

Institute for
Monetary and
Financial
Stability



IMFS Interdisciplinary Studies in
Monetary and Financial Stability

1 / 2015

The ECB's Outright Monetary Transactions in the Courts

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Helmut Siekmann and Volker Wieland Introduction

ECB President Mario Draghi's "whatever it takes" speech and the subsequent unveiling of a new sovereign debt purchase program of the European Central Bank, the Outright Monetary Transactions (OMT), in the summer of 2012 have been key drivers of the decline of sovereign risk premia in euro area crisis countries. Yet the program has been questioned from a legal perspective by the German Constitutional Court. Legal and economic issues concerning the OMT program were in the focus of the IMFS Conference on November 26, 2013 on "The Economic and Legal Limits of Central Banking", sponsored by the Stiftung Geld und Wahrung (Foundation of Monetary and Financial Stability).

On the imminent occasion of the European Court of Justice's Advocate General summing up of the OMT case in January 2015, this issue compiles selected contributions of the IMFS Conference in an updated version. At the same time, the crisis in the euro area is back on the agenda amid investor concerns about Greece leaving the currency union and speculation about the European Central Bank moving closer to large-scale sovereign-bond purchases.

In their article, Helmut Siekmann and Volker Wieland explore the legal implications of the German Court's announcement of referring the OMT case to the European Court of Justice in February 2014 as well as the respective responsibilities of the German and the European Court.

Dr. Avv. Antonio Luca Riso provides an analysis of the OMT case from an EU law perspective arguing that the monetary policy transmission mechanism not only allows but sometimes requires a central bank to intervene in the government bond markets. According to this analysis, the ECB mandate is wide enough to include the implementation of measures such as the OMT. The views expressed in this article are

those of the author and do not necessarily represent those of the ECB or the Eurosystem.

On the other hand, Christoph Degenhart, Professor of Law at the University of Leipzig, comes to the conclusion that the unlimited purchase of government bonds of individual euro zone countries extends the remit assigned to the European Central Bank by the European Treaties up to the legally admissible limit and beyond. In Degenhart's opinion, "the legal limits for rescue measures of the ECB are not only exhausted, they are exceeded".

Following these legal considerations, Harald Uhlig, from the University of Chicago, investigates if and when the ECB policy of buying government bonds amounts to a bailout, pointing out that ECB policies in general, and the OMT in particular, lack democratic control. According to Uhlig, there is a "dramatic democratic legitimacy vacuum concerning the powers available to the ECB".

Helmut Siekmann and Volker Wieland*

The German Constitutional Court's decision on OMT: Have markets misunderstood?

1. The Bank, the Court and the Markets

ECB President Mario Draghi's "whatever it takes" speech on July 26, 2012 and the subsequent unveiling of a new sovereign debt purchase program, the Outright Monetary Transactions (OMT), on August 2 and September 6 of the same year have been widely credited as key drivers of the decline in sovereign risk premia since the middle of 2012.¹ Altavilla et al (2014), for example, estimate that the OMT announcements decreased the Italian and Spanish two-year government bond yields by about two percentage points. By June 2013, when asked at the ECB press conference about the upcoming hearings on the OMT held by the German Constitutional Court in Karlsruhe², Mario Draghi himself responded: "When we all look back at what OMT has produced, frankly when you look at the data, it's really very hard not to state that OMT has been probably the most successful monetary policy measure undertaken in recent time. ... OMT has brought stability, not only to the markets in Europe but also to the markets worldwide."

However, when the German Constitutional Court announced on February 7, 2014 that it did not consider the ECB's OMT announcement consistent with EU primary law, financial markets did not even blink. In fact, sovereign risk premia of euro zone crisis countries continued to decline steadily throughout 2014 (Figure 1).

Initially, many market participants may have thought that the referral of questions concerning this case to the European Court of Justice meant that it would be assured that the European Court would ultimately rule in favor of the OMT. Yet, commentators quickly pointed out that the German Consti-

tutional Court reserved its own judgment and pronounced the OMT program "effectively dead".

How could the benign behavior of sovereign risk premia for euro area crisis countries then be reconciled with the Court's decision on OMT?³

Of course, there are many other factors that are potentially influencing sovereign risk premia. One explanation could simply be that the progress achieved in terms of economic fundamentals due to fiscal consolidation and structural reforms has been sufficient to justify the lower sovereign risk premia even with the OMT "effectively dead". Indeed, Ireland successfully completed its program with the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) in December 2013. Spain also exited its financial assistance program in that month. And Portugal's performance had been so positive that by February 2014 it was fairly likely that it would successfully complete its EFSF/ESM program.

Portugal then exited the program in May 2014.⁴ These countries have undergone major adjustment programs. As a result, competitiveness has improved, exports have increased, private indebtedness has improved, public deficits have declined and government debt-to-GDP ratios have begun to stabilize. Italy has not needed ESM support. It has achieved a primary fiscal surplus and succeeded in rolling over its large outstanding debt at relatively low cost. Thus, one might conclude that the continued decline in sovereign risk premia following the announcement of the Federal Constitutional Court of Germany was the result of a rational response of financial market participants to improved economic fundamentals.

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¹ Supportive empirical analysis has been provided by Altavilla et al (2014) and De Grauwe and Ji (2014), for example.

² For an analysis of the legal matters at stake at the time of the hearings conducted by the German Court see, for example, Siekmann and Wieland (2013a) and (2013b).

³ See for example, Fratzscher (2014) and Münchau (2014).

⁴ The restructuring of Portugal's Banco Espírito Santo on August 3, 2014, however, required a recapitalization on the scale of 4.4 bln. To this end, the Portuguese government drew on some 6.4 bln leftovers from the from the IMF/EU bailout funds that were specifically earmarked to banks' assistance.

Nevertheless, it is easy to make the case that the situation remains very fragile and the euro area sovereign debt crisis is far from over.⁵ Unemployment in crisis countries is very high and economic activity fairly low compared to the levels before the crisis. Italian GDP, in fact, remains furthest below the level reached before the start of the global financial crisis among the four countries mentioned so far. Only Greek GDP is even more distant from the level reported for 2007. While government debt-to-GDP ratios are stabilizing, they are doing so at high levels. Hence, these countries remain vulnerable. From this perspective, some observers might simply take the fact that financial market participants have ignored the German Constitutional Court's negative assessment of OMT as another indication of their lack of rationality.

In the remainder of this note we aim to explore in more detail the legal implications of the German Court's announcement regarding OMT, the respective responsibilities of the German and the European Court and the possible outcomes of this judicial process. We also aim to assess to what extent these outcomes would support the lack of a reaction of sovereign risk premia to the German Court's announcement.

2. Key Features of the ECB's OMT Announcement

On August 2, 2012, Mario Draghi expressed the ECB's concerns that the exceptionally high risk premia embodied in sovereign bond prices in several euro area member countries were hindering the transmission of monetary policy. Specifically, risk premia driven by fears of the reversibility of the euro as the currency of these countries were unacceptable to the ECB.

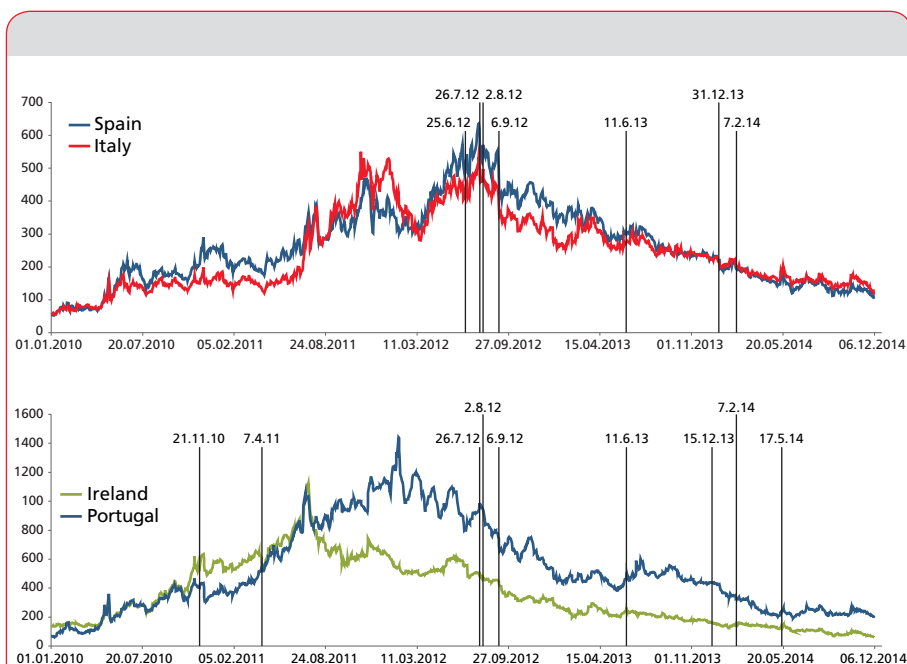


Figure 1: 10-year Sovereign Debt Spreads versus Germany

Notes: the following dates are indicated in format day/month/year by vertical bars in the panels: 21.11.10 Ireland announced request for EFSF/ESM support, 7.4.11 Portugal announced request for EFSF/ESM support, 25.6.12 Spain announced request of ESM financial assistance, 26.7.12 Mario Draghi's "whatever it takes" speech, 2.8.12 ECB announces OMT program, 6.9.12 ECB publishes technical details of OMT program, 11.6.13 Constitutional Court hearings on OMT, 15.12.13 Ireland exits ESM program, 7.2.14 Announcement of the Constitutional Court, 17.5.14 Portugal exits ESM program.

While emphasizing that governments would need to push ahead with fiscal consolidation, structural reform and European institution-building in order for those risk premia to disappear, Draghi also called on them to request support by the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) in the bond market when exceptional financial circumstances and risks to financial stability exist. In those circumstances, the ECB would then be willing to buy sovereign bonds in the quantity needed to reduce the above-mentioned risk premia.

⁵ De Grauwe and Jin (2014), for example, claim that their analysis indicates that "most of this decline in government bond premia is due to the positive market sentiments that OMT has triggered, and is not related to underlying economic fundamentals such as debt-to-GDP ratios or external debt positions".

Clearly, such interventions could be very large and many commentators treated the ECB announcement as a promise of unlimited ECB intervention in government debt markets. Importantly, the ECB stated that it would forego seniority status and that its holdings of these sovereign bonds would be subject to the same losses as privately-held bonds in the event of a sovereign default.

The ECB was well aware of the danger that monetary policy might come to be seen as subordinated to fiscal concerns. For this reason, the ECB made clear that such interventions would be subject to the conditionality imposed on the respective government by the EFSF/ESM.

The technical features of the OMT were described in the ECB Press Release of September 6, 2012, which is also found in Appendix 1 to this paper.

3. The German Constitutional Court's Decision in February 2014

On February 7, 2014 the German Federal Constitutional Court (GFCC) announced the following (for the full press release see Appendix 2):

(i) the charges concerning the OMT Decision of the ECB of September 6, 2012 are separated from the other matters (concerning the amendment of Art. 136 TFEU, establishing the permanent support mechanism ESM, and the "fiscal compact");

(ii) the proceedings concerning the OMT Decision are suspended and several questions are referred to the European Court of Justice (ECJ) for a preliminary ruling;

(iii) a final decision on the part of the case which is not suspended will be pronounced on Tuesday, March 18, 2014.

And in fact, this latter decision has been handed down with all remaining complaints being dismissed.

The questions presented to the ECJ deal with the problem whether the OMT is consistent with EU primary law. In view of the German Court, the OMT may well exceed the mandate given to the ECB which is limited to monetary policy. It lists a number of important reasons why the OMT may interfere with economic policy reserved to Member States and why the OMT may violate the prohibition of monetary financing of the EU or its Member States. The key argument used by the ECB to justify its actions "disruptions of the monetary policy transmission mechanism" was rejected by the Court as being irrelevant.

From this perspective, the OMT may have to be considered as "ultra vires" (i.e. outside the competences given to the EU and the ECB in line with the EU treaties and thus outside democratic legitimation) and could constitute a violation of German constitutional law. However, the GFCC also delineated an alternative interpretation of OMT that it would consider consistent with EU primary law. This interpretation involves a range of constraints and limitations. The Court had concluded from the statements of the ECB's representatives presented in the hearings in June 2013 that the objectives of OMT could be achieved within such constraints.

4. German Constitutional Court versus European Court of Justice: Who is going to have the last word?

The tasks of the ECJ and the GFCC are well defined: The ECJ shall ensure that in the interpretation and application of the Treaties the law is observed whereas the GFCC is installed as the “guardian” of the German Federal Constitution, the “Basic Law” (Grundgesetz). The domain of the ECJ is the enforcement of EU law; the domain of the GFCC is the compliance with the Basic Law. In particular, the GFCC has the power to control whether a statute is in accordance with the constitution. Its competences are, however, limited to acts of German authorities and do not include the control of institutions and organs of the EU. Although no formal hierarchy has been established between the ECJ and the national courts, the described distribution of competences in conjunction with the primacy of application of Union law would give the word of the European Court clearly greater weight. As a consequence, OMT and all other actions of the ECB would not fall into the jurisdiction of the German Court.

While this demarcation of powers is clear in theory, it has been blurred in practice by the judicature of the GFCC. In a series of decisions the Court has held that acts of institutions and agencies of the European Union have a binding effect in the Federal Republic of Germany only within certain limits. It has reserved the right to review whether these acts are based on manifest transgressions of powers or affect the area of constitutional identity, which cannot be transferred. If such an infraction is manifest and entails a structurally significant shift in the allocation of powers to the detriment of the Member States, it would have to be judged as a violation of German constitutional law as it were not covered by the legislative Acts of Assent to the Treaties conferring powers on the EU. In addition, the protection of the core content of the Basic Law (“identity”) is considered a task of the Federal Constitutional Court alone.

The Court concedes, however, that these reserved powers of control have to “be exercised only in a manner that is cautious and friendly towards European law”. This means for

the ultra vires review at hand that the Federal Constitutional Court must in principle comply with the rulings of the Court of Justice as a binding interpretation of Union law. But the GFCC “will take the interpretation which the Court of Justice gives in a preliminary ruling” only as a basis. In their “cooperative relationship”, it attributes to the Court of Justice the interpretation of the act. On the other hand, it shall be the GFCC which “determines the inviolable core content of the constitutional identity, and to review whether the act interferes with this core”. By this, the German Court claims to have the “last word” in extreme cases.

According to the opinion of the GFCC, a manifest and structurally significant transgression of powers would have to be assumed if the European Central Bank acted beyond its monetary policy mandate or if the prohibition of monetary financing of government budgets was violated by the OMT program. Additionally, the GFCC has reserved the right to determine whether the OMT – even after an interpretation by the ECJ taking into account the concerns of the German Court – infringes the inviolable core content of the constitutional identity. Such a “last word” of the German Court could possibly lead to an open conflict among the judicial institutions.

The GFCC's decisions are binding for all German authorities. They have the virtue of law. Thus, the German government and the Bundesbank would be obliged to comply with the decisions of the Court. If not, legal actions against them could ensue. As a consequence the Bundesbank would be prohibited to participate in the OMT, in case the GFCC finally comes to the conclusion, after receiving answers from the ECJ, that the OMT violates the core content of the constitutional identity; regardless of what the European Court pronounces about the conformity with EU law.

In case the ECJ were to decide that OMT conforms to EU law and the Bundesbank did not implement Euro system policy appropriately, the ECB could sue the Bundesbank in a specific procedure before the ECJ laid down in the Statute of the ESCB and the ECB.

5. Key considerations of the German Court concerning the OMT

5.1. Transgression of mandate

The GFCC points out that the mandate of the ECB is limited to monetary policy, while other economic policies are reserved to Member States. According to its assessment, already the OMT decision – let alone its implementation – interferes with Member States' competences in economic policy. Reasons for this assessment are the following:

(i) with OMT the ECB aims to neutralize risk premia on the debt of certain sovereigns which are market results;

(ii) an approach that differentiates between Member States does not fit with the monetary decision-making framework for a monetary union;

(iii) the linkage to the conditionality of an ESM program of the Member States indicates that it reaches into the realm of economic policies reserved to Member States;

(iv) that the purchase of government debt as outlined in the OMT exceeds the support of the general economic policies in the European Union that the European System of Central Banks is allowed to pursue. The reason being the ECB would make an independent economic evaluation that could imply removing the support when conditions are not met.

5.2. Violation of prohibition of monetary financing of budgets

The GFCC expresses a broad interpretation of the prohibition of monetary financing of budgets. It holds that the (explicit) interdiction of direct purchase of government debt on the primary market also applies to functionally equivalent measures that are simply intended to circumvent that prohibition. In this context, it also views the total or partial forgiveness, i.e. acceptance of haircuts on sovereign debt, as inadmissible monetary financing. It is functionally equivalent

to just handing over resources up-front.

5.3. Justification

The Court also rejected the objective used by the ECB to justify the OMT Decision “to correct a disruption of the monetary policy transmission mechanism” as irrelevant. It could neither change the transgression of the European Central Bank's mandate, nor the violation of the prohibition of monetary financing of the budget. The main argument is that it would amount to granting plain power to the European Central Bank to remedy any deterioration of the credit rating of a euro area Member State. Furthermore, it also “seems irrelevant” to the Court that the ECB only intends to assume a disruption to the monetary policy transmission mechanism if the interest rate charged from a Member State of the euro currency area were “irrational”. To its view it would be an almost “arbitrary interference with market activity” to single out individual causes as irrational. Thus, the distinction between “rational and irrational” ultimately appears to be “meaningless in this context”.

5.4. Alternative interpretation of OMT in conformity with Union law

The GFCC offers an alternative interpretation of OMT that it would consider consistent with EU primary law. This would be the case if the OMT would not subvert the conditionality of EFSF and ESM rescue programs and if it would only be of a supportive character for EU policies. Specifically, in the GFCC's view, the following limitation for the OMT would be essential:

(i) no acceptance of possible haircuts on Member States' debt;

(ii) no purchases of selected Member States' debt up to unlimited amounts;

(iii) avoiding interference with the price-formation on the market as much as possible.

In this regard, the detailed explanations issued by the GFCC include an interesting reference to the testimony of ECB representatives during the hearings of the GFCC in June 2013. Specifically, the explanations to the framework of the OMT (limited purchase volume, no participation in haircut, intervals between issuance of debt and ECB purchase, not held to maturity) by the ECB representatives would indicate that the GFCC's "alternative interpretation of an OMT that would be consistent with EU primary law" would still achieve the objective of the ECB's OMT announcement.

6. Outlook

6.1. Potential outcome of the struggle of the courts

At first sight, the German Court has demonstrated respect for the distribution of powers in the multilevel system of the European Union and specifically for the European Court of Justice. Some legal scholars, however, have questioned this view (see Heun 2014, Thiele 2014). They claim a closer look reveals that the decision does in fact not respect the primacy of application of Union law (Anwendungsvorrang) and its interpretation by the ECJ as the GFCC has reserved the right to review whether an act has interfered with the inviolable core content of the constitutional identity – even after a "friendly" interpretation of the OMT by the ECJ.

The reputation of both courts would suffer from a conflict. The judges of both institutions know each other and meet often in a variety of settings. Note also, the President of the ECJ, Vassilios Skouris, a Greek national, speaks German, studied law in Germany, and was professor of law in Germany. Though the courts may well disagree, they certainly understand where each is coming from in its analysis.

The German court referred key questions to the ECJ while at the same time unmistakably signaling its own judgment of the facts. Furthermore, by not asking for an expedited procedure the GFCC left room for delaying a final decision until the economic situation in the euro area has improved. This way, the crisis need not influence unduly either Court's

decision on the lawfulness of the OMT.

If the ECJ were to completely ignore the GFCC's analysis and the arguments presented without providing substantially new arguments or evidence, the GFCC could consider itself well-justified to rule that the OMT are beyond the ECB's mandate and forbid German authorities to support them.

