I. Introduction: the darker side of market processes

The sense of foreboding that pervaded the economic and financial scene in the period under review proved unwarranted. Without doubt, some bad things happened. The Asian crisis lingered on, reminding both those directly affected and those on the sidelines that the great strengths of a market-based system can be marred by institutional and other weaknesses. The spread of the turmoil to Russia was less of a surprise than the subsequent violent repercussions on financial markets of the Russian devaluation and debt moratorium. Attempts to flee from credit and transfer risks led to sharp drops in the prices of many financial assets, and a drying-up of liquidity in a large number of markets. Banks, hedge funds and other financial institutions in the major financial centres suffered massive losses and one financial institution previously respected for its market acumen was rescued from failure.

Still, events did not unfold as badly as some had feared. The crisis in financial markets in August and September last year was contained through a timely policy response. Moreover, the underlying infrastructure continued to function well even under unusual stress. The Brazilian real was devalued but this did not lead to the collapse of other exchange rate regimes in either Latin America or Asia. On the contrary, the overall impression in spring 1999 was that financial markets in Asia had stabilised and that the deep recession seen in many Asian economies had bottomed out. Even in eastern Europe, which might have been regarded as vulnerable, financial conditions generally remained calm and growth prospects weakened only a little.

A significant factor underpinning the good news which emerged over the last year or so was the continuing strength of the US economy. Past, and perhaps even anticipated, stock market gains amid plentiful job opportunities fuelled consumer spending and contributed materially to the seventh consecutive year of economic expansion. Unexpectedly subdued inflation played a major role by allowing interest rates to remain at low levels. Inflation was generally absent in Europe as well, where aggregate demand also strengthened on the back of consumer spending, a welcome development in the light of weak export growth and still hesitant business confidence and investment. The introduction of a common currency and the lowering of interest rates in most countries may well have contributed to this outcome. Of the major industrial countries, only Japan failed to advance.

The period under review was, however, also characterised by the continuation of some potentially worrisome trends in both the real and the financial sector. Divergences in economic growth both between and within country groups were remarkable. So too were trade imbalances. Real commodity prices hit 40-year lows and the prices of many tradable goods fell as well. In the financial area, credit growth in most industrial countries was again surprisingly strong, although still very weak in economies hampered by fragile banking systems. Equity prices continued to reach record highs in many industrial countries and property prices also began to move up. The US dollar stayed generally firm in spite of the increasing weight of external indebtedness and the perception that the euro, introduced on 1 January 1999, might become a competing reserve currency. Finally, under the influence of past excesses and recent deregulation, financial restructuring continued on an ever growing scale.

Developments that seem unusual, even unbalanced, need not necessarily be judged unsustainable. For example, the potential gains offered by new technology, particularly in the production of goods and financial services, may provide the sound rationale for a number of trends that currently seem hard to explain. Yet a starting point characterised by significant macroeconomic imbalances and major financial restructuring does not present a comforting environment for policymakers; given very low interest rates and virtual price stability in many countries, the scope for lowering real policy rates is now limited. This environment also implies a continuing need to focus on measures to strengthen the global financial system, which, after the events of last autumn, looks to be the most vulnerable part of our market-based economies.

This Introduction to the 69th BIS Annual Report is essentially retrospective. In contrast, the Conclusion is more forward-looking and focuses on the policy implications arising from the preceding analysis. Finally, the chapter on the Activities of the Bank sets out what the BIS itself has been doing to contribute to both monetary and financial stability at the global level. The Bank's activities, based largely on the work of the many committees of officials meeting in Basle, have recently expanded significantly, commensurate with the identification of a growing number of problems at hand.

Global disinflation and crisis dynamics

The process of global disinflation which has been under way for almost two decades quickened last year, leading to effective price stability in many countries and outright declines in price indices in some others. Within the industrial countries (see Chapter II), headline inflation fell on average to around 1½%, the lowest level since the 1950s. Among the emerging markets (see Chapter III), most countries in South-East Asia demonstrated an unusual degree of price stability given the need to absorb the impact of sharply lower exchange rates. In the People's Republic of China and Hong Kong SAR, exchange rate stability was maintained and domestic prices fell. In Latin America, traditionally a region of very high inflation, prices also fell in some countries while in Brazil the inflationary effect of the depreciation of the real in early 1999 was surprisingly muted.

