We’ve got a serious pan-European constitutional problem - not just a German one

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Debt mutualisation across EU Member States has recently been brought to the forefront of discussion. Firstly, because of the European Central Bank’s (ECB) balance-sheet operations, through Eurozone members’ public debt purchases in financial markets or via TARGET2 balances, where the balance of payments amongst countries are recorded.

Secondly, through the settlement and ratification of the Next Generation EU package that deals with the aftermath of the Covid-19 pandemic. Both the ECB’s sovereign securities purchase programmes and the pandemic funding injection have been addressed by the German Constitutional Court in 2020 and 2021. This unveiled some constitutional weaknesses in the EU that must be sensibly solved as soon as possible to avoid major undesired effects.

The briefing suggests deepening the Single Market through fiscal harmonisation, sound monetary policy, and by maintaining the free movement of goods, services, and people. EU decision-makers should not rely on monetary or fiscal weapons that distort competition and create perverse incentives.

Europe could face a problem of taxation without representation as a result of the German Constitutional Court’s (BVG) ruling on the Next Generation EU package in May 2021.

There are two decisions in front of the BVG: One from 2020 that relates the ECB’s Outright Monetary Transaction (OMT) Programme and was ultimately given the green light and the second that relates to the Next Generation EU package. The Next Generation EU package has given the BVG the opportunity to paralyse the ratification process of Member States until the BVG’s final judgement.[2] OMT relates to debt monetization and the EU Recovery Fund is about debt mutualisation, but both are two halves of a whole; the distributional problem amongst EU citizens, and constitutional legitimacy which is the heart of public choice. This briefing will address both separately, although through the same lens of constitutionality.

ECB: The Emperor with no clothes

Words like “bombshell”, “disloyalty”, and “bleeding knife wound” were used to refer to the crisis caused by the above-mentioned 2020 BVG ruling on the ECB’s OMT Programme which struck the EU in a time of suffering during the pandemic. Political leaders demanded a response from the European Commission by encouraging it to start an infringement procedure against Germany. This influenced the European Central Bank’s directors to change their stance from “We take due notice” to “No reason to change our course of action”.

According to P. Tucker (2018), officials of trustee-like independent agencies such as a Central Bank are solely sustained by their renowned technical expertise through reputational opprobrium and their professional stance that create the most effective incentive for the right course of action. That said, the ECB’s mandate does not reach the distributional realm of taxation which lies beneath sovereignty. The EU’s constitutional power remains within the realm of Member States, not the ECB or directly with citizens – one of these constitutional powers being taxation.

In EU primary law, powers not explicitly attributed to the EU are assumed to belong to Member States. Thus, the burden of proof lies with the ECB to justify any fiscal powers. This is exactly what the BVG asked for in its 2020 ruling.

It is highly unlikely that the €2.2 billion of public debt securities purchased by the ECB and European System of Central Banks (ESCB) − which increases to €2.8 billion when including private sector debt − in March 2021 are fiscally neutral and could be considered to remain within the boundaries of monetary policy.

Gaining time for Member States to enact structural reforms by harnessing the sovereign debt in the markets is one thing, however pooling the fiscal burden of Eurozone countries is another. The latter is prohibited by Article 125.1 of the Treaty on the

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[2] Both of them (English version) are accessible online; the March 26 here: https://www.bundesverfassungsgericht.de/SharedDocs/Downloads/DE/2021/03/rs20210326_2bvr054721.pdf?__blob=publicationFile&v=1 ; and the April 17 here: https://www.bundesverfassungsgericht.de/SharedDocs/Pressemitteilungen/EN/2021/bvg21-029.html . There is a strongly recommendedblog by Wolfgang Münchau that explains in a very simple way the context and background of the conflict recently raised: “How not to think about Karlsruhe. Here is my guide on how to misread the German constitutional court”, Eurointelligence, May 1, 2021, accessible online at https://www.eurointelligence.com/column/karlsruhe .

