

The ECB as a lender of last resort

Session II: Monetary Policy Challenges in the Era Draghi

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- Pollin: Agree with the second part (importance of macroprudential regulations), but have reservations on the first part (inflation target and monetary policy objective).
- Focus on Wollmershäuser/Sinn because it illustrates a lack of understanding what a financial crisis is all about (Bindseil and Modery 2011, Winkler 2011)
- On top of it: it illustrates a lack of understanding of a financial crisis in a currency union ...
- ... and as a result TARGET balances are fundamentally misinterpreted (Bindseil and König 2011)

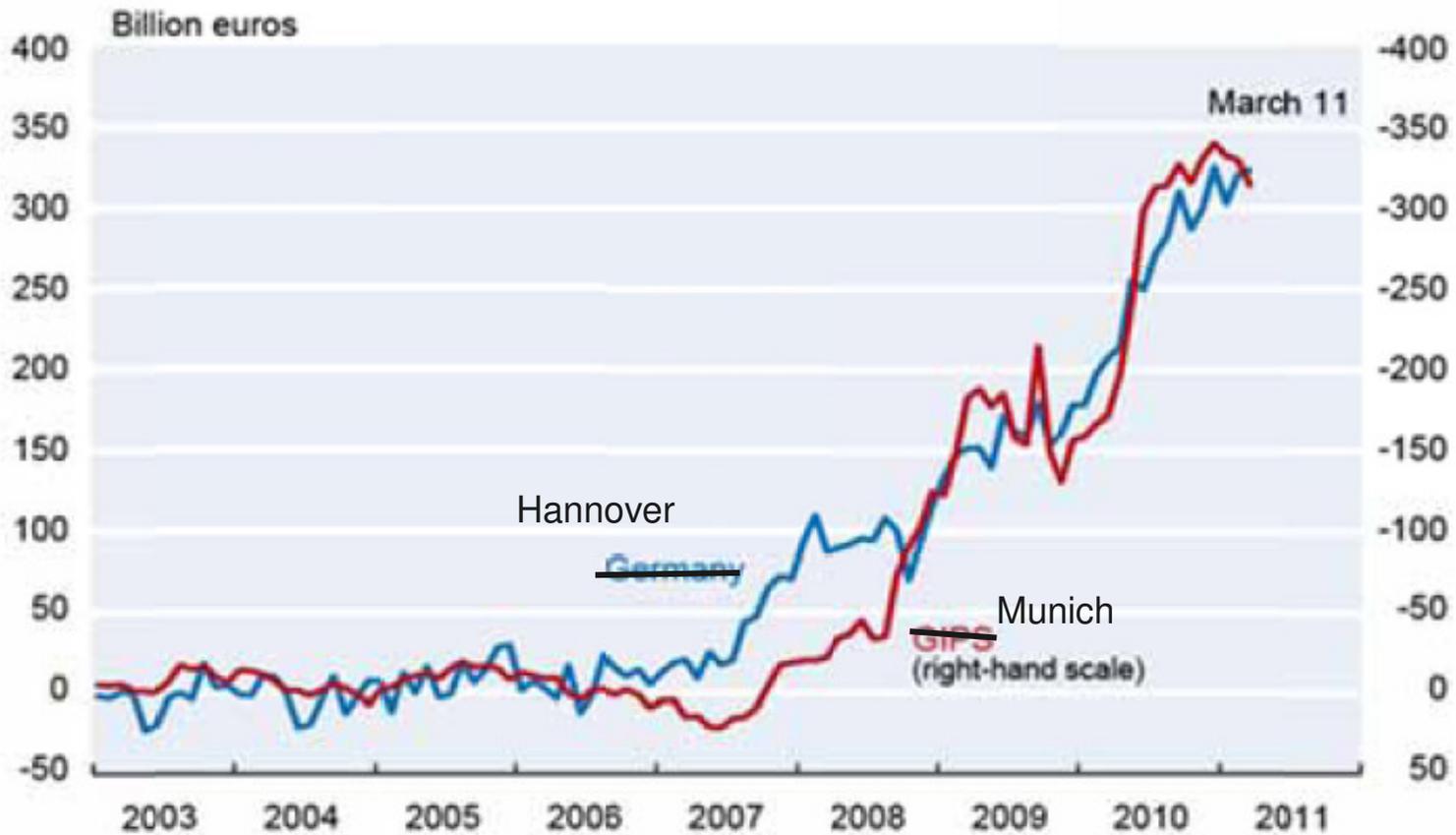
- Germany still has the Deutsche Mark (not the euro), but there are three Bundesbanks in Germany (a system of Bundesbanks):
 - The Bundesbank in Frankfurt conducts monetary policy for Germany
 - The Bundesbank in Hannover is in charge for the savings and cooperative banks (*Hannover Bundesbank*)
 - The Bundesbank in Munich is in charge for the private commercial banks and the Landesbanken (*Munich Bundesbank*)

