World Economy to Shrink for First Time in 50 Years

By Timothy R. Homan and Rich Miller

Dec. 18 (Bloomberg) -- The world economy will contract next year for the first time in almost 50 years, as industrial nations are wracked by recession, and growth in emerging markets is cut almost in half, a banking industry group said.

The Institute of International Finance, which represents the world's largest commercial and investment banks, said the global economy has been hit by an "unholy trinity" of financial problems. Banks have suffered big losses on troubled assets, have inadequate capital to cover holes in their balance sheets and are having trouble raising funds, the IIF said.

"The weakening of economic activity and intense financial market strains are feeding on each other and are reinforced by the global synchronization of the slowdown," Charles Dallara, IIF managing director, said in a statement.

The institute, which has more than 400 members in over 70 countries, urged policy makers to take substantial steps to turn economies around, such as committing $3 trillion to $4 trillion to buy mortgage-backed securities from banks and other assets that have lost value.

The global economy will contract 0.4 percent in 2009, the first drop since at least 1960, after expanding an estimated 2 percent this year, according to the forecast.

The International Monetary predicted on Nov. 6 that the world economy will grow 1.1 percent next year, although officials since then have said the forecast will likely be cut.

Developed countries, which include the U.S., the euro area and Japan, will contract 1.4 percent next year after expanding 0.9 percent in 2008, the IIF said in the forecast released today in Washington.

Global Recession

The U.S. will contract 1.3 percent after growing 1.2 percent in 2008, and the euro area will decline 1.5 percent after expanding 0.9 percent. Japan's economy is forecast to shrink 1.2 percent following no growth this year, the IIF said.

Interest-rate cuts by the Federal Reserve, and other actions announced by the U.S. central bank this week, "will contribute to the restoration of confidence and revive credit flows in due course," Dallara said in the statement.

The Fed lowered the main U.S. interest rate to a range between zero and 0.25 percent and said it will take all necessary steps to end the recession and unclog credit markets.

Policy makers "will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability," the Federal Open Market Committee said in a statement Dec. 16.

Emerging Markets

Economies in emerging markets will grow 3.1 percent in 2009, following a 5.9 percent gain this year. In May, the IIF forecast emerging economies would expand 6.5 percent next year.

Losses stemming from Bernard Madoff's alleged $50 billion Ponzi scheme will probably cause investors worldwide to retrench, hurting emerging market economies even more, Dallara said during a briefing with reporters.

"Hedge funds are even more risk averse at a time when they're trying to look at their books and think about where their exposures might or might not be" in the Madoff case, Dallara said.

The IIF report also said Ecuador's decision last week to default on its external debt "was the latest setback in a trend towards deterioration in sovereign emerging-market creditworthiness."

Without naming specific countries, Dallara told reporters the same could happen to some economies in Central and Eastern Europe and Latin America that "have not followed sound policies for some time."

Oil prices are forecast to average $55 a barrel next year, compared with $98 in 2008. “Among emerging markets, the main losers from this shift are the Gulf oil-exporting countries, Russia and, to a lesser extent, Latin America,” the IIF said in a statement. “Emerging Asia, including China, is the major beneficiary.”

China will grow 6.5 percent in 2009, following a 9.3 percent expansion this year, today’s report said.

Last Updated: December 18, 2008 14:17 EST

http://www.bloomberg.com/apps/news?pid=20601081&sid=a_sbtjboHu8A&refer=australia