Falling T2 balances bode well for eurozone's stability

Impact of fragmentation would be less severe today than in 2010s, says Marcello Minenna

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After a decade of below-zero levels, interest rates in the eurozone have been trending back into positive territory. This, together with the gradual downsizing of balance sheets in the Eurosystem – the European Central Bank and national central banks (NCBs) – is reducing the amounts of risk segregated in member states' financial systems. This means that if a country crashed out of the eurozone, the remaining members would be less severely affected than they would have been had a fragmentation occurred in the 2010s – when the bloc was still dealing with the aftermath of the Greek debt crisis.

The improvement in the Eurosystem's finances can be seen in NCBs' T2 account balances. T2 – the successor to Target2 – is an accounting system

that records payments between private banks and in which all payments between countries are recorded as debits or credits. NCBs' T2 account balances peaked in August 2022 at nearly €1.9 trillion ($2.0 trillion) – a direct result of the ECB's unconventional policies aimed at easing monetary and financial conditions in the eurozone. The most notable of these policies were the asset purchase programme (APP), which includes the public sector purchase programme (PSPP), and the pandemic emergency purchase programme (PEPP). The PSPP was active from March 2015 to June 2023, while the PEPP has been ongoing since March 2020.
NCBs were responsible for 90% of the purchases made within the PSPP, and 80% of those within the PEPP, with the ECB taking up only the remaining 10% and 20% respectively. This arrangement distributed the risk among eurozone members. In effect, the ECB provided liquidity to NCBs, which then channelled it into their own banking systems. This liquidity enabled the banking systems to service debts to their European counterparts and to buy the national government debt that their European counterparts were selling. The twist was that member states had to pay interest on bonds purchased under the programmes.

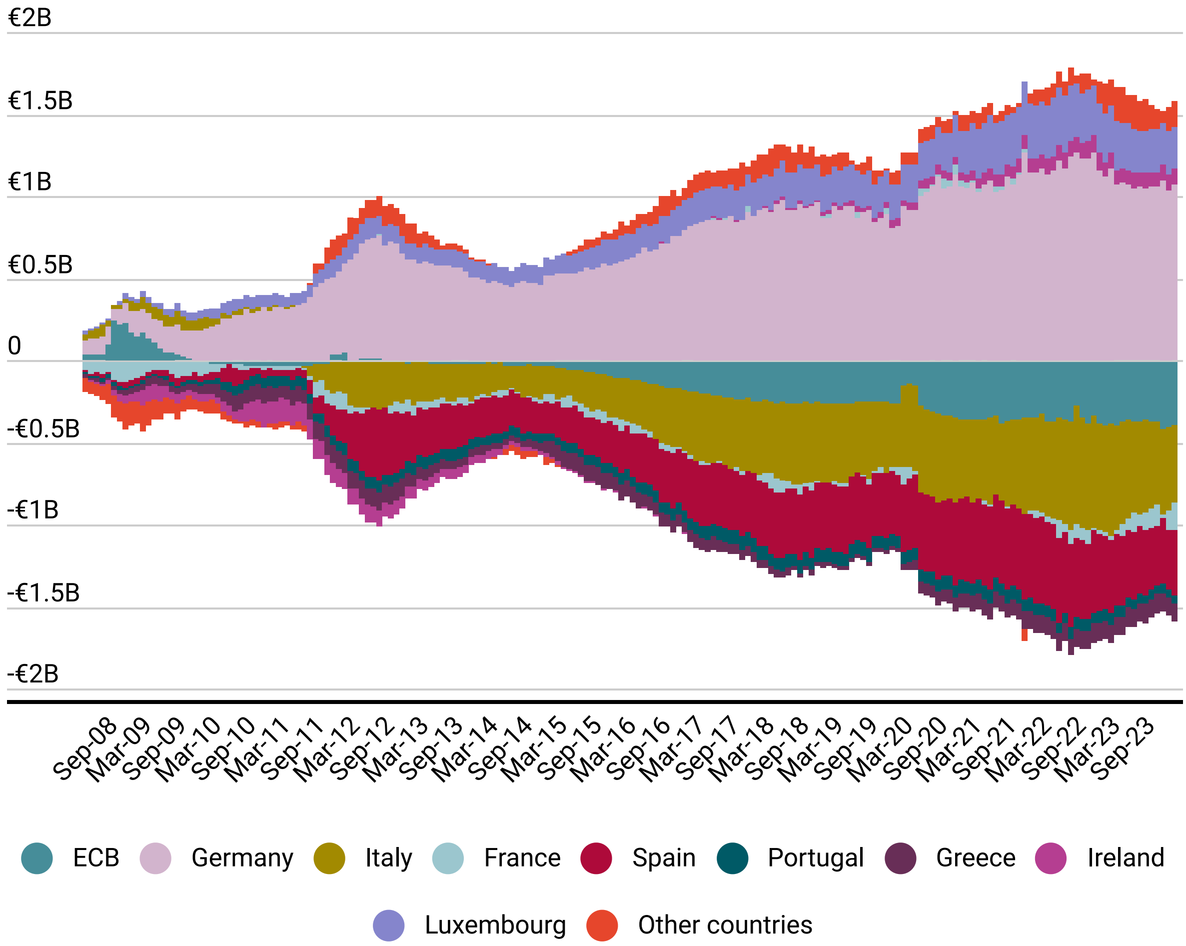
At the time, **I compared** the PSPP to a credit default swap (CDS) trade, with the interest payments on the bonds taking the place of the premium that would be paid to a CDS seller. In effect, the NCBs were guaranteeing the nominal value of the purchased bonds – essentially renationalising the risk – and **implicitly protecting** the ECB against the debt devaluation that would follow if a member state had to exit from the eurozone. The costs were borne by those NCBs that required the most liquidity support.

