# I. Introduction: a sudden change of fortunes?

The most significant development during the period under review was the sharp slowing of the US economy beginning in the second half of last year. Although a slowdown had long been expected, and even desired, its suddenness was remarkable for a variety of reasons. It seemed to mark the ending of, or at very least a significant pause in, the decade-long global expansion in which the US economy had played a disproportionate but welcome role (see Chapter II). It was accompanied by an apparent interruption of recovery in Japan, as well as by a slowdown in many emerging markets (see Chapter III) and, albeit to a considerably lesser degree, in Europe. And it profoundly disappointed those who had hoped that a "new economy" based on information technology had made both inventory cycles and sharp fluctuations in investment spending a thing of the past.

The usual suspects were quickly rounded up to explain this global turn of events. Oil prices had risen sharply, affecting spending in many emerging market economies even more than in industrial ones. Short-term interest rates had been raised in all the major industrial countries either to resist incipient inflationary pressures or, in the case of Japan, to restore a more normal policy stance in response to some signs of economic recovery. Financial markets were also thought to have played a role as, everywhere, new economy stock indices had fallen substantially from peaks reached in March 2000. Worldwide credit conditions had also tightened, unevenly but inexorably over the year, particularly for lower-quality credits. In these circumstances, some slowing of spending was regarded as natural, and indeed welcome, in countries operating at full capacity. So too was a reversal of the previous trend towards monetary tightening in the countries most affected by the slowdown. In the light of postwar economic history, all of this could be described as a normal development.

Yet, at the same time, there were concerns that less usual forces were at play. The preceding upturn seemed to some observers to have certain of the characteristics of business cycles prior to the First World War; a novel comparison but perhaps not inappropriate given the relentless tide of financial deregulation and globalisation that has typified the last few decades. As with earlier technological revolutions – the canal, the railway, electrification and the car – there was a pronounced increase in related capital accumulation, with the information technology and telecommunications sectors being most favoured in this current cycle. Associated with this, and reinforcing it, were sharp increases in equity prices which encouraged the abundant supply of low-cost venture capital. Moreover, with inflation generally low or falling,

real interest rates stayed relatively low. While these trends were particularly evident in the United States, to varying degrees other countries shared similar experiences. The ensuing perception of global vulnerability, should anticipated benefits fail to materialise, probably contributed to the willingness of many central banks to lower interest rates once the Federal Reserve initiated an unusually aggressive phase of monetary easing in January this year (see Chapter IV).

A further and welcome characteristic of the last few years of expansion, which continued throughout the period under review, was the quiescence of aggregate measures of inflation. In a wide range of countries, both emerging markets and industrial economies, measures of core inflation reacted in an unexpectedly muted way to pressures arising from low unemployment rates, exchange rate depreciation and higher oil prices. In part, this was the result of the greater production capacity, particularly for manufactured goods, generated by the previous long period of heavy investment. Yet other factors also played a role, such as the deregulation of product markets, the globalisation of trade in goods and services, fiscal restraints and the growing credibility of central bankers' anti-inflation objectives. All contributed to creating a "buyer's market" which acted both to dampen inflation and to keep it low.

Of course, with prices generally more sticky, shocks such as higher oil prices had to be absorbed in other ways if profits were not to be affected. This was successfully achieved for much of the period under review. In the United States, most of Europe and Japan, nominal wage increases were surprisingly restrained, reflecting better functioning labour markets in the first two cases and job insecurity and depressed conditions in the last. Moreover, throughout the global economy, there was evidence of a virtuous circle of wage moderation following the moderation of prices. And finally, in the United States in particular, significant gains in labour productivity had been recorded over the previous few years, which helped to contain prices without squeezing profits. Nevertheless, the outlook for profits in many countries has deteriorated sharply in recent quarters, with new economy sectors worldwide being especially hard hit. This contributed materially to the worsening of conditions in financial markets, which then began to feed back to the level of global economic activity.

Another recent feature of ongoing globalisation has been the ease with which large divergences in national saving rates have been dealt with through international capital flows. In the United States, the net private saving rate fell below –6% of GDP last year (a decline of 12 percentage points since 1992), whereas in Japan net private saving rose to almost 9%. While fiscal balances provided some domestic offsets, significant current account imbalances remained, which were accommodated through massive capital flows into the United States, increasingly in the form of equity purchases and foreign direct investment. More broadly, a similar divergence of saving patterns could be seen when contrasting the high-saving Asian and European economies with those of the western hemisphere. Again, foreign direct investment played a large role, particularly in Latin America, in financing the resulting current account deficits.