In the meantime, the final decision on the rest of the proceedings has been pronounced: The GFCC judged the insertion of the new paragraph 3 in Article 136 TFEU opening the door for permanent support facilities by Member States, the Treaty establishing the European Stability Mechanism (ESM), and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (new fiscal compact) as consistent with the Basic Law without reservation. In this manner, the Court has again demonstrated its principally friendly attitude towards European integration. In constant jurisdiction it has never halted a step towards more integration but has only provided a voice for concerns about flaws associated with those steps, for example deficits in democratic legitimation, in particular in budgetary matters.

All aspects considered, the ECJ has an incentive to adopt at least some of the limitations held essential by the GFCC. However, it could announce its own interpretation of an OMT that would incorporate a subset of the criteria under 3.4 but not all of them. The GFCC might then find it rather difficult to reject such a "compromise interpretation". What to accept and what to drop would likely depend on which aspect the ECB would consider most important in order to achieve the objective it had in mind for the OMT.

6.2. Implications for market perceptions of OMT effectiveness

The above analysis of the possible outcomes of the judicial process involving GFCC and ECJ suggests no simple conclusion. The ECJ can neither simply ensure the continued

effectiveness of the ECB's OMT, nor are the OMT necessarily effectively dead.

First, the ECJ may simply delay any decision until the euro area economies are finally out of the crisis. As long as no new shock pushes these economies back to the brink, the low level of risk premia might not be disturbed.

More importantly, a "compromise interpretation" may be possible. Already during the period leading up to the June 2013 hearings of the Constitutional Court the ECB made clear that the OMT program not literally unlimited. Thus, some more formal limits need not destroy its effectiveness. After all, the real resources at the disposal of the ECB in terms of real income it can raise are quite limited in any case. Furthermore, even nominal monetary expansion would eventually have to be curtailed, once it causes inflation to rise significantly above the ECB's objective of close to 2 percent.

The ECB's decision that it would forego seniority status was certainly a crucial feature of the OMT announcement. It had become clear during the process leading up to the write-down of Greek sovereign debt, the so-called Private Sector Involvement (PSI) finalized in February 2012, that sovereign debt purchases by the ECB under its SMP program would not stabilize prices. Rather, because the ECB maintained seniority status, they would reduce the amount of privately-held paper and increase the likely haircut imposed on them.

If the ECJ were to rule that foregoing ECB seniority status on its sovereign debt holdings resulting from OMT purchases were consistent with EU primary law, the GFCC would face a difficult decision as it clearly criticized this aspect of the OMT program. Even so, one could envision adjustments to the OMT program that would keep it effective. For example, it might be decided that a certain extent of losses on ECB holdings were to be covered by guarantees from the ESM. Hence, the OMT could still function as a leveraging of the ESM's resources.

In sum, the fact that sovereign risk premia have continued to decline after the GFCC's critical statements on OMT need not be taken as a sign that market participants irrationally refuse to accept that the OMT program is "effectively dead".

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Appendix 1: ECB Press Release of 6 September 2012 - Technical features of Outright Monetary Transactions

As announced on 2 August 2012, the Governing Council of the European Central Bank (ECB) has today taken decisions on a number of technical features regarding the Eurosystem's outright transactions in secondary sovereign bond markets that aim at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy. These will be known as Outright Monetary Transactions (OMTs) and will be conducted within the following framework:

Conditionality

A necessary condition for Outright Monetary Transactions is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. Such programmes can take the form of a full EFSF/ESM macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases. The involvement of the IMF shall also be sought for the design of the country-specific conditionality and the monitoring of such a programme.

The Governing Council will consider Outright Monetary Transactions to the extent that they are warranted from a monetary policy perspective as long as programme conditionality is fully respected, and terminate them once their objectives are achieved or when there is non-compliance with the macroeconomic adjustment or precautionary programme.

Following a thorough assessment, the Governing Council will decide on the start, continuation and suspension of Outright Monetary Transactions in full discretion and acting in accordance with its monetary policy mandate.

Coverage

Outright Monetary Transactions will be considered for future cases of EFSF/ESM macroeconomic adjustment programmes or precautionary programmes as specified above. They may also be considered for Member States currently under a macroeconomic adjustment programme when they will be regaining bond market access.

Transactions will be focused on the shorter part of the yield curve, and in particular on sovereign bonds with a maturity of between one and three years.

No ex ante quantitative limits are set on the size of Outright Monetary Transactions.

Creditor treatment

The Eurosystem intends to clarify in the legal act concerning Outright Monetary Transactions that it accepts the same (*pari passu*) treatment as private or other creditors with respect to bonds issued by euro area countries and purchased by the Eurosystem through Outright Monetary Transactions, in accordance with the terms of such bonds.

Sterilisation

The liquidity created through Outright Monetary Transactions will be fully sterilised.

Transparency

Aggregate Outright Monetary Transaction holdings and their market values will be published on a weekly basis. Publication of the average duration of Outright Monetary Transaction holdings and the breakdown by country will take place on a monthly basis.

Securities Markets Programme

Following today's decision on Outright Monetary Transactions, the Securities Markets Programme (SMP) is herewith terminated. The liquidity injected through the SMP will continue to be absorbed as in the past, and the existing securities in the SMP portfolio will be held to maturity.

Appendix 2: Federal Constitutional Court, Press release no. 9/2014 of 7 February 2014, Orders of 17 December 2013 and of 14 January 2014: Principal Proceedings ESM/ECB: Pronouncement of the Judgment and Referral for a Preliminary Ruling to the Court of Justice of the European Union

Based on the oral hearing of 11 and 12 June 2013 (see press releases no. 29/2013 of 19 April 2013 and no. 36/2013 of 14 May 2013), on Tuesday 18 March 2014, 10:00 am in the Courtroom of the Federal Constitutional Court, "Waldstadt" seat, Rintheimer Querallee 11, 76131 Karlsruhe the Second Senate of the Federal Constitutional Court will pronounce its judgment on the subjects of the proceedings that relate to the establishment of the European Stability Mechanism (ESM) and the Treaty of 2 March 2012 on Stability, Coordination and Governance in the Economic and Monetary Union (Fiscal Compact). The conditions for accreditation will be announced at a later stage; currently, no accreditations are possible.

The Senate has separated the matters that relate to the OMT Decision of the Governing Council of the European Central Bank of 6 September 2012, stayed these proceedings and referred several questions to the Court of Justice of the European Union for a preliminary ruling. The subject of the questions referred for a preliminary ruling is in particular whether the OMT Decision is compatible with the primary law of the European Union. In the view of the Senate, there are important reasons to assume that it exceeds the European Central Bank's monetary policy mandate and thus infringes the powers of the Member States, and that it violates the prohibition of monetary financing

of the budget. While the Senate is thus inclined to regard the OMT Decision as an ultra vires act, it also considers it possible that if the OMT Decision were interpreted restrictively in the light of the Treaties, conformity with primary law could be achieved. The Senate decided with 6:2 votes; Justice Lübke-Wolff and Justice Gerhardt both delivered a separate opinion.

Facts of the Cases:

In a reasonable assessment of their applications, the complainants and the applicant challenge, first, the participation of the German Bundesbank in the implementation of the Decision of the Governing Council of the European Central Bank of 6 September 2012 on Technical Features of Outright Monetary Transactions (OMT Decision), and secondly, that the German Federal Government and the German Bundestag failed to act regarding this Decision. The OMT Decision envisages that the European System of Central Banks can purchase government bonds of selected Member States up to an unlimited amount if, and as long as, these Member States, at the same time, participate in a reform programme as agreed upon with the European Financial Stability Facility or the European Stability Mechanism. The stated aim of the Outright Monetary Transactions is to safeguard an appropriate monetary policy transmission and the consistency or "singleness" of the monetary policy. The OMT Decision has not yet been put into effect.

Essential Considerations of the Senate:

1. According to the established case-law of the Federal Constitutional Court, the Court's powers of review cover the examination of whether acts of European institutions and agencies are based on manifest transgressions of powers or affect the area of constitutional identity of the Basic Law, which cannot be transferred and is protected by Art. 79 sec. 3 of the Basic Law (Grundgesetz – GG).
2. If the OMT Decision violated the European Central Bank's monetary policy mandate or the prohibition of monetary

financing of the budget, this would have to be considered an ultra vires act.

a) Pursuant to the Federal Constitutional Court's Honeywell decision (BVerfGE 126, 286), such an ultra vires act requires a sufficiently qualified violation. This means that the act of authority of the European Union must be manifestly in violation of powers, and that the challenged act entails a structurally significant shift in the allocation of powers to the detriment of the Member States.

b) The mandate of the European Central Bank is limited in the Treaties to the field of monetary policy (Art. 119 and 127 et seq. TFEU, Art. 17 et seq. ESCB Statute). It is not authorised to pursue its own economic policy but may only support the general economic policies in the Union (Art. 119 sec. 2, Art. 127 sec. 1 sentence 2 TFEU; Art. 2 sentence 2 ESCB Statute). If one assumes – subject to the interpretation by the Court of Justice of the European Union – that the OMT Decision is to be qualified as an independent act of economic policy, it clearly violates this distribution of powers. Such a shifting of powers would also be structurally significant, because the OMT Decision could be superimposed onto assistance measures which are part of the “Euro rescue policy” and which belong to the core aspects of the Member States' economic policy responsibilities (cf. Art. 136 sec. 3 TFEU). Moreover, the Outright Monetary Transactions can lead to a considerable redistribution between the Member States, and can thus gain effects of a system of fiscal redistribution, which is not entailed by the European Treaties.

c) Should the OMT Decision violate the prohibition of monetary financing of the budget (Art. 123 TFEU), this, too, would have to be considered a manifest and structurally significant transgression of powers. The violation would be manifest because primary law stipulates an explicit prohibition of monetary financing of the budget and thus unequivocally excludes such powers of the European Central Bank. The violation would also be structurally significant, because the prohibition of monetary financing of the budget is one of the fundamental rules for the design of the Monetary Union

as a “community of stability”. Apart from this, it safeguards the overall budgetary responsibility of the German Bundestag.

3. The existence of an ultra vires act as understood above creates an obligation of German authorities to refrain from implementing it and a duty to challenge it. These duties can be enforced before the Constitutional Court at least insofar as they refer to constitutional organs.

a) It is derived from the responsibility with respect to integration that the German Bundestag and the Federal Government are obliged to safeguard compliance with the integration programme and, in case of manifest and structurally significant transgressions of powers by European Union organs, to actively pursue the goal to reach compliance with the integration programme. They can retroactively legitimise the assumption of powers by initiating a corresponding change of primary law, and by formally transferring the exercised sovereign powers in proceedings pursuant to Art. 23 sec. 1 sentences 2 and 3 GG. However, insofar as this is not feasible or wanted, they are generally obliged within their respective powers, to pursue the reversal of acts that are not covered by the integration programme, with legal or political means, and – as long as the acts continue to have effect – to take adequate precautions to ensure that the domestic effects remain as limited as possible.

b) A violation of these duties violates individual rights of the voters that can be asserted with a constitutional complaint. According to the established case-law of the Senate, Art. 38 sec. 1 sentence 1 GG is violated if the right to vote is in danger of being rendered ineffective in an area that is essential for the political self-determination of the people. On the other hand, Art. 38 sec. 1 sentence 1 GG does not entail a right to have the legality of decisions taken by a democratic majority reviewed by the Federal Constitutional Court.

Vis-à-vis manifest and structurally significant transgressions of the mandate by the European institutions, the safeguard provided by Art. 38 sec. 1 sentence 1 GG also consists of a

procedural element: In order to safeguard their democratic influence in the process of European integration, citizens who are entitled to vote generally have a right to have a transfer of sovereign powers only take place in the ways envisaged, which are undermined when there is a unilateral usurpation of powers. A citizen can therefore demand that the Bundestag and the Federal Government actively deal with the question of how the distribution of powers can be restored, and that they decide which options they want to use to pursue this goal. An ultra vires act can further be the object of Organstreit proceedings [proceedings relating to disputes between constitutional organs].

4. Subject to the interpretation by the Court of Justice of the European Union, the Federal Constitutional Court considers the OMT Decision incompatible with primary law; another assessment could, however, be warranted if the OMT Decision could be interpreted in conformity with primary law.

a) The OMT Decision does not appear to be covered by the mandate of the European Central Bank. The monetary policy is to be distinguished according to the wording, structure, and purpose of the Treaties from (in particular) the economic policy, which primarily falls into the responsibility of the Member States. Relevant to the delimitation are the immediate objective of an act, which is to be determined objectively, the instruments envisaged to achieve the objective, and its link to other provisions.

The classification of the OMT Decision as an act of economic policy is supported by its immediate objective, which is to neutralise spreads on government bonds of selected Member States of the euro currency area. According to the European Central Bank, these spreads are partly based on fear of investors of a reversibility of the euro; however, according to the Bundesbank, such interest rate spreads only reflect the scepticism of market participants that individual Member States will show sufficient budgetary discipline to stay permanently solvent.

The purchase of government bonds from selected Member

States only is a further indication of the OMT Decision being an act of economic policy because the monetary policy framework of the European System of Central Banks does generally not have an approach which would differentiate between individual Member States. The parallelism of the OMT with assistance programmes of the EFSF or the ESM and the risk of undermining their objectives and requirements confirm this assessment. The purchase of government bonds to provide relief to individual Member States that is envisaged by the OMT Decision appears, in this context, as the functional equivalent to an assistance measure of the above-mentioned institutions – albeit without their parliamentary legitimation and monitoring.

b) Art. 123 sec. 1 TFEU prohibits the European Central Bank from purchasing government bonds directly from the emitting Member States. It seems obvious that this prohibition may not be circumvented by functionally equivalent measures. The above-mentioned aspects, namely the neutralisation of interest rate spreads, selectivity of purchases, and the parallelism with EFSF and ESM assistance programmes indicate that the OMT Decision aims at a prohibited circumvention of Art. 123 sec. 1 TFEU. The following aspects can be added: The willingness to participate in a debt cut with regard to the bonds to be purchased; the increased risk; the option to keep the purchased government bonds to maturity; the interference with the price formation on the market, and the encouragement, coming from the ECB's Governing Council, of market participants to purchase the bonds in question on the primary market.

c) In the view of the Federal Constitutional Court, the objective mentioned by the European Central Bank to justify the OMT Decision, namely to correct a disruption to the monetary policy transmission mechanism, cannot change this assessment. The fact that the purchase of government bonds can, under certain conditions, also help to support the monetary policy objectives of the European System of Central Banks does not turn the OMT Decision itself into an act of monetary policy. If purchasing of government bonds were admissible every time the monetary policy transmis-

sion mechanism is disrupted, it would amount to granting the European Central Bank the power to remedy any deterioration of the credit rating of a euro Member State through the purchase of that state's government bonds. This would largely suspend the prohibition of monetary financing of the budget.

d) In the view of the Federal Constitutional Court, the OMT Decision might not be objectionable if it could be interpreted or limited in its validity in conformity with primary law in such a way that it would not undermine the conditionality of the assistance programmes of the EFSF and the ESM, and would indeed only be of a supportive nature with regard to the economic policies in the Union. In light of Art. 123 TFEU, this would probably require that the acceptance of a debt cut must be excluded, that government bonds of selected Member States are not purchased up to unlimited amounts, and that interferences with price formation on the market are to be avoided where possible. Statements by the representatives of the European Central Bank in the course of the proceedings and the oral hearing before the Senate suggest that such an interpretation in conformity with primary law would most likely be compatible with the meaning and purpose of the OMT Decision.

5. Whether the OMT Decision and its implementation could also violate the constitutional identity of the Basic Law is currently not clearly foreseeable and depends, among other factors, on the content and scope of the OMT Decision as interpreted in conformity with primary law.

Separate Opinion of Justice Lübke-Wolff:

In an effort to secure the rule of law, a court may happen to exceed judicial competence. In my view, this has occurred here. The motions should have been rejected as inadmissible. How Bundestag and Federal Government are to react to a violation, martial or non-martial, of German sovereign rights is a question that cannot reasonably be answered by rules making certain predetermined positive actions mandatory. Selecting from the variety of possible

reactions, which range from expressions of disapproval to an exit from the Monetary Union, can only be a matter of political discretion. Accordingly, it comes as no surprise that no such rules are detectable either in the text of the Constitution or in the case-law interpreting it.

The assumption that under specified conditions not only acts of German federal organs which positively restrict sovereign rights, but also mere inaction in the face of qualified transgressions on the part of the European Union can be challenged on the basis of Art. 38 sec. 1 GG departs from earlier case-law, just recently corroborated, according to which parliamentary or governmental inaction is contestable in constitutional complaint proceedings only if the complainant can rely on an explicit constitutional mandate substantially specifying the content and reach of the alleged duty to act. With respect to *Organstreit* challenges of inaction, too, the Senate has just recently repeated that they are admissible only if directed against a specific omission, i.e. against the omission of a specific action which can arguably be presented as constitutionally imperative. Moreover, the notion that a mere omission of certain governmental behaviour on the Union level can be a proper object of constitutional complaint would seem to stand in contrast to recent case-law according to which even positive acts of governmental cooperation in EU decisions or in intergovernmental decisions related to the Union will not be examined.

Separate Opinion of Justice Gerhardt:

I hold that the constitutional complaints and the application in the *Organstreit* proceedings, in so far as they relate to the OMT Decision, are inadmissible. The Senate's decision extends the possibilities of the individual to initiate via Art. 38 sec. 1 GG – without connection to a substantive fundamental right – a review of the acts of Union institutions by the Constitutional Court. By admitting such an *ultra vires* review, the door is opened to a general right to have the laws enforced (*allgemeiner Gesetzesvollziehungsanspruch*), which the Basic Law does not contain.

The responsibility with respect to integration (Integrationsverantwortung) of the German constitutional organs exists vis-à-vis the general public, and yields nothing for the construction of a subjective right of any person entitled to vote to have constitutional organs take action. With regard to the question of whether there exists a qualified ultra vires act, the Federal Government and the Bundestag must have a margin of appreciation and discretion, which the citizen needs to accept. The decision is based on the assumption that a transgression of powers can also be manifest if it is preceded by a lengthy clarification process. This case shows in abundant clarity how difficult it is to handle the criterion "manifest". Monetary and economic policies relate to each other and cannot be strictly separated.

In an overall assessment, it seems to me that the claim, that the objective of the OMT Decision is first and foremost the re-establishment of the monetary transmission mechanism, cannot be contradicted with the unequivocalness to be required.

That, with the help of the Federal Constitutional Court, an individual may steer the Bundestag's right of initiative into a specific direction, does not fit into the constitutional framework of parliamentary work. The citizens can influence the way and objectives of the political process through petitions, the political parties and Members of Parliament, and in particular through the media. The Bundestag could readily have criticised the OMT Decision by political means, threatened, if necessary, to bring proceedings for annulment before the Court of Justice of the European Union, waited for the reactions of the European Central Bank and the financial markets and then taken further steps. The fact that it did none of this does not indicate a democratic deficit, but is an expression of its majority decision for a certain policy when handling the sovereign debt crisis in the euro currency area.

Antonio Luca Riso ¹

An analysis of the OMT case from an EU law perspective

1. Introduction

On 14 January 2014 the German Constitutional Court (Bundesverfassungsgericht, BVerfG) held a decision² to refer for the first time a case to the Court of Justice of the European Union (CJEU) for a preliminary ruling, pursuant to Article 267 of the Treaty on the Functioning of the European Union (TFEU), and addressed to the CJEU a series of questions³ regarding the compatibility of the Outright Monetary Transactions (OMTs) programme announced by the ECB⁴ with EU law.

