VIII. Conclusion: change, uncertainty and policymaking

No one would deny the sense of relief generated by recent releases of better numbers for economic growth, particularly but not exclusively pertaining to the United States. It may be recalled that, less than a year ago, some economies seemed to be flirting with deflation and policymakers were actively considering their options should a deflationary situation arise. What a difference a year makes. Now the consensus expectation is for steady and essentially non-inflationary growth, albeit subject to increasing geopolitical uncertainties. In turn, the focus of policymakers has begun to shift towards how they might most effectively exit from the highly stimulative policies of the immediate past.

Gauging the effects of such a change in policy will not be easy. Over the last few years the economic landscape has altered in important ways and, indeed, is still in a state of flux. Technological developments have improved the prospects for faster growth and lower inflation, trends already evident in the United States. The opening-up to trade of such giants as China and India offers similar opportunities for gain, both for their own populations and more broadly. At the same time, these developments imply major structural adaptations, including in the labour forces of industrial countries. Accurately estimating the level of potential growth, or the level of full employment, has become more difficult, as has the conduct of national policies based on such domestic constructs.

The financial side of the global economy has also been transformed in recent years. Technological advances and deregulation have helped make markets more efficient and more resilient. These new attributes, together with better risk management and supervision, go some way towards explaining the continued robust behaviour of the economy in the face of recent shocks. At the same time, however, financial liberalisation may also have contributed to the occasional tendency for financial markets to overreach and to aggravate the cyclical propensities of the real economy. Not least, since these new markets increasingly allow wealth to be liquefied, perceptions of wealth have gained in importance as drivers of spending. Such perceptions are inherently hard to measure, can be subject to error relative to underlying fundamentals, and can rapidly disappoint. All of this makes it more difficult to get an accurate fix on the transmission mechanism of monetary policy.

Finally, the policy regime itself has changed over recent decades, with policymakers focusing more successfully on maintaining inflation at a low and stable level. This has clearly contributed to stabilising inflation and inflation expectations, both desirable outturns. In such an environment, it is possible not only to allocate resources more efficiently but also to push with less fear against the limits of production possibilities. However, there is also a growing recognition that this welcome stability could have an unwelcome side effect.

With inflation not thought to be a threat, and interest rates not seen as likely to be raised in consequence, any tendencies towards imprudent lending behaviour by the financial system might well be encouraged. On the one hand, this might give rise to a delayed upturn in inflation when underlying pressures eventually come to the surface, perhaps even suddenly if inflation expectations ratcheted upwards. On the other hand, it might result in an unanticipated move in the direction of disinflation, should debt burdens become too onerous or should significant stress emerge in the financial system. Demand shocks to the economy could tilt the balance either way, while negative supply shocks could potentially lead to both outcomes in succession.

Currently, the policy problem seems more likely to be of the inflationary kind. How best can policy be tightened, and communicated, so as to avoid undesirable effects on stretched financial markets? However, looking back over the last decade or so, and particularly the last few years, it seems clear that a more common problem has been how best to ease in response to financial strains. In answer, given that inflation was generally well under control, both monetary and fiscal policies tended to be eased by more than they had been tightened in the preceding upturn. It is the simple arithmetic of this asymmetry that may account for current record low policy rates in the major industrial countries, as well as government debt burdens that in a number of countries are unsustainably high.

Fortunately, the global economy now appears to be on an upward path, and there is less call for macroeconomic stimulus. We should use this opportunity to reflect on the processes that allowed our armoury of macroeconomic instruments to become so depleted. An obvious point, but not without objections, is that this situation should be addressed directly through more aggressive tightening in good times. In addition, policies to strengthen the financial system, and to encourage more prudent lending behaviour in upturns, might help to mitigate the damage in downturns and reduce the need to resort to aggressive policy easing in the future. Finally, recognising the increasing interdependencies in the modern, liberalised world between financial behaviour and macroeconomic outturns, it is crucial that the supervisory and monetary authorities work together ever more closely.

Will the expansion prove sustainable?

