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Rescues Violating the German Constitution: The Federal Court Decides on a Theory of Finance

By

Adalbert Winkler

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Adalbert Winkler is Professor of Development Finance at the Frankfurt School of Finance and Management. In 2001, he joined the European Central Bank, where he served as Deputy Head of Division at the Directorate General International and European Relations from 2004 to 2007. His research interests include financial development and growth, development and microfinance as well as monetary policy and financial stability challenges in emerging markets, the international role of currencies and developments in the global monetary system. Any opinions expressed here are those of the author and not necessarily those of the FMG. The research findings reported in this paper are the result of the independent research of the author and do not necessarily reflect the views of the LSE.

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Abstract

The Federal German Constitutional Court has made it clear that it considers the OMT program to be in violation of the ECB's mandate. This paper argues that the Court's decision reflects an endorsement of the efficient-market hypothesis. If financial markets are efficient, interference of any kind in these markets cannot be regarded as monetary policy and hence violates the ECB's mandate. In 1962, Helmut Schmidt, who was then Minister of the Interior of the city-state of Hamburg, violated the German constitution by making use of the Federal Armed Forces [*Bundeswehr*] within the country's borders in a non-military context, specifically to rescue fellow citizens during the great North Sea flood of that year. However, despite acting unconstitutionally he was seen as being in compliance with his mandate. This contrasts with Mario Draghi who – without having yet bought a single sovereign bond – has been accused of violating the German constitution because the Court ignored alternative theories of finance which have been put forward in the debate among economists about the proper conduct of monetary policy in a financial crisis.

Key words: Efficient-market hypothesis, monetary policy, Federal German Constitutional Court

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Contact:
Adalbert Winkler
Professor für Development Finance
Leiter Centre for Development Finance
Frankfurt School of Finance & Management gemeinnützige GmbH
Sonnemannstrasse 9-11
60314 Frankfurt am Main
Deutschland / Germany
Tel: +49 69 154008 - 776
Fax: +49 69 154008 - 4776
a.winkler@fs.de

1. Introduction[1]

Since 7 February it has, as it were, been official: by implementing the Outright Monetary Transaction (OMT) program, Mario Draghi and the ECB have been in violation of the German constitution: the OMT program does not constitute monetary policy, but rather fiscal policy/economic policy. Moreover, it might represent monetary financing.[2] By their actions, Draghi and the ECB have overstepped their authority because the ECB, a European institution, was given responsibility by the euro area member states only for monetary policy, but not for fiscal and economic policy. Furthermore, they are in violation of the explicit prohibition against monetary financing. Because the OMT program does not constitute monetary policy, pointing out that, according to the Maastricht Treaty, the ECB is permitted to buy sovereign bonds to serve monetary policy purposes, also does not provide a justification for this measure. Finally, against this backdrop it is also irrelevant that the OMT program has helped to calm the markets and save the euro.

In the following it will be shown – taking the perspective of an economist[3] – that this decision is not only based on legal considerations but to a substantial extent on economic arguments. In the majority opinion setting forth the reasoning behind the ruling of the Second Senate, which heard the case, the justices explained their decision not only by citing articles and clauses in the German constitution and the Maastricht Treaty, but also by determining that a certain theory of finance, namely the theory of efficient markets, is the only correct one (see also De Grauwe 2014). At the same time, they reject other theories about financial markets which have been advanced by economists, e.g. the theory which posits that financial markets may also be beset by panic and thus need a lender of last resort. Moreover, no substantive explanation is provided for the preference given to the theory of efficient markets; rather, it is simply assessed as being more convincing than other theories.

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[1] This is a slightly revised English version of the paper „*Mario Draghi und Helmut Schmidt – Retter, die gegen die Verfassung verstoßen*“ which will be published in Credit and Capital Marktes (*Kredit und Kapital*). I thank Martin Hellwig and an anonymous referee for helpful comments and suggestions.

[2] http://www.bverfg.de/entscheidungen/rs20140114_2bvr272813en.html [69]. This link takes the reader to the official English translation of the decision that is available alongside the original German version on the Federal Constitutional Court’s website. Whenever passages from the decision or the dissenting opinions are quoted, the corresponding passages from this official translation have been provided. Unless otherwise specified, the numbers in square brackets refer to the numbered paragraphs of the majority opinion and the dissenting opinions.

[3] The *German Law Journal* just published a Special Issue with papers reviewing the decision from a legal perspective (Miller 2014).

In order to illustrate what this decision on the correct theory of finance means, and the implications of the reasoning on which it is based, we will compare the actions of two crisis managers who endeavored to fulfill their mandates in difficult times: Helmut Schmidt and Mario Draghi. More than 50 years ago, Helmut Schmidt found himself in a situation similar to that of Mario Draghi in 2012. He had to manage a crisis. Back then, during the great North Sea flood in Hamburg, he called for, and succeeded in overcoming the resistance to, the utilization of the German Federal Armed Forces [*Bundeswehr*] within the country's borders in a non-military context. At that time, a deployment of this kind was explicitly prohibited by the constitution, and indeed – unlike possible purchases of sovereign bonds by the ECB – it was prohibited unconditionally. There were no arrangements analogous to those contained in the Maastricht Treaty which would have allowed the minister of the interior of a German state to make use of the armed forces within the country's borders in a non-military operation, provided that their utilization supported the fulfillment of his mandate – in this case: to prevent the death and injury of citizens in a crisis situation. Nonetheless, legal proceedings were never initiated against Helmut Schmidt in the Federal German Constitutional Court.

