INSIGHT

Disorder and Discipline: The ECB's Transmission Protection Instrument

Anna Peychev*

ABSTRACT: In the asymmetric Economic and Monetary Union "market discipline" has played an important and controversial role to compensate for the weakness of the legal framework as regards fiscal affairs. Both as an empirical matter of market behaviour and as a matter of the "no bail-out" clauses of arts 123 and 125 TFEU being effectively undermined after the crisis, however, "market discipline" has never worked as advertised. Instead, the Court of Justice has offered a contrived "synthesised" version of the "logic of the market" as a marker of the legality of financial assistance by the European Stability Mechanism and of the European Central Bank bond purchasing programs. The recent Transmission Protection Instrument announced by the Bank should be seen, so it is argued here, as an attempt not just to facilitate the normalisation of monetary policy, but to bring the relationship between economic law and governance, on the one hand, and market discipline, on the other, back to normal.

KEYWORDS: Economic and Monetary Union – European Central Bank – Transmission Protection Instrument – economic governance – sovereign debt – conditionality.

I. Introduction

The European Central Bank (ECB) announced the Transmission Protection Instrument (TPI) in July 2022 as a tool against "unwarranted, disorderly market dynamics" that cause Eurozone governments to experience deteriorating financing conditions not justified by "country-specific fundamentals". By purchasing securities on secondary markets, the Bank will thus "correct" the market in sovereign debt if and when that market gets it "wrong". Returning the market to proper, orderly pricing of debt is not just a matter of sophisticated financial engineering: in European economic governance, as we shall see, the "right" price is also the exact spot beyond which ECB intervention becomes unlawful lest States lose the "impetus to pursue sound budgetary policy" that follows from the "logic of the market".

The TPI is the latest product of Europe's fantastically dysfunctional relationship with "the market" that has both informed the peculiar structure of the Economic and Monetary

* Max Weber Fellow, European University Institute, Anna.Peychev@eui.eu.

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Union (EMU) since its inception and forged Europeans' understanding of fiscal discipline. Importantly for our purposes, it has even managed to redraw the boundaries of EU law as a result of the toxic political dynamic of the sovereign debt crisis.

II. EMU and market discipline

That the EMU has underlying structural problems is, to put it politely, an understatement. The wise men behind the contract terms of the Treaty of Maastricht were well aware of the inherent shortcomings and troubled dynamics that Europe's idiosyncratic monetary-without-fiscal union would suffer. The success of the enterprise was entirely dependent on a single assumption – a wager that Eurozone economies would be wholly converged and thereby capable of operating at optimum levels as a "synthetic" fiscal union within the parameters of a single monetary policy.

This set up would ensure there would be no divergent economic pressures on the single monetary authority for an accommodative policy that could channel the costs of profligacy across national borders. Governments would be precluded both from interfering with inflation and interest rate parameters and any access to debt monetisation. National spending habits would thus remain critically exposed and constrained by the dynamics of the sovereign debt market. But said market, in its organic form, presented itself as more of a problem than a solution to securing the political bottom line behind the legal construct of EMU – to prevent the cross-border transfer of funds between sovereigns.

In his divinations on the matter, Alexandre Lamfalussy argued the market would actually come to serve as a conduit of financial risk between cross-national creditors and debtors in a highly integrated single money market. Moreover, as was well understood at the time, the market could not be counted upon to price risk responsibly. In fact, quite the opposite.

Having calculated the prohibitive costs and spillovers of a sovereign default in a highly integrated monetary union, the market would know that the risk dynamic of debt in EMU could not remain insulated within national borders. To this end, it could never support the founding idiosyncrasy of an asymmetric EMU. In expectation of a bailout, the market would undoubtedly underprice investment risk, thereby incentivising an excessive debt dynamic and increasing economic divergences over time.[1] This would, in turn, pressure the Central Bank towards embracing a more accommodative monetary stance and higher inflation levels in order to control the cost of sovereign debt – a practice well known to European governments prior to the monetary union.

