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The European Central Bank Goes to Court

Will Germany's high court strike down the EU's bailout program?

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Last week, Germany's Federal Constitutional Court concluded public hearings in Karlsruhe on the European Central Bank's (ECB's) program of bond purchases from shaky eurozone member nations. The court ranks among the most powerful national courts in the world, and historically it has not shied away from controversial decisions — like overturning the decriminalization of abortion in 1975, two years after *Roe v. Wade*. So a sweeping decision in this case would not be out of character.

It may seem odd that a German court would have jurisdiction over European monetary policy. In fact, the court can rule only on the legality of Germany's participation in the ECB; but since Germany is easily the eurozone's biggest cash cow, if it stops shoveling money to the ECB, the ECB will have to curtail its activities drastically.

At issue is a provision in Germany's constitution, the *Grundgesetz*, that allows for the transfer of authority over monetary policy from Germany's Bundesbank to the ECB only if the ECB is bound by the purpose of securing price stability. For understandable reasons, the Germans are historically skittish about inflation.

The hearings took place following a series of complaints that the ECB's bond-buying program, known as Outright Monetary Transactions (OMT), goes beyond the bank's narrow official mandate of maintaining price stability, and is therefore illegal under German constitutional law. The fact that OMT exceeds the mandate is not seriously in question: The program was launched in September 2012 by the ECB expressly to provide liquidity for eurozone members in fiscal distress, such as Greece, Portugal, and Italy. Yet the court may well rule nonetheless that it passes constitutional muster.

Legal issues aside, the case raises the question: What should the purpose of monetary policy in the eurozone be? Clearly, in the face of an economic downturn, there is a place for monetary stabilization. In the United States in the early 1930s, according to a classic work by Milton Friedman and Anna Schwartz, the Fed let the money supply collapse, leading to the Great Depression.

It would probably have been a mistake if the ECB had not tried to prevent a collapse in the money supply, which could easily have occurred during Europe's continuing sovereign-debt crisis. In fact, one could argue that the ECB should have been much more aggressive in preventing the contraction in credit that has occurred since the beginning of the crisis.

Yet the OMT program is very different from the pursuit of usual monetary-policy goals — stabilizing inflation, output, credit, and employment. The ECB has embarked on an unlimited program of purchasing government bonds issued by the peripheral countries. By doing so, the ECB not only lends money to the countries directly but reduces their cost of borrowing from private investors, both by decreasing the need for private capital (thus keeping yields low) and by making default less likely.

Although the OMT's total exposure is currently limited to €524 billion ($700 billion) — slightly over half the lending capacity of the European Stabilization Mechanism (ESM), the EU's bailout fund — that limit can be increased at the ECB's sole discretion. As ECB president Mario Draghi has said, the ECB is ready to "do whatever it takes to preserve the euro. And believe me, it will be enough." As was the case with establishing the euro, OMT's goal was not economic; it was political — to keep the European-integration project going.

What the ECB has done is nothing less than a bailout through the back door. Instead of mobilizing the needed liquidity through the ESM, or through issuing common European bonds backed by the EU as a whole, which the German voters and government have staunchly opposed, the same result was achieved by essentially printing money and buying the debt of the eurozone's less-than-well-managed governments.

No wonder this is making the Germans nervous. Although proponents of the program are correct to point out that it has been successful in bringing down yields on government bonds to the point where the risk of an imminent default in the eurozone seems to have been averted, that victory has come at a price.

True, given the moribund state of private lending and the banks' efforts to shrink their balance sheets, the inflation risks that bond purchases create are negligible — although the mere thought can be upsetting for the Germans. More important, though, bailouts, whether performed directly or through monetization of debt, are detrimental to fiscal discipline. The alleged austerity that the EU has attempted to impose on the eurozone's periphery has so far failed to produce the needed consolidation of public finances (i.e., reduction of debt and deficits) — mostly because it is naïve to expect the discipline imposed by fellow finance ministers to be more conducive to fiscal prudence than the discipline of the marketplace.

Despite all this, the likelihood that the Federal Constitutional Court will strike down OMT as unconstitutional is very low. For all its domestic aggressiveness, the court has traditionally been very accommodating of all things EU — including the Lisbon Treaty and the ESM. That's good for the EU goal of "ever closer union" (another historically important concern for Germans), but much less so for German democracy — or for fiscal discipline in the eurozone.

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