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Gloom envelops markets as outlook dims

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gust, according to Markit, a financial data provider. The reading, released Thursday, was below the consensus forecast of 49.8. Both the manufacturing and services indexes declined.

Analysts said the fall in the euro zone index reflected a combination of slowing global growth, significant belt-tightening in the euro area and growing concern about the escalating sovereign debt crisis.

''Whether or not the economy dips into another recession largely depends on whether governments move to contain the crisis,'' said Nick Kounis, head of research in Amsterdam for ABN Amro. ''These surveys suggest that the window of opportunity is closing fast.''

''Clearly the risks of recession are elevated,'' he added.

Mr. Jasper of WGZ Bank said the gloomy economic backdrop belied the fact that many companies in Europe were in fact in a positive position in terms of their order books, profit margins and cash positions.

''We're in a politics-driven market,'' he said, ''and it's hard to see light at the end of the tunnel until we have a workable solution for Greece and stabilization of the situation in Italy and Spain.''

The declines in commodity markets were spurred by general investor pessimism, but also by factors unique to those markets, analysts said.

In gold, for example, ''the market had performed so bullishly across all the precious metals that a correction was probably in the offing,'' said James Steel, an analyst at HSBC. ''And it may have been used as a convenient place for some profit-taking.''

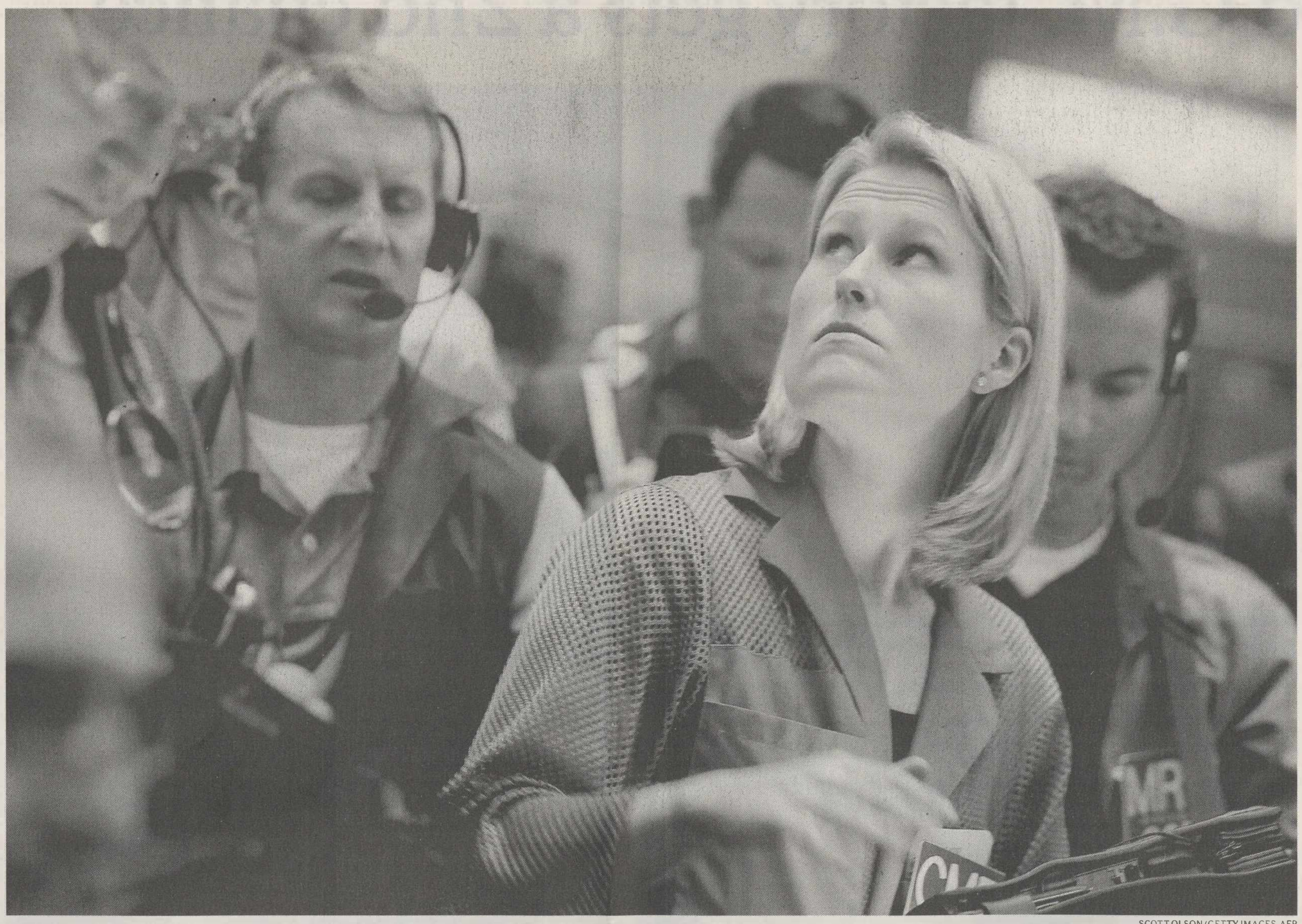
When the price of gold moved so quickly below $1,800, he added, it encouraged further selling. With sustained equity losses, investors could be using gold as it was meant to be used — to raise cash.