- The Bundesbanks are connected via a German TARGET system through which the banks of the *Hannover Bundesbank* make payments to the banks of the *Munich Bundesbank*.
- In normal times the TARGET balances of the *Hannover* and *Munich Bundesbanks* are zero
- Banks do not need the Bundesbank system to borrow from and lend to each other (functioning interbank market)

A thought experiment

- It is Monday, October 6 2008
- Markets open after they learned that *Hypo Real Estate* has severe liquidity problems which reflect solvency concerns (which are to be confirmed at a later stage)
- Markets interpret this as a sign that several private commercial banks may have solvency problems (contagion)
- Depositors / lenders of private commercial banks withdraw their funds from those banks, including savings and cooperative banks which were before the crisis net lenders to private commercial banks
- There is no unlimited guarantee by the government on the solvency of all banks
- How would the TARGET balances of the *Munich and Hannover Bundesbanks* develop?

A thought experiment



Source of original slide: Sinn and Wollmershäuser 2011, Adaptation by the author

What do we learn / see?

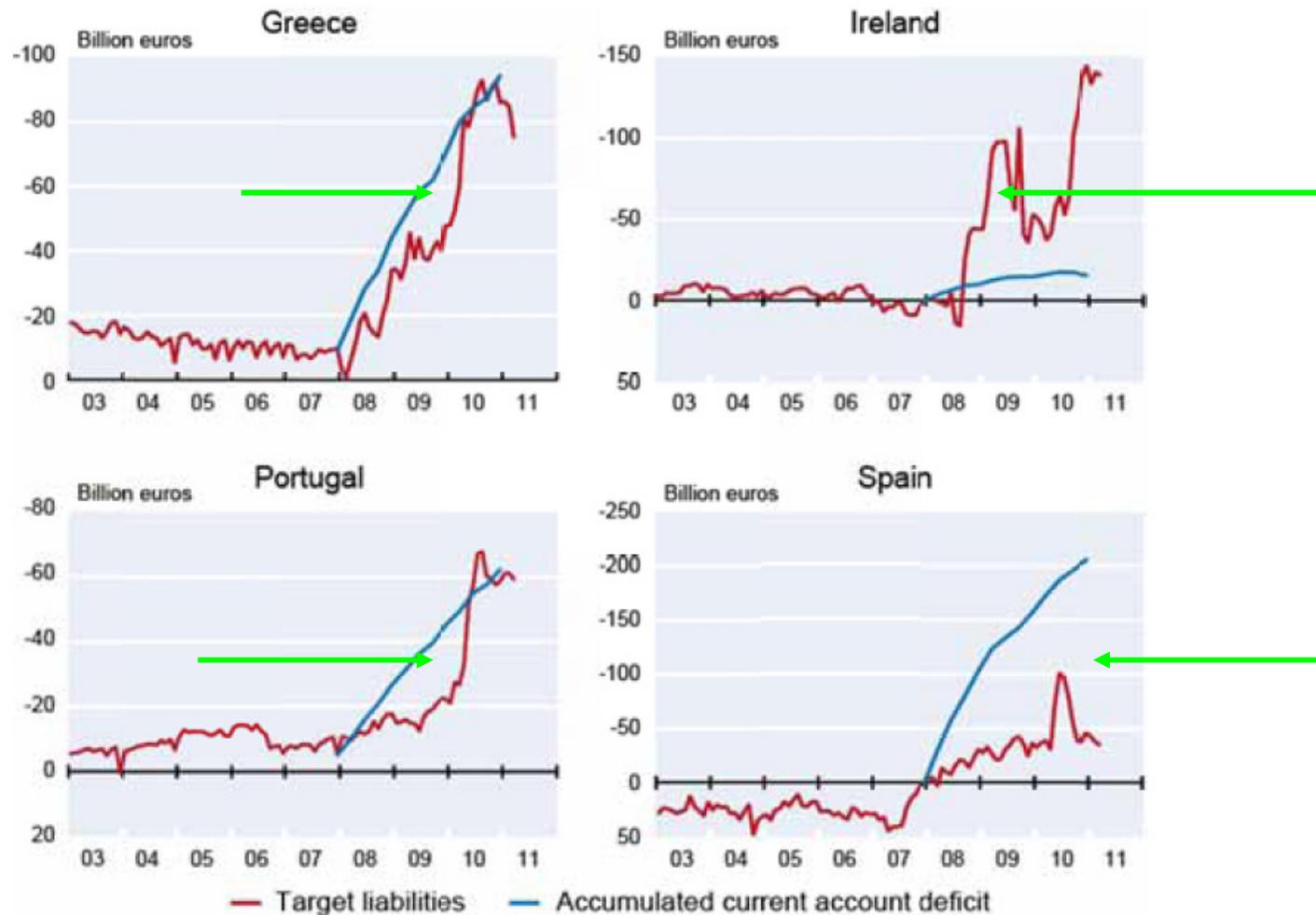
- TARGET balances can have nothing to do with current account balances (note: the banks linked to the *Hannover and Munich Bundesbanks* operate in one country)
- TARGET balances can only reflect an illiquid interbank market as savings banks and cooperatives with excess liquidity park their excess balances at the *Hannover Bundesbank*, while private commercial banks demand liquidity from the *Munich Bundesbank* to avoid illiquidity and hence banking sector collapse
- The Bundesbank system acts as a lender of last resort and provides this liquidity by serving as an intermediary between German banks.

