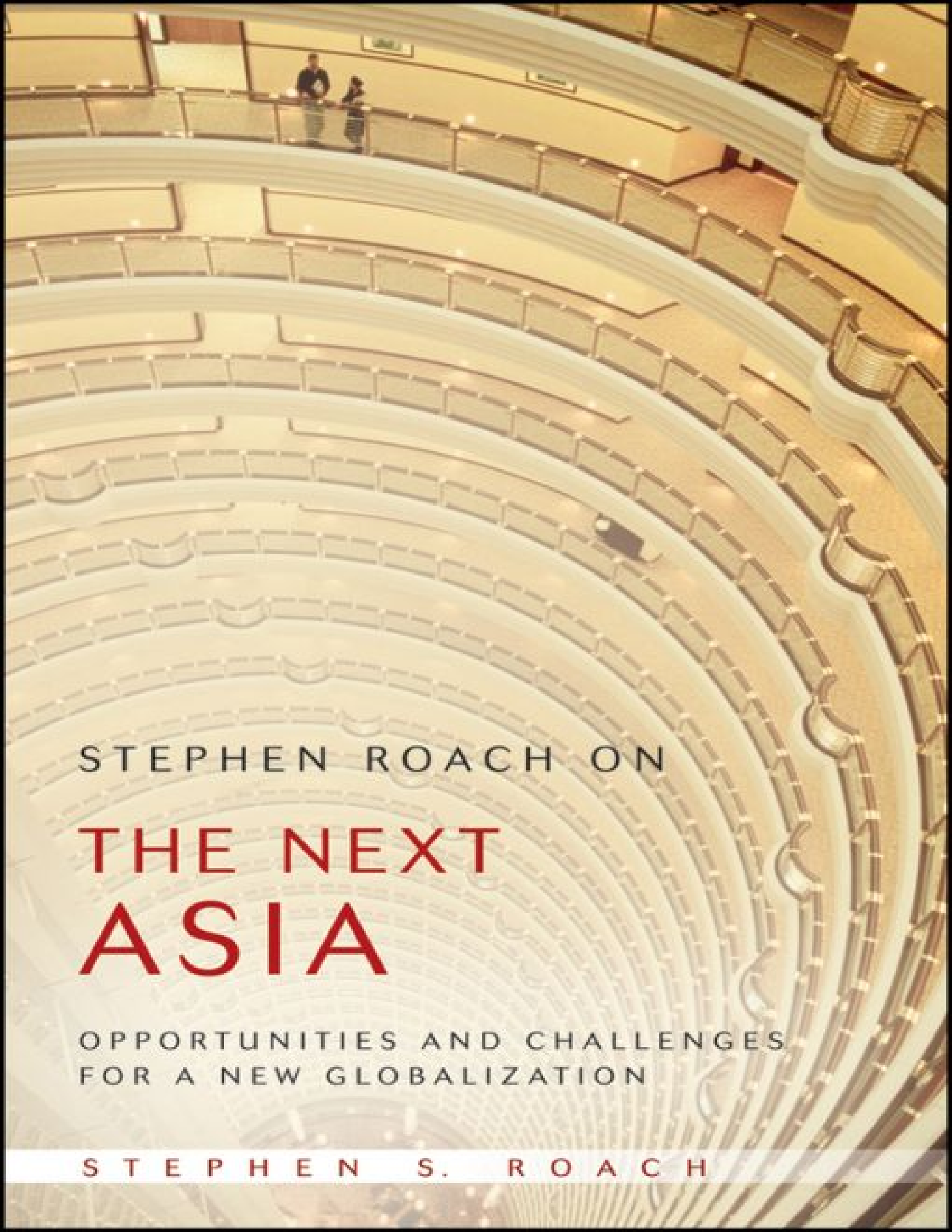


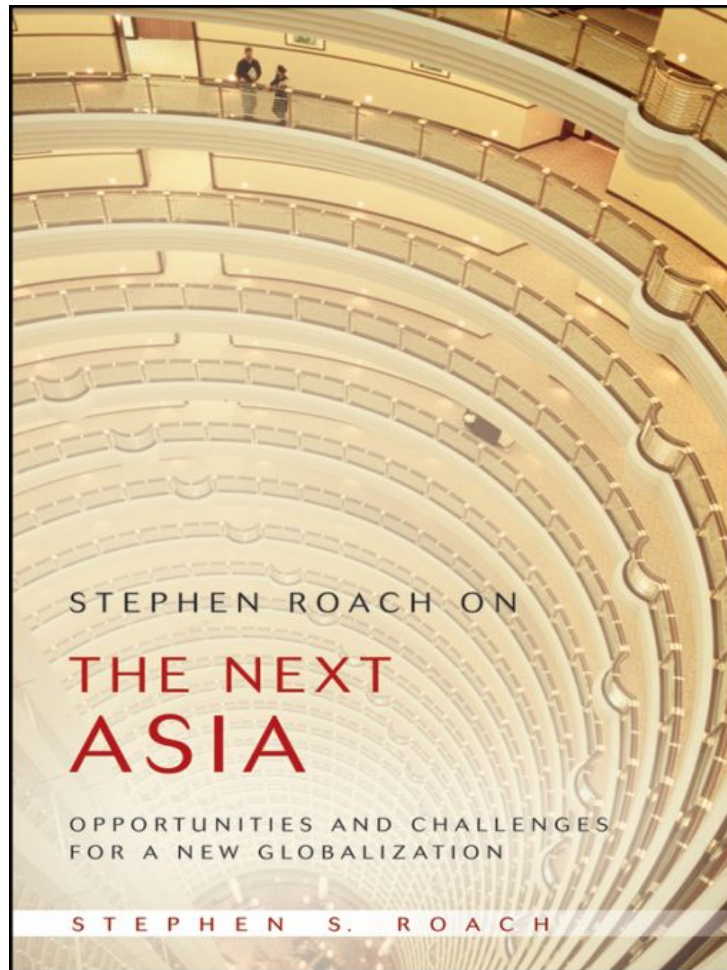


STEPHEN ROACH ON

THE NEXT
ASIA

OPPORTUNITIES AND CHALLENGES
FOR A NEW GLOBALIZATION

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Table of Contents

[Title Page](#)

[Copyright Page](#)

[Dedication](#)

[Acknowledgements](#)

[Introduction](#)

[Chapter 1 - A World in Crisis](#)

[A Subprime Outlook for the Global Economy - October 18, 2007](#)

[Save the Day - September 25, 2007](#)

[Coping with a Different Recession - January 17, 2008](#)

[Davos Diary: 2008 - January 26, 2008](#)

[Double Bubble Trouble - March 5, 2008](#)

[Even When the Worst Is Over—Watch Out for Aftershocks - April 15, 2008](#)

[Pitfalls in a Postbubble World - August 1, 2008](#)

[Panic of 2008: Enough Scapegoating - October 1, 2008](#)

[Global Fix for a Global Crisis - October 9, 2008](#)

[Changing the Fed's Policy Mandate - October 28, 2008](#)

[An Early Leadership Opportunity for Barack Obama - November 6, 2008](#)

[Dying of Consumption - November 28, 2008](#)

[Uncomfortable Truths about Our World after the Bubble - December 3, 2008](#)

[A Postbubble Global Business Cycle - January 7, 2009](#)

[America's Japan Syndrome - January 13, 2009](#)

[Whither Capitalism? - February 23, 2009](#)

[After the Era of Excess - March 5, 2009](#)

[Same Old, Same Old - March 10, 2009](#)

[Depression Foil - April 15, 2009](#)

[Chapter 2 - The Globalization Debate](#)

[Open Macro - February 21, 2006](#)

[The Battleground of Globalization - February 6, 2006](#)

[The Global Delta - January 13, 2006](#)

[Beggars Can't Be Choosers - February 27, 2006](#)

[Perils of a Different Globalization - March 20, 2006](#)

[Bad Advice and a New Global Architecture - April 24, 2006](#)

[Doha Doesn't Matter - August 4, 2006](#)

[Global Speed Trap - September 11, 2006](#)

[Hitting a BRIC Wall? - September 25, 2006](#)

