Christoph Degenhart, Member of the Verfassungsgerichtshof des Freistaates Sachsen and Professor of Law at Leipzig University

Contribution to the IMFS Conference on Monetary and Financial Stability 2013 - Economic and Legal Limits of Central Banking, November 26, 2013

I am one of the lawyers who – in the name of the German people – brought a legal action against the European Stability Mechanism (ESM) and in consequence against the Outright Monetary Transactions (OMT) of the ECB. The case is pending, and we expect the court to lay out the legal limits of central banking as determined by the German Constitution, the Basic Law ("Grundgesetz")

I. Introduction: the Union as a Community based on the Rule of Law

One of the primary tasks of the judiciary is to determine the limits set for government action by the national or supranational legal system. However, from the beginning, the evolution of the European Economic and Monetary Union has been characterized by evasions of those limits; either a secret breach of law or sometimes, in the wake of rescue measures, even an open breach. The evasion of the legal limits has never been justified by an alleged emergency law as has been argued. One cannot simply change a treaty by implementing consensual contractual practice in derogation of said treaty. The European Union is a union based on the rule of law. It is first and foremost defined by its legal order. To insist on safeguarding the rule of law does not mean to question European integration, on the contrary.

The Union can only exist as a community based on the rule of law – the values on which it is based are fundamental values – Article 2 TEU mentions human rights, democracy and the rule of law. The constitutional complaint against the ESM aims to safeguard democratic principles and the democratic process. After amending the motion during the ongoing

complaint, the complaint is also directed against the unconventional measures of the ECB, in particular its OTC program. The establishment of the ESM posed the question of whether the German Bundestag had carelessly given up its facility to influence European issues; the question of whether the Bundestag had risked its budgetary authority in an inadmissible manner. In that complaint, as well as in the previous complaints against the Treaty of Lisbon and the Special Committee of Nine, the German Federal Constitutional Court reminded Parliament that European Union issues are not solely government issues. Parliamentary minorities as well as the people had to rise up to the task and defend the rights of Parliament. They forced Parliament and the government to have the public discourse that they were neglecting to have. The procedural set-up was very specific: the applicants invoked an impairment of material competencies of the German Bundestag; the German Bundestag was quick to assuage fears and declare in agreement with the German government that it did not, in any way, feel impaired in performing its functions.

II. Union legislation as subject-matter of a constitutional complaint

1. Identity and Ultra-Vires control

Originally, the questions asked were all a matter of national constitutional law. The complaint was aimed directly against actions and omissions of state authorities of the Federal Republic of Germany. Amending the complaint to include measures taken by the ECB adds a new dimension. The Federal Constitutional Court is now asked to consider measures taken directly by a European institution, the ECB. However, only acts performed by German public authorities can form the basis for a constitutional complaint at the Federal Constitutional Court. Even if the OMT-program, the decision to launch an unlimited bond purchase program, can be qualified as an act of a public authority, it is still the act of a **European** public authority. Does that mean that the ECB as an organ of the European Union has to submit to the jurisdiction of a Member State court? That

question is crucial to the pending case. It does not automatically influence the admissibility of the constitutional complaint though. The constitutional organs of the Federal Republic of Germany have the duty to preserve the identity of the German Basic Law within the framework of European integration. The Federal Constitutional Court therefore reserves for itself the competency to review whether acts of European Union organs respect the inviolable core content of the constitutional identity of the Basic Law, in particular with regard to the principle of democracy (see the so-called "Lisbon-decision" of the Federal Constitutional Court, volume 123, page 267 [353]). The Federal Constitutional Court further reviews whether legal instruments of European organs "keep within the boundaries" of the sovereign powers accorded to them by way of conferred power. The former is called „identity control", the latter „ultra vires control". The competency is exercised when a legal act is „breaking out"– which means a legal act that transgresses the legal boundaries set out for the Union.

