THE WALL STREET JOURNAL.
WSJ.com

Why We Can't Escape the Eurocrisis

EU and U.S. debt are interlinked through the banking system.

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When is a bailout not a bailout? When the bailor is short of funds. The recently announced debt plan in the European Union comes up short in almost all respects.

The debt crisis is not just an EU problem, but a trans-Atlantic financial crisis. The overwhelming debt problems on either side of the pond are interlinked through the banking system.

First to the EU. The underlying dilemma is that governments have promised their citizens more social programs than can be financed with the tax revenue generated by the private sector. High tax rates choke off the economic growth needed to finance the promises. Economic activity gets driven into the underground economy, where it often escapes taxation.

Nowhere is this truer than in Greece, which has a long history of sovereign defaults in the 19th and 20th centuries. There is a bloated public sector, and competitive private enterprise is hobbled by regulation and government barriers to entry. Successive Greek governments ran chronic budget deficits, and the Greek banks lent to the government. Banks in other EU countries, such as France, lent to the Greek banks.

In Greece and elsewhere in the EU, the banks support the government by purchasing its bonds, and the government guarantees the banks. It is a Ponzi scheme not even Bernie Madoff could have concocted. The banks can no longer afford to fund budget deficits, yet they cannot afford to see governments default. Governments cannot make good on their guarantees of the banks.

Details differ by country. In Ireland, problems began with an overheated property sector that brought down the banks. The economy went into depression, which threw the government's budget into deficit. Further aggravating the deficit was the government's decision to guarantee bank deposits, converting private, financial-sector debt into public-sector debt. The details differ from Greece, but the linkage between the government and the banks is the common factor.

France's growth is weak to nonexistent. Germany's economy has performed well since the recession, but concerns are growing regarding its banks' exposure to greater EU risk. And U.S. banks and financial institutions are exposed to EU banks through funding operations, issuance of credit default swaps and unknown exposure in derivatives markets.

The Federal Reserve has engaged in currency swaps with the European Central Bank to support the dollar needs of EU banks. The ECB deposits euros (or euro-denominated assets) with the Fed and receives dollars in return. It promises to repay dollars plus interest.

The Fed maintains they cannot lose money because the ECB promises to repay the swaps in dollars. And yet, with the world awash in greenbacks, it is unclear why the Fed and the ECB even needed to engage in these transactions—except that it suggests funding problems at some EU banks. And if neither EU banks nor the ECB can secure enough needed dollars in global markets, there is a serious counterparty risk to the Fed. The ECB can print euros but not dollars. Sen. Richard Shelby (R., Ala.), ranking member of the Senate Banking Committee, was correct to raise concerns about the Fed's policy last week. Losses on the Fed's balance sheet hit the U.S taxpayer, not EU citizens.

The sad fact is that there is not enough money in the EU to pay off the public debts incurred by the governments. Most countries have long since squeezed as much tax revenue from their citizens as they can. That is why they have toyed with a tax on financial transactions, the one remaining untaxed activity in all of Europe.

Greece is the first of other sovereign defaults to come. With last week's bailout, the EU leaders might have bought time, perhaps a year. But at some point, the ECB will cave and monetize the debt, leading to euro-zone inflation.

The debt calculus changed dramatically this week with the announcement of a Greek referendum on the bailout agreement next January. If voters reject the agreement, the ultimate outcome is unpredictable.

Americans must not be smug about the suffering of Europeans—our financial system is thoroughly integrated with theirs. Moreover, the International Monetary Fund will most likely be involved in the event of future bailouts and will likely need large funds from its members, which ultimately means the taxpayers.

And, of course, the U.S. has its own large and growing public debt burden. We have not gone as far down the road to entitlements, but we are catching up. If you want to know how the debt crisis will play out here, watch the downward spiral in the EU.

Meanwhile, expect more volatility in financial markets. U.S. traders in particular simply have not grasped the enormity of the EU debt crisis.