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On 5 May 2020 the German Constitutional Court (GCC) ruled that the decision taken by the European Court of Justice (ECJ) on whether the ECB's Public Sector Purchase Program (PSPP) was consistent with the Treaty was "incomprehensible" and as a consequence not valid. The GCC gave three months to the ECB to provide the evidence showing that its asset purchase program did not violate the principle of proportionality.

The ruling has been examined by several commentators and academics mainly from the legal viewpoint, in particular with respect to the relationship between the national and European Courts. Less attention has been devoted to the economic and institutional analysis underlying the decision. This is the purpose of this note. A thorough consideration of the main reasoning behind the GCC decision leads to conclude that the judgment of the German court is not only incomprehensible, but also fundamentally flawed.

The reasoning behind the GCC ruling

The GCC considers that, in implementing the PSPP, the ECB did not violate the treaty provision which prohibits the monetary financing of the member states but may have violated the principle of proportionality. The ruling indicates that the GCC is not able to fully ascertain such a violation because the ECB and the ECJ did not provide evidence that the principle of proportionality was indeed taken into due consideration. This is the reason why the ECB has been given three months to make such evidence available.

The violation of the principle of proportionality derives from the fact that the ECB motivated its actions mainly by the fact that the rate of inflation was below its target (below but close to 2%) and that "less intrusive" instruments were not available. The ECB did not make reference to the impact that the PSPP would produce on the economies and policies of the Member States and did not assess whether such effects were proportionate to the intended results obtained in the area of monetary policy.

The ruling of the GCC goes into some detail in describing the potential "negative" effects produced by a prolonged implementation of the PSPP, in particular:

(a) The PSPP improves the refinancing conditions of the Member States as it allows them to obtain financing on the capital markets at considerably better conditions than would otherwise be the case. This gives rise to the risk that the necessary consolidation and reform measures will either not be implemented or will be

discontinued. In particular, the volume and duration of the PSPP may prevent Member States from adopting own measures to pursue a sound budgetary policy and, more generally, result in “monetary dominance”, with the ECB determining fiscal policies of the Member States.

(b) The program affects the balance sheets of the commercial banking sector by transferring large quantities of government bonds, including high-risk ones, to the balance sheets of the Eurosystem, which significantly improves banks’ credit rating. At the same time, it creates an incentive for banks to increase lending despite the low level of interest rates.

(c) The PSPP may increase the risk of creating real estate and stock market bubbles as well as the economic and social impact on virtually all citizens who are at least indirectly affected *inter alia* as shareholders, tenants, real estate owners, savers or insurance policy holders. For instance, there is a considerable risk of losses for private savings. This has direct consequences for (private) pension schemes and the returns they generate.

(d) As the PSPP lowers general interest rates, it allows economically unviable companies to stay alive by having access to cheap credit.

(e) In addition, the longer the program continues and the more its total volume increases, the greater the risk that the ECB becomes dependent on the Member States’ politics, as it can no longer simply terminate and undo the program without jeopardizing the stability of the monetary union.

Given that the PSPP produces the abovementioned relevant economic policy effects, the GCC considers that the ECB should have “*weighed these effects and balanced them, based on proportionality considerations, against the expected positive contributions to achieving the monetary policy objective the ECB itself has set.*”

This note considers first the monetary and economic analysis underlying the GCC’s judgment and subsequently the coherence with the institutional framework of the ECB.

A flawed analytical framework

I will start by explaining five main reasons why the analytical framework used by the GCC is flawed.

The first reason is that the PSPP is considered as a fundamentally different instrument than the other monetary policy tools that the ECB uses to achieve its objective. In examining the presumed “negative” collateral consequences produced by the PSPP, such as facilitating financing conditions for the Member States or the banking system or “penalizing” savers, the GCC seems to ignore that these effects are not any different from other instruments used by the ECB over the past few years, such as the purchase of private assets or the lengthening of the fixed-term-full-allotment refinancing operations.

The GCC ruling seems to suggest that the sheer size of the PSPP, which amounts to several billion euros of asset purchased since the start of the operation, should be a measure of the negative collateral effects. The empirical evidence suggests that this is not necessarily the case. Looking at the evolution of Government bond yields, for instance, or even spreads, the other policy instruments, such as the change of policy rates, including into negative territory, or the OMT announcement in July 2012, seem to have had a similar, or an even bigger impact than the PSPP (charts 1,2).

