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Europe Signals Global Gloom
World Markets Fall as Continent’s Debt Crisis Fuels Worries of Lengthy Slowdown

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FRANKFURT—International financial markets tumbled as a darkening global economic outlook and deepening fissures in Europe over its debt crisis fueled fears the world economy could slip into a period of prolonged malaise.

The Stoxx Europe 600 index fell 4.1% Monday, with banks hard hit. The euro slid below $1.42, its lowest in a month. The declines followed a slide in Asia, where stock indexes in China and Japan dropped by about 2% Monday. On Tuesday morning Asian markets again moved lower, with Japan shares falling 1.2% by late morning. During early Asian trading the 10-year U.S. Treasury yields hit as low as 1.911%, the lowest level in at least five decades, according to traders.

U.S. markets, which were hit on Friday by a dismal job market report, were closed for Labor Day.

Monday’s rout is a sign investors increasingly worry that a mix of slow economic growth and high public debt will tip the global economy back into a recession.

"There is clearly a recognition that the debt crisis started in Europe, but the story is similar across the Western world," said Silvio Peruzzo, economist at Royal Bank of Scotland.

Though both the U.S. and Europe emerged from recession about two years ago, a recent string of economic data suggests the recovery is fading on both sides of the Atlantic. A report Friday that the U.S. posted no job growth in August was a watershed, Mr. Peruzzo said, "a turning point" showing that economic risks are turning negative.

Until recently, the global economy appeared on track for a solid, if unspectacular, recovery, led by emerging markets such as China, India and Brazil. As a top exporter of specialty machine tools, Germany in particular benefited from this growth, and so did the Netherlands and Austria, helping the euro bloc offset weakness in Greece and Ireland.

Trouble Ahead
Europe’s selloff was an ominous start to a key week.

Tuesday: Euro-zone 2nd-quarter GDP expected to be confirmed at a 0.7% rise.

Wednesday: German constitutional court rules on Germany’s participation in Eurozone bailout fund.

Thursday: ECB expected to signal steady interest rates for several months.

Friday: G-7 finance officials meet in France

Now emerging markets, though still expanding, aren’t growing fast enough to lift the entire global economy. U.S. consumers, burdened by unemployment and a continuing housing slump, are unlikely to generate a new consumption boom. That leaves the global economy without a potent growth engine.

Some investors are concerned that more-mature economies have entered a period of prolonged weakness related to heavy debts and aging populations.

Analysts attributed Monday’s stock selloff, sending shares down around 5% in much of Europe, to a multitude of factors. Among them, the market anxiety reflects a concern that euro-zone officials “are not able to get a handle on this crisis,” said Carsten Brzeski, economist at ING Bank in Brussels.

The negative turn comes at the start of a pivotal week that includes the European Central Bank’s monthly decision on interest rates and a decision by a German court on the legality of Germany’s participation in Europe’s €440 billion ($625 billion) rescue fund.

The ECB purchased Italian and Spanish government bonds Monday in a bid to keep 10-year borrowing costs from rising further above 5% —a threshold analysts say is key to their ability to finance their high debt loads. The ECB has purchased over €50 billion in bonds since reactivating the program four weeks ago.

ECB officials make clear they are buying bonds reluctantly until the rescue fund is granted power to intervene in bond markets. ECB President Jean-Claude Trichet said Monday there is an “immediate need” to implement Greece’s second bailout, which included a pledge by governments to give the rescue fund the ability to buy bonds.
But the Greek bailout, and efforts to keep debt problems from engulfing Spain and Italy, are under threat. Talks between Greece and its international lenders at the International Monetary Fund and European Union broke down last week amid signs Athens will miss its 2011 deficit target.

Adding to the pressure, cracks are widening within the group of 17 nations that use the euro over the best way to deal with the crisis. “Reform fatigue” is spreading in countries such as Greece, where austerity coincides with a deepening recession.

The issue, analysts say, has never been one of Europe’s financial ability to bail out Greece and others; the bloc’s budget deficit this year will only be around 4.5% of gross domestic product, a fraction of the deficit levels in the U.S., U.K. and Japan. Rather, the issue is the ability of political leaders to persuade taxpayers in Germany and other prosperous countries it is in their interests to lend money to Greece.

An electoral defeat for German Chancellor Angela Merkel’s coalition in local elections Sunday served as a reminder that bailing out Greece and others, however good for the euro as a whole, has repercussions at home. “You have this continuous struggle between domestic and European politics,” Mr. Brzeski said.

For almost two years, the debt crisis was centered on small economies such as Greece, Portugal and Ireland that combine for only 6% of the euro bloc’s GDP. When the debt crisis threatened Italy early last month, the dynamics changed. Despite economic and debt problems, Italy is an advanced economy that has long been a member of the club of wealthy countries.

In recent days, doubts emerged about Italy’s ability to deliver on its promised deficit cuts, and a decision due Wednesday by a German constitutional court on the bailout fund is an added uncertainty. Neither is expected to derail efforts to stem the crisis, but they serve as a reminder that for each step policy makers take, new problems can emerge.

Roadblocks come from small countries as well as big ones. Finland already imperiled the Greek rescue by cutting a side collateral deal with Athens, prompting fury from others. A leading legislator in Slovakia, even smaller than Finland, has warned of delays in that country’s approval of the revamped bailout fund, threatening to delay the process.

“It’s a pattern,” said Mr. Brzeski. The response of policy makers at first looks good, “but then there are things missing or you need approval by politicians and all of a sudden there are new demands.”

European banks fell sharply Monday amid worries such as sovereign-debt exposure. Royal Bank of Scotland Group shares tumbled 12.3%, and Deutsche Bank 8.9%. The cost of insuring European banks against default hit record highs Monday. Default-insurance prices for Spanish and Italian government bonds increased.

In a speech Monday in Frankfurt, Deutsche Bank chief executive Josef Ackermann warned of a “new normalcy” of a volatile global economy and general market shakiness. “All of this is reminiscent of autumn 2008, although the European banking sector is, in comparison to then, much better capitalized and less dependent on short-term liquidity,” he said.

In 2008, ECB officials slashed interest rates only three months after raising them, seeking to blunt the effects of Lehman Brothers’ collapse.

On Thursday, the ECB is widely expected to signal a lengthy pause in its rate-increase cycle that began in April. But a rate cut remains unlikely.

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