T2 balances are a handy way to keep track of these obligations. If an Italian bank buys a government bond from a German bank, this creates a debt in the Bank of Italy's T2 account and a credit for the Deutsche Bundesbank's. As more bonds are purchased this way, Italy's T2 account becomes increasingly negative and its interest costs rise as more risk is renationalised.

As such, the T2 debt balance provides a measurement of how much risk each country has renationalised as a result of the ECB's policies.

The system is 'zero-sum': debtor countries' aggregate negative balances must equal the sum of creditor countries' aggregate positive balances. At the end of 2023, the overall picture was as follows:

Trend of T2 balances



Source: ECB
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Germany has acted as a 'magnet' for flows from southern Europe. This reflects the nationalisation of risks by countries such as Italy and Spain, and German public debt's consolidation of its role as a safe haven for eurozone investors.

France's T2 balance, on the other hand, has remained broadly constant. This reflects the disproportionate size of the country's banking system in relation to the economy when compared with other member states, such as Italy. In fact, France's banking system has compensated for the country's double deficit by attracting capital.

The positive figures for Luxembourg, Ireland and the Netherlands – the last-named being a dominant element of the 'other countries' category – reflect the significant weight of foreign-invested entities operating in these countries.

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The growth in ECB debt reflects the increase in direct purchases of European government bonds as part of centralised risk-sharing programmes. This is in contrast with the purchase programmes conducted through NCBs from 2011 in response to the fallout from the Greek debt crisis.

The good news is that T2 accounting debits and credits have fallen by more than €200 billion since September 2022. These figures should continue to drop – assuming that interest rates remain positive and inflation returns to normal levels, and barring abnormal liquidity outflows from the most exposed countries.

This is significant for countries with large debits. Italy's balance dropped from a peak of €714 billion in September 2022 to €467 billion in February of this year. With interest being paid on negative balances at the ECB's main refinancing rate (MRO), which has exceeded 4%, this amounts to €10 billion in savings. It also means a reduction in eurozone 'fragmentation risk'.

