Morgan Stanley

Multi-Asset Research
Global

Economics

Global Investment Research

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Global Rebalancing

Please see the important disclosures at the end of this report.

Morgan Stanley

Morgan Stanley Global Economics

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Note: Daily updates of Morgan Stanley's *Global Economic Forum* — a compilation of dispatches filed by the firm's economists around the world —can be found on the World Wide Web of the Internet, at the following address: **http://www.morganstanley.com.**

Overview: The Perils of a Dysfunctional World

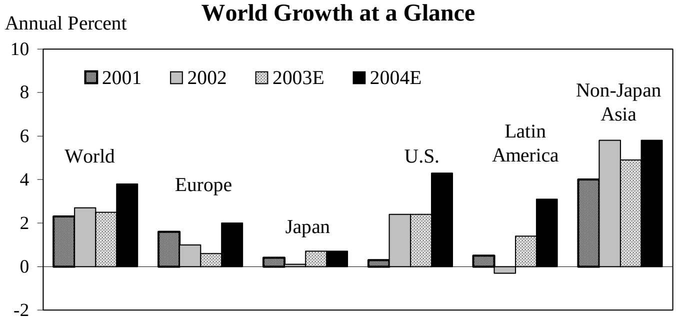
- **The global economy remains in a weakened state.** In late 2002, industrial world growth slowed to roughly a 1% pace and has remained on that sluggish path ever since. Europe continues to weaken and the US shows only tentative signs of recovery, at best. Meanwhile, Asia is still feeling the pressures of SARS-related shortfalls, although China seems to be rebounding smartly. All in all, our current baseline forecast calls for 2.5% growth in world GDP in 2003 — about one percentage point below trend and a pace that leaves the global economy on the brink of recession for the second time in the past three years.

- **Two macro forces are bearing down on the global economy — the imbalances of a US-centric world and the post-bubble shakeout of the US economy.** Since 1995, the United States has accounted for about 60% of the cumulative increase in world GDP — double its share in the global economy. This has resulted in a massive US current-account deficit (5.1% of GDP in 1Q03) that seems likely to widen further as America's budget deficits expand in the years ahead. Meanwhile the United States, the unquestioned engine of the global economy, is now in the midst of a post-bubble shakeout. Real GDP growth has averaged just 1.7% since early 2000, less that half the 4.3% average pace that prevailed during the 17 quarters of the bubble (1Q96 to 1Q00). This sluggishness reflects the lingering post-bubble headwinds of record private sector indebtedness, subpar national saving, and a massive current account deficit.

- **Deflation is the main risk in this dysfunctional global economy.** Three key forces are at work — all of which have contributed to a significant gap between aggregate supply and demand: First, there are cyclical deflationary pressures stemming from the recession of 2001 and the subsequent subpar recovery. Moreover, with a US-centric world having entered this cyclical downturn at an exceedingly low inflation rate — 2.3% in the case of the US — a cyclical whiff of deflation is all the more likely. A second factor is the bubble, itself. It led to excess capacity on the supply side of the equation and has been followed by a post-bubble compression of aggregate demand. Third, globalization has resulted in marked increases in aggregate supply — not just in tradable goods but also in once non-tradable services; this latter phenomenon reflects the globalization of deregulation, the M&A-induced expansion of multinational service providers, and the Internet, which has led to a surge of IT-enabled outsourcing from countries such as India. Traditional reflationary policies may fail to achieve traction in this climate.

- **Global rebalancing is the only way out.** The world needs to begin functioning as a global economy. A significant depreciation of the US dollar is likely to facilitate such a transition. After having risen 47% from its record low in the spring of 1995, the broad dollar index is off about 10% from its early 2002 highs. Based on current account adjustments of the past, the dollar may have completed only 25-33% of its eventual decline. Not only will a weaker dollar help arrest deflationary pressures in the US, but it will force a shift in the mix of US growth away from the excesses of domestic demand toward externally-led growth. The opposite can be expected elsewhere in the world — but only if structural reforms commence in Europe and Japan. An anti-reform backlash is possible, driven by political and social concerns and fuelled by competitive currency devaluations. That would short-circuit global rebalancing and lead to a far more treacherous end-game for the global economy and world financial markets.

World Growth at a Glance



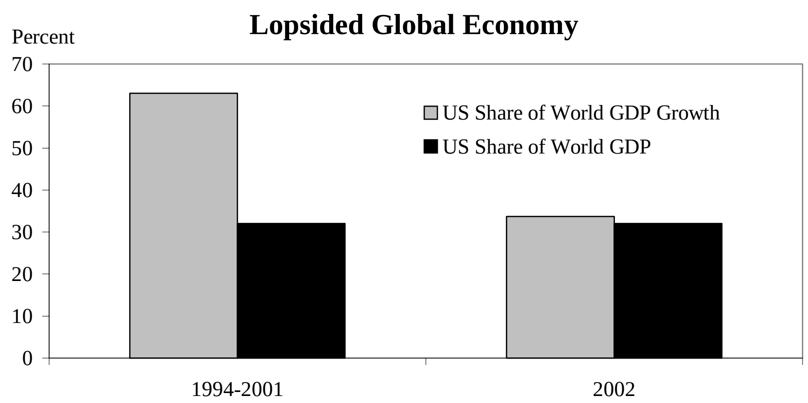
E = Morgan Stanley Research Estimate

Source: Morgan Stanley Research

Please see the important disclosures at the end of this report.

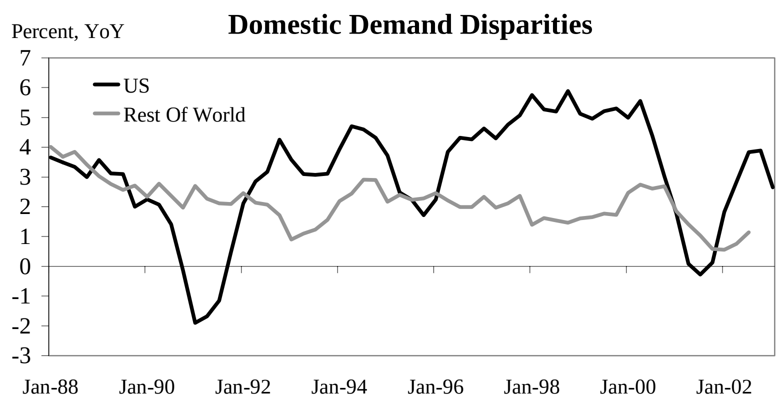
A US-Centric World

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



Source: IMF

Since the mid-1990s, domestic demand in America has been growing at twice the clip evident elsewhere in the world.



Source: Bureau of Economic Analysis, IMF, Morgan Stanley Research

The days of balanced global growth are long gone.

Mix of Global Growth

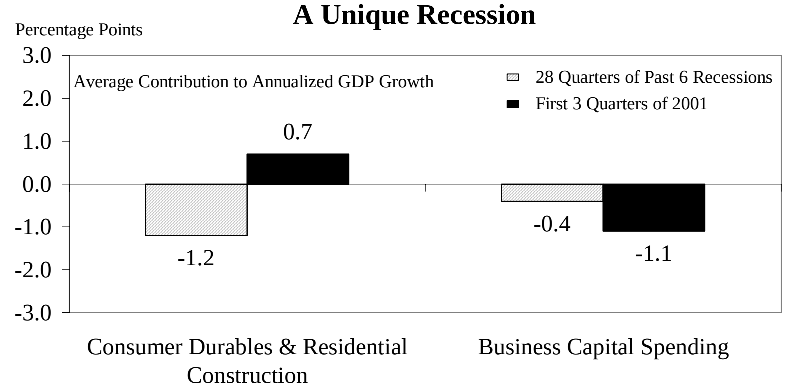
	Average		
GDP Growth	**1985-90**	**1996-2000**	**2001-02**
US	3.4%	4.0%	1.4%
Japan	4.8	1.5	0.3
Europe	3.0	2.6	1.3
Non-Japan Asia	8.1	6.1	4.9
Latin America	2.9	3.1	0.1

Source: Morgan Stanley Research

Post-Bubble US Economy

The most recent recession broke the mold of the typical business cycle.

