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Reforming Economic and Monetary Union:

The ECB's Transmission Protection Instrument

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At a Glance

In principle, the TPI is suitable to fill a relevant gap in the institutional framework of the euro area. In times of high economic uncertainty and changing expectations, financial markets can trigger an unwarranted self-fulfilling prophecy toward a market equilibrium with high interest rates and unsustainable public debts in countries with elevated debt levels. In such a scenario, the transmission of monetary policy and thus the ECB's primary objective of price stability will also be negatively affected. The ECB with its potentially large market power can help stabilise market expectations and prevent interest rates from spiralling out of control in an unwarranted way.

However, fiscal policy must also play its part. The phenomenon of multiple equilibria usually only arises in countries with elevated debt levels. Therefore, the main objective of the euro area governance framework should be to lower public debts over the medium term in a sufficiently growth-friendly way.

The ECB should not be allowed to use the TPI to cover excessive government spending. This would open the door to so-called fiscal dominance – a situation in which a central bank no longer clearly prioritises price stability, but feels responsible for ensuring fiscal sustainability in highly indebted countries. The TPI in its current form poses several additional dangers. It is unclear how the ECB can distinguish between a warranted and unwarranted increase in interest rate spreads. On top of that, with a lax interpretation of the eligibility criteria the TPI could create moral hazard and might result in large losses. In its current form, it could even prove legally problematic. In view of these problems, several reforms are required. In general, the ECB should use the TPI with great caution and only when necessary. Clear evidence is needed that the transmission mechanism is impeded and that spread increases are unwarranted by economic fundamentals. When the ECB intervenes, it should concentrate on the shorter maturity spectrum of one to three years, as this spectrum is relevant for the transmission. Moreover, the ECB should publish more details on the TPI with regard to, for example,

the distinction between warranted and unwarranted spread increases, the treatment of the eligibility criteria and the planned characteristics of possible secondary market interventions.

For legal reasons, the ECB intends to keep a large degree of discretion in deciding on the eligibility of countries. However, the conditionality criteria must be reliable in order to prevent moral hazard. Moreover, the ECB’s large discretion raises serious concerns about legality and democratic legitimacy. A better solution would be to involve the European Stability Mechanism (ESM), as is the case with the OMT. This arrangement is legally sound, offers a reliable form of conditionality, and is democratically legitimate, because the ESM is governed by elected politicians. As the pre-existing OMT requires an ESM programme with ex post conditionality, this does not appear appropriate at present. For this reason, the proposal by some experts to abolish the TPI and to simply rely on the OMT does not seem reasonable. A reform of the ESM, which has nearly been completed, offers a solution. Among other issues, the reform introduces a new programme that – like the TPI – is also based solely on ex ante conditionality with quite similar criteria – a new PCCL (Precautionary Conditioned Credit Line). Therefore, the ECB should base the TPI eligibility on the condition that the respective country uses the new PCCL. Decisions about the eligibility criteria for the new PCCL would rest with the democratically legitimised ESM. An even better option would be to replace the TPI by a reformed OMT. The reform should condition sovereign bond purchases on an ESM programme that reflects the economic fundamentals of the respective country. If fundamentals are sound, only a new PCCL would be required. If fundamentals are less sound, the country would have to take up an alternative, appropriate ESM programme.

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1. Introduction

After the Russian invasion of Ukraine and the ensuing energy crisis, it was feared that the highly indebted euro area countries might be fiscally overburdened. A dangerous combination of burdensome factors put pressure on government budgets (see Paper 1). Even before the war began, public debt had already increased significantly in the course of the Covid-19 pandemic, and the green and digital transition required higher government spending in the medium term. Moreover, the European Central Bank (ECB) had started to raise interest rates to counter previously underestimated high inflationary pressures. The energy crisis put additional pressure on public spending to cushion the worst impacts on the private sector. Moreover, higher energy prices further worsened the inflation outlook. Therefore, the ECB was forced not only to increase interest rates steeply and rapidly, but also to end its sovereign bond purchase programmes. Against this backdrop, the risk premia on sovereign bonds of highly indebted countries started to rise considerably as financial markets became nervous.

In view of this development, the ECB introduced a new instrument to prevent and counteract a looming fragmentation of government bond yields among euro area countries, the so-called Transmission Protection Instrument (TPI) (ECB, 2022a). It allows the ECB to intervene in government bond markets under certain conditions in order to counteract the above-mentioned development, which the Governing Council of the ECB considers inappropriate. This instrument induced a controversial discussion about its justification. While the ECB President Christine Lagarde said "I think it's a rather historical moment for me" (ECB, 2022b), others considered this instrument as "toxic" (Feld et al., 2022), close to monetary financing or as an invitation to fiscal profligacy (e.g. Feld et al., 2022; Heinemann, 2022; Meyer/Hansen, 2022; Peter, 2022).

This paper provides an overview of the academic discussion that followed the introduction of the TPI and proposes changes to it. After introducing the TPI in chapter 2, the pros (Chapter 3) and cons (Chapter 4) of the TPI are discussed, before chapter 5 concludes with a summary and concise recommendations.

This publication is the second part of a series of three interdependent papers:

- In Paper 1 (Kauder et al., 2023) the overarching problem is set out that the EU is challenged by high government spending demands that collide with already high levels of public debt in many member states and with a worsening outlook for public debt sustainability. Against this background, the authors evaluate the European Commission's reform proposal for the Stability and Growth Pact and conduct a public debt sustainability analysis showing that a lax fiscal policy stance could lead to a sovereign debt crisis.
- The present paper warns that ignoring the conflict between high spending requirements and elevated debt levels by increasing government expenditures too generously and by addressing the emerging problems for public debt sustainability with a lax TPI would be a dangerous and legally problematic strategy. Rather, the ECB's intervention programme should be linked to the ESM, which is better suited to tackle the trade-off between preventing undue nervousness in financial markets and offering reliable conditionality.
- Paper 3 (Matthes, 2023) recommends to reactivate the European Stability Mechanism (ESM) in order to flank potential dangers for public debt sustainability with a newly introduced instrument that is better suited to the current situation than the existing ones. Moreover, it is pointed out that the large funds of the NGEU should be used to mitigate the above-mentioned conflict between high spending demands and elevated debt levels.

