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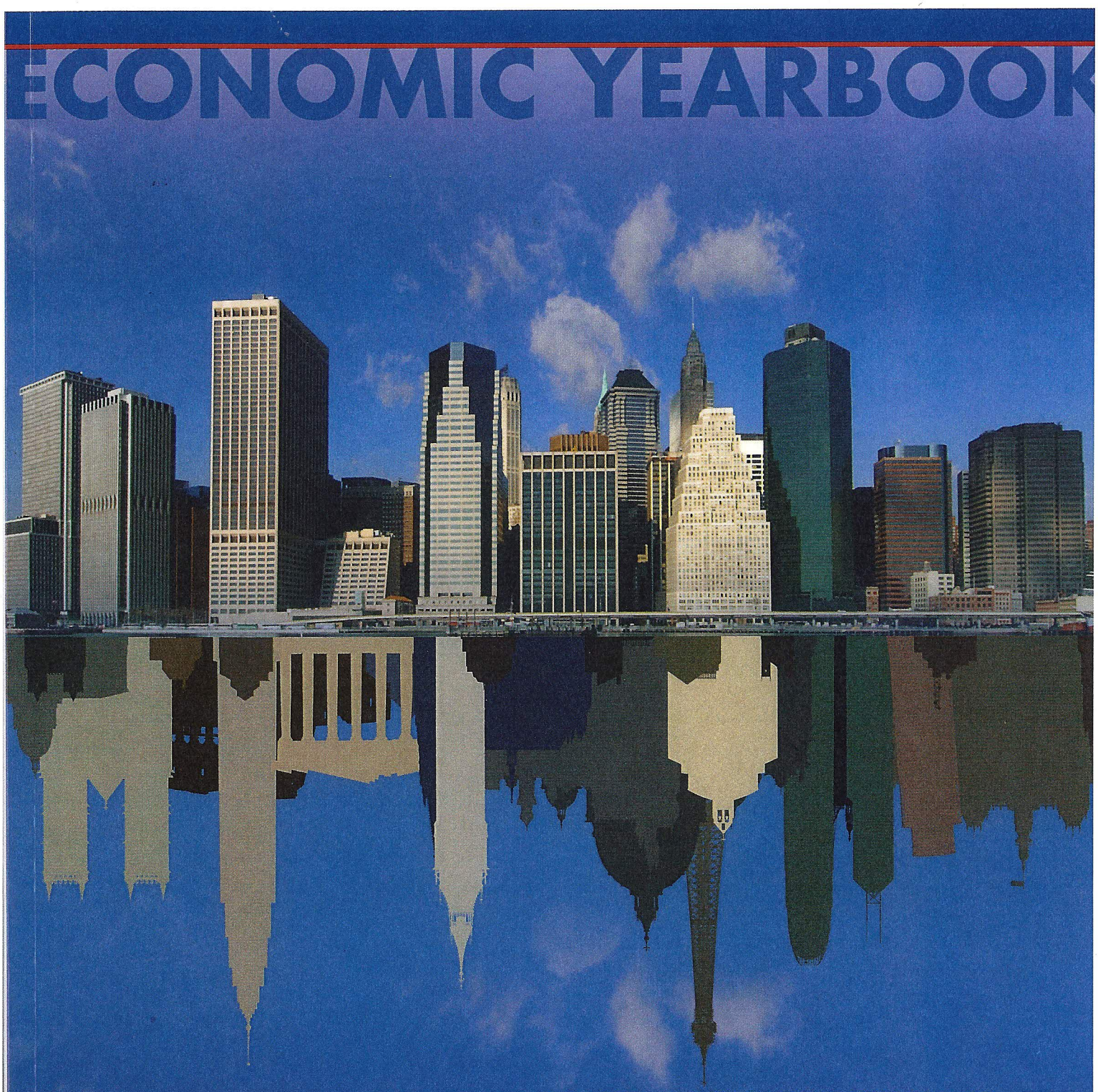

