

## No Turning Back for *The Next Asia*

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Foreign Policy magazine recently convened an on-line discussion of my new book, *The Next Asia*. The following is a summary of the discussion of four experts — along with a rejoinder that I penned. The complete transcript can be found at <http://books.foreignpolicy.com>.

### The One-man Early Warning System Reviews Old Calls

By Blake Hounshell

Stephen Roach is a rare bird in the punditry business: He isn't afraid to make tough calls that might later embarrass him. Like anyone else, he gets things wrong from time to time. But on the big questions, he's more often right than not, and when he's "wrong," it's usually only because he makes predictions far ahead of most others. A one-man early warning system, it's no wonder he developed a cult following among the econoblogging community from his former perch on Morgan Stanley's research website (formerly chief economist, he has since moved on to chair the bank's operations in Asia).

For years, Roach was in the company of doomsayers like Nouriel Roubini, Mark Faber, and George Soros, and was warning as far back as 2004 that global imbalances and a U.S. real-estate bubble threatened to end in "economic Armageddon." Critics dismissed him as a Chicken Little. When the sky finally did fall, he says, even he hadn't anticipated just how bad it would get.

"I honestly thought that modern risk management practices," he writes, "were far more robust than they ended up being. Mea culpa."

In *The Next Asia*, Roach reviews his own track record and also makes a few new predictions. One interesting comment he makes, especially relevant in light of the recent G-20 conference in Pittsburgh, is that China will need to address its internal economic imbalances for its own reasons, and not because it is being badgered by the likes of Timothy Geithner. He approvingly quotes Wen Jiabao's "four uns" — the Chinese premier's 2007 admission that his country's economy is "unstable, unbalanced, uncoordinated, and unsustainable." Roach says China has hardly addressed these problems yet, and its much-ballyhooed package of stimulus measures was only a short-term move designed to allow the country to muddle through the crisis.

Among other suggestions, Roach calls repeatedly for China to boost domestic consumption, a task that will require putting in place a modern safety net so that Chinese citizens don't feel compelled to sock away such a large percentage of their incomes (by some estimates, China's private savings rate is as high as 40 percent). He thinks China will eventually be able to pull this task off, but I'd be curious to know what sorts of unintended consequences he thinks might result. One of the great fears of environmentalists, for instance, is a world where tens of millions of Chinese and Indians begin driving cars and watching plasma TVs at the rate of Americans. Others worry about the effects on commodity markets for things like oil and all those rare minerals that go into cell phones.

Roach also warns of the continued risks of a lose-lose trade war between the United States and China, something he expected would have happened by now. Here again, maybe he was just early: After his book went to press, U.S. President Barack Obama slapped a much-criticized tariff on Chinese tires, and the Chinese retaliated by going after imports of U.S. chicken and car parts. It's not clear yet whether this particular skirmish will escalate into a full-blown conflict, but Roach thinks the ongoing rise in U.S. unemployment might make it inevitable.

As he puts it, with characteristic drama, “If these two nations end up at odds with one another, they will both suffer — with dire consequences for the rest of a crisis-torn economy. The stakes are enormous. There is no margin for error.”

He also still thinks, as he wrote in *Foreign Policy* last January, that the economic recovery will be “anemic at best,” pointing to continued weakness in U.S. consumer demand, which for years was propped up by credit that is no longer so easy to get.

Roach’s larger purpose in writing his book is to point out that although Asia has an extraordinary opportunity to grow and prosper, the region’s rise is hardly written in the stars. (“It may be premature to crack out the champagne,” he writes.) Getting there will take strong leadership, some very hard choices, and a much longer timeframe than most of us anticipate. Wen Jiabao, call your office.

Blake Hounshell is managing editor of *Foreign Policy*.

## Two Daunting Challenges for Asia’s Economy

By Clyde Prestowitz

In his new book, *The Next Asia*, Stephen Roach demonstrates yet again why he is the best economic analyst out there, not only on Asia but on the structure and underlying dynamics of the globalization that is revolutionizing our world and dramatically shifting the balance of international power.

