Eco FLASH
Group Economic Research
http://economic-research.bnpparibas.com

Flash Research
N°15-17 /// 08 April 2015

Target 2 imbalances: where do they stand?

Clemente De Lucia

- **The ongoing disputes between Greece and its international creditors raise again the question of stability of Greece and the risk of spill-over to other peripheral countries.**
- **Consequently, Target 2 positions are once more under the spotlight.**
- **Although policy makers' actions allowed to stabilize and to slightly decrease target 2 imbalances from the highs of mid-2012, current positions are far from being back to pre-crisis levels.**

Ongoing tensions between Greece and its international creditors brought back under the spotlight the question of its financial stability and of potential consequences on other peripheral countries. Financial markets have started to look again at central banks' Target 2 positions, fearing that their increases are a threat for the stability of the zone. As it has been well described by several economists[1] , the financial and debt crisis was also a balance of payment crisis, during which countries managed to cover their trade imbalances thanks to official flows of capital, measured by Target 2 positions, as private inflows of capital drained.

Some definitions

Target 2 is an integrated platform which registers and manages all cross-border transfers of central bank liquidity between eurozone countries. In particular, it manages operations initiated by commercial banks and/or by bank customers for trade transactions or cross-border capital flows (portfolio investments, direct investments or deposit transfers). Once, for instance, a bank customer decides to transfer deposits from country A to country B, the commercial banks settle these transactions by transferring reserves they hold in their National Central Banks' (NCB) accounts. These current accounts are reported as liabilities for the NCBs. In order to match the change in reserves, a Target 2 claim on country B NCB's balance sheet is automatically generated (it being the country to receive the inflow of capital), while a Target 2 liability is generated on country A NCB's balance sheet (it being the country that originated the outgoing payment. For an in-depth analysis of Target 2, see "At the root of Target 2 imbalances", BNP Paribas Conjoncture, September 2012).

[1] *See among others Merler and Pisany-FerryJ (2012) " Sudden Stops in the Euro Area " Bruege Policy Contrbution N. 06, March*

Target 2 positions

EUR billions

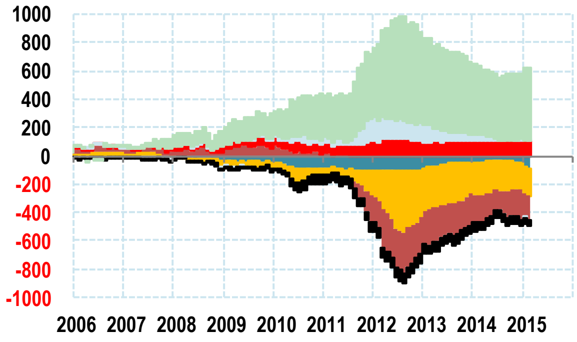

Chart 1 Source: National central banks

Portugal: Flows of capital

Cumulative sum since 1999, EUR, billions

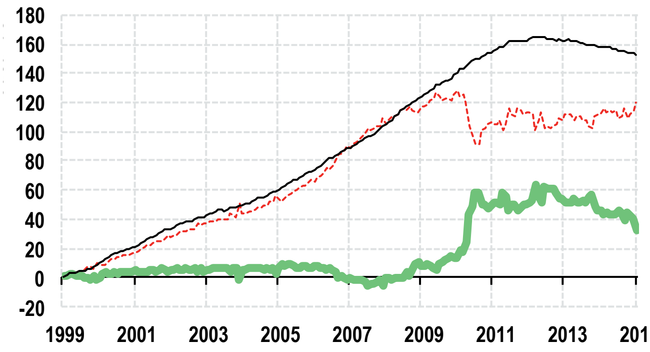

Chart 2 Sources: Datastream, NCB, BNP Paribas

Private flows of capital are the difference between the cumulated financial account balance and the Target 2 balance. Positive figures are net liability positions which represent inflows of capital. Negative figures are net assets positions which account for outflows of capital

As we are dealing with transactions between countries, Target 2 movements are also accounted into the balance of payments, and particularly into the financial account balance (under "other investment" with the sub-category "monetary policy"). Considering a balance of payments approach, Target 2 net positions signal how much current account disequilibria are covered by official flows rather than by private flows of capital[2] . In the rest of the article we define, for the sake of simplicity, private flows of capital as the difference between the cumulated financial account balance and Target 2 positions (see for instance chart 2 for the case of Portugal). Lastly, it is worth remembering that once a flow of capital is recorded as liability it represents an inflow of capital for the country (reported as a positive figures -see again chart 2-) while if recorded as an asset it represents an outflow of capital for the country (negative figures).

