Financing the euro area economy: The role of the Eurosystem

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Explaining the increasing role of the Eurosystem in financing the Euro Area economy and what to do about it.

As a result of the environment of uncertainty related to the viability of the Euro Area and the tensions in sovereign debt markets with systemic impact, Eurosystem funds have replaced a good portion of private capital in the peripheral economies. Private capital outflows and the recourse to the liquidity of the Eurosystem are today the highlights that explain the composition of the financial account in the peripheral economies, while capital inflows and excess liquidity in the banking system define the structure of financial accounts in the core countries. The imbalances generated in these two areas signal a process of increasing financial fragmentation inside the EMU. To reverse this process, in addition to ECB institutional support announced on September 6th, more advances in European integration and more internal developments in the economies with higher imbalances are required. These actions will be a prerequisite to reduce private capital outflows and rebalance both current accounts and the composition of financial accounts among the euro economies, reducing Eurosystem liquidity as a significant source of funding.

Introduction

The idiosyncrasy and persistence of the current financial and economic crisis has substantially changed the sources of funding in main developed economies and, in particular, in the Euro Area countries with a growth model supported by the increased reliance on external savings (as is the case in most of the denominated peripheral economies –Greece, Ireland, Portugal, Spain and Italy), due to persistent current account deficits.

Until 2007, banking systems in these countries, the main intermediaries in the funding of households and non-financial corporations, could access, without restrictions of volume or cost, to wholesale money markets (through interbank loans, deposits and/or repos and the issue of securities), thus covering external financial needs coming from a growing net imports balance and the acquisition of financial assets in the rest of the world (in this last case, coinciding with the financial internationalization process in some countries).

However, with the eruption of the financial crisis and following the collapse of private funding markets, central banks initiated non-conventional monetary policy measures in order to reduce liquidity tensions in key segments of the market,

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like collateralized banking debt (covered bonds) or even, more recently, sovereign debt. In the euro Area, the ECB has become the lender of last resort, providing funding to the banks in the periphery with open market operations and covering not only new financial needs but also net outflows of private capital. The environment of uncertainty related to the viability of the euro Area, the programs of financial assistance to the Greek, Portuguese and Irish economies or the Spanish banking sector, and the tensions in sovereign debt markets with systemic impact, have contributed to boost the replacement of private capital with Eurosystem funds in the peripheral economies.

Financing structure of the euro Area: Financial account analysis

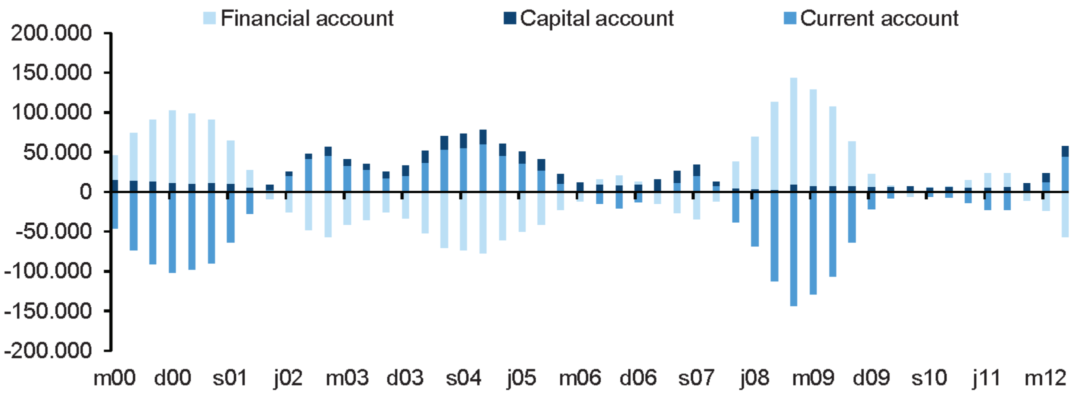
As expected, the analysis of the financial account reveals no significant changes in the nature of financial flows in the euro area, although we observe (i) a swing in the aggregate balance since late 2011 and (ii) a significant reduction in cross-border flows since the beginning of the crisis.

