TARGET2 imbalances in the Eurozone[1]

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The Trans-European Automated Real-time Gross Settlement Express Transfer System, or TARGET2, allows financial transactions to be settled between commercial banks located in different euro-area countries via a settlement system between national central banks (NCBs) and the European Central Bank (ECB). Transactions accumulate in net terms, resulting in a balance which is recorded on the balance sheet of each NCB[2].

TARGET2 balances are therefore an accounting representation of the cross-border economic and financial relationships that the free movement of capital in the Euro area entails. In addition to trade in goods and services and portfolio investments, these balances reflect a variety of different types of flows of funds: flows between subsidiaries or branches of the same banking group that participate in TARGET2 via different NCBs, flows resulting from non-standard monetary policy measures, and "technical" flows associated with the location of accounts for the settlement operations of securities.

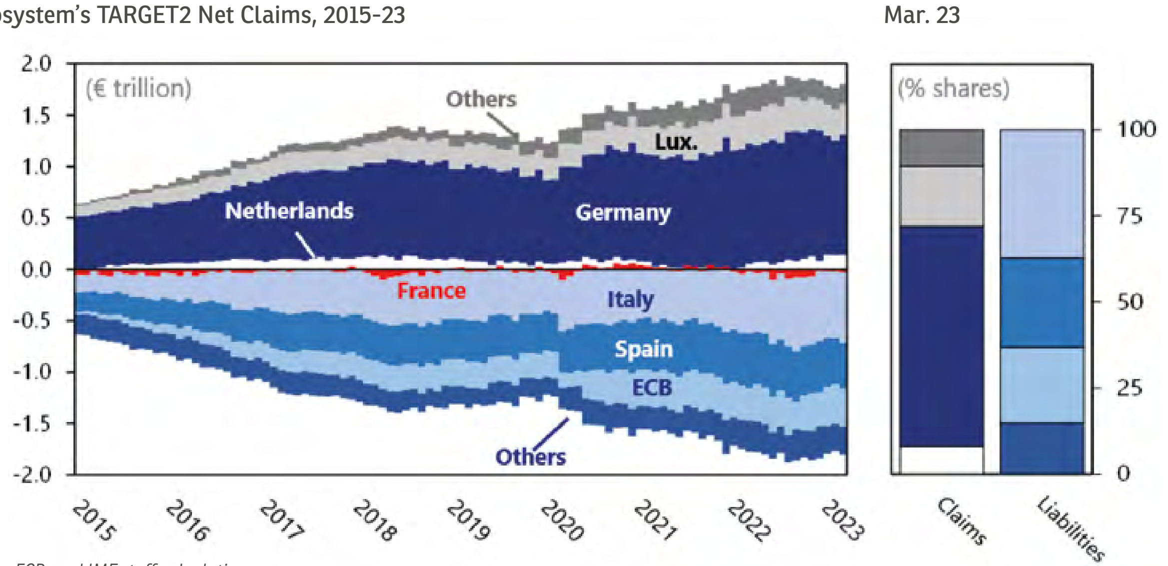
Why is a positive net TARGET2 balance referred to as a claim and a negative balance as a liability?

This has to do with accounting and balance sheets, so to understand this, we must first keep in mind two facts:

- The Euro area has one currency, but because it is made up of multiple countries, there is not one central bank with one balance sheet for the euro. Instead, each central bank in each country has its own balance sheet. TARGET2 has separate central bank components to reflect this.
- When a central bank issues money for the first time, it is recorded on its balance sheet. The money is recorded on the liability side of the balance sheet (as a deposit), while the assets (or claims) corresponding to the money created are recorded on the asset side (for example as a loan).

Back to TARGET2: when money moves between Euro area countries via TARGET2, the central bank of the country receiving the money registers this on its balance sheet as an additional liability. But only the liability moves: the asset stays on the original balance sheet.

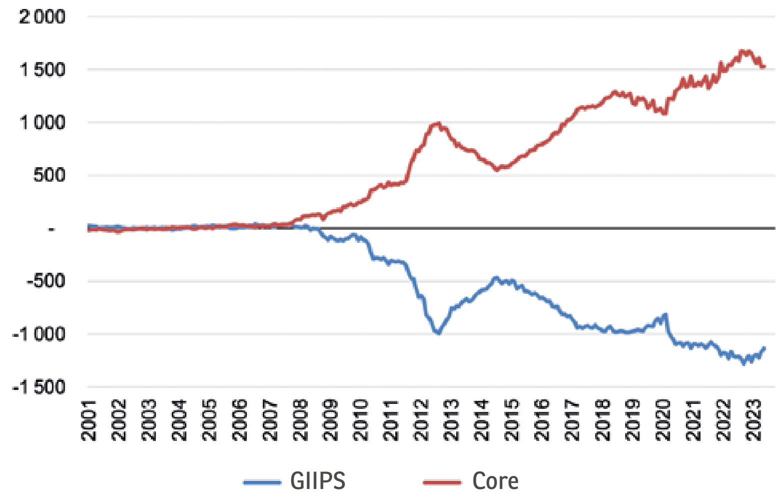
CHART 1.
Eurosystem's TARGET2 Net Claims, 2015-23



