Financial and Monetary Policy Studies 40

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Central Banking and Financial Stability in East Asia

Springer

Financial and Monetary Policy Studies

Volume 40

Series Editors

Ansgar Belke, Essen, Germany

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Central Banking and Financial Stability in East Asia

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ISSN 0921-8580 ISSN 2197-1889 (electronic)
Financial and Monetary Policy Studies
ISBN 978-3-319-17379-5 ISBN 978-3-319-17380-1 (eBook)
DOI 10.1007/978-3-319-17380-1

Library of Congress Control Number: 2015943583

Springer Cham Heidelberg New York Dordrecht London
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Preface

"Central Banks, Financial Stability and Legal Issues in East Asia" was the title of an international conference staged at the East Asia Institute in Ludwigshafen in May 2014. The conference brought together leading experts from academia as well as monetary authorities from Asia and Europe to explore issues of central banking and financial stability in East Asia from different economic, legal, and policy perspectives. The papers delivered at the conference form the basis for this book.

The conference was made possible through the generous support of the *Deutsche Bundesbank* and the *Haniel Foundation*, which is gratefully acknowledged. Likewise, we wish to thank Springer International Publishing for accepting this volume into its series entitled *Financial and Monetary Policy Studies*. Finally, we are indebted to Chris Engert for his excellent work in the language correction and copy-editing of the manuscript.

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List of Abbreviations

ABC	Agricultural Bank of China
AML	Anti-Money Laundering
BoC	Bank of China
BoCA	Bank of Canada
BOE	Bank of England
BoJ	Bank of Japan
CBI	Central Bank Independence
CBRC	China Banking Regulatory Commission
CBSG	Central Bank Study Group
CCB	China Construction Bank
CCP	Chinese Communist Party
CFA	*Communauté Financière Africaine* (African Financial Community)
CFT	Combating the Financing of Terrorism
CISIDA	Comprehensive Iran Sanctions, Accountability, and Divestment Act
CPI	Consumer Price Index
CPR	Common and General Provisions Regulation
DFS	Department of Financial Services
DNB	Dutch National Bank
DPA	Deferred Prosecution Agreement
EAFRD	European Agricultural Fund for Rural Development
EAGGF	European Agricultural Guidance and Guarantee Fund
EC	European Community
ECB	European Central Bank
ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council
EDP	Excessive Deficit Procedure
EEC	European Economic Community
EFSF	European Financial Support Facility
EFSM	European Financial Stability Mechanism
EGTC	European Grouping of Territorial Cooperation
ELA	Emergency Liquidity Assistance

EMFF	European Maritime and Fisheries Fund
EMU	European Monetary Union
EPA	Economic Planning Agency
ERDF	European Regional Development Fund
ESCB	European System of Central Banks
ESF	European Social Fund
ESM	European Support Mechanism
EU	European Union
FATCA	Foreign Account Tax Compliance Act
FCPA	Foreign Corrupt Practices Act
FDI	Foreign Direct Investment
Fed	US Federal Reserve
FFI	Foreign Financial Institution
FIFG	Financial Instruments for Fisheries Guidance
FILP	Fiscal Investment and Loan Program
FinCEN	Financial Crimes Enforcement Network
FRB	Federal Reserve Bank
FSB	Financial Stability Board
FY	Financial Year
GDP	Gross Domestic Product
GFCC	German Federal Constitutional Court
GG	*Grundgesetz* (German Basic Law)
GHQ	General Headquarters
HICP	Harmonised Index of Consumer Prices
ICBC	Industrial and Commercial Bank of China
ICJ	International Court of Justice
IMF	International Monetary Fund
IRS	Internal Revenue Service
IT	Inflation Targeting
JGB	Japanese Government Bonds
LDP	Liberal Democratic Party
LGFP	Local Government Financing Platforms
LTRO	Long-Term Refinancing Operations
MoF	Ministry of Finance
MTO	Medium-Term Objective
NDRC	National Development and Reform Commission
NPC	National People's Congress
NPL	Non-performing Loan
NY	New York
OECD	Organisation for Economic Co-operation and Development
OFAC	Office of Foreign Assets Control
OMT	Outright Monetary Transactions
PBoC	People's Bank of China
PCIJ	Permanent Court of International Justice

PM	Prime Minister
QE	Quantitative Easing
QQE	Quantitative and Qualitative Monetary Easing
RMB	Renminbi
SDP	Social Democratic Party
SME	Small- and Medium-sized Enterprise
SMP	Securities Market Programmes
SNB	Swiss National Bank
SOE	State-owned Enterprise
TEEC	Treaty Establishing the European Economic Community (Treaty of Rome)
TEU	Treaty of European Union
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance
TSF	Total Social Financing
UK	United Kingdom
UN	United Nations Organization
US	United States of America
USD	US Dollars
WMP	Wealth Management Product

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Introduction: Financial Stability in East Asia—A Tentative Assessment

Frank Rövekamp, Moritz Bälz, and Hanns Günther Hilpert

Abstract The global financial crisis which began in 2007 has induced a wealth of research on financial stability. Many open issues remain, but a useful framework from which to draw lessons from the crisis has been developed by Stanley Fischer. It assesses the role of monetary policy at the zero interest lower bound, macroprudential supervision and exchange-rate management for the preservation of financial stability. It furthermore assigns important functions to central banks in dealing with bubbles and in fulfilling the role of lender of last resort.

This introduction takes up Fischer's "lessons" in order to put the contributions in this volume into perspective and to draw tentative conclusions on the state of financial stability in East Asia: while there are no signs that a financial crisis is imminent, the task of preserving stability remains nonetheless arduous.

The breakdown of financial stability in Western markets during the global financial crisis of 2007–2010 came as a shock to world governments and the general public alike. After the sub-prime mortgage bubble burst, major financial institutions collapsed or had to be bailed out by massive capital infusions, the banking credit market and the commercial paper market nearly came to a halt, sovereign bonds were charged with huge risk premiums and the real economy took a nosedive. The great crisis has served to remind authorities not only of the well-known virtues of stable monetary and financial policies (as well as of fiscal discipline), it has also taught them some new lessons. East Asia, which had already undergone its own financial crisis in 1997–1998, was largely spared on the financial side this time, but also incurred heavy losses in the real economy. And yet, the jury is still out on the

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F. Rövekamp et al. (eds.), *Central Banking and Financial Stability in East Asia*, Financial and Monetary Policy Studies 40, DOI 10.1007/978-3-319-17380-1_1

thorny question of how prone East Asia actually is to financial instability. How resilient are East Asia's financial institutions?

Stanley Fischer, for decades one of the most prominent figures in international financial policy-making, has filtered out precisely what central banks, the institutions he considers to be important guardians for financial stability, should learn from the global financial crisis.[1] This introductory chapter first recalls Fischer's lessons, then it takes a look at the contributions to this volume, all of which deal with various aspects of central banking and financial stability in East Asia both from economic and from legal perspectives. As a comparative reference, two chapters on Europe are included, too. Finally, it asks what policy conclusions East Asia's financial authorities can, and indeed should, draw. Is financial stability in East Asia at risk? What institutional weaknesses remain?

Essentially, Fischer's lessons can be summarised in seven points:

1. *Even after reaching the zero interest lower bound, monetary policy can continue to be effective.*
   Before the crisis, it was conventionally held that monetary policy loses its effectiveness if the nominal interest rate reaches zero. Only fiscal policy could make a difference then.[2] The FED, the Bank of England and, prominently, the Bank of Japan, however, even under zero interest conditions were able to increase liquidity and to affect long-term interest rates and thereby influence the private sector's demand for longer term assets. Occasionally, they were even the lenders of last resort. Thus, the policy of quantitative easing (QE) has shown the potential for central banks to act under extreme circumstances. It remains to be seen, however, whether the expansionary monetary measures taken subsequent to the first round of monetary easing are actually doing good to the economies affected.[3]

2. *A strong and robust financial system is of critical importance.*
   The events after 2007 have re-affirmed that, during a global crisis, countries with a weak financial sector suffer a much deeper and long-lasting output crisis. This is because, if the financial system is robust, standard measures such as cutting interest rates encourage investment in machinery equipment, in housing and the purchasing of durable consumer goods, thereby mitigating the downturn. The collapse of the financial system, however, blocks the monetary transmission mechanism, and renders the standard crisis responses ineffective. Measures to improve the resilience of the financial system include capital requirements for banks, an appropriate structure of incentives, corporate governance, risk management, and resolution mechanisms for failing systemically important financial

[1] Fischer (2012, pp. 1–16).

[2] More than 10 years ago, Bernanke et al. (2004) provided evidence that monetary policy even has options at the zero bound.

[3] For a cautious view, see Bean et al. (2010), and Goodhart (2014).

institutions. In this respect, emerging Asia's regulators and financial institutions have shown that they learnt some lessons from their own financial crisis of 1997–1998.

3. *Macroprudential supervision is necessary.*
   Macroprudential supervision is a rather recent notion.[4] It involves supervision related to the entire financial system with a special view on systemic interactions. This implies financial system regulation at a very broad level well beyond the banking system, and requires co-ordination among different regulators. The need for macroprudential supervision is exemplified by the role of the shadow banking system and the bankruptcy of Lehman Brothers during the present ongoing global financial crisis.

   The respective policy tools are still somewhat elusive. Beyond awareness-raising by financial stability reports, counter-cyclical capital requirements are sometimes stated as an example. Macroprudential supervision serves to strengthen the role of central banks, as it is they who are entrusted with developing the concept.

4. *Bubbles matter and need to be dealt with.*
   Formerly, the idea was held that central banks should not react to asset prices. This notion has been widely discarded as a result of the financial crisis,[5] although it remains a challenge to identify correctly bubbles with potentially systemic implications and to apply effective counter-measures in a timely manner.[6]

5. *A lender of last resort is needed.*
   Whereas the idea of central banks as lenders of last resort in the case of liquidity crises is well accepted, problems with the concept nonetheless remain. First, it is not easy, in practical cases, to distinguish between a liquidity crisis and a solvency crisis. The existence of a lender of last resort furthermore raises moral hazard issues. Nevertheless, without such a lender, massive costs might be imposed on an economy far surpassing any negative impact of moral hazard.

6. *The exchange rate matters.*
   Erratic fluctuations of the exchange rate produce hugely negative effects, especially for small open economies. Thus, exchange rate management to absorb the fluctuation margins by meaningful interventions in the currency markets can be

[4] Galati and Moessner (2011) provide a comprehensive overview about the issues at hand. For a short assessment, see Claessens and Kose (2013, p. 37).

[5] See, for example, Dell'Ariccia et al. (2010), Claessens and Kose (2013, p. 36).

[6] For a discussion on adjusting monetary countermeasures, see Bean et al. (2010).

an important policy tool for central banks.[7] However, its proper execution is not easy, since, on the one hand, the accumulation of reserves to avert appreciation incurs high economical costs, whereas, on the other, the avoidance of depreciation may prove impossible should market pressure persist. Whatever exchange rate arrangement a country chooses, there will be times when it wishes it had a different one.

7. *Flexible inflation targeting is the best way to conduct monetary policy.*
   As a consequence of the above lessons, a central bank should simultaneously aim for the maintenance of price stability, the support of other economic goals such as growth and employment, as long as medium-term price stability is preserved, and the promotion of stability and efficiency within the financial system.[8]

As Fischer himself concedes, a final conclusion on the lessons learnt or to be learnt from the global financial crisis would be premature. The debate is still going on.[9] But, without any doubt whatsoever, the above-mentioned seven points can also serve as a useful set of criteria to assess the status of financial stability in East Asia.

The contributions to this volume take a critical look at East Asia's monetary and financial policy operations and institutions. Their analysis may reveal some potential financial vulnerabilities.

The volume begins with *Knut Benjamin Pißler*'s account of the history and legal framework of the People's Bank of China (PBoC). It was only in 1983, well into the reform era, that the PBoC was assigned the sole function of central banking. A further landmark was the adoption of the Central Banking Law in 1995, even though the PBoC's institutional setting is still lacking clarity and unambiguity. Remarkably, the legal status of the PBoC with regard to its legal personality and its legal rights are not entirely transparent to date. The Central Bank Law formulates "maintaining the stability of the value of the currency and thereby promoting economic growth" as the dual objectives of the PBoC. Conflicts might arise here, and in the 1998–2002 era of economic downturn and high inflation, growth was supported by an expansionary monetary policy. Furthermore, the PBoC is also responsible for "maintaining the stability of the banking industry". This does not include, however, the micro-prudential task of banking supervision, which is assigned to another institution, the China Banking Regulatory Commission (CBRC). Things are further complicated by the fact that the PBoC is subordinated to the State Council, the Chinese government. Thus, the State Council may assign further monetary policy tasks to the PBoC, it appoints and removes members of the

[7] Calvo and Reinhart (2002) have shown that exchange rate management remained important even after the Asian financial crisis, when countries claimed to have abandoned it.

[8] This monetary policy conclusion may be the most controversial of Fischer's lessons. Other authors plead for a return to a rule-based monetary policy; see, for example, Taylor (2010).

[9] For an overview about important elements of the debate, see Claessens and Kose (2013), Lo (2012), and Reinhart and Rogoff (2013).

PBoC's Monetary Policy Council at its discretion, and it may approve or disapprove any monetary policy measures. Thus, central bank independence is not provided for the PBoC.

Moritz Bälz and Markus Heckel undertake to assess of the independence of the Bank of Japan (BoJ) in the light of statutory rules and central bank independence indices. Established in 1882 to fight the hyperinflation prevailing at that time, the bank was firmly put under government control right from its very inception. The so-called old Bank of Japan Act of 1942 further strengthened government authority. Even though some reforms after the war were aimed at de-centralising the monetary policy process, the BoJ remained subordinate to the Ministry of Finance (MoF). It was only in 1997 in the wake of the "Big Bang" reforms for financial liberalisation that the Bank of Japan Act was revised, and the MoF lost much of its wide-ranging authority over the BoJ. Against this backdrop, the authors examine the *de iure* independence of the BoJ with a view to the various dimensions of central bank independence—in particular, institutional, personal, functional, and financial independence—and critically assess quantitative approaches to measure the independence of the BoJ in international comparison. Whilst they identify methodological issues with various of these indices, they nevertheless conclude that the results of the indices are roughly in line with the findings of the authors' legal analysis that the 1997 reform has substantially strengthened the independence of the BoJ. On the other hand, as evidenced by recent developments under the second Abe government, weaknesses with regard to personal independence of the BoJ and factors of Japan's political economy seem to make the Bank still prone to political interference. One may conclude from this contribution that the Japanese government has thus been able to pressure the BoJ into applying a kind of flexible inflation targeting by not pursuing price stability alone, but in the context of the "sound development of the national economy".

A point of reference for the set-up and function of central banks in East Asia is offered by *Helmut Siekmann* in his contribution on the legal framework for the European System of Central Banks (ESCB), which is formed by the European Central Bank (ECB) together with the national central banks of all EU Member States. After providing a general overview of the European Economic and Monetary Union, the set-up and the tasks of the ESBC are explained, thereby taking a deeper look at the legal and institutional setting of the ECB. Siekmann proceeds to elaborate on the euro, for example, its use both inside and outside the EU. In detail, he specifies the legal obstacles against the exit and exclusion from the euro and against the introduction of a parallel currency. The ESCB set-up evidences the special legal challenges that a central bank faces if its area comprises a number of independent countries. Remarkably, the stability of the financial system is not part of the basic tasks of the ESCB. Given the very diverse political and legal backgrounds in East Asia, the ESCB may, therefore, serve as a reference point for the central banks in the region, but certainly not as model for the foreseeable future.

In his contribution, *Franz Waldenberger* asks whether central bank independence (CBI) can be maintained in Japan in times of high fiscal risk. Thus, he assesses potential price-stability threats emanating from fiscal policy interests.

Can independent monetary policy be upheld in the wake of prolonged fiscal instability? Waldenberger argues that the deflationary environment in Japan has, to date, ensured harmony between monetary and fiscal policy as well as financial stability goals. Large increases in the monetary base since 1990 have not compromised the price-stability goal to date. The Bank of Japan (BoJ) also did not contribute to the accumulation of government debt until recently. Things might change, however, under the recent government economic policy, dubbed "Abenomics", which seeks to overcome deflation, among other things, by aggressive BoJ purchases of Japanese government bonds. These so-called quantitative and qualitative easing (QQE) measures have created a direct link between government debt and monetary policy for the first time. As a side effect, the BoJ has assumed an important function with regard to fiscal and financial system stability. Policy conflicts may occur once the current inflation target (of 2 %) has been achieved. Then, CBI would be put to the real test. The price-stability goal could be abandoned, although fiscal consolidation and other measures might still avert these consequences.

The potential legal problems of asset-buying, especially of government bond-buying programmes by central banks, are highlighted by *Helmut Siekmann* in his contribution on the legality of "Outright Monetary Transactions (OMT)" by the European Central Bank (ECB). With the OMT programme, the ECB has set up the framework for government-bond purchases in the secondary market with no *ex-ante* quantitative limits under certain conditions. The OMT programme has been challenged in the German Federal Constitutional Court (GFCC) on the grounds that it blurs the line between monetary and fiscal policy, the latter not being covered by the mandate of the ECB. The GFCC has referred the issue to the European Court of Justice (ECJ), but indicated its concerns with the legality of the OMT programme. The GFCC may also take the issue up again after a final ruling by the ECJ. In Japan, too, fiscal policy does not fall within the mandate of the central bank. Therefore, theoretically, the quantitative and qualitative easing measures of the Bank of Japan could be subject to legal challenges, even though the legal circumstances in Japan are very different. The case study on Europe shows that "unconventional" measures for financial stability which could be deemed as appropriate from an economic point of view could encounter legal hurdles and challenges. Such hurdles could also manifest themselves in East Asian countries, depending on their various legal traditions and systems.

Gunther Schnabl offers a perspective on renminbi internationalisation which is contrary to the widely-held view that the Chinese currency is likely to be liberalised step-by-step until it reaches full convertibility. He argues that China cannot fully internationalise the renminbi due to the effects of hot money inflows. With interest rates mostly near zero in most of the industrialised countries, China has become the target of buoyant capital inflows, which were encouraged, among others, by appreciation expectations of the renminbi against the US dollar. To check these expectations and thereby control speculative capital inflows, the People's Bank of China (PBoC) keeps the exchange rate tightly pegged to the US dollar by a combination of capital controls and currency market interventions. The latter has

led to an accumulation of foreign reserves to the amount of about four trillion US dollars, which constitutes the breeding ground for inflationary pressure and uncontrolled credit growth. The PBoC has reacted to this by sterilising the increased monetary base mainly through increasing the reserve requirements on commercial-bank deposits. This has restricted the function of commercial banks as financial intermediaries and led to distortions such as the emergence of an extensive "shadow" banking sector. Schnabl argues that hot money inflows into China and, with it, the negative consequences, would accelerate if the peg on the renminbi-dollar exchange rate were removed. Thus, the peg needs to be maintained. He proposes a re-balancing of the Chinese economy via real wage increases with the effect of reducing the current account surplus, thereby reducing the upward pressure on the renminbi.

ZHANG Xuechun and Patrick Hess look at the supply and the demand of shadow banking in China. "Shadow banks" offer traditional quasi-banking products without prudential supervision. The sector has been growing rapidly, and estimates of the size of shadow banking in China range from 40 % to about 70 % of China's GDP. Local governments and real-estate developers are the major actors at the demand side. The former, in particular, have to shoulder most of the expenditure for urbanisation without having stable tax revenues for this purpose. Major risks are revealed here as short-term assets are used to fund long-term projects. The supply of funding for the shadow-banking sector is provided by individual investors and by banks. Since individual investors are limited in their investment choices, most of their savings go to bank deposits or real-estate investment. Commercial banks, on the other hand, expand their business via off-balance-sheet operation for better profitability. The root cause of this phenomenon is the still-to-be-accomplished interest-rate liberalisation. Issues of moral hazard, and various other risks which may threaten financial stability pile up with the growth of the shadow banking sector. Against this backdrop, Zhang and Hess propose the following solutions to tackle the problems: a budget law reform, as already envisioned by the Chinese authorities, that will allow local governments to issue their own bonds, which reduces their need to turn to the shadow banking sector for financing. The introduction of a deposit guarantee system will address moral hazard problems by drawing a clearer line between safety (insured deposits) and risk (uninsured investments). Further liberalisation of interest rates will finally allow them to reflect risk properly, thereby enabling their signalling function for investors.

Ulrich Volz explores the potential conflicts between inflation targeting, exchange-rate management, and guarding financial stability that central banks in East Asia face. Inflation targeting rose to prominence in the early 1990s and, from the year 2000, was also adopted in East Asia on a wide scale. Volz argues that, notwithstanding this development, exchange-rate management and financial stability have continued to be important goals for East Asian central banks. No conflict between these goals arose during the so-called "Great Moderation" that lasted from 1982 to 2007, as keeping domestic inflation under control appeared to be an easy task. However, the global financial crisis from 2007 onwards demonstrated that financial risks may accumulate even when price stability is under control, pointing

to possible conflicts. On the other hand, exchange-rate management might take precedence over price stability, given the importance of the exchange rate for the open economies in East Asia to stabilise output. Thus, despite labelling their strategy as "inflation targeting", East Asian central banks have, in practice, been pursuing multiple objectives, with financial stability ranked high on the priority list. As a result, Volz suggests that they should discard their entire inflation-targeting framework.

Takashi Kubota is concerned with the financial stability risks emanating from legal expansionism. He explores the potential consequences in East Asia of the application of US laws, even if its territory or its citizens are not directly involved or affected. He takes the example of the French bank *BNP Paribas*, which was fined 8.9 billion US dollars for using US dollars for transactions with Iran, Syria and other states subject to US sanctions, even though these transactions were perfectly legal under both French and European law. Kubota argues that such an application of US laws infringes on the principles of "territoriality" and "personality" which are commonly held in defining the reach of national law. Banks in East Asia, increasingly feeling the impact of US law compliance costs, may be induced to decrease their use of US dollars in international transactions systematically. This may also foster the development of payment systems in Asia that avoid the US dollar or the United States, which, in turn, may harm financial stability in the global US dollar market. As a solution, Kubota proposes the conclusion of a multilateral agreement on economic sanctions similar to the US-Japan "Agreement Concerning Cooperation on Anticompetitive Activities" or to the US-Japan "Income Tax Convention".

Which conclusions can be drawn from these contributions when they are "measured" against Fischer's criteria for financial stability?

Central banks in East Asia do, indeed, play an important role in financial stability, but there are still issues with the exact definition of their responsibilities and functions, and with their independence from interference by governments, as shown by *Pißler* for the case of China, and *Bälz and Heckel* as well as *Waldenberger* for the case of Japan. *Siekmann* shows that institutional arrangements, once they are fixed by international treaties or constitutional guarantees, cannot be changed at will, even if an adaptation were urgently needed to preserve financial stability or to foster economic growth. *Volz*, in his contribution, has demonstrated that East Asian central banks have already been exercising *flexible* inflation targeting and macro-prudential supervision for a long time, but that issues might arise from the fact that they still tend to adhere to the one-dimensional inflation-targeting officially. He furthermore confirms the importance of exchange rate stability for the East Asian economies, as does *Schnabl* for the case of China, although we can certainly not speak of "*a small and open economy*" here. *Zhang and Hess* have shown the potential risks arising from the growing shadow banking system in China, and have proposed some solutions for this, thereby underlining the critical importance of having a strong and robust financial system. *Kubota*, last, but by no means least, has pointed out that risks for financial stability may also come from unexpected quarters, such as shifts in international settlement currencies.

Clearly, the contributions in this volume give no indication and make no prediction that a financial crisis may be imminent in East Asia. But the nine chapters highlight areas where risks may accumulate and where the attention of monetary policy-makers is called for. They thus confirm that the preservation of financial stability remains an ongoing and arduous task.[10]

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[10] This conclusion may also be drawn from Lo's illuminating review of key literature about the global financial crisis: Lo (2012).

History and Legal Framework of the People's Bank of China

Knut Benjamin Pißler

Abstract This chapter gives a short overview on the history of the People's Bank of China (PBoC), the central bank of the People's Republic of China, and introduces its legal environment. Upon the basis of the Central Banking Law, promulgated in 1995 and amended in 2003, the chapter illustrates the following topics: the legal status of the PBoC, its objectives and tasks, its organisational structure, the independence of the Chinese central bank, the capital and instruments of the PBoC, and its reporting obligations and supervision. The PBoC developed in an environment which is most accurately described as one of managed transition, entailing the gradual transformation of the economic system and allowing a market-oriented framework slowly to grow out of the planned economy. The legal framework creates much flexibility or—from a more formal legal perspective—a particular uncertainty regarding the role of the PBoC, which advanced from a department of the Ministry of Finance to a state organ at ministerial level with growing authority within the hierarchy of the Chinese party-state. When it comes to the question of the independence of the PBoC, the prevailing opinion in the academic literature is that the Chinese central bank's independence is in a critical situation, given its subordinate status to the State Council. Nevertheless, the rising authority of the PBoC in China has marked a significant change in Chinese monetary institutions and policy.

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F. Rövekamp et al. (eds.), *Central Banking and Financial Stability in East Asia*,
Financial and Monetary Policy Studies 40, DOI 10.1007/978-3-319-17380-1_2

1 The History of the People's Bank of China

The *People's Bank of China* (PBoC) was established in 1948 (Wei 2005: 65 et seq; Hess 2014: 25 et seq).[1] During the pre-reform period (until the end of 1978), it monopolised almost all banking activities.[2] The PBoC was the only bank in the People's Republic of China. Its activities included central banking and commercial banking operations. The banking system in that period can thus be characterised as an all-inclusive mono-bank system. This system corresponded to the then-prevailing central planning mechanism, under which the PBoC appropriated the investment funds and working capital to state-owned enterprises according to a central fiscal budget.

In the 1980s, as part of economic reform, specialised state banks were introduced due to the financial needs of the real economy. This created a complicated situation in which the PBoC, while acting as both a central bank and a commercial bank, competed directly with other specialised banks. After 1983, the State Council (the Chinese government) assigned the PBoC the sole function of central banking,[3] and divided the commercial banking functions of the PBoC into four independent, albeit state-owned, banks [the *Industrial and Commercial Bank of China* (ICBC), the *Bank of China* (BoC), the *Agricultural Bank of China* (ABC), and the *China Construction Bank*, (CCB)] (Bell and Feng 2013: 266 et seq).[4] This central bank status of the PBoC was affirmed in a regulation by the State Council in 1986, which evidenced the official formation of a two-tiered banking system. However, for a long period, the effectiveness of the two-tiered banking system remained only on paper, as the state plan continued to play a decisive role in the lending activities of the state-owned banks (private banks were virtually non-existent). Due to the fact that budgetary grants were replaced by bank loans in the 1980s, the state-owned banks were essentially assuming certain budgetary functions that the state fiscal department should have undertaken (but didn't). During this period, the PBoC largely operated on the sidelines of macroeconomic policy-making and institutionally in the shadow of the State Planning Commission (which later became the National Development and Reform Commission—NDRC) and the Ministry of Finance.

A general shift in the PBoC's operational context in the 1990s marked a second era of reform. The adoption of the Central Banking Law ("Law of the People's

[1] On the history of the PboC, see Wenbin Wei, *The Banking Law in Transnational China: A Comparative Review in the Light of EU Banking Rules*, (Zürich: Schulthess, 2005), p. 65 et seq. On the development of Chinese financial sector reforms since 1978, see Patrick Hess, "China's Financial System: Past Reforms, Future Ambitions and Current State", in: Frank Rövenkamp and Hanns Günther Hilpert (eds), *Currency Cooperation in East Asia* (Cham et al.: Springer, 2014), p. 25 et seq.

[2] The institutional status of the PBoC had reached a nadir in the period from 1969 to 1979, when it was relegated and absorbed into the Ministry of Finance.

[3] See Resolution of the State Council on PBoC specifically conducting central bank functions [国务院关于中国人民银行专门行使中央银行职能的决定], dated 17.9.1983.

[4] On the banking reforms in the 1980s, see, for example, Stephen Bell and Hui Feng, *The Rise of the People's Bank of China* (Cambridge, MA: Harvard University Press, 2013), p. 266 et seq.

Republic of China on the People's Bank of China"[5]) and the Commercial Banking Law in 1995 was generally regarded as a landmark in China's banking sector reform, and a signal for the rise of the PBoC's status within the central government (Bell and Feng 2013: 130).[6] This empowered reformers within the party leadership and within the PBoC, which, in turn, propelled further institutional changes on the part of the PBoC. In addition to its monetary policy functions, the Central Banking Law also provided the PBoC with the responsibility for banking supervision.

1998 saw a major re-structuring in the organisation of the regional banks of the PBoC: all local branches were abolished, and the PBoC opened nine regional branches, whose boundaries did not correspond to local administrative boundaries. The aim was to re-centralise decision-making power, and enhance the independence of the PBoC from the influence of the provincial governments (Bell and Feng 2013: 145; Hess 2014: 26 et seq).[7]

Since the establishment of the China Banking Regulatory Commission (CBRC) in March 2003 and the revision of the Central Banking Law in December of that year, banking supervision has been taken over by the CBRC, and the PBoC is solely in charge of China's monetary policy, as will be described in more detail below.

2 The Legal Framework of the People's Bank of China

Regarding the legal framework of the PBoC, the following sections will—upon the basis of the Central Banking Law—describe (i) the legal status of the PBoC; (ii) its objectives and tasks; (iii) its organisational structure; (iv) the independence of the Chinese central bank, (v) the capital and instruments of the PBoC; and (vi) the reporting obligations and supervision of the PBoC.

2.1 Legal Status

The legal status of the PBoC is rarely addressed by scholars writing about the Chinese central bank. The Central Banking Law itself, in its Article 2 para. 1, simply

[5] [中华人民共和国中国人民银行法]; Chinese-English in: CCH Asia Pacific (eds.): *CCH China Laws for Foreign Business, Business Regulations, Volume 1–5*, Hong Kong, 1985 et seq., pp. 8–450.

[6] This rising stock of the Chinese central bank went hand-in-hand with the appointment of ZHU Rongji as the PBoC's governor in July 1993, who later (in 2003) became prime minister. None of the PBoC's governors before 1993 was a political heavyweight, which is seen as both a result and an indicator of the central bank's actual status within the party-state. Bell and Feng (note 4 above), p. 130.

[7] Bell and Feng (note 4 above), p. 145. This restructuring falls in the "Jiang-Zhu Era" (1991–2005), when JIANG Zemin became General Secretary of the CCP and ZHU Rongji served as Vice-Premier (from 1998: Premier), see Hess, note 1 above, p. 26 et seq.

stipulates that the PBoC "is the central bank of the People's Republic of China".[8] This does not say anything about the legal status of the PBoC with regard to its legal personality or the legal rights which the PBoC enjoys.[9]

Academic authors see the PBoC "within the rank of the State Council's organizational structure" (Wei 2005: 69) or as an "organ at ministerial level",[10] without defining the legal status of the PBoC. The decision of the State Council of 1983 clearly states that the PBoC is established in the form of a "state organ".[11] This would mean that the PBoC was granted legal personality with its establishment according to Article 50 General Principles of Civil Law.[12] The literature apparently does not elaborate further on this matter (Li and Li 2004: 5; Wang 2004: 6).[13]

2.2 *Objectives and Tasks*

The objectives and tasks of the PBoC are laid down in the Central Banking Law (Bell and Feng 2013: 157 et seq).[14]

It should be inferred from Articles 2 and 3 of the Central Banking Law that the PBoC, by formulating and implementing the state monetary policies, has the objective of "maintaining the stability of the value of the currency and thereby promoting economic growth". Academic literature concludes from a literal reading of the provision that the PBoC is mandated with dual objectives which are placed on

[8] "Central bank" = chin. "中央银行".

[9] Compare Art. 9.1 Statute of the European System of Central Banks and of the European Central Bank (Official Journal of the European Union C 326, 26.10.2012, p. 230 et seq.): "The European Central Bank [. . .] shall have legal personality, shall enjoy in each of the Member States the most extensive legal capacity accorded to legal persons under its law; it may, in particular, acquire or dispose of movable and immovable property and may be a party to legal proceedings." Compare also Art. 2 Bundesbankgesetz (German Central Banking Law): "Die Deutsche Bundesbank ist eine bundesunmittelbare juristische Person des öffentlichen Rechts." (The Deutsche Bundesbank is a federal institution with legal personality under public law.)

[10] See, for example, China Data Supplement of the *Journal of Current Chinese Affairs*, May 2011, p. 11.

[11] Chin. "国家机关".

[12] Art. 50 para. 1 General Principles of Civil Law [中华人民共和国民法通则], dated 12 April 1986: "An organ [机关] with independent funds shall have the status of a legal person [法人资格] from its date of establishment."

[13] See Dawei LI and Honghua LI [李大伟/李红华] (eds), *Commentary on the Law of the People's Republic of China on the People's Bank of China*, [中华人民共和国中国人民银行法释义], (Beijing, 2004), p. 5: "The central bank is a special financial organ with characteristics of a state organ [. . .]; on the one hand the central bank is a bank, but it is not a general bank; on the other hand it is a state organ, but it is not a general state organ; it is a special state organ. Under these two attributes, the banking attribute is the basis and the state organ attribute is the guidance." Compare Shengming Wang [王胜明] (ed), *Commentary on the Law of the People's Republic of China on the People's Bank of China*, [中华人民共和国中国人民银行法释义], (Beijing, 2004), p. 6.

[14] On the long and intense debate on the objectives of the PBoC since the beginning of the reform era, see Bell and Feng, note 4 above, p. 157 et seq.

an equal footing, namely, to sustain currency stability and to promote economic growth (Wei 2005: 76).

However, given the status of the PBoC as a department of the State Council, the objective of currency stability is often taken as secondary to the objective of economic growth (Wei 2005; Zhou 2007: 5).[15] This approach was seen in the 1980s before the Central Banking Law was implemented during a great swing in money supply, when the PBoC was either pumping large amounts of money into the economy or tightening the money supply—a policy largely attributed to the priority placed by the central and local government on short-term economic growth (Wei 2005: 76). Also, when China experienced a continuing downturn in growth and inflation during the period of 1998–2002, the PBoC operated an expansionist monetary policy to sustain economic growth (Ibid.). However, there is also the opinion in the literature that the Chinese Central Bank views reducing inflation (and thereby preventing social unrest (Hess 2014: 36)[16]) as its primary goal, especially since 2003, when it endeavoured to contain inflation induced by external shocks through a large-scale sterilisation programme (Bell and Feng 2013: 192 et seq; Miller 2008; Pettis 2009).[17] In the immediate aftermath of the global financial crisis in 2009, when the PBoC adopted an accommodative monetary policy, its leaders acknowledged the difficulties in pursuing both goals simultaneously and that compromises were required (Bell and Feng 2013: 205 et seq; Ng 2011).[18]

Other objectives are to be found in Article 1 of the Central Banking Law. According to this provision, the PBoC has the objectives of "establishing and perfecting a macro-control system" and "maintaining the stability of banking industry". The latter objective, however, has, since 2003, not included supervising

[15] Ibid. But see ZHOU Zhongfei, *Banking laws in China*. Alphen a/d Rijn: Kluwer Law 2007, p. 5, who infers from Article 3 Central Banking Law that the objective of the PBoC is to maintain monetary stability, "and in this way promote economic growth". Therefore, in his opinion, monetary stability is a primary objective "while economic growth is a secondary one".

[16] See Hess, note 1 above, p. 36 ("Due to the social unrest that high inflation can cause—as happened in 1989—China's leaders and the PBoC have shown a strong determination to fight inflation.").

[17] Bell and Feng, note 4 above, p. 192 et seq. See, also, Tom Miller, "PBoC lifts reserve ratio as inflation rises to 8.5 per cent", *South China Morning Post*, dated 13 May 2008 ("Consumer inflation on the mainland rebounded unexpectedly to 8.5 per cent last month, prompting the central bank to take immediate tightening measures and raising the prospect of faster currency appreciation to control prices.") and Michael Pettis, "Can China avoid US pre-Depression errors?", *South China Morning Post*, dated 2 February 2009 ("PBoC is not as free to manage domestic monetary policy as the Federal Reserve was in the 1930s, because its primary obligation is to manage the foreign-exchange value of the currency.")

[18] Bell and Feng, note 4 above, p. 205 et seq. See, also, Eric Ng, "Beijing raises rates again to fight inflation", *South China Morning Post*, dated 9 February 2011 ("The PBoC has to strike a difficult balance between fighting inflation via rate rises and fending off speculative flows into the mainland.").

and administrating the banking industry, as this objective was taken over by the CBRC (Bell and Feng 2013: 147 et seq).[19] Nevertheless, the PBoC may, in accordance with Article 33 of the Central Banking Law, with the aim of implementing the monetary policy and maintaining the stability of the finance system, suggest that the CBRC conduct inspections and supervise the banking institutions.[20] Moreover, where a banking institution has difficulty in payment, which may give rise to financial risks, the PBoC, according to Article 34 of the Central Banking Law, and upon the approval of the State Council, have the right to inspect and supervise the banking institutions with the aim of maintaining financial stability.

The PBoC is entrusted with the following tasks, stipulated in Article 4 of the Central Banking Law:

- promulgating and implementing orders and regulations in relation to its functions;
- formulating and implementing monetary policies in accordance with the law (e.g., decisions concerning the annual supply of currency, interest rates (Hess 2014: 31)[21] and foreign exchange rates (Bell and Feng 2013: 209),[22] Article 5 of the Central Banking Law);
- issuing *Renminbi*, i.e., the "people's currency" of the People's Republic of China, and controlling its circulation;
- supervising the inter-bank borrowing or lending market and inter-bank bonds markets;
- administering foreign exchange(Bell and Feng 2013: 249 et seq),[23] and supervising inter-bank foreign exchange markets;
- supervising the gold market;
- holding, controlling and managing the state foreign exchange reserve and gold reserve;
- managing the state treasury;
- maintaining the normal operation of the systems for payments and settlements of accounts;
- directing and disposing over the anti-money-laundering efforts of the financial industry, and being responsible for capital supervision and anti-money-laundering measures;

[19] On the separation of banking regulation from the Chinese central bank after 2003, see Bell and Feng, note 4 above, p. 147 et seq.

[20] Chin. "银行业金融机构". For a definition of this term, see Article 52 Central Banking Law.

[21] On the administrative setting of interest rates, see Hess, note 1 above, p. 31. Hess observes that interest rates are set in favour of borrowers barely above the inflation rate, which results in a significant re-distribution of income from depositors to the rest of the economy.

[22] On the PBoC's management of the exchange rate system, see Bell and Feng, note 4 above, p. 209 et seq.

[23] On the PBoC's administration of the foreign exchange reserves, see Bell and Feng, note 4 above, p. 249 et seq.

- being responsible for the statistics, investigation, analysis, and forecasting of the financial industry; and
- undertaking the relevant international banking operations as the central bank of the state (Bell and Feng 2013: 259; Ruan 2013).[24]

However, this list of tasks of the PBoC is not exhaustive. Article 4 No. 13 of the Central Banking Law provides that the State Council is authorised to assign any other tasks to the PBoC. As the PBoC is entrusted with the general objective of safeguarding financial stability and preventing financial risks (Article 2 para. 2 Central Banking Law), the PBoC's lender of last resort function, although not explicitly spelled out in the law, is assumed in academic literature (Wei 2005: 80; Zhou 2007: 26 et seq).

2.3 Organisation

The top management of the PBoC is composed of a governor[25] and a certain number of deputy governors[26] according to Article 10 para. 1 of the Central Banking Law.

The governor of the PBoC is nominated by the Premier of the State Council (currently LI Keqiang) and affirmed for the post by the National People's Congress.[27] The deputy governors of the PBoC are appointed or removed by the Premier of the State Council. The powers and responsibilities of the governor and the deputy governors[28] are only vaguely stipulated in the law.[29]

[24] This task includes the conclusion of bilateral currency swap agreements with the central banks of other countries. For a list of such agreements concluded by the PboC, see Bell and Feng, note 4 above, p. 259. The European Central Bank and the PBoC concluded a swap agreement in October 2013; see Victoria Ruan, "People's Bank of China in swap deal with European Central Bank", *South China Morning Post*, dated 11 October 2013. Such swap agreements allow central banks to purchase and subsequently re-purchase Chinese yuan and each bank's respective foreign currency, for example, Euro, from each other. The swap agreement between the PBoC and the European Central Bank, which will be valid for 3 years, will allow the European Central Bank to access at most 350 billion yuan while the PBoC will be able to secure as much as 45 billion Euro from its European counterpart when needed.

[25] Chin. "行长".

[26] Chin. "副行长".

[27] When the National People's Congress is not in session, the governor is affirmed by the Standing Committee of the National People's Congress and is appointed to or removed from the post by the President of the People's Republic of China (currently XI Jinping).

[28] For a list of current deputy governors, see www.pbc.gov.cn/publish/english/953/index.html.

[29] See Article 11 Central Banking Law, according to which the PBoC has to "institute a system in which the governor assumes the full responsibility". It further provides that "the governor directs the work of the PBoC and the deputy governors assist the governor in his or her work".

The PBoC consists of 18 functional departments (bureaus),[30] of which one is the Monetary Policy Committee,[31] playing an important role in the macroeconomic control of the state and in the formulation and adjustment of monetary policies, Article 12 para. 2 of the Central Banking Law. The functions, composition and working procedures of the Monetary Policy Committee are to be prescribed by the State Council,[32] and reported to and put on record at the Standing Committee of the National People's Congress, Article 12 para. 1 of the Central Banking Law.

Currently, there are 15 members in the Monetary Policy Committee of the PBoC. The governor of the PBoC (since 2002, ZHOU Xiaochuan) is the *ex officio* chairman of the committee. Other members include ministers, chairmen or other high-ranking officials of government bodies (the State Administration of Foreign Exchange, the CSRC as well as the China Banking Regulatory Commission, the China Insurance Regulatory Commission, the Ministry of Finance, the National Development and Reform Commission and the National Bureau of Statistics),[33] the governors of two of the state-owned banks, and also some professors of renowned universities (Prof. QIAN Yingyi, Tsinghua University, Prof. CHEN Yulu, Renmin University, and Prof. SONG Guoqing, Peking University).[34]

Concerning the officials of government bodies, their membership is directly connected to the functional position in the respective government bodies. A member would automatically lose his or her membership in the Monetary Policy Committee if he or she ceased to hold the position in the office concerned.[35] The exception is the academic members and the presidents of the state-owned banks, who hold the position for a maximum period of 2 years.[36]

[30] The 18 departments (bureaus) are: General Administration Department, Legal Affairs Department, Monetary Policy Department, Financial Market Department, Financial Stability Bureau, Financial Survey and Statistics Department, Accounting and Treasury Department, Payment System Department, Technology Department, Currency, Gold and Silver Bureau, State Treasury Bureau, International Department, Internal Auditing Department, Personnel Department, Research Bureau, Credit Information System Bureau, Anti-Money Laundering Bureau (Security Bureau), Education Department of the Chinese Communist Party PBoC Committee. See www.pbc.gov.cn/publish/english/969/index.html. Compare Bell and Feng, note 4 above, p. 144, who include only 14 functional departments in their chart.

[31] Chin. "货币政策委员会".

[32] See the Regulations on the Monetary Policy Commission of the PBoC [中国人民银行货币政策委员会条例], promulgated on April 15, 1997 by the State Council; reprinted in: Wang, note 13 above, p. 246 et seq.

[33] See Art. 5 Regulations on the Monetary Policy Commission of the PBoC (note 32 above).

[34] See the list of "Members of the Monetary Policy Committee of the People's Bank of China", available at: http://www.pbc.gov.cn/publish/english/955/2013/20131014162143309746782/20131014162143309746782_.html.

[35] Article 11 Regulations on the Monetary Policy Commission of the PBoC (note 32 above).

[36] Article 10 Regulations on the Monetary Policy Commission of the PBoC (note 32 above).

The appointment and removal of members in the Monetary Policy Committee is at the discretion of the State Council, a fact that curtails the independence of the PBoC (further elaborated infra at II 5).[37]

2.4 *The Capital and Instruments of the PBoC*

When it comes to the capital of the PBoC, Article 8 of the Central Banking Law stipulates that "all capital of the PBoC shall be allocated by the state and owned by the state". This provision is rarely questioned in legal literature. This is surprising because, firstly, the provision does not stipulate any registered capital of the Chinese central bank.[38] Usually, authors merely mention that nowadays the PBoC is the world's biggest central bank in terms of total assets (2012: RMB 28 trillion Yuan), ahead of the European Central Bank and the US Federal Reserve (Bell and Feng 2013: 306). Secondly, the statement that the capital of the Chinese central bank is "owned by the state"[39] certainly deserves some attention.[40] As an entity with legal personality, the PBoC should have the ability to hold its own rights, i.e., ownership of its capital. Therefore, the question arises of how to interpret the statement in Article 8 of the Central Banking Law that the capital of the PBoC is "owned by the state". One could interpret the provision in the sense of a restraint on alienation, i.e., the PBoC is prohibited from selling its "capital" (i.e., its "shares") to private persons or other government agencies; a restriction that is not uncommon for central banks.[41]

The instruments of the PBoC for implementing its monetary policies are stipulated in Article 23 of the Central Banking Law. According to this provision, the PBoC may use the following instruments:

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[37] Article 5 paras. 2, 6, 11 Regulations on the Monetary Policy Commission of the PBoC (note 32 above).

[38] Compare Article 28.1 Statute of the European System of Central Banks and of the European Central Bank (note 9 above): "The capital of the ECB shall be euro 5,000 million. [. . .]" Compare also Article 2 *Bundesbankgesetz* (German Central Banking Law): "Die Deutsche Bundesbank ist eine bundesunmittelbare juristische Person des öffentlichen Rechts. Ihr Grundkapital im Betrage von 2.5 Milliarden Euro steht dem Bund zu. [. . .]". (Its capital, amounting to 2.5 billion Euro, is owned by the Federal Republic of Germany.)

[39] Chin. "属于国家所有".

[40] A similar problem existed until 2005 in Chinese company law: The 1993 Company Law of the People's Republic of China provided that the "ownership of state-owned assets in a company resides with the state" (Article 4 para. 3 Company Law). With the revision of the Chinese company law in 2005 this provision was dropped without much attention being given in academia.

[41] Compare Article 28.4 Statute of the European System of Central Banks and of the European Central Bank (note 9above): "[. . .], the shares of the national central banks in the subscribed capital of the European Central Bank may not be transferred, pledged or attached." Compare also Article 2 Bundesbankgesetz (German Central Banking Law) (note 38 above).

- demand that the banking institutions[42] deposit the reserve fund at a required ratio;
- fix the base interest rates of the central bank;
- handle re-discounting for the banking institutions which have opened accounts in the PBoC;
- provide loans for commercial banks;
- deal in treasury bonds, other government bonds, financial bonds and foreign exchange on the open market.

As with the list of tasks of the PBoC, the list of instruments is not exclusive. Article 23 No. 6 of the Central Banking Law provides that the Chinese central bank may use “other monetary policy instruments as determined by the State Council”.

There are also some restrictions stipulated in the Central Banking Law regarding instruments that the PBoC is not allowed to use. According to Article 29 of the Central Banking Law, the PBoC is prohibited from overdrawing the financial budget of the government or from directly subscribing to, or acting as, the sole sales agent for treasury bonds and other government bonds. The PBoC is also prohibited from providing loans for local governments or departments of governments at all levels, non-bank financial institutions and other entities or individuals; it may, however, provide loans for non-bank financial institutions when specially permitted by the State Council, as stated in Article 30 para. 1 of the Central Banking Law. Moreover, the PBoC is not allowed to act as financial guarantor for any entity or individual, as per Article 30 para. 2 of the Central Banking Law.[43]

2.5 *Independence*

One of the most crucial questions for central banks in general, and in particular for the Chinese central bank, is their independence. The independence of the PBoC is significantly delineated by Article 7 of the Central Banking Law:

> The PBoC shall, under the guidance of the State Council, independently implement monetary policies, perform its functions and carry out its operations according to law free from any intervention of local governments, departments of governments at all levels, public organizations or individuals.

The formal institutional independence of the PBoC is therefore curtailed largely by the “guidance of the State Council” and its subordinate status to the State Council. The functional independence of the PBoC is challenged by the

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[42] See note 20 above.

