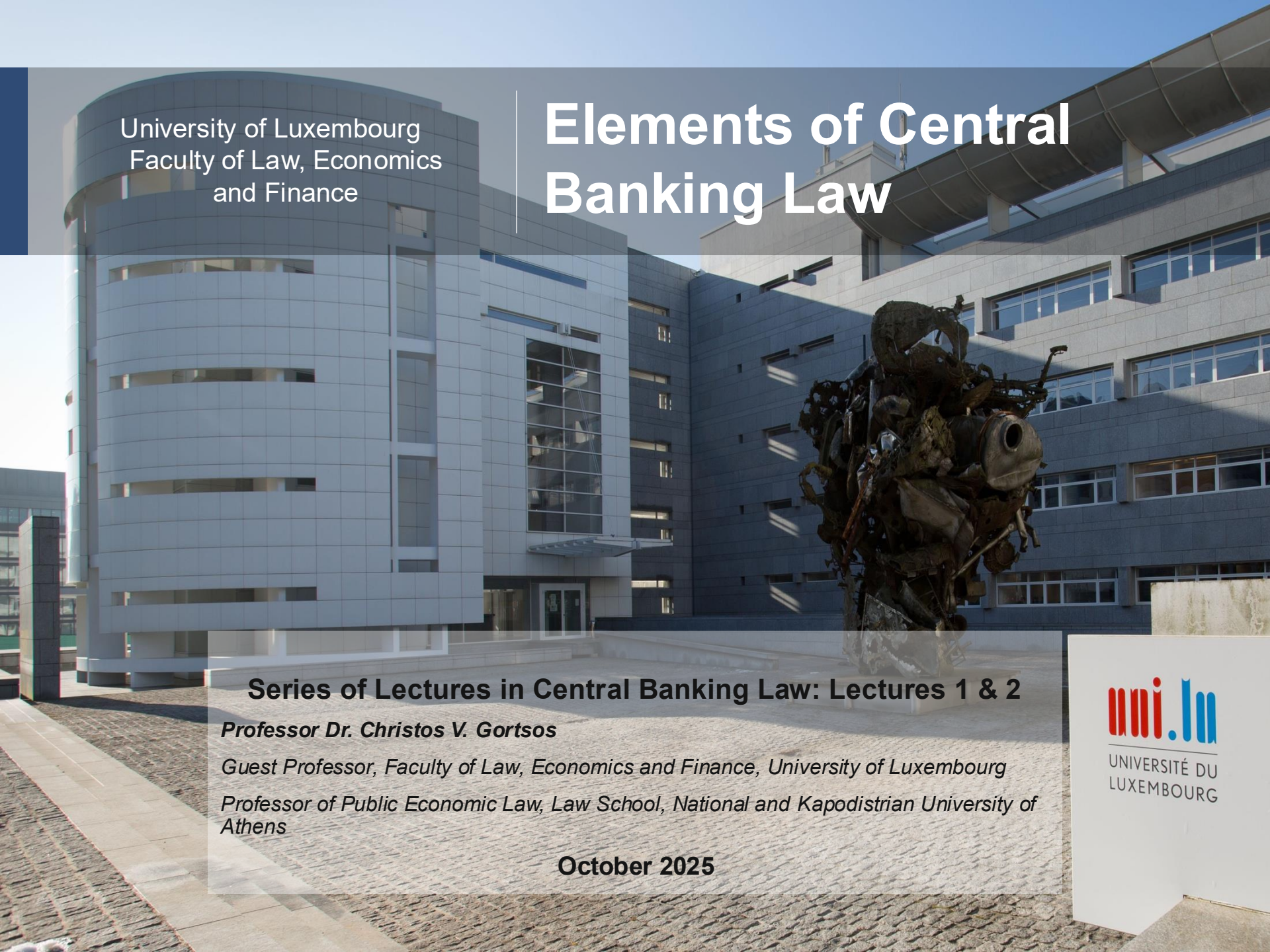


University of Luxembourg
Faculty of Law, Economics and Finance

Elements of Central Banking Law

Series of Lectures in Central Banking Law: Lectures 1 & 2

Professor Dr. Christos V. Gortsos

Guest Professor, Faculty of Law, Economics and Finance, University of Luxembourg

Professor of Public Economic Law, Law School, National and Kapodistrian University of Athens

