Euro Zone Grapples With Debt Crisis

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European Outlook

In 2010, many nations in the currency bloc will attempt to shore up finances and sustain fitful economic recoveries

By TERENCE ROTH

After two years of crashing banking systems and economic recession, the euro zone enters 2010 with a full-blown debt crisis.

The European Commission warns that public finances in half of the 16 euro-zone nations are at high risk of becoming unsustainable.

Governments will spend the next year and beyond balancing the urgent need to fix public-sector debt and deficits -- without imperiling what appears to be a feeble economic recovery.

Even the staunchest optimists in Brussels and Frankfurt see a rocky process, with rating firms poised for more downgrades and bond markets meting out daily judgment over how governments are doing.

Greece and Spain saw their ratings downgraded. Ireland and Portugal have been warned they could be next. Even broader downgrades threaten if other European governments don't shape up.

Fitch warns in a December report that particularly the U.K. (which isn't in the euro zone) and Spain and France (which are) risk being downgraded if they don't articulate more-credible fiscal-consolidation programs during the coming year given the pace of fiscal deterioration.

With the young currency bloc facing the first major test of its fiscal reliability, financial markets are hedging their bets.

The euro ended 2009 slipping off its highs for the year and bank stocks were sliding on perceptions that their government-bond holdings could lose value. Economists worry the fiscal damage could take years to repair. The recession that has gripped the euro zone since mid-2008 collapsed tax revenues and sent welfare costs soaring.

Billions of euros dedicated to fiscal-stimulus plans and bank bailouts completed the devastation to government finances.

Investors also worry about the danger of a "double dip" European recession if governments get the timing and pace of budget consolidation wrong and choke off the recovery.

That prospect comes alongside concerns of more ratings downgrades and higher default risk if governments act too slowly.

Budget deficits for the region as whole in 2009 swelled to 6.4% of gross domestic product from 2% the year before. The EU forecast sees that gap widening to nearly 7% in 2010 before the worst is over.

European Central Bank President Jean-Claude Trichet says he worries that runaway government borrowing could undermine his ability to hold down inflation, and wasted no opportunity to cajole governments back into line. But ECB officials also acknowledge that countries such as Greece and Spain may need to move earlier in reducing deficits and the amount of debt flooding European bond markets.

By contrast, Germany and France will increase spending to add fresh fiscal stimulus in 2010, in France's case swelling its budget gap to more than 8% of GDP next year, according to EU projections. The concern in Berlin and Paris is that rising unemployment, a lagging indicator that continues to rise in the early stages of recovery, will do enough to limit domestic demand without the governments also turning off the taps too early.

The fiscal juggling acts within a multinational currency union frame the test that worried skeptics before the euro's launch a decade ago.

They said a monetary union unsupplemented by a political union risked a fiscal free-for-all among governments, especially in a full-blown recession. The next year will be a good time to prove them wrong.

The focus in early 2010 will remain on Greece and its budget deficit at 12.7% of GDP, four times the EU limit. The Greek government is trying to hammer together a political consensus in parliament for a plan to bring down public spending without triggering more social unrest seen in the country's streets at the close of 2009.

Europe has told Athens that it has to get itself into shape without outside help. Not many Europe watchers believe the euro zone would allow one of its own to go into default, discrediting the euro currency and the philosophy of a monetary commonwealth behind it.

If things did get that far, euro-zone governments would be expected to rush in with a rescue plan to absorb some of Greece's debt, or issue guarantees.

As if to cover all possibilities, ECB legal counsel Phoebus Athanassiou in December discussed in a working paper how and under what conditions a euro-zone country might withdraw or be expelled from the currency union.

But Brussels is still taking a hard line. The European Commission, in its latest quarterly economic report issued in December, said the strong reaction in financial markets to signs of fiscal laxness highlights the priority of getting a handle on runaway government spending.

It called Greece "a source of serious concern," but urged other member states to bring public finances into sustainable parameters of borrowing and debt.

The ECB is equally unforgiving. "One has to be very clear: The ECB has no mandate or intention to take into account the situation of a specific country, especially not with regard to public finances," Ewald Nowotny, the Austrian member of the ECB's Governing Council, said in a December interview with The Wall Street Journal.

That leaves it up to national leaders to take the pain to the people with varying combinations of more taxes, deeper spending cuts and scaled-back social programs. The tale of what Europe's big fiscal crackdown will look like, and how it will be received, will unfold over the next two years. The first chapter in Europe's big fiscal crackdown comes in January, when Greece is due to submit what is expected to be a radical fiscal overhaul.

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