[43] Articles 48 and 49 Central Banking Law stipulate administrative sanctions against “the person directly in charge and other persons directly liable” if the PBoC commits acts proscribed in Article 30 Central Banking Law or where the local governments, the departments of the governments at all levels, public organisations or individuals coerce the PBoC and its functionaries into providing loans or guarantee in violation of Article 30 Central Banking Law.

requirement of Article 5 para. 1 of the Central Banking Law, which demands that important monetary-policy decisions made by the central bank (e.g., annual supply of currency, interest rates, and foreign exchange rates) be implemented only after the prior approval of the State Council. The State Council has the discretion to identify what "important matters"[44] are as the Central Banking Law does not elaborate on this question any further.

With regard to the financial independence of the PBoC, there are some facts that lead to the conclusion that the PBoC is financially dependent on the State Council. First, the capital of the Chinese central bank is entirely contributed by the State (Article 8 of the Central Banking Law), whose interests are represented by the State Council. Second, the PBoC's budget is verified and supervised by the (financial department of the) State Council (Article 38 of the Central Banking Law). Third, the PBoC has the obligation to transfer its net profit to the state treasury, while its losses are off-set by the central finance allocations (Article 39 of the Central Banking Law).

The arrangement of giving the National People's Congress responsibility for the appointment of the governor of the PBoC, bypassing the State Council's power, could be conceived both as an attempt to insert some distance between the PBoC and the State Council, and to provide for some personal independence.[45] However, as the State Council determines the composition of the Monetary Policy Committee of the PBoC, the actual monetary policy decision-making body, and has the full discretion on the appointment and removal of members in the committee, such a personal independence of the PBoC is contested (Wei 2005: 96). Personal independence of the PBoC is further flawed by the fact that the candidate for the governor of the PBoC is decided by the Central Committee of the Chinese Communist Party (CCP) in advance and that the term of office for governors is not determined by the law (Zhou 2007: 37 et seq).

Recent literature, however, argues that it has actually been the mutual dependencies between the PBoC and the leadership of the Communist Party which has helped to underpin the growing authority of the PBoC within the hierarchy of the Chinese party-state, because, since the 1990s, the Chinese central bank is said to have built up its institutional capacity and to have established a credible policy record. Along this line, Bell and Feng claim that, notwithstanding the formal non-independent status of the PBoC, the rising central bank authority in China has marked a significant change in Chinese monetary institutions and policy (Bell and Feng 2013: 298 et seq).

[44] Chin. "重要事项".

[45] On the political relations between the PBoC and the party leadership, see Bell and Feng, note 4 above, p. 116 et seq.

2.6 Reporting Obligations and Supervision

The PBoC has reporting obligations and is subject to supervision.

As mentioned already in the context of the independence of the Chinese central bank, decisions of the PBoC concerning the annual supply of currency, interest rates, foreign exchange rates and other major issues specified by the State Council have to be reported to the State Council for approval before implementation, Article 5 para. 1 Central Banking Law. For other matters concerning monetary policies, the PBoC, after making such decisions, has to carry them out immediately and then report them to and put them on record at the State Council, Article 5 para. 2 Central Banking Law.

In respect of the Standing Committee of the National People's Congress, the PBoC is obliged to submit a report on monetary policies and the operation of the financial industry, Article 6 Central Banking Law.

According to Article 40 Central Banking Law, the PBoC has to manage its revenues and expenditures and accounting affairs in accordance with laws, administrative regulations and the uniform financial and accounting systems of the state. The provision further stipulates that the Chinese central bank is subject to the auditing and supervision of the respective audit organs and the financial departments of the State Council in accordance with the law.

The PBoC must, within three months following the end of each fiscal year,[46] complete the compiling of balance sheets, statements of profit and loss and the relevant finance and accounting report forms, and it must prepare its annual report and publish them in accordance with the relevant state regulations, Article 41 Central Banking Law.

3 Conclusions

The PBoC developed in an environment most accurately described as one of managed transition, entailing the gradual transformation of the economic system and allowing a market-oriented framework to slowly grow out of the planned economy. While the first reform era of the 1980s was dominated by the planning apparatus and a battle between reformers and conservatives, the Chinese central bank developed into a policy-making heavyweight within the central government in Beijing in the 1990s.

The legal framework, laid down in the Central Banking Law, promulgated in 1995 and amended in 2003, creates much flexibility or—from a more formal legal perspective—a particular uncertainty regarding the role of the PBoC. This begins with the unclear status of the Chinese central bank, which developed from a

[46] According to Article 41 para. 2 Central Banking Law, the fiscal year of the PBoC runs from 1 January to 31 December of the Gregorian calendar.

department of the Ministry of Finance to a state organ at ministerial level with growing authority within the hierarchy of the Chinese party-state. However, neither the legal status nor the registered capital of the PBoC is stipulated in the law. The flexibility continues in the dual objectives the PBoC is mandated with, namely to sustain currency stability and to promote economic growth. Furthermore, the PBoC is delegated a broad range of tasks by the Central Banking Law, while further tasks may be assigned to the PBoC by the State Council. The same is true for the instruments the PBoC has for implementing its monetary policies, because the State Council has the authority to determine other monetary policy instruments besides those enumerated in the Central Banking Law. Regarding the organisational structure of the Chinese central bank, the powers and responsibilities of the governor as well as the deputy governors are also only vaguely stipulated in the law. Moreover, the appointment and removal of members in the Monetary Policy Committee, which plays an important role within the PBoC, is at the discretion of the State Council.

When it comes to the question of the independence of the PBoC, the prevailing opinion in academic literature is that the Chinese central bank's independence is in a critical situation given its subordinate status to the State Council. The PBoC's independence is especially challenged by the requirement that its decisions concerning the annual supply of currency, interest rates and foreign exchange rates as well as other major issues specified by the State Council be submitted to the State Council for approval before implementation. The commitment of the PBoC to fight inflation and the long track record of keeping inflation low have clearly strengthened foreigner's confidence in the stable value of the RMB, even if the central is not independent. Nevertheless, the rising authority of the PBoC in China has marked a significant change in Chinese monetary institutions and policy.

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The Independence of the Bank of Japan in the Light of Statutory Rules and Central Bank Independence Indices

Moritz Bälz and Markus Heckel

Abstract This chapter undertakes to assess of the independence of the Bank of Japan (BoJ) in the light of statutory rules and central bank independence indices. It starts off by tracing the historical development of the BoJ which, from its establishment in 1882, was firmly put under government control. During World War II the so-called old Bank of Japan Act of 1942 even strengthened government authority, and despite some efforts to de-centralise the monetary policy process after the war, the BoJ remained subordinate to the Ministry of Finance (MoF) until 1997. At that time, in the wake of the "Big Bang" reforms for financial liberalisation, the Bank of Japan Act was fundamentally revised, and the MoF lost much of its wide-ranging authority over the Bank. Against this backdrop, in a second step this chapter examines the *de iure* independence of the BoJ with a view to the various dimensions of central bank independence—namely, institutional, personal, functional, and financial independence. In a third step quantitative approaches to measure the independence of the BoJ from a comparative perspective through central bank independence indices are assessed. Whilst methodological issues are identified with various of these indices, their results are roughly in line with the findings of the legal analysis that the 1997 reform has substantially strengthened the independence of the BoJ. On the other hand, as evidenced by recent developments under the second Abe government, weaknesses with regard to the personal independence of the BoJ and factors pertaining to Japan's political economy seem to continue to render the Bank prone to political interference.

1 Introduction

According to a widely held view, central banks should enjoy a high degree of independence from governments in order to hold inflation down (Berger et al. 2001; Cukierman 1992). While a central bank can focus on long-term price stability, it is

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© Springer International Publishing Switzerland 2015

F. Rövekamp et al. (eds.), *Central Banking and Financial Stability in East Asia*, Financial and Monetary Policy Studies 40, DOI 10.1007/978-3-319-17380-1_3

argued, governments aiming at being re-elected at the next election have a natural tendency to shy away from anti-inflationary measures which might stifle the economy. In fact, governments at times might even welcome inflation to make public debt more bearable (Lucas and Stokey 1983; Phelps 1973). By the adoption of the current Bank of Japan Act (hereinafter the "BoJ Act" or "the Act"),[1] which was passed by the Japanese Diet in 1997 and entered into force in 1998, the Japanese legislator has, in principle, joined the global trend towards more central bank independence. However, the degree to which the Bank of Japan (the "BoJ" or the Bank), with regard to its task of ensuring price stability, is really shielded against government interference has remained controversial. Developments since the 1997 reform, last, but not least, the most recent ones under the second government of the present Prime Minister Shinzō Abe, seem to testify that the BoJ is still prone to political pressure. In addition, Japanese economists and a substantial number of Japanese politicians have already raised doubts as to whether the aforementioned rationale for central bank independence is at all valid in view of Japan's continuing deflationary *malaise*.

This contribution takes a closer look into the independence of the BoJ. After a brief historical overview (Sect. 2), it examines the independence of the BoJ first from a legal point of view (Sect. 3), and then in the light of central bank independence indices (Sect. 4). It concludes by providing an outlook on some of the most recent developments (Sect. 5).

2 The Genesis of Today's Bank of Japan[2]

The Bank of Japan was established in October 1882. The most pressing objective at the time was fighting hyperinflation triggered by inconvertible national banknotes issued by the government and private banks. Following the establishment of the BoJ, Japan's national banks lost their power to print banknotes. The new central bank's mission was to provide a stable and reliable currency for the national markets. The 1882 Bank of Japan Regulation[3] privileged the government with a high amount of control over the Bank. That is to say, the Ministry of Finance (MoF) had a dominant position over the BoJ, and, from its foundation, the latter was considered as part of the government. In February 1942, Japan's military government re-organised the BoJ. The so-called old Bank of Japan Act, modelled on the German *Reichsbank* Law of 1939, imposed unconditional government authority over the Bank. The BoJ's central role was to support the government by financing

[1] *Nihon Ginkō-hō*, Law No. 89 of 1997. Where this article quotes the Act in English, it follows the semi-official translation of the Ministry of Justice available at http://www.japaneselawtranslation.go.jp/.

[2] For a more detailed description of the Bank of Japan reform process, see Heckel (2014).

[3] *Nippon Ginkō jōrei*, Dajōkan Decree No. 32 of 1882.

the war economy through monetising government debt and an unlimited supply of credit. The Governor of the BoJ was appointed by the government and enjoyed complete power over the board of directors regarding monetary policy (Cargill 1989: 21–24; Iwata 1994: 145–148; Kanegae 1999: 71–78; van Rixtel 2002: 124–126).

After World War II, the Supreme Commander for the Allied Powers aimed at democratising the monetary policy process. By 1949, these efforts had led to the implementation of a Policy Board (*Seisaku iin-kai*) as the highest authority on monetary policy. The Policy Board consisted of seven members: the Governor, four business and finance experts as representatives of the city banks, the regional banks, commerce and industry, and agriculture, and, without voting rights, two government representatives from the MoF and the Economic Planning Agency (EPA) (Bank of Japan 1986: 295–301; Kamikawa 2014: 18; Yamawaki 2002: 72–75). Formally, the newly implemented Policy Board was the supreme decision-making body concerning monetary policy (Miller 1996: 5–6). However, particular measures were put into effect to limit the power of the Board in order to make the new structure conform to the conditions of the Japanese political economy. The result was a Policy Board with relatively low *de facto* influence. Consequently, the new Policy Board was called a "sleeping board", given the fact that the real power rested with the Executive Board, whose policy recommendations were often followed by the Policy Board (Cargill et al. 1997: 22–23; Holtfrerich and Iwami 1999: 97–100; Kamikawa 2014: 19–20; Kawakita 1995: 47–50). Attempts to revise the Bank of Japan Act in the late 1950s and mid-1960s failed. The BoJ sought more independence in its operations, but the MoF successfully defended its wide-ranging control over the Bank.

It was not until 1996 that the complex issue of central bank reform became a subject of discussion again. The Hashimoto government, a tripartite ruling coalition consisting of the Liberal Democratic Party (LDP), the Social Democratic Party (SDP), and the New Party Sakigake (a party formed from a split in the LDP), put financial system reform on the Cabinet's political agenda, including a revision of the Bank of Japan Act (Grimes 2001; Toya 2006: 162–163). After intense and complex discussions involving various advisory councils, such as the Project Team of the government, the "Central Bank Study Group" (*Chūō Ginkō Kenkyū-kai*),[4] a private advisory council of the Prime Minister, and the Financial System Research Council, an advisory committee of the Minister of Finance, the Diet passed the bill on 11 June 1997, and the new Bank of Japan Act came into effect on 1 April 1998.

It can be argued that the initiative for central bank reform in Japan was, at the same time, a struggle for the political survival of the LDP. In other words, "selfish politico-economic reasons" were a driving force for reform (Pascha 2005: 9), which aimed at weakening the powerful MoF and distracting attention away from their own policy mistakes. The results suggests that the new Bank of Japan Act

[4] The CBSG published a report entitled *Chūō ginkō seido no kaikau –hirakareta dokuritsu-sei wo motomete* [Reform of the Central Bank System—In Pursuit of Open Independence] which considered securing central bank independence the key subject of financial reform (The Central Bank Study Group 1996: 5).

constitutes a political compromise between the three parties in power and the MoF. The SDP and, in particular, the New Party Sakigake were in favour of more radical reform, whereas the LDP—although it claimed to be in favour of MoF reform at the beginning—at a later stage tried to "protect" the MoF from changes which it adjudged to be too far-sweeping.

By the enactment of the new Bank of Japan Act, the position of the Policy Board as the supreme decision-making body which determined the fundamental direction of monetary policy operations was confirmed, while the Executive Board was abolished, resulting in a one-tier board system. The Policy Board's powers relating to currency and monetary control are now stipulated in Article 15 BoJ Act. The composition of the Board was fundamentally modified. According to the new Act, the Board consists of nine members: the Governor, two Deputy Governors and six "deliberative members" (Article 16). The deliberative members are to be "persons with relevant knowledge and experience, including experts on the economy or finance" (Article 23(2)) which includes, for example, academics, thus leading to a greater degree of diversity on the Board.

Under the new Act, the BoJ, which is now recognised as a juridical person authorised by the government (*ninka hōjin*),[5] has two main purposes: maintaining price stability, and ensuring financial system stability. Accordingly, the Act stipulates that the purposes of the Bank are to issue banknotes and perform currency and monetary control (Article 1(1)), and to ensure smooth settlement of funds among financial institutions, thereby contributing to financial stability (Article 1(2)).

3 The Legal Independence of the Bank of Japan

3.1 The Establishment of Central Bank Independence in Principle

The enactment of the new BoJ Act has, for the first time, introduced legal independence of the Bank of Japan *in principle*. Earlier controversies in Japan as to whether central bank independence was constitutionally permissible at all, given that, Article 65 of the Japanese Constitution states that "Executive power shall be vested in the Cabinet", today seem to be settled (IMES: 38 et seq; Katagiri 2013: 145). However, there still is no constitutional guarantee of the independence of the BoJ. The possibility of amending the BoJ Act again, and curtailing or even abolishing the independence of the Bank, has not been without its implications regarding how the political struggles between the BoJ and the ruling parties have been playing out in recent years (Kamikawa 2014: 31, 269).

[5] Of the BoJ's 100 million capital, 55 % are provided by the state, subscription certificates for 45 % are traded on JASDAQ (IMES 2000: 25).

Even under the new BoJ Act, the independence granted to the BoJ is not without significant limits. At the same time, the independence of the Bank is accompanied by enhanced transparency and accountability. To assess the BoJ's *de iure* independence, various dimensions of legal independence beg a more detailed analysis.

3.2 Institutional Independence

Institutional independence can be defined as the overall independence of a given institution within the set-up of the various organs of government (Bini Smaghi 2008: 449). The 1997 reform has strengthened the BoJ's ability to take decisions without government interference. While the "old" BoJ was subject to the broad control rights of the MoF, the 1997 Act restricts the latter to a control of the Bank's legality (Article 56, 57 BoJ Act). It is important to note, however, that even the new Act expressly recognises the autonomy of the BoJ only with regard to monetary policy. In this regard, Article 3 stipulates that:

> The Bank of Japan's autonomy (*jishu-sei*) regarding currency and monetary control (*tsūka oyobi kin'yū no chōsetsu*) shall be respected.[6]

While this is interpreted as including all measures which are indispensible to conduct monetary policy (IMES 2000: 35, 57), the Bank's independence is not guaranteed when it performs other functions. In particular, the authority to conduct foreign exchange interventions still rests with the MoF. Where the BoJ buys and sells foreign exchange it conducts national government affairs and acts upon request or with the approval of the MoF (Article 36, 40).[7] Also, with regard to measures which contribute to the maintenance of financial stability, defined as the second key purpose of the BoJ by Article 1(2), the Prime Minister and the Minister of Finance may, under certain conditions, request the Bank of Japan to act as lender of last resort and to extend special financing to ailing financial institutions (Article 38). It has been called a fundamental problem of this approach that the various functions of a central bank often have to be balanced against each other, and a strict separation of monetary policy from other responsibilities may prove impracticable (Mikitani and Kuwayama 1998: 5).

Even with regard to monetary policy, the independence of the BoJ is subject to significant limitations: in order to ensure that the Bank's monetary policy and the government's economic policy are mutually compatible, the Act requires the BoJ to take into account the fact that currency and monetary control is a component of overall economic policy and always to maintain close contact with the government and exchange views sufficiently (Article 4). Like various other parts of the Act

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[6] According to Article 5(2) BoJ Act in implementing the Act "due consideration shall be given to the autonomy of the Bank of Japan's business operations". However, it is controversial to what extent this grants independence beyond monetary control (IMES 2000: 35).

[7] For details, see Bank of Japan (2012: 208 et seq).

(and many other Japanese statues, for that matter), this article leaves much room for interpretation. The Council on Economic and Fiscal Policy[8] currently serves as a forum for such communication. Furthermore, the Act stipulates that the Minister of Finance or the Minister of State for Economic and Fiscal Policy or their respective delegates have the right to attend the meetings of the Policy Board on monetary policy matters (the so-called Monetary Policy Meetings), express their opinions, submit proposals, and request monetary policy decisions be postponed until the next Board meeting (Article 19). However, the government representatives have no voting rights. With regard to considering the opinions the government representatives express, and any request for postponement they make, the Policy Board decides by a majority vote. In practice, the attendance of government representatives is the rule. In a much-discussed demonstration of the Bank's independence, in August 2000, the Policy Board rejected a request by the government representatives to postpone a decision to terminate the Bank's zero interest rate policy.

3.3 Personal Independence

Personal independence of a central bank is arguably of particular importance where the legal rules concerning the other dimensions of independence leave room for interpretation. The Governor, the two Deputy Governors and the six deliberative members of the Policy Board are appointed by the Cabinet subject to the consent of both Houses of the Diet (Article 23 BoJ Act). Their initial term lasts for 5 years (Article 24(1) BoJ Act). The comparatively short term—members of the Executive Board of the European Central Bank (ECB) have a term of 8 years, members of the Board of Governors of the U.S. Federal Reserve (Fed) even have a term of 14 years—must be assessed critically with regard to central bank independence. There is the possibility of being re-appointed (Article 24(2)), which, theoretically, might affect the willingness of a board member to withstand political pressure on the part of the government. However, in practice re-appointment has been limited to special cases to date. Thus, this point should not be over-emphasised. During their term, members of the Policy Board need have no fear of their removal against their will. Article 25 BoJ Act allows for dismissal only in exceptional circumstances. Personal independence is supported by the fact that the standards for remuneration of the BoJ's officers are set by the Policy Board (Article 15(2)(x) BoJ Act).

[8] The Council on Economic and Fiscal Policy serves as the government's top advisory panel and consists of 11 members, including the Prime Minister, four other ministers, the Chief Cabinet Secretary, business leaders, academics and the BoJ Governor. It reviews and monitors macroeconomic policies including monetary policy, the current state and future prospects of prices in regards of the inflation target. Due to these functions, the Council tends to restrict the BoJ's independence.

3.4 Functional Independence

A functional independent central bank should have a clearly-defined goal and be free to establish the policy instruments in order to pursue it. With regard to the objectives of the BoJ, Article 2 BoJ Act requires the Bank to aim its monetary policy at "achieving price stability, thereby contributing to the sound development of the national economy" (*bukka no antei wo harakukoto wo tsūjite kokumin keizai no kenzenna hatten ni shisuru*).[9] To what extent price stability takes priority over the development of the economy has remained controversial. Some, stressing that Article 2 BoJ Act reads "thereby" (*wo tsūjite*), have argued that price stability should take priority, even if the ultimate purpose is to promote sustainable growth over time (Mikitani and Kuwayama 1998: 9; IMES 2000: 35–36), while others consider both price stability and sustainable growth as dual objectives, with no clear ranking (Iwata 2008; Bebenroth and Vollmer 2007: 45).

The BoJ is free to choose the measures it deems necessary to achieve price stability. In other words, it can be said to enjoy instrument independence (IMES 2000: 30). It may adopt a quantitative target for inflation, and has done so since 2012.[10] By contrast, plans to amend the BoJ Act and to grant the government the right to prescribe such a target have, to date, not been realised.

The BoJ is, in principle, prohibited from extending credit to the government. According to Article 5 of the Fiscal Act,[11] the government may not make the BoJ underwrite government debt or make borrowings from the Bank. This is in line with the rules of most central banks in other major economies, and, at the same time, reflects Japan's own experience with hyperinflation caused by the BoJ's direct financing of the government during World War II. However, in exceptional circumstances, the BoJ may underwrite government bonds or treasury bills, or extend credit to the government, up to an amount approved by Diet resolution (Article 5 proviso Fiscal Act, Article 34 BoJ Act). In practice, such cases are limited to the BoJ's underwriting of government bonds or treasury bills in order to refund on maturity such government securities purchased by the Bank through market operations (Sugimoto 2012: 27–28; Bank of Japan 2012: 239–240).

3.5 Financial Independence

Financial independence refers to the ability of any third party to influence, be it directly or indirectly, a central bank' ability (understood both operationally, in

[9] It should be noted that, as stated already above, the BoJ is only responsible for internal monetary stability (i.e., price stability), while external monetary stability (stable foreign exchange rates) even under the new Act falls into the remit of the MoF.

[10] See Sect. 5 below.

[11] *Zaisei-hō*, Law No. 34 of 1947.

terms of manpower, and financially, in terms of appropriate financial resources) to fulfil its mandate (Bini Smaghi 2008: 452). In discussions prior to the 1997 reform, the MoF's control over the BoJ's budget has proved a particularly sensitive point. Article 51 of the Act now provides for a compromise. Only those operational expenses (*keihi*) specified by cabinet order[12] as not hampering currency and monetary control, including, for example, the costs of producing banknotes and personnel expenses, are subject to MoF approval. If the MoF denies its approval, the reasons for such decision are to be published, and the BoJ may make public its opinion on such decision. In this respect, transparency can be said to work in favour of the BoJ.

The BoJ is to prepare financial statements for each 6-month period running from April through to September and from October through to March (Article 52 BoJ Act). In 1998, the Bank made public its Accounting Rules, which take into consideration generally accepted accounting principles of corporate accounting. From its annual net income, the BoJ is required to attribute at least 5 % to a legal reserve and may, upon approval by the MoF, pay its shareholders up to 5 % of the face value of their shares in dividends. The remainder is transferred to the government (Article 53 BoJ Act) (Bank of Japan 2012: 45).

3.6 Transparency and Accountability

In order to counter-balance the enhanced independence of the BoJ, the 1997 Reform simultaneously strengthened the Bank's transparency and accountability. Thus, Article 3 of the BoJ Act, after establishing in para. 1 the autonomy of the Bank regarding currency and monetary control, goes on in para. 2 to require the BoJ "to endeavour to clarify to the citizens the content of its decisions, as well as its decision-making process, regarding currency and monetary control". The BoJ must prepare and make public the minutes of any meeting of the Policy Board on monetary policy matters. Transcripts of the meetings usually are made public after 10 years (Article 20). Furthermore, the Bank has to make public the remuneration standards and rules on service for its officers and employees (Articles 31 and 32).

The BoJ must report to the Diet every 6 months with regard to Board decisions on currency and monetary control matters and conditions of its business operations based upon such resolutions (Article 54(1)). The Governor or his designated representative has to attend sessions of either house of the Diet or their committees upon their request in order to explain the state of the business operations and the property of the Bank (Article 54(3)).

[12] Article 14 Order for the Enforcement of the Bank of Japan Act (*Nihon Ginkō-hōshikō-rei*), Government Ordinance no. 385 of 1997.

4 Measuring the Independence of the Bank of Japan: Central Bank Indices

4.1 Measuring Central Bank Independence Through Indices

A quantitative approach, as opposed to a qualitative approach, to the assessment of central bank independence can be determined through the application of central bank independence indices ("CBI indices"). They allow a—somewhat rough—comparative perspective of the independence of central banks to be made. The most common methodology is to build an index based upon an arrangement of institutional and legal aspects (*de iure* index). Standard proxy measures for central bank independence rely on interpreting quantitative measures for formal institutional arrangements, such as appointment procedure, the Bank's monetary policy decision-making body, and the interaction with the government. Taking into account the fact that legal independence is a necessary, though by no means sufficient condition of *de facto* independence, a small number of studies additionally use behavioural features. These *de facto* CBI indices are usually based upon surveys. The vast divergence of the various indices, both *de iure* indices and *de facto* indices, suggests that there is no standard methodology for analysing and building measures of central bank independence. In order to compare the BoJ before and after the BoJ reform, this chapter uses five different CBI indices: the Bade and Parkin (1985), the Grilli et al. (1991), the Cukierman et al. (1992), the Alesina and Summers (1993), and the Eijffinger and Schaling (1993) indices. These CBI indices have been chosen because they are the basis of many empirical papers, and "represent the most diversified methodological source in this field" (Arnone et al. 2006: 8):

- Bade and Parkin (1985)[13] is a simple CBI index based upon three proxies for central bank independence, the primary objective, the Policy Board, and the appointment procedure of a central bank;
- The Grilli et al. (1991) index distinguishes between policy independence (monetary policy objectives), and economic independence (monetary policy instruments). The sum of the two indices is presented as the general autonomy index;
- Alesina and Summers (1993) build an index upon the basis of Alesina (1988, 1989), and Grilli et al. (1991) indices, thus including categories of political and economic independence;
- Cukierman (1992)[14] was the first to point out the major difference between *de iure* and *de facto* central bank independence. That is, central bank independence is not only made of legal arrangement, but also of informal rules, such as actual practices. However, Cukierman (1992) finds that, in developed countries, the

[13] See, also, Bade and Parkin (1977, 1988).

[14] In the following analysis, we refer to the legal central bank independence index by Cukierman et al. (1992).

difference between *de iure* and *de facto* central bank independence is not as large as in the case of developing countries;

- The Eijffinger and Schaling's (1993) index of political independence can be characterised as an updated version of the Alesina and Summers index and the Bade and Parkin index.

4.2 The Bank of Japan and Central Bank Independence Indices[15]

4.2.1 The Bank of Japan Act of 1942

In principle, in line with the legal analysis above, the majority of CBI indices assess the "old" Bank of Japan as having a comparatively low amount of central bank independence in comparison to other major central banks in the developed world.

Table 1 presents the results of selected CBI indices for the Bank of Japan before the 1997 revision, and compares it with other major central banks, namely, the German *Bundesbank*, the US Federal Reserve (Fed), and the Bank of England (BoE), the Swiss National Bank (SNB), the Bank of Canada (BoCA), and the Netherlands Bank (DNB). The results demonstrate that, at the time, the *Bundesbank* was the most independent central bank, scoring an average value of 0.9, followed by the Swiss National Bank (0.88) and the Fed (0.69). Taking the average value of all five indices into account, the BoJ has a similar result to the Bank of Canada and the BoE (0.51 versus 0.49 and 0.41 respectively).

Table 1 confirms that the classification of the BoJ is particularly divergent and reveals many contradictions.[16] One example is that of Bade and Parkin (1985) who rate the BoJ with a relatively high degree of central bank independence, namely, three points out of four, the same level as the US Federal Reserve. However, they mistakenly argue that the Policy Board of the BoJ, under the 1942 BoJ Act, had

Table 1 Results of selected CBI indices for various central banks

	BoJ	Bundesbank	Fed	BoE	SNB	BoCA	DNB
Bade and Parkin (1985)	0.75	1	0.75	0,5	1	0.5	0.5
Grilli et al. (1991)	0.38	0.81	0.75	0.38	0.75	0.69	0.63
Cukierman et al. (1992)	0.18	0.69	0.48	0.27	0.64	0.45	0.42
Alesina and Summers (1993)	0.63	1	0.88	0.5	1	0.63	0.63
Eijffinger and Schaling (1993)	0.6	1	0.6	0.4	1	0.2	0.8
Average Value	0.51	0.9	0.69	0.41	0.88	0.49	0.6

Note: Numbers are in normalised values
SNB Swiss National Bank, *BoCA* Bank of Canada, *DNB* Netherlands Bank

[15] This part follows Heckel (2014).

[16] See, also, Mangano (1998), and Acemoglu et al. (2008).

extensive powers with regard to deciding the operation of business, changing discount rates, changing the qualifications of bills to be discounted, fixing, changing, and abolishing maximum rates of interest, reserve ratios, and controls over loans (Bade and Parkin 1988: 8). As explained above, in reality, the Policy Board constituted a "sleeping board", and the real power rested with the Executive Board. That is to say, omiting the erroneous Bade and Parkin evaluation would correct the result of the old BoJ downwards.

4.2.2 The New BoJ Act

The majority of CBI indices confirm that the 1997 Bank of Japan Act had a significant impact on the independence of the BoJ. Table 2 shows the results according to the five CBI indices for the BoJ after the 1997 reform. The BoJ scores higher in almost all CBI indices. One exception is the index of Bade and Parkin (1985), in which the value did not change because the structure of this index is very simple and the estimation of the "old" BoJ in the original study was inaccurate (see above). The average value of all five CBI indices increased from 0.51 to 0.66.

4.2.3 Independence of the Bank of Japan in International Comparison

In a more recent study, Laurens et al. (2009) present an update of the Grilli et al. (1991) index based on the Cukierman (1992) index. The Laurens et al. (2009) index is divided into political and economic independence. Political independence consists of three aspects: the appointment procedure, the relationship with the government, and constituting laws. Economic independence consists of the financing of public debt and monetary instruments. A perfect score (maximum independence) would be 16 points, eight points for each category, and a higher score means greater independence. Table 3 shows the scores for the various central banks. For the new BoJ an alternative score is given in brackets based upon the analysis below.

Table 3 summarises the results for the BoJ, in comparison to the ECB, the Fed the BoE, the Swiss Nationalbank and the Bank of Canada. Again, the ECB, the

Table 2 Results of selected central bank independence indices before and after the BoJ Act revision

	BoJ 1942	BoJ 1997
Bade and Parkin (1985)	0.75	0.75
Grilli et al. (1991)	0.38	0.63
Cukierman et al. (1992)	0.18	0.39
Alesina and Summers (1993)	0.63	0.75
Eijffinger and Schaling (1993)	0.6	0.8
Average Value	0.51	0.66

Source: Own calculation based upon the central bank indices
Note: Numbers are in normalised values

Table 3 Independence of various central banks

	BoJ 1997	BoJ 1942	ECB	Fed	BoE	SNB	BoCA
Political independence							
I. Appointment							
1. Governor appointed without government involvement	**0**	0	1	0	0	0	1
2. Governor's tenure higher than 5 years	**0**	0	1	0	0	1	1
3. Policy Board members appointed without government involvement	**0**	0	1	0	0	1	0
4. Policy Board members appointed for more than 5 years	**0**	0	1	1	0	1	0
II. Relationship with the Government							
5. Mandatory involvement of the government in the Policy Board (yes = 0; no = 1)	**[1] 0**	0	1	1	1	1	0
6. Government approval is required in formulating monetary policy (yes = 0; no = 1)	**[1] 0**	0	1	1	0	1	0
III. Constituting Laws							
7. Legal obligation to pursue price stability as one of primary objectives	**1**	1	1	1	1	1	1
8. Legal protection for central bank in case of conflict with government (yes = 1; no = 0)	**[1] 0**	0	1	1	1	1	0
Score (I)	**[4] 1**	1	8	5	3	7	3
Economic Independence							
I. Financing of Public Deficits							
1. No automatic procedure for govt. to get credit from the central bank	**1**	1	1	1	1	1	1
2. Credit at market interest rate	**0**	0	1	1	1	1	0
3. Credit is temporary	**1**	1	1	1	1	1	1
4. Credit limited amount	**1**	0	1	1	1	1	1
5. Purchase of government securities in the primary market (yes = 0; no = 1)	**0**	1	1	1	1	1	1
II. Monetary Instruments							
6. Central bank is responsible for setting policy rate	**1**	1	1	1	1	1	1
7. Monitoring of the banking sector (no responsibility = 2 points; shared responsibility = 1 point)	**2**	1	2	1	2	2	2
Score (II)	**6**	5	8	7	8	8	7
Overall Score (I + II)	**[10] 7**	6	16	12	11	15	10
Normalised Value	**0.44 [0.63]**	0.38	1	0.75	0.69	0.94	0.63

Source: Based upon Laurens et al. (2009), complemented by own alternative scores in brackets

Swiss Nationalbank and the Fed score best. Following the original assessement by Laurens et al. (2009), the BoJ has a significant lower value of central bank independence than the other central banks. However, the result of this index for the BoJ is not without some reservations. In the following, we argue that the BoJ may well deserve a higher score in certain categories. In particular, regarding political independence, the BoJ scores only one point according to Laurens et al. (2009); in other words, in their opinion, the political independence of the BoJ has not improved with the 1997 reform. However, it can be argued that the BoJ assessed correctly should score up to half of the possible points (alternative scores above in brackets) which equals a value higher than the Bank of Canada and the BoE. In short, while we tend to agree with Laurens et al. (2009) analysis on economic independence,[17] we consider the aforementioned alternative scores regarding the BoJ's political independence more realistic. The reasons are as follows: regarding point 5 of the index (mandatory involvement of the government in the Policy Board), Laurens et al. (2009) give no points to the BoJ. This seems questionable at the very least. According to the new BoJ Act, there are no mandatory government members on the Policy Board. Even if we consider the presence of government representatives at Monetary Policy Meetings, the answer remains unclear. They seem to base their score on Article 19(1) BoJ Act, which grants the government the right to send representatives to such meetings. As mentioned earlier, in practice, government representatives are, in fact, present at every meeting. However, from a *de iure* perspective, it is hard to understand why this is assessed as a mandatory involvement of the government at the Board meetings on monetary policy matters. For the BoE, for which Schedule 3, paragraph 13 of the Bank of England Act 1998 states that "A representative of the Treasury may attend, and speak at, any meeting of the Committee", the government's right to send representatives does not prevent Laurens et al. (2009) from letting the BoE score a point. The same is valid for the ECB, for which Laurens et al. (2009) grant a point. Here, the President of the ECOFIN and Commission are present (Bini Smaghi and Gros 2001). In short, following the same standard for all central banks, it is possible to grant a point to the BoJ.

Also, regarding point 6 of the index (government approval required in formulating monetary policy), it seems at least plausible to allow the BoJ to score a point, while Laurens et al. (2009) deny a point. As explained, the Japanese government has the right to request a postponement of a monetary policy decision (Article 19 (2)). However, this request can be rejected by the Policy Board (Article 19(3)), as has actually happened in practice. Thus, it can be argued the BoJ is, in fact, able to decide on monetary policy independently. While there well be a psychological

[17] The BoJ has improved its score on economic independence from five to six points with the 1997 reform. However, the BoJ still scores lower than all other central banks. This is due to categories 2 (Credit at market interest rate) and 5 (Purchase of government securities in the primary market). The Act does not define the interest rate for the credit extended to the government. Also, the Bank may and does underwrite government securities in certain cases.

hurdle in rejecting a government request for postponement, it seems hardly appropriate to deny a point to the BoJ in this category.

Finally, an adequate assessment regarding point 8 (legal protection for central bank in the case of conflict with government) seems difficult. Article 3 BoJ Act states that the "Bank of Japan's autonomy regarding currency and monetary control shall be respected". Under the new BoJ Act, the government is restricted to legal supervision of the BoJ, and can no longer intervene in monetary policies as easily as it was able to do prior to the 1997 reform. In addition, with regard to personal independence, it is no longer possible for the government to fire BoJ key staff as it wishes (Article 25). Irrespective of the above-mentioned limitations to the *de iure* independence of the Bank, is seems at least possible to grant the BoJ even this point. All things considered, this aspect demonstrates that the index' binary approach is a very rough method, leading to inaccuracies and mis-interpretations.

Our suggestion is that one can argue that the political independence of the BoJ was strengthened by the 1997 BoJ Act revision, meaning that it is possible to grant the BoJ up to four points, instead of just one. Aggregating political and economic independence, the BoJ then scores ten points, or in normalised values 0.63, which is substantially higher than before the 1997 reform and the original assessment by Laurens et al. (2009). In comparison with other major central banks, notably the ECB's perfect score, the independence of the BoJ is lower, but the same level as the independence of the Bank of Canada or nearly the same level as the BoE (0.69), a result that seems more realistic.

However, our analysis also shows that the binary assignment of points in a CBI index raises problems. In particular, if one compares many central banks, it is difficult to keep a stringent distinction between the *de iure* and *de facto* situation of all central banks. In addition, researchers often find mistakes for the central banks that they know best[18] (James 2010). Whether or not one sees the need to correct Laurens et al. (2009) with regard to their calculation of the BoJ score, their assessment nonetheless confirms that the 1997 reform has, in fact, enhanced the independence of the BoJ, albeit only to some extent.

5 The Independence of the Bank of Japan in the Light of Recent Developments

How can what we observe under the second Abe government be reconciled with the results of the above analysis of the new BoJ Act and common CBI indices? Do the developments since 2012 not demonstrate that the independence of the BoJ still is far too weak? We would argue that the situation is slightly more complicated.

The Abe government has, indeed, successfully forced the BoJ to support the government's aggressive anti-deflation politics. Under former Governor Maasaki

[18] See, for example, Grilli et al. (1991), Alesina (1988) and Eijffinger and de Haan (1996).

Shirakawa, the BoJ grudgingly adopted a 1 % inflation target at first, which, under pressure by the Abe government, was subsequently raised to 2 %. At first, no fixed date to achieve this target was given. Only after Shirakawa stepped down slightly before the official end of his term of office in March 2013 and Abe's favourite Haruhiko Kuroda became Governor, did the BoJ introduce an aggressive "Quantitative and Qualitative Monetary Easing" (QQE) framework [for a more detailed analysis, see Franz Waldenberger (2015)]. Now, the date for when the 2 % inflation target was to be met was prescribed: a mere 2-year term was given. Also, within just 2 years, the monetary base was to be doubled to reach 270 trillion yen. Even if, in late 2014, it seems unlikely that the ambitious schedule of 2 % inflation can be realised, this indeed seems to demonstrate that, in the end, the government was able to corner the BoJ successfully.

While we have found substantial limitations to the independence of the BoJ even under the new BoJ Act above, these limitations nevertheless offer only a partial explanation of the BoJ's recent swing. Clearly, the government's right to appoint Kuroda as Governor reflects the limited (personal) independence of the BoJ. It seems quite likely that Prime Minister Abe will exploit future opportunities in order to replace members of the board with "reflationist" candidates. Still such appointment rights are not unusual. In a sense, Abe was lucky that Shirakawa's term (as well as the term of his two deputies) was ending during his own term in government. It has been argued that, paradoxically, the increased independence of the BoJ, thanks to the 1997 reform, might even have made the BoJ more vulnerable to political pressure. This is because the BoJ, with a view to its enhanced independence since the reform, now has much to lose in terms of a possible reversal of the reform (Kamikawa 2014). This points us to factors of political economy. Limitations to the independence of the Bank of Japan continue to persist under the new BoJ Act. However, vanishing support from the general public, which, in part, blames the BoJ for the mistakes in monetary policy since the 1980s, as well as a trend among economists, not limited to Japan, to shift priorities away from anti-inflationary politics and thus potentially also from central bank independence, certainly also seem to be important factors worth considering.

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The Legal Framework for the European System of Central Banks

Helmut Siekmann

Abstract The Treaty of Maastricht imposed the strict obligation to establish an economic and monetary union as an integral part of the EU. The single currency was to become the currency of the EU and the legal tender in all Member States unless an exemption was explicitly granted.

Consequently, the primary law systematically only speaks of economic policy or monetary policy which is the task of the Eurosystem, consisting of the ECB and the central banks of the Member States whose currency is the euro. Although the national central banks of all the Member States together with the ECB constitute the European System of Central Banks, only the ECB is granted legal personality.

General economic policy is not a task of the EU, but has been retained by the Member States. Exceptions have to be provided explicitly in the primary law. EU law, however, contains a host of rules to prevent excessive debt and deficits on the part of the Member States.

Price stability has been set as the "primary objective". The term has to be interpreted as close to zero per cent inflation. To safeguard the primary objective, a comprehensive guarantee of the independence of the ESCB, the ECB, and the members of its organs has been provided for.

Exit from the Monetary Union while remaining a EU Member State is not possible. The introduction of a parallel currency is prohibited. If a new currency in substitution of the euro or parallel to it is introduced, all claims denominated in euro will remain in euro and, economically, the burden will most likely even increase.

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F. Rövekamp et al. (eds.), *Central Banking and Financial Stability in East Asia*,
Financial and Monetary Policy Studies 40, DOI 10.1007/978-3-319-17380-1_4

1 The European Economic and Monetary Union

1.1 Formation of the European Economic and Monetary Union[1]

A report, delivered in February 1969 by the then French Vice-President of the European Commission and later Prime Minister Raymond Barre, proposed greater co-ordination of economic policies and closer monetary co-operation.[2] These two proposals were eventually realised by the Treaty of Maastricht,[3] but to a different extent. Since then, the "exclusive competence" "for monetary policy for the Member States whose currency is the euro" is vested in the European Union (EU),[4] but not the competence for economic policy, which has remained, in principle, with the Member States, although with an obligation of close co-operation. This result is laid down in Article 119(1) TFEU[5] for all Member States, and intensified by Article 136(1) for the Member States whose currency is the euro. Furthermore, the details of the rules for the European System of Central Banks (ESCB) and its competences, especially Article 127(1) and (2) TFEU, are determined by it.[6]

To date, it has remained an open and debated question whether a common economic policy would have been an essential pre-requisite for the functioning of the Monetary Union, or whether a monetary union (automatically) leads to a common economic policy. This discussion is frequently continued under the label of the necessity of a closer "political union" for the functioning of the monetary union.[7]

The Treaty of Maastricht introduced the Economic and Monetary Union de facto without fully-fledged political integration. The euro was created as a currency without a state.[8] This was done fully aware of the fact that many critics, to wit,

[1] For a more comprehensive description, see Helmut Siekmann (2012). Some of the following is derived from this work.

[2] Commission Memorandum to the Council on the co-ordination of economic policies and monetary co-operation within the Community, submitted on 12 February 1969, Bulletin of the EC No. 1, 1971. A predecessor was the "Marjolin Memorandum" of the Commission, see Hanspeter K. Scheller (2006, p. 17); André Szás (1999, pp. 8, 9). Upon the basis of the "Barre Report", a more specified three-step plan was developed by the prime minister of Luxembourg, Pierre Werner. The final design was framed in a plan delivered by the then President of the Commission, Jacques Delors; see Helmut Siekmann (2013, *Einführung* [introduction], No 10–26).

[3] Signed 7 February 1992, Official Journal, 29 July 1992, C 191/1.

[4] Now Article 3(1) lit. c TFEU.

[5] Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union, Official Journal of 26 October 2012, C 326/01.

[6] More Sect. 4 below.

[7] Paul de Grauwe (2010, p. 31).

[8] Critical: *Deutsche Bundesbank*, Monthly Report, February 1992, p. 53; Peter J. Tettinger (1992, p. 10), with further references; defending the creation of the Monetary Union at an early stage Gert Nicolaysen (1993, pp. 10–18). A topic which was treated by Otmar Issing, leading economist, former member of the board of the *Deutsche Bundesbank* and of the Executive Board of the ECB, see, e.g., Otmar Issing (2008a); Idem (2008b, p. 297).

economists, considered this procedure to be taking the second step before the first.[9] Even if this closer political union was not realised from the beginning, the single currency nonetheless both extends and completes the "single market". To this extent, it has worked as "integration via the economy",[10] even in view of the financial turbulences of the past years.

The Treaty of Maastricht amended the primary law of the European Economic Community (EEC) to the extent that all institutional, procedural, and substantive provisions for the new common currency and its functioning were already in force before the European System of Central Banks (ESCB) and its main actor, the European Central Bank (ECB), had effectively been set up. Even the statute for this system had already been formulated in all details by the Treaty of Maastricht and was attached to it as a protocol.[11] As such, it is part of the primary law of the EU, Article 51 TEU, and these provisions have become the cornerstones of the European Monetary Union (EMU).[12] The amendment procedure is, however, simplified to a certain extent in comparison to the other parts of the primary law of the EU, Article 40 Statute ESCB/ECB.

1.2 The Transfer of Monetary Authority to the European Union

1.2.1 Monetary Policy as Exclusive Competence of the Union

The Treaty of Maastricht introduced the obligation for the EU (EEC) and the Member States to create a single currency. It started from the premise that the new currency was to become the *currency of the European Union* as it originally assumed that—at least in the medium term—all Member States would introduce the euro.[13] In other words, the Member States had to give up a substantial part of their sovereign powers:[14] the "right to create, to define, and to re-organise a national monetary

[9] See, for example, J. E. Meade (1957, p. 388); the references given by Gert Nicolaysen (1993, p. 7 note 2); see, also Christoph Degenhart (2012, p. 158 et seq.); for a balanced discussion with mild scepticism, see Otmar Issing (2008c, pp. 227–236).

[10] Described by Otmar Issing (2008b, p. 299 et seq.).

[11] Protocol (No 4) on the Statute of the European System of Central Banks and of the European Central Bank, Official Journal C 326/230 of 26 October 2010; afterwards referred to as "Statute ESCB/ECB".

[12] Now Part III, Title VIII of the Treaty on the Functioning of the European Union (TFEU), consolidated version, Official Journal, 30 March 2010, C 83/1 (96).

[13] The wording of Article 3(4) TEU is somewhat murky: "The Union shall establish an economic and monetary union whose currency is the euro". The EMU has been established by the Treaty itself but the introduction of the single currency needed additional measures; see also European Commission (2006).

[14] Otmar Issing (2008b, p. 301).

system”. They also lost “the right to conduct an independent monetary policy”.[15] The “exclusive competence” for “monetary policy” has been vested in the European Union; but only for the Member States whose currency is the euro, pursuant to Article 3(1)(c) TFEU. This means that they have lost all powers in this field; unconditionally and irrevocably, regardless of the specific actions of the Union. The loss of competences is total.[16]

The power to create money in the legal sense of the word (“legal tender”) had been widely considered to be a sovereign right of a ruler (*ius cudendae monetae*),[17] but it is not indispensable for a qualification as (sovereign) state, as history shows.[18] There have always been sovereign entities which did not exercise this right and did not create a currency of their own, or which acknowledged more than one currency as legal tender, or left it to the several entities of a federal system to exercise this right on their own. In any case, the general decision to transfer this sovereign right to the EU was taken and the judiciary did not object.[19] For the state theory of money, the state is even a pre-requisite for the existence of money, since money is considered only as a creation of the legal system and is defined by an arbitrary act of the state.[20]

1.2.2 The Obligation to Introduce the Euro

The primary law of the Union expects all Member States to introduce the euro once they fulfil the convergence criteria.[21] When negotiating the Treaty of Maastricht, it became, however, clear that not all Member States were prepared to introduce the

[15] Charles Proctor (2012, nos. 31.09 and 31.10).

[16] Literal translation of Christian Calliess (2011b, Article 2 margin no. 9) with further references.

[17] Permanent Court of International Justice—PCIJ, Judgment of 12 July 1929, case concerning the payment of various Serbian loans issued in France, Publications of the Permanent Court of International Justice, Series A—Nos. 20/21, p. 44: “It is indeed a generally accepted principle that a State is entitled to regulate its own currency.” The same wording is used in the judgment of the same day on the case concerning the payment in gold of Brazilian federal loans contracted in France, id. p. 122. See, in detail, Frederick A. Mann (1992, pp. 14, 16 and 18); Fred Hirsch (1967, p. 30); Herrmann Fögen (1969, p. 35); Robert A. Mundell (1997, p. 16) with a detailed description of the development in history (pp. 9–15); Rosa María Lastra (2006, p. 16); Frank Vischer (2010, section 15 II); Christoph Herrmann (2010a, pp. 99–102) with further references; Charles Proctor (2012, p. 526); tentatively German Federal Constitutional Court [GFCC] of 20 July 1954, BVerfGE [Decisions of the Federal Constitutional Court] 4 [volume], 60 [page].

