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Prohibition of monetary financing: an economic perspective

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Contents

Abstract

This paper analyses the European prohibition of monetary financing from an economic perspective. The prohibition seeks to safeguard central bank independence in setting monetary policy to maintain price stability, and to preserve fiscal discipline, thereby preventing monetary policy from becoming constrained or hindered by fiscal policies. Imposing a prohibition on financing public deficits helps to ensure a clear separation of responsibilities between monetary policy and fiscal policy and is consistent with a range of macroeconomic theories, including monetarism and the fiscal theory of the price level. The current EU-wide ban is more stringent than those in place in Europe before the start of Economic and Monetary Union and also than those prevailing in other major currency areas of the world. Tasked with monitoring compliance with the prohibition among European national central banks, the European Central Bank (ECB) has developed certain standards over time, informed by definitions contained in EU regulations and by cases that have arisen over the years. Over the three decades since its introduction, the prohibition in general has been well respected, although a few actual or potential conflicts with the prohibition have required national central banks to take corrective action. Recent economic crises in Europe have given rise to academic proposals to reinterpret or circumvent the ban, notably during the COVID-19 pandemic. These suggestions have included central banks handing out “helicopter money” to the public and cancelling part of the government debt held by European central banks. In general, these proposals would seem to jeopardise the prohibition of monetary financing and ultimately weaken price stability and sound public finances.

JEL codes: E58, E61, E62, F45, K33

Key words: monetary financing, debt monetisation, fiscal policy, monetary policy

Non-technical summary

This paper analyses the European prohibition of monetary financing from an economic perspective. The prohibition, as set out in the Treaty on the Functioning of the European Union, forbids the ECB and the national central banks of the EU from granting credit to governments or purchasing their bonds at issuance. Having such a ban in place helps to ensure that central banks act independently in safeguarding price stability, while also providing incentives to preserve fiscal discipline, thus preventing monetary policy from becoming constrained or hindered by fiscal policy. By cutting off access to central bank financing, government debt is subject to the disciplinary forces of the market, much like private sector debt. Imposing such a prohibition on financing public deficits is consistent with a range of macroeconomic theories, including monetarism and the fiscal theory of the price level, although this approach is not without its detractors, including proponents of Modern Monetary Theory.

The EU-wide ban is more stringent than those in place in Europe before the start of Economic and Monetary Union (EMU) and also than those prevailing in the United Kingdom and the United States. Whereas some form of monetary financing is usually permitted in other countries when certain exceptional conditions are fulfilled, the prohibition as defined in Europe makes no provision for this. This strict approach reflects a desire to replicate the credibility of the Deutsche Bundesbank and counters the risk of a larger deficit bias arising in EMU, as national central banks and exchange rates are no longer able to counter unsound fiscal policies, while more integrated financial markets facilitate government borrowing.

The ECB has been tasked with monitoring compliance with this prohibition among EU national central banks. Over the three decades since its introduction, the prohibition in general has been well respected, although a few actual or potential conflicts with the prohibition have required national central banks to take corrective action. These include cases that have surfaced multiple times in the ECB Annual Reports, notably concerning activities by Magyar Nemzeti Bank, Hungary’s central bank, that fell outside the remit of a central bank (e.g. large-scale purchases of artwork), the Central Bank of Ireland’s acquisition of government securities related to the liquidation of an Irish bank and, more recently, the financing by some central banks of debt relief for low-income countries via IMF trusts. Overall, compliance with the prohibition is supported by the possibility of the ECB initiating infringement proceedings against national central banks.

The ECB has developed certain standards for enforcing the prohibition of monetary financing over time, informed by definitions contained in an EU regulation and by cases that have arisen over the years. Interest in the possibilities and implications of the monetary financing prohibition rose when the ECB initiated programmes that included purchases of government bonds on secondary markets, to support the transmission of monetary policy and/or to provide an additional monetary impulse when inflation was too low. While such programmes may have favourable effects on governments’ financing conditions, the same is true when a central bank lowers its key interest rates. Compliance with the prohibition requires that the purchases have no effect equivalent to that of direct purchases of government bonds, and that

sufficient safeguards are in place to ensure that the purchases do not reduce countries' incentives to pursue sound budgetary policies. Standards have also been developed for other activities, such as central banks acquiring government bonds outside ECB monetary policy, central bank financing of obligations vis-à-vis the International Monetary Fund (IMF), the remuneration of government deposits at central banks, and national tasks performed by central banks.

Recent economic crises in Europe, particularly the COVID-19 pandemic, have given rise to academic proposals to reinterpret or circumvent the ban. These suggestions include the cancellation of part of the government debt held by central banks and the handing out of "helicopter money" by central banks to the public. The proposals are typically characterised by a permanent increase in the money supply and an emphasis on providing cheap funding for government spending. In general, these ideas are not compatible with the prohibition of monetary financing. Their permanent nature is inconsistent with the flexibility needed to adjust monetary policy to maintain price stability, and their focus on providing cheap financing to governments or taking over a national task would be tantamount to monetary financing. Moreover, governments would come to expect such central bank support, thus limiting their incentives to pursue sound and sustainable public finances.

Looking forward, while the prohibition is firmly anchored in the Treaty on the Functioning of the European Union, historically high government debt, low structural growth rates, a sequence of supply shocks, the rise of populism and threats to central bank independence worldwide may once again increase pressure on central banks to use monetary financing to address macroeconomic and fiscal challenges. To enable the ECB to fulfil its price stability mandate and maintain incentives for sound and sustainable public finances, it will be essential to keep these risks at bay.

1 Introduction

A major motivation for the creation of central banks since the seventeenth century has been the financing of government debt. Nowadays, however, central banks play a very limited role in providing finance to governments, given the adverse economic and financial consequences of engaging in such practices, as witnessed during past episodes of hyperinflation in Germany and elsewhere. In most advanced economies, monetary financing is no longer allowed, or is permitted only in exceptional circumstances (e.g. severe crises) and only if specific conditions are met (see, for example, Jacome et al., 2012).

Some three decades ago, policymakers in Europe faced the question of what the prohibition of monetary financing in the European Union (EU) should look like when they went about the task of establishing Economic and Monetary Union (EMU). The outcome was a strict ban that does not allow for any central bank financing of government deficits, with no exception made for voluntary financing of deficits or financing in exceptional circumstances, both of which had been common practice prior to EMU. Moreover, the prohibition was enshrined in a supranational treaty as a requirement, rather than merely a consideration, thus making it a hard constraint, including on the use of monetary policy instruments. The ban currently in place was influenced by macroeconomic theory and empirical evidence emphasising the benefits of a regime of "monetary dominance", as well as by the new institutional context created by EMU, which was feared would give rise to fiscal relaxation.

Over time, and especially since the ECB started purchasing assets in response to successive crises and low inflation, the prohibition has become a subject of public debate.[1] Views range from claims that the ECB was de facto engaging in monetary financing to accusations that it has been too strict in interpreting the prohibition, thereby aggravating crises. Discussions intensified during the COVID-19 pandemic, with suggestions that central banks hand out "helicopter money" to euro area citizens or write down government debt on their balance sheets.

This paper focuses on the prohibition as set out in the Treaty on the Functioning of the European Union (subsequently the "European Treaty"), which forbids the ECB and the national central banks (NCBs) from granting credit to governments or purchasing their bonds at issuance. Other concepts of monetary financing (sometimes referred to as "debt monetisation", especially in the United States) have also been used in the literature. For some observers, monetary financing also refers to central bank purchases of government bonds on the secondary market financed by issuing reserves ("printing money"), which are regarded as "hidden", "shadow" or "indirect" forms of monetary financing, or monetary financing "from an economic perspective". Others consider the permanent nature of an increase in the monetary base aimed at supporting the funding of government spending to be a crucial

1 Throughout the paper, references will be made to the ECB as decisions on monetary policy and on compliance with the monetary financing prohibition are a competence of ECB's Governing Council (comprising ECB Executive Board members plus all governors of the central banks of euro area countries).

element of monetary financing, or place greater emphasis on which policymaker (central bank or government) ultimately makes the relevant decisions.

Economic aspects of the prohibition of monetary financing are central to this paper, ranging from the macro-theoretical reasons supporting a strict ban to proposals for reinterpreting/circumventing the prohibition in order to address economic and/or fiscal crises.[2] Inevitably, it also touches upon certain legal aspects, as the prohibition is a key provision of the European Treaty and the case law of the Court of Justice of the European Union (CJEU) has shaped the ECB's interpretation.

This paper is organised as follows. Section 2 describes the history of the EU prohibition, its objectives and the theories supporting it. Section 3 then discusses how the prohibition has been interpreted and how the ECB has gone about monitoring it, while Section 4 illustrates how the prohibition has been applied in several key cases. Section 5 examines proposals in the literature to reinterpret or circumvent the ban in view of the crises experienced by Europe, while Section 6 concludes.

[2] The legal aspects of the prohibition are discussed, for instance, in Lopez Escudero (2021) and Gortsos (2024).