UNITED STATES-GERMAN ECONOMIC YEARBOOK 2012

ANNUAL SURVEY: GERMAN AMERICAN BUSINESS OUTLOOK • 38TH EDITION

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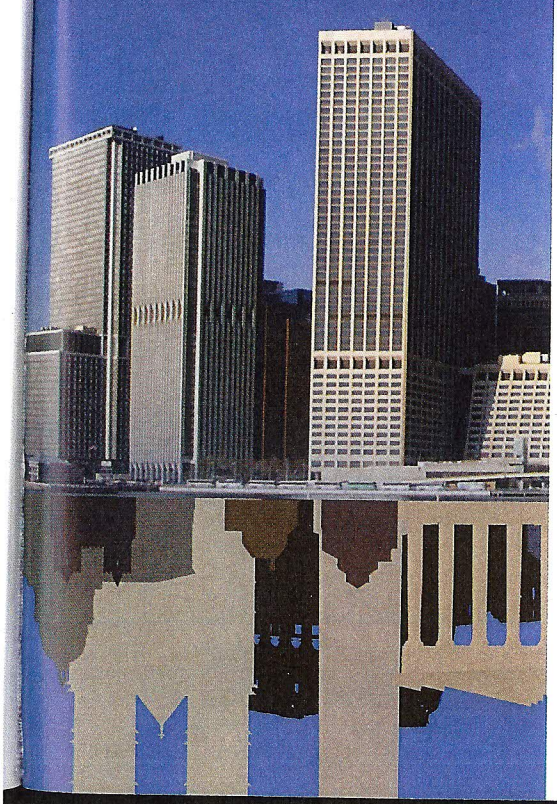

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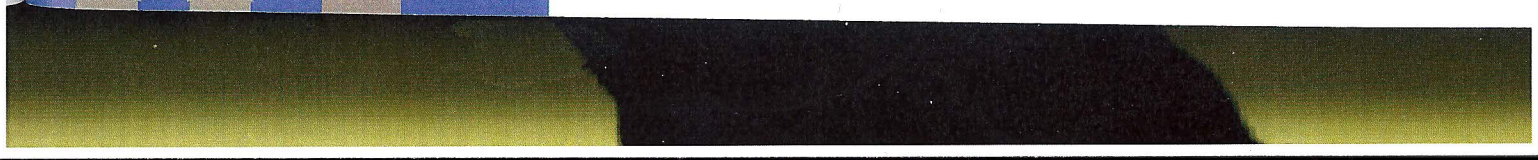

How Target-Like Balances are Settled in the USA

by Hans-Werner Sinn

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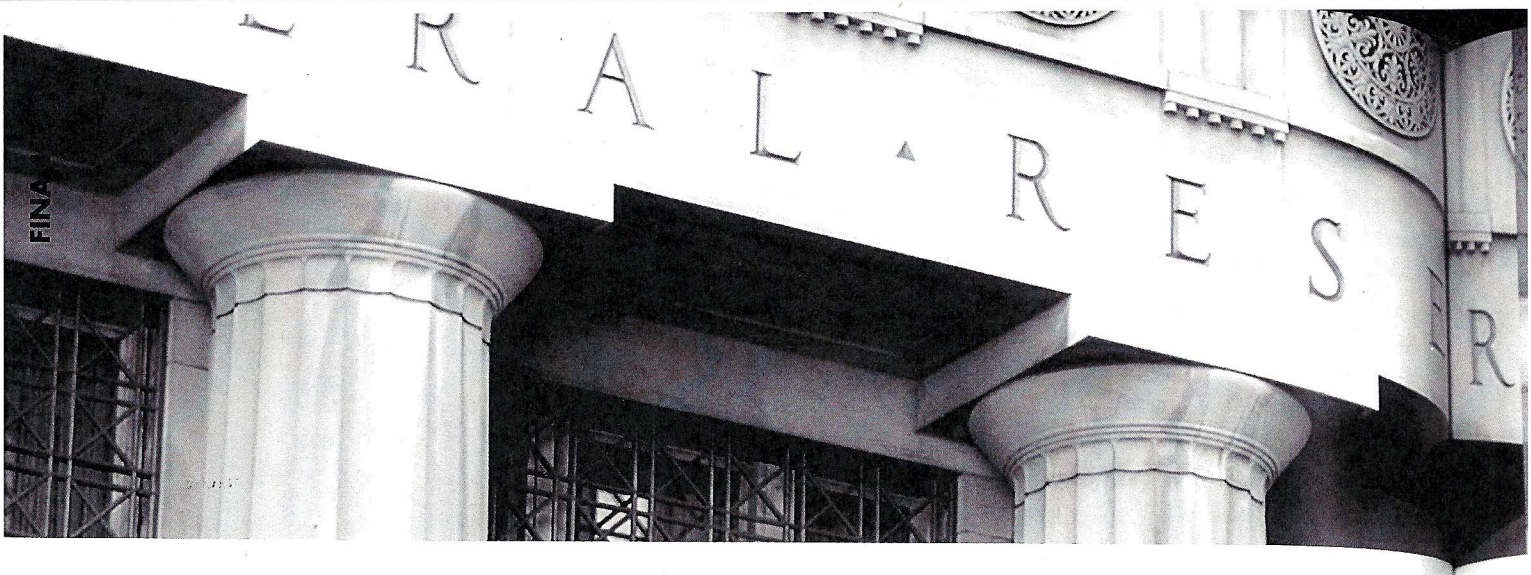


