Roundtable: Monetary Policy in the EU
Will Bateman, Quantitative Easing, Quasi-Fiscal Power and Constitutionalism

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Unconventional monetary policies, particularly quantitative easing (**QE**), have pushed central banks into unchartered territories, triggering anxieties about (hyper-)inflation, asset bubbles and central bank credibility. As QE has expanded in response to the COVID-19 pandemic, new anxieties have arisen, notably central banks' potential role in distorting price discovery in capital markets, as debt capital is directly monetised via central bank corporate bond purchases and equity capital is inflated via the portfolio re-allocative effects of QE.

Deep constitutional issues lurk behind those high-profile economic topics.

Liberal constitutional systems assume a hard boundary between fiscal and monetary authority. Special rules are imposed on fiscal authorities, requiring parliamentary voting for taxation and public expenditure. Those rules recognise the potency of governments' economic powers and bless the largest economic actor in advanced mixed-economies, the state, with a measure of democratic legitimacy.

All central banks in the OECD fall outside those rules, implicitly or explicitly. Older constitutional systems (like the US and UK) developed their rules for governing fiscal authority before the growth of modern central banks.[1] Newer constitutional systems (like the EU) explicitly remove central banks from the set of fiscal institutions by banning them from directly funding treasuries via so-called, “monetary finance” rules.[2] In both cases, central banks occupy a *sui generis* constitutional position: they clearly exercise the state’s economic power and their actions impact on fiscal policy, but their market operations are unburdened by parliamentary voting requirements and judicial review.[3]

This essay argues that QE fundamentally challenges the constitutional status quo for central banks.[4]

First, it explains how monetary (central banks) and fiscal (treasuries) institutions interact legally and financially under QE, focusing on the direct and indirect monetary finance provided by central banks in the US, EU and UK. Secondly, it addresses the consequences of blurring the fiscal/monetary divide, commenting on the relevance of “central bank independence” and the shift from conventional to unconventional monetary policy on the *sui generis* constitutional position of central banks. Thirdly, the essay concludes by mooting various constitutional futures facing central banks.

QE’s Fiscal and Monetary Dimensions

The highly technical debates about QE can obscure some basic facts, common to the US, EU and UK, about the financial relationship between central banks and treasuries.

1. QE involves central banks buying large volumes of sovereign debt.
2. QE coincides with unusually-large issues of sovereign debt.
3. QE results in the consolidated public sector buying-back its own debt.
4. Legal rules require profits earned on sovereign bonds in QE portfolios to flow back to national governments and reinvestment of QE portfolios reduces financing costs for treasuries

1. QE and sovereign debt: while all QE programs include a mixture of debt instruments, in the US, EU and UK non-sovereign debt purchases are relatively insignificant.[5] This is a point of political sensitivity, which can lead to awkward and misleading public relations campaigns. The ECB insists on presenting its “Public Sector Purchase Programme” (**PSPP**, in which sovereign debt is purchased) as only 1 of 4 “Asset Purchase Programmes” (**APP**), and the PSPP is always listed below the “Corporate Sector Purchase Programme”. The optics distort the reality that Eurozone QE, like US and UK programs, is primarily concerned with purchasing central government debt.[6]

2. QE coincides with historic government debt issues: QE began in the Western Hemisphere with government-guaranteed residential-mortgage backed security purchases by the Federal Reserve Bank of New York (**FRBNY**) in 2008, but then promptly switched focus to government debt in 2009-2010 just as the US Treasury started to scale bond issues to fill fiscal deficits created by economic stabilisation measures. QE continued to increase in lock-step with widening fiscal shortfalls and concomitantly large debt issues in the US and UK between 2010 and2015. In the Eurozone, the commencement of QE also tracked increased government debt issues, as was starkly illustrated by the “Securities Markets Programme” (**SMP**) in 2010, which authorised the “National Central Banks” (**NCBs**) (largely the Bundesbank, Banque de France and Banca d’Italia) to purchase sovereign bonds issued by distressed treasuries in Greece, Ireland, Italy, Portugal and Spain. The aborted 2012 “Outright Monetary Transactions” program reinforced the connection between Eurozone QE and sovereign indebtedness. The headline Eurozone QE programs, the PSPP (2015->) and the “Pandemic Emergency Purchase Programme” (2020->) confirmed the connection.

