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Research Report

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Interest Rates, not the Money Supply

— Towards a Non-Monetarist Interpretation of the TFEU

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Executive Summary

In this paper, we show that the case law on the legality of bond purchases by Eurosystem central banks is partly based on the economic theory of monetarism and, in particular, on a 1981 paper by Thomas Sargent and Neil Wallace ("Some Unpleasant Monetarist Arithmetic"). However, monetarism, already controversial in the 1970s and 1980s, is now recognised as false. The assumptions on which Sargent and Wallace based their argument were already partially inaccurate at the time; today, it is generally accepted that these assumptions do not hold in reality.[2] This intellectual progress should be taken into account in ongoing interpretation of the European treaties and the European legal framework.

Building on this observation, in this paper we develop an updated, "non-monetarist" interpretation of Article 123 TFEU. This interpretation deviates from the standards developed in previous case law in three ways:

First, the prohibition under which the European System of Central Banks may not purchase government bonds on the secondary markets under conditions which would, in practice, have an effect equivalent to that of a direct purchase of government bonds ("prohibition of transactions with equivalent effect") should be given up on.

Second, the restriction that secondary market purchases must not weaken incentives (judicially speaking, the “impetus”) towards “sound fiscal policy“ ("prohibition on circumvention") should be replaced. Instead of this restriction, the proper limiting principle is that secondary market purchases must pursue the objective of price stability and, if possible without compromising the first objective, support the general economic policies in the European Union. Within the purposes of Article 123 TFEU, sound public finances are only a means for achieving price stability. The focus of the interpretation should therefore be the pursuit of price stability. The general economic policy goal of sound public finances is the subject of other rules.

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2 Bindseil, The operational target of monetary policy and the rise and fall of reserve position doctrine, ECB Working Paper Series, No. 372 / June 2004. Kern/Sigl-Glöckner/Krahé, Monetary Targeting Revisited, Dezernat Zukunft, June 2022.

Third, and on a related point, the Federal Constitutional Court of Germany (BverfG) should no longer ground the protection of the Bundestag's budgetary right in Article 123 TFEU. The increasingly detailed measures and prohibitions built on an extensive reading of this article are detrimental to monetary policy and thus to price stability. This does not mean that the Federal Constitutional Court should give up on protecting the Bundestag's budgetary sovereignty. Instead, the protection of the Bundestag's budgetary right should be carried out under the legal benchmarks actually created for this purpose: Articles 121, 125 and 126 TFEU.

#MONETARY POLICY
#EUROPEAN LAW
#INTEREST RATE MANAGEMENT

Introduction and overview

In recent years, the European System of Central Banks (ESCB) has been subjected to strict limits on the purchasing of Eurozone government bonds by the European Court of Justice (ECJ) and the German Federal Constitutional Court (BVerfG). In particular, Article 123 of the Treaty on the Functioning of the European Union (TFEU), which prohibits the purchase of government bonds on the primary market, was given an extensive interpretation by the courts: secondary market purchases, which are not mentioned in the text of Article 123, were also subjected to restrictive conditions in order to prevent alleged circumventions of the ban on primary market purchases. However, by referring in their case law to the historical background of the regulations, which itself refers to Sargent and Wallace (1981) and monetarism, the ECJ and the BVerfG rely on an erroneous understanding of the instruments and causal mechanisms that central banks use to influence aggregate demand and price levels.

The structure of this paper is as follows: in the first section, we examine how monetarism has influenced the institutional framework of the Economic and Monetary Union. We provide a brief summary of the main arguments of Sargent and Wallace's paper (1.1) and show how it shaped the rules of the Economic and Monetary Union (1.2). We then summarise how and why the core theses of their paper are refuted today (1.3). In the second section, we describe how the European Court of Justice and the Federal Constitutional Court have interpreted the prohibition on monetary financing of Member States. In doing so, we first explain the three prohibitions formulated by the ECJ in its rulings in *Gauweiler* and *Weiss* (2.1), and then turn our attention towards budgetary discipline, which the BVerfG has placed at the heart of its rulings (2.2). In the third section, we consider what consequences for the interpretation of Article 123 TFEU follow from the fact that the monetarist view is considered outdated among central banks practitioners and in academia today. In particular, we show that in a non-monetarist interpretation, Article 123 TFEU need not be interpreted extensively in order to avoid inflation (3.1), nor to protect the independence of central banks (3.2). We then explain the proposed changes in interpretation that result from an updated understanding of the context underpinning the jurisprudence on Article 123 TFEU (3.3). The paper ends with a brief conclusion (4).

1. Monetarism in the institutional framework of the Economic and Monetary Union

In this first section, we examine how monetarism – the prevailing understanding of the functioning of monetary policy in the 1980s – has influenced the institutional framework of the Economic and Monetary Union. We summarise the 1981 paper by Sargent and Wallace, a touchstone in monetarist monetary theory (1.1), and show how it has shaped the rules of the Economic and Monetary Union (1.2). We then summarise how and why the core of this paper has been refuted today (1.3).

1.1 Sargent and Wallace: the fear of fiscal dominance

In today's institutional framework, the primary task of central banks in general, and of the ECB in particular, is to control inflation. The question of what instruments and what relationship to fiscal policy are necessary to achieve this objective has been the subject of long-running economic, political, and legal debates.

One historically important contribution to these debates is the essay "Some Unpleasant Monetarist Arithmetic".[3] It was written by Thomas Sargent and Neil Wallace for the 1981 Fall Report of the Federal Reserve Bank of Minneapolis, shortly after the U.S. Federal Reserve (Fed) introduced central bank monetary targeting. In this paper, the authors argue that the central bank can control inflation only if it exercises sole control over the central bank money supply. The authors referred to this state of affairs as a system of "monetary dominance". In such a system, it is impossible for the Ministry of Finance and the elected government to exert any significant influence on the central bank money supply.

In their paper, Wallace and Sargent make three assumptions:

1. Deposits that commercial banks hold at the central bank do not yield any interest. This results in an interest gain for the central bank when it acquires interest-bearing assets. (This is commonly referred to as "seigniorage".)[4]
2. There is a stable and causal relationship between the money created by the central bank (the monetary base) and the price level.
3. The yield on risk-free government bonds, and hence the government's financing costs, depend on the supply of and demand for bonds. If the supply of risk-free government bonds increases while demand stays the same, the price of new government bonds falls, i.e. the yields and thus the government's financing costs rise.

Building on these three assumptions, Sargent and Wallace then argue that the central bank can only stabilise the price level if it has decision-making authority over the size of the government deficit. If parliaments, acting independently and without limits, were to run bigger deficits than there is demand for risk-free government bonds, deficits would become impossible to bond-finance (Assumption 3).[5] This would leave seigniorage as the only financing option, which the central bank would be *de facto* obliged to provide, to preserve the risk-free nature of government bonds. The central bank would thus be forced to buy the bonds, putting the newly created reserves at the government's disposal. The government would then spend the money, so that the reserves end up in commercial banks' accounts held at the central bank.[6]

3 Sargent and Wallace, Some Unpleasant Monetary Arithmetic, Federal Reserve Bank of Minneapolis Quarterly Review Vol. 5 No. 3 (Fall 1981), p. 1 ff.

4 See ECB, What is Seigniorage?, April 7, 2017.

5 More precisely, above a certain deficit level, the yields that would be required to sell the desired amount of government bonds would exceed the growth rate of the economy. If this remained the case over the longer term, a debt spiral would result, making it impossible to finance further deficits through bonds (see Blanchard, Public Debt and Low Interest Rates, American Economic Review, 109(4), 2019).

6 For example, the Bundestag could finance the construction of an expensive statue. In order to do so, it would need to hire a contractor. The construction company has an account with Deutsche Bank. Accordingly, a transfer would be made from the central bank account of the German government to the central bank account of Deutsche Bank, which would credit the balance to the construction company.