How Target-Like Balances

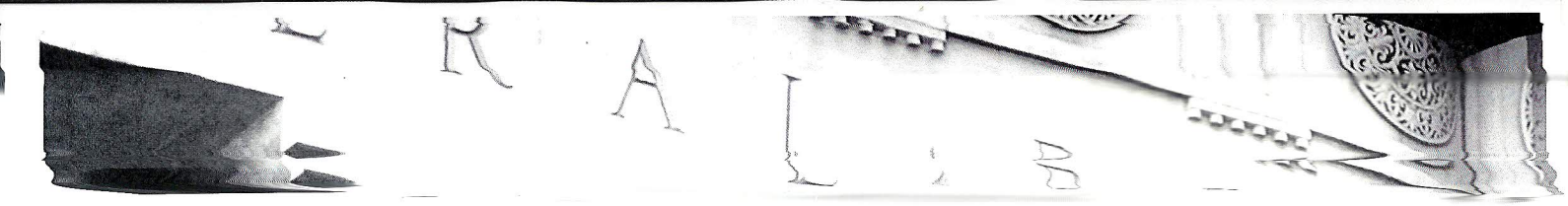
THE BALANCES HAD TO BE SETTLED PHYSICALLY, USUALLY WITH GOLD, WHICH THEN HAD TO BE TRANSPORTED BETWEEN THE BANKS INVOLVED. ANY LOVER OF WESTERNS WILL HAVE CLEAR IMAGES IN HIS MIND.

The USA evolved to its present form gradually, over the course of its two-hundred-year history. Likewise, its monetary system was not devised on a drawing board, but evolved over time. From early on there were dollar coins and, since their exact gold and silver content was set by law, the official mint of each federal state could issue currency. Paper money was first brought into circulation in 1861 to finance the American Civil War. The Federal Reserve System ("Fed"), America's central bank, was not established until 1913. To be sure, there were earlier attempts at setting up central banks, in 1791 and 1816, but they were only granted 20-year charters and were closed once the charters expired. Together with the Fed, 12 regional central banks were established (officially known as Federal Reserve Banks, shortened to "District Feds"), which issue and lend out money in adherence to Fed rules. The structure of the American monetary system is comparable in this respect with the Eurosystem. The size of the District Feds is also similar to that of the 17 national central banks in the Eurosystem.

The U.S. central bank system, however, is not a governmental institution. The District Feds belong to the private commercial banks that hold stock in them, and are at their service. Their district boundaries have little to do with federal state borders: in some cases, several states belong to one District Fed; conversely, there are states whose territory falls within two different District Feds' jurisdictions.

This history may serve to illustrate why the issue of Target-like balances has never reached the significance in the U.S. that it has attained in the Eurozone. For one thing, it explains why the central bank system did not lend itself to financing individual federal states, unlike in the Eurosystem, where the national central banks issue money and lend it out to domestic commercial banks in order for them to purchase government bonds, accepting then these bonds as collateral. For another thing, balances could not acquire the same importance as in Europe because the District Feds always tried to avoid them.