The subject matter of the case requires a prior understanding of the monetary policy transmission mechanism and the role in this context of government bond markets: paragraph 2 will thus be devoted to the attempt to shed some clarity on these highly technical issues, which certainly pertain more to the domain of economics, rather than to that of law. Paragraph 3 and 4 will instead be devoted to the analysis of the two questions of law raised by the BVerfG in the present case, relating to the scope of the ECB monetary policy mandate, and to the (alleged infringement of the) prohibition of monetary financing principle. Paragraph 5 concludes.

2. Monetary Policy Transmission Mechanism

In the BVerfG decision, it is maintained that the reference in the ECB decision on technical features of the OMTs to a disruption of the monetary policy transmission mechanism would be irrelevant, because the BVerfG believes that significant deteriorations of the monetary policy transmission mechanism, which may be expected in virtually every debt crisis of a state, should not amount to granting the ECB the

power to remedy any deterioration of the credit rating of an euro area member state, and spreads on government bonds would only result from the market participants' expectations, thus intervening on them would be tantamount to an arbitrary interference with market activity⁵. While the first argument refers to the fact that the ECB would act to remedy any deterioration of the credit rating of member states, the second one implicitly admits that this would not be the case, but nonetheless assessing a portion of the spreads on government bonds as a result of a market failure should be precluded from the scope of monetary policy measures as an 'arbitrary interference with market activity'. Such view disregards the fact that any monetary policy measure entails an interference with market activity: following the line of reasoning suggested in the BVerfG decision, any policy measure may qualify as an 'arbitrary' for the mere fact of purposely affecting market dynamics⁶.

a. How monetary policy measures affect economic variables

Central banks, being the monopoly supplier of the monetary base, can influence money market conditions, and thereby steer short-term interest rates⁷. By monetary policy transmission mechanism, the ECB and economists in general refer to the process through which monetary policy decisions affect economic variables, such as output or prices. The several, individual links between monetary policy decisions and economic variables are defined as 'transmission channels'.

The main transmission channel⁸ is the so-called interest-rate channel, through which in normal conditions central banks

¹ Legal Counsel, European Central Bank (ECB). The views expressed in this article are those of the author, and do not necessarily represent those of the ECB or the Eurosystem. The author, who is not directly involved in the case before the Court, would like to thank Christiane Hellstern for her valuable contribution.

² BVerfG, 2 BvR 2728/13 of 14.1.2014 (the 'BVerfG decision').

³ For ease of reference, the questions to the CJEU will be indicated as the 'BVerfG reference'.

⁴ See for more details the ECB press release of 6 September 2012 - Technical features of Outright Monetary Transactions (also referred to as the 'ECB decision'), available at the website of the ECB.

⁵ See the BVerfG decision, pp. 95-98. In Bast J., Don't Act Beyond Your Powers: The Perils and Pitfalls of the German Constitutional Court's Ultra Vires Review, in *German Law Journal*, Vol. 15, No. 2, p. 177 it is noted that it is not clear which method the BVerfG uses to exclude the possibility to apply a distinction between 'rational' and 'irrational' spreads.

⁶ See Thiele A., Friendly or Unfriendly Act? The "Historic" Referral of the Constitutional Court to the ECJ Regarding the ECB's OMT Program, in *German Law Journal*, cit., p. 262.

⁷ See ECB, *The Monetary Policy of the ECB*, 2011, pp. 55-62, available at the ECB's website.

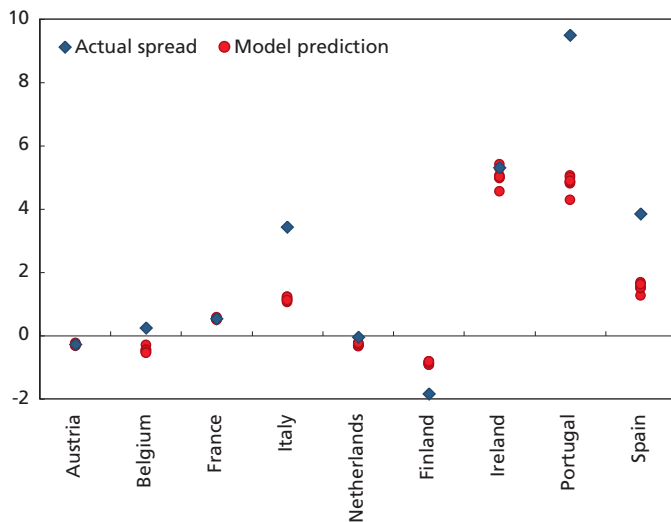


Figure 1. Selected Euro Area Economies: Comparison of Predicted and Actual Long-Run Real Bond Spreads vis-à-vis Germany (first half of 2012)

steer money market interest rates: interest rates on monetary policy operations carried out by a central bank affect the funding costs of liquidity for banks, which banks pass on to their customers. In addition, expectations regarding the interest rates on monetary policy operations affect long-term (market) interest rates. Changes in market interest rates affect both demand and supply of goods and services, and thereby result in upwards or downwards pressure on prices.

factors and contagion risks, while the room of manoeuvre is limited if the determinants are aggregate risk and changes in default probabilities on sovereign debt¹⁰.

Government bonds can temporarily deviate from their long-run equilibrium as a result of market overreaction during the periods of financial stress, when investors' decisions can be largely explained by "herding behaviour" amidst increased risk aversion rather than economic fundamentals¹¹. The

Economic variables are also affected by exogenous shocks, which central banks need to monitor and react to, to grant that the transmission mechanism works in an effective manner: if transmission mechanisms are impaired, monetary policy decisions cannot display their effects in full, and a central bank ultimately risks to lose its 'grip' on price dynamics or, in other words, its capacity to maintain price stability.

b. Developments on government bonds markets

Tensions and disruptions in the government bond markets can affect private sector conditions and have an impact on the monetary policy transmission mechanism, mainly through a price channel, a balance sheet channel and a liquidity channel⁹. Central banks can successfully react to such developments when they are determined by liquidity

⁸ Another important transmission channel is the so-called credit channel, which relates to the supply of credit by banks: higher interest rates can affect the ability of customers to repay their loans and thus the willingness of banks to grant such loans, as well as the worthiness of firms' collateral and thus their ability to borrow. This, again, affects in turn the demand and supply aggregates and thereby prices.

⁹ See ECB, *Assessing the financing conditions of the euro area private sector during the sovereign debt crisis*, in *ECB Monthly Bulletin*, August 2012, p. 77-80. The price channel produces the most direct effects, as substantial increases government bond yields can lead to higher financing costs for the private sector via the capital market as well as bank lending rates. Revaluations of government bonds are relevant for the balance sheet channel, as they can both affect the credit risk of borrowers and the banks' capital base, with a resulting higher leverage negatively affecting banks' funding conditions and ultimately their capacity to grant loans to the private sector. Finally, with regard to the liquidity channel, given the high liquidity in normal circumstances of government bonds which are thus used as collateral, and the increased reliance of banks on wholesale funding during the crisis, disruption in the government bond markets can lead to deterioration in banks' access to liquidity.

¹⁰ De Santis R., *The Euro Area Sovereign Debt Crisis – Safe Heaven, Credit Rating Agencies and the Spread of the Fever from Greece, Ireland and Portugal*, ECB Working Paper No 1419, February 2012, pp. 2-3, available at the ECB's website.

¹¹ See Poghosyan, T., *Long-Run and Short-Run Determinants of Sovereign Bond Yields in Advanced Economies*, IMF Working Paper No 12/271, 8 November 2012, p. 13.

euro area government bonds markets were affected by similar developments in the first half of 2012, when sovereign borrowing costs deviated from the equilibrium level defined by macroeconomic fundamentals¹².

Figure 1¹³ shows the divergence from a model prediction of sovereign debt spreads in some euro area member states for the first half of 2012, while Figure 2 illustrates that actual spreads follow more closely the model prediction when calculated in average over a 10-year period¹⁴.

c. How government bonds market affect other sectors of the economy

The developments illustrated in the charts trickled down to other sectors of the economy in the affected member states. Since the beginning of the financial crisis in 2007, financing conditions of both the financial and the non-financial sector in the euro area have remained tight over the period¹⁵, while they also became increasingly diverse across euro area countries, to such an extent that heterogeneity in financial conditions posed a major challenge for the single monetary policy¹⁶. The cost of bank funding increased significantly in countries subject to difficult funding conditions, while it declined markedly in those countries exhibiting a funding surplus. Such divergence in bank funding conditions was a key factor to explain the differences in bank lending rates offered to

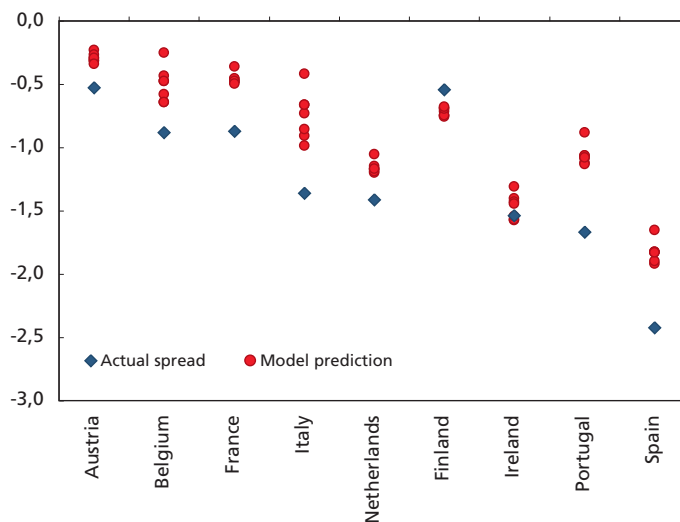


Figure 2. Selected Euro Area Economies: Comparison of Predicted and Actual Long-Run Real Bond Spreads vis-à-vis Germany (1999-2009, average)

Note: reported are prediction results from seven models shown in tables 4-5. All spreads are calculated using real bond yields.

non-financial corporations and households across euro area countries¹⁷. Standard pass-through models which consider policy interest rates and market interest rates as being the most direct determinants of retail bank lending rates proved ill-equipped to explain the increasing levels of heterogeneity in bank lending rates which have been observed during the crisis, as also shown by the following charts¹⁸.

¹² *Ibidem*, p. 14. See also De Grauwe, P., and Ji, Y., *Mispricing of sovereign risk and multiple equilibria in the Eurozone*, CEPS Working Document No 361, January 2012.

¹³ *Ibidem*, p. 24.

¹⁴ *Ibidem*, p. 25.

¹⁵ After the financial turmoil rapidly turned in a global financial and economic crisis following events in September 2008, the ECB, like other major central banks, lowered its key interest rates and embarked in a series of non-standard policy measures. See ECB, *The Monetary Policy of the ECB*, 2011, pp. 124-128.

¹⁶ See ECB, *Heterogeneity in euro area financial conditions and policy implications*, in *Monthly Bulletin*, August 2012, pp. 63-75.

¹⁷ See ECB, *Box 1 – Monetary policy measures decided by the Governing Council on 6 September 2012*, in *ECB Monthly Bulletin*, September 2012, p. 9.

¹⁸ See *Assessing the retail bank interest rate pass-through in the Euro Area at times of financial fragmentations*, in *ECB Monthly Bulletin*, August 2013, p. 84.

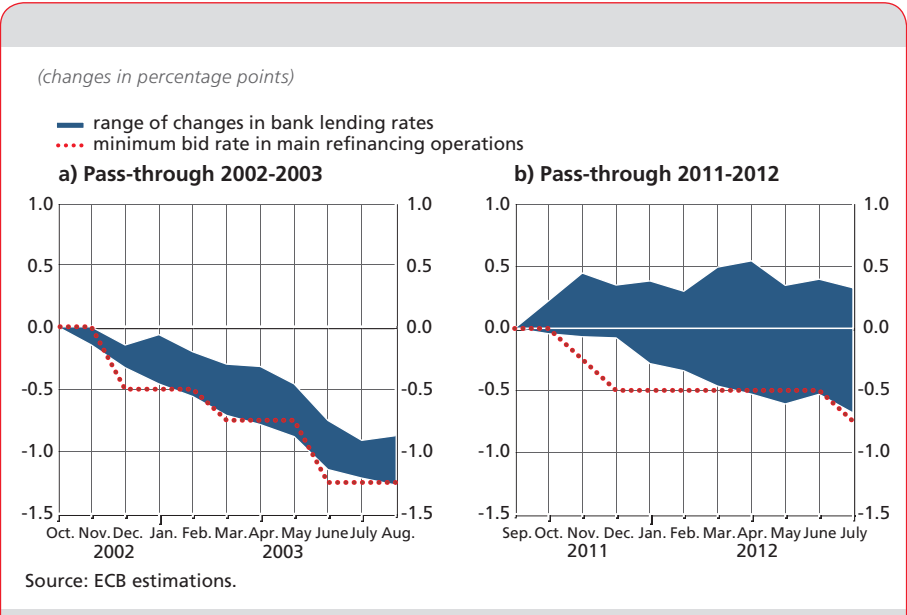


Figure 3: Cumulated changes in an ECB policy rate and bank lending rates for short-term MFI loans to non-financial corporations across euro area countries

Figure 3¹⁹ (in the left-hand panel) shows how the short-term bank-lending rates to non-financial corporations across the euro area reacted rapidly and homogeneously to the 125 basis point cut in ECB rates implemented between November 2002 and August 2003. Figure 4²⁰ (in the left-hand panel) shows a similar reaction to the 325 basis point cut in key ECB interest rates implemented between October 2008 and May 2009. Figure 3 and Figure 4 (in the respective right-hand panels) show by contrast that, following the 75 basis point cuts implemented between October 2011 and July 2012, the lower bound of the range of changes in bank lending rates for short-term loans to non-financial corporations declined, as it would be expected, while the upper bound increased, despite lower ECB policy rates.

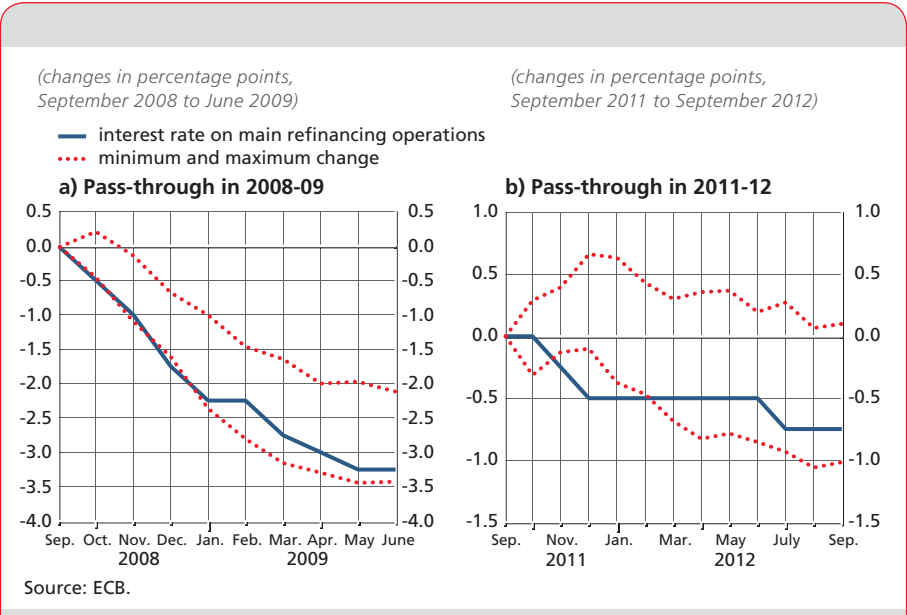


Figure 4: Cumulated changes in the ECB's interest rate on main refinancing operations and in the composite indicator of the cost of borrowing for non-financial corporations

The empirical evidence reported above suggests that the stance of monetary policy was not transmitted appropriately in the observed period (2011-2012). The ECB thus took decisions on a number of technical features regarding the Eurosystem outright monetary transactions in secondary sovereign bond markets with the aim to safeguard an appropriate monetary policy transmission and the singleness of the monetary policy²¹.

3. ECB monetary policy mandate

The preceding paragraph showed that, from a monetary policy perspective, diverging spreads in different government bond markets of the euro area can affect the financing conditions of non-financial corporations and households, to such an extent that the monetary policy trans-

¹⁹ Chart E, in ECB Monthly Bulletin, September 2012, p. 9.
²⁰ Chart 5, in ECB Monthly Bulletin, August 2013, p. 84.
²¹ See the ECB press release, cit., fn. 4.

mission mechanism is impaired, i.e. monetary policy decisions do not produce their effects evenly across the area. In such a circumstance for a central bank it is not only appropriate, but also necessary to act in a targeted manner in the affected markets, to restore the transmission mechanism and the singleness, i.e. the effectiveness across the whole area, of its monetary policy. From a legal point of view, the BVerfG questions whether the OMTs, which according to the ECB are measures aimed at restoring the transmission mechanism and the singleness of the ECB monetary policy, exceed the ECB's monetary policy mandate, as they would be allegedly incompatible with Article 119 and Article 127(1) and (2) TFEU, as well as with Articles 17 to 24 of the ESCB Statute, and infringe the powers of the member states²²: even if the OMTs would in the end produce the objective that the ECB thereby intends to pursue, i.e. restoring the monetary policy transmission mechanism and the singleness of its monetary policy, for the BVerfG this would only be an indirect objective, the 'direct' or immediate objectives being others, which would allegedly not pertain to the monetary policy domain.

To support the claim that the OMTs would not be covered by the ECB's mandate, the BVerfG indicates several arguments, (partially) mirroring the subquestions addressed to the CJEU in the reference for a preliminary reference: (a) the OMTs' immediate objective, allegedly being an economic policy one, (b) their selectivity, (c) their 'parallelism' with ESM and EFSF

programmes, including also the arguments of 'conditionality' and 'bypassing', for the purposes of this Article), i.e. the risk to undermine the objectives and requirements of such programmes. These arguments are analysed separately below, in line with the structure of the BVerfG decision.

a. Immediate objective

According to Article 127(1) TFEU, the primary objective of the ESCB shall be to maintain price stability. The Treaty does not define the concept of price stability, whose definition is left to the independent assessment of the ECB's Governing Council in line with Article 12 of the ESCB Statute²³, and with the overriding principle of central bank independence, as set out in Article 130 TFEU²⁴. Accordingly, the ECB has provided a technical definition of price stability since the beginning of its mandate²⁵ as a year-on-year increase in Harmonised Index of Consumer Prices for the euro area of below (but close to) two per cent over the medium term: it should be noted that the use of the word "increase" in the definition clearly signals that decreases in prices are not deemed consistent with price stability.

Without prejudice to this primary objective, pursuant to Article 127(1) TFEU the ECB is also requested to support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union. The definition and implementation of the monetary policy

²² See the BVerfG reference, question 1(a), and the BVerfG decision pp. 55 to 83. *Contra*, see Steinbach A., *Die Rechtmäßigkeit der Anleihekäufe der Europäischen Zentralbank*, in NVwZ, 2013, 918 ff., Thiele, *Die EZB als fiskal- und wirtschaftspolitischer Akteur?*, in EuZW 2014, 694 ff., Wendel, M., *Kompetenzrechtliche Grenzgänge: Karlsruhe Ultra-vires-Vorlage an den EuGH*, in ZaöRV, 2014, 615 ff..

²³ See Waldhoff C., Art. 127, in Siekmann H. et al., ed., *Kommentar zur Europäischen Währungsunion*, 2013, p. 291. *It has been noted that the introduction of the principle of independence of the ECB in the Treaties has been mainly adverted for at the time by Germany and an equivalent principle is enshrined in Article 88 GG (Grundgesetz), which would not necessarily warrant a narrow reading of the ECB's mandate: see Goldmann M., *Adjudicating Economics? Central Bank Independence and the Appropriate Standard of Judicial Review*, in German Law Journal, cit., p. 267.*

²⁴ See also in the BVerfG decision the dissenting opinion by Justice Richter, p. 17: 'a review with regard to whether the principle of conferral has been adhered to must take into account that, in consideration of the nature of independent central banks, the delimitation of their assigned powers has only been made with a view to their functions; this assignment of powers must, to a certain extent, include the authorisation to define one's own limits of actions'.