October 2025

uni.lu
UNIVERSITÉ DU LUXEMBOURG

TABLE OF CONTENTS

A. Legal nature of central banks

(1) In principle: central banks are "administrative" authorities established by the laws (Constitution and (or only) secondary legislation) of a specific jurisdiction (delegation of administrative actions) – exception the **European Central Bank** (ECB) is an institution of the European Union (EU), established by the founding Treaties and performing central banking tasks

(2) The founding laws set out (*inter alia*) **their:**

- **ownership**;
- **legal personality**;
- **objectives, tasks, *as well as* powers and instruments to exercise them**; as well as
- **internal governance (bodies), independence and accountability**

Hence, central banking law sets out the framework (i.e., the limitations) for their operation

(3) Some central bank acts s are subject to **judicial review by courts – see further Section D**

A. Legal nature of central banks (cont'd)

- **(4) To the extent that "legal personality" has been conferred upon a central bank – which is the usual case, *inter alia*:**

➢ it can be a counterparty to contracts and acquire (and dispose of) property;

➢ it has legal standing in judicial disputes;

➢ it has the power of representation (e.g., **it can represent a country in international organisations, e.g., IMF**): most importantly

❑ **it can be a member of an international organisation (Bank for International Settlements, BIS)**

A. Legal nature of central banks (*cont'd*):

UNIVERSITÉ DU LUXEMBOURG

an example of binding rules relating to monetary policy instruments

(1) Under EU law (and, in particular, under the **"general framework" set out by an ECB Guideline)**, the ECB and the national central banks (NCBs) of the euro area Member States have the following instruments for the implementation of monetary policy:

- conduct of **open market operations –** interest rates set by the ECB;
- offering of **standing facilities (marginal lending facility + deposit facility)** to credit institutions – interest rates set in this case as well by the ECB; and
- imposition on credit institutions (and other categories of financial service providers) to **hold minimum reserves** on accounts with the Eurosystem

(2) "Unconventional" monetary policy instruments (after the (2007-2009) Global Financial Crisis **(GFC)**: they are based on the asset purchase programmes of the Eurosystem and can be implemented **upon preservation of the primary objective set out in the EU Treaties, i.e., price stability** (case law of the Court of Justice of the EU)

B. Objectives of central banks

UNIVERSITÉ DU LUXEMBOURG

1. In all cases:

- provision of **means of payments** to the economy (banknotes – digital cash)
- preservation of **monetary stability (an objective that can be defined)**
- preservation of **financial stability (an objective that cannot be easily defined)**
- in particular: preservation of the stability of payment systems (typically, large-value ones)

2. On a case-by-case basis: distinction between primary and secondary objectives(?):

- contribution to other **macroeconomic objectives** (e.g., economic growth and employment)
- contribution to other **microeconomic objectives**
- in particular: contribution to **environmental sustainability**

C. Tasks conferred upon central banks

UNIVERSITÉ DU LUXEMBOURG

1. In all cases (traditionally):

- **issuance of banknotes** (a legal monopoly and *quasi de facto* monopoly as well) – control of the amounts of coins in circulation produced by the Government (note: banknotes and coins (cash = **"public money"**) are the only money form accessible to the general public)
- definition and **implementation of monetary policy** to achieve specific, well defined macro-economic objectives
- **provision of last resort lending** to solvent banks exposed to liquidity risk (but no deposit guarantee when a bank is exposed to insolvency = fails)
- **conduct of foreign-exchange policy** – holding of official foreign reserves
- **oversight of** large-value and small-value **payment systems**
- contribution to the preservation of **financial stability**

C. Tasks conferred upon central banks (*cont'd*)

2. In all cases (mainly after the GFC):

- **macroprudential financial oversight**

3. In certain cases:

- **microprudential supervision of banks** and other categories of financial firms: conflicts of interest (?);
- **resolution of banks** and other categories of financial firms;
- **protection of consumers** of financial services;
- promotion of **"financial inclusion"** and of **"financial literacy"**;
- combatting of **money laundering and terrorist financing** through the financial system;
- issuance of **digital currencies** (CBDCs);
- contribution to government debt management
- management of capital controls (if and when imposed)

