

BALANCES IN THE TARGET2 PAYMENTS SYSTEM – A PROBLEM?

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The public debate over Target2 balances suffers from numerous misunderstandings and wrong conclusions. Because the Target2 balances are seen as the core of a problem and not as an accidental symptom, it obstructs the view of the true challenges for monetary and fiscal policy in order to solve the financial and debt crises. This realisation is the prerequisite, however, for setting the debate on the Target2 balances right again.

Target2¹ is a platform for the payments system that is jointly run by the central banks of the Eurosystem. Payments in central bank money are settled ultimately and in real time. They are primarily payments between banks, payments between banks and ancillary systems (e.g. security settlement systems, mass payments systems) as well as payments as part of open market operations of the Eurosystem. Overall (as of 15 July 2011) 190 entities are participating *via* the Bundesbank in Target2.² These direct participants include, in addition to German banks, German subsidiaries of foreign banks as well as some third country banks whose national central banks are not themselves participating in Target2. In 2010 about 45 million transactions with a total value of around 214 trillion euros were processed by the German Target2 component. Thus, Target2-Bundesbank is the biggest component of the common platform in terms of units (about half of all transactions) as in terms of volume

(with a share of more than a third). About one quarter of all transfers were cross-border in 2010.

The so-called Target2 balances of the national central banks reflect cross-border transactions. On the one hand they are based on transactions of the banks in the money and capital market. On the other hand they may be traced to transfers of the non-bank sector that are carried out by banks. A positive balance at a national central bank means the inflow of central bank money to the respective banking system, whereas a negative balance correspondingly implies an outflow. This can occur when a country's banking system obtains more refinancing at its central bank than corresponds to its calculated liquidity needs (for example for meeting its reserve requirement and for cash). This is the case, for example, if a cross-border payment of a merchandise shipment is not offset by a return flow of capital from abroad.³ The settlement balances against the European Central Bank (ECB), which functions as the central counterparty, generated in the course of the day by cross-border transactions between the participating national central banks are netted at the end of each business day. The Target2 claims balance against the ECB, accumulated by the Bundesbank before 31 July 2011, amounted to roughly 343 billion euros.⁴

Target2 payments are made in central bank money. An additional procurement of liquidity *via* Target2 is not possible. In the Eurosystem, central bank money is primarily provided by monetary refinancing operations that are subject to uniform rules in every country. Risks from these operations are principally distributed among the national central banks according to their respective share in the capital of the ECB, regardless of which national central bank has conducted a monetary refinancing operation. To this extent, the Target2 balances of a national central bank are not an appropriate indicator of its actual risk position resulting from the supply of central bank money. For the Bundesbank a positive Target2 balance represents no other risk than a



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¹ Target2 stands for Trans-European Automated Real-time Gross Settlement Express Transfer System 2.

² A total of about 4,500 institutes participate directly or indirectly in Target2. If branches and subsidiaries of the direct and indirect participants as well as correspondent banks are included, around 60,000 banks worldwide may be reached *via* Target2 (European Central Bank 2011).

³ A detailed presentation of the process with the help of stylised accounts and a discussion of possible causes for the generation of settlement balances in Target2 is given by Bindseil and König (2011).

⁴ On the development of the Target2 balance, see Deutsche Bundesbank (2011).

positive Target2 balance of the Banque de France. Target2 balances depend largely on the distribution of the bank-treasury activities in the euro area. Thus, a foreign bank could get the needed central bank credit also *via* its legally independent subsidiary or a branch in Germany that then passes these funds to the parent office *via* Target2. This transaction would *ceteris paribus* lower the Target2 balance of the Bundesbank. The risk borne jointly by the Eurosystem would remain unchanged compared to a direct refinancing at with the central bank of the parent institution. This also becomes clear from another vantage point: if the provision of central bank money in the Eurosystem were done centrally by the ECB, there would in principle be no national Target2 balances. Countries/regions of the monetary union with deficits in their payment transaction would increasingly take up refinancing credits at the ECB; other countries/regions would take up less. In the final analysis, Target2 claims against the ECB are generated because of the decentralised construction of the Eurosystem; the absolute size is limited by the total amount of the central bank money supplied.

