Oral hearing of the Federal Constitutional Court 16 February 2016 in the OMT proceedings

Speech by Yves Mersch, Member of the Executive Board of the ECB,

Introductory statement of the European Central Bank,

Karlsruhe, 16 February 2016

Mr Chairman,

Distinguished members of the Second Senate,

Introduction

You have once again invited the European Central Bank to provide its opinion, as an expert third party, on the decision of the Governing Council of the European Central Bank of 6 September 2012, whose compatibility with national constitutional law you are reviewing in these proceedings. This is the decision that approves the main parameters of the Eurosystem's outright monetary transactions on the secondary market for government bonds - so-called OMTs. I am happy to accept this invitation.

What has changed since the last oral hearing on 11 June 2013?

The Court of Justice of the European Union has, on the basis of the facts provided by you, responded to the questions submitted to it for a preliminary ruling.

The Court of Justice of the European Union, which is competent under the Treaties to interpret Union law and the validity of the acts of the Union's institutions, including the European Central Bank, found OMTs to be compatible with Union law:

The European Central Bank did not exceed its monetary policy mandate either as regards the conditionality, the selectivity or the parallelism of OMTs nor as a circumvention of the limits and conditions laid down by the assistance programmes of the European Stability Mechanism – the so-called ESM. The Court of Justice of the European Union followed the arguments put forward by the European Central Bank and confirmed that OMTs in view of their objectives and the instruments provided for achieving them, fall within the area of monetary policy and therefore within the powers of the Eurosystem. Monetary policy measures, such as OMTs, may have indirect effects on the stability of the euro area, without this leading to monetary policy measures being treated as equivalent to economic policy measures. The fact that the European Central Bank will take an independent monetary policy decision on the implementation of OMTs also excludes the possibility that the ESM's assistance programmes were circumvented.

The Court of Justice of the European Union also confirmed that OMTs are proportional and that the European Central Bank, as regards the judicial review of these conditions, should be granted a broad discretion. As a result the European Central Bank was entitled to take the view that the purchase of government bonds on the secondary markets, in accordance with the conditions laid down on 6 September 2012, is likely to facilitate the monetary policy transmission mechanism and to safeguard the singleness of monetary policy. These conditions were characterised by the fact that the interest rates for government bonds in the various euro area Member States were highly volatile with extreme spreads, which were not caused by macroeconomic differences but by strong distortions of the government bond markets, largely due to the unfounded concerns of investors regarding the reversibility of the euro. OMTs do not go beyond what is required in order to achieve these objectives. They are not only strictly linked to their objectives, their volume is also - as the European Central Bank indicated in the last oral hearing - limited in several respects.

The Court of Justice of the European Union also decided that OMTs do not breach the prohibition of monetary financing. In particular, the Court emphasised that OMTs do not remove the impetus for Member States to follow a sound budgetary policy. The Governing Council of the European Central Bank's draft decision and draft guideline on OMTs, which were already available on 6 September 2012, contain adequate safeguards to ensure that the intervention of the Eurosystem does not result in an effect equivalent to that of a direct purchase of government bonds from the public authorities and bodies of the Member States.

I should like to cite a few examples. The European Central Bank's Governing Council decides on the scope, the start, the continuation and the suspension of the intervention on the secondary markets. In addition, a minimum period is observed between the issue of a security on the primary market and its purchase on the secondary market. Furthermore, any prior announcement concerning either its decision to carry out such purchases or the volume of purchases envisaged is precluded. There is therefore no certainty that government bonds will be purchased.

What role does the European Central Bank see for itself in these oral proceedings in the light of this confirmation of its actions?

The European Central Bank cannot make any statements on the compatibility of OMTs with national constitutional law as it has no competence in this regard. Nevertheless, the ECB's working assumption has always been that the Maastricht Treaty, which transferred monetary policy to the European Central Bank, has been declared as being compatible with national constitutional law.

The European Central Bank is participating in this oral hearing in order to assist in clarifying any remaining questions, insofar as they are based on the subject matter of these proceedings, i.e. OMTs are covered but not other monetary policy measures.

At the same time the European Central Bank's Governing Council must be able to decide independently on future monetary policy, in order to fulfil its duty of maintaining price stability in the euro area, as the Senate has described in paragraph 32 of its order for reference.

Mr Chairman,

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Following on from these introductory words I will focus on two points, which you identified in your communication with the European Central Bank as being significant:

- First, the timeliness and modalities for the implementation of OMTs;
- Second, the possible volume of OMTs and potential risks for the federal budget.

Timeliness and modalities for the implementation of OMTs

As regards the timeliness of OMTs, let me be quite clear: OMTs were developed in January 2012, to confront an extraordinary crisis situation. This crisis situation was characterised by massive distortions of the government bond market that developed their own momentum. This in turn led to a disruption of the monetary policy transmission mechanism, which posed a threat for price stability.

With OMTs the Eurosystem substantiated one of the monetary policy instruments provided for under the Statute. It can be activated by the Governing Council, providing the conditions and the need for such action are present.

