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TARGET2: I'm a euro, get me out of here!

Unsurprisingly, **the massive injection of liquidity by the ECB in both of its two three-year LTROs was disproportionately taken up by Spanish and Italian banks**. That's clearly evident in the latest data showing the take-up of those loans. However, that has also been associated with **a continued increase in the TARGET2 liabilities** of the Spanish and Italian central banks.

We explained the TARGET2 system and why these balances had increased last year. The increases in these balances are **symptomatic of the euro area's problems rather than the problem itself**. They reflect capital flight from the countries in question and consequent increased dependence on ECB financing of their banking sectors.

In our view, **it is not surprising that the increase in TARGET2 liabilities has coincided with the increase in LTRO lending**. There has generally been a close correlation between the two even if there is little causality. That said, rising TARGET2 liabilities in Italy and Spain are **indicative of a continued net departure of capital from these economies**. That trend continued during the first quarter of 2012, and market price action for April suggests that has not yet started to abate.

And **that is a problem**. Continued capital flight from the periphery has the **potential to derail the adjustments** undertaken by these countries by putting enough downwards pressure on the money supply and nominal activity to prevent orderly public and private sector deleveraging. That manifests itself through low asset prices and high real interest rates.

Of course, policy measures such as the **LTRO go some way to mitigate those effects**. Even after the recent sell-off in Italian and Spanish debt, bank and sovereign funding conditions are much improved from the autumn of last year. But if **capital flight from these countries continues, then there will be a need for more, not less, of these policies.**

It's instructive to examine what has been driving these capital outflows from Italy and Spain. So far, **the outflows have been predominantly from foreign investors rather than domestic capital flight**, and largely in the form of deposit outflows.

So far, the **stability of domestic investors is a positive**. The outflows have been narrow rather than broad. And it's likely that policy measures of financial repression will attempt to hinder domestic funds from leaving their counties, but such policies cannot be absolute. So if the crisis was to deepen this year **a broadening of the outflows to include domestic investors would mean they'd run at a completely different order of magnitude**: TARGET2 balances could increase far more dramatically than they already have.

I'm a euro, get me out of here!

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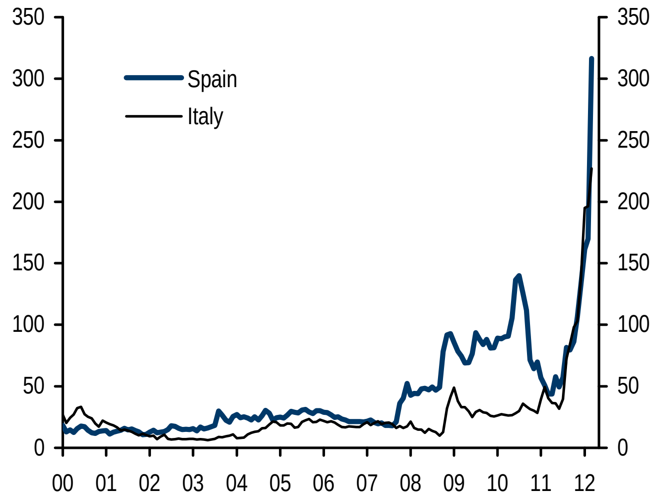
It is now clear that Italian and Spanish banks took considerable advantage of the ECB's liquidity provision in the LTRO. The dependence of these banks on central bank financing has increased considerably in recent months.

That rise has been accompanied by a further substantial rise in these central banks' TARGET2 liabilities with the ECB. And there has been an associated rise in the Bundesbank's net TARGET2 claims on the ECB. The rise in the latter has, once again, prompted much misguided commentary about these claims constituting a "stealth bailout" from the core to the periphery.

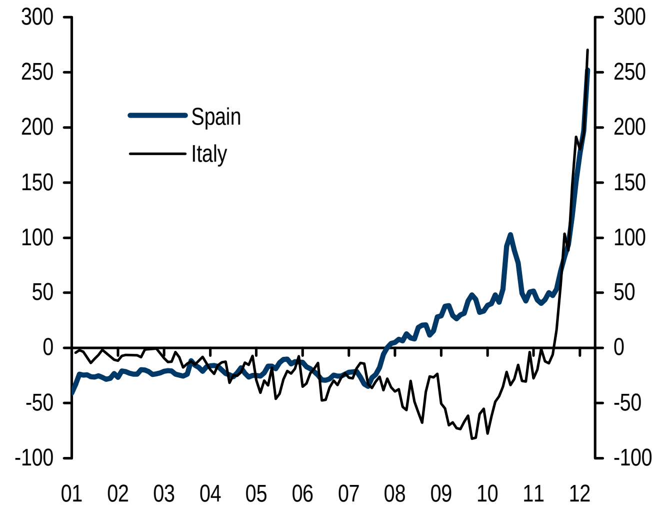
Exhibit 1: Spain & Italian borrowing from ECB

