I. Introduction: so far, so good

On the occasion of the 75th anniversary of the BIS, it seems appropriate in this Annual Report to look back over a longer historical period than normal. Granted, placing the primary focus on the events of the Bank's last financial year has its advantages. In particular, even casual readers of the newspapers will be familiar with the issues. Yet this focus on the recent past also has its shortcomings. The first is that inadequate attention might be paid to the implications of underlying structural changes in the economy. Powerful but glacial developments can easily be missed in analysis directed to short time spans. A second, related problem is that events come to be viewed in isolation, rather than as the dynamic consequences of much earlier developments. A third issue is that of short-sightedness in policy advice, which could turn today's solution into tomorrow's problem. All these considerations indicate the merits of analysing not only the current state of the global economy, but also the forces that have shaped and will continue to shape it.

A number of trends in the global economy have become well established over the last two decades or so, some welcome, others less so. Moreover, recent developments have also been broadly consistent with these trends. This has frequently elicited the comment "so far, so good", from optimists and pessimists alike. The former see no good reason why the favourable aspects of these long-standing developments should not continue. The latter focus rather on such underlying issues as internal and external imbalances, and see the potential for trouble ahead.

This Introduction begins with a description of these salient features, before going on to provide some alternative explanatory hypotheses. The subsequent chapters of the Annual Report analyse and distinguish between these alternatives, and provide support for the Conclusion. The policy issues raised centre around two questions. What policies might best help preserve the many satisfactory features of today's economic and financial world? And in the longer term, is there a need for a new macrofinancial stabilisation framework to prevent future build-ups of both domestic and international imbalances?

It must be said at the outset that both questions raise difficult issues. Opinions may reasonably differ about either paradigm choices or trade-offs within chosen paradigms. This implies that arriving at an international consensus on the answers will be no easy task. Yet a retrospective glance at the BIS's long history of fostering cooperation among central banks, and increasingly other involved parties, offers grounds for optimism, given how many agreements were in fact reached in similarly contentious circumstances in the past.

Economic and financial trends over recent decades

Looking back over the last two decades or so, four features stand out. The first has been a welcome reduction in the level of inflation worldwide and an associated decline in its volatility. The second has been generally robust growth in the global economy, again accompanied by lower short-term volatility, with sluggish growth in Japan and Germany more recently an important exception to the rule. The third feature has been the widening of external imbalances. And finally, one must note the increasing prominence of credit, asset price and investment booms, often followed by financial difficulties of various kinds.

In broad terms, these established trends were also evident in the BIS financial year completed at the end of March 2005. Yet as the year progressed, evidence also began to accumulate which suggested a heightened probability of turning points. Inflationary pressures appeared to be growing, even as output growth in the industrial countries showed signs of slowing. In addition, the prices of many financial assets started to soften after looking increasingly disconnected from both fundamentals and the mounting uncertainties about the economic outlook.

Turning to the longer-run features, inflation in every industrial country has fallen sharply from its peaks in the 1970s. A similar pattern has been observed in the majority of emerging market economies. Even in countries which previously suffered from hyperinflation, notably in Latin America, inflation is now generally at single digit levels. Significantly, in Argentina and Brazil the pass-through from the most recent large depreciations failed to reignite inflation expectations as had almost always happened previously. Global inflationary pressures have, in fact, receded so far that deflation was actually recorded for a time in China, Hong Kong SAR and Japan, and was briefly viewed as a serious possibility in the United States, Germany and Sweden.

Over this last financial year, higher commodity prices, particularly for oil, have finally begun to feed down the production line almost everywhere. Moreover, in the United States fears have increased that core consumer prices might also be moving up and that a further depreciation of the dollar could exacerbate these pressures. Nevertheless, it is still too early to say whether the earlier trend has ended. Indeed, a wide body of empirical evidence indicates that inflation upticks have recently become much less persistent, that exchange rate pass-through to domestic prices has fallen considerably, and that inflation expectations are now much better anchored at low levels than in the past. To this must be added recent, massive increases in production capacity in China and India which are beginning to come on line. In sum, the jury is still out on the future path of inflation.

A second broad trend has been towards faster economic growth at the global level, often accompanied by lower short-term output volatility. As to growth rates, phases of expansion in industrial countries have lengthened, while the rate of expansion in many emerging market economies has turned sharply upwards. China, for example, has recorded an average growth rate of about 10% per annum over the last 20 years, and India also seems to be on a significantly higher growth path than two decades ago. Together, these two countries now account for a much larger share of global growth than in the recent past. As for output volatility, economic downturns have generally become less common and less severe. In the United States, growth during the last 20 years or so has been interrupted only twice: by the mild recession of 1990–91 and the even milder one of 2001–02. In contrast, all the countries hit by financial crisis over recent decades, as described below, did experience a very sharp slowdown during the worst phase of the crisis. Moreover, in the case of Japan, very rapid growth through the 1980s gave way to a much more sluggish output trend after the bubble burst.