While most observers believe that the recovery has now gained a firm hold virtually across the globe, the question of sustainability continues to receive an unusual amount of scrutiny. One reason for this is that the overall good performance seems supported disproportionately by two particular pillars of strength: domestic demand in the larger English-speaking economies and in China. In both cases, a number of economic variables have shown sustained deviations from accepted historical norms ("imbalances"). Since economic processes tend to be mean reverting in the long run, large imbalances must warrant attention from prudent policymakers, particularly if a plausible story can be told about negative feedback effects on the real economy. Although it is no easy task to determine the length of the long run, with imbalances tending historically to be sustained far longer than expected, history also teaches us that reversions rarely occur painlessly.

To suggest that the influence of the United States and China in the current recovery is disproportionate is also to say that Japan and the larger economies of continental Europe are still not pulling their weight. While there are some indications of a turnaround, in both cases domestic demand remains weak and the recovery overly dependent on future export growth.

Among those experiencing weaker growth, prospects in Japan look relatively more positive. Investment is finally picking up at the larger firms, in response to increased cash flow and much healthier balance sheets. Moreover, consumers have reduced their saving rates in order to carry on spending, and this will be further encouraged if job growth strengthens. Yet sentiment among smaller Japanese firms has only just begun to brighten, and it is not certain whether the financial system has improved enough to provide the support that might be needed to underpin sustainable growth going forward. In any event, many old economy firms are still overindebted, and the emergence of new economy firms continues to be impeded by regulation.

In continental Europe, profits have not yet rebounded sufficiently to encourage investment, particularly since corporate balance sheets remain burdened with comparatively high debt levels. Consumer spending has also been generally restrained to date, especially in Germany, and is likely to expand vigorously only if some degree of optimism can be restored. The hope must be that ongoing structural reforms in Europe, which currently seem to be sapping optimism, will eventually be recognised as welfare-enhancing and influence the mood of consumers correspondingly. This possibility would be all the greater were reforms seen to be more decisive, comprehensive and coherent than is suggested by the current piecemeal approach. If inflation again drops below 2%, this will be helpful not only to consumers but also to the European Central Bank.

In the United States, a different and more welcome pattern of consumer behaviour has been observed, but also one with implications for the future. Unusual joint developments in labour and debt markets merit special attention. Though it has shown distinctly more positive signs recently, overall the demand for labour in the United States since the trough of the recession has been very weak, even compared to the "jobless recovery" of the early 1990s. While the share of labour in factor incomes has fallen sharply, the share of consumption in US spending has continued to grow, extending the trend begun in the 1990s. To a significant degree, recent spending has been financed by tax cuts, but US consumers have also relied heavily on debt accumulation to smooth spending. Household debt has risen faster than income for some time and currently stands at a record high as a proportion of household income. In particular, US households have found it cheaper and more attractive to refinance their houses as mortgage rates have trended downwards and house prices upwards. This has allowed them either to lower monthly interest payments, raising cash flow, or to withdraw housing equity to support spending. This phenomenon has also been seen in the United Kingdom, Australia, New Zealand, Spain and some smaller European economies.

Are such trends a cause for concern? One view would be that greater financial efficiency and lower interest rates have allowed a once and for all upward shift in sustainable debt levels in many countries, including the United States. Accordingly, higher debt levels do not constitute an imbalance needing to be reversed. Coincident with a temporary slowing in the rate of growth of wage income in the United States, largely reflecting cost cutting made possible by productivity growth, more debt has allowed consumption to be maintained in a welfare-enhancing way. Looking forward, the shift of factor incomes towards profits has already led to higher investment spending and, over time, this should support both output growth and jobs. Indeed, in the long run, productivity gains must have such beneficial effects. And in such an environment, debt accumulation will moderate and the burden of debt service should fall too.

Yet not all observers share this view, particularly those focused on shorter-run transitional problems. Given the size and scope of recent structural changes, some feel the demand for labour could continue to lag, not just in the United States but in the other industrial countries as well. For example, increases in US productivity growth could begin to be reflected elsewhere, implying transitional problems that other countries might find it even harder to cope with. The upward shift in the cost of labour (including medical and other benefits) relative to the declining cost of capital goods also seems set to continue. And competition from cheaper labour in the newly opened emerging market economies is steadily intensifying. Should consumer confidence falter as a result, or alternatively should the limits of household debt sustainability be reached, the willingness of still heavily indebted corporations to invest the increased profits arising from faster productivity growth might well be tested.

