I. Introduction: resilience to mounting strains

This time last year, there was both satisfaction and surprise at the continuing excellent performance of the global economy. Satisfaction, because buoyant growth and persistently low inflation, particularly in many emerging market economies, meant generally higher living standards and a significant reduction in poverty. Surprise, because a whole set of imbalances, which some thought had clear potential to eventually threaten that good performance, had still not done so. Many key macroeconomic variables, which had exhibited substantial and sustained deviations from historical norms, surprised by showing none of the typical signs of reverting to the mean. Record and rising household debt levels and a further increase in oil prices did not weigh on spending in the United States. Nor did record high house prices collapse, anywhere. China's investment boom was not interrupted. The easy flow of funds to borrowers of all types did not falter. And an unexpected further leap in what were already unprecedented external imbalances did not lead to disorder in exchange markets.

One year later, the same sentiments could be invoked in even greater measure. There are still grounds for satisfaction. Not only has the good performance continued (Chapters II and III), but there are even indications that some aspects of the imbalances might themselves be receding. The recovery in Japan seems firmly established, and more sustained growth in Germany, as well as elsewhere in continental Europe, appears increasingly likely. This reduces the dependence of the global expansion on the previous two poles of growth, the United States and China. As a result of this broadening expansion, trade imbalances could also be lowered. And there are still more grounds for surprise. Over the course of the last year, other imbalances that had earlier seemed worrying grew even larger. In particular, another year of massive borrowing further raised debt and potential debt service levels. Yet the global economy has powered on, regardless.

This continued strong economic growth has, however, begun to raise concerns about global inflationary pressures. As a result, policies which had previously contributed to extremely easy monetary conditions worldwide have begun to be modified (Chapter IV). Significant adjustments to policy over the last year or so include further monetary tightening in the United States and Europe, the end of "quantitative easing" and foreign exchange intervention in Japan, and the announced change in the exchange rate regime in China (Chapter V). The good news, again both welcome and surprising, is that these moves have not to date (late May) been accompanied by any severe tensions in financial markets. The fear, thankfully unrealised, was that higher policy

rates would interact with the underlying imbalances to affect both financial markets and spending proclivities, with a related effect on global growth and employment.

This does not mean that there has been no response to the recent policy restraint. A number of signs have emerged that some kind of turning point might have been reached. Long bond rates have finally begun to rise, more sharply since the turn of the year, and evidence has been accumulating that other financial markets are increasingly being affected (Chapter VI). Moreover, in the United States and a number of other countries, house price increases (Chapter VII) and construction activity have recently become less vigorous. Evidently, the wish of policymakers must be that this orderly deceleration will continue, and that a smooth adjustment to a sustainable rate of growth will be the eventual outcome. Indeed, this is the consensus forecast, as well as that of the IMF and OECD.

Yet, even if this is the expected outcome, how sure of it can we be? Perhaps the principal point to make is that the cycle of policy tightening globally, as opposed to that in the United States, is not well advanced. Moreover, it is only since early 2006 that long rates, which play a key role in so many financial markets, have risen noticeably. More disruptive effects could still materialise. The recent historical experiences of Japan, Germany and Southeast Asia all indicate that costly economic downturns are possible, even after long periods of exceptional performance. The same examples also suggest that long periods of price stability are no guarantee of future robust growth.

Prudent policymakers today should still be thinking about remaining risks, and how they might respond to them. In advance, what steps might they take to minimise both the likelihood of difficulties and the scale of the losses that could be incurred should they arise? During and after the emergence of problems, what could be done to reduce the collateral damage? The Conclusion of this Annual Report addresses these forward-looking and more normative issues.

Constraining our capacity to assess both emerging problems and potential solutions is the continuing process of structural change in the global economy. New technology and the opening-up of previously closed economies to cross-border influences are all profoundly affecting the real economy. The inflation mechanism has also changed, perhaps dramatically. The financial sector too has felt the combined impact of globalisation, consolidation and the increased influence of market forces. The good news is that central bankers seem well aware of these changes and the uncertainties they create. Existing policy frameworks were increasingly questioned last year, and signs emerged that they were being significantly adapted in response. Change is begetting change, which is no bad thing.

Meeting the challenges of recent success

The strong economic growth during the period under review was shared by all major geographical areas. The impetus for this expansion had largely

originated in the United States and Asia, and first benefited others that exported to these regions. Higher demand led in turn to substantial increases in energy and other commodity prices. Through both volume and price effects, this benefited emerging markets more generally, including, for the third year in a row, Africa. In spite of being on the negative side of this same price shift, Japan and continental Europe also showed clearer signs of recovery.

