VIII. Conclusion: the recent past as prologue?

All eyes turned towards the United States as growth in the world's largest and most vibrant economy decelerated abruptly in the second half of last year. Moreover, answering the obvious question – where to from here – took on added importance given the failure of Japan to show signs of sustainable recovery amid indications of softening elsewhere. These events confirm that the business cycle has not disappeared. Moreover, they indicate that those forecasters who simply extrapolate the recent past are sure, by definition, to miss the turning points. This lesson applies to bankers, trying to anticipate future loan losses, as surely as it applies to economists.

These developments also sparked debate about the limitations of a number of policy prescriptions which still enjoy widespread support. Low inflation, while just as desirable as ever, increasingly appears to be an insufficient condition for ensuring macroeconomic and financial stability. Likewise, the achievement of a sound banking system does not preclude disruptive financial turbulence arising from other sources. Finally, it has become increasingly apparent that monetary authorities and financial regulators can no longer do their jobs adequately without effective domestic and international dialogue. Sadly, these new insights lead only to the old conclusion that things always turn out to be more complex than they appear at first glance.

Making predictions about the near-term growth prospects for the United States is complicated by the coexistence of a number of competing paradigms, all of which have some plausibility. The first to be advanced has a supply side focus, and might be called the "new era" story. It emphasises the increased growth potential of the United States, higher underlying profits justifying higher asset prices, and the greater capacity of firms to prevent large inventory swings. This is essentially a soft landing scenario implying a V-shaped recovery. The second story is more demand-oriented and, thus, has a somewhat Keynesian flavour. On this view, regardless of positive supply side developments in the United States, aggregate demand has grown too fast and for too long. Unwinding such excesses in the postwar period has always entailed a period of below par growth, even in cases where measured inflation was not high. The third paradigm emphasises both supply side and demand side elements, and has its intellectual roots in European thinking during the prewar period. A cycle begins with accelerating credit expansion and optimism possibly justified by new technology, followed by "excessive optimism" and overinvestment. It ends with the collapse of profits feeding back into stock prices and, eventually, a reduced capacity of the financial system to support new spending. Clearly, this last scenario would imply a harder landing, even without having been preceded by any significant degree of aggregate inflation.

Whichever paradigm one subscribes to, developments in the United States seem likely to affect other countries more than in the past, and vice versa. On the real side, trade links have been growing for decades. More recently, flows of foreign direct investment and mergers and acquisitions in particular have greatly magnified the role played by multinational firms, whose consolidated profits increasingly reflect developments worldwide. Moreover, the growing complexity of the international supply chain for high-tech products means that inherent product cycles in this rapidly expanding industry have powerful effects virtually everywhere. Improved communication in itself has facilitated the international transmission of shifts in mood and confidence, with attendant effects on consumption and investment.

Capital markets, whose size and scope have greatly increased in recent years, provide further international linkages. There has been a growing tendency for bond rates, stock prices, credit spreads and risk premia in various markets to show similar movements, with the direction commonly set in the United States. Moreover, these connections also increase the likelihood that any failure in the functioning of one market will quickly be manifested elsewhere. Such linkages are clearly important in themselves, but they also imply that the diversification of risk in capital markets could become progressively more difficult. And, as was seen at the time of the LTCM crisis, never more so than when the markets are under stress. Finally, while the process of consolidation within the financial industry remains primarily domestic, growth in the cross-border activity of the largest banks provides another channel through which shocks could be transmitted internationally.

Given these linkages, two simple implications suggest themselves. The first is that domestic policies have international effects and are thus a legitimate subject for international debate. The delayed restructuring of the Japanese corporate and financial system could affect many non-Japanese, particularly in East Asia. Should the US downturn last longer than expected, any failure of European policymakers to sustain growth in Europe would be bound to have repercussions elsewhere. In addition, how US policies might seek to cushion a protracted downturn, and the importance policymakers might attach to resulting exchange rate movements, is clearly of great significance to the world in general and to those who have recently invested in the United States in particular. Similarly, policies designed to make domestic financial systems more resilient would obviously be of interest to foreign institutions potentially offering new sources of investment capital and expertise.

