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THE OUTLOOK
Economy May Face Prolonged Pain, History Suggests

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The worst of the financial pain may have passed, but the economic pain could be just starting.

The nation's financial markets have rallied since early March, with stocks up and yields on risky corporate and mortgage-backed bonds falling relative to safe U.S. Treasurys. Optimists got an added boost Friday from a government report that U.S. unemployment fell in April.

But history suggests celebration may be premature. It's common in a crisis for markets to hit bottom long before the economy does. That's because markets are forward-looking and because economic weakness is the way the underlying imbalances that produced a crisis are corrected.

"The financial crisis is usually an expression of broader problems in the economy," says Harvard University economist Kenneth Rogoff, who along with Carmen Reinhart of the University of Maryland, recently wrote a history of financial crises back to the 1300s. "It's a mechanism that exacerbates and deepens the recession, but it's seldom the trigger."

The economic fallout from a crisis depends on how much underlying economic factors -- such as consumption, investment and asset prices -- are out of whack with their fundamental determinants. The 1987 stock-market crash and the near-collapse of hedge fund Long Term Capital Management in 1998 threatened the heart of the financial system. But the underlying imbalances were largely limited to the financial markets themselves: stocks overvalued relative to earnings in 1987, and excessive hedge-fund borrowing in 1998. Thus, once the Federal Reserve's rescue operations had mitigated the threat to the financial system, the economic fallout was limited.

The current crisis is different. For several years, U.S. home prices and home construction kept climbing past levels considered sustainable. Homes became collateral for trillions of dollars in borrowing. That depressed savings, inflated consumption, fueled rapid lending and loosened loan standards.

When home prices stopped rising, the diciest mortgages began to default, triggering the crisis. But even now, prices are above most estimates of sustainable levels, and household saving has barely picked up. Even if the Fed's bailout of Bear Stearns Cos. in mid-March proves the apex of the crisis, as some think, the economy could still contract as consumers adjust to lost wealth and reduced access to credit.

For a parallel, the U.S. might look to South Korea. Its financial crisis peaked on Dec. 24, 1997, when its currency, the won, hit a record low against the dollar. The International Monetary Fund and the U.S. Treasury orchestrated a rescue and persuaded foreign banks to roll over their loans to Korea. Over the ensuing year, the won rose 63%. But the Korean economy sank into a deep recession. In 13 months, the jobless rate soared to 7.9% from 3%. The economy shrank 6% in 1998, a huge shock to a country accustomed to 8% growth.

Korea's economy had been bolstered for years by overinvestment by its chaebols, or industrial conglomerates. They financed extensive capital investment by borrowing heavily from banks on preferential terms, says Kihwan Kim, then a key Korean government official managing the crisis and now an adviser to Goldman Sachs. The banks, in turn, borrowed in dollars from overseas.

But in early 1997, several chaebols, which had been losing competitiveness, began to experience difficulties. When Korean banks lost their ability to borrow overseas, many failed; those that survived severely cut back lending. The chaebols slashed investment and laid off thousands. Many went bankrupt. Layoffs and recession were a shock to Koreans who "were so used to high growth and very low levels of unemployment," Mr. Kim says.

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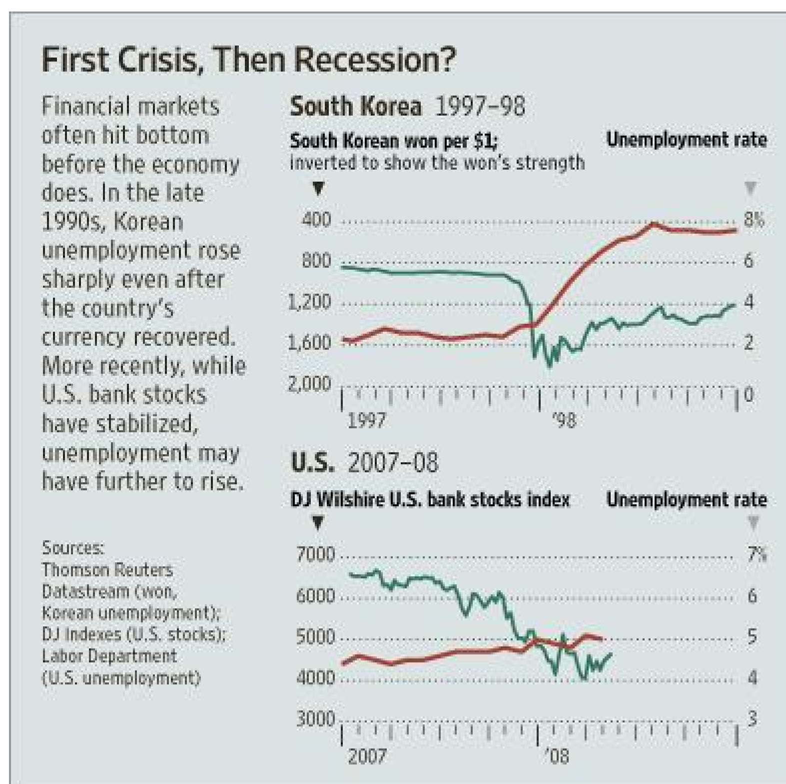
Ted Truman, a scholar at the Peterson Institute for International Economics who worked on the Korean rescue as a Fed official, says the overexpansion and excessive borrowing of Korea's corporate sector in the run-up to its crisis are analogous to the overexpansion of housing and consumption in the U.S. in its crisis. In each case, a collapse in the affected sector severely wounded the financial system. Korea's recovery was led by exports, much as exports are proving a cushion to the U.S. now.

Korea's recovery began in 1999. Mr. Kim says that capital investment never fully recovered and that economic growth, while a healthy 4% to 5%, hasn't returned to the precrisis pace. Unemployment is deceptively low, he says, because of hidden unemployment, such as students who can't find jobs staying in school. Korea's lesson to the U.S., he says, is that "imbalances must be corrected." A recovery doesn't need a full resolution of those imbalances, he says, only a "convincing sign that change is taking place."

The risk for the U.S. is that weakness goes beyond the correction of housing excesses and begins to feed back into the financial system and then, again, hurts the wider economy.

By contrast, says Nouriel Roubini, an economist who heads RGE Monitor, a financial- and economic-forecasting service, the U.S. financial system has adjusted only to the losses on mortgage loans. He predicts that a wave of defaults on industrial loans, municipal bonds and consumer credit is coming, which will trigger another wave of financial-system distress.

Fed Chairman Ben Bernanke believes such feedback effects are what made the Great Depression great. Mr. Bernanke's awareness of such risks is why he cut rates last week and, despite signaling a pause, is still focused on the risks that the U.S. economy may deteriorate further.



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