

# EMU Target2 imbalances are not a sign of something wrong

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- As disagreement between parts of the German economic establishment and the ECB is heating up, it can only be a matter of time before the German popular press latches onto the recent widening of Target2 imbalances as a sign that something is terribly wrong.
- However, in this note we show that the recent widening of Target2 imbalances is neither a sign of financial stress nor that recent ECB actions are unjustified.

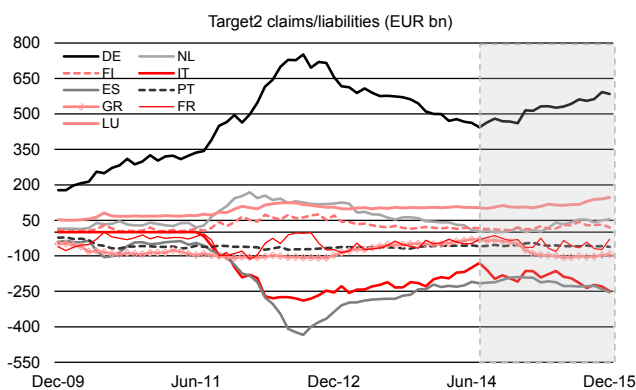
## 1. Target2 imbalances again under scrutiny

The ECB has recently come under attack once again from the German political and economic establishment for its loose monetary policy. It can only be a matter of time before the German popular press turns its attention to the recent widening of Target2 imbalances as a sign of something terribly wrong in the Eurosystem, as it did back in 2012 when the eurozone debt crisis was raging.

Target2 is a payment system that facilitates the final settlement of cross-border payments in central bank money by National Central Banks (NCBs) in the euro area. The resulting Target2 balances reflect the claims and liabilities of the NCBs against the Eurosystem (see Box).

Chart 1 plots the Target2 balances for euro area member states. It shows that the imbalances rose strongly during the 2011-12 eurozone debt crisis, with liquidity shifting from the periphery (Italy, Spain, Greece and Portugal) to the core (mostly Germany). And in the last 18 months these imbalances have grown again, with higher German claims being reflected in a rise in the liabilities of Italy and Spain.

**CHART 1: THE LATEST DEVELOPMENTS IN TARGET2**



Source: national central banks, UniCredit Research

In this note, we look at the drivers of the notable build-up of core/periphery Target2 imbalances since July 2014, disentangling country-specific factors – which will also help to explain the significant deterioration in Italy – from those common among eurozone countries. The main conclusions of our analysis are **1.** Higher German Target2 claims in part reflect a larger German current account surplus not completely matched by portfolio investment outflows; and **2.** The recent build-up of Target2 liabilities in the periphery is not a sign of stress, unlike that of the eurozone sovereign debt crisis. This is related to residents seeking better returns, in the wake of ECB actions, and peripheral banks increasingly replacing interbank market cross-border funding with (cheaper) Eurosystem liquidity. And this is good news because it contributes to the effective transmission of the ECB’s monetary policy.

### BOX: A brief explanation of Target2 balances

Target2 balances are positions on the balance sheets of all EMU countries’ national central banks. Changes in the Target2 balances of each NCB result from the settlement of cross-border payments executed between banks via the Target2 system. These cross-border payment flows reflect transactions that are initiated by the official sector, and private entities (i.e. banks, corporates and households), such as the purchase or sale of goods, services, securities or interbank loans.

They are recorded in a country’s balance of payments (BoP). The associated movements in the current account and in the financial accounts (either “portfolio investment” or “other investment afferent to banks”) of the BoP are balanced by an increase in the liability (asset) side of the “other investment – monetary authority” item in the financial account of the BoP. This is because the potential payment between two banks is settled in Target2 and generates a debit (credit) position of the NCB towards the ECB.

From the perspective of the NCBs’ balance sheets, Target2 reflects the decentralized distribution of CB liquidity within the Eurosystem. Banks in countries that face net payment outflows needs more central bank liquidity than those in other countries where commercial bank money is flowing in.