The second implication is that there needs to be more, and more effective, international cooperation. Meeting this need will be made more difficult if the new governments in Washington and Tokyo choose to focus more single-mindedly on domestic affairs, if the European Union becomes too preoccupied with the issue of enlargement, and if policymakers from emerging markets shun all cooperation because they feel marginalised by processes centred in the industrial countries. There is also a growing risk that, if the less palatable implications of globalisation are not effectively managed, developments could tilt in the opposite direction. Excessive reliance on regional solutions is one possibility. Recourse to outright protectionism, which is still thought to be a viable option by many, is another. Should the eruption of long-standing latent trade frictions or worsening economic circumstances bring such tendencies to the surface, they will have to be vigorously resisted if the economic gains of the last few decades are not to be jeopardised.

Policies to promote macroeconomic stability and growth

Good policymaking demands knowing not only what the objective is but also how to achieve it. As this Annual Report went to press, uncertainty attended both issues. For many commentators, a rapid rebound in spending and growth in the United States seems clearly desirable. It would avoid an extended slowdown and validate the potential offered by the new economy. Moreover, arguments can be mustered to support the view that such an outcome is possible, albeit likely to need some assistance from policy. Consumers still have assets vastly in excess of their liabilities. Stock market analysts still expect profits to recover to a double digit growth path and investment to be boosted accordingly. The continuing strength of the dollar and large capital inflows to the United States seem to offer further grounds for optimism.

Others, however, question both the desirability and the likelihood of such a quick recovery. There are many well recognised financial imbalances in the US economy, including historically high debt levels for both consumers and corporations, and a mounting external debt as well. This leads some to conclude that an only moderate recovery and expansion might actually be a better outcome, as it would allow the imbalances to be worked off gradually and avoid the possibility of a still sharper setback later. This conclusion would be bolstered by any doubts as to whether the growth rate of potential output has really accelerated as much as some have claimed. If not, a robust recovery might more easily reignite inflationary pressures.

For those who would consider it prudent to avoid a sharp rebound, it is perhaps fortunate that the same financial imbalances make such an outcome seem less likely. There also appear to be other forces working in the same direction, perhaps quite powerfully. Stock prices have already fallen a long way but, by most traditional measures, equities still seem highly valued. The outstanding stock of recently purchased consumer durables and loss-making investment in equipment, particularly in the IT area, could easily lead to new spending being postponed. If demand did slacken, the downside of faster productivity growth would be fewer hours worked and more unemployment, with feedback effects on consumer confidence. For its part, the financial sector, once it begins to focus on the risks to which declining corporate profits are exposing it, might also prove unwilling to finance new spending plans for quite some time.

The Federal Reserve initially perceived the balance of these risks to be on the downside. In early January this year it began a process of aggressively reducing interest rates which continued through to mid-May. Concerns that prevailing high debt levels and tightening credit standards might limit the effects of these moves were mitigated by the fact that there was seen to be scope for further cuts if deemed necessary. The decline in benchmark long-term rates up to March 2001 was consistent with such an expectation, and also with the view that the Federal Reserve would not be constrained by any significant increase in inflationary pressures. Since then, however, worries about inflation have been voiced more frequently, as long rates rose back above levels seen prior to the easing of policy. Higher levels of compensation, a downturn in productivity growth, persistent energy shortages and the implications for inflation of a possible fall in the dollar were all sources of concern.

The near-term outlook for the US economy will also be influenced by the ultimate shape of the tax cut legislation proposed by the new administration. A tax reduction of $1¼ trillion, to be implemented between 2002 and 2011, has already been approved by Congress. However, it remains uncertain whether a tax rebate with effect for this year will also be included in the final legislation. The desirability of such a rebate depends very much on the macroeconomic outcome envisaged. If the economy recovers rapidly, a front-loaded fiscal expansion will tend to worsen underlying savings deficiencies in the United States. Conversely, this rebate would be more appealing if the economy was expected to be significantly weaker. The problem of course is that such a policy decision has to be made up front, based on a highly uncertain macroeconomic forecast.

What can be said with considerably more certainty is that restoring prospects for a recovery in profits will go a long way towards offsetting any prolonged economic weakness. Fortunately, the United States has many attributes in this regard. Labour markets and wages tend to be flexible and the legal structure for organising debt workouts and closing excess capacity is well established. The financial industry, while sharing in the diminished expectations for profits, appears generally sound. The fact that the overhang of investment goods is primarily in the IT sector, where depreciation rates are rapid, is also expected to prove helpful. Moreover, since the savings and loan crisis of the early 1990s, politicians have understood more clearly that the early resolution of financial sector problems is ultimately much less costly than forbearance.

