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Eurozone Watch

Group Economics

Financial Markets Research

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Target2 balances a ticking time bomb?

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- **The Target2 balances at the ECB have received a lot of attention in the press during the past few years, particularly in surplus countries such as Germany and the Netherlands …**
- **… as their potential losses in case of the exit of a single euro country or a complete euro break up are huge**
- **During the euro crisis of 2011-2012 sharply rising Target balances were a sign of stress in the system and were an indication of the risks creditor countries were running**
- **The main driving force this time around is the ECB's QE programme, not rising imbalances or rising tension**
- **Balances are expected to continue to rise in the coming months, probably reaching a total of more than EUR 3 trillion by mid-2018**
- **Germany's surplus could surge to around EUR 1 trillion, which is equal to around a third of Germany's GDP, the surplus of the Netherlands could rise to almost 20% of Dutch GDP**
- **Should the euro break up completely, creditor central banks hold a claim against a system that will cease to exist. Therefore, it is very questionable what will happen with these claims**
- **In case a single (weak) country withdraws, it will have to settle its bill, but default is likely, as the debt is in euro and the country involved will adopt a new currency which is likely to weaken sharply**
- **Depending on which single country left, the potential loss for the surplus countries could rise to some 3.5% of their GDP**

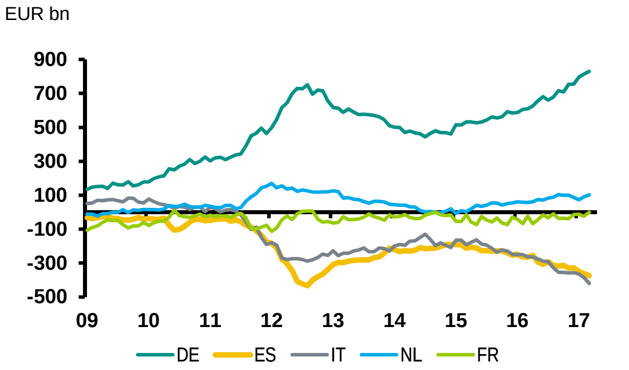
What are Target2 balances?

Target (Trans-European Automated Real-time Gross Settlement Express Transfer System) balances represent the claims and liabilities of euro area national central banks (NBCs) vis-à-vis the ECB arising from cross-border payment flows executed through Target2. Individual NCBs data are netted figures. They represent Target claims netted against total Target liabilities. A positive number is a net NCB claim on the ECB. Non-euro area NCBs can also participate in the Target system. By design, the sum of all Target balances of claims and liabilities must equal zero. National data are made available for euro area NCBs only.

What determines the size of the balances?

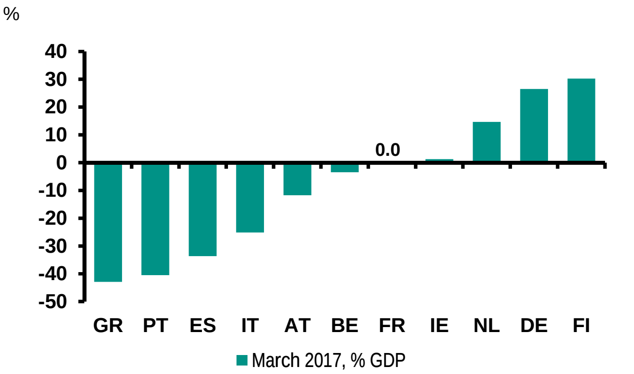
The Target balances of euro area NCBs in essence reflect the uneven distribution of central bank liquidity within the Eurosystem. Large cross-border payment flows between banks in the euro area are a normal feature of Monetary Union, and the Target system is essential for the smooth processing of those payments. The settlement of cross-border payment flows in central bank money creates balances for each NCB that are connected to Target. The Target balances are aggregated and netted out at the end of each business day. In most cases, the cross-border payment flows reflect transactions which are initiated by private entities, such as credit institutions, corporates or individuals.

