The World Economy at the Crossroads:
Outsourcing, Protectionism, and the Global Labor Arbitrage

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An unbalanced global economy is at a critical juncture. The world can no longer afford to rely on a US-centric global growth dynamic. Massive external imbalances would only worsen, putting enormous pressure on financial markets, the global economy, and on the world's commitment to free trade. Nor can a saving-short US economy continue to shoulder the burden of providing a disproportionate share of global growth. The rest of the world must pick up the slack. A global rebalancing is necessary. Such realignment entails structural reform on a scale that the modern-day world economy has never seen. That, in turn, raises the risk of a politically inspired backlash. The heavy lifting of global rebalancing is not without risk. But in the end, there is no alternative.

Never before has the modern-day world economy been this lopsided. Over the 1995 to 2002 period, the United States accounted for fully 96% of the cumulative increase in global GDP (at market exchange rates). That's more than three times America's roughly 30% share of world output (see Exhibit 1). Putting it another way, the non-US portion of the global economy, which accounts for 70% of world output, contributed a mere 4% to overall global GDP growth in the seven years ending in 2002. This has led to unprecedented and ever-widening disparities between the world's current-account deficits (in the United States) and surpluses (mainly in Asia), imbalances that are inherently destabilizing for the global economy and world financial markets. That's no way to run a $32 trillion global economy. Something has to give.

The Dollar Must Fall

Global rebalancing is an analytical framework that offers a resolution of this fundamental disequilibrium in the global economy. My basic premise is that an unbalanced world requires a shift in relative prices in order to re-establish a new and more sustainable equilibrium. That brings the dollar into play — the world's most important relative price. In my view, global rebalancing and dollar depreciation go hand in hand. The world needs a weaker dollar in order to uncover a new and sustainable paradigm of balanced growth.

How would the world benefit from an orderly depreciation of the dollar? From the standpoint of the United States, a weaker currency shifts the mix of economic growth from domestic demand to exports. Given America's massive external financing needs — currently more than $2 billion of capital inflows per business day — foreign investors will probably need to be compensated for taking increased currency risk. That should result in higher real interest rates and a related suppression of domestic demand growth. Such an outcome would be key in enabling the US to rebuild its depleted reservoir of national saving — thereby weaning America from its increasing dependence on foreign saving and the current-account deficits needed to attract such capital from abroad. As an important aside, a weaker dollar will also be helpful in America's anti-deflation campaign, transforming imported deflation into imported inflation.

Relative price adjustments in currency markets are, of course, a zero-sum game for the global economy at large. For the major countries or regions that will have to bear the burden of the dollar's correction, that means the impacts are essentially the mirror image of those facing the US. As the yen and the euro rise in response, the competitiveness of Japanese and European exporters will diminish. That should pressure both economies to take actions aimed at promoting growth in long-sluggish domestic demand. At a minimum, fiscal and monetary policies will need to be more biased toward accommodation than would be the case if the yen and the euro were artificially depressed. But I expect the key impacts on Japan and Europe will be to accelerate progress on reforms. Stronger currencies are the functional equivalent of straightjackets, forcing nations or regions to unshackle domestic demand by making internal markets more flexible, businesses more efficient, and price-setting mechanisms more competitive. Without such reforms, there can be no global rebalancing.

History tells us that the US dollar may have only just begun its descent. On a broad trade-weighted basis, the dollar (in real terms) has now fallen about 10% from its early-2002 highs. In a full-blown current-account adjustment, a drop of around three times that magnitude can be expected — quite similar to the 30% real depreciation of the dollar that occurred in the late 1980s, when the US current-account disequilibrium was far less acute (see Exhibit 2). In the end, a lopsided world has no choice but to accede to a weaker dollar. The economics I practice suggest that for an unbalanced world, a shift in relative prices in the form of a weaker dollar is the only way out. The key question is whether the world has the political fortitude to stay this course.

Japan is a case in point. The world's second-wealthiest nation has long been a major stumbling block on the road to rebalancing. That may now be changing for two reasons — economic growth and politics. The Japanese economy expanded at a 4.0% annual rate in 2Q03, bringing the year-over-year increase to 3.0%. On both counts, that qualifies Japan as the fastest-growing economy in the G-7. While some weather-related consolidation is possible in the current period, there is good reason to believe that the Japanese economy is on a moderate cyclical recovery path that could extend through mid-2004. Meanwhile, Prime Minister Koizumi has solidified his political position, garnering 61% of the votes in the recent LDP leadership elections, setting the stage for a solid general election victory in early November. At the same time, he has reaffirmed his support for the principal reformer in his cabinet — Heizo Takenaka, the economics and financial services minister. With growth and politics moving into favorable alignment, this is a perfect opportunity for Japanese policy to shift focus from currency manipulation to reform. For Japan, the time for talk is over. It's critical for the Koizumi government to seize the moment.

For Europe, the basic message is equally tough: Under a weaker-dollar scenario, the imperatives of reform are about to become even more urgent. That's not say Europe hasn't made any progress on this front. Recently, that's been the case in Germany, where Chancellor Schroeder's government has not only accelerated the pace of tax cutting but has also moved ahead in proposing reforms of labor market regulations and social security. Meanwhile, the French government has withstood this spring's widespread protest and stayed the course on public-sector pension reform; healthcare insurance reforms are next on France's agenda. At the same time, there has been progress on Austrian pension reform and on Portuguese corporate tax reforms. At work have been the strictures of the Stability and Growth Pact, reinforced by the mounting pressures of a stronger euro.

