Research Note

The increasing significance of Target2

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SUMMARY

- Target2 is an obscure, technical issue that is becoming a matter of grave concern for the financial markets; and which is being increasingly raised in Germany, which is exposed to the bulk of the liabilities.
- Target2 is the mechanism which ensures that there is neither a 'German' Euro nor a 'Greek' Euro but simply a Euro. It is what makes the Eurozone a single currency area as opposed to a currency pact. In many ways, Target2 *is* the Euro.
- The financial crises affecting southern Europe over the last five years have had the consequence of creating vast imbalances in Target2. This is a result of the collapse of the inter-bank lending market. The ECB has stepped in to provide liquidity for increasing capital flight from banks of periphery countries, on top of existing trade deficits.
- This has shifted the risk of repudiation of debts by the periphery countries to remaining members of the ECB – most significantly, Germany. This risk is real, and not merely an accounting issue as some continue to claim. It is also a very substantial risk: German exposure to the ECB through Target2 at the end of May 2012 is over €600 billion
- Nevertheless, as long as uncertainty remains about countries leaving the Eurozone, these imbalances are likely to accelerate. Capital flight can only be expected to continue, further increasing the risk to countries such as Germany.
- Germany is therefore in a position where continued capital flight is likely to spark domestic pressure against what is perceived to be an underhand bailout. This is already beginning to happen. But, paradoxically, these losses will only begin to be crystallised if countries leave the Euro. Public and political pressure to halt Target2 could force this to occur.
- If one country were to leave the Euro, the cost of the repudiation of Target2 balances would be shared across remaining Euro area central banks. But this risks a domino effect of other periphery countries then being unable to shoulder their burden.
- In the event of a complete break-up, the Bundesbank would be forced to take the loss on its full exposure to Target2, whilst likely honouring all the depositors' funds from southern Europe. The Bundesbank could simply choose to print its way out of this. However, this would raise serious issues for the Germany economy and, more broadly, the concept of 'fiat" currency.

Why look at Target2?

Target2 is an abstruse, technical issue that is rapidly becoming a matter of grave concern for the financial markets.

It is not a well understood concept, and expert opinion can be divided over its implications. But more and more attention is now being paid to Target2; and in Germany, there are increasingly vocal concerns that Target2 may inadvertently be a mechanism which has substantially increased German exposure to a Euro break up (note, for example, that Greece's sovereign debt is in the order of €120 billion. German exposure to the ECB through Target2 at the end of May 2012 is over €600 billion).

In early 2007, sub-prime mortgages were also an abstruse technical issue, having received almost no media attention for the previous six years. By the end of that year – as the table below shows – it was the subject of intense media interest. Note that interest in Target2 is arguably following a similar trajectory.

Number of media hits of a phrase, as recorded by Google News

	Sub prime	**Target2**
1 Jan to 1 July 2000	12	0
1 July 2000 to 1 Jan 2001	8	0
1 Jan to 1 July 2001	8	0
1 July 2001 to 1 Jan 2002	20	0
1 Jan to 1 July 2002	19	0
1 July 2002 to 1 Jan 2003	19	0
1 Jan to 1 July 2003	27	0
1 July 2003 to 1 Jan 2004	33	0
1 Jan to 1 July 2004	26	1
1 July 2004 to 1 Jan 2005	24	0
1 Jan to 1 July 2005	38	0
1 July 2005 to 1 Jan 2006	51	0
1 Jan to 1 July 2006	57	2
1 July 2006 to 1 Jan 2007	68	0
1 Jan to 1 July 2007	**1270**	9
1 July 2007 to 1 Jan 2008	7210	16
1 Jan to 1 July 2008	5080	22
1 July 2008 to 1 Jan 2009	4020	7
1 Jan to 1 July 2009	1640	11
1 July 2009 to 1 Jan 2010	885	22
1 Jan to 1 July 2010	1070	20
1 July 2010 to 1 Jan 2011	395	12
1 Jan to 1 July 2011	187	36
1 July 2011 to 1 Jan 2012	571	22
1 Jan to 1 July 2012	2750	**1170**

For the peripheral countries, without Target2, the Eurozone project would have ended a long time ago. As such, it is likely to play an important role in any decision around a member state's exit. Indeed, the denial of access to Target2 could be the mechanism by which they would be excluded from the Euro.

