BRIEFING

MONETARY DIALOGUE - November 2017

ECONOMIC AND MONETARY AFFAIRS

TARGET (IM)BALANCES AT RECORD LEVEL: SHOULD WE WORRY?

BACKGROUND

TARGET balances are the claims and liabilities of euro area national central banks (NCBs) with the ECB. TARGET balances add up to zero but the sum of the absolute value of these balances has grown substantially since 2008. The levels of TARGET balances within the Eurosystem has never been so high. In September 2017, Germany's positive TARGET balance equalled €879 billion, which is over 25 percent of current German GDP. Luxembourg, Netherlands and Finland have also built up large claims relative to their levels of GDP. On the other side, Italy (€432 billion) and Spain (€373 billion) have built up large negative balances. The ECB itself had a negative TARGET balance of €215 billion in September 2017.

INSIDE

This leaflet provides a background and abstracts of relevant studies prepared by the European Parliament's Policy Department A on Economic and Scientific Policy

Contact us:
poldep-economy-science@ep.europa.eu

There are different factors determining the evolution of TARGET-related balances. The ECB has argued that the recent build-up in TARGET balances are essentially a mechanical by-product of the Eurosystem's purchases of sovereign bonds from foreign investors. This is partially true but there is also evidence that portfolio rebalancing by Spanish and Italian banks and investors (which has seen them sell domestic sovereign bonds to the Eurosystem and reallocate their money into foreign assets) has also played an important role.

For the November 2017 session of the Monetary Dialogue, the Committee on Economic and Monetary Affairs (ECON) of the European Parliament has asked monetary experts to analyse underlying factors underlying the rise of TARGET imbalances and associated risks for the conduct of monetary policy. The publications are prepared by the Policy Department A of the European Parliament and are available in the relevant section (**Monetary Dialogue**) of ECON internet website.

IN-DEPTH ANALYSES

In-Depth Analysis on 'TARGET imbalances at record levels: Should we worry?' by Daniel GROS (CEPS)

The imbalances within the Eurosystem's TARGET2 (the successor of TARGET) payment system are an indication that financial markets are not fully integrated. However, the increase in these imbalances in the wake of the large asset purchases (quantitative easing or QE) that started in early 2015, should not be a particular cause for concern.

The imbalances had declined until the start of QE, accompanied by a reduction in risk premia. QE was associated with a further reduction in financial stress. There is thus little reason to believe that the increase since 2015 reflects renewed fears about a euro break-up.

The 'technical' nature of the increasing imbalances in the wake of QE is illustrated by the fact that the ECB (the central institution of the Eurosystem) has also run up a negative Target balance of over EUR 200 billion. No one would argue that this is motivated by a fear of a break-up of the euro area. There are reasons to believe that the recent run-up in the negative balances of Italy and Spain is due to similarly technical reasons.

In-Depth Analysis on 'Should we be concerned about TARGET balances?' by Karl WHELAN (University College Dublin)

The paper describes how the Eurosystem's processing of cross-border banking transactions via its TARGET2 payments system produces a set of assets and liability items on the balance sheets of NCBs. The factors determining the evolution of TARGET2-related balances are discussed and the risks associated with these balances are addressed.

In-Depth Analysis on 'TARGET (im)balances at record level: Should we worry?' by Salomon FIEDLER, Stefan KOOTHS, Ulrich STOLZENBURG (Kiel Institute for the World Economy)

TARGET2 balances have re-increased since late 2014 in parallel with the extraordinary monetary policy measures. At first glance, the ECB's asset purchasing programme seems to contribute just mechanically to a widening of TARGET2 positions. However, excessive liquidity provision reduces the role of cross-border interbank markets, which could otherwise reduce TARGET2 imbalances. Also, other factors like heterogeneous country risk may also continue to play a role, but are concealed in the current monetary policy environment. After categorising the root causes of TARGET2 imbalances (current account financing, capital flight, or deposit flight) and the associated risks, the paper discusses possible reforms that would prevent the build-up of large TARGET2 imbalances.

In-Depth Analysis on 'TARGET (im)balances at record level: Should we worry?' by Paul DE GRAUWE (LSE), Yuemei JI (University College London and LSE), Corrado MACCHIARELLI (LSE and Brunel University London)

According to the ECB, the recent rise in TARGET2 balances could be seen as the result of the decentralised implementation of the extended APP. The programme entails cross-border payments by the purchasing NCBs, with around 50% of involved counterparties resident outside the euro area, including the UK. These counterparties access the TARGET2 system via a limited number of financial centres, particularly Germany and, to a lesser extent, the Netherlands.