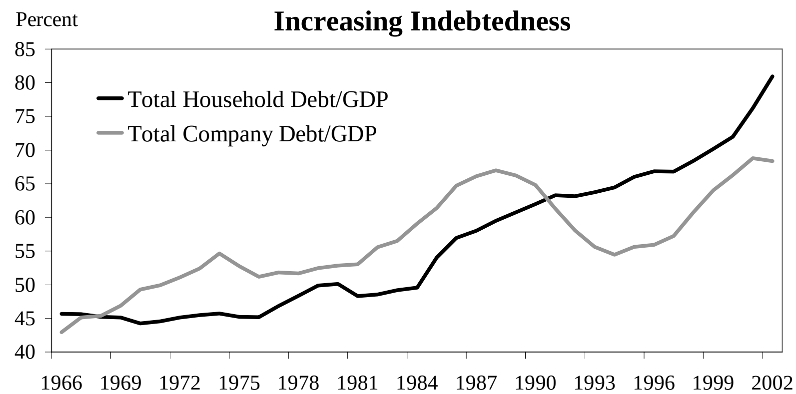
A Unique Recession



Source: Bureau of Economic Analysis, Morgan Stanley Research

America's debt overhang is a key post-bubble headwind.

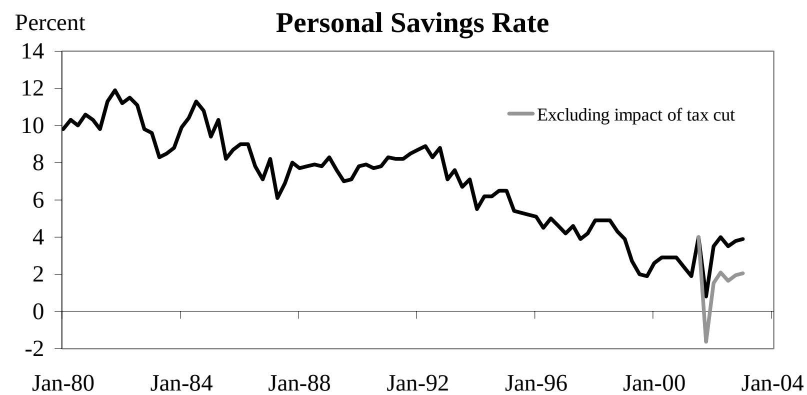
Increasing Indebtedness



Source: Bureau of Economic Analysis, Federal Reserve Board

A shortfall in personal saving is another headwind that could restrain consumer demand.

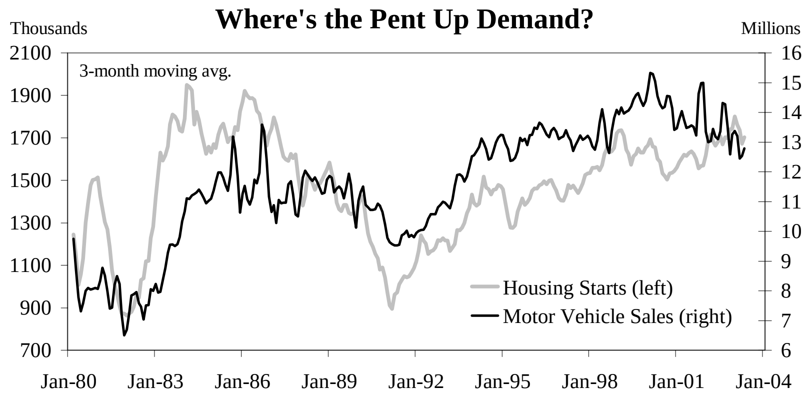
Personal Savings Rate



Source: Bureau of Economic Analysis, Morgan Stanley Research

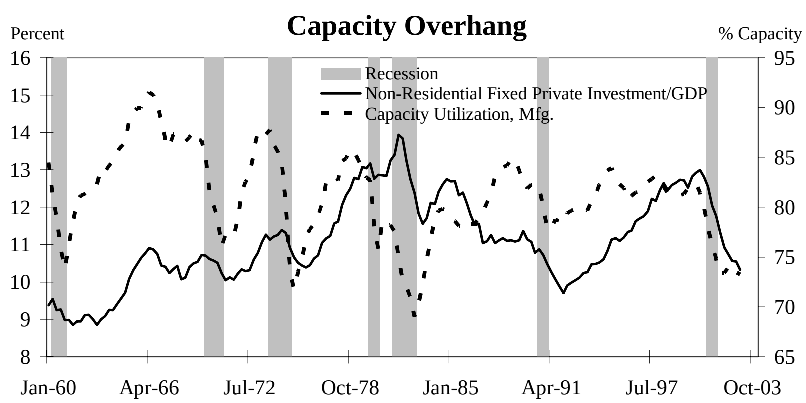
Policy Traction?

There is no pent-up demand evident in two of the US economy's most policy-sensitive sectors ...



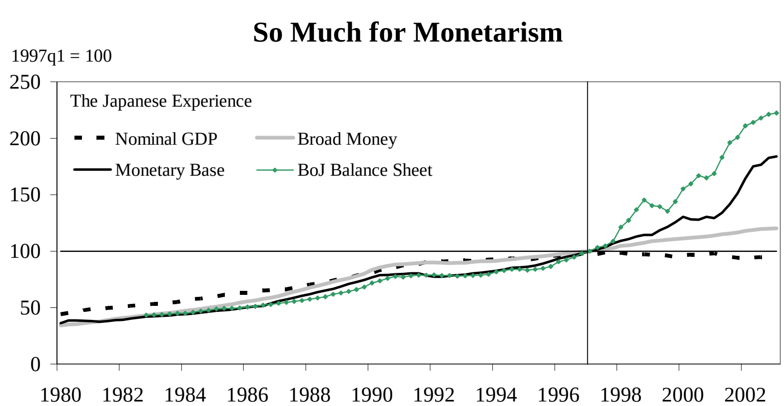
Source: Bureau of Economic Analysis, Census Bureau

...Nor is "capex" likely to spring to life.



Source: Bureau of Economic Analysis, NBER

A key lesson from the Japanese experience is that monetarism may not work in a post-bubble climate.

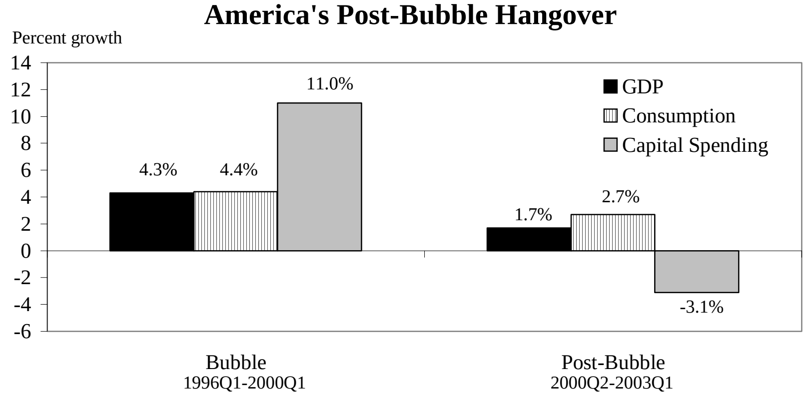


Source: Bank of Japan, Cabinet Office

Subpar US Prognosis

A post-bubble shakeout in the US economy is well under way and could continue for some time.

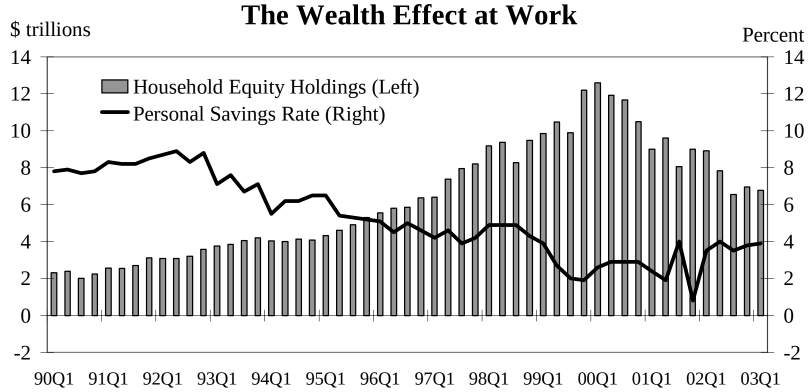
America's Post-Bubble Hangover



Source: Bureau of Economic Analysis

Saving-short US consumers may face the toughest adjustments to post-bubble realities.

