

LEADING THE WAY THROUGH: THE ROLE OF THE EUROPEAN CENTRAL BANK AS PENDULUM, SHIELD AND SUPERVISOR OF THE EURO AREA

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ABSTRACT: In 2012, in a conference in London, Mario Draghi claimed “the ECB is ready to do whatever it takes to preserve the euro. Believe me, it will be enough”, as he announced the Bank was ready to intervene by entering the market and steadily buying sovereign bonds. The “whatever it takes” policy was a drastic shift in ECB policy, thus bringing measures with sizable results, such as the Outright Monetary Transactions Program. However, questions were asked and complex policy options were at stake, namely in what concerns the dynamics and interaction of several European Institutions and the Member States. This article presents the major issues that surrounded the introduction of the Outright Monetary Transactions Program and gives an overview of the European Court of Justice’s decision that backed the unconventional use of powers by the European Central Bank, defending an important tool in safeguarding the stability of the Eurozone.

INDEX: 1. Introduction. European Central Bank: dark knight born from the ashes of the crisis. 2. Mario Draghi’s Whatever it takes policy. 3. Gauweiler v. Deutscher Bundestag and the Outright Monetary Transactions Program. The Court of Justice decision. 4. Final reflections.

1. INTRODUCTION. EUROPEAN CENTRAL BANK: DARK KNIGHT BORN FROM THE ASHES OF THE CRISIS

Europe is struggling. Shock waves of the 2008 crisis¹ are still echoing, slowing down economies and forcing an intense spirit of survival in the international

1 For further study of contagion, spillover and the propagation of shocks across countries, v. Rigobon, 2016. With an overview of such problem in the light of international macroeconomic policy, explaining the inherent interdependence of open national economies, v. Krugman, 2012: 504 ff..

financial and capital markets². It has been a bear market in which securities prices fell and pessimism has risen, endangering both external and personal financing³. As such, economic resilience⁴ and think-tank innovative approaches to hold the line and *carve the way out* of these asphyxiating times is amongst the main issues of the present era.

It has been argued that Europe, and the euro area⁵ particularly, were not prepared for such hostile environment – namely for such hit – and *stress induced diseases* in the financial institutions⁶. In fact, the euro area faced a crucial need to build an economic and financial crisis management framework almost from scratch⁷. Thus, while sovereign debt crisis raises financial and economic issues to be addressed, it also involves a variety of legal doubts and implications. First and foremost, the euro area is not the European Union, being only a fraction of it. Its Members do not constitute an institution⁸, which raises two important and related issues: can they elaborate (binding) procedures to *carve out* of the crisis? How can they enforce emergency measures (as, for example, the

2 Following Krugman, Obstfeld and Melitz's definition of international capital market closely, it is *not really a single market; it is instead a group of closely interconnected markets in which asset exchanges with some international dimension take place. (...) The main actors in the international capital market are the same as those in the foreign exchange market: commercial banks, large corporations, nonbank financial institutions, central banks, and other government agencies.* (v. Krugman, 2012: 586).

3 Even though acknowledging the crucial role of the *roots of the crisis*, we will not engage in a retrospective in this paper. About the roots of 2007/2008 crisis and the fighting step plan introduced by the Basel Committee, v. Magalhães, 2012: 285-371; our Meneses, 2014: 793-807; and Haas, 2016.

4 *Economic resilience is essential to better withstand adverse shocks and reduce the economic costs associated with them* v. Sondermann, 2016.

5 The euro area or Eurozone comprises the EU Member States whose currency is the euro and in which a single monetary policy is conducted by the European Central Bank.

6 With a different position, v. the European Commission's communication to the Council and the European Parliament in June 2006: "Overall, the one-year experience with the revised Stability and Growth Pact shows that the EU fiscal framework is regaining credibility". European Commission, 2006.

7 Despite having functioning well since inception until the Eurocrisis. The Eurozone, however, still embraces some of the earlier growth pains, as a grouping of States wishing to remain in the Eurozone but with an exit option.

8 The Eurozone's promotes its activity through intergovernmental cooperation, in an informal gathering of the Ministers of Finance of each Member, named Eurogroup. Despite economic and monetary union is within the former First Pillar – European Communities, which typically held a community integration method, in the Eurozone the method is intergovernmental cooperation. Nowadays, after the Lisbon Treaty, Monetary policy is faced as of the exclusive competence of the European Union. The Economic and Financial Affairs Council (Ecofin) of the Council of the European Union gathers all Ministers of Finance of Member States. However, only Eurozone Ministers (*i.e.* the informal Eurogroup present at the formal Ecofin) vote in euro related issues. Therefore the Eurogroup, even though being an informal gathering, has a growing central role in the European Union.

