

5 September 2011

## **The Karlsruhe Factor: What will the German Constitutional Court ruling mean for the eurozone crisis?**

### **Summary**

On 7 September, the German Constitutional Court will deliver its keenly anticipated verdict on the eurozone bailouts, following several challenges against the rescue packages of Greece, Ireland and Portugal in addition to complaints against the ECB's bond buying programme.<sup>1</sup> The Court will almost certainly approve the bailouts, fearing that any other decision would spell disaster for the euro. In order to protect its reputation, however, the Court could well demand more influence for the German parliament and lay down additional constitutional red lines – possibly including restrictions on joint debt liabilities in the eurozone – in return for approving the bailouts. Any such limits would hugely complicate any move towards a fiscal union in the eurozone.

Injecting more parliamentary democracy into the eurozone crisis is clearly a good thing, but it will also further limit EU leaders' room for manoeuvre when dealing with the crisis, which in turn could increase market uncertainty. Unfortunately for the ECB, under such a scenario it would once again be forced to pick up the responsibility of lender of last resort, as the EFSF will be too inflexible and unresponsive to play that role.

### **Background**

In May 2010 eurozone leaders agreed to establish two separate bailout funds – the European Financial Stability Mechanism (EFSF) and the European Financial Stability Mechanism (EFSM) – in a bid to prevent Greece from defaulting on its debt and stabilise the euro. Since then, Ireland and Portugal have also tapped the bailout funds, and Greece has requested a second rescue package (pending approval by the Finnish parliament).<sup>2</sup> Germany is currently underwriting close to €50bn in loan guarantees under the current bailouts, although this is set to increase once the second Greek bailout is finalised.

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<sup>1</sup> German Constitutional Court Press release, 'Urteilsverkündung in Sachen „Griechenlandhilfe / Euro-Rettungsschirm“, 23 August 2011: <http://www.bundesverfassungsgericht.de/pressemitteilungen/bvg11-054.html>. Although a complaint has been lodged against the ECB's bond buying programme (SMP) it looks unlikely that the court will provide a ruling on the issue on 7 September or at least will not focus heavily on the topic, judging by the context of a preliminary hearing on the challenges earlier in year.

<sup>2</sup> For more on the second Greek bailout, see Open Europe, "Abandon Ship: time to stop bailing out Greece?", June 2011, available at <http://www.openeurope.org.uk/research/greece2ndbailout.pdf>

Since May 2010, the European Central Bank has also bought some €115.5bn in government bonds on the secondary market in an attempt to keep borrowing costs down and shore up struggling countries.

In the wake of these extraordinary decisions, a series of constitutional complaints have been filed with the German Constitutional Court (*Bundesverfassungsgericht*). The Court, based in Karlsruhe, is charged with overseeing the German Basic Law and possesses the power to rule laws and measures unconstitutional, in effect rendering them void.

The eurozone rescue packages are highly controversial in Germany since they appear to water down, or even break, the EU Treaties' 'no-bailout' clause – which prohibits one member state from taking on the debt of another. Article 104b of the Maastricht Treaty – which has been carried over to successive Treaties – states that,

“The Community shall not be liable for or assume the commitments of central governments, regional, local or other public authorities.”

At the same time, the ECB is explicitly forbidden by its own statute from engaging in fiscal policy and “taking instructions” from governments.<sup>3</sup> That the ECB should remain completely independent from politics was a key promise given to the German electorates when the Single Currency was forged, and those who now challenge the bailouts argue that the ECB has broken both the spirit and the letter of its own statute by buying government bonds (though the ECB itself argues that it is merely transmitting monetary policy).<sup>4</sup>

Around 100 claimants are, independently from each other, challenging the bailouts at the Court, although it has decided to only consider 15 of these. Although, the claimants are also arguing that bailouts violate the EU Treaties, they are mainly challenging the decisions in light of the German Basic Law. Three complaints, submitted by three separate groups, have figured most prominently in the public discussions over recent months (discussed below). Though using different lines of reasoning, all three refer to the same legal provisions arguing that the bailouts breach the German Basic Law in various ways, including:<sup>5</sup>

- The fundamental principle of democracy and electoral law by limiting the role of the German parliament in key decisions involving public money.
- The fundamental right of property by violating the EU's no-bailout clause and fostering inflationary tendencies and moral hazard in the monetary union, which in turn have a negative impact on the right of property by the owner of money.
- The ECB's purchases of government bonds via its Securities and Markets programme (SMP) distorts competitiveness in capital markets.

