The role of central bank positions in TARGET2

The TARGET2 payment system\(^1\) plays a major role in the smooth functioning of the financial and money markets of the euro as it ensures not only the settlement of the Eurosystem central bank operations (bank refinancing operations, securities purchases) but also the execution of payments between the commercial banks in real time and in central bank money, i.e. using the funds held in accounts with their national central bank (NCB). In addition, the payment and settlement systems managed by the private sector\(^2\) are also linked to TARGET2 in order to allow the settlement in central bank money of the balances between their participants. Concretely, all payment orders relating to these transactions are sent to TARGET2 and settled in central bank money.

When payments are made between banks that have accounts open in different NCBs, the net positions are booked in the accounts that the relevant NCBs hold at the European Central Bank (ECB) in order to account for cross-border payment flows of central bank money. For each NCB, the balance of these payment flows constitutes its TARGET2 balance. This balance may be positive or negative. When the TARGET2 balance of a given NCB is positive (negative), it means that banks with accounts on its books have experienced a net inflow (outflow) to banks with accounts at other NCBs. Therefore, this NCB has a claim (liability) vis-à-vis the ECB.

The transactions at the origin of these cross-border payment flows are of a varied nature, reflecting the diversity of the economic and financial activities within a highly integrated currency area.

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1. TARGET2 is a Real Time Gross Settlement System (RTGS) for large-value payments.
2. These systems, exogenous to TARGET2, notably include securities settlement systems (that ensure the settlement of securities transactions in central bank money), retail payment systems, the Euro1 large-value payment system managed by the Euro Banking Association (EBA) for European commercial banks, and the settlement in euro of the CLS system (Continuous Link Settlement) specialised in the settlement of foreign exchange transactions.
We can illustrate the role of TARGET2 by taking the example of a French company that has invested in the construction of a new production line and has ordered the industrial equipment from its German supplier for a value of EUR 50 million. The company will pay the sum by requesting its bank (Ba1) to transfer the funds to its supplier’s bank in Germany (Ba2).

The payment between the two banks Ba1 (French) and Ba2 (German) will trigger a cross-border payment executed in TARGET2 and resulting in the credit of the TARGET2 balance of the Bundesbank and debit that of the Banque de France.

The settlement in TARGET2 of balances of other payment and settlement systems also has an impact on the balances of the different central banks. One of the aims of TARGET2 is to offer a high degree of flexibility to its users in their liquidity management. A bank may choose to settle the balances resulting from its payment or settlement activities in numerous euro area systems via a single account with an NCB, which leads to numerous cross-border settlements.

In this respect, two systems are particularly important. The first is the settlement of the euro component of the CLS system and the second is the settlement in the Euro1 payment system. In both cases, the settlement of the net balances in euro within these systems is carried out by the payment of the different banks that participate directly in these systems, on the accounts at their respective NCB, to or from the account opened by the system manager (CLS and EBA Clearing for Euro1) at the ECB.
The reasons for the growth of central bank positions in TARGET2

Although the cumulated balances in TARGET2 represent a relatively low amount compared with the total daily amounts exchanged within the system (for example, France’s debit peak at end-2011 represented less than 1% of the total cross-border transactions of the French community), the balances of a number of euro-area NCBs have substantially expanded since the beginning of the financial crisis, with the development of higher positive balances at the NCBs of Germany, the Netherlands and Luxemburg and higher negative balances at the NCBs of countries like Greece, Ireland, Spain and Italy.

As Chart 1 shows, certain NCBs have accumulated either a large credit position or a large debit position vis-à-vis other Eurosystem NCBs. For France (see Chart 2), we see debit peaks (between end-2008 and 2011) followed by a gradual return to a more balanced position.

Chart 1 – The TARGET2 net balances of NCBs

![Chart 1](image1)

Source: ECB

Chart 2 – The TARGET2 net balance of the Banque de France

![Chart 2](image2)

Source: Banque de France

The impact of the economic and financial crisis on the functioning of markets is indeed the main factor at the origin of the divergent evolutions of the TARGET2 balances.

Normally, the TARGET2 balances remain moderate because the market mechanisms allow for the netting of cross border flows. Taking the example of the French company importing industrial equipment from Germany: normally the French bank that will have to finance the transfer to the German bank would be able to borrow the necessary amount on the money market, probably, in this case, from a German counterparty; the transactions would therefore have a zero-impact on the TARGET2 balances of the Banque de France and of the Bundesbank. In times of market stress, when market mechanisms start to seize up, the company has no choice but to seek refinancing from its NCB and this means that the TARGET2 balances remain. At the same time, the situation is exacerbated by a migration of capital from countries whose banks are being weakened by the crisis towards countries whose banks appear more stable within the euro area; these flows are automatically reflected in TARGET2 balances without the interbank market being able to play its stabilising role on cross border flows.

As a result, numerous banks seeking liquidity turn to their NCB because banks that normally lend on the interbank market prefer to deposit their funds with these NCBs rather than lending to each other. In order to maintain the smooth operation of payment systems and hence financial stability, central banks in Europe (and the United States and the United Kingdom) have gradually taken the place of commercial banks in the provision of liquidity; NCBs have therefore become an essential link in the liquidity chain.
This phenomenon is therefore not unique to the euro area. We also see it in countries whose payment systems in central bank money are organised under the same principles as TARGET2, such as Fedwire in the United States. In this payment system, the District Reserve banks that constitute, along with the Board of Governors, the Federal Reserve System, use accounting principles similar to those used in TARGET2 by the Eurosystem NCB's to record payments between the banks that have their accounts at different District Reserve banks. The interdistrict balances also grew in a disorderly way following the impact of the collapse of Lehman Brothers on the interbank market and the resulting development of the US Federal Reserve’s intermediation role.

The implementation of limits on TARGET2 balances would have the effect of preventing capital flows within the euro area, which is contrary to the very principles of Monetary Union. This system of unconstrained TARGET2 balances is naturally only possible within the Monetary Union in the framework of a single monetary policy. Indeed, the TARGET2 balances are a genuine representation of this unity: within the Eurosystem, the positive balances of some countries reflect the negative balances of others and the consolidated balance is zero.

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