That Was the World
That Was (TW3)
I am writing from Boracay, with both my feet well-sunk into the powder-textured white sand on the best stretch of beach in the world, located south of the city of Manila. The weather was just nice enough for me to think about what to write for my second essay in *The Star* (the first was on December 20, 2008, now published as Chapter 101, “Getting ‘Cangkul-Ready’”) as another annus horribilis draws to a sad conclusion. Hence, TW3 2008, or that was the world that was in 2008.

Looking back, it’s hard to summarize a year that blew hot and cold—both rather uncomfortable. The first half of the year reminds me of Malthus’s challenge to the dwindling global supply of resources—oil, food, and other commodities. None foresaw (including me) that the crude oil price would rise so fast from its lows in early 2007 to US$87 a barrel on February 6, 2008, to US$100 on February 19, and then on to a high of US$145 on July 3, only to fall precipitously to US$31 by December 22 (US$44.60 on December 31, 2008). Similarly with crude palm oil: from a low of RM1,893 per tonne on January 30, 2007, to RM3,117 by end-2007 to a high of RM4,330 on March 3, 2008; the highest price reached in the second half of the year was RM3,600 on July 3, before falling to its lowest on October 24 at RM1,390 (RM1,629.50 on December 31).

Name the commodity, and we see similar sharp gyrating trends all within a calendar year. In the same vein, central banks saw the scepter of inflation and debated seriously on the trade-off between growth and inflation. The second half of the year turned it all around—by year-end, the talk had centered on how to avoid stag-deflation (Columbia University’s Professor Nouriel Roubini’s combination of *stagnation/recession and deflation*) or even depression (at worse, the Great Depression Mark II). Just as quickly, John Maynard Keynes has been disinterred and became the topic of conversation within the infamous Malaysian *tai-tai* network, so I was told.
Politicians have since had a field day and decided that the state now has a proactive role beyond standing back, since the market no longer has all the answers. They do have good reasons.

**Annus Horribilis**

Indeed, 2008 was the year the system failed in the United States. Consider these contradictory phenomena: (1) In this year, US long-term interest rates were at their lowest in 500 years; but the year also saw the highest rates in 20 years; (2) this year was the worst for the US stock market in 70 years—yet, of the 10 best days experienced during this long period, 6 came in 2008; (3) this year, economists started off by worrying a lot about inflation but then switched to concerns about recession and deflation, all within a year; (4) this year, the US government started lending to businesses and banks in ways that they could never have borrowed before, as people feared widespread corporate and financial bankruptcies since the businesses and banks could not borrow to repay; and (5) this year, a few trusted Wall Street personalities defrauded their own kind (Madoff for a reported US$50 billion through a Ponzi-like fraud scheme, and lawyer Marc Stuart Dreier getting hedge funds to invest monies that eventually landed in his pockets). These glaring contradictions—all within a year—reflect the sentiments behind the title: “The Year Free Markets Ran Amok.”

That’s not all: (1) This year, in a dramatic turnaround to save the financial system, Washington practically nationalized federal government–guaranteed housing mortgage institutions, Fannie Mae and Freddie Mac, as well as the AIG group of insurance companies (including bailing out those who lent to Bear Stearns) and later, Citigroup; however, it allowed investment bank Lehman Brothers to fail with disastrous worldwide repercussions; (2) this year, the US securitization machine (which was heavily relied on previously to “prop up” the system) collapsed so badly that the financial system could not perform its traditional role of “bridging” lenders and borrowers—worse still, banks could no longer trust one another’s balance sheet; as a consequence, government had to become lender of first and only resort; (3) this year, it took Washington most of the year to realize that the underlying problem of the banks and investment houses was one of solvency, not just illiquidity; (4) this year, most economists were caught flat-footed before they realized that the US recession had already started in December 2007, with optimists still thinking then that it wouldn’t last longer than early 2009; (5) this year, with oil and commodity prices collapsing, inflation vanishing, and unemployment rising rapidly, the US Federal Reserve Bank (Fed) cut short-term interest rates rapidly to about zero by near year-end with 10-year Treasuries at close to 2 percent (not seen since Eisenhower years); but junk bond yields rose to
17 percent (i.e., about 1990 levels, the last time the banking system almost collapsed)—indeed, money has become so cheap that recently the US Treasury bills rate turned negative briefly (can you imagine, the government got paid for borrowing!); (6) **this year**, we began to see that the expected push of the Chinese and Indian locomotives could not be de-coupled from the ever-evolving global interdependence—that the BRIC nations’ (Brazil, Russia, India, and China)\(^3\) expansion was not sufficiently dynamic to offset the recession contagion originating in the United States and Europe, whose virulence has since surprised even those who supposedly had the prescience to foresee; and (7) **this year**, we saw a crisis of global proportions made in the West—from irresponsibility emanating not from “them” (for until now such crises only happen to “them” in Asia, Latin America, and Russia) but from indiscipline, profligacy, and regulatory failures of the United States and Europe, ironically with “them” as the creditors and the West, the debtors—and this list is not exhaustive.

