, Möller (2012).

have negative impacts on other economic outcomes that are outlined in Article 3 as goals of the Union, such as full employment.

Consider the situation where the ECB decides it needs to raise interest rates to bring down inflation, something it has done several times in the past. As pointed out on Twitter by Jean-Pierre Landau, a former high-ranking official of the Banque de France: *"The judgment would allow any Government or Parliament to legally challenge the ECB on the ground that the "balance" between the positive monetary effects and the negative economic consequences (on unemployment) has not been properly assessed."*¹⁰ In light of these potential threats to its independence, it is crucial that the ECB stress that the ECJ is the only court allowed to interpret the legality of its actions.

4.2.2. Negative economic effects of the PSPP

While its legal arguments are weak, the economic arguments underlying the BVerfG judgement are even weaker. The negative economic effects the BVerfG is so concerned for ECB to address are not serious problems and largely reflect a set of inaccurate talking points that have dominated German economic discussions in recent years. There were more bad economic takes in this judgement than I have space to address here but I will single out four for discussion.

Losses for savers: A key supposed economic cost of the PSPP according to the BVerfG is that *"there is a considerable risk of losses for private savings."* (Paragraph 173). This reflects an assumption common in German economic debates that most people's savings are kept in deposit accounts and thus the return on household savings is depressed by the ECB's low interest rate policies. Leaving aside for a moment the question of whether the PSPP actually affected deposit interest rates — most of these rates were zero prior to PSPP and have continued to be zero — this is simply not an accurate way to think about how asset purchase programmes impact the value of private savings.

For most households, the principal source of savings is the ownership stake they built up over time in the house they live in. Beyond that, there are many households with significant wealth in the form of pension assets or other financial assets. Indeed, the most recent Household Finance and Consumption Survey (HFCS) conducted by the Eurosystem in 2017 shows that financial assets only account for 19 percent of total household assets.¹¹ And bank deposits only account for 44 percent of those financial assets with the rest being in mutual funds, bonds, shares, pension funds etc. In other words, bank deposits account for only about 8 percent of the total assets of euro area households.¹²

This point is relevant because it is widely believed that asset purchase programmes drive up prices for assets such as stocks and housing. This means that the assets that account for the majority of household wealth have gone up in value during the PSPP rather than down.

Indeed, while the BVerfG may not be aware of it, there has been much discussion among economists (including those at the ECB) about whether asset purchase programmes increase wealth inequality by making those who have significant savings better off.¹³ As I discussed in Whelan (2015), it is not clear that these programmes really have had much impact on wealth inequality but the idea that they disproportionately negatively affect households with savings is certainly incorrect. And even if it was correct, there is nothing in the ECB's legal mandate that requires it to consider distributional issues —

¹⁰ See <https://twitter.com/JPLandau/status/1257840241777479680>.

¹¹ HFCS data are available at https://www.ecb.europa.eu/pub/economic-research/research-networks/html/researcher_hfcs.en.html.

¹² Despite the focus on bank deposits in German economic discussions, Germany is almost exactly typical of euro area countries. Financial assets account for 21 percent of German household assets and deposits account for 46 percent of these financial assets. So bank deposits account for 9.6 percent of German household assets.

¹³ See, for instance, Lenza and Slacalek (2018) for an ECB study on the effects of asset purchase programmes on wealth inequality.

whether its actions affect one group of citizens more than another — when making its monetary policy decisions.

Banks and insurance companies: The judgement makes some strange comments about the PSPP's effects on the banking sector. Paragraph 172 states:

“The PSPP also affects the commercial banking sector by transferring large quantities of high-risk government bonds to the balance sheets of the Eurosystem, which significantly improves the economic situation of the relevant banks and increases their credit rating.”

This is inaccurate on several levels. As explained in ECB (2017), relatively few of the bonds acquired by the Eurosystem in the PSPP came directly from euro area banks. And given that there were active secondary markets for these bonds throughout this period, there was no need for commercial banks to rely on ECB intervention to get risky bonds off their balance sheet. The reality is the ECB's asset purchase programmes were unpopular with the banking sector. The Eurosystem paid for its assets by creating a huge amount of money in the deposit accounts that commercial banks hold with their national central banks. The decision to impose a negative deposit rate, combined with the huge stock of deposits created by the Eurosystem, amounted effectively to a tax on the banking sector. Indeed, it was intensive lobbying against the negative impact of these developments on bank profitability that led to the introduction last September of “tiering” of reserves.

