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Pitfalls in a Post-Bubble World

A year ago, there was barely an inkling of what was about to transpire in world financial markets and the global economy. There were some early warning signs that all was not well in the subprime slice of the US mortgage market. But as was the case with the dot-com bubble in early 2000, subprime was widely judged to be of little consequence for the macro story. Denial, one of the most powerful of human emotions, once again had the upper hand. The broad consensus of consumers, business people, policymakers, and politicians ignored simmering problems on the subprime front and believed that the global boom of the preceding five years was very much intact.

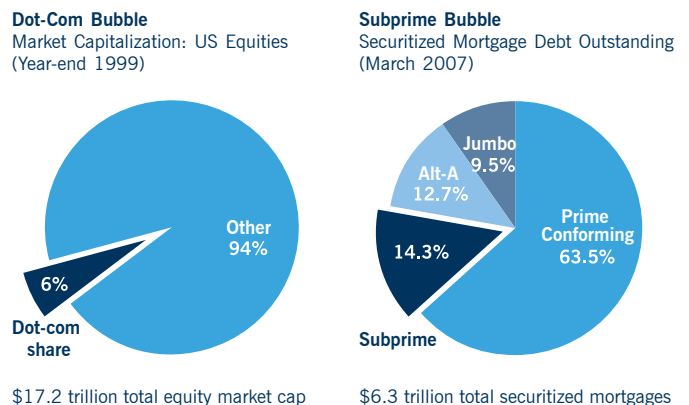
The argument a year ago was laced with a painful sense of déjà vu. At the end of 1999, dot-com accounted for only 6% of the market capitalization of US equities. A powerful, flexible, and innovative US economy was believed to offer built-in resilience and ongoing support to the other 94% of the US equity market and the macro economy. A year ago, subprime accounted for only 14% of total securitized mortgage debt outstanding. A still powerful, flexible, and innovative US economy was once again believed to offer ongoing support to the other 86% of the mortgage market and the broader economy (see Figure 1).

How wrong this logic was – in 2000 and, again, just a year ago. Eight and a half years ago, the bursting of the dot-com bubble was, in fact, followed by a 49% decline in the broader S&P 500 index over the next two and a half years. And the bursting of the subprime bubble a year ago has triggered an unprecedented contagion throughout the broader credit and

capital markets. The lessons are painfully similar. When an entire asset class – or for that matter, an economy – goes to excess, the weakest link in the chain often deals a decisive blow to the system as a whole. The bubble analogy works all too well. When the thinnest part of the membrane gives way, the rest of the air escapes all too quickly.

But the imagery misses one critical point. The progression of bubbles is an insidious process. From equities to property to credit, the bubbles have expanded in scope and risk. A bubble-prone US economy became a breeding ground for a gathering storm of systemic risks in America and in an increasingly interdependent world economy. And now we are left to pick up the pieces.

Figure 1: Two Canaries in the Coal Mine



Source: Federal Reserve, FDIC, MBA, Morgan Stanley Research

In the Beginning

No economy can live beyond its means in perpetuity. Yet like others that have tried to do so in the past, the US thought it was different. America's current account deficit surged from 1.5% of GDP in 1995 to 6% in 2006. At its peak annualized deficit of \$844 billion in the third quarter of 2006, the US

required \$3.4 billion of capital inflows from abroad each business day in order to fund a massive shortfall of domestic saving.

For the longest time, such funding was there for the asking. There were plenty of new theories concocted to rationalize why the unsustainable might actually be sustainable. Foreign lending with impunity was a special privilege that fell to the nation possessing the world's reserve currency, many argued. Some went further, celebrating the advent of a new "Bretton Woods II" arrangement, whereby surplus savers such as China could forever recycle excess dollars into US assets in order to keep their currencies competitive and their export-led growth models humming. In the end, of course, these "new paradigm" explanations – like those of the past – failed the test of time and the markets.