Such strengths cannot be said to characterise the Japanese economy. On the contrary, the decade-long process of corporate and bank restructuring left a legacy of trend declines in asset prices, excess industrial capacity and, above all, continuing poor prospects for profits. The major impediment to fundamental change is still the special interest political system in Japan and the culture of mutual obligation. Ongoing fiscal infusions and guarantees to support the economy, while originally intended as stopgap measures, have been increasingly used as a substitute for politically painful measures which would threaten the survival of many firms and temporarily raise the unemployment rate. While there is now more talk of action under a new prime minister, this will only materialise once a political consensus has emerged for real change.

Another unfortunate problem is that not only does the prospective pain of restructuring intensify the longer it is delayed, but the ability of policymakers to ease the pain with macroeconomic stimulus becomes more circumscribed. Policy interest rates in Japan have effectively reverted to zero and, with prices still falling, real interest rates are once again positive. Moreover, successive fiscal packages have raised the ratio of public debt to GNP to more than 120%. Nevertheless, were far-sighted structural reforms to proceed, it might still be worth taking further risks on both policy fronts to ensure that increases in demand cushion the resulting rise in unemployment.

The Bank of Japan has previously been willing to purchase a wider than normal range of assets. It could conceivably broaden the range still further were the government to provide guarantees that would preserve the Bank's independence in the face of credit losses. Unsterilised purchases of assets denominated in foreign currency could also be considered, although clearly the interests of other national authorities would also have to be taken into account. The recent commitment not to raise policy rates until the CPI stopped falling was helpful. However, it might also be worth considering a more explicit commitment to a price level or inflation targeting regime. Such a framework would allow the public to anticipate a substantial rebound in prices and thus negative real interest rates. At the same time, it would give some reassurance that eventual price increases would not be allowed to get out of hand, as occurred in similar circumstances in the 1930s.

Whether further fiscal stimulus is to be recommended will depend on the desired balance between shorter-term exigencies and the need for longer-term fiscal retrenchment. The shorter-term need for fiscal stimulus will be determined in part by shifts in confidence associated with the restructuring process. On the one hand, the associated job losses might reduce confidence but, on the other, leadership as opposed to drift might have the opposite effect. Of course, if increased spending on the social safety net could be funded by reductions in unproductive public sector investments, even an unchanged fiscal stance might provide material benefits. As for the longer-term need for fiscal retrenchment, a credible plan for dealing with this problem clearly needs to be laid out as quickly as possible. What is harder to accept, however, is that a period characterised by needed restructuring in Japan and a simultaneous slowing in the global economy would also be the appropriate moment to actually begin such a process.

Compared to the conundrums besetting policymakers in the United States and Japan, the problems confronting their counterparts in the euro area seem trivial. On the face of it, there are no major financial imbalances affecting either consumers, corporations or governments. Moreover, significant but unremarked progress has been made in many countries in enhancing the efficiency of labour and product markets, and in introducing other structural reforms to improve allocative efficiency over time. This is not to say that further reforms are not needed. Tax regimes have artificially raised the cost of labour and tax burdens remain very heavy. Some sectors urgently await further deregulation. And there is a growing awareness that the potential productivity gains offered by new technology will only be fully realised with the aid of greater flexibility in labour markets and increased training.

An indication of such underlying problems affecting European markets is that skills shortages increasingly began to appear as the expansion continued, and that inflation stayed stubbornly above the Eurosystem's announced target. It was this latter consideration, together with the sense that otherwise all was well, that helped explain the Eurosystem's "wait and see" attitude with respect to the emerging signs of economic slowdown. In addition, many national central banks in the euro area have traditionally shown a marked preference for taking a medium-term view in conducting monetary policy, thereby eschewing what they consider excessive policy activism. Whatever the merits of these views, policymakers in Europe did remain open to the possibility that the economic prospects for the euro area might now be more closely tied to those of other regions than in earlier decades. As a result, the authorities relaxed monetary policy slightly in mid-May. They should also be prepared to ease further in the event that forces, whether global or local, lead to a still clearer reduction of inflationary pressures.