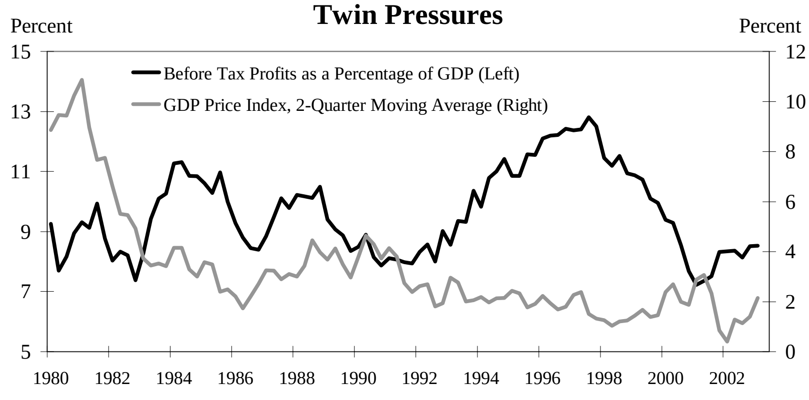
The Wealth Effect at Work



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

The recent earnings bounce has been small when compared with the record profits carnage over the 1999 to 2001 period.

Twin Pressures



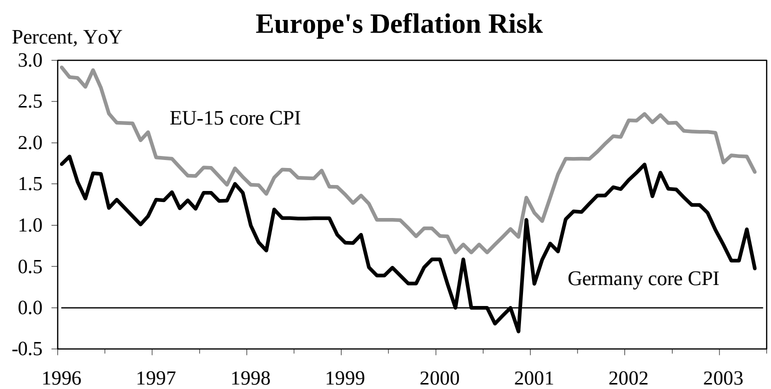
Source: Bureau of Economic Analysis

Euro-Shock

Lacking in domestic demand, a stronger euro raises big risks to the European growth outlook.

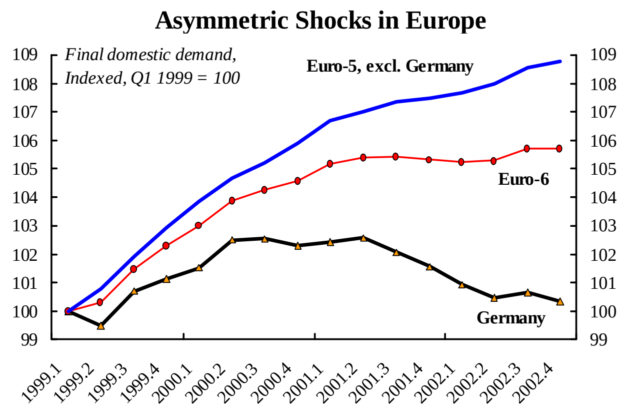
Source: Federal Reserve Bank of New York

Europe has been hit by an asymmetrical shock from its largest member, Germany.



Source: Eurostat

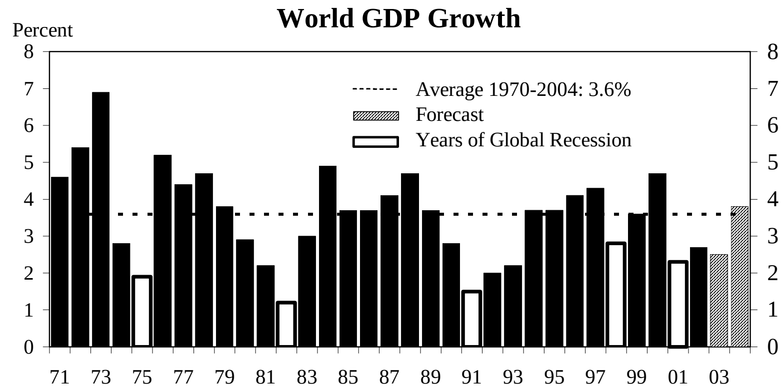
Germany is closest to the brink of outright deflation.



Source: Eurostat, Morgan Stanley Research

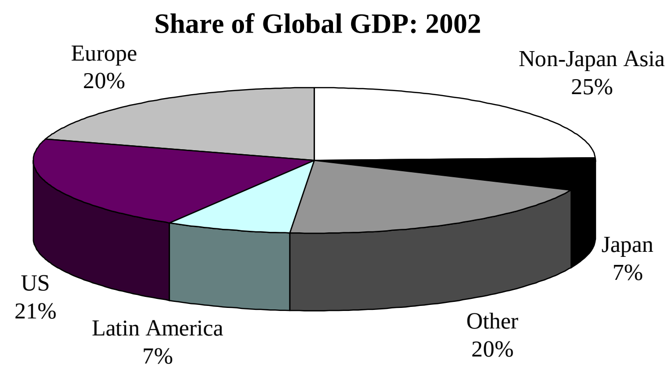
Subpar Global Prognosis

Our 2.5% estimate of global GDP growth in 2003 sees the world on the brink of its second recession in three years.



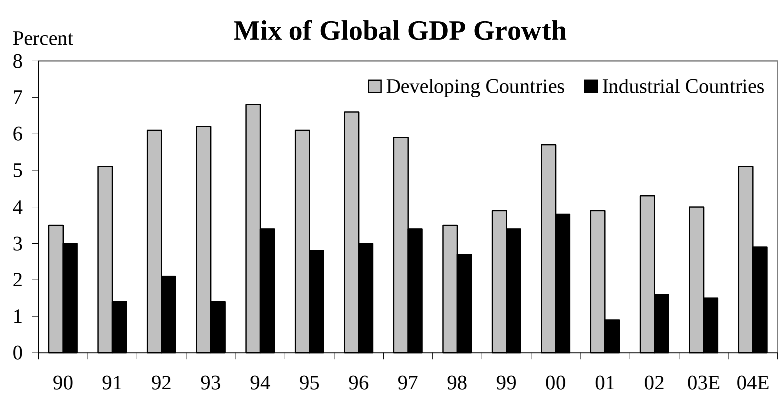
Source: IMF, Morgan Stanley Research

The mix of world GDP keeps growth risks skewed to the downside.



Source: IMF

Unlike the crisis-induced downturn of 1998 that originated in the developing world, the current global downshift reflects a synchronous slowing in the industrial world.

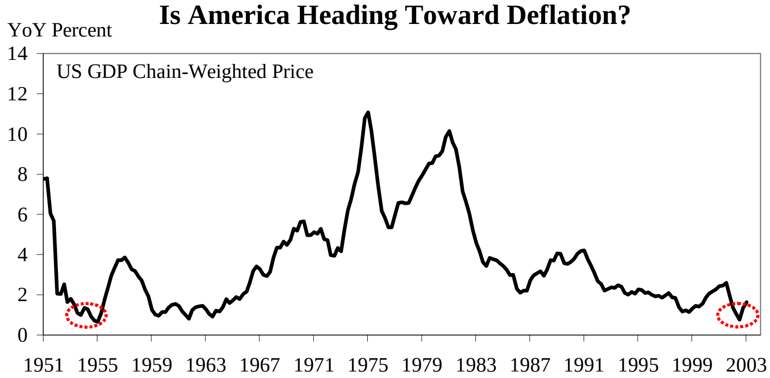


Source: IMF, Morgan Stanley Research

Risk of Deflation

US inflation is currently running near a 50-year low, and there could be more to come on the downside.