Since the central bank deposits of commercial banks do not yield any interest in the Sargent and Wallace model (Assumption 1), this would not result in any interest costs for the central bank; the spending plans of the state could therefore be accommodated without any further impact on the budget (no need for new taxes, no new interest costs for the central bank and hence no reduction in seigniorage profit transfers). According to Assumption 2, however, these new balances would raise the general price level.

If parliaments were able to determine their budgets independently of the central bank, a state of "fiscal dominance" would therefore prevail: the price level would be determined indirectly by budget legislation; the central bank would always have to follow suit and close any gaps between deficits and the demand for government bonds through seigniorage. Since seigniorage increases the money supply, which in turn increases the price level, the central bank would not be able to ensure price stability.

The central bank could only ensure price stability in a regime of "monetary dominance", in which it provides just enough money to keep the growth in lending volumes to a desired level, and thus growth in the price level (via the money creation multiplier) stable. Parliaments would then be able to finance deficits only to the extent dictated by the sum of the seigniorage independently set by the central bank (which is paid into the budget) and the demand for government bonds (which, according to Assumption 3, determines the cost of financing and thus sets a limit on the ability to finance deficits).

1.2 Sargent and Wallace in the institutional framework of the Economic and Monetary Union

This notion of controlling inflation through controlling the central bank money supply took on a central role in the establishment of the European Economic and Monetary Union in the Maastricht Treaty of February 7, 1992. There was significant concern about a regime of "fiscal dominance", in which "monetary stability" would be threatened by deficits that required the use of seigniorage.[7] On October 27, 1990, the Economic and Financial Affairs Council (Ecofin), in which the finance ministers of the Member States meet, presented the so-called Carli Report under the then-Chairman, Italian Finance Minister Carli, which described the institutional conditions that the finance ministers believed were necessary for a monetary union to succeed. The report shows that Ecofin considered the money supply to be an instrument of monetary policy and wanted to allow purchases of government bonds only for the purpose of controlling the money supply.

7 See e.g. Economic and Monetary Union, Bulletin of the European Communities, Supplement 2/91, p. 24, where the Commission expresses its concern about "pressure for monetary accommodation"; see also Committee for the Study of Economic and Monetary Union: Report on economic and monetary union in the European Community, 17.4.1989 (the so-called Delors Report), para. 30 at p. 19 and para. 59 at p. 35 f.

Box 1: Extract from the Report of the Economic and Financial Affairs Council to the Council of Heads of State and Government of the Union, October 27, 1990 (Carli Report)

According to the view shared by all the Member States, except the United Kingdom, the final stage of economic and monetary union will be achieved through the transfer of national powers to a monetary authority responsible for conducting monetary policy. The aim of that policy will be ***to ensure that the purchasing power of the currency remains stable****; measures to support the policy for boosting income and employment would not be ruled out but, in the event of a conflict of interests, price stability would have to take precedence.*

A monetary policy of this nature presupposes that the authority conducting it would enjoy complete independence and absolute autonomy. ***The money supply and interest rates are monetary policy instruments and the authority responsible for maintaining price stability would have to be free to decide on their use.***

This has the following implications:

(1) ***Budget deficits could not be financed****, either directly or indirectly* ***through money creation****. The central banks would have to be barred from granting governments advances or subsidies.* ***Purchases of government securities could be permitted exclusively on the initiative of the central banks and solely in order to regulate the amount of money in circulation.*** *Similarly, the commercial banks could not be obliged to purchase securities or to finance governments in any other way;*

(2) No Member State could benefit from the guarantee afforded by other Member States or by the Community budget in respect of operations to finance its budget deficit;

(3) Excessive deficits would not be permitted. A clear definition of what constitutes an excessive deficit has yet to be agreed on, but work is in progress with a view to reaching a consensus on this point. [...]

The Maastricht Treaty codified these considerations in Article 104 of the "Treaty establishing the European Community" (TEC). This article was transferred, with its wording unchanged, to Article 123 of the "Treaty on the Functioning of the European Union" (TFEU) by the Lisbon Treaty of December 13, 2007:[8]

> *"(1) Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States [...] in favour of [...] central governments, regional or local authorities, [or] other bodies governed by public law [...] shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments."*

8 In the Treaty of Nice of February 26, 2001, it was (also with the wording unchanged) moved to Article 101 TEC.

The first implication of the Carli Report is that it was intended to ensure that overdraft or other lending activities or the purchase of government bonds by central banks should only take place "exclusively on the initiative of the central banks and to regulate the amount of money in circulation." These actions were explicitly not to be used to finance the deficits of Member States.

At the same time, the reference to regulating the money supply reveals the underlying assumption that inflation depends on the money supply, i.e. that monetary measures such as lending to governments or the purchase of bonds by central banks – if carried out in amounts other than those intended by the central bank – would automatically result in inflation risks. This would run counter to the objective of price stability, which forms the basis for all rules governing the functioning of the Economic and Monetary Union (Article 3 TEU and 119 TFEU, formerly Article 3a TEC-Maastricht and Article 4 TEC-Nice, respectively). In this vein Advocate General Juliane Kokott explained, in her Opinion before the ECJ from March 2022, that "its [the prohibition of monetary financing's] purpose is, on the one hand, to prevent the governments of the Member States from increasing the monetary base through their fiscal policy decisions and thereby possibly influencing the monetary policy of the ESCB."[9]

Based on this understanding, the additional "disciplining effect" of market interest rates on the management of public finances through the prohibition on central bank financing would also, in particular, have the effect of preventing government debt from being issued in volumes exceeding the market demand for government bonds. As a reminder, according to Sargent and Wallace, a deficit larger than this market demand would automatically result in central bank money creation, and thus an increase in the money supply and ultimately inflation.

In this narrative, Article 124 TFEU,[10] too, which prohibits the privileged access of the public sector to financial institutions, is also intended to prevent an increase in the money supply, in this case via money creation by commercial banks, in addition to the desired disciplining effect of the markets, as can be seen in the first implication of the Carli Report. As late as October 2020, Isabel Schnabel declared, in the language of Sargent and Wallace: "The euro has been built on the principle of monetary dominance."[11]

9 Opinion of 31.3.2022, C-45/21 - Banka Slovenije, ECLI:EU:C:2022:241, para. 129. The passage continues: "On the other hand, however, by precluding national governments from having extensive access to the resources of the NCBs, that prohibition is also intended to prevent governments from undermining the financial independence of their central bank in that way." We pick up on this intent, i.e. the protection of central bank independence, in Section 3.2 below.

10 At the time, Article 104a TEC.

11 Schnabel, The shadow of fiscal dominance: Misconceptions, perceptions and perspectives, SUERF Policy Note No. 198, October 2020.

1.3 The assumptions of Sargent and Wallace do not hold in reality

We have explained elsewhere that the balances of commercial banks held at the central bank earn interest today (contrary to Assumption 1) and that there is no stable money multiplier (contrary to Assumption 2). If the Fed financed U.S. congressional deficits today, this would increase the Fed's interest expense (and thus reduce the central bank profit that gets transferred to Congress) in the same amount as the reduction in interest costs of Congress.[12] A central bank paying interest on reserve balances therefore cannot be abused for the generation of seigniorage. More fundamentally, **in the absence of a stable money multiplier, there is no reason to assume that the type of financing (purchase of bonds by the central bank or purchase of bonds by market participants) would have a decisive impact on aggregate demand and the price level.** This observation alone implies that the danger described by Sargent and Wallace is not a danger we need to worry about today.

