Threat Spreads Across Europe

Borrowing Costs Rise Across Continent as World Bank Sees Global Impact From Crisis

By SUDEEP REDDY And BRIAN BLACKSTONE

Borrowing costs for Italy and Spain continued to surge on Tuesday, escalating calls for bigger steps from euro-zone leaders amid a new warning that the crisis is dragging down even the world’s resilient emerging economies.

Spain’s 10-year borrowing costs touched 6.80% before settling at a euro-era closing high of 6.72%, the second straight jump in the two trading days since European officials announced a bank bailout of as much as €100 billion ($126 billion) that was intended to calm markets. That fueled fears that the government itself could need its own rescue from the rest of Europe.

Italy’s borrowing costs also climbed, with its 10-year yield hitting 6.26%, the highest level of the year. Investors are frightened by the high government debt in the euro-zone’s third-largest economy.

In a further ominous sign, bond yields were higher all across the currency union—even in havens such as Germany, the Netherlands and Finland. In most other fear-driven trading days, selling in Spain and Italy has been matched by shifts into German and Dutch bonds.

Meanwhile, the World Bank forecast another pullback for global growth this year—to 2.5%, the slowest pace of the recovery—largely because worries emanating from Europe are depressing trade, tourism and confidence. It said the latest European turmoil is ricocheting through developing economies, which had propelled the global recovery over the past three years.
Separately, the European Central Bank warned governments must take strong action to stabilize European financial markets.

The latest jumps in interest rates demonstrated that the weekend action to back Spanish banks failed in its key goal: calming potential buyers of Spanish debt. The move appears to have exacerbated the country's troubles by making clear that Spain, with a weakening economy and a wide budget deficit, may need to turn to the euro zone for a rescue of its government as well.

Adding to tensions are Greece's Sunday election to determine a new government—and the nation's future in the euro zone—and next week's meeting of the Group of 20 leading industrialized and emerging nations in Mexico, where the European crisis will be a central topic.

"We're in very precarious times yet again," said World Bank economist Andrew Burns, warning of years of volatility ahead for the global economy even if Europe manages to calm the crisis for now.

Despite the Europe worries, U.S. investors pushed stocks higher as expectations built for action next week from the Federal Reserve to support the economy. The Dow Jones Industrial Average rose 1.3%, or 162.57 points, to 12573.80, in a jump that easily recouped Monday's decline.

Asian markets opened slightly higher on Wednesday morning, with Japan up 0.5%, Australia up 0.3% and South Korea up 0.3%.

The ECB repeated its call for a common banking union to shore up the euro zone's financial system, even though Germany's central bank warned such proposals are "premature" and risky.

"There is a need to...conceive a banking union as an integral counterpart of monetary union," the ECB said in its semiannual financial-stability review. Such a union would include regionwide bank supervision, deposit guarantees and a funding mechanism from banks. "These reforms will certainly take time to implement," the ECB said.

The ECB's No. 2 official, Vitor Constancio of Portugal, also said the central bank should have the power to supervise large European banks, saying it has the institutional resources and knowledge to perform such a task. He played down the recent surge in Spanish bond yields, saying markets are still digesting Madrid's recent decision to seek European aid for its struggling banks.

"What has been decided has been very pre-emptive and it has certainly contributed to stabilize very much the situation in Spain, and that should be recognized by the markets in the end," he said.

The ECB news helped limit the selloff in Spanish bonds, and even Spain's stock market closed slightly higher. But there is widespread skepticism that Tuesday's stock rally is built to last.

"Investors are going to be in a very precarious position between now and the Greek elections this weekend," said Barry Knapp, head of U.S. equity strategy at Barclays. "I would be a seller of this bounce for sure."

The idea of closer banking ties gained steam this month when ECB President Mario Draghi raised the issue in testimony to the European Parliament. But the idea got a cool reception from Germany's Bundesbank, putting the ECB at odds once again with its most powerful member.

"Recent proposals of a so-called banking union appear to be premature," Bundesbank executive board member Andreas Dombret said in a speech Tuesday. Creating a banking union "without having established a genuine, democratically
A legitimated fiscal union would risk undermining the no-bailout clause and the disciplining effects of financial markets on fiscal policy," he said.

The back-and-forth over banking overhauls is the latest sign of friction between the ECB and Germany. Bundesbank officials have been vocal opponents of the central bank's purchases of government bonds, saying they blur the line between fiscal and monetary policy. Bundesbank President Jens Weidmann also opposed the ECB’s decision to widen the pool of collateral it accepts for its loans, and has warned of the financial risks the ECB is taking onto its balance sheet through its policies.

Given Germany's influence—it accounts for 30% of euro-zone gross domestic product and is a key funding source for rescue programs—the disputes have undermined the effectiveness of ECB crisis policies, analysts said.

"You take one step forward then one step back," said BNP Paribas economist Ken Wattret. "The fact that you have high-profile figures making the case for financial integration is good...but any enthusiasm in markets is diminished by opposition" from individual countries, he said.

The rest of the world is increasingly coming to terms with a global economy that will be gripped by European troubles. Starbucks Corp. on Tuesday said its European business is struggling more than expected this quarter, as broader economic challenges on the Continent hurt the coffee giant while it attempts to orchestrate a turnaround in the region.

"It's clear we will have increased pressure on our earnings," Chief Financial Officer Troy Alstead said at an investor presentation. In the latest quarter, Starbucks saw a 1% decline in same-store sales in its Europe, Middle East and Asia division.

The World Bank found Europe's troubles are jeopardizing prospects for emerging economies through market jitters, lower capital flows and the effects of bank consolidation.

The bank estimates developing countries collectively will grow 5.3% this year, a continued slowdown from the 6.1% expansion last year and 7.4% growth in 2010. But if another global crisis hits, economic activity in developing countries could take a hit that erases nearly all of their expected growth.

Even if the latest stage of the crisis abates and growth picks up modestly next year, the bank says developing nations must brace for years of uncertainty as troubles in advanced economies become a chronic risk hanging over the global economy.

Emerging economies rebounded quickly from the 2008-09 global financial crisis largely because of strong cushions in their government budgets and their control of inflation. While their budgets remain in far-better shape than those of high-income countries, emerging economies now have less room to boost government spending if a new crisis emerges.

International Monetary Fund Managing Director Christine Lagarde, who also said Tuesday that developing countries must prepare for a worsening in the economy, urged European officials to act quickly with "decisive steps to break free of the crisis."

"Great uncertainty hangs over global prospects," she said. "Tensions are on the rise again and financial-stability risks have once more moved front and center."

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