Global rebalancing need not put direct pressure on China and other developing nations to abandon currency pegs and adopt more flexible exchange-rate regimes. The lack of a sound financial system and freely functioning capital markets suggests that China is simply not prepared to cope with open capital accounts and the flexible currencies that more advanced nations can accommodate. These considerations should not, however, be viewed as permanent. As China and other developing nations make progress on the road to reform and prosperity, currency flexibility can become an important element of their growth strategies. In the end, there can be no special exemptions from global rebalancing.

Jobless Recoveries

While global rebalancing can alleviate unsustainable pressures in today's world economy, it is also a breeding ground for a new set of tensions. Chief among those is an outbreak of "jobless recoveries" in the developed world. Here, as well, America is leading the way, as concerns over job security now transcend most other economic issues. And with good reason: This jobless recovery is in a league of its own. Fully 22 months after the economy purportedly bottomed in November 2001, private nonfarm payrolls are down some 1.1 million workers; relative to the hiring that would have occurred in business-cycle upturns of the past, that translates into a cyclical shortfall of about 4.3 million jobs (see Exhibit 3).

As always, America's focus is on the manufacturing sector, where jobs have been in a secular decline for most of the post-World War II era. Normally, the secular decline in factory sector hiring gets interrupted in economic recoveries. In fact, in the first 22 months of the past six recoveries, manufacturing payrolls increased, on average, by 5%. Not so this time. Manufacturing headcounts are, in fact, down fully 8% over the first 22 months of this recovery. That means today's depressed level of factory sector payrolls is fully 2 million workers below the path implied by historic cyclical norms. Consequently, even though the factory sector accounts for just 13% of the total private workforce in the US, it explains nearly half the current hiring shortfall of the overall economy.

That's not to say the white-collar services sector isn't suffering. Headcount in this vast area of the US economy is virtually unchanged over the past 22 months, in sharp contrast with the 5% average gains of the past six cycles. That puts the service sector also about 2 million jobs in the hole compared with the hiring that would have occurred in a normal business-cycle upturn.

In this context, the motivation behind America's support for global rebalancing and a weaker dollar is not hard to fathom. A jobless recovery is on a collision course with the Bush Administration's reelection hopes. With America's fiscal and monetary levers already fully engaged, the currency option takes on new and critical importance as the only means left to provide macro stimulus to a beleaguered US labor market. It remains to be seen whether such tactics will work. Mindful of those risks, I sense that the Bush administration has now decided to take out more insurance against a pre-election economic downdraft in the event the current growth spurt proves to be short-lived. That gives a weaker dollar a new and prominent role in America's reflationary policy arsenal. Here, fundamental economics is on the administration's side, as America's massive current-account deficit cries out for a depreciation of the dollar.

The Global Labor Arbitrage

The big risk, of course, is that traditional economic policies do not provide a neat and easy fix for what ails the US or a US-centric global economy. That's especially the case with respect to jobless recoveries — the political hot button in the current climate. As I see it, there is, in fact, a distinct chance that there has been a fundamental breakdown in the relationship between aggregate demand and employment in the United States. At work is a new and increasingly potent structural depressant on US employment growth — what I call the "global labor arbitrage." This phenomenon — a by-product of IT-enabled globalization — is now acting as a powerful structural depressant on traditional sources of job creation in high-wage developed countries such as the United States. That means America's jobless recovery could well be here to stay.

A unique and powerful confluence of three mega-trends is driving the global labor arbitrage. The first is the *maturation of offshore outsourcing platforms*. China exemplifies the critical mass in new outsourcing platforms for manufacturing. Built on a foundation of massive inflows of foreign direct investment and domestically funded infrastructure, the Chinese factory sector has become a key link in the global supply chain. But China is not alone. Similar outsourcing patterns are evident elsewhere in Asia and in Mexico, Canada, South America, and Eastern and Central Europe. Outsourcing is hardly a new phenomenon, but today's offshore manufacturing platforms offer low-cost, high-quality alternatives for goods production and labor on a scale and with a scope never seen before.

A comparable trend is now emerging in the once-sacrosanct services sector. Long dubbed "non-tradables," services have long been perceived as having to be delivered in person, on site. That's no longer the case. Offshore outsourcing of services is now occurring up and down the value chain — from low-value-added transactions processing and call centers to activities with a high intellectual capital content, such as software programming, engineering, design, accounting, actuarial expertise, legal and medical advice, and a broad array of business consulting functions. India exemplifies the critical mass in offshore services outsourcing. One study estimates that India's IT-enabled services exports will increase tenfold over the next four years, from US$1.5 billion in 2001–02 to US$17 billion by 2008, making it one of the fastest-growing major industries in the world (see *The IT Industry in India: Strategic Review 2002,* published by India's National Association of Software & Service Companies with McKinsey & Co.). Nor is India alone. Services outsourcing is increasingly prevalent in countries like China, Ireland, and Australia.

