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Focal Point
German CC ruling: How much pain for the ECB?

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- The German Constitutional Court (CC) judged the ECB's Public Sector Purchase Program (PSPP) as partly unlawful as the German parliament did not demand a justification of it by the ECB but also ruled that it was no state financing.
- While a formal proof by the ECB that the PSPP is needed could easily allow the Bundesbank to proceed participating in the PSPP, the criteria for state financing will limit the ECB's future policy leeway significantly.
- There will be additional stress on the functioning of EMU, damage to the ECJ and likely be a headwind for the application of EU law in critical circumstances, e.g. Hungary. But if the threat to EMU becomes threatening, deeper integration could follow.
- European government bond markets reacted with a modest spread widening to the ruling. As the immediate consequences are likely to remain limited, we do not expect a disproportionate market reaction in the near term. But the reduced ECB flexibility and the additional layer of uncertainty justify a slightly higher risk premium for the time being.

Following the Great Financial Crisis (GFC) and the euro crisis monetary policy has been forced into unchartered, unorthodox territory. Milestones were Draghi's famous "whatever-it-takes" speech in 2012, the implementation of the Outright Monetary Transaction Program (OMT) and QE. These measures attracted some criticism. Critics complain that the ECB exceeds its competencies; in Germany this triggered two major lawsuits. In the first one, on the OMT, the German Constitutional Court (CC) decided in June 2016 that the ECB does not exceed its competencies and that the budgetary right of the German parliament was not violated. In a second case, a lawsuit against the ECB's Public Sector Purchase Programme (PSPP) was brought before the CC. Here, the ruling from May 5, 2020 qualified the PSPP as partly unlawful. This was unexpected, all the more as the European Court of Justice (ECJ) in December 2018 assessed the PSPP as lawful.

In what follows we will take a closer look at the ruling and highlight its likely consequences for monetary policy, European integration and government bond markets.

What the German CC decided

More precisely, the CC had to decide on two related questions: First, does the ECB with the implementation of the PSPP exceed its competencies and, second, is there a case of state budget financing? On the first the CC ruled that the ECB stays within its limits, but on the second it assessed PSPP as "partly unlawful".

Regarding the exceeding of competencies, it was complained that the German government as well as the parliament should have asked the ECB to prove why the PSPP was commensurable given its various side effects. In the reasons given for the judgement for instance it was stated that risks were transferred from the banking sector to the Eurosystem while for savers the loss risks increased. Moreover, it was argued that the negative effects from the PSPP increase with volume and duration of the program so that over time proving its necessity becomes harder.

Furthermore, the CC is very critical regarding the fiscal policy effects of the PSPP. It finds that it significantly changes the member states' policy framework and could have the same effect as financial aid, which is forbidden by the European Treaties. The longer the program lasts the more dependent on it government finances will become. This would make it more difficult to unwind the program without threatening the stability of EMU. However, it was also made clear that the PSPP was no monetary financing of governments. The CC also listed the criteria leading to this assessment (see Box 1).

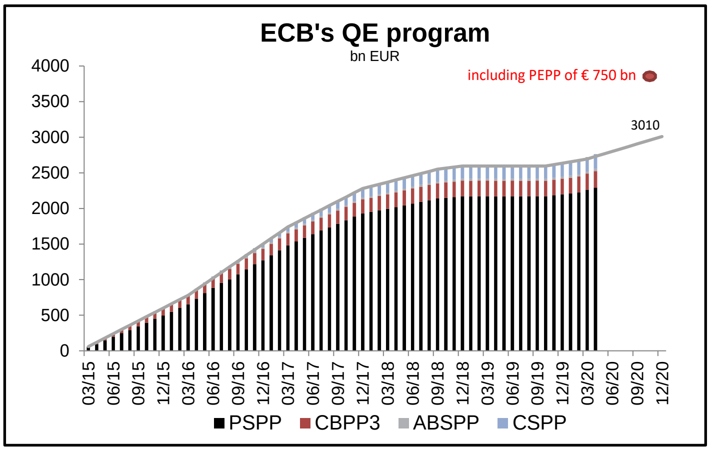
Box 1: Why the PSPP is no monetary financing

- The volume of purchases is limited in advance.
- The purchases made by the Eurosystem are only announced as an aggregate.
- The 33 % issue limit is respected.
- Purchases are made according to capital keys.
- Only IG bonds are purchased.
- Purchases shall be reduced or stalled once the inflation objective is reached. The stock of purchased bonds shall then be reduced as well.