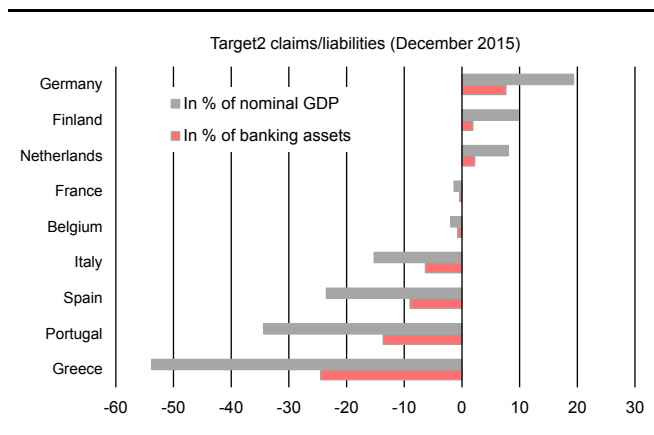
## 2. Italy and Spain vs. Germany

After reaching a peak at EUR -289bn in August 2012 at the height of the sovereign debt crisis, Italy's Target2 balance gradually improved, reaching EUR -130bn in July 2014. The improvement was mainly due to massive foreign inflows in the wake of the ECB's OMT announcement. Subsequently, Italy's negative balance has fluctuated widely (down, then up and then down again) between mid-2014 and end-2015, leading to significant deterioration, which brought Target2 liabilities very close to August 2012's peak. On the back of this trend, some commentators have suggested that capital flight is resuming, but this is wrong.

There is no doubt that the widening in Italy's Target2 liabilities since July 2014 has been significant both in absolute terms (EUR -119bn) and as a percentage of GDP, with the balance moving from -9% to -15% of GDP at end-2015. Also, in terms of the size of the banking system, where payment flows originate, Target2 liabilities doubled from 3.3% to 6.3% of total assets.

To put these trends into context and to isolate local factors, we compare Italy with Spain and Germany, two EMU countries characterized, respectively, by a negative and a positive Target2 balance of a similar size to Italy, both in relation to GDP and the size of their banking sector (see chart 2).

**CHART 2: TARGET2 VS. NOMINAL GDP AND BANK ASSETS**

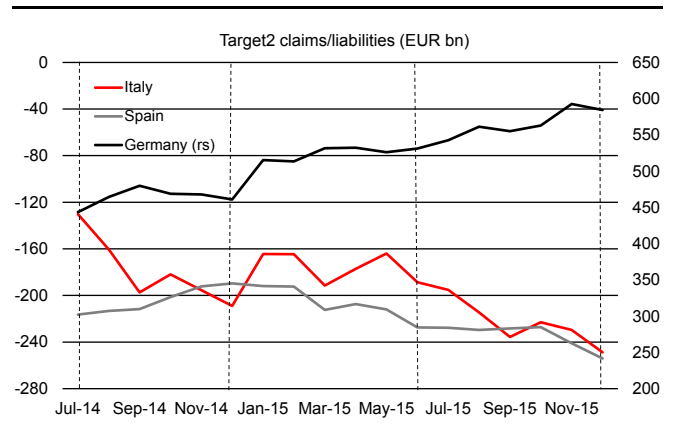


Source: national central banks, Eurostat, ECB, UniCredit Research

Chart 3 focuses on developments of Target2 balances in Italy, Spain and Germany since July 2014. It shows that the renewed increase in Target2 liabilities started in Italy before it did in Spain, where the post-OMT reduction in liabilities continued at least until the end of 2014. After that, Target2 imbalances re-emerged also in Spain, although the deterioration was much lower than in Italy.

These developments have led to a notable build-up of core/periphery Target2 imbalances<sup>1</sup>, similar to what occurred in the early part of the eurozone debt crisis (see chart 1). This is illustrated by Germany re-accumulating Target2 claims, together with other core countries such as the Netherlands and Finland. For Germany, in the period between July 2014 and December 2015, Target2 claims returned to EUR 584bn, equal to mid-2013 levels.

