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The global economy: so far so good?[1]

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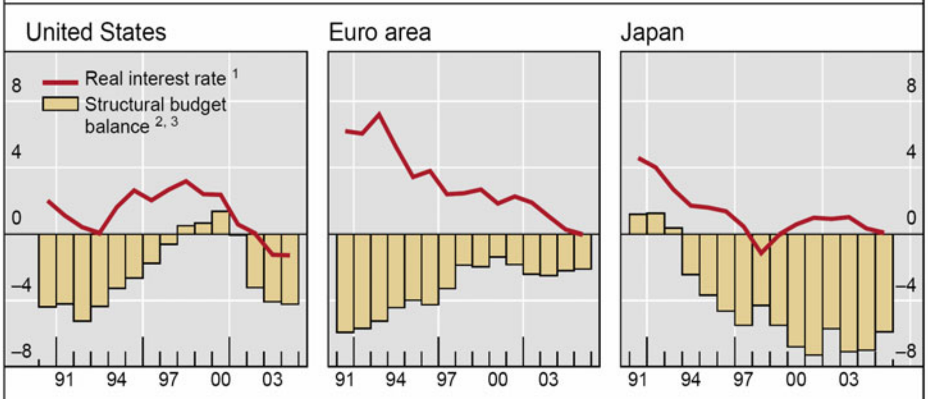
2004 was one of the best years for global growth. Global GDP grew by 5%, the highest rate since 1976. This performance is surprisingly strong given the sharp increase in commodity prices, not only oil. But the geographical distribution of global growth is uneven. The United States and emerging Asia - especially China and India - have been the principal engines of growth, accounting for more than half of global GDP growth.

This strong global growth has been supported by *expansionary macro policies*. Structural fiscal deficits remain large. The general government cyclically adjusted financial balance in the United States deteriorated from a surplus in 2000 into a deficit of more than 4% of potential GDP in 2004. In Japan, the deficit has been fluctuating between 6 and 8% of potential GDP for nearly 10 years. In the euro area the structural reduction of fiscal deficits in the 1990s, associated with the preparations for the launch of the euro in 1999, has not continued. Government deficits are fluctuating between 2 and 3%.

Real interest rate and structural budget balance



[1] Short-term interest rate deflated by annual consumer price inflation. [2] General government cyclically adjusted financial balance. [3] As a percentage of potential GDP.

Sources: ECB; OECD; Eurostat; national data.

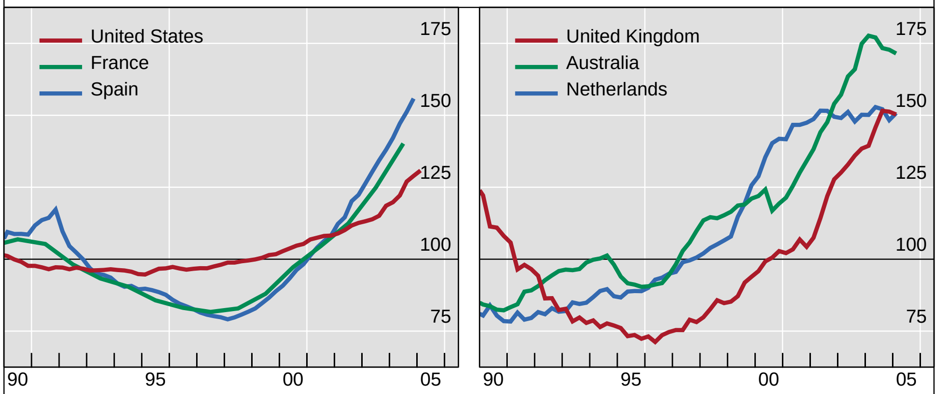
Accommodative monetary policies also contributed to the economic expansion. The real short-term interest rate deflated by annual consumer price inflation in the United States came down from +3% in 1998 to –1% in 2004. In Japan the real interest rate was negative in 1998

[1] Transcript of a presentation to the Belgian Financial Forum in Brussels on 8 July 2005. I am indebted to Philip Turner and Dietrich Domanski for their support in the preparation of the presentation. Many thanks to Frank Lierman, chief economist of Dexia Bank, for his strongly appreciated help in the preparation of this transcript.

and close to zero in subsequent years. In the euro area the real interest rate dropped from 7% in 1992 to zero in 2004. But even long-term government bond rates have been extremely low for many years. It is interesting to see that 10-year US Treasury yields are now 50 basis points lower than when the Federal Reserve began its tightening in June 2004. Long-term interest rates in the euro area have reached their lowest level ever. Meanwhile, credit spreads are close to historical lows, notwithstanding some widening in spring 2005. The gap between US and European interest rates is growing. These low interest rate levels are in part attributable to a rapid rise in saving by companies after the cleanup of their debt positions. But households are also increasing their saving ratio, as witnessed in Germany and the Netherlands. In Latin America government budget surpluses are up, and China still has a high saving ratio. There is certainly no lack of liquidity - on the contrary.