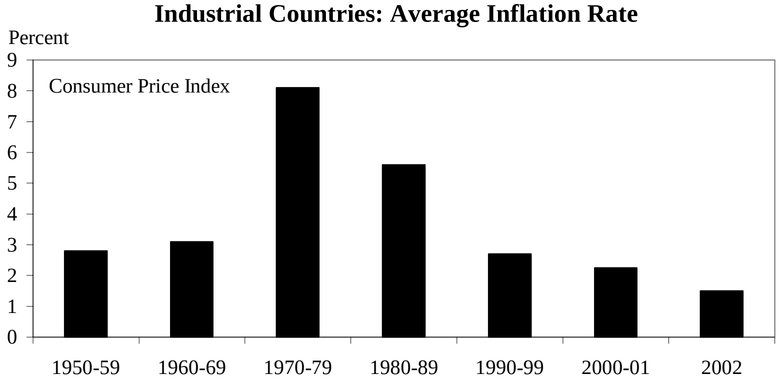
Is America Heading Toward Deflation?



Source: Bureau of Economic Analysis

Deflationary risks are increasingly evident throughout the industrial world.

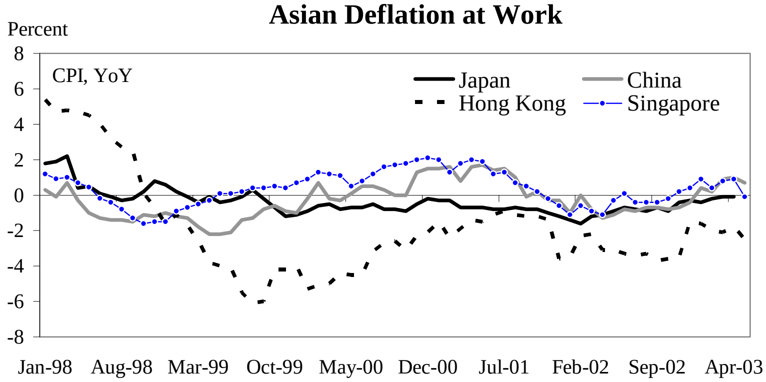
Industrial Countries: Average Inflation Rate



Source: IMF

Falling prices in Asia, whose economies collectively account for about 30% of world GDP, are a key driver of global deflationary trends.

Asian Deflation at Work

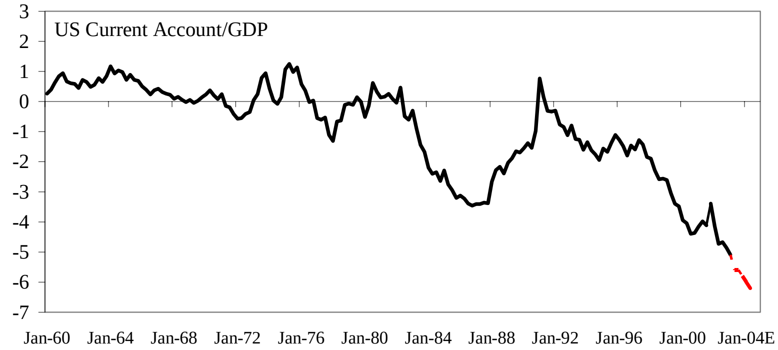


Source: Bloomberg

Global Imbalances

A saving-short US economy has little choice other than to import saving from abroad — and run ever-wider current-account deficits to attract the foreign capital.

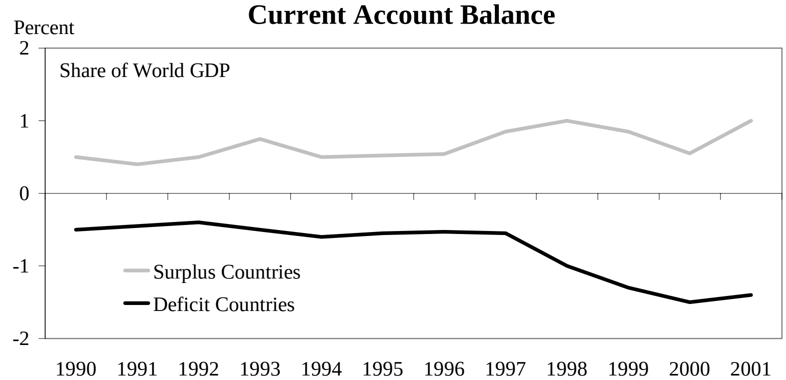
A Balance of Payments Crisis?



Source: Bureau of Economic Analysis, Morgan Stanley Research

Huge current-account disparities between deficit and surplus countries underscore the tension in currency markets.

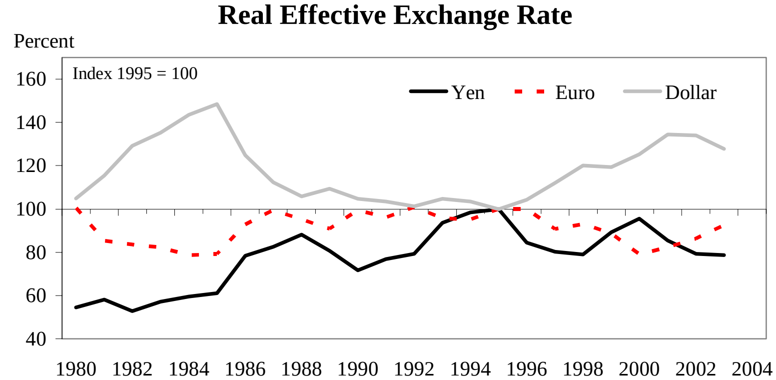
Current Account Balance



Source: IMF

The dollar has corrected only a small portion of its over-valuation.

Real Effective Exchange Rate

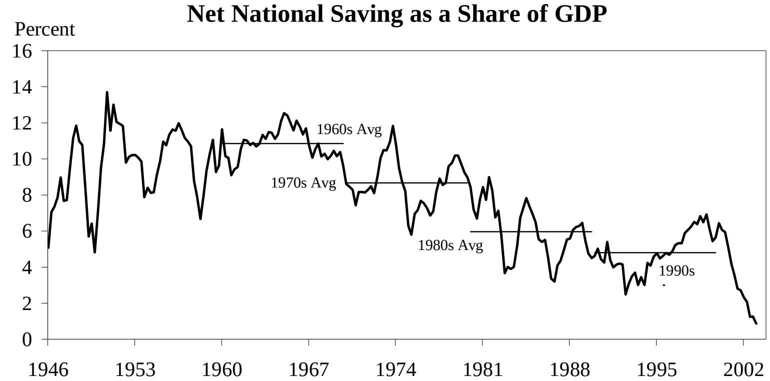


Source: IMF

US Saving Shortfall

America's net national saving rate fell to an all-time low of 0.9% in the first quarter of 2003.

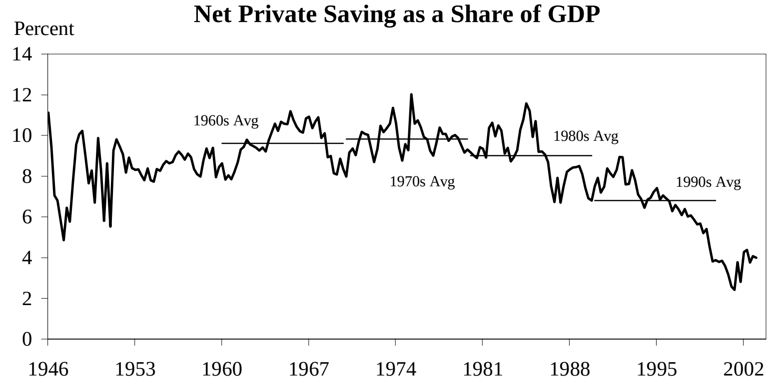
Net National Saving as a Share of GDP



Source: Bureau of Economic Analysis

This reflects a bubble-induced plunge in private saving…

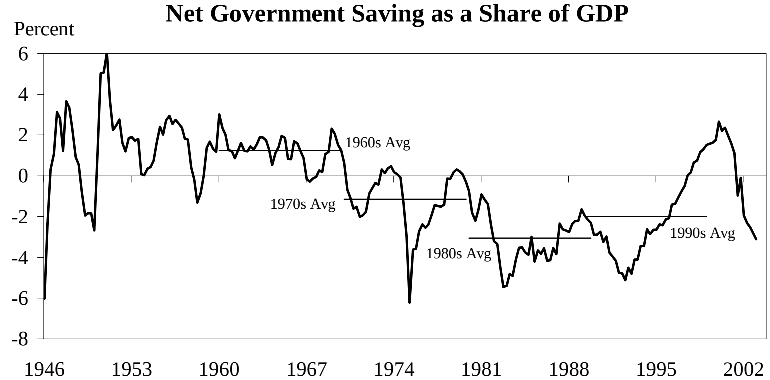
Net Private Saving as a Share of GDP



Source: Bureau of Economic Analysis

…And a sharp swing from government surplus to deficit that is about to take a serious turn for the worse.

