Abstract

Purpose of the article is to present in two parts the selected aspects of application of monetary policy in the euro area pre and post 2008 as well as insitutional adaptations brought by the EU legislator.

Methodology/methods In order to better explain these points, the article relies partially on a comparison with the framework and application of the monetary policy by the Federal Reserve as well as on a historic method when outlining the influence of definition of financial stability from the ECB/Eurosystenm towards other prominent central banks.

Scientific aim The article presents selected aspects of the monetary policy in the part of the EU where single currency was introduced in order to outline state of the art governance structure as well as a certain institutional creativity in application of powers conferred upon the central banks by the Treaty on the Functioning of the European Union and Protocol on the Statute of the European System of Central Banks and of the European Central Bank. The goal is to prove (i) the hypothesis of robustness of the framework and (ii) present the limits that can only be pushed further by the legislative power.

The conclusions confirm on the one hand that the framework of monetary policy based on strong institutional safeguards such as legislative power and independence is very resilient and can prove efficient and creative enough to stabilise an innovative monetary system, however, on the other hand, validate the hypothesis that certain adaptations can only be performed on the basis of a legislative adaptations.

Keywords: European Central Bank, Eurosystem, monetary policy, central banking

JEL Classification: E52, E58, F02
Introduction

As a follow up to the first part of the article covering the framework available and policies of the ECB/Eurosystem applied pre-2008, this second part focuses on a certain institutional creativity in the ways of application of the existing framework as well as adaptations brought by the EU legislator to the roles and functions of the ECB. The former ranges from fixed rate full allotment provision of liquidity via standard and longer term operations, revival of impaired monetary policy transmission channels by establishment of Securities Markets Programme and Outright Monetary Transactions to tree Covered Bond Purchase Programmes and one Asset Backed Securities Purchase Programmes, while the latter is represented by conferring upon the ECB a new supervisory tasks underpinned by the establishment of the Single Resolution Mechanism.

1 New ways of application of ECB/Eurosystem functions based on the pre-existing framework

The Eurosystem reacted to the financial crisis by adopting a number of new measures of monetary policy aimed at reactivating impaired transmission mechanism.

Figure 1 Transmission mechanism of monetary policy in the euro area

1.1 Three-year LTROs

While the standard liquidity provision operations have a maturity of one week (main refinancing operations – MRO), Eurosystem has in its toolbox also longer term liquidity providing operations of three months (longer term refinancing operations - LTROs). In addition to these standard or regular monetary policy operations, Eurosystem has put in place also two rounds of tree year longer-term refinancing operations and one round of longer targeted operations (TLTROs) as well as operations providing liquidity operations in US dollar. The latter was only possible because ECB has put in place a euro dollar swap facility with the Fed.
Another aspect of change with respect to refinancing operations is the shift from variable rate tenders based on auctioning of the counterparties of a fixed amount of liquidity to fixed rate tenders with full allotment permitting the counterparties to receive the amount of liquidity they wish in exchange of interest payment that is known (fixed) in advance to the relevant operation.

Table 1 Targeted longer-term refinancing operation and two longer term refinancing operations

<table>
<thead>
<tr>
<th></th>
<th>Settlement</th>
<th>Maturity date</th>
<th>Duration (days)</th>
<th>Allotted amount (EUR bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>TLTRO</td>
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<td>26/09/2018</td>
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<td>82.60157</td>
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<tr>
<td>LTRO</td>
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<td>1092</td>
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<td>22/12/2011</td>
<td>29/01/2015</td>
<td>1134</td>
<td>489.19075</td>
</tr>
</tbody>
</table>


1.2 Securities Markets Programme (SMP)

The SMP was established by the Decision of the European Central Bank of 14 May 2010 establishing a securities markets programme (ECB/2010/5).

The justification of the SMP was announced by the Governing Council on 10 May 2010 in the sense that severe tensions in the financial markets creating exceptional circumstances hampering monetary policy transmission mechanism call for establishment of a temporary securities markets programme.

It aimed at purchasing (i) in the secondary market eligible marketable debt instruments issued by the euro area Member States’ central government or public entities or (ii) in both primary and secondary markets eligible marketable debt instruments issued by private entities incorporated in the euro area. These assets were purchased from monetary policy counterparties and ECB/NCBs euro denominated portfolio investment counterparties.

SMP was discontinued and replaced by Outright Monetary Transactions (OMT). Governing Council at this occasion decided that the liquidity provided within SMP will be absorbed and the securities purchased within SMP will be held to maturity.