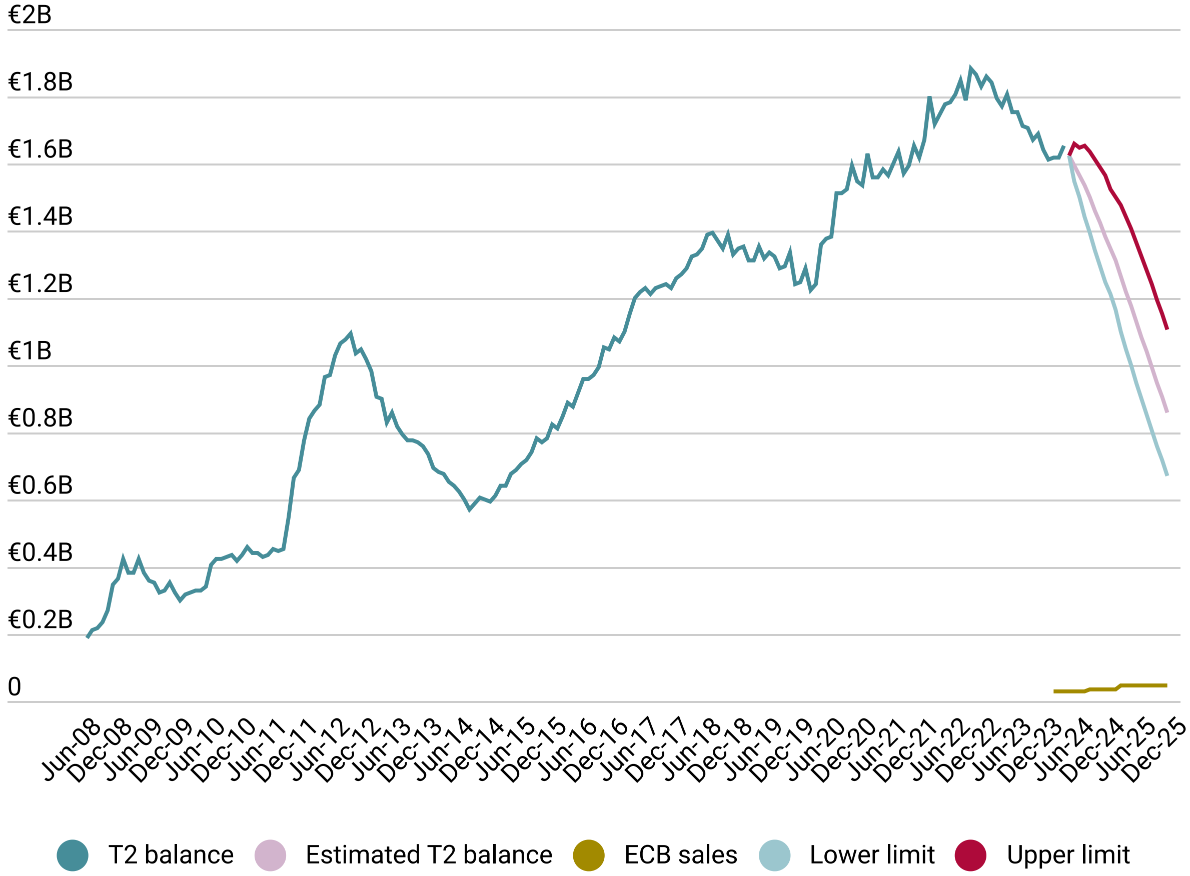
Expansionary policy

More important than the redistribution of flows among countries is the gradual growth of liquidity in the Eurosystem resulting from the ECB's expansionary policy. The central bank provided 'fuel' for the growth of T2 balances by allowing excess bank reserves to increase through its government and corporate bond purchase programmes – quantitative easing (QE) and PEPP – and its concessional loans to banks.

The balances declined in 2012 and 2013, just as banks were repaying the €1 trillion in emergency loans provided by the ECB during the 2011–12 crisis, thereby reducing their excess reserves.

Starting in the second half of 2022 – with the suspension of QE and PEPP, and the contraction of ECB acquisitions at the rate of €30 billion a month – the total sum of balances stopped growing. The projected increase in this monthly contraction to €37.5 billion in 2024 and €45 billion in 2025 creates the necessary conditions for reducing balances over the coming years.