**CHART 3: IMBALANCES RISE AGAIN**



Source: national central banks, UniCredit Research

## 3. The BoP and the driving forces of Target2

The balance of payment accounting identity facilitates a better understanding of the fundamental determinants of changes in Target2 balances<sup>2</sup>. Table 1 displays the key sub-components of the balance of payments for Italy, Spain and Germany for the recent period as well as during the height of the sovereign debt crisis for comparison. In the table we refer to gross flows of portfolio investment (as opposed to net), because there is useful information in separating foreign investment in domestic securities from investments by residents in foreign securities.

The recent (July 2014-December 2015) increase in Target2 liabilities, especially in Italy, was due to a mix of factors, but is mainly explained by changes in the flows of portfolio investment (debt securities and equity). Also changes in the net funding abroad by resident banks contributed to the increase of Target2 liabilities. The progress in CA developments in recent years – while having moderated the

<sup>1</sup> As for the other periphery countries, there was an abrupt deterioration of the Target2 deficit in Greece at the beginning of 2015 and this lasted until the summer. This is understandable given the political crisis faced by the country. In contrast, the widening in Portugal's Target2 liabilities remained relatively contained.

<sup>2</sup> The BoP tracks all transactions between a country and the rest of the world, while Target2 is a payment system for banks operating in the EMU, and in some non-EMU EU countries, such as Bulgaria, Denmark, Poland and Romania. Nonetheless, the reason why the relationship still holds is that Target2 balances also arise from settlement of the transactions in foreign currency.

potential accumulation of Target2 liabilities, more so in Italy than in Spain – has remained insufficient to finance overall net financial outflows. The opposite has continued to occur in Germany, where the large current account surplus is only partly offset with financial outflows, leading Germany to accumulate Target2 claims.

**TABLE 1: TARGET2 BALANCES AND THE BOP IDENTITY**

Cumulated sum of flows (EUR bn)	Current account (CA) (+)	Net FDI (+) <sup>3</sup>	Foreign investment in domestic securities (+) <sup>4</sup>	Net funding abroad by resident banks (+) <sup>5</sup>	Residual items (+)	Investment by residents in foreign securities (-) <sup>6</sup>	Target2 balance
<b>Italy</b>							
Jun15-Dec15	28	0	-51	-21	17	34	-60
Dec14-Jun15	7	-8	77	41	-8	88	20
Jul14-Dec14	18	-3	-32	-16	7	52	-79
Jul11-Aug12	-26	-17	-140	-117	-48	-74	-273
<b>Spain</b>							
Jun15-Dec15	14	-7	2	-31	5	10	-27
Dec14-Jun15	1	-16	53	-7	-7	62	-38
Jul14-Dec14	12	-13	40	18	-7	22	27
Jul11-Aug12	-22	3	-151	-228	-13	-32	-378
<b>Germany</b>							
Jun15-Dec15	140	-31	-68	3	53	44	53
Dec14-Jun15	117	-26	-7	57	9	80	70
Jul14-Dec14	99	-29	-5	-14	25	59	17
Jul11-Aug12	202	-20	32	265	-28	44	408

Source: national central banks, Eurostat, UniCredit Research

Inflows and outflows of foreign direct investment (FDI) continued to move sideways in Italy with no meaningful sign of improvement in the net balance. In contrast, net FDI outflows contributed to the increase Target2 liabilities in Spain, while moderating the increase in German claims. In both countries, this was due to a strong increase in direct investment abroad by domestic firms, which significantly outpaced direct investment in the country, a reversal of what happened between August 2012 and July 2014.

Consistent with these data, the main trends behind recent movements in Target2 balances appear to be the following:

- A good appetite among foreign investors for Italy's sovereign risk;
- Residents seeking better returns;

<sup>3</sup> For the net FDI balance, a negative value indicates that domestic acquisitions of a controlling interest in a foreign business outpaced FDI in the country.

<sup>4</sup> For the item "Foreign investment in domestic securities", a positive value indicates that foreign investors are moving funds into the country; a negative value indicates that they are moving funds abroad.

<sup>5</sup> A positive value for peripheral countries indicates increasing cross-border interbank funding to match a net portfolio investment outflow, which is not matched by improvement in the CA balance. This contributes to reducing the liabilities of Target2. At the opposite end, a negative value fuels an increase in Target2 liabilities.

