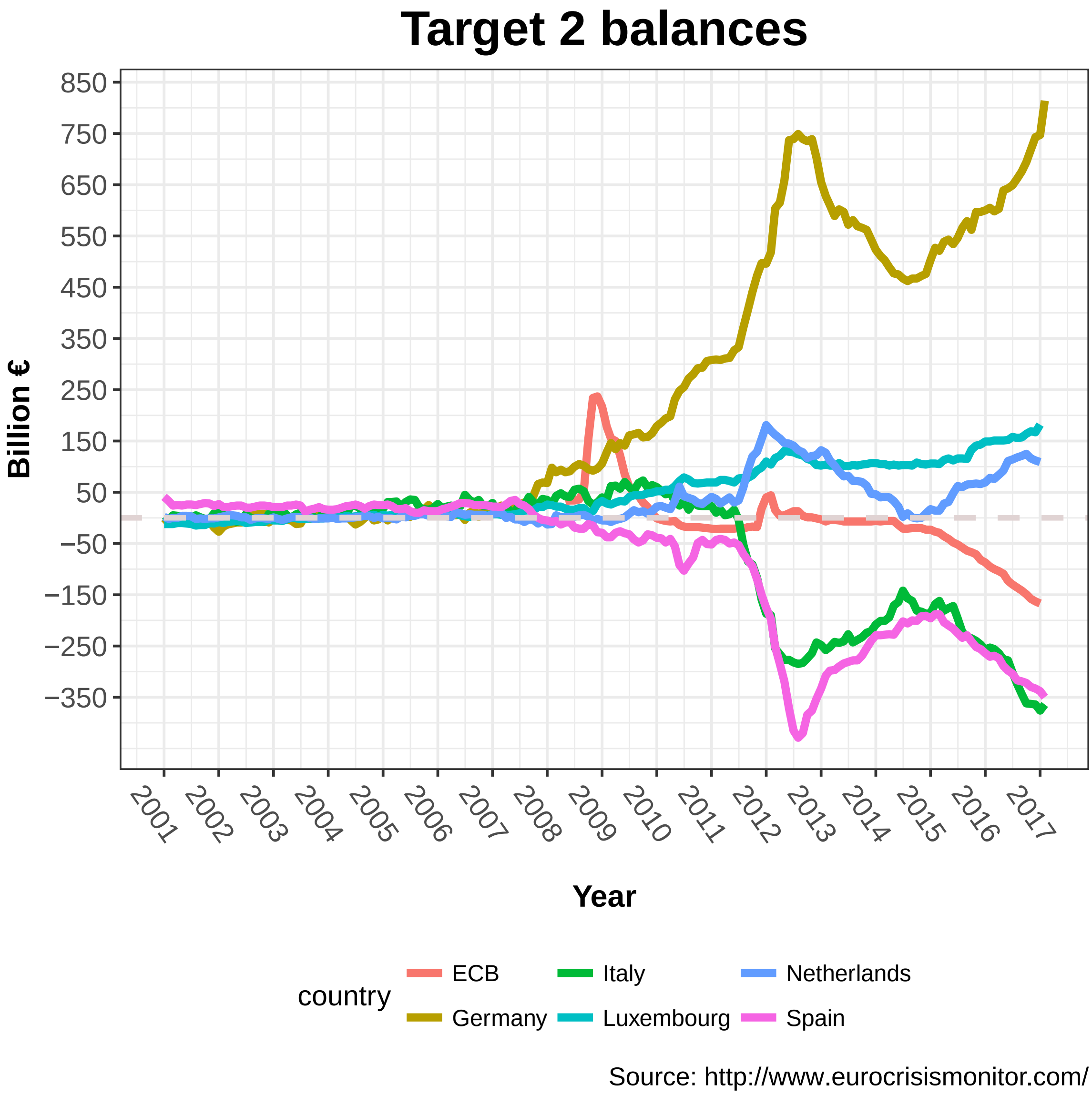

The Chart

The chart shows the TARGET2 balances for euro-area states whose balances have at some time been greater than €150 bn (positve or negative). A negative balance means that state owes the TARGET2 system (aka Eurosystem) money, a positive balance means it is is owed money. The data for the chart is available from Euro crisis monitor

TARGET2 stands for Trans-European Automated Real-time Gross Settlement Express Transfer System, the "2" arising because its version 2. It is abbreviated "T2". According to the ECB €1.8 trillion goes through TARGET2 every day.

The Euro crisis monitor data stops at January 2017 but in Frankfurter Allgemeine Zeitung (13/07/2017) February balances for Germany, Italy and Spain are given. These were €814 bn, €-364 bn and €-350 bn respectively. I have added these to the chart.