TARGET balances and current account deficits in the euro area

- Sinn and Wollmershäuser: TARGET balances finance current account deficits
- Aggregation in terms of countries involved and time misleading
- Disaggregation needed

TARGET balances and current account deficits in the euro area

Figure 14: Current account and Target balances in detail



Source: Sinn and Wollmershäuser 2011

- Development of TARGET balances not identical and most importantly not synchronal with current account balances
- But current account deficits have to be financed *uno actu* with their occurrence: Nobody can spend more than he earns without someone else providing credit
- Credit did not come from Eurosystem
- Result: TARGET balances have not “financed” current account deficit. In some countries at some point in time they are close to accumulated current account deficits (since the crisis)

- TARGET balances show strong spikes 
- Spikes occur in line with developments in the euro (sovereign bond market) crisis 
- Spikes show contagion effects from government bond markets to banking sectors

- If the Eurosystem had not provided funds to illiquid banking sectors the collapse of the euro (financial system) would have (most likely) already occurred ...
- ... as it would have occurred to the German banking system in the thought experiment if the Bundesbank system would not have provided loans via the *Munich Bundesbank* to the private commercial banks and would have accepted a build-up of liquidity at the *Hannover Bundesbank*

- If at all, TARGET balances reflect a “capital account crisis” within a currency union with free capital movement and a highly integrated financial system
- The comparison with the Bretton Woods system, which was built to a large extent on capital account restrictions, is misplaced

- The euro area is not a fixed exchange rate system but a currency union with free capital movements and a highly integrated financial system
- From a monetary and financial perspective the benchmark for analysis is a “normal” domestic economy. Applying comparisons based on international monetary economics fail to take account of this
- TARGET balances reflect standard LOLR activities
- Criticizing the ECB / Eurosystem for accepting TARGET balances to accumulate is equivalent to criticizing ECB / Eurosystem liquidity measures in the 2008 financial crisis

- The “distribution of the monetary base” is a non-issue, **provided** we consider the euro area (as – in our thought experiment – the Deutsch Mark area) as an irrevocable currency area
- Thought experiment: Does it make sense to talk about “crowding out” of refinancing credits of savings and cooperative banks and “excessive” demand for refinancing credit by private commercial banks in Germany when there is a financial crisis that raises (in the first stage) solvency concerns only for (some) private commercial banks?

- Should the Bundesbank system not have acted decisively against such a liquidity crisis?
- Answering the last question with “No” implies rejecting the very reasons central banks were historically founded for (Bagehot 1873, Goodhart 1988) and shows a lack of understanding of drivers of financial crises
- And in 2008 the Bundesbank did not say “No”!

- The composition of the monetary base is again a non-issue
- Again, the wrong benchmark is applied: in a financial crisis a central bank provides emergency loans where liquidity deficits **arise** (which most likely will be with the debtors of the pre-crisis period (Bagehot 1873)) **and not** by the contribution of those debtors to domestic GDP
- Thought experiment: Why should savings and cooperative banks account for the same percentage of the monetary base as their share in total German banking sector assets if they have no liquidity needs?
- Thought experiment: Monetary base only “composed” of private commercial banks

- Yes, the TARGET balances represent a risk for the Eurosystem
- But it is the same risk any LOLR has to take when becoming operational
- Indeed, it is the essence of a LOLR (Bagehot 1873, Bindseil and Modery 2011)
- Again: arguing that the ECB / Eurosystem should not accept that risk is equivalent to arguing that the ECB / Eurosystem should not operate as a LOLR

- Nature of the risk: possible default of respective governments banks in the crisis countries are exposed to
- Ironically: Sinn and many other German economists have argued from the very beginning of the euro crisis that one should let countries default / “orderly restructure” (Franz et al. 2010, Plenum der Ökonomen 2011) and ignore contagion effects (Homburg 2011). It is as if they had advised the German government to let Hypo Real Estate fail
- TARGET balances show the implications what would have most likely happened if policy makers had followed this advice (Bindseil and Modery 2011): a collapse of the euro area financial system

