# TARGET2: Not why Germans should fear a euro breakup

# [Karl Whelan](http://www.voxeu.org/index.php?q=node/6624)29 April 2012

*In recent years, instability in many European countries has led to large transfers of money into Germany. This in turn has led the Bundesbank to build up large credits with other central banks in Europe – via the TARGET2 system. Does this represent a risk to Germany in the event of a breakup of the euro? This column argues that Germany will have far bigger things to worry about.*

The balance sheet of Germany’s Bundesbank reports an item labelled “Other Assets”. The value of these assets rose from about €40 billion in summer 2007 to €576 billion in February of this year, so they currently stand at about 20% of German GDP. This increase represents the outcome of money that has flowed into Germany via the Eurosystem’s TARGET2 system.

The idea that German taxpayers are taking on a significant risk via the Bundesbank’s so-called TARGET2 credit was first raised last year by Hans-Werner Sinn and Timo Wollmershäuser (2011). There has since been an intense debate on this site and elsewhere (see for instance [Buiter et al 2011](http://www.voxeu.org/index.php?q=node/6945), [Jobst 2011](http://voxeu.org/index.php?q=node/6768), and [Sinn 2011](http://www.voxeu.org/index.php?q=node/6599)). More recently, this idea received further attention with reports that it was raised in a confidential letter to Mario Draghi from Bundesbank president, Jens Weidmann.

# Central bank balance sheets

To assess the issues relating to the Bundesbank’s TARGET2 credit, it is necessary to understand what central bank balance sheets describe. Contrary to Milton Friedman’s helicopter drop analogy, standard central bank practice is to create money via open market operations involving the purchase at market price of financial assets or making collateralised loans to banks.

This means that central banks build up stocks of assets over time. Depending on how much of the revenue stream from these assets has been passed over to governments over time, the current value of a central bank’s assets may exceed the amount of money they have created in the past when acquiring these assets.

Central banks release a balance sheet to summarise the assets they own and the money they have issued. In a stylised example, such as the one below, assets are shown on the left-hand side while the right-hand side lists the amount of money that has been created as ‘Liabilities’. The difference between the current value of assets and liabilities is labelled ‘Capital’.

**Figure 1.** Stylised central bank balance sheet



# Central bank capital with fiat and non-fiat currencies

When a central bank operates a non-fiat currency, it agrees to have sufficient ‘hard assets' of a particular type (gold in the case of the Gold Standard) so that it can swap its currency for the hard assets at the agreed conversion rate. In contrast, in a fiat currency system, there is no promise to redeem notes for any particular amount of gold or other assets. Since central bank money costs next to nothing to create, its ‘Liabilities’ are essentially notional in this case.

Central bank assets thus play very different roles in fiat and non-fiat currencies. In non-fiat currencies, they are required to ‘back’ the money in circulation, while with fiat currencies, the value of money reflects only its use as a medium of exchange rather than its backing by central bank assets. With fiat currencies, a central bank’s asset holdings could fall below the value of the money it has issued – the balance sheet could show it to be ‘insolvent’ – without impacting on the value of the currency in circulation. A fiat currency’s value, its real purchasing power, is determined by how much money has been supplied and the various factors influencing money demand, not by the stock of central bank assets.

This isn’t to say that countries that issue fiat currencies choose to ignore whether a central bank’s assets exceed its liabilities. Money creation is an extremely powerful tool and needs to be carefully monitored. For example, a central bank that makes loans to insolvent banks and then writes them off is creating money to bail out bank creditors, effectively at the expense of other citizens.

For these reasons, even areas that operate fiat currencies may require their central bank to maintain a positive level of capital. For example, each national central bank in the Eurozone must have its accounts audited regularly and it is generally understood that EMU membership requires these central banks to be ‘recapitalised’ by fiscal transfers from their national government should their assets fall below their liabilities. Important, however, this is a *choice* made by those operating the EMU system and there is no reason why this choice would need to be replicated by those operating any post-EMU system.

# The TARGET2 system

TARGET2 is the Eurozone’s payments system that allows money to be transferred between bank accounts in different countries.[1](http://www.voxeu.org/index.php?q=node/7921#fn1) It works as follows. Eurozone banks maintain accounts with their country’s national central bank and these accounts are counted as part of the central bank’s liabilities. When a Spanish bank asks to transfer money to a German bank, the TARGET2 system ensures that its account with the Spanish central bank is deducted and the receiving German bank’s account with the Bundesbank is credited.

