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Expert Statement for the Oral Hearing before the Federal Constitutional Court (BVerfG) Regarding 2 BvR 1390/12, 2 BvR 1421/12, 2 BvR 1438/12, 2 BvR 1439/12, 2 BvR 1440/12, 2 BvR 1824/12, and 2 BvR 6/12, on 11 and 12 June 2013

This expert statement focuses on the following questions:
1. From an economic perspective, should the ECB's bond purchase programme be ascribed to the domain of monetary policy or rather to that of fiscal policy as a form of government financing?
2. What are the consequences for the independence of monetary policy, for the budgetary sovereignty of the German Bundestag, and for the functional integrity of the ESM?

1. Government bond purchases and the difference between monetary policy and government financing

In principle, the purchase of government bonds by the ECB on the secondary market is possible, provided this purchase represents a form of monetary policy and the ban on the financing of member state governments is not circumvented. Bond purchases by the ECB have the effect of easing the ability of governments to finance their budgets, particularly because such purchases influence the interest rates on new bond issues. Accordingly, it is difficult to draw a clear distinction between monetary and fiscal policy when it comes to the purchase of government bonds.

In order to assess whether such purchases should be interpreted as monetary or fiscal policy, one can place a focus on the *economic effects* of the purchases that have been announced or carried out. Alternatively, one can ask if the *arguments* for why the purchases represent a form of monetary policy are valid.

1.1. Economic effects
Let us first consider economic effects. It is clearly apparent and generally accepted that the ECB's bond purchase programme has the effect of maintaining the ability of highly indebted member states to access capital markets while also reducing their financing costs. Furthermore, it is accepted that the programme eases the ability of countries that have received bailout loans to return to the capital market. These are clearly fiscal policy effects.

However, one could argue that these effects represent *secondary impacts* and that the bond purchase programme at its core is actually a form of monetary policy. This argument rests on the observation that monetary policy measures – such as a reduction in the prime lending rate – do not bolster the real economy when a country's government and banks are on the doorstep of insolvency. Yet this means solely that for monetary policy to function, solid public-sector finances and a stable financial sector are required. It does not mean monetary policy should be responsible for stabilizing public-sector finances, thereby creating the preconditions necessary for monetary policy to function. The direct extension of credit by the ECB to member state governments would also have the effect of eliminating disturbances to the transmission of monetary policy, yet such support is difficult to categorize as a monetary policy measure.

1.2. Arguments
Let us now turn to the arguments: there are four main arguments used to justify the purchase of government bonds under the SMP (Securities Markets Programme) and OMT (Outright Monetary Transactions) programmes.

The first argument is that uncertainties on capital markets concerning the solvency of individual member states and their banking systems are hindering the effectiveness of monetary policy in the countries beset by crisis. Yet as explained in the previous section, it would be erroneous to conclude that because bond purchases restore the transmission mechanisms of monetary policy, they must be considered a form of monetary policy.

The second argument asserts that the risk premiums on bond rates witnessed over the course of the sovereign debt crisis represent a form of market failure, as increased bond rates reflect an unfounded fear that individual member states might depart from the eurozone. The eurozone is irreversible, it is argued, making such fears baseless.[1] In my view, this argument is ambiguous and untenable. It is certainly plausible that the risk of member state departure from the eurozone is playing a role in price formation on financial markets. However, there is no convincing evidence that the main reason for the observed risk premiums is the fear that the eurozone might break up. The observed risk premiums can be explained instead by investors fearing a haircut on their bond holdings, without member states necessarily departing from the eurozone.

In any event, it is by no means unfounded or irrational for investors to take into consideration the possibility that individual countries might exit the currency union. The members of the eurozone are sovereign nations and a departure from the EU, which would also mean a departure from the eurozone, is an explicit contingency in EU treaties. Yet even if departure from the EU was not explicitly addressed in treaties, it cannot be discounted as a possibility.

[1] Cf. ECB Monthly Bulletin, October 2012, p. 8-9.

Furthermore, one must ask whether it is the responsibility of monetary-policy makers to intervene when capital market investors make false predictions – whether founded or unfounded – about the future.

The third argument asserts that the collapse of the eurozone or the departure of individual member states is irreconcilable with the maintenance of price stability.[2] Accordingly, measures to prevent breakup represent a form of monetary policy. This argument is not convincing either, for four reasons: (1) The ECB is unable to prevent the departure of member states under any and all circumstances, as the eurozone is a union of sovereign states; (2) It is not the case that the insolvency of banks or member states in the eurozone will automatically lead to member-state departure, as demonstrated by Cyprus and Greece; (3) It is not necessarily the case that the departure of a member state will threaten price stability in the rest of the eurozone. The departure of a member state would cause many economic problems, but price stability in the remaining member states is unlikely to be the cardinal problem. Instead, the main problem would likely be turbulence on financial markets; (4) Even if one assumes that the departure of a member state would threaten price stability in the eurozone, if the ECB were to announce that it intends to do everything in its power to keep the monetary union together, this would also pose massive risks to price stability. Such an announcement would make the ECB susceptible to blackmail.

