REVIEW & OUTLOOK | MAY 5, 2010

The Greek Bailout Flop

So much for stopping the contagion.

It hasn't been a week since the terms of Athens's €110 billion ($145 billion) bailout were set, and already the reviews of this latest Greek drama are saying it's a flop. Yesterday the euro sank to its lowest level in a year. Stock markets across Europe fell nearly 3%, and the carnage spread to Wall Street and beyond. Greek interest-rate spreads climbed higher again, and market players have turned their attention to the euro zone's other weak sisters as everyone tries to figure out who is most likely to follow Greece down the road to national insolvency.

The bailout, in other words, hasn't stopped the much-feared contagion. If anything, it has spread it.

Part of the problem lies with the bailout's terms. The €110 billion agreed over the weekend was more than twice the €45 billion originally proposed, but it came with revised deficit projections that immediately made even the higher number look inadequate to fund Greece's bloated state. Part of the problem, too, comes from the Greeks themselves: On Tuesday, civil servants held another paralyzing strike, calling into question Athens's will to see through its program of spending cuts and tax hikes.

But perhaps the largest part of the problem has been the view, pervasive among European leaders, that the Greek crisis is fundamentally an issue of market confidence or psychology. They have misread the signals that Greece is well and truly bankrupt.

According to the latest official projections, Greek public debt, currently 108% of gross domestic product, will top 149% of GDP in 2013, the year that the bailout loans, in theory, come due. Assuming an average interest rate of 6% on that debt, Greece would be left paying 9% of its GDP to bondholders, 80% of whom are located abroad. Put another way, 25% of Greek tax revenue would go toward interest payments to foreign bondholders. Meanwhile, Greece's government spending equals more than 50% of GDP and labor productivity is well below the EU average, neither of which bode well for growth going forward.

The EU and IMF insistence that no haircuts and no restructuring are in the cards isn't credible, as yesterday's market turmoil testifies. There is now a real possibility that national parliaments in Germany, Slovakia and other EU states won't approve some of the promised funds. The contentiousness of funding Greece's bailout makes any further bailouts, whether for Portugal or for Greece in a second round, look remote. Far from silencing market speculation about Greece's fate, the bailout has turned up the volume.

It's time that Greece and the rest of Europe started listening to the market instead of attacking it. Greece needs a debt restructuring and wholesale reforms that reduce the state's share of GDP and promote economic growth. As for the rest of Europe and the U.S., Greece's predicament is a warning to stop the tax and spending binge before it leads to crisis.

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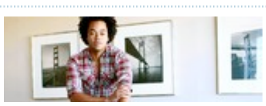

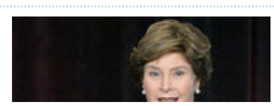

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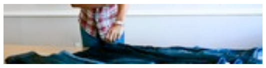

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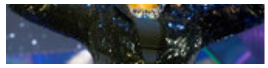

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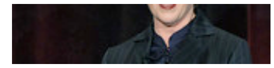

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