What are TARGET2 balances?

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Perhaps you've read in the news that some euro area countries have large negative TARGET2 balances (liabilities), while others have large positive ones (claims) – and all kinds of theories about what that might mean. But what actually are they?

What is TARGET2?

TARGET2 ("Trans-European Automated Real-time Gross settlement Express Transfer system 2") is a system that moves money from one bank to another, both within countries and across borders. Central banks and commercial banks use it to process payments in euro and move money safely and easily between them. This is essential for the economy to function.

Both central banks and commercial banks have accounts in TARGET2.

Read more about TARGET2 and how it works

What are TARGET2 balances?

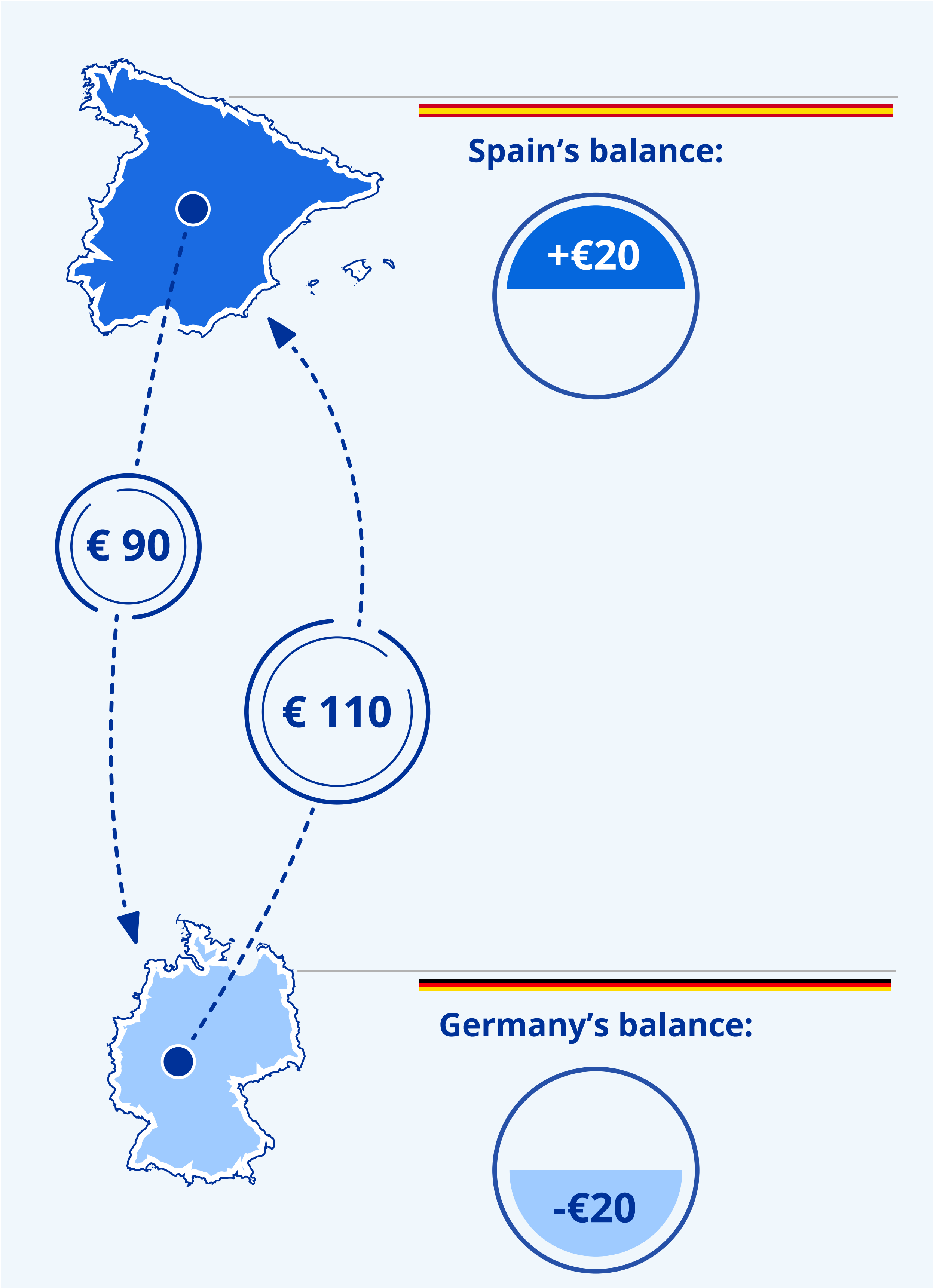
In an integrated market, money is moving all the time, including across borders. Every single euro started off in one particular euro area country or at the ECB, but naturally did not necessarily stay there.

The net flow of money between two countries (i.e. the total received minus the total sent) is recorded on the balance sheets of the national central banks of the two countries involved, regardless of whether the transfer was initiated by a commercial bank or the central bank. The accumulation of these flows over time are TARGET2 balances. The ECB also sends and receives money across borders for the implementation of its monetary policy, so it also has its own TARGET2 balance.

