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I. Introduction

I would like to begin with the consensus **forecast** which is pretty optimistic. Behind it all is the idea of structural reforms and a "New Era", starting in the US and spreading out. The "bottle is more than half full" according to this view.

But then I would like to go on to talk about the **risks** to the outlook, first in industrial countries but then the emerging markets as well. If there are chances of a "hard landing" in the United Stares, or if the "global business cycle" is at a turning point, then it is all the more important that the financial system be healthy. Typically, the biggest problems emerge when macroeconomic disturbances interact with financial weakness, e.g.:

- Germany/Austria early 1920s
- US 1920s
- Japan late 1980s
- Mexico mid-1990s
- East Asia late 1990s

My presentation then complements those of Andrew Crockett's, Karl Cordewener's and Knut Hohlfeld's. I will finish by looking at some of the possible **implications** should some of these risks materialise.

II. Consensus forecast

(see Table 1)

- Discussion of near-term prospects in ICs. It is still looking good re both growth and inflation.
- Most recent indicators show that US could have a soft landing. Third quarter NIA much weaker.
- Japan is picking up.
- Europe may have peaked at a high and sustainable level.
- Emerging markets all expected to do well.
- Yet when we focus on **mean** forecasts we should recognise their limitations.

- Moreover, recall that nobody forecast the Mexican crisis, nor the Asian crisis, nor the speed of the recovery. It is well-known that forecasters always miss turning points and generally underestimate cyclical fluctuations.

(see Graphs1 and 2)

III. Risks to the forecast

A. Impact of higher oil prices?

- Oil prices are up a lot, especially in Europe. Yet they are still only one-third of the real price in 1974.

(see Graph 3)

- Moreover, oil dependency in industrial countries way down, even if emerging markets will be harder hit.

(see Graph 4)

- Estimates by IMF of the direct effects on real growth of a $10pb increase are not so catastrophic. Yet big concern is whether higher CPI will feed through to wages and so on. This brings me to a second set of risks.

B. Macroeconomic imbalances

United States: the **level** of output is greater than potential. Even Chairman Greenspan [a New Era advocate] says we need a period of below potential growth to restrain inflation.

Inflationary pressures seem to be rising. Evidence from wages and benefits. Oil prices increase does not help. On the other hand, ULC in manufacturing continues to decline.

(see Graph 5)

Japan: level of output is below potential even if the exact gap is hard to estimate given obsolescence of much capital installed during the 1980s boom.

Deflationary pressures are not yet gone. Wholesale prices falling for almost a decade. CPI falling for the last 3 years.

Recent pick-up has been driven by exports and imports in IT. Corporations are beginning to restructure but this has increased unemployment and led to lower consumer confidence. Consumer spending is still falling.

Return to Table 1. Current account deficit of United States is 4% of GDP and rising. One part of the counterpart is a big surplus in Japan.

Underlying problem is markedly different private savings rates. US savings rate has declined as “wealth” in equity markets has increased. Japanese savings rates seem largely “precautionary”.

(see Table 2)

Europe: bit of a travesty to talk about macro imbalances in Europe as: current accounts are in good shape; the fiscal position is better, even if it has slipped a bit recently; unemployment rate has fallen more than expected due to structural reforms; yet there are still concerns about wage developments, exacerbated by oil price increases. And domestic demand is still not very robust.

The **bottom** line, given the importance of the United States, the recovery in Europe and strong recovery in emerging markets, is that policy rates everywhere have been heading **up** after almost a decade of heading down.

(see Graph 6)

This brings me to my third set of risks.

C. Financial sector imbalances

Before turning to some recent indicators, let me make a few historical observations. Financial imbalances and associated exposures generally arise after a long period of credit excesses. I have no difficulty in believing this has been the case.

- Somewhere, in a major financial centre, the cost of capital has been zero since 1985.
- Monetary growth rates have been high

(see Graph 7)

Moreover, it also appears as if investors' appetite for risk varies with interest rate levels. So, as rates came down through most of the 1990s, the appetite for risk has increased. Unfortunately, now rates are going back up.

The question is: what will be the implications?

(see Graph 8)

First, consider recent developments in financial markets. Major changes in prices in some areas. Is this the **end** of the adjustment or only the **beginning**?

- **Equities**: big decline in TMT stocks

(see Graph 9)

Yet, P/E ratios for the market as a whole remain high.

(See Graph 10)

- **Bonds**: yield spreads rising and, in the case of "Junk" rising sharply.

(see Graph 11)

Yet, while spreads for Junk are already at 600bp., in 1990 they went to 900bp. Moreover, loan defaults have already increased sharply in the United States and are forecast to increase still further.

- **Property**: no major reversals here, though prices have been softening in major commercial centres in the United States.

Yet, prices remain very high in many countries. France and Germany have been spared to date.

(see Graph 12)

- **Currencies**: in the last week or so the euro has strengthened and the yen has stabilised.

Yet, in light of both cyclical and secular developments (net foreign assets/liabilities) there remain some puzzles. The strength of the dollar reflects a strong economy, strong capital inflows (especially from Europe/Japan/oil exporters) and a willingness of the market to ignore current account deficits. Thus, the strong dollar is not completely inexplicable even if it could quickly reverse .

(see Table 3)

In contrast, the weakness of the euro and the strength of the yen make no sense given their respective cyclical positions. The yen's strength might be explicable on grounds of the strong external asset position of Japan but why should markets value this if they simultaneously ignore the US liability position?

(see Graph 13)

So there are a lot of dangers that assets may lose their value after a long period of rising prices! Moreover, for completeness, it should be noted as well that many of these assets have been purchased using borrowed money. If the value of the assets decline, the value of the liabilities remains. Who looks vulnerable given such a scenario?

- **Consumers** in most Anglo-Saxon countries (Canada/US/Australia) and many others. They have borrowed to the hilt and are awash with consumer goods. Further spending will be easily postponable.

(see Graph 14)

- The **US corporate sector** has used much of their corporate earnings to finance share buy-backs. Thus, 80% of investment has been financed by debt. If markets turn sour, investment could be hard hit (especially TMT)?
- The **TMT sector everywhere**, especially Telecommunications. They need at least $100 billion more in financing to build infrastructure. What if they don't get it?
- **Anyone who is long $?**
- **Financial institutions** that have been "going for risk" in the face of declining interest rates, declining rates of return, increased competitive pressure and greater emphasis on shareholder value.

Putting all of these risks together, it is not hard to envisage a harder landing than many currently expect. This brings me on to two sets of implications which could well interact with the risks I have just outlined. Let me say a few words about the implications for: the orderly functioning of the financial system and the potential effect on emerging market economies.

IV. Implications of a sharper correction than the consensus expects

A. For the orderly functioning of the financial system

Many aspects to this, but let me focus on just two.

If financial institutions are under threat, the **availability** of loans and market financing may be much reduced. IPOs in the TMT sector for example, will prove much more difficult to float [Ben Bernanke etc]. Lending standards in the United States are already tightening.