2 History of the EU prohibition

2.1 Monetary financing before EMU

Restrictions on central bank financing of governments seem a far cry from the historical reasons for establishing central banks, one of the main ones being to provide finance to the state and manage their debt (alongside issuing banknotes to provide stable money and backstopping the stability of the banking system). This fiscal role diminished over time, reflecting also periods of hyperinflation following massive central bank financing of deficits and the development of bond markets, which enabled governments to borrow without having to rely on the central bank. Exceptions occurred during and after wars and during severe financial crises, when central banks sometimes acted as lenders of last resort to governments (not just to banks), with the ensuing bout of high inflation serving to reduce the real value of outstanding debt.[3] Nowadays, central banks typically pursue price stability as their primary objective.

Before the start of EMU, nearly all EU countries had restrictions in place on central bank loans to governments and on purchases of government securities (see, for example, European Parliament, 1990; Leone, 1991; Cottarelli, 1993). However, the rules usually allowed central banks to make cash advances to governments in order to cover seasonal fluctuations in government revenues and expenditures. Moreover, some central banks purchased government debt up to specific limits or acted as residual buyers of government securities – especially short-term debt – if private sector demand proved insufficient (see also Bateman and van ‘t Klooster, 2023). If deemed necessary, such limits could usually be, and often were, loosened.

2.2 Defining the EU prohibition

When laying the foundations for EMU, two main purposes drove the discussions on defining the prohibition in the EU Treaty:

- protecting the central bank, as monetary financing can endanger price stability and undermine central bank independence:
- supporting sound public finances by enhancing the disciplinary forces of the market mechanism.

The first motivation emphasises the need to create a situation in which monetary policy takes precedence over fiscal policy, with the central bank primarily focused on maintaining price stability without being influenced or constrained by fiscal policy (“monetary dominance”). This consideration played a major role in the views of

[3] Other ways used to reduce government borrowing costs include setting a cap on interest rates, exerting pressure on central banks to lower interest rates, and asking for a larger and/or faster pay-out of central bank profits (Adrian et al., 2021).

central bankers during the run-up to EMU. Already in 1989, then Bundesbank President Pöhl opined that: *“The financing of public sector deficits by the central bank (apart from occasional cash advances) makes effective monetary control impossible over the long term. For a European central bank to be able to fulfil its mandate to ensure monetary stability, strict limitations must be imposed on its granting credit to public authorities of all kinds (including Community authorities).*”

At that time, the option of voluntary monetary financing was still on the table, in line with existing practices. In subsequent discussions, the Committee of Governors argued against any voluntary (short-term) overdraft facility and voluntary purchases of government bonds on the primary market. A note from the Economic Unit of the Committee (1991) argued that, while occasional short-term credit to government could help smooth out short-term market fluctuations, it could also raise concerns about central bank independence, as markets might expect temporary monetary financing to persist over time. It could also weaken market discipline. At the decisive 1990-91 Intergovernmental Conference, Greece, Ireland and the United Kingdom objected to removing the option of voluntary monetary financing but ultimately accepted the restriction, although the United Kingdom was granted an exception for its Ways and Means credit facility provided that it did not join the euro (see Van den Berg, 2004).

At the same time, the prohibition seeks to promote sound public finances, this being the second main motivation. Ultimately, this purpose came to have greater legal prominence, as reflected by its position in the Treaty: it is part of Chapter 1 (economic policy), not Chapter 2 (monetary policy). This primary aim has been confirmed by the CJEU (2015), which stated that the aim of the prohibition is *“to encourage the Member States to follow a sound budgetary policy, not allowing monetary financing of public deficits … to lead to excessively high levels of debt or excessive Member State deficits”.*

The prohibition is located alongside other Treaty provisions designed to ensure that public finances are subject to market forces, placing government debt on the same footing as private debt, in line with the principle of an open market economy: no privileged access of governments to financial institutions (Article 124; also see Box 1) and no bail-out of one EU country by other EU countries (Article 125). The underlying idea is that unsustainable public finances give rise to higher long-term interest rates as credit risk increases, which should incentivise governments to return to sound and sustainable public finances. However, recognising that financial markets do not operate perfectly, that interest rates may adjust in a non-linear way, and that governments may react late and/or only partially to market dynamics, these safeguards were supplemented by rules designed to avoid excessive deficits (Article 126), which set thresholds for national government deficits (3% of GDP) and debt levels (60% of GDP), as further specified in the Stability and Growth Pact.

One material consequence of the monetary financing prohibition in a monetary union with decentralised national fiscal policies is that the ECB cannot act as lender of last resort to governments. If a government’s solvency were to come under threat and markets were to lose confidence in its ability to repay its debt (i.e. bonds), the ECB would not be able to purchase that government’s bonds at issuance. In the absence of a fiscal union in EMU, this institutional gap requires an even greater emphasis on maintaining fiscal sustainability than in other currency areas.

Box 1
Prohibition of privileged access

The prohibition of privileged access (Article 124 of the European Treaty) complements the prohibition of monetary financing. It forbids governments from enjoying preferential access to financial institutions by obliging banks, insurance companies and pension funds to hold government debt or by granting them specific tax relief for that purpose. Such practices were common prior to EMU. For instance, commercial banks were required to invest a certain percentage of customers' deposits in government bonds, or financial institutions were required to provide credit at below-market rates (see Bruni, 1996). Like the prohibition of monetary financing, the ban on privileged access aims to subject public finances to market discipline.

Article 124 reads as follows: "Any measure, not based on prudential considerations, establishing privileged access by 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 to financial institutions, shall be prohibited."

An exception to the prohibition applies for prudential considerations, such as capital and liquidity requirements for financial institutions. This represents a material advantage for domestic government bonds, as they carry a zero risk weight (i.e. are considered risk-free) and are exempt from concentration limits. The additional demand for government bonds resulting from this preferential treatment supports favourable government financing conditions and strengthens the sovereign-bank nexus (see Van Riet, 2018). Additional exceptions apply in a few very specific cases, such as obligations imposed on primary dealers that actively participate in government bond issuances.

The prohibition also applies to certain ECB operations. In particular, government debt securities must be treated on an equal footing with private debt securities in the ECB's collateral policy, with differences allowed only on the basis of the solvency of the issuers or the liquidity of the markets for the debt instruments.

The prohibition of privileged access receives much less public attention than the prohibition of monetary financing, and hardly any instances of (potential) non-compliance with this prohibition have been recorded in the EMI/ECB Annual Reports. One exception concerns changes in Magyar Nemzeti Bank's monetary policy instruments that could have incentivised banks to purchase domestic government securities (ECB, 2015 Annual Report).

Coupled with the above requirements and a high degree of central bank independence, the prohibition of monetary financing helps to keep the single monetary policy separate from national fiscal policies. It is an essential condition for the central bank to fulfil its price stability mandate, by not allowing the use of monetary policy for other purposes (see Yiangou et al., 2013). Fiscal policy focuses on enhancing growth, employment and a fair allocation of resources, while helping to ensure sound and sustainable public finances, supported by the scrutiny of financial markets and fiscal rules. In this world with limited interactions, each policymaker focuses on its own task, with coordination taking place implicitly only. However, this separation is not absolute, given the financial links between governments and central banks. In particular, the monetary policy stance affects the interest rates at which governments can borrow in the market, with governments also benefiting from profit transfers (and in some cases taxes) paid out by central banks. Central bank purchases of government bonds on secondary markets have intensified these links by reducing interest rates on government bonds, with central bank profits initially increasing before turning into losses. The separation of responsibilities does not preclude dialogue: for instance, the European Commissioner for Economic Affairs attends Governing Council meetings without the right to vote, while the ECB President is free to attend meetings of the Council of Economic and Financial Affairs.

2.3 Macroeconomic underpinnings

The existing body of economic literature highlights that statutory central bank independence and a clear price stability objective are necessary conditions for achieving price stability, although fulfilling these conditions may not suffice in all cases. Financing government expenditures via taxes typically hampers economic growth and is inevitably unpopular among voters, while financing through bond issuance to the public may be costly in terms of the interest rate payable and may, at times, be limited if markets fear they will not be repaid in full and on time. Having access to monetary financing offers a third way of financing expenditures, via the central bank purchasing bonds at issuance or through central bank credit (including higher profit transfers to the government). This channel does not seem to carry the same immediate macroeconomic, financial and/or electoral costs and may therefore be an attractive option for governments. As a result, governments may be tempted to pressure central banks to provide monetary financing or may themselves take insufficient action to maintain sound and sustainable fiscal positions, which may in turn adversely affect macroeconomic and financial stability, making it costly for the central bank to maintain price stability. The monetary financing prohibition is therefore a key element in ensuring the central bank’s ability to maintain price stability, contributing significantly to a stable nominal anchor for inflation and inflation expectations.

While monetarist ideas strongly influenced the design of monetary policy at the ECB, including the need for a monetary financing prohibition, other macroeconomic theories also supported the inclusion of this provision.