3. Consolidated public sector buying-back its own debt via

QE: Under financial reporting rules promulgated by the IMF and OECD, and adopted in the US, EU and UK, central banks and national treasuries exist within the "consolidated public sector".[7] Thus, at the level of economic reality, QE involves the public sector buying-back its own financial liabilities. While sovereign bonds remain in QE portfolios, those liabilities are effectively cancelled, because national treasuries' formal debt servicing liabilities are discharged by making payments to monetary authorities (central banks) within the same accounting entity, which are under legal obligations to remit profits from interest earning back to the treasury and have signalled a policy position to re-invest principal payments in the same treasury's debt securities and have reliably followed-through on that policy.[8].

4. Remittances and reinvestment: in the US, EU and UK central banks are under legal obligations to transfer (to "remit") most of their annual profits to their national treasuries.[9] Prior to QE, those remittances were economically and financially insignificant. Post-QE, they are vastly more important.[10] As treasuries pay interest on the bulk of sovereign bonds held in QE portfolios, central bank profits increase substantially. By complying with the legal frameworks governing remittances, central banks act as conduits for a "round robin" of public debt costs: treasury -> central bank -> treasury.

Even in the Eurozone, with its fixation on "monetary finance", NCBs remit sovereign bond earnings to their treasuries in compliance with member-state law and the size of the remittances can be enormous.[11] A stunning example is the Bundesbank, which remitted a bumper profit of +€4billion to the German state in 2013,[12] accounting for all of Germany's budget surplus in that fiscal year. Much of that profit stemmed from earnings on distressed Greek, Italian, Irish, Spanish and Portuguese bonds purchased through the SMP.

When sovereign bonds in QE portfolios mature, central banks “reinvest” the capital. In the US, that is done directly at US Treasury auctions: ie, the FRBNY directly purchases US sovereign debt in Treasury refinancing operations.[13] In the EU and UK, reinvestment purchases occur on the secondary market. In both cases, the effect is to provide guaranteed demand in sovereign debt markets by a purchaser (the central bank) that is unmotivated to squeeze every basis-point of interest out of the treasury. The (roughly) 30 American, British, French, German and Japanese banks and securities dealers that are the principal (if not exclusive) bidders at treasury auctions price their bids to maximise profit.[14] Central banks, contrastingly, price their market operations to deliver a diverse set of public goods, including:[15] the familiar (pre-Crisis) triad of “price stability, employment and growth”; the nebulous set of objectives (assumed post-Crisis) such as supporting large and small enterprises, maintaining credit offerings to the real economy and saving the payments system from collapse; and (in the future) the progressive de-carbonisation of the financial industry.[16]

Financial reality vs intentions

Some readers may dismiss those 4 basic facts about QE and public debt as a repetition of the, so-called, “Modern Monetary Theory”.[17]

That would be a mistake.

None of the 4 basic facts is “theoretical”. Each simply presents the legal and financial reality of central bank and treasury relations under QE.

Together, they meet standard definitions (used by the IMF and the OECD) of “monetary finance”:[18]illustrating how central banks use their money issuing authority to support public expenditure by reducing the public debt burden. Coupon payments flow from treasury to central bank and back to treasury, cancelling out much of the interest liability on the proportion of sovereign debt purchased via QE. Central bank reinvestment of maturing QE assets and an expansions of QE programs provides enormous primary and secondary market support for treasuries, especially where fiscal fundamentals are lacking, as they were for most of the last 10 years, and will be again for the foreseeable future.

A different view is taken by some central bankers, who define monetary finance very narrowly. So it goes, monetary finance only occurs when central banks "intend" to issue money for treasuries to spend.[19] On that view, a definitive answer to the question "is QE monetary finance" can be deferred until the successful cross-examination of a central bank governor: i.e., indefinitely.

