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TREND TO MONITOR: ITALY'S TARGET 2 DEFICIT HIT NEW HIGH IN MARCH AT EUR 420BN (PEAK DURING 2012 CRISIS WAS 290BN)

Within the monetary union, capital outflows from peripheral Europe are hard to gauge. One measure for it is to look at balances of national central banks (NCB) versus the ECB, in the Target II Eurosystem.

This morning, the Bank of Italy reported that **Italy's Target 2 deficit rose to new highs in March at Eur 420bn, from 386bn in February**. As a way of comparison, **during the peak of the EU Sovereign crisis in 2012 crisis, Italy's liabilities stood at Eur 290bn**.

While we are told that record T2 balances are pure accounting values and should be viewed as a benign by-product of the decentralized implementation of the asset purchase program (APP) rather than renewed capital flight (link), and while Draghi refers to them as a form of solidarity within the European system, in a letter to Italian EU politicians Draghi also maintained that such debts should be settled in full should Italy decide to leave the euro. So, **the number matters and represents a liability**.

Target II liabilities are now above 25% of GDP In Italy (from 22% in January), and above 30% of GDP in Spain.

Similarly to what happened in 2012, **it is imaginable for Germany to soon start to feel uncomfortable with such levels of exposure and demand more vocally a reversal of the trend**. At the time, it sufficed for Draghi to cheap talk about the 'irreversibility' of the EUR for the trend to reverse. In contrast, this time around, the ECB is tapering, on the presumption of economic growth to take firm hold, and on evidence of inflation having resurfaced. Tapering can be seen as a way to reverse those Target II flows, or at least prevent them from rising further. Incidentally, tapering is today also needed to prevent too heavy a tax on German savers / electorate, as they are hit hard by negative real rates, now that inflation spiked up for the first time in a while: with inflation at 1.9% and short term rates at almost -1%, real rates are negative by 2% to 3%, and the German electorate is paying for the EMU party more than ever before.

It should also be said that Target II deficit should be seen as one of the components of country risk, not the only one or the most relevant one. Take the case of Italy, for example, where the Target 2 euro system exposure at EUR **420bn** is to be added to BTP owned by foreigners (approx. EUR **710bn** at the end of 2016), funding (non-financial deposits and interbank funding) for Italian banks (in excess of EUR **350bn**), financing to Italian companies made by foreigners (EUR **700bn**+). On the side of public debt alone, Italy spends 5% of GDP in interest payments alone.

This is the background against which tapering enters the stage, and rates rise.

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Italy's Target 2 liabilities reach new high in March:

- Italy's Target 2 liabilities rose to a new record high in March pointing to growing imbalances in the position of different central banks within the euro zone. The Bank of Italy's position within the Target 2 system, which settles cross-border payments in the euro zone, is monitored because its increase can indicate financial stress.

- The Bank of Italy said on Friday its Target 2 position rose to 419.8 billion euros ($446.2 billion) in March from 386.1 billion euros in February. ($1 = 0.9407 euros) (Reporting by Stephen Jewkes; editing by Agnieszka Flak)

Source: http://www.reuters.com/article/italy-target-idUSI6N1H8002

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