2.3.1 Monetarism

Monetarist theory holds that inflation is “always and everywhere” a monetary phenomenon (Friedman, 1969). Models in the New Keynesian tradition also embody the property of the long-run neutrality of monetary policy. In these settings, monetary policy loosening can temporarily spur output but is neutral for economic activity in the longer term, showing up only as higher inflation. In this context, monetary financing of government deficits increases the money supply, which will lead to higher inflation sooner or later. Imposing a prohibition of monetary financing therefore allows the independent central bank to set money supply in line with medium-term price stability.[4]

2.3.2 Time inconsistency

Time-inconsistency theory (see Kydland and Prescott, 1977) points to the benefits of policymakers announcing a policy path but, once expectations are set, then deviating from that path, as this can temporarily boost output, employment and inflation. In particular, governments may pressure central banks to create "surprise" inflation to reduce the real value of government debt. However, such short-term gains come at the cost of longer-term credibility: when the public anticipates such monetary policy behaviour, inflation expectations are adjusted upward, leading to higher inflation without the desired economic stimulus. A credible commitment enshrined in central bank law forbidding monetary financing helps to ensure that central banks do not yield to such pressures, thereby supporting stable inflation expectations.

2.3.3 Unpleasant monetary arithmetic

Contrary to traditional monetarism, this theory holds that a central bank's ability to control inflation can be constrained by fiscal policies (see Sargent and Wallace, 1981). For example, let's assume a government runs a persistently large budget deficit and is unwilling or unable to raise sufficient revenues through taxation or borrowing. If the central bank raises rates to curb high inflation in such a situation, this will exacerbate fiscal deficits through higher interest rates and lower economic growth. Private agents therefore perceive a higher risk of government finances derailing, raising expectations that the central bank will eventually give in and issue more reserves to banks to generate a higher profit ("seigniorage") for the government.[5] Anticipating higher future inflation, households and firms bring forward their purchases, raising current inflation. Therefore, a restrictive monetary policy when public finances are in dire straits may result in higher – not lower – inflation, hence the term "unpleasant monetary arithmetic". Central bank independence therefore needs to be supplemented by limits on government deficits and debt to avoid unsustainable public finances. Adding a ban on monetary financing also makes it harder for governments to pressure central banks to facilitate their funding needs at the expense of price stability.

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4 Reflecting monetarist views, the ECB, in its early years, assigned a prominent role to money as one of the two pillars of its monetary policy strategy, indicative of longer-term inflationary trends. This was subsumed in a broader monetary and financial analysis in 2021.

5 Kase et al. (2026) model this mechanism assuming the existence of a ceiling on the debt ratio, which translates into a ceiling on policy rates, as beyond a certain point policy rates would push debt above the debt limit, with severe consequences, including a possible political backlash. Markets anticipate that the central bank will pay less attention to price stability as it approaches the debt ceiling, leading to higher inflation expectations that feed into current inflation.

2.3.4 Fiscal Theory of the Price Level (FTPL)

FTPL rests on interpreting the intertemporal government budget constraint as an equilibrium condition, requiring that the present value of future primary surpluses matches current government debt (see, for example, Leeper, 1991; Woodford, 1996). Under monetary dominance, monetary policy is said to be active, setting its preferred path for achieving price stability, and if fiscal policy is not sustainable – i.e. if future surpluses are insufficient to cover current debt – the government adjusts the primary surplus ("passive fiscal policy"). However, in a world with active fiscal policy and passive monetary policy, the real value of government liabilities (money and bonds) adjusts via changes in the price level. For example, a tax cut that is not expected to be reversed raises after-tax income and inflation. A tighter monetary policy then can raise inflation by increasing households' net interest income, which is then spent. In such a case, it is therefore the fiscal stance rather than monetary policy that determines the price level. This theory therefore emphasises the importance of setting limits on government finances for enabling monetary policy to achieve price stability without being subject to fiscal dominance. The ban on monetary financing limits opportunities for governments to succeed in exerting pressure for easy solutions via monetary financing, thus contributing to monetary dominance and making monetary policy more credible.

While both the theory of unpleasant monetary arithmetic and the FTPL focus on national situations, with one government and one central bank, they also have some relevance for monetary unions with decentralised fiscal policies such as the EMU. If several of its countries, or one or more major countries, find themselves in fiscal dire straits, the situation may resemble that of a one government, one central bank setting, especially if markets perceive government debt as being implicitly guaranteed by the union or by the central bank. A rise in government debt in one country that is not backed by future taxes can raise the price level throughout the wider monetary union. Such a situation may arise more easily in a monetary union, as national governments may not internalise the impact of their actions on euro-area-wide inflation, leading to excessive debt issuance and inflation and putting pressure on the central bank to accommodate this through monetary financing. At the same time, the ECB is not the lender of last resort to governments, which makes restoring equilibrium in a monetary union through higher risk premiums and, ultimately, a debt default more likely than through higher inflation, compared with national situations involving one government and one central bank.

The idea of shielding monetary policy from government influence was furthermore supported by the growing importance of central bank independence, both in theory (see, for example, Rogoff, 1985; Alesina and Summers, 1993) and in practice. Institutional economics point in the same direction, supporting a strict separation between monetary and fiscal policy, as central banks are not subject to ordinary judicial review or parliamentary oversight and therefore should not engage in quasi-fiscal activities through monetary financing (Bateman, 2021).

2.3.5 Modern Monetary Theory (MMT)

A rather contrarian view has more recently been put forward by MMT (see, for example, Mitchell et al., 2019; Cauneau, 2025), strongly supporting monetary financing. It asserts that inflation is not the result of excessive money creation but of real resource constraints (e.g. labour shortages), which are best tackled by fiscal policy. Fiscal policy should aim to achieve full employment with price stability, with government debt solvency not being a concern for countries that issue their own currency, as they cannot be financially constrained. Lacking a price stability role, monetary policy should aim for low interest rates so that the government can borrow on favourable conditions and growth is adequately supported. To ensure positive but low interest rates, the government may issue government bonds that have the effect of lowering interest rates by increasing bank reserves, thus avoiding any crowding-out. As monetary financing is a legitimate and effective tool for governments that issue their own sovereign currency, there is no need for central bank independence under MMT.[6]

MMT theory has been heavily criticised (see, for example, Drumetz and Pfister, 2021), among other reasons, because governments are more prone to increase net spending than to lower it due to short-term political considerations, thus creating an inflationary bias; because fiscal policy operates with significant time lags; and because permanently low interest rates encourage excessive risk-taking and asset bubbles. In any case, MMT is not particularly relevant to the EMU, given the region’s centralised monetary policy and fiscal policies that are decided at the national level, without governments having control over monetary policy.

2.3.6 Other relevant considerations

Most of the theories described above therefore support restrictions on monetary financing. The strictness of the current prohibition, which does not allow for any temporary or voluntary central bank financing of deficits, as had been the case prior to EMU, may be attributed to the unique nature of EMU. In particular, centralised monetary policy combined with decentralised national fiscal policies could lead to less emphasis being placed on sound public finances. Before EMU, a national central bank could counter national fiscal measures posing a threat to price stability, while exchange rate developments could act as a countering market-based disciplinary device. In EMU, these countervailing forces are no longer in place, given the existence of a single monetary policy for the entire euro area and a single currency. Moreover, integrated financial markets since the start of EMU have created a large common pool of savings, enabling cheaper financing and therefore increasing the deficit bias.

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6 Galle and Listokin (2022) take a middle position between conventional theory and MMT, arguing that an independent central bank may consider monetary financing (purchasing government bonds with newly minted money) if the marginal social costs of inflation are lower than those of raising additional government revenue through taxation. In their view, this would be the case only if the demand for holding money is nearly inexhaustible, as may occur during crises.

Another relevant factor explaining the strictness of the current prohibition was the desire to replicate the credibility of the Deutsche Bundesbank, which had been the anchor of monetary stability in Europe before EMU. Leaving the door even slightly open to monetary financing could raise doubts over the ECB's anti-inflation commitment, particularly when we consider that it was a new institution at that time and looking to earn full credibility. This aspect may have been reinforced by the supranational nature of the ECB, with all central bankers – including the President of the Bundesbank – each having just one vote on the Governing Council. Conservative central bankers would thus risk being outvoted if other Council members supported a lenient interpretation of "voluntary" monetary financing or occasionally yielded to pressure from governments to engage in monetary financing due to "exceptional circumstances". The German Federal Constitutional Court also supported this strict approach by emphasising the monetary financing prohibition as a fundamental constitutional condition for Germany's participation in EMU, as failure to achieve a "stability community" could be seen as valid grounds for Germany to leave EMU.

2.4 Practices in other major currency areas

The strictness of the final wording of the prohibition is evident not only by comparison with pre-EMU experiences in Europe, but also when compared with exceptions to the monetary financing prohibitions that exist in other major currency areas, such as the United States and the United Kingdom.

2.4.1 United States

The press release following the 1951 Accord between the US Treasury and the Federal Reserve (Fed) stated*: "The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt."*[7]

Direct financing of government securities by the Fed has not been allowed since 1935, with purchases to be made only in the open market.[8] However, the Fed may make direct purchases when reinvesting the proceeds of maturing securities, by placing non-competitive bids in public auctions, thus purchasing on the primary

7 See https://fraser.stlouisfed.org/archival-collection/william-mcchesney-martin-jr-papers-1341/reports-472962?page=111. The Accord itself does not refer to monetary financing.

8 Federal Reserve Act, section 14: "Any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest may be bought and sold without regard to maturities but only in the open market". See Garbade (2019) and https://www.federalreserve.gov/aboutthefed/section14.htm. An exception applied between WWII and 1981.

market but without influencing prices.[9] The Fed limits its holdings to 70% of the total outstanding amount of any individual Treasury security.

