

# TARGET2 and central bank balance sheets

## DISCUSSION

Ehtan Ilzetzki: Comment (on Whelan), in: Karl Whelan, TARGET2 and central bank balance sheets, *Economic Policy* 29, Nr. 77, Januar 2014, S. 125-130, <https://doi.org/10.1111/1468-0327.12025>

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Rarely does a technical topic such as the interbank payment system make news headlines or cause tempers to rise. But over the past year, the cross-national balances that

have built up in the European Monetary Union's (EMU) TARGET2 gross-settlement system have received much attention.

It is not surprising that the gross financial flows transferred through the payment system of the second-largest monetary block in the world are enormous, at €2.5 billion a day. But such a settlement system was not designed for a large build-up of net cross-border positions, and these positions were indeed close to zero prior to the current economic crisis. But during the crisis, net positions have accumulated, and their magnitudes are remarkably large. In 2012, Bundesbank claims on the European Central Bank (ECB) due to TARGET2 balances amounted to €656 billion – well over half of all Bundesbank assets and over 40% of German GDP.<sup>37</sup> On the other side of the ledger, countries that suffered most from the financial crisis have built up large net liabilities towards the Eurosystem, with the ECB's claims on the central banks of Greece, Ireland, Italy, Portugal and Spain summing to more than €650 billion in 2011. In the midst of a financial crisis that has taken many unexpected turns, it is natural that concerns be voiced about such imbalances. Concerns about the risks of the TARGET2 system have indeed been outlined by Sinn (2011a, 2012b) and Tornell and Westerman (2011a, 2012), for example.

Dr Whelan's paper does an excellent job in describing the mechanics of the TARGET2 system. The surprising imbalances in the Eurosystem began as a result of capital flight from the crisis countries toward the financial systems of northern Europe. As depositors withdrew from Spanish banks to deposit in German banks (as an example), Spanish banks drew down their reserves (or accumulated a liability) against the European Monetary System (EMS). Similarly, German banks accumulated reserves with the EMS. As with any other settlement system, these changes in reserves netted to zero and the balance sheet of the EMS as a whole remained unchanged. However, two features of the TARGET2 system have allowed the noted imbalances to arise. First, eurozone national central banks (NCBs) remain in existence and are the reserve institutions for banks in their respective countries. Second, NCBs are not required to settle their intra-EMS claims. Thus, while the balance sheet of the Eurosystem as a whole is unaffected by the capital flight from southern to northern Europe, the NCBs, having failed to settle their cross-border positions, have accumulated large positions vis-à-vis the ECB.

The paper proceeds with careful accounting for the balances of various NCBs, their relation to current account deficits and central banks' exposure to risks of a break-up of the Eurosystem. Through this accounting exercise, Whelan points out that TARGET imbalances simply shift assets and liabilities within the Eurosystem, and that the habitat of these assets and liabilities is immaterial if the eurozone is a true currency union. He also points out that there is no correlation between current account balances and TARGET2 balances. Finally, he shows that the net exposure of the

<sup>37</sup> The central banks of the Netherlands and Luxembourg also hold large claims on the ECB, accumulated due to TARGET2 imbalances, at €153 billion and €109 billion in 2011, respectively.

Bundesbank to the Eurosystem is small and that scenarios under which a eurozone break-up is enormously costly to Germany are not very likely. This painstaking accounting exercise is useful. But the exercise is an accounting one, rather than a true risk assessment of financial, economic and political-economy risk.

Let me begin by taking on a claim made repeatedly in the paper that if a (central) bank simultaneously takes on to its balance sheet assets and liabilities of identical magnitudes, nothing has really changed in the world, because the bank's 'net assets' have not changed. This position seems rather untenable to me, particularly given all we have witnessed in the past six years. It is a feature of double-entry accounting that any standard banking transaction does not increase the net assets of the bank. But this is not a risk assessment. By this logic a private bank borrowing short term to purchase toxic assets has changed nothing in risk characteristics. The logic is flawed for two reasons. First, this transaction *does* increase the bank's leverage, and therefore the riskiness of the bank's balance sheet. I will turn later to the question of whether negative net worth is a problem for a central as opposed to a commercial bank. But there is no question as to whether the risk characteristics of the bank's balance sheet have changed. Second, all assets and liabilities are not created equal. Taking on a certain liability (a debt to the EMS), while taking on a risky asset (eligible collateral from Spanish banks) increases the riskiness of a central bank's balance sheet.

