Op-Ed

Marco Lamandini and David Ramos Muñoz

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"Monetary policy judicial review by 'hysteron proteron'? In praise of a judicial methodology grounded on facts and on a sober and neutral appraisal of (ex ante) macro-economic

Marco Lamandini and David Ramos Muñoz

1. Please facts (and macroeconomic analyses), not just political preferences

A German motto says '*Verstehen ist ein dreiseitiges Schwert. Es gibt deine Seite, meine Seite und die Wahrheit*' ('understanding is a three-edged sword. Your side, my side and the truth'). On 5 May 2020, the Bundesverfassungsgericht (BVerfG), the German Federal Constitutional Court, sent shockwaves through markets, the press, and blogosphere with its ruling on the Public Sector Purchase Programme (PSPP) by the European Central Bank (ECB). The decision declared PSPP *ultra vires* absent a further justification of its proportionality by the ECB, because it seems to exceed monetary policy, and impinges upon economic policy, which is beyond its mandate, and within the purview of Member States. Equally important, the Court has declared that the ruling of the Court of Justice of the European Union (CJEU) holding the PSPP is in accordance with EU law is not only invalid and *ultra vires*, but 'incomprehensible' and 'untenable' from a methodological perspective.

The BverfG's *Weiss* judgment, no matter its legality in the German legal order, is problematic for the European legal order. Its grounds are built on a crescendo of the BverfG's scepticism towards the assumption of more powers by EU institutions that dates back to its *Maastricht* ruling, but that certainly gained momentum after its *Lisbon* ruling, and quickened its pace with the saga of *OMT-Gauweiler* (*I* and *II*), and *SSM-SRM*. To an external observer the tone, especially that of the latest ruling, seems oddly political, grounded on a 'Germany first', 'old style' 1828 South Carolina-like constitutional inclination (fn 1). Its view may even unfortunately cast serious doubts against any future political evolution of the EU. In light of the ruling's conclusion, and its language, it is logical to concentrate on its 'big' questions, such as the primacy of European law, the room for a model of constitutional pluralism, or the meaning and significance of the principle of democratic legitimacy.

These are crucial questions that need to be pondered and given the necessary attention. Yet, our basic problem is more mundane, but no less persistent. We have read, re-read, and then read the ruling again, and we do not understand its merits *in its own terms*. Let us just accept for a minute the BVerfG's constitutional views on supremacy, democratic legitimacy, or the ECB's monetary mandate. To lead to the *ultra vires* conclusion, both the ECB and the CJEU should still have failed to assess the PSPP's proportionality.

This, in our view, is the most troubling point of the German Constitutional Court's ruling, and we fail to grasp how the Court could validly claim, on the *merits*, that the ECB first, and then the CJEU, failed to subject the PSPP to the necessary proportionality test under Article 5 TEU, when publicly available information shows that the programme was based upon complex macroeconomic analyses, which included strategies to minimise unwelcome economic side effects, aka a 'proportionality assessment'.

Why the ruling has this blind spot, which if not a subversion, at least entails a misapprehension of the facts, we do not know, but it looks like a 'hysteron proteron', that is, a ruling where the conclusion comes first, as it is the most important, and the assessment next, as it is secondary (and, further, the assessment is bent to the desired end). By way of summary of our understanding of the (quite long) statement of reasons of this consequential (and unfortunate) judgment: (a) economic effects are re-characterised by the BverfG from side effects into major (if not the preponderant) effects of the ECB action; (b) ECB strategies to cope with such effects are sidestepped; (c) the Court only highlights the economic effect of the measures, without considering the counterfactual (monetary and also economic) risks of doing nothing (a deflationary recession and associated financial instability) which could have impaired any monetary policy; and (d) monetary policy effects are downplayed as representing an accompaniment of an otherwise *ultra vires* economic measure.

2. For a compelling reality check on the PSPP macroeconomic underpinnings

In light of the BVerfG's characterisation of the measures, and to better explain our point on the merits, let us briefly recall a few facts.