TABLE 1: A simplified central bank balance sheet

Assets	**Liabilities**
1. Gold and reserves	1. Banknotes in circulation **& CBDCs**
2. Claims on banks related to monetary policy operations ("open market operations" & "marginal lending facility")	2. Liabilities to banks related to monetary policy operations • "reserve accounts" • "deposit facility"
3. Other claims on banks	3. Liabilities to other parties (in domestic or foreign currencies)
4. Securities issued by Governments – firms – financial firms	4. Other liabilities
5. Other claims (in domestic or foreign currencies)	5. Revaluation reserves
6. Other assets	**6. Capital and reserves**

C. Tasks conferred upon central banks (*cont'd*)

UNIVERSITÉ DU LUXEMBOURG

Central banks' finances – sources and distribution of monetary income

(1) Sources of monetary income

- **interest on money lent by the central bank** (net of interest on deposits with it)
- **return on assets held by the central bank** ***(very important when pursuing "balance sheet policies" – quantitative easing and tightening)***

(2) Distribution of monetary income:

- **capital structure**: shareholders – subscribers/capital holders
- distribution/recapitalisation policies – **relationship with monetary policy objectives – independence of central bank**

TABLE 2: A simplified, typical bank balance sheet

Assets		Liabilities	
Cash	**5**	**CB funds:** Monetary policy – **LLR**	**5**
Loans – performing	**68**	**Retail deposits**	**55**
Loans – non-performing	**3**	Corporate deposits – Government deposits	**15**
		Interbank deposits	**5**
Securities (issued by Governments and corporates)	**14**	Senior bonds	**10**
Other	**10**	**OF - Subordinated bonds** **(Additional Tier 1 cap + Tier 2 capital)**	**5**
		OF - Capital (CET 1 capital)	**5**
	100		**100**

D. Independence and accountability of central banks (1)

(1) The four dimensions of central banks' independence:

- **institutional** – limitations on interference of the political system;
- **personal** – relating to the persons appointed in the bodies governing the central bank;
- **economic** – sources of financing; as well as
- **operational** – endowment with appropriate means to achieve statutory objectives and tasks

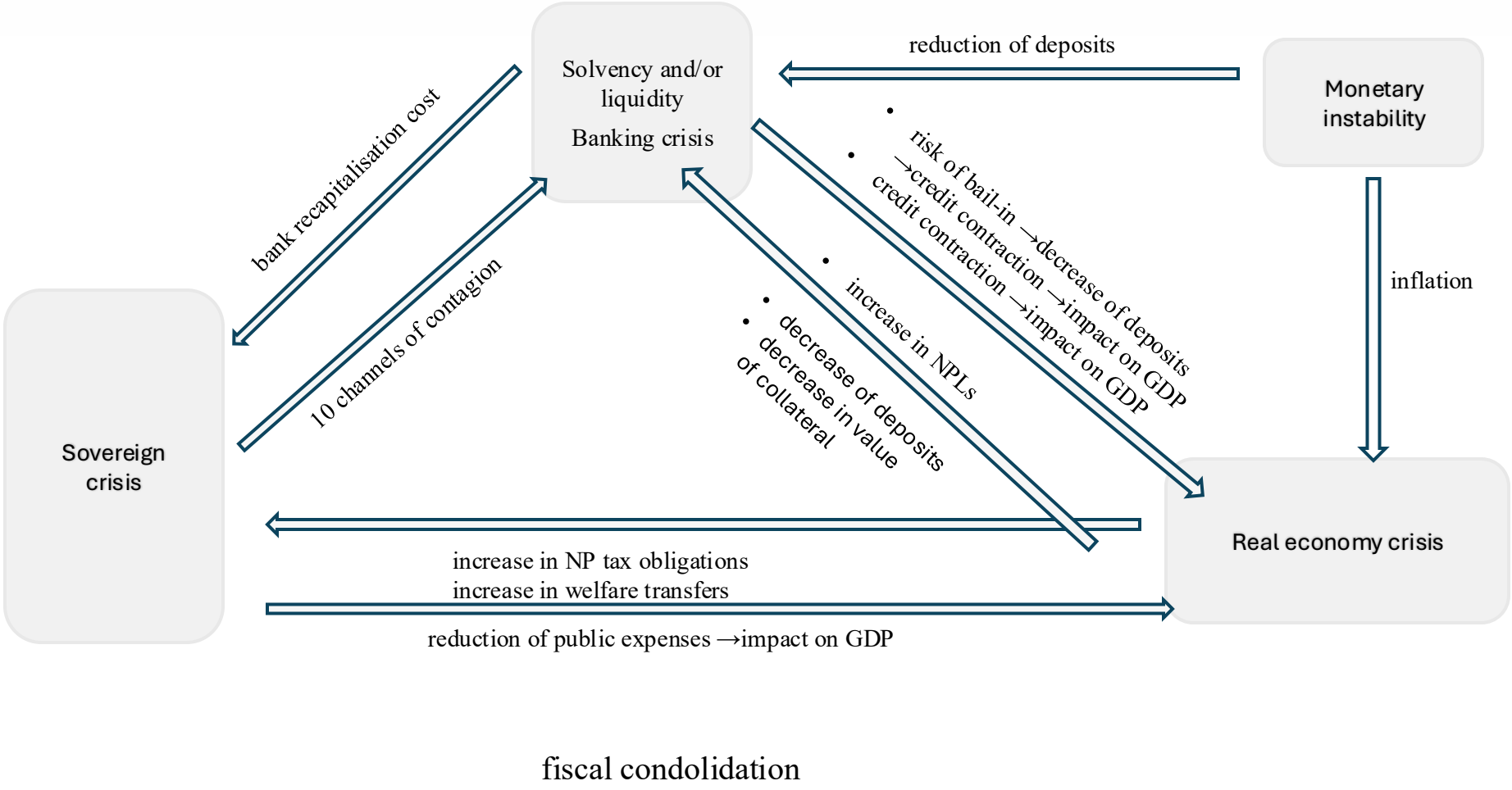
They should all be embedded in law.