**What’s in Store for 2009?**

What, then, are the lessons? What are we to do? The thing that continues to puzzle and intrigue is how the two halves of 2008 could not have been more different and yet, they came together rather seamlessly within the same year. It does, however, point to the inadequacy of conventional wisdom to explain just how quickly the unthinkable can readily come to pass and just as quickly become the unremarkable. The big lesson: It is foolhardy to even offer to peer into 2009. We just don’t know enough about the nature of the global transmission mechanism and the time taken for economic interdependence to work through on the financial front (failure of political governance to keep pace with tightening interconnections among markets, banks, and regulators), on the geopolitical side (the disappearing line between “them” and “us” regarding the origin of crisis) and in the wider context of a “cracked” established world economic order that is not working and not properly understood. Nevertheless, let’s take stock and see where the unfolding financial crisis and current recession in the United States and Europe are leading us. My own take is as follows:

1. We are already witnessing (and most certainly feeling) a global recession, and it is likely to get worse.
2. US gross domestic product (GDP) will likely remain negative over most of the first half of 2009; the best-case scenario being negative until the end-2009. Recovery in late 2009 is still possible but will be weak (it’s going to still feel like a recession) and is expected to be still rather weak in 2010. Unemployment could possibly peak at 9 percent
in 2010 (nowhere close to the 25 percent, and a 50 percent national income loss, as in 1929–1933).

3. Things have happened (and are still happening) that I have not seen in my 39 years as a working economist and banker: (a) the sharp amplitude of US stock market movements—value of the real (adjusted for inflation) S&P 500 Index tripled in 1995–2000, but by November 2008, it fell 60 percent from its 2000 peak (in 1924–1929, real stock prices tripled, and then fell 80 percent in 1929–1932); (b) the biggest housing bust since the Great Depression; (c) zero interest rates—and briefly, in December, negative rates—not seen since 1941; (d) global equity values estimated to be down by 50 to 60 percent in 2008—the year in which every asset class (stocks, real estate, commodities, even high-yield bonds) fell by significant double digits. Total paper wealth destruction could be in the region of US$30–35 trillion. The list goes on.

4. I don’t see a Great Depression Mark II coming on.

Lessons

Here are 10 useful lessons from the Great Depression to think about:

1. Adjustment from the sharp downturn will be long and painful.
2. Credible solutions need to focus on demand and output, and in the process, avoid fixing prices and wages.
3. It is useful to have a willingness to explore new, lean-against-the-wind programs.
4. Time is of the essence in the politics of recovery—large direct spending fusions do serve to weaken downward spirals; recessions are prone to develop.
5. When spending during recessionary times, deflation is a worse enemy than inflation.
6. Do not engage in beggar-thy-neighbor policies.
7. When trust is shattered, economic stakeholders need firm leadership and confidence in an effective public authority to manage expectations and address the destructive deleveraging recession.
8. Economic mishaps can quickly eat up political capital since expectations are high to deliver quick results.
9. Need to address early the capitulation of underlying consumer spending since both income and wealth have been drastically reduced—the policy response needed is purposeful measures to fill the void left by retrenching consumers—that is, a massive fiscal stimulus.
10. The key economic lesson: The political will to do enough—that is, leadership to err on the side of doing too much to stimulate rather than doing too little and too late.