The European Central Bank's Governing Council may activate OMTs under the following conditions, which must be met cumulatively:

- The Governing Council of the European Central Bank must establish that the monetary policy transmission mechanism is impaired, in particular due to unfounded fears regarding the reversibility of the euro, and is leading to unwarranted spreads on the government bond markets.
- The Member State whose government bonds will be sold on the secondary market must participate in an appropriate ESM programme. Appropriate, in this context, means exclusively macroeconomic adjustment programmes or enhanced conditions credit lines, which facilitate primary market purchases on the government bonds market via a corresponding ESM facility.
- The Member State whose government bonds are being purchased on the secondary market must comply with the strict conditionality and satisfactorily implement, as verified by the Governing Council of the European Central Bank, the programme.
- The Member State whose government bonds are being purchased on the secondary market must have access, or be regaining access, to the government bonds market. This will also be verified by the European Central Bank's Governing Council.

As regards the first condition, the impairments to the monetary policy transmission mechanism have noticeably declined, not least thanks to the monetary policy measures carried out by the European Central Bank, in particular the development of OMTs. The euro area is confronting a slow but steady recovery. Certain Member States that in 2011 and 2012 were subject to market overreactions are now seeing signs of positive growth. Irrespective of the fact that yields for government bonds have reacted in varying degrees to new economic developments, there has been a clear reduction in the yield spreads compared to the situation in 2012. It is not the aim of OMTs to harmonise interest rates regardless of the differences between Member States' macroeconomic or budgetary situation.

Concerning the second condition, two euro area Member States are currently undergoing ESM macroeconomic adjustment programmes. However, none of these programmes allow primary market purchases through the ESM to the government bonds market.

In conclusion, I can state that OMTs are in principle available as monetary policy instruments. The conditions for their crisis and location-related activation are, however, not currently met.

Possible volumes and potential risks for the federal budget.

With regard to the possible volume of OMTs it remains the case that no ex ante quantitative limits are set on the size of OMTs in order to prevent market participants from adjusting to this situation and using these instruments for their own purposes to the detriment of the effectivity of the monetary policy instruments put in place. Notwithstanding this, the possible volume of OMTs is in fact quantitatively limited to one to three-year government bonds, which are suitable for OMTs. Government bonds with a maturity of one to three years form only a small part of the entire volume of government bonds. The Court of Justice of the European Union has confirmed that it follows from this that the commitments that the European Central Bank enters into are, in fact, circumscribed and limited. In order to ensure that maturities are not significantly shortened, it is foreseen that the European Central Bank's Governing Council will closely monitor the maturity structure and the termination of new issues of government bonds in the concerned Member States. Thus the volume of OMTs is limited in a variety of ways.

In assessing the potential risks of OMTs it should be taken into account that, in principle, the use of monetary policy instruments to maintain price stability entails financial risks for the Eurosystem. This applies not only to OMTs but also to main refinancing operations, to cite just one standard monetary policy instrument as an example. The Eurosystem uses main refinancing operations to make central bank money available to banks. In principle, these bank loans could also fail, even though the risk of this occurring is slight. Therefore, the European Central Bank's Governing Council limits these risks, by requiring the provision of collateral for main refinancing operations. The European Central Bank's Governing Council has also taken precautions with regard to OMTs in order to limit the Eurosystem's financial risk. This is done, in particular, by applying a requirement of strict conditionality and the monitoring of the satisfactory implementation of the programme. This strict conditionality, compliance with which is to be independently assessed by

the European Central Bank from the monetary policy perspective, ensures that the Member States concerned apply sufficient budgetary discipline and carry out structural reforms, to achieve a sustainable budgetary position. For the implementation of OMTs, as for other monetary policy operations of the European Central Bank, creditworthiness and risk management rules apply. In this way an excessive default risk is avoided.

It should be added, that the European Central Bank will not carry out any purchases using OMTs during the review of an ESM assistance programme. This also ensures that market conditions are not directly influenced by European Central Bank purchases whilst the programme is being assessed by the Troika.

The comparison between OMTs and main refinancing operations demonstrates that the financial risks of various monetary policy instruments differ as to their degree but not as regards their principle nature. Thus the Court of Justice of the European Union held in its judgment that the precautions foreseen for OMTs are likely to reduce the risk of losses. It also recalled that a central bank, such as the European Central Bank, has a duty to take decisions that, like open market transactions, inevitably involve a risk of loss.

With regard to the necessity mentioned in the hearing outline, in connection with the potential risks of OMTs for the federal budget, for a recapitalisation of the Bundesbank, I would confirm the position of the European Central Bank that was provided in the last oral hearing.

As far as I am aware, under German law there is no obligation for the federal government to recapitalise the Bundesbank, even when its losses are of such a magnitude that its equity base is threatened.

Such a “default liability” can also not be deduced as a general rule under Union law in respect of the individual Member States when the central bank’s equity is drastically reduced. In accordance with the principle of financial independence as established by Article 130 of the Treaty on the Functioning of the European Union it follows that a central bank must permanently have adequate equity available to fulfil its monetary policy tasks within the Eurosystem. However, this does not mean that every loss must be immediately and fully offset by private or public shareholders or the Member States. A central bank can in the short and medium-term, even with reduced or negative equity, fulfil its Eurosystem monetary policy tasks. In this respect a reduced or negative equity does not preclude from the outset an orderly and stability-oriented monetary policy.

Only when this situation continues for too lengthy a period – the European Central Bank’s last Convergence Report spoke of “a prolonged period of time” - would doubts arise as to whether the central bank can still adequately fulfil its Eurosystem monetary policy tasks. Only in such an extreme case - and exclusively in this case - would they be recapitalised, not immediately, but - again in the words of the European Central Bank’s Convergence Report - “within a reasonable period of time”.

Conclusion

Mr Chairman,

Distinguished members of the Second Senate,

I and my colleagues are at your disposal for further questions on these and other issues.