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GERMAN COURT LEAVES EUROPE'S SAFETY NET INTACT

Berenberg Macro Flash

Europe dodges another bullet. In its final verdict on the ECB's "all it takes" OMT programme, Germany's Constitutional Court today rejected the legal challenges against the Eurozone's premier safety net. Although the court did so with some unease and placed some limits on potential Bundesbank participation, the verdict allows the OMT to serve its purpose if it ever has to be activated. The German court shied away from open conflict with the European Court of Justice (ECJ), which approved the OMT last June already. Two days ahead of the Brexit referendum, that is at a time when the cohesion of Europe is at risk like never before in recent decades, this in itself is another piece of good news. All in all, the German court verdict is roughly in line with expectations. The ruling today makes it even more likely that the German court will also reject the separate legal cases against the ECB's current active asset purchase programmes ("quantitative easing").

In the summer of 2012, the European Central Bank stopped the spread of contagion in Europe ('euro crisis') by announcing its readiness to back up European support programmes for struggling euro members with major bond purchases if need be. In doing so, it prevented Germany from falling into the recession which German leading indicators had been flagging at the time. In January 2014, Germany's Constitutional Court voiced serious concerns about this never-activated OMT programme and asked the European Court of Justice (ECJ) whether the OMT is compatible with European law. Following the European court's verdict of 16 June 2015 that endorsed the OMT programme with only minor restrictions, the German court has now rejected claims that the OMT, or the Bundesbank's potential participation in any OMT programme, would breach the German constitution.

The German court issued its verdict today with some palpable unease. No surprise. After all, the judges are part of Germany's conservative-liberal elite which harbours strong reservations against current ECB policies. The German judges criticise the European Court of Justice (ECJ) for not taking all their reservations against the OMT programme seriously. First, they claim that the European judges did not sufficiently discuss or review indications that the OMT programme may go beyond the legitimate scope of monetary policy. Second, they complain that the ECJ did not ask whether the ECB, as an independent institution not subject to strong parliamentary oversight, needs to interpret its mandate in a more restrictive fashion. But after voicing these concerns, the German judges concluded that the OMT programme does not **manifestly** exceed the competences which Germany had transferred to the ECB upon agreeing to monetary union. Subject to some restrictions, the OMT programme also does not "manifestly violate the prohibition of monetary financing" of budgets. The emphasis on the word "manifestly" shows the dilemma in which the German judges found themselves: while they seem to think that the ECB may have overstepped the limits as the German judges would like to interpret them, they do not rate the breach as significant enough to really contradict the ECJ.

Instead, the German judges took the ECJ's interpretation of the OMT programme from last June and added their own interpretation under which circumstances they view the ECB verdict as compatible with the German constitution. According to the German court, the Bundesbank may only participate in an OMT programme if:

- bond purchases are not announced,
- the purchase volume is limited from the outset,
- the bonds have been traded for an – undefined - minimum period already,

- the ECB buys only bonds of member countries who have not lost market access,
- the purchased bonds are held to maturity in exceptional circumstances only, and
- the purchased bonds are sold again once the intervention becomes unnecessary.

In our view, these conditions for the Bundesbank do not overly restrain the OMT programme. For example, the ECB wants to restrict any hypothetical purchases under the OMT programme to bonds with up to three years maturity. That already limits the purchases significantly, as the ECJ argued last June. In addition, the OMT is meant only for countries with an adjustment programme or credit line from the Eurozone's bailout fund ESM. The ESM can offer conditional support for countries who meet conditions approved by the German Bundestag and the relevant bodies of other member states. Under an ESM programme, most countries would likely have market access for issuing bonds, especially if markets were to expect that the ECB may activate its OMT programme for a particular country if need be. Small Greece is a separate case, but for small Greece, the OMT would never have been needed anyway. The requirement to sell bonds again and hold them to maturity only in exceptional circumstances suits the character of the OMT programme. After all, it is a programme for temporary emergencies, namely for cases in which an irrational market panic obstructs the transmission of the ECB's monetary impulse to the real economy. Once the emergency is over, it can be unwound. For a genuine monetary stimulus – as opposed to fixing an acute problem in the transmission channel of monetary policy - the ECB has its regular bond purchase programmes.

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