Sunday Wrap

Happy Sunday,

It's been a relatively uneventful week in economics and markets – but not in politics in Berlin, where the calm on the surface betrays the furious activities to deal with the bomb tossed at the political leadership by the Constitutional Court in Karlsruhe 12 days ago.

Today's note will be all about Berlin's massive dilemma and how I see the way through the first hurdle, while the bigger issue remains somewhat more complicated. The stakes couldn't be higher – for Germany, and for Europe.

But let me first briefly digress to this past week's economics news and market reactions because they so very much following our playbook: We got further evidence of the economic slump that gripped us in Q1 (German and UK GDP shrank by 2.2% and 2.0%, respectively), and additional indications of the even deeper Q2 economic hole. Our UniCredit Global Leading Indicator posted the lowest reading on record, and the Fed's Jay Powell warned about "significant" downside risk to growth.

Not surprisingly, equities and credits lost ground as investors moved to safer grounds in government bonds. Sovereign bonds were well bid across the US and Europe, but German bunds didn't participate in the party – partly for the reasons I'll discuss today.

As you know, I have long been wondering about the strength of equity markets, and this past week even The New Yorker got involved to express similar concerns, making a profound point which reminded me of one of the first rules-of-thumb I learned when I joined Goldman in New York 25 years ago: When buyers in a market shifts from big and institutional investors to small and retail investors, that market will likely soon be in trouble. To make that point, John Cassidy quotes several big and professional actors and academics on the unattractiveness of equities at these levels. Legendary investor Stanley Druckenmiller claims that "the risk-reward for equity is maybe as bad as I've seen in my career". Cassidy contrasts that with the fact that "In March alone, TD Ameritrade added more than 400,000 accounts … [and] Charles Schwab added nearly 300,000 accounts. He concludes by recommending "small investors … would be safer sticking to golf." I agree. Cassidy's very read-worthy piece is here: Have the Record Number of Investors in the Stock Market Lost Their Minds?

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But let me now return to the single biggest issue in Europe right now, namely Berlin's scrambling to deal with the German Constitutional Court's ruling that the Bundesbank must stop being part of the ECB's QE program within three months, unless this important - but rather vague - concept of proportionality can be satisfied (by that same court of judges…)

The ruling has brought a massive dilemma out from under the German carpet and right to the front door of the political class. The dilemma spans across both legal and economic issues.

Legally, it's ultimately an issue of "who governs the governors?" Or more specifically, how to address the "dual reporting lines" for the (independent) Bundesbank to German law and the "governors" in Karlsruhe and to European law via its commitment to the ECB and the "governors" in Luxembourg. Economically, the issue is how any law can both grant independence to a central bank to pursue one key objective (price stability), while making its use of instruments to achieve that target subject to political oversight.

In other countries, the courts have – so far – wisely stayed out of this minefield, but not the German Constitutional Court, the BverfG. I'm not a legal expert, but it seems to me that peace was first broken when the BVerfG accepted complaints from a small group of German citizens who felt their democratic rights had been violated by ECB policies. And, while they cleared the ECB's OMT (overruling the Bundesbank's objections, no less), mysteriously to me, the BVerfG decided to take on the ECB, and thereby the German government and the entire European project, on something as vague as proportionality for the PSPP.

To suggest that the German political leadership is furious with the judges in Karlsruhe would – without a doubt – be the understatement of the year. This, along with the uproar in parts of German society, has led the judges to embark on an unprecedented media blitz to explain and justify their ruling.

Whether they'll be successful remains to be seen, but one must not underestimate the BVerfG's standing in German society. I have highly educated German friends who have responded to the ruling with statements like "I'm not a legal expert, but I trust it must be right if the BVerfG has ruled that way". Wow! - One could only dream of similar respect for us economists by non-economists, or by legal experts when it comes to monetary policy …. An online survey by Handelsblatt showed than 85% of the 75,000 respondents think the ECB provides the wrong incentives with their policies (which in layman's term is probably pretty close to not satisfying the "proportionality" requirement), but – importantly – all such surveys of "self-selectors" in an online poll should be taken with a huge grain of salt. As any professional pollster will tell you, it's basically meaningless.

So what's going to happen? As far as I can judge, there are three possible outcomes – and the stakes couldn't be higher:

First, and most likely, I think a pragmatic solution will be found to the immediate problem at hand, namely of the Bundesbank's participation in the QE program, but that the underlying problem will be tougher to address.

Merkel has said that the government wants the Bundesbank to remain part of the ECB's asset purchases. I suspect this reflects a straight-forward political judgement that without the Bundesbank's active and direct involvement in all ECB policies at par with other national central banks, the eurozone itself will be at risk. And, as Merkel has said in earlier contexts, "if the euro fails, Europe fails". For Germany to face the risk of European disintegration – let alone being the one and only to blame for it – remains an inconceivable policy outcome, not only for Merkel but for the vast majority of Germans.

The pragmatic solution will probably lead the government to ask the Bundesbank to provide the necessary help to prepare a report for the BVerfG that verifies that proportionality was indeed considered carefully, and that the PSPP meets the criteria. This will be an uncomfortable request for Jens Weidmann, given his voting record and public statements, but both legally and politically he doesn't seem to have much choice but to cooperate - constructively.