2. Is the ECB subject to the jurisdiction of the Federal Constitutional Court?

In order to pursue legal remedies against the OMT program, the complainant either has to demonstrate that by launching the OMT program the ECB severely exceeds the boundaries of its conferred powers – ultra vires control – or that it affects the inviolable core content of the democratic principle, the legitimacy for all national or even supranational action. Further preliminary questions of admissibility of the constitutional complaint against the OMT program cannot be addressed in this context; they are only of interest to a limited legal audience anyway. During oral arguments, it was heavily debated whether the ECB's announcement that it would launch an unlimited bond purchase program would constitute a legal act. On the other hand, whether the ECB acted in a sovereign capacity was not questioned. The crucial question remains: did the ECB exceed the legal boundaries set by European Union law? If yes, did it constitute a „legal act

that is breaking out“ within the meaning of the constitutional case law on ultra vires control and is the inviolable core content of the constitutional identity of the Basic Law affected?

III. Exceeding the mandate of the ECB: The OMT program as fiscal policy

1. Prohibition of monetary government financing - Criteria

It is undisputed that Article 123 para. 1 TFEU contains the prohibition of monetary government financing by the ECB. That prohibition was *conditio sine qua non* for the transfer of monetary sovereignty to the European System of Central Banks. The prohibition directly covers the purchase of bonds on the primary market. The prohibition of monetary financing limits the monetary mandate of the ECB set out in Article 127 para. 2 TFEU and constitutes a fundamental pillar of the Monetary Union according to the Treaty of Maastricht, as stipulated in the Approving Act.

According to the Federal Constitutional Court in its decision of September 12th, 2013 on the ESM (para. 278), purchases of government bonds by the ECB on the secondary market are also prohibited, if the purchases are aimed at financing the Member States’ budgets independently of capital markets, as it would circumvent the prohibition of monetary financing. If an unconventional measure such as the OMT program constitutes such circumvention - if it has a monetary or a fiscal motivation - is therefore of utmost importance for its compatibility with the prohibition of monetary financing in Article 123 para. 1 TFEU.

2. OMT program - Effects

a) Monetary financing independently of capital markets?

A circumvention of the prohibition of monetary financing takes place if Member States are financed independently of capital markets. That prohibition sets out limits for actions of Central Banks. According to experts, the main objective of the ECB's OMT program is to influence market interest rates in the Eurozone States and to facilitate refinancing for crisis-ridden Eurozone States at rates that are more favorable than market rates. Interest rate conditions for refinancing generally reflect the creditworthiness of the state in question. They are also influenced by the level of soundness of public finances. This reflects the independence of national budgets. The present design of the monetary union is based on that independence.[1] The bond purchase program of the ECB makes states independent of capital markets. The OMT program has the effect, and that is actually its objective, that individual states can refinance themselves at conditions that do not reflect their actual valuation on the market. According to the expert *Konrad* and others, the OMT program provides individual countries with a certain interest rate advantage, which amounts to around 40 Billion Euro for Italy for only a 2% difference and therefore constitutes a distortion of market prices. This runs contrary to Article 127 TFEU.

The ECB program thus causes exactly the kind of financing independently of capital markets that the ECB is not allowed to perform. In this context, it makes no difference whether the ECB acquired the bonds directly from the issuing state on the primary market or in a subsequent sale on the secondary market. The goal is not to temporarily intervene in the bond market to compensate for interest rate volatilities, but to purchase bonds

---

[1] See BVerfGE 129, 124 (181).

from crisis-ridden states permanently. Even if the envisaged secondary market activities of the ECB were only intended to lower the interest rate for the state in question, therefore facilitating the refinancing and reducing the costs, they would still constitute a means to finance the public sector.[2] That the program is intended to circumvent the prohibition on monetary financing is indirectly admitted by the ECB as it cites differences in interest rates between the members of the Eurozone as a way to justify the bond purchase program.

b) Intent to circumvent, conditionality, selectivity

Another point which indicates that the program can be qualified as disguised government financing is the submission of the ECB that it is not allowed to purchase bonds directly on the primary market and that in order to comply with Article 123 TFEU, purchases will only be conducted on the secondary market.[3] One could not articulate the intention to circumvent the prohibition with more clarity.

