Weidmann, Munchau and Target2

Wolfgang Munchau writes today about the letter from newish Bundesbank president Jens Weidmann to Mario Draghi, as discussed here

> *The Bundesbank initially dismissed the Target 2 balance as a matter of statistics. Their argument was: yes, it is recorded in the Bundesbank's accounts, but the counterparty risk is divided among all members according to their share in the system. But last week, Jens Weidmann, president of the Bundesbank, acknowledged the Target 2 imbalances are indeed important, and an unacceptable risk. The Bundesbank has now joined the united front of German academic opinion.*

Wolfgang is a fantastic journalist and his FT column is essential reading. But this is a very bad paragraph. It is indeed the case that the Bundesbank has published an analysis of Target2 balances in its monthly report making it clear that the Bundesbank's credit risk associated with Eurosystem operations was not measured by its Target2 balances (see page 34-35) of this report.

That Weidmann now wishes to publicly claim he is concerned about risk associated with the Bundesbank's Target2 credit does not simply mean that this is a truth that has now been "acknowledged". I suspect most of us have worked for bosses that say things in public that are just plain wrong and I would guess that the sober Bundesbank officials that approved of the monthly bulletin piece on Target2 are fairly disgusted that Weidmann is adopting an approach in public that they know is ungrounded.

As for Wolfgang's idea that German academics are united behind Hans Werner Sinn in his concern about the Target2 credit (which he consistently and incorrectly labels "Target loans") I'd note that Ulrich Bindseil and Philipp Johann König appear to have missed the memo that all Germans are supposed to agree with Sinn.

Wolfgang also discusses an aspect of the Target2 issue that did not feature in Sinn's original contributions, but which is now becoming a blogosphere staple: The supposedly enormous credit risk the Bundesbank is incurring in the event of the end of the euro.

> *if the euro were to collapse suddenly, Germany could stand to lose a large proportion of its claims – some 20 per cent of gross domestic product.*

A couple of comments about this issue.

First, every national central bank in the Eurosystem currently has assets that exceed their liabilities and total Target2 credits equal Target2 liabilities. Thus, the most likely resolution of Target imbalances in the case of a full Euro breakup would be a pooling of assets held by Target2 debtors to be handed over to Target2 creditors to settle the balance. This may leave the Bundesbank holding a set of peripheral-originated assets that may be worth less that face value but this scenario would result in losses to the Bundesbank that would be far short of the current value of its Target2 credit.

Second, as Gavyn Davies discusses in this interesting FT article, central bank balance sheets are simply not the same as normal private sector balance sheets. It is unwise for central banks to go around printing money to purchase worthless assets so it is generally appropriate to insist that a central bank's assets at least equal the value of the money it has created.

That said, should the Bundesbank end of losing a bunch of money because its Target2 credit was worth less than stated, there would be no earthly reason why the German public would need to give up large amounts of money to ensure that the Bundesbank remained “solvent”.

In a post-euro world, the Bundesbank would be one of a select number of central banks that could be counted on to print a currency likely to retain its value. Weidmann could write himself a cheque, stick it in the vaults and declare the Bundesbank to be solvent without any need to call on the German taxpayer.

That isn’t to say a euro break-up would cause no problems for Germany. The likely appreciation of the new DM would see Germany lose competitiveness which would hit its exports. It would also require recapitalisation of its private banks as their DM-denominated liabilities would rise in value relative to their balance sheets that may be left with significant non-DM assets. But the solvency of the Bundesbank will be very low down the list of potential problems.

One has to wonder whether Weidmann really doesn’t understand the nature of the Bundesbank’s Target2 credit or whether he is simply playing to a German audience that is used to regular missives on this issue from Hans Werner Sinn. Neither are attractive possibilities.