

27 January 2017

## **How did the ECB become a fully-fledged central bank of the euro zone?**

*by Jakub Gren<sup>i</sup>*

Since the outbreak of the recent global financial crisis, there has been an intensive political discussion regarding the scope of the ECB's monetary policy instruments designed to combat the crisis and revive economic growth across the euro zone. The main issue was whether certain ECB measures, both those adopted and those yet to be adopted, could be regarded as falling within the ECB's monetary policy mandate.

In the light of principal agent theory, any delegation of a mandate<sup>ii</sup> to carry out specific policies to the Union's administrative unit (the agent) by the Member States (the principals) can be conceived in terms of an agency contract.<sup>iii</sup> Depending on the policy area, such a contract may list tasks, objectives and competences which the agent is expected to pursue on behalf of the principal. However, such contracts are essentially incomplete in their nature since it would be impossible to stipulate explicit details in order to anticipate all possible contingencies.<sup>iv</sup> In those situations, a role to interpret and fill-in the details of such contracts can be assigned to other administrative agents or courts.

The Maastricht Treaty, which established the foundations of the Economic and Monetary Union (EMU), is a good example of such an incomplete contract. The Member States - acting as the principals - were very explicit about the objectives which the future European monetary authority (the ECB)<sup>v</sup> was expected to pursue within its monetary policy mandate. They established a clear hierarchy of the Union's monetary policy objectives, in which the price stability has been stipulated as the primary objective whereas other objectives, including support of general economic policies in the Union, have been subordinated to the pursuit of the former.<sup>vi</sup> This has been codified at the Union's constitutional level (primary law).<sup>vii</sup>

The Member States' final commitment to stability-oriented monetary policy was confirmed by giving the ECB very strong guarantees of independence.<sup>viii</sup> In parallel, the ECB was prohibited from undertaking any action in the area of the Member States' economic policies (notably fiscal)<sup>ix</sup>, for which the mandate remains at national level.

While being very specific about the hierarchy of objectives of the Union's monetary policy mandate, the principals did not define the meaning of price stability leaving it to the agent.<sup>x</sup>

They also left the agent with some room of manoeuvre regarding the choice of appropriate policy instruments to achieve price stability.<sup>xi</sup> In normal (non-crisis) times this ambiguity did not raise any controversies, mainly due to a global consensus seeing the steering of short-term interest rates as the key monetary policy instrument.<sup>xii</sup>

However, during the crisis as the ECB developed more sophisticated monetary policy instruments, some influential economic policy-making circles of a number of the euro zone Member States started to challenge them as going beyond the monetary policy mandate stipulated in the original agency contract.<sup>xiii</sup>

As a result, the contested scope of the ECB's incomplete mandate has become a question of how legitimate the Union's monetary policies are, or more broadly, can be.

The opportunity to resolve this issue and possibly provide further details of the ECB's mandate occurred when a group of German individuals (Gauweiler et al.) decided to issue a constitutional complaint to the German Federal Constitutional Court (FCC) in 2012. They claimed that the activation of the new ECB monetary policy programme<sup>xiv</sup> (Outright Monetary Transactions, OMT) went beyond the ECB monetary policy mandate. They argued that the ECB commitment to purchase government bonds of those euro area member states whose found themselves in trouble and needed to introduce specific macroeconomic adjustments<sup>xv</sup> could be regarded as a monetary policy measure equivalent to economic policy action which the ECB was prohibited to undertake.

Whereas the FCC initially upheld the validity of their concerns, it nevertheless decided to refer the issue to the Court of Justice of the European Union (CJEU) through the preliminary ruling procedure, since the latter is the sole competent judicial authority to review the ECB's acts and omissions.<sup>xvi</sup>

Contrary to the FCC, the CJEU ruled that the OMT Programme was within the scope of the ECB's monetary policy mandate. It stated that when assessing the legality of the ECB's measures one has to take into account primarily their objectives rather than their effects. As the OMT Programme was designed to safeguard both "*an appropriate monetary policy transmission mechanism and the singleness of the monetary policy*", the CJEU qualified the possible purchases of government bonds of troubled euro area member states as measures contributing to the ECB's primary monetary policy objective (price stability) since the Union's monetary policy must be single.<sup>xvii</sup>

Furthermore, the CJEU confirmed that the ECB has the authority to purchase government bonds on secondary markets as long as it does not have "*an effect equivalent to that of direct purchase*" which is constitutionally prohibited.<sup>xviii</sup> To highlight the CJEU's objectives-based

approach, it is worth noting that the purchases of government bonds on secondary markets by the European Stability Mechanism are classified as an economic policy measure when conducted with a view to “*safeguard the stability of the euro area as a whole (...)*” even when they “*may have indirect effect on the stability of euro*”.<sup>xi</sup>

It follows that the same action can be considered either a monetary or an economic policy measure solely on the basis of its prescribed objectives and not by its material effects on the markets.

This judgment has important consequences in terms of supplementing the incomplete agency contract — the Maastricht Treaty provisions — regulating the scope of the Union’s monetary policy — both in terms of defining necessary requisites of price stability and available monetary policy instruments to pursue it. As ruled by the CJEU, price stability entails not only a numerical inflation target but is also about ensuring the seamless functioning of the whole infrastructure necessary to send out “*impulses across the money market to the various sectors of economy*”.<sup>xx</sup>

Furthermore, the CJEU also confirmed the ECB’s discretion in engineering more sophisticated monetary policy instruments.<sup>xxi</sup> Such instruments are considered legitimate even if they entail indirect economic effects<sup>xxii</sup>, but only as long as their purpose is not to circumvent constitutionally embedded monetary financing prohibition. Indeed, as the CJEU observed, the ECB’s role is also “*to support the general economic policies in the Union*”<sup>xxiii</sup> as long as this does not interfere with its price stability objective.

