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Loans to Italy from other eurozone countries will not increase their risk exposure, irrespective of the method of financing.

This is because loans will displace an equal amount of Italy's Target2 debt, leaving unchanged the total claim of the eurozone creditors. Italy currently has Target2 debt of €513bn to other eurozone countries through its central bank.

If Italy receives grants, this will amount to forgiveness of some of its Target2 debt, which will be no loss to the creditors because its Target2 debt is unlikely ever to be repaid at full value.

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Financial support for Italy

Countries such as Italy are likely to receive some financial support from other European Union governments to assist with recovery from the coronavirus pandemic. Under the latest 'recovery plan'[1] proposed by the European Commission and endorsed by France and Germany, the Commission will raise funds by issuing long-dated debt on behalf of the EU, to be repaid from the EU budget from 2027 onwards.

The centrepiece of the plan is the Recovery and Resilience Facility with a proposed budget of €560bn, of which €250bn will be loans and €310bn grants. Of the grants, Italy is allocated the largest slice of €63bn. However, the value of any grants that finally reach Italy and other beneficiaries may be smaller, as all EU governments need to agree.

Whatever financing structure is arranged, the overriding constraint is the reticence of some of the potential lenders or donors, *i.e.* the other eurozone or EU countries. There is concern about the risk exposure of loans and a general aversion to handouts.

They need not be concerned. Eurozone countries are already exposed to Target2 debts of other eurozone members through the eurosystem of central banks. For instance, Italy currently owes €513bn (April 2020, Chart 1). As will be explained, loans or grants to Italy cause Italy's Target2 debt to fall by an equal amount; therefore loans leave the exposure of other eurozone countries to Italy unchanged, where exposure is properly measured as the sum of loans and the ECB's Target2 claim on Italy.

If the assistance is grants, this has no cost to the donors as it merely amounts to reducing Italy's Target2 debt closer to its market value.

[1] European Commission (2020a, 2020b). For helpful analyses of other possible funding devices, including the much-discussed eurobond and the Corona bond, see Perotti (2020) and Bini-Smaghi (2020).

Target2 balances

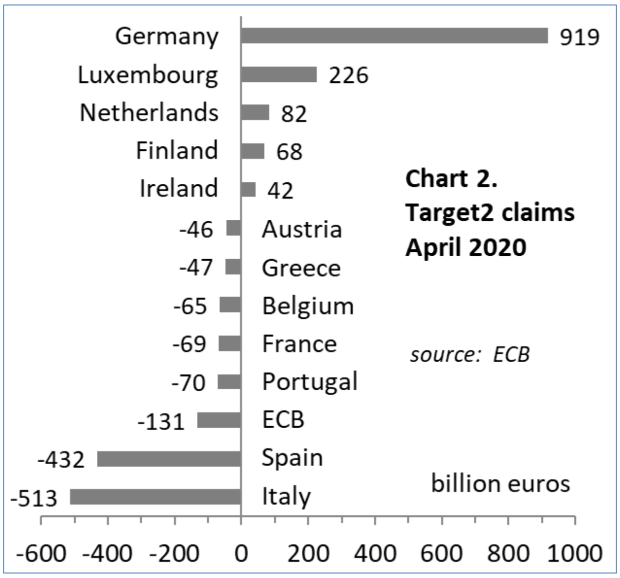
Target2 balances are debts between the national central banks (NCB) of the eurosystem and the European Central Bank (ECB) and they are an essential feature of monetary union. Unlimited credit between the NCBs is necessary to ensure that euros exchange at par in all eurozone countries. Target2 balances are the result of accumulated net cross-border financial flows, which may be payments for trade or they may be investment flows unrelated to trade.[2]

Consider, for instance, a movement of a bank deposit from an Italian bank to a German bank. The Italian bank makes up for its lost deposit by drawing from its current account at its central bank (the Bank of Italy: BoI); the current account of the German bank at the Bundesbank (German central bank) is credited; and the Bundesbank acquires a claim on the BoI. Under eurosystem accounting practices, such changes in NCB Target2 balances are netted across all NCBs and recorded as claims on or liabilities to the ECB.

