The ECB's OMT Programme and German Constitutional Concerns

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In June 2013, the German constitutional court (Karlsruhe) debated the legality of the European Stability Mechanism (ESM) and the European Central Bank (ECB)'s Outright Monetary Transaction (OMT) programme. After the court had preliminarily approved the ESM in September of last year, Karlsruhe is now evaluating the scope and boundaries of the ECB's monetary policy mandate and the OMT programme and its consequences on the budget right of the Bundestag. While it is very unlikely, the court, in theory, could force the German government to bring the ECB to the European Court of Justice or, even more dramatically, it could request Germany to leave the eurozone as the former constitutional court judge, Udo di Fabio argued in a recent study[2].

So how should the ECB's programme be evaluated? Is the ECB acting beyond its mandate? Are the potential fiscal consequences of the OMT programme a relevant dimension for the constitutionality of the OMT programme? Or is the OMT programme without fiscal consequences?

The ECB's OMT Programme

As a first step, the ECB's OMT programme needs to be described in detail. The ECB released on September 6, 2012 the programme outlining its potential "Outright Monetary Transactions". The details of the programme are[3]:

1. Objective: "safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy".
2. Conditionality: An EFSF or ESM programme with the possibility of EFSF/ESM primary bond market purchases must be in place in the respective country.
3. Decision: The decision on starting and ending OMT for a country is taken by the ECB governing council.
4. Unlimited purchases: no ex ante quantitative limits exist on bond purchases.
5. Focus on short-term debt: OMT will concentrate on buying one to three year bonds.
6. No direct government financing: Bonds are purchased on secondary bond markets only.
7. No seniority: The Eurosystem has "pari passu" creditor status (unlike in the SMP programme).
8. Full sterilisation of the liquidity effect.

Two features of the OMT programme have generally been seen as particularly important: its potentially unlimited nature as well as the conditionality defined in a standard financial assistance program in the eurozone. The ECB has emphasized that the conditionality would be a necessary but not sufficient condition for a program and that it would keep its discretion when deciding on an OMT programme. Yet, precisely those two conditions have also been criticized the most. As regards conditionality, Boone and Johnson (2012) argue that conditionality on austerity programs will eventually fail, as further austerity is politically impossible to enforce in Southern Europe. Along similar lines, Steltzner and Starbatty (2012) argue that the conditionality of OMT is not credible: if conditions are not met, stopping bond purchases would cause further harm to the monetary policy transmission mechanism. Once started, bond purchasing can no longer be stopped.

The more recent debate is about the potentially unlimited nature of the OMT programme. It is exactly this point that is at the core of the constitutional complaints against the ECB's program in the

German court. The plaintiffs argue that exactly the fact that the program is unlimited leads to incalculable costs to the German tax payer. Since there is no budgetary decision by the German parliament, the Bundestag, the plaintiffs argue that the potential bond purchases may lead to unlimited costs to the German taxpayer without a proper involvement of the Bundestag that is supposed to take this decision. This in turn would undermine the budgetary autonomy of the German parliament.

Before assessing the OMT programme in light of the discussion of the German constitutional court, I will review the OMT programme's context and effects as well as its importance for proper monetary policy transmission.

The Effects of the OMT Programme and Its Importance for Monetary Policy Transmission

The situation in the eurozone was dramatic before the announcement of the OMT programme. Nominal interest rates had hugely diverged, banks' access to finance was severely hampered, and the eurozone's financial system was deeply fragmented. Changes in the monetary policy stance of the ECB were not transmitted throughout all the eurozone and the ECB was therefore not able to fulfil its mandate of ensuring the proper conduct of monetary policy in the eurozone.

