Analysis

TARGET2 balances – a truth more boring than fiction?

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As a result of the euro area sovereign debt crisis, the Eurosystem's internal receivables and liabilities have risen from the depths of technical details into headlines. What are these much discussed TARGET2 balances, and why have they grown again, although the financial crisis and sovereign debt crisis are already a thing of the past? The ECB's extensive securities purchase programme has been increasing the balances recently. Thus, the reason for the increase is not the same as during the darkest period of the sovereign debt crisis.



TARGET2 balances have existed since the beginning of the Eurosystem, but they did not make the headlines until during the sovereign debt crisis, when they grew substantially. That was when money began to flow from banks in countries with a weaker credit rating, such as Greece and Italy, to those in countries with a higher rating like Finland and Germany. As the sovereign debt crisis began to subside, the balances shrank, until the ECB's expanded asset purchase programme began to increase them again.

TARGET2 is a payment system managed by the Eurosystem for payments between commercial banks' central bank accounts. The system is used in all euro area countries and a few other EU

countries. The system essentially settles all euro-dominated electronic payments, ranging from retail card payments to securities trading. For example, when a Finnish company pays an import invoice to its Dutch supplier, the funds are transferred in the TARGET2 system from the payer's bank's account at the Bank of Finland to the recipient's bank's account at De Nederlandsche Bank.

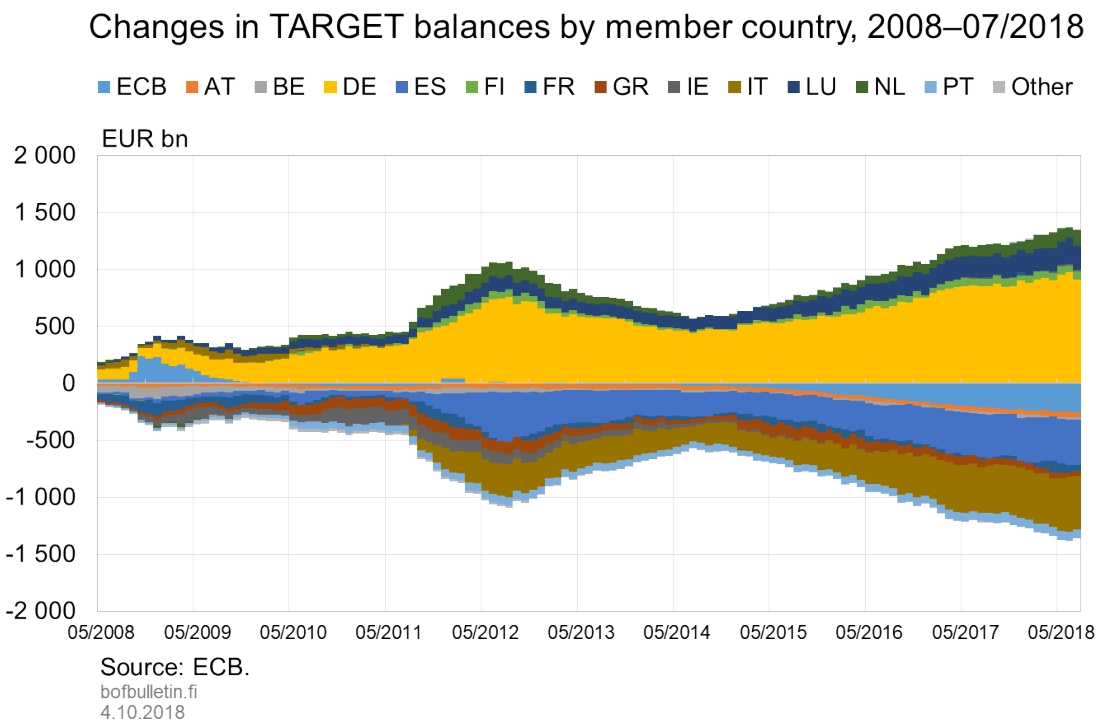
The payment system used throughout the euro area is necessary in order for the common currency to be used fluently, because it enables free movement of funds between the euro-area countries. The TARGET2 system transfers payments worth some EUR 2,000 billion per day[1]. TARGET2 balances, that is TARGET2 receivables or liabilities, get their names from this payment system.

