Time to relax austerity plans? Europe takes new direction

By Tim Mullaney, USA TODAY

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Europe's voters called for less fiscal austerity and more economic growth last weekend. Now the questions are how to do it — and will it do any good?

By Antoine Antonioli, Getty Images

French President-Elect Francois Hollande appears Monday on the balcony of Socialist Party headquarters in Paris.

A change in course seemed inevitable on Monday, a day after the French elected their first Socialist president in 17 years — ousting incumbent Nicolas Sarkozy— and Greek voters declined to give any political party the parliamentary majority needed to form a government.

The winner of the French election, Socialist candidate Francois Hollande, campaigned on a platform that included anti-austerity planks such as hiring 60,000 teachers and renegotiating a deal that would give Europe more control over each nation's tax and spending decisions.

In Greece, initial efforts to form a coalition government failed Monday, raising the chance that new leadership might renege on a bailout that cut Greece's debt to private banks in exchange for draconian budget measures such as firing government workers and cutting pensions.

The common theme was fatigue with the fiscal austerity that bond markets and Germany, Europe's biggest economy, have imposed across the 17-nation eurozone to better manage swollen government debt loads. With the eurozone and about half its members in recession, some critics say severe cutbacks in government spending are only making matters worse. France's 10% unemployment rate is the highest in 12 years.

"These changes will make Germany soften its tone, even while continuing to talk austerity," said Peter Cardillo, chief market analyst at Rockwell Global Capital. "The political changes in France and scenarios in Greece are going to be a long-term positive."

The new governments will struggle to find policies that will deliver short-term relief while still demanding long-term fiscal changes that will make Europe more competitive worldwide, said Jürgen Odenius, chief economist at Prudentual Fixed Income.

The right balance will put some money into consumers' hands quickly, letting debtor nations such as Greece, Italy and Spain boost exports, he said. At the same time, bond investors and ratings agencies will demand that borrowing and spending restrictions remain in place, analysts said. That may set the stage for limited short-term stimulus plans, even as Europe continues to pursue fiscal tightening.

Even deficit hawks such as the International Monetary Fund and Standard & Poor's indicated Monday that there might be room to loosen austerity.

"Markets will be looking at the credibility of medium-term plans, not the short term," said John Chambers, chairman of the sovereign debt rating committee at Standard & Poor's, whose downgrade of U.S. Treasury bonds last summer riled world markets.

Faltering economies

Unemployment is rising in Europe amid recession in eight countries and slowing growth in others. Unemployment rates are for March or for the latest available month. Eurozone countries are shaded.

Country	Unemployment rate	2012 GDP forecast
European Union (27 countries)	10.2%	0.03%
Eurozone (17 countries)	10.9%	-0.3%
Spain	24.1%	-1.8%
Greece	21.7%2	-4.7%
Portugal	15.3%	-3.3%
Latvia	14.6%1	2%
Ireland	14.5%	0.5%
Lithuania	14.3%1	2%
Slovakia	13.9%	2.4%
Bulgaria	12.6%	0.8%
Estonia	11.7%1	2%
Hungary	11.2%	0%
Poland	10.1%	2.6%
France	10.0%	0.5%
Cyprus	10.0%	-1.2%
Italy	9.8%	-1.9%
Slovenia	8.5%	-1%
United Kingdom	8.2%2	0.8%
USA	**8.2%**	**2.1%**
Denmark	8.1%	0.5%
Romania	7.5%	1.5%
Finland	7.5%	0.6%
Belgium	7.3%	0%
Sweden	7.3%	0.9%
Malta	6.8%	1.2%
Czech Republic	6.7%	0.1%
Germany	5.6%	0.6%
Luxembourg	5.2%	-0.2%
The Netherlands	5%	-0.5%
Austria	4%	0.9%

1-December, 2011; 2-January
Source: Unemployment rates from Eurostat, GDP forecasts from International Monetary Fund's April 2012 World Economic Outlook

IMF Managing Director Christine Lagarde said Europe's recovery is being held back by weak housing markets, including the one in the U.S.— and by restrictive fiscal policies that have been pushed by advocates for creditors. Markets should judge debtor countries' plans by how well they protect bondholders over time, rather than right away, she said in a speech Monday in Zurich.

"These are not normal times," she said. "We know that fiscal austerity holds back growth, and the effects are worse in downturns. So the right pace is essential — and the right pace will be country-specific. The right mix between cutting spending and raising revenue is also critical."

The path Europe chooses will have consequences for the U.S.

It's likely that Europe's next steps will reduce the value of the euro, currently about $1.30, which will make European imports cheaper in the U.S. and American exports pricier in the eurozone, said Cornell University economist Eswar Prasad. A cheaper currency helps the eurozone countries try to grow their way out of debt.

The tumult in coming weeks may hurt business and consumer confidence, even in the U.S., Prasad said.

For example, markets will be closely watching another pivotal moment coming in June in the long-running Greek financial crisis. That's when Greece is to introduce new austerity measures worth $19 billion, a condition of the $39.4 billion installment in rescue funds it is counting on in June from the eurozone nations and the International Monetary Fund.