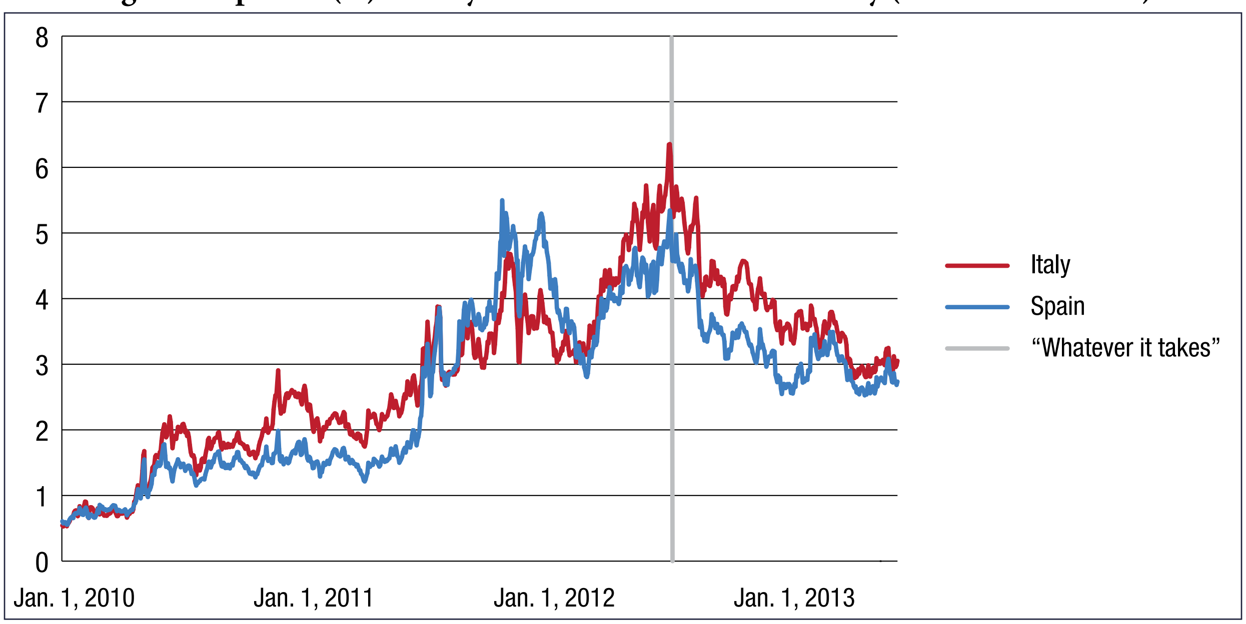
To fix this untenable situation for the ECB, bold action was required and the OMT programme delivered.

The decision has led to a dramatic improvement in the monetary policy transmission. Sovereign bond yields in Spain and Italy fell by 100 and 50 basis points in the first month after Draghi's 'whatever it takes'-speech in July 2012 and are now 200–300 basis points lower. Also, the bond spreads fell very significantly (see Figure 1).

Why was the OMT programme so successful in bringing down sovereign spreads? The effects materialized without the ECB needing to buy any bonds. So the pure announcement by the ECB that it could potentially buy bonds sufficed. It appears that the announcement moved the sovereign bond market from a "bad" to a "good" equilibrium.

The bad equilibrium is one in which doubts about the solvency of a government lead to a self-fulfilling crisis. Once investors start losing trust in the

Figure 1: Spreads (%) on 10 year bonds relative to Germany (1.1.2010–9.7.2013)