2. Characteristics of the TPI

On 21 July 2022, the ECB announced the TPI. Its aim is to “counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area” (ECB, 2022a). According to the ECB, the sound transmission of monetary policy is crucial to ensure the consistency of monetary policy across the euro area, which is regarded to be a precondition for price stability. The TPI allows the ECB to purchase securities in the secondary market, with a focus on public sector securities, with maturities between one and ten years. If private sector securities are considered appropriate, they may also be purchased.

The ECB (2022a) has outlined four eligibility criteria to assess whether country-specific macroeconomic conditions justify the activation of the TPI for the respective country:

- Compliance with the EU fiscal framework, which means neither being in an Excessive Deficit Procedure (EDP) nor being non-compliant with European Council recommendations when being on the verge of an EDP;
- absence of severe macroeconomic imbalances, in particular not being subject to an Excessive Imbalance Procedure (EIP);
- fiscal sustainability as measured by the trajectory of public debt based on debt sustainability analyses of other institutions (e.g. European Commission, ESM, IMF), where available, and internal analysis;
- compliance with the commitments laid out in the respective Recovery and Resilience Plans for the Recovery and Resilience Facility (RRF) and the European Commission’s country-specific recommendations in the framework of the European Semester in the fiscal sphere.

In general, the activation of the TPI will depend on a decision made by the Governing Council of the ECB. This decision will be based on the following three-step analysis (ECB, 2022a; European Parliament, 2022):

- A comprehensive assessment of market and transmission indicators,

- an evaluation of the eligibility criteria,
- an assessment of the proportionality of activating the TPI to the achievement of the ECB's primary objective of price stability.

However, it is stressed that there is an element of discretion and judgment on part of the Governing Council regarding the activation of the TPI. In particular, the eligibility criteria will only 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, 2022a).

There are additional important characteristics to be mentioned:

- Ex ante, there is no limitation to the securities purchases under the TPI. The amount would depend on the severity of the risks to the transmission of monetary policy.
- There is no credit seniority of the securities purchased under the TPI, the ECB's creditor status is pari passu with any other creditor, meaning that it is treated equal to any other creditor in case of insolvency.
- The reinvestment flexibility of the PEPP (Pandemic Emergency Purchase Programme) will continue to be the first line of defence to counter risks to the transmission mechanism.

The PEPP is an unlimited ECB securities purchase programme – now expired – that was set up in reaction to the Covid-19 pandemic in March 2020. It was meant to stabilise the economy and to tackle potential risks to the transmission of monetary policy. The PEPP was terminated at the end of March 2022 due to rising inflationary pressures (ECB, 2023). However, the stock of sovereign bonds purchased by the Eurosystem since 2020 will be kept stable at least until the end of 2024. Thus, when the sovereign bonds held by the ECB on its balance sheet reach their final maturity and are repaid, the ECB will buy new sovereign bonds from euro area member states in similar amounts. Usually, the ECB would replace, for example, maturing German sovereign bonds with new German sovereign bonds purchased on the secondary market. However, the PEPP offers the possibility of flexibly changing the structure of its

holdings, i.e. substituting German bonds with Italian bonds, for example. However, this flexibility is obviously limited to the amounts of sovereign bonds falling due in total – thus the need for the TPI as a second line of defence.

Table 1: Comparison of OMT to TPI

	OMT	TPI
Publication date	26 July 2012	21 July 2022
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 (either a full programme or a ECCL), both with the requirement of a Memorandum of Understanding and ex post conditionality in the form of reform requirements.	Criteria to take into consideration: (1) Compliance with the EU fiscal framework. (2) Absence of severe macroecon mic 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	The ECB is **treated in the same way as private or other creditors** with respect to bonds issued by euro area governments.	The ECB is **treated in the same way as private or other creditors** with respect to bonds issued by euro area governments.
Purchase parameters	Sovereign bonds with a remaining maturity of **1 to 3 years.**	Public sector securities with a remaining maturity of **1 to 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.**	The TPI purchases would be conducted in such a way 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 the Eurosystem balance sheet.
Actual use	Not yet	Not yet

Table 1 – Source: Bernoth et al., 2022a, with limited additions by the German Economic Institute

In fact, the PEPP was heavily used in June and July 2022, before the TPI was established at the end of July. During these two months, the ECB intervened strongly to the benefit of vulnerable euro area countries in Southern Europe. This induced a shift in the Eurosystem's PEPP holdings. The holdings (or net purchases) of sovereign bonds of core countries declined by nearly 19 billion Euro in total, i.e. for Germany (-14.3 billion Euro), the Netherlands (-3.3 billion Euro) and France (-1.2 billion Euro). At the same time, net purchases of sovereign bonds of peripheral countries increased considerably in June and July 2022 for Italy (9.8 billion Euro), Spain (5.9 billion Euro), and Greece (1.1 billion Euro). The ECB's interventions happened as Mario Draghi's government in Italy stumbled and Draghi eventually resigned in mid-July. Angeloni et al. (2022) point out that for Italy, Spain, and Greece this can be considered a significant intervention by historical standards.

The TPI can be compared to another securities purchase programme – the OMT (Outright Monetary Transaction) programme. The OMT was introduced in 2012 at the height of the euro debt crisis (Table 1) – nearly ten years before the TPI.

3. Pros

Views differ on the pros and cons of the TPI. As is often the case, views tend to diverge between the Southern and Northern European countries. This chapter first outlines the arguments for introducing the TPI and the perceived benefits of this new instrument from the proponents' point of view. Then, in a more detailed section, some important pro-arguments are put into perspective and further aspects of criticism are added. This reflects the fact that a majority of the discussants criticise the TPI or at least certain aspects of it.