[18] Helmut Siekmann (2014, Article 88 margin no. 107; and Sect. 3.3. below).

[19] BVerfGE 89, 155; 97, 350; Helmut Siekmann (2014, Article 88 margin nos. 30, 33).

[20] Georg Friedrich Knapp (1905, pp. 1, 20). This insight had been publicised almost a generation earlier by a much less famous author: Gustav Hartmann (1868, pp. 12, 58, 64, 112): “Da der Satz, daß eine bestimmte für unseren Verkehr eigens geschaffene Münzsorte ‘Geld’ (. . .) sein sollte, juristisch nur auf einen besonderen Act unserer Rechtsordnung zurückgeführt werden kann.”

[21] Now Articles 3(4) TEU, 119 (2), 140 (1) TFEU in conjunction with Protocol (No 13) on the convergence criteria; without reservation: Charles Proctor (2012, margin no. 31.44); Bernard Kempen (2012, Article 119 margin no. 6); in favour of a strict interpretation, see Werner Heun (1998, p. 866).

euro as their currency. Some did not want to accept the obligation to introduce the new currency, others were not yet ready to take this step. As a result, the United Kingdom obtained a provision which allowed it to refrain from entering the third stage of the European Monetary Union even if it fulfilled the convergence criteria (opt-out clause).[22] As the Treaty was rejected by a referendum in Denmark, this country was also granted an exemption as well.[23] For most new Member States, mainly from eastern-central Europe, custom-made rules for the transition period were adopted in the respective treaties admitting them to the Union. They were signed by all the Member States and have the quality of primary law of the Union. Only Sweden was neither granted an exemption nor completed the admittance procedure to the euro despite the general obligation to do so.[24] This is also the reason why the obligation to set up the Monetary Union was retained as a permanent duty even after the revisions of the Treaties although it already had been established.[25]

1.2.3 The Legal Formation of Two Groups of Member States

As it was initially not envisaged to have permanently—or for a longer period of time—two classes of Member States—those whose currency is the euro and those which have another currency—no specific clauses in the Treaties dealt with this situation. First, the fundamental revision of the primary law of the Union by the Treaty of Lisbon[26] entering into force in 2009 led to the "official" recognition of the two groups of Member States, despite the fact that this had been considered to be highly questionable before:

1) A special section was inserted into the Treaty on the Functioning of the European Union (TFEU) with "provisions specific to Member States whose

[22] Protocol (No 15) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, Official Journal of 26 October 2010, C 326/284: "1. Unless the United Kingdom notifies the Council that it intends to adopt the euro, it shall be under no obligation to do so. (...) 3. The United Kingdom shall retain its powers in the field of monetary policy according to national law."

[23] The exemption had the effect that all Articles and provisions of the Treaty and the Statute of ESCB/ECB referring to a "derogation" should be applicable to Denmark. The admission procedure of Article 140 TFEU should only be initiated at the request of Denmark, No 1 and 2 of the Protocol (No 16) on certain provisions relating to Denmark, Official Journal of 26 October 2010, C 326/287.

[24] More details Sect. 3.1 below.

[25] Article 3(5) TEU, cf. Helmut Siekmann (2013, Article 3 margin nos. 9–12).

[26] Signed on 13 December 2007 and entering into force on 1 January 2009, Official Journal C 306/1 of 17 December 2007; rectification on 30 April 2008, Official Journal C 111/56 of 6 May 2008; rectification on 27 November 2009, Official Journal C 209/1 of 6 May 2008.

currency is the euro".[27] Semi-officially, they are called the "euro area" or "eurozone". Their representatives in the organs and other institutions of the EU are referred to as "euro group".[28]

2) The Member States whose currency is not the euro are now called by the primary law "Member States with a derogation", regardless of the reason why they did not introduce it.[29] Most provisions regulating the Monetary Union are not applicable to them, Article 139(2)–(4) TFEU, and do not confer any rights or impose any obligations on them, Article 42(1) Statute ESCB/ECB. The "Member States with a derogation" (and their national central banks) are almost completely excluded from the decision-making process concerning the euro and the actions taken by the ECB.[30] This makes sense as they keep their monetary competences and retain their own currencies.[31] The provisions of the primary law of the Union concerning economic policy, in specific Articles 119–126 TFEU, are, however, with minor exceptions[32] still applicable to them.[33]
3) The Treaty of Lisbon re-affirmed, in view of this development as one of the aims of the Union, the wish "to establish an economic and monetary union whose currency is the euro" by inserting the new Article 3(4) TEU.[34]

1.3 Safeguarding Price Stability

1.3.1 Price Stability as Objective of the EU

Price stability is one of the many objectives which the EU is designated to pursue, Article 3(3) sub-paragraph 1 TEU. "Stable prices" are re-iterated as one of three "guiding principles" for the whole Economic and Monetary Union in Article 119 (3) TFEU, but without granting this principle priority.

[27] Part III, Title VIII, Chapter 4, Articles 136–138 TFEU. Under certain provisions an "enhanced cooperation" had also been generally acknowledged, Part VI, Title III, Articles 326–334 which served as justification for secondary legislation of the Union concerning only Member States whose currency is the euro aiming at preventing and solving financial crises.

[28] Protocol (No 14) on the Euro Group, Official Journal C 326/283 of 26 October 2010.

[29] Article 139(1) TFEU: "Member States in respect of which the Council has not decided that they fulfil the necessary conditions for the adoption of the euro shall hereinafter be referred as 'Member States with a derogation'."

[30] Article 139(3) and (4) TFEU, Article 42.3. and Article 42.4. Statute ESCB/ECB.

[31] Ulrich Häde (2011, Article 139 at margin no. 4).

[32] For example, deficit control pursuant Article 126 (9 and 11) and special wording for the UK.

[33] See Bernard Kempen (2012, Article 139 margin no. 6).

[34] See, for reference, footnote 25 above.

1.3.2 Price Stability as Primary Objective of Monetary Policy

For monetary policy, price stability is to be the "primary objective", Article 119 (2) sentence 1, Article 219(1) sub-paragraph 2 TFEU. Monetary policy is here understood in a wide sense, *i.e.*, monetary policy in the narrow sense plus the exchange-rate policy which has to be thoroughly separated in theoretic analysis. How far this separation can be upheld in practical policy is another question. For the monetary policy in the narrow sense including the ESCB, the priority of price stability is repeated in Articles 127(1) and 282(2) sentence 2 TFEU.

This, does not imply that in this field the other objectives may be neglected. They only have to step back in the event of a conflict. Nevertheless, this distinct priority was again called into question in the recent past in favour of growth and unemployment objectives by politicians and special interest groups.[35] The priority of price stability is, however, unconditional, and it remains a strict obligation embedded in the primary law of the Union. It may not be watered down by means of interpretation.[36] The framers of the Treaty of Maastricht did not want several objectives of the same rank, but a clear hierarchy of goals.[37] This was decided in distinct contrast to the Federal Reserve Act where three objectives—not two as is often contended—of equal rank are prescribed: "maximum employment, stable prices, and moderate long-term interest rates".[38]

The general economic policies "in" the Union are only to be supported without prejudice to the primary objective, that of "price stability", Articles 127(1), 282 (2) sentence 3 TFEU. Also the wording of Article 119(2) and (3) TFEU defining the general path of monetary and economic policy is revealing since it does not contain a growth or employment objective.

1.3.3 The Content of the Term "Price Stability"

The primary law does not provide a numeric value for price stability. Thus, almost as a dogma, the annual 2 per cent increase of the harmonised consumer price index,

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[35] For quite some time in the past price stability, growth, and (full) employment had been designated as objectives of equal rank, for details see: Sachverständigenrat (1965), preface at no. 3; Alex Möller (1969, p. 91 et seq.); Hans-Heinrich Hansmeyer (1972, pp. 133–139), with some reservations; Helmut Siekmann (1985, pp. 148, 151 et seq.); Werner Heun (1998, p. 869); see, also, Markus Wiebel (1968, p. 904 et seq.).

[36] Werner Heun (1998, p. 869).

[37] Jörn Pipkorn (1994, p. 285); Jean-Victor Louis (1995, p. 59); René Smits (1997, p. 399); Helmut Siekmann (2013, Article 119 margin no 98); partially disagreeing, see Rainer Stadler (1996, p. 101 et seq.): relativization by goals of Article 2 TEEC.

[38] Federal Reserve Act, Section 2A. Monetary policy objectives: "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the *goals of maximum employment, stable prices, and moderate long-term interest rates* [emphasis added]."

but slightly below this, in medium range, defined by the ECB as price stability,[39] is widely used both by economists and the public.[40] Nevertheless, it must be kept in mind that this value is not a legal norm but a unilateral and, perhaps, arbitrary setting by an administrative body. In addition, it is not clear whether it conforms to the language of the primary law if taken seriously. This is also the reason why the majority of legal scholars in Germany understand the term "price stability" as a change of approximately zero per cent of the consumer price index.[41]

For a long period of time, the definition of price stability was also not understood as a goal to be achieved but as a tolerable margin consistent with the price stability objective. More recently, not only in the media but also in official documents of the ECB, the "price stability" goal has been increasingly substituted by an "inflation goal" (*Inflationsziel*)[42] which the ECB allegedly has to pursue. In the language of the primary law of the EU, however, not even the faintest trace of an "inflation target" can be found. The change in terminology is clearly used as an instrument to make the "unconventional" measures of the ECB appear "normal", with the further effect that such a "new normal"[43] should no longer be judged as illegal. The downside of such an "inflation goal" is that it does not take adequately into account the prevailing interest rates. From the microeconomic perspective, an inflation rate of 2 per cent has a considerably different effect depending on whether the interest rate for riskless investments is 3 per cent or 0.5 per cent. Striving for a situation of negative real interest rates over an extended period of time, as is in act at the moment, at least needs critical scrutiny.

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[39] In October 1998 the Governing Council of the ECB defined price stability as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 %" and added that price stability "was to be maintained over the medium term". The Governing Council confirmed this definition in May 2003 following a thorough evaluation of the ECB's monetary policy strategy. On that occasion, the Governing Council clarified that "in the pursuit of price stability, it aims to maintain inflation rates below but close to 2 % over the medium term"; European Central Bank, Press Report of 8 May 2003, *Monthly Bulletin*, June 2003, p. 87; European Central Bank (2011b, p. 69); Hanspeter K. Scheller (2006, p. 80); see, also, Helmut Siekmann (2013), at Art. 119 TFEU margin no. 49; Alexander Thiele (2013, p. 30).

[40] ECB *Monthly Bulletin*, October 2014, p. XIV: "Price stability: as defined by the Governing Council, a year-on-year increase in the HICP for the euro area of below 2 %. The Governing Council has also made it clear that, in the pursuit of price stability, it aims to maintain inflation rates below, but close to, 2 % over the medium term."

[41] Cf. Gert Nicolaysen (1993, p. 39); for references, see also Helmut Siekmann (2014, at Art. 88 margin no. 92). Also, non-German scholars preferred originally a margin of "less than 2 %" [René Smits (1997, p.185)] with further references.

[42] See, for example, ECB vice president Constancio in an interview with *Börsen-Zeitung* of 11 September 2014: "(...) is the responsibility of monetary policy to reach the inflation goal", available at: (http://www.ecb.europa.eu/press/inter/date/2014/html/sp140911.en.html); see, also, Mark Schröers (2014) citing the critique of Otmar Issing, who had, initially, shaped the monetary policy of the ECB.

[43] Hermann Remsperger (2013, pp. 2 et seq., 10 et seq.).

Another problem which is not sufficiently treated in legal reasoning is the role of asset prices and their tendency to form fatal bubbles if not reined back appropriately by the competent authorities. This also holds for sovereign debt. The framers of the treaty of Maastricht did not envisage their detrimental effect on monetary and financial stability. From an economic point of view, the increase of prices that have to be paid for assets reveals also a form of inflation, asset price inflation. A record in stock market indices implies, for example, that the share of a corporation which can be bought for a given amount of money diminishes. This is also a loss of price stability and should be taken into account when exhorting the meaning of "price stability" in legal documents.[44]

1.3.4 Safeguards to Guarantee the Objective "Price Stability"

The essential role that the objective of "price stability" plays in the architecture of the Monetary Union is emphasised by the variety of safeguards included in the primary law to procure the achievement of this goal effectively:

- high admission standards (convergence criteria), Article 140 TFEU;
- comprehensive guarantee of independence of the monetary institutions, Articles 130, 131, 282(3) TFEU;
- no monetary financing of public sector, Article 123 TFEU;
- no privileged access of public sector entities to financial institutions, Article 124 TFEU;
- strict fiscal discipline of Member States and interdiction of excessive government debt, Article 126(1) TFEU; and
- no liability of the EU or Member States for the public sector debt of another Member State or assumption of financial commitments of the public sector of another Member State, Article 125(1) TFEU.[45]

1.4 General Economic Policy not a Task of the EU

1.4.1 Separation of Monetary Policy and Economic Policy

The primary law follows a clear and systematic separation between (general) economic policy, including fiscal policy, and monetary policy in Part III, Title VIII TFEU.[46] This systematic distinction is taken up in Article 119 (1) and (2) TFEU.[47]

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[44] Helmut Siekmann (2014, Article 88 margin no. 91).

[45] Often labelled as the "no bail-out clause", which is, to a certain extent, at least misleading.

[46] Title VIII: Economic and Monetary Policy Chapter 1: Economic Policy Chapter 2: Monetary Policy.

[47] Emphasised by the GFCC: "According to Title VIII of the Treaty on the Functioning of the European Union and notwithstanding the special powers expressly assigned to the Union (e.g., Art.

1.4.2 Competence for General Economic Policy with Member States

Article 119(1) TFEU speaks of "the close coordination of Member States' economic policies".[48] In Articles 119(2) and 127(1) sentence 2 TFEU, the "general economic policy in the Union" is referred to, but is distinctively not "of" the Union.

This statutory distinction between monetary policy and (general) economic policy and its diverging attribution is crucial for the whole architecture of the Economic and Monetary Union and its institutions.[49] It discriminates the competences given to the Union from the powers remaining with the Member States. Such a distribution of competences presumes the separability of both areas of policy, which might be questionable from an economic perspective,[50] but has become decisive for judging the support mechanisms set up by the EU and the Member States in the course of the crisis,[51] and the unconventional measures of the ECB.[52] Despite all interconnections and repercussions, a dividing line can be drawn with grey areas at the margins.[53]

121, 122, 126 TFEU), the responsibility for economic policy lies clearly with the Member States. In this field of economic policy, the European Union is—apart from individual exceptions that are in particular regulated in Part III of the Treaty on the Functioning of the European Union—essentially limited to a coordination of Member States' economic policies" (judgment of 14 January 2014, cases: 2 BvR 2728/13, 2 BvR 2729/13, 2 BvR 2730/13, 2 BvR 2731/13, 2 BvE 13/13, available at: [http://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2014/01/rs20140114_2bvr272813en.html?nn=5403310] [OMT-judgment] margin nos. 39, 63, 68; = BVerfGE 134, 366 [margin nos. 39, 63, 68]).

[48] Emphasis added. Furthermore, the Council is to "adopt measures specific to those Member States whose currency is the euro: (a) to strengthen the coordination and surveillance of their budgetary discipline; (b) to set out economic policy guidelines for them (. . .)", Article 136(1) TFEU.

[49] Hermann-Josef Blanke (2012, p. 80 et seq.); Helmut Siekmann (2013, Article 119 at margin nos. 22, 24, 26).

[50] Alexander Thiele (2014a, p. 694).

[51] See Helmut Siekmann (2013, pp. 112–113):

- 2 May 2010, pledge of financial support for Greece by Member States through bilateral agreements, Statement by the Eurogroup;
- 11 May 2010, general (temporary) support by the EU (European Financial Support Mech anism - EFSM), Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism, Official Journal of 12 May 2010 L 118/1;
- 7 June 2010, general (temporary) support by Member States (European Financial Stability Facility - EFSF), EFSF Framework Agreement, draft of 20 May 2010, Executive Version of 7 June 2010;
- 11 July 2011/2 February 2012, (permanent) European Stability Mechanism (ESM).

[52] For details, see Helmut Siekmann (2015, Section 2.4.2. and 3.3.1.).

[53] ECJ, decision of 27 November 2012 in the proceedings *Thomas Pringle* v *Government of Ireland* Case C-370/12 for a preliminary ruling under Article 267 TFEU from the Supreme Court (Ireland), Reports of Cases ECLI:EU:2012:756, margin nos. 53, 92, 96, 108, 114. A very lax delineation is given by Alexander Thiele (2014a, pp. 694–697): The monetary goal shall be decisive. The ECB commands wide discretionary power in defining it. Effects on government finances shall be irrelevant and it shall not be forbidden to undermine economic and fiscal policy. This attempt is clearly oriented at the goal to justify the debated and questionable measures of the ECB, cf. Helmut Siekmann (2015, Section 2).

The German Federal Constitutional Court (GFCC) delineates monetary policy in distinction from economic policy "according to the wording, structure, and purpose of the Treaties".[54] Concurring with the European Court of Justice, it discards acts which directly pursue economic policy objectives from monetary policy. Acts which only indirectly pursue monetary policy objectives are not to qualify as acts of monetary policy.[55] Although this description seems to come close to a tautological transformation, it offers additional insight as it shifts the emphasis to the objectives of the respective policies which can be differentiated. Moreover, certain tools or instruments can clearly be labelled as economic policy: for example, "the granting of financial assistance",[56] or "the control of budgetary policy".[57] Finally, the relation of the act in question to other provisions and its embedding in an "overall relation" are also to be relevant.[58]

As a consequence, the ESCB and the ECB are barred from pursuing an economic policy of their own.[59] This, of course, does not hinder them from considering the consequences of their decisions for the general economic policy. The distinction and separation of tasks, powers, and competences have also played a major role in the ongoing debate on the "unconventional" measures taken by the Governing Council of the ECB fighting the financial crisis and its aftermath. However, the label "unconventional" might well prove only to be a euphemism for "illegal".[60]

1.4.3 The Fiscal Responsibility of the Member States

In the language of the Union law, economic policy comprises also fiscal policy. This implies that the Union does not have—albeit with some explicit exceptions—the power to regulate the fiscal and budgetary decisions of the Member States. They have remained fully responsible for their fiscal policy and its results. Neither a (horizontal) federal equalisation system which is mainly intended to mitigate budgetary problems pro-actively has been established (1), nor an *ex-post* liability of the Union or Member States for the debt of each other (2). An open and much debated question has been the conformity of a purely voluntary financial assistance of Member States (3).

(**1**) Great care was taken by the framers of the Treaty of Maastricht that the Economic and Monetary Union did not include any trait of a horizontal or vertical

[54] GFCC, OMT-judgment (footnote 47 above), margin no. 63.

[55] Margin no. 64; following Pringle (footnote 53 above) at nos. 56 and 97.

[56] Margin no. 65; following Pringle (footnote 53 above) at no. 57.

[57] Margin no. 67.

[58] Margin no. 66.

[59] GFCC, OMT-judgment (footnote 47 above), margin no. 39: "It [the European Central Bank] is not authorised to pursue its own economic policy." See, also, margin no. 68: "The authority to support the general economic policies of the Member States at Union level (Art. 127 sec. 1 sentence 2 TFEU) does not justify any steering of economic policies in the System of European Central Banks."

[60] See, for details, Helmut Siekmann (2015, Section 3.3.).

(power) equalisation system among Member States or between the EU and the Member States. All Member States were expected to remain fully responsible for their finances, and no expectations were to be nourished that outside help would come in the event of budgetary problems.[61] The capital markets were to provide the appropriate sanctions for unsound fiscal policy. Permanent instruments to prevent irresponsible fiscal policy were included in the legal framework besides the screening at admission time. Both safeguards,[62] however, allegedly not fulfil their tasks properly.[63]

At EU level, it was envisioned that—in the absence of the possibility of depreciating a national currency after entering the third stage of the Monetary Union—the root causes of economic and budgetary problems should be addressed by developing greater economic strength, which would eventually lead to the necessary convergence. This is also the reason for the existence of the structural funds and the cohesion fund of the EU which aim to improve the infrastructure of defined areas and/or to solve structural economic deficits. They have been greatly extended parallel to the introduction of the single currency[64] and consume a large portion of all funds of the EU.[65]

These funds and programmes are now based upon Article 174 TFEU, which provides that, in order to strengthen its economic, social and territorial cohesion, the Union is to “aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions” or islands, and that “particular attention is to be paid to rural areas, areas affected by industrial transition, and regions which suffer from severe and permanent natural or demographic handicaps”. A rich host of funds and programmes[66] are now in operation[67] to mitigate structural and regional imbalances at the roots:

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[61] René Smits (1997, p. 77); Thomas Mayer (2010, p. 49); Helmut Siekmann (2010).

[62] On the safeguards to guarantee permanent stability of the EMU Sect. 1.3.4. above.

[63] Jean-Victor Louis (2010, p. 979).

[64] Structural funds: Framework regulation 1993/2081, Official Journal of 31 July 1993, L 193/5; Coordination regulation 1993/2082, Official Journal of 31 July 1993, L 193/20; ERDF regulation 1993/2083, Official Journal of 31 July 1993, L 193/34; ESF regulation 1993/2084, Official Journal of 31 July 1993, L 193/39; EAGGF, Guidance Section regulation 1993/2085, Official Journal of 31 July 1993, L 193/44; FIFG regulation 1993/2080, Official Journal of 31 July 1993, L 193/1; Cohesion Fund: Regulation establishing the Cohesion Fund, 1994/1164, Official Journal of 25 May 1994, L 130/1; Regulation establishing a financial Cohesion Instrument.

[65] Hermann-Josef Blanke (2012, p. 107) provides 35 per cent as number.

[66] Common and general provisions regulation—CPR: Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006, Official Journal of 20 December 2013, L 347/320.

[67] Period of 2014–2020.

- European Regional Development Fund (ERDF);[68]
- European Social Fund (ESF);[69]
- European Agricultural Fund for Rural Development (EAFRD);[70]
- European Maritime and Fisheries Fund (EMFF);[71]
- Cohesion Fund;[72]
- European Territorial Cooperation Goal (ETC);[73]
- European Grouping of Territorial Cooperation (EGTC).[74]

A clear distinction, however, has been maintained from a (power) equalisation system, as the funds are earmarked for specific purposes, mainly investments, and are not granted at the general disposition of a government with the possibility of handing out "gifts" to its electorate. The crucial point is to improve the competitiveness of the Member States which are in need. To the displeasure of many national or regional politicians, the correct disposition of these financial means is strictly controlled by the EU (Article 325 TFEU on combatting fraud), in specific by the Court of Auditors, established pursuant Article 13(1) TEU and Articles 285–287. This is a major difference to funds granted by a (federal) equalisation system.

(**2**) Neither the Union nor the Member States are to be liable for the commitments of any level of government of a Member State including its agencies, public

[68] ERDF regulation: Regulation (EU) No 1301/2013 of the European Parliament and of the Council of 17 December 2013 on the European Regional Development Fund and on specific provisions concerning the investment for growth and jobs goal and repealing Regulation (EC) No 1080/2006, Official Journal of 20 December 2013, L 347/289.

[69] ESF regulation: Regulation (EU) No 1304/2013 of the European Parliament and of the Council of 17 December 2013 on the European Social Fund and repealing Council Regulation (EC) No 1081/2006, Official Journal of 20 December 2013, L 347/470.

[70] EAFRD regulation: Regulation (EU) No 1305/2013 of the European Parliament and of the Council of 17 December 2013 on support for rural development by the European Agricultural Fund for Rural Development (EAFRD) and repealing Council Regulation (EC) No 1698/2005. Official Journal of 20 December 2013, L 347/487.

[71] EMFF regulation: Regulation (EU) No 508/2014 of the European Parliament and of the Council of 15 May 2014 on the European Maritime and Fisheries Fund and repealing Council Regulations (EC) No 2328/2003, (EC) No 861/2006, (EC) No 1198/2006 and (EC) No 791/2007 and Regulation (EU) No 1255/2011 of the European Parliament and of the Council, Official Journal of 20 May 2014, L 149/1.

[72] Cohesion Fund regulation: Regulation (EU) No 1300/2013 of the European Parliament and of the Council of 17 December 2013 on the Cohesion Fund and repealing Council Regulation (EC) No 1084/2006, Official Journal of 20 December 2013, L 347/281.

[73] ETC regulation: Regulation (EU) No 1299/2013 of the European Parliament and of the Council of 17 December 2013 on specific provisions for the support from the European Regional Development Fund to the European territorial cooperation goal, Official Journal of 20 December 2013, L 347/259.

[74] EGTC regulation: Regulation (EU) No 1302/2013 of the European Parliament and of the Council of 17 December 2013 amending Regulation (EC) No 1082/2006 on a European grouping of territorial cooperation (EGTC) with regard to the clarification, simplification and improvement of the establishment and functioning of such groupings, Official Journal of 20 December 2013, L 347/303.

undertakings, or any other body governed by public law. But it is not only liability that is strictly forbidden by the primary law of the Union, it is also the assumption of such a liability, Article 125(1) TFEU. This clause is the complement of the freedom that the Member States enjoy in economic and fiscal matters.

Only under extraordinary circumstances—not due to decisions of the government of the state in difficulty—may (limited) financial support by the EU be granted. The provisions are laid down in Article 122(2) TFEU: “natural disasters” or “exceptional occurrences beyond its [the Member States’] control”. This clause constitutes in no way a claim for support but authorizes measures at the discretion of the Council. The establishment of the European Financial Stabilisation Mechanism (EFSM) in 2010 by the EU was explicitly based upon this clause,[75] although it remains questionable whether its pre-requisites were fulfilled.[76]

(**3**) Aside from this specific clause, it is an open and not-easy-to-answer question as to whether voluntary financial assistance by Member States[77] would be admissible.[78] In this context, it was called into question whether the aid granted by the Member States was compatible with Article 125 TFEU and the fundamental requirement of fiscal self-responsibility.[79]

Voluntary financial assistance by Member States is not explicitly regulated by the primary law. The wording of Article 125(1) TFEU could be interpreted in the way of an interdiction. In addition, the (restrictive) provisions of Article 122 (2) TFEU may be used as an argument against the legality of financial support outside its range. Finally, the existence of Article 143(1) TFEU which regulates voluntary support for Member States whose currency is not the euro (states “with a derogation”[80]), is an indication that financial support should not, otherwise, be

[75] Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism, Official Journal of 12 May 2010 L 118/1, recital 1; for details see note 51 above.

[76] Kurt Faßbender (2010, p. 800 et seq.); Walter Frenz and Christian Ehlenz (2010, pp. 213–215), specifically criticising the foundation of the EFSM on Article 122(2) TFEU (p. 212 et seq.); Hanno Kube and Ekkehart Reimer (2010, p. 1914); Kai Hentschelmann (2011, pp. 295–300, p. 304); Doris Hattenberger (2012, margin nos. 6, 9, 12); Hermann-Josef Blanke (2012, p. 106); Christian Calliess (2013, p. 99 et seq.); Michael Potacs (2013, p. 137 et seq.), not objecting: GFCC judgment on support for Greece, BVerfGE 129, 124; comment by Michael Elicker and Veris-Pascal Heintz (2012); justification also by: Alberto de Gregorio Merino (2012, p. 1634), as Member of the Legal Services of the Council of the European Union; Christian Herrmann (2010b, p. 416); idem (2012, pp. 807, 808); Martin Nettesheim (2012, pp. 66–73). The ECJ differentiates explicitly between setting up a stability mechanism and the power to grant assistance upon the basis of Article 122(2) TFEU which may only be used to grant temporary assistance but may not be used as basis for setting up a permanent mechanism, ECJ Pringle (note 53 above) at nos. 64, 65, 116. For more details, see note 89 below.

[77] See note 51 above.

[78] For details, see Helmut Siekmann (2013, pp. 132–137).

[79] Vestert Borger (2013, p. 120), emphasises an interpretation of Article 125 TFEU as “the basic agreement” in contrast to Article 143(2) and Article 122(2) TFEU as its exceptions.

[80] For more details regarding them, see Sect. 1.2.3. above.

admissible.[81] Both norms could, also be interpreted as being only an authorisation of the organs of the EU,[82] which is, perhaps, restricted to be used as an *ultima ratio* only.[83]

The European Court of Justice also took a lenient view of Article 125 TFEU as a starting-point and concluded from the language of this clause, in comparison with the allegedly much stricter language in Article 123 TFEU, that "it is not intended to prohibit any financial assistance whatever to a Member State".[84] It stated, however, two constraints:

(1) (. . .) the activation of financial assistance by means of a stability mechanism such as the ESM is not compatible with Article 125 TFEU unless it is indispensable for the safeguarding of the financial stability of the euro area as a whole and subject to strict conditions.[85]
(2) (. . .) Article 125 TFEU does not prohibit the granting of financial assistance by one or more Member States to a Member State which remains responsible for its commitments to its creditors provided that the conditions attached to such assistance are such as to prompt that Member State to implement a sound budgetary policy.[86]

The logic of the basic principles of the Monetary Union speaks, in fact, against the admissibility of voluntary support by Member States or the Union, unless the pre-requisites of the exemptions—interpreted strictly—are fulfilled. A differing

[81] Kurt Faßbender (2010, p. 800): Article 125 TFEU interdicts any kind of support; Walter Frenz and Christian Ehlenz (2010, pp. 212 et seq.); Hanno Kube and Ekkehart Reimers (2010, p. 1914); Martin Seidel (2011, p. 241); Daniel Thym (2011, p. 169); Christoph Degenhart (2012, p. 161) with further references: incompatible with Article 125 TFEU; Idem (2013, p. 96): interdiction to grant aid.

[82] Not objecting voluntary support: GFCC judgment on support for Greece, BVerfGE 129, 124: Alberto de Gregorio Merino (2012 [member of the Legal Services, Council of the European Union], p. 1627), under the condition of budgetary adjustments; Werner Heun and Alexander Thiele (2012, p. 979); in favour of granting loans as compatible Jochen Wieland (2011, p. 341); in effect also René Smits (1997, p. 77) only interdicting the assumption of liabilities which follows already from the explicit wording of the clause.

[83] Ulrich Häde (2010, pp. 859–862).

[84] ECJ Pringle (note 53 above) at no. 132; supporting explicitly the opinion of the court: Christian Calliess (2013, pp. 99, 103); Martin Nettesheim (2013, p. 14 et seq.); Michael Potacs (2013, pp. 134, 141 et seq.); Wolfgang Weiß and Markus Haberkamm (2013, p. 97 et seq.); questioning the ECJ's interpretation of Article 125: Vestert Borger (2013, p. 133 et seq.); Ulrich Palm (2014, Article 136 TFEU, margin no. 45 et seq.).

[85] ECJ Pringle (note 53 above) at no. 136.

[86] ECJ Pringle (note 53 above) at no. 137.

interpretation would substantially undermine the (intended) pressure for budgetary discipline.[87]

The problem of the admissibility of financial support by Member States has been resolved by inserting paragraph three into Article 136 TFEU.[88] The European Court of Justice has acknowledged its conformity with EU law,[89] and the German Federal Constitutional Court its conformity with German constitutional law.[90] According to the interpretation preferred here, this new clause[91] is not only a clarification[92] but opens constitutively the door to the granting of financial aid[93] under certain restrictive conditions, which had hitherto been closed. This is also the assumption of the German Federal Constitutional Court in its decision recognising the admissibility of the insertion although it nonetheless acknowledges that the amendment constitutes a fundamental re-shaping of the European Economic and Monetary Union.[94]

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[87] Helmut Siekmann (2013, pp. 134–137); Vestert Borger (2013, pp. 134–137).

[88] European Council Decision of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro (2011/199/EU), Official Journal of 6 April 2011, L 91/1; entering into force on 1 May 2013, BGBl II [Federal Law Gazette II], p. 1047.

[89] ECJ (note 53 above), at margin nos. 1 and 2, after an contradicting evaluation by the Supreme Court of Ireland; supporting: Christoph Herrmann (2012, p. 807 et seq.), Vestert Borger (2013, p. 127); critical: Christoph Degenhart (2012, p. 162); idem (2013, pp. 95–97); Ulrich Palm (2014, Article 136 TFEU, primarily margin nos. 45–47); only in view of the reasoning of the court, Matthias Ruffert (2013, p. 258); Martin Nettesheim (2013, pp. 14–17).

[90] GFCC, judgment of 18 March 2014 upon the basis of the oral hearing of 11 and 12 June 2013, cases: 2 BvR 2728/13, 2 BvR 2729/13, 2 BvR 2730/13, 2 BvR 2731/13, 2 BvE 13/13, available at: ((www.bundesverfassungsgericht.de/entscheidungen/rs20140318_2bvr139012en.html) (in English)) [ESM final judgment], in specific margin no. 177 et seq.

[91] The new paragraph reads as follows: "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

[92] The ECJ (note 53 above) assesses a wide range of financial aid as compatible with Article 125 TFEU but inconsistently examines the compatibility of the new Article 136(3) with the primary law (margin no. 131 et seq., 138–143); consenting Daniel Thym (2013, p. 262). This argumentation is highly questionable from a methodological point of view as the new article is primary law and must not be judged by a norm of the same level. Primary law may be changed by primary law at the discretion of the competent organs and institutions as long as the competences and procedures are obeyed.

[93] Granting loans may have been compatible with Article 125 TFEU without Article 136(3) TFEU, Werner Heun and Alexander Thiele (2012, p. 979), with further references; also in favour of differentiation, Vestert Borger (2013, p. 125).

[94] GFCC, ESM final judgment (note 90 above), at margin no. 180: "(. . .) constitute indeed a fundamental reshaping of the existing Economic and Monetary Union, because it detaches its concept, albeit to a limited extent, from the principle of independence of the national budgets which had characterised it before (cf. on this BVerfGE 129, 124 <181 and 182>; 132, 195 <248>, n. 128; cf. however ECJ, Judgment of 27 November 2012, Case C-370/12—*Pringle* –, n. 73 et seq.)"; agreeing Christian Calliess (2013, p. 104); Matthias Ruffert (2013, p. 259); see, also, Christian Calliess (2011a, p. 279); Hanno Kube (2012, p. 245).

1.5 The Rules on Government Deficits and Debt[95]

1.5.1 Primary Law

Although the Member States negotiating the Treaty of Maastricht could not reach a consensus about giving up their fiscal and budgetary autonomy, they conceded to insert binding rules on government deficits and debt into the primary law.[96] The material rules are, however, only vague, and the procedure to enforce them is complicated, extended over a long period of time, open for discretionary decisions, and without the necessary sanctions. As a general rule, Member States are to avoid "excessive" government deficits.[97] The primary law uses "the sustainability of the government financial position" as the essential criterion for a sustainable convergence in the framework of the Economic and Monetary Union.[98] Even if this clause belongs to the transitional provisions, it can nonetheless be used as a basis for the interpretation of the obligation to "avoid excessive government debts".

The EU Commission has to monitor the development of the budgetary situation and of the stock of debt of all the Member States. The aspired budgetary discipline in particular is to be judged following the so-called Maastricht Criteria,[99] which have found almost ubiquitous dissemination in political debate, economic analysis, and the media: (a) the ratio of government deficit to gross domestic product, and (b) the ratio of government debt and gross domestic product.[100] The first reference value has been set at 3 per cent and the second at 60 per cent.[101] These reference values are part of the primary law of the Union.[102]

[95] The following draws from Helmut Siekmann (2012, section D V); id. (2013, pp. 126–129).

[96] Now Article 126 TFEU and Protocol (No 12) on the excessive deficit procedure, Official Journal of 26 October 2010, C 326/279.

[97] Article 126(1) TFEU. The United Kingdom watered this clause somewhat down as it promised only to "endeavor to avoid an excessive government deficit"; No 5 of Protocol (No 15) (note 22 above).

[98] Article 140(1) indent 2 TFEU.

[99] Not unfrequently, the criteria used to judge whether a Member State fulfils the necessary conditions to adopt the euro are also called "Maastricht Criteria"; see, for example, Charles Proctor (2012, margin nos. 26.13 and 26.14). The naming of these four criteria, laid down in Article 140(1) TFEU and further developed in Protocol (No 13) on the convergence criteria (Official Journal of 26 October 2012, C 326/281), should, however, follow the terminology of the primary law. They are to be called "convergence criteria". This also helps to avoid confusion.

[100] Article 126(2) TFEU.

[101] Article 1 Protocol (No 12) (note 96 above).

[102] Article 51 TEU.

A lot of confusion and, presumably, intentional mis-representation has to be observed with regard to these rules. This holds especially in view of alleged "breaches" of the Stability and Growth Pact and alleged "transgressions" of the "Maastricht" limits for government deficits and debt. This is why the following should be absolutely clear: (1) the described rules are not the Stability and Growth Pact even though this is almost permanently claimed in public; (2) the numeric values of the ratios (3 and 60 per cent) are not binding limits. They serve only as reference values in a complex assessment procedure with plenty of additional vague terminology and a notable amount of discretionary power vested in the competent organs of the EU. The only certain and strict obligation lacking any discretionary power is, that, in the event that the Commission has come to the conclusion that an excessive deficit exists,[103] the Council may not simply stop the procedure and do nothing, as it had decided in respect of the unsound deficits of Germany and France in 2003.[104]

The Excessive Deficit Procedure (EDP) may result in admonitions and recommendations.[105] If a Member State persistently fails to implement the recommendations, sanctions may be imposed which may eventually entail a non-interest-bearing deposit with the Union or a "fine of an appropriate size".[106] In essence, both the procedural and the substantial rules for enforcing the requirement of permanent budgetary discipline are laid down in the primary law of the Union. However, really effective sanctions have not been embodied. Specifically, an *exclusion* of a Member State from the eurozone is not foreseen and would be *illegal*.[107]

From its inception, it has been criticised that the procedure provided in the primary law would be too tedious and, above all, that the political determination would be lacking to impose appropriate sanctions.[108] The definitions and specifications of the rules on both government debt and deficits *and* the deficit procedure had been undertaken by the secondary law of the Union, but no reduction of the

[103] Following Article 126(6) TFEU.

[104] ECJ, judgment of 13 July 2004—C-27/04 (Commission vs. Council), *Europäische Zeitschrift für Wirtschaftsrecht*, 2004, p. 465; *Juristen Zeitung*, 2004, p. 1069 with comment, Markus Kotzur (2004); see, also, Dimitrios Doukas (2005); Barbara Dutzler and Angelika Hable (2004); Gert Nicolaysen (2004, pp. 1322, 1325); Christoph Degenhart (2012, p. 161).

[105] Article 126(7–9) TFEU.

[106] Article 126(11) sub-paragraph 1.

[107] Paul Kirchhof (1994, p. 72); probably also Christoph Herrmann (2010b, p. 417); for more details, see Sect. 4.3. below.

[108] Franz-Christoph Zeitler (1995, p. 1611).

scope of discretion for imposing sanctions was provided.[109] It was mainly Germany that demanded a "stability pact", preferably with automatic sanctions.[110]

1.5.2 Secondary Law

The Stability and Growth Pact

The Stability and Growth Pact is neither an agreement nor a treaty, but three acts of secondary law.[111] The term "pact" was retained to emphasise the underlying political consensus.[112] It can be taken as a remnant of the initially considered separate treaty. Technically, the pact consists of one resolution of the European Council,[113] which is legally not binding,[114] and two—binding—regulations. One is mainly designed as an early warning system and is called preventive arm of the "pact".[115] The other contains mainly procedural rules in the event that a Member State shows a lack of budgetary discipline, and is called the corrective arm of the "pact".[116] The resolution contains a multilateral promise to achieve an almost balanced budget in the medium term. As the corrective arm is based upon Article 126(14) sub-paragraph 2 TFEU empowering the Council to enact rules which replace the Deficit Protocol (No 12), the extent to which this may be done is/remains an open and much debated question.[117]

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[109] Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community, Official Journal of 31 December 1993, L 332/7; amended several times, codified version: Council Regulation (EC) No 479/93 of 25 May 2009, on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community, Official Journal of 10 June 2009, L 145/1; Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) of the Treaty, Official Journal of 31 December 1993, L 332/1.

[110] A "Stabilitätspakt für Europa" was presented by the German Minister of Finance on 10 November 1995; see for details, Ulrich Palm (2000, pp. 44 et seq., 142); Ulrich Häde (1996, p. 139); extensively on this and the origins of the Stability and Growth Pact, Kai Hentschelmann (2009, pp. 205–285).

[111] For the following, see, already, Helmut Siekmann (2012, Section D V 2).

[112] Explicitly expressed in recital no. 2 of both regulations, notes 115 and 116 below.

[113] Resolution of the European Council on the Stability and Growth Pact Amsterdam of 17 June 1997, Official Journal of 2 August 1997, C 236/1.

[114] But allegedly a "political" obligation, see Hugo J. Hahn and Ulrich Häde (2010, p. 318) with further references for varying opinions.

[115] Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Official Journal of 2 August 1997, L 209/1.

[116] Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, Official Journal of 2 August 1997, L 209/6.

[117] For details, see Charlotte Gaitanides (2013, Article 126 TFEU margin no. 162 et seq).

The Stability and Growth Pact sets as its goal a “close to balance or in surplus position” of the budget. This is an enhancement compared to the requirement of Article 126(1) TFEU which was to “avoid excessive government deficits”.

Revisions of the Stability and Growth Pact: An Overview
The requirements of the Stability and Growth Pact can be relaxed much easier and faster than primary law since they are no treaties—counterfactual to their labelling—which can be amended only unanimously. Such a relaxation was readily done in 2005,[118] ironically at the special request of the German government.[119]

With the evolvement of the financial crisis into a sovereign debt crisis in Europe, the legal instruments of the Stability and Growth Pact were enhanced and tightened in several steps: first, by the so-called “six-pack” legislation in 2011 which not only contained amendments of the Stability and Growth Pact,[120] but also rules on the prevention and mitigation of macro-economic imbalances,[121] and on budgetary surveillance;[122] not only for the euro area but also for the whole EU, including the

[118] Council Regulation (EC) No 1055/2005 amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies of 27 June 2005, Official Journal of 7 July 2005, L 174/1; Council Regulation (EC) No 1056/2005 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure of 27 June 2005, Official Journal of 7 July 2005, L 174/5.

[119] Critical namely: Deutsche Bundesbank (2005a, p. 42; 2005b, p. 21), also European Central Bank (2011a, p. 113) with reference to European Central Bank (2005), where the criticism is indirect and rather mild; for more details, see Charlotte Gaitanides (2013, margin no. 23 et seq.).

[120] Regulation No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Official Journal of 23 November 2011, L 306/12 (strengthens the preventive surveillance and coordination instruments of the Stability and Growth Pact); Regulation No 1177/2011 of the European Parliament and of the Council of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, Official Journal of 23 November 2011, L 306/33 (aims to improve the effectiveness of the corrective measures in case of an excessive deficit by providing stricter requirements for the stages of the deficit procedure pursuant to Art. 126 TFEU).

[121] Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area, Official Journal of 23 November, L 306/8 (provides a system of sanctions for the effective correction of excessive macroeconomic imbalances in the euro area [Art. 1]). Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances, Official Journal of 23 November 2011, L 306/25 (sets out detailed rules for the detection of macroeconomic imbalances, as well as the prevention and correction of excessive macroeconomic imbalances within the Union [Art. 1 sec. 1]).

[122] Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011, on the effective enforcement of budgetary surveillance in the euro area, Official Journal of 23 November 2011, L 306/1 (sets out a system of sanctions for enhancing the enforcement of the preventive and corrective parts of the Stability and Growth Pact in the euro area [Art. 1]). Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of Member States, Official Journal of 23 November 2011, L 306/41 (aims to ensure transparency and

"Member States with a derogation".[123] As these reforms left considerable room for continuing scepticism,[124] a second round of enhancements was adopted in 2013, the so-called "two-pack".[125]

It was a major goal of the reforms to make the Excessive Deficit Procedure (EDP) more effective:

> Overall, the two main objectives of the six-pack and two-pack reforms in the area of fiscal surveillance were (1) a strengthened and deepened budgetary surveillance by making it more continuous and integrated, also via an intensified sanctions mechanism; and (2) an additional surveillance for euro area Member States to ensure the correction of excessive deficits and an appropriate integration of EU policy recommendations in the national budgetary preparation.[126]

For the Member States of the euro area a semi-automatic sanctioning mechanism was introduced in the framework of the preventive arm. It is designed to work via a reversed voting mechanism.[127]

The Preventive Arm

The preventive arm aims to ensure the underlying strength of the Member States' public finances in order to create macroeconomic stability and the fiscal space to address the economic shocks that may arise. The core requirement is that Member States reach and maintain a Medium Term Objective (MTO), a country-specific budgetary reference value defined in structural terms (that is, cyclically adjusted and net of one-off and temporary measures). The country specific MTO is to be set within a safety margin in view of the 3 per cent deficit limit, to ensure rapid progress

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availability of the necessary data, which are a requirement for compliance with and enforcement of the obligations under the Treaties regarding the avoidance of excessive budgetary deficits, with detailed requirements for, *inter alia*, public accounting systems, the use of numerical fiscal rules, medium-term budgetary forecasts and the implementation of independent analysis and monitoring).

[123] For more details on them, see Sect. 1.2.3. above.

[124] Critical in-depth assessment by Schuknecht/Moutot/Rother/Stark (2011); for details see Hermann-Josef Blanke (2012, pp. 83–95), judging the measures as not going far enough (p. 94).

[125] Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability, Official Journal of 27 May 2013, L 140/1; Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area, Official Journal of 27 May 2013, L 140/11; critical assessment: European Central Bank (2013).

[126] Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, Economic governance review, Report on the application of Regulations (EU) No 1173/2011, 1174/2011, 1175/2011, 1176/2011, 1177/2011, 472/2013 and 473/2013, 28. November 2014, COM(2014) 905 final, p. 4.

[127] Article 4 regulation 1173/2011 (supra footnote 122); for details, see Charlotte Gaitanides (2013, margin no. 45 et seq.).

towards sustainability, and to allow room for budgetary manoeuvre. For the euro area and the exchange rate mechanism (ERM II) Member States, the limit has to be set at −1 per cent of GDP. The 2011 reform introduced an expenditure benchmark: the expenditure net of discretionary measures should grow less than the medium-term potential GDP.[128]

The preventive arm requires that the Member States of the eurozone yearly transmit a "stability programme" to the Commission in order to facilitate surveillance. "The Member States with a derogation" transmit "convergence programmes". A major component of both programmes is the formulation of an adjustment path towards meeting the benchmarks. The adjustment path towards a sustainable deficit has 0.5 per cent of GDP as its benchmark and should follow the general rule: more in good times, less in bad times. The 2011 reform tightens the adjustment requirement and introduces the obligation to reduce the deficit by more than 0.5 per cent of GDP under two conditions: (i) the debt level is greater than 60 per cent of GDP; or (ii) "pronounced sustainability risks" exist.[129]

A temporary deviation from the adjustment path is allowed if the implementation of major structural reforms with a verifiable impact on the long-term sustainability of public finances—emphasis on pension reform—is undertaken. The 2011 revision also allowed deviations in the event of: (i) an unusual event outside the control of the Member State concerned with a major impact on its financial position; and (ii) a severe economic downturn for the euro area or the EU as a whole provided this does not endanger the medium-term fiscal sustainability.[130]

The enforcement of these rules was significantly enhanced by the 2011 revision: A procedure for correcting significant deviations (0.5 per cent in 1 year or cumulatively over 2 years from the MTO or the adjustment path) was installed. For euro area Member States, financial sanctions (interest-bearing deposit of up to 0.2 per cent of GDP) in the event of repeated non-compliance are foreseen.

