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- JULY 18, 2011, 1:33 P.M. ET

Euro-Zone Summit Gets The Band-Aid Ready

- By IRWIN STELZER



The euro-zone debt crisis is over. Most of the banks are sound, and there will be a summit meeting on Thursday to solve any remaining problems. Believe that and you should bid madly for the Spanish bonds that will come to market on Thursday.

Never mind that the stress tests that most large banks passed were about only a tad more stressful than the derisory last round, which found Irish banks to be in great shape right before they went bust. It seems that the banks were not asked anything about the stability of their deposits and other funding, or how they would survive a default by Greece, Portugal or other countries, and were allowed to include sovereign debt on their books at well above market values. All of this against the background of stern warnings from the International Monetary Fund, which told a meeting of the G-20 that capitalization of European banks "remains relatively low" compared with U.S. banks, and that their funding plans for 2011 are inadequate.

Bad Grades

European banks that failed the stress tests and need to raise new capital by the end of 2011

BANK	COUNTRY	CAPITAL SHORTFALL, IN MILLIONS
Caja de Ahorros del Mediterraneo	Spain	€947
ATEBank	Greece	713
Banco Pastor SA	Spain	317
Volksbank AG	Austria	160
Grupo Caja3	Spain	140
Unnim	Spain	85
CatalunyaCaixa	Spain	75
Eurobank EFG	Greece	58
Helaba	Germany	n.a.*

Total: €2.5 billion

Notes: Banks failed if their capital buffers fell below 5% of risk-adjusted assets under a hypothetical economic downturn

*Not available because Helaba forbade EBA from publishing its figures

Sources: European Banking Authority; the banks

The failure to ask the banks how they would cope with sovereign defaults is particularly important given that we know that Thursday's heads-of-government summit will likely trigger a Greek default.

Germany has won. Private creditors are to "volunteer" to take losses on their holdings of Greek sovereign debt, the quid pro quo German Chancellor Angela Merkel has been insisting on for her agreement to continue to bankroll the Greek bailout. The route to this conclusion is a typically convoluted one. Officials will meet for "technical negotiations." That will produce a blueprint to reduce Greece's \$500 billion debt burden. That blueprint will then be put before the heads of the 17 euro-zone nations on Thursday. The heads will then come together and approve the blueprint, leaving it to their officials to work out the details, which will determine just how much Greece's debt burden—now heading for 150% of GDP—will be reduced. If all is agreed, approval of a second bailout package for Greece should follow.

The credit-ratings firms will then declare Greece to be in at least "selective default." Bidders for the €3 billion (\$4.2 billion) of Spanish bonds to hit the market, and the larger offerings from Belgium and Italy still to come this month, will be certain of what until now was only a possibility: They might end up on the queue at the euro-zone barber shop, next in line for a haircut now that Ms. Merkel has routed the European Central Bank and established the principle that private investors will share the pain of defaults.

Even before this new risk became a certainty, Italy had to pay a premium to peddle €5 billion of its long-term IOUs. Goldman Sachs' Global Economics group notes, "If the current rise in bond spreads is sustained ... current yield increases would add to investor concerns that levels of public debt in Italy may not be sustainable."

In the end, in Italy as in the rest of the euro zone, much will depend on the ability of these economies to grow more rapidly than they have in the past. Faster growth reduces the burden of benefits paid to the unemployed, and increases the flow of revenue to national treasuries.

Unfortunately, the outlook is rather bleak. The Economist Intelligence Unit forecasts that the growth rate in the euro area will fall from this year's 2.0% to 1.4% next year, and then settle at 1.7%, 1.8% and 1.8% in the three following years. "Concerns about Italy's debt sustainability center on its low growth rate. Raising this would require structural changes, which the current political system seems unlikely to deliver," concludes the EIU.

It is difficult to imagine that Thursday's meeting will do more than put a Band-Aid on the hemorrhage now afflicting the euro zone. Economists at Goldman Sachs say "the interconnectivity between the Italian/Spanish sovereign, their banks and the European financial system is such that long-term perceived instability has the scope to have extreme consequences beyond national borders." In plain English, the 17 euro-zone countries are in the same boat. And that boat does not have the capacity to take on survivors from Italy and Spain if those countries cannot borrow at sustainable rates. These countries are simply too big to bail.

Which is why there is talk of a radical reform of the euro-zone governing and financing structure

—a Eurobond. Economists at Jefferies International put the weighted average of the rates paid by euro-area countries on 10-year bonds at 4.8%. Sale of such bonds would lower the borrowing costs of Greece, Spain, Italy, Ireland and Portugal, and raise the borrowing costs of other euroland countries, in the case of Germany by 2.1 percentage points. This all-for-one-and-one-for-all proposal has produced a resounding "nein" from German Finance Minister Wolfgang Schäuble, and an equally enthusiastic "si" from his Italian counterpart, Giulio Tremonti. No surprise there.

Mr. Schäuble's problem is that one way or another preservation of the eurozone will require massive transfers of money from north—read primarily Germany—to south, a process already in motion.

Generations of German politicians have promised their voters that would never happen. "There are few signs," advises the EIU, "that politicians or electorates are prepared to back the reforms necessary to consolidate the euro zone in a structural fashion, such as the introduction of fiscal transfers between stronger and weaker states." That leaves three choices: lurching from crisis to crisis, the meat on which the eurocracy's Caesars feed; allowing defaults; or waving a not-so-fond goodbye to the zone's Club Med.

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