Source: ECB: and IMF staff calculations

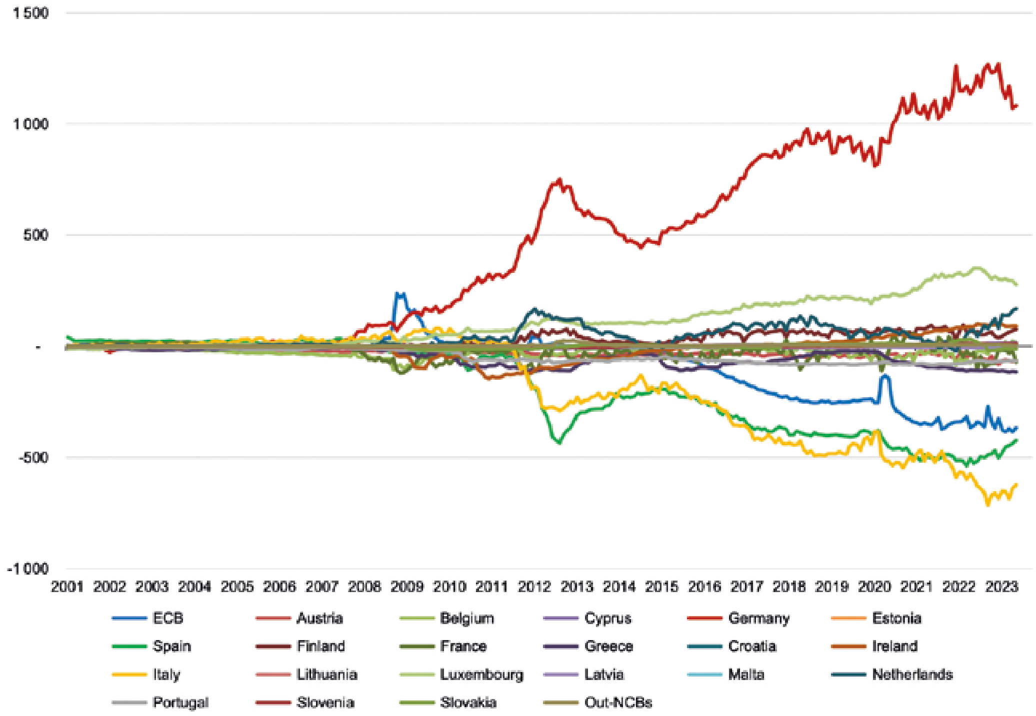
1. This section takes up the conclusions of the note: C. Deubever & Nicolas Toulemond, target 2 imbalances in the euroi area, Tresor Eco, May 2021.
2. TARGET2 ("Trans-European Automated Real-time Gross settlement Express Transfer system 2") is a system that moves money from one bank to another, both within countries and across borders. Central banks and commercial banks use it to process payments in euro and move money safely and easily between them. This is essential for the economy to function. Both central banks and commercial banks have accounts in TARGET2.

CHART 2.
GIIPS's liabilities versus Core's claims, EUR bn



Source: Euro Crisis monitor
GIIPS = Greece, Italy, Ireland, Portugal, Spain;
Core = Germany, Netherlands, Luxembourg
Last observation from May 2023

