CENTRAL BANKS

Target2 imbalances are rising, should we worry?

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- **Target2 imbalances have been widening in Spain, Italy and Germany reaching maximum levels since mid 2012.**
- **Such imbalances are linked to the ECB Asset Purchase Programme and not to stress in financial markets, as in previous episodes. TARGET2 balances are expected to further increase until December 2017, as the ECB has extended the purchase programme, while from April 2017 at a slower pace.**
- **However, the reversion of TARGET2 balance poses some questions on how the APP programme is already working and on lingering fragmentation in the EZ. It may also fuel criticisms to the ECB policies in Germany.**

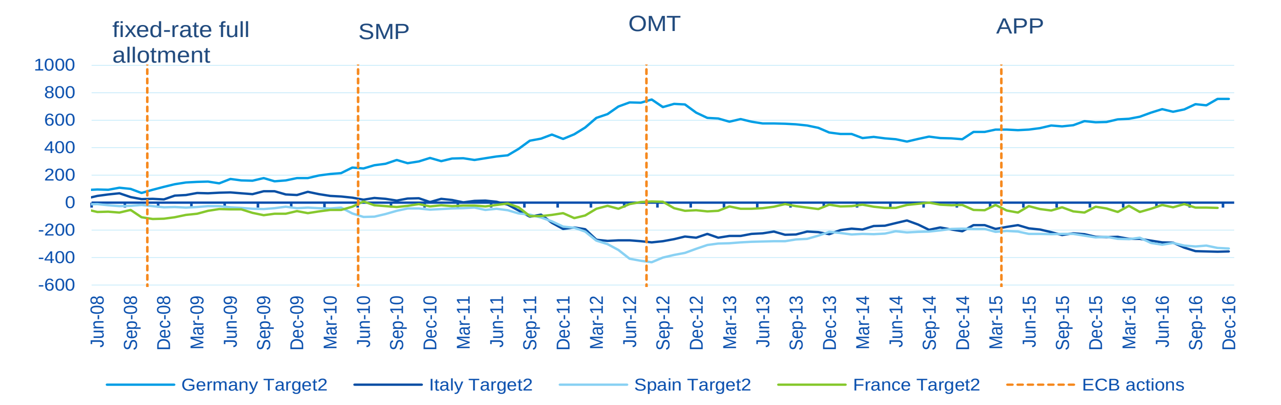
Target2 imbalances are widening again

Target 2 imbalances are sharply rising in Spain, Italy (liabilities) Germany (claims) once again, getting closer to August 2012 record levels, when the financial and sovereign debt crisis reached its pick. In December 2016 Target2 liabilities increased to EUR3556 bn in Italy and EUR333 bn in Spain), while Germany Target2 claims climbed to EUR754bn (figure1).

Back to 2012, TARGET imbalances was viewed as an indicator of financial fragmentation or financial stress. The global financial crisis combined with the following European sovereign debt crisis led to an increase in counter-party credit risk and a redenomination risk which translated into a liquidity crisis in the peripheral banking sector. Thus, against the backdrop of capital outflows from the periphery and the lack of access of the banking sector to wholesale funding market, the ECB had to step in to ensure liquidity needs as private sector's funding dried out. As a result, Target 2 liabilities for peripherals increased sharply. This situation reverted in mid-2012, after Mr. Draghi addressed the confidence crisis with the famous sentence "whatever it takes", adding the OMT program to the ECB's monetary policy tool kit. Outflows from peripheral countries started to moderate gradually and markets conditions, including access to wholesale funding, started to normalize. Since then, periphery banks reduced the reliance on the ECB funding, so that the Target 2 imbalance decreased, reaching a minimum at the beginning of 2015 (- EUR165bn in Italy, -EUR192 bn in Spain and +EUR460bn in Germany).