The ECB, too, no longer considers an increase or decrease in the money supply to be a monetary policy instrument for managing demand (and thus inflation, since price increases are caused by a stronger rise in demand compared to supply). Instead, the ECB, like other central banks, uses

a. short-term interest rates,
b. forward guidance,[13] i.e., the expression of expectations regarding the future course of short-term interest rates, as well as
c. purchase programmes aimed at reducing so-called term premia, i.e. the deviation of actual market interest rates from expected short-term interest rates over time.[14]

Whereas the Carli Report stated that "the (central bank) money supply and interest rates are monetary policy instruments" (see Box 1 above), the ECB's updated monetary policy strategy no longer makes any reference to the central bank money supply or to money supply management.[15]

This view is shared by the Bundesbank.[16] At his presentation on "The Eurosystem's New Monetary Policy Strategy" in Berlin on November 25, 2021, the Chief Economist of the Bundesbank, Jens Ulbrich, presented the following slide on this topic (Figure 1), which describes the effect of monetary policy instruments on both short-term and long-term nominal interest rates (as reflected in bond yields).

12 Monetary financing could result in a marginal difference in financing costs equal to the spread between Treasury refinancing costs (T-bills) and the expectations of central bank interest rate changes from overnight indexed swaps. This difference amounts to only a few basis points.

13 No. 8 of the Statement on the ECB's monetary policy strategy and An overview of the ECB's monetary policy strategy, Chapter 3, ECB Economic Bulletin 5/2021, August 5, 2021.

14 cf. Kern, Das Anti-Fragmentierungstool des Eurosystems – verständlich erklärt, Geldbrief, July 7, 2022. (DE)

15 See references in footnote 11.

16 See Deutsche Bundesbank, The Role of Banks, Non-Banks and the Central Bank in the Money Creation Process, Monthly Report April 2017, pp. 15 ff. The Bundesbank explains here why the notion of a money creation multiplier is misleading. However, in a regime of central bank money supply control, the existence of a money creation multiplier is necessary in order to establish any causal relationship at all between the central bank money supply and aggregate demand, through which monetary policy ultimately affects the price level.

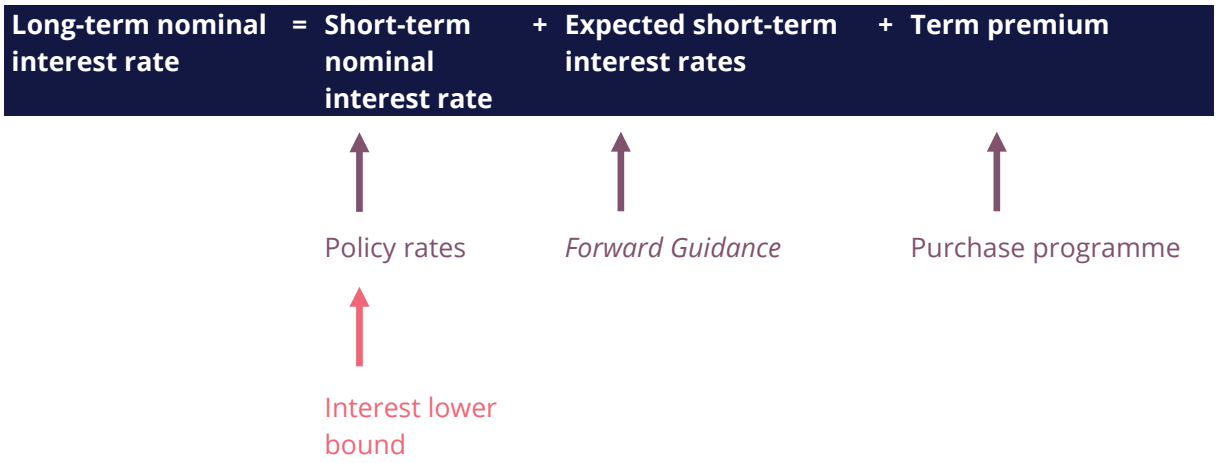

Figure 1: Effects of Monetary Policy Instruments; **Source:** Recreated excerpt from the presentation "The Eurosystem's New Monetary Policy Strategy" by Jens Ulbrich, Nov. 25, 2021

Parallel developments took place in the USA. Starting in 2008, the Fed implemented a so-called ample reserve regime, which it reaffirmed in 2019 for the longer term.[17] Under this regime, interest rates are not controlled indirectly, via varying the money supply, but explicitly, i.e. via setting the amount of interest paid by the central bank in remuneration for commercial bank deposits.

The Eurosystem has long used the same approach to manage interest rates. In such a system of monetary policy implementation, the size of the monetary base is irrelevant.[18]

Accordingly, the consensus view in economics no longer regards a change in the money supply as a driver of inflation.[19] This is because when the market is saturated with central bank money, the central bank influences aggregate demand and thus the price level by changing interest rates.[20] In such an implementation regime, the interest rate on the interbank money market is no longer determined by demand and supply, but by arbitrage (no money market participant would grant a loan at conditions that are less favourable than what they would receive at the central bank).[21]

17 See Federal Reserve, Statement Regarding Monetary Policy Implementation and Balance Sheet Normalization, January 30, 2019.

18 As long as it does not fall below a minimum level at which point central bank money would become so scarce that commercial banks would pay more for reserves in the money market than they receive from the central bank. Kern/Sigl-Glöckner/Krahé, Monetary Targeting revisited, pp. 16.

19 See Kern/Krahé, Der leise Tod der Geldmengensteuerung: Ende eines Irrwegs, Geldbrief, April 7, 2022. (DE)

20 See Sigl-Glöckner, Der Zinshammer – Wie Zentralbanken Inflation bekämpfen, Geldbrief, Jan. 28, 2022. (DE)

21 See in detail Åberg/Corsi/Grossmann-Wirth/Hudepohl/Mudde/Rosolin/Schobert, ECB Occasional Paper Series No. 282 (September 2021) - Demand for central bank reserves and monetary policy implementation frameworks: the case of the Eurosystem, pp. 8 and 11.

The third key assumption of Sargent and Wallace does not hold either. The yields on government bonds – and hence, the financing costs – of states with monetary sovereignty derive from

1. expectations about the future development of policy interest rates,
2. term premia (deviations from interest rate expectations),[22] as well as
3. balance sheet costs[23] (regulatory costs for investment banks that result from holding risk-free government bonds).

If a government runs higher deficits, i.e. increases the supply of government bonds, this will only lead to higher yields if one of these three variables increases at the same time.[24] Since additional deficits (i.e. a higher supply of bonds) do not automatically lead to higher expectations regarding the future development of policy rates, higher term premia – i.e. deviations of actual interest rates from expected future policy rates – or increased balance sheet costs, they do not automatically imply higher yields.[25]

The prohibition on monetary financing in today's Article 123 TFEU and the prohibition on privileged access to financial institutions in today's Article 124 TFEU were thus built on assumptions that we now know to be flawed.

- The deposit rate is not zero (Assumption 1), but is used by the central bank specifically to steer interbank rates.
- There is no stable relationship between the money supply and the price level (Assumption 2). "Monetary" measures, i.e. measures affecting the money supply, do not automatically lead to inflation.
- The financing costs for government bonds are not mainly driven by the demand and supply of bonds (Assumption 3), but by expected future policy rates for the remaining term of the respective bond, by the term premium and by balance sheet costs for investors, none of which necessarily change with higher government debt or deficits.[26]

As a consequence, fiscal dominance does not make it impossible for the central bank to control the price level. The monetary financing of government spending does not have inflationary effects – when it has any – because of the concomitant increase in the money supply.

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22 See Kern, Finanzmärkte sind keine Luftballons – Wie sich die Geldpolitik auf Vermögenspreise auswirkt, Geldbrief, Sept. 14, 2021 (DE). See also Bundesrepublik Deutschland – Finanzagentur GmbH, Understanding Federal Securities: How does a bond work?.

