Issues of Legal Uncertainty Arising in the Context of Monetary Finance

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Financial Markets Law Committee[1]

This paper has been drafted by and on behalf of the FMLC Secretariat[2]

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1. INTRODUCTION

1.1. The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. In the E.U. and the U.K., central banks are tasked with the responsibility of determining monetary policy to ensure price stability. Central banks conduct monetary policy by adjusting the supply of money, generally through open market operations. For instance, a central bank may reduce the amount of money by selling government bonds to commercial banks under a "sale and repurchase" agreement, thereby taking in money from those banks. This is known as quantitative easing ("**QE**"). The purpose is to steer short-term interest rates and the base interest rate, at which banks may borrow from the central bank (the "**Base Rate**"), which in turn influence longer-term rates and overall economic activity. However, QE activities through the purchase of government bonds on secondary markets may constitute monetary *financing*, which is prohibited under Article 123 of the Treaty on the Functioning of the European Union ("**TFEU**"). Similarly, stimulus activity may fall outside the monetary policy mandate if not properly construed. This note outlines some of the legal issues which arise in the context of monetary policy and monetary financing, and considers a recent judicial decision in relation to the distinction between monetary policy and monetary financing, so as to highlight particular consequences for stimulus policies by National Central Banks ("**NCBs**").

2. BACKGROUND

2.1. The TFEU empowers the European Central Bank ("**ECB**") to conduct the monetary policy of the European Union and provides that the primary objective of the ECB and the European System of Central Banks ("**ESCB**") is to maintain price stability.[3] Monetary policy is action undertaken by an NCB to promote sustainable economic

[3] Articles 127(1) and 282(1), (2) TFEU.

growth and achieve macroeconomic objectives.[4] In the U.K. and the E.U., monetary policy aims to maintain price stability and hold inflation rates at 2%.

2.2. The two main monetary policy tools used to achieve price stability are setting the Base Rate and QE. The Base Rate is the interest rate that banks and lenders pay when they borrow from the central bank, which influences the rates offered by banks to their customers. Speaking broadly, the lower the Base Rate, the cheaper it is to borrow and less attractive it is to hold savings, driving consumer spending. QE refers to the creation of new central bank money, which is then used to purchase government bonds. Large-scale acquisition of government bonds reduces their yields, and puts downward pressure on interest rates offered on loans. QE also increases money supply. In addition, NCBs and the ECB are obligated to provide monetary support for the economic policy of their governments, including objectives for growth and employment.[5] In performing its role, the central bank is prohibited from engaging in "monetary financing"; i.e. directly financing government spending.[6]

2.3. In response to the economic impact associated with the novel coronavirus pandemic, both the ECB and the BoE have engaged in QE activities. Such programmes have been justified on the basis that they advance the objective of a 2% per annum inflation target. In other countries, however, questions have been raised as to whether such programmes are *ultra vires* or amount to monetary financing.

3. BOUNDARIES OF "MONETARY POLICY"

3.1. What is sometimes reductively called "the prohibition on monetary financing" is set out in Article 123 of the TFEU, which provides

> 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

4 Despite the U.K.'s withdrawal from the E.U., it continued to be bound by and receive E.U. law during the so-called Transition Period that ended on 31 December 2020. Until that date, the mandate under the TFEU extended to the Bank of England ("BoE"). In addition, section 11(a) Bank of England Act 1998 provides that the principal objective of the Bank of England is to maintain price stability.

5 Article 127(1) TFEU, Section 11(b) Bank of England Act 1998.

6 Article 123 TFEU.

> 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.

In essence, Article 123 of the TFEU prohibits the ECB and NCBs from providing "credit facilities" or purchasing bonds directly from the relevant Treasuries or any government agency. As a result, when the ECB initiates a programme for the purchase of government bonds that has significant economic policy effects, it is required to identify and weigh the programme's monetary policy objective and economic policy effects and balance them against one another.

