I. Introduction: time to rebalance?

In the wake of the economic slowdown that began in early 2001, there was an extended period of both disappointment and puzzlement that the unprecedented degree of monetary and fiscal stimulus applied was not having more evident success in rekindling global growth. Of particular concern to central bankers was the fact that some of the main channels of monetary stimulus appeared to be blocked by heightened risk aversion on the part of both markets and financial institutions. Subsequently, these dark clouds lifted as financial markets again found grounds for optimism, while continuing to be buoyed by extremely accommodative macroeconomic policies. Indeed, at 0%, 1% and 2% in Japan, the United States and the euro area respectively, policy rates in the major industrial economies were at or near postwar lows. Moreover, these forces for global expansion were augmented by another unprecedented development. In large part to prevent the appreciation of their currencies against the US dollar, several governments intervened massively in foreign exchange markets during the period under review. In addition, there was a general easing of financial conditions in many emerging markets.

Looking back over the last year or so, as this Introduction will chiefly do, it seems clear that these policies played a key role in stimulating a strong recovery in global output. In virtually every region other than the euro area, growth has markedly exceeded the consensus forecasts of a year ago. Moreover, more robust growth has not to date led to any significant pickup in core consumer inflation. Looking forward, as the Conclusion of this Annual Report will do, the consensus forecast is for a continuation of this happy combination of circumstances, underpinned in particular by relatively strong growth in productivity in some industrial countries. What then is there to worry about, besides the usual problems of measurement error, and the fact that forecasts are as often wrong as they are right?

One potential worry would be an unexpected acceleration in inflation, perhaps already being presaged by the recent sharp increase in commodity prices and associated inflation in China. Another could be the re-emergence of asset price bubbles and unprofitable investments, as often seen in past periods of excessive credit growth. Indeed, the widening of spreads for sovereign and high-yield corporate issues which began in April 2004 could even be an early sign of embedded excesses unwinding. However one chooses to assess the likelihood of financial tensions in the near term, it is clear that the current level of policy stimulus is not sustainable over time. The crucial challenge facing policymakers, as the cycle turns up, will be how best to tighten without destabilising a global economy already exhibiting various economic and financial imbalances.

Longer-term questions must also be raised about the profound implications of three interacting structural changes in global policy regimes. First, deregulation

and globalisation in the markets for goods and services have made the world more productive and arguably less inflationary. Second, financial liberalisation may have increased the potential for booms and busts in credit and asset prices. The third change is the growing focus of policymakers on inflation control, and their growing credibility. Against the backdrop of the first two changes, this last one might imply significantly less policy tightening in response to unusually rapid growth or to suspected excesses in the financial system. In contrast, again assuming inflation is under control, policymakers might feel they could afford to respond much more aggressively than in the past to either an economic slowdown or financial difficulties associated with earlier excesses.

Such an asymmetric application of monetary policies, and fiscal policies for that matter, has contributed to the welcome reduction in cyclical volatility observed in recent years. However, this approach could also have downside risks if treated as a repeated game. Indeed, with government debt levels still very high by recent standards, and nominal interest rates close to zero, policymakers' room for manoeuvre in response to further unwelcome shocks has already become quite limited.

For the moment, we are fortunate that a global economic recovery is under way, and that shocks remain possibilities rather than realities. Nevertheless, once the robustness of the expansion has been confirmed, the need to re-establish policy flexibility will call for an unusual degree of fiscal and monetary rebalancing going forward. In addition, the analytical assumptions that have underpinned policy formulation to date would merit rigorous re-examination. With the structure of the economic and financial world having changed so quickly and dramatically, and perhaps with further change still to come, it could well be dangerous for policymakers to simply assume that their old answers will remain the right answers.

Faster growth at last

The global slowdown earlier this decade was met with unusually strong fiscal and monetary stimulus in the major industrial countries, especially in the United States. This degree of stimulus was made possible by the prevailing low level of inflation, which generally continued during the period under review.

In the United States, fiscal policy was remarkably expansionary as a result of both expenditure increases and tax cuts. Monetary policy became and remained highly accommodative. Not only was the federal funds target rate held at 1%, but extensive efforts were also made to convince the bond markets in particular that this stance was likely to be maintained for a considerable period. A somewhat different, but still expansionary, set of policies was seen in Japan, where a very large government deficit and high debt levels constrained any further recourse to fiscal stimulus. Against this background, the monetary policy of "quantitative easing" was intensified, as were attempts to convince the public that all arms of government were now working together to bring Japanese deflation to an end. In the euro area, fiscal deficits in three countries (including the two largest economies) rose above ceilings stipulated

in the Stability and Growth Pact. While this drew harsh criticism from countries which had respected the rules, the effects on spending were supportive, as was the continued accommodative stance of the European Central Bank (ECB).