Target 2 positions before and during the crisis

Before the crisis net Target 2 positions were almost balanced (see chart 1). In most cases a cross border payment originated for trade purposes, for instance, was followed by a capital flow in the other direction which net out the Target 2 position. In other words, current account imbalances were offset by private flows of capital.

Since the outbreak of the crisis the liability position in the Target 2 balance of peripheral countries rose significantly. This means that peripheral countries, which were running large and mounting current account deficits, needed significant official inflows of capital for compensating the lack of private funding as they suffered from a "sudden stop" of inflows of private capitals. On the same line, lack of confidence in peripheral countries induced investors in core countries to reduce their external exposures. The financial account net asset position of core countries decreased (see chart 3 for the case of Germany), which means that the private outflows of capital from core countries diminished. By contrast, the net asset Target 2 position rose sharply (the outflows of official capitals increased).

Where do we stand now?

Actions taken by governments to address their external and internal imbalances combined with actions aimed at improving eurozone governance halted this process. ECB actions were essential to stop this process. The ECB provided large amounts of liquidity at longer maturity to the peripheral countries (3-y LTROs) at a time when the lack of private funding and the freeze of the money market posed the risks of financial stability of several peripheral countries. In addition, the announcement of the OMT ended the speculation of the reversibility of the euro, helping restoring investors' confidence. These actions have been essential to stop the outflows of private capital from peripheral countries.

Germany: Flows of capital

Cumulative sum since 1999, EUR, billions

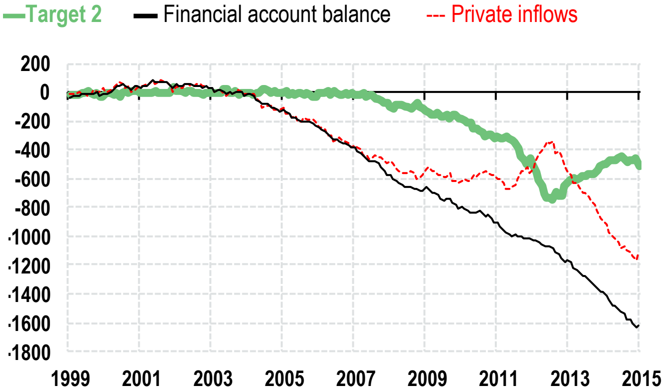

Chart 3 Source: National central banks

Italy: Flows of capital

Cumulative sum since 1999, EUR, billions

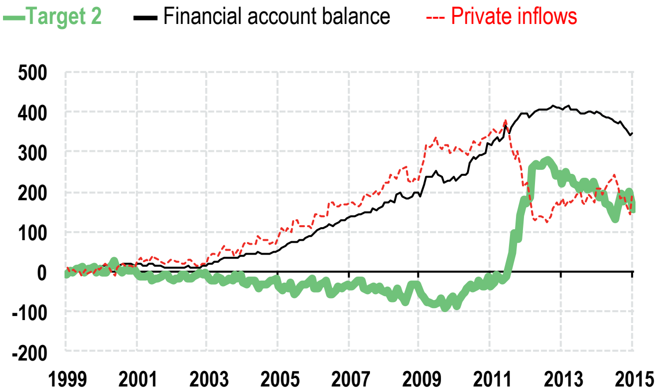

Chart 4 Sources: Datastream, NCB, BNP Paribas

Greece: Flows of capital

Cumulative sum since 1999, EUR, billions

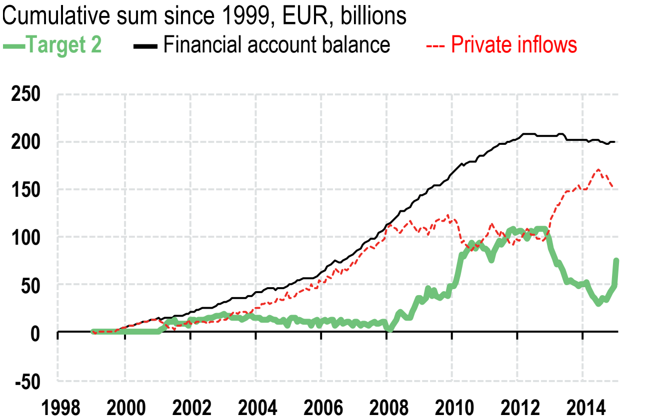

Chart 5 Sources: Datastream, NCB, BNP Paribas

---

[2] *The balance of payment is always in equilibrium. Without taking into account, for simplicity, the capital account and errors and omission, the following identity always holds CA+FAP+T2=0, where CA is the current account balance, FAP is the financial account balance, considering just the private flows of capital, and T2 is the target 2 balance, which accounts for the largest part of official flows. Other official flows are recorded under the category "other investment" with the sub-category "government". This category essentially records official flows of capital related to country programme assistance. For simplicity they are not taken into account in our analysis. FAP is obtained by subtracting the Target 2 balance from the financial account balance*