Using an analysis of what the two situations have in common, and the ways in which they differ, it will be shown that the justices whose majority opinion prevailed in the Second Senate, and which was reflected in their decision on 7 February, deemed the OMT to be unconstitutional because they endorse the efficient markets hypothesis. By contrast, in 1962 charges were not even brought against Helmut Schmidt because at that time no serious theory existed which could have provided a basis on which to accuse Schmidt of violating his mandate. It is precisely in this regard that Mario Draghi's situation is different: his critics claim that, by establishing the OMT, he violated his mandate – which is to engage in monetary policy with the goal of ensuring price stability – because, if one assumes the validity of the efficient markets hypothesis, the OMT does in fact constitute economic or fiscal, but not monetary policy. In their decision, the majority of the justices fully embrace this view. By so doing, they frivolously reject other theories and the arguments their proponents advance which support the view that the OMT serves a monetary policy purpose. They also do not take into account that there are many other instruments which unquestionably fall within the realm of monetary policy but which nonetheless exhibit several, and in some cases indeed all, of the characteristics which the Senate majority regard as an indication that the OMT is not a monetary policy instrument. Finally, the majority opinion ignores the fact that so far there have been no signs that the ECB has not fulfilled its

mandate. All in all, the decision is thus one which was made “on an airy basis”, as Justice Lübbe-Wolff puts it in her dissenting opinion.

Against this background, one can almost understand why, at the last moment, prior to finalizing their decision, the justices hesitate, as it were, to elevate their opinion on what is the correct financial theory to constitutional status and “only” issue an Order for Referral [*Beschluss*] instead of delivering a judgment [*Urteil*]. For the questions which the Court has now referred to the European Court of Justice for a preliminary ruling are intended to provide confirmation by their colleagues in Luxembourg that the opinion advanced by the Senate majority on what constitutes monetary policy is in fact correct. In the final analysis, though, this means that the – at times heated – debate among economists about the proper conduct of monetary policy in a crisis may now become a matter of dispute between the highest courts in Germany and Europe. This cannot be a good thing, regardless of which view of the proper theory of finance and the associated scope of monetary policy one is inclined to support.

The paper is structured as follows: after a discussion of the salient points of the Order of 7 February 2014 regarding the OMT program (Section 2), the allegedly unconstitutional actions of Helmut Schmidt during the crisis created by the great North Sea flood in Hamburg are described (Section 3). Section 4 explains why it is a debate over the correct theory of finance which has led to Mario Draghi’s being accused of having violated the German constitution, while charges were never even brought against Helmut Schmidt. Section 5 asks if the Court could have arrived at alternative decisions on the OMT program – decisions that would not have been predicated (exclusively) on determining that a certain theory of finance is the only correct one. Section 6 sums up and draws conclusions.

2. The Decision of the German Federal Constitutional Court

On 7 February 2014 the Second Senate of the Federal Constitutional Court in Karlsruhe issued an Order by which it referred the questions pertaining to the issue of whether the OMT program of the ECB is to be regarded as a monetary policy measure, or as monetary financing, to the European Court of Justice for a preliminary ruling. At the same time, in the majority opinion setting forth the reasoning behind the Senate’s decision, the justices make it clear that, in their view, the OMT does not constitute monetary policy, but rather must be

regarded as fiscal and economic policy, and perhaps also as monetary financing. They arrive at this opinion because they endorse the theory of efficient financial markets.[4] This theory states that in financial markets prices are always generated which correctly reflect all available information that is relevant for price formation. Thus, price changes always reflect changes in the available information and the evaluation by the markets of such changes. In credit markets, the key category of information is that pertaining to the solvency of debtors. If one embraces this theory, then what could be observed in the markets for European sovereign bonds in the summer of 2012 was not in fact a crisis, but rather an efficient reaction by financial markets vis-à-vis debtors who had come under suspicion of being insolvent (Deutsche Bundesbank 2012). The best economic-policy response to this behavior of the financial markets would have been to not respond at all so as to avoid efficiency losses and rule out moral hazard problems (Konrad 2013). But if action of some sort had to be taken,[5] then, at the very most, fiscal policy measures should have been carried out to offset the effects of what was occurring in the markets because if a debtor, i.e. one of the crisis states, had actually become insolvent, the taxpayers in the other countries would have suffered losses commensurate with the extent of the default (Fuest 2013, Sinn 2013).[6]

The decision of the Constitutional Court on 7 February, as set forth in the majority opinion, fully endorses this theory [71f.]. In contrast, the argument put forth by the ECB, namely that the OMT program constitutes monetary policy in a crisis situation, with the crisis manifesting itself in a disruption of the monetary policy transmission mechanism, is dismissed in a few

[4] This view of financial markets is one of the core elements of the modern version of ordoliberal thinking, particularly in Germany, which is why the OMT's critics include many economists who subscribe to the basic tenets of ordoliberalism. However, in writings of the fathers of ordoliberal thinking, e.g. in the early works of Hayek (1933), but also in Eucken (1990), there are indications that they were aware of the tendencies toward instability exhibited by financial markets (see Winkler 2013c), as are discussed in Section 4. Accordingly, the OMT can also be justified from an ordoliberal perspective (see, for example, Schmieding 2014b, Paqué and Winkler 2014).

[5] It would be best not to intervene at all and to assign to the financial markets the role of an "independent watchdog" (Issing 2014) whose assessment each individual country would be obliged to, and should, accept. Only if this were the case would there be an incentive for a better and sounder fiscal policy. The financial markets may be entrusted with all aspects of this role because they are efficient, i.e. because they always correctly translate all available information regarding borrowers into price signals. "There is no case in which a country, through no fault of its own, was driven into difficulties as a result of the actions of evil speculators." (Issing 2014, 49).

