Premature Celebration? Euro's Hopes Hinge on German High Court

By Matt Egan

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Even as Wall Street celebrates the European Central Bank’s latest crisis measures, the ability of the besieged eurozone to avoid a painful breakup could actually be decided next week by a handful of judges in Karlsruhe, Germany.

That’s because the German Constitutional Court is slated to rule on September 12 on the legality of the European Stability Mechanism, the $631 billion bailout fund at the heart of the rescue unveiled on Thursday.

While it’s seen as unlikely, a ruling to strike down or impose tough conditions on the fund would effectively cripple the largest crisis-management tool currently in Europe’s arsenal.

“There is a small risk of a big disaster. If they say [it’s unconstitutional], that could blow up the euro,” said Jack Goldstone, senior fellow at George Mason University.

A breakup of the eurozone would likely engulf the already-teetering global economy, creating severe turbulence in financial markets around the world.

ESM as a Permanent TARP

To fight against this, European officials have raced to create the ESM, which would be deployed to rescue drowning banks and buy up the bonds of bailed-out countries.

Replacing the temporary EFSF bailout fund, the ESM would provide the financing, conditionality and oversight of future bailouts.

Germany, which would contribute a hefty 27% of the ESM’s firepower, is among the final countries to ratify the ESM; German parliament overwhelmingly approved the plan but it won’t be formally approved until the ruling by the high court.

“Germany needs to be able to participate to reach critical mass so the ESM can launch,” said Marc Chandler, global head of currency strategy at Brown Brothers Harriman.

Rejection Would Crush Rescue Efforts

On Thursday the ECB announced a limitless plan to use the ESM to buy up short-term bonds of struggling eurozone countries, triggering a 200-point surge on the Dow.

“Everything hangs on the ESM,” said Jan Randolph, director of sovereign risk at IHS Global Insight.

Fearing the ESM is encroaching on Germany’s sovereignty and doesn’t include enough oversight or accountability, the court could rule the fund unconstitutional.

The chances the court will strike down the ESM seemed to rise in June as it delayed its decision until next week. However, global markets have rallied since then amid hopes Europe will take concrete steps to move toward a resolution of its never-ending debt crisis.

“A consensus appears to have developed that the court will not rule against the ESM,” analysts at Fitch Ratings wrote in a note on Wednesday. “However, a negative verdict by the court would be likely to create significant market volatility, in light of concerns about the capacity of the bailout funds that may be needed to support larger deficit countries.”
Randolph said he sees a less than 10% chance of the ESM being struck down entirely. He pointed to the "weighty importance" of the bailout fund as well as key clauses in the German constitution explicitly calling for a commitment to European unit.

“They don’t want to be seen as the spoiler of the party or the stumbling block to European crisis management. It’s all getting quite urgent in terms of timing,” said Randolph.

**Conditions Could Saddle ESM**

However, observers see a decent chance the court could approve the ESM with conditions.

“They’re very unlikely to say ‘no’ but they’re more likely to say, ‘yes, but...’ The question is what the ‘but’ is,” said Randolph.

Potential conditions include a cap on Germany’s contributions, a requirement to go back to parliament for further approval or even sending the matter to a rare referendum before German voters, who may or may not sign off on the ESM.

Polls show German citizens do support keeping the euro and deepening fiscal ties, but voters don’t love the idea of further bailouts for the likes of debt-ridden Greece.

“Theyir view is those countries got themselves into trouble and they need to figure out how to get themselves out of it,” said Goldstone.

It’s possible the German court announces it needs further clarification to make a decision, further delaying implementation of the bailout.

**Other Bailouts, Obstacles Loom**

Cam Harvey, a finance professor at Duke University, said the court could also weigh in on the legality of Germany’s larger role in the ongoing bailout.

This includes the 727.2 billion euros the ECB owed Germany as of July 31, accounting for more than 25% of the country’s 2.6 trillion euro gross domestic product.

“How can the court ignore the big picture and simply focus on one specific bailout when there are others going on behind the scenes?” said Harvey.

Even if the German court approves the ESM with minimal conditions, the road ahead in Europe this month is riddled with other obstacles: a key parliamentary election in the Netherlands, a vote in France’s parliament on the Fiscal Compact Treaty and the completion of bank stress tests in Spain that Fitch estimates could show a 50 billion to 60 billion capital shortfall under a base case scenario.

“I think investors are showing a great deal of faith that the ECB and the U.S. Fed can somehow levitate the global economy. I just don’t think that’s in the cards,” said Goldstone. “Without growth, the ESM is just a holding operation.”