[Global Comeback—First Japan, Now Germany - October 2, 2006](#)

[Labor versus Capital - October 23, 2006](#)

[Global Lessons - December 8, 2006](#)

[From Globalization to Localization - December 14, 2006](#)

[Unprepared for Globalization - February 2, 2007](#)

[The Currency Foil - February 9, 2007](#)

[The Shifting Mix of Global Saving - June 6, 2007](#)

[Chapter 3 - Chinese Rebalancing](#)

[China's Rebalancing Challenge - April 24, 2006](#)

[A Commodity-Lite China - June 5, 2006](#)

[Scale and the Chinese Policy Challenge - June 19, 2006](#)

[China's Great Contradiction - July 3, 2006](#)

[Soft Landing Made in China? - August 21, 2006](#)

[The Great Chinese Profits Debate - October 6, 2006](#)

[China Goes for Quality - December 4, 2006](#)

[Heavy Lifting - March 5, 2007](#)

[Two Birds with One Stone - March 12, 2007](#)

[Unstable, Unbalanced, Uncoordinated, and Unsustainable - March 19, 2007](#)
[China's Global Challenge - March 22, 2008](#)
[Consumer-Led Growth for China - February 19, 2009](#)
[China's Macro Imperatives - March 22, 2009](#)
[Manchurian Paradox - May 1, 2009](#)

[Chapter 4 - Pan-Asian Challenges](#)

[The Next Asia - April 16, 2007](#)
[Rebalancing Made in Japan? - February 13, 2006](#)
[From Beijing to Dubai - March 24, 2006](#)
[A Tale of Two Asias - May 19, 2006](#)
[Kim's Boost to Globalization - July 7, 2006](#)
[Japan's Missing Link - October 20, 2006](#)
[India on the Move - February 5, 2007](#)
[The Cranes of Dubai - February 23, 2007](#)
[Asian Decoupling Unlikely - March 26, 2007](#)
[The Korea Test - April 5, 2007](#)
[Asia's Policy Trap - May 29, 2007](#)
[Complacency Asian Style - January 8, 2008](#)
[The End of the Beginning - March 2008](#)
[Another Asian Wake-up Call - November 27, 2008](#)
[India's Virtuous Cycle - June 2, 2009](#)
[Risks of an Asian Relapse - June 8, 2009](#)

[Chapter 5 - U.S.-China Tensions](#)

