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Stress Tests Have Good and Bad News, Depending on Which Way You Look

- By IRWIN STELZER



Now we know why so many eurocrats announced that very few banks had failed the stress tests — before the tests were completed. The tests were sufficiently unstressful to allow such foresight. In the event, only seven of the 91 sample banks in 27 countries flunked, five small ones in Spain and one each in Greece and Germany.

The stress tests proved three good things. We are not facing apocalypse now — later, perhaps, but not now; the eurocracy is capable of getting a complicated program done in quick time when disaster threatens; and all save the German banks, which came reluctantly to the party, revealed their exposure to sovereign debt so that the market can decide just how stressed they really are.

And two bad things.

- The quality of a stress test determines the number of banks that will pass: pretend that there is no threat of sovereign default, place outdated values on assets, pretend that troubled loans of Spain's banks constitute about 5% of the total when the real figure is closer to 14% (estimates UBS analyst Carvajal Cebrian), and you can make a balance sheet seem to have an abundance of capital. The tests

include an assessment of the impact on bank viability of the "haircuts" that might be imposed on holders of sovereign debt, but not of default, which the eurocracy insists can't happen. And the haircuts are applied only to the debt held on trading books. That impact, says the European Central Bank in an appendix, "is mitigated by the fact that banks' holdings of government securities are primarily in the banking book." Translation: we have not asked the banks to mark-to-market 80% of their holdings of government securities, even though the market value of those securities is far less than the value recorded on the books.



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Zapatero, left, will be fine so long as Merkel pays to keep the euro healthy.

- The fact that only seven banks failed to pass is less relevant than the fact that the five Italian banks tested only squeaked by, as did Postbank, one of Germany's largest, and that Germany's eight landesbanken received a passing grade only because they "have yet to record a substantial part of total estimated write-downs," according to the International Monetary Fund. That relieves the pressure on a sector that German finance minister Wolfgang Schäuble says needs "an urgent reform." These regional banks are an important source of funding for Germany's small businesses. If they fail, the locomotive of the European economy might have a lot less fuel.

Song writers Rodgers and Hart were right that "the self deception that believes the lie" results in "no more pain, no more strain," at least for a while. But not permanently. It seem that the eurocracy has deceived itself into believing that all is well — it is, after all, easier to deceive others if you first deceive yourself. So the Committee of European Banking Supervisors, or CEBS, professes to find the results of the tests "rather reassuring" even though almost half of the banks that passed the test continue to "incorporate [in the required capital] a significant amount of government support." Indeed, the CEBS assumes that "government paid in capital cannot be simply withdrawn." Except for those life-saving tubes we have inserted in your arms, José Luis Rodriguez Zapatero and friends, you are in fine shape, capable of handling any stress the world economy might dish out.

And by the way, no need to worry about a double dip recession. The so-called "adverse case" defines a "double dip" as no growth in 2010 and a 0.4% decline in GDP next year in the 27-nation European Union. Not very "adverse" by historical standards, given the fact that GDP in the EU declined by 4.2% in 2009.

There's more, but you get the idea. Markets "don't think the scenarios were stressful enough," Brian Dolan, chief strategist at Forex.com told Bloomberg News. How they will react in the long run will depend on two things.

The first is Europe's ability to sustain the recent uptick in its economic growth. The CEBS "benchmark", or most likely case, assumes euro area growth of 0.7% this year, and 1.5% in 2011. Not likely to produce many jobs, or tax revenues to help bring down fiscal deficits.

The second is Germany's continued willingness to be paymaster of last resort. Europe's banks passed the tests because those who devised them assume that Germany will continue to bankroll the various institutions set up to pump capital into the banks, and to provide an implicit guarantee against default by Club Med countries. German Chancellor Angela Merkel's plummeting popularity, in part a result of her reluctant agreement to have German taxpayers foot the bill for the excesses of its euro-zone partners, suggests limits to Germans' eagerness to work harder so that banks holding Spanish, Greek and other sovereign debt will face a mere trim around the edges rather than a crew cut.

The tests might be over, but stress is not. Don't discard the Valium just yet.

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