Ultimately, any conflict between those who argue QE is/is not "monetary finance" is rhetorical. One can readily concede that public debt purchases through QE are motivated by attempts to provide monetary stimulus to "the economy" rather than "the treasury" while recognising the reality that QE provides very direct, and desperately needed, financial accommodation to national governments. It is also relatively clear that the financial press, financial markets and prominent central bankers accept the reality that QE boosts sovereign coffers.[20]

<u>Constitutional predicates of legitimate fiscal power</u>

Rather than hand-wringing about "monetary finance", the more interesting topic is whether the intimate connection of central banks and treasuries via QE call into question the *sui generis* constitutional position of central banks. If central banks are providing the raw material for public expenditure, then what justifies their distance from the constitutionally-enshrined principles governing fiscal institutions?

One answer to that question focuses on the reasons for "independence": the risks of inflation and economic mismanagement requires that central banks be separated from the cut and thrust of political and parliamentary life, particularly where national budgets are concerned.[21] While interesting, that answer overlooks the fact that central banks were constitutionally *sui generis* (being formally and functionally immune from judicial review and parliamentary oversight)[22] well before “independence” became voguish and the principal villain of the pre-independence era, inflation, has not arisen since QE began and central banks started subsidising treasuries: at least not the “CPI” version of inflation.[23]

A more satisfying answer could focus on the nexus between “conventional” monetary policies and fiscal power: central banks’ exclusion from constitutional accountability mechanisms was justified when their core function was lending to (rather than buying from)[24] the commercial banking sector.[25] When monetary policy focused on setting interest rates, central banks were less directly embroiled in fiscal policy.[26] Theoretically, higher/lower rates meant lower/higher lending, lower/higher employment and, therefore, lower/higher tax revenues; but that final fiscal impact depended on the behaviour of several million market actors, each acting at arm’s length from treasury officials. In that way, “conventional” monetary policy was comparatively remote to treasury decisions about funding, say, the construction of a new hospital or the rate of an old-age pension.

Under QE, central bank operations directly impact on those substantive policy choices. Decisions of monetary policy committees and central bank markets-teams about which sovereign bond to buy (interest rate, duration, commercial structure) potently affect the resources available to treasuries to, say, provide pay-check insurance programs or free childcare programs, both high-profile measures in a post-COVID-19 recovery. Reliable public delivery of social services under persistent fiscal deficits depends on guaranteed access to cheap sovereign credit, as tax revenues falter and demand-driven expenditure surges, and QE pays a number of concrete dividends to government debt managers. It reduces financing costs in primary markets by creating favourable market conditions at bond auctions. It reduces debt-servicing costs by remitting interest payment on public debt held in QE portfolios. It guarantees favourable re-financing via reinvestment programs.

Viewed in that way, QE breaks new constitutional ground for central banks, moving them outside the exclusive category of "monetary institutions" and into a "quasi-fiscal/quasi-monetary" category.

Pathways forward

If the brute facts of QE justify labelling central banks as quasi-fiscal institutions, what next for their *sui generis*constitutional position?

In a world of frictionless policy choices, there are three main options.

Option 1: stop and unwind QE: flooding the market with sovereign bonds, absorbing excess reserves, returning to interest-rate setting and erasing the quasi-fiscal complexion of modern central banks. While that would cure the constitutional dilemma, it is a longshot option. Despite the sunk reputational costs in describing QE as "unconventional", no financial *cognoscenti* serious contemplates its reversal over the medium term.

Option 2: continue QE and leave the institutional status quo un-touched. Although it appears to be the preference of many policy makers, that option carries significant risks to the legitimacy of central banks, treasuries and governments, given the widespread acceptance of the quasi-fiscal behaviour of central banks running QE programs. Many legitimacy problems can be ignored if underlying institutional conditions remain outside the public domain. Concealment is a non-viable option for the legitimacy problems stemming from unconventional monetary policy, which is a topic of vibrant public debate in major financial and non-financial newspapers.