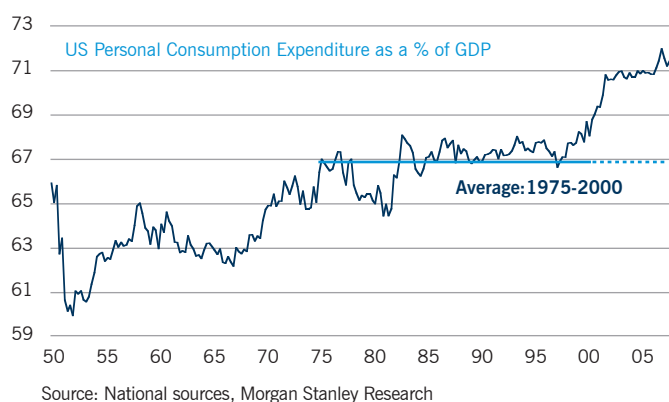
A record US consumption binge was at the root of the problem – sparked by an audacious shift from income- to asset-based saving.

At the root of the problem was America's audacious shift from income- to asset-based saving. The US consumer led the charge, with trend growth in real consumer demand hitting 3.5% per annum in real terms over the 14-year interval, 1994 to 2007 – the greatest buying binge over such a protracted period for any economy in modern history. Never mind a seemingly chronic shortfall of income generation, with real disposable personal income growth averaging just 3.2% over the same period. American consumers no longer felt they had to save the old-fashioned way – they drew down income-based saving rates to zero for the first time since the Great Depression. And why not? After all, they had uncovered the alchemy of a new asset-based saving strategy – first out of equities in the latter half of the 1990s and then out of housing in the first half of the current decade. Laxity in regulatory and supervisory oversight, in conjunction with excessive monetary accommodation, led to an explosion of free and easy credit that turned out to be the icing on the cake.

In retrospect, the equity wealth effect was child's play in comparison with what the American home eventually was to offer. At its peak in mid-2006, net equity extraction from residential property had soared to nearly 9% of disposable personal income – fully three times the 3% reading only five years earlier. That enabled income-short American consumers not only to squander income-based saving but also to push consumption up to a record 72% of real GDP in 2007 (see

Figure 2). Behind this outcome was the confluence of two monstrous bubbles – property and credit – that transformed residential dwellings into the functional equivalent of ATM machines. In the end, US consumers had no compunction about tapping their main source of future saving – housing wealth – to fund current consumption. And, of course, they went on a record debt binge to pull it off. Household sector indebtedness surged to 133% of disposable personal income by year-end 2007 – up over 40 percentage points from debt loads of 90% prevailing just a decade earlier. It was the height of folly. Yet the longer it lasted, the more it became deeply ingrained in the American psyche. And now it is finally over.