Certainly, before the Federal Reserve System existed money transfers were already being made right across the country, without cash having to be transported physically from one place to another. People would send checks as payment, and in order for them to be cashed, transfers had to be made between the banks involved. The banks netted out the transfer orders and provided temporary



are Settled in the USA

credit to each other, but eventually the balances had to be settled physically, usually with gold, which then had to be transported between the banks involved. Any lover of Westerns will have clear images in his mind.

The new Federal Reserve System made settling payments easier by setting up a clearing portfolio for gold-backed securities at the Fed in which each District Fed owned proportional shares. Parts of these shares were transferred from one bank to another within the clearing portfolio in order to settle the balances, rendering the physical transportation of gold unnecessary.

After the gold-based Bretton Woods System of international exchange rates broke down in 1973, gold also lost its role for the intra-U.S. settlement procedure. From 1975 onwards gold-backed securities were replaced by ownership shares in the Fed system's open market portfolio of assets acquired in the process of money creation, with the interest on these ownership shares being reallocated accordingly. This, however, did not alter the nature of the settlement procedure.

The instrument to reduce deficits in the payments settlement procedure is the curtailment of local lending. If money flows out in net terms towards other districts, for instance as a result of the economy of the district in question overheating and building up an excess of imports (i.e. a trade deficit) which the capital markets are not willing to finance, the District Fed can abstain from compensating the entire outflow through the granting of new credit. The consequence is that money becomes tight, pushing up local interest rates. Throughout history, time and again there have been differences in the interest rates among the districts that were sufficiently high to attract lending from outside the district, thereby reducing the size of the deficits. In this way, the District Feds avoided accumulating large balance-of-payments imbalances throughout the pre-crisis history of the U.S. Fed.

To be more precise: under the U.S. system, transfer orders between the commercial banks flow solely through the District Feds, and each keeps an Interdistrict Settlement Account (ISA) with each of the eleven other District Feds. The balance on this account is in principle the same as the Target balance of a national central bank in the Eurozone, since it shows how many net money transfers a District Fed has performed on account of the others; in other words, how much credit it has granted them by crediting the account of the beneficiary bank at its own expense. The difference is only that the ISA balances lead to bilateral obligations, whereas the Target balances represent obligations towards the ECB system as a whole, because at the end of each day, the bilateral Target balances are converted into claims on, and liabilities to, the entire Eurosystem.

If a District Fed holds a negative ISA balance with respect to other District Feds, it must have run up a balance-of-payments deficit because in net terms, money it created through refinancing credit or the purchase of securities and passed on to the private economy was cabled to other jurisdictions. That is exactly what a negative Target balance shows in the Eurozone. Of course, the exact opposite occurs with positive balances.

In the U.S. it is also possible for a District Fed to create more money through the granting of local credit than is necessary for circulation within its own jurisdiction, resulting in, or compensating for, an outflow of electronic central bank money towards the jurisdiction of other District Feds, which forces the other District Feds to honour the money transfers by handing out money without in the process acquiring credit claims on the commercial banks. This leads to the District Fed that originally created the money having a negative ISA balance, i.e. a debt towards other regional central banks.

Unlike in the Eurozone, the debt does not accumulate from year to year: it is settled every year in April by reallocating ownership of the securities in the clearing portfolio in response to the changes in the ISA balances. That is the key difference. Only in Europe can a region, within the rules of the Eurosystem, draw as much money as it wishes by cranking up the local printing press at an interest rate of only 0.75% in order to buy goods or assets elsewhere, elsewhere, letting the corresponding sums be chalked up to their local central bank's credit account. In the U.S., the debtor District Feds must relinquish marketable assets that yield market interest.

The incentive for building up balances in the payments settlement system by creating more money than needed for local circulation is limited in the U.S. system. For one thing, as a rule the District Fed must create the money by acquiring an unbiased share in the market portfolio, which precludes any lowering effects on the local interest rates. The irresistible incentive to take on low-interest credit below market conditions by resorting to the local money-printing press observed in the Eurozone is thus absent in the U.S.. For another thing, the District Fed must relinquish ownership shares in its open-market portfolio, losing the corresponding returns, if it wants to grant refinancing credit of the European type that will lower local interest rates and lead to a net outflow of money. Since the interest rates for the open-market portfolio are higher than those for short-term refinancing operations, this will hit its profits. True, the excess of revenue over costs has to be delivered to the Federal government. However, costs include local salaries and many other things that make the District Fed an attractive employer. Thus, such a hit in profits is not welcome for local decision-makers and they will certainly try to avoid it. In any case, under normal circumstances a single District Fed has no incentive to create too much money, since by drawing down its assets in the Clearing Portfolio it reduces its room for manoeuvre in any future balance-of-payments crises.

