Special Issue
The OMT Decision of the German Federal Constitutional Court

Law Meets Economics in the German Federal Constitutional Court: Outright Monetary Transactions on Trial

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A. Introduction

The Eurozone banking and sovereign debt crisis has brought the fragility of the European monetary union into sharp focus and exposed the lack of effective instruments at the European level to maintain financial stability. As a response to the crisis, the Member States and the institutions of the Union adopted in short succession several financial assistance measures that have given rise to much political and legal controversy.[1] The European Central Bank (ECB) played an active role in the institutions' efforts to contain the crisis and prevent the disintegration of the Eurozone by deploying a number of so-called non-standard or unconventional monetary policy measures, namely its Securities Markets Programme, Long-Term Refinancing Operations, and in September 2012 the Outright Monetary Transactions Programme (OMT Programme).[2] The OMT Decision envisages

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[1] The most important rescue measures were: Council Regulation 407/2010, 2010 O.J. (L 118/1) (EC) (establishing a European Financial Stabilisation Mechanism (EFSM)); European Financial Stability Facility (EFSF), EFSF Framework Agreement (2010) (establishing the EFSF on the basis of an intergovernmental agreement of the Eurozone Member States on May 9, 2010); Treaty Establishing the European Stability Mechanism (ESM), Feb. 2, 2012, 2011 O.J. (L 91) 1 - The rescue measures have been the subject of a number of legal challenges, see, e.g., Case C-370/12 *Thomas Pringle v Government of Ireland, Ireland and The Attorney General*, Judgment of 27 November 2012, n.y.r.; and the decisions of the German Federal Constitutional Court: Bundesverfassungsgericht [BVerfG - Federal Constitutional Court] Case No. 2 BvR 1099/10, 126 ENTSCHEIDUNGEN DES BUNDESVERFASSUNGSGERICHTS [BVERFGE] 158 (June 9, 2010), http://www.bundesverfassungsgericht.de/en/index.html; 129 BVERFGE 124 (ESF); 130 BVERFGE 318 (StabMechG); BVerfG, Case No. 2 BvR 1390/12 (Sep. 12, 2012), http://www.bundesverfassungsgericht.de/en/index.html (ESM Judgment).

[2] *See* Press Release, ECB, Technical Features of Outright Monetary Transactions (Sep. 6, 2012), http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html, for a press release that sets out the OMT Decision of the Governing Council of the ECB.

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unlimited purchases by the ECB of specific types of sovereign bonds[3] issued by Member States participating in an EFSF/ESM macroeconomic adjustment or precautionary program in the secondary market. Without the program having been activated, i.e. without the ECB actually implementing the decision and without any purchases of government bonds, yields on bonds of the affected Eurozone countries decreased markedly after the announcement of the OMT Decision. The OMT Programme has accordingly been credited with having been instrumental in restoring financial stability and preventing a breakup of the Euro area and with being one of the most effective announcements any central bank has ever made.[4]

Notwithstanding the economic success of the OMT Programme, a number of private citizens and a German political party brought legal actions before the German Federal Constitutional Court (Constitutional Court). In their constitutional complaints, the claimants challenge the rescue measures adopted by the Member States, the ECB, and the other relevant European institutions during the Euro crisis, and in particular the OMT Decision, on various grounds. The claimants argue *inter alia* that (future) purchases of government bonds on the basis of the OMT Decision would constitute illegal monetary financing; that the German Federal Government is under an obligation to work towards a repeal of the OMT Decision, including by bringing proceedings for annulment of the ECB's actions before the Court of Justice of the European Union (ECJ); that German constitutional organs "must refrain from all acts or decisions which serve to implement [the OMT] Decision"; and that the German Bundestag fails to exercise its overall budgetary responsibility by not withholding consent to ESM-related measures.

In its ruling, the Constitutional Court expresses serious concerns about the legality of the ECB's actions envisaged in its OMT Decision.[5] The Constitutional Court does not, however, reach a final decision on the matter, but has made for the first time in its history a reference to the ECJ pursuant to Article 267 TFEU. The referral follows the procedure set out by the Constitutional Court in its Honeywell and Lisbon decisions.[6] Honeywell, in particular, has been interpreted as an example of judicial self-restraint on the part of the Constitutional Court fostering a cooperative relationship between the German Court and the ECJ in the spirit of the German constitution's "openness towards European Law

[3] i.e. sovereign bonds with a maturity of one to three years at the time of purchase; *id*.

[4] INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: RESTORING CONFIDENCE AND PROGRESSING ON REFORMS 4 (2012); GUILLERMO DE LA DEHESA, *NON-STANDARD AND UNCONVENTIONAL MONETARY POLICY MEASURES* (2013), http://www.europarl.europa.eu/document/activities/cont/201309/20130920ATT71694/20130920ATT71694EN.pdf.

[5] BVerfG, Case No. 2 BvR 2728/13 (Jan. 14, 2014), http://www.bundesverfassungsgericht.de/en/index.html [hereinafter OMT Ruling].

[6] BVerfGE 126, 286, Decision of 6 July 2010, 2 BvR 2661/06 (Honeywell); BVerfGE 123, 267, Judgment of 30 June 2009, 2 BvE 2/08 (Lisbon).

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(*Europarechtsfreundlichkeit*)".[7] In the two decisions, the Constitutional Court reiterated that, while it accepts in principle the primacy of EU law, it reserves the right to review acts of the EU institutions for being *ultra vires* (*ultra vires* review) or affecting the constitutional identity of Germany (identity review). However, such a review will "only be exercised in a manner which is friendly towards European law."[8] This means for the ultra vires review that the ECJ must first be given the opportunity to interpret the Treaty and rule on the validity of the challenged act and that the Constitutional Court will only exercise its powers of review "if it is manifest that acts of European institutions and agencies have taken place outside the transferred powers."[9] A breach of the principle of conferral is manifest if it is "sufficiently qualified", which is defined by the Constitutional Court as a transgression that is "evident"[10] and "highly significant for the allocation of powers between the Member States and the Union."[11] As far as identity review is concerned, the Constitutional Court will declare acts of the EU institutions as inapplicable in Germany if they interfere with "the inviolable core content of [Germany's] constitutional identity."[12] In its ESM Judgment, the Constitutional Court previously held that identity review might be triggered where the federal parliament's budgetary autonomy was compromised because of supranational obligations to provide financial assistance to other states.[13]

In its OMT Ruling, the Constitutional Court has now, to widespread surprise, activated this review procedure and, as a first step, referred the following questions to the ECJ for a preliminary ruling:

(a) Whether the OMT Decision is incompatible with Articles 119 and 127 TFEU as well as the ECB's Statute, because it constitutes an overstepping by the ECB of its monetary policy mandate, and because it infringes the powers of the Member

[7] *See*, *e.g.*, Honeywell, *id*. para. 225. For an analysis of the relationship between the Constitutional Court and the Court of Justice of the EU in light of Honeywell see Gertrude Luebbe-Wolff, *Who Has the Last Word? National and Transnational Courts—Conflict and Cooperation*, 30 YEARBOOK OF EUROPEAN LAW 1, 4 (2011).

[8] Honeywell, *id*. para 58.

[9] *Id*. at paras. 60-61.

[10] In German: "offensichtlich", see *id*. at para. 61.

[11] *Id*.

[12] Lisbon Judgment, *supra* note 6, para. 240. Germany's constitutional identity is embodied in the principles laid down in Arts. 1 and 20 of the German Constitution (*Grundgesetz*).

[13] ESM Judgment, *supra* note 1, para. 213. See also the explanations of the Court *id*. at para. 214 (quoted also in the OMT Ruling, para. 28): "[N]o permanent mechanisms may be created under international treaties which are tantamount to accepting liability for decisions by free will of other states, above all if they entail consequences which are hard to calculate. The *Bundestag* must individually approve every large-scale federal aid measure on the international or European Union level made in solidarity resulting in expenditure."

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States, and whether a transgression of the ECB's mandate follows in particular from:

(i) the fact that the OMT Programme is linked to assistance under EFSF/ESM;
(ii) the selectivity of the envisaged bond purchases;
(iii) the OMT Programme running in parallel with assistance under EFSF/ESM; or
(iv) the fact that it might bypass the terms and conditions of these assistance programmes.

(b) Whether the OMT Decision is incompatible with the prohibition on monetary financing according to Article 123 TFEU, and whether a violation of this provision follows, in particular, from the fact that

(i) bond purchases by the ECB are potentially unlimited in volume;
(ii) according to the OMT Decision, bond purchases could take place immediately after the emission of bonds by a Member State;
(iii) the ECB "interfere[s] with market logic" by potentially holding bonds to maturity;
(iv) bonds could be purchased irrespective of the issuing sovereign's credit rating; and
(v) the ECB does not envisage demanding for itself preferred creditor status, but would in case of a default be treated equally with private bond holders.

Although the Constitutional Court refers these questions to the ECJ, it already makes it clear in its ruling that it considers the OMT Decision to exceed the ECB's mandate (Articles 119, 127 TFEU) and to be in violation of the prohibition on monetary financing of national budgets (Article 123 TFEU), unless the Decision is interpreted in narrow terms that are spelled out precisely in the Constitutional Court's ruling.[14]

In particular, the Constitutional Court holds that the OMT Decision "might not be objectionable" if it were "interpreted or limited in its validity" in a way that ensures that OMTs do not undermine the conditionality of EFSF/ESM and are only supportive of (rather than determining) economic policies in the Union. This is only possible, in the view of the Constitutional Court, if the ECB's participation in a debt cut is excluded, limits for purchase amounts are set *ex ante*, and interferences with market price formation are avoided where possible.[15]

[14] *Id*. at para. 100.

[15] *Id*.

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The ruling raises a number of questions, not only regarding the interpretation of EU law and the mandate of the ECB, but also, and perhaps more fundamentally, the supremacy of European law and the relationship between the ECJ and the courts of the Member States.

In this article, we will focus on the first of these sets of issues: the operation and effect of OMTs and how they fit within the framework of the monetary union established by the TFEU. However, it is submitted that this has also implications for the relevance of the other issues raised in this case. We argue that the Constitutional Court's ruling is based on an incomplete understanding of the economic rationale and intended functioning of the OMT Decision. Within its margin of discretion, as defined by the Treaty, the ECB can, and we submit that it has signaled that it will, implement the OMT Decision lawfully and in compliance with the principle of conferral. If this is correct, there is no conflict between European law and German constitutional law. Importantly, this result does not depend on an altered interpretation of the Treaty by the Constitutional Court, but merely on a different approach to how the OMT Decision should be characterized.

We will first show how the restrictive understanding of the OMT Decision by the Constitutional Court, and the narrow requirements for its implementation as set out in the Constitutional Court's ruling, limit the options that both the ECJ and the Constitutional Court have in resolving the potential constitutional conflict and at the same time making allowance for the necessity of providing for an effective mechanism to safeguard the common currency (Part B). We will then provide an overview of several economic features of monetary unions that are essential for an understanding of the functioning of OMT (Part C). In Part D, we will use these economic concepts to analyze the validity of the Constitutional Court's arguments and characterize the OMT Decision as a monetary policy measure. Part E concludes.

B. A German Catch-22?

On a very high level, the judgment's effects can—in our view—be summarized as follows. The Constitutional Court has largely made up its mind about the legality of the ECB's OMT Programme. It concludes that, if implemented in accordance with the text of the ECB's announcement,[16] it is very likely incompatible with the Treaty as interpreted by the Constitutional Court. The significance of the Constitutional Court's interpretation of the Treaty is, of course, that it simultaneously delineates the inviolable boundaries of the German constitution in the present context.[17] Consequently, nothing is gained from a broad interpretation by the ECJ of the Treaty provisions in question, at least from a German constitutional law perspective.

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[16] Press Release, *supra* note 2.

[17] *See* OMT Ruling at para. 55.

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The assessment is subject, however, to the ECJ's interpretation of the OMT Decision—not, ultimately, the Treaty—or equivalently its setting of boundaries for the relevant implementation of OMT. If, and it seems *only if*, the ECJ interprets the scope of a Treaty-compliant OMT Programme in a way that complies with the conditions set out in the Constitutional Court's judgment,[18] or otherwise limits it in accordance with this set of criteria, the Programme could still be found valid by both the European and the German courts. Thus, an unsolvable and highly problematic conflict between the ECJ's and the Constitutional Court's interpretation of primary EU law could be avoided.

