Has the Euro-system become a transfer union by stealth?

Tim Congdon

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*The Economics of Monetary Unions: Past Experiences and the Eurozone*

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In his 1970 Institute of Economic Affairs pamphlet on *The Counter-Revolution in Monetary Theory* Milton Friedman, who was to be awarded the Nobel prize for economics six years later, wrote,

“...Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output. ... A steady rate of monetary growth at a moderate level can provide a framework under which a country can have little inflation and much growth. It will not produce perfect stability; it will not produce heaven on earth; but it can make an important contribution to a stable economic society.”
Has the Euro-system become a transfer union by stealth?: some organizational challenges facing a multi-government monetary union in the managed currency era

*Tim Congdon*

European monetary unification has been a unique endeavour. The sharing of one currency by countries which retain fiscal sovereignty and a substantial degree of banking-system autonomy has been attempted nowhere else in the era of managed currencies.¹ What are the conditions for the achievement of monetary and financial stability in a multi-government monetary union of this sort?² And how far have these conditions been met since the introduction of the euro in 1999?

This paper will begin by arguing – in its opening sections – that the conditions are of two kinds,

- those which are much the same as in a traditional monetary jurisdiction, and
- those which are specific to Europe’s post-1999 exercise in monetary unification.

Neither set of conditions has been fully met in practice, although the third section will find that the Eurozone’s managers came closer to achieving them in the euro’s first decade than subsequently. The violation of the conditions for the success of the monetary union has led a conspicuous financial imbalance in the Target 2 settlement system. This imbalance is manifested in a large, persistent and unresolved nexus of debits and credits between the central banks of member states; it is of great concern to member states partly because of potential defaults and losses, but also because – even if they are eventually honoured – the terms of the debts have significant distributional implications while they are current.³ Some observers believe that the Target 2 imbalance is unsustainable and may rupture the monetary union.⁴ By specifying the requirements for the avoidance of inter-state transfers via the ECB’s balance sheet and hence for the Eurozone’s constitutional integrity, the paper may help to inform the debate on future policy-making.

I.

Now that all the world’s currencies have broken the link with a commodity, most economists agree that they have to be managed by the appropriate state-backed authorities, usually a central bank. Given the long-run similarity of the rates of changes of the quantity of money and nominal national income, a well-established point of view is that these authorities should ensure that money growth is held at a low, but positive rate, and that it should be steady over time.⁵ A suitably low rate of money growth ought to deliver stability of the price level (or, at any rate, modest inflation in line with an official target), while money growth that is steady at a positive rate can contribute to the avoidance of large cyclical fluctuations in demand, output and employment.

No consensus has emerged on the concept of money that is appropriate in a prescription for currency management, but it is taken for granted here that an all-inclusive (or broadly-defined) money aggregate is to be watched and controlled in the Eurozone.⁶ This is compatible with the
tradition of monetary targeting pursued by the Bundesbank when in the 1980s and 1990s it was, by common consent, the most admired central bank in Europe; it is also consistent with the so-called “P star” approach to the specification of a money target.  Although the correct approach to monetary management is another matter for debate, it is undoubtedly true that bank deposits are the principal constituent of broad money in modern Europe, that deposits are the main liabilities of banking systems and that any increase in banks’ total liabilities must be matched by an identical increase in their assets. A desired rate of growth of the quantity of money therefore has implications for the growth of the credit counterparts on the assets side of bank balance sheets and so for policy decisions in the management of those counterparts.

Can these remarks be translated into more specific numbers for monetary control? To set the favoured rate of money growth, guidance is needed on the two components of the nominal growth of gross domestic product (that is, real growth and inflation), and allowance should be made for any likely change in the ratio of money to GDP. The trend rate of growth of real output in the Eurozone at present is widely thought to be under 1½ per cent a year, although a somewhat higher number prevailed before 2008. The European Central Bank’s website has for many years given a clear and exact statement about the meaning of the price stability notion. In 1998 its Governing Council advanced a quantitative definition in the following words, “Price stability is defined as a year-on-year increase in the harmonised index of consumer prices (HICP) for the euro area of below 2 per cent.” It further elaborated in 2003 that, “in the pursuit of price stability [the ECB] aims to maintain inflation rates below, but close to, 2 per cent over the medium term”. A reasonable view is that price stability is tantamount to a rise in the price level of 1 per cent a year. On this basis an increase in nominal GDP of about 2½ per cent a year ought to be consistent with price stability, as the ECB sees the matter.

Quantity-theory economists have long appealed to the “proportionality hypothesis” in their theoretical work. This boils down, in essence, to the claim that changes in the quantity of money and the price level ought to equi-proportional when the quantity of money is subject to a large upward or downward shift and nothing real in the economy is altered. In practice most nations experience a rise in the ratio of broad money to GDP in the course of economic development. The early phases of European monetary unification amounted to a major financial liberalization in many member states, notably those on the Eurozone periphery where burdensome official restrictions on banks’ asset composition were common before 1999. The single currency therefore boosted the competitiveness of the banking system and enabled banks to grow their balance sheets faster than GDP without adverse macroeconomic consequences. A plausible surmise is that in the Eurozone broad money can safely be allowed to expand by 1 or even 2 per cent a year more than nominal GDP. With the aim of a 2½ per cent a year advance in nominal GDP, the ideal rate of money growth for the Eurozone comes out at, say, 3 to 4½ per cent a year.