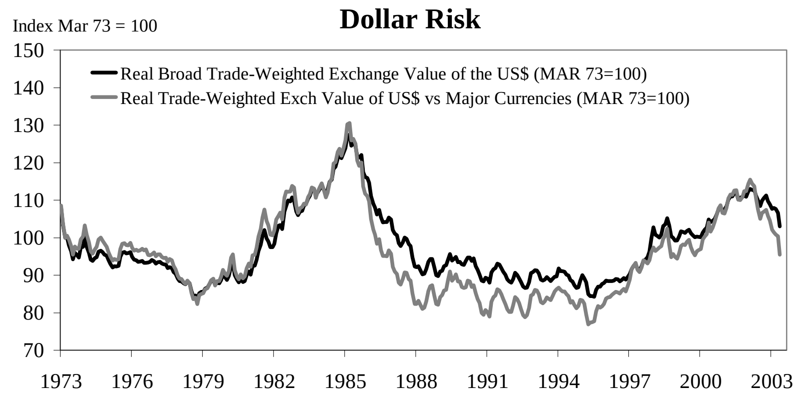
Net Government Saving as a Share of GDP



Source: Bureau of Economic Analysis

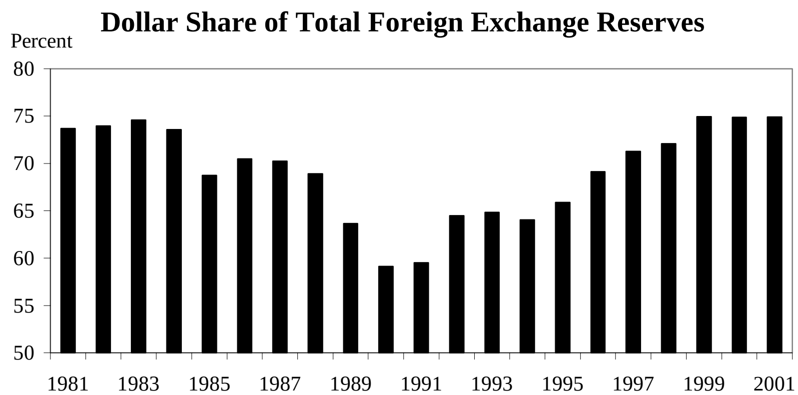
Rebalancing and the Dollar

A further weakening of the dollar may ultimately be an unavoidable by-product of America's external imbalance.



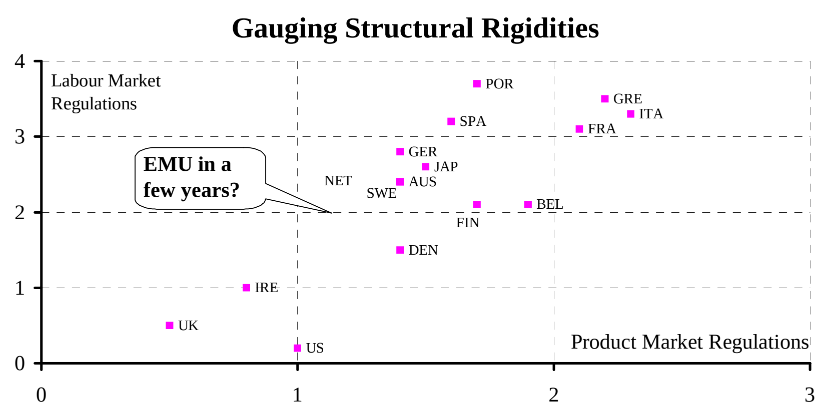
Source: Federal Reserve Board

The composition of currency reserves remains heavily skewed toward dollar-denominated assets.



Source: Bank for International Settlements, IMF

The heavy lifting of structural reform cannot be minimized — especially for Europe and Japan.

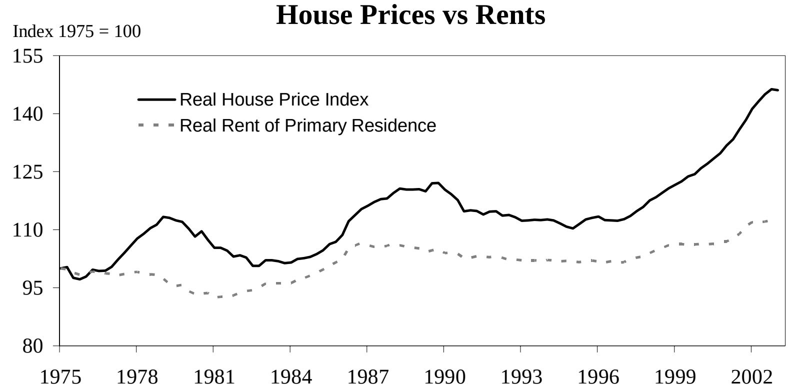


Source: OECD, Morgan Stanley Research

US Housing Bubble Alert

US housing prices have surged, while rental rates have moved up far more modestly.

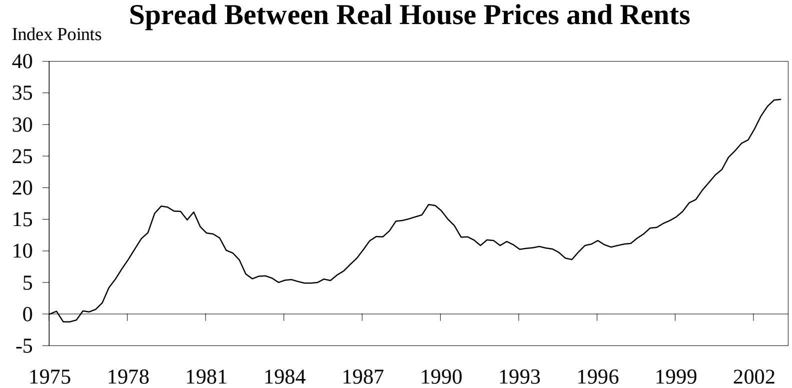
House Prices vs Rents



Source: Office of Federal Housing Enterprise Oversight, Bureau of Labor Statistics

The gap between housing prices and rental rates is now at its widest on record.

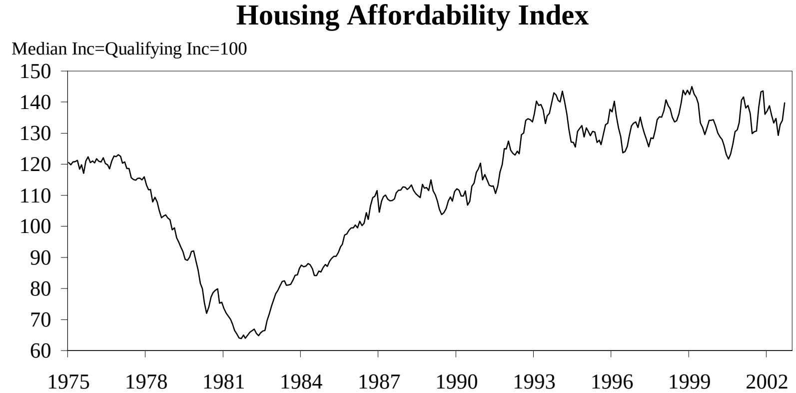
Spread Between Real House Prices and Rents



Source: Office of Federal Housing Enterprise Oversight, Bureau of Labor Statistics

Affordable housing has fueled the demand for shelter and the associated surge in home prices.