(a) Starting from 2008 the ECB adopted several measures of so called non-conventional monetary policy (fn 2) including the Targeted Longer-Term Refinancing Operations, (TLTRO) and the Asset Purchase Programme (APP). In 2010 the ECB adopted the Securities Market Programme (SMP). In June 2012, the ECB announced the Outright Monetary Transactions (OMT) Programme. In 2014 it started the Asset-backed Securities Purchase Programme (ABSPP), the third Covered Bond Purchase Programme (CBPP 3), and the fourth Corporate Sector Purchase Programme (CSPP), as well as a new TLTRO. This was further extended by Decision 2016/810 (ECB/2016/10) (OMRLT-II) and, with respect to seven targeted refinancing operations, by Decision 2019/1311 (ECB/2019/21) (OMRLT-III). It is against this backdrop that the ECB, on 22 January 2015 also announced its Public Sector Purchase Programme (PSPP), which was then implemented initially to run until September 2016 for a monthly amount of 60 billion euros, and then expanded until the end of 2017 (ECB/2015/2464) and further increased to a maximum amount of 80 billion until March 2017 (ECB/2016/702 and ECB/2017/100). From January 2018 the amount was *reduced* to 30 billion until September 2018 and after that date and until December 2018, to 15 billion. The programme was concluded in December 2018. It was finally resumed on 12 September 2019 with a monthly amount of 20 billion starting from 1 November 2019.

(b) Despite the deep dissatisfaction of the BverfG with this review, and the standard of the manifest error adopted, the CJEU considered the factual, macroeconomic assessment underpinning the adoption of the PSPP, as expressly results from paragraphs 34-41 of the *Weiss*

Based upon such factual assessment, the CJEU, in concise words, concluded at paragraph 42 that those factual factors, and macroeconomic analyses, establish that the ECB duly stated the reasons for Decision 2015/774.

(c) The BverfG disagreed with very harsh tone and offered its views on this in several paragraphs of the judgment (see for instance paragraphs 116, 123, 133, 134, 135, 137, 140, 156, 166, 171-173), noting that 'effects can no longer be qualified as being indirect in nature if the economic policy effects of a measure are intended or knowingly accepted, and these effects are at least comparable in weight to the monetary policy objective pursued (…)' and that 'the CJEU accept[ed] the proclaimed objectives of the ECB as fact *without further scrutiny and without regard to foreseeable and/or intended — perhaps even primarily so — consequences of the programme in the areas of economic and fiscal policy'*. In the BverfG's words, therefore (§§ 135-141) :

'[T]he CJEU expressly acknowledges the economic policy dimension of the asset purchase programme yet declares this aspect to be irrelevant in view of the monetary policy objective purportedly pursued. As a result, the CJEU allows asset purchases even in cases where the purported monetary policy objective is possibly only invoked to disguise what essentially constitutes an economic and fiscal policy agenda'*(…)* The CJEU simply accept[ed]that 'the PSPP pursued a monetary policy objective, without questioning the underlying factual assumptions or at least reviewing whether the respective reasoning is comprehensible, and without testing these assumptions against other indications that evidently argue against the classification as a monetary policy measure. (…)'. Relying on the principle of proportionality to distinguish between monetary policy and economic policy (Article 5(1) second sentence and Article 5(4) TEU) implies that the programme's effects can render it disproportionate. Thus, assessing the consequences of such a programme is a necessary step in the delimitation of competences. 'Nevertheless, the CJEU's approach does not require weighing the PSPP's actual contribution to achieving the objectives pursued, even though such a contribution is far from apparent given that interest rates remain at permanently low levels, that the requirements deriving from Article 126 TFEU and from the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (SCG Treaty) must be borne in mind, and that the risk of "reversal effects" discussed in public finance research increases over time […]. Nor does the review of proportionality conducted by the CJEU give consideration to the economic and social policy effects of the PSPP. The fact that the ESCB has no mandate for economic or social policy decisions, even when using monetary policy instruments, does not rule out taking into account, in the proportionality assessment pursuant to Article 5(1) second sentence and Article 5(4) TEU, the effects that a programme for the purchase of government bonds has on, for example, public debt, personal savings, pension and retirement schemes, real estate prices and the keeping afloat of companies that are not economically viable, and —in an overall assessment and appraisal — weighing these effects against the monetary policy objective that the programme aims to achieve and is capable of achieving

(…)' the CJEU's approach 'ultimately entails that the ECB is free to choose any means it considers suitable even if the benefits are rather slim — compared to possible alternative means —, while collateral damage is high'.

