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The ECB's liquidity lines – insuring deposits, both domestically and abroad

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I. Introduction

During the global financial crisis in 2008 and the March 2020 market turmoil, liquidity facilities for foreign central banks – especially those of the Federal Reserve Bank of New York – were seen as essential to stabilise global financial markets (Bahaj/Reis 2022). They enabled central banks around the globe to distribute the foreign exchange needed to their economies to alleviate funding strains experienced by their financial sector. Among others, the ECB has been one of the main beneficiaries of this global scheme since the demand for US dollars in Europe was extraordinarily high during those crises. Furthermore, it enjoyed privileged access to the NY Fed's emergency dollars among other Western central banks. By contrast, other monetary authorities were only granted access to those emergency dollars through the FIMA repo facility (Murau et al. 2022). One must distinguish between two financial instruments central banks use to implement their liquidity lines to other central banks. Either they agree on a currency swap, or they set up a repurchase agreement (repo). Both contractual agreements are effectively secured loans, but the borrowing conditions are significantly better under a currency swap agreement.

At the same time, the ECB also established a net of lines providing euro liquidity to other central banks, mainly to those in the vicinity of the euro area (Albrizio et al. 2023). After the 2020 market turmoil, the ECB quickly extended its facilities for central banks, now allowing a broad range of counterparties to access euros through them. However, like its American peer, the ECB grants privileged access to euros via swap lines only to some foreign central banks. All the others can only access euros through repo facilities. There is one elephant in the room since the vicinity of the euro area mainly includes non-euro area

Member States: the ECB accords better borrowing conditions to some Member States' central banks than others (Spielberger 2023). It set up swap lines for the Sveriges Riksbank, the Danmarks Nationalbank, and the Narodowy Bank Polski, while the Magyar Nemzeti Bank and the Banca Naţională a României may only borrow euros through a repo line.

In short, the ECB and its peers in other jurisdictions actively established a web of liquidity lines over the last 15 years essential for the globalised financial system. By using two different financial instruments to implement them, they privilege some central banks over others, which, in the case of the ECB, raises questions about its standing towards non-euro area Member States.

As an independent central bank, the ECB must justify its policy choices with its legal mandate. Since the ECB is also a Union institution, it is also required to do so by the principle of conferral enshrined in the Treaties. However, the Treaties did not anticipate that development in the area of external relations of the euro. They hardly provide any clear guidance in that regard, leaving room for a new interpretation. In my reading, the ECB has the necessary legal powers to enter and implement such arrangements with other central banks. Moreover, the ECB is not bound by a principle of equal treatment when it enters business relationships with non-euro area Member States' central banks. In other words, establishing liquidity lines with central banks in third countries to safeguard global financial stability is legally permissible and the ECB may freely choose on which terms it grants other monetary jurisdictions access to its currency (including non-euro area Member States).

I develop my argument in two steps: first, I will explain how and why liquidity lines are essential to stabilise the global financial system. Second, I analyse the ECB's legal powers to arrange and implement such schemes, and assess if the ECB must comply with a principle of equal treatment when doing business with other Member States' central banks.

II. How liquidity lines contribute to global financial stability

In jurisdictions that ensure capital mobility, financial actors may transact in foreign units of accounts. These transactions are funded and facilitated by so-called offshore deposits. These are bank deposits denominated in a foreign currency, for instance US dollar deposits held at a European bank within Europe. What makes these offshore deposits special is that they are not insured by a state, neither in a narrow sense nor in a brother sense. By contrast, onshore deposits – deposits denominated in the domestic currency – fall under a deposit insurance scheme. Moreover, they are effectively insured by the bedrock power of the local central bank that is to theoretically provide as much liquidity as needed to the bank in case all customers were to withdraw their deposits at once (a so-called bank run scenario). In other words, it is almost as safe for the general public to have money on a bank account as to have bank notes under the pillow. There is one caveat, though: the deposits must be denominated in the domestic currency.

Since extending the deposit insurance scheme to other jurisdictions is hardly feasible, the only option to guarantee the safety of offshore deposits is to extend effectively the central bank powers to other jurisdictions. In a scenario where there is a run on deposits denominated in foreign units of account, like in March 2020 or in the 2008 Global Financial Crisis, the demand for foreign exchange increases rapidly, leading to soaring borrowing conditions on foreign exchange markets where banks fund their offshore deposits.

Thus, central banks cooperate with their peers in other jurisdictions to avoid a liquidity-draining spiral in these funding markets and all its negative spillbacks to the real economy. Through their liquidity lines, they empower each other to inject the necessary liquidity into their financial systems in a scenario where there is, in principle, no lender of last resort since the demand is requested in foreign currencies that central banks cannot supply without any constraints. Simply put, during a run on offshore deposits, a liquidity line of the domestic central bank functions as a bridge for the financial system to the actual lender of last resort located in another jurisdiction. By that, liquidity lines are one cornerstone of the safety net for the globalized financial system. However, their legal foundations remain somewhat unclear.