(see Table 4)

Another aspect of this is much shorter term; the **liquidity** of financial markets. How easy will it be to trade without moving prices significantly. Already a concern about this in many circles, though the evidence of declining liquidity is in fact very mixed. The forthcoming BIS Quarterly Review has three relevant articles which you might wish to read.

(see Graph 15 and 16)

Without wishing to be alarmist, the central point is that market liquidity under stress may be quite different from liquidity under normal circumstances.

B. For emerging market countries

They have been doing very well recently but are still vulnerable in many respects. Some risks are idiosyncratic.

Asia:

- restructuring going too slowly (Korea/Thailand/India etc)
- Political uncertainties (Taiwan/Philippines/Indonesia/Malaysia).
- Relatively heavily exposed to oil prices.
- Heavily dependent on exports of electronic products. While "plain vanilla" products like semiconductors, TVs and household appliances are doing well now, a sectoral downturn is forecast. Recession in the industrial countries would aggravate this sectoral downturn.

Latin America

- Large current account deficits which need to be financed. However, FDI is getting more important as a financing source and this may prove more robust.

(see Table 5)

- Political problems in many countries (Argentina/Peru/Venezuela/Columbia).

Some risks apply to all emerging markets, especially deteriorating conditions in the financial markets of the industrial countries. Until recently, bond yield differentials have narrowed. Now beginning to widen again.

(see Graph 17)

Moreover, exchange rates and stock prices have recently fallen significantly, especially in Asia (recall Graph 9). If there is a generalised flight from risk, emerging markets will be hard hit. Market financing will dry up first, and banks (while a little more enthusiastic recently) would be unlikely to step into the gap (recall Table 5).

V. Conclusion

The consensus forecast is most likely right. Nevertheless, there are some downside risks. The public sector at least should “hope for the best and plan for the worst”. You are best placed to evaluate what all this might mean to the German Public Sector Banks.

Table 1

Expected developments in output growth and current account balances

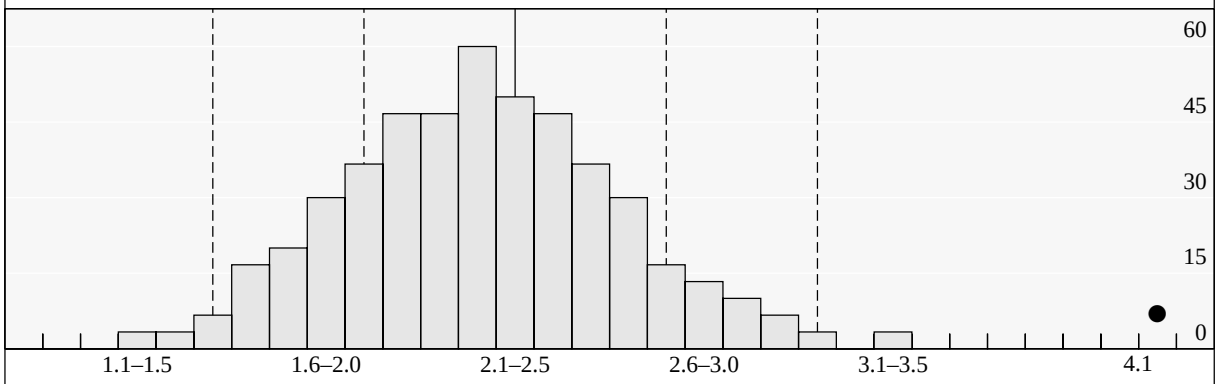
Countries and groups of countries	Growth of real GDP (%)			Current account balances (US$ bn)		
	1999	2000	2001	1999	2000	2001
Industrial countries	*2.9*	*3.9*	*3.0*	*–182*	*– 261*	*– 283*
United States	4.2	5.2	3.6	–331	– 429	– 459
Japan	0.2	2.0	2.0	107	117	111
Euro area	2.3	3.4	3.1	37	17	25
Germany	1.6	3.1	3.0	–19	– 16	– 10
France	2.9	3.4	3.3	37	28	30
Italy	1.4	2.9	2.8	6	1	2
United Kingdom	2.2	3.0	2.7	–18	– 23	– 25
Canada	4.5	4.7	3.5	–2	9	6
Australia	4.7	4.5	3.4	–23	– 18	– 16
Sweden	3.8	4.2	3.6	6	5	6
Switzerland	1.7	3.2	2.3	30	29	31
Emerging economies [1]	*4.3*	*6.1*	*5.4*	*58*	*59*	*13*
Asia	6.5	7.3	6.1	113	82	62
China	7.1	7.9	7.8	16	15	12
Hong Kong	3.1	8.8	4.4	8	6	5
India[2]	6.4	6.6	6.7	–4	- 5	- 6
Korea	10.7	8.7	5.8	24	8	3
Singapore	5.4	8.4	6.4	21	19	19
Thailand	4.2	5.0	4.6	12	9	6
Latin America	0.0	3.8	4.0	–53	– 49	– 62
Argentina	– 3.2	0.9	2.8	–12	– 11	– 12
Brazil	1.1	3.8	4.3	–25	– 25	– 25
Chile	- 1.1	5.5	5.7	0	- 1	- 2
Mexico	3.7	6.8	4.7	–14	– 18	– 23
Venezuela	- 7.2	2.7	3.9	4	11	6
Eastern Europe	1.1	5.0	4.2	1	7	– 3
Russia	3.2	5.1	4.1	25	38	27
Saudi Arabia	0.4	3.3	3.4	–2	20[3]	18[3]
South Africa	1.2	3.7	3.8	–1	– 1	– 2
World [1]	3.5	4.8	4.0	–	–	–

[1] Excluding most of the Middle East and Africa. [2] Forecasts and estimates refer to fiscal years (April-March). [3] Tentative estimate.

Sources: JP Morgan *World Financial Markets*; Consensus Economics *Consensus Forecasts*; Lehman Brothers *Global Economic Monitor*; BIS estimates.