Figure 2: US Consumption Binge



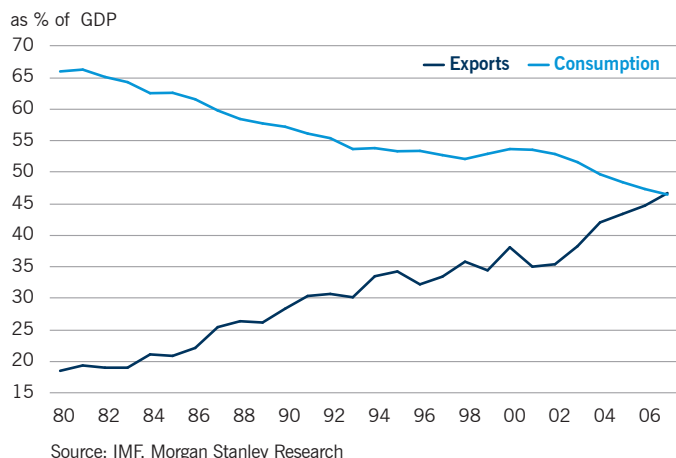
The Asia Connection

While seemingly made in America, the era of excess was truly global in scope. The US consumption binge was fodder to export-led economies elsewhere in the world. That was especially the case in Developing Asia – the fastest growing major region in the world since the turn of the century. Large enough to account for fully 20% of total world output (as measured on a purchasing power parity basis), real GDP growth in Developing Asia averaged 8% over 2000-07 – more than two and a half times the 3% growth trend elsewhere in the world over the same period. In search of rapid growth in order to achieve its development and poverty-reduction objectives, Developing Asia viewed America's consumption binge as "manna from heaven." Consumption deficient Japan had a similar response, as did the large newly industrialized economies in the region such as Taiwan and Korea.

Yet there can be no mistaking the high-octane fuel that drove the Asian growth boom – an increasingly powerful export-led growth dynamic. For Developing Asia as a whole, exports hit a record of more than 45% of pan-regional GDP in 2007 – up more than ten percentage points from the share prevailing in the mid-1990s (see Figure 3). That left the world's fastest growing region more dependent on external demand than

ever before. And with the American consumer – the biggest source of that external demand – finally in trouble, Asia’s export-led growth dynamic is now at risk.

Figure 3: Export-Led Developing Asia



With the American consumer now in trouble, Asia’s export-led growth dynamic is now at risk.

China is undoubtedly key in that regard. After two years of nearly 12% GDP growth in 2006-07, Chinese growth slowed to 10.1% in 2Q08. That downshift was largely an outgrowth of marked deceleration in the growth of Chinese exports to the US – +8% y-o-y in June 2008 following average annual gains in excess of 25% over the 2003-07 period. Significantly, the US-centric compression of Chinese export and GDP growth – hitting about 20% of China’s total external demand – was accompanied by ongoing vigor of China’s shipments to Europe (+25% in June 2008) and Japan (+22%). As Japan and Europe now weaken, the heretofore resilient pieces of Chinese external demand – collectively accounting for about 30% of China’s total exports – will also begin to falter. With lags, that could well prompt another downleg in Chinese GDP growth from 10% to 8% within the next six months.

A key question for Asia is whether an external demand shock will be sufficient to contain the region’s recent outbreak of inflation. China could well be the most important case in point – namely, whether its likely slowing to 8% growth represents enough of a “landing” to temper a sharp build-up of inflationary pressures. With wage inflation surging in the 15%-plus range on the back of recently enacted labor reforms, administrative controls biasing its “core” inflationary pressures to the downside, and short-term policy rates extremely low

in real terms, China’s inflation risks cannot be minimized in the current climate. China’s reliance on increasing its bank reserve ratios – as opposed to rate hikes – as the principal instrument of monetary tightening is especially problematic in this regard.

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India has adopted a very different approach to deal with its inflation problem, with the central bank moving aggressively to boost policy rates by a total of 125 basis points since early June. Unlike China, who seems to be counting on an external demand shock to temper excessive GDP growth and inflationary pressures, the Reserve Bank of India is not taking any chances in confronting its inflation problem head on. As a result, Indian GDP growth could fall below the 7% threshold in 2009 – a major shortfall from average gains of nearly 9% over the preceding four years, 2005-08.

Japan brackets the other end of the spectrum in terms of Asia’s repercussions to a US-led external demand shock. Overall Japanese export volume growth went into negative territory in June (-1.6% y-o-y) for the first time in 16 months. At work in this case was emerging sluggishness in Japanese exports to Europe and elsewhere in Asia – once resilient markets that previously had been masking emerging weakness to the US. China and Japan are at the opposite ends of Asia’s external vulnerability chain. China has a huge cushion – nearly 12% growth over the past two years – to ward off the blow of an external shock. Japan, by contrast has been only a 2% growth economy in recent years and has no such cushion. In a weaker external demand climate, the downside to Chinese economic growth appears to be around 8%. For Japan, the downside is probably closer to “zero” – underscoring the distinct possibility of a recessionary relapse in the region’s largest economy.