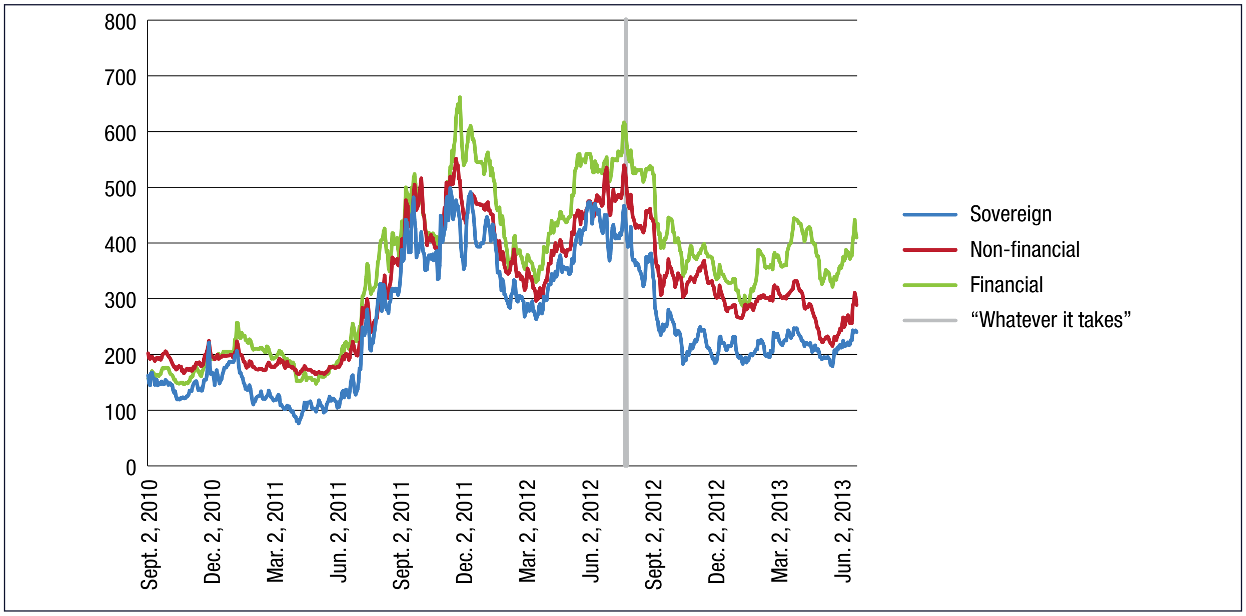


Source: Bruegel based on Datastream.

government's fiscal sustainability, they start selling bonds and push up interest rates. Yet, it is in fact the rising interest rates themselves that eventually render government debt unsustainable and thereby the initial doubt is self-fulfilling[5].

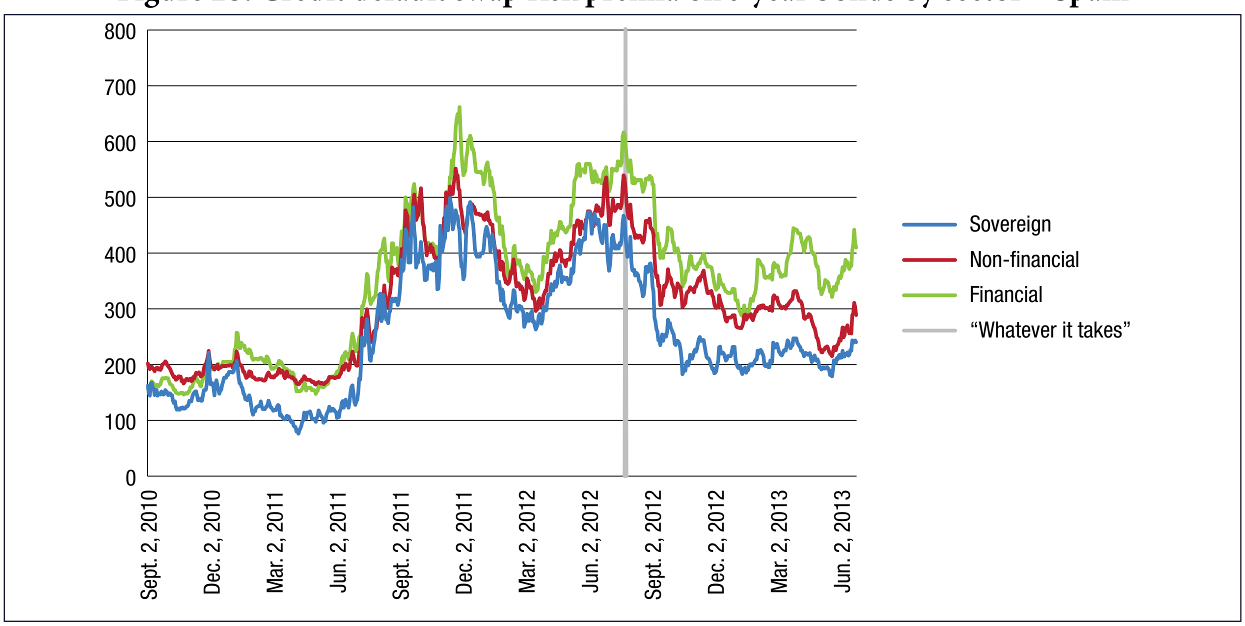
The programme was thus successful because it addressed a fundamental problem of the monetary union. Countries in the eurozone do not have direct influence on monetary policy, but issue debt in euros. This constellation resembles a situation

