I. Introduction: old problems in a new era?

A decade of tumultuous economic developments ended with a year full of surprises, the majority of them welcome. Inflation stayed very low in most industrial and emerging market countries, while economic growth remained high in the United States, picked up in Europe and began to recover later in the year in Latin America. The turnaround in the fortunes of several crisis-hit East Asian countries was nothing short of remarkable, and China and India continued to expand at high rates. Even in Japan there were signs that the worst might be over. In financial markets, stock prices reached new peaks, generally led by companies in the high-technology sector. Issues of corporate bonds also set new records, with issuance in the newly (and smoothly) created euro developing particularly rapidly. All of these events were judged by most observers to bode well for prospects early in the new millennium, with the absence of any serious computer problems at the moment of transition being taken as another good omen.

The prevailing spirit of optimism was materially supported by recognition that the last decade had established a number of desirable trends. Technological advances were stunning and measured productivity in the United States increasingly seemed to reflect their influence. Furthermore, assuming adequate flexibility in labour, capital and product markets, there was no obvious reason why these transferable technologies could not bear fruit elsewhere. Indeed, this logic may have underpinned the infatuation with "new era" stocks on a global level. In addition, deregulation and privatisation proceeded apace, promising not only a more efficient allocation of resources, but also (through financial markets) new means to discipline irresponsible governments. Whatever the reason, the commitment to sound monetary and fiscal policies was widespread in both industrial and emerging market economies. Finally, it had become increasingly accepted that well functioning markets require a comprehensive infrastructure of legal, institutional and governance systems.

Ironically, as history has repeatedly shown, even well founded optimism has the insidious tendency to transform itself into excess. The probability of this happening seemed to increase during the period under review. The near universal underestimation of the strength of the expansion in the English-speaking countries (see Chapter II) and of the recovery in East Asia (see Chapter III) suggests that the underlying causes of this good performance remained less than completely understood. However, one disconcerting observation was that the various economic and financial forces at work seemed unusually interrelated. For example, in the United States rising stock prices (especially in the high-tech sector) added to personal wealth and facilitated business financing, contributing in turn to stronger consumer spending and

investment respectively. Higher demand and capital deepening raised measured productivity, which enhanced optimism about future profits, further supported stock prices, and so on. Clearly, mutually reinforcing processes of this sort can exaggerate both financial market and real fluctuations, particularly if accentuated by supportive exchange rate shifts.

A further reason for tempering optimism is that many of the imbalances and structural deficiencies which had characterised the global economy in the previous few years came no closer to being redressed. Indeed, in some respects they worsened. Foremost amongst these imbalances was the unprecedented gap between the record high rate of private saving in Japan and the record low rate in the United States. While shifts in fiscal positions moderated the impact of these extremes, albeit at the cost of a steep deterioration in the public finances of Japan, large current account imbalances remained, carrying risks of exchange rate consequences. As for reducing structural impediments to sustained growth, progress continued to be made in both Japan and continental Europe, although rigid product and labour markets remained a source of concern. In all regions, but perhaps particularly in East Asia, there was the fear that the political support for restructuring efforts would dwindle owing to the strength of the economic recovery. Thus, again, albeit in a different way, short-term optimism tended to undermine the very foundations necessary for longer-term optimism.

While recognising the prevailing uncertainty, financial market participants and monetary authorities in the industrial countries concluded that interest rates ought to be higher. Long rates on government bonds rose throughout 1999, although prices later rallied temporarily, and policy rates were also raised as many central banks concluded that action was needed to confront the risk of higher inflation. Nevertheless, at the time of writing, higher rates had provoked neither a clear reduction in the pace of economic growth nor any sharp break in important financial markets. In particular, while equity prices became much more volatile and technology stocks fell substantially, equities suffered no generalised retreat.

Inflation, interest rates and debt levels

In the prevailing circumstances, it seemed difficult to imagine that only a year previously some commentators had been worried about the prospect of global recession and deflation. The unanticipated evidence of stronger economic growth almost everywhere rightly refocused the attention of both markets and policymakers on inflationary pressures. Nevertheless, the fact that these pressures remained relatively muted confirmed the powerful effect of such underlying disinflationary forces as technological change, deregulation, excess capacity and fiscal restraint in many countries. Moreover, the possible interaction of higher interest rates, increased debt levels and widening imbalances heightened concerns about unpredictable, and possibly disinflationary, consequences at some point in the future.