What is Target2?

If Target2 had a logo, it should be on the back of the one Euro coin. In essence the Target2 system is the financial plumbing that turned the ERM (a currency pact) into the Euro (a single unified currency). It is the mechanism which ensures that there is not a 'German' Euro and not a 'Greek' Euro but simply a Euro. In the UK, we have no need for an equivalent system as we have a single Central Bank dealing with the domestic currency. The Bank of England can create an infinite supply of sterling, but the Greek central bank can only create Euros with reference to the ECB.

For the Euro to function as a single currency, each of the individual central banks of the member states, including the Greek central bank, needs to be able to deliver all Euros legitimately demanded from it. However, at the Eurozone level, the total amount of Euros needs to be reconciled: withdrawals (made from, for example, Greece) need to balanced elsewhere within the system (for example, from Germany). In simplified terms the ECB effectively acts as the Central Bank to the individual Eurozone Central Banks, and Target2 is the settlement system and scorecard that allows this to happen.

Consequently large and accelerating Target2 balances are exactly what we should expect in a financial crisis, especially when the market has concerns over the future of the Euro itself. Target2 is behaving exactly as designed: despite local default, capital flight and market speculation, a 'Greek' Euro is still identical to a 'German' one.

This is identical to the way that a local recession, default and speculation could not push the Northeast England out of sterling. Target2 ensures the same is true of Greece within the Euro. As a side effect, Target2 prevents speculators pushing a country out of the Eurozone, because it provides infinite liquidity.

Nevertheless Target2 does represent real transfer of risk. Consequently accelerating Target2 balances cannot simply be ignored or dismissed as accounting anomalies as they have real economic and political implications. Moreover, the sooner this is understood the lower the potential shock to markets and the Eurozone voters.

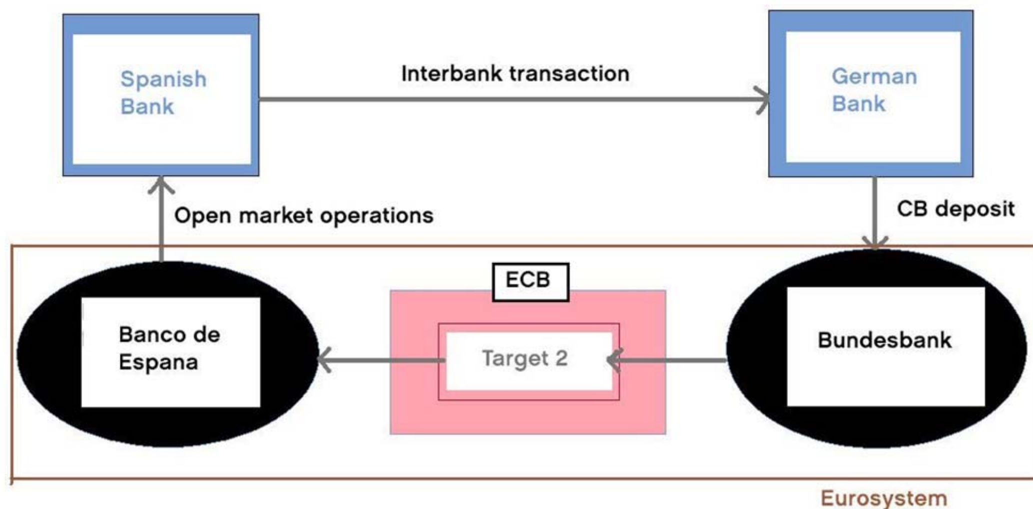
Note also that the liabilities of the ECB are shared between the Eurozone member states as a function of each state's GDP and population size. It goes without saying that Germany has the largest share at 28%. Should Greece exit, then Germany would be exposed to 28% of the Greek liabilities held at the ECB underTarget2. Should any other country then exit the Euro, then its exposure would increase in proportion to its original liability.

How Target2 works in practice

As an example of the mechanism at work, let us consider the case where a Spanish depositor moves his cash from a Spanish bank to a German one.

