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Greece, QE and the Target balances

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Target balances as crisis barometer

The Target balances proved to be a reliable crisis barometer in the course of the euro crisis. They allow us to measure the cross-border capital flows between central banks within the eurozone. When things are running "as normal", they fluctuate around the zero mark because outflows and inflows always balance each other out when the financial market is in good working order – the purchase of foreign goods (capital outflow), for example, is countered by the granting of a loan from abroad (capital inflow), or the export of goods (capital inflow) prompts corresponding investment abroad (capital outflow).

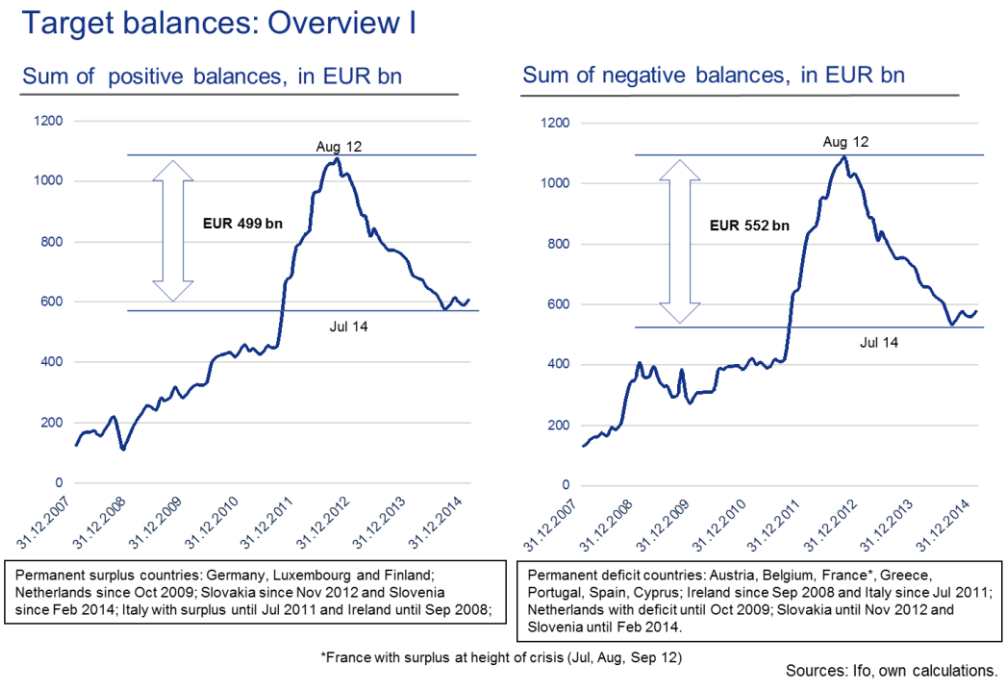
This was not the case during the euro crisis. Private capital flows dried up and were replaced by public funds in the form of bilateral or multilateral aid provided by the EMU states – or in the form of ECB funds: the unlimited supply of liquidity to banks that was introduced in the course of the crisis meant that banks no longer had to turn to the capital market (or deposits) for refinancing, but had direct access to the central bank printing presses. This money was also used on a large scale to pay off foreign debt or finance transfers abroad – shifting capital. In other words: capital outflows were no longer countered by corresponding (private) inflows from abroad, but rather "only" by central bank funds; as a result, any offsetting took place within the Eurosystem and resulted in mounting imbalances between the central banks, the Target balances. On the one hand, there are the liabilities of the central banks in the crisis-ridden countries, which have been hit by massive capital outflows, while on the other there are the receivables of the other central banks, first and foremost the Bundesbank, which have seen just as sizeable inflows.[1]

It is no exaggeration to say that the increase in the Target balances managed to save the euro area from collapse. It allowed the central banks to cushion the blow of the withdrawal of private capital donors from the periphery states *en masse*. The Target balances became an extremely effective means of combatting the crisis, rising to over EUR 1000bn (see Chart 1) at their peak.

The flip side of this policy of using the Eurosystem balance sheet to provide aid is that private risks were socialized "through the back door". Over the years, a large chunk of cross-border credit relationships, which were entered into primarily by banks in the first debt-laden years of the euro, was transferred to the public sector via Target balances.

[1] For detailed information on the Target balances, see the Ifo institute: http://www.cesifo-group.de/de/ifoHome/policy/Spezialthemen/Policy-Issues-Archive/Target.html.