Households have taken advantage of exceptionally low interest rates. Investment in residential property has boomed worldwide. In the euro area, Spain and France have taken the lead. Housing equity withdrawal has supported consumption in the United States and the United Kingdom. House price/rent ratios have reached new highs in most countries and valuation levels appear stretched. The overall increase in house price/rent ratios is relatively modest in the United States compared to the levels in other countries considered, such as the United Kingdom, the Netherlands, France and Spain.

House price/rent ratios[1]



[1] 1980–2004 = 100; for Spain and the United Kingdom, 1987–2004 = 100.

Sources: Various real estate associations; national data.

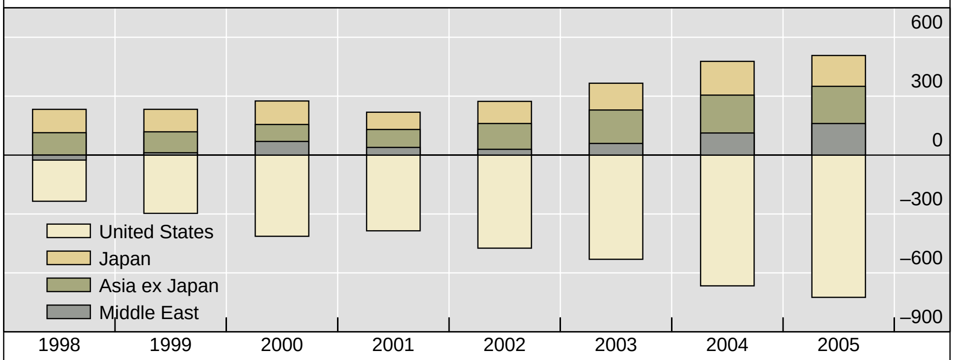
This buoyant housing market activity is associated with increasing household debt. Mortgage borrowing has risen sharply due to the low interest rates. Debt/asset ratios have been stable because of higher house prices, and debt service ratios have barely changed, also as a result of the low interest rates. But income growth has not kept pace with rising debt. Of course, aggregate spending is exposed to decelerating house prices and/or rising interest rates. A household saving rate of nearly zero in the United States is an additional risk factor.

Companies welcomed a strong increase in profits. Property and entrepreneurial income as a percentage of GDP increased worldwide. But business spending was surprisingly sluggish. In 2004 investment as a share of GDP picked up in the United States but not at all in Japan. In the euro area the increase was moderate. The levels reached are still below those of the second half of the 1990s, both in terms of growth rates and as a share of GDP. Firms are focusing on the restructuring of balance sheets, which is visible in the falling debt/equity ratio. Corporates are holding huge amounts of cash. This reflects the fear of being punished by capital markets in a downturn, as well as the uncertain outlook for domestic demand in the euro area. The substantial improvement in corporate credit quality is of course good news. Market-based measures of default risk, ie the expected probability in per cent that a company will default within one year, are very low everywhere. Stronger corporate balance sheets explain the better situation in the United States and Japan.

Global current account imbalances have widened further due to the uneven global growth. The US deficit is at a record high: the OECD forecasts a current account deficit of almost 6.5% of GDP for 2005. The US deficit has more than doubled since 1998. The current account surplus in Asia has remained high. The Chinese trade surplus jumped in the first quarter of 2005. A large shift in the terms of trade also contributed to the imbalances. The surplus of oil exporters is now as large as that of emerging Asia. An oil price of USD 60 per barrel could add substantially to the surplus of oil exporters in 2005. It is clear that investment decisions by Asian economies and oil exporters have an impact on international financial markets. The current configuration of *exchange rates* complicates the adjustment of current account imbalances. The real exchange rates of surplus countries in emerging Asia are well below long-term averages. The US real exchange rate is only less than 10% below its long-term average. Against this background, the recent strengthening of the US dollar is particularly puzzling.

Developments in current account balances

In billions of US dollars



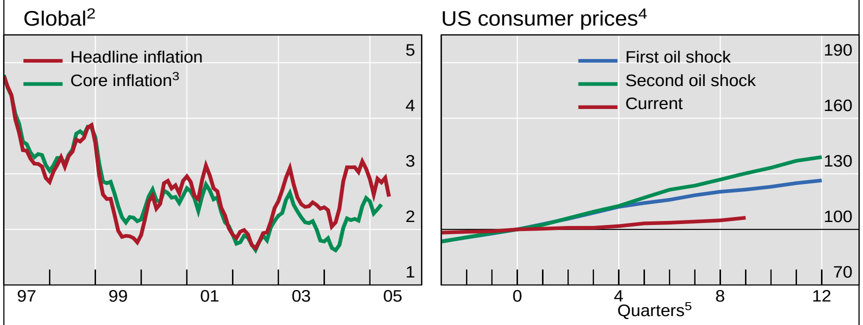
Note: 2005 figures are estimated.