Roughly speaking, the implied prescription is that banks’ assets ought also to expand at the same rate. But a complication arises from role of banks’ equity capital and such non-monetary liabilities as bonds. As capital is a liability of the banking system, large rises and falls in capital may cause bank deposits (and hence broad money) to increase at a different rate from total assets. The procedure in this paper is to suggest that the desired percentage increase in total assets be
expressed relative to broad money, which is somewhat lower than banks’ balance-sheet totals. If equity and bond capital is taken to be about 20 per cent of liabilities, the policy prescription – the rule that should deliver approximate stability of the price level and output growth – becomes that banks’ assets should grow in any particular year at between 4 and 6 per cent of the stock of broad money at the start of that year. Another difficulty with the approach is that banks can acquire claims on the foreign sector, while money growth is affected by the Eurozone’s international financial transactions. Although important, this difficulty is ignored here in order to keep the analysis manageable. So the rule applies to banks’ domestic assets, that is, the sum of their credit to the public and private sectors.

Figure 1 shows the annual sum of bank credit to the public and private sectors as a per cent of the stock of broad money at each year’s beginning, in the 20 years to October 2018, and Figure 2 the annual value of bank credit to the private sector by itself. (The data are monthly.) If the Eurozone’s monetary managers had remembered the Bundesbank’s commitment to low and stable money growth at a constant rate, and if the prescription of the last few paragraphs had been respected, the line representing credit expansion would have been between the two straight lines horizontal to the x axis, for the floor and ceiling to the credit growth prescription. It is quickly evident that this was not the case. Credit expansion exhibited much year-by-year volatility and was much more rapid in the Eurozone’s first decade than in its second.

In the ten years to October 2018 the sum of bank credit to the public and private sectors in one-year periods averaged 12.1 per cent of M3 at the years’ starts; in the next ten years it averaged only 3.4 per cent, on the same basis. Perhaps surprisingly, the buoyancy of credit growth in the first decade was consistent with reasonable price stability of goods and services. Part of the explanation was a rise in the equilibrium ratio of broad money to GDP, due to financial-liberalization effects, as noted above; another influence was that banks funded their balance-sheet growth to a significant extent from bond issuance (that is, not by money creation), as securitisation was popular in global financial markets. Overall the first decade was regarded by contemporaries as a success, not least because the credit boom and high money growth were associated with big gains in the prices of assets (notably residential real estate), and robust advances in output and employment, particularly in 2006 and 2007. (But by late 2007 and early 2008 the ECB was nervous about the spread of inflation to labour and product markets.)

The second decade was quite different. For much of it policy-makers were concerned that the price level might fall, with some commentators making conjectures that deflation could become entrenched. Their job was less to restrain inflation, more to prevent deflation.

The macroeconomic experience of the Eurozone as a whole is consistent with a monetary account of the determination of national income and wealth; it confirms the importance of suitably low and stable growth of credit and money to the attainment of wider monetary stability. Unhappily, in the euro’s first 20 years instability in credit expansion and money growth was accompanied by variations in inflation pressure, and marked cyclical fluctuations in output and employment. A fair comment is that these variations and fluctuations undermined the popularity of European integration. Nevertheless, the price level rose only slowly and in that sense monetary stability was secured.
Figure 1: Bank credit to the Eurozone domestic economy (i.e., to public and private sectors), in 12-month periods, as % of stock of M3 at period start
Source: ECB database and author’s estimates
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Figure 2: Bank credit to the private sector (flow), in the euro’s first two decades - 12-month totals, monthly data, in billions of euros

In the year to February 2008 bank credit to the private sector peaked at 1,423 billion euros and even in August 2008 the figure was 1,329 billion euros. At end-2009, after a year of response to the G20/BIS demands for more bank capital, the figure was down to under 100 billion euros.
II.

What about the second type of conditions for the realization of a multi-government monetary union, namely those that are specific to it and are not applicable in a traditional currency jurisdiction? Has the Eurozone performed any better on this front?

The extension of bank credit involves the laying of claims to resources, since the borrower is enabled by a loan to spend money on the acquisition of goods, services and assets that would not otherwise be possible. Since resources are finite and parties excluded from their use may resent the loss, the distribution of a nation’s resources between different agents is – at least partly – a political matter. Of course, if the extension of bank credit affects the distribution of control over resources and output between different groups, it is liable to cause tension between them. History provides many examples in which, even within a nation, the selection of a currency standard (gold rather than silver, for example) excites antagonism between sectional interests. But the risk of inter-group (or inter-governmental and international) tension is much greater in a multi-government monetary union.

Of course, many credit decisions are driven by market criteria rather than political considerations. Bank lending to the private sector by privately-owned banks – where both the borrower and the lender are motivated by profit and returns – may proceed with no reference to politics whatsoever. However, credit can be extended by the central bank as well as by profit-seeking commercial banks, and nowadays the central bank is invariably state-owned. In general, credit extension by the central bank is therefore far more political – and hence much more likely to stir up sectional grievances (or even international sensitivities) – than commercial bank credit to the private sector. The scope of central-bank credit extension is a crucial issue in the design of a multi-government monetary union.

The Maastricht Treaty of 1992, which set in train the process of European monetary union, appeared to limit the availability of bank credit to particular governments and nations. Most fundamentally, the “no bail-out” clause (Article 125) was meant to ensure that the responsibility for repaying public debt stayed at the national level. Indeed, a protocol to the Treaty spelt out that nations incurring budget deficits that exceeded certain percentages of GDP could be fined by the EU authorities. The resulting “excessive deficits procedure” had its origins in Article 121 and 126 of the Maastricht Treaty, but was made more definite in a separate Stability and Growth Pact agreed by Eurozone member states in 1997.

