Despite debt deal, Europe may slide into recession

DAVID McHUGH - AP Business Writers - Associated Press

Europe may be able to dodge a financial meltdown. It may not be able to avoid a recession.

The deal European leaders reached last week is intended to defuse the continent's debt crisis and avert a panic like the one that nearly toppled the U.S. financial system in 2008.

Skeptics caution that the agreement isn't a long-term solution to the debt crisis. Even if it were, the pact did nothing about other threats to Europe's economy: deep cuts by over-indebted governments, high unemployment, stingier bank lending and declining exports.

Many economists think Europe is nearing a recession that would harm the United States, China and other countries whose economies depend on the continent. The problems are illustrated by The Associated Press' latest quarterly Global Economy Tracker, which monitors data in 30 countries:

— Four nations — Italy, Spain, Britain and Norway — reported annualized growth of less 1 percent in the April-June quarter. Economies generally must grow at least 2.5 percent a year just to keep unemployment from rising.

— Spain had the highest unemployment among countries the AP tracked: 21.2 percent in August. It was followed by Poland's 9.4 percent.

—Greece and Italy were buckling under the weight of government debt. In Greece, those debts equaled 161 percent of national output in the January-March quarter, second to Japan's 244 percent. Italy's government debt equaled 113 percent.

Financial markets have been spooked by fears that Greece and perhaps larger countries, like Italy, would default on their debts. Banks would be stuck with huge losses on their government bond holdings.

European banks agreed last week to take a 50 percent loss on their Greek bonds. They will also set aside more money to cushion against future losses. In addition, eurozone leaders hope to strengthen their bailout fund to keep the crisis from spreading to bigger countries.

Financial markets roared their approval.

Jacob Funk Kirkegaard, a research fellow at the Peterson Institute for International Economics, says the deal helped ease fears of a catastrophe.

"We're not going to have a disorderly Greek default," he says. "We're also much less likely to have a large European bank suddenly collapse."

But analysts noted the paucity of details, wondered how many banks would adopt a voluntary 50 percent write-down on Greek bonds and questioned where the money for the enlarged bailout fund would come from. European leaders last week approached China for financial help.

Kirkegaard expects the continent to slip into a mild recession late this year or early next, though its strongest economy, Germany, may escape a downturn.

Economic growth in the 17 countries that use the euro will slow to 0.3 percent next year from 1.6 percent this year, the Organization for Economic Cooperation and Development estimated Monday. Some European economies may stop growing altogether, the organization of wealthy nations warned.

One reason for the pessimism: Smaller countries, particularly Greece, Ireland and Portugal, are slashing spending. The bigger ones are raising taxes and also cutting spending.

Italy, Europe's No. 3 economy, is carrying out a $76 billion package of spending cuts and tax increases to try to convince bond investors it won't default on its debt. Britain has imposed an austerity program that's stalled growth.

The debt crisis has shaken the confidence of those whose spending must fuel growth. Business executives and consumers seem less likely to step up purchases for new factories or SUVs.

And the prospect of having to absorb huge losses on their bond holdings has caused banks to retrench. The European Central Bank's October lending survey showed that banks cut net credit to businesses by 16 percent in the July-September quarter. The 124 surveyed banks expected even tighter credit as the year ends.

Automaker Daimler AG said last week that it saw little prospect of significant growth in Western Europe. Its French competitor Peugeot Citroen SA said it would cut 6,000 jobs because of flat demand in Europe.

The weakness has already caused pain across the Atlantic.

Jeff Fettig, CEO of U.S. appliance maker Whirlpool, said Friday that demand is tumbling in parts of Europe. Whirlpool cut its earnings estimates and said it would lay off 5,000 in North America and Europe.

The United States exported $240 billion in goods to the European Union last year — more than twice its export total to China. U.S. companies have also sunk $2.2 trillion into long-term investments in Europe, such as factories and acquired companies. No other region comes close to drawing so much U.S. investment.

Germany has 2,200 American-owned companies. General Motors and Ford Motor Co. have divisions based there. ExxonMobil Corp., ConocoPhillips, GE, IBM, Hewlett-Packard Co., Procter & Gamble Co. and Dow Chemical Co., all generate billions in annual European sales.

Exports have accounted for 47 percent of growth since the Great Recession ended in mid-2009. That's more than twice their share after the previous three recessions.

"It is the reason Europe matters," says Steve Blitz, senior economist at ITG Investment Research.

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Wiseman reported from Washington.

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