The global boom of 2002 to mid-2007 was an outgrowth of the powerful cross-border linkages of globalization. No region of the world benefited more from this connectedness than export-led Asia. That has been especially the case in the region’s high-flying developing economies, dominated by China. Decoupling – the supposed untethering of developing economies from the developed world – is antithetical to the linkages that have become central to the powerful globalization trends of the past five years. Those linkages are

just as intact on the downside of the global business cycle as they were on the upside. And through well-developed cross-border feedback mechanisms, the responses to a major weakening in US demand by Asia's export-led economies are now triggering powerful repercussions across markets and economies in an interdependent world.

Taking Stock

Alas, the bloom is now off the rose – the global business cycle has turned. World GDP growth, which averaged close to 5% annually over the 2004-07 period – the strongest four consecutive years of global growth since the early 1970s – now seems headed back down into the 3.5% to 4% range for a couple of years. While that is hardly a disastrous outcome, it does represent a 20-30% deceleration in the growth rate of the previous four years.

This likely downturn in the global business cycle has not occurred in a vacuum. It has been accompanied by unprecedented outbreak of credit market contagion that has wreaked havoc throughout world financial markets. The interplay between financial markets and the real economy undoubtedly holds the key to the global macro outlook over the next few years. For expositional purposes, I have found it helpful to break down the macro pyrotechnics into three stages (see Figure 4):

Figure 4: Taxonomy of a Crisis

IMPACTS	TRANSMISSION MECHANISM	OUTCOME
First-order	Cross-Product Contagion: Derivatives and Structured Products	De-risking De-leveraging
Second-order	Asset-Dependent Real Economies	Consolidation of Consumption and Homebuilding
Third-order	Cross-Border Linkages: Trade and Capital Flows	Export and Vendor Financing Risks

The credit crisis is the first stage. Sparked by the subprime meltdown that began in the summer of 2007, a cross-product contagion quickly spread to asset-backed commercial paper, mortgage-backed securities, structured investment vehicles (SIVs), interbank offshore (LIBOR) financing, leveraged lending markets, auction rate securities, so-called monoline insurers, and a number of other opaque products and structures. Unlike the Asian financial crisis of ten years earlier, which was a powerful cross-border contagion, the “originate and distribute” characteristics of today's complex instruments and structures ended up infecting offshore investors as well. That puts the current crisis in the rarefied breed of being both cross-product and cross-border. US financial institutions generally have been aggressive in marking down the value

of distressed securities. Largely for that reason, I believe that this first phase is about 65% complete – more behind us than ahead of us but still a good deal more to come as the business cycle now kicks in and produces yet another round of earnings impairment for financial intermediaries.

A three-stage interplay between financial markets and the real economy holds the key to the global macro outlook over the next few years.

The second stage reflects the impacts of the credit and housing implosions on the real side of the US economy. As noted above, the main event in this phase of the adjustment is the likely capitulation of the over-extended, saving-short, overly-indebted US consumer. For nearly a decade and a half, real consumption growth averaged close to 4% per year. As consumers now move to rebuild income-based saving and prune debt burdens, a multi-year downshift in consumer demand is now likely. Over the next two to three years, I expect trend consumption growth rate to be cut in half to around 2%. There will be quarters when consumer spending falls short of that bogey and the US economy lapses into a recessionary state. There will undoubtedly also be quarters when consumption growth is faster than the 2% norm and it will appear that a recovery is under way. Such rebounds, unfortunately, should prove short-lived for post-bubble American consumers. This aspect of the macro-adjustment scenario has only just begun. As a result, Phase II is only about 20% complete, in my view.

