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The Threat of Global Economic Recession

The great US housing bubble has burst with an explosive force that few had foreseen, triggering an all-out financial crisis that has decimated markets around the globe. The pain has spread rapidly from the markets to the broader economy, and there is now a very real threat of global recession on a scale not seen in our lifetimes.

Planting the Seed of Today's Problems

The source of the present-day travails can be traced back to two major developments in 2001. In an effort to offset the collapse of the dot.com bubble and keep the US economy from slipping into recession, the US central bank pushed the Federal Funds Rate from 6% in early 2001 to 1% in 2003. The policy was wildly successful. Low interest rates fueled a sharp surge in US housing prices, generating a positive wealth effect and encouraging the US consumer to keep on spending like there was no tomorrow.

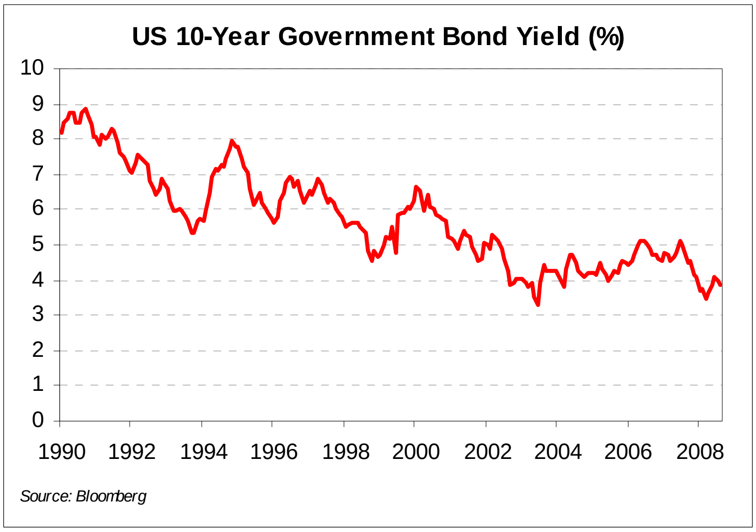
In the same year, following its entry to the World Trade Organization, China launched the 10th 5-year plan with the aim of transforming its coastal cities into a manufacturing powerhouse. The policy succeeded in spades, with companies around the globe jumping on the outsourcing bandwagon. Tapping into China's deep labour pool, Asian economies quickly expanded regional cooperation through manufacturing specialization, significantly enhancing operational efficiency and lowering production costs.

Better and cheaper consumer goods from Asia were a perfect fit with US efforts to stimulate consumer spending. From 2001 to 2007, the US current account deficit widened from US$384bn to US$731bn, while Asia's current account surplus ballooned from US$84bn to US$509bn. Despite frequent warnings about the dangers of the widening trade imbalance, this "Asia produces – US consumes" model proved extremely robust and was sustained for far longer than basic economics would support.

All the while, significant market distortions were building.

By bringing China's labour surplus into the global economy through trade outsourcing, wage growth in the developed economies was capped. In the US, for example, the wage component of GDP was three percentage points lower in July 2008 than it was at its peak in 2000. This helped to lower the inflation pressure.

Meanwhile, still locked in their traditional habits of saving for a rainy day, Asian consumers were slow to spend their export earnings. As a result, most of the trade surplus flowing to Asian economies was accumulated as forex reserves, of which the largest chunk ended up in the US bond market. Japan and China together held US$1,112bn in US treasury securities as of July 2008. Together with the effect of the low inflation environment at the time, US financial markets were flushed with low interest liquidity. This encouraged US banks to lend even more to the US housing market, pumping up consumer spending higher and higher. As we now realise to our chagrin, as the bubble grew, more and more loans were being extended to the sub-prime market. These were quickly repackaged and spread through the global financial system.



Credit Crunch

When US housing prices began their downward spiral in mid-2006, US financial institutions started to rein in lending to the housing market. But it was too late to prevent catastrophe.

The fuse was already burning toward a tinder-dry Lehman Brothers, inching toward an explosion that would whack the entire global financial system. Interbank lending dried up. Institutions were unable to replenish their funds. The US Federal Reserve attempted to put out the resulting fires, but the conflagration was so great that market participants could only look on in horror before running to the hills.