Therefore, if the PSPP creates disproportionate consequences, but at the same time these consequences are not proven to be qualitatively and quantitatively different from other policy instruments that are not considered in violation with the proportionality principle, only two conclusions are possible. Either the PSPP

does not violate the proportionality principle, or all ECB instruments do. In that case, the ECB has violated the proportionality principle since the start of its operations.

The second reason why the theoretical framework used by the GCC is flawed is that it is based on the assumption whereby the economy is always in equilibrium, with full employment of resources and price stability, and the rate of interest is always in line with its long-term equilibrium level. In such a model a change in monetary policy produces a divergence from equilibrium, which produces distributive effects such as those detailed in the Court judgment. For instance, starting from an equilibrium position, a reduction in the rate of interest tends to produce an apparently undue advantage for borrowers and a disadvantage for lenders, an advantage for fixed-rate bonds holders and a disadvantage for variable-rate bondholders.

In the real world, the economy is rarely positioned at equilibrium. Therefore, the impact of a given level of interest rate, or a change of that rate, cannot be assessed in absolute terms but in relation to the value required to bring the economy back towards the equilibrium, as reminded by Knut Wicksell more than a hundred years ago.¹ For instance, when the economy grows less than its long-term potential and inflation is much below the level consistent with price stability, the interest rate should be below its long-term level in order to avoid a further divergence from equilibrium. In these circumstances, a decision not to cut rates would not only increase the divergence away from equilibrium but also produce disproportionate effects on other variables and policies. Savers, in particular, would be penalized if rates were not reduced as the further economic divergence would increase credit risk and produce bankruptcies. In sum, the proportionality of policy instruments cannot be assessed independently of the underlying economic conditions and of the divergence of the policy instrument from the level required to reach the equilibrium.

One of the possible divergences from equilibrium may be due to shifts in the liquidity preference of market participants, due to financial instability or to demand for safe liquid instruments. If the central bank, which is the main provider of safe and liquid assets, does not accommodate the increased demand for such assets, for instance by implementing a program like the PSPP, real rates of interest may rise and deflationary pressures may lead to further divergence from equilibrium. The GCC framework does not seem to take these factors into consideration.

Furthermore, evidence shows that the long-term equilibrium value of key economic variables does not remain constant over time, including the equilibrium or natural rate of interest. There is broad evidence in the literature that the neutral rate of interest has decreased in advanced economies over the last decades, as a result of different factors, such as demographics, productivity trends and savings-investment imbalances.²

To sum up, the actions of the central bank, and the proportionality of the measures that have been adopted cannot be assessed on the basis of a mechanistic model but taking into account the underlying economic conditions, in particular with respect to inflation which is the central bank's primary objective, and the shocks affecting the economy. If such an approach is adopted, the negative collateral effects that the GCC attributes to the PSPP lose significance or even change in sign, to the point of making the assessment underlying the court ruling not pertinent.

¹ Wicksell, K. "Interest and Prices" McMillan, London, 1936 (from "Geldzins und Güterpreise", 1898).

² Holston, K., Laubach T. and J. Williams, "Measuring the Natural Rate of Interest: International Trends and Determinants" Federal Reserve Bank of San Francisco Working Paper 2016-11, 2016.

The third weakness in the GCC analysis derives from a lack of understanding of the process of money creation, especially when interest rates reach the zero-lower-bound.³

The interest rate is the key instrument that central banks use to achieve their objective of price stability. When the economy is overheating, the central bank raises rates to make the borrowing by commercial banks more expensive and thus slow credit and cool the economy down. Vice versa, when inflation is much below the target the central bank can cut rates to stimulate aggregate demand and inflation by making bank lending cheaper. However, when the policy rate reaches the zero level, the effectiveness of this instrument decreases substantially. Bringing rates into negative territory may not be as effective and can produce collateral effects which make the use of such an instrument suboptimal. The quantity of central bank money which is determined by the demand from commercial banks may fall further, generating a deflationary spiral. In such conditions, the only way for the central bank to increase the money supply is to purchase assets by increasing the deposits of counterparties. The increase in central bank money raises market liquidity and tends to compress long term interest rates, in particular over the maturity of the assets purchased, enhancing the demand for credit and supporting aggregate demand.