ECB – quantitative tightening and T2 total balance development



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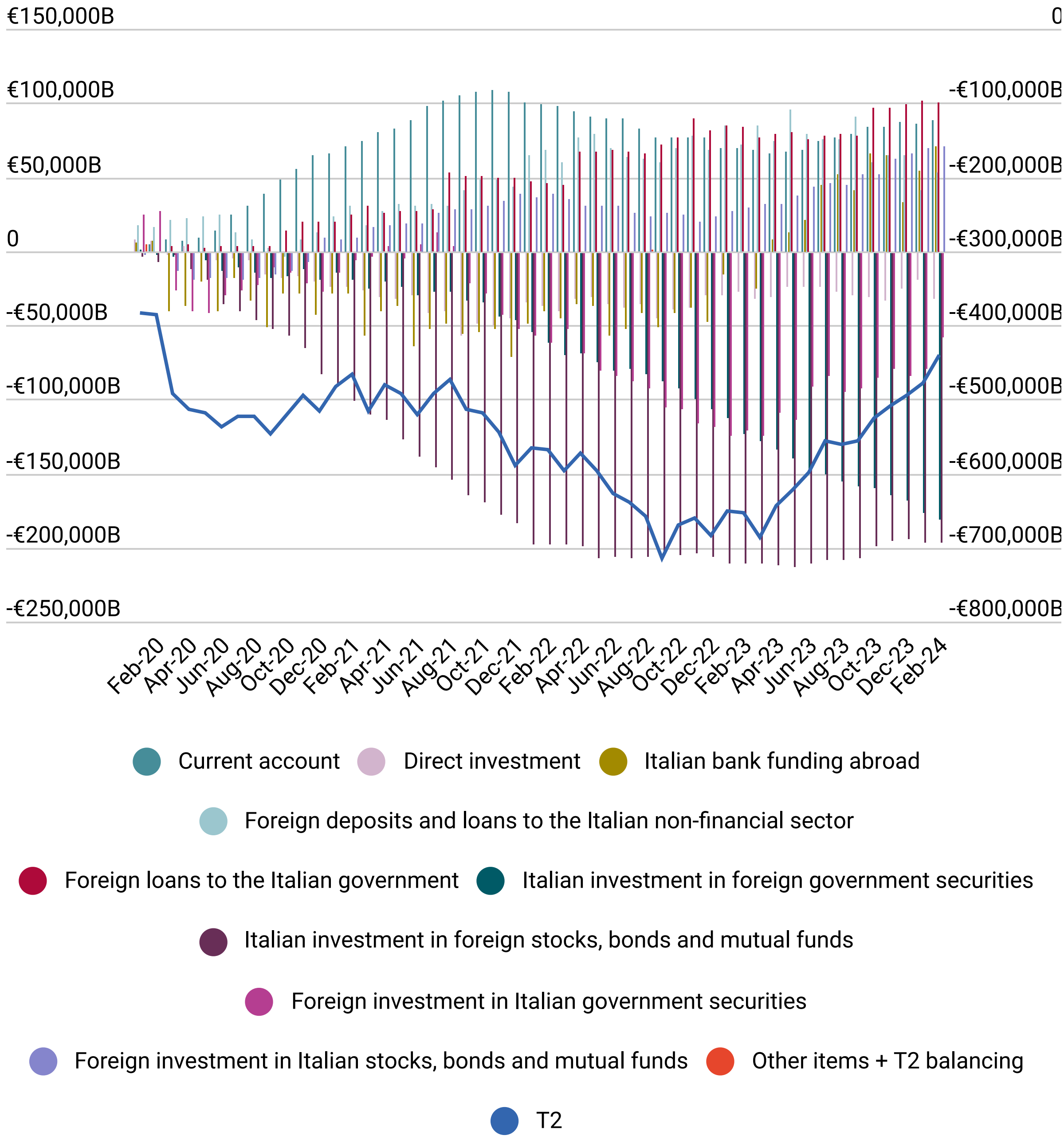
Another important factor in reducing T2 balances is the initiation of European risk-sharing financial programmes, such as Support to mitigate Unemployment Risks in an Emergency (Sure) and NextGenerationEU (NGEU). These involve centralising risk through the settlement of financial flows at the European level – in contrast to APP and PEPP, which took place through NCBs.

News from Italy

Italy's most recent balance-of-payments data, released in February, provides a clear accounting picture of the factors behind recent cross-border liquidity transfers to and from the country.

Italy – T2 net balance (right column) vs balance of payments liquidity inflows (cumulated, left column)



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There was a resumption of liquidity inflows in the summer of 2023, and outflows have stabilised. This has led to an improvement in the T2 balance.

The main determinants of these dynamics are rising interest rates and the persistent perception of systemic risk from investors, who tend to downplay country-specific risks by favouring bond investments and deposits.

On the inflows front, there has been an increase in the trend of net inflows from the domestic banking system and, conversely, a decrease in net inflows from their foreign counterparts (for example, funding from the foreign banking system to Italy). There has also been an increase in purchases of Italian securities by foreign investors and an interruption in purchases of foreign securities by Italian investors and a resumption of sales of risky securities (stocks, bonds and mutual funds).

