Europe in a hole: Which way out?

PARIS

Budget-trimming cure could have dangerous side effects, critics say

BY STEVEN ERLANGER

Across Europe, from profligate Greece to newly strait-laced Ireland, governments are promising deep, painful cuts in public spending even as they face the likelihood of a new recession.

To protect the value of the euro, satisfy investors and appease Europe's economic taskmaster, Germany, the region's most heavily indebted countries believe they have no choice but to slim down. Reviving economic growth and reducing unemployment must wait until countries get their fiscal houses in better order, the thinking goes.

But some argue that Berlin is pressing too hard, and that the region's new fixation on debt has created a "cult of austerity" that could make it harder to recover from the slump. Drastic budget cuts, if implemented as promised, could set off deflation, send already high unemployment rates surging, bring governments down and even create popular opposition to the euro, critics say.

The pressure "will impose terrible strains on the government and society" for years to come, said Jean-Paul Fitoussi, professor of economics at the Institut d'Études Politiques in Paris. "It's self-defeating, because if you have austerity and deflation in Greece, Portugal and Spain, then the European economy will not recover, firms will fail and jeopardize the banks."

Opposition to austerity is spoken softly in official circles, as political leaders fret that markets will punish countries that show weak resolve to lower debt. But Germany, which has insisted on steep cuts in public spending in the most indebted countries, is facing criticism for harping about the dangers of debt without doing more to support growth, mainly by buying more from its neighbors.

The French finance minister, Christine Lagarde, warned Berlin that it must increase its domestic demand to help partners in trouble. Could Germany, with its high savings and big trade surplus, "do a little something," she asked in an interview with The Financial Times. "It takes two to tango. It can't just be about enforcing deficit principles."

The debate is partly about economics — what steps European countries need to take to tackle their demons of high debt and slow growth. But it is also about leadership, as the European Union struggles to define its mission during the deepest economic crisis in its history.

The Germans insist the problem is debt. Addressing it means radical and immediate cuts in public spending, using the pressure from markets to impose changes that are politically difficult but crucial to long-term health.

France has a different, softer approach, akin to the U.S. perspective. Public spending must expand in times of economic crisis to bolster employment and growth, which will gradually cut the deficit through increased tax receipts. Many European countries need to streamline their public sectors, France argues, but not as shock therapy.

German rigor has worked well for Germany, which has kept wages down, overhauled its social-welfare system and remained one of the world's top exporting countries. Psychologically, Germans remain obsessed with inflation and saving. But Germany consequently has a big trade surplus with its euro-zone partners. And that imbalance makes it harder for less competitive countries to grow out of their own problems.

The Germans note that Spain, Portugal, Greece and Italy did not play by the rules of monetary union, drafted largely by Germany.

"Wages rose very fast, productivity stayed low and governments went on a spending spree, and that makes Germans angry, because they did the opposite," said Thomas Klau of the European Council on Foreign Relations.

The Germans are preaching harsh budget cuts, tax increases, changes to pension systems, a later retirement age and a quick return to government deficits closer to the euro-zone requirement of 3 percent of gross domestic product, a far cry from Greece's 12.7 percent for this year.

On the other side are worries that this sounds similar to the austerity mantra that helped prolong the Great Depression of the 1930s. Mr. Fitoussi said that it risked throwing the Mediterranean countries into deflation, which would create huge political and social pressures and short-circuit Europe's economic recovery. Forecasts already predict recession for the most of the southern rim for at least another year or two.

While Greece clearly must overhaul its public sector — and stop manipulating its economic statistics — market credibility does not require murdering the economy, argued Mr. Fitoussi, who is close to Joseph E. Stiglitz, the American economist who has advised Greece. Mr. Stiglitz warns of "deficit fetishism," arguing that further recession could increase the deficit beyond the government's ability to cut spending.

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Even the International Monetary Fund, Mr. Fitoussi said, having learned lessons from the Asian crisis of the 1990s, would not try to impose as much austerity all at once, but would instead try to alleviate the immediate debt crunch and help revive growth before insisting on the biggest cuts.

The United States, too, has taken a different tack, accumulating new debt to stimulate growth and worrying later about reducing deficits. The U.S. budget deficit this year will be 11.2 percent of G.D.P., nearly the level of Greece. But Washington can better afford it. Not only does it control the dollar, which remains the world's reserve currency, but

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gross U.S. debt is only half that of Greece when measured against G.D.P.

France, hit less hard by the crisis, is trying to find a median — with moderate stimulus, no tax increases, support for small and midsize businesses, and a deficit growing to 8.2 percent of G.D.P., even as unemployment has climbed back over 10 percent.

To an extent, smaller economies like Greece have to bow to the demands of the market. Iceland with its bank disasters, Ireland with its real estate and bank bubbles, also have buckled down to cut budgets considerably in the face of plunging tax receipts, but their politicians are expected to suffer.

Moreover, accumulated debt in Southern Europe has become an urgent issue, with Greece only the most egregious example. The Greek ratio of debt to G.D.P. is forecast for 125 percent and climbing; Italy is at nearly 118 percent and the euro zone itself is at 84 percent.

But inevitably the policies to deal with the debt have to balance political and economic realities. Elected governments may promise drastic cuts, but it is not clear they can stay in office to implement them.

Greek unions are striking regularly, determined to keep their perks, and consumer organizations are decrying a new poverty. Babis Delidaskakis, an economist with INKA, the Greek consumers' federation, called the sudden cuts "a nefarious dead end for the economy."

"Can the Greek government survive this?" asked Julian Callow, chief European economist at Barclays Capital. "Spain looks better, but the government hasn't even begun to get tough on the fiscal side. This is going to have to be a six- to eight-year project to stabilize these debt-to-G.D.P. ratios — and it gets progressively harder to keep at it."

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