Target balances eurozone Big-5 countries



Source: Thomson Reuters Datastream, ABN Amro Group Economics

Target balances, % GDP



Source: Thomson Reuters Datastream, ABN Amro Group Economics

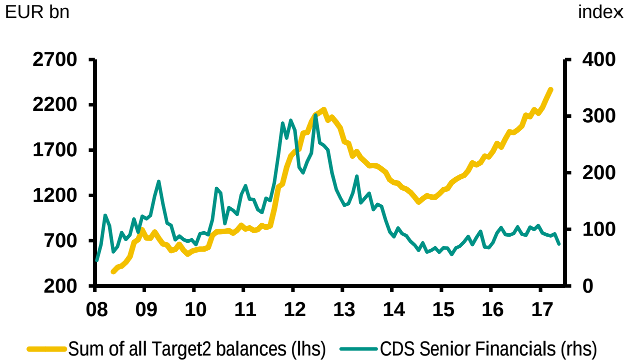
Before the crisis, Target balances were limited in size, …

In the years before the crisis, banks in the periphery had easy access to private funds. They received cross-border interbank loans, direct investment or deposits from abroad to broadly compensate for the payment outflows that resulted from the deficits on the country's trade balance or the acquisition of foreign assets. In short, the countries had broadly balanced cross-border payment flows initiated by the private sector. This reflects that the sum of any country's current account balance and capital account balance was roughly zero. In other words, no central bank money was needed to finance the current account deficits of the countries in the periphery and their respective NCBs maintained roughly neutral Target balances. In the theoretical case of one individual country that has its own central bank this would mean that the foreign currency reserves of the central bank remained roughly unchanged and its exchange rate remained roughly stable.

… but they soared during the years 2011-2012

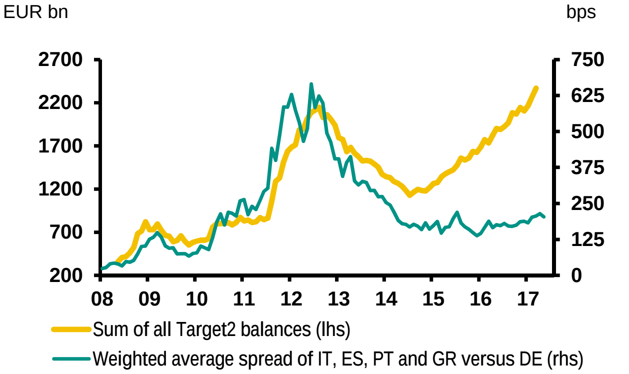
Target balances soared during the years of the eurozone financial crisis in 2011-2012. This resulted from funding tensions in the banking sectors of some countries in the periphery (Italy, Spain, Portugal, Greece and Ireland). During this period, private money no longer flowed into the peripheral countries in quantities sufficient to compensate for their payment outflows. Their banks suffered from funding tensions. In order to prevent a banking crisis the ECB stepped in, accommodating the banks' liquidity needs, by issuing three-year LTROs with full allotment and by lowering the collateral requirements in the ECB's regular open market operations. Thus the shortage in private flows into the periphery was settled in central bank money which resulted in their respective NCBs displaying, in cumulative terms, liabilities in Target. In the theoretical case of one individual country that has its own central bank either the foreign currency reserves of the central bank would have declined or its exchange rate would have depreciated or a combination of the two. At the same time, the NCBs of countries which are net recipients of private sector flows (e.g. the countries with a surplus on the balance of payments) display claims in Target. The rise in the Target balances during the years 2011-2012 went hand in hand with sharp rises in sovereign bond yield spreads of the peripheral countries over Germany as well as jumps in CDS spreads of financials (see graphs below).

Target balances and CDS spread of financials



Source: Thomson Reuters Datastream, ABN Amro Group Economics

Target balances and peripheral spreads



Source: Thomson Reuters Datastream, ECB, ABN Amro Group Economics

Complications due to financial innovation and EMU

However, the story is not as clear cut as it looks. In its Monthly Bulletin of October 2011, the ECB mentions that 'the distribution of central bank liquidity by NCBs in the individual euro area countries is related to the domestic liquidity needs of their banking communities, but in a loose way'. According to the ECB, financial innovation and EMU has weakened the link between the Target balance of a country and the economic reality of banks' funding needs in the individual countries, due to three main reasons. First, multi-country banking groups can raise funds in a decentralised manner, and have at the same time increasingly centralised their liquidity management. For instance, a banking group can refinance itself at an NCB in another euro area country through a subsidiary (generating a Target claim in the country of the parent bank and a Target liability for the NCB of the country of the subsidiary). Also, a payment from a French bank to its German subsidiary will be accounted for in the Target balances of the NCBs in the two countries. Second, some cross-border payment flows are not settled in central bank money, and are thus not accounted for in Target balances (for instance, flows due to correspondent banking or retail payments conducted with some credit card schemes). Last but not least, euro transactions involving banks in non-euro area countries whose NCBs are *not* connected to Target can still be settled in this payment system via accounts at banks that are holding Target accounts in different euro area NCBs (e.g. Bundesbank and DNB), thus affecting the Target balances of the respective euro area NCBs. Indeed, this factor has played an important role in the recent rise in the Target balances.