The Corrective Arm

The objective of the corrective arm of the Stability and Growth Pact is the correction of gross policy errors. The 2011 revision laid increased emphasis on the debt criterion and aims at speeding up the convergence to sustainable debt limits. As a starting-point, the 3 per cent of GDP deficit and the 60 per cent of GDP debt or a "sufficiently diminishing debt" remain as the thresholds. The reform specified numerically what has to be considered as "sufficiently diminishing". A debt will now be considered as sufficiently diminishing if the debt reduction benchmark is respected. The debt reduction benchmark is set at a reduction of 5 per cent per year on average over 3 years (one-twentieth of the gap to 60 per cent) taking the cycle into account, or, if the benchmark is respected, in the next 2 years regardless of the cycle. A minimum annual improvement of the deficit of

[128] European Commission (2014a, Annex 1).

[129] Ibid.

[130] Ibid.

0.5 per cent of GDP is required as a benchmark in structural terms.[131]

Specific Amendments by the "Two-pack" Regulations

The first regulation of the "two-pack"[132] codifies a regime of "enhanced surveillance" for a Member State which is in one of the following situations: (i) experiencing serious difficulties with regard to its financial stability or is threatened by them without receiving financial assistance; or (ii) receiving financial assistance on a precautionary basis, for instance, from the European Financial Stability Facility, the European Stability Mechanism, or the International Monetary Fund (IMF). Under certain conditions, the Commission, in liaison with the ECB and—where applicable—the IMF, must conduct "regular review missions" in order to ascertain that the envisaged "progress in implementing the agreed measures" is made. In a further step, a "macroeconomic adjustment programme" may replace the EDP targets in the event that financial assistance is requested.[133]

The second regulation of the "two-pack"[134] requires Member States to publish their medium-term fiscal plans by 30 April each year and the draft of their annual budgets by 15 October. The budget is to be adopted by 31 December at the latest. In the event of "particularly serious non-compliance" with the budgetary policy obligation, the Commission will have to "adopt an opinion on the draft budgetary plan" and request "revised draft budgetary plans".[135]

Effectiveness of the Reforms

In its economic governance review of November 2014, the EU-Commission reviewed the effectiveness of the "six-pack" (2011) and the "two-pack" (2013). Although expressly acknowledging the short time-span since their adoption, it arrived at the overall assessment that the "reformed framework has proven effective in strengthening budgetary surveillance and thus in guiding Member States in their efforts to consolidate public finances in difficult economic conditions". The Commission admits, however, that the "specific contribution" of the new rules is "difficult to distinguish from other factors", and that "first experience suggests that the reformed fiscal rules indeed have played a role".[136] In the light of the most recent handling of the rules with regard to the budgetary plans of France doubts ramain whether the Commission has the necessary verve to enforce the rules in view of a big Member State.

[131] Ibid., p. 3 and footnote 4.

[132] Regulation 472/2013 (note 125 above).

[133] European Central Bank (2013, p. 54).

[134] Regulation 473/2013 (note 125 above).

[135] European Central Bank (2013, p. 53).

[136] European Commission (2014a, p. 5). Detailed and disaggregated numbers within the context of fiscal surveillance can be found in the 2014 report on public finances of the European Commission (2014b), especially in Part III.

1.5.3 Euro Plus Pact

The so-called Euro Plus Pact is neither a legislative act of the EU, nor a treaty. It is a declaration adopted by the European Council,[137] even though the German Federal Constitutional Court calls it a treaty:

> Pursuant to the text of the treaty and its conclusions, it aims to strengthen the economic pillar of the monetary union, to achieve a new quality of economic policy coordination between the Member States of the euro currency area, to improve their competitiveness, and thereby to achieve a higher degree of convergence. The focus is to be placed primarily on the policy areas that fall within the competences of the Member States and which are crucial for increasing competitiveness and avoiding harmful imbalances.[138]

In fact, it appears more to be a camouflage in order to allow additional spending programmes which might be questionable with regard to the provisions of the Stability and Growth Pact.

1.5.4 Law of Nations

The regulations of the "Stability and Growth Pact" and its foundations in the primary law were supplemented by new contractual arrangements among the Member States for more fiscal stability in the eurozone. They have to be considered as part of the law of nations, in contrast to EU law.

By joining the European Union, a Member State does not lose its capacity to close treaties governed by the law of nations, even in fields which principally fall within the domain of the European Union. This is also true for treaties among a subset of Member States of the EU, such as those whose currency is the euro. However, some *caveats* have to be respected:

- Treaties of this kind may only deal with topics which are covered by Member State competences. This implies that they may never regulate a matter which falls within the exclusive competences[139] of the EU, such as the monetary policy for the Member States whose currency is the euro, Article 3(1)(c) TFEU; and
- the provisions of such a treaty must be compatible with "common legal rules" of the EU.[140]

As has already been stated, general economic policy—including fiscal policy—does *not* belong to the competences of the EU. In principle, it has remained with the

[137] EUCO 10/1/11 REV 1, Annex I.

[138] GFCC ESM final judgment (note 90 above, margin no. 18); see, for details, BVerfGE 131, 152 et seq.

[139] More details Sect. 1.2.1. above.

[140] ECJ, Case C-524/04, Test Claimants, reports 2007, I-2107 margin nos. 49, 53; ECJ Pringle (supra footnote 53) at nos. 68, 98, 101; Koen Lenaerts and Piet Van Nuffel (2011, margin nos. 22–110); Christian Tietje (2011, p. 10 et seq.); Rudolf Streinz (2012b), margin nos. 524, 526 specifically for the fiscal treaty.

Member States. This was the intention of the framers of the Economic and Monetary Union.[141] Fiscal and budgetary policies are part of the (general) economic policy,[142] with the exception of the provision on government deficit and debt in Article 126 TFEU.

Exercising this (residual) power, on 2 March 2012, the heads of state or government of 25 Member States[143] signed the "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union", which became better known as the (new) "fiscal compact".[144] It entered into force on 1 January 2013[145] after ratification by twelve member states of the euro area.[146]

The Treaty introduced strengthened rules for fiscal discipline and stricter surveillance within the euro area without prejudice to the legal obligations from the EU law,[147] in particular, by establishing a "balanced budget rule". According to the provisions of the Treaty, "national budgets must be in balance or in surplus under the balanced budget rule, a criterion that is met if the annual structural government deficit does not exceed 0.5 per cent of GDP at market prices.[148] They must also be in line with the country-specific medium-term budgetary objective, as defined in the EU's stability and growth pact.

The balanced budget rule has to be incorporated into the Member States' national legal systems, preferably at constitutional level, within 1 year of the entry into force of the Treaty, *i.e.*, by 1 January 2014.[149] In the event of deviation from the balanced budget rule, an automatic correction mechanism is triggered. It will be defined by each Member State upon the basis of principles proposed by the European Commission and endorsed by the signatories. The violation of these rules may result in fines up to 0.1 per cent of the GDP of the Member State in question. The implementation in national law can be enforced by legal action in the European Court of Justice (ECJ).[150]

[141] Section 1.1. above.

[142] Section 1.4.1. above.

[143] As the United Kingdom and the Czech Republic objected an amendment of the primary law the way of a separate treaty or compact had to be chosen, Frank Schorkopf (2012, pp. 3, 14, 17).

[144] Adopted and transformed into German law by act of 13 September 2012, BGBl II [Federal Law Gazette II] 2012, p. 1006, giving the text of the treaty also in English.

[145] BGBl II [Federal Law Gazette II] 2013, p. 162. The Act on the National Implementation of the Fiscal Compact entered into force on 19 July 2013, BGBl I [Federal Law Gazette I] 2013, p. 2398.

[146] Austria, Cyprus, Germany, Denmark, Estonia, Spain, France, Greece, Italy, Ireland, Lithuania, Latvia, Portugal, Romania, Finland, and Slovenia. Finland deposited its instrument of ratification 21 December 2012.

[147] Frank Schorkopf (2012, pp. 6, 14).

[148] This is a contractual obligation: Doris Hattenberger (2012, Article 126 TFEU margin no 70); Rüdiger Bandilla (2012, Article 126 TFEU margin no 120).

[149] Article 3(2) sentence 1 fiscal compact; see, also, press release of the EU-Commission, 21 December 2012, 18019/12, PRESSE 551.

[150] For more details, see: Frank Schorkopf (2012); Hermann-Josef Blanke (2012); Charlotte Gaitanides (2013, margin nos. 169–190).

2 The European System of Central Banks

2.1 The ESCB as the Core Content of the Monetary Union

The European Central Bank (ECB) together with the national central banks of all Member States form the European System of Central Banks (ESCB).[151] It is construed as a de-centralised but single entity of the European Union (EU) and resembles the Federal Reserve System of the United States in this aspect. The ESCB is the core content of the Monetary Union, which, in its turn, forms an integral part of the EU (Part III, Title VIII TFEU). An often forgotten trait is that the central banks of all the Member States including those "with a derogation",[152] and not just those whose currency is the euro, are part of the ESCB.

2.2 The Institutional Set-Up of the ESCB

2.2.1 The ESCB

The ESCB is governed by the decision-making bodies of the ECB: the Governing Council, the Executive Board, and the General Council.[153] The ESCB does not have legal personality.

The monetary authority transferred to the Union does, in fact, not only comprise the competence and power to employ the usual instruments that central banks command to regulate interest rates and the volume of money, but also the regulation of foreign exchange rates and international agreements on money and monetary policy. The latter, however, do not belong to the competences passed on to the ESCB,[154] although it is stated indiscriminately in Article 282(1) sentence 2 TFEU that the European Central Bank, together with the national central banks of the Member States whose currency is the euro, is to conduct the "monetary policy of the Union". Article 219 TFEU dealing with the fixing of foreign exchange rates by the Council shows that the term "monetary policy" is used with different meanings depending on the context.

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[151] Article 282(1) sentence 2 TFEU.

[152] For details, see p. 54 above.

[153] Article 282(2) sentence 1 TFEU.

[154] Gert Nicolaysen (1993, p. 29).

2.2.2 The Eurosystem

The European Central Bank together with the national central banks of the Member States whose currency is the euro constitute the Eurosystem, Article 282(1) sentence 2 TFEU.

2.2.3 The ECB

In contrast to the ESCB, the ECB has legal personality, Article 282(3) sentence 1 TFEU. Its decision-making bodies are the Governing Council and the Executive Board, Article 283(2) TFEU with six members.

The Executive Board comprises the President, the Vice-President and four other members, making six members in total, Article 283(1) sub-paragraph 1 TFEU. They have to be nationals of the Member States and are appointed by the European Council, acting by a qualified-majority, “from among persons of recognised standing and professional experience in monetary and banking matters”, Article 283 (1) sub-paragraphs 2 and 4 TFEU. Their term of office is a fixed period of 8 years and is not renewable, Article 283(1) sub-paragraph 3 TFEU.

The Governing Council comprises the members of the Executive Board of the ECB and the Governors of the national central banks of the Member States whose currency is the euro. Since Lithuania introduced the euro on 1 January 2015, it has 25 members.

For monetary policy decisions, the primary law follows the principle of “one member, one vote”, Article 10.2. sentence 1 Statute ESCB/ECB. However, from the date on which the number of members of the Governing Council exceeds 21, only 15 governors from the national central banks will have the right to vote following a complicated rotation system, outlined in the remainder of Article 10.2. Statute ESCB/ECB. This restriction may be necessary for practical purposes, but may lead to the exclusion of voices from major participating countries.

2.2.4 The ECB and National Central Banks

The national central banks are an integral part of the ESCB. They are to act in accordance with guidelines and instructions of the ECB, Article 14.3. Statute ESCB/ ECB. Additional functions may be performed by the national central banks unless a two-third majority of the Governing Council deems that they are interfering with the objectives and tasks of the ESCB, Article 14.4. Statute ESCB/ECB. A special procedure at the European Court of Justice has been implemented to enforce the obligations of the national central banks, Article 35.6. Statute ESCB/ECB.

2.2.5 The Finances of the ECB

The national central banks, not the Member States, are the sole subscribers and holders of the capital of the ECB, Article 28.2. Statute ESCB/ECB. No minimum capital is required. Both ECB and national central banks may even have negative capital. Only a *limited liability* of the national central banks for losses has been stated, Article 33.2. Statute ESCB/ECB. Any attempt to establish further contributions, levies, or taxes to finance losses of the ECB would not be consistent with the primary law of the EU.

2.3 The Comprehensive Guarantee of Independence

The primary law provides for a comprehensive guarantee of the independence of the European Central Bank, the national central banks, and all members of their decision-making bodies, Articles 130, 131, 282(3) sentence 2 TFEU. Several aspects of independence can be distinguished:

- institutional;
- personal; and
- financial.[155]

The personal independence of the members of the Executive Board is warranted by several provisions: the fixed term of office with no possibility of renewal and the removal from office only under very restrictive conditions.

Only if a Board Member no longer fulfils the conditions required for the performance of his or her duties or if he or she has been found guilty of serious misconduct, is removal from office foreseen by the EU primary law. If these conditions are met, (compulsory) retirement has to ensue. But it is neither the appointing institution, nor an organ of the ECB, that has the power to take such a measure. It is reserved to the independent judiciary. The European Court Justice has to retire the member in question, Article 11.4. Statute ESCB/ECB.

The primary law does not protect the personal independence of the Members of the Governing Council to the same degree it does concerning the Executive Board. It only prescribes a minimum term of office of 5 years for the Governors of national central banks and contains no interdiction of the renewal of their term of office, Article 14.2. Statute ESCB/ECB. Experience tells that a long duration of office combined with the lack of the possibility of renewal are the strongest safeguards for true independence. The desire for renewal of the terms of office may *de facto* pose a significant threat for independent and unbiased decisions.

[155] For an in-depth analysis of the independence guarantee, see Barbara Dutzler (2003, pp. 88–109); Charlotte Gaitanides (2005, pp. 199–279); Werner Heun (1998, p. 874 et seq.); Helmut Siekmann (2013, Article 130 TFEU).

2.4 Limited Tasks

The primary law lists, in Article 127(2) TFEU, basic tasks of the ESCB as:

- the defining and implementing of the monetary policy of the Union;
- the conducting of foreign-exchange operations with prejudice to Article 219 TFEU;
- the holding and managing of foreign reserves; and
- the promoting of the smooth operation of payment systems.

For monetary policy, a restatement can be found in Article 282(1) sentence 2 TFEU: the "European Central Bank, together with the national central banks of the Member States whose currency is the euro, (. . .), shall conduct the monetary policy of the Union." Thus, it is effectively the Eurosystem which has to conduct the monetary policy of the Union.

Not a basic task of the ESCB are the following:

- general economic policy;[156]
- the stability of the financial system; and
- the supervision of the financial institutions.

The ESCB shall "contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system", Article 127(5) TFEU. As it shall only "contribute" to the policies of the "competent" authorities, it does not have a competence of its own for these tasks.

When framing the Monetary Union, it was a fiercely debated topic whether the new European Central Bank should have competences in banking supervision.[157] It was finally agreed that banking supervision should not belong to its tasks, in contrast to the first draft of the statutes by the committee of central bank governors.[158] Already in the final draft, it was reduced to an advisory function.[159] The actual wording of the norm states that the ECB is only to play an ancillary role by "contributing" to supervision by other authorities and has no powers of its own in this field. However, consensus could be reached to the effect that a limited transfer of competences should not be blocked in the future should it become a common wish of the Member States. Thus, Article 127(6) TFEU from the beginning allowed for "specific tasks (. . .) concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings" may be conferred upon the ECB by unanimous vote of the Council. This means that the conferral requires the consent of all Member States. In the

[156] Section 1.4. above.

[157] Harold James (2012, p. 313); see, also, Christos Hadjiemmanuil (1996).

[158] Stefan Glatzl (2009, p. 257); Harold James (2012, pp. 292, 315).

[159] René Smits (1997, pp. 335–337).

meantime, a conferral has been adopted within the framework of the so-called Banking Union (the Single Supervisory Mechanism—SSM).[160]

3 The Euro

3.1 Member States Whose Currency Is the Euro

As already mentioned,[161] all Member States are obliged to introduce the euro unless an exemption has been granted by primary law. In effect, 19 of the 28 Member States have introduced the euro by now. The initial participating countries were Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.[162] Greece was admitted before the introduction of euro notes and coins on 1 January 2002.[163] Cyprus, Malta, Slovenia, Slovakia, and Estonia followed. The last country to be admitted was Lithuania. The United Kingdom and Denmark did not adopt the euro in accordance with the exemptions granted to them.[164] Sweden refrained from continuing the process of introducing the euro,[165] although it would—on closer scrutiny—have fulfilled all the admittance requirements.

[160] Council Regulation (EU) No 1024/103 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, Official Journal of 29 October 2013, L 287/63; Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013, Official Journal of 29 October 2013, L 287/5; for more details, see Alexander Thiele (2014b, pp. 521–523).

[161] Section 1.2.2. above.

[162] Regulation (EC) No 974/98 of the Council of 3 May 1998, Official Journal of 11 May 1998, L 139/1.

[163] Council decision (2000/427/EC) of 19 June 2000 in accordance with Article 122(2) of the Treaty on the adoption by Greece of the single currency on 1 January 2001, Official Journal of the European Communities of 7 July 2000 L 167/19; Council Regulation (EC) No 2169/2005 of 21 December 2005 amending Regulation (EC) No 974/98 on the introduction of the euro, Official Journal of 29 December 2005 L 346/1; for the legislative history cf. EU Bulletin 5—2000, point 1.3.5: 3 May 2000 “the Commission adopts a proposal for a Council decision aiming the adoption by Greece of the single currency on 1 January 2001. On the basis of the report of the European Central Bank (adopted on 27 April 2000) and of its own 2000 convergence report, the Commission has concluded that Greece fulfils the necessary conditions for the adoption of the single currency and is proposing a Council decision abrogating Greece’s derogation from its obligations regarding the achievement of economic and monetary union. The derogation would be abrogated with effect from 1 January 2001. The report (document COM(2000) 274) was endorsed by the European Parliament on 18 May”.

[164] Notes 22 and 23 above.

[165] Automatic consequence of the decision of the EU Council of 3 Mai 1998 and Article 121 para. 1 phrase 3 TEC.

As a result, the following Member States of the EU have not introduced the single European currency to date: Bulgaria, Croatia, the Czech Republic, Denmark, Hungary, Poland, Romania, Sweden, and the United Kingdom. They are the "Member States with a derogation".[166]

3.2 Euro Banknotes and Coins

The euro is the only official currency in the Union. Euro banknotes and euro coins are legal tender in all Member States whose currency is the euro; the only legal tender.[167] All other currencies or means of payment had to cease to fulfil this function. Euro banknotes may be issued by the ECB or the national central banks, Article 128(1) sentence 2 TFEU. However, without authorisation by the ECB, no euro banknote may be issued. It is an exclusive right of the ECB, Articles 128(1), 282(3) sentence 2 TFEU. In this way, the ECB has effective control over the kind and volume of euro banknotes, even though the actual production is cared for by the national central banks as the "operative arm" of the Eurosystem. All notes are identical no matter where they are produced. These banknotes are the only banknotes which have the status of legal tender within the Union, Article 128(1) sentence 3 TFEU.

In contrast, euro coins are issued by the Member States and have different designs on one side of the coin. Approval by the ECB is required regarding the volume of the issue, Articles 128(2), 282(3) sentence 2 TFEU, thus retaining control over the volume of central bank money.

3.3 The Euro Outside the EU

Usually, sovereign states have their own currencies and central banks, and some of these currencies are pegged to the euro.[168] Some countries use the euro as legal tender upon the basis of formal agreements following Article 219(3) TFEU, with the right to mint euro coins, such as Andorra, Monaco, San Marino, and the Vatican, as a source of revenue for their budgets.[169] Some countries use the euro as legal tender without permission.[170] In some areas, it is used *de facto* as currency without

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[166] For more details, see Sect. 1.2.3. above.

[167] Now Article 128 para. 1 TFEU.

[168] In Europe: Macedonia and Bosnia & Herzegovina (indirectly via the former Deutsche Mark); in Africa: Cape Verde, São Tomé and Príncipe, the Comores, and all countries using the CFA.

[169] For details and references see: Monetary and exchange rate arrangements of the euro area with selected third countries and territories, European Central Bank (2006, p. 87); Helmut Siekmann (2013), *Einführung* [introduction], margin no. 58 and 59.

[170] Montenegro, Kosovo.

being legal tender.[171] Its use in the overseas territories of Member States and associated countries follows complex rules.[172]

4 Exit, Exclusion, or Parallel Currencies in the Eurozone?

As the Monetary Union is an integral part of the EU[173] and each Member State is obliged to introduce the euro,[174] exit from the eurozone, which has been discussed quite frequently by economists, politicians and the media, is legally not possible and economically questionable (Sect. 4.1).[175] The introduction of a new currency parallel to the euro by a Member States which has introduced the euro is also forbidden since the Member States lack the competence to implement such a measure (Sect. 4.2). Neither exit, nor the implementation of a parallel currency may be permitted by the organs of the EU or of the Member States (Sect. 4.3). The exclusion of a Member State from the EU or the Monetary Union is highly questionable from a legal point of view (Sect. 4.4). This does, however, not imply that there are no possibilities for sanctions. Any illegal action taken within this framework will have at least serious consequences for the affected claims and property rights (Sect. 4.5).

4.1 Exit or Withdrawal

Pursuant to Article 50(1) TEU, any Member State may "decide to withdraw from the Union in accordance with its own constitutional requirements". However, a partial or total exit solely from the eurozone is not provided for. Before the introduction of this clause into the primary law by the Treaty of Lisbon,[176] it had been debated for quite some time whether a Member State could legally leave the European Economic Community (EEC) or—later—the European Communities (EC). This was also discussed in view of a partial renouncement. The legal

[171] For example, in Zimbabwe, or on the British military bases Akrotiri and Dekelia on Cyprus, although the UK does not belong to the eurozone.

[172] For details, see Helmut Siekmann (2012, pp. 359, 360); id. (2013, *Einführung* [introduction] nos. 53–59); id., Protocol (No 17) nos. 6–8; id., Protocol (No 18) nos. 14, 15, 18, 20, 21.

[173] Section 2.1. above.

[174] Section 1.2.2. above.

[175] Beatrice Weder di Mauro (2010, p. 99 et seq.), points out that monetary systems that provide an exit option are inherently instable. Hal S. Scott (1998) discusses the situation "when the euro falls apart" pretending this would be the natural (and legal?) course of the development. Implicitly he assumes that a withdrawal is legally possible as he assesses the consequences of a withdrawal or breakup. This was written, however, before the introduction of Article 50 TEU.

[176] Note 26 above.

literature of the time predominantly denied the possibility of an exit or withdrawal.[177] In cognisance of this controversy, consensus was finally reached with the introduction of Article 50 TFEU. It was meant as a final answer to all questions arising from this problem.[178] As a consequence, Article 50 TEU has to be judged as being conclusive.

From this it follows that a recourse to the Vienna Convention on the Law of Treaties[179] or to general rules of the law of nations (*clausula rebus sic stantibus*) is prohibited.[180] The application of the Conventions is interdicted in the first place for reasons of the EU law. Furthermore, the provisions of the Vienna Convention regulating the termination of a treaty[181] are also not applicable because of the subsidiarity of the following provisions:

- Article 54 refers expressly to the provisions of the treaty in question:

  The termination of a treaty or the withdrawal of a party may take place: (a) in conformity with the provisions of the treaty; or (b) at any time by consent of all the other parties after consultations with the other contracting States.

- Article 56(1) clearly restricts the grounds for the termination of a treaty:

  A treaty which contains no provision regarding its termination and which does not provide for denunciation or withdrawal is not subject to denunciation or withdrawal unless (a) it is established that the parties intended to admit the possibility of denunciation or withdrawal; or (b) a right of denunciation or withdrawal may be implied by the nature of the treaty.

  Both do not hold in the case of the European Monetary Union.
- Article 70(1) accordingly delineates the consequences:

  1. Unless the treaty otherwise provides or the parties otherwise agree, the termination of a treaty under its provisions or in accordance with the present Convention (a) releases the parties from any obligation further to perform the treaty; (b) does not affect any right, obligation or legal situation of the parties created through the execution of the treaty prior to its termination.

[177] Rudolf Streinz (2012a, Article 50 TEU, margin no. 3) with further references.

[178] Oliver Dörr (2011, Article 50 TEU, margin no. 3); Koen Lenaerts and Piet Van Nuffel (2011, margin nos. 6–015); Helmut Siekmann (2012, p. 376).

[179] Chapter XXIII Title 23.1 of 23 May 1969, entry in force on 27 January 1980; official publication in three languages as appendix to: Gesetz zu dem Wiener Übereinkommen vom 23. Mai 1969 über das Recht der Verträge vom 3. August 1985, Federal Law Gazette, Part II (*Bundesgesetzblatt Teil II*) 1985, p. 926.

[180] Claudia Annacker (1998, pp. 59–61), denies the validity of the rules of the law of nations inside a supranational organisation, i.e., among the members inter se; Christian Calliess (2011b, Article 50 TEU margin no. 13), understanding the consent of Member States to the Treaty of Lisbon as an implicit renunciation of any exit rights; Ulrich Becker (2012, Article 356 TFEU margin no. 5) without reservation; disagreeing: Bernhard Kempen (2012, Article 140 TFEU margin no. 32) without regarding Article 50 TEU; Ulrich Häde (2011, Article 140 TFEU margin no. 63) without reasoning; Oliver Dörr (2011, margin nos. 3 and 4) but still considering the provision as constitutive; Michael Rodi (2012, Article 140 TFEU margin no. 4) without considering Article 50 TEU.

[181] Section 3: Termination and Suspension of the Operation of Treaties.

Since the Treaty of Lisbon, Paragraph 1 of Article 56 of the Vienna Convention now clearly blocks Member State exit or withdrawal upon the basis of the Convention in the context of the EU. The Treaty of Lisbon created a provision which explicitly regulated withdrawal from the Union, but does not provide for exit solely from the EMU, and thus there is no space for the application of Article 56 of the Convention. In addition, it is highly questionable whether this convention is applicable to a supranational organisation such as the EU.[182]

In effect, the provisions on a "fundamental change of circumstances" also do not allow exit or withdrawal from the eurozone. Aside from the highly problematical applicability of the Vienna Convention in the context of the EU, the pre-requisites of its Article 62 are not fulfilled:[183] Article 62(1) of the Convention stipulates, in the first place, that:

> a fundamental change of circumstances (. . .) has occurred with regard to those existing at the time of the conclusion of a treaty (. . .) which was not foreseen by the parties.[184]

Nor will recourse to the general *clausula rebus sic stantibus* allow exit. It, too, is foreclosed.[185]

The problems with the fiscal sustainability or competitiveness of a Member State introducing the euro had been foreseen by the parties of the Treaty of Maastricht as the admission procedure imposed admission criteria,[186] and the expansion of the cohesion and structural funds[187] clearly prove. Article 126 TFEU and the Protocol on excessive deficits also regulate the matter. In addition, Article 62(2) of the Convention expressly interdicts a fundamental change of circumstances being invoked as a ground for terminating or withdrawing from a treaty "if the fundamental change is the result of a breach by the party invoking it". This would be the case not only for Greece[188] but also for other Member States which do not fulfil the rules on fiscal soundness, as specified in Article 126(1) TFEU and the ensuing secondary law.

An opt-out has been granted specifically for the UK and Denmark in the Protocols to the Treaty of Maastricht. If, in general, an exit from the euro area were permissible, these legal acts would have been totally superfluous.

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[182] Cf. the material presented by Ralf G. Wetzel and Dietrich Rauschning (1978, pp. 390–395); Hal S. Scott (1998, p. 241), discussing in depth Article 56 of the Vienna Convention on the Law of Treaties expressing doubts whether the provisions of paragraph 1 of the article are met regarding the EU law but does not come to a clear result (p. 214). This was, however, before the insertion of Article 50 TEU.

[183] This article is considered to be a codification of the general law of nations: Jörg P. Müller (1971, p. 217).

[184] For details, see Jörg P. Müller (1971, pp. 217–226).

[185] Christian Calliess (2011b, Article 50 TEU margin no. 13).

[186] Section 1.3.4. above.

[187] Section 1.4.3. (1) above.

[188] More Sect. 4.2. below.

A withdrawal from the obligations of the Monetary Union allowing the re-introduction of a currency of its own by a Member State would therefore have to be judged as illegal[189] with severe economic and legal consequences.[190]

4.2 The Introduction of a Parallel Currency

It has also been proposed to maintain the euro in a distressed Member State such as Greece, likewise to introduce a second (new) currency parallel to the euro.[191] It is highly questionable whether such a measure could mitigate the financial problems of the country as all financial claims are still denominated in euro. National legislation to change this would probably be void as a breach of national and international civil rights statutes. Furthermore, intricate problems of international private law would also have to be solved.

In any case, such a measure would also be illegal from the point of view of the primary law of the Union. Euro banknotes are the only legal tender within the Member States whose currency is the euro, Article 128(1) sentence 3 TFEU. Also the secondary law categorically forbids a currency other than the euro.[192] As the sovereignty in monetary affairs of the euro Member States has been transferred to the Union, "all national powers of legislation and action in the monetary law field came to an end when the euro was introduced in these states".[193]

A statute trying to introduce a new drachma, for example, as legal tender would be void, with the result that nobody would have to accept it. The action would also be useless from an economic point of view.

[189] With in-depth analysis: Chiara Zilioli (2005, pp. 126, 132); Phoebus Athanassiou (2009, p. 21); Siekmann (2013, *Einführung* [introduction] margin no. 48); in effect similarly: Paul Kirchhof (1994, p. 72); Hugo J. Hahn and Ulrich Häde (2010, § 26 margin no. 7 et seqq.; disagreeing—although hesitating—without any legal reasoning: Martin Seidel (2007, p. 617): despite the distinct missing of an exit clause like in the system of the European Monetary System (EMS): probably enabled by "unwritten community law"; questioning but without a clear solution Behrens (2010, p. 121); unclear: Ulrich Häde (2011, Article 140 TFEU margin no. 59 and no. 63). The GFCC mentions in its Maastricht-judgment a right or even an obligation to leave the EMU as *ultima ratio*, however, only as an *obiter dictum* without sufficient reasoning, BVerfGE 89, 155 (204). From its Lisbon-judgment can be gathered on the other side that an exit would not be compatible with German constitutional law, BVerfGE 123, 267(346 et seq.).

[190] More Sect. 4.5. below.

[191] For example Thomas Mayer (2014, p. 35), idem (2015).

[192] Article 2 sentence 1 Council Regulation (EC) No 974/98 on the introduction of the euro, Official Journal of 11 May 1998, L 139/1; cf. Charles Proctor (2012), margin no. 29.13 emphasizing that the euro has been made the sole currency in the participating Member States judging it as the *lex monetae* of the eurozone (margin no. 29.10).

[193] Charles Proctor (2012, margin no. 31.10).

4.3 Exclusion

4.3.1 General Rules

An exclusion from the eurozone by an act of the EU or the eurogroup is not allowed as the needed legal basis for such an onerous measure is not visible. The primary law does not provide a statutory basis for such a sanction.[194] Also Article 7 TEU could not serve as an instrument for an exclusion for three main reasons:

1) It contains an elaborated procedure for enforcing the fundamental values of the EU and only them. It is restrained to the values laid down in Article 2 TEU such as respect for human dignity, freedom, democracy, equality, the rule of law and the respect for human rights. The breach of the rules for the economic and monetary policy does not, as such, belong to it. Only a serious aberration from the various aspects of the procedural or substantive requirements set up by the rule of law might suffice this requirement. This is, however, not yet in sight;
2) In line with the argumentation above, it does not provide a basis for a separate exclusion from the Monetary Union;
3) Moreover, it does not even provide a basis for an exclusion from the EU as its most severe sanction for "a serious and persistent breach by a Member State" is the suspension of "certain rights of the representatives of the government of that Member State in question including the voting rights", Article 7(3) sentence 1 TEU.

The common breach of EU law by a Member State has been specifically regulated in Articles 258 and 259 TFEU. The exclusion is also not a sanction foreseen in the detailed procedure laid down there.

The described statutory provisions have to be judged as conclusive. A recourse to rules of the law of nations is not allowed.[195]

4.3.2 Renunciating the Acts of Admittance to the Euro

It has been deliberated[196] that the legal acts admitting a country to the euro, could be renounced, in specific by amending the regulation about the introduction of the single currency[197], not regarding whether they were obtained by fraud or

[194] Koen Lenaerts and Piet Van Nuffel (2011), margin nos. 6-014; in general, also: Christian Calliess (2011b, Article 50 TEU, margin nos. 12, 13) but exception for extreme cases.

[195] Juliane Kokott (2012, Article 356 margin no. 6); partially disagreeing: Rudolf Streinz (2012a, Article 50 TEU margin no. 13), considering it for an exclusion from the EU (not the EMU!) in "extreme cases"; also Matthias Pechstein (2012, Article 7 margin no. 23) without reasoning; unclear Christian Calliess (2011b, Article 50 TEU margin nos. 17, 21 (advice to withdraw pursuant Article 50 TEU)).

[196] Peter Behrens (2010, p. 121); Christoph Herrmann (2010a, b, p. 417).

[197] Council Regulation (EC) No 974/98 on the introduction of the euro, Official Journal of 11 May 1998, L 139/1.

misrepresentation. Even if it could be true that legal acts might be revocable by the competent institutions as *actus contrarii*[198] this does not hold in the course of introducing the single currency in a staggered procedure prescribed by the Maastricht Treaty. Those acts were clearly designed to be complete, unconditional, and irrevocable.[199] Otherwise, speculative pressure would have been provided an open door. All details were meticulously regulated. A way back was not foreseen and would have been contrary to the principle dominating the formation of the EU: an always closer integration; and not a way back and forth, Article 1 TEU.[200]

4.3.3 The Specific Circumstances in the Case of Greece

In the case of Greece, however, it could be argued that the permission to introduce the euro was obtained as a result of fraud, misrepresentation, or force. It might suffer from a serious legal defect allowing the removal from the eurozone. In technical legal terms it could be renounceable, voidable, or invalid from the beginning on. In the case of Greece it would have to be examined whether the decision of the Council of 19 June 2000 ordering that the derogation in favour of Greece shall be abrogated with effect of 1 January 2000,[201] in effect admitting Greece to the eurozone, suffers from such a serious legal flaw due to fraud or misrepresentation on the side of Greece[202] that it would be void or could be abolished.

The rules of the Vienna Convention on the invalidity of treaties as a consequence of error,[203] fraud,[204] or its breach,[205] may be worth considering but will probably not be applicable. The EU is—despite its origin in treaties—more than just a contractual arrangement. Also the termination or suspension of the operation of a treaty following Article 60 of the Convention because of its breach or non-fulfilment of obligations by one of the parties may be barred for the same reasons.[206]

[198] This is true even if Article 3 TEU may not be interpreted as a general interdiction of regression in the course of European integration, see, for this Ulrich Becker (2012, Article 3 TEU margin no. 10), but without reasoning.

[199] Charles Proctor (2012), margin no. 29.10; Christoph Herrmann (2010a, b, p. 417).

[200] Christian Calliess (2011b, Article 1 TEU margin no. 12): interdiction of regression.

[201] Article 1 of the decision (note 163 above).

[202] The questionable actions of the Greek government to obtain admittance are described by the Commission in its "Report on Greek Government Deficit and Debt Statistics" of 8 January 2010, COM(2010) 1 final; detailed analysis by: Theodore Pelagidis and Michael Mitsopoulos (2014); George C. Bitros (2013), especially pp. 13–17.

[203] Article 48.

[204] Article 49.

[205] Article 60.

[206] Accepted by the law of nations as general principle, see Franz Pfluger (1936, p. 129) also already mentioning the exit from a multilateral agreement (p. 131 et seq.).

It could be discussed if and to which extent the general rules contained in the (private) law of contracts on the validity of the declaration of intention may be applied to sovereign acts. In general, also the law of nations accepts force,[207] error,[208] and fraud[209] as flaws that might lead to the invalidity of a sovereign act. Even more intricate is the question whether those rules are applicable to acts designing the setup of an institution and its operation. Institutions, like the European Union or its subset, the Monetary Union, are designated to be stable and permanent and cannot work under the lasting danger of being dismantled because of defects in the founding legal acts. At least the time span between the disclosure of such a defect and ensuing legal actions has to be limited. Finally the subsequent behaviour of the victim of fraud or misrepresentation has to be taken into account.[210] Granting financial support for Greece fully aware of the facts of a misrepresentation might remedy the legal defects of the admittance decision.[211] However, the principle of trust and good faith within organizations[212] might require that Greece discharges its (new) obligations within this context. A failure to do so might also lead to serious legal consequences.

However, the general or the contractual law of nations is not applicable in case the EU contains a specific regulation of the problem. This is to be found in Article 7 TEU which provides in a staggered procedure as most severe sanction the suspension of membership rights.[213] An exclusion is not foreseen and would be illegal.[214]

4.4 Permission to Introduce a New Currency

An exit from the Monetary Union or the introduction of a parallel currency may also not be *permitted* on the basis of Article 3(1) TFEU. This clause does not comprise the power to amend primary law.[215] This would, however, be indispensable because of Article 50 TEU and of Article 128 TFEU. It has to be kept in mind, that the euro

[207] Ibid., pp. 78–88.

[208] Ibid., pp. 88–91.

[209] Ibid., pp. 91–93.

[210] Regulated in Article 45 of the Vienna Convention.

[211] In general, Claudia Annacker (1998, p. 273 et seq.).

[212] Generally accepted Jörg P. Müller (1971, p. 227 et seq.).

[213] Article 7 TEU margin no. 3 with some *caveats*; Article 356 TFEU margin nos. 5, 7 with further references; in general also Matthias Ruffert (2011, Article 7 TEU margin no. 31 et seq.), with further references.

[214] Koen Lenaerts and Piet Van Nuffel (2011, margin nos. 6-014); Juliane Kokott (2012, Article 356 TFEU margin no. 6) with further references.

[215] Ulrich Häde (2011, Article 140 TFEU margin no. 60).

banknotes are "the only such notes to have the status of legal tender within the Union", Article 128(1) sentence 3 TFEU.

4.5 Consequences of an Illegal Exit from the Eurozone

Serious and hard to calculate problems would above all arise for the debt denominated in euro in case the new currency is introduced despite the contradicting rules of EU law.[216]

It is already highly questionable, whether such debt would automatically be transformed into debt denominated in the new currency (e.g., *nea drachme*); especially as the old currency will continue to exist. The national government may, however, try to change the denomination of the existing debt by a unilateral administrative or legislative act. This act would have to be judged as void since the Member State whose currency is the euro does not have competences in monetary affairs any more. As its withdrawal from the Monetary Union or the introduction of a new (parallel) currency are illegal the EU continues to command the exclusive competence in all monetary affairs, Article 3(1)(c) TFEU.[217] Acts of a Member State in this field are void or at least illegal as well.

In general, it can be assumed that EU law is the *lex monetae*[218] governing obligations originating from a Member State. A change of the currency would at least be ineffective in view of the objective to reduce the burden of debt.[219] This result is not affected by the fact whether the law of the re-denominating country or a foreign law is governing the underlying contracts; for example it would be irrelevant whether a bond has been issued pursuant to the law of the United Kingdom or of Greece in case the Hellenic Republic would introduce a new currency. The fact according to which law the obligation has come into existence may only be used as criterion for determining the *lex monetae* in situations of *uncertainty* about the applicable currency.[220] This uncertainty is, however, not given in a case when a

[216] For an extensive analysis of the severe consequences, in specific for all contractual obligation denominated in euro, see Wolfgang Ernst (2012, pp. 50, et seq., 57); Frank Vischer (2010, Section 18).

[217] Section 1.2.1. above.

[218] For definition and function, see, already, Frederick A. Mann (1992, pp. 219 et seq., 272, 278); later: Charles Proctor (2012), margin no. 32.16; Frank Vischer (2010 margin no. 358–364); Wolfgang Ernst (2012, pp. 52–55).

[219] Without referring to this crucial clause Hal S. Scott (1998, p. 223) comes to a similar conclusion: "Note that if reference was made to EU law as *lex monetae*, [...] re-denomination would be ineffective." Nevertheless, he does not state a clear result because of the lack of precedents in the case of a surviving monetary union. Arthur Nussbaum (1925, p. 161) is searching for a line of discrimination when a sovereign ruler introduces a new currency but only in a fraction of the territory and the old currency continuing to exist in the rest of the territory. He pre-supposes, however, that the change of the monetary system has been performed lawfully by exercising a sovereign right.

[220] Already described by Arthur Nussbaum (1925, pp. 228–231).

government changes, by sovereign act, the denomination referred to in a contract to another currency, *e.g.*, from euro to “new drachme”.[221]

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[221] Hal S. Scott (1998, p. 223) supposes that only foreign courts would apply the *lex monetae*. This is, however, an irrevelant guess in delivering an opinion on the merits of a legal question. He cites Frederick A. Mann for leaving the decision to the proper law of the contract. In fact it is, in the first place a question of the sovereign right which has been decided by the primary law of the Union.

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Central Bank Independence in Times of High Fiscal Risk: The Case of Japan

Franz Waldenberger

Abstract The Bank of Japan Act of 1997/1998 grants the Bank of Japan (BoJ) operational independence regarding the conduct of monetary policy. This independence is legally constrained and has also been questioned politically by the Abe administration's recent usurpation of monetary policy as part of its overall economic policy. The deflationary environment characteristic of the Japanese economy over the last 20 years has, to date, avoided fiscal and monetary policy goals coming into conflict. The real test for central bank independence in Japan will come once deflation has been overcome and the harmonious relation between price stability and fiscal, as well as financial system, stability comes to an end. Price stability may still be maintained as long as fiscal consolidation is synchronised with the reduction in the non-public sector's saving-investment balance.

1 Central Bank Independence: Relevance and Challenges

Central bank independence (CBI) is considered important for the achievement of price stability in fiat money regimes, where governments may be tempted to finance public expenditure by printing additional money (Cukierman 2008; Eijffinger and de Haan 1996). Clearly, in democracies, such behaviour could be precluded by strict parliamentary control. However, since ruling parties often hold the majority of seats in the parliament, such budgetary control may be limited. CBI can thus provide an additional institutional safeguard (Bernholz 2013). More generally, CBI is seen as a means for protecting monetary policy not only from fiscal interests, but also from other political interests that may conflict with price stability. Again, it has been argued that sound monetary policy required strict rules rather than an institutional arrangement such as CBI (Friedman 1962: 49–52; Taylor 2013). However, as the constant debates about the "right" monetary policy show, economists cannot provide a commonly accepted "best rule", and even less so clear prescriptions as to

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F. Rövekamp et al. (eds.), *Central Banking and Financial Stability in East Asia*, Financial and Monetary Policy Studies 40, DOI 10.1007/978-3-319-17380-1_5

how such a rule would have to be applied under various economic scenarios. So, again, CBI may be justified as a pragmatic institutional solution.

The possible benefits of CBI do not, however, ensure that it actually works. There are two basic challenges. One is political. Even legally independent central banks do not operate outside political spheres. Their actions are scrutinised and regularly criticised in public. Whether central banks are strong enough to resist political influence depends not only on how well their independence is legally protected, but also on the commitment and personality of those in charge of monetary policy (Metzler 2013: 406). The second challenge relates to the problem of multiple objectives. Central banks are often required to consider the stability of the financial system, the employment situation and economic growth in their policy choices. As these other goals may conflict with price stability, trade-offs have to be made. Here, the political challenge becomes relevant again, because the other goals, even if they are formally subordinated to price stability, tend to attract more political attention and support (Walsh 2011; Berger and Kißmer 2013).

In the following, we will consider the challenges to CBI in the case of Japan. As the title indicates, the major challenge stems from fiscal instability. Japan's record-high government debt raises not only fiscal stability concerns, but also puts the financial system and the overall health of the economy at risk. Can a central bank pursue an "independent" monetary policy in such circumstances? The recent global financial crisis has revealed the relevance of this question, and not just for Japan (Blinder 2013).

The next section analyses the legal foundations of CBI in Japan. It argues that CBI must be interpreted from three perspectives—legal, political, and functional. Whereas CBI is legally-constrained and has been politically questioned, it has, to date, not been challenged from a functional perspective, because, up until now, the price stability goal has not had to be sacrificed. The third section further analyses the functional aspect by looking at the link between government debt, monetary expansion, and price stability, after the burst of the asset price bubble at the beginning of the 1990s. It concludes that, to date, the deflationary environment has ensured the harmony between monetary and fiscal policy as well as the financial stability goals. The fourth and last section asks what happens once deflation has been overcome. Will this put CBI in Japan to a final test or can the conflict between price stability and fiscal stability still be avoided?

2 Central Bank Independence in Japan: The Real Test Is Still to Come

The major revision achieved by the Bank of Japan Act of 1997/1998 was to declare the Bank of Japan (BoJ) as independent with regard to currency and monetary control (Articles 3 and 5), the aim of currency and monetary control being price

stability (Article 2).[1] The reform has been interpreted as a legal confirmation of the "meaningful practical independence" secured by the BoJ since the mid-1970s (Cargill et al. 2000: 111). However, the explicitly granted operational independence still remains constrained in three ways:

- Besides price stability, the BoJ has also to "ensure the smooth settlement of funds among financial institutions, thereby contributing to the maintenance of stability of the financial system". (Article 1);
- Monetary policy is conceived as "a component of overall economic policy", implying that the BoJ's currency and monetary control "shall be mutually compatible" with "the basic stance of the government's economic policy" (Article 4);
- The Governor, the Deputy Governors and all members of the BoJ's policy board are to be appointed by the Cabinet with the approval of the House of Representatives and the House of Councillors. Executive Directors and Counsellors are recommended by the Board, but finally appointed by the Ministry of Finance (Article 23).

Since the establishment of the new Bank of Japan Act, all three constraints have, in some way or another, proved relevant:

- The BoJ's responsibility for "financial stability" was called upon during Japan's banking crisis (1997–2004). To ensure the viability of the financial system, the BoJ implemented a zero-interest rate policy, which implied a heavy expansion of the monetary base (Ito and Mishkin 2004; see, also, Sect. 3.2 below);
- The subordination of monetary policy to the government's overall economic policy became evident when Prime Minister Shinzō Abe shortly after his election in December 2012 made monetary policy the first of the "three arrows of Abenomics" (Waldenberger 2014; see, also, Sect. 3.3 below).
- The usurpation of monetary policy by the government forced the then Governor Masaaki Shirakawa of the BoJ to resign on 19 March 2013, 3 weeks before the actual end of his term. His successor, Governor Haruhiko Kuroda, was appointed in the knowledge that he would be fully willing to support Abe's "bold monetary policy" (*The Wall Street Journal Europe*, 3 March 2013).

The legal limitations combined with the above evidence seem to put the viability of CBI in Japan into question. However, such a conclusion is premature, because it does not pay due consideration to the fact that price stability has so far not been sacrificed. The Japanese experience suggests that there are at least three dimensions of CBI or three perspectives when it comes to an analysis of its viability. From a purely legal perspective, CBI in Japan is certainly still suffering from the constraints described above. These have been exploited by the present Abe administration putting CBI into question from a political point of view. However, factually or functionally the BoJ has so far not been forced to abandon the goal of price

[1] For a comparison with the old Bank of Japan Law established in 1882 and little changed by the revision in 1942, see Cargill et al. (2000: 96–112).

stability. The stabilization measures during Japan's financial crisis as well as the new expansionary policy under Abenomics were and are implemented in a deflationary environment. In such an environment, monetary expansion is not endangering, but contributing to price stability.

The true test of CBI in Japan will come once price stability goals conflict with fiscal and financial stabilization. This could happen when the presently envisaged inflation target of 2 % is reached. Will the BoJ then have to sacrifice price stability for the sake of fiscal and financial stability? Before turning to this question, let us first look at why high fiscal deficits along with strong monetary expansions have so far not put the BoJ's responsibility for price stability into question.