3. What is wrong with the appraisal of merits of the BverfG

Who could ever disagree that, as a matter of principle, the ECB is not *legibus soluta*? Who could disagree with the statement that the ECB cannot use its technical discretion to morph its monetary stance into an economic weapon of mass destruction that tramples upon the competences of Member States, distorting their economic policies, nor use its powers to inflict 'high collateral damage when the benefits of its monetary policy are slim'? Yet, the two very basic questions are whether this really happened in this case, and how far a court can go to assess that. In this case, with all due respect, our answers are 'no', and 'way too far'. It is useful to measure the BVerfG's harsh words on what it feels to be the effects of the programme, against the assessment of the PSPP in the ECB's stock taking exercise. This exercise offers factual evidence of the following:

(a) The programme was launched because 'following a double-dip recession in the wake of the financial and sovereign debt crises, the euro area experienced a prolonged period of deleveraging, an atypically shallow recovery and persistently weak inflation. Bank lending conditions started to deteriorate and loan volumes (in particular those involving non-financial corporations) to contract at the end of 2011. Persistent weakness in the underlying growth momentum perpetuated capacity underutilisation, as also visible in high levels of unemployment. Inflation rates exhibited a protracted downward trend (…). Euro area inflation was generally projected to remain weak and fall over time (…) from 1.1% to 0.7% in 2015 and from 1.4% to 1.3% in 2016'.

(b) During the period 2015-2018 net asset purchases under the APP were the principal instrument of monetary policy and their size and duration were linked to achieving a sustained adjustment in the path of inflation towards price stability.

(c) 'The APP, in conjunction with the other monetary policy measures, has provided a substantial contribution to the economic recovery and the formation of inflation expectations. According to calculations by Eurosystem staff, the overall impact of the policy measures adopted since mid-2014 on the euro area inflation rate is estimated to be around 1.9 percentage points cumulatively between 2016 and 2020, with the strongest impact being felt in 2016 and 2017. The impact on real GDP growth is of a similar size'. It is no surprise that, once the Governing Council positively assessed the progress towards a sustained adjustment of inflation over the course of 2018 closer to 2% (the ECB's inflation aim), the programme was suspended. Additional useful findings can be read in a recent ECB paper which measures the interaction between this monetary policy and bank stability (fn 3).

4. The Court's assessment and the facts

The concerns raised by the BverfG in Weiss as examples of undesirable economic effects to be balanced against the monetary policy expectations are summarised in paragraphs 171-173. of the judgment as follows:

'The programme affects balance sheets in the commercial banking sector by transferring large quantities of government bonds, including high-risk ones, to the balance sheets of the Eu-

rosystem, which significantly improves the economic situation of the relevant banks and increases their credit rating. At the same time, it creates an incentive for banks to increase lending despite the low level of interest rates […].

Relevant economic policy effects of the PSPP furthermore include the risk of creating real estate and stock market bubbles as well as the economic and social impact on virtually all citizens, who are at least indirectly affected inter alia as shareholders, tenants, real estate owners, savers or insurance policy holders. For instance there is a considerable risk of losses for private savings. This has direct consequences for (private) pension schemes and the returns they generate […]. Both factors lead to, in part excessive, portfolio shifts […], while risk premiums are in decline. Real estate prices are on the rise with trends of sometimes particularly sharp increases — especially regarding residential property in major cities — […], which possibly already come close to creating a 'market bubble', as the oral hearing confirmed. It is not for the Federal Constitutional Court to decide in the current proceedings how such concerns are to be weighed exactly in the context of a monetary policy decision; rather, the point is that such effects, which are created or at least amplified by the PSPP, must not be completely ignored. As the PSPP lowers general interest rates, it allows companies that are not economically viable to stay on the market since they gain access to cheap credit […].'

Yet, again, the problem with the BVerfG's assessment is that, in our modest view, it is based on a misapprehension of the facts. To our minds, with a paralogism, the BverfG: (a) neglected the comprehensive macroeconomic analysis made by the ECB, which included also the economic side effects which the BverfG claims were neglected, and strategies to counter these undesirable side effects of the monetary action'; and (b) failed to consider that any assessment of the PSPP and its direct and indirect economic effects must be measured against the macroeconomic effects which, in the counterfactual scenario of no action, would have followed an inertial conventional monetary policy stance without more, when interest rates were already close to zero. The balancing exercise of considering the goals to be pursued, and the risks at stake for monetary policy, including those resulting from inaction, as well as from ECB policies (from asset prices to moral hazard) were part of the backbone of ECB policy making, not only in its ex ante analysis, but also on its ex post monitoring of the situation. This is seen for instance in a clear statement of President Draghi in a Madrid speech in 24 May 2017, where he said that:

"When we [the ECB] introduced unconventional policy instruments in order to secure a return of inflation towards our objective, we were aware that those new instruments could result in somewhat more pronounced side effects than conventional instruments. These side effects have remained contained, *but we take them into account in the formulation of our policy, in the sense that we try to minimise them, without prejudice to our ability to achieve our objective"*. (Emphasis added.)

