The Washington Post

European Slump May Stall Global Rebound

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Slowdown Deepens Even as U.S. Inches Closer to Recovery

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Saturday, May 23, 2009

The financial crisis in the United States may have tipped the world into a global recession, but the biggest obstacle to a full-scale recovery may now lie on the other side of the Atlantic -- in Europe.

Yesterday, Britain reported that its economy suffered its steepest quarterly decline in 30 years and that car production fell 55 percent in April from a year earlier. On Thursday, Standard & Poor's took the extraordinary step of lowering Britain's credit outlook to negative, raising the specter of a cut in that nation's golden rating on government bonds. And some European nations, including Germany and Italy, are now in the midst of their sharpest downturns on record.

Nine months into the worst economic downturn since the Great Depression, the free fall in the United States appears to be giving way to a more measured decline, but economists are struggling to find a steady pulse in European and other industrialized nations, such as Japan, where the world's second-largest economy is also slowing the global recovery. These countries' recessions are shaping up to be both deeper and longer than the one in the United States, where the pace of job losses has eased and there are fresh signs of life in financial markets.

There are hints of stabilization in the Old World -- in Germany, for instance, investor sentiment is up amid indications that factory orders are stabilizing after months of sharp drops. But many economists now say Europe will trail the United States in pulling out of recession by at least three to six months.

Critics charge that this is partly because Europe is still moving slowly to roll out government stimulus programs and right its own ailing financial system. Some countries, such as Ireland, are so cash-strapped that they've raised taxes in the middle of a deep recession, making things worse. In addition, European leaders have only recently signaled their willingness to conduct broad, systematic stress tests on their financial institutions, similar to the ones on major U.S. banks already concluded by the Treasury Department.

Indications are that they need such tests, and fast. While U.S. banks have already written down about half the estimated $1.1 trillion in troubled loans and toxic assets on their books, Europe's financial institutions have thus far written down less than 25 percent of their $1.4 trillion in bad debts related to the crisis, according to a report from the International Monetary Fund. Many major Western European banks are also heavily invested in hard-hit Eastern Europe, where the risk of a fresh wave of corporate and consumer defaults is considerable.

"Recovery here depends on recovery abroad," U.S. Treasury Secretary Timothy F. Geithner told a House Appropriations subcommittee Thursday. "Our financial reform effort in the United States must be matched by similarly strong efforts elsewhere in order to succeed." In the face of congressional criticism of Europe, however, he defended the actions taken by its governments thus far, saying they were "better than you think."

Nevertheless, Europe's troubles are bad news for a global recovery. The 27-nation European Union accounts for almost a quarter of the world's economic activity, and its sluggish emergence from the crisis is likely to slow any rebound in world trade and foreign investment.

About one-fifth of all U.S. exports -- including big-ticket items like nuclear reactors and aircraft -- head to the E.U., with American companies including McDonald's and Google earning an increasing portion of their revenue there. The developing nations of Eastern Europe and Africa are also reliant on Western European investment, which has evaporated in recent months. Though private investors have begun plunking cash back into emerging markets in recent weeks, many developing nations are still predicting net outflows in overall foreign investment for 2009, for the first time in years.

Some emerging giants such as China and India are continuing to grow, though the pace of their growth has slowed and experts doubt it will be enough to offset the slowdown in Europe.

"The net effect is that Europe will not be an engine in a global recovery, in fact, it will be quite the opposite," said Eswar Prasad, senior fellow at the Brookings Institution and professor of trade policy at Cornell University. "Europe is going to be a drag on the world economy for the next one to two years."

Europe is grappling with complex problems. The global slump in demand for everything from cars to heavy equipment has particularly hurt its largest economy, Germany, where exports account for about 40 percent of the value of the national economy, compared with 13 percent in the United States. In the first three months of the year, the German economy shrank at a startling 14.4 percent annualized rate, compared with 6.1 percent in the U.S.

Other nations in Europe, including Spain and Britain, whose economy slowed at a nearly 8 percent annual rate in the first quarter, are also weathering American-style housing collapses. That means the E.U. -- a political and economic union of nations, some with vastly different economies -- is collectively suffering from both the economic problems of the United States and the problems of the export-dependent nations in Asia. Earlier this week, Japan reported that its economy contracted at a 15.2 percent annual pace in the first quarter, while in China, growth has slowed as exports have plummeted this year.

Yet while Europe may be worse off statistically, most Europeans are not feeling the crisis to the same level as most Americans. Millions of European workers have been spared the full impact because of strict labor laws that make it profoundly difficult for a company, in, say, France, to lay off employees in times good or bad. And those workers who lose their jobs in Europe often receive generous unemployment benefits, covering the lion's share of their lost salaries for many months.

In the short run, that may aid in keeping consumer demand relatively robust. But the longer the crisis goes on, analysts say, the more likely it is that European companies will fall behind U.S. firms in overall competitiveness, potentially reversing the productivity gains made in a number of European countries in recent years.

Some critics have also faulted the European Central Bank -- which sets monetary policy in the 16-nation zone that uses the euro -- for being too slow to lower interest rates. That might have helped prevent the profound recessions now gripping countries like Spain and Ireland. But instead, the ECB has kept an emphasis on containing inflation in nations like France, where the downturn has not been so acute.

"I think there has been a quicker response in the U.S.," said Howard Archer, chief European economist for IHS Global Insight. "The Federal Reserve has cut interest rates much more aggressively than the European Central Bank, and there is much debate about whether the fiscal stimulus in Europe has been enough."

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