The capital flows into the United States, as well as other recipient countries, were driven in part by the quest for diversification and perceived opportunities to earn above average investment returns. As a by-product, however, they provided strong support for the US dollar (see Chapter V), which in turn helped to tame inflationary pressures. The fact that the dollar remained strong, even after clear signs of an economic slowdown in the United States, may indicate that the market judged this to be only a temporary interruption before the growth potential of the new economy reasserted itself. A complementary explanation could be that the safe haven aspect of the reserve currency, particularly given perceptions of sound fiscal and banking systems, received increased emphasis as uncertainties mounted about global economic prospects. Whether these assumptions and perceptions will be validated over time remains to be seen.

Not all countries with a need for external borrowing had a similarly easy time. Among other reasons, continuing fiscal excesses in Argentina and fundamental problems in the banking sector in Turkey led to strong interest rate and exchange rate pressures, and in the latter case to a sharp currency depreciation. By the end of April, there had been relatively little contagion from these incidents. Not only was there less leverage in the system than during earlier crises, but international financial markets seemed increasingly adept at distinguishing between different degrees of credit risk (see Chapter VI). The fact that many adjustable peg exchange rate regimes had been replaced by some form of managed floating is also likely to have played a role.

In the period under review, a number of steps were taken to promote a healthier international financial system. Ongoing efforts to improve domestic financial and payment systems, often reflecting the pursuit of internationally agreed best practices, were observable in many emerging market countries. Moreover, intensified competition and consolidation within the financial sectors of the industrial countries drew increased attention from policy-makers. There was a growing consciousness that rapid financial changes and associated credit expansion had historically led to a variety of difficulties (see Chapter VII). The fact that officials were regularly assessing such vulnerabilities was welcome but, of course, no guarantee that the problem of recurrent financial crises had been eliminated.

## Sentiment, asset prices and macroeconomic developments

While shared shocks and real and financial interdependencies increasingly shaped the global economy, idiosyncratic developments related to mood and sentiment in the major regions remained of great significance. Nowhere were economic developments more dramatic than in the United States, where GDP growth accelerated to almost 6% in the first half of 2000 under the influence of strong consumer spending and a further large increase in business fixed investment. Both owed much to the earlier strength of stock markets, which increased consumer wealth while also reducing the costs of business financing. Ready access to credit from a widening variety of sources, many of them foreign, also played a supporting role. Underpinning it all was a

feeling of well-being arising from the belief that new information and communications technology had set both productivity and earnings on a permanently higher growth path.

Yet, as the year progressed, signs began to emerge that risks were accumulating. The Nasdaq fell and kept falling, as did other indices to lesser degrees. As a consequence, nominal household wealth in the United States actually declined in 2000 for the first time in the postwar period. Conversely, household liabilities and debt service requirements as a percentage of personal disposable income rose to near record levels, while the personal saving rate fell still further below zero. While corporate debt levels were in aggregate further from historical highs, the circumstances of smaller enterprises became more problematic. Banks imposed much stricter lending standards, bond market financing for non-investment grade borrowers became almost unobtainable for a time, and vendor financing by technology equipment suppliers also tightened.

Final domestic sales in the United States slowed sharply in the fourth quarter, with all components sharing in the downturn, and consumer confidence also declined markedly. Measured profits fell and profit warnings came in rapid succession. Moreover, there was a growing awareness that reversible factors might have inflated reported profits or diluted share values: rising stock prices encouraged holidays for pension contributions; the growing use of stock options created corporate tax benefits and the potential for shareholder dilution; and the use of common stock to make acquisitions at inflated price/earnings multiples reduced the claims of acquiring firms' shareholders still further. Nevertheless, more favourable economic indicators subsequently reinforced the conviction of those who expected the economic downturn to be only temporary. In particular, the reduction in inventories in the first quarter of 2001 was much greater than had been expected. Moreover, consumer spending held up surprisingly well given announcements of job losses and further recorded declines in consumer confidence.