Economic indirect (side) effects were far from being 'completely ignored' as the BverfG claims. President Draghi started by noting that price stability and financial stability are inherently interlinked: as financial turbulence impairs the monetary policy transmission mechanism, by 2014, [the crisis] 'had left its mark in the form of a very challenging situation both for price stability and financial stability in the euro area. Accordingly, the policy response has involved decisive action aimed at both policy

domains'. The ECB justified its unconventional measures as necessary to enhance the transmission of monetary policy and secure its mandate, enabling a longer period of low interest rates unmarked by any significant negative side-effects on financial stability. In detail, by the start of 2014 'the euro area found itself in a vicious circle: as credit tightened, the economy worsened and risk perceptions rose, causing credit to tighten still more. The economic outlook at the time was marked by the risk of a further recession and potentially even deflation – a combination that would likely have resulted in worse outcomes for financial stability. This is why in 2014 and thereafter, the ECB took further decisive action to counteract these forces and comply with its price stability mandate to combat the impairment of the transmission mechanism caused by bank deleveraging, and thereby ensuring the even transmission of ECB policy decisions across all euro area countries and along the yield curve'.

President Draghi further commented on the side effects of this monetary policy, noting that 'monetary policy always has side effects. *Some of them* can have positive side effects on financial stability. Lower interest rates across the curve reduce the debt-servicing costs of households and businesses. Furthermore, by sustaining the recovery and the consequent lower unemployment, monetary policy bolsters the earnings of households and businesses, reducing the likelihood of default, which in turn supports bank profitability. Banks also benefit from capital gains on assets held, and from a short-term reduction in overall funding costs. Finally, banks accessing the Eurosystem funding via the TLTRO-II can borrow at rates as low as the deposit facility rate, provided that they exhibit strong performance in loan origination'.

Likewise, however, President Draghi was explicit that there may be negative side effects of monetary policy: 'Yet the current environment also suggests that close monitoring is necessary in the following three areas: the effect on risk-taking in bank lending, the impact on bank profitability and the impact on institutional investors. The so-called risk-taking channel of monetary policy transmission is where changes in interest rates may also affect banks' incentives to bear risks. In particular, low interest rates may lead to a search for higher yields, encouraging banks to soften their credit standards, thereby increasing both the volume and average riskiness of supplied loans. If credit growth and additional risk-taking became excessive, this could lead to a build-up of imbalances and endanger the stability of the financial system. Of particular concern is the development of so-called credit-fuelled bubbles, which previous experience has shown to be particularly detrimental to financial stability. Such bubbles, which typically plague real estate markets, are characterised by an adverse spiral between asset price and credit growth. Positive growth in the market value of real estate supports credit growth, which at the same time contributes to inflating the value of real estate. When the resulting bubble bursts, the collateral underlying the credit loses value, impairing the lending and borrowing ability of lenders and borrowers, respectively. The second challenge arising from the current environment is that a reduction in the spread between short and long-term rates may compress banks' net interest margins and thus exert pressure on their profitability. (…) Finally, the protracted low interest rate environment also puts pressure on the profitability of financial institutions that provide long-term return guarantees, such as life insurance or pension funds. To meet their challenging return targets, such institutions could be prone to engage in search-for-yield

behaviour and take on excessive risks'.

As is apparent from President Draghi's statement, the ECB did not ever neglect, in the macroeconomic assessment underpinning its not conventional monetary policy through the PSPP, its inevitable economic side effects, whether positive or negative. *And this was done not only (as requested by the BverfG) to balance in the proportionality assessment the pros and cons of the PSPP but also to devise strategies to minimise the impact of the negative side effects in a timely way*. The ECB relied on this – for example, on the complementary tools of macroprudential policy (including caps on loan-to-value ratios), the newly conferred micro-prudential supervisory tasks and powers and on a close monitoring of all relevant market developments, to counteract emerging risks.

