ALPHAVILLE

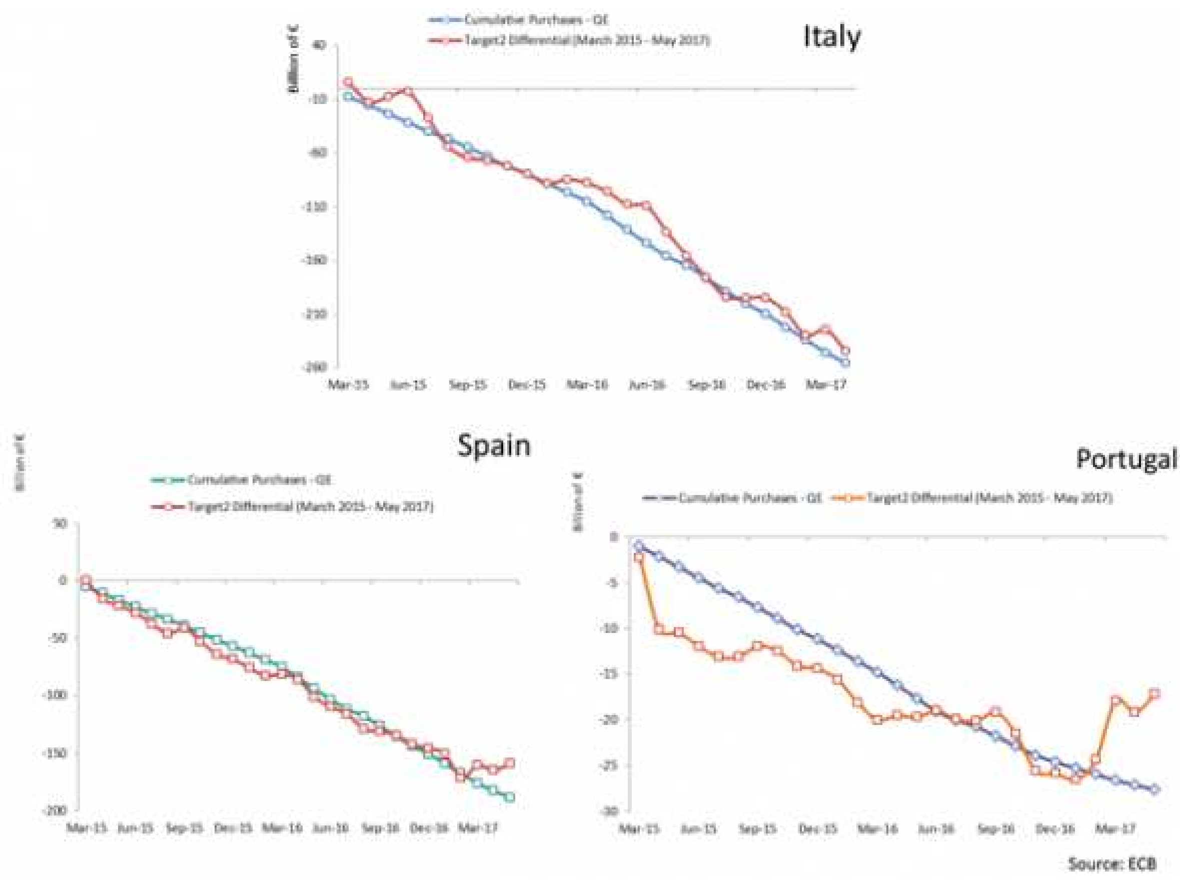
The ECB’s story on Target2 doesn’t add up

The following guest post on Target2 imbalances and capital flows is from Marcello Minenna, the head of Quantitative Analysis and Financial Innovation at Consob, the Italian securities regulator. The views expressed here are his personal opinions and do not necessarily reflect the views of Consob.