Whelan argues forcefully, but rather semantically, that the eurozone's clearing system does not provide a 'stealth bailout' to peripheral Europe. I can't see a case that no assistance is provided to the crisis countries through this system. I should emphasize from the start that – unlike the critics of the TARGET2 system – I view these 'stealth bailouts' as a desirable feature rather than a bug in the EMS. But then again, I am not a German taxpayer and won't have to bear the consequences if these gambles fail.

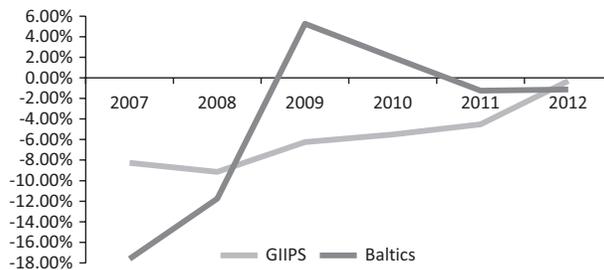
An analogy from the International Monetary Fund (IMF) is useful. When the IMF provides a loan to an emerging market (EM) central bank, which then might turn around and provide a loan to a domestic bank, there too the assets and liabilities of the central bank have expanded by identical amounts. According to Dr Whelan, the IMF is not providing any assistance to the EM central bank. What the author fails to recognize is that creating high quality assets at a low social cost is an enormous challenge for a central bank in a financial crisis. This in large part accounts for the difference between the experience of Thailand during the Asian financial crisis and the United States in the current one, to take two examples. When an EM (or small, open eurozone country) experiences a sudden stop in capital inflows, the last thing investors are looking for is another baht, peso, or drachma on their balance sheets. The simple act – that Whelan takes for granted – of expanding the central bank's balance sheet is in these cases difficult or counterproductive. The central bank simply does not have the 'technology' to provide private investors with assets they are willing to hold.<sup>38</sup> The

<sup>38</sup> The problem is particularly acute if the EM is committed to a fixed exchange rate, as eurozone members are. In this case expanding the central bank's balance sheet may be inconsistent with its mandate.

IMF was designed precisely to exchange a central bank liability that others are unwilling to bear in return for a desirable liquid asset in the form of hard currency reserves. That the Greek central bank can freely issue liabilities, in euros, 27% of which are backed by the full faith and credit of the German taxpayer is a privilege any emerging market would have loved to have in such a crisis.

I now turn to the question of current account balances. Has the TARGET2 system allowed GIIPS countries a more orderly unwinding of current account deficits? **It is unclear to me what we learn from the regression in the paper that shows that current account balances have been uncorrelated with TARGET2 balances. This is precisely what we'd expect if the TARGET2 system provided a very effective bailout.** As capital flows out of peripheral Europe during this sudden stop episode, the balance of payments identity requires that the current account contract sharply. But each euro that the TARGET2 system allows in the form of automatic capital inflows from the Bundesbank to crisis-affected countries is a euro of current account reversal that need not occur. **Thus if TARGET2 provides a bailout to the crisis-ridden countries, TARGET2 balances should be correlated with the counterfactual current account deficit that *did not* occur.**

No such counterfactual is available, but I will draw a (somewhat crude) comparison between the GIIPS and another set of countries in the European periphery, also hit by a sudden stop in capital flows, and also committed to maintaining a peg with the euro: the Baltic economies. Figure 14 shows the average path of the current account in these countries on the one hand and in the GIIPS countries on the other. In the Baltic, we see a very sharp and sudden current account reversal, a reversal of 17% of GDP in 2009 alone. None of these countries saw a reversal of less than 12% of GDP; their current account balances were all in surplus in 2009, with surpluses ranging from 3.4% to 8.6% of GDP. In contrast, with the exception of Ireland, all GIIPS countries were still running current account deficits in 2012 and even Greece has seen a gradual rather than precipitous decline in its current account deficit, which stood at 15% prior to the crisis. These comparisons are admittedly crude; there are many confounding factors; and it is certainly fair to question whether the TARGET2 balances are the reason for these differences. But it is also fair to wonder whether a Greek central bank



**Figure 14. Current account surpluses of GIIPS economies and Baltic economies, in percentage of GDP**

would have been able to increase its liabilities by 50% of GDP, while issuing hard-currency loans to its domestic financial sector, as it has done through TARGET2, if it were not part of the EMU.