If this account of the decision is correct, this ultimately leaves us with three possible scenarios:

(1) The ECJ decides that the OMT Decision in effect envisages actions by the ECB, which are incompatible with *its* interpretation of the Treaty.
(2) The ECJ decides that the OMT Decision, even if taken as interpreted by the Constitutional Court, is in line with the ECB's mandate under the Treaty and in particular does not violate Articles 119, 123, and/or 127 of the TFEU.
(3) The ECJ interprets the Treaty in a way that sets effective limits to any implementation of the OMT Decision, and the resulting limits happen to be compatible with the Constitutional Court's interpretation of the relevant Treaty constraints. In other words, the ECJ could effectively impose the same limits and conditions on the implementation of OMT as the Constitutional Court suggests in paragraph 100 of its judgment.

In effect, this creates a Catch-22 with respect to the ECB's OMT Programme:[19]

- In the first (unlikely) scenario, the OMT Decision clearly could not be implemented by the ECB, because doing so would violate the ECJ's interpretation of the ECB's mandate, which undoubtedly is binding on the ECB.[20]
- In the second scenario, the ECJ's interpretation of the Treaty would—at least very likely—be incompatible with the Constitutional Court's interpretation of the Treaty.[21] Since, in interpreting the Treaty, the Constitutional Court follows the boundaries of German constitutional law, it would not be able to defer to the ECJ's interpretation in this case. From the Constitutional Court's perspective, this scenario would be the result of an extension of the Union's competences in

[18] *Id*. at para. 100; see *supra* text to note 15.

[19] This is a reference to the paradox described in JOSEPH HELLER, CATCH-22 (1961).

[20] *See, e.g.*, Case C-11/00 *Commission v. ECB* [2003] ECR I-7147 (regarding the, admittedly limited, accountability of the ECB).

[21] *See* OMT Ruling at paras. 56, 84.

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violation of the principle of conferral, thus triggering the Constitutional Court's ultra vires review and identity review.[22] Although this would not necessarily have a direct *legal* effect on the ECB's ability to implement OMT, it would trigger what could be called a "duty to sabotage," i.e. an obligation on the part of all German public officials to work towards a reversal of the OMT Decision and to prevent its implementation.[23] It seems reasonably clear that this situation would, at the very least, substantially reduce the confidence of market participants as to the practical possibility of implementing the OMT Decision.

- The third scenario may well, at first glance, seem like a door the Constitutional Court left open for the ECJ. It allows for a solution in which interpretations of the Treaty by the ECJ and the Constitutional Court are compatible (as in the first scenario), but without directly declaring the OMT Decision unlawful. On closer examination, however, it becomes clear that this is not in fact a way out. Although it would solve a legal problem,[24] this comes at high cost. As we will argue in Part D, following the Constitutional Court would necessarily render any future use of OMT ineffective.

The Catch-22, then, is that only rendering OMT ineffective can save it. Else, the ECJ can only choose between declaring OMT illegal itself, or leave this task to the Constitutional Court. This assessment is of course based on the assumptions that, first, the Constitutional Court does not ultimately "settle for less," i.e. accept an interpretation of the OMT Decision that is broader than the one suggested in its judgment to be compatible with German constitutional law, and that, second, an OMT Programme re-interpreted or otherwise limited so as to comply with the Constitutional Court's OMT Ruling would indeed be meaningless and ineffective.

We believe the latter assumption to be true for reasons discussed in Part D; we will argue, however, that there are good reasons for the Constitutional Court to relax the requirements it set out in its ruling and accept a wider range of possible implementations of the OMT Decision to be compatible with the Treaty and with German constitutional law. As we will show, these reasons do not ultimately depend on disagreeing with the Constitutional Court on the legal boundaries set by the Treaty. We will argue that there is scope for an implementation of the OMT Decision that is compatible with the fundamental arguments put forward by the Constitutional Court in interpreting the Treaty and that, by extension, respects the limits set by German constitutional law as interpreted by the Constitutional Court. In going beyond the narrow conditions established by the Constitutional Court for OMT, such an implementation, it is submitted, is both legal *and*

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[22] *See supra* text to notes 6-13.

[23] *See* OMT Ruling at para. 49.

[24] i.e. that of irreconcilable differences in the interpretation of the Treaty.

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effective, and thus constitutes a possible way out of the Catch 22. Our argument is based on the economic rationale of the OMT Decision, which we will discuss in the following sections.

C. Economics of Incomplete Monetary Unions

I. Incomplete Monetary Unions

The European monetary union has been credited with reducing the costs of conducting cross-border trade within the EU, improving allocative efficiency, and being an engine of European integration. However, it is also commonly accepted that monetary unions may give rise to dynamics that distort market operations and prove detrimental to individual members of the union. Most importantly, by joining a monetary union, a country gives up the possibility of unilaterally setting monetary policy to stimulate demand or otherwise react to national economic conditions, and, naturally, a permanent monetary union also means that economic imbalances can no longer be counterbalanced by changes in the exchange rate. In particular, members lose the ability to cause a depreciation of their currency and thereby increase the competitiveness of the domestic economy. Joining a monetary union also means that a country will have to start borrowing in a currency it does not (directly) control. This exposes member countries to liquidity risks: a national central bank, no matter how independent, will usually be perceived by the market to stand ready "to do whatever is necessary" to avert liquidity risks. This essentially means that sovereigns outside a monetary union have, or are perceived as having, "access to the printing press" in a manner members of a monetary union do not.

These features of a monetary union naturally make member countries vulnerable to economic shocks and may, under certain conditions, set in motion a chain of events leading, in the worst case, to the insolvency of the country. In this picture, investor sentiment plays a crucial role. Let us assume that a country's economy is affected by a negative demand shock. The necessary adjustment cannot be accomplished by simply adjusting the interest rate and exchange rate and thus stimulating demand.[25] Instead, governments will need to implement deflationary policies to devalue wages internally. As a consequence, they may experience a recession, possibly leading to a growing budget

[25] It is controversial to what extent monetary policy and flexible exchange rates are able to bring about the necessary adjustment to demand or supply shocks. The main theoretical argument in favour of a flexible exchange rate regime was put forward by Milton Friedman, *The Case for Flexible Exchange Rates*, *in* MILTON FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS (1953), 159. For a recent empirical study see Atish R. Ghosh, Jonathan D. Ostry & Charalambos G. Tsangarides, *Exchange Rate Regimes and the Stability of the International Monetary System*, IMF OCCASIONAL PAPERS 270 (2011). It seems clear that at least in cases of severe macroeconomic shocks and financial crises, such as the one witnessed in the Eurozone in the last years, monetary policy can assist countries in making the adjustment process less painful. In comparison, for the possibilities of European countries to react to failed economic policies by using monetary policy before monetary union, see for example Jeffrey Sachs and Charles Wyplosz, *The Economic Consequences of President Mitterrand*, 1 ECONOMIC POLICY 261 (1986).

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deficit and thus calling into question the country's ability to pay bondholders. As investor sentiment becomes more unfavorable, the country's costs of refinancing increase. This further impairs the fiscal position of the country, and the liquidity problems that the country faces may ultimately develop into a solvency crisis.[26] In this sense, the position of the members of a monetary union is comparable to that of private banks.[27] The banking sector is characterized by a mismatch between liquid liabilities and illiquid assets. As a result, it is inherently fragile and prone to bank runs induced by a loss of confidence in the solvency of financial institutions. The member countries of a monetary union are in a similar position. Their assets, future claims on taxpayers and physical assets, cannot easily be liquidated to meet short-term needs to finance a deficit.[28] Without a lender of last resort, they may therefore be susceptible to a liquidity crisis.[29]

In federal systems, fiscal policies play an important role in facilitating the adjustment of the different regions to asymmetric shocks.[30] Whether fiscal centralization is a necessary condition for a monetary union is a matter of debate,[31] and it has been pointed out that a number of federal systems, including the United States until 1929, established monetary unions without providing for a major role of the central budget.[32] However, it is clear that *some* mechanism is necessary to enable the union to react to shocks and prevent a loss of confidence in the liquidity of the national (or regional) government, which may otherwise lead to a self-fulfilling solvency crisis as described in the preceding paragraph. The mechanism can be market-based, in the form of flexible wages and mobile labor moving quickly from the countries (or regions) experiencing a negative demand shock to those experiencing a positive shock, or it can be in the form of the consolidation of parts of the national budgets and debts and the control of budgetary policies. Both types of

[26] For a more detailed description of this process see PAUL DE GRAUWE, ECONOMICS OF MONETARY UNION 1–9 (9th ed. 2012).

[27] *Id.* at 203.

[28] Paul De Grauwe & Yuemei Ji, *Self-fulfilling crises in the Eurozone: An empirical test*, 34 J. OF INT'L MONEY AND FIN. 15, 17 (2013).

[29] See e.g. Charles A.E. Goodhart, *Myths about the Lender of Last Resort*, 2 INT. FINANCE 339 (1999); Charles A.E. Goodhart and Haizhou Huang, *A Simple Model of an International Lender of Last Resort*, 29 ECONOMIC NOTES 1 (2000).

[30] An example for such a policy is the system of fiscal equalization in Germany, where about 20 billion Euros are redistributed annually between the states and from the federal budget to the states. See Federal Statistical Office, *Ausgaben und Einnahmen* (Expenditure and Revenue), https://www.destatis.de/DE/ZahlenFakten/GesellschaftStaat/OeffentlicheFinanzenSteuern/OeffentlicheFinanzenSteuern.html (follow "Länderfinanzausgleich" hyperlink), for data.

[31] See the references in Lorenzo Bini Smaghi & Silvia Vori, *Rating the EC as an Optimal Currency Area: Is It Worse than the US?, in* FINANCE AND THE INTERNATIONAL ECONOMY, 78, 94 (6th ed. 1992).

[32] *Id*.

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mechanisms are not well developed in the EU. Labor mobility is, of course, legally facilitated by the TFEU and has increased over the years, but various *de facto* impediments to a fully integrated labor market persist, for example language barriers and differences in social security systems.[33] In addition, wages tend to be rigid and do not adjust instantaneously to supply or demand shocks.[34]

In the wake of the sovereign debt crisis, the European institutions and the EU Member States have made great efforts to establish financial assistance facilities in the form of the EFSF and ESM, improve economic governance and control of the Member States' budgets,[35] and complete the banking union.[36] However, in particular the EFSF and ESM have been criticized as being insufficient in size to function as an effective backstop preventing the emergence of a crisis of confidence. In this context, the European monetary union has been described as an *incomplete* monetary union.[37] The ECB's intervention

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[33] Herbert Brücker & Thomas Eger, *The Law and Economics of the Free Movement of Persons in the European Union, in* RESEARCH HANDBOOK ON THE ECONOMICS OF EUROPEAN UNION LAW 162 (Thomas Eger & Hans-Bernd Schäfer eds., 2012); Philip R. Lane, *The Real Effects of European Monetary Union*, J. ECON. PERSPECT. 47, 60 (2006); Klaus F. Zimmermann, *Labor Mobility and the Integration of European Labor Markets, in* THE INTEGRATION OF EUROPEAN LABOUR MARKETS 9 (Ewald Nowotny et al. eds., 2009). The lack of full factor mobility raises doubts whether the euro area can be characterised as what has been termed an 'optimum currency area', see Robert A. Mundell, *A Theory of Optimum Currency Areas*, 51 AM. ECON. REV. 657, 661 (1961). The literature analyzing this issue is vast. For two examples see BARRY EICHENGREEN, EUROPEAN MONETARY UNIFICATION: THEORY, PRACTICE, AND ANALYSIS (1997), in particular pp. 51 et seq.: *Is Europe an Optimum Currency Area?*; Paul De Grauwe and Wim Vanhaverbeke, *Is Europe an Optimum Currency Area?: Evidence from Regional Data*, *in* POLICY ISSUES IN THE OPERATION OF CURRENCY UNIONS 111 (Paul R. Masson & Mark P. Taylor eds., 1993).

[34] Kai Christoffel et al., *The Role of Labor Markets for Euro Area Monetary Policy,* 53 EUR. ECON. REV. 908 (2009).

[35] The various regulatory measures to improve economic coordination and fiscal discipline are known collectively as the "Stability and Growth Pact," complemented by the so-called Fiscal Compact contained in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, an intergovernmental treaty that is binding on the ratifying Eurozone members. The original Stability and Growth Pact dates from 1997. As part of the EU's reaction to the financial crisis, the original rules were comprehensively reformed in 2011 and 2013 by two sets of measures, the so-called Six-Pack and Two-Pack. See http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm, for references to the relevant legislative measures.