Hans-Werner Sinn first drew attention to TARGET2 in The ECB's Secret bailout strategy (2011).

Discussion

Mechanism of TARGET2 balances

Every commercial bank in the eurozone is obliged to maintain a reserve account with its national central bank. Commercial banks use these accounts to transfer money around the euro area. The basic mechanism is in support of trade is as in Table 1

Suppose Mr A in Italy buys machinery from Mr B in Germany using his account with Monte dei Paschi. Monte dei Paschi debits Mr A's account and tells the Italian central bank to debit its reserve aacount and send the money to Mr B's account with Commerzbank. Banca d'Italia tells the Bundesbank to credit Commerzbank's reserve account. Banca d'Italia incurs a TARGET2 debit and the Bundesbank incurs a credit. Finally Commerzbank credits Mr B's account in turn and the machinery passes from Germany to Italy. Apart from Mr A and Mr B everyone's transaction sum to zero.

Without TARGET2 Banca d'Italia would make a gain and the Bundesbank a loss. Note that no assets flow from Italy to Germany though they do in the opposite direction. So TARGET2 surely has the characteristic of a loan.

Table 1: TARGET2 Trade Example

Mr A	Reduced assets €100
Monte dei Paschi	Reduced liability to Mr A €100 Reduced assets with Banca d'Italia €100
Banca d'Italia	Reduced liability to Monte dei Paschi €100 *Increased TARGET2 liability €100*
Bundesbank	Increased liability to Commerzbank €100 *Increased TARGET2 assets €100*
Commerzbank	Increased assets with Bundesbank €100 Increased liability to Mr B €100
Mr B	Increased assets €100

The second example shown in Table 2 involves the Spanish bank Santander moving €100 million from its deposit account with Monte dei Paschi to its account with Commerzbank. To meet the obligation, Monte dei Paschi borrows the money from Banca d'Italia thereby exchanging a liability to Santander for a liability to Banca d'Italia. Banca d'Italia incurs a liability to TARGET2 and the Bundesbank an asset (credit)

To borrow money from Banca d'Italia Monte dei Paschi must post collateral of a sort allowed by the ECB. As time passes, ever more dubious collateral has been allowed. There comes a time when the ECB insists that a government apply for an official loan (bailout) with conditions attached rather than continuing to allow borrowing against TARGET2.

However as long as a national central bank can use TARGET2 there is no limit to the size of its liabilities and no date for settlement. Interest is however payable at the ECB MRO (Main Refinancing Operation) rate but since March 2016 this has been 0.0%

Table 2: TARGET 2 Bank Example

Santander	Reduced assets at Monte dei Paschi €100m
Monte dei Paschi	Reduced liability to Santander €100m Increased liability to Banca d'Italia €100m
Banca d'Italia	Increased asset via the loan to Monte dei Paschi €100m *Increased TARGET2 liability €100m*
Bundesbank	Increased liability to Commerzbank €100m *Increased TARGET2 assets €100m*
Commerzbank	Increased assets with Bundesbank €100m Increased liability to Santander €100m
Santander	Increased assets at Commerzbank €100m

Do The Imbalances Matter?

A florid affirmative view (but oh so readable!) is Ambrose Evans-Pritchard in the Telegraph (27/02/17). Here are some selections:

> The Target2 system is designed to adjust accounts automatically between the branches of the ECB's family of central banks, self-correcting with each ebbs and flow. In reality it has become a cloak for chronic one-way capital outflows. ...
>
> The ECB argued for years that these Target2 imbalances were an accounting fiction that did not matter in a monetary union. Not any longer. Mario Draghi wrote a letter to Italian Euro-MPs in January warning them that the debts would have to be "settled in full" if Italy left the euro and restored the lira. ...
>
> The Banca d'Italia alone now owes a record €364bn to the ECB - 22pc of GDP - and the figure keeps rising. Mediobanca estimates that €220bn has left Italy since the ECB first launched QE. The outflows match the pace of ECB bond purchases almost euro for euro.

John Whittaker Eurosystem debts do matter quotes the ECB as saying the balances were a "normal feature of the decentralised implementation of monetary policy in the euro area" and "the size of the TARGET balances does not pose additional risk to the Euro-system or the NCBs given the irreversibility of the euro." But he comments "the euro is not irreversible" because no currency union is. Further TARGET2 imbalances represent a stealth bailout which may then be replaced by an official ones: "official lending merely displaces lending via the eurosystem: one form of bailout is displaced by another". However the official sort has "austerity" conditions attached whereas TARGET2 borrowing does not. This they found out in Greece (and Cyprus, and Ireland).

My main source for the mechanism of TARGET2 was Karl Whelan TARGET2 and Central Bank Balance Sheets (2013).

Peter Mott, March 22, 2017