The sudden change in US economic circumstances was reflected in an unusually rapid shift in the stance of monetary policy. Broadly, both the earlier tightening and later easing phases were consistent with a desire to moderate the business cycle while continuing the pursuit of domestic price stability. Yet, given the increased importance of financial asset prices in the United States and their related dependence on confidence, the Federal Reserve faced significant if subtle constraints on its behaviour. In particular, it was more vital than ever that the decline in rates be judged neither too small nor too large: too small, and spending might fail to revive; too large, and the result might be euphoria in financial markets or, conversely, panic, if markets felt the Federal Reserve knew something they did not. In the event, the first substantial easing in January did lead to a sharp loosening in credit conditions, which further monetary easing helped to sustain. It was also fortunate that another potential constraint on the Federal Reserve's willingness to ease, a rebound in domestic inflation, did not materialise in as substantial a way as might have been expected given earlier increases in energy prices and the more recent acceleration in unit labour costs.

The Japanese economy remained generally weak but demonstrated a similar quarterly pattern to that seen in the United States. Whereas faith in new technology preserved an underlying spirit of optimism in the United States, in spite of the slowdown in the second half of last year, a different sentiment prevailed in Japan. The country was still suffering the consequences of the collapse of the bubble economy a decade earlier – excess industrial capacity and low profits, falling asset values and continuing weakness in the financial sector. Moreover, given the authorities' persistent inability to deal decisively with these issues, popular disappointment about the current situation was matched by the belief that the future was likely to bring only more of the same.

Industrial production in Japan did rise temporarily in the first half of 2000, reflecting the recoveries in the United States and Asia. This generated both higher profits and increased investment, particularly in the IT sector. However, as the external stimulus receded and the effects of the earlier strengthening of the yen became more apparent, this promise faded. Consumers, in contrast, were hesitant throughout. Having previously suffered major losses to their personal wealth, doubtful about the status of unfunded pension schemes, and facing threats to both earnings and employment as industrial restructuring slowly proceeded, consumers were more inclined to save than to spend. Declining retail prices, partly due to positive supply side developments, may have further encouraged this "wait and see" attitude.

For their part, the macroeconomic authorities used what little room for manoeuvre they still had. The zero interest rate policy was briefly suspended as economic conditions seemed to improve during the summer, but was then effectively reimposed in the form of an explicit quantitative target for banks' excess reserves. At the same time, the Bank of Japan stated that this policy would remain in place until consumer prices had stopped falling. This commitment was expected to help sustain the impressive and welcome decline in longer-term rates in the second half of the year. Fiscal policy provided further stimulus to the economy, though its effects were increasingly mitigated by the growing recognition that loss-making investments and government guarantees would eventually prove a significant burden to taxpayers.

Hopes that slow growth in the United States and Japan might be offset by faster growth elsewhere were only partially realised. Like the United States, the other major English-speaking countries grew uncomfortably rapidly in the first half of the year, but most also showed signs of sharp deceleration later, accompanied by interest rate cuts. Only the United Kingdom bucked the slowing trend though, even there, policy rates were ultimately lowered in the light of prospective developments.

Nor did economic activity in the euro area speed up as hoped, although the deceleration in growth was at least less pronounced than elsewhere. With levels of domestic demand relatively robust, reflecting increasing consumer confidence as employment rose unusually rapidly, continental Europe seemed for a time to be insulated from developments elsewhere. Even so, the two-year declining trend of the euro exchange rate failed to reverse decisively. Moreover, the weak euro along with higher oil prices helped to push headline

inflation above the ECB's objective for price stability. When, towards the end of the period under review, indicators showed slowing growth and somewhat improved inflation prospects, there was an eventual cautious easing of policy by the Eurosystem. Indeed, given the recent record of fiscal restraint, it was even possible for a number of European countries to cut tax rates. While originally motivated by structural concerns, the demand side effects of these tax cuts promised to provide a welcome underpinning to future growth prospects.

The emerging market economies recorded an average real growth rate of 6% in 2000. Moreover, all of the major regions and virtually all of the largest economies shared in the expansion. Nevertheless, various signs of stress gradually emerged and stock prices fell on a broad front in the wake of the decline in the Nasdaq. Export growth also tended to decelerate, though in some countries rising domestic demand provided a partial offset.

Export orders for electronic products fell everywhere, but particularly sharply in East Asia. Knock-on effects on exchange rates, however, were much more muted than in 1997 given the trend towards floating, generally positive trade balances, high levels of reserves and a much reduced reliance on short-term capital inflows. China and India were affected to a lesser degree, as they remain relatively closed economies, though each continued to face domestic difficulties arising from still pervasive state ownership and associated fiscal problems. In Latin America, Argentina's persistent inability to control its fiscal deficit raised questions about its debt service capacity and the possible need for debt restructuring. As a result, Argentine bond spreads temporarily rose above 1,000 basis points, and spreads on some other sovereigns also started to widen. Elsewhere in the region, more rapid growth began to lead to inflationary pressures which, while far removed from historical norms, nonetheless prompted a number of central banks to tighten monetary policy. And, with the exception of the oil producers, concerns mounted over the continuing large trade deficits of countries in Latin America and central Europe and their potential exposure should the confidence of foreign investors begin to waver.