E-based connectivity is the second new mega-trend behind the global labor arbitrage. This is the first business cycle since the advent of the Internet. Say what you will about the Web, but I believe it has transformed the supply side of the global macro equation. For manufacturing, it gives new meaning to the real-time monitoring of sales, inventory, production, and delivery trends that drive the logistics of global supply chain management. And it provides new transparency to the price discovery of factor inputs and upstream materials and supplies. For services, the Internet enables a dramatic expansion of outsourcing options. The intellectual capital of research, analysis, and consulting can be transmitted anywhere in the world with the click of a mouse. A systems problem in New York, for example, can now be quickly fixed by a software patch written in Bangalore. Such connectivity creates a new pipeline for the global information flows that drive the service-sector supply chain. The Internet allows well-educated, hard-working, and relatively low-wage offshore knowledge workers to be seamlessly integrated into global service businesses, once the exclusive domain of knowledge workers in the developed world.

The new imperatives of cost control are the third factor in this equation — in effect, the catalyst that brings the global labor arbitrage to life. In an era of excess supply, companies lack pricing leverage as never before. As such, businesses must be unrelenting in their search for new efficiencies. Not surprisingly, the primary focus of such efforts is labor, representing the bulk of production costs in the developed world; in the US, for example, worker compensation still makes up nearly 80% of total domestic corporate income. And that's the point: Wage rates in China and India range from 10% to 25% of those for comparable-quality workers in the US and the rest of the developed world. Consequently, offshore outsourcing that extracts product from relatively low-wage workers in the developing world has become an increasingly urgent survival tactic for companies in the developed economies.

Mature outsourcing platforms, in conjunction with the Internet, give new meaning to such tactics. General Electric's "70-70-70" credo says it all: One of the world's most successful companies has publicly stated the goals of outsourcing 70% of its headcount, pushing 70% of that outsourcing offshore, and locating 70% of such workers in India. With 16,000 workers in India today — about 5% of its global workforce of 313,000 — GE has only just begun to exploit global labor arbitrage to achieve efficiencies in today's intensely competitive climate. This suggests such an arbitrage is only in its infancy.

These mega-forces are largely irreversible — especially mature outsourcing platforms and the Internet. The imperatives of cost cutting could diminish once global supply and demand are in balance. But in my view, that won't occur for some time. Meanwhile, the resulting global labor arbitrage continues to have a profound impact on restraining job creation in the United States. The footprints of accelerated outsourcing are unmistakable. For example, an 11.4% surge in US real goods imports growth over the first six quarters of this recovery is far in excess of what might normally be expected in the context of an anemic 4.2% increase in domestic demand over this period. In the case of the US, rising import propensities and the concomitant offshore outsourcing of jobs are the functional equivalent of "imported productivity," as the global labor arbitrage substitutes foreign labor content for domestic labor input. In my view, that could well go a long way in explaining the latest chapter of America's fabled productivity saga.

Halfway around the world, there are clear indications of complementary adjustments in Asia's huge reservoir of surplus labor. In China, foreign-funded subsidiaries now employ some 3.5 million workers, up more than 3.5 times over the past decade. Moreover, another 3.25 million Chinese workers are employed by subsidiaries funded in Hong Kong, Taiwan, and Macao. Similar trends are evident in services outsourcing. India currently employs about 650,000 professionals in IT services, a figure that is expected to more than triple over the next five years, according to the McKinsey study cited above. Moreover, there is good reason to believe that increased staffing by Indian subsidiaries of multinational service providers will be matched by headcount reductions elsewhere in their global platforms; evidence for this can be found in a tabulation prepared by Morgan Stanley's own Mumbai-based research outsourcing center (see Exhibit 4).

The global labor arbitrage underscores a profound asymmetry of globalization. Offshore outsourcing is an unmistakable first-round opportunity for low-cost developing nations to enter the supply side of global commerce. But their demand response typically lags, often by a considerable interval. China is a classic example. Its production-based growth is obvious, but its demand response, especially domestic private consumption, remains weak. That shouldn't be surprising: Chinese reforms of state-owned enterprises are resulting in ongoing layoffs of 6–8 million workers per year. Moreover, without well-developed national social security and retirement schemes, China still lacks a viable safety net. In the absence of job and income security, the emergence of consumer culture understandably lags. Today, China is about supply. Tomorrow, it will be about demand.

The first-round asymmetrical impacts of globalization and the global labor arbitrage are now sparking a great debate in political circles. That's mainly because the arbitrage raises the possibility that jobless recoveries could well remain the norm in high-cost developed economies for some time. Threats to traditional sources of job creation strike at the heart of economic security. This has already led to a protectionist backlash in the US Congress — underscoring the potential politicization of the global labor arbitrage.

Trade Frictions and Protectionism

Ominous signs of trade frictions and protectionism are the ultimate challenge to global rebalancing. They are a by-product of a potentially lethal interplay between politics and the economics of jobless recoveries in the developed world. Several developments point to an intensification of global trade frictions.

First, the recent breakdown of talks at the WTO ministerial meetings in Cancun was a major setback for trade liberalization. Tensions between rich and poor countries came out into the open on such long-standing issues as agricultural subsidies, investment and competition rules, and financial market transparency. The failure of this meeting of the World Trade Organization is reminiscent of the fiasco in Seattle in 1999 and raises serious questions about the successful completion of the so-called Doha Round of trade liberalization slated for 2004.