As pointed out above, interest rate spreads, particularly of Italian sovereign bonds, rose considerably in the months after the Russian invasion of Ukraine and during the period when it became clear that the ECB would raise interest rates considerably and would refrain from purchasing sovereign bonds to increase its balance sheet. The ECB viewed the symmetrical transmission of its monetary policy in the euro area and thus its objective of achieving price stability endangered.

The relatively hasty introduction of the TPI appears to reflect the concern at the time that particularly Italian interest rates could spiral out of control. In fact, Figure 3–1 illustrates that interest rate spreads of Italian government bonds increased by about 100 basis points from about 150 to about 250 basis points between the end of March 2022, when the PEPP was terminated, and mid-June 2022 (or the end of July). As the ECB intervened heavily during June and July 2022 by reshuffling PEPP holdings (Chapter 2), spreads would probably have risen more without the ECB. In such a situation, a vicious circle can be set in motion with several factors mutually reinforcing each other (e.g. rising interest rates, rating downgrades, fiscal austerity, declining growth perspectives and bank losses) – until public debts appear no longer sustainable and sovereign solvency is endangered.

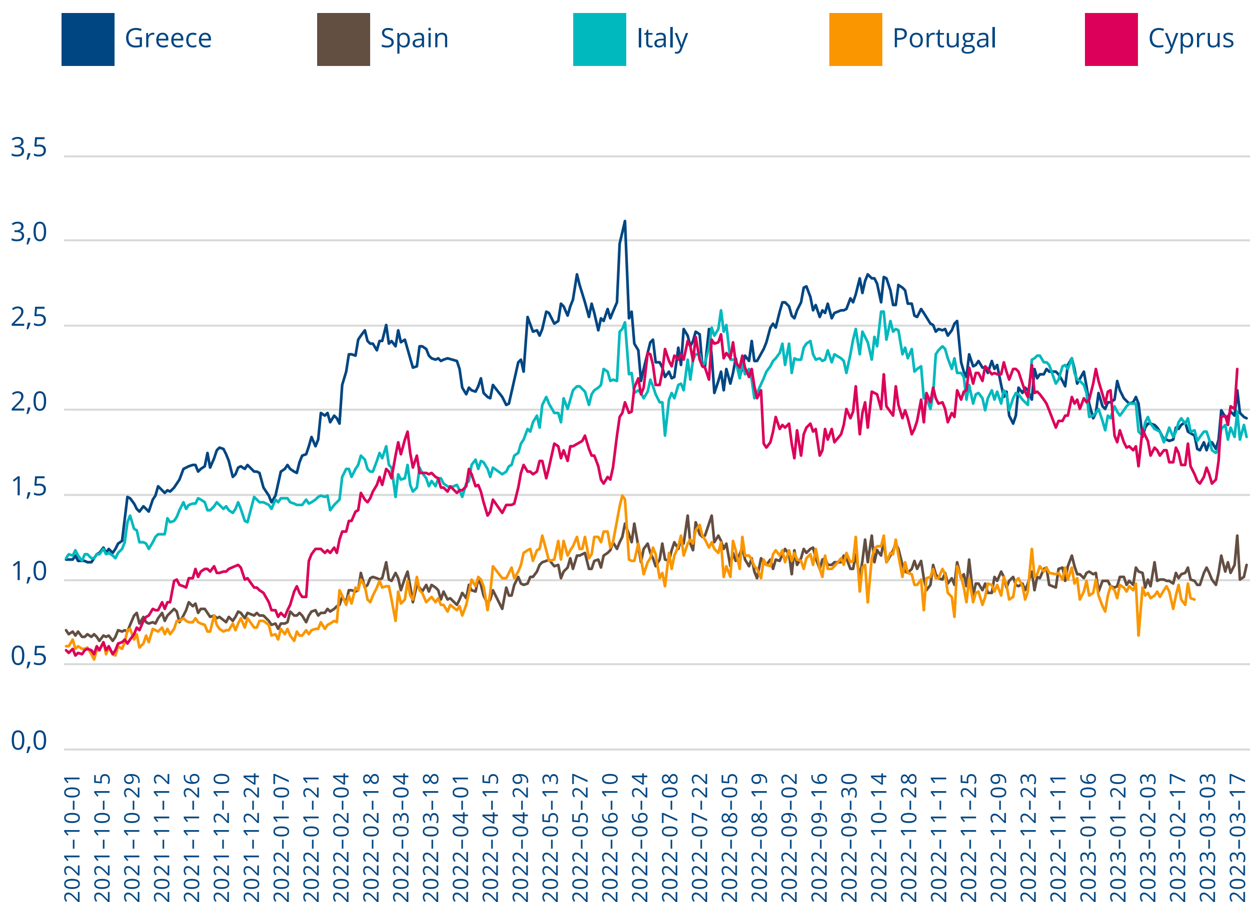
Without doubt, a sovereign debt crisis in the euro area would be highly detrimental. This is particularly true as the European economy is facing various serious challenges:

- When Russia invaded Ukraine, European countries were still

recovering from the crisis due to the Covid-19 pandemic and from severe supply chain frictions.

- The ensuing energy crisis hit Europe hard and dampened the recovery.
- The green and digital transformations have to be financed.
- Demographic trends limit the growth potential in the near future.

Figure 3–1: Interest rate spreads of selected euro area countries
Difference between the 10-year government bond yields of selected countries and Germany since October 2021 in percentage points



Sources: Macrobond; German Economic Institute

A sovereign debt crisis – and a probably connected larger financial crisis – would have significantly weakened Europe in economic and political terms.

Such a development would have been particularly problematic, because Italian government debts can be considered sustainable in 2022 and 2023 based on economic fundamentals (see Paper 1). However, due to the numerous challenges for Europe and due to the high uncertainty after the invasion of Ukraine, financial markets became nervous and risk aversion increased considerably. In such a situation, the economic phenomenon of multiple equilibria can become relevant.

