



BALANCE OF PAYMENTS ADJUSTMENT IN THE MONETARY UNION: CURRENT EVENTS HELP SHED NEW LIGHT ON AN OLD QUESTION

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Remarks on the use of Target balances

Recently Hans-Werner Sinn has quite forcefully drawn attention to the fact that the Greek balance of payments deficit has been and still must be (re-)financed to a considerable extent via the Target system of the ESCB. This has touched off a discussion that could and should have been held already well before finally implementing monetary union in 1999, as the possibility and questionability of central banks participating in the financing processes within the European Monetary Union had already been brought up at the time (Reeh 1999). As welcome as the present debate is, unfortunately it – and debates on European Monetary Union in general – is conducted almost exclusively in concepts of economics instead of those of business economics or more precisely banking economics. Concepts in economics have always been relatively vague and in globalised and especially highly Europeanised economies can only become even vaguer in their national delimitation. They will also not become more concrete by being based on data from national accounts or various national economic statistics. Such very nationally shaped perception patterns are not only overestimated regarding their cognitive capacity but are also responsible for discussions that revert to dangerous generalisations and revivals of old *clichés* once believed to have been overcome. And this is not only limited to pub talk and articles in the yellow press but is also found in debates at the highest political and academic levels.

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That is why in this article Target balances will not be put into the context of traditional economics and correlated with the usual time series of national accountants and official statisticians for shedding light on all sorts of macroeconomic relationships. Rather, only the political and financial or banking handling of Target balances will be looked at.

What does the existence of permanent Target balances imply?

Durable surpluses and deficits among ESCB members are a clear indication that EMU-internal cross-border financing has not taken place at market-based commercial conditions. In the normal case, economic actors in surplus finance those in deficit without having to resort to central bank refinancing. However, if this happens permanently, it foremost reflects a distortion of competition. As such, this process contradicts the avowed monetary union objective to assure terms of financing that are as uniform as possible. In short, durable surpluses and deficits among ESCB members are an indication of a privileged access to credit being granted within monetary union. It is not that there is not and should not be any privileged access to financial funds in the European Union. To the contrary, it is exactly this end that the European Investment Bank and the EU budget¹ serve, each of which democratically legitimises privileged access in its own way. Systematic financing of deficits through the ESCB, however, was not at all and is not even now intended, not least because there is no legitimising procedure for it.

Whenever there are such surpluses and deficits, this is also a strong indication of lacking financial solidity. Here an often long-term financial need is being financed regularly in the short-term. With rising volumes, the nervousness on financial markets – on which refinanced bonds are first issued, later replaced and traded permanently – can only rise so that interest rates on new issues will increase rapidly and, at

¹ This is also the purpose to be served by the rescue fund, on whose final design, especially regarding its democratic legitimisation, work is ongoing.

least if checked accurately, additional collateral for ongoing refinancing will have to be provided.

Permanent and permanently rising surpluses and deficits are thus proof that a hidden as well as slowly extending monetary transfer union has been established. However, such a transfer union cannot be concealed forever, especially as the costs of concealment will rise considerably because of the participation of commercial banks (or more generally of Monetary and Financial Institutions, in Euro-speak of MFIs) that have to acquire the corresponding debt instruments. Therefore, a hidden monetary transfer union will sooner or later be replaced by an open fiscal transfer union or an open monetary transfer union or a combination of the two. This is precisely what is happening now. This can be done; this may even have to be done, as it is surely better than to continue as at present. However, it would have been better if it had been done earlier when accumulated surpluses and deficits were still quite smaller. Or better yet, if such durable surpluses and deficits had not been allowed to come into existence in the first place. However, for that to happen, one would have had to pay attention to the balances, which, at least until recently, no one has done.

Why does the ESCB ignore ESCB-internal surpluses and deficits?

