The Hidden Mutualization That Bailed-Out German Banks

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- In a currency area, persistent current a/c surpluses imply vendor financing.
- Persistent vendor financing is likely to create unsustainable debts.
- By 2008 German Banks had accumulated over € 900 bn of credits on the Periphery, equal to 2.5x their equity.
- German banks were able to off-load on Target 2 € 520 bn of their souring credits on the Periphery.
- Target 2 balances are guaranteed by the ECB shareholders' States, hence German credits on the Periphery were largely mutualized.
- Had the German banking system remained at risk of insolvency, more leniency on the Debtors and more natural solidarity would have emerged.

VENDOR FINANCING

In a currency area, such as the Eurozone, a net exporting country must accept as payment the liabilities of net importing countries.

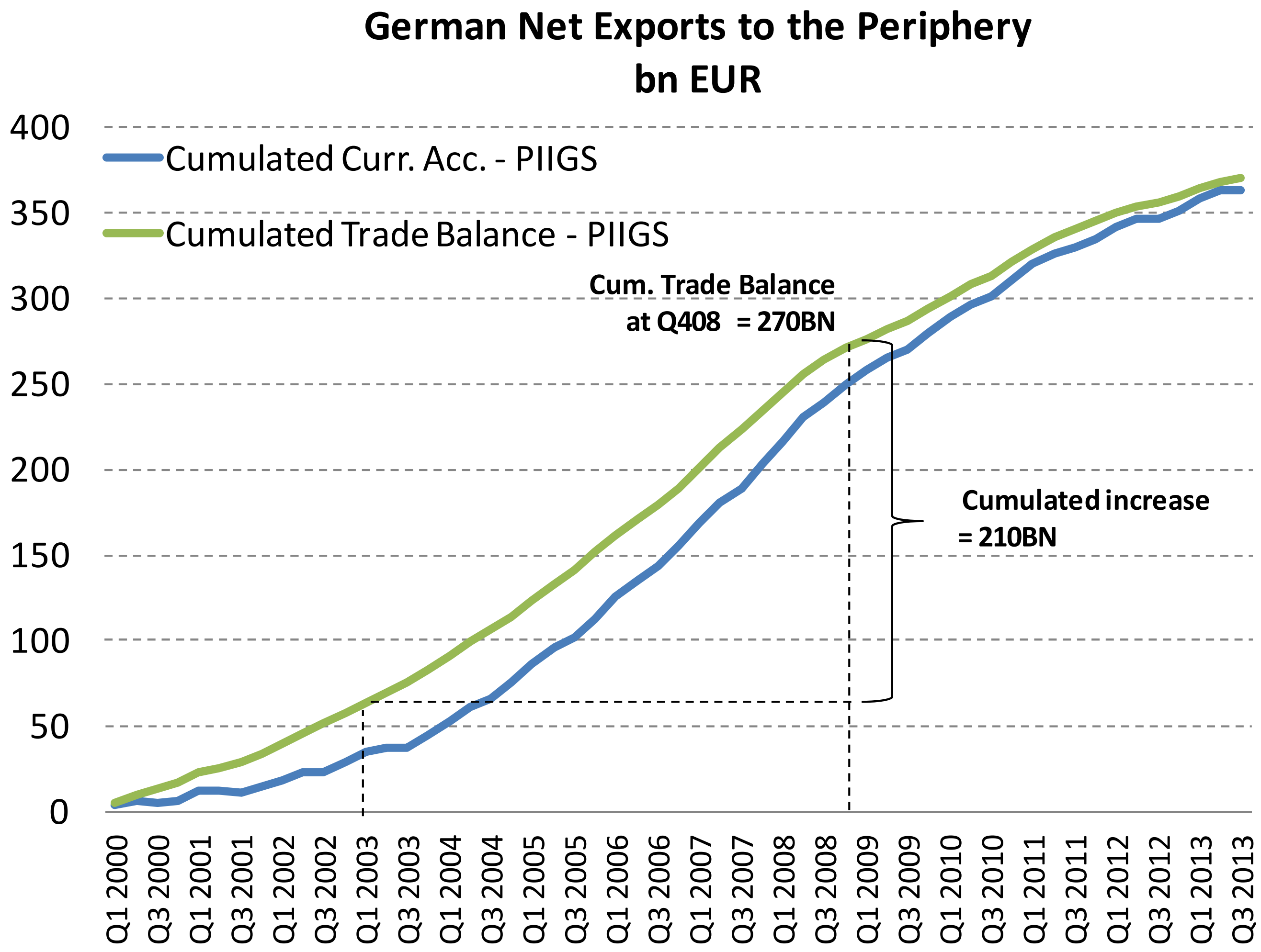
Over time, the persistent accumulation of credits on net importers living beyond their means makes those credits become ever more vulnerable.