1.3 Outright Monetary Transactions (OMT)

President of the ECB Mario Draghi in his speech at the Global Investment Conference in London on 26 July 2012 said amongst others: *Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.*

This opened the way to Governing Council announcement of 2 August 2012 on Outright Monetary Transactions and further publication on 6 September 2012 of Technical features of Outright Monetary Transactions aiming at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy.

OMT is based on the following four principles:

a) **Conditionality** – the relevant Member States whose sovereign bonds would be considered for OMT has to strictly abide to the European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. This can be a macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line). Further condition is that the Eurosystem would not act alone – indeed EFSF/ESM has to stand ready as well to intervene via primary market purchases. Ideally, the IMF should also be involved in setting up and monitoring of the above mentioned programme. The final condition is that the OMT intervention must be relevant from monetary policy perspective and that the relevant Member State continuously complies with the programme. The failure to comply would terminate the OMT intervention even before the objectives are achieved. The limited character of an OMT inter-
vention therefore expresses via these two conditions – termination once the objectives are achieved or due to Member State’s non-compliance with the programme.

b) **Pari passu treatment** with other investors holding the same assets – in contrast to restructuring of Greek debt in February 2012 that featured only private sector involvement and no official sector involvement where ECB and other euro area NCBs fall under the “official sector” (see IMF).

c) **Sterilisation** – the liquidity injected by the purchases of eligible assets will be fully sterilised.

d) **Transparency** – weekly publication of OMT holdings including their market values and monthly publication of average duration of these holdings as well as breakdown by country.

Executive Board member Benoît Cœuré made an assessment of the OMT one year following its introduction outlining its **necessity, effectiveness and robustness**. He argued that the necessity of OMT is justified by the existence of financial fragmentation in the euro area. However, the Eurosystem has to achieve price stability in the euro area as a whole. Indeed the substantial divergence of borrowing costs for firms and households in various Member States makes difficult the implementation of coherent monetary policy across the euro area. This is exacerbated by the dependence of the banks’ rating on the rating of the respective sovereign where they are established. Further tail risks in euro area sovereigns expressed by the expectations of them leaving the euro area could drive public and private financing costs in these countries so high, in a way of self-fulfilling expectations, that they would have no other option than actually leave the euro area. Indeed in 2012, there were signs that investors started to calculate with redenomination risk with respect to various euro area sovereign bonds. The justification for existence of OMT therefore is price stability, as properly functioning transmission mechanism is hardly imaginable without proper functioning sovereign bond markets. Indeed, these are the most prominent benchmark for pricing of other assets, including loans. This turmoil could therefore impair lending of entire national economies. Therefore, if these differences in financing are not based in fundamentals, the monetary policy needs to restore the proper functioning of transmission mechanism. For that reason, the OMT is designed to eliminate self-fulfilling expectations of euro area break-up not interfering with sovereign bonds’ prices based on economic fundamentals. The effectiveness of OMT was illustrated by decreasing of Credit Default Swaps with respect to periphery economies, easing of bank borrowing costs as well as allowing them to raise capital. This in turn stopped the deposits outflows from periphery banks. Finally, the robustness of OMT lies in its conditional. As mentioned above, Governing Council decides on the possibility of buying sovereign bonds independently and only if the relevant Member State complies with the relevant adjustment programme. This eliminates moral hazard of Member States just waiting and not addressing domestic issues including structural reforms. Indeed, if this was the case, they would face the conditions of ESM programme first, before any purchases of their bonds under OMT would be considered. These arguments permitted to Mr Cœrè to conclude that conditionality (ESM programme) and complementarity (to national efforts) ensure compliance of the OMT with the monetary financing prohibition established by Article 123 of the Treaty on the Functioning of the European Union.

**Article 123 TFEU**

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.
On 14 of January 2015 Advocate General (AG) of the Court of Justice of the European Union Cruz Villanón rendered an opinion on the preliminary ruling from the preliminary ruling from the Bundesverfassungsgericht (Germany’s Federal Constitutional Court) concluding that OMT is compatible with TFEU as long as legal act implementing it will require that government bonds are purchased in the secondary markets in a way that would ensure that a genuine market price would develop first. This means that a given asset should only be purchased if a adequate time lapsed since the issuance of this asset since a purchase on the secondary market that is made seconds after the issue of the bonds on the primary market could completely blur the distinction between the two markets, although, formally, the purchase has taken place on the secondary market.