[A Slippery Slope - May 9, 2007](#)
[Past the Point of No Return - May 14, 2007](#)
[Debating U.S.-China Trade Policy - October 13, 2006](#)
[Who's Subsidizing Whom? - December 18, 2006](#)
[Protectionist Threats—Then and Now - January 29, 2007](#)
[The Ghost of Reed Smoot - April 2, 2007](#)
[China's Pace, America's Angst - May 25, 2007](#)

[The Politics of Trade Frictions - October 24, 2007](#)
[A Wake-Up Call for the United States and China: Stress](#)
[Testing a Symbiotic ...](#)

[*Afterword*](#)

[*Sources*](#)

[*About the Author*](#)

[*Index*](#)

STEPHEN ROACH ON
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ASIA

*Opportunities and Challenges for
a New Globalization*

STEPHEN S. ROACH



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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data:

Roach, Stephen, 1945-
Stephen Roach on the next Asia : opportunities and challenges for a new
globalization / Stephen Roach. p. cm.
Includes index.

eISBN : 978-0-470-56422-6

1. Investments—Asia. 2. United States—Foreign economic relations—Asia. 3.
Asia—Foreign economic relations—Asia. I. Title.

HG5702.R63 2009'

332.67'3095—dc22

2009023131

*For the 1.8 billion who remain on the outside looking in:
There can't be a Next Asia without you.*

Acknowledgments

This effort is an outgrowth of the journey that I have been on over the past quarter century plus. There are countless souls who have touched me along the way—offering guidance, encouragement, feedback, and pushback at each and every fork in the road. In the interest of space, I single out those who have been instrumental in guiding me in my explorations of Asia and in getting me to put pen to paper in finishing this project—apologies to those who may have been left out.

My friends and colleagues at Morgan Stanley are at the top of the list. From John Mack, who came up with the hare-brained scheme to kick me upstairs and ship me off to Asia full time, to my partners in the region—Wei Christianson, Shane Zhang, Owen Thomas, Vincent Chui, Charlie Mak, Kate Richdale, Gokul Laroia, Will McLane, Aisha De Sequeira, Chetan Ahya, Ridham Desai, Qing Wang, Matthew Ginsburg, Che-Ning Liu, Gary Kuo, Ho Yang, and Jon Kindred—thanks to all of you and your teams for your unfailing support, curiosity, incredibly hard work, and for never failing to respond to my middle-of-the-night salvos. Your passion for Asia is infectious. It gave me the same bug.

The value of this journey is underscored by the friends I've made and the relationships that I have been privileged to build literally all over Asia—individuals who have added immeasurably to my own thinking and analysis of this extraordinary region. Special mention is due to my good friends in China—especially Zhu Min, Guo Shuqing, Lou Jiwei, Gao Xiqing, Jianxi Wang, Yang Yuanqing, Zhou Xiaochuan, Hu Xiaolian, Liu Minkang, Lu Mai, Levin Zhu, Liu Andong, Justin Lin, Fan Gang and Xiang Huaichen. Elsewhere

in Asia, I have immense gratitude and respect for the insights of my friends in India—especially Mukesh Ambani, Deepak Parekh, Montek Singh Ahluwalia, Rajiv Lall, and Pramod Bhasin—and in Singapore—especially Lee KuanYew, Lee Hsien Loong, Ho Ching, Ng Kok Song, and Heng Swee Keat. And this book has benefited immeasurably from my special friends in Hong Kong—in particular, Donald Tsang, K-S Li, Charley Song, Lawrence Lau, Frank Sixt, Solina Chau, Laura Cha, Ronnie Chan, Joseph Yam, and Shan Weijian. Finally, there is a cottage industry of Asian experts living outside the region, whose counsel and inspiration have been critical in shaping my impressions over the years. In that vein, I am particularly grateful to David Loevinger, David Ho, Pedro Nueno, Nick Lardy, Morris Goldstein, Laura Tyson, Jack Wadsworth, and Chip Kaye.

It took a lot of blocking and tackling to pull this effort together. My Morgan Stanley support team was awesome in that respect—especially the indefatigable Stefanie Fischer who shepherded this project along at each and every stage—but also Noel Cheung, Susanna Ip, Katherine Tai, and Denise Yam. My gratitude also to the editorial team at Wiley, especially Bill Falloon, Stacey Fischkelta, and Meg Freeborn.

Finally, my family. How they put up with my wanderlust, long absences, nocturnal work habits, and chronic jet lag, I'll never know. For my special partner, Katie—and our six wonderful girls—"Thanks" doesn't exactly cut it. But it will have to suffice for now—and it comes from the bottom of my heart.

Introduction

As the most dynamic and rapidly growing region in the world over the past decade, Developing Asia has attained a new level of prosperity. From China to India, the region's per capita income has more than doubled since the wrenching Asian financial crisis of 1997-1998. Since 1990, over 400 million fewer Asians are living at poverty levels defined by incomes of less than \$2 per day. On the surface, the region has much to celebrate on the long and arduous road to economic development. Many believe the Asia Century is now at hand.