Further, by Article 123 the Maastricht Treaty prohibited overdraft finance from the ECB (or any of the national central banks that constituted the so-called “Euro-system”) to any national government. Article 123 spread to the entire Eurozone a principle contained in the 1957 German legislation which created the Bundesbank, that governments must not finance their expenditure by resort to the printing press. According to Wyplosz in a 2010 analysis, the no bail-out clause, the excessive deficits procedure and the prohibition on overdrafts to governments were three vital “safeguards” for the Eurozone’s long-run viability. They would prevent fiscal irresponsibility at the national level undermining the price stability that monetary union was intended to deliver. Governments had to keep deficits and borrowing down, and – if they did have deficits – they were not to finance them from central banks.
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Nevertheless, the Maastricht Treaty was far from rigorous and comprehensive in its treatment of the potential problems. Specifically, it failed to spell out in enough detail how the ECB and the national central banks were to operate once the single currency came into being. In a traditional monetary jurisdiction the central bank has two customers, the government and the commercial banking system. It takes deposits from the government and records the government’s transactions across this account, and it finances part of the government’s activities. A key observation for the present discussion is that finance can be granted by holding securities issued by the government rather than by making direct loans. The central bank also takes deposits from commercial banks, which settle imbalances between each other in its legal-tender cash liabilities. Occasionally it also lends to commercial banks. Such loans may be routine and uncontroversial in nature, or they may be necessary in conditions of financial stress when banks have trouble funding their assets. In stress conditions the central bank loans are typically called “lender of last resort finance” or “emergency liquidity assistance”.

The Maastricht Treaty was silent on basic issues which stemmed from these recognised and familiar functions of a central bank. First, while Article 123 stopped overdraft finance from the central bank to the government, the Treaty empowered it to buy and sell marketable securities for monetary policy purposes. Government securities are of course everywhere the most liquid and therefore the most marketable available. By implication, the ECB might hold the government securities of any or all of the Eurozone’s sovereign states.

Sometimes such holdings might be temporary and technical, as with repurchase operations used to signal interest rate levels. With repo activity in a one-government monetary area, holdings of government securities do not represent a long-term intention to own and constitute only a nominal granting of central bank credit. But sometimes the central bank buys government securities and sits on them for several years or even to redemption. Ownership is then meaningful. It follows that, in a monetary union, the central bank’s decisions on government bond purchases could affect the distribution of resources and output between member states. But the Maastricht Treaty did not specify the proportions of its assets – or of its total holdings of government securities – that might be represented by securities issued by the governments of individual nations. Given that central bank finance is usually lower-cost than funding from capital markets, this omission was potentially serious. If the government securities of one nation were over-represented in the ECB’s balance sheet (relative, say, to that nation’s output share in the Eurozone), that might lead to charges of discrimination and unfairness. To offer an extreme example, would it be right for the liabilities of the Portuguese government to exceed half of the ECB’s total holdings of government securities? Would that not be hard to justify, in view of Portugal’s much lower share (about 2 per cent) of Eurozone output?

Secondly, the Maastricht Treaty gave no indication about how the ECB was to act as a lender of last resort. Almost by definition, banking emergencies due to cash runs on deposits are inherently unpredictable. The central bank has to act flexibly, pragmatically and with full discretion. Often there is rough justice in its behaviour. In established nation states – to which political and financial elites have long-standing loyalties – people tolerate the rough justice for the sake of the financial system (and the nation) as a whole. Given the opacity of banking crises,
and the dangers of media misrepresentation, the central bank’s last-resort loans are likely to be far more controversial in a multi-government monetary union than in nation states with one government, one central bank and one commercial banking system. A refusal by the ECB to lend to cash-short, but solvent banks in one member country could heavily damage that country’s financial system and its economy. At the time of the Maastricht Treaty, a sensible conjecture might be that the ECB would not antagonize member states in this way, and hence would be liberal and easy-going with lender-of-last-resort assistance. An obvious danger would then be that an accompanying relaxed attitude to banking supervision might lead, over time, to lower credit standards.23

The textbook formula for last-resort lending is that, as long as it is collateralised by good security, it should be available on an abundant scale, but at an above-market (or “penal”) interest rate.24 This formula dates back to the mid-Victorian thinker, Walter Bagehot, who wrote about the subject in his path-breaking 1873 book, Lombard Street. The ready availability and amplitude of cash support are vital. Market participants must appreciate that the cash will not run out, so that they have no further incentive to convert deposits into cash. It follows that last-resort facilities in a multi-government monetary union must be potentially on a massive scale if they are to work, just as applies in a one-nation currency jurisdiction. But there is an awkward new wrinkle in the Eurozone. To the extent that the ECB makes emergency loans disproportionately to the commercial banking system of one member country rather than the commercial banking system(s) of another (or others), the nation’s banking system – and so that nation itself – is receiving a privileged form of finance. If the last-resort loans are at a penalty rate, in line with the Bagehot principle, the lending countries are unlikely to be worse-off. However, if the last-resort loans are at a beneath-market rate, the borrowing countries may benefit unfairly at the lenders’ expense.

