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The ECB's Transmission Protection Instrument: a legal & economic analysis



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

With the rise in interest rates and the phasing out of ECB's asset purchase programmes, highly indebted countries such as Italy and Greece are facing a sharper rise in their bond yields than Germany – a development often referred to as 'bond market fragmentation'. In response, the Governing Council of the European Central Bank announced the Transmission Protection Instrument on 21 July 2022. This paper provides a legal and economic examination of this new monetary policy instrument. It is compared with other non-conventional instruments in the context of the Treaty framework and the doctrine of the European Court of Justice.

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LIST OF ABBREVIATIONS

APP	Asset Purchase Programme
BVerfG	Bundesverfassungsgericht (German Federal Constitutional Court)
CJEU	Court of Justice of the European Union
ECB	European Central Bank
ECJ	European Court of Justice
EDP	Excessive Deficit Procedure
EFSF	European Financial Stability Facility
EIP	Excessive Imbalance Procedure
ELA	Emergency Liquidity Assistance
EMU	Economic and Monetary Union
ESCB	European System of Central Banks
ESM	European Stability Mechanism
GCC	German Constitutional Court
GDP	Gross Domestic Product
GFC	Global Financial Crisis
IMF	International Monetary Fund
OMT	Outright Monetary Transaction Programme
PEPP	Pandemic Emergency Purchase Programme
PSPP	Public Sector Purchase Programme
SMP	Securities Market Programme
TEU	Treaty on European Union
TFEU	Functioning of the European Union
TPI	Transmission Protection Instrument

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EXECUTIVE SUMMARY

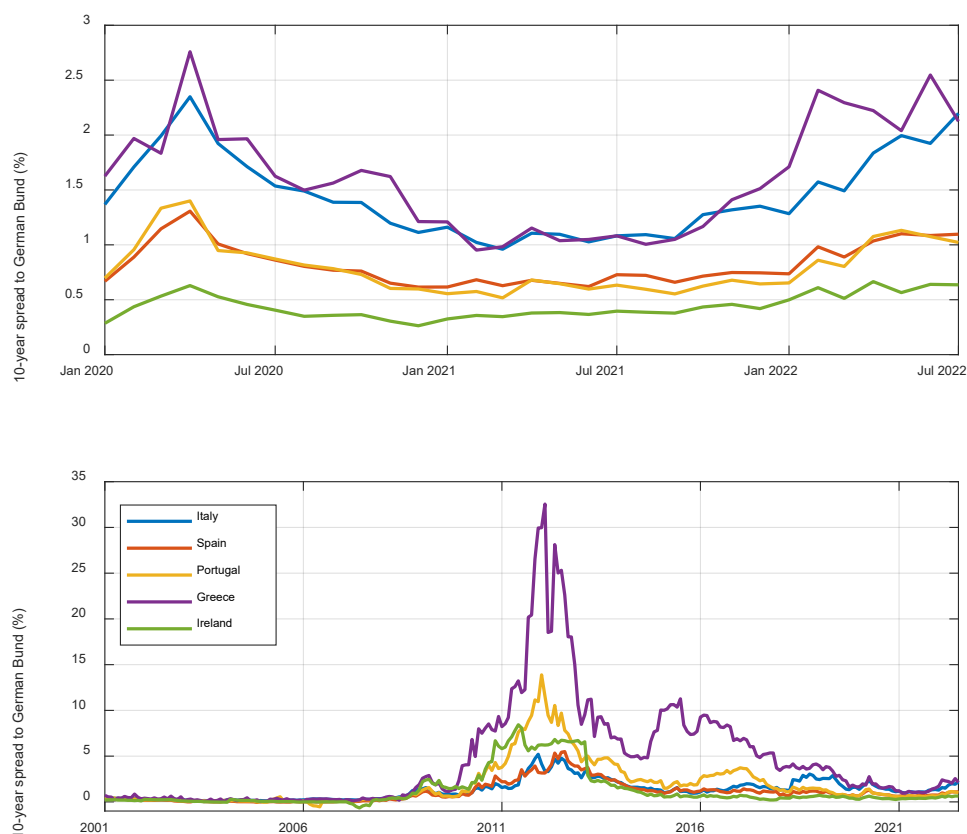
- With the rise in interest rates and the end of purchases of government bonds, highly indebted countries such as Italy and Greece are facing a sharper rise in their bond yields than other countries, especially Germany, which is leading to a fragmentation in the bond market.
- The Governing Council announced its new anti-fragmentation tool, named **the Transmission Protection Instrument** (TPI) on 21 July 2022. TPI is aiming to counter this bond market fragmentation by secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals.
- TPI's predecessor, the Outright Monetary Transaction (OMT) announced in 2012, has not been activated so far though it still part of the ECB's toolkit. OMT and TPI share similarities with regard to the objective of the measure, the potential selectivity and the conditionality/eligibility requirements.
- The legitimacy of the TPI turns on the words 'unwarranted' and 'not justified by country specific fundamentals'. One of the main challenges for the ECB will be to objectively determine whether and when the financing conditions of individual countries, i.e. their yields on government bonds, are no longer justified by country-specific fundamentals.
- Estimation of a nonparametric fixed-effects panel model shows that financial markets currently do not treat any of the countries under consideration separately in terms of their bond yield levels. Bond yields of all countries considered can be well explained on the basis of their fundamentals and the general risk aversion in financial markets.
- The activation of TPI requires sound and sustainable fiscal and macroeconomic policies. The ECB as an independent institution is bound by its price stability mandate. Making economic assessments on the fiscal and economic situation of Member States goes beyond its mandate; even if it is adhering to the decisions of external bodies, it remains the ECB that takes the decision to activate TPI with regard to a certain jurisdiction. This may expose the ECB to political pressure, threatening its independence.
- A point of criticism of TPI is the lack of substantiation, justification, and detail in the terms set out in the Press Release. There might be good reasons for keeping some features of the programme secret. However, reasons that justify not disclosing parameters of monetary policy instruments to the general public do not dispense the ECB from writing down these confidential parameters to allow for judicial review and parliamentary review in non-public fora.
- The guidelines given in the Press Release leave questions with regard to the distinction and relation of TPI with OMT and PEPP unaddressed. The ECB needs to provide further clarification to avoid confusion for market participants and to fulfill its duty to give account of its actions.
- Risk- and loss-sharing is not addressed in the Press Release. In the light of its accountability requirements, the ECB should disclose such information to ensure that its independent decisions can be scrutinized by the EP. The social legitimacy of the institution – and in turn the acceptance of its independence and its institutional framework – will increase if those aspects of monetary policy which are politically sensitive are explained and justified.

1. INTRODUCTION

In view of steadily rising inflation in the euro area since mid-2021, the European Central Bank (ECB) began signalling a normalisation of its monetary policy at the end of 2021. Inflation accelerated after the Russian invasion of Ukraine in February 2022. Net purchases under the Pandemic Emergency Purchase Programme (PEPP) were discontinued at the end of March 2022 and those under the conventional Asset Purchase Programme (APP) in July 2022. Only the redemption of these purchase programmes will continue to be reinvested for a longer period of time – that of the PEPP until the end of 2024. Further, key interest rates were raised by 50 basis points in July 2022.

In response to the ongoing monetary policy normalisation, spreads on peripheral government bonds have risen steadily since the beginning of 2022. With the rise in key interest rates and the end of purchases of government securities, which have pushed down risk premiums on government bond yields in recent years, highly indebted countries such as Italy, Greece, Portugal and Spain are facing a sharper rise in their bond yields than the “core countries” (Germany and France), a development often referred to as “bond market fragmentation” (Figure 1).

Figure 1: 10-year government bond spreads of periphery countries

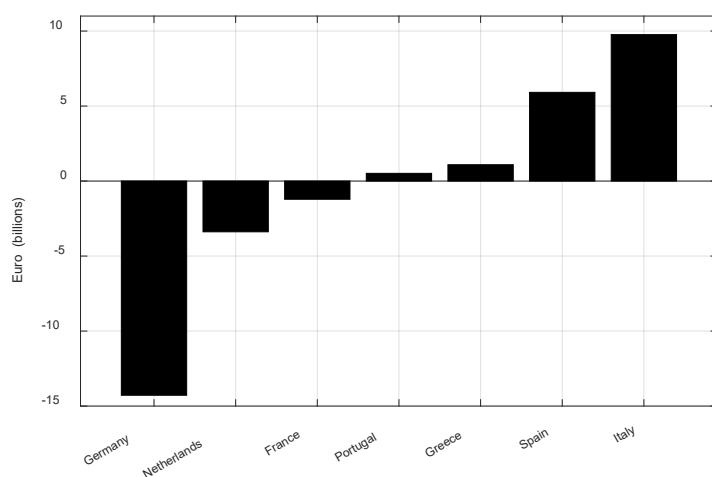


Given the heterogeneous bond yield development, concerns arose among central bankers and financial markets that, similar to the euro area debt crisis in 2010/11, bond yields of highly indebted

countries such as Italy or Greece would continue to rise, jeopardising the integrity of the euro area and the single European monetary policy. The reason for these concerns is that government bond markets are characterised by multiple equilibria in a monetary union. As De Grauwe (2012) points out, capital flight and liquidity crises are much more likely in a monetary union than in countries with autonomous monetary policies and their own currencies. When the perception of a country's default risk increases, private investors sell these government bonds and, because of the free movement of capital across borders, they can quickly invest the freed-up funds in government bonds of other member countries in the same currency area that are considered safer. A self-fulfilling prophecy of default can occur, since once a member country enters a liquidity crisis, its borrowing costs increase as interest rates rise, and the liquidity crisis can turn into a solvency crisis. Thus, initially small exogenous triggers (e.g., a rise in risk aversion) in financial markets can amplify and cause large changes in credit and asset prices because of these negative feedback loops. *"If these amplifying forces are strong enough, multiple equilibria can emerge so that the system itself generates systemic risks"* (Brunnermeier and Reis, 2019). In a monetary union, the central bank's responsibility as a lender of last resort is therefore even more important. (As acknowledged, the ECB has responsibility for market liquidity assistance, while national central banks keep responsibility for individual Emergency Liquidity Assistance or ELA).

To counter *"unwarranted"* fragmentation risks, the ECB has used in June and July 2022 redemption payments from purchases of bonds of core countries under the PEPP to reinvest them in bonds of peripheral countries, especially Italy and Spain (Figure 2). This is consistent with the ECB's communication that flexibility in PEPP reinvestments will be the first line of defence against fragmentation risks. However, the size of PEPP repayments is unlikely to be sufficient to halt any divergence in the dynamics of yield divergence among euro area Member States once it emerges.

Figure 2: PEPP reinvestments in June and July 2022



Source: European Central Bank.

Once again, the ECB felt compelled to *"put its foot down"* on the financial markets in order to prevent, or at least curb, market speculation about bond yields drifting further and further apart. On 21 July 2022, the ECB announced a new instrument, the Transmission Protection Instrument (TPI), to *"ensure that the monetary policy stance is transmitted smoothly across all euro area countries"* as the ECB continues policy normalisation. The ECB explains that the TPI will be a new addition to the toolkit and *"can be activated to counter unwarranted, disorderly market dynamics that pose a serious threat to the*

transmission of monetary policy across the euro area". The TPI allows for secondary market purchases of securities *"issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals"* (ECB, 2022). The announcement of TPI has ignited a heated debate amongst academics, central bankers and the general public. While some query whether more asset purchases are the right way forward from an economic perspective with inflation rising, others question TPI on legal grounds.