Chart 1: Development of Target balances in the eurozone



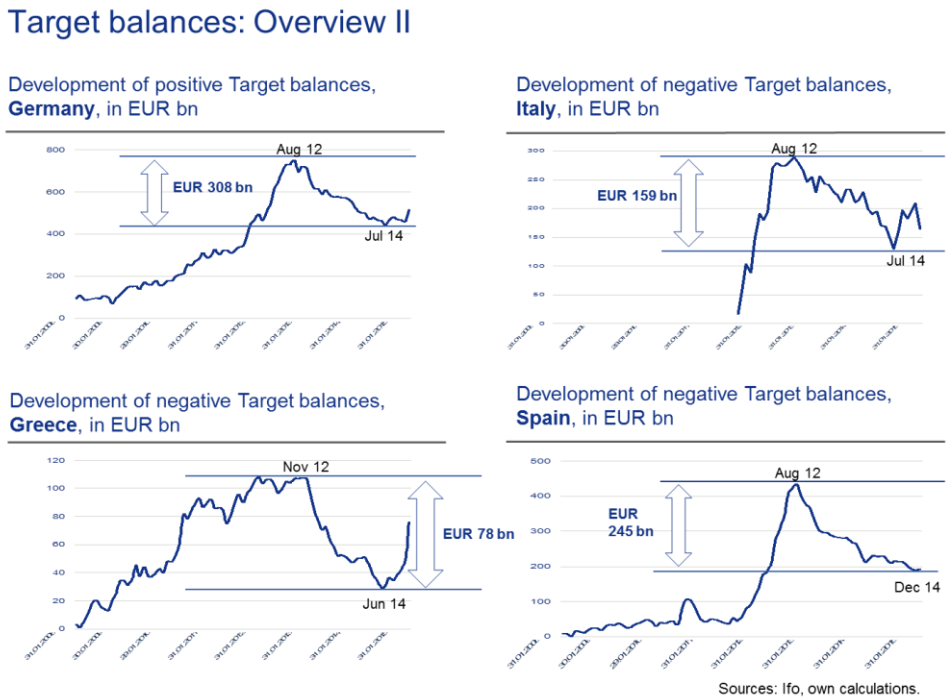
Since August 2012, however, the Target balances have been gradually falling again. There are several reasons behind this trend, not least Draghi's famous "whatever it takes" speech only one month earlier, which dispelled any fears regarding the imminent collapse of monetary union. Other developments are at play here, too, however: the fact that the countries on Europe's periphery, which are now generating current account surpluses, need less capital; the increasing fragmentation of the euro financial market, leading to a reduction in cross-border transactions in general, as well as the growing confidence regarding the economy, which is helping to counter any continued flight of capital.

But despite what has been a positive development on the whole in recent years, the status quo ante is still a long way off. Foreign debt is still being financed partly via Target. What is more, the reduction in Target balances has more or less come to a standstill since last summer; in Italy and Greece, and – on the other side of the equation – also in Germany, they were actually up substantially again of late. The only country in which the recovery appears to be continuing is Spain, the fourth largest Target country[2]. (see Chart 2)

So what is behind this reversal? While Greece's case would appear to be relatively clear cut, understanding the situation in Italy means taking a closer look at how the country's banks stand, as well as at the European interbank market.

[2] Spain, Italy and Greece on the negative balance side, and Germany on the positive balance side, account for roughly four-fifths of the total balances.

Chart 2: Development of German, Italian, Spanish and Greek Target balances



Greece: A new confidence crisis

The Greek (negative) Target balances soared by EUR 27bn in January alone, meaning that they have more than doubled again since reaching a low in the summer of last year. It is no secret why this has happened: the change in government and policy after the elections has fueled a new wave of uncertainty and the country's future within the eurozone is, once again, as uncertain as it was when the crisis was at its peak. Many people in Greece reacted by stashing their capital abroad and the lack of private lenders left the banks with only the central bank as a source of refinancing – pushing the Target balances up. This development is likely to continue over the next few months, as there is currently no way of knowing how the stand-off between the new Greek government and its lenders will be resolved. Paradoxically, the launch of the ECB's large-scale government bond purchasing program (QE or quantitative easing to use the technical jargon) has actually put Greece in a worse position than it was before.

There are two reasons for this: with the QE program to back them up, both the ECB itself and the other partners can take a hard line when standing up to the Greek threats. After all, there is no longer the same risk of contagion effects on other countries that there used to be a few years back as long as the ECB has an official mission to buy up large quantities of government bonds on the market. And the spreads between German yields and those of the countries on Europe's periphery have, in fact, continued to fall in recent weeks – in spite of Greece.