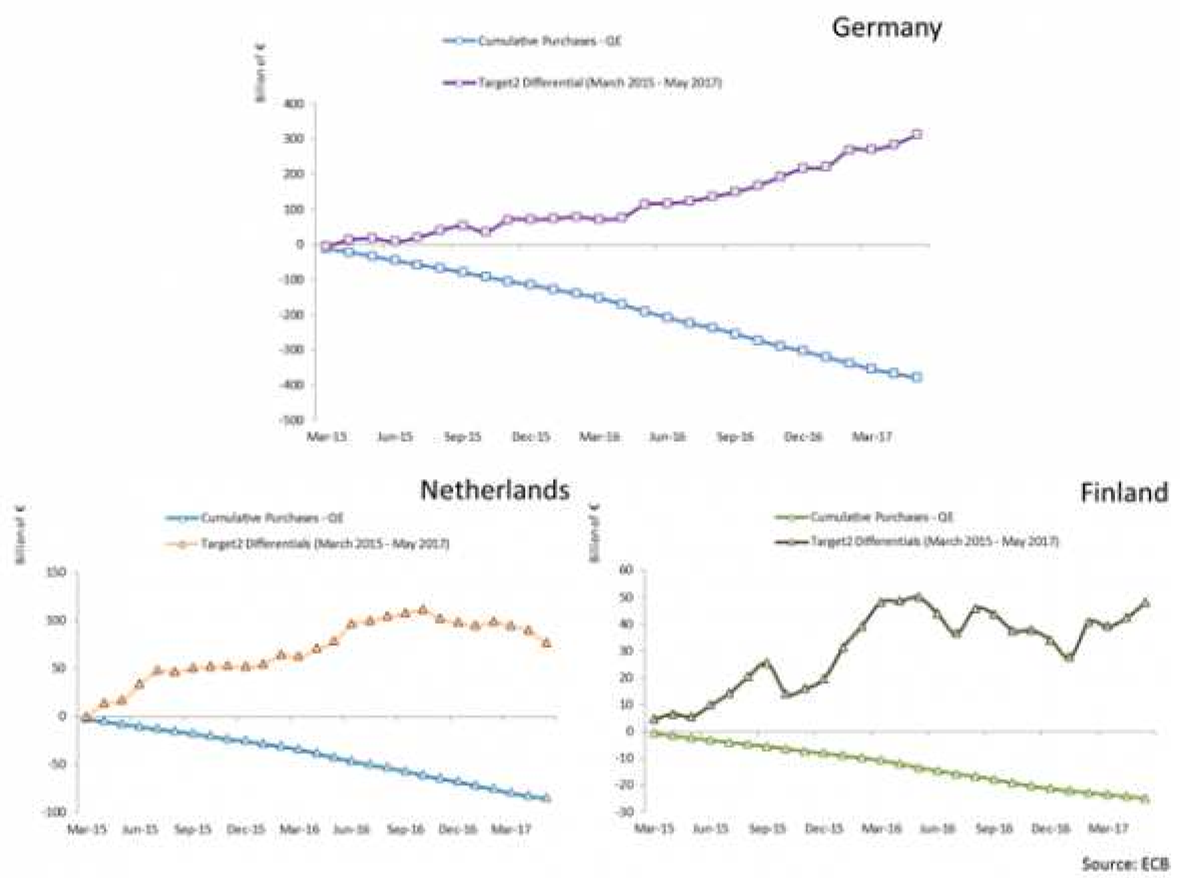
The euro area’s Target2 (T2) balances have continued to diverge. As of June 2017, Italy owes €430bn to the rest of the eurosystem and Spain owes €377bn, while Germany’s claims on the eurosystem are worth €835bn.

Recent research has linked the launch of the European Central Bank’s quantitative easing with the resumption of the T2 divergence process in the euro area, after a period (2012-2014) of relative reduction.

The ECB itself believes that QE has been the main driver of the T2 balances. In an official bulletin the ECB highlights the linear relationship between liquidity injected into European financial systems through the purchase of government bonds and the corresponding increase in T2 balances. For Italy, Portugal, and Spain, the effect has been to increase T2 obligations:



While QE has had the opposite effect in Germany, the Netherlands and Finland:



(The Target2 balances in countries such as France and Austria have been stationary and not correlated with the ECB's monetary expansion.)

At first look, you might conclude from this that all the new liquidity injected in the financial systems of the peripheral countries has been offset by capital flight to northern Europe.

The ECB study argues, however, that the relationship is only apparent. According to the QE engagement rules, the euro area's national central banks buy government securities from both domestic and foreign entities. When the Bank of Italy – for example – buys an Italian government bond from a German insurer, liquidity flows directly into the German financial system and is negatively/positively accounted in the T2 balance of the Bank of Italy/Bundesbank.

Moreover, the Bundesbank (or the Dutch and Luxembourg central banks) also intermediate the operations of banks outside the Euro area that tend to use their local subsidiaries to make purchases. For example, a British bank involved in purchasing Italian government bonds will pass through its German subsidiaries. The ECB's Bulletin reports that at the aggregate level 80 per cent of all purchases were made through cross-border operations of national central banks with foreign entities, while approximately 50 per cent of securities purchases within the QE involved residents outside the Euro area, thus fueling the growth of T2 balances in Germany, the Netherlands and Luxembourg.

