Crisis in the Zone

Everyone will be familiar with the euro crisis and the possible departure of Greece and other countries from the monetary union. The crisis has many sub-plots – political, economic and financial – but even a well-informed reader might be forgiven for not following the curious tale of the TARGET2 (Trans European Automated Real Time Gross Settlement Express Transfer) balances.

It has attracted little attention in the UK press but it has emblazoned all over the German media. The story begins with the birth of monetary union and involves a fundamental lack of transparent accounting which has fuelled complexity and distrust throughout the entire system.

Within a currency area, payments between participants are ultimately settled by their banks in 'central bank money'. This means that the payer will instruct its bank to transfer money to the recipient's bank. The respective banks will reflect their settlements via their accounts with the central bank. A central bank will monitor balances with individual banks and may set limits. In addition, it will usually ask for any claims it may have on a bank to be collateralised by, for example, government debt.

Within the euro area, there are seventeen national central banks (NCBs) and the European Central Bank (ECB), collectively called the euro system. These separate organisations have to function in effect, as a single, central bank and the role of TARGET2 is to bind them together.

If a depositor transfers money from a Greek Bank to a German Bank, ultimately the transfer will show up as a claim by the Bundesbank against the National Bank of Greece. These balances between NCBs are not cleared down or settled by the transfer of foreign exchange or gold, nor are they collateralised.

Incredibly, there is no cap on how large they can get.

When the euro was set up, the claims were bilateral between NCBs. However, as the pre-euro national payment systems have been replaced by TARGET and now TARGET2, the ECB has stepped in as a clearing house. Intra-Eurosystem balances are now automatically aggregated and, at the end of the day, netted out throughout the euro system, leaving each NCB with a single bilateral position vis-a-vis the ECB. As a result some NCBs have a TARGET2 claim and others are TARGET 2 liability vis-a-vis the ECB.

Lack of Accountability

Does any of this matter? Before the crisis, the balances between the NCBs were not significant at January 2007. The banks funded them through the interbank market privately. However, following the crisis, these private sources of funding dried up and the banks in sovereign states of the periphery (the PIIGS – Portugal, Ireland, Italy, Greece, Spain) could only raise funds via the TARGET2 system. The TARGET2 balances began to rise after 2007 but this was not noticed because of the opaque accounting treatment adopted by the ECB. Any normal bank or company shows the money owed to it in its current assets and money owed by it in its current liabilities so you get a full picture of what is due in and what is owed. But the ECB is not a normal bank. It NETTED OFF the liabilities against the assets so it showed a mere €49.4 billion owed to it by member states.

However in 2011 two enterprising economists, Hans-Werner Sinn and Timo Wollmershauser, found a way of sourcing the full data from the IMF databank and were able to present the full picture.

As of April 2012, the debtor NCBs have BORROWED over €850bn from the rest of the system , €650bn of which is owed by the PIIGS. This is principally funded by Germany (€463bn) and the

Netherlands (€152bn) and little Luxemburg ((€109bn. Worryingly, these negative balances have arisen despite public money inflows such as European Union International Monetary Funds loans, which eventually end up in the banking systems. These balances represent massive transfers of wealth – Germany’s balance represents 20% of its annual GDP. This transfer happened without any political accountability or democratic process – just through the automatic function of the monetary union. It is worth comparing this complete absence of political process with the attention and scrutiny associated with the European financial stability facility (EFSF), which was recently increased to €780bn.

Who Knew?

In the absence of standard accounting practices, or at least disclosure by the ECB, nobody knew what was happening. The ECB responded that the TARGET2 system was working as it was intended to, and cannot be capped since a euro must be worth the same in all parts of the currency area, and freely transferable as well. Some official voices have even suggested that the size of these balances is only a problem if the public know about them.

The debate, indeed outcry, in Germany about these balances shows that the full implications of monetary union were not properly understood by the vast majority of citizens, even though there were references to the possibility of this type of event in academic literature.

Concern is particularly high now because if Greece were to leave the monetary union, it would not be in a position to repay the €100bn odd Euros that its NCB owes the rest of the euro system. Of course, the whole edifice was set up without any limitations on TARGET2 balances, wholly on the basis that no country would ever leave the euro. Although this remains the official position of the ECB, in practice politicians speak openly of this as a possibility.

If the ECB were to suffer from an NCB not meeting its obligations on TARGET2, a Greek exit would wipe out the entire capital of the ECB which has capital and reserves of approximately €31bn, rendering it insolvent. This would require the other NCBs, which collectively own the ECB, to contribute additional capital to it but 12 of the 17 NCBs are already heavily indebted to the ECB and are certainly not in any position to contribute more capital.

The absence of proper accounting for these balances deprived the public of visibility on the balance of payments crisis developing within the euro zone after the credit crunch and has the potential to bring down the ECB and national central banks of member countries with it.

Intra Eurosystem Assets (€billion)

Austria	-34.6	Belguim	-52.8
Cyprus	-7.9	France	-79.6
Greece	-104.8	Ireland	-142.4
Italy	-191.4	Malta	-0.4
Portugal	-60.9	Slovakia	-13.6
Spain	-150.8	Total	-842.0

Intra Eurosystem Liabilities (€ billion)

Estonia	1.0	Finland	66.0		
Germany	463.3	Luxembourg	109.5	Netherlands	152.8
Total	792.6				

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