3 Government Debt and Monetary Expansion in a Deflationary Environment

3.1 Rich Country: Poor Government

The Japanese government is the most highly indebted both in terms of gross and net debt to GDP (Fig. 1). However, more than 90 % of its debt is internally financed (Fig. 2). In fact, Japan is the richest country in terms of net international investment position (Fig. 3). Lack of internal funds does therefore not explain the built-up of Japan's government debt. Even during the two "lost decades" after the burst of the stock market and real estate bubble at the beginning of the 1990s, the economy as a whole generated a positive financial surplus as seen by the increase in its net international investment position: net foreign assets increased more than sixfold

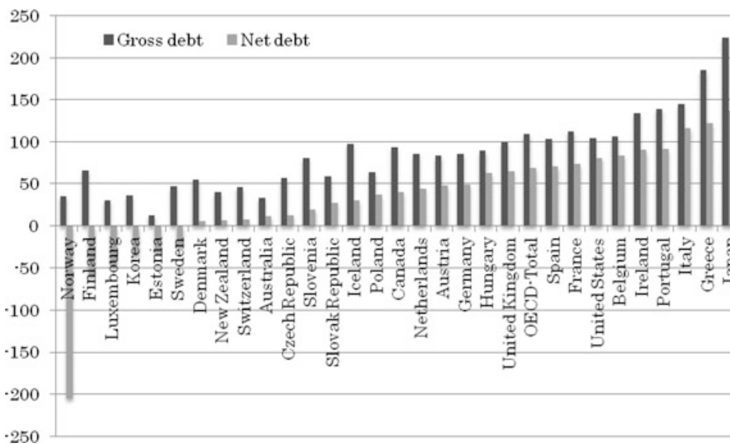

Fig. 1 Government debt in per cent of GDP for OECD countries 2013. *Source*: OECD Economic Outlook 95, May 2014

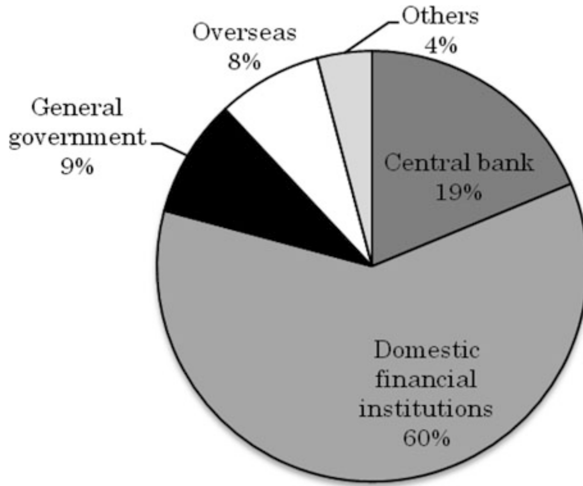

Fig. 2 Financing of Japan's government debt by economic sector. *Source*: Bank of Japan, Flow of Funds Statistics. *Note*: "Government debt" includes treasury bills, central and local government securities and FILP bonds. "Others" are domestic non-financial corporations, households and private non-profit organisations

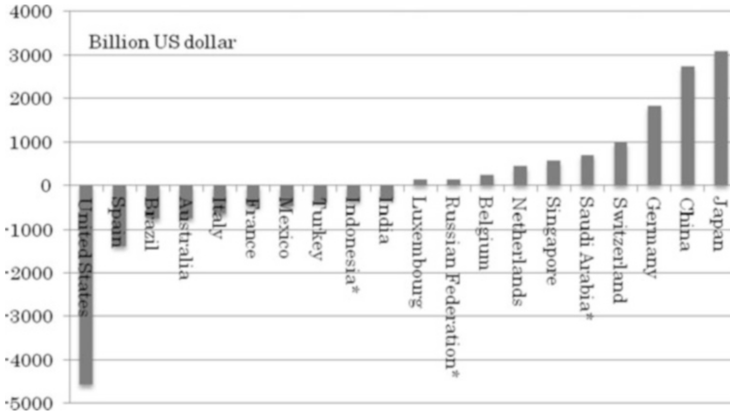

Fig. 3 Net international investment positions 2013. *Source*: IMF, Balance of Payments and International Investment Position Statistics. The ten *top* and ten *bottom* ranked countries; *asterisk* = data are for 2012

from about 50 trillion yen in 1990 to above 300 trillion yen in 2013 (Fig. 4). Why would a rich economy want its government to take on such a huge amount of debt? How should such a situation be evaluated? And what role did monetary policy play in this process?

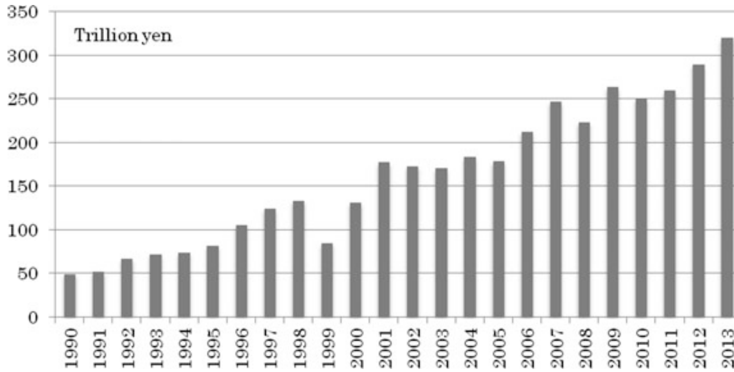

Fig. 4 Japan's net international investment position 1990–2013. *Source*: Bank of Japan, Flow of Funds Statistics. *Note*: The net international investment position equals the "difference of financial assets and liabilities" of the overseas sector multiplied by minus one

There are three possible answers to the first question:

- Public debt can be seen as a rational and necessary response to Japan's "balance sheet recession" caused by the strong decline in asset prices, especially shares and real estate (Koo 2009: Chap. 1).
- Government indebtedness can be needed to support the intergenerational transfer of funds in an ageing society (von Weizsäcker 2011). Households foreseeing a longer after retirement period want to save more than the corporate sector faced with decreasing returns on capital can profitably invest. The government steps in absorbing the private surplus funds. The retired generation is paid out by the surplus funds invested in new government bonds by the new working generation.
- Fiscal deficits might be an indication of weakened governance over budgetary processes. The 1990s in Japan meant an end of stable Liberal Democratic Party (LDP) rule, the so-called 1955 system. The party landscape changed bringing with it more political instability (Hori 2005: 59–61, Cargill and Sakamoto 2008: 151–157). The implied increased political competition might have made governments more willing to use deficit financing as a means to secure political support. Administrative reforms at the turn of the millennium gave the government, especially the prime minister, more control over the budgetary process (Cargill and Sakamoto 2008: 160–163).

The first two arguments evaluate the debt re-allocation from the private to the public sector positively although they do not allow for an exact conclusion as to whether the amount of debt shifted onto the public sector was too little or too much. The last answer would suggest that fiscal deficits might have been too high due to weakened governance over the budgetary process.

The three answers are not mutually exclusive and are likely to have been at work simultaneously or consecutively. They are all intriguing and worth further

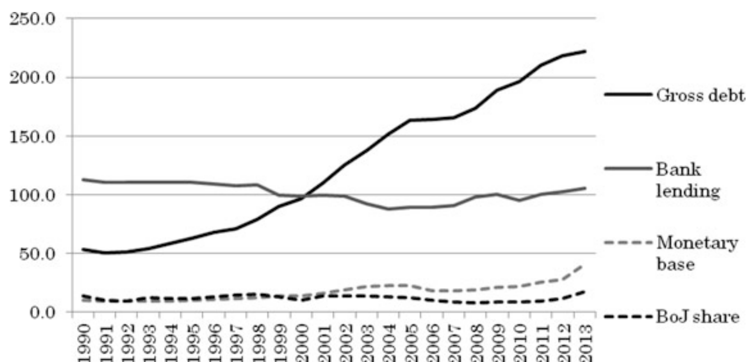

Fig. 5 Government debt, monetary base, bank lending as percentage of GDP and BoJ share in government debt in per cent 1990–2013. *Source*: Bank of Japan, Flow of Funds Statistics. *Note*: Government debt is defined as in Fig. 2. Bank lending corresponds to loans and bills by domestically licensed banks. All data are year end. The Flow of Funds Statistics was revised in 1997. Gross debt and bank lending date from 1990 to 1996 were calculated by successively discounting 1997 data from the revised series with the annual growth rates inherent in the discontinued series

exploration. However for the purpose of our investigation, it is important to look at the role monetary policy played during the built-up of public debt and at the implications for the BoJ's price stability goal.

3.2 Deficit Spending and Monetary Expansion

The last 23 years saw an enormous increase in government debt from 50 to 220 % of GDP (Fig. 5). The monetary base[2] rose from 10 % of GDP in 1990 to around 20 % between 2002 and 2010. As a result of the "new quantitative and qualitative monetary easing" (QQE) (Waldenberger 2014) it has presently reached a record high level of above 40 % of GDP. Monetary expansion did not increase the BoJ's share in the financing of government debt. In fact, the share had declined from its temporary high of 15.2 % in 1998 to 7.4 %, *i.e.*, less than half, in 2008. However, after the start of QQE in early 2013 it surged to a record high level of 19 % by the end of March 2014 (Fig. 2, above).

Government debt accumulated in the context of a surplus of funds from the corporate and household sector (Koo 2009: Chap. 1). There was no crowding out of private demand for funds as evidenced by the increase in net foreign assets (Fig. 4 above) and the steady decline in domestic interest rates (Fig. 6). Interest rates

[2] The monetary base represents the money aggregate most closely controlled by a central bank. It is defined as the currency in circulation plus the amount of reserves that commercial banks deposit at the central bank.

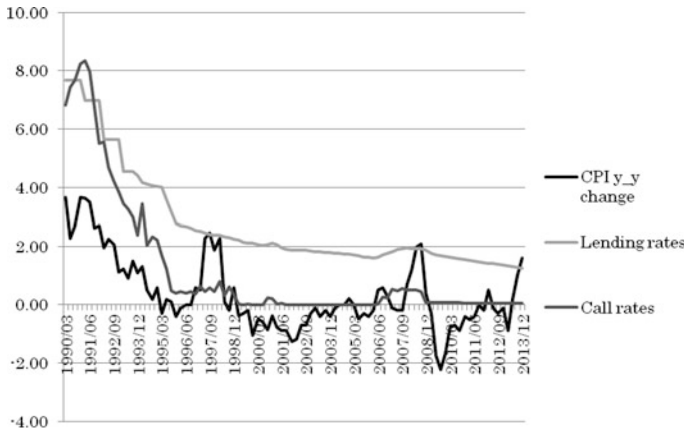

Fig. 6 Interest rates and year to year price level changes 1990–2013. *Source*: Bank of Japan, Deposit and Loans Market Statistics, Financial Market Statistics; Statistics Bureau of the Ministry of Internal Affairs and Communication, Consumer Price Index; Cabinet Office, National Accounts Statistics. *Note*: CPI (Consumer Price Index) includes all items; lending rates refer to average interest rates on outstanding loans and bills by domestically licensed banks, lending rates for 1990 to 1993 are only available upon an annual basis. Call rates refer to collateralised over-night rates

should have risen, had the reallocation of funds between the private and the public sector been demand side driven.

Monetary expansion and the implied lowering of interest rates were undertaken to contain the asset price burst, to soften its effect on bank balance sheets, to overcome the banking crisis that finally broke out in 1998 and to fight deflation. However, the strong expansion did not, except for a few interruptions, put an end to deflation (Fig. 6). The price level continued to decline until recently, though at a modest pace. Central bank liquidity did at first also not induce banks to provide more credit (Fig. 5). It was only after 2004 that the volume of loans provided by domestic banks slowly increased after economic activity had picked up. 2010 then saw another decline, this time however followed by a more pronounced recovery.

The effectiveness of the BoJ's policy is difficult to assess. It very much depends on how one interprets the overall condition of the Japanese economy. Proponents who see Japan in "a balance sheet recession" or more generally in "an over-supply of funds situation", conclude that monetary policy is per se ineffective, as the private sector does not demand additional credit (Koo 2009: Chap. 4). For those who consider deflation as Japan's main macro-economic problem, the BoJ's expansionary measures have just not been bold enough (Svensson 2001; Eggertsson and Woodford 2003).

The evaluation of monetary policy aside, we can conclude that the BoJ did not contribute to the accumulation of government debt in Japan and that both monetary expansion and continued deficit spending had not run into conflict with price stability.

3.3 Japan's New Monetary Policy and Fiscal Stabilisation Under Abenomics

Although the BoJ has not been involved in the built-up of government debt, it might still be called upon once fiscal stability becomes an issue. Firstly, the government might pressure the bank to directly or indirectly purchase debt in order to keep interest rates low or otherwise ensure smooth refinancing. Secondly, the BoJ may be forced to intervene out of concerns for financial system stability. If financial institutions, especially large banks, hold large amounts of government debt, a fiscal crisis will have immediate repercussions on the financial system.

With the level of gross debt of the Japanese government sector surpassing 200 % of GDP, fiscal stability has become an issue. For Japanese Government Bonds (JGB), which are issued by the Central Government and make up about 75 % of the government sector's securitised debt, new bond issuance including re-financing needs amounted to 180 trillion yen in fiscal year (FY) 2012 marking a historic record (Ministry of Finance 2013: 10). After an issuance volume of 168 trillion yen in FY 2013, financing needs for FY 2014 are expected to reach a new record high of 182 trillion yen (Ministry of Finance 2014) corresponding to almost 40 % of GDP.

The Japan Post Bank became significantly exposed to JGBs after 2001. At the peak end of 2009, 82 % of its assets under fund management were invested in government bonds. The increase however mainly reflects the reform of the Fiscal Investment and Loan Program (FILP)[3] that took effect in 2001 (Cargill and Sakamoto 2008: 197–200), whereby assets that had previously been deposited directly with the Fiscal Loan Fund were partly re-invested in FILP bonds.[4] The large, internationally operating City Banks reported their highest exposure of 25 % end of March 2012 (Fig. 7). For them, JGBs were attractive not only due to lack of alternative investments, but also because government securities were and still are recognised as risk free under bank capital regulations, which means that they require no additional risk capital.

The burgeoning government debt combined with the high exposure of financial institutions must have created worries at the BoJ about financial system stability. The BoJ indeed raised the issue in its Financial System Reports from October 2012 and April 2013:

> Due attention should be paid, however, to a further increase in the amount outstanding of JGBs held by financial institutions. (Bank of Japan 2012: 89)

> Due attention should be paid, however, to the fact that the amount outstanding of JGBs held by financial institutions remains large. (Bank of Japan 2013a: 79)

[3] The FILP represented a specific Japanese public investment scheme financed by postal savings and life insurance as well as public pension funds. For details, see Cargill and Yoshino (2003).

[4] Deposits with the Fiscal Loan Fund were reduced by 210 trillion yen between end of March 2001 and end of September 2007. Over the same period investments in JGBs and FILP bonds increased by 120 trillion yen, total assets decreased by 90 trillion yen and the overall exposure to government debt declined from 88 to 85 % (Bank of Japan, Flow of Funds Statistics).

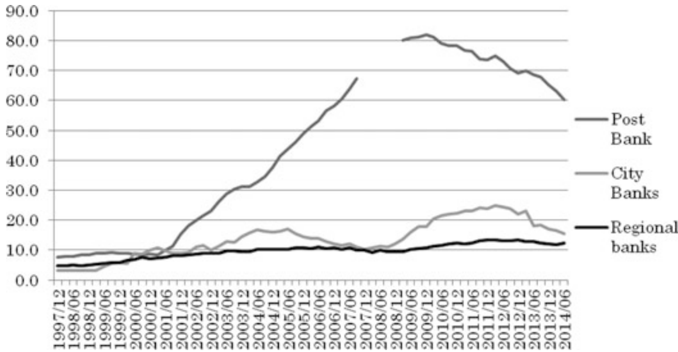

Fig. 7 Share of central government securities in total assets of Japanese banks December 1997 to June 2014. *Source*: Bank of Japan, Flow of Funds Statistics; Japan Post Bank, Selected Financial Information (http://www.jp-bank.japanpost.jp/en/aboutus/ financial/en_abt_fnc_financialdata.html). *Note*: Central government securities under trading and investment accounts; Japan Post Bank data are separately given under Flow of Funds Statistics only up to September 2007 (from December 2007 onwards they are included in the "financial institutions for small businesses" series), data from 2009 onwards refer to JGBs under Fund Management Status as reported in "Selected Financial Information" by the Japan Post Bank

Respective warnings have since then not been repeated. The report published October 2013 only notices that banks "significantly reduced their holdings of domestic bonds, as the Bank's JGB purchases expanded." (Bank of Japan 2013b: 15). The remark explicitly recognizes the beneficial side effects of QQE. The April 2014 report altogether drops the issue, which means the BoJ no longer considers the JGB exposure of financial institutions worth explicit mentioning in its assessment of financial system stability.

Officially, QQE is undertaken to finally overcome deflation (Kuroda 2013). However, whether deflation is the cause or rather the symptom of Japan's malaise can be disputed (Waldenberger 2014). The symptom versus cause question aside, QQE for the first time created a direct link between government debt and monetary policy. The increase in the monetary base targeted by QQE is to be achieved by purchases of JGBs through open market transactions. On the liability side of the BoJ's balance sheet, these purchases are not to be financed by printing more money, but by increasing the reserves that domestic banks deposit with the BoJ.[5] As a consequence, the so-called "banknote principle" stating that the BoJ's JGB holdings shall not be larger than the amount of currency in circulation had to be suspended (Bank of Japan 2013c: 2).

[5] Basically, the banks selling JGBs to the BoJ immediately deposit the central bank money from the transaction with the BoJ.

Table 1 The Bank of Japan's balance sheet 2012–2014 (trillion yen)

	(Asset positions)		(Liability positions)	
	Total	Government securities	Banknotes	Current deposits
31.03.2012	139	87	81	34
31.03.2013	165	125	83	58
31.03.2014	253	213	86	136

Source: Bank of Japan, Bank of Japan Accounts Statistics

The result is depicted in Table 1. It clearly shows that QQE whether or not it was needed to fight deflation had two likely to be welcomed "side effects":

- an almost threefold increase in JGB buying capacity from the side of the BoJ visible also in the BoJ's share in JGB holdings (Figs. 2 and 5);
- and a significantly reduced exposure of the Japan Post Bank and city banks to JGBs (Fig. 7).

The "side effects" of QQE indicate that the BoJ has assumed an important function both with regard to fiscal as well as financial system stability. This is fully in line with its responsibility for financial system stability as stated in the Bank of Japan Act. Also, it has so far not inflicted upon the price stability goal. Quite to the contrary, QQE is justified with the aim to achieve "price stability" operationalized by a 2 % inflation target.

4 Outlook: What Will Happen Once the Inflation Target Has Been Achieved?

The BoJ has not been needed to finance public deficit spending, however under QQE it has started to aggressively expand its holdings of JGBs. This has so far not questioned the BoJ's responsibility for price stability. Given the deflationary environment characteristic of the Japanese economy over the last 20 years, monetary and fiscal policy goals have not been in conflict with each other. But what will happen once the BoJ achieves its inflation target of 2 %? As can be seen in Fig. 6, CPI year-to-year changes surpassed 1 % in 2013. In its August 2014 "Statement on Monetary Policy" the annual inflation rate excluding fresh food and the effects of the consumption tax hike is seen at 1.25 % and "inflation expectations appear to be rising on a whole" (Bank of Japan 2014a), indicating that the Bank sees the 2 % target achievable in the near future.

Whether or not the BoJ will then face a policy dilemma between price and financial system and fiscal stability depends on how the economy evolves. Under favourable circumstances the dilemma might still be avoided. The necessary conditions would be that:

- inflation will not overshoot the 2 % target;

- the private sector continues to provide enough surplus funds to refinance government debt internally; and
- the government uses the extra time gained to consolidate its fiscal position.

The first condition is most difficult to assess. It very much depends on whether inflation expectations can be controlled and whether inflationary pressures presently exerted by labour shortages and a weak yen can be contained.

The second condition requires that commercial banks can finance additional credit demand of the corporate sector through the growth of private household's deposits. This very much depends on how the non-public sector's savings-investment balance evolves under the continuing ageing and decline of the population. Businesses' credit needs can be expected to remain moderate or even again turn negative in the context of a declining population. According to the BoJ's most recent Financial System Report, deposits of private households will for demographic reasons start to decline after 2020 (Bank of Japan 2014b: 71–73). The second condition therefore could be met. However, there are two additional *caveats*. First, private households must remain calm in the face of a possible default of the government. Given the exchange rate risk, a capital flight across borders as seen in the euro zone is less likely, though it cannot per se be excluded (Yoshino and Vollmer 2014). Japanese households might still withdraw their deposits or shift them to other domestic financial institutions that are less exposed to government debt. In fact, the strong decline in Japan Post Bank deposits from 250 trillion yen end of March 2001 to 175 trillion yen end of March 2011 could be interpreted as an indication of such fears.[6] However, shifts between deposits and cash or among domestic financial institutions will keep the surplus funds within the system. It will only change the channel through which the government can draw on them.

The third necessary condition of the favourable scenario requires the Japanese government to stick to its consolidation plan of reducing the primary deficit by half in FY 2015 as compared to FY 2010 and to start reducing government debt from 2020 onwards (Cabinet Office 2013). So far, the 2015 goal is likely to be achieved. The 2020 goal, however, requires quite ambitious efforts in terms of tax increases and reductions or at least caps on public expenditure (IMF 2013; Sugimoto and Ueda 2013).

The chances for a smooth exit and the avoidance of a conflict between price stability and fiscal as well as financial system stability goals are not too unrealistic. The key is the synchronization of fiscal consolidation and the internal supply of funds conditions dictated by demographic change. However, political instabilities, turbulences in the global economy or another natural disaster similar to the Tohoku earthquake and tsunami could easily jeopardize fiscal consolidation. This would

[6] Data from Statistics Bureau, Japan Statistical Yearbook 2014, Tables 14-10 (http://www.stat.go.jp/english/data/nenkan/1431-14.htm). By end of June 2014, deposits had slightly recovered to 178 trillion yen according to the Japan Post Bank summarized balance sheet statement in its "Selected Financial Information" available at: (http://www.jp-bank.japanpost.jp/en/aboutus/financial/en_abt_fnc_financialdata.html).

finally put CBI to a real test. Given the political influence on the BoJ, the concerns for financial system stability and other overarching socio-economic reasons, the price stability goals will then most likely be abandoned.

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The Legality of Outright Monetary Transactions of the European System of Central Banks

Helmut Siekmann

Abstract On 6 September 2012, the Governing Council of the ECB took decisions on a number of technical features regarding the Eurosystem's outright transactions in secondary sovereign bond markets (OMT). This decision was challenged in the German Federal Constitutional Court (GFCC). In its seminal judgment of 14 January 2014, the GFCC expressed serious doubts about the compatibility of the ECB's decision with EU law.

It admitted the complaints and petitions even though actual purchases had not been executed and the control of the acts of an organ of the EU is, in principle, not the task of the GFCC. As justification for this procedure, the court resorted to its judicature on a reserved "ultra vires" control and the defence of the "constitutional identity" of Germany. In the end, however, the court referred the case to the European Court of Justice (ECJ/CJEU) for preliminary rulings on several questions of EU law. In substance, the German court assessed OMT as an act of economic policy beyond the competences of the ECB. Furthermore, it judged OMT as a monetary financing of sovereign debt prohibited by EU primary law. The defence of the ECB (the disruption of the monetary policy transmission mechanism) was dismissed as "irrelevant". Finally, the court presented a way for a compromise by an interpretation of OMT which was in conformity with EU.

Both the procedure and the findings of this judgment were harshly criticised not only by many economists but also by the majority of legal scholars. This criticism is, by and large, convincing in view of the admissibility of the complaints. It is also questionable whether the referral to the ECJ/CJEU was indicated. The arguments of the court are, however, conclusive with regard to the transgression of competences by the ECB, and—to somewhat lesser extent—with regard to the monetary debt financing.

This essay uses reflections of Helmut Siekmann and Volker Wieland (2014a) and Helmut Siekmann and Volker Wieland (2014b) as a starting-point. They are considerably intensified and enlarged. All references are new

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F. Rövekamp et al. (eds.), *Central Banking and Financial Stability in East Asia*,
Financial and Monetary Policy Studies 40, DOI 10.1007/978-3-319-17380-1_6

1 Introduction

In the course of the crisis, the European Central Bank (ECB) has acted several times to support the EU Member States and banks in financial distress: Covered Bonds Programmes,[1] Securities Market Programmes (SMP),[2] and Long Term Refinancing Operations (LTRO).[3] These measures were accompanied by a substantial lowering of the quality standards for the (outright) purchase of securities or for accepting them as collateral,[4] and by allowing national central banks to provide liquidity to basically insolvent banks in their home countries through the granting of "Emergency Liquidity Assistance" (ELA). Although, in applying these measures, a substantial amount of sovereign debt from selected Member States was purchased and a major part of the banking system was protected from bankruptcy, the public outcry was relatively mild[5] and the judiciary did not object in substance.[6] This changed with the announcement of another newly-designed measure.

Despite these measures, the interest rates for the bonds of various euro-area Member States rose sharply in the summer of 2012. It was at this time that the President of the ECB made the statement that subsequently became so famous:

[1] ECB/2009/16, Official Journal 2009/L 175/18; ECB/2011/17 Official Journal 2011/L 297/70.

[2] Decision of the European Central Bank of 14 May 2010 establishing a securities markets programme (ECB/2010/5), Official Journal 2010/L 124/8.

[3] Two longer-term refinancing operations provided about one trillion euro to commercial banks at favourable interest rates for 3 years, ECB press release of 8 December 2011.

[4] For example, the decision of the European Central Bank of 6 May 2010 on temporary measures relating to the eligibility of marketable debt instruments issued or guaranteed by the Greek Government ECB/2010/3, Official Journal of 11 May 2010, L 117/102; the decision of the European Central Bank of 31 March 2011 on temporary measures relating to the eligibility of marketable debt instruments issued or guaranteed by the Irish Government ECB/2011/4, Official Journal of 8 April 2011, L 94/33; the decision of the European Central Bank of 7 July 2011 on temporary measures relating to the eligibility of marketable debt instruments issued or guaranteed by the Portuguese Government ECB/2011/10, Official Journal of 12 July 2011, L 182/31; for further examples, see Helmut Siekmann (2013a, p. 113 at footnote 55).

[5] Critical, see Martin Seidel (2010); Martin Seidel (2011); supporting, or at least not questioning, the "unconventional" measures: Christoph Herrmann (2010b).

[6] GFCC, judgment of 7 May 2010, BVerfGE [Reports of judgements of the Federal Constitutional Court] 125, 385 et seq.; judgment of 7 September 2011, BVerfGE 129, 124 (128 et seq.); GFCC, judgment of 18 March 2014 on the basis of the oral hearing of 11 and 12 June 2013, cases: 2 BvR 2728/13, 2 BvR 2729/13, 2 BvR 2730/13, 2 BvR 2731/13, 2 BvE 13/13, available at: www.bundesverfassungsgericht.de/entscheidungen/rs20140318_2bvr139012en.html (in English) [ESM final judgment]. A transgression of the competences of the ESCB and a (prohibited) monetary financing of budgets was already seen by Helmut Siekmann (2013a, pp. 144–149); Helmut Siekmann (2014c, Article 88 margin no. 20).

> Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.[7]

Some weeks later, on 6 September 2012, the Governing Council of the ECB took "decisions on a number of technical features regarding the Eurosystem's outright transactions in secondary sovereign bond markets" which allegedly "aim at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy". Under the name of "Outright Monetary Transactions" (OMTs), they were to be conducted in a specific framework which required adherence to a European support programme ("conditionality"), with no *ex-ante* quantitative limits ("coverage"), accepting same creditor treatment with private creditors ("creditor treatment"), and promising full "sterilisation" of the created liquidity and enhanced "transparency".[8]

This announcement spawned a lively debate on its economic suitability, political feasibility and—particularly—on its legality.[9] From the legal concerns, several lawsuits brought against the German Federal Constitutional Court (*Bundesverfassungsgericht*) evolved, with petitioners also asking the court to issue provisional orders with the goal of halting the ratification process.

2 The Rulings of the German Federal Constitutional Court

2.1 The Course of Action

With some reservations, the German Federal Constitutional Court (GFCC) refused, in its judgment of 12 September 2012, to issue a temporary injunction (provisional order) to halt the ratification process in act to establish a European Stability Mechanism (ESM). In this decision, it expressed the already considerable concerns about the legality of the ECB's OMT Decision, but left the final decision to the

[7] The context was as follows: "When people talk about the fragility of the euro and the increasing fragility of the euro, and perhaps the crisis of the euro, very often non-euro area Member States or leaders underestimate the amount of political capital that is being invested in the euro. And so we view this, and I do not think we are unbiased observers, we think the euro is irreversible. [. . .] But there is another message I want to tell you. Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." The full text of the speech can be found at: http://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html.

[8] Press release of 6 September 2012, infra Appendix 1.

[9] Supporting the measure: Roland Henry (2012); Guntram Wolff (2013)—also in view of German constitutional concerns; Vestert Borger (2013, p. 125), as an obiter dictum; critical: Deutsche Bundesbank (2012); Martin Seidel (2010, p. 521); Hans-Werner Sinn (2013, pp. 9–30); to some extent sceptical in view of quantitative easing and "unconventional" monetary policies: International Monetary Fund (2013); Carl Christian von Weizsäcker (2012).

judgment issued in the main proceedings.[10] Eventually, on 7 February 2014, the German Federal Constitutional Court announced the following[11]:

- the charges concerning the OMT-decision of the ECB of 6 September 2012 are separated from the other matters subject to adjudication: the amendment of Article 136 TFEU, the creation of a permanent support mechanism (ESM), and the "fiscal compact"[12];
- the proceedings with regard to the OMT-decision are suspended and a list of questions with regard to its compatibility with EU law is referred to the European Court of Justice (ECJ) for a preliminary ruling pursuant to Article 19(3) letter b TEU, Article 267(1) letters a and b TFEU[13];
- a final decision on the part of the case which is not suspended will be pronounced on Tuesday, 18 March 2014.

In effect, the final judgment, delivered on 18 March 2014,[14] dismissed the remaining complaints as mainly inadmissible and unfounded, with some minor reservations concerning mainly the prerogatives of the *Bundestag* (the federal parliament) to participate in crucial questions regarding the new support mechanism in plenary session.[15] The insertion of the new paragraph 3 in Article 136 TFEU opening the door for permanent support facilities on the part of the Member States, the Treaty establishing a European Stability Mechanism, and the Treaty on Stability, Coordination and Governance in the Economic and

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[10] German Federal Constitutional Court, judgment of 12 September 2012, cases: 2 BvR 1390/12, 2 BvR 1421/12, 2 BvR 1438/12, 2 BvR 1439/12, 2 BvR 1440/12, 2 BvR 1824/12, 2 BvE 6/12, (http://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2012/09/rs20120912_2bvr139012en.html?nn=5403310) [ESM provisional order] at margin no. 278: "For an acquisition of government bonds on the secondary market by the European Central Bank aiming at financing the Members' budgets independently of the capital markets is prohibited as well, as it would circumvent the prohibition of monetary financing" (= BVerfGE 132, 195 [286]).

[11] Press release No. 9/2014 of 7 February 2014, available at: http://www.bundesverfassungsgericht.de/SharedDocs/Pressemitteilungen/EN/2014/bvg14-009.html?nn=5404690.

[12] German Federal Constitutional Court, judgment of 17 December 2013, cases: 2 BvR 1390/12, 2 BvR 1421/12, 2 BvR 1438/12, 2 BvR 1439/12, 2 BvR 1440/12, 2 BvR 1824/12, 2 BvE 6/12 (http://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2014/01/rs20140114_2bvr272813en.html?nn=5403310) [ESM separation order] (= BVerfGE 134, 357).

[13] GFCC, judgment of 14 January 2014, cases: 2 BvR 2728/13, 2 BvR 2729/13, 2 BvR 2730/13, 2 BvR 2731/13, 2 BvE 13/13, available at: [http://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2014/01/rs20140114_2bvr272813en.html?nn=5403310] [OMT-judgment] (= BVerfGE 134, 366); now ECJ case C-62/14.

[14] GFCC, judgment of 18 March 2014 upon the basis of the oral hearing of 11 and 12 June 2013, cases: 2 BvR 2728/13, 2 BvR 2729/13, 2 BvR 2730/13, 2 BvR 2731/13, 2 BvE 13/13, available at: (www.bundesverfassungsgericht.de/entscheidungen/rs20140318_2bvr139012en.html) (in English) [ESM final judgment].

[15] At margin no. 176.

Monetary Union ("the new fiscal compact") were all judged as being consistent with the German Basic Law (*Grundgesetz*).[16]

2.2 Demarcation of Court Competences

The tasks of the ECJ and the GFCC are well defined: The ECJ is to ensure that, in the interpretation and application of the Treaties, the law is observed, whereas the German Court is installed as the "guardian" of the German Federal Constitution (*Grundgesetz*), the "Basic Law". The domain of the ECJ is the enforcement of EU law; that of the GFCC, the compliance with the Basic Law. In particular, the GFCC has the power to control whether a statute is in accordance with the constitution.

The competences of the German Court are, however, limited to the control of acts of the German authorities and do not include the control of the measures of the institutions and organs of the European Union.[17] Although no formal hierarchy has been established between the ECJ and the national courts, the described distribution of competences—in conjunction with the primacy of Union law in application (*Anwendungsvorrang*)-[18] would give the word of the European Court precedence. As a consequence, OMT and all other actions of the ECB would not fall within the jurisdiction of the German Court.

This, theoretically clear, demarcation of competences has been blurred by the judicature of the German Federal Constitutional Court. In a series of decisions, the Court has held that the acts of the institutions, agencies, and organs of the European Union are binding in the Federal Republic of Germany only under certain conditions:

> [If] European agencies or institutions were to administer the Union Treaty, or develop it by judicial interpretation, in a way that is no longer covered by the Treaty as it underlies the Act of Assent, the ensuing legislative instruments would not be legally binding within the area of German sovereignty. For constitutional reasons, the organs of the German government would be prevented from applying these instruments in Germany.[19]

[16] At margin nos. 158, 176 et seq. (Article 136 paragraph 3 TFEU), 183 et seq. (Treaty Establishing a European Stability Mechanism), 243 et seq. (Treaty on Stability, Coordination and Governance in the Economic and Monetary Union [SCG Treaty—TSCG]).

[17] Enumeration of competences in Articles 93(1) and 100 *Grundgesetz* [GG] (German Constitution).

[18] ECJ, judgment of 15 July 1964, Case 6/64 *Costa/E.N.E.L.*, Reports of Cases 1964, 587 (594); judgment of 9 September 1978, Case 106/77 *Simmenthal*, Reports of Cases 1978, 630 margin no. 17: "automatically inapplicable"; BVerfGE 31, 145 (173 et seq.); 37, 271 (277 et seq.); 73, 339 (375 et seq.); 89, 155 (175); see, for more details, e.g., Hans D. Jarass and Saša Beljin (2004, pp. 1–6); Burkhard Schöbener (2011, p. 889 et seq.).

[19] BVerfGE [Reports of judgments of the Federal Constitutional Court] 89, 155 (187 and 188); earlier BVerfGE 58, 1 (30 and 31); 75, 223 (235, 242); affirmed in the judgment on OMT (footnote 14 above) at margin no. 21.

This holds, however, only "if a violation is manifest and that the challenged act entails a structurally significant shift in the allocation of powers to the detriment of the Member States".[20]

> Transgressions of the mandate are structurally significant especially (but not only) if they cover areas that are part of the constitutional identity of the Federal Republic of Germany (*Verfassungsidentität*), which is protected by Art. 79 sec. 3 Basic Law or if they particularly affect the democratic discourse in the Member States.[21]

The Federal Constitutional Court thus examines whether the legislative instruments of European agencies and institutions remain within the limits of the sovereign powers conferred upon them, or whether they transgress these limits.[22] This examination is called *ultra vires* control. In this context, it considers the protection of the core content of the Basic Law ("constitutional identity": *Verfassungsidentität*) as a task of the Federal Constitutional Court alone.

The German Court concedes, however, that these reserved powers of control have to "be exercised only in a manner that is cautious and friendly towards European law. This means for the *ultra vires* review at hand that the Federal Constitutional Court must in principle comply with the rulings of the Court of Justice as a binding interpretation of Union law". But it "will take the interpretation which the Court of Justice gives in a preliminary ruling" only as a basis. In their "co-operative relationship", it attributes the interpretation of the act to the European Court of Justice. On the other hand, it is to be the GFCC that "determines the inviolable core content of the constitutional identity (*Verfassungsidentität*), and to review whether the act interferes with this core".[23] By this, the German Court claims to have the "last word" in extreme cases.

In the German Court's opinion, a manifest and structurally-significant transgression of powers would have to be assumed if the European Central Bank acted beyond its monetary policy mandate or if the prohibition of the monetary financing of the budget was violated by the OMT programme.[24] In addition, the GFCC has reserved the right to determine whether the OMT—even after an interpretation by the ECJ has taken the concerns of the German Court into account—would infringe the "inviolable core content of the constitutional identity".[25] Such a "last word" of the German Court could lead to an open conflict among the judicial institutions.

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[20] BVerfGE 126, 286 (304 and 305 with further references); affirmed in the judgment on OMT (note 14 above) at margin no. 21.

[21] BVerfGE 126, 286 (307).

[22] Cf., BVerfGE 58, 1 (30 and 31); 75, 223 (235, 242).

[23] BVerfGE 123, 267 (354); 126, 286 (303 and 304); GFCC, OMT-judgment (footnote 14 above), margin nos. 27, 29.

[24] GFCC OMT-judgment (footnote 14 above), margin no. 42.

[25] GFCC, OMT-judgment (footnote 14 above), margin no. 27: "it is for the Federal Constitutional Court to determine the inviolable core content of the constitutional identity, and to review whether the act (in the interpretation determined by the Court of Justice) interferes with the core."

2.3 The Substance of the Referral Decision

The questions presented to the ECJ deal with the problem of whether the OMT is consistent with EU primary law. In view of the German Court, the OMT may well exceed the "mandate" given to the ECB, which is limited to monetary policy. It lists a number of important reasons why OMT may interfere with the economic policy reserved to Member States,[26] and why OMT may violate the prohibition of the monetary financing of both the EU and its Member States.[27] The key argument employed by the ECB in order to justify its actions is "the disruption of the monetary policy transmission mechanism". This argument is rejected by the Court, without closer scrutiny, as being irrelevant.[28]

If all this is true—pursuant to the opinion of the German Federal Constitutional Court—the decision of the ECB Council introducing the design for the OMT may have to be considered as *ultra vires* already, even if actual purchases have not taken place to date. An act of any organ or other institution of the EU has to be judged as *ultra vires*—following this view—if it transgresses, in a "manifest and structurally significant way", the competences granted to the EU and the ECB in line with the EU Treaties and the consent of the German legislature (the *Bundestag* and the *Bundesrat*). Such a transgression, lacking democratic legitimation, could constitute a violation of German constitutional law even if it were inconsistent with EU law in the first place.

However, the GFCC also delineated an alternative interpretation of OMT, which it would consider to be consistent with EU primary law (*unionsrechtskonforme Auslegung*). This interpretation involves a range of constraints and limitations that the Court derived from the statements which the representatives of the ECB presented in the hearings in June 2013. They had conceded that the objectives of OMT could also be achieved within such constraints.

2.4 The Reasoning of the Court

2.4.1 Preventative Legal Protection

The German Federal Constitutional Court has admitted complaints with regard to the OMT Decision of the ECB despite the fact that this instrument has not been applied to date. In its opinion, the admissibility "does not depend on whether the OMT Decision can already be understood as an act with an external dimension within the meaning of Art. 288 sec. 4 TFEU, or only as the announcement of such an act". Instead, it holds that "the requirements for granting preventive legal

[26] Section 2.4.2. below.

[27] Section 2.4.3. below.

[28] Section 2.4.4. below.

protection are met".[29] The main reason for this result is that the "execution of the OMT Decision could lead to [. . .] consequences that could not be corrected".[30]

2.4.2 Transgression of Competences

The German Court points out that the "mandate of the ECB" is limited to monetary policy, while economic policies in general are reserved to Member States.[31] According to its assessment, the OMT Decision—not to mention its implementation—already interferes with Member State competences in economic policy.[32] The reasons for this assessment are as follows:

- with OMT, the ECB aims to neutralise risk premiums on the debt of certain sovereigns which are market results[33];
- an approach that differentiates between Members States does not fit in with the monetary decision-making framework for a monetary union[34];
- the linkage to the conditionality of an ESM programme of the Member States indicates that OMT reaches into the realm of the economic policies reserved to Member States[35];
- the purchase of government debt as outlined in the OMT-decision of the ECB Council exceeds the support of the general economic policies in the European Union that the European System of Central Banks is allowed to pursue.[36]

The German Court also emphasises that the ECB is expected to make an independent economic evaluation of its own, which could imply removing its support when conditions are not met. Such a decision would be of an economic-policy nature, at its core.

2.4.3 The Violation of the Prohibition of Monetary Financing

Furthermore, the German Federal Constitutional Court assumes a wide understanding of the prohibition of monetary financing of the budget. It holds that the (explicit) interdiction of direct purchase of government debt on the primary market also applies to functionally-equivalent measures that are simply intended to circumvent this prohibition. Article 123 TFEU is considered as "an expression of a broader

[29] GFCC, OMT-judgment (footnote 14 above), margin no. 34.
[30] At margin no. 35.
[31] At margin no. 56.
[32] At margin nos. 56–83.
[33] At margin no. 70.
[34] At margin no. 73.
[35] At margin no. 74.
[36] At margin no. 80.

prohibition of monetary financing of the budget".[37] In this context, it lists aspects that "indicate the OMT Decision aims at a circumvention of Art. 123 TFEU and violates the prohibition of monetary financing of the budget"; in particular, the willingness to participate in a debt cut, the increased risk of such a cut, the option of keeping the purchased bonds until maturity, the interference with the price formation on the markets, and the encouragement of market participants to purchase government bonds.[38]

In essence, it judges the OMT Decision as "likely to violate" the prohibition of monetary financing of the budget as "enshrined in Art. 123 TFEU".[39]

2.4.4 No Justification

Without closer scrutiny, the German Court also rejects the objective used by the ECB to justify the OMT Decision—"to correct a disruption of the monetary policy transmission mechanism"—as irrelevant. It could neither change the assessment of the transgression of the European Central Bank's mandate, nor the violation of the prohibition of monetary financing of the budget.[40] The main argument is that it would amount to granting plain power to the European Central Bank to remedy any deterioration of the credit rating of any euro-area Member State. Furthermore, it also "seems irrelevant" to the Court that the ECB only *intends* to assume a disruption to the monetary policy transmission mechanism if the interest rate charged from a Member State of the euro-currency area were "irrational". To its view, it would be an almost "arbitrary interference with market activity" to single out individual causes as irrational. Thus, the distinction between "rational and irrational" ultimately appears to be "meaningless in this context".[41]

2.4.5 Alternative Interpretation of OMT in Conformity with Union Law

The German Court offers, however, an alternative interpretation of OMT, which it would consider to be consistent with primary law (*unionsrechtskonforme Auslegung*).[42] This would be the case if the OMT did not subvert the conditionality

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[37] GFCC, OMT-judgment (footnote 14 above), margin no. 85 et seq.; already prepared by GFCC, ESM provisional order (footnote 11 above), margin no. 278. As support for this view, it gives exactly the following references: "cf. VESTERT BORGER (2013) 14 *German Law Journal*, pp. 113–140, at 119, 134; ALBERTO DE GREGORIO MERINO, *CMLR* (2012, p. 1613, 1625, footnote 36, 1627); KOEN LENAERTS and PIET VAN NUFFEL, *European Union Law*, 3rd ed., London: SWEET & MAXWELL, 2011, margin no. 11-037."

[38] "GFCC, OMT-judgment (footnote 14 above), margin no. 87, elaborated at margin nos. 88–93.

[39] At margin no. 84.

[40] At margin no. 95.

[41] At margin no. 98.

[42] At margin nos. 99 and 100.

of the European System of Financial Supervision EFSF and ESM rescue programmes and if it were only of a supportive character for EU policies. Specifically, in the Court's view, the following limitations on OMT would mitigate the legal concerns:

- exclusion of the possibility of a debt cut;
- no purchases of selected Member States' debt up to unlimited amounts;
- the avoidance of interference with the price formation on the market as much as possible.[43]

In this regard, the detailed explanations issued by the Court include an interesting reference to the testimony of ECB representatives during the hearings of the Court in June 2013. Specifically, the explanations to the framework for the implementation of the OMT Decision (limited volume of a possible purchase, no participation in a debt cut, observance of certain time lags between the emission of a government bond and its purchase, no holding of the bonds to maturity) by the ECB representatives[44] would "suggest that an interpretation in conformity with the Union law would also most likely be consistent with the meaning und purpose of the OMT Decision".[45] It has remained, however, unclear how many of these provisions have to be implemented in order to make OMT legally acceptable for the German Federal Constitutional Court.

3 Evaluation

The judgment of the German Federal Constitutional Court of 14 January 2014 has been widely criticised, not only by economists,[46] but also by legal scholars.[47] However, consenting, or at least balanced, comments which see the merits of the clear stance that the Court has taken can also be found.[48]

[43] At margin no. 100.

[44] Ibid.

[45] Ibid.

[46] ADALBERT WINKLER (2014), imputing that the Court has decided on a financial theory.

[47] WERNER HEUN (2014), questioning the admissibility of the original complaints (p. 331), also questioning the admissibility of the referring order (p. 332), and criticising distinctively the qualification of OMT as *ultra vires* (p. 333); ALEXANDER THIELE (2013, p. 320); IDEM (2014b), stating serious technical flaws (p. 694) and disagreeing with the demarcation between monetary policy and general economic policy and stipulating in essence an almost free discretion of the ECB (pp. 694–697); DANIEL THYM (2013, p. 264); see, also, JÖRG UKROW (2014, p. 120) ("not continuously convincing"); ALEXANDER THIELE (2014a, pp. 244, 246–250).

[48] ASHOKA MODY (2014, p. 6 et seq.), discussing the tasks the ECJ now has to fulfil (p. 17 et seq.).

3.1 The Integration-Friendly Attitude as a Starting-Point

At first sight, the German Court has demonstrated respect for the distribution of powers in the multilevel system of the EU and specifically for the European Court of Justice. Some legal scholars, however, question this[49]: a closer look would reveal that the decision of 14 January 2014 does, in fact, not respect the primacy of application of Union law (*Anwendungsvorrang*) and its interpretation by the ECJ,[50] as the GFCC has reserved the right to review whether an act has interfered with the inviolable core content of the "constitutional identity" (*Verfassungsidentität*)—even after a "friendly" interpretation of the OMT Decision by the ECJ.[51]

The German Court referred key questions concerning the European System of Central Banks to the ECJ while, at the same time, unmistakably signalling its own judgment of the facts. Furthermore, by not asking for an expedited procedure pursuant to Article 23a ECJ Statute,[52] the GFCC left itself room to wait for a final decision when the economic situation in the euro area has improved. This way, the crisis does not need to unduly influence the ECJ's decision on the lawfulness of the OMT Decision.

In the final decision on the rest of the proceedings, the Court has again demonstrated its integration-friendly basic attitude.[53] In its constant jurisdiction to date it has never blocked a step towards further integration. After some initial reservations,[54] it conceded judiciary protection of fundamental rights against acts of the European organs to the ECJ (*Solange*) as long as it provided—"in general"—protection that was comparable to the German civil rights in force and their judicial enforcement.[55] Since this is warranted, the German Federal Constitutional Court does not exercise its jurisdiction in these fields and will treat complaints and petitions as inadmissible.[56] Only if this level of protection is not upheld in the jurisprudence of the ECJ, can a petition to the GFCC be admissible.[57]

In effect, the German Court has also not halted the Treaty of Maastricht,[58] the introduction of the euro,[59] or the re-shaping of the European Union by the Treaty of Lisbon,[60] all of which have brought considerable structural changes and

[49] Alexander Thiele (2014a, p. 264): "can hardly be interpreted as a 'friendly act'".

[50] Cf. Alexander Thiele (2014a, p. 248).

[51] GFCC, OMT-judgment (footnote 14 above), margin nos. 27, 29.

[52] Protocol (No 3) on the Statute of the Court of Justice of the European Union, Official Journal of 26 October 2012, C 83/210; hereafter "Statute ECJ".

[53] GFCC, ESM final judgment (footnote 15 above); partially dissenting Jörg Ukrow (2014, p. 120).

[54] BVerfGE 37, 271 (285)—*Solange I*.

[55] BVerfGE 73, 339 (387)—*Solange II*; 102, 147 (162 et seqq.)—*Soweit I*; 118, 79 (95)—*Soweit II*.

[56] BVerfGE 102, 147 (162 et seqq.)—*Soweit I*.

[57] BVerfGE 102, 147 (164)—*Soweit I*; 118, 79 (95)—*Soweit II*.

[58] BVerfGE 89, 155.