Figure 1

Official TARGET2 Balance (EUR bn)

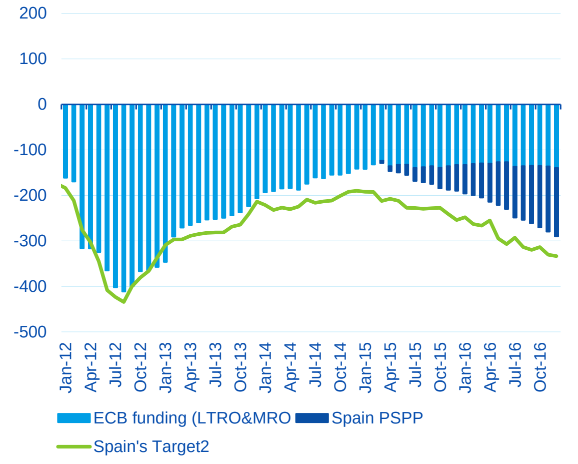


Source: ECB, and Haver

Since March 2015 the Target2 imbalance has been widening mainly in Spain, Italy and Germany (see figure 1) **linked to the implementation of the ECB Asset Purchase Program (APP**). Since the launch of the AAP in March 2015, Target2 liabilities have increased by EUR141bn in Spain and by EUR 192bn in Italy, broadly in line with the PSPP assets bought under the ECB´s programme (Spain's EUR150bn, Italy's 210bn). Meanwhile, German' Target2 claims have increased by EUR 240bn. Figures 2 and 3 showed that the increase in Italy and Spain´s Target2 liabilities since early 2015 is mainly explained by purchases under the APP (dark-blue bar); meanwhile Spain and Italy's banking sector reliance on the ECB funding (light-blue bar), has remained broadly unchanged with banks still taking advantage of favourable funding conditions through TLTRO´s II.

Figure 2

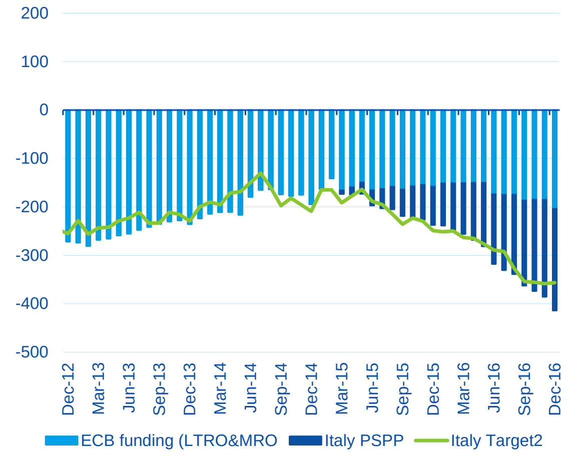
Spain: Target2 and selected counterparties, (EUR bn)



Source: ECB and BBVA Research

Figure 3

Italy: Target2 and selected counterparties, (EUR bn)



