

COVER STORY

The U.S. Economy Faces the Guillotine

America is on the road to recession, and many predict a worldwide slowdown. But it's a new economic order, and the emerging markets could take the lead.

By Daniel Gross | NEWSWEEK

Feb 4, 2008 Issue When a group of community volunteers rang the bell to signal the close of trading at the New York Stock Exchange last Friday, it brought to a close one of the most tumultuous weeks in global markets since the fall of 2001. On Tuesday, the Dow Jones industrial average, already down 9 percent in 2008 on glum economic news, plummeted nearly 600 points (5 percent) before rallying after the announcement of an emergency three-quarter-point interest-rate cut by the Federal Reserve, the biggest such reduction in 24 years. Wednesday was like Groundhog Day, with the Dow falling more than 3 percent before closing with a gain. "Yesterday was a s—t storm and today really isn't any better," said a glum broker in a green trading jacket outside the New York Stock Exchange. Cari Maher, who works in an office building on Wall Street across from the exchange, noticed a sign of market stress—an unusual number of nervous smokers outside, huddling on the cold sidewalk.

Investors also sought solace in nicotine outside a branch of Zheshang Securities in central Shanghai. Several elderly men, barred from smoking indoors, peered through the doorway at the big screen inside showing stock prices. "It was pretty scary earlier this week," said Zheng Xiaosheng, 68, puffing his cheeks against the cold. The Shanghai Composite index, which has quadrupled in the past two years, fell more than 10 percent in 48 hours—the biggest two-day fall in Shanghai's stock-market history. The same day, stunned Indian investors, angered that Mumbai's benchmark Sensex index had fallen 5 percent for two straight days, staged a protest outside the Bombay Stock Exchange, chanting "Death to [Finance Minister Palaniappan] Chidambaram."

In Davos, Switzerland, the volatility derailed the agenda at the World Economic Forum. Participants were disembarking from the rustic train that chugs into the Alpine ski resort just as all hell was breaking loose back home. Instead of discussing malaria and microfinancing, many big shots spent their time anxiously hunched over computer screens and fingering BlackBerrys like prayer beads. Treasury Secretary Henry Paulson canceled his planned visit and stayed in Washington to help hammer out a stimulus package.

The Great Global Market Freak-Out of 2008 has everyone asking whether the United States—already on the road to recession—is entering into a protracted period of economic trouble where jobs will be slashed, prices will continue to rise and the dollar will keep falling; and if so, whether the declining U.S. economy will pull the rest of the world down with it. A recession is defined as a widespread contraction in economic activity lasting more than a few months, and because of the lag in financial data, recessions typically aren't officially declared until long after they start. In short, the United States could already be in one. Though world markets stabilized by late last week, buoyed by the Fed's rate-cut action and a proposed stimulus package of \$150 billion that was hastily cobbled together by leaders in the House of Representatives and President Bush, the question remains: how ugly will it get, and when will it end? The disappointing jobs and retail-sales data from December indicate the economy has stalled. Given the complex financial machinery that now connects the world's market, will a U.S. recession quash the booming growth we've seen in emerging markets like India and China and tip European economies over the edge? "We are, of course, far

short of a Great Depression now," said Nouriel Roubini, professor of economics at New York University's Stern School of Business. "But in terms of systemic risk and the risks of a financial meltdown, you almost have to go back that far to find a good analogy."

The questions are open, contingent and confusing, and deeply meaningful for markets and their underlying economies—as well as for workers and consumers. And the answers probably won't be clear until a year from now, when Davos 2009 opens. In the meantime, the uncertainty acts like kindling for volatile stock action. Investors from Shanghai to Seattle, from hedge-fund cowboys to slow-and-steady 401(k) savers, today resemble circus acrobats who teeter on a board atop a ball. They maintain a precarious balance only by careening wildly back and forth. Despite the best efforts of analysts, the daily fluctuations of stock markets frequently defy reason or easy explanation. The markets endlessly process expectations, hopes and fears about the immediate future for stocks and the economic activity that ultimately underlies them.