European Union does)? Some authors also admit that the crisis *was aggravated by uncertainty about the “no-bailout” clause (Art. 125 TFEU) would be interpreted and enforced strictly or whether troubled Member States would receive some support and on what conditions*⁹.

Also, in a monetary union, the interaction between several governments and a single central bank is of a difficult nature, as *each government has strong preferences over local spending and taxation but suffers only part of the costs of union-wide inflation and higher interest rates, creating a tendency toward excessive debt*¹⁰, i.e. the lack of a common view over the actions and role of the central bank¹¹ were also blocking the road further. Thus, during the pre-crisis period the European Central Bank’s conduct of monetary policy was founded on temporary credit operations in the form of repurchase agreements, which was proven to be an inadequate response to the *winter that came*¹².

According to Article 282 (1) of the Treaty for the Functioning of the European Union (TFEU), the European Central Bank (hereinafter ECB), together with the national central banks of the Member States of the euro area, constitute the Eurosystem and shall conduct the monetary policy of the Union. Articles 127 and 282 of the TFEU, following the adoption of the Lisbon Treaty, indicates that financial stability, which was *somewhat neglected when the ECB was created*¹³, has been entrusted to it. And wisely, as Central Banks have a major role in the euro area¹⁴, and as the ECB proved to be a trustworthy key player in the financial and economic arena¹⁵.

As we will describe further, the ECB’s role in the crisis management framework has been of the traditional and conventional nature until 2012, when

9 V. Enderlein, 2016, 15.

10 Basso, 2016.

11 About the relationship between governments and banks, v. De Grauwe, 2013. In this article the authors state that *The new responsibilities entrusted to the European Central Bank as the single supervisor in the eurozone create a unique opportunity for that institution to change the regulatory and supervisory culture in the eurozone – one that has allowed the large banks to continue living dangerously, with insufficient capital*. And our Meneses, 2014.

12 Studies indicate that the 2007/2008 crisis led to the loss of a decade v. Enderlein, 2016: 10 ff.

13 V. Lastra, 2012: 2.

14 As the vast majority of companies and citizens meet their financing needs through the traditional banking system, via direct bank intermediation. As a result, *the euro area banking system lies at the heart of the conduct of our monetary policy*, v. speech by Praet, 2016.

15 Proving a major shift in the EU’s institutional framework. The Eurocrisis has placed the ECB well in the top, nonetheless the Parliament and the European Council being the *winners* with the Lisbon Treaty.

the ECB¹⁶ stepped in in the public bonds market, avoiding interest rates to keep steadily and lethally climb towards a state where Member States could not afford to borrow anymore. Such action in the secondary market is comparable to a *de facto* lender of last resort to fiscally stable Member States measure¹⁷, which was subject of intense debate. The ECB opened, then, a window in this crisis, *letting the sun shine in*.

2. MARIO DRAGHI'S *WHATEVER IT TAKES* POLICY

In 2012, in a conference in London, Mario Draghi claimed “*the ECB is ready to do whatever it takes to preserve the euro. Believe me, it will be enough*”¹⁸, as he announced the Bank was ready to intervene and change the *state of the art* by entering the market and steadily buying sovereign bonds. In fact, Spain’s high borrowing costs were summing up, leading the path to a full sovereign bailout.

Draghi asserted that the role of the ECB was to maintain price stability at every cost and if the high interest rates interfered with the central bank’s implementation of monetary policy, drastic measures should be taken. So, the core idea was that the European Central Bank would buy government bonds from euro countries in trouble, when nobody else buys these bonds, or their yield¹⁹ is becoming so high that a member state will not be able to cover interest payments on newly-issued bonds, thus having no more access to credit and risking default²⁰.

The *whatever it takes* policy was a drastic shift in ECB policy. As previously said, the ECB’s traditional role is to conduct monetary policy for the euro area. However, it has rapidly extended over the last few years, as the ECB uses several different monetary policy instruments to face the financial crisis,

16 The ECB was also involved in areas such as debt sustainability analysis, the preparation and monitoring of macroeconomic adjustment programmes for Member States requesting financial rescue.

17 The monetary approach of the lender of last resort the ECB addressed. The other approach is the credit approach, which relates to the Eurosystem’s Emergency Liquidity Assistance (ELA) to individual credit institutions, whose responsibility is of the National Central Banks. We won’t develop further this credit approach of the lender of last resort role of the ECB. For further development on the ELA procedure, underlying the Governing Council’s role pursuant to Article 14(4) of the Statute of the European System of Central Banks and of the ECB, v. European Central Banks 2014.

