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Press Release

- Sinn's misleading statements at Germany's Constitutional Court
- FAZ.net user network and AfD voters have strong overlap

The ECB's Role, Banking Union and the OMT Programme

In 2012, the European Central Bank adopted the Outright Monetary Transactions Programme which consists of the policy option that the ECB could buy government bonds with a remaining maturity of 1 to 3 years, in principal in unlimited quantity; provided that the respective government has concluded an adjustment programme with the rescue fund ESM. Germany's Constitutional Court has raised doubts about the OMT programme – apparently on the basis of the testimony of Hans-Werner Sinn, the head of both the Ifo Institute and the CESifo in Munich. Sinn had argued that such intervention would amount to an economic policy intervention by the ECB, i.e. an overstepping of its mandate. The German court has decided to submit the case to the European Court of Justice, however it has already indicated that in the case that the European Court of Justice would not put reasonable limits on the OMT programme, the Deutsche Bundesbank would no longer be allowed to be part of the European Central Bank, with the consequence that Germany would have to leave the euro area. Unlimited intervention is a central bank turn of phrase which can also be found in other cases where a central bank wants to signal its strong determination to the market that it definitely will want to achieve a certain goal – for example, Switzerland's central bank announced on September 6, 2011, that it will defend a target Swiss Franc-€ exchange rate, namely, that the SFR should not fall below 1,20 SFR/€. If the euro would depreciate below this limit, the central bank would engage "in **unconditional buying of foreign exchange**"; this is the wording of a central bank with a very high reputation.

There is certainly a critical level of foreign reserves beyond which the Swiss Central Bank would not like to further accumulate euro currency, but as long as this level – unknown to speculators in the foreign exchange market – has not been reached, market participants will most likely not speculate against the critical exchange rate limit of the Swiss Central Bank: i.e. its goal is achieved. The higher the holdings of euro in the stock of foreign exchange, the higher the risk from an appreciation of the Swiss Franc (a 10% appreciation implies that the Swiss central bank will suffer a loss of 0.1 times the stock of foreign reserves denominated in €). Hence, once a critically high amount of euros has been accumulated by the central bank, the market will start to raise doubts about the exchange rate limit of 1.20 SFR/€. Should the Swiss central bank decide to immediately announce that it will defend the critical parity of 1.20 SFR/€ only within a limited approach, markets will be quick to test this limit and this implies that the announced limit is not credible at all. Following the strange logic of Hans Werner Sinn, who is against OMT, this implies that Switzerland would be forced by a Constitutional Court not to implement a credible exchange rate limit and so the Swiss economy would come under heavy stress of ongoing real appreciations which would translate into deflation, the massive reduction of net exports of goods and services and also a fall of foreign direct investment inflows so that mass unemployment and deflation could be the result (!). If the ECB should be forced to announce at the beginning of an OMT programme a certain limit on intervention, markets will be quick to test this limit and this means that the OMT programme would be unworkable in practice. Thus the ECB would, for example, be impaired in correcting a "bad equilibrium" which can occur in financial markets under certain conditions (see for example the paper by Gärtner/Griesbach, 2012; from the University of St. Gallen). However, this would be a very strange scenario, as it is in the natural interest of the population that in a situation with multiple equilibriums the central bank should try to achieve the favourable equilibrium solution. It is unlikely that any researcher from any central bank would deny this logic and it would be irresponsible to deny a central bank this policy option.

It also is noteworthy, that the whole scenario analysed by the German Constitutional Court has changed with the enhanced mandate of the ECB, which will be the prudential supervisor of big banks in the euro area as of November 2014; at the discretion of the ECB it can also extend its supervisory activities over smaller banks. By implication, the ECB will now have much better insight into the viability of banks in euro countries and hence the risk of incurring major losses when buying, within OMT, government bonds or other assets from an ESM programme country will be rather limited in the future. Naturally, however, there always remains some risk in ECB transactions, however this simply reflects the fact that we are living in a stochastic world with imperfect information and inefficient financial markets. There is also, of course, some risk involved in any open market policy (central bank buying government bonds) of the FED or the ECB.