This paper seeks to answer the following questions. First, is the currently observed increase in bond yields linked to a specific macroeconomic situation or problem that falls into the competence of the respective Member State, or is the disruption based on market failure, which is not rooted in the macroeconomic fundamentals of a Member State, but lies within the monetary competence of the ECB in line with Art. 123 and 127 TFEU? (see section 2). Second, what are the differences and similarities between TPI and earlier programmes, especially the Outright Monetary Transaction Programme (OMT) which has announced (but has never been activated) in 2012? (see section 3). OMT and TPI share many similarities but also differ in several aspects. As acknowledged, the OMT was challenged by the German Constitutional Court (GCC) and upon the referral by the GCC, the European Court of Justice (ECJ) has developed guidelines for sovereign bond purchase programmes in its ruling in *Gauweiler* and later on the Public Sector Purchase Programme (PSPP) in its ruling on *Weiss*. Building on these guidelines, we address the legal considerations underlying TPI and its conformity with the provisions of the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU) in particular the prohibition of monetary financing. (see section 4). The paper concludes with policy recommendations (see section 5).

2. UNDERSTANDING DISORDERLY BOND FRAGMENTATION

According to the official statement of the ECB, the purpose of the TPI is to purchase securities on the secondary market in the event that the financing conditions of individual euro area countries deteriorate without this being justified by country-specific fundamentals¹. One of the main challenges in this respect for the Governing Council of the ECB will be to objectively determine *whether* and *when* the financing conditions of individual countries, i.e. their yields on government bonds, are no longer justified by country-specific fundamentals. Thus, understanding the driving forces of sovereign yield differentials in the Economic and Monetary Union (EMU) is an important issue for policymakers and economists.

The general consensus in the existing literature is that sovereign bond yields are determined by country-specific risk factors and also international factors such as global investors' risk aversion². The sharp rise in government bond yield spreads during the euro area debt crisis in 2010/11 suggests that bond yields are not only driven by changes in macroeconomic fundamentals but also by the fact that overall risk assessments vary over time (Figure 1). By estimating an additive non-parametric fixed-effects panel model framework similar to Bernoth and Erdogan (2012), we determine the extent to which an observed change in the yield spread is due to a change in macroeconomic fundamentals, such as a country's fiscal position, and the extent to which it reflects a change in the markets' valuation of these fundamentals, as reflected in a change in model coefficients (Box 1). Moreover, we endogenously determine the timing and patterns of changes in model coefficients. While this analysis cannot provide a clear answer to the question of whether or not market adjustments in risk pricing are unwarranted, it does provide an indication of the underlying drivers of the current rise in bond yields and allows an assessment of current risk premium levels relative to past crisis periods.

2.1. Data

We analyse the (end-of-month) sovereign bond yields of ten euro area Member States: Belgium, Finland, France, Greece, Ireland, Italy, the Netherlands, Austria, Portugal and Spain provided by Bloomberg. The period covered runs from January 2001 to June 2022, so our monthly data sample comprises a total of 258 observations. The yield spreads of the individual countries are calculated as the yield difference of their 10-year benchmark bonds versus the 10-year German Bund at month-end.

Since estimating time-varying coefficients is very data-intensive, we focus only on the basic explanatory variables that are most commonly used in the literature. To estimate credit risk, we focus on variables that measure a country's fiscal performance, i.e., the debt-to-GDP ratio and the projected (12-month-ahead) deficit-to-GDP ratio³. Both variables are expressed in differences to the corresponding debt and deficit figures of the benchmark country, Germany.

¹ ECB (2022).

² Bernoth et al. (2012) and Bernoth and Erdogan (2012) for a more extensive literature review. For a recent view on bond fragmentation, see also Angeloni and Gros (2022b).

³ We also include the squared terms of the two fiscal variables to test for a "credit penalty effect," meaning that interest rate spreads do not grow linearly with the level of the fiscal variables. However, both squared variables were found to be insignificant, ensuring that the variation in the estimated coefficients over time is indeed due to a change in risk pricing and does not indirectly reflect a nonlinear response of interest rates to debt or the deficit.

Box 1: The estimation model

Our model is motivated by Sun et al. (2009), who develop a general varying coefficient panel data model with fixed effects using a local linear regression approach. We modify their model in the sense that we introduce smoothly time-varying coefficients. Let's assume that the sovereign bond yield spread of country i at time t is denoted by y_{it} and has the following functional form:

$$y_{it} = x'_{it}\beta_t + \mu_i + v_{it}$$

where $i = 1, \dots, N; t = 1, \dots, T$ and $x_{it} = (x_{it,1}, \dots, x_{it,k})'$ is a vector of explanatory variables of dimension k , which consists of variables measuring default, liquidity and global risk factors. $\beta_t = (\beta_{1t}, \dots, \beta_{kt})'$ are time-varying coefficients and μ_i are country specific fixed effects. The random errors, v_{it} , are assumed to be i.i.d. with zero mean and finite variance $\sigma_v^2 > 0$, which are independent of μ_i and x_{js} for all i, j, t and s .

The basic idea of the local linear regression approach is to fit locally a straight line through the observations around a specific point in time. Thus, to estimate the slope coefficient at time t , we give those observations that lie in a close neighbourhood around time t more weight than observations that are measured much earlier or later than at time t . This is done by introducing a Kernel function into the regression equation, which weighs the observations according to their distance to the specific point in time under consideration. The optimal smoothing parameter is determined by the "leave-one-out cross-validation" methodology described by Hoover et al. (1998). For a more detailed description of the estimation approach, see Bernoth and Erdogan (2012).

Source: Bernoth and Erdogan (2012).

We assume that if a country's fiscal position deteriorates relative to the reference country, the bond premium increases as the market demands a higher default risk premium⁴. In addition, we use the bid-ask spread provided by Bloomberg (end-of-month value) as a measure of liquidity risk, which is generally considered the best measure of liquidity (Fleming, 2003; Barrios et al., 2009). A deep market is characterised by low bid-ask spreads, which reduces the inherent liquidity premium in bond yield spreads. The bid-ask spreads are also measured relative to the bid-ask spread of the German benchmark bond. And finally, we use the US corporate bond yield spread as a proxy for general investors' risk aversion. The corporate bond spread measures the spread between low grade US corporate bonds and US government bonds. In times of increased uncertainty, the corporate bond yield spread widens due to a shift in investor preference from riskier corporate bonds to safer government bonds.

2.2. Time-varying determinants of yield spreads

Figure 3 present the estimated time-varying coefficients together with the 95% pointwise confidence intervals when regressing the sovereign yield spreads on our set of regressors⁵. The upper left panel indicates that the degree of general investors' risk aversion plays an important role in explaining sovereign bond yield spreads in the euro area. With few exceptions, the coefficient on the US corporate bond spread was always positive, suggesting that interest rate differentials between euro area

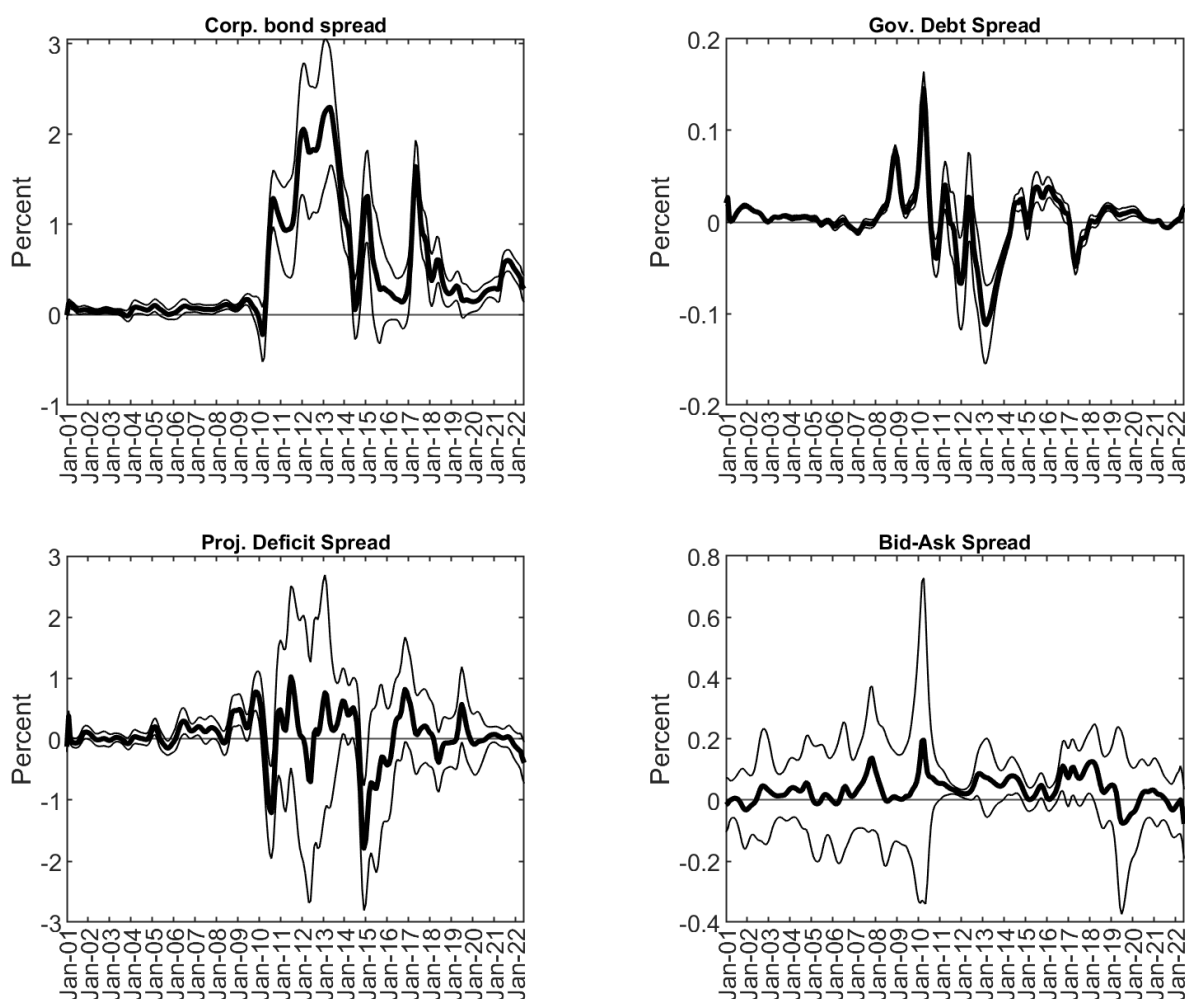
⁴ As the debt-to-GDP ratio is reported by Eurostat on a quarterly basis, we interpolate the debt to a monthly frequency. Projected deficit ratios for the previous year are published semi-annually in the OECD Economic Outlook. Therefore, we assign the projected deficit figures published in the mid-year report to the first six months of the year, and the projected deficit figures published in the end-year report to the last six months of the year. Since the annual budget deficit numbers are flows, we divide the projected deficit numbers by 12 to convert them to a monthly frequency.