²⁵ See ECB, *The stability-oriented monetary policy strategy of the Eurosystem*, in ECB Monthly Bulletin, January 1999, p. 46. See also O. Issing, *The Eurosystem: Transparent and Accountable or 'Willem in Euroland'*, in Journal of Common Market Studies, Vol. 37, No. 3, September 1999, p. 517: Vol. 37, No. 3, September 1999, p. 517: 'The ECB Governing Council has provided a quantitative definition of price stability, the primary objective assigned to it by the Maastricht Treaty. [...] The very purpose of a monetary policy strategy is to provide a clear and coherent framework to structure information and the decision-making process internally and to explain monetary policy decisions externally. Transparency extends beyond mere openness, but requires a degree of clarity that in fact enhances the public understanding of monetary policy'.

of the Union is mentioned by Article 127(2) TFEU as the first of the basic tasks to be carried out through the ESCB. For the avoidance of any doubt, Article 119(2) refers to the definition and conduct of a single monetary policy [...] the primary objective [...] of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Union.

Finally, pursuant to Article 18.1. ESCB Statute, the ECB may operate in the financial markets by buying and selling outright [...] marketable instruments, i.e. including government bonds. According to Article 18.2 ESCB Statute, the ECB shall establish general principles for open market operations [...] carried out by itself or the national central banks, including the announcement of conditions under which they stand ready to enter into such operations.

While the Treaty falls short from providing a definition of the announcement of 'monetary policy', the BVerfG maintains that it is necessary to distinguish monetary policy from economic policy²⁶, as the latter primarily falls into the responsibility of the member states²⁷, and that a delimitation between the two concepts could be based on the immediate objective of an act, on the instruments used to achieve the objectives and on its links with other provisions²⁸.

Albeit this classification was inspired a *contrario* by the one applied by the CJEU in the *Pringle* case²⁹, it is at least unclear whether such classification could have a general scope of application beyond the specific case for which it was originally designed, especially considering that Union competences can preempt member states from taking action in a certain field, rather than the opposite³⁰. Monetary policy measures are always, inevitably, related to economic policy, as they always affect the behaviour of economic agents, including governments, both on the money and financial markets, and on the markets for goods and services.

Anyhow, even where the proposed classification was followed, the OMTs could not be considered as an economic policy measure for the mere fact that they may have indirect effects on the economic policies of some member states, while the objective pursued by such measure, as illustrated in the preceding paragraph, is to restore the monetary policy transmission mechanism across the whole euro area. While the BVerfG considers that the objective of the OMTs would be to neutralise spreads on the government bonds of member states, in fact such objective would be limited, as illustrated above, to the part of the spreads on government bonds prices not corresponding to their long-run equilibrium as based on economic fundamentals³¹. The BVerfG also refers to a speech³² of the ECB's President on 26 July 2012,

²⁶ Goldmann M., *Adjudicating Economics?* cit., see fn. 26, p. 269-280, argues that underlying this conclusion of the BVerfG is the decision to support the 'separation theorem', thus completely disregarding the arguments of other schools of thought in economics on this point, thereby showing the difficulties of judges in getting around this dispute when engaging in a full review of central bank policy. Therefore, the author suggests that judicial self-restraint should be used when reviewing ECB measures, as well as rationality check instead of full review, the latter resulting into a manifest threat to the ECB independence. See also Gerner-Beuerle C. et al., *Law Meets Economics in the German Federal Constitutional Court: Outright Monetary Transactions on Trial*, in *German Law Journal*, cit., p. 302.

²⁷ In Bast J., *Don't Act Beyond Your Powers*, cit., see fn. 8, p. 175, the distinction is refused, as the competence of the member states in the field of economic policy should be intended as such 'unless a measure falls within the scope of a legal basis provided in the EU Treaties'.

²⁸ See the BVerfG decision, pp. 61 and 63-68.

²⁹ See CJEU, *Pringle v Government of Ireland*, C-370/12, in particular pp. 53, 56-60, 97, and the BVerfG decision, p. 71.

³⁰ In *Pringle* the question at issue was whether the joint action of member states (through the ESM, which is not an EU institution), should have been considered as pre-empted, insofar as it insisted on a field on which the Union has made use of its competence, i.e. monetary policy. See Bast J., *Don't Act beyond Your Powers*, cit., see fn. 8, p. 176.

³¹ The BVerfG decision, p. 70, refers to the ECB Monthly Bulletin of September 2012, p. 7, and the ECB Monthly Bulletin of October 2012, pp. 7 and 8: in fact both documents clearly state that the Governing Council will consider OMTs 'to the extent that they are warranted from a monetary policy perspective'. See also Thiele A., *Friendly or Unfriendly Act?* cit., fn. 9, p. 256-259. See Gerner-Beuerle C. et al., *Law Meets Economics* cit., fn. 30, p. 289 and 298-302 for additional arguments on the compatibility of the OMTs with the mandate of a central bank.

³² The speech, which is available at the ECB's website, was pronounced on 26 July 2012, while the OMTs were announced on the following 2 August, and the decisions on their technical features were taken on 6 September 2012. In the speech the ECB President affirmed that: 'within our mandate, the ECB is ready to do whatever it takes to preserve the euro', and defined the euro as 'irreversible' (emphasis added). While in the first statement the reference to the limits of the ECB's mandate is explicit, it should be noted that the euro is 'irrevocably' adopted by member states: see Article 140(3) TFEU. See also Bast J., *Don't Act beyond Your Power*, cit., fn. 8, p. 177.

whereby the ECB would have claimed to safeguard the current composition of the euro area with the OMT decision, as this would have allegedly impinged on a prerogative of the Council, the European Parliament, the Commission and the member states, pursuant to Article 140 TFEU³³: in said speech, however, there is no reference to the OMTs in particular, nor to the aim to safeguard the composition of the euro area.

b. Selectivity

In paragraph 73 of the BVerfG it is maintained that the targeted approach of the OMTs (selectivity³⁴) would suggest that these are not monetary policy measures because such measures do not generally differentiate between individual member states. In this respect, it should be firstly observed that no provision in the Treaty requires that monetary policy measures are implemented in a geographically uniform manner. Secondly, the reference to a supposed general nature of monetary policy measures as not differentiating between individual member states is only partly accurate³⁵: an undifferentiated scope of application has been chosen when this

was the most appropriate to grant the singleness and ultimately the effectiveness of the monetary policy, but such approach should not on the contrary bind the ECB to the detriment of the latter³⁶.

c. Parallelism with ESM and EFSF programmes (including conditionality and bypassing)³⁷

The BVerfG maintains that the OMTs are a 'functional equivalent' to an assistance measure of the ESM or of the EFSF, due to the fact that the purchase of government bonds by the ECB is made conditional to the full compliance of the relevant member states with the conditions of such programmes³⁸.

Whereas participation of a member state in a programme of the ESM or of the EFSF would be a necessary precondition for the implementation of the OMTs, it should be noted, however, that 'the Governing Council will decide on the start, continuation and suspension of Outright Monetary Transactions in full compliance of Monetary Transactions in full discretion and acting in accordance with its monetary

³³ See the BVerfG decision, p. 72. It should be noted that Article 140 TFEU does not allocate any competence regarding the composition of the euro area, once a derogation from the obligation to achieve of the economic and monetary union (EMU) has been abrogated: on the contrary, left any feasibility assessment aside, under the legal framework currently in force a member state's unilateral withdrawal from the EMU may only be conceived in combination with the withdrawal of such member state from the Union as a whole pursuant to Article 50 TEU, while the expulsion of a member state from the EMU would be legally impossible. See Athanassiou P., *Withdrawal and expulsion from the EU and EMU - Some reflections*, ECB Legal Working Paper No 10, 2009.

³⁴ See the BVerfG referral, sub-questions 1(a)(bb) and 2(a)(bb).

³⁵ The BVerfG refers to a legal act (Guideline ECB/2011/14 of 20 September 2011 on monetary policy instruments and procedures of the Eurosystem (recast), OJ L 331, 14.12.2011, p. 1), which includes in annex the general framework for monetary policy operations (the 'General Documentation'). Prior to the introduction in the General Documentation of a single list of collaterals in 2007 there was a double-tier system, whereby the acceptance of some collateral was differentiated at national level: for more details, see the ECB press release of 10 May 2004 - *Review of the Eurosystem's Collateral Framework: First step towards a Single List*, available at the ECB's website. In addition, during the crisis the ECB adopted several decisions with differentiated application among member states: Decision ECB/2009/16 on the implementation of the covered bonds purchase programme; Decision ECB/2010/5 establishing a securities market programme; Decision ECB/2011/25 on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral; Decision ECB/2012/34, Decision ECB/2012/14, Decision ECB/2012/3, Decision ECB/2012/2, Decision ECB/2010/3; Decision ECB/2014/32, Decision ECB/2013/36, Decision ECB/2013/22, Decision ECB/2013/21, Decision ECB/2013/13; Decision ECB/2011/10; Decision ECB/2011/4; regarding the eligibility of marketable debt instruments issued or guaranteed by the governments of Greece, Cyprus Portugal and Ireland respectively.

³⁶ Gerner-Beuerle C. et al., *Law Meets Economics* cit., fn. 30, p. 305, observe that the issue would be relevant only insofar as the ECB treated different countries' bonds differently despite the countries being in the same circumstances, while actually treating countries equally despite relevant differences in their economic situations would be as problematic.

³⁷ The BVerfG reference addresses the two argument separately, in sub-questions 1(a)(aa) and 2(a)(aa) (conditionality) and 1(a)(cc) and 2(a)(cc) (parallelism), as well as 1(a)(dd) and 2(a)(dd) (bypassing). Conditionality and parallelism are addressed jointly in pp. 74-78 of the BVerfG decision, while bypassing is recalled in p. 79 and parallelism is implicitly recalled in pp. 80-83 thereof.

³⁸ See the BVerfG decision, pp. 77-78.

policy mandate', following an independent thorough assessment³⁹: thus the decision to implement the OMTs does not follow automatically to the activation of a programme of the ESM or of the EFSF, nor does it incorporate the objectives of such programmes as its own objective, this remaining solely confined to monetary policy considerations.

The same argument, i.e. that the ECB decides independently, without being tied to the decisions of the ESM or of the EFSF, is used by the BVerfG to claim that such independent economic assessment goes beyond a mere monetary policy support to economic policies carried out by member states (through the ESM)⁴⁰, thus exceeding the ECB's mandate. This argument is peculiar for its contradiction with the arguments illustrated above: the OMTs would be an economic policy measure both because the ECB takes its decision independently (parallelism) and because it does not (conditionality). Similarly, the BVerfG decision argues that the OMTs, due to the lack of quantitative limitations⁴¹ to government bonds purchases and to the unilateral significant increase of the assistance volume as well as the impact on the conditions agreed by ESM or EFSF members⁴², would go beyond a mere support and thwart the ESM or EFSF decisions.

Finally, no Treaty provision requires the imposition of quantitative limits *ex ante* to monetary policy measures: on the contrary, it is not contested that imposing any quantitative limitation *ex ante* would impair the effectiveness of such measures, as market participants could adapt to this situation and use it for their purposes. Nonetheless, a factual limitation to the maximum potential volume of OMTs can be derived from the volume of outstanding government bonds on the secondary markets⁴³. Moreover, since OMTs target government bonds with a maturity of between one

and three years, they would only affect short-term financing conditions, as it is usually the case with monetary policy measures, and would not have consequences on the pricing of government borrowing on the long-term, thereby also limiting potential influences on ESM and EFSF assistance programmes.

4. The prohibition of monetary financing

Whereas the BVerfG acknowledges that Article 123 TFEU only prohibits the ECB purchase of government bonds on the primary market, it also advocates for an extensive ("teleological") interpretation of this provisions, aimed at granting its *effet utile*, and at including within the scope of the prohibition also measures which are functionally equivalent to purchases on the primary market⁴⁴.

Whereas Council Regulation 3603/93⁴⁵, implementing Article 123 TFEU, in Recital 7 recalls that purchases made on the secondary market should not be used to circumvent the objective of that Article, it should be noted that only 'direct' purchases are expressly prohibited by Article 123 TFEU, and pursuant to Article 2(2) of the same Council Regulation 3603/93 even some purchases on the primary market are not considered as 'direct' in certain circumstances: *a fortiori*, purchases of government bonds on the secondary market should not be necessarily considered as 'direct' purchases prohibited under Article 123 TFEU.

It has also been noted that the ECB independence under European (and German constitutional) law, as well as its prerogatives in the assessment of its monetary policy objectives play a role against the qualification of OMTs as measures infringing the prohibition of monetary financing⁴⁶.

³⁹ See the ECB press release, *cit.*, fn 4.

⁴⁰ See the BVerfG decision, p. 82.

⁴¹ See the BVerfG decision, p. 83.

⁴² See the BVerfG decision, p. 81.

⁴³ See also below, Paragraph 4, subparagraph a.

⁴⁴ See the BVerfG decision, pp. 84-86. See also the BVerfG reference, questions 1(b) and 2(b). *Contra see Mensching C., Das Verbot der monetären Haushaltsfinanzierung in Art. 123 Abs. 1 EAUV - eine kritische Bestandsaufnahme*, in *EuR*, 2014, p. 333.

⁴⁵ Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b (1) of the Treaty, OJ L 332, 31.12.1993, p. 1.

⁴⁶ See C., Herrmann, *Luxemburg, wir haben ein Problem!*, in *EuZW* 2014, p. 161. See also Zilioli C., *Independence and Legitimacy in the Institutional System of the EU*, in *EUI Summer Academy 2012*, in print.

To support this interpretation, the BVerfG refers to five arguments⁴⁷, which are briefly analysed below: (a) volume, (b) market pricing, (c) interference with market logic, (d) default risk (included under 'volume' for the purposes of this Article), (e) debt cut, and (f) encouragement to purchase newly issued securities. These arguments are analysed separately below, in line with the structure of the BVerfG decision.

a. Volume

According to the considerations of the BVerfG purchases of government bonds that carry an increased risk of failure or even of a debt cut is likely to violate the prohibition of monetary financing, insofar as these purchases do not envisage quantitative limits⁴⁸ and thus qualify as 'large and unnecessary risks of losses'⁴⁹. Albeit the BVerfG mentions it as a non-relevant argument, it should be highlighted that no Treaty provision prohibits the ECB to enter in potentially loss-making monetary policy operations, whose lawfulness is confirmed by Article 33.2 ESCB Statute⁵⁰.

From a more general viewpoint, *ex ante* limitations would impair the effectiveness of any monetary policy measures, while any such measure, including OMTs, is factually limited by the volume of the targeted instruments which are outstanding in the market. Finally, a change in the issuance policy of the relevant government would not bind the ECB to increase the volume of purchases, since the Governing Council will decide not only on the start, but also on the continuation and suspension of Outright Monetary Transactions in full discretion and acting in accordance with its monetary policy mandate.

b. Market pricing

According to the BVerfG, if government bonds were to be purchased by the ECB on the secondary market to a considerable extent and shortly after their emission⁵¹, i.e. without a certain time lag between the emission of government bonds and their purchase by the Eurosystem on the secondary market⁵², these purchases could be considered as a circumvention of monetary financing.

Once more, it should be highlighted that any monetary policy measure produces by its own nature direct and indirect effects on several markets, including the primary markets for government bonds: if the production of any such effect had to be precluded, it would be impossible for the ECB to take any monetary policy measure at all. In this regard, while the implementation of OMTs purchases on the secondary market could affect market participants' expectations of secondary market pricing and thus indirectly affect primary market pricing, this would not however result in any prohibited monetary financing, i.e. funds flowing to the government budget independently from the capital markets.

c. Interference with market logic

According to the BVerfG, holding (all)⁵³ government bonds purchased to maturity could qualify as monetary financing, in particular if a substantial amount of such bonds is permanently removed from the market, preventing thus certain effects from the sale of the bonds prior to maturity to occur. As a preliminary consideration in this respect, it should

⁴⁷ Schneider K., *Questions and Answers: Karlsruhe's Referral for a Preliminary Ruling to the Court of Justice of the European Union*, in *German Law Journal* cit., p. 229, maintains that the BVerfG would consider the OMT framework to be incompatible with Article 123 TFEU because some information is not contained therein, rather than because some information confirms a breach.

⁴⁸ See the BVerfG reference, questions 1(b)(aa) and 2(b)(aa).

⁴⁹ See the BVerfG decision, p. 89. Beukers T., in *The Bundesverfassungsgericht Preliminary Reference on the OMT Program: "In the ECB We Do Not Trust. What About You?"*, in *German Law Review*, p. 359 argues that the BVerfG seems to be willing to be flexible on principled issues, as long as the scale of the programme is limited.

⁵⁰ Losses were indeed recorded by the ECB in carrying out conventional monetary policy operations in the past (1999, 2003 and 2004). See Vergote et al., *Main drivers of the ECB financial accounts and ECB financial strength over the first 11 years*, ECB Occasional Paper No 111, May 2010, pp. 28-29.

⁵¹ See the BVerfG decision, p. 92.

⁵² See the BVerfG reference, questions 1(b)(bb) and 2(b)(bb).

⁵³ The BVerfG reference, in questions 1(b)(cc) and 2(b)(cc), refers to 'all' purchased bonds. Such requirement is not mentioned in the BVerfG decision, p. 90 and 91.

be noted that the ECB decision on the technical features of OMTs does neither expressly provide nor imply that the ECB will hold purchased government until maturity: such decision leaves the full discretion of the ECB, in accordance with its monetary policy mandate. The Treaties do not, however, specify how long the ECB may hold purchased securities: on the contrary, as also acknowledged in BVerfG decision, Article 18.1. ESCB Statute explicitly allows outright purchases of marketable instruments (i.e. including government bonds). Finally, when referring to market logic, the BVerfG seems to assume the application to government bond markets of the supply and demand law, whose application to this market is arguable, in particular insofar as an artificial shortage of bonds in the secondary market would influence their price⁵⁴.

As an additional argument, the BVerfG decisions also mentions that holding government bonds to maturity would allow the ECB to delay any disclosure on losses incurred on the balance sheet. In this regard, it is noted that one of the technical features decided by the ECB is indeed that aggregate OMTs holdings and their market values will be published on a weekly basis⁵⁵.

d. Default risk

In addition to what has been mentioned above with regard to volume⁵⁶, an increased risk of failure because of lower credit rating is also relevant for the purposes of the default risk argument in the BVerfG reference⁵⁷, whereby it is asked to consider whether the fact that the OMT decision contains no specific requirements for the credit rating of government bonds to be purchased implies a breach of the prohibition of monetary financing.

In this respect it should be preliminarily highlighted that no provision in the Treaties subjects the ECB's faculty to purchase outright marketable instruments to any assessment by external ratings entities: the responsibility to assess such risk and accept it to the extent necessary to carry out its institutional tasks is allocated exclusively to the ECB.

Without prejudice to the foregoing, by indicating in the decision on the technical features of the OMTs that the full compliance of the issuing governments with the conditionality attached to an ESM or EFSF programme would be a necessary precondition for the implementation of the OMTs, the ECB identified such element as a creditworthiness requirement, insofar as it would grant that the government debt is sustainable in the long term, in line with standard creditworthiness and risk management rules applied by the ECB in conventional monetary policy operations.

e. Debt cut

The BVerfG also claims that the Eurosystem waiving of an alleged preferred creditor status against individual member states⁵⁸, due to the OMTs envisaging an equal treatment with any other government bond holder⁵⁹, would amount to an illegal monetary financing of the budget of these member states, at least if the OMTs purchase do not exclude from the outset the prospect of subsequently becoming part of a potential debt cut. In this respect, it is not clear on which basis the ECB would rely on such a preferred creditor status, which could then be waived. The acceptance by the ECB of the *pari passu* treatment simply reflects the legal position enjoyed by the Eurosystem in any open market operation⁶⁰.