To avoid each euro area central bank having a separate balance with all of the other euro area central banks and the ECB, at the end of each day all bilateral balances are simplified to one single balance with the ECB.

In a nutshell, if banks in one country have – overall – sent more money through TARGET2 than they have received, then the central bank of that country would have a negative balance. If they have received more than they sent, the central bank would have a positive balance. If payments out and payments in were to be exactly equal, the TARGET2 balance for that central bank would be zero.

The accumulation of flows of money over time creates TARGET2 balances


Spain's balance:
+€20
€ 90
€ 110
Germany's balance:
-€20

Why do banks send money to banks in other countries?

Central banks and commercial banks make cross-border payments to each other via TARGET2:

- to pay for goods, services or financial assets that come from another country (for themselves or on behalf of their customers)
- when they want to lend money to each other, in relation to the implementation of monetary policy, e.g. open market operations such as asset purchases which could entail cross-border settlement.

Why is a positive TARGET2 balance referred to as a claim and a negative balance as a liability?

This has to do with accounting and balance sheets, so to understand this, we must first keep in mind two facts:

1. The euro area has one currency, but because it is made up of multiple countries, there is not one central bank with one balance sheet for the euro. Instead, each central bank in each country has its own balance sheet. TARGET2 has separate central bank components to reflect this.

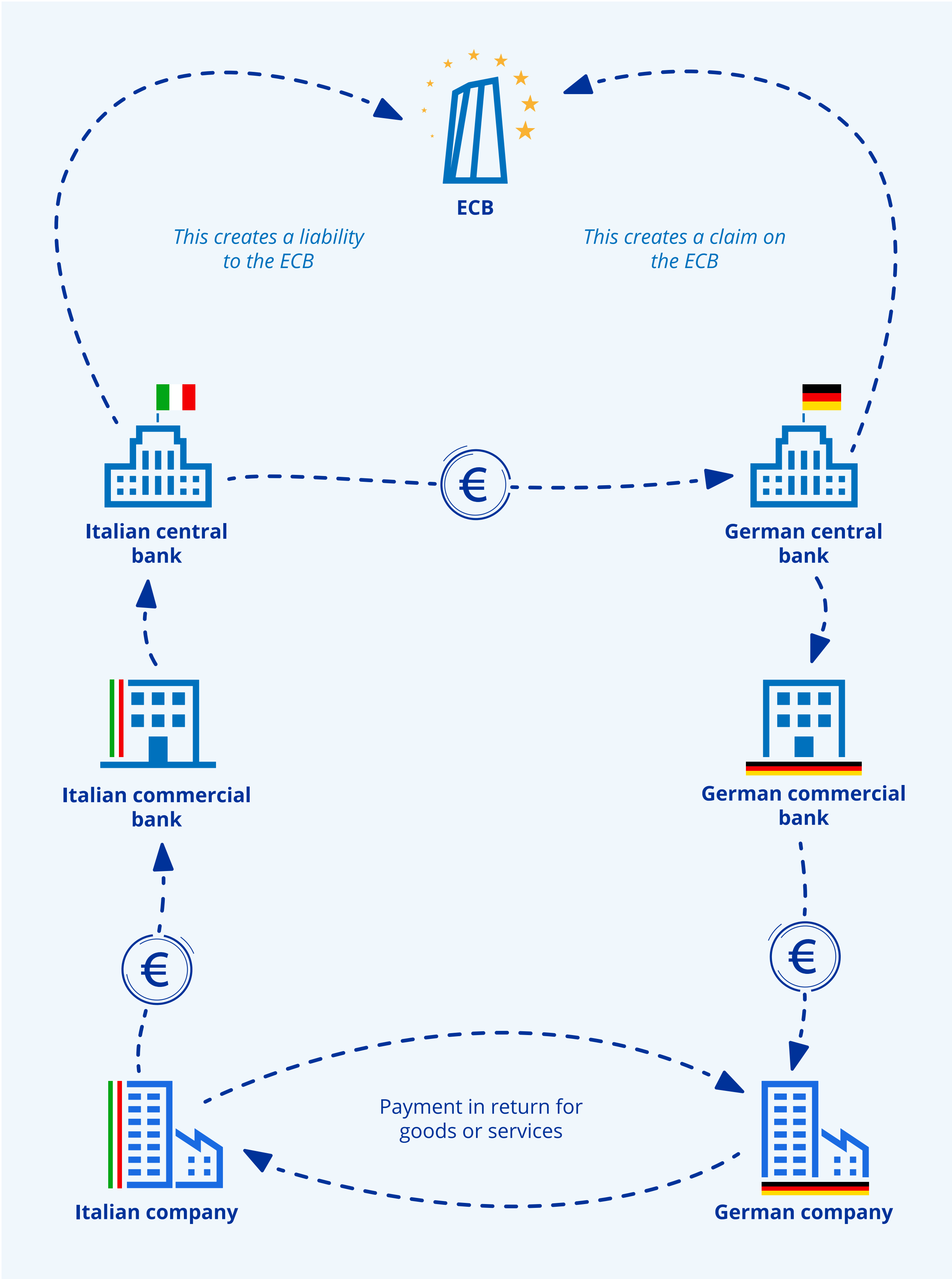
2. When a central bank issues money for the first time, it is recorded on its balance sheet. The money is recorded on the liability side of the balance sheet (as a deposit), while the assets (or claims) corresponding to the money created are recorded on the asset side (for example as a loan).

