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

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

There is far more to this story than a potential downturn in the global business cycle. Another post-bubble shakeout poses a serious challenge to the timeworn inflation-targeting approach of central banks. It also presents the body politic with a fundamental challenge to its tolerance and, in many cases, encouragement of a new asset-dependent strain of global economic growth. Subprime spillovers have only just begun to play out - as has the debate this crisis has spawned.

Game Over for the American Consumer

The American consumer has been the dominant engine on the demand side of the global economy for the past 11 years. With real consumption growth averaging nearly 4% over the 1996 to 2006 interval, US consumption expenditures currently total over $9.6 trillion, or 19% of world GDP (at market exchange rates).

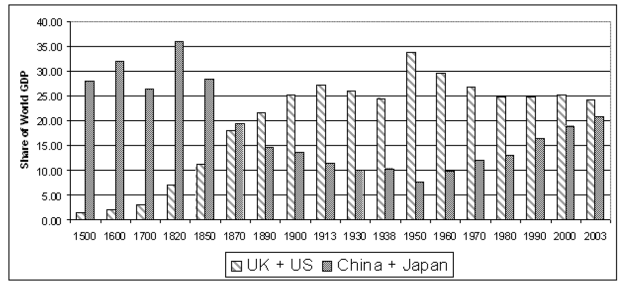
Growth in US consumer demand is typically powered by two forces - income and wealth (see Figure 1). Since the mid-1990s, income support has lagged while wealth effects have emerged as increasingly powerful drivers of US consumption. That has been especially the case in the current economic expansion, which has faced the combined headwinds of subpar employment growth and relatively stagnant real wages. As a result, over the past 69 months, private sector compensation - the broadest measure of earned labor income in the US economy - has increased only 17% in real, or inflation adjusted, terms. That falls nearly $480 billion short of the 28% increase that had occurred, on average, over comparable periods of the past four US business cycle expansions.

Lacking in support from labor income, US consumers turned to wealth effects from rapidly appreciating assets - principally residential property - to fuel booming consumption. By Federal Reserve estimates, net equity extraction from residential property surged from 3% of disposable personal income in 2001 to nearly 9% by 2005 - more than sufficient to offset the shortfall in labor income generation and keep consumption on a rapid growth path.

There was no stopping the asset-dependent American consumer.

That was then. Both income and wealth effects are now coming under increasingly intense pressure - leaving consumers with little choice other than to rein in excessive demand. The persistently subpar trend in labor income growth is about to be squeezed further by the pressures of a cyclical adjustment in production and employment. In August and September 2007, private sector nonfarm payrolls expanded, on average, by only 52,000 per month - literally one-third the average pace of 157,000 of the preceding 24 months. Moreover, this dramatic slowdown in the organic job creating capacity of the US economy is likely to be exacerbated by a sharp fall off in residential construction sector employment in the months ahead. Jobs in the homebuilding sector are currently down only about 5% from peak levels despite a 40% fall-off in housing starts; it is only a matter of time before jobs and activity move into closer alignment in this highly cyclical - and now very depressed - sector.

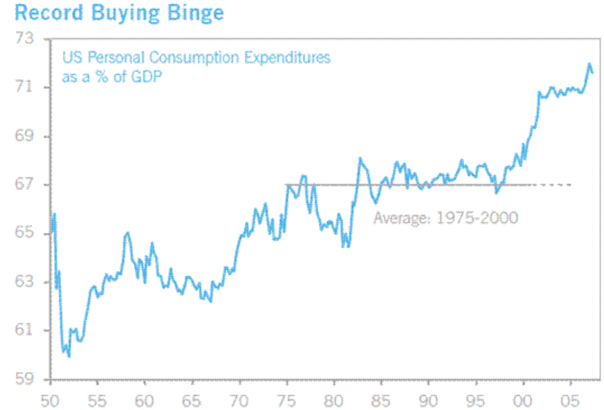
Moreover, the bursting of the property bubble has left the consumer wealth effect in tatters. After peaking at 13.6% in mid-2005, nation-wide house price appreciation slowed precipitously to 3.2% in mid-2007. Given the outsize overhang of excess supply of unsold homes, I suspect that overall US home prices could actually decline in both 2008 and 2009 - an unprecedented development in the modern-day experience of the US economy. Mirroring this trend, net equity extraction has already tumbled - falling to less than 5.5% of disposable personal income in 2Q07 and retracing more than half the run-up that began in 2001. Subprime contagion can only reinforce this trend - putting pressure on home mortgage refinancing and thereby further inhibiting equity extraction by US homeowners.