In dealing with these predicaments, the best that the Maastricht Treaty could offer were the "no bail-out" clauses now in arts 123 and 125 TFEU – disallowing the ECB from acting as a lender of last resort to Eurozone sovereigns and protecting governments from

[1] A Lamfalussy, 'Macro-coordination of Fiscal Policies in an Economic and Monetary Union in Europe' (1989) Report on Economic and Monetary Union in the European Community 91,125.

each other's debt liabilities, respectively. Knowing there would be no aid when in dire straits, these measures were to intimidate governments into responsible borrowing *and* markets into responsible lending by bluffing the highly unrealistic possibility of Eurozone sovereign defaults. As such, arts 123 and 125 TFEU were designed to constrict the market-sovereign relationship within a certain theoretical iteration of "market discipline" that would contribute to the fiscal consolidation of the Eurozone and thereby protect the unnatural uncoupling of economic and monetary policy that the Treaty of Maastricht had brought about.

On both counts, of course, this "market discipline" turned out to be remarkably ineffective: until the sovereign debt crisis hit, interest rates converged rapidly throughout the Eurozone with little regard to "country-specific fundamentals" at all,[2] and investors perversely filled their balance sheets with periphery debt just to make absolutely sure they would be "too big to fail".[3]

Truth be told, all of this was of little surprise – and predicted by the working group on EMU in the Delors Report itself:

> "To some extent market forces can exert a disciplinary influence. However, experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive".[4]

III. How the markets would behave

When the Eurozone house came crashing down following the global financial meltdown of 2008-9, the immediate question before the CJEU in *Pringle* was how to reconcile the financial assistance granted by the European Stability Mechanism (ESM) with the no bailout rules. As Lamfalussy had predicted, the amount of cross-border risk exposure precluded the possibility of allowing a Eurozone sovereign default and, so, the question came down to how to execute said bailout in the spirit of the law – satisfying both the disciplinary and liability-limiting purposes of art. 125 TFEU. The Court did so largely by re-imagining the concept of "market discipline" in its very absence. As part of its teleological foray into the intent of the Treaties, the Court reverse-engineered art. 125 TFEU. It reasoned from consultations with

[2] "The story of the Eurozone is also a story of systematic mispricing of the sovereign debt": see P de Grauwe and Y Ji, 'Mispricing of Sovereign Risk and Macroeconomic Stability in the Eurozone' (2012) JComMarSt 866, 879.

[3] See M Blyth, *Austerity - The History of a Dangerous Idea* (Oxford University Press 2013) 81 ff., on "[t]he Mother of all Moral Hazard Trades".

[4] Committee for the Study of Economic and Monetary Union, *Report on Economic and Monetary Union in the European Community* (Opoce 1989) 20.

the text of the Draft Treaty on EMU that the intent of art. 125 TFEU had been to ensure that Member States follow a sound budgetary policy, yet nothing was mentioned of the markets' incentive to follow a sound pricing policy. The prohibition of assuming liability for Member States' debt either by the Union or by other Member States, then, was re-interpreted as ensuring that "Member States remain subject to the logic of the market when they enter into debt, since that ought to prompt them to maintain budgetary discipline". Said discipline then, for good measure, contributes to the attainment of a higher objective, namely maintaining "the financial stability of the monetary union".[5]

The "logic of the market" was thus cast in stone as the measure of legality of emergency measures taken to counter the disastrous effects of the utter failure of those very same markets to follow their own logic and to exercise disciplining power.[6] This plays out in several ways. It dictates that governments just saved from insolvency are still to behave *as if* they were still heading for insolvency, or, in other words, governments that have just been bailed out are to be punished by pretending the "no bail-out" clause were still exerting its power. This is the basis for the Court's insistence on the "strict conditions" associated with ESM programmes, its embrace of a necessary link between the pains of austerity and irresponsible fiscal policies, and hence the juridification of a particular understanding of the euro crisis.[7] Crucially, the move signals a profound shift in the relationship between "the market" and EMU: no longer an autonomous force working its magic on political decision-making from the outside, the market's "logic" is now synthesised and internalised in the constitutional construct and political economy of the monetary union itself.

