Finding solutions to Target-2 dilemma

Bundesbank credit holds EMU together

by Marcello Minenna and Edoardo Reviglio in Rome

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Europe's monetary union rules that have generated a sharp increase in the Bundesbank's Target-2 claims on the European Central Bank provide a strong incentive for Germany to remain a euro member to safeguard its credit position.

Only a broad political agreement to change radically the mutual financing inherent in the treaties on economic and monetary union would give Germany room to reclaim part of its enormous Target-2 credit of €975bn at end-June.

Prof. Clemens Fuest, head of the Munich Ifo economic research institute, has proposed changing the legal framework with an exit mechanism that would supply the 'get-out' clause some Germans apparently desire – allowing the country's possible EMU escape with its credit intact.

However, considering that EMU debtor countries have a blocking share of votes, that proposal appears a political non-starter. The reasonable alternative would be to set up a risk-sharing framework to eliminate the risk of a country leaving. This would entail the completion of banking union, a sizeable European budget and a system of fiscal transfers.

Roberto Violi, senior director in the Banca d'Italia's risk management department, Giovanni Dosi and Andrea Roventini of the Sant'Anna School of Advanced Studies (a university centre of worldwide renown based in Pisa) Marcello Minenna have proposed a technical tool to share gradually the risks of euro area public debt in a market perspective. Unfortunately, implementing such a plan will not be easy.

The Bundesbank's exposure towards other EMU central banks represents 50% of Germany's net international investment position. Some German economists believe these assets may be substantially irredeemable. The Target-2 balances of Italy and Spain reached record heights of €465bn and €393bn respectively in May. The June data will probably be even worse.

Target-2 has grown into a complex accounting system of debts and credits between national central banks that intermediate 90% of cross-border transactions between private banks. It has several advantages: minimum counterparty risk, quick settlement times and reduced costs.

Target-2 growth reflects imbalances in trade and capital flows Germany's average annual current account surplus of 7% of GDP over the past decade (although not all of this from intra-euro area transactions) has not been matched by a corresponding increase of banks' credits towards the rest of the euro area. Owing to higher post-2008 financial crisis risk perceptions, German banks' lending towards the euro area has declined.

The more recent build-up of southern European countries' Target-2 debts has stemmed from the ECB's €2tn-plus quantitative easing that started in March 2015. Italian and Spanish private investors have progressively sold more than half their government bond holdings to their national central banks and invested the proceeds in financial assets in northern countries, the UK and US.

The last three years have seen over €500bn in capital flight from southern economies. The ECB has played this down as healthy behaviour of investors seeking to improve returns and diversify risks. A less benevolent reason could be investors' search for a hedge against the redenomination risk that would arise from a member state's exit.

Renewed Target-2 divergence was not completely unexpected. Already in 2015 Paolo Savona, the renowned Italian economist who is now Europe minister in the Rome government, warned that the ECB's QE would drive capital flight from weaker countries and increase the German credit position. In an eternally immutable euro area, it would be perfectly reasonable for Target-2 balances to be non-collectable, without expiry and without interest (as they are currently). In any standard scenario, these accounting entries would bear no risk at all.

But the scenario now – increasing political discord, with a eurosceptic government in Rome and a weakened administration in Berlin – is not standard. In the hopefully unlikely event of a euro exit, the departing national central bank would regain independent status. The Banca d'Italia, an ECB shareholder, would separate itself from ownership. In a normal transaction, the exiting shareholder would pay back (in euros) what is effectively an intra-group loan from the subsidiary.

The ECB has seemed to support this position in past official declarations . But, under current regulations, there is no legal tool that could force an exiting country to settle its debts in euros. If a debtor country departed, the Bundesbank would find it very difficult to collect even a small fraction of its Target-2 credit. A unilateral German exit would imply total loss of the credit. The same would happen if the euro area broke up entirely.

This uncompromising equation is part of the cement holding EMU together. Perpetually alive to any form of moral hazard, German economists find this position increasingly unpalatable. Pressure on the German government and the Bundesbank to mitigate the Target-2 dilemma may increase.

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