MROs + LTROs



Source: Credit Suisse, National Central Banks

Exhibit 2: TARGET2 net liabilities – Italy and Spain

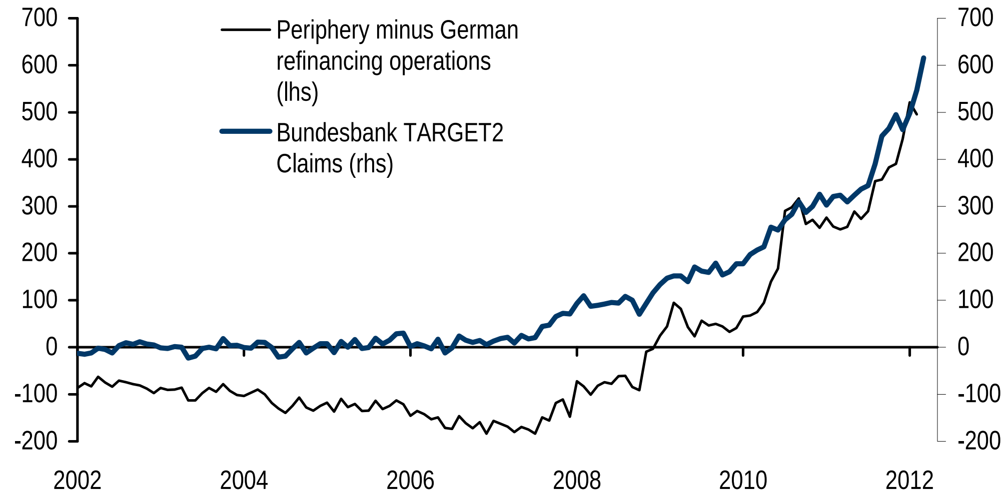


Source: Credit Suisse, National Central Banks

We explained the mechanics of the TARGET2 system, and why they do not constitute a stealth bailout of the periphery last year (Missing the TARGET, 16 December 2011). In our view the increasing TARGET2 balances are another manifestation of the problems – and solutions – experienced by the euro area in the past year: current account deficits and capital flight from the periphery; and increased bank borrowing from the ECB through LTROs and MROs.

As the chart below shows, there's a clear correlation between banking sectors' dependence on ECB funding. But they are effectively caused by the same thing: the crisis and policy responses to it. The euro area has enough problems without double-counting them!

Exhibit 3:Refinancing operations and TARGET 2



Source: Credit Suisse, National Central Banks

Consequently, we are not that surprised that the increase in LTRO borrowing by Italian and Spanish banks has been accompanied by a further increase in TARGET2 imbalances.

However, as our colleague William Porter has pointed out (see, for example, the European Credit Flash of the 19th April),that's not to say that there isn't any new information in their increase. Rising TARGET2 liabilities are indicative of:

- current account deficits not being financed by private capital; or
- net private capital outflows from that economy; or, more likely,
- both of the above.

What matters here is the change in TARGET2 balances, not the stock. If a country stopped experiencing the problems in the bullets above, its TARGET2 liabilities would no longer rise. But the accumulated stock on TARGET2 liabilities could remain substantial.

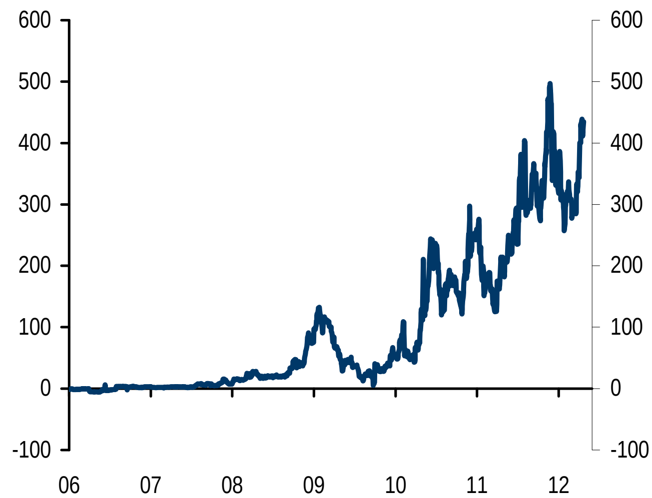
So the rise in TARGET2 liabilities in Italy and Spain in Q1 is likely to be indicative of continued capital outflows from those countries.

