Austerity's Achilles' heel

For the past five years, members of the European monetary union have been swinging the axe at public budgets to rebalance their books. Europe's age of austerity has been grueling and, for some, there is no end in sight.

In 2009, Greece's debt-to-GDP ratio stood at a desperate 127 percent. After five years of public spending cuts—a contingency of its bailout—that has surged to 177 percent amid a humanitarian crisis of mass unemployment and economic ruin. Other parts of the eurozone are also struggling, particularly to the south, where cuts have been felt the deepest. Countries have been conserving themselves into stagnation.

Deficits are tightening, but public debt—both gross and relative to economic output—remains stubbornly high. This is one of two reasons investors continue to have cold feet about Europe. State Street Global Exchange's global investor confidence index fell by 5.5 points in January to 106.7, with sentiment in Europe behind the flagging numbers. The other cause for concern is a lack of meaningful growth.

Even Germany, routinely lauded as Europe's "economic powerhouse" has seen demand sag in recent times. As recently as last August, before the crisis in Ukraine escalated, factory orders tapered by 5.7 percent, the biggest monthly fall since the height of the global financial crisis in January 2009. Thankfully, the country has turned a corner more recently.

Tepid economic activity is having a dampening effect on investor demand. The EURO STOXX 50—a composite of the 50 biggest companies trading in the currency bloc—finished 2014 virtually where it had started at the beginning of the year. It wasn't until markets were confident that Mario Draghi was going to fire his monetary "bazooka," a larger than expected €1.1 trillion stimulus triggered in January to prop up stock markets and keep government borrowing costs to a minimum, that investors reacted with their wallets, sending the index up.

But Europe has a long way to go before it is out of the mire. By the third quarter of 2014 there were signs that debt may finally be receding, yet countries will have to stay the course for years to come. Unfortunately, and despite the European Central Bank's best efforts in bailing out the continent's periphery and keeping the currency union intact, the future of its austerity program has never looked less certain; and if there's one thing that investors hate, it's uncertainty.

Snap stats: eurozone

GDP growth **2014: 0.9%**
Gross debt **2013: €9.029 trillion**
Gross debt **2014: €9.292 trillion**
Debt-to-GDP **2013: 90.9%**
Debt-to-GDP **2014: 91.9%**
Debt-to-GDP ratio required by Maastricht criteria for eurozone accession: 60%

Source: Eurostat, as at end of second-quarter 2015.

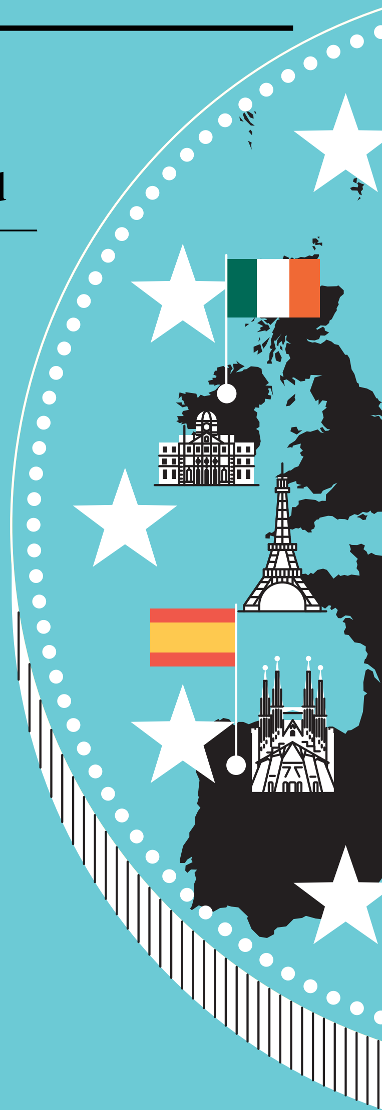
Years of fiscal tightening and inevitable economic hardship have provided fertile ground for socialist politics. Greece's recently elected leftist Syriza party rose to power on a key manifesto: to call time on austerity. The country's prime minister, Alexis Tsipras, wishes to renegotiate the terms of the country's current borrowing program. So far the Troika—the three-piece commission comprising the European Central Bank, International Monetary Fund and European Commission—have held firm, refusing to pardon debts. Greece has softened its pre-election stance and put forward reform proposals, essentially winning itself extra time and temporarily staving off a default.

But this is no more than a grace period. Greece has only a few months to negotiate a more definitive way forward. In that short time, the question of how to overcome Europe's ongoing austerity fix and the balance between growth and prudence will not be answered. Not only that, investors will be all too well aware that populist politics are gathering steam, adding more risk to the mix.

In Spain, the latest opinion polls show that its radical left anti-austerity party, Podemos, has a strong chance of winning the country's next election, due later this year. Like Syriza following its election victory, Podemos has toned down its earlier demands, including a call for Spain to default on its national debt, a move that could derail the eurozone.

As the party continues to win support, it will have its eye firmly on developments in Greece, which will set a precedent for the rest of Europe. Investors will be hoping for minimum rhetoric and maximum pragmatism.