[6] This raises the question of why efficient markets take so long to recognize the insolvency of borrowers – in this case, the crisis states within the euro area – and when they finally do, why this occurs so suddenly, i.e. as a manifestation of a crisis. In this context it is often argued that prior to the crisis the market, which is fundamentally efficient, was misled by state interventions, e.g. an unconvincing no-bailout clause (Sinn 2013) and a misguided monetary policy (White 2012), and on this basis arrived at an incorrect assessment of the risks associated with, and the solvency of, borrowers. When the market becomes aware of its error, i.e. when the crisis emerges, then it begins to function efficiently again, which means that interventions by monetary or fiscal policy have to be strictly rejected as they once again interfere with the private sector exerting its proper monitoring role (Mayer 2013).

paragraphs. However, according to the theory of efficient markets, the ECB does not need an OMT program in order to fulfill its mandate – the maintenance of price stability. On the contrary: the program is blatantly inconsistent with its mandate because, in reality, the attempt to correct the ostensible disruption of the transmission mechanism implies an arbitrary "interference with market activity" which represents not monetary policy but fiscal and economic policy, or indeed monetary financing, and is thus doubly unconstitutional. [95ff.]. The fact that the OMT achieved its goal, namely to bring interest rates in the crisis countries at least approximately into line with the interest rate level which the ECB strives to maintain for the euro area as a whole (which means that the disruption of the transmission mechanism was at least partially eliminated), is irrelevant in the justices' view. Because it simply does not constitute monetary policy, the (economic) validity or plausibility of the rationale advanced for the OMT program is not even worth considering.

This reasoning behind this conclusion is spelled out in detail in the list of 10 criteria which, in the justices' view, invalidate the assumption that the OMT is a monetary policy instrument: conditionality, selectivity, parallelism, bypassing, volume, market pricing, interference with market logic, default risk, debt cut, and encouragement to produce newly issued securities. They are very important for the final outcome of the proceedings because, explicitly citing these criteria, the justices in Karlsruhe request their colleagues at the European level to confirm that the OMT does not constitute monetary policy but rather monetary financing. For only if that is the case does it then follow automatically, based on the prevailing legal norms, that the OMT is unconstitutional, because the ECB is only authorized to conduct monetary policy and is not permitted to engage in monetary financing.

Should the Court of Justice of the European Union endorse this line of argumentation, the situation would be clear: Mario Draghi, who is already very unpopular in the German media in view of his "wondrous increase in the money supply" (Steingart 2013), may have saved the euro, but this rescue was achieved by unconstitutional means. After all, even in a crisis, not everything is allowed (Weidmann 2013a), a statement for which the president of the Bundesbank often garners applause from many important opinion leaders in Germany, and the validity of which has now been confirmed by the highest court in the land. If, at the end of the judicial process, this view were to be given the full weight of constitutional authority in the form of a final judgment to this effect by the Court, the resulting (economic) policy implications would be very serious. Indeed, it is already being inferred from the decision

announced by the justices in Karlsruhe that "The policy of giving winking approval to the policies of the ECB by which Chancellor Merkel has stabbed the Bundesbank in the back can thus be assumed to have run its course" (Sinn 2014a).

3. Crisis and Rescuer – Helmut Schmidt and the Great North Sea Flood in Hamburg

On 23 December 2013, i.e. just under two months before the Federal Constitutional Court announced its decision regarding the OMT, the country marked the 95th birthday of Helmut Schmidt. Unlike Mario Draghi, Helmut Schmidt is very popular in Germany, not least because of his forceful crisis management during the great North Sea flood in Hamburg in February 1962. It is regarded as indisputable that had it not been for Helmut Schmidt, who at the time was the head of the newly established Hamburg Ministry of the Interior, the death toll from the flood – which was substantial in any case – would have been even higher. Thus, he fulfilled the mandate which is given to a minister of the interior, namely to maintain public safety, in an exemplary manner. But it is also indisputable that Helmut Schmidt's actions in those days in February 1962 were unconstitutional, and it is safe to say that he violated the constitution in more than one way. For one thing, he made use of the Federal Armed Forces for a non-military mission within the country's borders – a mission of a type which the armed forces were expressly prohibited from carrying out by the constitution. For another, while this mission was being executed, he "awarded contracts creating financial obligations which, due to constraints posed by budgetary law, the Senate [the executive branch of Hamburg's government – author's note] would not have been able to fulfill" (Soell 2003, 388).

Table 1 briefly summarizes the situations the two crisis managers faced. It shows that the crises were of a different nature: a natural disaster in Schmidt's case and man-made turmoil in Draghi's. However, the focus of this paper is not on the crisis, but on crisis management – specifically, whether the instruments the respective leaders made use of in containing the crisis complied with the law, here: the constitution. Given that Helmut Schmidt, unlike Mario Draghi, never faced charges in the Federal Constitutional Court – a "German miracle" as Schmidt himself later said (Rose 2012) – his actions are only characterized as unconstitutional

here because this is the view taken both by historians (Soell 2003) and by Schmidt himself.[7] However, in contrast to Mario Draghi and the ECB, charges were never brought against Schmidt, although in view of the unconditional prohibition against the use of the German armed forces in a domestic, non-military context at that time, there could not have been any doubt that Schmidt acted in violation of the German constitution.

Table 1: Comparing two rescuers: Draghi and Schmidt

Rescuer	Draghi	Schmidt
Mandate	Monetary policy with the primary goal of price stability	Public safety
Crisis	Financial crisis	Flood
Unconstitutional overstepping of legal authority in the course of crisis managment	Purchase of sovereign bonds (prohibited by Maastricht Treaty except when it serves monetary-policy purposes)	Use of the armed forces in a non-military context on German soil (at that time, unconditionally prohibited by the constitution)
Faced legal proceedings in the Federal Constitutional Court	Yes	No
"Prevailing theory" regarding fulfillment of mandate in the crisis	Mandate is not fulfilled	Mandate is fulfilled