Article 13 of the Bundesbank law says that the "Bundesbank shall advice the Federal Government on matters of material monetary policy importance and provide it with information on request." Weidmann's public dislike for QE is well known, but unless he can produce a formal warning from the Bundesbank to the federal government that proportionality was not properly considered, he'll have a weak hand when invited to help. But also, purely politically, Weidmann owes his job to Merkel, and not being cooperative for the Bundesbank president in times crisis would simply be inconceivable. The ECB may also be helpful here, although without necessarily telling us how much of the work they do. As I argued last Sunday, the BVerfG will almost certainly accept the report to be produced as "good enough" to clear the Bundesbank's continued participation in the PSPP. They'll have marked what they think is their territory, and the stakes will simply be too high to push any further on this specific issue.

In addition, to show that the government takes Karlsruhe seriously, I suspect the government will formally request regular hearing of the Bundesbank President before a Bundestag committee or the full Bundestag, not too dissimilar from in the US, where the Fed president testifies on a regular basis to congressional committees.

However, this pragmatic "solution" will only address the fire presently at the door, the Bundesbank's participation in the PSPP, but it would not address the underlying issue of judiciary supremacy. So this "emergency response" would still expose Germany to the virtual certainty of infringement charges by the European Commission at the European Court of Justice. Apart from being a political embarrassment for Berlin, it'll also be highly inconvenient, not least during the second half when Germany, as EU president, will need to lead EU negotiations on a host of critically important issues, including the next EU multi-year budget and solidarity measures for those hardest hit by the pandemic.

I suspect that this is what has led Merkel to imply that a change of the treaty may have to be considered as well – and rightly so. But, as I have discussed before and richly illustrated in the past, changing the treaty is no simple matter!

So I come back to what I wrote last Sunday: A pragmatic "solution" to the present legal dilemma, without a change of the treaty, will only kick this "can of destructive legal ambiguity" down the road, where it'll wait for the next law suit to arrive at the BVerfG's door in Karlsruhe. And that one (surely targeting the PEPP) could be a whole lot more complicated to deal with – unless Berlin manages to change the composition of the Second Senate of the Constitutional Court during the coming 2-3 years towards a more pro-European (and monetary literate) bench.

In this context, interestingly, it was reported this past week that Stephan Harbarth, the former deputy party whip for CDU in the Bundestag, who was set to replace the outgoing president of the Second Chamber of the BVerfG, Andreas Voßkuhle, (the Second Senate is where these matters are dealt with), will remain in the First Senate. Instead, Frankfurt law professor Astrid Wallrabenstein will replace Voßkuhle. Wallrabenstein was proposed by the Green party, and is reported to be euro-friendly. Sueddeutsche Zeitung has the scoop: Besetzung nach Fachkompetenz

Second, if I'm wrong on this "most likely pragmatic" route – either because I have misjudged Berlin's willingness or ability to pull it off, or the Court's willingness to take the peace proposal via a report on proportionality – then I suspect we'll see the eurosystem throw a near-nuclear bomb at Berlin to deal with instead.

As you know, the ECB's purchases of sovereign debt are done by the individual national central banks and held on their national central bank books. When putting this "national system" in place in 2015, the ECB diverted from previous practices of operating on the ECB's common book – a practice continued for purchases of "European bonds" issued by the likes of the EIB. So one – rather neat for those believing in federalism – solution to the problem now posed by the BVerfG would be for the Eurosystem collectively to move all future holdings also of sovereign securities onto the common ECB book. The operational aspect of QE could still be done by national banks.

Such a move by the ECB and all other members would be a huge step towards "full integration" and more normal central bank functions by the ECB. Some would no doubt call it an opportune correction of a mistake made in 2015, in the name of compromise to get political buy-in of QE - with nobody less than Germany.

Of course, while "neat" in terms of clearly taking the German Constitutional Court out of the equation of ECB policies, it would be a huge political embarrassment for Germany – and politically explosive, not least as it would reverse what Berlin wanted, on the advice of the Bundesbank, five years ago. While surely politically explosive in Germany, I do wonder how the popular conservative media would manage to create a lasting anti-ECB momentum in the general public. After all, accounting rules and central bank balance sheets do not sell newspapers very well, as illustrated by e.g. professor Sinn's continuous – but unsuccessful – crusade against Target-2 (an issue that would broadly evaporate with this "neat" solution, by the way.)

Finally, if I'm also wrong on this one, it's on to Plan C: The Bundesbank "checks out" of the QE program, and the ECB continues with the cooperation of the other central banks. However, while "Plan B" above would be a very high-risk strategy by the ECB and the rest of the eurosystem, I cannot see this Plan C as a politically tenable route. The Bundesbank would be side-lined in all ECB matters and what started as a legal war between Karlsruhe and Luxembourg would quickly turn into an institutional war between central banks, played out in the media – and not as a story about balance sheet bookings, but about exclusion of the Bundesbank - with unquestionably serious implications for the German political landscape. In my book, this basically rules out this scenario or, put differently, it's the scenario which would make me – for the first time – seriously question the sustainability of the eurosystem.

The Bundestag has only a good month left before summer recess, but I can think of a lot staff in Berlin who won't have much vacation, if any, this side of August 5. And once papers are delivered to Karlsruhe, it'll almost certainly straight off to fight infringement charges at the European Court of Justice in Luxembourg – while running the EU as president during H2, including managing a planned high-profile EU-China summit in Leipzig with President Xi in the autumn.

In the middle of the pandemic, one could have wished for less excitement. Let's hope Berlin will manage to navigate this very complicated road ahead. All of Europe – and possibly the world economy – will depend on it.

It's worth remembering that – ultimately – in a democracy, the answer to the question "who governs the governors" is the elected politicians, not the courts.

Best

Erik

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