D. Independence and accountability of central banks (2)

(2) Accountability:

- **central banks are accountable** to political institutions (e.g., the Parliament) – even more enhanced when the persons in their governing bodies are not democratically elected (e.g., the ECB case);
- the accountability regime includes **disclosure and transparency requirements**;
- it is usually **more stringent in relation to central banks' supervisory tasks**;
- **judicial review by the courts is an additional layer of control (under different conditions in relation to monetary policy decisions *vs.* supervisory decisions)**;
- ***quasi*-judicial review of certain acts by *ad hoc* administrative bodies**

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks



E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

UNIVERSITÉ DU LUXEMBOURG

2. The appropriate mix between monetary and fiscal policies

(1) The efficiency of monetary policy can be negatively affected by prolonged and non-targeted fiscal expansion (meaning that, while higher official interest rates are aimed at dampening demand, fiscal expansion may lead to the opposite direction). An aspect, thus, requiring close attention is the extent to which the effects of monetary policy tightening could be neutralised by unwarranted expansive fiscal policy measures (especially as regards the exit strategy when the negative conditions on the inflation front will have been tamed).

- Apparently, due consideration must be given in this respect to the different time horizons of action for (independent) central banks when defining and implementing their monetary policy, and governments when exercising their fiscal policies.

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

- Furthermore:

(a) in view of the high levels of inflation, even though central banks are globally tightening monetary policy to restore price stability, "*challenges related to how to manage the monetary tightening cycle remain open*";

(b) there is a need to adopt an appropriate policy mix between monetary policy and the formulation and calibration of "*responsible fiscal policy in an environment with persistent price pressures*" to preserve that those fiscal policies do "*not further fuel inflation and side-track the efforts of monetary policy*".

(2) The ECB has also been involved in the discussion on the predominant importance of an appropriate monetary policy – fiscal policy mix. According to its Chief Economist, Philip Lane:

- "*Finding the "sweet spot" between fiscal and monetary policies will allow for continued support to vulnerable Europeans hard hit by high energy prices and double-digit inflation without further straining public finances.*"

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

- The **ECB "Financial Stability Review" of November 2022** also discussed the role of targeted fiscal policy measures in supporting vulnerable sectors of the economy, while avoiding actions that could interfere with the monetary policy normalisation process. In the same vein, Christine Lagarde, noted in the press conference following the GC meeting of 2 February 2023:

"*Government support measures to shield the economy from the impact of high energy prices should be temporary, targeted and tailored to preserving incentives to consume less energy.*

In particular, as the energy crisis becomes less acute, it is important to now start rolling these measures back promptly in line with the fall in energy prices and in a concerted manner. Any such measures falling short of these principles are likely to drive up medium-term inflationary pressures, which would call for a stronger monetary policy response.