Option 3: continue QE and amend institutional frameworks to ensure a measure of constitutional accountability of central banks in recognition of their quasi-fiscal role. This appears to be the preferred option of some major monetary systems: notably, the European Parliament is moving to re-think the balance of constitutional authority of monetary policy.[27] Elsewhere,[28] the reality of monetary finance under QE is forthrightly denied with the hope that constitutional confrontations can be avoided. Practical solutions to those confrontations could include institutional reforms inside central bank governance structures, perhaps the creation of ‘fiscal policy committees’ which could release summaries of their deliberations to parliaments and the public. Deeper interventions could include legislative reforms which make parliamentary voting a condition precedent to the exercise of central bank powers which directly implicate fiscal authority. Article 34 of the *Bank of Japan Act* would be an exemplar.[29]

Whatever solutions are settled on, it is clear that QE has upended central banks’ *sui generis* constitutional position and exposed the reality that central banks are both “bankers’ banks” and “governments’ banks”.[30]The revelation of that dual identity clashes with conventional wisdom in mainstream policy circles, financial markets and economics faculties: so it goes, monetary authority is exercised via financial markets, not via government spending. That thinking, although never entirely true, stems from the “mystique” which was once understood as the vital precondition to effective central banking.[31] If the enemy of conventional wisdom is “not ideas but the march of events”,[32] no gentle restoration of a hard boundary between monetary and fiscal authority should be expected. Under those conditions, central banks face a legitimacy crisis which can only credibly be overcome by embracing the end of "conventional" monetary policy, and their greater integration into the architecture of liberal democratic government. The end point of that process should not be the radical politicisation of central banks, but the fusion of economic and technical expertise with the deliberative processes under which self-governing societies choose their futures.

[1] This glosses a complex of issues covered, variously, in Will Bateman, *Public Finance and Parliamentary Constitutionalism* (2020, Cambridge University Press); Peter Conti-Brown, *The Power and Independence of the Federal Reserve* (Princeton University Press, 2017), Rosa M Lastra, *International Financial and Monetary Law* (Oxford University Press, 2015); Forrest Capie, Charles Goodhart and Norbert Schnadt 'The Development of Central Banking' in Stanley Fischer, Charles Goodhart and Norbert Schnadt (eds), *The Future of Central Banking: The Tercentenary Symposium of the Bank of England* (Cambridge University Press, 1994).

[2] Prominently Art 123 of the *Treaty on the Functioning of the European Union*. This is a uniquely European legal position, as the US Federal Reserve Banks are legally authorised (and do) purchase debt securities directly from the US Treasury, and the Bank of England is legally authorised to (and does) provide unsecured lines of credit to the UK treasury. For the interpretation of s 14(b) of the *Federal Reserve Act* that permits the FRBNY to participate directly in US Treasury auctions, see Kenneth Gardabe, 'Federal Reserve Participation in Public Treasury Offerings' (Federal Reserve Bank of New York Staff Report No. 906, December 2019); for the legal authority of the Bank of England to provide vanilla credit to the UK Treasury, see s 12(7) of the *National Loans Act 1968* (UK); and for the full legal analysis in both jurisdictions, see Will Bateman, 'The Law of Monetary Finance

under Unconventional Monetary Policy’, *Oxford Journal of Legal Studies* (forthcoming), Part 2.

[3] The Bundesbank being the exception that proves the rule: see, *Weiss v Bundesbank*, BVerfG, 2 BvR 859/15 (5 May 2020); Charles Goodhart and Rosa Lastra, ‘Populism and Central Bank Independence’ (2018) 29(1) *Open Economics Review* 49; Chiara Zilioli, ‘Justiciability of Central Banks’ Decisions and the Imperative to Respect Fundamental Rights’ paper presented to ‘ECB Legal Conference 2017: Shaping a New Legal Order for Europe: a Tale of Crises and Opportunities’ (December 2017); Bateman (n1), chs 3 and 8; Bateman (n 2), Part 4.

[4] The extended arguments and empirical evidence for this proposition are contained in Bateman (n 2).

[5] Before 2020, non-sovereign debt assets never exceeded 40% (or $1.5tr) of the QE purchases in the US (but virtually all securities purchased were, directly or indirectly, guaranteed by the US government), 10% (or €600b) in the Eurosystem and 25% (or £126b) in the UK: Federal Reserve Bank of New York, SOMA Holdings: https://www.newyorkfed.org/markets/soma/sysopen_accholdings#export-builder; European Central Bank, Asset Purchase Program: https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html; Office of National Statistics, Public Sector Finances – PSA9. All those percentages have dropped precipitously since March 2020.