To summarize, the Maastricht Treaty contained a no bail-out clause intended to clarify a core organizational principle: the introduction of the single currency would not lead to inter-governmental (and hence inter-state) transfers within the Eurozone. Monetary union was to promote political union between Eurozone members, but it was not to become “a transfer union” between them. Unfortunately, the treaty overlooked a difficulty so fundamental that it amounted to virtual self-contradiction. The very existence of a fully-empowered central bank was almost certain to result in significant net cross-border payments. If open market operations had the effect that one government’s debt was over-represented in ECB assets, and if last-resort lending were skewed towards the banks of one or a few member states, the ECB’s decisions – even if ostensibly technical in nature – could have the same results as inter-state payments in a transfer union.

In other words, by pursuing its understood objectives, and by doing so with long-established methods in accordance with functions and responsibilities blessed by precedent, the ECB would – very probably – affect the inter-governmental distribution of resources and output. If undertaken on a large scale, familiar and seemingly unobjectionable central-banking operations could breach the no bail-out clause. The ECB’s actions as a central bank might result in bail-outs by stealth. A de facto transfer union might emerge, regardless of the precise wording of Article
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125 of the Maastricht Treaty.

The risk of these outcomes was greatest in a certain kind of macroeconomic context. The first section above contrasted the Eurozone’s first and second decades, with policy-makers in the second decade often more worried about deflation than inflation. Some critics of the single currency had remarked in the 1990s that monetary policy might find deflation the harder evil to tackle. In his 2008 book *The Birth of the Euro* Otmar Issing, the ECB’s first chief economist, tried to meet this challenge. In his words, the ECB could respond to “a highly deflationary” environment “just like other central banks”. It “could if necessary inject unlimited amounts of central bank money through the purchase of all kinds of debt securities”.25

The trouble was that the ECB was not – and still is not – “just like other central banks”. Whereas they are answerable to just one government and one commercial banking system, the ECB conducts business with a large number of governments and commercial banking systems.26 If the central bank in a multi-government monetary union has to expand its balance sheet rapidly to counter deflation, it has to decide the quantities of government and other securities it will buy from each and every member state, and the prices at which such purchases will take place. These are vexed and intensely political issues, with immediate distributional consequences akin to those in a transfer union. Indeed, before the euro began in 1999, the various European nations had utterly different intellectual traditions and practices in this area of policy-making. Germany – with the Eurozone’s largest economy – had virtually no post-war experience of short-term government financing at all.27 On the other hand, the government of Italy – with the Eurozone’s third-largest economy – had for decades been reliant on banks to meet its enormous short-term cash needs.28

Suppose that the deflation threat is real. Suppose that ECB’s Governing Council decides to counter it by large-scale purchases of “all kinds of securities”, in line with Issing’s remarks in *The Birth of the Euro*. The ECB could buy bonds issued by the private sector, but it thereby takes risk onto its balance sheet and may be charged with favouritism if it buys too much paper from one country’s private sector than another’s. In practice, purchases of government securities are almost certain to be the dominant element. We come back to the issue raised a few paragraphs ago. By what criteria is the value of purchases of the different governments’ debt to be determined? Given that ratios of public debt to GDP vary widely across the Eurozone, any set of criteria is likely to be contentious. A policy debate might expose the rift between German (and North European) and Italian (and South European) mind-sets about these matters. Indeed, for the ECB deliberately to buy the debt of a government (or governments) with public debt far in excess of the limits stated in the Maastricht Treaty might appear to reward it (or them) for fiscal profligacy.29

III.

What does the discussion in the last section imply about the circumstances in which a multi-government monetary union would be a success? Of course, the three crucial rules of fiscal discipline spelt out in the Maastricht Treaty, and identified as essential “safeguards” by Wyplosz in 2010, had to be respected. But, over and above that requirement, our discussion predicts that inter-governmental tensions would be least, and that the monetary union would avoid friction, if
• the dominant form of credit extension is commercial bank lending to the private sector, rather than the central bank financing of budget deficits,
• the rate of growth of bank credit to the private sector is just right – not too high, not too low - to sustain domestic credit expansion at a level consistent with inflation-target money growth,
• central bank operations are mostly repurchase agreements to signal interest rate intentions rather than operations which result in the long-term granting of credit, perhaps on a differential basis, to the governments and banks of particular nations, and
• banks are profitable, well-capitalised and credit-worthy, since that facilitates the funding of assets from wholesale sources and limits the need for last-resort central bank loans to meet cash runs.

The first two conditions go together. If bank credit to the private sector is too high and results in excessive money creation, the result will be inflation, which will discredit the monetary union; if bank credit to the private sector is too low, inadequate money growth and the deflation peril may have to be avoided by central bank purchases of sovereign bonds that discriminate improperly between governments, which will also discredit the monetary union.

The contrast between the euro’s successful first and its unsatisfactory second decade now becomes easier to understand. Figure 1 shows that the rate of growth of domestic bank credit fell markedly between 2008 and 2010, and Figure 2 highlights that the slump in bank credit to the private sector was far greater than in bank credit to the public sector. Whereas in the peak period (the year to February 2008) new bank credit to the private sector was over €1,420 billion, just two years later (the year to February 2010) it was less than €30 billion. The figure was to remain at under €200 billion until mid-2016. Indeed, for an extended period, the three years to April 2015, the annual change in the stock of bank credit to the private sector was negative.

