12 September 2012 for a single supervisory mechanism (SSM) involving the ECB, to be established through a Council regulation on the basis of Article 127(6) of the Treaty. The Governing Council considers an SSM to be one of the fundamental pillars of a financial union and one of the main building blocks towards a genuine Economic and Monetary Union. The ECB will formally issue a legal opinion in which it will, in particular, take into account the following principles: a clear and robust separation between supervisory decision-making and monetary policy; appropriate accountability channels; a decentralisation of tasks within the Eurosystem; an effective supervisory framework ensuring coherent oversight of the euro area banking system; and full compatibility with the Single Market framework, including the role and prerogatives of the European Banking Authority. As the Commission proposal sets out an ambitious transition schedule towards the SSM, the ECB has started preparatory work so as to be able to implement the provisions of the Council regulation as soon as it enters into force.

This issue of the Monthly Bulletin contains two articles. The first article provides a detailed definition of global liquidity, assesses how it can ultimately influence domestic price stability and discusses the implications for monetary policy. The second article documents developments in euro area labour markets since the start of the economic and financial crisis in 2008 and reviews the impact of the crisis on structural features of euro area labour markets.

Box 1

COMPLIANCE OF OUTRIGHT MONETARY TRANSACTIONS WITH THE PROHIBITION ON MONETARY FINANCING

On 6 September 2012 the Governing Council of the ECB decided on the modalities for undertaking Outright Monetary Transactions (OMTs) in secondary markets for sovereign bonds in the euro area.[1] While the acceptance of government bonds or other public debt instruments as collateral by Eurosystem central banks in the context of credit operations with monetary policy counterparties has been considered compatible with the monetary financing prohibition since the start of EMU, this box deals briefly with the compliance of OMTs with the prohibition on monetary financing.

From the ECB's perspective, OMTs are a necessary, proportional and effective monetary policy instrument. They aim at ensuring an effective transmission of the Eurosystem's monetary policy and, thereby, at securing the conditions for an effective conduct of the single monetary policy within the euro area, with a view to achieving its primary objective of maintaining price stability. In defining the operational modalities for OMTs, particular care has been given to the need to comply with the prohibition on monetary financing laid down in Article 123 of the Treaty on the Functioning of the European Union (TFEU). This Article prohibits the ECB or NCBs from purchasing public debt instruments on the primary market. Moreover, secondary-market purchases of public debt instruments – although allowed, in principle, under the monetary financing prohibition – must not be used to circumvent the objectives of the prohibition on monetary financing. Such clarification is provided for in Council Regulation (EC) No 3603/93.[2] In the context of OMTs, secondary-market

1 See the box entitled "Monetary policy measures decided by the Governing Council on 6 September 2012", *Monthly Bulletin*, ECB, September 2012.

2 Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 [renumbered after the Lisbon Treaty as Article 123 TFEU] and 104b(1) [renumbered after the Lisbon Treaty as Article 125 TFEU] of the Treaty (OJ L 332, 31.12.1993, p. 1).

purchases of public debt instruments will, under no circumstances, be used to circumvent the objectives of the prohibition on monetary financing. In particular, specific operational modalities have been set up to ensure that OMTs do not interfere with the three objectives of the monetary financing prohibition, namely safeguarding (i) the primary objective of price stability, (ii) central bank independence, and (iii) fiscal discipline. A major concern has been the need to ensure that this monetary policy instrument could not ultimately weaken fiscal discipline.

OMTs as a monetary policy measure to achieve the primary objective of price stability

A necessary monetary policy measure

The current situation is characterised by severe distortions in government bond markets which originate, in particular, from unfounded fears on the part of investors of the reversibility of the euro. This translates into severe cases of malfunctioning in the price formation process in the government bond markets, which undermines the functioning of the monetary policy transmission mechanism. Government bond markets play a key role at various stages of the transmission mechanism in the euro area. Thus, the efficacy of standard monetary policy tools in the affected jurisdictions has been reduced by market dysfunctions impairing the transmission mechanism. This warrants action by the ECB to mitigate medium-term risks to price stability. Thus, OMTs are a non-standard, but necessary, monetary policy instrument in the current exceptional circumstances in financial markets. The use of outright purchases of bonds as a monetary policy tool is expressly provided for in Article 18.1 of the Statute of the ESCB.

A proportional monetary policy measure

OMTs will only be used to the extent necessary to achieve the objective of maintaining price stability. The Governing Council will consider them as a monetary policy tool insofar as they are warranted from a monetary policy perspective. Following a thorough assessment, the Governing Council will decide on the OMTs necessary to address the malfunctioning of certain market segments. This assessment implies a strict selection of the Member States for which OMTs are carried out. Moreover, OMTs will be focused on purchases of government bonds with maturities of between one and three years, thereby underlining the close link to traditional monetary policy. Furthermore, the Governing Council will terminate OMTs once their objectives have been achieved.

An effective monetary policy measure

Specific modalities for undertaking OMTs have been established in order to maximise the OMTs' positive impact on the functioning of the monetary policy transmission mechanism. The effectiveness of OMTs is linked to the due and timely adoption by Member States of macroeconomic, structural, fiscal and financial measures aimed at restoring and maintaining their macroeconomic fundamentals. The undertaking by the Eurosystem of OMTs in the sovereign bond market of a Member State is therefore based on that State's compliance with its commitments and timelines under the economic governance framework applying to the euro area. Strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme, including the possibility of EFSF/ESM primary-market purchases, will be essential, while IMF involvement will be sought. This will not, however, be sufficient. The Governing Council will have full discretion in deciding on the start, continuation and suspension of OMTs and will act in accordance with its monetary policy mandate. It will consider OMTs to the extent that they are warranted from a monetary policy perspective and will terminate them once their objectives have been achieved or in cases where there is non-compliance with the programme. For this purpose, the Governing Council will closely monitor all developments and make the necessary assessments.

Neutral impact on liquidity conditions
The liquidity created through OMTs will be fully sterilised. With the total absorption, there will be no increase in the supply of base money and no change in the liquidity conditions.

Fiscal discipline

In order to ensure and maintain fiscal discipline, OMTs will be restricted to Member States which are subject to strict conditionality covering the necessary macroeconomic, structural, fiscal and financial adjustment needs. Any purchases of government bonds of those Member States will be focused on bonds with maturities of between one and three years. These operational modalities are essential to ensure that OMTs do not impair simultaneous tangible progress by those Member States in the areas of fiscal consolidation and, in particular, longer-term structural reforms.

Central bank independence

The operational modalities for OMTs have been designed by the Governing Council, in full independence, from the perspective of what is necessary, proportional and effective for monetary policy purposes. The Governing Council will have full discretion in deciding on the start, continuation and suspension of OMTs in accordance with its monetary policy mandate.