Graph 1

Dispersion of US growth forecasts for 1999[1]

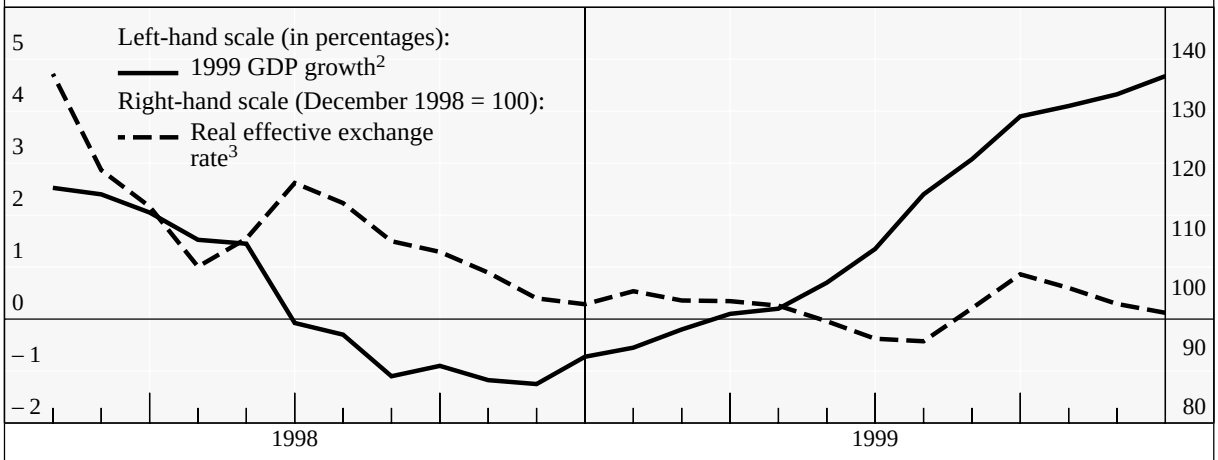


[1] Number of forecasts (made in December 1998) falling in rolling ranges of 0.5 percentage points, as a percentage of total forecasts. The dot indicates actual 1999 GDP growth, the solid line the mean of the consensus forecasts and the dotted lines ±1 and 2 standard deviations from the mean.

Sources: © Consensus Economics; national data.

Graph 2

1999 GDP growth forecasts for Asia and the real effective exchange rate[1]



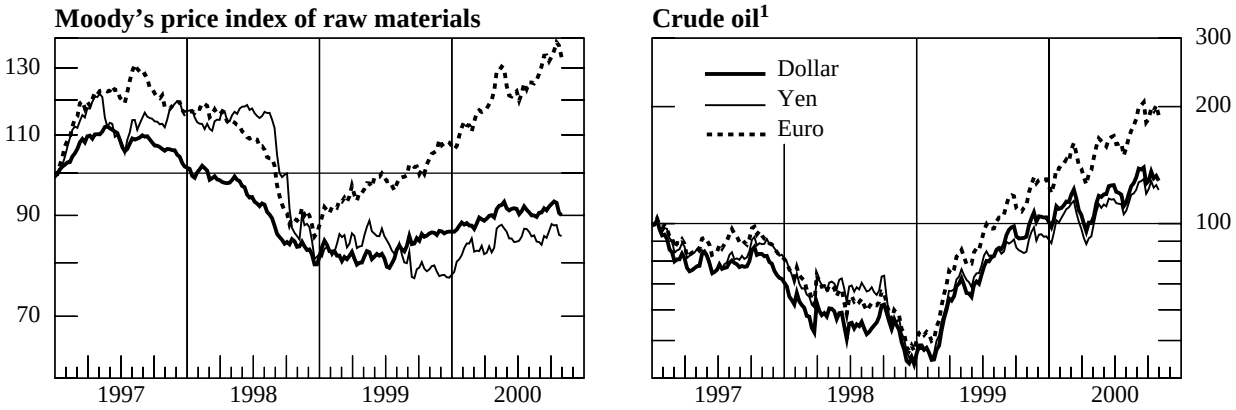
[1] Simple average of Indonesia, Korea, Malaysia and Thailand. [2] 1999 GDP growth forecast in the months shown. [3] In terms of relative consumer prices; an increase indicates a depreciation.

Sources: © Consensus Economics, London; national data.

Graph 3

Commodity prices in the three major currencies

End-December 1996 = 100; weekly averages; semi-logarithmic scale



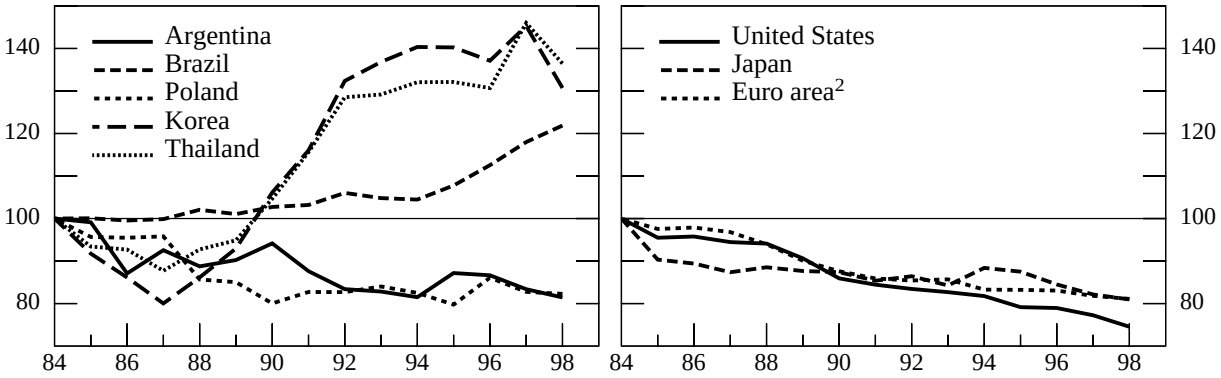
[1] Unweighted average of the price of Dubai Fateh, UK Brent and West Texas Intermediate.

Source: Standard and Poor's DRI.

Graph 4

Oil dependency[1]

1984 = 100



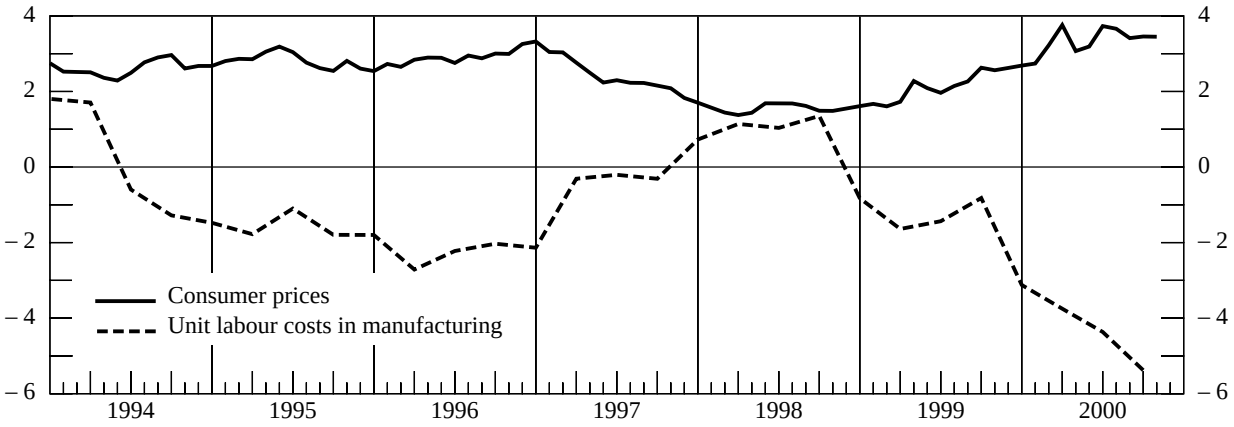
[1] Oil consumption (in tons) as a ratio of real GDP. [2] Proxied as the GDP-weighted average of Germany, France and Italy.

