

The Coming Euro Crack-Up

A currency divided against itself cannot stand.

BY IRWIN M. STELZER

A spectre is haunting Europe—the spectre of the disintegration of the eurozone. All the powers of old Europe have entered into a holy alliance to exorcize this spectre: German chancellor and French president, the Brussels eurocracy and the bonus-laden bankers. Let the ruling classes tremble. The debtors have nothing to lose but their burdens.

So Karl Marx might have written were he watching unfolding events in the eurozone. In a sense, it is like watching a slow-motion train wreck.

A quick review: Some 17 of the 27 nations that constitute the European Union have abandoned their own currencies in favor of the euro. This means they have given up control of their exchange rates and their interest rates, the latter set by the European Central Bank on a one-size-fits-all basis. In fact, it is the state of the German economy, the area's largest, that dictates interest rate policy for the entire 17-country group. When Germany was suffering under the weight of the costs of reunification, its sluggish economy needed, and got, a low-interest rate policy from the European Central Bank. That eventually proved too stimulative for, say, Ireland, which was in the midst of an inflating property bubble.

The creation of the eurozone also led lenders to assume that the credit of every member was just about as good as the credit of Germany and France. So Greece, Portugal, Spain,

and Italy could sell sovereign debt at very low interest rates and use the borrowed money to finance an expansion of their welfare states—Greeks, for instance, could retire at 50 if they were in a hazardous occupation such as hairdressing (all those chemicals). More important, countries like Portugal, with a poorly educated workforce, and Spain, with politically run regional banks making imprudent loans to local property developers, became noncompetitive with their eurozone colleagues and international rivals. No problem: Fiscal policy was not controlled from the center, and investors hadn't yet realized that lending to the so-called PIGS (Portugal, Ireland, Greece, and Spain) was a hazardous occupation. So the latter could tap the credit markets to fill the gap between tax receipts and spending, and benefit from German-level interest rates.

Then the rating agencies rose from their torpor and downgraded the sovereign debt of Greece, helping to drive interest rates on its government bonds to unsustainable levels. Enter Brussels with a bailout for Greece. And when Ireland's deficit soared to 32 percent after the government decided to guarantee the debts of its insolvent banks, enter Brussels with a bailout for Ireland. Now Portugal, burdened with an economy that has not grown for a decade, also is rattling its begging bowl, and another bailout is being negotiated with a conclusion along the lines of earlier bailouts imminent, never mind that the previous two have done more harm than an honest confession of insolvency would. If at first you don't succeed, repeat the mistake.

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The main bailer, of course, is Germany, its economy growing smartly on the back of an export boom—it does not make what China makes, but makes what China buys. Chancellor Angela Merkel has two reasons to play Lady Bountiful. The first is her belief, shared by the German elite, that if a euro country declares bankruptcy, the currency will lose credibility and the entire European project will come unhinged. That would leave Germany alone at the top of the European heap, Europe's most powerful country with its most powerful economy. History makes many Germans less comfortable with a German Europe than with a European Germany.

Second, there is the small matter of the German banking system. The German banks, especially the state-run Landesbanken, are so woefully undercapitalized that some are planning to opt out of the new stress tests because they know they will fail. These banks are sitting on 220 billion euros of sovereign and bank debt of Greece, Portugal, and Spain, and if those IOUs become worthless, the German financial system might come tumbling down or at minimum require a taxpayer bailout. To make matters worse, France sits on another 150 billion euros of this dicey paper.

To the intrinsic flaws in the euro system—a one-size-fits-all interest rate and the inability of the eurozone bureaucracy to control the fiscal policies of members—add the news from tiny, previously europhile Finland. In last month's election, the anti-euro, anti-bailout True Finn party's share of votes jumped from 4 percent to 19 percent, and its parliamentary seats from 5 to 39 in a 200-seat parliament, enough to insist on inclusion in a coalition government. Just as the Tea Party sent a message politicians can't ignore, so the True Finns sent a message to the incoming government that it should think hard before casting

a vote—unanimity is required—for the impending Portuguese bailout. As Tony Barber put it in the *Financial Times*, “Finns are angry because, like the Austrians, Dutch, and Germans, they dislike rushing to the aid of countries that in their eyes have cheated, idled, lied, lived beyond their means, and let reckless bankers run amok.” Finland's “no” vote is all that is needed to leave Portugal drowning in debt.

All of these bailouts, and those to come, are premised on the notion that the troubled countries are having a liquidity problem, and a bit of cash will enable



them to get back on their feet and repay their debts in full and on time. It is now clear that these countries are not merely illiquid but are insolvent, and that they will one way or another have to renege on their debts, at least in part. Unless, of course, Germany agrees to convert the eurozone into what is called a transfer union, in which funds from the rich countries are regularly shipped to the poorer ones. That route seems to be blocked by the unwillingness of German taxpayers to agree to such an arrangement and the German constitution which prohibits it.

The cold facts are these:

- Greece, Ireland, and Portugal are now frozen out of credit markets. The

yield on Greek two-year bonds is 24 percent and on both Irish and Portuguese bonds of similar maturity around 12 percent. No country can afford to borrow at those rates. Of interest to the White House and Congress might be the speed with which the markets move: Interest rates charged on Greek debt increased by 10 percentage points in the past month.

- The debt burden on these countries is in excess of the 90 percent of GDP that scholars now agree stifles growth. Portugal's debt is at 90 percent of its GDP and rising, Greece's is approaching 150 percent, and “Ireland's debt now appears to be bigger, in relation to its economy, than the reparations imposed on Germany after the First World War,” according to economist Anatole Kaletsky.

- These economies cannot grow their way out of the problem. The Greek economy shrank at an annual rate of 4.5 percent last year and is forecast to decline this year at 3.2 percent. Portugal's will shrink at an annual rate of 1.5 percent, guesses the International Monetary Fund. And Ireland, despite a robust export industry and a corporate tax rate of 12.5 percent that, at half the EU average, remains attractive to foreign investment, might eke out growth of 1 percent. No way these growth rates produce enough tax revenues to meet debt obligations.

There's more, but you get the idea: These countries are bankrupt and will have to default on their debts—“restructure” them, to use the term spoken in polite European circles. Germany's finance minister Wolfgang Schäuble was among the first to mention the possibility of default, and more recently Clemens Fuest, chair of the German finance ministry's advisory committee, said a Greek restructuring is not merely possible, it is inevitable. “Most intelligent people know there has to be a significant

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