Prior to the financial crisis, the Spanish bank would have been able to plug the resulting gap by turning to the interbank market, where German institutions were only too happy to lend to it. The private sector therefore played the dominant role in keeping money shifting around the Eurozone, with the ECB there to work at the margins.

In the post financial-crisis world, this interbank market has ceased to function. In order to prevent a liquidity issue at the Spanish bank in our example, the Spanish National Central Bank therefore borrows money from the ECB. The Spanish National Central Bank then lends into the Spanish bank. On the other side, the German bank places the money it has received from the Spanish bank on deposit with the Bundesbank, which, in turn, places its excess liquidity on deposit at the ECB. Thus, the ECB balance sheet has expanded, with a new Target2 liability to the Bundesbank and a Target2 asset on the Spanish National Central Bank.



Since the private sector has refused to run the risk of exposing itself to the peripheral states, these imbalances have been increasingly left to accumulate within Target2. This has led to some commentators describing the Target2 system as the actual, live bail-out, which is currently taking place within the Euro.

Perhaps more importantly, it has been described as a transfer of risk from the private to the public sector. More accurately, the risks (both to individual states Capital Accounts and to depositors) to peripheral states, which is normally shared and diversified among the private sector, are now being centralised and managed within ECB.

Why capital flight changes everything

Historically, changes in Target2 balances have not been considered risky as it has been assumed that they simply reflect the flows of capital as a function of trade within the countries of the Eurozone. Such flows would, it was assumed, eventually rebalance over time, via private sector intervention. At the very least, there would never be any call to crystallise or suddenly make good said imbalances.

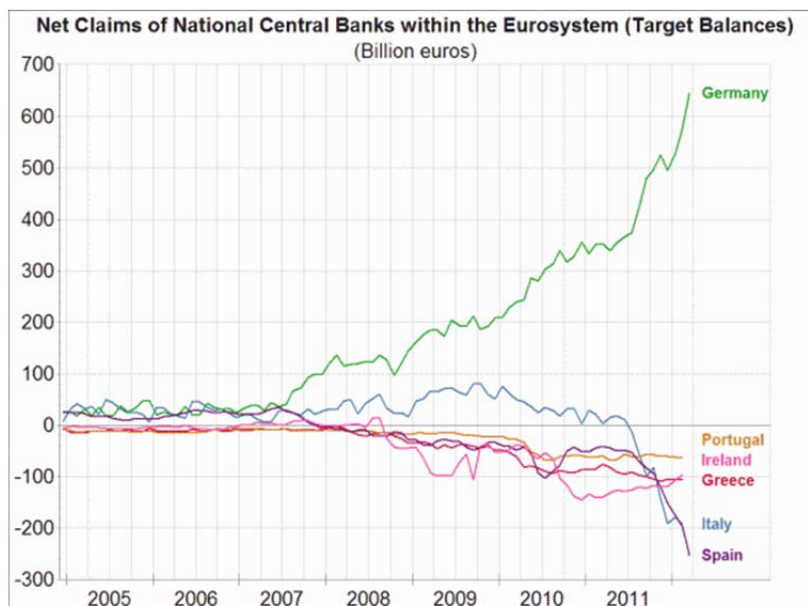
With the worsening of circumstances in the peripheral Eurozone countries, another phenomenon has started to arise: capital flight, on a grand scale. Deposits held in Greek or Spanish banks have started to be moved to northern European banks, such as Germany. The concern is not simply the credit worthiness of Spanish or Greek banks, but also that were Spain or Greece to leave the Eurozone, the savings held in Spanish or Greek banks would be redenominated into the peseta or drachma; which in turn would devalue; in turn creating a capital loss for the depositor.

Traditionally, capital flight is far easier to spot, as it is accompanied by a run on the currency. That is to say, as depositors remove their money from one currency and exchange it into another, the exchange rate itself undergoes an equivalent adjustment to reflect the sudden shift in supply and demand.

However, within the Eurozone, capital flight is hidden by the single currency – as money leaves Greece to be deposited in Germany, there is no direct impact on the Euro. Capital flight has no immediate impact on the value of the Euro.