The first point is the result of a change in the current account balance, which stood at -150 billion euros in mid-2008, and turned positive in the first months of 2012. So, as happened in 2001-05, the euro Area has become a net lender to the rest of the world (financial liabilities operations with the rest of the world are lower than asset operations, in terms of volume).

With regard to cross-border capital flows, it is noteworthy that since their sharp fall in late 2008 and the first half of 2009, coinciding with one of the greatest periods of financial stress in the current crisis (Lehman Brothers bankruptcy), they have gradually recovered, although are still far from pre-crisis levels. The strongest drop is observed in the more volatile and short-term capital flows. For instance, portfolio investment or "other investment" positions (banking deposits, loans or *repo* operations). The relative stability in aggregate balances is primarily attributable to two facts: the drop of liability operations fell at the same (or similar) pace as that of asset transactions.

Exhibit 1

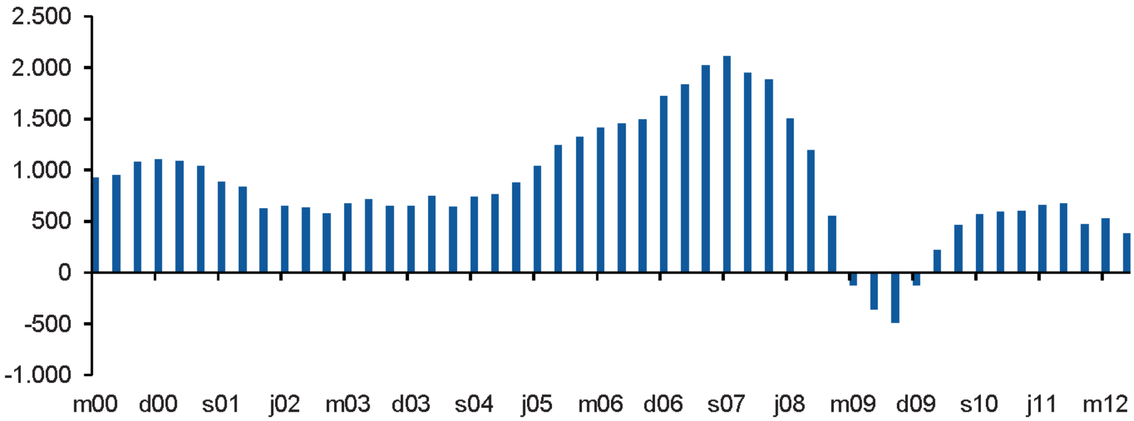
Euro Area financial account (millions of euros, cumulative balances in last 12 months)



Source: A.F.I., ECB.

Exhibit 2

Cross-border capital flows in the euro Area (billion of euros, cumulative flows in last 12 months)



Source: A.F.I., ECB.

Individual, and not aggregate, imbalances matter. A three-pronged approach

Significant swings in the euro area funding framework are detected when we analyze individual countries. Contrary to peripheral economies, where funding restrictions in the private sector have exacerbated their dependence on Eurosystem's liquidity, core economies, with more solid external positions, have benefited from their status as "safe havens" (net inflows of private capital) and the ECB's liquidity provision.

Divergences between core and peripheral economies and the role of the Eurosystem in their scheme of funding, are more than evident when one considers (i) the evolution of financial accounts; (ii) gross and net borrowing with the Eurosystem; and (iii) TARGET 2 positions (*Trans-European Automated Real-time Gross settlement Express Transfer system*).