⁵ The first three and the last three months of our data sample are estimated with reduced bandwidths to account for the boundary effect.

countries and Germany increase with global risk aversion. At the beginning of the EMU, however, global risk aversion played only a minor role in explaining the interest rate differential between the Member States. With the onset of the global financial crisis (GFC) in 2008 and even more pronounced during the euro area debt crisis in 2010/11, the influence of the global risk factor on euro area yield differentials increased dramatically. It was only around the time of the start of quantitative easing by the ECB in 2015 that the impact of global risk aversion on government bond spreads weakened again. But it has since remained at a significantly higher level than in the period before the financial crisis. This suggests that financial markets ascribe safe haven status to Germany, especially in times of crisis, and prefer German government bonds.

The upper right panel of Figure 3 plots the estimated coefficient of the debt variable over time. Our results show that, at the beginning of EMU, financial markets generally perceived differences in government debt significantly and priced them into bond yields. In the beginning of 2001, a 10% increase in the debt-to-GDP ratio compared with Germany led to an increase in the yield spread of around 20 basis points. However, this market disciplining effect diminished and even disappeared altogether in subsequent years. With the onset of the financial crisis in mid-2008 and the European debt crisis in 2010, when financial markets began to worry about the sustainability of Greek, Irish and Portuguese debt, markets started to take public debt much more into account again in their risk assessment. Mid-2010, the coefficient on the debt-to-GDP ratio peaked and a 10% increase in the debt-to-GDP ratio compared with Germany led to an increase in the yield spread of around 150 basis points.

Figure 3: Time-varying coefficients of European bond yield spreads



Source: Bloomberg, OECD Economic Outlook, Eurostat and authors' own calculations.

With the announcement of the introduction of the Securities Market Programme (SMP) in May 2010, debt levels abruptly lost their influence on bond yield spreads. The estimated coefficient became insignificant or occasionally even significantly negative. This dynamic became even more pronounced after Mario Draghi's famous "Whatever it takes" speech and the announcement of the Outright Monetary Transaction (OMT) programme in the summer of 2012. Until the beginning of 2014, market discipline was turned on its head: Countries whose government debt ratios were rising paid a lower interest rate than Germany.

Since the beginning of 2015, the estimated coefficient resembled more of an up-and-down pattern, which may be explained by the fluctuating expectations of monetary normalisation and an exit from expansionary monetary policy. With monetary policy normalisation on the horizon since the end of 2021, the impact of the sovereign debt differential with Germany has been rising steadily and has been significantly positive again since February (following the war of aggression on Ukraine). This means that market discipline is being exercised again by the financial markets. However, it is not – yet – apparent that there are any overreactions here. Compared with the 2010 crisis, the slope parameter is still moderate and rather comparable with that at the start of monetary union. In June 2022, a 10% increase in debt compared with Germany explains an increase in the yield differential of around 16 basis points. On the basis of this result, one could therefore rather speak of a normalisation, that financial markets again take a country's fiscal situation into account for the assessment of default risk.

The estimated coefficients of the deficit variables are shown in the lower left panel of Figure 3. It can be seen that the coefficient of the projected deficit spread between the issuer country and Germany fluctuated around zero most of the time and is – with only a few exceptions – not significant. Thus, while financial markets pay attention to debt-to-GDP ratios, they seem to ignore deficit differentials.

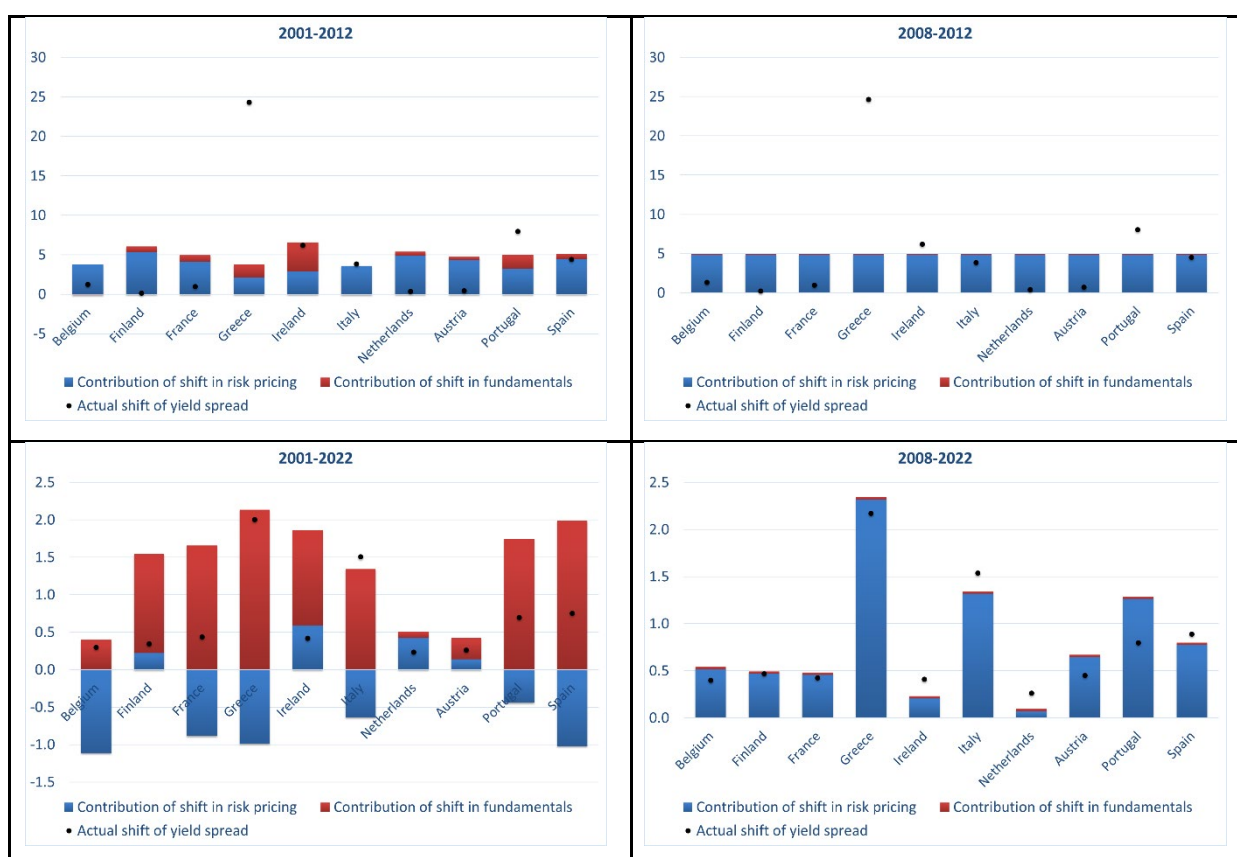
Finally, the estimation results in the bottom right panel of Figure 3 suggest that the liquidity premium does not play a large role in explaining bond yield differentials in EMU. The coefficient on the bid-ask spread mostly exhibits the expected positive sign, but was only occasionally significant between 2011 and 2017.

2.3. Assessment of current rise in yield spreads

In this section, we analyse on basis of our estimates above the drivers of the current rise in yield spreads with the aim of providing an indication of whether EMU Member States are experiencing *"a deterioration in financing conditions that is not justified by country-specific fundamentals."* Unfortunately, it is not possible to say what level of bond yields would actually be justified by country-specific fundamentals. What we can do, however, is to compare the current behaviour of bond spreads with that in earlier periods when we think the risk assessment was most likely realistic. We choose here January 2001, the date of the beginning of EMU, and January 2008, the date before the financial crisis erupted into a GFC. At both reference dates, the bond yield spreads of our sample countries were at broadly comparable levels, but the risk assessment of financial markets differed substantially. For comparison reasons, we also examine the steep rise in yield spreads of some EMU Member States in June 2012, which was officially classified as not justified by country-specific fundamentals and led to the ECB's intervention in the bond market through the announcement of the OMT programme.

We split the change in observed bond yield spreads into two parts: first, the increase in the bond spread that would result if financial markets consistently valued macroeconomic fundamentals as they did in 2001 or 2008 (blue bars); second, the bond spread that would result with the 2012 risk assessment, respectively today in June 2022, if macroeconomic fundamentals were at the level of early 2001 or mid-2008 (red bars).

Figure 4: Decomposition of the change in yield spreads in different time periods



Source: Bloomberg, OECD Economic Outlook, Eurostat and authors' own calculations.

Notes: The blue bars measure the change in the yield spread that can be explained by a shift in the model coefficient and are calculated by $(\hat{\beta}_t - \hat{\beta}_r)x_{it}$, where $\hat{\beta}_t$ denotes the estimate of the model parameters at time t , and $t = 2012M6$ or $t = 2022M6$ and $r = 2001M1$ or $r = 2008M1$. The red bars are calculated as $\hat{\beta}_r(x_{it} - x_{ir})$ and show the yield spread explained by a shift in the macroeconomic fundamentals, i.e. an increase in its debt or deficit figures or, possibly, an increase in investors' risk aversion. The two bars together correspond to the fitted/estimated value of yield spreads.

The top panels of Figure 4 show that if we focus on the rise in bond yields during the European debt crisis in 2012, most of the rise in government bond yield spreads can be attributed to a rise in risk pricing, in the sense that bond yields responded much more strongly to a deterioration in macroeconomic fundamentals after the crisis erupted than before. Without this change in market risk prices, bond yields would have risen much less, as shown by the contribution explained by the change in countries' macroeconomic fundamentals alone. Moreover, it turns out that our model captures the actual development of bond yields during the European debt crisis in 2012 quite well overall; the only major exception is Greece. The Greek bond yield spread increased by around 20 percentage points more than our model would have predicted. This outlier implies that financial markets demanded a much higher yield for Greek government bonds compared to those of other European countries. It is therefore indeed reasonable to classify this increase in yield spreads on Greek bonds as not being driven by fundamentals or a general shift in risk pricing as it was also the ECB's view at the time⁶.

The lower panels of Figure 4 decompose the current rise in yield spreads observed since beginning 2022. Here, the results depend strongly on reference date considered. If we compare current bond

⁶ Part of the unexplained rise in Greek government bond yields very likely also reflects re-denomination risk in the event that Greece leaves the euro area.

yields with bond pricing at the beginning of EMU, we conclude that most of the rise in yields in the southern euro countries France, Greece, Italy, Portugal and Spain between 2001 and 2022 is due to a deterioration in macroeconomic fundamentals, first and foremost the debt-to-GDP ratio. However, debt and deficit ratios are currently less strongly priced by financial markets than in 2001, which is precisely why these countries and also Belgium are currently paying lower bond yields than if risk pricing had remained constant as in 2001. By contrast, if we take the bond price behaviour of just before the GFC as a reference, we conclude that most of the increase in bond yield spreads between 2008 and 2022 is due to a now stricter assessment of macroeconomic fundamentals. The reason for these different results is that financial markets had a stricter risk assessment of macroeconomic fundamentals in 2001 than in 2008.

Unlike our result on bond yield spreads during the European debt crisis in 2012, our model results suggest that we currently observe no major outliers where some countries pay a bond yield that is significantly higher than our model predictions. Thus, so far we cannot speak of a decoupling of bond yields from the perspective macroeconomic fundamentals. However, this can also only be a snapshot. As developments during the European debt crisis in 2010 showed, the risk assessments of the financial markets can change very quickly.