The ECB welcomed the opinion and expressed satisfaction by the intermediary of Executive Board Member Yves Mersch that stated: We have always been convinced that OMTs are legally sound and in line with our mandate. Any decision the Governing Council takes will be motivated by and restricted by its mandate to ensure price stability. As in the past, the Governing Council will comply with EU law.

While the AG Opinion on any given case is not binding on the Court of Justice, we note that the Court mostly follows the direction set up by the AG, even if sometimes using slightly different arguments. An affirmative judgment by the Court of Justice will certainly foster the reputation of the ECB as well as the whole Eurosystem and add credibility to the monetary policy implementation not only with respect to the economy, but also preservation of the very existence of the Economic and Monetary Union.

1.4 CBPP and ABSPP

Following two rounds of Covered Bond Purchase programmes of 2009/2010 (CBPP) and 2011/2012 (CBPP2) the ECB decided on 4 September 2014 two additional rounds of private debt instruments purchase programme – this time complementing CBPP3 with Asset-backed Securities Purchase programme (ABSPP).

While the CBPP3 targets debt instruments issued by euro area credit institutions backed typically by mortgages or exposure to public sector, the debt instruments targeted under ABSPP are backed by a wide range of exposures to euro area non-financial private sector, such as auto loans/leasings, SME loans, consumer credit and mortgages. Revival of ABS market should facilitate flow of new credit into economy.

These tools aim at complementing the tools of monetary policy and fostering the forward guidance given by the Governing Council. This should, in addition to the increased flow of credit to economy, enhance monetary policy transmission mechanism in order to bring medium to long-term expectations closer to the price stability target, i.e. inflation in terms of consumer prices close but below 2%.

While the CBPP3 is not substantially different from previous waves, ABSPP is a new instrument complementing Eurosystem’s toolbox. Following the September 2014 announcement, ABSPP was established by the Decision of the ECB of 19 November 2014 on the implementation of the asset-backed securities purchase programme (ECB/2014/45). The programme is based on Article 18.1 of the Statute of the European System of Central Banks and of the European Central Bank and is designed to last at least two years. It will be in an initial phase centralised at the ECB level and relying on the Eurosystem instructing its agents (External Asset Managers) to execute the deals. The originality of the program, in contrast to eligibility assessment for collateral purposes, is that purchases are allowed also in the primary markets. Further, in contrast with covered bonds that are liquid instruments, ABS will be purchased also in case they are retained by the originator, but on conditions that other investors will purchase asset with the same ISIN alongside Eurosystem. Finally, the ECB will perform risk assessment and due diligence relating to ABS purchases similarly to credit institutions.

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2 New tasks for the ECB following the unfolding of the financial crisis
Post-2008, the ECB has been vested with a range of new tasks such as participation in troika
(alongside the EU Commission and the IMF) effectively bringing its expertise in follow up of
adjustment programmes of Greece, Ireland and Portugal as well as taking over new tasks as a euro zone
wide supervisor of credit institutions.

2.1 Participation in troika
The ECB, together with the Commission and the International Monetary Fund, participates in
the so-called troika that assess the progress of EU Member States under the adjustment programme.
This permitted to suspend rating requirement for government bonds and certain government guarantee
d assets in the collateral policy with respect to Member States under the adjustment programme.
This was spelled out e.g. in the Guideline ECB/2013/4 as follows:

Article 7 of the Guideline ECB/2013/4
Suspension of the requirements for credit quality thresholds for certain marketable instruments
1. The Eurosystem’s minimum requirements for credit quality thresholds, as specified in the
Eurosystem credit assessment framework rules for marketable assets in Section 6.3.2 of Annex I to
Guideline ECB/2011/14 shall be suspended in accordance with paragraph 2.
2. The Eurosystem’s credit quality threshold shall not apply to marketable debt instruments is-
 sued or fully guaranteed by the central governments of euro area Member States under a European
Union/International Monetary Fund programme, unless the Governing Council decides that the re-
spective Member State does not comply with the conditionality of the financial support and/or the
macroeconomic programme.

2.2 Single Supervisory Mechanism (SSM)
The possibility to confer supervisory tasks upon the ECB was made possible by Article 127
TFEU where EU legislator left an open door to centralise supervision of credit institutions, however,
this same article excludes the possibility to extend this supervision to insurance companies.

