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Karlsruhe Refers the QE Case to Luxembourg: Summer of Love

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Matthias Goldmann about the differences to the OMT case and what the European judges will now have to clarify

On 15 August 2017, the turning point of Summer, the case of the European Central Bank's opponents against the policy of Quantitative Easing (QE) reached a turning point of its own. The Bundesverfassungsgericht (BVerfG) referred the case to the European Court of Justice (http://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/DE/2017/07/rs20170718_2bvr085915 (ECJ). This is only the second referral of the BVerfG after the case concerning Outright Monetary

Transactions (OMT), in many respects the blueprint of the present case. While OMT consisted in the announcement that the ECB would make selective purchases of treasury bonds of countries with a dysfunctional sovereign debt market that would inhibit monetary policy transmission, QE had fare more

incisive consequences. Specifically, the ECB's Public Sector Purchase Program (PSPP) involved massive purchases of government bonds of eurozone members since 2015 to expand the monetary base. By May 2017, the volume of these purchases exceeds 1.5 trillion euros.

Does QE violate the Treaty?

As in the OMT case, the BVerfG suspects that QE violates the provisions of the Treaty on the Functioning of the European Union (TFEU) in two respects. First, QE might represent a disguised form of government financing in contravention of Art. 123(1) TFEU. In this respect, the BVerfG proceeds from the assumption that secondary market purchases of government bonds should not undercut the prohibition of primary market purchases. It argues that this might be the case here. With the overall monthly volume of purchases under QE and its distribution among the eurozone members being known, it does not require extraordinary mathematical talent from market participants to calculate the volume of debt which the ECB will absorb of each eurozone member per month. Also, the sheer volume of QE has led to a shortage of qualifying debt instruments. As a consequence, market participants could expect with certainty that the ECB would buy their qualifying bonds. Hence, it might be possible that secondary market purchases are effectively like purchases on the primary market, thereby jeopardizing price discovery. The BVerfG considers this assumption corroborated by the fact that the ECB makes a secret of the blackout period which needs to pass between the emission and the purchase, the fact that QE does not have a date of expiry, and that the bonds purchased so far have been held to maturity.

Concerning the limits of the ECB's monetary policy mandate (Arts. 119 and 127 TFEU), the BVerfG recognizes that it is a legitimate goal of the ECB's monetary policy to bring inflation up close to 2%, and that the instrument employed for QE is one of monetary policy. However, it doubts whether the sheer volume of QE would not distort the character of the program as one of monetary policy. While its effects on inflation remained unclear, it provided reliable financing for states, which could therefore scale back their efforts towards fiscal consolidation.

The German court has learned a lesson

Apart from the legal issues, the referral is really different this time. The referral of the OMT case triggered a winter of discontent between the two courts. Karlsruhe had left no doubt that it considered the OMT program to be in violation of the Treaty. It went as far as to "suggest" to the ECJ a downsized version of OMT – at the threat of disobeying the ECJ should the latter decide otherwise. The ECJ (http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:62014CJ0062&from=DE)coldly rejected the BVerfG's view, conferring upon the ECB a large margin of discretion to determine its monetary policy. The BVerfG (https://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2016/06/rs20160621_2bvr27281 complied.

It seems that the BVerfG has learned a lesson. This time, the referral sets a completely different tone. It reads like a modest and balanced plea for judicial dialogue, rather than an indictment. Fifty years after the original event, a new Summer of Love seems to thrive between the highest judicial bodies. The BVerfG leaves all doors open. Virtually every conclusion it reaches on the 63 pages of its decision is relativized and framed as a possibility, a probability, a prospect, not as an assertive truth claim.

What the European judges will have to clarify

The referral seems to raise two controversial points which the ECJ will have to clarify. The first concerns the extent to which the ECJ's findings in its OMT judgment of 2015 are relevant for QE. In that respect, the BVerfG does not explore some crucial differences between the two programs. OMT was intended to

undermine supposedly irrational, speculative developments on sovereign debt markets. It therefore had to be clandestine, without any upfront limitation of its volume – something which the BVerfG hardly could accept – and no information about potential purchases. By contrast, QE is meant to affect the decisions of supposedly rational investors and consumers. It is set to manage their expectations. That requires a great deal of reliability. The information about the astronomic volume and about the volume of monthly purchases serves that purpose. That this might lead to great levels of certainty among investors is thus the direct consequence of the specific objective of QE. If one considers QE to be admissible at all, which the BVerfG explicitly does, this appears almost inevitable. Whether certainty about ECB purchases will undermine price discovery to an extent relevant under Art. 123(1) TFEU is up for the ECJ to decide. However, one should bear in mind that the ECB only buys a maximum of 25% to 33% of qualifying bonds, leaving the private sector with enough risk to shoulder in case of a restructuring. It should therefore not surprise that, as the ECB claims, spreads between different bonds still reflect differences in economic fundamentals.

The second point concerns the standard of review applicable to monetary policy. This is a general point of great interest. Like in the OMT case, in the recent decision concerning the classification of German L-Bank (http://curia.europa.eu/juris/documents.jsf?num=T-122/15) as an entity to be supervised by the Single Supervisory Mechanism, the European General Court granted the ECB a large margin of discretion (see comment by Tobias Tröger (http://safe-frankfurt.de/policy-blog/details/the-judgement-in-the-case-of-l-bank-is-unsatisfactory.html)). One cannot blame the BVerfG for wondering whether there is any limit to that discretion. But the BVerfG provides little insight how tight judicial review could be exercised over the ECB without encroaching upon its autonomy in monetary policy matters – and thus upon the very essence of central bank independence. Tight control seems only feasible if monetary policy was an objective, mathematical craft. This, however, is not the case. (https://static1.squarespace.com/static/56330ad3e4b0733dcc0c8495/t/56a6cc074bf11888327a3dc9/14537717 Different approaches to monetary policy and the high level of uncertainty surrounding its effects make it very difficult to review in a marginally objective way whether a specific monetary policy is proportionate without engaging in the making of monetary policy. Such determinations presuppose projections of past and future developments – including the potential effects of tapering QE – which courts simply should not make. Instead, courts could do the public a great service by defining standards of justification and procedure for the ECB.

Thus, procedural strictures are the avenue which separates the Summer of 2017 from the Summer of 1967 where anything was going. They require rational discourse, dialogue and cooperation, hence a spirit of cooperation that cannot be taken for granted any longer in Europe in the year two before Brexit. One cannot avoid the impression that this might have had an impact upon the BVerfG's conciliatory tone. Honni soit qui mal y pense.

For a longer version of this text see SAFE Policy Letter No. 58 (https://safe-frankfurt.de/policy-center/policy-publications/policy-publ-detailsview/publicationname/karlsruhe-refers-the-qe-case-to-luxembourg-summer-of-love.html).

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