23 Until the financial crisis, the yield on safe assets was usually explained as the sum of average expected short-term interest rates and a term premium, which represented deviations from expectations, cf. Kim/Orphanides, The bond market term premium: what is it, and how can we measure it?, BIS Quarterly Review, June 2007, p. 27 ff. Since the introduction of the leverage ratio in Basel III, which sets a debt ceiling for investment banks acting as market makers as marginal investors in the government bond market and whose funding costs are therefore reflected in market prices, balance sheet costs have also been cited in the literature. The balance sheet costs correspond approximately to the pro rata equity costs that investment banks use to calculate holding a given position. cf. Fleckenstein/Longstaff, Shadow Funding Costs: Measuring the Cost of Balance Sheet Constraints (2018), NBER Working Paper Series (Working Paper 24224).

24 If yields were to rise above the sum of interest rate expectations, term premiums, and balance sheet costs, banks could buy government bonds and sell an interest rate swap in which they pay fixed rates and receive floating rates, earning an arbitrage profit equal to the difference.

25 If, for example, a parliament were to adopt a deficit-financed investment program in an economic crisis with high unemployment, this does not necessarily have an inflationary effect, since it will mainly mobilise unused economic capacity. In this case, the central bank may not raise interest rates despite higher public spending and government bond yields would not respond to the higher supply of government bonds.

26 See footnote 25 above.

Obviously, this does not imply that there is no place for fiscal rules. *Deficits* usually have an impact on aggregate demand, which could have an inflationary effect (and would therefore weaken the monetary value of the single currency).

However, the inflationary effect is not a question of the quantity of central bank money. Instead, it is driven by the volume of credit creation or destruction, the composition of public spending, the elasticity of supply, possible reactions in financial markets, as well as a number of other factors. Indeed, even large government deficits may not have an impact on demand (and thus remain inflation-neutral), as when a Member State assumes the debts of financial institutions during a financial crisis.[27]

Since bank bailouts can be simultaneously deficit-increasing and (central bank) money supply-increasing *as well as* financial stability-enhancing and inflation-neutral, restricting the size of public deficits or interpreting the prohibition on central bank bond purchasing extensively may run counter to the objective of ensuring price stability in critical situations. This example demonstrates the dangers of looking only at the money supply or the size of deficits to safeguard price stability. Doing so would be problematic with respect to the goal of price stability, might result in excessive restrictions on Member States' budgetary sovereignty, and undermine the democratic legitimacy of the overall framework of monetary and economic governance.

27 The assumption of debt - or rather the payment of creditors by the state - does not create new demand, but instead satisfies already-existing demand. It could be countered that this prevents defaults on payment, which themselves would have slowed demand. Such situations, however, have only a very indirect connection with the intended purpose of limiting the money supply.

2. Traces of monetarism in the case law on Article 123 TFEU

As a general principle, the interpretation of legal concepts cannot be delegated to the respective disciplines from which the concepts originate, but is instead determined through jurisprudence. In order to preserve the underlying purposes of a legal text and to avoid exceeding the expertise of the respective decision-makers, the interpretation of legal standards cannot depend solely on the – often disputed – state of the respective discipline at the time of enactment, of application by the addressees, or of interpretation during legal examination.[28] The problem of legal interpretation becomes truly complex when certain economic ideas are themselves written into the legal code.[29] However, on the basis of implementing the individual provisions (Articles 120-126 TFEU) for the purposes listed in Article 119 TFEU, it seems methodologically important to identify the area where the relevant factual knowledge has developed, and to attempt possible translations into the teleological-legal interpretation of the provisions. Therefore, in this section we will first look at how the ECJ (2.1) and the BVerfG (2.2) have interpreted the prohibition on monetary financing, in order to then, in section 3, draw conclusions for interpretation from the amended understanding of monetary policy.

2.1 ECJ: Three prohibitions, one thought

In its rulings on Outright Monetary Transactions (OMT; *Gauweiler*) and the Expanded Asset Purchase Programme/Public Sector Purchase Programme (EAPP/PSPP; *Weiss*), the ECJ developed a three-step legal compliance test for central banks' bond purchasing programmes:

- First, primary market purchases are completely prohibited under Article 123 TFEU[30] (direct prohibition);
- second, "the ESCB does not have authority to purchase government bonds on secondary markets under conditions which would, in practice, mean that its action has an effect equivalent to that of a direct purchase of government bonds [...] thereby undermining the effectiveness of the prohibition in Article 123(1) TFEU"[31] (prohibition on transactions with equivalent effect); and
- third and finally, "purchases made on the secondary market may not be used to circumvent the objective of Article 123 TFEU"[32] (prohibition on circumvention).

In the following sections, we will look at the second (2.1.1) and third prohibitions (2.1.2), each of which also prohibits certain bond purchases in secondary markets.

28 On the importance of new economic findings in the interpretation of constitutional law BVerfGE 79, 311 (336 ff.); BVerfGE 119, 96 Rn. 127 ff.; see also Kirchhof, Die Allgemeinheit des Gesetzes, p. 580 f. with further references (DE).

29 For interesting discussions around this issue, see the judgments cited in footnote 28 above.

30 ECJ judgment of 16.6.2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:400, para. 94 f.; ECJ judgment of 11.12.2018 - C-493/17 - Weiss, ECLI:EU:C:2018:1000, para. 102.

31 ECJ judgment of 16.6.2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:400, para. 97; ECJ judgment of 11.12.2018 - C-493/17 - Weiss, ECLI:EU:C:2018:1000, para. 106.

32 ECJ judgment of 16.6.2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:400, para. 101.

2.1.1 Second: No actions with an effect equivalent to primary market purchases

The second prohibition established by the ECJ is that the ESCB "does not have authority to purchase government bonds on secondary markets under conditions which would, in practice, mean that its action has an effect equivalent to that of a direct purchase of government bonds [...] thereby undermining the effectiveness of the prohibition in Article 123(1) TFEU".[33] An action would have this "effect equivalent to that of a [prohibited] direct purchase of government bonds [...] if the potential purchasers of government bonds [...] knew for certain that the ESCB was going to purchase those bonds within a certain period and under conditions allowing those market operators to act, de facto, as intermediaries for the ESCB for the direct purchase of those bonds [...]".[34] In this regard, the ECJ stated that "safeguards" were needed in order to "prevent the conditions of issue of government bonds from being distorted by the certainty that those bonds will be purchased by the ESCB after their issue".[35] In its later *Weiss* ruling, the ECJ further specified this condition to the effect that the safeguards are "specifically to prevent private operators from predicting with certainty whether particular bonds will in fact be purchased on the secondary markets under the PSPP."[36]

Conclusion: *In terms of its content, this interpretation does not focus on the purpose or historical origin of the provision, but rather on the wording of the prohibition on primary purchases, which in this interpretation may not be undermined by any parallel actions.*

33 ECJ judgment of 16.6.2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:400, para. 97; ECJ judgment of 11.12.2018 - C-493/17 - Weiss, ECLI:EU:C:2018:1000, para. 106.

34 ECJ judgment of 16.6.2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:400, para. 104; ECJ judgment of 11.12.2018 - C-493/17 - Weiss, ECLI:EU:C:2018:1000, para. 110.

