Hans Werner Sinn and Timo Wollmershaeuser's target loans, current account balances and capital flows: the ECB's rescue facility. A comment

Schilirò, Daniele

DESMaS

October 2012

DESMaS "V.Pareto"

UNIVERSITA' DEGLI STUDI DI MESSINA

Daniele Schilirò

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Abstract

The present paper firstly examines and comments the arguments proposed by Werner Sinn and Wollmershaeuser in their paper on Target loans, current account balances and capital flows: the ECB's rescue facility. Secondly, this contribution suggests an alternative view for solving the crisis in the eurozone adopting a coopetitive strategy and also regarding the role of the European Central Bank.

Keywords: Target loans, current account balances, capital flow, EBC' rescue facilities, ECB's role, coopetition in the eurozone.
Jel Classification: *E58,E63,F32,F34, F50.*

October 2012

1. Introduction

Werner Sinn and Wollmershaeuser's (WS.&W.) paper[1] is an insightful contribution that sheds light into the Eurosystem which has proved to be an imperfect, baroque, asymmetric and little transparent institutional architecture. The member countries of the euro area, in fact, do not have the necessary degree of homogeneity in their market institutions and policy attidudes to become a complete and coherent monetary union, despite the path towards integration imposed by EMU governance and by the EU. The Eurosystem has a common currency, the euro, but it does not have a significant federal budget and a form of integrated financial supervision (Schilirò, 2012). In addition, the monetary policy is managed by the European Central Bank within a multi-level governance context and is equal for all countries in the euro area, while fiscal policy is fragmented and managed by individual states, although the member countries of eurozone are constrained by the Stability and Growth Pact, and more recently (March 2012), by the more stringent Fiscal Compact, which takes effect January 1, 2013. Moreover, the ECB is managing the monetary policy without being an official and true lender of last resort. Even if, at the end of 2011, ECB has engaged in unconventional measures beyond standard monetary tools, as for instance the longer-term refinancing operations (LTROs) providing large amounts of liquidity at very low interest rates to eurozone banks with the aim of helping a dysfunctional inter-bank market.
The present paper examines the arguments proposed by Werner Sinn and Wollmershaeuser in their paper on target loans, current account balances and capital flows, and it suggests an alternative view for solving the crisis in the eurozone and also regarding the role of the European Central Bank.

2. Euro-crisis as a balance of payments crisis.

The key issues that have attracted attention as a result of the euro crisis after 2008 were the sovereign debt and the fiscal discipline. However, some economists like Giavazzi and Spaventa (2010) and, later on, Werner-Sinn and Wollmershaeuser (2011) have argued that the euro-crisis is mainly a balance of payments crisis.

Werner-Sinn and Wollmershaeuser' s paper in particular reveals an accounting system embedded in a dull way in the balance sheets of the Eurozone's National Central Banks (NCBs): the Target balances.

WS.&W. demonstrate that the Target balances are not a statistical item, related to an interbank settlement system, of no consequence. Target balances (where the term Target is an acronym for Trans-European Automated Real-time Gross Settlement Express Transfer) are claims and liabilities of the individual central banks of the Eurozone *vis-à-vis* the European central bank system that one booked as such in the balance-sheets of the NCBs. But as WS.&W. emphasize mainly from an economic point of view, Target balances measure accumulated deficits and surpluses in each euro country's balance-of-payments with other countries. In fact, Target liabilities are the portion of the original central bank money created by a given NCB that exceeds the stock of central bank money available in the NCB's jurisdiction and that was employed for the net acquisition of goods and assets from other euro countries. Correspondingly, Target claims measure the surplus of the stock of central bank money circulating in one country above the central bank money created "inside" this country, and which arose from the net sale of goods and assets to the other euro countries. WS.&W. call this surplus "outside money" (2011, p.6).

If we look at the euro crisis and to the remedies discussed during the last European summits we realize that all the emphasis has been on the budget and debt problems of the economies of GIIPS[2].

[1] "Target loans, current account balances and capital flows: the ECB's rescue facility", NBER Working Paper 17626, November 2011.
[2] GIIPS are Greece, Ireland, Italy, Portugal and Spain.

Obviously, those problems exist and are rather severe, but as Martin Wolf wrote on December 6, 2011 in the *Financial Times* the crisis in the euro area after 2007 has become above all a balance of payments crisis:

«In 2008, private financing of external imbalances suffered "sudden stops": private credit was cut off. Ever since, official sources have been engaged as financiers. The European System of Central Banks has played a huge role as lender of last resort to the banks, as Hans Werner Sinn of Munich's Ifo Institute argues». (Martin Wolf, *FT*, 6th December, 2011).

Werner-Sinn and Wollmershaeuser provide the figures of this shift in financing imbalances of the balance of payments in the Eurozone, and these figures are indeed very eloquent numbers.

Due to the crisis, in September 2011 the accumulated payment imbalance between Germany and the rest of the Eurozone, in particular the GIIPS countries, reached the considerable amount of 450 billion euros. The Target liabilities of the GIIPS are gross government debt, for Greece this debt is 44% of GDP, for Ireland is 76%, for Italy 3%, for Portugal 35%, for Spain 6%.

