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Economic Policy Positions

TARGET imbalances: The multi-billion euro bombshell?

Summary

The Chief Economists of the Savings Banks Finance Group are playing a keen and persistent part in the debate concerning the future of the European Monetary Union. They are accordingly concerned about the current forecasts that the TARGET system is going to lead to dramatic discord within the euro area. From our point of view, it is necessary to bring a greater measure of objectivity to the discussion, and we would recommend the following guidelines for action:

- → **The fact that TARGET imbalances are currently increasing is primarily attributable to the Quantitative Easing (QE) policy of the ECB.**

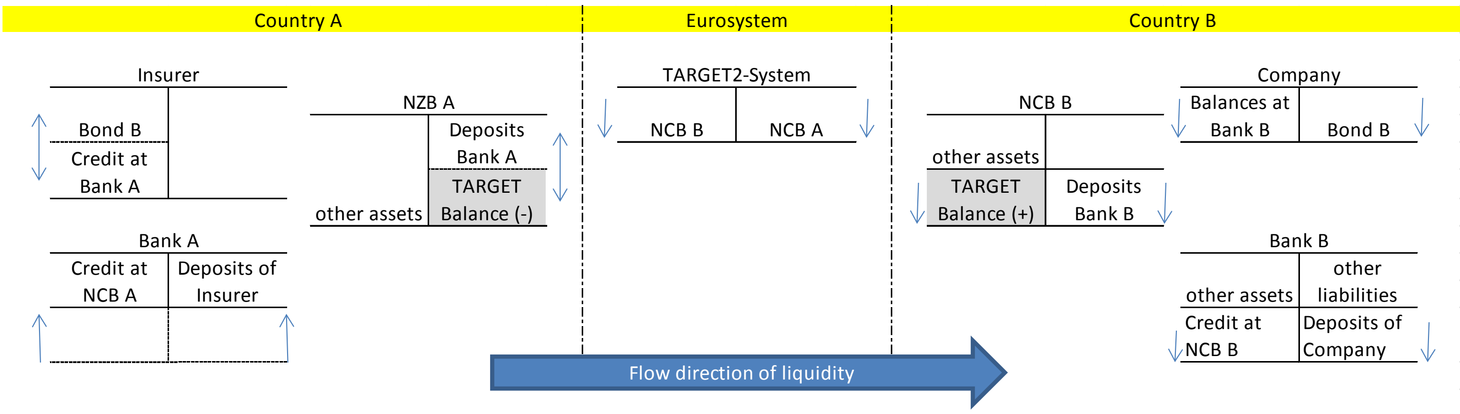
- → **When net purchases under the Eurosystem's Asset Purchase Programme (APP) have been discontinued this year, further exit measures will need to be envisaged, assuming a persistently favourable cyclical situation and gradually rising inflation rates: ECB key-rate hikes, first of all, and later a reduction in the stock of government-bond holdings on the Eurosystem's balance sheet.**

- → **TARGET imbalances are part of the "Big Picture" regarding risk-sharing and risk-collateralisation in the euro area. These imbalances also need to be taken into account in the debate about further equalisation mechanisms within the European Monetary Union.**

TARGET – How the Eurosystem's payment system functions

The Eurosystem's TARGET system is designed to settle cross-border payments within the euro area. TARGET is an abbreviation of Trans European Automated Real Time Gross Settlement Express Transfer, with TARGET2 being an improved successor of the original system. Participating in the system are euro area national central banks (NCBs) along with the ECB itself and five further EU central banks (those of Bulgaria, Croatia, Denmark, Poland and Rumania). All payment transactions are settled in central bank money, i.e. a participant is obliged to hold an account at a central bank. All payments are routed through the central banks participating. In principle, all (more sizeable) cross-border payment transactions in the euro area can be cleared via the TARGET2 system (referred to in the following, for simplicity's sake, as "TARGET system" or else "TARGET balances"). Eurosystem payments made in connection with the implementation of the Asset Purchase Programme (APP) are likewise settled through the TARGET system.

