PAGE TWO

How the euro zone will manage once the Greek fiasco is resolved

[Agenda]

BY IRWIN STELZER

As the Greek financial fiasco heads toward its conclusion, we can turn the page and make some guesses as to the longer run outlook for that country and, indeed, for Europe.

Greece will ask for and get a bailout. Chris Pryce, senior Greece analyst for rating agency Fitch, tells Reuters, "It is now up to the Greek government to go publicly to the European Union and International Monetary Fund and ask for the cash and the support." Laurent Bilke at Nomura agrees. He considers it "increasingly likely that the Greek government will be forced to...ask for a rescue." And European Central Bank President Jean-Claude Trichet assures us, "default is not an issue for Greece," implying withdrawal of his objections to an IMF role in any bailout. But restructuring is a possibility: even a €20 billion-to-€30 billion ($27 billion-to-$40 billion) loan package would leave Greece with an unmanageable debt burden.

Never mind George Petalotis, the Greek government's official spokesman, says there is no need for a rescue package "for the time being," insisting Greece will get its funds from the market. Greece won't pay what he calls "barbaric" interest rates. But Greek 10-year bonds command interest rates in the neighborhood of 7%, and two-years 8%. So good luck to him: Asian investors want no part of Greek bonds, and Americans don't seem eager to fill the gap.

Finance Minister George Papaconstantinou will visit the U.S. to urge investors to take all or part of dollar-denominated debt issues scheduled for later this month and May. No easy sell: capital is fleeing Greece, manufacturing output and new orders are shriveling at alarming rates, and no one can predict the size of the "haircuts" the ECB will insist on if it is to continue accepting Greek government paper as collateral for ECB loans to teetering Greek banks.

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A street vendor sells Greek flags to drivers passing by in Athens

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As both Messrs. Pryce and Bilke argue, the only way Greece can avoid paying "barbaric" rates is for the EU and IMF to make funds available at below-market rates, something German Chancellor Angela Merkel certainly won't agree to before May 9, the date of the election in North Rhine-Westpahalia. After that, with IMF participation and strict supervision of Greek spending as cover, she might risk a constitutional challenge and back down. Germans might hate the idea of bailing out people who retire earlier than they do, but they hate even more the thought of a collapse of "the European project" that they see as the ultimate constraint on the re-emergence of the nationalist sentiment that has done so much harm to their country, not to mention the rest of the world.

Once markets absorb the fact that default by Greece and other troubled euro-zone countries is unlikely, attention will turn to the EU's medium- and long-term economic prospects. Unalloyed gloom is being replaced with those famous green shoots that economy-watchers love to spot.

Markit, which compiles the Purchasing Managers' Index, reports that the euro zone grew in March for the eighth consecutive month, and at the fastest rate since August 2007. Germany, France, Italy, and even Spain recorded growth, the latter for the first time since December 2007.

So far, so good. But the economic data don't all point in one direction. The Economist Intelligence Unit doesn't foresee growth in Western Europe reaching even the still-unsatisfactory rate of 2.0% until 2014, less than half the rate at which it expects the rest of the world to be growing at that time.

Germany, the euro zone's largest economy, is in better shape than it has been, largely due to a spurt in exports, but domestic demand is insufficient to enable it to become the engine that enables the EU to grow at the rate of 3% and over that America is already chalking up. The German government is forecasting a growth rate of only 1.4% this year, after a 5% shrinkage of the economy in 2009. Germany's family-owned, small and medium-size companies, the traditional backbone of the economy, are struggling. MittelstandMonitor, an annual report on the sector, says 40,000 such German companies will go bust this year, a 16.6% rise over 2009 and a record.

Still, the prospect of some growth in the near- and medium-term in Germany and the rest of the euro zone is a considerable improvement over the declines of 2009. But it is the longer term that is most worrisome.

At some point the European Central Bank, which held interest rates steady at 1% last week, will have to begin withdrawing what Mr. Trichet calls its "significant economic stimulus." If it moves prematurely, even the modest growth now forecast might prove unattainable.

More important, in the longer term the euro-zone economies will remain growth laggards if they don't enact the labor-market reforms that they have for so long promised and for so long avoided, make it easier to start new businesses by rolling back regulations, and ease the tax burden on wealth creators by trimming their welfare states. Almost all of Europe's policy makers concede this to be the case, but so far the so-called "Europe 2020" reform strategy exists only on paper.

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