[36] Responsibility for the direct prudential supervision of credit institutions in the Eurozone countries and additional participating countries was conferred on the ECB by Council Regulation 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, 2013 O.J. (L 287/63); and Parliament and Council Regulation 1022/2013 amending Regulation 1093/2010 establishing a European Supervisory Authority (European Banking Authority), 2013 O.J. (L 287/5). The conferral is based on Article 127(6) TFEU. The single resolution mechanism will be established by a regulation, see *Proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund*, COM (2013) 0520 final (July 10, 2013).

[37] DE GRAUWE, *supra* note 26, at 17, 124.

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measures, including the OMT Programme, aim at remedying problems related to these defects of the European monetary union.[38]

II. Multiple Equilibria

There exists an extensive literature on market failures and the self-fulfilling nature of currency crises.[39] One aspect of the economics of currency crises, the possibility of multiple equilibria, seems particularly relevant in the present context and will prove central to our analysis below. It thus deserves a brief—and necessarily simplified—treatment here.

As put by the Constitutional Court,[40] the interest rate charged by investors for extending credit to a sovereign "always only result[s] from the market participants' expectations."[41] This is of course unquestionably true—market actors' willingness to purchase sovereign bonds at a particular price (and thus accepting a particular bond yield) will depend on their expectations as to the debtor's future ability to repay the bonds. What is omitted from this statement, however, is the inter-dependence of these two factors.

[38] ECB, MONTHLY BULLETIN 7 (Sep. 2012), *available at* http://www.ecb.europa.eu/pub/pdf/mobu/mb201209en.pdf. Already before the Eurozone crisis, it was pointed out that the insufficient coordination of national fiscal policies and the lack of a Eurozone-wide fiscal system that could facilitate the adjustment to macroeconomic shocks might jeopardize the political viability of the euro and that the ECB could be forced to step in and take emergency measures, see Lane, *supra* note 33, 64.

[39] *See, e.g.,* Guillermo Calvo, *Servicing the Public Debt: The Role of Expectations*, 78 AM. ECON. REV. 647 (1988); Maurice Obstfeld, *Models of Currency Crises with Self-Fulfilling Features*, 40 EUR. ECON. REV. 1037 (1996); Paul Krugman, *Are Currency Crises Self-Fulfilling?,* 11 NBER MACROECONOMICS ANNUAL 345–407 (1996); CARMEN REINHART & KENNETH ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY 60 (2009); De Grauwe & Ji, *supra* note 28; Philip R. Lane, *The European Sovereign Debt Crisis*, 26 J. OF ECON. PERSPECTIVES 49, 60 (2012); and Paul De Grauwe, *The Governance of a Fragile Eurozone*, 45 AUSTL. ECON. REV. 255 (2012). For empirical support of this concept's relevance in the present context, see Manfred Gärtner & Björn Griesbach, *Rating Agencies, Self-Fulfilling Prophecy and Multiple equilibria?: An Empirical Model of the European Sovereign Debt Crisis 2009-2011* (Universität St. Gallen, Discussion Paper No. 2012–2015, 2012), *available at* http://www1.vwa.unisg.ch/RePEc/usg/econwp/EWP-1215.pdf; and Daniel Gros, *A Simple Model of Multiple Equilibria and Default* (Centre for European Policy Studies, Working Document No. 366, 2012), *available at* http://aei.pitt.edu/35886/1/WD366_DG_Multiple_Equilibria.pdf. See also the initiative by Marcel Fratzscher et al., *A Call for support for the European Central Bank's OMT Programme*, BERLIN OECONOMICUS (July 19, 2013), https://berlinoeconomicus.diw.de/monetarypolicy/a-call-for-support-for-the-european-central-banks-omt-programme/, which has been signed by some 250 economists around the world.

[40] *See* OMT Ruling at para. 98.

[41] The Constitutional Court continues by stating that bond spreads are therefore "regardless of their rationality, essential for market-based pricing." OMT Ruling at para. 98. It is hard to see content in this statement—bond spreads (i.e. here the difference between the bond yields of different Member States) are not "essential" for market-based pricing, they are the *result* of pricing, whether rational or irrational, and whether market-based or not.

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Whenever a sovereign is perceived to pose a non-negligible default risk, investors will be unwilling to buy its bonds unless the bond yield exceeds the yield of an alternative risk-free investment.[42] In equilibrium, the prevailing bond yield has to fully compensate investors for the (perceived) additional risk they expose themselves to by choosing to buy the risky bond, rather than, say, a German sovereign bond.

A sovereign default occurs when a sovereign borrower is unable to raise enough revenue to pay the interest on its debt, or –perhaps more likely– when it is *unwilling* to make interest payments, rather than spending the available resources on providing essential government services such as health care or pensions, because doing so would be too costly politically.[43] The perceived risk of a sovereign bond—i.e. the probability of a default—thus depends on three factors. The first factor is the debtor's ability—or willingness[44]—to generate a primary fiscal surplus, i.e. the ability to raise revenues in excess of government expenditures, before any interest payments on existing debt are made. Second, the probability of default depends on the amount of its debt on which interest must be paid and, to some extent, the term structure of its indebtedness.[45]

Finally, a country's riskiness also depends on the interest rate necessary to induce investors to extend credit to the sovereign. This seemingly self-evident point has important implications for distinguishing between different types of sovereign debt crises and, consequently, classifying different policy remedies. It is this interdependence or "feedback effect"—namely that default risk is reflected by market interest rates, but that at the same time market interest rates also *affect* the default risk they reflect—that is the central connecting feature of the relevant economic literature analyzing currency crises.[46]

Clearly, countries within a monetary union and countries indebted in a foreign currency can be insolvent in the traditional sense.[47] Let us first consider a somewhat extreme case

[42] In the current context, it is best to view the yields in German sovereign bonds as representing this "risk-free" interest rate. *See, e.g.,* Paul De Grauwe, *The European Central Bank as Lender of Last Resort in the Government Bond Markets*, 59 CESIFO ECON. STUDIES 520, 529 (2013).

[43] This is a (highly) simplified version of the currency crisis model described in DAVID ROMER, ADVANCED MACROECONOMICS 632 (4th ed. 2012).

[44] Creditors will have certain expectations as to the extent to which revenue can be increased or public expenditures reduced without rendering the option of defaulting relatively more attractive.

[45] In essence, the term structure of a country's indebtedness determines the proportion of a country's debt that falls due and thus must be refinanced every year.

[46] *See* the literature cited *supra* at note 39 and accompanying text.

[47] We will ignore the fact that countries indebted in a currency they control themselves cannot (at least under normal circumstances) "default" in the traditional sense, given that they can always print enough money to satisfy any creditors' claims (albeit at the cost of creating inflation).

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where a country is unable to raise enough tax revenues (or reduce expenditures by enough) to even create a primary fiscal surplus that suffices to pay the risk-free interest rate on all its debt. Since investors *ex hypothesi* will not accept an interest rate lower than the risk free rate, such a country will certainly be unable to refinance itself in the marketplace. In this situation, because refinancing of existing debt is impossible, only support in the form of wealth transfers (e.g. from other countries or international organizations) can avert the country's eventual default.

However, a country's insolvency does not depend on the existence of these extreme conditions. Even if a country's tax revenue suffices to pay the risk-free rate, investors will still demand an adequate risk premium whenever they consider the borrower to represent a non-negligible risk of default, despite it only having to pay the low risk-free rate. Based on the prevalent bond yields since the beginning of the current crisis, this is the case for almost all Eurozone countries except Germany. Under these conditions, the sovereign will have to raise the interest rate it offers to investors in order to (re-)finance its debt. Doing so, however, necessarily also *increases* the probability of default. Thus, raising the offered interest rate induces and deters investors at the same time—it induces investment because it increases a return if no default occurs; it deters investors because the very fact that the borrower promises higher interest payments increases the likelihood of the borrower no longer being able to raise enough revenue to honor this commitment.

It should intuitively make sense,[48] therefore, that a sovereign can be in a situation where the inducing effect of an interest rate increase is always outweighed by the increased probability of default that it triggers. In other words, such a country is not an attractive investment at *any* interest rate, because at any given level of interest rates, the default probability is higher than the interest rate promise can justify.[49] In this case, the sovereign is in effect insolvent, because no (profit maximizing) investor has an incentive to extend credit to such a borrower at any promised rate of return.

There also exist two more benign scenarios. The standard case is a situation where *one* interest rate exists at which investors regard themselves as fairly compensated for the default risk they accept. This means that the probability of default *at that interest rate* is justified given that interest rate. In other words, a market equilibrium exists at that interest rate. Such an equilibrium is generally stable. Any (at least any moderate) increase

[48] *See*, for example, ROMER, *supra* note43, for a formal model of this process.

[49] Let us assume that a country has a probability of default of 5%, if it were to pay the risk-free interest rate. Since 5% is too high a risk for only receiving the risk-free rate, investors demand a higher return. The country doubles the interest rate, but as a result its default probability rises to, say, 15%. Investors may say that a default probability of 15% is too high, *even at the higher interest rate*. Further increases of the interest rate always lead to the same result —investors are not interested in an investment. There thus exists no equilibrium in which the country avoids default, unless the country receives a wealth transfer that, for instance, reduces the amount of its outstanding debt and thus the probability of default.

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in interest rates without changes in the country's economic situation will tend to be reversed by market forces, as it will make investors either feel over- or undercompensated for the risk they take on, leading to an adjustment of bond prices.

It is, however, also possible for multiple equilibria to exist for a particular borrower. This is the case where, at a given low interest rate prevailing in the market, the equilibrium exists as above. A sudden increase in the interest rate demanded by investors, however, pushes the market to a second, albeit unstable, equilibrium. Such a sudden increase can, for instance, be triggered by fears about the reversibility of a currency union which had previously been perceived, and was designed, as being irreversible, and the ensuing redenomination risk. Moreover, the market may well be overreacting to such fears, just as even modest doubts about a bank's solvency and fears of a bank run may cause an actual bank run.

Why, one may ask, will the market for the same country's bonds also be at equilibrium at high yields, even if nothing much has changed fundamentally? As discussed above, a country's solvency also depends on the interest rate charged by investors. Thus, the question simply is whether, after an increase in interest rates, the risk of default and the return investors receive is justified when compared to other assets. Because the increase in interest rates will also have increased the probability of default, this is possible. A closer examination also shows that interest rates will not, at least not necessarily, return to the previous stable equilibrium. Rather, it is possible that *two* equilibria co-exits: one with a low interest rate, which, crucially, is adequate in market terms to compensate investors for the risks taken; and a bad equilibrium, where high interest rates have the effect of increasing the likelihood of default and *because of this* are also justified – i.e. they are also equilibrium rates because they compensate investors for the higher risk. To put it differently, a country may be required to pay higher interest rates because, given that it has to pay that high rate, it is indeed a high risk borrower. This holds true even if investors are individually rational and recognise that *collectively* accepting a lower interest rate would leave them no worse off.

Two central implications are worth highlighting here. First, two sovereign borrowers can effectively be charged very different interest rates by rational investors, even if they are in very similar fiscal situations to start with. Second, the "bad" equilibrium is unstable. Even small changes in the market's sentiments can trigger a self-fulfilling sovereign debt crisis, culminating in an avoidable default. Because even a small increase in the prevailing interest rate, or an insignificant change in the economic prospects of a country, increases the default probability of the country in question, this can induce investors to demand an even higher interest rate in response. Very quickly, the market can reach yet another, and final equilibrium—namely investors are unwilling to lend to the sovereign at any interest rate because default is certain. Given that sovereign defaults are always costly to society, an entirely avoidable default triggered by market developments can hardly be described as anything but a clear market failure.

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Overall, this (very simplified) account leaves us with three different situations a Eurozone member can be in. First, it can be at a stable equilibrium, in which case the questions considered by the Constitutional Court do not matter. Second, a country can be in a "bad" and unstable equilibrium, in which fundamentally insignificant changes in the country's prospects or in investors' sentiments can have drastic effects. Third, a country can simply be insolvent, requiring assistance in the form of wealth transfers in order to avoid a default (at least without exiting the Euro). We will argue below that differences between the latter two scenarios are closely linked to the legal questions about the ECB's mandate and the prohibition on monetary financing in the Treaty. They are thus central for the legal assessment of the OMT Programme and its compatibility with the Treaty.