## Coping with financial fragility

Over the last 20 years, recurring crises have provided graphic evidence of how problems in the financial system can both generate macroeconomic disturbances and seriously amplify their costs. Some deficiencies have to do with individual institutions, others with market functioning, and still others with the properties of the global financial system itself. Not surprisingly, given concerns about level playing fields as well as contagion effects, extensive efforts have been made by governments in recent years to identify financial vulnerabilities and to deal with them. As doubts surfaced about the durability of the global economic expansion, these efforts took on a new importance.

Some of the financial vulnerabilities highlighted in the period under review were of old vintage. Chief among them was the failure to muster enough will

to restructure decisively the Japanese corporate and banking system. Indeed, allowing the merger of large banks without requiring restructuring implied maintenance of the status quo. Similarly, the extension of the deposit insurance programme and a renewal of government attempts to support declining stock prices may have discouraged banks from taking decisive restructuring measures themselves. The fact that the supervision of financial institutions improved, and that new and more demanding accounting standards were proposed, only partly compensated for these broader shortcomings. Elsewhere in East Asia, financial sector restructuring generally proceeded, but often still not far and fast enough. Broadly speaking, banking systems had not yet been restored to profitability and growth in bank credit remained weak. In central Europe and Latin America, the trend towards the greater involvement of foreign banks continued. On the one hand, this was welcomed since their new capital, technology and management skills were expected to contribute to local financial stability. On the other hand, there were concerns in some countries that foreign entities lacked both the will and the expertise required to lend to smaller, local enterprises.

Some of the other worries which surfaced in the period under review were inherently less concrete. In spite of high levels of profits and capital, banks in some of the countries furthest ahead in the business cycle were suspected of having become inadvertently exposed to credits of higher risk. The fact that loan loss provisions were low was one factor behind these suspicions. Large volumes of syndicated loans to telecoms companies were a further concern, especially in Europe, as it became less likely that these would be quickly paid back using the proceeds of asset sales, initial public offerings and bond issues. A similar set of worries arose in the context of difficulties faced by some issuers in rolling over outstanding commercial paper, which implied that previously negotiated standby lines with banks might be drawn upon. In both cases, anxieties were accentuated by the surprising speed with which a number of previously highly rated companies were downgraded to less than investment grade credit status.

Partly in response to such developments, there was a broad tightening of credit standards by banks in many of the industrial countries and a general widening of credit spreads in traded markets. Yet, in contrast to previous episodes, concerns about the credit standing of financial institutions did not seem to spill over into reduced functioning or liquidity of financial markets. To some extent, this was because of the more cautious attitude that the main dealing institutions had taken towards large trading exposures.

Longer-term efforts to promote a healthier financial system were vigorously pursued. Particularly notable and welcome were the efforts made by the Basel Committee on Banking Supervision, working closely with emerging market supervisors and the private sector, to develop a more risk-sensitive Capital Accord. Details of these as well as the contributions made by other Basel-based groups and committees can be found in the chapter on the Activities of the Bank. Moreover, under the aegis of the Financial Stability Forum, related progress continued to be made in developing standards that could contribute to financial stability, and in providing recommendations

pertaining to problems posed by highly leveraged institutions, offshore financial centres and international capital flows. However, it was in the area of the implementation of international standards that the greatest progress was achieved, as the IMF and World Bank sharply increased the attention paid to such issues on the ground in both emerging market and industrial countries. While an awareness of problems may seem only a step on the way to their resolution, it is an important step nonetheless.

Some limited progress was also made towards resolving differences of view concerning appropriate procedures for the management and resolution of sovereign liquidity and debt crises. These issues again came to the fore in the light of recent Fund support for both Argentina and Turkey. Various examples during the period under review also indicated that sovereign debt restructuring, at least involving bonds issued by smaller countries, could be more successfully managed than earlier anticipated if there was a willingness to apply exit and collective action clauses in existing bond contracts. In turn, given that the possibility of orderly workouts with strong private sector participation now seemed somewhat enhanced, these experiences may have helped tilt the balance, even if only slightly, in favour of a less interventionist approach to sovereign crises.