The broad features of Target2 balances (Chart 2) are that 'core' countries such as Germany have

[2] The nature of the Target2 balances has been widely discussed elsewhere. See, for instance, Whittaker (2016) and the comprehensive analysis in Sinn (2014).

claims, whilst the greatest liabilities are those of the 'peripheral' countries, notably Italy and Spain, largely caused by capital flows from the periphery to the core since 2008. Movements in Italy's Target2 liability (Chart 1) are related to the spread in yields between Italian and German 10-year government bonds and reflect changes in investors' views of Italy's debt sustainability.[3]



If Italy receives funds from the EU recovery plan, whether as loans or grants, this is an inflow into Italy and it will cause an equal reduction in Italy's Target2 liability, in the same manner as the private cross-border flows described above.[4]

Target2 Risks

Target2 balances are a peculiar form of debt in that they are never settled. No NCB with a Target2 liability is ever obliged to pay to Target2 claimants, nor is there any mechanism for this.[5] And although Target2 debts bear interest (at the ECB's main refinancing rate, currently zero) the interest is merely rolled into the debt. Thus, Italy's Target2 liability is solely driven by net cross-border payments through the eurosystem. At present, there is little prospect of Italy achieving trade surpluses or attracting capital inflows sufficient to cause a significant reduction.

The only event that would bring a demand for Italy to settle its Target2 liability would be its departure from the monetary union (exit from the euro) and the reestablishment of its own currency.[6] However, the BoI would be unable to pay because it does not have enough suitable assets. It has gold and net foreign (*i.e.* non-euro) assets of €184bn (April 2019, see balance sheet, Table 1) which are potentially available for this purpose. Otherwise, the BoI's main assets are its holding of Italian government debt (€522bn, mostly acquired as part of the ECB's asset purchase programmes) and its refinancing loans to banks (€279bn, collateralised mostly by Italian government debt).

The best that the ECB and other NCBs could hope for, in settlement of most of their €513bn

[3] Eisenschmidt et al. (2017) argue that much of the increase in Italy's Target2 liability during 2016-17 was associated with the asset purchase programme. They point out that some of the Italian government debt purchased by the BoI came from non-euro countries (e.g. the UK) with the payment routed through the Bundesbank. These transactions are therefore recorded as capital outflows from Italy to Germany. But this explanation of the rise in Italian Target2 debt does not lessen the eurosystem exposure to it.

[4] As an example of the relevant transactions, suppose the Italian government receives a tranche of a loan from the recovery fund, which the fund draws from its ECB account and the Italian government deposits at the BoI. Clearance of the position between the ECB and the BoI occurs by means of a fall in the ECB's Target2 claim and a fall in the BoI's Target2 liability, each by the amount of the tranche.

[5] This contrasts with the US where there is annual settlement of the inter-district balances of the Feds (Federal Reserve Banks), using Federal government debt or agency debt. The US system also differs from the eurosystem in that the Feds are not associated with states: each Fed deals with banks in several states and Fed profits go to the US government.

[6] Former ECB President Mario Draghi has said that *"If a country were to leave the Eurosystem, its national central bank's claims on or liabilities to the ECB would need to be settled in full"* (Draghi, 2017).

Target2 claim on the BoI[7], would be a claim on the Italian government. Unhelpfully, this would replace one type of claim against the Italian state with another. And with its new currency likely to depreciate relative to the euro, Italy's capacity to pay euro-denominated debt would be further eroded.