D. Economic Logic and Legal Reasoning

I. The ECB's Mandate

1. Monetary vs. Economic Policy

The ECB is set up in the tradition of the German model of central banking, which is made clear by two features of the institutional arrangements. First, the primary objective of the European System of Central Banks (ESCB) is defined as the maintenance of price stability. The mandate of the ESCB encompasses other objectives that "support the general economic policies in the Union," but these objectives are subordinated to the preservation of price stability.[50] Second, the TFEU stresses the political independence of the ECB, which shall not take instructions from the institutions of the EU or any government of a Member State.[51] Both features mirror the organization of the German Bundesbank[52] and helped to overcome initial skepticism in Germany towards monetary union.[53] Empirical evidence

[50] TFEU arts. 119(2), 127; Protocol on the Statute of the European System of Central Banks and of the European Central Bank, art. 2, 2012 O.J. (C 326) 230. The main principles defining the role and institutional structure of the European System of Central Banks and the ECB, including an emphasis on price stability, were already laid down in the Delors report. *See* COMMITTEE FOR THE STUDY OF ECONOMIC AND MONETARY UNION, REPORT ON ECONOMIC AND MONETARY UNION IN THE EUROPEAN COMMUNITY 21–23 (1989).

[51] TFEU art. 130.

[52] See the original version of the German Bundesbank law establishing the central bank: Gesetz über die Deutsche Bundesbank [Law on the German Bundesbank], Bundesgesetz Blatt I [BGBL. I – Federal Law Gesetz] §§ 3, 12 (1957). Research indicates that the ECB's independence is even more pronounced than that of the Bundesbank. For a review of these findings and a critical discussion, see LORENZO BINI SMAGHI & DANIEL GROS, OPEN ISSUES IN EUROPEAN CENTRAL BANKING 125–132 (2000).

[53] Niels Thygesen, *The Delors Report and European Economic and Monetary Union*, 65 INT'L AFF. 637, 646–647 (1989). Price stability continues to be of central concern to the Bundesbank. For this reason, the German Central Bank was critical of the ECB's actions during the financial crisis, see for example: Jens Weidmann, Eingangserklärung anlässlich der mündlichen Verhandlung im Hauptsacheverfahren ESM/EZB [Opening Statement at the hearing in the proceedings for ESM/ECB] (June 11, 2013), available at

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indicates that the ECB has pursued the objective of price stability consistently and successfully since it assumed monetary policy making authority. For most of the bank's existence, inflation was close to the bank's target level of 2%.[54]

The emphasis on price stability reflects the view that monetary policy can only influence macroeconomic conditions in the long run by focusing on inflation.[55] The intuition is clear. An expansionary monetary policy may be able to stimulate consumption and, as a consequence, increase output and reduce unemployment in the short run, but it will lead to higher prices and higher wages, which will bring unemployment back to its "natural" level.[56] The only long-run effect is inflation. Since central banks cannot know what the "natural" rate of unemployment is, they should therefore not seek to influence real variables, but focus on what they can control, namely the price level.[57]

Until recently, this view was widely held in academic and policy circles.[58] With the financial crisis, however, academics and central bankers have called for a greater role of central banks in monitoring and preserving financial stability.[59] While the precise tasks of the central bank in the area of financial stability are a matter of debate, the issue is not so

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http://www.bundesbank.de/Redaktion/DE/Kurzmeldungen/Stellungnahmen/2013_06_11_esm_ezb.html, and the Bundesbank's submission in these proceedings, pp. 12–13, available at http://www.bundesbank.de/Navigation/DE/Presse/Stellungnahmen/stellungnahmen.html.

[54] DE GRAUWE, *supra* note 26, at 178 (arguing that interest rate decisions of the ECB were close to what was optimal for the largest Eurozone economies—France, Germany, and Italy), 184–185 (showing that from 1999-2011 inflation was on average 2.02%).

[55] This view goes back to Milton Friedman, *The Role of Monetary Policy*, 58 AM. ECON. REV. 1 (1968). For this reason, standard economic theory speaks of the "long-run neutrality" of money. For a non-technical overview, see ECB, THE MONETARY POLICY OF THE ECB 55 (3rd ed. 2011), *available at* http://www.ecb.europa.eu/pub/pdf/other/monetarypolicy2011en.pdf.

[56] *Id*. at 10.

[57] There is some disagreement about the intermediate target the central bank should choose in order to achieve the policy goal of price stability. Friedman, *id*. at 15, favored a monetary total, while several central banks now target inflation. *See* DE GRAUWE, *supra* note 26, at 197. The ECB follows a two-pillar approach, consisting of economic and monetary analysis. As far as economic analysis is concerned, the ECB reviews a broad range of real variables, cost and price indicators, and fiscal policy in order to assess the likely development of prices and identify potential threats to price stability. Monetary analysis seeks to identify the growth rate of the money stock, which is associated with inflation in the medium to long run. On the basis of the information from both pillars, the ECB's Governing Council then takes its monetary policy decision. See ECB, *supra* note 55, at 69–82, for an explanation of both pillars in detail.

[58] A notable exception is the Federal Reserve System of the United States, which pursues price stability as one of several policy goals on an equal footing. *See* EMMANUEL APEL, CENTRAL BANKING SYSTEMS COMPARED: THE ECB, THE PRE-EURO BUNDESBANK, AND THE FEDERAL RESERVE SYSTEM 31–32 (2003).

[59] *See, e.g.,* DE GRAUWE, *supra* note 26, at 190; Otmar Issing, *A New Paradigm for Monetary Policy*, 16 INT'L FIN. 273, 279 (2013).

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much one of redefining the ultimate policy goal of central banks, but rather of the intermediate targets that the bank pursues and the information it relies on when making monetary policy decisions. It is clear that developments endangering financial stability, for example asset price bubbles, can affect price stability and that the central bank, as part of its price stability mandate, can take appropriate measures to counteract such developments. This is also the approach of the ECB. The Bank reiterates in its latest monetary policy overview that "the contribution [of monetary policy] to financial stability is subordinated to the objective of price stability."[60] Furthermore, the bank's approach is in line with "conservative," monetarist thinking in that the ECB does not attempt to target asset prices, for example by broadening the definition of "price stability," which is currently based on an index of consumer prices, to include asset prices.[61] Rather, within its two-pillar approach,[62] the ECB monitors asset prices and seeks to identify developments posing a risk to price stability over the medium to long term. If such a risk is identified, the ECB employs a strategy that has been called "leaning against the wind." It adopts a somewhat tighter policy stance than it would have done under more normal macroeconomic conditions in order to avoid feeding into the bubble, as arguably happened in the run-up to the subprime mortgage crisis in the United States.[63] The question remains whether the ECB is also empowered to adopt unconventional policy measures, such as the OMT Programme, within its monetary policy mandate to safeguard the financial system. We will analyze this question in the next section.

2. Legal Framework of the ESCB

The Constitutional Court held that the OMT Decision was likely to exceed the ECB's mandate as laid down in the TFEU and the ESCB Statute. The Court distinguished between the two objectives of the ESCB specified in Article 127(1) TFEU: The primary objective of maintaining price stability and the secondary objective of supporting the general economic policies in the Union. It advanced six arguments to substantiate its conclusion that the OMT Decision was in violation of both the primary and the secondary objectives and hence transgressed the ECB's mandate. The Court argued that the OMT Decision did not fall within the field of monetary policy because of (1) its objective; (2) its selectivity; (3) the parallelism with the assistance programs agreed on by the Member States; and (4) the bypassing of the narrow limits that the European Stability Mechanism imposed on the

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[60] ECB, *supra* note 55, at 83.

[61] *Id*. at 84–85. *See id*. at 64, for a formal definition of "price stability."

[62] *See supra* note 57 and accompanying text.

[63] ECB, *supra* note 55, at 85. The ECB does not see the task of monetary policy as having to prevent asset bubbles from occurring or "pricking" such bubbles. The bank therefore emphasizes that it is important to adopt a carefully calibrated response that does not affect economic growth and takes into account that policy makers may have difficulties in assessing whether a speculative bubble is in the process of forming. *See id*. at 84–85.

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purchase of government bonds. The Court further argued that the OMT Decision could not be qualified as support of the general economic policies in the Union because (5) the volume of the financial assistance provided through outright monetary transactions was such that it could potentially multiply the assistance provided for by the European Stability Mechanism and thus "thwart"[64] the agreed-upon volume and the imposed conditions; and (6) the ECB declared that it would decide on the start, continuation, and suspension of outright monetary transactions "in full discretion," instead of merely retracing the decisions of the Commission or so-called Troika. We will group the six arguments under the following headings: (1) objective of the OMT Decision (dealing with (1); (2) technical features of outright monetary transactions (dealing with (2)-(4)); and (3) support of the economic policies in the Union (dealing with (5) and (6)).

2.1 Objective of the OMT Decision

According to the Constitutional Court, the immediate objective of the OMT Decision was the neutralization of spreads on government bonds of selected Member States that adversely affected the refinancing of these States.[65] The Court argued that these interest spreads reflected "the skepticism of market participants that individual Member States will show sufficient budgetary discipline to stay permanently solvent" and that "the existence of such spreads [was] entirely intended" by the Treaty.[66] In neutralizing the spreads, the ECB was, accordingly, acting in breach of the Treaty, including its mandate, since such outright monetary transactions did not constitute acts of monetary policy, but economic policy.[67] The Court further explained that as to "the European Central Bank claiming to safeguard the current composition of the euro currency area with the OMT Decision . . . , this is obviously not a task of monetary policy but one of economic policy, which remains a responsibility of the Member States" pursuant to Articles 139 and 140 TFEU.[68] According to the division of powers expressed in these articles, it was for the Member States "to prevent the reversibility of the Euro," and they had acted upon this authorization by setting up the European Financial Stability Facility and the European Stability Mechanism.[69]

Several points can be made about this line of reasoning. First, the declared aim of the OMT Decision was not the neutralization of spreads on government bonds of selected Member States, but the "safeguarding [of] an appropriate monetary policy transmission and the

[64] In the German language version of the decision the Court uses the word "konterkarieren."

[65] OMT Ruling at para. 70.

[66] *Id*.

[67] *Id*. at para. 69.

[68] *Id*. at para. 72.

[69] *Id*.

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singleness of the monetary policy." The Constitutional Court does not consider this aim relevant in distinguishing between monetary and economic policy,[70] but instead focuses on what it calls the "immediate objective,"[71] which it sees in the elimination of spreads that are, in the view of the Court, a function of the insufficient budgetary discipline of the affected Member States.[72] This is, however, not the economic rationale of the OMT Decision. The market for sovereign bonds in a monetary union is affected by two factors that potentially distort the pricing mechanism of the market, the moral hazard that exists if national governments can expect to be bailed out in case of insolvency,[73] and the self-

[70] *See id.* at paras. 95–97, in particular para. 96: "The fact that the purchase of government bonds can, under certain conditions, help to support the monetary policy objectives of the European System of Central Banks [here the correction of a disruption to the transmission mechanism] does not turn the OMT Decision itself into an act of monetary policy."

[71] *Id*. at para. 69.

[72] In order to substantiate that this is the aim of the decision, the Constitutional Court makes references to ECB, MONTHLY BULLETIN 7 (Sep. 2012); ECB, MONTHLY BULLETIN 7–8 (Oct. 2012). See OMT Ruling at para. 70. However, the ECB's explanation in these documents shows clearly that the intended economic effect of OMTs is not simply to neutralize spreads (see also the discussion in the text immediately following this footnote). On p. 7 of the Monthly Bulletin September 2012, the ECB states:

> OMTs aim at safeguarding the transmission mechanism in all euro area countries and the singleness of the monetary policy. OMTs will enable the Eurosystem to address severe distortions in government bond markets which originate, in particular, from unfounded fears on the part of investors of the reversibility of the euro, as reflected, inter alia, in widening differences in the pricing of short-term sovereign debt up to July 2012 . . . . In such an environment, OMTs will provide a fully effective backstop to avoid destructive scenarios with potentially severe challenges for price stability in the euro area.

ECB, MONTHLY BULLETIN 7 (Sep. 2012). On p. 8 of the Monthly Bulletin October 2012, the ECB states:

> [S]pecific operational modalities have been set up to ensure that OMTs do not interfere with the three objectives of the monetary financing prohibition, namely safeguarding (i) the primary objective of price stability, (ii) central bank independence, and (iii) fiscal discipline. A major concern has been the need to ensure that this monetary policy instrument could not ultimately weaken fiscal discipline . . . . The current situation is characterised by severe distortions in government bond markets which originate, in particular, from unfounded fears on the part of investors of the reversibility of the euro. This translates into severe cases of malfunctioning in the price formation process in the government bond markets, which undermines the functioning of the monetary policy transmission mechanism.

ECB, MONTHLY BULLETIN 8 (Oct. 2012).