Notwithstanding this welcome vigour at the aggregate level, the pattern of spending in some of the fastest-growing countries continued to be highly unusual. In the United States and a number of other countries, private consumption has been strikingly high, as has private residential investment. Both have been buoyed by easy credit conditions, rising house prices and a well developed financial capacity to extract housing equity. The associated effect has been a continuing very low rate of household saving (indeed, sharply negative in some countries) and a further increase in household debt. In contrast, in China it is the level of fixed investment that has been strikingly high. Here, too, easy credit conditions have played a prime role, as has political influence over loans for projects that might not meet normal credit risk criteria. Foreign direct investment has also been a significant factor, with much of the output intended for foreign markets. To oversimplify, the upshot of these unusual patterns is that the English-speaking countries have become the global pole accounting for increases in the consumption of tradables, while Asia, with China at the centre, has become the global pole of their increased production.

Elsewhere in the world, the most striking deviation from more normal spending patterns has been the persistently low rate of corporate investment, against the background of a continuing high level of household saving. The persistence of low investment in so many countries is particularly puzzling given generally high levels of measured profits and what still seem to be very accommodative financing conditions. Plausible explanations for this weakness could include hesitancy in the wake of earlier excesses as well as hurdle rates that are too high for a low interest rate world. The influence of such factors should diminish with time. A more fundamental explanation might be doubt about the profitability of investments looking forward. One reason might be a concern that past profit growth was largely due to non-repeatable factors: falling interest rates, tax breaks and cost cutting. Another might be the conviction that current elevated levels of household spending in countries like the United States are not sustainable. And still another might be fears about future competition, from China and India in particular.

An international implication of the fact that the United States and a number of other countries save so little relative to domestic investment, while other countries save so much, is that external imbalances have grown to record levels. The US current account deficit at the end of 2005 was equivalent to 6½% of the country's GDP, despite the net investment income account having remained stubbornly positive until very recently. Almost every region of the world has contributed to the offsetting surplus, but China, Japan and recently the oil exporters have contributed the most.

If robust global demand remained a source of satisfaction last year, so too did global inflation performance. While higher energy prices generally lifted

headline inflation, there was little pass-through to underlying measures of inflation. In most jurisdictions, wages and benefits remained generally well under control. Moreover, productivity increases tended to be higher in countries with faster-rising wage bills, like the United States, implying offsetting effects on unit labour costs. The fact that profits as a share of factor incomes hit record levels globally in 2005, in spite of higher commodity prices, also has favourable implications. New cost pressures could, for a time, be contained by margin compression.

But, as with the aggregate demand data, looking beneath the surface reveals latent issues that warrant attention. First, the data may not be reliably measuring the underlying inflation trends, already made difficult to identify by massive shifts in relative prices in recent years. For example, in most countries the costs of housing services have been rising sharply, but these tend to be either badly measured or even ignored in the calculation of consumer price indices. Second, the concept of "core" inflation is based on the exclusion of volatile price components, but the price of excluded energy has now been trending upwards for over three years. It is the reality of consumers facing higher costs for energy and housing services that could still pass through to wage settlements. Third, in many countries the effects of higher energy prices have been muted by regulatory constraints and fiscal subsidies, but these will have to be removed over time. And finally, as the global economy moves closer to full capacity, rising inflationary pressures might be expected.

The growing concern in recent quarters with the need for "vigilance" against potential inflationary pressures was reinforced against the backdrop of many years of highly accommodative monetary and credit conditions. Real policy rates in the United States and the euro area had been negative for some years, and well below potential rates of growth since the beginning of this decade. Monetary and credit aggregates tell much the same story. All have shown sharp increases in recent years, and most accelerated in the period under review. A similar pattern is discernible in emerging market economies, reflecting domestic tendencies towards more rapid credit creation and the effects on domestic liquidity of large capital inflows. The subsequent reflow of funds to the industrial countries, in the form of foreign exchange reserves, completes the process by which the official sector has increased liquidity globally.

Movements in other financial variables over the last fiscal year also indicated the influence of continuing easy monetary conditions. Perhaps the most important development, given its impact on a wide range of other markets, was the protracted refusal of the long bond rate in the United States to rise in response to sizeable increases in the federal funds rate accompanied by continued strong economic growth. Indeed, after earlier persistent declines in the long rate, it was only in March 2006 that its level returned to that prevailing when the Federal Reserve began to tighten in June 2004. Bond rates in other industrial countries traced out similar movements, albeit at the lower levels justified by weaker economic numbers. On the one hand, a number of studies seemed to indicate the influence of massive purchases of long-term bonds by foreign central banks, primarily in US dollars, and by pension funds

and insurance companies seeking to hedge their long-term liabilities. On the other hand, the possibility that the market was simply pricing in the increased likelihood of an extended economic recession, perhaps in response to current excesses, could not be ruled out completely.

