Fallout from US Meltdown

At the Hot Seat Forum organised by the Friedrich Naumann Foundation in Kuala Lumpur way back in 2005, many did not take me seriously when I spoke of an impending financial and economic meltdown in the United States. The audience was even more skeptical when I said that the crunch was likely to take place in 2008.

Admittedly, forecasting is a hazardous exercise, especially when one takes a leap three years down the road. To my mind, the US meltdown was inevitable given the sheer size of the fiscal and current account imbalances the US economy was shouldering. The US has been borrowing at the rate of USD 2 billion a day to finance these deficits.

To be sure, the US is no ordinary economy, being the largest and most powerful. No doubt, its capacity to withstand such imbalances is enormous, but by no means unlimited. It was not difficult for the US to manage the imbalances, as the rest of the world has been more than willing to lend to the US. Indeed, it is in the interest of others to do so, as this would enable the US to continue to import from the rest of the world.

East Asia has been a major source of capital flows into the US, thanks to the huge current account surpluses and massive reserves. East Asian economies have been doing this in the hope that they can continue to export to the US. It is also in their interest to ensure that the greenback remains strong and stable, as this would render East Asian exports competitive in the US market.

Understandably, a week dollar is not good for US imports and dollar-denominated foreign exchange reserves. Therefore, East Asian economies have been buying US treasury bills and bonds to support the US economy and propping up the dollar in the foreign exchange market.

Obviously, the US is pleased with all this, as it has to only issue papers, which the rest of the world would like to buy and keep, so that the party can go on. But no party can go on forever.

The long and short of all this is that the US has been "managing" the problem, without "fixing" it. In fact, the deficits are a reflection of major fault lines, a structural rather than a cyclical phenomenon. The crux of the problem is that the US has been consuming too much and saving too little. The US economy is driven largely by consumption expenditure, with households living beyond their means on borrowed money and borrowed time.

It is not hard to figure out that all this is unsustainable. The US economy needs serious adjustments, which must include significant dollar depreciation and expenditure cutbacks. The latter can be painful with the real sector of the economy slipping into a recession. The greenback has been depreciating gradually over the years until recently.

In 2005, I thought that the US dollar was overvalued by 25 per cent and I saw a 35 per cent chance for US recession in 2008. Many at the Hot Seat Forum were asking why

2008. Rough, back-of-the-envelope calculations showed then that it would take three more years for all this to percolate and boil over.

The US economy has performed surprisingly well thus far in terms of growth, registering a creditable 3.3 per cent growth in the second quarter of 2008. Although this does not jive with a priori expectations, it is not inexplicable. The US exports have perked up in recent times, thanks to dollar depreciation. The low interest rate regime maintained by the Federal Reserve has kept consumption and investment momentum, reinforced by the fiscal stimulus package from the US Treasury.

In other words, the anticipated US recession has been held at bay, at least for now. Apparently, the US has successfully postponed a recession, a bitter medicine that can possibly cure the ailing US economy. The chronic fiscal and current account imbalances cannot be trimmed to sustainable levels without expenditure and exchange rate corrections.

There are ominous signs that the inevitable is not far away. The financial sector meltdown usually precedes contraction in the real sector of the economy, although the severity of the latter can be reduced through public sector interventions, which are beginning to unfold in the US.

The US financial turmoil, which began with the crisis in the sub-prime market, is far from over. The recent revelations, involving Fannie Mae, Freddie Mac, Lehman Brothers, American International Group (AIG) and Merrill Lynch are very scary. While government bailouts, which run into billions of dollars, are reassuring to the market, they unleash the spectre of moral hazards and impose a heavy burden on the US tax payers.

The chances are there are many more skeletons waiting to fall from the closet. Already, Goldman Sachs and Morgan Stanley are seeking shelter with the US Federal Reserve. The low interest rate regime of the Fed may be good for the real sector but does not solve the financial sector's sub-prime problem, for which long-term interest rates matter, over which the Fed has no control.

All this does not augur well for the real sector of the US economy. The crunch may come next year.

The US financial woes have not directly affected the Malaysian economy, as it has no direct exposure. That economic growth in Malaysia has exceeded the potential growth rate of 6.0 per cent in the first half of this year, growing at 6.7 per cent, is not surprising as the US growth has also exceeded expectations, not to mention the high commodity prices which have kept Malaysia's external sector fairly vibrant thus far this year.

Malaysia's GDP (gross domestic product) growth this year appears to be within the striking distance of the 5.4-5.7 per cent government target. The economy only needs to register 4.1 per cent growth in the second half to achieve 5.4 per cent growth for the year as whole. All indications are that it may well be a very different story come next year.

The US is still very important to Malaysia, despite the falling US share of Malaysian exports. Trade figures are misleading, given that most of our exports to China and Singapore actually end up in the US. A recession in the US will certainly impact on the Malaysian economy. What is more worrisome is the secondary impact through China, which has a huge direct exposure, both in real and financial terms, to the US situation. China's reserves are largely linked to the US. For example, it is reported that China had locked about USD 400 billion into Fannie Mae and Freddie Mac.

China may suffer huge financial losses, should the US financial woes deepen or the US dollar were to depreciate, not to mention severe setbacks for China's exports in the wake of a US recession. China itself may be able to weather the storm fairly well, as it has a huge domestic market to fall back on, but economies like Malaysia's, which are linked to China, may experience a double whammy. Considerations such as this suggest that Malaysia is likely to face strong headwinds in 2009.

Emeritus Professor Datuk Dr Mohamed Ariff is the executive director of the Malaysian Institute of Economic Research.