Growth rates recorded over the period under review were again broadly consistent with these longer-term trends. Many industrial countries advanced strongly, with consumption and housing continuing as important drivers, and fixed investment finally showing signs of a response to sharp increases in profits. Japan, Germany and Italy generally remained laggards, although there were some encouraging signs in early 2005. The growth of the emerging market economies was particularly impressive, notwithstanding some moderation as the period wore on. China, despite the use of both administrative and market means to slow growth, decelerated only slightly in aggregate. In addition, while some very buoyant sectors at first appeared to be slowing more markedly, evidence subsequently emerged of a rapid rebound.

Even if the economic features described above have been broadly satisfactory, two other, less welcome, longer-term trends deserve to be singled out. The first of these has to do with global current account imbalances. For at least the last 15 years, the US external deficit has been trending upwards, accompanied by rising, if still relatively low, external debt. Correspondingly, various other countries have recorded substantial surpluses, not least the slower-growing economies of Germany and Japan. The period under review was no exception. The US deficit expanded to a record high as a proportion of GDP (almost 6%), and this in spite of a reduction in the effective real value of the dollar of more than 20% from its peak in early 2002. It is unprecedented for a reserve currency country to have a current account deficit of such magnitude.

Concerns about the implications over time of these external imbalances have been heightened by another longer-term trend. The global financial system seems to have become increasingly prone to financial turbulence of various sorts. The Mexican, Asian and Russian crises of the last decade indicated the force with which shocks could be transmitted both across liberalised financial markets and across countries. Short-term price volatility in financial markets, often associated with a sudden drying-up of previously abundant liquidity (as in the Long-Term Capital Management (LTCM) episode), has at times been another source of turbulence. A number of small but high-profile bankruptcies of financial firms (eg Drexel Burnham Lambert and Barings) have occurred, raising sensitivities to the potential implications of larger and more complex institutions getting into difficulties. And finally, financial losses due to operational risks seem to have been on an upward trend. This has reflected not only the increased complexity and IT dependence of modern financial systems, but also governance issues (eg Enron, Parmalat and AIG) and the new reality of terrorist disruptions (11 September 2001).

Yet the single most remarkable feature in the financial area has been the recurrence of credit, asset price and investment booms and busts. A first cycle began in the industrial countries in the 1970s, affecting both equities and real estate. A second cycle started in the mid-1980s, ending in a property bust a few years later. While the Nordic countries, Germany and Japan were most affected, each made vulnerable by other domestic problems, many other countries were also caught up by the exuberance. Moreover, it seems increasingly evident that we are today well into the boom phase of a third such cycle, dating from the economic upturn of the mid-1990s. Equity prices were affected first but, after their sharp decline in early 2001, the upward momentum of demand was transferred to the housing market. Indeed, it is not an exaggeration to say that, over the last year or so, the house price phenomenon has achieved global sweep. Most industrial countries are showing symptoms of overheating in the housing market. So too are many emerging market economies, including China and Korea.

In virtually every instance, the bust phase of credit, asset price and investment cycles has been accompanied by some kind of headwind that has slowed down the subsequent economic recovery. The most serious effects have generally been due to outright crises in the banking system, as was the case in the Nordic countries in the late 1980s, Mexico in 1994 and a number of Asian countries in 1997–98. Within this class of problems, the economic costs were usually greatest when large-scale borrowing abroad in foreign currencies contributed subsequently to joint banking and foreign exchange crises. Fortunately, the overall health of financial systems in most industrial countries appears in recent years to have improved significantly. In eastern Europe and Latin America, where the local presence of foreign banks has increased markedly over the last 10 years or so, a similar conclusion seems warranted. However, in some parts of Asia the robustness of the system remains open to question. In particular, the continuing rapid growth of credit in China could well translate into a rebound in non-performing loans over time.

In any event, even short of financial crisis there have been many examples in recent decades of loss-impaired financial institutions restricting lending, with negative effects on real economic activity. Moreover, headwinds seem sometimes to have arisen also from overstretched corporate and household balance sheets and the overhang of unprofitable capital investment. The decade-long decline in corporate investment in Germany and Japan, the continuing weakness of post-crisis investment in most countries in Asia (excluding China), and the recent sluggishness of consumption in Korea and the Netherlands may all be illustrations of this phenomenon. From this historical perspective, the continuation last year of the longer-term trend towards increased household debt in many industrial countries, particularly those characterised by relatively rapid economic growth, is worth watching. The same might be said for the balance sheets of the production sector in China, assuming that the basic data are reliable enough to support such examination.

How did we get here and where are we going?

