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The Bundesbank has no right at all to be baffled

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One of the more intriguing recent developments of the eurozone crisis is the shock expressed by Germany's economic establishment that the eurozone is, in fact, a monetary union. No one had apparently told them.

The story behind this is long, but needs to be told. At issue is a rather technical debate about imbalances in the eurozone's central payment system, known as Target 2. Germany has built up claims of now more than €500bn ($660bn) against the eurosystem – the network that consists of the European Central Bank and the various national central banks. The Bundesbank is getting nervous about a counterparty risk if the euro were to collapse suddenly.

The discovery of the importance of Target 2 was made by Hans-Werner Sinn, president of the Ifo economics institute in Germany, and his co-author Timo Wollmershäuser*. They found that the Target 2 balance mirrors current account imbalances since the outbreak of the crisis. There was no problem before 2007, when current account balances were funded by commercial banks. Once that stopped, national central banks took over this role. Spanish banks can now refinance themselves with no limit from the Bank of Spain. If a Spanish company buys a German product, for example, the chain of transactions goes from the buyer's Spanish bank to the Spanish central bank, which effectively creates the money for this transaction, and then sends it on to the Bundesbank, which records this transaction as a claim against the eurosystem.

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.

So, the two "Target 2" professors deserve credit for explaining the detailed mechanisms of how a monetary union functions in the presence of a broken banking sector. And they are also right in pointing out that 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.

However, it is hard to understand why everybody feigns surprise at the fact that current account imbalances can be financed indefinitely in a monetary union. Is this not one of the characteristics that distinguish it from a fixed-exchange rate system?

As long as banks have access to the central bank, and can provide good collateral, countries can run current account deficits for an infinite period. A friend of mine once remarked – when I asked about the significance of intra-eurozone current account imbalances – that the way to solve the problem sustainably was no longer to publish the figures. He was only half joking.

The presence of unlimited funding does not mean imbalances are irrelevant. On the contrary, they have highly negative economic effects, as the crisis shows. The point is that in a monetary union, imbalances do not adjust automatically. If you want them to adjust, you need to do it yourself.

One would assume that the best policies would be those that attack the root of the problem – the imbalances themselves. One of the deep causes behind this problem is, of course, Germany's persistent current account surplus. The problem can thus easily be solved through policies to encourage Germany to raise its imports relative to its exports. You need policies that provide eurozone-wide backstops to the banking sector, and also policies to insure against asymmetric shocks. And you need to harmonise many aspects of structural policy to ensure imbalances do not become entrenched.

But there is no appetite for any of this in Germany. Instead, the Bundesbank prefers to solve the problem by addressing the funding side. Mr Weidmann proposed last week that Germany's Target 2 claims should be securitised. Just think about this for a second. He demands contingent access to Greek and Spanish property and other assets to a value of €500bn in case the eurozone should collapse. He might as well have suggested sending in the Luftwaffe to solve the eurozone crisis. The proposal is unbelievably extreme.

It also tells us something else: by seeking insurance against a collapse of the euro, the Bundesbank tells us it no longer regards the demise of the euro as a zero-probability event. If the Bundesbank seeks insurance, so should everybody else.

The Target 2 debate is important because it goes to the root of the problem. But Germany's economic establishment is disingenuous. What people are really saying is that they no longer want a monetary union. They want a looser single currency regime.

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