The ECB cut interest rates into negative territory, in 2014 and in subsequent years. The evidence shows that such cuts and the implementation of forward guidance were not able to stimulate central bank money, while inflation continued to drop much below its target and inflation expectations de-anchored (see charts 3,4). Central bank money started rising significantly only after the ECB implemented its quantitative easing, in February 2015.

In short, while different in nature, the PSPP cannot be an instrument that is assessed separately from the others but rather in conjunction or in continuity with the others.

The fourth problem with the GCC's analysis, which is a combination of the two previous ones, is that it does not understand the reasons why the rate of return on certain assets, such as the 10-year Bund, which is widely held by savers, has fallen so sharply, even into negative territory. The GCC's ruling seems to suggest that the PSPP is the main underlying factor for such a development. This is clearly wrong. In other countries where quantitative easing was implemented much earlier, as in the US, long-term rates never became negative, in spite of the safe haven status of the dollar. The main reason is that policy rates were never cut to negative levels. Indeed, the negative yields on long maturities are largely the result of negative policy rates and forward guidance.

There is also evidence that long term rates are more the result of global savings-investment stocks and flows and long-term productivity trends than the result of monetary policy (chart 5).⁴ Just as an example, after the ECB stopped its PSPP, in December 2018, the yield on the German 10 Bund fell from -.20 to -.70 in the following months, as a result of the expected growth and inflation slowdown. It is the excess of savings over investment at the global level, but in particular in Germany, which put downward pressure on rates, much more than monetary policy.

The fifth mistake underlying the whole analysis is the well-known fallacy of composition, underlined by Keynes and others, which consists in looking at the impact of a specific policy on different components of the economy rather than on the whole. This leads to a wrong analysis not only of the whole, but also of the components.

³ Powell, G. "COVID-19 and the Economy", The Brookings Institution, Washington, April 09, 2020.

The impact of a macro policy cannot be assessed separately on single economic agents or behavior without an encompassing model of the economy, because the overall outcome is not the simple sum of the components. Each economic agent is either a saver or a borrower, or a combination of the two, an employee or an employer, a landlord or a tenant, and nearly everybody is a taxpayer, although with different tax brackets and exemptions. An analysis of the effects of a monetary policy instrument like the PSPP focusing on different aspects of an economic system is not only conceptually wrong; it is likely to lead to wrong answers. This point has been made several times by economists and policy-makers, but doesn't seem to have been retained by the GCC.⁵

The impact of monetary policy can only be made through models which consider all the possible interactions in the economy, in particular between monetary and fiscal policy. For instance, the monetary restriction implemented by the Bundesbank in 1991-92 cannot be assessed, either in terms of the price stability or with respect to possible collateral effects, without considering the consequences of the fiscal expansion implemented in those years, the external deficit and the one-to-one conversion rate between the two currencies. Similarly, the ECB monetary policy enacted in recent years, including the PSPP, cannot be assessed without taking due account of the effects of the fiscal consolidation in the Euro area which took place between 2015 and 2019 (by 2 percentage points in terms of deficit, with respect to GDP, and 10 points for the debt ratio) and the high net saving ratio.

The ECB recently published comprehensive research assessing the impact of various policies, including the PSPP.⁶ The main findings are that without the asset purchase program, GDP would have grown substantially less and inflation would have been further away from the target.

Applying a flawed analysis

The foregoing analytical flaws explain why the GCC's assessment leads to wrong conclusions.

The first argument used by the GCC to suggest that the ECB's monetary policy might have had disproportionate effects is that the PSPP created favorable financing conditions for the Member States, better than otherwise would have been the case. These favorable conditions would have led the Member States to weaken their budgetary adjustment and reform process. This argument is not founded. First, the GCC fails to understand, or to recognize, that the PSPP produced effects that are substantially not different than other monetary policy instruments, for instance a reduction in interest rates or a fixed-rate-full allotment procedure. Therefore, either the Court condemns all ECB instruments used over the last few years, or it condemns none. Second, the GCC fails to provide any evidence about the supposed perverse incentive that the PSPP would have induced in the Member States. During the period when the PSPP was implemented the Eurozone countries all got out of the Excessive deficit procedure and reduced their deficits and debts, although at a different pace. In the same period, countries like the US and Japan instead had much higher deficits and increasing debts, with respect to GDP. It is thus not possible to support the contention that the PSPP induced the perverse effects mentioned by the GCC.