The incentives to excessive use of the printing press are low, even though the ISA balances do not have to be settled quite in full every April. Applying a complex formula and under the influence of individual decisions of the Federal Reserve Board, what is actually calculated for settlement is essentially the difference between the last year's daily average of the balances and its value in April a year ago. This is not entirely insignificant, since it means that, in the U.S., balances can also accumulate during a crisis. The balances, however, do not increase steadily and systematically, but are brought down on a regular basis.

What happened in reality is shown by the blue curve in the figure below, which shows the gross sum of the ISA balances, that is, the sum of all claims of the District Feds (or, which is the same thing, the sum of all liabilities) relative to U.S. GDP. It can be seen that the volume of ISA balances before the financial crisis was around 0.2% to 0.3% of GDP, rising during the crisis to 2% and then to nearly 3%, to sink thereafter to a level comparable to that before the crisis.

It can also be seen that the volumes do come down in April of each year. Before April 2009 they decreased gradually, month by month, because the District Feds apparently took care, by granting less credit, to avoid the losses resulting from the reallocation of securities in the Fed's clearing portfolio. The cutback in credit gave rise to an inflow of funds from other districts, because economic agents had to tap the American financial market for private credit. After the settlement deadline, the balances went up again. The upward-and-downward movement around April 2009 is evidence of the incentive effect mentioned above.

In April 2010, the ISA balances receded markedly, evidently because outstanding liabilities were retired by having the deficit District Feds transfer securities in the clearing portfolio to the District Feds in surplus.

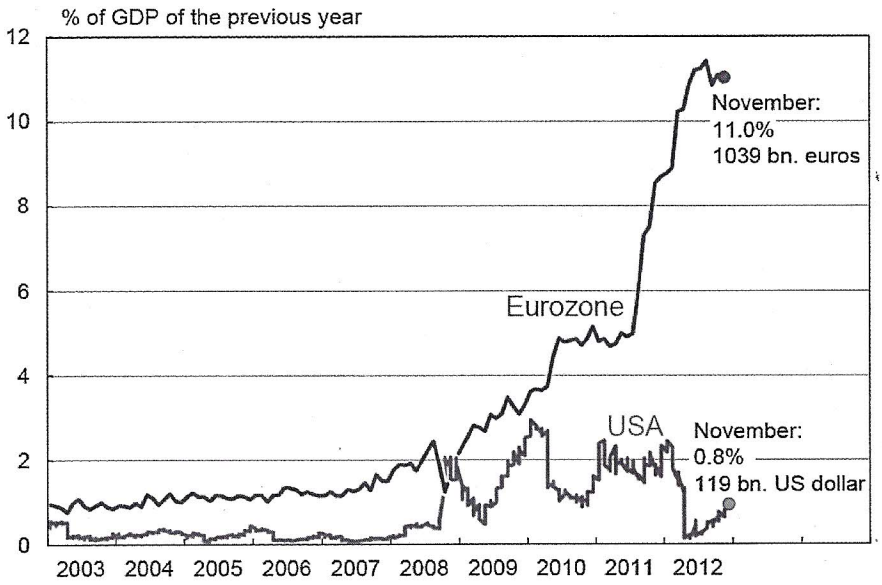
In April 2011, however, such was not the case, as the balances hardly moved. The Board of Governors at the Fed reportedly decided to postpone debt retirement for one year. This led to an even larger cutback in refinancing credit by the deficit District Feds in the months leading to April 2012, when the balances settled, as well as to larger settlement volume itself. In July 2012, the gross vol-

ume of ISA balances amounted to merely 0.3% of U.S. GDP, or 39 billion dollars.

