Tullett Prebon Research, a blog by Dr Tim Morgan

Way off Target – settlement imbalances in the Eurozone

by Tim Morgan on October 2, 2012

For understandable reasons, attention in the Eurozone has focussed on the difficulty that some governments are having with refinancing sovereign debt, and on the need to shore up vulnerable banks.

Remarkably, much less attention has been devoted to the balance of settlements between Eurozone countries. The consensus seems to be that Spanish banks, for example, are going to need support of between €80bn and €100bn, and that Madrid will need a sovereign bail-out as well - but what about Spain's truly enormous (€434bn) arrears under the Target2 settlement system?

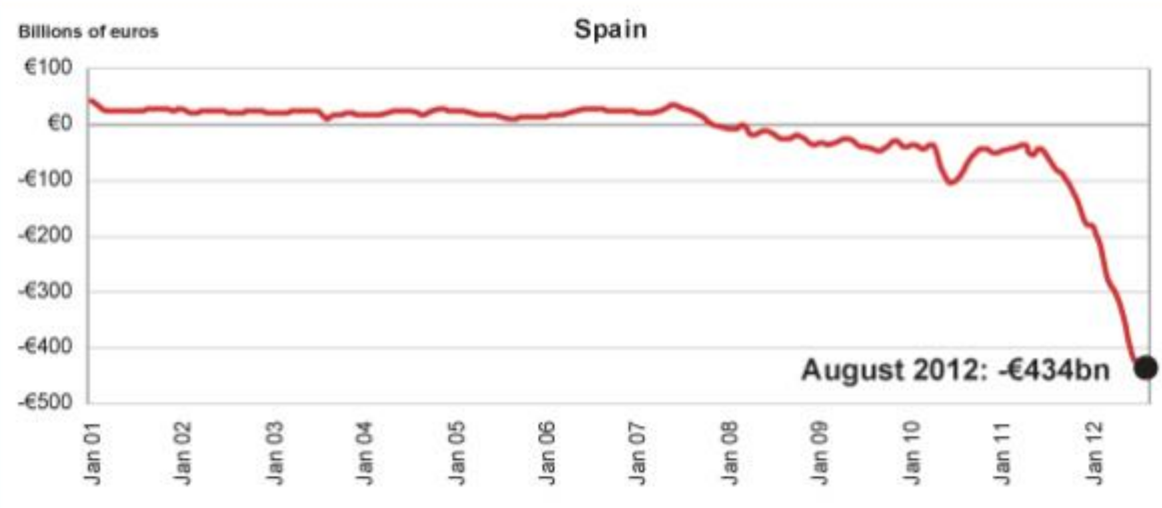
Imagine, if you will, the circumstances of an antiquarian bookseller who conducts regular business with a collector (and sometimes seller) of rare volumes. Small payment imbalances, in either direction, have customarily arisen over many years. In April 2011, for example, our bookseller was owed £3,750 by his customer.

Then, however, the customer started to slip ever further behind on his payments. By the end of last year, he owed the bookseller £17,500. The sum rose to £30,000 by April this year, and at the end of August stood at £43,000. Long before then, I think, the bookseller would have become seriously alarmed, particularly if he was hearing on every hand that his customer was in very severe financial trouble.

This situation is in some ways analogous to the position of Spain within the Target2 settlement system operated by the European Central Bank (ECB). Between April and December last year, Spain's negative balance rose from €38bn to €175bn. The latest available data puts the August balance at €434bn.

The ECB does not publish outstanding balances – more of this in a moment – but economists at the Institute of Empirical Economic Research at Osnabrück University put the numbers together from a variety of official sources. This chart uses their data to show the pattern where Spain is concerned.

Spain: Outstanding Target2 balances

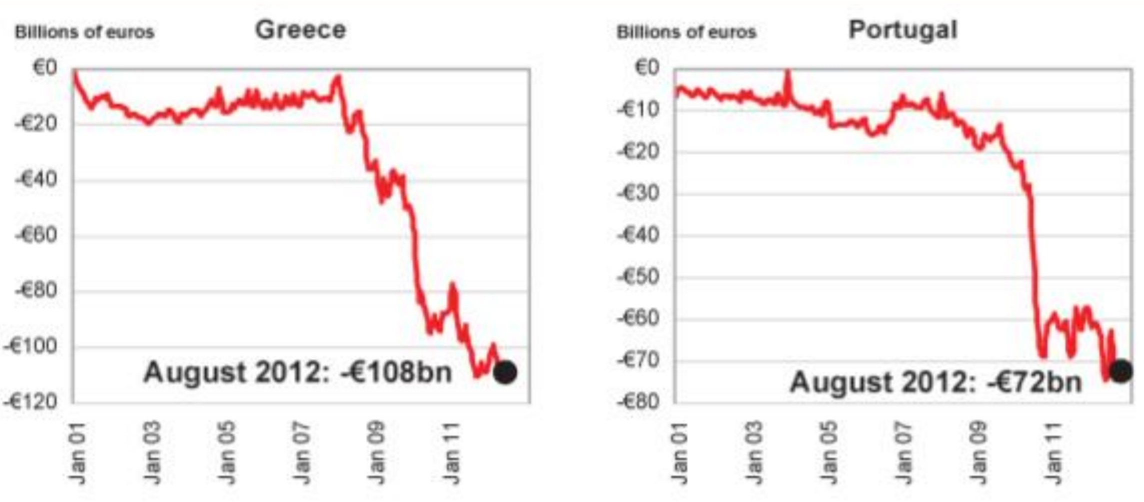


Source: Institute of Empirical Economic Research, Universität Osnabrück

In the Spanish context, €434bn is a huge sum. It equates to 40% of Spain's GDP, exceeds last year's government revenue, and compares with end-2011 public debt of €600bn. Thus far in 2012, the balance has been worsening by about €32bn per month.