"Deficits are tightening, but public debt—both gross and relative to economic output—remains stubbornly high. This is one of the reasons investors continue to have cold feet regarding Europe"



FINLAND

GDP 2013: €202 billion
GDP 2014: €204 billion
Gross debt 2013: €112.7 billion
Gross debt 2014: €121.1 billion
Debt-to-GDP 2013: 55.8%
Debt-to-GDP 2014: 59.3%

Political risk:
Like Germany, Finland's public accounts are in order, and it believes the only way forward is a dose of austerity. Outgoing prime minister Alex Stubb refused Greece's pleas to have part of its debts pardoned and argued against the short-term loan extension that has now been granted. Stubb's center-right National Coalition party may have lost power in the elections in April, but its liberal opponent, Centre, is leading a new coalition government and is less prone to populism than parties elsewhere in the eurozone.

IRELAND

GDP 2013: €174.8 billion
GDP 2014: €185.4 billion
Gross debt 2013: €215.3 billion
Gross debt 2014: €203.3 billion
Debt-to-GDP 2013: 123.2%
Debt-to-GDP 2014: 109.7%

Political risk:
As one of the first recipients of bailout funding, Ireland knows all about austerity. Thus far, there has been enough political will to commit to the conditions of its rescue and it is making admirable progress, but the country is saddled with considerable debt since propping up its banking sector. Established left-leaning party Sinn Féin continues to build momentum in the run-up to Ireland's election, which will go ahead no later than April 2016. Anti-austerity is at the very center of the party's manifesto.

SPAIN

GDP 2013: €1.049 trillion
GDP 2014: €1.058 trillion*
Gross debt 2013: €966.2 billion
Gross debt 2014: €1.034 trillion
Debt-to-GDP 2013: 92.1%
Debt-to-GDP 2014: 97.7%

Political risk:
Podemos is second only to Syriza in challenging the course of austerity. The leftist party was formed just last year and has already corralled enough support to make it a serious contender for the next election, due in 2015. Its secretary general, Pablo Iglesias, has stood defiantly side-by-side with Greece's prime minister, Alexis Tsipras, in calling for an urgent easing of austerity policies.

FRANCE

GDP 2013: €2.114 trillion
GDP 2014: €2.142 trillion
Gross debt 2013: €1.953 trillion
Gross debt 2014: €2.038 trillion
Debt-to-GDP 2013: 92.3%
Debt-to-GDP 2014: 95%

Political risk:
France is committing itself to austerity, but that commitment hasn't come without its problems. President François Hollande was forced to dissolve his socialist government in August 2014 after dissenting comments from Economy Minister Arnaud Montebourg over Paris's compliance with austerity. A new administration, absent of dissidents, was reassembled by Prime Minister Manuel Valls, although he has since called for leniency: "Be careful how you talk to the countries in the South, and be careful how you to talk to France," he said in October 2014, addressing Germany and EU institutions. Elections in France are not due until 2017.

GREECE

GDP 2013: €182.4 billion
GDP 2014: €179.1 billion*
Gross debt 2013:€319.1 billion
Gross debt 2014: €317.1 billion
Debt-to-GDP 2013: 175%
Debt-to-GDP 2014: 177.1%

Political risk:
There is no greater threat to the future of the current eurozone austerity program than Greece. Its debts continue to spiral out of control as its economy sinks. This gave the country's radical left Syriza party the perfect environment in which to win power in January. It has negotiated a short-term extension on its existing loans, while conceding that it won't be able to write off Greece's debts. However, it does appear to have won a crucial concession to lower its public budget surplus target down from 4.5 percent. All anti-austerity parties preparing for elections will be keenly watching Syriza's progress.

ITALY

GDP 2013: €1.609 trillion
GDP 2014: €1.616 trillion
Gross debt 2013: €2.069 trillion
Gross debt 2014: €2.135 trillion
Debt-to-GDP 2013: 128.5%
Debt-to-GDP 2014: 132.1%

Political risk:
When center-left prime minister Matteo Renzi said at the beginning of February 2015 that he would offer "bilateral cooperation" to dialogue between Greece and Germany, he hinted at his desire to change the current course of the austerity program. Like others, he believes that Italy and other parts of Europe would benefit from fiscal expansion: higher taxes and expenditure in the public sector producing much needed economic growth. The country is due for an election no later than 2018.

GERMANY

GDP 2013: €2.809 trillion
GDP 2014: €2.904 trillion
Gross debt 2013: €2.166 trillion
Gross debt 2014: €2.170 trillion
Debt-to-GDP 2013: 77.1%
Debt-to-GDP 2014: 74.7%

Political risk:
The lynchpin of the austerity program, Chancellor Angela Merkel has demanded that Europe tighten its belt and has the full support of the Troika. As the largest and one of the most fiscally robust economies in the region, Germany's word carries weight. The country is not due for a federal election until 2017.

Data source: Eurostat, as at end of second-quarter 2015. Figures cited were accurate at the time of going to press and subject to change.
**Provisional.*