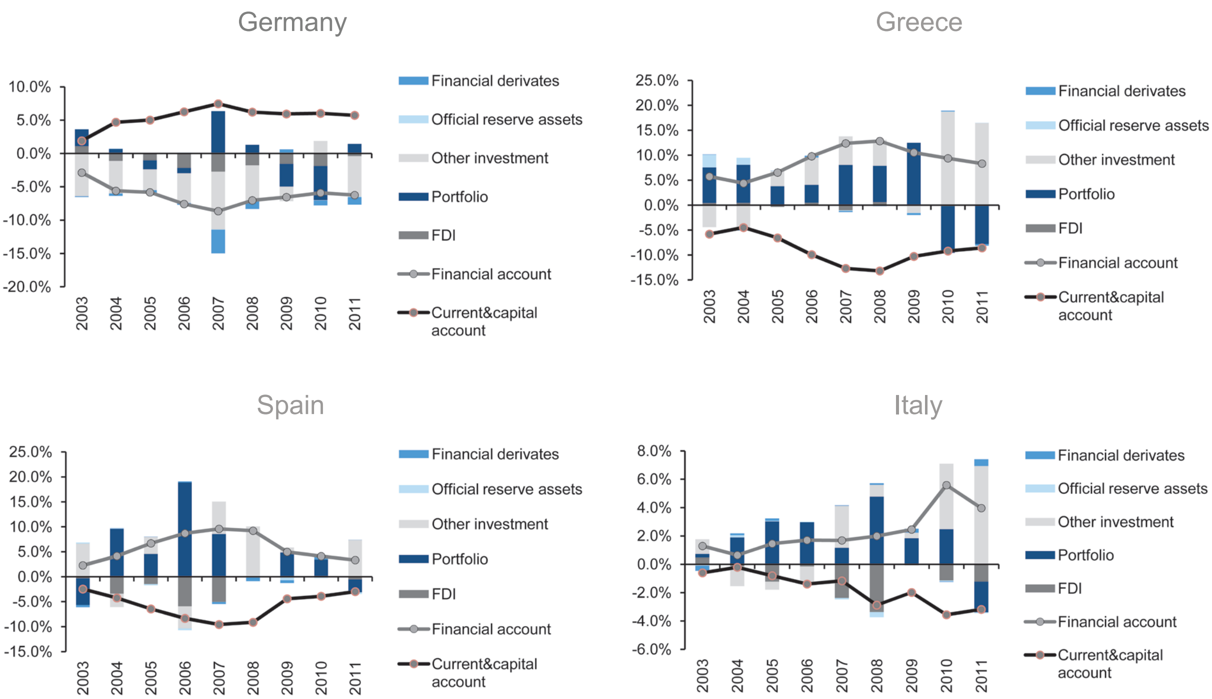
The evolution of the financial accounts by euro area country

On the one hand, since the early 2000s and until 2007, economies like Greece, Portugal or Spain funded levels of current account deficit close to 10% of their GDP, mainly, through portfolio inflows (shares and other securities which account for capital, without the aim of controlling or influencing the management of a company; and fixed income, both public and private securities) and, to a lesser extent, via "other investment" positions (bank funding like deposits, loans and repos).

On the other hand, the persistent excess of savings in Germany or the broadly balanced external position of France, resulted in negative portfolio balances in both cases (these countries oversees investment outflows were greater than their investment inflows from the rest of the world) and in "other investment" too, in the case of Germany.

Exhibit 3

Balance of payments of euro Area countries (% of GDP) (*)



** FDI=Foreign direct investment.*
Source: A.F.I., EUROSTAT.

Net sales of portfolio assets by the rest of the world in the peripheral economies in 2008 and afterwards (first led by bank securities and, since 2011, as a result of the stress in sovereign debt markets, by public debt), resulted in an increasing reliance on Eurosystem liquidity, strengthened by measures taken by the ECB during the crisis (see annex).

Nowadays, positive balances in "other investment" balances in Greece, Portugal, Ireland, Spain or Italy are reflecting the fact that Eurosystem loans account for an "other investment" liability. In countries under a programme of financial assistance (Greek rescue in May 2010; Irish and Portuguese bailouts in November 2010 and in May 2011, respectively), loans provided by the IMF, EU/EMU or financial stability facilities (EFSF, ESM) are also classified as "other investment" in the financial account.