3. TPI WITHIN THE EXISTING ECB'S MONETARY TOOLKIT

The TPI constitutes the third time that the ECB announces an instrument to curb bond market fragmentation⁷. In the aftermath of the financial crisis of 2008/09 the debt-to-GDP ratios of euro area countries increased significantly; this led to a higher perception of default risk for peripheral countries that were considered vulnerable, causing the risk premium on these countries' government bonds to rise and spreads to widen dramatically (Figure 1). In several EMU countries, most prominently Greece, a cascade of liquidity flight and looming credit risk was set in motion, as described above, and there was growing evidence that bond yields were indeed not equally reflective of macroeconomic fundamentals in EMU Member States (compare also results in Section 2). The ECB responded to increasing tensions in the bond market by introducing a programme to purchase secondary market bonds, the Securities Market Programme (SMP)⁸. However, bond yield spreads on peripheral countries continued to rise, peaking at never seen levels in mid-2012.

Following the limited success of the SMP⁹ and the famous "whatever it takes" speech by former ECB President Mario Draghi, the Outright Monetary Transactions (OMT) was announced in September 2012 and the SMP was terminated. Similar to the SMP, the ECB's OMT also allows the purchase of government bonds in secondary markets, but the two programmes differ in several important ways that should make the OMT (if activated) more effective: The activation and continuation of the OMT is subject to strict economic and fiscal conditions, while there was no such requirement for the SMP; there are no quantitative limits on the size of purchases under OMT, while intervention under the SMP was limited in scope; the ECB's preferred creditors status in debt markets under the SMP was replaced with *pari passu* treatment under the OMT¹⁰. These changes were considered to be critical for restoring confidence in sovereign bond markets, with the ECB acting as the de facto lender of last resort. In reaction to the mere announcement of OMT, yields of euro area Member States converged again rapidly. This was widely viewed as economically effective for solving the problem.

The newly announced TPI presents a new, "third version" of an anti-fragmentation tool to address diverging borrowing costs of Member States in the euro area and the risks arising from fragmentation. Interestingly, the word "fragmentation" is not included in the TPI Press Release nor in the name of the policy instrument itself¹¹. Prior discussions among Members of the Governing Council still referred to the term "anti-fragmentation-tool"¹².

TPI resembles the OMT with regard to some features and parameters. Therefore, understanding the similarities and differences between OMT and TPI is important, in particular because OMT was challenged by constitutional complaints brought to the German Constitutional Court (GCC), which made a preliminary reference to the ECJ. The next section provides detailed information on the key parameters of TPI (section 3.1) and the differences and similarities between TPI and OMT (section 3.2).

⁷ The PEPP was also introduced by the ECB as a tool to address risks to the monetary policy transmission mechanism. However, this asset purchase program was explicitly introduced as a temporary tool to address the challenges posed by the outbreak and increasing spread of the COVID-19 virus. For this reason, we do not list this instrument here.

⁸ See Decision of the European Central Bank of 14 May 2010 establishing a securities markets programme (ECB/2010/5) OJ L 124, 20.5.2010, pp. 8–9.

⁹ See also Angeloni and Gros (2022b), p. 4.

¹⁰ ECB (2012c): "Creditor treatment: The Eurosystem intends to clarify in the legal act concerning Outright Monetary Transactions that it accepts 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 Outright Monetary Transactions, in accordance with the terms of such bonds."

¹¹ See also Nicolaides (2022), p. 4.

¹² Schnabel (2022).

3.1. The Transmission Protection Instrument (TPI)

The Press Release outlining the key elements of the decision of the Governing Council of 21 July 2022 to approve TPI¹³ provides limited information on this new monetary policy instrument.

3.1.1. Objective of TPI

TPI aims to support the effective transmission of monetary policy in the case of *"unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area"*. In such circumstances, TPI's objective is to *"ensure that the monetary policy stance is transmitted smoothly across all euro area countries"*¹⁴, since the singleness of the Governing Council's monetary policy is a precondition for ensuring price stability. Ensuring a smooth monetary policy transmission in all euro area Member States is linked to the ECB's primary mandate to safeguard price stability according to Art. 127 (1) 1 TFEU. This is further considered in section 4.3.1 below.

3.1.2. Parameters of TPI

In pursuit of this objective, the Governing Council considers *"secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals, to counter risks to the transmission mechanism to the extent necessary"*¹⁵.

The volume of the purchases are not restricted *ex ante*, but instead will depend on the severity of the risks facing monetary policy transmission. Purchases will mainly consist of public sector securities, i.e. marketable debt securities issued by central and regional governments as well as agencies, as defined by the ECB, with a remaining maturity of between one and ten years. Purchases of private sector securities are not ruled out within TPI and the ECB might consider such purchases additionally, if appropriate.

In order to be eligible for such purchases, *"[t]he Governing Council will consider a cumulative list of criteria to assess whether the jurisdictions in which the Eurosystem may conduct purchases under the TPI pursue sound and sustainable fiscal and macroeconomic policies"* (convoluted language). In particular, four criteria will be considered¹⁶ according to the TPI Press Release:

- (1) compliance with the EU fiscal framework: not being subject to an excessive deficit procedure (EDP), or not being assessed as having failed to take effective action in response to an EU Council recommendation under Art. 126(7) of the Treaty on the Functioning of the European Union (TFEU);
- (2) absence of severe macroeconomic imbalances: not being subject to an excessive imbalance procedure (EIP) or not being assessed as having failed to take the recommended corrective action related to an EU Council recommendation under Art. 121(4) TFEU;
- (3) fiscal sustainability: in ascertaining that the trajectory of public debt is sustainable, the Governing Council will take into account, where available, the debt sustainability analyses by the European Commission, the European Stability Mechanism, the International Monetary Fund and other institutions, together with the ECB's own internal analysis;

¹³ ECB (2022).

¹⁴ ECB (2022).

¹⁵ ECB (2022).

¹⁶ The Press Release states that the criteria listed above *"will be an input into the Governing Council's decision-making and will be dynamically adjusted to the unfolding risks and conditions to be addressed"* (ECB (2022)).

- (4) sound and sustainable macroeconomic policies: complying with the commitments submitted in the recovery and resilience plans for the Recovery and Resilience Facility and with the European Commission's country-specific recommendations in the fiscal sphere under the European Semester.

Concerning creditor treatment, the Eurosystem will not take a preferential creditor status, but accept the same *pari passu* equal treatment with other creditors with respect to bonds issued by euro area governments and purchased by the Eurosystem under TPI.

The Governing Council has not yet decided on a specific start date for its implementation so far. Instead, activation of TPI *"will be based on a comprehensive assessment of market and transmission indicators, an evaluation of the eligibility criteria and a judgement that the activation of purchases under the TPI is proportionate to the achievement of the ECB's primary objective"*¹⁷. The programme will be terminated *"either upon a durable improvement in transmission, or based on an assessment that persistent tensions are due to country fundamentals"*¹⁸.

3.1.3. Impact on monetary policy stance

The Governing Council outlines that it will consider the impact of TPI purchases on the monetary policy stance. In particular, it will *"address the implications of the TPI purchases for the scale of the aggregate Eurosystem monetary policy debt security portfolio and the amount of excess liquidity"*¹⁹. Also, purchases under TPI may not cause a *"persistent impact on the overall Eurosystem balance sheet and hence on the monetary policy stance"*²⁰.

These considerations contain relevant aspects which the ECB must include in its proportionality assessment. They address the implications of sovereign bond purchases for price stability, especially with regard to excess liquidity created through asset purchases. In addition, they also relate to the prohibition of monetary financing (Art. 123 TFEU) and the restrictions resulting from the role of the ECB as creditor of Member States with regard to the potential for fiscal dominance, risks to independence and primacy of the price stability mandate.

3.1.4. Relation to PEPP and OMT

The Governing Council also addresses the relation of TPI to the PEPP and OMT. PEPP reinvestment flexibility is considered as the "first line of defence" to mitigate problems in the transmission mechanism related to the pandemic.

In so far as Member States fulfill the requirements of OMT, the Governing Council declares that it retains the option to activate OMT for these countries.

3.2. Comparison of OMT and TPI

OMT and TPI have relevant similarities that are summarised in Table 1. Both programmes share the objective of safeguarding the singleness of monetary policy by counter-acting distortions in the monetary policy transmission arising from increasing yield spreads of government bonds of certain Member States.²¹ Directly linked to this objective, a central feature of both programmes is the

¹⁷ ECB (2022).

¹⁸ ECB (2022).

¹⁹ ECB (2022).

²⁰ ECB (2022).

²¹ See ECB (2022); ECB (2012c); ECB (2012b), p. 7; ECB (2012a), pp. 7 and 8.

"selectivity"²²: only bonds of those Member States that experience such yield spreads and hence cause a deterioration of the transmission mechanism should be purchased²³. The Press Release of OMT itself did not lay out further qualifications which yield spreads are to be neutralised. Whether neutralising yield spreads falls within the ECB's competence was a major point of discussion in the *Gauweiler* proceedings²⁴. In the TPI Press Release, the Governing Council explicitly states that TPI shall be used to counter "*unwarranted, disorderly market dynamics*". TPI may not be used to neutralise yield spreads irrespective of their cause, but only when those spreads are not warranted by country-specific fundamentals²⁵.

In OMT, the ECB made purchases conditional upon participation of the respective Member State in an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme and adhering to the conditionality enshrined in these programmes²⁶. Although TPI does not include specifically the word "conditionality"²⁷, it requires that sound and sustainable fiscal and macroeconomic policies are in place in the Member States that would benefit from it and lists four criteria that the Governing Council will take into consideration for its assessment. The language in the TPI Press Release does not specifically state that a Member State must fulfill the listed criteria to be eligible for the programme as it is the case for the OMT²⁸. Rather, the ECB enjoys discretion in balancing and weighing these criteria, which only provide an "*input*" in the ECB's decision. Moreover, the eligibility criteria of TPI are substantially less demanding than the requirements of OMT.

While OMT focused only on government debt within the shorter part of the yield curve with a maturity of between one and three years, TPI is applicable to a broader set of securities. Within TPI, sovereign bonds with a remaining maturity of between one and ten years are eligible and also private sector securities can be included in the purchases if deemed appropriate. Therefore, also in this regard, TPI provides more flexibility and a broader scope of securities that can be included.

For both programmes, no *ex ante* quantitative limits are set for the size of the purchases. Likewise, both programmes contain a *pari passu* provision for equal treatment of the ECB with other private creditors.

As regards sterilisation, in OMT, the ECB Press Release clearly stated that the liquidity created would be sterilised. Against the background of the objective of the instrument – fighting fragmentation tendencies and sovereign bond yield spreads and not fuelling inflation – the requirement of sterilisation was a necessary feature of the programme²⁹. Sterilisation is especially important in the current economic environment as the ECB is raising the policy rate to curb inflation. The language of the TPI Press Release is less definite in that regard, although the role of excess liquidity for the monetary policy stance is addressed as a relevant aspect to be taken into account³⁰.

²² Matos (2022), p. 2.

²³ See footnote 21.

²⁴ See below 4.1.

²⁵ ECB (2022).

²⁶ ECB (2012c): "*Conditionality*: A necessary condition for Outright Monetary Transactions is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. 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."

²⁷ ECB (2022).

²⁸ The TPI Press Release states that these four criteria "*will be an input into the Governing Council's decision-making and will be dynamically adjusted to the unfolding risks and conditions to be addressed*".

