Economic outlook remains bleak as world leaders gather

By David J. Lynch, USA TODAY

President Obama sees "glimmers of hope" in the U.S. economy, while Federal Reserve Chairman Ben Bernanke spies "green shoots" sprouting from the barren financial plain.

Look hard enough, and a few wobbly signs of life are visible outside the United States, too. China's 6.1% rate of first-quarter growth, though only about half the rate at which it was expanding in mid-2008, offers some solace. The most recent global industrial production figures show the fourth quarter's collapse in output has eased a bit from its white-knuckle pace. And after six months of downward revisions, economists at JPMorgan earlier this month even cautiously raised their global economic forecast.

IMPACT: Global recession dumps on Caterpillar

The increase, however, was a barely perceptible 0.3 percentage points. Investors greeted the prospect of world output shrinking in 2009 by 1.5% rather than 1.8% with something less than euphoria. "It's better to have some green shoots rather than nothing at all. But the green shoots could be weeds," says Kenneth Rogoff, former chief economist for the International Monetary Fund.

As the world's finance ministers and central bank chiefs descend on Washington for this weekend's annual meeting of the IMF and World Bank, those few spindly green tendrils remain pretty lonely. Business sentiment in Germany is terrible. Japanese exports are in a terrifying state of near collapse. And the evaporation of private cross-border capital flows is starving emerging economies, especially in Eastern Europe, of desperately needed financing.

For the United States, the pronounced weakness in Europe, Asia and pretty much everywhere else means a key escape route from the crisis is blocked. In previous recessions, the U.S. could export its way out of trouble. (In the three years before the crisis, exports were responsible for 47% of U.S. economic growth.) But with customers around the world digging in for a long siege, exports are "unlikely to provide much support for domestic production going forward," Federal Reserve Governor Donald Kohn said in a speech earlier this week, adding that the global economy had yet to hit bottom.

In a pair of reports this week that will guide the weekend talks, the IMF warned that despite a full-court press by major industrial and developing country governments, both the global economy and financial system remain deeply impaired. In the worst recession since World War II, world output is expected to contract by 1.3% this year.

"The downturn is truly global: Output per capita is projected to decline in countries representing three-quarters of the global economy," the IMF said.

The weekend blitz of conferences, luncheons, dinners and press statements will revolve around efforts to nail down crisis-fighting commitments agreed at the G-20 summit in London earlier this month. World leaders promised to arm the IMF with $1 trillion to battle financial contagion, but the details remain to be decided. One stumbling block: Fast-growing developing countries, such as China, want a greater say in running the fund in return for ponying up. European nations, which must swallow a smaller role, want to focus on raising money to battle the crisis and deal with so-called governance issues later.

"There's a very intense tussle going on," says Eswar Prasad, former head of the IMF's China division and now an economist at Cornell University.

Officials also are expected to work out the specifics of the IMF's future role in managing the global financial system, in an effort to prevent a repeat of the current crisis.

Negative feedback

Think of what's happening in the world economy as akin to running globalization in reverse. For two decades, blossoming trade and finance links bound nations ever tighter. Americans binged on cars from Stuttgart and dining room sets from Guangzhou, while Hungarians took out mortgages from bankers in Vienna.

Now, fewer cargo ships are visiting ports in Rotterdam, Long Beach or Shanghai; the volume of trade is expected to shrivel by 9% this year, according to the World Trade Organization in Geneva. Likewise, the torrents of cash that splashed across borders, incongruously turning the

Chinese into the USA's lender-of-first-resort, are drying up.

In the past two decades, globalization raised new economic powers; China's $4 trillion economy today is roughly five times larger than in 1991. But borderless commerce also has introduced new vulnerabilities. Banks in Austria, Belgium and Germany are massively exposed to potential loan losses in Eastern Europe.

A negative feedback loop is transmitting economic weakness into ballooning losses for financial institutions, causing them to throttle back on credit, leading to more economic pain and starting the cycle anew. "The key challenge is to break the downward spiral between the financial system and the global economy," the IMF said.