Developments in other financial markets, however, seemed less supportive of these more pessimistic interpretations. Indeed, the prices of almost all longer-term financial assets have been consistently strong. Spreads on high-yield corporate bonds tightened back close to cyclical lows. The spreads on sovereign bonds fell even further to reach record lows, which have essentially been maintained to date. With the exception of the US markets, global equity prices showed at least steady gains almost everywhere in 2005, while gains in Japan and many emerging market economies bordered on the spectacular. And, as noted, house prices continued to advance in most countries. Finally, and also consistent with optimistic forecasts, the cost of insuring against expected volatility (as derived from option prices) has also been unusually cheap in recent quarters.

It is not hard to find specific factors in each of these markets to support an upbeat view about the future. For example, corporate bond defaults have, in recent years, been exceptionally low. Moreover, many sovereigns have benefited from better domestic policies, better external positions and less macroeconomic volatility in the industrial countries. Yet the fact that all these long-term asset prices were rising simultaneously also leads naturally to consideration of the possibility of a common cause. To varying degrees, they may all be manifestations of the extended period of easy credit conditions just referred to. Indeed, this interpretation of developments in financial markets is given further credence by the recent behaviour of commodity prices in general, and oil and gold prices in particular. The almost uninterrupted upward trend in all these prices began around the middle of 2003, when policy rates in the main industrial countries reached their lowest level in this cycle.

While their precise motivations clearly differed somewhat, the central banks in almost all the larger industrial economies tightened policy in the period under review. This process continued to be most advanced in the United States, where each meeting of the Federal Open Market Committee resulted in a 25 basis point rise to a level of 5% by the middle of May 2006. While the Federal Reserve's preferred measure of core inflation remained well under control, headline inflation peaked around 4½% in 2005 under the particular influence of higher energy prices. Moreover, reductions in measures of domestic excess capacity indicated the potential for further inflationary pressures, as did the continued and rapid increase in house prices. The ECB also raised rates twice, in spite of relatively higher levels of excess capacity, with concerns being expressed about developments in both of the pillars supporting the ECB's policy strategy: higher oil prices pushed up headline inflation, further reinforcing the need for vigilance against subsequent wage increases, while credit growth, especially in the form of household mortgages, accelerated sharply.

Even in Japan, where the authorities had for years been focusing on the need to eliminate deflationary tendencies, emerging signs that the policy had

finally succeeded led the Bank of Japan to conclude that it could begin to carefully remove its policy of "quantitative easing". However, the Bank of Japan also made it clear that this was quite distinct from a decision to raise short-term policy rates. As with the "measured" increases in policy rates in the United States, this was designed to avoid any disruptive unwinding of the financial exposures built up during the long period of extremely low Japanese interest rates. Elsewhere in the industrial world, monetary policy was also tightened cautiously for very similar reasons.

This tightening process had an unwelcome side effect. In response to the fact that policy rates rose more in the United States than elsewhere, the dollar actually strengthened materially on an effective basis during most of 2005 before subsequently falling back somewhat. This confounded the expectations of those who had focused on the growing, indeed unsustainable, size of the US external deficit. Moreover, the strengthening of the dollar perhaps contributed to making the deficit larger than would otherwise have been the case. Imports rose sharply as a share of GDP, and only partly as a result of higher oil prices. In other industrial economies, weaker currencies helped reduce the generally negative effects on current account balances of higher commodity prices and deteriorating terms of trade.

The strengthening of the dollar, in association with higher policy rates in the United States, might also have been expected to reduce the flow of capital to emerging market economies. This in turn would cause their currencies to weaken. But, again confounding expectations, most such currencies strengthened, some significantly, over much of the period under review. In part, this was due to improved trade balances, related to commodity gains and better domestic policies, but capital inflows in a wide variety of forms also rose to sharply higher levels. Apparently, as US rates rose, the funding for "carry trade" purchases supporting such inflows simply shifted to other industrial countries with lower interest rates.

Emerging market economies reacted to these pressures with various combinations of exchange rate appreciation, exchange rate intervention and easier domestic monetary policy. There was generally a greater willingness than hitherto to accept stronger currencies. Yet, other than in Latin America, real interest rates in many emerging markets were kept close to zero throughout much of the period under review, a situation very similar to that seen in most of the industrial countries. As for recourse to intervention, the level of reserves held by emerging market countries rose to record levels, albeit more slowly. While virtually every country showed some gains, those recorded by China were huge.

