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# German court decision unlikely to stop QE

## The ECB may even increase the size of bond purchases soon

The German Constitutional Court recently ruled that the ECB had not sufficiently justified its original QE programme and gave it three months to do so. We expect the required justification will be provided and that ECB government bond purchases will continue and even increase in size soon. Indeed, in our view QE is an important part of the monetary policy toolkit that has helped keep the single currency intact.

Source: Istock

"The Federal Constitutional Court is not bound by the CJEU's decision but must conduct its own review to determine whether the Eurosystem's decisions on the adoption and implementation of the PSPP remain within the competences conferred upon it ...."

German Constitutional Court, May 5, 2020

The German Constitutional Court (GCC) ruled on Tuesday May 5[1] that the ECB had not sufficiently justified its original QE government bond purchase programme, the Public Sector Purchase Programme (PSPP), established in 2015. The PSPP saw the ECB buying billions of euros of Eurozone government bonds for the first time and is still ongoing today. The GCC said that the ECB would need to provide a justification for the programme, based on a 'proportionality assessment', within the next three months for the Bundesbank to be allowed to continue to participate in this programme of bond purchases.

What's more, at first glance, the ruling could also limit the flexibility and firepower of the ECB's other asset purchase programmes, notably the recently announced EUR 750bn Pandemic Emergency Purchase Programme (PEPP). This would be unfortunate because credibility in markets from a policy perspective is often about conveying the impression of unlimited firepower.

However, the ECB has made it clear since the verdict that it intends to continue with large-scale asset purchases and could even increase them if it deems this to be necessary. Indeed, we do not expect the ECB's PSPP or any other asset purchase programmes to suddenly stop in three months' time.

The ECB has said that it regards itself to be accountable to the European Parliament and under the jurisdiction of the European Court of Justice (ECJ), not the German Constitutional Court (GCC), potentially setting up a stand-off between the two courts, that may eventually need to be resolved by a vote in the German parliament or a change of law.

### The facts

The GCC gave its ruling on Tuesday May 5 in a long-running complaint brought by various German academics and commentators that the ECB's original government bond buying programme, the PSPP, violated the articles of the EU treaty under which the ECB was established. They argued that the ECB was making economic policy (as opposed to just targeting inflation) and engaging in monetary financing of Eurozone government deficits, both of which are against the EU treaty articles under which the ECB was set up.

The GCC initially passed the complaint to the European Court of Justice (ECJ or CJEU) for a preliminary ruling. The ECJ ruled in December 2018 that the ECB was not contravening its articles of establishment. Now the GCC has reviewed this preliminary ruling by the ECJ, rejected it and given its verdict and assessment instead.

The GCC concluded that while it could not find direct evidence that the ECB violated its mandate by engaging in monetary financing of government deficits, the ECB did not give sufficient justification for its decision to start QE in 2015, such as considering the pros and cons of the PSPP and engaging in a proportionality assessment. It also found that the ECJ ruling was 'not comprehensible' because if did not engage in or ask for this

[1] BVerfG, Judgment of the Second Senate of 05 May 2020 - 2 BvR 859/15 -, paras. (1-237) and accompanying press release No. 32/2020.

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assessment either. Similarly, it found that the German parliament and government were remiss because they did not sufficiently check what the ECB was doing in its use of unconventional monetary policy, which they had a responsibility to do.

Finally, the GCC said that the ECB now has three months to provide the necessary justification for the PSPP, otherwise the Bundesbank will have to stop its participation in the programme and over time sell the government bonds that it has already purchased back into the market.

### The Bundesbank is unlikely to stop QE

While at first glance the ruling by the GCC is concerning, we think it is highly unlikely that the Bundesbank will stop QE bond purchases in three months' time or sell its existing holdings of government bonds bought under the PSPP back into the market.

Instead, it is more likely that the ECB, or the Bundesbank directly, will provide a justification for the PSPP, which will then have to be assessed by the GCC and possibly the German parliament as well. This will take some time, but it should ultimately be possible to satisfy the GCC of the proportionality of QE, especially as the ECB has already carried out various studies on its impact.