In 2020, the Fed exceptionally lent directly to states, counties and cities through its Municipal Liquidity Facility (see Haughwout et al., 2022) to enhance the liquidity of the primary short-term municipal securities market. The decision was based on Section 13(3) of the Federal Reserve Act, which allows the Fed to lend to bank and non-bank entities "in unusual and exigent circumstances", subject to Treasury approval. The facility, with a capacity of $500 billion, enabled lending to investment-grade government entities in exchange for short-term anticipation notes[10], with the U.S. Treasury providing $35 billion to cover potential losses.

2.4.2 United Kingdom

The Bank of England (BoE) was subject to the EU prohibition of monetary financing from 1994 until the United Kingdom left the EU ("Brexit") at the end of 2020. However, it benefited from an exception for its "Ways and Means" facility, a government overdraft facility that would otherwise have qualified as monetary financing. The Treasury drew £20 billion from this facility over a few weeks in 2008, compared with around £0.4 billion under calmer circumstances. During the pandemic that emerged in 2020, the BoE and the Treasury agreed to temporarily expand the overdraft facility without imposing a ceiling, allowing the government to smooth its cash flow, although ultimately the Treasury did not make use of this additional capacity.

The central banks in the United States and the United Kingdom are therefore also subject to restrictions on monetary financing, but unlike in the EU, exceptions are permitted in special circumstances.

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9 Allotments to the Fed are add-ons to the publicly offered amounts, ensuring that the Fed receives the full amount of the bonds it requests.

10 Short-term notes issued by municipalities in anticipation of the receipt of (tax) revenues or bond issuances.

3 Interpreting and monitoring the prohibition

3.1 Definition of the prohibition

The text of the prohibition of monetary financing, as enshrined in the European Treaty[11], reads as follows:

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.

The wording of the prohibition requires some further clarification, which has been partly provided through secondary EU legislation (Council Regulation No 3603/93, 1993).

“Overdraft facilities” refer to the provision of funds to governments resulting, or likely to result, in a debit balance.

As for “other types of credit facility”, this includes operations that are economically equivalent to credit, such as non-reimbursable loans or gifts to governments, or providing resources to governments for free, such as by allowing central bank staff to work for governments. It also includes financing of national obligations towards other parties. Therefore, a central bank should not, for instance, finance an insolvent financial institution, as the recapitalisation of banks is the government’s responsibility. However, providing liquidity to a solvent but illiquid bank is possible, if needed, outside regular monetary policy operations.[12]

The prohibition applies to the public sector in a broad sense, covering not only the central governments of EU Member States but also regional and local governments, public undertakings and European institutions and bodies (e.g. the European

[11] Article 123 of the Treaty on the Functioning of the European Union (TFEU), ex Article 101 of the Treaty establishing the European Community (TEC), ex Article 104 of the Treaty on European Union (“Maastricht Treaty”).

[12] With a view to maintaining financial stability, central banks may provide Emergency Liquidity Assistance to illiquid but solvent financial institutions against a wide range of collateral, subject to conditions including short-term duration, high interest rates, and no interference with monetary policy.

Stability Mechanism). This broad definition of the public sector limits the opportunity to circumvent the prohibition through government-linked bodies.

The prohibition on buying debt instruments “directly” from government institutions means that this may not take place at issuance, as doing so would be tantamount to providing finance to the government. Purchases on secondary markets are, in principle, allowed, as they do not entail financing and the new debt has already been subject to market pricing, thus not weakening market discipline. The ESCB/ECB Protocol – part of the Treaty – specifies that central banks may “operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claims and marketable instruments” to achieve the objectives of the ESCB and carry out its tasks (Article 18.1).

The exception for publicly owned credit institutions in paragraph 2 implies that these banks can participate in monetary policy liquidity-providing operations on the same terms and conditions as commercial banks.

A few exceptions to the prohibition have been defined in secondary EU legislation to account for other central bank tasks, notably the fiscal agent function and foreign reserve management. These exceptions cover intraday credit to the public sector, credit arising from the collection of cheques on behalf of the public sector, credit resulting from central bank holdings of coins issued by the public sector, and central bank financing of public sector obligations vis-à-vis the IMF, all within certain limits or subject to certain conditions (see Wittelsberger, 1994). While such transactions could be classified as monetary financing under a literal interpretation of the prohibition, they are considered not to undermine the purpose of the prohibition.

The distribution of central bank profits to their owners – usually national governments – has also garnered some discussion in the economic literature. This practice could lead governments to pressure central banks to print more money to increase the size of the profit flowing to the government (see, for example, Cottarelli, 1993, and Bateman, 2021, who refers to this as indirect monetary financing), at the expense of price stability and financial independence. However, it was decided to prolong existing practices, likely reflecting the robustness of the other safeguards for price stability already in place.[13]

Apart from asking for larger profits, governments might also seek to speed up the transfer of profits to fill budgetary gaps. To avoid such a practice, which is similar to requesting a loan from the central bank, it has been clarified that no distribution of central bank profits may take place before their full realisation, accounting and auditing, and that profit transfers may not be paid out of central banks’ reserves (ECB, 2025).

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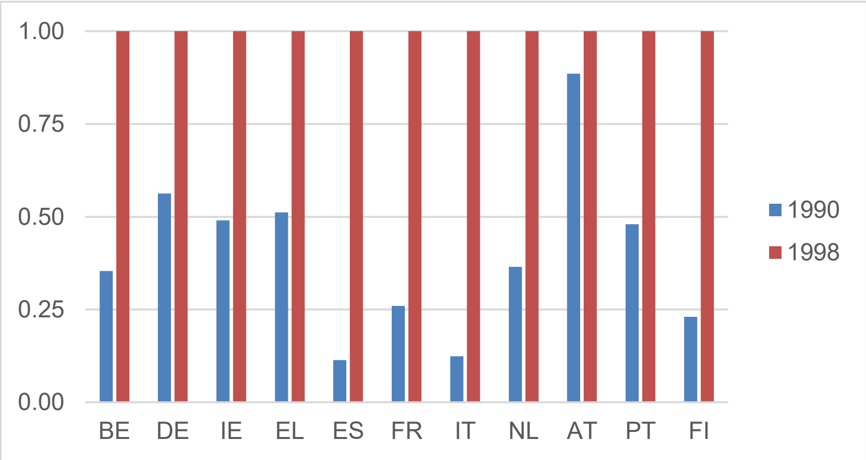
[13] The European Parliament unsuccessfully proposed making profit distributions an own resource of the Community.

3.2 Legal convergence

Progress towards compliance was rapid following the adoption of the European legal framework, including the ban on monetary financing. Taking Romelli's (2024) classification of lending to governments, Chart A below shows the position of the first eleven euro area countries on a scale from 0 (monetary financing) to 1 (strict limitations).[14] In 1990, before the start of EMU, Spain, Italy and Finland scored below 0.25 on the overall index, while only Austria scored above 0.75. Eight years later, in 1998, when the ECB started operating, all countries had already reached a value of 1, with most changes having already occurred around 1994, when the prohibition first took effect (see also Bruni, 1996). For comparison, the US Federal Reserve System scored 0.94 on Romelli's index in 1998, while the Bank of England scored 0.13.

Chart A

Limitations on lending to government, 1990 and 1998



Source: Romelli database (2024).
Note: A value of '0' indicates monetary financing, while a value of '1' indicates strict restrictions on lending to the government.

For some government debt held on central banks' balance sheets, grandfathering provisions were applied: stocks of non-negotiable central bank claims on the public sector acquired before 1994 were allowed to continue, provided they were converted into fixed-maturity claims (see EMI Annual Report, 1994).[15] This was motivated by concerns over disrupting the markets if large amounts of debt had to be sold in a short period of time, and by the fact that the main effects of the purchases already had already occurred (see Wittelsberger, 1994). Some of these claims still persist today (the last maturity date is around 2045) and continue to carry low interest rates, as no conditions were set regarding either the maturity of the claims or the interest rates payable.

[14] The score is based on the legal scope for central banks to finance governments, rather than on whether those powers have actually been used.

[15] A few central banks, such as those of Italy and Greece, had stepped up purchases of government debt just before 1994 (see ECB, 1995).

3.3 ECB monitoring process

The ECB is tasked with monitoring compliance with the prohibition among EU national central banks.[16] To that end, all EU central banks complete an annual questionnaire on activities that could be associated with monetary financing. The ex post monitoring covers many financial transactions undertaken by the central banks, including financial investments, and non-standard monetary policy actions taken by non-euro area NCBs, such as asset purchase programmes conducted by the Bank of England and Sveriges Riksbank. The ECB's non-standard monetary policy measures are in principle not subject to this exercise, as the ECB takes the prohibition into account when designing and calibrating its monetary policy instruments.[17]

The ECB's monitoring role is backed by its power to initiate infringement proceedings against national central banks (see also Korencsi et al., 2013).[18] If an NCB fails to respond to a negative monetary financing assessment of one or more of its activities[19], the ECB may initiate an infringement procedure by issuing a letter of formal notice to the NCB, requesting it to submit its observations by a specified date. If this does not succeed in resolving the matter, the ECB delivers a reasoned opinion, giving the affected NCB the opportunity to comment. If satisfactory corrective measures are not taken within a set deadline, the ECB may bring the matter before the CJEU, which can require the NCB to take the necessary action and, in the event of continued non-compliance, levy financial fines. So far, no infringement case has been put by the ECB before the CJEU. The mere availability of this infringement instrument, coupled with the adverse reputational effects for the NCB concerned were such a procedure to be initiated, may have supported early efforts to bring non-compliant policies in line with the prohibition (see Elderson, 2025).