The accumulation of official reserves, or of Target 2 balances, shifts the risks of vendor financing to the public sector.

By hiding the risk, this transfer inhibits the private sector's self restraint and, in effect, subsidizes exports.

PERSISTENT C/A SURPLUS

From 2000 to 2008, Germany's cumulated current a/c position towards the Periphery (PIIGS) grew by over € 350 m.

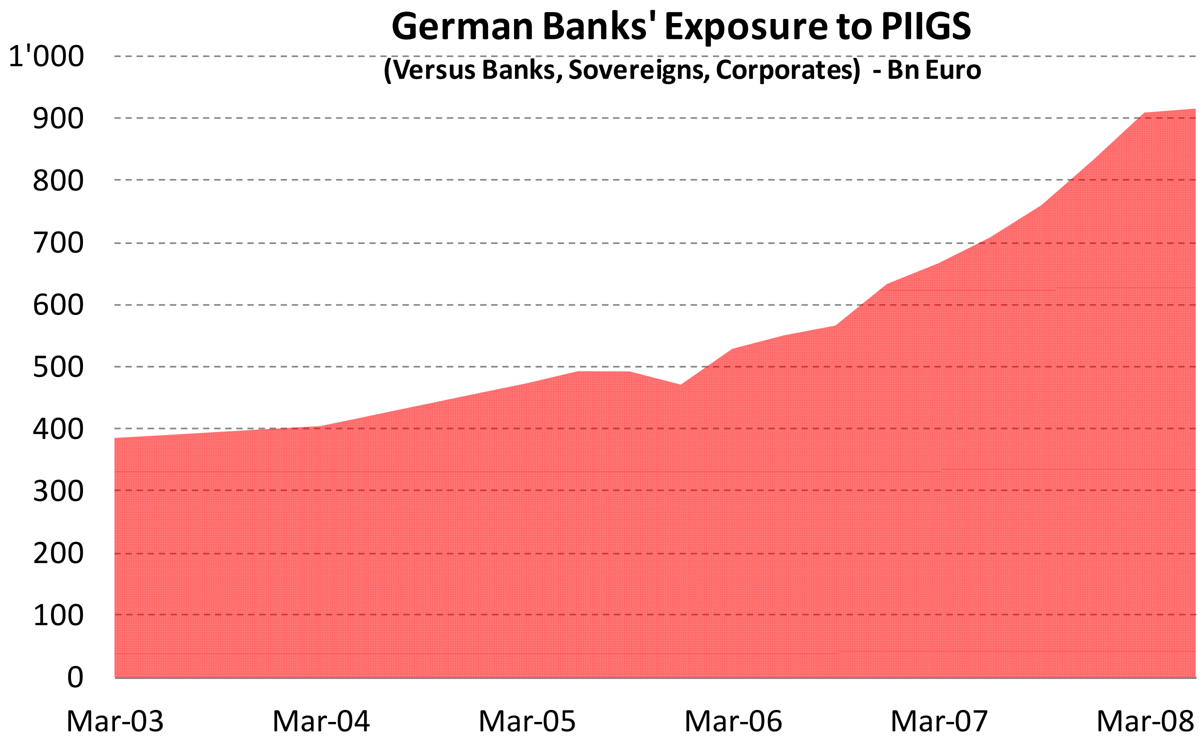


ACCUMULATION OF CREDITS

Between 2003 and 2008 the German banking system accumulated over € 500 bn of additional credits on the Periphery.