Consistent with the relative easing of US monetary policy, and the accumulating weight of US external deficits and debt, the US dollar trended downwards last year. This effective exportation of US disinflationary pressures was strongly resisted by some, in particular by countries which had adopted a fixed exchange rate regime against the dollar. The Japanese authorities also undertook an unprecedented amount of foreign exchange market intervention to prevent too rapid an appreciation of the yen against the US dollar and the Chinese renminbi. Other governments, especially elsewhere in Asia, intervened heavily as well. In response to the upward pressure on their currencies against the dollar, many emerging market countries also eased monetary policy. Finally, some countries in Latin America, as well as in central and eastern Europe, put on hold plans for fiscal restraint and structural reform that had previously seemed necessary in the light of downward pressures on their currencies. Whatever the longer-term implications, this too was conducive to expansion.

Virtually all financial markets responded vigorously to this general easing of monetary policy, although the lags involved varied substantially. Long bond yields in the United States, having trended down over a number of years, essentially plateaued at unusually low levels during the period under review. This overall stability, however, concealed alternating periods when the markets reacted to forces calling for higher rates and then for lower ones. Among the former were expectations for growth and prospective government deficits that were being revised upwards. Factors tending to restrain rates were massive purchases of US Treasuries by Asian central banks and the guidance provided by the Federal Reserve as to its prospective policy actions. Yields in the euro area moved closely with US rates over much of the period under review, but decoupled somewhat at the end as US rates rose sharply. This was not inconsistent with the region’s more muted growth prospects.

In most other financial markets, there was much less equivocation. Asset prices increased strongly for most of the period and this further contributed to confidence and encouraged economic expansion. Equity markets worldwide were particularly strong, with technology and emerging market stocks leading the way. Spreads on high-risk corporate bonds declined sharply, as did those on credit default swaps. The spreads on sovereigns also narrowed, and capital again became more readily available to emerging market economies, including a significant number with questionable credit records. And perhaps most important, the price of residential properties continued to rise in many countries, as did related levels of indebtedness. Only in the last few months of the period under review did these trends begin to reverse in some markets and become significantly less pronounced in others.

In part, these increases in asset prices could be associated with low bond yields. Lower nominal mortgage rates changed the payment profile of borrowers and eased cash constraints up front. It is thus neither surprising nor unsettling that this was eventually reflected in both higher house prices and higher debt levels. However, a more disturbing effect of the lower bond yields

is that they may have induced a growing appetite for risk. In the case of insurance companies, with contractual obligations to pay high rates of return on their liabilities, such behaviour became almost a matter of survival. Pension funds with target rates of return exceeding government bond yields might have been similarly tempted. Moreover, as memories of past financial losses began to fade, it was natural for confidence to recover. And finally, as prices began to rise, extrapolative expectations appeared to set in, as had often occurred in the past.

But if these interest rate related explanations for asset price increases have some weight, so too does the argument that, in many markets, the underlying fundamentals were improving at the same time. For example, in the industrial countries, the rate at which corporations have been defaulting has been declining, as have the losses suffered when defaults did occur. In a number of emerging market countries, particularly in Asia, government policies now seem more appropriate and conducive to growth than a decade ago. As for house prices, in many countries they have been boosted by a varying mixture of zoning regulations, immigration and the focus of purchasers on specific geographical areas. Such forces are not likely to recede soon, though other forces could still overwhelm them.

What can be said with more certainty is that the combination of easy macroeconomic policies and more buoyant financial markets contributed to a pickup in the pace of global economic growth. Among the industrial countries, the United States was the star performer, closely followed by Australia and the United Kingdom. The expected rotation of spending into investment began to materialise under the influence of sharply rising profits, but consumption also held up. Households either withdrew and spent equity arising from higher house prices or refinanced their mortgages so as to lower monthly interest payments. Very robust growth was also the norm in a number of other industrial countries, including some of the smaller euro area economies. Japan, too, showed signs of impending recovery as exports soared, to China in particular. Still more encouraging, investment spending by large Japanese corporations also turned up, after a decade of restraint during which positive cash flows were used primarily to reduce debts built up in the boom of the 1980s.

