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A "Trillion Euro" Problem: Target 2 as a Risk for Germany

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In the German discussion on the eurozone, there is not only a question of reforms, e.g. the introduction of a joint budget and finalisation of the banking union. Much attention is also paid to the Target 2 payment system, which simultaneously accumulated the high, positive balance of the Bundesbank and the negative balances of the central banks of the southern European countries. This imbalance is considered an economic and political risk for Germany. However, remedies against it are in short supply. Actions that are too rapid or radical could destabilise the eurozone.

Target 2 is a technical platform run since 2007 by the European Central Bank (ECB) and national central banks to handle payments in the single currency. It is one of the pillars of the eurozone, enabling quick and inexpensive settlement of obligations, which clearly facilitates economic activity, strengthens links between Member States and promotes economic growth.

The payment system did not raise too much public interest during the first years of its existence. The situation started to change after the outbreak of the financial crisis in 2008. Since then, the system has been drifting into an internal imbalance. In June 2018, the Bundesbank's Target 2 account balance was €996.3 billion, while the Italian and Spanish balances were both in the red (€480.9 billion and €398.3 billion, respectively). These numbers have provoked questions, especially in Germany, about the sources of imbalances and risks related to the "trillion euro" problem.

Functioning of the System. The essence of Target 2 operation can be illustrated with the example of a typical commercial transaction between a company from Spain, which acquires a machine worth €1 million from a German manufacturer.

In the first step, a commercial bank debits €1 million from a Spanish company account and orders the Spanish central bank, Banco de España, to transfer the sum via Target 2 to the commercial bank in Germany that maintains the seller's account. Banco de España then charges the Spanish commercial bank (it can grant a loan secured, for example, by bonds) and, via the European Central Bank (ECB), orders Bundesbank to transfer €1 million to the commercial bank in Germany. As a consequence of this transaction, Banco de España has an obligation and Bundesbank a liability of €1 million each. The ECB calculates and balances a great many such operations every day. In this way, a given central bank incurs a single liability to the ECB. This amount is shown as a Target 2 balance.

The rise of imbalances in the first years of the crisis fits quite well with the example described above. Commercial banks in southern European countries willingly used access to the capital offered by the central bank because it was more difficult for them to obtain funds from the interbank market. After 2015, the ECB ordered the central banks of the monetary union to buy government bonds, which also drove the increase in balances. The problem was that bond sellers were often located outside the eurozone but maintained Target 2 accounts to handle euro transactions at the German Bundesbank. If, for example, the Spanish central bank bought bonds from such an institution, the effect was to deepen Banco de España's negative balance and increase the Bundesbank's positive balance.

Target 2 as a Risk. German economists such as Hans-Werner Sinn, critical of current policy in the eurozone, say that Target 2 is in essence a mechanism to provide interest-free, poorly secured credit from the Bundesbank for structurally weaker financial systems in southern Europe, in the form of support for banks which would have difficulty obtaining favourable credit conditions in the interbank market.