For one, the ESCB has not been given the explicit task of preventing ESCB-internal imbalances or at least of seeing to it that such imbalances do not become permanent. It is also not one of the publicly expressed convictions of the ESCB that the absence of such imbalances is an indication of market-based commercial relations between debtors and creditors, and, conversely, that durable and thus structural ESCB-internal imbalances suggest that privileged access to credit is granted (see Reeh 1999). As these surpluses and deficits are not part of the otherwise quite comprehensive statistical publication programme of the ECB, as they should be, some cumbersome research is necessary to derive them from the balance sheets of the ESCB central banks.² However, some uncertainties have to be taken into account, not least because the implicitly assumed relationship that economic actors get their deficits financed through 'their' national commercial bank that in turn gets refinance from 'its' national central bank, is no longer so close due to

financial integration. Even public deficits are today increasingly financed through foreign financial institutions. Therefore, the original financing and subsequent refinancing may diverge in their national attribution. Nonetheless, solely on the basis of the magnitude of the currently calculated surpluses and deficits, we have every reason, with due caution, to believe that a correction would not significantly change the result, as difficult as this correction may be in reality.

The statistical eye of the ESCB has obviously a kind of blind spot here, and supplementing it from outside the ESCB is not a trivial matter. Worse, it is not at all considered to be a problem for and by the ESCB management, because the ESCB is supposed to focus, in accordance with its legal obligations, only on inflation as measured by the HCPI for the euro area as a whole. Consequently, the data set on which the ESCB management bases its decisions only consists of statistics for the euro area as a whole, and this limitation is meant to underline that the ESCB policy, according to both the law and its self-understanding, is obligated to the whole and does not take account of the general state of the economy or the states of individual member countries.

National data – and this is probably the most important exception – only play a role for the ESCB in so far as they serve to shed light on the fiscal situation of the individual member countries. This fiscal focus ultimately shows that in the self-understanding of the ESCB the monetary union can only be threatened by public sector deficits. That the ESCB possibly promotes excessive borrowing by its own business practices and conversely, as refinancing institution, could make a contribution to reducing excessive public borrowing (and also would want and be in a position to do so) is neither part of the basic convictions of the ESCB management nor those of the EMU's founding fathers or the EMU's current political masters.³ The ESCB was always understood – and itself wanted to be seen – as an independent and competent administration that keeps the money supply sufficiently tight and utters well-chosen statements on the basis of elaborate models about the general state of the economy and especially of inflation. At best, it sees itself, without saying it out loud, as part of a cartel for set-

² On the calculation of the surpluses and deficits, see Sinn and Wollmershäuser (2011)

³ Whereas before accession to the Monetary Union, central banks granted loans to each other only under very restrictive conditions (we are reminded of the haggling over terms, especially the provision of collateral), it was believed at the time of entering the Monetary Union and still seems to be believed that the unrestricted granting of credit must belong to the constitutional parts of a monetary union or equivalently that there can be no credit relationships between participating national central banks.

ting refinance conditions and distributing profits, but without any latitude for discriminating between public debtors. In short, the ESCB embodies an understanding of the business of EMU central banks that has little to do with the banking business. Accordingly, it is largely irrelevant that EMU central bank are banks in public ownership, with assets and liabilities, especially with equity, with an investment policy and finally with duties of accountability to their owners.⁴ The public-law mission of the ESCB determines its self-understanding much more than the constitutive nature of its member institutions and the techniques with which they implement their tasks.

On the other hand, the ESCB does pay some attention to the Target balances. Within its CCBM, the joint management of collateral from issuances, collateral is transferred as of recently from deficit to surplus central banks in accordance with respective surpluses and deficits. These balances may perhaps be (at least tacitly also in the perception of the ESCB) claims of surplus central banks and liabilities of deficit central banks, and ultimately interest-free loans.⁵ With some good will, this arrangement may even reflect a very weak form of balance adjustment, as surplus central banks now own some corresponding collateral deriving from the emission of deficit central banks. This guards at least somewhat against a direct plundering of surplus by deficit central banks.

