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Opening Remarks

Germany's Hidden Risk

The Bundesbank has quietly lent half a trillion euros to the European Central Bank. Could that determine the fate of the euro? By Peter Coy

Involuntary lending is what happens when your teenager figures out how to charge stuff to your credit card. The kid promises to pay for the purchases but never gets around to it, so your involuntary loan keeps getting bigger. At some point it dawns on you that you might never get your money back.

Something similar is happening in Europe, except the dysfunctional family consists of central bankers, with Germany's Bundesbank in the role of aggrieved parent. The figures are hard to find, policymakers don't like to talk about them, and the accounting is far from sexy. Outside of Germany, headlines have been few. But the numbers are huge-so huge that they may be one of the biggest factors in whether the euro zone hangs together or falls apart.

Expect to hear more about this issue as the glow from the Dec. 8-9 Brussels summit continues to dim and the stresses on Europe's common currency intensify. The term to remember is Target2. It's the name for the European Central Bank's suddenly important interbank payment system, which before the crisis was just a lowly bit of financial plumbing.

The bottom line: Germany's Bundesbank-BuBa for short-has quietly, automatically lent €495 billion to the European Central Bank via Target2. That lending has balanced correspondingly huge borrowings from Target2 by the central banks of weaker nations including Greece, Ireland, and Portugal-and lately Spain, Italy, and even France. They are technically "claims," not loans. To find them you have to root around in the footnotes of the reports of the 17 national central banks of the euro zone.

If the euro zone breaks into sorry little pieces, Germany could possibly lose its entire €495 billion claim. That's more than $650 billion. It is 60 percent bigger than Germany's annual federal budget-and larger than the lending under the European Financial Stability Facility and other aid programs that have received more scrutiny.

Germany's plight gives it an incentive to keep the euro zone intact. "If the euro breaks up then the whole claim is under risk," Hans-Werner Sinn, president of the Ifo Institute, a Munich-based economic research group, says in an interview. Sinn, the first economist to focus attention on the Target2 imbalances earlier this year, wrote in a November research paper, "This may be the largest threat keeping Germany within the Eurozone."

Nobody designed Target2 to ensnare Germany as a creditor. It was the most boring back-office transaction-processing system imaginable when it was launched in 2007-08 as a successor to the equally boring original Target (a rough acronym for Trans-European Automated Real-time Gross Settlement Express Transfer system). In the early days of the euro currency, Germany wasn't even always a creditor: It had a net liability of €31 billion at the end of 2001.

Then came the financial crisis of 2007-08. Europe's peripheral nations began to suffer capital flight. Until then their chronic trade deficits were completely offset by inflows of private capital, both loans and investments. Afterward, lenders and investors grew leery of putting more and more money into those countries. Euros began to flow from the periphery into Germany and to a lesser extent Luxembourg, the Netherlands, and Finland. The Target2 imbalances are an accounting reflection of those outflows. From 2008 to 2010, Sinn estimated in his paper, "Target credits financed almost the entire current-account deficits of Portugal and Greece and a quarter of the Spanish one."

That makes it sound like a central-bank policy decision, which it wasn't. On the micro scale it was nothing but routine transaction-processing. The most powerful forces are the unguided ones, like the wind and the tides.

Here's how it happened. When a Greek businessperson buys a truck from Germany with money from a checking account, the transaction is carried out between the two nations' central banks via Target2. The truck seller isn't interested in financing the purchase-it wants euros now. So the Bundesbank has to

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come up with money in order to deposit it in the seller's checking account. In accounting terms, the Bundesbank acquires a liability (what it owes to the truck seller's checking account) and an asset (a claim on the ECB).

The transformation of the Bundesbank's balance sheet through this slow-but-steady process has been stunning-and to hard-money Germans, sickening. At the end of 2006, Target claims represented just 7 percent of the Bundesbank's assets. By this October they represented 64 percent, according to data compiled by economists Aaron Tornell of the University of California-Los Angeles and Frank Westermann of Germany's University of Osnabriick. The collateral the ECB holds to back those loans is primarily the sovereign debt of the euro zone's weakest nations. It's a far cry from the gold that's the Bundesbank's second-biggest asset (17 percent).

