Bulletin Institute for Western Affairs

No. 156 / 2014
08’01’14

Institute for Western Affairs
Poznań

Author:
Marta Götz

OMT in Karlsruhe – Awaiting a Verdict

The background of OMT developments

In the summer of 2012, the President of the European Central Bank (ECB) announced the possibility of unlimited purchases of eurozone member state bonds on the secondary market as part of the OMT (Outright Money Transactions) program. The ECB says, on its website, that while unconditional outright purchases have been available as ECB's monetary policy instrument since as early as 1999, they were not applied until 2009. It may therefore be considered an unconventional measure. Eligibility for OMT requires a strictly defined enforceable conditionality attached to a relevant EFSF/ESM (European Financial Stability Facility/European Stability Mechanism) program. OMTs are unlimited and available for purchases of sovereign bonds with maturities of 1 and 3 years. The ECB agrees that none of the sovereign bonds it acquires in OMT transactions will have seniority over private or other creditors. The liquidity generated through the OMT program will be fully sterilized (i.e. offset by money withdrawals out of circulation). Interestingly, OMTs has calmed down financial markets and prevented outbreaks of panic even before the transactions actually took place. The promise itself has put things right.

The controversies which prompted the German complaint in the first place have to do with specific adverse implications that ECB’s actions are expected to have on Germany's budget and the desire to have the budget size determined exclusively by the Bundestag, as elected by German citizens. What is more, as an independent EU institution, the ECB falls under the jurisdiction of the Court of Justice of the European Union (CJEU) rather than the Karlsruhe-based court which has no competence to rule in the case.

ECB in the crossfire of German criticism

Note that it is not only the OMTs that have fallen under the criticism of German politicians and economists. Another cause for concern (expressed, among others, by President of the Bundesbank Jens Weidman) is the Emergency Liquidity Assistance (ELA) and the Securities Market Programme (SMP) designed to serve as liquidity bailout instruments to be extended in crisis-stricken states by their central banks and considered to be outside ECB's mandate. The controversy centers around perceiving such measures as either necessary for clearing the clogged-up channels of monetary policy transmission (as seen by their advocates) or as ignoring the fundamental macroeconomic rules of fiscal policy engagement (as perceived by their opponents). Bond purchases in peripheral economies would breach the principle of ECB's autonomy and go against its prerogative of ensuring monetary stability. As such, they would blur the line between monetary and fiscal policies. The majority of German opinion-makers who deal with economy have opposed Mario Draghie's ECB policy which they see as exacerbating inflation risk and easing reform pressures on South European countries: "It is governments rather than the ECB that should safeguard stability". The ECB has put forward a disquieting proposal to stimulate lending by promoting the growth of asset-based securities (ABS) previously blamed for contributing to the crisis and considered to be "a weapon of mass destruction". This would break another taboo which results from the growing sense of helplessness and ineffectiveness of the currently employed tools (low interest rates). The ABS program contemplated by the ECB involves, put simply, using loans extended to small and medium-sized enterprises (SMEs) as a basis for developing instruments which the ECB can accept as collateral. This, however, could only increase the temptation to abuse the system (moral hazard). The first step to be taken is to cure the country's banking system. Criticism has been raised over the November reduction of the reference rate to the record low of 0.25% and over the announcement of possible plans to adopt a negative deposit rate aimed at discouraging commercial banks from "parking" their available funds in the ECB to revive their economies. Controversies among German economists and politicians arose also over the transparency of ECB's actions and, in particular, the postulate to disclose Council meeting minutes to reveal the arguments behind its decisions. Although such transparency of the Frankfurt-based bank would be by all means desirable in view of its significance for overcoming the crisis and fits into the approach of other central banks, including the FED, experts fear it may leave the Council members who "cast dissenting votes" open and susceptible to influence from politicians and the banking community. This would run counter to the fundamental principle of ECB's independence. Besides, a certain degree of ambiguity and a certain lack of clarity are good for financial markets. As suggested by business press, an ECB interest rate at a level too low for Germany's needs raises concerns over a real estate bubble. The majority of German economists are orthodox in their perceptions of ECB views – they disagree with the postulates to extend ECB's monetary policy and adopt the so called nominal GDP.