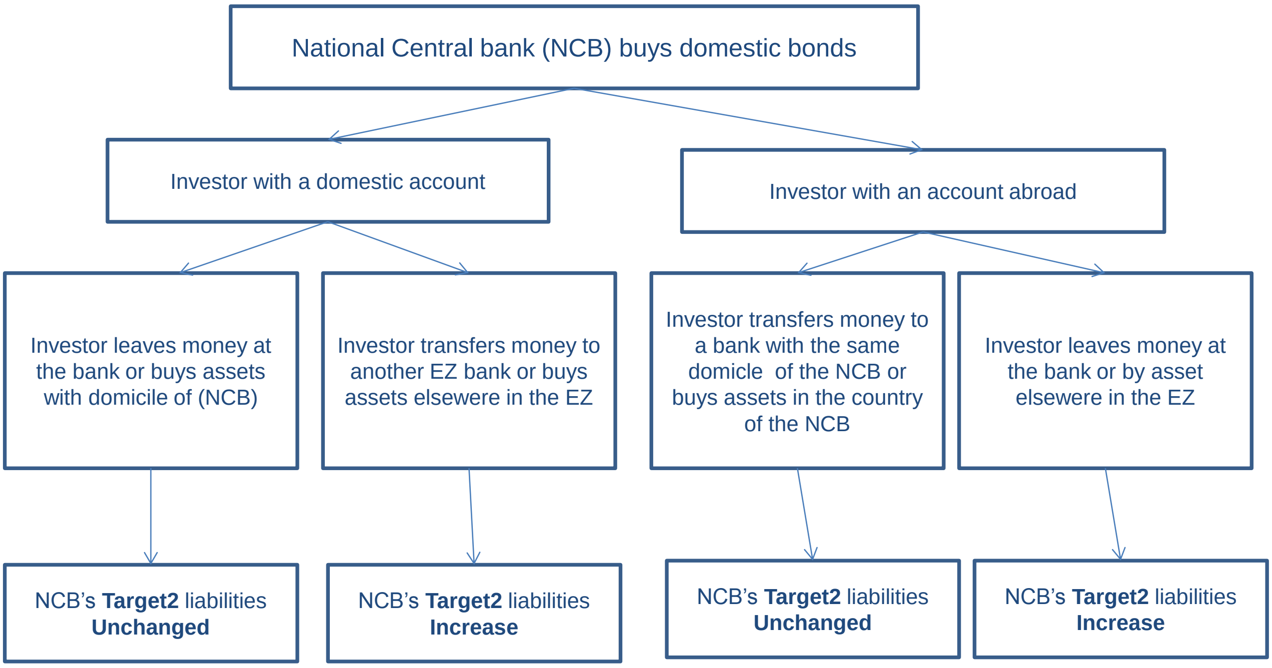
Source: ECB and BBVA Research

Why does the ECB APP impact directly in Target2 balance?

According to the ECB, the launch of the APP has caused a direct impact on Target2 balances as the implementation of Eurosystem purchases could entail cross-border payment by the purchasing national central bank (NCB) as securities can be bought from a range of counterparties (including those located outside the Eurozone which participate via other NCB, mainly the Bundesbank). Thus, when a NCB purchases domestic securities from a domestic financial institution, which leaves the money in domestic both deposits or assets, the NCB Target2 balance remains unchanged. However, when the NCB purchases securities from a non-domestic bank, the purchase is likely to give raise to cross-border flows of central bank money, increasing its Target2 liabilities (see Figure 4). According to the ECB[1] around 80% of Eurosystem purchases by volume have been carried out through non-domestic counterparties. Moreover, 60% of purchases have been made from counterparties that participated in Target 2 via Germany (not only German banks but also UK-based banks), what explains the increase in German Target 2 claims (see appendix for further details and Praet (2016)).

Figure 4

Impact of the ECB APP implementation into Target2 liability



Source: ECB, and Haver

1: Peter Praet: Remarks at the BNYM 20th anniversary dinner on the dynamics of TARGET2 balances and monetary policy implementation
https://www.ecb.europa.eu/press/key/date/2016/html/sp160915.en.html

Some takeaways

Current widening in Target2 imbalance is directly linked to the APP and, unlike previous episodes, it is not related to lack of access to funding markets for peripherals financial institution or governments. Peripheral banks have access to funding markets, while remaining reliant on ECB funding as the TLTROII provides good funding condition. Moreover, considering that the ECB has already extended the purchase programme until December 2017, the TARGET2 balances are expected to further increase until then (while from April 2017 at a slower pace once that monthly purchases will be scaled back from EUR 80 bn to EUR 60 bn).

Having said that, the reversion of TARGET2 balance poses some questions: First, to what extent is the ECB´s APP working properly? The liquidity injection of the ECB via asset purchases is not flowing towards the real economy, it is just contributing to increase excess of liquidity particularly in some core countries. On the other hand, fragmentation is still a problem in the Eurozone. While TARGET2 balances cannot be read as an indicator or financial stress as in the past, cross-border flows seem to signal that those investors that sell securities from peripheral countries prefer to transfer the money to other EZ bank or to buy assets elsewhere in the EZ (thus reducing its exposure to the periphery). Finally, regardless of its origin, an increase in Target2 imbalances would certainly fuel criticism to ECB policies in Germany[2].

Apendix: effect of the implementation of the ECB APP into the Target2 position

The impact of the ECB PSPP program on the Target2 of each country depend on the where banks decide to leave the money after selling assets to the National Central Bank (BoE or BoI in this case).

The National Central Bank can decide to buy bonds from an investor with a domestic account or from an investor with an account in other country. The investor receives a credit on the deposit account at his bank, and the bank gets a credit on their current account at their national central bank.

In the case of an investor with an account in the country of the National Central Bank he may decide:

a. Leave the money at the bank, or buy other assets in the country, in this case Target2 liabilities would remain unchanged for the National Central Bank.

b. Buy assets in other Eurozone countries, in this case Target2 liabilities would increase for the National Central Bank.

In the case on an investor with an account abroad, the investor can

a. Buy other assets in the same domicile-country of the bond previously sold, in this case Target2 liabilities would remain unchanged for the National Central Bank of the domicile bond.

b. Leave the money as deposit, or buy assets elsewhere, in this case the Target2 liability would increase

2: Moreover, risk-sharing, considering that 80% of current APP are made from non-domestic accounts, and 60% via Bundesbank is and open question.

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