<sup>6</sup> The item "Investment by residents in foreign securities" is reported with a negative sign in the table. Positive values mean that domestic investors are moving funds abroad, while negative means moving funds back home.

- Banks are increasingly replacing interbank market cross-border funding with Eurosystem liquidity.

The following delves deeper into each of these factors.

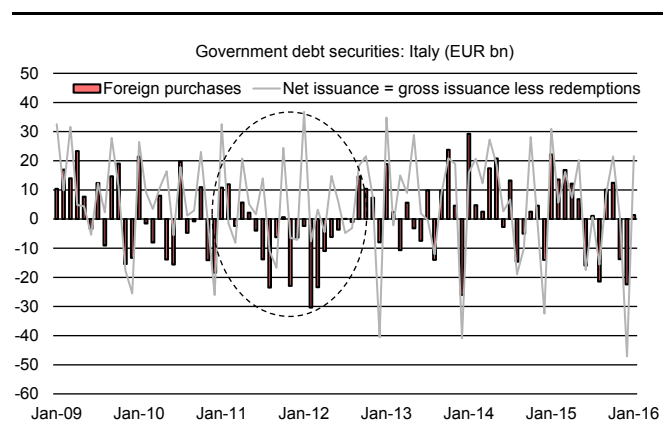
**4. The foreign appetite for sovereign debt did not fade**

With regards portfolio investment, foreigners reduced their purchase of Italian assets, principally government securities, in 2H14 and again in 2H15, while 1H15 saw an increase in the wake of QE (table 1). This contrasts with the picture emerging for Spain, where foreign private inflows were positive in all periods, although they weakened significantly towards the end of 2015, probably due to political risks around the Catalan and national elections.

A reduced appeal had characterized Italian government securities mainly in 2H14, with the spread BTP-SPGB (10Y) averaging 20bp and hitting a peak of 40bp during the big financial storm of mid-October 2014. Among other things, the latter reminds us that periods of higher market volatility came with a surge of risk aversion towards Italy, due to its persistent weak growth and high public debt. However, we think that this is only part of the story.

Chart 4 shows that large foreign outflows from Italian government securities over the last few years were principally concentrated in specific months of the year, especially August and December. This is increasingly related to the issuance policy adopted by the Italian Treasury, which used the large volume of liquidity accumulated in its own accounts with the Bank of Italy (as we will show below) to make net redemptions of securities. The correlation between foreign purchases and net issuance rose to around 80% in the period from January 2013 to the present, compared to around 60% in the four years before, including the sovereign debt crisis. This suggests that active selling by foreigners was less (possibly much less) than implied by BoP statistics.

**CHART 4: TIGHTER CORRELATION OF LATE**



Source: Bank of Italy, UniCredit Research

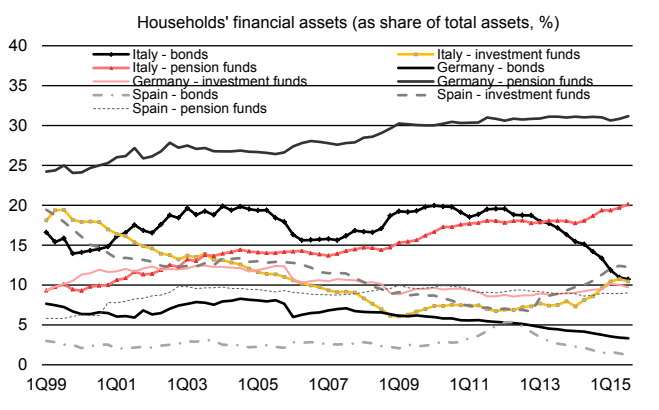
**5. Yield-hunting by residents**

On the asset side of the portfolio investment balance, Italian residents made substantial net purchases of foreign assets and this represents a novelty compared to the period before July 2014. Particularly, statistics show that there was a significant increase in purchases of shares of investment funds and, to a lesser extent, in direct purchases of foreign debt securities. This suggests that households and firms were mainly behind these purchases. This determined large private domestic outflows, particularly until June 2015, which further contributed to the deterioration in Target2 balances, especially, but not only, in Italy. This capital outflow slowed in the final part of 2015.

Indeed, over the last few years, households' portfolios in all selected countries have progressively been shifted from debt securities mainly towards the higher-yielding asset-management industry (investment and pension funds). This is consistent with the portfolio rebalancing effect of QE, with NCBs purchasing bonds from investors who then seek better returns elsewhere. Residents' decisions to invest abroad were also in part influenced by the weakening of the exchange rate, in the wake of QE, which encouraged outflows into non-EUR assets.

This shift from bonds to funds was particularly accentuated in Italy, where holdings of government and bank bonds were higher compared to those of other countries. Chart 5 shows that the share of holding of debt securities by Italian households declined from 16% of total assets at the end of 2013 to less than 11% at the end of 2015.

**CHART 5: HOUSEHOLDS: LESS BONDS, MORE FUNDS**



Source: national central banks, UniCredit Research

Moreover, it is worth highlighting that the BoP's definition of foreign investment funds is based on the domicile of the funds and that, in Europe, asset-management companies are mainly located in Luxembourg, Ireland, Germany and France. In practice, this means that, if Italian residents

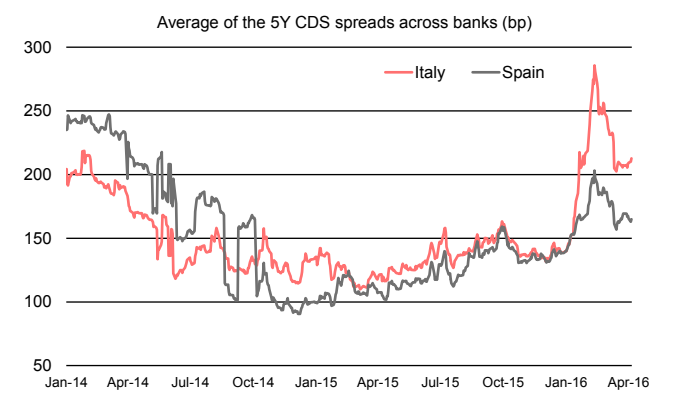
decided to sell BTPs and buy Italian equities through mutual funds, it is highly likely that the BoP recorded this transaction as a purchase of a foreign asset.

**6. Banks substituting foreign financing for cheaper ECB liquidity**

Changes in Italy's Target2 balance are also explained, although at a lesser extent, by the net balance between loans from foreign banks (and deposits of foreign non-banks) to domestic banks and loans of domestic banks to foreign banks and non-banks. We labeled this "Net funding abroad by resident banks" in table 1, which shows that, in 2H14, Italian banks reduced their foreign interbank funding (lower inflows of EUR 16bn), while Spanish banks did not. This might be occurred because Italian banks made more extensive use of the ECB's TLTROs than Spanish banks. The first half of 2015 saw more than a reversal of this, reducing Italy's Target2 liabilities. After that, in 2H15 both Italian and Spanish banks reduced their exposures to interbank foreign markets, increasing their dependency on NCBs' support.

It is reasonable to conclude that Target2 balances remain affected by banks' capability to access interbank market cross-border funding. Ceteris paribus, the weaker the banking sector, the higher its dependency on Eurosystem liquidity than on market funding (hence, the higher Target2 liabilities). Chart 6, which compares the 5Y credit default swap (CDS) spread for Italian and Spanish banks, provides a reasonable proxy for investors' evaluation of the soundness of banks.

**CHART 6: GAUGING MARKET-BASED FUNDING CONDITIONS**



Source: Markit, UniCredit Research

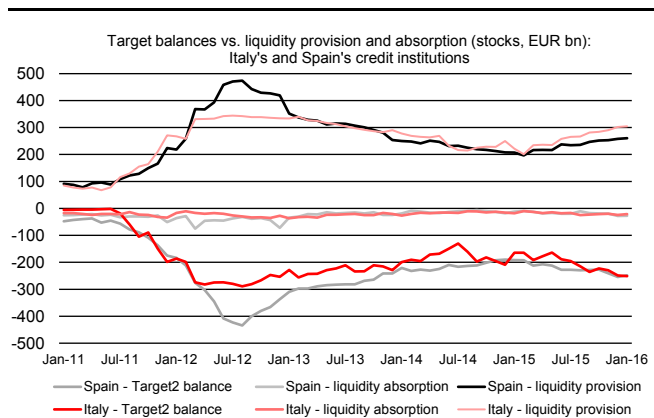
For most of the last two years, market-based funding conditions have been slightly less favorable for Italian banks, compared to Spanish ones. Among other things, this might have played a role in explaining the different evolution of Target2 balance between the two countries.

### 7. Target balances and ECB's accommodative policy

Finally, we turn to assessing the role played by the exceptionally accommodative ECB policy and by government actions in the formation of Target2 balances.

Banks that face net payment outflows need more central bank liquidity than those that have easy access to commercial bank money. Therefore, their NCBs increase the liquidity injected into the system via refinancing operations more than NCBs that deal with more solid banks or that are characterized by net payment inflows. In contrast, liquidity injected by NCBs via QE is proportional to their size of the respective jurisdictions, given that QE purchases are carried out according to capital keys. Regardless of whether liquidity is injected via refinancing operations or QE, it is recorded on the asset side of NCB's balance sheets, while on the liability side Target2 records this liquidity net of liquidity-absorbing factors. These factors mainly refer to changes in the banks' reserves at the NCB (via the reserve accounts, the deposit facility and fixed-term deposits), and to changes in deposits of the general government and banknotes in circulation (the so-called "autonomous factors").

**CHART 7: TARGET2 AND NCB LIQUIDITY: ITALY & SPAIN<sup>7</sup>**



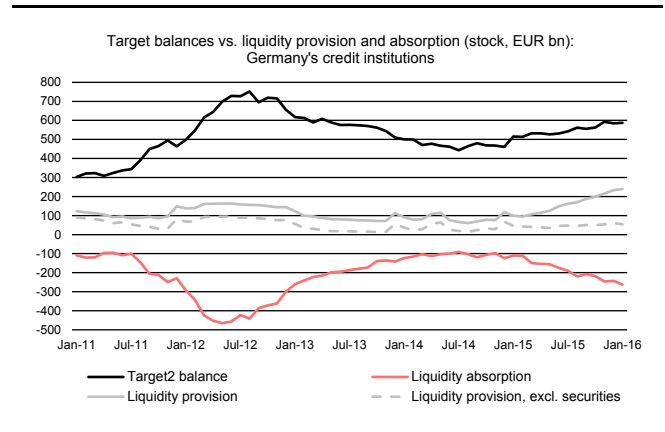
Source: Bank of Italy, Bank of Spain, UniCredit Research

In Italy, the increase in Target2 liabilities from July to December 2014 (EUR -79bn vs. EUR +27bn in Spain) was closely related to the more ample creation of liquidity by the Bank of Italy, for example, within the framework of TLTRO I. Thereafter, both in Italy and Spain, changes in the Target2 balance correlated with wider recourse to central bank

<sup>7</sup> The aggregates used here for liquidity provision not only include the monetary policy lending operations but also other forms of provision of central bank money, such as "claims on euro area residents denominated in foreign currency", "other claims on euro area credit institutions denominated in euro", as well as "securities held for monetary policy purposes". These other forms of provision of central bank money indeed also allow a banking system to fund net payment outflows. The liquidity absorption via credit institutions corresponds principally to total deposits of credit institutions at their NCBs listed in NCB's balance sheet as "liabilities to euro area credit institutions related to monetary policy operations denominated in euro".

liquidity (see chart 7), with the QE which has gradually replaced refinancing operations.