Whether household and corporate debt levels will eventually act as a drag on spending depends partly on the level of interest rates and the impact of debt service. Clearly, higher rates in response to continued economic recovery will be much more manageable than in the absence of such a recovery. However, the level of asset prices is another important factor, since it influences both the willingness to spend and the ability to raise money against collateral. During the period under review, equity prices and house prices rose sharply in a wide range of countries, perhaps due in part to unusually liquid global financial conditions. Whatever the cause, a number of asset prices are now at levels which look rich compared to traditional benchmarks. Were these asset prices to fall back, it would be too much to hope that spending would remain unaffected. Indeed, even if prices only stabilised, the contribution made to growth by wealth accumulation would come to a halt. The recent slowdown in consumer spending in the Netherlands is a clear example of this effect.

One could go further still and ask whether the level of spending associated with equity withdrawal from housing might eventually have to be reversed, at least partially. Increases in the value of equity reflecting expectations of higher rates of return on capital are truly "wealth", which can be spent up front if desired. Provided the expectations are correct, no payback is needed. In the case of house price rises, however, the greater value of the asset is offset by the value of the future liabilities – the cost of living in a house. If prices stay elevated, this will reduce the discretionary income and spending of all non-homeowners for the foreseeable future. Conversely, if prices decline, the burden of future adjustment falls back on those who withdrew equity from their homes. They thought they were wealthier and spent the money, but risk finding that the asset gains were illusory while the increased debt was anything but.

A final concern has to do with external imbalances and their implications for growth prospects globally. In particular, consumer spending and the associated current account deficit in the United States have ultimately been financed with money borrowed from foreigners. The bulk of this has, until recently, been willingly supplied by private sector lenders. Although the private inflows into the United States have increasingly taken the form of bond purchases, potentially easily reversible, the rate of interest demanded was, until mid-April 2004, trending down rather than up. The appetite for US dollar assets in particular has been supported by the fact that debt service requirements have not, to date, risen along with the stock of external debt. Moreover, the expectation of sustained, relatively rapid growth in the United States has provided further support. The real exposure in the current circumstances would be for those growth expectations to be disappointed. This might result in an unwelcome and restraining shortfall of foreign funding. Indeed, the textbook pattern of current account adjustment for debtors, based on long historical experience, involves a lower exchange rate and a reduction of domestic demand, and the opposite for creditors.

Two new realities are also likely to affect the dynamics of the external adjustment process. The first is the very high level of dollar debt now held by foreigners. The prospect of wealth losses due to dollar depreciation could make assets denominated in dollars look less attractive, and could even feed back on global bond yields. At the same time, realised losses on their foreign portfolios could slow domestic spending in creditor countries. Since spending in such countries ought rather to rise, in order to offset the impact of currency appreciation, neither of these effects would be helpful to the adjustment process. Second, there is the growing presence of China and, increasingly, India on the global trading scene. Debtor countries with depreciating exchange rates will be trying to move resources into the production of tradable goods and services in the face of formidable new competition. Should the adjustment process appear to falter, the implication might be the need for still larger changes in both exchange rates and relative spending levels.

Imbalances also characterise the performance of the second pillar of current global growth, domestic demand in China. The numbers describing the performance of the Chinese economy in recent quarters are truly staggering, and still point more to accelerating than to decelerating economic activity. While consumption and exports have provided support, investment spending has been especially strong. Particularly in the manufacturing sector, a massive addition to global productive potential is now being put into place.

Two concerns could be raised, both arising from "overheating". The first is of a more medium-term nature. Much of the investment spending in China has been by local authorities and state-owned enterprises. To the extent that such borrowers are not motivated by prospective rates of return, there is a greater likelihood that these investments will prove unprofitable. The fact that they have been accompanied by very rapid rates of monetary and credit expansion, at state-owned banks with little experience of credit risk evaluation, is also notable. A similar set of phenomena was seen at the beginning of the 1990s, and subsequently led to a sharp deceleration of economic activity. The difference now is that China plays a much larger role in the world economy. Should China's imports decelerate sharply, there might be discernible effects on growth elsewhere in Asia and even beyond. In the Middle East, Africa and Latin America, the support hitherto provided by high prices for oil and other commodities could also be removed, leaving a number of inherently vulnerable emerging market economies more exposed to possible shocks.