The remarkable, uninterrupted and non-inflationary economic expansion in the United States continued last year, underpinned by both supply and

demand side components. On the supply side, unexpected wage moderation and capital deepening actually reduced unit labour costs as the unemployment rate fell below levels that historically would have triggered inflation. On the demand side, household consumption rose strongly, spurred by higher stock prices, expanding employment opportunities and rising confidence in a "new economy" based on high technology. Investment also rose strongly, with the high-tech sector again being particularly favoured. Moreover, many of these features were shared by the other major English-speaking countries, with the important exception that measured productivity gains elsewhere were generally less evident.

The decision of the US Federal Reserve to begin cautiously raising policy rates in mid-1999 (see Chapter IV) reflected a worry that demand was likely to continue to outstrip supply, even supposing the advent of a "new economy". Stepped-up government expenditures, responding to pre-election pressures and projections of massive surpluses, may have added to the arguments for restraint. Sharply higher oil prices, after a long period of decline, also raised concerns, even though the role of oil in the industrial countries has been much reduced. By spring 1999, these worries were being aggravated by more overt upward pressure on both prices and employment costs. The balance sheets of both households and businesses in the United States also suggested the need for some moderation in private sector behaviour. The household saving rate fell again during the year, accompanied by a further increase in indebtedness. Margin lending for the purchase of equities rose sharply, albeit to still low levels, and other forms of household borrowing also continued to grow rapidly. The sustained high level of equity prices may well have supported these propensities, given that over 50% of US households now own stocks. Corporate debt also expanded at a fast pace, reflecting strong investment growth and continuing share buybacks.

In sharp contrast, net private sector saving in Japan rose to a record high. Since the resultant dampening of demand was only partially offset by an increase in government dissaving, overall growth in the Japanese economy was very modest and deflation was barely avoided. Cautious behaviour on the part of both corporations and households played a role. Faced with the continuing burden of excess capacity inherited from the 1980s, firms cut investment further in spite of their growing expenditures in the high-tech area. With profits recovering in the wake of internal restructuring, priority was given to repaying debt.

As for the household saving rate, the upward trend that had begun in 1997 resumed after a slight dip in the early part of 1999. Households' anxiety stemmed from a number of sources. Corporate restructuring created worries about employment and hurt confidence. Perhaps of longer-term significance, growing government debt along with a rapidly ageing population raised concerns about future tax burdens and the viability of pension commitments. The Bank of Japan pledged to maintain its zero interest rate policy until a self-sustaining recovery was under way, and this helped support confidence and keep bond yields at low levels. Nevertheless, a threatened downgrading by Moody's, continued liberalisation in the Japanese financial system which will

offer savers new possibilities, and ongoing government deficits aroused concern that bond yields might rise before robust growth resumed.

The divergence in the saving behaviour of the US and Japanese economies was mirrored in the record US current account deficit and the persistently large Japanese current account surplus. Indeed, the US deficit rose to a record high as a proportion of GDP. In contrast, the euro area as a whole maintained a small, if declining, current account surplus, consistent with its intermediate cyclical position. For most of the period, the major exchange rates seemed more influenced by cyclical factors than by these external balance sheet considerations. Thus, a depreciating euro and a still strong dollar could continue to divert demand pressures to countries with relatively more excess capacity.

Starting in the second half of 1999, however, the unexpected weakness of the euro (even as European growth increased) and the very sharp appreciation of the yen (even as Japan fell into technical recession) implied that other factors were also at work (see Chapter V). In the former case, market commentary focused on the allegedly slow pace of structural reform in Europe and supposedly contradictory comments from policymakers. In the latter case, it was contended that the external surplus was at last beginning to have an effect, and that structural reforms would give a spur to profits. What is indisputable is that there were large recorded outflows of longer-term capital from Europe into both the United States and Japan, primarily into high-tech sectors promising attractive rates of return. In a sense, the newly created euro may have proved too successful. Larger and more liquid markets, along with relatively low interest rates, encouraged the issue of euro-denominated bonds whose proceeds could then be exchanged and used to finance investment elsewhere.