Second, America is now at risk of imposing protectionist sanctions on China. In mid-September, legislation was introduced in both houses of the US Congress that threatens large across-the-board tariffs on all Chinese exports to the US if the renminbi currency peg is not abandoned. At present, I would assign no higher than a one in five chance of this legislation being enacted. Yet those odds will likely rise as the US political cycle heats up, especially if America remains stuck in a jobless recovery. Significantly, this action is bipartisan — sponsored by Democrats and Republicans alike. It also has broad appeal by ideology, geography, and industrial orientation Moreover, unlike the protectionist drift of the recent past, there is no political counterweight in the White House to this sentiment; after all, the current Bush administration led the charge in boosting steel tariffs in 2002. All this underscores the breadth of political support for the assault on China — an especially worrisome portent of more protectionist forays to come from the United States.

Third, Japan has continued its campaign of leaning against market-driven economic forces. So far this year, Japanese authorities appear to have spent a record US$125 billion intervening in foreign exchange markets in an effort to stem the depreciation of the yen. This has been a key force in shifting the burden of the dollar's adjustment to other currencies, especially the euro. Moreover, the Japanese have led the way in China bashing over the past year, arguing — erroneously, in my view — that China is to blame for exporting global deflation and for the "hollowing out" of Corporate Japan.

Fourth, European leaders have also joined the fray, aiming to protect their sluggish economy. Their concern is that the euro has borne too much of the burden of the dollar's recent depreciation. This has led European officials to point the finger at Asian countries whose currency pegs are perceived to insulate them from adjustments in the dollar. This sentiment, which came to a head in a mid-September meeting of European finance ministers in Stresa, Italy, appears to have formed the basis of a more formal protest that was registered at the recent G-7 meeting in Dubai.

As I see it, all of these examples are part of the same mosaic — by-products of an increasingly treacherous interplay between a tough global economic climate and the mounting pressures of the political cycle. In the context of jobless recoveries in the developed world, this interplay has assumed even greater importance, with politicians increasingly taking the lead in shaping the outcome as elections draw near. The conclusion is inescapable, in my view: The greater the pressures on job and income security, the greater the risk of protectionist responses by the high-labor-cost nations of the industrial world.

In 1930, Senator Reed Smoot and Representative Willis C. Hawley sponsored legislation that significantly raised the level of US tariffs. Courtesy of a recently popped equity bubble, the US economy was then in recession, and a Republican administration favored the protectionist remedy as a means to provide relief for American workers. President Herbert Hoover signed the Smoot-Hawley Tariff Act into law in June 1930. Global trade retaliation quickly followed, as did a downward spiral of world trade. Many believe that such frictions ultimately set the stage for the Great Depression that followed. Such lessons should not be ignored in today's unbalanced, post-bubble era.

No one, including myself, thinks such an outcome is likely. Yet that's a risk that can no longer be taken lightly as politics comes face to face with the stresses and strains of globalization. Are we forever doomed to repeat the mistakes of history?

The Scapegoating of China

The recent outbreak of protectionist sentiment has been virtually unanimous in singling out China. In particular, world opinion is increasingly focused in putting pressure on a vigorous Chinese economy to "play fair" and revalue its currency. In my view, there are several reasons why that would be a serious mistake.

First and foremost, there is enormous confusion over the character of the so-called Chinese export threat. In my opinion, the world has formed an erroneous impression that newly emerging Chinese companies are capturing global market share with reckless abandon. In fact, nothing could be further from the truth. As noted earlier, for more than a decade, the real export dynamic in China has come far more from the deliberate outsourcing strategies of multinationals than from the rapid growth of indigenous Chinese companies. "Foreign-invested enterprises" — Chinese subsidiaries of global multinationals and joint ventures with industrial-world partners — have accounted for fully 65% of the total increase Chinese exports over that period (see Exhibit 5).

This is hardly an example of China grabbing market share from the rest of the world. Instead, it is a by-product of the determined struggle for competitive survival by high-cost producers in the industrial world. Last year, a record US$52.7 billion of foreign direct investment flowed into China, making the country the largest recipient of FDI in the world. This inflow did not occur under coercion — it was entirely voluntary. A high-cost industrial world has made a conscious decision that it needs a Chinese-based outsourcing platform. Dismantling the RMB peg would destabilize the very supply chain that has become so integral to new globalized production models. It would be a serious negative for those same economies — Japan, the US, and Europe — that have led the rush to Chinese outsourcing. By putting pressure on China to change its currency regime, the industrial world runs the risk of squandering the fruits of its own cost-cutting efforts. Fear of the so-called China threat completely misses this critical point. The power of the Chinese export machine is more traceable to "us" than it is to "them."

A second argument in support of China's currency peg is the nature of the nation's competitive prowess. Contrary to widespread perception, China does not compete on the basis of an undervalued currency. It competes mainly in terms of labor costs, technology, quality control, infrastructure, and an unwavering commitment to reform. I have a hunch that if China were to revalue the RMB upward by 20% — a change I do not expect nor advise — its exports would suffer minimal loss of market share.

Third, it's important to stress that there is little doubt over the endgame. China has consistently reiterated its long-term commitment to opening its capital account and making its currency fully convertible. At the same time, China knows full well that a good deal of heavy lifting on the reform front has to occur before these objectives can be accomplished. That's true of both capital-market reforms and the need to clean up its banking problems. China is taking great strides on these fronts, but a lot more needs to be done. Until there is more progress on financial reforms, it would be premature and risky for China to float its currency, in my view. That's a critical lesson of the Asian financial crisis of 1997–98 that an impatient world should not lose sight of when putting pressure on China.