But all of this is rightfully treated as a purely technical arrangement, as it means nothing in the every-day business of the ESCB. It does not cost anybody anything and neither does it benefit anybody. It neither constricts the scope of deficit countries and their central banks, nor does it expand the scope of surplus countries and their central banks. The fact remains that surplus central banks have lost control over their balance sheets, even it is acknowledged that they were allotted collateral that is admissible throughout the ESCB. And if this arrangement were to take on importance, as in the case of an EMU exit of a country in deficit and thus an ESCB exit of its central bank, then the collateral from the issuing activity of this central bank is probably not so safe either.

⁴ Central bank presidents are rarely true bankers. Today they are former advisors of their heads of government, former state secretaries of relevant ministries, sometimes even former ministers. Among the nine presidents, Karl Klasen was the only true banker at the head of the Deutsche Bundesbank.

⁵ Interest-free loans may be justifiable, as central banks share the interest income from their emission. But it is in no way imperative. Thus, it could be argued that central banks in deficit ought to relinquish at least part of their seigniorage, especially if their deficits are permanent. It is not so much a question of principle than one of weighing advantages and disadvantages; maybe also of one of fairness and justice.

Nonetheless, it is a good thing that this arrangement exists, as it may serve as starting point for further considerations.

What has happened in and because of Greece (and elsewhere)?

Evidently central bank refinancing has been very attractive due to the large interest rate differential between government bonds (of Greece and other countries) used as collateral and central bank credit. In addition, the ‘haircut’ to be applied, dependent on the debt instrument, was – if at all relevant because significant – more distant from the market, at least for the debt instruments of public debtors. And nothing is to be learnt either about providing additional collateral because of a margin call. However, here not only a national finance minister has pushed ‘his’ national debt instruments into the balance sheets of ‘his’ national commercial banks in order to have them refinanced by ‘his’ national ESCB central bank. Rather, once it had been started, this form of privilege expanded on its own, as financial institutions from other member states with access to central bank finance sensed a simple and profitable business deal here. With little operative expense, much could be earned. As in a gearbox, it was enough to move a large wheel, which is especially easy to turn in times of crisis when central bank rates are close to zero. That is why the bonds did not have to be pushed; they were simply sucked in by commercial banks (more precisely by all sorts of MFIs with access to EMU central bank finance) almost everywhere in the euro area.

In this context it should not be overlooked that delays in debt restructuring (of Greece and other countries) widens interest rate differentials without substantially increasing the risk (or what is believed to be the risk). The commercial banks were and still are ‘too big to fail’, and although sovereign default (of Greece and other countries) was always conceivable, in the final analysis it is considered to be ‘unrealistic’.⁶ An always present moral hazard, afflicting the supply as well as the demand side of credit, has therefore at least

⁶ After all, the Stability and Growth Pact has the objective of rendering improbable a sovereign bankruptcy made conceivable by monetary union. But at the same time it undermines the ‘no-bail-out’ rule, for, if despite the Pact, sovereign bankruptcy threatens, this also implies a collective failure of the institutions carrying the Pact, which should entail co-responsibility. This applies all the more as the Pact places conditions on member state threatened by bankruptcy that restrict its scope of fiscal action and thus its dealing with the threatening bankruptcy. One could therefore also speak of a system with too many controls. Double is not always more durable, and certainly not in this case.

delayed market price adjustments, if not suspended them, and thus permitted or possibly even promoted an excessive public (in the case of Greece) or private (in the case of Ireland) indebtedness.