Such celebration may be premature. As 2008 came to an end, every economy in the region had either slowed sharply or tumbled into outright recession. Far from having the autonomous capacity to decouple from weakness elsewhere in the world, export-led Developing Asia had become even more tightly tethered to foreign markets than was the case a decade earlier. The export share of panregional gross domestic product (GDP) hit a record 47 percent in 2007, fully 10 percentage points higher than the portion in the late 1990s. With approximately 50 percent of those exports earmarked for the rich countries of the developed world, a rare and sharp synchronous downturn in the United States, Europe, and Japan undermined an increasingly important source of Asia's seemingly invincible growth dynamic. Far from celebrating a newfound resilience, the region was reeling from a severe external shock. Like it or not, Asia's newfound ascendancy remains precarious.

Ironically, this very outcome was predicted by China's Premier, Wen Jiabao. In a statement following the conclusion of the National People's Congress in March 2007, Premier

Wen acknowledged that the Chinese economy looked extremely strong on the surface, especially in terms of GDP and employment growth. Yet, beneath the surface, he cautioned, such strength was far more questionable. In the case of China, he warned of an economy that was increasingly, “unbalanced, unstable, uncoordinated, and unsustainable.” Little did he realize at the time how those “four uns,” as they were later to become known, would pose an immediate and tough challenge to China’s growth imperatives. Nor did he or other Asian leaders appreciate the broader implications of those insights for the region as a whole.

In warning of the precarious state of the Chinese economy, Premier Wen Jiabao was expressing concerns about the nation’s very risky macro bet. With nearly 80 percent of its GDP going to exports and fixed investment, China had become overly reliant on cross-border exports and on the investments required to support the logistics and capacity of its increasingly powerful export machine. In the boom, that structure worked spectacularly. With world exports moving up from 25 percent to a record 34 percent of global GDP trade over the 2000-2008 period, export-led economies had nothing but upside. They were in the right place at the right time, perfectly positioned to reap major windfalls in an era of unfettered globalization. But with the global boom now having gone bust, the imbalances of Asia’s export-led growth strategy have played out to the downside with a vengeance. The region was overly reliant on exports at precisely the moment when external demand collapsed. Not only has China slowed dramatically—with export growth turning sharply negative in late 2008 and industrial output growth slipping into the low-single-digit zone—but the rest of an increasingly China-centric Asian economy has been quick to follow.

China's export dependency went far beyond the unbalanced structure of its real economy. Its financial and currency policies were also aimed at deriving maximum support from external demand. A closed capital account and an undervalued renminbi (RMB) were icing on the cake for China's powerful strain of export-led growth. Moreover, to the extent that its currency management objectives required ongoing recycling of a massive reservoir of foreign exchange reserves into U.S. dollar-based assets, such capital inflows helped keep longer-term U.S. interest rates at exceptionally low levels. In effect, China's implicit interest rate subsidy ended up becoming a key prop to bubble-prone U.S. asset markets and, ultimately, for the asset-dependent American consumer.

The linkage between Asian growth and the American consumer bears special mention. The U.S. consumer is still the dominant consumer in the global economy. Although America accounts for only about 4.5 percent of the world's population, its consumers spent about \$10 trillion in 2008. By contrast, although China and India collectively account for nearly 40 percent of the world's population, their combined consumption was only about \$2.5 trillion in 2008. Moreover, within the large economies of the developed world, America's trend growth of nearly 4 percent in real consumer demand over the past decade and a half was fully three times the pace of underlying consumption growth in Europe and Japan. During the boom, China and the rest of Asia reaped enormous benefits from a mercantilist growth model that was tied increasingly to the voracious appetite of the American consumer. As private U.S. consumption eventually surged to a record 72 percent of real GDP in early 2007, it was a virtuous cycle that seemed to have no end. Yet, as is now painfully evident, that boom became a bubble that has now burst.

In the end, nothing was more important to export-led economies—not just in Asia but elsewhere in the world—than the staying power of the American consumer. Unfortunately, Asia did not do a good job in hedging that bet. Once the asset-dependent American consumer went from boom to bust in the aftermath of the subprime crisis, export-led China and the rest of Asia quickly found itself with nowhere to hide. To the extent that the United States is now only in the early stages of a multiyear consumption retrenchment—a strong possibility, in my view—the problems of an unbalanced Asian economy may be even more acute.

But that's not the only challenge that Asia faces. Significantly, Premier Wen Jiabao's warning was not just about the imbalances of an economic and financial structure that had become overly reliant on exports. By raising concerns over instability, he was also cautioning of the perils of overreliance on energy, industrial materials, and base metals. In an era of booming global growth, the threat of the so-called commodity supercycle and its ever higher price structure was a crushing burden on resource-intensive developing nations. The Premier urged China to focus more on what he called a "scientific development" strategy that would be based on improved efficiencies of resource consumption. Similarly, by warning of the lack of coordination, Wen was highlighting the fragmentation of the Chinese system—not just its banks and companies but also a system of governance that was still heavily dominated by power blocs at the provincial and local level. And his concerns over sustainability were specifically aimed at pollution and environmental degradation—unmistakably negative externalities of China's fixation on open-ended manufacturing-led economic growth.

To the extent that the Chinese experience is a microcosm of the broader Asian development model, Premier Wen

Jiabao's "four uns" are very much a blueprint of what it will take to realize the aspirations of the Asian Century. The *Next Asia* defines the daunting character of that transition. It won't be easy—nor will it happen over night. Despite the extraordinary successes of the past decade, Asia now faces a new set of formidable challenges. Just as the financial crisis of the late 1990s was a wake-up call for the region to put its financial house in order, the global crisis and recession of 2008-2009 is a strong signal for Asia to refocus the basic structure of its economic development model.

