THE €CONOMICS OF TARGET BALANCES

Hans-Werner Sinn

From Lehman to Corona

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Abbreviations

ANFA	Agreement on Net Financial Assets
APP	Asset Purchase Programme
b.o.p.	balance of payment
BIS	Bank for International Settlements
COMECON	Council for Mutual Economic Assistance
CU	Currency Union
CUNCB	Currency Union National Central Bank
ECB	European Central Bank
EDIS	Eurozone Deposit Insurance Scheme
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EIB	European Investment Bank
ELA	Emergency Liquidity Assistance
EPU	European Payments Union
ESA	European System of Accounts
ESM	European Stability Mechanism
EU	European Union
Fed	Federal Reserve System
GDP	Gross Domestic Product
GIPSIC	Greece, Ireland, Portugal, Spain, Italy, Cyprus
i.i.p.	International investment position
IBEC	International Bank for Economic Co-operation
IMF	International Monetary Fund
ISA	Interdistrict Settlement Accounts
LTRO	Longer Term Refinancing Operations
MEP	Member of the European Parliament
MMT	Modern Monetary Theory
NCB	National Central Bank
OMT	Outright Monetary Transactions
PEPP	Pandemic Emergency Purchase Programme
PSPP	Public Sector Purchase Programme
QE	Quantitative Easing
SMP	Securities Markets Programme

SNB	Schweizerische Nationalbank
Target	Trans-European Automated Real-time Gross Settlement Express Transfer System
TFEU	Treaty on the Functioning of the European Union
WTO	World Trade Organization

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CHAPTER 1

Target: An Obscure Aspect of the Eurosystem

Target balances result from previous net payment orders fulfilled by the national central banks (NCBs). They constitute claims on, and liabilities with, the Eurosystem and are mostly hidden as "other items" in the respective balance sheets of these NCBs. While the sum of all balances is zero by definition, the positive and negative balances alike have grown throughout the euro crisis reaching values way beyond €1.2 billion, with Germany as the biggest Target creditor and Italy and Spain as the biggest Target debtors. The development of the Target balances mirrors the course of the euro crisis.

1.1 The Meaning of Target Balances

"Target" is the name of an international payment system sustained by the Eurosystem.[1] It derives its meaning from the fact that the Eurosystem is organized in a decentralized manner, consisting of a set of national central banks (NCBs) and the European Central Bank (ECB). The NCBs are owned by the respective nation states and distribute their profits to them, but they carry out the orders of the ECB Council. Target balances measure the sum of net payment orders that have been made between the countries of the Eurozone to buy goods and assets and to repay foreign debt. They are negative for a country that gave these net payment orders and positive for a country whose NCB carried out the orders. The balances are respectively booked as liabilities and assets in the individual NCBs' balance sheets.

The Target balances were very small before the Lehman crisis, showing slightly negative values for countries like Belgium, Greece, Austria and even Germany, while slightly positive values occurred for countries like France, Italy and Spain. But since the outbreak of this crisis, huge imbalances arose with strongly negative values for Greece, Italy, Portugal, Spain, Ireland and

[1] Trans-European Automated Real-time Gross Settlement Express Transfer System.

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Cyprus (GIPSIC), while Germany, the Netherlands, Luxemburg and Finland showed substantial or even very large positive balances. Figure 1.1 gives an overview of the structure of Target balances by the end of 2019. Note that among the negative balances, the figure includes those of the ECB itself. These balances resulted primarily from net payment orders the ECB made to the NCBs in order to buy assets from their territories. Intra-Eurosystem interest payments on the Target balances that the NCBs pay to one another and that result from the pooling of the NCBs' seignorage income are also recorded in the Target balances. This issue will be discussed in Chap. 9.

The overall development of the Target balances until the end of 2019 is shown in Fig. 1.2. The sum of all positive balances which was equal to the absolute sum of all negative balances went way beyond €1000 billion. By the end of 2019, the sum was €1286 billion, where the Bundesbank alone accounted for €895 billion. The Target balances are the largest single items in some of the NCB balance sheets, often hidden under miscellaneous items, and yet, only a few people understand what they mean.

