



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 economists¹, 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

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

Target 2 positions

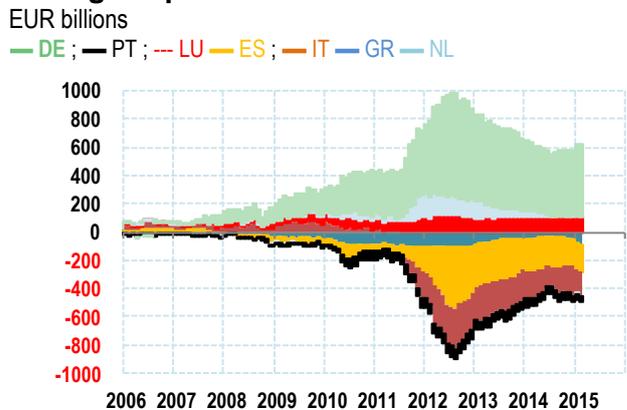


Chart 1

Source: National central banks

Portugal: Flows of capital

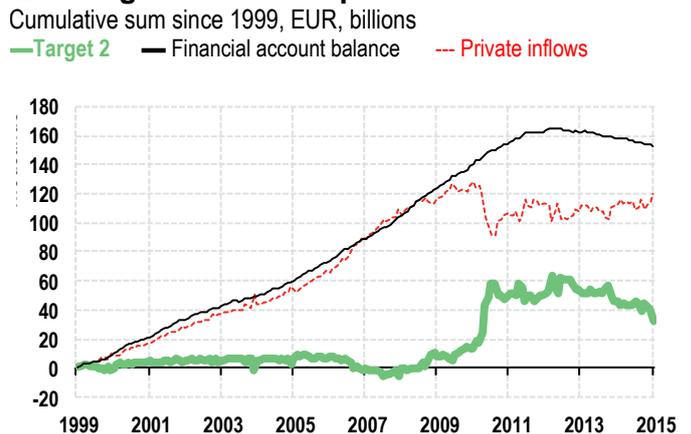


Chart 2

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

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).

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 capital². 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