From a macroeconomic point of view, better balance is Asia's most urgent priority. Central to that rebalancing will be the long-awaited emergence of the Asian consumer. For a region steeped in a culture of saving, this will not be an easy transformation. Here again, China undoubtedly holds the key. Its legendary excesses of precautionary savings are traceable to two major developments—massive layoffs associated with over 15 years of state-owned enterprise (SOE) reforms and the lack of an institutionalized social safety net. With SOE reforms likely to be ongoing—albeit probably at a slower pace in the years ahead—China needs to redouble its efforts on the welfare front. This includes more aggressive initiatives in the areas of social security, pensions, medical care, and unemployment insurance. China's 11th Five-Year Plan that was launched in early 2006, highlighted all of these areas as urgent priorities for a transformation to more of a consumer-led growth framework. Yet for reasons that remain unclear, the government has failed to deliver on these counts. That needs to change if China is to lead the way in the structural transformation that is at the heart of the *Next Asia*.

The same is true of other key dimensions of Asia's challenge. Heightened efforts in the area of resource efficiency are an urgent priority in dealing with the unstable characteristics of its growth experience. A shift from

manufacturing-led export growth to more of a services-based consumption model will relieve some of the inherent biases of energy-and resource-intensive growth. But Asia must also do more in the way of investing in alternative energy technologies, retrofitting existing production platforms, and moving to lighter construction and production techniques. A key challenge in this regard is to stay the course of resource efficiency in the downturn of the global commodity cycle. In an era of soaring commodity prices, reductions in the commodity content of economic growth become an obvious and urgent imperative. When the cycle swings the other way, however—as is very much the case for a world in recession—there is always the temptation to put off the heavy lifting for that proverbial another day. For the *Next Asia*, that temptation must be avoided at all costs.

So, too, should be the related case for environmental remediation and greener growth—central to the region's sustainability problems. Air and water pollution have become endemic to Asia's hypergrowth. That's especially true in China, home to seven of the ten most polluted cities in the world and whose level of organic water pollutants is, by far, the worst in the world—more than three times the emissions rate of the number two polluter, the United States. Asia has attempted to explain away its environmental problem in per capita terms—arguing that when scaled by its enormous population, its pollution problem still falls well short of that in less populated developed countries. Asian leaders have also argued that since economic development, itself, is a resource-burning and pollution-intensive endeavor, the delayed onset of the region's economic takeoff casts it unfairly as the villain in an era of global warming. Although both of these claims, have considerable merit, unfortunately, a damaged planet has little sympathy for the Asian excuse. On an absolute basis,

Asia now makes the largest contribution to total growth in global pollutants—a trend that must be arrested, regardless of the size of its population or the state of its economic development.

The *Next Asia* will also have to come to grips with its inherent lack of coordination by exerting greater control over its fragmented economies, markets, and political systems. Premier Wen Jiabao's concerns over the lack of coordination in China reflect a system that has long been known for a diffusion of localized power bases. China's four largest banks, for example, still have over 50,000 branches between them—branches that in many cases function autonomously with respect to deposit gathering and lending policies. Such a fragmented banking system has long been a major complication for China's central bank and its execution of a coherent monetary policy. Asia's rural-urban dichotomy also creates a natural fragmentation to its social and economic fabric—underscoring ever-widening income and educational disparities that remain a major source of instability in the region. Widespread corruption further complicates the macro implementation of Asia's development imperatives. The more the region matures and makes further progress on the road to economic development, the greater the need for improved macro coordination.

Premier Wen Jiabao's "four uns" largely offer inward-looking prescriptions. But the *Next Asia* still has much to gain from its external linkages—especially by focusing more on the benefits of cross-border economic integration. Perhaps the greatest opportunity in that regard could come from closer ties between the two greatest powers in the region—Japan and China. Despite a long and difficult history between them, these two nations are natural complements in many key respects. Japan, with its declining population and high-cost work force, has much to gain from Chinese

outsourcing and efficiency solutions. China, with its need for new technologies and pollution abatement, has just as much to gain from Japan's leadership position in both areas. And the rest of an increasingly integrated Asian economy would be well positioned to realize the benefits of supply-chain externalities that could be important by-products of greater integration between China and Japan.

Change and growth have been the mantra for Asia for the past quarter century. But the endgame of sustained economic development and rising prosperity continues to be a moving target. Developing Asia has enjoyed spectacular success in the decade after the wrenching financial crisis of the late 1990s. But, as they say in the investment business, a track record of success is no guarantee of future performance. The current global recession is an important wake-up call for Asia—in effect, a challenge to the old way, and a not-so-subtle hint to find a new recipe for its growth model. The *Next Asia* that emerges from this transition will need to be all about a shift in focus from the quantity to the quality dimension of the growth experience. Although the quality of economic growth is something of an amorphous construct, its attributes are undoubtedly steeped in better balance, stability, coordination, sustainability, and integration. This is the essence of a critical transformation that could well usher in more of a proconsumption, lighter, and greener Asian economy than is the case today. The *Next Asia* will need to measure its success increasingly on those counts.