Source: Author's compilation

The reason for this is to be found in the "prevailing theory" – why this term is used will become clear shortly – as to how public safety can and should be guaranteed in a crisis situation such as the great North Sea flood. According to this theory, there could be absolutely no doubt that Schmidt, despite – some would even say: precisely because of – the deployment of the German armed forces in a non-military context on German soil, fulfilled his mandate, namely to save lives. Thus, he may have acted unconstitutionally because he violated the German constitution (and the constitution of Hamburg), but he acted in conformity with his mandate: the end justifies the means.[8] In order to make sure that, in a comparable crisis situation in the future, office-holders would not have to face this conflict between fulfillment

[7] "We did not act in conformity with laws and regulations, we may have violated the constitution of Hamburg, we certainly operated outside the bounds of the German constitution. It was an emergency which could not have been dealt with adequately within the bounds of existing legal constraints [*übergesetzlicher Notstand*]." (NDR 2012)

[8] However, it is doubtful whether, in the eyes of the Senate majority, this would have been sufficient justification to exonerate Schmidt. The OMT decision states explicitly: "However, what is relevant is not only the objective, but also the instruments used for reaching the objective and their effects." [65] And the following is also clear: deploying the Federal Armed Forces is no more a part of the authorized powers of an interior minister than the monitoring of budgetary policy is a part of monetary policy. [67].

of their mandates and adherence to the constitution, Germany's Emergency Laws were passed in 1968.

Schmidt's unconstitutional actions could, however, have been interpreted differently. Indeed, drawing not least on a line of argumentation analogous to that put forward by the critics of the OMT and the majority of the justices in Karlsruhe, the following theories regarding the appropriate public safety policy during the great North Sea flood would have been conceivable:

a) What Hamburg was experiencing was not in fact a crisis, but rather what is to be expected when there is prolonged heavy rain and when the improvement of dikes, both as regards their overall quality and their height, is neglected. Thus, if there was a crisis at all, it was homemade. Hence, in the final analysis, the crucial factor is whether the state government takes appropriate action. It has to improve the quality of the dikes and increase their height. If it does, and a flood still occurs, then police and security personnel from other German states are available. They are authorized to intervene; the Federal Armed Forces are not.
b) With a large-scale flood like the one in Hamburg in 1962, one has to expect that streets and buildings will be inundated. This has to be accepted. If one were to justify making use of the Federal Armed Forces by citing the necessity of dealing with a flood, that would be tantamount to authorizing the Hamburg interior ministry to remedy every deterioration in the traffic situation in Hamburg by calling in the Federal Armed Forces. This would render inoperative the prohibition against the use of the Federal Armed Forces in a non-military context within Germany's borders.
c) The use of the Federal Armed Forces is not to be assessed as a rescue measure which served to protect the population but rather as the harbinger of a military coup which the young, ambitious politician wished to organize.[9]

While all of these theories have a certain element of plausibility, they were seen – and rightly so – as being not sufficiently convincing to invalidate the prevailing theory regarding the fulfillment by Schmidt of his mandate as interior minister in a manner appropriate to the

[9] On the face of it, this theory sounds absurd, given what actually happened and the future course of Helmut Schmidt's life. But it was Schmidt himself who pointed out the risks posed by the very extensive powers which he exercised during the hours in which the crisis was in its most acute phase. In a not particularly sympathetic biography, he is quoted in the chapter on the great North Sea flood – which is entitled "Virtually a Dictator" – as follows: "I … understood instinctively at that time: once one has resolved to take an action which is no longer covered by the law, the temptation is great to continue along this path." (Kahn 1973, 42)

situation: by deploying the Federal Armed Forces, Schmidt saved lives and thus discharged his mandate. Thus, as it turned out, the most serious criticism raised in the public debate over Schmidt's actions in the crisis focused on the conflict between the means and the end, a conflict which – given that the end was to save lives – no one wished to make the subject of legal proceedings. In the crisis back then, everything was allowed after all.

4. Crisis and Rescuer – Mario Draghi and the Euro Crisis

Helmut Schmidt experienced a German miracle; Mario Draghi did not. On the face of it, this is surprising given that – as the brief comparison in Table 1 shows – it is much less obvious that Draghi violated the constitution[10] than it is that Schmidt did so in 1962. Indeed, his actions ("whatever it takes") only violate the constitution if it can be demonstrated that the OMT does not serve a monetary policy purpose and thus that it is outside of the limits of the ECB's mandate.

The majority of the justices arrive at the conclusion that the OMT violates the constitution because it does not serve a monetary policy purpose. But one can adopt this point of view only if one endorses the efficient markets hypothesis, which rules out the possibility of liquidity crises in financial markets. However, there is also another theory of finance which explicitly recognizes the possibility of liquidity crises in financial markets. Based on Bagehot (1873) and the rationale for the role of a central bank as a lender of last resort which it develops, a liquidity crisis can arise because financial markets can also be irrational, inefficient and beset by panic (Diamond and Dybvig 1983, Givazazzi et al. 2013).[11] On this theoretical basis, a central bank is assigned the task of intervening in markets which are no longer capable of functioning properly because it is only by so doing that it can fulfill its mandate of maintaining price stability. In many other developed economies, this theory represents the majority view among economists on the proper role of a central bank. In

[10] Specifically, it is much less obvious that by adopting the OMT, the ECB, an institution of the European Union, has arrogated unto itself powers (in the areas of fiscal and economic policy) which it is not authorized to have, or that it has, in violation of the constitution, engaged in monetary financing.

