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Who will lead the world economy out of recession?

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By Emily Kaiser - Analysis

WASHINGTON (Reuters) - The United States and China hold the best hope for leading a global economic recovery, yet they may lack sufficient strength to firmly pull the world out of recession.

President Barack Obama warned fellow world leaders at the Group of 20 summit in London that they should not count on "voracious" U.S. consumers generating the level of demand that helped drive eight years of strong global economic growth.

But without an obvious growth engine to replace flagging American consumption, the global economy appears headed for a prolonged slump followed by only a tepid rebound.

"It is going to be a difficult paradox for the world, with the economy at the epicenter of the crisis -- the United States -- still being seen as the savior of the world at large," said Eswar Prasad, a senior fellow at the Brookings Institution.

Before the United States can hope to save the world, it must address its own obvious problems of the still-raging financial turmoil and the perilous state of banks.

But doing so will not fully regenerate the U.S. consumer, who has been the world's best customer for everything from socks to 60-inch plasma televisions in recent years.

Even with the U.S. Federal Reserve and the federal government committing trillions of dollars to revive the economy, Americans lost $11.2 trillion in wealth last year and are in no mood to go on a big spending spree.

China faces a similar situation. While it can potentially play an important role in recovery, its nervous consumers are more prone to save than spend, which does little to lift global growth, Prasad said.

SEEKING ATLAS

That leaves both countries even more reliant than usual on exports to lift output, which is not a good position to be in considering the Organization for Economic Cooperation and Development said this week that trade was "in free fall" and would likely tumble 13.2 percent this year.

"This creates a huge problem for the world economy," Prasad said. "The two potential drivers of growth are both looking for exports in order to generate growth or at least stay afloat."

That is part of the reason why the G20 agreed to make available $250 billion in trade financing. But for the United States and China, the bigger issue is finding customers. Exporters need importers, and few countries look likely to step up to fill the slack left by falling U.S. demand.

U.S. imports have more than doubled since 1999, hitting $2.5 trillion last year. Not surprisingly, though, they have been dropping this year. They were down 6.7 percent in January to the lowest level since March 2005. February's figures are due next week, and are likely to show more of the same.

Europe was slower to succumb to the economic slump and therefore will probably also be slower to exit. The OECD expects the euro zone economy to contract this year and next.

Peter Hooper, chief economist at Deutsche Bank in New York, said crisis repair typically requires four elements working in harmony: lower interest rates; fiscal easing; bank restructuring; and confidence boosting. But he said Europe in particular was lagging on those, and he expects "the end of the global downturn to be initiated by the U.S. and China."

Many emerging powerhouses are commodity-rich exporters struggling with falling prices and demand for their goods.

Developing countries face a financing gap as large as $700 billion, according to World Bank estimates, and are in no position to power a healthy rebound.

CRAWLING OUT

To be sure, there is mounting evidence that the global economy isn't unraveling quite as quickly as it was just a few weeks ago.

Manufacturing surveys released Wednesday bolstered the view that the pace of recession was slackening, with indexes for the United States, Britain and the euro zone all edging up in March.

Perhaps most promising, the survey's reading on new U.S. factory orders -- while still weak -- reached its highest level since August 2008, a month before the collapse of Lehman Brothers sparked a global panic that deepened the recession.

Stabilization would certainly remove a huge drag from the global economy. But it would not provide the level of growth needed to end the recession, let alone generate new jobs.

Turning stabilization into full-fledged recovery will require fixing the financial system and restoring confidence. Those are two herculean tasks that Brookings' Prasad said may need nothing short of "an act of magic" from Obama and other world leaders.

Reports this week showing a steep rise in unemployment in the United States and Europe provided a sobering reminder that stabilization and recovery are two very different things.

"One should not confuse green shoots with recovery," said Joseph Brusuelas, a director at Moody's Economy.com. "At best we have some hints that perhaps the economy will stabilize later this year and in a meaningful way in 2010."

(Editing by Dan Grebler)