⁵⁴ *Gerner-Beuerle C. et al., Law Meets Economics, cit., fn. 30, p. 317 note that sovereign bonds represent claims to cash flows, thus investors will not price them according to their rarity, but according to their risks and returns they pose in relation to other investments.*

⁵⁵ *See ECB press release, cit., fn. 4.*

⁵⁶ *See above Paragraph 4, subparagraph a.*

⁵⁷ *See the BVerfG reference, subquestions 1(b)(dd) and 2(b)(dd).*

⁵⁸ *See the BVerfG decision, p. 88.*

⁵⁹ *See the BVerfG reference, subquestions 1(b)(ee) and 2(b)(ee).*

⁶⁰ *In this respect, Article 12(3) of the Treaty establishing the European Stability Mechanism provides that, as of 1 January 2013, collective action clauses (CACs) must be included in all new euro area government securities with maturity above one year. On this basis, standardised and identical CACs have been developed, to be included in the bonds issued by the euro Area governments. Against this background, the ECB would be subject to a resolution adopted by the relevant majority of bondholders outweighing the ECB's vote.*

f. Encouragement to purchase newly issued securities

According to the BVerfG decision, the announcement of imminent government bonds of selected member states prior to a new emission could, independently of market conditions, provide private and institutional first takers with the prospect that the ECB will assume the financial risk of a purchase, and thus cause them to purchase the government bonds on the primary market, thereby bypassing the prohibition of monetary financing⁶¹. As a consequence of this, in the BVerfG reference the CJEU is also asked whether the Eurosystem is allowed to influence pricing by communicating the intent to buy or in other ways, coinciding with the emission of government bonds by member states of the euro area⁶². The ECB decision on technical features of the OMTs does not, however, imply that the purchase of specific bonds, and even more so the assumption of risks, will be announced by the Governing Council prior to its implementation, whereas it merely provides that such purchases will be considered by the Governing Council to the extent that they are warranted from a monetary policy perspective.

5. Conclusions

The arguments illustrated above are intended to show that the ECB decision on the technical features of Outright Monetary Transactions does not entail the breaches of EU law to which the BVerfG refers. First, it has been highlighted

that the monetary policy transmission mechanism not only allows, but sometimes requires a central bank to intervene in the government bonds markets. Second, it has been argued that this technical assumption is reflected by EU law, insofar as the ECB mandate is wide enough to include also the implementation of measures such as those envisaged under the OMT programme. Finally, several arguments which justify not to consider such measures as an infringement of the prohibition of monetary financing have been exposed.

While the Treaty subjected the ECB to the rule of law, at the same time it conferred upon such institution independence to fulfill its technical mandate to define and implement the monetary policy of the Union⁶³. This mandate by necessity implies a certain room for discretion for the ECB to assess the means to best implement its monetary policy decisions, including with a view to effectively face those irrational components of market behaviours which could be an obstacle to the full implementation of the ECB monetary policy through its technical decisions. The decision of the CJEU⁶⁴ on this case will have to deal with the scope of the mandate of an institution that has had a very important role in the last years in containing the consequences of the financial crisis in the EU by ensuring the continued functioning of its single monetary policy.

⁶¹ See the BVerfG decision, p. 93.

⁶² See the BVerfG reference, sub-question 2(b)(ff).

⁶³ See Article 127(2) TFEU, first indent.

⁶⁴ In this regard, it has been noted that the perspective of a national court taking a decision on the basis of a "national version of European law" with far-more-than-national implications would raise some concerns, to the extent to be considered as a possible anomaly of questionable democratic character ultimately also colliding with the principle of the separation of powers. See the dissenting opinions of Justice Lübbe-Wolff, pp. 3, 6 and 28, and the dissenting opinion of Justice Gerhardt, pp. 8 – 16, both attached to the BVerfG decision. It has also been noted (see Mayer F., *Rebel Without a Cause? A Critical Analysis of the German Constitutional Court's OMT Reference*, in *German Law Journal*, Vol. 15, No. 2, p. 134. *Ibid.*, p. 123 and 127-9) that a failure to follow the CJEU decision would be a violation of EU law, ultimately leading to the opening of an infringement procedure against Germany (see Articles 258-260 TFEU), and that the only German institution which would really be affected by a BVerfG decision declaring the OMTs 'ultra vires' would be the Bundesbank, insofar as OMTs need to be technically implemented by Eurosystem's NCBs, including thus the German Bundesbank. The latter would however need to choose between the BVerfG obligations, and the obligations deriving on it as a NCB directly from the Treaties. The author continues arguing that, in case the Bundesbank refused to participate to the implementation of the OMTs, this would qualify as a Treaty infringement, following which the intervention of the CJEU could be sought again on the basis of Articles 271(d) TFEU and 35.6 ESCB Statute, while despite the refusal to engage in the implementation of the OMTs, the possibility for the Bundesbank to incur in potential liabilities deriving from the implementation of OMTs would not be affected, as the relevant provisions of the ESCB Statute (article 28 to 33 thereof) would continue to apply. See along the same lines also Thiele A., *Friendly or Unfriendly Act?*, cit., fn. 9, p. 249).

*Christoph Degenhart*¹ **Legal Limits of Central Banking**

Unconventional measures of the European Central Bank (ECB), such as its Outright Monetary Transactions (OMT) program or now its Asset-Backed Securities (ABS) purchase program, raise the question of legal limits set to the ECB. The Federal Constitutional Court – the Bundesverfassungsgericht² – held on 14 January 2014 that the question should be referred to the Court of Justice of the European Union for a preliminary ruling.³ However, the German Court left no doubt about its opinion on the OMT program, which it esteems to be an ultra vires act and it even insinuated that the program might violate the inviolable core content of constitutional identity. Under these conditions, the Federal Constitutional Court of the Federal Republic of Germany requires jurisdiction on the ECB.

I. Introduction: The Union as a Community based on the Rule of Law

The European Union is a community based on the rule of law.⁴ It was created by legal act and it can only exist by the rule of law. One of the primary tasks of the judiciary is to determine the limits set for government action by the national or supranational legal system. However, from the beginning, the evolution of the European Economic and Monetary Union has been characterized by evasions of those limits: either through a clandestine breach of law or sometimes, in the wake of rescue measures, even an open breach, as the Barrosos and the Junckers frankly admitted. The evasion of the legal limits has never been justified by an alleged emergency law as has been argued. One cannot simply change a treaty by implementing consensual contractual practice in derogation of said treaty. As the European Union is a union based on the rule of law, it is first and foremost defined by its legal order, and so are its insti-

tutions. To insist on safeguarding the rule of law does not mean to question European integration, on the contrary. Constantly breaking the rules will destroy confidence and finally undermine the fundamentals of the Union.

The Union can only exist as a community based on the rule of law – the values on which it is based are fundamental values; Article 2 TEU mentions human rights, democracy and the rule of law. The constitutional complaint against the ESM aims to safeguard democratic principles and the democratic process. After amending the motion during the ongoing complaint, the complaint is also directed against the unconventional measures of the ECB,⁵ in particular its OMT program. The establishment of the ESM posed the question of whether the German Bundestag had carelessly given up its facility to influence European issues and risked its budgetary authority. In this complaint, as well as in several previous cases, the German Federal Constitutional Court reminded Parliament that European Union issues are not exclusive government issues. Parliamentary minorities as well as the people had to rise up to the task and defend the rights of Parliament. They forced Parliament and the government to have the public discourse that they were neglecting to have. The procedural set-up was very specific: the applicants invoked an impairment of material competencies of Parliament; the German Bundestag was quick to appease and declare in agreement with the German government that it did not, in any way, feel impaired in performing its functions. As it is often the case in European issues: the Parliament just was not aware of its functions and its responsibility.

¹ Updated and extended version of a lecture given by the author at the November 2013 IMFS Conference “The Limits of Central Banking”; the original version was translated by Jenny Döge.

² Published in NJW 2014, page 907; English translation available on www.bundesverfassungsgericht.de.

³ BVerfG, decision of 14 January 2014, – 2 BvR 2728/13, 2 BvR 2729/13, 2 BvR 2730/13 et al –; the author is one of the authorized representatives of the complainants; he brought in legal action against the European Stability Mechanism (ESM) and in consequence against the Outright Monetary Transactions (OMT) of the ECB in the name of more than 37,000 citizens.

⁴ cf. Möllers/Zeitler (ed.), *Europa als Rechtsgemeinschaft – Währungsunion und Schuldenkrise, 2013*, with essays by Möllers, Degenhart, Siekmann, Zeitler et al.

⁵ cf. Siekmann, in: Sachs, GG, 7th ed. 2014, Art. 88, para 36.

II. Union legislation as subject matter of a constitutional complaint

1. Identity and Ultra Vires control

Originally, the questions asked were all a matter of national constitutional law. The complaint was aimed directly against actions and omissions of state authorities of the Federal Republic of Germany. Amending the complaint to include measures taken by the ECB adds a new dimension. The Federal Constitutional Court is now asked to consider measures taken directly by an European institution, the ECB. However, only acts performed by German public authorities can form the basis for a constitutional complaint at the Federal Constitutional Court. Even if the OMT program, the decision to launch an unlimited bond purchase program, can be qualified as an act of a public authority, it is still the act of a European public authority. Does that mean that the ECB as an organ of the European Union has to submit to the jurisdiction of a Member State court? That question is crucial to the pending case. The Federal Constitutional Court approved the admissibility of the constitutional complaints brought in against the OMT program with a majority of 6:2.

The constitutional organs of the Federal Republic of Germany have the duty to preserve the identity of the German Basic Law within the framework of European integration. The Federal Constitutional Court therefore reserves for itself the competence to review whether acts of European Union organs respect the inviolable core content of constitutional identity, in particular with regard to the principle of democracy.⁶ The Court further reviews whether legal instruments of European organs “keep within the boundaries” of the sovereign powers accorded to them by way of conferred power. The former is called “identity control”, the latter “ultra vires control”. The competence is exercised

when a legal act is “breaking out” – which means a legal act that violates the legal boundaries set out for the Union – which is a community based on law, as previously established.

2. Is the ECB subject to the jurisdiction of the Federal Constitutional Court?

In order to pursue legal remedies against the OMT program, the complainant either has to demonstrate that by launching the OMT program the ECB severely exceeds the boundaries of its conferred powers – ultra vires control – or that it affects the inviolable core content of the democratic principle, the legal foundation for all national or even supranational action. There are difficult procedural questions raised by the complaint against the OMT program, which are mainly of interest to a limited legal audience anyway. During oral arguments, it was heavily debated whether the ECB’s announcement that it would launch an unlimited bond purchase program constituted a legal act. On the other hand, whether the ECB acted in a sovereign capacity was not questioned.

In its decision of 14 January 2014 the Federal Constitutional Court endorses its powers of review covering the examination of whether acts of European institutions and agencies are based on manifest transgressions of powers or affect the area of constitutional identity, which cannot be transferred (Art. 79 sec. 3 in conjunction with Art. 1 and Art. 20 GG).⁷ The Court also underlines that delimitation of powers of the European Central Bank cannot be exempt from judicial review because the European Central Bank would otherwise have the opportunity to expand its mandate at will.⁸ This would violate the democratic principles of the European Union and thus the constitutional identity of the German Federal Republic.

⁶ see the so-called “Lisbon decision” of the Federal Constitutional Court, volume 123, page 267 (353).

⁷ see the decision of 14 January 2014, para 22.

⁸ see the decision of 14 January 2014, para 60.

3. Conflict between Courts?

So the crucial question remains: did the ECB exceed the legal boundaries set by European Union law? If yes, did it constitute a “legal act that is breaking out” within the meaning of the constitutional case law on ultra vires control and is the inviolable core content of constitutional identity affected? The Federal Constitutional Court clearly approved the first question, though it confirms, that ultra vires review may only be exercised in a manner which is friendly towards European law.⁹ The Court also hinted that it might approve the second question as well. The latter would be the crucial point in case the Court of Justice of the European Union should deny the first question. In this case the Federal Constitutional Court would have to defend the inviolable core content of constitutional identity. This might possibly evoke a serious conflict between the Court of Justice of the European Union and the Federal Constitutional Court.

III. Exceeding the mandate of the ECB: The OMT program as fiscal policy

1. Prohibition of monetary government financing – Criteria

In its decision of 14 January 2014 on the OMT decision of the ECB the Federal Constitutional Court approved the position of the complainants. The OMT decision has no monetary policy objective.¹⁰ It exceeds the ECB's monetary policy mandate and infringes the powers of the Member States.

It is undisputed that Article 123 para. 1 TFEU contains the prohibition of monetary government financing by the ECB. That prohibition was *conditio sine qua non* for the transfer of monetary sovereignty to the European System of Central Banks. The prohibition directly covers the purchase of

bonds on the primary market. The prohibition of monetary financing limits the monetary mandate of the ECB set out in Article 127 para. 2 TFEU and constitutes a fundamental pillar of the Monetary Union according to the Treaty of Maastricht, as stipulated in the Approving Act.

According to the Federal Constitutional Court in its decision of 12 September 2012 on the ESM (para. 278)¹¹, purchases of government bonds by the ECB on the secondary market are also prohibited if the purchases are aimed at financing the Member States' budgets independently of capital markets, as it would circumvent the prohibition of monetary financing. If an unconventional measure such as the OMT program constitutes such circumvention – if it has a monetary or a fiscal motivation – is therefore of utmost importance for its lawfulness regarding the prohibition of monetary financing in Article 123 para. 1 TFEU. The ECB in its mandate, however, is limited to a primarily stability-oriented monetary policy. According to the Federal Constitutional Court in its decision of 14 January 2014, the constitutional justification of the independence cannot be transferred to other policy areas.¹²

2. OMT program – Effects

a) Monetary financing independent of capital markets?

A circumvention of the prohibition of monetary financing¹³ takes place if Member States are financed independently of capital markets. That prohibition sets out limits for actions of Central Banks. According to experts, the main objective of the ECB's OMT program is to influence market interest rates in the euro zone states and to facilitate refinancing for crisis-ridden euro zone states at rates that are more favorable than market rates. Interest rate conditions for refinancing generally reflect the creditworthiness of the state

⁹ see the decision of 14 January 2014, para 24; cf. Federal Constitutional Court, volume 123, page 267 (354).

¹⁰ see the decision of 14 January 2014, para 77.

¹¹ Bundesverfassungsgericht, volume 132, page 295.

¹² cf. Bundesverfassungsgericht, decision of 14 January 2014 para 59, available at www.bundesverfassungsgericht.de.

¹³ cf. Siekmann, in: Siekmann (ed.), *EWU – Kommentar zur Europäischen Währungsunion*, 2012, introduction para 84.

in question. They are also influenced by the level of soundness of public finances. This reflects the independence of national budgets. The present design of the monetary union is based on that independence.¹⁴ The bond purchase program of the ECB makes states independent of capital markets. The OMT program has the effect, in line with its objective, that individual states can refinance themselves at conditions that do not reflect their actual valuation on the market. According to Konrad and others, the OMT program provides individual countries with a certain interest rate advantage, which amounts to around 40 billion euros for Italy for only a two percent difference and therefore constitutes a distortion of market prices. This runs contrary to Article 127 TFEU.

The ECB program thus causes exactly the kind of financing independent of capital markets that the ECB is not allowed to perform. In this context, it makes no difference whether the ECB acquired the bonds directly from the issuing state on the primary market or in a subsequent sale on the secondary market. The goal is not to temporarily intervene in the bond market to compensate for interest rate volatilities, but to purchase bonds from crisis-ridden states permanently. Even if the envisaged secondary market activities of the ECB were only intended to lower the interest rate for the state in question, therefore facilitating the refinancing and reducing the costs, they would still constitute a means to finance the public sector.¹⁵ That the program is intended to circumvent the prohibition on monetary financing is indirectly admitted by the ECB as it cites differences in interest rates between the members of the euro zone as a way to justify the bond purchase program.

b) Intent to circumvent, conditionality, selectivity

Another point which indicates that the program can be qualified as disguised government financing is the submis-

sion of the ECB that it is not allowed to purchase bonds directly on the primary market and that in order to comply with Article 123 TFEU, purchases will only be conducted on the secondary market.¹⁶ One could not articulate the intention to circumvent the prohibition with more clarity.

As pointed out by Zeitler during the proceedings at the Federal Constitutional Court, there are other relevant factors which indicate quite clearly a fiscal and not a monetary policy character of the OMT program: conditionality, which is appropriate for fiscal policies and necessary because of Article 136 para. 3 TFEU. The expectation that the OMTs would be terminated if a review of the conditionality led to a negative result is not a very realistic one. That is another factor that indicates an inadmissible circumvention of the prohibition of monetary financing. An indicator for a monetary policy character would be the application of the program to all members of the euro zone according to a GDP (Gross domestic product)-based key.¹⁷ That is not the case for the OMT program. The "selectivity" of the OMT therefore indicates a fiscal policy character. The OMT decision aims to neutralize spreads on government bonds of selected Member States of the euro currency area which have emerged in the markets and which adversely affect the refinancing of these Member States.

c) Liability risks

The ECB is planning to purchase an unlimited amount of government bonds and keep them in the long term in order to allow the issuing states to refinance themselves independently of market interest rates. The ECB therefore assumes the risk of default of those government bonds. It also assumes the risk of feasibility of the macroeconomic adjustment programs it mandates, on which it can exert only limited influence. It seems clear from looking at the scenarios described by the experts, that the OMT program

¹⁴ see *Bundesverfassungsgericht*, volume 129, page 124 (181).

¹⁵ see *Kempen*, in: *Streinz* (ed), *EUV/AEUV*, 2th ed. 20124, Art. 123 para 1, 5.

¹⁶ As explicitly mentioned in the *Monthly Bulletin of the ECB of September 2012*, p. 11.

¹⁷ *Zeitler*, *Statement of 30 May 2013*, p. 10.

will give rise to liability risks for the Member States of the Economic and Monetary Union, no matter how the risks are categorized once they materialize. That means that the liability risks are also redistributed among the Member States of the Economic and Monetary Union. Ultimately, the Member States will bear the default risk of the government bonds held by the ECB. That circumvents the prohibition of assuming liability for commitments of other Member States (no-bailout clause) as a fundamental principle of the Monetary Union.

3. Assessment

The legal assessment is dependent on the opinion of the experts. During oral arguments at the Federal Constitutional Court on 11-12 June 2013 there seemed to be general agreement among nearly all of them. Across the board, the actions of the ECB were described with words such as Joint Liability Union, communitization of debt, and redistribution of liability risks. In a summary assessment it can therefore be concluded that the ECB or the European System of Central Banks conduct, as Kai Konrad put it during the proceedings at the Federal Constitutional Court, “redistribution in favor of a few and at the expense of most other Member States”¹⁸ with the announcement of the OMT program as with other unconventional measures before that, and others that may follow. The ECB undertakes a systematic redistribution of the refinancing costs for the euro zone states and causes a redistribution of the liability risks.

The effects can be described by using an analogy to German federalism. The Federal-State (*Länder*) community is perceived as a “joint liability community”. That has the effect of an alignment of refinancing costs independent of the debt-to-equity ratio of the individual regional authority – Berlin can refinance at almost the same costs as Bavaria.