The ECB communicates its standards and assessments of compliance with the prohibition through various channels:

- the ECB Annual Report (currently Section 9.3), which reports the main outcomes of the annual monitoring exercise;
- ECB Opinions on draft national legislation. While such opinions are non-binding, they clarify the position the ECB will take in the ex post

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16 The assessment was initially carried out by the ECB General Council, which includes all EU NCB governors, although responsibility for this task was subsequently taken over by the ECB Governing Council (including only euro area NCB governors) in 2006.

17 This exception reflects the ECB's governance structure, under which the ECB decides on monetary policy instruments as well as on compliance with the prohibition. For instance, the ECB Decision on the Public Sector Purchase Programme (PSPP) states: "The PSPP complies fully with the obligations of the Eurosystem central banks under the Treaties, including the monetary financing prohibition…".

18 The ECB may initiate an infringement procedure in the event of non-compliance with the prohibition, although it is under no obligation to do so, such as where the breach is considered minor and one-off. Where the NCB is willing to cooperate in resolving the issue but the relevant national government refuses to take the necessary action, the European Commission may also consider initiating an infringement procedure against that government.

19 Starting 2024, in addition to requiring reimbursement by the government, interest may also be charged on the reimbursement amount over the duration of the breach, with the relevant rate in principle being the national ten-year sovereign yield (ECB, 2024a).

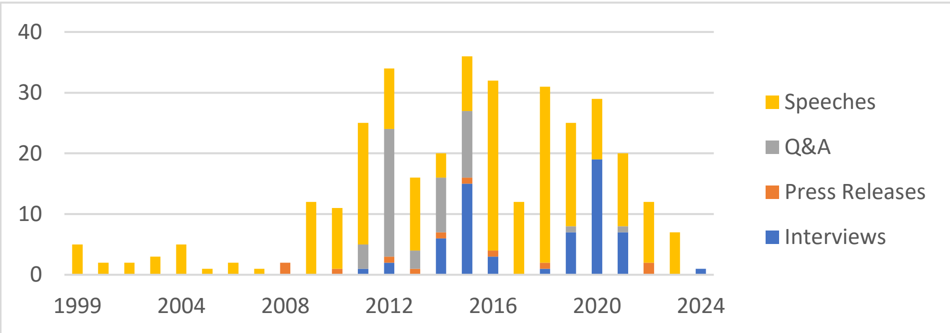
monitoring exercise from the prohibition's perspective should the legislation be adopted without due consideration of the concerns raised;

- ECB Convergence Report, which sets out practices in the candidate euro area countries against the convergence criteria, including legal convergence with the prohibition of monetary financing;
- ECB replies to letters from Members of the European Parliament (MEP);
- press conferences, speeches by, and interviews with ECB Board members.

Chart B below shows the number of references to monetary financing in speeches, press conferences (including the Q&A session), press releases and interviews with ECB Board members. It shows an increase over time, notably in speeches by ECB Board members and in questions raised at press conferences, with peak values observed in 2012, 2015 and 2020, when the OMT, PSPP and PEPP asset purchase programmes, respectively, were introduced. More recently, the number of references has declined, reflecting the absence of a major crisis and the wind-down of crisis-related monetary policy measures.

Chart B

References to "monetary financing" on the ECB website



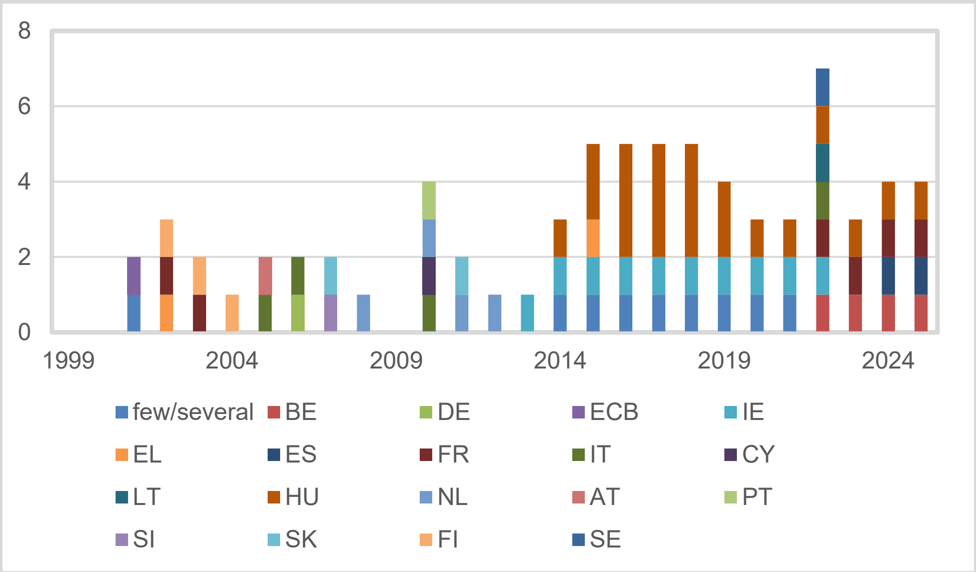
Note: Number of references to "monetary financing" on the ECB website in speeches, press conferences (including Q&A sessions), press releases and interviews with ECB Board members.

The outcomes of the monitoring of activities at risk of constituting monetary financing started appearing in the EMI/ECB Annual Reports in 1994, including the main cases of (potential) infringements. Such public reporting is a testimony to the ECB's monitoring process, incentivising the relevant central bank (and, where applicable, the government concerned) to bring its practices in line with the prohibition, while also serving to inform the public about how the ECB interprets the prohibition.

Discussions in the early years tended to focus on technical issues related to the change-over to the new set of rules, without naming the central banks involved. This changed following the establishment of the ECB (from 1 July 1998), when individual central banks were often mentioned (see Chart C). Apart from various isolated conflicts that many central banks experienced, relatively few cases surfaced repeatedly in the Annual Reports. The most notable concerned certain activities carried out by Magyar Nemzeti Bank, Hungary's central bank, outside its remit as a central bank (e.g. large-scale purchases of artwork); the Central Bank of Ireland's acquisition of government securities related to the liquidation of an Irish bank; and, more recently, several cases related to central bank financing of debt relief for low-income countries via IMF trusts. Section 4 contains more information on these cases.

Chart C

Central banks whose activity (potentially) conflicted with the monetary financing prohibition



Source: ECB Annual Reports.
Notes: The year refers to the year covered by the ECB Annual Report, which is published one year later. "Few/several" refers to cases in which more than one country was involved without the names of the countries being mentioned. In the case of Hungary, several activities were deemed to (potentially) give rise to monetary financing concerns, which are summarised here in three blocks (MARK, stock exchange, and other).

4 Standards and compliance

Over time, monetary financing standards have evolved in response to cases that have come to the ECB's attention, taking into account secondary EU legislation that further specifies or clarifies the terms of the Treaty provision (Council Regulation No 3603/93, 1993). Moreover, the CJEU has been asked to review central bank actions, notably the ECB's asset purchase programmes, with its judgments guiding the ECB's subsequent interpretation of the prohibition.[20]

While there are many aspects to the prohibition, the focus below is on cases that have garnered public attention: the ECB's asset purchase programmes, purchases of government bonds outside monetary policy operations, central bank financing of obligations vis-à-vis the IMF, remuneration of government deposits held at central banks, and central banks performing national tasks.

4.1 ECB monetary policy purchases of government bonds

Direct purchases of government debt by central banks, i.e. at issuance, are not allowed.[21] This applies also to the rollover of maturing debt through purchases on the primary market (see Draghi, 2014). Purchases of government debt on the secondary market are permitted if certain conditions are met (discussed further below).

The distinct treatment of purchases on primary and secondary markets reflects the fact that, in the case of primary market purchases, the government receives newly created money directly from the central bank in exchange for newly issued debt. In the case of secondary market purchases, another investor has already been paid at market prices, with the central bank transacting with the private investor, rather than with the government. Moreover, purchases at issuance may be regarded as direct central bank financing of the public sector, as the government sets the timing and maturity of the issuance, whereas for secondary market purchases the central bank can operate whenever it deems necessary, in whatever volumes and maturity bands it deems appropriate, given the high liquidity of sovereign bond markets. Forbidding primary market purchases may also serve an institutional signal function by strengthening the separation of monetary and fiscal policy (see Cottarelli, 1993).

The European Treaty explicitly refers to the purchase of government bonds on the secondary, open market as a potential monetary policy instrument. In normal times, however, the monetary policy stance is reflected in the key ECB interest rates that apply to refinancing operations, the main source of liquidity provision by the ECB,

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20 As an EU institution, the ECB's actions are subject to the CJEU's jurisdiction.