It would be unwise, however, to simply extrapolate these average tendencies and conclude that global deflation is now the principal policy concern (see Chapter IV). Over the period under review, there was an unusually high degree of divergence in economic performance between the advanced industrial countries and emerging markets. Moreover, there were significant differences among the major industrial countries as well. Indeed, even within many industrial countries, the gaps between survey results for consumer confidence (high) and business confidence (low) were striking. The evolution of the global economy and global prices will depend importantly on whether the laggers follow the leaders or vice versa in all these different areas.

Relative to the industrial countries taken together, most emerging market economies generally had a difficult year. In much of Asia, with the notable exception of China and India, the best that can be said is that the worst seems to be over, although weak banking systems throughout the region will continue to impede economic expansion. In many of these countries, the sudden reversal of capital inflows forced a wrenching drop in economic activity to reduce imports. To date, the massive improvement in the Asian trade account is due almost entirely to this factor. Whilst Latin America and other emerging markets were initially relatively untouched by the Russian crisis, subsequent outflows of capital meant that Brazil and other countries were pushed towards or even into recession. The Middle East and Africa, for their part, were hard hit by low prices for oil and other commodities respectively.

If the advanced industrial countries as a group did relatively well, this was not true for all of them. At one pole was Japan, where output fell sharply, unambiguous signs of stabilisation failed to emerge, and price declines were widespread. At the other pole was the United States, and to a lesser extent the other English-speaking countries, where growth in 1998 and early 1999 generally exceeded expectations, while at the same time wages and prices remained remarkably stable. Continental Europe found itself in an intermediate position, with growth first firming and then softening, but with marked differences across national economies. The fact that this lacklustre performance was accompanied by concerns about rising wage costs in Germany, even with unemployment still very high, underlines just how divergent economic performance was.

With South-East Asia and Japan so weak, and much of continental Europe not strong, it is not surprising that commodity prices also reached record lows. Nor should it come as a surprise that the price of traded goods more broadly also fell, since there was substantial excess capacity globally in many industries. This was particularly the case in Japan and in Asia more generally, but was also true of the United States. Whereas the unemployment rate in the United States trended ever lower, measured levels of capacity utilisation in manufacturing fell, contrary to what might have been expected. In this environment of heightened global competition, profits also began to weaken, sharply in some countries and sectors. Elsewhere, in continental Europe in particular, profits were sustained through a combination in varying degrees of moderate wage growth, lower input prices, higher productivity and lower interest rates.

It is worth exploring the origins of the increase in global industrial capacity because it could have further implications for prices through a variety of channels. One reason why investment trends have been strong has been technological advances driving down the cost of new investments in information technology. Another has been the growing acceptance of market processes in many emerging and transition economies, often allied with a development strategy embracing foreign direct investment and export-led growth as well as subsidised domestic capital formation. But yet another reason is that, at any given moment, the cost of capital in at least one important financial centre has been at an artificially low level for well over a decade. The process may have begun in Japan in the late 1980s when a soaring stock market led to a marked increase in domestic capital expansion. In the early 1990s interest rates in the United States were unusually low, leading to a lower dollar and a sharp expansion of production capacity in Asian countries with currencies pegged to the dollar. Moreover, while much of this expansion was in some way linked to Japanese companies, a commensurate reduction in Japanese domestic production capacities was not evident. And in more recent years, Japanese policy rates have also been pushed to very low levels, while stock markets elsewhere have risen to record highs, accompanied by a wave of initial public offerings and mergers and acquisitions.

Associated with this process has been a more rapid rate of credit expansion and a related tendency to lower credit standards and increase risk-taking more generally. This has been most pronounced in Japan and other parts of Asia, where the adverse effects on the banks themselves are already all too obvious. But such behaviour has characterised the activities of financial institutions in other industrial countries as well, spurred by increasing competition and ongoing deregulation. The large inflows into Asia in the early 1990s, mainly loans from European and Japanese banks at generally declining spreads, are a good example of this. Another is the virtual explosion in the issue of sub-investment-grade bonds in the United States and unprecedented levels of both consumer debt and personal bankruptcies.