The other side of the coin would be found in the "other investment" balance in core economies, particularly Germany, which has been markedly negative since 2011. Their position as net lenders vis-à-vis the rest of the world and, more specifically, vis-à-vis the peripheral economies, in this sort of investment, is symptomatic of the excess of liquidity in core banking systems. Sales of peripheral assets and extreme risk aversion have benefited lower yield but also less risky assets, explaining the fact that core economies have received, also since 2011, strong net portfolio inflows (appetite for core government debt).

Gross borrowing with the Eurosystem

The confirmation of uneven liquidity balances between the peripheral economies (strong deficit) and the core economies (with a broad surplus position) is reflected in borrowing levels with the Eurosystem. Through the reinforcement of temporary open market operations by the ECB (see annex), liquidity provision in the euro area rose from 400 billion euros in 2007 to 1.2 trillion in mid-2012 (July is the latest data available), after the two 3 year LTROs (*Long Term Refinancing Operations*), with liquidity in long term operations (more than three months) surpassing also one billion. The fact that a portion of the injected liquidity returns to the Eurosystem when it is placed in the marginal deposit facility (mainly, by core banking systems), puts net borrowing with the Eurosystem below one trillion (currently, 750 billion euros).

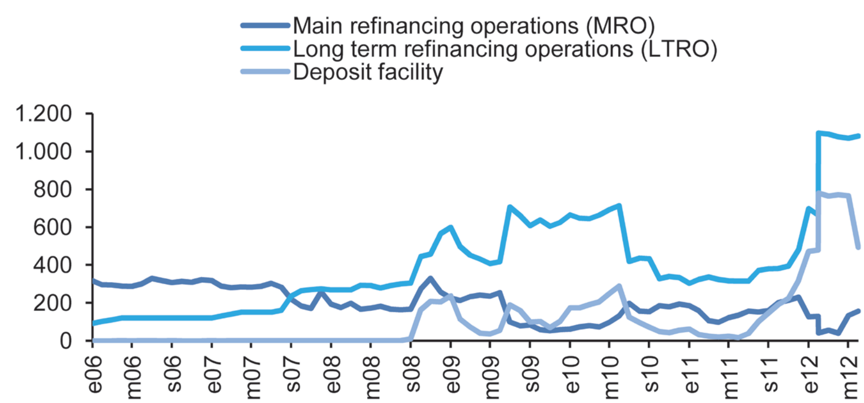
The capital key of each central bank in the Eurosystem is the main reference to measure the degree of dependence of each respective banking system to Eurosystem liquidity. Peripheral banking sectors, with capital keys between 1.5% in Ireland and 2.5% in Portugal, or 11.8% in Spain and 17.8% in Italy, are taking in more liquidity than expected regarding their capital keys. In July, only Spain and Italy accounted for 55% of total gross borrowing (the sum of their two capital keys is equal to 29.7%) and 88% of total net borrowing.

Recent reduction in the level of reliance by Greece is the result of constraints to access Eurosystem liquidity due to the shortage of collateral in the Greek banking system (not eligible in repo operations due to its low credit quality), and the replacement of the Eurosystem liquidity by the liquidity provided by the ELA (*Emergency Liquidity Assistance*) of the Central Bank of Greece, with more flexible standards in terms of eligible collateral for repo operations.

On the opposite side, the core countries have a participation in the Eurosystem's gross loans well below their capital keys (14% in France, compared to a capital key of 20.3%; 7% in Germany when its capital key is 27%), and a net lending in the Eurosystem very strongly reduced or even negative, as in Germany. Since early 2012, the German banking system has left, on average, 375,000 million in the marginal deposit facility.

