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- JUNE 20, 2011

## If All Else Fails, Lower Your Standards

- By IRWIN STELZER



By the time you read this a crisis will have been avoided for this week—the time period that most concerns the eurocracy. The International Monetary Fund, the European Central Bank, German chancellor Angela Merkel, French president Nicolas Sarkozy and others who delude themselves into believing they have a role in these matters will have released or be about to release the €12 billion (\$17.16 billion) second tranche of the previously agreed €110 billion Greek bailout.

Never mind that Greece has not upheld its end of the bargain—spending is up over last year, and tax receipts are down, the opposite of what was promised. Rioting in the streets of Athens makes it uncertain that the reshuffled government will survive a confidence vote and, if it does, be able to implement the new, tougher €28 billion austerity program. There is as yet no sign that the privatization program aimed at raising €50 billion is on the launching pad.



Reuters

German Chancellor Angela Merkel and French President Nicolas Sarkozy greet onlookers in Berlin, Friday.

But this week's solution gets the euro zone safely all the way to—June 23-24, when the European Council meets to sign off on any deal that has been negotiated by finance ministers. That allows about two weeks to concoct some way of involving private-sector lenders in the inevitable haircuts without triggering a default—now called a "credit event"—that would wipe out several banks and force the ECB to seek a capital infusion. Finding the right formula won't be easy, for two reasons.

The first is that the bailouts so far negotiated solve Greece's liquidity problem, but not its solvency problem. The bailouts will give Greece enough cash to cover its current deficits, but not enough to pay off creditors whose bonds are coming due.

The second is that Germany's chancellor wants "a substantial contribution" from private creditors who are due to be repaid some €64 billion by 2014. If those creditors balk but are nevertheless coerced into rolling over their loans, enter the credit agencies and the ECB, for both of whom a forced rollover is, dare we say it, a default.

Keep in mind that if private-sector creditors do decide to play along on the theory that something is better than nothing, and accept terms for the new loans that are less attractive than the market sets for existing loans, that is a "de facto default" according to Standard & Poor's. And right now the market says Greece must pay almost 30% for new two-year loans, and almost 20% for ten-year money.

Little wonder that most experts agree with former Federal Reserve Board chairman [Alan Greenspan](#) that the odds on a Greek default are "so high that you almost have to say there is no way out." But let's not finger Greece as the locus of some sort of "contagion."

Assume that Greece were the only European country to find itself with a budget deficit of 10%, a high debt-to-GDP ratio, and a no-growth economy. As a consequence, it needs a bailout from the 16 other (assume for these purposes) healthy, euroland economies. Would that make the front pages of all the world's newspapers, and not only those confined to financial reporting? Assuredly not.

Unfortunately, that is not the state of affairs either within the euro zone or, indeed, around the world. Outside of the zone both the U.K. and the U.S. have deficit:GDP ratios every bit as high as Greece's. Britain's plan to reduce its deficit is threatened by the slowdown in its economy induced by its spending cuts, while the U.S. has no plan at all.

Portugal and Ireland are only avoiding default because of a flow of bailout cash, but have no prospect of repaying their outstanding loans—and would not have even if Greece sovereign debt were triple-A rated: shrinking economies do not produce a robust flow of tax revenues.

Spain, the euro zone's fourth largest economy, is struggling with an unemployment rate in excess of 20%, undercapitalized regional banks, and an economy that at best barely ekes out a tiny bit of growth. Italy, the zone's third largest economy has already been warned by Moody's that its no-growth economy, deficits, and political chaos might lead to a down-rating.

Throw in what appears to be an economic slowdown in America and in Europe, not to mention China, the end of QE2 in the U.S., and worst of all a sudden realization that "too big to fail" might be less of a problem than "too interconnected to fail"—Lehman Brothers was, after all, small potatoes as financial institutions go—and there is ample reason for worry.

Not only about Greece. Worry, too, about:

- the undercapitalized banks of Germany, with €23 billion in Greek debt on their books;
- the American municipalities that are seeing their interest rates rise in response to nervousness about the soundness of [Dexia SA](#), the Belgian-French bank that backs municipal bonds but is exposed to Greek sovereign debt;
- the money funds in America that provide liquidity for European banks that have stacks of Greek debt on their balance sheets;
- the French banks, three major ones already threatened with ratings downgrades, that have €15 billion in Greek debt on their books;
- the exposure of world financial institutions to the almost-inevitable

Portuguese and Irish defaults, with Spain and Italy possibly next in line.

But fear not. Germany, France, Austria, Luxembourg and Denmark have a solution. They are urging European Commissioner Michel Barnier to water down the Basel III Accord that increases capital requirements imposed on all banks. Their motto: "If all else fails, lower your standards."

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