Second, the ECB is certainly aware of the risk that QE will be (mis)interpreted as an invitation to rack up debt again, allowing European policy to regress to the status quo ante of an irresponsible debt policy. In order to prevent this, the ECB has to draw a clear

red line: anyone who pulls out of the minimum agreements on consolidation and reform policy can wave goodbye to the hope of further support. This leaves Greece, whose new government is in the process of crossing the Rubicon, out in the cold, with the ECB striking a harsh tone in its dealings with the country instead, for example when it comes to the upper thresholds for short-term government bonds or ELA financing. The ECB simply cannot afford to give in to the new government in Athens if it wants to make sure that the QE program does not result in the "Greek tragedy" befalling the rest of the euro area. Giving Greece's demands the green light now implies major political and economic risks for both the ECB and a large number of governments. The QE experiment can only succeed if governments use the relief that it brings to implement further growth-enhancing reform measures. Otherwise, the ECB risks losing trust and its independent standing, something that would have fatal consequences for future EMU monetary and economic policy. The new Greek government would be well advised to acknowledge this new basis of calculation as soon as possible - and rethink its policies. Otherwise, we might well be in for a real showdown, ending either in another change of government in Athens or in the loss of the single currency.

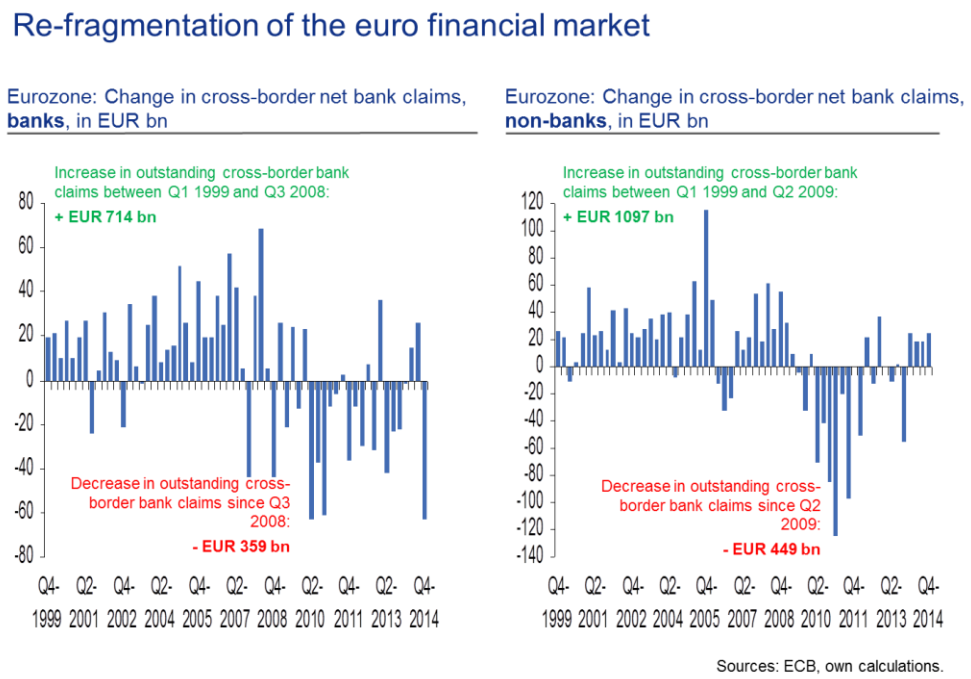
Italy: Bank deleveraging

In Italy's case, the theory of a renewed loss of confidence certainly does not fit. On the contrary: since the government led by Renzi took office, confidence has been on the rise again, backed by a number of key reform steps, especially on the labor market. The gradual narrowing of spreads suggests that investors are placing more, not less, trust in Italy again.

So how do we explain the deterioration in the Target balances in the period leading up to the end of 2014? The key lies in how the country's banks are behaving, particularly in respect of the interbank market.