The German Constitutional Court has obviously followed the strange conjecture of Mr. Sinn, when he argued that if market participants know about an OMT programme, it makes no difference whether the ECB buys newly issued paper or on the secondary market where it would buy from other market participants. This view is deeply flawed as the announcement of an OMT programme does not imply that the ECB could not end the buying of government bonds from the ESM programme country. The ECB has full discretion here so that market participants buying in the first round always face some risk in the future pricing of the bond. Thus, the ECB's buying in the secondary market is different from buying in the original issuing process – from that one should like to get an adequate market pricing and this is exactly what is achieved if the ECB lets markets work in the first round. To argue that buying bonds directly from the issuing country is fiscal policy and that buying in secondary markets amounts to the same thing is wrong.

It should be noted that any expansionary open market operation will bring about three effects, namely, a fall of the interest rate and a depreciation of the currency, as is well-known from the standard Branson model for an economy with flexible exchange rates. There is also an apparent effect on the government budget as the third effect, which is equal to the amount of bonds bought times the market interest rate – assuming that the central bank's increased profits will be fully distributed to the owners (for example Germany has a share of 18% of the ECB equity capital, France 14.2% etc.) so that governments will benefit through an effective reduction of interest payments. This, however, is a side-effect of all expansionary open market operations and if Mr. Sinn refutes OMT as a form of hidden fiscal policy on this ground, it only shows that he is not familiar with the fine print of open market operations in central banks. The Court should rethink the case.

Mr. Sinn with his populist anti-ECB views – poorly founded in theoretical terms - has to some extent grossly misled Germany's Constitutional Court; that Court could, however, not fully anticipate the banking union which is part of the new ECB's mandate. Thus, the verdict of the Court was reached on the basis of misleading and missing information. Finally, Mr. Sinn's statement argues that the US FED does not buy the bonds of US states – as he emphasized in his testimony before the Court. This is correct, but incomplete; nobody in Europe knows what bonds the US central bank would buy in a period of economic crisis and massive adverse shocks if no bonds of the central government existed: This is exactly the situation in the euro area where no supranational bonds exist. Nobody can rule out – perhaps with the exception of Mr. Sinn – that the FED would buy, with good reason as part of monetary policy, state bonds; either from all states or from some states. Mr. Sinn has misled the public, moreover, his strange views are also a driver for the right-wing AfD, a new anti-euro party in Germany which also is against free EU migration.

The standards of the debate on both the euro and the ECB have deteriorated in Germany. As early as September 11, 2011, Mr. Sinn called publicly (in a statement in the Frankfurter Allgemeine Sonntagszeitung) on the Deutsche Bundesbank and the German government to boycott the ECB; such a statement is well beyond the role of a scientist – at least within the approach of Critical Rationalism. The ECB, as an EU institution, has broad democratic legitimacy.

As regards the media networking of populist groups, AfD voters – according to the Bertelsmann Foundation Report (spotlight Europe # 2014/02) – and the users of FAZ.net show a very strong overlap: The FAZ.net has been identified in that report to be a crucial element of anti-euro networking on the internet. Why the formerly liberal FAZ has shifted its position to the far right, at least in the Economics/Finance section, is unclear. Recently it has argued that the ECB is responsible for the losses of German residents on savings accounts and lower interest income, respectively – the overall picture, which takes into account that the low interest rates (partly caused by the US and the UK) have also brought enormous wealth gains for those holding stocks and enjoying much higher stock prices, has not been considered: The net wealth effect is certainly positive for the German economy. The FAZ has developed a sharp anti-euro bias that represents part of a new right-wing ideology.

The debate about an adequate monetary policy and fiscal policy in the euro area, and the combination of structural reforms and austerity measures, should be based on careful analysis of macroeconomic and institutional aspects as well as International Economics. As regards the correction of international imbalances and current account deficits, respectively, the OBSTFELD-ROGOFF paper (2005) in the Brookings Papers on Economic Activity is of key relevance, as it shows – within a theoretical framework and based on simulations – to what extent external devaluation and internal devaluation (concerning the ratio of non-tradables prices to tradables prices) can be useful for correcting imbalances.