Figure 2a: Credit default swap risk premia on 5 year bonds by sector – Italy



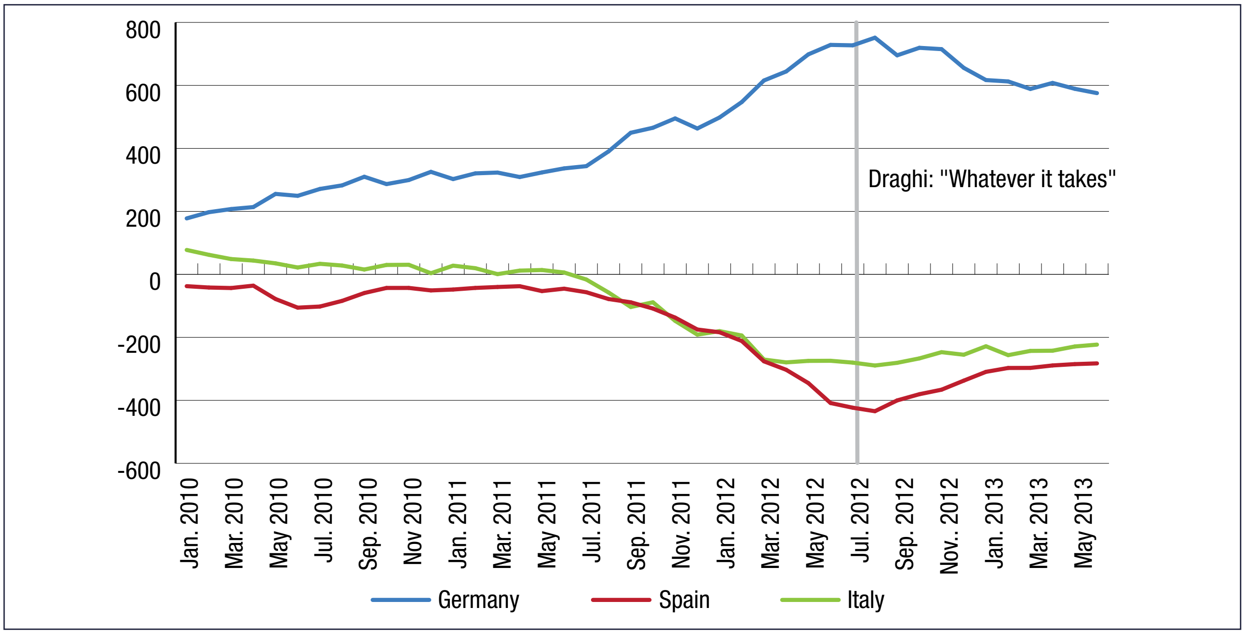
Source: Bruegel based on Datastream.
Note: The non-financial and financial series refer to the unweighted average of bonds by the five largest financial and non-financial corporations in the country.

Figure 2b: Credit default swap risk premia on 5 year bonds by sector – Spain



Source: Bruegel based on Datastream.
Note: The non-financial and financial series refer to the unweighted average of bonds by the five largest financial and non-financial corporations in the country.

Figure 3: TARGET2 net balances (bn EUR)



Source: Bruegel based on Osnabrück University.

in which governments issue debt in a foreign currency—and the breeding ground for a self fulfilling crisis is established[6]. Only the ECB has the capacity to address this problem and to credibly prevent a self-fulfilling crisis. Before the OMT programme, investors believed the ECB would not stand ready to do this and therefore betting against a country made sense as it would justify such setting ex-post due to the self-fulfilling nature of the bet.

Monetary Policy Transmission

The OMT programme was necessary from the point of view of ensuring proper monetary policy transmission. Figures 2a and 2b show that sovereign risk and financing conditions for financial and non-financial corporations are closely linked. In other words, the stress visible in the sovereign bond market related to a possibly self-fulfilling crisis did not only affect the sovereign but at the same time undermined the ability of the ECB to properly transmit monetary policy signals to the private sector.

The ECB could not ensure monetary policy conditions to be broadly similar throughout the eurozone, as the sovereign bond market divergences led to a dramatic financial fragmentation. This financial fragmentation was clearly visible in the interbank market, as banks in countries with stressed sovereigns were essentially prevented from accessing the unsecured interbank market[7].

This fragmentation meant that banks had to increasingly rely on the ECB for liquidity provisioning. The TARGET2 balances also increased dramatically, reflecting asymmetric liquidity flows within the European System of Central Banks (ESCB), up to the announcement by Mario Draghi. Since then this financial fragmentation trend was reversed and the so-called TARGET2 net liabilities fell by €141 billion in Spain and €57 billion in Italy between July 2012 and June 2013 (see Figure 3). The OMT programme was thus successful in improving and re-establishing the monetary policy transmission, even though the transmission mechanism has not been fully restored yet.