''This might sound perverse but gold is actually fulfilling its traditional role, allowing you to raise cash in uncertain times,'' Mr. Steel said.

Paul Zemsky, the chief investment officer of multiasset strategies at ING Investment Management, said crude oil was falling, as were industrial metals like copper, as the markets realigned their expectations for the global economy, with weak data continuing to trickle out of Europe and other regions.

''As people ratchet down their growth expectations, we need less commodities,'' he said. ''It is a pretty ugly day for stocks.''

Those growth expectations took a fresh hit Wednesday when the Fed, announcing its bond-buying program, pointed to a number of long-term problems in the U.S. economy, including high unemployment and a depressed housing market.



SCOTT OLSON/GETTY IMAGES-AFP

On the trading floor in Chicago. ''Whether or not the economy dips into another recession largely depends on whether governments move to contain the crisis,'' one analyst said.

The Fed's statement ''continued to suggest that the Fed funds rate will remain on hold until at least mid-2013,'' said Rob Carnell, an analyst in London for ING, referring to a benchmark interbank rate. He added that quantitative easing, or further bond purchases, could be introduced as early as November.

In Europe, uncertainty about the fiscal outlook for Greece persisted Thursday after Athens announced a new set of austerity measures Wednesday that were aimed at convincing international creditors to release an instalment of €8 billion, or $10.8 billion, in loans needed by mid-October to help Greece avoid bankruptcy.

The measures included cuts in civil servants' wages, lower pensions and a broader tax base. But before releasing the payments, the creditors will probably want to see the measures approved by Parliament and to know more about

“This is about to get ugly and there is very little anyone can do about it.”

a new set of privatizations, the details of which have yet to be spelled out by the government. According to local media, a parliamentary vote will be held in the next few days.

In Italy, the government lowered its forecasts for economic growth Thursday but stuck to its goal of balancing the budget in 2013, amid media reports that the government was moving toward announcing yet another batch of austerity measures. Economists at Barclays Capital said the government would have to find additional savings of €9 billion to €10 billion ''to increase the chances of reaching a budget that is close to balanced by 2013.''

In Asia, analysts said the declines Thursday showed that investors were unsure whether the Fed's action would fully address the economic slowdown in the United States.

The Hang Seng index in Hong Kong led declines in Asia, diving 4.8 percent. The Nikkei 225 in Tokyo closed 2.1 percent lower, the Kospi in South Korea fell 2.9 percent and the S.&P./ASX 200 in Australia dropped 2.6 percent.

The export-driven economies of Asia, like South Korea, are the most vulnerable to the European and American economic challenges, said Tim Condon, head of Asia research in Hong Kong for ING. Durable goods like automobiles and ships will be hurt most, he said.