[11] Thus, in this theory as well, the crisis is most definitely not a result of the actions of "evil speculators" (Issing 2014); on the contrary, it is attributable to the behavior of market participants who are seized by panic. The classic passage on this point in Bagehot (1873, 24f.) reads as follows: "At first, incipient panic amounts to a kind of vague conversation: Is A. B. as good as he used to be? Has not C. D. lost money? and a thousand such questions. A hundred people are talked about, and a thousand think, 'Am I talked about, or am I not?' 'Is my credit as good as it used to be, or is it less?' And every day, as a panic grows, this floating suspicion becomes both more intense and more diffused; it attacks more persons; and attacks them all more virulently than at first. … A panic grows by what it feeds on; if it devours these second-class men, shall we, the first class, be safe?"

accordance with this position, in a crisis situation such as the one which existed in the summer of 2012, a central bank should utilize instruments similar to the OMT program (Rajan 2013). But when doing so, it cannot and should not act alone. Indeed, it is the duty of monetary and fiscal policy to work together to stem the panic, and by so doing to ensure a smooth transmission of monetary policy impulses (Friedman and Schwartz 1965, Bernanke 1983, Goodhart 1999).

The most salient feature of the Karlsruhe ruling of 7 February 2014 is that it does not devote a single word to this competing theory of how financial markets work and its implications for monetary policy.[12] Hence, the majority opinion also does not provide a critical discussion or assessment of this theory, either from a legal standpoint or in economic terms. It is not much of an exaggeration to say that if the justices had only opened a newspaper, they would quickly have found sufficient evidence to conclude that, within the ranks of economists, there are two competing views on the way in which financial markets operate and on the implications of financial market behavior for the design of an appropriate monetary policy response in a crisis situation. For example, two groups of economists published diametrically opposed appeals which clearly expound the differing points of view (Fratzscher et al. 2013, FAZ 2013). The fact that, in the inter-bank market crisis of 2009, the Bundesbank challenged the validity of the theory of efficient markets (Deutsche Bundesbank 2009) should also have raised doubts on the justices' part. At that time, and in contrast to the position it takes in its expert testimony for the proceedings on the OMT before the Federal Constitutional Court (Deutsche Bundesbank 2012) – praised by the Court majority as "convincing expertise" [71] – the Bundesbank concluded that financial markets, here: the interbank market, can be beset by uncertainty and panic. From this theoretical basis it derived precisely the same implications for monetary policy, in the shape of the full allotment policy, which the ECB, given the turbulences in the market for sovereign bonds, draws in 2012 in the shape of the OMT program.

Accordingly, it would have been reasonable to subject the competing theories to a simple test, one which the court itself postulates: Do not the criteria which the Senate adduces in order to deny that the OMT is a monetary policy instrument, also apply to other instruments which are unquestionably regarded as monetary policy tools? To what extent does the minimum reserve requirement conform to the logic of the market? Is it not also conditional and selective,

[12] On this point, see also Schmieding (2014b).

because it is used only for banks (and not for other types of financial intermediaries) and only for certain types of liabilities? If it had asked such simple questions, which would have enabled it to gain a clear understanding of the nature of monetary policy instruments, the Court could have gone on to compare these instruments with the OMT. However, such questions are not only not answered; they are not even posed. To take one example: an analysis of the full allotment policy, which the ECB has been implementing since 2008, following the line of argumentation presented in Deutsche Bundesbank (2009) shows that this monetary policy instrument meets all of the criteria listed in the Court's decision (Table 2). Thus, according to the Court, the full allotment policy is an instrument which does not qualify for being called a monetary policy tool. Thus, one would have to conclude that the ECB already began acting outside its mandate in 2008 (Winkler 2013 a, b).

Table 2: Court criteria for assessing whether a measure violates the ECB mandate / does not constitute monetary policy – OMT versus Full Allotment Policy

Court criteria	OMT	Full allotment policy
1) Conditionality	ESM Program	Collateral
2) Selectivity	Yes	Yes implicit for all operations Explicit for ELA
3) Parallelism (fiscal/economic policy)	Yes	Yes
4) Bypassing (fiscal/economic policy)	Yes	Yes
5) (Unlimited) Volume	Yes	Yes
6) Market pricing (distortions)	Yes by intervention	Yes by intervention and price fixing
7) Interference with market logic	Yes	Yes
8) Default risk	Yes (but reduced via ESM programme)	Yes (but reduced via collateral)
9) Preferred creditor status (debt cut)	No	No
10) Encouragement to produce newly issued securities (on primary market)	Yes, this is the intention of the programme	Yes, this is the intention of the policy

Source: Author's compilation

A brief look at the conduct of monetary policy in other counties would also have been helpful in determining which tools can be regarded as monetary policy instruments in a crisis and precisely how they are designed and employed. Thus, for example, in early 2014 the outgoing chairman of the Federal Reserve Board, Ben Bernanke, noted that the independence of the central bank is undermined precisely when, in crisis situations, limitations are placed on its scope of actions and it is no longer able to make decisions solely on the basis of what it thinks is the correct course of action.[13] In his remarks he referred explicitly to the theory of finance formulated by Bagehot (1873), according to which markets may be seized by panic, and to the resulting implications for monetary policy in the form of a lender of last resort. If, on the other hand, the efficient markets hypothesis – to which the majority of the justices of the Second Senate wish, as it were, to accord constitutional status – is assumed to be correct, then from 2007 on Bernanke was not conducting monetary policy at all, but rather fiscal policy.[14]

Finally, in view of this lack of consensus among professional economists, the court could have examined that variable which indicates whether or not a central bank is properly fulfilling its mandate: the inflation rate (Figure 1) or inflation expectations. For both theories – the efficient markets hypothesis as well as the theory which draws on Bagehot's insights, according to which financial markets may also be seized by panic – imply that a central bank which over the course of several years has conducted selective fiscal policy instead of monetary policy, as well as engaging in monetary financing, creates inflation.[15] Accordingly, the proponents of the efficient markets hypothesis – at central banks, in the academic world and in the public debate over the euro crisis – have been warning for years about the threat of rising inflation, massive inflation and even hyperinflation. So far, though, these warnings have proved groundless. Moreover, looking ahead, inflation on the scale they have predicted is also not discernible, at least not for the policy-relevant medium term (Weidmann 2013b,