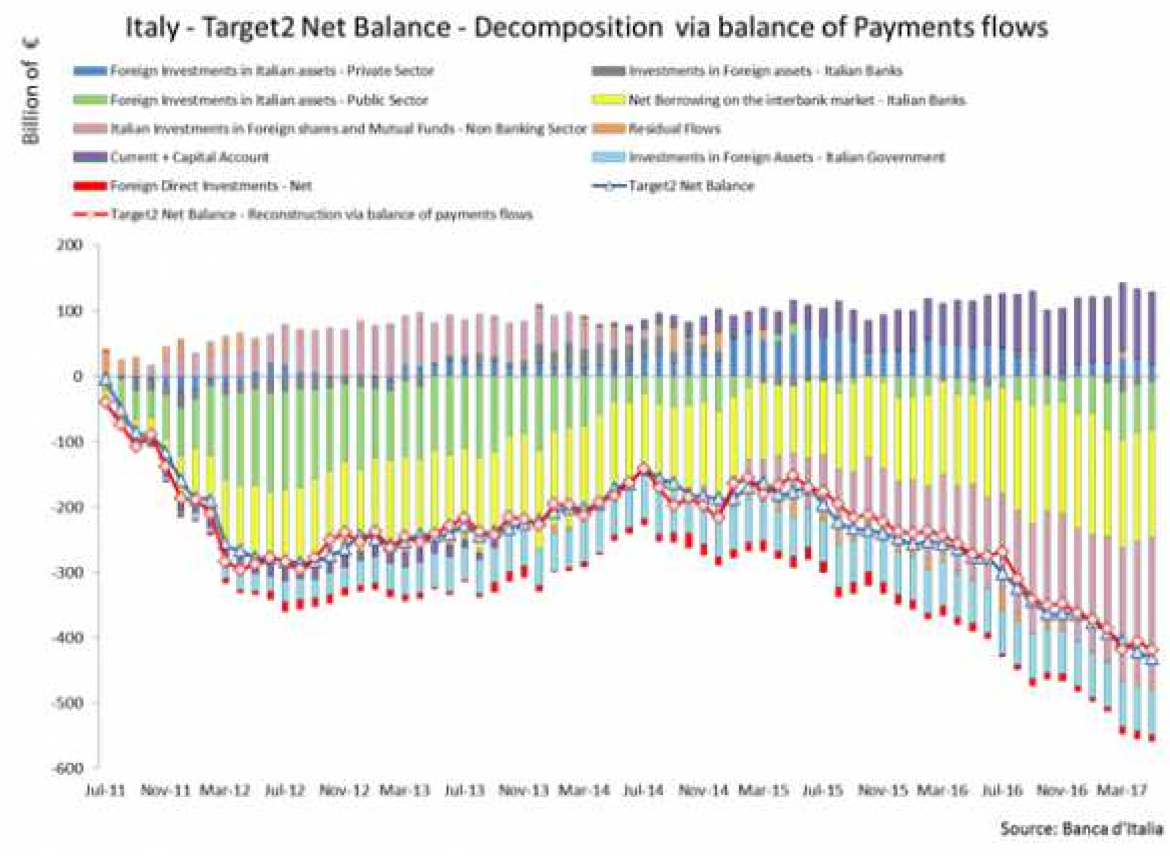
According to the Bundesbank, “the TARGET2 balance in the Bundesbank’s balance sheet is therefore mainly attributable to cross-border transactions which involve banks that participate in TARGET2 via the Bundesbank.”

However, these aggregate figures are not representative of what is happening in the large economies of Italy and Spain, where the government debt tends to be held by domestic investors. In Italy about 65 per cent of the debt is owned by locals, while in Spain this percentage is around 50 per cent. That suggests national central banks may not be buying from a representative sample of bondholders, or that other forces are at work.

In order to understand what is happening in Italy and Spain, the net balance of T2 can be reinterpreted as the result of movements of balance of payments’ accounts. (The International Monetary Fund states in its manual that the Target2 net balance has to be accounted inside the section *Financial account – Other investments.* See also Annex 3 A3.*46 Intra-CUNCBs and CUCB balances*.)

The balance of payments of each country keeps track of incoming and outgoing capital flows from the country of reference. These flows have to add up to zero, so arithmetic implies the T2 balance will vary in response to a variety of cross-border financial transactions carried out by banks, governments and the non-financial private sector. What follows is an explanation for what has happened in Italy, Spain, Portugal, Germany, and France.