Sources: International Energy Agency; OECD; national data.

Graph 5

Consumer prices and unit labour costs in the United States

Annual percentage changes



Source: National data.

Table 2

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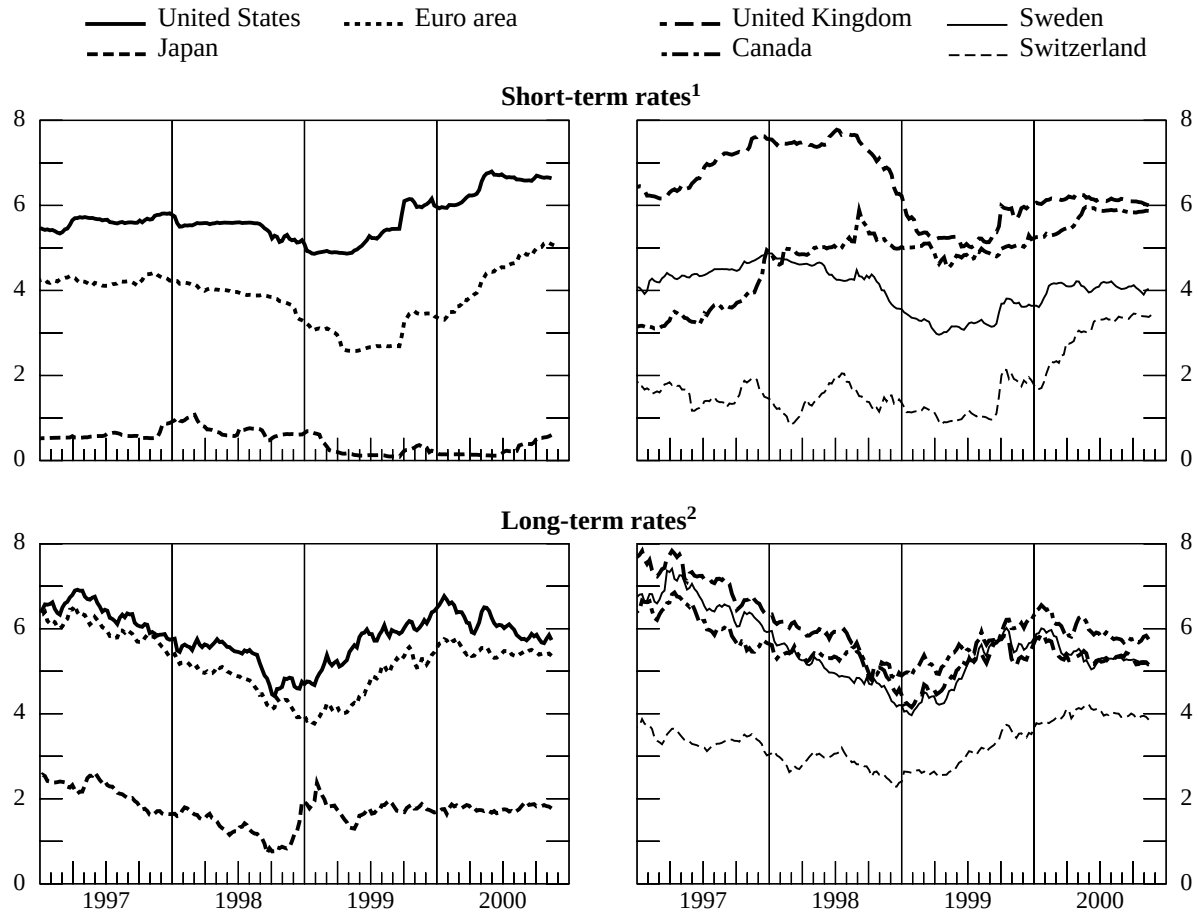
Graph 6

Interest rates in major industrial countries

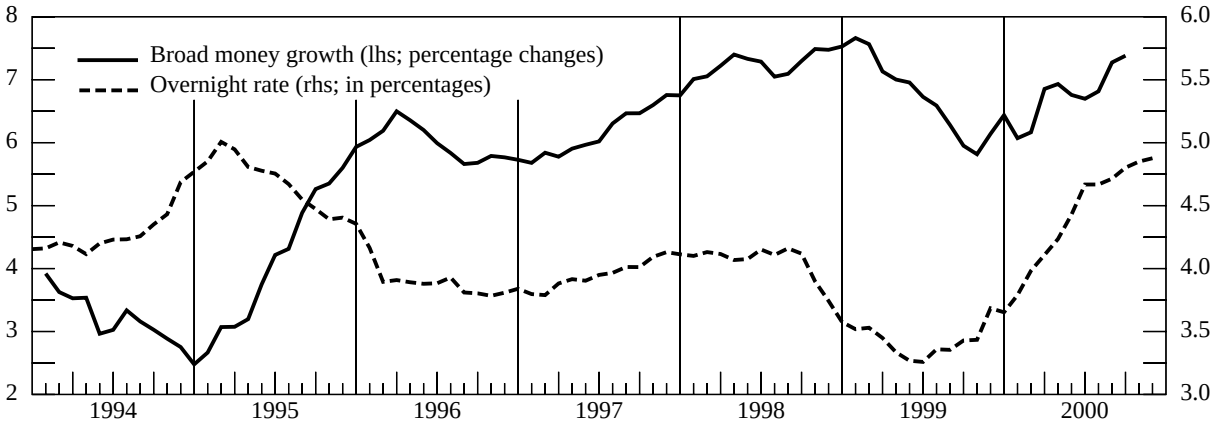
Weekly averages



[1] Three-month rates. [2] Ten-year government bonds or their closest equivalent.

Graph 7

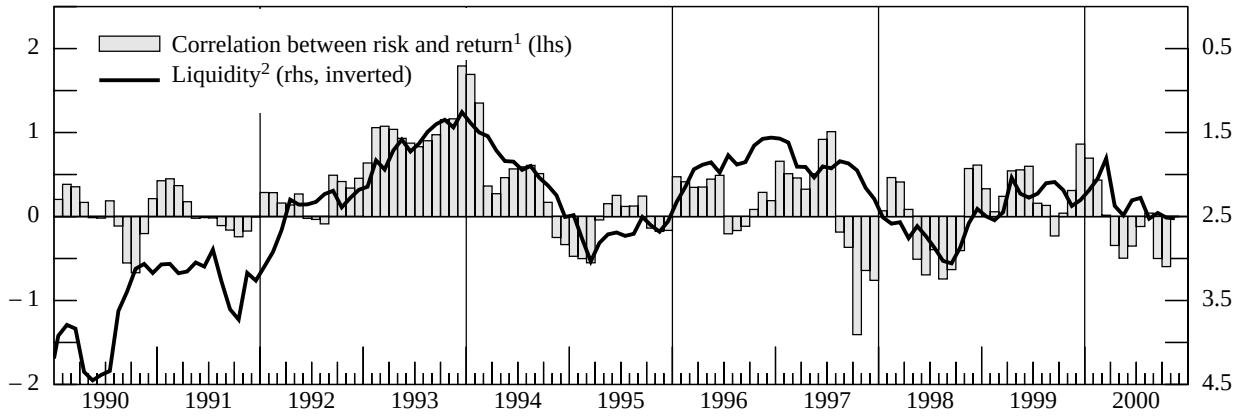
Globally aggregated money growth and short-term interest rates[1]



[1] Weighted average of the United States, Japan, the euro area and the United Kingdom.