35 ECJ judgment of 16.6.2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:400, para. 107.

36 ECJ judgment of 11.12.2018 - C-493/17 - Weiss, ECLI:EU:C:2018:1000, paras 117, 127.

2.1.2 Third: No circumvention of the objectives of Article 123 TFEU

For the third prohibition (prohibition on circumvention), i.e. that "purchases made on the secondary market may not be used to circumvent the objective of Article 123 TFEU", the purpose of Article 123 had to be considered.[37]

In order to identify this purpose, the ECJ relied on a 1991 contribution by the European Commission in which the Commission had presented proposals for the future rules on Economic and Monetary Union.[38] There, with respect to the predecessor provision to Article 123 TFEU, the Commission stated: "This Article is concerned with the potential threat to monetary stability posed by budget deficits and their financing."[39] On this basis, the ECJ attributed to Article 123 TFEU the objective of "encourag[ing] the Member States to follow a sound budgetary policy, not allowing monetary financing of public deficits [...] to lead to excessively high levels of debt or excessive Member State deficits."[40] Since the ESCB also has the task of supporting the general economic policies in the Union (Article 127(1), second sentence, TFEU), which include "sound public finances" (Article 119(3) TFEU), it may not simultaneously undermine this with its monetary policy.[41] The prohibition on circumvention would therefore be violated if the bond purchase program were such "as to lessen the impetus of the Member States concerned to follow a sound budgetary policy."[42]

Advocate General Pedro Cruz Villalón also stated in his Opinion:[43]

> *[218] Article 123 TFEU therefore reflects a very real concern on the part of those who drew up the institutional framework for economic and monetary union, which is why it was decided to introduce into primary law an absolute prohibition on any forms of financing States which could jeopardise the objectives of fiscal discipline laid down in the Treaties. One of those prohibited forms is so-called 'monetary financing', whereby a central bank, the institution with power to issue money, purchases a State's debt instruments. It is clear that this form of financing may jeopardise that State's ability to meet its financial obligations in the medium and long term, while it may also be a significant source of price inflation. Since a common economic and monetary policy presupposes the existence of States with healthy public finances and a policy whose priority is the maintenance of price stability, it is obvious that, in such circumstances, a monetary financing mechanism significantly impairs those objectives.*

The finding that the Union's policies' "priority is the maintenance of price stability" is further supported by the Carli Report cited above, which stated: "The aim of that policy will be to ensure that the purchasing power of the currency remains stable; measures to support the policy for boosting income and employment would not be ruled out but, in the event of a conflict of interests, price stability would have to take precedence."

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37 ECJ judgment of 16.6.2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:400, para. 98.

38 ECJ judgment of 16.6.2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:400, para. 100.

39 Draft Treaty, Bulletin of the European Communities, Supplement 2/91, p. 54.

40 ECJ judgment of 16.6.2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:400, paras 100 f. and 109 and Opinion of Advocate General Cruz Villalón of 14.1.2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:7, para. 217.

41 ECJ judgment of 16.6.2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:400, para. 109 and Opinion of Advocate General Wathelet of 4.10.2018, C-493/17 - Weiss, ECLI:EU:C:2018:815, para. 50 with further references.

42 ECJ judgment of 16.6.2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:400, paras 100 f. and 109; ECJ judgment of 11.12.2018 - C-493/17 - Weiss, ECLI:EU:C:2018:1000, para. 107.

43 Opinion of Advocate General Cruz Villalón, 14.1.2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:7, para. 218.

Having said this, in her Opinion of March 31, 2022, Advocate General Juliane Kokott expressed matters in a more reserved way, stating that the purpose of the prohibition of monetary financing is "to prevent the governments of the Member States from increasing the monetary base through their fiscal policy decisions and thereby possibly influencing the monetary policy of the ESCB. [...] This is the case even though – contrary to widespread belief – the monetary policy of the ESCB is not aimed primarily at controlling the monetary base or the money supply, but rather at ensuring price stability".[44]

Conclusion: *This interpretation is based on the underlying purposes of the provision. In this context, the ECJ places a particular focus on the soundness of public finances and the threats to price stability that would result from the monetary financing of excessive deficits. However, it is clear from historical documents that the overarching objective, including for the pursuit of fiscal discipline – contrary to their juxtaposition in Article 119(3) TFEU – was that of price stability.*

2.2 BVerfG: Prohibition on circumvention

From the perspective of the German Federal Constitutional Court, the objective of Article 123 TFEU is "to encourage Member States to pursue sound budgetary policies [...] and to prevent excessively high levels of debt or excessive Member State deficits".[45] It sees the prohibition on monetary financing as one of the central rules that define the monetary union as a "community of stability" (Stabilitätsgemeinschaft).[46] In the Court's view, this objective is accordingly also served by a prohibition on circumvention.[47] It sees two concrete risks for the German budget:

1. inflation risks, since the value of money represents the "general economic foundation of budgetary policy",[48] and
2. risks of loss for the Bundesbank due to defaults on government bonds, which the budget would have to compensate or, at any rate, bear (Section 27 No. 2 BBankG).[49]

44 Opinion of 31.3.2022, C-45/21 - Banka Slovenije, ECLI:EU:C:2022:241, para. 129 and footnote 65 thereof.

45 BVerfGE 154, 17 para. 181 with further references; BVerfGE 146, 216 para. 78.

46 BVerfGE 146, 216; BVerfGE 142, 123 para. 201.

47 BVerfGE 142, 123 para. 198-200; BVerfGE 154, 17 para. 182.

48 BVerfGE 89, 155 (207); BVerfGE 151, 202 para. 134.

49 BVerfGE 146, 216 para. 125 f. with further references; BVerfGE 154, 17 para. 227.

In its OMT ruling, the Federal Constitutional Court therefore followed the ECJ and held "[first,] that bonds may not be purchased on the primary market; [second,] that purchases on the secondary market may not give the affected Member States certainty that their bonds will be purchased by the ESCB, and [third,] that the purchase may not relieve the affected Member States of incentives to conduct sound budgetary policy".[50] In its PSPP judgment, Karlsruhe further stated that central banks should not become a "permanent source of finance for the Member States" by buying and holding a certain share of government debt on a permanent basis, which would then play no role at all in the credit rating of the respective Member State[51] ("the relevant sovereign debts would be neutralised with permanent effect");[52] this would remove the incentive for Member States to pursue sound fiscal policies.[53] If, when redeeming bonds, the central bank were to continuously reinvest the amounts collected, the prohibition on monetary financing under Article 123 TFEU would therefore be violated.[54]

Conclusion: *The Federal Constitutional Court placed the focus of Article 123 TFEU directly on budgetary discipline, whereas at the ECJ it had been more oriented teleologically and historically towards the goal of price stability, from which the goal of budgetary discipline was derived. Underlying the BVerfG's focus is the constitutional perspective concerning the budgetary sovereignty of the Bundestag, which may not be threatened by other Member States running unsafe finances with the support of the central bank.[55] However, here as well, the protective goals for the German budget remain inflation – i.e. price stability – and risk of loss.*

2.3 Conclusion: "May contain traces of monetarism"

The assumptions of Sargent and Wallace are thus subtly reflected in the courts' interpretation of Article 123 TFEU. The ECJ's interpretation that market participants may not act as *de facto* intermediaries for central banks in primary market-equivalent bond purchases (second prohibition) and that they must not reduce Member States' incentives to pursue sound fiscal policies (third prohibition) aims to ensure that all participants act with caution: Member States in their spending behaviour, potential primary market buyers in their demand for government bonds, and central banks in their bond purchases. This reflects the fear of fiscal dominance in the presence of elevated levels of government debt, which in the minds of Sargent and Wallace would lead to monetary financing (Assumption 2), an increase in the central bank money supply and, consequently, inflation. In the courts' jurisprudence, the third assumption of Sargent and Wallace (that yields are independent of interest rate expectations on the basis of the supply and demand for capital) has become a normative requirement for the formation of market prices for government bonds, in which central banks are not allowed (or allowed only under narrow conditions) to intervene through bond purchases.[56]

50 BVerfGE 142, 123 para. 199.

51 BVerfGE 154, 17 para. 195.

52 BVerfGE 146, 216 para. 98.

53 BVerfGE 146, 216 para. 98.

54 BVerfGE 154, 17 para. 195.

55 BVerfGE 134, 366 para. 43.

56 See Orphal, Marktlogik ist kein Rechtsgebot, VerfBlog of Aug. 2, 2022 (DE) and the same in Politik & Ökonomie, Aug. 16, 2022. (DE)

3. A non-monetarist interpretation of Article 123 TFEU

On the basis of the case law described above, this section draws out the implications for the interpretation of Article 123 TFEU from the fact that monetarism is now considered obsolete in academia and among central bank practitioners worldwide. In doing so, we find that dropping the notion of a money multiplier also shifts the relationship that bond purchases (3.1) and fiscal dominance in the sense of Sargent and Wallace (3.2) have to price stability. As a result, there is a need for a new interpretation of the prohibition on monetary financing under Article 123 TFEU, which historically assumed economic relationships that have since been refuted (3.3).