As this book was completed just a few weeks after the outset of the Corona crisis, a complete set of data showing the effect of that crisis was not yet available when it was due. However, for the Bundesbank, Banco de España and

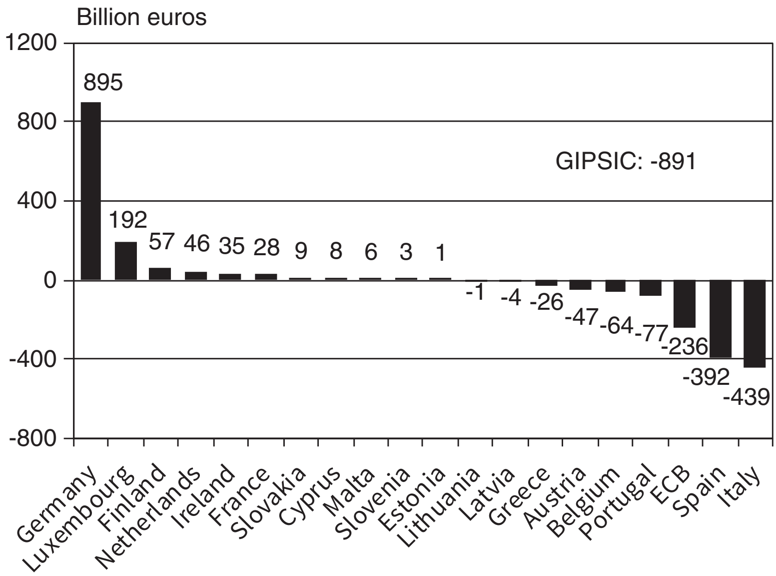

Fig. 1.1 Target balances 2019. (Note: The external countries associated with the Eurozone (Bulgaria, Croatia, Czech Republic, Denmark, Hungary, Poland, Romania and Sweden) are also allowed to have small positive Target balances. They are not included in this diagram. Source: European Central Bank, Statistical Data Warehouse, ECB/Eurosystem policy and exchange rates, Target balances of participating NCBs)

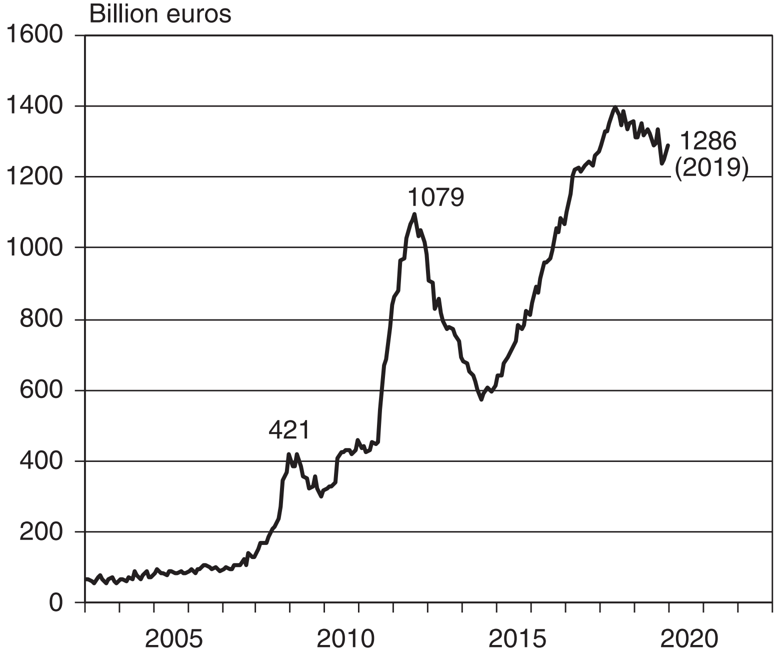

Fig. 1.2 The development of Target balances (absolute sum of negative Target balances). (Note: The graph shows the positive Target balances and the absolute values of their negative counterparts alike, if account is taken of the fact that negative balances may occur not only with individual countries but with the ECB itself while non-euro countries associated with the Eurosystem (Bulgaria, Croatia, Czechia, Denmark, Hungary, Poland, Romania and Sweden) are allowed to participate in the Target system with positive balances. The Target data used in this book refer to end of month. The ECB's negative balances (€236 billion by the end of 2019) result primarily from the ECB's participation in asset purchasing programs. Sources: Sinn/Wollmershäuser (2012), until April 2008 on the basis of a calculation using IMF Data, thereafter: European Central Bank, Statistical Data Warehouse, ECB/Eurosystem policy and exchange rates, Target balances of participating NCBs as well as Deutsche Bundesbank, Banca d'Italia, Banco de España, balance sheets)

Banca d'Italia the Target data covered in this book extend to March 2020 and thus do include the reactions of the respective balances after the first rapid breakdown of the stock market during the Corona crisis. Chapter 5 will argue that the Corona crisis opens up a new phase in the development of the Target balances, and Chap. 11 will discuss what has happened and might still be happening.

Much light has been shed on the Target balances in recent years, but there is an ongoing controversy about their meaning. Are they a normal implication of a well-functioning monetary system or do they indicate financial stress and problems? Do they involve risks for the creditor countries? Are they perhaps even a time bomb for the Eurozone? Or are they the glue that is keeping everything together? Whatever the appropriate answers to these questions, it seems fair to say that they have not yet been well understood by policy makers and even by many experts in academia and in the financial industry.