This is not an isolated stance. The discussion of 'unconventional' tools, their side effects and risks, can be found in speeches made in 2015 (when the policy was about to or beginning to be implemented) by Benoit Couré, Victor Constâncio, or *Mario Draghi* himself. The list of examples goes on through 2016, 2017 (see above) and 2018 and 2019. It is too long to be included here, but it stresses a constant message to the point of exhaustion: the benefits of 'unconventional' policies, consisting in asset purchases such as sovereign debt needed to be balanced by the downside risks, and the need for such policy had to be constantly reassessed in light of new facts, which should determine whether it was time to limit it or abandon it.

Maybe, one could think, the problem is that these were just unilateral statements, not exchanged with an audience that could actually question the ECB's stance. Yet, the ECB President had two yearly hearings at the European Parliament (the Monetary Dialogue) where he was also questioned by elected representatives of a very different disposition, ECB officials have also appeared at EP hearings for specific policy matters, and both President and officials have exchanged views with the parliaments of Finland, Italy, Spain, or Ireland, where the drawbacks of the policy stance were some of the key points. These were not cursory remarks, without posterior exchange. In his last appearance before the European Parliament on 28 January 2019, Mr Draghi discussed the PSPP, among other aspects. One of the interventions to discuss PSPP was from Mr Bernd Lucke. He was an MEP from Alternative für Deutschland (AfD), and he asked about the PSPP. Roughly translated (because he made his intervention in German) the question was:

"One question concerns the deterioration in the economic situation, which you have highlighted. The ECB has announced that the PSPP has now been scaled back and that no net new purchases are taking place, but given the fact that the PSPP should continue to be an instrument of the ECB: so you consider it conceivable that the net purchases will resume later this year – 2019 – to generate further stimulus? And from your point of view, what reasons might make this necessary?"

Thus, in his last year of tenure, in the very last hearing before the EP, Mr Draghi was being questioned about the *necessity* aspects of the PSPP from a macro-economist who, like MEP Lucke, believed that the ECB was exceeding its mandate, and that the Euro is a mistake. The question was accompanied by an introductory statement. There Mr Lucke reiterated his position about the Monetary Union and the ECB's trespassing of mandate, but it also included an evaluative statement about how Mr Draghi had absolved himself in the debates in the Commit-

tee. Again, roughly translated, the statement was:

"Mr. Chairman! Mr Draghi, I would also like to thank you for the kind words that you have addressed to this committee, although I have to say that you should not count me among those who will work with you to finalise the euro and the euro area , because I still do not believe that the euro is a suitable currency for the euro zone or for the EU as a whole, and because I do not believe that the ECB is sticking to its mandate, but actually exceeding it. As you know, we are on different sides of a fight, I regret that you are a good fighter, but a fighter for the wrong thing. Nevertheless, I would like to thank you personally for the fact that the way you have conducted the monetary policy dialogue here has been one of the best that I have seen in this House. The way you argue, the amount of information you bring, the stringency of your reasoning – all of that was exemplary, and I thank you for really having made a fruitful exchange possible".

Now, if we do not consider Mr Lucke's approach towards the ECB's mandate, but the approach of the BVerfG, the Court said that the ECB breached its mandate because it did not properly assess or justify the proportionality (especially the necessity) of the measure. Yet, what the evidence overwhelmingly suggests is that, on the contrary, ECB officials would simply not shut up about the subject. If that is the case, the point is not whether the ECB, President Draghi, or other high-ranking officials could accurately predict the future, or whether economists could honestly disagree with them, or even think that the ECB was not fulfilling its mandate because that is not how a central bank is supposed to behave. The point is that, to act beyond its mandate to the point of illegality, the ECB had to fail to do a proportionality assessment. To us, having *actuallyread* the statements by the ECB and its officials, it is clear that this is simply not supported by the facts.

5. What way forward?

To our minds, the above may therefore offer an indication for the course of action necessary to solve the unfortunate institutional conflict generated by the BverfG judgment in the three month-period now granted by the BverfG to better explain the underpinnings of the PSPP. However, in our view, it is not the ECB or the Bundesbank (which is part of the ESCB) that should respond (Article 130 TFEU stands in the way and this would, de facto, endanger the central bank's independence), but rather the German Government, which can perhaps prove more successful than the CJEU at keeping a dialogue, in plain German, with its Constitutional Court to dispel, once and for all, any misconception that the monetary policy was exceeded to attain unwarranted economic ends. In so doing, the BverfG should also be gently reminded that, in Europe, judges normally balk at dictating policy or showing personal preferences.