Additionally, investors were beginning to worry that China's rate of growth might slow, said Dariusz Kowalczyk, senior economist and strategist in Hong Kong for Crédit Agricole CIB.

The aversion to riskier assets helped prop up the dollar in the foreign exchange markets Thursday. The euro was trading at $1.3469, down from $1.3573 in late New York trading.

On Thursday, the yield on 10-year U.S. Treasury securities hit a new low of 1.73 percent.

''It really comes down to political immaturity in both the U.S. and Europe,'' said Stephen Davies, chief executive of Javelin Wealth Management in Singapore. ''The increasing chance of a U.S. recession and European implosion has shortened the odds of an overall second recession.''

Matthew Saltmarsh reported from London. Niki Kitsantonis in Athens, Elisabetta Povoledo in Rome, Kevin Drew in Hong Kong, Robert Pear in Washington and Jennifer Steinhauer in New York contributed reporting.

Drought in bank financing raises doubts about E.U. growth

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creasingly likely. But the crisis has also raised fundamental doubts about the underlying health of the European banking system, and whether governments would be able to step in to rescue their banks in the wake of another financial catastrophe.

''Banks certainly do not have enough capital in relation to their government bonds,'' said Dorothea Schäfer, an expert in financial markets at the German Institute for Economic Research in Berlin. She has calculated that the 10 largest German banks would need to raise €127 billion, or $171 billion, to bring their capital reserves to 5 percent of gross assets — a level she considers barely adequate.

''That could substantially heighten trust, I would even say would bring it back,'' Ms. Schäfer said. But raising that additional capital would be politically fraught, because it would probably require another taxpayer-financed bailout. Many of the banks that need capital most are already owned by government entities and, because they are not listed on stock markets, cannot sell new shares to increase their capital.

The banking industry is also fighting requirements that would require them to keep more ample reserves, which would cut into profits.

According to the standard used by regulators, banks are much better capitalized than they were in 2008. Banks in Europe had so-called core Tier 1 capital — the most durable form of reserves — equal to 10.6 percent of their assets at the end of June, according to calculations by analysts at Nomura. That compares with a previous low of 6.4 percent.

For that reason, some analysts say that the alarm about bank financing is overblown.

''I don't think we're overly concerned yet,'' said Jon Peace, a banking analyst at Nomura. But he added, ''Definitely we are watching the data week by week.''

He said that banks in Northern Europe, where government debt is less of a problem, are having an easier time raising money.

Ms. Schäfer argues, though, that current measures of capital reserves are ''useless'' because they do not capture the risk from holdings of government bonds, which the International Monetary Fund this week estimated at €300 billion for European banks.

Regulations still treat European government debt as if it were risk free, though it obviously is not. As a result, banks are not required to set aside extra capital to cushion against a government default. And holdings of government bonds are excluded from the calculation of capital ratios.

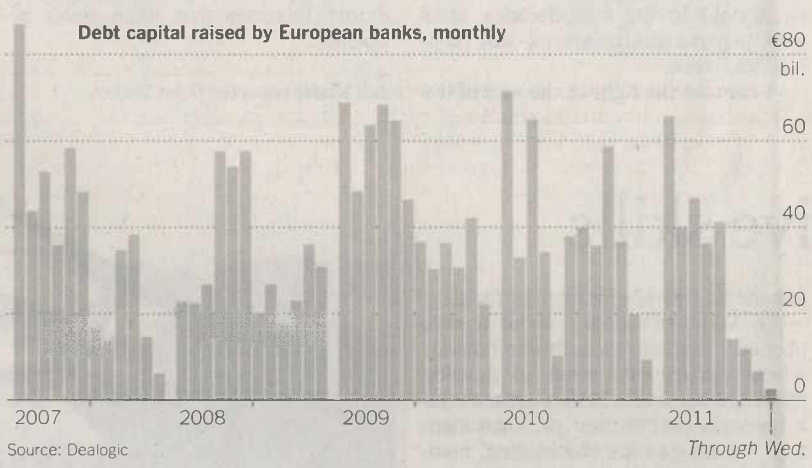
Sophisticated investors are well aware of these shortcomings, which helps explain the drastic drop in debt issuance recently. Since July, sales of bonds and other debt instruments has plummeted 85 percent compared with the period in 2010, according to Dealogic, a data provider in London.