Any losses on Target2 are supposed to be shared by the euro zone's 17 central banks in proportion to their share of the ECB's capital, which for Germany is 28 percent of the total. But since the central bank of any country that couldn't repay Target2 obviously wouldn't share in the losses, Germany would have to pick up even more than its share. And as Sinn notes, there are no laws governing who would be responsible for the claim if the euro zone broke up entirely.

The European Central Bank is trying to be reassuring about the growing Target2 imbalances. In its October monthly bulletin it said "the uneven distribution of central bank liquidity within the Eurosystem provides stability, as it allows financially sound banks-even those in countries under financial stress-to cover their liquidity needs." The ECB, though, doesn't report which central banks are in the black and which are in the red on Target2, since the combined positions always net out to zero.

The 17 member central banks don't exactly trumpet the numbers, either. At the Bundesbank, the most up-to-date figures are available only in an obscure table called "Time series EU8148: External position of the Bundesbank in the EMU / Claims within the Eurosystem / Other claims (net)."

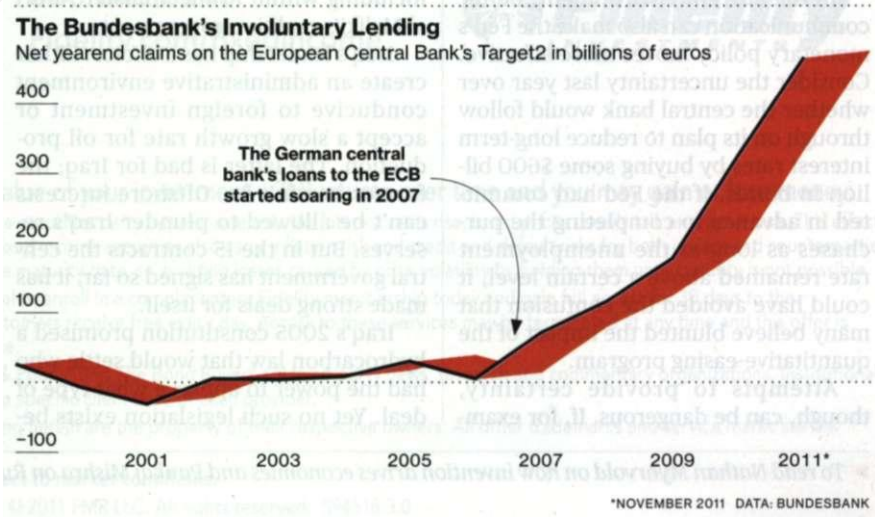
As Europe's financial crisis has worsened, the ECB has benevolently turned a blind eye to the poor quality of collateral posted by the Bank of Greece and others. But a reckoning is due. In an interview with Bloomberg News on Dec. 13, Bundesbank President Jens Weidmann expressed more concern about the collateral than the volume of ECB balances. "In a situation like the current one, where we are providing solvent banks with liquidity," he said, "for me the size of the Target2 balances is less important than the risks we are taking on. It is my concern that we limit these risks as much as possible."

An alternate theory is that there's really nothing to worry about. University College Dublin Professor Karl Whelan says Sinn, Tornell, Westermann, and other economists who have raised red flags over Target2 are being alarmist. While Europe has plenty of other problems, "this is a crisis that is not about to happen," Whelan wrote in a recent article posted at VoxEU.org, a forum mostly for European economists.

Yeah, maybe. What happens next depends on how far Germany is willing to go in converting its treasured central bank into a repository for more claims on the ECB, which are ultimately backed by the junk debt of Southern Europe. To fund more loans to Target2, BuBa could either sell some of its gold (unlikely) or take in more euro deposits, which it could then recirculate via the ECB (much more likely). "In principle this can go on indefinitely," says Ebrahim Rahbari, an economist for Citigroup in London.

Germany faces a dilemma familiar to anyone who has ever made a bad loan-whether to keep throwing good money after bad to keep the debtor afloat or pull the plug and suffer the consequences. The half-trillion-euro claim the Bundesbank has on the ECB is an important but poorly understood factor in the decisions over the future of the euro. So it's in the interests of everyone that central bankers provide more transparency when it comes to Target2. Says Citi's Rahbari: "From the moment that you seriously start to consider breakup as a plausible scenario, these issues should probably be given more prominent space in the public debate."

—With Jeff Black in Frankfurt



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