Spain isn't the only Eurozone country whose payment balance with the ECB is deeply in the red. The next charts show how the balances of both Greece and Portugal crashed in sync with their respective bailouts.

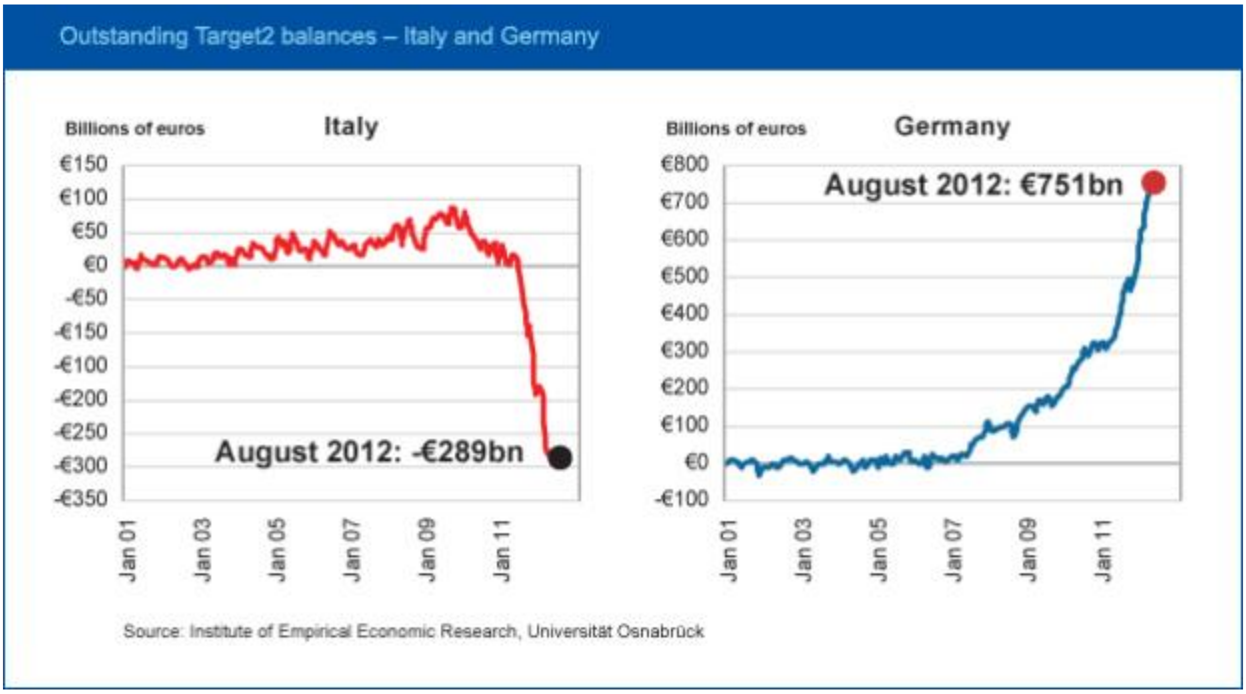
Outstanding Target2 balances – Greece and Portugal



Source: Institute of Empirical Economic Research, Universität Osnabrück

One of the more disturbing charts is surely that of Italy, which had a positive balance as recently as the middle of last year, but has since plunged to a negative of almost €290bn.

Of course, debtors are necessarily offset by creditors, of which by the far the biggest – owed €750bn by the settlement system – is Germany. The Netherlands, Finland and Luxembourg are also creditors of the system. Together, these countries are owed about €1,000bn.



How significant is the sharp division of Eurozone countries into debtors and creditors of the settlement system? According to the ECB – and cited as a reason for not publishing Target2 balance data – it is not significant at all, because the sum total of debtors and creditors nets off to zero.

This must be one of the most fatuous arguments ever to emerge from the Eurozone. It is equivalent to saying that "banks needn't worry about the quality of their loan books because assets are matched by liabilities"!

Others take the view that the weaker Eurozone countries are using the settlement system as a means of "withdrawing savings from those countries with more solid economies using a virtual cash dispenser that they were allowed to set up upon joining the euro", and that a steady drip-feed of bailouts has become the only way of stopping the system from failing.

Widening negative balances raise the question of what happens in the event of default. If a single country were to exit the Eurozone, the sum that it owed would become a loss to the ECB, to be apportioned to members in proportion to their ownership shares. It would command high seniority, which must worry holders of conventional sovereign debt (and, as a result, might well be contributing to the prohibitive borrowing costs faced by Spain and others).

My suspicion is that the widening in Target2 imbalances is indicative of a severe liquidity squeeze in the weaker economies – though others might describe it as a capital flight – and that this makes "one-off, done-and-dusted" bailouts seem conceptually illogical. As soon as you've plugged one hole, another one starts to emerge.

We can look forward to more and more drip-feed bailouts, then – until the music stops.