With Member States primarily interested in avoiding liability for each other's bills, they gave the market a free pass and bailed it out through the accounts of troubled sovereigns. To that end, art. 125 TFEU was deconstructed very selectively indeed in *Pringle*. The original intent for its equal disciplinary influence on the markets was altogether ignored in favour of the disciplinary influence onto Member States. Simply, if the ESM embraced doing to Member States what the market would have done – mimicking its disciplinary potential through strict conditionality and lending at unfavourable terms, it most definitely refused to do onto the market what a sovereign default should have done with a promise of debt restructuring. Said market, after all, to a significant extent now consisted of the very same Member States whose unwillingness to carry each other's debts led to the entire predicament in the first place.[8]

[5] Case C-370/12 *Pringle* ECLI:EU:C:2012:756 para. 135.

[6] See H Schepel, 'The Bank, the Bond, and the Bail-Out: On the Legal Construction of Market Discipline in the Eurozone' (2017) Journal of Law & Society 79, and M Ojala, 'Doing Away with the Sovereign: Neoliberalism and the Promotion of Market Discipline in European Economic Governance' (2021) New Political Economy 203.

[7] See e.g. *Pringle* cit. para. 137.

[8] The attempt was made to involve the private sector early on in the design of what was to become the ESM. This was just one of the far-reaching ideas that found its way in the ill-fated Franco-German

IV. How the markets should behave

If *Pringle* was the Court's answer to market forces being "too slow and weak", *Gauweiler* was the opportunity to find a way to legally tame market forces when they are "too sudden and disruptive". In 2012, with the ink on the ESM Treaty barely dry, the ECB was faced with alarming spreads in periphery Member States, and decided to intervene by announcing a massive – "whatever it takes" – sovereign bond purchasing programme under the banner of Outright Monetary Transactions (OMT). Technically, the OMT firing power was designed to back up the limited financing capabilities of the ESM, should a large enough government lose market access, e.g. Italy. That is why potential OMT beneficiaries were required to first sign adjustment programmes with the ESM, although in truth the order of intervention would have likely been reversed.

Since these purchases on secondary markets clearly intervene in the "normal" market process of price formation, i.e. in "market discipline", the Court held on to the fact that beneficiary states were subject to ESM conditionality as a way of maintaining the "logic of the market". Conditionality, it was reasoned, precludes the possibility of OMT acting as an "incentive to dispense with fiscal consolidation" and does not, therefore, "lessen the impetus to follow a sound budgetary policy".[9]

The more profound issue in *Gauweiler*, however, was not to divine how markets *would* behave, but how markets *should* behave according to the synthesised "logic of the market". According to the ECB, the alarming increase in spreads was not a sign of the market doing its proper disciplinary job, but a result of "high volatility" and "excessive risk premia" being demanded in light of potential defaults and even a break-up of the Eurozone.[10] In other words, the market was acting out, behaving irrationally and, why not, illogically. That much noise in the system, the Bank argued, impeded any effort at conducting effective monetary policy since any "impulses" it tried to send through the money markets would get lost in the chaos. The OMT, in that sense, was the original "transmission protection instrument".

If the Court accepted the legality of the Bank's efforts to counter "excessive" and "irrational" interest rates, it did so by consecrating "proper" and "correct" market dynamics as the measure of the law's tolerance. Purchases, it insisted, must be limited to the extent necessary to safeguard the monetary transmission mechanism and must cease the moment that objective has been achieved. This would ensure that States cannot base their

Deauville declaration in October of 2010. Predictably, the markets did not appreciate the intent and rallied even harder against the euro in the aftermath of the announcement. For an in-depth account of the consequences see: B Blackstone, 'As Ireland Flails, Europe Lurches Across the Rubicon' (27 December 2010) Wall Street Journal www.wsj.com.