Housing Affordability Index

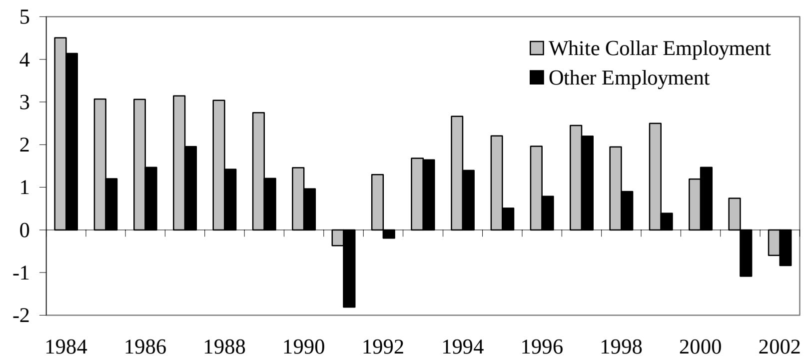


Source: National Association of Realtors

Please see the important disclosures at the end of this report.

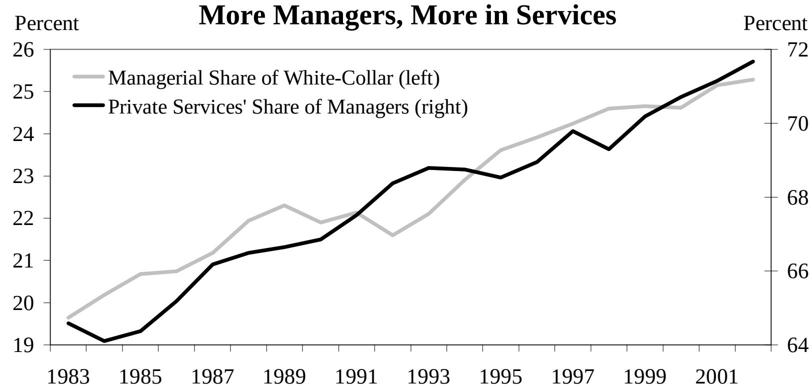
Pruning White-Collar Bloat

Over the past 20 years, white-collar employment growth has averaged 2.0%, double the 0.9% growth in other employment.



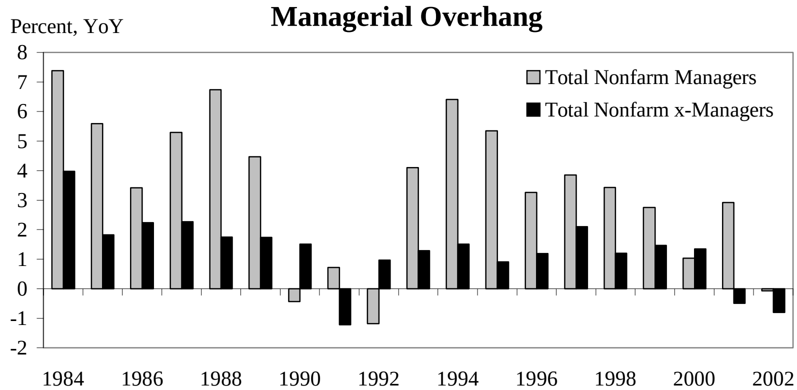
Source: Bureau of Labor Statistics, Morgan Stanley Research

White-collar hiring has been increasingly skewed toward services and has become increasingly top-heavy with managers.



Source: Bureau of Labor Statistics, Morgan Stanley Research

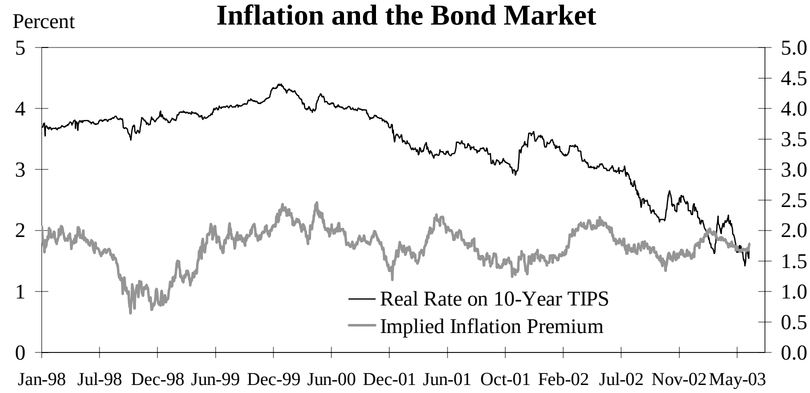
Businesses are only now beginning to rationalize the chronic condition of managerial bloat that materialized in the 1990s.



Source: Bureau of Labor Statistics, Morgan Stanley Research

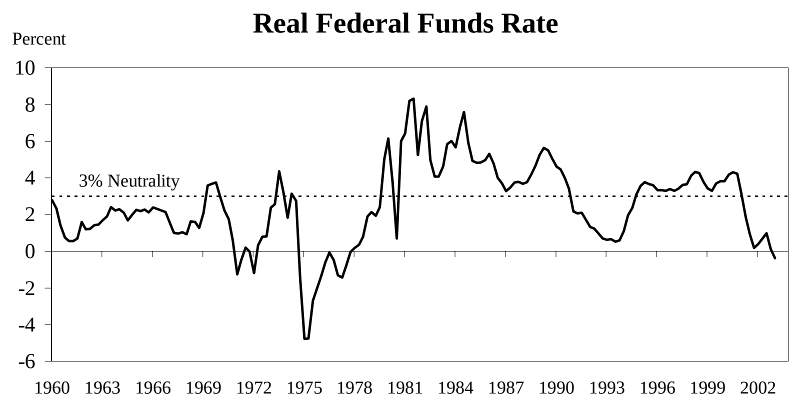
Bond Market Risk

The recent rally in the bond market appears traceable mainly to a decline in real interest rates; a full-blown deflation scare is not in the price.



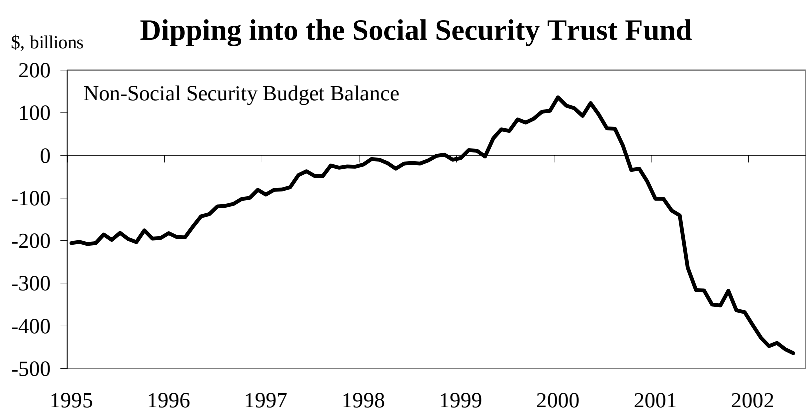
Source: Bloomberg

In a deflation-prone post-bubble world, the Fed could remain accommodating for longer than most think.



Source: Bureau of Economic Analysis, Federal Reserve

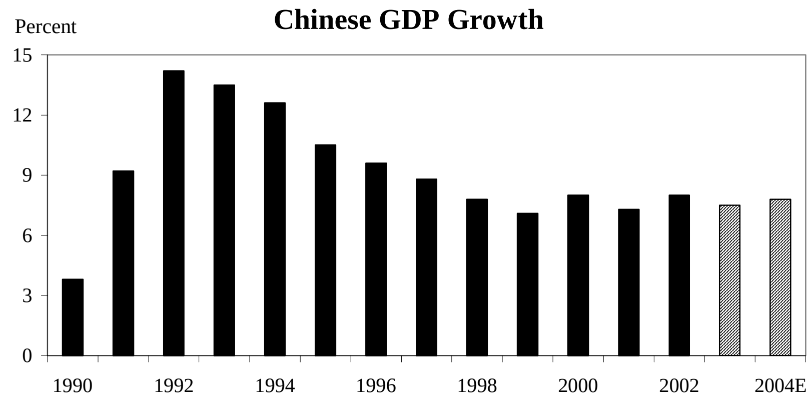
Courtesy of the Bush administration's tax cuts and a weak economy, the non-Social Security budget surplus has morphed into a massive deficit.