Judging by the recent mood swings, the global economy can be diagnosed as manic-depressive. Through the haze around the markets last week, a clear reason for this bipolar condition emerges. On the one hand, the United States, the world's largest economy and the destination of many of the world's exports, may be on the brink of recession. But at the same time, the global economy—after a remarkable five-year period in which almost every major economy has been growing in concert—is showing signs of what economists call "decoupling." What decoupling means is this: even as the globe's economic engine, the United States, has stalled, optimists believe the train cars it has been pulling for the last several decades—especially emerging markets like India and China—may finally be able to chug along under their own power.

The current troubles were years in the making, and in retrospect, easy to see coming. In the United States, the problems started with excesses and defaults in the subprime lending and housing markets. As the bubble burst, foreclosures mounted and housing activity ground to a halt. Throughout 2007, the carnage spread slowly, from subprime borrowers and home builders to middle-class homeowners and the stores they frequent, like Home Depot. As subprime debt went bad, the lenders and banks that plunged into the subprime market suffered huge losses. In recent weeks, blue-chip banks Citigroup and Merrill Lynch took huge write-downs—more than \$30 billion—on subprime mortgages and investments tied to them. What started as an effort to spread risk—securitizing mortgages, trading them and getting them off the books of banks and into the global capital markets—has in fact multiplied it. In the wake of the loss, they dispatched squadrons of corporate jets to the Persian Gulf and Asia to raise new capital from the various sovereign-wealth funds that have replaced private-equity and hedge funds as the investors of choice for ailing companies. With credit in tighter supply, consumers, who account for 70 percent of U.S. economic activity, began to scale back, leading to a blue Christmas for retailers from Dollar General to Tiffany.

Of course, at every stage, policymakers and business leaders have declared the damage contained, only to see the financial mold spread like dry rot. "It's following the well-trodden paths of past financial folly," said Ken Rogoff, professor of economics at Harvard. "Just like this one, most banking crises in the past were also driven by rising real-estate and equity prices. It takes time to sort it out."

The U.S. stock markets held up quite well for 2007 in the face of the rising distress, thanks to two strong macroeconomic trends. Economic growth was strong through the third quarter, and the Federal Reserve, under the leadership of Ben Bernanke, began cutting interest rates in September—which usually presages market gains. A continued global boom buoyed multinationals like IBM, General Electric and Coca-Cola. But one by one, the pillars supporting the stock market—housing, the consumer, financial services, luxury goods—developed cracks, and the macroeconomic news worsened through December and January. By last week, investors seemed to have retreated to their last redoubt—big technology firms like Apple with healthy margins, popular products and dramatic global growth. But Tuesday afternoon, Apple issued an earnings report that disappointed analysts; its stock has been pared 31 percent so far this year. Fast-growing Google, the darling of the late bull market, has fallen 26 percent since its November 2007 peak.

So what does all this have to do with the price of stocks in China? With the rising volume of trade, open flows of capital and tighter economic integration, the world's stock markets have become synchronous: they're far more likely to move in the same direction at the same time. That was explicitly not the case in the 1990s. Still, despite all the global growth, the United States remains the world's largest economy, and the largest single source of demand for exports from China and many other countries. "There is a very tight link now between China and the global economy," said Wang Tongjiang, a finance specialist at Shanghai's East China Normal University (ECNU). "The fall in the markets partly reflected pessimism and worries about the future for companies involved in the export industry." If the United States sneezes, economic conventional wisdom holds, the rest of the world will catch a cold. Or pneumonia.

But there's a difference between markets and the real economy. More and more business people and economists think the United States and the rest of the world may be moving in different directions. "We're seeing a general decoupling," said James Owens, chairman of U.S. machinery giant Caterpillar. While demand is weak in the U.S., he says, "South America, Asia, Russia, Eastern Europe, all have very strong commodity-based exports. The fundamental economic health in these markets is strong." In addition, companies and consumers in these countries no longer rely mostly on U.S. financing to buy tractors and construction equipment.

"Decoupling" was one of the hot buzzwords to emerge from Davos. A bestselling book is "The World Without Us," about the fate of the globe without humans. But that could well be the title for the global economy in 2008. For while the U.S. may not be contributing materially to economic growth, cocky newcomers to the global party say they can take it from here.