Yet, while the haemorrhage has been blocked, the eurozone patient has not totally recovered yet. In Portugal, for instance, the cumulative inflows of private capital, after falling sharply in 2010, have just stabilised, without, however, coming back to pre-crisis levels (chart 2). Admittedly, there has been an improvement over recent months, but it is too early to conclude that it is flowing in again. In Italy, after the “sudden stop” of private capital inflows at the end of 2011, conditions have improved, as suggested by the increase of cumulative inflows of private capital and the decrease of Target 2 liability position (see chart 4). Yet, over recent months, this positive process seems to have stopped and even reversed

The situation in Greece is more alarming. After the outflows of private capital between 2010 and 2012, conditions have improved over the last couple of years (chart 5). Yet, since the end of 2014, conditions have changed again; markets are particularly concerned by ongoing disputes between the Greek Government and its international creditors. Between February and December 2014, Greek deposits declined by around EUR 23bn (chart 6). Without an agreement, there is real risk that Greece might run short of liquidity to pay salaries and pensions and might default on its obligations.

The positive exception seems Spain. The “sudden stop” of inflows of private capital has been reversed and the net liability position of Target 2 has been declining (chart 7). Early implementations of labour market reforms, combined with actions to strengthen the banking sector have contributed to restore confidence in financial markets. Those factors are clearly favouring the recovery of the Spanish economy. Admittedly, spare capacities are still large with the unemployment rate at around 23% and GDP, well below its pre-crisis level. Yet, the pace of the recovery is rather impressive with respect to the other peripheral countries.

To sum up, Target 2 imbalances arose as a consequence of the balance of payment crisis which affected several eurozone countries. Lack of confidence and the perceived increase in country risks have prevented many eurozone peripheral countries from financing their trade deficit positions through private inflows of capital. Government actions aimed at addressing internal and external imbalances and actions at the eurozone level, mainly from the ECB, managed to stabilise markets and to eradicate the perceived risk of the reversibility of the euro, restoring some confidence and the flows of private capital towards peripheral countries. Yet, our analysis shows that conditions remain far from normal, with official flows of capital still representing a predominant part of the total flows needed to finance current account disequilibria. Hopefully, the ongoing process of reforms combined with the short-term support from an ultra-accommodative monetary policy stance will contribute to fully restore confidence, bringing the situation back where current account deficit or surplus are essentially matched through flows of private capitals, with official flows remain the exception rather than the rule.

.

Greece : deposit flight

EUR, billions, deposits of households, NFC and financial corporations except MFIs

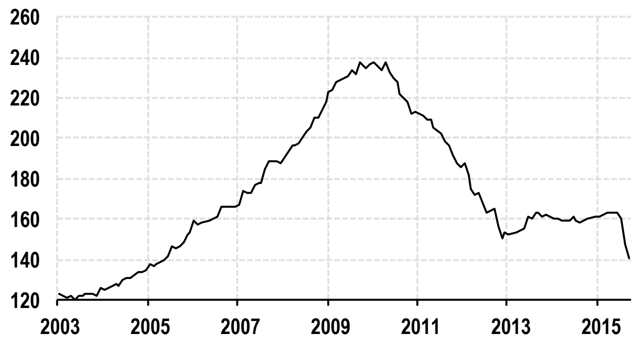

Chart 6 Source: ECB

Spain: Flows of capital

Cumulative sum since 1999, EUR, billions

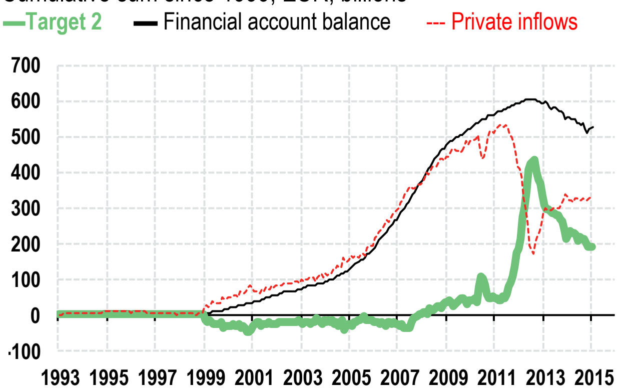

Chart 7 Sources: Datastream, NCB, BNP Paribas

.