How different is the situation in Europe! In the Eurozone, depicted by the red curve, the gross volume of Target balances amounted to around 1% of GDP until the financial crisis hit in 2007, rose steadily thereafter until it levelled off temporarily at about 5%, and rocketed afterwards to currently 11.4% of the Eurozone's GDP, or 1.075 trillion euros in August 2012. The lion's share of the corresponding claims was held by Germany, with 751 billion euros. On the other side of the balance sheet Spain leads with 434 billion euros in Target liabilities, followed by Italy with 287 billion euros. By November 2012, the Eurozone balances had come down a bit after the ECB's announcement of unlimited purchases of government bonds in the secondary market, which induced new private capital flows to the crisis countries.

Behind the dizzying upward swing of the Target curve lies a huge shifting of German savings from investments in fungible marketable assets which people can resort to in their later years, to mere clearing balances that can never be called due and carry a minuscule rate of interest while being gradually eroded by inflation. German banks, for example, withdrew their funds from southern Europe and France, the latter acting as an intermediary for the credit flows to the south, and invested them with the Bundesbank, which in turn was accumulating Target claims on the ECB system, which itself held Target claims on the southern national central banks resulting from their excessive provision of refinancing credit.

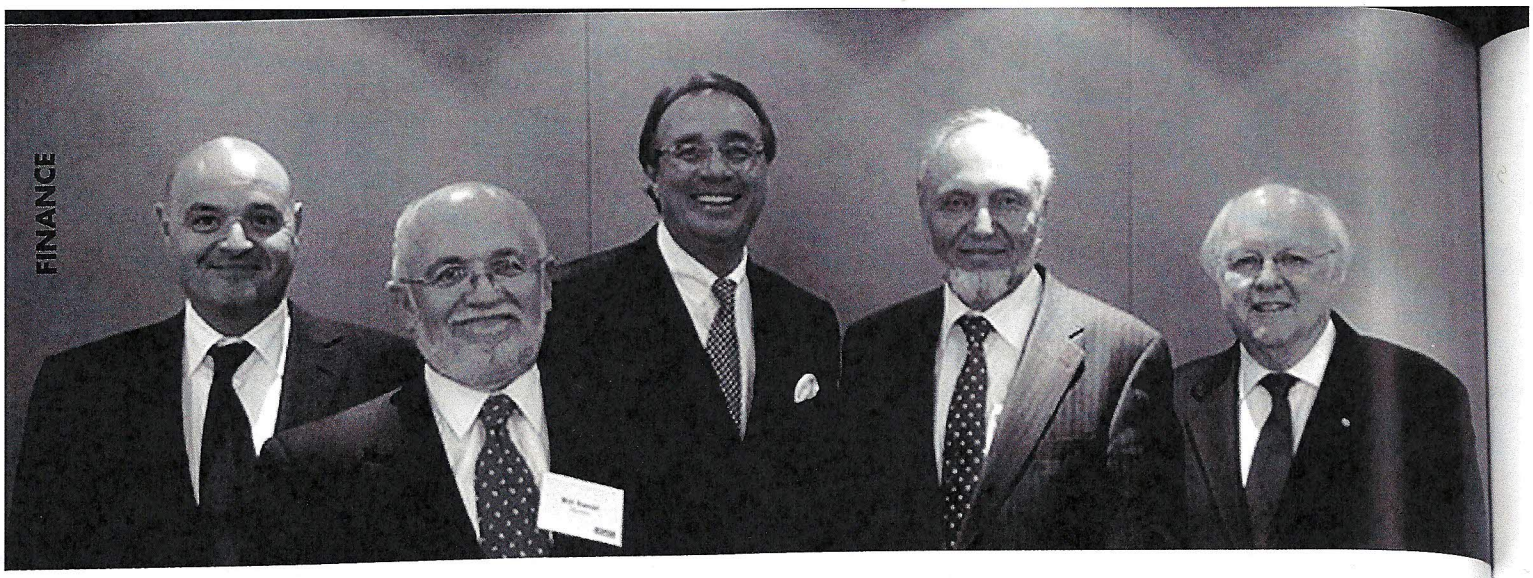
Target and ISA balances* as a share of GDP in the Eurozone and the USA, respectively (January 2003 – July 2012)



** Sum of the gross Target claims and sum of the gross ISA claims, respectively, of the Eurosystem's central banks and the Federal Reserve's System, respectively*

Note: The chart is based on data up to November 2012. Since each euro country publishes its Target balances at a different time, the data towards the margin is somewhat non-uniform. The data for the Eurozone's gross balance includes the surplus countries, i.e. Germany (November 2012), the Netherlands (October), Finland (September) Luxembourg (September), France (September) and Estonia (September).