Source: Department of Treasury

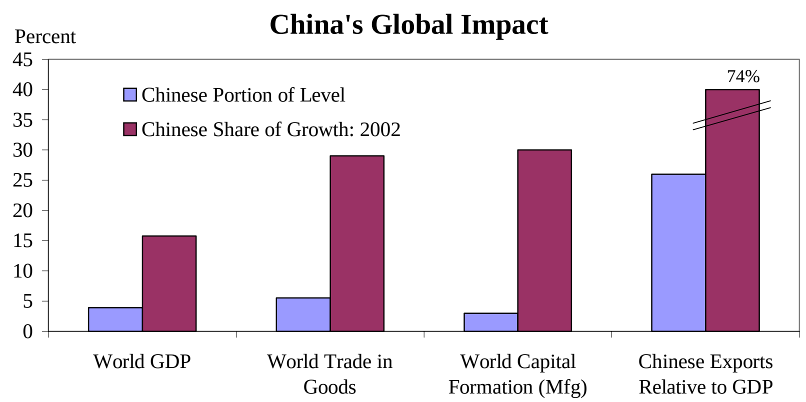
The China Factor

China remains the fastest-growing economy in the world.



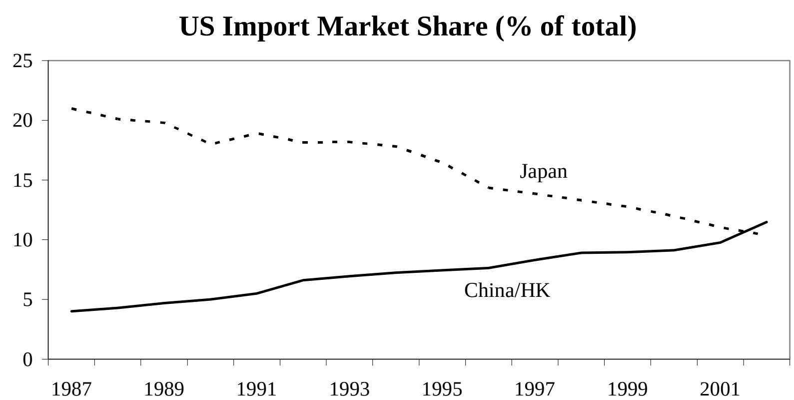
Source: IMF, Morgan Stanley Research

While China is still a small economy, its growth is having a major impact on the rest of the world.



Source: IMF, World Trade Organization, Morgan Stanley Research

China now exports more to the US than Japan.

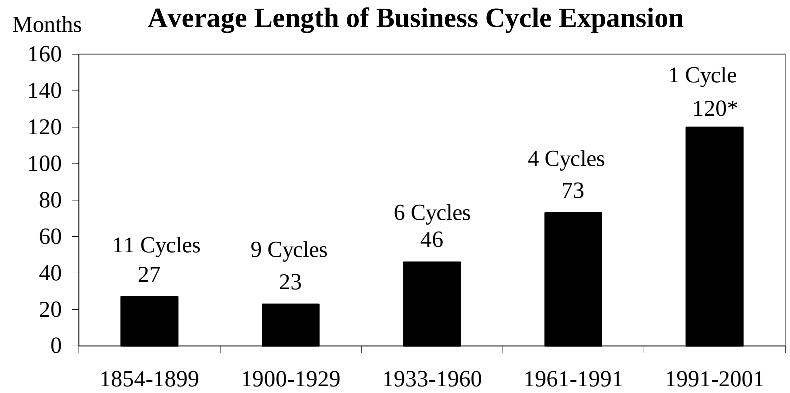


Source: Morgan Stanley Research

Please see the important disclosures at the end of this report.

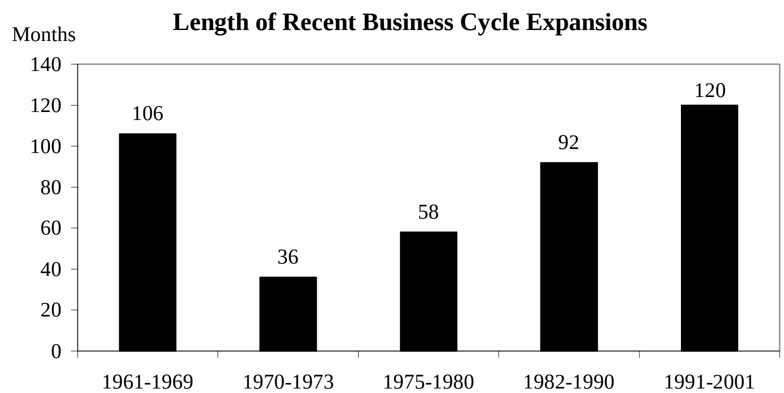
An Old Cycle?

There has been a dramatic lengthening of the business cycle over the past 140 years.



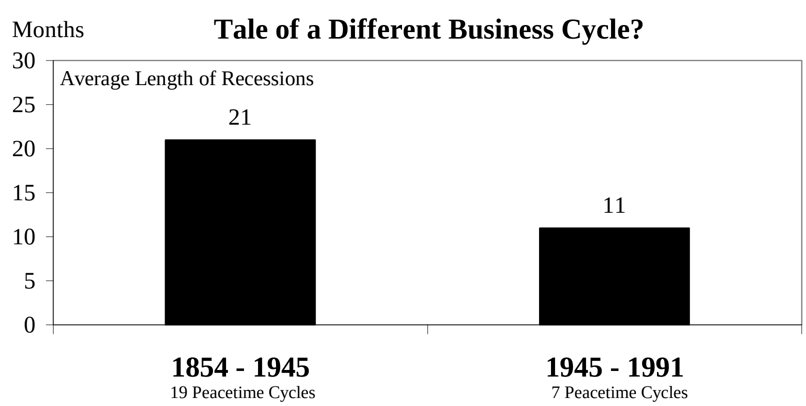
Source: Morgan Stanley Research

The just-ended economic expansion outlasted the long-cycle outcomes of the 1960s and 1980s.



Source: Morgan Stanley Research

The current bubble-distorted business cycle may bear a closer resemblance to those of a more distant past than to the modern-day cycles of the post-World War II era.



Source: Morgan Stanley Research

* *Latest cyclical peak has been designated as March 2001 by the National Bureau of Economic Research. A cyclical trough has yet to be identified.*