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

UNIVERSITÉ DU LUXEMBOURG

Moreover, in line with the EU's economic governance framework, fiscal policies should be oriented towards making our economy more productive and gradually bringing down high public debt. Policies to enhance the euro area's supply capacity, especially in the energy sector, can help reduce price pressures in the medium term. To that end, governments should swiftly implement their investment and structural reform plans under the Next Generation EU programme. The reform of the EU's economic governance framework should be concluded rapidly."

UNIVERSITÉ DU LUXEMBOURG

3. The linkages between financial and monetary stability

3.1 Introductory remarks

- Financial stability is a "global public good". There is no single generally accepted definition of this term; the ECB defines it as follows:

"*a condition in which the financial system – which comprises financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances*".

- In accordance with the **"financial trilemma"** (**Schoenmaker (2011)**), in open market economies the objectives of financial stability, financial integration and national financial policies are incompatible; any two can be combined, but not all three.

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

UNIVERSITÉ DU LUXEMBOURG

- The causes of major financial crises are usually not one-dimensional but are a function of a combination of market, supervisory, regulatory and macro-economic failures. In the words of **Honohan (1997)**:

"*Systemic failures in the financial system are typically complex, and they differ one from the other. In order to understand the processes involved it is necessary to schematize and simplify, but extreme reductionism is misleading.*"

- The linkages between financial stability and monetary stability are significant. In this respect, in the aftermath of the GFC, the aim of monetary policy remained price stability, while macroprudential policies were tasked with the preservation of financial stability. In particular:

(1) Financial instability in the form of a financial/banking crisis (or even a turmoil) may cause the monetary authority (central bank) to adapt its monetary policy by lowering interest rates.

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

UNIVERSITÉ DU LUXEMBOURG

(2) This was the case during the GFC, which was then followed by the adoption of even more drastic unconventional monetary policy measures. Amidst that crisis, monetary policy moved in parallel to financial policy and coincided, since the primary concern in relation to price stability was the support of aggregate demand and the avoidance of deflation and recession, while that in relation to financial stability the primary concern was to avoid deeper financial distress.

(3) The stance of monetary policy and the level of official interest rates set by central banks, *vice versa*, may also have an impact on the financial system.

UNIVERSITÉ DU LUXEMBOURG

3.2 The impact of monetary policy actions on financial stability

3.2.1 An environment of high inflation

- In an environment of high inflation and, thus usually, comparatively high official interest rates, the dynamics of debt servicing and the balance sheet of credit institutions and other financial firms may be negatively affected. In particular, rising interest rates lead to tighter financing conditions to address high inflation.
- In accordance with **Jiménez *et al.* (2023)**, analysing 17 countries over 150 years, a raising of official interest rates materially increases crisis risk *via* credit and asset price cycles, but only if rates were previously cut (or low) for long ("U-shaped" monetary rate path), while rate cuts in the first half of such a path increase the likelihood of vulnerable "red zones" of high credit and asset prices, while subsequent rate hikes within "red zones" tend to trigger crises.

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

- **Boissay *et al.* (2023)** also defend the view that financial crises may occur after a long period of unexpectedly loose monetary policy as the central bank abruptly reverses course.
- In combination with strained market liquidity conditions and risk-aversion on behalf of (some) investors, this may lead to an increase in market volatility and an (eventually sharp) correction of the price of several classes of financial assets (such as stocks and bonds, bond yields rising broadly across credit ratings). The tightening of financial conditions, especially if also combined with a deterioration of the macroeconomic outlook leading to conditions of anaemic growth (an economic environment of stagflation or even recession) may have the following consequences:

(1) Higher interest rates may affect (at least) medium-term sovereign debt dynamics, as sovereigns are facing rising funding costs, financial vulnerabilities being elevated for governments with mounting debt. In this respect, the following is noted in relation to actual developments:

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

- *First*, according to the OECD Sovereign Borrowing Outlook 2023 of 22 May 2023 (**OECD (2023)**), sovereign borrowing needs were expected to further increase, as many of its member states sought to cushion households and businesses from rising prices; the same applies to net borrowing needs.
- *Second*, the OECD's Global Debt Report (**OECD (2024)**) discusses how governments and firms need to address the key risks from the sharp increase in global bond borrowing (raising also potential financial stability considerations), since, by end-2023, the total volume of sovereign and corporate bond debt stood at almost 100 trillion USD, similar in size to global GDP, and the central government debt-to-GDP ratio in OECD countries reached 83% (thus, an increase of 30% in comparison to 2008).
- Thus, in an environment of high inflation and restrictive monetary policies, government bond markets are affected with profound implications for government spending and financial stability at a time of renewed financing needs (i.e., refinancing of outstanding debt).