One possible source of disinflationary pressure in the euro area could be a significant upturn in the value of the euro, perhaps against both the dollar and the yen. This would, of course, be associated with inflationary implications for the United States and a weakening of disinflationary pressures in Japan. The logic underlying such a scenario need be no more complicated than the anticipation of a reversal of euro weakness, whose magnitude and duration were never easy to explain in the first place. But a possible ancillary argument for euro strength rests on the assumption of an extended period of relatively faster growth in Europe, primarily reflecting more hesitant growth in both the United States and Japan. However, the continued failure of the euro to rise decisively against the dollar, even as these macro assumptions look increasingly plausible, suggests an alternative scenario. If the dollar stays strong, either because markets expect a sharp rebound in US growth, or because the dollar is seen as a safe haven in troubled times, the US current account deficit will stay high. This could imply an even sharper exchange rate adjustment at some point in the future.

How events will unfold with respect to the dollar/yen relationship is even more difficult to predict. Nevertheless, there seems to be a growing willingness in both Japan and the United States to tolerate a depreciation of the yen, provided that it happens gradually and is linked to significant structural reforms in Japan that will improve longer-term growth prospects. The obvious danger, however, is that this process might get out of hand. With booming, low-cost imports already causing Japan's trade surplus to shrink, interest rates effectively at zero, and the health of financial institutions increasingly questioned, this possibility cannot be ruled out. If the weakness of the yen were then to lead to higher interest rates in Japan, with feedback effects on banks that have taken on very large positions in Japanese government bonds, this could even have implications for domestic financial stability. Another unwelcome by-product would be an increase in protectionist pressure in the United States, where the bilateral trade position with Japan is a political issue of very long standing. And, of course, the danger of competitive devaluations in Asia, potentially including China, cannot be ruled out. The recent Asian crisis was, after all, precipitated in part by the strength of the dollar against the yen in 1996 and 1997.

It is fortunate, for reasons discussed in the Introduction to this Report, that in the meantime most Asian countries have become generally more resilient to shocks arising from changes in the exchange rates of the currencies of the major industrial countries. Nevertheless, some vulnerabilities remain. Growth in many of the smaller Asian economies is highly dependent on exports. This is certainly no bad thing, except that they have been heavily weighted towards electronic products destined for the United States. Any prolonged slowdown in that country, particularly one that is investment-led, will clearly have important knock-on effects. Moreover, with China receiving a larger share of a shrinking pot of foreign direct investment, many Asian countries can no longer count on the cushioning effect of such flows.

In such circumstances, it would be normal to rely more on domestic demand to stimulate growth, and indeed a number of welcome steps have already been taken in this direction. A growing concern, however, is that the fiscal positions of a number of Asian countries have become less healthy. This is true for China, where improvements in tax administration are clearly required, and particularly for India. In many countries, the continuing fiscal costs of restructuring banking systems also need to be taken into account. Moreover, with such restructuring still incomplete in many cases, doubts remain as to the ability of the financial system to create the credit that a domestically led expansion might require. The obvious conclusion is that restructuring should have been done quickly and definitively. However, now that this chance has been missed, it is less clear what to do in the prevailing circumstances. To some, a simple conclusion seems obvious – better late than never. However, as in the case of Japan, it should also be noted that a less propitious moment for undertaking needed structural reforms can scarcely be imagined.

The vulnerabilities of the other main emerging markets are of a rather different nature. Latin American countries are in general less open to trade and therefore less exposed to a downturn in demand elsewhere. While Mexico is in one respect an outlier, because of its extensive and growing trade ties with the United States, there is the hope that in such circumstances it will benefit increasingly from foreign investment looking for a low-cost production source. Nor do most Latin American countries, with the clear exception of Argentina, seem greatly discomforted by the continuing strength of the dollar, even though many have large underlying current account deficits. While those countries that are oil exporters have profited from higher oil prices, virtually all have seen a sharp rise in consumer spending and imports. Their ongoing financing needs have to date been met by strong inflows of foreign direct investment. However, they remain highly exposed to any change in sentiment in international financial markets, in particular the possibility of a generalised increase in risk aversion that might be precipitated by a global slowdown. There have already been several periods when financing on international bond markets has proved very expensive or even impossible. Many Latin American countries have made remarkable progress in privatising and deregulating their economies, bringing inflation down to low levels and introducing legislation for sustainable monetary and fiscal frameworks. The more credible these longer-term frameworks can be made, the greater will be the reassurance given to foreign investors, and the more accepting they will be of shorter-term policies to sustain demand in the face of global shocks. The troubles currently faced by Argentina, which has consistently failed to follow up on its commitments to fundamental fiscal and labour market reforms, bear eloquent testimony to this.