18 V. Financial Times’s piece, from 26 July, 2012.

19 Yield is the profit expressed as a percentage of the investment, namely the annual interest paid on a security (esp. a bond) divided by the security’s par value. It is represented by a percentage, which is tied to the risk associated with the investment.

20 V. Hinarejos, 2015: 565.

providing technical assistance in designing programme conditionality and monitors implementation of agreements with borrower states as a member of the Troika (now, Quadriga). In addition, the ECB now assumes a pivotal role in bank supervision and resolution²¹.

However, the expansion of powers through the period of the euro area sovereign crisis was not backed – at least not expressly. By instance, Article 123 TFEU prohibits the Bank from acquiring government bonds as it could be considered as monetary financing or the ECB becoming a direct lender of last resort to a member state²². However, the truth is that after this announcement, the euro strengthened and bond prices of debt issued by stressed Eurozone countries rallied.

In September 2012, the Governing Council of the European Central Bank decided on several technical features regarding the Eurosystem's outright transactions in secondary sovereign bond markets, aiming the safeguard of both appropriate monetary policy and singleness of the monetary policy²³. The main decision was the well-known Outright Monetary Transactions Programme (OMT)²⁴. Such programme enables and designs a step action where that the Bank would buy government bonds in the secondary market, rather than from a member state directly.

With the OMT, the ECB added a strict and effective conditionality to an appropriate European Financial Stability Facility/ European Stability Mechanism (EFSF/ESM) programme. The Member State in question would need to obtain financial assistance from the EFSF/ESM and comply with its conditions, i.e., macroeconomic reforms negotiated between the member state and the troika²⁵.

21 V. Craig, 2016: 5.

22 Article 123 TFEU reads: "1. Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.

2. Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions."

23 V. European Central Bank's press release, from 6 September 2012.

24 With a detail description of the OMT programme, Guntram, 2013.

25 V. Hinarejos, 2015a: 564.

Per the ECB's press release the Governing Council would 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*".

3. GAUWEILER V. DEUTSCHER BUNDESTAG AND THE OUTRIGHT MONETARY TRANSACTIONS PROGRAM. THE COURT OF JUSTICE DECISION.

Despite the important role played by the mere announcement²⁶ of the OMT scheme, which had the ability of getting Europe of the crisis' acute phase²⁷, the legality of this program was judicially challenged. The complainants challenged the Bundesbank's participation in implementation of the ECB's OMT program and the failure by the Federal Government and the Bundestag to act regarding the OMT decision²⁸. It was argued before the German Court that the ECB had overstepped its Treaty role by creating a Program that should be viewed as a tool of economic, not monetary policy²⁹, violating the prohibition on monetary financing.

The German Constitutional Court's preliminary response was that the OMT Program was "likely" *ultra vires*³⁰, but referred the case to the European Court of Justice (ECJ), arguing that whether the scheme could be held to violate the *Grundgesetz für die Bundesrepublik Deutschland* (GG) depended on the ECJ's interpretation of the OMT conformity with the EU primary law³¹. In fact, the

26 About the macroeconomic effects of the OMT's announcement by the ECB, v. Altavilla, 2014.

27 V. Hinarejos, 2015a: 564.

28 V. Gauweiler, BVerfG 21 June 2016.

29 The mandate of the European Central Bank is limited in the Treaties to the field of monetary policy (Articles 119 and 127 et seqs. TFEU, Article 17 et seqs. ESCB Statute). It is not authorized to pursue its own economic policy but may only support the general economic policies in the Union (Article 119 sec. 2, Article 127 sec. 1 sentence 2 TFEU, Article 2 sentence 2 ESCB Statute). "*If one assumes – subject to the interpretation by the Court of Justice of the European Union – that the OMT Decision is to be qualified as an independent act of economic policy, it clearly violates this distribution of powers*" (Gauweiler, BVerfG 2016). The BVerfG case law on *ultra vires* dates back to the Maastricht judgement and was developed in the Lisbon judgement. V. Craig, 2016: 3.

30 Pursuant to the Federal Constitutional Court's Honeywell decision (BVerfGE 126, 286), for an act to be considered *ultra vires* it requires a sufficiently qualified violation, manifestly in violation of powers and that the challenged act entails a structurally significant shift in the allocation of powers to the detriment of the Member States. V. Opinion of Advocate General Cruz Villalón delivered on 14 January 2015.

31 V. Hinarejos, 2015a: 565.

existence of an *ultra vires* act creates an obligation of German authorities to refrain from implementing it and a duty to challenge it. The German Court argued the OMT Decision did not appear to be covered by the mandate of the ECB, as the monetary policy is to be distinguished according to the wording, structure and purpose of the Treaties from the economic policy, which primarily falls into the responsibility of the Member States.