With both income and wealth effects under pressure, I don't see any way saving-short, overly-indebted American consumers can maintain excessive consumption growth. For a US economy that has drawn disproportionate support from a record 72% share of personal consumption (see Figure 2), a consumer-led capitulation spells high and rising recession risk. Unfortunately, the same prognosis is likely for a still US-centric global economy.

Figure 2: The Overextended American Consumer

Record Buying Binge



Source: OFHEO, Federal Reserve, Bureau of Economic Analysis, Morgan Stanley Research

Don't Count on Global Decoupling

A capitulation of the American consumer spells considerable difficulty for the global economy. This conclusion is, of course, very much at odds with notion of "global decoupling" - an increasingly popular belief that depicts a world economy that has finally weaned itself from the ups and downs of the US economy.

The global decoupling thesis is premised on a major contradiction: In an increasingly globalized world, cross border linkages have become even more important - making globalization and decoupling inherently inconsistent. True, the recent data flow raises some questions about this contention. After all, the world seems to have held up reasonably well in the face of the slowing of US GDP growth that has unfolded over the past year. But that's because the downshift in US growth has been almost exclusively concentrated in residential building activity - one of the least global sectors of the US economy. If I am right, and consumption now starts to slow, such a downshift will affect one of the most global sectors of the US. And I fully suspect a downshift in America's most global sector will have considerably greater repercussions for the world at large than has been the case so far.

That's an especially likely outcome in Asia - the world's most rapidly growing region and one widely suspected to be a leading candidate for global decoupling. However, as Figure 3 clearly indicates, the macro structure of Developing Asia remains very much skewed toward an export-led growth dynamic. For the region as a whole, the export share has more than doubled over the past 25 years - surging from less than 20% in 1980 to more than 45% today. Similarly, the share going to internal private consumption - the sector that would have to drive Asian decoupling - has fallen from 67% to less than 50% over the same period.

Nor can there be any mistake as to the dominant external market for export-led Asian economies. The United States wins the race hands down - underscored by a 21% share of Chinese exports currently going to America. Yes, there has been a sharp acceleration of intra-regional trade in recent years, adding to the hopes and dreams of Asian decoupling. But a good portion of that integration reflects the development of a China-centric pan-Asian supply chain that continues to be focused on sourcing end-market demand for American consumers. That means if the US consumer now slows, as I suspect, Asia will be hit hard - with cross-border supply chain linkages exposing a long-standing vulnerability that will draw the global decoupling thesis into serious question. A downshift of US consumption growth will affect Asia unevenly. A rapidly growing Chinese economy has an ample cushion to withstand such a blow. Chinese GDP growth might slow from 11% to around 8% - hardly a disaster for any economy and actually consistent with what Beijing has tried to accomplish with its cooling-off campaign of the past several years. Other Asian economies, however, lack the hyper-growth cushion that China enjoys. As such, a US-led slowdown of external demand could hurt them a good deal more. That's especially the case for Japan, whose 2% growth economy could be in serious trouble in the event of a US demand shock that also takes a toll on Japanese exports into the Chinese supply chain. While less vulnerable than Japan, Taiwan and South Korea could also be squeezed by the double whammy of US and China slowdowns. For the rest of Asia - especially India and the ASEAN economies - underlying growth appears strong enough to withstand a shortfall in US consumer demand. But there can be no mistaking the endgame: Contrary to the widespread optimism of investors and policy markers, the Asian growth dynamic is actually quite vulnerable to a meaningful slowdown in US consumption growth.

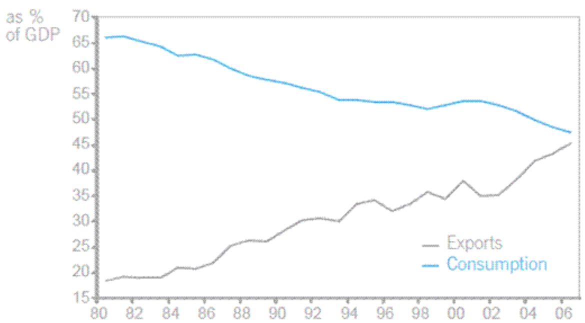
A Subprime Dollar

This constellation of forces could prove especially vexing for the US dollar. Currencies are, first and foremost, relative prices - in essence, measures of the intrinsic value of one economy versus another. On that basis, the world has had no compunction in writing down the value of the United States over the past several years. A broad dollar index, which measures the US currency relative to those of most of America's trading partners, is off about 20% from its early 2002 peak. Recently, it has hit new lows against the euro and a high-flying Canadian currency, likely a harbinger of more weakness to come.