Higher wages

Europe's campaign for fiscal austerity, designed to shrink budget deficits and mollify bond investors who are worried that high public debt levels will lead to national defaults, has become a case study in unintended consequences. Instead of sparking growth, the eurozone has lapsed back into recession. And the pain is especially severe in highly indebted countries such as Spain, where unemployment has reached 24.1% and is 51.1% among workers 25 and younger.

Critics have said deals to reduce or extend repayment of the debts of countries such as Greece, Italy, Spain, Portugal and Ireland have included almost no measures to boost economic growth, either through stimulus spending, or by changing rules to make those nations' products or services more attractive on world markets. Without offsetting policies to boost short-term growth, the debtor nations can't earn enough money to make their debt payments, and they face huge social costs.

Lagarde seemed to move in that direction Monday. "Right now, there are 200 million people worldwide who cannot find work, including 75 million young people," she said. "This is a potential disaster — in economic, social and human terms."

The most important step Europe can take is to raise wages in countries such as Germany and the Netherlands that aren't in financial trouble, said Kemal Dervis, director of global economy and development for the Brookings Institution in Washington.

For example, German ironworkers are threatening a strike, seeking a 6% raise over two years from companies including automaker Daimler, he said. If it were granted, some portion of that money is sure to be spent on vacations in Greece or goods from Italy, he said. Nations such as Germany that have trade surpluses can afford to raise wages and can tolerate a small amount of inflation if necessary, Dervis said.

Hollande also campaigned on a plan to invest another 10 billion euros ($13 billion) in the European Investment Bank, an agency of the European Union that backs infrastructure projects on the continent. Including money that can be borrowed against that investment, that could produce as much as 60 billion euros ($78 billion) in projects, said Odenius, the economist.

"Not even this minimalist proposal is uncontroversial," Odenius said. Germany has committed to balance its own budget by 2014 and is likely to resist any drive for more spending, he said.

Many bond investors still hope that the change in direction, especially in France, will prove to be more a shift in rhetoric than policy, Odenius said. In particular, Hollande should not reopen the March agreement under which the euro nations agreed to link their fiscal policies, a move intended to prevent spendthrift nations from running up debts their currency partners might have to pay.

Markets are likely to "draw a line in the sand" on insisting that highly indebted countries stick to announced deficit targets, such as Spain's pledge to cut its 2013 deficit to 3% of its gross domestic product, Odenius said. When Spain said it would have a bigger-than-expected deficit this year because of its economic collapse, markets pushed interest rates on Spain's 10-year debt to Monday's 5.75%, twice as much as Germany pays.

"If Greece fails to deliver and Europe continues to pay, it could … undermine the entire credibility of the crisis management," ING chief economist Carsten Brzeski said.

If Greece, which has already been granted a 70% reduction of its privately held debt, fails to open up its markets and cut its deficit, other nations could force it to leave the euro, he said.

In addition, Europe's long-term health depends on moves to reduce labor costs, such as making it easier to hire and fire workers, and undoing regulations that support artificially high prices in markets such as Greek trucking services and pharmacies, said Prasad, former head of the IMF's financial studies division.

The U.S. is different

Steps that Europe may take to ease the pain of Spain or Greece aren't very relevant to the debate the U.S. faces about its own fiscal situation, Chambers and Prasad said.

Congress is expected to wait until after the November election to decide whether to extend the expiring Bush tax cuts and the payroll-tax cut, and to impose more than $900 billion in spending cuts agreed to last year, all of which is set to take effect Jan. 1.

As a percentage of its gross domestic product, the U.S.' current debt is not nearly as large as those of most of the nations in trouble, Chambers said.

"The U.S. has room to maneuver in the short term, but it depends on Congress having a medium-term plan that is credible," he said.

Contributing: Matt Krantz in Los Angeles; Karine Barzegar in Paris; and Jabeen Bhatti and Ruby Russell in Berlin

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Bill Fields · Top Commenter

Silly wabbits.

If everyone had the midset they'd all get free everything and no one worked and paid taxes, who'd pay for the benefits?

A great French joke.....

"The elderly American gentleman arrived in Paris by plane. At French Customs, he fumbled for his passport.

"You 'ave been to France before, monsieur?" the customs officer asked sarcastically. The old gent admitted that he had been to France previously.

"Zen, you should know enough to 'ave your passport ready for inspection."

The American said, "The last time I was here, I didn't have to show it."

"Impossible. You Americans alwayz 'ave to show your passports on arrival in France!"

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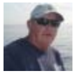

Andy Griggs · Top Commenter

2008...another example that we are always ahead of the French. Hopefully the rest of Europe won't let the French out of their austerity obligations. If they reverse a course, that was tentative at best, to reduce the very small effort they made to reduce retirement benefits then they will end up like Greece and Italy. Bill Fields, I have always loved that passport story.

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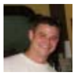

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Epic failure of austerity measures(Drastically cutting all spending) in France rose unemployment to over 25%, now they elect a true socialist.. This goes to show that cutting all government spending only deepens the depression which will lead to true socialism.

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