Because of the automatic if not forced lending, there is a deterioration of the balance sheet quality not just of surplus central banks but of the entire ESCB. Roughly following Gresham's Law, good collateral is driven out by bad collateral: the good collateral is kept for the normal business, the bad collateral for the business with the ESCB's central banks that have accepted, since 2007, an especially wide and uniform range of collateral. Even if for Axel Weber the related flexibility permitted the ESCB to act effectively in the crisis without the need to extend its monetary tool kit quickly,⁷ the price to be paid for it in terms of the declining overall quality of the collateral accepted for emission must at least be acknowledged.⁸ Collateral quality represents, after all, the basis of a currency and determines the inflation potential: the worse the collateral quality, the bigger the inflation potential and the more volatile the exchange rate in the up and downs of speculation. With collateral quality declining it becomes ever more improbable if not impossible that the central bank would be able to withdraw all its money issued.⁹ And this not only leads eventually to inflation, this is ultimately inflation.

We should further not overlook that the cheap refinancing of recent months, if not years, is accompanied by considerable profit losses of the ESCB. We could even speak of a partial privatisation of seigniorage *via* a subsidised refinancing of commercial banks by near-zero interest rates. Commercial banks are princely rewarded for holding as long as possible the debt instruments primarily of public debtors, and the longer the princelier until there is ultimately a debt restructuring.

And a last aspect must at least be mentioned, which is also expressly pointed out by Hans-Werner Sinn. As a result of the subsidised refinancing of debtors, the ESCB's special refinancing business increases so much relative to the normal refinancing business that at the

end of this process the ESCB may be largely unable to conduct a monetary policy

What now? How could and should things continue?

A hidden monetary transfer union is not sustainable in the long run. Even policy-makers seem by now to be convinced of this, despite the fact that a hidden transfer union has some charm for them since, as it is hidden, they do not have to defend it in public. Therefore they are taking action these days, quite late to be sure, but action nonetheless as they are launching a large and enlargeable rescue fund in order to extend maturities and reduce refinancing costs for public debtors in trouble through a collective EMU liability. Whether EMU policy-makers are allowed to do this is controversial and will probably remain so, but it has by now created facts and that is as important as imperative. The ESCB management has taken actions as well by outright buying government bonds of crisis-ridden countries. This way it has not only assumed (or better absorbed) risks but also has stabilised bond prices. However, whether this is permissible is particularly controversial. Nevertheless, the question must be permitted whether in the present situation these bonds are really better placed in commercial bank balance sheets than in central bank balance sheets.

In this way, the hidden, purely monetary transfer union is about to be replaced by a more open transfer union that combines monetary and fiscal transfers; how complete and how open remains to be seen. With the fiscal transfer union that is emerging, as is constantly emphasised, there is at least hope that in the end it will be only a fiscal liability union. And with the open monetary transfer union it can also be hoped that the outright purchase of government bonds in the end will not have been such a bad deal. Such a combination is certainly elegant and flexible, but in order to work the mix must be right.

Policy-makers and the ESCB management are thus trying to put out the fire with a hastily cobbled-together EMU fire sprinkler; whether they will be successful is an open question as are the costs of the operation. It may well result in a smouldering fire and the fire may flare up time and again. Then, too, they may not be able to distribute the extinguishing water as well as can be done in normal times with their usual monetary and fiscal combi-sprinkler that is meant to irrigate the economy and optimise inflation-free eco-

⁷ Axel Weber on 6 June 2008 in his lecture on Financial Market Stability at the London School of Economics.

⁸ For more on the importance of collateral, see the various writings of Gunnar Heinsohn and Otto Steiger, but also by Hans-Joachim Stadermann.

⁹ For sure, this will never be done in practice, but it is a useful thought experiment that has the advantage of establishing a fairly direct link between central bank policy and inflation, at least much more direct than the usual theorisations about transmission mechanisms.

conomic growth. Some collateral damage in the form of inflation and recession must also be expected. However, putting out the fire is one thing. Preventing fire in the future is another. That is why the question should be raised of how a new and continued march into a new, hidden monetary transfer union may be avoided.