[6] Public sector purchases amount to +83% of the total asset purchased under Eurozone QE (APP+PEPP): data available at https://www.ecb.europa.eu/mopo/implement/app/html/index.en.html#cbpp3; https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html(accessed 13/11/20).

[7] The foundational documents are the IMF Government Finance Statistic Manual and the OECD System of National Accounts 2008

which entrench the accounting treatment of central banks within the public sector in the US, EU and UK.

[8] A further curiosity is the treatments of the ‘central bank reserves’ issued through QE as ‘liabilities’ of the central bank despite the fact that a central bank is under no legal obligation to do anything in respect of a credit balance in a reserve account. For legal and economic arguments against that accounting treatment, see Michel Kumhoff, Jason Allen, Will Bateman, Rosa Lastra, Simon Gleeson and Saule Omarova, ‘Central Bank Money: Liability, Asset or Equity of the Nation’ (Cornell Legal Research Paper 20-46, 17 November 2020). For legal treatments of central banks reserves, see Simon Gleeson, *The Legal Concept of Money* (Oxford University Press, 2018), 4.41, 6,10-6,12, 6.58; Charles Proctor, *Mann on the Legal Aspect of Money* (Oxford University Press, 2012, 7th ed), 2.75-2.76, 33.57.

[9] For the US, see, the *Federal Reserve Act*, s 7; for the complicated legal structure governing QE remittance in the UK, see Bateman (n 1), ch 7.

[10] For the UK experience, see Bateman (n 1), ch 7.

[11] Eg, *ECB Statute*, Arts 29-33 and Decision (EU) 2016/2248 of the European Central Bank of 3 November 2016 on the allocation of monetary income of the national central banks of Member States whose currency is the euro (ECB/2016/36) [2016] OJ L 347; *Bundesbank Act,* Art 27; *Statute of the Bank of Italy*, Art 38; *Monetary and Financial Code* Art L 142-2.

[12] Deutsche Bundesbank, Annual Report 2013, page 74.

[13] Since the 1930s, s 14(b) of the *Federal Reserve Act* has been interpreted as permitting direct transactions between the FRBNY and the US Treasury at auctions ‘if they were undertaken on terms specified in Treasury circulars, i.e., on terms available to the general public’: Gardabe, (n 2), page 7. *Data* on direct US sovereign bond purchases by the FRBNY from: US

Treasury, ‘Auction Allotments By Investor Class For Marketable Treasury Coupon Securities’ <https://home.treasury.gov/data/investor-class-auction-allotments>.

[14] ‘Primary Dealers’ in France, Italy, Japan, Spain and the US; members of the ‘Bund Issues Auction Group’ in Germany; ‘Gilt-Edged-Market-Makers’ in the UK: see further Will Bateman and Steffen Murau, ‘Intermediating Central Bank and Treasury Balance Sheets: Primary Dealers in Sovereign Bonds’ (forthcoming).

[15] Much relevant literature on the impact of QE on the borrowing costs of sovereigns is collected in Loriana Pelizzon et al, ‘Scarcity and Spotlight Effects on Liquidity and Yield: Quantitative Easing in Japan’ (IMES Discussion Paper Series No 18-E-14, Bank of Japan, 22 February 2019).

[16] See the comments of President Lagarde of the ECB on the likely prospects of adopting targeted “green” monetary policy operations in the Eurosystem (Committee on Economic and Monetary Affairs, Monetary Dialogue with Christine Lagard, President of the European Central Bank, Brussels, 28 September 2020), page 13) in response to Jens van t’ Klooster and Rens van Tilburg, ‘Targeting a Sustainable Recovery with Green TLTROs’ (Working Paper: Positive Money Europe and the Sustainable Finance Lab, September 2020): <https://www.positivemoney.eu/2020/09/green-tltros/>.