"Our growth is not export driven," India Trade Minister Kamal Nath told NEWSWEEK. "It's driven by domestic demand. We have not been growing on the back of the United States." He says that China has displaced the U.S. as India's largest trading partner, and that exports to the U.S. are concentrated in areas like information technology and pharmaceuticals. Exports, while important, make up about 23 percent of India's gross domestic product. Still, Shankar Acharya, an economist with the Indian Council for Research on International Economic Relations, suggests that a recession in the United States could cut growth by 0.5 percent in India this year.

Chinese economists are similarly sanguine about their country's prospects. "China is in a good fiscal position, and we have strong domestic demand," said Yu Yongding, director of China's Institute of World Economics and Politics. Due to falling demand for exports to the United States, China's overheating economy will likely slow, however. Yu believes China's growth rate will fall in 2008 to 9 or 10 percent, down from the current rate of about 11 percent, "and I'm very conservative."

To be sure, Chinese manufacturers of toy cars who export all their production to the U.S. could be hurt. But manufacturers of real cars in China—and elsewhere—are producing for the emerging markets. In 2007, for the first time, Audi sold more cars in China than in Britain or the U.S.; it has set up its first joint venture in India. "We've worked on diversifying our export markets away from being dependent on just one major region," Audi chief executive officer Rupert Stadler told NEWSWEEK. He is confident "growth in the emerging markets is going to compensate for slower regions elsewhere."

Not everyone is convinced that the economies of the United States and the rest of the world are headed for divorce. "The headwinds facing the U.S. economy right now are mainly the housing downturn, capital market turmoil and rising energy prices," David McCormick, Treasury under secretary for international affairs, told NEWSWEEK. "For the decoupling theory to work, you'd have to make the case that these issues are not, at least to some extent, ones impacting economies outside the U.S. I don't think that case can be made."

One thing that is certain is that the United States is now dependent on the kindness of foreigners, instead of the other way around. With the dollar sagging, many American businesses are being buoyed by exports. "At least up to the end of 2007, exports compensated for the drag on growth coming from the housing sector," said Edward Gresser, trade project director at the Progressive Policy Institute. Exports have risen from \$980 billion in 2002 to \$1.62 trillion last year, up 65 percent. **Nina Kaplan, founder of Summit Metals Recovery Corp., a scrap-metal dealer in Leonia, N.J., saw her income double last year, thanks to booming demand from China, and just hired a Mandarin speaker. "Right now there is an insatiable demand for scrap metal due to globalization and worldwide industrialization," she said.**

But the increase in exports hasn't stopped the slide in the U.S. economy, which is why Washington has had to step in to deliver a jolt. Under the bipartisan deal between President Bush and the House, taxpayers making less than \$75,000 as individuals or \$150,000 as families will receive \$300 per person and \$600 per couple, plus \$300 per child. In addition, some 35 million families that don't pay federal income taxes would also receive checks for \$300; the checks should push \$100 billion into the hands of tapped-out consumers. Companies would receive \$50 billion in tax cuts in the form of a temporary increase in deductions for certain business investments. The plan also boosts for one year the size of loans Fannie Mae and Freddie Mac can buy, from \$417,000 to \$625,500, which will translate into lower mortgage interest rates for many homeowners.

"There are no silver bullets here, but it will be very helpful," said Rep. Barney Frank, chairman of the House Financial Services Committee, who played a key role in negotiating some measures in the stimulus package. But the impact—and the ultimate passage—of the package remain in doubt. The Senate must still weigh in. Some Democrats are

disappointed that it doesn't extend unemployment benefits and increase food stamps, which tend to get spent quickly. Sen. Kent Conrad of North Dakota, chairman of the budget committee, frets that checks likely wouldn't arrive in consumers' mailboxes until June. "The 2001 results show that it took one to two quarters for people to actually spend the money," he said. That could be too late to help retailers that are closing stores by the dozen. While the mortgage measures can't hurt, much of the damage has been done. Existing home sales fell again in December by 2.2 percent, with prices slipping further. Last Thursday, Lennar, the giant home builder, reported that home sales fell 50 percent in the fourth quarter from 2006. Lennar CEO Stuart Miller's glum prognosis for 2008: "We are not expecting market conditions to improve."