There are a couple of ways that the Bundesbank and Banco de España could adjust their balance sheets to reflect these transfers in ways that left each central bank’s capital unchanged. One method would be for the Banco de España to transfer some of its assets to the Bundesbank. In practice, the Banco de España does not transfer assets but instead incurs an ‘Intra-Eurosystem liability’ (TARGET2 liability) while the Bundesbank obtains an ‘Intra-Eurosystem asset’ (TARGET2 credit).

TARGET2 liabilities incur interest charges at the ECB’s refinancing rate which are then passed on to those central banks that have accumulated TARGET2 credits, so a TARGET2 credit provides the same amount of income to the Bundesbank as its assets obtained from normal monetary policy operations.

The past few years have seen significant transfers from banks in the rest of the Eurosystem to banks in Germany. This has led to a significant change in the composition of the Bundesbank’s balance sheet, so that TARGET2 credits now account for the majority of its assets while loans to German banks have declined because they have ample supplies of deposits. In recent months, as Figure 2 illustrates, with loans to German banks already at very low levels, the continuing transfers to German banks have led to a dramatic increase in the assets of the Bundesbank.

**Figure 2.** The Bundesbank’s assets (billions of euros)



# What happens if there is a euro breakup?

As long as the Eurosystem continues to exist, the Bundesbank’s TARGET2 assets will continue to generate income and play the same role as its other assets. However, recent developments raise the question of what would happen to the TARGET2 credit if there was a complete breakup of the Eurosystem.

The answer depends in part on how orderly such a breakup would be. An orderly negotiated breakup would likely see TARGET2 debtors hand over assets of equivalent value to their liabilities to be pooled together and redistributed to TARGET2 creditors. Because the ECB Governing Council has agreed that the credit risk associated with assets obtained from Eurosystem monetary operations should be shared among its members, such a ‘TARGET2 Treaty’ could also include an agreement to compensate TARGET2 creditors for any subsequent credit losses on their newly acquired assets.

That scenario may sound a bit rosy. What happens if there is a disorderly breakup and TARGET2 debtors refuse to continue paying interest or hand over assets as compensation, so the Bundesbank’s TARGET2 credit becomes worthless? For many, the answer is: “Germany will have to provide the Bundesbank with a fiscal transfer of 20% of GDP to ensure its solvency”.

If this answer was correct, then the TARGET2 credit would indeed represent a large risk for German taxpayers. However, there is no reason whatsoever why a post-EMU German government would need to adopt such a policy. The new Deutschemark would, like the euro, be a fiat currency and there would be no need for all D-marks to be fully backed by hard assets held by the Bundesbank.

If German officials were concerned about the need for the Bundesbank’s balance sheet to show assets greater than liabilities, then they could agree for the Bundesbank to write itself a cheque equal to the value of the TARGET2 credit and to top it up each year with interest. There would be no need to also top up its liabilities, so the Bundesbank’s technical solvency will have been restored without raising any taxes on German citizens.

I suspect some may suggest that a failure to fiscally recapitalise the Bundesbank would produce a currency that people will have no faith in and/or that this will result in inflation. However, this approach would do nothing to change the amount of money circulating in a post-EMU Germany. And a cheque tossed in an empty vault can’t trigger hyperinflation. More likely, because the value of a fiat currency depends largely on the faith of citizens that the quantity of the currency will be kept in limited supply, is that the new Deutschemark will appreciate significantly, with the result being deflation rather than inflation.

Indeed, it is likely that Germany would face serious problems after a euro breakup because of the appreciation of its currency. Its export-oriented economy would suffer badly and its commercial banks would find that their assets – much of which would now be denominated in weaker foreign currencies – no longer cover their liabilities. The German taxpayers would likely have to pay a serious price to maintain a hard currency and a solvent private banking system.

So a euro breakup could be very damaging to Germany but these dangers are not related to the Bundesbank’s TARGET2 credit. To avoid the dangers associated with a euro breakup, it is imperative that payments system continue to function smoothly. Proposals, such as those of Sinn and Wollmershäuser (2011), to restrict the functioning of the TARGET2 system would, if implemented, lead to the end of the euro and cast Germany into severe economic difficulties.

It is time for those German economists who understand the meaning of the TARGET2 balances to respond to the scaremongers before it is too late.

# References

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| 1 See Bindseil and König (2011) and Ulbrich and Lipponer (2012) for more detailed descriptions. | [**Print**](http://www.voxeu.org/index.php?q=node/7921) [**Email**](http://www.voxeu.org/index.php?q=forward&path=node/7921)[**Comment**](http://www.voxeu.org/index.php?q=node/7921#comments) [**Republish**](http://www.voxeu.org/index.php?q=node/87) |
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