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

Germany: Flows of capital

Cumulative sum since 1999, EUR, billions

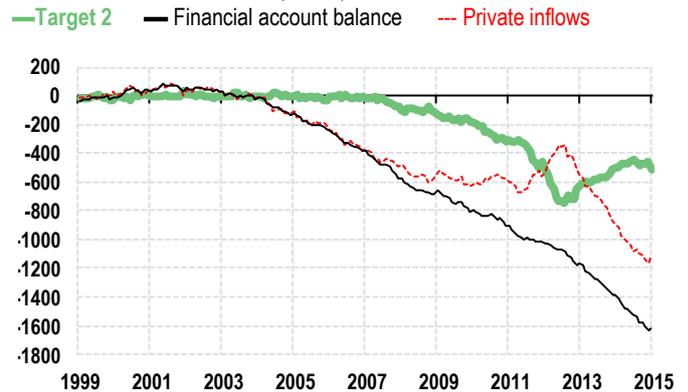


Chart 3

Source: National central banks

Italy: Flows of capital

Cumulative sum since 1999, EUR, billions

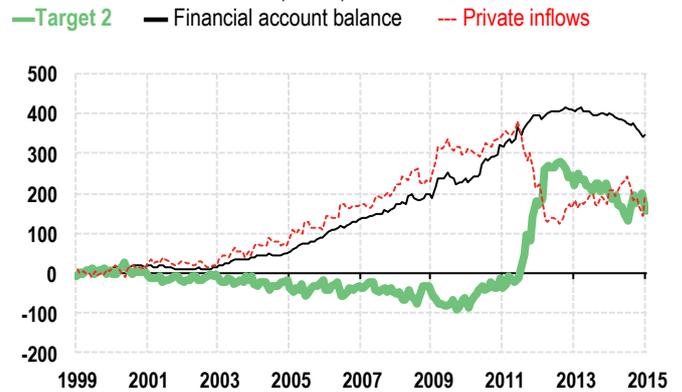


Chart 4

Sources: Datastream, NCB, BNP Paribas

Greece: Flows of capital

Cumulative sum since 1999, EUR, billions

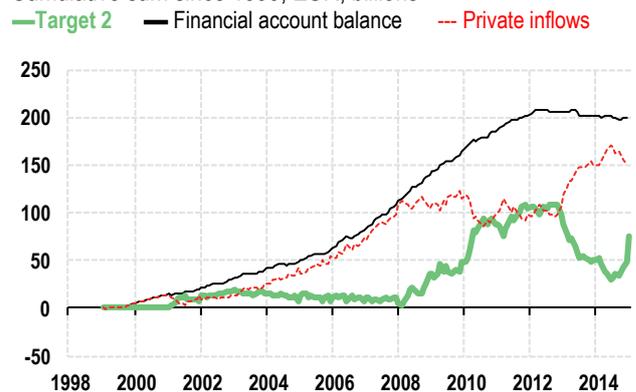


Chart 5

Sources: Datastream, NCB, BNP Paribas

reversibility of the euro, helping restoring investors' confidence. These actions have been essential to stop the outflows of private capital from peripheral countries.



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

— Target 2 — Financial account balance --- Private inflows

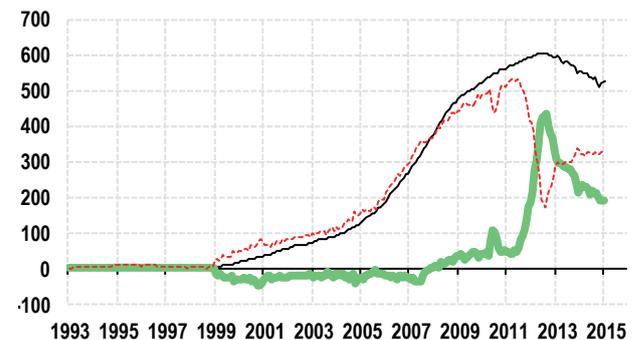


Chart 7

Sources: Datastream, NCB, BNP Paribas

Clemente De Lucia
clemente.delucia@bnpparibas.com



GROUP ECONOMIC RESEARCH

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

OECD COUNTRIES

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

- **Tarik RHARRAB** +33.(0)1.43.16.95.56 tarik.rharrab@bnpparibas.com
Statistics

BANKING ECONOMICS

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

EMERGING ECONOMIES AND COUNTRY RISKS

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

- **Michel BERNARDINI** +33.(0)1.42.98.05.71 michel.bernardini@bnpparibas.com
Public Relation Officer

OUR PUBLICATIONS



CONJUNCTURE
 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...



ECOFASH
 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

The information and opinions contained in this report have been obtained from, or are based on, public sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate, complete or up to date and it should not be relied upon as such. This report does not constitute an offer or solicitation to buy or sell any securities or other investment. Information and opinions contained in the report are published for the assistance of recipients, but are not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient, are subject to change without notice and not intended to provide the sole basis of any evaluation of the instruments discussed herein. Any reference to past performance should not be taken as an indication of future performance. To the fullest extent permitted by law, no BNP Paribas group company accepts any liability whatsoever (including in negligence) for any direct or consequential loss arising from any use of or reliance on material contained in this report. All estimates and opinions included in this report are made as of the date of this report. Unless otherwise indicated in this report there is no intention to update this report. BNP Paribas SA and its affiliates (collectively "BNP Paribas") may make a market in, or may, as principal or agent, buy or sell securities of any issuer or person mentioned in this report or derivatives thereon. BNP Paribas may have a financial interest in any issuer or person mentioned in this report, including a long or short position in their securities and/or options, futures or other derivative instruments based thereon. Prices, yields and other similar information included in this report are included for information purposes. Numerous factors will affect market pricing and there is no certainty that transactions could be executed at these prices. BNP Paribas, including its officers and employees may serve or have served as an officer, director or in an advisory capacity for any person mentioned in this report. BNP Paribas may, from time to time, solicit, perform or have performed investment banking, underwriting or other services (including acting as adviser, manager, underwriter or lender) within the last 12 months for any person referred to in this report. BNP Paribas may be a party to an agreement with any person relating to the production of this report. BNP Paribas, may to the extent permitted by law, have acted upon or used the information contained herein, or the research or analysis on which it was based, before its publication. BNP Paribas may receive or intend to seek compensation for investment banking services in the next three months from or in relation to any person mentioned in this report. Any person mentioned in this report may have been provided with sections of this report prior to its publication in order to verify its factual accuracy.