[59] BVerfGE 97, 350; affirmed BVerfG (K), *Neue Jurisitsche Wochenschrift* 1998, p. 3187.

[60] BVerfGE 123, 267.

fundamental advancements towards a closer union. However, it has expressed its concern about the flaws of some acts at European level, such as the deficits in democratic legitimation,[61] specifically in budgetary matters,[62] but eventually refrained from interfering with the various measures introduced in the course of the crisis: financial support for Greece,[63] the establishment of the European Financial Support Facility (EFSF),[64] and its refusal to issue temporary injunctions (provisional orders) to stop the ratifications of ESM.[65]

In the procedures dealing with the creation of a European Stability Mechanism and the OMT Decision, the admissibility of the complaints has been largely rejected by the Court.[66] Only in view of the "overall budgetary responsibility" of the German federal parliament (*Bundestag*) have complaints been admitted,[67] largely due to the hard-to-calculate financial risks for German finances.[68] From a dogmatic point of view, the decisions can be questioned for procedural reasons.[69] The Court's arguments in favour of a review of the acts of the institutions and organs of the EU by a national court are not totally convincing.[70]

[61] GFCC judgment of 27 October 2011, EFSF temporary injunction (BVerfGE 129, 284); final decision: GFCC judgment of 28 February 2012 (BVerfGE 130, 318), no decision by small committee of *Bundestag*; GFCC judgment of 29 June 2012 (BVerfGE 131, 152), obligation to inform the *Bundestag*.

[62] GFCC ESM provisional order (footnote 11 above) (= BVerfGE 132, 195 [239, margin no. 106]).

[63] BVerfGE 125, 260 (denial of issuing a temporary injunction).

[64] BVerfGE 126, 158 (denial of issuing a temporary injunction); GFCC judgment of 27 October 2011, EFSF temporary injunction (= BVerfGE 129, 124); see commentary, Daniel Thym (2011, p. 1011).

[65] GFCC ESM provisional order (footnote 11 above) (= BVerfGE 132, 195); additional provisional order denied: BVerfGE 132, 287.

[66] GFCC ESM provisional order (footnote 11 above) (= BVerfGE 132, 195); margin nos. 91, 93–102; GFCC ESM final judgment (note 15 above), margin no. 123.

[67] GFCC, ESM provisional order (footnote 11 above), margin no. 197 et seq., with reference to BVerfGE 129, 124 (167 et seq.); GFCC ESM final judgment (note 15 above), margin no. 122.

[68] GFCC ESM final judgment (note 15 above), margin no. 122: "complaints are admissible to the extent that (. . .) incalculable risks are taken and democratic decision processes are shifted to the supranational or intergovernmental level, so that it is no longer possible for the German *Bundestag* to exercise its overall budgetary responsibility."

[69] See the dissenting opinion of Justice Lübbe-Wolff to GFCC OMT-judgment (footnote 14 above), margin no. 1; highly critical in this point Alexander Thiele (2014a, pp. 250–255).

[70] Dissenting opinion Gertrude Lübbe-Wolf, GFCC, OMT-judgment (footnote 14 above), margin no. 1; Alexander Thiele (2014a, pp. 250–255); Jörg Ukrow (2014, p. 128); disagreeing Armin Steinbach (2013, p. 918).

3.2 The Admissibility of the Referral

The admissibility of the order for referral by the German Federal Consitutional Court has been questioned; mainly for three reasons[71]: (1) the opinion of the ECJ would, in essence, be reduced to a mere advisory statement; (2) the OMT Decision of the ECB were only the preparation of an act and not a measure with legal consequences suitable for a review; (3) the asked questions would lack relevance for the cases pending in Germany.

3.2.1 The Reservation About Having the "Last Word"

It was argued that the referral for a preliminary ruling is intended to ensure that the review is carried out by a judicial body which has exclusive jurisdiction for this purpose. If a national court were to reserve the last word to itself, like the GFCC does in view of the "identity control",[72] the preliminary ruling of the ECJ would then only be of an advisory nature.[73]

In several judgments, the ECJ has clearly stated that the preliminary ruling procedure may not be used as an instrument to obtain "advisory opinions on general or hypothetical questions". The activation of the procedure has to be an essential pre-requisite for the "effective resolution of a dispute". Article 267 TFEU may not be regarded as providing for a possibility of extracting an opinion from the European Court while at the same time reserving itself the right to depart from the answer handed down.[74]

With its judgment the GFCC has used a legal tool it had accepted in theory also for constitutional courts some time ago but had refrained to apply it in fact. It had accepted already many years ago, that the ECJ is part of the procedural due process in Germany[75] and that even supreme federal courts (*oberste Bundesgerichte*) are obliged to refer to the ECJ.[76] It had also required that before an *ultra vires* control takes place by the GFCC, the ECJ has to be given an opportunity to express its

[71] Werner Heun (2014), questioning the admissibility of the original complaints (p. 331), also questioning the admissibility of the referring order (p. 332); Jörg Ukrow (2014, p. 20); Alexander Thiele (2014a, pp. 250–255).

[72] See p. 123 above.

[73] Alexander Thiele (2014a), p. 247 et seq.

[74] ECJ, judgment of 12 March 1998, C-314/96 *Djabali*, I-1157 margin no. 19, judgment of 30 March 2004, C-147/02 Alabaster, I-3127 margin no. 4, judgment of 26 February 2013, C-617/10 Å*kerberg Fransson*, ECLI:C:2013:105, margin no. 2.

[75] BVerfGE 73, 339 (366).

[76] BVerfG, 1 BvR 1036/99, judgment of 9 January 2001, *Deutsches Verwaltungsblatt*, 2001, p. 720; 1 BvR230/09, judgment of 25 February 2010, *Neue Juristische Wochenschrift*, 2010, p. 1268.

opinion on the questions of EU law in debate.[77] This now initiated practice is in line with the judicature of the majority of other supreme courts in the EU.[78]

This can be regarded as a sign of the intensification of a development in which EU law becomes a constitutional legal order of its own, and in which even a constitutional court with a prominent status evolves into a "normal" court or tribunal within the meaning of Article 267 TFEU.[79] The "cooperative relationship"[80] between the ECJ and the GFCC may require a more receptive stance on the part of the ECJ in exceptional cases like this. At the level of constitutional courts, "mutual loyalty" might require it to open a path to dialogue. A "spirit of co-operation" "must prevail in the preliminary ruling procedure".[81] Trust in the loyalty of the national court should speak in favour of the admissibility of the GFCC's order of referral.

The reservation of a "last word" may be questionable in view of the consequences as the European organs and institutions are likely to follow the ECJ and the *Bundesbank* may be forced by the instruments of the primary law (Article 35.6 Statute ESCB/ECB) to follow as well. This appears to be consistent with the logic of a multilayered governmental structure. Only in extreme cases, it might be appropriate that national courts refuse to follow court-decisions of the higher level.

3.2.2 The OMT Decision as Object of Judicial Review

Since no purchases under OMT have actually been performed to date, it could be questioned whether the decision of the Governing Board of the ECB and the publication of the "technical features" at the subsequent press conference and on the Internet already constitute an act which could be subject to legal challenge. Preventive legal protection has been provided before by the GFCC in order to "avoid consequences that cannot be corrected".[82] The minutes of the board meeting[83] clearly show that a distinct decision was taken by the competent organ and it was not just a discussion of a tentative plan. In contrast to other legal acts of the EU, formal publication was not necessary for its legal validity; not even *any* form of publication at all. An often-overlooked provision in EU primary law explicitly leaves it to the discretion of the ECB to decide whether to publish "its decisions, recommendations and opinions", (Article 132 (2) TFEU). This rule makes sense in

[77] BVerfGE 126, 286 (304).

[78] See, for details, with many references also for German courts: Jörg Ukrow (2014), p. 122 et seq.

[79] Specifically, Jörg Ukrow (2014, pp. 122, 124, 129 et seq.); see, also, Giuseppe Martinico (2010); Franz C. Mayer (2010, pp. 402, 434–436); Jan Komárek (2013).

[80] Also, the ECJ describes the reference procedure as an "instrument of cooperation", judgment of 12 March 1998, C-314/96 *Djabali*, I-157, margin no. 7.

[81] ECJ judgment of 30 March 2004, C-147/02 *Alabaster*, I-3127 margin no. 54.

[82] GFCC, OMT-judgment (footnote 14 above), margin no. 34, referring BVerfGE 1, 396 (413); 74, 297 (318 et seq.); 97, 175 (164); 108, 370 (385); 112, 363 (367); 123, 267 (329).

[83] Appendix 2 below.

view of the global economic consequences that a decision or even a mere opinion of this institution may have.

In addition to this argument, it can also be argued that the ECB emphasises the objective of the ECB to "intervene" in the markets in an unconventional way. It highly esteems (informal) communication as an instrument to conduct monetary policy. Also, with regard to the statement of the President of the ECB about defending the euro "whatever it takes"[84] and its effect on the markets, the announcement of OMT with specific details regarding its the technical features can only be judged as an act of legal significance that is open to judicial review.

3.2.3 Lacking Relevance

It has been deliberated that the questions submitted by the GFCC to the ECJ lack relevance for the cases pending in the German court. In specific, it has been doubted that the petitioners have standing in the German court.[85] Accepting the standing of the petitioners, however, appears to be consistent with the former jurisprudence of the German court in respect of Article 38 (1) of the German federal constitution but contains an extension.[86] A simple omission by the German federal government to act may now satisfy the requirements for a standing.[87] More serious are the concerns, that by granting standing for everyone in a constitutional complaint on the grounds of a transgression of competences any complaint of a breach of competences by a European organ or institution would have to heard in the national court.[88] Whether the "qualified" and "evident" transgression of competences has been demonstrated by the petitioners may also be doubtful. The German court states such a breach only in conditional[89] even if it makes clear that in its opinion it would have to be affirmed. By using the phrase "controversial but evident breach" it shows some additional flexibility.

Concerns about the admissibility of the complaints do, however, not affect the admissibility of the referral.[90] To a large extent, the ECJ has left to the national

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[84] See supra 1.

[85] Alexander Thiele (2014a, p. 250).

[86] Even stricter Jörg Ukrow (2014, p. 127) (change of judicature), contending furthermore that another extension can be seen that not only an "identity control"—affecting only German constitutional law—but also an "*ultra vires control*"—affecting all Member States—has been admitted (p. 125 et seq.).

[87] Jörg Ukrow (2014, p. 127 et seq.); Werner Heun (2014, p. 331).

[88] Alexander Thiele (2014a, p. 253 et seq.); Werner Heun (2014, p. 332); Jörg Ukrow (2014, p. 128), disagreeing: dissenting opinion of judge Gerhard, GFCC, OMT-judgment (footnote 14 above), margin no. 54; Werner Heun (2014, p. 331).

[89] Critical Alexander Thiele (2014a, p. 254 et seq.).

[90] Jörg Ukrow (2014, p. 128), disagreeing: dissenting opinion of judge Gerhard, GFCC, OMT-judgment (footnote 14 above), margin no. 54; Werner Heun (2014, p. 331).

courts to decide which questions of EU law are considered relevant for the pending case.

3.3 *The Conformity of OMT with EU Law*

However, the legal concerns expressed by the German Court with regard to the conformity of OMT with key provisions of the primary law of the EU are convincing and well-founded. The very wording of the provisions, the systematic structure of the rules, and the history of the legislation, which led to the Treaty of Maastricht, all support the reasoning of the Court.[91]

The Court is right in judging OMT to be a measure of economic policy which is not covered by the competence of the EU and the ESCB, which is an instrument that undermines the prohibition of monetary financing by the Member States, and in discarding the alleged malfunctioning of the monetary transmission mechanism as a pretext for justification.

3.3.1 OMT as Measure of Economic Policy

Several legal scholars question already the possibility of distinguishing between monetary policy and economic policy.[92] Both were too closely interwoven for a clear separation. It is contended that all measures of monetary policy have economic consequences. Hence, only a distinction according to the instruments used would be feasible.[93] Furthermore, it is argued—contrary to the opinion of the GFCC—that an independent economic policy is essential for conducting monetary policy.[94]

Rescuing insolvent banks, banking systems, and sovereigns has always been a matter of fiscal or economic policy. The primary law of the Union strictly separates monetary policy—attributed exclusively to the EU (Article 3(1) lit. c TFEU)—from (general) economic policy—retained by the Member states (Articles 119, 127 TFEU). Economic policy does—in general—not belong to the tasks and competences of the ESCB. This separation and distribution of competences is fundamental for the design of the Economic and Monetary Union, found after long debates.[95]

[91] Martin Seidel (2010, p. 521); Walter Frenz and Christian Ehlenz (2010, p. 334); Helmut Siekmann (2013a, p. 144–149); disagreeing: Christoph Herrmann (2010b, p. 645); Hanno Kube (2012); Peter Sester (2013, pp. 453–456) (without structured legal reasoning); Werner Heun (2014, pp. 333–335); Alexander Thiele (2014a, pp. 256–264); idem (2014b, p. 697 et seq.).

[92] Alexander Thiele (2014a, pp. 255–264); idem (2014b, p. 697 et seq.).

[93] Werner Heun (2014, p. 333); Alexander Thiele (2014a, pp. 255–264); idem (2014b, p. 697 et seq.).

[94] Werner Heun (2014, p. 333).

[95] Helmut Siekmann (2012, p. 366); idem (2013b), *Einführung*, margin no. 30; Article 119 TFEU margin nos. 22, 24 et seq.; strongly disagreeing Alexander Thiele (2013, p. 33), referring to Article 127(1) sentence 2 TFEU, which is, however, not a suitable basis for measures outside of monetary policy.

It would become meaningless, however difficult it might be to draw the line in a specific situation, if it were the ECB allowed to salvage insolvent debtors. For the same reasons the often-propagated wide margin of discretion for the ECB[96] cannot be acknowledged. If the superior expertise of the persons framing a decision would be a decisive threshold for judicial control the most existential decisions would be excluded from the system of checks and balances. The principle of limited government, fundamental for western democracy, would come to an end.

This result is even more compelling in case the rescue operations could select single institutions and countries to save from financial distress. Monetary policy at its core is characterised by its global scope. It may not be used to support only fractions of the area in which the currency is legal tender. Along this line, the Federal Reserve System of the USA may not support single states. It may not purchase debt of these entities but only of the Federal Government.[97] Simply because there is no sufficient debt of a central government does not justify an expansion of the range of competences[98]; in specific, not to selectively purchase debt of specific subsets of the currency area.

It would be a serious methodological flaw to conclude from instruments given to the ECB, like operations in the open market (Article 18.1, first indent, Statute ESCB/ECB), to its legality, no matter what purpose or what effect is pursued by employing them. The provision clearly states that this instrument may only be used to achieve the *objectives* of the ESCB and to carry out its *tasks*. Neither the objective of price stability is promoted by Outright Monetary Transactions nor do they serve the discharge of the tasks outlined in Article 127 (2) TFEU.

The ancillary tasks described in Article 127 (5) TFEU only allow the ESCB to "contribute" to the smooth conduct of policies pursued by the "competent authorities". Outright Monetary Transaction as designed by the ECB would not contribute to the actions of the competent (national) authorities but replace them; at least to the greatest part. Not all measures involving money are monetary policy.

In the beginning, the support measures of the ECB might have been justifiable as providing liquidity for basically solvent institutions. This cannot be supported any more after 7 years of financial distress, re-structuring the Greek sovereign debt, rescuing the insolvent banking system of Cyprus, and the still unsound southern European banking systems despite a zero-interest environment.[99]

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[96] Max Vogel (2012, p.487 et seq.); Alexander Thiele (2013, p. 39 et seq.); Werner Heun (2014, p. 333).

[97] In essence, only bonds of the Federal Government and the agencies it has assumed liability for may be purchased, provided that they are bought "in the open market". The purchase of obligations of any state, county, district, political subdivision, or municipality in the continental United States is *only allowed* if they are issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues and only if they have maturities not exceeding 6 months from the date of purchase, 12 USC § 355(1).

[98] This is, however, a main argument of Werner Heun (2014, p. 334).

[99] Martin Seidel (2010, p. 521); Walter Frenz and Christian Ehlenz (2010, p. 334); Helmut Siekmann (2012, p. 371); idem (2013a, p. 144–149); disagreeing: Christoph Herrmann (2010b,

3.3.2 Monetary Financing of the Budget

Article 123 TFEU and Article 21.1. Statute ESCB/ECB forbids the purchase of government bonds "directly" from the emitting Member States, *i.e.*, the purchase on the primary market. This prohibition is, however, not limited to this interdiction, but is an expression of a broader prohibition of monetary financing of the budget.[100] In specific, it interdicts all manoeuvres to elude, dodge, or to circumvent this provision.[101]

It is, however, contended that all arguments in favour of such an evasion of strict legal norms are not valid: debt cut, enhanced default risk, holding until maturity, financing of budget aloof from capital markets, and incentive to purchase in the primary market although not warranted by the fundamentals of the issuer.[102]

The GFCC has seen all this. To alleviate the dangers (so far) negated in the scholarly writings it has listed the crucial points for a benign interpretation of the OMT Decision in order to be acceptable.[103]

3.4 Consequences of Diverging Court Rulings

The GFCC's decisions are binding for all German authorities. They have the virtue of law. Thus, the German government and the *Bundesbank* would be obliged to comply with the decisions of the Court. All constitutional organs, authorities and courts "may not take part in the decision making process and the implementation of *ultra vires* acts".[104] If, notwithstanding this, they proceed to do so, legal actions against them could ensue. As a consequence, the *Bundesbank* would be prohibited from participating in OMT, regardless of what the European Court of Justice pronounces about the conformity with EU-law. In the event that the GFCC finally comes to the conclusion that OMT violates the "core content of the constitutional

p. 645); Werner Heun (2014, pp. 333–335); Alexander Thiele (2014a, pp. 256–264), idem (2014b, p. 697 et seq.).

[100] See Koen Lenaerts and Piet van Nuffel (2011, margin no. 11–037); Alberto de Gregorio Merino (2012, p. 1625, footnote 36, 1627); Helmut Siekmann (2012, p. 370 et seq.); Vestert Borger (2013, pp. 119, 134).

[101] Walter Frenz and Christian Ehlenz (2010, p. 334); Helmut Siekmann (2012, p. 371); with further references; idem (2013a, p. 149); in principle, also conceded by: Alexander Thiele (2013, p. 73); with critical discussion of Siekmann (2013a, b)); Werner Heun (2014, p. 335).

[102] Werner Heun (2014, p. 335), retreating again to a wide margin of discretion; cf. with a more sublime argumentation Alexander Thiele (2013, pp. 63–76), discussing in particular the possibilities of circumvention.

[103] Section 2.4.5. above.

[104] GFCC, OMT-judgment (footnote 14 above), margin no. 29 at the end, with reference to: BVerfGE 89, 155 (188); 126, 286 (302 et seq.).

identity" protected by Article 79 sec. 3 GG, it would be inapplicable "from the outset".[105]

In the event that the ECJ were to decide that OMT was in conformity with EU law and thus that the *Bundesbank* was not implementing the Eurosystem policy appropriately, the ECB could sue the *Bundesbank* in a specific procedure before the ECJ, pursuant to Article 35.6. Statute ESCB/ECB.

4 Outlook

The reputation of both courts would suffer from an open conflict. The judges of both institutions know each other and meet often in a variety of settings. It is also noteworthy that the President of the ECJ, Vasilios Skouris, of Greek origin, speaks German, studied law in Germany, and was professor of law in Germany. Although the courts may well disagree, they certainly understand where each is coming from in its analysis.

If the ECJ were to ignore completely the GFCC's analysis and the arguments presented without providing substantially new arguments or evidence, the GFCC could consider itself well-justified in ruling that OMT are beyond the ECB's mandate and forbid German authorities to support them.

All things considered, the ECJ has an incentive to adopt at least some of the limitations held to be essential by the GFCC. However, it could announce its own interpretation of OMT which would incorporate a subset of the criteria given by the GFCC for a potential admissibility of OMT,[106] but not all them. The GFCC might then find it rather difficult to reject such a "compromise interpretation". What to accept and what to reject would depend, importantly, on which aspect the ECB considered to be most important in order to achieve the objectives that it has in mind.

Appendix 1: Press Release on the OMT-Decision of the ECB

6 September 2012: Technical features of Outright Monetary Transactions

As announced on 2 August 2012, the Governing Council of the European Central Bank (ECB) has today taken decisions on a number of technical features regarding the Eurosystem's outright transactions in secondary sovereign bond markets that aim at safeguarding an appropriate monetary policy transmission and the singleness

[105] GFCC, OMT-judgment (footnote 14 above), margin no. 27.

[106] Section 2.4.5. above

of the monetary policy. These will be known as Outright Monetary Transactions (OMTs) and will be conducted within the following framework:

Conditionality

A necessary condition for Outright Monetary Transactions is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. Such programmes can take the form of a full EFSF/ESM macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases. The involvement of the IMF shall also be sought for the design of the country-specific conditionality and the monitoring of such a programme.

The Governing Council will consider Outright Monetary Transactions to the extent that they are warranted from a monetary policy perspective as long as programme conditionality is fully respected, and terminate them once their objectives are achieved or when there is non-compliance with the macroeconomic adjustment or precautionary programme.

Following a thorough assessment, the Governing Council will decide on the start, continuation and suspension of Outright Monetary Transactions in full discretion and acting in accordance with its monetary policy mandate.

Coverage

Outright Monetary Transactions will be considered for future cases of EFSF/ESM macroeconomic adjustment programmes or precautionary programmes as specified above. They may also be considered for Member States currently under a macroeconomic adjustment programme when they will be regaining bond market access.

Transactions will be focused on the shorter part of the yield curve, and in particular on sovereign bonds with a maturity of between 1 and 3 years.

No ex ante quantitative limits are set on the size of Outright Monetary Transactions.

Creditor Treatment

The Eurosystem intends to clarify in the legal act concerning Outright Monetary Transactions that it accepts the same (*pari passu*) treatment as private or other creditors with respect to bonds issued by euro area countries and purchased by the Eurosystem through Outright Monetary Transactions, in accordance with the terms of such bonds.

Sterilisation

The liquidity created through Outright Monetary Transactions will be fully sterilised.

Transparency

Aggregate Outright Monetary Transaction holdings and their market values will be published on a weekly basis. Publication of the average duration of Outright Monetary Transaction holdings and the breakdown by country will take place on a monthly basis.

Securities Markets Programme

Following today's decision on Outright Monetary Transactions, the Securities Markets Programme (SMP) is herewith terminated. The liquidity injected through the SMP will continue to be absorbed as in the past, and the existing securities in the SMP portfolio will be held to maturity.[107]

Appendix 2: Minutes of the 340th Meeting of the Governing Council of the European Central Bank on 5 and 6 September in Frankfurt am Main

[. . .]

With regard to Outright Monetary Transactions (OMT), on a proposal from the President, the Governing Council:

(b) approved the main parameters of the Outright Monetary Transactions (OMT), which would be set out in a press release to be published after the meeting (Thursday, 6 September 2012);

[. . .][108]

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[107] Taken from the report of the facts of the Case, GFCC, OMT-judgment (footnote 14 above), margin no. 3.

[108] Taken from the report of the facts of the Case, GFCC, OMT-judgment (footnote 14 above), margin no. 2.

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Externally Imposed Financial Repression, Conflicted Internationalisation of the Renminbi and External Balancing via Wage Adjustment

Gunther Schnabl

Abstract China has made several important steps to liberalise its domestic financial markets and to open up its capital markets internationally in order to promote the renminbi as an international currency. To make the renminbi a convertible, freely floating international currency is a pre-requisite for the renminbi to challenge the dollar as an international currency. The chapter shows, however, that the very benign liquidity conditions in the US, combined with very large foreign currency denominated assets, constitute an insurmountable impediment for the floating and the internationalisation of the renminbi. With exchange-rate stability being seen as an important determinant of macroeconomic stability and growth in China (and East Asia), domestic-wage increases are proposed in order to reduce the appreciation pressure on the Chinese currency.

1 Introduction

The industrialised world has experienced a gradual decline of interest-rate levels. Due to asymmetric interest-rate policies—larger interest-rate cuts during the crisis than interest rate increases during the recovery after the boom (Hoffmann and Schnabl 2011)—prime interest rates have converged towards zero (Fig. 1) being followed by a set of unconventional monetary policies, which have inflated central bank balance sheets. The unprecedented growth of liquidity in the large industrialised countries has created growing challenges for the emerging market economies. While, in the short-term, capital inflows contribute to more growth and employment, in longer run, declining interest rates constitute the breeding ground for undue credit growth, inflation and speculative waves in stock and real estate markets (Hoffmann and Schnabl 2014).

The paper is based upon joint research with Ronald McKinnon, published as McKinnon and Schnabl 2014. I thank Kristina Spantig and Hannes Böhm for excellent research assistance.

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F. Rövekamp et al. (eds.), *Central Banking and Financial Stability in East Asia*,
Financial and Monetary Policy Studies 40, DOI 10.1007/978-3-319-17380-1_7

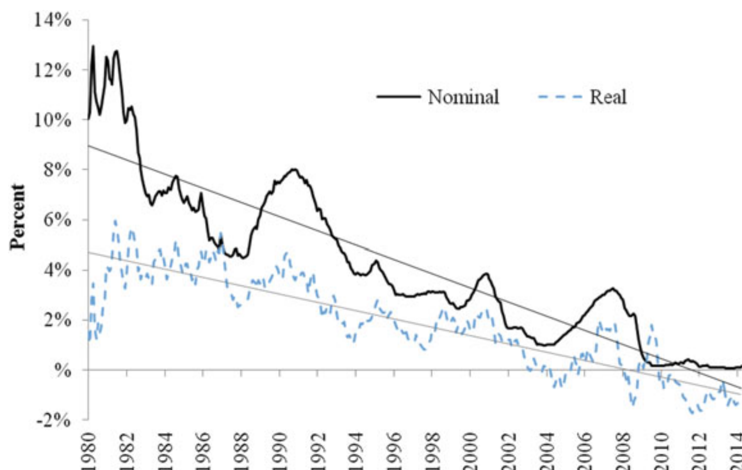

Fig. 1 G3 short-term interest rates (Arithmetic average). *Source*: IMF, via datastream. G3 = US, Japan and Germany (up to 1998) euro area

In particular, fast growing China has become the target of buoyant capital inflows for several reasons. Firstly, market-oriented reforms and the large supply of low-cost, motivated labour force have attracted large-scale foreign direct investment (FDI) (from the industrialised countries. Secondly, the very benign liquidity conditions in the large industrialised countries have motivated hot money inflows into China. With money market and deposit rates in the industrialised countries being close to zero and Chinese lending rates being at least at a level of 6 %, a respectable margin of temptation has emerged to find a way around the inward-bound capital controls. Thirdly, up to the year 2014, these hot money inflows were encouraged by a predictable appreciation path of the renminbi against the dollar, which has systematically appreciated renminbi assets versus dollar assets.

Given very buoyant capital inflows, the Chinese monetary authorities have taken several measures to reduce price pressure in goods and—in particular—real estate markets. It will be shown that these measures have been the origin of externally-imposed financial repression, which is *per se* an impediment for the liberation of Chinese capital markets, and thus, for the internationalisation and the floating of the renminbi. To reduce hot money inflows into China—and therefore the degree of financial repression—this chapter proposes tight exchange-rate stabilisation against the dollar, combined with wage increases.

2 China's Response to Buoyant Capital Inflows

In the face of buoyant capital inflows, China has been keeping the renminbi tightly pegged to the dollar, and because the resulting reserve accumulation constituted an inherent source of inflationary pressure and uncontrolled credit growth, the People's

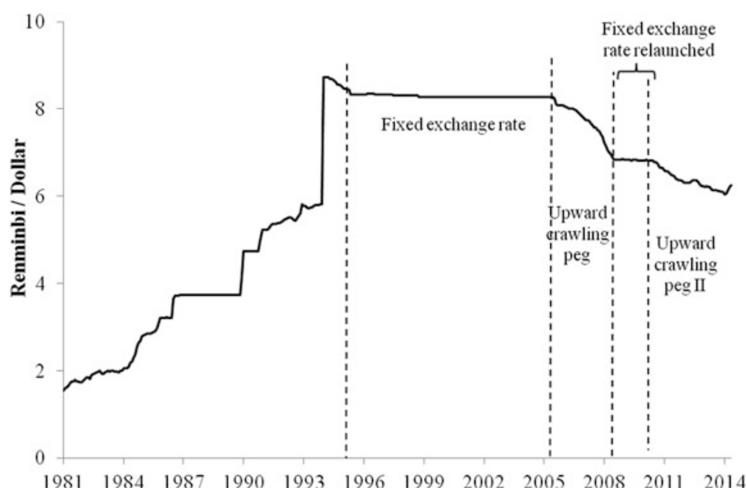

Fig. 2 Renminbi exchange rate against the dollar. *Source*: IMF, Federal Reserve Bank of St. Louis

Bank of China has been forced into extensive sterilisation measures,[1] which have become the breeding ground for shadow banking.

2.1 Exchange Rate Stabilisation and Reserve Accumulation

Since the unification of the dual exchange rate in the year 1995 and the abolition of exchange controls on current-account transactions (exporting, importing, interest and dividends), China has been keeping the exchange rate of the renminbi tightly pegged to the dollar (Fig. 2). Between 1995 and July 2005, as well as between July 2008 to July 2010, the Chinese yuan was kept mainly unchanged *versus* the dollar. From July 2005 to July 2008 and from July 2010 to December 2013, the renminbi has followed an upward crawling peg against the dollar.

China's dollar peg has become the basis for stable and high growth (McKinnon 2004). From a goods-market perspective, China's outstanding growth performance has been export-led. Capacities, which have been created based upon large investment activity, continued to be cleared on international markets. With China stepwise becoming the hub of the sophisticated East Asian production system (Thorbecke and Smith 2010), exchange stability against the dollar remains the basis for stable exports to the US as the most important single export-target market (Schnabl 2012). Because the common dollar peg of all East Asian countries (excluding Japan) is the backbone

[1] Schobert and Yu (2014) show, based upon a comparison between Germany in the 1970s and current China, that reserve requirement policies are an important macroprudential tool in the face of buoyant capital inflows.

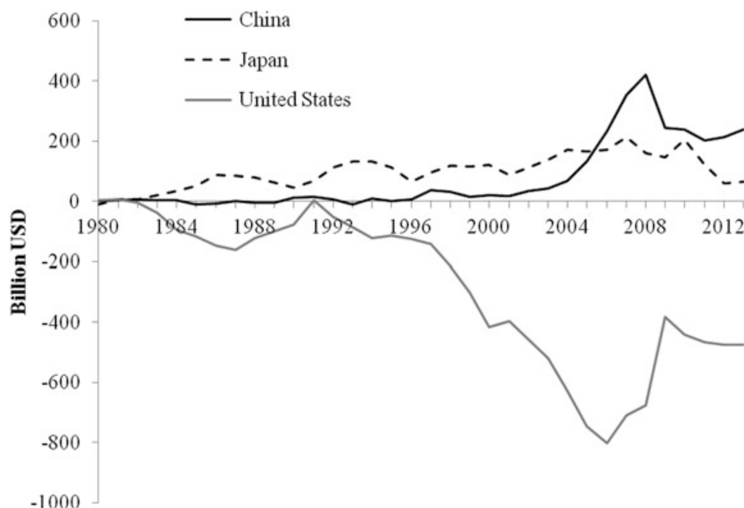

Fig. 3 Current account balance of China, US and Japan. *Source*: IMF: IFS

for a high degree of intra-regional exchange-rate stability, also from the perspective of intensive intra-East Asian trade, China's growth remains strongly dependent on exchange rate stability against the dollar (Schnabl and Spantig 2014).

From a financial market perspective, the combination of large current account surpluses (as shown in Fig. 3) with under-developed capital markets constitutes a strong incentive to keep the renminbi tightly pegged to the dollar (McKinnon and Schnabl 2004). Since the turn of the millennium, based upon sustained current account surpluses, China has built up large net foreign assets against the world in general and the United States in particular. With developed capital markets, a creditor country could have a capital outflow in the form of portfolio investment and FDI that finances (matches) its current account (saving)[2] surplus. With the capital outflow and the resulting build-up of claims on foreigners being denominated in the currency of the creditor country, domestic financial institutions such as banks, pension funds, and insurance companies do not face any foreign exchange risk.

However, China, as an immature creditor country, cannot lend to foreigners in its own currency. Because the US dollar is the dominant international money and China's financial markets are under-developed—with their development being impeded by interest rate and capital controls—Chinese financial institutions cannot lend in international capital markets in renminbi. The acquisition of large foreign currency denominated assets makes Chinese financial institutions vulnerable to exchange rate appreciation, because a strong appreciation of the renminbi against

[2] The current account balance is, *per* definition, equal to the gap between aggregated saving and investment. If aggregated saving is larger (smaller) than aggregated investment, the current account is positive (negative).

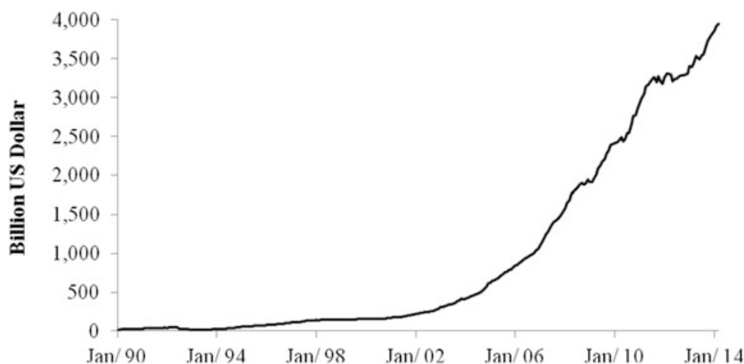

Fig. 4 Chinese foreign reserve holdings. *Source*: IMF: IFS

the dollar erodes the net worth of the ever-rising dollar assets in terms of domestic currency.

The upshot is that China finances its current account surpluses and capital inflows via the public sector, *i.e*., foreign reserve accumulation. The People's Bank of China has accumulated a large stock of foreign reserves, which had grown up to 3.85 trillion dollars by spring 2014 (Fig. 4). In addition to these large liquid dollar claims, foreign direct investments, mostly to countries producing primary products as input for the Chinese industry, are piled up by the Chinese government. The gradual rise of—mostly—dollar denominated international assets constitutes a strong incentive to soften the appreciation of the renminbi against the dollar.

If China stopped exchange-rate stabilisation against the dollar, the buoyant liquidity conditions in the US combined with large foreign-currency denominated assets would signal an appreciation of the renminbi. The quasi-riskless anticipation of renminbi appreciation would encourage one-way bets on renminbi appreciation and therefore additional speculative capital inflows into China. In an extreme scenario, the renminbi/dollar exchange rate would spiral upwards, with the exchange rate coming under strong appreciation pressure because of the positive unfinanced gap between saving and investment (McKinnon and Schnabl 2014).

Therefore, to maintain appreciation expectations—and thereby speculative capital inflows—under control, the People's Bank of China keeps the exchange rate tightly pegged to the dollar (Fig. 2). It sets the central renminbi/dollar rate in the morning of every trading day close to the rate prevailing at the end of the previous day. It maintains a narrow band of about 2 % (before 2014, 1 %) between bid and ask prices throughout the day to facilitate the international payment transactions of commercial banks.[3]

[3] From January 2014 into June 2014, the renminbi started to depreciate against the dollar, in what was seen as a move by the People's Bank of China to deter speculators. The depreciation of the renminbi against the dollar could, however, also be due to slowing growth dynamics.

2.2 Sterilisation, Externally-Imposed Financial Repression, and Shadow Banking

If unsterilised, the tremendous accumulation of foreign reserves by the People's Bank of China would constitute the breeding ground for inflationary pressure and uncontrolled credit growth, as experienced by several Southeast Asian countries in the run up to the Asian crisis (Corsetti et al. 2000). Given that open interest rate parity[4] holds, with the US money market rate being close to zero and the renminbi being tightly pegged to the dollar, the money market interest rate in China would be zero as well. This would be far too low for a fast growing economy, where real output expands by 7–10 % per year. For this reason, the People's Bank of China is forced to mop up, *i.e.*, to sterilise, large amounts of (potential) liquidity in the domestic financial system to prevent inflation from rising and to forestall an unsustainable credit boom.

There are two main sterilisation techniques (Löffler et al. 2013). With market-based sterilisation, the central bank sells domestic-currency (central bank) bonds to commercial banks and other financial entities which reduces the amount of liquidity in the domestic financial sector. Because these bonds are remunerated at market rates, the market mechanism remains in place. The disadvantage is often substantial sterilisation costs and an upward pressure on interest rates, which would *ceteris paribus* attract even more hot money inflows.

In contrast, with non-market-based sterilisation, the central bank raises reserve requirements on commercial-bank deposits so that less bank credit can be issued for any given increase in base money. Because reserve requirements tend to be remunerated at low interest rates or not at all, sterilisation costs are kept low. The disadvantage is that commercial banks become restricted as financial intermediaries, because sterilisation costs are shifted to the commercial banks. To maintain profit margins, commercial banks have to increase lending rates and/or lower deposit rates.

If commercial banks shift the sterilisation costs to depositors in the form of lower deposit rates, this encourages the emergence of a less regulated "shadow" banking sector, which offers better deposit conditions. As the sterilisation process aims to keep credit provision tight, non-market-based sterilisation is usually combined with capital controls. Inward-bound capital controls aim to reduce speculative capital inflows, which are attracted by the domestic credit tightening. Outward capital controls can be necessary, if the costs of non-market-based sterilisation are shifted to depositors in the form of lower deposit rates.

[4] The open interest rate parity is an equilibrium condition in international capital markets assuming the absence of transaction costs and risk. The domestic interest rate i_d is equal to the foreign interest rate i_f adjusted for exchange rate changes $\hat{e}$ ($i_d = i_f + \hat{e}$). At the end of an investment period, both investment in home currency and in foreign currencies have the same yield in terms of domestic currency.

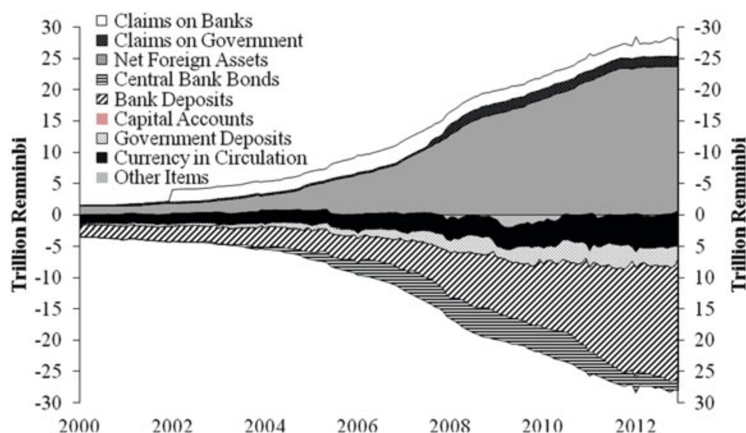

Fig. 5 People's Bank of China balance sheet. *Source*: IMF:IFS

In practice, the People's Bank of China has resorted to both techniques for sterilising foreign exchange intervention with a rising tendency to use non-market-based instruments. Figure 5 shows that, on the asset side of the balance sheet (with the positive sign), foreign reserves have grown massively. On the liability side (with the negative sign), the sterilisation instruments are shown. Starting from the year 2003, the People's Bank of China issued central bank bonds to absorb liquidity from the Chinese banking sector. Starting from 2006 increasingly the reserve requirement ratio was raised and the reserve requirement basis was widened, which is reflected in the steep rise of (commercial) bank deposits at the People's Bank of China. Whereas interest rates paid on the People's Bank of China's bonds tended to follow closely the interbank rate (which can be assumed to be mainly market-determined), the remuneration rate on required reserves is at around 2 %, which is substantially below the inflation rate (Fig. 6).

The consequence is *financial repression*, a concept developed by McKinnon (1973) and Shaw (1973). It describes a situation in which capital markets do not fully follow free market principles, but are strongly controlled by governments, often leading to re-distribution effects in favour of the government. During the 1960s and 1970s, high reserve requirements, interest rate ceilings, tight bank regulation, rising consumer price inflation and restrictions on international capital flows led to negative real interest rates in many Latin American and East Asian countries. This financial repression was imposed internally by national governments to cover fiscal deficits. The modern form of financial repression in emerging markets and developing countries is externally imposed (McKinnon and Schnabl 2014). As the core countries of the asymmetric world monetary system keep short-term rates close to zero and hold long-term interest rates low by quantitative easing, the countries at the periphery of the world monetary system are forced into capital and interest rate controls.

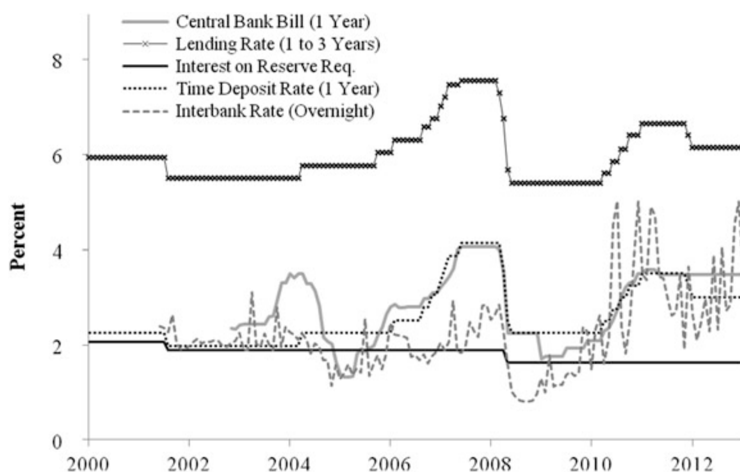

Fig. 6 Fragmented interest rate structure in China. *Source*: People's Bank of China

The government in China has introduced controls on capital inflows and outflows as well as ceilings on domestic deposit and lending rates as forms of financial repression. Reserve requirements of banks at the central bank are remunerated at (less than) 2 %, as shown in Fig. 6. At the same time, commercial banks are forced to keep interest rates on credit provision below specific upper ceilings. For a fast growing country, bank lending-rates of about of 6.5 % are low. An excess demand for domestic bank credit emerges, which allows state-owned banks to direct credit allocation to the large state-owned enterprises and export enterprises (window guidance) (McKinnon and Schnabl 2012; Bai 2013).

Because small- and medium-sized enterprises are risky, and credit provision to small- and medium-sized enterprises is expensive (*per* renminbi lent), China's banks become unwilling to lend at the low, controlled interest rates. Therefore, small- and medium-sized enterprises as well as local governments[5] have to rely on credit by shadow banks, which charge a substantially higher interest rate level than the state-owned banking sector. In practice, state-owned banks may provide funding to informal (off book) affiliates. Large customers may be guided to deposit their savings in trust funds, which pay higher deposit rates and make high-interest—but also riskier—loans. The consequence is the growth of a shadow-banking sector that covers credit market segments which are not covered by state-owned banks.

[5] Local governments have been restricted by law to issue own bonds. Recently, this restriction was loosened.

3 Limits to Renminbi Internationalisation

To escape from externally-imposed financial repression, China has to become a mature international creditor with a freely floating exchange rate. Chinese banks and insurance companies could then lend to foreign enterprises and governments in renminbi without foreign exchange risk. International bonds denominated in renminbi could be sold in Shanghai (or other Chinese cities) to foreigners. China's private financial sector could finance its current account surpluses without the People's Bank of China intermediating international capital outflows. The liberalisation—both at national and international level—would allow China's capital market to thrive, which is an indispensable pre-requisite for the renminbi to challenge the dollar as an international currency.

China's government has taken several steps to liberalise domestic capital markets and to make the renminbi convertible. It supports offshore renminbi trading in Hong Kong and other financial centres, including London and Frankfurt. Chinese and foreigners can now open renminbi deposits in authorised foreign banks, which can be used to make offshore renminbi loans or renminbi payments. Renminbi deposits in Hong Kong and the issuance of so-called renminbi-denominated Dim Sum bonds have grown fast since 2010 (the upper panel of Fig. 7). Swap lines with other central banks were initiated by the People's Bank of China to encourage more renminbi-based trade at lower exchange rate risk (the centre panel of Fig. 7), although they remain very small compared to the partners' dollar reserves. In particular, the share of the renminbi in the overall turnover in global foreign exchange markets is still miniscule (the lower panel of Fig. 7).

Furthermore, to promote the renminbi as an international currency, the Chinese government plans to introduce the Shanghai Free Trade Zone for international financial flows, where access for foreign investors to this renminbi capital market will be facilitated. Chinese investors can use the capital free trade zone as a platform for overseas investments. However, capital controls between the Shanghai Free Trade Zone and the rest of China have to remain in place. Otherwise, if capital controls on inward flows were removed, hot money inflows into China would accelerate, as long as appreciation expectations persist. More dollars will be converted into renminbi, pushing Chinese interest rates towards zero. A zero interest rate would be far too low for fast growing China.

The upshot is, that the US zero interest rate policy and quantitative easing have become an insurmountable impediment for the national and international liberalisation of China's capital market as a pre-requisite for the renminbi to become a freely floating international currency. While the Federal Reserve Bank has signalled a prudent exit from quantitative easing, other large central banks (the European Central Bank, the Bank of England, and the Bank of Japan) are expected to perpetuate very benign liquidity conditions. As first announcements of US monetary tightening have caused financial turmoil in major emerging markets, the future path of US monetary tightening remains uncertain. The benign liquidity conditions in the large industrialised countries combined with pressure on China to

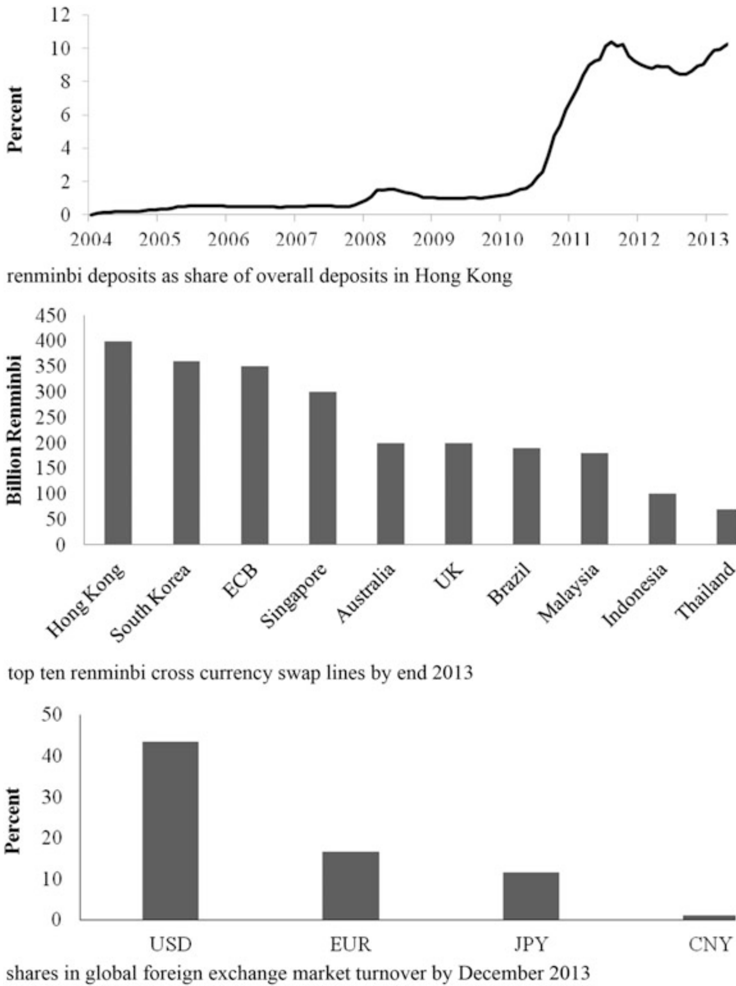

Fig. 7 Internationalisation of the renminbi. *Source*: People's Bank of China and Bank of International Settlements

let the renminbi appreciate constitute an external constraint on China's ability to liberalise its domestic capital market and to remove international capital controls. China must remain an immature creditor and the renminbi cannot be fully internationalised. The second best solution is to keep the renminbi pegged to the dollar, to minimise speculative capital inflows and to facilitate international and intra-regional trade flows. The current account surplus and the oversized net international asset position can be balanced via wage increases.