Capital outflows from the periphery are one of the factors that have most exacerbated the euro area crisis, in our view. As we discussed last year (Slouching towards union, 19 August 2011), these outflows tend to intensify and accelerate the process of economic divergence between the periphery and the core to such a degree as to render it almost unsustainable.

That's because those capital outflows are likely to intensify the downwards pressure on activity in those countries from domestic private and public sector deleveraging. Instead of those economies experiencing those adjustments against a backdrop of relatively low nominal and real rates, the capital outflows effectively raise the cost of capital in those economies, dampening activity and making those adjustments all the harder to achieve. That's all too evident in market pricing.

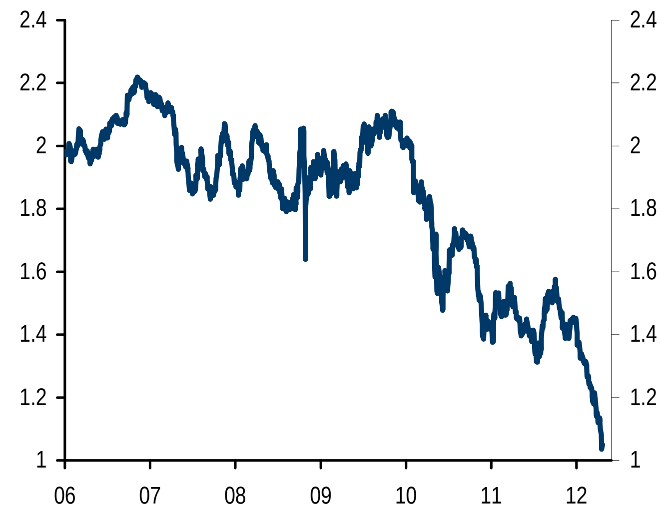
Exhibit 4: Spread of 5yr Spanish bonds vs. Germany

bps



Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 5: Ratio of Spanish IBEX to German DAX



Source: Credit Suisse, Thomson Reuters DataStream

In effect, the liquidity provided by the ECB goes some way to counter the effects of those outflows. That's apparent from the effects of the LTRO. Without it, the distress in asset prices – and pressure on the real economy – would have been far more severe. It's not clear that either the banks or the sovereigns would have been able to finance themselves at sustainable rates in recent months if the LTRO has not been undertaken.

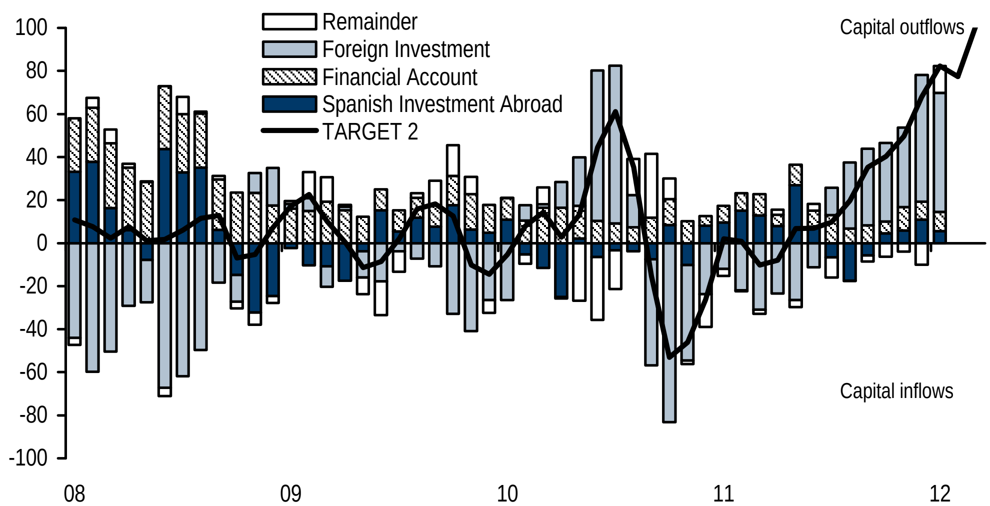
But until those capital outflows diminish the financial backdrop to the adjustments these countries need to make will remain challenging. And while those outflows continue the tendency will be for these countries' TARGET2 liabilities to rise further, and there will be pressure on the ECB to do more, not less.