The fourth argument that is waged to justify the ECB's bond purchase programme draws attention to the fact that capital market failure can take the following form: If market participants predominantly have pessimistic forecasts, then they demand high risk premiums for the purchase of bonds. The elevated financing costs that result from this risk premium can lead a country to become over-indebted – with the outcome of proving the pessimistic forecasts correct. When optimistic forecasts rule the day, then financing costs are low, and the country in question remains solvent. On a basic level, this argument speaks in favour of providing assistive loans to countries that are experiencing financial difficulties but which are not clearly over-indebted. But regardless of how one assesses this argument, the situation in question is a fiscal policy problem, meaning that an institution with a fiscal-policy mandate should intervene (such as the ESM), but not monetary-policy makers. As stated, the most important economic effects of the ECB bond purchase programme are that it preserves the ability of some highly indebted countries and their banks to access private providers of capital.

The ECB does not hide the fact that this policy can lead to conflicts with a monetary policy stance that is oriented to price stability. In order to address this problem, the ECB has decided to bind the OMT programme to the administration of an ESM/EFSF programme. There can be no doubt that this policy has monetary policy effects, *among others*. However, the arguments that are waged to assert that the ECB programme *primarily* pursues monetary policy goals are not very convincing.

[2] To my knowledge this argument is not used by the ECB to justify the OMT programme.

2. The consequences of binding the OMT programme to ESM/EFSF programmes

2.1. The independence of the central bank

In my view, the independence of the ECB is not threatened by the fact that the ECB has made the existence of an ESM/EFSF programme and the fulfilment of its economic policy requirements a necessary condition for the purchase of government bonds. This is because the ECB can change the conditions of the OMT programme at any time.

As long as the OMT programme is in force, one can speak of a voluntary commitment on the part of the ECB. This commitment should be understood as a signal that the ECB is willing to purchase bonds in order to prevent bond rates from rising, but that this bond purchase programme will reach its limits when it comes into conflict with the goal of maintaining price stability. Such a conflict would arise if individual members states were to make use of the cheap financing conditions afforded by the OMT programme to excessively expand public-sector debt.

The independence of the ECB's monetary policy would certainly be undermined if the ECB were to amass large holdings of a given country's bonds, making it a significant direct creditor of that member state. This would engender a conflict between the interests of the ECB as a creditor and the price stability goals of the ECB's monetary policy. If the ECB were to guarantee the irreversibility of the monetary union, promising by any and all means to prevent over-indebted countries from leaving the eurozone because of insolvency, then this would clearly be incompatible with monetary policy independence. Such a step would make the ECB susceptible to blackmail, and clearly undermine its independence. While the ECB has not made such an announcement to date, the very absence of such an announcement underscores the fact that the proposition that the currency union is irreversible cannot serve as a basis for ECB monetary policy.

2.2. Effects on the budgetary sovereignty of the German Bundestag

The effects of the OMT programme on the budgetary sovereignty of the German Bundestag are also worthy of discussion. If a request for assistance from the ESM is made in the future, then the Bundestag will have to rule on such a request. In this regard, the clear definition of the liabilities to be assumed or guaranteed is of key importance, so that the risks to German taxpayers are known by Bundestag MPs. The existence of the OMT programme undermines the ability of German MPs to be informed about the scope of liabilities assumed and the associated risks. With the Bundestag's approval of an aid programme, a necessary condition is fulfilled for the ECB to purchase bonds from a member state in an amount not determined at the time of the Bundestag’s decision. Because these purchases mean that additional risks are assumed on behalf of the German taxpayer, one cannot say that the Bundestag reaches a decision in full awareness of the extent to which liabilities are to be assumed. The only counterpoint that can be raised in this regard is that the ECB's bond purchases are not an automatic consequence of the Bundestag's decision. However, the Bundestag’s decision is a *sine qua non* for ECB bond purchases.

2.3. Impacts on the functional integrity of the ESM

The OMT programme has clear potential impacts on the functionality of the ESM, as well as on the implementation of macroeconomic adjustment programmes that are agreed to within the scope of ESM loan extension. As bond purchases under the OMT programme are suspended while a review is conducted to see whether the country in question has fulfilled the requirements associated with the adjustment programme, one must assume that the review will not be conducted in a completely independent manner, without concern for the future of the OMT programme. As the finding that a country had failed to meet the requirements of the adjustment programme would mean that the ECB is no longer able to make bond purchases, we can assume that there would be incentives not to arrive at this finding.

3. Conclusion

The most important economic effect of the ECB's bond purchase programme is to sink financing costs for highly indebted member states while also ensuring them continued access to funding from private investors. This stabilization of a country's public-sector finances in connection with the stabilization of its banking system has impacts on the transmission of monetary policy. Clearly, the mechanisms by which monetary policy is transmitted would otherwise be disturbed in an environment characterized by the looming insolvency of a country's government or its large banks. In any event, ensuring the function of monetary policy is not sufficient for categorizing intervention as monetary rather than fiscal in nature, as the direct extension of loans by the ECB to member states would also serve to eliminate disturbances to the transmission of monetary policy. Yet other justifications are also not appropriate for establishing that the ECB is acting under its rightful mandate. This is particularly true of the argument that ECB programmes have the goal of ensuring the irreversibility of the currency union.

We must take into account that the ECB is operating from a difficult position, as there is a great deal of pressure on the ECB to stabilize the public finances of members states as well as Europe's financial sector, not least because political progress in battling the crisis is proceeding at a slow pace. With the introduction of conditionality to the OMT programme, the ECB has underscored the potential conflicts between the purchase of government bonds and the preservation of price stability. At the same time, there can be no doubt that the ECB is operating in a grey area between monetary and fiscal policy, undertaking actions to preserve the stability of the financial sector. There is a clear danger that monetary policy will become increasingly dominated by the concerns of fiscal policy and the desire to stabilize the financial sector, thus engendering conflict with the goal of maintaining price stability.