The redistribution of the economic costs of public debt between euro zone countries due to measures taken by the

ECB has a comparable effect. My opinions “Joint Liability Union” and “Transfer Union” therefore accurately describe the development that has taken place. We may approve of such development, or we may disapprove, but it has to take place under the rule of law and consented in a democratic way. The treaties do not provide a transfer of liability. Thus it is the attitude of the Federal Constitutional Court as well. The Court points out that the OMT decision leads “to a considerable redistribution between the budgets and the taxpayers of the Member States, and can thus gain effects of a system of fiscal redistribution, which is not entailed in the integration program of the European Treaties. On the contrary, independence of the national budgets, which opposes the direct or indirect common liability of the Member States for government debts, is constituent for the design of the monetary union.”¹⁹ If such are the effects of the OMT program of the ECB, the same must apply to its ABS decision, which seems to be a measure of economic and not of fiscal policy.

IV. Ultra Vires-Control, Identity Control

1. ECB – Ultra vires policy

The conclusion must be: the ECB exceeds its monetary policy mandate. It is neither authorized to force the Member States to establish adjustment programs, nor to influence their budgetary policies. Furthermore, it is not authorized to redistribute credit risks among the Member States. The ECB is acting ultra vires. Those actions directly and adversely affect the contractual foundations of the Monetary Union. The foundations of the Monetary Union are already severely weakened due to the abandonment of the no-bailout rule. The fact that the ECB is exceeding its competency is therefore also structurally relevant. The communitization of the assumption of debt destroys the link of the Economic and Monetary Union. Ultra vires acts destroy the link to democratic legitimization.

¹⁸ Konrad, *Statement of 10 June 2013*, p. 8.

¹⁹ cf. *Bundesverfassungsgericht, decision of 14 January 2014*, para 41.

2. Constitutional identity of the Basic Law

Another important factor has to be considered: The acts of the ECB affect the inviolable core content of the constitutional identity of the Grundgesetz.

a) Exceeding the mandate without democratic legitimation

The ECB can act without the consent of the Member States' parliaments. This is mandated by the European treaties and a necessary consequence of bestowing independence on the European Central Bank. The ECB's independence means an exception from the general principle of parliamentary responsibility for sovereign action. It "releases national sovereign powers from direct state or supranational parliamentary control" as remarked by the Federal Constitutional Court in its decision on the Treaty of Maastricht.²⁰ This constitutes a "restriction of the democratic legitimation which is derived from the electorate in the Member States". This limitation of democratic legitimation affects the principle of democracy as the very core of constitutional identity. However, this is provided for in Article 88, sentence 2 Grundgesetz.²¹ The restriction of democratic legitimation is still compatible with democratic principles of the Basic Law and thus compatible with its Article 79, para (paragraph) 3, because it takes the tested and scientifically documented special character of monetary policy into account that an independent central bank is more likely to safeguard monetary stability, and thus the general economic basis for budgetary policies, than state bodies whose actions depend on money supply and value and which need to rely on short-term approval by political forces.²²

The modification is compatible with the democratic principle, because it is strictly limited, as the Federal Constitution

nal Court underlines in its decision on the OMT program of the ECB. The fact that the monetary policy of the ECB has been rendered independent²³ is acceptable to the extent that, and for so long as, the ECB stays with monetary policy and under condition that fiscal policy, in particular monetary government financing, remains forbidden. It is acceptable under the condition that its objectives are clearly defined and its actions are geared towards achieving price stability. Replacing the authority of Parliament is only compatible with the democratic principle of the Grundgesetz if the limits of the competencies of the ECB are clearly defined. Otherwise Article 79 para. 3 Grundgesetz would be violated.

The circumvention of the prohibition of monetary financing exceeds those limits. The conditionality of the bond purchases blends fiscal and monetary policy and leads to a subjugation of the ECB to policy decisions, which most definitely exceeds the limits in an inadmissible manner. The emancipation of monetary policy within the competence of an independent ECB can only live up to the democratic principle to the extent that and for so long as the decisions and actions of the ECB are still independent of the will of "political powers"²⁴.

b) Automatic liability

The program also affects the budgetary sovereignty of the Bundestag; its fiscal responsibility. The redistribution of liability risks as implemented by the OMT program according to the experts may lead to automatic liability, which needs to be avoided from a constitutional point of view. It occurs when liability risks ultimately have to be borne by the Member States without giving them the opportunity to influence the manifestation of those risks.

²⁰ see *Bundesverfassungsgericht, Volume 89, page 155 (208)*.

²¹ see *Bundesverfassungsgericht, Volume 89, page 155 (208)*; see additionally *Siekman, in: Sachs, GG, 6th ed. 2011, Art. 88 recital 38 et seq.*

²² see *Bundesverfassungsgericht, decision of 14 January 2014, para 59*.

²³ see *Bundesverfassungsgericht, volume 89, page 155 (209)*.

²⁴ *ibid.*

V. Result and future prospects

The unlimited purchase of government bonds of individual euro zone countries extends the remit assigned to the European Central Bank by the European Treaties up to the legally admissible limit and beyond. The ECB exceeds its competencies, *ultra vires*. The budgetary sovereignty of the Bundestag is therefore threatened and this will ultimately lead to an inadmissible assumption of liability by the Federal Republic of Germany; the necessary democratic legitimacy is lacking; the safeguards laid down by the legislation of the Union for the constitutional precepts of democracy are significantly weakened.

Extreme caution is necessary before proposing further unconventional measures to safeguard the Monetary Union, such as the ABS program, whose risks are esteemed to be still higher than those of the OMT program. If the OMT decision has no monetary policy objective, the same applies to the ABS program still to a higher extent. Facilities for the banking sector, as provided within the ABS program, would run contrary to Article 127 TFEU. It needs to be confirmed that the stability structure that has been built into the Monetary Union can be preserved even if an extensive view of the role of an independent European Central Bank is applied. The significant dilution of the no-bailout prohibition in Article 136 para. 3 TFEU already severely weakened the stability structure. The dilution of the bailout prohibition is especially serious as the once so clearly defined limits of the role of the ECB falter and put a strain on the stability structure. Which other elements are superfluous, which pillars can be knocked over, is the whole structure shattered in its constitutional sustainability?

The legal limits for rescue measures of the Central Bank are not only exhausted, they are exceeded. In order to extend the current framework, an amendment of the Primary Law is necessary. An extension of the tasks of the Central Bank while at the same time keeping its independence, will likely encounter opposition in light of national constitutional law. The ECB, as it is "three steps away from democracy" as Harald Uhlig put it in his speech at the IMFS Conference, has to be strictly limited in order to sustain democratic legitimation within the Union.

The story of the introduction of the Euro is a story of neglected promises and of breaches of law, open or clandestine. The moment has come to return to law.

Harald Uhlig[†]

Remarks on the OMT Program of the ECB*

1 Introduction

These are remarks on the Outright Monetary Transactions program or OMT program of the ECB. Under this policy and under certain conditions, the ECB is prepared to purchase bonds of monetary union member countries with the explicit goal of lowering their yields. I analyze when this policy amounts to turning bad luck into good luck (presumably acceptable also to tax payers in non-affected countries), and when this policy amounts to a bailout (ruled out by the Maastricht Treaty). I follow this with more general remarks regarding the relationships between fiscal and monetary policy, with comments regarding ECB communications and with a personal assessment and view of the OMT program. The reader shall be warned. This may be intellectually necessary and mathematically accessible reading for ECB officials and journalists, but emotionally painful for some of them. In the interest of the affected public, let me hope that these will read it carefully anyhow. I can already sense the insulted pride and the desire to stop right here for some of them, and nodding agreement from those in these ranks that will find themselves of having been in consent with large portions of the analysis below all along.

From 2010 to 2013, the euro zone was in a deep crisis, threatening several of its economies and the very existence of its common currency. And perhaps, the crisis may flare up once again. Indeed, default fears for Greece have risen anew and many of the issues raising concerns then are far from fully resolved today.

For that reason, it is still paramount to understand some of the economic policies advocated or put in place to deal with aspects of this crisis. Most notably, the announcement of ECB President Mario Draghi to “do whatever it takes” in his

speech of summer 2012 and the subsequent announcement of the OMT program by the ECB has created heated debates. On the one hand, it has been viewed as a crucial and highly desirable step forward, with the ECB finally taking the appropriate and necessary measures to rescue euro zone economies from disaster. Draghi himself has called it the best idea ever, since it actually has not led to any purchases, at the time of writing these remarks. On the other hand, observers in particular in Germany have viewed this policy as a blatant violation of the Maastricht Treaty and its no-bailout clause. Given that Germany would most likely be the nation shouldering the lion share of any losses of such purchases and is already effectively paying the insurance premium implicitly granted by the OMT policy, prominent German economists such as the president of the Ifo Institute, Hans-Werner Sinn, have viewed it along with other ECB policies as a blunt implementation of an illegal transfer scheme of German savings and tax payer resources to countries such as Greece, Spain, Portugal and Italy.

I have some own views on these matters. However, the intent of these remarks is clarification foremost, rather than offering my own opinion (which I shall add at the end, though). I shall first investigate the OMT program, or at least a stylized version thereof. I shall assume that there are countries in a potential sovereign default situation while others are not. I seek to clarify whether and when the OMT program results in a transfer from the healthy countries to affected countries and when it leads instead to an improvement in the affected countries without putting tax payer money in the healthy countries at risk. I try to provide a very simple model, which a reader with some modest training in economics or mathematics should be able to follow. Necessarily, this will be neglecting a number of key elements, which would be crucial in a more sophisticated analysis.

* This research has been supported by the NSF grant SES-1227280.

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Such an analysis is available in Roch-Uhlig (2014). The remarks here build on that paper, and provide a simplified version thereof. The sovereign debt literature is much larger, of course, and the reader of these remarks is encouraged to consult the references in Roch-Uhlig (2014) or other places. The remarks here are not meant to provide a guide or detailed connection to the literature, with all due apologies.

Given that an early draft of the Roch-Uhlig (2014) paper was presented at the ECB and numerous other venues in Europe already in 2011 and well before Draghi's famous speech, it is entirely possible that these ideas have somehow found their way into ECB policy: a benign version of the OMT program is implied by that paper and the simplified version below, under appropriate circumstances. Perhaps, versions of that paper and, by implication, versions of the remarks below have been circulating in policy-making circles in the ECB when it was designing its crisis policy. That would be a good thing: economic policy too often seems remarkably detached from sound economic analysis, and it more often than not puzzles academic economists such as myself as to why their input seems to be routinely ignored. So, if this has been a counterexample: great!

Unfortunately, it is hard to recognize these ideas in the many speeches given by the ECB. Some of the words show up, but so do many others. It is hard to avoid the impression that much gets said by ECB officials with the hope that something sticks and that, somehow, everything has been said. It is hard to avoid the impression that policy measures have been decided by the Governing Council without a genuine intellectual penetration of the social, economic and political issues at hand, and that the speeches only serve to provide the appearance of a thought-out justification. I return to these issues in section 4 and 5 below.

We need a debate built on sound economic analysis rather than presenting some analysis to justify a preconceived conclusion. Perhaps, these remarks can help. I used a version of

the analysis presented here in my statement to the constitutional court or Bundesverfassungsgericht in Germany during their hearings in June 2012, see Uhlig (2013). I was given 15 minutes to make that statement, and the published version is a literal version of that statement. As a consequence, it is a precise, but rather dense version of the arguments below. Hopefully, the more elaborate remarks here and the analysis in Roch-Uhlig (2014) provide a more accessible version.

2 Bad luck or insolvency? A simple model

The key issue I wish to address in my model is this. Suppose interest rates in a country are high, repaying new debt is thus very costly and a default may be in the cards. Is this a situation due to just bad luck? If so, is this a situation in which purchases of government bonds at lower interest rates by the ECB can possibly turn bad luck into good luck, rectifying matters without endangering resources of tax payers in other countries? Or is the country simply fundamentally insolvent? And if so, does an ECB purchase of these government bonds therefore entail a transfer of resources to the country in question and the type of bailout ruled out by the Maastricht Treaty? And if both are possible, how can we tell? The simple model below will shed light on these questions and provide a guide for a more substantive debate on these key issues.

Consider then three periods or years: say, 2015, 2016 and 2017. Suppose the interest rate on safe euro debt is zero percent, and that risky debt will be priced at actuarially fair rates¹. That is, assume that the market for sovereign debt is very deep, in principle.

Consider now some country in the euro zone, possibly on the brink of insolvency, but which is not considered to be in default in 2015. Suppose, this country issues one-year debt in 2015 with a face value of 100 billion euro, and thus needs to pay 100 billion euros to the holders of this debt in 2016. To make things a bit more specific, suppose that one billion

¹ Perhaps you, the reader, prefer explanations building on irrationalities and mispricing of sovereign debt. I comment on such approaches in the last paragraph pertaining to Figure 4. However, I do concede that I ignore bona fide issues such as risk premia arising from risk aversion, government interference in bond purchases by banks or market failures, among other things, in order to keep the analysis simple.

notes have been issued, with a face value of 100 euro each and due in 2016. Below, we shall calculate the price of such notes in various scenarios.

To warm up, consider a very simple two-year scenario, see Figure 1. Suppose the government has 120 billion euros in 2016 for sure, which they can spend on repaying debt as well as other matters. Thus, they can repay the debt in 2016, if they so choose. For simplicity, I shall assume throughout that the country will always repay, if it can do so, unless it is already in default. With that, the debt holders receive 100 euros in 2016 for sure. Discounted at zero percent interest rate, the notes then trade at a price $P = 100$ euros in 2015. The yield r on these notes is the same as the safe rate, i.e. zero percent.

Let me jazz this simple example up just a bit by assuming that there is a 50-50 chance that the government has more than enough to repay the debt in 2016 or no resources at all, see Figure 2. Given the assumption of actuarially fair pricing, the notes will be sold at $P = 50$ in 2015. If the investor buying this debt is lucky (and this happens with 50 percent probability here), she receives the face value of 100 euro in 2016. If she is unlucky, she receives nothing. On average then, she receives the amount of 50 euros originally invested in 2015. The yield r on these notes is 100 percent: they promise to repay twice as much as the price at which they are traded in 2015. But that promise is only kept with a probability of 50 percent.

Governments typically do not repay all their debt with available resources, though. Rather, they typically roll over debt into the future, issuing new debt to repay the old. We need at least three periods to capture this, see the base-line three

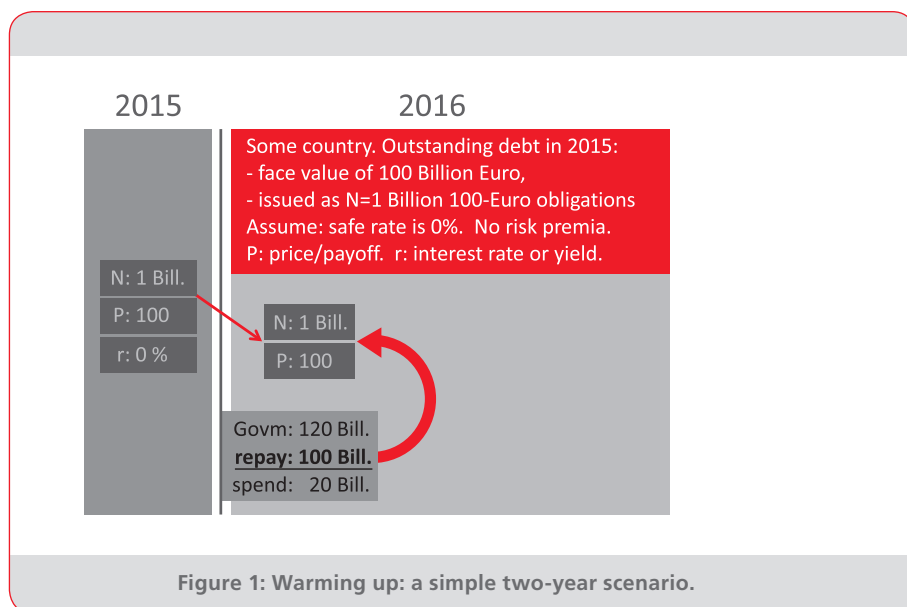


Figure 1: Warming up: a simple two-year scenario.

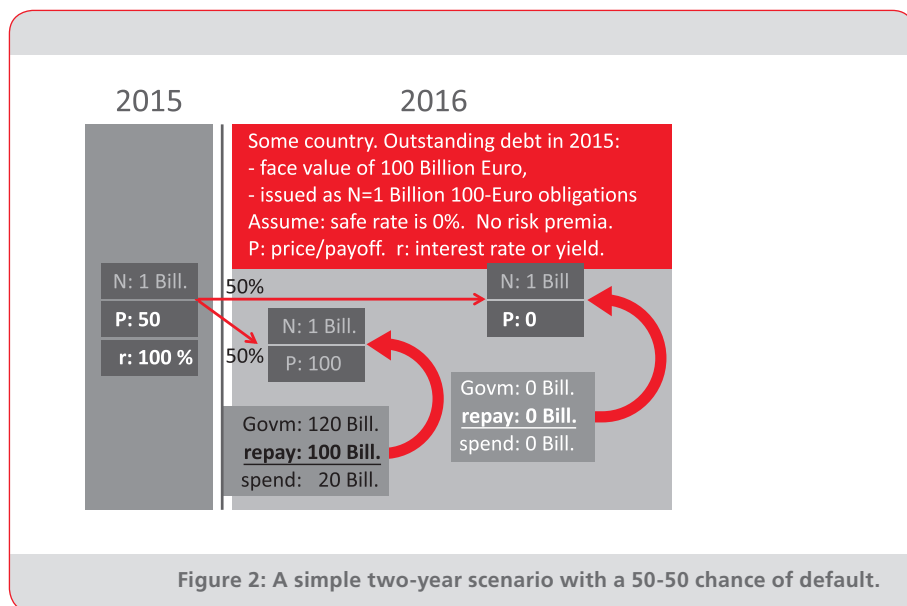


Figure 2: A simple two-year scenario with a 50-50 chance of default.

period “regular scenario” in Figure 3. There, it is assumed that the government has 70 billion euros each in 2016 and in 2017.

What will happen in this situation? To figure this out, let us start from the end, in 2017. Suppose, for some reason, that 500 million notes with a face value of 100 euro each need

to be repaid then. The government has 70 billion and can do so. If the government is not in default by then (and let us assume for now that it is not), it will repay the outstanding debt. The government then has 20 billion left, which it can spend on other matters. But given this outcome in 2017, debt can partially be rolled over in 2016, when 1 billion notes with a face value of 100 euro each are supposed to be paid. The government pays half of them with available resources, spending 50 billion on debt repayment and 20 billion on other matters. For the other half, the government issues 500 million new notes with a face value of 100 euro each due in 2017. Given that they will be repaid in full in 2017, they trade at a price of $P = 100$ and a yield of $r = 0\%$ on the secondary market among investors, and thus, investors are willing to buy them at a price of $P = 100$ on the primary market, when the government sells them to investors in the first place in 2016. The government can therefore raise 50 billion euros in this manner. Combined with the 50 billion used for repaying debt out of current resources, this suffices to pay off the the notes originally issued in 2015 in full. Investors in 2015, expecting this outcome, will thus pay $P = 100$ in 2015 for the 2015-issued notes, and the yield on these notes is once again $r = 0\%$.

However, a "crisis scenario" may unfold too, see Figure 4, despite the same fundamentals as in the "regular scenario" in Figure 3. To understand this "crisis scenario", we need to introduce an additional and important assumption, which is common in the sovereign default literature: if a government has defaulted on its debt in the past, i.e. if the government is in default, then it will default on its debt now. The argument is that a default excludes the country from international debt markets, non-repayment of old debt is going to be contested in international courts and reputation is already lost: so, it makes little sense to repay any new debt that has been issued since that first default, and the attempt to make any such payments may go to old debt holders and lawyers anyhow, rather than the new debt holders. There are softened variants of this assumption, but let me stick to the clean-cut (and admittedly somewhat extreme) version: a default in the past means a default now. Furthermore, I assume that a default is always a full default and no payments on any outstanding debt are made.