A key issue, then, is what is driving these capital outflows. In a series of charts below we've accounted for the changes in the TARGET2 balances for Italy and Spain through the balance of payments. Unfortunately the data are only available for January, but they still provide some useful perspectives. In effect, the change in Italian TARGET2 liabilities is the sum of the Italian current account deficit (shown here as the financial account), net Italian investment abroad less net foreign investment in Italy.

The first two charts show very clearly that the sharp rise in TARGET2 liabilities for Italy and Spain in the second half of last year was driven by foreign investors withdrawing funds from Italy. That dwarfed the effects of the current account deficit. Interestingly, there has been little evidence of Italian and Spanish domestic investors channeling funds out. And although we only have data to January, there has been little sign of this outflow coming to an end.

Exhibit 6: Accounting for Spanish TARGET2 changes – domestic vs. foreign investors

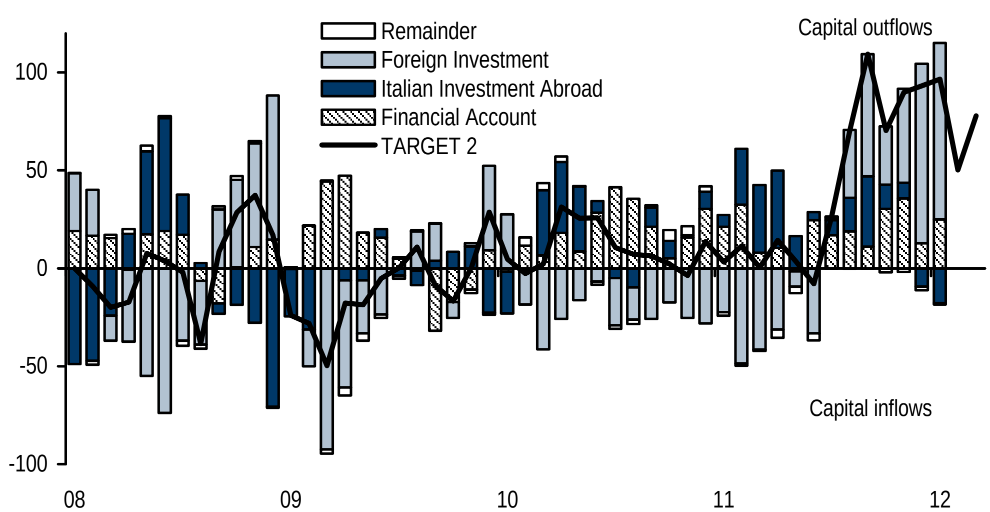
€bn, 3mma



Note: TARGET2 data available to March 2012; balance of payments data available to January 2012
Source: Credit Suisse, National Central Banks

Exhibit 7: Accounting for Italian TARGET2 changes – domestic vs. foreign investors

€bn, 3mma

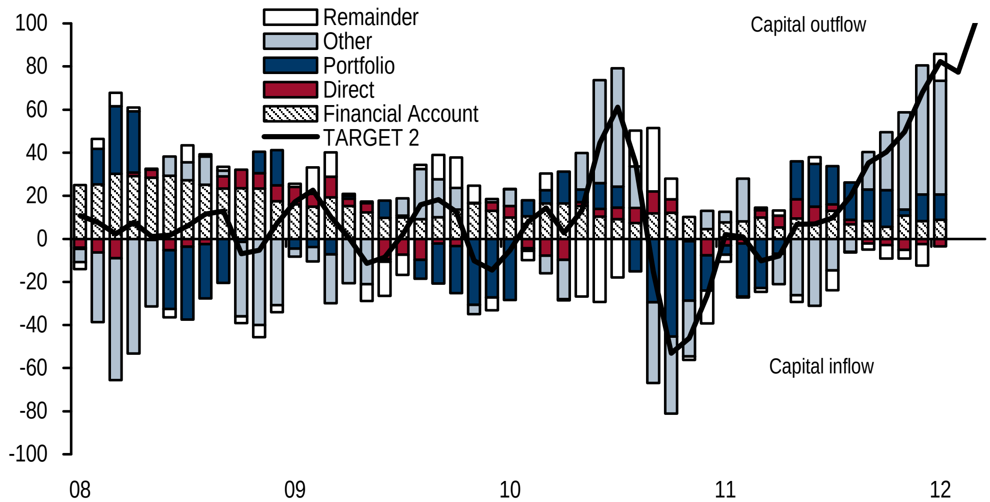


Note: TARGET2 data available to March 2012; balance of payments data available to January 2012
Source: Credit Suisse, National Central Banks

We can look at these numbers from a different perspective. The next two charts account for the change in TARGET2 liabilities by looking at the form of the financial transactions in the balance of payments. Here the predominant source of the capital outflows was the "other" account – effectively bank deposits. However, there have also been significant outflows from the portfolio balance – effectively liquidation of bonds and equities.