Consequently, as capital flight has accelerated throughout 2012, a huge imbalance of payments has started to build up at the ECB. The size of the liability faced by the ECB (and by extension of the way in which the ECB's liabilities are shared by the Eurozone countries, Germany) has now escalated to a point where it can no longer be ignored.

This is now influencing how Germany approaches any policy decisions which relate to any member state exiting the Euro – that point being around €600 billion and growing daily.



Can restrictions be placed upon the imbalances?

It is impossible to stop capital flight without a break up of the Euro. There is some anecdotal evidence of an informal attempt to limit further growth in the imbalances: for example, German banks are said to be making it difficult or prohibitively expensive for Greek citizens to set up accounts.

Target2 is the mechanism by which the Euro exists. As such, the Euro's survival as a common currency (as opposed to a currency pact) is inextricably linked to the imbalances **not** being restricted. While a given country remains within the Eurozone, the market can never create a run on that country.

What are the implications of Target2 imbalances remaining?

If the Eurozone holds together, the imbalances will probably continue to grow until the markets are satisfied that:

- the peripheral states will continue to be a part of the single currency; and
- their independent financial systems are sufficiently guaranteed such that they can attract more capital than they are losing.

However, as the exposure for northern European countries grows, it is likely that taxpayers within those countries will become more worried by the size of their exposure to the periphery.

This is already beginning to happen: for example, the German academic Dr Sinn has spearheaded a campaign in Germany to outline the risks that the Germans are taking on. Some Germans are also now claiming that Target2 breaks German constitutional law (which requires any assistance from Germany to the rest of the EU to be ratified and restricted by the German parliament). This legislation was put in around the time when the European Financial Stability Funds was set up to prevent open ended bail-out commitments: many Germans are concerned that Target2 could be a back-door means of circumventing this rule. This is likely to lead to enhanced popular and political pressure to end Target2. Here there is a great danger of a "positive feedback loop": while the only way these losses will be crystallised is if Target2 is shut down and/or countries leave the Euro, anxiety over the possibility increases the likelihood of it occurring. This, in turn, obviously increases the anxiety further.

Nevertheless, in theory, these imbalances could remain indefinitely and be uncapped all the time the Euro remains together.

What are the risks if a country exits the Euro?

First of all, it is important to be clear as to who carries the risk. In effect, it is all of those countries which retain a liability to the ECB: that is, all those who remain within the single currency (as previously discussed, the ECB member states split the liability as a proportion of GDP. When someone exits, their liability increases in proportion to their original exposure).

The risks are that, if an individual state were to leave the Eurozone, they will repudiate their liabilities at the Target2 level. However, the remaining National Central Banks (in particular Germany), would presumably still have to honour the deposits held by foreign nationals and

absorbed by the ECB members. This would create a real loss, which would be shared among the remaining members of the ECB but fall hardest on Germany.

One interesting consideration is that of a domino effect of increased liabilities upon the peripheral states which remain. For example, if Spain were to exit the Euro, would Italy or perhaps even France be able to shoulder their portion of the ECB's liabilities at the Target2 level?

It would probably be extreme to say that this has given any form or negotiating leverage to the peripheral countries. However, it will continue to ask serious questions around Germany's commitment to the single currency.

It is for this reason that some commentators have said that before the Target2 imbalances accrued to this level, the gun that Spain pointed at Germany's head was empty. Target2 is what loads a bullet into the chamber.

How might this pan out?

Scenario 1: *the combination of credible banking union and a large enough rescue fund with open ended commitments from the ECB assuages the markets. Over a given period, the imbalances created by capital flight start to unwind as risk appetite for peripheral debt improves and the private sector begins to operate more normally. Target2 never becomes an issue.*

Once the political will is there, the financial mechanics of the above are relatively easy to execute. This scenario is clearly dependent on huge concessions either by Germany, or by the peripheral states. However, if at any given point, Germany was to feel that the amount of money owed by the peripheral states was too large to write off, and yet there was the risk that by one or more states exiting, writing it off would become an inevitability, the imbalances might hasten their policy response. The solution which seems best suited to bringing the private sector back into play is Eurobonds, or perhaps even the shared rescue fund proposal (national debt in excess of 60% of GDP is pooled to reduced borrowing costs).