The ECB is of the view that the increase in TARGET2 balances stemming from the concentration of cross border flows due to APP transactions would reflect technical features of the euro area financial structure rather than evidence of financial stress. However, these imbalances recently may be well indicative of a persistent fragmentation within the euro area's financial markets as well as uneven liquidity allocation the risks of which may be understated. Against this background, the paper discusses what the underlying factors behind the recent rise of TARGET2 (im)balances are and the risks associated to rising TARGET2 (im)balances for the ECB's monetary policy.

In-Depth Analysis on 'TARGET (im)balances at record level: Should we worry?' by Andrew HUGHES HALLETT (Copenhagen Business School)

TARGET is the payments system for making settlements between euro area economies and five other EU economies. Cross-border transactions generate claims/surpluses and liabilities/deficits among national central banks which "net out" for the system as a whole. These imbalances are manageable in relative terms, but look large in absolute terms. None are larger than one third of their corresponding public debt ratios and despite a big build up in the 2010-13 period, the imbalances now appear to be on a non-expanding cyclical path.

The implications for the EU economies and their policymakers are less easy. The main drivers, beyond the need to fund persistent current account deficits or surpluses, are the use of different funding sources (some outside the euro area), internal and external portfolio re-balancing, loose monetary policy and exchange rate risks. TARGET imbalances support quantitative easing, but are not driven by it. The main threats are the divergence that interrupts further economic integration and the increasing liabilities taken on by the ECB since 2015. That said, self-correcting mechanisms are weak which makes symmetric adjustments by both creditor and debtor countries essential (because of the adding up constraint); and the difficulty that the imbalances cannot always be eliminated simply by balancing current accounts around the system.

ADDITIONAL PUBLICATIONS ON MONETARY POLICY

September 2017:

1. The single monetary policy and its decentralised implementation: An assessment – **Individual notes**
2. The corporate sector purchase programme (CSPP): Challenges and future prospects – **Individual notes**

May 2017:

3. Financial innovation and monetary policy: Challenges and prospects – **Individual notes**
4. Rising long-term interest rates: Is the European bond market overshooting? – **Individual notes**

February 2017:

5. Extending QE: Are there additional risks for financial stability? – **Compilation of notes**
6. Side effects of non-standard monetary policy: How long is the short-run? – **Compilation of notes**

November 2016:

1. An assessment of the impact of Brexit on euro area stability - **Compilation of notes**
2. How do low and negative interest rates affect banks' activity and profitability in the euro area? - **Compilation of notes**
3. Transmission channels of unconventional monetary policy in the euro area: Where do we stand? - **Compilation of notes**

September 2016:

1. Ultra-low/Negative yields on euro-area long-term bonds: reasons and implications for monetary policy - **Compilation of notes**
2. Financial market fragmentation in the euro area: state of play - **Compilation of notes**

June 2016:

1. Why has ECB's very accommodative monetary policy not yet triggered a rebound of investment? – **Compilation of notes**
2. Effectiveness of the ECB programme of asset purchases: where do we stand? – **Compilation of notes**

POLICY DEPARTMENTS

The five policy departments are responsible for providing - both in-house and external - high-level independent expertise, analysis and policy advice at the request of committees and other parliamentary bodies. They are closely involved in the work of committees which they support in shaping legislation on and exercising democratic scrutiny over EU policies. Policy departments deliver policy analysis in a wide variety of formats, ranging from studies and in-depth analyses to briefings and the Fact Sheets on the EU. This written output serves a variety of purposes by feeding directly into the legislative work of a specific committee or serving as a briefing for delegations of members.

CONTACTS

Policy Department A: Economic and Scientific Policy
ECON - ENVI - EMPL - IMCO - ITRE - PANA
poldep-economy-science@ep.europa.eu

MONTHLY HIGHLIGHTS

The *Monthly highlights* provide an overview, at a glance, of the on-going work of the policy departments, including a selection of the latest and forthcoming publications, and a list of future events. To receive this publication send an email to:
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SUPPORTING ANALYSES

Access all Studies, In-depth analyses, Briefings and At a glance notes produced by the Policy Departments.

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