The Balance of Payments Tells Us the Truth

Helmut Schlesinger*

It is frequently argued that in a currency union the balances of payments of individual member countries are superfluous, as there is only one currency, one exchange rate, and – as was once thought – only one interest rate, and external economic problems would only affect the entire monetary union. In terms of European goals, this concept is understandable but too ideal; in reality there was less 'convergence' not more. Of course, the European Monetary Union needs an overall balance of payments, and it is supplied month after month, not without errors and omissions that may already originate in the national figures. In terms of external economic relationships, the individual euro countries are independent units; foreign trade and payments with other member countries constitute as a rule less than 50 percent, the remainder is with the rest of the world. The member countries share the fate of a common exchange rate and common European rules of trade, among other things. The factors that are important for a country's competitiveness – production costs, distribution services, innovations – are determined at the national level, and in their business dealings with third countries they are largely autonomous. It is interesting that the national central banks also have largely autonomous command over their own, not communitarised stock of gold and foreign exchange. In the German case this implies, for instance, that the Bundesbank has command over about one third of German net foreign assets. The national balances of payments in the Eurosystem should not be disregarded as they reveal the potential and actual tensions in the system that should not be overlooked.

Balance of payments disequilibria within the euro area

The current account of the euro area, viewed in its entirety, appears to be more or less in equilibrium. With one exception, from 2006 to 2010 (and in early 2011) the annual deficit amounted to only 10 to 30 billion euros. No major problems are discernible; this is confirmed by the stable effective exchange rate. Reports on the balance of payments of the European Monetary Union, like those published in the Monthly Report of the European Central Bank, are not spectacular. This would be different were one to analyse a breakdown by member country – here the economic disequilibrium within the Monetary Union would be clearly revealed. The near balance of payments equilibrium of the total euro area hides the fact that it is the result of large annual surpluses of some countries, especially Germany, and corresponding deficits of the others, especially the Southern member countries. During the period from 2006 to 2010, the annual current account surplus of Germany alone *vis-à-vis* the rest of the world averaged about 150 billion euros; the average deficit of the other euro countries, which are combined here in an overview, was somewhat higher. In these five years, trade with the euro countries accounted for two thirds of the entire German current account surplus, i.e. far more than the corresponding share of the foreign trade volume, which amounts to 40 percent.

The balance of payments, a system of equations, no causal analysis

The balance of payments, like any balance, is constructed as an equation: the balance on current account equals the balance on capital account. In other words, with each surplus in the current account there is a correspondingly high increase in net claims on foreign countries. In the balance of payments statistics, current and capital accounts are disaggregated by merchandise, region, type of capital transactions, etc. in order to permit an in-depth analysis, but by themselves they do not supply an answer to the question of whether capital exports are the cause of current account surpluses or *vice versa*. Further, the attempt to assign certain capital movements, like direct investment, to certain merchandise groups, is controversial. In order to grasp the causal relationship between capital movements and cross-border flows of goods and services, various allocations were made nonetheless. In the past, one relied

* Former President of the Deutsche Bundesbank.

on the distinction between autonomous and adjusting capital flows, in the sense that 'autonomous' capital flows promote exports and hence the current account surplus, whereas 'adjusting' capital flows result as a necessity, as the surplus of capital inflows from abroad must arrive somewhere.

In a system of fixed exchange rates – to the dollar or within the European Monetary System – it is the central bank that ultimately has to absorb the surplus of foreign exchange deriving from the current account surplus and private net capital exports. In a system of flexible exchange rates it is primarily the domestic banking system that acquires short-term claims on foreign countries. These flow to them quasi automatically as part of cross-border payments, provided there are no 'autonomous' capital exports. As the central bank refrains from acting, it is up to the banks to decide whether to keep short-term foreign deposits and claims or exchange them for long-term assets.

In transactions with third countries, the European Monetary Union works in a system of flexible exchange rates, i.e. without interventions in the foreign exchange market. A third form was developed for balance of payments adjustment among member countries. For one, the convergence in terms of current accounts among the member countries has reversed itself. In particular, the surplus position of Germany has increased as have the deficits of many member countries. The financing of these growing balance of payments deficits within the group of EMU member countries was also based on considerable 'autonomous' capital exports, especially purchases of securities by Germany and other countries, although until the outbreak of the financial crisis in 2007 interest rate spreads between the euro countries were small. Furthermore, banks assumed a considerable portion of the adjusting capital flows. Thus, short-term claims and loans of German banks to foreign countries reached 1,001 billion euros at the end of 2007. But the growing distrust of banks regarding partner banks, especially those abroad, after the outbreak of the crisis, led them to reduce these outstanding short-term claims to 720 billion euros by the end of 2010 (all figures refer to worldwide positions).

Available transaction figures for the euro countries show that the focus was primarily on a reduction *vis-à-vis* the euro countries. This was combined with an expansion of credit *via* the Target2 settlement system. The more the payment inflows at the Bundesbank from partner countries fell behind payments to domestic customers, the more rose the net claims of the Bundesbank on the other member countries, to 338 billion euros by the end of 2010 and 462 billion euros in September 2011 compared to 18.3 billion euros at the end of 2006.

Looking at the German economy by itself, the Bundesbank thus assumed the function of 'balancing' the payments *vis-à-vis* the rest of EMU, similar to the way it did in the Bretton Woods System and the European Monetary System, when the intervention points were reached. But there was a major difference: in the old system of fixed exchange rates, the Bundesbank had to become active as soon as the extent of these inevitable purchases appeared to become indefensible from a monetary policy point of view. It then asked the German government for an appreciation or an exit from the system and did so successfully in the Bretton Woods System in 1961, 1969 and 1973 and in the European Monetary System (most recently in 1986 and 1992).