Explaining these broad macroeconomic developments in a parsimonious way presents a great analytical challenge. What is clear is that they have taken place against a background of at least three welcome structural shifts in the global economy. First, the liberalisation of the economies of many emerging markets has unleashed competitive forces that have led to major changes in the industrial world as well. Indeed, the integration of China and other previously socialist countries into the global market economy is an unprecedented occurrence. Second, there has been a similar pattern of liberalisation in financial markets, which has both made them more efficient and given them global reach. And third, monetary authorities almost worldwide have focused increasingly on bringing inflation down to low levels and keeping prices stable thereafter. What is not so clear is whether the interaction of these structural forces has had, or might still have, some unwelcome side effects as well. At the least, such massive changes must raise questions about the dynamics of modern economies, and uncertainties as to the proper conduct of policies looking forward. These policy issues are returned to in the Conclusion of this Annual Report.

Finding explanations for low and stable inflation is perhaps the easiest task. Recognising the harm done by high and volatile inflation in the 1970s, a public consensus emerged for central bankers to reduce it in both these aspects. They have indeed succeeded admirably. And their subsequent commitment to price stability has also contributed materially to the maintenance of low inflation over almost all of the last two decades. In particular, expectations about future inflation developments seem much more firmly anchored than before, and wage setting behaviour accordingly more stable. The growing recourse to inflation targeting regimes in emerging market economies attests to the efficacy of anti-inflationary policies.

It is a fact, however, that central bankers were also aided by powerful non-monetary forces supporting disinflation, particularly over the last 15 years or so. In the industrial countries, there has been continued (if still uneven) liberalisation of markets for goods and services as well as factors of production. Technological advances have also boosted productivity growth in some countries, particularly the United States, and technology transfers have benefited many others. Globalisation and the impact of massive increases in the supply of manufactured goods, especially from China and other transition economies, have resulted in the prices of traded goods falling for almost a decade. The increasing cross-border mobility of labour, the growing contestability of labour markets and the threat of factories moving to lower-cost jurisdictions have had further disinflationary effects on wages and work practices. Everywhere, the emphasis has been on cost cutting. Supermarkets, car makers and others directly serving consumers have been putting relentless pressure on global suppliers to provide more for less.

In this environment, explaining more rapid growth, and less volatile growth, also becomes easier. Trend growth is now higher, without the inefficiencies associated with inflation, and cyclical fluctuations have also abated. In part, this reflects the fact that monetary policy no longer has to lean vigorously against periodic bursts of rising inflation expectations. With such expectations now more firmly anchored in the framework of monetary policy, the risks of inadvertently triggering a recession are much lower. This reduced uncertainty also helps explain the remarkably muted response of long-term bond rates, even in the face of rising policy rates in the United States over the last year.

Another benefit of the low-inflation environment is that monetary policy has been able to react vigorously whenever growth and employment have been threatened on the downside. Consider, for example, how aggressively policy rates were lowered worldwide in the aftermath of the 1987 global stock market crash. Consider too the policy reaction to the property collapse of the late 1980s and the associated problems in many banking systems. After tightening sharply in 1994, and moderately thereafter, it was possible to put further monetary restraint on hold in the wake of the Asian crisis. In 1998, still further into the economic upturn, policy rates were lowered in response to the Russian debt moratorium and the LTCM crisis. And, again, after stock markets nosedived in 2001, and the global economy slowed markedly, policy rates were cut sharply and have only recently begun to rise again.

Yet the cumulative impact of these policy responses is also worth noting. The real policy rate gap (defined as the difference between the real rate and estimated potential growth) in the G3 has been trending down since the early 1990s, and sharply so since around 1999. The aggregate rate of growth of credit, as well as broader measures of the money supply, has also tended to be well above the growth rate of nominal income in the industrial countries since the early 1990s. Today, real policy rates remain around zero in spite of last year's record global growth and emerging signs of tightening capacity constraints. In Japan, where the nominal policy rate has been zero for some time, the policy of "quantitative easing" has pushed the Bank of Japan's balance sheet to 28% of GDP, an unprecedented level. This policy easing has also manifested itself in many emerging market economies, for reasons also related to the world's growing external imbalances.

Explaining the long upward trend in the US current account deficit is a more challenging task. Some see the US current account deficit as largely the by-product of a stronger dollar, driven by private sector capital inflows reflecting expectations that recent, relatively rapid, growth in the United States will continue. Moreover, as countries have progressively relaxed their restrictions on holding foreign currencies, this has led to a steadily rising demand for dollar securities, particularly on the part of countries where domestic saving rates are high. However, others emphasise the decade-long decline in the US household saving rate, and the more recent massive swing into deficit of the US federal government. In contradiction to the first school of thought, they note that the US current account deficit has been increasingly financed by foreign governments rather than the private sector. As their own currencies have tended to rise against the US dollar, the monetary authorities in many countries have intervened heavily to counter this movement and have then largely recycled the resulting reserves back into dollar-denominated securities.