This is the rationale for this book: It seeks to give a systematic assessment of the Target phenomenon which may counter distorted narratives influenced by vested political interests. The book aims at addressing most of the controversial questions and views that have been expressed about the Target balances. The interpretation as well as the data and facts presented here are partly new, just because the balances have recently been influenced by new policy decisions. However, the book reflects the author's and others' writings on the issue[2] and it also reveals the general scientific knowledge that has accumulated since the rising balances were made known to the public and the economics discipline in 2011. This book tries to be objective, logical and truthful, but at the same time non-trivial, interesting and understandable to non-specialist economists, politicians and people interested in financial matters.

For politicians, Target balances are unpleasant accompaniments of the Eurosystem and make it difficult for them to offer explanations, because the potential policy implications are disturbing, and also because the issue is difficult in itself. The Target balances are therefore often named "meaningless, irrelevant accounting items". However, this view is certainly not correct. It conflicts with the fact that the balances are part of a country's net foreign asset position as published by Eurostat, and their fluctuations enter a country's official balance of payment statistics as public capital export. Former ECB President Draghi said he observes the Target balances "every day actually, not almost every day!" and warned that countries exiting the Eurozone would have to redeem their Target debt in full.[3]

1.2 Mirroring the Eurozone Crisis

Some observers see the balances as a mirror of the crisis if not as a kind of fever thermometer. Indeed, it is noteworthy that the rise of the Target balances coincides with the Eurozone crisis, which broke out in 2007/2008. Whether this mirror interpretation is true or false, it is useful for the reader of this book to be aware of some basic facts about the real economy of the Eurozone and in particular the way it changed when the euro was introduced and when a decade later the world financial crisis broke out in the US and swept over to Europe, igniting in its wake a long lasting Eurozone crisis.

[2] The earliest contributions in terms of short policy notes and newspaper articles were Sinn (2011a, b, c, d, e). For more extensive and scholarly early contributions see Sinn and Wollmershäuser (2011, 2012), Sinn (2012a, c, 2013, 2014a, 2015b, d, 2016a, pp. 213–33, 2018a). Homburg (2011, 2012), Schlesinger (2011, 2012), Westermann (2014b). The latest contribution is Sinn (2019b). Further references will be given below.

[3] Draghi (2012, 2017).

The crisis of the Eurozone began in August 2007 when, unnoticed by the general public, the European interbank market broke down for the first time and the first banks came into difficulties, above all French PNB Paribas and German IKK. It culminated with the collapse of the world interbank market after the Lehman crisis in September 2008.

The world financial crisis revealed profound structural imbalances among the countries of the Eurozone. These imbalances became clear, when the world economy and with it the economies of northern Europe recovered in the autumn of 2009 and 2010 while the southern European countries and France lagged behind. These countries suffered from the sudden disclosure of a loss of competitiveness in those sectors of the economy that face fierce international competition. By the end of 2019, twelve years after the outbreak of the financial crisis, the manufacturing output of Italy, Greece and Spain were all still about 20% below the level of Q3 2007. Figure 1.3 depicts the performance of the manufacturing sectors of a selected number of European countries.

Italy, the largest economy in the south, has shown a particularly poor performance. At the time of the Lehman crisis, its manufacturing output dropped by a quarter as did Spain's, and significantly much more than that of Germany or France. Thereafter, until 2010, the country experienced only a mild recovery, much less than Germany for example, and worse, in 2011 a new and serious decline began which caused an upheaval in Italian politics. In the autumn of 2011, Premier Silvio Berlusconi started secret negotiations about a Eurozone exit, but had to resign instead, together with Greek Premier Georgos A. Papandreou, who had had similar intentions.[4] As of 2019, 12 years after the outbreak of the crisis, Italy's overall performance was hardly better than that of Spain, suffering from an output decline of 19% over the entire period. From 2007 to 2019, the stock of manufacturing firms in Italy, net of business start-ups, dropped by 19.4% in net terms.[5]

Arguably, the structural problems that were suddenly revealed when the financial crisis swept over from the US to Europe had been caused by the euro itself, because the euro had created a dangerous economic bubble in southern Europe that ultimately burst. After being announced with a definite time table at the Summit of Madrid in 1995, the euro had wiped out the interest spreads relative to Germany because exchange risks were disappearing and investors believed that, despite the no-bail-out clause of the Maastricht Treaty, bankruptcies would no longer be possible. In Spain, Italy and Portugal, long-term interest rates came down by about 500 basis points, and in Greece they declined even by about 2000 basis points, the rate of interest for ten-year government bonds dropping from 25% to about 5%. This truly dramatic disappearance of interest spreads caused excessive private and public borrowing, which in turn created inflationary Keynesian bubbles that burst at the time of the Lehman crisis. The bursting left in its wake overpriced torsos of once halfway

[4] See Bini Smaghi (2013, p. 29) and Djankov (2014, p. 3, 17).

[5] See Istituto Nazionale di Statistica (2020).