In Europe, spending cuts fail to ease debt burdens

By PAUL WISEMAN, AP Economics Writer – Feb 21, 2012 0

WASHINGTON (AP) — Europe has endured the pain of layoffs, wage cuts and tax increases designed to bring government debt under control.

So where's the gain?

Far from falling, debt burdens are rising fastest in European countries that have enacted the most draconian austerity programs, according to The Associated Press' Global Economy Tracker, which monitors the performance of 30 major economies.

The numbers back up what many analysts say: Austerity isn't just painful. It can be counterproductive and even make a country's debt load grow.

Many fear the cutbacks will cause Europe to sink into a self-defeating spiral: Higher debt leads to harsher austerity, growing social instability and deeper economic problems. Governments could find it even harder to pay their bills.

The pain is already intense. Portugal's unemployment rate hit a record 14 percent at the end of last year. Ireland's economy contracted a worse-than-expected 1.9 percent in the July-September quarter of 2011. And Greece reported that its already basket-case economy shrank 7 percent in the October-December quarter of last year.

"This isn't a healthy situation," says Peter Morici, an economist at the University of Maryland.

Under a deal approved Tuesday by the 17 countries that use the euro and the International Monetary Fund, Greece will get a $172 billion bailout in exchange for accepting another dose of austerity that includes laying off 15,000 civil servants and slashing the minimum wage by 22 percent.

Progress has been made in the bond market, where interest rates on government bonds have declined. That's made it cheaper for some indebted countries to borrow.

But the drop in rates might not last. And the lower rates probably have less to do with budget cutting than with what the countries' central banks are doing: They're buying bonds, which pushes down rates, and providing low-cost loans for banks to do the same.

Borrowing costs haven't eased for every country: The yield on Portugal's 2-year government note is near a painful 13 percent, up from under 5 percent a year ago.

The best way to compare debt burdens among countries is to look at the debt as a percentage of gross domestic product. When it exceeds 90 percent, it's considered bad for an economy's health. GDP is the broadest gauge of economic output.

The AP's Global Economy Tracker illustrates how countries that have imposed austerity measures to slash costs have actually ended up with bigger debt problems:

— Portugal cut pensions, reduced public servants' wages and raised taxes starting in 2010. Yet in the third quarter of 2011, government debt equaled 110 percent of GDP. That was up from 91 percent a year earlier.

— In Ireland, middle-class wages have been reduced 15 percent and the sales tax boosted to 23 percent (the highest in the European Union). But its debt amounted to 105 percent of economic output in the third quarter of last year; a year earlier, it was 88 percent.

— In Britain, Prime Minister David Cameron staked his political future on his austerity plan. Government debt ratios, though, reached 80 percent in third-quarter 2011, up from 74 percent a year earlier. And Moody's this month cut its outlook on Britain's prized AAA credit rating from "stable" to "negative."

— In Greece, two years of austerity programs have devastated the economy and triggered riots. Still, the government's debt equaled an alarming 159 percent of the country's GDP in the July-September quarter of 2011. That was up from 139 percent a year earlier.

— Norway, by contrast, has a strong economy and has avoided painful austerity measures. And its debts dropped to 39 percent of GDP in the third quarter, from 43.5 percent in the same quarter of 2010.

Economic conditions deteriorated at the end of last year, suggesting that Europe's government debt likely grew even heavier. Many economists question whether the latest rescue plan can succeed over the long run.