The second, more immediate concern is of rising inflation in China. While CPI inflation has in the past not moved closely in tandem with producer prices, the latter are now moving up so strongly that they are having an impact on the former. Shortages have also begun to emerge in various domestic markets, with rationing effectively being imposed in areas where prices are still tightly controlled. Due in part to Chinese demand, commodity prices are rising globally, though currency appreciation is mitigating the effects in some countries. It is not implausible that these pressures will also begin to feed through to other prices in both industrial and emerging market economies, provided of course the global recovery remains robust.

Turning to global capital markets, prospects have become more unsettled but still seem reasonably satisfactory. As noted in the Introduction, economic growth was buoyed not only by low policy rates and liquidity expansion, but also by the rediscovery of the appetite for risk-taking. All the same, markets have been less welcoming in recent months and long bond yields and sovereign spreads have moved up sharply. The effect will be to leave some sovereigns (and other, less creditworthy borrowers) facing higher costs, at best, or financial strains, at worst. Fortunately, the more general pursuit of sensible economic policies in emerging economies has significantly diminished the possibility of widespread problems, even though countries with weak fiscal or current account positions remain vulnerable. Such dangers would seem greatest in some countries in Latin America and, to a lesser extent, central and eastern Europe. As for corporate spreads, only those for high-risk bonds have thus far been affected given an environment where corporate defaults have been falling and are expected to continue to fall.

It is, however, also not impossible that rising risk aversion could get out of hand, perhaps leading to some of the worthy being punished along with the less worthy. Furthermore, currently high levels of leverage, and the rumoured size of the carry trade business, imply that changes in some prices might be both rapid and large if traders were to seek to cover their exposures. Techniques such as convexity hedging in the US mortgage market could strengthen such tendencies. The widening of interest rate swap spreads last summer attests to this possibility.

What provides a good measure of comfort in this context is that financial institutions in the major industrial countries, with Japan still a notable exception, have successfully absorbed quite a few such shocks recently, and might now be even better placed than before to absorb new ones. Bank capital ratios remain high, loan default rates have generally fallen further and profits have also generally improved. Moreover, this has been due in large part to cost cutting, increased fee income and greater attention to the proper pricing of risk. Particularly, but not exclusively, in the United States, banks have managed to redistribute a significant amount of credit risk through a variety of credit risk transfer instruments. While a number of large international banks have sharply stepped up their proprietary trading, it is generally believed that their market risk management systems are adequate to this task. This assumes, of course, that the liquidity required in highly concentrated markets to carry out the requisite transactions would be there even in times of stress.

Most other financial institutions, in particular insurance and reinsurance companies, also seem in better shape than last year. To a considerable extent, this has been due to such cyclical factors as the sharp rebound in asset prices, especially equity prices. The same could be said for defined benefit pension funds, where underfunding problems have been reduced in various ways. Despite the rapid growth of a wide range of hedge funds, strains in this sector, were they to occur, would not be expected to have systemic repercussions. In short, there are no obvious grounds for believing that lending restraint by damaged financial institutions would hold back a resilient global recovery in any significant way.

Policies to promote monetary and financial stability

The current global economic upswing seems to be gaining momentum under the influence of unusually expansionary, in fact unsustainable, macroeconomic policies. While there are many threats to future growth, the central scenario is that of a continuing and even strengthening recovery. Under this assumption, the immediate challenge for monetary and fiscal policy must be to restore more normal policy conditions in a way that avoids catalysing instability. The longer-term challenge must be to establish more robust policy regimes for promoting monetary and financial stability in a global economy whose structure has changed profoundly and is still changing.