- Any financial crisis has its roots in concerns about the solvency of individual debtors performing maturity transformation (Winkler 2011)
- These concerns may be valid or unfounded
- As a result those debtors become illiquid
- Without LOLR interventions they become insolvent for sure
- Their insolvency spreads concerns about the solvency of other debtors
- The result is a systemic liquidity crisis

- TARGET II balances – like the ECB bond purchases – have up to now prevented such a systemic crisis in the euro area
- For this the ECB has been heavily criticized
- Analysis suggests that Mr Draghi should not listen to those critics
- He should continue doing what historically is the key function of central banks ...
- ... the function for which they have been founded for: acting as a lender of last resort

Thank you very much for your attention

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TARGET balances and current account deficits in the euro area

- TARGET II balances develop in spikes

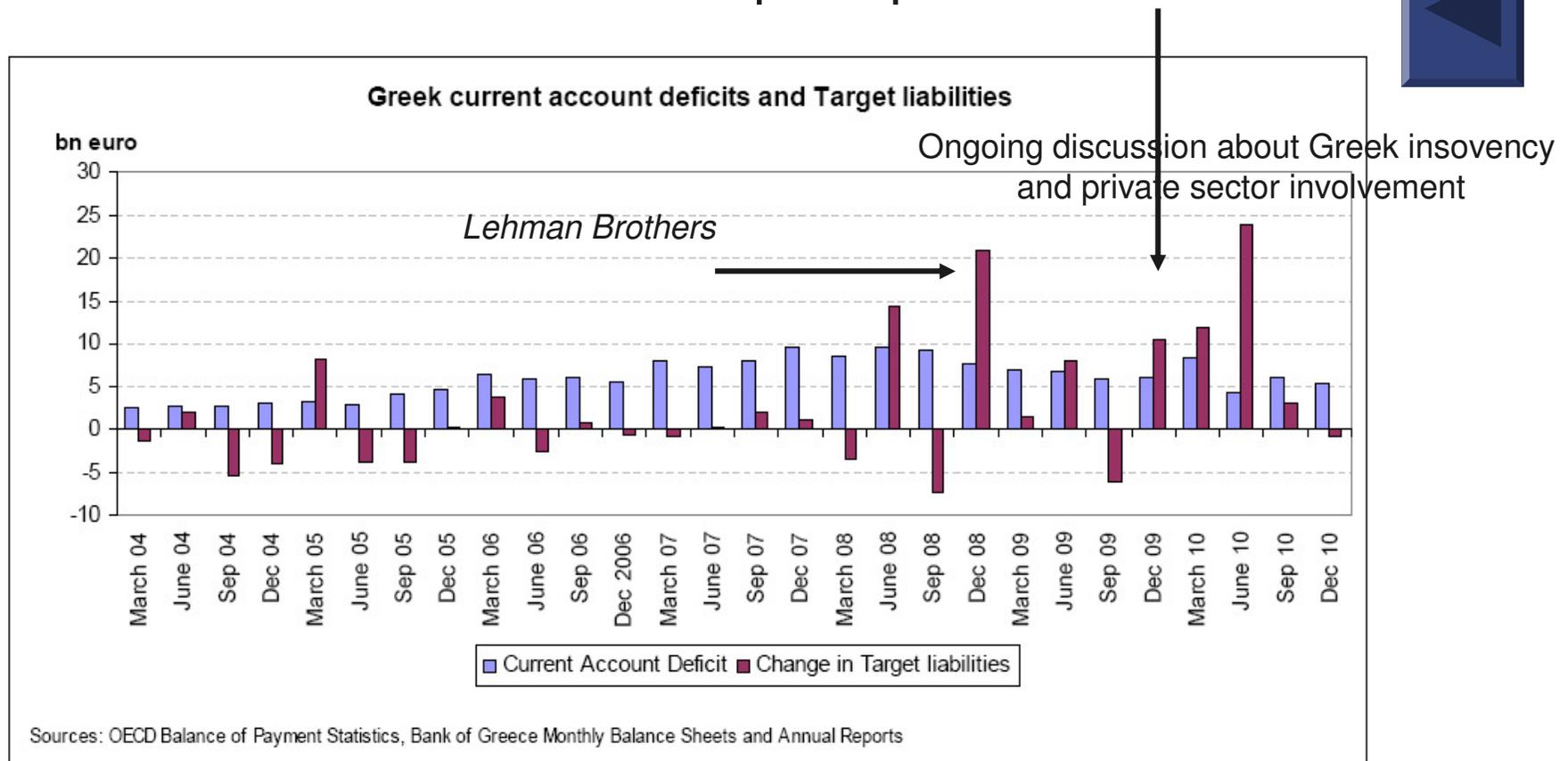


Figure 1: Greek current account deficits and change in TARGET2 liabilities.

Source: Bindseil and König 2011