A glimmer of hope?

The worst thing for the world economy would be to assume the worst is over

THE rays are diffuse, but the specks of light are unmistakable. Share prices are up sharply. Even after slipping early this week, two-thirds of the 42 stockmarkets that *The Economist* tracks have risen in the past six weeks by more than 20%. Different economic indicators from different parts of the world have brightened. China's economy is picking up. The slump in global manufacturing seems to be easing. Property markets in America and Britain are showing signs of life, as mortgage rates fall and homes become more affordable. Confidence is growing. A widely tracked index of investor sentiment in Germany has turned positive for the first time in almost two years.

All this is welcome—not least because the slump has been made so much worse by panic and despair. When the financial system was on the brink of collapse in September, investors shunned all but the safest assets, consumers stopped spending and firms shut down. That plunge into the depths could be succeeded by a virtuous cycle, where the wheels of finance turn again, cheerier consumers open their wallets and ambitious firms turn from hoarding cash to pursuing profits.

But, welcome as it is, optimism contains two traps, one obvious, the other more subtle. The obvious trap is that confidence proves misplaced—that the glimmers of hope are misinterpreted as the beginnings of a strong recovery when all they really show is that the rate of decline is slowing. The subtler trap, particularly for politicians, is that confidence and better news create ruinous complacency. Optimism is one thing, but hubris that the world economy is returning to normal could hinder recovery and block policies to protect against a further plunge into the depths.

Ominous indicators

Begin with those glimmers. It is easy to read too much into the gain in share prices. Stockmarkets usually rally before economies improve, because investors spy the promise of fatter profits before the statisticians document a turnaround. But plenty of rallies fizzle into nothing. Between 1929 and 1932, the Dow Jones Industrial Average soared by more than 20% four times, only to fall back below its previous lows. Today's crisis has seen five separate rallies in which share prices rose more than 10% only to subside again.

The economic statistics are hard to interpret, too. The past six months have seen several slumps, each with a different trajectory. The plunge in manufacturing is in part the result of a huge global inventory adjustment. With unsold goods piling up and finance hard to come by, firms around the world have slashed production even faster than demand has fallen. Once firms have run down their stocks they will start making things again and the manufacturing recession will be past its worst.

Even if that moment is at hand, two other slumps are likely to poison the economy for much longer. The most important is the banking crisis and the purge of debt in the bubble economies, especially America and Britain. Demand has plummeted as tighter credit and sinking asset prices have exposed consumers' excessive borrowing and scared them into saving more. History suggests that such balance-sheet recessions are long and that the recoveries which eventually follow them are feeble.

The second slump is in the emerging world, where many economies have been hit by the sudden fall in private cross-border capital flows. Emerging economies, which imported capital worth 5% of their GDP in 2007, now face a world where cautious investors keep their money at home. According to the IMF, banks, firms and governments in the emerging world have some $1.8 trillion-worth of borrowing to roll over this year, much of that in central and eastern Europe. Even if emerging markets escape a full-blown debt crisis, investors' confidence is unlikely to recover for years.

These crises sent the world economy into a decline that, on several measures, has been steeper than the onset of the Depression. The IMF's latest *World Economic Outlook* expects global output to shrink by 1.3% this year, its first fall in 60 years. But the collapse has been countered by the most ambitious policy response in history. Central banks have pumped out trillions of dollars of liquidity and, in rising numbers, have resorted to an increasingly exotic arsenal of "unconventional" firepower to ease credit markets and loosen monetary conditions even as policy rates approach zero. Governments have battled to prop up their banks, committing trillions of dollars in the process. The IMF has new money. Every big rich country has bolstered demand with fiscal stimulus (and so have many emerging ones). The rich world's budget deficits will, on average, reach almost 9% of GDP, six times higher than before the crisis hit.

The Depression showed how damaging it can be if governments don't step in when the rest of the economy seizes up. Yet action on the current scale has never been tried before and nobody knows when it will have an effect—let alone how much difference it will make. Whatever the impact, it would be a mistake to confuse the twitches of an economy on life-support with a lasting recovery. A real recovery depends on government demand being supplanted by sustainable sources of private spending. And here the news is almost uniformly grim.

Searching for new demand

Take the country many are pinning their hopes on: America. The adjustment in the housing market began earlier there than anywhere else. Prices peaked almost three years ago, and are now down by 30%. Manufacturing production has been falling at an annualised rate of more than 20% for the past three months. And the government's offsetting policy offensive has been the rich world's boldest.

As the inventory adjustment ends and the stimuli kick in, America's slump is sure to ease. Cushioned by the government, the economy may even begin to grow again before too long. But it is hard to see the ingredients for a recovery that is robust enough to stop unemployment rising. Weakness abroad will crimp exports. America's banks are propped up with public capital, but their balance-sheets are clogged with toxic assets. Consumer spending and firms' investment will ►►

be dragged lower by the need to pay back debt and restore savings. This will be a long slog. Private-sector leverage, which rose by 70% of GDP between 2000 and 2008, has barely begun to unwind. At 4%, the household savings rate has jumped sharply from its low of near zero, but it is still far below its post-war average of 7%. Higher unemployment and rising bankruptcies could easily cause a vicious new downward lurch.