Now, examine Figure 4 and start once again in 2017. Suppose that for some reason the government happens to be in default by then, i.e. has defaulted at some point in the past. Why? This is an issue we need to resolve as we proceed

backwards through time with the analysis: for now we shall just assume it. With our additional assumption, the government will fully default on its outstanding debt, and make no payments at all. If any investor purchased such a piece of paper in 2017 just before approaching the government, she would only do so at a price of $P = 0$.

By implication then, the secondary market price in 2016 is $P = 0$ and it will coincide with the price on the primary market then. That is, when the government in 2016 attempts to raise revenue by selling 500 million notes with a face value of 100 euro each, they will get nothing for it. But now that government has a problem when attempting to repay the

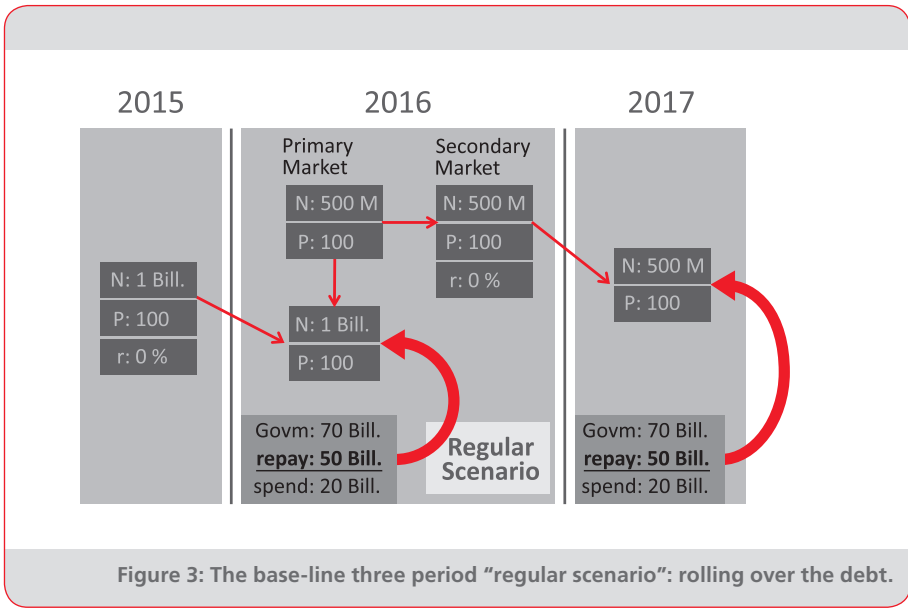


Figure 3: The base-line three period "regular scenario": rolling over the debt.

outstanding 2015-notes. It has 70 billion euros on its own, at most. But it cannot raise the additionally needed 30 billion, and will need to default. Given this default, the government will indeed be in default in 2017, as we have assumed at the start of this reasoning. The price for the old debt now also trades at $P = 0$ in 2015, with an infinite yield. Given that the fundamentals here are no different than the fundamentals in the “regular scenario” of Figure 3, this is bad luck indeed!

There are thus two scenarios which can arise out of the same fundamentals, as shown by Figures 3 and 4. In more technical language that means that there are multiple equilibria. Which one will emerge? The analysis here cannot answer that. One may wish to argue that it depends on subtle matters of psychology or market moods. Perhaps investors are somehow “pessimistic” in the “crisis scenario” and “optimistic” in the “regular scenario”. Nonetheless, investors are fully rational in both scenarios in the end, regardless which one of these two scenarios emerges. The optimism that investors may exude when buying bonds in the scenario of Figure 3 will be fully justified by the repayment down the road. Conversely, investor pessimism and unwillingness to pay anything at all for the bonds both in 2015 and 2016 in Figure 4 is fully justified by the subsequent defaults later on. There is nothing irrational about either scenario, markets are not out of line with fundamentals, there is no mispricing at all, there is nothing “benign” or “evil” that “speculators” may or may not be doing here. Prices are fully justified by what is about to unfold and that is that. Obviously, if prices can be arbitrary, one can generate all kinds of scenarios. But it is too easy to proceed then with little or no intellectual discipline in such exercise. It is remarkable how often ECB officials and journalists alike appeal to market irrationalities and market mispricing in their effort to explain why yields rise to unprecedented levels, even if nothing has changed in

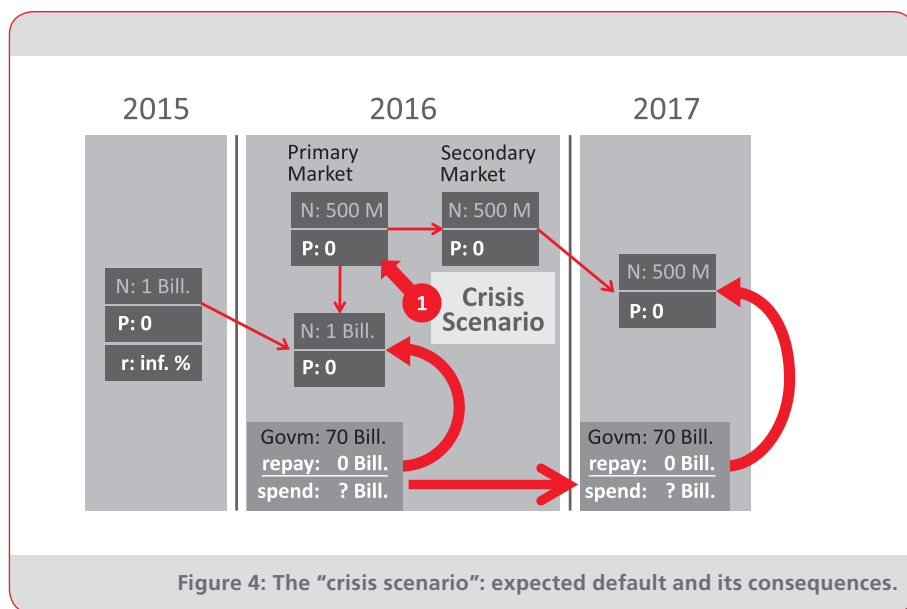


Figure 4: The “crisis scenario”: expected default and its consequences.

the fundamentals. Of course, one may do so if one has no intellectual discipline or very limited capabilities of economic analysis or is simply too lazy to think matters through with some care². But one does not have to, as Figures 3 and 4 and the analysis above show, and it takes quite a bit more brilliance than the usual speech or journalistic analysis to argue why irrationality nonetheless is required to explain the observed facts.

It often is helpful to imagine that a default does not happen for sure. Thus, and similar to Figure 2, Figure 5 puts together a “crisis scenario”, occurring with a 50 percent chance and shown in detail, with a “regular scenario” as detailed in Figure 3 and moved “to the side” here, for graphical reasons. The resulting price for the notes issued in 2015 is now $P = 50$ and the yield is $r = 100\%$, as much as and for the same reasons as in Figure 2.

This 50-50 scenario shall now serve as our starting point to think about the OMT program of the ECB. To that end, let us imagine that the ECB is prepared to purchase 400 million notes in 2016 on the secondary market at a price of

² I am not saying that journalists and ECB officials who take this route are devoid of intellectual discipline or capabilities of economic analysis or are too lazy to think matters through with some care. I am just saying that most well-trained academic economists will easily think they are and will easily remain unconvinced by their arguments.

$P_{ECB} = 100$, investing a total of 40 billion euros. To understand the consequences of this policy, I shall take two intermediate steps in the analysis.

For the first step, consult Figure 6. Here, I imagine first that nothing happens regarding what private investors do or are willing to pay on the secondary market in 2016 or 2017 and I

imagine that the government is still defaulting in full in 2017. But now the calculus on the primary market in 2016 changes. Investors there will be able to sell their acquired note either to the ECB at a price of 100 euros or to other private investors at a price of zero euros in the secondary market of 2016. Let us suppose that these resales are probabilistic, i.e., the chance that a sale to the ECB occurs is 80 percent, whereas a sale to private investors (or no sale to the ECB) occurs with a probability of 20 percent. These numbers come about since the ECB will only purchase 400 million of the newly issued 500 million notes. Given these percentages then and given actuarially fair pricing, the investors on the primary market are now prepared to pay the government 80 euros for each note auctioned off. The ECB does not need to be present on the primary market: what matters here is the expectation that the notes can be sold with some probability to the ECB on the secondary market.

If the government still defaults in 2016 then only the resources raised from the newly issued bonds are used to pay off the old debt: the 40 billion eventually provided by the ECB effectively pay off the holders of 2015-issued notes. The price in 2016 of these notes in 2016 is then 40 euros (on average), and, with the appropriate 50-50 calculus in 2015, the price in 2015 is 70 euros.

However, there are now enough resources in total in 2016! Even if the government receives just 40 billion euros from issuing bonds in 2016, it has 60 billion on its own to repay the bonds issued in 2015. It has only 10 billion left to spend on other matters, and that may impose hardships on the country, but it does not need to default. Given our assumptions that governments repay, unless they are in default, it will therefore proceed to repay in 2016, gi-

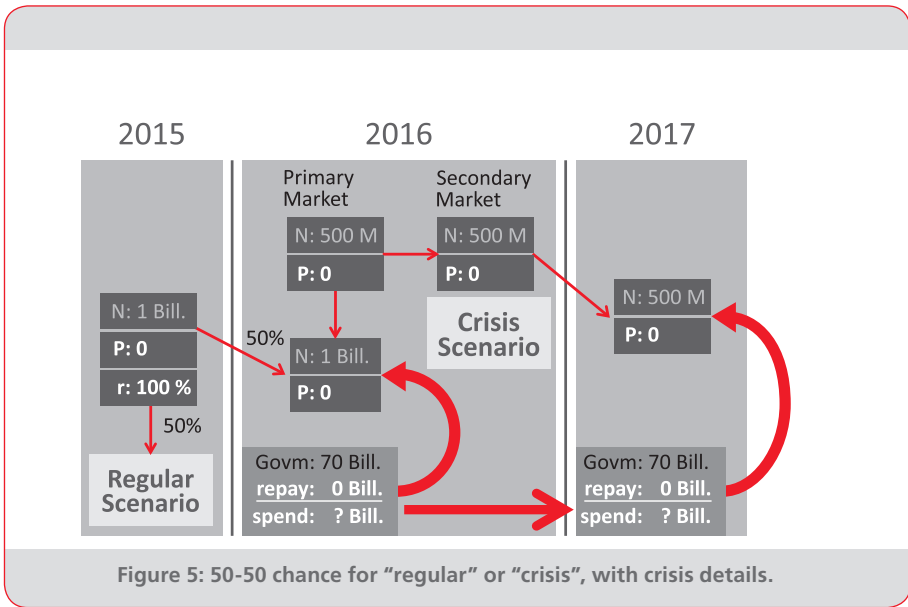


Figure 5: 50-50 chance for "regular" or "crisis", with crisis details.

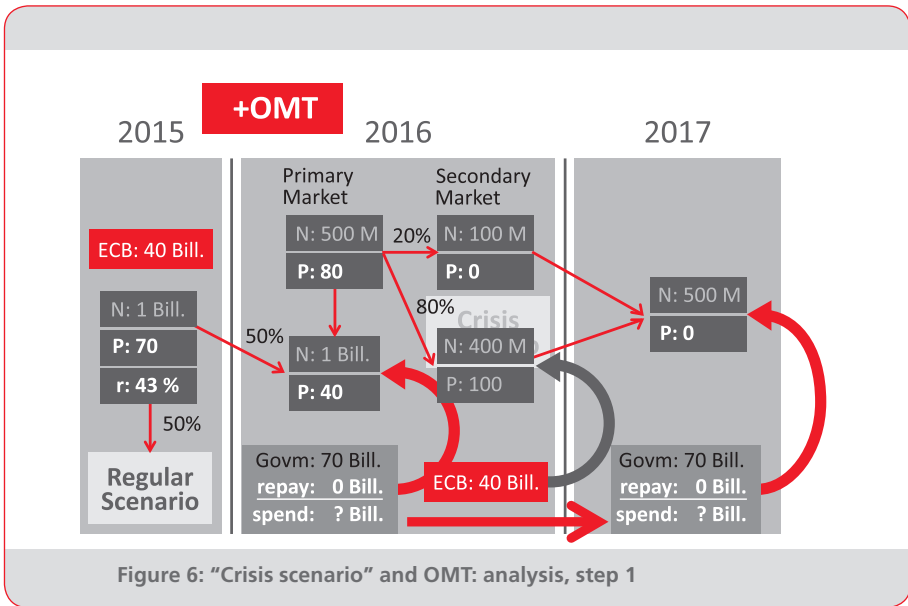


Figure 6: "Crisis scenario" and OMT: analysis, step 1

ven the bond prices calculated in the first step of the analysis and Figure 6.

But now, and given that it is not defaulting in 2016, the government will not be in default in 2017, see Figure 7. In 2017 it will thus once again fully repay the outstanding debt issued in 2016 and presented to it by the ECB as well as the private debt holders. But given these repayments, the secondary market price in 2016 will now rise to $P = 100$, in line with the price paid by the ECB. The same then is true on the primary market in 2016. At all nodes, the notes now trade at $P = 100$ and the yield is $r = 0\%$.

Indeed, and remarkably, there actually is now no longer a need for the ECB to purchase any debt, see the "benign result" in Figure 8. All that matters is that the ECB is prepared to purchase the debt at a price of $P = 100$ and is prepared to accept a low yield in 2016. The secondary market investors in 2016 are likewise willing to pay a price of $P = 100$ for it. Indeed, if the ECB gives slightly less favorable conditions than second-market investors (say, willing to pay up to 99 euros, rather than 100 euros), then all primary market investors would either hold on to their debt or sell them to other private investors on the secondary market in 2016: the ECB will not be involved at all. So, just the announcement that the ECB is prepared to step in and purchase debt on the secondary market resolves the situation, without any purchases ever made by the ECB. Bad luck is turned around into good luck, per this OMT program. The "crisis scenario" is turned into the "regular scenario". This is a benign outcome indeed and not one which tax payers in healthy countries should seriously complain about, I believe.

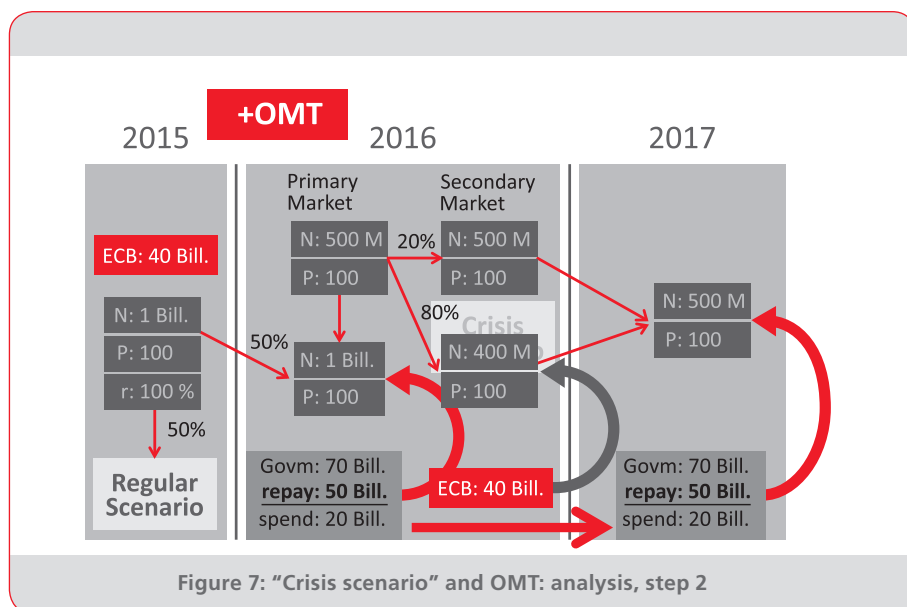


Figure 7: "Crisis scenario" and OMT: analysis, step 2

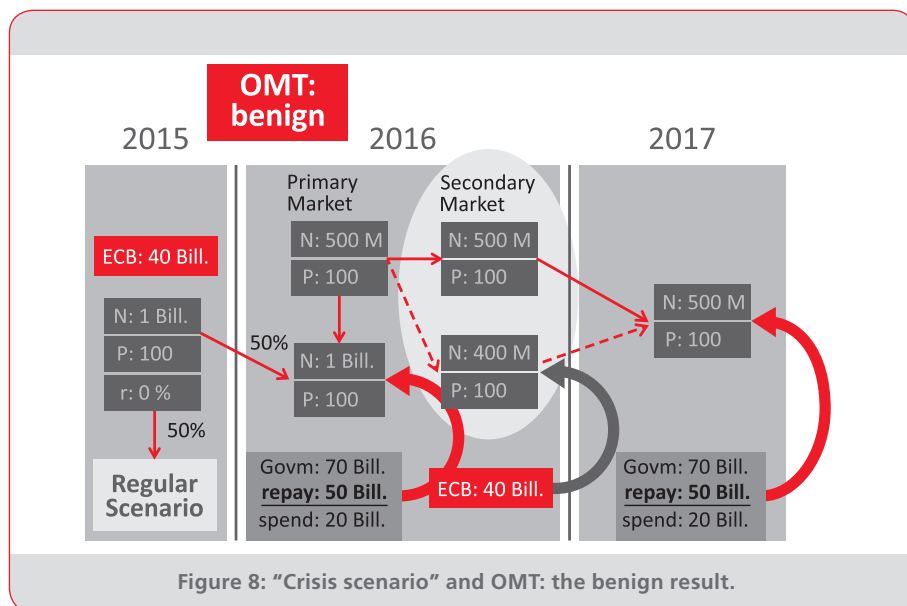


Figure 8: "Crisis scenario" and OMT: the benign result.

It may well be that the ECB has a version of this benign scenario in mind when celebrating the fact that the OMT program and the announcement to do "whatever it takes" has lowered yields and eased the situation, without any need so far for the ECB to step up to the plate and do any purchases. Note that prices P in 2015 are higher and yields r in 2015 are lower in the benign scenario of Figure 8 with OMT than in the 50-50 crisis

scenario of Figure 5 and that no purchases by the ECB are taking place in 2015. The self-congratulatory remarks by Draghi and the ECB may well be about pointing to such lower yields and the absence of purchases in 2015 and, implicitly, their belief that this policy is justified by the benign result of Figure 8. That, however, is a deeply flawed conclusion. It is remarkable that this conclusion appears to show up in many speeches of ECB officials without the appropriate caveats. These caveats are very important. Allow me to elaborate.

To that end, consider the “bailout, version 1” scenario of Figure 9. There, the fundamentals are assumed to be different. The government in 2017 is literally insolvent: nothing will be repaid on any bonds presented then, simply because the government has no resources to do so. Consider once again a program by the ECB to purchase 400 million bonds at a price of $P = 100$ in 2016. Given the impending default in 2017, the private-market secondary price P in 2016 is zero. Using the backward calculus much as in Figure 6, the primary market price in 2016 is $P = 80$. There is no default in 2016, since the government is capable of contributing the remaining 60 billion. And hence, the price for the bonds issued in 2015 is $P = 100$ with a yield of $r = 0\%$. Note that, once again, the price P in 2015 is high, the yield in 2015 is low, and the ECB is

not purchasing any bonds in 2015. In that way, it looks much the same as the benign result of Figure 8: just the mere announcement that the ECB is ready to purchase bonds at a high price in the future, if need be, lowers the yields in 2015. The ECB would celebrate just as much! However, there are two key differences between the scenario of Figure 9 and the scenario of Figure 8. First, the ECB ends up losing 40 billion euro on its purchases of debt issued in 2016. This is, in the end, a transfer from other countries to the country in question and a bailout in 2016, all of which is illegal under the Maastricht Treaty.