It's not all doom and gloom, however. Even as politicians congratulated themselves for taking the courageous step of voting to send cash to voters in an election year, investors were looking to the Federal Reserve to cut interest rates further at its regularly scheduled meeting this week. Unemployment claims have hovered at a low 300,000 in recent weeks, suggesting the economy may have added a decent number of jobs in January, notes Ian Morris, an economist at HSBC. "This is the reason why we have so far been reluctant to call for a recession." If the economy responds as it traditionally has to such dramatic measures, it's possible any recession will be mild and relatively short.

But politicians are more optimistic than most analysts and economists at the moment, in part because of a widespread fear of further problems with credit—beyond consumers, businesses and homeowners. The U.S. financial system is like the game Jenga, where participants remove supporting beams from the structure until it topples. The stimulus package won't do much to shore up the current weak links in the tottering edifice. Over lunch in Davos, hedge-fund manager George Soros spun a tale of credit sufficiently dire to make several journalists choke on the veal steak with shallots. "The ability of the Fed to come to the rescue is constrained to an extent it wasn't before," he said. It's not simply a matter of cutting rates to enable banks and companies to get more money. His concern, and that of many others, is the value of bond insurers, credit-default swaps and other derivatives—obscure, largely unregulated corners of the market.

Starting in the 1990s, investment banks developed a sort of parallel credit system. It includes credit-default swaps, a form of insurance that pays off if a bond goes bad. The global value of such contracts in 2007, according to the International Swaps and Derivatives Association: \$45 trillion. Companies that used to be in the boring business of insuring municipal bonds branched out aggressively into this system, insuring bonds based on subprime debt. The declining value of subprime debt has brought into question these companies' own stability and the validity and value of the insurance they sold, and it could lead to a downward cycle of write-downs. Defaults on these could trigger up to \$250 billion in losses, according to Bill Gross, founder of the bond mutual-fund giant PIMCO—about the amount that investors will lose on subprime mortgages. Concern over the plummeting share prices of bond insurers like MBIA and Ambac has risen to such a level that New York State Insurance superintendent Eric Dinallo has been meeting with financial-services-industry executives to organize a potential bailout. "We have dealt with liquidity, now we must deal with solvency," Soros said.

Economists aren't generally an ironic lot. But there's a great deal of irony in the global economy today—especially when insurers need insurance. Subprime mortgages, and the bonds based on them, are the U.S. equivalent of lead-laced toys and chemical-spiked toothpaste from China—exports presumed to be safe that can prove toxic.

Last year's bears and scolds at Davos have become this year's sages. In 2007, U.S. private-equity and banking executives were the rock stars on the Swiss slopes. This year, the managers of sovereign-wealth funds from the Persian Gulf and Asia were the main attraction. What was generally regarded to be the world's strongest financial system now seems one of its weakest, while emerging economies are practically paragons of fiscal and monetary health. In the 1990s, crises in the developing world—Latin America, Russia and the Far East—roiled the global markets. Today problems in the most-developed countries—subprime in the United States; the failure of mortgage lender Northern Rock in the U.K.; the rogue-trading scandal at France's Société Générale. A new financial order is clearly dawning.

Extrapolating from existing trends—which is how most economists forecast—the United States will likely continue to struggle as it cleans up after the deluge of bad debt and copes with systemic credit issues, while emerging markets like China and India will probably downshift from overdrive into high gear. But forecasts at times of transition are inherently unreliable. To a large degree, the global economy and some of its high-flying constituents are in uncharted territory.

That doesn't mean the world is facing the Great Depression II—the world's economies are radically different than they were fourscore years ago, when our forefathers were forced to beg for dimes. At Davos, Fred Bergsten, director of the Washington-based Peterson Institute of International Economics, pointed out that emerging markets today

constitute about half the global economy. Assuming that the United States and Japan are flat, and emerging markets grow at 5 or 6 percent, the global economy would still show decent growth in 2008. "My conclusion is that a global recession is inconceivable," said Bergsten.

But in economics and the markets, inconceivable developments—good and bad—tend to crop up with some regularity. That point was dryly nailed home at Davos by Jacob Frenkel, the former governor of the Bank of Israel. Amid a generally optimistic session about the fate of the global economy, he pointed out: "Last year, nobody mentioned subprime."

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