BRACING FOR A FALLOUT

The Malaysian economy has its own list of woes to contend with at this juncture. In addition to keeping an eye on domestic issues, it is necessary for local investors and policy makers to bear in mind the possible shocks that could emanate from external sources.

The U.S. economy, in particular, merits close monitoring since developments there could have serious consequences on the Malaysian economy.

Although some analysts have bandied the argument that there has been a decoupling of sorts between the U.S. economy and that of ours, it is doubtful to what extent we have isolated ourselves from their influence.

It is sufficient to take note the Malaysia's exports to the U.S. account for about 16 per cent of our total exports. The U.S. is the single largest destination for Malaysian exports.

Indeed, it is true that about 15 per cent of our exports are to Singapore, but then, a substantial portion of those exports are ultimately re-exported to the U.S.

As recently as in 2001, when there was a collapse of the dotcom bubble in the U.S., the growth rate in Malaysia slid down to a humble 0.5 per cent. This should serve as a quick reminder that events in the U.S. could shake an otherwise smooth trot up the growth trajectory. It also blows away all talk of Malaysia being decoupled from the U.S.

June 2008 has not been the most favourable of months for the U.S. economy. The rate of inflation in that month was the highest since the last 17 years. Consumer prices were five per cent higher than in 2007.

Again, in June, the U.S. economy lost 62,000 jobs. A similar number of jobs were lost in May.

Since the start of the year no less than 440,000 jobs were lost, putting unemployment levels at something like 5.5 per cent. Forecasts on unemployment are not optimistic, and every indication points to a possible six per cent unemployment rate.

Economists had expected consumer confidence to fall in June from the 57.2 mark in May. The actual reading in June for consumer confidence recorded a mere 50 (the threshold) as observed by the Conference Board's Consumer Confidence Index.

What is striking about the consumer confidence figures is the fact that not since 1992 has consumer confidence been as low. These numbers should be worrying because consumer expenditure accounts for about 60 per cent of U.S. economic activity.

If June was a month that revealed worrying news, July did not bring good tidings either. IndyMac Bank (Independent National Mortgage Corporation), the largest savings and loan association in Los Angeles, collapsed on 11 July.

IndyMac's operations were transferred to the Federal Deposit Insurance Corporation (FDIC) because it was thought that IndyMac could not meet depositor's demands, making it one of the biggest banks to collapse in U.S. history.

IndyMac, valued at an estimated US$32 billion, was taken over by the government to avoid a further meltdown.

To add to the air of gloom, we have the rescue plan (or, in language we are more familiar with, "the government bailout") for Fannie Mae and Freddie Mac. Trendy as these names are, they conceal a reality that is hardly perky.

The Federal National Mortgage Association (or Fannie Mae) and the Federal Home Loan Mortgage Corporation (otherwise known as Fannie Mac), both government-sponsored enterprises, were hit hard by the subprime mortgage crisis in late 2007.

The fallout of that problem has required a housing rescue bill, and a rescue plan that might cost the U.S. government anything from US$25-100 billion, depending on whose estimates you look at.

There are legislators who do not agree with this bailout since it encourages irresponsible borrowing and lax lending procedures. It is hard to be stern with Fannie Mae and Freddie Mac, when between them they own or guarantee a significant portion of the mortgage market, which has been estimated to be close to US$6 trillion.

Besides, Fannie and Freddie cannot be punished at a time when the housing recession is at its worst since the Great Depression, even at the risk of invoking serious moral hazards.

Some reports claim that more than a million Americans have lost their homes. The rescue package is necessary to extend a hand to homeowners who need cheaper loans, and to curtail massive mortgage foreclosures.

In late February, Nouriel Roubini, in a written testimony to the House of Representatives' Financial Services Committee, claimed that the U.S. economy was at risk of a systemic financial meltdown. Roubini, a professor at the Stern School of Business, New York University, presented eight reasons why he thought a financial meltdown could not be avoided.

Structurally, the U.S. economy has not been on solid ground for some time now. Its budget deficit has been rising, and now amounts to something like US$357 billion. It has a current account deficit of about 5.5 per cent of gross domestic product, which declined from a deficit that stood at about seven per cent, a few years ago.

By many accounts worst is not over for the U.S. economy. In addition to falling consumer confidence, high inflation, and reduced demand from firms, the U.S. dollar is expected to drop further. The dollar, which has already dropped by 21 per cent against the currencies of its major trading partners, is expected to drop further, reducing the purchasing capacity of Americans.

All of this does not bode well for the Malaysian economy in the months to come. The Central Bank may have no option but to raise interest rates in an effort to curb inflation, if inflation persists.

Higher interest rates will adversely affect domestic investment. This will be compounded by the decline in exports destined for the U.S. economy. As it is, the Malaysian economy has been facing what has been characterised as “jobless growth”. It is likely that growth will assume the same lacklustre picture that presently portrays employment figures.

The government response to the oil price hike had a semblance of being ad hoc. Perhaps policy makers will be better prepared the next time an external shock occurs, and this time it could be because of the workings of the U.S. economy.

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