Exhibit 8: Accounting for Spanish TARGET2 changes – type of flows

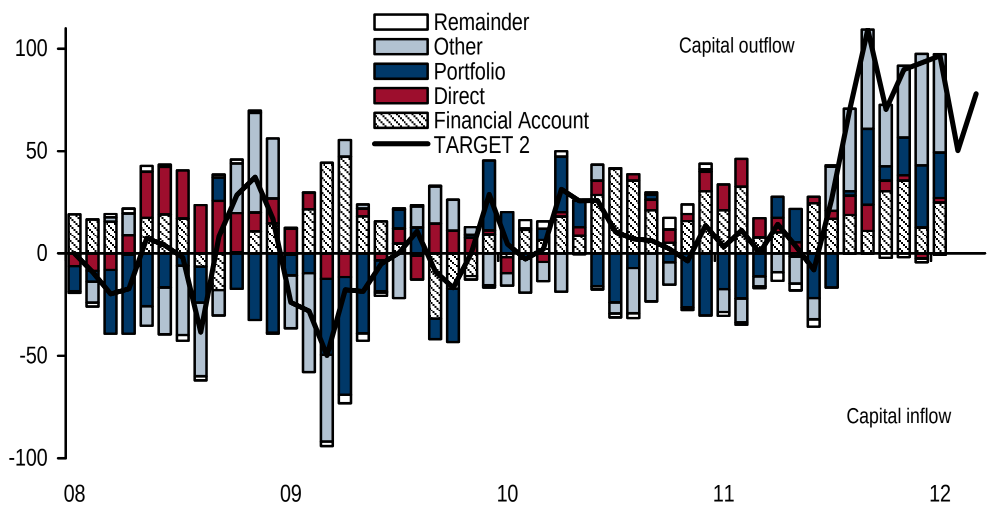
€bn, 3mma



Note: TARGET2 data available to March 2012; balance of payments data available to January 2012
Source: Credit Suisse, National Central Banks

Exhibit 9: Accounting for Italian TARGET2 changes – type of flows

€bn, 3mma



Note: TARGET2 data available to March 2012; balance of payments data available to January 2012
Source: Credit Suisse, National Central Banks

Finally, the table below provides a line-by-line account of the flows determining the rise in TARGET2 balances in Italy and Spain since July last year. It's interesting to note that although domestic residents weren't the main driver of the outflows in aggregate, there was some outflow of "other" investment from domestics.

Exhibit 10: Sum of Flows July 2011 to January 2012

Positive number indicates liability/outflow (i.e. a tendency to increase TARGET 2 liabilities)

	Italy	Spain
Financial Account	39.5	20.7
Domestic investment abroad		
Direct	20.7	10.4
Portfolio	-49.1	-25.6
Other	30.2	18.5
Foreign investment in		
Direct	-14.2	-17.6
Portfolio	97.8	57.3
Other	63.4	63.3
Remainder	-2.2	1.2
TARGET 2	186.2	128.4

Source: Credit Suisse, National Central Banks

The data above beg the question as to how much more foreign investors can withdraw. In light of the higher risks associated with government debt, and the lower expected return on equity markets, it is natural to expect foreign investors to unwind some of the investments they accumulated during the “Great Moderation” years prior to the great recession and euro crisis.

To investigate how much unwinding has been done, we took cumulative sums, since January 2002, of foreign investor’s financial inflows into Spain and Italy in direct, portfolio and other investment categories. The purpose of this was to find out how much of the investment since 2002 has flowed out in the past few years, and at what stage the investment peaked. For example, in Italy, €530bn from foreigner investors flowed into Italy via portfolio investment between January 2002 and January 2012. However, this had peaked in June 2011 when €628bn of foreign portfolio investment had flowed in between January 2002, and June 2011.

The table shows that, on average, about 20% of the peak cumulative portfolio and other investment made since 2002 has been withdrawn recently. This suggests that while foreign investors have already considerably reduced their exposure to Italy and Spain, there is still much more they could do.