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<sup>3</sup> ECB, Article 7, Statute of the European System of Central Banks (ESCB) and of the European Central Bank, see [.ecb.int/ecb/legal/pdf/en\\_statute\\_2.pdf](http://www.ecb.int/ecb/legal/pdf/en_statute_2.pdf)

<sup>4</sup> See *Open Europe*, 'A House Built on Sand', June 2011, available at: <http://www.openeurope.org.uk/research/ECBandtheeuro.pdf>

<sup>5</sup> A good summary of the court cases: Deutsch Bank research, 'Constitutional Complaints – German rejection of rescue packages unlikely', 17 March 2011, available at: [http://www.dbresearch.info/PROD/DBR\\_INTERNET\\_EN-PROD/PROD000000000271154/Constitutional+complaints%3A+German+rejection+of+rescue+packages+unlikely.pdf](http://www.dbresearch.info/PROD/DBR_INTERNET_EN-PROD/PROD000000000271154/Constitutional+complaints%3A+German+rejection+of+rescue+packages+unlikely.pdf)

The Court will address the complaints from these three claimants in the judgement that will be delivered on 7 September, though it looks unlikely that the court will provide a ruling on the challenges against the ECB's SMP. The stakes are enormous. Should the Court find the complaints substantive, and effectively over-turn the bailouts, markets would descend into chaos.

### **What will the Court's decision be?**

- The Court will almost certainly find the complaints non-substantive – and therefore approve the bailouts – probably citing what it sees as the need to balance different legally protected interests, e.g. economic and monetary stability on the one hand, and property (owners of money) and democratic rights on the other. However, while the Court clearly is subject to political influences, it is also susceptible to public opinion, and will want to guard its own reputation. Similar to the line it has taken in past rulings on the Maastricht Treaty (1993), the euro itself (1998) and the Lisbon Treaty (2009), the Court might try to avoid sounding too positive on the bailouts by laying down further conditions as quid pro quo for nodding through the new measures.
- There is some uncertainty over whether the court will rule on both the EFSF, and its post-2013 successor, the European Stability Mechanism (ESM) on 7 September. Given that the German Parliament is still to approve the ESM, it's unclear whether the Court could pass judgement in any substantive way on something that has not yet been passed.<sup>6</sup>
- The judges have already made some statements, with the President of the Court, Andreas Voßkuhle, stressing that "Europe's future and the correct economic strategy to deal with the public debt crisis" are not part of the consideration. Despite this, the claimants have argued that the economic aspects cannot be separated from the wider legal discussion.<sup>7</sup> When the Court held hearings about the complaints, on 5 July 2011, the Court only scrutinised some of the legal arguments put forth in the complaints, which has led to criticism that the Court suffers from selection bias.<sup>8</sup> In its ruling, the Court may not, for example, address the complaints relating to the ECB's bond-buying programme.<sup>9</sup>

### **What will be the impact of the ruling?**

- No matter how the judges rule, the outcome will be important, as it will provide more clarity about the significant legal and democratic constraints the German government faces as it attempts to tackle the eurozone crisis.
- The constitutional complaints have already had an impact on the eurozone crisis and EU policy-making. The German insistence on an amendment to the EU Treaties (Art. 136 TFEU) to allow for countries to default or restructure under the

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<sup>6</sup> For an interesting discussion, see: *Der Spiegel*, 'German Court likely to rule 'Yes, But' on Euro Bailout', 7 June 2011: <http://www.spiegel.de/international/europe/0,1518,772674,00.html>

<sup>7</sup> Cited in *Focus*, 'Karlsruhe entscheidet über Euro-Rettungsschirm', 23 August 2011: [http://www.focus.de/politik/deutschland/prozesse-karlsruhe-entscheidet-ueber-euro-rettungsschirm\\_aid\\_658017.html](http://www.focus.de/politik/deutschland/prozesse-karlsruhe-entscheidet-ueber-euro-rettungsschirm_aid_658017.html)

<sup>8</sup> German Constitutional Court Press release, 'Mündliche Verhandlung in Sachen „Griechenland-Hilfe / Euro-Rettungsschirm“', 9 June 2011: <http://www.bundesverfassungsgericht.de/pressemitteilungen/bvg11-037.html>

<sup>9</sup> Cited in *Sueddeutsche Zeitung*, 'Karlsruhe prüft Griechenland-Hilfe', 5 July 2011: <http://www.sueddeutsche.de/wirtschaft/verfassungsbeschwerde-karlsruhe-prueft-griechenland-hilfe-1.1116166>