Roughly half of this growth was due to persistent current a/c surpluses (vendor financing), and half to the search for the higher yield available in the Periphery.

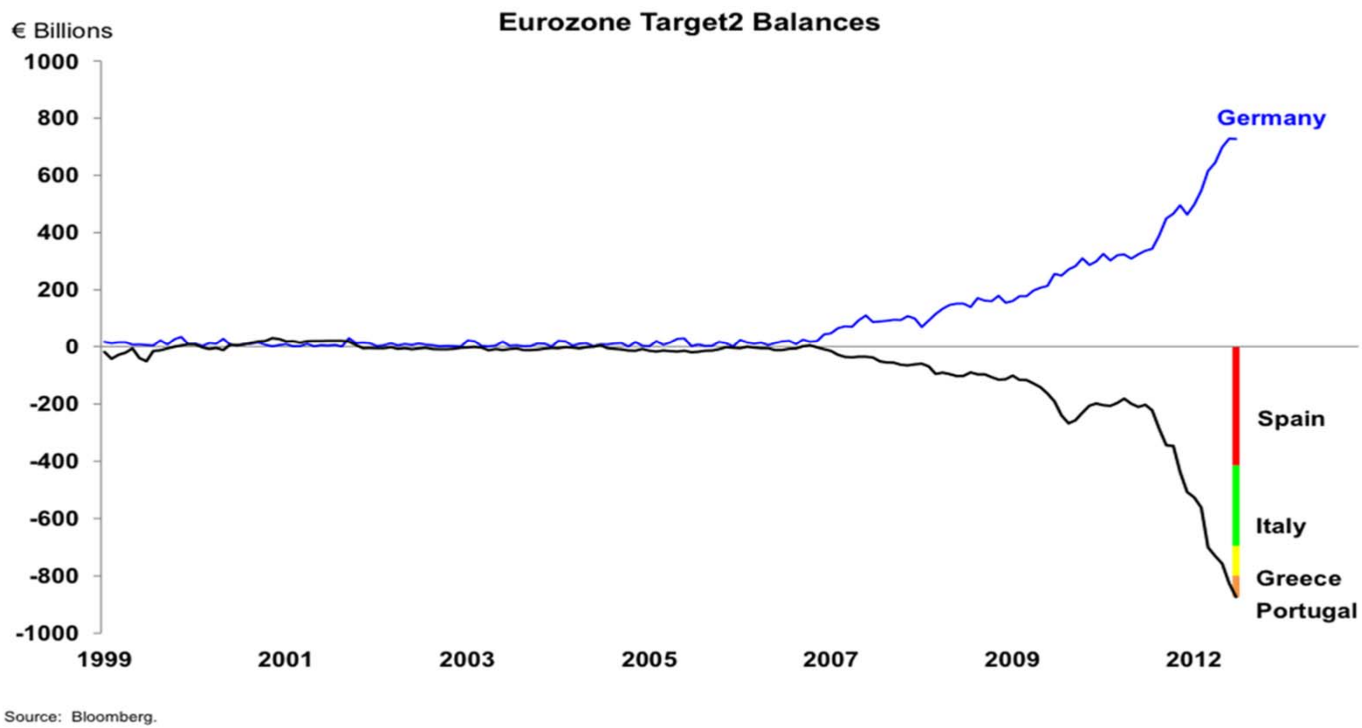
By 2008, the German banking system had accumulated € 900 bn of credits on the Periphery, equal to over 2.5x its capital.



RISKS ARE EXPOSED

With the onset of the financial crisis, the private sector became less willing to finance the Periphery.

Repatriation of bank credits on the Periphery was made possible by the intervention of the public sector as evidenced by the sudden increase of Target 2 balances.

