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Greece: The sudden stop that wasn’t

Aaron Tornell Frank Westermann

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With economists’ eyes fixed squarely on Greece, this column tries to solve a puzzle. Since 2008, tens of billions of euros have fled Greek bank accounts. Yet somehow the country still has a current-account deficit. Where has this money come from?

Normally, things don't work like this for nations in crisis. Greece has experienced severe capital flight yet its current-account deficit has remained almost unchanged; its international reserves are little changed. On net, €24 billion of private capital left the country between 2008 and 2010, but Greece still managed to accumulate a €85 billion current-account deficit – 12% of GDP.

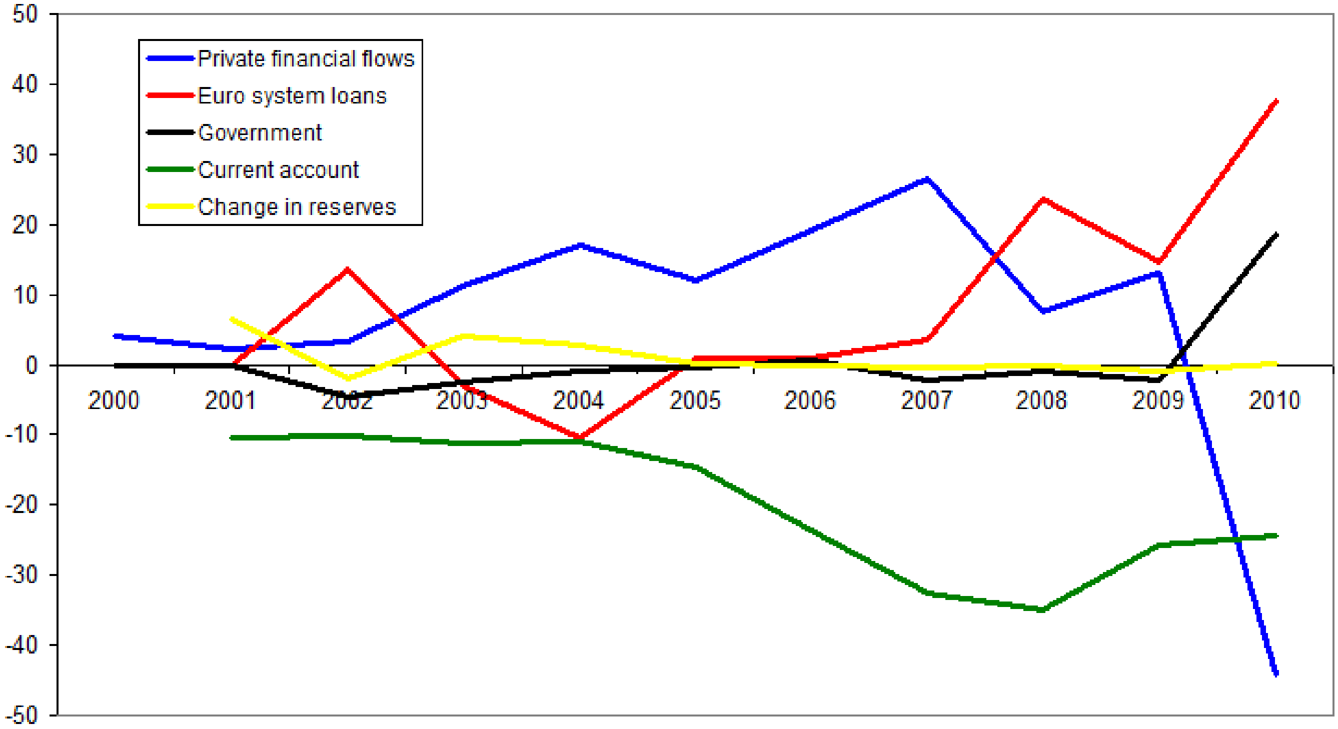
Where has the money come from? The answer can be found by looking at the balance of payments statistics. Mainly from fresh loans provided by Eurozone central banks to the Greek central bank. These amount to €76 billion. This figure is almost 90% of the cumulative current-account deficit during this period, and it is increasing fast. It reached €110 billion in June 2011.

Although these Eurosystem loans are channelled via the ECB, the funds involved are over and beyond those used in the ECB's government bond-purchase programme – a programme opposed by Juergen Stark, Germany's top representative at the ECB, who has recently resigned. Furthermore, they are different from theEU rescue package to Greece, which is scheduled to be ratified by the German parliament on 29 September.

While tough public spending cuts are attached to the EU rescue package, the Eurosystem loans have no such restrictions attached, have been disbursed already, and have been spent by Greece already. Moreover, they do not need parliamentary ratification.

The Eurosystem loans to Greece were small until 2007. Since then, however, they have increased enormously, as shown in Figure 1. Together with the large increase in official inflows from the IMF and the EU, the Eurosystem loans have allowed Greece to avoid the sharp cut in expenditure – both public and private – that typically occurs in countries experiencing a sharp reversal in private capital inflows. As seen in Figure 1, the current-account deficit, the excess of national expenditure – including interest payments – over national income, has had very little improvement in the face of the sharp drop in private capital flows.