[9] Case C-62/14 *Gauweiler* ECLI:EU:C:2015:400 paras 120 and 121. See e.g. M Wilkinson, 'The Euro is Irreversible… or Is It? OMT, Austerity, and the Threat of "Grexit"' (2015) German Law Journal 1049.

[10] *Gauweiler* cit. para. 72.

budgetary policy on any reliance on ECB purchases of government bonds and, more fundamentally, that

> "the programme in question cannot be implemented in a way which would bring about a harmonisation of the interest rates applied to the government bonds of the Member States of the euro area regardless of the differences arising from their macroeconomic or budgetary situation".[11]

In other words, the spread is a good thing – but in moderation. The "logic of the market" – in the guise of the proper amount of discipline the market is to exercise – was hence re-synthesised as something to be discerned and engineered by the technocratic prowess of the ECB. *Gauweiler* was no small feat for the ECB. The Bank claimed for itself, and the Court acquiesced, the capacity and competence to judge the sensibility of the market spread, evaluating the relationship between government fundamentals and market dynamics – in other words, the right to quantify and arbitrate just the right amounts of market discipline all within the mandate of monetary policy.

The "logic of the market" comes back one more time where the Court lays down conditions on the manner and modalities the ECB can use to intervene in the irrational market to bring it back to "correct" functioning. The starting point here is art. 123 TFEU which prohibits monetary financing and, hence, bond purchases on primary markets. Buying up bonds on secondary markets, on the other hand, is allowed, but only to the extent that it doesn't have an "equivalent effect" of direct purchases from public authorities and public bodies of Member States. To that end, "safeguards" needed to be built into the OMT programme to make sure that it doesn't disrupt "normal" market dynamics: for example, the ECB is not to make any prior announcements of whether and how much it plans to buy where, and it is to leave enough time between issues on primary markets and purchases on secondary markets to make sure that "normal" price formation can take place.[12] So enamoured was the Court with the idea of bringing disorderly markets back to order through the very logic of the market that it notes with apparent regret that "it is true that, despite those safeguards, the ESCB's intervention remains capable of having… some influence on the functioning of the primary and secondary sovereign debt markets", only to remember, belatedly it seems, that "having some influence" on the functioning of the market was the very purpose of the programme.[13]

V. Protect and Discipline

Since the Eurozone crisis the ECB has demonstrated itself as a remarkably self-aware fast learner. The TPI programme is just the latest, and perhaps unsurprising, manifest in a

[11] *Ibid*. para. 113.
[12] *Ibid.* paras 104-107.
[13] *Ibid*. para. 108.

line of "here to stay" unconventional policy measures, expanded policy space, broad discretion, and right to take on risks.[14] In fact, in the current context of major shocks to the global economic system and rampant inflation, it is arguably more plausible now than it was in 2012 to argue that the purchasing programme is merely a matter of "transmission protection" and not of financial assistance.

The purchases are not restricted *ex ante*, and can be activated to counter "unwarranted and disorderly"' market dynamics "to the extent necessary". The announcement is remarkably lax about any "safeguards", promising to terminate the programme only once there is a "durable improvement in transmission". The one nod to "the logic of the market" is a vague threat to stop TPI purchases "based on an assessment that persistent tensions are due to country fundamentals", i.e. based on the assessment that the justification for intervention is no longer valid.

To the predictable anger of people from certain quarters in certain German cities,[15] the ECB is even more relaxed about any conditionality attached to the programme. The one firm condition is that beneficiary States "pursue sound and sustainable fiscal and macroeconomic policies". That, however, is assessed by a list of criteria that will be but an "input" into the Governing Council's decision-making, but does not constitute an absolute measure.

