The Current Account Deficits of the GIPS Countries and Their Target Debts at the ECB

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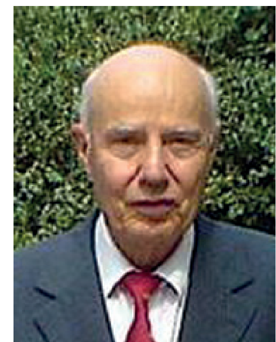

It goes without saying that a country's current account deficits must be financed. In the case of a country with its own currency, this means that it needs foreign exchange to pay for the deficit. Its possibilities for paying for a deficit are accordingly limited by its foreign exchange reserves and the willingness of foreign private or public persons or organisations to grant private or public credit.

The same holds with some differences for a member state of the European Monetary Union (EMU), since the central bank of the country that is a member of the EMU does not need foreign exchange reserves for payments within the euro area, as these are transferred *via* the European Central Bank by means of the so-called Target clearing system. If, for example, a Greek buyer of German goods wants to pay for them, his account at a Greek bank will be debited, which in turn has the same amount debited at the Greek central bank that transfers it to the ECB. At the ECB, a corresponding amount is debited to the Greek central bank and credited to the Deutsche Bundesbank (Buba) that subsequently credits the account of the seller's bank. The seller finally receives the amount in question in his account at this bank.

Regarding the financing of a current account deficit in the amount D of a member state of the currency union, apart from negligible presents, the following financing condition holds:

(1) $D = DKpr + DKpu + DKprf + DKpuf,$

where $DKpr$ and $DKpu$ are private and public credits granted by other countries of the monetary union; correspondingly, $DKprf$ und $DKpuf$ are private and public credits granted by foreign countries outside the currency union. For the country itself K represents an increase in its liabilities (debts).

As the country's deficit *vis-à-vis* non-EMU countries, Df, is being financed by these *via* lending, the following equation results using equation (1)

(2) $Df = DKprf + DKpuf = D – DKpr – DKpu,$

where the country's deficit *vis-à-vis* the other states of the EMU, named Dew, is

(3) $Dew = D – Df.$

Let us assume now (assumption 1) that there is no deficit of the country under consideration with countries outside the EMU, e.g. because its insolvency is feared and therefore neither private nor public lenders are willing to grant new loans, i.e. to export more capital to this country. Then

(4) $DKprf + DKpuf = 0$

and it follows from equations (2) and (3)

(5) $D = Dew = DKpr + DKpu$

This means that, because of assumption 1, the current account deficit only exists *vis-à-vis* the EMU countries and is being financed by them. We now divide public lending $DKpu$ into that of the governments and the European Commission, DKg, and that of the central banks, $DKcb$, of the remaining EMU countries, so that

(6) $DKpu = DKg + DKcb.$

It must be noticed that $DKcb$ shows up as a liability of the country in question on the balance sheet of the ECB, and that the latter then credits the central banks of the other member states with the same amount.

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Thus we obtain

(7) $DVcb = DKcb,$

where $DVcb$ denotes the increase in the liabilities of the country *vis-à-vis* the ECB.

Let us now use assumption 2, that private entities inside the EMU for similar reasons as those outside are no longer prepared to grant the country any further credit; and further make assumption 3, that governments and the commission have not granted any loans during the period in question, then, because $DKpr = 0$ and $DKg = 0$ it follows from equations (5) and (6)

(8) $D = Dew = DKcb$.

This result follows from the tautology and assumptions 1 to 3. Whether it corresponds to the facts is an empirical question that depends on the countries considered, the period chosen and the correctness of the assumptions.

Let us now test this for the period from 2007 to 2010 for the hypothesis that the deficit country refers to all GIPS, i.e. to Greece, Ireland, Portugal and Spain, whereas Germany and therefore its central bank is the only creditor. Then the assumptions, especially equation (7) can at most be approximately correct. To the extent to which the approximation is close enough, we may consider the hypothesis that mainly the Bundesbank has financed the deficits of the GIPS as by and large confirmed.

Therefore equations (8) and (7) should be confirmed according to their magnitudes, since only then are the three assumptions roughly fulfilled. This means that firstly the combined deficit D of the GIPS should correspond to the change in their Target debt at the ECB, $DVzb$, and secondly that this should roughly correspond to the change in the Target credit of the Buba, $DKcb$, at the ECB.

The results for the period from 2007 to 2010 are:

Dew = 365 billion euros;

$DVcb$ = 340 billion euros and

$DKcb$ = 326 billion euros.

The highest and the lowest of these figures differ by not more than 7.4 percent or 4.1 percent respectively from 340 billion euros. Considering our drastic assumptions 1 to 3, these differences do not suffice to refute the hypothesis that the accumulated deficit of the GIPS countries from 2007 to 2010 was essentially financed by the increase of their Target debt at the ECB, which in turn was financed by the creation of a corresponding Target credit of the Bundesbank.

In view of the derived results it is reasonable to ask how long this kind of financing the deficits of the GIPS countries may be continued. In the past, this was possible without damage to the system, as the ECB expanded its monetary base so much after 2007 that it was possible to raise the Target debts all the more without a strong expansion of the monetary base, i.e. the central bank money supply issued by the ECB. The existing scope, however, will be exhausted in the foreseeable future, probably in two years, if the monetary base does not grow further. This would further increase the risk of inflation, however. And it would do so in a situation in which inflation will threaten anyway if the ECB does not succeed in a timely reduction of the excessive central bank money supply and raise its interest rates. This risk posed by Target financing should not surprise anybody, as the increase in the Target debt of the GIPS countries is nothing else than the financing of deficits by monetisation. It therefore comes as no surprise that the ECB is arguing so energetically in favour of an expansion of the rescue funds for these countries and thus for the assumption of their debts by the member states of the euro area, the EU Commission and the International Monetary Fund.

But there may be another possibility for a time for the GIPS countries and thus the ECB instead of expanding the monetary base. Instead of increasing their Target debts at the ECB, these countries would have to finance their deficits by relinquishing their gold reserves to the ECB and thus indirectly to the Bundesbank. This would, of course, only be possible until their gold stocks were exhausted.