THE WALL STREET JOURNAL. ONLINE

How Europe's Bailout Delays Raised Its Cost

By STEPHEN FIDLER And MARCUS WALKER

As the International Monetary Fund and euro-zone governments finalize their debt rescue package for Greece, there is wide agreement on at least one thing: European governments could hardly have managed it worse if they had tried.

Euro-zone governments, held back above all by a reluctant Germany, have taken so long to arrange financial support for Greece that its debt crisis is turning into a wider European conflagration that threatens Portugal, Spain and potentially other indebted countries.

Asociated Press

Riot police restrain a protester in Athens Thursday, as Greece negotiated with the International Monetary Fund on terms of an aid package.

"The Greek crisis has been so severely mishandled by European policy makers that the markets legitimately fear that matters are now beyond repair," argues Alessandro Leipold, a former acting director of the IMF's European Department.

Germany is facing accusations from other euro-zone governments that it has put the stability of the euro zone at risk by taking a hard line on Greece in order to appease domestic opinion in Germany, where Greek aid for what are regarded as profligate Southern European countriesis deeply unpopular.

Other analysts warn that the fractious handling of the Greece crisis will create lasting additional costs for Greece and other governments—and taxpayers—around the euro zone. "Debt will likely stabilize at a higher amount and at a higher economic and social cost than previously expected," Moody's said in a report this week.

Many economists believe Greece's fiscal problems—now projected to require up to €120 billion ($158 billion) in aid—are too great to avoid an eventual restructuring of its debt. Yet even if earlier action by the EU and IMF may not have prevented such an outcome for Greece, it could have increased the chances of averting this week's contagion along the euro zone's fringe, they say.

"A couple of months ago, this problem could have been contained with relatively small-scale financial support for Greece," says Ken Wattret, European economist at BNP Paribas in London. "Now, even if it's €120 billion, market jitters won't disappear because people are focusing on other countries' problems too."

Lessons from sovereign debt crises over 30 years suggest they tend to intensify until the financial markets are confronted with evidence that leads to a sharp shift in investor expectations. For a bailout to restore confidence it needs to meet several conditions, say analysts.

First, it should be assembled rapidly. "Procrastination can be fatally toxic for countries hit by financial turbulence," says Mr. Leipold, in a paper written for the Lisbon Council, a Brussels-based think tank.

In late 2008, arrangements for Hungary, Iceland, Latvia, Pakistan and Ukraine were approved within three and a half to six weeks. By contrast, it is six months since Greece shocked financial markets by announcing a drastic revision to its 2009 budget forecast.

Germany's government has been reluctant to rescue Greece, knowing that most German voters—and even many lawmakers in Chancellor Angela Merkel's ruling coalition—view a bailout as a reward for Greece's wasteful spending. Germany's Bild Zeitung, Europe's biggest newspaper, in recent days has run headlines such as "Fear for our money," and "Greeks want even more billions from us."

A spokeswoman for Ms. Merkel said Germany has always said it would help Greece in an emergency. The chancellor's defenders say she had to balance the clamor for a bailout against the need to keep up pressure on Greece to overhaul its budget.

Meanwhile, almost everything said by politicians to comfort the German electorate has done exactly the opposite for the financial markets.

Italy's Foreign Minister Franco Frattini, in an unusually strong criticism of a fellow euro member, accused Berlin of "intransigence" on Monday. His German counterpart, Wolfgang Schäuble, had said over the weekend that a decision on bailing out Greece—already unable to raise more money on capital markets—was still open.

Such discord has been common as the package was being assembled, breaking what Mr. Leipold says is a second condition of a successful bailout: speaking with one voice.

A third requirement is that a bailout needs to be big enough to deliver a surprise of "shock-and-awe" proportions to the financial markets. A perfect bailout, economists say, is one that is never used by the recipient. Next best is one, like Mexico's $50 billion package in 1995 after a crisis over foreign-currency debts, that is rapidly paid back.

The longer governments delay, the larger "shock and awe" has to be—thus the rising estimate for Greece. Mr. Leipold says commitment to multiyear support has to be credible. "With questions and doubts swirling wildly over Germany's commitment to financing—even for 2010—any evasion or hedging on financing for 2011-12 will sink the whole exercise," he says.

Fourth, markets need to be convinced that the money is real. European officials have repeatedly failed to calm markets in recent weeks because they kept fanning doubts about the existence of the package. Officials were trying, but failing, to help this week. "There is no doubt that debt restructuring in a euro-zone member state is not an option," said one spokesman, as markets were signaling frantically that there was, in fact, plenty of doubt.

Mr. Leipold suggests some further rules. Conditions for economic adjustment are essential, but will lack credibility if they are too tough—and they must cover the relevant issues, but only the relevant issues. In Greece, that means dealing with fiscal policy but also financial policy, because of the strains the banks are under.

Finally, he suggests the package must not just provide financing to allow bondholders to rush for the exits. Economists say Greece's creditors will continue to flee until they are convinced that the Greek government has put its debt burden on a sustainable downward track.