

Anatomy of a Meltdown

As the U.S. housing-market crisis spreads to the global economy, more pain is ahead



A YEAR AGO, THERE WAS BARELY an inkling of what was about to happen in the global economy and world financial markets. There were some early warning signs that all was not well in the subprime slice of the U.S. mortgage market. But as was the case in early 2000 at the end of the dotcom bubble, when few thought a crash in Internet stocks could cause widespread economic pain, problems within the subprime sector were widely judged to be of little consequence for the big picture. Most felt that the global boom of the preceding four years was very much intact.

Alas, another postbubble business cycle has turned. Annual global GDP growth, which averaged close to 5% from 2004 through 2007—the strongest four consecutive years of growth since the early 1970s—now seems headed back down into the 3.5% range. While hardly a disaster, there can be no mistaking the abrupt downshift now at hand.

A Crippled U.S. Consumer

THE INTERPLAY BETWEEN FINANCIAL markets and the real economy holds

the key to the global outlook over the next few years. Much depends upon how events unfold in three distinct phases of the adjustment process:

The credit crisis. Sparked by the subprime meltdown in the summer of 2007, an unprecedented financial contagion has broken out. It is more lethal than the cross-border contagion of the Asian crisis 10 years ago because, while toxic financial products were made in America, they were distributed to investors around the



world—so the current affliction includes both cross-product and cross-border viruses. U.S. financial institutions generally have been quick to mark down the value of distressed securities, suggesting that the process of digesting all of the bad debt is about 65% complete. However, as underscored by the recent shakeouts at Lehman Bros. and Merrill Lynch and the rescue of AIG, a softening business climate could have further impacts on loans and earnings of shaky financial institutions.

The U.S. economy. The bubble-dependent U.S. is first in the line of fire in the aftermath of the bursting of credit and property bubbles. The main event is the capitulation of income-short, overextended American consumers. For over a decade, U.S. consumer-spending growth averaged close to 4% per year, taking consumption to a record 72% of GDP. As asset-dependent consumers, who are seeing marked declines in the value of their homes, now move to rebuild savings and prune outsized debt burdens, a multiyear slowdown in consumer demand is likely. Over the next two to three years, consumption growth could decline by half to



around 2%, leaving the U.S. on the brink of recession, if not in one; any recovery will be weak. This process has just begun, suggesting adjustments in the U.S. economy are only about 20% complete.

The global economy. Growth is slowing throughout the world due to the important linkages between the U.S. consumer and the global economy. With shifts in export orders and shipping taking time to occur, this phase should unfold with a lag. Manufacturers in China and Japan are already pruning their shipments to U.S. customers. Ripple effects are now beginning to show up in Europe and will gather strength in the coming months. All in all, global adjustments are probably only about 10% complete; they should last well into 2009 and could spill over into 2010.

Asia: Torrent to Trickle?

THE U.S. CONSUMPTION BINGE WAS fodder for export-led economies everywhere. This was especially the case in Asia, which since the turn of the century has been the world's fastest-growing major region. 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 large, newly industrialized economies such as Taiwan and Korea.

Indeed, exports provided high-octane fuel for Asia's growth, accounting for more than 45% of pan-Asian GDP in 2007, which was a record and was more than 10 percentage points higher than the share prevailing in the mid-1990s. But this left the region more dependent on external demand than ever before. And with the American consumer—the biggest source of that demand—now in trouble, Asia's export-led growth formula is getting squeezed.

After two years of nearly 12% GDP growth in 2006-07, China's slowed to 10.1% in the second quarter of 2008, largely because of lower growth of exports to the U.S. Now the Japanese and European

economies—which collectively account for about 30% of China's total exports—are weakening. This could well prompt another drop in Chinese GDP growth, from 10% to 8% within the next year.

Japan's economic position is more precarious. Japanese exports turned down in June 2008 for the first time in 16 months. At work was emerging sluggishness in Japanese exports to Europe and elsewhere in Asia—once resilient markets that previously had been masking growing weakness in the U.S. While China has a huge cushion (its double-digit growth rate) to ward off the blow of an external shock, Japan's economy has been growing at just 2% in recent years. In a weaker external demand climate, there is a distinct possibility of a recessionary relapse in the region's largest economy.

Asia's adjustments should not be surprising. The global boom of 2002 to mid-2007 was an outgrowth of the powerful linkages of globalization. No region benefited more from this connectedness than Asia. These linkages are just as strong on the downside of the global business cycle as they are on the upside. Connectivity is now hitting Asia head-on.

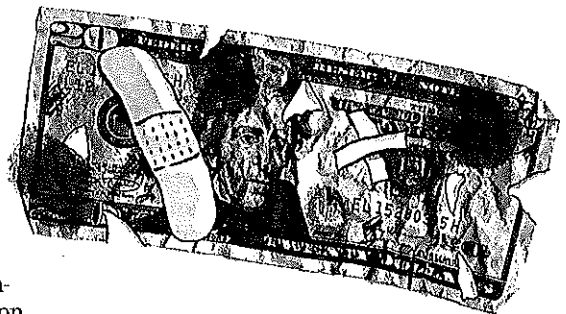
Hard Lessons

IT DIDN'T HAVE TO BE THIS WAY. AMERICA went too far in its borrowing and spending sprees, and the rest of an export-dependent world was more than happy to go along for the ride. Policymakers 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 all enjoyed the

fruits of this boom. Now that it is over, can an interdependent world learn the tough lessons of the current upheaval?

These developments underscore the perils of misguided open-ended growth strategies. The U.S. 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. Similarly, developing Asia became overly reliant upon its export-led model. The credit crisis is a strong signal that these strategies are not sustainable. They led to multiple layers of excess, fueling dangerous housing and credit bubbles. These bubbles have burst, unmasking a worrisome financial and economic disequilibrium. This demands a new approach to policy as well as significant behavioral shifts by households, businesses and financial-market participants.

Financial and economic crises often define some of history's greatest turning points. They can be the ultimate in painful learning experiences. If all the authorities can do is opt for



politically-expedient quick fixes—such as tax rebates for overextended American consumers, lax monetary and currency policies for inflation-prone developing economies and the creation of more asset bubbles—the world will have squandered a critical opportunity to put its house in order. That would be the greatest tragedy of all. ■

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