

Are ECB Bond Purchases Legal?

There had been no doubt for investors that the German Constitutional Court would find that the European Central Bank (ECB) had not been engaged in monetary financing, but the details of the judgement sent ripples through the markets as the ruling raised questions about potential constraints on European monetary policy.

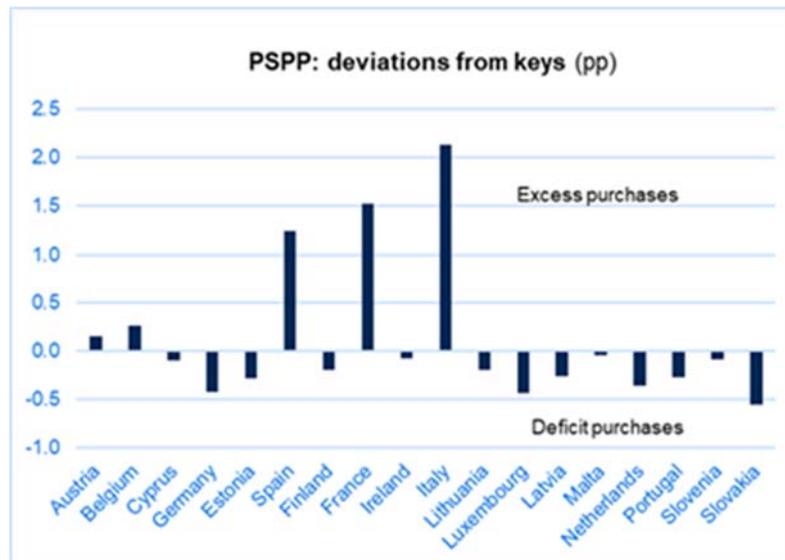
Groups of German complainants have been questioning the ECB's asset purchase programs for a while. In 2012, they brought a case in front of the German Constitutional Court arguing that the Outright Monetary Transaction (OMT) program, in which the ECB could buy euro area government bonds in the secondary market, was monetary financing, which is prohibited by the EU Treaty. In 2015, the European Court of Justice (ECJ) ruled OMT's secondary market purchases not to be monetary financing and closed the case. The German Constitutional Court went along with this ruling.

Later in 2015, a similar group of German industrialists and academics put a new case in front of the German Constitutional Court questioning the legality of the Public Sector Purchase Programme (PSPP) launched that year. The German Constitutional Court first asked the opinion of the ECJ, who delivered its judgment of full legality in 2018. The German Constitutional Court went ahead with the case and issued its own judgement Tuesday, noting it "didn't find a violation of the prohibition of monetary financing of MS budgets". Yet, it gave the ECB three months to justify the PSPP. If the ECB did not, the German central bank, the Bundesbank, would be forbidden from participating in the program and would need to sell its portfolio of German bunds held for the purpose of the PSPP.

The news was badly received. It transforms the ECB's "whatever it takes" into a "yes, but..." The Pandemic Emergency Purchase Programme (PEPP), launched this year to support bond issuance to finance fiscal support amidst a pandemic, was not included in the judgement. It was not in existence when the trial was launched—but a new trial could target it now. Of course, given the length a ruling takes, the PEPP will be terminated long before the ruling would be delivered. Still, the process puts into question efforts to further integrate the monetary union.

At the center of the debate are deviations in the proportion of ECB purchases from capital keys, which represent the share of the capital of the ECB that are the responsibility of each country in case of losses. The German plaintiffs argue that buying more bonds from a government than its share in the capital of the central bank would transfer to other euro area countries a share of the loss. The Monetary Union is not a transfer union, as per the European Treaties. To abide with the rule, the ECB made clear when launching the PSPP that the keys would guide the purchases, but that temporary deviations would be allowed.

Since inception, deviations from capital keys in the purchase of national government bonds have been small. As of April 2020, there was virtually no deviation for Germany and small ones, of between 1.5 and 2 percentage points, for France, Italy and Spain (Chart). This is nothing that cannot be easily corrected by year-end.



Source: ECB and Barings calculations

Even though the German Constitutional Court recently expressed concerns about one of its government-bond purchase programs, the ECB continues to stand by the commitment to its mandate. The ECB will have an easy time justifying its purchases and the deviation from the keys: it did it for the OMT program and can do it again. The ECB's Governing Council also issued a swift reply to the Court, insisting it would continue to take measures to raise levels of euro area inflation to its target range. Still, today's decision serves as a reminder that the ECB is not completely free to act, unlike its sisters in other advanced economies. It may also remind national governments that it is their responsibility to alleviate the burden on the ECB of supporting the Euro Area, if they want to see the region thrive. If Tuesday's judgment manages to drive this point home that fiscal coordination is necessary, it may instead turn a success for Europe.



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