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

(2) Tighter financial conditions may affect both households (particularly those on lower incomes since their purchasing power may be reduced and their ability to repay loans be compromised) and corporates (depending on their outstanding debt level, their rating (and the prospects thereof) and, thus, their borrowing cost and their overall profitability).

- According to **Bellon and Gnewuch (2023)**, low-income households were hit the most by the recent inflation, since they typically spend a larger share of their income on energy and that this inequality creates vulnerabilities that can aggravate recessions, reinforcing the need to build resilience through larger fiscal buffers.
- Higher interest rates may also activate vulnerabilities in the residential and the commercial real estate sectors. On the appropriate macroprudential policies to mitigate housing market risks, *see* **Committee on the Global Financial System (2023b)**.

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

(3) Credit institutions may also be negatively affected as financial stability risks are increasing, even though their profitability may increase due to gains derived from higher interest rates and margins (especially after a period of very low interest rates due to the abolition of maturity mismatches) and positive deposit facility rates at the central bank. In particular (and in brief):

- *first*, a correction of asset prices may expose them to market risks (which largely depends on their business models and the robustness of their risk management techniques); this has, indeed, been the case during the 2023 banking turmoil in the US;
- *second*, the quality of their assets may deteriorate due to a potential increase of non-performing loans ('**NPLs**', impaired assets) and non-performing exposures ('**NPEs**') in their portfolios leading to the risk of high rates of corporate defaults and bank losses;

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

- *third*, their liquidity position may be adversely affected taking into account in particular the higher cost for market funding (mainly through the issuance of bonds in money and capital markets); in this environment of higher interest rates, significant credit institutions in the BU were also required to raise debt in capital markets to fully meet the binding target for the minimum requirement for own funds and eligible liabilities ('**MREL**'), as set out in **Articles 12-12k SRMR**, by end-2023 (which marked the end of a transitional period).
- *fourth*, a negative impact on their profitability may be caused by tightened lending standards and, thus, a decrease in outstanding loan exposures to non-financial corporates and households (including for residential and commercial and real estate-related lending), as well as by an increase in their funding cost to higher interest rates (the level depending on their rating);
- *finally*, deteriorating growth prospects may expose them to rising medium-term risks.

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

UNIVERSITÉ DU LUXEMBOURG

(4) Beyond the banking sector, financial markets and non-bank financial intermediation ('**NBFIs**', as the "shadow banking sector" is currently named) may also become vulnerable to the risk of disorderly asset price adjustments (particularly in the event of a recession) due to investment fund vulnerabilities, stretched valuations, high volatility, tighter financing conditions and lower market liquidity. Financial vulnerabilities may also be elevated for regulated financial firms, such as insurance companies, as well as pension, hedge and mutual funds.

3.2.2 An environment of very low inflation

(1) In an environment of very low inflation (or even deflation) and, thus usually, very low official interest rates, laxer financing conditions prevail (to the benefit of governments, individuals and firms), with an increase in asset prices (making them, however, susceptible to corrections), a reduction in risk aversion and an expansion in the housing market. However, financial stability risks are also apparent. Key concerns are:

- *first*, a potential overheating of the economy by increased demand for borrowed funds and an overvaluation in housing prices in both residential and commercial real estate markets;
- *second*, the (eventually significant) increase of asset prices taking into account the potential for their (even sharp) correction when the period of very low interest rates is terminated; on the basis of historical data for 18 countries between 1870-2020, **Grimm, Jordà, Schularick and Taylor (2023)** come to the conclusion that the likelihood of a financial turmoil increases considerably when the stance of monetary policy is accommodative over an extended period due to (*inter alia*) credit creation and asset price overheating; and

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

- *third*, a destabilising impact on the financial system and credit institutions' profitability, in particular in a territory of negative DFRs, taking account of the fact that they face (legal or business) limitations in passing negative rates through to (in particular) retail depositors.

