Editor's Comments

Hans-Werner Sinn*

Reply to Bindseil, Cour-Thimann and König

I am grateful for the comments of these authors and would like to offer this very brief reply.

a) Non-necessity hypothesis

Timo Wollmershäuser and I have argued that the ECB was right to provide generous refinancing credit in 2008/2009, but was wrong to continue this policy when the world economy recovered in the second half of 2009, because the public international credit flow it organized undermined the functioning of the capital market. This does not mean that I am willing to accept defaults by major banks. On the contrary, I elaborated on this topic extensively in the last chapter of my book Casino Capitalism (Oxford University Press, 2010), which argues that insolvent banks need to be recapitalized with public funds in exchange for shares. My point is merely that it is not the ECB's job to act as a lender of last resort by endowing banks with more equity capital by providing them with cheap credit below market levels. This is a fiscal function that should be controlled by parliaments.

b) Fiscal character hypothesis

Target credits are purely fiscal as they neither imply an increase in the stock of aggregate base money nor a change in its international allocation. As such, they should be controlled by parliaments. The smooth operation of the payment system is essential, but it does not required unlimited Target credits at below market conditions, as shown by the US system. In the United States Target credits have to be redeemed once a year with marketable assets at market conditions. One of the reasons for the explosion in Target credits and capital flight within Europe is that the ECB is trying to undercut market prices by offering credit at rates below those required by the market. This policy risks destroying the eurozone, as no system can survive the kind of capital flight we are currently experiencing within our currency area.

c) Credit replacement hypothesis

I agree that the second part of the hypothesis is more difficult to test, but our emphasis has always been on the first part. My point has often been interpreted and misunderstood as a credit squeeze. Any such interpretation is absurd. The argument is simply that the abundance of inflowing liquidity is crowding out refinancing credit in Germany. I am glad that the authors share this view.

References to the second part of the hypothesis were never meant to be much more than an accounting statement. To understand this part, it is important to realize that the Target credit virtually amounts to a public rescue credit provided by Germany. I believe that we are in agreement up to this point. So the whole question boils down to whether or not such rescue credit implies that less capital is available for other internal investment in Germany or for foreign investment in third countries than would otherwise have been the case. Views can differ on this point, depending on whether one argues in a world of neoclassical resource constraints or in a Keynesian setting, where the credit given to other countries to support their consumption and investment generates itself through multiplier processes. These two opposing views are discussed in the June version of my working paper with Timo Wollmershäuser.

d) Recommendation to limit T2 positions

Here I strongly disagree. The US system reallocates the ownership shares in a common portfolio of assets, as well as the interest income generated by that portfolio. This implies that the Target-like credit can only be drawn at market conditions and thus loses its attraction. The capital flight measured by the Target balances would not occur if the refinancing credit were not available at conditions that undercut market conditions. I fail to see where the institutional description of the US system differs from the description we

*Ifo Institute.

have given. This is the most important point. If we mimic the United States, the capital flight will come to an end.

e) Risk hypothesis

This seems to be a misunderstanding. The authors write: "according to Sinn (2011b), risks related to Target2 liabilities to the GIPS countries do not account for the source of risk related to the central bank credits in the context of the normal refinancing operations". This quote stemming from a short remark in previous article I wrote for the *Süddeutsche Zeitung* is not meant to imply that the Target credit does not result from a refinancing credit, but from a refinancing credit that goes beyond the provision of money balances for national transactions purposes. The Target positions mean that money has been seeping away to other states in net terms because a greater amount of refinancing credit than normal has been provided. This poses an extra risk to the community of states, should the national central bank and its collateral default. It even poses an additional risk to the Bundesbank, which is the main accumulator of Target claims, if the euro falls apart, because the Bundesbank will then have a claim against a system that no longer exists. (I am not aware, by the way, that the Bundesbank ever objected to the risk interpretation I have given. It argued against a phantom position that I never took, and did not even claim that I took it. So I do not understand this remark.)

f) 'Five-minutes to midnight' hypothesis

This hypothesis was not meant to signify the end of the world, but refers to a situation whereby German net refinancing credit would be eliminated and whereby the Bundesbank would be forced to become a net borrower of the banking system to sterilize the inflowing money created in the periphery. The authors try to counter the argument made in my June CESifo working paper with Timo Wollmershäuser by pointing out that the ECB could easily perform this sterilization by, for example, issuing debt certificates and collecting time deposits. Yes, of course, but that is our argument! Otherwise, I agree that defining the territory in which the ECB will operate once total net refinancing credit in the periphery has become negative, as it has indeed (compare Figure 1 in my introductory statement), is a difficult task and I welcome the fact that the authors have offered a formal model capturing this. We need more discussion of this model than I can provide in this short reply. Kohler, as well as Tornell and Westermann, also speculate on what this could mean for the viability of the eurozone. They are less optimistic.

Reply to Ulbrich and Lipponer

These authors misrepresent the working paper by Timo Wollmershäuser and myself when they claim that we argue that gold and foreign exchange reserves are necessary to absorb the excess liquidity seeping in from countries relying heavily on refinancing credit. They forget to mention that we also argue that the extra liquidity can be re-absorbed from the banking system *via* the Bundesbank's borrowing funds.

The authors also misrepresent the current account problem, although without citing us explicitly. A current account deficit needs to be financed either by an ordinary capital import or by refinancing credit and money creation (Target). I am more than surprised to read this statement: "a direct financing of current account deficits by the central banks has not occurred and will not take place in the future". Unless the authors want to hide behind the word 'direct' this is utterly wrong. It is a matter of fact that the ECB financed nearly the entire current account deficit of Greece in the years 2008–2010 by allowing the Greek central bank to create and lend out the necessary money. Greece's current account deficit for this period was 83.6 billion euros and its Target liability increased by 76.2 billion euros or 91 percent. Logically, this implies that only the remainder, 7.4 billion euros or 9 percent was financed by other net capital imports (private capital and public rescue funds).