Several other considerations argue against an RMB revaluation: an intensification of imported deflationary pressures for a Chinese economy that is only now climbing out of deflation; the possible emergence of bubbles in other asset markets, especially property; and a signal to market speculators that the RMB is now "in play." I fear there's a deeper meaning to the pressures now being put on China: Unwilling to accept responsibility for their own shortcomings, the wealthy economies of the industrial world are making China a scapegoat for their weak recoveries.

That's especially true of Japan, which has led the way in China bashing over the past year. Senior Japanese officials have blamed China for exporting deflation and for the "hollowing out" of the Japanese labor market. Nothing could be further from the truth, in my view. Low-cost, high-quality Chinese imports provide a windfall to the purchasing power of beleaguered Japanese consumers — precisely the same type of benefits that Japan's export machine provided the world in the 1970s and 1980s. If you want an example of an undervalued currency, study the path of the yen during Japan's economic renaissance; it averaged close to ¥300 versus the dollar in the 1970s and about ¥220 in the 1980s — dramatically cheaper than its current reading in the ¥110 range. It strikes me as extremely hypocritical for Japan to criticize China for emulating a strategy that was central to its own development model. Putting pressure on China to revalue its currency is a poor excuse for Japan's inability or unwillingness to reform.

I am also concerned about the China bashing that I am hearing in the United States these days. Many have noted that America's largest trade deficit is now with China — a $103 billion shortfall in 2002 and on track to exceed $120 billion in 2003. Like it or not, trade deficits should not come as a surprise for a saving-short US economy. Unfortunately, they are part and parcel of America's increasing need to import surplus foreign saving in order to finance economic growth; the only way to get that capital is for the US to run massive current-account and trade deficits. If America weren't trading with China, those deficits would have to occur with other nations — Canada, Mexico, other Latin economies, Japan, or possibly even Europe. That the United States now runs its largest trade deficit with China is a good thing, in my view. As in Japan, China is providing American consumers with the cheapest high-quality goods that producers worldwide can offer today. If the United States wants to reduce its trade deficit, it must come to grips with more fundamental problems of its own, namely a rapidly vanishing national saving rate. Until it does so, US trade deficits are likely to be the rule, not the exception, and the low-cost, high-quality option of Chinese trade is in America's best interest.

Nor should "fair value" of the RMB be judged on the basis of China's large bilateral trade deficit with any nation, let alone the United States. What matters most in terms of assessing the fair value of any currency is a nation's overall trade balance with the world as a whole. In the first nine months of 2003, China ran only a US$9.1 billion trade surplus with the world — far short of the $30.4 billion surplus in 2002. A trade position that is in near balance with the rest of the world hardly speaks of an undervalued currency (see Exhibit 6).

Moreover, there has been far too much focus on the so-called Chinese export threat. Overlooked in all this angst is the increased power of the Chinese import machine — a force that is putting China in an increasingly prominent role as a new engine on the supply side of the global economy. In the first nine months of 2003, Chinese imports were up 40.5% over the same period a year ago — on track to surpass the 37% increase in 2000, the fastest annual increase of the last ten years. This powerful import dynamic is at the heart of China's "demand pull" on other nations in its supply chain. Of particular importance is the Chinese-led growth impetus to Japan — the world's newest recovery story. In the first eight months of 2003, our estimates suggest that China's imports accounted for fully 73% of Japanese growth in goods exports — a key factor behind the externally led growth dynamic of the long-stagnant Japanese economy (see Exhibit 7). Moreover, Chinese import growth accounted for fully 99% of Taiwan's export growth in the first eight months of this year, 35% of Korea's, and even 24% of the increase in US goods exports. Far from acting as a depressant on a long sluggish global economy, the Chinese growth engine is making a real difference in stimulating demand elsewhere in Asia and in the broader global economy.

I continue to believe that China is the world's greatest development story of the 21st century. Its emergence will benefit not only the 20% of the world that lives in its most populous nation but also the 80% of us who do not. Periods of economic distress often produce scapegoats. China is at risk of becoming a scapegoat in today's increasingly dysfunctional global economy. It's high time for an increasingly self-absorbed world to look in the mirror and put an end to this dangerous blame game.

Hope or Despair?

Over the next year, it all boils down to a very simple question: Are there realistic policy options that can temper the imbalances of a US-centric world? As far as I am concerned, conventional reflationary policy initiatives are no substitute for global rebalancing. In the case of the United States, another burst of deficit-financed domestic demand will only worsen the excesses of debt, saving, and the current account. In Japan and Europe, competitive currency devaluation could well inhibit the very reforms that are needed to unshackle domestic demand. And at the same time, politically inspired China bashing can only threaten the global trade dynamic that now plays such an important role in driving world economic growth. All this underscores the ultimate irony of the so-called reflation play — that a policy-inspired rebound may well exacerbate the imbalances of the US-centric world.

There's always the issue of timing — that imbalances are more of a distant concern that can be finessed for the time being. While I certainly concede that's possible, I fear the excesses have created a fundamental disequilibrium that is only getting worse — and at an increasingly alarming rate. Borrowing from physics, I also believe that unstable systems are less able to withstand ever-present macro shocks than more stable systems. That underscores a persistent vulnerability that makes sustained vigorous recovery in today's global economy exceedingly difficult. Those who bet on the quick and easy fix — economic or political — do so at considerable peril. It is high time to get on with the heavy lifting of global rebalancing.