Multiple equilibria imply that different combinations of interest rates and of views about public debt sustainability can occur under the same fundamental economic conditions in countries with elevated debt levels – depending on financial market expectations (De Grauwe, 2011; Wyplosz, 2011; De Grauwe/Ji, 2012; Rangvid, 2002a). If financial market actors regard public debts to be sustainable, they demand low risk premia, so that interest rates are low – and debts actually appear sustainable. If, on the contrary, financial market actors doubt sustainability, they demand high risk premia which can lead to a self-fulfilling prophecy and eventually to a sovereign debt crisis. The key insight is that a mere change in expectations – rather than irrational speculation – can lead to such an outcome in countries with elevated debt levels. In the current situation, where uncertainty is very high and interest rates are rising sharply, such a shift of expectations is more likely than in normal times. The ECB can help stabilise expectations at the good equilibrium with the TPI.

Fiscal policy could also potentially contribute to stabilising expectations. During the Covid-19 pandemic, this aim was achieved through quickly designed large fiscal support, involving a new ESM programme and eventually the creation of the NGEU. After the Russian invasion, fiscal space in 2022 was more limited due to the debt increase caused by the Covid-19 pandemic. At the same time, the need for fiscal measures to cushion rising energy costs arose. Thus, concerns about fiscal space and fiscal sustainability came up and fiscal policy was far less able to act as a stabilising factor, but added to uncertainty. Therefore, one

could argue that in this situation only the ECB was able to achieve stabilisation in a credible way.

To make the TPI work in the desired way, several aspects are relevant (see Chapter 4 for a critical discussion of the following propositions):

- The ECB would have to distinguish between justified and unjustified spread increases. Econometric models and comparisons with former periods can facilitate this decision.
- While the TPI would increase the risk of losses for the ECB and eventually for European taxpayers, this can be regarded as being in the interest of Northern European countries in order to strengthen the EU in the currently challenging geopolitical times (Tillmann, 2022).
- The approach of basing the TPI on the above-mentioned eligibility criteria introduces a kind of ex ante conditionality. Even though the ECB reserves room for discretion, countries can only be sure that the TPI will be available to them if they fulfil the four conditions listed. As the TPI is a powerful tool, it is hoped that this approach can strengthen incentives to stick to the relevant rules of economic governance in the euro area (Redeker, 2022; Sandbu, 2022).
- Keeping important features of the TPI unpublished can be seen as important (ECB, 2022b). Such constructive ambiguity may contribute to preventing the financial market from speculating against the ECB, as the risks of such a strategy are high and difficult to evaluate.

If the TPI is successful and stabilises the expectations of financial markets, its mere existence could suffice – as was the case with the OMT.

4. Cons

After this positive view of the TPI, this chapter focuses on various aspects of criticism.

4.1 Lack of transparency

Information about important details concerning the TPI is not available. To some extent, this can be explained by the above-mentioned need for constructive ambiguity which some see as a precondition for the effectiveness of the TPI.

However, the lack of transparency about important features of the TPI goes too far, as will be pointed out in this chapter on the drawbacks of this new programme. In particular, information is missing on the following aspects (Angeloni/Gros, 2022; Bernoth et al., 2022a; 2022b; Wellink, 2022):

- How and what kind of sovereign bonds the ECB will purchase,
- how the ex ante conditionality will be decided upon,
- whether and how risks will be shared among the national central banks (NCBs) of the Eurosystem, and
- what general criteria the ECB will apply to determine that transmis sion is affected by "unwarranted, disorderly market dynamics".

4.2 Problems with the distinction of warranted and unwarranted spreads

The latter aspect refers to a major point of contention. Since the TPI was introduced as a tool that can be employed more easily than the OMT, it is even more important to be sure that the TPI is only activated when high or rising spreads are not based on economic and political fundamentals. Several experts criticise that such a distinction is hardly possible in practice (e.g. Bernoth et al., 2022a; 2022b; Feld et al., 2022; Rangvid, 2022b).

Econometric models can assist with such a distinction, as for example is shown by Bernoth et al. (2022b). In some cases, the situation will be quite clear – either black or white. In other cases, reality will be

more difficult to analyse, as shades of grey will prevail. Even experts in the field of econometrics and economic models concede that it is basically impossible to estimate the 'right' price for a financial asset (Rangvid, 2022b) – and in particular to estimate the level of risk spreads justified by economic fundamentals (Bernoth et al., 2022b). The ECB surely has well-versed and highly competent economists and econometricians, but even their ability to make the required distinction is limited by the complexity of reality.

4.3 Moral hazard and legitimacy concerns due to unclear conditionality

The ECB has put up the four general eligibility conditions mentioned above. However, it retains a large degree of discretion in its decision to activate the TPI. While relying on ex ante conditionality is basically a valuable approach suitable for the current situation, the ECB's large discretion could undermine the potential of setting up ex ante conditionality as a qualification hurdle. This construction could even be problematic in legal terms, as the ECB is to some extent venturing into the field of economic policy (see Chapter 4.4.3).

Conditionality is indispensable because otherwise moral hazard problems would arise. If no conditions were attached to the ECB's support, the EMU member states' incentives for sound fiscal policy would be significantly lower. The ECB would then act as a kind of insurer against high or rising spreads (Meyer/Hansen, 2022). This problem was also clearly acknowledged by former ECB President Mario Draghi in relation to the OMT (Feld et al., 2022). If financial markets could broadly rely on the ECB to step in, financial market discipline would be weakened and lax fiscal policies would be less restricted by rising risk premia and interest rates. However, this concern is hardly mentioned in the ECB's current communications (Heinemann, 2022). Bernoth et al. (2022b) show that between 2012 and 2014 – after the OMT had been introduced (and although it was not used) – financial market discipline turned out to be weak: During this period, higher government debts went hand in hand with lower interest rate spreads – the opposite of what would have been

expected, if financial market discipline had worked. This could also apply to the TPI, even if it was not actually used.

