

The American “financial tsunami” hits Asia

Regional downturn

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The American financial crisis has sent shockwaves throughout Asia over the past few days as governments, banks and corporations scramble to cope with plunging share prices, international financial turmoil and the prospects of a serious downturn in the US and other major economies.

The bankruptcy of US financial house Lehman Brothers and the takeover of Merrill Lynch prompted sharp falls on Tuesday when many Asian stock markets resumed trading after a public holiday. Tokyo fell by 4.95 percent to its lowest level in three years and Hong Kong’s Hang Seng Index shed 5.4 percent to reach its lowest point in nearly two years. The Shanghai share index fell 4.47 percent, Taiwan’s market tumbled 4.89 percent and South Korea’s benchmark index dropped 6.1 percent to an 18-month low.

The falls continued across Asian markets yesterday even after the US government announced an \$85 billion bailout to prevent the impending collapse of insurance giant American International Group (AIG). Despite reassurances, worried AIG policyholders thronged to the company’s offices in Asian countries to terminate their agreements. Hundreds queued in Singapore outside the local AIG headquarters, while in Taipei more than 1,200 descended on the AIG subsidiary, Nan Shan Life Insurance.

In government and financial circles, concern extended beyond the immediate financial turmoil to the longer term impact of a recession in the US, which is the major export market for the entire region. At the same time, China, Japan, South Korea and Taiwan have all used their huge monetary reserves to invest heavily in the US as a means of preventing a slide of their currencies against the dollar. Fear is mixed with a certain bitterness over the potential for huge losses in their dollar-denominated assets.

All eyes were on China, which has functioned as the main economic motor for growth throughout the region. Within hours of Lehman Brothers filing for bankruptcy, the Chinese central bank cut the official interest rate for the first time in six years, from 5.85 to 5.31 percent. The decision signalled an end to Beijing’s tight monetary policy to fight inflation and a renewed focus on economic growth to avoid widespread unemployment and social unrest.

China’s exports have already been hit by economic slowdowns in the US, Europe and Japan. Although China’s economy grew at more than 10 percent at the first half of the year, there are signs of a sharp downturn in the second half. Exports have weakened, share prices have plunged by more than 60 percent since the beginning

of the year and the property sales have reversed from a 25.7 percent increase in square footage last year to an annualised 10.8 percent decline for the first six months.

The official *People’s Daily* warned on Wednesday that a “financial tsunami” was approaching, which recalled the Great Depression in the US in 1929. “As the contemporary economy has been integrated globally, American consumption and currency exchange rates will directly influence countries dependent on the US as the main export destination for economic growth and employment”. The Chinese Communist Party organ complained that the US had unleashed financial “weapons of mass destruction” on the world economy in the form of subprime debts and related financial derivatives.

China is particularly vulnerable. For years, Beijing has been financing debt-driven consumption in the US by recycling its huge foreign currency reserves earned from exports back into US Treasury bonds and other investments to prevent the yuan rising against the dollar and thus maintain exports to the US. According to the China International Capital Corp (CICC), China holds a fifth of its foreign currency reserves, or up to \$400 billion, in the mortgage giants Fannie Mae and Freddie Mac, which the US administration had to bail out this month.

Since the US subprime crisis erupted last year, Beijing has been cautiously reducing its holding of dollar-denominated assets from the current 60 percent. But amid the concerns about suffering huge losses, there are also fears of using what Chinese officials refer to as the “nuclear option”—a sudden dumping of China’s dollar holdings. As Beijing is well aware, such a step could precipitate a crash of the US dollar, economic depression and endanger the entire international financial system—with devastating economic, social and political ramifications for China.

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In line with central banks around the world, the Bank of Japan injected 3 trillion yen (\$US28.32 billion) into the domestic money market on Wednesday, taking the total to 5.5 trillion yen this week. Although Japan’s financial institutions claimed to have just 400 billion yen (\$3.8 billion) in exposure to Lehman Brothers, banks such as Aozora Bank and Mizho Bank are among the top

creditors to the bankrupt US investment house. Share prices continued to fall yesterday following the AIG bailout, amid fears that the US economic turmoil would hit Japanese exports.

Japan, the world second largest economy, is already in deep trouble. The US financial crisis hit as official figures published last week showed that the economy had shrunk by 3 percent on the annualised basis in the second quarter this year. After two decades of economic stagnation, Japan's growth rate has made a limited recovery in recent years, mainly as a result of exports to China. Like other Asian economies dependent on exporting parts, capital goods and raw materials to China, Japan faces a double whammy as any US recession will affect its exports to both the US and China.

