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The Euro Zone Has Little to Smile About

- By IRWIN STELZER



"Don't worry. Be happy. Ain't got no cash... but don't worry be happy... Put a smile on your face." Bobby McFerrin's pop classic is the new theme song of the euro-zone policy makers. They point to several developments to support this cheeriness.

European stock markets finished April with a flourish. The Stoxx 600 index was up 2.9%, registering the fourth increase in the past five months; in Frankfurt the DAX 30 jumped 6.7% to close at its highest level since January 2008; in Paris the CAC 40 closed April up 3%; London was up 2.7%.

Even better, the European Central Bank will be in safe hands. The powers-that-be in euroland have decided to toss stereotypes of Italians to the wind, overlook his former employment by Goldman Sachs and name Mario Draghi to succeed Jean-Claude Trichet to head the ECB. Mr. Draghi has the respect of markets as a sensible banker and a man who tells the truth, as that term is understood by central bankers.



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Mario Draghi has the respect of the markets, but still has plenty of worries.

It seems that French President Nicolas Sarkozy forced German Chancellor Angela Merkel's hand by adding his voice to Mr. Draghi's other backers while Ms. Merkel was still wondering how her inflation-phobic voters would react were she to put an Italian in charge of the euro-zone money supply and interest-rate policy.

Another reason we are told to be happy is the aggregate performance of the euro-zone economy, which continues to expand at a more rapid rate than most forecasters had anticipated.

Finally, we are told we can relax about the plight of Portugal because the team that brought us the Greek and Irish bailouts is on the job, negotiating an aid package.

But don't start going around humming Mr. McFerrin's tune just yet. The overall euro-zone economic performance conceals the wide differences in performance of different countries; consumer confidence is at its lowest level in eight months; the zone's banks are undercapitalized; inflation is rising and the ECB is set for a round of interest-rate increases that will be no friend to the current recovery.

More important, the euro-zone leaders persist in two quite erroneous beliefs. The first is that they are confronting a series of liquidity crises. Give Greece, Ireland and Portugal a bit of cash to tide them over while they make the adjustments that will permit them to return to capital markets, and all will be well. It won't. Greece, with a debt:GDP ratio of about 150% has missed its deficit-reduction targets, its economy is shrinking at an annual rate of 3.2%. The markets are demanding an interest rate of 24% to buy Greek two-year bonds.

Germany's finance minister, Wolfgang Schäuble, was the earliest to recognize Greece's insolvency. More recently, Clemens Fuest, president of the German finance ministry's advisory committee, declared that restructuring, the polite word for default, is inevitable. To which the widely respected director of London-based Centre for European Reform, Charles Grant, adds, "Most intelligent people know there has to be a significant restructuring to ease the burden on Greece, and we're not talking about a painless extension of maturities, but wiping away a large portion of the debt."

Such a write-down, estimated by experts to run somewhere between 40% and 70%, would have "consequences ... [that] would in all probability be bigger than after the collapse of Lehman Brothers," says José Manuel González-Páramo, a member of the executive board of the ECB. But Mr. McFerrin tells us: "In every life we have some trouble, when you worry you make it double."

Ireland, the other country currently on euro-zone life support, has somewhat better prospects because of a strong export sector and a low—mad-denyingly low, according to Germany and France—12.5% corporate tax rate that attracts foreign investment.

Nevertheless, a restructuring is in its future. With general government debt already well above 100%, Ireland has just cut its growth forecast for this year from 1.75% to 0.75%, and for next year from 3.25% to 2.25%, and raised its deficit forecast from 9.75% of GDP to 10%. High debt, falling growth and rising deficits do not ordinarily allow a country to avoid default.

The second erroneous assumption of euro-zone policy makers is that by bailing out Portugal they can prevent "contagion," an attack on Spain by the bond vigilantes. They can't. Spain announced late last week that its unemployment rate in the quarter just ended rose from 20.3% to 21.3%; almost five million are unemployed, the largest number in 14 years. The nine-month-long collapse of retail sales accelerated in March, dropping by 8.6%. The banking system is woefully undercapitalized; Spain's banks hold €70 billion (\$104 billion) in Portuguese assets; and its economy is likely grow at "close to zero," according to Citigroup Global Markets. These economists are not happy: "For Spain, we believe risks of fiscal slippage over time are greater than markets currently price in."

If Spain cannot hold the line, the battle will shift to Italy. Italian debt is over 120% of GDP, growth is forecast at a meager 1%, real incomes and domestic demand are falling. The markets noticed last week. Italy did flog more than €10 billion of its bonds, but yields jumped. Not enough to trigger a panic, but enough to make it difficult not to worry, and be happy.

Policy makers deny they have plans for orderly restructurings. Let's hope they are being economical with the truth. Perhaps tiny Finland, a faraway country about which we know nothing, to borrow from Neville Chamberlain, will force a change of course by refusing to go along with a bailout of Portugal.

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