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Europe's woes pall U.S. economic rebound

Italy's debt crisis seen as threat to eurozone, beyond

By Patrice Hill
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Just as the outlook for the U.S. economy finally brightened in recent weeks, the darkening clouds in Europe threaten to overshadow budding signs of growth.

Some critical parts of the U.S. economy recently have cast off the doldrums and shown signs of improving. Exports and manufacturing have gotten a second wind, joblessness is slowly declining, and even the stressed-out American consumer has shed some gloom and is getting into the holiday spirit, recent reports showed.

Economic growth picked up to 2.5 percent this summer after a dismal first half of the year, and economists expect it to continue apace in the final quarter of the year. While that performance ordinarily might seem unremarkable, economists view it as reassuring, considering the widespread fears of a double-dip recession only a few weeks ago.

"The news out of Europe seems darker and gloomier by the day, but the U.S. economic data continue to be the bright spot of late," said Beth Ann Bovino, chief economist at Standard & Poor's Corp. She said the modest improvements in manufacturing and employment seen in the U.S. in recent weeks have cut the risk of recession to 35 percent from 40 percent earlier this fall.

Part of the economic renaissance is due to the truce in the fiscal war — at least temporarily — between Congress and the administration, after a showdown this summer struck a heavy blow to confidence among consumers, businesses and investors, while roiling U.S. financial markets.

But analysts are now warning that the European crisis has entered a dangerous new phase that could quickly become a problem for the U.S., with Italy, the world's seventh-largest economy, succumbing to the market turmoil and forcing out long-serving Prime Minister Silvio Berlusconi. The troubles facing Italy are on a far greater scale than those plaguing smaller European economies, such as Greece and Portugal.

Italy's debt crisis threatens not only the 17-nation eurozone economy, which by all accounts already is sinking into recession, but it could bring down the entire global economy and financial markets in a way not seen since the darkest days of the 2008 financial crisis, analysts say.

"The basic problem is Europe. The fundamentals are not that bad" in the U.S., said former Federal Reserve chairman Alan Greenspan, speaking before the Council on Foreign Relations last week. He noted that the U.S. stock market has dropped in tandem with European markets and seems irrevocably tied to the drama unfolding across the Atlantic.

"If it wasn't for Europe, I think the market would be much higher" and unemployment would be lower in the U.S., because worries about the European debt crisis are prompting U.S. businesses to put off major hiring and investment decisions, he said.

Overall, Mr. Greenspan remained optimistic. If the U.S. can steer clear of the problems in Europe for a while longer, and the administration and Congress can avoid another fiscal disaster and agree on a budget plan in coming weeks, you might see a "bounce back" in the economy, he said.

Despite the growing optimism, the broadening crisis in Europe has reached a stage where it could quickly unravel into a full-scale financial panic and undo much of the gains eked out recently, analysts say.

Some investment gurus warn that an economic disaster is waiting in the wings and that Americans shouldn't be lulled into thinking all is well. They see the possibility of widespread debt defaults in Europe and even the breakup of the European Union.

"It's over. An important chapter in the 60-year history of European economic integration is coming to an end. A new, more ominous chapter is about to begin," **said Bernard Baumohl, chief global economist at the Economic Outlook Group**. "We now believe the European governments and the European Central Bank do not have the resources to avert a default by Italy, Greece, and very likely Spain and Portugal, too."

Mr. Baumohl said the economic tsunami created by a sudden breakup of the European Union would be so great it would topple the U.S. and nearly every other part of the global economy.

"The U.S. economy will suffer a hit in foreign trade at a time when Americans exports are one of the few bright spots keeping the country out of recession," he said. Further danger arises from the close connections between U.S. banks and the European banks that hold most of the European debt that's likely to go into default, he said.

"So grave is this threat that we have warned clients in recent weeks to hunker down, ride out this historic storm, move out of risky assets and focus on preserving capital," **Mr. Baumohl** said.

The only thing that can keep Europe from the brink of disaster, he added, would be for the European Central Bank to start acting more like the U.S. Federal Reserve and accommodate the Continents profligate governments by buying their bonds. That would help to keep interest rates at low levels and buy time to resolve the crisis.

The ECB stepped in and bought some Italian bonds in recent days, helping to ease rates from unsustainable levels of more than 7 percent, where they landed early last week. But the central bank has indicated there are limits to how far it will go to help out indebted governments.

"We are not there to backstop the Italian government," said Gabriel Glockler, a deputy director at the European Central Bank, said on a Washington visit Monday. He emphasized the central bank's role primarily is to keep inflation at bay while also acting to discipline wayward governments by allowing their bond rates to rise when they fail to act responsibly.

He noted that Italian bond yields have eased some since Mr. Berlusconi left the government in the hands of a technocrat over the weekend.

With bond rates rising rapidly, digging out of a debt hole becomes exponentially harder for Italy and other stressed nations. Still, Mr. Glockler and other analysts are hopeful that a full-scale meltdown can be still avoided in Europe.

Mr. Glockler said the European Union is piecing together a comprehensive program to address debt emergencies step by step, albeit not in one dramatic measure, as hoped by financial markets. He added that Italy is fully capable of getting its economic act together and averting a panic.

"Italy has been on the brink of fiscal problems for a decade," and has always managed to pull through, he said.

"Italy can still stumble out of the current crisis," said Raj Badiani, European economist at IHS Global Insight. But to do so, the country will need considerably more help from the ECB after it adopts its economic-reform program, he argued.

Harm Bandholz, economist with Unicredit Markets, pointed out that regardless of what happens in Europe, another threat is looming for the U.S. economy — the return of gridlock and partisan warfare in Washington over the budget deficit in coming weeks.

The "unseemly" budget debate "disappeared from the spotlight in recent weeks," he said, "but that is likely to change again soon."