The mood of gloom was reflected in an editorial in the conservative *Yomiuri Shimbun* on September 17: "A vicious cycle—in which financial uncertainty cools down the real US economy and causes an economic downturn—is become a reality. Fears over ensuing slowdowns in the economies of Japan and other nations are growing... Under these circumstances, the government's top priority should be to quell uncertainty over the financial markets."

But the Japanese government is divided. Prime Minister Yasuo Fukuda resigned earlier this month after an 11.7 trillion yen (\$110 billion) stimulus plan received a generally negative response in financial circles. The contenders for his post are split over economic policy, with the frontrunner Taro Aso known as an advocate of greater government spending, while his main rivals are demanding greater austerity, higher consumption taxes and further economic restructuring to rein in the country's massive public debt—now equivalent to 180 percent of GDP, the highest of all OECD industrialised countries.

Other major Asian economies have fared no better. India, the world's 12th largest economy, is often hailed alongside China as one of the latest economic miracles. While Indian officials reassure the markets that the country is less dependent on exports than China, investors are already leaving. Last week, prior to the announcement that Lehman Brothers was bankrupt, foreign investors dumped \$610 million worth of Indian shares.

India's central bank injected 298.15 billion rupees (\$6.37 billion) into the local market yesterday to try to maintain financial stability. But all the indicators point to further turmoil. The Sensex index has declined by a third this year, representing a net withdrawal so far this year of \$8 billion in foreign investment—compared to net inflow of \$17.4 billion in 2007. The Indian rupee has also weakened by 8.3 percent against the dollar this year.

The potential impact goes far beyond India's money and equity markets as any global downturn would seriously undermine India's ambition to become a new manufacturing powerhouse. Known at present for its low-cost call centres, software development and outsourcing of financial services, India had plans to create 250 "special economic zones" by the end of 2009.

Even before the US financial crisis, Indian economic growth had slowed to 7.9 percent in the second quarter on an annualised basis—down from 8.8 percent in the previous quarter. Even though still high, it is the lowest rate since 2004. Driven by rising global

oil and food prices, the inflation rate has almost tripled this year to 12.4 percent. In response, the central bank has raised interest rates three times since June, but now confronts the dilemma that further hikes could send the economy into a tailspin.

In South Korea, the world's 13th largest economy, there is deep concern about a further tightening of the global credit markets, even though the exposure of financial institutions to Lehman Brothers is relatively small. The Bank of Korea has declared that it will inject funds into the financial and foreign exchange markets if needed in order to "calm nerves of market participants".

The *Chosun Ilbo* sounded a sharp warning: "Many small and mid-sized businesses are being pushed to the verge of bankruptcy as banks toughen loan requirements amid heightened fears of defaults as economic uncertainties grow. The financial shock that began in the US has begun to impact not only Korea's financial markets but also its real economy. If conditions worsen in the US financial markets, there are worries of an intensifying vicious cycle of banks and businesses facing tougher conditions raising funds overseas, which will lead to cutbacks in corporate activities, which in turn will slow the economy."

Like Japan, any slowdown in the US that impacts on China will adversely affect South Korea, which is heavily dependent on both markets. South Korean companies have in recent years received a huge boost from exports to China, which is now the country's largest trade partner.

Any slowdown will be an Asia-wide trend. The Asian Development Bank (ADB) released a study on Tuesday, which foresaw a sharp downturn in the Asian economies. The report pointed out that India would end five consecutive years of rapid growth, which would decrease to 7.4 percent this year and an estimated 7 percent in 2009, down from 9 percent last year. The ADB also forecast that China's growth rate would fall to 9.5 percent in 2009, down from 11.9 percent last year.

The ADB predicted the average growth rate for its 44 member states to be 7.5 percent for this year, followed by 7.2 percent next year. Both figures were revised down from estimates in April. The predicted average inflation rate is 7.8 percent this year and 6 percent in 2009, both significantly higher than the previous estimates of 5.1 percent and 4.6 percent respectively. Rising prices and falling growth rates confront all these economies with the prospect of stagflation, posing deep dilemmas for governments.

All of this is before the full force of the US financial tsunami takes its toll in Asia. The empty speculation about the prospect of Asia—China in particular—being "decoupled" from the US crisis and pulling the world economy out of recession, has been quietly shelved in recent days. The regional ruling elites confront a new period of capitalist breakdown and the political and social struggles it will inevitably produce in Asia and internationally.



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