

Eurozone austerity moves increase threat of deflation

By [David J. Lynch](#), USA TODAY

From a new crisis tax in [Portugal](#) to the elimination of [Spain's](#) "baby checks," [Europe](#) is embarking upon a protracted period of austerity. The belt-tightening in several continental nations is needed to curb ballooning government debt loads that have spooked investors.

But in trying to resolve their fearsome public debt crisis, European leaders may be risking another equally dangerous malady. The new debt-fighting measures will siphon demand from a eurozone economy that was expected to barely grow 1% this year even before concerns over a potential Greek default roiled world markets.

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Now, some analysts warn that the fiscal discipline could even tip Europe into outright deflation, a potentially destabilizing episode of self-reinforcing price declines that once begun would be enormously difficult to escape. Already in April, consumer prices fell in Spain for the first time since the government began keeping such records in 1986.

"The European situation is dicey. ... Deflation risks globally are high and rising," said David Rosenberg, chief economist of Gluskin Sheff, a Toronto-based investment firm.

European retrenchment will have implications for U.S. policymakers, who confront a federal budget deficit this year of an estimated 10% of gross domestic product. Even though the economy is showing signs of strength, the Obama administration is reluctant to do anything that would reduce domestic demand until the nearly double-digit unemployment rate begins declining. Some analysts say that the [Bush](#) tax cuts scheduled to expire in December 2010 could be extended, if only temporarily, as [Harvard University](#) economist [Martin Feldstein](#) suggested last week.

"The creditors of the United States government will not sit there idly in perpetuity if the deficit is basically left to inertia or lack of political will to fix it. Within the next six to 12 months, I think it's important to make some progress in that direction," said George Magnus, senior economic adviser to UBS in London.

The nascent global rebound was fragile even before the debt crisis erupted. Earlier this week, the [Organisation for Economic Co-operation and Development](#), the Paris-based club of wealthy nations, said its composite leading indicators were pointing to a slowdown. In the latest [OECD](#) data from March, France and Italy were virtually moribund. Powerhouse developing economies such as China and Brazil also were showing signs of weakening growth.

Several of the eurozone's most heavily indebted members are small economies, such as Greece, where cutbacks in spending won't have a major global impact. But Spain, the world's ninth-largest economy, also is trimming state spending, including canceling the roughly \$3,000 payment parents receive with the birth of each child.

The newly frugal mood shows signs of spreading to Europe's core. France is freezing government spending after inflation through 2013. German Chancellor [Angela Merkel](#) has canceled plans for new tax cuts. And the new British government says that corralling its swollen budget deficit is its top priority.

Rob Shapiro, chairman of the Washington, D.C., consulting firm Sonecon, also says Europe could witness debt defaults by up to five countries: Greece, Portugal, Spain, Italy and Ireland. "Should we have serial defaults, we are in a second financial crisis," he said.

Not everyone buys the deflation scare. [Morgan Stanley](#) analysts told clients last week that crisis-fighting efforts will mean looser monetary policy in Europe and the United States. Commodity and stock prices should rise as a result, they say, and that could boost global inflation.

For now, however, the inflation expectation remains a minority view. Commodity prices have fallen amid the Greek crisis. A barrel of oil that sold for \$87 on April 6 now costs \$71.61, and copper prices dropped 12% over the same period. Given the ongoing debt pay down, or deleveraging, underway in the U.S. and elsewhere, inflation remains a distant concern, Rosenberg said.