²⁹ See also Angeloni and Gros (2022b), p. 9.

³⁰ See above 3.1.3.

Table 1: A comparison of OMT and TPI

	OMT	TPI
Selectivity	Secondary market purchases of government bonds of selected Member States which experience high yield spreads to safeguard monetary policy transmission.	Secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals , to counter risks to the transmission mechanism to the extent necessary.
Eligibility/Conditionality	Strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme.	Criteria to take into consideration: (1) compliance with the EU fiscal framework. (2) absence of severe macroeconomic imbalances. (3) fiscal sustainability (4) sound and sustainable macroeconomic policies
Limit on purchases	No ex ante quantitative limits are set on the size of the purchases.	No ex ante quantitative limits are set on the size of the purchases; volume depends on severity of risks facing monetary policy transmission.
Creditor treatment	ECB is treated the same as private or other creditors with respect to bonds issued by euro area governments.	ECB is treated the same as private or other creditors with respect to bonds issued by euro area governments.
Purchase parameters	Sovereign bonds with a remaining maturity of 1-3 years .	Public sector securities with a remaining maturity of 1-10 years ; if appropriate (at the discretion of the ECB), purchases of private sector securities could be considered.
Relation to monetary policy stance	Liquidity created through OMT is fully sterilised .	Purchases under the TPI would be conducted such that they cause no impact on the monetary policy stance; the Governing Council is responsible for addressing the implications of TPI purchases for the aggregate Eurosystem monetary policy debt security portfolio, the amount of excess liquidity, and Eurosystem balance sheet.

Source: ECB (2012, 2022), authors' own elaboration. Legal considerations in the introduction of the TPI.

4. LEGAL CONSIDERATIONS

In this section we will assess the legal grounds of TPI. Section 4.1 provides an overview of the legal framework applicable to non-conventional monetary policy instruments. The validity of sovereign bond purchase programmes has been challenged and discussed intensively before the GCC and the ECJ in *Gauweiler* and *Weiss*³¹. Against the background of the similarities between OMT and TPI, the legal assessment of OMT by the GCC and the ECJ bears special relevance for the TPI. Section 4.2. will therefore outline the key points of discussion and the relevant guidelines developed in the jurisprudence of the GCC and the ECJ. Against this background, section 4.3 provides a legal assessment of TPI highlighting aspects that seem problematic with regard to its conformity with the ECB's mandate.

4.1. Legal framework applicable to non-conventional monetary policy instruments

When the Maastricht Treaty was drafted and signed in 1992, it reflected the way monetary policy was conducted at the time: interest rate policy based upon “conventional” instruments of monetary control. Yet, the provisions in the Treaty and the ESCB Statute that refer to monetary policy (in particular, Art. 127 TFEU, Art. 18 of ESCB Statute on open markets and credit operations and Art. 20 of the ESCB Statute on other instruments of monetary control³²) are formulated in sufficiently broad terms to provide an enabling legal basis for an ever expanding range of “unconventional” monetary policy instruments. Accordingly, the ECB has relied upon balance sheet policy (asset purchases programmes) as the key instrument of monetary policy following the GFC and to counter the pandemic.

But the Treaty is also clear in delineating what the ECB cannot do, and it does so in relatively precise and narrow terms. The provisions that refer to monetary financing (Art. 123 TFEU) and the so-called no bail-out policy (Art. 125 TFEU) establish clear legal prohibitions, in line with the different jurisdictional domains of monetary policy (centralised, ECB responsibility) and fiscal policy (decentralised, national responsibility). The principle of independence (a constitutive cornerstone of the ECB, anchored in Art. 130 TFEU), the principle of democracy (a fundamental basis of the EU, in accordance with Art. 2 and 10 of the Treaty on European Union) together with the EU principles of conferral, subsidiarity, and proportionality (Art. 5 of the TEU) as well as the principle of institutional balance constitute firm limits for the ECB. Indeed, this is the legal framework which the CJEU (which has exclusive jurisdiction over the ECB) takes into account when judging the legality of the ECB monetary policy decisions³³.

³¹ ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400. ECJ, Judgment of the Court of 11 December 2018, Case C-498/17, *Weiss et al.*, ECLI:EU:C:2018:1000.

³² Art. 18 of the ESCB Statute, on Open market and credit operations, reads as follows:

18.1. *In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may: – operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claims and marketable instruments, whether in euro or other currencies, as well as precious metals; – conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral.*

18.2. *The ECB shall establish general principles for open market and credit operations carried out by itself or the national central banks, including for the announcement of conditions under which they stand ready to enter into such transactions.”*

Art. 20 of the ESCB Statute, on Other instruments of monetary control, reads as follows:

“The Governing Council may, by a majority of two thirds of the votes cast, decide upon the use of such other operational methods of monetary control as it sees fit, respecting Article 2. The Council shall, in accordance with the procedure laid down in Article 41, define the scope of such methods if they impose obligations on third parties.”

³³ With regard to the latest green monetary policy measures and the relevant legal framework see Zilioli and Ioannidis (2022); Dietz (2022); Lastra and Skinner (forthcoming).

4.2. Guidelines developed by the ECJ and the GCC for sovereign bond purchase programmes

The focal points in the ECJ's and GCC's jurisprudence on sovereign bond purchase programmes – especially with regard to OMT – were the monetary policy nature of the measure in question (section 4.2.1) and the prohibition of monetary financing enshrined in Art. 123 TFEU (section 4.2.2).

4.2.1. Monetary policy nature and competence structure

a. Preliminary reference by the GCC

In its preliminary reference, the GCC questioned whether OMT constituted an act of monetary policy, or a predominantly economic-policy act and referred, *inter alia*, to the immediate objective of OMT, its selectivity and conditionality and its potential volume as indications against its monetary policy nature.³⁴

With regard to OMT's objective, the GCC recapped the ECB's reasoning brought forth in the proceedings, yet not mentioned in the Press Release, that the spreads were partly based on an irrational fear of a reversibility of the euro. According to the Bundesbank, however, such spreads only reflected the valid scepticism of the markets with regard to the perceived solvency of some Member States and were therefore not irrational. The GCC found this reasoning persuasive and concluded that (rational) market reactions resulting into such spreads were intended for by the EMU framework³⁵ as important incentives for Member States' fiscal discipline. Further, Art. 123 prohibits monetary financing³⁶.

The GCC referred to the selectivity of the programme as an additional indication against the monetary policy nature of OMT. The monetary policy framework generally assumes that the same monetary policy measures are applied to all Member States in a non-selective manner. While the design of monetary policy measures is generally not differentiating between different Member States according to the principle of the singleness of monetary policy, the effects of such a single monetary policy can, however, differ across the Euroarea³⁷.

The conditionality of OMT also raised the GCC's scepticism. OMT made purchases conditional upon the Member States' compliance with the obligations of an assistance programme of the EFSF or of the ESM, which relate to the general economic, social and especially fiscal policy of the Member States. In view of the GCC, it is for the Commission and the Council to monitor such compliance according to Art. 126 TFEU, but not for the ECB³⁸. *"By tying the purchase of government bonds of selected Member States to full compliance with the requirements of the assistance programmes of the European Financial Stability Facility and the European Stability Mechanism and thus retaining its own conscientious examination, the European Central Bank makes the purchase of government bonds on the basis of the OMT Decision an instrument of*

³⁴ BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, para 69 (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813).

³⁵ See also BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, para 98 (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813): "Finally, it seems irrelevant in this regard that the European Central Bank only intends to assume a disruption to the monetary policy transmission mechanism if the amount of the refinancing interest of a Member State of the euro currency area were 'irrational'. Spreads always only result from the market participants' expectations and are, regardless of their rationality, essential for market-based pricing. To single out and neutralise supposedly identifiable individual causes would be tantamount to an arbitrary interference with market activity (cf. above n. 88). Ultimately, the distinction between rational and irrational is meaningless in this context and can in any case not be operationalised."

³⁶ BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, paras. 70 f. (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813).

³⁷ BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, para 73 (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813):

"Different effects that derive from these measures are a consequence of the open market economy, which Union law presupposes (Art. 127 sec. 1 sentence 3 TFEU), and an indirect effect that can be controlled by the European System of Central Banks only to a limited degree."

³⁸ BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, para 75 (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813).

economic policy"³⁹ according to the GCC. It was argued by the GCC that government bond purchases in high volume also exceeded the ECB's competence to support the general economic policies in the European Union (Art. 119 (2), Art. 127 (1) S. 2 TFEU)⁴⁰.

Against this background, the GCC considered the ECB's reference to the disruption of the monetary policy transmission mechanism as "irrelevant"⁴¹. *"If purchases of government bonds were admissible every time the monetary policy transmission mechanism is disrupted, it would amount to granting the European Central Bank the power to remedy any deterioration of the credit rating of a euro area Member State through the purchase of that state's government bonds. This would suspend the prohibition of monetary financing of the budget."*⁴²

b. Preliminary ruling by the ECJ

The ECJ did not concur with the GCC. In its view, the OMT's objective of safeguarding an appropriate transmission of monetary policy *"is likely both to preserve the singleness of monetary policy and to contribute to its primary objective, which is to maintain price stability"*, since the ESCB's ability to influence the price level depends to a large extent upon an effective transmission of the monetary impulses across money markets. It is therefore directly linked to the ECB's price stability mandate in Art. 127 (1) 1 TFEU⁴³; a disrupted monetary policy transmission will render monetary policy measures ineffective and undermine the singleness of monetary policy⁴⁴. Since the disruption of the monetary policy transmission mechanism, which OMT aims to address, results from a specific situation of government bonds issued only by certain Member States, the selectivity of OMT is seen as a necessary consequence of the underlying fiscal or economic problem OMT is targeted at⁴⁵.

Within its proportionality assessment, the ECJ made reference to further substantiation provided by the ECB in the proceedings regarding the fragmentation of interest rates as grounds for the disruption of the monetary policy transmission. This further substantiation was not contained in the OMT Press Release. According to these explanations provided, OMT is *"based on an analysis of the economic situation of the euro area, according to which, at the date of the programme's announcement, interest rates on the government bonds of various States of the euro area were characterised by high volatility and extreme spreads. According to the ECB, those spreads were not accounted for solely by macroeconomic differences between the States concerned but were caused, in part, by the demand for excessive risk premia for the bonds issued by certain Member States, such premia being intended to guard against the risk of a break-up of the euro area."*⁴⁶ The ECJ cannot detect a manifest error of assessment in this analysis

³⁹ BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, para 77 (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813).

⁴⁰ BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, para 81 (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813).

⁴¹ BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, paras. 95 ff. (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813): *"The fact that the purchase of government bonds can, under certain conditions, help to support the monetary policy objectives of the European System of Central Banks does not turn the OMT Decision itself into an act of monetary policy. (...) Moreover, one can expect a significant deterioration of the monetary policy transmission mechanism in virtually every debt crisis of a state. A critical deterioration of the solvency of a state typically coincides with a corresponding deterioration of the solvency of the national banking sector (so-called bank-state nexus). As a result, in this situation, the lending practices of the banks tend to hardly reflect the reductions in the key interest rate anymore; the monetary policy transmission mechanism is disrupted."*

⁴² BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, para 97 (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813).

⁴³ ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, paras. 47 ff.

⁴⁴ ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, para 50.