The Bank of **Italy** recently published a study decomposing the growth of the country’s Target2 liabilities according to the balance of payments. This is their key result:



The initial deterioration of the Target2 balance in 2011-2012 can be attributed to foreign sales of Italian government bonds and foreign withdrawal of interbank lending to Italian banks. The combined effect of the government bonds' fire sale to Italian banks (green bars) and the contraction of interbank credit (yellow bars) fully explains the explosion of the T2 balance up to €280 billion at the end of 2012.

When LTRO repayments began in 2013, the ECB's balance sheet gradually deflated in sync with the T2 balances of all major Eurozone countries. The divergence of T2 balances resumed in June 2014 when Draghi launched a new loan program for European banks, this time aimed at increasing corporate credit (T-LTRO, Targeted Long Term Refinancing Operations).

However, the most important boost to the divergence process in T2 balances came from the launch of QE and of the Public Sector Purchase Program (PSPP) in March 2015. In June 2017 total purchases had already exceeded €1650 billion. The total assets of the Bank of Italy rose by €350 billion in 26 months.

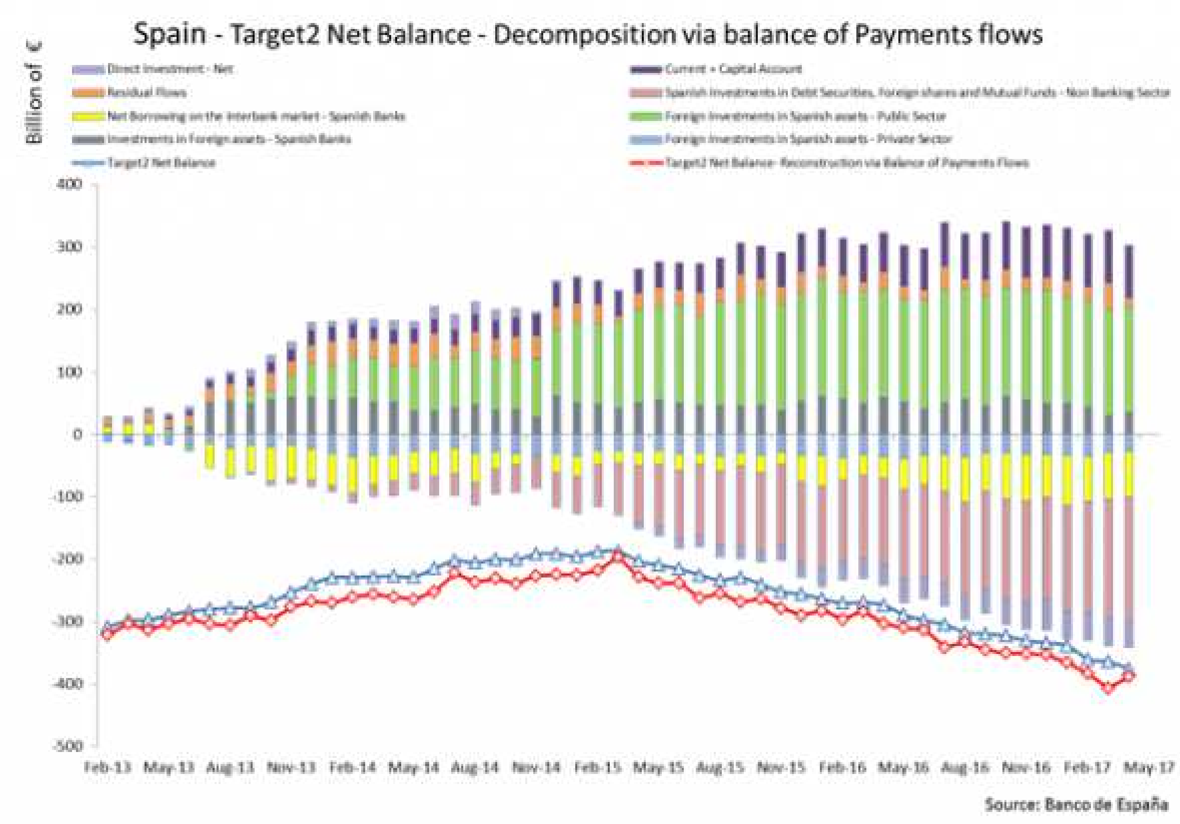
In sync with the launch of PSPP, a new phenomenon has become the main determinant of deterioration of Italy's T2 balance: a reallocation of the non-financial private sector wealth from government bonds to foreign bonds, mutual funds and shares (pink bars).

From March 2015 to the June 2017, over €250 billion were reinvested by non-financial Italian enterprises in vehicles with legal residence in Luxembourg, the Netherlands and Germany. Only 20 per cent of these can be attributed to Italian entities (through "round trip" funds). Much of these transactions were allowed by the monetary policy of the Bank of Italy, which purchased government bonds from private investors providing the necessary financial resources.