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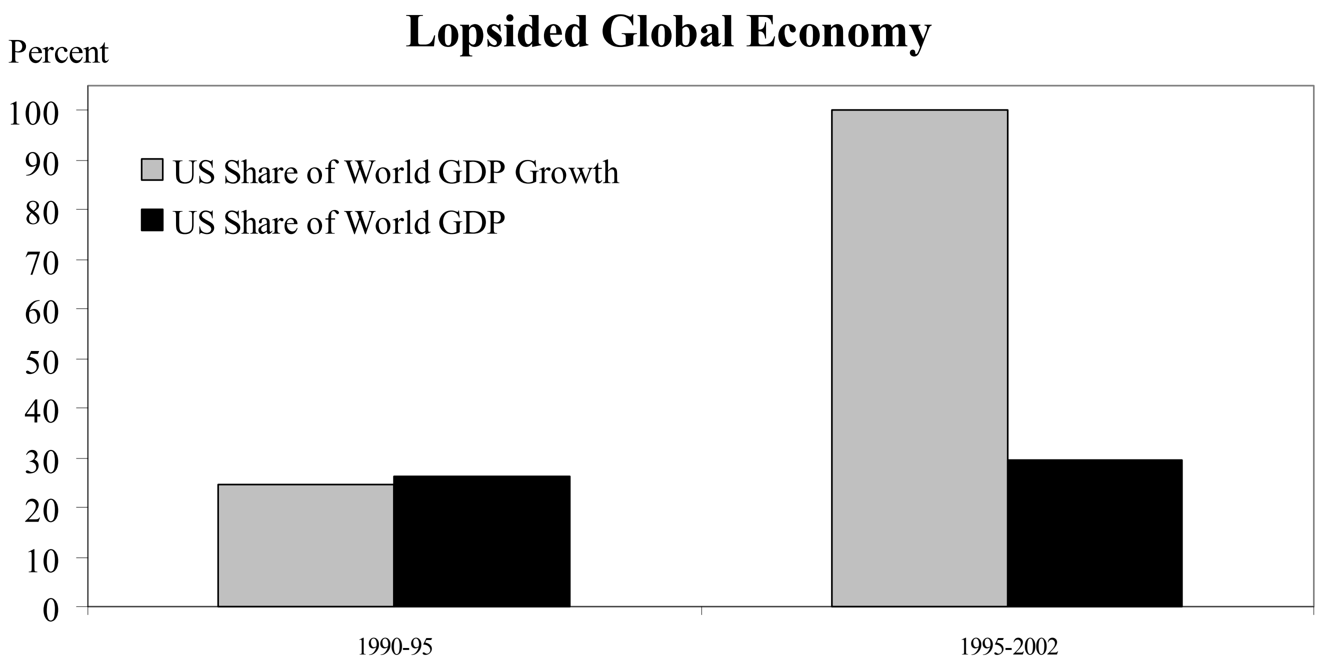
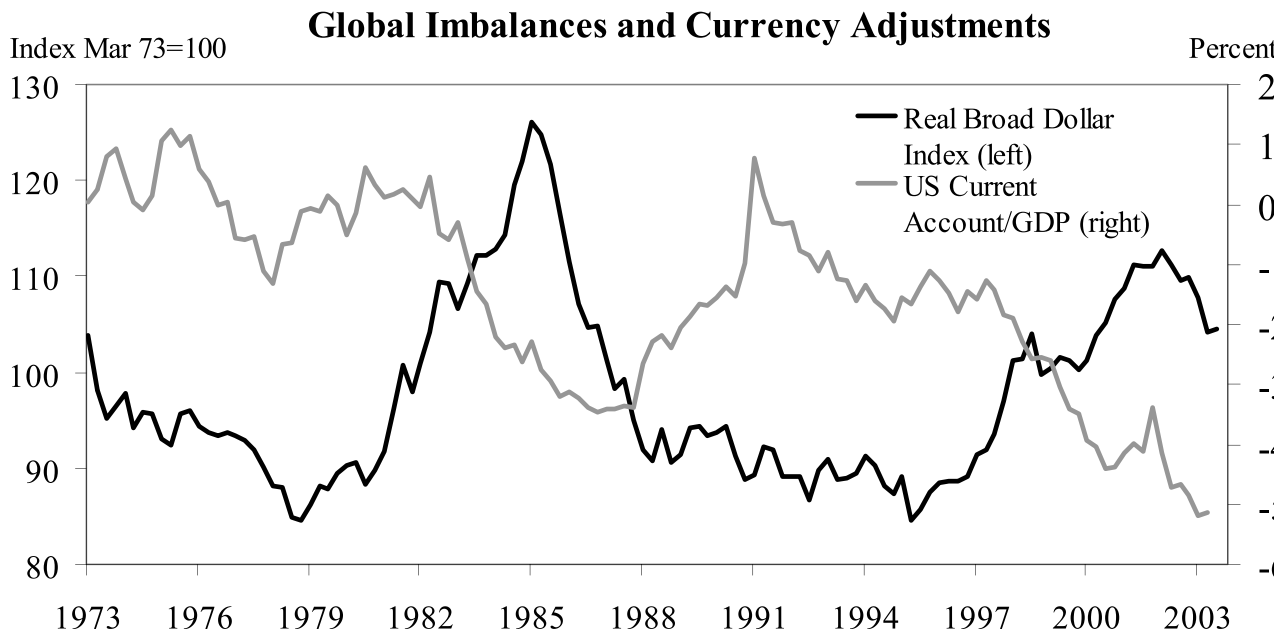
Exhibit 1



Source: IMF, Bureau of Economic Analysis

Never before has the modern-day global economy
been more dependent on the US as its sole engine of growth.