Functioning of the European Union (TFEU). This ban on Member States' monetary financing via sovereign debt primary market transactions was deemed a legal nicety by the ECB.

Secondary market purchases produce the monetization of public deficits but in a non-previously agreed context, which is a huge change as ECB policy is not aligned with Member States' fiscal imbalances. The surprise factor is indispensable to preserve the real independence of the ECB and to escape from fiscal policy moral hazard. Even the distinction between primary and secondary market purchases fades at the shadow of the OMT programme's astronomical amounts.

The WIT (Whatever It Takes) mantra will always be the wrong response to national fiscal disorders. Eurozone countries understand that it is not about preserving the common currency but mutualising budgetary deficits. In such a context, the fiscal pact is nonsense, as is fiscal cohesion as a step towards the fiscal union. As the ECB comes to the rescue of profligate national governments, it resembles the Schmidtian sovereign, "the one capable to declare [and manage] the state of emergency".

Supporters of the European project should be keen to follow the ideals incarnated in the current Treaties. One may have – perhaps controversial – reasons to support the EU in its current institutional setup: asymmetries between economies, tax rivalries, and wide room for intergovernmental negotiations. One does not need to reject a fiscal union in principle, but it cannot be achieved by all means and any costs. The strength of the EU is not just measured in outcomes, but the process of cooperation itself. Member States' renunciation of sovereignty not only implies devolution to a common centralized entity, but to the citizens, the original bearers of liberty in a free society. Building a gigantic state from the aggregation of smaller ones has little to do with the European dream.

The ECB has failed to give a good explanation for its OMT programmes, and the European Court of Justice (ECJ) Pringle-Gauweiler-Weiss case law has endorsed these defective arguments by taking for granted that they both fit into EU law and are technically consistent with it (Ruiz-Ojeda 2020). The BVG asserted that an independent central bank only gets it legitimacy from 'trust responsiveness' (Pettit 1995), or its professional and public reputation.

The ECB's balance-sheet operations: transnational equity

In her 1992 speech to the World Economic Development Conference, Margaret Thatcher highlighted what the Maastricht Treaty would entail for the EU:

> "If the divergence between different European economies is so great that even the ERM cannot contain them, how would those economies react to a single European currency? Huge sums would have to be transferred from richer to poorer countries and regions to allow them to take the strain. Even then unemployment and mass migration across now open frontiers would follow. And a full-fledged single currency would allow no escape hatch".[3]

All of this has come true − the 'huge sums' Thatcher referred to can be found in the ECB's balance sheet. The ECB market purchasing programmes are not the only way accountants can disguise an unprecedented transfer of resources between countries in the Eurozone.

H.W. Sinn (2020) explains in his recent book that payments across the Eurozone are made through the banking system pipelines for expediency and safety reasons. For example, a Belgian can buy a camera by charging their credit card. The buyer's bank charges their current account for the amount of the camera, but the money is transferred to the seller, who is Irish, by a charge on the buyer's reserve bank account at the Belgium Central Bank (the National Bank of Belgium-NBB) which, in turn, gives notice to the ECB which, in turn, charges the NBB reserve account at the very ECB and credits the Irish Central Bank (ICB) reserve account which, in turn, credits the seller's reserve bank account at the ICB for the same sum, and finally the seller's bank credits their current account.

In short, the ECB *would* function like a clearinghouse for Eurozone transnational payments. TARGET2 balances are the ledgers that record the credits and debits between the ECB and the National Central Banks of the Eurozone for that purpose. However, TARGET2 balances are never cleared as the ledgers remain unsettled. The Eurozone's current account deficits are logged in the ECB's balance-sheet, converted into a phenomenal bilge that contains the Eurozone's financial garbage without any recycling process in sight. Not only does the ECB purchase Member States' unpayable securities, but also National Central Banks' and commercial banks' discrepancies between their depositors' wealth and the commercial banks' lower effective payment capacity. The ECB's books show a broken structure despite its directors' frequent statements to the contrary.