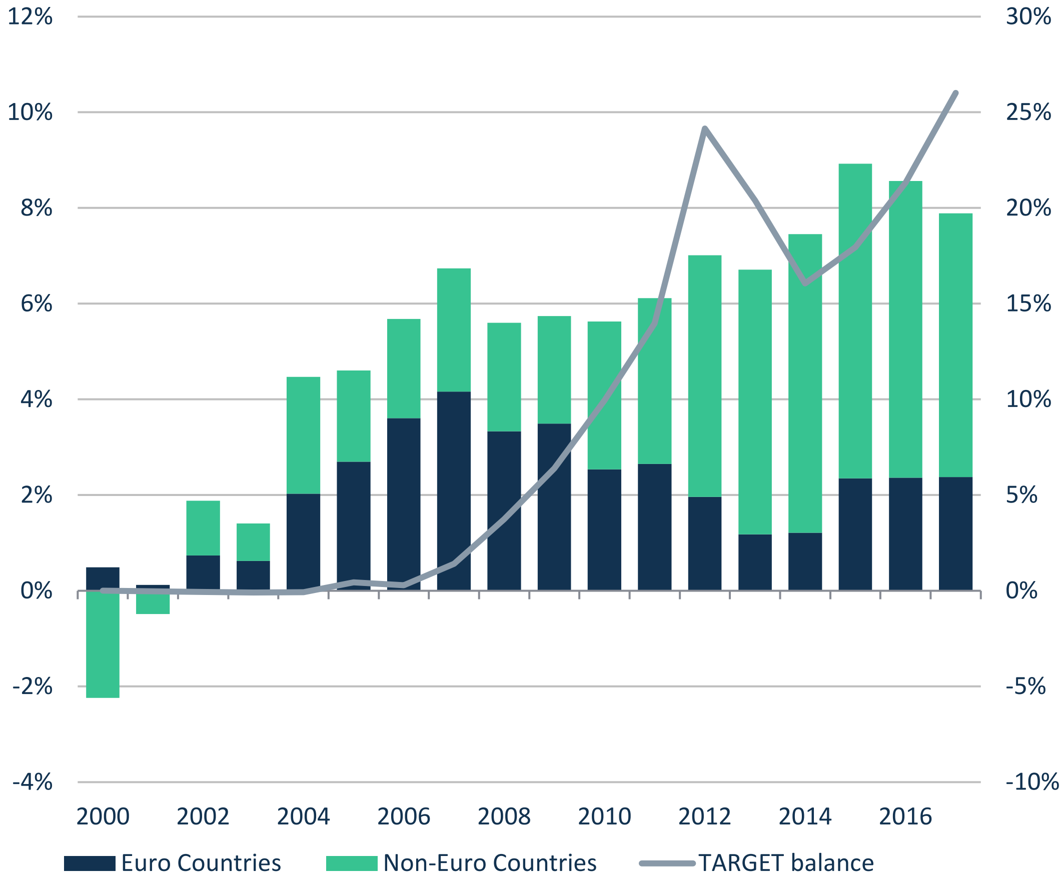
The TARGET system enables daily real-time gross settlement. If cross-border transfers are carried out, they are cleared via the TARGET system; at the end of the day, then, a central bank has a claim against, or else owes a liability to, the TARGET system, not vis-à-vis another central bank.



Source: LBBW Research

A typical payment transaction could look as follows: an insurance company in Country A acquires bonds issued by a company in Country B. The purchase amount is transferred from the insurer's account at a commercial bank in Country A to the issuer in Country B. To this end, Commercial Bank A debits its account at Central Bank A. As a result, a TARGET liability arises for Central Bank A. By contrast, Central Bank B now has a claim against the TARGET system to the same amount. The amount in question is credited to Commercial Bank B's account at the respective national central bank. Commercial Bank B will, in turn, credit this amount to its customer, in this case the company which issued the bonds. The TARGET-relevant transaction takes place between Central Banks A and B. Central Bank A incurs a liability to, and Central Bank B has a claim against the TARGET system. If payment then flows through the TARGET system from B to A, e.g. if the company in Country B acquires an equity interest in Country A, the balances will net out to zero.

