Business comment

A growing risk to the euro project that would put Brexit in the shade

AMBROSE EVANS-PRITCHARD

Vast liabilities are being switched from private banks and investment funds on to the shoulders of taxpayers across southern Europe. It is Greece again, but on a far larger scale.

There has been no democratic decision by any parliament to take on these 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 sets off a serious run on the euro, 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 at any time in the history of the euro project.

The debt markets are a barometer of stress. Yields on two-year German debt fell to an all-time low of minus 0.91pc yesterday. "Alarm bells are starting to ring again. Our flow data is picking up serious capital flight into German safe-haven assets. It feels very 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. In reality it has become a cloak for capital outflows. Private investors sell their holdings of Italian sovereign debt to the ECB at a profit, and rotate the proceeds into mutual funds Germany or Luxembourg.

REUTERS/ROBERT PRATTA

The Banca d'Italia now owes a record €364bn to the ECB, 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 risk from the private to the public sector exposes the Italian central bank to insolvency if the euro breaks up. "Frankly, these sums are becoming unpayable," he said.

The ECB argued for years that Target2 imbalances were an accounting fiction that did not matter in a monetary union. Not any longer. The bank's Mario Draghi wrote a letter to Italian Euro-MPs in January warning that the debts would have to be "settled in full" if Italy left the euro.

It is an admission that Italy's public debt is 22pc of GDP higher than officially declared. Much the same applies to Spain with Target2 liabilities of €328bn. Portugal and Greece are both at €72bn. Willem Buiter from Citigroup says central banks within the euro structure are like currency boards. They can go bust, and several are likely to do so. 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. This may come back to haunt them.

On the other side of the ledger, the German Bundesbank has built up Target2 credits of €795bn. Luxembourg has credits of €187bn, reflecting its role as a financial hub. This is roughly 350pc of the tiny Duchy's GDP.

So what happens if the euro fractures? The chain-reaction would begin with a southern default to the ECB. Frankfurt in turn would struggle to meet its Target2 obligations to the northern bloc, if it was still a functioning institution at that point.

The northern central banks would lose some of their Target2 credits, yet they would have offsetting liabilities under enforceable legal contracts to banks operating in their financial centres. The central bank of Luxembourg would suddenly owe 350pc of GDP to private counter-parties. I am not sure that printing Luxembourgish francs would get them out this pickle.

The EMU system is built on sand. This did not matter as long as the euro 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.

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 Francois Fillon. The Elabe polling group say they have never before seen such numbers for Ms Le Pen. The glass ceiling is cracking.

What is striking is that the Front National's Marine Le Pen has closed the gap to 44:56 in a run-off against former premier Francois Fillon

'The EMU system is built on sand. This did not matter as long as the euro project retained its aura of inevitability'

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 run-off 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.

Anything could happen 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 anti-euro 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. 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 in any case.

It is France and Italy that will subject the euro experiment to its ordeal by fire. If the system breaks, the Target2 liabilities will be crystallised and 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 headaches stemming from Brexit. Would anybody even be talking about Brexit in such circumstances?