Elsewhere in the global economy, macroeconomic imbalances are not hard to identify but are generally of lesser significance than underlying structural problems impeding growth. In Turkey, as in much of Africa as well as Russia and the other CIS countries, the basic problem continues to be one of political and corporate governance. Without adequate laws and an independent judiciary, property rights remain doubtful and corruption endemic. In such adverse circumstances, made worse by an almost non-existent financial infrastructure in many countries, it is not surprising that domestic levels of both saving and investment remain very low and foreign direct investment has not markedly increased. While it will take years to address these fundamental issues, the World Bank and the IMF are to be commended for bringing them increasingly to the world's attention.

Finally, structural changes are also required in many countries in the Middle East and central Europe. In the former case, efforts need to be made to diversify the production structure of the local economy and reduce the reliance on skilled immigrant workers. In oil-exporting countries, it is to be hoped that the continuing buoyancy of oil prices will provide the financial impetus for such a transition, rather than offering an easy excuse for postponing it. And in central Europe, greater attention should be focused on the problem of structural unemployment as well as the reliance on heavy capital inflows to finance large trade deficits. The profound structural reforms already undertaken in the region are expected to encourage inflows to continue. Nevertheless, steps must also be taken to ensure the maintenance of financial stability should those inflows ever reverse.

Policies to promote financial stability

In drafting financial legislation and regulation, there is a well known trade-off between safety and efficiency. Recent events suggest, however, that this trade-off has a dynamic as well as a static component. More market-driven systems seem to have a greater propensity to provide the start-up capital that will allow the implementation of innovations that increase productivity growth over time. At the same time, such systems may provide too much credit, thereby financing dubious projects as well as artificially intensifying competition for good ones. As a result, there can be a tendency for both productive and unproductive loans to go bad at the expense of the lender and the health of the financial system. This suggests that policies to promote financial stability may have to balance the benefits of faster secular growth against the costs of more violent economic cycles as financial excesses are unwound. Given such a trade-off, it is difficult to identify optimal global policies for promoting financial stability, particularly in a world where national preferences still differ appreciably. Nevertheless, policies which seem likely to improve this trade-off can still be identified and implemented.

In practice, policies to promote financial stability have a number of different dimensions. One important aspect is identifying specific vulnerabilities arising from recent macroeconomic developments. A second is identifying new trends and products with a view to forecasting their possible impact on financial stability. And a third is finding ways to strengthen each of the three basic platforms which support the international financial system: financial institutions, market functioning and the underlying infrastructure. Significant steps forward were taken in all of these areas in the period under review.

Turning first to the issue of current vulnerabilities, it is worth recalling that the world financial system has gone through a long period of deregulation as well as consolidation. In consequence, it has become more market-driven, globalised, interconnected and fast-moving than ever before. These characteristics have made it inherently difficult to spot vulnerabilities and to assess what should be done about them. Even so, the obvious question needs to be asked. Given that the recent long phase of economic expansion was associated with very rapid credit growth and overly buoyant asset prices, could a slowdown in activity expose resulting weaknesses in the financial system that might accentuate these real side developments?

One set of arguments plays down this possibility. Excessively high property prices have tended to be the major source of financial fragility in the past, but property prices were relatively subdued in the most recent upturn. Moreover, policy rates began to be raised as far back as the middle of 1999. Since then, stock price declines have lowered global valuations by $10 trillion, or one third of global GDP. Credit spreads have also increased significantly, in many cases beyond levels seen in late 1998, as credit standards have tightened globally. Nevertheless, in spite of the duration and magnitude of these shocks, markets have continued to function smoothly and there have been no significant signs of financial distress.

Another set of arguments points to a less reassuring conclusion. The slowdown in economic activity and profits growth is actually of very recent vintage. Much depends on what happens in the months ahead. Furthermore, while the exposure of financial institutions to individual regions and industries – for example Argentina, Turkey and technology companies – seems manageable, joint exposures need more careful examination. It is gratifying that the larger financial institutions have in recent years relied much more on stress tests to evaluate how they would fare in extreme but plausible situations, and to protect themselves accordingly. Nevertheless, it remains to be seen whether they have paid adequate attention to the way that credit risk, market risk and liquidity risk all tend to move together in periods of stress. It is appropriate that supervisors, aware of such interactions, have become generally much more vigilant and increasingly prepared to ask "what if?".