⁴⁵ ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, para 55. See also para 89: *"(...) in so far as the referring court raises the question of the selectivity of such a programme, it should be recalled that this programme is intended to rectify the disruption of the ESCB's monetary policy which arose as a result of the particular situation of government bonds issued by certain Member States. In those circumstances, the ESCB was fully entitled to take the view that a selective bond-buying programme may prove necessary in order to rectify that disruption, concentrating the ESCB's activity on the parts of the euro area which are particularly affected by that disruption and thereby preventing the scale of that programme from being needlessly increased, beyond what is necessary to achieve its objectives, or the programme's effectiveness from being diminished."*

⁴⁶ ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, para 72.

conducted by the ECB⁴⁷. Therefore, according to the ECJ, targeted secondary market purchases of government bonds of Member States affected by interest rates which the ECB considers to be excessive, are likely to contribute to reducing those rates by dispelling unjustified fears about the break-up of the euro area and thus to play a part in bringing about a fall in — or even the elimination of — excessive risk premia⁴⁸.

Interestingly, though, both the Advocate General and the ECJ made reference to selectivity as a criteria with regard to PSPP in the *Weiss* proceedings. They referred to the non-selectivity of PSPP as a reason to argue for the compatibility of PSPP with EU Law. The Advocate General pointed out that the absence of selectivity in PSPP furthered the argumentation in support of a monetary policy objective⁴⁹ and reduced the predictability of purchases.⁵⁰ The ECJ took up this line of argument in *Weiss* within its assessment of proportionality in relation to the objectives of PSPP and concluded that the non-selectivity helps to ensure that "*the ESCB's action will have an impact on financial conditions across the whole of the euro area and will not meet the specific financing needs of certain Member States of that area*"⁵¹.

The ECJ conceded in *Gauweiler*, that the conditionality embedded in OMT might increase the incentive to comply with EFSF or ESM adjustment programmes and thus support economic policy objectives. It classified these effects as "*indirect effects*" in line with the ECB's mandate to support the general economic policies in Art. 127 (1) 2 TFEU⁵².

The ECJ also pointed out that the scale of OMT is limited by the various programme requirements, thereby also reducing the risk of excessive losses on the side of the ECB⁵³. Hence, the ECB was allowed to adopt a programme without pre-set quantitative limits, especially if *ex ante* set or/and communicated limitations could undermine the programme's effectiveness⁵⁴.

4.2.2. Prohibition of monetary financing (Art. 123 TFEU)

a. Preliminary reference by the GCC

The GCC also considered OMT to be in violation of the prohibition of monetary financing according to Art. 123 TFEU. The fact that the ECB accepted the *pari passu* status and was willing to participate in a debt cut, the increased risk of losses, the possibility to hold bonds until maturity, the interference with the market mechanism and the encouragement of market participants to purchase bonds on the primary market, among others, presented grounds for a circumvention of the prohibition of monetary financing.⁵⁵

Concerning the *pari passu* provision, the GCC held that the fact that the ECB did not retain a preferential creditor status but would have to participate in a potential restructuring amounts to illegal monetary financing. It argued that waiving the repayment obligation from a loan vis-à-vis Member States has equal effects to directly providing funds to Member States⁵⁶.

⁴⁷ ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, para 74.

⁴⁸ ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, para 76, see also para 78.

⁴⁹ Opinion of Advocate General Wathelet, Case C-493/17, *Weiss et al.*, ECLI:EU:C:2018:815, para 105.

⁵⁰ Opinion of Advocate General Wathelet, Case C-493/17, *Weiss et al.*, ECLI:EU:C:2018:815, para 57.

⁵¹ ECJ, Judgment of the Court of 11 December 2018, Case C-498/17, *Weiss et al.*, ECLI:EU:C:2018:1000, para 82.

⁵² ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, paras. 57 ff.

⁵³ ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, paras. 85 ff.

⁵⁴ ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, para 88.

⁵⁵ BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, paras. 87 ff. (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813).

⁵⁶ BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, para 88 (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813).

The GCC also saw an indication for a violation of Art. 123 TFEU in the fact that within OMT, the ECB would buy government bonds that carry an increased risk of failure because of their lower credit rating. Taking large and unnecessary risks of losses by buying very risky government securities would not only turn the ECB into a "*bad bank*" but also indirectly contribute to the financing of the budgets of those Member States⁵⁷.

OMT contains no provision stipulating how long bonds acquired under the programme are to be held. If government bonds were largely held to maturity, market pricing mechanism would be distorted, since for those bonds the respective Member State would not have to be subject to market pricing according to GCC. In addition, the amounts of bonds held by the ECB would shorten the supply of bonds circulating in the secondary market, thereby also indirectly financing the respective budgets⁵⁸.

Since there is no pre-set fixed time lag between the announcement of the purchases and the potential purchases, the announcement of imminent purchases of government bonds can interfere with the market pricing mechanism for these bonds and motivate market participants to buy government bonds on the primary market irrespective of market conditions since they have the expectation to pass on the bonds and their associated financial risks to the ECB in any case – another reason why OMT violated Art. 123 TFEU according to the GCC⁵⁹.

b. Preliminary ruling by the ECJ

The ECJ elaborated a decisive guideline to assess conformity with Art. 123 TFEU. In sum, in order to ensure conformity with Art. 123 TFEU, the ECB must ensure that purchases are not predictable by market participants, that Member States cannot count on their bonds being held to maturity by the ECB, thereby ensuring that market pricing mechanism and the incentive for fiscal discipline stays in place. Time lags between the issuance and the purchases as well as *de facto* quantitative limits on the purchases are essential criteria to ensure these requirements⁶⁰. Also the risk of losses⁶¹ and the *pari passu* provision⁶² are no indication for a violation of Art. 123 TFEU in view of the ECJ.

The ECJ found OMT to be compatible with Art. 123 (1) TFEU⁶³. OMT does not have an effect equivalent to direct purchase of government bonds, because the implementation was subject to certain conditions according to the ECB⁶⁴. It was only for the ECB to decide on the scope, activation and suspension of purchases and there was a minimum period between the issuance of a bond on the primary market and the purchase by the ESCB. The ECB would also refrain from communicating the scope and the timing of purchases. Therefore, there would not exist certainty that certain governments bonds were bought by the ECB and hence no relevant distortion of market mechanisms⁶⁵. Moreover, the parameters of OMT also ensure that potential secondary bond purchases would not lessen the impetus of Member States to follow budgetary discipline⁶⁶.

⁵⁷ BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, para 89 (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813).

⁵⁸ BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, paras. 90 f. (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813).

⁵⁹ BVerfG, Order of the Second Senate of 14 January 2014 – 2 BvR 2728/13 –, paras. 92 f. (ECLI:EU:BVerfG:2016:rs2016060621.2bvr272813).

⁶⁰ See also Nicolaides (2022), p. 3.

⁶¹ ECJ, Judgment of the Court of 11 December 2018, Case C-498/17, Weiss et al., ECLI:EU:C:2018:1000, paras. 123 ff.

⁶² ECJ, Judgment of the Court of 11 December 2018, Case C-498/17, Weiss et al., ECLI:EU:C:2018:1000, para 126.

⁶³ ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, paras. 93 ff; ECJ, Judgment of the Court of 11 December 2018, Case C-498/17, *Weiss et al.*, ECLI:EU:C:2018:1000, paras. 101 ff.

⁶⁴ See ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, paras. 105 f.

⁶⁵ ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, para 107.

⁶⁶ ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, paras. 110 ff.

4.3. TPI within the ECB's mandate

Against this legal and operational framework, the European Parliament must hold the ECB to account regarding the use of unconventional monetary policy instruments, including TPI, and the ECJ has to assess their validity if challenges of these measures are brought forward.

4.3.1. Safeguarding the transmission mechanism as a monetary policy objective?

Though the purpose of TPI is to prevent the fragmentation in bond markets, with widening spreads between German and Italian government bonds in particular, the name chosen for the instrument is far more technical⁶⁷ – Transmission Protection Instrument – and refers to the “*effective transmission of monetary policy*”. While “*effective transmission*” is no doubt a necessary prerequisite in the pursuit of a price stability-oriented monetary policy, the expression is broad, imprecise, discretionary and “relational”. The TPI Press Release further specifies: “*The singleness of the Governing Council’s monetary policy is a precondition for the ECB to deliver on its price stability mandate*” in line with Art. 127 (1) TFEU and “*the single monetary policy*” in Art. 119 (2) TFEU⁶⁸. The singleness of the ECB’s monetary policy was also invoked as an objective in OMT⁶⁹. Monetary policy is “*one and indivisible*”⁷⁰ and shall not be different in different parts of the euro area.

However, the singleness of the monetary policy transmission process is determined not only by sovereign bond yields and financial market conditions, but by the entire economic system of the individual EMU member countries. For example, the different employment policies within the euro area, which are a national competence, influence monetary policy transmission and price levels via labour markets⁷¹. Also economic downfalls, for example caused by climate change or the Ukraine war, which may impact the economies across the euro area to a different degree, influence the effectiveness of the monetary policy transmission. The ECB’s competence in the sphere of economic policy, however, is limited to “*to support the economic policies in the Union*” in accordance with Art. 127 (1) 2 TFEU and in line with the principle of conferral (Art. 5 (1) and (2) TEU).

The design of EMU rests on a division of competences between the ECB and Member States, and while monetary policy has been transferred to the Union level as an exclusive competence (see Art. 3 (1) c) TFEU) and is conducted uniformly for the whole euro area, economic policies remain the competence of the Member States⁷². Thus, for monetary policy in a currency union to be effective, the economies within the currency union must share some very basic economic parameters in order to allow monetary impulses to be transmitted effectively across the euro area. For that purpose, the EMU legal framework relies upon basic entry requirements and fiscal rules which Member States must adhere to with regard to deficits and sound fiscal policies. While these criteria should in theory ensure some basic homogeneity among euro area economies, the construction of the EMU has encountered and continues to face in practice heterogeneous economic preconditions and environments. Therefore, while the ECB conducts a single, uniform monetary policy for the euro area as a whole, the effects of this monetary policy are by definition not uniform – in so far as heterogeneities remain and in so far as fiscal rules are not always adhered to. Therefore, while the objective of ensuring a smooth function of

⁶⁷ As recognised by Nicolaides (2022).

⁶⁸ ECB (2022).

⁶⁹ ECB (2012c): “Eurosystème’s outright transactions in secondary sovereign bond markets (...) aim at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy”.

⁷⁰ Lastra (2012), p. 6.

⁷¹ See also Gerlach (2022): “*The TPI is another case of mislabelling. It is supposedly intended to ensure that the monetary transmission mechanism is equally strong throughout the euro area. But the strength of the transmission varies naturally between euro area economies because of differences in economic and financial structures. This has not caused concerns in the past.*”

⁷² See generally Lastra (2015), chapter 8.

the monetary policy transmission falls within the ECB's mandate, invoking the monetary policy transmission without further qualifications could obscure the fact that the ECB might be entering the realm of fiscal dominance (see 4.3.5).