21 An exception applies to purchases of debt issued by other EU countries and denominated in currencies other than the euro in the context of foreign reserve management. Moreover, primary market purchases of debt instruments issued by public sector banks are permitted in the context of liquidity-providing operations, such as covered bonds issued by public sector banks in the context of the ECB's Covered Bond Purchase Programmes (CBPPs).

given the largely bank-based nature of financing for firms and households in the euro area.

The first ECB purchases of government bonds for monetary policy purposes took place between 2010 and 2012 under the Securities Markets Programme (SMP). The SMP covered secondary market purchases of government debt issued by Ireland, Greece, Spain, Italy and Portugal, motivated by severe tensions in certain market segments which had been hampering the monetary policy transmission mechanism. The liquidity created by these purchases was sterilised.

Outright Monetary Transactions (OMTs) replaced the SMP in 2012, following ECB President Draghi's "whatever it takes" speech. OMTs allow for secondary market purchases of government bonds, provided the country complies with strict conditions attached to a European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme aimed at restoring fiscal and macroeconomic stability. Adding this condition makes OMTs incentive-compatible, ensuring that bond purchases complement rather than weaken fiscal and structural reform efforts (Cœuré, 2013). As with the SMP, the liquidity created by purchases would be sterilised, so no new money would be created on a net basis. Purchases would focus on the shorter part of the yield curve (1-3 years) to "leave room for market discipline on longer maturities" (Draghi, 2012). A box in the ECB Monthly Bulletin of October 2012 (ECB, 2012) addresses potential monetary financing aspects of OMT, arguing that they are necessary, proportionate and effective, with several operational safeguards in place. So far, OMTs have not been used.

The ECB started its Asset Purchase Programme (APP) in 2014. While initially focusing on the purchase of private sector assets, government bonds were added to the purchase spectrum in March 2015 under the Public Sector Purchase Programme (PSPP). Given the ample supply of government bonds, these purchases were seen as capable of providing a meaningful boost to growth and inflation at a time when inflation was well below the 2% target and the ECB's interest rates were close to their lower bound. Therefore, the programme also aimed to provide an additional monetary impulse ("quantitative easing"), unlike the earlier programmes, which focused solely on supporting monetary policy transmission. Purchase amounts were subject to quantitative limits both per issuer and per individual bond (33% in both cases).

On top of these existing programmes, the Pandemic Emergency Purchase Programme (PEPP) was launched in March 2020 in response to the COVID-19 pandemic, to ensure "supportive financing conditions for all sectors in the economy, applying equally to individuals, families, firms, banks and governments". Under the PEPP, the eligibility requirements for Greek government securities, which had low credit ratings at the time, were waived. Moreover, it was stated that: "To the extent that some self-imposed limits might hamper action that the ECB is required to take in order to fulfil its mandate, the Governing Council will consider revising them to the extent necessary to make its action proportionate to the risks that we face".

Several aspects of the PEPP are noteworthy from a monetary financing perspective. For one, there is the explicit reference to ensuring supportive financing conditions for governments, which was absent under previous purchase programmes. Previously, purchases of government bonds were justified by the pivotal role played by government bond yields in the transmission of monetary policy to corporate bond yields and bank lending rates for firms and households. There is also a reference to "self-imposed" limits and to the option of relaxing them if needed in order to maintain price stability. This language should not be seen as subordinating the monetary financing prohibition to the primary objective of price stability, but rather as being consistent with the CJEU's interpretation in its Weiss judgment (CJEU, 2018), which states that "…in every case, only a minority of the bonds issued by a Member State can be purchased … which means that that Member State has to reply chiefly on the markets to finance the budget deficit", a passage that may be seen as suggesting a maximum limit of 49%.[22] Nevertheless, suggesting that the PEPP introduced a "dramatic transformation in attitudes toward monetary financing" and represented a paradigm shift (Van 't Klooster, 2021) is a step too far, as it fails to take account of the severe nature of the pandemic, which affected all euro area countries and was beyond the control of governments.

In 2022, the ECB established the Transmission Protection Instrument (TPI) to counter unwarranted, disorderly market dynamics posing a serious threat to monetary policy transmission across the euro area. In such cases, secondary market purchases of securities issued by countries experiencing deteriorating financing conditions that are not warranted by country-specific fundamentals may go ahead, subject to certain conditions. As with the other transmission instruments, the liquidity implications of any TPI purchases will be considered. No TPI purchases have been conducted to date.

Central bank asset purchases of the kinds listed above are sometimes associated with monetary financing. This view reflects a different concept of monetary financing, with some defining it as any purchase of government bonds financed through the creation of reserves ("printing money"), including purchases conducted on the secondary market. Moreover, concerns have been raised that such purchases were not conducted (solely) for monetary policy reasons, but also to support government finances, especially in Southern Europe.[23]

The interpretation of the prohibition in the context of asset purchases has been clarified in various CJEU cases, notably the Gauweiler case (CJEU, 2015) on OMTs and the Weiss case (CJEU, 2018) on the PSPP. In its assessments, the Court focused mainly on the objectives of the purchase programmes, granting the ECB broad discretion in its monetary policy choices given their technical nature, involving complex forecasts and assessments.

As regards secondary market purchases of government bonds, the Court held that these are not allowed if, in practice, they have an effect equivalent to that of a direct

[22] The size of central banks' holdings of government debt may also be relevant from a monetary financing perspective in the event of a government debt restructuring.

[23] This includes certain former Governing Council members arguing that continued asset purchases had barely any effect on growth, concluding that "…the suspicion that behind this measure lies an intent to protect heavily indebted governments from a rise in interest rates is becoming increasingly well founded. From an economic point of view, the ECB has already entered the territory of monetary financing of government spending, which is strictly prohibited by the Treaty" (Hannoun et al., 2019).

purchase of government bonds, such as where investors are certain that bonds purchased on the primary market can be resold to the ECB. Moreover, sufficient safeguards should be in place to ensure that purchases do not reduce countries' incentives to pursue sound budgetary policies. The favourable effects of asset purchases on long-term government interest rates do not constitute monetary financing, given that monetary policy always affects interest rates and refinancing conditions. Such effects on the interest rates that governments pay arise also when the central bank changes its policy interest rates.

According to the Court, the ECB's asset purchase programmes contain sufficient safeguards to fulfil both conditions. These include a blackout period[24] and limits on how much debt the ECB may hold from a specific government bond issue (issue limit: 33%) and of a given government's outstanding debt (issuer limit: 33%). Such limits prevent investors from being able to anticipate that bonds can always, or with reasonable certainty, be sold to the ECB, with private investors merely acting as intermediaries.[25] Other relevant PSPP safeguards are that purchases take place according to the ECB capital key, that bonds meet certain minimum credit rating requirements, that purchase volumes for the whole APP programme were announced in advance, but not for the PSPP, and that net purchases are temporary and remain in place only for as long as necessary to maintain price stability.

It has been argued that central bank purchases produce an effectively cost-free issuance of government bonds, as the interest that the central bank receives on the bonds is returned to governments via the central bank's profit transfer mechanism. However, this line of reasoning ignores the fact that the central bank purchases bonds from banks, which consequently hold more reserves on which the central bank pays interest. While therefore not being a "free lunch", the central bank purchases of bonds financed by reserves are often beneficial for governments, as the short-term interest rate on reserves tends to be lower than the long-term interest rate on government bonds. However, this is not always the case, as demonstrated by the significant central bank losses recorded in recent years, resulting in the suspension of dividend payouts to governments. In addition, when holding more government debt, a central bank usually increases its precautionary accounting reserves in order to cover financial risks and therefore does not return all the interest income earned on the government bonds it holds.

4.2 Other central bank acquisitions of government bonds

Outside ECB monetary policy operations, central banks may purchase government bonds for the purpose of managing foreign reserves, for their own investment portfolios and, in the case of non-euro area central banks, for monetary policy purposes.

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24 A period of several days around the issuance of government bonds during which the ECB does not conduct purchases on the secondary market.

25 Therefore, suggestions that the prohibition could easily be circumvented by using straw men to purchase the new debt and quickly sell it on to the central bank (see, for example, Buiter, 2025) would not hold up to legal scrutiny.

As regards the first purpose, Eurosystem NCBs can purchase, at issuance, the non-euro-denominated debt of non-participating EU countries, while non-participating NCBs can do so for all government bonds issued by EU countries.

When it comes to purchasing government bonds for central banks' own investment portfolios and, in the case of non-euro area central banks, for monetary policy purposes, the ECB has set monthly and quarterly GDP-proportionate monitoring thresholds, against which NCB's net purchases (gross purchases minus sales and redemptions) of government debt are held so as to monitor whether secondary market purchases circumvent the prohibition. These thresholds apply to investments in own asset portfolios and to non-euro area central bank purchases of government bonds for monetary policy purposes, but they do not apply to ECB bond purchases carried out in the context of monetary policy. As they are monitoring thresholds rather than limits, exceeding a threshold prompts the ECB to invite the relevant central bank to explain the reasons, which the ECB then assesses. Purchases made above the threshold may be due to a range of factors, including human error and "technical" factors such as where the proceeds of a maturing government bond are reinvested in another month. Breaches requiring correction are typically resolved by selling the relevant security once the mistake is discovered.