What, Then, Are We to Do?

The key to good leadership is to be ahead of the curve. For us in Malaysia, there is no doubt that the worst is yet to come—likely to come on after the Chinese New Year festivities in early 2009. Already, businesses and consumers are getting that “sinking feeling” regardless of what the economic numbers now show. One of the lessons from our short history of recessions and slowdowns is that things can smolder for a longer time than expected. As of now, confidence is still fragile, and whatever is being done, don’t forget we are dealing with managing expectations, a psychological phenomenon.

People need to believe that public policies will do the whole job, not just plugging holes. As I see it, we are at most times more of an ostrich than a sage owl. Realistically, our macroeconomic adjustment is likely to be longer than shorter. Unfortunately, we are optimists by nature, already thinking too soon that we can discern a beginning of better days ahead. I assure you, there will be time for optimism, but not just yet. I fear we must expect macroeconomic weaknesses still to come and maybe even persist through most of 2009.

I realize, of course, it’s hard to know what’s going to happen next week, never mind the entire 2009. My gut feeling is that the overall economy is worse than what many people expect. The year 2008 saw the markets pushing the economy down; if so, 2009 will see the macroeconomy impacting the markets. Indeed, the process has already started—surely in the United States and Europe, and the impact is beginning to be felt in China, India, and Japan.

Through good and bad times, the Malaysian economy has always shown an innate resilience that eventually pulls the country through, mainly with firm leadership at the helm to restore confidence and, when needed, rejuvenate Keynes’s “animal spirits” to help jump-start the economy.

But before this can happen, at a time like now, we need the type of leadership we deserve to stimulate activity through large-scale effective government spending to fill the gap created by softening consumer spending (because of declining wealth, stock prices and Bursa Malaysia market capitalization had fallen 45 percent between their high and low in 2008, with expectations of income loss), business downswing in profits and reduced earnings growth, if any, and the deleveraging of private balance sheets as the slowdown bites. The key push must be to generate employment since the economy will not stabilize until wealth and incomes are rebuilt in a
sustained way. The full force of fiscal policy needs to be deployed to push for an early recovery through compensatory government spending to fill the void left by business and consumer withdrawal of spending and borrowing.

In earlier essays (published in The Star on December 20, 2008, and in The Edge on December 29, 2008), both now reproduced as Chapters 101 and 102, respectively, I proposed (and rationalized in some detail) the urgent need for a second stimulus program of RM30–40 billion over the next two to three years. This should give us the value-added jobs and evolving income we badly need, bearing in mind the lessons we can learn from the past. Indeed, we need to do more rather than less at a time of great uncertainty in the face of a rapidly expanding global recession, and at a time when the risks of pump-priming are minimal.

In times of complexity, I believe commonsense pragmatism has to prevail. I am optimistic about the macroeconomic choices now before us. The political and economic risks can be readily managed. The current and unfolding uncertain circumstances present the best time for Malaysia to spend smartly on projects with lasting benefits, and at the same time, add value and restructure the economy to build capacity in an environment of slowing and weakening economic conditions at home. We deserve more.

Boracay, Philippines
Kuala Lumpur
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Notes

2. Refers to the proactive network of well-to-do and well-connected housewives (mainly tai-tais, usually rich or titled or both) with nothing better to do than organize regular get-togethers (usually lunches, sometimes dinners) at which they exchange the latest goings-on around town (and act as an online “breaking news”) over a game of mah-jongg or afternoon tea.
3. This new grouping (first suggested by Jim O’Neill, then of Goldman Sachs, in 2001) comprises Brazil, Russia, India, and China—the rapidly rising major emerging “developing” nations. Together, they exceed 3 billion people (nearly 45 percent of world) and account for 25 percent of the global GDP on a purchasing power parity basis. South Africa was included as a member since December 2010, with the grouping consequently known as BRICS.