Back to TARGET2: when money moves between euro area countries via TARGET2, the central bank of the country receiving the money registers this on its balance sheet as an additional liability. But only the liability moves: the asset stays on the original balance sheet.

For example, if euros that were originally issued in Italy end up in Germany, from an accounting perspective, the German central bank has an additional liability (the money), while the asset stays with the Italian central bank. This means the balance sheets no longer balance: the German central bank needs to add a balancing item to reflect that there are now more euros on its balance sheet than it originally created, while the Italian central bank needs to add a balancing item to reflect that it has fewer euros on its balance sheet than it originally created. This balancing item – which is called the TARGET2 balance – is a claim (or asset) for the Bundesbank and a liability for the Banca d’Italia.

But, of course, in a currency union like ours, there is no distinction between a euro issued in one country and one issued in another. It had to start somewhere, but it does not need to stay there, and in fact, it is essential and part of the reason for a currency union that it can move around to other countries freely and easily.

Claims and liabilities in TARGET2


ECB
This creates a liability to the ECB
This creates a claim on the ECB
Italian central bank
German central bank
€
Italian commercial bank
German commercial bank
€
€
Payment in return for goods or services
Italian company
German company

Why have TARGET2 balances been increasing since the financial crisis?

Commercial banks usually lend money to each other via the money market. But when the crisis hit in 2008, trust evaporated and one consequence was that more money was kept at or moved to countries perceived as less vulnerable. This meant that commercial banks in the countries hardest hit by the crisis faced difficulties in getting funding. As lending between banks is key to keep the banking sector functioning, the ECB and the euro area national central banks stepped in.

Central banks provided the necessary funding to commercial banks. A lot of this money was used to replace market-based funding that had dried up, especially funds lent by banks in countries perceived as less vulnerable to those located in countries perceived as more vulnerable. And so, between 2008 and 2012, TARGET2 balances grew because of the larger amount of money that had been created and that crossed borders on a net basis.

TARGET2 balances have again been increasing since 2015 but for different reasons. This is related to monetary policy decisions taken by us at the ECB together with all Eurosystem central banks.

What has the ECB, together with the euro area national central banks, been doing since 2015 that has contributed to increasing TARGET2 balances?

In 2015 the ECB introduced a new programme – the asset purchase programme – as part of the package of measures designed to support the return of inflation to levels in line with our inflation aim. As part of this programme, the central banks in each euro area country buy various assets across borders in return for money. This means that the total amount of money is rising again, but this time driven by the ECB.

Often the assets that are bought by a central bank are held by investors in another country – including countries outside the euro area – who typically have bank accounts in one of the euro area financial centres, such as Frankfurt, Luxembourg or Amsterdam.

So, for example, imagine that under the asset purchase programme, the Spanish central bank buys a bond held by an investor whose bank account is in Frankfurt. To get the money to the German bank account of the seller, the Banco de España makes a cross-border transfer through TARGET2. The seller's bank account is credited and the German central bank registers an increase in its TARGET2 claim, while the Banco de España increases its TARGET2 liability.

Since many assets have been purchased from investors with bank accounts in Germany, money has been flowing into Germany. The money has then remained in countries like Germany because the return on other safe investments (such as domestic government bonds) has been relatively low. Because of this accumulation of money, the Bundesbank's TARGET2 claim has been rising. On the other hand, the liabilities of countries sending money have been increasing.

TARGET balances of participating national central banks

(EUR billions; outstanding amounts at end June 2020)

Source: ECB

So increasing TARGET2 balances are nothing to worry about?

TARGET2 balances can be an important indicator of what is happening in the economy, i.e. the direction in which money is moving around the euro area. However, their driver and interpretation may change over time and it is a key feature of a currency union that money flows across borders.

TARGET2 balances can sometimes act as a signal that something is wrong, for example if lots of money is flowing out of a particular country because of worries about the financial situation there. If this is the case, TARGET2 balances are not the only signal that there is a problem.

The current TARGET2 balances across countries are principally the result of monetary policy measures designed by the ECB to boost the economy. They are not the result of financial stress and thus not a source for concern.

Read more on the topic:

- TARGET balances and the asset purchase programme, Economic Bulletin 7/2016
- Remarks at the BNYM 20th anniversary dinner on the dynamics of TARGET2 balances and monetary policy implementation, speech by Executive Board member Peter Praet on 15 September 2016

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