Exhibit 4

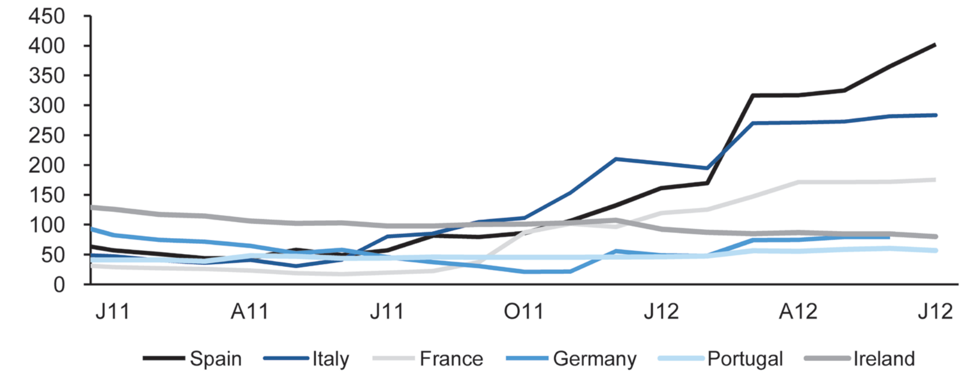
Eurosystem balance: gross and net loans to euro area counterparties (billions of euros)



Source: A.F.I., ECB.

Exhibit 5

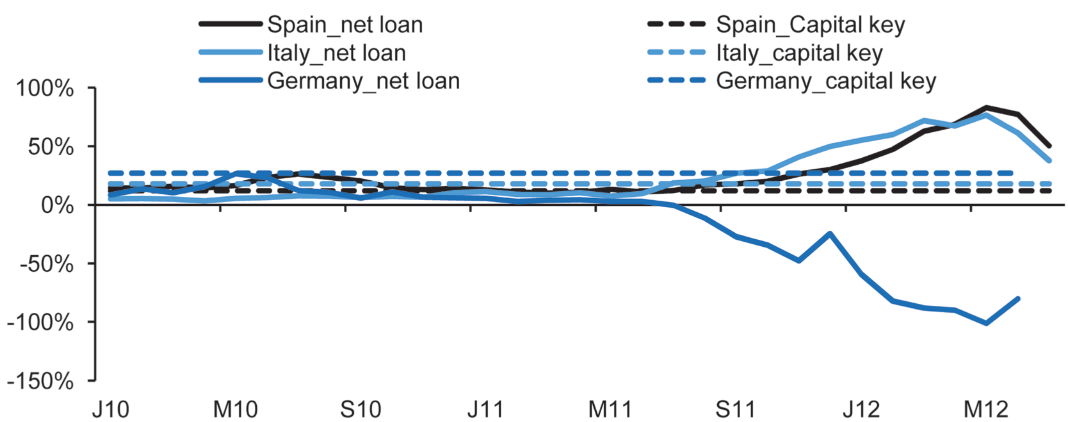
Recourse to Eurosystem liquidity by euro area countries: gross loans (billions of euros)



Source: A.F.I., NCB.

Exhibit 6

Recourse to Eurosystem liquidity by euro area countries: net loans as % of total and respective to capital key



Source: A.F.I., NCB.

TARGET 2 positions

Another way to analyze changes in the funding structure of euro area economies is to analyze swings in National Central Banks (NCBs) TARGET 2 positions since the beginning of the crisis.

TARGET 2 (“*Trans-European Automated real-time Gross settlement Express Trasnfer System*”) is used to denominate the system of payment and compensation of the European Economic Area (EEA), which includes the euro Area and near countries. Whether for buying a good or service or for the acquisition of a financial asset, if this implies an exchange of capital flows between countries of the EEA, TARGET2 is the tool which acts as the intermediary in the operation.