The third stage is a global phase – underscored by the linkages between the US consumer and the rest of the world. As also noted above, those linkages are only now just beginning to play out. Ordering and cross-border shipping lags suggest that this phase of the adjustment will take a good deal of time to unfold. Early impacts are already evident in China and Japan – largely on the basis of US-led export adjustments. With ripple effects now only beginning to show up in Europe, these cross-border impacts should gather in force over the months and quarters to come. That suggests to me that Phase III is only about 10% complete.

In short, this macro crisis is far from over. The main reason is that the bubbles that have burst – property and credit – became so big they ended up infecting the real side of the US economy. And as the US now adjusts to much tougher post-bubble realities, the rest of an interdependent, globalized world should follow. Moreover, there are undoubtedly

feedback effects between the various stages – especially as the business cycle now starts to bear down on financial institutions that were initially buffeted by the credit contagion. A new round of earnings pressures on banks and other lending institutions could exacerbate the credit crunch further, reinforcing the cyclical pressures on debt-dependent economies in the US and around the world. All in all, macro adjustments should last well into 2009 and possibly spill over into 2010.

Rebalancing the Hard Way

A voracious appetite for economic growth lies at the heart of the boom that has now gone bust. An income-short US economy rejected a slower pace of domestic demand. It turned, instead, to an asset- and debt-financed growth binge that had little to do with the time-honored underpinnings of income generation forthcoming from current production. For the developing world, rapid growth was a powerful antidote to a legacy of wrenching poverty. And the hyper-growth that was realized in regions like Developing Asia became the end that justified all means – including the negative externalities of inflation, pollution, environmental degradation, widening income disparities, and periodic asset bubbles. The world’s body politic wanted – and still wants – growth at all costs. But now the bill is coming due.

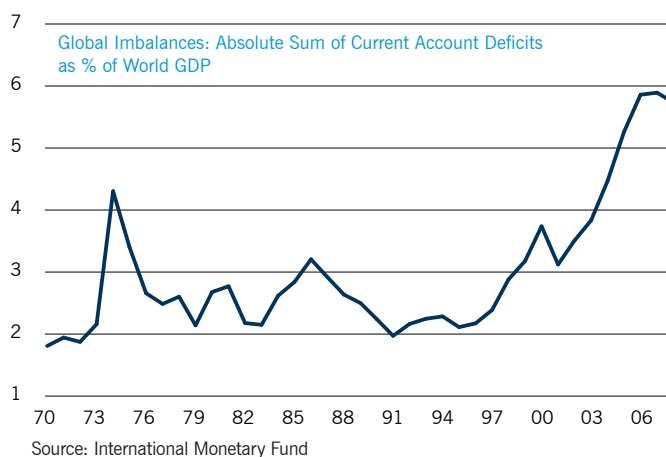
The global economy is facing a multi-year rebalancing as it now reins in its appetite for unsustainable hyper growth.

The global economy is facing a multi-year rebalancing. For the US, this spells a sustained deceleration in personal consumption growth as households abandon newfound asset-dependent saving and consumption strategies in favor of the income-led fundamentals of the past. Hope springs eternal that a weaker dollar will enable America to finesse this transition without skipping a beat – that consumer led growth will now give way to currency-led export growth. Anything is possible, but I have my doubts of a US export renaissance – especially in the aftermath of a multi-decade hollowing out of America’s manufacturing and export base. Jobs and industries that were once “lost forever” do not spring back to life over night. The US, in my view, will now have to come to grips with a much slower growth trajectory – with real GDP growth likely to slow from the 3.2% trend of the past 13 years to no higher than 2% over the next 2-3 years, or longer.

This should prove to be a very challenging outcome for the rest of the world – especially for those developing nations, which have derived so much of their economic sustenance from exporting goods to over-extended American consumers. The task here is essentially the opposite of that which faces the United States – for export-led developing economies to shift the mix of growth toward domestic demand, especially private consumption. That won’t be easy for nations who have relied on cheap currencies, surplus saving, and infrastructure strategies as the principal means to achieve spectacular progress on the road to economic development. But with their major export market – the US – now under pressure and with little consumption offset likely elsewhere in the world, the developing world has little choice other than to embark on a consumer-led rebalancing of its own. This probably means slower economic growth in the developing world as well for the next several years – with the 7.3% average annual growth pace of the past years conceivably slowing into the 5% vicinity over the next 2-3 years.

