Europe's debt fix falters, rattling markets

By David McHugh

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FRANKFURT, Germany—Europe's plan to fix its debt crisis by imposing budget cuts frayed Monday. Heavy selling rocked financial markets, uncertainty gripped two governments, and the economic outlook darkened across the continent.

The German stock market suffered its worst day in six weeks. In the United States, the Dow Jones industrial average lost more than 100 points.

Across Europe, the debt crisis appeared at its most perilous point since December, when most of the continent united behind a plan to place strict caps on government spending, a strategy known as austerity, and the European Central Bank made the first of two infusions of cheap credit into the banking system. New governments in Spain and Italy got to work on improving growth.

Now the first pillar of Europe's approach -- austerity -- is faltering.

"Europe has not solved its problems, and the austerity programs are making things worse, not better," said Peter Morici, an economist at the University of Maryland.

Cutting government spending can weaken an economy and result in less tax revenue flowing back to the government. So the goal of cutting the deficit can backfire and make it grow.

And even if a country is reducing its deficit, it still has one, which means the debt is increasing. The European Union said Monday that governments did cut their budget deficits in 2011, but government debt nonetheless rose as a percentage of economic output.

Meanwhile, developments across the continent cast doubt on public support for Europe's austerity prescription: government layoffs and wage reductions, spending cuts on government programs and higher taxes.

The government of the Netherlands, which has loudly cricitized its European neighbors for inflaming the crisis by losing control of their budgets, submitted its resignation to Queen Beatrix after failing to agree on its own budget cuts.

The Dutch prime minister, Mark Rutte, had hoped to clinch a deal to cut the Netherlands' budget deficit to within a target range adopted by European countries last fall.

But his most important political ally, populist Geert Wilders, walked out of the talks. He said that slavish adherence to rules set by "the dictators in Brussels," the headquarters of the European Union, would hurt the Dutch economy.

France headed for a presidential runoff election May 6 after the Socialist candidate, Francois Hollande, took the most votes Sunday in the first round of voting.

Hollande edged Nicolas Sarkozy, the incumbent president. Sarkozy and German Chancellor Angela Merkel have been such forces in setting debt-fighting strategy that they have come to be known as "Merkozy."

Hollande took 29 percent of the vote and Sarkozy 27 percent. The Socialist has said he would push to add measures to stimulate economic growth to the fiscal pact.

If Hollande is elected, it will mean "the end of the common road for France and Germany," with negative repercussions for the markets and the euro, said Stefan Scharfetter of Germany's Baader Bank.

Most French polls had predicted that Hollande would finish slightly ahead of Sarkozy in the first round. But the far-right candidate, Marine Le Pen, captured a surprise 18 percent. Where her voters will fall in the Hollande-Sarkozy runoff is uncertain.

Financial markets generally hate uncertainty, and they did not respond well to it Monday.

Germany's DAX index dropped 3.4 percent, the equivalent of a 450-point decline in the Dow. The benchmark stock index dropped 3 percent in Paris, 3 percent in Madrid and 2 percent in London.

Stocks also fell broadly in the United States, where a resurgence of fear about the fate of Europe has ended the steady ascent that the market enjoyed during the first three months of the year. The Dow fell back below 13,000 and was down a 0.8 percent for the day.

In the bond market, interest rates for U.S. Treasury securities dipped, a sign that investors were seeking safety by pulling money out of stocks and putting money into bonds.

The borrowing rate for Spain, probably the most closely watched thermometer of investor fear about Europe, remained close to 6 percent. Seven percent was the level that forced Greece and Ireland to seek international bailouts earlier in the crisis.

The central bank of Spain said that country had slipped back into recession. Its economy shrank 0.4 percent from January through March after shrinking 0.3 percent the quarter before. Two straight quarters of economic contraction is the generally accepted definition of a recession.

Spain's new conservative government has warned that its economy will get worse. A contraction of 1.7 percent is expected for the year. Spain, struggling after the collapse in 2008 of a housing bubble, emerged from a two-year recession in 2010.

Suggesting more obstacles to economic growth, an index of the European manufacturing and services industries dipped in April to a five-month low. It even declined in Germany, the economic bulwark of Europe and the country that has most insisted on budget cuts.

When the financial crisis struck in the fall of 2008, governments on both sides of the Atlantic Ocean rushed out big stimulus programs to protect their economies. Governments spent more and cut taxes. The U.S. Federal Reserve and the European Central Bank slashed interest rates.

But the Europeans gave up on stimulus a lot faster than the Americans did. The European Central Bank, worried about the prospect of rising inflation, raised interest rates last April and again in July, then reversed course and lowered them late last year as Europe slipped back toward recession.

The Fed, by contrast, cut short-term interest rates essentially to zero in late 2008, then in January promised to keep them there until at least 2014 if the U.S. economy remains weak.

The White House and Congress also extended unemployment benefits and tax cuts that were scheduled to expire at the end of 2010, and enacted a separate cut in the payroll tax that pays for Social Security.

In Europe, the bigger, more financially stable countries pushed for firmer limits in a so-called fiscal union agreed upon in December by every country in the 27-member European Union except Britain and the Czech Republic.

For three months, the bond market stayed calm. But recently, investors have worried that deficits will keep rising in Spain and other countries, and that those countries will have trouble financing these deficits by selling bonds. So investors have demanded higher rates, re-igniting the crisis.

The European Central Bank has bolstered the continent's financial system with (EURO)1 trillion in cheap loans to banks, in December and February, but the effects are wearing off.

Officials from the European Central Bank are resisting calls from the United States and the International Monetary Fund to offer more support to the struggling economies of the countries that use the euro.

Jens Weidmann, Germany's top central banker and a member of the ECB's governing council, said lower interest rates and more credit for the financial system were not the solution to the debt crisis.

"Monetary policy is not a panacea, and central bank firepower is not unlimited," particularly within the constraints of a currency shared by 17 countries, he said.

Spain's most recent budget slashed spending across government departments by an average of 17 percent, froze pay for civil servants and hit companies with new taxes.

That came on top of an austerity package in late December that raised income taxes, froze practically all government hiring and is slowing Spain's economy.

Spanish finance minister Luis de Guindos calls the austerity vs. growth dilemma a "lose-lose situation": If you cut spending, you risk slowing the economy. But if you borrow to stimulate the economy, you make the debt bigger.

The effects of government cuts, at least, are painfully clear. On top of Monday's news that the country is in recession again, Spain's unemployment rate is 24 percent.

Its debt is rising as a share of economic output. At the end of last year, the ratio stood at 68.5 percent, below the average for euro countries. But it is forecast to rise above 80 percent by the end of this year.

Spanish Prime Minister Mariano Rajoy and Italy's Monti, the two leaders on the front line of the debt crisis, are also trying to promote long-term reforms to their economies. Those include cutting regulation and easing labor market rules to make it easier for businesses to fire people and adjust workforces to global competition.

But structural reforms can take years to show results. And sometimes changes such as easing firing can make things worse in the short term, with the gains coming years later.

In the meantime, said Eswar Prasad, a professor of trade policy at Cornell University, "political support for fiscal austerity and structural reform measures are eroding all across Europe."

AP Business Writers Sarah DiLorenzo in Paris, Gabriele Steinhauser in Brussels and Paul Wiseman in Washington contributed to this report.