3.2. Article 119(2) of the TFEU introduces the distinction between monetary and economic policy but the TFEU does not explicitly define either term. The European Court of Justice in *Pringle* provided a distinction by referring to the objectives of monetary policy and distinguishing these from those of economic policy, and then looking at monetary policy instruments (for example, financial assistance is not a monetary policy instrument).[7] This offers the ECB and NCBs broad discretion in conducting their activities. Finally, in carrying out its monetary policy duties, the ECB is subject to the "proportionality" principle, a principle enshrined in Article 5 of the Treaty on European Union ("**TEU**") and binding upon all E.U. institutions. The TEU also mandates that the ECB may only exercise its designated powers to the extent necessary to fulfil its prescribed goals. As a result, when the ECB initiates a programme for the purchase of government bonds that has significant economic policy effects, it is required to identify and weigh the programme's monetary policy objective and economic policy effects and balance them against one another.

3.3. In this context, the purchase of government bonds on the secondary market may be viewed as monetary financing if appropriate safeguards are not implemented. The Eurosystem has put in place measures such as a blackout period, not buying government bonds around the date of a new issuance, and purchases are subject to issue share limits and an issuer limit.[8] In addition, the principle of proportionality may need to be evidenced in the ECB's decision-making around QE, in the event the ECB is seen to be acting *ultra vires*.

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7 *Thomas Pringle v Government of Ireland and Others* (2012) Case C- 370/12

8 Decision (EU) 2020/188 of the European Central Bank of 3 February 2020 on a secondary markets public sector asset purchase programme (ECB/2020/9)

3.4. The boundaries of the mandate granted to the ECB, NCBs are, however, blurry, and there is a risk that behaviours may be *ultra vires*. The test to determine whether action by the ECB or NCBs is a violation of the Article 123 "prohibition" turns on a determination of the objective for which the action was taken. This is necessarily a difficult determination to make. For example, secondary market purchases by the ECB—such as the purchase of Member State bonds selectively to reduce market distortions that limit the efficacy of the Bank's monetary policy—will not be considered to constitute monetary financing, even though, in theory and as described above, the ECB is prohibited from purchasing government bonds. Similarly, if an action taken in pursuit of monetary policy has an indirect effect on the stability of the Euro area, the ECJ has ruled that it is not to be considered an economic policy measure.[9]

3.5. It was this evidential uncertainty which was the subject of the Federal Constitutional Court of Germany (the "**Constitutional Court**").[10] On 5 May 2020, the Constitutional Court concluded that the ECB's QE asset purchase programme was *ultra vires*. The Constitutional Court disagreed with a prior determination by the Court of Justice of the European Union ("**CJEU**"), which found that such asset purchase programmes were within the ECB's powers.[11] The ECJ found that the ECB had put into place sufficient safeguards to ensure that there was no violation of Article 123 of the TFEU.[12]

3.6. The Constitutional Court concluded that the asset purchase programmes were not proportionate, and that the explanation given for the exigency of the circumstances and the need for an asset purchase programme was insufficient.[13] In particular, the Constitutional Court took the view that the ECB had failed to provide clarity on the balance between the monetary policy aims and the economic and social policy impacts. As the Constitutional Court found there was no evidence of a balancing exercise, it

9 In *Pringle*, the ECJ wrote:

> The objective pursued by that [the ESM] (…) is to safeguard the stability of the euro area as a whole, that is clearly distinct from the objective of maintaining price stability, which is the primary objective of the Union's monetary policy. Even though the stability of the euro area may have repercussions on the stability of the currency used within that area, an economic policy measure cannot be treated as equivalent to a monetary policy measure for the sole reason that it may have indirect effects on the stability of the euro.

10 BVerfG, 2 BvR 859/15, Judgment of the Second Senate (5 May 2020), English translation available online at: https://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2020/05/rs20200505_2bvr085915en.html.

11 Case C-493/17 *Weiss and Others,* EU:C:2018:1000 (11 December 2018) at [53]-[100].

12 *Ibid* at [109] – [128].

13 See *BVerfG*, 2 BvR 859/15, Judgment of the Second Senate (5 May 2020) at [176].

concluded that the ECB decisions exceeded its monetary policy mandate. The Constitutional Court did find, however, that there was no violation of Article 123 TFEU, considering that the various safeguards implemented were sufficiently effective.