The near-term issue in the United States is how quickly to tighten monetary policy, a decision which involves comparing the expected losses from going too fast with those from going too slow. On the one hand, as long as there are concerns about the durability of the expansion, going slow has obvious attractions. If, in addition, it is believed that ongoing productivity gains have created enough slack to keep inflation from rising, even given stronger growth, the same conclusion is suggested. In other words, raising rates too fast is very likely to entail real economic costs. On the other hand, maintaining the current historically low interest rates could inadvertently lead to higher inflation later on. Moreover, it could also contribute to a further build-up of financial imbalances that could weigh down the real economy over time. There is an obvious trade-off here, but no obvious right answer.

The policy dilemma is intensified by the fact that long rates, as well as policy rates, still seem rather low in spite of the recent backup. Long rates have in addition recently been subject to bouts of high volatility. One concern must be that rising rates could overshoot, potentially slowing the US recovery and having unwanted effects in foreign bond markets as well. Arguably, this risk is greater under the "go slow" scenario, which involves an increased likelihood of inflation expectations rising and policy rates having to respond sharply.

The use of a communication strategy to manage market expectations about future policy rate increases could be the key to ensuring that market volatility does not become excessive. However, recent experience has shown that this task is not easy. In a context of high debt levels and rising government deficits, markets could be split between two camps. One camp might suspect a greater tolerance for inflation or, more likely, that inflation could simply rise inadvertently. The other might fear an equally inadvertent process of debt deflation that would eventually move prices in the opposite direction.

Clarity in this environment, above all concerning the objective of policy, has much to recommend it. Tactical considerations pertaining to the Federal Reserve's "exit policy" might help explain the renewed interest in inflation targeting in the United States. Similar suggestions have also been made in Japan, where a massive and potentially inflationary overhang of bank reserves has been created by the central bank in the course of fighting deflation. Choosing an inflation targeting framework would help communicate, to the bond markets in particular, the idea that policymakers do not intend to let inflation get out of hand. Whether equal clarity is desirable with respect to the future setting of policy instruments is more debatable. Were it to encourage leverage and position-taking, and were objective conditions subsequently to change, requiring policy surprises, the collateral damage could be material.

Yet the choice of a medium-term framework, for monetary as for other policies, must be based primarily on more strategic considerations. A debate still continues on the pros and cons of inflation targeting. Its merits include clarity of purpose, enhanced credibility if objectives are met, and greater accountability if they are not. Conversely, it could be argued that inflation targeting provides no added credibility to central banks with a solid track record of fighting inflation, and that it can be too inflexible a framework to deal with a complicated modern world in which financial imbalances may emerge more readily.

In fact, a growing number of central banks seem to feel, given such imbalances, that it may sometimes make sense to alter the stance of monetary policy even when the near-term prospects for CPI inflation appear benign. To ensure that markets would not view deviations from the framework as indicating a return to pure discretion, and eventually a greater tolerance for inflation, one recommendation might be that the central bank set out such contingencies in advance. For those inflation targeting central banks that already have well established credentials, the presence of some kind of side constraint on the conduct of policy would not seem to pose a significant problem. Indeed, the threat that this side constraint might be triggered could have the further beneficial effect of moderating the build-up of financial excesses in the first place.

A second medium-term consideration affects not only monetary policy, but fiscal, regulatory and structural policies as well. It could be argued that policies generally need to be applied more symmetrically over the cycle – as vigorously in upturns as in downturns – if longer-term problems are not to accumulate. Consider first the case of monetary policy, particularly in a context of upturns associated with the build-up of financial imbalances. A generally tighter initial stance might restrain the worst excesses and could then obviate the need for subsequent drastic easing. In addition to lessening the risk of aggravating existing imbalances, such an approach might also lessen the likelihood of hitting the zero lower bound for policy rates. As for fiscal policy, the recent experience of France and Germany clearly shows how their failure to show adequate fiscal restraint in the upturn reduced their room for manoeuvre as the economy slowed. Accounting norms that allow perceptions of future loan losses to be lowered unduly in the good times, only to be raised in the recession as the losses materialise, share the same characteristic. And finally, the failure of countries to implement structural reforms in good times implies either that reforms are never introduced or that they are brought in when times are already uncertain, further undermining short-term confidence.