Clemente De Lucia
clemente.delucia@bnpparibas.com

GROUP ECONOMIC RESEARCH

William DE VIJLDER Chief Economist	+33.(0)1.55.77.47.31	william.devijlder@bnpparibas.com

OECD COUNTRIES

Jean-Luc PROUTAT Head	+33.(0)1.58.16.73.32	jean-luc.proutat@bnpparibas.com
Alexandra ESTIOT Deputy Head - Globalization, United States, Canada	+33.(0)1.58.16.81.69	alexandra.estiot@bnpparibas.com
Hélène BAUDCHON France, Belgium, Luxembourg	+33.(0)1.58.16.03.63	helene.baudchon@bnpparibas.com
Frédérique CERISIER Public finances - European institutions	+33.(0)1.43.16.95.52	frederique.cerisier@bnpparibas.com
Clemente DE LUCIA Euro area, Italy - Monetary issues - Economic modelling	+33.(0)1.42.98.27.62	clemente.delucia@bnpparibas.com
Thibault MERCIER Spain, Portugal, Greece, Ireland	+33.(0)1.57.43.02.91	thibault.mercier@bnpparibas.com
Caroline NEWHOUSE Germany, Austria - Supervision of publications	+33.(0)1.43.16.95.50	caroline.newhouse@bnpparibas.com
Catherine STEPHAN United Kingdom, Switzerland, Nordic countries - Labour	+33.(0)1.55.77.71.89	catherine.stephan@bnpparibas.com
Raymond VAN DER PUTTEN Japan, Australia, Netherlands – Environment - Pensions	+33.(0)1.42.98.53.99	raymond.vanderputten@bnpparibas.com
Tarik RHARRAB Statistics	+33.(0)1.43.16.95.56	tarik.rharrab@bnpparibas.com

BANKING ECONOMICS

Laurent QUIGNON Head	+33.(0)1.42.98.56.54	laurent.quignon@bnpparibas.com
Delphine CAVALIER	+33.(0)1.43.16.95.41	delphine.cavalier@bnpparibas.com
Céline CHOULET	+33.(0)1.43.16.95.54	celine.choulet@bnpparibas.com
Laurent NAHMIAS	+33.(0)1.42.98.44.24	laurent.nahmias@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISKS

François FAURE Head	+33.(0)1.42.98.79.82	francois.faure@bnpparibas.com
Christine PELTIER Deputy Head - Methodology - China, Vietnam	+33.(0)1.42.98.56.27	christine.peltier@bnpparibas.com
Stéphane ALBY Africa, French-speaking countries	+33.(0)1.42.98.02.04	stephane.alby@bnpparibas.com
Sylvain BELLEFONTAINE Latin America - Methodology, Turkey	+33.(0)1.42.98.26.77	sylvain.bellefontaine@bnpparibas.com
Sara CONFALONIERI Africa - English and Portuguese speaking countries	+33.(0)1.42.98.74.26	sara.confalonieri@bnpparibas.com
Pascal DEVAUX Middle East - Scoring	+33.(0)1.43.16.95.51	pascal.devaux@bnpparibas.com
Anna DORBEC CIE, Hungary, Poland, Czech Republic, Slovakia	+33.(0)1.42.98.48.45	anna.dorbec@bnpparibas.com
Hélène DROUOT Asia	+33.(0)1.42.98.33.00	helene.drouot@bnpparibas.com
Johanna MELKA Asia - Capital flows	+33.(0)1.58.16.05.84	johanna.melka@bnpparibas.com
Michel BERNARDINI Public Relation Officer	+33.(0)1.42.98.05.71	michel.bernardini@bnpparibas.com

OUR PUBLICATIONS

CONJONCTURE
Structural or in the news flow, two issues analysed in depth

EMERGING
Analyses and forecasts for a selection of emerging economies

PERSPECTIVES
Analyses and forecasts for the main countries, emerging or developed

ECOWEEK
Weekly economic news and much more…

ECOFLASH
Data releases, major economic events. Our detailed views…

ECOTV
In this monthly webTV, our economists make sense of economic news

ECOTV WEEK
What is the main event this week? The answer is in your two minutes of economy

To receive our publications, please subscribe on our website. You can read and watch our analyses on EcoNews, our iPad and Android application.

http://economic-research.bnpparibas.com