German economists are divided on the issue of legality of ECB activities. The opponents appear to be more vociferous in the media and more effective in getting through to the public. Yet, Mr. Draghie's defenders have not laid down arms. An expert group which included such luminaries as Marcel Fratzchser, President of the Deutsches Institut für Wirtschaftsforschung (DIW) of Berlin, Beatrice Weder di Mauro, former member of the Council of Economic Advisors, Peter Bofinger, current member of the Council and Michael Hüther, Head of the Institut der deutschen Wirtschaft, wrote a letter (signed by 246 persons, including many renowned economists from around the world) supporting the policies of the Draghie-led ECB.

The Karlsruhe proceeding – arguments on both sides of the issue

The Karlsruhe court has postponed its ruling on the legality of the adopted and yet so far unverified unconditional purchase of short-term bonds in the OMT program until the fall of 2013. The motion which triggered the postponement was submitted by the CSU politician Peter Gauweiler and the *Mehr Demokratie* Association led by the former Minister of Justice Herta Däubler-Gmelin. Their misgivings regarded a possible breach of the German Constitution which guarantees the Bundestag exclusivity in determining the size of the budget. The complaint was that ECB's measure went beyond its mandate laid down in the Treaty on the Functioning of the European Union which establishes a monetary financing prohibition and, by the same token, bans the ECB from purchasing debt securities directly from states (on the primary market).

To examine the complaint submitted in the summer of 2013, the Court launched a series of hearings. Even the press, otherwise skeptical about ECB's actions, admitted that the choice of "witnesses" clearly favored advocates of the orthodox monetary policy. The Court sought the opinions of, among others, Hans Werner Sinn, President of the Munich-based Ifo Institute for Economic Research, Mannheim C. Fuest, Head of the Center for European Economic Research and Marcel Fratzscher, President of the German Institute for Economic Research. Some of the positions were very unambiguous (H.-W. Sinn), others more balanced, recognizing the strengths as well as the drawbacks of ECB policies. What specific arguments were used for and against the policies?

The advocates agreed that the actions undertaken by the Frankfurt-based Bank are a response to higher needs. The extraordinary circumstances experienced in the eurozone justify resorting to non-standard instruments. As unusual as they are, the transactions do fit within the framework of monetary policy. OMT supporters have noted an inherent flaw of the Economic and Monetary Union, i.e. multiple equilibria. These allow economies to “settle” at a point at which their operation is less than optimal, meaning they underutilize their potential in many fields. Under such circumstances, the elevation of monetary policy to the EU level has not been followed up by a proper coordination of fiscal policies. Debt and the GNP are best balanced at a point where debt amounts to around 75% of the GNP, whereas a bad equilibrium would be one where indebtedness exceeds 106% of the GNP. A transition towards the good equilibrium to escape a spiral of rising interest rates, declining GNP, growing debt to GNP ratios and runaway inflation requires structural reform, including fiscal consolidation, as well as external aid injected into the banking system and public finance. Experts therefore believe that EU's debt market is particularly susceptible to self-fulfilling prophesies of crises. Increases in yields on bonds from the South of Europe will not necessarily weaken real economic conditions and basic macroeconomic factors and cause self-fulfilling prophesies to come true. In EMU countries, markets tend to misestimate perils. In other words, markets fail as they change their spread estimates during periods of prosperity and recession. Their effectiveness is lower than that of “autonomous” economies. A central role in this context is played by the way in which individual financial markets assess a given country’s standing. When a solvent country loses its liquidity due to panic breaking out on markets, a vicious circle of indebtedness sets in. As a result of steadily growing interest rates of treasury securities which need to be issued to repay prior debt, governments are unable to roll over debt as markets “lose confidence”. Transitions from good low-interest-rate equilibria to bad ones in which interest rates soar to levels where it is no longer possible to repay liabilities often result from irrational “market beliefs” rather than assessments of macroeconomic foundations, which actually makes them work as “self-fulfilling prophesies”.