Graph 8

Investors' attitude towards risk and liquidity



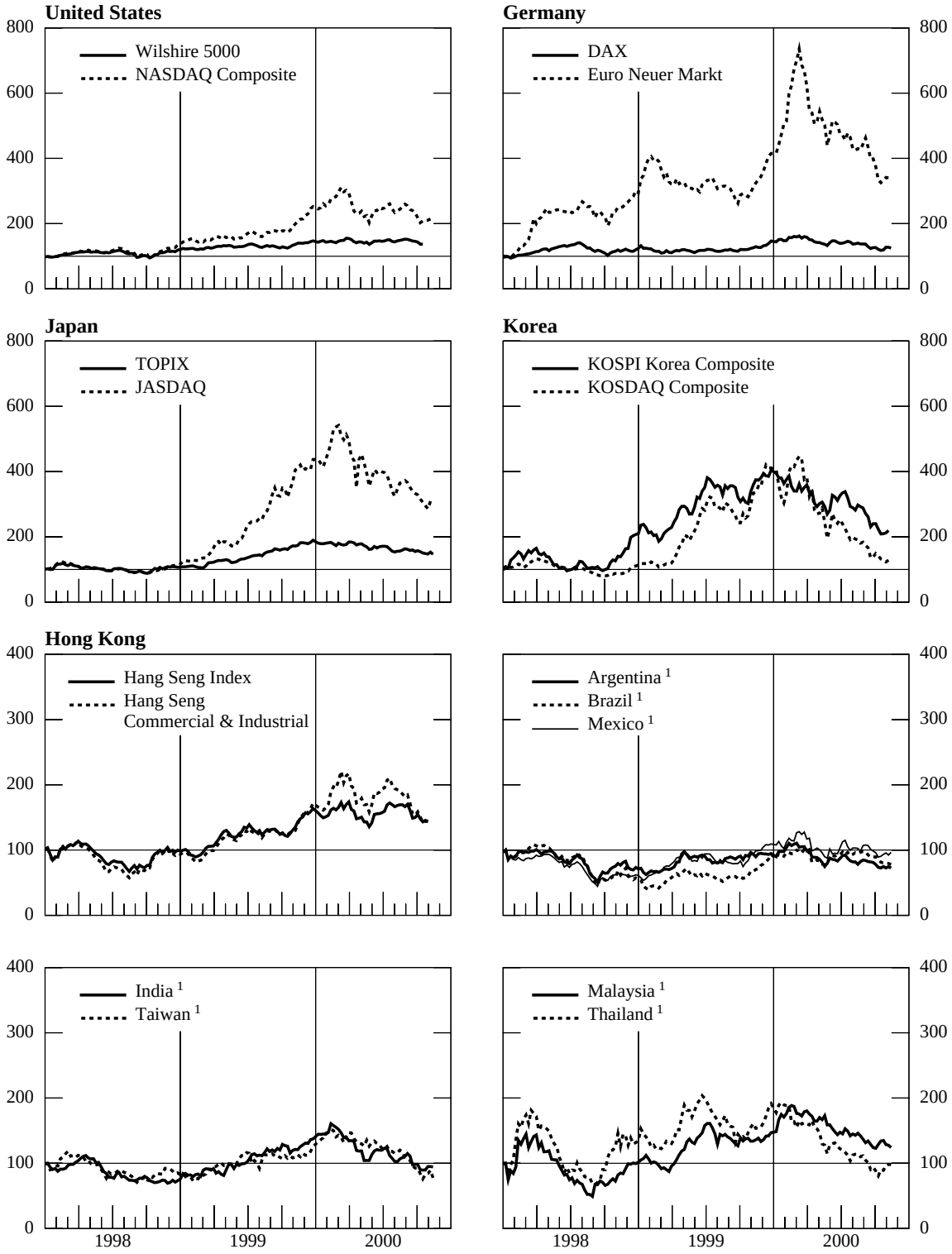
[1] Slope coefficient of a cross-sectional regression of realised returns on historical volatility for a number of asset classes.
[2] GDP-weighted average of overnight real rates in the eurocurrency market for the United States, Japan, Germany, France and the United Kingdom.

Sources: Datastream; national data; BIS estimates.

Graph 9

Stock market indicators (I)

Weekly averages; in US$ terms; beginning of January 1998 = 100

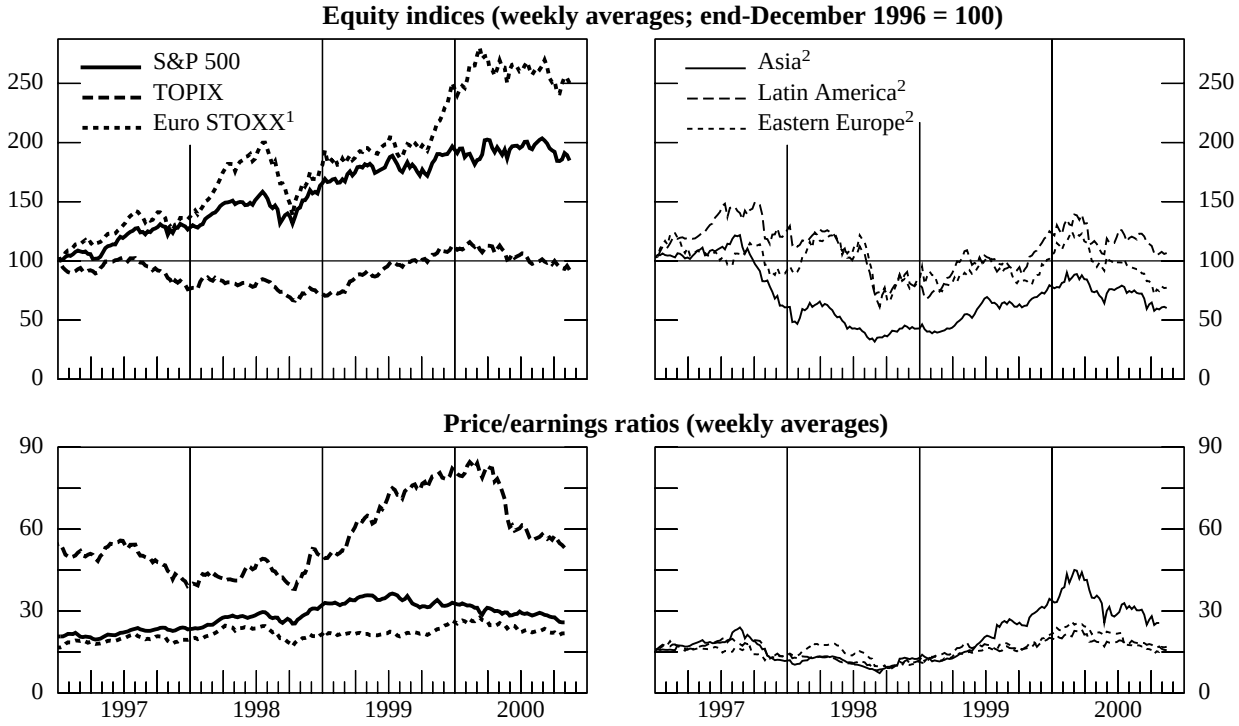


[1] IFC investable index.