Chart 1: German current-account balance vs. total of positive TARGET balances in the euro area (as a percentage of GDP)



Source: Eurosystem data derived from Thomson Reuters, chart generated by LBBW Research

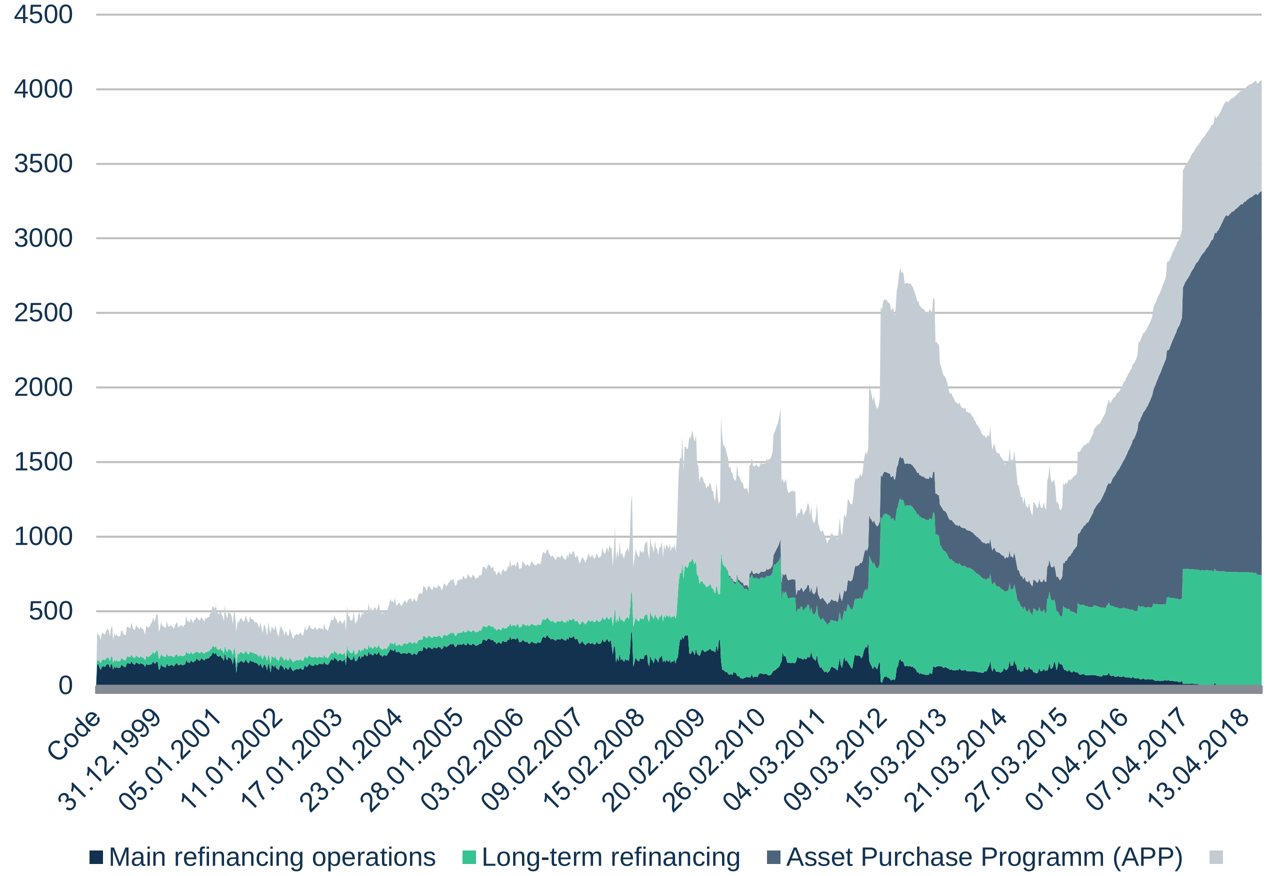
If more central bank money continually flows from A to B than the other way around, the imbalances will grow over the course of time. And this is precisely what has occurred within the Eurosystem since 2008. It is true that there tended to be an influx of net liquidity into Germany prior to 2008 as well in view of the country's current-account surplus. However, the liquidity concerned then flowed back to countries on the euro area periphery via the financing channel, e.g. as loans, with the net result that the Bundesbank's TARGET balances ended up close to zero (cf. Chart 1). Therefore, TARGET balances or imbalances do not primarily reflect a country's current-account position but rather the distribution of central-bank liquidity across the euro area. There is only a kind of synchronous co-movement between TARGET balances and the current-account position whenever cash-clearing operations through the commercial-bank system no longer function - a situation which, in the euro area's case, had its origins in the 2008 financial crisis.