4 Re-balancing the Chinese Economy via Wage Adjustment

A shrinking or even negative current account balance would slow down or even reduce China's large built-up international assets, which would increase the degree of freedom to liberalise capital markets and to float the renminbi against the dollar. To achieve this adjustment, real wage growth is superior to nominal exchange rate adjustment, because—as experienced by Japan—nominal exchange rate appreciation has no systematic impact on the current account balance (McKinnon and Schnabl 2009). All attempts to reduce the Japanese trade surplus by nominal exchange rate appreciation, including the post-Plaza 50 % appreciation *versus* the dollar, have failed. Declining exports in response to appreciation were followed by declining imports, as growth slowed down.

In contrast, given a fixed exchange rate, real wage increases can help to reduce the current account surplus for two reasons. First, a negative risk premium on wages, as it emerges under floating exchange rates in countries with large foreign-currency denominated assets, is eliminated.[6] In a highly competitive export market, as prevails in China, enterprises tend to be reluctant to grant wage increases if they face uncertainty concerning future exchange rate movements. If, after having agreed on a certain wage increase, the Chinese currency appreciates unexpectedly, export enterprises will face painful losses. Therefore, risk adverse employers tend to reduce wage offers *ex ante*, what lowers *ceteris paribus* the wage level, in particular if, due to large foreign currency denominated assets and expansionary US monetary policy, appreciation expectations persist. By keeping the renminbi tightly pegged to the dollar, this negative discount on wage increases can be eliminated.

Second, wage increases which go beyond productivity increases could contribute to the re-balancing from an export-led growth model towards growth being based more on domestic demand, as rising wages would stimulate domestic consumption. Figure 8 shows—for four sectors of the Chinese economy—that nominal wages in China have grown substantially since the renminbi was tightly pegged to the dollar in 1994. Nevertheless, consumption as a share of GDP has gradually decreased from about 50 % of GDP in 1994 to about 40 % currently, whereas investment as a share of GDP has increased from above 30 % to close to 45 % (McKinnon and Schnabl 2014).

One reason for this structural change in the composition of the GDP can be seen in the financial repression linked to the non-market-based sterilisation process as described above. The below-equilibrium official lending rates and preferential credit allocation to state-owned and export enterprises is equivalent to a subsidy to the enterprise sector, which allows enterprises keeping producer prices low to gain international market share. Figure 9 shows that the producer price-based real

[6] Concerning a negative risk premium, see Goyal and McKinnon (2003).

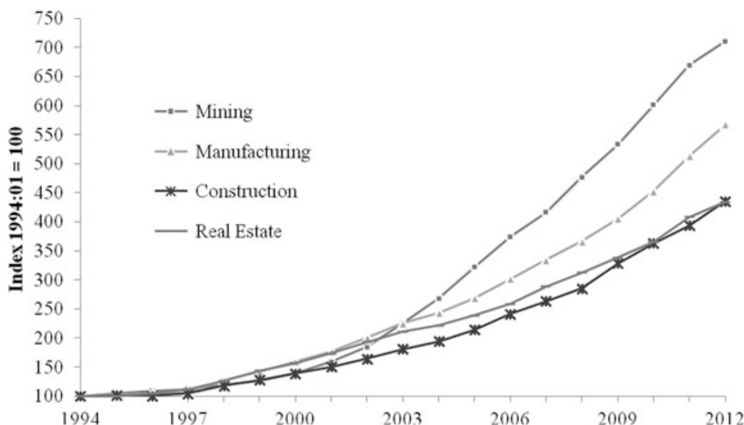

Fig. 8 Real wages in China by Sector 1999–2012. *Source*: National Bureau of Statistics, China

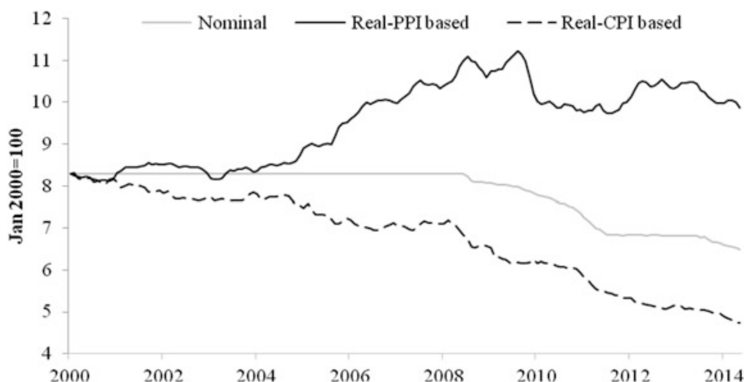

Fig. 9 Nominal and real exchange rate of the renminbi. *Source*: IMF. *PPI* producer price index, *CPI* consumer price index

exchange rate of the renminbi against the dollar has tended to depreciate since the year 2000, despite the considerably nominal appreciation of the renminbi against the dollar. Preferential low-cost capital allocation combined with producer price-based real exchange rate stabilisation is equivalent to a subsidy to the enterprise sector, which is reflected in the growing savings and investments of the enterprise sector.

In contrast, low deposit rates on household savings (Fig. 6) reduce one potential source of income for the household sector, thereby keeping consumption lower than without financial repression. As indicated by Fig. 9, consumer prices in China have increased faster than producer prices, which implies a decline in the demand for consumer goods relative to the demand for investment goods. Thus, given the implicit subsidy on investment, the Chinese current account surplus—as the gap

between national savings and investment—has been driven not only by the high savings of households, but also, to a significant extent, by the rising savings of the enterprise sector (Ma and Yang 2013).

This tilting of the demand structure towards investment and exports could be reversed if wages were allowed to increase further. Given the scarcity of skilled and semi-skilled labour, and the almost complete absorption of unskilled rural labour into the industrial sector, Chinese employers may be willing to bid more aggressively for workers. With wage increases in the industrial sector being strongly correlated to wage increases in other sectors (Fig. 8), a higher wage level in the public sector could extend to the whole economy. Consumption in China would rise relative to investment. The Chinese savings surplus over investment would decline and even turn negative, as enterprise savings and public savings would decline.

The rise in wages does not necessarily imply that wages increases would increase unemployment. In the current system, the productivity-based wage increases are reduced in two ways. First, exchange rate uncertainty is equivalent to a loss in welfare, which could be transformed into a respective real wage increase under a fixed exchange rate system. Second, the current Chinese current account surplus is not necessarily equivalent to inter-temporal optimisation, because rising Chinese net international assets tend to be devalued *via* dollar depreciation (and/or dollar/renminbi inflation). This corresponds to a transfer from Chinese workers to US workers, *i.e.*, a loss in real welfare for Chinese workers. If real wage increases were to contribute to a reduction of this transfer of welfare, a larger share of domestic productivity could be transformed into a higher real wage level. This would boost real consumption without leading to unemployment, as foreign demand would be transformed into domestic demand.

5 Outlook: International Repercussions

China seems to be trapped in the dollar-centred international monetary system. Given the dominating role of the dollar in the international monetary system, pegging the renminbi to the dollar is not only equivalent to stabilising China's and East Asia's macroeconomic development. As China's international assets are predominantly denominated in dollars, exchange rate stabilisation against the dollar also stabilises the value of China's ever-growing international assets in terms of domestic currency. A shift towards exchange rate flexibility of the renminbi against the dollar would signal substantial re-valuations gains for dollar assets being converted into renminbi (one-way bets) and thereby would cause a run on the Chinese currency. The resulting monetary expansion in China would drive up inflation and increase the risk of an unsustainable credit boom, thereby constituting a major risk for macroeconomic stability.

Therefore, keeping the renminbi tightly pegged to the dollar is currently the second-best solution for China's monetary framework. However, given the still very expansionary monetary policy of the Federal Reserve Bank, exchange rate

stabilisation against the dollar necessitates extensive non-market-based sterilisation measures, which are the basis for structural distortions in the Chinese and the international economy. Because the nominal exchange rate is not a reliable mechanism to reduce a current account surplus, domestic wage growth is recommended to re-balance the Chinese economy. Allowing domestic wages to grow would further appreciate the consumer-price based real exchange rate. Aggregate demand would be shifted towards domestic consumption, and because profit margins of enterprises would shrink, producer prices would have to increase, which would reduce enterprise savings and the producer-price-based real exchange rate would appreciate.

Re-balancing the Chinese economy would also imply re-balancing the US economy. As the Chinese current account surplus would be reduced, the US current account deficit would have to improve. This would go along with rising prices to be paid on imports from China, and—given a declining Chinese demand for US government bonds—upward pressure on long-term US interest rates. Higher income taxes would support this adjustment process, as household and government savings would increase. Thus, the shift towards growing Chinese consumption would have to be accompanied by a decline in private and public US consumption.

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Demand and Supply of Shadow Banking in China

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Abstract Shadow banking is a major financial risk faced by Chinese policymakers today. Instead of assessing, as others do, its size and impact, this chapter examines the demand and supply side of China's shadow-banking system. This distinction increases, on the one hand, the understanding of the drivers of the rapid growth of shadow banking in recent years. On the other hand, the distinction allows to derive targeted policy measures to contain the size and risks of shadow-banking activities in the future. The chapter looks into the definition of shadow banking (Sect. 2), puts Chinese shadow banking into perspective by assessing its structure, causes and risks (Sect. 3), and analyses, in greater detail, its demand and supply sides (Sects. 4 and 5 respectively). It finds a high degree of inter-connectedness of China's biggest challenges (shadow banking, public and corporate debt, financial repression and real estate issues), something which has to be taken into account when designing policy measures. The chapter concludes (Sect. 6) that, on the demand side, further fiscal reforms are needed to sort out the relationship between central and local government, so that local governments can secure the funding needed for urbanisation. On the supply side, interest rates should be further liberalised to avoid "bad money" driving out "good money".

1 Introduction

The surge of shadow-banking activities is considered a major financial risk in China today, and the topic has caught much attention around the globe. Many analysts have focused on the size and possible impact of the shadow-banking system in China, and their views vary. In June 2014, the *Financial Times*, for example, called

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F. Rövekamp et al. (eds.), *Central Banking and Financial Stability in East Asia*, Financial and Monetary Policy Studies 40, DOI 10.1007/978-3-319-17380-1_8

China's shadow-banking system "precarious" and compared it to the "shadow banking bubble in the US in the run-up to 2008",[1] while *UBS* economists have argued that China's default challenge is not of *Lehman* proportions, as its "shadow banking system is much smaller relative to the size of its overall financial system when compared with many developed economies such as the US".[2]

This chapter intends to shed more light on the "hot topic" of China's shadow-banking system by examining its demand side and its supply side. This distinction allows not only to understand better the rapid growth of Chinese shadow banking in recent years, but also to derive specific policy measures to contain the size and biggest risks of shadow-banking activities in the future. The main findings of the chapter are that the shadow-banking system should be addressed from both the demand side and the supply side and examined in the context of China's fiscal and financial reforms. On the demand side, further fiscal reforms are needed to sort out the relationship between central and local government, so that local governments can secure the funding needed for urbanisation. On the supply side, interest rate liberalisation should be further promoted to avoid "bad (risky) money" driving out "good money".

The chapter is organised as follows. The next section looks into the definition of shadow banking. The third section puts Chinese shadow banking into perspective and assesses its structure, causes and risks. Sections 4 and 5 analyse its demand and supply sides respectively in more detail, while the sixth section concludes with some policy implications and measures derived from this analysis.

2 Definition of Shadow Banking

The term "shadow banking" was first used in 2007 by Paul McCulley to describe financial intermediation outside the balance sheets of regulated commercial banks.[3] There is no clear and agreed definition of which entities or products should qualify as shadow banking. The Financial Stability Board (FSB) suggested that shadow banking can broadly be described as credit intermediation involving entities and activities outside the regular banking system. It emphasised the risks that might emerge from credit intermediation that involves maturity and liquidity transformation, leverage or credit risk transfer.[4] Ben Bernanke, the former chairman of the Federal Reserve, provided a definition in April 2012:

[1] Jamil Anderlini, "Into the Shadows: Risky Business, Global Threat", in: *Financial Times*, 15 June 2014, http://www.ft.com/intl/cms/s/2/a123375a-d774-11e3-a47c-00144feabdc0.html#axzz34tp9Fy00, last accessed 22 July 2014.

[2] Wang Tao *et al.*, UBS China Weekly Economic Focus: Why China is not Facing a Lehman Moment, 27 March 2014.

[3] Bryan Noeth and Rajdeep Sengupta, "Is Shadow Banking Really Banking?", in: *The Regional Economist*, Federal Reserve Bank of St. Louis, October 2011, pp. 8–13.

[4] FSB, Strengthening Oversight and Regulation of Shadow Banking, 18 November 2012. The FSB suggests to define shadow banking according to economic functions: whether the products or

> Shadow banking, as usually defined, comprises a diverse set of institutions and markets that, collectively, carry out traditional banking functions, but do so outside, or in ways only loosely linked to, the traditional system of regulated depository institutions.[5]

Examples of shadow banking products include derivatives, mutual funds, hedge funds, private equity, real estate investment trusts, and other high leverage products.

In China, the definition of shadow banking *yingzi yinhang* 影子银行 differs from that in the advanced economies, both in terms of the actors providing the services and the products involved. Specifically, shadow banking in China normally refers to traditional quasi-banking products without prudential supervision.[6] In many analytical papers, the involved actors include, among others, micro-credit co-operatives, pawn shops, financial guarantee companies, private equity funds, rural fund associations as well as organised informal lending. The shadow-banking products include wealth management products, off-balance sheet assets, some irregular trust plans, bank acceptance bills, trust loans, entrusted loans, entrusted investment, money market funds, and the like.

Although shadow banking activities are generally less regulated, the major difference between shadow banking in China and that in the advanced economies lies in the leverage ratio. In more mature markets, shadow-banking products normally carry higher leverage ratios, while, in China, most of the so-called shadow-banking products are low leverage products, and some are simply a variation of direct investment. The IMF comes to the same conclusion in its latest Article IV consultation report:

> On the positive side, although China's shadow banking system is neither simple in structure nor transparent, it is not dominated by complex derivatives and massive leverage.[7]

3 Shadow Banking in China: An Overall Picture

3.1 Size, Growth and Main Components

There have been different estimations of the size of Chinese shadow banking, depending on the definitions. According to the China Banking Regulatory

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institutions involve management of client cash pools, making them susceptible to runs; loan provision that is dependent on short-term funding; intermediation of market activities dependent on short-term funding or secured funding on assets; facilitation of credit creation; securitisation and funding of financial entities (see http://www.financialstabilityboard.org/publications/r_121118a.pdf).

[5] Ben Bernanke, "Some Reflections on the Crisis and the Policy Response", speech, New York, 13 April 2012 (see http://www.federalreserve.gov/newsevents/speech/bernanke20120413a.htm).

[6] State Council News Conference on 15 January 2014.

[7] International Monetary Fund, People's Republic of China: Staff report for the 2014 Article IV Consultation, 8 July 2014, p. 28 (http://www.imf.org/external/pubs/ft/scr/2014/cr14235.pdf).

Commission (CBRC), the shadow banking system totaled RMB 9.43 trillion by June 2013. *Deutsche Bank* estimated the total size to amount to RMB 21 trillion or 40 % of GDP at end-2012.[8] *JP Morgan Chase* used the broadest definition of China's shadow banking and arrived at a total size by end 2012 of RMB 36 trillion or 69.3 % of GDP.[9] Based upon a similarly broad concept of Chinese shadow banking, *Moody*'s estimated the balance of the outstanding shadow banking products at the end of the year 2012 to be at RMB 29 trillion (55 % of GDP).[10] An estimate done by the ECB in 2013 arrived at almost the same size, namely RMB 30 trillion or 57 % of GDP at end-2012, based on data by the *People's Bank of China* (PBoC), the *China Trustee Association*, *Deutsche Bank* and *JP Morgan Chase*, and including "micro loans, bank acceptance bills, entrusted loads, trust products, leasing activities and underground lending".[11]

What has concerned Chinese and foreign observers more than the absolute size of the shadow-banking sector is its rapid growth in recent years. Figure 1 shows the growth since 2007 of the main components of Chinese shadow banking, which are entrusted loans, trust loans and bank acceptance bills, derived from the monthly so-called "total social financing" (TSF) data published by the PBoC.[12] While the PBoC does not provide a definition and estimate of the "total" shadow banking, the chart illustrates the rapid growth of its main components, which have quadrupled since 2009 as a percentage of GDP:

- ***Entrusted loans*** are a form of inter-company lending, intermediated by banks. Entrusted loans are typically used by corporate groups to extend loans between different companies, as direct lending between corporate entities is legally prohibited. The intermediary acts only as an administrator and does not provide its own funds. Some banks had been providing credit guarantees for these products, but the CBRC banned this practice in September 2011.
- ***Trust loans*** are arranged by banks or trust companies, which offer so-called wealth management products (WMPs) *licai chanpin* 理财产品 to investors

[8] Ma Jun *et al*., Deutsche Bank Markets Research, China Strategy Update: Shadow banking risk is manageable, 28 March 2013.

[9] J.P. Morgan Chase, Economic Research Note: Shadow banking in China, 3 May 2013.

[10] Moody's Investors Service, Risks to China's Lenders from Shadow Banking: Frequently Asked Questions, 3 May 2013.

[11] Cited in Patrick Hess, "China's Financial System: Past Reforms, Future Ambitions and Current State", in: Frank Rövekamp and Hanns Günther Hilpert (eds), *Currency Cooperation in East Asia*, (Heidelberg, Springer Verlag, 2014).

[12] The PBoC introduced the TSF concept in 2001 as a gauge for monetary conditions. It captures the total financing obtained by the real economy from the financial system and includes loans in RMB and foreign exchange, entrusted loans, trust loans, bank acceptance bills, corporate bonds, equity financing by non-bank institutions and a residual including micro loans. See Zhongguo Renmin Yinhang 中国人民银行 (The People's Bank of China) *Shehui rongzi guimo goucheng zhibiao de shuoming* 社会融资规模构成指标的说明 (Explanations on sub-indices of TSF) 20 May 2011. http://www.pbc.gov.cn/publish/diaochatongjisi/194/2011/20110520190935664550535/20110520190935664550535_.html, last accessed 27 July 2014.

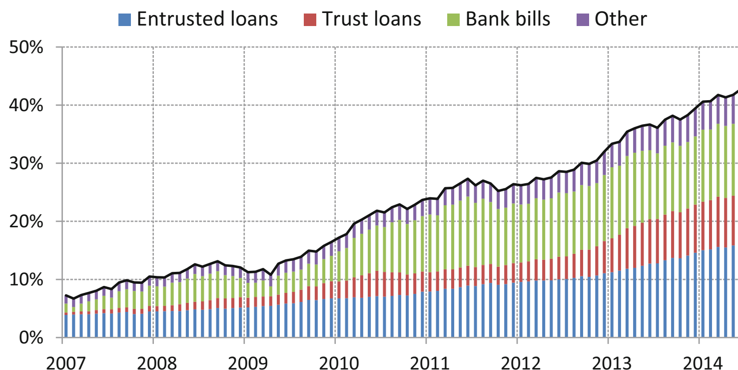

Fig. 1 Growth of main components of Chinese shadow banking (% of GDP). *Source*: PBoC. Last observation: June 2014

attracted by yields well above those of regulated savings accounts. The funds raised from the issuance of such WMPs are partly and temporarily invested in liquid instruments (bonds, equities, interbank money market), but mainly used to provide longer-term loans to local governments, real-estate developers and enterprises (typically with higher risk profiles) for infrastructure or investment projects.[13] These WMPs—with the exception of principle-guaranteed WMPs—are held off-balance sheets and their transparency is typically very low.

- ***Bank acceptance bills*** constitute a promise to pay, issued and guaranteed by banks on behalf of companies. The company posts a margin deposit, which is, on average, 30 % of the sum to be paid, and the bank then guarantees payment, usually for a short-term debt obligation. The recipient can cash the bill early for a discount. If a bank discounts the bill, it becomes a short-term credit and is recorded on the bank's balance sheet. However, Chinese banks have increasingly shifted these assets off-balance sheets by using re-purchase agreements with domestic brokerages or trust companies.

[13] An example of such a WMP can be found in the famous trust product "Credit Equals Gold" issued by *China Credit Trust*, the third largest Chinese trust company, and distributed by the *Industrial and Commercial Bank of China*. In January 2014, the trust product stood at the verge of default after its lender, a privately-owned coal-mining company, which had received a loan of RMB 3 billion, went bankrupt in 2012. The intervention of an unknown investor prevented the default of Credit Equals Gold in the last minute. For an illustration of the set-up of this trust product, see Sandra Heep, "Risiken in Chinas Finanzsystem: Warum Verschuldung und Schattenbanken Chinas Wirtschaftswachstum gefährden", *Merics China Monitor* No. 12, 1 July 2014 (see http://www.merics.org/fileadmin/templates/download/china-monitor/China_Monitor_No_12.pdf).

3.2 International Comparison

Although the size of China's shadow banking is relatively high compared with that in other emerging markets, it pales when compared with that in advanced economies.

UBS has defined Chinese shadow banking to include entrusted loans, trust loans, undiscounted bank acceptance bills, corporate bonds and "others"—that is TSF less bank lending and equity issuance. By this standard, according to the *UBS* estimation, the shadow banking to GDP ratio was 50–70 % in China in the year 2013.[14] This is much higher than the non-bank credit intermediation in other emerging market economies, but lower than the global average (117 % in 2012), and much lower than for example the figure for the US (1,744 % in 2012).[15] Another estimate by *Standard Chartered* shows a ratio of shadow banking to GDP of 61 % for China in 2011, compared to 152 % for the US, 168 % for the European Union and 310 % for the UK.[16] The fact that the size of shadow banking in developed countries dwarfs that in emerging countries can be explained by the role of the former as financial centres and also by the difference in the composition of shadow banking: in the UK and the US, non-bank financial intermediation is mainly composed of investment funds, broker dealers and structured finance vehicles, which play no or only a minor role in China and other emerging markets. The impact of regulation on the size of shadow banking remains unclear: Is it so mature in the Western world that it can "afford" such a high shadow banking sector relative to GDP, or is it so inadequate—with the post-crisis focus being on the banking sector—that Western non-bank activities have grown so large?

3.3 Causes and Risks

Many shadow-banking products are funded through WMPs because Chinese savers lack investment channels for their savings, most of which have to go into deposits with very low returns. In addition, with partially-controlled interest rates, banks are subject to rigid supervisory requirements and can only expand their profits through interbank, off-balance sheet or WMP business. At the same time, many shadow banking products can post returns at least 200 basis points higher than annual returns of traditional investments (see Table 1). On the other hand, shadow-banking products are needed because the current financial system in China cannot meet the

[14] UBS (2014), p. 2.

[15] In India, Indonesia, Argentina, Russia and Saudi-Arabia, it remained below 20 % of GDP at end-2012. FSB, Global Shadow Banking Monitoring Report 2013, 14 November 2013, p. 12 and p. 2 (see http://www.financialstabilityboard.org/publications/r_131114.pdf).

[16] Standard Chartered, China banks: Out of the shadows, 12 November 2012.

Table 1 Rates of return of different products

Product	Rate %	Note
FX loan	2.78	1-year USD loan on 1 June 2013
Bond	5.36	1-year weighted average premium for AAA-rated companies in October 2013
RMB loan	5.71	1-year base rate on 25 October 2013
Bank bill	5.88	Q2 weighted average rate for bill financing (most of the bills are paper-based with a maximum term of 6 months)
Trust loan	6.00	Minimum expected rate of return for 1-year trust loan in October 2013
Entrusted loan	12.23	Q1 2013 data for listed companies (media reports)
Peer-to-peer lending (P2P)	13.57	Average annualised rate of return of 10 internet lenders (announced on 25 October 2013)
Informal lending	17.68	1-year Wenzhou informal finance interest rate index
Pawnshop financing	34.40	Maximum of 6-month pledge rate, but the real rates are normally higher

Source: Compiled by Financial Market Department, PBoC

financing demand of many economic entities, such as SMEs, firms in industries with over-capacities, and local governments.

In general, the systemic risks of China's shadow-banking system can be contained as few shadow-banking products carry high leverage. However, the surging size of the shadow-banking system and its risks are nevertheless a cause for concern. In order to assess the risks, it is helpful to differentiate them according to the different actors involved:

For **investors**, many shadow-banking products are like deposits with higher interest rates. This implies massive moral hazard—the common belief that the banks or authorities will bail out investors—as they may not recognise that some products carry significant credit risks, which can translate into future losses. In the case of a default, this can cause bank runs. The investment strategy of trusts and WMPs is often not fully disclosed, particularly for pooled assets. Trust companies and banks arrange and distribute the trust products, but do not, at least explicitly, take on credit risk. The products offer high returns and investors appear to believe that WMPs have an implicit bank capital guarantee, which is not the case. In 2012, three WMPs defaulted, leading to street protests. If the risks are not fully understood due to this lack of investor sophistication, the products may be vulnerable to a swift reversal of confidence. It is not clear whether banks would then feel compelled to step-in to support troubled WMPs, potentially bringing assets back on their balance sheets.

For **commercial banks** and **trust companies**, the risks mainly stem from the financial arrangements between themselves and with local government financing platforms (LGFPs) and other lenders. In a typical shadow-banking operation, banks or trust companies sell the assets as loans, for example, to LGFPs with high rates of return, and, at the same time, they sell the liability (*i.e.*, WMPs) to individual

investors. This gives rise to several risks. First, there are considerable maturity mismatches between short-term financing and long-term investments: the WMPs are normally for several weeks or months, while bank loans or trust loans are typically long-term and with high rates of return. This can generate roll-over risks and liquidity risks, especially in the short-term interbank money market. Second, if the trust product carries high leverage, potential systemic risks may occur. The leverage of most shadow-banking operations is still rather low but the opaque structure of WMPs implies the possibility of hidden complexity and there is anecdotal evidence of increasing leverage: some reports suggest behaviour which is similar to the securitisation industry prior to the global financial crisis, with trusts investing in other trusts with the intention of packaging high-risk securities into products that can be sold as low-risk financial instruments. Third, banks sometimes move non-performing assets off-balance sheet, and reduce their risks through interbank operations. This can conceal part of their non-performing loans (NPL) through transferring risks to other entities, and result in opaque bank balance sheets and risks to financial stability.

From the point of view of **local government financing platforms**, their high dependence on bank loans implies deteriorating collateral quality in cases of weakening real estate markets and moderating growth. This will lead to hiking NPL ratios.

For **monetary and supervisory authorities**, the shadow-banking system can reduce the efficiency in monitoring total credit growth and managing macro-level liquidity. Moreover, the fact that shadow banking injects capital into industries with high pollution, high-energy consumption and excess capacity, makes macro control and structural adjustment more difficult for **economic policy-makers**.

4 Demand for Shadow Banking in China

There are many reasons for the surging shadow-banking activities in China, and the demand mainly comes from local governments and real-estate developers. Moreover, the root cause for such demand is the fiscal system established in 1993. As a result of the rapid economic development in the 1990s, the taxation system yielded unbalanced central and local government revenues and expenditures.

Local governments in China are in a more difficult situation than Western local governments: they have to shoulder major responsibilities of the urbanisation process and 60 % of total public expenditure. However, their share of total tax revenues is only 40 %, and there are no stable tax sources for urbanisation, such as a real-estate tax or an inheritance tax.

In the Chinese bureaucratic system, officials are evaluated by growth rates of GDP and thereby investment. However, local government debts have been prohibited. Under Article 28 of the Budget Law (1994), local governments are not allowed to carry deficit, and cannot issue bonds unless otherwise stipulated by the State Council and the Central Government. The historical background for the

stipulation in the Budget Law was that, in the early 1990s, there had been a few cases of local government mismanagement of debt, and risks emerged.

Thirty years have passed since the promulgation of the Budget Law, and local government expenditures have surged. A significant part of this expenditure increase comes from urbanisation. In 1994, China's urbanisation ratio was around 30 %, and, in 2013, it had grown to 53 %. It has been projected that the urbanisation ratio will rise to 60 % in 2020, around 1 % point per year. This means massive funding demand for infrastructure and education, as well as the social safety-net. However, under the current tax system, the funding sources of local governments are limited.

Local governments need to shoulder most of the expenditure for urbanisation, even though they have no stable tax revenues for this purpose. In advanced economies, municipal governments have real-estate taxes, inheritance taxes and other tax revenues to support a relatively slow urbanisation process. In China, such taxes are yet to be introduced, and the urbanisation process is much faster. To make ends meet, the local governments have to rely heavily on land-selling because they are not entitled to issue debt in their own name. In fact, more than half of local government fiscal income comes from land-selling. This has become a key reason for the surging real-estate prices in China, which has induced many real-estate developers to expand their business rapidly. These developers have a strong demand for shadow-banking products because they have long run out of the credit lines with banks. Shadow-banking products with short maturity have been a very convenient source of funding to finance their long-term projects—as long as real-estate prices are rising.

Local governments are not allowed to borrow in their own name, so they have established city investment companies based upon various projects or for the general purpose of municipal infrastructure. With trillions of RMB of funding shortage each year, local governments are forced to tap the shadow-banking products through urban investment companies. They do this by establishing urban investment companies which borrow from banks with an explicit or implicit local government guarantee. However, the massive funding demand from local governments cannot be met by banks alone, especially when banks are subject to prudential regulations, and shadow-banking products come as a natural complement.

After 30 years of accumulation, local government debts have skyrocketed. According to the National Audit Office, local government debts totalled RMB 10.88 trillion by June 2013, an annual increase of 19.97 % from 2010. If contingent liabilities are included, the total local government debt even amounted to RMB 17.89 trillion by end-June 2013, compared to RMB 15.9 trillion at end-2012 (this means an increase of 12.6 % in just 6 months).[17] By the end of 2013, the LGFP loans outstanding had reached 1.6 times the total fiscal revenue of local

[17] NAO report no. 32, Results of A Nationwide Audit of Government Debt (全国政府性债务审计结果), 30 December 2013 (see http://www.audit.gov.cn/n1992130/n1992150/n1992500/3432077.html).

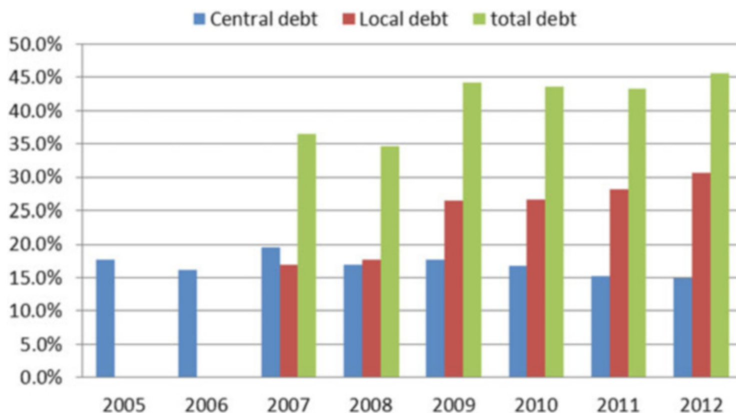

Fig. 2 Central versus local Chinese government debt since 2005 (% of GDP). *Source*: NAO, MoF and own calculations (local debt figures before 2007 are not available)

governments. Moreover, many LGFPs suffer from limited profitability, and the repayment of the debts mainly depends on non-operational cash flows, such as land transfer income.

The steady increase of local debt relative to GDP, with the central debt-to-GDP ratio coming down (Fig. 2), was the result of the post-Lehman economic stimulus consisting mainly of credit-financed infrastructure investments by local governments. Overall, this has led to a rising leverage in China, which is also increasingly unbalanced in terms of central *versus* local indebtedness.

There are some distinct geographical features of local government debts. First, most of the debts were borne by the eastern region, as the 11 eastern regions accounted for 47.5 % of all local government debts. Second, in less developed regions, government agencies issue most of the debt, while, in more developed regions such as Beijing and Shanghai, quasi-government agencies play a more important role. Third, debt issuance by local government urban investment companies mostly occurs in the less developed provinces, while trust loans accounted for a higher proportion in the more developed provinces. Fourth, the use of local government debt also differs, with the eastern region using more debt on municipal infrastructure, and the western region more on transportation facilities.

Another concern of local government debt is the high repayment pressure, particularly in the western region. In 2014, total debt repayment amounts to RMB 3.56 trillion, and the repayment burden will be around RMB 2 trillion in the period 2015–2016. The average local government debt repayment to fiscal revenue ratio is 70 %. Debt repayment dependence on land transfer is another indicator causing concern, which averaged 40 % nationwide, with Zhejiang and Tianjin being close to 65 %.

The demand side also reveals the major risk of the shadow-banking system in China, which is the above-mentioned maturity mismatch: short-term assets are used to fund long-term projects.

5 Supply of Shadow Banking in China

The supply of funding for shadow-banking products mainly comes from individual investors and banks. The investment opportunities for individual investors are so limited that most of their savings either go to bank deposits or real-estate investments. For commercial banks, their regulatory constraints prevent higher profitability and force them to expand their business via off-balance sheet operations.

The root cause of this phenomenon is the unfinished interest-rate liberalisation, which has enabled "bad money" to drive out "good money". That is, riskier products are more welcome to the suppliers of funds than less risky products. For savers, the interest rate for time deposits was less than 1 % per annum as of end-2013, while the 1-year deposit can receive an annual interest rate of around 3.5 %. For financial institutions, the base lending rate for a 1-year RMB loan is 5.71 %, while entrusted loans can get as much as 12.23 % (see Table 1). At the same time, the informal lending rates are generally higher than 17 %.

This means that the riskier money gets higher returns, without the risks ever materialising. Even if there were a few cases of defaults until 2013, the banks were always forced to shoulder the costs, with the result that most investors still treat most shadow-banking products as having the same risk as bank deposits. As discussed above, this gives rise to massive moral hazard and is also the source of the uninterrupted funding supply for shadow-banking products.

In China, the banks are very much involved in the shadow banking. Because of various constraints such as a loan to deposit ratio of 75 % and credit growth quota, banks have been looking to expand their business, which has boosted the shadow-banking sector in recent years by offering off-balance sheet transactions and market-based pricing. It has also promoted speculation and sizable funding flows between the regulated banking sector and unregulated non-bank sector.

The interbank market plays a crucial role in linking the banking and shadow-banking sector. First, both rely on the interbank market for liquidity management purposes. Hence, any liquidity stress arising in the shadow-banking system can easily translate into higher interbank rates, directly impacting on the traditional banking system, and *vice versa*. In practice, interbank rates and returns on trust products and WMPs are closely-related as banks compete for funds. On the positive side, this link allows the PBoC to manage liquidity stress in both the banking and shadow-banking sectors through open-market operations. Second, by re-packaging the proceeds of loans and other trust assets as interbank assets, the interbank market allows banks to circumvent the limits on the amount that WMPs can invest in trust products. Thirdly, certain products issued by banks, such as bank acceptance bills and trust beneficiary rights, act as collateral in interbank transactions between banks.

Banks are heavily exposed to the risks in the shadow-banking sector: they own and operate many of the structures, rely on collateral and liquidity generated through shadow-banking activities, and are potentially liable for losses on the shadow-banking products (WMPs) that they have marketed. Recent increases in

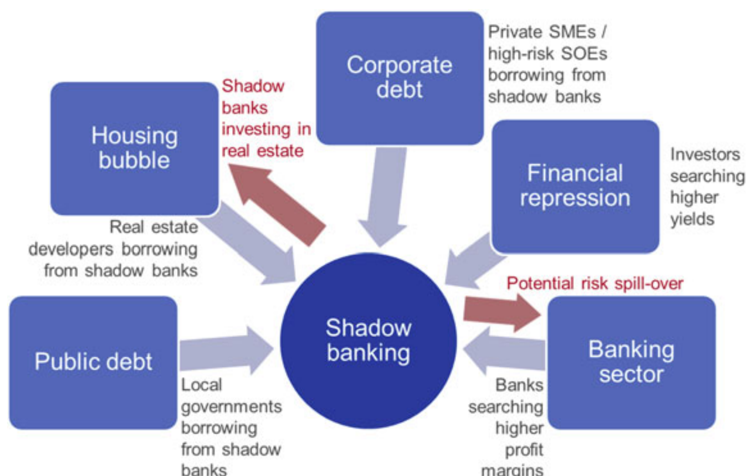

Fig. 3 Inter-connectedness of Chinese shadow banking. Illustration by Patrick Hess

volatility in interbank market rates[18] and a greater reliance on central bank funding, including by large banks, suggest funding strains are increasing and could be spreading to the core of the banking system. In Figure 3, this is depicted by the arrow indicating "potential risk spill-over" between the shadow-banking sector and the formal banking sector.

6 Conclusion: Implications for Policy-Makers

Figure 3 summarises the aforementioned main drivers of the growing shadow-banking system in China. It also shows the high degree of inter-connectedness of some of the most pressing challenges faced by Chinese policy-makers. There is a tendency among analysts and observers to look at these challenges and imbalances in China's financial and economic system in isolation, while they are, in fact, highly inter-connected. This has also to be taken into account when designing policy measures, in order to avoid their being biased with a tendency to create more issues than they actually solve. The inter-connectedness of the challenges facing China has recently also been noted by the IMF in its staff report for the 2014 Article IV consultation: "Credit and 'shadow banking', local government finances, and the corporate sector—particularly real estate—are the key, and interlinked, areas of rising vulnerability."[19]

[18] Hess (2014) discusses the spike in money market rates in June 2013 and interprets the initial inaction of the PBoC as being motivated by the "aim to force the banks to cut down their lending to SOEs, Local Government Financing Vehicles (LGFVs) and the riskier parts of shadow banking" (p. 38).

[19] IMF (2014), p. 1.

The surging shadow-banking system has increased financial risks in China, and policy measures are needed to address the issue from both the demand side and the supply side. These measures are not only essential in order to contain both the growth of and the risks of the shadow-banking system and to meet the funding requirements for urbanisation, but also critical to the transformation of the economic growth model away from exports and investment towards domestic consumption and services. Since the global financial crisis, GDP growth in China has become increasingly reliant on credit, but needs to be re-balanced towards less resource-intensive growth to remain sustainable in the long run.

Budget Law Reform The Decision of the 18th National People's Congress (NPC) in 2013 has already signalled the relaxation of local government bond constraints. In fact, there have been three revisions of the Budget Law (*Yusuan fa* 预算法) sent to the NPC since 2002. And in the most recent proposed revision, Article 28 has become the focus. The third proposed revision stated that part of the required fund for infrastructure investment listed in the budget that is approved by the State Council can be raised through local government bonds. The scale of such bond issuance should be within the limits determined by the State Council. The role of the local NPC would include approval of the scale of bond issuance, and the auditing of the use of the bond proceeds. In addition, measures for enhancing the transparency of the issuance of local government bonds have been included in the proposed revision of the Budget Law, which was finally adopted on 31 August 2014 by the Standing Committee of the NPC (*Quanguo renda changwuhui* 全国人大常委会), China's top legislator. Under the new law, 31 provincial governments are allowed to issue bonds, and the debt management is included in the budget management, which is subject to the supervision of the local NPCs. The revised law also increases fiscal transparency and the accountability of local governments by asking governments at all levels to publish their budgets for public scrutiny within 20 days of being approved by the legislatures.[20]

In fact, as often happens in China, market practices are already ahead of the legislative process. In 2010, the State Council issued a notice to allow several local governments to issue debt, with the Chinese Ministry of Finance (MoF) handling bond services. In May 2013, the MoF issued a notice to allow ten local governments (Shanghai, Zhejiang, Guangdong, Shenzhen, Jiangsu, Shandong, Beijing, Qingdao, Ningxia and Jiangxi) to issue bonds in 2014. These provinces and cities can issue, service and redeem bonds within quotas approved by the State Council, gradually replacing the local government bond issuance by the MoF. The bonds with

[20] See Li Li, "Overhauling the Budget System: A revised budget law aims to address the most worrying loopholes in China's public fund management", *Beijing Review*, No. 39, 25 September 2014 (http://www.bjreview.com.cn/quotes/txt/2014-09/24/content_641504_2.htm). A transcript of the press briefing where Finance Minister Lou Jiwei answered questions related to the revision can be found under http://news.sina.com.cn/c/2014-08-31/182130772363.shtml (in Chinese only).

maturities of 5, 7 and 10 years will be issued with credit ratings attached to each issuer,[21] and the yield will be determined through underwriting and tendering. The pilot marks the beginning of local government bond issuance in China, and may become a watershed event to enhance local government debt transparency as well as local government bond market development.

Despite the rise in local government debt, its overall scale is still under control. If municipal bonds are allowed, not only can the transparency of local government debts be enhanced, but their financing costs can also be reduced. This is a win-win situation for both the government and the market.

Deposit Guarantee System Another important measure will be the planned introduction of formal deposit insurance, which will draw a clearer line between safety (insured deposits) and risk (uninsured investments), and help to address the important moral hazard problem. Such a deposit guarantee system will force investors to consider the risks that they are taking, and it will force banks to pay for implicit state guarantees, thereby limiting the potential liability of the government in cases of defaults of shadow-banking products.

Interest Rate Liberalisation Over time, China needs to liberalise fully its interest rates to allow them fully to reflect risks, and such risks should be shouldered by investors. By 2013, most of the interest rates have been liberalised except for deposit interest rates. According to the Governor of the PBoC, ZHOU Xiaochuan, such rates should be fully liberalised within 2 years (*i.e.*, by 2016).[22] Then, savers will be able to find more profitable investment opportunities for their assets, which will reduce the funding supply of the shadow-banking system in China. This is one of the motivations of Zhou's advocacy in August 2013 of a "deeper capital market with more layers", in which he made the following statement:

> [. . .] Incidents related to the financial industry usually bring financial losses, carrying with them great shocks to both the economy and the public. It was easy to over react and resort to financial repression through rigid regulation over the financial industry. There are rationales for this historical experience. After all, that happened during China's transition into an emerging economy. Thanks to the reform and development, we have begun to enter into a new stage.[23]

In the transitional period, it is imperative also to reform the interbank activities. In May 2014, a rule to regulate the interbank market was promulgated. The new rule requested that banks move part of their off-balance sheet products (for example,

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[21] To attract bond investors, credit rating agencies are used, which link the credit rating to the debt ratio of the local government issuing the bond.

[22] Statement made at the press conference for the second session of the 12th NPC on financial reform, 11 March 2014 (see http://en.ce.cn/subject/exclusive/201403/11/t20140311_2460792.shtml).

[23] Zhou Xiaochuan, "The Multi-layered Feature of Capital Market", in: *Financial Market Study Journal*, August 2013 (for the English version first published on 16 December 2013 on the PBoC website, see http://www.pbc.gov.cn/publish/english/956/2013/20131227143119476660412/20131227143119476660412_.html).

short-term debts used to finance long-term projects) back onto their balance sheets. In addition, interbank deposits from non-bank financial institutions intended to avoid paying reserve requirements are now also subject to reserve requirements. These measures are mainly targeting regulatory arbitrage, and will probably increase the cost of re-financing, which may prove useful in containing interbank operations and thus shadow-banking activities.

However, speculation cannot be eliminated in an environment of partially controlled interest rates. Sooner or later, further financial liberalisation will be required. Otherwise, tightening credit may starve shadow-banking products but will, at the same time, impair the investments needed by SMEs and emerging industries, and needed for economic recovery.

The above policy measures to (a) allow local governments to finance development through bond issuance, (b) establish a deposit insurance, and (c) liberalise interest rates fully have also received the blessing of the Chinese Communist Party by being included in the decisions of the Third Plenum of its 18th Central Committee in November 2013.[24] While this alone does not guarantee timely and complete implementation, the fact that the leadership has invested substantial political capital in the overall reform process—first and foremost, XI Jinping, who personally oversees it—increases the chance that these measures will be implemented step by step. The long-awaited amendment of the Budget Law, which takes effect on 1 January 2015, is the first proof of this determination.

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Navigating the Trilemma: Central Banking in East Asia Between Inflation Targeting, Exchange-Rate Management and Guarding Financial Stability

Ulrich Volz

Abstract Inflation targeting (IT) arrangements rose to prominence in the early 1990s, when a couple of advanced countries adopted IT as their formal monetary policy framework. Over the years, IT arrangements have also been implement by a growing number of emerging economies, including Korea, Indonesia, Thailand and the Philippines, all of which adopted IT frameworks soon after the Asian crisis. Although formally following IT regimes, the central banks of these four countries have continued to manage their exchange rates against the dollar. While generally low inflation rates during the period of "great moderation" made inflation targeting a relatively easy job and gave central banks leeway to manage exchange rates without compromising their inflation targets, there have been episodes during which conflicts arose between explicit internal inflation targets and informal external exchange rate targets. Conflict, however, may not only arise between inflation and exchange-rate targeting, but also when taking into account the nexus between monetary policy and financial stability. After the Global Financial Crisis clearly exposed the problems that can arise for financial stability when central banks focus too narrowly on inflation rates, a consensus is currently emerging that central banks ought to include financial stability in their policy reaction functions. Against this backdrop, the chapter discusses the trilemma faced by East Asian central banks in targeting inflation rates while at the same time guarding financial market stability and managing exchange rates. It reviews the experience of East Asian countries with inflation targeting to date and discusses the challenges for incorporating macroprudential regulation into monetary policy frameworks while keeping an eye on the exchange rate.

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F. Rövekamp et al. (eds.), *Central Banking and Financial Stability in East Asia*,
Financial and Monetary Policy Studies 40, DOI 10.1007/978-3-319-17380-1_9

1 Introduction

Inflation targeting (IT) rose to prominence in central banking in the early 1990s, when a couple of advanced countries—including New Zealand (1990), Canada (1991), the United Kingdom (1992), Australia (1993) and Sweden (1993)—adopted IT as their formal monetary policy framework. Bernanke et al. (2001: 4) define IT as:

> a framework for monetary policy characterized by the public announcement of official quantitative targets (or target ranges) for the inflation rate over one or more time horizons, and by explicit acknowledgement that low, stable inflation is monetary policy's primary long-run goal.

Over the years, IT became the dominant paradigm in central banking, and formal IT arrangements have also been adopted by a growing number of emerging economies, including several East Asian economies, notably Thailand (2000), Korea (2001), the Philippines (2002), and Indonesia (2005).[1] The central banks of these four countries have been mandated to achieve price stability as their primary objective, although the Bank of Thailand Act has widened the goal slightly ("monetary stability, financial institution system stability and payment systems stability"), and the Bank of Indonesia is tasked to "maintain the stability of the rupiah value", which may also include the external value, *i.e.*, the exchange rate (Table 1). In January 2013, in its attempts to combat deflation, the Bank of Japan (BOJ) also adopted a two per cent inflation target, although the new BOJ governor, Haruhiko Kuroda, has emphasised that the BOJ plans to pursue its inflation target "very flexibly" (Soble and Giles 2013).

Even as IT has become the dominant paradigm in monetary policy-making—or the "sacred cow of central banking" as Rodrik (2009) puts it—it has always been exposed to severe criticism for its narrow focus on price stability (and also for using consumer price indices as a benchmark for inflation). In particular, it has been pointed out that central banks ought to consider other goals besides the inflation rate, including employment and the (real) exchange rate.[2] Especially for developing and emerging economies, it has been long argued that an IT regime may conflict with sensible developmental policies, and criticisms of IT have received more attention since the outbreak of the Global Financial Crisis. The failure of central banks to identify the risks that had built up in financial sectors—for which many economists blame too expansionary monetary policy that focused only on stability of consumer prices and disregarded asset price developments—has led to some soul-searching in the economics profession. Most importantly, it has become

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[1] Bank Indonesia has set inflation targets since the year 2000, but IT was formally adopted only in 2005 (Inoue et al. 2012).

[2] For various critical perspectives on IT see, for instance, Stiglitz (2008) or the articles in a special issue of the *International Review of Applied Economics* on "Inflation Targeting, Employment Creation and Economic Development: Assessing the Impacts and Policy Alternatives" (Epstein and Yeldan 2008).

