

For Euroland, First Comes Pain, Then Comes the Hard Work

- By IRWIN STELZER



Germany is the new China.

China keeps its export machine rolling by pegging its yuan to the dollar, so that America cannot devalue its currency relative to the yuan, and instead must live with a large trade deficit. Which Americans can't afford. So China lends America the money with which to buy Chinese goods.

Germany keeps its export machine rolling by in effect pegging its currency, the euro, to the currencies of its European trading partners, who share that currency. So Greece, to which Germany sells lots of goods cannot devalue, and must live with large trade deficits. Which it can't afford. So Germany is setting about lending money to Greece—other countries to follow shortly—so that Greeks can continue to buy Mercedes and other products of the efficient German manufacturing and service sectors. And for good measure, it benefits from the falling euro, driven down by the Greek tragedy or comedy, take your pick, to increase its sales to non-euro countries.

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Containers loaded in Hamburg. Germany would like a few to still go to Greece.

Which tells us something about how all of this is going to play out. In the short term, Greece's euro-zone partners and the IMF will cover its needs. Fathom Financial Consulting reckons that the €110 billion (\$140 billion) bailout package will cover the €50 billion in Greek debt due to mature by mid-2012, plus deficits the government will incur this year and next. That assumes the Greek government sticks to its austerity program in the face of continuing riots. Then it will have to restructure, the polite term for a partial default, with unpleasant consequences for the balance sheets of German and French banks, which hold €63 billion out of €290 billion of outstanding Greek government bonds.

The hope is that the European Commission's forecasts will prove excessively gloomy, and that the European economies will grow more rapidly than the EC expects, producing at least some additional tax revenues that might, only might, make the transition from red to black ink less socially disruptive. The EC is guessing the EU and euro zone will grow at annual rates of only 1% and 0.9%, respectively, this year, and both will grow at 1.5% in 2011. But it expects the economies of Greece, Ireland and Spain to contract, and Portugal's to grow at less than 1% in 2010 and 2011. Such contractions, and even the anemic growth predicted for Portugal would, of course, make it even more difficult for these countries to reduce their deficits to close to the 3%-of-GDP target, and even more likely we will see restructurings.

The economists at Goldman Sachs think this an unduly pessimistic outlook. They have upped their euro-zone forecasts from 1.25% and 1.9% for 2010 and 2011, respectively, to 1.7% and 2.2%, based on

expectations that stronger global growth and a weaker euro will stimulate exports, and the inventory build-up will continue.

Reports that Spain's economy grew a bit in the first quarter, and data compiled by Markit seem to lean in Goldman Sachs's direction. The EU's private manufacturing and service economies expanded in each of the last nine months, and Markit's index of such activity now stands at its highest level since August 2007. New orders for manufactured products are at close to a ten-year high, and order backlogs are rising. All of this despite ash from street fires in Athens and from a volcano in Iceland.

Such higher but still modest growth rates can ease, but not eliminate, the crisis on euroland's periphery. Euroland policy makers will have to be more specific about the "stabilization mechanism" they agreed in the early hours of Saturday morning if markets are to stop demanding the almost-nine-percentage premium over safe German IOUs that Portugal is now forced to pay. Austerity targets will have to be enforced. The ECB will have to overcome its reluctance to engage in quantitative easing (a.k.a. monetization), and continue to take sovereign low-rated and junk bonds as collateral for low-interest loans.

Larry Lindsey, the economic consultant who served as chief economist to George W. Bush in the successful years of that president's reign, sums it up this way. "There are three choices: major fiscal contraction, default, or monetization. Pain, pain, or pain."

Sensible emergency measures, of course, would only get the EU over this crisis. Then there is the harder, long-term job of restoring the health of what is now the sick man of the global economy. Europe's sclerotic economies can only defuse the ticking demographic time bomb created by its aging population if Europe reins in its welfare states, reforms its labor markets, and adopts the measures necessary to unleash the animal spirits of its entrepreneurs. No secret how to do that: the path is laid out in numerous EC policy documents. All that is required is the political will, one of the few things in short supply in the otherwise underutilized European economies.

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