[17] “MMT” is quite a broad church, stretching from academia to deep in the Twitter-sphere: canonical texts include L Randall Wray, ‘Modern Money’ (Levy Economics Institute Working Paper No. 252, November 1998); L Randall Wray, ‘The Origins of Money and the Development of the Modern Financial System’ (Levy Economics Institute Working Paper No. 86, May 1999); Bill Mitchell, L Randall Wray and Martin Watts, *Macroeconomics* (Red Globe Press, 1999).

[18] Richard Hemming, ‘The Macroeconomic Framework for Managing Public Finances’ in Richard Allen, Richard Hemming and Barry Potter (eds), *The International Handbook of Public Financial Management* (Palgrave Macmillan, 2013) 17, 21.

[19] David Andolfatto and Li Li, ‘Is the Fed Monetising Government Debt?’ [2013] (5) *Federal Reserve Bank of St Louis: Economic Synopses* 1; Andrew Bailey (Governor of the Bank of England), ‘Bank of England is not doing ‘monetary financing’’, *Financial Times* (5 April 2020).

[20] Gertjan Vlieghe, ‘Monetary policy and the Bank of England’s balance sheet’ (Speech, Bank of England, 23 April 2020).

[21] Jens Weidmann (President of the Bundesbank), ‘Money Creation and Responsibility’ (Speech, 18th colloquium of the Institute for Bank-Historical Research, 18 September 2012).

[22] See, eg, *Raichle v Federal Reserve Bank of New York*, 34 F.2d 910 (2d Cir. 1929); *The King v The Governor and Company of the Bank of England* (1819) 2 Barnewall and Alderson 620 [106 ER 492]; *The King v The Governor and Company of the Bank of England* (1780) 2 Douglas 524 [99 ER 334].

[23] For some squabbles about the impact of QE on “asset prices” see Ben Broadbent, ‘The History and Future of QE’ (Bank of England, 23 July 2018); Thomas Hale, ‘The Bank of England has a strange idea of what QE has achieved’ (Financial Times, 3 August 2013), Rob Macquarie, ‘The History and Future of QE: 3 Ways the Bank of England’s Analysis Falls Short’ < https://positivemoney.org/2018/07/the-history-and-future-of-qe />.

[24] Of course, most interest rate setting operations occurred through sale and repurchase operations rather than vanilla “loans”: the defining feature of QE’s outright purchases is the omission of the “repurchase” arm of the operation.

[25] The institutional and constitutional impacts of the shift from "conventional" to "unconventional" monetary policy are elegantly explained by Christine Desan and Nadav Orian Peer, 'The Constitution and the Fed after the COVID-19 Crisis' (Just Money, Policy Spotlight): https://justmoney.org/the-constitution-and-the-fed-after-the-covid-19-crisis-2/.

[26] As Gardabe and Lastra explain, interest rate setting did have meaningful impacts on fiscal policy and government finance: Kenneth Garbade, 'Direct Purchases of U.S. Treasury Securities by Federal Reserve Banks' (Staff Report No 684, Federal Reserve Bank of New York, August 2014); Rosa Lastra (n 1) ch 2.

[27] See, Rosa Lastra, 'Accountability Mechanisms of the Bank of England and the European Central Bank' (Report to the European Parliament, September 2020); Rosa Lastra and Alexander Kern, 'The ECB Mandate: Perspectives on Sustainability and Solidarity' (Report to the European Parliament, June 2020).

[28] Eg, Andolfatto and Li (n 14); Bailey (n 14).

[29] See, Bateman (n 2).

[30] A point emphasised by Perry Mehrling, 'Essential Hybridity: A Money View of FX' 41, *Journal of Comparative Economics* No. 2 (May 2013): 355-363; and 'Monetary Policy Implementation: A Microstructure Approach' in Robert Leeson (ed), *David Laidler's Contributions to Economics* (Palgrave Macmillan, 2013), 212.

[31] As the former Governor of the Bank of England, Mervyn King, wrote "When I joined the Bank of England in 1991, I asked the legendary American central banker Paul Volcker for one word of advice. He looked down at me from his great height (a foot taller than I) and said, 'Mystique.'": *The End of Alchemy* (WW Norton & Company, 2017),

[32] According to Kenneth Galbraith, ‘The Affluent Society’ easily found in *The Essential Galbraith* (Houghton Mifflin Company, 2001), page 24.