The worrying fact is that Italian enterprises have always preferred the reinvestment abroad rather than inside the national economy.

The decomposition makes also appreciable the direct effect of the mechanics of QE on the T2 balances, as described by the ECB. Indeed, the green bars — starting from early 2015 — began to grow again, signaling in this way a gradual release of government securities by foreign investors (€90 billion from March 2015 to April 2017), reasonably due to the purchases made by the Bank of Italy on international markets.

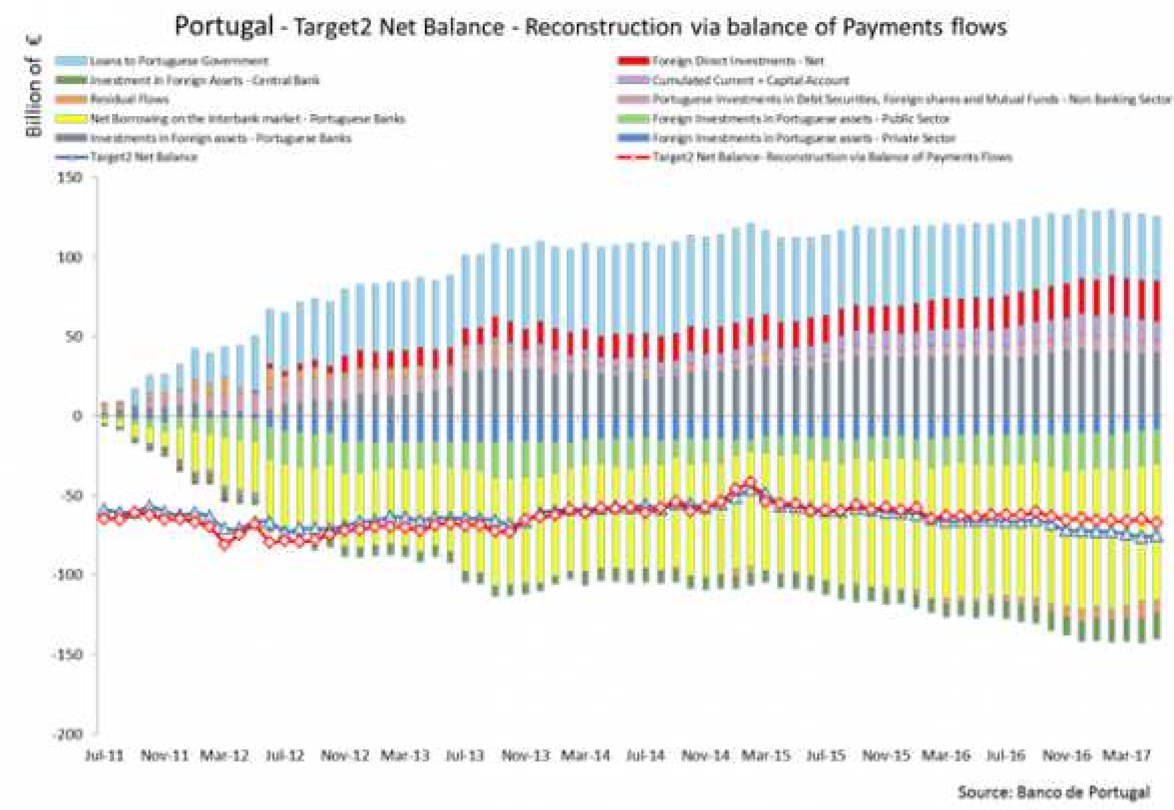
Similar conclusions can be drawn from the analysis of **Spain's** balance of payments:



From the chart one can definitely appreciate the massive return of foreign capital into government bonds (green bars) after the banking system stabilization through the intervention of the ESM (European Stability Mechanism). At the same time, renewed access to interbank credit (moderate reduction of yellow bars) contributed to the stabilization of Spain's negative T2 balance in 2013-2014.

From early 2015, with the launch of the QE the T2 balance is gradually deteriorating, reaching record negative values. From the performed reconstructions three key determinants have emerged in the period March 2015 – May 2017, in line with the Italian case: the growth of non-financial private sector foreign investments (pink bars, €82 billion in the two-year period 2015-2017), the selling of government assets by foreign investors to the Banco de España (the change in green bars, €23 billion) and the reduction in the foreign borrowing of the banking sector (growth of yellow bars, €30 billion).