The objective of the OMT Decision is to neutralize spreads on government bonds of selected Member States, which fall under the category of an act of economic policy, especially because the monetary policy framework of the ESCB does not differentiate between individual Member States. The parallelism of the OMT with assistance programs of the EFSF or the ESM and the risk of undermining their objectives and requirements confirm this assessment. The purchase of government bonds to provide relief to individual Member States that is envisaged by the OMT Decision appears as the functional equivalent to an assistance measure.

However, Judge Lübbe-Wolff had a strong dissent with most the Senate, arguing the court exceeded its judicial competence to secure the rule of law. A similar perspective was adopted by Judge Gerhardt, who noted that by admitting such an *ultra vires* review, the door is opened to a general right to have the laws enforced, which the Basic Law does not contain³². Despite these contradicting voices, the CJEU was asked to rule on the validity of an act found by the BVerfG to be *manifestly ultra vires* the ECB and “which involved a *structurally transgression of powers*”³³. The ECB itself pronounced vividly against these claims, arguing that the aim of the scheme is not to facilitate the financing conditions of certain member states, or to determine their economic policies, but rather to unblock the Bank’s monetary policy transmission channels and that the elements of conditionality was necessary to ensure that the OMT scheme would not interfere with the macroeconomic reform agreed between ESM and the member state in receipt of financial assistance³⁴.

32 Gerhardt, 2014.

33 V. Craig, 2016: 4. However, the BVerfG claimed it was only obliged *in principle* to comply with a ruling by the CJEU.

34 V. Hinarejos, 2015a: 567, 568.

This scenario created a Catch-22³⁵, with an unsolvable and highly problematic conflict between the ECJ's and the Constitutional Court's interpretation of primary EU law. In fact, three different scenarios could emerge: (i) the ECJ decides that the OMT Decision in effect envisages actions by the ECB, which are incompatible with its interpretation of the Treaty; (ii) the ECJ decides that the OMT Decision, even if taken as interpreted by the BVerfG, is in line with the ECB's mandate under the Treaty and in particular does not violate Article 119, 123 and/ or 127 of the TFEU; (iii) the ECJ interprets the Treaty in a way that sets effective limits to any implementation of the OMT Decision, and the resulting limits happen to be compatible with the Constitutional Court's interpretation of the relevant Treaty constraints³⁶.

Whichever path the ECJ had chosen to take would have resulted in a complicated situation. In the first scenario, the OMT Decision could not be implemented by the ECB, because doing so would violate the ECJ's interpretation of the ECB's mandate. In the second scenario, the ECJ's interpretation of the Treaty would be incompatible with the BVerfG's.

According to the Constitutional Court's perspective it would trigger a "duty to sabotage" the OMT Decision. All German public official would be obliged to work towards a reversal of the program. The third scenario would, at first glance, be the best one, as it appears to reflect a consensus between the BVerfG and ECJ, but it would come at high cost, as the Constitutional Court would necessarily render any future use of OMT ineffective. The Catch-22 is the conclusion that only rendering OMT ineffective can save it³⁷.

The ECJ started by assessing the nature of the OMT Decision, responding to the claim that the scheme should be qualified as an economic policy measure, and not monetary. The Court stated that the possible indirect effects of the Program in economic policy – namely the contribution to safeguarding the stability of the euro area – did not mean the measure should be classified as economic policy³⁸. The bond-buying conditional upon the member state's

35 Catch-22 is a novel written by Joseph Heller. The book's popularity initiated a habit of describing a problematic situation for which the only solution is denied by a circumstance inherent in the problem or by a rule as a "catch-22". For example, when you lose an object, the solution to that problem is to find the lost object. However, if you lose your glasses, you cannot find them.

36 V. Gerner-Beuerle, 2014: 286.

37 V. Gerner-Beuerle, 2014: 287.

38 The court drew an analogy with *Pringle* (Case C-370/12), which opposed the plaintiff *Mr. Pringle* to Ireland. For further Reading on the judgment, Hinarejos, 2015b: chapter 8.

compliance with ESM or EFSF was also irrelevant to the classification of the measure³⁹. The judgement conducted a review of proportionality and recognized ECB's discretion to make complex assessments and technical choices in the area and that, in its view, the OMT Program would be appropriate to achieve the objectives envisages with the policy.

Additionally, the OMT did not collide with the prohibition on monetary financing of member states because the bond-buying would take place in the secondary market, which means it wouldn't buy bonds directly from a member state. However, the court emphasized that under some circumstances buying bonds in the secondary market would have the same effects as buying directly from the member state, in which case the outright operations should be prohibited.