PSPP to stay in place …

As a consequence, the German government and the parliament are obliged to ask the ECB for a proportionality assessment of the PSPP within three months. The ECB will have to be asked to justify that the PSPP is appropriate given its economic and fiscal policy effects. This also applies for the reinvestment phase of the PSPP that started in January 2019. Should the CC find the ECB response unconvincing or without a response, the Bundesbank will not be allowed to participate in the PSPP any longer.

Looking ahead, we think that it is in nobody's interest to jeopardize the continuity of the ECB policy stance, which is a necessary condition for a post-Covid-19 recovery. Before the Covid-19 crisis and the establishment of the Pandemic Emergency Purchase Program (PEPP) the bulk of asset purchases have been done within the PSPP. As of April, a total of €2.3 tr out of €2.8 tr assets held under the Asset Purchase Program (APP) belong to the PSPP. The Bundesbank withdrawing from it would likely be interpreted as start of the end of EMU, a financial market tsunami that nobody wants to trigger. The ECB has over the past years justified its policy in publications, press conferences and

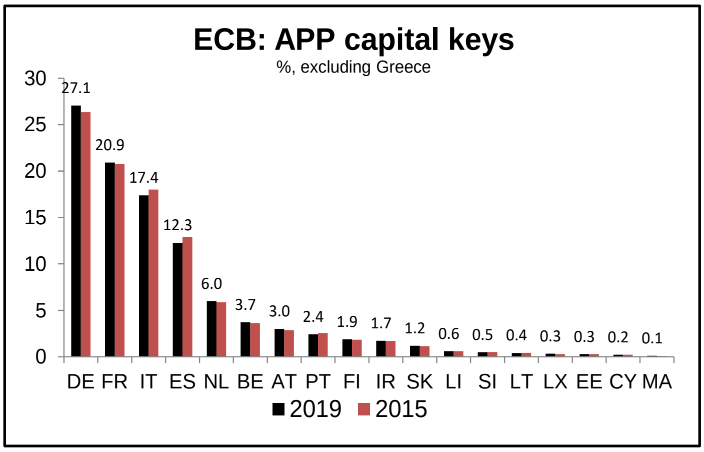


speeches by Governing Council members. We expect that in the end the Bundesbank will continue to participate in the PSPP. Bundesbank President Weidmann emphasized the importance of a sufficient safety margin to monetary financing and stated that he would support efforts to meet the CC requirements. In contrast, ECB officials emphasize the supremacy of the ECJ. A face-saving compromise like the ECB justifying its policy formally to the ECJ or the European Parliament seems most likely in order to avoid a clash.

… but job for the ECB becomes harder

Longer term we look for more severe consequences. Over the past decade the ECB was perceived as solid as a rock in turbulent times. Its ability to act timely, decisively and also unconventionally contributed to its reputation as an actor of last resort. The CC ruling introduces some uncertainty as whether this will still be the case in the future. The CC de facto defined hard criteria for the assessment of a measure as not being government financing. The most crucial ones are capital key buying and the issuer limit. The ECB considered these criteria so far as self-imposed and implied that they could be relaxed if needed. After the ruling, this will no longer be possible without major woes as it stands now. Maintaining capital key buying in the current situation will be made easier by huge supply of pandemic-related debt. Longer term a scarcity problem regarding Bunds might arise again thereby potentially damaging the credibility of QE and the effectiveness of monetary policy.