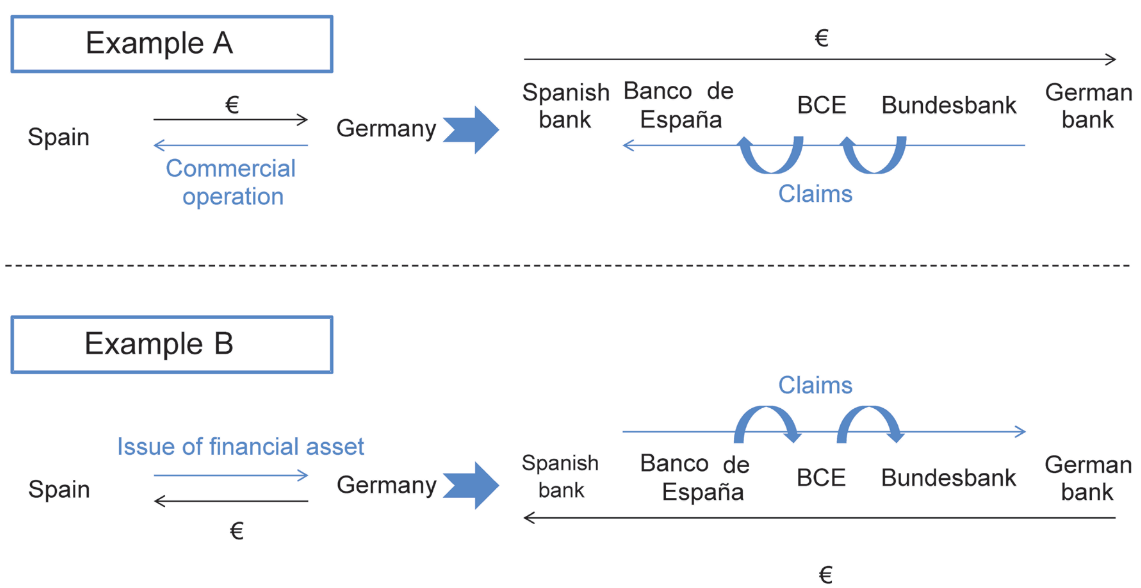
TARGET2 system implies necessarily intra-Eurosystem rights and claims (we assume, just to simplify, that the system only rules for euro area countries): NCBs can have rights, and thus a positive TARGET2 position (an asset in the balance sheet), or claims (a negative TARGET2, on the liability side of the balance), with the ECB as the counterparty of all of them. In a baseline scenario, TARGET2 positions of NCBs are balanced or close to equilibrium. When this happens, capital outflows in an economy are offset, approximately, by capital inflows. Otherwise (as we can observe since the start of the crisis) an imbalance arises, creating a positive position (in general, in NCBs of core economies) or negative (NCBs in the periphery) in NCBs balance sheets in terms of TARGET2.

With regard to the Spanish economy, monitoring the balance sheet of Banco de España (BoS) offers a good overview of the changes in TARGET2 positions inside the Eurosystem.

Before the crisis, capital outflows related to current account deficit and the acquisition of assets in the rest of the world were offset by inflows to buy Spanish assets. In other words, there was a practical balance between assets and liabilities of the BoS in terms of TARGET2: the value of products and assets bought outside -a TARGET2 liability in the balance sheet of BoS- was similar to asset acquisitions by the rest of the world -a TARGET2 asset-.

As the crisis arises, the prior scheme is broken. Capital inflows abruptly fall while confidence in the national banking system erodes. Outflows are exacerbated in spite of a reduction in the current account deficit and the acquisition of external

Table 1
How TARGET 2 operations are registered?

