Greece: The Sudden Stop That Wasn't

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Now that economists' eyes are fixed squarely on Greece, a puzzle has emerged that this article attempts to solve. 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 do not 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 have barely changed. On net, 24 billion euros of private capital left the country between 2008 and 2010, but Greece still managed to accumulate a current account deficit of 85 billion euros, i.e. 12 percent of GDP.

Where has the money come from? The answer can be found by looking at the balance of payments statistics – primarily from fresh loans provided by eurozone central banks to the Greek central bank. Between 2008 and 2010 these loans amounted to 76 billion euros. This figure is almost 90 percent of the cumulative current account deficit during this period and it has been increasing rapidly: it reached 110 billion euros in June 2011.

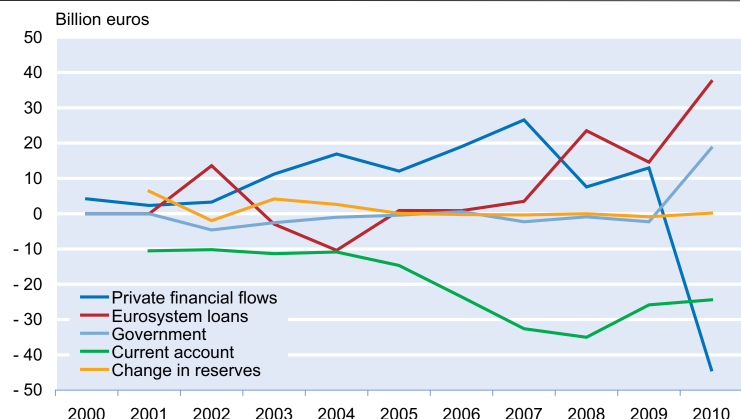
Although these Eurosystem loans are channelled *via* the ECB, the funds involved are over and beyond those used in the ECB's government bond purchase programme – a programme opposed by Jürgen Stark, Germany's top representative at the ECB, who has recently resigned. Furthermore, they are different from those provided by the EU rescue package to Greece, which was 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. They have already been disbursed and spent by Greece. Moreover, they do not need parliamentary ratification.

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

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 peri-

Figure 1
Components of the balance of payments



Source: IMF International Financial Statstics.

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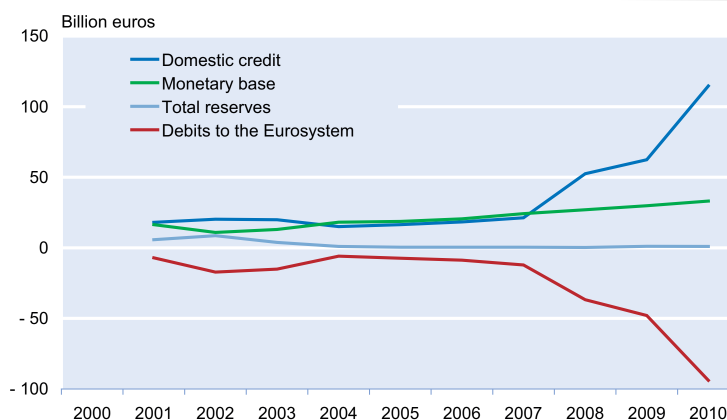
od of time. Starting in 2008, however, this has not been the case for Greece. In fact, the Eurosystem loans to Greece have taken on a magnitude which makes them anything but transitory. In other words, it looks like this line is not going to revert zero anytime soon.

Figure 2
Components of the monetary base



Sources: IMF International Financial Statstics; central bank survey.

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 '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 (2011) have investigated.[1]

The mechanism by which Eurosystem loans have led Greece to avoid the sharp adjustment in its current account has enabled 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 strong 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 illustrated in Figure 1. Interestingly enough, both the monetary base and international reserves remained practically unchanged.

This lack of expenditure adjustment contrasts with Mexico in the wake of the Tequila Crisis: from a current account deficit of 7 percent of GDP in the year prior to the crisis, Mexico was forced to practically balance its current account during the crisis year (– 0.5 percent in 1995 and – 0.7 percent in 1996).[2] 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 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. Jürgen Stark's resignation should help concentrate minds in finding a long-lasting solution.

[1] The Target balances are also discussed in Garber (1998).
[2] Sachs, Tornell and Velasco (1996) discuss Mexico's balance of payments crisis in detail.

References

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