The ECB's net layout, whether positive or negative, belongs to its shareholders − the Eurozone member states− in a per quota basis. The TARGET2 balances show illustrative data: by December 2020, the German claim against the ECB was for €1.136 billion, whereas Italian and the Spanish obligations to the ECB jointly totalled €1.016 billion. In terms of GDP, Germany's TARGET2 balances reaches 40.99% of the 2020 Italian and Spanish GDP put together. This is reminiscent of the post-World War I era and J.M. Keynes' warnings in *The Economic Consequences of the Peace*.

[3] The whole speech is accessible at https://www.margaretthatcher.org/document/108304 . The passage quoted is available at https://youtu.be/_dEp4V1zCvA

If we go back to the pre-Euro phase, M. Friedman and A. Schwartz (1986) explain the state of the European Economic and Monetary Union project. The European Currency Unit (ECU) played the role of a common unit of account for the European Rate Mechanism (ERM), whose demi-fixed band of exchange rates for the then-sovereign currencies provided national polities with a sufficient margin of manoeuvre. The ECU was originally conceived to settle commercial current accounts amongst member states external funds for the indexation of a growing number of transactions. Competition among currencies goes hand in hand with national economic and commercial competition without relevant spill-over effects or, at least, with much more manageable ones.

This does not happen in a single currency context, which is the tightest form of monetary union. Dirk Schoenmaker's (2013) reformulation expands on Dani Rodrik's (2011) trilemma: financial and economic integration and financial stability are incompatible with a national, democratic control of the financial system. Those three things cannot be achieved simultaneously.

Conclusion: the BVG always rings several times

Distributional economics is a zero-sum game and Germany has been the loser within the EU, something which is unlikely to continue for much longer. The German experience teaches us that sound money, along with budgetary equilibrium, are the guiding stars of their political identity (Mee 2019), and the BVG will not pass up the opportunity to remind us.

Margaret Thatcher was right to emphasise the merits of democratic accountability of political decisions which are made at the national level. The ECB's fiscal counterpart is not the EU, but each Member State[4]. Forgetting about this would lead to the implosion of the EU.

Taking a step back could be the way to move forward. Perhaps the recovery of the ECU's flexibility at a monetary policy level could be the wisest strategy. Since ancient national currencies do not exist anymore, their function might be accomplished by member states mechanism for public debt restructuring in the Eurozone, in the vein proposed, among others, by D.P. Tsomocos and X. Wang (2020).

When rules are replaced by institutions to drive a process, incentives become critical. The present set-up transfers the worst counterincentives onto political and economic stakeholders: fiscal incontinency, debt addition, poor innovation, and productive stagnation. The ECB has become a non-stop financial market distorting force exclusively based on the (virtually) infinite power to create money.

Quite often, constitutional failings are stated by outsiders. For dissenting thinkers who go against the grain, there are still honest judges in Karlsruhe. And even if BVG decisions are not considered relevant to the ECB, the search for contingent legitimacy (Scharpf 2009) in the form of good arguments shall remain alive until they may be properly given. Constitution matters a lot (Heinig et al. 2020) and the ECB should be much more preoccupied about its lack of legitimacy than about Member States' fiscal deficit hidden under the clothes of the OMT programmes.

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[4] Olivier Blanchard, Robert M. Solow, and Álvaro Leandro have recently proposed a complex multi-level EU fiscal cohesion strategy, "Revisiting the EU fiscal framework in an era of low interest rates" (draft March 9, 2020), available at https://ec.europa.eu/info/sites/info/files/s3-p_blanchard_et_al_0.pdf . I also recommend the critical review by Marco Dani, Dario Guarascio, Joana Mendes, Agustín José Menéndez, Harm Schepel, and Michael Wilkinson, "What Blanchard gets wrong: The puzzling persistence of managerialism in EU fiscal governance", March 25, 2021, EUROPP (European Politics and Policy or the London School of Economics), available at https://blogs.lse.ac.uk/europpblog/2021/03/25/what-blanchard-gets-wrong-the-puzzling-persistence-of-managerialism-in-eu-fiscal-governance/

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