Handelsblatt 14. August 2018

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Target Balances: Monetary Policy is key

The EUR 900 bn of claims held by the Deutsche Bundesbank in the payments system of the European Currency Union – so-called target 2 claims – have made it to the headlines of newspapers. What is the story behind these numbers? Critics see a "hidden" credit scheme in the euro area, disconnected from any process of parliamentary decision making, only in the domain of the ECB. If a country with a negative target balance left the currency union, it is said, the others would have to take up the bill. The Bundesbank, e.g. would be accountable for 27% of the loss according to the ECB's capital key. Others, including the central bank itself, argue that imbalances in the payments system must be possible to ensure a smooth functioning of transactions within the EMU. Imbalances in the flow of money between regions of a monetary union are perfectly normal in this line of interpretation, which points to the US' Fedwire as an example. So much ado about nothing?

As often, truth is to be found in the middle. First, it is important to note that target balances result from decisions of private agents regarding cross-border financial transactions. If a country accumulates a surplus in incoming payments, a positive target II balance builds up. It is booked as an asset in the central bank's balance sheet, but it is not a legally enforceable claim against other countries. What are the causes for such payments imbalances? The private money flows can have their origin in the movement of goods or of capital. Countries with ongoing trade deficits or capital outflows accumulate negative balances. For the two countries with the biggest target imbalances, Italy and Spain, that have been running a trade surplus for some years now, the liabilities must result from decision on capital account transactions.

In recent years, another explanation can be found in the asset purchase program of the ECB. National central banks are responsible for its execution. The way this program works is best explained by an example. If the Italian central bank buys Italian government bonds outside of its national territory, for example from a bank in Frankfurt, the following transaction is created: Banca d'Italia receives a claim on the state of Italy and a liability in the Target2 clearing system vis a vis the German Bundesbank. The Bundesbank, in turn, grants a deposit to the selling bank and thereby accumulates a liability. In return, it receives a claim on the ECB and thereby on the Banca d'Italia. As a result, the seller of the government bond has replaced a claim against the Italian state with a claim against Bundesbank.

If the sales revenue had been transferred to a bank account in Italy, target balances would not have been changed: Banca d'Italia would not have a liability against Bundesbank, but against a domestic commercial bank. Apparently, such return remittances do not happened to a larger extent, creating a shift in risk.

The central question is: Why are balances settled through target balances and not through the private money market? The answer lies in the decision of the ECB to offer practically unlimited and currently free of charge funding for commercial banks. Funding via the central bank has replaced the cross-border interbank market since the financial crisis 2008: Payments do not lead to claims between the commercial banks themselves, but are cleared via central bank deposits. It is more convenient and cheaper to use the funding commitment of central banks than to bid for credit with corresponding risk premium from foreign banks. Monetary policy creates the incentive to use the balances sheet of central banks – and thereby creates the imbalances in the Target2 clearing system. What can be done? There are proposals to collateralize liabilities with gold and other international reserves or to levy a positive interest rate on liabilities. But this would not really change the fundamental incentive for commercial banks to use central bank money for cross border transaction, unless the interest payment of the central bank is passed on to its clients. In my opinion, it would be more effective and much simpler to reactivate the cross-border interbank money market. This could be achieved through a gradual normalization of monetary policy that ends the unlimited access to central bank money, the so-called full allotment, and returns to the practice of steering the liquidity supply to the banking system. If there is no unlimited access to the central bank liquidity, commercial banks will again start to manage their business with private credit lines. Hopefully, such changes in liquidity policy are being discussed in the Governing Council. If they were implemented, the issue of target balances would soon lose its relevance and explosiveness.