Good luck with that, a cynic might say. Financial institutions still face the painful chore of writing off more than $4 trillion in losses on troubled loans and securities, according to the IMF. Banks will absorb two-thirds of that total. And stabilizing wobbly financial markets "will take longer than previously envisaged, even with strong efforts by policymakers," the IMF warns.

Governments, especially in the U.S., have thrown just about every monetary and fiscal policy tool at the crisis that they can muster. Interest rates have been slashed to near zero in the U.S. and U.K. — the Bank of Canada cut its to 0.25% Tuesday — and lowered significantly in Europe. G-20 nations have launched major spending programs, worth almost 2% of global output, to jump-start their economies. That includes the Obama administration's $787 billion stimulus program.

The IMF, however, says more is needed. Fiscal stimulus must be "at least sustained, if not increased in 2010," the global lender says. Substantial amounts of new capital also are needed to repair damaged banks. To return banks to their pre-crisis state will require $875 billion; $1.7 trillion would be needed if regulators sought to enforce mid-1990s limits on banks. Whether the political will exists to do either is an open question.

There's no longer any doubt: This is not a garden-variety recession. As research by Rogoff and Carmen Reinhart of the University of Maryland — now confirmed by the IMF — has shown, the economic downturns that follow financial crises last longer, cost more in terms of lost wealth and are far more difficult to resolve than routine downturns.

Such episodes typically slash more than one-third off home values over six years and shrink stock prices by 56% over about 3½ years. "The sense among professionals is this could take a long time," said Donald Marron, CEO of the private equity firm Lightyear Capital in New York.

If there's any good news, it is that the acute phase of the crisis — where the world faced the greatest risk of rerunning the Great Depression — might be past. The bad news is that years of debt repayment, painful restructuring and high unemployment lie ahead.

"The crisis is probably over. The free fall in the economy has probably stopped … but the unemployment rate has a long way to go," Glenn Hutchins, co-chief executive of private equity firm Silver Lake said last week at a Brookings Institution conference.

Capital crunch

As embattled banks in Europe and the U.S. hunker down, emerging economies — where the IMF says conditions have most deteriorated since October — are feeling the pinch. Net private capital flows to such countries peaked in 2007 at 5% of emerging markets' output. This year, emerging markets are likely to suffer a net outflow of private capital with only a "slim" chance of a turnaround in the next two years, according to the IMF.

The impact is likely to be especially acute in Eastern Europe, where Hungary, Romania and Ukraine already have sought financial assistance from international lenders.

Countries in the region require large amounts of foreign money to roll over corporate and consumer loans coming due as soon as this year. As banks retrench — in part because of pressure from their governments to increase lending at home — that cash isn't available, raising the prospect of a wave of defaults and "severe loan write-downs" for affected banks, the IMF says.

Geopolitical risks also are rising because of the dislocations triggered by the economic meltdown. One country drawing increased scrutiny is Russia, where excessive dependence upon oil revenue and a limited industrial base have left the economy particularly exposed to the global crisis. The Russian economy "deteriorated dramatically in early 2009," the World Bank said in a recent report, predicting output would shrink by at least 4.5% this year.

As the financial crisis intensified late last year, the river of foreign cash that fueled Russia's multiyear boom suddenly reversed course. Foreigners had funneled $42 billion in 2007 and $81 billion in 2008 into the Russian private sector. But in the fourth quarter last year, amid the post-Lehman-Bros.- bankruptcy panic, the economy suffered a net capital outflow of more than $130 million.

Russia also has burned through more than $100 billion of foreign exchange reserves trying to support the value of its currency, the ruble. Mikhail Kasyanov, a former prime minister, said this month that the country faced "disaster" and "revolution" within a year because of the economic spiral.

Hopes for a less apocalyptic outcome, for both Russia and the global economy, rest on forecasts of a return to growth next year. As global stimulus efforts take hold and financial institutions and households work off their excesses, the global economy should begin expanding again next year, the IMF says.

But after repeated downward revisions of official forecasts, there is little reason to count on such predictions. One year ago, the IMF predicted the world economy would grow at an annual rate of 3.8% in 2009.

"It's very, very hard to figure this out," Rogoff says. "This is a once-in-a-century phenomenon."

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