Unless offset by some other influence on bank balance sheets, weakness in bank credit to the private sector is certain to be associated with low growth in the quantity of money. Outright contractions in the stock of such credit may result even in falls in the quantity of money. Low growth or falls in the quantity of money are likely to lead to recession, rising unemployment and heightened deflation risk. These were indeed the experiences of the Eurozone in its first recession (in 2008 and the first two quarters of 2009) and a second milder one (in the two years to the second quarter of 2013). In the first recession budget deficits widened sharply, because of the cyclical hits to tax revenues and social security costs, and governments sought bank finance to a greater extent than in previous years. But this was far from being a deliberate policy across the entire Eurozone. (Note, however, that banks needed more short-term government securities in order to comply with regulatory demands that they hold more liquid assets.) After the second recession the ECB embarked, amid much publicity and with full self-awareness, on a programme of large-scale asset purchases (or “quantitative easing”), which in fact meant mostly central bank purchases of government securities. Bank credit to the general government sector was €326 billion in the year to January 2016 and €453.5 billion in the year to January 2017. This contributed to an acceleration in broad money growth and a recovery in the real economy.

Figure 3 shows the split between bank credit to the private and public sectors in the Eurozone’s
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Figure 3: Destinations and growth rates of stock of bank credit in the Eurozone, 1998-2018
Figures are annual totals as % of M3 at period start
first two decades. The increase in bank credit to the private sector was cumulatively €7,375.6 billion in the decade to October 2008 and a mere €998.4 billion in the decade to October 2018. The behaviour of bank credit to general government sector was completely different. The increase in bank credit to general government was cumulatively a tiny €59.4 billion in the decade to October 2008 and €2,169.5 billion in the decade to October 2018. The first decade of the Eurozone was characterised by a surge in the banking system’s claims on the private sector, which meant that market criteria became more important in asset-acquisition strategies and could be viewed as a “de-politicisation” of banking. For much of the time the ECB’s holdings of securities were attributable to repo activity, which was virtually neutral in its effects on different member states. By contrast, the second decade saw a clampdown on banks’ risk assets and a build-up of their safe claims on the state sector. This would have made banks’ asset portfolios more political even in a standard monetary jurisdiction with only one government. In the Eurozone it was accompanied by almost constant inter-governmental bickering and an undoubted politicisation of monetary decision-taking.

It was suggested earlier that high-level disagreements, reflecting de facto inter-governmental redistributions of claims on resources, would arise if credit extension were mostly from state-owned central banks (that is, the central banks belonging to the Euro-system) rather than from privately-owned commercial banks. Such credit extension could take the form of both central bank acquisitions of government debt and of central bank lending to commercial banks. What do the data show about the development of these two forms of central bank credit since 1999?

Figure 4 tells the story. In the first four years of the euro’s existence the ECB’s domestic claims fell slightly. The next five years saw the ECB’s claims on other Eurozone credit institutions (that is, on banks) more than treble, with the bulk of the increase occurring in 2007 and 2008. This reflected the adoption of so-called “non-standard measures” after August 2007. They were mostly ECB loans to banks to counter the damaging effects of the withdrawal of inter-bank credit lines, and so to ensure that banks could finance their portfolios of loans and securities. The non-standard measures were for the most part were not priced at penalty rates and represented a low-cost form of last-resort finance. In 2009 and 2010 the ECB tried to cut back on the non-standard measures, with its chief economist, Jürgen Stark, anxious that the expansion of the central bank balance sheet foreshadowed a return to inflation. In the two years to end-2010 the ECB’s claims on commercial banks duly dropped from €917.3 billion to €592.4 billion.

Unhappily, if predictably, the withdrawal of the non-standard measures weakened the ability of banks to fund their assets, particularly in the Eurozone periphery (in, for example, Greece, Portugal and Ireland). These banks sold the most liquid assets they had (that is, securities issued by their governments, the governments of Greece, Portugal, Ireland and so on). The sales drove up yields on government bonds, giving rise to the Eurozone’s “sovereign debt crisis” in spring 2010. In April 2010 the yield on 10-year Greek government bonds soared above 30 per cent. The member states were split about how best to respond to this situation, which might culminate in Greece’s departure from the Eurozone and massive harm to the single currency’s credibility. On Friday 14 May a sharp confrontation between the French President, Nicolas Sarkozy, and the German Chancellor, Angela Merkel was widely reported. Sarkozy favoured large-scale and
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Figure 4: Growth and composition of the ECB’s domestic claims, 1999 - 2018
Figures are in billions of euros and relate to year-end. Source: ECB database
highly publicised ECB purchases of peripheral government debt, while Merkel opposed them. Sarkozy’s view prevailed, and in the next few weeks the ECB organized significant purchases of Greek, Portuguese and Irish government debt. These transactions were largely responsible for the increase in the ECB’s total holdings of government debt from €364.8 billion at end-2009 to €492.4 billion at end-2010.

For the rest of 2010 and most of 2011 Greece and other vulnerable Eurozone states struggled to bring their public finances and banking systems into better order. Throughout the period worries about possible Eurozone break-up, and about banks’ loan losses and capital strength, weakened banks’ ability borrow from inter-bank markets or to raise long-term capital. Although the crisis was widely perceived as posing an existential threat to the Eurozone, the ECB’s President, Jean-Claude Trichet, made no effort to restore the non-standard measures. In December 2011 Mario Draghi, shortly after succeeding Trichet at the top of the ECB, changed tack radically. He announced the return of the non-standard measures, but on a larger and more easy-going basis, and emphasized that banks that drew on the over €1,000 billion of available funds (from “long-term refinancing operations”) would suffer no reputational stigma. The press gave the return of the non-standard measures the label of “Draghi’s bazooka”. At the end of 2012 the ECB’s loans to commercial banks approached €1,330 billion. With the extra firepower many banks were able to increase their holdings of government securities, which usually offered a yield well above the low cost of the LTRO money. As a result, the pressure on the ECB to buy government bonds was less acute. At end-2014 its holdings of government bonds were €617.0 billion, slightly lower than three years earlier.