The advocates of ECB policies, as formulated by Mario Draghie, note also that, owing to its statutory independence, the Frankfurt-based Bank is autonomous in its decision-making and can afford to make unpopular decisions at its sole discretion. The mandate of independence shields it from political influences. Defenders of OTM recall ECB's responsibility for ensuring the coherence of the eurozone. Seen in this light, all that ECB is doing through its transactions is attempt to clear the channels of monetary policy transmission to the real economy. After the euro has been “irrevocably” adopted within the framework of the EMU, the ECB was forced to make every effort to keep the euro area coherent and integral.

The opponents recognize that the ECB operates outside of its prerogatives and, in fact, comes very near to the grey zone. Its policy is fiscal rather than monetary. Conservatives, with Hans Werner Sinn in the forefront, believe that by acknowledging the legality of OTMs, the Court would contradict itself as it would cancel a prior ruling that recognized the rightfulness of purchasing bonds in the ESM which, as is commonly known, is not entitled to conduct monetary policy. Hence, if that step is considered to fall within the scope of fiscal policy, an identical step taken by the ECB, may not be judged to be monetary policy.

Critics of Mario Draghie's actions believe one should not fiddle with eurozone "disequilibria" as the situation at hand only results from fundamental macroeconomic factors rather than an unhealthy and irrational panic on financial markets. This is because even volatile markets have the capacity to recognize (often only with a certain delay) the discrepancies between the macroeconomic standings of individual countries seen in the huge differences between the rates of return on treasury bonds between one country and another. As a consequence, the financial difficulties of businesses in the South of Europe (higher credit risk and, consequently, more costly borrowing) result from national (rather than pan-European) factors associated with a given economy. This makes it necessary to "lay the groundwork" by conducting structural reforms, ensuring fiscal consolidation and restoring competition.

Opponents of ECB policies and the OMT program see this as a "discriminatory" purchase of selected bonds of countries mired in recession or experiencing economic difficulties against doubtful quality collateral. Such actions resemble ex-post insurance which increases the temptation of fraud.

And the ruling?

Presumably, the Karlsruhe Court will attempt to reconcile both sides of the argument and issue a ruling to the effect of "yes, but" or "granted as long as …". The judges are well aware that the ECB operates on the fringes of legality due, basically, to the specific nature of the EMU which remains a work in progress (there is a need to clear the channels of monetary policy transmission and preserve the coherence of the eurozone). Therefore, the hopes of certain orthodox groups in Germany are false as the Court will never pronounce the ECB to be in breach of the Constitution and to have exceeded its mandate by encroaching on Bundestag prerogatives. Rather, its judgment will confirm the bitter realization that the Bundesbank is but one of the sixteen members of the ECB Council and that the Karlsruhe-based Court is not competent to rule on the legality of such instruments as the OMT as the ECB is governed solely by the TSUE. By pronouncing the actions unlawful, the Court could significantly erode the meticulously restored confidence and upset financial markets.

The most likely scenario is that the decision, expected early this year, will support the philosophy of "conditionality" and say "yes to assistance on the condition that …" (the conditions being Bundestag's consent and a strictly defined limit of financial support). This is because, by and large, the discourse on the future of the eurozone and the EU taking place among German economists seems to boil down to promoting a certain "conditional" (and perhaps "elite") integration and validating the notions of "a multi-speed Europe" and "variable geometry". The Karlsruhe decision will most likely add another piece to the German puzzle of conditional integration (as well as e.g. the Competitiveness and Convergence Instrument: CCI).

The theses included in this text express the opinions of the author only.

Marta Götz – economist at the Institute for Western Affairs in Poznań; research interests: foreign direct investment, economic crisis, the economy of Germany.