Moreover, the problem of time inconsistency will be relevant in relation to moral hazard concerns. Would the ECB really be willing to let a country fall into a sovereign debt crisis, if the respective government clearly deviated from the path of sound economic policy? With the TPI in place, the withdrawal of this instrument would be a clear testimony of a problematic economic policy and an invitation to financial markets to move toward a bad equilibrium. However, to prevent such a scenario, the OMT could come into play if the government were willing to apply for an ESM programme with ex post conditionality. Yet, if the government were to refuse this, the same dilemma would occur with the OMT as with the TPI.

It should also be critically noted that the PEPP reinvestment flexibility as a first line of defence is completely without any particular conditionality, which also appears problematic and could cause moral hazard problems (Heinemann, 2022). However, this is likely to be a temporary phenomenon, as the ECB is likely to fully terminate the PEPP in the longer term and thus gradually reduce its holdings of sovereign bonds purchased under the PEPP.

Ex ante conditionality tends to be a weaker and less intrusive approach than ex post conditionality, which usually involves an ESM programme with reform requirements. Basically, ex ante conditionality can be useful (see Chapter 3). However, Redeker (2022) questions whether the ECB's approach can be effective by taking a closer look at the interaction between the TPI and the individual eligibility criteria. The author argues that, in principle, the TPI gives the European Commission a stronger hand in dealing with highly indebted countries and thus has the potential to strengthen the fiscal and macro-economic discipline and compliance with EU rules. However, he also sees the danger that the connection of the TPI to the EDP and the EIP could make it even less likely for the European Commission and the Council to decide that member states are not complying with these rules. Moreover, the RRF and European Semester lack clear procedures for defining non-compliance, which would make it more difficult for the ECB to judge eligibility. Overall, he argues that the

TPI puts an even larger burden on policymakers (see also Sandbu, 2022).

Another point of contention concerns the lack of democratic and political legitimacy of the ECB as an institution whose decision-makers are not elected. A clear dilemma becomes obvious here: On the one hand, only the ECB has the power to stabilise nervous financial markets with a high degree of certainty, while on the other hand, the ECB should not play too large a role in the game. It would be highly problematic if the ECB eventually decided the fate of a more or less populist government and whether an economy or society would fall into a deep crisis resulting from a sovereign default (Heinemann, 2022). Such decisions must be made by elected political decision-makers. Overloading the ECB with such kind of power can undermine its independence, as the ECB would be drawn into the political arena (Bernoth et al., 2022b).

4.4 Legal risks

The information available on the TPI leaves open the question of whether this new instrument is legal under the provisions of the EU Treaty and jurisprudence. Should it turn out that the TPI exceeds the limits of the ECB's competences, this would be highly problematic not only from a political but also from an economic point of view, as this would come as a shock for the financial markets and reintroduce a high degree of uncertainty. It is therefore important to ensure legal compatibility and to take a closer look at potentially problematic aspects of the TPI.

Apart from the EU Treaties, rulings by the Court of Justice of the European Union (CJEU) and the German Constitutional Court (GCC) on former purchase programmes of sovereign bonds define the scope of the legal compatibility of the TPI (Höpner, 2020; Whelan, 2020, Bernoth et al., 2022a; Nicolaides, 2022):

- The OMT was subject to criticism by the GCC (BverfG, 2014/2016) which questioned its legal basis but submitted the case to the CJEU which published its judgement ("Gauweiler") on 16 June 2015 (CJEU, 2015). On this basis, the GCC (2014/2016) also consented on 21 June 2016. In this process, important constraints were established for the OMT.

- Another, even more controversial case concerns the PSPP, a securities purchase programme, also of government bonds that started in 2015 to tackle deflationary tendencies. Again, the GCC saw the programme very critically and submitted the case to the CJEU. The CJEU's (2018) "Weiss" judgement of 11 December 2018 did not find the consent of the GCC in its ruling of 5 May 2020. The GCC criticised the CJEU ruling fundamentally and stated that the CJEU exceeded its competencies. The press release reads as follows: "The review undertaken by the CJEU with regard to whether the ECB's decisions on the PSPP satisfy the principle of proportionality is not comprehensible ... ; to this extent, the judgment was thus rendered ultra vires." (BverfG, 2020) As a result, the European Commission intended to open an infringement proceeding against Germany. However, the problem was solved in principle: The Deutsche Bundesbank, as part of the Eurosystem, provided reasoning and rationales to the German Bundestag to prove that the ECB had made a sufficient proportionality assessment.

In the following, several important legal aspects are discussed based on the existing rules and rulings and the consequences for the TPI are laid out.

4.4.1 Prohibition of monetary financing

The ECB is prohibited from providing monetary financing. Article 123 of the TFEU states: "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 Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments."

Several aspects play an important role in the analysis of whether an ECB purchase programme of sovereign bonds constitutes monetary financing. The existing rulings provide some guidance as to how a treaty breach can be prevented.

Primary and secondary market differentiation of OMT and PSPP

An important distinction needs to be made regarding the exact procedures by which the ECB buys sovereign bonds. The ECB is prohibited from doing so on the so-called primary market, i.e. the market where governments sell their bonds to investors, as this would clearly imply financing government budgets. In addition, there is a so-called secondary market, where only investors trade sovereign bonds among each other. It is this secondary market where prices and interest rates (yields) of sovereign bonds are determined on a continuous basis. When the ECB buys sovereign bonds on the secondary market, the investors obtain the money in exchange – and not the government. However, the interest rate conditions between the secondary and primary markets are to a large extent connected.

The CJEU rulings establish important conditions for the purchase of sovereign bonds on the secondary market (Bernoth et al., 2022a; Nicolaides, 2022). The key objective is to prevent banks or other investors, who buy the bonds on the primary market, from being sure that they can subsequently sell these bonds to the ECB on the secondary market. In general, market participants must not be able to predict the ECB's purchases and there must be time lags between the issuance of bonds on the primary market and the ECB's purchases on the secondary market. Moreover, de facto quantity limits are required. This is also to ensure that sovereign bonds remain subject to the market price mechanism. Also for this purpose, the ECB should not hold the purchased bonds until maturity, as this would completely eliminate the price formation mechanism for these bonds. The CJEU has found that the OMT programme is in line with these requirements.