Between February and mid-May 2006, as the pattern of stronger growth and monetary tightening in the industrial countries became more generalised, signs began to emerge of a change in the financial climate. Of perhaps greatest significance, long bond rates moved up sharply in the United States, as they also did in Europe and Japan. In addition, the dollar began to weaken once more, indeed at an accelerating pace from April onwards, while the yen and euro strengthened. High-yield currencies like the New Zealand dollar, the Hungarian forint and the Icelandic króna, previously much favoured by

speculators, fell sharply as attention refocused on both domestic imbalances (such as rapidly rising house prices and low private saving rates) and associated large external deficits. Stock markets in the Middle East, a region which had benefited greatly from higher energy prices, fell even more dramatically as regional investors reined in their earlier exuberance. Equity markets in many other emerging market economies also fell back in May as foreign investors withdrew. Whether these events foretell a more widespread and longer-lasting return to more cautious behaviour on the part of investors remains an open question. Many false predictions of such a change have been made in the recent past, albeit not against the background of a global tightening of monetary policy.

Structural change and policy regime shifts

Production processes in the global economy have become significantly more integrated over time, particularly since the early 1990s. This has implied both higher levels of global productivity and massive increases in the effective supply of global labour. Together, these factors have continued to put direct downward pressure on the prices of traded goods and services, although perhaps less so in 2005 than in previous years. But there have also been continuing indirect effects, with attendant implications for wage and price setting behaviour. Not only has foreign labour become increasingly available to deal with bottleneck problems, but threats to move whole factories to lower-cost jurisdictions have become increasingly credible. Last year, merger and acquisition activity further contributed to these longer-term trends, particularly in Europe. Moreover, what became distinctly more noticeable last year were the efforts of enterprises from emerging market countries to seek control over companies in other emerging markets, as well as in industrial countries. This marks a significant and politically more sensitive phase in the globalisation process.

As the year wore on, there were growing signs of resistance to all these forces. In the United States, the rising bilateral trade deficit with China led to an intensification of the political pressure for an increase in the exchange value of the renminbi. The slight revaluation in July 2005, and the associated announcement of a new framework based on an exchange rate basket, were seen by many in the United States as less than adequate. As a result, a number of bills were introduced in the US Congress threatening to impose punitive tariffs on Chinese imports. Political forces in the United States also showed strong resistance to attempts by first Chinese and then Middle Eastern companies to buy controlling stakes in certain US interests. In Europe, the resistance took the form of measures to impede the liberalisation of service industries within the European Union and to prevent cross-border takeovers, particularly in the financial and energy sectors. In France, widespread protests in opposition to measures to liberalise labour markets further attested to the uncertainties and fears generated by the globalisation process.

Ongoing structural change also characterised global financial markets in the period under review. One welcome development was the increased

capacity of borrowers in emerging market countries to issue bonds, sometimes of quite long maturity, denominated in local currencies. Indeed, in the course of the year, this seemed to develop into a new asset class of interest to pension funds and many others. On the face of it, this development appears to refute the doctrine of "original sin", according to which countries with a history of bad macroeconomic performance would never again be offered such borrowing opportunities. Of course, it could also be asked whether this renewed access will prove to be only a temporary by-product of easy monetary conditions and an enhanced appetite for risk.

Another notable development was the continued spectacular growth in markets for the transfer of credit risk, in particular various forms of structured debt obligations backed by a widening range of risky assets, including commercial property. Again, this constitutes a significant step towards making markets more complete and efficient, even if it also implies attendant risks. A private sector working group on these markets, which reported last year, drew particular attention to frequent shortcomings in the supporting legal documentation and to other operational risks. Supervisory authorities in New York and London, where most of these markets operate, immediately responded with forceful steps to encourage improvements.

The work of central bankers has been affected, for better and for worse, by these structural developments. In particular, positive supply side shocks, including the effects of globalisation on labour markets, have made it easier than it would otherwise have been to maintain inflation at low levels. Less helpfully, this development may also have led to a certain complacency that the war against inflation has been won for good. Moreover, more complete and generally more efficient financial markets seem to have experienced occasional phases when risk has been underpriced and credit has grown excessively. This combination of easy money and low risk premia could eventually lead to future inflation, or financial imbalances, or both.

Over the last few years, central banks have shown a greater willingness to factor such concerns into their policy frameworks. Central bankers have been making increasingly frequent reference to the need to raise policy rates back towards more "normal" or "neutral" levels. More formally, the Bank of Japan has announced that its future policy moves will be guided by two "perspectives": the prospects for near-term inflation and the need to avoid longer-term problems of the sort that emerged in the late 1980s. The ECB's two-pillar approach also seems to have been evolving in a similar direction. All of these changes have been supported by a growing body of empirical research indicating that, when it comes to ensuring longer-term macroeconomic stability, money, credit and financial conditions might still matter after all.