The criteria themselves, moreover, seem far removed from the toxic demands of the days of ESM austerity and are instead found with the edifice of European economic governance constructed after the crisis – the European Semester. TPI-candidate governments *i)* should not be subject to an excessive deficit procedure (EDP) or an excessive macroeconomic imbalances procedure (MIP) *or* at least demonstrate compliance with the Commission's recommendations within said procedures; *ii)* have the "trajectory" of their public debt considered sustainable by some or all of the relevant bodies (Commission, ESM, IMF, but mostly, one suspects, the ECB itself); and *iii)* stick to commitments made in the framework of the Recovery and Resilience Facility as a measure of sound and sustainable macroeconomic policies.

But the indignation over the ECB's seemingly superficial treatment of conditionality in the design of the TPI is misinformed. The crux of understanding – and accepting – the Bank's approach is to properly understand the framework of EU economic governance and conditionality's role within it.

Firstly, the European Semester is subject to the same economic and political rationality which dominated the management of the Eurozone crisis. It came together as part of the same wave of legislative reforms which created the ESM and is, moreover, normatively aligned with the *raison d'être* of the ESM toward the same goals identified by the

[14] See C Zilioli, 'The ECB's Powers and Institutional Role in the Financial Crisis, A Confirmation from the Court of Justice of the European Union' (2016) Maastricht Journal of European and Comparative Law 171, and M Draghi, *Central Bank Independence - Lamfalussy Lecture* www.ecb.europa.eu.

[15] See eg L Feld and others, 'The ECB's Toxic Bond-Purchase Program' (27 July 2022) Project Syndicate www.project-syndicate.org, and O Issing, 'The ECB's Political Overreach' (27 July 2022) Project Syndicate www.project-syndicate.org.

Court in *Pringle* – the intent of the Treaties to deliver level fiscal consolidation across the Union. The Semester rules, procedures, and instruments to bring about said fiscal stance intensify proportionately to the level of government transgression mimicking the disciplinary relationship between sovereigns and the market within the bounds of EU law and the discretion of the European Commission. The ESM comprises but the pinnacle of this structure of ever-intensifying surveillance and correction, i.e. discipline.

Secondly, the integrated nature of EU economic governance means that "conditionality", understood in the terms most notoriously popularised during the Eurozone crisis and associated with the ESM, is nothing but the ultimate escalation and extension of Semester disciplinary procedures. In fact, it extends so far that is reaches beyond the confines of EU law. The imaginary line which divides the ESM from the Semester and its particular level of conditionality is the same line which designates access to both EU law and market financing at reasonable cost.

Lastly, the above framework allows a new manner of contextualising the legality of the TPI and its very existence. Legal issues can hardly be raised with *what* the ECB plans to do: the CJEU has already confirmed the legality of the nature of such operations in *Gauweiler*. The question is about *when* the ECB plans to act, dictating the intervention instrument itself and the extent of accompanying conditionality.

While both TPI and OMT are measures of monetary policy, the legality of their activation rests on context beyond the reach of the ECB. With the activation of OMT dependent on the financial stability of the Eurozone being in peril per the mandate of the ESM, TPI intervention must take place within the confines of the normal economic governance cycle of EMU, when financial stability is not in question. That is, TPI must be activated before the possibility for OMT intervention is even raised. In fact, a successful activation of the TPI, or perhaps its very existence, ought to disqualify the need for the OMT altogether.

Similarly, it would make little sense to enforce OMT-level conditionality – that is, to activate the ESM in parallel to TPI – in a framework which rationalises disciplinarity on a gradient. Eurozone conditionality will always be proportionate to how far off Member State are from the parameters of prudent fiscal policy and, by extension, the presumed levels of reasonable financing conditions on the sovereign debt market.