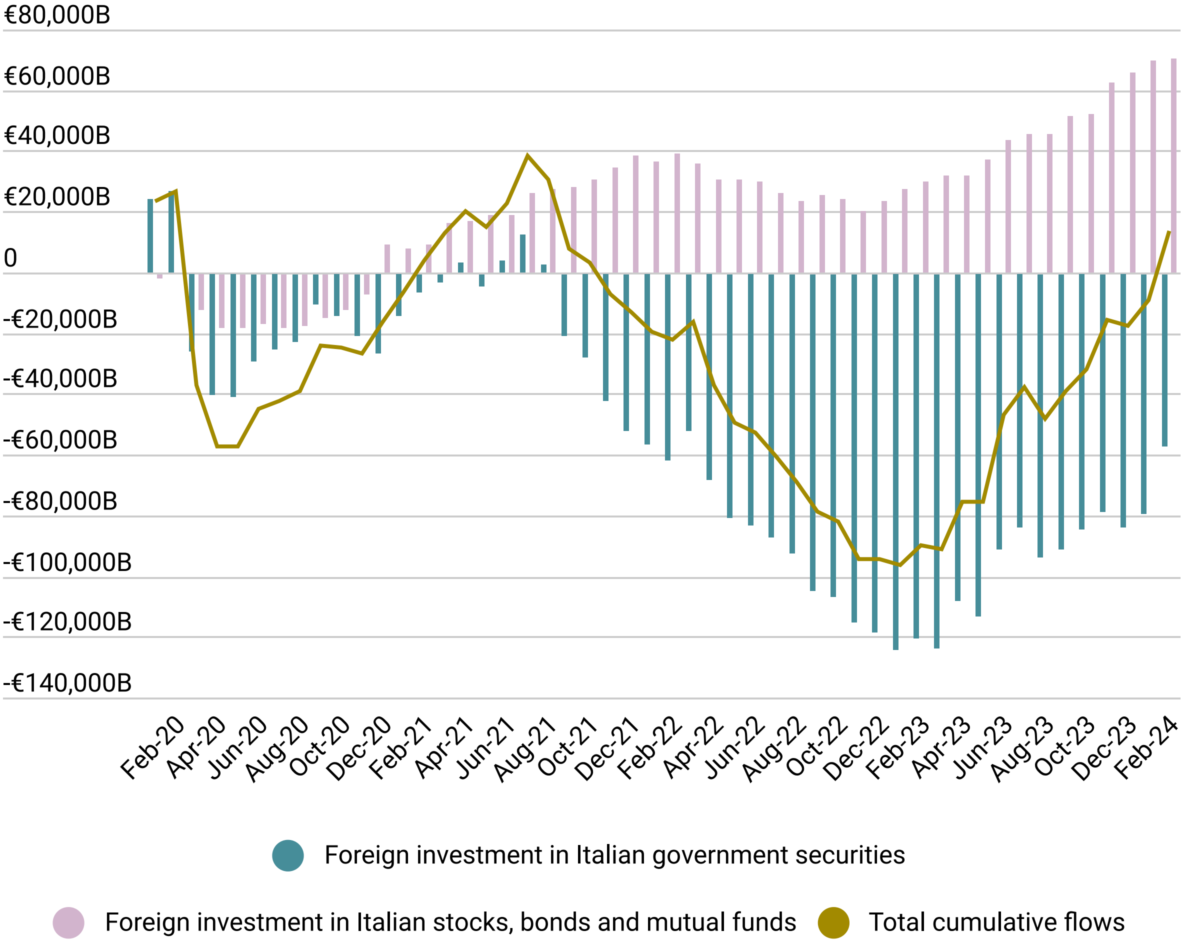
From 2020, inflows were also affected by the two loans the Italian government took out under the Sure and NGEU schemes.

The ECB’s unconventional programmes and the negative interest rates on core government bonds stabilised the demand for Italian government debt.

The rise in interest rates heightened the perception of fragmentation risk, which caused foreign investors to put their capital in bonds issued by their own governments and to reduce their exposure to Italian sovereign debt. However, with the reduction of fragmentation risk, this no longer appears to be the case. The rise in rates has, in fact, contributed to a growing appreciation among foreign and Italian investors for the spread offered by Italian treasuries (BTPs).

Foreign investors’ ‘love affair’ with Italian government securities – which began at the end of 2020 before petering out around a year later – seems to have found new life. The lack of interest in Italian risk that had been shown since 2021 had, by the beginning of 2023, turned into €100 billion in cumulative flows.

Foreign investment in Italian securities (cumulated flows)