The TPI remains silent on these conditions. However, it can be assumed that the ECB is well aware of the limits set by the CJEU and probably has internal plans that go in this direction.

Selectivity

The court rulings have also raised concerns about selectivity, i.e. the fact that selective interventions in the sovereign bond market could imply

monetary financing in favour of the respective member states. These concerns are related to the fact that monetary policy is usually applied throughout the euro area in a common way. Sovereign bond market purchase programmes for general monetary policy objectives, such as the PSPP, are not selective. This issue was highlighted by the CJEU (and also by the Advocate General at the CJEU) to justify the compatibility of the PSPP with EU law (Article 123).

On the contrary, the OMT also has a selective design. However, the CJEU also found the OMT to be compatible with the prohibition of monetary financing, because it was based on the ECB's perception that excessive risk premia prevailed before the OMT was introduced. At that time, the ECB maintained that financial actors unwarrantedly feared a break-up of the euro area.

As the TPI is also selective, its compatibility with EU law Article 123 will also rest on the unwarranted and excessive nature of interest rate risk premia – but this is difficult to prove (Chapter 4.2). However, concerns about the TPI may be significantly larger than for the OMT, as the TPI has less strings attached to it.

Potential sovereign debt restructuring

Another issue relevant to the prohibition of monetary financing relates to potential sovereign debt restructurings in which the ECB would be involved as a holder of the respective sovereign bonds. In the event of a debt restructuring, the bondholders usually agree or are forced to waive a certain share of their outstanding claims against the respective sovereign. If the ECB was among the creditors, this would imply that the ECB provided money to the sovereign in the past that is not fully repaid. This could be understood as monetary financing. However, the CJEU's rulings are interpreted as allowing the ECB to participate in a sovereign debt restructuring that is decided by "other creditors" – thus without the ECB explicitly agreeing to the restructuring (Whelan, 2020).

While this condition prevents a sovereign debt restructuring from being considered monetary financing, the problem of moral hazard (Chapter 4.3) may arise. In fact, the ECB's prohibition from actively con-

senting to a sovereign debt restructuring could render such a step basically impossible.[1] This raises moral hazard concerns, as a government that leads a country into a sovereign default is very likely to fail at the next elections. Thus, the threat of a potential sovereign default can act as an important incentive against fiscal profligacy.

Since the ECB has bought considerable amounts of sovereign bonds in the course of the PSPP and partly also under the PEPP, the question arises whether the Eurosystem's share has already approached the level of one-third, so that this threshold would be exceeded for individual countries if the TPI were used to a considerable extent.

4.4.2 Loss risks for the ECB and taxpayers

The ECB's purchases of sovereign bonds entail the risk of loss for the ECB, i.e. for the Eurosystem including NCBs which usually purchase most of the bonds of their respective sovereign – for several reasons.

First, in case of sovereign restructurings, the sovereign bonds bought by the Eurosystem under the TPI would participate pari passu, i.e. to the same extent as other bonds, as the ECB does not have preferred creditor status. Such a step could imply significant losses for the Eurosystem, depending on the amount of sovereign bonds held of the respective state. However, the CJEU does not consider such potential losses as a breach of the Treaty (Bernoth et al., 2022a).

Since NCBs usually make profits and transfer them to the government budget, taxpayers would be indirectly involved. Losses would reduce or eliminate the NCB's profits and, as a result, lead to lower public revenues. Moreover, the OMT and the PSPP were based on risk sharing among the NCBs. Thus, the losses of one NCB would be shared with all other NCBs according to the ECB capital shares of the NCBs. In this way,

1. The prohibition of actively consenting to sovereign debt restructuring would become relevant, because sovereign bonds issued in the euro area since 2013 involve particular restructuring rules – the so-called Collective Action Clauses (CACs). CACs imply that if a qualified majority of bondholders (usually two-thirds in value terms) votes in favour of a debt restructuring, the remaining bondholders are forced to participate as well. CACs are designed to prevent so-called hold-outs from non participating, which would be at the expense of the participating bondholders. Under these conditions, it would be problematic if the ECB held more than one-third of the existing stock of sovereign bonds (or of a particular bond issuance). With the threshold of a two-thirds majority, the ECB would hold a blocking minority (Havlik/Heinemann, 2020). Since the ECB is prohibited from consenting to a sovereign debt restructuring, this constellation would basically make a sovereign debt restructuring impossible – unless the ECB would sell so many sovereign bonds beforehand that its share would fall below the one-third threshold (Whelan, 2020).
Moreover, the likelihood that a sovereign default is prevented could also be higher, if the ECB holds a large amount of sovereign bonds of a distressed country (but below the one-third threshold). Since the ECB might tend to avoid the involved losses, the incentive for the ECB to use the TPI in an overly generous way in order to prevent a sovereign default might rise with the ECB's risk exposure.

losses would be shared indirectly by all taxpayers in the euro area. In the event of major losses, this construction leads to potential political and democratic problems, because the budget sovereignty of national parliaments would be affected.

Second, losses can also occur if the value of the sovereign bonds held by the ECB (and the Eurosystem) decreases. This is currently the case due to rising interest rates, which implies a reduction of bond prices. However, this is a normal risk of monetary policy when the sovereign bond holdings result from common purchase programmes such as the PSPP. With the OMT and the TPI, the increase in risk would be more focused on sovereign bonds of certain countries, especially if the ECB bought sovereign bonds with low credit ratings which was criticised by the GCC in relation to the OMT and the euro debt crisis. Regarding the OMT, the CJEU dealt with the problem of potential losses – and the criticism of the GCC – by pointing to the various requirements of the OMT which would limit the risk of excessive losses (Bernoth et al., 2022b). These aspects are also relevant for the TPI:

- The criticism of the GCC relating to a potential sovereign debt restructuring applies, as the pari passu status also applies to the TPI (see above).
- It could be that the ECB has purchased lower-rated sovereign bonds – even though the TPI is more focused on countries with relatively good economic fundamentals.
- It might be expected that a risk sharing arrangement among NCBs would also apply to the TPI – even though this has not been communicated.
- The TPI has fewer (communicated) requirements and restrictions than the OMT (Chapter 2.2). Thus, the risks of potential losses could become more relevant.