There is no doubt that the low interest rate environment has been difficult for certain financial institutions. The relatively flat yield curve has had a negative impact on bank profitability and institutions that rely heavily on income from low yielding safe bonds (such as insurance companies) have also been negatively affected. The ECB monitors how these sectors are operating, consistent with its mandate for maintaining the stability of the financial system, as set out in Article 127 of TFEU. However, it is not the job of the ECB to make insurance companies profitable, nor are considerations like this part of economic policy goals of the Union as set out in Article 3 of TEU.

Structural reforms: Paragraph 170 covers a familiar ordoliberal theme:

“It is therefore undisputed that the budgetary situations of Member States benefit from the reduction of general interest rates facilitated by the PSPP. This gives rise to the risk – despite the “safeguards” referred to by the CJEU – that necessary consolidation and reform measures will either not be implemented or discontinued.”

Leaving aside for a moment the dubious assumption that worsening fiscal conditions lead states to conduct “necessary reforms”, it is hardly believable that the BVerfG think this is the kind of consideration the ECB should be considering when making its decision. Imagine if the ECB President said “We probably should take this action to lower interest rates to restore price stability but we are going to keep interest rates higher to maintain pressure on Italy to introduce structural reforms.” It might be a popular decision in Germany but would be viewed elsewhere as a failure to pursue its primary objective and a move well outside its mandate into involvement in political decisions.

Zombie firms: Paragraph 174 expresses a concern often aired about low interest rates.

“As the PSPP lowers general interest rates, it allows economically unviable companies to stay on the market since they gain access to cheap credit”.

Arguments that so-called “zombie firms” are a problem generally rely on the idea that these firms have weaker productivity than the rest of the economy and thus perhaps drag down the productivity of the economy as a whole.¹⁴ But the observation that zombie firms have low productivity on its own

¹⁴ See, for example, Banerjee and Hofmann (2018).

means little and this debate is riddled with reverse causality problems. It is hardly surprising that the weakest, least productive, firms in the economy are more likely to carry large debt burdens and have cash flow sensitive to interest rates on their loans. It's unlikely, however, that it is the debt burden of these firms that causes them to have low productivity. It is also unclear as to whether shutting down the least productive firms in the economy will do anything other than temporarily raise unemployment. There is little reason to think the workers and managers who operated these low-productivity firms will automatically operate at higher productivity levels once they get new jobs.

In any case, whatever value there is to this particular debate, it is surely not something the ECB should be giving much consideration to. Again, if the ECB were to announce *"We probably should take this action to lower interest rates to restore price stability but we are going to keep interest rates higher so that some low-productivity firms go bankrupt because we think that might be good for productivity in the long run"*, it would clearly be acting well beyond its mandate.

To summarise, the negative economic impacts of the PSPP cited by the BVerfG — and which are central to its decision — are either non-existent or relatively limited in nature and, in any case, lie beyond the ECB's mandate for consideration.

It is worth asking how the court can have been so convinced by such a weak set of economic arguments and in this context it is worth noting that half of the experts called on for economic advice in this case were representatives of the German banking and insurance sector. A cynical view might be that advice was largely sought from those who agreed with the pre-existing views of the judges. Rather than re-enforcing their ordoliberal "echo chamber", the Court would be well advised to listen to a wider and more representative set of economists. The German economists who are members of Monetary Expert Panel of the European Parliament's Committee on Economic and Monetary Affairs (ECON Committee) would be a good place to start if the court is open to hearing a wider range of opinions at some point in the future.

4.2.3. Evidence of consideration by ECB

A final element of the BVerfG judgement is its claim that there is no evidence that the ECB considered the negative impacts of the PSPP when taking its decisions. Paragraph 169 asserts:

"It is not ascertainable that the ECB Governing Council did in fact consider and balance the effects that are inherent in and direct consequences of the PSPP."

