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PARTNERSHIP SINCE 1590

Holger Schmieding, Chief Economist | Holger.schmieding@berenberg.com | +44 20 3207 7889

GERMAN COURT VERDICT ON ECB: A SERIOUS RISK AHEAD?

Berenberg Macro Flash

Will Germany's supreme court constrain the European Central Bank's response to the worst ever peacetime recession in Europe? At a time when a "whatever it takes" stance is needed more than ever before, Germany's Constitutional Court will publish its verdict on ECB sovereign bond purchases on 5 May at 9:00h London time. We do not expect the court to rule that the ECB's "Public Sector Purchase Programme (PSPP)" violates the German constitution. Such a step could otherwise trigger serious turmoil in markets as well as an unprecedented clash between German and EU law. However, we need to watch the risk that the court could spell out conditions for the ECB's sovereign bond purchases that could make it more difficult for the bank to use this part of its monetary toolkit flexibly and efficiently.

THE GERMAN BACKDROP

Some German eurosceptics have repeatedly asked the German supreme court in Karlsruhe to outlaw some unconventional ECB policy responses. Having first solicited an opinion on the ECB's still unused OMT programme from the European Court of Justice (ECJ), the German court accepted it on 21 June 2016. With its "Outright Monetary Transactions" (OMT) programme, which codified Mario Draghi's famous "whatever it takes" commitment, the ECB had singlehandedly ended the euro crisis in the summer of 2012.

A similar group of Germans filed a separate suit after the ECB announced its regular programme to buy public bonds as of March 2016. While the German Court had accepted the OMT programme with some strings attached, the judges did not come across as friends of unconventional monetary policies. Upon once again asking the ECJ for its opinion, the German court suggested on 15 August 2017 that it sees weighty arguments against the ECB's stance. The judges voiced doubts that the programme to buy sovereign bonds is compatible with the prohibition of monetary financing.

In its subsequent hearings on 30-31 July 2019, the German court again expressed sympathy for the claims that the ECB

- has overstepped its mandate and infringed the prohibition of monetary financing, and
- needs to adequately take negative side effects into account, notably on savers.

THE EUROPEAN VIEW

Responding to the German request for an opinion on the ECB's PSPP programme, the ECJ ruled on 11 December 2018 that it "*does not exceed the ECB's mandate and does not contravene the prohibition of monetary financing*". Explaining its pro-ECB verdict, the ECJ argued that the purpose of the PSPP is to return inflation to a rate "below, but close to, 2% over the medium term", in line with the ECB's mandate. The ECJ emphasised that a monetary policy measure, to be effective, must "*have certain effects on the real economy, which might also be sought, to different ends, in the context of economic policy*". The ECJ found that the ECB's rationale for the PSPP is not "*vitiated by a manifest error of assessment*".



The ECJ also rejected the “moral hazard” argument, that is the claim that ECB asset purchases could stifle the will of countries to pursue prudent fiscal policies. Instead, the ECJ explained that *“the effects of the PSPP programme on the impetus to conduct a sound budgetary policy are limited by (i) the restriction of the total monthly volume of public sector asset purchases, (ii) the subsidiary nature of the PSPP programme, (iii) the distribution of purchases between the national central banks in accordance with the key for subscription of the ECB’s capital, (iv) purchase limits per issue and issuer (which means that only a minority of the bonds issued by a Member State can be purchased by the ESCB under the PSPP) and (v) stringent eligibility criteria (based on a credit quality assessment)”*.

WHAT COULD THE GERMAN COURT DO?

The hurdles for the German Court to rule directly against the ECB and hence the ECJ are high:

- The German Court would have to find that the ECJ’s ruling is arbitrary and gravely unreasonable. Simply disagreeing with it would not suffice to overrule the ECJ.
- It would raise potentially toxic legal issues about the supremacy of German versus EU law.

More likely, the German Court could interpret the ECJ ruling in a restrictive manner without contradicting it head-on. In a way, the ECJ’s reasoning why the PSPP is compatible with the ECB’s mandate points in that direction. The German court could stress the **capital key** as well as the **issuer** and **issue limits** which the ECJ has mentioned itself. The German court might interpret the ECJ notion that only a “**minority of the bonds** issued by a member state can be purchased by the ESCB under the PSPP” in a restrictive way, perhaps by saying that this should mean a substantially lower limit than 49%.

Any such restrictions could be seen as curtailing the ECB’s flexible use of its current “Pandemic Emergency Purchase Programme”. Such restrictions could thus have an impact on market perceptions as to how effective the ECB can respond to the current economic emergency. However, the new PEPP response to the pandemic is not identical with the older PSPP. As a result, we cannot rule out the possibility that the German court tries to impose significant limits on ECB purchases in its ruling on the PSPP – and the ECB then pays only limited attention to them as the new €750bn PEPP is a separate programme with a separate rationale. If so, we would likely get a new court case against the PEPP immediately – which could then take time to wind its way through the German and European courts.

WHAT IF?

Technically speaking, the German Court has no jurisdiction over the ECB. In the unlikely case that the German court rules strongly against the current ECB purchases of public sector bonds, the court could order the German Bundesbank to abstain from such purchases, which are largely done by the national central banks under the direction of the ECB. If so, the result could be that all other national central banks continue to buy their national bonds in the pursuit of ECB policies whereas Bunds would no longer be bought. The ECB’s “capital key” distribution of purchases would then be broken to the detriment of Germany itself because of the German court verdict. Such an outcome seems unlikely, in our view.



MACRO NEWS

Separately, the German court could ask the government to use its political influence in Europe to change the legal basis for the ECB so that, even under EU law, the PSPP would be illegal eventually. Such a political process would, by necessity, take a long time. I would probably yield few results beyond some significant noise.

The German judges probably know that, under current circumstances, an overly restrictive verdict could cause serious turbulences in the Eurozone at the worst possible time. Judges do not live in a political vacuum. Constitutional judges tend to be well aware that they need to take the potential consequences of their verdicts into account. While we need to watch the risk, we do not expect the German court verdict on 5 May to be so restrictive as to cause major upheaval in European markets and do serious damage to the economic and political outlook for the Eurozone. Fingers crossed.

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Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7889
www.berenberg.com
holger.schmieding@berenberg.com