Renewed rise largely due to ECB's QE policy …

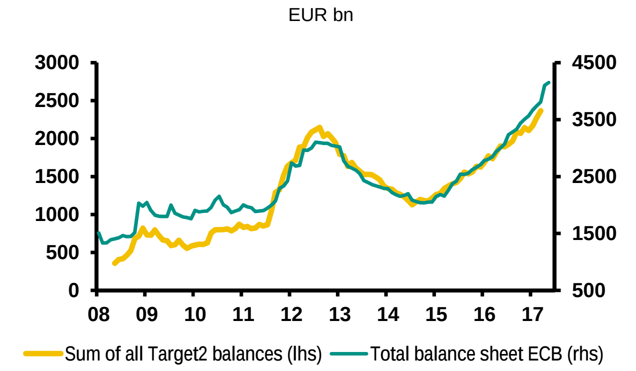
In the first years after the eurozone crisis of 2011-2012, the Target balances declined as financial stress eased. Since the start of 2015 they have been rising again. However, the factors driving the increase have changed. According to the ECB, the German Bundesbank and the BIS these renewed increases largely reflect cross-border liquidity flows arising from the settlement of purchases under the ECB's QE programme (APP).

The size of this programme currently totals EUR 1834bn. Under this programme, central banks purchase securities from a wide range of counterparties located across the euro area and beyond. In the case of a cross-border transaction, the liquidity flow affects the Target balances of the sending and receiving NCB. For instance, if the central bank of Italy purchases an Italian bond from a German investor and this investor keeps the liquidity in Germany, the Banca d'Italia builds up a liability vis-à-vis the euro system and the Bundesbank a claim.

… as purchases from 'outside parties' are also settled in Target ...

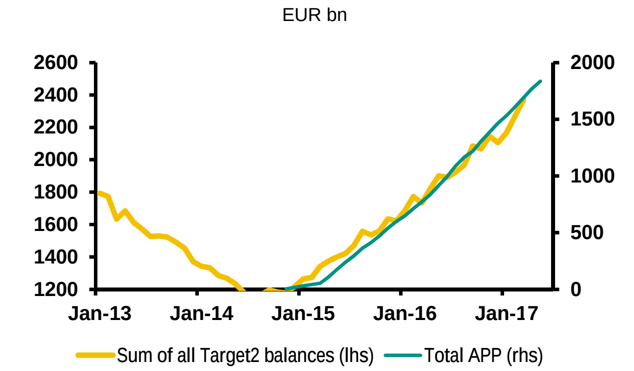
Also, counterparties located in countries that are not connected to Target can use an account at a correspondent bank with access to Target. It follows that when an NCB purchases securities from a non-domestic counterparty, whether it is located in another euro area country or outside the euro area, the purchase is likely to give rise to cross-border flows in central bank money and thus results in changes in Target balances. According to the ECB, in volume terms, around 80% of all APP purchases have involved non-domestic counterparties. The BIS mentions that whereas the Bundesbank itself purchases less than a quarter of the total APP purchases, around 60% of all Eurosystem purchases under the APP are conducted via banks that connect to the Target system via the Bundesbank.

Target balances and the ECB's total balance sheet



Source: Thomson Reuters Datastream, ABN Amro Group Economics

Target balances and the ECB's QE programme



Source: Thomson Reuters Datastream, ABN Amro Group Economics

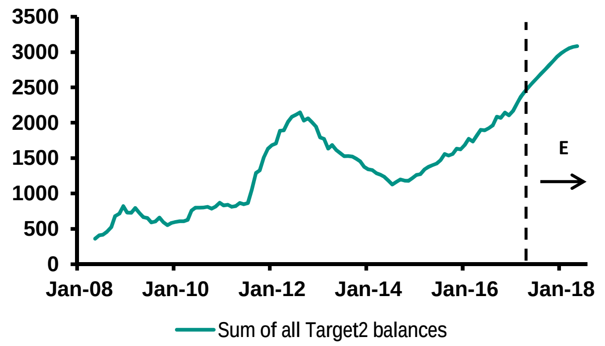
… but risk perception might still be relevant too