''A lot of money has been lost,'' said Kenneth Rogoff, a Harvard professor and former chief economist at the I.M.F., during an appearance in Frankfurt on Thursday. Greek default is inevitable, said Mr. Rogoff, author of a history of sovereign defaults. ''Banks and governments may not have put it in their books,'' he said of the losses, ''but it's gone.''

Though September is not yet over, it is clear that issuance will be well below levels seen earlier this year, denying banks one of their main sources of financing. Through Thursday, Dealogic

Less debt, fewer options

Sales of bonds and other debt instruments by European banks have fallen precipitously over the past several months. August and September so far are the worst two months since the financial crisis began in 2007.



Source: Dealogic

CHRIS RATCLIFFE/BLOOMBERG NEWS

The French bank BNP Paribas dismissed a report Thursday that its executives were trying to raise capital in the Gulf. Last week it denied it had a problem raising dollars.

recorded a meager €2.6 billion in debt issues. That compares with €6.2 billion for all of August and €65.5 billion in January, the most active month for bond issues this year.

The plunge in bond issues by banks is happening at the same time that European financial institutions are having trouble borrowing from each other at reasonable rates on the open market. As a result, bank borrowing from the European Central Bank — the lender of last resort for euro zone banks — surged again this week.

In another measure of banks' suspicion of each others' creditworthiness, a closely watched measure of interbank stress, known as the Euribor-OIS spread, rose to its highest level since March 2009, according to Bloomberg data. The cost for European banks for financing in dollars rose to near the highest level in almost three years.

It is the nature of the interbank market that just a whisper of doubt about a bank's solvency can be enough to keep lenders away, and lead them to the E.C.B. loan window.

''Nobody really wants to lend to anybody where there is the slightest doubt,'' said one banker in Frankfurt involved in fixed-income markets, who did not want to be identified by name to avoid offending clients. ''Any counterparty where the market suspects underlying problems will have trouble finding liquidity from sources other than the E.C.B.''

In what investors take as a particularly bad sign, a small number of banks have also been borrowing emergency dollars from the E.C.B. That raises questions whether some large European banks are having trouble refinancing assets in the United States, a problem disturbingly reminiscent of the 2008 financial crisis.

Shares of French banks have been particularly hard hit because of perceptions that they are not prepared for potential losses on their holdings of Greek debt. Last week the French bank BNP Paribas denied a report in The Wall Street Journal that it had had a problem getting dollars on the market. The E.C.B. closely guards the identity of borrowers.

On Thursday, the bank also dismissed a report in The Financial Times saying that BNP executives were to tour Abu Dhabi and Qatar in a bid to raise fresh capital. ''I formally deny this,'' Baudouin Prot, the bank's chief executive, told BFM Radio. ''We have no particular contact because we don't need a capital increase.''

Regulations allow banks to ignore market movements in the prices of sovereign bonds, classifying the bonds as long-term holdings and pretending that governments will always pay the promised interest and principal.

But those bonds may still represent a continuing liability to banks, and another source of market nervousness.

Many banks may have borrowed money on a short-term basis to buy the bonds in the first place — for example, taking out a three-month loan to buy a bond that matures in 10 years. This is a common practice known as maturity transformation. In good times, banks can profit from the difference between short-term and long-term interest rates. But it means that banks must continually refinance the original purchase price of the bond. Without financing, or enough capital to absorb the loss, a bank can go broke.

Those bonds are worth less today in another way. Government debt is the most common asset banks use as a collateral to obtain loans in the so-called repo market, which is another crucial source of financing. But lenders have

“A lot of money has been lost. Banks and governments may not have put it in their books, but it's gone.”

become less willing to accept European bonds except at a discount to their face value, if at all.

Use of Greek, Portuguese and Irish bonds as collateral in the repo market fell by half in the second half of 2010 compared with 2009, as markets imposed steep discounts, according to a study by Michael Davies and Tim Ng at the Bank for International Settlements in Basel, Switzerland.