The comparison with the U.S. starkly exposes this design flaw in the Eurosystem. If a monetary system offers the weaker economies unlimited amounts of money on a display window, confidence will be maximised, stabilising the capital markets and minimising interest rate differences across regions. But this is precisely what destabilises the regions, since it encourages them to take on too much credit. This, in turn, leads to inflationary overheating, huge trade imbalances and loss of competitiveness until their external debt is so large that the markets be-



Dr. Bernd Mayer, William Sweet Jr., both Partner with Skadden, Arps, Slate, Meagher & Flom LLP; Caroll H. Neubauer Chairman of the GACC New York and Chairman & CEO of B.Braun of America, Inc.; Professor Dr. Hans-Werner Sinn, President of the IFO Institute in Munich; Dr. Jackson Janes, Executive Director of AICGS at the Johns Hopkins University, Washington, DC.

gin to expect a breaching of the system ceilings and decide to withdraw, prompting the credit-dependent economies to start taking the money from the display window. The red curve shows the funds that have been withdrawn.

It is not sensible to induce absolute market confidence in the economy of a country or region through artificial protection mechanisms such as unlimited amounts of funding on a display window or unlimited firepower of the central banks. The capitalist system thrives upon a healthy scepticism on the part of investors, upon the caution of those who fear losing their money. The possibility of losing the money invested should never be removed, because otherwise the markets run wild and control is lost, just like a driver rolling downhill in a car without brakes.

It has been argued that no measures can be instituted to put a brake on Target balances, since the Eurosystem would collapse in that case. The balances are necessary for a smooth flow of transactions, and for this reason everything should stay as it is. If this were right, the U.S. system would have collapsed long ago.

In reality, the U.S.'s monetary system has existed for quite some time, because it does not offer the possibility of a self-service culture through its inter-district settlement system, nor of issuing joint state bonds: in other words, because it imposes hard budget constraints. In the U.S. it is also possible for a region to need more goods than it produces, so that it will run up a current account deficit, but for this it has to take on credit at market conditions; i.e., it must offer yields and collateral sufficient to encourage private investors from other regions to grant it credit. The higher the debts, the more interest it must pay, and the less attractive the taking on of more credit. This mechanism prevents excessive private or public indebtedness, inflationary overheating and the large local trade deficits that plague Europe's southern countries.

PROFESSOR DR. HANS-WERNER SINN *is the President of the IFO Institute in Munich, the Director of the Center of Economic Studies (CES) since 1991 and Professor and Chair for Economics and Public Finance at the University of Munich. He is a member of the Council of Economic Advisors to the German Ministry of Economics and holds several honorary doctorate degrees and recipient of awards and book prizes. Prof. Dr. Sinn has been honored with the Order of Merit of the Federal Republic of Germany and the Maximilians Order and is author of over 20 monographs and more than 135 scientific articles.*

The U.S. system is not so strict as to demand a continuous evening out of balance-of-payments imbalances. As the chart shows, temporary balance-of-payments deficits are definitely possible. If private credit from other regions does not suffice to cover the current account deficit, the District Fed in question may issue and lend out more money. But the resulting outflow of money must be compensated before long. The system thus has shock absorbers that are stiff enough to keep the wheels from bouncing about, holding the economic vehicle on course.

The balance-of-payments imbalances used to be settled with gold, in the same way that it was long customary among different monetary zones around the world, and not until more than a century after the founding of the USA a system was created, the Fed, that settled the balances with gold-backed securities placed in a central clearing portfolio, which later mutated to safe marketable securities. To this day, the balance-of-payments deficits must be settled by transferring ownership of real assets. After considering the evolution of the U.S. system, the ECB's notion that it is not necessary to settle the balances, just chalking them up to a credit account as it is done is Europe, is not convincing.

Translation by Julio Saavedra, Director of External Relations Ifo Institute -Center for Economic Studies(CES)