This collection of essays addresses the challenges and opportunities, as well as the stresses and strains, that await the *Next Asia*. It is both a journal and a framework. In the first sense, it is a creature of the debate that embroiled financial markets and policy circles during the critical period

of 2006-2008—a debate that I was actively engaged in, initially as Morgan Stanley's Chief Economist and then as the Chairman of the firm's Asian businesses. These three years saw the world at both its highs and its lows—an unbalanced global economy lurching toward the final stages of an unsustainable boom followed by the sickening implosion of a bust of unimaginable proportions. It was a period that not only marked a critical turning point for the global economy but also one that underscores the risks and rewards that await the *Next Asia*.

The framework is organized around five building blocks that I believe will be key in driving the coming transition of Developing Asia: the wake-up call of the global crisis, Asia's critical role in the globalization debate, the rebalancing imperatives of the Chinese economy, a new pan-regional framework of integration and competition, and a frank discussion of the risks of trade frictions and protectionism.

This latter risk cannot be minimized. As the biggest beneficiary of globalization, Asia stands much to lose if the rich countries of the developed world—especially the United States—start to use trade policy to shield hard-pressed middle-class workers from the angst of the global labor arbitrage. In a period of deepening recession and rising unemployment, pressures on labor can only intensify—increasing the temptations and perils of China bashing and other forms of scapegoating. As responsible stewards of globalization, both the West and the East will need to be steadfast in forestalling such an outcome. Yet as the pendulum of political power has swung from capital to labor, there is a growing risk those noble principles could be compromised. In that case, the consequences would be dire for all of us, especially for an externally dependent Asian economy.

Needless to say, the *Next Asia* has a full plate as it now faces a most daunting transition. Although predicting the future is always problematic, one thing is absolutely certain: For Asia, inertia is not an option. It is, of course, always tempting to take the path of least resistance and avoid the wrenching changes that a consumer-led, lighter, and greener Asia now requires. But that is a path to nowhere—one that will ultimately stymie the region's ambitious development objectives.

Change is never easy—especially on a scale that the *Next Asia* requires. But change has been at the core of all the Asian miracles of the post-World War II era. Once again, circumstances require this dynamic region to look inside itself and reinvent the model that will take it to the next phase of its remarkable journey. I remain confident that Asia will be able to pull it off. At the same time, I don't underestimate the risks that the *Next Asia* will face as it once again moves out of its comfort zone. That's something we all have in common in looking to the postcrisis era.

In order to preserve the flow of the extraordinary chain of events of the past several years, the essays in each chapter are presented largely in sequential order. Facts and conclusions prevailing at the time of writing have not been altered to fit the events that have since transpired. Instead, they are left largely in their raw initial form—providing a real-time impression of what it's like to try to crack the code of one of the most challenging periods in modern economic history. Although some of the data points presented in this fashion have been altered by the rush of subsequent events, the broad sweep of the analytics and conclusions have withstood the test of time reasonably well—at least, so far. But there are no guarantees for a world in crisis—or even for a megatrend as compelling as the *Next Asia*. Stay tuned.

Chapter 1

A World in Crisis

• Introduction • A Subprime Outlook for the Global Economy • Save the Day • Coping With a Different Recession • Davos Diary: 2008 • Double Bubble Trouble • Even When the Worst Is Over—Watch Out for Aftershocks • Pitfalls in a Postbubble World • Panic of 2008: Enough Scapegoating • Global Fix for a Global Crisis • Changing the Fed's Policy Mandate • An Early Leadership Opportunity for Barack Obama • Dying of Consumption • Uncomfortable Truths about Our World after the Bubble • A Postbubble Global Business Cycle • America's Japan Syndrome • Whither Capitalism? • After the Era of Excess • Same Old, Same Old • Depression Foil •

Introduction

As the greatest beneficiary of globalization, Asia continues to take an important cue from the broader global environment. With the world economy in its most wrenching crisis in 75 years, that cue is more daunting than ever before.

The origins of this crisis will long be debated. As the world still grapples with the wrenching aftershocks of what was initially billed as America's subprime crisis, it is entirely premature to render a definitive verdict on the how's and why's of this mess. Suffice it say, the financial crisis that began in earnest in 2008 was the outgrowth of a confluence of failures, including massive risk management mistakes on Wall Street, egregious errors by rating agencies, staggering

lapses of regulatory oversight, a politicization of the home-ownership and mortgage boom, and the search for returns by yield-hungry investors on Main Street. The most serious failure, in my view, was that of central banks. That's especially the case with America's ideologically driven Federal Reserve, led by market libertarians who condoned an insidious succession of asset bubbles and ignored its regulatory responsibility in an era of unprecedented financial engineering and excess leverage.

The main thesis of this chapter is that this is not just a financial crisis. The excesses in the financial markets were so extreme they ended up infecting the real side of the global economy. Nowhere was that more evident than in the United States, where asset-dependent consumers drew extraordinary support from the confluence of property and credit bubbles. In the second half of 2008—in the aftermath of the bursting of those twin bubbles—the American consumer pulled back more severely than at any point in the post-World War II era. Yet that correction left the consumption share of GDP at a still elevated 71 percent in late 2008—down only 1 percentage point from its record 72 percent high in early 2007 and 4 percentage points above the prebubble norm of 67 percent that prevailed from 1975-2000. With personal debt ratios still excessive and saving rates far too low, there is good reason to believe that there is more to come in what looks to be a multiyear adjustment for the U.S. consumer. If mean reversion is in the offing for a postbubble U.S. consumer, and if that mean is close to the prebubble norm of the consumption share of U.S. GDP, then only about 20 percent of the correction has occurred.