Adding yet another layer of uncertainty, the debt crisis has undermined the longstanding assumption that governments will step in if their domestic banks get in trouble. Lenders have begun to wonder if countries like Italy — which already has one of the world's highest debt burdens as a percentage of its economy — would even be able to.

In the B.I.S. study, which was published this week, Mr. Davies and Mr. Ng warned: ''Sovereign credit risk and its implications now pose a significant and urgent challenge to banks.''

E.U. seeks to reverse stagnation in Greece

BRUSSELS

Official speaks of giving hope to people in pain from state cutbacks

BY STEPHEN CASTLE AND NIKI KITSANTONIS

The European Union said Thursday that it was exploring new ways to try to stimulate economic growth in Greece, with one senior official acknowledging that Greek citizens were on the verge of rejecting any more austerity measures.

Horst Reichenbach, who heads a task force set up by the European Commission to give technical aid to Greece, said it was important to ''give some hope to the Greek population which, as we all know, is at the brink of not accepting any further pain.''

Mr. Reichenbach said th ''the commission, the Union's execu branch, was examining ways of allowing E.U. funding to be used to help guarantee increased lending by the European Investment Bank in order to fill a vacuum caused by the inability of Greek banks to lend to businesses. Around €15 billion, or $20 billion, in E.U. structural funds have been allocated to Greece through 2013.

His comments come amid increasing concern that, in addition to pressing for essential changes to the Greek economy, international lenders need to step up their efforts at reversing economic stagnation.

As if to underline the point, Greek transport workers staged a 24-hour strike Thursday, bringing the transit system to a standstill to protest the austerity drive deemed essential by Greece's creditors. General strikes have been called for Oct. 5 and 19.

Speaking in Parliament on Thursday, the Greek finance minister, Evangelos Venizelos, said that Greece's situation was ''critical'' and that the government's priority was to keep its commitments to foreign creditors so as to avoi what happened to Argentina, which de faulted on its debt in 2001-02.

''The crisis is not what we are livin today, namely cuts to wages, pensior and income,'' Mr. Venizelos said. ''That our effort to avert against the crisis. Th real crisis will be like that of Argentina in 2000 — a total collapse of the econor of institutions, of the social fabric a productive forces of the country.''

He added that a new property t part of the additional austerity m sures, would apply beyond 2012 and just for the next two years as sta when the levy was announced month. But the long-term unemplo would be exempt from the tax as lon their gross annual income was less t €12,000, with that threshold increas by €4,000 for each child.

Mr. Venizelos appealed for grea honesty in the debate over the econo

“The lies to the Greek people must stop.”

saying that the country's political cla must be clearer about the situation a what is required.

''The lies to the Greek people m stop,'' he said, adding that now it w time for ''work, work and more wor to meet fiscal targets and revive t economy.

The European commissioner for e nomic and monetary affairs, Olli Re said Thursday that Greece would main within the euro zone but did explicitly rule out the possibility of it faulting.

''An uncontrolled default or exit Greece from the euro zone would cau enormous economic and social dama not only to Greece but to the Europe Union as a whole, and have serio spillovers to the world economy,'' Rehn said during a speech to Peterson Institute for Internatio Economics in Washington. ''We will let this happen.''

International lenders have to deci shortly whether to release the next i stallment of aid, worth around €8 billio without which Greece probably wou default in October. Experts from t three international institutions kno as the troika — the European Comm sion, the European Central k the International Monetary Fund — likely to return to Athens early week to pave the way for a decisio the next loan.

In the meantime, longer-term w going on to try to help the Greek go ment undertake crucial changes, i ing an overhaul of a tax collectio tem widely seen as ineffe European experts believe that t to changing the system is the i tion of more information tech equipment and the creation o rules that reduce the amount of tion tax inspectors have.

Substantial changes will probab around a year, said an E.U. official thorized to speak publicly on the who likened the problem to an ic ''The tip looks O.K., but what's everyone tells me, is quite differe

Niki Kitsantonis reported from Ath