ESM post-2013, was clearly an attempt by German policymakers to pre-empt future bailout challenges at the Court by putting the rescue packages on a sounder constitutional footing. Incidentally, the German insistence on such an amendment was one of the reasons why markets became nervous about Ireland in autumn 2010, as it fuelled investor uncertainty about potential future losses. Germany has also refused to change the no-bailout clause (Art. 125 TFEU) fearing that the Court would rule such a move wholly incompatible with the German Basic Law. In addition, making the EFSF subject to pro rata shares (with Germany currently offering up to €211bn in total loan guarantees) rather than joint liability is clearly designed in part to keep Germany within its constitutional limits.<sup>10</sup>

- As mentioned above, in exchange for approving the bailouts the judges are likely to give the German parliament (presumably both Bundestag and Bundesrat, since the German regions are already pushing to have their say) greater powers over the activation of the EFSF and possibly also the ESM, although the claimants' argue the German parliament already possesses such powers. German Chancellor Angela Merkel has also already indicated that she is willing to give MPs a stronger say, in a bid to get the revised EFSF through Parliament. In fact, the extension of the EFSF's scope and mandate – agreed by eurozone leaders on 21 July amid fears over escalating Italian and Spanish borrowing costs – has threatened to break up Merkel's governing coalition. 23 MPs from her own party have said that they plan to vote against the package when it comes before Parliament on 29 September. Even though the package is likely to pass with support from opposition parties anyway, a coalition split on such a key issue could result in a massive push for an early general election.
- What could make the ruling political dynamite is if the Court lays down specific constitutional red lines, on, for example, joint debt liabilities, an upper ceiling on any future rescue package - asking for additional safeguards for the ESM for example - or on the relationship between the bailouts and Germany's constitutionally rooted debt-brake. Any such limitations would further complicate moves towards a eurozone fiscal union, including the widely discussed pooling of debt and risk through Eurobonds. It's also interesting to see whether the Court will address the reduced interest rates under the second Greek bailout (from over 5% for Greece, Ireland and Portugal under their original bailout deals, to around 3.5% now), since this increases the moral hazard of the loans and decreases the returns from them.
- While it still remains unclear whether the Court will want to go that far, precedence suggests that the judges could indeed lay down some constitutional red lines. In its ruling on the Lisbon Treaty, while stopping just short of striking down the Treaty, the judges ring-fenced several policy areas which it said were vital for a nation to "democratically govern itself", including social policy. The Court required a new law giving the Parliament the right to block further transfer of powers to the EU (not miles away from the UK government's EU Bill).<sup>11</sup>

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<sup>10</sup> Under the expanded EFSF, with a lending capacity of €440bn, this is the total share of the fund which Germany guarantees.

<sup>11</sup> Incidentally, the Court also stated that the European Parliament is an inadequate guarantor of democracy and that the net effect of the Treaty was that national parliaments lost substantial power, see: German Constitutional Court press release, 'Act Approving the Treaty of Lisbon compatible with the Basic Law', 30 June 2009, available at: <http://www.bundesverfassungsgericht.de/en/press/bvg09-072en.html> and Open Europe blog, 'Ja, Aber', 10 July 2009, available at: <http://openeuropeblog.blogspot.com/2009/07/ja-aber.html>

- Giving Parliament a stronger say over EFSF/ESM would further restrict the manoeuvring room of EU politicians to swiftly bail out struggling governments and banks during market turmoil. While injecting more parliamentary democracy is clearly desirable, it will make the EFSF even more inflexible, in turn increasing market uncertainty, as EU leaders could see their hands tied in a crisis situation. One likely side-effect of this would be that the ECB has to take on the role of lender of last resort again (a role it is keen to avoid), as the EFSF would simply be too unresponsive to shoulder that responsibility. That would raise further questions over the political independence of the ECB and its primary mandate of price stability (rather than guarantor of the euro).<sup>12</sup>
- No matter what the decision is, the debate over the legality of the bailouts and the ECB's actions during the crisis is certainly heating up in Germany. In surprisingly stark terms, the German President Christian Wulff recently questioned the ECB's purchases of government bonds, saying:

“I regard the huge buy-up of government bonds of individual states...as legally questionable.”<sup>13</sup>

In a similar vein, Bundesbank President Jens Weidmann has said that ECB bond purchases have

“strained the existing framework of the currency union and blurred the boundaries between monetary policy and fiscal policy.”<sup>14</sup>

The Bundesbank has also warned against further watering down the no-bailout clause, saying:

“Unless and until a fundamental change of regime occurs involving an extensive surrender of national fiscal sovereignty, it is imperative that the no bail-out rule that is still enshrined in the treaties and the associated disciplining function of the capital markets be strengthened, and not fatally weakened.”<sup>15</sup>

- Therefore, these are unlikely to be the last legal challenges against the bailouts. Future complaints can be lodged on the basis that the bailouts pose a threat to Germany's constitutional debt-break, or could come in the wake of a possible Greek default, which would involve outright losses to German taxpayers. Professor Marcus C. Kerber – one of the claimants – is also exploring whether the ECB's actions could be challenged at the European Court of Justice.<sup>16</sup>

### Who are the most prominent complainants?

<sup>12</sup> See *Open Europe*, 'A House Built on Sand', June 2011, available at:

<http://www.openeurope.org.uk/research/ECBandtheeuro.pdf>

<sup>13</sup> Cited in *FT*, 'German president says ECB bond buying illegal', 24 August 2011:

<http://www.ft.com/cms/s/0/b05e5324-ce5f-11e0-99ec-00144feabdc0.html#axzz1Vyikfhif>

<sup>14</sup> Cited in *Handelsblatt*, 'Weidmann kritisiert Europas Regierungen - und die EZB', 1 September 2011:

<http://www.handelsblatt.com/politik/konjunktur/nachrichten/weidmann-kritisiert-europas-regierungen-und-die-ezb/4564552.html>

<sup>15</sup> Open Europe press summary 23 August 2011, available at: <http://www.openeurope.org.uk/media-centre/summary.aspx?id=2666>

<sup>16</sup> Kerber, Städter: Die EZB in der Krise: Unabhängigkeit und Rechtsbindung als Spannungsverhältnis, *Europäische Zeitschrift für Wirtschaftsrecht*, 18 August 2011

- The three most prominent groups that have lodged complaints at the constitutional court are:
  - CSU MP Peter Gauweiler;
  - Five professors, including Joachim Starbatty and Wilhelm Hankel, who in the past also have challenged the Maastricht Treaty, the introduction of the euro, as well as the Lisbon Treaty.
  - The “Europolis Group”, led by Paris and Berlin – based Professor Markus C. Kerber. This complaint is based more on economics, and less on national sovereignty. The group consists of 55 prominent German academics and business leaders, including Hans-Olaf Henkel, the former head of the Germany employers’ organisation BDI. Also Patrick Adenauer, of the Association of Independent Entrepreneurs and Family-Owned Companies, based in Berlin, and the grandson of Chancellor Konrad Adenauer, has supported the Group, without being a formal member.
  
- Incidentally, no representative from the Eurpolis group – which is the most high-profile alliance of the three – was invited to the Court’s hearings on the bailouts.<sup>17</sup> Professor Kerber therefore argues that the Court has deliberately refused to seriously consider and investigate the group’s arguments. On this basis, the group has even filed a complaint against the German Constitutional Court at the European Court of Human Rights in Strasbourg.<sup>18</sup>

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<sup>17</sup> Cited in *Die Welt*, ‘Wem dient Karlsruhe wirklich?’, 18 July 2011:

[http://www.welt.de/print/die\\_welt/politik/article13492591/Wem-dient-Karlsruhe-wirklich.html](http://www.welt.de/print/die_welt/politik/article13492591/Wem-dient-Karlsruhe-wirklich.html)

<sup>18</sup> The Group has also demanded that one of the judges, Udo di Fabio should not be allowed to rule on the issue, as he has participated in public debates about the bailouts (which isn’t allowed): Europolis press release, ‘Bundesverfassungsrichter Prof. Dr. Dr. Udo di Fabio befangen?’, 26 August 2011,

available at: [http://www.europolis-](http://www.europolis-online.org/index.php?id=35&tx_ttnews[tt_news]=66&tx_ttnews[backPid]=2&cHash=dfc7d5d6e9)

[online.org/index.php?id=35&tx\\_ttnews\[tt\\_news\]=66&tx\\_ttnews\[backPid\]=2&cHash=dfc7d5d6e9](http://www.europolis-online.org/index.php?id=35&tx_ttnews[tt_news]=66&tx_ttnews[backPid]=2&cHash=dfc7d5d6e9) and

Cited in *Die Welt*, ‘Ist ein Richter im Euro-Prozess befangen?’, 27 August 2011:

[http://www.welt.de/print/die\\_welt/politik/article13568455/Ist-ein-Richter-im-Euro-Prozess-befangen.html](http://www.welt.de/print/die_welt/politik/article13568455/Ist-ein-Richter-im-Euro-Prozess-befangen.html)