

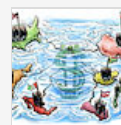
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REVIEW & OUTLOOK | MAY 10, 2010

The Real Euro Crisis

The EU's bailout postpones the day of fiscal reckoning.

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A trillion dollars is a lot of money, even these days, and the European Union has demonstrated that a check for €750 billion (\$972 billion) can produce a rally in European debt markets and global equities. Too bad the larger price for Sunday night's "shock and awe" intervention is likely to be paid in the further erosion of Europe's fiscal and monetary credibility.

French Finance Minister Christine Lagarde noted Monday's exuberant market reaction with satisfaction, saying that the "message had gotten through" that Euroland would defend its currency. Yes, creditors no doubt love that governments have guaranteed their high-yield loans to Greece, Portugal, Spain and any other profligate government that comes under bond-market siege. What investor doesn't like a risk-free loan that pays 9%?

But there is no such thing as a free sovereign bailout, and the EU's intervention merely transfers those risks from banks and other creditors to taxpayers and the European Central Bank. The real gamble is being made by politicians who are calculating that, by taking the risk of sovereign default off the table for now, they are giving the global economic recovery time to build and making it easier to address Europe's fiscal woes.



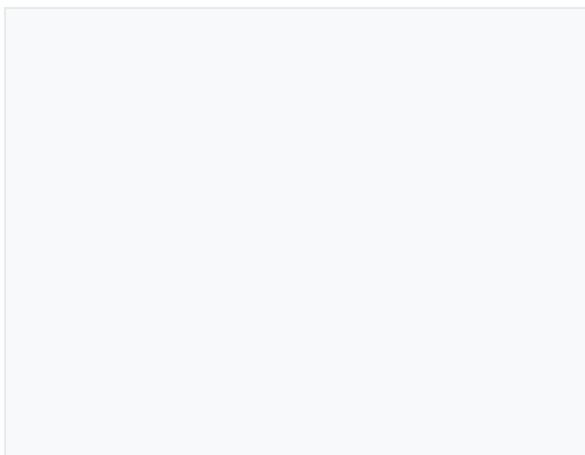
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In a sense, Europe has decided to TARP itself. German taxpayers have undertaken to underwrite the spending of Southern European governments, with Greece playing AIG, and Portugal starring as Citigroup. Spain, we suppose, is Goldman Sachs. Perhaps it will all work. But our guess is that Germany and France will have a harder time shedding responsibility for the fiscal policies of entire nations than the U.S. Treasury has had selling shares in bailed-out banks.

There is also the small matter of the rule of law. Such bailouts are expressly prohibited by the 1992 Maastricht treaty, and that promise is now in tatters. In the euro's first serious test, the political class blinked. The resulting moral hazard will haunt the single currency for years and reduce the incentive for governments to keep their fiscal houses in order.

Most dangerous, the European Central Bank has also been dragooned into this bailout through a program to buy euro-zone bonds in unspecified amounts. The ECB says that it will "sterilize" its bond purchases by selling other assets, so the intervention won't affect monetary



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policy. In Switzerland on Monday, ECB President Jean-Claude Trichet also denied that the ECB decision, announced at the same time as the fiscal rescue, was taken under political pressure.

But the timing smacks of a coordinated campaign and so undermines the ECB's most precious asset—its reputation for political independence and an unwavering commitment to price stability. The bonds the ECB will buy are the sovereign debt of individual nations, which looks to us as if the central bank will directly monetize debt. Mr. Trichet should ask the U.S. Federal Reserve if buying mortgage-backed securities has had no effect on monetary policy. The Frenchman's assurances are hard to credit.

While the sheer size of the bailout fund impressed investors, it also raises questions about the borrowing capacity of the euro zone as a whole. In 2009, the 16 countries of the euro zone ran collective deficits of €565 billion, or 6.3% of GDP. Every member of the European Union had a fiscal deficit.

That's understandable in a recession, but the markets have been sending a message that this spending path is unsustainable. Sunday's "bazooka," to borrow former Treasury Secretary Hank Paulson's famous 2008 metaphor, has silenced the bond messengers for now. But if Europe's political class doesn't use this opening to shape up, the crisis will return—and there will be no richer nations left to do the rescuing.

The real euro crisis, in short, is one of overspending and policies that sabotage economic growth. Sunday's shock and awe campaign has merely postponed that reckoning—and at a fearsome price.

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