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## The Austerity Medicine Is Being Taken, and Now We Wait to See Its Side Effects

- By IRWIN STELZER



It might seem like the same old story, but it isn't. Markit reports that growth in the euro zone continues to moderate, to the slowest rate in a year, and that disparities continue: France and Germany are growing, while "conditions deteriorated further in the region's periphery." And early data suggest that France will experience a slowing of growth in coming months, although the wave of strikes that are curtailing fuel supplies will make it difficult to separate the transient effects of that unrest from longer-term, more enduring developments.

Nothing much new there, except perhaps that the scale of the dissatisfaction with President Nicolas Sarkozy's plan to extend the retirement age to 62 from 60 was underestimated, and the willingness of students who have yet to work a day in their lives to join those protests, introducing a level of violence the trade unions sought to avoid, was unforeseen.

So much, so old hat. One thing is new: We are getting a better understanding of which side might just have it right in the policy battle—that is the only way to describe it—that is raging among economists. The European Central Bank's austerity-now prescription medicine is being taken by most

countries, while the International Monetary Fund's warning that the side effects of an austerity overdose include significantly slower growth and higher deficits is being ignored.



Associated Press

Spanish Prime Minister José Rodríguez Zapatero reshuffled his cabinet last week.

Spain, Portugal, Greece, Ireland and now Britain have joined the austerity-now club. Spain's economy is larger than any of the others except Britain's, and is struggling to record any growth. Its unemployment rate is stuck at 20%, in June its borrowing costs hit their highest level since the euro was introduced, and the government is under such pressure that Prime Minister José Rodríguez Zapatero has had to reshuffle his cabinet in the hope that new faces will enable him to meet new demands from Brussels for still more spending cuts. In Portugal, the deficit rose in the first nine months of the year as a consequence of a fall in income tax receipts and a rise in spending on the unemployed.

Greece has religiously swallowed the austerity medicine since it was first prescribed. That, plus China's promise to buy Greek bonds when the government returns to the markets next year, and investors' expectations that the euro zone countries will do whatever is necessary to avoid a restructuring, has resulted in an improvement in investor

sentiment towards the country. But the economy is declining at perhaps twice the 4% rate the IMF predicted, consumer demand has collapsed, credit is tight, business confidence is low, and the housing and construction markets continue to contract. Worse still, the government has reached its deficit-reduction target only by exceeding planned spending cuts, as "revenues... have consistently fallen short of the program targets," reports Nick Kojucharov of Goldman Sachs. Further spending cuts are probably unobtainable, and unless the promised amnesty for tax cheats produces a large flow of revenues, it is difficult to see how Greece can make much of a dent in its deficit.

Which brings us to Ireland, which has finally confronted the fact that all the spending cuts and tax increases that are imaginable cannot put it in a position to save all of the creditors of Anglo Irish Bank from a haircut. Holders of some €2 billion (\$2.8 billion) of junior debt are being offered anywhere from five cents to 20 cents on the dollar, and threatened with an even closer cropping if they turn the offer down. If these haircuts for junior creditors come, can shavings for senior debt be far behind, even though the Dublin barber has promised to sheath his shears when dealing with senior creditors?

The tale of British austerity is yet to be written. Bond markets reacted to the announcement of an £81 billion (\$127 billion) cut in spending over four years by bidding up gilts to a level that brings interest rates (inversely related to bond prices) down to 1.43%, below even that enjoyed by rock-solid German bunds. Whether that was a way of applauding austerity, or anticipating that cuts of this magnitude will slow the economy, or that fiscal tightening will prompt the Bank of England to keep interest rates low by buying gilts, can't yet be determined.

What can be determined is that the ECB has won its fight for austerity-now, and that the countries that are moving down that path are not having immediate luck in reviving their economies or reducing their deficits. But austerity is a longer run play, and there are signs that the markets are not demanding immediate results.

Peripheral bond yields are no longer soaring, and although they remain elevated, seem to be stabilizing. Most of the peripheral countries have completed most of the borrowing they had to accomplish this year. No governments have yet fallen, and no sovereign debt has yet been repudiated. The key word is "yet."

—Irwin Stelzer is a director of economic-policy studies at the Hudson Institute

Write to Irwin Stelzer at [irwin.stelzer@wsj.com](mailto:irwin.stelzer@wsj.com)