Whatever the cause of the shift in the yen/euro exchange rate, it was not deemed unequivocally helpful by policymakers in either Japan or the euro area. Conscious of the persistent fragility of the Japanese economy and the fact that policy rates could be lowered no further, the Bank of Japan intervened repeatedly to slow the yen's rise. The European Central Bank, given its focus on domestic price stability, was discomforted by the inflationary effects of depreciation at a time when commodity prices were also rising and wage demands in some countries looked excessive. As a result, the ECB first raised policy rates in late 1999, and this policy tightening subsequently continued.

The trend towards higher bond rates in the industrial countries (see Chapter VI) had no immediate effects on most emerging market economies. Inflows of foreign capital continued at about the same pace as in 1998 (ie still well below pre-crisis levels), with foreign direct investment being the primary vehicle and bank loans declining further. While the strength of the recovery in many Asian countries was unexpected, the dynamic process was rather traditional, beginning with expansionary macro policies, higher exports and inventory swings. In this context, the strong appreciation of the yen played in these countries' favour, as did the continuing heavy purchases of IT products by customers in both Japan and the United States. The fact that most Asian countries were growing fast, while still reporting large current account

surpluses, underpinned the currencies in the region and allowed central banks to keep rates low. In most countries, inflation remained subdued, which was a further positive factor.

What was more surprising was that higher interest rates in industrial countries had so little impact in Latin America and eastern Europe. Many countries in these regions had high levels of external debt and large current account deficits that had persisted through the previous deep recession. Yet the downward pressure felt by most currencies was not great and proved insufficient to derail a continuing modest upturn in economic growth. As in Africa and the Middle East, many countries in Latin America also benefited from higher commodity prices, although the effects varied greatly given diverse movements in the prices of oil, metals and other products. What particularly seemed to aid confidence was the new emphasis on fiscal restraint, even in the midst of recession. Markets viewed this as a regime shift which, in association with privatisation and other structural reforms, would provide a sound basis for sustainable growth. Whether such optimistic views prove correct will only be revealed in the fullness of time.

Structural and architectural achievements

Macroeconomic policies and demand-driven events work within a framework which includes the supply side of the economy, its financial structure and the host of international agreements and conventions comprising the "international financial architecture". While changes in these areas tend to be undramatic and evolutionary, it is here that the foundations of lasting prosperity must be laid.

Significant supply side reforms took place around the world against the backdrop of the apparent upward shift in trend productivity in the United States. This led to a large number of involuntary job losses, yet the unemployment rate fell continuously nevertheless. With this US experience in mind, many other countries began to adopt the more flexible practices characteristic of US labour and product markets. With respect to the former, some progress was made in Europe towards the adoption of plant-level wage bargaining, and preliminary evidence began to emerge that the natural rate of unemployment might be moving down as well. In France, the introduction of the 35-hour working week was rightly seen as a retrograde step, but significant efforts were subsequently made to use it as a catalyst for reforming outdated working practices. In Japan, the lifetime employment policy in large firms showed signs of breaking down, reflecting corporate cutbacks affecting the old as well as cultural changes affecting the young.

As for structural advances in product markets, many public utilities and telecommunications companies were privatised in Europe, and in a number of emerging market countries, often resulting in sharply lower prices for services. In spite of the enthusiasm of financial markets, progress in Japan was less obvious, although the gradual rationalisation of the distribution system continued, again putting downward pressure on prices. Moreover, there were growing indications that keiretsu links were breaking down, and that ties

with foreign firms were becoming more acceptable. In Korea, corporate restructuring seemed well under way, with strong support from the government. Although many of the chaebol shifted their focus from size to profits, the commitment to sell non-core businesses nevertheless remained largely untested. Finally, there was a remarkable upsurge of interest in the business uses of internet technology, both in Europe and in many emerging markets. Given the existing overhang of anti-competitive practices in many countries, this could eventually lead to even greater cost reductions than in the United States.

