

# Why the European Court of Justice should reject the German Constitutional Court's ruling on Outright Monetary Transactions

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*Despite having a positive effect on the economic situation within the Eurozone, the European Central Bank's Outright Monetary Transactions (OMT) program has proved controversial, with the German Constitutional Court in Karlsruhe recently deeming it illegal under EU law. **Paul De Grauwe** argues that the ruling reflects a serious misunderstanding of central banking on the part of the German Court, and that the European Court of Justice should reject its conclusions. Failure to do so would undermine the effectiveness of the OMT program and risk reigniting the Eurozone crisis.*



Two weeks ago the German judges of the Constitutional Court in Karlsruhe came to a preliminary conclusion: the European Central Bank's government bond buying program (OMT) is illegal according to EU law. The judges referred the case to the European Court of Justice asking the Luxembourg judges to add conditions to the OMT program to make it possible for them to reconsider their judgment. These conditions, if implemented, would in fact rob the OMT program of its effectiveness and make it totally useless. This would create the risk of repeated crises in the government bond markets of the Eurozone.

The main argument used by the German judges, which was very much influenced by the Bundesbank advice on OMT, can be summarized as follows. When the ECB buys government bonds it mixes monetary and fiscal policies. The fiscal component of OMT arises from the fact that the government bonds bought by the ECB can lose value if the governments whose bonds are bought default. If that happens the ECB will incur a loss that can wipe out its equity. As a result, governments of the member countries will have to use taxpayers' money to recapitalize the ECB. Thus, by buying government bonds the ECB puts future taxpayers at risk. The latter may be forced to pay taxes, without due democratic process. Indeed decisions to tax can only be taken by national parliaments, and not by a politically irresponsible bureaucracy like the ECB.

This sounds like a very weighty argument. If true, there is not much one can put in the way of the judges and one has to conclude that the OMT program undermines the basic democratic principle of "no taxation without representation". The problem with this argument is that it is wrong.

A first thing to note is that a central bank cannot default as long as it has the monopoly power to issue money. Money is the "debt" of the central bank but the central bank can redeem this "debt" by issuing fresh money, i.e. by converting an old banknote into a new one. These banknotes do not constitute a claim on the assets of the central bank. As a result, the central bank does not need equity (in contrast to private companies). It can live perfectly with negative equity. As long as the central bank keeps its promise of price stability any amount of equity, positive or



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negative, is fine.

Let's return to the OMT program and let us develop an example. I will show that at no time during and after the implementation of the program taxpayers' money of member countries is at stake.

Suppose the ECB buys €1 billion of Italian government bonds with a coupon of 4 per cent. These are government bonds bought in the secondary market. Thus, the Italian government must have decided earlier to issue these bonds, and this must have passed due democratic process in Italy. As soon as the ECB holds these bonds on its balance sheet an interest rate transfer process is set in motion. The Italian treasury now has to pay every year €40 million to the ECB. (Note that before the ECB purchase the same Italian treasury was paying the same €40 million to private holders of these bonds. The ECB purchase of bonds does not affect the Italian taxpayer).

The next step is that the ECB transfers the €40 million of interest revenues to the national central banks of the member states which pass these on to their national treasuries. This distribution is done according to the capital shares of the national central banks in the ECB. Thus Germany, which has the largest share, receives the largest part of these interest revenues. Italy receives a fraction and is thus the net payer. The point is that the Italian taxpayer is not asked to pay more taxes because of the ECB bond purchase. The other member countries are at the receiving end. Thus, taxpayers in these countries, in particular the German taxpayer, are not asked to pay more taxes, either. On the contrary they could lower taxes as a result of the transfers from Italy. This goes on until the Italian bonds held by the ECB mature.

What happens if the Italian government defaults on its debt? Two things. First, the flow of interest revenues from Italy to the other member states stops. Again there is no increased taxation. Italian taxpayers just stop sending money to German, French, Dutch, etc. taxpayers.

Second, following the Italian default the ECB has to write down the Italian bonds. This loss leads to a decline of the ECB's equity by €1 billion. A recapitalization of the ECB appears to be necessary. However, as argued earlier, the ECB can easily live with a lower equity because a central bank does not need equity to function properly.

But suppose that for reasons of reputation the member states decide to recapitalize the ECB. Will that not inevitably involve taxpayers in Germany, France, etc? The answer is no. This will just be a bookkeeping operation without involving taxpayers. When national governments decide to recapitalize the ECB to make up for the loss of €1 billion, they transfer bonds to the ECB worth 1 billion, allowing the ECB to increase its equity by €1 billion. These transfers occur using the same capital shares. Thus the ECB holds government bonds worth €1 billion. As a result, each government pays interest to the ECB in the same proportion to its capital share. But at the end of the year the ECB transfers these interest revenues back to the same governments using the same [capital shares](#).\*

It will be clear that a recapitalization of the ECB would be a pure bookkeeping operation. It would not require Eurozone citizens to pay more taxes. Each government gets back from the ECB exactly what it has put into the ECB. The German and other taxpayers can sleep peacefully. In this whole operation, including the default by the Italian government, taxpayers would not be asked to pay one additional eurocent. The fact that a recapitalization of the ECB can only be a bookkeeping operation should not come as a surprise. A government that can default cannot possibly be a fiscal backup of a central bank that cannot default.

There are of course risks involved in the use of the OMT program. These risks have to do with potential inflation and with moral hazard. But none of these risks have anything to do with taxpayers that are being forced to pay a tax without a democratic vote in national parliaments. The inflation risk arises from the fact that a government bond purchase leads to a creation of money base. Elsewhere I have [argued](#) that this risk is small as the ECB will be called upon to activate the OMT program during moments of financial crisis when economic agents scramble for liquidity. During such moments the greater risk is deflation, not inflation.

The risk of moral hazard is a real one. It arises because the OMT could give incentives to governments to be more

relaxed about debts and deficits. In order to deal with this risk a separation principle should be applied. The responsibility of the central bank is to provide liquidity in times of crisis. The European Commission is responsible for containing the moral hazard risk. It has a legal mandate to do so through the Stability and Growth Pact that has been strengthened since the outburst of the sovereign debt crisis.

One can conclude that an important argument used by the judges of Karlsruhe to declare the OMT illegal testifies to an appalling lack of understanding of the basics of central banking. The OMT program does not create a risk that Eurozone citizens will have to pay taxes arising from losses of the ECB. It is quite terrifying that such an important judgment that could destroy the ECB's necessary responsibility of lender of last resort is based on ignorance. One can only hope that the judges of Luxembourg will not show the same degree of ignorance.

***\*If the interest rates on the bonds are different there could be transfers between countries resulting from a recapitalisation. In general countries with high interest rates would transfer interest to the low interest rate countries (like Germany). The ECB could offset this by a rule of "juste retour".***

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*Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.*

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