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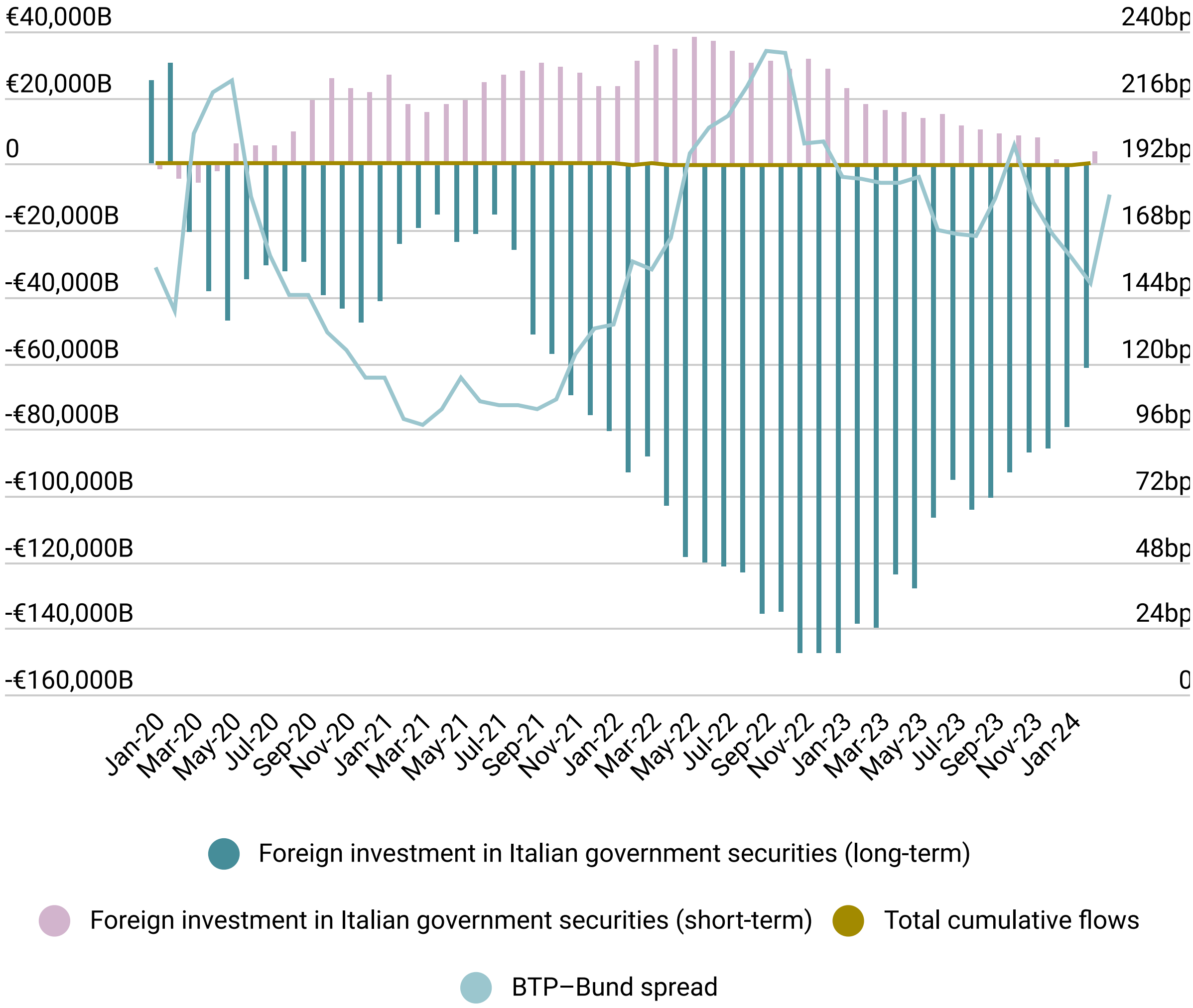
This has contributed to the normalisation of the T2 balance and a reduction in the spread offered by Italian government bonds.

The chart below shows how investors have tried to reduce their 'Italy risk' by focusing on higher duration securities that are more sensitive to yield volatility, and which therefore allow for greater capital gains.

Foreign investors reduced their exposure to Italian government debt by selling at an advantageous price. They strategy was to anticipate the end of QE and PEPP, which guaranteed the presence of a safe and predictable buyer in the market. The combination of lower demand from the ECB and higher supply from abroad pushed up Italian government bond yields. The spread between BTPs and German Bunds surpassed 230 basis points, before settling at lower levels as the BTPs in foreign portfolios that were needed to perpetuate this strategy were exhausted. The inverse relationship between the spread and the amount of foreign investment in BTPs with higher maturities is not surprising.

Foreign investment in Italian government securities (cumulated flows)



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The reduction in the stock of BTPs in foreign hands was first accompanied by the substitution of long-term securities for those with maturities of less than 12 months. This behaviour was consistent with the wish to reduce exposure to interest rate risk following the anticipated end of QE and PEPP. However, this was not just a rebalancing. The pace of divestment of long-dated securities dramatically outpaced the growth in foreign demand for short-dated ones.