Such policies have impeded the reduction of external imbalances in at least two ways, though both are hard to quantify. The effective value of the dollar is arguably higher than it would otherwise have been. Moreover, long-term interest rates in the United States probably remain lower than otherwise, with associated implications for increased domestic spending. These attempts to stem currency appreciation have also tended to result in easier monetary and credit conditions than otherwise in the intervening countries. In some cases, as in Japan and China, where deflation had emerged for a time as a problem, these effects were initially welcome. However, the contribution of such policies to both domestic and global inflationary pressures, as well as financial imbalances, is now receiving increasing attention.

The recurrence of bouts of financial instability, even after inflation had been sharply reduced, also allows for alternative explanations, and perhaps alternative policy responses. One possibility is that problems encountered to date will, in the end, prove only transitional. Learning to live with low inflation, a liberalised financial sector and recent advances in financial technology simply takes time. During the learning process, disruptive mistakes have been made but their incidence and costs will decline. Support for this position is provided by the remarkable reduction in risk spreads in financial markets over the last year or so, and the equally remarkable decline in volatility. Moreover, some have put forward the complementary argument that more volatile financial conditions might even be welcome in some respects. They could be the mechanism through which shocks that might otherwise have harmful effects on the real economy are painlessly dispersed by modern financial systems to those most capable of absorbing them.

An alternative possibility is that such instability might be longer-lasting. Liberalised financial systems, while more efficient than repressed ones, might be inherently prone to instability if competitive pressures occasionally lead to excessive risk-taking. A second point is that they also seem to be inherently procyclical. That is, perceptions of value and risk move up and down with the economy, as does the willingness to take on risk. Credit spreads, asset prices, external ratings, internal ratings and loan loss provisions have all demonstrated this characteristic over the last few decades at least. This can result in powerful financial forces spurring real growth during an economic upturn, but an equally powerful downdraft should the initial optimism eventually come to be seen as excessive.

Nor is it hard to imagine that these normal tendencies to boom-bust behaviour might be aggravated by easy monetary conditions. At the heart of the matter is the “search for yield” when nominal risk-free rates are very low. Being able to borrow at very low interest rates provides incentives to credit creation, carry trade behaviour and leverage, all of which have been increasingly evident in financial markets in recent years. From this vantage point, the fact that the prices of all non-monetary, “illiquid” assets (long-term bonds, credit instruments, houses, etc) have risen rapidly over the last few years, and that measures of implied volatility are down sharply, need not be primarily due to the economic environment having become less risky, as hypothesised above. Rather, it could reflect a generalised effort to “buy illiquidity" and "sell liquidity" given a surfeit of the latter. While this explanation might seem less compelling against the background of almost a year of policy tightening in the United States, policy rates in fact remain very low both there and elsewhere.

These different perspectives on structural changes in the financial system are nowhere more evident than in current assessments of developments affecting the household sector. Some see the greater capacity for households to borrow, including against increased housing wealth, as highly desirable. In the face of slowing wage growth in the industrial countries, and weak business investment outside China, this borrowing has allowed a form of intertemporal expenditure smoothing that has helped maintain aggregate demand across the globe. Others, however, focus rather on the decade-long decline in household saving rates in many countries, the rising share of consumption in GDP, and a potentially dangerous exposure to debt service requirements as rates rise to more normal levels. In any event, if we have just witnessed the high borrowing phase of intertemporal smoothing by households (and some governments), this must by definition imply some payback, sometime.

To summarise, we seem to have a reasonable set of explanations for how the global economy got to where it is. There can be little doubt that the easing of global liquidity conditions, made possible by well anchored low inflation and financial liberalisation, has served to sustain aggregate spending levels. Nevertheless, looking forward, alternative paths still seem plausible. A continuation of steady, non-inflationary growth might seem the most likely outcome, given the positive aspects of the fundamental structural changes described above. However, it is by no means guaranteed. On the one hand, the significant monetary stimulus seen to date could yet end in overt inflation. On the other hand, the implications of growing debt levels, both domestic and international, remain a great unknown. Either debtors or creditors, or both, might retrench as debt levels mount. Reductions in asset prices and assessments of private sector wealth could reinforce such behaviour. Conversely, increases in debt levels might simply be a normal part of financial deepening as markets mature and become more complete.

Given how little experience we have had with the interactions of the many structural changes identified above, these less welcome possibilities cannot be ruled out. Thus, one important task for policymakers in this new environment is to assess what policies might best help limit the costs of something going wrong. Another, no less challenging, is to consolidate, at the same time, the significant benefits these structural changes have already provided.