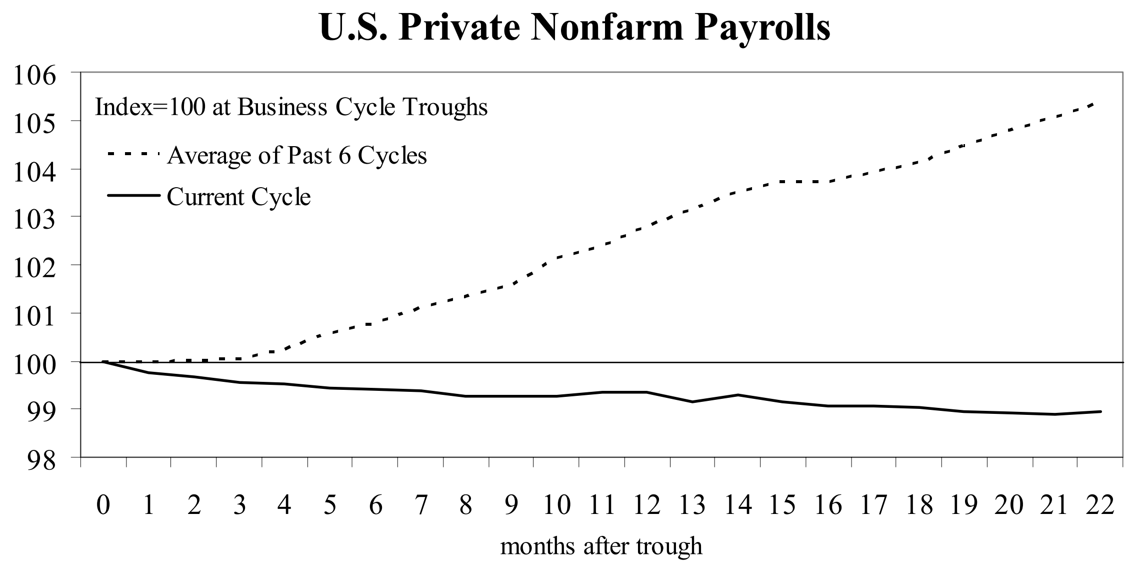
Exhibit 2



Source: Bureau of Economic Analysis, Morgan Stanley Research

The dollar still has a good deal further to go on the downside in facilitating America's current-account adjustment.

Exhibit 3



Source: Bureau of Labor Statistics, Morgan Stanley Research

Since the US economy bottomed in November 2001, current hiring has fallen 4.3 million workers short of the cyclical norm.

Exhibit 4

Services Outsourcing: More Jobs Headed to India

	Latest Manpower	India Manpower	Plans for India Office	Job Cuts Announced / Carried out in the last 12 months
Accenture	65000	3500	8000 Employees by Aug 2004	1000
Adobe Systems	3250	185	250 People in 6 months	260
Cadence	5000	315	Doubling team in 4 years	500
Cap Gemini	56500	800	2000 People by December 2003	1000
Cisco	34466	2300	NA	Have frozen hiring engineers globally but have continued to increase India outsourcing
Covansys	4556	2000	2800 People in 1 year	200
CSC	92000	1200	4800 People by 2004	607
EDS	138000	300	2400 People by 2005	8200
i2	2800	1000	Recruiting actively	Nearly 1800 people
IBM Global Services	150000	3100	10000 People In 3 years	Nearly 2000 people
Intel	79200	950	3000 People by 2005	4700
Keane	5819	623	2000 People by end 2003	607
Logica-CMG	24000	350	1000 People by end 2004	2650
Lucent	35000	570	NA	13800
Microsoft	55000	200	500 People in 3 years	Increasing w orkforce
Oracle	40000	3159	6000 People in the next 12 months	200
Sapient	1500	600	Grow ing the India Center and Global Delivery	863
SunMicro	36000	700	Grow ing the India Center	5480
Syntel	2700	2000	650	NA
Texas Instruments	34400	900	1500 People by Mar 2006	800 personnel
Xansa	5583	1200	6000 People in a few years	502