National central banks and the ECB implement the euro area's common monetary policy in a decentralised manner, and also carry out their own national banking operations, such as managing their national foreign reserves. This means that each national central bank within the Eurosystem and also the ECB have their own balance sheets. Banks' accounts in the TARGET2 payment system are on the liabilities side of the central banks' balance sheets, and monetary policy operations creating central bank money into the payment system are entered on the receivables side of central banks' balance sheets.

A cumulative net position is calculated for each central bank in the Eurosystem from the flow of central bank money between the national central banks and the ECB. If more payments are transferred to TARGET2 accounts than from them, a TARGET2 receivable is created to the central bank. A TARGET2 liability is created by a reverse process. TARGET2 receivables are remunerated at the main refinancing rate (currently at 0%). The same interest is paid on TARGET2 liability. In the combined balance sheet of the entire Eurosystem, TARGET2 receivables and liabilities cancel each other out.

The following examples demonstrate how an Italian bank's payment to a Finnish bank changes the TARGET2 balances. The accounts of the Finnish and Italian banks are located on the liabilities side of the central bank. Following the payment, the Italian bank's account in the central bank is reduced, that is, in the current liquidity conditions, the bank's excess liquidity on the central bank account is reduced, which leads to a higher TARGET2 liability. The Finnish bank's account in the Bank of Finland, on the other hand, increases. That is, in the current liquidity conditions, the bank's excess liquidity on the central bank account increases, thereby also increasing the Bank of Finland's TARGET2 receivables on the receivables side of the balance sheet.

Chart 1.



If the payer and payee banks' accounts are located in the same national central bank, the central bank's TARGET2 balance will not change as a result of the payment, because money is only transferred from one bank to the other within the same central bank. Neither will the TARGET2 balance change if the Bank of Finland buys securities from a bank that has an account with the Bank of Finland. The Bank of Finland's securities ownership increases, but so does the excess liquidity in the balance sheet's liabilities side on the seller bank's central bank account[2]. If, on the other hand, the Bank of Finland buys securities from a foreign bank, this reduces the Bank of Finland's TARGET2 receivables. The Bank of Finland's securities ownerships grow, but nothing changes on the liabilities side, only the TARGET2 receivables decrease on the receivables side.

As a result of the decentralised implementation of the Eurosystem's monetary policy and the central banks' own banking operations, TARGET2 balances are required to keep track of receivables and liabilities within the Eurosystem. This is mainly just a technical arrangement.

During the sovereign debt crisis, TARGET2 receivables and liabilities increased as money was flowing out of banks in countries with a weaker credit rating into banks in countries with a higher credit rating. Banks were financing the outflow of funds by borrowing money from the national central banks as part of monetary policy operations. Thus, for example, in the balance sheet of the Spanish central bank, monetary policy credit to banks increased on the receivables side, while TARGET2 liabilities increased on the liabilities side of the balance sheet. In countries with a high