4.4.3 Monetary policy or unwarranted economic policy?

Additional legal concerns relate to the ECB's mandate to conduct monetary policy to achieve its primary aim of price stability.

Impairment of price stability objective?

Purchasing sovereign bonds enlarges the ECB's balance sheet and provides more money to the euro area economy, as the ECB obtains sovereign bonds in exchange for the money it creates. A larger volume of money/liquidity can lead to higher aggregate demand in the economy and thus to higher inflation. This is why the ECB conducted the PSPP in recent years in order to fight the perceived threat of deflation.

Currently, however, inflation is far too high so the ECB does not intend to further increase the money volume in the euro area. Potentially large-scale purchases of sovereign bonds under the TPI could undermine this objective. The ECB states in its TPI press release that "no persistent impact on the overall Eurosystem balance sheet and hence on the monetary policy stance" will be caused (ECB, 2022a). This implies that the ECB would reduce the holding of other bonds in order to sterilise the TPI purchases. However, if TPI purchases were very large, the question arises whether the ECB would be able to achieve this sterilisation in a sufficiently short period of time (Bernoth et al., 2022b).

Monetary policy transmission concerns only a pretext?

The TPI was introduced to ensure that the transmission of monetary policy is achieved in all euro area member states. The ECB sees the danger that with generally rising interest rates (to combat inflation), the interest rates in individual member states could rise in an unwarranted and disorderly way which would hamper the monetary policy transmission – and could directly affect the ECB's primary objective of achieving price stability.

However, this view has been criticised from various perspectives. For example, Mayer (2022) claims that the ECB should focus on the money market to ensure a smooth transmission and not on government securities, as the ECB does with the TPI. From this he derives the "strong suspicion that the TPI is in fact an undercover instrument to provide monetary financing to needy governments". Meyer and Hansen (2022) see the focus on the transmission as a kind of magic to allow the ECB to provide interest rate subsidies.

While this criticism may appear somewhat exaggerated, Gerlach (2022) points out that in the early 2000s the ECB did not bother about declining spreads in Italy, which also affected the transmission mechanism. Angeloni et al. (2022) also argue that the transmission of monetary policy is mainly relevant for sovereign bonds with shorter maturities (see also Mayer, 2022). The OMT also focused on the shorter spectrum of one to three years (Chapter 2), while the ECB can buy sovereign bonds with a maturity of up to ten years under the TPI. Angeloni et al. (2022) argue that disturbances in longer term maturities of sovereign bonds should not be sufficient to activate the TPI if no transmission problem can be detected at the shorter end. On top of this, they point out that in the spring of 2022, when the ECB bought a lot of Italian and Spanish bonds by reshuffling PEPP holdings, there was no indication of a seriously disturbed transmission mechanism when looking at short term maturities. Nevertheless, the ECB intervened on a large scale in sovereign bonds with longer term maturities. Therefore, Angeloni et al. (2022) ask whether this was a “false alarm”.

A more general criticism of the transmission argument refers to the fact that the transmission of monetary policy is complex and often differs across member states due to normal economic reasons (Tillmann, 2022). For example, real interest rates (which are more relevant than nominal interest rates for affecting aggregate demand and thus price stability) currently differ to a large extent in the euro area, as inflation rates diverge strongly. Moreover, the economic and financial systems of euro area countries differ significantly. For example, it makes a big difference for the transmission of monetary policy whether interest rates on commercial or real estate loans are flexible and change with market interest rates or whether they are based on contracts that fix interest rates for a longer period.

From a legal perspective, the GCC also viewed the reference to an alleged transmission disturbance critically, which was also a relevant argument used by the ECB to justify the OMT (Bernoth et al., 2022a). However, the CJEU accepted in principle the transmission argument and its key relevance for ensuring the singleness of monetary policy and

achieving price stability with regard to the OMT. However, the CJEU only found the OMT to be justified after analysing and accepting the ECB’s assessment that interest rate spreads were excessive at the time. The TPI’s reliance on the transmission argument thus refers once again to the discussion on selectivity (Chapter 4.4.1) and to the distinction between unwarranted and warranted risk spreads – and the difficulties associated with this (Chapter 4.2).

Unwarranted economic policy?

The ECB can support general economic policy objectives, but only if they do not impede the ECB’s primary objective of price stability. Article 282 TFEU, paragraph 2 reads: “The primary objective of the ESCB [European System of Central Banks] shall be to maintain price stability. Without prejudice to that objective, it shall support the general economic policies in the Union in order to contribute to the achievement of the latter’s objectives.” In this respect, the GCC criticised the conditionality of the OMT – i.e. to condition the OMT on the country signing an MoU in relation to specific ESM reform programmes – as unwarranted economic policy. However, the CJEU regarded the OMT’s approach only as “indirect” economic policy in line with the ECB mandate (Bernoth et al., 2022a).

With the TPI, the ECB does not rely on an ESM programme, but formulates its own conditionality with the eligibility criteria mentioned above (Chapter 2.1). In terms of influencing the economic policy of the member states, this could also go too far in relation to the CJEU’s view (Bernoth et al., 2022a). Probably for this reason, the ECB has chosen to use the conditionality criteria only as an orientation and to keep a large degree of discretion. However, this discretion is a key criticism with regard to moral hazard dangers of the TPI (Chapter 4.2).