As pointed out by the expert *Zeitler* during the proceedings at the Federal Constitutional Court, there are other relevant factors which indicate quite clearly a fiscal and not a monetary policy character of the OMT program: conditionality, which is appropriate for fiscal policies and necessary because of Article 136 para. 3 TFEU. The expectation that the OMTs would be terminated if a review of the conditionality led to a negative result is not a very realistic one. That is another factor that indicates an inadmissible circumvention of the prohibition of monetary financing. An indicator for a monetary policy character would be the application of the program to all

---

2 See *Siekmann*, in: Sachs, GG, 6th ed. 2011, Art. 88 recital 31.

3 As explicitly mentioned in the Monthly Bulletin of the ECB of September 2012, p. 11.

members of the Eurozone according to a GDP-based key.[4] That is not the case for the OMT program. The "selectivity" of the OMT therefore indicates a fiscal policy character.

c) Liability risks

The ECB is planning to purchase an unlimited amount of government bonds and keep them in the long term in order to allow the issuing states to refinance themselves independently of market interest rates. The ECB therefore assumes the risk of default of those government bonds. It also assumes the risk of feasibility of the macroeconomic adjustment programs it mandates, on which it can exert only limited influence. It seems clear from looking at the scenarios described by the experts, that the OMT program will give rise to liability risks for the Member States of the Economic and Monetary Union, no matter how the risks are categorized once they materialize. That means that the liability risks are also redistributed among the Member States of the Economic and Monetary Union. Ultimately, the Member States will bear the default risk of the government bonds held by the ECB. That circumvents the prohibition of assuming liability for commitments of other Member States (no bail-out clause) as a fundamental principle of the Monetary Union.

3. Assessment

The legal assessment is dependent on the opinion of the experts. During oral arguments at the Federal Constitutional Court on June 11-12, 2013 there seemed to be general agreement among them. Across the board, the actions of the ECB were described with words like Joint Liability Union, communitisation of debt and redistribution of liability risks. In a summary assessment it can therefore be concluded that the ECB or the European

---

4 *Zeitler*, Statement of May 30th, 2013, p. 10.

System of Central Banks conduct, as the expert *Kai Konrad* put it, "redistribution in favor of a few and at the expense of most other Member States"[5] with the announcement of the OMT program as with other unconventional measures before that. The ECB undertakes a systematic redistribution of the refinancing costs for the Eurozone states and just as systematically causes a redistribution of the liability risks.

The effects can be described by using an analogy to German federalism. The Federal-State (*Länder*) community is perceived as a "joint liability community". That has the effect of an alignment of refinancing costs independent of the debt to equity ratio of the individual regional authority. The redistribution of the economic costs of public debt between Eurozone countries due to measures taken by the ECB has a comparable effect. In my opinion "Joint Liability Union" and "Transfer Union" therefore accurately describe the development that has taken place.

IV. Ultra-Vires-Control, Identity Control

1. ECB – Ultra vires policy

If one agrees with the aforementioned assessment of the OMT program, the inevitable conclusion must be that the ECB exceeds its monetary policy mandate. It neither has sufficient legitimacy to force the Member States to establish adjustment programs, nor sufficient legitimacy to influence their budgetary polices. Furthermore, it is not legitimized to redistribute credit risks among the Member States. The ECB is acting ultra vires. Those actions directly and adversely affect the contractual foundations of the Monetary Union. The foundations of the Monetary Union are already severely

---

5 *Konrad*, Statement of June 10th, 2013, p. 8.

weakened due to the abandonment of the bail-out prohibition. The fact that the ECB is exceeding its competency is therefore also structurally relevant. The communitisation of the assumption of debt destroys the link of the Economic and Monetary Union. Ultra vires acts destroy the link to democratic legitimization.

