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The Fed's Tapering: Economic and Strategic Impact from Advanced Economies to Emerging Asia

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The day Dr Dan Steinbock first visited ISIS Malaysia in February 2009, export-led growth economies plunged that morning. Many thought the financial crisis in the United States, which had spread to Europe, was simply a bump on the road. However, Steinbock predicted a long recovery — a prediction which, unfortunately, proved to be true for many countries.

During his most recent visit to ISIS, Steinbock touched on a wide range of issues including the impact of the Federal Reserve (Fed) tapering, the disconnect between the real and market economy, the impact of the economic crisis on the advanced economies, China and the emerging economies as well as what to expect next.

Steinbock believes that the current situation reflects a major shift from advanced economies to large emerging economies. Together the emerging economies become multiple sources of growth for the world economy and this shift has 'huge ramifications'.

Not long ago our world economy was fuelled by the US consumption. While this offered some predictability and stability to the market, over-reliance on a single economy also meant dangerously tying the world's well-being to the health of one country, namely the United States. According to Steinbock, business cycles work simultaneously with structural transitions and this creates much volatility.

Such precariousness generates a great deal of opportunities for Wall Street. In fact, the number of Dow Jones investors is higher than it was before the crisis. It is thus natural to assume that the economy is doing fine but there is a problem — the total debt burden has not changed, let alone been reduced.

While the markets have been soaring, the real economy reveals a different picture. The Baltic Dry Index (BDI) is currently hovering around 1,200. (BDI is a shipping and trade index that 'measures changes in the cost to transport raw materials such as metals, grains and fossil fuels by sea'. BDI indirectly measures the global supply and demand for the commodities shipped aboard dry bulk carriers, and because these commodity consists of materials that function as raw material inputs to the production it is also seen as an efficient indicator of future economic growth and production.) The BDI soared near the 12,000 level in May 2008. Real economic activities are significantly lower than its pre-crisis level.

According to Steinbock, the US government was printing a lot of money and this caused a disparity between the soaring markets and the sluggish real economy (the Fed was engaging in expansionary money policy which increased liquidity in the economy). Steinbock believes it was a necessary action in the early stages of the crisis. However how long can such a policy be carried out before it accumulated significant collateral damage not only in the United States but other economies as well?

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The US economy

The US economy, Steinbock feels, managed better compared to other troubled advanced economies because of the actions of the Fed and US government at the onset of the crisis. European countries had initially opted for austerity measures before embracing the expansionary policies but the impact on their economies may not be as positive as in the case of the United States due to the time lag and worsening economic conditions. It is important therefore to study the US monetary policy which has paced, dictated and shaped other monetary policies.

In December 2008 the Fed reduced the fund rates to 0-0.25 per cent and implemented a 'non-traditional' monetary policy which encompassed three strategies. The first strategy was through 'Forward Guidance' where the Fed informed on the future direction of interest rates ahead of time. This reduced uncertainty and increased transparency on its intentions.

Dan Steinbock

Second, the size of the Central Bank (CB) balance sheet or QE (Quantitative Easing) was increased. Three large-scale asset purchases increased the balance sheet from $0.4 trillion in 2007 to $4 trillion at the end of 2013. Third, the composition of the CB, which included purchasing long-term bonds to reduce its long-term interest rates, was reformed.

As a result of the measures taken, combined with expansionary monetary and fiscal policies, the US economy has improved. US economic growth is expected to be at 2.6-2.8 per cent for 2014 with an inflation rate of 1.6-2 per cent and unemployment rate will decrease from 6.2-5.8 per cent. Inspite of the rosy outlook, Steinbock remains cautiously optimistic. He thinks that the consensus view may have underestimated the robustness of the housing market, strength of the labour market and challenges of structural debt. In addition, there are downside risks which include external risks from the eurozone and emerging markets that took a toll on the US economy in the first quarter of 2014.

However, the central issue for Steinbock is unemployment rate. The Fed will begin tightening monetary policy once unemployment rates approach its trigger rate of 6.5 per cent. The unemployment rates are at 6.8 per cent and the participation rate (to labour market) has also declined. Steinbock estimates that at least half to two-thirds of the decline is caused by an aging population and not by the recession. If this proves to be the case then there is a possibility of the Fed hiking interest rates prematurely.

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China

Many have described the change of leadership in China in 2013 as a victory for the conservatives over the liberals. Steinbock, on the contrary, deems Xi Jinping and Li Keqiang, as consensus leaders — mainstream leaders who enjoy support from a wide range of segments within the Chinese society. Xi, he admitted, wields a lot of economic power and while the Chinese President makes some understandably uneasy, Steinbock contends that it would be difficult to implement change without having real concrete power.

Steinbock also pointed out that China's leadership is in transition. The current leaders would likely retire within five years and the next generation of liberal reformers, such as current Deputy Prime Minister Li Yuanchao, would lead China.

China's real gross domestic product (GDP) growth was 7.7 per cent last year and Steinbock expects a real growth of 7-7.4 per cent for 2014 and 2015, with an inflation rate or consumer price index (CPI) of 3.5 per cent. The policy rate is projected to remain at 4 per cent in 2014. Nevertheless corruption remains a challenge in China; while one should not underestimate the problem of corruption, one should not overestimate its extensiveness either.

Steinbock thinks China's growth will remain at 5-6 per cent for years to come, assuming the situation in South China Sea remains peaceful. The downside risks could come from its property market, where there is a danger of property prices declining too much, or from 'faster-than-anticipated' deleveraging efforts as well as from its shadow-banking defaults.

Malaysia

According to Steinbock, Europe's stable albeit slow economic recovery, progress in Japan's economy and continued improvement in the US economy all work in Malaysia's favour. Their increase in demand will help boost Malaysia's exports.

Where China is concerned, Steinbock highlighted that the development in its third- and fourth-tier cities now needs commodities that the first- and second-tier cities no longer need. In Shanghai, Foreign Direct Investment (FDI) in manufacturing is leaving but other types of investments, such as business-FDI, are going in. Hence China should be examined both in terms of its regions and sectors. Different regions require various levels of development and needs and these present diverse business opportunities for Malaysia.

The downside risks in China — a faster-than-expected deceleration in its economy, the inability to implement full economic reforms, and increased isolation due to its noneconomic policies particularly on the South China Sea — is likely to impact Malaysia negatively. Pertaining to MH Flight 370, Steinbock is not overly worried about the ramifications; he believes there is real intention and desire on both sides to develop cooperation beyond the daily issues.

Fed tapering

The key issues to consider here are when and how long is the interim period before the Fed starts hiking interest rates as well as the kind of impact it would have on the world and emerging markets in particular. Increased interest rates would make US financial instruments more attractive as they offer better returns to investment and may cause capital outflows from some regions, namely the emerging markets. Nonetheless, China would still be attractive provided its extensive reforms are implemented accordingly.

As for the rest of Asia, Steinbock feels that there will be increased volatility and more uncertainty and more importantly, there will also be differentiation in emerging markets. Factors such as fiscal deficit or surplus, current account balance, inflation level, macroeconomic policies, stability, and so on, will be important considerations for investors. The better managed emerging markets are likely to benefit in a market differentiation situation than those which are not.

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A participant poses a question