"The Greek debt deal puts off the day of reckoning," says Eswar Prasad, senior professor of trade policy at Cornell University. "We can breathe a sigh of relief for the next few weeks. But a

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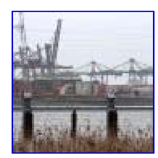
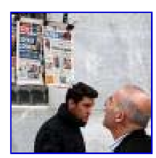
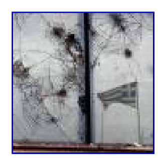
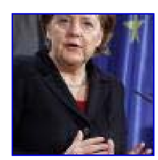
FOR RELEASE AT 12:01 A.M EST WEDNESDAY, FEB. 22, 2012. THIS PHOTO MAY NOT BE PUBLISHED IN PRINT, ONLINE OR FOR BROADCAST UNTIL 12:01 A.M. EST - FILE - In this Feb. 10, 2012 file photo, a protester is led away by police officers during a protest against sweeping labor market reforms announced by Spain's new conservative government in Madrid. Far from falling, government debt burdens are rising fastest in European countries that have enacted the most draconian austerity programs, according to the Associated Press' Global Economy Tracker. (AP Photo/Pedro Acosta, File)



Map

lot of trouble is still coming."

Simple math explains why austerity can worsen government debt: If spending cuts and tax increases tilt a country into recession, GDP shrinks. So debt doesn't even have to grow to become a bigger burden on a contracting economy.

"You can't fix the debt-to-GDP problem if GDP is falling," says David Kelly, chief market strategist for JP Morgan Funds.

Recession also adds strains to the budget. Tax revenue dries up. Spending on unemployment benefits and other social services rises.

Bond investors tend to favor austerity programs, and here's why: The narrower the gap between what a government spends and what it collects in taxes, the likelier it will repay its debts. Countries that strive to balance their budgets are rewarded with lower interest rates on their debt.

That's one reason the yield on Britain's 2-year notes has dropped from 1.5 percent to 0.4 percent over the past year. Likewise, yields on Italian government bonds fell after the country's new technocratic prime minister, Mario Monti, unveiled plans to get the country's finances in order.

But the Bank of England and the European Central Bank can also claim much of the credit for the lower rates. The Bank of England has pushed yields down by actively buying bonds, a policy known as "quantitative easing."

The ECB in December provided hundreds of commercial banks with nearly $640 billion in low-interest three-year loans. The banks used some of this money to buy Spanish and Italian government bonds, pushing yields lower. The central bank intends to make more bank loans later this month.

But the bond-market exuberance may not last.

Olivier Blanchard, chief economist at the International Monetary Fund, has said even bond investors can rebel against austerity, once they realize that government cutbacks can squeeze growth and cause debt burdens to rise.

"There's no doubt that the strategies pursued in Greece, Portugal and Ireland have contributed to a dramatic increase in those countries' overall debt burdens," says Simon Tilford, chief economist at the Centre for European Reform in London.

"Strengthening public finances is a marathon, not a sprint, and it can only take place across a backdrop of reasonably healthy economic activity."

The United States is taking the marathon approach, putting off serious budget cuts until the economy is stronger.

What Europe needs, says Paul Christopher, chief international investment strategist at Wells Fargo Advisors, "is not austerity but economic reforms."

Across Europe, economic growth is constrained by inefficiencies, such as rules that protect favored businesses from competition and generous retirement plans that cost too much and pull productive workers out of the labor force.

But reform takes time that Europe can't spare.

Analysis by the Kiel Institute for the World Economy in Germany suggests the outlook is hopeless for Greece. Researchers at the think-tank estimate that Greece would have to turn its annual budget deficit — now about 5 percent of GDP before debt payments — into a daunting surplus of around 30 percent of GDP to return to financial health.

"Greece will most likely not be able to get grip on its debt," write the institute's analysts David Bencek and Henning Klodt. Portugal, too, faces long odds, they found.

The only way out, the University of Maryland's Morici says, is a breakup of the eurozone. Weak countries like Greece and Portugal must abandon the euro and reintroduce their old, less valuable currencies. The return of the weak Greek drachma and Portuguese escudo would make Greek and Portuguese products less expensive in foreign markets and allow them to get a rejuvenating economic boost from growing exports.

The alternative, he says, is deepening pain and social instability.

"The stakes are enormous," Morici says. "Unemployment could easily rocket above 30 percent in Greece for years. With the government having no real means to ease the pain, revolutionary conditions will prevail. Even now Greece is little more than a barn full of straw in the middle of a summer drought."

AP Economics Writer Derek Kravitz contributed to this report.

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