III. Legal analysis

Starting point of the legal analysis is the treaty between the ECB and the respective foreign central bank to provide each other access to their currencies. Provided with its own legal personality (Article 282(3) TFEU), the ECB may be the legal counterparty of this agreement. In terms of International Law, this treaty is seen as a gentlemen's agreement because none of the monetary authorities wants to be legally bound by it. Instead, the agreement is backed by the moral integrity of the involved central bankers, whose role crucially depends on their credibility. However, I will leave further questions in this regard to the scholars of International Law and focus on the legal powers of the ECB to enter and implement its liquidity line arrangements.

1. Within the mandate?

The statutory authority for the ECB to enter those agreements can be found in Article 23 ESCB Statute, allowing the ECB to 'establish relationships with central banks'. However, the law is silent to what end the ECB may establish those business relationships.

Historically, the Committee of Governors that drafted the ESCB Statute assigned the instruments provided in Article 23 ESCB Statute to the 'tasks laid down in Article 3.1, second and third indents, ESCB Statute.' In other words, the ECB may establish relationships with central banks 'to conduct foreign exchange operations consistent with the provisions of Article 219 TFEU' (second indent) and 'to hold and manage the official foreign reserves of the Member States' (third indent). Behind that somewhat opaque wording lies the approach of the drafters of the Maastricht Treaty to carefully assign the relevant powers in the EMU's external relations field to the more political Ecofin Council. As *Herrmann* once pointed out, it is the Council that takes the 'fundamental decisions [...] with regard to which it can bind [the Union] vis à vis other international legal persons'. For instance, the Council may conclude formal agreements on an exchange-rate system for the euro (Article 219(1) TFEU) or may bind the euro area through other monetary or foreign exchange regime agreements with third States (Article 219(3) TFEU). Until today, the Council has hardly used its legal powers. It only used the legal basis in Article 219(3) TFEU to enter formal agreements with the Republic of San Marino, the Vatican City State, the Principality of Andorra, and the Principality of Monaco regarding the introduction of the euro as a legal tender on their territories.

The ECB's role should be more passive, according to the original institutional assignment. If one strictly follows an originalist reading of Article 23 ESCB Statute, one may conclude that the ECB's liquidity lines are not set up for a legitimate purpose since they neither implement an exchange-rate policy pursued by the Council nor a formal agreement of the Union with third states that concerns 'monetary or foreign exchange regime matters'. Furthermore, it is not an exercise of its relatively limited task of holding and managing the official foreign reserves of the Member States.

However, for good reasons, there is no originalism in EU Law. Hence, the ideas of the drafters of the ESCB Statute are not strictly binding. This leaves room for a new interpretation of Article 23 ESCB Statute. Nonetheless, the preparatory work relating to the ESCB Statute and the Maastricht Treaty may provide valuable insights for that exercise, especially against the background that the legislative outcome 'was more ambiguous, however, than it appeared at first glance' as one involved negotiator, André Szász, later admitted in 'The Road to European Monetary Union' (p. 153). The strategic use of ambiguity within the ESCB Statute will play a crucial role in my argument later.

In my reading, the attribution to the enumerated tasks (Article 3 ESCB Statute) and the conduciveness to the objectives laid down in Article 2 ESCB Statute may legitimise the establishment of business relationships with central banks based on Article 23 ESCB Statute. In that way, the 'internal banking powers' of the ECB under Article 18 ESCB Statute are mirrored, safeguarding the consistency of the ESCB Statute by following the general doctrine of parallelism. Pursuant to Article 18, open market and credit operations are only warranted '[i]n order to achieve the objectives of the ESCB and to carry out its tasks'. Furthermore, this parallelism guarantees that establishing and implementing liquidity lines follow the same legal conditions since the provision of foreign liquidity to the financial system in the euro area may need to be based additionally on Article 18 ESCB Statute.

Liquidity lines between central banks contribute to global financial stability. Therefore, they may be attributed to the task of the ECB to '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.' In my reading, Article 3.3. ESCB-Statute includes two separate tasks. The paragraph should be read, on the one hand, as a responsibility to contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and, on the other hand, as a competence to contribute to the stability of the financial system.

This reading reflects the legislative history of this somewhat opaque provision in Article 3.3. As the preparatory work relating to the ESCB Statute shows, there was a consensus among the drafters of the Statute that somehow a reference to the concept of financial stability should be made, but not in a way that created a moral hazard for individual financial institutions. In other words, a clean-cut responsibility as a lender of last resort for individual financial institutions had to be ruled out. However, it was not intended by the Statute's drafters to tie the ECB's hands in a situation of financial market stress. Therefore, the drafters of the Statute chose to incorporate enough ambiguity in the relevant provisions.

