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German Bundesbank comes clean on euro default risks after Italy's 'parallel currency' decree

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Nobody ever asked the hardworking German taxpayer whether they wanted to lend €920bn through Target2 payments. There was no vote in the Bundestag

The German Bundesbank has warned that it could face heavy losses if a major country leaves the euro and defaults on debts to the European Central Bank system, but warned that any attempt to prepare for such a crisis could backfire by triggering a speculative attack.

The analysis is highly sensitive coming just days after the insurgent Lega-Five Star government in Italy passed a decree in the Italian parliament authorizing the creation of a parallel payments system known as 'minibots', a scheme decried by critics as a threat to the integrity of the euro and potentially a 'lira-in-waiting'.

While the Bundesbank text sticks to the standard line that a euro break-up is hypothetical it nevertheless admits - after years of obfuscation - that the ECB's internal Target2 settlement system entails inescapable costs for Germany and other EMU member states should it ever happen. It also gives the impression that the monetary authorities have no clear strategy for handling such a crisis.

The conclusions will be presented to the finance committee of the German parliament on Wednesday by Burkhard Balz, the institution's head of payments. They are a response to growing alarm among the Free Democrats (FDP) and the Alternative fur Deutschland Party (AfD) over the Bundesbank's eye-watering Target2 credits to the ECB nexus.

These credits have reached €920bn or 27pc of German GDP. Bond purchases by the ECB under its quantitative easing scheme have exacerbated the imbalances, effectively becoming a disguised conduit for capital flight from Italy.

The Bank of Italy's Target2 liabilities on the other side of the ledger have climbed to €481bn. The Bank of Spain owes a record €403bn, and the Portuguese central bank owes €79bn.

Professor Philip Turner, a former monetary official at the Bank for International Settlements, said the politics of Target2 are poisonous. "This is lending on a huge scale that no government has approved. It is covering fundamental imbalances at the heart of the eurozone system, and it can't go on indefinitely," he said.

The International Monetary Fund says it would be hard to prevent a sovereign debt crisis in Italy engulfing Spain and Portugal. The ECB could therefore face a Target2 crisis approaching €1 trillion if Italy's rebel government sets off a chain reaction with its 'minibot' notes - which it claims are needed to cover €52bn of state arrears to Italian contractors and households.

The Bundesbank's text states that if a country leaves EMU and its central bank defaults on Target2 liabilities, the ECB will have to eat through a series of buffers: first its own capital - dramatic enough - and then by drawing in money from the remaining central banks on a 'capital key' basis.

The logical inference is that this sequence eventually turns into a margin call. German, Dutch, Finnish, or French taxpayers might have to write fat cheques to bail out their central banks.

Clemens Fuest, head of Germany's IFO Institute, says the ECB will have to draw a line in the sand at some point. It should not keep extending unlimited credits to the Bank of Italy if Rome's populist coalition defies the EU authorities and goes ahead with budget policies that subvert monetary union.

The ECB could dial up the pressure by imposing collateral haircuts. In the end it could cut off Target2 access - as it did in the Greek crisis - and force Italy to impose capital controls. But this has explosive implications.

Germany's FDP leader Christian Lindner wants changes in EU law to foreclose any possibility of an Italian Target2 default. He has proposed a capture mechanism that automatically converts the Target2 debts back into euros if any country leaves EMU. The certificates would be lodged in the vaults of the ECB in Frankfurt.

He also wants an exit procedure written in stone. The Bundesbank said this could lead to a self-fulfilling crisis. "The danger is that it could fuel speculation about the possible exit of a country," said the text.

Marcello Minenna, Quant director at the Italian securities commission CONSOB, said it would be madness to establish an exit procedure. Hedge funds would circle like sharks for the kill.

"It would be very dangerous. Markets would try to make money out of the spread arbitrage. They would invent strategies to exploit it. This is what they did with QE," he told the Telegraph.

Mario Draghi, the ECB's president, says the Bank of Italy will be liable for every last euro of Target2 debts if Italy leaves monetary union - although this liability, interestingly, is not recorded by Eurostat in Italy's debt to GDP ratio.

In reality these debts are a legal minefield. Contracts are subject to the principle of Lex Monetae. Professor Minenna, an expert on Target2 from his days at Bocconi University, says the Bank of Italy is legally entitled to repay the money in 'lira' at the prevailing market exchange rate.

"In the case of 'Italexit' the ECB would face a currency haircut of 60pc on its Italian Target2 credits. There would be an enormous devaluation against new euro, which would no longer be the same old euro without Italy. There is always an overshoot in these situations," he said.

Prof Minenna said Italexit would be deemed a technical default under the ISDA rules for credit default swaps. The recovery rate on debt would be around 40pc. It would amount to a major financial shock. "The Bundesbank would lose a lot of money," he said. So would all the other residual central banks of EMU.

He said the Target2 system combined with QE has degenerated into a racket allowing private banks and investment funds to exit positions and switch liabilities onto the shoulders of taxpayers across southern Europe, and especially in Italy. The fundamental errors made over the handling of Greece are being repeated - in a disguised form - on a far larger scale.

In the end Italy's creditors will be faced with a choice: either accept the disorderly default of Italexit; or put the country's debt on a "sustainable path" by stretching maturities, or by an interest rate haircut, or both. "If you keep adding pressure, the glass will break at some point," he said.

For the creditors there is an issue of democratic accountability. The Target2 credits entail mounting risks for German taxpayers yet there is no vote to approve this in the German parliament. The Bundesbank hands over the money automatically.

Professor Hans-Werner Sinn from Munich University said the Target2 regime is a systematic deception of the German people. The imbalances are not self-correcting - contrary to the long-asserted claims of the Bundesbank - and the existing credits will never be recovered. "They are already lost," he said.

If that happens, there is going to an awkward reckoning when German voters realize what has been done to them.