

## **The German Court Does Europe a Favour**

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The German Constitutional Court has been widely criticized for questioning the legality of the European Central Bank's Outright Monetary Transactions (OMT) program. The OMT was a promise by the ECB in August 2012 to buy unlimited quantities of bonds issued by distressed European sovereigns, and was widely credited with reducing risk premia on Italian and Spanish sovereign bonds—thereby taming the resurgent euro area crisis.

To the supporters of the OMT, the activist Court is once again taking a narrowly-defined position in the German interest while disregarding the greater vision of European integration. But what if the German Court is doing Europe a favour? The Court's unease arises from the culture of quick-fixes on offer since the crisis started. By referring the case to the European Court of Justice, the German Court has created an opening for a more durable political and economic solution, necessary for the euro to survive.

At issue is a matter central to the design of the euro area. The authors of the Lisbon Treaty—the legal basis for the European Union—chose to create a common currency shared among its Member States, while leaving fiscal sovereignty at the national level. Fiercely jealous of their fiscal authority, the Member States were, and remain, unwilling to cede that authority, even while knowing the economic risks this entails.

The crisis has reinforced the huge costs of this arrangement. But even as the need for a sizeable fiscal union—requiring the Members to cede some control of their budgets—is more evident, so is the frustrating political intractability of achieving such a union. Distressed member states need generous help amidst a crisis but the prospect of writing blank checks to profligate governments makes such help a political landmine.

At a time when European nations are threatening to roll back the long-cherished freedom of free movement to protect themselves against the misuse of their welfare systems by migrants, fiscal support to other Member States can only be provided under the radar screen; hence the appeal of the OMT.

A central bank has a legitimate role as a lender-of-last resort to dampen temporary disruptions in market liquidity. The ECB should be in this business. If anything, the ECB has been too stodgy even within its mandate.

But the OMT is a bridge-too-far. It is not a lender-of-last resort instrument. It only superficially addresses market liquidity. In its intent and design, the OMT works because it addresses the market's concern about a sovereign's solvency. It works by offering to share the losses on sovereign bonds if they are not repaid in full, rendering it more attractive than its predecessor Securities Market Programme (the SMP). Under the SMP, the ECB's holdings of Greek debt were protected while large losses were imposed on private creditors. By now promising to share losses, the ECB acknowledged that default was a real risk.

The German Bundesbank fiercely opposed the OMT. But the German Chancellor, Angela Merkel, first gave the programme her tacit approval and then her Finance Minister, Wolfgang Schauble, defended the OMT at the German Court. For the Chancellor, the OMT was an apparently costless way to help Europe without fighting a losing domestic political battle on transparently providing more fiscal resources.

Based on its prior judgments—the European Court of Justice will be predisposed to sympathize with the German Court's concerns. The European Court stretched thin the Treaty to validate the European Stability Mechanism (ESM), the channel through which governments make loans to fiscally-troubled governments in Europe. In doing so, that Court was at pains to note that the ECB is held to a "stricter standard." Since the OMT is triggered contingent on the distressed Member State seeking support from the ESM, the European Court will need to retrace its earlier argument.

Many expect the European Court to adhere to a pro-Europe stereotype by declaring the OMT legal. That would validate a simulated fiscal union within the central bank, an outcome that would politicize the ECB and weaken its independence and credibility. The Court could restrict the OMT's reach and undermine its effectiveness. Or the Court could do the right thing.

And that would be to agree that the OMT is needed as a temporary support because an incomplete monetary union creates intolerable risks. It would ask the political actors to meet their responsibility by providing a transparent and legitimate mandate for a permanent OMT. They would do so by jointly guaranteeing the ECB against losses incurred if a particular transaction ends in a default. That guarantee may never be needed. But it would focus the minds and clarify who bears the cost. Then Europe would have taken a real step forward.