The ECB's Secret Bailout Strategy

By Hans-Werner Sinn

But in the end, either the euro will collapse or Europe will establish a transfer union.

Why did Greece, Ireland, and Portugal have to seek shelter under the European Union's rescue umbrella, and why is Spain a potential candidate?

For many, the answer is obvious: international markets no longer want to finance the PIGS—Portugal, Italy, Greece, and Spain. But that is only half true. In fact, international markets have not financed any of them to a considerable extent for the past three years; the European Central Bank has. The so-called "Target" accounts, hitherto ignored by the media, show that the ECB has been much more involved in rescue operations than is commonly known.

But now the ECB no longer wants to do it, and is urging eurozone members to step in.

Normally, a country's current account deficit (trade deficit minus transfers from other countries) is financed with foreign private capital. In a currency union, however, central bank credit may play this role if private capital flows are insufficient. This is what happened in the eurozone when the interbank market first broke down in mid-2007.

The PIGS' own central banks started to lend newly printed money to their private banks, and this money was then used to finance the current account deficit. These funds went to the exporting countries, where they circulated as part of normal transactions.

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The exporting countries' central banks responded by reducing their emissions of fresh money to be lent to the domestic economy. In effect, central bank money lending in exporting countries, above all in Germany, was diverted to the PIGS.

The ECB's policy was not inflationary, because the aggregate stock of central bank money in the eurozone was unaffected. But, as PIGS' central bank lending came at the expense of central bank lending within the eurozone's exporting countries, the policy amounted to a forced capital export from these countries to the PIGS.

The amount of the ECB's "replacement lending" is shown by the so-called Target2 account, which measures the deficit or surplus of a country's financial transactions with other countries. As the account includes international payments for both trade in goods and financial claims, a deficit in a country's Target account indicates foreign borrowing via the ECB, whereas a surplus denotes foreign lending via the ECB.

The balance is not reported on the ECB's balance sheet, since it is zero in the aggregate, but it does show up on the respective balance sheets of the national central banks as interest-bearing claims against, and liabilities to, the ECB system. Until mid-2007, the Target accounts were close to zero, but since then, they have grown by about €100 billion per year.

For example, the Bundesbank's Target claims ballooned from €5 billion in 2006 to €323 billion by March 2011. The counterpart to these claims were the PIGS' liabilities, which had grown to about €340 billion by the end of last year. Interestingly, the PIGS' cumulative current account deficits from 2008 through 2010 were of roughly the same order of magnitude—€365 billion, to be precise.

Had the ECB failed to finance these deficits, the PIGS would have had a hard time finding the money to pay for their net imports. If they succeeded at all, high interest rates would have induced them to tighten their belts, and their current account deficits, which in the case of Greece and Portugal exceeded 10 percent of GDP, would have diminished.

One should not criticize the ECB for propping up the PIGS' current accounts during the global crisis. Unconventional measures were necessary to prevent their economies from collapsing. But it should be clear that this was not a *sui generis* monetary policy; it was a bailout. Now that the world economy has largely recovered from the crisis, it is time to end this policy—not least because the ECB is running out of ammunition.

By the end of last year, the aggregate stock of central bank money in the euro area was €1.07 trillion, and €380 billion euros was already absorbed by ECB credit to the PIGS. So financing a continued PIGS current account deficit of about €100 billion a year would consume the entire stock of base money within another six or seven years.

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To exit this policy, the ECB wants the European Union's Luxembourg rescue facility, the European Financial Stability Facility or European Stability Mechanism, to take over, and some countries even call for the issuance of eurobonds. But this would simply prolong community financing of the PIGS' current account deficits, now in its fourth year, for another couple of years. In the end, either the euro will collapse, or a transfer union will be established in Europe, in which the current account deficits will be financed with inter-country donations.

It would be better if the European Union kept the Luxembourg fund for real emergency measures, and if the ECB instructed its member institutions in the PIGS to demand significantly better collateral for their lending operations. Tight national caps on Target balances could provide the right incentive to comply. Such a cap would not eliminate current account deficits, but it would reduce deficits to the flow of private capital willing to finance them.

Setting a cap on Target accounts is a fundamentally more appropriate policy to keep current account deficits in check than the wage policies contemplated by the new Pact for the Euro. Wage policies are appropriate only for centrally planned economies.

Perhaps the PIGS should ponder how Italy handled itself. Even though it had to pay interest premiums and was running a current account deficit, Italian central bank chief Mario Draghi (the leading contender to take over the ECB this autumn) kept his central bank's lending under tight control throughout the crisis. Although it must have been sorely tempted, Italy did not accumulate Target deficits. It opted for virtuous abstention. ◆