*The Next Asia*, a collection of Roach’s columns and analyses over the past several years, could just as well be read from back to front as in the traditional front to back mode. Going backwards gives one the feeling of traveling with Sherlock Holmes as he unravels the threads of a great mystery to find the ultimate secret cause of the crime or accident. But either way you read it, the book is a constant reminder of how on target and correct Roach has been in his analyses of the causes and effects of economic trends over the past decade. In particular, he saw the recent crisis coming before almost anyone else, and also correctly foresaw that the much ballyhooed notion of Asian decoupling from the U.S. economy was a dangerous fallacy.

More important than what Roach saw in the past, however, is what he sees coming in Asia in the future. His fundamental view is bullish but realistic. The achievements of Asia, and particularly of China, in the past twenty years are presented not only as obviously impressive but also based on extraordinarily wise policies and leadership. At the same time, Roach focuses on the “four uns” of Chinese Premier Wen Jiabao whose statement at the conclusion of the March 2007 National People’s Congress acknowledged the economy’s

strong performance but then went on to emphasize that despite its apparent strength, the economy was “unbalanced, unstable, uncoordinated, and unsustainable.”

Coming more than a year before the fall of Lehman Brothers and the eruption of the recent crisis now being called the Great Recession, that statement was prescient not only for China but also for the whole global economy. In *The Next Asia*, Roach makes a double point. Whether China and India and the rest of developing Asia will continue to prosper and to lift hundreds of millions out of poverty while shifting the center of the world economy to the east will depend on removing the “un” prefix from in front of each of Wen’s adjectives. This will entail two particularly daunting challenges. The Asian developing economies are unbalanced and unstable by dint of their reliance on exports to generate growth. To become balanced and stable, they must shift to domestic consumption led growth. That sounds easy but in fact will be quite difficult because the physical, institutional, political, and social structures are all organized around exports. Changing that will not be just a matter of a stroke of the Premier’s pen. Similarly, the second challenge of developing in a way that does not result in unacceptable global warming and environmental degradation will also not be met only by making policy statements. Roach shows that spectacular as the Asian performance has been thus far, it will have to be even more spectacular going forward.

His second point is that the outcome is just as important to the United States and the rest of the world as it is to Asia, and that a positive outcome is not possible unless America also acts much more wisely in the future than it has in the past.

Clyde Prestowitz is founder and President of the Economic Strategy Institute.

## The Uncertain Future of the Next Asia

By Ben Simpfendorfer

The rise of Asia has captured the world’s attention. It is has also made the world a more complex place.

It is no longer enough to simply observe events in the United States, Europe, and Japan in order to make assumptions about the global economy. We must add China, India, and the Gulf to a growing list of countries. The recent decision to establish the G20 as the world’s leading economic body, rather than the G8, only confirms the growing proliferation of economic power.

If that wasn’t enough, the linkages in Asia itself are growing. The region no longer simply supplies oil and consumer goods to the industrialized world. Today, a Middle East sovereign wealth fund can buy a stake in a listed Chinese company that

employs 9,000 Chinese workers to build roads, apartments, and even government offices in Algeria.

It is thus a rare skill to make sense of the changes taking place. Stephen Roach is in a position to do so, having spent thirty years working and travelling in Asia and the United States.

His new book *The Next Asia*, a collection of essays written over the past three years, is expansive and deals with everything from worries about credit bubbles to the need for Chinese rebalancing. In today's fast-moving world, there is a risk that such a collection reads more as a record of recent events rather than a map to the future. But the book holds important truths and Roach is at his best when talking about the structural challenges faced by China and the United States, and the linkages between the two economies.

For all the excitement over China's apparent rapid recovery, the economy still faces large imbalances. Fiscal stimulus has focused on building infrastructure and subsidizing exporters. Yet, as Roach rightly argues, the Chinese leadership appear complacent to the risks of a protracted retrenchment in global consumer demand. They have still to make the type of bold policy decisions that would either spur consumption or unleash the services sector.

Yet, these challenges are often overlooked by the West. I sympathize with Roach when he argues that the West wants to look at the Chinese economy in the same way as any industrialized economy, using a similar set of policy tools to decipher policy actions. This can only lead to confusion. The People's Bank of China is responsible for a much larger, and much poorer, population than the U.S. Federal Reserve, and its mandate differs accordingly.

The confusion is at its greatest when debating the Chinese yuan. Roach rightly notes that United States Congress argues too narrowly for a stronger Chinese yuan. The currency is only one part of a larger economic challenge. Too rapid appreciation would simply push export factories to other low-cost countries, while deterring the Chinese leadership from liberalizing energy markets, tightening environmental laws, and raising minimum wages.