In addition, the ECB also has to explain the relation between the transmission mechanism as an "interim" goal with price stability as its primary and "end" goal. Currently, with surging inflation, the ECB is trying to curb it by increasing interest rates. This puts a heightened burden of justification on the ECB to explain how further asset purchases – an expansionary monetary policy as such – fit within the overall monetary policy stance of fighting inflation⁷³. It amounts a bit to square the circle, if on the one hand, the ECB is trying to lower interest rates for some Member States with TPI, while on the other hand, the ECB is raising interest rates in reaction to the increasing inflation. The Governing Council declares in the Press Release that it will address the implications of TPI purchases for the amount of excess liquidity, but at the same time it states that the volume of asset purchases is not pre-determined but depends on the severity of the risks facing the monetary policy transmission. The question arises: Which of the two considerations is the prevailing one? And would they require different actions in a scenario in which the amount of excess liquidity suggests terminating the purchases, while persisting severe risks for the monetary transmission suggest the continuation of purchases⁷⁴?

In addition to the volume, sterilisation measures are of great importance for ensuring compatibility with the monetary policy stance and the effects on price stability, yet the Press Release is silent in that regard⁷⁵.

4.3.2. Financial fragmentation due to sovereign bond yield spreads

As the forgoing analysis has shown, the ECB needs to prove that the distortions of the transmission mechanism pertain to the monetary policy domain in accordance with Art. 127 TFEU. Only if market failures are identified as the cause for the financial fragmentation with regard to sovereign bond yield spreads, should the ECB take selective and targeted measures to address these causes. Otherwise, monetary policy is used as a means to support the debt of some Member State/s which undergo high risk premia, which are, however, simply a consequence of the Member State's fiscal and economic policy. Fiscal support for highly indebted Member States which struggle with increased, but justified risk premia is a decision to take by Member States according to the democratic processes in place. Such a decision should be subject to political and public scrutiny.

Thus, a preferential treatment of some Member States by selective bond purchases, as it is potentially the case if TPI is activated, needs to be justified on the grounds that such purchases fall within the competence of the ECB, i.e. it should rest on monetary considerations in line with the overall mandate of the ECB. The ECJ stressed this point in *Gauweiler*⁷⁶ and the Governing Council also included this requirement in its Press Release by stipulating that the deterioration in financing conditions potentially hampering monetary policy transmission may "*not [be] not warranted by country-specific fundamentals*"⁷⁷. As also pointed out by Angeloni and Gros (2022b), Greene (2022), Feld et al. (2022) and Issing (2022), the decisive question then becomes: How will the ECB define what spreads are appropriate versus unacceptable? How will the ECB assess with regard to what criteria whether yield spreads are warranted by country-specific macroeconomic fundamentals and not a result of market

⁷³ Benigno et al. (2022) for example raise concern with regard to unwanted long-term consequences for the price stability objective with regard to new monetary policy tools, as the TPI.

⁷⁴ See also Matos (2022), p. 1.

⁷⁵ See also Angeloni and Gros (2022b), p. 9.

⁷⁶ See above 4.2.2.b.

⁷⁷ ECB (2022).

failures? Both concepts “unwarranted” and “not justified by country specific fundamentals” are highly subjective.

In section 2, we consider for instance the fiscal stance (debt/GDP and deficit/GDP), the bond market liquidity and the degree of general investors’ risk aversion as macroeconomic determinants of bond yields. The estimation of a nonparametric fixed-effects panel model shows that financial markets currently do not treat any of the countries under consideration separately in terms of their bond yield levels. Bond yields of all countries considered can be well explained on the basis of their fundamentals and the general risk aversion in financial markets. Thus, so far we cannot speak of bond yields that are “unwarranted” and “not justified by country specific fundamentals”. But this estimate depends on the model and the variables considered.

Thus, since such an assessment is decisive for ensuring that the ECB is not overstretching its mandate, the ECB should explain and substantiate its method, benchmark, criteria and assessment – especially if other economic studies challenge the results or come to different conclusions⁷⁸.

4.3.3. Eligibility/conditionality

As stated above, the activation of TPI requires sound and sustainable fiscal and macroeconomic policies and the Press Release lists four eligibility criteria which are to be taken into account when assessing whether a Member State is fulfilling these requirements. Compared with OMT conditionality, can TPI be considered “OMT-light”?

The extent to which the ECB itself should be making such assessment, or whether such assessment should be the responsibility of external bodies (ESM and IMF for example), is an important issue that has been addressed by some scholars⁷⁹. While the ECB generally assesses the quality and creditworthiness of eligible counterparties and securities in its open market and credit operations (see Art. 18.1 and 18.2 ESCB Statute), and therefore the requirement of creditworthiness is *per se* nothing exceptional in the monetary policy framework, linking a monetary policy measure to the requirement of compliance with economic and fiscal rules adds a new dimension to monetary policy and the institutional role of the ECB.

Indirectly enforcing the EMU fiscal framework by monetary means would go beyond the ECB’s task to support economic policies in the EMU according to Art. 127 TFEU⁸⁰. While the objective of ensuring observance with the EMU economic and fiscal framework is desirable, the legal order is not indifferent with regard to the means to obtain it. Also with regard to the conditionality in OMT, Advocate General Cruz Villalón raised concern in *Gauweiler*⁸¹ on the involvement of the ECB in the monitoring of the financial assistance programme⁸². Overstepping the relevant mechanism and institutional competences foreseen in the Treaties, such as the EDP or other mechanisms, would violate the principle of conferral and would be in conflict with the will of “the Masters of the Treaties” who consciously decided by which institution and by which mechanism rules underlying the EMU should be enforced.

In addition, since the Governing Council only refers to the criteria as an input into its ultimate decision, which will be dynamically adjusted to the unfolding risks and conditions to be addressed, the ECB retains the discretion to conduct purchases even if certain criteria relating to sound and sustainable

⁷⁸ Matos (2022), p.6: “Any critics will demand proof that the intervention does not go beyond the extent of the market’s overreaction or the extent of the market’s deviation from the underlying fundamentals”.

⁷⁹ See e.g. ESFR (2022).

⁸⁰ For a different opinion see for example Sandbu (2022).

⁸¹ Opinion of Advocate General Cruz Villalón, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:7, para 150.

⁸² See also Matos (2022), p. 2.

fiscal and macroeconomic policies might not be fulfilled. This could potentially also contradict the procedures in place for excessive deficits or excessive imbalances or the European Commission's country-specific recommendations under the European Semester.

The institutional set up of the ECB is not tailored for such a role either. The ECB as an independent institution is bound by its price stability mandate. Making economic assessments on the fiscal and economic situation of Member States goes beyond its mandate; even if it is adhering to the decisions of external bodies – the debt sustainability analyses by the European Commission, the European Stability Mechanism, the International Monetary Fund and other institutions – it remains the ECB that takes the decision to activate TPI with regard to a certain jurisdiction.

To monitor the adherence to the EMU fiscal rules and to ultimately take a discretionary decision whether a Member State sufficiently fulfills the requirement of sound and sustainable fiscal and economic policies may also expose the ECB to political pressure, threatening its independence⁸³.

4.3.4. Monetary financing

The ECJ has laid down guidelines for compliance of government bond purchases with Art. 123 TFEU in *Gauweiler and Weiss*⁸⁴. When conducting such purchases, the ECB needs to ensure that primary market participants do not become mere intermediaries of the ESCB and that the impetus of the Member States to follow sound fiscal policies set by market mechanisms is not lessened by the ECB intervention. Whether this is the case will depend on the scale of the purchases, the time lag between the purchases and the emission volume, and whether bonds are held to maturity and dispensed of market pricing mechanisms. The TPI Press Release is silent on these aspects, but the ECB needs to substantiate the parameters of TPI in that regard, which will be open for review by the EP and the ECJ.

It is questionable whether the eligibility criteria suffice to ensure that TPI does not amount to monetary financing. Such criteria refer to the applicable fiscal rules in place in the EU (a byzantine set of rules and procedures by the way).

In addition, also the selectivity of the programme raises questions with regard to the compatibility of TPI with Art. 123 TFEU. Both the ECJ and the Advocate General referred to the non-selectivity of PSPP as an argument for the legal validity of the PSPP and a sign that PSPP was not a means for financing certain Member States. The ECB is therefore under a heightened "*burden of proof*" to show that TPI as a selective purchase programme is in compliance with Art. 123 TFEU⁸⁵.

4.3.5. Balance sheet measures, fiscal dominance and central bank independence

TPI is potentially contributing to further increase in the size of the ESCB's balance sheet. Balance sheet policy measures are of special relevance with regard to the relation that is built between the financial situation of the central bank and the fiscal situation of the debtor. If the Member State is not able to pay back its debt, the central bank incurs losses on its balance sheet. While central banks in the national context have the sovereign as a fiscal backstop to compensate losses, the ECB does not have such a fiscal counterpart. That makes the ECB more vulnerable and also more vigilant when it comes to losses and the creditworthiness of its creditors.

Expansionary monetary policy measures reduce the factual debt obligation of Member States and ease the conditions for a short- to medium-term economic upturn. The central bank might therefore be

⁸³ Matos (2022), p. 2 f.; Issing (2022).

⁸⁴ See above 4.2.2.b.

⁸⁵ See above 4.2.1.b. Concern with regard to the compatibility of TPI with Art. 123 TFEU has been raised by Nicolaidis (2022), p. 5; Feld et al. (2022) have addressed the potential problematic fiscal redistribution effects of TPI.

inclined to serve the financial needs of its debtors, the Member States, with its monetary policy potentially losing sight of its primary objective – price stability⁸⁶. A situation where fiscal interests take precedence over monetary policy objectives, is described as "*fiscal dominance*"⁸⁷. In such a situation, the central bank not only assumes the role of the main creditor of states with large balance sheet measures; it also assumes political responsibility for those states. The danger of fiscal dominance is omnipresent in the case of sovereign bond purchase programmes.

The Governing Council addresses this problem in its Press Release and states that purchases under TPI would be conducted such that they cause no persistent impact on the overall Eurosystem balance sheet and on the monetary policy stance. But this remains to be proven⁸⁸. Especially since the scale of TPI purchases would depend on the severity of the risks facing monetary policy transmission. The question arises: What if the severity of fragmentation is demanding large scale purchases whereas that puts the ECB even more at risk of fiscal dominance⁸⁹?

Connected with these concerns is also a free-rider problem. Currently, the euro area is facing the highest inflation rate since the inception of the euro. While the financing conditions of those jurisdictions, whose bonds are purchased by the ECB, benefit from such asset purchases, the inflation problem is carried on the shoulders of all euro area Member States – classical free rider problem⁹⁰.

4.3.6. Substantiation, transparency and accountability

A point of criticism of TPI is the lack of substantiation, justification, and detail in the terms set out in the Press Release. As mentioned above, the Governing Council talks about "*unwarranted, disorderly market dynamics*" and "*country-specific fundamentals*," which is very unspecific. Moreover, the listed eligibility criteria shall be "*dynamically adjusted to the unfolding risks and conditions to be addressed*" and present an "*input*" into the Governing Council's decision on the eligibility of certain sovereign bonds according to the wording of the Press Release. Yet, it remains unclear, which other factors might come into play and when the listed criteria might not be decisive, weighed less or maybe even ignored.

With regard to the potential activation and termination, the Press Release stipulates: "*A decision by the Governing Council to activate the TPI will be based on a comprehensive assessment of market and transmission indicators, an evaluation of the eligibility criteria and a judgement that the activation of purchases under the TPI is proportionate to the achievement of the ECB's primary objective. Purchases under TPI would be terminated either upon a durable improvement in transmission, or based on an assessment that persistent tensions are due to country fundamentals.*" The Press Release does not specify the transmission indicators that can be used nor the extent to which negative effects on the price stability objective can justify its termination.