2. Constitutional identity of the Basic Law

Another important factor has to be considered: The acts of the ECB affect the inviolable core content of the constitutional identity of the Basic Law.

a) Exceeding the mandate without democratic legitimation

The ECB can act without the consent of the Member States parliaments. That is mandated by the European treaties and a necessary consequence of bestowing independence on the European Central Bank. The ECB's independence results in a departure from the general principle of parliamentary responsibility for sovereign action. It "releases national sovereign powers from direct state or supranational parliamentary control" as remarked by the Federal Constitutional Court in its decision on the Treaty of Maastricht.[6] That constitutes a "restriction of the democratic legitimation which is derived from the electorate in the Member States". It affects the principle of democracy as codified in the Basic Law. That modification of the principle of parliamentary responsibility though is provided for in Article 88, sentence 2 of the Basic Law and is therefore compatible with Article 79, para. 3 of the Basic Law.[7]

---

6 BVerfGE 89, 155 (208).

7 BVerfGE 89, 155 (208); see additionally *Siekmann*, in: Sachs, GG, 6th ed. 2011, Art. 88 recital 38 et seq.

The modification is compatible with the democratic principle, because it is strictly limited. The fact that the monetary policy of the ECB has been rendered independent[8] is acceptable to the extent that, and for so long as the ECB stays with monetary policy and fiscal policy, in particular monetary government financing, remains forbidden, and as long as its objectives are clearly defined and its actions are geared towards achieving price stability. Replacing parliamentary legitimacy and responsibility is only compatible with the democratic principle of the Basic Law if the limits of the competencies of the ECB are clearly defined. Only to that extent is the modification still covered by the limits mandated by Article 79 para. 3 of the Basic Law.

The circumvention of the prohibition of monetary financing exceeds those limits. The conditionality of the bond purchases blends fiscal and monetary policy and leads to a subjugation of the ECB to policy decisions, which most definitely exceeds the limits in an inadmissible manner. The emancipation of monetary policy within the competence of an independent ECB can only live up to the democratic principle to the extent that and for so long as the decisions and actions of the ECB are still independent of the will of "political powers"[9].

b) Automatic liability

The program also affects the budgetary sovereignty of the Bundestag; its fiscal responsibility. The redistribution of liability risks, as done by the OMT program according to the experts, may lead to automatic liability, which needs to be avoided from a constitutional point of view. It occurs when liability risks ultimately have to be borne by the Member States without giving them the opportunity to influence the manifestation of those risks.

---

8 BVerfG ibid.

9 See BVerfGE 89, 155 (209).

V. Result and Future prospects

The unlimited purchase of government bonds of individual Eurozone countries extends the remit assigned to the European Central Bank by the European Treaties up to the legally admissible limit and beyond. The ECB exceeds its competencies, ultra vires. The budgetary sovereignty of the Bundestag is therefore threatened and that will ultimately lead to an inadmissible assumption of liability by the Federal Republic of Germany; the necessary democratic legitimacy is lacking; the safeguards laid down by the legislation of the Union for the constitutional precepts of democracy are significantly weakened.

Extreme caution is necessary before proposing further unconventional measures to safeguard the Monetary Union. It needs to be confirmed that the stability structure that has been built into the Monetary Union can be preserved even if when an extensive view of the role of an independent European Central Bank is applied. The significant dilution of the no-bail-out prohibition in Article 136 para. 3 TFEU already severely weakened the stability structure. The dilution of the bail–out prohibition is especially serious as the once so clearly defined limits of the role of the ECB falter and put a strain on the stability structure. Which other elements are superfluous, which pillars can knocked over, is the whole structure shattered in its constitutional sustainability?

The legal limits for rescue measures of the Central Bank are not only exhausted, they are exceeded. In order to extend the current framework, an amendment of the Primary Law is necessary. An extension of the tasks of the Central Bank while at the same time keeping its independence, will likely encounter opposition in light of national constitutional law.

Translation by **Jenny Döge** (IMFS)