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Debt Deal Provides Wrong Incentives

• By IRWIN STELZER



With money markets so nervous about the condition of the euro zone's periphery that interest rates on Portugal's debt seemed headed towards 8%, the leaders of the 17-nation zone finally cut a deal on Saturday morning. Serious students of government know that it is important to get the incentives right if the desired behavior is to be induced. The euro-zone leaders got them wrong.

In the week before the meeting:

- Moody's again downgraded Greek debt and Greece sacked its chief tax collector for failing to boost tax receipts to levels it needs if it is to close its budget gap. Net revenue fell from €3.15 billion (\$4.38 billion) in February of last year to €2.85 billion this year, making it almost certain that Greece will not hit its revenue target;
- China's rating agency, Dagong, downgraded Portuguese debt, driving interest rates on that nation's 10-year bonds close to 8%. "These levels of interest rates are not sustainable over time," says Carlos Costa Pina, Portugal's secretary of state for treasury and finance, who nevertheless says Portugal, with an economy that has grown at a rate of under 1% in the past decade, does not need a bailout. Never mind that its central bank predicts the economy will shrink by 1.3% this year;



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French President Nicolas Sarkozy is unimpressed by Irish gestures.

- Moody's downgraded Spanish government debt and threw in a negative outlook for good measure. Madrid says its banks need to raise €15.15 billion in capital, but Moody's and most analysts put the figure at €40 billion-€50 billion, running as high as €110 billion-€120 billion in a "more stressed scenario," to use Moody's formulation of what might happen if the European Central Bank raises interest rates, triggering a rise in mortgage rates for Spain's already-stressed homeowners;
- Analysts decided that the new stress tests planned for Europe's banks will be no more stressful than the meaningless last batch, in part because Germany wants relaxed definitions of what constitutes capital applied to its banks. And what Germany—without whose backing there would be no bailout fund—wants, Germany gets. "We expect Germany's particular needs to be taken into account," one banker told the press. Recall that the last round of stress tests concluded that busted Allied Irish Banks and the Bank of Ireland were sound. Only seven of 91 banks, five of them tiny Spanish cajas, failed the tests. "Many European banks, starting with Germany's, are dangerously over-leveraged, undercapitalized, and exposed to Greek, Irish and Portuguese debt," University of California economics professor Barry Eichengreen told a Wall Street Journal symposium on the future of the euro;
- There is increasing evidence that the austerity programs are doing just what some Keynesian economists predicted: stifling growth and making it harder for the stricken countries to get their economies

moving again. That has no purchase with high-tax euro-zone leaders, who denied Ireland relief from the terms of its bail-out because Enda Kenny, Ireland's new Taoiseach (prime minister), refused to raise the country's 12.5% corporate tax rate.

Such was the background noise when the leaders met into the early hours of Saturday. The pressure to do something was irresistible. And what they did was to multiply the moral hazard created by the initial bailouts. The European Financial Stabilization Facility will be allowed to lend €500 billion, rather than only part of that amount under the initial arrangement. And the fund will be extended beyond its planned expiration date of 2013. It seems that stronger countries such as Germany and France will provide callable guarantees, but weaker countries will have to contribute hard cash, although how that drain helps them to grow is unclear. The fund will be able to buy newly issued sovereign bonds at auction, but not older issues held by the ECB, which was hoping to offload the €77 billion in bonds it acquired to support the prices of troubled countries' bonds.

German Chancellor Angela Merkel, attempting to soften German voters' annoyance at still another concession, told reporters, "I don't think it has such a huge impact."

Greece, as reward for not meeting its targets—surely a counter-productive incentive—will have the interest rate on its bailout money lowered by one percentage point (it asked for a reduction of two points), and agreed to sell off €50 billion worth of state assets, although to whom is unclear. Ireland, which probably has the most vibrant economy of all the troubled countries, will not get relief from the terms of its €67.5 billion bailout loan unless it damages its recovery by raising its 12.5% corporate tax rate, as French President Nicolas Sarkozy demands, or agreeing to a harmonized tax base, a demand of Ms. Merkel.

So Ireland now has what economists call a perverse incentive—it gets the benefit of short-term relief from the terms of its loan if it agrees to damage its long-run growth prospects by bringing its tax rates closer to those that have stifled euro-zone growth for decades. "Ireland was asked to make a gesture, but we didn't get satisfaction. So the renegotiation of loans that Greece has was not done for

Ireland," Mr. Sarkozy told reporters. Tax harmonization has long been a goal of slow-growing (below 2% per annum on average), high unemployment (above 9%) France, which recently removed the 50% cap on total taxes to be paid by the wealthy in an effort to shore up Mr. Sarkozy's 22% approval rating.

On to the next summit March 24-25, when Ms. Merkel will have to lay out the price for her continued willingness to play Lady Bountiful and savior of the euro.

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