Figure 1. Components of the balance of payments



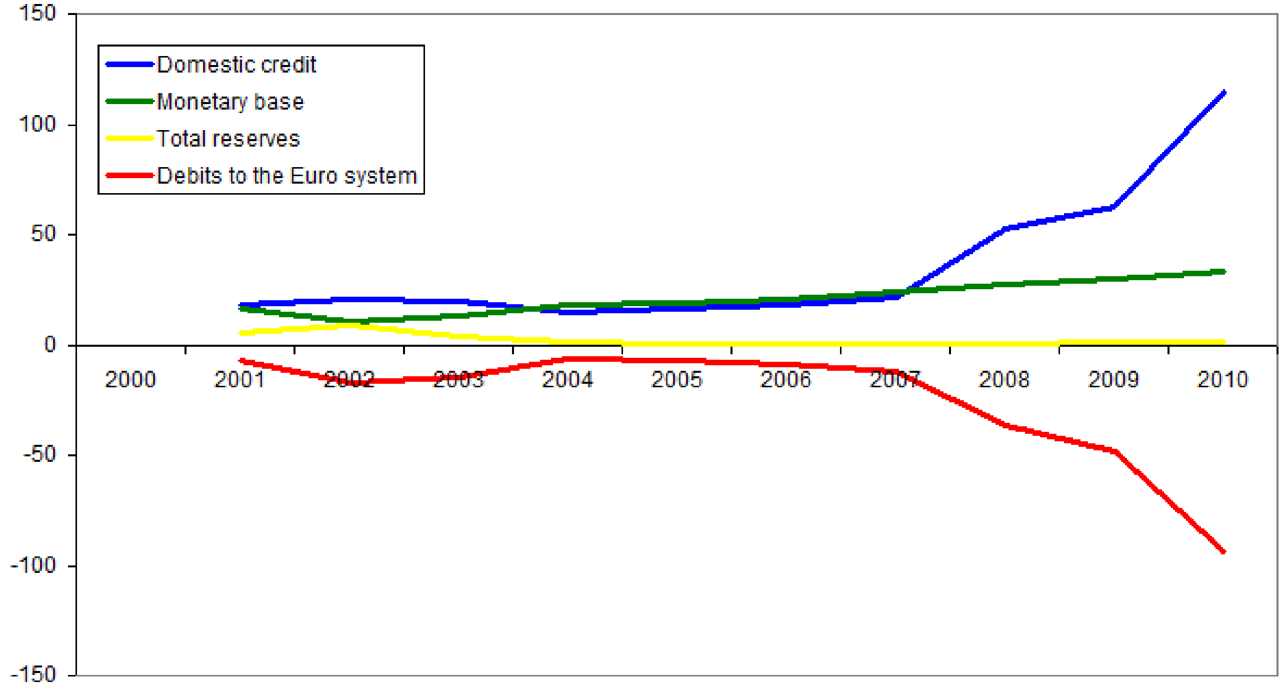
Source: International Financial Statistics, IMF

In theory, Eurosystem loans should not be counted as long-term debt because they only represent transitory debits and credits across central banks that allow for a smooth settlement of trades in goods and services. Thus, the Eurosystem loans line in Figure 1 should in theory not be far away from zero for an extended period of time. Starting in 2008, however, this has not been the case for Greece. In fact, the Eurosystem loans to Greece have taken on a magnitude which makes them anything but transitory. In other words, that line looks like it is not going to revert to zero anytime soon.

The data on official inflows and Eurosystem loans are buried in two obscure lines in the balance of payments statistics of the IMF. Official inflows are captured by the 'other investments–government', while the Eurosystem loans are captured by 'other investments–monetary authorities'. In the national central banks' accounts, the Eurosystem loans correspond to the so-called TARGET balances, which Hans-Werner Sinn and Timo Wollmershäuser of the ifo institute in Munich, have recently analysed (see the debate on this site, including Sinn 2011 and responses from Whelan 2011 and Buiter *et al* 2011 among others).

The mechanism by which Eurosystem loans have allowed Greece to avoid the sharp adjustment in its current account is by allowing the Greek central bank to increase domestic credit in the face of a massive capital flight. In fact, as shown in Figure 2, starting in 2008 the sharp increase in domestic credit provided by the Greek central bank mirrors the cumulative Greek liabilities to the Eurosystem that resulted largely from the Eurosystem loans shown in Figure 1. Interestingly enough, both the monetary base and international reserves remained practically unchanged.

Figure 2. Components of the monetary base



Source: IFS, International Financial Statistics, central bank survey.

This lack of expenditure adjustment contrasts with Mexico in the wake of the Tequila Crisis: From a current-account deficit of 7% of GDP in the year prior to the crisis, Mexico was forced to practically balance its current account during the crisis year (-0.5% in 1995 and -0.7% in 1996). Yes, in 1995 Mexico experienced a sharp real depreciation and a deep recession. By 1996, however, net exports rebounded and economic growth resumed. At the time it was argued that Mexico could have avoided the severe crisis by adjusting in early 1994. Unfortunately, like Greece today, the authorities chose to increase domestic credit to delay a recession. The difference between Mexico and Greece is that while Mexico had to run down its international reserves, Greece has been able to keep them practically unchanged. Instead Greece has used the EU rescue package and the Eurosystem loans to increase domestic credit. Had Greece been like a typical small economy with no access to rescue packages, it would have had to close its massive current-account deficit by now. Its ability to maintain such massive current-account deficit in the face of a sharp reversal in private capital inflows will be recorded in the annals of financial crises as a remarkably rare feat.

It is time to address Greece's economic policy options in a holistic manner, and stop the emergency measures that only provide Greece with another lifeline. Greece's fresh financing needs are much larger than those considered in the Greek rescue package. The financing gap has been covered with *de jure* revolving loans from European central banks to the Greek central bank, that *de facto* have become long-term debt. This backdoor financing, however, cannot go on indefinitely. Jurgen Stark's resignation should help concentrate minds in finding a long-lasting solution.

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