The Telegraph

Unpayable debts and an existential EU financial crisis - are eurozone central banks still solvent?

Central banks can go bust in a currency union. The Bank of Italy is flirting with danger, racking up €364bn in ECB liabilities that the Italian state cannot easily cover

By Ambrose Evans-Pritchard

23 FEBRUARY 2017 • 12:25PM

Vast liabilities are being switched quietly from private banks and investment funds onto the shoulders of taxpayers across southern Europe. It is a variant of the tragic episode in Greece, but this time on a far larger scale, and with systemic global implications.

There has been no democratic decision by any parliament to take on these fiscal debts, rapidly approaching €1 trillion. They are the unintended side-effect of quantitative easing by the European Central Bank, which has degenerated into a conduit for capital flight from the Club Med bloc to Germany, Luxembourg, and The Netherlands.

This 'socialisation of risk' is happening by stealth, a mechanical effect of the ECB's Target 2 payments system. If a political upset in France or Italy triggers an existential euro crisis over coming months, citizens from both the eurozone's debtor and creditor countries will discover to their horror what has been done to them.

Such a tail-risk is real. As I write this piece, four out of five stories running on the news thread of France's financial daily Les Echos are about euro break-up scenarios. I cannot recall such open debate of this character in the Continental press at any time in the history of the euro project.

As always, the debt markets are the barometer of stress. Yields on two-year German debt fell to an all-time low of minus 0.92pc on Wednesday, a sign that something very strange is happening. "Alarm bells are starting to ring again. Our flow data is picking up serious capital flight into German safe-haven assets. It feels like the build-up to the eurozone crisis in 2011," said Simon Derrick from BNY Mellon.

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.

Private investors sell their holdings of Italian or Portuguese sovereign debt to the ECB at a profit, and rotate the proceeds into mutual funds Germany or Luxembourg. "What it basically shows is that monetary union is slowly disintegrating despite the best efforts of Mario Draghi," said a former ECB governor.

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.

Professor Marcello Minenna from Milan's Bocconi University said the implicit shift in private risk to the public sector - largely unreported in the Italian media - exposes the Italian central bank to insolvency if the euro breaks up or if Italy is forced out of monetary union. "Frankly, these sums are becoming unpayable," he said.

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.

This is a potent statement. Mr Draghi has written in black and white confirming that Target2 liabilities are deadly serious - as critics said all along - and revealed in a sense that Italy's public debt is significantly higher than officially declared. The Banca d'Italia has offsetting assets but these would heavily devalued.

Spain's Target2 liabilities are €328bn, almost 30pc of GDP. Portugal and Greece are both at €72bn. All are either insolvent or dangerously close if these debts are crystallized.

Willem Buiter from Citigroup says central banks within the unfinished structure of the eurozone are not really central banks at all. They are more like currency boards. They can go bust, and several are likely to do so. In short, they are "not a credible counterparty" for the rest of the euro-system.

It is astonishing that the rating agencies still refuse to treat the contingent liabilities of Target2 as real debts even after the Draghi letter, and given the self-evident political risk. Perhaps they cannot do so since they are regulated by the EU authorities and are from time to time subjected to judicial harassment in countries that do not like their verdicts. Whatever the cause of such forbearance, it may come back to haunt them.

On the other side of the ledger, the German Bundesbank has built up Target2 credits of €796bn. Luxembourg has credits of €187bn, reflecting its role as a financial hub. This is roughly 350pc of the tiny Duchy's GDP, and fourteen times the annual budget.

Luxembourg is a huge 'creditor' through the Target2 system but it too could get into trouble if the France breaks up the euro

So what happens if the euro fractures? We can assume that there would be a tidal wave of capital flows long before that moment arrived, pushing the Target2 imbalances towards €1.5 trillion. Mr Buiter says the ECB would have to cut off funding lines to "irreparably insolvent" central banks in order to protect itself.

The chain-reaction would begin with a southern default to the ECB, which in turn would struggle to meet its Target2 obligations to the northern bloc, if it was still a functioning institution at that point. The ECB has no sovereign entity standing behind it. It is an orphan.

The central banks of Germany, Holland, and Luxembourg would lose some of their Target2 credits, yet they would have offsetting liabilities under enforceable legal contracts to banks operating in their financial centres. These liabilities occur because that is how the creditor central banks sterilize Target2 inflows.

In other words, the central bank of Luxembourg would suddenly owe 350pc of GDP to private counter-parties, entailing debt issued under various legal terms and mostly denominated in euros. They could try printing Luxembourgish francs and see how that works.

Moody's, Standard & Poor's, and Fitch all rate Luxembourg a rock-solid AAA sovereign credit, of course, but that only demonstrates the pitfalls of intellectual and ideological capture.

It did not matter that the EMU edifice is built on sand as long as the project retained its aura of inevitability. It matters now. Bookmakers are offering three-to-one odds that a candidate vowing to restore the French franc will become president in May.

Marine Le Pen

What is striking is not that the Front National's Marine Le Pen has jumped to 28pc in one poll, it is that she has closed the gap to 44:56 in a run-off against former premier François Fillon.

The Elabe polling group say they have never before seen such numbers for Ms Le Pen. Some 44pc of French 'workers' say they will vote for her, showing how deeply she has invaded the industrial bastions of the Socialist Party. The glass ceiling is cracking.

The wild card is that France's divided Left could suppress their bitter differences and team up behind the Socialist candidate Benoît Hamon on an ultra-radical ticket, securing him a runoff fight against Ms Le Pen. The French would then face a choice between the hard-Left and the hard-Right, both committed to a destruction of the current order. That contest would be too close to call.

Anything could happen over coming months in France, just as it could in Italy where the ruling Democratic Party is tearing itself apart. Party leader Matteo Renzi calls the mutiny a "gift to Beppe Grillo", whose euro-sceptic Five Star movement leads Italy's polls at 31pc.

As matters now stand, four Italian parties with half the seats in parliament are flirting with a return to the lira, and they are edging towards a loose alliance.

This is happening just as the markets start to fret about bond tapering by the ECB. The stronger the eurozone economic data, the worse this becomes, for pressure is mounting in Germany for an end to emergency stimulus.

Whether Italy can survive the loss of the ECB shield is an open question. Mediobanca says the Italian treasury must raise or roll over €200bn a year, and Frankfurt is essentially the only buyer.

Greece could be cowed into submission when it faced crisis. The country is small and psychologically vulnerable on the Balkan fringes, cheek by jowl with Turkey. The sums of money were too small to matter much in any case.

It is France and Italy that threaten to subject the euro experiment to its ordeal by fire. If the system breaks, the Target2 liabilities will become all too real and it will not stop there. Trillions of debt contracts will be called into question.

This is a greater threat to the City of London and the banking nexus of the Square Mile than the secondary matter of euro clearing, or any of the largely manageable headaches stemming from Brexit. Would anybody even be talking about Brexit in such circumstances?

* This text has been modified to reflect the value of the assets held by the Banca d'Italia