Sadly, this depreciation of the US currency is not surprising. Because Americans haven't been saving in sufficient amounts for a long time, the United States must import surplus savings from abroad in order to grow. And it has to run record balance of payments and trade deficits in order to attract that foreign capital. The United States current account deficit - the broadest gauge of America's imbalance in relation to the rest of the world - hit a record 6.2% of gross domestic product in 2006 before receding slightly in the first half of this year. America must still attract some $3 billion of foreign capital each business day in order to keep its economy growing.

Figure 3: The Myth of Asian Decoupling

Export-Led Developing Asia



Source: IMF, Morgan Stanley Research

Export Linkages to the US

	Export Share of GDP	US Share of Exports
China	36.6	21.0
Japan	14.8	22.5
Korea	36.7	13.3
Taiwan	59.0	14.4
ASEAN	72.7	13.6

Economic theory is very clear on the implications of such huge imbalances: Foreign lenders need to be compensated for sending scarce capital to any country with a deficit. The bigger the deficit, the greater the required compensation. The currency of the deficit nation usually bears the brunt of that compensation. It then follows that as long as the United States fails to address its saving problem, its large balance of payments deficit will persist and the dollar will keep dropping.

The only silver lining so far has been that these adjustments to the US currency have been orderly - declines in the broad dollar index averaging a little less than 4% per year since early 2002. Now, however, the possibility of a disorderly correction is rising - with potentially grave consequences for the American and global economy.

A key reason is the mounting risk of a recession in America. As noted above, the bursting of the subprime mortgage bubble - strikingly reminiscent of the dot-com excesses of the 1990s - could well be a tipping point. In both cases, financial markets and policy makers were steeped in denial over the risks. But the lessons of post-bubble adjustments are clear. Just ask economically stagnant Japan. And of course, the United States lapsed into its own post-bubble recession in 2000 and '01. Sadly, the endgame could be considerably more treacherous for the United States than it was seven years ago. In large part, that's because the American consumer is now at risk. Consumption expenditures currently account for a record 72% of the gross domestic product - a number unmatched in the annals of modern history for any nation.

This buying binge has been increasingly supported by housing and lending bubbles. Yet, as also stressed above, both of these bubbles are now in the process of bursting - an outcome which could put US consumer demand under considerable pressure. That will make it exceedingly difficult for the United States to avoid a recession.

Fearful of that possibility and the additional Fed easing it implies, foreign investors are becoming increasingly skittish over buying dollar-based assets. The spillover effects of the subprime crisis into other asset markets - especially mortgage- backed securities and asset-backed commercial paper - underscore these concerns. As a result, foreign appetite for America's complex and opaque financial instruments is likely to be sharply reduced for years to come. That would choke off an important avenue of capital inflows, putting more downward pressure on the dollar.

The political winds are also blowing against the dollar. In Washington, China-bashing is the bipartisan sport du jour. New legislation is likely that would impose trade sanctions on China unless it makes a major adjustment in its currency. Not only would this be an egregious policy blunder - attempting to fix a multilateral deficit with more than 40 nations by forcing an exchange rate adjustment with one country - but it would also amount to Washington taxing one of America's major foreign lenders.

That would undoubtedly reduce China's desire for United States assets, and unless another foreign buyer stepped up, the dollar would come under even more pressure. Finally, the more the Fed under Ben Bernanke follows the easymoney, market-friendly Alan Greenspan script, the greater the risk to the dollar.

Why worry about a weaker dollar? The United States imported $2.2 trillion of goods and services in 2006. A sharp drop in the dollar makes those items considerably more expensive - the functional equivalent of a tax hike on consumers. It could also stoke fears of inflation - driving up long-term interest rates and putting more pressure on financial markets and the economy, exacerbating recession risks. Optimists may draw comfort from the vision of an export-led renewal arising from a more competitive dollar. Yet history is clear: No nation has ever devalued its way into prosperity.

So far, the dollar's weakness has not been a big deal. That may now be about to change. Relative to the rest of the world, the United States looks painfully subprime. So does its currency.

The Failure of Central Banking

The recent chain of events is not an isolated development. In fact, for the second time in seven years, the bursting of a major asset bubble has inflicted great damage on world financial markets. In both cases - the equity bubble in 2000 and the credit bubble in 2007 - central banks were asleep at the switch. The lack of monetary discipline has become a hallmark of an unfettered globalization. Central banks have failed to provide a stable underpinning to world financial markets and to an increasingly asset-dependent global economy.