Another medium-term policy issue has to do with the choice of exchange regime. Given the size of the US current account deficit and the surpluses being recorded in Asia, it has been argued that the maintenance of the fixed exchange rate regime between the Chinese renminbi and the US dollar constitutes an impediment to the global adjustment process. Moreover, it may also be contributing to the excessively rapid credit growth now being seen in China. These effects have been amplified since, as the renminbi has fallen with the dollar, a number of other Asian monetary authorities have also adjusted their policies, for example by intensifying their foreign exchange intervention. The upshot has been that many Asian currencies have depreciated in effective terms. In some cases, concerns about the loss of competitiveness and domestic job opportunities have been augmented by a desire to build up reserve levels for use in potential future crises. This latter rationale has sometimes been described as a "lesson" from the Asian crisis. While valid, it should not obscure another lesson from that period: holding down real exchange rates invites capital inflows that can make crises more likely.

It would be satisfying and simple to conclude on this basis that China, and the other Asian countries in turn, should remove remaining capital controls and float more freely. Unfortunately, this simple answer might well be the wrong one. China is key to exchange rate decisions in the region, and it faces some very particular domestic constraints. Chinese financial markets are still at an early stage of development; the banking system still has huge problems; and the apparatus for effective supervisory oversight is not yet in place. Freeing up the exchange rate without adequate control over capital flows could have highly unpredictable, and probably highly undesirable, consequences. A more reasonable possibility, but not without its own technical difficulties, might be to revalue and peg against a basket of currencies. Yet even this should not be seen as a panacea, either for China's overheating problems or for global trade imbalances.

With respect to overheating, the Chinese authorities must attempt to satisfy numerous conflicting demands with imperfect policy instruments. Presumably, they would prefer to use market-based restraints, like higher interest rates, but such instruments do not yet work effectively. Conversely, many of the old controls, administrative and political, that allowed the influence of the centre to be pervasive have now been partially or fully dismantled. In all likelihood, the authorities will continue to encourage market-based developments, while using whatever powers of command and control they still have to contain spending and credit. The expansionary stance of fiscal policy could also be scaled back. However, this would aggravate unemployment problems, which remain particularly troubling in rural areas. The only thing that is clear is that the Chinese authorities, after years of steady progress towards a market economy, now find themselves in a very challenging position.

As for global trade imbalances, these have been building up for years and presumably have deeper roots than just currency misalignments. The fundamental issue is that Asia currently saves too much, relative to domestic opportunities for profitable investments, and the western hemisphere (especially the United States) saves too little. However, while the diagnosis and policy recommendations might be clear, implementation is another issue, at least for creditors. Lower saving rates in Asia could be encouraged by easier credit policies, designed to spur consumer spending. But the recent experience of Korea and Thailand indicates that this could easily get out of hand. Investment in Asia (outside China) has also been very low since the crisis and could also be stimulated. Again, the dangers inherent in such policies are starkly underlined by what we are currently seeing in China, and by what we observed in Japan in the late 1980s. It should be recalled that the Japanese investment boom was, in part, a by-product of expansionary policies designed to help alleviate the then existing trade imbalances.

If creditors should make a contribution to unwinding global trade imbalances, so too should debtors. In the United States in particular, there is clearly a twin deficit problem. Equally clearly, the fiscal deficit needs to be reduced. But to say that this is part of the US problem is not to imply that it is the heart of the problem. The current account deficit ballooned in the 1990s long before the fiscal accounts suddenly turned sour. Indeed, a closer examination reveals that the underlying cause has been the long downward slide in net saving by US households. This is unfortunate, since theory offers less guidance on how policy might be used to reverse such a trend in an orderly way. Moreover, it implies the potential for an undesirably swift adjustment on the part of US households should their current assumptions about future incomes and wealth prove overly optimistic.