⁵ Schnabel, I. "Narratives about the ECB's monetary policy – reality or fiction?" Speech at the Juristisch Studiengesellschaft, Karlsruhe, 11 February 2020.

⁶ Rostagno, M. et al "A Tale of two decades: monetary policy at 20", ECB Working paper 2346, 2019.

The second argument used by the GCC is that the PSPP might have created an advantage to the banking system, which was able to unload high risk assets to the central banks, thus improving the credit rating. It might also have induced banks to take on further risks by lending, “in spite of the low interest rates”. The reasoning is both inconsistent and contradictory. First, the GCC fails to understand that the banks that have sold so-called “high risk” government bonds are not necessarily those of the same countries. In fact, evidence suggests that banks sold mainly bonds of other countries, which has further increased financial fragmentation in the Eurozone (chart 6). Second, the improvement of the risk profile of banks in some countries has not been due to the reduction of public bond holdings, but rather to the reduction in the share of NPLs in the overall balance sheet. Third, if banks use the proceeds of the sale for new risky lending, the risk profile of the banks should not improve. Fourth, the increase in lending, to support the economy, is an intended consequence of the PSPP to be assessed favorably if the economy grows below potential. It should thus not be considered as a negative collateral effect but rather a reason to provide a positive judgment on the PSPP.

The third argument used by the GCC is that the PSPP created additional risks of losses for savers, in particular for pension funds and insurance holders. This argument is flawed in many respects. The first is that savers are not all equal, as their position depends ultimately on their portfolio allocation. The GCC analysis seems to consider only the flow impact of the reduction in interest rates but ignores the effect of higher price valuations. For instance, savers who held fixed rate bonds did not suffer during the period in which the PSPP was implemented. Second, the GCC fails, again, to understand that the strongest impact on long-term yields derives mainly from the negative interest rate policy decided by the ECB – incidentally with the unanimity of the Governing Council – rather than the PSPP. If the GCC had something to reproach the ECB for it should be that it started the PSPP too late. The ECB should have implemented the PSPP earlier, rather than cutting rates into negative.⁷ This could have prevented long-term rates from falling below zero. Finally, empirical analysis shows that the level of long-term rates depends also on the net asset position of the various countries. In short, the strongest factor behind the low level of interest rates in the Eurozone is the high savings ratio and the low investment (including public investment) ratio particular in some of its countries, and the high preference for liquidity emerged in financial markets.

The fourth argument used by the German court is that low interest rates kept many zombie companies alive. Also in this case the GCC fails to provide evidence of such an effect. The reasoning according to which companies go bankrupt just because long-term rates fall or rise by 100 or more basis points is purely theoretical, and distant from reality, as shown by ample research.⁸ The main reason for the existence of zombie companies is largely associated with banks’ inefficient capital allocation. The most efficient way to deal with it is not through monetary policy.⁹

The last argument used by the GCC to criticize the PSPP is that the longer it lasts, the more difficult it would be to terminate it. The PSPP would thus make the ECB “dependent” on the Member States and would put at risk the stability of the monetary union. The argument according to which the ECB might have become “addicted” to asset purchase is unsubstantiated and contradicted by the facts. The PSPP was terminated at

⁷ Bini Smaghi, L. “*Is the ECB at risk of becoming an underachiever?*”, LUISS Policy Brief 1/2020, January 2020.

⁸ Andrews, D., M. Adalet McGowan and V. Millot, “*Confronting the zombies: Policies for productivity revival*”, *OECD Economic Policy Papers*, No. 21, OECD Publishing, Paris, 2017; Binseil, u. and Schaaf, J. “Zombification is a real, not a monetary phenomenon: Exorcising the bogeyman of low interest rates”, *Vox.EU*, 10 January 2020.