Second, and more subtly, the price the ECB is paying for the bonds in 2016 is different from the secondary market price then. Put differently, the ECB is not really buying on the secondary market: it is not buying at market prices! A tell-tale sign then that something is wrong is the fact that the ECB is not doing its purchases in 2016 on the secondary market at secondary market prices! It is well possible that it was this safeguard that the drafters of the Maastricht Treaty had in mind when they demanded that the ECB buy sovereign bonds only on secondary markets. On the primary market, the issue would be obfuscated considerably more: the ECB would presumably bid its 100 euros for 400 million

of the to-be-auctioned-off securities, and the rest would go to other bidders, here for zero euros. In this simple example, there would be a steep fall-off in the auction sales price, as one goes from ECB buyers to private buyers. Or perhaps the government simply stops at selling 400 million of the notes. There are various ways in which one could think about designing even the primary market in such a way as to reveal whether the ECB is buying at prices, which the private sector is willing to accept or not. It is just that much simpler and more direct on the secondary market. As long as there are private-sector traders out there who will hold their bonds to maturity and payout by the government in 2017 (or only sell to other private-sector traders who,

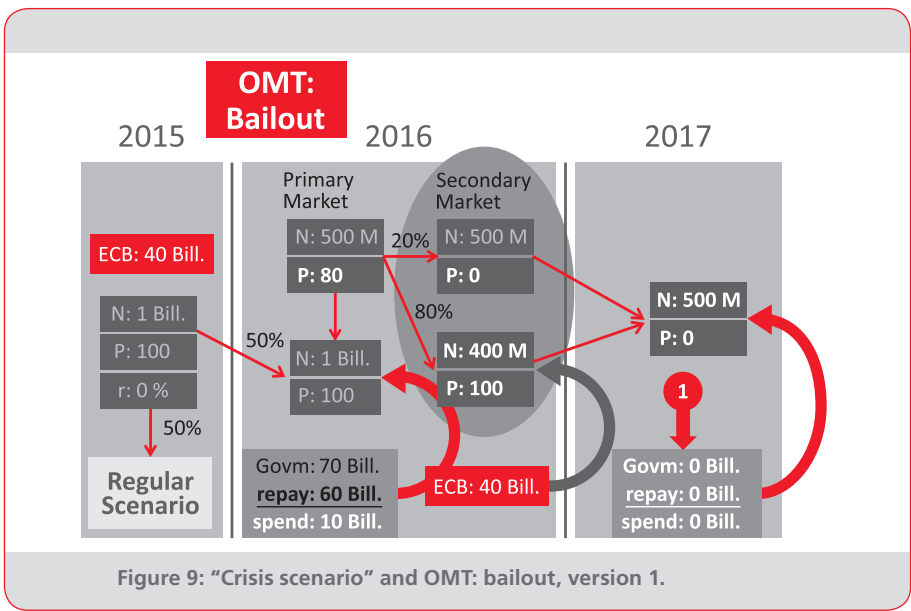


Figure 9: “Crisis scenario” and OMT: bailout, version 1.

down the chain, eventually do so), and who pay the same price as the ECB, we are in the benign scenario of Figure 8. This comparison obviously needs to exclude private-sector investors who are pressured or subsidized by their governments to purchase these bonds or who sell to some other government-type agency like a bailout fund or such pressured investors down the chain. And if the ECB pays considerably more than genuinely private-sector investors are willing to pay, we are in a bailout scenario such as the version shown in Figure 9. The Maastricht Treaty demands avoidance of the latter. It seems to me one cannot reasonably object against the former. Paying the going and genuinely private-sector second-market price is the litmus test to distinguish the two.

In all this it is important that there is a reasonably healthy and sizeable secondary market in 2016 remaining in order to check which of these scenario pertains. Consider Figure 10. It is based on the same calculus as Figure 9, except that the government in 2016 smartly only issues 400 million notes, not 500 million, knowing that only the ECB will purchase these notes at a nonzero price in the end, anyhow. In that scenario, the private investors will pay 100 euros for these notes in the primary auction in 2016, and sell all of it to the ECB in the secondary market. The ECB might argue it is paying the secondary market price: after all, all transactions on the secondary market are now indeed taking place at a price of $P = 100$. However, there is no longer a secondary market to speak of. All sales are ultimately made to the ECB, even if there are some intermediate private-sector trades where the bonds are traded from one to the next at a price of $P = 100$, with the last private sector buyer eventually selling to the ECB.

To put it more succinctly, the important market test that the OMT program of the ECB is indeed implementing the benign scenario of Figure 8 and not the bailout scenarios of Figures 9 or 10 is that the ECB is purchasing only a fraction (say, no

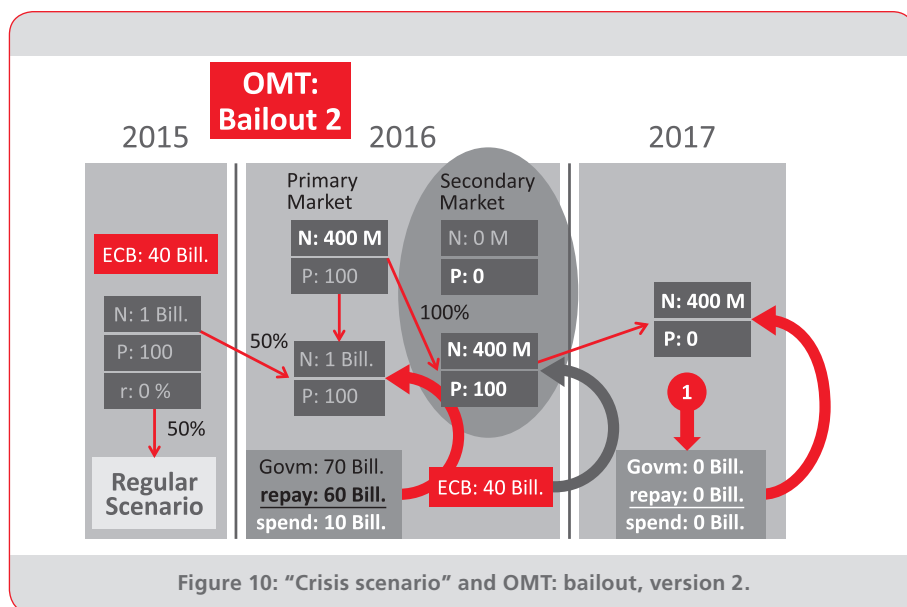


Figure 10: "Crisis scenario" and OMT: bailout, version 2.

more than 80 percent) of a single debt issue of the government and does so at the same price or below the price that private sector participants pay for this debt, where these private sector participants do not in turn receive pressures or subsidies for purchasing this debt and, ultimately, hold this debt until maturity and repayment by the government.

3 Fiscal and redistributive consequences of monetary policy

One may note that the analysis above looks rather far from traditional monetary policy. Some may argue, that all this is fiscal policy, even in the benign scenario of Figure 8, rather than monetary policy. I shall concede that the boundary here is murky at best. The only defense of the OMT policy is simply that it improves the situation in one country without drawing on the resources on the other and that it is within the possibilities of the ECB to carry it out. The defense is not that we should expect a common monetary policy to carry it out, and this may be a fine debate to have, see section 4. But some observers even go so far as to argue that monetary policy should have no fiscal consequences at all. Or they interpret the Maastricht Treaty as ruling out any actions by the ECB which might have fiscal consequences.

That, however, is practically impossible. Monetary policy actions nearly always have fiscal consequences.

On the most basic level, creating money supply essentially amounts to providing agents with an asset which they value ("money") and which costs nearly nothing to produce: the costs of production are the costs of operating the ECB and the money printing press. It should be fairly obvious that this should normally be a profitable enterprise. The profits or seignorage income is distributed to the treasuries at the end of each year: so that creates fiscal consequences right there.

Seignorage is only a very minor way in which low-inflation central banks impact on fiscal policy. The larger impact is directly on sovereign debt and its interest payments. A key instrument for central banks is the short-term interest rate: typically, they raise it in order to tighten the money supply and lower it to loosen it. Consider now a country such as Germany. It has a debt level of about 2 trillion euro. Suppose this debt was all entirely short-term with a maturity of one year. If the ECB now raises interest rates by one percent, and the German treasury has to subsequently refinance its debt at this higher interest rate, it is now hit with the additional repayment burden of 20 billion euros. This is not a trivial amount.

Consider long-term debt instead and that it has been sold with a given repayment schedule in the past. If the ECB takes actions which permit inflation to rise by, say, one percent for a single year, this amounts to deflating the real value of the repayments on the outstanding debt by one percent or once again 20 billion euros. The fiscal consequences of varying inflation will be considerably larger with ongoing inflation. Moreover, monetary policy actions may often have effects on the economy as a whole, stimulating or dampening economic activity. This results in increases or decreases of tax payments, once again creating fiscal consequences.

So: monetary policies will have fiscal implications, whether you like them or not. They just should not be the rationale for undertaking a monetary policy action.

Some seem to have interpreted the Maastricht Treaty as ruling out any actions by the ECB which might have redistributive consequences between countries. But once again, they are nearly always a byproduct of monetary policy actions and unavoidable. Debt levels and debt maturity structures of countries in the euro zone differ: so the calculation above already shows that the fiscal consequences across countries will be different. But one needs to broaden the perspective also to private debt: some countries are, on balance, indebted to others, and the same arguments above then lead to cross-country redistributions between private economic participants. Likewise, there are redistributions between debtors and creditors within any given economy.

In sum, monetary policy actions nearly always have fiscal consequences and practically always have redistributive consequences, too. Therefore, one cannot logically object to the OMT program just on the basis that it has fiscal consequences or redistributive consequences.

4 ECB communications

The analysis above provides for one potential avenue to defend the OMT program and its merits and to delineate it from a potential bailout, ruled out by the Maastricht Treaty. It is conceivable that ECB Governing Council had versions of this analysis in their mind when defending the OMT program in public.

However, the communication policy and the intellectual defense of the OMT policy by the top ECB policy-makers has been a hair-raising, intolerable and unfathomable disaster. It has remained unclear exactly what the ECB wishes to accomplish with its policy and on what economic analysis it has been built:

1. In the official ECB documents and speeches defending the OMT program one repeatedly finds references to the "disturbance of the monetary transmission mechanism". Yet, the ECB has been remarkably opaque in clarifying exactly what

constitutes such a “disturbance”, how to sufficiently clearly distinguish it from normal times, and which sound economic research and analysis can be consulted to understand the market failure the ECB seeks to address. For example, while some symptoms, such as differences in the effect on bank lending rates in response to a monetary easing by the ECB, could be a sign of a “disturbed” situation, pointing to it raises the serious concern that one would then have to declare the monetary transmission mechanism in Europe to be disturbed at all times or that some entirely nontransparent judgment call by ECB officials is required as to when the monetary transmission mechanism is deemed to be “disturbed”.

2. In a number of ECB speeches one does find references to “multiple equilibria”, which indeed featured prominently in the analysis above when comparing the “regular scenario” of Figure 3 to the “crisis scenario” of Figure 4. Some have argued that this shows indeed that the ECB is fully on top of the multiple equilibrium argument, and that it has used it in its own thinking. However, the arguments are typically laid out in such a generic, fuzzy and vague way that it can refer to almost everything else, too. If they really had the Roch-Uhlig (2014) paper in mind as the intellectual basis, for example, why did they never say so? If they had some other paper in mind, why did they not refer to that one then? Where is the clean, transparent explanation of their thinking that would stand a respectable chance to make for a good presentation or paper in a decent undergraduate seminar on economics?

3. When Jörg Asmussen defended the OMT program at the Bundesverfassungsgericht hearings in June 2013 and was given a chance to assess the views given by the economic expert witnesses (of which I was one), the lack of comprehension and the tangle of disjoint bits and pieces was truly painful to anyone with some expertise to listen to, as it may represent the convoluted level of intellectual debate inside the ECB council. I certainly would have thought this to be worthy of some clear-minded and sharp commentary by

leading newspapers that pride themselves with expertise on economic matters, but perhaps journalists with that kind of expertise were not present at these deliberations or it was not deemed of sufficient importance. It probably is all available in the written record now, though, and it may be well worth examining it with a critical mind.

The documents and speeches by the ECB give the impression³ that various speech writers and staff members are repeatedly given the unenviable task of trying to build some substance around some half-baked thoughts coming from the very top where these top decision makers are motivated only by undertaking some specific policy rather than thinking through or even understanding what those policies are meant to accomplish, let alone bothering with any serious attempt of thinking it through. All kinds of mush then gets thrown at the wall in the hope that something might stick (and no, I certainly have not read it all. It would be utterly painful).

In the end, I find it very hard to give any intellectual credit to this sea of words and soup of sound bites, for which students might well receive a failing grade but which appears to be affordable to independent top monetary policy decision makers when defending how to potentially spend trillions of euros. This is a tragedy and a disrespect of the institution and the trust granted to these decision makers see also section 5. The constructive version of these comments is that it is upon the ECB to provide clean and clear-minded analysis and intellectual basis for its policies, which can be understood and discussed in a serious manner by economists whose profession it is to do such things. At current, it is far from that.

5 An assessment

I hope the remarks have been helpful and clarifying. Let me end with an assessment of the situation and my own view on these matters, leaving the safe grounds of scientific and detached analysis. Perhaps, I left it already in section 4.

³ It is just an impression, of course! I may be entirely wrong, and it may well be that there is a deep understanding of economics in the ECB council. It seems well hidden from the public, though.

Europe and the euro zone are in a difficult situation. Much has been written about whether the euro zone is an optimal currency zone or not and whether a monetary union improves the economic situation there or not. But the euro zone has never been about the economic argument first. The creation of the euro was, in essence, a concession by the German Kohl government to get international agreement to German re-unification. The peaceful end of the cold war and the peaceful re-unification of Germany are a unique historical achievement that we should collectively celebrate. It was feared then that a united Germany with the Bundesbank as the effective central bank of Europe would be too powerful. Memories of the horrors of the two World Wars of the 20th century and the disastrous consequences of an overly powerful and dictatorial German Reich are still very painfully present in Europe. They mandated then and still mandate now working towards harmony and cooperation within Europe and mandated then and still mandate now the dissolution of the power of the Bundesbank over European monetary affairs. Malta has as much voting rights as Germany in the ECB Governing Council, and I believe this is entirely appropriate, for these reasons. Germany may often be asked to pay for other European member countries in disarray for many years to come, and, once again, I believe this is entirely appropriate, for these reasons.

That said, one needs to be extremely cautious about the powers one allows a pan-government agency such as the ECB to execute. The ECB has been created as a very independent entity, with weak accountability and weak possibilities for elected politicians to influence its decisions or change its leadership. It has been tasked with price stability, first and foremost. This organization structure was chosen based on the insight that the Bundesbank has been remarkably successful in its execution of monetary policy as well as the scientific arguments put forth most forcefully by Kydland and Prescott (1977) and then developed further by many others, that good monetary policy means sticking to rules and not to meddle politically with monetary policy decisions period by period.

One extreme interpretation of the Kydland-Prescott (1977) insight is to instruct a machine on how to run monetary policy and then throw away the keys. However, monetary policy is too complex to literally instruct a machine to run it well. We choose human decision-makers, hopefully well trained in economic matters, to execute it, and we provide them with the mandate enshrined in the Maastricht Treaty. We promise these decision-makers and the ECB that they will be independent in their choices, that political meddling will be avoided.

But it is important to recognize how far the ECB is removed from any democratic control. Voters can express their dissatisfaction with its leadership and trigger a change only via multiple steps and layers, via elections in individual countries to multi-country meetings of finance ministers and the like, and typically convoluted with many other issues at stake. There is a dramatic democratic legitimacy vacuum concerning the powers available to the ECB. Good democrats should not sleep well at night when reflecting about this. Indeed, for the very reasons listed above, for the memories of the horrors of emperors and dictators leading countries into mutual destruction, without democratic checks and balances, in the two World Wars of the 20th century, any power delegated at several arms length to institutions such as the ECB must be used with utmost caution. Democracy may be flawed in so many ways but red flags need to be raised whenever someone proposes that a committee of experts is better at running our countries or a subset of their policies. Such committees can serve a useful function but that requires restraint in the execution of their powers and a very limited mandate. Put differently, I cannot simultaneously agree to have Malta have the same voting rights as Germany in the ECB Council, while letting the ECB get away with a generous interpretation of the limits on its powers. It is too dangerous a proposition. Power always corrupts eventually. It is much better that red flags get raised too early than too late and that restraint is observed with great care.

For that reason, the OMT program is highly problematic. The core of my argument here is not whether the OMT program is helpful economically or not, or whether it is going to be costly for the Germans or not. I have analyzed these tradeoffs in section 2: yes, the OMT program can be helpful without taxing healthy countries in some circumstances, and will amount to a transfer in others. Judging that may be enough for others. But the core of my argument here is that ECB policies in general and the OMT program in particular are out of democratic control. The ECB is too far removed from the sovereign, the voter.

I do believe that Germany ought to help Greece or other countries in Europe in trouble (and vice versa), and I deeply believe that this view is shared by the vast majority in Germany. I also do believe that, in any such help, the end needs to be in sight, limits need to be spelled out and respected. Help can and will be given if the recipients do their share of getting their house in order. Frankly, Greece, Italy and Spain have not done enough there yet. This is not about “austerity”. This is about the ability of living within one’s means on their own and perhaps, at some future point, help out Germany or northern neighbors in trouble. This is about a viable, credible plan going forward to do so. This is about painful choices. And frankly, the debate in Germany has veered too far into an overly cautious short-term perspective rather than the perspective of a grand scheme to resolve the economic malaise, even if a large burden is imposed on, say, German tax payers. This is about creating a pact based on friendship and trust between the sovereigns, the voters, and in light of the responsibilities imposed on us as a consequence of two disastrous wars.

But these are matters of politics and of fiscal policy and of careful democratic debates, checks and balances. The ECB has no place to meddle in it. Precisely because it is several steps too far from democratic control, it must restrain itself in the powers it will execute. Just because it is capable of interfering does not imply that it should. I even cautiously side with those that argue that the OMT program of the

ECB may have been a bit like administering morphine to a moderately sick patient, taking away the pain and thus the necessity to take the appropriate measures in the affected countries, while they are still sufficiently healthy, and risking greater disaster down the road. It well may be a policy where the majority of the ECB Governing Council ultimately felt justified to put their hands in the pockets of the tax payers in the healthy countries in order to transfer resources to the others. This is a dangerous path indeed.

I do not mean that the ECB should look the other way when the economic situation in Europe can be helped by actions of the ECB or when the ECB can support the political process. I do not endorse an ECB policy stubbornly focused on nothing but price stability, but I do endorse getting very close to it. That implies that whenever the ECB seeks to execute powers or announce policies that can reasonably be considered questionable from the perspective of the Maastricht Treaty – and there is no doubt that the OMT is such a policy – that it is then of utmost importance, that the ECB delineates very clearly the merits of this policy in an intellectually honest manner. It needs to be intelligible and replicable not only to fans of the policy but also to critics, and certainly to the academic economists in the areas of monetary economics and macroeconomics. It is very important that the ECB carefully delineates where the limits of these policies ought to be and why. It is very important that the ECB identifies the failures in the market place that mandate these actions by the ECB. It is absolutely essential that the ECB provides a clear explanation of how it is still exercising the restraint demanded here. Exactly because the ECB is further removed from democratic control than any other central bank in advanced countries, it needs to work extra hard at showing legitimacy in its actions.

The ECB leadership may argue that they have tried. But they have not tried hard enough: not even nearly so. I have tried to argue this point in more detail in section 4. The ECB leadership has a responsibility here to improve these matters, and they should not treat this responsibility as lightly as they

have done so far. Otherwise they endanger the legitimacy of the institution entrusted to them. Otherwise they risk the very destruction of the institution they are trusted upon to safeguard. Otherwise they risk that Europe, once again, sinks into the hole of mutual distrust that we have worked so hard to escape. That would be a huge loss indeed.

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