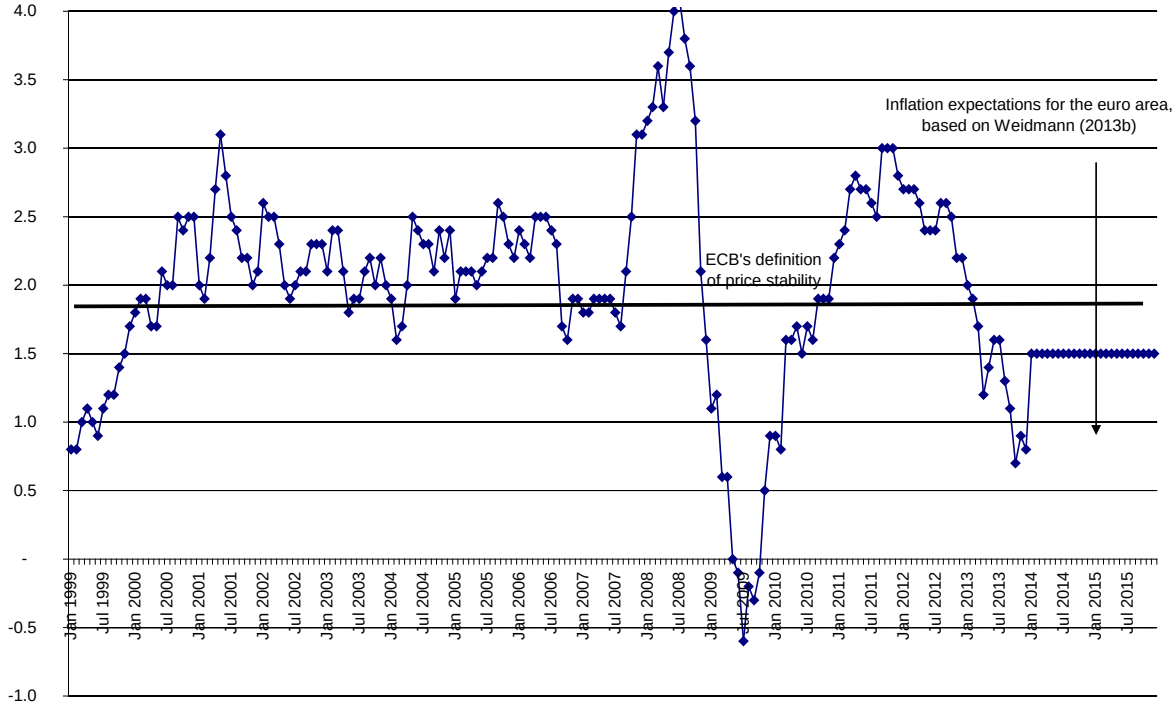
[13] "The reason the Fed is independent is so that it can take emergency actions or any other actions, policy actions independent of short-run political pressures. And the day that we allow those short-run political pressures to make us do something which is not the right thing for the economy, then our independence at that point is effectively gone." (Bernanke 2014). Helwig (2013) also subscribes to this view.

[14] Ben Bernanke's opinions are of course irrelevant if the point is to interpret German constitutional law. They are, however, relevant if one seeks a better understanding of how monetary policy is to be defined, above all monetary policy in a crisis situation. Precisely this question forms the focus of the decision of the Constitutional Court on 7 February 2014.

[15] One could posit here that the OMT cannot be reflected in the inflation rate because it has not even been implemented yet. This is, however, at odds with the OMT-critical expert testimonies in court, which suggest – rightly so – that the OMT has already achieved those effects which, in their view, are not in conformity with the mandate of the ECB, e.g. a decrease in the interest spreads in the sovereign bond markets (Sinn 2014b). But if this is true, then the critics at least need to explain why these effects, which are presumed to be incompatible with the bank's mandate, are not also reflected in the monetary policy target used by the ECB.

Deutsche Bundesbank 2013, 13).[16] Against this background, the glaringly obvious question would seem to be: Which of the two theories appears more plausible or is more consistent with the facts – the one which says that the OMT is fiscal policy, or the one which says that the OMT constitutes monetary policy?

Figure 1: Inflation rate in the euro area, 1999 - 2015



Source: ECB, Weidmann (2013b)

However, the justices' majority opinion again does not discuss the fact that to date Mario Draghi and the ECB have completely fulfilled their mandate. Thus, the Court does not acknowledge the contradiction between, on the one side, the implications of the theory which lead it to conclude that by adopting the OMT program the ECB overstepped the bounds of its legal authority, namely inflation, and, on the other, the empirical fact that price stability has been maintained. It is as if in imaginary legal proceedings against Helmut Schmidt a court had allowed its deliberations to be guided by the theory that Schmidt violated his mandate and deployed the Federal Armed Forces in a domestic non-military context because in reality he was planning a coup d'état, or because – exploiting the crisis situation – he sought to create the preconditions for a coup, or because he wished to create a precedent (for the deployment of the Federal Armed Forces in a non-military context within the country's borders). It is

[16] While "the medium-term orientation cannot be reduced to a fixed time horizon" (Issing 2003), the medium term usually means around two years.

correct that none of these interpretations can be ruled out entirely, but at least so far, nothing has come to light which would indicate that Schmidt actually intended to do anything along these lines. However, exactly the same is true of Mario Draghi. Notwithstanding the concerns about the maintenance of price stability that have been expressed for years in Germany, euro area inflation rate has, despite the OMT program,[17] not risen but fallen. Given that for the future as well, the inflation projections forecast a rate below the level defined as price stability, i.e. close to but under 2% p.a., the monetary union is, and continues to be, the "community of stability" which, as the Constitutional Court reminds all concerned, must not be put in jeopardy [43].[18] This ought to at least suggest that doubts might be in order as to the validity of the assumption that the ECB is engaging in economic or fiscal policy. Such doubts are, however, not to be found in the majority opinion.