[73] For a discussion of the moral hazard problem and its implications for the role of the central bank see, for example, BINI SMAGHI & GROS, *supra* note 52, at 45–49.

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fulfilling dynamics of a loss of confidence in the solvency of a member of the monetary union and of a potential break-up of the euro zone. As discussed above, the loss of confidence may lead to a liquidity crisis, which may, in turn, develop into an actual solvency crisis because the affected country will only be able to refinance its debt at prohibitive interest rates.[74] In this sense, the loss of confidence in the solvency of the country is self-fulfilling and the country may find itself in a "bad equilibrium." The country will default because investors expect the country to do so, even though a "good" equilibrium that does not lead to a default would be possible under different investor expectations.[75]

As is clear from the explanations given by the ECB, it is the aim of the OMT Decision to mediate between these two dynamics by, on the one hand, providing for *ex ante* unlimited bond purchases and thus removing the threat of a liquidity crisis leading to a self-fulfilling solvency crisis and, on the other hand, combining outright monetary transactions with the conditionality attached to an EFSF or ESM program to address the moral hazard problem. To put it differently, the OMT Decision is not intended to "neutralize" the differences in yields of bonds of different Member States, but to "break" the expectations leading to a bad equilibrium.[76] The announcement of the decision has also in practice not led to a

[74] *See supra* Part C.

[75] *See supra* Part C.II. For a model specifically dealing with members of a monetary union, see De Grauwe & Ji, *supra* note 28, at 33–35. It is important to note that this problem is particularly pronounced in a monetary union, because member countries cannot provide for potentially unlimited liquidity, *see id*. at 35.

[76] *See* ECB, MONTHLY BULLETIN 7 (Sep. 2012), *supra* note 72; ECB, MONTHLY BULLETIN 7–8 (Oct. 2012), *supra* note 72; and Introductory statement to the press conference with Q&A (Sep. 6, 2012), *available at* http://www.ecb.europa.eu/press/pressconf/2012/html/is120906.en.html (explanations of Mario Draghi after the OMT Decision was taken). In the Q&A session, Draghi is very clear:

> [T]he assessment of the Governing Council is that we are in a situation now where you have large parts of the euro area in what we call a "bad equilibrium", namely an equilibrium where you may have self-fulfilling expectations that feed upon themselves and generate very adverse scenarios. So, there is a case for intervening, in a sense, to "break" these expectations, which, by the way, do not concern only the specific countries, but the euro area as a whole. And this would justify the intervention of the central bank. But then, we should not forget why countries have found themselves in a bad equilibrium to start with. And this is because of policy mistakes. That is why we need both legs to fix this situation and move from a bad equilibrium to a good equilibrium. If the central bank were to intervene without any actions on the part of governments, without any conditionality, the intervention would not be effective and the Bank would lose its independence. At the same time, we see that we are in a bad equilibrium and, therefore, policy action, though convincing, does not seem to produce – at least not in the relatively medium term – the results for which it is geared. So that is why we need both legs for this action.

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neutralization of the yield differences, as Figure 1 shows. It should be emphasized that the aim of the OMT Decision, breaking the dynamics that lead to a self-fulfilling solvency crisis, is generally already achieved by the simple announcement that the central bank is, in principle, prepared to purchase government bonds up to an amount that is *ex ante* unlimited. The activation of the program is not necessary, as evidenced by events of the recent past. However, should the program be activated, the ECB would need to show that it does not purchase bonds (and as a consequence reduce spreads) beyond the point that moves the country away from the bad equilibrium in order to ensure compliance with the prohibition on monetary financing.

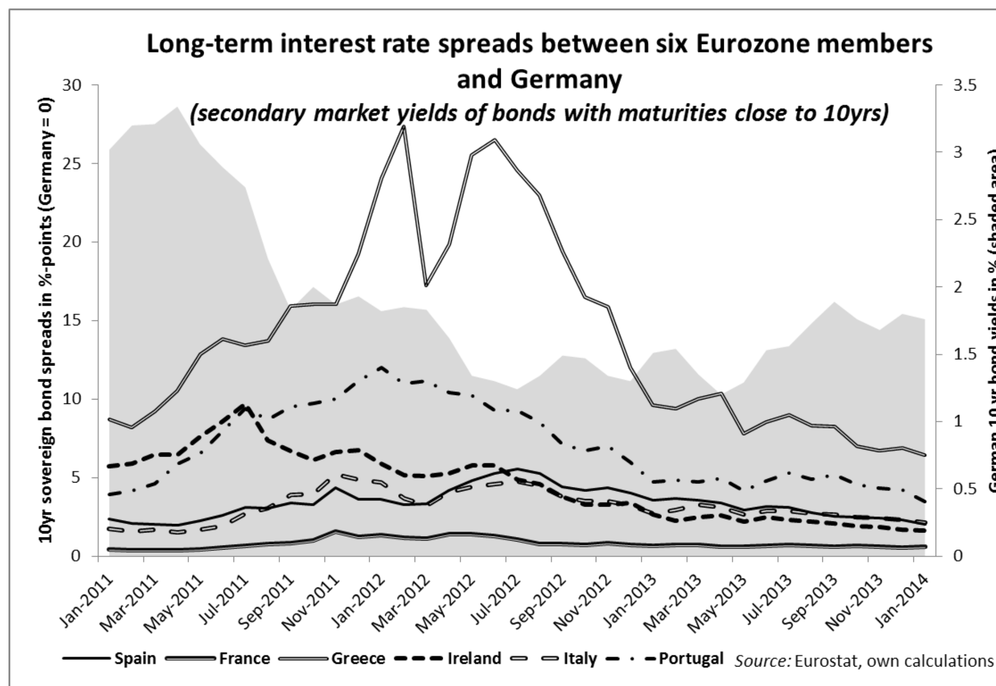

Figure 1: Secondary market bond spreads

It is puzzling that the Constitutional Court does not consider this economic rationale. The Court seems to have based its assessment exclusively on the moral hazard problem, the existence of which is not disputed by the ECB. In fact, in order to ensure that OMT only protects a country from entering a bad equilibrium, rather than providing financial assistance to countries that are insolvent, the ECB requires a mechanism that ensures that it withdraws any secondary market support if and when the country becomes insolvent. Tying OMT to conditionality under an EFSF/ESM program seems to us to be a suitable mechanism in this respect. The Court dismisses the ECB's argument that the distortions in the sovereign bond markets stemmed "from unfounded fears on the part of investors of

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the reversibility of the euro"[77] by simply stating that "one cannot in practice divide interest rate spreads into a rational and an irrational part"[78] and disregarding empirical studies that indicate the contrary.[79] These are complex questions of economic theory and the explanatory power of quantitative models. Few, if any, economists today believe that markets are completely immune to inefficiencies, and wide areas of financial regulation are indeed designed to address situations in which markets would, left to themselves, produce sub-optimal results.[80] It is questionable whether a court should attempt to reinterpret the technical decision of a body of experts that is rational in the sense that it is adopted in line with applicable theoretical models and empirical evidence and hold that the decision has a different effect than the one it professes to have. This is particularly problematic if the court does not discuss the scientific arguments supporting, and those casting doubt on, the rationale of the decision, but merely refers to one view and the "convincing expertise" of the institution expressing that view, which was in this case, incidentally, also the institution providing the one dissenting vote when the Governing Council of the ECB adopted the challenged decision. The fact that the dissenting institution itself bought its sovereign's bonds in significant volumes to keep interest rates low–i.e. for monetary policy reasons–during the 1970s,[81] can hardly be said to strengthen the force of that institution's submission.

To be sure, this is not, at least not necessarily, a technocratic argument against the Constitutional Court—or indeed the highest court of any other country—reviewing important and potentially problematic decisions taken by the ECB on the basis that "the experts know best." It is worth remembering here, however, that the Constitutional Court goes far beyond this: rather than reaching the conclusion that a particular implementation of OMT is or would be incompatible with the Treaty (and German law), it seems to assume that it is able to identify definitively the *one and only* scenario that is compatible with it.[82]

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[77] ECB, MONTHLY BULLETIN 7 (Sep. 2012).

[78] OMT Ruling at para. 71; para. 98 ("[T]he distinction between rational and irrational is meaningless").

[79] *See* De Grauwe & Ji, *supra* note 28 (calculating the part of the surge in spreads of peripheral Eurozone countries that was disconnected from underlying increases in the debt to GDP ratios and fiscal space variables and arguing that this part was associated with negative self-fulfilling market sentiments); Tigran Poghosyan, *Long-Run and Short-Run Determinants of Sovereign Bond Yields in Advanced Economies,* IMF WORKING PAPER 12/271 (2012) (arguing that "that spreads against Germany in some European periphery countries exceeded the level determined by fundamentals in the aftermath of the crisis, while some North European countries have benefited from 'safe haven' flows").

[80] *See, e.g.,* ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000).

[81] See Christoph Herrmann, *EZB-Programm für die Kapitalmärkte verstößt nicht gegen die Verträge*, 21 EUROPÄISCHE ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (EUZW) 645, 646 (2010); Christoph Herrmann, *Die Bewältigung der Euro-Staatsschulden-Krise an den Grenzen des deutschen und europäischen Währungsverfassungsrechts*, 23 EUROPÄISCHE ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (EUZW) 805, 811 (2012).

[82] OMT Ruling at para. 100.

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The second part of the Constitutional Court's argument—namely that safeguarding the current composition of the euro currency area "is obviously not a task of monetary policy"—is based on an equally peculiar understanding of what the ECB intends to achieve with the OMT Decision. The Court applies Articles 139 and 140 TFEU to the case in order to hold that the OMT Decision does not fall within the mandate of the ECB. These two articles deal with the transition to monetary union and the criteria that a Member State must fulfill in order to be eligible to join the Eurozone (convergence criteria). They set out a procedure for the assessment of the convergence criteria and accord the Council and Commission the main role in this procedure. It is not clear what this has to do with the case at hand.[83] Articles 139 and 140 TFEU concern the introduction of the euro; once a currency has been introduced, it is evident that it falls within the mandate of the central bank to protect it. This applies to the ECB as much as it does to any other central bank in the world.[84] As discussed above, crisis prevention and intervention by central banks are in line with the goal of monetary policy as set out in Article 127(1) TFEU if they are designed to address threats to price stability.[85] The relevant question is not so much whether the central bank acts within its monetary policy mandate when it counteracts distortions in financial markets but rather what types of instruments it can make use of within its mandate. The ECB's monetary policy instruments are laid down in the Statute of the European System of Central Banks and of the ECB.[86] Pursuant to the Statute, the ECB has three types of instruments at its disposal: Open market operations,[87] standing facilities,[88] and minimum

[83] The Constitutional Court seems to believe that the allocation of competences in Articles 139 and 140 TFEU apply generally to any question concerning the "composition of the euro currency area." OMT Ruling at para. 72. The Court also refers to a press release of the ECB in which it allegedly claimed that the OMT Decision served to safeguard the current composition of the Eurozone. This press release—ECB Press Release of 26 July 2012—could not be retrieved by the authors. Possibly the Court means the speech by Mario Draghi given in London on 26 July 2012, in which he famously said that "the ECB is ready to do whatever it takes to preserve the euro," but where he did not mention the composition of the euro area. Mario Draghi, President, European Cent. Bank, Global Inv. Conference in London (July 26, 2012), *available at* http://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html (last visited Feb. 21, 2014). He also said on this and other occasions that it was the aim of the ECB to make the euro "irreversible." *Id.* These statements were aimed at reassuring investors that the common currency would not disintegrate. They are, therefore, better understood as comments regarding financial stability concerns than the composition of the Eurozone.

[84] *See*, for example, the original version of the German Bundesbank law establishing the central bank, *supra* note 52. "The German Bundesbank shall regulate, by exercising the powers in the field of monetary policy conferred on it by this law, the circulation of money and the supply of credit to the economy with the aim of protecting the currency . . . ." *Id.*

[85] *See supra* text accompanying notes 59–63.

[86] *See supra* note 50.

[87] *Id.* art. 18.1.

[88] *Id.*

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reserve requirements.[89] Under the OMT Decision, the ECB envisages purchasing government bonds in the secondary market. OMTs may, therefore, fall within the definition of open market operations given in the Statute.[90] Whether they are indeed comparable to these monetary policy instruments, or rather to economic policy instruments such as the ESM, depends on their technical features. We turn to this question next.

2.2 Technical Features of Outright Monetary Transactions

The second set of arguments put forward by the Constitutional Court in relation to an infringement of Article 127[91] concern the technical features of OMTs: The selectivity of the bond purchases, targeting specific Member States participating in an EFSF/ESM assistance program, and the parallelism with the European Financial Stability Facility or European Stability Mechanism.