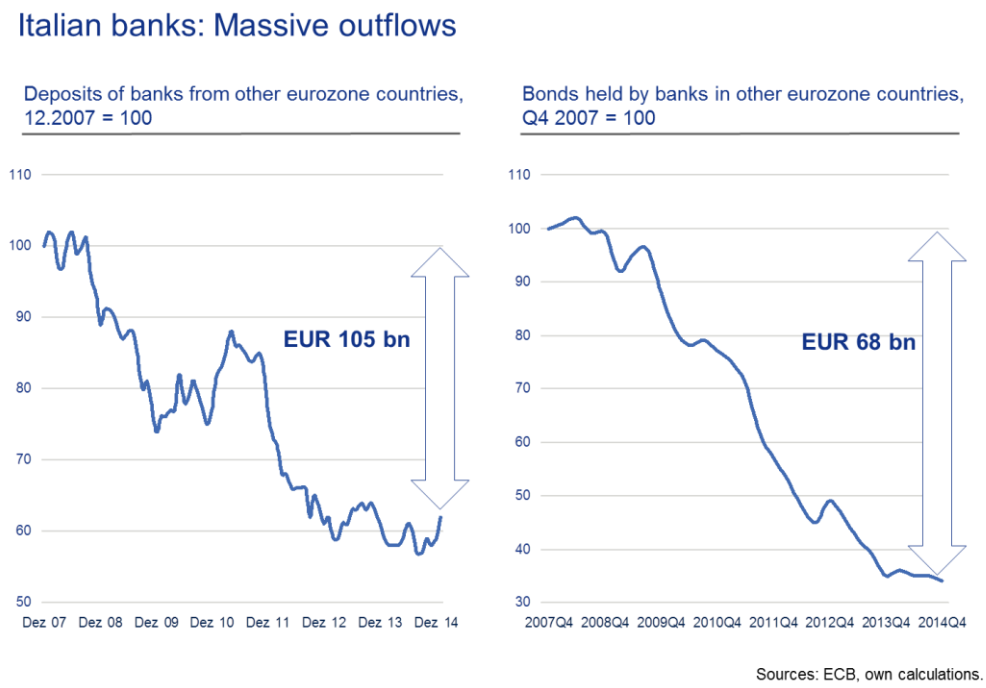
When the euro was still in its infancy, banks were the engine driving the integration process. Cross-border business, be it the granting of loans to other banks or to countries and companies, was ramped up on a huge scale. The periphery states were the main beneficiaries of this development in the sense that they accumulated considerable debt at low interest rates. Everyone knows how the story ends: the Lehman crisis, at the very latest, turned this flow of capital around again and signaled the start of the euro crisis. But while the situation regarding lending to sovereigns and the corporate sector has at least stabilized again over the last few quarters, the interbank market remains very volatile. It would appear that the relationship between banks is still plagued by a strong dose of mutual mistrust. (see Chart 3)

Chart 3: Development in the cross-border business of euro banks



For Italy's banks, this development has translated into cash outflows on a massive scale. Starting at the end of 2007, banks from other eurozone countries slashed their deposits with Italian banks by around 40%, which corresponds to more than EUR 100bn. At the same time, they reduced their Italian bank bond holdings by almost EUR 70bn. October 2014 would, however, appear to have brought a slight turnaround, at least as far as deposits are concerned. It is certainly no coincidence that this slight glimmer of hope emerged just as the results of the Europe-wide bank stress tests were published and the eurozone embarked on its banking union concept. (see Chart 4)

