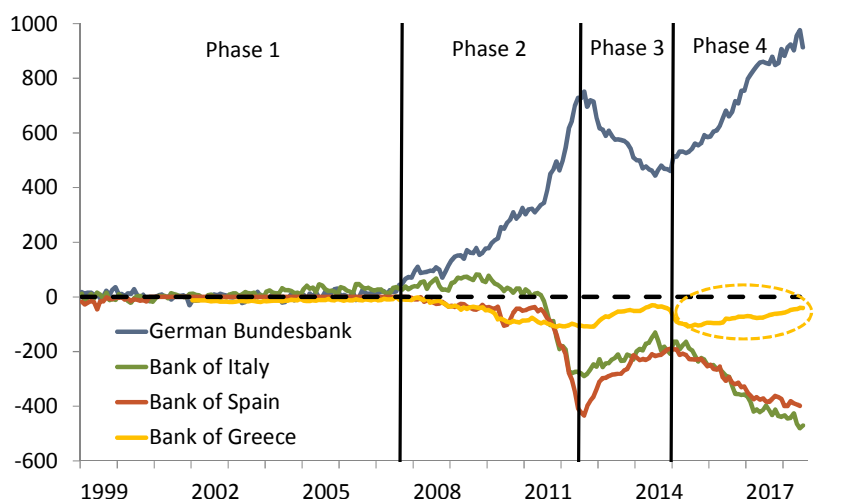


10 August 2018

Target2: a time bomb, or a German obsession?

Balances of national central banks with the ECB in the Target2 system, in €bn



Sources: Deutsche Bundesbank, Banca d'Italia, Banco de Espana, Bank of Greece, Haver Analytics.

- **Exploiting German generosity?** Are prudent Germans inadvertently financing alleged spending or borrowing excesses of profligate countries at the Eurozone periphery? This is the undertone of a debate that has erupted again in Germany since the claims of the Bundesbank on the European Central Bank (ECB) in the Target2 payments system surged to €976bn in June before falling slightly to €913bn in July as tensions around Italy eased a little.
- **The nature of the beast:** The ECB runs a common monetary policy and a common payments system in which most transactions are executed through national central banks with their own balance sheets. When the system processes more payments from, say, Italy to Germany than vice versa, the Bundesbank gains a claim and the Banca d'Italia incurs a liability against the ECB. If the same payments were processed through a unitary Eurozone institution with only one common balance sheet, "national" Target2 imbalances would not exist in the same way.
- **Spending excesses?** The oft-heard German assertion that Target2 imbalances reflect peripheral overspending is largely wrong. Changes in Target2 balances do not correlate well with current account positions. When Spain had record external deficits of almost 10% of its GDP in 2007 and 2008, its Target2 balance remained close to zero. Italy's Target2 balance has worsened although the country has run sizeable current account surpluses since 2013.
- **The four phases of Target2:** After a long period of calm until 2007 (Phase 1), capital flight out of the Eurozone periphery into safe havens during the 2008/2009 financial crisis and the subsequent euro crisis did show up in rising Target2 imbalances (Phase 2). When the ECB finally stopped the irrational panic in mid-2012, the imbalances receded (Phase 3). The new rise in the imbalances since the end of 2014 (Phase 4) mostly reflects a technical feature of the ECB's decentralised bond-buying programme. Many international banks hold their Target2 account with the Bundesbank. Frankfurt is a bigger financial centre than Milan. When the Bank of Italy buys an Italian bond from a non-Italian institution, the payment to the seller is often settled through Frankfurt. Within the Target2 system, this shows up as a new Bundesbank claim on the ECB and a further liability of Banca d'Italia.
- **What if Italy leaves the euro?** Today's Target2 imbalances are internal bookkeeping entries within the Eurosystem of national central banks and the ECB. They have little practical relevance and are no time bomb. However, in the unlikely case that, say, Italy leaves the euro, Banca d'Italia's domestic assets would likely lose value. In the ensuing chaos, Banca d'Italia may not fully honour its Target2 liabilities to the ECB (€471bn in July). If the ECB were to lose, say, 30%, the share of ECB losses that would ultimately accrue to the Bundesbank (31%) would amount to €44bn.
- **Time can resolve the issue:** The ECB will end its net bond purchases in December. Unless Italy's radical government triggers massive capital flight, Target2 imbalances are likely to recede again slowly. The ECB is not buying Greek bonds. As a result, Greece's Target2 imbalance has fallen since the Greek crisis ended in mid-2015.

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