Draghi’s bazooka was sufficient to keep the Eurozone intact, but it did not stop the Eurozone entering its second recession in 2012 and 2013. Even in early 2014 growth was sluggish, and deflation later in the year and in 2015 was viewed as a serious possibility. Towards the end of 2014 the ECB’s Governing Council decided to copy the asset purchase programmes (or “quantitative easing”) that had been adopted successfully in the USA and the UK (in 2008 and later) to combat recession. As noted earlier, the ECB’s asset purchases were predominantly of government bonds and constituted finance for the governments of the Eurozone’s member states. The ECB’s claims on general government soared from €617.0 billion at end-2014 to €2,923.2 billion at end-2018.

To summarize, in the early years of the single currency central bank financing of either commercial banks or the Eurozone’s governments was negligible. But the paralysis in the international wholesale money markets from August 2007 obliged the ECB to lend to commercial banks so that they could continue to finance their assets, and it did so freely and generously. From then until now pressures of various kinds have made it expedient for the ECB to increase its claims on both commercial banks (with finance that is privileged, low-cost and quasi-permanent) and governments. Latterly the increase in claims on governments has been rationalized in macroeconomic-policy terms, in that central bank asset purchases should help economic activity and prevent deflation.

An earlier discussion in the paper demonstrated that in a multi-government monetary union the extension of large-scale central bank finance – even if apparently justified as the traditional exercise of central bank responsibilities – could have a differential effect on member nations’
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command over resources and output. At the end of 2018 the ECB’s combined claims on Eurozone “credit institutions” and general governments totalled €3,675.3 billion, more than ten times higher than at end-1999 (when the figure was €333.4 billion). If the pattern of net claims on different nations’ credit institutions and governments was unbalanced (that is, if the Euro-system had a mix of large and persistent net debtors and creditors), the Eurozone could be interpreted as in reality a transfer union.

IV.

As is well-known, the pattern of net claims between central banks in the Target 2 settlement system is indeed unbalanced and has been so for over a decade. Germany (that is, the Bundesbank) first became a creditor of the system in 2005, but only since 2009 has it been a significant net creditor to the tune of hundreds of billions of euros. The counterpart debtors have been particularly Italy and Spain. Since early 2012 they have been consistently in the red, also to the tune of hundreds of billions of euros.

The argument of this paper has been that, if the ECB acts – like any central bank – as a claimant on governments and lender to commercial banks, and if its claims are in practice on differential basis to the governments and banks of the various Eurozone member states, the result will be a de facto transfer union. An explanation for the Target 2 nexus of debits and credits is therefore that the ECB has behaved according to its remit as the Eurozone’s central bank. In the course of open market operations, notably the large-scale asset purchases from early 2015, and of support for commercial bank liquidity through the “non-standard measures” from 2007 to 2010, and again from 2011 to today, it has extended credit to Eurozone government and banks to the value of over €3,500 billion. The credit has to some extent been unbalanced, most clearly helping Italian and Spanish banks rather than the banks of other countries, and that is why the Target 2 debit/credit position has emerged. Figure 5 shows the correlation between Germany’s Target 2 credit balance and the growth of the ECB’s domestic assets.32

Sure enough, Germany’s Target 2 credit position can also be attributed to the large and apparently chronic current account surplus on Germany balance of payments. But that is not a rival analysis or a wholly compelling answer. A nation’s current account surplus can be recorded in a variety of financial channels; it can appear in central banks’ accounts or in the accounts that member central banks hold in the settlement system of a multi-government monetary union; it can also appear in trade credit, in commercial bank accounts and in holdings of a plethora of financial securities. If the ECB had not extended so much credit to Eurozone governments and banks, and if it had not done so on a differential basis, Germany could not have had a large surplus in the Target 2 settlement system. The German current account surplus would have been registered in other ways (in trade credit, on commercial bank accounts, etc.).

In conclusion, the Maastricht Treaty overlooked the dangers inherent in giving the ECB the powers of a traditional central bank. As a by-product of standard central bank operations, the Eurozone could mutate into a transfer union. The three “safeguards” identified by Wyplosz in 2010, and much emphasized by German commentators throughout the process of currency unification, were necessary conditions for the prevention of a transfer union. But they were not sufficient. A separate and more far-reaching agreement was required to pre-empt the risk of
Figure 5: The growth of the Bundesbank’s claims on the Target2 settlement system and the ECB’s domestic claims
Domestic claims are on governments and banks. Figures in billions of euros and relate to end-year Source: ECB database
a transfer union. Such an agreement would have specified that the ECB would not hold large claims of any sort on any government, and that the task of emergency liquidity assistance to the banking system should be conducted only at the national level (so that no cross-border claims could emerge) and not on the account of a Euro-system member.\textsuperscript{33}

In June 2012 Angela Merkel, the German Chancellor, said in an interview for Spiegel International, there would no debt mutualisation in the Eurozone “as long as I live”.\textsuperscript{34} But in fact the first two decades of the euro’s existence – and particularly the second of those decades – had already seen extensive debt mutualisation in the Eurozone. The contrast between the first and second decades further suggested how best to limit the tensions and strains that may be inevitable in a multi-government monetary union with a fully-empowered central bank. If money growth arises solely from commercial bank credit to the private sector, if the pace of growth of both money and bank credit are consistent with price stability, and if central bank operations are restricted to repurchase transactions (between it and commercial banks) for the signalling of interest rates, a multi-government monetary union should work easily and with little inter-governmental rancour. In these circumstances there should be little or no inter-state transfers by stealth, and little or no quarrelling between member states’ governments. On other hand, if money growth stems from the extension of central bank credit, if the pace of growth of money and credit is volatile and inconsistent with price stability, and if central bank operations result in large and seemingly ineradicable claims on different nations’ governments and banking systems, a multi-government monetary union is likely to be fractious and difficult to manage. It might also appear to suffer from centrifugal forces as disadvantaged member states – whether they have a legitimate grievance or not – threaten to break away.
References