Notably, the CJEU’s objectives-based approach to distinguish monetary and economic policy measures gives to the ECB further opportunities for action as long as the pursuit of price stability *largo sensu* is listed among its objectives.

To sum up, although this ruling can be perceived in terms of the ECB’s significant institutional empowerment,<sup>xxiv</sup> it can also be seen as a necessary and judicially-orchestrated rectification of the EMU’s imperfect institutional design, which was put into force by the Maastricht Treaty. This development resembles to certain extent US constitution-making where the US Supreme Court used to step-in to strengthen the federal level’s mandate in different public policy areas when the political commitment willing to introduce necessary constitutional adjustments was absent.<sup>xxv</sup>

The CJEU — as the EU’s rough equivalent of the US Supreme Court — strengthens both the constitutional legitimacy and the international effectiveness of complex policies pursued by the Union. As famously noted by Jean-Victor Louis — the CJEU only confirmed that the ECB can use instruments that most central banks in the world have been using for years.<sup>xxvi</sup>

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<sup>ii</sup> In this context, policy mandate can be understood as a combination of responsibility and authoritative decision-making exercised by a public agent in order to pursue goals of certain public policy.

<sup>iii</sup> M. A. Pollack, 'Delegation, agency, and agenda setting in the European Community', 1997 *International organization* 51, no. 01, p.103

<sup>iv</sup> P. Milgrom & J. Roberts, 'Bargaining costs, influence costs, and the organization of economic activity', 1990 *Perspectives on positive political economy* 57, p. 62

<sup>v</sup> To be precise, the monetary policy mandate was assigned to the European System of Central Banks (ESCB), of which the ECB is the pivotal element.

<sup>vi</sup> See Art. 127(1) of TFEU.

<sup>vii</sup> Notably, primary law mentions price stability as the primary objective of the Union's monetary policy at least five times which manifests the firmness of the Member States' preferences.

<sup>viii</sup> See Art. 130 of TFEU.

<sup>ix</sup> See Art. 123-125 of TFEU.

<sup>x</sup> Over years the ECB developed a numerical target of price stability as a state in which a year-on-year increase in the Harmonised Index of Consumer Prices for the euro zone is below, but close to 2% over the medium term.

<sup>xi</sup> In this context, take a look at the broad scope and vagueness of the ESCB monetary policy measures, as laid down Art 18 of Statute of the ESCB and ECB.

<sup>xii</sup> To steer interest rates to the targets defined by its decision-making bodies, the ECB made use of credit and open market operations (mainly weekly main refinancing operations, MROs). On the consensus, see J. Gren, *The impact of the global financial crisis on central banks independence and mandate: cases of the US Fed, the ECB and the BoE: CEU Legal Studies Department master theses;2013/17*, p. 3.

<sup>xiii</sup> For an overview of the critique of the ECB's anti-crisis measures, see A.-L. Högenauer & D. Howarth, 'Unconventional Monetary Policies and the European Central Bank's Problematic Democratic Legitimacy', 2016 *Zeitschrift für öffentliches Recht* 71, no. 2, pp. 1–24.

<sup>xiv</sup> For the more detailed specification of the OMT Programme, see the ECB press release 'Technical features of Outright Monetary Transactions, 6 September 2012, available at [http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906\\_1.en.html](http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html)

<sup>xv</sup> So-called Macroeconomic Adjustment Programmes (MAP) providing financial assistance from the European Stability Mechanism subjected to conditionality.

<sup>xvi</sup> See Art. 35 of Statute of the ESCB and ECB.

<sup>xvii</sup> See Case C-62/14 Gauweiler, para. 48-49.

<sup>xviii</sup> *Ibid.* para. 97, 101. To assess whether the equivalence occurs the CJEU enumerated several conditions, see para. 104-121.

<sup>xix</sup> See Case C-370/12 Pringle, para. 56.

<sup>xx</sup> Case C-62/14 Gauweiler, para. 50.

<sup>xxi</sup> *Ibid.*, para 68. It has been well-established in the CJEU jurisprudence that the EU technocratic institutions should be allowed broad discretion when making choices of a technical nature, undertaking forecasts and complex assessments. On this trend, see also H. C. H. Hofmann, 'Gauweiler and OMT: Lessons for EU Public Law and the European Economic and Monetary Union', 2015, p. 16.

<sup>xxii</sup> *Ibid.*, para. 52.

<sup>xxiii</sup> *Ibid.*, para. 109.

<sup>xxiv</sup> T. Tridimas & N. Xanthoulis, 'A Legal Analysis of the Gauweiler Case: Between Monetary Policy and Constitutional Conflict', 2016 *Maastricht journal of European and comparative law* 23, no. 1, p.31

<sup>xxv</sup> Just to mention four landmark cases empowering the federal level: Case *McCulloch v. Maryland*, 1819; Case *Brown v. Board of Education*, 1954; Case *Loving v. Virginia*, 1967; Case *Obergefell v. Hodges*, 2015.

<sup>xxvi</sup> J. V. Louis, 'The EMU after the Gauweiler Judgment and the Juncker Report', 2016 *Maastricht journal of European and comparative law* 23, no. 1, p.56