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The Next Global Problem: Portugal

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The bailout of Greece, while still not fully consummated, has brought an eerie calm in European financial markets.

It is, for sure, a huge bailout by historical standards. With the planned addition of International Monetary Fund money, the Greeks will receive 18 percent of their gross domestic product in one year at preferential interest rates. This equals 4,000 euros per person, and will be spent in roughly 11 months.

Despite this eye-popping sum, the bailout does nothing to resolve the many problems that persist. Indeed, it probably makes the euro zone a much more dangerous place for the next few years.

Next on the radar will be Portugal. This nation has largely missed the spotlight, if only because Greece spiraled downward. But both are economically on the verge of bankruptcy, and they each look far riskier than Argentina did back in 2001 when it succumbed to default.

Portugal spent too much over the last several years, building its debt up to 78 percent of G.D.P. at the end of 2009 (compared with Greece's 114 percent of

G.D.P. and Argentina's 62 percent of G.D.P. at default). The debt has been largely financed by foreigners, and as with Greece, the country has not paid interest outright, but instead refinances its interest payments each year by issuing new debt. By 2012 Portugal's debt-to-G.D.P. ratio should reach 108 percent of G.D.P. if the country meets its planned budget deficit targets. At some point financial markets will simply refuse to finance this Ponzi game.

The main problem that Portugal faces, like Greece, Ireland and Spain, is that it is stuck with a highly overvalued exchange rate when it is in need of far-reaching fiscal adjustment.

For example, just to keep its debt stock constant and pay annual interest on debt at an optimistic 5 percent interest rate, the country would need to run a primary surplus of 5.4 percent of G.D.P. by 2012. With a planned primary deficit of 5.2 percent of G.D.P. this year (i.e., a budget surplus, excluding interest payments), it needs roughly 10 percent of G.D.P. in fiscal tightening.

It is nearly impossible to do this in a fixed exchange-rate regime — i.e., the euro zone — without vast unemployment. The government can expect several years of high unemployment and tough politics, even if it is to extract itself from this mess.

Neither Greek nor Portuguese political leaders are prepared to make the needed cuts. The Greeks have announced minor budget changes, and are now holding out for their 45 billion euro package while implicitly threatening a messy default on the rest of Europe if they do not get what they want — and when they want it.

The Portuguese are not even discussing serious cuts. In their 2010 budget, they plan a budget deficit of 8.3 percent of G.D.P., roughly equal to the 2009 budget deficit (9.4 percent). They are waiting and hoping that they may grow out of this mess — but such growth could come only from an amazing global economic boom.

While these nations delay, the European Union with its bailout programs — assisted by Jean-Claude Trichet's European Central Bank — provides financing. The governments issue bonds; European commercial banks buy them and then deposit these at the European Central Bank as collateral for freshly printed money. The bank has become the silent facilitator of profligate spending in the euro zone.

Last week the European Central Bank had a chance to dismantle this doom machine when the board of governors announced new rules for determining what debts could be used as collateral at the central bank.

Some anticipated the central bank might plan to tighten the rules gradually, thereby preventing the Greek government from issuing too many new bonds that could be financed at the bank. But the bank did not do that. In fact, the bank's governors did the opposite: they made it even easier for Greece, Portugal and any other nation to borrow in 2011 and beyond. Indeed, under the new lax rules you need only to convince one rating agency (and we all know how easy that is) that your debt is not junk in order to get financing from the European Central Bank.

Today, despite the clear dangers and huge debts, all three rating agencies are surely scared to take the politically charged step of declaring that Greek debt is junk. They are similarly afraid to touch Portugal.

So what next for Portugal?

Pity the serious Portuguese politician who argues that fiscal probity calls for early belt-tightening. The European Union, the European Central Bank and the Greeks have all proven that the euro zone nations have no threshold for pain, and European Union money will be there for anyone who wants it. The Portuguese politicians can do nothing but wait for the situation to get worse, and then demand their bailout package, too. No doubt Greece will be back next year for more. And the nations that "foolishly" already started their austerity, such as Ireland and Italy, must surely be wondering whether they too should take the less austere path.

There seems to be no logic in the system, but perhaps there is a logical outcome.

Europe will eventually grow tired of bailing out its weaker countries. The Germans will probably pull that plug first. The longer we wait to see fiscal probity established, at the European Central Bank and the European Union, and within each nation, the more debt will be built up, and the more dangerous the situation will get.

When the plug is finally pulled, at least one nation will end up in a painful default; unfortunately, the way we are heading, the problems could be even more widespread.

Update: An earlier version of this post had an incorrect number for Portugal's planned budget deficit in 2010. It is 8.3 percent, not 9.3 percent.