Such global rebalancing arises from an unprecedented disparity that opened up over the past several years between nations with current account deficits and those with surpluses. By the IMF’s reckoning, the absolute sum of current account deficits hit a record of nearly 6% of world GDP in 2006-07 – fully three times the 2% share prevailing in the mid-1990s (see Figure 5). Where the apologists went seriously wrong, in my view, was not in coming up with new ways to rationalize unprecedented external imbalances but in failing to appreciate the impact of asset and credit bubbles in spawning these excesses. Now that those bubbles have burst, global rebalancing has become an urgent task for a lopsided world. And the global economy will undoubtedly pay a steep price for years of neglect by moving to a much slower growth trajectory in the years immediately ahead.

Figure 5: Global Imbalances



Financial Market Implications

The events of the past year have certainly not been lost on financial markets. As forward looking discounting mechanisms, much of the macro adjustments that have unfolded are now “in the price” of major asset classes. But denial remains deep as to the full extent of the adjustments. To the extent that there is more to come in the global economy, the same can be said for financial markets. Four key conclusions in that regard:

To the extent that there is more to come in the global economy, the same can be said for the broad classes of financial assets – equities, bonds, currencies, and commodities.

With equity markets now in bear-market territory in most parts of the world, it is tempting to conclude that the worst is over. I am suspicious of that prognosis. The trick, in my view, is to resist the temptation to view equity markets as a homogenous asset class. Instead, it is important to make the distinction between financials and nonfinancials. The former have certainly been beaten down. While the adjustments of Phases II and III as outlined above will undoubtedly put more cyclical pressures on the earnings of financial institutions, share prices now seem to be discounting something close to such an outcome. That is not the case for nonfinancials, however. For example, consensus earnings expectations for the nonfinancials component of the S&P 500 are still centered on prospects of close to 25% earnings growth over 2007-08. As US economic growth falters, however, I fully expect earnings risks to tip to the downside for nonfinancials – underscoring the distinct possibility of yet another important downleg in global equity markets. The equity bear market is likely to shift from financials to nonfinancials.

For bonds, the prognosis centers on the interplay between inflation and growth risks – and the implications such a tradeoff has for the policy stance of central banks. As inflation fears have mounted recently, yields on sovereign government bonds have risen as market participants have started to discount a return to more aggressive monetary policy stances of major central banks. In a faltering growth climate, however, I suspect cyclical inflation fears will end up being overblown and monetary authorities will turn skittish out of fear of overkill. Over the near term, that leads me to conclude that major bond markets could rally somewhat on the heels of a rethinking of the aggressive central bank tightening scenario.

Over the medium term – namely, looking through the cycle – I concede that the jury is still out on stagflation risks, especially in inflation-prone developing economies. The bond market prognosis is more uncertain over that time horizon.

For currencies, the dollar remains center stage. I have been a dollar bear for over six years for one reason – America’s massive current account deficit. While the US external shortfall has been reduced somewhat over the past year and a half – largely for cyclical reasons – at 5% of GDP, it is still far too large. And so I remain fundamentally bearish on the dollar. At the same time, it appears that the dollar has overshot on the downside over the past 10 months on the fear that subprime is mainly a US problem. As the global repercussions of the macro crisis spread as outlined above, I believe that investors will rethink the belief that they can seek refuge in euro- and yen-denominated assets. As a result, I could envision the dollar actually stabilizing or possibly even rallying into yearend 2008 before resuming its decline in 2009 due to America’s still outsized current account deficit.