1 The “era of managed currencies” is understood to be that which has prevailed since the ending of the dollar’s convertibility into gold in 1971. In contrast to the gold standard, the value of money is no longer linked to a commodity and must instead be managed by discretionary state action. The only comparable approach (that is, the sharing of a currency by fiscally-sovereign states) is small-scale, the Eastern Caribbean Currency Union, where – in any case – monetary policy is not discretionary. It is instead geared to maintaining a fixed exchange rate with the US dollar.

2 In accordance with an emerging consensus, monetary stability is to be understood as the stability of a price index, maintaining the real value of money, while the touchstone of financial stability is deemed to be the convertibility of bank deposits into legal-tender cash, so that deposit money keeps its full nominal value.

3 At present no return is received on Target 2 credit balances. Given that a reasonable long-return expectation on foreign equity investments might be 5 per cent a year in real terms, Germany suffers (at the time of writing, July 2019) an implicit almost €50 billion-a-year loss on its Target 2 credit balance, relative to that which would have been achieved if its citizens held equity investment abroad. (The German Target 2 balance has been positive – at over €900 billion – since early 2018.)

4 See, for example, Ambrose Evans-Pritchard ‘German Bundesbank comes clean on euro default risks after Italy’s “parallel currency” decree’ The Daily Telegraph, 4 June 2019, about a Bundesbank report on the risk of losses to ECB creditors in the event of default by a member state. Analyses by Hans-Werner Sinn of the Ifo Institute have raised the alarm for some years, but Sinn supports the euro, and European monetary and political integration. See, again for example, Hans-Werner Sinn The Target Trap (Oxford: Oxford University Press, 2014).

5 In a large literature the classic statement is perhaps Milton Friedman A Program for Monetary Stability (New York: Fordham University Press, 1960).

6 The author has long argued that the key propositions in monetary theory apply only with a broadly-defined money aggregate. See, for example, essays 15 and 16, pp. 330 – 73, in his 2011 collection, Money in a Free Society (New York and London: Encounter Books, 2011).


8 According to the International Monetary Fund, the average growth rate of Eurozone output was 1.9 per cent in the last seven pre-single-currency years from 1992 to 1998 and 2.1 per cent in the first decade of the single currency. It was only 0.7 per cent in the eleven years to 2019 inclusive. In its October 2018 Economic Outlook, the IMF expected average growth in the five-year period 2020 – 24 inclusive to be 1.4 per cent.


10 In their conclusion (pp. 149 – 53) to Michael Bordo and Lars Jonung The Long-Run Behaviour of the Velocity of Circulation (Cambridge: Cambridge University Press, 1987), Bordo and Jonung propose that institutional forces such as monetization and financial development can explain secular declines in the velocity of circulation of broad money in several societies.
Has the Euro-system become a transfer union by stealth?

So, if the rate of money growth is much above 6 per cent a year for an extended period, inflation is likely to exceed target. Conversely, if it is much beneath 2 per cent a year, then the price level may fall for several years, accompanied by disappointing output and employment outcomes.

Banks’ capital-raising reduced the annual rate of money growth by 1.07 per cent on average in the decade to October 2008 and by 1.13 per cent in the following decade. (The estimate is the author’s, using ECB data.) Given that the second decade saw much slower growth of bank balance sheets, this shows how after autumn 2008 the drive for extra bank capital – under the auspices of the Bank for International Settlements – became a more important concern for banks’ managements.


In its March 2008 Monthly Bulletin the ECB noted that consumer inflation had “stabilised in February after reaching a record level of 3.2 per cent in January, following five consecutive months of sharp increase”. It opined, just a few months before the start of the Great Recession, that, “The risks to the outlook for inflation over the medium term are on the upside.” (See March 2008 issue of the ECB’s Monthly Bulletin [Frankfurt: ECB], p. 58.)

See, for example, Ferdinando Giugliano, ‘Europe: Deflation decoded’, Financial Times, 9 January 2015.

The topic is large, but the rise of Eurosceptic populism in Italy and Greece in the 2010s has been interpreted in these terms. The financial crises in Europe caused the future French president, Emmanuel Macron, to talk in July 2015 of a new “war of religion” in Europe, between the prudent Nordics, Germany and the Netherlands in one camp, and the more financially relaxed France, Italy and Spain on the other. Adam Tooze Crashed: How a Decade of Financial Crises Changed the World (London and New York: Penguin Random House, 2018), p. 531.

According to the IMF, the average rate of consumer inflation in the 20 years 1999 to 2018 inclusive was 1.7 per cent, while in the decade 1999 to 2008 inclusive it was 2.2 per cent and in the decade 2009 to 2018 inclusive it was 1.2 per cent.

The word “resources” is shorthand. Of course loan proceeds can be used to acquire factors of production, goods and services recently produced, and existing assets.