How TARGET imbalances have developed

The phase immediately after the outbreak of the financial crisis was characterised by increasing uncertainty. In that context, liquidity in the interbank market effectively dried up. In order to alleviate the knock-on effects of this on the banking system, the ECB switched to full-allotment tender operations, enabling considerably more central-bank liquidity to be channelled into the euro area. At the same time, the incipient sovereign-debt crisis saw rising outflows of deposits - a kind of capital flight - from the euro area periphery to secure "core" member countries (including Luxembourg, the Netherlands and Finland, as well as Germany). TARGET imbalances grew accordingly. The first peak in TARGET imbalances coincided with the sovereign-debt crisis, which also spread to the euro area. Fears on the markets that the euro area might break apart - not a nebulous but a very real risk back in those days - caused investors to unwind their exposures to periphery countries and to instead look around for investment opportunities in core euro area member states. The upshot was that Germany, in particular, was a net recipient of liquidity.

Furthermore, the ECB began to make its policy more attractive. An especially striking ratcheting-up of liquidity provision was the introduction of Long-Term Refinancing Operations (LTROs). The first of these three-year tenders was allotted in late 2011, with bidders receiving a total of EUR 489 billion. Between November and December 2011, the Banca d'Italia's balance sheet reveals a EUR 92 billion increase in long-term refinancing operations with commercial banks (along with a EUR 34 billion decline in main refinancing operations). Italian commercial banks utilised part of the additional net liquidity (+ EUR 58 billion) in order to acquire Italian government bonds abroad. Insurers and private non-banks were also involved in this procedure. At any rate, Italy's TARGET balance moved into negative territory from mid-2011 onwards, with the deficit then widening at the end of that year at around the time of the first LTRO tenders (cf. Chart 2). On the markets, this trading strategy was called the "Sarko Trade" in reference to a corresponding proposal by the then French president: "Borrow money at 1% and reinvest these funds at 4%."

Chart 2: Liquidity provision by the Eurosystem (EUR billion)



Source: Eurosystem figures derived from Thomson Reuters, chart generated by LBBW Research

The repercussions of "whatever it takes"

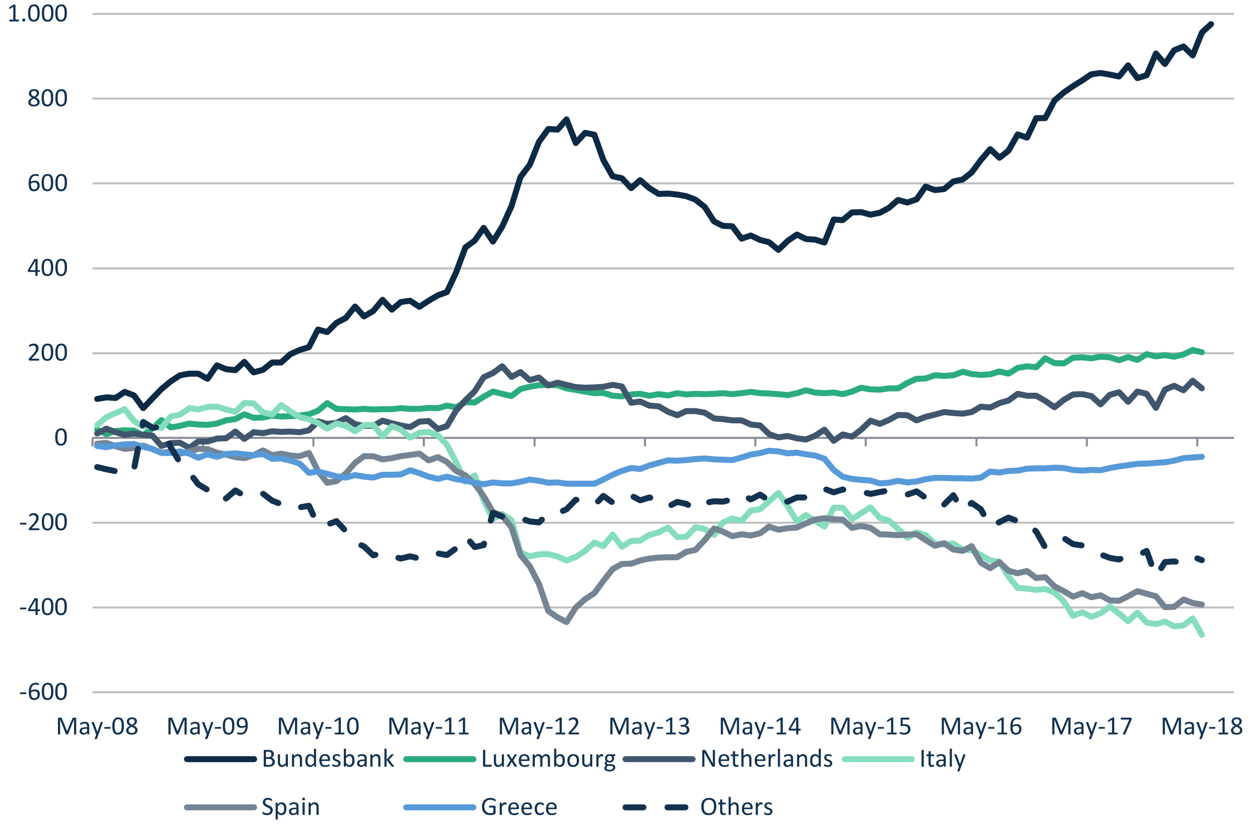
The situation on the financial markets became less tense in around the middle of 2012 in the wake of ECB President Draghi's now-famous dictum that the ECB was ready to do "whatever it takes" to preserve the euro. After these words had been spoken, the situation on financial markets calmed down to some extent and risk premiums on government bonds issued by southern euro area member states declined, with TARGET balances declining in parallel. Deutsche Bundesbank's TARGET imbalance peaked provisionally in August 2012 at over EUR 750 billion before decreasing by more than EUR 300 billion to approximately EUR 440 billion by July 2014. In the following months, however, the ECB embarked on the launch of its Asset Purchase Programme (APP). The sub-programmes governing the purchase of covered bonds and corporate bonds were followed in March 2015 by the particularly high-volume programme involving public-sector bonds.