Periods of permissive or imprudent lending have many downsides. The first is that credit is increasingly used to push up the price of financial assets to unrealistic levels, even as increases in productive capacity push down the rates of return on the underlying real assets. The second is that accommodating attitudes on the part of lenders are also subject to sharp reversals. Mexico and Asia both experienced massive inflows followed by even more massive rates of outflow. With Asia suffering, flows to Latin America and Russia actually accelerated, only to completely change direction after the Russian moratorium. In response to that event, virtually all emerging markets were denied access to most forms of international credit almost overnight while lower-grade corporate borrowers suffered similarly (see Chapter VII).

The events set in train by the Russian moratorium also revealed a third potential downside to rapid credit expansion, namely the effects on highly leveraged financial markets. The Russian default was a catalytic event, changing the rules of the game for all those who had counted on some form of bailout. Credit spreads rose sharply and liquidity dried up in many secondary markets, reinforcing these rate movements. Moreover, the solvency of firms known to have speculated heavily on the narrowing of such spreads came increasingly into question. Margin calls came quickly, forcing the liquidation of whatever seemed salable under the circumstances and transmitting the turmoil into markets for prime quality bonds. Estimates of market risk exposure based on historical volatility rose above desired levels, leading to generalised attempts to reduce exposure which in turn only made the market turbulence worse (see Chapter V). Such tendencies were further reinforced as many investors recognised that their risk management procedures had in fact broken down and sought out safety and liquidity as an alternative. Before things finally calmed down, prices in many markets had demonstrated intraday variations many times greater than normal. The yen/dollar rate rose almost 7% in one day in October as highly leveraged borrowers in yen were forced to close out their positions (see Chapter VI).

Against this background, Brazil's inability in early 1999 to maintain the dollar peg of the real might have been expected to initiate a new phase of currency and market turbulence. In fact, the reverberations appeared to have been well contained at the time of going to press, perhaps because the devaluation was widely anticipated and much deleveraging had already occurred. Indeed, capital was beginning to flow back into many emerging markets, albeit subject to greater discrimination between different classes of creditors. Stock prices rebounded to near record levels in many industrial countries after the interest rate reductions of last autumn, further stimulating confidence and spending, and began to recover in South-East Asia as well. The continuing strength of the US economy and of the effective value of the dollar also had advantages; both helped strengthen export demand in countries where domestic demand remained relatively weak. In Japan, investors became less sceptical that the government's plans to restructure and recapitalise the banking system would prove effective and share prices rose significantly. Of course, whether this new optimism marks a definitive end to the crisis or only a temporary pause remains to be seen.

Crisis management and prevention

In this environment, it is not surprising that policy rates trended down almost everywhere. In the United States and the United Kingdom, rates were reduced in response to concerns about international financial stability and an anticipated weakening in spending. In continental Europe, as disinflationary pressures became more intense and markets became increasingly confident about the introduction of the euro, short rates converged without incident at low levels; the European Central Bank cut rates in April 1999. In an unprecedented move, overnight rates in Japan were effectively lowered to zero and the Bank of Japan sharply expanded its purchases of private sector paper. Policymakers in different emerging market economies generally responded to their crises similarly, often under the influence of IMF programmes. While rates had first to be raised to restore confidence in financial markets, they were lowered again when this objective had been achieved. Indeed, rates are now below pre-crisis levels in many Asian countries and have also begun to decline in Latin America.

Other policy instruments, some conventional and some not so conventional, were also used to help manage the crisis. Fiscal restraint was a common conventional response, though in Brazil insufficient steps were taken to reduce the widening budget deficit and the exchange rate regime could not be maintained. Prior to this, Brazil reacted to weakening confidence by issuing increased volumes of shorter-term debt and domestic debt indexed to the dollar (similar to Mexican tesobonos), but this approach eventually proved costly when devaluation occurred nevertheless. Analogous to movements in interest rates, fiscal policy was first tightened but then eased in many Asian countries in spite of concerns about rising debt ratios associated with the need for bank restructuring. In China, government spending on infrastructure rose markedly to maintain domestic demand.