Table 1. Bank of Italy balance sheet April 2020

assets	€ billions
gold and net foreign assets	184
loans to banks (refinancing)	279
Italian government debt	522
intra-eurosystem claims:	59
claim on the ECB [1]	8
banknote adjustment	51
other	78
total	1,122
liabilities	
banknote allocation	209
bank reserves	115
government deposits	70
intra-eurosystem liability:	
Target2	513
other	53
capital [2]	162
total	1,122

net eurosystem debt = 513 – 59 = 454
actual banknote issue = 209 – 51 = 158

[1] The Bank of Italy's share of ECB capital and its claim for foreign (non-euro) assets transferred to the ECB.
[2] includes revaluation accounts (€136bn).
Source: Bank of Italy

[7] There is another important contribution to intra-eurosystem debts which arises from differences in the values of banknotes issued by each NCB (see Whittaker, 2016). In the case of Italy, the banknote issue of the BoI is less than its allocation, leading to a credit of €51bn (April 2020). Taking this and some other small adjustments into account, Italy's total (but still unpayable) eurosystem debt is €454bn (see balance sheet, Table 1).

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This leads to two relevant conclusions. First, a departure of Italy from monetary union would force the ECB to recognise a loss of part of the BoI's Target2 liability. The other NCBs would bear this loss, apportioned according to their capital keys (*i.e.* shares) in the ECB, with the Bundesbank suffering the most (31.8%: higher than its current 26.4% capital key because of Italy's departure).[8] And because all NCB profits and losses accrue to their respective governments,[9] it is the German government that bears the exposure to this risk of loss on the Bundesbank's Target2 claim.

In assessing the risk exposure of Germany and other eurozone countries, Italy's Target2 liability must therefore be counted together with any official lending to Italy. It follows that lending to Italy will not increase the exposure of the eurozone creditors because it will displace an equal value of Italy's Target2 debt.**[10]**

[8] There is no provision on NCB balance sheets for this risk, the official justification being that no country is likely to leave the euro. According to the Bundesbank (Annual Report 2019, liabilities note 12 provisions):

> *The Bundesbank could hypothetically be affected - - - by the risk to which the Eurosystem is exposed if a euro-area country were to leave the single currency area and its central bank failed to settle its TARGET2 liability to the ECB - - -. It considers this scenario to be unlikely to materialise .*

[9] Most central banks are owned by their governments, an exception being the BoI whose private owners receive a maximum of 6% of profits as dividends (Bholat, 2019). The Italian government receives BoI profits after private dividends (and any provisions) have been covered and bears its losses. The processes for NCBs' remittances to their governments are described in Bunea et al. (2016). The profits and losses of the ECB accrue to its shareholders: the NCBs.

[10] The set of countries that will be relieved of Target2 exposure to Italy if Italy receives a loan or grant (the 18 eurozone countries, excluding Italy), may not be the same or in the same proportion as the set providing the loan or grant. The 'recovery fund' will be repaid by all EU members.

Second, neither principal nor interest on Italy's Target2 debt will be paid whilst Italy remains in the euro and in the only scenario in which payment would be demanded, *i.e*. exit from the euro, full payment would not be possible. Hence, however remote the possibility of Italy's exit, the fair value of the BoI's Target2 debt (*i.e.* its current market value if it were a tradable asset) is less than its book value.

If Italy receives assistance in the form of grants, this will also displace an equal value of Italy's Target2 debt. Even if Italy is given as much as the €63bn proposed by the Commission, this reduction in Italy's Target2 debt is unlikely to take it below its fair value. The grants amount to forgiveness of debt that will never be settled. They will be effectively costless.

Why not just cancel some Target2 debt?

There is a simpler way to give money to the Italian government. The ECB could just cancel some of Italy's Target2 debt directly, which would amount to a transfer from the ECB to the BoI. The BoI balance sheet would record an increase in profit that would pass to the Italian government; and the other eurozone governments would need to pay through their NCBs to replenish the ECB's capital.

This would hand cash to Italy while avoiding the agony of finding an agreed funding structure. It would also need some inventive interpretation of the Treaties or the ECB Statute.

Yet, the more important issue both for Italy and its eurozone partners is not how to go about giving or lending to Italy, but rather to ensure sustainability of its government debt. While direct financial support for the Italian government will help, the main instrument for this purpose remains BoI purchases. The ECB will have to find ways to placate the German Constitutional Court, allowing this to continue indefinitely.

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