External imbalances might also be reduced by fiscal policy stimulus elsewhere in the industrial world. However, the combination of already high government debt levels and ageing populations imposes significant constraints. Debt is a charge on future taxpayers, who will have to service it. Pensioners constitute a further charge, since governments generally have pay-as-you-go pension schemes and health services. The danger is that the declining group of taxpayers will eventually find the tax burden too heavy, and an effective and perhaps disruptive repudiation of the government's obligations will be the end result. This prospect is most serious in Japan and continental Europe, but could affect the United States and even some emerging market economies over time. Against this backdrop, the emphasis ought to be on getting debt levels under control, rather than increasing them further. Even if the current conjunctural circumstances were thought to militate against near-term tightening, a credible medium-term plan for restoring fiscal health needs to be put in place. One important aspect of this in many countries will be to announce cutbacks to future entitlements so that individual citizens can try to prepare themselves. A useful preliminary step will be to confront the public still more assertively with the arithmetic of the current situation. In principle, no one can argue with arithmetic, but in practice this will be a long, hard sell.

Structural reforms in the industrial economies would also serve to attenuate the burden of debt, whether government or private, by raising the productive potential of the economy and associated levels of income per head. The United States already appears to be on a higher growth path, but some structural reforms would still seem helpful. Policies pertaining to energy, health care and the increasing burden of litigation all deserve attention. In continental Europe, one must round up the usual suspects: labour market reform to raise employment, deregulation of services, and the creation of truly pan-European markets. Everywhere, but perhaps most evidently in Japan, policies will be needed to shift labour into the production of non-traded goods and services as international competition mounts. Within sectors producing tradables, there may have to be a progression up the value added chain, with a correspondingly greater focus on education and training. For governments that are already fiscally challenged, finding the funds will be no easy task. A ruthless pruning of unproductive expenditures and wasteful subsidies would be a good place to start.

Raising productive potential and then keeping it fully employed requires marrying efficiency with stability in the financial system. Unfortunately, in some countries initial conditions are less than optimal, with reliance still being placed exclusively on loans from banks, and bankers often charging less for risk than they should. Moreover, certain banking systems themselves are still operating under the burden of bad loans made in the past. Japan seems to be making some progress with corporate and bank restructuring, after a decade of false starts, but China has only just begun to address its banking problems.

An even greater challenge than recapitalising commercial banks, difficult as that may be, will be to ensure they can operate profitably over time. In this latter regard, one of the most pernicious forces is continued political influence. To be sure, directed loans to state-supported sectors seem increasingly to be out of favour, even in such countries as China and India. However, the damage that can be done to the private sector through competition from state-supported financial institutions is still not adequately recognised. The influence of the Japanese postal savings system, the German public sector banks and the government-sponsored enterprises in the United States is pervasive, and only in Europe have concrete steps been taken to rein back state support. Both in industrial countries and in many emerging market economies, the costs and benefits of such support for the financial sector need to be rigorously evaluated.

Even countries with robust financial systems must make efforts to keep them that way. One structural vulnerability evident almost everywhere is the shortage of accurate information required to assess the health of corporations, that of the institutions which have lent to them, and the resulting financial vulnerability of the economy as whole. Concerning each aspect, this information should cast light on three issues: first, the current financial condition of individual firms and the economy in aggregate; second, the risk profile looking forward; and third, the uncertainties associated with all of these estimates.

With respect to the first issue, the accounting profession is leading attempts to establish harmonised international financial reporting standards for firms. This work needs to be brought to a successful conclusion, with due regard paid to the ability to assign fair values to assets and liabilities. With respect to the second, the Basel Committee on Banking Supervision has put greater emphasis in recent years on the disclosure of the risk profiles of individual financial institutions. The successful negotiation and implementation of Basel II will lead to an even closer focus on risk measurement and risk management at the institutional level. Moreover, at the macroprudential level, the Financial Stability Forum and other bodies have increasingly underscored systemic vulnerabilities and the need to formulate early warning indicators of trouble ahead. All of these efforts should be actively pursued. The development of methodologies to assess systemic vulnerabilities when financial institutions face common shocks, to which they might well react similarly, needs particular attention. As for the third issue, providing some sense of the uncertainties associated with all empirical measurements, very little progress has been made to date.

We need to assess the gaps in the information we require for proper economic management, and then take action to fill them. Cost cutting with respect to the collection and analysis of needed statistics could well prove to be a false economy. In the interim, in recognition of how much we do not know, policies need to be conducted more prudently than would otherwise be the case. Avoiding hubris is, in the light of historical experience, the best safeguard against truly bad outcomes in most areas of human endeavour.