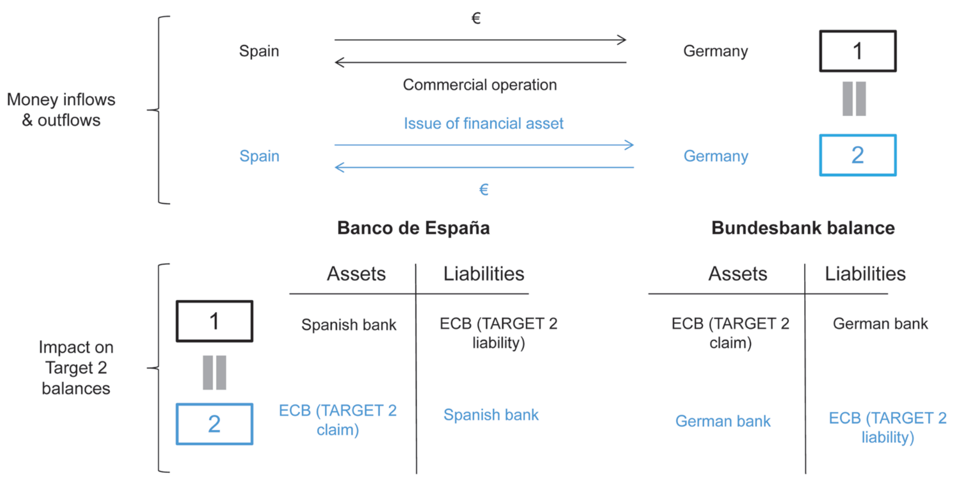


Source: A.F.I.

Table 2

TARGET 2 balances. Example of Bank of Spain position. Before the crisis

- Money outflows in the Spanish economy due to current account deficit and the acquisition of external assets were offset by money inflows destined to buy Spanish assets. So Banco de España TARGET 2 liabilities were covered by TARGET 2 assets, in balance.

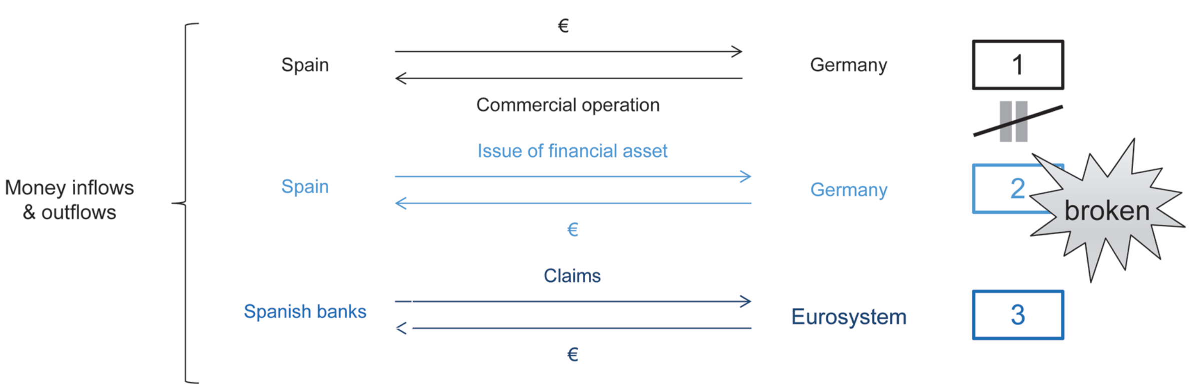


Source: Afi.

Table 3

TARGET 2 balances. Example of Bank of Spain position. After the crisis

- The prior mechanism is broken. Private money inflows fall abruptly as confidence in the banking system is eroded. Money outflows exacerbate in spite of a reduction in current account deficit and acquisition of external assets due to the sell off in Spanish assets.
- As private liquidity dries up, Eurosystem liquidity comes into action.



Source: A.F.I.

assets as a result of the sell-off in Spanish assets by foreign investors. The shortage of private funding sources, and its progressive replacement by Eurosystem liquidity, is now one of the most idiosyncratic elements of the funding scheme for Spanish banks, with implications in the TARGET2 position of the BoS, markedly "negative" in this moment (TARGET2 liabilities higher than assets). On the other side is, the situation of NCBs in core economies, the Bundesbank among them, with very "positive" TARGET2 positions due to the excess of liquidity in their banking systems.