⁹ Obstfeld, M. “*Can Accommodative Monetary Policies Help Explain the Productivity Slowdown?*” Joint BIS-IMF-OECD Conference on Weak Productivity: The Role of Financial Factors and Policies, , January 10, 2018

the end of 2018 and there is no evidence that the ECB had any difficulty in doing so. The termination of the program did not seem to have put the stability of the monetary union at risk. Second, the GCC indicated that the PSPP did not violate the prohibition of monetary financing, which is the main criteria set by the Treaty to assess the risk of central bank dependence on the Member States. Third, it is not clear how the ECB, by becoming a victim of its own policy, could infringe on the policies of the Member States.

In its ruling, the GCC fails to provide sufficiently robust arguments to prove its case, in particular that the ECB's PSPP produced disproportional effects. The reason is that its judgment is based on a weak analytical framework and a lack of convincing evidence. To some extent, the Court recognizes this. It recognizes that it has no evidence to show that the PSPP violates the Treaty. The ruling is based on suspicion and lack of evidence to the contrary. In other words, the ECB is guilty because it cannot demonstrate – beyond reasonable doubt - its innocence.

Institutional implications for the ECB

The final issue concerns the risks that the GCC ruling creates for the independence of the ECB. The decision to separate monetary from fiscal policy and allocate the former to an independent institution, run by unelected technocrats, is possible from the viewpoint of democratic legitimacy only to the extent that the mandate of the central bank is well defined and does not involve major trade-offs between divergent targets. An independent central bank would not have the legitimacy to choose between different objectives. This is the reason why central banks generally have price stability as their primary mandate, also in view of the fact that monetary policy is the best instrument to achieve such a target over the medium term.

The ECB, as most central banks, was created with statutes that ensure a strong independence, a primary objective and an accountability system. The statutes also indicate that, subject to the objective of price stability, the ECB should support the general economic policies of the Community. The statutes also make reference to the principles of decentralisation, open market economy and free competition. The GCC ruling creates a problem to the extent that it requires the ECB to take monetary policy decisions not only with a view to achieve its primary objective but also giving particular prominence to the principle of proportionality. Such a principle is supposed to imply, according to the GCC, that the ECB should conduct a careful assessment of the effects of its policies on other policies, in particular those that are within the competence of the Member States, such as fiscal policy. The fundamental question is what the ECB should do once it has conducted such an assessment? Should it change its policy decision, and in what ways? What other principles should be compromised to give way to proportionality?

If, for instance, in considering an interest rate rise with a view to counter inflationary pressures the ECB found that such a decision would produce losses for fixed rate bondholders, increase the rate of unemployment, lead to tax increases to cover for higher debt costs, etc., how should the ECB take this information into account? Should it change its decision to avoid or mitigate some of these effects and possibly decide to have a smaller interest rate rise and accept a somewhat higher inflation rate?

If the answer to this question is positive, it would mean that the ECB would no longer have a single primary objective, but several ones. However, it would not have the democratic legitimacy to choose between these various objectives, in case trade-offs emerged. The ECB would inevitably be subject to political pressures raised by the different countries and groups of interests. The ECB would become strained by political tensions and likely lose its independence. This would raise a major constitutional issue.

If the answer to the above question is instead negative, which means that the main purpose of the GCC is to check formally that the ECB does not take its decisions lightly, but rather bases them on a thorough analysis, considering all the possible implications and effects, the ruling does not have material consequences for the conduct of monetary policy. Indeed, there is evidence that the ECB takes all the relevant issues into consideration, consistently with its mandate. It would thus be sufficient to provide the GCC with the accounts of the ECB policy meetings, the monthly bulletins and speeches and background material. Most of this material is readily available.

To conclude, whether or not a given monetary policy is consistent with the Treaty, in particular with the principle of proportionality, is an issue that should not be settled by courts. However, if a court is called to express a judgment, it should at a minimum equip itself with the necessary analytical tools to examine the case in a rigorous way, rather than giving the impression that its rules are based on prejudices or preconceptions.