Chart 4: Financing of Italian banks on the euro interbank market

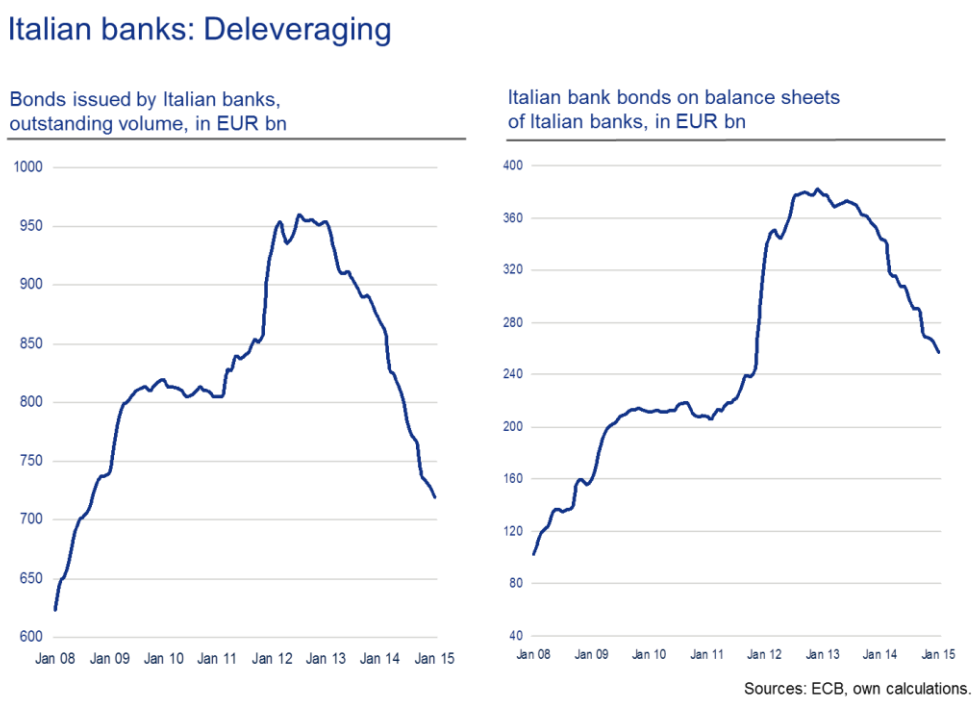


Irrespective of this low-level stabilization on the interbank market, however, Italy's banks are continuing to rein in their capital market debt. Over the past two years (from January 2013 to January 2015), the volume of outstanding Italian bank bonds has fallen by EUR 235bn. The end of this reduction path would not appear to be in sight yet either: in the fourth quarter of 2014, the volume dropped by EUR 38bn and by another EUR 9bn or so in January 2015. (see Chart 5)

Naturally, these bank bonds are not just held in other European countries, quite the contrary: domestic investors are likely to be the dominant force, with Italian banks themselves, in particular, increasingly taking on the role of buyer of late: their slice of the outstanding volume has risen from around 17% at the start of the crisis to over 40% (summer of 2013), and is currently sitting at 36%.[3] Nevertheless, foreign investors are likely to have been on the receiving end of part of this bank bond redemption. In other words: Italian banks paid debt back to abroad without taking out a corresponding volume of new debt.

But how was the redemption financed? During the same period spanning the past two years, the aggregated balance sheet of the Italian banking system fell by only EUR 116bn, i.e. only half of the maturing bank bonds were redeemed by selling assets, while new liabilities had to be taken out to cover the other half. And this is where it seems reasonable to assume that these new funds were made available primarily by the central bank. If this is true, then the increase in Italy's Target balances last year was mainly due to the clearing of bank debt in other European countries using central bank money.

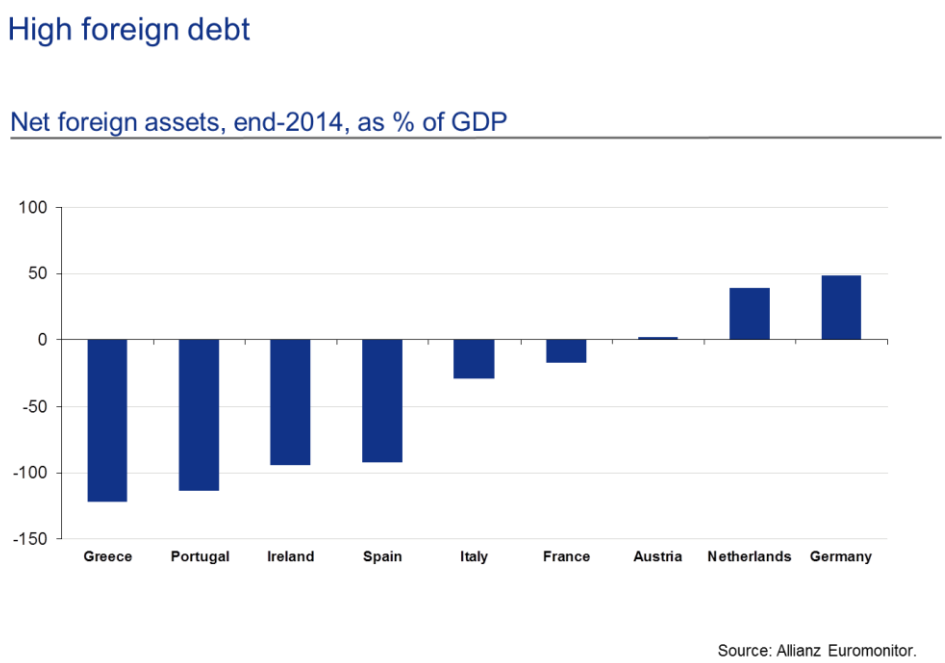
Chart 5: Financing of Italian banks on the capital market



[3] This marked increase in Italian bank bond purchases by Italian banks themselves points towards reciprocal exchange transactions between banks. This form of self-stabilization of the Italian banking system was financed by the central bank.

