Europe's debt crisis intensifies

Portuguese vote against austerity plan to intensify market worries over Europe's debt crisis

By Aoife White and Pan Pylas, AP Business Writers, On Friday February 5, 2010, 5:22 pm EST

BRUSSELS (AP) -- Fears of another crisis spiral for the world economy deepened Friday after the Portuguese parliament defeated a government austerity plan, triggering renewed concern that the financial crisis in that country and in Greece could spread through the euro zone and spill across its borders.

Spooked investors worldwide were fleeing risky assets like stocks. And from Shanghai to Sao Paolo, people were awakening to the reality that what is happening in these European minnow states has vast implications for the fate of the fragile global economic recovery.

Stocks fell in Asia and Europe as governments in Portugal and Greece pushed against fierce political resistance at home to cutbacks aimed at getting their deficits under control.

Markets fear Greece may default or require a costly bailout from already strapped European governments, and those concerns are spreading to other financially troubled governments such as Portugal and Spain.

Canadian Finance Minister Jim Flaherty said that finance officials gathering for a meeting in Iqaluit, Canada, on Friday and Saturday had already had some preliminary discussions about the market turbulence in Europe.

"There are concerns about Greece," Flaherty told reporters before the start of formal talks in Iqaluit.

Flaherty said the issue was fundamentally one for EU countries, but said it would be discussed here given the presence of Britain, Germany, Italy and France in the G-7.

"I think we have to be very mindful of the failure or potential failure of domestic economies and of the persistence of some toxic assets in some banks," Flaherty said. "These are issues that are persisting. We have been advocating for a long time now that we need to fix the banks.

"Assets have to be appropriately valued, market value, so there can be mutual confidence in financial systems and we need a mutual assistance system for financial systems."

Portugal's position looked even weaker Friday after opposition parties defeated a government plan for austerity measures that the country needed to pass to soothe markets and reduce the soaring cost of insuring its debt, a measure of investor fear.

"Portugal is next in line with ... what is now a very timid attempt" to bring its deficit down, said Marco Annunziata, chief economist at UniCredit.

Top EU officials, the economy commissioner Joaqin Almunia and European Central Bank head Jean-Claude Trichet, tried Wednesday and Thursday to reassure markets of the strength of the euro zone and Greece's determination to bring down spending. But markets haven't listened.

The reason is a growing reassessment of government finances worldwide, and knowledge that a Greek default would tear new holes in banks' already battered finances if they hold Greek bonds, most of which were sold to west European investors outside Greece.

The Athens government has outstanding securities of euro290 billion, more than twice those of the U.S. investment bank Lehman Brothers, whose bankruptcy brought the world financial system to its knees.

Those fears have pounded stock markets in recent days, with German, French and British stocks closing down 1.8, 3.4, and 1.5 percent down Friday. What would have been a bounce on Wall Street from positive jobs figures remained flat.

On Friday, the Portuguese opposition passed their own bill, which the government says will punch a euro400 million ($550 million) hole in its budget over the next four years. The government says it is "irresponsible" and that it will try to annul it, risking new political friction.

"The risk of contagion now is very very serious. By the end of next week, if things haven't calmed down or if they have actually intensified further, then it will be a matter of a short while before some steps are being taken," Simon Tilford, chief economist at the Centre for European Reform, said.

European officials have said there is no need for a bailout for Greece and that it will be able to borrow the euro54 billion it needs to plug its budget gap this year.

They say Greece must climb out of the crisis by itself, warning against a financial rescue that would reward Athens' decades-old failure to make its sluggish economy more competitive.

But Tilford said those worries are now swamped by worries of contagion within the euro zone.

"We could get into the position where we have a serious crisis in Spain which might not be containable because Spain's a bigger economy," he said. "It's possible for the euro zone to cope with a bailout in Portugal or Greece but Spain would present a problem of a whole different order."

Governments around the world are going to issue huge amounts of debt this year, making it hard even for countries with good prospects to attract investors who can pick and choose bonds to buy.

That environment will also hike the cost of borrowing for other debt-laden EU members that don't use the euro -- such as Britain and Hungary, and making their debt troubles harder to climb out of. However, Greece and Portugal "are right at the bottom of the developed country pile," says Tilford.

Together, Greece and Portugal make up less than 5 percent of economic output in the 16-nation euro zone and would be far less expensive to bail out than Spain, where the economy is a much larger 11.7 percent of euro zone GDP.

Spain has tried to shrug off a comparison with Greece and Portugal -- but markets were dubious following comments by EU Economy Commissioner Joaquin Almunia who said Wednesday that high wages and low productivity in all three make them less competitive against other European nations.

Changing that would mean wide economic reforms -- such as making labor conditions more flexible and opening up markets for goods and services. Greece is promising to do this but markets doubt that it can in time to generate growth.

In the meantime, hefty public spending cuts could wreck any chance of economic recovery.

"The reason why investors are so scared is that they find it difficult to see how these economies are going to return to reasonably robust growth or any growth," said Tilford, adding that a devaluation usually accompanies such cuts.

Euro countries no longer have their own currency to devalue, which boosts exports and makes them more attractive manufacturing destinations. So instead they have to force wages down by other means, in part by cutting them for public sector workers.

They also have to work toward getting back below the strict EU limits on debt and deficits that the financial crisis has forced them to break, as they spent billions to rescue banks and boost economic growth with extra spending and welfare payments.

Ireland has been widely praised for a harsh budget program to curb its deficit -- which, unlike the Greek plan, contains big public sector pay cuts. But Greece faces problems that Ireland doesn't -- an aging population, few foreign exports and a credibility problem after it falsified economy statistics last year to make its deficit look smaller.

Greece has pledged to bring its deficit down to the EU limit by 2013 -- but there are serious doubts about whether it can, given the huge economic reforms that the EU says are needed and growing public opposition to an austerity program that aims to slash public spending.

Greek tax and customs officials were on strike for a second day Friday while civil servants will walk off the job next Wednesday. However, the government had some relief on Friday as farmers scaled down highway blockades despite not winning the extra subsidies they want.

Tilford said the euro zone also needs to think about the divide between northern export-led countries and its southern big spenders. Germany and the Netherlands "need to consume more" to lead the demand needed to propel Europe out of a long period of stagnant growth.

Associated Press writers Jane Wardell in Iqaluit, Canada, Barry Hatton in Lisbon, Portugal, and Elena Becatoros in Athens, Greece, contributed to this story. Pan Pylas reported from London.

http://finance.yahoo.com/news/Europes-debt-crisis-apf-4191247252.html?x=0&sec=topStories&pos=6&asset=&ccode=