Source: IMF, World economic outlook.

Inflation has remained subdued even after the increase in 2004: global headline inflation has increased from 2 to 3%, core inflation has climbed above 2%. This low inflation is striking in comparison with past episodes of rising oil prices: the first oil shock in the fourth quarter of 1973 resulted in a 40% increase in consumer prices after 12 quarters; the second oil shock in the fourth quarter of 1978 was good for +25%; now we have only 5% after eight quarters. This low inflation is attributable to reduced oil dependence, especially on the part of advanced economies, and well anchored inflation expectations. The integration of major emerging market economies into the world economy makes it easier to switch to cheaper suppliers in the world market. The steadily growing import penetration from China illustrates this effect (less than 1% in the 1970s, now already more than 12%). The total import penetration of the United States, Japan and the euro area increased during the same period from 8 to 20%.

Competition has also increased in *labour markets*. Huge wage differentials have encouraged migration, which now accounts for the lion's share of EU population growth (three quarters in the period 2000-03 against one quarter in the 1980s and as little as 20% in the 1970s). The mere threat of production relocation seems to have curbed the bargaining power of workers and trade unions. So inflation stays at a low level.

Inflation[1]

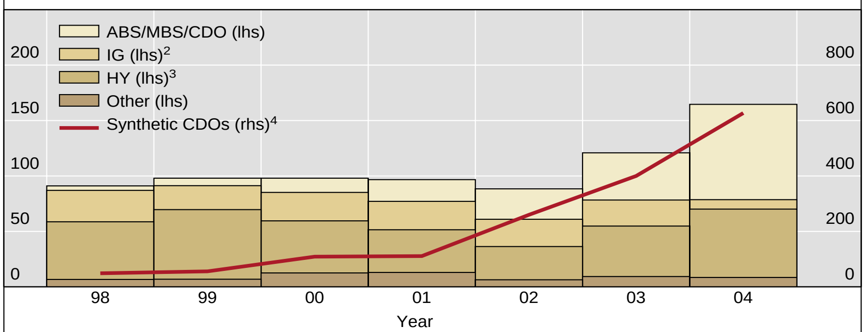


[1] Uncentred 12-month moving averages of annualised monthly changes in consumer prices, in per cent; weighted averages based on 2000 GDP and PPP exchange rates. [2] Industrial and emerging economies. [3] CPI excluding food and energy components. [4] All urban consumers. [5] Zero quarters correspond to 1973 Q4 (first oil shock), 1978 Q4 (second oil shock) and 2003 Q1 (current).

Sources: OECD; CEIC; national data; BIS calculations.

Financial institutions had a good year in 2004. Banks and insurance companies in industrialised countries reported higher profits and strengthened balance sheets. Consequently, default risk (ie the expected probability in per cent that a company will default within one year) has declined in the United States, Japan and the euro area. This reflects the improved credit environment and the healthy revenues from retail business. On the other hand, the search for yield continued to compress spreads in credit markets. Risk-taking by investment banks persisted at high levels and the hedge fund sector experienced large inflows while returns declined. The rapid growth of credit derivatives markets has transformed the trading and management of credit risk: the notional amount of ABSs (asset-backed securities), MBSs (mortgage-backed securities) and CDOs (collateralised debt obligations) quadrupled between 2001 and 2004; the outstanding amount of high-yield loans and bonds grew by 50%. This has contributed to a better dispersion of credit risk and increased the liquidity of credit markets. But the proliferation of new instruments such as CDOs has also raised questions. One issue is complexity: it is not clear whether all risks are fully appreciated. Another issue concerns the untested nature of these instruments: how will the new markets function under stress? It is very important to improve our understanding of how these markets function, and of their interaction with changes to the macroeconomic environment.