By now, the cumulative purchase volume under the APP amounts to EUR 2,500 billion, with somewhat more than EUR 2,000 billion of this sum involving government-bond holdings. In this connection, the Eurosystem's purchases under the APP were transferred through the TARGET system, causing renewed growth in TARGET imbalances. This is because the national central banks participating in the system purchase bonds from their respective home countries ("jurisdictions"). Above all in the case of government securities, however, these are frequently owned by foreign parties who are resident in Germany in any case or who, to the extent that they are resident in non-European countries, quite often conduct their transactions with euro area counterparties via the Frankfurt financial centre through an account at Deutsche Bundesbank. By way of illustration, if the Italian central bank purchases a bond issued by the Republic of Italy in Frankfurt, the purchase amount will be credited to the seller's account at the Bundesbank and the Bundesbank receives a credit through the TARGET system, while the Banca d'Italia's TARGET deficit will increase correspondingly. Since only a portion of the liquidity has been flowing back in the other direction, the liabilities accumulated by the Italian central bank have grown by EUR 330 billion to EUR 460 billion since the middle of 2012. By contrast, the Bundesbank's TARGET surplus has grown by more than EUR 500 billion, to EUR 976 billion at last count, during the same period. The root-cause here was - and continues to be - the relative lack of attractiveness of Italian debt instruments. It is a fact that yields on higher-risk assets have been artificially depressed, i.e. distorted downwards, by the ECB's purchases and by the concomitant flood of surplus liquidity. This is the reason why the liquidity parked in Germany is not flowing back to Italy.

The current debate: The Bundesbank's TARGET claims of almost EUR 1,000 billion and Italy

In view of these truly vertiginous sums, and above all of the fact that the Bundesbank's TARGET claims are approaching the "magic" EUR 1,000 billion mark, the debate about the risks entailed by the TARGET system has taken on a new intensity in recent days. It is being asserted that the Bundesbank's TARGET claims are virtually irrecoverable, and that the Eurosystem would, at the very least, sustain losses of up to EUR 460 billion in the event of Italy leaving the European Monetary Union, with the Bundesbank having to bear a proportionate share of these losses. After Italy's (hypothetical) exit, so the argument runs, the Bundesbank would be left saddled with irrecoverable claims to the tune of more than EUR 140 billion (31% of EUR 460 billion).

Chart 3: TARGET balances of selected central banks (EUR billion, monthly figures)



Source: Eurosystem figures derived from Thomson Reuters, chart generated by LBBW Research

An “Italexit” (an Italian exit from the EMU) is neither possible according to the EU Statutes nor something which the Italian government is striving for (except as a political threat scenario which does not look to be very credible at the moment). Even if an Italian exit from the euro area were to materialise, that would not be identical with a loss for the Bundesbank on the basis of the Eurosystem’s TARGET mechanism. Let us, for example, assume a scenario under which Italy leaves the euro project “overnight.” It is true that ECB President Draghi has clarified in a letter to Italian members of the European Parliament that any country leaving the euro area would first need to settle its debts with the bloc’s TARGET system, but it is unlikely to be within the ECB’s power to enforce such an outcome. On the day that Italy severed its ties with the euro area, therefore, the country’s TARGET liabilities would run into the hundreds of billion euros.