So at the end of the day, the temporary increase in Target balances cannot, in Italy's case, be attributed to a genuine flight of capital, but rather is due to the behavior of the country's banks, which are continually reducing their capital market debt – and making use of the Italian central bank's money press in the process. This theory is also supported by the considerable drop in Italian Target balances at the start of the year, which corresponds with the slight increase in bank deposits from other eurozone countries (=inflow of capital). This – together with the rising demand for Italian government bonds prior to QE – is one of the first signs suggesting that banks and other investors are starting to come Italy's way again. As long as the ECB continues to supply banks with unlimited liquidity, however, there will remain a strong incentive to swap (expensive) liabilities like capital market debt for (virtually free) central bank money. In this sort of environment, any sustainable drop in Target balances is highly unlikely. After all, the countries with negative Target balances still have a hefty level of foreign debt – despite current account surpluses – that can be "transferred" using this method. (see Chart 6)

Chart 6: Net foreign asset positions of selected EMU countries



QE and Target balances: a complementary relationship?

Will the launch of the ECB's QE program change anything about this situation? QE will provide the banks with even more liquidity – provided that they are prepared to sell their government bonds.

This could result in more foreign debt being paid off using cheap central bank money again – which could potentially push the Target balances back up again. This would, however, clearly contravene the intention of the QE program, which is aimed not at allowing banks to passively swap liabilities, but rather to expand their balance sheets by stimulating lending. What is more, this sort of activity would only push the Target

balances up if QE were, at the same time, not to have any impact on the investment decisions of international investors, i.e. if the Target balances were to be determined largely by the behavior of domestic banks, as they were last year (with the exception of Greece). This, however, would appear unlikely. Rather, QE is expected to re-establish foreign investors as the determining factor.

We can already see that investors are starting to turn more attention back to the eurozone periphery, driven primarily by return considerations, although their focus is less on the supply of government bonds, which has become scarcer as a result of the ECB's measures, and more on corporate bonds or equities in particular. If this trend persists, then the Target balances should also start heading back down: with the ECB as "anchor investor", the level of confidence in these countries could pick up again, in terms of both their continued membership of the eurozone and their prospects of economic recovery. It is, at any rate, no coincidence that it is precisely Greece that has been (initially) excluded from the QE program - and is grappling with massive capital flight.

Summary and conclusions

1. The Target balances were an upshot of the ECB's unlimited allocation of liquidity and proved to be the ECB's most effective tool in combating the crisis. They prevented the euro area from imploding as capital was pulled out. As investor nerves started to settle, the Target balances tailed off again as well.

2. There are various reasons behind the recent return to rising Target balances: for Greece, the theory of a renewed flight of capital certainly holds true. In Italy, on the other hand, the main reason lies in the behavior of domestic banks, which reduced their capital market debt while using the very favorable central bank refinancing route.

3. The recently launched QE program is likely to be a double-edged sword in terms of its impact on the Target balances: even more liquidity could actually encourage banks to make even more use of the central bank refinancing route, institutionalizing this bypassing of the market. On the other hand, the program could also help to build trust, steering more private capital back towards the eurozone periphery and, as a result, reducing the liquidity that the banks in these countries need.

4. This means that the "success" of QE can be read directly from the Target balances: if the program works by bolstering confidence and stimulating the economy, it will attract more investor funds back to the peripheral states – pushing the Target balances down. If, on the other hand, the Target balances remain at their current level or even increase, this would strongly suggest that the ECB is simply using up all of its ammunition with the QE program and merely allowing the money market to be bypassed - without any lasting effect on the real economy.

This risk once again serves to highlight the long-term perils associated with the QE program, particularly also for the banking sector. After all, getting the money market back on track and promoting an increase in cross-border interbank loans again should be one of the ECB's critical objectives. This is not only because the risks associated with the Target balances would place a huge burden on taxpayers in the event of euro exits and also constitute a form of hidden lending, but also, and in particular, because a well-oiled money market gives banks an incentive to strengthen their balance sheets so they can hold their own on the market. But as long as unlimited free liquidity is available from

central banks, this sort of market discipline cannot be established. The only disciplinary pillar left is the supervisory authority, which has to make sure that growth is not thwarted by "zombie banks", such as those seen in Japan.

As a result, it is important that the Target balances do not become an all-too-familiar permanent feature. They still point towards a money market that is not working as it should and constitute a far from insignificant risk for taxpayers in creditor countries. To date, however, the QE measures, which had a tangible impact on interest rates and exchange rates even before they were implemented, have not yet exerted any positive influence over this side of things.

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