As far as the selectivity of the announced bond purchases is concerned, the Constitutional Court explicitly recognizes a central problem of its position—namely that any form of monetary policy, including setting uniform short-term interest rates for the entire Eurozone, affects the countries within the Eurozone very differently, hence calling into question any interpretation of "independence" as requiring equivalent effects. But it brushes away this complication by, it seems, drawing a line between formal equal treatment (one interest rate for all countries) and equal effects (same interest rate is suitable for some, and damaging for other countries). Because mere differences in effect are indirect and "can be controlled by the [ESCB] only to a limited degree," such monetary measures are to be distinguished from the OMT Programme, which "envisages a targeted purchase of government bonds of selected Member States," resulting in the "government bonds of other Member States [being] . . . eventually placed at a disadvantage."[92]

The argument does not seem particularly convincing to us. First, had the ECB announced its willingness to buy any sovereign Eurozone bond at yields of, say, 5%, would that satisfy the formal equivalent treatment requirement? Clearly, the effect would not have been very similar, especially in relation to the "bonds of other Member States" the Constitutional Court refers to. Second, the Constitutional Court seems to take issue with

[89] *Id.* art. 19.

[90] Pursuant to Article 18.1 of the Statute, the ECB and the national central banks may "operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claims and marketable instruments . . . ." ESCB Statute, *supra* note 50, art 18.1.

[91] The same arguments are used to substantiate a violation of Article 123 TFEU. *See* OMT Ruling at para. 87 and our analysis *infra* part D.II.

[92] *Id.*

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differentiation between individual Member States by the ECB, at least where this is the result of "targeted" action. Even if one were to ignore the fact that any rate setting is at least implicitly targeted—because the Council will look at and weigh the likely effects of its measures on different countries against each other[93]—whether or not selective buying does in fact represent differentiation of the sort that calls into question the central bank's independence is very much a matter of one's viewpoint.

While the OMT Decision does involve targeted and selective buying of bonds, it is also a policy based on objective and relevant criteria. Any Eurozone country meeting the conditions of the ECB's policy could potentially benefit from the OMT Programme. Moreover, the fact that changing market conditions may result in other Member States "eventually [being] placed at a disadvantage" does not seem to have a more direct consequence than, for instance, forgone economic output due to a uniform monetary policy that is predictably unsuitable for certain countries in the Eurozone.

It seems to us that relevant and meaningful doubts regarding the ECB's independence would only exist if there was any indication of the ECB treating different countries' bonds differently despite the countries being in the same circumstances. In fact, the reverse is equally true—treating countries equally despite relevant differences in their economic situations would be as problematic from an independence point of view as unequal treatment of like cases. Of course, this is not to say that the ECB can justify any selective and targeted market intervention by pointing to different conditions. The point is simply that market interventions by the ECB based on relevant and objective criteria are neither rendered more nor less likely to constitute prohibited monetary financing by the fact that they involve transactions in only some, rather than all, sovereign bond markets. Instead, whether or not ECB intervention constitutes monetary financing depends on the criteria used for targeting its actions, the aims pursued, and the likely effects of such actions, in particular, whether the effect can in economic terms be described as an extension of credit by the ECB to national governments. Given what we said above, the decisive requirements for a permissible use of OMTs will be that bond buying, if it happens at all, occurs at equilibrium rates and is used only to prevent bad equilibria from arising.

Furthermore, according to the Constitutional Court, a violation of the Treaty is also indicated by its running in parallel with the EFSF and ESM assistance programs.[94] In particular, the Constitutional Court argues that the ECB's OMT approach is "likely to bypass the conditions and conditionalities" of the EFSF and the ESM. The Constitutional Court

[93] In fact, the ECB's inability to target its monetary policy, combined with a lack of fiscal coordination, can create moral hazard among Member States, as fiscal responsibility may be a sub-optimal strategy depending on the behavior of other Member States; see Bob Hancké, *The Political Economy of Fiscal Policy in EMU*, 1 EUR. POL. ECON. REV. 1 (2003) (analyzing the adoption of low inflation policies as a collective action problem for Member States).

[94] *See* OMT Ruling at para. 87.

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points to the fact that secondary market purchases are also envisaged by the ESM Treaty.[95] Under the ESM Treaty, however, secondary market operations are only permissible in the case of "exceptional financial market circumstances and risks to financial stability" and "stricter conditionality" exists than envisaged by the OMT Programme. The main problem with this seems to be that it results in purchases under OMT to be possible in a wider scope of circumstances than under the ESM Treaty, thus resulting in the "bypassing" of the latter facility. Moreover, not only are the conditions for OMT laxer than for ESM intervention, but—as the ECJ has held in *Pringle*[96]—the ESM clearly constitutes economic policy.[97] In the view of the Constitutional Court, this shows that the OMT Programme necessarily is an instrument of economic policy, a conclusion it sees confirmed by the fact that the OMT Decision explicitly emphasizes its conditionality, including the ECB's intention to terminate the program in case of non-compliance with the relevant adjustment program.

It follows, in the view of the Constitutional Court, that OMT is "the functional equivalent to an assistance measure of the above-mentioned institutions."[98] Here, the Constitutional Court seems to derive from the fact that both the general conditions and the instruments run, somewhat, in parallel that the two mechanisms are ultimately equivalent in function.

It is correct that a program such as the one described in the OMT Decision could be used to bypass, complement, or substitute the ESM mechanism. If, for instance, the OMT were used to neutralize bond spreads, this would not only result in *de facto* monetary financing of European sovereigns, but would also undermine the ESM. It does not follow, however, that any implementation of OMT is functionally equivalent in this way; neither does it follow that only a program limited in the way the Constitutional Court demands in paragraph 100 of its judgment is. The crucial question in this context concerns both the pricing conditions for ESM loans—and other Financial Support Instruments under the ESM Treaty—and the aims set by the ECB for its OMT Programme.

As discussed above,[99] sovereign borrowers can be subject to multiple equilibria in the sense that more than one interest rate can be justified in market terms for a particular economic scenario the country is in. Apart from a "good" equilibrium with relatively low, sustainable interest rates and default probability, a "bad" and unstable equilibrium may exist with higher rates and resulting higher default probability. The latter equilibrium is

[95] *See* ESM Treaty art. 18(2).

[96] *See Pringle*, *supra* note 1.

[97] *See* OMT Ruling at para. 76.

[98] *Id.*

[99] *See supra* Part C.II.

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unstable because minor deviations in market conditions and investor sentiment can trigger the country to enter the "default equilibrium," for example in a situation where default is certain and investors are unwilling to lend at any price.[100]

Now let us assume that the ECB's policy regarding the OMT is simply to create a "firewall" intended to avoid or revert the bad equilibrium. In order to do so, it would have to credibly alter the expectations of investors as to the possibility of entering the default equilibrium. Crucially, as long as the intervention is restricted to preventing a country from entering a bad equilibrium, this does not amount to a transfer of wealth to the country in whose bonds intervention is being promised. This is due to the fact that in a good equilibrium, investors are already fully compensated for the default risk of the sovereign issuer in question. Given the avoidance of the bad equilibrium, the "put option" promised by the ECB has no value for investors beyond having changed expectations so as to bring the country into that equilibrium.

As discussed, actions by the ECB, as well as statements by Mario Draghi,[101] lend strong support to the notion that this is in fact the intention behind OMT. In that case, we would also expect the ECB to accept positive bond spreads across different countries, reflecting their respective "good equilibria"—as the default probabilities will differ across countries, so will the interest rates in the good equilibrium.

For this to be an adequate description of OMT, it is a necessary but insufficient condition that the ECB does not actually have to make good on its promise, at least not beyond the point where it makes its commitment credible. If the aim is to push the market to an equilibrium, the fact that the ECB actually does have to intervene in the market would strongly suggest that it has failed to meet its target, as in equilibrium the market interest rate is both sustainable and adequate from the investors' perspective.

In this case, OMT would in effect simply address a market failure; this does not mean, as suggested by the Constitutional Court, declaring "irrational" a certain portion of a country's bond yield.[102] In fact, self-fulfilling crises of this sort do not involve irrational behavior by the economic actors individually, as pointed out above. Instead, like in the case of a "sunspot" bank run[103] on a solvent bank, the "irrationality" is the failure of the market to produce a better state of the world that leaves everyone better off. In that

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[100] *See* the literature cited *supra* note 39.

[101] *See supra* note 76 and accompanying text.

[102] *See* OMT Ruling at para. 98.

[103] *See e.g.* Mark M. Spiegel*, Solvency Runs, Sunspot Runs, and International Bailouts*, 65 J. OF INT'L ECON. 203 (2005).

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sense, the market as a whole can be regarded as irrational, or suffering from a lack of coordination, for failing to produce the right outcome.

This also tells us something about the alleged functional equivalence between the OMT Programme and the ESM. Financial Support by the ESM clearly is not intended to only bring about good equilibria. This is evidenced by the financing conditions for ESM support. According to Article 20 of the ESM Treaty, the "ESM shall aim to fully cover its financing and operating costs."[104] This is reflected in the ESM's pricing policy. The interest rate for financial support by the ESM is calculated in accordance with the pricing policy described in the relevant guideline.[105] The interest rate charged to Member States consists of four main elements:

1. The base rate, essentially representing the ESM's refinancing costs which are passed through to the sovereign borrowers;
2. A Commitment Fee, in effect compensating the ESM for the fact that it plays "reverse bank"—also issuing long-term bonds, which it invests in low-yielding short term assets until support is actually needed and drawn by participant Member States.
3. A Service Fee which covers ESM operational costs, as well as other direct costs and fees the ESM incurs.
4. An "appropriate margin"[106] charged to the Member State. Depending on the Financial Support Instrument, this margin lies between five and thirty-five basis points.[107]

In short, financial support by the ESM is available at the interest rate the ESM has to pay to finance itself, plus costs and expenses, plus a margin of five to thirty-five bps. Upon its inaugural issuance of a long-term bond in October 2013, the ESM had to offer a yield of 1.288%.[108] For comparison, Italy issued bonds of the same maturity in October 2013 at a yield of 2.89%,[109] which was seen as a considerable success at the time. Early this year,

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[104] ESM Treaty art. 20.

[105] *See* EUROPEAN STABILITY MECHANISM, ESM PRICING POLICY (2012), *available at* http://esm.europa.eu/pdf/Pricing%20guideline.pdf.

[106] ESM Treaty art. 20.

[107] *See* EUROPEAN STABILITY MECHANISM, *supra* note 105, at 7.

[108] *See* Press Release, European Stability Mechanism, ESM Issues Inaugural Long-Term Bond (Oct. 8, 2013), *available at* http://www.esm.europa.eu/press/releases/esm-issues-inaugural-long-term-bond.htm.

[109] *See* Lukanyo Mnyanda, *Italian Bonds Rise as Five-Year Borrowing Costs Fall at Auction*, BLOOMBERG (Dec. 30, 2013), http://www.bloomberg.com/news/2013-12-30/italian-bonds-advance-after-borrowing-costs-fall-at-debt-auction.html.

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Portugal issued bonds of the same maturity at 4.657%, again viewed as a vote of confidence of the market.[110] In other words, the ESM facilities do, indeed, seek to partly "neutralize" the spreads in borrowing costs between Member States; as argued above, the OMT does not. This also weakens substantially arguments the Constitutional Court wants to derive from *Pringle*.

It follows in our view that viewing the ESM and the OMT Programme as functionally equivalent is misguided. ESM loans and other support available from the ESM are provided to Member States at rates and conditions that very clearly do not reflect the market view of an adequate risk premium, given the perceived default risk of the beneficiary countries. The ESM thus constitutes economic policy, as held in *Pringle*, because it is obvious that it in effect involves a wealth transfer to beneficiary countries. The solvency of the ESM is higher than that of the beneficiary countries, and it—and the "strong" countries behind it—pledge this higher solvency for the benefit of the recipient Member States.

As stated above, much the same could in theory be achieved through OMT, but this would require a similar disconnect between equilibrium market rates and the ECB's "trigger price", i.e. the price at which it is prepared to start its intervention. In our view, there is no evidence that it was intended for OMT to be used in this way. Moreover, strict adherence to the Constitutional Court's description of a Treaty-compatible implementation of OMT may be a sufficient, but it is hardly a necessary condition for avoiding the "bypassing" problem the Court seeks to address.