BNP Paribas is incorporated in France with limited liability. Registered Office 16 Boulevard des Italiens, 75009 Paris. This report was produced by a BNP Paribas group company. This report is for the use of intended recipients and may not be reproduced (in whole or in part) or delivered or transmitted to any other person without the prior written consent of BNP Paribas. By accepting this document you agree to be bound by the foregoing limitations.

Certain countries within the European Economic Area:

This report is solely prepared for professional clients. It is not intended for retail clients and should not be passed on to any such persons. This report has been approved for publication in the United Kingdom by BNP Paribas London Branch. BNP Paribas London Branch is authorised and supervised by the Autorité de Contrôle Prudentiel and authorised and subject to limited regulation by the Financial Services Authority. Details of the extent of our authorisation and regulation by the Financial Services Authority are available from us on request.

This report has been approved for publication in France by BNP Paribas SA, incorporated in France with Limited Liability and is authorised by the Autorité de Contrôle Prudentiel (ACP) and regulated by the Autorité des Marchés Financiers (AMF) whose head office is 16, boulevard des Italiens 75009 Paris, France.

This report is being distributed in Germany either by BNP Paribas London Branch or by BNP Paribas Niederlassung Frankfurt am Main, a branch of BNP Paribas S.A. whose head office is in Paris, France. BNP Paribas S.A. – Niederlassung Frankfurt am Main, Europa Allee 12, 60327 Frankfurt is authorised and supervised by the Autorité de Contrôle Prudentiel and it is authorised and subject to limited regulation by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

United States: This report is being distributed to US persons by BNP Paribas Securities Corp., or by a subsidiary or affiliate of BNP Paribas that is not registered as a US broker-dealer to US major institutional investors only. BNP Paribas Securities Corp., a subsidiary of BNP Paribas, is a broker-dealer registered with the U.S. Securities and Exchange Commission and a member of the Financial Industry Regulatory Authority and other principal exchanges. BNP Paribas Securities Corp. accepts responsibility for the content of a report prepared by another non-U.S. affiliate only when distributed to U.S. persons by BNP Paribas Securities Corp.

Japan: This report is being distributed to Japanese based firms by BNP Paribas Securities (Japan) Limited or by a subsidiary or affiliate of BNP Paribas not registered as a financial instruments firm in Japan, to certain financial institutions defined by article 17-3, item 1 of the Financial Instruments and Exchange Law Enforcement Order. BNP Paribas Securities (Japan) Limited is a financial instruments firm registered according to the Financial Instruments and Exchange Law of Japan and a member of the Japan Securities Dealers Association and the Financial Futures Association of Japan. BNP Paribas Securities (Japan) Limited accepts responsibility for the content of a report prepared by another non-Japan affiliate only when distributed to Japanese based firms by BNP Paribas Securities (Japan) Limited. Some of the foreign securities stated on this report are not disclosed according to the Financial Instruments and Exchange Law of Japan.

Hong Kong: This report is being distributed in Hong Kong by BNP Paribas Hong Kong Branch, a branch of BNP Paribas whose head office is in Paris, France. BNP Paribas Hong Kong Branch is registered as a Licensed Bank under the Banking Ordinance and regulated by the Hong Kong Monetary Authority. BNP Paribas Hong Kong Branch is also a Registered Institution regulated by the Securities and Futures Commission for the conduct of Regulated Activity Types 1, 4 and 6 under the Securities and Futures Ordinance.

Some or all the information reported in this document may already have been published on <https://globalmarkets.bnpparibas.com>

© BNP Paribas (2015). All rights reserved.

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>