As America has entered a major postbubble shakeout, so, too, has the rest of an interconnected world. It's not just the cross-border linkages of trade flows that have been shocked by the capitulation of the world's largest consumer. Liquidity-driven asset bubbles have burst everywhere—from

emerging market equities to most segments of the global commodity market. The pitfalls of a postbubble world are especially daunting for an externally led Asian economy.

Lacking dynamism from its main source of external demand—the U.S. consumer—Asia faces two distinct possibilities: slower growth or the imperatives of uncovering new sources of growth. Since the latter option takes time to implement, I conclude that the Asian growth dynamic is likely to be a good deal slower in the years ahead than the 7 percent growth pace that has been realized since the turn of the century. For now, I would pencil in about 5 percent growth in panregional GDP for Developing Asia over the next three to five years.

A similar downshift is likely to be in the offing for the global economy. Notwithstanding the massive policy stimulus that has been injected into the system, America's multiyear consumer retrenchment will provide stiff headwinds to global growth for quite some time. In that important respect, policy stimulus will be “pushing on a string”—leading to something resembling a Japanese-like outcome for a postbubble world economy. There will be no V-shaped recovery from this global recession. When it comes in earnest—probably at some point in 2010—the rebound in world economic growth is likely to be unusually anemic.

Meanwhile, it's important not to get too far ahead of this story—a postcrisis world still has to pick up the pieces from a wrenching global recession. This is a profound challenge to policy makers, regulators, and politicians—to say nothing of posing a challenge to the free-enterprise system of market capitalism. To date, the policy response has been very short-term oriented. In effect, it has marshaled the heavy artillery of fiscal and monetary policy, together with government-sponsored capital injections and bailouts,

toward rescuing and restarting a damaged and dysfunctional financial system.

Although this short-term focus is understandable in light of the extraordinarily dangerous freezing up of global credit markets, there are deeper longer-term issues that policy makers must also confront. At the top of the list are the daunting imperatives for a postbubble world to come up with nothing short of a new recipe for economic growth. In effect, the unbalanced global growth model of the past decade—dominated by America's excess consumption and Asia's excess saving—needs to be turned inside out. The United States needs to save more and consume less while Asia needs to save less and consume more. Policies need to be directed toward those twin objectives with an aim toward fostering the long-awaited rebalancing of a postbubble world. The crisis that began in 2008 is a wake-up call that global rebalancing can no longer be deferred to that proverbial another day.

The problem is not with capitalism but with its system of governance. As such, this crisis is a wake-up call to central banks, regulators, and their political overseers—the authorities who are charged with being the ultimate whistle-blowers in an era of excess. Sadly, that didn't happen as a bubble-prone world lurched headlong toward disaster. Central banks were especially derelict in their responsibilities. Although the monetary authorities did a terrific job in winning the war against the Great Inflation of the 1970s and early 1980s, they failed in their efforts to manage the peace of the postinflation global economy. Blinded by ideology, monetary policy makers paid little or no attention to the imperatives of financial stability. Instead, they believed incorrectly that the world was learning to live with its imbalances. Needless to say, the postbubble world is paying a horrific price for this dereliction of duty. That leaves the body politic with little choice other than to alter

the policy mandate of central banks to incorporate an explicit focus on financial stability. A crisis like this must never be allowed to happen again.

A Subprime Outlook for the Global Economy

October 18, 2007

After nearly five fat years, the global economy is headed for serious trouble. This will come as a surprise to policy makers and investors, alike—most of whom were counting on boom times to continue.

At work is yet another postbubble adjustment in the world's largest economy—this time, the bursting of America's massive property bubble. The subprime fiasco is the tip of a much larger iceberg—an asset-dependent American consumer who has gone on the biggest spending binge in the modern history of the global economy. At the turn of the century, the bursting of the dot-com bubble triggered a collapse in business capital spending that took the United States and global economy into a mild recession. This time, postbubble adjustments seem likely to hit U.S. consumption, which, at 72 percent of GDP, is more than five times the share the capital spending sector was seven years ago. This is a much bigger problem—one that could have much graver consequences for the United States and the rest of the world.

There is far more to this story than a potential downturn in the global business cycle. Another postbubble shakeout poses a serious challenge to the timeworn inflation-targeting approach of central banks. It also challenges the body politic's acceptance of a new strain of asset-dependent

global economic growth. Subprime spillovers have only just begun to play out, as has the debate this crisis has spawned.