By his celebrated “cross of gold” speech at the Democratic National Convention in Chicago in 1896, William Jennings Bryan secured his nomination as presidential candidate. Bryan supported bimetallism or “free silver”, which he believed would bring the nation prosperity. He condemned the gold standard with his conclusion, “you shall not crucify mankind upon a cross of gold”.

Charles Wyplosz ‘European Stabilisation Mechanism: Promises, realities and principles’, 12 May 2010 blog for VoxEU. Wyplosz also said that that the Stability and Growth Pact “never worked”, while the two remaining of his three safeguards had “been blown away”.

The author made this point in a 1992 paper (Tim Congdon ‘Problems that were neglected at Maastricht’, summer 1992 issue, Central Banking [London: Central Banking Publications], pp. 54 -62.) in the early debates on European monetary union. “Extremely awkward questions relate to the ECB’s holdings of different governments’ debts.” (p. 57) The Treaty also said nothing about government financing from commercial banks (which can increase money growth) or about deposit insurance.
Again the author made this point in his 1992 paper for *Central Banking*. See the discussion on pp. 61 – 2 of his ‘Problems that were neglected at Maastricht’. Similar concerns were expressed by two IMF economists, Alessandro Prati and Garry Schinasi, in ‘Will the European Central Bank be the lender of last resort in EMU?’, pp. 227 – 56, in Michael Artis, Axel Weber and Elizabeth Hennessy (eds.) *The Euro: the challenge and opportunity for financial markets* (London and New York: Routledge, 2000). Even in nation states banking crises can fuel misunderstanding and resentments. Thus, in the USA the massive Federal Reserve loans to the banking system in 2008 and 2009 provoked hostile comment. Many members of the public believed that taxpayer dollars would be lost, with rich bankers “bailed-out” at the expense of low-paid government employees. In fact, according to Bernanke, then the Fed’s chairman, “although we made thousands of loans to a wide range of borrowers, every penny was repaid, with interest – and the Fed, and thus the taxpayers, profited by billions of dollars.” Ben Bernanke *The Courage to Act* (New York and London: W. W. Norton & Company, 2015), p. 469.

The travails of the Banca Monte dei Paschi di Siena, the fifth largest in Italy, illustrate the problem. See B. Mesnard, M. Magnus and A. Margerit ‘The precautionary recapitalisation of Monte dei Paschi di Siena’, 6 July 2017 briefing for European Parliament. In 2017 the European Commission permitted a state-aid capital injection of over €5 billion, but by early 2019 this was deemed insufficient.


Otmar Issing *The Birth of the Euro*, p. 124.

Initially, at the ECB’s establishment in 1999, the Eurozone had 11 members; at the time of writing (July 2018) it has 19.


This would be true even, for example, if the mix of government bond purchases accorded with the ECB’s capital key, which reflected member states’ share of Eurozone GDP.

Jürgen Stark ‘Economic recovery and exit strategies’, speech at the debate on “The post-crisis strategy for growth and jobs” and “Modernisation of the global financial architecture” between the Committee on Economic and Monetary Affairs of the European Parliament and national parliaments, Brussels, 16 March 2010. To quote Stark in that speech, the “phasing-out some of the non-standard measures to avoid risks to price stability at a later stage is fully in line with the ECB’s price stability mandate under the current circumstances.”


When the Bundesbank’s net claim on the Eurosystem is regressed on the ECB’s total domestic claims (that is, the sum of its credit to general governments and Eurozone credit institutions), the best-fitting equation has a coefficient of determination of 0.9. The t statistic on the regression coefficient (0.31) is 12.3. When the Bundesbank’s credit balance is regressed on either ECB claims on general government or ECB claims on credit institutions (that is, banks), the equation is of lower quality.

Banks in a particular nation could capitalize an emergency funding entity that could hold claims only on banks in that nation. The emergency funding entity – which might receive state support or be associated with a deposit insurance fund (financed by insurance premiums from banks, as with the Federal Deposit Insurance Corporation in the USA) – would be separate from the central bank.

Has the Euro-system become a transfer union by stealth?

Professor Tim Congdon CBE

Tim Congdon is an economist and businessman, who has for over 40 years been a strong and widely-respected advocate of sound money and free markets (‘Thatcherite monetarism’) in the UK’s public policy debates. He is currently chairman of the Institute of International Monetary Research, which he founded in 2014. The Institute is based at the University of Buckingham, where he is a professor of economics. His most influential position was as a member of the Treasury Panel of Independent Forecasters (the so-called ‘wise men’, or ‘wise person’ after a lady joined them) between 1992 and 1997, which advised the Chancellor of the Exchequer on economic policy in a successful period for the UK economy. In June 2017 a collection of papers Money in the Great Recession, edited by Professor Congdon, was published by Edward Elgar Publishing Ltd.

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Synopsis

As was well-known at the inception of Europe’s single currency, a multi-government monetary union was vulnerable to “free rider” problems. Some member states might run large budget deficits, or even monetise their public debts, to take advantage of the benefits of sound fiscal and monetary management by others. The 1992 Maastricht Treaty therefore contained limits on budget deficits and public debts, and prohibited central bank overdrafts to governments; it also specified a “no bail-out” clause that was intended to prevent the Eurozone becoming a so-called “transfer union”. However, it also gave the European Central Bank the full powers of a central bank, including the powers to purchase government securities in open market operations and to extend loans to commercial banks. This research paper shows how in practice the empowerment of the ECB enabled the Eurosystem of national central banks – by differential financing of member states’ governments and commercial banks – to become a transfer union by stealth. The main symptom is the large imbalances between these central banks in the Target2 settlement system.

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