However, on a more positive note, crises also offer opportunities. And this case confirms our view that the CJEU should continue insisting on a robust review of acts by other institutions, even if they entail 'complex economic assessments'. One thing that the BVerFG seems to have missed is that the level of detail at which the ECB's acts were scrutinized by the CJEU in *Gauweiler* and *Weiss* hardly has any parallel in any jurisdiction. Certainly not in the United States, where judges who are otherwise keen to use arguments of policy consider that this proclivity should stop at the water's edge of monetary policy. In *Raichle v Federal Reserve Bank of New York* (which is still cited as valid

precedent), the court said that:

'It would be an unthinkable burden upon any banking system if its open market sales and discount rates were to be subject to judicial review. Indeed, the correction of discount rates by judicial decree seems almost grotesque, when we remember that conditions in the money market often change from hour to hour, and the disease would ordinarily be over long before a judicial diagnosis could be made.' (fn 4)

If we compare this standard of review with that of the CJEU, there is actually no possible comparison, because for that there should be two standards, one on each side. This does not mean that the CJEU should not advance further, to the extent possible, in its endeavours to exercise a demanding and sophisticated standard of review for monetary policy decisions. It means that it is, and will be alone in its endeavour, as it lacks models. In this line, commenting a few years ago on the ECB mandates and *Gauweiler* (fn 5), we noted that, at the time both the FCC and the CJEU were already relying intensively on the distinction between economic policy and monetary policy, and we commented that this quite slippery distinction should be approached with caution. Moreover, Article 127 TFEU does not try to establish a purely objective distinction between economic and monetary policy. Such a distinction responds to the purpose of the provision, to protect central bank independence and democratic legitimacy. Thus, the rationale for the distinction between economic and monetary policy is to carve-out a set of tools and goals which help enhance the credibility of an independent body in its achievement of price stability, while leaving other powers, especially those involving public expenditure, to democratically elected bodies. In our view, courts trying to draw the distinction should remember this purpose, and the exercise of ascertaining the limits of monetary policy should never undermine the principle of independence, enshrined in Article 130 TFEU, under which the ECB is meant to operate. It would be highly ironic if Germany, which in the last two decades has derived the most visible gains from the ECB's monetary mandate and its conduct of monetary policy, were to end up violating such independence, jeopardising the euro.

Marco Lamandini is Professor of Law at the Alma Mater Studiorum Università degli Studi di Bologna, and David Ramos Muñoz is Professor of Law at the Universidad Carlos III Madrid. Professor Lamandini is also Chair of the Board of Appeal of the European Supervisory Authorities and a member of the Single Resolution Board Appeal Panel, and Professor Ramos Muñoz is an alternate member of the Single Resolution Board Appeal Panel; however, the views presented here are entirely personal and are expressed in their academic capacity only. They do not represent, therefore, and cannot be construed as representing, views that could be attributed to the Board of Appeal or the Appeal Panel or to the respective EU agencies. All the usual disclaimers apply.

(fn 1) Compare S. Cassese, L'Unione europea e il guinzaglio tedesco, in Giornale di diritto amministrativo, 2009, p. 1007.

(fn 2) For a discussion, see F. Avalos and E. C. Mamatzakis, 'Euro area unconventional monetary policy and bank resilience', BIS Working Papers, no. 754, 2 November 2018; S. Neri and S. Siviero, 'The non-standard monetary policy measures of the ECB: motivations, effectiveness and risks', Questioni di Economia e Finanza (Occasional Papers), Banca d'Italia, no. 486, March 2019.

(fn 3) 'Monetary policy and bank stability: the analytical toolbox reviewed', Working Paper Series, No 2377, February 2020. It cites many sources (for and against) different kinds of policies.

(fn 4) Raichle v. Federal Reserve Bank of New York, 34 F.2d 910 (2d Cir. 1929).

(fn 5) M. Lamandini, D. Ramos, and J. Solana, 'The European Central Bank (ECB) as a catalyst for change in EU Law. Part 1: The ECB's mandates', (2016) Columbia Journal of European Law, 23(2), p. 18.

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