An answer was already given by Wolfgang Stützel in the 1970s. For him it would have been important for a European monetary constitution (or at least a widely respected European central bank practice) to force central banks to act like commercial banks, ensuring, like old-fashioned bankers, the maintenance of solvency with bankers' methods (see Stützel 1975; Reeh 1999). It is well-known, of course, that with the collapse of the Bretton Woods System and the introduction of flexible exchange rates, the bankruptcy of central banks in their own currency was abolished. Since the euro, like other currencies of this world, is just definitive paper money that is in forced circulation, the ESCB central bankers can no longer have any liquidity or solvency problems in euros that they would then have to solve with bankers' methods. However, that is only true of the ESCB as a whole, not for its parts. And here one could and should start.

Instead of, within the ESCB, keeping to an inconsequential transfer of collateral corresponding to the Target balances, measures ought to be taken that would impose more or less painful constraints that are meant to prevent the accumulation of both deficits and surpluses and assure a sufficient emission lock-step among national central banks within the ESCB. This would make an excessive indebtedness across EMU-internal borders more difficult. First, the payment of interest on deficit balances could be agreed so that surplus central banks could benefit from part of the seigniorage of deficit central banks. Something like this could easily be agreed internally among ESCB managers. The provision of high-quality collateral could also be prescribed within the ESCB. Here, fixing a standard portfolio would be an obvious solution; in this case one would not be far from Wolfram Engels' ideas for a solid monetary constitution (Engels 1996). Then there could still be an internal ESCB agreement that balances would have to be settled at regular (at least at annual) intervals by introducing a redemption duty (Reeh 1999 and 2001). Finally, a kind of Cook ratio for ESCB central banks could be conceived that would then lead to a limitation of refinancing activities of central banks of countries with excessive deficits or require a recapital-

isation of the central bank. For an arrangement like this, however, not only the ESCB but also the European Commission, the ECOFIN Council of Ministers, the European Parliament and finally the European Council would have to agree. If in the end also mergers and acquisitions of national central banks were imaginable and permitted, only then would the European monetary union be so far denationalised that a merger of all ESCB central banks would be conceivable, through which the balances would rightfully receive the importance that they are unfortunately already getting today, however on false assumptions, i.e. none at all.

Seen this way, the ESCB itself indeed has options of initiating a more solid and conflict-free, because truly denationalised, monetary integration process within the presently prescribed legal framework. To this end, the ESCB central bankers would have to start with themselves and besides their usual roles as 'techno' and 'psycho' central bankers could also credibly assume the straightforward role of 'banko' central bankers (Reeh 2001). A redemption obligation within the ESCB, however designed, would facilitate the practice needed for this role. This is certainly but not impossible; it is doubtlessly bold but very promising.

The question arises, however, whether the members of the ESCB have the courage to implement such a communication strategy, especially now that the image of bankers has been tarnished. The public, after all, has come to accept the current discourse on bankers, not least because it is largely propagated by the academic community and the media.

It might be worth pointing out that the ESCB could become more effective in its communication. There is no good central bank technique without a good communication technique. And since central bankers must credibly communicate that they are not creating too much money, with such an approach they would have even more arguments as to why they cannot but limit the money supply.

It is also evident that doubts about the ability to control the financial system with traditional technocratic and psychological means have increased. As early as 1975, Wolfgang Stützel foresaw and hoped that monetary engineers and monetary bureaucrats (and also the monetary psychologists, largely unknown at the time) would step aside to make room for true bankers and businessmen (Stützel 1975). The ESCB-

internal transformation of national central banks into real banks would give rise to an alternative control mechanism, for which it would pay to give some thought.

It would certainly help to tell central bankers that if they played this additional role well, they could be on the golf course by early afternoon, instead of having to study the complicated papers of their scientific staff, sit hours on end in meetings with worried colleagues or calm the nerves of financial market actors at evening receptions with reassuring small talk. If national central bankers were, within the ESCB, to become solid, old-fangled bankers instead of seemingly smart new-fangled types that ride every wave, their lives would become simpler since it would be enough to focus on balances and balance sheets. Some among them might find such a job a bit boring, but society would definitely benefit because it would then be somewhat clearer what central bankers do and why.

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