The small **Portuguese** economy shares with Italy and Spain a trend of the T2 balance negatively correlated with the ECB PSPP. However, in the longer-run, the T2 balance has barely budged:



In June 2011 the balance was already heavily negative due to the financial crisis that led Portugal to seek the help of the EFSF (European Financial Stability Facility) bail-out fund in exchange of hard concessions in terms of austerity.

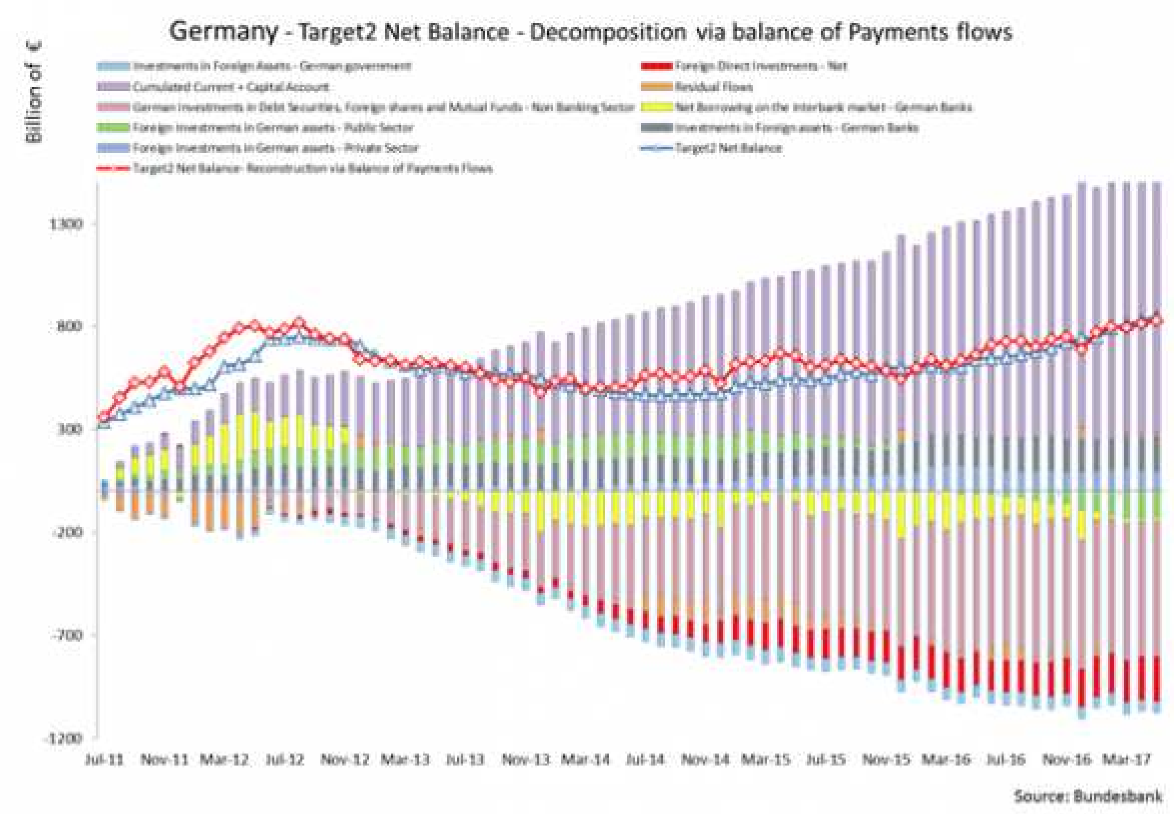
During the 2012-2013 recession, the Portuguese T2 balance improved slightly, despite the sharp deterioration in the health of the banking sector, which almost lost access to foreign interbank lending (yellow bars, €67 billion between July 2011 and December 2013) and a further selling pressure on government bonds held abroad (green bars, €20 billion in the same period).

The improvement is almost entirely due to a compensating inflow of loans to the Portuguese government that corresponds to the financial aid plan agreed with the European Authorities (light blue bars, €50 billion between June 2011 and December 2013).

In the period of QE implementation (March 2015-May 2017), the data do not show evidence of capital flight induced by the ECB. Indeed, investment flows in the non-financial private sector remain in positive territory, (pink bars), signaling a prevalence of foreign investment in entrance. It is therefore not possible to extend the conclusions reached for Spain and Italy to the case of Portugal.

The deterioration of the T2 balance by about €27 billion appears to be attributable primarily to a moderate selling of government bonds by foreign investors (€10 billion) to the Banco de Portugal, further deteriorating interbank lending conditions (€10 billion), and a reduction in the Portuguese Government's debt towards the EFSF fund (€10 billion), in accordance with the repayment arrangements agreed with the European institutions.