Yet, there are also limits to this argument. Chinese exporters have, in the past six months, rapidly captured market share, not just in the United States, but also in developing countries, such as Egypt and India. The need for a stronger Chinese yuan is thus increasingly urgent as developing countries compete more directly with China while also lacking the fiscal resources to soften the blow for unemployed manufacturing workers.

The risks of protectionism are growing. It is surprising then

that we have yet to see a serious trade war in the midst of what is a historic economic crisis. Perhaps the answer lies in Roach's observation that if the United States was to impose tariffs on Chinese goods it would act as a tax on consumers and would only wind up diverting trade to other low-cost producers. It might be that globalization is too entrenched to reverse. The costs are all too great.

If so, the risks of protectionism are greater between Asia's own low-cost producers. For all the attention paid to Asia's relationship with the West, it is Asia's relationship with itself that might present the greatest challenge in the coming years.

Ben Simpfordorfer is chief China economist for the Royal Bank of Scotland.

## A Bear in a China Shop

By Minxin Pei

Stephen Roach, chairman of Morgan Stanley Asia, is an unusual Wall Street banker. In his previous incarnation as the investment bank's chief economist, Roach was one of the few who actually warned against both the tech bubble at the end of the 1990s and the credit bubble a few years ago. He characterized the former Fed Chairman Alan Greenspan as a "serial bubble blower." And he sounded alarm about America's overconsumption and debt binge. His bearish views, of course, earned him few friends during the bubble years.

Although he has been vindicated by the Great Recession, Roach has apparently set his sight on a new target: the booming Asia. If you shudder what a bull can do in a china shop, wait until you see a bear inside.

*The Next Asia*, on the surface, does not seem very bearish. A collection of Roach's essays on the United States, global trade, and Asia, this book tries to maintain a delicate balance between celebrating Asia's dramatic achievements in economic development since WWII and warning against complacency and the continuation of an unsustainable export-led growth model. Unlike the recent flood of books that portray Asia as an unstoppable juggernaut that will continue to grow at its current pace, *The Next Asia* provides a more realistic and cautious prognosis: While the region's fundamentals are strong, most of the Asian economies (except for India's) need to rebalance by boosting domestic consumption and reducing reliance on exports.

The reason, according to Roach, is straightforward. Asia's phenomenal growth in recent years was driven largely by rising exports absorbed by America's debt-fueled overconsumption. At the height of the boom, in 2007, exports accounted for a whopping 47 percent of Asia's GDP. Now that the party is over, Asia's export powerhouses cannot

count on the ever-rising external demand to keep their factories running at full capacity. The danger, warns Roach in *The Next Asia*, is that Asia may not fully understand the permanent structural change in the American economy brought about by the Great Recession. With stagnant income and the end of excess consumption supported by asset bubbles, the overstretched American consumers will have no choice but to repair their household balance sheets and cut their purchases of goods made in Asia. Consumption as a share of the U.S. GDP, which reached 72 percent in 2007, will probably fall 4-5 percentage points and settle at its historical norm of around 67 percent, effectively taking \$650-700 billion in final demand off the table. For Asia, this would be a huge demand shock.

To continue its drive to prosperity, Roach argues, Asia must reinvent itself.

But will Asia rebalance?

As a seasoned Asia-watcher steeped in the region's cultures, Roach is perhaps too polite to be blunt. But the sections on China in his book reveal his cautious pessimism (despite his repeated proclamation that he is an optimist). Roach pointed out China's structural imbalances — such as overinvestment, excess export dependence, and anemic domestic consumption — many years ago, but he steadfastly maintained his faith in Beijing's ability to tackle the challenges because he believed in China's "unrelenting commitment to reforms." But that was in October 2006. However, in early 2009, Roach clearly grew less confident in his earlier assessment. He characterized Beijing's pledge to boost domestic consumption "lip service." He noted Beijing's inadequate progress in building a social safety net in encouraging consumption. He was alarmed by the display of complacency and assertiveness by Chinese officials who were blissfully unaware of the changing landscape of the global economy.

China, of course, is not the only sinner in East Asia. Japan, according to Roach, has also miserably failed to rebalance its economy, and has suffered a lost decade.