It is wrong, therefore, to assume that original risks of the national central banks in the Eurosystem result from Target2 balances. It is, however, correct that the development of the Target2 balances since the start of the financial crisis in mid-2007 has revealed problems in the European banking and financial system. In the crisis, the Eurosystem consciously assumed a larger intermediation function in view of the massive disruptions in the interbank market by extending its liquidity control instruments. With this greater role in the provision of central bank money – essentially by changing to a full allotment procedure in refinancing operations and the extension of longer-term refinancing operations – the total volume of refinancing credits provided has increased (temporarily even markedly). At the same time, the quality requirements for the underlying collateral were reduced in the crisis. The higher risk was accepted in order to maintain the functioning of the financial system under more difficult conditions.

The need for additional liquidity has occurred especially in the periphery countries, whose banks in order to refinance have been relying to an ever increasing extent on the central banks there, as they can obtain no or hardly any funds in the capital market. Thus, banks from the countries most affected by the sovereign debt crisis (Greece, Ireland and Portugal) now account for about half of the entire refinancing volume of the Eurosystem. Shifts in regional demand for

central bank liquidity have significantly contributed to the generation of Target2 balances. In the course of this development, the overall risk of the monetary refinancing operations has risen markedly for the Eurosystem. To a certain extent this was the unavoidable consequence of responding to the crisis. The generally accepted role of the central banks as lender of last resort for the banking system must remain temporary, however. In a monetary union, the risks can be distributed widely to the taxpayers of the member countries *via* the balance sheet of the central bank. Since it cannot be the responsibility of an independent monetary policy to redistribute the solvency risks of banking systems or even countries to the taxpayers of the monetary union, high demands are placed, as a matter of principle, on the collateral. Banks that are cut off permanently from the capital market and are therefore potentially confronted by solvency rather than liquidity problems should not be financed primarily *via* central bank credit in the medium to long term. Such risk assumptions and decisions on their distribution are the responsibility of the democratically legitimised political institutions. The central banks should thus keep extraordinary crisis measures within strict bounds and then quickly reduce them. This applies regardless of the development of Target2 balances.

The public discussion has identified other problems associated with the rising Target2 balances. It is feared, for example, that the shift in the refinancing behaviour has crowded out investment in Germany. German banks have indeed reduced Eurosystem refinancing, as funds flowed in from abroad and because they were able to obtain liquidity at favourable terms in the interbank market. Consequently, the share of German banks involved in the refinancing operations of the Eurosystem, which amounted to about 250 billion euros in early 2007 – more than half of the total volume – most recently declined to about one tenth. However, this decline of the refinancing volume was – no least due to the full allotment policy of the Eurosystem – a *voluntary decision* of the German banks. As a consequence of the liquidity inflow from abroad, the German banks – given corresponding demand – were able to do more lending. This mechanism has thus not led to a crowding out of domestic investment. A possible ‘resource competition’ does not exist either in real economic terms or with respect to the central banks. As long as banks in the core countries have central-bank eligible collateral, their refinancing possibilities via the central bank are not constrained.

Furthermore, some argue that a continuation of recent developments would inhibit monetary policy, as the surplus liquidity at individual banks in core countries, especially in Germany, would impair the Eurosystem's interest-rate control. These fears are not convincing. If liquidity is plentiful, the deposit facility puts a floor on the lending interest rates of the commercial banks. For the commercial banks the interest rate of the deposit facility constitutes opportunity costs for any other form of deposit and lending. If the key interest rate is raised – as a rule the interest rates of the deposit facility are raised by the same amount – the opportunity costs of the commercial banks also rise. Consequently, a plentiful supply of liquidity cannot in itself disrupt monetary policy transmission. The empirical finding concerning the interest rate pass-through, also in a crisis, confirms that in this respect there has not been a structural change in the euro area. Beyond this, the Eurosystem can withdraw liquidity from the market at any time by absorbing operations (e.g. repurchase operations) if the abundant surplus liquidity of the commercial banks in the core countries is likely to jeopardise price stability. Reliance on gold and foreign exchange reserves considered necessary by some critics of Target2 balances (Sinn and Wollmershäuser 2011) is not necessary. Decisive for the monetary policy of the Eurosystem are basically not the Target2 balances but the total supply of liquidity – no matter which national central bank is the primary provider. A differentiation between central bank money that is created by a central bank of the Eurosystem in refinancing operations with domestic banks and that which is supplied in other countries and flows to the banks *via* Target2 is irrelevant in a monetary union. A euro is a euro, independent of which of the national central banks puts it into circulation.

