SPILLOVERS FROM THE FINANCIAL CRISIS

The U.S. financial crisis has pushed American policy makers to the wall, forcing them to devise rescue plans that run against the grain of free-market economic principles.

First we had the packages that were meant to support mortgage companies Fannie Mae and Freddie Mac. This amounts to the nationalisation of the two giants whose assets are at least worth US$5 trillion.

Then the Federal Reserve made a bridge loan to AIG, the world's largest insurance company. AIG has assets in excess of US$1 trillion and is employer of over 100,000 staff worldwide. This seriously ailing company received US$85 billion to keep it afloat.

Under the Fed's intervention in AIG, the Fed has the option of purchasing up to 80 per cent of the company's shares and replacing its management. Again, this comes as close as one can get to the nationalisation of AIG.

The next significant milestone along the path to mending the damage that could be wreaked by the U.S. financial crisis is the relief plan that has been engineered by Treasury Secretary's Henry Paulson and the Federal Reserve Chairman Ben Bernanke.

In what could be the most desperate attempt at saving the glory of the world's largest economy, President Bush has proposed a US$700 billion proposal to bailout the country's financial system.

The figures are simply staggering. The sheer act of gladly throwing out fondly espoused notions of the free market simply points to the panic that has seized the financial sector.

Under prevailing conditions, where the entire U.S. economy is under distress and the risk of global spillovers is no laughing matter, being alive is more important than upholding one's faith.

And this, it seems, is clearly not the time to frown upon government intervention.

While the Republican administration in the U.S may be criticised for bulldozing itself through the financial markets, we in Malaysia are not uncomfortable with the idea of government interference. But there may be more that links us with the U.S.

The magnitude of the problem is of such a scale that the Malaysian economy cannot claim to be isolated from what is happening in the U.S.

Although the U.S. government has made ample funds available in the U.S. credit markets, there is a strong likelihood that excessive caution, in the face of what has been happening, will slow down lending activities within the country. This will induce a sick investment climate.

Add to this the fact that the housing market continues to do poorly in the U.S. Lending is more stringent, salaries are stagnant in the U.S. and do not seem, on average, to be able to cover housing prices.

It still remains cheaper to pay rentals than to commit to mortgage rates of 6.5 per cent. The demand for housing in the U.S. is going to be limp for a long time to come. This will translate itself into weak consumer spending with attendant effects on exports from Malaysia that would otherwise have been directed to the U.S. consumer.

The picture is equally bleak if viewed from the technology sector. All indications point to a slowing down of demand emanating from this sector.

Ingram Micro, the world's largest IT distributor, forsees a slowing in the demand for technology goods. Dell for its part reports a "further softening in global end-user demand".   In particular it observed conservative IT spending in the U.S., Western Europe and in several countries in Asia.

Financial services firms account for an encouraging 18 percent of overall IT spending. And this sector is reputed to be the largest purchaser of computer servers. Both these facts explain why crippled U.S. firms in the financial sector are not a good omen.

The implications for us are clear since a major slice of Malaysia's export earnings are from the electronics and electrical sub-sector.

Suggestions by the Ministry of Finance that Malaysia can turn its eyes to Asia, particularly China and India, do not offer us adequate consolation. Asia suffers from its own signs of nervousness due to the havoc that has been wreaked in the U.S.

Ifzal Ali, chief economist at the Asian Development Bank, predicts that the turmoil in Wall Street will hurt exports from China. In 2007, Malaysia's exports to China accounted for about eight percent of our total exports. If China's growth is going to be wounded there is little joy that can be expected for our eastward bound exports.

The same holds true for the Ministry of Finance's recommendation that we draw sustenance from our trade and investment ties with India. India, although it has a huge domestic market to drive its growth, will not be spared the spillovers of the crisis in the U.S.

A host of economic activities in India, ranging from the IT industry to garments and the real estate business are poised for a slowdown. Given the internal dynamic and the extent of its external reliance, there would be a slide in India's economic growth, contained though it may be.

In any case, since our exports to India constitute only about three per cent of total exports, our trade with India cannot be expected to substitute for what we will lose from the U.S.

The recommendation that the ringgit be re-pegged does not seem to be based on sound reasoning. Of course, having a lower ringgit will allow us to go some distance in lowering the costs of our exports. But that is not what is at the heart of the problem.

The point is that demand will be at low levels in various sectors in the U.S. for some time to come. Some of these sectors will be ones in which we have an interest.

If there is no drive to increase production, lowering prices will not help, unless the high cost of input was the culprit in the first place. That is not the case. Rather, companies in the U.S. have to sort out other more basic issues that are not related to the cost of imports as the constraint to production. Fortunately, the Minister of Finance has brushed aside the suggestion to revisit the peg.

The U.S. meltdown is likely to have a more insidious impact on the Malaysian economy and this is not a danger that could be measured in real terms. Instead, it is the danger of misplaced imitative behaviour that is threatening.

The actions that have been taking in the U.S. can be interpreted as a failure of the free market system, a time to resort to more government intervention, and in the process to smuggle in cronyism and opaque policies.

The first bait to revisit a pegged ringgit has been rebuffed both by the Minister of Finance and the Governor of Bank Negara, and it shows a healthy respect for market forces.

We hope this persists and will not be tainted by the bailouts in the U.S. because, if that is the lesson we choose to learn, it runs the risk of being coloured by non-efficiency oriented considerations.

The writer is a senior research fellow at the Malaysian Institute of Economic Research.