Sources: Bloomberg; Datastream; International Finance Corporation (IFC); national data.

Graph 10

Stock market indicators (II)



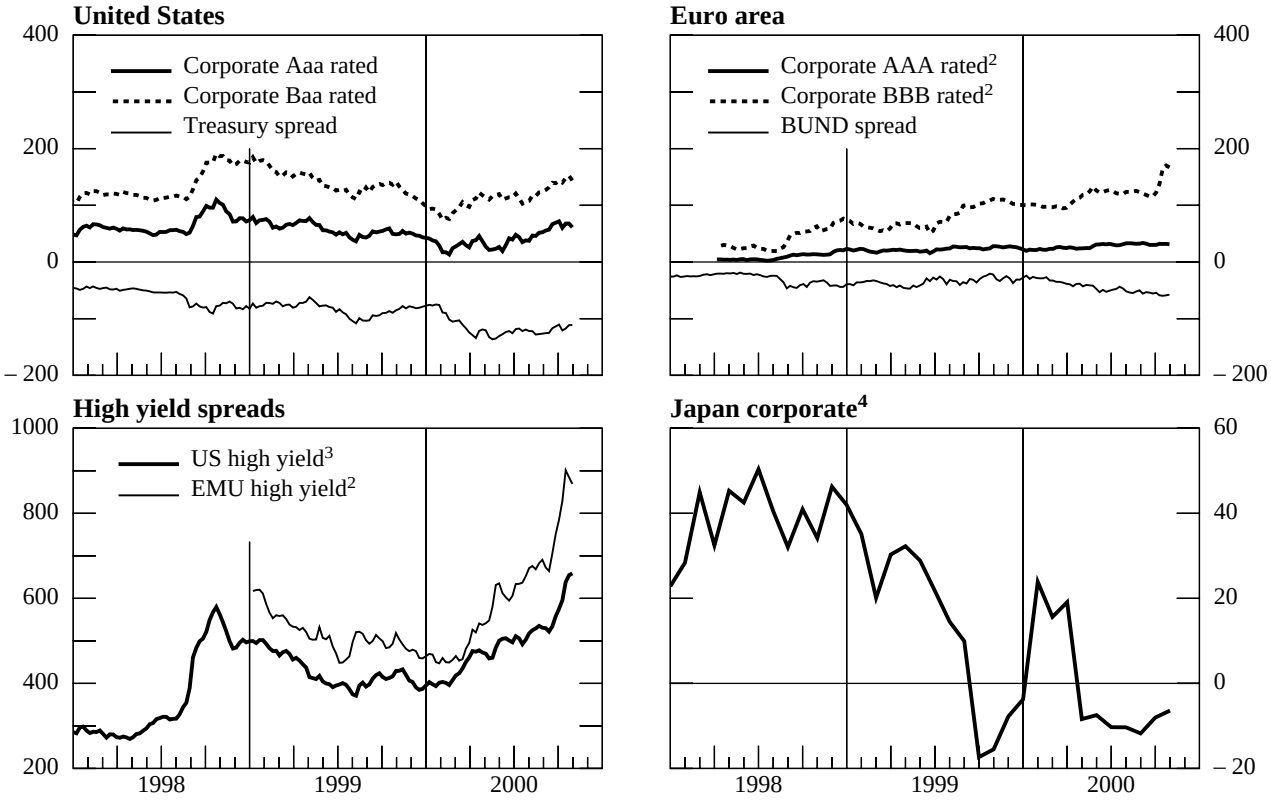
[1] For price/earnings ratio, weighted average of Euro area countries except Austria, Ireland and Portugal.
[2] IFC investable indices; for Asia, excluding Japan.

Sources: Datastream; IFC; national data.

Graph 11

Corporate and government bond spreads[1]

In basis points



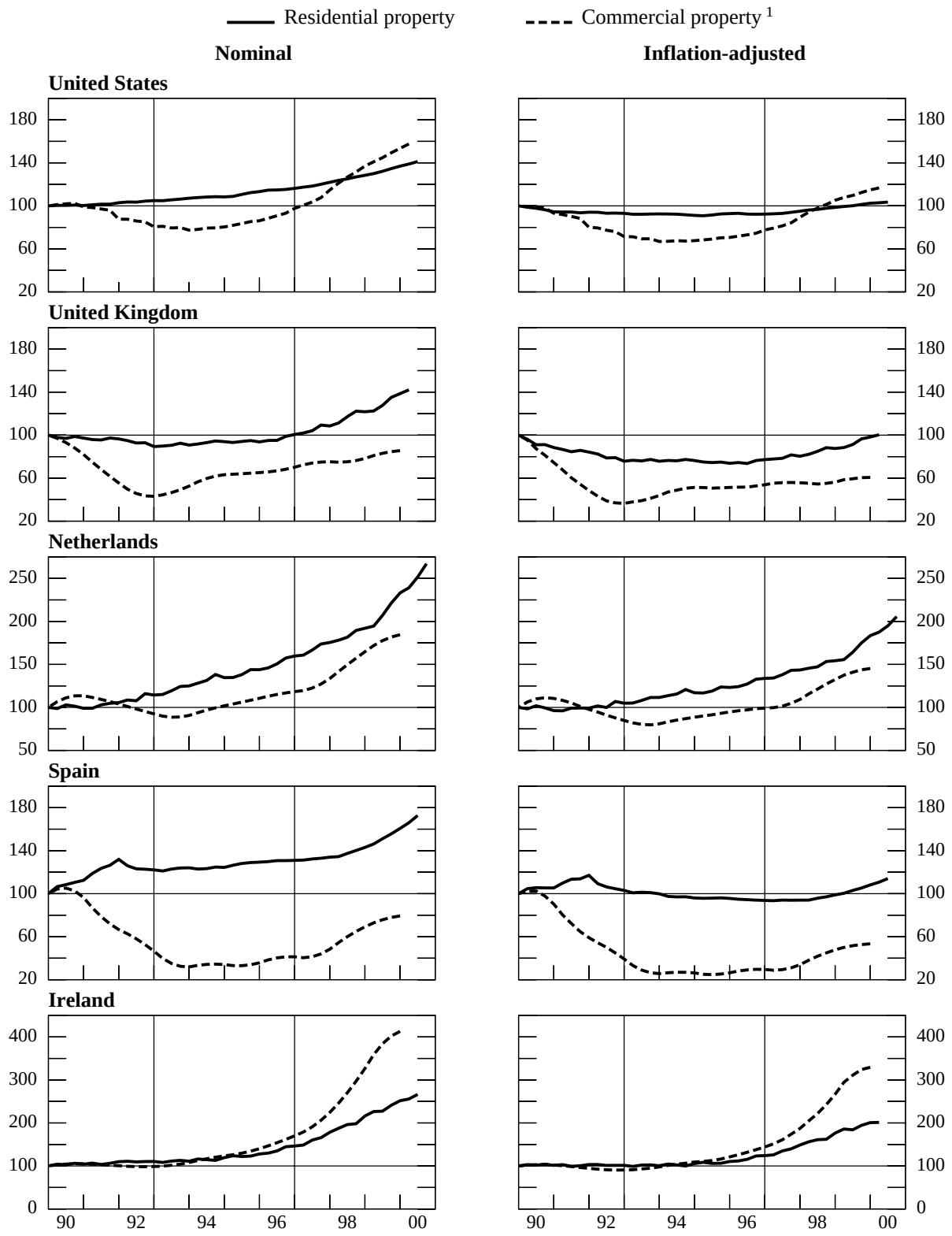
[1] Weekly averages against ten-year swap rates. [2] Merrill Lynch EMU versus government yields. [3] Merrill Lynch US High Yield Master II. [4] Three-month moving averages against 12-year swap rates.

