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Investors Will Soon Be Stressing Growth Rather Than Euro-Zone's Stress Tests

• By IRWIN STELZER



"Europe will certainly overcome its difficulties," says Chinese Premier Wen Jiabao, a man who should know a thing or two about how to get a tired old economy moving. "The poor old euro area has hardly got going," says David Owen, Chief European Financial Economist at Jefferies International, a man who has his finger on the pulse of the euro-zone economy.

It's not easy to come up with a definitive view of the state of things in the European economy (or economies, if you prefer a disaggregated view). One reason is that the powers-that-be issue studiously optimistic reports about the progress being made to cope with the problems unleashed by the discovery that Greece had been economical with the truth in reporting its deficits.

Take the stress tests now being conducted on 91 banks in 20 countries, with the results, or at least some of them, to be published on Friday after the markets close. Somehow, before the results are in, International Monetary Fund Managing Director Dominique Strauss-Kahn has divined that Europe's "banks are solid enough to resist shocks that could result from a state in crisis." Any shot big enough to matter — the heads of the European and Italian Central Banks among others — is equally confident that the banks will meet the still-secret soundness criteria set out in these still on-going tests. To his credit, Olli Rehn, European economic and monetary affairs commissioner, concedes that the stress tests might reveal "pockets of vulnerability."



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Reasons to be cheerful: Angela Merkel, left, and Wen Jiabao, center.

There is some reason for optimism. The financial seas are undoubtedly calmer than they were a few months ago, in part because of backup financing that might be made available by newly established EU facilities. But a look ahead is hardly reassuring. For one thing, it is hard to imagine there will not be several shocks to an already stressed financial system. A partial default by Greece, unless or perhaps even if its €110 billion multilateral support package is renewed in 2012. Or more bad news about the state of the U.S. recovery. Or an uprising by German voters tired of financing the profligacy of their euroland colleagues. Or a conflagration in the Middle East if Israel decides to damage Iran's bomb-making facilities.

Such shocks are not the only worry. Europe's banks have to roll over some €1.5 trillion in debt by the end of 2012, and will be competing for investor favor with U.S. banks that must refinance \$1.3 trillion, and sovereign governments that must raise billions more. It is one thing for investors to cough up the odd billion, as they did recently when they bought some short-term Greek debt (€1.625 billion of six-month Treasury bills at an average yield of 4.65%), and €3 billion of Spanish 15-year government bonds, albeit at high premiums. It is quite another to make trillions rather than billions available to these troubled financial institutions.

Indeed, banks in Spain and elsewhere have had to rely on the European Central Bank for funding. Spain's prime minister, José Luis Rodríguez Zapatero, has tried to reassure markets by predicting that his economy will grow next year, and announcing, in another exercise in prescience, that the stress tests "will reestablish the confidence of capital markets, thus permitting the normalization of credit."

Meanwhile, banks in several euro-zone countries have been frozen out of the interbank lending market, and the risk premium investors are demanding for lending money to Spain is at the highest level since 1999, when the euro replaced the peseta and other national currencies.

In the end, the stress tests will fade in importance as the summer passes, to be replaced by a more important factor: expectations concerning the performance of Europe's economy. Mr. Wen is among the optimists, and backed his words with a €400 million purchase of 10-year Spanish bonds, encouraged in part, he says, by the bounce in the euro.

But he is a special kind of investor. Like others, he has invested in euroland debt for a return that the market feels compensates for the risk. But unlike other investors, he gets three bonuses: political goodwill that he can spend when circumstances warrant; a stronger euro (boosted 6% say some analysts) that increases the value of China's massive euro holdings, guesstimated at €630 billion; and increased competitiveness of his country's exports in European markets.

Other, less-politicized investors have fewer reasons to hop on the pro-euro bandwagon. Both the Economist Intelligence Unit and Jefferies are guessing that overall area growth will come in at an uninspiring 0.7% and 0.8% this year and next, respectively, as austerity reduces demand and a stronger euro reduces exports. That makes debt service and repayment more difficult. So ordinary investors with none of the pluses available to Mr. Wen might demand sky-high rates in return for their cash, and certainly will if the stress tests prove to be as straightforward and transparent as Greek accounting practices have been.

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