Diverging paths in the euro zone as recession looms

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Europe's economies are still on divergent paths, with Italy and Spain dragging down the region as it faces a mild recession this year that could turn far worse, an official forecast said Thursday.

While almost all countries face a slowdown, differences remain "pronounced," the report from the European Commission said. With the debt crisis hitting worst those nations with poor public finances, weak banks and a history of low growth — a cocktail common to several countries in Southern Europe.

Meanwhile, so serious is the recession in Spain that it may be given more leeway over meeting budget targets laid down by the commission, the E.U.'s executive branch.

"Decisions will be taken once we have a full picture," Olli Rehn, the European commissioner for economic and monetary affairs, said Thursday.

The euro zone economy as a whole will probably shrink 0.3 percent in 2012, the commission said. Last November, it had forecast growth of 0.5 percent.

The euro zone's large, core nations, Germany and France, are set to grow in 2012, but only 0.6 percent and 0.4 percent respectively. But pushing the projections down were a predicted contraction of 1.3 percent foreseen for Italy and 1 percent in Spain — two of the euro zone's big economies, which are also beset by debt troubles.

Of the three small countries that have received international bailouts, Ireland was expected to experience slight

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OMINOUS LOSSES AT EUROPEAN BANKS
Greek debt weighed on results issued Thursday by Royal Bank of Scotland, Crédit Agricole and Dexia. *PAGE 17*

Recession is looming for the euro zone

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growth, while Greece and Portugal were projected to suffer steep contractions.

There was a 0.1 percent drop in employment during the third quarter in both the 27-country European Union and the 17-nation euro zone, with the worst impact felt in the south. "Greece, Portugal and Spain account for 95 percent of the rise in unemployment in the E.U. since late 2010," the report said. "Additionally, Spain and Greece have seen their youth unemployment rates surge (from already high pre-crisis levels) to close to 50 percent."

The report is likely to intensify concerns that as countries enact austerity measures to appease the debt markets, they are undermining the economic growth needed to help pull them out of financial distress. The risk of a downward spiral was highlighted by the report, which suggested that, while the debt crisis has abated somewhat since December, politicians should not use that as a reason for complacency.

"If the sovereign-debt crisis were to rebound massively, with a broad surge in risk premia and spillovers across countries, severe credit rationing and a collapse of domestic demand could ensue," the report said. "Such an outcome would most likely trigger a deep and prolonged recession, not sparing even those countries which have shown more resilience so far."

"There are many pieces that have to fall into place for this to be just a mild recession."

That warning sets the stage for a battle next week at a summit meeting of European Union leaders, as Germany is resisting moves to increase the size of a firewall for the euro zone so that Italy and Spain can be protected.

The economies of the Netherlands and Belgium are both expected to contract this year, painting a more complex picture than that of a straight north-south divide. The Dutch and Belgian economies both suffered in the global business downturn. Confidence was hit further in Belgium by worries about the banking sector, following the collapse of Dexia, and in the Netherlands by a decline in home prices.

The only countries projected to grow by more than 2 percent this year — Latvia, Lithuania and Poland — are East European and outside the common currency bloc.

A recovery is "still forecast for the second half of the year but is expected to be more modest and to occur later than forecast in the autumn," the report said.

Even this could prove optimistic, however, because the findings are premised on an assumption that key decisions are made to tackle the debt crisis and restore confidence.

Mr. Rehn said Thursday that there was "a clear need to further strengthen the euro area financial firewalls," so that Europe was "fully equipped to overcome the current crisis and return to recovery." Most policy makers outside Germany are hoping they can gain momentum for bolstering the firewall after the decision Tuesday to grant a second bailout to Greece. The Greek Parliament on Thursday approved a huge bond swap that will write down around €107 billion, or $143 billion, of the country's privately held debt.

"There are many pieces that have to fall into place for this to be just a mild recession," said Marco Stringa, the European economist in London for Deutsche Bank. "What is needed is that politicians should continue to deliver at a European level even if things are improving."

As gloomy as the report Thursday was, some maintained that it could have been a lot worse. Compared with last November, "prospects have worsened and risks remain, but there are signs of stabilization especially in the recent period," Mr. Rehn said. He added that, with the exception of Greece, risk premiums, on the sovereign bonds of struggling euro zone countries had come down since mid-November — a measure of investor confidence.

Mr. Rehn also argued that there were no signs of a credit crunch after the European Central Bank offered cheap, longer-term loans to the banking sector in December.

"The new liquidity measures by the European Central Bank have contributed to the improvement," Mr. Rehn said.

Separately, a barometer of German business sentiment rose more than expected, raising optimism that the euro zone's biggest economy is growing again after declining 0.2 percent in the last quarter of 2011. The Ifo business climate indicator, considered a reliable predictor of future economic performance, rose for the fourth month in a row in February. Manufacturers, retailers, wholesalers and builders all reported feeling better about their prospects than in January.

"Today's Ifo index provides further evidence that the economic contraction at the end of last year was only a brief stopover," Carsten Brzeski, an economist at ING Bank, wrote in a note to clients. The data mean there is "at least some good news for the euro zone," he said.

Jack Ewing contributed reporting from Frankfurt.