Looking back, one notes that the inflows of foreign exchange, which happened before the appreciation or the exit from the Bretton Woods System, were large but by far smaller than the increase in net claims in the EMU's Target2 system, as the latter amounted to 148 billion euros in 2010 and 124 billion euros in the first nine month of 2011. In addition, the old fixed exchange rate systems contained in part repayment obligations that led to outflows of foreign exchange resulting in the fact that the foreign exchange reserves of the Bundesbank (excl. gold stocks) never exceeded the D-mark equivalent of 100 billion euros, whereas the net stocks of Target2 claims amounted to 462 billion euros at the end of September 2011.

Another decisive difference to earlier foreign exchange regimes is that the Bundesbank is now part of the Eurosystem without its own decision-making monetary policy authority, and the monetary policy effect of the growing Target2 claims is not comparable to the foreign exchange purchases by the formerly independent Bundesbank. By purchasing foreign exchange, the 'old' Bundesbank expanded the asset side of the balance sheet and thereby also the monetary base (currency in circulation plus deposits of the banks at the Bundesbank); it could try, of course, to offset this by other asset transactions. If today the Bundesbank expands its claims on the other EMU countries (centralised at the European Central Bank), then it also creates central bank money. This is clearly shown in the balance sheet of the Bundesbank, which amounted to

679 billion euros at the end of August 2011; of this the biggest amount was accounted for by net claims from Target2 alone. This is not only the most important position in the Bundesbank balance sheet but is also a major part of the foreign assets of the Federal Republic, and therefore not only 'a statistical position', as it has been mentioned (Deutsche Bundesbank 2011).

But the monetary policy function is different from that in the old Bundesbank system, in that an expansion of Target2 claims more or less automatically involves a reduction of claims arising from normal refinancing transactions. These Bundesbank claims, stemming from monetary policy operations with German commercial banks, declined from 268 billion euros at the end of 2007 – when the stock of Target2 claims was still relatively small – to 37.6 billion euros in August 2011. Whether the German banks were disadvantaged by the reduction of their refinancing at the Bundesbank to one sixth of the past amounts cannot be discerned. During this time, the interest rates on overnight deposits were as a rule below the refinancing rates of the ECB, which is an indication of excess liquidity. However, in the balance sheet of the Bundesbank there was a massive change of debtors.

In place of the normal borrowers of the Bundesbank, the domestic banks, we now find the partner countries in the Eurosystem, primarily Greece, Ireland, Portugal and Spain (the GIPS countries) (Deutsche Bundesbank 2011).[1] Formally, the claims of the Bundesbank are directed at the ECB, which offsets the positive and the negative balances of all member countries in its balance sheet.

Regarding the individual countries, Hans-Werner Sinn and Timo Wollmershäuser (2011, 20) speak of "a relocation of central bank credit from Germany to the respective GIPS country". Credit granted by the Eurosystem as a whole to commercial banks is not limited by this. In lieu of the Bundesbank, the central banks of the GIPS countries grant additional refinancing credits; these can, to the extent to which these funds enter the payment flows with Germany, arrive at the Bundesbank as claims in Target2 clearing transactions. There is no crowding out of credit granted by the Eurosystem, but a considerable change of debtors in the total system. In place of German banks there are now banks of the GIPS countries, whose creditworthiness is often so poor that they can only solve their liquidity problems with the help of their central banks and this on the basis of a serious downgrading of the demands on collateral. In the balance sheets of the national central banks and in that of the ECB, as well as the accompanying explanations, possible differences in creditworthiness are not accounted for. The principle seems to be 'euro equals euro'.

Keep the overall picture in mind

In addition to considering the relationship of the balance of payments and the intrinsic value of a central bank balance sheet (a special concern of the author, who co-signed the Bundesbank balance sheets for 22 years) it is important to evaluate the effect of this kind of financing of balance of payments deficits on the stability of the financial system. It is evident that for countries with high balance of payments deficits, the need to reduce the disequilibrium is dispensed with to the extent to which the deficit may be automatically financed *via* the Target2 system. In past years, normal capital movements contributed to the financing of the deficits; the government bonds of the GIPS countries were sold abroad, but as soon as the risk involved became obvious, this was only possible at high interest rates and finally hardly at all. And, as discussed above, the private banks withdrew from short-term financing. Yet for some time, being able to finance deficits *via* Target2 allowed the deficit countries to avoid the need of adjustment, which for non-monetary-union countries is enforced by the market. The same applies to the surplus countries, in which the increase of Target2 claims prevents an additional expansion of the money supply through diminishing domestic credit creation and thus additional domestic demand. Both effects suggest limiting the creation of excessive balances in the Target2 System, which originally was only supposed to be a clearing system without lending, and/or introducing a punitive interest rate,[2] a task that can only be tackled after the current turbulences have abated.

References

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[1] Sources of all figures mentioned: *Monthly Reports of the Deutsche Bundesbank* and especially *Statistische Beihefte zum Monatsbericht* No. 3, Balance of Payments Statistics.
[2] Theurl (1995) reports that in the Scandinavian Monetary Union and its clearing system, limitations for the automatic lending finally became necessary and commission fees were introduced (see also the references on settlement rules in the banks in the US Federal Reserve System in Sinn and Wollmershäuser (2011).