It thus seems misguided to claim that OMT purchases replicate or substitute ESM support facilities. The parallelism in the conditionalities of the two mechanisms does not alter this conclusion. Even if the conditions for making the two mechanisms available run in parallel, the conditions can be seen as pursuing different aims. In a wealth transfer scenario, the ESM conditionality seeks to ensure that fiscal discipline results in a sustainable budgetary position, where reliance on refinancing at market (equilibrium) rates becomes sustainable in the future. In the case of an OMT Programme seeking only to avert bad equilibria, conditionality seeks to ensure that current financing conditions *remain* in equilibrium.

In conclusion, we submit that it is more convincing to liken OMTs to the monetary policy instruments listed in Article 18.1 of the ESCB Statute, rather than to the ESM or other instruments of economic policy. At the very least, there exists a range of possible implementations of OMT that should not raise these concerns.

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[110] *See* Peter Wise, *Portugal Enjoys Strong Demand in Debt Sale*, FINANCIAL TIMES (Jan. 9, 2014), http://www.ft.com/intl/cms/s/0/9b47af68-791a-11e3-b381-00144feabdc0.html#axzz2v17AUrMP.

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2.3 Support of the Economic Policies in the Union

As we have seen, there are good reasons to conclude that OMTs are covered by the ECB's monetary policy mandate. Even if this was not the case, the ECB would be competent to take actions falling outside of monetary policy to "support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union", provided that the ECB's primary objective of price stability is not compromised.[111] The TFEU does not define what "support of the general economic policies in the Union" means. It may be useful to distinguish between two points. First, the article refers to the economic policies "in the Union," not "of the Union." It therefore encompasses not only the limited areas where the Union has competences in economic policy, but also actions taken by the Member States in the field of economic policy with a view to achieving the objectives of the Union.[112] The objectives that are relevant in this context include, pursuant to Article 3 TEU, the sustainable development of Europe based on balanced economic growth and price stability, a competitive social market economy, economic and social cohesion, and the establishment of a monetary union. It therefore seems to be clear that actions of the ECB aimed at preserving the common currency, addressing severe distortions in the financial markets, and mitigating to some extent the economic and social consequences of deflationary pressures in some Member States are related to the objectives laid down in Article 3 TEU.

The second, and more problematic, question is whether OMTs can be qualified as "supporting" the relevant economic policies of the Member States. The Constitutional Court answers this question in the negative for two reasons. The OMTs were potentially of such magnitude that the volume of the assistance measures agreed under the European Stability Mechanism "could *de facto* be considerably broadened, and potentially even multiplied, through parallel purchases of government bonds by the Eurosystem."[113] In addition, due to its position, the ECB must act independently in deciding on the start and duration of outright monetary transactions. This is, in fact, how the ECB explains it will implement the OMT Decision.[114] However, if the ECB's action requires an independent economic assessment and does not merely "retrace" the decisions of the institutions responsible for deciding on assistance measures under the ESM or comparable programs, it goes, in the opinion of the Constitutional Court, beyond what could still be qualified as

[111] TFEU art. 127(1); ESCB Statute, *supra* note 50, art. 2.

[112] *See* Ulrich Häde, *in* EUV/AEUV Article 127 TFEU, para. 5 (Christian Calliess and Matthias Ruffert eds., 4th ed. 2011).

[113] OMT Ruling at para. 81.

[114] The decision states that 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." *Id.*

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"support" of economic policy.[115] Thus, the Court's argument rests on two legs, a quantitative and a qualitative one. It will be argued that both are unconvincing.

As far as the qualitative leg is concerned, a requirement that the support of economic policy requires the exclusion of any independent economic assessment cannot be derived from the Treaty or the ordinary meaning of the word "support." The narrow interpretation of the Constitutional Court would also render Article 127(1) TFEU all but contradictory. The Constitutional Court juxtaposes the independence of the ECB as enshrined in Article 130 TFEU with the supposed incompatibility of an independent economic assessment and the meaning of "support."[116] Obviously the Treaty cannot on the one hand have required an independent ECB to support the general economic policies in the Union and on the other hand intended the word "support" to be interpreted as excluding any activity that involves an independent economic assessment.

As far as the quantitative leg is concerned, two points can be made. First, as explained above, the rationale of the OMT Decision is that it allows for *ex ante* unlimited purchases of government bonds. The actual purchases will, however, always be limited and will often be equal to zero. The ECB only intends to purchase, and is possibly only competent to purchase within its mandate, the amount necessary to change the expectations leading to a bad equilibrium and restore a good equilibrium.[117] The Constitutional Court's argument seems to be based on a different understanding of the operation of the OMT Decision. Second, by pointing out that OMTs could potentially multiply the volume of assistance provided under the ESM, the Constitutional Court implicitly assumes that the right point of reference to measure whether support has been given are the decisions of the Member States that have led to the establishment of the ESM. However, it is not clear why the ESM should be the economic policy measure that is used as a comparator. It is more convincing to hold that the OMT Decision supports the functioning of the economic and monetary union as such, which would, arguably, have faced severe detrimental economic consequences if the common currency had disintegrated. Through this lens, it is difficult to argue that OMTs were actually or potentially of such a volume that they went beyond a mere supporting measure.

Consequently, it is by no means evident that the OMT Decision exceeds what can be qualified as support of the general economic policies in the Union. If this is correct, it is doubtful that the challenged act constitutes a transgression of the ECB's mandate that

[115] *See* OMT Ruling at para. 82.

[116] *Id.*

[117] *See supra* text to notes 73–76 and 97–102.

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satisfies the heightened standard of review applicable here (*manifest* transgression of the Union's powers).[118]

II. Prohibition on Monetary Financing

The Constitutional Court further argues that the OMT Decision is also "likely to violate"[119] Article 123(1) of the TFEU.[120] The provision prohibits overdraft facilities or other credit facilities provided by the ECB to national governments, EU institutions, and other public bodies.[121] The prohibition also includes any primary market purchase[122] of sovereign bonds by the ECB as well as by national central banks. Secondary market purchases[123] of government debt instruments by the ECB, on the other hand, are not illegal per se.[124] As argued by the Constitutional Court, Article 123 TFEU is to be interpreted widely and in particular also applies to any circumvention of this prohibition.[125] In its submission, the ECB agrees with this broad view.[126]

It is undoubtedly correct that secondary market purchases by the ECB can in theory be used to effectively render Article 123 TFEU meaningless. Were the ECB to—credibly and unconditionally—commit to offer buying any or all newly issued government bonds of a particular sovereign issuer the day after they are issued to private investors, and were it to also announce the price (yield) at which such purchases will happen, investors would have to view the purchase of such bonds as equivalent to an overnight deposit with the ECB.

[118] On this standard of review see OMT Ruling at paras. 24, 37–38 and Part A above.

[119] *Id.* at para 84 (translating from "dürfte . . . ebenfalls verstoßen").

[120] *See* OMT Ruling at paras. 84–94.

[121] *See also* ESCB Statute, *supra* note 50, art. 21(1).

[122] i.e. purchases directly from the issuer, and thus transactions where the price paid for the purchase of the debt instrument directly flows to the issuer (i.e. the sovereign debtor). This prohibition is explicitly made in Article 123 TFEU, although primary market purchases are clearly caught by the general prohibition of any "credit facility."

[123] i.e. purchases of such securities from bond holders after the issuance by the sovereign. Obviously, in such secondary market transactions, any purchase price paid by the ECB—or any other purchaser—flows to the seller of the bond, with no immediate impact on the credit position of the initial issuer.

[124] The notion that secondary market purchases are in principle permissible has not been seriously questioned. *See also* ESCB Statute, *supra* note 50, art. 18 (providing explicitly for these transactions).

[125] *See also* Council Regulation 3603/93, pmbl., 1993 O.J. (L 332) (EC) ("In particular, purchases made on the secondary market must not be used to circumvent the objective of that Article.").

[126] *See* ECB submission, http://www.handelsblatt.com/downloads/8135244/3/EZB%20Gutachten, 16–17.

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This of course depends on the sovereign in question actually issuing bonds at the announced ECB purchase price (or below).[127] If, say, the ECB were to credibly commit to buying any German ten-year sovereign bond at an implied yield of 10% p.a. the day after such bonds are issued, investors would have little reason to pay any attention to this announcement. Because Germany will issue bonds at a higher price (lower yield), the ability to sell the asset at a loss immediately after having purchased it is in effect worthless. If, however, the announced ECB purchase price exceeds what the market thinks is justified in light of the country's default risk, the ECB's promise would constitute an economically valuable option to sell to a solvent counterparty. In this case, the yield at which the government in question can issue bonds would necessarily have to equal the yield implied in the ECB's purchase promise.

In economic terms, the situation would be indistinguishable from a direct monetary financing of the national government in question by the ECB. While investors are the formal owners of the bonds they purchase, all associated risks would effectively be borne by the Euro system, and bond yields would have to be regarded as centrally and unilaterally determined by the ECB. It can convincingly be argued that ECB intervention in the markets of that kind would constitute the very sort of monetary financing that Article 123 TFEU outlaws, and that a sensible interpretation of the provision has to take this into account by extending the prohibition to certain secondary market purchases.

Having established that Article 123 TFEU also applies to certain types of open market operations by the central bank, the Constitutional Court argues that the OMT Decision (likely) violates this wide understanding of the monetary financing prohibition. The Constitutional Court first states that its doubts in relation to: (1) the neutralization of interest rate spreads, (2) the selectivity of purchases, and (3) the risk of OMT running in parallel—and perhaps undermining—the EFSF and ESM[128] call into question the legality of OMT in light of Article 123 TFEU. It then adds four additional aspects of the program which "at least when taken together"[129] also suggest that the OMT Decision violates Article 123 TFEU. These additional aspects are (4) the lack of a preferred creditor status of the ECB in relation to the bonds purchased and the increased risk of a sovereign default of the Eurozone countries in question;[130] (5) the general possibility for the ECB to hold the purchased government bonds to maturity; (6) the interference with market price formation; and (7) the "encouragement" of private bond purchases as a consequence of the OMT Programme.[131]

[127] Minus the negligible discount for overnight deposits.

[128] *See supra* Part D.I.

[129] OMT Ruling at para. 87.

[130] *Id.* The Constitutional Court treats this aspect as two distinct points, but clearly they are inseparable.

[131] The latter two points are also best treated together. *See infra* Part D.II.4.

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We have addressed points (2) and (3) above.[132] The arguments advanced there apply equally to a possible violation of Article 123 TFEU. The remaining points will be dealt with in turn below. In short, we will argue that the Constitutional Court is correct in so far as it identifies a number of possible breaches of Article 123 TFEU, which could result from particular forms of the OMT Decision's implementation. At the same time, however, the Constitutional Court ignores—or at least addresses incompletely[133]—the circumstances in which OMTs do not violate Article 123. Based on an extended range of possible OMT-implementations compatible with the Treaty, we conclude that there exists no indication that the ECB does in fact intend to implement OMT contrary to the Treaty.

1. Neutralization of Interest Rate Spreads

The Constitutional Court points out[134] that the existence of interest rate spreads "is entirely intended" by the Treaty and exists by design. By attempting to "neutralize" these spreads, the ECB not only oversteps its mandate,[135] but in the view of the Constitutional Court also violates the prohibition on monetary financing.

The Constitutional Court's argument is of course a valid one. To the extent that the market perceives different Eurozone countries to represent different default risks—which is undoubtedly true—the persistence of interest rate spreads is a natural consequence of the fundamental differences in countries' solvency, including within a monetary union of the Eurozone-type. The existence of such yields ultimately is an expression of Article 123 TFEU being regarded as effective and binding by the market.[136] In the absence of monetary financing by the central bank, investors holding sovereign bonds will assume that they bear the economic risk of a sovereign default and will "charge interest" accordingly.

Thus, a neutralization of bond spreads in the form of a single Eurozone sovereign bond yield—e.g., Greek and German bonds trading at the same price—brought about by the ECB is a sufficient condition for finding a violation of Article 123 TFEU. It is unclear, however, why the Constitutional Court would assume that this type of "neutralization" is the intention behind OMT. As is plainly clear from Figure I above, significant interest rate spreads still exist across different Eurozone countries. The ECB has not put into action the OMT Programme, presumably because its mere announcement has already produced the

[132] *See supra* Part D.I.2.2

[133] *See*, *e.g.*, OMT Ruling at para. 100.

[134] *See* OMT Ruling at para 71.

[135] *See supra* notes 65–79 and accompanying text.

[136] Or, at least, as long as no other mutualization of debts are expected by the market.

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desired effects.[137] Unless one assumes that the ECB holds back action for reasons other than that implementing OMT is unnecessary under current market conditions, any assertion about a violation of Article 123 by the ECB based on the "neutralization argument" seems very weak indeed.