Article 127 TFEU
5. The ESCB shall contribute to the smooth conduct of policies pursued by the competent au-
thorities relating to the prudential supervision of credit institutions and the stability of the financial
system.
6. The Council, acting by means of regulations in accordance with a special legislative proce-
dure, may unanimously, and after consulting the European Parliament and the European Central
Bank, confer specific tasks upon the European Central Bank concerning policies relating to the pru-
dential supervision of credit institutions and other financial institutions with the exception of insur-
ance undertakings.

The importance of establishing a Single Supervisory as one of the lessons learned from the fi-
nancial crisis was clearly spelled out by the ECB President Mario Draghi: [...] because national su-
pervisors, looking at the crisis, have asked their banks, the banks under their supervision, to withdraw
their activities within national boundaries. And they ring fenced liquidity positions so liquidity can’t
flow, even across the same holding group because the financial sector supervisors are saying “no”.
And further […] in the banking union or financial markets union, we will have one supervisor for the whole euro area.

SSM was established by the Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions and further complemented by the Regulation of the European Central Bank of 22 October 2014 on supervisory fees (ECB/2014/41) and by the Decision of the European Central Bank of 17 September 2014 on the implementation of separation between the monetary policy and supervision functions of the European Central Bank (ECB/2014/39).

Within the SSM, ECB will become a supervisor of approximately 6000 credit institutions across euro area. The functioning of monetary policy will be separated according to the Decision ECB/2014/39, including the meeting and agendas of the Governing Council. While the supervisory staff is separated from the monetary policy staff, the former will still be under the responsibility of the Executive Board with respect to organisational, administrative and human resources, however, will functionally report to the Chair and Vice-Chair of the Supervisory Board. This set up is necessary in order to allow exchange of non-anonymised information between the two policy functions under the responsibility of a common decision making body, the Executive Board.

Direct supervision of the ECB will extend to approximately 130 Significant Supervised Entities/Groups and will exercise supervisory oversight over the rest of the credit institutions/holdings.

Significant Supervised Entities/Groups are selected on the basis of published criteria, such as the volume of assets (min 30 billion) or share of these assets with respect to national GDP (20%). In Slovakia for example, SSE are the three largest credit institutions and some others via consolidated groups.4

In order to allow for smooth functioning of the supervision, SSM will still rely on National Competent Authorities (NCA). NCAs will still be the contact point for the licencing; they will prepare a draft decision on granting/refusing the authorisation to given candidate wishing to operate a credit institution. ECB in its capacity of SSM will decide on the authorisation as ultimate decision maker. Similarly the ECB will decide in fine on acquisition that would trigger qualifying holding thresholds, but the first assessment and recommendation will come from the NCAs.

It remains to be seen whether this development will continue further and EU legislator decides that an EU wide supervision of other important actors in the financial markets is appropriate. This happened is some Member States at the national level, e.g. National Bank of Slovakia and Czech National Bank regulate and supervise in addition to credit institutions also insurance companies, pension funds, etc.

2.3 Single Resolution Mechanism (SRM)

Unlike the SSM that has as members 18 Member States of the euro area (19 with Lithuania as of 1 January 2015), the SRM, more precisely the inter-governmental Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund was signed by 26 EU Member States (all but Sweden and the United Kingdom). The SRM is further legally based on a Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010.

Therefore, there is an open door for out-euro area EU Member States to adhere to SSM and in consequence benefit from SRM that would permit their troubled credit institutions to benefit from the coverage of the Single Resolution Fund. According to Article 2 of the SRM Regulation uniform rules and uniform procedure for credit institutions and financial holdings subject to SSM will be applied by the Single Resolution Board. This will naturally involve the consultations of the ECB and NCA. According to Article 7 of the SRM Regulation, for institutions or groups that are not considered significant under SSM or otherwise supervised by the ECB, NCA will still be responsible to draw the resolution plans. Further, cooperation of the NCA will be necessary in order to ensure on-site inspections of the relevant credit institutions by the Single Resolution Board.

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According to Article 69(1) of the SRM Regulation the Single Resolution Fund is planned to reach at least 1% of the amount of covered deposits of all credit institutions authorised in all of the participating Member States. This will happen over an 8 year transitional period and national contributions, while compartmented at the beginning, will gradually merge as of 1 January 2016 during the same period. The contributions of the relevant credit institutions will be adopted by the Single Resolution Board depending on their risk profile.