Finally, let us turn to the risks facing the German taxpayer. If the eurozone continues to operate indefinitely as it did in the first decade of existence far into the future, the balance sheet of the Bundesbank, as distinct from the EMS as a whole, is clearly immaterial.<sup>39</sup> We should then acknowledge that the concern for the Bundesbank's balance sheet is only a true threat to German taxpayers in the unlikely scenario of a eurozone break-up, further involving a default on EMS liabilities toward the Bundesbank. Dr Whelan is on much less firm ground in claiming that there is little *theoretical* link between the Bundesbank's balance sheet and the interests of the German taxpayer even under this disaster scenario. First, Whelan claims that a central bank need not be solvent. After all, its liabilities are in the form of fiat currency. Certainly, the Bundesbank issues no guarantee that it will trade euros for other assets. But refusal to do so is akin to defaulting on its ability to conduct monetary policy and to control inflation. As the crisis unfolds, and demand for bank reserves drops to normal pre-crisis levels – more so as interest rates begin to rise – the orderly conduct of monetary policy does indeed require assets on the Bundesbank's balance sheet to (buy) back currency in circulation. Could the Bundesbank meet a commitment to price stability if it lost three-quarters of its assets? We are in uncharted territory.<sup>40</sup>

To illustrate the potential risks to the conduct of German macroeconomic policy, Figure 15 shows the evolution of German M1 from the early 2000s to today. From the adoption of the euro until 2008, German M1 increased at a remarkably steady rate. German M1 increased precipitously since 2009. While the exact relationship between M1 and inflation is hard to assess, we might conjecture that demand for real balances might return to its previous trend when the dust of the current crisis settles. This (admittedly crude) back-of-the-envelope analysis would require the Bundesbank to dispose of €340 billion of assets from its balance sheet to reduce outstanding liquidity. The concern that the Bundesbank is skating on thin ice follows from the fact that Bundesbank assets net of TARGET2 claims amount to €370 billion.<sup>41</sup>

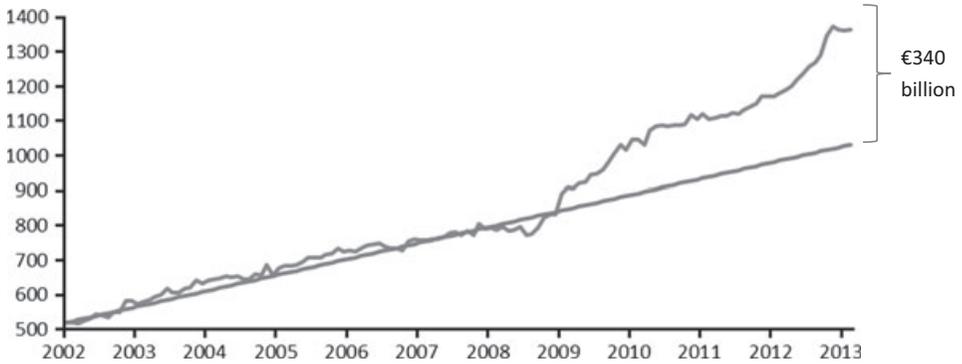
I should emphasize that I share Dr Whelan's point of view that the scenarios outlined here are very low-probability events. Should the jeremiads of German comment-

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<sup>39</sup> There is still a separate issue whether the German taxpayer should worry that she is on the hook for a quarter of all liabilities that, say, the Banco de España has built on its balance sheets.

<sup>40</sup> The losses would be an order of magnitude larger than the recent experiences of insolvent central banks. See, for example, Dalton and Dziobek (2005).

<sup>41</sup> The companion claim in the paper that a Bundesbank recapitalization has no fiscal cost, because it simply exchanges a Federal liability for a Bundesbank asset is easy to dispel. The main rationale for Bundesbank capitalization would be the need for contractionary open market operations, which would quickly place these Federal liabilities in the hands of the public.



**Figure 15. The evolution of German M1 from the early 2000s to date**

ators be dismissed as excessively panicky? Perhaps. But the current crisis has taught us that once the unexpected occurs, it is very difficult to predict how events will unfold. A risk-management strategy that tries to reduce the costs of tail events ultimately seems prudent. If the black swan of eurozone break-up occurred, the distributional implications will be determined by a host of political and economic factors that are very hard to foresee. If I had to voice one critique of those worried about these distributional factors it is that they would likely be dwarfed by the overall economic costs of such events. Perhaps it is precisely these uncertainties that will preserve the eurozone intact during the turbulent years to come.