Table 1 Central bank's policy objectives

Bank of Korea	". . .to contribute to the sound development of the national economy by pursuing price stability through the formulation and implementation of efficient monetary and credit policies." (Bank of Korea Act, Article 1)
Bangko Sentral ng Pilipinas	"The primary objective of the Bangko Sentral is to maintain price stability conducive to a balanced and sustainable growth of the economy. It shall also promote and maintain monetary stability and the convertibility of the peso." (The New Central Bank Act, Article 1, Sect. 3)
Bank of Thailand	"The BOT's objectives are to carry on such tasks as pertain to central banking in order to maintain monetary stability, financial institution system stability and payment systems stability." (Bank of Thailand Act, Sect. 7)
Bank Indonesia	"The objective of Bank Indonesia is to achieve and maintain the stability of the rupiah value." (Act of the Republic of Indonesia No. 23 of 1999 Concerning Bank Indonesia, Article 7)

Source: Compiled by author with information obtained through central banks' websites

apparent that central banks ought to keep an eye on potential instabilities developing in the financial sector. After the Global Financial Crisis clearly exposed the problems that can arise for financial stability when central banks focus too narrowly on consumer price inflation, a consensus is currently emerging that central banks ought to include financial stability in their policy reaction functions. Even in institutions that were previously amongst the most ardent promoters of IT, a process of re-considering the optimal conduct of monetary policy has begun. At the International Monetary Fund's (IMF) 2011 Macro Conference, IMF Chief Economist Olivier Blanchard (2011: 8) debunked the simplistic pre-crisis orthodoxy which he described as "a one target one instrument world". Blanchard (2011: 1) criticised the mainstream view as follows[3]:

> Before the crisis, mainstream economists and policymakers had converged on a beautiful construction for monetary policy. To caricature just a bit: we had convinced ourselves that there was one target, inflation. There was one instrument, the policy rate. And that was basically enough to get things done. If there is one lesson to be drawn from this crisis, it is that this construction wasn't right, that beauty is unfortunately not always synonymous with truth. The fact is that there are many targets and there are many instruments. How you map the instruments onto the targets, and how you use these instruments best is a very complicated problem. This is the problem we have to solve. Future monetary policy is likely to be much messier than the simple construction we had developed earlier.[4]

In East Asia, the central banks that have adopted IT regimes have, in fact, never followed strict IT even if their monetary policy was conducted under this label. As will be discussed below, exchange-rate management has always been an important

[3] I first came across this quotation in Epstein (2013).

[4] Despite the evident shortcomings of IT, many of its proponents seem to cling on to their belief that IT provides the best possible monetary policy framework and only needs "to be refined, not replaced" (Davies 2013: viii). Examples of this view can be found amongst the contributions in Reichlin and Baldwin (2013).

goal for East Asian central banks. During the so-called "Great Moderation" that lasted from 1982 to 2007 and that was characterised by generally low global inflation rates, keeping domestic inflation under control was arguably an easy task and conflicts with exchange-rate management were limited.[5] But the Great Moderation has ended and re-aligning IT with exchange-rate management is likely to become much more challenging in the future. Very importantly, conflict may not only arise between IT and exchange-rate management, but also when taking into account the nexus between monetary policy and financial stability.

Against this backdrop, this chapter discusses the problems associated with IT, and particularly the tensions that will inevitably arise when a central bank committed to achieving an inflation target at the same time tries to pursue other goals including a stable (effective) exchange rate and financial stability. The following section will look at the potential conflicts between IT and exchange-rate management. Section 3 will discuss the role of central banks in guarding financial stability and the ways this may conflict with an IT regime. Section 4 concludes that IT is no longer (or, rather, never really has been) an appropriate monetary framework for East Asian countries, and that IT regimes should therefore be abandoned and replaced by transparent monetary frameworks that take into account the multiple goals that are being pursued by East Asian central banks. Keeping a low and stable inflation rate is certainly one important goal for East Asian countries, but it is not the only one, and, very importantly, in small open developing economies, it cannot be achieved in a framework based upon one target and one instrument.

2 Inflation Targeting and Exchange-Rate Management in East Asia

As pointed out by Jahan (2012), IT requires not only that the central bank is "able to conduct monetary policy with some degree of independence", IT also requires the "willingness and ability of the monetary authorities not to target other indicators, such as wages, the level of employment, or the exchange rate". In the simple Taylor rule, a policy-reaction function which determines the central bank's interest-rate change in response to a divergence from the announced inflation target, the interest rate as the policy instrument is a weighted function of inflation and output gap—the exchange rate plays no role. The problem, however, is that, in the (small) open economies, like those of East Asia, the exchange rate plays a pivotal role in stabilising output and inflation, and therefore *is* a key economic variable for monetary authorities.

[5] The expression the Great Moderation was termed by Stock and Watson (2003) to describe the decline of volatility in employment, consumption, output as well as wage and price inflation since the early 1980s. It was popularised in a speech by Ben Bernanke (2004). The preceding period is commonly referred to as the "Great Inflation" (cf. Meltzer 2005).

Emerging market countries following IT regimes have basically behaved as described by Blanchard (2011: 6):

> Before the crisis, many emerging market countries had adopted inflation targeting. This was seen as state of the art monetary policy, and there was strong pressure to adopt it. These countries described themselves as floaters. They argued that they cared about the exchange rate only to the extent that it affected inflation, and so as part of inflation targeting they took into account the effect of the exchange rate on inflation. But they put no weight on the exchange rate as a target. . . . These were the words. The deeds, in many cases, were often quite different. Most inflation targeters in fact cared deeply about the exchange rate, beyond just its effect on inflation, and this affected monetary policy.

This description fits perfectly well for the East Asian IT countries. For East Asian countries,

> changes in the exchange rate [not only] act as a potent transmission channel for monetary policy, exchange rate volatility may also have first-order effects on the traded sector of the economy (Debelle 2001: 77).

Because of their involvement in the regional trade-production network, East Asian economies are very sensible to exchange rate gyrations. The close trade and investment relations among East Asian countries make relative intra-regional exchange rate stability an important regional public good (Volz 2010, 2011). Moreover, because of the high degree of asset and liability dollarisation in the East Asian economies, exchange rate changes can cause balance sheet effects, with potentially serious implications for financial stability. It is precisely for these reasons that a widespread "fear of floating" exists among East Asian countries, and that the central banks of Indonesia, Korea, Thailand, and the Philippines have continued to manage their exchange rates against the US dollar, despite formally following IT regimes. Although the currency regimes of Korea, Thailand, and the Philippines are classified by the IMF as floating with IT frameworks (Table 2), these countries continue to follow the US dollar closely (Kawai and Pontines 2014) and thereby adhere to the East Asian dollar standard, to use the phrase coined by McKinnon (2005). Indonesia, which was previously listed as having a floating exchange-rate regime was re-classified by the IMF as having a crawl-like arrangement (with a depreciating trend against the US dollar) in June 2012, which is closer to reality than the previous classification as a floater with an IT regime.

During the times of the Great Moderation the inconsistency between IT and exchange-rate management seemed unproblematical. Generally low inflation rates made IT a relatively easy job and gave central banks leeway to manage exchange rates without compromising the inflation target. However, there have been episodes during which conflicts arose between the formal internal inflation targets and informal external exchange-rate targets. Most notably, in the period 2005–2008, the East Asian countries experienced rising inflationary pressures due to rising food prices and large capital inflows. While countries could have countered the inflationary pressures through currency appreciation, China had effectively set a ceiling to appreciation across East Asia because China allowed only for very gradual appreciation against the dollar over this period (Ito 2008; Pontines and Siregar

Table 2 The IMF's de facto classification of exchange rate arrangements

Country	Currency regime
Brunei Darussalam	Currency board (*vis-à-vis* Singapore dollar)
Cambodia	Stabilised arrangement (*vis-à-vis* US dollar)
China	Crawl-like arrangement[a]
Indonesia	Crawl-like arrangement[a] (with inflation targeting framework)
Japan	Free floating
Korea	Floating (with inflation targeting framework)
Lao	Stabilised arrangement[a]
Malaysia	Other managed arrangement
Myanmar	Other managed arrangement
Philippines	Floating (with inflation targeting framework)
Singapore	Other managed arrangement (composite exchange rate anchor)
Thailand	Floating (with inflation targeting framework)
Vietnam	Stabilised arrangement[a]

Source: Compiled by author based on information extracted from IMF (2013), Table 1 "De Facto Classification of Exchange Rate Arrangements and Monetary Policy Frameworks, April 30, 2013"
[a]The de facto monetary policy framework is an exchange rate anchor to the US dollar

2012). With China being a major, if not the most important, trading partner and competitor, the other East Asian countries had, therefore, only limited leeway to appreciate their currencies against the dollar, and therefore the *renminbi*, despite large capital inflows and inflationary pressures, would have warranted currency appreciation.

The vulnerability of East Asian countries to exchange-rate swings was also illustrated when currency markets entered turbulences after then Federal Reserve Chairman Ben Bernanke's tapering announcement in May 2013. The announcement led to capital outflows from emerging markets across the board, although countries with a weak/negative current account such as Indonesia and Thailand were particularly affected and forced to intervene heavily in foreign exchange markets in order to stabilise the value of their currencies. Such interventions, even if sterilised, clearly have an effect on monetary policy.

3 IT and Financial Stability

Conflict may not only arise between IT and exchange-rate management, but also between monetary policy and financial stability goals. Price stability and financial stability may be complimentary at times, but this will not always be the case. The recent crisis has demonstrated very clearly that financial risks may accumulate even if price stability is under control. Consumer prices may be stable even in the presence of rapid asset price inflation.

Since the Global Financial Crisis clearly exposed the problems that can arise for financial stability when central banks focus too narrowly on consumer price

inflation, a consensus is currently emerging that central banks ought to include financial stability in their policy-reaction functions. In a recent IMF staff discussion note, Bayoumi et al. (2014: 3) note that while:

> [l]ong-term price stability must remain a primary objective of monetary policy . . . the crisis showed that it is not a sufficient condition for macro stability. Going forward, additional intermediate objectives (such as financial and external stability) may play a greater role than in the past. When possible, these should be targeted with new or rethought instruments (macroprudential tools, capital flow management, foreign exchange intervention).

While it is now widely accepted that there is a role for central banks in guarding financial stability, Blanchard (2011) argues against "the emerging consensus among central bankers" that they should be "pursuing monetary policy very much in the same way as before, using a rule for the policy rate, perhaps giving more weight to the output gap per se" to maintain macroeconomic stability, and merely add a second target—financial stability—that can be achieved with a second instrument—macro-prudential tools.[6]

Agénor and Pereira da Silva (2013: 3) believe that "monetary policy and macroprudential policy are largely complementary instruments [that] must be calibrated jointly" to account "for the fact that macroprudential regimes may affect in substantial ways the monetary transmission mechanism". However, even if monetary and macro-prudential policies are largely complementary, Beau et al. (2012) emphasise that conflicts may arise at times between monetary policy targeting inflation and macro-prudential policies targeting financial stability. As they point out,

> [w]hether macro-prudential and monetary policies . . . have complementary, conflicting or independent outcomes on financial and price stability will depend on the type and diffusion of supply and demand imbalances across the financial system and the real economy (Beau et al. 2012: 9).

Although monetary and macro-prudential policies may operate relatively independently at most times, and are complementary at other times, conflicts may arise when the real and financial cycles are moving in opposite directions (cf. Table 3).[7] A monetary framework such as IT that cannot deal appropriately with periods of financial boom or bust at all times is futile, for financial booms and busts are a recurrent feature of economic cycles, and real and financial cycles will not always be aligned.

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[6] Macro-prudential policy is aimed at mitigating the build-up of systemic risk in the financial system at large and limiting the pro-cyclicality of the financial system, in contrast to micro-prudential regulation, which has the objective of ensuring the stability of individual financial institutions. Numerous macro-prudential tools have been proposed, including caps on loan-to-value ratios and loan loss provisions, caps on debt-to-income ratios, countercyclical capital requirements, caps on leverage, time-varying reserve requirements, or liquidity coverage ratios. For a review of proposed macro-prudential tools, see Galati and Moessner (2011) and Schmitz (2013).

[7] On the interlinkages between financial stability and monetary policy, see, also, Smets (2014).

Table 3 Likely instances of conflicts between monetary and macro-prudential policies

	Inflation above target	Inflation close to target	Inflation below target
Financial exuberance (boom)	**Complementary**	*Independent*	***Conflicting***
No imbalance	*Independent*	*Independent*	*Independent*
Financial deflation (bust)	***Conflicting***	*Independent*	**Complementary**

Source: Table 2 in Beau et al. (2012)

That monetary policy and macro-prudential policies are intertwined is not new for East Asian central bankers. As a result of the Asian financial crisis of 1997–1998, central bankers across the region have been cautiously monitoring financial stability, implementing counter-cyclical policies, and curbing overall leverage in the financial sector. In fact, many measures that are today being referred to as macro-prudential policies had already been implemented across East Asia in the aftermath of the Asian crisis, including sector-specific measures such as loan-to-value ratios and debt-servicing caps in the housing market, or the ruling out of certain financial products, as well as broader, system-wide tools, such as reserve requirements, capital account restrictions or loan quotas (Lyons 2010). Through various ways, these different measures have affected the conduct of monetary policy. In practice, East Asian central banks have been effectively pursuing multiple objectives, with financial stability being a very important objective among them.[8]

During the Great Moderation, when inflation rates were, more or less, close to target, monetary and macro-prudential policies could be conducted largely independently of each other under what could still be labelled a flexible IT framework. But, in the post crisis era, which some have dubbed the "New Normal" (e.g., Bayoumi et al. 2014), the risks are that policy-makers will find themselves in the lower left (financial bust and too high inflation rates) or upper right corner (financial boom and too low inflation rates) of Table 3, where policy conflicts may arise. Moving forward, monetary authorities, including those in East Asia, will have to take on board financial stability as an explicit policy objective, and they need to acknowledge that this objective may, at times, be in conflict with other policy objectives such as consumer price stability. Targeting multiple objectives in a supposed IT framework will not work, but will instead damage the credibility of central banks.

[8] While the mandates of the Bank of Korea and Bank Indonesia only mention "price stability" and "stability of the rupiah value", respectively, as primary policy objectives, the Bangko Sentral's mandate at least mentions that price stability as its primary objective should be "conducive to a balanced and sustainable growth of the economy" (cf. Table 2). The Bank of Thailand Act (Sect. 7) requires the Bank of Thailand not only to "maintain monetary stability" but also "financial institution system stability and payment systems stability".

4 Conclusion

This chapter has discussed the trilemma faced by East Asian central banks in targeting inflation while, at the same time, guarding financial market stability and managing exchange rates. While some may claim that the IT regimes adopted by Indonesia, Korea, the Philippines, and Thailand have been a success, and, hence, need not be changed, this chapter has argued that these respective IT regimes worked relatively well *only* in the exceptional times of the so-called Great Moderation, when global interest rates were low and East Asian central banks had sufficient leeway to pursue other objectives than consumer price stability.

Strict IT, with the inflation target as the primary objective for monetary policy, is unlikely to work for the small open economies of East Asia at times of choppy international capital flows and abundant global liquidity (cf. Volz 2012). Yet, a monetary framework that is compatible with a financial stability mandate only in "normal" times is inadequate, for it is the un-normal times that require quick and decisive policy responses. Safeguarding financial stability will require central banks to conduct various macro-prudential policies, which, at times, will impact adversely on monetary policy. Moreover, exchange-rate management will continue to be important for developing East Asian economies. The different objectives may at times conflict with each other and therefore monetary, exchange rate and macro-prudential policies need to be carefully calibrated. This cannot be done with simple policy reaction functions.

It is important to highlight that the trilemma discussed above is a challenge for *all* central banks, not just for those that have declared a formal IT target. Navigating this trilemma will not be easy for any central bank, but it will be even harder—if not impossible—for central banks that stick to IT frameworks that unnecessarily constrain their policy choices and undermine their credibility.

Blanchard (2011: 8) recently noted that:

> [w]e have moved from a one target-one instrument world to one where there are many targets and many instruments. And we are just starting to explore how [sic] such a new framework may look like. It is going to be a long and difficult process.

East Asian countries had never really lived in this simplistic one target-one instrument world as price stability has been *only one* out of several targets which have included exchange rate stability, the current account, employment, and financial stability. It is time for East Asian central banks to stop pretending, and to shed IT frameworks and instead develop transparent frameworks that account for their multiple objectives.

Acknowledgment This chapter is based upon a presentation given at the conference "Central Banks, Financial Stability and Legal Issues in East Asia", at the East Asia Institute in Ludwigshafen on 23 May 2014. Comments by participants and by the editors of this volume are gratefully acknowledged.

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Concern About Financial Stability Following the Recent US Legal Expansionism: International Law and East Asian Perspectives

Takashi Kubota

Abstract This chapter looks into the effects of the extra-territorial application of US economic laws on financial institutions. It undertakes to do so both from the perspective of international law in general, and from an East Asian perspective in particular. It is argued that the expansionist approach applied by US governmental agencies is not only questionable under the principles of international law, but may actually also create risks for the financial stability of East Asia. This is because the banks in the region increasingly feel the impact of US law compliance costs, which may induce them systematically to decrease their use of US dollars in international transactions. This, in turn, may foster the development of payment systems in East Asia that avoid the US dollar or the United States, and thus harm financial stability in the global US dollar market. A solution to this problem may lie in the conclusion of a multilateral agreement on economic sanctions similar to the "Basel Concordat" framework, or of a bilateral treaty like the US-Japan "Agreement Concerning Cooperation on Anticompetitive Activities" or to the US-Japan "Income Tax Convention".

1 Introduction

Under international law, each state is, in principle, prohibited from interfering with another state's internal/domestic affairs. Thus, national law is usually effective only within its territory (territoriality principle) or against its nationals (personality principle). In the *Paribas* Case,[1] the United States (US) government applied US law to impose huge penalties against *Paribas* even though the facts of the relevant

This article has benefitted from valuable comments by Moritz Bälz and is supported by a Japanese Grant-in-Aid for Scientific Research (JSPS Kakenhi No. 25380065).

[1] See the U.S. Department of Justice, "Justice News: BNP Paribas Agrees to Plead Guilty and to Pay $8.9 billion for Illegally Processing Financial Transactions for Countries Subject to U.S. Economic Sanctions", June 30, 2014 available at: http://www.justice.gov/opa/pr/bnp-paribas-agrees-plead-guilty-and-pay-89-billion-illegally-processing-financial.

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© Springer International Publishing Switzerland 2015
F. Rövekamp et al. (eds.), *Central Banking and Financial Stability in East Asia*,
Financial and Monetary Policy Studies 40, DOI 10.1007/978-3-319-17380-1_10

acts mostly happened in France and were carried out by a French bank. Though it may seem weak, the link between the case and the US was due to US Dollar (USD) payments. It may seem that French law should have been applied, but there is no clear international law standard to decide which jurisdiction has priority. Thus, my first mission is to introduce some of the limits of the effectiveness of international law.

On the other hand, without the USD payments, *Paribas* would not have had to pay a huge penalty and foreign banks could begin to seek alternatives to USD payments. However, this expected move may harm the financial stability in the global USD market. It would be desirable that the US refrained from imposing *huge* penalties *unilaterally*, and that, instead, a joint effort be made to establish a framework comparable to that of the Basel Concordat. Thus, my second mission is to consider the concern about financial stability from East Asian perspectives.

2 Concerns About Financial Stability in the Light of US Legal Expansionism

The recent extra-territorial impact on foreign banks by US economic sanctions can affect global financial stability and might lead to the decline in the hegemony of the US Dollar not only in Europe, but also in East Asia. Let me introduce two interesting articles concerning the *BNP Paribas* case, which were published in June 2014, when the US government imposed huge penalties and sanctions on the French bank *BNP*. Even before the *BNP* case, the US government had increasingly imposed similarly severe sanctions on foreign banks, including the British *HSBC* and the Japanese *BTMU* banks in 2012. As a result, foreign banks—not only in Europe but also in East Asia—are beginning to worry about the US law compliance costs of using the USD as a means of payment, and are considering the alternatives.

2.1 Foreign Resentment Caused by the Recent US Legal Expansionism

Tonya Putnam, Professor at Columbia University, wrote in the *Washington Post*, on 30 June 2014 (Putnam 2014), as follows:

> French banking giant BNP Paribas was just hit with an $8.9 billion fine resulting from a combined settlement with federal and state government agencies. The reason? Extraterritorial violations of U.S. laws that prohibit private banks *anywhere in the world* from using U.S. dollars to transact with Iran, Sudan, Syria and other states under U.S. sanction. The unprecedented size of this penalty, which stems from transactions with Sudanese companies between 2002 and 2007, is raising eyebrows on both sides of the Atlantic—along with European hackles. Especially galling to many, including finance journalist Felix Salmon, is that the laws BNP Paribas violated have little or nothing to do with protecting the

> international banking system. Instead, they exist to serve U.S. foreign policy goals of isolating politically recalcitrant regimes. France, like the United States, wants to prevent Iran from acquiring nuclear weapons, and both countries condemn the Sudanese government's brutal actions in Darfur. However, the U.S. and French governments differ on what to do about it. Consequently, U.S. efforts to force foreign banks to follow U.S. policies instead of those of their own governments are a source of foreign resentment . . . and not only in France.

Yes, not only in France or European countries, but also in East Asian countries, including China and Japan, financial institutions are really worried about this recent tendency to apply US laws of economic sanctions extensively to foreign affairs or concerns (the details of the laws will be explained later). In order to avoid the huge penalties imposed by the US economic sanctions, foreign banks need to stop using USD and replace it by other currencies such as the Euro, the Yen, the Renminbi or something else. Though such a major shift seems hard to realise in the near future, some minor shifts that might affect financial stability are giving rise to serious concern, as is illustrated by the following statement by the former First Deputy Governor of the Federal Reserve Bank (FRB) of New York, and currently a partner with the international law firm *White and Case*, Ernest T. Patrikis.

2.2 *The Concern with Financial Stability Caused by the US Penalties*

Patrikis wrote in the *Financier Worldwide* in September 2014 (Patrikis 2014) as follows:

> Restricting US-dollar payments as a basic foreign policy tool should not work at cross purposes with global financial stability goals. . . . While such actions (note: U.S. law enforcement) may spur calls for an alternative global reserve currency, replacing the US dollar would be a long-term effort. The more immediate concern is that monetary and other penalties may cause one or more banks that serve to enable the flow of US dollars to withdraw from the market, which would give rise to a more concentrated payments system, and thereby, one more susceptible to systemic risk. . . . Penalties should take into account the potential for resulting systemic risk. . .. Recent penalties, however, may prompt even seemingly captive banks to explore alternatives. Developing a viable alternative to the US dollar as the global medium of exchange may take some time. But potential is visible on the horizon. Traditional currencies, such as the renminbi and the euro, may be groomed to take on that role, as the former takes on a singular form that facilitates its use, export and repatriation within and outside China, and the latter begins to benefit from consolidated supervision of banks in the community. There is early promise too that the protocols underlying cybercurrencies may one day offer a cost-effective, globally accessible payment system. . . .Market participants may begin to consider nearer-term alternatives. One thought may be to establish additional US-dollar payment systems in a major European city or elsewhere outside the United States. . .. Exceedingly punitive penalties may foster the development of payment systems that avoid the US dollar or the United States. It is hard to see how that would be a good thing for New York, the US banking system or even the US government's effort to use sanctions to prompt countries to cease offending conduct. One would hope that the US authorities recognise that. But should enforcement actions indicate

otherwise, it would not be surprising to see non-US banks begin to explore US-dollar clearing alternatives with increased earnest.

This analysis is correct and I really hope that the US regulators, in the OFAC (Office of Foreign Assets Control, Department of US Treasury, which controls US Economic Sanctions), recognise the importance of financial stability, a task which mainly falls to the FRB (Federal Reserve Bank, which is in charge of financial stability). From the banking regulation perspective, the OFAC should respect the "Basel Concordat" Principle,[2] which bank regulators have traditionally observed. Since 1975, the Basel Committee on Banking Supervision has outlined the Basel Concordat principle that the supervision of foreign banking establishments calls for contact and co-operation between host and parent supervisory authorities, in order that no foreign bank establishment should escape supervision. To date, the OFAC does not adhere to this traditional principle of international consensus, and this has led to an increase in the concern about financial stability.

2.3 Alternative Currency in East Asia and the Role of International Law

If the OFAC continues to impose huge penalties on foreign banks without caring about financial stability, how should East Asian countries react? There are two options.

The first option is, as Patrikis showed, to develop an alternative payment method to using the existing USD correspondent accounts in New York. There are some possibilities: (a) use the existing East Asian currencies such as the Japanese Yen or the Chinese Renminbi; (b) develop the existing overseas USD payment system in Tokyo (Tokyo Dollar Clearing operated by J.P. Morgan[3]) and Hong Kong (Hong Kong USD Clearing System settled by HSBC[4]); (c) create an East Asian common currency like the Euro; and (d) increase the use of cyber-currencies such as Bitcoin. However, all the alternatives seem difficult to realise in the near future because: (a) the current strength of the Japanese Yen is not as strong as it was 20 years ago in order to influence the whole of East Asia, and the Chinese Renminbi is not sufficiently developed for free trade and the international floating currency market; (b) the Tokyo and Hong Kong USD clearing systems are finally settled in New York among banks through accounts in the US central bank (FRB New York) and are still under US control, which seems unlikely to change soon (however, see the last section); (c) the creation of an East Asian common currency will be difficult because of the Euro crisis, the difference in economic conditions, and the political

[2] For details of the current principle, see http://www.bis.org/publ/bcbsc312.htm.

[3] See https://www.jpmorgan.com/tss/General/Japan_The_Sleeping_Giant_Awakes_/1320516726098.

[4] See http://www.hkicl.com.hk/clientbrowse.do?docID=119&.

conflicts among China, South Korea and Japan; and (d) Bitcoin and other cyber-currencies can harm financial stability because they are beyond the control of the regulators. Thus, it is unlikely that East Asian countries will take this option, at least in the near future.

The second option is that, by employing international law as a justifiable cause to initiate negotiations with the US regulators, East Asian governments could start to ask the US to refrain from legal expansionism. As the US and East Asian countries are the members of the United Nations (UN), the Charter of the United Nations[5] could provide a suitable starting-point for East Asian countries to begin negotiations. According to the Article 2 of the Charter, the UN Organization and its members are to act in accordance with the following principles: the principle of the sovereign equality of all its members (Sect. 1); the principle of the territorial integrity or political independence of any state (Sect. 4); and the principle of no intervention in matters which essentially fall within the domestic jurisdiction of any state (Sect. 7). Thus, the extra-territorial application of US law is limited by the above-cited principles. However, this international law approach still seems difficult as will be shown in the next section.

3 International Law Concerns

3.1 Basic Legal Principles

Based upon Article 2 of the Charter of the United Nations, the United Nations members including the US and Japan are to act in accordance with the above-cited principles of sovereign equality, territorial integrity and non-intervention, by which each state can freely determine its own internal/domestic affairs without the intervention of other states. Let us take an example: when a Japanese company does business within the Japanese territory according to the Japanese law, another powerful state, the US, for example, cannot apply its economic laws to interfere in Japanese domestic affairs without legitimate motivations, as will be explained later. However, US economic laws are, in fact, applied in some cases, even without some legitimate motivation or justifications. Let us suppose that a Japanese bank X in Tokyo paid USD to an Iranian bank Y in Tokyo, which is lawful in Japanese law but unlawful in US law. X has a New York branch and the branch has no relation with the Iranian transaction. If there is no treaty or legal consensus between the US and Japan, X should not be punished under US law by the above-cited international principles or by other basic principles of law, such as "*nulla poena sine lege* (no punishment without law)". If the US government is worried about such Japanese bank transactions with Iranian banks, the consensus between Japan and the US, such as those through above-mentioned "Basel Concordat" mechanism, can

[5] See http://www.un.org/en/documents/charter.

work to promote international co-operation between US and Japanese regulators. In a way that is compatible with international law principles, Japanese regulators, instead of US regulators, may order X in Tokyo to cease transactions with the Iranian bank if they think it necessary. US regulators can punish X in New York if it is also involved in the Iranian transactions and may not allow X to do business in the US. When the US and Japan both prohibit bank transactions with Iranian banks, this mechanism can also function to avoid double jeopardy by promoting international regulatory talks. Examples of such consensus of avoiding double jeopardy can be seen in the fields of cartels and taxation. The US and Japan have the Agreement Concerning Co-operation on Anti-competitive Activities (signed in October 1999) and the US-Japan Income Tax Convention (signed in March 1971).[6] Ideally, similar agreements or consensuses should also be made in the field of economic sanctions, although they prove to be difficult here because they are often highly political in nature.

3.2 Traditional Understanding of the Extra-Territorial Applications

Though there are many legal issues relating to extra-territorial applications and the impact[7] of the foreign economic laws, this chapter focuses on bank-related issues (the US Foreign Corrupt Practices Act (FCPA) issues are important, but are omitted here). The issue has been widely discussed for more than 30 years in the field of anti-monopoly, export control (for example, the Euro-Syberian Gas Pipeline Dispute: the US economic sanctions and the US' response, including the UK claw-back statutes, 1981–1982[8]) and others,[9] but the international law standards for settling disputes have not been developed sufficiently.

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[6] See http://www.justice.gov/atr/public/international/docs/3740.htm, and http://www.irs.gov/pub/irs-trty/japan.pdf.

[7] As in the USD correspondent bank transfer jurisdiction we consider later, there are some cases which extraterritorial impacts are huge but is still debatable whether they are extra-territorial applications or not. As the structure of the problem is similar, we use the term, "extra-territorial impacts" to include both extra-territorial applications and controversial applications.

[8] According to Matthias Herdegen, *Principles of International Economic Law* (Oxford, Oxford University Press, 2013), pp. 79–80: "The extraterritorial application of laws can conflict with the regulatory interests of other States. These conflicts are rooted in the colliding spheres of sovereignty between States, i.e. in competing claims to jurisdiction as to the same set of facts. These conflicts may, in extreme cases, culminate in the enactment of 'blocking statutes' (which other non-compliance with the extraterritorial legislation or non-recognition of judgments) or 'claw-back statutes' (ordering restitution of benefits conferred by extraterritorial legislation) by other States." The UK enacted law to block the recognition and enforcement of US legislation for economic sanctions in 1980 (Iran) and the EU also did so in 1996 (Cuba).

[9] For example, securities, bankruptcy, trademark protection, international taxation and human rights.

According to the normal understanding of international law (Herdegen 2013),[10] extra-territorial jurisdiction is considered to be legitimate if it meets with the principles of "territoriality" (the location of a person or an object, or, alternatively, the performance of an action or the occurrence of effects in the territory of the state which exercises jurisdiction is the legitimatising justification) and "personality" (the nationality or the domicile (residence) of an individual and/or the management seat of a corporation serve as a legitimising link/justification). However, the principles do not provide clear and concrete criteria which draw the line between what is lawful and what is unlawful. In the territoriality principle, whether jurisdiction is based merely upon the effects of the actions on a state's territory carried out abroad ("effects doctrine", established in the US domestic case, *United States* v *Aluminum Co. of America*[11]) is lawful or not was the most controversial issue in the debate on the extra-territorial impact of the US Anti-Monopoly laws. Under current customary international law, the effects doctrine is limited to cases of a "substantial, direct and foreseeable effect" on the territory of the regulating state (Herdegen 2013).

In the personality principle, many countries, including Japan, punish overseas crimes committed by their nationals only if the law of the place in which the crime was committed also punishes it (dual criminality), but some countries, including the US and the UK, do not require dual criminality, and this difference can increase the extra-territorial impact. Though controversial, there are other possible legitimatising links, such as the "principle of control" (in exceptional cases, the exercise of jurisdiction can be justified merely by reference to the monetary control of a company over an affiliate company), the "principle of protection of national interests" (the exercise of jurisdiction can be allowed in defence of national security or other important national concerns), and the "principle of universality" (jurisdiction can be granted in cases of genocide, piracy, slavery, and possibly certain acts of terrorism).

3.3 Enlarging Territoriality: US Dollar Correspondent Bank Account Jurisdiction

In the recent extension of the extra-territorial reach of US law, three new methods of authorising US extra-territorial reach call for discussion under international law. The first method is enlarging US jurisdiction by adopting the so-called "US Dollar

[10] According to Herdegen note 9 above, p. 88: "In the absence of a legitimate link, the exercise of jurisdiction with respect to activities of foreign nationals would violate the principle of non-intervention in the internal affairs of other states. In practice, the most important links with a State which legitimize the exercise of its jurisdiction rest on the principle of territoriality and the principle of personality."

[11] 148F.2d 416, 2d Cir. 1945.

Correspondent Bank Account Jurisdiction". The second method is to limit judicial screening by means of the "Deferred Prosecution Agreement (DPA)" and "Plea bargaining" with the targeted foreign companies, including individuals. The third method extends personality by using the concepts of "Agent", "Aiding and Abetting with U.S. person", "Mail & Wire Fraud", and the "U.S. Travel Act". From the perspective of financial stability, the first method is the most important. Thus, I will focus here on the "US Dollar Correspondent Bank Account Jurisdiction".

Let me give an example: when a Japanese company (*Toyota*, for instance) sends one million US Dollars by bank transfer through a Japanese bank (say *BTMU*) to a German company (*Daimler-Benz*, for instance) which has an account in a German Bank (*Deutsche Bank*, for instance), US law usually intervenes because the corresponding transactions are almost always made in New York in overseas US Dollar (or USD) transactions. As the US Dollar is the key currency, US law can easily extend its reach outside its territory (Fig. 1).

The US does not clarify what international principles apply to the extended jurisdiction. Does this so-called "US Dollar Correspondent Bank Account Jurisdiction" meet the territoriality principle of international law? Some may say "Yes", because a part of the transactions were actually made within US territory, New York. In addition, "monetary sovereignty" should be stressed in some cases. Others may answer "No", because it was just online, which is not enough to meet territoriality and it lacks all connections such as personality to this case. The Japanese and German parties usually expect that only Japan and Germany have jurisdiction. If this money transmission was made in Japanese Yen and Japanese economic law extended its reach to impose huge penalties on the parties, they would avoid using Japanese Yen. Only the US can do this at the moment. It is still hard for foreign banks to avoid using USD and to find alternative methods as previously mentioned.

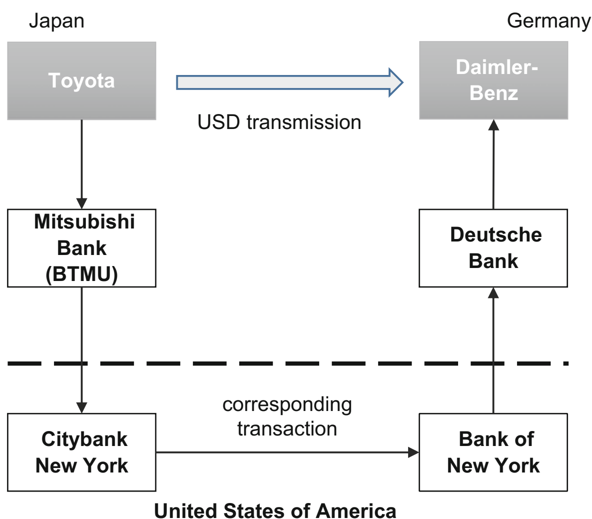

Fig. 1 Global mechanism of overseas USD transactions

3.4 Some US Scholars' Views

Then what do the United States scholars think of such expansionism of US law? Let me introduce two articles.

3.4.1 Extra-Territorial Application by Prof. Putnam

Let us quote Tonya Putnam's article again (Putnam 2014):

> So, who gets to decide which laws, if any, govern banks, corporations and other non-state entities whose activities affect multiple countries simultaneously? This is a question of growing importance as the world becomes more interdependent. The answer will not surprise you (spoiler alert: it's the exceptionally powerful states), but the scope and character of the mechanism might.

As Putnam is a political scientist, it sounds very cynical, but international law should still govern the issue.

> Because so many large enterprises have links to the United States, U.S. law has considerable reach. Banking is a prime example, since no large international bank can avoid dealing in U.S. currency.

This is true, but the international law principle of sovereignty should also function regardless of the economic power.

> Do options exist for countering unwelcome instances of U.S. extraterritoriality? Foreign governments have long tried to find ways to restrain the United States with limited success. One emerging possibility for checking U.S. assertiveness is reciprocal actions from the European Union, which now rivals the United States in the size of its internal market.

However, Europe cannot retaliate successfully (except in personal data protection, *etc*.) and accuse the US of its unilateralism at the same time.

> First, Europeans have long been critical of U.S.-style jurisdictional unilateralism and often underscore its poor fit with international law. Second, regulatory enforcement in Europe is still largely the job of public officials, whereas in the United States private litigants can directly initiate extraterritorial enforcement of many U.S. public laws using domestic courts.

This may show the different views on international law between the US and other countries.

The second point made by Putnam in the preceding paragraph relates to the stance of US courts regarding its extra-territorial reach. According to Putnam,

> [her] research suggests it is actually becoming more difficult to get U.S. federal courts to interpret the extraterritorial reach of ambiguous U.S. laws expansively.[12] This is evident in

[12] However, it does not mean that U.S. federal courts ceased to do so. In September 2014, a foreign bank has been held liable for the first time under a broad antiterrorism statute at the U.S. federal court. See Stephanie Clifford, "Arab Bank Liable for Supporting Terrorist Efforts, Jury Finds", *The New York Times*, 22 September 2014, available at: http://www.nytimes.com/2014/09/23/nyregion/arab-bank-found-guilty-of-supporting-terrorist.html?_r=0.

> decisions handed down over the last decade in issues ranging from human rights to securities regulation. This reticence may be a sign of waning U.S. hegemony, or the product of dynamics internal to the U.S. judiciary—or both. What is clear is that a growing coterie of textual literalists on the Supreme Court is doing more to reel in U.S. extraterritoriality using a judicially constructed 'presumption against extraterritoriality' than have decades of foreign criticism.

Yes, the federal courts seem to be getting better, but the state courts sometimes deserve criticisms of excessive extra-territorial reach, as will be explained later. Most notably is the New York Highest Court case, *Koehler* v. *Bank of Bermuda*,[13] which ruled that the state courts may access debtors' assets anywhere in the world as long as those assets are held by a bank that also has a branch in New York, as many large international banks do.

3.4.2 Supremacy of Treaties in the US and the Theory of Alex Glashausser

Alex Glashausser, Professor of Washburn University School of Law, wrote an interesting article in a Japanese law journal (Glashausser 2009). According to him, the supremacy of treaties is based upon the US Constitution and US case law (*The Paquete Habana*[14]), but the legal interpretation may not be the same between the US and other countries. According to US case law, subsequent law such as federal domestic law made after the treaty can prevail over a preceding laws including treaties (*Dred Scott* v. *Sandford*[15]). In addition, the Supreme Court has ruled in *Medellin* v. *Texas*[16] that a treaty, unless it conveys an intention that it is "self-executing", is not binding domestic law without Congress enacting statutes implementing it. Even the duty to comply with the decision of the International Court of Justice under Article 94 (1) of the Charter of the United Nations was sometimes interpreted by the courts as just a commitment for the future conduct through political sections. The courts may sometimes refrain from judging because of political and administrative issues. On the other hand, the state courts do not always follow the Federal Supreme Court. Even the President cannot force the states to follow the interpretations of the administrative branch.

[13] 12N.Y. 3d 533, 911N.E.2d 825 (2009).

[14] 175 U.S. 677, 700 (1900).

[15] 60 U.S. (19 How) 393 (1856).

[16] 128S.Ct. 1346, 1366 (2008).

Under the US domestic legal circumstances, international law is not very effective for solving extra-territorial applications. Power and economic mechanisms in the global market have much more effect.

3.5 AML/CFT Combined with US Economic Sanctions

The US Patriot Act of 2001 (Pub. Law 107–56) in the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) is often combined with some US Economic Sanctions [for example, the Foreign Assets Control Regulations (Rules of OFAC) and the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (CISADA)]. These US domestic laws extend their reach not only to the US but also to foreign financial institutions. In fact, many foreign financial institutions have actually had to pay huge fines to the US OFAC, Department of Justice, or to New York State), including the above-mentioned French "*BNP Paribas*" for 8.9 billion USD (2014) and the English "*HSBC*" for 1.9 billion USD (2012), together with the Japanese *Bank of Tokyo-Mistubishi UFJ* (*BTMU*) for 8.6 million USD (2012). These huge US penalties increased the US law compliance costs for foreign financial institutions. Such penalties are usually used for the new law enforcement by the US government, and the related foreign governments are not involved in the re-allocation of the revenue.

The US Patriot Act prescribed articles which legitimised the expansion of the US extra-territorial reach, such as Sect. 311 (Special measures for jurisdictions, financial institutions, or international transactions of primary money laundering concern), Sect. 312 (Special due diligence for correspondent accounts and private banking accounts), Sect. 313 (Prohibition on United States correspondent accounts with foreign shell banks), Sect. 317 (Long-arm jurisdiction over foreign money launderers), Sect. 318 (Laundering money through a foreign bank), Sect. 319 (Forfeiture of funds in United States interbank accounts), and Sect. 377 (Extra-territorial jurisdiction). Foreign banks are concerned about the case of *US* v. *Union Bank (Jordan)*.[17] In this case, when US citizens had been defrauded by a telemarketing scheme in the Middle East, the Union Bank was unsuccessful in recovering the funds. Though the bank claimed that it was impossible to do so, the US seized 2.8 million USD from the Union Bank (Jordan)'s correspondent account with the Bank of New York under Sect. 319.

[17] 487 F3d 8 (1st Cir. 2007).

3.6 Not only Federal, but also State Governments

The New York State Government has also increased the compliance costs for foreign banks. Together with the federal government agencies such as the OFAC, FinCEN,[18] the Department of Justice and the FRB, the State Government of New York, the economic centre of the US, can order an extension of its extra-territorial reach. In the *BNP Paribas* case, the New York State Department of Financial Services (DFS) imposed a penalty of 2.24 billion USD on *BNP* and suspended USD clearing operations for 1 year. In 2013, the Japanese bank *BTMU* also had to pay 250 million USD to DFS (not to the OFAC) because of Iranian-related USD transactions. In 2014, *Pricewaterhouse Coopers* (PwC) agreed to pay the DFS (not the SEC) 25 million USD and accept other sanctions to settle accusations that it had sanitised a report about sanctions-related controls at the Tokyo branch of the *BTMU*.[19]

Let me introduce another interesting Japanese case. In May 2012, the Japanese bank *BTMU*, which handles most of Japan's payments for oil imports from Iran, froze transactions with Iranian banks on orders from the New York State Court. According to the above-mentioned *Koehler* case law, the Court ordered the *BTMU* to disclose details of the accounts that the Iranian Government and Central Bank have at its branches, not only in the US, but also at its Tokyo headquarters, and ordered the bank to freeze up to 2.6 billion dollars. This was in connection with a suit for damages filed by the survivors and family members of the victims of the 1983 bombing of a US Marine barracks in Lebanon. There is a court decision of 2007 that ordered Iran to pay damages to the plaintiffs, but Iran has so far failed to comply, thereby prompting a seizure of Iranian assets in support of the damages order in favour of the plaintiffs. As in other jurisdictions, foreign court orders should only be recognised and executed within Japan when they are judged by the Japanese courts to meet the domestic law requirements, and the *BTMU* filed an objection with the court. Luckily, from the bank's perspective, the plaintiff transferred the case from New York State Court to the Federal District Court for the Southern District of New York. The federal court decided the NY state court order was void, and the *BTMU* resumed transactions with Iranian banks. If the plaintiff had not transferred the case, the NY state court order for freezing the accounts in Tokyo might have survived and caused significant trouble in the *BTMU* because of the possible Japanese court order[20] prohibiting it from following the US court order, and the subsequent US sanctions for disobeying it.

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[18] The Financial Crimes Enforcement Network (FinCEN) in the US Department of Treasury.

[19] See http://www.dfs.ny.gov/about/press2014/pr140818_PwC_Order.pdf.

[20] Yukio Edano, a lawyer and then a minister in the Japanese government is reported to have said at the press conference, "What happened is clearly wrong because a U.S. court decision isn't supposed to apply outside the United States".

3.7 FATCA

For foreign banks, the US Foreign Account Tax Compliance Act (FATCA: Public Law 111–147) also increases the US law compliance costs significantly. In order to make it more difficult for US taxpayers to conceal assets held in offshore accounts and shell corporations, and to recoup federal tax revenues, FATCA requires US persons including individuals who live outside the US to declare their financial accounts held outside the US, and requires foreign financial institutions (FFIs) to report to the Internal Revenue Service (IRS) about their US clients. The duty of FFIs comes from a contract made between an individual FFI and the IRS. To increase the incentive for FFIs to agree with the IRS, all FFIs without such contracts have to pay additional tax.

FATCA was severely criticised because it enables the US to impose regulatory costs and potential penalties on FFIs, which, otherwise, would have few dealings with the US. To ameliorate the criticism, the US offered reciprocity to potential countries which sign Intergovernmental Agreements (Model I for the UK, France, Germany, Italy and Spain; Model II for Japan and Switzerland). In addition, the OECD issued the Standard for Automatic Exchange of Financial Account Information (Common Reporting Standard)[21] in 2014. At the end of the Standard, it says that:

> it incorporates progress made within the European Union, as well as global anti-money laundering standards, with the intergovernmental implementation of the U.S. Foreign Account Tax Compliance Act (FATCA) having acted as a catalyst for the move towards automatic exchange of information in a multilateral context.

Though the FATCA itself seems to burden foreign companies with unreasonable costs without offering any benefit to them, the outcome shows some hope for the other US extra-territorial economic laws to be also a "catalyst" for the move towards multilateral treaties compatible with international laws.

3.8 The Role of International Law

The role of international law is limited. In the *BNP Paribas* case, *BNP* cannot file suits against the US in the International Court of Justice (ICJ) because only states can sue. *BNP* can litigate in the US with little possibility of winning, or litigate in France, but the US government will not follow a French judgment. Even if the French government sues the US on *BNP*'s behalf at the ICJ, it will take a long time with little prospects of winning because there are no clear standards for limiting extra-territorial applications, as shown above. In addition, during the lengthy

[21] See http://www.oecd.org/ctp/exchange-of-tax-information/automatic-exchange-financial-account-information-common-reporting-standard.pdf.

judicial procedures, *BNP* would lose significant business opportunities, which is far worse than paying the huge penalties imposed by the US regulators. However, international law still has some role.

4 International Law and East Asian Perspectives

Even though lacking in clear standards, international law principles which the US cannot neglect do exist. Based upon the Article 2 of the Charter of the United Nations, the US and other UN members should observe: (1) the principle of the sovereign equality (Sect. 1); (2) the principle of the territorial integrity and political independence (Sect. 4); and (3) the principle of non-intervention in domestic matters (Sect. 7). Together with the threat of losing USD hegemony by foreign banks creating alternative means, and the needs for US inside policy co-ordination among the US regulators, especially the co-ordination of the OFAC's and the DFS's economic sanctions with the FRB's financial stability goals, the consensus-making of foreign and US regulatory jurisdictions, such as the "Basel Concordat" framework in banking regulation, should be done in the near future. If the US goes this way, the concern about the financial stability in East Asia will not be badly affected by the US laws.

However, if things go in the opposite direction, the systemic risk concern will not be limited to the US but will also be extended to East Asia. What countermeasures can be thought up from East Asian perspectives? Let us re-consider the above-mentioned four alternatives to the USD: (a) using the existing East Asian currencies such as the Japanese Yen or the Chinese Renminbi; (b) developing the existing overseas USD payment system in Tokyo and Hong Kong; (c) creating an East Asian common currency like the Euro; and (d) increasing the use of cyber-currencies such as Bitcoin. As alternatives (a) and (c) seems politically unlikely in the near future, and alternative (d) cannot be controlled by governments, let us focus on the alternative (b). East Asian countries already hold significant cash-equivalent USD reserves which are bigger than those in Europe. Regarding the US Treasury Securities, China (1,268.1 billion USD in August 2013) and Japan (1,149.1 billion USD) are by far the first and second largest holders in the world, while the distant third is the Caribbean Islands, with 300.5 billion USD. Even without relying on finality functions in New York, the USD clearing schemes in Hong Kong and Tokyo can be re-arranged to provide final settlement in East Asia if Japan or China really wished because their abundant cash-equivalent USD reserve may be used to offer cash-equivalent finality to some extent (if you pay 20 USD in cash outside the US, and not through a bank wire, you do not need to finalise it in New York). Though Japan is currently a faithful US ally, China is the US's political rival, and might easily reject US extra-territorial sanctions. However, I do hope that this possibility does not happen, and hope it will lead the US to create an economic sanction version of "Basel Concordat" framework in order to promote international consensus-making in a friendly manner.

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F. Rövekamp et al. (eds.), *Central Banking and Financial Stability in East Asia,*
Financial and Monetary Policy Studies 40, DOI 10.1007/978-3-319-17380-1

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