After Italy had left the euro area, the Italian central bank would no longer be part of the Eurosystem. From the Banca d’Italia’s perspective, its TARGET liabilities would be foreign-currency liabilities and thus irrecoverable for the Eurosystem. Admittedly, the Italian central bank’s liabilities are collateralised, but the collateral would be virtually worthless if Italy were indeed to opt out of the euro project. On the other hand,TARGET balances have neither a final maturity date nor are they transferable. The TARGET system could simply keep its claims against Italy on its books; write-offs would not be required.

There is no threat of the Eurosystem becoming insolvent: after all, the offsetting items counterbalancing Italy's liabilities include, for example, the Bundesbank's claims. But these claims too are only a euro-denominated claim on the TARGET system and thus, by extension, on the Eurosystem. The fact remains that the Eurosystem is solvent on a euro basis at any point in time. It should be noted that Germany too would not be able to recover its supposed treasure of TARGET claims in the event of an EU exit. The Bundesbank would only have (non-transferable) euro-denominated claims against the TARGET system with an indeterminate maturity date and not, for instance, a kind of foreign-currency account at the ECB, holdings of euro-denominated government bonds issued by other euro area member states, or indeed a trove of gold.

The question of interest rates must be clarified. Target balances earn interest according to the interest rate on the ECB's main refinancing operations (currently 0%). In view of the dimensions of Italy's TARGET liabilities, higher ECB policy rates would constitute a major burden. Nevertheless, TARGET balances do not, per se pose a threat to the inherent stability of the system. The difficulties which could be expected if individual member states were to exit the EU would appear to be manageable - at any rate, significantly more manageable than the considerable negative consequences which would be on the cards for financial markets and the real economy.

Admittedly, such immediate consequences for the Eurosystem's TARGET mechanism must also been discussed within the context of the overall consequences for Europe policy of an "Italexit" which would impose a burden on all European countries. All things considered, then, this option would confer advantages neither on Italy nor on other euro area countries.

The political implications of TARGET balances

Is the implication of the above that TARGET balances are unproblematic because they are pure offsetting items netting out to zero? No, because the balances themselves are only a symptom. As argued above, such imbalances signal that market-based liquidity clearing is not working in the euro area because the interbank market has become dysfunctional. Johannes Beermann, Member of the Board of Deutsche Bundesbank, has recently argued in the German weekly newspaper "Die Welt" (issue dated 20th July 2018) that lost trust could be regained with the help of growth-boosting structural reforms and by strengthening the solvency and resilience of commercial banks. Such measures would undoubtedly be helpful but may not necessarily prove to be sufficient. In today's circumstances and under today's constraints, TARGET imbalances are an expression of misguided currency integration in Europe - the euro area is not yet an optimum currency area. A number of states have been granted the status of euro area members for political reasons.

In macroeconomics, a cardinal importance is attributed to three central prices: the exchange rate, the interest rate and the wage rate. For all euro area decision-makers, the advent of the European Monetary Union meant that the instrument of exchange-rate adjustments could no longer be used to correct macroeconomic imbalances. This was known, and indeed actively embraced, when the European Monetary Union was set up. However, the process of adjustment via real interest rates and real wages in the aftermath of shocks or previous mis-developments has not worked out as envisaged ex ante. Adjustment via declining real wages has indeed been attempted in some member countries but is unpopular and takes a long time. It is true that the ECB's monetary policy and the steps taken towards a fiscal union (the ESM being a central case in point here) have stabilised the government-bond markets, and financing conditions across the European Monetary Union in general, while keeping Greece in the euro. At the same time, however, the decision to set non-risk-adequate interest rates created an incentive for borrowing in the periphery countries and for acquiring goods and assets in the core member states. TARGET imbalances are not the trigger of this erroneous development; they merely point it up. By virtue of the measures it has taken, the ECB has bought the political class a good deal of time. But some countries have used this time better than others. It does not amount to a comfortable cushion for the foreseeable future. Reform tasks have been abandoned by the wayside, above all in Italy but also in France, Spain, Portugal and Greece.

