

TARGET2 balances in the Eurosystem

The TARGET2 balances that have arisen at some Eurosystem national central banks (NCBs) since the onset of the financial crisis have sparked a broad public debate. The discussion has mainly focused on the causes of these balances and the risks associated with them.

TARGET2 is a payment system that enables the speedy and final settlement of national and cross-border payments in central bank money.¹ An average of around 350,000 payments with a value of just under €2½ trillion are processed using TARGET2 each working day,² a figure which is broadly equivalent to the size of Germany's GDP. These payment transactions can take a wide variety of forms, such as payment for a goods delivery, the purchase or sale of a security, the granting or repayment of a loan or the depositing of funds at a bank, among many others. Whenever the banks of a given country are net recipients of central bank money, the national central bank (NCB) in question records a positive TARGET2 balance, as is the case with the Bundesbank. This represents a claim not on another NCB but rather on the European Central Bank (ECB), which acts as a clearing house that settles transactions among NCBs.

Commencing in 2007, larger positive and negative TARGET2 balances have accumulated within the Eurosystem as a result of the financial crisis. Since then, the redistribution of liquidity among credit institutions via the money market has ceased to operate normally owing to mutual mistrust among banks. Another factor is that wholesale funding on the financial markets has become harder and dearer for the banks. Some institutions have effectively been cut off from the market and so are reliant on liquidity assistance from central banks. Ul-

timately, the TARGET2 surpluses and deficits result from disequilibria in the balance of payments of several euro-area countries. This may entail current account deficits or capital exports by the private sector, which are then reflected in liquidity outflows from these countries.

The chart on page 49 gives an overview of the level of TARGET2 claims and liabilities at the end of 2009, 2010 and 2011. Alongside Germany (€463 billion on 31 December 2011), the Netherlands, Luxembourg and Finland all showed net claims in the most recent balance sheet. These claims increased strongly in the course of 2011, particularly in the second half of the year as the financial and sovereign debt crisis grew more acute. Concurrently, Spain and Italy amassed sizeable liabilities, while the deficit recorded by the Irish central bank, for example, declined.³ Viewed in relation to GDP,⁴ Luxembourg (around 260%), Finland (35%) and the Netherlands (25%) posted the largest positive balances, ahead of Germany at 18%. The largest negative balances were recorded by Ireland (77%), Greece (48%) and Cyprus (45%).

Banking systems that receive inflows of central bank money through TARGET2 have a lesser need to seek funding from their domestic central bank. Institutions in Germany have therefore steadily reduced the volume of their refinancing from the Bundesbank

¹ The ECB publishes detailed information on TARGET2 every year in its TARGET Annual Report, the most recent of which can be downloaded from <http://www.ecb.int/pub/pdf/other/targetar2010en.pdf>.

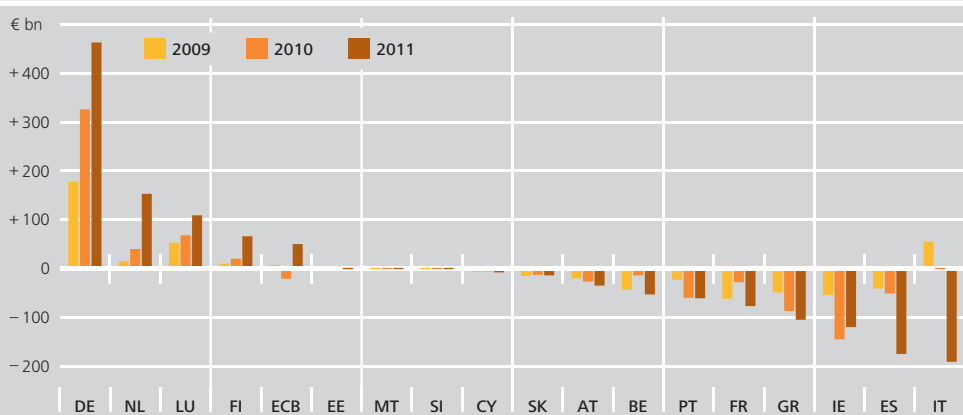
² TARGET2 stands for Trans European Automated Real-time Gross Settlement Express Transfer System. See also the chapter "Cashless payments and securities settlement" in this Annual Report on pp 105-110.

³ The positive balance posted by the ECB at the end of 2011 is largely attributable to claims on the NCBs arising from tender operations denominated in US dollars.

⁴ Source: European Commission.

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Year-end data



Deutsche Bundesbank

and now actually have a large credit balance on their Bundesbank account. Consequently, they are parking excess inflows of central bank money in the Eurosystem's deposit facility or are investing them in Eurosystem liquidity-absorbing operations. This has the effect of extending the Bundesbank's balance sheet. A sale of assets, for example of reserve assets, is not necessary to compensate for the influx of central bank money. Nevertheless, a dysfunctional interbank market featuring institutions that are heavily dependent on central bank financing is not a desirable situation.

TARGET2 cannot be used to create liquidity. Instead, the sole purpose of TARGET2 is to transfer liquidity (ie central bank money) that is already at the disposal of the participating banks. Providing liquidity is one of the key tasks of any central bank. The exact manner in which this is achieved in the euro area is decided by the Governing Council of the ECB as part of its monetary policy mandate. Banks are primarily provided with central bank money through refinancing operations, but also *inter alia* by national central banks acquiring securities portfolios and conducting operations on their own responsibility.

With regard to the risks attached to the Eurosystem's business activities, the debate surrounding TARGET2 balances is in danger of diverting attention from the real challenges. No steps to directly limit TARGET2 balances are envisaged at present. Moreover, any measures that tend to promote a segmentation of the money market or restrict the free movement of capital run counter to the principles upon which monetary union and the single European market rest.

Risks emanate from the operations through which central bank liquidity is created. In order to participate in Eurosystem refinancing operations, the counterparty has to be both solvent and able to post adequate collateral. Losses may potentially arise if the counterparty defaults and the collateral provided by the latter concurrently proves insufficient upon realisation. These losses are customarily borne jointly, dependent on a decision of the ECB Governing Council, by the partner central banks in line with their capital share in the ECB. Such risk-sharing is explicitly ruled out in the case of certain kinds of transactions. These include, for example, the provision of emergency liquidity assistance (ELA). A new provision was introduced by the Governing Council in Decem-

ber 2011 allowing national central banks to accept credit claims as collateral under certain conditions. In this case, too, risk-sharing is ruled out and any potential losses are to be borne solely by the respective national central bank.

The Eurosystem's exposure to risk increased significantly during the financial crisis following its assumption of more and more banking intermediation functions and, in particular, the decision to dilute the collateral standards for monetary policy operations, the build-up of securities portfolios for monetary policy reasons and the granting of ELA by individual countries. Ultimately, monetary policymakers always have to tread a careful path between taking crisis-related measures and seeking to mitigate the risks for central banks. It is not the task of an independent monetary policy to redistribute the solvency risks of banking systems, or indeed of sovereigns, among taxpayers across the euro area. Such risk-taking and decisions pertaining to risk redistribution fall within the remit of fiscal policymakers.

The financial risks that have arisen from the expanded refinancing operations and the purchase of covered bonds and, more especially, of government bonds are also mirrored in the Bundesbank's higher risk provisioning. Furthermore, the Eurosystem's short-term non-standard liquidity policy measures to contain the acute consequences of the financial crisis should not delay, let alone substitute, the necessary adjustment processes in individual countries. Any extraordinary crisis measures initiated by the central banks should therefore be kept within narrow bounds and reversed as soon as possible. This applies irrespectively of the growth of TARGET2 balances.

One hypothetical case under public debate in which parts of the negative TARGET2 balances might be transformed into actual

balance sheet risks could occur if a member state were to exit monetary union. Such a case is unlikely and not provided for in the terms of the Treaty on the Functioning of the European Union. However, should a country with TARGET2 liabilities opt to leave the euro area, any claims the ECB might have on the national central bank of that country would initially persist in the same amount. If the exiting central bank proved unable to repay its liabilities despite loss-offsetting within the Eurosystem and the collateral available, it would be necessary to devise a solution for the outstanding amount. Only if and when a residual claim were deemed unrecoverable would the ECB actually recognise a loss by virtue of writing it off as a bad debt. Compensation for any losses incurred by the ECB would be decided by the NCBs in their capacity as shareholders on the ECB Governing Council, based on a capital majority. Any participation in the ECB's loss would have the effect of reducing the profits of the NCBs and, for example in the case of Germany, reduce the Bundesbank's TARGET2 claims on the ECB. In reality, the Bundesbank expects monetary union to persist in its present form.

The tensions in the financial markets will abate once confidence in the euro-area banking sector as a whole and in individual banks has been restored and those banks that are currently experiencing major liquidity problems have been restructured or disappear from the market. The recapitalisation of solvent banks, if necessary through government assistance, and the winding-up of non-viable institutions are key prerequisites for this. In addition, countries that have forfeited the confidence of the capital markets need to remedy their structural shortcomings and boost their competitiveness with the ultimate aim of improving their public finances and their current account situation and hence of being able to attract private capital once again.