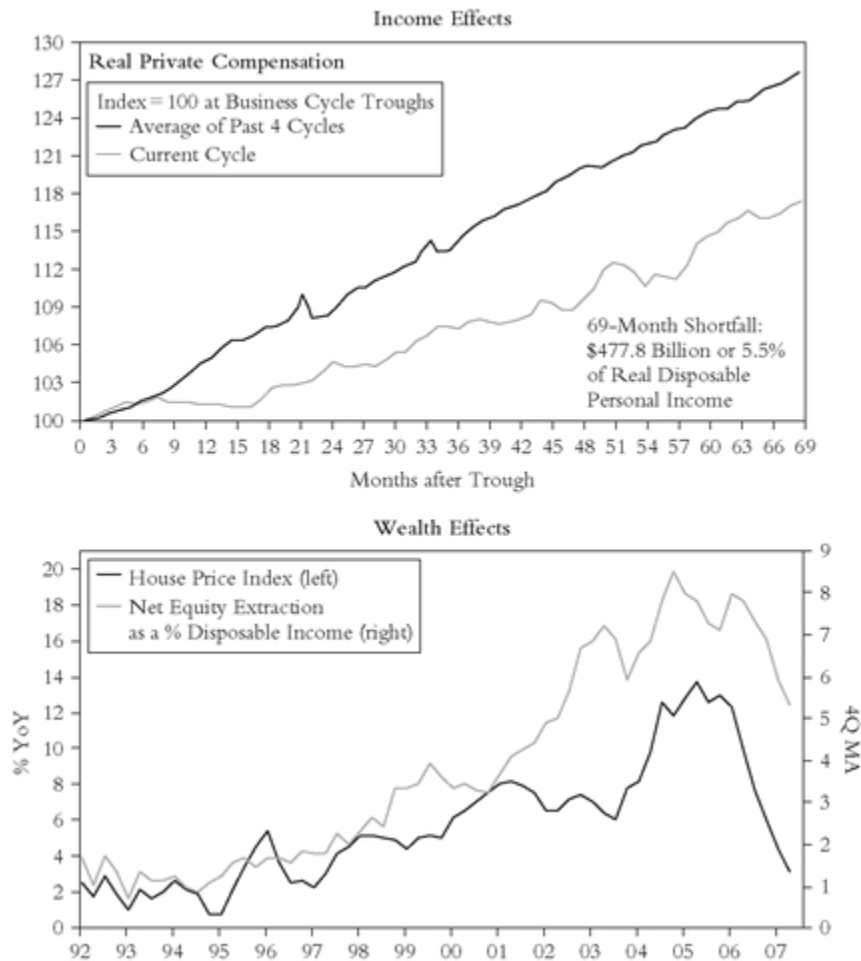
Game Over for the American Consumer

The American consumer has been the dominant engine on the demand side of the global economy for the past 11 years. With real consumption $\uparrow$ 5 $\uparrow$ growth averaging nearly 4 percent over the 1996-2006 interval, U.S. consumption expenditures totaled over \$9.6 trillion in 2007, or 19 percent of world GDP (at market exchange rates).

Growth in U.S. consumer demand is typically powered by two forces—income and wealth (see [Figure 1.1](#)). Since the mid-1990s, income support has lagged while wealth effects have emerged as increasingly powerful drivers of U.S. consumption. That has been especially the case in the current economic expansion, which has faced the combined headwinds of subpar employment growth and relatively stagnant real wages. As a result, over the first 69 months of the now-ended expansion, private-sector compensation—the broadest measure of earned labor income in the U.S. economy—increased only 17 percent in real, or inflation-adjusted, terms. That was nearly \$480 billion short of the 28-percent increase that had occurred, on average, over comparable periods of the past four U.S. business cycle expansions.

Figure 1.1 The Macro Drivers of U.S. Consumption

Source: Office of Federal Housing Enterprise Oversight (OFHEO), Federal Reserve, U.S. Bureau of Economic Analysis, Morgan Stanley Research.



Lacking in support from labor income, U.S. consumers turned to wealth effects from rapidly appreciating assets—principally residential property—to fuel booming consumption. By Federal Reserve estimates, net equity extraction from residential property surged from 3 percent of disposable personal income in 2001 to nearly 9 percent by 2005—more than sufficient to offset the shortfall in labor income generation and keep consumption on a rapid growth path. There was no stopping the asset-dependent American consumer.

That was then. Both income and wealth effects have come under increasingly intense pressure—leaving consumers with little choice other than to rein in excessive demand. The

persistently subpar trend in labor income growth is about to be squeezed further by the pressures of a cyclical adjustment in production and employment. In August and September 2007, private sector nonfarm payrolls expanded, on average, by only 52,000 per month—literally one-third the average pace of 157,000 of the preceding 24 months. Moreover, this dramatic slowdown in the organic job-creating capacity of the U.S. economy is likely to be exacerbated by a sharp fall in residential-construction-sector employment in the months ahead. Jobs in the homebuilding sector are currently down only about 5 percent from peak levels, despite a 40 percent fall in housing starts; it is only a matter of time before jobs and activity move into closer alignment in this highly cyclical—and now very depressed—sector.

Moreover, the bursting of the property bubble has left the consumer wealth effect in tatters. After peaking at 13.6 percent in mid-2005, nationwide house price appreciation slowed precipitously to 3.2 percent by mid-2007. Given the outsize overhang of excess supply of unsold homes, I suspect that overall U.S. home prices could actually decline in both 2008 and 2009—an unprecedented development in the modern-day experience of the U.S. economy. Mirroring this trend, net equity extraction has already tumbled—falling to less than 5.5 percent of disposable personal income in the second quarter of 2007 and retracing more than half the run-up that began in 2001. Subprime contagion can only reinforce this trend—putting pressure on home mortgage refinancing and thereby further inhibiting equity extraction by U.S. home owners.

Figure 1.2 The Overextended American Consumer

Source: U.S. Bureau of Economic Analysis, Morgan Stanley Research.