This sorry state of affairs can be traced to developments that all started a decade ago. Basking in the warm glow of a successful battle against inflation, central banks decided that easy money was the world's just reward.

America's IT-enabled productivity resurgence in the late 1990s was the siren song for the Greenspan-led Federal Reserve - convincing the US central bank that it need not stand in the way of either rapid economic growth or excess liquidity creation. In retrospect, that was the "original sin" of bubble-world - a Fed that condoned the equity bubble of the late 1990s and the asset-dependent US economy it spawned. That set in motion a chain of events that has allowed one bubble to beget another - from equities to housing to credit.

Yet bubbles always burst. And when that happened to the equity bubble in 2000, central banks threw all caution to the wind and injected massive liquidity into world financial markets in order to avoid a dangerous deflation. With globalization restraining inflation and real economies recovering only sluggishly in the early 2000s, that excess liquidity went directly into asset markets.

Aided and abetted by the explosion of new financial instruments - especially what is now over $440 trillion of derivatives worldwide - the world embraced a new culture of debt and leverage. Yield-hungry investors, fixated on the retirement imperatives of aging households, acted as if they had nothing to fear. Risk was not a concern in an era of open-ended monetary accommodation cushioned by a profusion of derivatives-based shock absorbers.

As always, the cycle of risk and greed went to excess. Just as dot-com was the canary in the coal
mine seven years ago, subprime was the warning shot this time. Denial in both cases has eerie similarities - as do the spillovers that inevitably occur when major asset bubbles pop. When the dot-com bubble burst in early 2000, the optimists said not to worry - after all, Internet stocks accounted for only about 6% of total US equity market capitalization at the end

of 1999. Unfortunately, the broad S&P 500 index tumbled some 49% over the ensuing two and a half years and an over-extended Corporate America led the US and global economy into recession. Similarly, today's optimists are preaching the same gospel: Why worry, they say, if subprime is only about 14% of total US securitized mortgage debt? Yet the unwinding of the far broader credit cycle, to say nothing of the extraordinary freezing up of key short-term financing markets, gives good reason to worry - especially for over-extended American consumers and a still US-centric global economy.

Central banks have now been forced into making emergency liquidity injections - including a rare intra-meeting cut in the Fed's discount rate that was then followed by a 50 basis point reduction in the overnight lending rate. The jury is out on whether these efforts will succeed in stemming the current rout in still overvalued credit markets. While tactically expedient, these actions may be strategically flawed in that they fail to address the moral hazard dilemma that continues to underpin asset-dependent economies. Is this any way to run a modern-day world economy?

The answer is an unequivocal "no." As always, politicians are quick to grandstand and blame financial fiduciaries for problems afflicting uneducated, unqualified borrowers. Yet the markets are being painfully effective in punishing these parties. Instead, the body politic needs to take a look in the mirror - especially at the behavior of its policy-making proxies and regulators, the world's major central banks.

It is high time for monetary authorities to adopt new procedures - namely, taking the state of asset markets into explicit consideration when framing policy options. Like it or not, we now live in an asset-dependent world. As the increasing prevalence of bubbles indicates, a failure to recognize the interplay between the state of asset markets and the real economy is an egregious policy error.

That doesn't mean central banks should target asset markets. It does mean, however, that they need to break their one dimensional fixation on CPI-based inflation and also pay careful consideration to the extremes of asset values. This is not that difficult a task. When equity markets go to excess and distort asset-dependent economies as they did in the late 1990s, central banks should run tighter monetary policies than a narrow inflation target would dictate. Similarly, when housing markets go to excess, when subprime borrowers join the fray, or when corporate credit becomes freely available at ridiculously low "spreads," central banks should lean against the wind. The current financial crisis is a wake-up call for modern-day central banking. The world can't afford to keep lurching from one bubble to another. The cost of neglect is an ever-mounting systemic risk that could pose a grave threat to an increasingly integrated global economy. It could also spur the imprudent intervention of politicians, undermining the all-important political independence of central banks. The art and science of central banking is in desperate need of a major overhaul.

The Political Economy of Asset Bubbles

There may be a deeper meaning to all this. It is far-fetched to argue that central banks have consciously opted to inflate a series of asset bubbles - and then simply deal with the aftershocks once they burst. At work, instead, are the unintended consequences of a new and powerful asset-led global growth dynamic that is very much an outgrowth of the political economy of growth and prosperity.

