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Beyond the EU Policy Makers' Dream

- By IRWIN STELZER



Let's do a thought experiment: assume that all goes as planned by euro-zone policy makers. German Chancellor Angela Merkel recovers her balance and stops nickel-and-diming the various rescue funds being set up to succor troubled euro-zone members. Let's assume that all of the countries that have promised to contribute cash to the new €700 billion (£996 billion) European Stability Mechanism (ESM), scheduled to begin operation in mid-2013, cough up their shares of its callable capital, and that all of them—including Greece, Portugal, Ireland and Spain—prove able to respond if they are called on to meet billions in guarantees.

Let's assume further that Greece figures out how to collect taxes, and succeeds in reducing its deficits, as it promised when handed bail-out money. And that its banks, holding some €77 billion of Portuguese IOUs, somehow survive the new euro-zone plan to have creditors share the pain of bank bailouts.

A new Portuguese government, cobbled together after the June 5th elections and led by Pedro Passos Coelho, institutes a credible austerity program, and requests and receives the bailout his predecessor, José Sócrates, shunned. Better that than pay market interest rates that are well above 8% on 10-year bonds, and rising. That would require Brussels to overlook Lisbon's recent discovery that it understated its 2010 deficit by €2.5 billion (1.5% of GDP, bringing the total to 8.6% of GDP), and will miss its deficit reduction target.



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Catalonian Prime Minister Artur Mas has rejected Spain's austerity measures.

Ireland's banks, meanwhile, somehow raise the additional €24 billion the new not-very-stressful tests say they need, and Taoiseach Enda Kenny persuades his euro-land colleagues to lower the interest rate and extend the time period for repayment of the bail-out loan.

Let's go even further down this road and assume that Spain, under new leadership—Prime Minister José Luis Rodríguez Zapatero will not stand for re-election in March 2012—avoids hitting the buffers, even though regional governments such as Catalonia have announced that they have no intention of making what Catalonia's premier, Artur Mas, calls the "destructive ... mad" austerity cuts demanded by central government.

And that new governments in Portugal, Spain, Ireland, Germany (if Ms. Merkel can't hold on), France (Nicolas Sarkozy is polling in the low 20s), and Italy (if Silvio Berlusconi is otherwise engaged) do not cave in to popular pressure and opt for electoral survival over austerity and peer-group approval.

Finally, let's assume that investors, now alert to the fact that their hair will be cut in future bailouts, do not raise the already-substantial premia they are charging euro-zone borrowers that want to tap capital markets. If I have missed anything on the bright side, add your own items to the list.

Even under such a benign scenario it is likely that some euro-zone member will default on its sovereign debt. Worse still, the fundamental economic problems that produced the current difficulties remain untouched.

Spain's banks will still be carrying too much undeveloped property on their books given the huge overhang of unoccupied houses, 1.5 million reckons consultancy RR Acuña. This surplus bodes ill for the construction industry in a country heavily dependent on it for jobs to reduce its 20.5% unemployment rate.

Portugal will still have an economy with an overwhelming proportion of unskilled workers incapable of competing with those in China, Central America and other countries. Greece will still have an economy incapable of producing more than tourist-attracting sunshine (tourism accounts for 15% of GDP and around 16.5% of all jobs), and reduced to appealing to expatriates to buy diaspora bonds at below-market interest rates, a fund-raising tool used by Israel and India.

Ireland will spend years digging out from under the debris that was its banking system, and its ability to continue to attract foreign investment will depend on the new government's ability to resist the relentless pressure of its euro-land colleagues to raise its corporate rate—in the jargon of the business, "harmonize" its tax policies with those of other EU countries.

Germany will remain the China of the continent, an export-led economy that benefits from the depressing effect that non-performing Club Med countries have on the euro.

But its banks can avoid failure only if Germany continues to bail out the governments whose sovereign debt German banks hold. Remember, a German bank was the first to collapse during the recent crisis, and a just-released report shows that others had recourse to the emergency lending facility of the Fed.

More important, nothing in the rosy scenario with which this thought experiment opened gives weight to the possibility that Germany's politicians will call halt to the process of converting the euro zone into a transfer area in which Germany's good credit is put behind the poorer credit of profligate countries. It is not lost on them that Ms. Merkel began bleeding popularity when temporary bailouts morphed into permanent mechanisms to transfer liabilities of weak countries to Germany's balance sheet.

Most of all, the euro zone needs to allow the troubled countries to restructure, and then institute three fundamental reforms: rebalancing, reform and administrative clarity.

Germany must contribute to rebalancing by doing what EU leaders are demanding of China: step up domestic consumption so that euro-zone members begin exporting something other than jobs. The euro zone, indeed the EU, must then initiate some of the labor market and other reforms that have been on its agenda for decades.

And the Brussels powers-that-be must come to understand that their opaque reports and statements demonstrate their ability to manufacture fudge, but an inability to make hard decisions. Bond markets are too lean and mean to feast on fudge.

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