Source: Morgan Stanley India Research

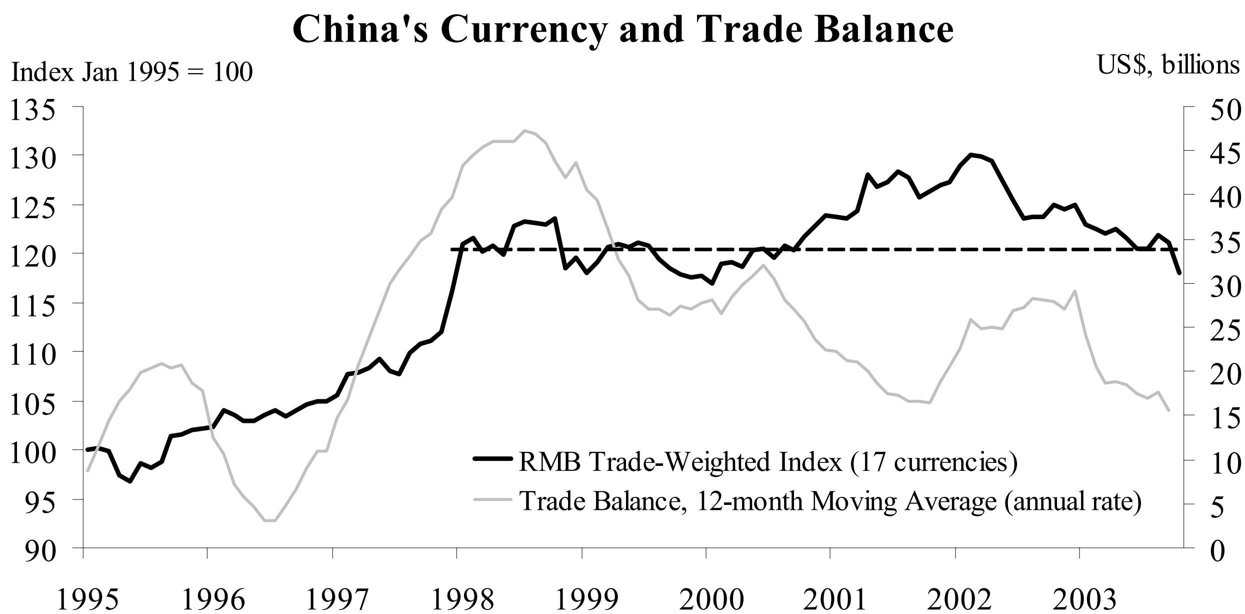
The global labor arbitrage is now shifting into the once-sacrosanct services sector.

Exhibit 5

Source: China National Statistical Bureau, CEIC, Morgan Stanley Research

China's industrial growth dynamic
is heavily influenced by outsourcing.

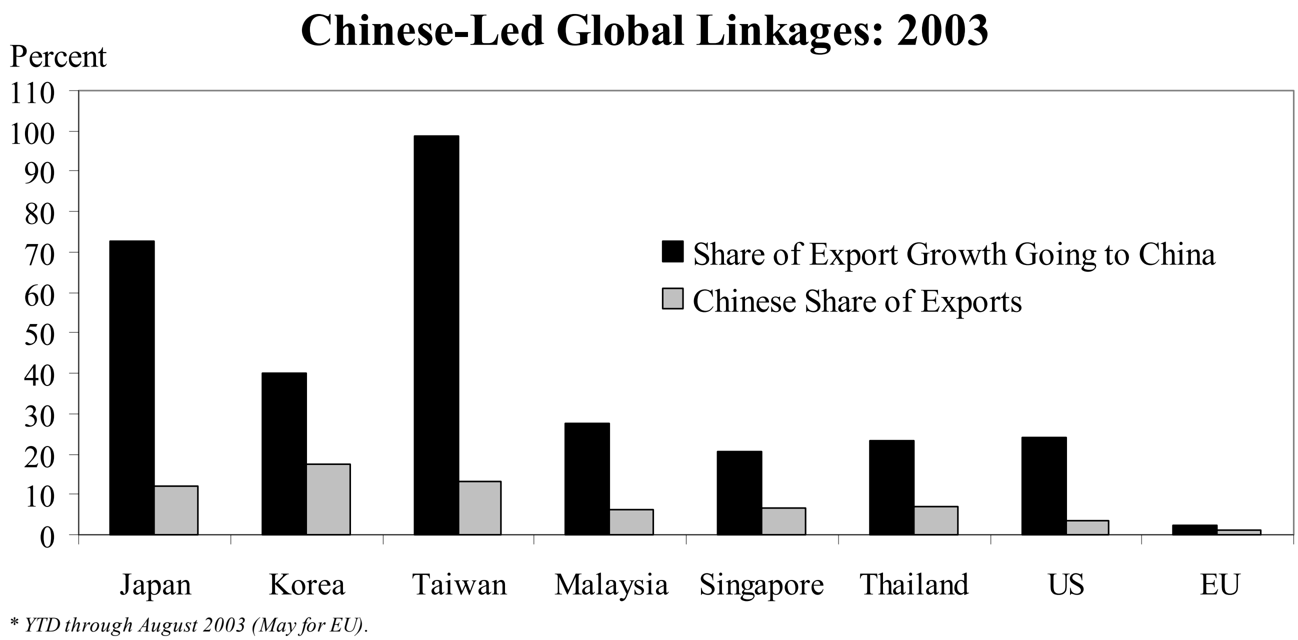
Exhibit 6



Source: CEIC, China Customs, Morgan Stanley Research

With China's relatively small trade surplus,
the RMB can hardly be called undervalued.

Exhibit 7



Source: IMF

Chinese import demand is playing a key role in driving exports elsewhere in the world.

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(as of September 30, 2003)

	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight	577	31%	243	39%	42%
Equal-weight	854	46%	274	44%	32%
Underweight	411	22%	99	16%	24%
Total	1,842		616		

Data include common stock and ADRs currently assigned ratings. For disclosure purposes (in accordance with NASD and NYSE requirements), we note that Overweight, our most positive stock rating, most closely corresponds to a buy recommendation; Equal-weight and Underweight most closely correspond to neutral and sell recommendations, respectively. However, Overweight, Equal-weight, and Underweight are not the equivalent of buy, neutral, and sell but represent recommended relative weightings (see definitions below). An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

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