Signs of recovery were distinctly fainter in a number of the larger continental European economies. In spite of the effective appreciation of the euro, these countries still benefited from the stimulus provided by rising exports, and business confidence seemed buoyed in turn. The real problem was that consumers remained reluctant to spend, even though household balance sheets looked quite healthy by international standards. The uncertainties generated by proposals to urgently confront structural deficiencies in labour markets, pensions, health care and tax administration may well have played a role here. So too might public perceptions of higher inflation after the introduction of the euro. The fact that housing wealth cannot be liquefied as easily in these countries as in, say, the United States and United Kingdom also implies that consumption is more constrained by cash flow. It was thus more vulnerable to the setbacks in labour markets discussed below.

Most emerging market economies also showed improved growth in the period under review. Positive international influences, in particular higher commodity prices and more welcoming financial markets, often interacted with stronger domestic demand to push up growth. China's performance was impressive, producing knock-on effects throughout the Asian region and even beyond. With massive capital inflows and very rapid rates of growth of domestic credit, business investment rose to over 40% of GDP. Elsewhere in emerging Asia, investment levels remained well below earlier peaks, perhaps reflecting continuing excess capacity in some countries and the pressures of international competition. However, a number of countries saw an acceleration of consumption, often under the influence of government policies to stimulate domestic demand. India's performance also stood out. While good weather supported greater agricultural production, slow but steady structural reforms seemed increasingly to be improving productive potential and India's international competitiveness.

Growth in other emerging market regions was mostly less strong than in Asia, even if sometimes underpinned by idiosyncratic forces. The recovery in the Middle East, Africa and Russia was obviously encouraged by higher prices for oil and other commodities, while growth in Latin America owed a lot to the rebound from the earlier crises in Argentina and Venezuela. That said, the nascent but still uncertain recovery in Mexico had deeper roots as the pickup in the United States had a material, though lagged, impact on growth. The favourable global interest rate environment also helped Brazil until very recently, although evidence of a broad recovery remains mixed.

In central and eastern Europe, possibly due in part to the slower pace of euro area recovery, growth was maintained but did not increase. The new EU members in particular continued to be influenced by optimism surrounding their accession and associated capital inflows on the one hand, and the need to address long-standing and difficult structural problems on the other.

Other developments – some expected and some not

As the global recovery gained strength, other economic trends became more clearly defined. While most were more welcome than not, some were also more surprising than not. Whether any of these unexpected outcomes increase the vulnerability of the global economy going forward, and, if so, what policymakers might do about it, will be dealt with in the Conclusion.

One widely expected consequence of faster growth was a sharp rebound in global trade, in particular intra-Asian trade. China is now a heavy importer of primary and intermediate products required for the assembly and subsequent export of finished goods, and is rapidly becoming the world's manufacturing centre. In this context of expanding trade, it is a landmark change in attitude that the emergence of China now seems to be viewed in Japan and India more as an opportunity and less as a threat.

Another development accompanying the recovery was a further worsening in the external trade position of the United States. While this is consistent with the relatively faster growth of the US economy, it confounded the views of

those who had been expecting US growth to falter under the weight of perceived internal and external imbalances. Moreover, while the effective depreciation of the dollar helped contain the deterioration of the trade balance, the size of the effective exchange rate movement itself was limited by the exchange market intervention carried out by many foreign governments for a variety of reasons. In fact, to the extent that the subsequent investment of foreign reserves in US securities helped to lower US bond yields, it could be contended that both the "elasticity" and "absorption" channels of the prospective trade adjustment were attenuated. It remains an open question how long this uninterrupted joint flow of goods and capital into the United States from Asia, vendor financing in all but name, can be sustained.

In spite of the strength of the global recovery, upward pressures on CPI inflation only became clearly perceptible towards the end of the period under review. Even in the rapidly growing United States, and in the presence of a lower dollar, inflation continued for the most part at a very low level under the influence of remaining, though fast declining, output gaps. In the euro area, albeit aided by currency appreciation, inflation slid below the 2% level in the early months of 2004 before rebounding under the influence of higher oil prices. And in Japan, deflationary pressures seemed to ease, even after adjustment for measurement bias and the effects of sharp increases in various regulated prices.