This outcome reflects the confluence of three mega-trends - globalization, the IT revolution, and the provision of retirement income for aging workers. Globalization has injected a powerful new impetus to the disinflation of the past quarter century - facilitating a cross-border arbitrage of costs and prices that has put unrelenting pressure on the pricing of goods and many services, alike. At the same time, IT-enabled productivity enhancement - initially in the United States but now increasingly evident in other economies - has convinced central banks that there has been a meaningful increase in the non-inflationary growth potential in their respective economies. Finally, rapidly aging populations in Japan, Europe, and the United States are putting pressure on plan sponsors - public and private, alike - to boost investment yields in order to fund a growing profusion of unfunded pension and retirement schemes.

A key result of the interplay between the first two of these mega-trends - the globalization of disinflation and IT-enabled productivity enhancement - has been a sharp reduction in nominal interest rates on sovereign fixed income instruments for short- and long-term maturities, alike. Lacking in the yield to fund retirement programs from such riskless assets, investors and their fiduciaries have ventured into increasingly riskier assets to square the circle. That, in conjunction with the ample provision of liquidity from inflation-relaxed central banks, has driven down yield spreads in a variety of risky assets - from emerging-market and highyield corporate debt to mortgage-backed securities and a host of other complex structured products. In an era of spread compression and search for yield, the rising tide of ample liquidity covered up a profusion of jagged and dangerous rocks. As the tide now goes out, the rocks now get uncovered. The subprime crisis is a classic example of what can be unmasked at low tide.

The same set of forces has had an equally profound impact on the investment strategies of individual investors. Lacking in traditional yield from saving deposits and government bonds, families have opted, instead, to seek enhanced investment income from equities and, more recently, from residential property. This has created a natural demand for these asset classes that then took on a life of its own - with price increases begetting more price increases and speculative bubbles arising as a result. As long as inflation-targeting central banks remained fixated on their well-behaved narrow CPIs, there was little to stand in the way of a powerful liquidity cycle that has given rise to a multi-bubble syndrome.

In the end, it is up to the body politic to judge the wisdom of this arrangement - essentially, whether the inherent instability of increasingly asset-dependent and bubble-prone economies is worth the risk. Lacking a clear feedback mechanism to render such a verdict, it falls to the world's central banks - the stewards of economic and financial stability - to act as proxies in resolving this problem. This is where the problem gets particularly thorny. It takes a truly independent central bank to take a principled stand against the systemic risks that may arise from the pro-growth mindset of the body politic and act to "take the punchbowl away just when the party is getting good" - to paraphrase the sage advice of one of America's legendary central bankers, William McChesney Martin. Yet as recently retired Fed Chairman Alan Greenspan concedes, "I regret to say that Federal Reserve independence is not set in stone."

Greenspan's confession underscores the important distinction between two models of the central banker - those who are truly politically independent and those who are more politically compliant. The United States has had both types. I would certainly put Paul Volcker in the former category; amid howls of protest, his determined assault against the ravages of double-digit inflation was conducted at great political risk. Yet in the end, he held to a monetary policy that was fiercely independent of political pressures. By contrast, Arthur Burns, who I worked for in the 1970s, was highly politicized in his decisions to avoid the wrenching monetary tightening that a cure for inflation would eventually require. The market-friendly stance of Alan Greenspan - and the asset-dependent US economy it spawned - was more consistent with the model of the complaint central banker who was very much in sync with the pro-growth mindset of the body politic. Greenspan's memoirs are as much about politics as economics - underscoring his much stronger sense of the interplay between these two forces than a more independent central banker might otherwise perceive.

Yet Greenspan's basic point is well taken: It is not easy for any central banker to do unpopular things - especially if he happens to be a political animal operating in a highly charged political climate. But that's where I would draw the line. With all due respect to Alan Greenspan, the truly independent central banker was never supposed to win political popularity contests. I would be the first to concede, however, that it will take great political courage to forge the new approach toward monetary policy that I am advocating. But it can be done - as exemplified by the legacy of Paul Volcker.

In the end, it will undoubtedly take a crisis to provide central banks with the political cover they believe they need to broaden out their mandate from the narrow dictums of CPI-based price stability. Who knows if such a crisis is now in the offing? But with the credit cycle unwinding at the same time that Washington is turning protectionist and the overly-indebted American consumer is in trouble, the wisdom of condoning asset-dependent, bubble-prone economies may finally be drawn into serious question.

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