Investors could put euro zone to test after downgrades

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In a bid to put the crisis to bed, most European countries have been embracing Mrs. Merkel's prescription of austerity to resolve what markets say is their big problem: high debts and deficits. Prime Minister Mariano Rajoy of Spain on Saturday pledged spending cuts and a cleanup of his country's banking system, while Mr. Fillon acknowledged that "the drifting off course of our public finances in the last 30 years is a major handicap."

But in their zeal to mend their balance sheets, European leaders have until now rarely been heard talking about how they can take advantage of the crisis — as Germany has with past crises — to rebuild their economies for the future by investing in new technologies or making their labor markets more flexible.

"In one sense the resources — human, natural — of Europe are not much different than before the crisis, so our potential is not that different," Joseph E. Stiglitz, the Nobel laureate, said in an interview before S.&P.'s downgrade Friday. "But what's clear is that misguided policies and market failures are leading Europe not to use its resources well, by not investing in people and capital, or improving technology, in a way that will help them be more competitive with what's going on in Asia."

In addition to France, S.&P. downgraded Austria, Italy, Spain, Cyprus, Portugal, Malta, Slovakia and Slovenia.

S.&P.'s assessment revealed little new about the European crisis. But it was a potent reminder that at the heart of the euro zone's problems — perhaps more than its fragile banks and political disarray — is the gap in competitiveness between Europe's wealthy northern countries and the more spendthrift south.

"The current financial turmoil stems primarily from fiscal profligacy at the periphery of the euro zone," Standard & Poor's said in a statement. But the biggest problem, the agency added, is the "divergences in competitiveness between the euro zone's core and the so-called 'periphery.'"

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In other words, politicians, especially in southern European countries like Greece, Portugal and Spain, are focusing so intently on cutting spending and raising taxes to placate international investors that they are not devoting sufficient resources to renewing their economies to be more competitive with their northern neighbors and more potent forces like China and Eastern Europe.

In a conference call Saturday, Moritz Krämer, a managing director at S.&P., was blunt, saying politicians had missed the mark in their diagnosis of the crisis.

"All countries are focusing so much on budget remedies by reducing their excessive deficits, especially in the peripheral countries," he said. "But the euro crisis is due primarily to a divergence in competitiveness that has not stopped growing between certain euro countries since the introduction of the single currency."

From that perspective, the focus on stricter budgetary discipline is not enough to cure Europe's problems, economists say. A few years ago, for instance, Germany's budget deficit was higher than Spain's, but the competitiveness of the German economy far outpaced that of its southern neighbor. A major reason is that Germany spent the better part of a decade reworking its inflexible labor market and revising a costly and cumbersome social safety net. Those changes have helped to turn Germany into the economic powerhouse that it is today.

Of course, being in the euro zone helped. Because the single currency also made the price of German goods less costly, Spain, Portugal and other countries in the south of the zone snapped up German products when times were good. Now that their economies have crumbled, they see as unfair Germany's portrayal of them as lazy southerners.

The issue, economists say, is how to improve productivity, and they ask whether Southern European economies can ever be diligently reformed, as Germany's was. Workers in southern tier countries, for example, often cite studies showing that they work longer hours than their neighbors in Germany. Indeed, Greeks with full-time employment worked an average of 42 hours a week last year, according to Eurostat, the European Union's statistics agency, while the average in Portugal was 38 hours. In Germany, the average was just over 35 hours.

But the impact on competitiveness was starkly different. A Eurostat index measuring labor productivity per person employed in each country gave Germany a mark of 105 in 2010, the latest year for which data were available. But productivity was only 94.8 in Greece and 76.4 in Portugal.

What's more, austerity measures seem to be frightening investors who would otherwise pump money into the economy and help create jobs in the private sector. Many realize that it will be harder for Europe's strapped countries to get back on their feet if economic growth has slowed sharply because of budget cuts and tax increases.

A number of large and medium-sized businesses around the world are sitting on piles of unspent cash amid the financial crisis. None of the measures that any of Europe's crisis-stricken countries have adopted has done much to lure them to the table.

"Companies are asking if fiscal policies are sustainable in Europe," said Stefan Schneider, the chief international economist at Deutsche Bank in Frankfurt. "They are saying, 'We are worried about whether the tax burden would rise.' They are not prepared to commit to production or to invest. It's going to take time."

Mario Monti, the new Italian prime minister, is one of the few top politicians who has refused to remain silent on the issue. Barely two months after Mrs. Merkel and President Nicolas Sarkozy of France welcomed him to Europe's bargaining table, he recently told Mrs. Merkel to her face that austerity alone would not resolve Europe's woes.

This weekend, Mr. Monti seized on S.&P.'s assessment to bolster his argument that politicians must now focus just as much on planting the seeds for future growth as they do on trying to repair their finances through austerity. Europe needs to support "national efforts in favor of growth and employment," Mr. Monti told the newspaper Il Sole 24 Ore.

Jack Ewing reported from Frankfurt.