3.1 Money supply and price stability?

The central purpose of Article 123 TFEU is recognised to be the objective of guarding **price stability** against the risk that the government's access to central bank financing might increase the money supply and thereby jeopardise "monetary stability". This relates to Sargent and Wallace's concern that monetary financing increases the central bank money supply, which in turn raises the (commercial) bank money supply, which in turn would increase inflation. The result would be a loss of central bank control over inflation.

According to today's understanding of monetary policy transmission, this relationship does not hold. Prices rise because of a reduction in supply or an increase in demand, not because of an increase in the central bank or commercial bank money supply. Central banks do not use their monetary policy instruments (short-term interest rates, forward guidance, bond purchase programs) to control the money supply, however defined, but to control the financing conditions of households, companies and governments, and especially the interests rates they face as borrowers and lenders. Accordingly, monetary financing, including bond purchases by central banks, does not automatically generate an increase in demand (there is no money creation multiplier).[57] If demand is not automatically increased by an increase in the money supply, however, then an increase in the money supply, e.g. through bond purchases – be it on the primary market or on the secondary market – does not in itself imply an increase in demand and thus (a risk of) inflation.[58]

This changes a central presupposition behind the prohibition on monetary financing. Inflation can still pose a threat where monetary financing is concerned, namely through increased government demand (if the additional government spending does not expand supply and/or is not offset by a sufficient reduction in demand, for instance, through increased taxes or other demand-reduction measures such as lending-reducing bank regulations). In such a constellation, aggregate demand would rise, and inflation may follow.

57 See above 1.3 and Kern/Sigl-Glöckner/Krahé, Monetary Targeting revisited, May 31, 2022, p. 5.

58 Monetary policy bond purchase programs do not work by increasing the money supply but by influencing financing conditions (including maturity and risk premia), cf. Kern, Das Anti-Fragmentierungstool des Eurosystems – verständlich erklärt, Geldbrief, July 7, 2022. (DE)

However, this no longer follows from the historical understanding in which inflation resulted from an increase in the money supply, but from a lack of balancing out the increase in demand in a context where the economy is running at full capacity. Most importantly, in the latter case, the central bank responds to an inflationary increase in demand by activating its instruments – especially the policy rate(s) – and tightening financing conditions. The possible fear that central banks might refrain from tightening out of deference to heavily-indebted Member States, in turn, does not depend on whether the creditors of the Member States are the central banks or private market participants. The prohibition on monetary financing does not prevent this form of "consideration". An increase in interest rates will curb inflation regardless of who is driving demand and who the state's creditors are. It slows down investment activity and consumer spending in the economy as a whole, tightens the financing conditions for all market participants and, as a result, may also drive the lowest-ranking actors into insolvency.[59] Whether such "crowding out" by the state is desirable is a political question – but it is no longer a question of inflation. And only the question of inflation is the subject of the ESCB's primary mandate.

A corresponding non-monetarist understanding, in which the central bank does not aim for control over the money supply, but instead manages financing conditions with an eye on aggregate demand, is reflected in the monetary policy strategies pursued by central banks today. In both the ESCB and the Fed, the key interest rate corresponds to the deposit rate paid by central banks on balances held by commercial banks at the central bank. For the central bank to be able to control interest rates in this way, central bank money must never run short; otherwise, the effective short-term interest rate risks rising above the central bank's desired policy rate. Accordingly, in the monetary policy strategy of central banks today, there is no maximum limit for central bank money, but only a minimum limit (below which monetary policy would be curtailed in its effect, as interest rates on the market would then rise above the level desired by monetary policy).[60]

Article 123 TFEU therefore does not have to be interpreted extensively, i.e. beyond the explicitly mentioned prohibition of primary market purchases, **at least not on the grounds of avoiding inflation**.

3.2 Fiscal dominance and price stability?

According to some authors, Article 123 TFEU is also intended to protect the **independence of central banks** so that they cannot come under pressure to finance Member State deficits.[61] The ECB, too, has implied this in one of its statements.[62] This reflects, in the tradition of Sargent and Wallace, a fear of fiscal dominance,[63] in which central banks might become unable to maintain price stability because they would be forced to keep increasing the money supply.

59 See Sigl-Glöckner, Der Zinshammer – Wie Zentralbanken Inflation bekämpfen, Geldbrief, Jan. 28, 2022. (DE)

60 cf. Kern/Sigl-Glöckner/Krahé, Monetary Targeting revisited, p. 11 ff.

61 cf. Schnabel, The shadow of fiscal dominance: Misconceptions, perceptions and perspectives, SUERF Policy Note No. 198, October 2020.; Häde in: Calliess/Ruffert, EUV/AEUV, 6th ed. 2022, Art. 123 TFEU para. 5 with further references (DE); Tutsch in: von der Groeben/Schwarze/Hatje, Europäisches Unionsrecht, 7th ed. 2015, Art. 123 para. 6-8 (DE); in this sense also BVerfGE 154, 17 para. 161.

62 ECB, Opinion on a draft European Council Decision amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro, CON/2011/24, OJ. EC C 140 v. 11.5.2011, p. 8, note 9.

63 cf. BVerfGE 154, 17 para. 175.

First, however, based on what we know today, fiscal dominance in the sense coined by Sargent and Wallace would not prevent the central bank from pursuing price stability, since aggregate demand is controlled through interest rates and not the money supply.

Second, this concern has also been addressed through ensuring the independence of the ESCB (Article 130 TFEU). So far, there is no reason to doubt that its legally-secured independence is anything less than ironclad in practice.[64] To the extent that the ESCB considers the purchase of government bonds necessary for monetary policy purposes, banning or restricting such purchases therefore appears not only to obstruct the pursuit of its inflation target; it also seems disproportionate to place an unjustifiable distrust of the actual preservation of its independence above the effective pursuit of its price stability objective.

To elaborate on this point: neither at the time of the founding of the European Union, nor at any later point, has there ever been any serious reason to doubt the independence of the ECB. The ECB's actions in the face of the economic turbulence in the euro area during and after the financial crisis, the Eurozone sovereign debt crisis, the COVID-19 crisis and now in the context of the Russian war on Ukraine have, of course, led to doubts among some about the ESCB's de facto independence; however, neither the BVerfG nor the media were able to determine whether the ECB was acting *too* independently ("insufficient democratic and judicial control") or *not independently enough* ("fiscal dominance"). It is conceivable that this reflects a fundamental problem for the democratic legitimacy of independent institutions.[65] However, since the actions of the Bundesbank have never given rise to the same lack of trust – at least not in Germany – the voicing of this distrust by German commentators could also be seen as an expression of potential cultural prejudices. Be that as it may: there are no factual grounds for this suspicion, especially considering the fact that Eurozone inflation has long been below its inflation target.[66] Similarly, Article 123 TFEU does not prohibit the reduction (or increase) of key interest rates 'as a safeguard against an ECB ignoring its mandate', which has an even more dramatic effect on government interest burdens than increased (or reduced) bids in bond auctions.[67] Any remaining distrust in the ECB's de facto independence has therefore – and fortunately so, for the price- and economic stability of the euro area – been codified only to an inconsequential extent.

64 See also Neumeier in: Hufeld/Ohler, Enzyklopädie Europarecht, vol. 9 (1st ed. 2022), § 10 para. 59 f. (DE)

65 Paul Tucker in his book Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State (2018), p. 94, could be understood in this sense: "[...] the catalog of realist motivations is hardly conducive to producing enduring legitimacy. Even if political scientists are correct empirically, that does not mean that the resulting structures are sustainable or conducive to trust in government. [...] When it comes to constitutional politics and so to the distribution of government power, realism that does not look beyond the day after tomorrow is a cousin of roulette, as various Western democracies might currently be rediscovering in the reaction against technocracy." This work is also cited by the BVerfG (BVerfGE 151, 202 para. 131).

