

Why did the Italian Target2-deficit fall in July, despite ongoing QE?

The Italian Target2-balance, which started to increase steadily in early 2015 as the ECB's QE programme began, appears to have stabilised in 2017. But QE is still ongoing. What's going on?



Source: iStock

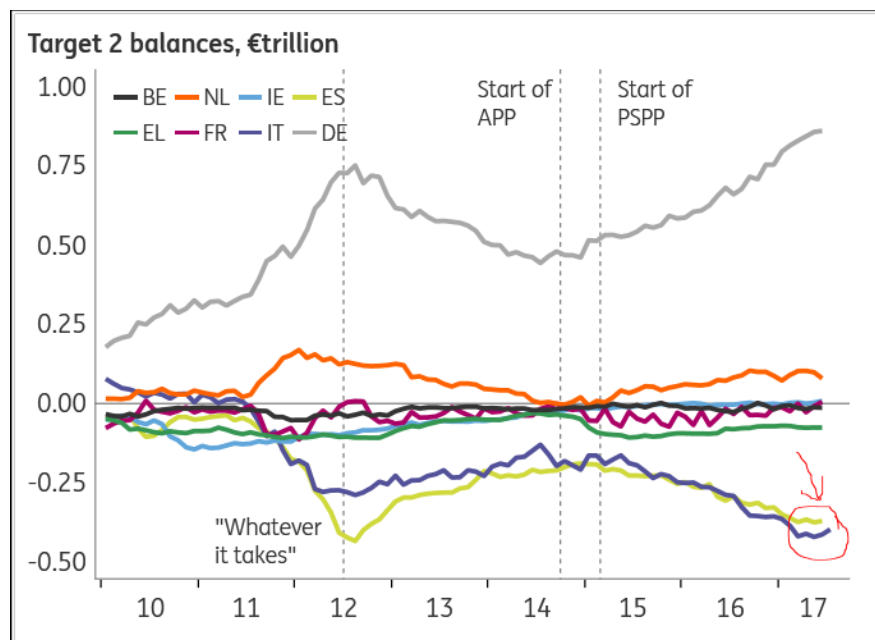
Eurozone Target2-balances widening since early 2015...

Target2-balances are the claims and liabilities between Eurozone central banks and the ECB, that result from cross-border payments settled in central bank money. That sounds rather arcane and technical. And in fact until 2008, few cared about these balances between central banks. That changed quickly after 2008 when in the midst of the Eurozone debt crisis, balances between Eurozone central banks rose to unprecedented heights. Mainly the German and Dutch central banks acquired net claims on the ECB, while Spain and Italy were the main deficit countries. Back then, these imbalances reflected a relocation of private capital out of the south and towards the north of the Eurozone.

After Draghi's famous "Whatever it takes" comments in July 2012, Target2-balances gradually declined again. But as the ECB embarked on QE in early 2015, Target2-balances started to widen once more. In fact, the German Target2-surplus is higher today than it ever was in 2012. Yet the

Italian Target2-deficit has stopped widening this year, and in fact, has been moving sideways since February.

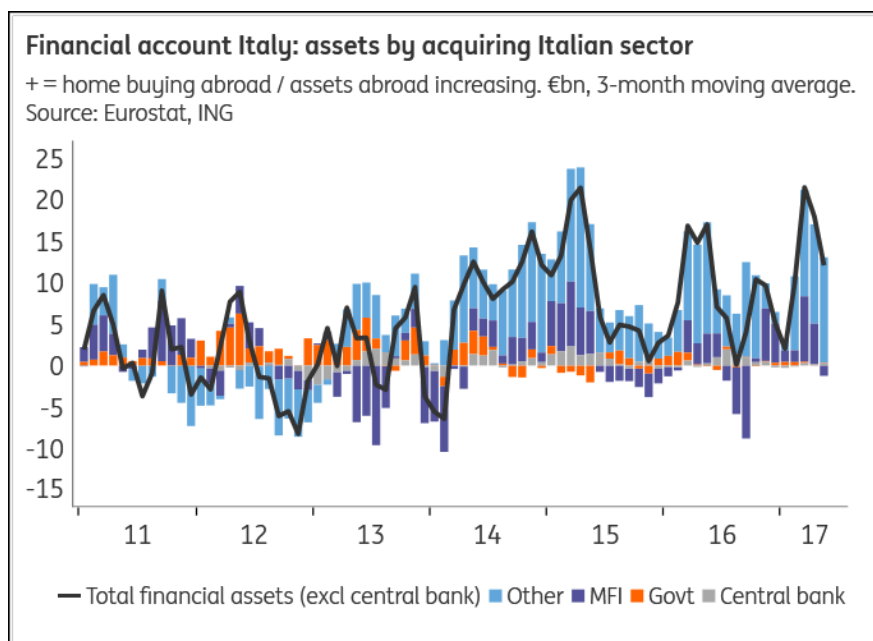
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Italian investors have been taking their money out of the country...

QE is an important driver of the Target2-developments witnessed over the past two years. The presence of central banks as dependable buyers in the market has enabled investors to sell their government bonds and direct the proceeds elsewhere. Zooming in on Italy, balance of payment data show that both foreign and Italian investors have taken the opportunity to sell Italian government bonds. As the chart below shows, Italian banks and especially Italian investors have been making substantial portfolio investments abroad over the past years, after selling some of their Italian government bonds. This portfolio reallocation by Italian investors explains roughly half of the observed increase in the Banca d'Italia's Target2-deficit over the past two-and-a-half years.

It should be noted that Italian foreign investment is also helped (and the Target2-deficit mitigated) by the fact that Italy runs a current account surplus today -- contrary to 2011-2012 when it ran a current account deficit.



...while foreign investors have stopped taking their money out of Italy

Italian portfolio reallocation abroad appears to continue unabated in 2017, and can therefore not explain that the Italian Target2-deficit stopped increasing this year. For that, we have to look at the other important driver of the Italian Target2-deficit, which is foreign investors. They have been divesting Italian government and bank bonds (the latter replaced partly by the ECB's TLTRO funding). Yet since the start of this year, the outflow of foreign money has greatly diminished (see chart below). The foreign divestment of Italian government bonds has shrunk, while foreigners are even back buying some corporate and bank bonds. This explains the stabilisation of the Target2-deficit since February.

It can be considered good news that foreign money is no longer leaving the country. Yet it remains to be seen how foreign (and domestic!) investors will behave in the near future. With QE slowly drawing to a close, the guaranteed buyer Eurozone government bond markets have grown accustomed to, is going to close up shop. Moreover, with Italian elections to be held in Spring 2018 at the latest, political uncertainty remains elevated.