5. Alternatives to the Decision to Elevate a Particular Theory of Finance to Constitutional Status

In evaluating the relevant issues and arriving at their decision, why did the majority of the justices take such a one-sidedly economic approach? This may have been attributable to the legal situation itself: fully in the tradition of the Bundesbank, the ECB enjoys a high degree of independence insofar as the conduct of monetary policy is concerned. Thus, the majority of the justices were presumably of the opinion that the OMT could only be characterized as unconstitutional if, by establishing the program, the ECB was deemed to have overstepped the limits of its legal authority. However, this requires that it be demonstrated that the OMT does not constitute monetary policy, because the purchase of government bonds to serve monetary policy purposes is permitted by the Maastricht Treaty. Thus, an approach analogous to the one

[17] As well as its predecessor, the Securities Market Programme (SMP).

[18] Critics of the OMT respond by saying that inflation has merely been deferred, but not eliminated. Others argue that inflation is already with us, and indeed has been present in the economy for a long time, but that it now manifests itself in different forms, e.g. in the shape of a rise in asset prices which has the character of a bubble. Finally, it is also claimed that Draghi has simply been lucky insofar as no inflation has been discernible to date. Such arguments have been employed successfully to make the (groundless) warnings that have been sounded for years about inflation and hyperinflation immune to the criticism that the facts contradict the theory (see also Schmieding 2014a). It is amazing that neither the Constitutional Court nor those whose views tend to shape the public debate do not recognize, and endeavor to find an explanation for, this contradiction. While meteorological services that forecast a big storm which then turns out to be somewhat smaller than had been feared, immediately face the question of whether, by their actions, they did not unnecessarily spread panic – as, for example, happened in December 2013 (Bojanowski 2013) – economists who have for many years been predicting inflation and hyperinflation are spared this question. This leads to the conclusion that apparently in Germany expertise on monetary policy issues is demonstrated not by correctly assessing inflationary pressures, but rather by continually warning about a rise in inflation, preferably to very high levels even if the predicted rise does not materialize.

that would have been feasible after the great flood in Hamburg – namely to point out the conflict between the interior minister's duty to fulfill his mandate on the one side, and, on the other, his duty to adhere to the constitution when utilizing the instruments available to him, and then to call upon the legislative branch of government to eliminate this conflict – appeared to be more of less impracticable because, in the case of the OMT, this conflict does not even arise provided it is regarded as a monetary policy measure.

However, when addressing the question of whether the OMT constitutes monetary policy, the Court certainly could have taken a more moderate position and still characterized the OMT as a borderline case in terms of its constitutionality. For one can argue that the OMT has implications which potentially conflict with the overall responsibility of the German parliament for budgetary policy. To be sure, this is more or less true of every monetary policy measure (Brunnermeier and Sannikov 2012, Hellwig 2013), but understandably the practical impact and potential scope of the conflict that might be created by the ECB's response to a crisis did not become apparent until the euro crisis in fact emerged and the OMT was established (Winkler 2013a). Thus, it can be argued that when the Maastricht Treaty was concluded, the possibility of a crisis like the euro crisis was not envisaged (Schmieding 2013, Obstfeld 2013), nor were the distributional effects of a monetary policy that could arise in such a crisis discussed (Richter 2013). For this reason it is unclear whether a crisis policy of this type is in line with the Maastricht Treaty. Accordingly, there are also doubts as to the validity of the legal (not economic) rationale for the arguments advanced by the proponents of OMT when they invoke as a justification the fact that the purchase of sovereign bonds as a monetary policy measure is explicitly permitted. After all, the possibility that a program like the OMT might one day have to be established, and the necessary scale of a program of this type, are topics that were not really discussed by governments and central banks in the early 1990s. For this reason, and not because a given theory of finance is preferred, one can express reasonable doubts as to whether the OMT is in conformity with the constitution.

Against this background, the Constitutional Court could have called for the passage of a kind of monetary-policy emergency legislation designed to reduce the currently prevailing legal uncertainty, and thus create a more secure foundation for the response to future crises. Specifically, the court could have reached the following conclusions:

1. The question of whether the OMT is a monetary policy instrument cannot be resolved on a legal basis. Moreover, authority for monetary policy has been

transferred to the European level, and consequently this question will be referred for judgement to the Court of Justice of the European Union.

2. There can be no doubt that the OMT was designed as a response to a crisis of a type which was not envisaged, and indeed not even discussed, during the process of consultation and negotiation which led to the conclusion of the Maastricht Treaty.[19]

3. Given the commitment undertaken by the euro area member states to design and implement the monetary union in such a way as to ensure that it functions as a "community of stability", as well as the possible implications of the OMT in terms of budgetary law and budgetary policy, Germany's political institutions and actors must take appropriate steps. Specifically, they are called on to press for an amendment of the treaty or for some other means of clarifying or specifying more precisely when and to what extent the unlimited purchase of sovereign bonds by the ECB can in fact support the fulfillment of its mandate, and is thus to be regarded as monetary policy, and when this is not the case.[20]

By issuing this call for a kind of monetary-policy emergency legislation, the court would thus opt for the course of action which in the 1960s – at that time, without a corresponding judgement by a court – was deemed to be the logical consequence of the great North Sea flood in Hamburg and Schmidt's actions: i.e. to resolve the (in this case: potential) conflict between fulfillment of a mandate and adherence to the constitution by means of an authoritative clarification.