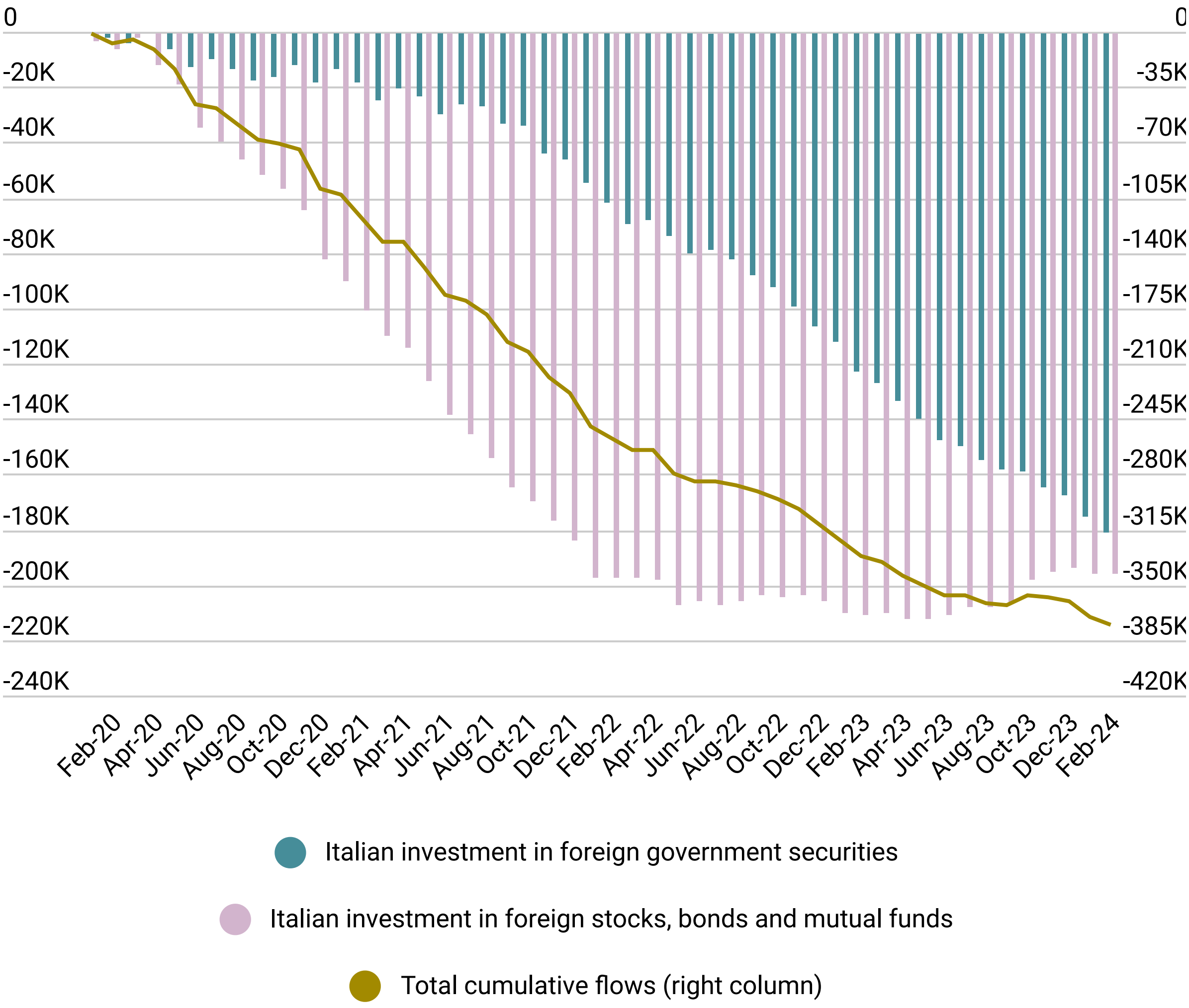
Nevertheless, the phenomenon seems to be slowing as nominal rates rise and inflation comes down.

The differential between US and eurozone interest rates is making Italian financial instruments more attractive. Inflation differentials cause real rates in the eurozone to be higher than those in the US. This is encouraging an inflow of liquidity that is being reflected in a reduction in T2 debt balances.

Home thoughts from abroad

Before discussing these new dynamics, it should be noted that the rise in interest rates in the main currency areas has led to a renewed interest on the part of Italian investors in foreign government bonds. For a long time, the latter have also offered negative interest rates, especially in the core countries of the eurozone. However, as said, the outflow appears to be stabilising and may even be reversing, which is of particular relevance to the T2 balance. The purchase of foreign securities causes, in fact, a liquidity outflow that also defines a debt position of the Bank of Italy with regard to other NCBs, which act as settlement counterparties to these investments – and thus worsens the T2 balance.

Italian investment in foreign securities (cumulative flows)



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In light of the above, there is a good chance that the decisive reduction in Italy's T2 balance will continue in 2024. This is important because the interest paid by NCBs from countries with negative net balances is redistributed annually by the ECB to NCBs with positive net balances.

To a large extent, these costs/profits are just an accounting item. This is because calculating the Eurosystem's annual monetary income involves aggregating the income of each participant (including that derived from

T2 balances) and adjusting it so that each NCB ends up with monetary income equal to its corresponding share of the ECB's capital.

However, at an average MRO of 4%, the current balances would generate more than €30 billion of interest expense for the Bank of Italy and well over €50 billion of interest income for the Bundesbank. Even assuming an interest offset of 80%, this would amount to €5 billion in additional costs – something that would be saved if the Eurosystem adopted a full risk-sharing model.