The volume of Target credit drawn by the GIIPS countries from the Bundesbank through the ECB system far exceed the offical loans given to them within the European Financial Stabilization Mechanism (EFSM) and the European Financial Stability Facility (EFSF). In fact, the official Eurozone aid to GIIPS totaled to 172 billion euros. Moreover, these Target claims and liabilities are interest bearing. Their interest rate equals the ECB's main refinancing rate. So in the Eurosystem, because of the severe crisis, the periphery's current account deficit and capital flight has been financed with the printing press, whereas the core has shred the money flowing in as payment for goods and assets sold to the periphery. Werner-Sinn and Wollmershaeuser argue, in fact, that in order to finance the balance of payments deficits, the ECB tolareted and actively supported voluminous money creation and lending by the NCBs of the periphery at the expense of money creation and lending in the core. The point is that WS.&W. doubt that this situation is really sustainable.

The problem arises because the relationship between NCBs in the Eurosystem is not direct but mediated by the ECB, so that it becomes a *menage à trois*. The fear, expressed by the two economists, is that this *menage à trois* implies the socialization of interests (2011, p.2) and that the actual system of refinancing Target loans looks like a surrogate of the Eurobonds. Since the present situation and the current solution is considered not healthy for the Eurosystem by WS.&W., they suggest a different solution drawing from the experience of the US Federal Reserve System. The solution envisaged by WS.&W. is based on a linear relation between the creditors and the debtors where the price mechanism, on one side, and a system of good quality of collaterals and real marketable assets provided to the creditors, on the other, bring back the system upon a convenient and sustainable path. First of all, they suggest to try to prevent that a huge stock of Target claims accumulate over time. This is possible if every year there is a true balance between claims and debts by surplus and deficit countries and this balancing process must be carried out by flex-price mechanism. Secondly, the debtor NCBs could at least secure their Target liability by handing over the collateral they received from their private banks when lending out the newly printed money. But, above all, to ensure that the Target loans are not more attractive for the debtor NCBs than market loans, WS&W underline that not only collateral must be provided, but remarketable assets (including their interest) would have to be handed over the creditor NCBs to redeem the Target debt. Lastly, WS.&W. are also against the one-country one-vote system that currently regulates the European Central Bank Council.

In conclusion, WS.&W. hope that Europe might think to adopt the US rules, those used in the Federeral Reserve System, about running a monetary union. These rules are well known and have been shown to fuction, instead of trying to invent other baroque and fanciful mechanisms.

However, given for granted the necessity of keeping the public budget of the Euro countries in equilibrium with an appropriate fiscal policy, I fully agree with the importance of revealing the role of Target balances, as WS.&W suggests, and the fact that the balance of payment imbalances among the euro countries have substantially contributed to the crisis. But this means that behind the imbalances there are problems of competitiveness. Since inside the Eurozone the weapon of the rate of exchange cannot be used, the only solution is a structural change of the weak economies (the periphery) through innovative investment, to gain competitiveness. But this policy can be implemented within a economic policy framework which aims at growth. As I wrote in a paper (Schilirò, 2012), it is necessary to reformulate the economic policy framework of the EMU considering the problems of competitiveness, of trade imbalances and of low and uneven growth inside the eurozone. Whithin this perspective, Carfì and Schilirò (2011, 2012) suggested an approach based on coopetition. First, they have pointed out the primary role of competitiveness in determining growth and the important relation between competitiveness and macroeconomic imbalances. Carfì and Schilirò (2011, 2012) have argued that to overcome macroeconomic imbalances it is necessary a medium term strategy for competitiveness and growth, based on innovative investments and a process of structural change of the production system and other reforms which change the functioning of labour market, of services and so on. Within this broad strategy, trade imbalances, in particular, can be addressed through a coopetitive strategy, which implies a cooperative attitude aiming at growth among the member countries of the euro area, despite their divergent interests. The coopetitive strategy, which implies the introduction of a coopetitive variable (i.e. exports, but also investments), will provide a *win-win solution* to the actors of the game and can constitute a new macroeconomic policy tool to help solving the imbalances problems and contribute to overcome the economic crisis in a medium-run perspective.

Regarding the issue of the Eurobonds, if they are meant as an instrument just to transfer resources to the indebted countries, I think that they are not the appropriate solution for the sovereign debt crisis, despite my previous more favourable opinion, suggested in Schilirò (2012.). I believe, instead, that the old Delors' idea of Unionbonds to finance the investement in infrastructure in the EU to boost the growth is still correct. So Unionbond can become an instrument for the growth policy and can also have an anticycliclal function.

3. Conclusions.

In this contribution I have tried to examine and comment the arguments proposed by Werner Sinn and Wollmershaeuser in their paper on target loans, current account balances and capital flows. I would like to highlight two final points. First, regarding the role of the European Central Bank, the question is whether it can be correct the recall to the US Federal Reserve System as an empirical model to overcome the problem of Target balances. But, at this point, why the ECB cannot be a lender of last resort like the FED?

The second point concerns the current account imbalances. I believe that external adjustment is crucial, maybe more important than fiscal austerity. In fact, the crisis has worsened the balance of payments of the GIIPS countries, while Germany improved his position and, despite the Target claims, it has profited most in terms of growth and of surplus. All this reveals a disequilibrium situation that must somehow be resolved. During the crisis, German banks were unwilling to send their money abroad, but they preferred lending it to other Germans instead, so the latters could use the money to buy German goods, in particular investment goods. This helps to explain why Germany has been booming after the crisis.

In conclusion, if we think, that the euro area must become a more integrated and balanced area, why a re-equilibrium of the balance of payments of the deficit countries should not imply a less surplus for Germany?

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