In Britain, given the size of its finance industry, housing boom and consumer debt, the balance-sheet adjustment will, if anything, be greater. The weaker pound will buoy exports, but fragile public finances suggest that Britain has much less scope to use government spending to cushion the private sector than America does—as this week's flawed budget made painfully clear (see our accompanying leader).

The outlook should in theory be brighter for Germany and Japan. Both have seen output slump faster than in other rich countries because of the collapse in trade and manufacturing, but neither has the huge private borrowing of the sort that haunts the Anglo-Saxon world. Once inventories have adjusted, recovery should come quickly. In practice, though, that seems unlikely, especially in Germany. As the output slump sends Germany's jobless rate towards double-digits, it is hard to see consumers going on a spending spree. Nor has the government shown much appetite for boosting demand. Germany's fiscal stimulus, although large by European standards, falls well short of what it could afford. Worse, the country's banks are still in trouble. Germans did not behave recklessly, but their banks did—along with many others in continental Europe. New figures from the IMF suggest that European banks face some $1.1 trillion in losses, hardly any of which have yet been recognised (see page 76). This week's German plan to set up several bad banks was no more than a down payment on the restructuring ahead.

Japan has acted more boldly. Its latest package of tax cuts and government spending, unveiled in early April, will provide the biggest fiscal boost, relative to GDP, of any rich country this year. Its economy is likely to perk up, temporarily at least. But its public-debt stock is approaching 200% of GDP, so Japan has scant room for more fiscal stimulus. With export markets weak, demand will soon need to be privately generated at home. But the past two decades offer little evidence that Japan can make that shift.

For the time being, the brightest light glows in China, where a huge inventory adjustment has exaggerated the impact of falling foreign demand, and where the government has the cash and determination to prop up domestic spending. China's stimulus is already bearing fruit. Loans are soaring and infrastructure investment is growing smartly. The IMF's latest forecast, that China's economy will grow by 6.5% this year, may prove conservative. Yet even China has its difficulties. Perhaps three-quarters of the growth will come from government demand, particularly infrastructure spending.

Not much to glow about

Add all this up and the case for optimism fades quickly. The worst is over only in the narrowest sense that the pace of global decline has peaked. Thanks to massive—and unsustainable—fiscal and monetary transfusions, output will eventually stabilise. But in many ways, darker days lie ahead. Despite the scale of the slump, no conventional recovery is in sight. Growth, when it comes, will be too feeble to stop unemployment rising and idle capacity swelling. And for years most of the world's economies will depend on their governments.

Consider what that means. Much of the rich world will see jobless rates that reach double-digits, and then stay there. Deflation—a devastating disease in debt-laden economies—could set in as record economic slack pushes down prices and wages, particularly since headline inflation has already plunged thanks to sinking fuel costs. Public debt will soar because of weak growth, prolonged stimulus spending and the growing costs of cleaning up the financial mess. The OECD's member countries began the crisis with debt stocks, on average, at 75% of GDP; by 2010 they will reach 100%. One analysis suggests persistent weakness could push the biggest economies' debt ratios to 140% by 2014. Continuing joblessness, years of weak investment and higher public-debt burdens, in turn, will dent economies' underlying potential. Although there is no sign that the world economy will return to its trend rate of growth any time soon, it is already clear that this speed limit will be lower than before the crisis hit.

Start preparing for the next decade

Welcome to an era of diminished expectations and continuing dangers; a world where policymakers must steer between the imminent threat of deflation while countering investors' (reasonable) fears that swelling public debts and massive monetary easing could eventually lead to high inflation; an uncharted world where government borrowing reaches a scale not seen since the second world war, when capital controls ensured that savings stayed at home.

How to cope with these dangers? Certainly not by clutching at scraps of better news. That risks leading to less action right now. Warding off deflation, for instance, will demand more unconventional steps from more central banks for longer than many now seem to foresee. Laggards, such as the European Central Bank, do themselves and the world no favours by holding back. Nor should governments immediately seek to take back the fiscal stimulus. Prolonged economic weakness does far greater damage to public finances than temporary fiscal activism. Remember how Japan snuffed out its recovery in the 1990s by rushing to raise taxes.

Japan also put off bank reform. Countries facing big balance-sheet adjustments should heed that lesson and nudge reform along, in particular by doing more to clean up and restructure the banks. Countries with surpluses must encourage private spending at home more vigorously. China's leaders are still doing too little to boost private citizens' income and their spending by fostering reforms, from widening health-care coverage to forcing state-owned firms to pay higher dividends.

At the same time policymakers must give themselves room to change course in the future. Central banks need to lay out the rules that will govern their exit from exotic forms of policy easing (see pages 69-71). That may require new tools: the Federal Reserve would gain from being able to issue bonds that could mop up liquidity. All governments, especially those with the ropiest public finances, should think boldly about how to lower their debt ratios in the medium term—in ways that do not choke off nascent private demand. Rather than pushing up tax rates, they should think about raising retirement ages, reining in health costs and broadening the tax base.

This weekend many of the world's finance ministers and central bankers will meet in Washington, DC, for the spring meetings of the IMF and World Bank. Amid rising confidence, they will be tempted to pat themselves on the back. There is no time for that. The worst global slump since the Depression is far from finished. There is work to do. ■