One case involving the acquisition of government bonds featured for several years in the ECB's Annual Reports. In 2013, the Central Bank of Ireland acquired €25 billion of long-maturity floating rate government bonds via a swap for promissory notes, amid the liquidation of the Irish Bank Resolution Corporation (see Central Bank of Ireland, 2013, for more details and Draghi, 2015, for the ECB's assessment). As it was akin to a primary market purchase, the swap raised serious monetary financing concerns. Moreover, it led to a substantial lengthening of the debt (up to 40 years) and a reduction in the interest rate payable, which was tantamount to the central bank providing debt relief to the Irish government. After assessing the operation as a whole, the ECB considered that a full disposal of the assets would dispel such concerns, which was accomplished ten years later, in 2023, despite the ECB calling for a more ambitious sales schedule. The extra time the whole process took reflected the size of the related government bond portfolio on the central bank's balance sheet (around €40 billion) and the fact that the government had to agree each year on the volume of bonds to be sold.

4.3 NCB financing of obligations vis-à-vis the IMF

Central bank financing of obligations vis-à-vis the IMF, which was common practice pre-EMU, was afforded exceptional treatment when defining monetary financing. While such transactions constitute a form of credit to the government, as the central bank is effectively financing the government's obligations, they are exempted from the prohibition of monetary financing because they result in foreign claims that have all the characteristics of reserve assets, and therefore constitute a form of foreign reserve asset management.

While the frequent increases in IMF quotas fall under this exception, this does not apply to donations of special drawing rights (SDRs) for debt relief to low-income countries. These donations do not lead to the creation of reserve assets but are more akin to development aid. Several central banks that contributed to debt relief for low-income countries around 2020 were therefore required to seek government compensation, ensuring that the relief was ultimately financed by the government, and not by the central bank.

The exception applies only to financing of obligations vis-à-vis the IMF, as the only institution explicitly mentioned in the relevant EU regulation, and not to other financial institutions such as the World Bank or multilateral development banks. This was confirmed by President Lagarde (2022): "*…we note that the channelling of special drawing rights by EU national central banks to multilateral development banks or individual countries would not be compatible with the EU's legal framework".*

4.4 Remuneration of government deposits held at central banks

In the early days of EMU, no explicit restrictions applied to the remuneration of government deposits held at central banks. This changed in 2014, when the ECB clarified that paying above-market interest rates on these deposits constituted a form of monetary financing by providing unwarranted financial benefits to governments. As a result, market interest rates now serve as remuneration ceilings (e.g. €STR for euro area overnight deposits; see ECB, 2014b). As this is a ceiling, NCBs are free to set lower rates, which some indeed do, typically at 0%. The absence of remuneration can be seen as the counterpart to central banks providing fiscal agent services to governments for free (see Cottarelli, 1993).

The criteria based on money market rates led to some cases of non-compliance over the course of several years, also reflecting time-consuming negotiations with governments given the significant financial stakes involved. Governments often hold sizeable deposits at the central bank as a precautionary reserve, for example in case a bond auction fails or an external shock, such as the pandemic, occurs. In a few cases, national legislation had to be adapted again when market interest rates – and therefore remuneration ceilings – turned negative in 2014.

4.5 National tasks performed by central banks

In general, NCBs may perform tasks assigned to them under national law, although they are prohibited from financing any government obligations vis-à-vis third parties. Central banks may not, therefore, assume pre-existing government obligations or obligations arising directly from government measures.

Several potential conflicts with this requirement arose in 2014, when Magyar Nemzeti Bank (MNB, the Hungarian central bank) initiated large-scale investments in real estate, a financial literacy programme run through several foundations, the transfer of staff formerly employed by the Hungarian Financial Supervisory Authority to the central bank, and a programme to purchase Hungarian artwork and cultural properties. As regards the foundations, concerns were raised that they could be used as vehicles for primary market purchases of government debt (Draghi, 2017). A year later, MNB also acquired a majority stake in the Budapest Stock Exchange, and one year on, it financed an asset management company (MARK) set up to purchase non-performing commercial real estate assets from Hungarian banks.

While some of these initiatives could arguably be justified as valid central bank activities if the amounts involved remained relatively small (e.g. building up an art collection), the ECB considered that “Given the multitude of programmes, their scope and their size, these programmes could be perceived as potentially in conflict with the monetary financing prohibition, to the extent that they could be viewed as the MNB taking over state tasks or otherwise conferring financial benefits on the state.” While many of these initiatives have since come to a halt, a few continue to this day.

5 Proposals by observers to loosen the prohibition

Following multiple crises, most notably the COVID-19 pandemic, several proposals have been put forward in the economic literature for central banks to create additional fiscal space to combat crises or to finance large-scale investments in defence and climate protection. The ECB is often regarded as the best candidate to finance such initiatives because (i) it can create money “out of thin air” without immediately visible costs to society; (ii) it can act more quickly than governments, whose measures require parliamentary procedures; and (iii) it is perceived as having interpreted its mandate more broadly, not only capturing price stability but also well-functioning financial markets, preserving EMU as, for instance, during the Greek crisis and addressing climate change.

A key aspect of most proposals is that the central bank financing is meant to be permanent. As a result, money-based fiscal expansions are expected to be more effective than debt-financed fiscal expansions: as the money created is an asset for the holder but not a financial liability of the central bank, governments do not need to raise taxes to pay for the additional stimulus, and private households and firms do not limit consumption and investment now in anticipation of higher tax bills down the line (i.e. there are no Ricardian equivalence effects). This permanent aspect distinguishes such proposals from asset purchase programmes, which by definition are temporary and remain in place only for as long as required to achieve price stability. When they are no longer required, the associated portfolios are scaled back to support restrictive monetary policy and/or to normalise the balance sheet, creating room for their reactivation if and when needed.

Another fairly common aspect of these proposals is that their primary focus is on providing finance to governments, rather than primarily supporting price stability. Thus, while ECB asset purchases focussed on bringing inflation back to target, either directly by providing monetary stimulus or indirectly by enhancing monetary policy transmission, these proposals seem to cater first and foremost on providing cheap funding for government spending. This difference in focus is clear from the permanent nature of the monetary expansion process, which is not reversed once inflation has returned to its target level.

More broadly, suggestions have been made to further examine and more openly debate the costs and benefits of the decades-long taboo on monetary financing, including by some IMF staff members. Bossu and Weenink (2021) propose adding an escape clause to the monetary financing prohibition that would enable a central bank to act as a lender of last resort to governments in dire emergencies such as war, pandemics and natural disasters causing severe funding market disruptions[26], while Tamez et al. (2024) suggest adding a provision allowing for temporary monetary financing in the event of an unforeseen natural disaster. Agur et al. (2022) likewise raise the possibility of allowing a limited exception to the monetary financing prohibition, notably in the event of a liquidity trap or a self-fulfilling sovereign debt crisis, provided that the central bank acts independently, provides monetary financing on a modest scale and exclusively for macroeconomic stabilisation, and does so in an environment of low inflation and sustainable fiscal positions, thereby limiting fears of fiscal dominance.[27]

The following section discusses the concrete options for debt cancellation, the conversion of central banks' government securities portfolio into perpetual debt, and helicopter money, including how ECB officials have reacted to such proposals. It focuses on some of the principal features of the proposals put forward, without aiming to provide a complete overview of all proposals.

5.1 Debt cancelation

Cancelling part of the government debt that the ECB holds in its APP and PEPP portfolios would result in lower government debt ratios and in governments no longer having to pay interest on the cancelled debt. The fiscal space created could be used to improve fiscal sustainability and/or support social and ecological recovery, ensuring that "petty legal issues fade away in front of robust political deals" (Andor et al., 2021). The write-off of government bonds would create a substantial loss for the ECB, implying lower profit distributions from central banks to governments.

The proposal to cancel government debt met with clear opposition from President Lagarde (2020b), who remarked: *"… my response is very short, because I don't even ask myself the question. It's as simple as that, because anything along those lines would simply be a violation of the Treaty. The ECB operates under the Treaty. There's an Article 123 of the Treaty, which prohibits that kind of approach, and I respect the Treaty: period!*". In a similar vein, Executive Board member Lane (2021) said: *"The simple answer is: no, we cannot do that, because the Treaties don't allow sovereign debt cancellation. But, regardless of the legal aspects, cancelling debt would not be a good idea in general, and the debate is a digression."*

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[26] Such an exception should be subject to several conditions, including a robust political procedure (e.g. a formal declaration of a catastrophic event by the government) and a formal framework defining borrowing ceilings and the interest rate payable. A few countries already have such an arrangement in place, including the Netherlands. The Dutch Emergency Act on Financial Transactions (Noodwet Financieel Verkeer) foresees the possibility of the government requiring temporary unlimited credit or advances from the central bank in exceptional circumstances.

[27] Focusing on emerging markets and developing economies, IMF staff members (Adrian et al., 2021) argue that limited direct financing can be justified in specific circumstances, such as poorly developed secondary markets or serious market dysfunction.

5.2 Perpetual debt

Instead of cancelling debt, some have suggested that fiscal space could be created by transforming part of the government debt held in central banks' portfolios into perpetual debt, i.e. debt that never has to be redeemed, possibly at a zero-coupon rate. Governments would stand to benefit from such an arrangement because they would not have to refinance the debt by issuing new debt on the market. Adding a monetary policy rationale, Wyplosz (2023) proposes that the central bank could issue short-term debt against the bond holdings, such as ECB debt certificates, which could be used to withdraw liquidity from the money market if needed.