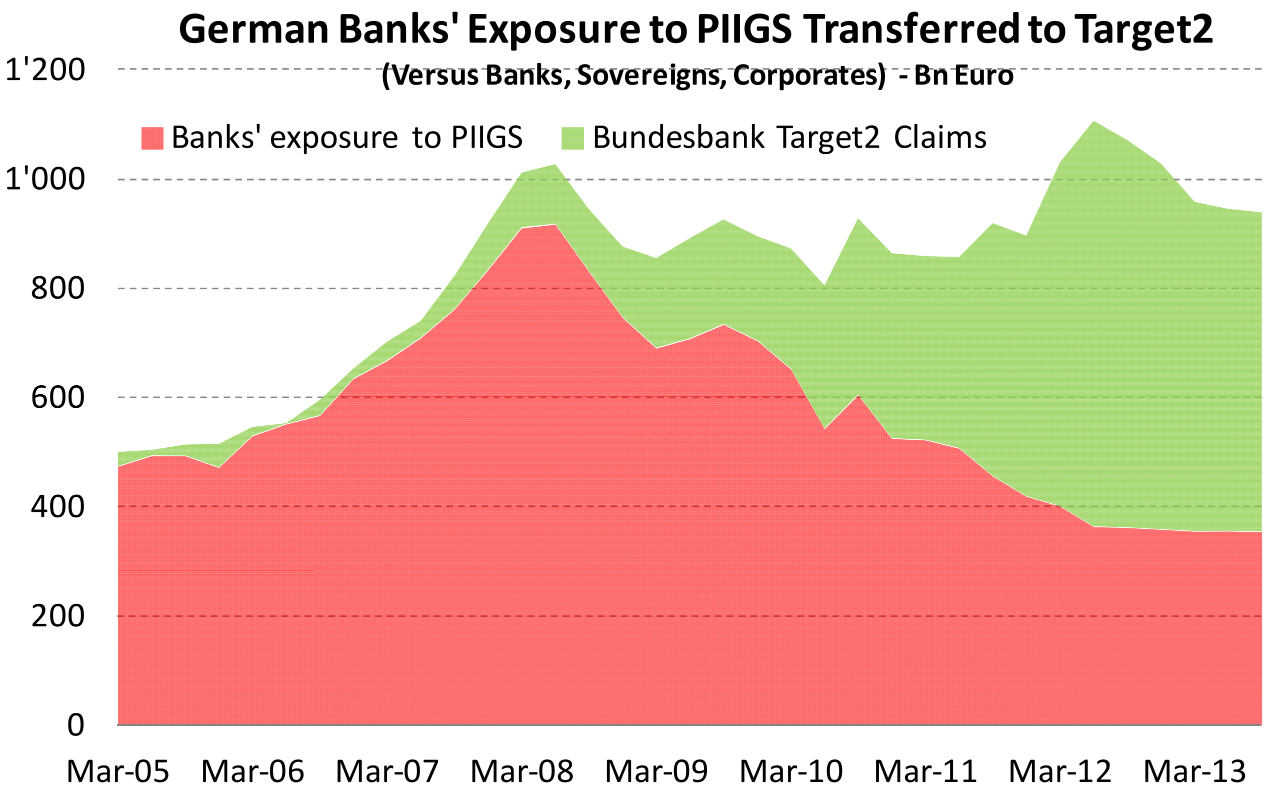


The ECB's LTRO funds accelerated the process by providing Periphery banks with cheaper funds and encouraging repayment of more expensive and drying international interbank flows.

€ 520 BN BAIL OUT OF GERMAN BANKS

Since the beginning of the crisis, the German banking system has been able to reduce exposure to the Periphery by about € 520 (equal to 1.4x its capital) despite continuing (but reduced) current a/c surpluses.

The Bundesbank filled the gap and saw its Target 2 balances grow by the required amount.



GERMANY MUTUALIZED ITS SOURING CREDITS

Target 2 allowed German banks to dispose of credits on the Periphery perceived as an increasing risk in favour of safer deposits at the Bundesbank.

The Bundesbank's Target 2 balance, though, is not a credit only toward the Periphery because it is guaranteed by all ECB shareholders.

Germany has in fact mutualized the souring credits it had accumulated on the Periphery (due in good part to its persistent current a/c surpluses) by replacing those with the much safer Target 2 balances.

Had the German private sector remained exposed to the Periphery, and its banking sector at risk of insolvency, German politicians would have been more lenient on Debtors, the natural solidarity between creditor and debtors would have emerged, and the risks of vendor financing would have been evident.