Scenario 2: *The process towards political union continues to evolve slowly. Meanwhile the Target2 imbalances continue to accrue – the pace determined by the varying degrees of risk associated with peripheral exit. As the economies of the peripheral states deteriorate, the ECB simply bloats its balance sheet to offset the increasing Target2 imbalances. The private sector would continue to seek assurances from Germany as to the reality of monetary union.*

This would be likely to last a long time and would throw out other unforeseen consequences. It is also hard to see how the economies of the peripheral states could ever recover as the private sector stays away. This will ultimately lead to an increase in the size of the imbalances, which could become an even more visceral issue for the German taxpayer. In essence, the longer the process goes on without resolution one way or the other, the more damage is done to peripheral (perhaps even total European) GDP. As such, the impact and cost of any exit further down the line will be increased for those who remain within the Eurozone.

Scenario 3: *The rhetoric and action from Northern Europe is deemed insufficient by the markets. Germany, in thinking that it does not want to increase its exposure, refuses to engage in any kind*

of transfer policy. All peripheral debt is eschewed by the market, increasing the funding pressure on Spain and the redemption pressure on Italy. Capital flight accelerates, paradoxically increasing Germany's liabilities (via the ECB mechanism). Greece, unable to continue with austerity exits the Euro. Spain and/or Italy follow suit. The losses are shared among the remaining ECB members. With regards to deposits that have been shifted into Germany, this represents a risk simply for the Bundesbank (and by extension the German taxpayer). Germany faces the invidious position of deciding whether to repudiate the deposits on the basis of the national identity of the holder. It is difficult to see how they could do so. And as such, there would be a real cost.

Further questions posed by a break up

The fate of the Euro and the consequences of its break up will clearly have a huge impact on the rest of the world.

But there are other considerations. For example, the Euro is the world's second largest reserve currency. At the margin, additions or subtractions to the Euro make little difference to its status as a reserve currency. However, were the Euro to cease to exist entirely, the question of the claims held by those using it as a reserve currency becomes problematic. The euro is not a basket of currencies and was never envisaged to break up: what legal claims would foreign reserve holders then have? If the reserves are held as cash and not simply as sovereign bonds, to whom do the holders address their claims? Does it follow that each nation would honour its portion of the old euro's liability?

The Euro's collapse also raises question for the countries which have chosen to peg themselves to it, including the 14 African nations with a population of around 150million people. To which new currency will they cling? The Euro 2.0? The Franc? Could they afford to cling to a new and rallying Deutschemark? Would they be capable of doing so?

The questions, as well as the answers, maybe infinite…

Conclusions

Target2 is not just one of the many issues affecting the Euro, but in many ways it actually *is* the Euro. Any alteration, impediment or constitutional obstacle placed upon it, is in reality a repudiation of the very concept of the Euro.

Were a single country to leave, the losses could fall on all remaining ECB members in proportion to their obligations. However, were that event to trigger more departures, the mounting losses would eventually fall on those who decided to remain, or alternatively, those with the largest exposures (Germany, primarily on account of deposit flight).

Admittedly, (as commentators such as Felix Salmon have illustrated) Germany could just print Dmarks to the effect of recapitalising the Bundesbank. We also agree that it is not clear that this is simply a monetisation of debt – it is simply the start of a new currency.

However, this might be complacent. In the event of that happening, could fiat currencies ever regain the confidence of the 350 million or so people living within the Eurozone? Maybe over time they would. But in the first instance, the turmoil and danger in the markets could be catastrophic.

Finally, note that the problems illustrated by the Target2 system highlight the complexities which accompany a single currency, plural country system. This could be relevant in the context of proposals for Scottish independence. In *Your Scotland, Your Future,* the SNP has stated that: "One important choice will be which currency we use. Upon independence, we believe Scotland should continue to use the same currency as now – the pound. We will operate within the Sterling currency area, providing us with continuity." While it is not clear whether the SNP is advocating a National Bank for Scotland, if it did, then, all the potentially damaging effects of Target2 would be replicated in the event of Scottish independence; and if it did not have control over its currency, then it is questionable the degree to which it would actually be independent.

KEY READING ON THIS SUBJECT

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