5. Conclusion and recommendations

5.1 Conclusion

In principle, an instrument like the TPI is suitable to fill a relevant gap in the institutional framework of euro area governance. In times of high economic uncertainty and shifting expectations, financial markets can trigger an unwarranted self-fulfilling prophecy toward a market equilibrium with high interest rates and unsustainable public debts in countries with elevated debt levels. In such a scenario, the transmission of monetary policy and thus the ECB's primary objective of price stability would also be negatively affected. The ECB with its potentially large market power can help stabilise market expectations and prevent interest rates from spiralling out of control in an unwarranted way. The TPI could be considered as relevant in this respect, as the pre-existing OMT, which requires an ESM programme with ex post conditionality, is not reasonably applicable to countries with relatively sound fundamentals that comply with EU rules despite higher debt levels, as is currently the case. Therefore, the TPI appears suitable to complement the OMT.

But fiscal policy must also make its contribution. Multiple equilibria usually arise only for countries with elevated debt levels. Therefore, the main objective of the euro area governance framework should be to lower public debts in a sufficiently growth-friendly way over the medium term (see Paper 1). The ECB must not use the TPI to cover outsized government spending that would lead to unsustainable debt levels in the medium term.

Moreover, the TPI in its current form poses several potential dangers. First, the main difficulty is to distinguish between justified and unwarranted increases in interest rate spreads. This opens the door to so-called fiscal dominance (Sargent/Wallace, 1981; Heinemann, 2022) – a situation in which a central bank no longer clearly prioritises price stability but feels responsible for ensuring fiscal sustainability in highly indebted countries. On top of that, with a lax interpretation of the eligi-

bility criteria the TPI could lead to moral hazard, result in high losses for European taxpayers, and could prove legally problematic in its current form. If legal action were to be taken and if the TPI were found not to comply with the legal requirements, a financial crisis would be likely. Therefore, several reforms are required.

5.2 Recommendations

General recommendations

As the reinvestment flexibility of the PEPP comes without any kind of particular conditionality, this first line of defence should only be used to a limited degree. The ECB should also use the TPI with caution and only when really necessary. Clear evidence is needed that the transmission mechanism is impeded and that spread increases are unwarranted by economic fundamentals. If the ECB intervenes, it should concentrate on the shorter maturity spectrum of one to three years, as is the case with the OMT (see also Angeloni et al., 2022; Mayer, 2022), even if the TPI rules allow maturities up to ten years. It would be preferable to change the TPI by limiting the possible maturity of securities to a similar spectrum as in the OMT.

Moreover, the ECB should publish more details on the TPI in order to facilitate further academic analyses of this programme (Angeloni et al., 2022; Bernoth et al., 2022a; Wellink, 2022). More detailed information should be provided on

- how the distinction between warranted and unwarranted spread increases will be made with regard to criteria, methods, and benchmarks;
- how strict the eligibility criteria will be treated;
- how secondary market interventions will be conducted with regard to the limiting conditions set by the CJEU;
- how the one-third limit of outstanding sovereign bonds of member states affects the TPI purchases which is relevant to sovereign restructurings;
- whether potential losses would be shared among NCBs.

As noted above, there is a certain trade-off between transparency and retaining constructive ambiguity to guarantee the effectiveness of the TPI. Therefore, information that is considered particularly sensitive may not be made available to the general public. However, the ECB should convey it on a confidential basis to parliaments and, if necessary, to courts.

Change eligibility conditions and establish connection to a light ESM programme

Especially problematic is the way in which the ECB intends to decide on countries' eligibility based on the four criteria mentioned above. While this approach of ex ante conditionality may, in principle, strengthen the incentives for euro area members to adhere to euro area governance rules, for legal reasons the ECB has chosen to keep a large degree of discretion in its eligibility decision (Chapter 4.4.3). This contradicts the requirement that conditionality criteria should be reliable in order to avoid moral hazard. Moreover, the ECB's large discretion raises concerns about democratic legitimacy and could undermine the ECB's independence as it would likely be drawn into the political sphere.

Looking at all the requirements, the ECB is by design unable to square the circle and fulfil all the above criteria at the same time. A better arrangement would be to involve the European Stability Mechanism (ESM), as is the case with the OMT. This design can meet all the criteria: It is legally sound, as attested by the CJEU and the GCC, offers a reliable form of conditionality and is democratically legitimate, as the ESM is governed by elected politicians. Moreover, the ESM is less politicised than the European Commission, which has several of the four criteria in its hands.

However, a reform of the current framework is needed, as the OMT requires an ESM programme with ex post conditionality, as explained above. Requiring such an ESM programme could even be counter-productive in the current situation, as it could be regarded by the financial market as a kind of stigma that would worsen the situation in an unwarranted way. For this reason, the proposal by Feld et al. (2022) to abolish the TPI and simply rely on the OMT does not appear reasonable.

An already envisaged reform of the ESM offers a solution. The ESM reform treaty has already been ratified by all member states except Italy, which has so far resisted this step. Among other issues, the reform introduces a new programme that – like the TPI – is also based solely on ex ante conditionality (see Paper 3; for more details see Matthes, 2023). This new PCCL (Precautionary Conditioned Credit Line) foresees rather similar ex ante conditionality as the TPI. Unlike the OMT, it would not require ex post conditionality (and no Memorandum of Understanding to be signed) by the respective member state, but only a so-called Letter of Intent. Thus, this construction would offer a solution to the current situation in which EU member states have no need for ex post conditionality.

Therefore, the ECB should base the TPI eligibility on the condition that the respective country uses the new PCCL. This would bring the ESM into the arena, as is the case with the OMT. The decision on the eligibility criteria for the new PCCL would lie with the democratically legitimised ESM. Should a country fail to qualify during the course of a PCCL term, different ESM programmes with ex post conditionality would be available. In this case, the TPI would be substituted by the OMT programme.

An even better option would be to replace the TPI with a reformed OMT programme. The reform should make sovereign bond purchases dependent on an ESM programme that reflects the economic fundamentals of the respective country. If fundamentals are sound, only a new PCCL would be required. If the fundamentals are less sound, the country would have to take up an alternative, appropriate ESM programme within the same framework of the OMT.

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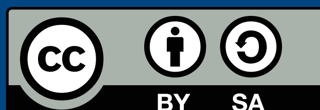

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