So the record of economic rebalancing in Asia is not exactly encouraging. I wish that Roach had gone a step further and analyzed the deeper causes of the region's chronic structural distortions. Without understanding why such obvious problems are left uncorrected for so long, it is hard to be optimistic that Asian countries will actually heed the advice, however well-meaning and useful, proffered by Roach in *The Next Asia*.

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## No Turning Back for The Next Asia

Stephen S. Roach

Not surprisingly, Minxin Pei has hit the nail right on the head: It's easy to make the case for Asia's structural transformation from an export- to a consumer-led economy. But will Asia actually step up and do it?

This question goes right to the core of my macro soul. I will confess that I am guilty of being an idealist. For most of my career, I have practiced what I would call disequilibrium macro — focusing on the destabilizing tensions that arise when economies have moved far from the tranquility of equilibrium. As such, I have tended to frame macro-analytic arguments and market calls from the standpoint of what should happen to relieve those tensions. That, of course, can often stand in sharp contrast to what actually will happen. As Blake Hounshell correctly observes, from time to time, this propensity has brought me to be "early" in several of my macro prognostications. And yes, I concede, that may also be the case with *The Next Asia*.

My fascination with Asia rests on a very optimistic conclusion: One of its greatest strengths lies in its practicality. As Clyde Prestowitz notes, that doesn't necessarily make me an optimist or a pessimist — but hopefully something closer to a realist. Asia is pragmatic out of necessity. The pervasive and serious poverty that has long plagued the region really leaves it with no other choice. Asian economic development strategies have long been focused on alleviating this critical condition. The imperatives of social and political stability underscore the dark side of failure.

With that key premise in mind, I believe strongly that this crisis — and the Great Recession it has spawned — is Asia's wake-up call. If the region's export-led economies stick with the old way, growth will be much harder to come by in a post-crisis climate characterized by a much slower pace of consumption growth in a U.S.-centric developed world. The resulting shortfall would fail to absorb Asia's surplus labor — leading to mounting unemployment and the heightened risk of social instability.

This would be an especially problematic outcome for China. Whenever I get stuck on a Chinese macro issue, I always go back to two key words — "social stability." They are, in many respects, the Holy Grail of the Chinese growth miracle. I remain absolutely convinced that China's leadership would do everything in its power to avoid destabilizing the social fabric of the nation's vast population. In that vein, a weak external demand climate poses a serious threat to the employment underpinnings of China's export-led growth model. The shift to internal demand is really Beijing's only

option. It's just a question of when, underscoring yet another occasion when I could well be early on a macro call.

Experience tells us that the New Asia responds well to crises. That was certainly the case in the aftermath of the wrenching pan-regional crisis of the late 1990s. That crisis was a devastating blow to most in the region — China and India, of course, being important exceptions. It tore the fabric of what had been dubbed the “East Asian Growth Miracle” just a few years earlier by the World Bank. In the years immediately after that earlier crisis, Asia moved aggressively to convert current account deficits into surpluses, reduce its exposure to short-term capital inflows, and build up its reservoir of foreign exchange reserves. These steps served the region well when the global crisis of 2008-2009 hit — especially the “self insurance” that was provided by now massive portfolios of currency reserves.

Of course, the next crisis is never like the last one. For Asia, that is very much in the case in the present climate. The pan-regional currency and banking crisis of 1997-1998 has been followed by a massive external demand shock that strikes right at the heart of the region's greatest structural vulnerability — over-reliance on exports and external demand. That underscores the obvious and urgent imperative: If Asia's external source of growth is drying up then it must uncover a new source of growth. Moreover, if it resists that shift, then it risks the protectionist pushback from the West that, as Ben Simpfendorfer notes, has long been a key feature of my Asia risk scenario.

This is where Asian pragmatism should come into play. Just as the region responded well to the wrenching pressures of a decade ago, I am convinced it will do the same this time as well. In the end, it really doesn't have any choice. Stay alert Minxin, the Next Asia could end up bearing fruit sooner than you think!

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**Stephen S. Roach is Chairman of Morgan Stanley Asia and author of *The Next Asia* just published by Wiley. Mr. Roach serves as the Firm's senior representative to clients, governments, and regulators across the region. Prior to this appointment as Asia Chairman, Mr. Roach was Morgan Stanley's Chief Economist.**

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