Among the larger economies, China provided the clearest evidence of an increase in inflation. Given a deflationary starting point, some upward movement in prices was initially not unwelcome, and was actually encouraged by government efforts to expand credit creation and raise investment. In recent quarters, however, the Chinese authorities have become much more concerned about overheating, and have taken a combination of market-based and administrative steps to slow down both lending and spending. In several other economies in the industrial world, policy rates have risen in the face of rapid demand growth and signs of financial excess, in spite of current CPI inflation seeming to be under control.

This relative quiescence of global CPI inflation to date has in fact been accompanied by a number of divergent price trends. The prices of finished goods have generally been easing for some time now, under the influence of productivity gains in global manufacturing as well as exports from newly emerging economies. In contrast, the prices of services have generally risen faster. This general trend was complemented in the period under review by a new and still more dramatic development. There was a very sharp increase in the price of oil and other raw materials, reflecting not only the global expansion, but also the growing weight of commodity-intensive investment in China. Fortunately, it has, to date at least, been relatively easy to absorb such increases into profit margins, particularly in countries where cost cutting in response to earlier economic and financial difficulties has advanced most.

Consistent with the desire to keep costs under control in a fiercely competitive international environment, the recent upturn in growth in many industrial countries has been met by both muted wage growth and an unusual reluctance to hire. In the United States, corporations seem to have used the

new technology embedded in recent investments to markedly increase labour productivity. Moreover, the sharply decreasing cost of capital, allied with a rise in medical costs and other employee benefits, has further tipped the scales in favour of capital deepening rather than job creation. In Europe and Japan, similar forces have also been at work recently, abetted by more traditional structural impediments to hiring the young and the old in particular. In general, those hurt the most by the weak demand for labour in the industrial countries have been the less well educated, who cannot be easily retrained when technological advances make their jobs redundant. Furthermore, through the labour content embodied in traded goods and services, they increasingly find themselves in a losing battle with lower-paid workers in emerging market economies. To date, however, soft labour market conditions have not caused a general retrenchment in consumer spending outside continental Europe. This has been both surprising and welcome, even though accompanied by a continuing build-up of household debt levels in several countries.

Another side effect of higher growth and more optimistic financial markets has been their contribution to improving the health of financial institutions. Particularly helpful has been the increased ability to dispose of non-performing loans in continental Europe and Japan. In the industrial countries, concerns about banks, insurance companies, reinsurance companies and pension funds have been significantly mitigated by a combination of unusually steep yield curves, rising asset prices, lower costs and increased revenues. In contrast, as growth gathered pace in China in response to officially encouraged increases in credit creation, fears began to mount that many of these loans might go bad, further weakening lending institutions that already had sizeable problems. Loans made to local authorities and state-owned enterprises, where profits were not the primary consideration, seemed most at risk.

Many financial institutions with a focus on consumer products, especially mortgages, fared particularly well in the period under review. This fostered a general reorientation of the activities of financial institutions in many industrial countries. Even in Japan, there was evidence that banks were starting to take more interest in lending to consumers and smaller enterprises where interest margins were greater. The trend towards lending to households was also observed in a number of emerging market economies, notably in Asia and in central and eastern Europe. While this has been especially welcome in the context of continued high levels of domestic savings, as in many Asian countries, the experience of Korea over the last year or two also shows that it is possible for this process to get out of hand. After an earlier consumer boom, fuelled by very rapid credit extension by both banks and credit card companies, consumer spending weakened last year as personal bankruptcies soared. The Korean government has tried to improve workout procedures for individual creditors as well as debtors, but the restraining effects on domestic demand growth may persist for some time.

In addition to the generally supportive impact of faster growth on their health, financial institutions benefited for the most part from general improvements in risk management. The cultural shift in the financial industry, associated to a considerable extent with the process of finalising the new

capital adequacy framework (“Basel II”), continued to gain in intensity. Nevertheless, some developments over the past year revealed disturbing laxities in internal governance, of both corporations and financial institutions, as well as in oversight and market discipline. The Parmalat affair, for example, indicated shortcomings at every possible level: senior management, internal audit, external audit, bank lenders, bond underwriters, rating agencies, investment bank analysts, and the overseers of many of the above. And yet the costliest corporate failure in history had no effect whatsoever on the market pricing of loans to corporates. Whether this was the appropriate reaction to the sui generis nature of a massive fraud, or the unfortunate by-product of the recent heightened appetite for risk in financial markets, remains a question. The answer, however, may become increasingly evident as markets prepare themselves for an eventual raising of policy rates.