The commodity market outlook is especially topical these days. A year from now, I believe that economically-sensitive commodity prices – oil, base metals, and other industrial materials – will be a good deal lower than they are today. Soft commodities – mainly agricultural products – as well as precious metals could well be the exception to that outcome. Two reasons underpin the case for a correction in economically-sensitive hard commodities – a marked deceleration in global growth leading to a related improvement in the supply-demand imbalance, as well as a pullback in commodity buying by return-seeking financial investors. This latter impetus to the commodity bubble cannot be underestimated, in my opinion. I am not sympathetic to the view that hedge funds and other speculators have driven commodity markets to excess. At work, instead, are mainly long-only, real money institutional investors such as global pension funds – all of whom have been advised by their consultants to increase their asset allocations into commodities as an asset class. Such herding behavior of institutional investors invariably turns out to be wrong. I expect that to be the case this time as well – although I would be the first to concede that my own record in calling the end of this commodity bubble has been nothing short of terrible over the past three years.

Perpetuating the Madness?

For reasons noted above, the current financial crisis is hardly lacking in superlatives. Whether it is truly the worst debacle since the Great Depression, as many have argued, remains to be seen. But it is certainly a watershed event in many

important respects – especially since it draws into sharp question the fundamental underpinnings of a US economy that has long ignored its imbalances and excesses. Sadly, America’s body politic seems both unwilling and unable to fathom the magnitude of the problems that have come to a head in this crisis.

America’s body politic seems unwilling to fathom the magnitude of the problems that have come to a head in this crisis. That’s true of tax policy, the housing “fix”, and management of the financial system.

Tax policy is a case a point. Rebates to over-extended American consumers have been the first line of defense, and there is new talk in Washington of a second round of such stimulus measures. Yet with personal consumer spending hitting a record 72% of real GDP in 2007, the government’s injections of spendable income are aimed at perpetuating the biggest consumption binge in modern history. For a nation that desperately needs to save more and spend less – and thereby pay down debt and reduce its massive current account deficit – politically expedient personal tax cuts are the wrong medicine at the wrong time.

Washington’s response to the housing crisis is equally problematic. The Congress seems determined to make foreclosure containment a key aspect of any fix; moreover, new legislation provides government guarantees for up to \$300 billion of home mortgage refinancing for low-income families. This is consistent with a philosophy that has long stressed ever-rising rates of homeownership as a key objective of US public policy. Yet truth be known, an obvious and painful lesson of the subprime crisis is that there are some Americans who simply cannot afford to purchase a home. Foreclosure is a tragic, but ultimately necessary, consequence of misguided home buying. For low-income victims of the housing bubble, assistance should be directed at income support rather than at perpetuating uneconomic homeownership. By opting for the latter, Congress is inhibiting the requisite decline in home prices that ultimately will be necessary to clear the market and bring the housing crisis to an end.

Nor have the financial authorities – the Federal Reserve and the US Treasury – distinguished themselves in this crisis. Ten years ago, it was a hedge fund (Long Term Capital Management) that was too big to fail. Now it is an investment

bank (Bear Stearns) and the country’s twin mortgage behemoths (Fannie Mae and Freddie Mac). And the Fed’s temporary liquidity facility for primary dealers in government securities is now starting to look less and less temporary.

Undisciplined risk taking has been a central element of this crisis. By tempering the consequences of the bursting of the risk bubble, the authorities are shielding irresponsible risk takers and thereby enabling a “moral hazard” that has become increasingly ingrained in today’s financial culture. At the same time, a Federal Reserve that continues to ignore the perils of asset bubbles in the setting of monetary policy is equally guilty of reckless endangerment to the financial markets and to an increasingly asset-dependent US economy.

In short, Washington has responded to this financial crisis with a politically-driven, reactive approach. Policy initiatives have been framed more by the circumstances of the moment than by a strategic assessment of what it truly takes to put the US economy back on a more sustainable path. By perpetuating excess consumption, low saving, unrealistic goals of home ownership, and moral hazards in financial markets, this patchwork approach has the biggest flaw of all – it does little to change bad behavior. Far from heeding the tough lessons of an economy in crisis, Washington is doing little to break the daisy chain of excesses that got America into this mess in the first place.