It is important to note that the creation of assets and liabilities vis-à-vis the ECB has no limits in the TARGET2 system. Otherwise, cross-border capital flows inside the euro Area would find a cap related to TARGET2 positions of NCBs, something contrary to the own logic of a monetary union.

Conclusions

The specific point with regard to the current funding scheme in the euro area is not the financial position of the sum of all euro economies, but the individual positions of each one. Private capital outflows and the recourse to the liquidity of the Eurosystem are today the highlights that explain the composition of the financial account in the peripheral economies, while capital inflows and excess liquidity in the banking system explain, the structure of financial accounts in the core countries.

These imbalances recorded in financial accounts and recourse levels to ECB liquidity in each banking system are, jointly with other measures analysed here (TARGET2 positions of NCBs) and others not mentioned but also evident, such as, money supply transmission by countries, debt holdings by nationality in each banking system, or sovereign spreads, some of the signals that point to a financial fragmentation process inside the EMU, which is gaining momentum in recent months due to the pressure on Italian and specially Spanish sovereign bond markets.

Latest institutional decisions, however, are expected to reduce the convertibility premium (risk of fragmentation or break up of the euro area) pricing in peripheral assets. Calls for stronger action by the ECB generated a response at the last meeting of the Government Council (September 6th), which marked the outline of a new programme to buy public bonds, now unlimited but subject to macroeconomic conditionality. This conditionality arises from the need to require financial assistance (EFSF and the future ESM financial lines) and the respect of commitments by the beneficiary country in order to obtain ECB support.

There is still room to see a meaningful correction in the measures of fragmentation of the euro area. ECB institutional support and advances in the integration area are critical, but should be carried out together with internal developments in the economies with more imbalances.

Only then can we witness a reduction in private capital outflows in these economies and, eventually, once the role of financial stabilization is adopted by the ECB and the ability of sovereigns under pressure to comply with the reform agenda and fiscal consolidation is confirmed, a gradual return of flows. Ultimately, we may see a current account rebalancing among the Euro economies (in fact, this is something which is currently taking shape) and a rebalancing in the composition of financial accounts, where the liquidity of the Eurosystem as a source of funding becomes less significant.

Annex. A summary of the most important monetary policy decisions in the euro area since 2010 (Greek bailout)

Exceptional measures have been taken by the ECB since the beginning of the euro crisis (2010: Greek bailout) with the aim of restoring the confidence in the financial system as a whole. We present here a summary of the most relevant, following a chronological order:

2010

May, 10th. The ECB decided to conduct interventions in the euro area public and private debt securities markets: activation of the SMP (Securities Markets Programme).

September and December meetings. The ECB extended its fixed rate tender procedures with full allotment.

2011

April, 7th. First repo hike: +25bp to 1.25%. Interest rate on both the marginal lending facility and the deposit facility were also increased by 25bp.

July, 7th. Another increase in official rates (+25bp).

August, 4th. The ECB announced the "reactivation" of the SMP to reduce financial stress in specific market areas. The Spanish and Italian sovereign debt markets, among them.

Additionally, the ECB decided to hold a liquidity-providing supplementary longer-term refinancing operation with a maturity of approximately six months as a fixed rate tender procedure with full allotment.

October 6th. Two more LTROs were announced: one with a maturity of approximately 12 months in October 2011, and another with a maturity of approximately 13 months in December 2011.

In addition, the ECB launched a new covered bond purchase programme in November 2011.

November 3th. The ECB cut official rates by 25bp. Repo rate: 1.25%.

December 8th. Another reduction in repo rates (-25bp). Further non-standard measures were adopted. Particularly: (i) two longer-term refinancing operations with a maturity of approximately three years; (ii) to increase the availability of collateral; and (iii) to reduce the reserve ratio to 1%.

2012

July 5th. Official rates were reduced to historical lows. Repo rate, 0.75%; marginal deposit facility: 0.0%.

September 6th. ECB launched OMT (Outright Monetary Transactions), the Eurosystem's outright transactions in secondary sovereign bond markets that aim at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy.