

## The dynamics of the Bundesbank's TARGET2 balance

In 2010, the Bundesbank's cross-border claims, which for statistical purposes include claims on the ECB, rose by €163 billion net as a result of transactions. A substantial part of this – €147½ billion – was attributable to an expansion of the TARGET2 balance. At the end of 2010, the Bundesbank's claims under TARGET2 stood at €325½ billion, all of which are claims on the ECB.

A systematic and exceptionally sharp rise in the Bundesbank's TARGET2 claims first emerged in 2007. During the previous years, Germany's TARGET2 positions had exhibited alternating signs and remained mainly within fairly narrow bounds.

The analysis below explains which transactions are predominantly reflected in the TARGET2 balance and how the observed increase came about. Finally, the associated risks are addressed.

### The TARGET2 system for individual payments

Cross-border payments that arise, say, from foreign trade transactions or from securities or lending transactions with non-residents are normally carried out via the banking system. These transactions are reflected in the corresponding (changes to the) interbank claims or liabilities vis-à-vis the rest of the world. These types of payments can be settled using TARGET2 by EEA commercial banks and Eurosystem

central banks. In addition to payments between credit institutions and from other systems (eg securities settlement systems), payments undertaken as part of the Eurosystem's open market operations are settled via TARGET2.<sup>1</sup>

### Origin of TARGET2 balances

If, for example, foreign funds are transferred to a bank that participates in TARGET2 via the Bundesbank, this results in a liability of the Bundesbank to this bank (such as in the form of a credit to this amount on the bank's current account). In return, the transaction generates a Bundesbank claim for the same sum on the sending central bank. This central bank then in turn debits the account of the originating commercial bank. This requires the originating commercial bank to have a sufficient credit balance in central bank money. Central bank credit balances are primarily provided by the Eurosystem's monetary policy refinancing operations.

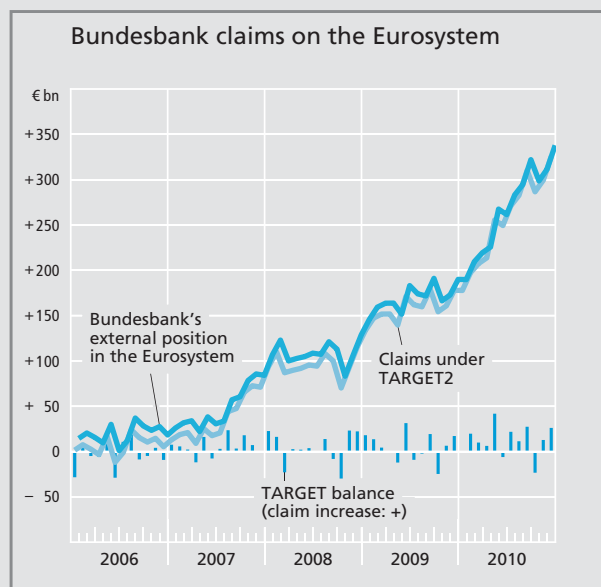
The resulting claims and liabilities generated at the national central banks by the multiple transactions over the course of a day normally do not fully balance out. Under the terms of a Eurosystem agreement, the outstanding claims and liabilities of all the national central banks participating in TARGET2 are transferred to the ECB at the end of the business day, where they are netted out. The resulting TARGET2 (net) balances hence arise from the cross-border distribution of central bank money within the Eurosystem's decentralised structure.

### Statistical implications

The TARGET2 balance in the Bundesbank's balance sheet is therefore mainly attributable to cross-border transactions which involve banks that participate in TARGET2 via the Bundesbank.<sup>2</sup> On the one hand, it is affected by credit institutions' operations on the money and capital markets and, on the other, by transactions carried out by the non-banking sector, which generates payments via the banking system. As the TARGET2 balance represents a settlement balance vis-à-vis the ECB, it is classified as "cross-border" and is therefore assigned to the net external position; the (transaction-related) change is recorded in the balance of payments within other investment under the Bundesbank's short-term external credit balance. For the purposes of the balance of payments, an increase in TARGET2 claims is considered to be a net capital export. Around half of Germany's net capital exports since the start of 2007 are attributable to TARGET2.

From a euro-area perspective, TARGET2 balances largely disappear, just like the national current account balances

eral banks from other EU countries participate in TARGET2 via the Bundesbank in cases where their own national central banks do not participate in TARGET2.



<sup>1</sup> For a detailed account see Deutsche Bundesbank, TARGET2 – the new payment system for Europe, Monthly Report, October 2007, p 69 – 82, and Deutsche Bundesbank, Annual Report 2010, p 129. — 2 Sev-

within the euro area. The claims of the Bundesbank (and other national central banks) on the ECB are offset by the liabilities of other national central banks (see chart below). The ECB's remaining liability-side position was mainly generated through the Securities Markets and Covered Bonds Programme, and to a lesser extent through ECB seigniorage liabilities to the Eurosystem national central banks.

#### Reason for the increase

The sharp rise in the Bundesbank's TARGET2 balance since 2007 is essentially due to the tension on the money market and problems in the banking sector within the euro area. In the years prior to the financial crisis, Germany's cross-border payments were virtually balanced. Credit institutions' (short-term) net external position in particular acted as a kind of "offsetting item" in the balance of payments. As the current account surplus and frequent net capital imports in portfolio transactions meant that incoming payments regularly outweighed outgoing payments, most years saw outflows of funds (net capital exports) in banks' short-term credit business. Hence temporary TARGET2 positions were quickly reduced by private capital flows.

This all changed with the financial crisis. While funds tended to continue to flow into German banks from abroad due to non-bank payments and their own operations, after the onset of the crisis they were less willing, and in some cases unable, to lend these funds to foreign institutions on the interbank market. Instead, they gradually curtailed their refinancing operations with the Bundesbank – at least in the aggregate. Thus whereas the refinancing volume attributable to German institutions amounted to €250 billion at the start of 2007 it had fallen to €103 billion, by the end of 2010. Conversely, since then banks domiciled in a number of other euro-area countries have been receiving larger amounts of central bank money through the Eurosystem.

The TARGET2 balances accumulated at the national central banks thus also reflect the changed distribution in refinancing operations in the euro area since the start of the financial crisis. This has been facilitated by the ample supply of Eurosystem liquidity as a result of the full allotment of all bids in the refinancing operations since October 2008, which was intended to counter the dislocations on the money market. It is, however, not possible to generate more liquidity than this via TARGET2 as it is a closed system that merely transfers liquidity between accounts.

The balances will contract again as the tension in the money markets abates and the situation in the national banking

systems eases. There is still much uncertainty, however, especially in the euro-area peripheral countries, which suggests that balances will not shrink rapidly.

#### Risks from TARGET2 claims

There is no immediate change in the level of risk to the Bundesbank due to the rise in its TARGET2 settlement accounts. This risk is not directly related to the TARGET2 positions and arises from the risks associated with the Eurosystem's liquidity supply. Although the Eurosystem as a whole has indeed incurred additional financial risks by expanding its refinancing operations and adjusting the collateral framework during the financial crisis, this was the result of a deliberate decision of the ECB Governing Council aimed at maintaining the financial system's functional viability in a stress situation.

An actual loss will be incurred only if and when a Eurosystem counterparty defaults and the collateral it posted does not realise the full value of the collateralised refinancing operations despite the risk control measures applied by the Eurosystem. Any actual loss would always be borne by the Eurosystem as a whole, regardless of which national bank records it. The cost of such a loss would be shared among the national banks in line with the capital key. In other words, the Bundesbank's risk position would be just the same if the positive settlement balance from TARGET2 were accrued not by the Bundesbank but instead by another Eurosystem national bank.