Among the less conventional responses was the Japanese government's issuance of vouchers to stimulate household spending, as well as credit guarantees in favour of small and medium-sized enterprises. Another was the direct purchase of equities by the Hong Kong Monetary Authority, which argued that this was necessary to repulse speculators seeking to destabilise the local financial markets. Still another was the imposition of controls on capital outflows by Malaysia in September last year, while Argentina warned that it would replace the peso with the dollar rather than see the peso devalued. Finally, the IMF package for Brazil was unusual in that it was supplemented by $14.5 billion of bilateral financial support which had been arranged in advance of the crisis. This second line of defence was put up by the central banks of 19 countries and was organised primarily through the BIS.

Given the costs and difficulties of managing crises, it is not surprising that the issue of preventing future crises received much attention last year. One forum for the work was the Willard Group, an informal assembly of senior officials from industrial countries and emerging markets. Its three working groups made a number of concrete recommendations for improving transparency and accountability in both the public and the private sector, finding ways to strengthen domestic financial systems, and finding means of involving the private sector more closely in crisis management and resolution. These efforts complemented work taking place in more established forums such as the G10 Deputies and the various BIS committees of national experts (see the chapter on the Activities of the Bank).

One encouraging aspect of last year's discussions was that input was increasingly sought and received from emerging market participants likely to be directly affected by the outcome. This is the only way to give moral authority to collective decision-making in the absence of effective international law. A second encouraging aspect of recent developments is that the recommendations made are generally practical and realistic, being premised on incremental reforms rather than grand solutions. Given how jealously nations guard their sovereignty, proposals for the establishment of a global central bank, an international lender of last resort, a global super-regulator or an international bankruptcy court are unlikely to be acted on in the foreseeable future. An important implication of this practical approach is that the work required to implement a wide variety of small but sensible reforms will be highly demanding, an issue taken up in the Conclusion of this Annual Report.

If the journey towards a financial world more resilient to crises is likely to be a long one, it has at least begun. Transparency is one area where significant progress has already been made. While previously available BIS statistics gave a reasonably accurate and timely picture of the debt exposure of Asian countries, improvements could be and already have been made. In a similar vein, the agreement on a set of standards for the disclosure of national foreign exchange reserves, including off-balance sheet claims, was a welcome advance on the partial information available earlier. Finally, it should be noted that a number of official initiatives are under way to find out more about the activities of highly leveraged financial institutions and those who finance their activities. A working group set up by the Basle Committee on Banking Supervision issued in January this year two reports concerning the involvement of banks. The recent events in Asia and those surrounding the Russian crisis provided at times alarming evidence of how complex the interactions between markets and financial institutions can be, and how quickly one form of risk can turn into another given high levels of leverage.

With respect to strengthening domestic financial systems, perhaps the single most important initiative of recent years has been the agreement on a set of Core Principles for Effective Banking Supervision. This approach of agreeing on international standards of good practice has already been widely emulated, by securities regulators and insurance company supervisors in particular. Last year, similar initiatives were undertaken in the area of payments and settlements, transparency in the conduct of monetary and financial policies, and corporate governance. The Basle Committee's proposed update of the 1988 Capital Accord will provide another useful guideline for the international banking community. The planned revisions will mark a further step towards reliance on market discipline to complement traditional supervision and an enhanced use of internal risk models for the calculation of regulatory capital requirements.

Given the scale of private capital flows, the private sector will inevitably have to become more fully and directly involved in crisis management and resolution. Many of the recommendations made by the G10 Deputies after the Mexican crisis in 1995 were reiterated subsequently, although they have not been acted upon to date. Nevertheless, several recent developments have been significant. Efforts to ensure the concerted, but voluntary, renewal of commercial bank credit lines were a central feature of the management of the Korean and Brazilian crises. The insistence of the Paris Club that international bonds be included along with bank loans in Pakistan's debt restructuring also established an important precedent. Finally, having suffered heavier losses in 1998 than at any time since the 1980s debt crisis, creditors became much more aware of their risk exposure. However welcome these developments may be in terms of reducing future excessive capital inflows into emerging markets, they may at the same time have increased the tendency for private sector capital that is already there to be withdrawn pre-emptively. Clearly, it will be important to proceed judiciously in this area given the difficulties still faced by many emerging market borrowers in accessing global capital markets.