Energy equation

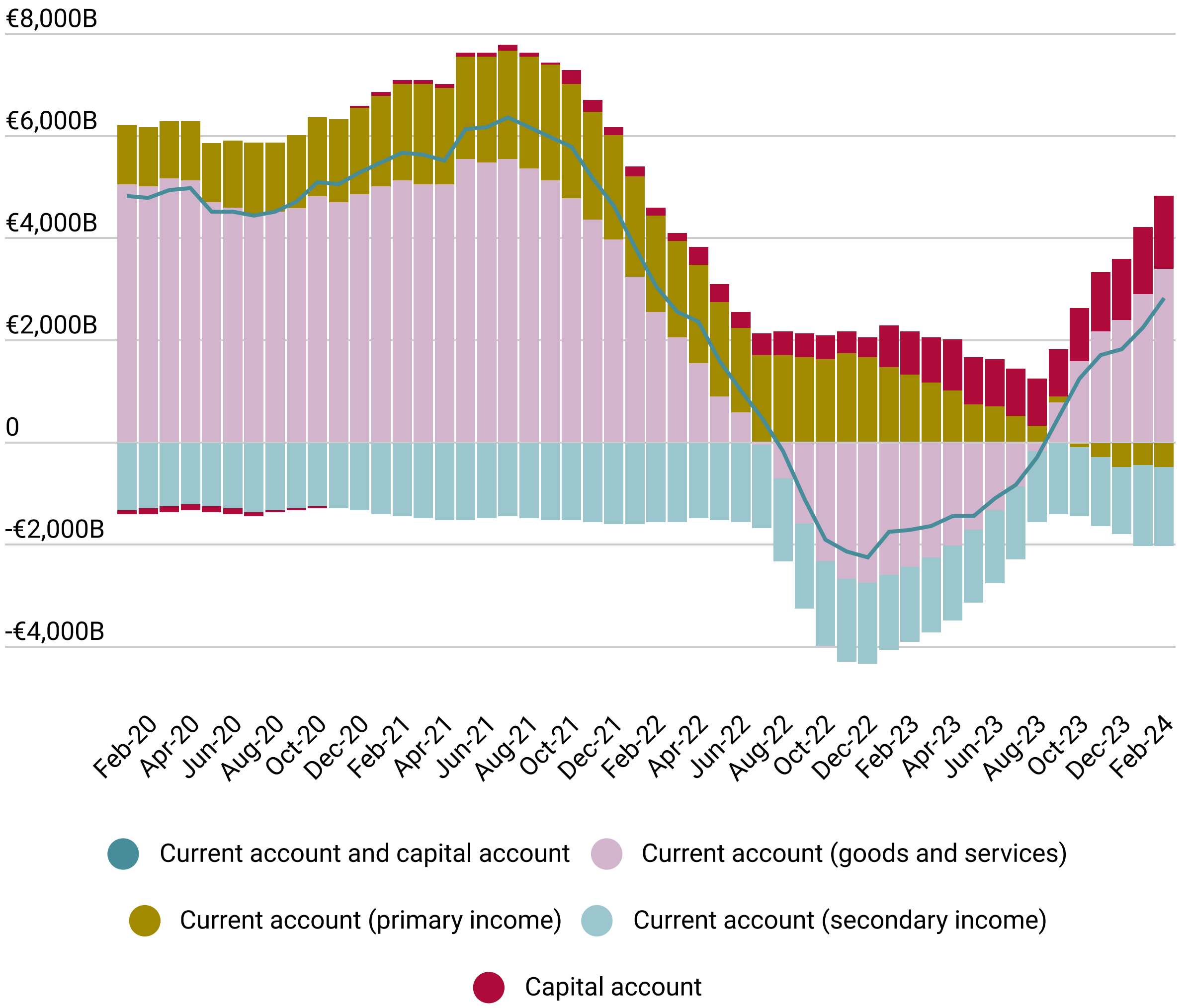
Since 2021, there has been a rise in the cost of raw materials and energy imports to Italy, exacerbated by the Russia-Ukraine conflict, while exports have essentially stalled. These phenomena caused the trade balance to shift into negative territory. As a consequence, Italy's current account balance also deteriorated, which contributed to the deterioration in its T2 balance.

However, the more recent normalisation of domestic energy balances and inflation have played a part in bringing Italy's trade balance back into positive territory. These developments, along with capital inflows from NGEU funds, are among the factors contributing to the improvement in the T2 balance.

Primary income will go in the opposite direction because of the high interest rates to be paid to foreign investors in Italian government debt. These investors are re-entering the market, attracted by its renewed profitability. In short, the current account's contribution to improving the T2 balance remains uncertain.

Italy – current account and capital account (balance)

12-month moving average (monthly flows)



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The dynamics of recent years, when taken in the round, are positive for Italy and for the Eurosystem more widely. Reducing the country's T2 balance means reducing the amount of risk segregated in the eurozone's national financial systems.

EU regulation should accelerate towards the risk-sharing model in order to concretely implement the project of a United States of Europe.

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Editing by Daniel Blackburn