Structural change also accelerated in the financial sector, with credit provided through markets continuing to gain at the expense of traditional bank lending. International issues of bonds and notes soared, as did cross-border trading in equities, even as international bank lending continued to fall in the wake of the recent crises. Competitive pressures increased everywhere, and so too did the search for shareholder value. In this harsher environment, two important trends stood out. First, there was a sharp step-up in merger and acquisition activity among financial firms in all parts of the world. While these were largely domestic events in most industrial countries, the penetration of emerging markets by financial firms from industrial countries increased substantially. Second, in the context of further increases in the resources controlled by the professional asset management industry, there seemed to be a shift towards funds which had successfully specialised in "momentum" strategies.

A unique structural development at the beginning of 1999 was the successful introduction of the euro as a replacement for its legacy currencies (see Chapter VII). Almost immediately, money and interbank markets in the euro area began to function in a wholly integrated way, and issues of corporate securities denominated in euros rose to multiples of those characteristic of the legacy currencies. Lower-rated credits benefited particularly from this trend, as did markets for mortgage-backed securities. Somewhat in contrast, equity and government debt markets failed to consolidate. While due in part to the failure to date to construct a common trading and clearing infrastructure, national conventions continued to be a significant impediment to full unification. In this new environment, banks faced intensified competitive pressures from markets, each other and a whole host of foreign and internet-based challengers. Many banks consequently recast their growth strategies while making plans for internal rationalisation as well as external consolidation.

In many countries, earlier financial crises had led to the need for further bank restructuring. As a result, in much of Latin America, but especially Brazil, the banking sector had by last year become significantly stronger. However, and in spite of a sizeable increase in foreign penetration, Mexico was an apparent exception as legal and judicial shortcomings continued to restrain creditors' rights to realise collateral. In Asia, progress was quite appreciable in some countries, in particular Korea and Malaysia, but slower in others. To some extent, this was because the task of corporate restructuring needed to be tackled at the same time as bank restructuring, and this proved a considerable complication. As for the restructuring of banks in China, it remains difficult

to assess recent developments. In Japan, the fact that the Japanese banking premium almost disappeared seemed to indicate market participants' confidence in the underlying solvency of the system, as a result of ongoing mergers and the government's injection of equity. Credit growth, however, still failed to recover.

In the light of the succession of international financial crises since 1994, public sector authorities in industrial countries as well as emerging markets directed increased attention to measures to prevent crises, to manage them better and to eventually resolve them. While significant progress was made in some areas, many participants in the process also noted the proliferation of working groups and the apparent lack of coherence amongst them. To judge by the results of its first three meetings, the newly established Financial Stability Forum seems likely to provide an effective means for dealing with overlaps and gaps in this area, as well as giving useful guidance on how recommendations might be implemented in practice. This last task constitutes a huge and critical challenge for the international community.

In the realm of crisis prevention, groups of national experts continued to meet, many of them at the BIS, where they focused increasingly on drawing up or revising codes of good practice in financial behaviour. The work undertaken by all the Basel-based committees is described in detail in the chapter on the Activities of the Bank. Going beyond statements of principle, particular progress was made in implementing the Core Principles for Effective Banking Supervision, through the cooperative efforts of the Basel Committee on Banking Supervision, and its Core Principles Liaison Group. The IMF and World Bank, which began an ambitious pilot programme for assessing financial stability in the context of Article IV consultations, also made key contributions. With regard to crisis management, the debate focused on the trade-off between the provision of liquidity to support sovereigns in difficulty, on the one hand, and the problem of moral hazard on the other. Discussions on how a framework of rules might be blended with the exercise of discretion, and the implications for the terms and conditions of IMF lending, served to underline continuing differences of view about appropriate procedures.

Some limited progress was also recorded in the area of crisis resolution. With the encouragement of the IMF, a number of smaller countries negotiated both a restructuring and a writedown of the value of their international bonds, without any obvious spillover effects on the cost of such credit to other emerging market borrowers. Moreover, recognising that bondholders are increasingly important creditors, Canada, Germany and the United Kingdom took various steps to encourage the use of collective action clauses in new bond contracts. Finally, further hesitant measures were taken to ease the debt burden of a number of the world's poorest countries, some of which had also suffered from natural disasters. However, the issue of debt relief arouses powerful emotions, which has made the international process of forging agreement painfully slow. In this area, as in others, further progress is needed, perhaps along the lines suggested in the Conclusion of this Annual Report.