The Fiscal Implications of the OMT Programme

So, has the ECB with its OMT programme taken on board excessive budgetary risks? Has this undermined the budgetary sovereignty of the German Bundestag?

To answer these questions, one first has to understand the fiscal implications of the OMT programme. Like any bond purchase programme, the OMT programme can have fiscal implications if a country were to default on its bonds[8]. The resulting loss would imply a reduction of seigniorage revenues that would normally be distributed via the national central banks of the eurozone governments. If the losses are even larger and the capital of the ECB is depleted, the value of the ECB would be lower. From the point of view of the eurozone as a whole, the net wealth of the government sector would not change as the losses by the ECB would be compensated by lower debt levels of the treasury. In other words, if we take the government sector as consisting of the treasuries and the ECB, there is no fiscal effect. However, the zero net effect masks gains by the defaulter that are paid by other members. The gain for the defaulting country would be equal to the difference between the total defaulted amount and the share of the country in recapitalisation determined by its capital key.

De Grauwe and Ji (2013) argue that in principle, the ECB would not need to be recapitalised in the event of a default on some of its asset holdings that would lead to a negative equity position. While this is true in principle, such an event would still have fiscal implications for the member states as shareholders of the ECB and that do not default. The country defaulting would obviously benefit, at the expense of others. Their claim that "because of the zero money multiplier there is a free lunch" cannot invalidate the distributional consequences of a bond purchase program targeted at one country. In the context of the money multiplier of zero, one can indeed make a case for a quantitative easing program as the effects on inflation would be limited. However, depending on which assets are bought and on which assets creditors default has distributional consequences.

The real case for the OMT programme should thus not be made on the question of its distributional and fiscal consequences. An asset purchase program can always have fiscal implications and even standard monetary policy operations can have fiscal consequences. The recent Long Term Refinancing Operation (LTRO) programme of the ECB, for example, by increasing the ECB's balance sheet size, increased the risk on the ECB's books with potential fiscal consequence. Yet, it was not at all put into question.

The central question is whether it falls in the remits of the ECB's decision-making power to use government bond purchases as a way to fulfil its mandate and to fulfil the mandate in an effective way. Arguably, before the OMT announcement, monetary policy did not operate properly. The OMT programme also reduced the budgetary risks for Germany, which were higher due to its exposure in the standard liquidity operations by the ECB. Only the OMT programme managed to bring down financial fragmentation and thereby helped the ECB to reduce its current role as a financial intermediary between banks in the fragmented financial system.

The ECB took action that was effective and appropriate in solving a fundamental problem it faced, namely a dysfunctional monetary policy transmission mechanism. Its action was clearly within its mandate of ensuring the proper conduct of monetary policy. The pure announcement of a potential OMT programme helped to reduce risks and to coordinate markets in a good equilibrium. For the German constitutional court, the only relevant question should be whether the OMT programme falls outside of the ECB's mandate.[13] For this, potential fiscal and distributional consequences are irrelevant, as many actions by the ECB can have fiscal consequences and it would be absurd to argue that the eurozone does not need a central bank. The OMT programme was an effective measure to help the ECB fulfil its mandate. This is what matters.

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Endnotes

[1] I gratefully acknowledge excellent research assistance by Erkki Vihiriäla.

[2] See Jahn (2012) quoting Judge di Fabio (http://www.faz.net/aktuell/wirtschaft/europas-schuldenkrise/frueherer-verfassungsrichter-di-fabio-notfalls-ist-deutschland-zum-euro-austritt-verpflichtet-12205592.html).

[3] See ECB (2012) Press Release (http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html).

[4] See "ECB Denies Newspaper Report of Setting Limits to OMTs" in The Wall Street Journal. http://online.wsj.com/article/BT-CO-20130608-701267.html

[5] See Calvo (1988).

[6] See De Grauwe (2011).

[7] See ECB (2013) "Financial Integration in Europe", (http://www.ecb.europa.eu/pub/pdf/other/financialintegrationineurope201304en.pdf).

[8] See Ricardo Reis at Columbia University summarized in *The Economist* (http://www.economist.com/blogs/freeexchange/2012/09/ecb-bond-purchases).

[9] Which in legal speak means that it would qualify as ultra vires, thereby undermining German sovereignty.