Chart 1

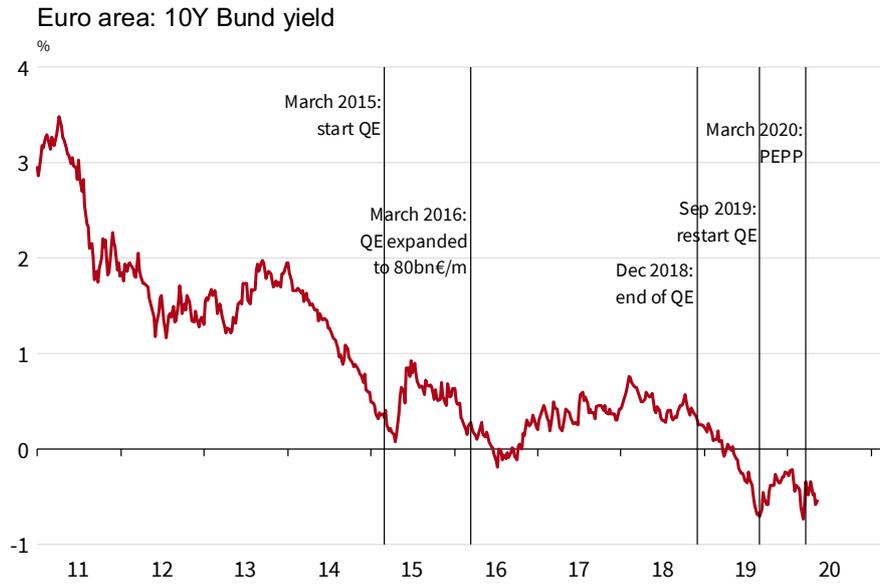


Chart 2

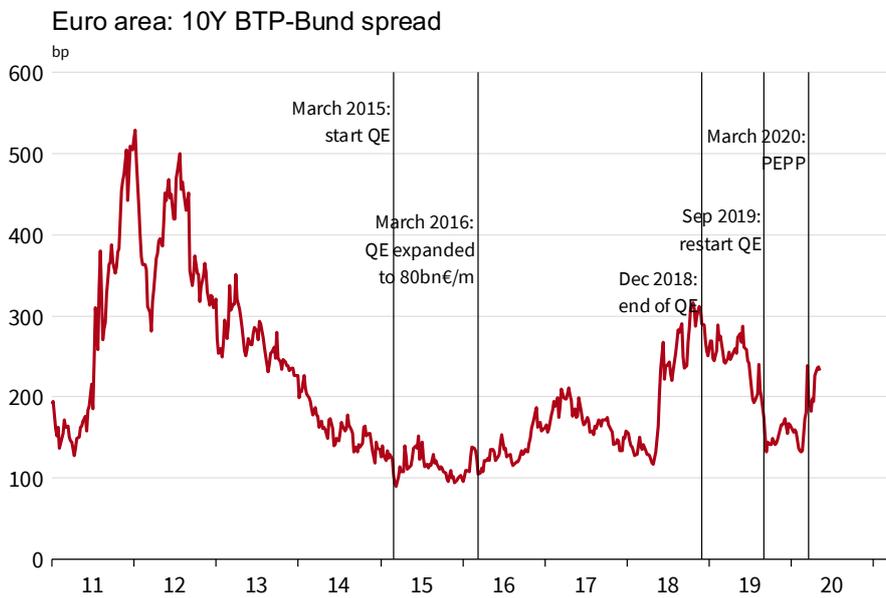


Chart 3

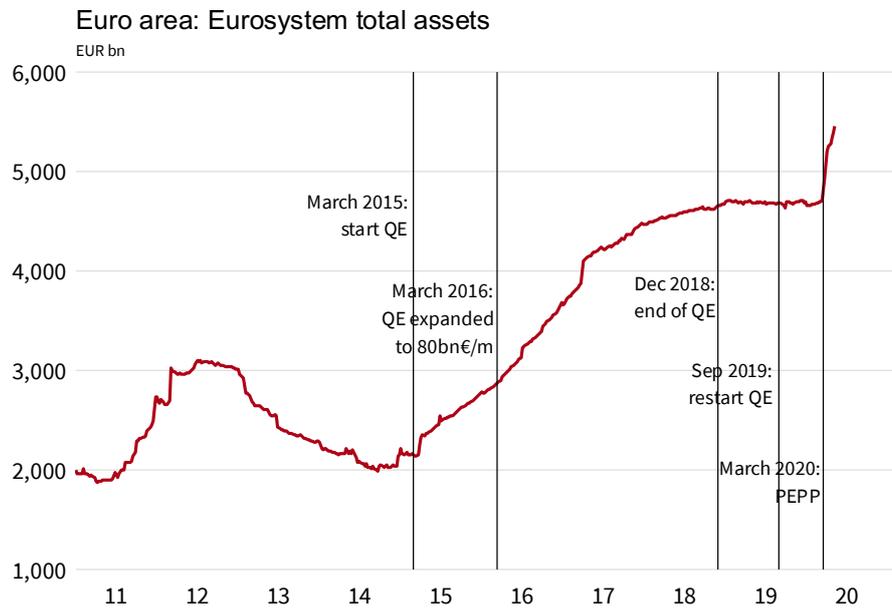