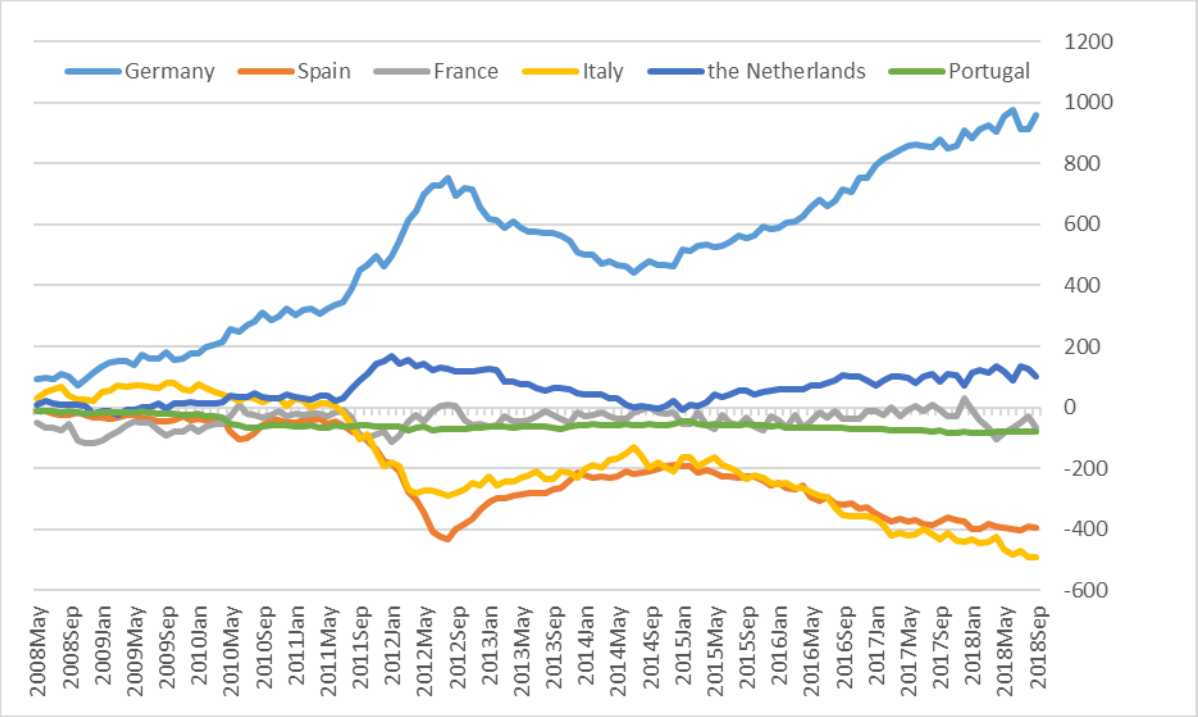
However, the greatest concern is the prospect of one of the countries with a negative Target 2 balance leaving the eurozone. As long as the monetary union exists, there is always the hope that a "loan" will be repaid and the imbalance reduced. Should a member with a negative balance leave the monetary union, the chances of this happening would diminish greatly. Government bonds held by the central bank in question would probably lose value, and domestic banks would have huge problems settling debts in euro due to the devaluation of the new currency. The ECB would therefore have to enter a loss which, as suggested in one of its Bundesbank documents, would be divided in accordance with the key national central banks' share in ECB capital, of which Germany holds over 26%.

In this situation, it would be desirable from the German point of view to reduce the balance as soon as possible. This would result in the ECB's withdrawal from the bond purchase programme, which is planned by the end of 2018 and partly anticipated by the financial markets. Indeed, there has already been a slight reduction in the German balance. The problem is that cutting off Italian and Greek banks from the source of cheap capital could lead to financial meltdown in these countries. There is speculation about other solutions, such as increasing domestic demand in Germany through higher government spending, and thus increasing imports from southern countries, or the possibility of the Bundesbank acquiring securities, land or shares in companies through Target 2 balances. These solutions, though, present legal and political problems. For example, increasing expenditure is incompatible with the German government's goal of lowering public debt below 60% of GDP this year.

Conclusions. There is little indication that the Target 2 balances will go down quickly. Thus, they may become a political factor influencing decisions on European integration. For example, in the course of ongoing negotiations on the final direction of eurozone reforms, and disputes over the budget deficit of Italy, the issue of Target 2 strengthens the southern European countries. On the one hand, they will argue that the imbalance proves the failure of economic policy based mainly on financial austerity that it is imposed on them; and, what is needed for a rebound is eurozone intervention, risk-sharing, and direct transfers. Neither could it be excluded that countries with negative Target 2 balances will resort to veiled blackmail, indicating that the lack of reforms they postulate raises the risk of eurozone disintegration and losses for central banks with positive balances (apart from Germany and, for example, the Netherlands and Luxembourg).

The controversies around Target 2 are also important for EU countries outside the monetary union. For eurozone candidate countries, including Poland, these issues reinforce uncertainty about the nature and scale of financial obligations related to adopting the single currency, and even raise questions about the survival of the eurozone in its current form. Imbalances in the system could be used by candidates in the upcoming European Parliament election campaigns to criticise the euro project for its hidden "debt" and argue for a slowdown or cessation of preparations for membership of the monetary union. Target 2 may also raise concerns about the direction of monetary union reform. The imbalance in the payment system is one among several factors that increase the probability of accelerated financial and political integration, deepening the division of the EU into the core of the eurozone and the periphery.

The problem of Target 2 balances may also complicate Germany's domestic policy, weakening the grand coalition and, in particular, the Christian Democrats. The "trillion euro" argument is a propaganda gift for this party's right-wing challenger, the Alternative for Germany (AfD), which in the past built support by attacking transfers to southern countries and could only gain from any escalation in the Target 2 dispute. The liberal FDP (Freie Demokratische Partei) also presents a hard stance in this matter, which should lead the Christian Democrats to minimise political risk and advocate a restrictive, conservative course of financial integration. Such a calculation is complicated, however, by the recent increase in popularity of the Greens, with whom the CDU/CSU coalition is fighting for the centre electorate. The Green success in the polls and at recent local elections suggests that support for less orthodox euro policy is growing in Germany. The new leadership of the Christian Democrats will therefore face a difficult choice.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