Box 4

Interpretations of the recent increases in TARGET2 balances

This box analyses the factors underlying the renewed increases in TARGET2 balances and concludes that they do not reflect capital flight from certain euro area countries in a context of generalised mistrust of the respective banking sectors.[30] The increase in TARGET2 balances since March 2015 largely mirrors the cross-border payments resulting from the injection of liquidity via the APP. Owing to the integrated financial structure in the euro area, securities purchased under the APP are often purchased from counterparties located outside of the jurisdiction of the purchasing central bank. When payments for the securities purchased are made

29 This observation is based on the data from BrokerTec, MTS and Eurex GC Pooling, which cover most of the repo market and are the only publicly available daily data.

30 TARGET stands for "Trans-European Automated Real-time Gross settlement Express Transfer system". TARGET2 balances are the claims and liabilities of euro area national central banks (NCBs) vis-à-vis the ECB that result from cross-border payments settled in central bank money.

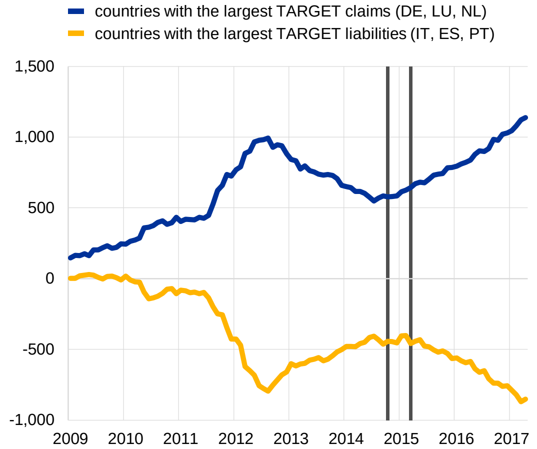
across borders, TARGET2 balances are affected.[31] A significant number of large APP counterparties are domiciled in financial centres located in a few countries. Moreover, non-euro area counterparties, from which around half of purchases by volume have been made, access the TARGET2 payment system mainly via Germany and therefore receive payment for the securities sold to the APP in that jurisdiction.[32] The outcome is that payments for securities purchased under the APP result in sizeable increases in TARGET2 balances (see **Chart A**).

Chart A

Renewed widening of TARGET2 balances in the euro area

Sum of TARGET balances for the three NCBs with the largest claims and the three with the largest liabilities

(€ billions; Jan. 2009 – Apr. 2017; end-of-month data)



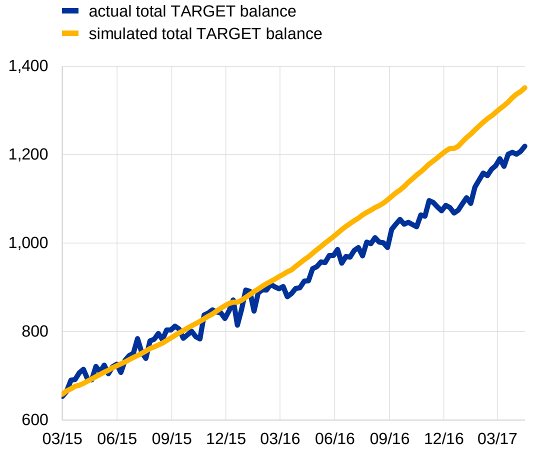
Source: ECB.
Notes: The three countries with the largest TARGET claims at the end of April 2017 were Germany, Luxembourg and the Netherlands, while the three with the largest liabilities were Italy, Spain and Portugal. The vertical black lines mark the commencement of purchases under the APP and the public sector purchase programme (PSPP) in October 2014 and March 2015, respectively.

Chart B

Actual and simulated TARGET2 balances closely track one another

Total TARGET balance since the launch of the PSPP and a simulated balance

(€ billions; 13 Mar. 2015 – 28 Apr. 2017; weekly data)



Sources: ECB, TARGET2 and ECB staff calculations
Notes: The simulated TARGET balance is calculated using APP transaction data and information on the location of the TARGET accounts of APP counterparties (the ECB's balance is treated separately from balances of non-euro area countries). The simulated balance shows how the total TARGET balance would have evolved since March 2015 if the only cross-border payments in the system had been the liquidity flows from central banks to counterparties' TARGET2 accounts resulting from APP purchases.

The recent increase in TARGET2 balances tracks fairly closely the pattern of financial flows stemming from payments for APP transactions, given the related portfolio rebalancing towards non-euro area assets. The growth in the total TARGET2 balance – which is the sum of all positive TARGET2 balances – has followed relatively closely a hypothetical TARGET2 balance calculated by summing only the liquidity flows from central banks to counterparties' TARGET2 accounts resulting from APP purchases (see **Chart B**). This suggests that, apart from the settlement of APP flows, there are no other significant one-way capital flows expanding the total TARGET2 balance further. As well as the direct effects stemming from the settlement of asset purchases, the APP also affects TARGET2 balances by inducing portfolio rebalancing by the sellers of the bonds. Indeed, over the period during which the APP has been active, there has been a

[31] See the box entitled "The ECB's asset purchase programme and TARGET balances: monetary policy implementation and beyond", *Economic Bulletin*, Issue 3, ECB, 2017.

[32] The locations of participation in TARGET2 by non-euro area banks typically reflect historical relationships with euro area branches or correspondent banks and have remained largely unchanged since the TARGET2 payment system was set up in 2007-08. Germany, for example, was already a major financial centre in the early days of the euro. See Cabral, I., Dierick, F. and Vesala, J., "Banking integration in the euro area", *Occasional Paper Series*, No 6, ECB, December 2002.

broad-based rebalancing towards non-euro area debt securities.[33] Hence the proceeds from the sale of securities under the APP are often not reinvested in the economy where the original securities were issued, but are invested in non-euro area assets. It is worth noting that investment flows related to this subsequent portfolio rebalancing are subject to the same settlement structure, leading to a concentration of payments to accounts held in major euro area financial centres. As a result, the rise in TARGET2 balances resulting from the initial settlement of purchases by the Eurosystem is not offset by a corresponding reverse flow of capital.

Overall, the underlying factors driving the current increase in TARGET2 balances are of an intrinsically different nature to those in previous episodes of rising balances, which were triggered by a replacement of private sector funding of banks through central bank funding in a period of stressed bank funding conditions, as also evidenced by a range of financial market, banking and balance of payments statistics.[34]

2, ECB, 2017.

34 See the box entitled “What is driving the renewed increase in TARGET2 balances?”, *Quarterly Review*, BIS, March 2017.