Germany's important Target-2 debate

Economists' view on countries leaving euro

by Marcello Minenna in Rome

Mon 14 May 2018

Europe and the rest of the world should be examining the debate among German economists about what would happen to the Target-2 intra-euro area imbalances if a member country left Europe's economic and monetary union.

Target-2, an operating arm of the European financial system set up in the 1990s to regulate interbank credit, has grown into a massive nodal arrangement of credits and debits linking EMU national central banks. Under Target-2, Bundesbank advances to the weaker states via the European Central Bank was €902bn at the end of April, down from €923bn at the end of March, having doubled in the past four years, partly as a result of the ECB's quantitative easing programme of government bond purchases.

Under current regulations, Target-2 balances are treated simply as central bank balance sheet entries that are unredeemable, without expiry dates and produce interest at the ECB's main refinancing rate (0%).

This should change, according to some leading German academics. Hans-Werner Sinn, Clemens Fuest, Karl Konrad and Christoph Schmidt are all associated with recommendations for a legal mechanism for countries to leave the euro without departing the European Union. They are suggesting a new framework to transform Target-2 imbalances into a collectable debt or credit that would be settled by the departing state.

The debate is important for four reasons. First, the economists are leading public figures with some traction in Chancellor Angela Merkel's 'grand coalition', as well as among parliamentary opposition parties. Sinn and Fuest are former and current presidents of the Ifo economics institute. Schmidt, president of the RWI-Leibniz institute, chairs the German council of economic experts. Konrad is a former chairman of the Berlin finance ministry's council of scientific advisers.

Second, their arguments add substance to discussions at the German finance ministry that were started in 2015 over whether Greece should leave the euro. The question could acquire fresh virulence if negotiations over Greece leaving its international rescue programme turn sour, or if the political and economic position in Italy deteriorates in coming months.

Third, the issue is closely linked to the wider question of reinforcing EMU's architecture. Germany has been pressing for a mechanism for an 'orderly' restructuring of euro area sovereign debts as a precondition for greater 'risk-sharing'. Leading figures in France have criticised the German initiative, pointing out that German insistence on private creditors writing off loans to Greece was a fundamental reason for the Greek debt crisis in 2010. Eight years later, establishing a method for finding a backdoor out of EMU is hardly consistent with the vision of a reformed euro area with a political commitment for sharing risks.

Fourth, the ECB has made fluctuating statements on the Target-2 impact if a country left the euro. In January 2017 Mario Draghi, the ECB president, in response to a written question from Italian MEPs, said that if a country were to leave the euro system, its central bank's claims on or liabilities to the ECB would need to be settled in full.

In April 2017, answering a question from Hans-Olaf Henkel, the German MEP, on whether Germany would get its money back if it left the euro, Draghi backtracked: 'The euro is irrevocable … it is not appropriate for the ECB to engage in any reflections on hypotheses or assumptions not provided for in the treaty.' In May 2017, in the Dutch parliament, Draghi refused to give further details when asked whether, if it left the euro, the Netherlands would receive a lump sum payment of €100bn, the size of the Dutch positive Target-2 balance.

Draghi's recent caution contrasts with a speech in 2014 in Helsinki in which he stated, 'If there are parts of the euro area that are worse off inside the union, doubts may grow about whether they might ultimately have to leave. And if one country can potentially leave the monetary union, then this creates a replicable precedent for all countries.'

On 9 April, answering questions at the European Parliament's economic and monetary affairs committee, Vitor Constancio, the ECB vice-president, stated that if a country left the euro (which he termed as very unlikely), central banks would settle Target-2 balances using their existing assets. Although he did not give details, this indicated that a departing country could make use of government bonds, foreign exchange reserves and even gold to settle its accounts.

These statements leave open the question of what currency would be used to settle the balances, which in the case of a weaker country leaving could be a lot less valuable than the euro. Furthermore, the definition of 'settle' requires explanation. A departing debtor central bank, after an accounting readjustment, could simply guarantee the new Target-2 debt with its assets, so nothing would change substantially. This appears to be the outcome the German economists wish to forestall.

If tensions in the euro area get worse, despite positive economic developments in the last five years, then the divide between the countries that have done well from EMU and those that have fared worse would intensify. And the €900bn Target-2 imbroglio would be in the centre of that discussion.

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