(2) The risk analysis in the **ESRB Report** "Lower for longer – macroprudential policy issues arising from the low-interest rate environment" of **1 June 2021** is illustrative in that respect, identifying several areas of concern (for the euro area) owing to the prolonged period of persistently low interest rates (a **"liquidity trap"** situation), including:

- *first*, credit institutions' profitability and resilience, as the negative effects of existing structural problems in the EU banking sector (including overcapacity and cost inefficiencies) were being compounded;
- *second*, indebtedness and viability of borrowers, who are taking on more debt due to search for yield; and
- *third*, systemic liquidity risk as the financial system has become more sensitive to market shocks, also due to structural changes.

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

According to **Keynes (1936)**:

> "*There is the possibility (...) that, after the rate of interest has fallen to a certain level, liquidity-preference may become virtually absolute in the sense that almost everyone prefers cash to holding a debt which yields so low a rate of interest.* ***In this event the monetary authority would have lost effective control over the rate of interest****. But whilst this limiting case might become practically important in future, I know of no example of it hitherto.*"

UNIVERSITÉ DU LUXEMBOURG

3.3 *Interim* conclusions

- There are conditions under which monetary policy *may* need to be adjusted in periods of a financial crisis, taking into account the threats to financial stability and to the real sector of the economy.
- On the other hand, typically, monetary policy is not considered as the appropriate means to safeguard financial stability. However, a trade-off between persistently high inflation and financial (in)stability (a **"balancing act"**) is evident. Thus, when setting interest rates to restore the level of inflation at their policy target (even in the medium term), central banks need to also integrate into their monetary analysis, *inter alia*, the impact of (further) increased interest rates on the lending activity of credit institutions and on capital markets (without prejudice to any potential conflicts of interest and taking into account their statutory objectives).

E. The interaction between monetary policy, fiscal policy and financial stability and the role of central banks

UNIVERSITÉ DU LUXEMBOURG

3.3 *Interim* conclusions

- According to **Glocker *et al.* (2023)**, restrictive monetary policy effectively dampens inflation but also raises stress in financial markets through revaluations of financial assets on banks' balance sheets and weakened economic activity. Furthermore, with most of the disinflationary impact of higher interest rates yet to materialise, monetary policy should allow the financial sector to digest the rapid rate hikes by reducing the pace of tightening.
- Under these conditions, the preservation of financial stability even in times of high(er) inflation mainly (and ultimately) depends on the existence of appropriate micro- and macroprudential financial/banking regulations, as well as the efficiency of macroprudential financial oversight by central banks (or other earmarked public authorities).

UNIVERSITÉ DU LUXEMBOURG

3.3 *Interim* conclusions

- It is noted that, in accordance with the (just above-mentioned) **2021 ESRB Report**, addressing the risks identified therein requires wide-ranging macroprudential policy responses; the Report set out a range of policy options for mitigating systemic risk and improving its analysis.
- Furthermore, predominant is the quality of financial/banking prudential supervision and the appropriateness of the related sanctioning regimes to ensure financial firms' (including credit institutions') compliance with the regulatory framework. This includes the monitoring of debt sustainability in the corporate sector and overall exposures in the financial system by capital market supervisory authorities.

UNIVERSITÉ DU LUXEMBOURG

3.3 *Interim* conclusions

- The above-mentioned remarks and considerations are clearly summarised in the remarks by **Kohn (2016)**, (then) External Member of the Financial Policy Committee of the Bank of England:

  "***Monetary policy can have important effects on financial stability risks, but, for the most part, it is not the right policy to address those risks***. *I am concerned about burdening monetary policy with too much to do; putting weight on financial stability in monetary policy decisions implies less weight on economic and price stability in the conduct of policy, and that can have substantial costs in terms of economic welfare.*

UNIVERSITÉ DU LUXEMBOURG

3.3 *Interim* conclusions

> ***Financial stability is a prerequisite for price and economic stability***, *so we cannot rule out adjusting monetary policy for financial stability purposes under some, hopefully rare, circumstances.* ***But authorities should develop other tools and other decision processes to rely on first – macroprudential policies*** *– and the more fully developed are these alternatives to monetary policy, the less monetary policy itself might need to be used to defend financial stability*".

Source of references:

Gortsos, Ch.V. (2024):*The Eurosystem at 25 (1999-2023): Legal Aspects of the Single Monetary Policy in the Euro Area – From the Establishment of the Eurosystem to the Current Inflation Crisis*, Europa Institut, University of Zürich, EIZ Publishing, available at: https://eizpublishing.ch/publikationen/the-eurosystems-monetary-policy-at-25-1999-2023