There will be no direct implications for the PEPP. The CC explicitly stated that the ruling does not apply here. That said, in our view this ruling may pave the way to lawsuits against the PEPP. While the state of emergency should be acknowledged, the CC suggested in between the lines that it might also want a justification for a possible extension of the program well into 2021. With de facto policy restrictions rising, the number of remaining monetary policy tools will be reduced. The hurdles for the ECB to embark



on more extreme measures like yield curve control or even helicopter money could become prohibitive in the view of markets thereby damaging the ECB's room for maneuver additionally.

ECB to move towards higher transparency

ECB President Lagarde announced a review of the bank's strategy which will be conducted by mid-2021. Already before she took office last year, she urged for more transparency and a better explanation of the monetary policy decisions. The CC ruling goes in the same direction and it would be face-saving to embed more transparency in the new strategy.

Risk of institutional hurly-burly …

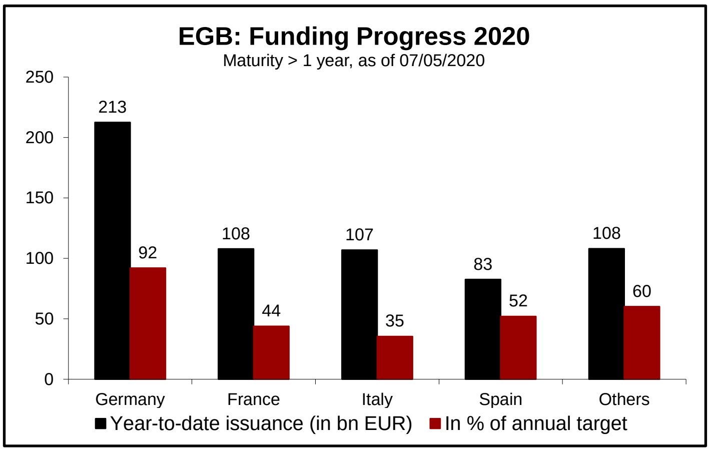
The CC ruling also has severe consequences going well beyond monetary policy, as it affects the fundamentals of the EU. As the CC stated, even after the Lisbon Treaty the EU member states remain Masters of the Treaty as the threshold towards a federation was not passed. This offers room for conflicts between national and EU institutions. In the legal sphere bigger conflicts remained contained not least because the ECJ was widely accepted as the ultimate authority on European issues. The ECJ considers itself as the ultimate jurisdiction to rule on EU law. With the CC ruling Germany, historically a key driver for European integration, deviated from this consensus. This will likely be taken as a signal for constitutional courts in other member states that one does not need to follow the ECJ. This will be particularly problematic in states like Hungary and Poland where the European Commission is heading towards Treaty violation proceedings.

… could in the end trigger further integration

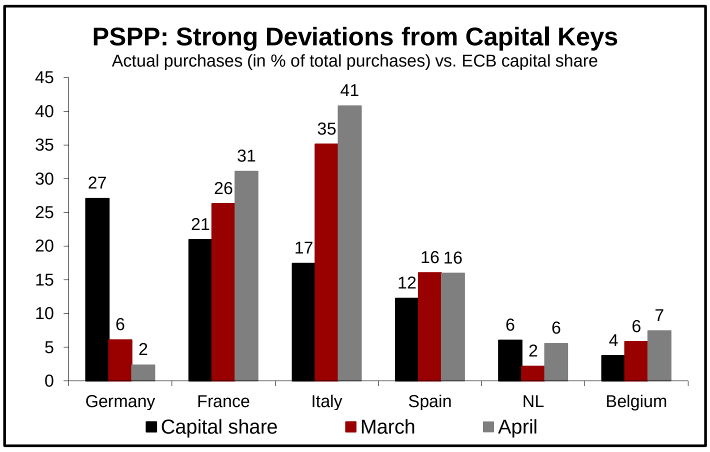
With institutional hurly-burly becoming more likely, the need to clean up institutional shortcomings increases as well. This concerns first of all the ECB, the only truly European institution. The burden to keep EMU together has almost completely been put on its shoulders by an implicit agreement of politicians to rely on ultra-supportive monetary policy measures as a substitute for proper fiscal policies. It became clear that there are limits to this strategy. Politicians are now forced to think about a deepening of integration towards fiscal policy. On the EU level the vision of a European federation could gain support as it would ultimately leave all member states with one ultimate court, namely the ECJ. While there is only very limited appetite by governments for embarking on such a way now, pressure and the perception of a die-or-stay-alive situation for the EU might ultimately be the key trigger.

