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Karlsruhe on Bond Buying: Searching the Limits to Quantitative Easing

Stefaan Van den Bogaert (Europa Institute Leiden Law School) and Vestert Borger, Frederik Behre (Europa Institute, Leiden Law School) · Thursday, November 30th, 2017

On 18 July 2017, the German Federal Constitutional Court issued its second preliminary reference to the Court of Justice of the European Union. This time, it doubts the legality of the 'Quantitative Easing' programme of the European Central Bank. The first reference, from 2014, also concerned central bank action. At the height of the debt crisis, in the summer of 2012, President Mario Draghi had announced his Bank was prepared to do 'whatever it takes' to save the euro. Soon afterwards, the Bank followed up on that pledge by announcing its bond programme *Outright Monetary Transactions*. In a referral characterized by a harsh tone and uncompromising terms, the *Bundesverfassungsgericht* sought to impose on the Court of Justice its view that the programme was an economic policy measure, violating the prohibition on monetary financing (Article 123 TFEU) and exceeding the Bank's mandate (Article 127 TFEU). In equally uncompromising terms, the Court of Justice cleared the programme in *Gauweiler*.

In its second reference, the *Bundesverfassungsgericht* adopts a different, more conciliatory tone. It recognizes that in an environment in which interest rates have reached the 'zero-lower bound', government bond purchases may help to increase the money supply, stimulate economic activity and combat the risk of deflation. Yet, it also voices its sincere concern about the legality of the purchases, calling upon the Court of Justice to clarify and apply the terms and conditions it set out in *Gauweiler*. This time too, the Court of Justice is expected to approve the programme. The key to approval lies in striking a balance between central bank independence and discretion.

Controlling bond market intervention: Between central bank independence and discretion

To many, this second reference came as a surprise. If *Outright Monetary Transactions,* aimed at lowering excessive government bond yields to secure the transmission of monetary policy, already fall within the Bank's mandate, then the Public Sector Purchase Programme (PSPP) certainly does. After all, over the past years central banks around the world have engaged in *Quantitative Easing* to combat the risk of deflation, a core monetary policy task.

Yet there is more to the concerns of the *Bundesverfassungsgericht* than meets the eye. In *Gauweiler* the Court of Justice made clear that the Bank has no *carte blanche* when it comes to bond buying. In particular, it may not intervene on secondary bond markets in such a way as to circumvent the prohibition on primary market intervention. The *Bundesverfassungsgericht* now questions whether the Bank complies with precisely this requirement. It points out that the announced modalities of the programme, the limited availability of qualifying bonds, and the enormous volume of purchases – which at the time of its reference already exceeded €1,5 trillion – create a *de facto* certainty on primary markets that bonds will be bought by the Bank.

This concern of the *Bundesverfassungsgericht* illustrates its desire to control the Bank's independence. While recognizing the importance of this independence, Karlsruhe also considers it at odds with the requirement that the exercise of public authority needs to be democratically legitimated. The mandate of the Bank therefore needs careful delimitation. Yet, in its desire to delineate this mandate, the *Bundesverfassungsgericht* fails to pay sufficient tribute to the Bank's discretion, a *conditio sine qua non* for monetary policy.

It is now up to the Court of Justice to reconcile Karlsruhe's concern about the Bank's mandate with the need for discretion. In relation to the prohibition on circumvention, it could do this by acknowledging the fundamentally different nature and objective of *Outright Monetary Transactions* and *Quantitative Easing*. While to the former uncertainty about central bank action was quintessential, the latter requires certainty so as to control inflation and inflation expectations. The periodic announcements of the Bank about the programme, indicating *inter alia* the monthly amount of purchases (varying between €30 up to 80 billion), creates this certainty. The safeguards outlined by the Court of Justice in *Gauweiler* concerning the prohibition on circumvention – no announcements and an embargo-period – need to be interpreted in light of this need for certainty. It first and foremost falls on the Bank to do this, exercising its discretion. Interesting in that respect is that it launched the *Quantitative Easing*-programme after the *Bundesverfassungsgericht* issued its first reference. It consequently designed the programme with the concerns of Karlsruhe about the *Outright Monetary Transactions* programme in mind.

But what then is the role of the Court of Justice? It should live up to its promise in *Gauweiler* to review the exercise of central bank discretion, albeit marginally. In *Gauweiler* itself, it did so leniently, perhaps even too leniently. It confined itself to stating (§75) that nothing more could be required of the Bank than that it uses 'its economic expertise and the necessary technical means at its disposal to carry out that analysis with all care and accuracy.' Yet, for the marginal review to bite, and in line with Karlsruhe's emphasis on the duty to state reasons, the Court of Justice should require the Bank to factually substantiate its claim that the purchases respect the prohibition on circumvention.

After a rocky start, now on the brink of a dialogue?

Gauweiler left many questioning the relationship between the two courts. The *Bundesverfassungsgericht* issued a dictate under the disguise of a preliminary reference, the Court of Justice didn't blink and refused to follow. Yet, if this time Luxembourg would conduct a thorough marginal review, it would reconcile the need for central bank discretion with Karlsruhe's serious concerns. What we would then be witnessing is the start of a true judicial dialogue.

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