The course was set at the Committee of Governors (CoG) meeting held on the 13th of November 1990: in the first step, the CoG entangled the responsibility to contribute to the work of the supervisory bodies with the responsibility to contribute to the financial system's stability in one provision instead of leaving them in two separate paragraphs as the former Draft Statute. In a second step, the Governors wiped out a draft provision allowing the ECB to 'determine policies and take measures within its competence necessary for the purpose of maintaining the stability of the banking and financial systems.' However, at the same time, they left the wording of Article 18 ESCB Statute untouched, which provided the ECB with the necessary banking powers to contribute to the financial system's stability. As mentioned above, this provision links the power to operate in the financial markets to the tasks of the ESCB. The neutral reference to the tasks was made on purpose since an earlier draft limited the banking powers to the 'sole purpose of implementing the monetary policy of the ESCB.' The Governors were aware of this since the link between the task of contributing to the financial system's stability and Article 18 was indicated to them before they discussed the particular provision. In that way, responsibilities for safeguarding the financial system were sufficiently watered down in the ESCB Statute without jeopardising the power of the ECB to intervene in financial markets for that particular purpose.

Therefore, the first requirement to legitimise the actions at play – attributing the use of the powers provided by Article 23 ESCB Statute to an enumerated task of the ECB – is met. Concerning the second requirement that liquidity lines with foreign central banks must, in addition, further the objectives set out in Article 2 ESCB Statute, it should not be sufficient that the exercise of an enumerated task itself serves these objectives; instead, a precise justification should be required for how a financial stability exercise contributes to these objectives. That way, it may address potential trade-offs between financial and price stability, which is necessary since safeguarding the latter is the ECB's overriding objective. Financial stability is typically seen as a precondition for safeguarding price stability through an inflation-targeting regime; this requirement should be easily met in most cases (likewise *Gauweiler*, para 50). Applied to liquidity lines, one may furthermore reason that by establishing and implementing them, the ECB supports one of the fundamental economic policy decisions, namely, to ensure free capital mobility (Article 63 TFEU) that includes the provision of loans denominated in foreign currencies (see Annex I, Council Directive 88/361/EEC).

2. Some member states are more equal than others?

Now that it is ascertained that the ESCB Statute and the Treaties provide the necessary legal bases for the ECB's actions, the question arises if the ECB complies with the rules governing the exercise of its competences. As mentioned above, the ECB effectively accords better borrowing conditions to the Swedish, Danish, and Polish central banks than to the Hungarian and Romanian central banks. *Spielberger* has pointed out that the ECB has not yet presented an official rationale for this unequal treatment. That would be legally problematic, if the ECB were obliged to treat the central banks of non-euro area Member States' equally.

The TFEU includes a separate chapter regarding the relationship between non-euro area Member States and those Member States whose currency is the euro. The central banks of non-euro area Member States are even explicitly a third decision-making body of the ECB; several primary law provisions refer to them as the 'General Council of the ECB'. However, a provision governing the business relationships between the ECB and the members of its 'General Council' is missing. Article 141(2) TFEU explicitly obliges the ECB ('shall') to strengthen cooperation between them but is silent about the principles governing that cooperation. In short, the ECB has no explicit obligation in primary law to treat them equally regarding business relationships.

Article 4(2) TEU, however, obliges the Union to respect the equality of Member States before the Treaties. One might therefore argue that this provision covers not only the equal application of primary law but also an obligation for the Union institutions to treat all Member States equal. Although it is common to derive a general obligation of equal treatment from the principle of equal application of the law, one should be careful not to undermine the silence of the Treaties and the ESCB Statute in that regard. Similarly, the ECJ recognised in *Gauweiler* (para 55) that there is simply no explicit obligation for the ECB to treat all states of the euro area equally when it operates in the financial markets. Hence, the Treaties do not principally rule out selective purchases of their bonds. The ECB, therefore, cannot be said to be obliged to treat non-euro area Member States' central banks equally when it sets up liquidity lines with them.

IV. Conclusion

In sum, the web of liquidity lines between central banks around the globe to that the ECB significantly contributed provides the offshore financial system the liquidity-insurance needed to operate. However, the insurance terms are different from jurisdiction to jurisdiction since central banks use two different financial instruments to grant each other access to their currencies. Legally, the ECB has the necessary powers to contribute to that global scheme, although there is no clear-cut responsibility for the ECB to stabilise the financial system. Furthermore, it may freely choose on which terms it grants other monetary jurisdictions access to its emergency euros. Since the institutional independence enshrined in Article 130 TFEU furthermore shields those decisions from the political process, there is a significant gap between input and output legitimacy. In other words, neither the political bodies nor the law itself may guide those policy choices.