To create room on the central bank's balance sheet, central bank profits could be used to reduce the central bank's holdings of government debt. Hansen and Meyer (2021) suggest writing off government bonds annually in an amount equal to the size of the central bank's profit, thus spreading the central bank's losses over time in line with its profits.

Moreover, various suggestions have been made for the ECB to buy and perpetually hold bonds issued by the European Investment Bank (EIB) to stimulate growth and tackle climate change. Watt (2016), for instance, proposes that the central bank commit to purchasing all EIB bonds shortly after issuance as long as inflation is below target, with the funds being made available to EU countries for public investment.

Such proposals generally lack a clear monetary policy rationale and would create expectations that similar conversions might also take place following future ECB government bond purchases.

In responding to a letter by a Member of the European Parliament (MEP), ECB President Lagarde (ECB, 2024) replied to the proposal that the Eurosystem permanently hold government bonds on its balance sheet while issuing its own debt instruments to banks as a counterpart (Wyplosz, 2023), stating that: *"… the proposal mentioned in the paper lacks a substantive monetary policy rationale and would permanently increase the Eurosystem's market footprint. Importantly, it is not compatible with the monetary financing prohibition laid down in Article 123(1) of the Treaty on the Functioning of the European Union."*

5.3 Helicopter money

Whereas debt cancellation and perpetual debt serve a distinct fiscal policy purpose, this is less obvious in the case of "helicopter money", meaning a central bank-financed transfer of money to households to stimulate growth and inflation.[28] Two main variants of helicopter money can be distinguished.

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[28] The term is based on Friedman's illustration of the effects of a monetary expansion: "Let us suppose now that one day a helicopter flies over this community and drops an additional $1000 in bills from the sky…" (Friedman, 1969).

A. Overt monetary financing/permanent quantitative easing

In this variant, governments issue bonds to finance additional purchasing power for households, with the central bank purchasing these bonds either at issuance or on the secondary market. The idea, also known as a Money-Financed Fiscal Programme (MFFP), began to garner attention when Federal Reserve Chairman Bernanke (2003) argued that a temporary monetary financing programme, consisting of central bank purchases of government debt used to finance tax cuts (or spending increases) in crisis-hit Japan, could restore inflation and growth.

It is usually seen as a measure of last resort, being especially useful during severe crises, characterised by a recession, below-target inflation, policy interest rates already close to their lower bound, and stretched government finances, leaving little budgetary room for further spending initiatives. Proponents (e.g. Turner, 2015) emphasise that money-financed fiscal expansions would be more effective than conventional fiscal expansions, as government debt and/or related interest costs would not increase, while the higher money growth resulting from the monetary expansion would stimulate inflation, thereby reducing real interest rates and lowering the real value of government debt.

Numerous proposals have been put forward, including those by De Grauwe (2020), who proposes that financial institutions buy new government perpetual bonds with a zero interest rate and sell them shortly afterwards to the ECB. In his view, setting aside the monetary financing ban is justified because “salus populi, suprema lex” (“the welfare of the people is the supreme law”). Weber (2020) suggests a rule-based monetarisation of debt through primary market purchases of long-term or even perpetual debt, arguing that QE – operating via banks – is less effective than giving money directly to governments.

While purchases at issuance would amount to monetary financing, this does not necessarily hold for secondary market purchases, as long as they are not conducted under conditions that would amount to circumventing the ban. However, as such purchases may send a weaker signal of monetary-fiscal policy cooperation than purchases at issuance, their effects may be more limited, although probably still greater than those produced under existing asset purchase programmes given their permanent nature.

Worried about rating and accounting implications, some have suggested circumventing the prohibition by having governments issue bonds denominated in a temporary legal tender other than the euro (see, for example, Wood, 2012), while creating a facility to exchange these bonds for euro at a future point in time. Meanwhile, Bossone (2013) proposes purchasing government bonds via the Emergency Liquidity Assistance instrument in countries where a monetary impulse is needed.

B. Money rain/QE for the people/going direct

The second variant of helicopter money avoids central bank purchases of government bonds and an increase in government debt. Instead of operating through banks or financial markets, the ECB would transfer money directly to citizens, possibly via a digital wallet (Hampl and Havranek, 2018), or indirectly by offering zero-interest perpetual loans to banks enabling them to transfer the money to households (Lonergan and Jourdan, 2016). Proposals include transfers of €500 or €1,000 per adult/household, payments on a degressive scale (e.g. Muellbauer, 2014; Blyth and Lonergan, 2014), and an expiry date or a negative interest rate to ensure that the money is actually spent rather than saved (Hampl and Havranek, 2018). To be maximally effective, the impulse should be permanent; otherwise, households would anticipate having to repay it in the future.

This form of helicopter money, otherwise known as "money rain", "QE for the people" and "going direct", benefits the government as it is the central bank that is giving purchasing power to citizens without this affecting fiscal deficits or debt. However, indirect budgetary costs would arise because central banks would sustain sizeable losses from handing out money to the public for free. This would result in the suspension of profit distributions to governments for a prolonged period and might even require fiscal recapitalisations of central banks, implying that governments would ultimately bear part of the cost of handing out this money.

A full assessment of both variants of helicopter money (overt monetary financing and money rain) requires a careful look at multiple aspects, including their effectiveness in raising output and inflation and how to coordinate with governments. Moreover, the permanent nature of the money supply expansion could increase inflation expectations, as could the expectation that such measures would be repeated more often ("moral hazard"), with central banks perceived to be less independent.

While this issue goes beyond the scope of this paper, it is worth noting that the central bank acting as a "spender of last resort" could also be regarded as a form of monetary financing, as the central bank would be assuming an obligation usually seen as falling within the remit of government (stimulating the economy/providing purchasing power to households). As Grenville (2013) puts it, central banks have no mandate to give money away; they can only exchange one asset for another.

From the ECB's perspective, President Lagarde (2020a), commented as follows on the idea of helicopter money*: "Let me reaffirm that the Governing Council has never discussed the issue of helicopter money. Hence, the ECB has not adopted a formal position on the matter. It should be noted that the term helicopter money has been associated with a wide range of policy proposals. In many cases, these proposals do not fully address the associated operational, accounting and legal complexities nor provide a comprehensive cost-benefit analysis of the full economic and monetary impact."* Executive Board member Praet (2015), talking about money rain, said: *"Should everybody get the same amount of money, rich and poor? It would be for parliaments to decide how to distribute it. But the ECB would then be directly involved in monetary financing of governments, which it is not allowed to do"*, while Vice-President Constâncio (2015) argued *"Helicopter money has had different* *meanings in various contexts, from giving money directly to households to financing of public infrastructure. But all these options would bring us very close to pursuing fiscal policy. And that's what we cannot do."*

6 Conclusion

EMU was founded on a strict ban on monetary financing, with no exceptions made, even in exceptional circumstances. This prohibition supports monetary policy by safeguarding central bank independence and enhancing fiscal discipline. In turn, this helps anchor long-term inflation expectations, even during periods of crisis for the euro area. With the monetary financing route effectively cut off, governments are incentivised to address fiscal imbalances and ensure debt sustainability, although in practice they do not always appear to have internalised the implications of the ban for the conduct of fiscal policy (see González-Páramo, 2011). Monetary financing, even if undertaken on a voluntary basis at the ECB's discretion, risks creating moral hazard, undermining fiscal discipline and thereby eroding monetary policy credibility.

Over time, a robust framework for applying the prohibition has emerged, helping to clarify in practice which central bank activities are permissible and which are not. In general, the standards have been applied strictly, including in cases of limited or unintentional violations. At the same time, some indications of a more lenient interpretation emerged during the COVID-19 pandemic, with the ECB noting the possibility of relaxing self-imposed limits where these would hamper its ability to achieve its primary objective of maintaining price stability. A more formal framework for dealing with such extraordinary circumstances could help clarify the benefits and limitations of the prohibition.

Several proposals for loosening or circumventing the ban surfaced when the euro area faced severe crises, most notably the pandemic. Most, if not all, appear to fall foul of the prohibition and their implementation would therefore require a change in the Treaty or the accompanying EU Regulation. Moreover, relaxing the ban risks creating moral hazard, with governments reacting less forcefully to new crises in the expectation that the central bank will once again step in as the "only game in town". It would also undermine the ban's role of strengthening the credibility of the ECB's price stability objective by allowing monetary policy to be used for other purposes.

Looking ahead, the prohibition appears to be in a safe place, embedded in the European Treaty, with any revision requiring the agreement of all EU countries and parliaments. At the same time, historically high government debt, low structural growth rates, a succession of supply shocks, the rise of populism and continued threats to central bank independence may increase pressure to resort to monetary financing to address macroeconomic and fiscal challenges, given that it can act quickly and with few immediately visible costs. The right way forward, however, is not to overburden monetary policy in a way that would blur the clear separation between monetary and fiscal responsibilities, undermine central bank independence and weaken the focus on price stability. Instead, completing European Monetary Union calls for a more robust European framework for tackling economic and financial crises, making the European economy more resilient and moving closer to a fiscal union.

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