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EU Strugglers Could Soon Reach for the Hair Shirts

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Once again a German retreat caused a sigh of relief in Europe. German Chancellor Angela Merkel had wearied of having her country the ultimate guarantor of the debts of the profligate periphery. So she announced that she would not get involved in permanent rescue schemes unless lenders take a haircut. She could not, she said, repeatedly ask voters to bear the costs of imprudent lending by investors "who have earned a lot of money from taking those risks." Sounds sensible to analysts who fear the moral hazard created by serial bailouts.

But sounds scary to private investors who lent to the troubled countries. They greeted the news by driving down the prices of Irish and other euro-zone bonds, and reigniting fears of sovereign defaults. So Ms. Merkel, climbed down, as her critics put it or, as she preferred, clarified her position. The hair on the heads of existing holders of euroland countries' debt would remain in place; the haircuts won't start until 2013.

Note this important message: Germany's tune is the one to which the markets dance. Yes, the European Financial Stability Facility (EFSF), a creature of euro-land governments, the European Central Bank and the International Monetary Fund, has close to €1 trillion (\$1.36 trillion) potentially available to lend to strapped countries. But when it expires in 2013, Germany will dictate the replacement regimen.



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Chancellor Angela Merkel in Karlsruhe Sunday for her party's annual convention.

Doubt that and consider this. The calming effect establishment of the EFSF had on markets melted away as quickly as had the price of periphery-country bonds when the German chancellor said that private investors would have to bear some pain before a country could call upon the EFSF. And when the German chancellor reversed course, and announced that the new tough-on-investors regimen will not come into effect until 2013, calm was restored or, more precisely, the level of panic declined.

So it's all right, then. Well, not exactly. For one thing, the problems of the periphery countries are getting worse. Eurostat, the EU's statistics gatherer, reports that growth in the 16-nation euro-zone declined in the third quarter to 0.4% from 1% in the second quarter. Germany, the EU locomotive that chalked up growth of 2.3% in the second quarter, grew only by 0.7% in the third. That general slowdown reduces markets for the products of the periphery countries, which are already in difficulty.

In the third quarter, the Greek economy actually declined by 1.1%, while Portugal's grew by 0.4%, and Spain's stalled completely. The shrinking of Greece's economy makes it likely that the inspectors now in Athens will report this week that Greece did not generate sufficient tax revenues to meet its deficit reduction targets. That will be grist for the mill of critics who are saying that the austerity program imposed on Greece by the IMF and the European Central Bank is the road to ruin, rather than to recovery.

More important is the fate of Spain. With a GDP approximately twice as large as the combined total of Greece, Portugal and Ireland, Spain

matters. And the outlook is not good. The Spanish economy grew not at all in the third quarter. Its unemployment rate is now 20% and headed higher. Its banks have yet to recognize the losses incurred from property loans that have gone sour, or completed consolidation. Higher taxes and spending cuts will slow things even more next year.

Meanwhile, if the government survives the Dec. 7 vote on his budget, Brian Lenihan, the Irish finance minister who took Ireland's banks under the government's (i.e., the taxpayers') wing, will travel to Brussels before mid-2011, when Ireland will have to return to the bond market, to ask for a bailout from the ESFS. He would pay a price: a high interest rate, and accession to Eurocrats' demand that he raise Ireland's 12.5% corporate tax rate that his high-tax euro-land partners see as a form of unfair competition, but that is Ireland's best bet for returning to growth. If the Eurocracy turns usurer and insists that Ireland adopt the tax policies that have kept unemployment in the EU in double digits for decades, Mr. Lenihan might just go directly to the IMF and cut a better deal. IMF head Dominique Strauss-Kahn hints that Barkis is willin'.

Greece will fail to meet its deficit-reduction targets, and lay plans for a default that will include some grief for the private investors that had a moment of relief when Ms. Merkel's eased her demands for a haircut. Portugal, still unwilling to adopt a strict austerity program, will follow suit, as will Ireland and, eventually, perhaps but not certainly Spain, which is less indebted than Greece.

The Royal Bank of Scotland estimates that banks outside the troubled countries hold over €2 trillion of those countries' debt, so their balance sheets will shrink, and with it their ability to lend in their home countries. Not a pleasant prospect in the run-up to Christmas.

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