Investors have only begun to appreciate the importance of the U.S. financial crisis for the Asian economy. The Kospi’s 7 per cent plunge on August 16th may have been a wake-up call for Korean investors. But for those hoping that the worst is over, I have news from America. You ain’t seen nothin’ yet.

The outlook for the U.S. economy is bleak. It is increasingly difficult to tell a story that doesn’t involve a recession, or at least a very significant economic slowdown, in the next 12 months. The U.S. housing bubble has burst. This is not exactly news, of course. Existing home sales had dropped by 20% from their peak even before the most recent bout of financial turmoil. New home sales had declined by 40%. The inventory of unsold homes had already exploded.

What is news is that the American consumer has woken up and smelled the coffee. Last week’s disappointing consumer confidence numbers from the University of Michigan clearly signaled this fact. Those numbers surely loomed large in the Fed’s extraordinary intra-meeting discount-rate cut last Friday. The threat to U.S. growth is not simply that residential construction has halted and that residential construction accounts for 40 per cent of all fixed investment. It is not simply that nonresidential investment will tank now that corporatons in other sectors are finding it more difficult and costly to borrow. It is that the growth of private consumption will now slow sharply. And private consumption accounts for more than 70 per cent of U.S. demand.

If the “consumer of last resort,” the American household, now goes on strike, this will have serious implications for other countries and for Asia in particular. There has been much talk in the last year of “decoupling” – of whether Asia can keep growing if U.S. growth stops. The idea is that Asia now has an independent growth pole in China. And with the Japanese economy doing better than it has in a decade, Asia can keep dancing even when the American music stops.

Nothing could be more wrong. Half of all Chinese investment is in the export sector. And those exports are heavily destined for the United States. Thus, a significant slowdown in Chinese growth is now all but inevitable.

As for Japan, Mrs. Watanabe’s rediscovery of risk and consequent decision to keep her money at home mean a significantly stronger yen. And in turn this bodes a slowdown in Japanese growth and even the return of deflation.

The implication is that all of Asia should prepare for a significant economic slowdown. With growth in China slowing significantly, none of the neighbors will be immune. Since much of what other Asian countries sell to China is, in turn, simply assembled and sold on to the U.S., the impact of U.S. troubles will be more immediate still.
In offering this gloomy forecast, I like to think that I am not simply joining the latest pessimistic bandwagon. Fully a year and a half ago, Yung Chul Park of Seoul National University and I wrote that the main threat to economic stability in Asia emanated from the United States. We warned that a significant fall in asset values in the U.S. could lead to an American recession and an economic slowdown in Asia. Rather than infecting Asian banks and financial markets, we saw problems in the U.S. as hitting Asian economies by slowing the growth of their exports.

Full disclosure requires acknowledging that we anticipated that those problems would be accompanied or even precipitated by a sharp drop in the dollar. So far, however, problems have centered in the markets for collateralized debt securities and commercial paper, not the market for foreign exchange. Investors have not fled the United States for other countries or caused the dollar to tank.

But it is still too early to dismiss this risk. Foreign investors, including central banks, have been diversifying out of U.S. treasury bonds into mortgage-backed securities and the U.S. stock market. These investments now look less attractive in light of recent developments. And if these alternative investments look dicey, diversifying out of U.S. treasuries will require diversifying out of dollars. The result will be a sharply lower dollar, which will be more bad news for Asian exporters.

Which countries are most at risk? Professor Park and I pointed to Hong Kong, Singapore and Taiwan, since they depend most on exports to the United States. Korea we lumped into a second group – still vulnerable if somewhat less so – along with Indonesia, Malaysia, the Philippines and Thailand. This is still my best guess of who will be hit hardest by the coming U.S. slowdown. It is time for Asian investors to fasten their safety belts.

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