3.7. The Constitutional Court has no jurisdiction over the ECB, and therefore its decision cannot and will not directly influence ECB decision-making or the validity of the CJEU's *Weiss* decision.[14] The ECB may, however, produce a new proportionality assessment of its asset purchase programme addressing certain of the issues identified by the Constitutional Court.[15] As such, the Constitutional Court's decision does not provide additional clarity on the lawful boundaries of monetary policy in E.U. Member States. Nonetheless, the reasoning provides a useful illustration and discussion of safeguards that could preclude against a violation of the prohibition against monetary financing, particularly in the context of the unique situation of the Eurozone legal framework.[16] In particular, the Constitutional Court discussed the efficacy of purchase limits, blackout periods, continued monitoring and credit quality assessments.[17]

4. DISTINCTION BETWEEN THE U.K. AND E.U. LEGAL FRAMEWORK

4.1. The domestic position in the U.K. is distinct from the prohibition on monetary financing in the E.U. The BoE Act does not expressly prohibit the direct financing of government expenditure. The BoE has emphasised the institutional safeguards in place which ensure that asset purchase programmes do not stray into the territory of monetary financing.[18]

4.2. A further relevant consideration arises from the Ways and Means Facility ("**W&M Facility**"), which HM Government holds with the BoE and which enables cash advances from the BoE to the government. The W&M Facility historically performed a daily role in the government's cash management and has largely remained unused in

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14 Rather, this decision only directly affects the legality of Germany's participation in ECB asset purchase programmes.

15 The Constitutional Court has provided a three-month transitional period, within which the ECB may adopt a new decision that provides greater detail on the monetary policy objectives pursued, and whether they are proportionate to the economic and fiscal policy effects of the programme; see *BVerfG*, 2 BvR 859/15, Judgment of the Second Senate (5 May 2020) at 235.

16 *Ibid* at [215]ff.

17 *Ibid* at [197] – [212].

18 Andrew Bailey 'Bank of England is not doing 'monetary financing'' *Financial Times* 5 April 2020 available at https://www.ft.com/content/3a33c7fe-75a6-11ea-95fe-fcd274e920ca.

recent years. When the U.K. was still an E.U. Member State, the existence and use of the W&M Facility was expressly subject to a safe-harbour within the terms of Article 123 of the TFEU.[19] In response to the novel coronavirus pandemic, the W&M Facility was temporarily extended to provide additional liquidity to smooth government cash flows and support the orderly functioning of markets.[20]

4.3. Given the absence of a prohibition of monetary financing in domestic legislation and the operation of the W&M Facility in a post-Brexit U.K., it is unclear whether the requirement to demonstrate that QE measures do not amount to monetary financing—in the manner interpreted by the Constitutional Court (in the context of Eurozone arrangements)—will be a feature of the U.K. legal regime.

5. IMPACT

5.1. The expected severity of the economic downturn experienced around the world since March 2020 will likely require the bold use of all the weapons in the arsenal of NCBs, which will go to considerable lengths to ensure that their price stability objectives are achieved. This may throw into relief the question of the boundary between monetary support for economic policy and monetary financing and it may stress test the nature of the safeguards that NCBs implement. The ECB has yet to respond to the Constitutional Court. If the ECB does now provide greater detail on their balancing exercise, this may create both a precedent for transparency and a guideline for future monetary operations.

6. CONCLUSION

6.1. The distinction between QE activities and monetary financing is ill-defined but the uncertainty favours the ECB and NCBs, who retain considerable discretion. The points of difference between the E.U. legal framework and the U.K. regime may mean that guidance issued by the ECB or other E.U. level authorities may not be directly relevant in determining the legality of BoE measures after Brexit.

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19 Paragraph 10, Protocol 15 to the TFEU states 'Notwithstanding Article 123 of the Treaty on the Functioning of the European Union…the Government of the United Kingdom may maintain its "ways and means" facility with the Bank of England if and so long as the United Kingdom does not adopt the euro.

20 See Bank of England "HM Treasury and Bank of England announce temporary extension to Ways and Means facility", 9 April 2020 available at: https://www.bankofengland.co.uk/news/2020/april/hmt-and-boe-announce-temporary-extension-to-ways-and-means-facility.

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