In fact, the acceptance by the ECB of significant risk premia for holding, say, Portuguese bonds, compared to German, Spanish and Italian bonds, very strongly suggests that it does not want to eliminate market incentives for national budgetary responsibility. Thus, the Constitutional Court's argument is perfectly valid, but does not necessarily apply in relation to the ECB's OMT Decision.

This is, admittedly, not a knockout argument. It would clearly be possible for the ECB to provide differential, but economically unjustified "put options" to holders of different countries' bonds, i.e. maintain bond spreads while still depressing yields to artificially low levels.

As a matter of fact, however, there is no indication of the ECB intending to do just that. Both market interest rates and the actions by the ECB are compatible with an interpretation of the OMT Programme as a way to "push" the market into a good and stable equilibrium.[138] There is also empirical support for the existence of potential bad equilibria in the European sovereign debt markets.[139] Furthermore, the ECB's president has explicitly stated that this is the aim of the ECB.[140]

2. Pari Passu

Another point which, in the view of the Constitutional Court, suggests that purchases on the basis of the OMT Decision constitute illegal monetary financing is the failure of the ECB to maintain a "preferred creditor status," i.e., the decision to accept that the ECB will rank *pari passu* with other creditors in relation to bonds actually purchased.[141] This includes, in case of a sovereign default, the participation in a haircut on debt owed by the defaulting country, which in the Constitutional Court's opinion "is not likely to be compatible with Article 123 TFEU." At least where the bonds acquired "contai[n], from the outset, the prospect of subsequently becoming part of a potential debt cut," the waiving of the repayment obligation and an outright advancement of funds without any repayment

[137] *See* the references *supra* note 4.

[138] *See supra* Part D.I.2.2.

[139] *See e.g.*, Gärtner & Griesbach, *supra* note 39; De Grauwe & Ji, *supra* note 28.

[140] *See supra* note 76.

[141] *See* OMT Ruling at para 88.

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obligation are essentially indistinguishable, and equally incompatible with Article 123 TFEU. If our view of the OMT Programme as a firewall against bad equilibria is correct, these arguments are ultimately not convincing.

Undoubtedly, the acquisition of bonds at a price that is unjustifiably high given the *ex ante* risk of default can constitute monetary financing.[142] This holds true irrespective of an actual or foreseeable default. As long as the ECB does not intend to purchase sovereign bonds at a price exceeding the equilibrium market price, however, this scenario does not seem relevant. Indeed, any purchase of securities contains from the outset the possibility of a loss; the question is whether the likelihood of a default is sufficiently small, given the price paid. Unless one calls into question any secondary market purchase of government securities by the ECB—as *pari passu* creditor—it has to be accepted that the ECB can in principle assume risk. The ECB would very likely exceed its mandate, were it to acquire government bonds it knows to turn into a loss. The reason for this is not, however, that it cannot or should not assume risk, but that bonds that are certain to default cannot be sold to an investor at any price.

Moreover, it is unclear to us how demanding a "preferred creditor status" would safeguard the interests of other Member States. By demanding a preferred creditor status the OMT Programme would, in our view, be more likely to leave the realm of monetary policy. This is because the likely impact on market prices and the risk of a decoupling between economic fundamentals and market prices would in fact be increased. By purchasing bonds as a preferred creditor, the ECB would in effect increase the equilibrium yield for the bonds it purchases because any possible future haircut for private investors would have to be higher to achieve the same outcome. For that reason, demanding a preferred creditor status would likely create, rather than prevent, market failures. By the same token, it would also vastly increase the risk of actual intervention becoming necessary. Similarly, requiring the ECB not to participate in a haircut would call into question the very monetary policy reasons the Constitutional Court finds lacking, as purchases—actual purchases as they then would likely be—by a preferred creditor ECB are unlikely to affect the monetary transmission mechanism, which the ECB argues was the main driver behind the OMT Decision.

Demanding, as the Constitutional Court does in paragraph 100 of its ruling, an interpretation of the OMT Decision that requires the ECB to obtain a preferred creditor status does not therefore solve the problem of compatibility with Article 123 TFEU. It would, however, likely create the risk of actual bond purchases being rendered necessary and would in effect defeat the purpose of OMT.

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[142] *See supra* Part D.II.1.

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3. Holding Government Bonds to Maturity under OMT

The Constitutional Court further holds that the possibility of the ECB holding bonds until maturity casts additional doubts on the OMT Decision's compatibility with the TFEU. The Constitutional Court claims that holding bonds to maturity prevents a market-based price determination for these bonds, "if a substantial amount of the government bonds issued by selected Member States is permanently removed from the market." This would "contribute to the financing of the respective budgets."[143]

It is unclear which mechanism the Constitutional Court has in mind here. It is of course theoretically possible, if unlikely in practice, that the ECB acquires virtually all outstanding bonds of a Member State, and that the reduced liquidity would lead to less efficient price formation in the market. However, since the OMT Decision makes clear that only short-term debt will be subject to the OMT Programme, other bonds would still provide the necessary price feedback the Constitutional Court seems to demand. Furthermore, even if the argument were valid, requiring the ECB to sell bonds before maturity would not change anything: Bonds sold shortly before maturity to investors who are assured of the ECB's continued buying of bonds—as the Constitutional Court must assume—would hardly result in what the Constitutional Court could call a disciplining market price. Even more problematic, the Constitutional Court suggests that government bonds are subject to laws of supply and demand in a way where a "shortage of the supply of bonds circulating on the secondary market"[144] has the effect of monetary financing of state budgets. This suggests that the Constitutional Court assumes that the mere fact that there is a shortage of bonds in circulation would increase their price—presumable due to their rarity; here the Constitutional Court seems to invoke a wilder version of market irrationality than the one it assumed away a few paragraphs later.[145] Sovereign bonds represent claims to cash flows; investors are not collectors of bonds—they will not price them according to their rarity, but according to the risks and returns they pose in relation to other investments. The rationales behind demanding a resale of the bonds before maturity for reasons of compliance with Article 123 are thus obscure at best. However, unlike the demand for a preferred creditor status, this requirement—if simply requiring the ECB to sell bonds shortly before they mature—is unlikely to create practical problems for the OMT Programme.

[143] OMT Ruling at para. 90.

[144] *Id*.

[145] *Id.* at para. 98.

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4. Interference with Market Price Formation and "Encouragement" of Private Bond Purchases

The Constitutional Court also holds that OMT's incompatibility with Article 123 TFEU is further indicated by the fact that government bonds could be purchased shortly after emission. Similarly, an announcement of "imminent purchases" prior to a new emission of bonds would encourage investors to purchase bonds in the primary market solely because they expect to be able to subsequently sell these bonds to the ECB under OMT.[146] As discussed above,[147] to the extent that purchases happen or are—explicitly or implicitly—promised to be made at artificially high prices, the argument is of course correct. However, to the extent that the market expects the ECB to buy bonds at such artificially high prices, the timing of such purchases is of little consequence. Only highly inefficient—and irrational—markets could be assumed to price government bonds according to fundamentals upon issue, despite expecting later secondary market purchases by the ECB at a price higher than fundamentally justified. Accordingly, these two objections are from our perspective similar to the preferred creditor status: They are ultimately unconvincing, but implementing or altering the OMT Decision to take them into account would not fundamentally alter the effectiveness of the OMT Programme.

E. Conclusion

The above analysis suggests that the program announced by the OMT Decision, interpreted in light of its likely economic rationale and mode of operation as envisaged by the ECB, falls within the monetary policy framework drawn by the Treaty. This is true for a range of possible implementations by the ECB, including the most likely course of action given OMT's economic rationale. Importantly, it is in our view unnecessary to deviate in any fundamental way from the Constitutional Court's interpretation of the Treaty (or of German constitutional law) in order to reach this conclusion; rather, it suffices to re-characterize the economic rationale behind the OMT Programme to identify additional scenarios in which the ECB is neither limited in the way envisaged by paragraph 100 of the Constitutional Court's ruling, nor breaches the relevant Treaty provisions. Based on the economic rationale discussed above and the expressed intentions of the ECB, these also happen to be the most likely scenarios for ECB action.

The Constitutional Court is certainly right when emphasizing that the independence of the ECB cannot mean independence in defining—or setting—its own mandate.[148] What it does mean, however, is independence in exercising economic judgment within its mandate. If,

[146] *See id.* at paras. 92–94.

[147] *See supra* Part D.II.1.

[148] *See* OMT Ruling at para. 60; Case C-11/00 *Commission v. ECB* [2003] ECR I-7147.

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as we argue, an OMT Programme intended to provide a firewall against bad equilibria, and thus to rectify or prevent market failures, falls within the ECB's mandate, and if this is the course of action the ECB is most likely to take, an argument can be made that only manifest proof for a misjudgment of the situation on the part of the ECB, or for the prevalence of other, extra-mandate motivations should trigger court review before the ECB acts. Absent this, the OMT Decision should at the very least be regarded as also covering possible implementations that are in line with the ECB's mandate and are properly described as monetary policy or, alternatively, as permissible support of the economic policies in the Union. In addition, if exercised as discussed above, the OMT Programme also does not constitute monetary financing of the Member States' budgets.

One may disagree with this point, and demand a clearer limitation of any such wide-ranging policy announcement *ex ante* in order to avoid "irreparable harm". While we do not think this to be a practicable solution,[149] we certainly do not think that courts will often be in a position to identify the only legal way in which existing discretion can in theory be used. What the Constitutional Court has done in its ruling, however, is exactly that.

Where does this leave us? Coming back to our considerations from Part B above, if we assume that the ECJ rules that OMT falls within the mandate of the ECB and does not violate Article 123 TFEU, the Constitutional Court has essentially two possible courses of action. We would not expect the interpretation of the Court of Justice to be in line with the one considered to be unobjectionable by the Constitutional Court in its OMT Decision.[150] Neither would that be desirable, since, as argued, it would render the OMT Decision meaningless.

The Constitutional Court will take the interpretation given by the Court of Justice as a basis for its further examination of the constitutionality of the challenged act.[151] It can then either decide that the relevant provisions of EU law, as interpreted by the Court of Justice, go beyond the powers conferred on the Union and that all acts based on the provisions are, consequently, *ultra vires*, or it can accept the interpretation given by Court of Justice but hold that the provision of EU law is in conflict with the constitutional identity of Germany. In the latter case, however, the Constitutional Court's reasoning could face the objection that the challenged acts fall within the mandate of the ECB as determined in the Treaty of Maastricht, and that this Treaty was held to be in conformity with the German

[149] In a way this would be akin to a "presumption of illegality": *whenever* an EU law instrument gives discretion to an institution or an official, this discretion could in theory be used in an illegal way. It would hardly be practicable to have the Court—whether national or European—limit the discretion before it is exercised in order to ensure legality. Were that possible, competent legislators would rarely decide that vesting discretion is necessary in the first place.

[150] *See* OMT Ruling at para. 100.

[151] *Id.* at para. 27.

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constitution in the Constitutional Court's Maastricht decision.[152] Such an objection would be based on the premise that it is impossible to interpret the Treaty as intending to establish a monetary union in which the central bank cannot rectify market failures, and avert bank run-like, self-fulfilling crises, without violating the boundaries of its mandate. In its Maastricht decision, the Constitutional Court has held that the Treaty laid down "the future course of implementation, that is to say, the possible uses to be made of the sovereign powers granted, in a manner which is sufficiently predictable."[153] It can be argued that the necessity to have a central bank with a mandate broad enough to cover an OMT Programme providing an effective backstop in a monetary union was already clear at the time of adoption of the Maastricht Treaty, and that the ECB's corresponding behavior during the financial crisis was, accordingly, covered by the Constitutional Court's formula of "sufficient predictability."

The easiest way out of what we have called the German Catch-22 may be a re-calibrated understanding of what the OMT Decision is intended to achieve along the lines suggested in this article. This would avoid both a contested interpretation of the Treaty and a situation that pits principles underlying Germany's constitutional identity against Union law.

[152] Bundesverfassungsgericht [BVerfG – Federal Constitutional Court], Case No. 2 BvR 2134/92, 2159/92, 89 ENTSCHEIDUNGEN DES BUNDESVERFASSUNGSGERICHTS [BVERFGE] 155 (Oct. 12 1993), http://dejure.org/dienste/vernetzung/rechtsprechung?Gericht=BVerfG&Datum=12.10.1993&Aktenzeichen=2%20BvR%202134/92.

[153] *Id.* at para. 92.

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