The SRM is a necessary corollary of the SSM and the ECB welcomed the plan to establish SRM in its opinion as follows:

**ECB Opinion CON/2013/76**

The ECB fully supports the establishment of a Single Resolution Mechanism (SRM), which will contribute to strengthening the architecture and stability of the economic and monetary union. The ECB also takes this opportunity to reiterate the position [...] , namely that the SRM is a necessary complement to the Single Supervisory Mechanism (SSM) in order to achieve a well-functioning financial market union. Such a mechanism must therefore be established by the time the ECB assumes its supervisory responsibility in full.

[...] The SRM is a necessary complement to the SSM, as the levels of responsibility and decision-making for resolution and supervision have to be aligned. In this respect, the ECB shares the view of the Commission that such a single mechanism is better placed to guarantee optimal resolution action, including adequate burden-sharing, than a network of national resolution authorities. Coordination between national resolution systems has not proved sufficient to achieve the most timely and cost-effective resolution decisions, particularly in a cross-border context.

[...]

The ECB welcomes the envisaged close cooperation between supervisory authorities and resolution authorities.

**Conclusion**

The Eurosystem monetary policy framework proved to be robust and flexible during the financial crisis. This can be illustrated by the resilience of euro against the dollar even if some pundits predicted and continue to predict at the minimum their parity. Indeed, the exchange rate only came down following implementation of ABSPP and third wave of CBPP and especially in expectation of large scale Fed-like quantitative easing by the Eurosystem. As the latter expectation will hardly materialise due to limits in the Eurosystem mandate as explained above, among others, referring to the Opinion of Advocate General Cruz Villanón, we can expect the exchange rate to trend back higher. The effectiveness of the Eurosystem monetary policy and its implementation can also be evidenced by a decrease in periphery euro area Member States’ sovereign bonds leading interest rates as well as swift adoption of unconventional measures such as SMP, OMT, CBPP and ABSPP. Moreover, instead of a feared euro area split up, the monetary union was enlarged by Slovakia in 2009, Estonia in 2011, Latvia in 2014 and Lithuania in 2015. In addition, the European legislator realised that functioning monetary policy requires banking union and established the first stepping stones in SSM and SSM.

The challenge that remains for the European Union and national institutions and bodies are structural adjustments of the economies as well as strengthening of the first leg of the Economic and Monetary Union, i.e. the coordination of economic and budgetary policies. This, however, goes beyond the scope of this article.

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The views and opinions expressed in this paper are those of the author and do not necessarily reflect the views or opinions of the Banque centrale du Luxembourg or the Eurosystem.

1 “Eligible” means assets that are eligible collateral for monetary policy operations.
2 “Marketable” means marketable assets eligible as collateral for monetary policy operations, such as corporate bonds, covered bonds, etc.
3 E.g. in July 2012 the two-year German government bonds turned negative.
Assuming a solution to the fiscal cliff is reached, what then is the next ‘shiny object’ that will capture the attention of the media, international politicians and the investing public? To us, it’s the over-valuation of the European Union’s common currency. The euro is the biggest factor preventing an economic recovery across the pond, exceeding even the indebtedness of Portugal, Italy, Greece and Spain, which no doubt remains a considerable concern.

Ben Marks - Euro Still Too Expensive Versus Dollar, Expect Parity, 27 December 2012


U.S. Dollar Will Achieve Parity With Euro by 2017, Says Goldman, 29 August 2014


Ben Rooney - Spanish debt en fuego, 13 June 2014 Earlier this week, Spain was able to borrow money from investors for 10 years at a lower interest rate than the United States, the world’s safest and most stable economy. Ireland and Italy have also seen their borrowing costs fall to levels that aren’t that much higher than what the U.S. government pays.

http://money.cnn.com/2014/06/13/investing/spain-ireland-italy-bonds/

4 For more details see The list of significant supervised entities and the list of less significant institutions

5 Ben Marks - Euro Still Too Expensive Versus Dollar, Expect Parity, 27 December 2012

6 U.S. Dollar Will Achieve Parity With Euro by 2017, Says Goldman, 29 August 2014

7 Ben Rooney - Spanish debt en fuego, 13 June 2014 Earlier this week, Spain was able to borrow money from investors for 10 years at a lower interest rate than the United States, the world’s safest and most stable economy. Ireland and Italy have also seen their borrowing costs fall to levels that aren’t that much higher than what the U.S. government pays.

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