Why have Eurosystem imbalances increased again since spring 2015?

The "Target 2" cross-border payment system (Trans-European Automated Real-time Gross settlement Express Transfer system) is a payment system that enables banks in the Eurozone to carry out cross-border transfers of funds in real time. The system records and manages cross-border transfers within the Eurozone. For example, when a Spanish resident makes a purchase from a German seller, his Spanish commercial bank asks the Spanish central bank to record a transfer to the Bundesbank, which then credits the account of the German seller with his commercial bank. This conversion of "Spanish" Euros into "German" Euros is recorded in the "balance" in the system, with Spain as the debtor and Germany as the creditor. The balances per country, or "Target 2 balances" thus track the net liquidity positions of the national central banks with the Eurosystem payment system.

"Target 2" imbalances have been growing again since Q2 2015

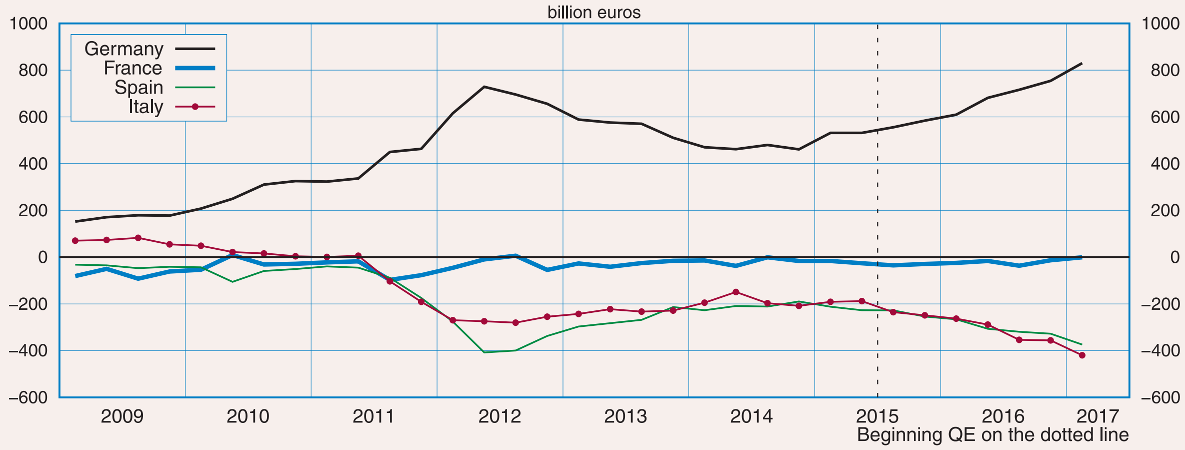
Prior to the 2008-2009 crisis, the Target 2 balances were in equilibrium, as international flows due to imbalances in current account balances were globally offset by financial flows, because, roughly speaking, the German commercial banks were lending to the banks in the southern countries of the Union. In the sovereign debt crisis, and in particular from mid-2011 to mid-2012, the imbalances grew (*Graph 1*): Germany showed an increasingly large surplus, while Spain and Italy went into deficit, a sign of the difficulties their financial institutions were having obtaining refinancing from their counterparts in the sounder countries in the Eurozone. These gaps then gradually closed.

Between Q2 2015 and Q4 2016, however, the imbalances between the Eurosystem central banks have been widening again, with the German balance even reaching its historical highest level in Q1 2017, and the Spanish and Italian balances showing a symmetrical deterioration.

The growing imbalances coincide with the BCE's Quantitative Easing

The return of these imbalances coincided with the start of the Quantitative Easing (QE) conducted by the European Central Bank (ECB), which is to say implementation of the programme of securities purchases by the Eurosystem, and more particularly purchases of sovereign securities, at a pace of €80 billion per month (reduced to €60 billion a month since April 2017). According to the ECB, this deterioration in the Italian and Spanish balances is a direct technical consequence of this purchase programme and the mechanism is as follows: the Italian and Spanish national central banks buy mainly from non-resident holders, who keep the majority of their assets in their German branches, thereby causing a "mechanical" deterioration of their target 2 balances to the benefit of German surpluses. In fact, between april 2015 and december 2016, the deterioration in the Target 2 balances of Italy (by €165.Bn) and Spain (by €116 Bn) corresponds more or less to the purchases of Italian (€202 Bn) and Spanish (€145 Bn) sovereign securities by the Eurosystem over that period.

1 - Target 2 balances



Source: European Central Bank

Residents have sold more sovereign securities to the Eurosystem than non-residents

However, if this had been the predominant mechanism, holdings of government securities by non-residents would have fallen sharply in favour of the resident national central banks (Dor, 2016), and according to the balance of payments data, it is mainly residents who have sold government securities to the Eurosystem (*Table 1*). As an illustration of this, Italian government debt increased by €40 Bn from april 2015 to december 2016, while that held by all residents increased by €79 Bn over the same period. As the Bank of Italy purchased €202 Bn in government securities, this means that the debt held by other Italian residents fell by €123 Bn, while that held by non-residents was down by just €39 Bn. In other words, in its government security purchases, the Bank of Italy was substituting for residents more than for non-residents. This situation is not specific to Italy and also applies to the other major Eurozone countries.

Since spring 2015, Italy has seen private capital outflows of €267 Bn

The balances of payments serve to pinpoint the causes of the deterioration in the Italian Target 2 balance. Between april 2015 and december 2016, Italy posted a current account surplus of €102 Bn, corresponding to the country's financing capacity, notably due to its balance of trade. As the Target 2 balance deteriorated by €165 Bn over the same period, that means that €267 Bn in private capital left Italy (*Table 2*)[1]. In comparison, only €39 Bn can be explained by the direct effect of ECB purchases via purchases of sovereign debt from non-residents.