This claim is extraordinary. The ECB has engaged in a huge amount of public communication on the rationale for the PSPP. Detailed descriptions of the debates at ECB Governing Council meetings have been released. ECB Presidents have regularly answered questions about the potential negative impacts of the programme during their regular press conferences and during their appearances before the ECON Committee. Indeed, a look at the briefing papers prepared for the committee over the past few years shows that potential negative side effects of asset purchase programmes has been a regular topic of interest for the committee to raise in its discussions with the ECB President.

More recently, ECB Executive Board member Isabel Schnabel (2020) delivered an excellent speech in February (in Karlsruhe of all places) addressing (and rebutting) many of the negative-side-effect arguments. Far from being *"not ascertainable"*, even the slightest bit of research would have unearthed many different signs that ECB has clearly considered these issues in depth.

The BVerfG's judgement acknowledges (paragraph 111) that there is a tension between its decisions and the other institution of the European Union.

“In principle, certain tensions are thus inherent in the design of the European Union; they must be resolved in a cooperative manner, in keeping with the spirit of European integration, and mitigated through mutual respect and understanding.”

Unfortunately, by ignoring so much of the public communication on PSPP made available by the ECB and the European Parliament, the BVerfG’s decision does not show respect for (or understanding of) these institutions.

5. CONCLUSIONS

At this time of global crisis, there are strong economic and legal arguments for the ECB to take exceptional action to stimulate the economy and support the economic policy objectives of the EU. The ECB was failing to meet its primary objective of price stability — defined as inflation of close to but below 2 percent — prior to the COVID crisis and without an exceptional policy response, inflation will likely move further away from its target level. So this is a moment when the ECB should consider using its money creation powers in a wide range of new and innovative ways that will support the economic policy objectives of the union and, through their positive effects on the economy, also help it move closer to meeting its price stability objective.

In practice, however, the way the EU Treaties are being interpreted by courts may curtail the ECB from taking some of the crisis prevention measures that it would like to. For example, while the ECJ declared the PSPP to be legal in its *Weiss* judgement in December 2018, it largely did so because the PSPP had a number of features that do not apply to the new PEPP. Should the PEPP be questioned at the ECJ, it may be deemed to be in violation of Article 123 of TFEU.

The other threat to the ECB's policies is the recent judgement of the German constitutional court, a judgement that I have argued here is flawed in both its legal and economic analysis. The ECB's response to the judgement simply takes note of it and restates that the ECJ (which must remain the final decision maker on European law) has declared PSPP to be legal. The ECB is clearly under no legal obligation to accede to the BVerfG's request to adopt "*a new decision that demonstrates in a comprehensible and substantiated manner that the monetary policy objectives pursued by the ECB are not disproportionate to the economic and fiscal policy effects resulting from the programme.*" But there is so much evidence in favour of the proportionality of the PSPP (all of which has been ignored by the BVerfG) that a decision of this sort could more or less consist of providing a list of all the different pages on the ECB's website where these issues have been discussed. However, given the BVerfG's particular ideas about the principle of proportionality, it is unclear if this would be enough for them to change their mind.

This leaves open whether the Bundesbank can continue to be a part of asset purchase programmes. It may be that the answer is "No" and that the Bundesbank needs to sell all of its German government bonds to the rest of the Eurosystem. On its own that is not likely to be a big threat to the euro, though it raises the question of whether it would put the Bundesbank in violation of Article 271(d) of TFEU which requires national central banks to fulfil their obligations under the Treaties (assuming participation in PSPP as directed by the Governing Council is interpreted as such an obligation). However, the more the Eurosystem moves away from implementing policy measures in a co-ordinated and shared manner, the weaker the arguments become for having a shared currency and monetary policy.

Given the various legal difficulties associated with sovereign bond purchases, there may be an argument for the ECB to switch its focus to newer and more innovative policy approaches.

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This paper considers how the ECB can implement its mandate in the current crisis conditions and the legal constraints that exist on its actions. The current position of the euro area economy means the threat to meeting the ECB's primary objective of price stability stems from the possibility of a long period of below-target inflation. This means the ECB should consider a wide range of stimulative policies that would help it meet both its primary and secondary objectives. The ECB, however, will be constrained by the ECJ's interpretation of the monetary financing clause and its ability to meet its primary objective (and its independence) could be threatened by the recent German constitutional court judgement which is flawed in both its legal and economic analysis.

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