Germany's T2 balance has expanded over time to record values:



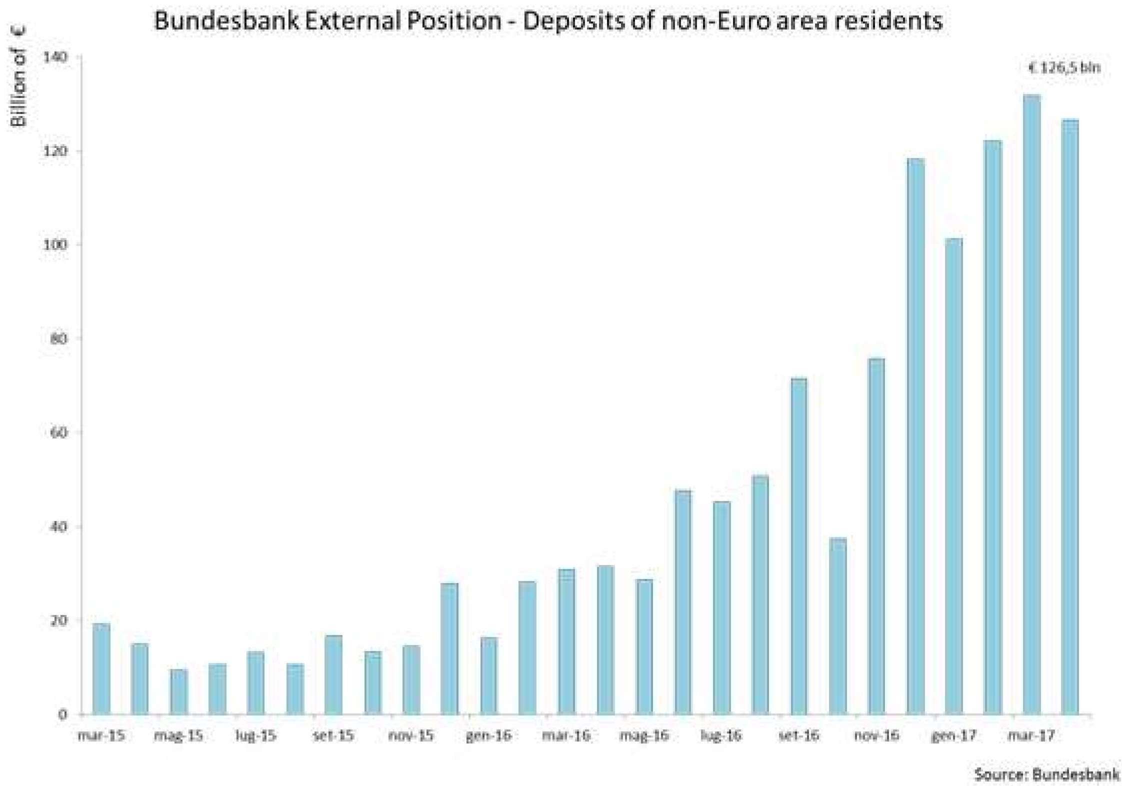
In 2011-2012, the balance grew positively due to three concomitant effects: the rise in interbank credit abroad (yellow bars – €170 billion from June 2011-April 2012), foreign investment in German government bonds (green bars – €100 billion) and a steady current account surplus of 6-8 per cent of annual GDP (purple bars).

The ECB’s monetary expansion, and in particular QE, have had a major impact on the German T2 balance.

The chart shows two channels of transmission, similar to the Italian and Spanish cases, through which the effects of the QE are paradoxically compressing the German T2 balance: the reduction in the amount of government bonds held by foreign investors (green bars – €240 billion) due to purchases by the Bundesbank, and the contextual growth of non-financial private sector investment abroad (pink bars — €345 billion).