66 In view of the proven easing effects of bond purchases on general financing conditions, which increase inflation, it is unconvincing to counter that the measures were not intended to increase inflation but to provide financial assistance to Member States. See Kern, Das Anti-Fragmentierungstool des Eurosystems – verständlich erklärt, Geldbrief, July 7, 2022 (DE) and Deutsche Bundesbank, Sectoral Portfolio Adjustments in the Euro Area in the Low Interest Rate Phase, Monthly Bulletin April 2020, p. 19 ff. (27); Congressional Budget Office, How the Federal Reserve's Quantitative Easing Affects the Federal Budget, September 2022.

67 Pursuant to No. 5 sentences 1 and 4 of the Auction rules for the issue of German federal securities, as amended on January 1, 2021, which apply in the tender procedure in accordance with section 1 sentence 2 of the Issuance terms and conditions for Federal bonds, five-year Federal notes, Federal Treasury notes and Treasury discount paper of the German Government, as amended in December 2012, bids may be submitted with or without the indication of a bid price or at different prices. That the interest rate is determined by supply and demand (according to Advocate General Cruz Villalón in his Opinion of 14 January 2015, C-62/14 - Gauweiler, ECLI:EU:C:2015:7, para. 222) is correct in that a low-interest bond will be purchased at a lower price (as a percentage of the nominal amount, No. 5 sentence 1 of the Auction rules for the issue of German federal securities).

The strictest possible ban on bond purchases is therefore **not necessary based on concerns about fiscal dominance**, either. Increasing the money supply would not have an inflationary effect, as the central bank maintains control over interest rates. The ECB and the other central banks of the ESCB are independent. Providing additional "safeguards" to this independence by prohibiting them from using an important monetary policy instrument only harms the effective realisation of their mandate.

3.3 Significance for the interpretation of Article 123 TFEU

The wording of Article 123 TFEU prohibits primary market purchases. With respect to price stability and the general objective of sound public finances (Article 119(3) TFEU), an extensive interpretation of the article is not necessary based on what we know now about the causes of inflation; on the contrary, the current state of knowledge would warrant a narrower interpretation. Based on current understanding, the cause of inflation (deflation) is not an expansion (contraction) of the monetary base, but a strengthening (weakening) of demand, or a contraction (expansion) of supply. Concerning demand management through monetary policy, if an additional strengthening of demand at the effective interest rate floor[68] cannot be achieved by a further reduction in short-term interest rates, bond purchase programs are now regarded as established monetary policy instruments with the aim of achieving a reduction in term premia and thus in long-term interest rates (see above Figure 1). Prohibiting central banks from using this instrument would constitute a severe restriction of their room for manoeuvre. This works against both price stability and, by damaging economic stability, sound public finances.

An updated interpretation of the prohibition should be guided by Article 123's underlying purpose, while also recalling that "sound public finances" as a general economic policy objective of the Union is defined neither by particularly high interest rates nor by frugal spending behaviour, since the soundness of public finances depends on many other factors, the assessment of which has primarily been entrusted not to law but to politics (Articles 121 and 126 para. 2 ff. and para. 10 TFEU).[69] That the recognition of this fact reduces the weight of Article 123 TFEU and thus of the judicial review of monetary policy measures, and that in its place, the precepts of the primary and secondary mandate of the ESCB come to the forefront, is to be welcomed in view of the fact that the article may be considered historically outdated.

68 cf. Benoît Cœuré, "How binding is the zero lower bound?" speech from May 18, 2015. The then-member of the ECB's Governing Council explains in this speech how the existence of an effective interest rate floor below the zero lower bound implies the need for an increased use of bond purchase programs.

69 See also Orphal and Krahé forthcoming, "Sound public finances".

Box 2: The Federal Constitutional Court and the budgetary right of the Bundestag

The protective purpose assigned by the BVerfG to Art. 123 TFEU in order to avert risks to the German budget[70] is subject to its own erroneous assumptions, which must be addressed specifically.

The BVerfG urges a narrow interpretation of the ESCB's powers in order to rule out risks to the German budget that could arise, for instance, if the Bundesbank were to incur losses from bond purchase programs when bonds default. In this **Box 2**, we explain that there are no risks to the federal budget from bond purchases by Eurosystem central banks beyond those generally inherent to participation in a monetary union and that Article 123 TFEU should therefore not be instrumentalised to prevent these general risks.[71] These risks should be taken seriously, but protection against them should be based on the legal standards that have been created for this purpose: Articles 121, 125 and 126 TFEU.

Since the beginning of the PSPP, government bonds have been purchased exclusively by their own national central banks. If, for example, the Austrian government were to default on its bonds, there would be no direct loss for the Deutsche Bundesbank, but only for the Austrian National Bank.

Indirect losses by the Bundesbank would be conceivable in a scenario in which the Austrian National Bank defaults on its TARGET liabilities.[72] Such liabilities may arise, for example, if the Austrian National Bank purchases government bonds from a German commercial bank or if the seller subsequently transfers the bank deposits received to an account at a German commercial bank: in both cases, the credit balance of a German commercial bank with the Bundesbank would increase.[73] For the Bundesbank, this creates a liability vis-à-vis the respective commercial bank.[74] In return, the Bundesbank receives a TARGET claim against the ECB and the ECB receives a claim against the Austrian National Bank.[75] In the event that a default on Austrian government bonds was followed by a default of the Austrian National Bank, the ECB could suffer losses accordingly. These losses would have to be borne jointly by the central banks in the Eurosystem according to the ECB capital key (Article 33.2 of the Statute of the ESCB).

70 BVerfGE 146, 216 para. 68 with further references.

71 See Steinbach in: Hufeld/Ohler, Enzyklopädie Europarecht, vol. 9 (1st ed. 2022), § 6 para. 74 f. (DE): "Until the 1990s, it was not debt that was considered the primary cause of destabilisation, but inflation. The phenomena of the sovereign debt crises are, for Europe, a comparatively recent issue"; see also General Court judgment of 9.2.2022, T-868/16, ECLI:EU:T:2022:58, para. 96; Cruz Villalón Opinion of 14.1.2015, C-62/14 (Gauweiler), ECLI:EU:C:2015:7, para. 219; ECJ judgment of 27.11.2012, C-370/12 (Pringle), ECLI:EU:C:2012:756, para. 135; Hufeld in: Hatje/Müller-Graff, Enzyklopädie Europarecht, vol. 4 (2nd ed. 2021), section 24 para. 8 (DE): "The guarantee and stabilization law, especially the budgetary law of 'sound public finances' (Article 119(3) TFEU), does not consolidate a series of ends in themselves. Certainly objective law, it [...] runs on the peace, values and welfare policy of a European economic policy committed to freedom [...]"; same wording Hufeld/Repasi in: Hufeld/Ohler, Enzyklopädie Europarecht, vol. 9 (1st ed. 2022), section 8 para. 8. (Translation by the authors). (DE)

72 On the functioning of the TARGET2 system at a glance. ECB, What is TARGET2?, 29.6.2016.

73 Annex II to Guideline ECB/2012/27 on a Trans-European Automated Real-time Gross settlement Express Transfer system, Art. 12 and Annex IIa ibid, Art. 12.

74 Annex IV to Guideline (EU) 2016/2249 on the legal framework for accounting and reporting in the European System of Central Banks (ECB/2016/34), Liabilities, item 2.

75 Article 6(2) of Guideline ECB/2012/12 and Annex IV to Guideline ECB/2016/34, Assets, item 9.5 and Liabilities, item 10.4.