Sources: Bloomberg; Datastream; national data.

Graph 12

Real estate prices

Fourth quarter 1989 = 100; quarterly averages



[1] For the United States, nationwide index; all others, commercial property prices of major cities.

Sources: US Office of Federal Housing Enterprise Oversight; Jones Lang LaSalle; Bloomberg; national data.

Table 3

Net long-term capital flows, the United States and the euro area

In billions of national currency

Items	United States		Euro area	
	1999	**2000**[1]	**1999**	**2000**[2]
Foreign direct investment	124.7	96.5	–138.8	201.0
Portfolio flows	213.8	345.5	–29.0	–288.5
Net long-term flows	338.5	442.5	–167.8	–87.5
Current account balance	*–331.5*	*–415.0*	*22.8*	*–24.0*

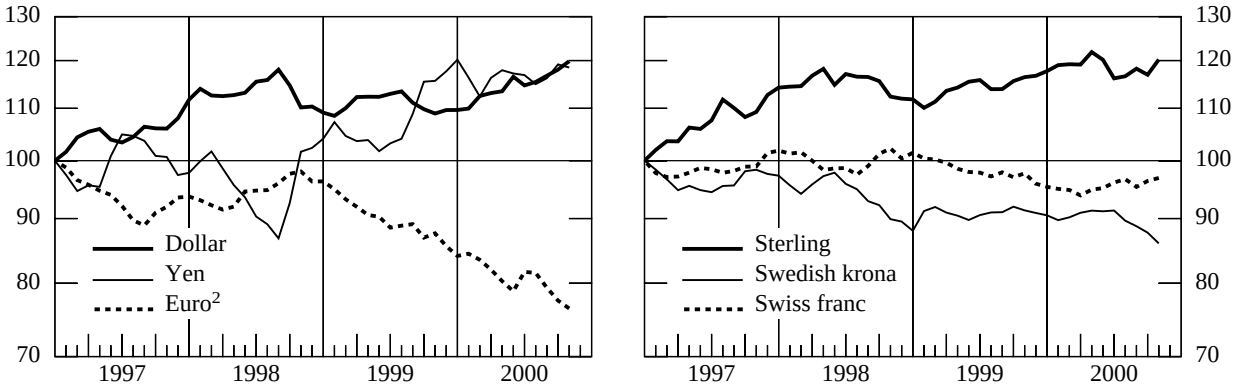
[1] Annualised, based on data for six months. [2] Annualised, based on data for seven months.

Source: BIS Databank.

Graph 13

Real effective exchange rates[1]

December 1996 = 100; monthly averages; semi-logarithmic scale

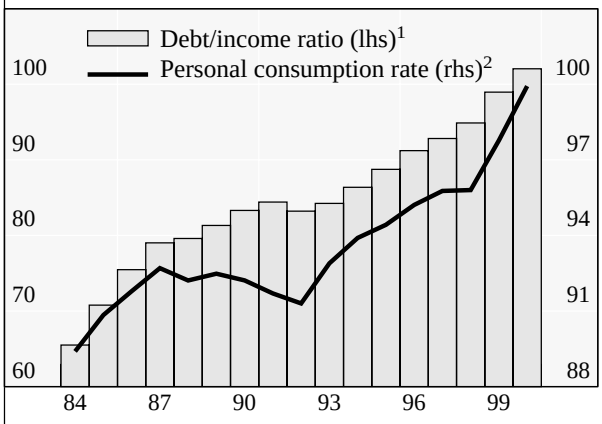


[1] In terms of relative consumer prices. [2] Prior to 1999, weighted average of euro legacy currencies.

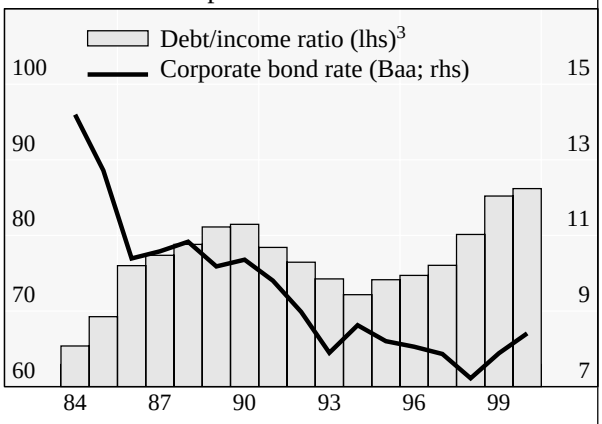
Graph 14

Private sector indebtedness in the United States

Household sector



Non-financial corporate sector



[1] Gross debt as a percentage of personal disposable income. [2] Personal outlays as a percentage of personal disposable income. [3] Gross debt as a percentage of GDP in the corporate sector.

Sources: Board of Governors of the Federal Reserve System; US Department of Commerce (data for 2000 are estimated).