CHART 3.
Target II imbalances, bn EUR



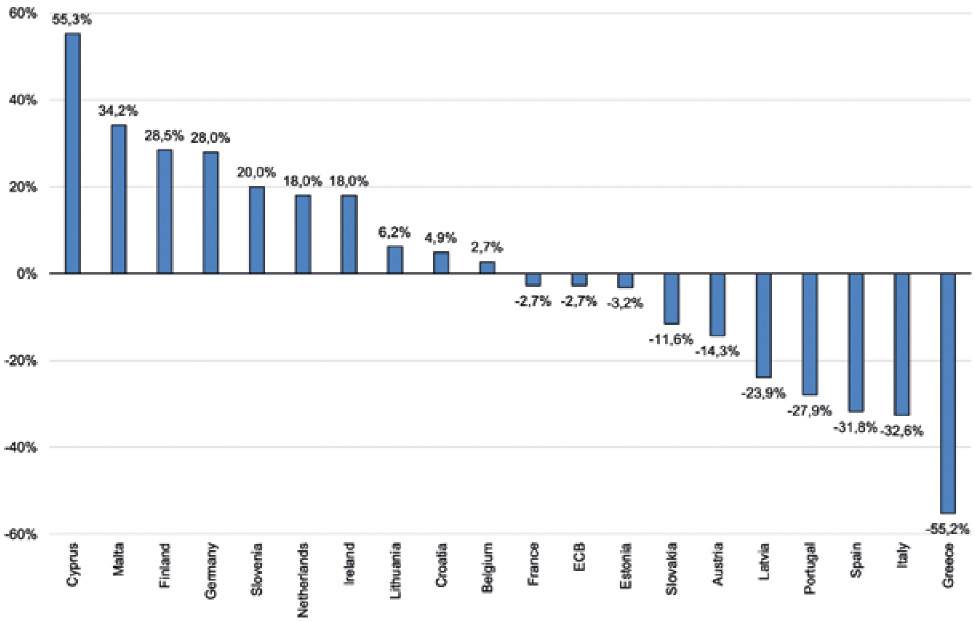
Source: Euro Crisis monitor
Last observation from May 2023

For example, if euros that were originally issued in Italy end up in Germany, from an accounting perspective, the German central bank has an additional liability (the money), while the asset stays with the Italian central bank. This means the balance sheets no longer balance: the German central bank needs to add a balancing item to reflect that there are now more euros on its balance sheet than it originally created, while the Italian central bank needs to add a balancing item to reflect that it has fewer euros on its balance sheet than it originally created. This balancing item – which is called the net TARGET2 balance – is a claim (or asset) for the Bundesbank and a liability for the Banca d'Italia.

Since the euro was created, TARGET2 balances have gone through several distinct phases. Prior to 2008, balances were practically zero: current account imbalances between Euro area countries were settled by means of interbank liquidity transfers.

After the 2008 financial crisis and the 2012 sovereign debt crisis, TARGET2 balances rose dramatically due to tensions on the interbank market and a flight of deposits from "peripheral" countries (Italy, Greece, Spain, Portugal, Ireland) toward "core" countries (Germany, Netherlands, Luxembourg), before gradually going back down. Total TARGET2 national surpluses stood at € 900 bn in mid-2012 and then

CHART 4.
Target II imbalances as of May 2023,% of GDP



Source : Euro Crisis monitor

gradually declined to stabilise at around € 600 bn by the end of 2014.

Since 2015, balances have been picking up again as a result of the ECB's asset purchase programmes. Since the mid-2010s, the main TARGET2-liability countries (in € bn) have been Greece, Ireland, Portugal, Spain and Italy, and the biggest surplus countries have been Germany, the Netherlands, Finland and Luxembourg.

The net TARGET2 liabilities of the Bank of Italy and the Bank of Spain are quite high, standing at respectively € 623 bn and € 422 bn in May 2023 (which represents roughly 32% GDP for the two countries). Conversely, the Bundesbank had a net TARGET2 credit of around € 1.082 bn in May 2023 (roughly 28 -% of Germany's GDP)

Today, balances reflect the legacy of QE bond portfolios and will fall steadily as the ECB reduces its balance sheet.

In January 2017, in a letter to members of the European Parliament, Mario Draghi wrote[3]: "If a country were to leave the Eurosystem, its national central bank's claims on or liabilities to the ECB would need to be settled in full".

According to B. Drut[4], "At least three problems would arise in the event of the exit from the Euro area of countries with significant net TARGET2 liabilities:

1. For several countries (Spain, Italy, Portugal), the TARGET2 liabilities are very large when taken as % of GDP, which implies that the amounts needed to settle the commitments would be colossal,
2. In the event of the exit of the Euro area from a relatively weaker country from an economic point of view, its new currency would probably be weaker, which would further increase the settlement to be made,

Would a country leaving the Eurozone necessarily want to settle all its commitments? We have seen in the case of Brexit that some British politicians were totally opposed to the divorce bill".

In the end, the TARGET2 imbalances (and the potential losses in case of departure from the Eurozone and the non-settlement of the TARGET2 balances) might strengthen the bargaining power of debtor countries in the case of harsh negotiations with core countries.

TARGET2 imbalances should fall as the ECB reduces its asset purchase programs and, more generally, if progress is made on the Banking Union and Capital Markets Union to the extent that cross-border flows will be more north-south than south-north.

3. Letter from Mario Draghi to the members of the European Parliament Marco Valli and Marco Zanni, January 2017.
4. B. Drut, "TARGET2 imbalances, again at the center of attention", CPR, 2018.