The situation is similar, if less pronounced, in Spain where a current account surplus over the period of the study (+€58 Bn) coincided with a deterioration of €116 Bn in the Target 2 balance. A calculation of the balance shows that €174 Bn in private capital left Spain. As no non-residents sold any Spanish government debt securities, it is residents who would appear to have used the liquidities from the BCE purchases to buy securities abroad.

France is in the same position as that of the Member States prior to the crisis: its Target 2 balance is almost stable and at equilibrium, as its current account deficit continues to be financed by inflows of private capital. Conversely, the German current account balance shows a large surplus (+€436 Bn), but German residents are only using a part of that windfall to invest abroad (€214 Bn), hence the rise in the German Target 2 balance (up by €223 Bn between april 2015 and december 2016).

1. The Target 2 balance is in the balance of payments financial account and represents the major part of the flows of non-private capital. Thus, following the works of C. De Lucia (2012; 2015), the financial account balance for flows of private capital only is obtained by deducting the Target 2 balance from the balance of payments financial account.

Table 1 - Variation in sovereign debt by type of holder, between mid-2015 and summer 2016

	Non-residents (1)	Residents (2)	Total (3) = (1) + (2)	QE purchases of government securities by the central bank (4)	Residents excluding the central bank (5) = (2) – (4)
Italy	–39	79	40	202	–123
Spain	31	48	78	145	–97
Germany	–209	–29	–239	293	–322
France	–50	108	58	232	–124

Sources: national central banks ((1), (2), (3)), European Central Bank (4), INSEE calculations (5)

Table 2 - Balance of payments financial account, variation in the Target 2 balance and net flows of private capital

Billion euros, variation between mid-2015 and summer 2016

	Balance of payments financial account (1)	Variation in the Target 2 balance (2)	Net flows of private capital (3) = (2) – (1)
Italy	+102	–165	–267
Spain	+58	–116	–174
Germany	+436	+223	–214
France	–21	+3	+24

Sources: balance of payments (1), ECB (2), INSEE calculations (3)

Italian residents have reallocated their portfolios to boost their investments in the rest of the monetary Union, mainly in investment funds

The balance of payments data provides details as to the nature of these private capital outflows[2]. The data from the Bank of Italy indicate, for example, that of the €267 Bn of private capital outflows between april 2015 and december 2016, €133 Bn were used for portfolio purchases abroad, of which €85 Bn in shares in investment funds and €44 Bn in debt securities. At the same time, debt securities held by foreigners in Italy fell back by €125 Bn. In its November 2016 report on financial stability, the Bank of Italy confirmed that residents have considerably reallocated their portfolios to the detriment of Italian securities. Nevertheless, while these movements may seem massive, they concern only portfolio securities: deposits and investments in passbook accounts, which represent one-third of the financial assets of households, have barely fallen at all since mid-2015.

In Spain, the private capital outflows (€174 Bn) are slightly different in nature, being driven first and foremost by considerable portfolio purchases abroad (€81 Bn). They have also been driven by an upturn in foreign direct investments from Spain (€91 Bn), which were only partly offset by foreign direct investments in the other direction (€45 Bn).

Ultimately, the widening imbalances in the Eurosystem since spring 2015 can only partly be explained by the direct effects of QE. There has also been the specific behaviour of Italian and Spanish investors who have reallocated their portfolios to increase their investments abroad. ■

2. The balance of payments financial account tracks all the financial flows between a country and abroad, or more precisely between residents and non-residents. These financial flows include: direct investments, portfolio investments, "other investments" in the form of current loans and borrowings (the category in which the Target 2 balances of the central banks are posted), flows linked to derivatives, and acquisitions or disposals of reserve assets. These flows taken together balance in equilibrium with the current account balance ("errors or omissions" excepted).

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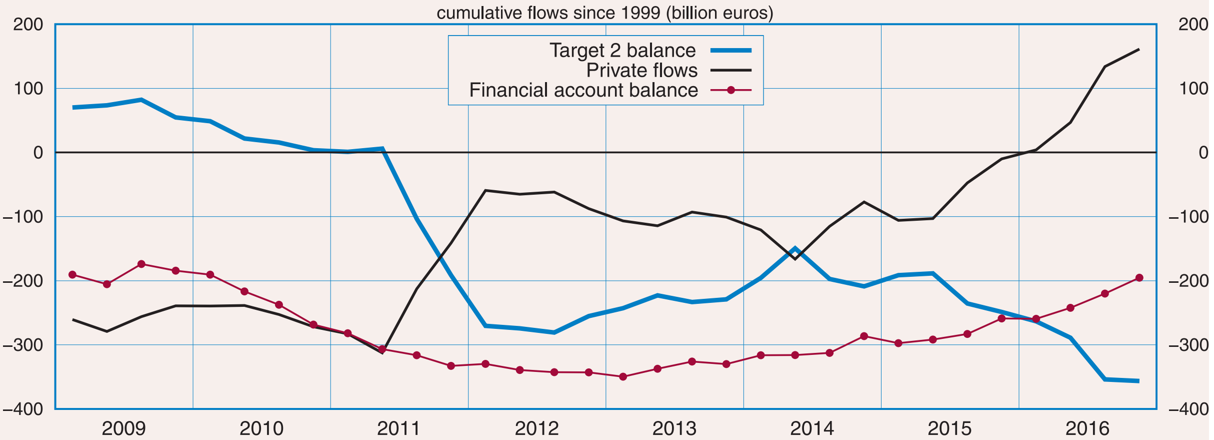
2 - Italian capital flows



Sources: ECB, Bank of Italy, INSEE calculations