Our interpretation of the GCC decision is that ultimately they would like a more thorough explanation and justification from the ECB for its actions and more oversight from the German parliament as well. In this context, we think it is highly unlikely that the German parliament would block the ECB's decisions, especially in the current environment of economic crisis. Indeed, German Chancellor Angela Merkel said last week in the lower house of the German parliament following the GCC's decision that she wanted to make sure that the Bundesbank can continue to participate in QE, and that the GCC's verdict gives a greater push for European integration.

### The verdict could have implications for PEPP

However, the GCC's verdict could have implications for the ECB's recently announced Pandemic Emergency Purchase Programme (PEPP). This was set up in March this year, at an emergency ECB meeting, to buy EUR 750bn of government bonds and private sector securities over the course of 2020, because of the COVID-19 epidemic.

While the GCC specifically states that the verdict relates to the QE programme announced in 2015, the PSPP, and not to the PEPP, a similar complaint could be made to the GCC on the merits of the PEPP, in which case it would then presumably apply the same reasoning and criteria that it has just laid out for the PSPP, asking for more justification and explanation from the ECB for example, and evidence of a proportionality assessment.

One reason why the GCC found that there was no clear evidence that the ECB's PSPP violated the monetary financing prohibition is because of the various limits and constraints the ECB included when it created the PSPP in 2015. In particular, the GCC mentioned the capital key, issue and issuer limits, and minimum credit rating conditions attached to government bond purchases under the PSPP as important reasons why it was not monetary financing of government deficits.

These constraints have been considerably relaxed for the PEPP, so it could be argued that it comes closer to monetary financing and the GCC would therefore deem to be illegal. For example, the issue/issuer limit has been waived and the ECB has so far disproportionately bought periphery bonds, especially Italian government bonds, suggesting that it is also showing flexibility with respect to the capital key. (The capital key is a previously self-imposed constraint by the ECB in its government bond purchases that it will only buy Eurozone government bonds in proportion to their relative GDP size, so as not to favour one country over another, or buy more bonds of one country simply because it has higher debt levels.)

Therefore, there is the risk that if a complaint were brought to the GCC regarding the PEPP, the GCC would conclude that there was sufficient evidence given the way it was constructed that it went beyond the ECB's mandate. Nevertheless, such a process with a fresh legal complaint would likely take many years before getting to this point. Therefore, in the near term, we do not think it would stop the ECB's PEPP either.

### The ECB may increase PEPP beyond 750bn

However, to the extent that the ECB will now have to be more careful about sticking to its self-imposed conditions going forward, this is a constraint that could impact its credibility and firepower with markets. Nevertheless, since the GCC announcement, the ECB has made it clear that is does not feel constrained by the verdict and that it will continue with QE and could even increase the size of government bond purchases if it deems this to be necessary.

An important test of this will come at the June 4 ECB monetary policy meeting. A clear commitment to increase the size and duration of the PEPP would help in assuaging investors' concerns that the GCC judgement has clipped the ECB's wings and made it more cautious on QE.

Indeed, paradoxically, the GCC verdict could increase the chances of the ECB increasing PEPP in the next few weeks or months in order to assert its independence and head off downside risks to the economy and financial markets.

### Conclusions and bond market implications

Periphery bond markets will likely remain volatile. The standoff between the GCC and ECJ is unlikely to be resolved quickly and this may be a cause for uncertainty about the future of the ECB's asset purchase programmes in some investors' minds. More generally, economic conditions and Eurozone government finances will remain weak because of the COVID-19 epidemic. However, as explained above, if we are right that the GCC's ruling forces the ECB's hand in increasing the size of the PEPP relatively soon, there could even be some near-term tightening in periphery bond spreads.

Ultimately, the GCC verdict simply precipitates what was likely to eventually be the endgame for the Eurozone. Germany will have to decide what it is prepared to do in order to keep the single currency together and whether it will explicitly allow the ECB to buy government bonds in large amounts. The GCC verdict has brought this crunch point nearer, but our key conclusion is that it is unlikely to stop the ECB's QE anytime soon nor prevent the Bundesbank's involvement in government bond purchases.

Indeed, in our view, the ECB's QE programme is an important part of the monetary policy toolkit, especially with the policy rate already in negative territory. It is therefore vitally important that it can continue.

ECB`s PEPP keeps periphery spreads contained despite newsflow


Source: Bloomberg

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