However, this case is not foreseen in the regulation on TARGET2 balances (Article 6 para. 2 of Guideline ECB/2012/27): by definition, a central bank does not become insolvent in its own currency unless this follows an explicit decision to do so. TARGET balances *are* central banks' wealth; in the Eurozone, central banks' capital increases are made by increasing their TARGET liabilities accordingly (and increasing their participating interest in the ECB in the same amount). "Rather, the amount required for the capital increase is in fact created by money creation."[76] In this respect, the question arises as to whether the crediting of TARGET2 balances is still a matter of "claims", or whether it is not already money itself or simply a balancing item.[77] In 1973, for example, the Bundesbank had negative equity of almost 7 billion German Marks, which it reported as a "balance sheet loss".[78] Former Bundesbank President Schlesinger made the following comments in an essay in the Bundesbank staff periodical:

"From a purely legal point of view, the Bundesbank was over-indebted because the loss carry-forwards significantly exceeded its equity capital. Although we had a negative balance, we were not insolvent because we were ultimately able to print the money ourselves. In the Central Bank Council, we discussed whether the government should pay for the losses. [...] We refrained from doing so. But the bottom line, of course, was that the government shared the cost because we didn't transfer profits to the federal government for a number of years until the loss carry-forward had been ablated."

Even if the Bundesbank were to incur a loss, there would be no constitutional obligation to make additional contributions to the federal budget. Money is *created* at the central bank. The federal government's obligation under Article 88 of the Basic Law to establish a monetary and central bank is not a financial one, but an institutional one;[79] the federal government must ensure the Bundesbank's ability to function, not its financing balance.[80]

The federal budget would thus only be threatened with an imputed loss in the form of lost profits if it were explicitly decided that another national central bank would now no longer fulfil its "obligations" vis-à-vis the Eurosystem (i.e. that TARGET2 balances would no longer be settled). In this case, too, the only loss to the federal budget would be the lost Bundesbank profit (section 27 no. 2 BBankG), which would be reduced proportionately in relation to the ECB capital key. However, the Member States consciously assumed this risk in the event of a breakup of the monetary union when they entered into a monetary union in the first place: as early as 1990, the Bundesbank emphasised that the participating economies would be "inextricably linked to one another in the monetary field, come what may."[81]

76 Opinion of Advocate General Juliane Kokott from 31.3.2022, C-45/21 - Banka Slovenije, ECLI:EU:C:2022:241, paras 61 ff., 62.

77 On this Sahr, Between Duties and Fictions: The Political Dimension of the Euro from the Perspective of a Relationist Sociology of Money, Zeitschrift für Soziologie Vol. 48 No. 3 (2019), p. 209 ff.

78 Annual Report of the Deutsche Bundesbank, 1973, p. 82. (DE)

79 See on this topic Remmert in: Epping/Hillgruber, BeckOK GG, 51st ed. as of 15.5.2022, Art. 88 para. 2 f. (DE)

80 See Ohler in: Schmidt-Bleibtreu/Hofmann/Hennecke, Grundgesetz, 15th ed. 2022, Art. 88 para. 6. (DE)

81 German Bundesbank Monthly Report, October 1990, p. 4.

The BVerfG took a similar view in a 2014 ruling. According to the court, the complainants had "not shown how and to what extent the implementation of the TARGET2 system could impair the overall budgetary responsibility of the German Bundestag [...]."[82] Nor had it been explained "why the formation of balances is tantamount to a liability mechanism [...] and how and to what amount liability risks arise to the Federal Republic of Germany" or how "the existing TARGET2 balances considerably impair the Federal Republic of Germany's decision-making power, for instance with regard to exiting the euro currency area."[83] The idea that, after such statements, it would now identify a threat to overall fiscal responsibility from TARGET2 balances in the case of bond purchases by itself, would at a minimum, be surprising.

Against this background, the role of Article 123 TFEU is clearly not to minimise hypothetical risks of loss for the federal budget in the event of the breakup of the monetary union, but to ensure price stability. It should therefore not be interpreted in a way that runs counter to its actual purpose of achieving price stability in the name of the Bundestag's budgetary right.

The Federal Constitutional Court understandably attempts to specify the limits of the ESCB's mandate in order to prevent a creeping transfer of competences to the European level.[84] The court also understandably tries within the legal framework to exclude risks for the German budget.[85] However, this objective cannot be convincingly achieved by means of a particularly strict and expansive interpretation of the prohibition on primary market purchases (Article 123 TFEU), as we explain in Box 2. The objective of Article 123 TFEU is to ensure price stability, the achievement of which is made more difficult by an extensive interpretation. Instead of interpreting Article 123 TFEU contrary to its own purpose, the protection of the German budget should be pursued through Articles 121, 125 and 126, which were expressly provided for this purpose.

With reference to the prohibitions developed in the case law, a non-monetarist interpretation of Article 123 TFEU has the following implications:

- The ECJ's second prohibition, which prohibits action with an equivalent effect to primary market purchases (such as secondary market purchases explicitly communicated to primary market purchasers in advance), should be discarded. It does not advance the purposes of Article 123. It can only serve these purposes coincidentally, and otherwise only do harm.

82 BVerfGE 135, 317 para. 139.

83 BVerfGE 135, 317 para. 140.

84 BVerfGE 154, 17 para. 103 f., 105 ff.; especially clear in ibid. para. 140, 142 f. cf. the delineation of economic and monetary policy.

85 See above footnote 68 and BVerfGE 154, 17 para. 222 ff.

- The third prohibition of the ECJ, according to which the objective pursued by Article 123 TFEU must not be circumvented by secondary market purchases (prohibition on circumvention), would have to be developed further on the basis of an open understanding of "sound" public finances. It is correctly oriented towards the purpose of the standard. However, its original purpose of preventing increases of the money supply to prevent inflation has now been refuted in its causality. A second purpose is seen by the ECJ in the pursuit of sound public finances with, again, the overriding objective of price stability. In the hierarchy of objectives of Article 123 TFEU, sound public finances serve to ensure price stability. On this basis, the appropriate question to ask of bond purchases on the secondary market is whether they serve the objective of price stability. If it is the case, ancillary objectives such as economic policy coordination and fiscal discipline should not be set in opposition to the pursuit of price stability by central banks, but should be enforced according to their own rules (Articles 121 and 126 TFEU).
- The Federal Constitutional Court should let go of tying the protection of the Bundestag's budgetary responsibility to Article 123 TFEU, through which it has derived ever more detailed requirements and prohibitions. That was never the purpose of Article 123. Its purpose was to prohibit monetary financing out of fear of the inflationary effects of an expansion of the money supply. In its current interpretation by the Federal Constitutional Court, however, Article 123 TFEU unnecessarily limits the room for manoeuvre of monetary policy and thus potentially prevents the achievement of price stability. A reinterpretation in our sense would not weaken the protection of the Bundestag's budgetary sovereignty. On the contrary, we maintain that the Bundestag's budgetary right should continue to be protected, but that this protection should be based on those legal benchmarks that were actually created for this purpose: Articles 121, 125 and 126 TFEU.

4. Conclusion

The understanding of economic relationships changes over time. Rules and regulations, once written, do not – until and unless they are formally changed.

The Maastricht Treaty contains various objectives, the macroeconomic foundations and (contemporary) presuppositions of which are reflected in the chapter on Economic and Monetary Union. The instruments chosen to pursue these goals were influenced by contemporary assumptions about how the economy works.

While the goals stay the same – price stability, sound public finances and the protection of Member State budgets –, our understanding of how the economy works has changed. We now know monetarism to be a false description of the world. It is the task of jurisprudence to integrate such changes into the interpretation of the relevant rules.

Central banks around the world have abandoned the attempt to control inflation through controlling the money supply. Article 123 TFEU persists. However, jurisprudence offers the possibility to reflect these advancements in economic knowledge within the law as well. This requires acknowledging that economic interrelationships are not only the subject of economic theory, but are also the subject of law in Article 123 TFEU and its interpretation. What is needed today is therefore a new interpretation of the prohibition on monetary financing: a **non-monetarist interpretation of Article 123 TFEU**.

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