The claims of the Bundesbank on the European Central Bank through the Target-2 system are approaching €1tn. What do these claims represent? Are they subsidised German loans to other euro-area countries – primarily Italy, Portugal and Spain? Do they signal further financial disintegration in Europe? Or, as large as these numbers are, are they simply a consequence of the complex mechanics related to the construction of the Eurosystem and how it implements monetary operations?

The answer is two-fold: for the first few years of the euro-area crisis – when German claims peaked at €750bn – imbalances reflected subsidised loans to counter rising financial fragmentation. Between 2008-12, funds shifted from banking systems in the periphery of Europe perceived to be under stress, to banks in the core seen as being relatively stable, creating a web of liabilities and claims among national central banks.

After 2012, the risk of breakup receded, so the interpretation of renewed increases in Target-2 balances has changed. Indeed, the doubling since early 2015 is a natural consequence of how the Eurosystem implements its various asset purchase programmes. Consequently, the impact of the APP expansion on Target-2 balances has concealed a further, if still incomplete, reversal of the financial fragmentation triggered by the euro area crisis several years ago.

The details of this are straightforward: when a national central bank like the Banca d’Italia purchases a government bond as a part of the APP, the seller typically uses a bank in Germany, the Netherlands or Luxembourg (see the recent ECB paper.) The result is a Target-2 liability for the Banca d’Italia and a claim for the national central bank in the country of the seller's bank.

The immediate implication is that there are specific assets backing today’s Target-2 liabilities, making them very different from those prior to the 2015 advent of the Eurosystem's APPs. In June 2012, when Eurosystem assets peaked at €3.1tn, most were in the form of repurchase agreements arising from various commercial bank refinancing operations. That is, the national central banks were providing reserves to their banks through lending operations rather than outright bond purchases.

Were euro area members so inclined, the availability today of specific sovereign securities to back Target-2 balances provides a means to reduce them. The approach we have in mind mirrors the one employed in the US, where the Federal Reserve System occasionally settles imbalances between the regional reserve banks through an asset transfer. The Fed publishes these imbalances in their weekly financial statement on the line labelled ‘interdistrict settlement account’. In recent years, these have often exceeded $100bn for some districts. To limit the accumulation of imbalances, each April the Fed reallocates its securities portfolio, shifting assets from reserve banks with liabilities to those with claims.

Could the Eurosystem adopt a similar practice, shifting securities from national central banks with liabilities to those with claims? Prior to the APP there were very few securities, so there would have been no simple way to implement such a reallocation. Today, the APP assets are roughly twice the level of Target-2 balances. To be sure, not all countries with liabilities currently hold sufficient securities available for transfer to the creditor countries. Nevertheless, by our estimate, the feasible reallocation would slash Target-2 imbalances by 85% – to €200bn from €1.385tn.

We draw three simple conclusions from this. First, we should only interpret those changes in Target-2 balances that are not associated with asset purchases as a symptom of financial stress. Second, the bulk of today’s Target-2 balances are an artefact of the way in which the Eurosystem implements its APPs, so that the totals are extremely misleading. Third, creditor countries may find it advantageous to view the majority of Target-2 imbalances as claims by one national central bank on securities that happen to sit on the balance sheet of another (or on the ECB’s own balance sheet).
The Eurosystem should follow the lead of the Fed and rebalance the system annually. Implementing this transfer today would make clear the extent to which financial fragmentation has receded since its peak in 2012.

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