Outlook: The ball remains in the monetary policymakers' court

During the remaining five months in which the asset-purchase programme is scheduled to be actively expanded, the Eurosystem will purchase holdings worth a little more than EUR 100 billion (August and September 2018: EUR 30 billion each; October-December 2018: EUR 15 billion each). On the basis of the ECB's capital key, the Bundesbank will therefore be shelling out a further EUR 25 billion, or thereabouts. If the empirically plausible 30% rule of thumb is applied here, Germany's TARGET surplus is probably going to increase further by somewhere in the region of EUR 8 billion, i.e. to only a very limited extent.

An end of the uptrend in TARGET imbalances before the end of 2018 is therefore not in sight. However, it is still unclear whether ongoing reinvestment of the proceeds of maturing securities on the ECB's balance sheet in 2019, after net purchases have been discontinued, could also have the effect of boosting TARGET imbalances. After all, the purchases concerned continue to target foreign portfolios whereas the redemption of bonds falling due is carried out by the public-sector authority in the country in question. The stock of APP-related bond purchases carried out so far (very nearly EUR 2.5 trillion for the euro area as a whole, around EUR 560 billion of this amount on the Bundesbank's portfolio) would imply an approximately EUR 200 billion TARGET2 exposure for Germany. Even without counting in changes in TARGET balances brought about by purchases through other Eurosystem national central banks, this would explain very nearly half of the increase in Germany's TARGET surplus since the beginning of 2015. All the same, at least part of the increase in the German TARGET surplus is probably attributable to current-account surpluses and to the absence of return flows of funds to southern regions of the euro area. On the whole, then, it is above all the ECB's QE purchases, but also Germany's current-account surpluses with other euro area member states, which explain the steady upward trend in TARGET imbalances, whereas short-term surges and peaks in capital flows are more probably a function of capital flight. It would therefore be important for the ECB to map out an exit strategy at the beginning of 2019 which not only includes ECB key-rate hikes but also explicitly addresses the issue of reducing the stock of government bonds held by the Eurosystem. That would probably also alter the debate concerning TARGET balances.

What is more, our root-cause analysis clearly indicates that proposed regulatory restrictions on TARGET balances - emulating the system in the USA - are not expedient. They would only damage free capital movement across the currency area, which is a valuable asset. The conclusion to be drawn here is that such new regulatory measures would fail to eliminate the underlying causes of TARGET imbalances.

TARGET balances should be taken account of as a contribution to risk-sharing

Acceptance of such elastic balance trends is, to a certain extent, necessary to ensure the efficient functioning of the European Monetary Union, the fungibility of central bank deposits and the uniformity of the euro. Under the current architecture, however, this also means considerable claims on solidarity. The current monetary-policy alignment which is driving TARGET imbalances higher is simultaneously shoring up the liquidity and stability of banking sectors in a number of countries. Countries whose banks have a large volume of high-risk assets (government bonds in particular) on their books are benefiting from QE and from the associated decline in risk premiums. Losses of confidence and proverbial “runs“ involving outflows of capital from certain countries and banking systems are being prevented or - to put the point another way - elastically financed with the help of TARGET balances.

In this sense, the TARGET system already foreshadows other risk-sharing and solidarity-based stabilisation systems for the euro area which have been proposed and discussed. The significant degree of cross-border financing and risk assumption which the TARGET system is already performing could therefore be taken into account when new additional systems are being pondered. It could - and indeed should - also be considered whether it would not be suitable and appropriate to explicitly rope in TARGET balances as cover if new cross-border protection systems are introduced. Such an approach would make sensible use of these balances while potentially reducing them, and would also avoid double burdens. Existing positive TARGET balances could, for example, be counted as contributions to the new schemes. That would take account of the interpretation of TARGET imbalances as an expression of existing disequilibria and/or risks within the euro area. Under such a scenario, only the deficit countries would need to actively build up new safety funds - but that would be only appropriate and incentive-compatible in view of their risk profiles. After all, it is these countries and their banking systems which give rise to the relevant risks, give cause for capital flight and necessitate stabilising interventions by national central banks. And it is they who profit from elastic refinancing through the TARGET system. In the light of this, TARGET imbalances should be part of the “Big Picture” when it comes to appraising any new common European safety funds. To that extent, the task of scaling back the stock of bonds held by the Eurosystem ought to be linked to the political debate about the safety-funds architecture.

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