However, the majority of the justices did not opt for this approach. For this reason it must be assumed that they subscribe to the same economic views as were advanced by the majority of the experts whose testimony they heard during the proceedings (Schieritz 2013). In and of itself that is not problematic. What is problematic is that they wish, as it were, to elevate these

[19] No more than the members of the German Parliamentary Council, when formulating their well-meant prohibition against the deployment of the Federal Armed Forces in a non-military context within Germany's borders – a prohibition which, in view of Germany's recent history, was plausible and correct – were thinking of a flood on the scale of the one which Hamburg experienced in 1962. Here as well, one is struck by the parallels between the two cases, for, in view of various countries' experiences with inflation and hyperinflation which were fed by central banks that provided governments with unlimited credit, the prohibition against monetary financing is undoubtedly correct.

[20] One could, for example, stipulate that such an activity may only be undertaken if an ESM program is in place. For one thing, an ESM program must be unanimously approved by the euro area member states – thus it requires approval by the German government; moreover, implementation of an ESM program is by definition only appropriate when the point is precisely not to support an individual member state financially (monetary financing), but rather to safeguard the financial stability of the euro area as a whole; see also Winkler (2013a).

economic views to constitutional status, and, by so doing, to declare to be irrelevant, and effectively put an end to, an (economic) policy discourse which can be expected to eventually lead to a decision on the appropriate role of monetary policy in a crisis situation like the euro crisis.[21] Perhaps the majority of the justices recognized this implication of their decision and then, at the last moment, shied away from actually giving it legal force by delivering a final judgement. The referral of the case to the European Court of Justice for a preliminary ruling is thus to be seen as a kind of request for reassurance: Does the European Court of Justice concur with the economic rationale for our decision, and with its legal implications? At the same time, though, it is a step by which the majority was able to ensure that it could not be held responsible for the consequences of its decision in case the theory of finance endorsed by the Court, which it in effect seeks to elevate to constitutional status, should turn out to be wrong.[22] After all, as economic history teaches us, a central bank which is not permitted to utilize instruments that are similar to the OMT is deprived of all means of responding to financial crises. It can neither guarantee price stability, nor is it able to stabilize the real economy, i.e. incomes and employment.

[21] In his dissenting opinion, Justice Gerhardt implicitly draws attention to this approach: "Under such a perspective [that of the majority of the justices – author's note], political acts and omissions are subjected to an inappropriate legal standard." [14] For – in the view of Justice Gerhardt – the majority of the members of the German parliament and of the German government are evidently of a different opinion than the court as to which instruments may be regarded, from an economic – and thus also from a political – point of view, as appropriate monetary policy tools in the crisis: "If – to keep to the present case – the Federal Government approves the OMT programme and makes it one of the foundations of its own acts, and if the German Bundestag accepts all this with open eyes – against the backdrop of an intensive public debate, after having heard the President of the European Central Bank, and, according to the information provided by a member of the Budget Committee in the oral hearing, on the basis of the Bundestag's observation and assessment of the acts of the European Central Bank – this is the exercise of its democratic responsibility. The *Bundestag* could readily have criticised the OMT Decision by political means, threatened, if necessary, to bring proceedings for annulment before the Court of Justice of the European Union, waited for the reactions of the European Central Bank and the financial markets and then taken further steps. The fact that it did none of this does not indicate a democratic deficit, but is an expression of its majority decision for a certain policy when handling the sovereign debt crisis in the euro currency area." [23]

[22] It would appear that Justice Lübbe-Wolff shares this interpretation, as evidenced by her dissenting opinion, which closes as follows: "That some few independent German judges – invoking the German interpretation of the principle of democracy, the limits of admissible competences of the ECB following from this interpretation, and our reading of Art. 123 et seq. TFEU – make a decision with incalculable consequences for the operating currency of the euro zone and the national economies depending on it appears as an anomaly of questionable democratic character. No such anomaly would impend if the present decision were to be read as not envisaging any serious consequences[, but only, at the most, the obligation to hold a debate in the *Bundestag* – addition by the author; translation was incomplete]."

6. Conclusion: Overstepping of Authority or Strong Leadership? The Verdict Depends on the Theory Used to Explain the Actions in Question

Overstepping of authority in Draghi's case, strong leadership in Schmidt's case – actions taken by individuals exercising political power which appear to be in violation of the constitution, at least in terms of the letter of the document, may be subject to greatly differing interpretations. Clearly, the context in which a policy-maker acts when carrying out his or her mandate, and how that context is perceived – specifically, the theory used to analyze the interplay between various factors and competing goals which inevitably defines that context – play an important role in determining how a presumed violation of the constitution by that decision-maker is viewed. Helmut Schmidt was lucky, as he himself writes (Schmidt 2008, 169): although it did not just appear that he had made use of the Federal Armed Forces in non-military context within Germany's borders – indeed, he actually did deploy the armed forces, and on a massive scale – he did not have to defend himself in court because it was irrelevant whether he fulfilled his mandate as Minister of the Interior in a crisis such as the great North Sea flood by using inflatable boats and helicopters bearing the coat of arms of the Free and Hanseatic City of Hamburg or the emblem of the Federal Armed Forces. Mario Draghi is unlucky: although the ECB has not bought a single sovereign bond, he is deemed to have violated the German constitution because the majority of the justices in the responsible Senate of the Constitutional Court in effect intervened in the debate among economists on the merits of various competing theories of finance and gave preference to one, namely the theory of efficient markets. This theory interprets the establishment of the OMT as an overstepping by the ECB of its authority which is both unnecessary and violates its mandate, and holds that the program constitutes monetary financing. Only rarely has what Keynes wrote in 1936 at the end of the General Theory proved to be so correct as it is here: "The ideas of economists and political philosophers, both when they are right and when they are wrong are more powerful than is commonly understood. Indeed, the world is ruled by little else." With reference to the specific case at hand, the practical implications of this insight are summed up very briefly by Justice Lübbe-Wolf in the first two sentences of her dissenting opinion: "In an effort to secure the rule of law, a court may happen to exceed judicial competence. In my view, this has occurred here." [1] The outcome cannot be a good one, regardless of which financial theory one is inclined to regard as the correct one.

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