

Portugal Gets a Little Friendly Advice

By IRWIN STELZER



The Portuguese hope to emulate the Beatles and get by with a little help from their friends, never mind that the €80 billion-€90 billion (\$115 billion-\$130 billion) of help they need hardly qualifies as "little."

Portugal cannot repay the loans that are falling due, or cover current spending with the tax revenues generated by its stagnant economy. Enter its friends, who propose to lend it money with which to repay the creditors that are about to bang on the door. The cure for too much debt, believe euro-zone policy makers, is more debt, more favorably priced than the market would require, but debt nevertheless. This would be fine if the problem were one of tiding Portugal over until it can pay its creditors. But that day will never come so long as Portugal adheres to the euro-zone line that creditors must be made whole, and cannot devalue its currency, or set an interest rate that will heat up its frozen economy rather than one that keeps Germany's bustling economy from overheating. "Euro-area countries [have] no choice but to default," conclude economists at Fathom Consulting. Ah, but they do—"Countries that are unable to sustain growth leave the euro zone. That... is the best for everybody," says bond specialist and political adviser Jochen Felsenheimer.



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Portugal's parliament may be pushed to implement even tougher austerity.

Portugal has managed growth of only 1% per year in the past decade. It is now in decline, its economy shrinking at a rate of at least 1.4%. Because wages have increased six times as fast as productivity in the past decade, labor costs are so high that Portuguese goods are priced out of world markets. But its friends at the European Central Bank, responding more to Berlin's worries about inflation, running at a rate of 2.6% in the euro zone, than Lisbon's need for a growth stimulus, have raised interest rates. This is "in the interests of all members," claims Jean-Claude Trichet, president of the ECB. Never mind that an interest-rate increase is the last thing needed by the troubled economies and hard-pressed mortgage payers not only of Portugal, but of Greece, Ireland and Spain. But no one ever said that every one of 17 countries can slip comfortably into a one-size-fits-all interest rate. Strike one: interest rates too high.

To make matters worse, Portugal's friends will help it to get by by insisting on what European finance ministers call an "ambitious fiscal adjustment". Translated from bureaucratese, that means what Finnish Finance Minister Jyrki Katainen calls an austerity program "stricter, harder and more comprehensive than the one the Portuguese parliament voted against." Strike two: Eurocracy trumps democracy.

In short, more debt, higher interest rates, and tighter fiscal policy—a combination not likely to produce a rapid economic recovery. But that is not the goal of the bailout exercise. Its first aim is to protect banks in Germany that hold €46.5 billion of Portuguese government bonds and €90 billion of IOUs from the banking sectors of Portugal, Ireland

and Greece. A Portuguese default, setting in train similar restructurings in Greece and Ireland, would bring down undercapitalized banks: most notably those in Germany that are already considering opting out of the new stress tests lest they get a poor grade. Which explains German Chancellor Angela Merkel's willingness to shore up the stricken countries. Otherwise, she would have to pull the rug back and reveal the dirt underneath: the questionable balance sheets of her nation's banks. Strike three: voters to bear pain to shield rich bankers and investors from losses.

And out, taking the road less traveled, the one that leads out of the euro zone. The reinvented escudo would undoubtedly drop like a stone, but to a level that makes Portugal's under-educated and under-trained work force competitive in world markets. The Portuguese people could then decide whether they want to make the reforms necessary to restore the value of their currency, and the competitiveness of their economy, or see their standard of living continue to fall.

Of course, that will not happen: Those devoted to the euro and European project prefer to maintain the fiction that Portugal is suffering from a temporary liquidity crisis, and that all its friends need do is tide it over a temporary rough spot. Unfortunately for them, sooner or later reality bites.

Euro-zone leaders will eventually have to admit that they are now managing a transfer union, one in which more-than-a-little help for one's friends is a permanent feature. Germany, France and other countries that will be doing the transferring will have to accept their role as supporters of the more languid lifestyles of Club Med, and get their voters to agree to this arrangement lest the credit markets doubt its durability.

Small problem: Germans were assured when they surrendered their beloved deutschemark that the euro zone would not be a transfer union. But that was then and this is now. The policy makers who run the euro zone have never been squeamish about adopting the approach used by President Richard Nixon and treating their promises as "no longer operative". Or overly concerned about the

democratic deficit that is far more significant than the mere budgetary deficits with which they prefer to deal.

The Portuguese have a choice. Unless a transfer union is established, they can agree to have taxpayers, workers, mortgage holders and others bear the cost of the failed investments made by informed investors who misappraised risk, which is what their eurofriends want them to do. Or they can defy their friends, restructure their debts, and write on a clean slate outside of the euro one. They have defaulted before and lived to borrow another day.