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## Waking Up to Greece's Default Position

- By IRWIN STELZER



Have I got a deal for you. You can earn close to 25% on the bonds of a sovereign country that has the support of the entire euro zone. Of course, that country is Greece, again downgraded last week, this time to four notches below investment grade, and the support is not quite rock-solid now that German Chancellor Angela Merkel says she is through playing Lady Bountiful to an unreformed Greek economy, and also wants private investors to feel her taxpayers' pain. And although you will never be at risk of a default, you might be "repositioned," or "restructured" or asked to drop in for a voluntary haircut. There is the risk that you will be paid in drachmas rather than euros, but, hey, no investment is without a bit of risk.



Agence France-Presse/Getty Images

A Greek municipal worker confronts police in Athens last week during a protest against government austerity measures.

Besides, think of the 200 basis point (20 percentage point) yield over those boring bunds.

Enough jocularly, or what passes for it from a Wall Street Journal scrivener. Last week saw real progress in reaching a solution to the Greek, Portuguese and Irish debt crises. It is now recognized that these countries can never, ever, repay their debts, certainly not on time, and more than likely not in full. A default by any other name is a default. It might doff its name, as Juliet thought Romeo might do, and choose "repositioning," or "soft restructuring," or "voluntarism," but it remains a default. If the renaming permits banks to continue the fiction that Greek paper is worth what is inscribed in their ledgers, so be it: sooner or later reality will catch up with them just as it has with the profligate governments now at the mercy of their euro-zone benefactors.

No need to rehearse the arithmetic that has appeared in this and other columns. It is enough to point out that the bailouts assumed that the recipient governments would be able to return to the financial markets after a period of reliance for cash on the European Central Bank, the International Monetary Fund, and their euro-zone partners. In short, the eurocracy devised a plan for coping with a liquidity crisis when these countries were facing a solvency crisis. Diagnose the disease incorrectly, and the prescribed medicine will make the disease worse by prolonging the period before which a proper diagnosis is developed.

The new diagnosis is closer to reality: These countries are insolvent. Indeed, Greece is unable even to meet the short-term reform goals it agreed as a condition for its bailout. That may be the real reason that the three pillars of support are threatening to withdraw. The ECB has made it clear that it is unalterably—well, unalterably but subject to change, as is the custom in these euro-zone matters—opposed to any form of restructuring, which it sees as a diversion from the hard work of deficit reduction, and even plans to raise interest rates to make life harder for the debtors.

The ECB balance sheet is loaded down with €45 billion (\$65.7 billion) of Greek bonds, plus billions more in Greek assets that it has accepted as collateral. The booked value of this paper would drop

like a stone if there were any sort of restructuring of Greek debt, which even France now concedes is inevitable. Allow default, says Jürgen Stark, a member of the Bank's executive board, and we will cut off Greek banks' cash flow by refusing to accept their paper as collateral. Worse still, markets will likely assume that Portugal and Ireland will follow in Greece's footsteps. That would put a serious enough dent in the ECB's balance sheet to force the euro-zone countries to recapitalize it—embarrassing for the ECB, and costly for its member countries.

Which brings us to the IMF. The fund has been a voice for the proposition that part of the solution to the afflicted countries' problems is faster economic growth. That means austerity-light, spending cuts to rein in the worst excesses, but not enough to tilt the countries into recession while they reform their economies. That voice will be less powerful now that the terms of Dominique Strauss-Kahn's own bailout restrict his ability to attend euro-zone meetings. The new managing director will speak with less authority, and might prefer austerity-heavy to austerity-light, making it even more likely that recessions and defaults are in the bailees' future.

The third source of support has come from the members of the euro zone. That, too, threatens to dry up as the Germans, Finns and French get increasingly insistent on new conditions. In the near term Ms. Merkel wants more austerity and a real privatization program from the Greeks before she asks her taxpayers to do more. In the longer term she wants the €500 billion European Stabilization Mechanism, to be established in 2013, to include haircuts for private bond holders, a provision other governments vehemently oppose.

The Finns are insistent that the Greek government overcome the opposition of the trade unions and move its stalled privatization program forward. The French won't do more for Ireland unless it raises the 12.5% corporate income tax rate that is its potent weapon in stimulating the growth it needs to dig its way out from under the mountain of debt it took on when it bailed out its banks.

In short, the initial view that we are all in this together, that to save the euro and, indeed, the European Project, everyone must provide

support for Club Med and Ireland, is less dominant than it once was. The only serious question now is what form the defaults should take.

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