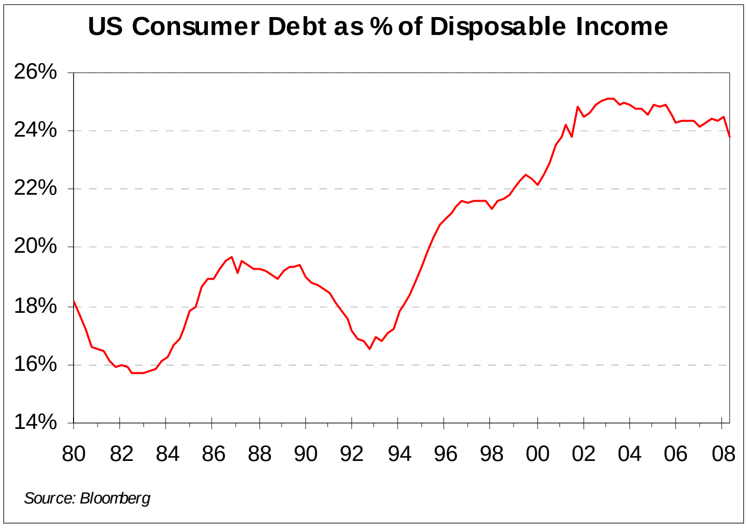
The mighty investment banks are no more. All have either transformed themselves into or merged with commercial banks – or gone bankrupt. Leverage – the mighty king of the investment banking world – is now a dirty word. The supremacy of the US financial industry is in question.

Meanwhile, the government has poured US$700bn to rescue the battered banking sector. It has de facto guaranteed debt of US$5.2trn issued by the mortgage corporations Fannie Mae and Freddie Mac. The use of public money to save the financial system, though necessary, has been deeply unpopular with taxpayers. It has also increased the government's debt burden. To safeguard public interest, regulation and oversight of the financial industry will be stepped up significantly. Furthermore, banks are now focused on repairing their balance sheets, and are disinclined to lend. The fallout will weigh on the global economy for years.

The Unwinding of US Consumer Debt

With slumping asset prices and banks' risk-averse stance, US consumer debt cannot be sustained at its current level – US$2.5trn as of mid-2008. During the housing bubble from 2000 till mid-2008, consumer debt averaged 24.6% of total annual disposable income. This is significantly higher than the average of 18.9% during 1980s and 1990s.

US consumers are being squeezed from two sides. On one hand, unemployment has surged in recent months. Some projections see unemployment reaching 8% next year, the highest level since 1984. Already, fears of recession and rising unemployment are forcing consumers to stop their spendthrift ways, sending chills throughout the US economy.



On the other hand, US households are coming to terms with a new beast – negative home equity. Property prices have dropped by 20% from their peak and the bottom is not yet in sight. Many personal housing assets, particularly those purchased in the past two years, are in or near negative equity. Those in this situation can cut their losses and walk away from their homes; or they can sit tight and attempt to pay down their debts without knowing just how great those debts could become.

Rising foreclosures will add further pressure on the housing market and economic sentiment. Slowing consumption will force a new round of layoffs. Unemployment and negative equity will reinforce each other, creating a desperate downward spiral. The situation is similar to the negative equity era suffered by Hong Kong during the period 1998 – 2003.

Will Asian Savings Help?

With the US Federal Funds Rate now at 1%, the room for further interest rate cuts is very limited. Growing public debt will also restrict the government's room to manoeuvre in designing a new fiscal stimulus package. The IMF forecasts that domestic demand of the US and Euro area to grow by -1.1% and 0.1% in 2009. This is significantly lower than the 2-3% pace recorded in the past few years.

With the West deep in trouble, it is natural to look to the East for solace. Asian economies are likely to resort to fiscal and monetary stimulus by drawing on the reserves they have built up in the recent past. The region is estimated to have accumulated US$2trn in current account surpluses between 2001 and 2008. China accounts for half of this surplus, and the effectiveness with which it uses these savings will be a key determinant of future growth in the region and in the West.

While infrastructure investments are likely to increase under encouragement from regional governments, the ability of the Chinese government to jumpstart local consumer spending is questionable. Compared to their US counterparts, Chinese households have a much healthier balance sheet. Rural and urban deposits have doubled since 2003 to Rmb 20trn. However, due to the lack of a secure social security net, and the underdeveloped state of the asset and consumer markets, Chinese consumers save 30-40% of their incomes. With the worsening external economic environment, they are likely to save the lion's share of any fiscal and monetary stimulus thrown their way. Other Asian economies will behave similarly, though to different degrees. Hence, Asian consumers will do very little to fill the spending gap left by retreating US consumers.

Conclusion: A Reflection on Globalization

The rapid globalization process since the turn of the century has allowed Asia and the US to raise trade co-operation to a higher level, and together they have produced a larger economic pie.

However, little thought was given as to how the two should consume this bigger pie in an optimal and sustainable manner. With Asia more willing to lend than to spend, the US has been doing most of the borrowing and consumption. With the pockets of US consumers now well and truly empty, we are missing the essential ingredients to bake the next pie. The mistakes of regulators, credit rating agencies and bankers have exacerbated the problem; but the unsustainable trade imbalance has been the underlying economic problem all along.

The global economic recession we are facing today is structural in nature, the consequence of the collapse of the "Asia produces – US consumes" model. If the world does not have enough customers to consume what it produces, perhaps the world may have to produce less. Hence, excessive production capacity and deflation are the twin challenges the world will face in the next two years.