Finally, there is the argument that the current account deficits of the peripheral countries were and are financed by Target2 balances. In fact, the relationship, purely based on the mechanism of net balances between the current account balances on the one hand and Target2 positions on the other, which has been observed lately, may have led to the conclusion that by accepting Target2 balances the Eurosystem made current account disequilibria all too easy. This accusation is not justified, however. It is true that in a monetary union diverging current account balances may be generated and that these were generated after the establishment of the European Monetary Union (EMU). In a common financial market with a common currency they can be financed more easily *via* private capital

movements. In this respect, a monetary union may also facilitate the maintenance of such disequilibria if no adequate pricing of risks takes place with the provision of capital and credit. A direct financing of current account deficits by the central banks has not occurred and will not take place in the future. This is also shown by Bindseil and König (2011) as well as Buiter *et al.* (2011), by comparing current account balances and changes in Target2 positions of individual countries over time. The example of Ireland, whose current account turned from a large deficit into a surplus, also confirms that this need not be accompanied by a corresponding reduction of Target2 balances; the Irish negative balances even rose sharply during this period. This makes clear that the problems with the Target2 balances lie primarily in the banking systems of the peripheral countries of the EMU. It is the voluminous supply of liquidity by the Eurosystem that supports the banking systems with limited access to market financing. This prevents extremely short-term adjustment processes, not least also of current account deficits, and instead allows for a somewhat extended but orderly process of the necessary adjustments in the peripheral countries. Such a gradual adjustment without serious distortions in the financial systems of these and potentially also other countries can keep the total economic costs markedly lower. This does not mean, however, that the correction of the disequilibria can be avoided or should be postponed.

A more accurate look at the relationships and backgrounds of the Target2 balances has thus shown that the idea of a direct limitation or the demand for a regular settlement of the Target2 balances is not appropriate. This applies also to proposals for Europe to adopt the annual settlement of the Interdistrict Settlement Accounts (ISA) of the US Federal Reserve System (see Board of Governors of the Federal Reserve System 2010). They fail to recognise the form and purpose of the US settlement system: the settlement that is practiced – as a rule only partly – in the Fed system is done with securities received by the regional Federal Reserve banks from open market operations of the system. A limitation of the balances or a constraint of payment transactions among the districts has never been intended. The mechanism is not capable of eliminating disequilibria among the districts or preventing them permanently. It only serves to exchange non-interest bearing ISA balances into interest-bearing positions. In contrast, the Target2 balances in the Eurosystem *a priori* bear interest at the marginal allotment rate for main refinancing operations, due to the present full allotment

currently at the minimum bid rate. This is based on the view that such assets in the central bank balance sheet should in principle bear appropriate interest rates. As the interest rates on Target2 settlement balances enter the profit distribution of the Eurosystem in the end, no additional interest income is generated for the participating national central banks.

A decline of Target2 balances is expected as soon as foreign banks no longer seek or are able to procure excessive liquidity from the Eurosystem and the liquidity then is indirectly distributed throughout the system. This should happen as soon as the tensions abate in the financial markets and not least the euro-inter-bank money market has regained its full functionality so that the liquidity balancing among commercial banks (also international) will function once again. This would require that the confidence in the banking sector in the euro area and in the individual banks is restored and the problem banks are rehabilitated or exit the market. For the Eurosystem it is decisive in this context that the corresponding responsibilities between monetary policy and fiscal policy are preserved. In concrete terms this means that the short-term special liquidity measures of the Eurosystem aimed at containing the acute crisis-like developments must not delay the necessary restructuring process or even replace it. For this reason alone a timely reduction of the special measures is a must.

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