At the Press Conference in Frankfurt following the announcement of TPI President Lagarde stated: "*[Y]ou should not expect all details to be there, because there is an element of discretion and judgement on the part of the Governing Council members to decide or not on activation and to assess eligibility or not*"⁹¹. There might be good reasons for keeping some features of the programme secret, not disclosing it to the markets nor to the general public⁹². For example, keeping the timing of the purchases or the

⁸⁶ See also Feld et al. (2022).

⁸⁷ In order to avoid fiscal dominance and still address risks of fragmentation, Benigno et al. for example advocate for strengthening the EU's temporary fiscal capacity (Benigno et al., 2022).

⁸⁸ See also Feld et al. (2022).

⁸⁹ See also Matos (2022), p. 1.

⁹⁰ See Congdon (2022), p. 12 with regard to balance sheet measures and the free rider problem.

⁹¹ Lagarde and De Guindos (2022).

⁹² See Lastra and Dietz (2022).

expected volume for a certain period of time confidential can be necessary for the efficiency of the respective monetary policy instrument and its compatibility with Art. 123 TFEU⁹³. However, reasons that justify not disclosing parameters of monetary policy instruments to the markets and the general public do not dispense the ECB from writing down these confidential parameters to allow for judicial review and parliamentary review in non-public fora. While central banks should enjoy discretion and many decisions by definition require the exercise of judgement, such judgement and discretion are constrained by a normative framework that ensures that independent central banks stay within their legal mandate. Central banks should always be held accountable *ex post* via judicial review and parliamentary accountability⁹⁴.

Moreover, discretion is not to be equated with a permission not to explain and justify the adherence to legal requirements (at least in unpublished documentation that can be available for judicial review by the ECJ and parliamentary scrutiny). Especially with regard to the proportionality assessment, the ECJ has afforded in its judgment broad discretion to the ECB⁹⁵. But, as the ECJ also noted, discretion does not discharge the ECB from certain legal requirements with regard to the way such discretion is being exercised. The duty to state reason according to Art. 296 TFEU is an important procedural requirement to effectuate accountability mechanisms. The ECJ therefore rightfully stresses the duty to state reasons also for the ECB: *"Nevertheless, where an EU institution enjoys broad discretion, a review of compliance with certain procedural guarantees is of fundamental importance. Those guarantees include the obligation for the ESCB to examine carefully and impartially all the relevant elements of the situation in question and to give an adequate statement of the reasons for its decisions. In that regard, the Court has consistently held that, although the statement of reasons for an EU measure, which is required by Article 296(2) TFEU, must show clearly and unequivocally the reasoning of the author of the measure in question, so as to enable the persons concerned to ascertain the reasons for the measure and to enable the Court to exercise its power of review, it is not required to go into every relevant point of fact and law. In addition, the question whether the obligation to provide a statement of reasons has been satisfied must be assessed with reference not only to the wording of the measure but also to its context and the whole body of legal rules governing the matter in question"*⁹⁶. Whether the Press Release in conjunction with other non-disclosed documents fulfill these requirements to state reason remains to be proven.

4.3.7. Relation to OMT and PEPP

The Press Release briefly addresses the relation between TPI and OMT and PEPP. PEPP reinvestment flexibility shall remain the first line of defense to counter risks for monetary policy transmission related to the pandemic. Yet, it is unclear how the ECB will decide when risks for monetary policy transmission result from the pandemic and when they fall under the remit of TPI. Also the pandemic can cause a deterioration in financing conditions not warranted by country-specific fundamentals, which TPI is tailored to address. At least with the very narrow information provided in TPI, there still seems to be potential overlap of the two programmes. The ECB has to further elaborate when TPI in contrast to PEPP will be activated and better distinguish the two programmes and explain the interaction of the two.

⁹³ See also ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, para. 106; Opinion of Advocate General Wathelet, Case C-493/17, *Weiss et al.*, ECLI:EU:C:2018:815, para 60 f.

⁹⁴ Lastra (2020) with further references.

⁹⁵ ECJ, Judgment of the Court of 11 December 2018, Case C-498/17, *Weiss et al.*, ECLI:EU:C:2018:1000, para 73; ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, para 68 with further references: *"As regards judicial review (...), since the ESCB is required, when it prepares and implements an open market operations programme (...), to make choices of a technical nature and to undertake complex forecasts and assessments, it must be allowed, in that context, a broad discretion."* See also Craig and Markakis (2016); Tridimas and Xanthoulis (2016); Mooij (2019); Bobić and Dawson (2019).

⁹⁶ ECJ, Judgment of the Court of 16 June 2015, Case C-62/14, *Gauweiler et al.*, ECLI:EU:C:2015:400, paras. 69 f.; ECJ, Judgment of the Court of 11 December 2018, Case C-498/17, *Weiss et al.*, ECLI:EU:C:2018:1000, paras. 30 f.

The same holds true for OMT. The Governing Council makes clear, that the announcement of TPI does not render OMT obsolete and that it retains discretion to conduct OMT for those Member States which fulfill the relevant criteria. But could the ECB also decide to activate TPI for a country theoretically fulfilling the OMT criteria? Angeloni and Gros (2022b), for example, argue that "[t]he new ECB tool should thus be seen as constituting a first line of defence, concentrated on limited amounts on longer maturities. If this is not sufficient, countries with sound fundamentals may 'buy insurance' by using the ESM precautionary line – whose pre-set conditions are now broadly set – to unlock OMT, allowing for unlimited interventions, including at shorter maturities." They also argue that "any proposal for a new anti-fragmentation instrument must be carefully justified, to avoid duplications and confusion". Another, even more important issue is whether TPI with its "OMT-light" eligibility criteria might provide a way for Member States to circumvent the much harder OMT conditionality⁹⁷.

The guidelines given in the Press Release leave these and other questions with regard to the distinction and relation of TPI with OMT and PEPP unaddressed. The ECB needs to provide further clarification to avoid confusion for market participants and to fulfill its duty to give account of its actions⁹⁸.

4.3.8. Risk- and loss-sharing

Risk- and loss-sharing, a most sensitive topic, is not addressed in the Press Release⁹⁹. This is nothing new, though. Also in the past, the Governing Council has kept its decision about the allocation of profits and losses resulting from purchase programmes often confidential¹⁰⁰.

SMP and OMT, the predecessors of TPI, were based on a loss sharing regime, so that all NCBs would have had to carry losses of purchases of selected government bonds according to the capital key. While confidentiality of such decisions is formally granted by Art. 15 (3) par. 4 TFEU and Art. 4 of the Decision of the ECB on public access, there are good reasons to disclose profit- and loss-sharing decisions and explain their rationale to the general public. Those decisions might trigger dispute and may be contentious, but disclosure does not minimise the effectiveness of the monetary policy measure in question¹⁰¹. Also in the light of its accountability requirements, the ECB should disclose such information to ensure that its independent decisions can be scrutinised by the EP also with regard to risk- and loss-sharing¹⁰².

Controversial monetary policy measures including risk- and loss-sharing arrangements require the ECB to engage in the conversation and communication with the relevant stakeholders in order to explain their rationale as advocated by Lastra and Dietz (2022). The social legitimacy of the institution – and in turn the acceptance of its independence and its institutional framework – will increase if those aspects of monetary policy which are politically sensitive are explained and justified.

⁹⁷ See also Feld et al. (2022).

⁹⁸ Wellink (2022); Angeloni and Gros (2022b), p. 8.

⁹⁹ Angeloni and Gros, for example, advocate for a regime of risk- and loss-sharing if TPI was really confined to addressing the problem of asymmetric monetary policy transmission (Angeloni and Gros, 2022a).

¹⁰⁰ Regarding the risk of incurring losses with respect to TPI, see Marsh (2022).

¹⁰¹ See Lastra and Dietz (2022), p. 17.

¹⁰² See also Wellink (2022): "In the negotiations on 'fine tuning' the TPI now under way among the NCBs and ECB committees, unrestricted/unlimited risk sharing will undoubtedly come up again as a proposal. This is not illogical given the nature of TPI. But I don't see a mutual risk-sharing decision gaining the approval of the German constitutional court. Whether we like it or not, German institutions and citizens have to obey the court – and this includes the Bundesbank."

5. CONCLUSION AND POLICY RECOMMENDATIONS

The euro area is currently facing a most challenging period with high energy and food prices triggering surging inflation, while at the same time being confronted with an economic downturn following the COVID-19 pandemic and the devastating effects of the ongoing war of aggression in Ukraine. The ghost of “stagflation” looms in the background. Government debt ratios of most euro area Member States have risen, now potentially fuelled by the latest tightening of the monetary policy to curb inflation. The rising risk premia of government bonds of indebted countries, especially Italy and Greece, pose fragmentation risks. Against this background, the ECB has come up with a new instrument, the TPI, announced on 21 July 2022, which we have examined thoroughly, comparing it also with earlier anti-fragmentation tools.

The forgoing economic analysis in this paper shows that the bond yield spreads are, however, not yet to be qualified as disorderly or unwarranted, decoupled from macroeconomic fundamentals. Rather, we find that yield spreads find their origin in the macroeconomic fundamentals of the respective Member State and in the increase in general risk aversion and are not (yet) to be considered the result of market irrationalities¹⁰³. Therefore, the government bonds of euro area Member States are currently not fulfilling the requirements set out in the TPI Press Release, which foresees that only bonds of those jurisdictions which experience a deterioration in financing conditions not warranted by country-specific fundamentals are eligible for secondary market purchases.

TPI entails some features and parameters that raise concerns from a legal perspective. Therefore, the Eurosystem might be well advised to first resort to other measures and actors that are more suited to address the challenges of risk fragmentation and rising yield spreads. It falls foremost within the realm of Member State's responsibility for economic policy to take – unilaterally or more effectively at the EU level within the existing European institutional and legal framework – action to fight rising government debt and economic fall-outs.

The exclusive competence of the ECB in monetary policy and the primacy of its price stability mandate as stated in Art. 127(1) S. 1 contrast with the ECB's contributory role to “*support of the general economic policies in the Union*” – Art. 127(1) S. 2 – in line with the competence for economic/fiscal policy, which remains decentralised at the level of the Member States albeit subject to coordination and rule harmonisation (a shared competence). It is not for the ECB to compensate the absence of fiscal integration by monetary policy means to ensure that the euro area is not torn apart by diverging economic and fiscal situations of its Member States, which are reflected on the financial markets.

We should be wary of overextending the powers of the ECB¹⁰⁴. The ECB legal framework was designed to preserve its independence from political pressure in the the conduct of a price stability oriented monetary policy¹⁰⁵.

¹⁰³ See above 2.3.

¹⁰⁴ See Issing (2017), (2018).

¹⁰⁵ Tucker (2018).

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With the rise in interest rates and the phasing out of ECB's asset purchase programmes, highly indebted countries such as Italy and Greece are facing a sharper rise in their bond yields than Germany – a development often referred to as 'bond market fragmentation'. In response, the Governing Council of the European Central Bank announced the Transmission Protection Instrument on 21 July 2022. This paper provides a legal and economic examination of this new monetary policy instrument. It is compared with other non-conventional instruments in the context of the Treaty framework and the doctrine of the European Court of Justice.

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