Global Economic Outlook: GDP and Inflation

	GNP/GDP Growth (%)					CPI Inflation (%)				
	2000	2001	2002	2003E	2004E	2000	2001	2002	2003E	2004E
Global Economy	**4.7**	**2.3**	**2.7**	**2.5**	**3.8**	**2.5**	**2.4**	**2.4**	**2.4**	**2.0**
Industrial World	**3.8**	**0.9**	**1.6**	**1.5**	**2.9**	**2.3**	**2.2**	**1.5**	**1.8**	**1.4**
US	**3.8**	**0.3**	**2.4**	**2.4**	**4.3**	**3.4**	**2.8**	**1.6**	**2.2**	**1.8**
Australia	2.8	2.7	3.6	2.5	3.0	3.0	3.0	3.0	2.9	2.3
Canada	5.3	1.9	3.3	2.3	3.8	2.7	2.5	2.2	3.2	2.2
New Zealand	3.5	2.1	4.0	2.5	2.5	2.6	2.7	2.6	2.1	2.3
Europe	**3.4**	**1.6**	**1.0**	**0.6**	**2.0**	**2.2**	**2.3**	**2.1**	**2.0**	**1.6**
EMU	**3.5**	**1.5**	**0.8**	**0.4**	**1.9**	**2.1**	**2.3**	**2.2**	**1.9**	**1.4**
Austria	3.0	1.0	0.9	0.4	1.6	2.3	2.7	1.8	1.4	1.2
Belgium	3.7	0.8	0.7	0.7	1.9	2.6	2.5	1.6	1.2	1.3
Denmark	2.8	1.4	1.6	0.8	2.0	3.0	2.2	2.3	1.6	2.2
Finland	5.5	0.6	1.6	1.1	2.9	3.0	2.7	2.0	1.2	1.1
France	4.2	2.1	1.2	0.8	2.2	1.7	1.6	1.9	1.8	1.4
Germany	2.9	0.6	0.2	0.0	1.7	1.5	2.0	1.4	0.9	0.7
Greece	4.1	4.1	3.6	3.8	4.0	3.2	3.4	3.6	3.4	2.8
Ireland	10.0	5.7	6.0	3.0	4.0	5.2	4.0	4.7	4.1	3.2
Italy	3.3	1.7	0.4	0.4	1.6	2.5	2.8	2.5	2.5	2.2
Netherlands	3.3	1.3	0.2	-0.5	1.4	2.4	4.2	3.4	2.3	1.8
Norway	1.9	1.4	1.4	0.0	1.6	3.1	3.0	1.3	2.8	1.3
Portugal	3.7	1.6	0.5	0.0	1.7	2.9	4.4	3.6	3.5	2.8
Spain	4.3	2.7	2.0	1.7	2.7	3.5	3.6	3.5	2.9	2.4
Sweden	3.6	1.5	1.9	1.4	2.2	1.4	2.8	2.6	2.1	1.2
Switzerland	3.1	0.9	0.1	0.7	2.1	1.6	1.0	0.6	0.7	0.8
UK	3.1	2.1	1.8	1.7	2.4	2.9	1.8	1.6	2.9	2.6
Emerging Europe	**6.3**	**1.6**	**3.6**	**3.6**	**4.3**	**20.9**	**20.1**	**16.0**	**11.6**	**8.9**
Czech Republic	3.3	3.5	2.0	2.2	2.8	3.9	4.7	1.8	0.8	3.0
Hungary	5.2	3.7	3.3	2.7	3.3	9.8	9.2	5.3	4.3	4.1
Israel	6.5	-1.0	-1.4	2.3	4.1	1.1	1.1	5.7	3.3	1.8
Poland	4.0	1.0	1.3	2.5	4.0	10.1	5.5	2.0	1.2	2.2
Russia	9.0	5.0	4.1	4.5	4.6	21.0	21.6	15.1	13.6	10.5
Turkey	7.3	-7.5	6.5	4.2	5.8	56.4	53.5	47.2	26.9	19.2
South Africa	3.4	2.2	3.0	2.1	3.0	5.3	5.7	10.1	7.2	4.5
Japan	**2.8**	**0.4**	**0.1**	**0.7**	**0.7**	**–0.3**	**–0.9**	**–0.8**	**–0.5**	**-0.7**
Asia Ex-Japan	**7.3**	**4.0**	**5.8**	**4.9**	**5.8**	**1.5**	**2.2**	**1.3**	**1.7**	**1.9**
China	8.0	7.3	8.0	7.5	7.8	0.4	0.7	-0.8	0.1	0.1
Hong Kong	10.2	0.5	2.3	1.8	3.5	–3.7	-1.6	-3.0	-2.2	-0.5
India	5.1	4.1	4.7	4.9	5.6	4.2	3.8	4.3	4.3	4.4
Indonesia	4.9	3.4	3.7	3.0	3.8	3.8	11.5	11.9	9.0	8.0
Korea	9.3	3.0	6.3	3.0	4.9	2.3	4.1	2.8	2.5	3.1
Malaysia	8.5	0.3	4.1	3.0	4.7	1.6	1.4	1.8	2.0	2.2
Philippines	4.4	4.5	4.4	3.1	3.9	4.3	6.1	3.1	3.5	3.8
Singapore	9.4	-2.4	2.2	1.0	4.3	1.3	1.0	-0.4	0.9	1.2
Taiwan	5.9	-2.2	3.5	2.0	3.4	1.3	0.0	-0.2	0.0	0.8
Thailand	4.6	1.9	5.2	3.5	4.3	1.6	1.7	0.6	1.7	1.5
Latin America	**4.1**	**0.5**	**-0.3**	**1.5**	**3.1**	**6.5**	**5.4**	**12.9**	**9.5**	**6.9**
Argentina	-0.8	-4.4	-10.9	5.8	4.3	–0.7	-1.5	41.0	7.0	7.9
Brazil	4.4	1.4	1.5	2.0	3.0	6.0	7.7	12.5	12.0	8.0
Chile	4.2	3.1	2.1	3.6	4.5	4.5	2.6	2.8	2.9	3.5
Colombia	2.9	1.4	1.5	2.1	2.7	8.7	7.6	7.0	6.5	6.0
Mexico	6.6	-0.3	0.9	1.9	2.6	9.0	4.4	5.7	3.8	4.0
Peru	3.1	0.6	5.2	3.3	3.2	3.7	-0.1	1.5	2.2	2.5
Venezuela	3.2	2.8	-8.9	-15.0	3.0	13.4	12.3	31.2	40.0	20.0

E = Morgan Stanley Research Estimates

Global Investment Research – July 2003

Global Economic Outlook: Interest Rates, Bond Yields, and Currencies

	3-Month Euro Rates (%)				10-Year Bond Yields (%)					Exchange Rates			
	June 27	Sep03	Dec03	Mar04	June 27	Sep03	Dec03	Mar04		June 27	Sep03	Dec03	Mar04
G-3 Countries													
US	0.85	1.40	1.60	1.75	3.5	4.0	4.25	4.40					
Euro	2.1	1.7	1.6	1.7	3.8	3.5	3.7	3.9		1.18	1.21	1.17	1.14
Japan	0.08	0.06	0.06	0.03	0.7	0.7	0.6	0.4		120	116	113	110
Dollar Bloc													
Canada	3.2	3.3	3.3	3.4	4.5	5.2	5.3	5.5		1.35	1.29	1.32	1.32
Non-EMU Europe													
Denmark	2.2	2.2	2.0	2.0	4.0	3.8	4.0	4.2		7.42	7.46	7.46	7.46
Switzerland	0.3	0.2	0.2	0.2	2.5	2.4	2.4	2.4		1.55	1.53	1.50	1.50
Sweden	3.0	2.6	2.5	2.7	4.3	4.0	4.1	4.3		9.08	8.70	8.80	8.80
UK	3.6	3.5	3.7	4.0	4.2	4.0	4.2	4.7		0.70	0.74	0.70	0.68
									$/GBP	1.67	1.64	1.67	1.68

Note: Data are end-of-period values. European exchange rates are against the Euro except where noted. *E = Morgan Stanley Research Estimates*
More detailed exchange rate forecasts are available in Morgan Stanley's FX Pulse *weekly.*

Global Stock Ratings Distribution

(as of May 31, 2003)

	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight	549	30%	223	37%	41%
Equal-weight	858	47%	276	46%	32%
Underweight	416	23%	107	18%	26%
Total	1,823		606		

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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Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, or the relevant country MSCI index, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, or the relevant country MSCI index, on a risk-adjusted basis over the next 12-18 months.

Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, or the relevant country MSCI index, on a risk-adjusted basis over the next 12-18 months.

More volatile (V). We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Ratings prior to March 18, 2002: SB=Strong Buy; OP=Outperform; N=Neutral; UP=Underperform. For definitions, please go to www.morganstanley.com/companycharts.

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Attractive (A). The analyst expects the performance of his or her industry coverage universe to be attractive vs. the relevant broad market benchmark over the next 12-18 months.

In-Line (I). The analyst expects the performance of his or her industry coverage universe to be in line with the relevant broad market benchmark over the next 12-18 months.

Cautious (C). The analyst views the performance of his or her industry coverage universe with caution vs. the relevant broad market benchmark over the next 12-18 months.

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