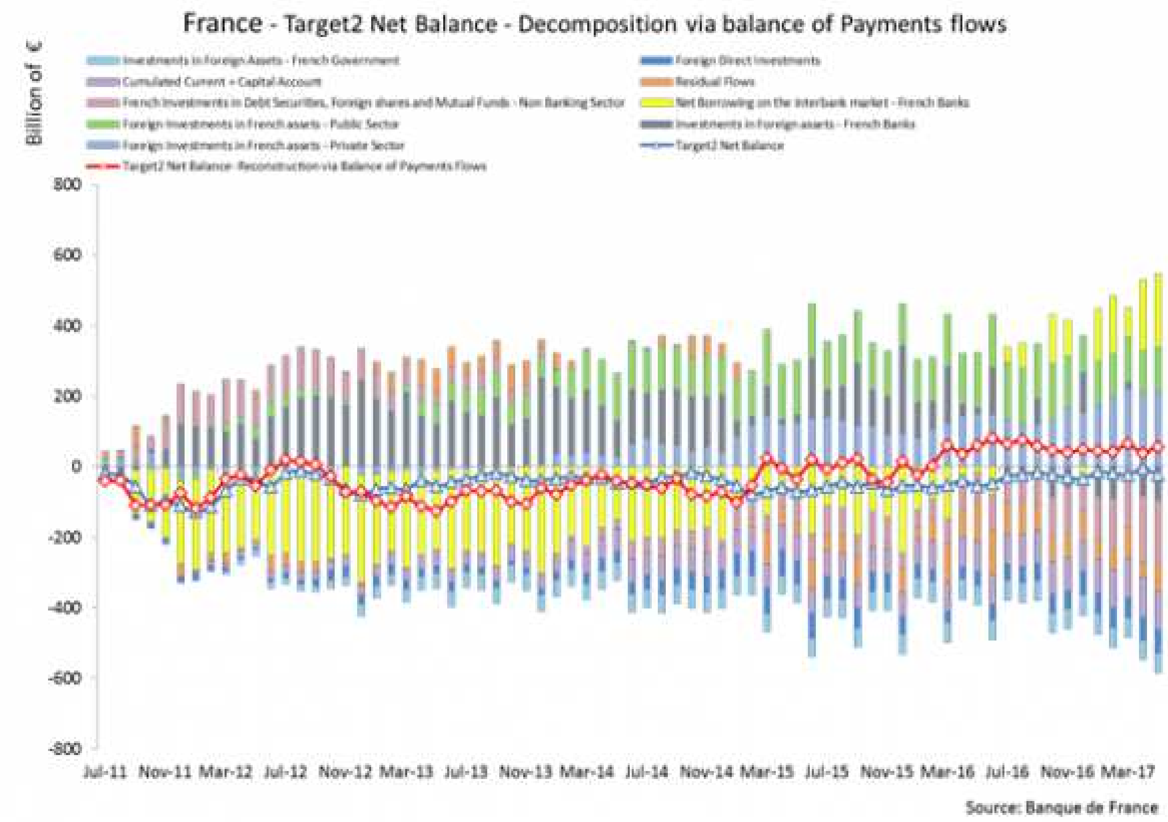
Nonetheless, the T2 balance rose by about €365 billion in less than 36 months. This phenomenon can be attributable to the uninterrupted growth of the cumulative surplus of the current account (€405 billion in the reference period). That in turn can be attributed to the acceleration of the growth of German trade surplus, which in turn is related to the devaluation of the euro — one of the indirect effects of QE.

Regarding the Bundesbank’s role as a conduit for buying bonds from investors based outside the euro area, these show up as euro deposits appearing in the passive side of foreign exposure of the central bank:



The growth of these deposits is clearly linked to the purchase of government bonds by the Bundesbank and can reasonably be explained by the German central bank's role as an intermediary on behalf of financial institutions resident outside the euro area. Compared to the change in T2 balance in the reference period (€307 billion), non-euro area residents' deposits with the Bundesbank increased by about €110 billion.

France is the Eurozone largest economy for which the T2 balance does not show a particular correlation with the ECB's monetary expansion. The T2 net balance of France has remained low in the course of the period of analysis, oscillating between €126 billion in January 2012 and €14 billion in June 2017:



The strongest influence in determining the balance of France's T2 is interbank credit. This should not be surprising given the large size of the French banking system. During the 2011-2013 crisis, foreign credit to French banks experienced a significant contraction (yellow bars, €300 billion between June 2011 and the negative peak in November 2013); in the following years they significantly recovered the gap. Credit to French banks has expanded by €208 billion since June 2011, with a notable boom following the outcome of the presidential election in April 2017.

Other significant phenomena affect the T2 balance and demonstrate an increase in financial flows to France over time. French banks' (gray bars) foreign investments expanded by €245 billion between 2011 and 2012 but have since declined and reached negative territory in 2017 — a sort of "reverse capital flight". Also interesting is the progressive expansion of foreign investment in the French non-financial private sector (€214 billion), which has accelerated over the last few months.

The French T2 balance has remained basically stationary due to different compensating effects: the "export of capital" towards foreign countries – that is predominant in the economies of South Europe – is visible, but is offset by a powerful capacity of the French banking and non-financial private sector to attract investment flows towards the French economy.

All of this suggests that mechanistic explanations for the growth of Target2 divergences since the start of the ECB's bond-buying are incomplete. For Italy and Spain, the QE programme has facilitated capital outflows by domestic investors. Elsewhere, it has not.