Chart 4

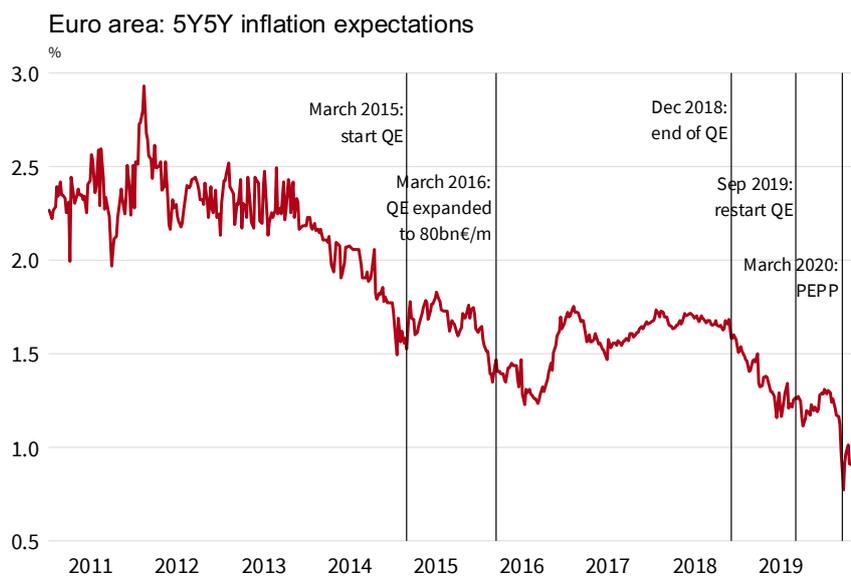


Chart 5

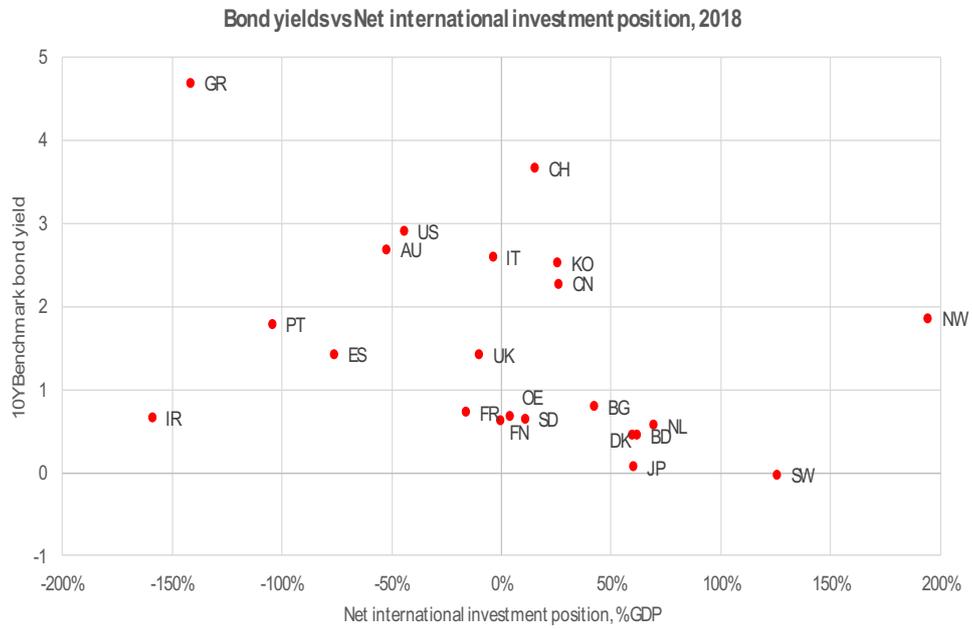


Chart 6