In the case of the OMT, where governments find themselves on the far end of the spread and beyond the bounds of EU law, the ECB defers the management of profligates' budgetary policies to the ESM. In the case of the TPI, the ECB – rightly – defers to the competences of the European Commission in the area of economic policy coordination, as per arts 121 and 126 TFEU. And so it should be.

VI. Conclusion

It is probably wise not to read too much into TPI and its potential significance for Eurozone governance: as the ECB emphasises, the programme is designed to function alongside – and not as an alternative to – two standing mechanisms. The "first line of defence"

remains the reinvestment of redemptions of maturing securities purchased under the Pandemic emergency purchase programme (PEPP). Though logically finite, the stock is estimated to stand at well over 1.5 trillion Euros by the time the reinvestment programme is to stop in 2024.[16] In June 2022, moreover, the ECB announced that it may resume net purchases under PEPP "if necessary" to counter negative shocks related to the pandemic.[17] Second, of course, the OMT remains in place as a last line of defence, even if all other ECB programmes in place are designed to make it useless.

And yet, TPI could very well be seen as signalling a new phase in the governance of EMU.

Most obviously, by linking, however weakly, the programme to the legislative construct of economic governance, it gives real teeth to the European Semester, EDP, MIP and the rest of it all.[18] If European economic governance could not be relied upon to map out a "sound budgetary policy", as pre-conditioned by the CJEU in *Pringle*, one would have to despair about its lack of purpose. A mature, reasonable system of economic governance within the confines of EU law is surely to be preferred over the profoundly toxic austerity measures that *Pringle* held to flow from the "logic of the market".

With the TPI power to "time out" market tantrums before they can threaten the singleness of monetary policy and, by extension, the financial stability of the Eurozone, the ECB has fully embraced the competences granted onto it by the CJEU in *Gauweiler,* while paying lip service to the misguided prescriptions on how to intervene in irrational markets according to the logic of the irrational markets to restore a precise point of "correct" and orderly market equilibrium.

This is perhaps the only silver lining to the otherwise terrible idea, borne of the Eurozone crisis, to consecrate the "logic of the market" within EU law. In this regard, the TPI may perhaps herald a slightly healthier relationship between EMU and "the market", reclaiming a semblance of control for sovereigns. The Bank seems fairly confident that the mere announcement of its intentions will be enough to bully markets, as was the case with OMT, still never activated. Accommodation may be important in a relationship, but once in a while you have to just stand up for yourself.[19]

[16] However, the Bank is coming under pressure to embrace 'quantitative tightening' as part of its monetary policy normalisation. That means reinvestments would be increasingly – politically – difficult in the context of a focus now shifted towards the disposing of stocks. See European Central Bank, *Press Conference of 8 September 2022* www.ecb.europa.eu.

[17] European Central Bank, *Monetary Policy Decision of 9 June 2022* www.ecb.europa.eu.

[18] See e.g. N Albuquerque Matos, 'Transmission Protection Instrument: the European Central Bank as Promotor and "Enforcer" of Fiscal Discipline' (22 July 2022) EU Law Live www.eulawlive.com, and N Redeker, 'Wielding the Big Gun. What the ECB's New Bond Purchasing Program Means for EU Governance' (2 August 2022) Jacques Delors Centre www.delorscentre.eu.

[19] Note in this regard Christine Lagarde's twice repeated promise, during the TPI announcement press conference, that the ECB Governing Council will not be bullied. One imagines, by the market. European Central Bank, *Press Conference of 8 September 2022* cit.

If market discipline was ever to flow from the no bail-out clauses of arts 123 and 125 TFEU, the idea of investors “correctly” pricing default risk has always been misplaced and should logically have been thrown out after the sovereign debt crisis bail-outs. To substitute a synthetic “logic of the market” for actual market behaviour and codify that logic into EU Law was not just an awful idea *per se*, but also at odds with the limited role “the market” was allocated in the original set up of EMU as a complement at best – not an alternative – to the legal mechanisms and parameters of debt and deficits in the Treaties and legislation.