Exhibit 11: Foreign Investor’s Balance of Payments Outflows in Italy and Spain

Recent outflows as a % of peak cumulative inflows

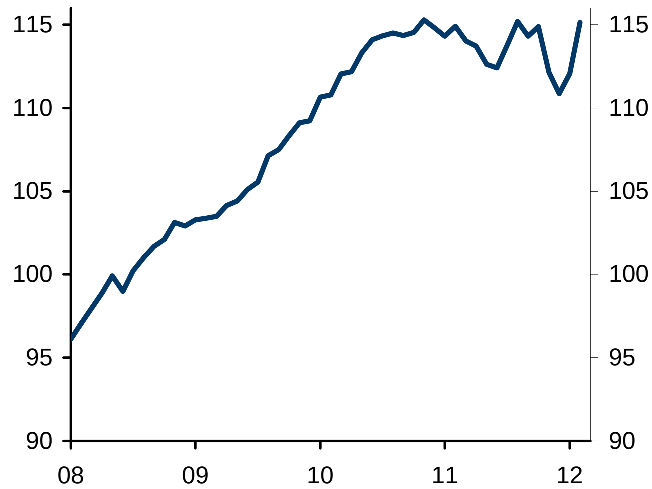
	Italy		Spain	
	Peak Date	Percent from Peak	Peak Date	Percent from Peak
Direct	Dec 2011	-0.6	Jan 2012	0.0
Portfolio	Jun 2011	-15.6	Jan 2010	-18.0
Other	Aug 2008	-36.8	Jun 2011	-13.4

Source: Credit Suisse, National Central Banks

The continued rise in the TARGET2 balances in Q1 shows that those outflows have not eased. But it may be that their nature has changed. The evidence from the ECB’s monetary data suggests that the decline in Spanish and Italian bank deposits – the counterpart to the outflows seen in the “other category” – did come to an end in the first two months of Q1. On a seasonally adjusted basis deposits remained stable in Spain and rose somewhat in Italy.

Exhibit 12: Italy private non-financial deposits

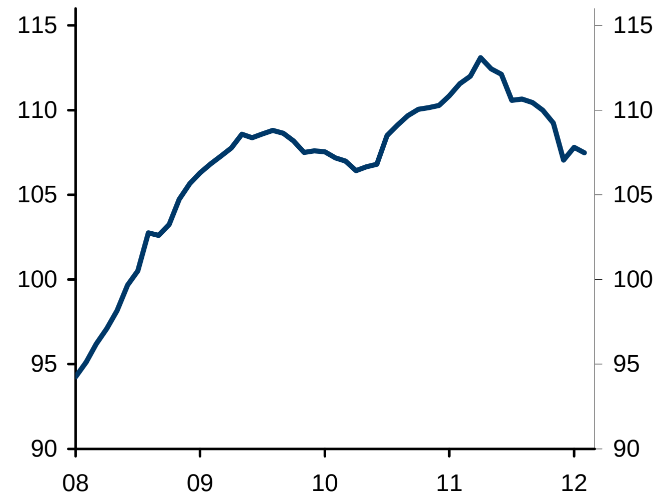
2008=100



Source: Credit Suisse, European Central Bank

Exhibit 13: Spain private non-financial deposits

2008=100



Source: Credit Suisse, European Central Bank

Consequently, it may well be the portfolio balance that predominated the outflows in Q1. That could, in part be a reflection of the fact that government and bank bond redemptions were considerable in Q1. For example, in Q1 Spain had €25bn of bank debt maturing in Q1 and Italy €20bn. If much of that debt was held outside those countries then the redemption of those bonds – if it was not reinvested – would effectively count as a capital outflow. All the same, the continued relative poor performance of Italian – and particularly Spanish – asset prices means that net capital outflows continued in April, which would mean a further rise in the TARGET2 balances.

In one sense, the fact that these capital outflows are relatively narrow in nature – predominantly foreign investors withdrawing funds rather than domestic investors taking money out – is encouraging as there's scope for it to stabilise. It's also likely that policies of financial repression (as we discussed a few weeks ago) will increasingly work at directing domestic funds to domestic investments, limiting the scope for broad-based domestic outflows.

However, it serves as a warning that, in extremis, these capital outflows could become much larger if domestic investors were to join foreign investors in pulling money out. In that event, the increases in TARGET2 balances would be larger than those seen until now.

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