Table 4

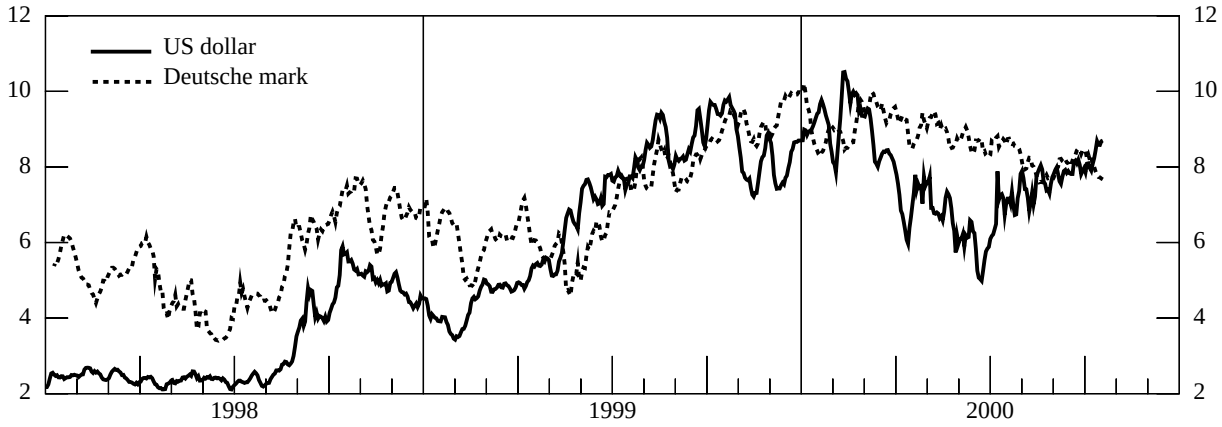
Telecoms Share Price Information as at 21 Nov 00

	Currency	*2000 High*	*Current Price*	*%Decline*
AT&T	USD	60 ¼	19 ½	68%
BT	GBP	1423	643.5	55%
Deutsche Telecom	€	103.6	38.4	63%
France Telecom	€	219	108.3	51%
Sprint	USD	67 ¼	24 ½	64%
Vodafone Airtouch	USD	6 ⅛	3 ¼	47%
WorldCom	USD	52 ¼	15 ⅛	71%

Graph 15

Yield curve arbitrage indicator[1]

Five-day moving averages



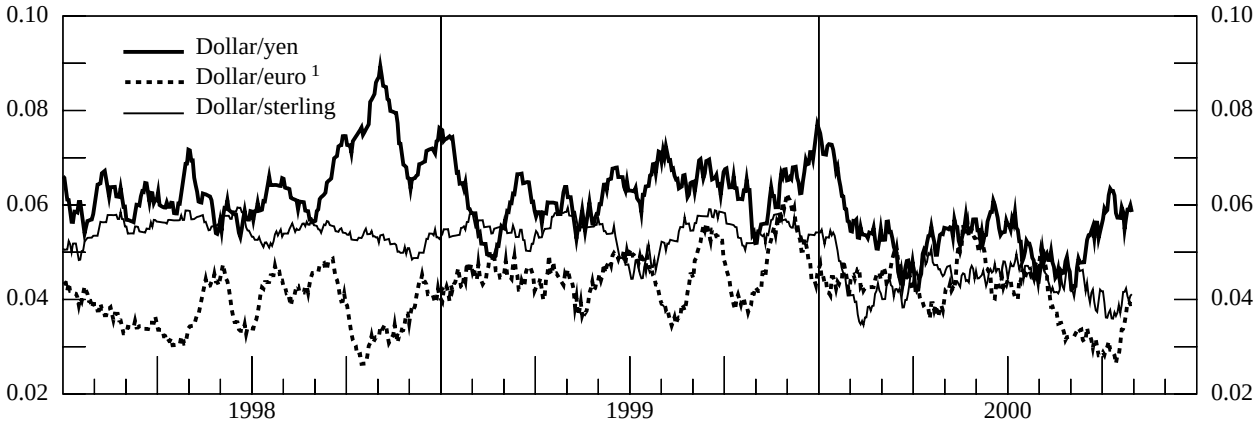
[1] Standard deviation of static spreads of all bonds over a zero coupon yield curve (excluding callable bonds).

Sources: Datastream; BIS calculations.

Graph 16

Bid-ask spreads of major currencies

Twenty-day moving averages; as a percentage of the bid-rate



[1] Prior to 1999, dollar/Deutsche mark.

Source: Standard & Poor's DRI.

Table 5

Net capital inflows to emerging Asia and Latin America

In billions of US dollars

Items	Emerging Asia[1]			Latin America[2]		
	1999	2000	2001	1999	2000	2001
Net private flows	30.0	62.0	76.5	67.5	78.5	80.0
Direct investment	52.5	50.5	53.0	72.5	51.0	48.0
Portfolio investment	18.0	26.5	18.0	–7.0	5.0	7.5
Banks	–40.0	–14.0	1.5	–15.0	4.0	4.5
Other creditors	–0.5	–1.0	4.0	17.0	18.5	20.0
Current account balance	*73.0*	*50.0*	*35.5*	*–49.0*	*–47.5*	*–59.0*

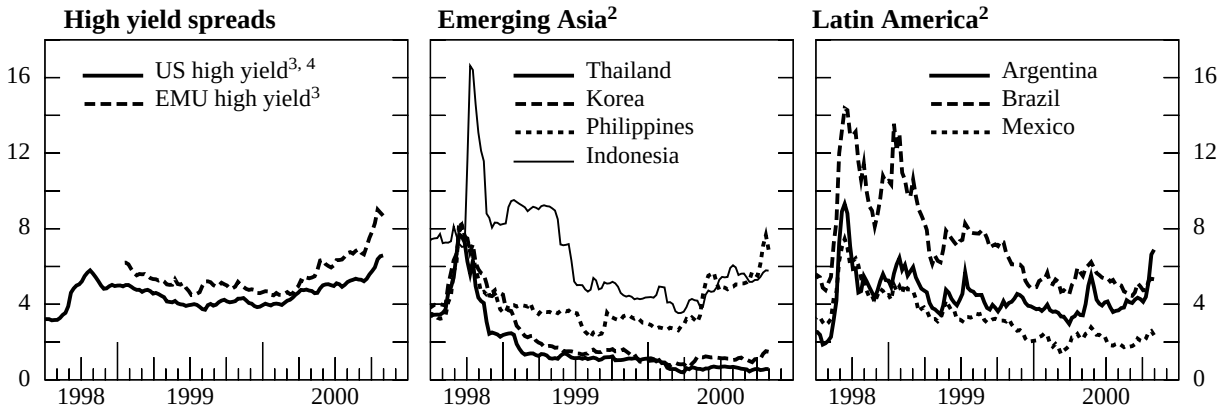
[1] China, India, Indonesia, Korea, Malaysia, Philippines and Thailand. [2] Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela.

Source: Institute of International Finance.

Graph 17

Yield spreads[1]

Weekly averages; in percentage points



[1] Against 10-year swap rates. [2] Of US dollar-denominated sovereign bonds. [3] Merrill Lynch. [4] US High Yield Master II.

Sources: Bloomberg; Datastream.