Limited impact on bond markets near term, but …

Following the CC ruling, risk premiums on European government bond markets (EGBs) increased moderately. Particularly, bonds regarded as more risky suffered. However, the spread widening was limited and e.g. in no case exceeded 10 bps in the 10-year segment.



As we outlined above, we expect the ECB to give sufficient rationale for the need of the PSPP and, hence, the Bundesbank is forecast to continue its purchases for the time being. Therefore, the PSPP will be carried out as before and the impact of the CC decision on non-core government bond spreads in the near term is likely to remain limited. This applies even more as the PEPP is not (yet) affected by the ruling and purchases conducted under the PEPP are a multiple of the PSPP.



What is more, issuance activity of euro area treasuries is already well advanced. Despite the strong increase in annual issuance which has become apparent in recent weeks, they have issued more than 50% of the annual target. Some countries are even well ahead of this (though Germany's issuance activity looks overstated due to €100 bn tap of already issued securities which serve as a liquidity reserve and are currently still in the government's own holding) – with Italy a notable exception. Therefore, amid the only remote possibility of a changing ECB policy stance due to the CC ruling, the impact on EGBs is seen to remain limited near term.

However, this does not mean that the CC decision will not impact EGBs at all. While the ECB broadly complied with the capital shares in the past, it has started deviating in March and April (see chart above). This looks unsustainable as the CC explicitly demanded purchases to be conducted according to the capital keys. What is more, as the CC ruling refers to the public sector purchases but not to private sector ones, this might trigger an increase in the amount of private sector purchases further down the road. Given the verdict, future HYs purchases appear less likely as the CC required a minimum credit quality. However, IG corporate bonds could come to the fore. Finally, as the CC confirmed the legality of OMT in 2016, it cannot be excluded that this instrument will gain in relevance again in future.

… uncertainty justifies a higher risk premium

Beside these short-term considerations, the decision raises a number of legal issues. As stated above, there is no easy way out. At the very least it increases the uncertainty about future ECB actions. As the ECB will have to justify its measures to a greater extent, the ruling reduces the bank's flexibility to respond to exceptional circumstances. In any case it complicates the ECB effort to avoid a fragmentation of EGBs and, accordingly, will reduce financial markets' trust in the ECB's ability to fight the current crisis.

Additionally, the PEPP clearly does not meet the criteria laid down by the CC. Among others, the ECB signalled its intention to deviate from the capital keys and will handle the issuer limit flexibly. The inclusion of Greek non-investment grade sovereign bonds is questionable as well from the CC point of view. Hence, as discussed above a new trial is probably only a question of time – and chances of success for the plaintiffs are good. Although this will take a while and the emergence of the pandemic was obviously beyond anybody's control, the sword of Damocles will hang over all future decision regarding any extension of the PEPP. This is all the more true as the low inflation environment and the tensions on EGBs will likely continue. Hence, the ECB is expected to further on rely on QE measures.

All in all, the uncertainty triggered by the CC ruling justifies a slightly higher risk premium for euro area non-core spreads for the time being. Only in the event that the CC decision will speed up negotiations addressing the issue of burden sharing and deeper fiscal integration there is a silver lining of sustainably tighter government bond spreads.

Imprint

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