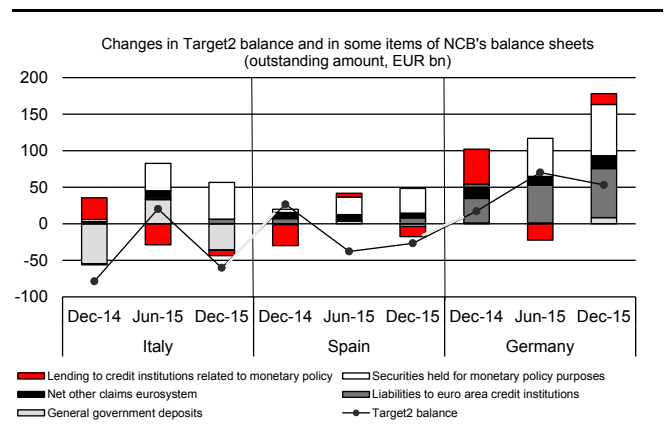
**CHART 8: TARGET2 AND NCB LIQUIDITY: GERMANY<sup>6</sup>**



Source: Bundesbank, UniCredit Research

The opposite mechanism has been in place in Germany since July 2014. The increase in Target2 claims from July to December 2014 closely correlated with an increase in German banks' deposits at the Deutsche Bundesbank, or liquidity absorption. And these developments were further amplified in 2015 (see chart 8). In the meantime, the Bundesbank injected liquidity into its banking system mainly via QE (grey solid line).

**CHART 9: CHANGES IN TARGET2 BALANCES (JUL14-DEC15)<sup>8</sup>**



Source: national central banks, UniCredit Research

Chart 9 shows, in more detail, the common changes in central bank liquidity management among these three countries, and the lower liquidity provision for Spain than Italy and Germany. All other things being equal, this was related to the potentially smaller size of ECB's QE for Spain. Indeed, in January 2016, cumulative PSPP alone amounted

<sup>8</sup> In the chart, we omitted the contribution of the net other assets, which also include banknotes in circulation.



to EUR 81bn for Italy vs. EUR 58bn in Spain (and EUR 118bn in Germany).

In addition, Chart 9 reflects the changes that occurred in government deposits at the NCB, which were an especially important liquidity-absorption factor for Italy. The chart shows that there was a pronounced decline in government deposits in the second halves of 2014 and 2015 (grey bar), periods when Italy accumulated Target2 liabilities. In contrast, in 1H15, an increase in government deposits, together with a reduction in central bank refinancing operations, more than offset the larger volume of liquidity injected via security purchases.

It seems possible to infer some seasonality in the Italian government's behavior with the Bank of Italy, related to the issuance policy of the Treasury discussed in section 4. Thus, this is one local factor that could be related to the deterioration of Target2 balances at the end of each year.

## 8. Where we may go from here

National central bank data show that, in the first quarter of 2016, Target2 liabilities increased further in Italy and Spain (both to above EUR 260bn). For Italy, BoP data available for January show that the deterioration in this month was mainly due to foreign portfolio investment outflows, which were related to private securities rather than to government securities. This is clearly related to increased market stress, especially for the banking sector.

The future direction of Italy's Target2 balance will continue to depend on a number of factors. One of these is the general sentiment prevailing in financial markets. A new increase in volatility, for example, related to the risk of a Brexit, may come with some re-pricing of credit risk in peripheral countries, including Italy. Other things equal, this would be negative for the Target2 balance. Another factor is Eurosystem liquidity injection, which will intensify in the wake of the stimulus package announced by the ECB on 10 March. With Italian banks likely to bid aggressively at the upcoming TLTRO II, a further increase of Target2 liabilities via this channel seems more likely than not. Partly offsetting this, we think that most of the adjustment in household portfolios is behind us, also due to both the declining economic outperformance of extra-EMU countries and the end of EUR depreciation.

## 9. Concluding remarks

Overall, we think that the high amount of attention being paid to developments in Target2 liabilities is unwarranted. Rather than tinkering with the symptom, the best way to obtain a durable reduction in Target2 balances is to address their root causes, i.e. the soundness of national banking systems and

structural economic weaknesses. Both of these are not something that can be urged and resolved within a short period of time.

Banks have to continue to apply effort to their adjustment processes, so that market confidence is fully restored and so that, in the medium term, the ECB's provision of money will again be substituted with inflows from the private sector. Completing the banking union and pushing ahead with country-specific structural reforms should remain top priorities at the eurozone and Italian levels.

In the meantime, we are left with a distribution of liquidity that remains uneven across eurozone countries. But this uneven distribution of liquidity is of secondary importance when compared to the counterfactual of no ECB intervention.

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