The wisdom of Karlsruhe: The OMT court case should be dismissed

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An ongoing German Constitutional Court case threatens to make the Eurozone Crisis much worse. This column argues that a Eurozone breakup could well be self-fulfilling given the absence of large-scale fiscal backstopping. The ECB's Outright Monetary Transactions (OMT) programme has so far blocked speculation that could lead to such a breakup. A German court ruling against the OMT would destroy the programme's credibility. The court would be wise to dismiss the case, if it does not want to risk becoming a threat to Eurozone stability and to taxpayers in Germany and beyond.

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This week the German Constitutional Court in Karlsruhe is considering a case in which the plaintiffs oppose the Outright Monetary Transactions (OMT) programme announced last September by the ECB. The court will consider whether the ECB overstepped its mandate and thus imposed undue risks on German taxpayers. The court would be wise to dismiss the case, if it does not want to risk becoming a threat to Eurozone stability and to taxpayers in Germany and beyond.

Since the court itself has invited economists to testify in the case, in this column we consider only economic reasoning.

OMT logic

The OMT was intended to stop a vicious spiral in spreads on sovereign bonds, which was translating into ever higher borrowing rates for the real economy in EZ countries with problems. This falls squarely within the mandate of the ECB. The ECB is supposed to ensure that monetary conditions are appropriate for the real economy to maintain price stability.

In a detailed deposition to the court, the Bundesbank discusses the intricacies of the transmission mechanism and concludes that differences in the level of interest rates across different countries of the Eurozone reflect economic fundamentals rather than a broken transmission mechanism. OMT is thus, the Bundesbank argues, outside the ECB's mandate.

But the Bundesbank fails to acknowledge that during the escalating crisis period of 2010-12, the ECB was no longer able to control monetary conditions – not even the direction of change. Despite continuous efforts to loosen monetary conditions, conditions steadily tightened in some countries. The ECB was losing control over the very first stage of the transmission process.

- The German Constitutional Court need not discuss the role of models for the transmission mechanism (fundamentals versus expectations in forming risk premiums, or multiple equilibria with creditor runs).

These issues are difficult enough for economists to assess and certainly cannot be decided by courts.

- A legal view on these issues would seriously endanger the independence of the ECB.

This independence has rightly been in very high regard – particularly in Germany. It would be ironic if the highest German court were to undermine it. We can well imagine what The German Court would say if high courts in other countries started interfering with ECB decisions.

The magic of OMT

OMT works through the successful communication of a commitment "to do everything it takes …". And the OMT had immediate success in stopping the viscous circle of spiralling sovereign bond spreads and it has started to affect lending rates. It has done this without the ECB having to buy a single bond so far. This is a free lunch, where a credible commitment alone is sufficient to eliminate the speculative equilibrium.

The OMT success is based on a mechanism just like the one for bank deposit insurance. Deposit insurance eliminates the possibility of a self-fulfilling bank run (Diamond and Dybvig 1983). Namely the situation where a solvent bank becomes illiquid and fails simply because depositors fear that the bank would become insolvent were a run to occur. Fear of the run can cause the run.

To eliminate such bank runs fully, deposit insurance should be unlimited. Any person who wishes to withdraw his or her short-term deposits must be able to do so. Whether the withdrawal is motivated by a need for liquidity or simply by a panic makes no difference. This is exactly what was done in Europe in 2008 at the height of the financial crisis and, indeed, we have not observed any panic movement. The mere announcement was sufficient without any need for actual intervention.[1]

As in the case of deposit insurance, the OMT programme could work even if the ECB never buys assets. It is sufficient that it announce its intention to buy were a run to occur.

- No wise economist would suggest dropping deposit insurance, nor should one suggest preventing OMT.

After the ECB announced the OMT programme, markets have been stabilised without the ECB having to buy a single Spanish or Italian bond. But for this to work, it is necessary that the commitment be unlimited in size.

The intervention of the Swiss National Bank capping the exchange rate of the Swiss franc is another example of a credible commitment that works. Except in times of extraordinary stress, the Swiss National Bank has not had to intervene. The central bank is on the right side of the trade – selling francs – so it has unlimited buying power to keep the exchange rate at or below the peg of 1.2 Swiss francs per euro. The markets know this, and there are no speculative attacks.

How a ruling could ruin the OMT magic

A ruling by the German Court in Karlsruhe that there must be financial limits on the commitment would destroy the credibility of OMT. A requirement that any specific use of the scheme would have to be approved by the Bundestag would do the same. Markets would again drive up spreads to unsustainable levels, this time with no way of stopping them.

It would be self-defeating if the German Constitutional Court were to undo the magic of the OMT and thus force the ECB to start buying bonds. Sovereign insolvencies would entail such massive costs to creditors that the ECB would not knowingly take on such a liability. It should not commit to purchase bonds of a country likely to default – hence the need for a European Stability Mechanism programme with conditionality as a prerequisite for OMT.

Conclusions

The Eurozone is still fragile. Both at the country level and at the supranational level, much remains to be done to build a robust framework. In the meantime, in the absence of large-scale fiscal backstopping, speculations about a Eurozone breakup could be self-fulfilling. Fear of a breakup could cause a breakup. At the moment, these speculations have been successfully blocked by the OMT programme.

The integrity of the Eurozone is at the very core of the ECB mandate, because a breakup would be extremely disruptive and costly, for creditor as well as debtor countries, including German taxpayers. We must hope that the Court will see that damaging the ECB's credibility would not be wise.

Editor's note: A version of the column appeared in German in Handelsblatt earlier this week.

References

Gertler, Mark and Nobuhiro Kiyotaki (2013). “Banking, Liquidity and Bank Runs in an Infinite Horizon Economy”, Princeton manuscript.

Diamond, Peter and Dybvig (1983). “Bank Runs, Deposit Insurance, and Liquidity”, *Journal of Political Economy*, Vol. 91, No. 3, Jun., 1983.

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1 The analogy between deposit insurance for commercial banks and central bank interventions such as the OMT has recently been analysed by Mark Gertler and Nobuhiro Kiyotaki in

"Banking, Liquidity and Bank Runs in an Infinite Horizon Economy" (2013) which extends the time-honoured Diamond and Dybvig (1983) model to show that a central bank commitment to use lender of last resort policies to support liquidation prices might be effective in keeping liquidation prices sufficiently high to rule out the possibility of runs.

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