To sum up, the OMT program was deemed to violate the EU internal law when the indirect bond-buying would defeat the purpose of Article 123 (1) TFEU in the same way as buying bonds directly. This means that the transactions should be limited only when it discourages the member states to pursue a sound budgetary policy (which is the purpose of the prohibition on monetary financing)⁴⁰. But to the extent that the program presented safeguards to prevent that situation⁴¹ it should be considered legal.

4. FINAL REFLECTIONS

It comes as no surprise that ECB and Eurozone' leaders stand ready to do *whatever it takes* to preserve the euro⁴². Therefore, it is baffling that the BVerfG decision failed to see the "*invisible elephant in the room*"⁴³ – financial stability –, essentially because it did not go into the merits of the ECB's monetary policy motivation. The *ratio* of the ECB's OMT program can be found on

39 V. the dissenting voice of Judge Cruz Villalón (cit. *supra*), who thought this scheme's peculiarity set it of the boundaries of the EBC's powers, which, according to *Pringle*, could only be of monetary policy with, at most, a supporting role in economic policy.

40 V. Hinarejos, 2015a: 566-570.

41 According to the OMT program, distortion to the conditions under which a member state can sell its bonds in the primary market would be limited by not announcing in advance the Bank's intention to buy a member state's bonds in the secondary market and by allowing a reasonable period of time to elapse between the member state's sale of its bonds in the primary market and their subsequent acquisition by the European Central bank.

42 Also about why preserving the euro should be a priority, v. Enderlein, 2015.

43 Thomas Beuker's expression (Beuker, 2014: 360).

the assertion that a disruption in the functioning of the markets, the fragmentation of the markets, and financial instability, hinder a proper functioning of the transmission mechanisms during the crisis. Although we might question if OMT is effective in safeguarding the proper functioning of the monetary transmissions mechanism and the singleness of the monetary policy, its impact on the markets optimism and strengthening of the euro cannot be denied.

The ECJ's decision, in line with *Pringle*, reconciles monetary and financial stability. The ECJ argued the outright transactions program is, at its core, a monetary policy scheme and that indirect bond-purchases are not textually prohibited by the TFEU, if conditional and necessary for the financial stability of the single currency. This conclusion leads to a less strict interpretation of the no-bailout clause rather than that the BVerfG would have liked, but a statement has been made by the ECJ. Therefore we can state that the pledge to do *whatever it takes to preserve the euro* has been fully tested by the ECJ.

It can be interesting, however, to contemplate another line of thought and ponder the hypothesis of a teleological interpretation of Article 125 TFEU, considering that financial stability of the currency area is the regime's higher objective. The truth is that ECB's limited powers have two rationales.

On the one hand, assure the bank's independence and maintain separation between monetary policy, fiscal policy and economic policy. On the other hand, to preserve the configuration of Economic and Monetary Union as a currency union and not a transfer union, i.e., where member states are responsible for their own debts. But these powers are not an end in themselves, but a means to achieve a greater good.

We cannot simply deny ECB's responsibility for financial stability, because in broader terms it implicates the stability of the financial system or sector and even price stability. The ECB has responsibilities, as before mentioned, in such both issues even if financial stability is an area in which Member States are primarily responsible⁴⁴. We have already stated and hereby realize that the TFUE is not only about its letter, but its objectives and spirit, and therefore there is nothing in the way of ECB's fulfillment of its major roles and premises.

As a final note, we must question if the control the ECJ exercises over European Central Bank is not a limitation in its independence, especially when complex policy options are at stake. But as much as such judicial control

44 V. Beuker, 2014: 361.

can be regarded as a restraint in the Bank's independence, we cannot have it any other way.

Although as challenging as it may be, *we should do whatever it takes to preserve the euro*. The unconventional use of powers by the European Central Bank, backed by the ECJ, has been an important tool in safeguarding the stability of the Eurozone.

It is desirable that less of the burden for preserving the euro falls on ECB's shoulder – a wish expressed by Mario Draghi himself. In fact, the EU democratic Institutions are the ones to look at for inspiration and solutions, but failing to act accordingly. They should be the ones *leading the way through*.

But as long as the ECB is needed to preserve the “fragile and imperfect”⁴⁵ currency union, it should be there, even if it means non-conventional approaches.

However, all EU Institutions must adapt and perform accordingly, or the system as a whole is at stake. *And, believe me, it will be enough. (?)*

45 Kennedy, 2015.

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EUROPEAN CENTRAL BANK

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