CDO issuance[1]

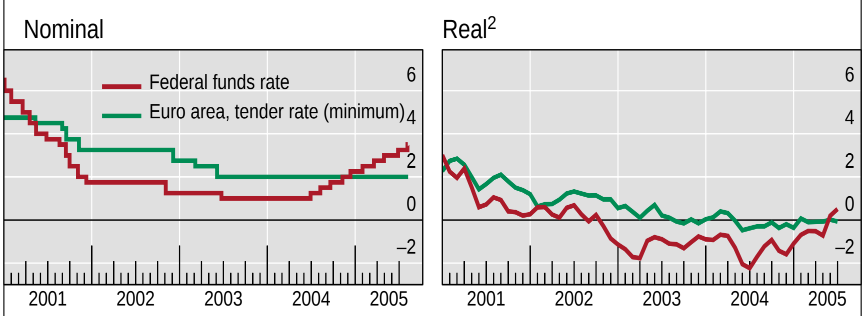


[1] Categories refer to primary collateral composition of cash CDOs (except for synthetic CDOs); in billions of US dollars. [2] Investment grade. [3] High-yield loans and bonds. [4] Total notional volume of synthetics (ie CDS protection sold to support issuance).

Sources: Bloomberg; JPMorgan Chase; BIS calculations.

What is the impact of these trends on monetary policy? The US Federal Reserve has pursued a policy of gradual tightening since mid-2004. The ninth 25 basis point increase in late June lifted the federal funds rate to 3.25%. The fact that the tightening was well advertised seemingly contributed to the unusual reaction of long-term interest rates. Real short-term interest rates turned into positive territory recently. In the euro area the ECB has kept policy rates on hold because of the much weaker economic performance: the output gap has increased, and business and consumer confidence is weak. Moreover, there is little evidence that high commodity prices have affected medium-term inflation expectations or wage setting behaviour. In the United States the output gap is closing and there is a belief that growth will be roughly in line with potential in the coming quarters, even with inflation at a relatively high level. Meanwhile, the zero interest rate policy in Japan continues. The Bank of Japan has linked the end of its zero interest rate policy to the end of deflation, and mild inflation has persisted until recently. Improved conditions in the financial sector have eased concerns about a deflationary spiral, but bank lending and money growth are still weak.

Policy rates in the United States and euro area[1]

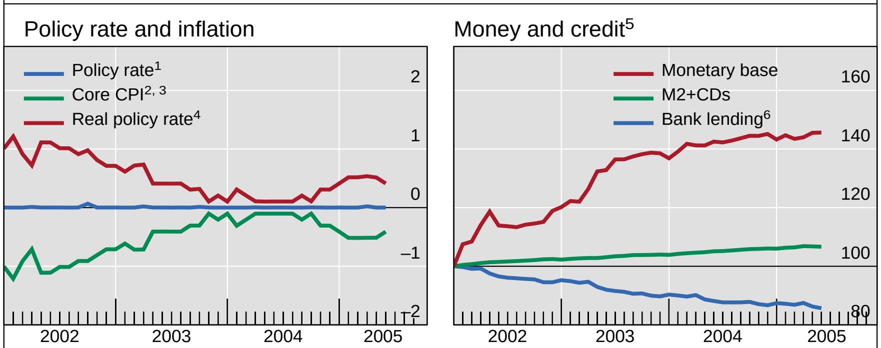


[1] In per cent. [2] Nominal rates less annual changes, in per cent, in the consumer price indices.

Sources: OECD; national data; BIS calculations.

Regarding *oil prices*, market participants expect that prices will remain high for a prolonged period. Long-dated oil futures are close to USD 55 per barrel and suggest that the equilibrium price of oil has moved upwards. So far the effects on global activity and inflation have been mild. The increase in real oil prices is still modest: they are currently about one third lower than in 1980. Second-round effects of higher oil prices are largely absent. But expectations that oil prices will stay high may change the picture. Corporations may try to pass on higher costs. Will heightened global and domestic competition limit the pricing power of corporations? At what point could higher oil prices do greater damage to the world economy?

Monetary indicators for Japan



[1] Uncollateralised call money rate at end-month, in per cent. [2] Annual changes, in per cent. [3] CPI excluding fresh food. [4] In terms of core CPI. [5] December 2001 = 100. [6] Lending by domestic commercial banks.

Sources: Bank of Japan; OECD; national data.

Looking forward, I see *three major challenges*. The first is restoring the medium-term fiscal balance. Sustainable fiscal policies are a precondition for effective monetary policy. Medium-term fiscal trends are unsustainable in major economies. Ageing populations require determined policy action. Fiscal consolidation in the United States would also support global rebalancing.

The second challenge is to allow greater exchange rate flexibility in Asia, to contain global imbalances but also to ensure sustainable growth with low inflation and no overinvestment.

The third challenge is the necessity for central banks to remain alert despite the benign inflationary environment. There is the rapid growth of new instruments and the greater risk taking in financial markets. There is also the growing exposure to interest rate risk, especially by households through mortgages. Finally, there is the combination of financial innovation and a long period of very low interest rates, which may lead to new, undetected vulnerabilities.