If this crisis is anything, it is a wake-up call. For all too long, the United States broke many of the most important rules of conduct for a leading economy. It failed to save. It levered asset bubbles in both equities and homes to sustain unparalleled excesses in current consumption. It went deeply into debt to sustain that course of action and borrowed heavily from the rest of the world to close the funding gap. The authorities were complicit in this binge – especially a central bank that condoned unbridled risk taking and excessive monetary accommodation.

The longer the United States sustained the unsustainable, the more it believed in the perpetuity of its charmed existence. The real message of this crisis is that this game is now over. But steeped in denial and feeling the heat of voters in a politically charged presidential election year, Washington politicians insist that the game can go on.

More than anything, America now needs “tough love” – a new course that owns up to years of excess and the remedies those excesses now require. It is not that difficult to fathom the broad outlines of what that new approach might entail – more saving, as well as more investment in both people and infrastructure. An energy policy might be nice as well – as

would be more prudent stewardship of the financial system. This program won't win any popularity contests. But in the end, it is America's only hope for a sustainable post-bubble prosperity.

Lessons

It didn't have to be this way. America went to excess and the rest of an export-dependent world was more than happy to go along for the ride. Policy makers and regulators – the stewards of the global economy – looked the other way and allowed the system to veer out of control. Investors, businesspeople, financial institutions, and consumers were all active participants in the Era of Excess.

The key question going forward is whether an adaptive and increasingly interrelated global system learns the tough lessons of this macro upheaval. At the heart of this self-appraisal must be a greater awareness of the consequences of striving for open-ended economic growth. The US couldn't hit its growth target the old fashioned way by relying on internal income generation, so it turned to a new asset- and debt-dependent growth model. Export dependent Developing Asia took its saving-led growth model to excess: Unwilling or unable to stimulate internal private consumption, surplus capital was recycled into infrastructure and dollar-based assets – in effect, forcing super-competitive currencies and exports to become the sustenance of a new development recipe.

Can the world learn the tough lessons of this macro upheaval? The US and China are likely to be key in this regard, and recent signs are not encouraging.

This crisis is a strong signal that these strategies are not sustainable. They have led to multiple layers of excess – underscored by a precarious interplay between internal and external imbalances within and between the world's largest economies. It took unsustainable credit and risk bubbles to hold this system together in an unstable equilibrium. But now those bubbles have burst, unmasking a worrisome disequilibrium that demands a new approach to policy and an important shift in behavior by households, businesses, and financial market participants.

The early verdict on such a new approach is not encouraging. That's especially the case in the US and China – the two key players of the new globalization. As noted above, Washington is reverting to timeworn recipes that perpetuate the excess consumption and moral hazard problems of the past decade.

And Beijing is sending new pro-growth signals that seem to back away from recent tightening measures – an especially disconcerting development in light of China's ongoing problems on the inflation front. The body politic in both nations is clinging steadfastly to its core values – that rapid economic growth is the antidote to any and all problems. Concerns regarding the sustainability of that growth are being deferred to that proverbial “another day.”

Financial and economic crises often define some of history's greatest turning points. They can be the ultimate in painful learning experiences. But there can be no escaping the urgent imperatives of learning these lessons and addressing the systemic risks that have given rise to the crisis. Such heavy lifting rarely sits well with the body politic. A path of least resistance is invariably selected that leads to more of a reactive response – the quick fix that tempers immediate dislocations but does little to tackle deep-rooted systemic problems. That's the risk today. And if that's where the Authorities end up, a globalized world will have squandered a critical opportunity to put its house in order. That would be the ultimate tragedy. If this crisis demonstrates anything, it's that it only gets tougher and tougher to pick up the pieces in a post-bubble world.

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