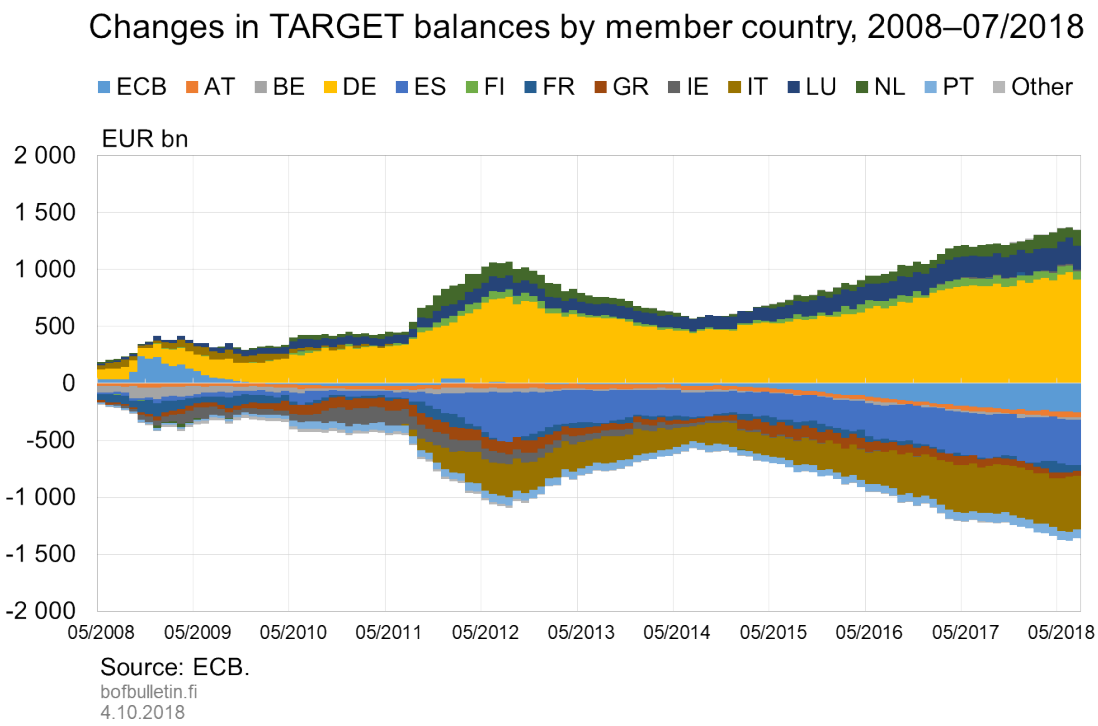
credit rating, on the other hand, deposits by banks increased significantly in their domestic central banks. As the sovereign debt crisis began to subside, the TARGET2 balances contracted. This increase of TARGET2 balances can be characterised as demand-driven, because it was largely the result of the need by banks in countries with a weaker credit rating to borrow from national central banks as the price of market financing went up and availability went down as a result of the sovereign debt crisis.

Recently, however, the increase in TARGET2 balances is supply-driven. This is largely the result of the expanded asset purchase programme started in 2015 as part of the ECB's monetary policy. Buying securities from a foreign bank increases the TARGET2 liability or reduces receivables if the central bank's balance is on the receivables side. The ECB and national central banks buy debt securities from international banks. The TARGET2 receivables of such national central banks increase in which these international banks have their TARGET2 accounts.

The asset purchase programme also increases the amount of central bank funds in the banking system, thereby increasing the banks' TARGET2 account balances. Even after the financial crisis, differences in interest rates between countries with high and low credit ratings continue to be significant, even though interest rates have fallen. Therefore it is not only the implementation of asset purchases that affects TARGET2 balances, but partly also the markets' view of certain countries' and banks' creditworthiness.

The Bank of Finland's TARGET2 receivable was EUR 76 billion at its highest during the sovereign debt crisis, in October 2012. By 2014, it was only EUR 9 billion, but has risen after that as a result of the asset purchase programme. In June 2018, TARGET2 receivables stood at EUR 57 billion. The increase of the Bank of Finland's TARGET2 receivables is also affected by the fact that not only Finnish banks but also many large Nordic commercial banks manage their euro liquidity using accounts located in the Bank of Finland.

Chart 2.



National central banks' TARGET2 balances are either a receivable from or liability to the ECB. This means that the ECB operates at the very core of the TARGET2 system, and the Bank of Finland's TARGET2 receivables do not carry a risk. Monetary policy credit and purchased assets involve risks, which are divided in the Eurosystem primarily on the basis of the capital key. This means that the Bank of Finland's monetary policy risks should not be viewed on the basis of TARGET2 balances but rather on the basis of Eurosystem monetary policy credit and purchased assets. Risk management methods decided by the ECB's Governing Council are applied to such credit and assets, with the objective of avoiding possible losses.

Notes

1. The Bank of Finland's TARGET2 system transfers payments worth some EUR 40 billion per day. ↑
2. See also Jussi Terho's blog "Mistä eurot rahapolitiikan osto-ohjelmiin?". (In Finnish only.) The blog discusses in more detail how monetary-policy securities purchases are carried out in the TARGET2 system. ↑

Keywords

monetary policy implementation, purchase programmes, TARGET2