The Dutch central bank takes a different perspective than the ECB, Bundesbank and BIS and assesses that the persistent fragmentation and risk perceptions within the euro area also has had an impact on the renewed rise in the Target balances. It mentions that institutional investors selling under QE prefer to hold deposits at banks in euro area countries with the highest perceived creditworthiness (mainly Germany and the Netherlands). According to DNB, on the one hand the current rise in the Target imbalances are no longer an indicator for rising market tensions, but on the other they do signal that risk perceptions within the euro area have not normalised either. The assessment of whether the current rise in the Target balances is due to the ECB's QE programme (APP) or to renewed financial tensions within the eurozone is complicated by the fact that the ECB's QE programme in itself has limited risk perception in financial markets. Indeed, it has depressed government bond yield spreads of the peripheral countries over Germany as well as CDS spreads of financials. On the other hand, there is a strong link between the rise in the total size of the ECB's APP programme and the size of the total Target balances since the start of 2015 (see graphs above).

The outlook is for a further increase in the Target balances

Assuming that the QE purchases are the dominant factor behind the recent rise in Target balances, we think that the Target balances are set to increase further in the coming months. Indeed, we expect the ECB to continue its asset purchases at the current monthly size of EUR 60bn until the end of this year. Starting in January 2018, we expect the central bank to gradually reduce its monthly purchases in six steps of EUR 10bn each, implying that by June 2018 the programme is expected to end altogether. This would mean that the total Target balances would rise to a level somewhat above EUR 3 trillion by the middle of 2018. Moreover, we think that the risks to this estimate are tilted to the upside. There are considerable political risks related to the upcoming elections in Italy (due in the first months of 2018), where the populist and Eurosceptic Five Star movement (M5S) currently is leading in the polls. If these risks were to sharply escalate, the ECB could be forced to provide extra liquidity to the system yet again, implying that the Target balances could turn out higher than we currently estimate.

Projection for Target balances



Source: ABN AMRO Group Economics

What will happen with Target balances in a euro break-up scenario?

With regard to the potential settlement of the Target balances, there is probably a difference between a complete euro break-up scenario or the 'exit' of one single country. After a complete break-up every individual country would take control of its own monetary policy and have its own currency and, initially, all financial ties between the individual countries probably will be broken. This will probably make the settling of the existing Target balances extremely complicated. Probably also because of the earlier mentioned distortions in the link between the Target balance of a country and the economic reality of its banks' funding needs. This distortion is largely (but not exclusively) due to the ECB's QE programme. In this respect, the former head of Germany's Ifo Institute Hans-Werner Sinn also pointed out that a country's Target claims are claims on the ECB system, whose value hinges on the ECB's continued existence. On other words, if the eurozone breaks up and the Target debtors go bankrupt, there might be no clear legal basis for the Target claims, as the surplus countries would hold a claim against a system that no longer exists.

Huge potential losses for Germany and Netherlands in case of a euro break-up …
Consequently, in the worst-case scenario of a eurozone break-up, the surplus countries risk losing their total Target balances. Given the expected further increase in the Target balances until the middle of 2018, and under the assumption that the distribution of the balances over the various eurozone countries will remain roughly the same, the potential total loss for the surplus countries Germany and the Netherlands could rise to around EUR 1000bn for Germany (around one third of German GDP) and EUR 130bn for the Netherlands (around 20% of GDP).

… but also considerable losses involved with the exit of a single country
In case of the 'exit' of a single country, the procedure could be more simple, although calculating the exact size of the ECB's claim probably will also be complicated and open to debate. That said, the leaving country would need to pay its obligations to the ECB in euros, while its new national currency will probably have depreciated significantly. Although, in theory, the new central bank of the leaving country should be able to print money to fulfil the obligations, the sheer size of the claims would make a default very likely. Also, the more money it prints the more the currency depreciates. In March 2017, the Target liabilities of Italy were equal to 25% of Italy's GDP. Spain had a deficit of 33% and Greece and Portugal both had deficits of more than 40% (see graph on page 2). What is more, these deficits are all expected to rise between now and the middle of 2018. If a country were to default on its obligations to the ECB, the national governments of the countries remaining in the euro area would have to share the losses, in proportion to their share in the ECB's capital. In the hypothetical event of a Grexit or Itexit, the potential losses for Germany could be around EUR 18bn (0.5% of German GDP) and around EUR20bn (around 3.5% of German GDP), respectively. For the Netherlands, the hypothetical losses would be around EUR 4bn (0.5% of Dutch GDP) and EUR25bn (around 3.5% of Dutch GDP), respectively.

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