As for new trends in the financial sector with possible implications for financial stability, perhaps the most important has been the rapid growth of new techniques for transferring credit risk. On the one hand, the benefits are expected to include improved risk management as comparative advantages in bearing such risk are exploited. Moreover, as liquid markets develop, participants will be better able to set an appropriate price for accepting credit risk. This will be of enormous, perhaps revolutionary, benefit. On the other hand, certain aspects of this development raise supervisory concerns. Such transactions could make the distribution of risk within the system less transparent, and could just as easily concentrate risk as disperse it. A further issue is that insurance companies will become increasingly involved, not surprisingly since most of these credit transfer instruments are similar to insurance policies. This implies the need for ever closer collaboration between banking and insurance supervisors to prevent the possible growth of regulatory arbitrage and to ensure that risks are monitored and priced correctly. Finally, as with all new instruments, questions have to be raised about the adequacy of the documentation supporting them and their legal status. Just as in the case of closeout netting, special purpose investment vehicles and a host of other recent innovations, legal uncertainties may only be finally resolved in the courts. In the interim, the one sure thing is that harder economic times will lead to a sharp pickup in litigation. Supervisors would thus be well advised to investigate concentrations of exposures to identified legal risks since, as a recent judgment in the United States has demonstrated, the sums at stake can be huge.

Turning finally to measures designed to strengthen the foundations of the international financial system, great efforts have been made to improve risk management at banks, insurance companies and investment dealers. The greatest attention has been reserved for the revised set of proposals for a New Basel Capital Accord circulated in January this year. The original 1988 Accord helped raise capital levels everywhere. Because it relied on a small number of fixed risk weights, it had the advantage of simplicity and was quickly adopted as a worldwide standard. However, with time, its shortcomings also became more evident. Because credits of different quality were lumped together for regulatory purposes, there was an incentive to remove good quality loans from the balance sheet to increase the overall rate of return. Moreover, as banks' internal risk assessments grew more sophisticated, it became clearer that the regulatory requirements of the original Accord were less and less able to adequately cover the underlying risks actually being taken.

The New Accord addresses these issues head-on. As a result, it is necessarily more complex. In particular, it allows a number of different options for calculating minimum capital requirements, and seeks to provide incentives for banks themselves to continuously improve their internal risk management capabilities. Common to all the options presented is a greater differentiation between loans of different qualities. Accordingly, it is foreseen that the capital charge against any given loan may vary over time as its assessed riskiness changes with evolving circumstances. For the first time ever, the proposals also address the issue of operational risk, which is clearly becoming increasingly significant. Finally, the proposals also stress the importance of the supervisory review process, in particular the review of banks' internal risk assessment procedures, as well as the need for banks to be more transparent about their risk profiles and operations. The premise in this latter case is that market discipline, based on such disclosure, will encourage greater prudence.

All of these proposals are major steps forward. However, as the supervisors, together with the industry, move towards their implementation by 2004, certain important details still need to be addressed. One open question is whether banks' internal risk assessments might not vary excessively over the course of the business cycle, possibly leading to undesirable decreases in capital cushions during booms and increases during recessions. A tendency to use comparatively short horizons and techniques that effectively extrapolate the recent past could encourage this. Fortunately, the supervisory review process offers a vehicle for addressing these practical issues of risk measurement and capital, provided of course that the supervisory authority has the resources, skills and powers necessary to enforce compliance. Particularly for supervisors in many emerging market countries, this looks likely to be a considerable challenge.

A closely related issue, affecting the functioning of all financial institutions, has to do with recent proposals to extend the use of fair value accounting. From the perspective of financial stability, it is argued that it would improve market discipline by making financial statements more transparent and a better reflection of firms' financial condition. In particular, it would lead to immediate recognition of gains and losses from movements in interest rates and changes in credit quality. In contrast, others worry that net profits and valuations could be made excessively volatile from one period to the next, and might fluctuate too much over the business cycle. This might lead to the financial system becoming even more procyclical than it is thought to be currently.

Given the potential difficulties with fair value accounting, a suggested middle way is the adoption of more forward-looking provisioning for credit losses. Under existing accounting rules, provisions normally fall as the economy expands and only increase in economic downturns. Forward-looking provisioning would allow the earlier recognition of expected credit losses and make it more likely that adequate resources are available to deal with the emergence of loan defaults in a downturn. Unfortunately, this middle way is also not without its difficulties. Foremost amongst these is the potential subjectivity of this type of provisioning, opening up the possibility of banks manipulating their accounts for taxation or other purposes. Moreover, if changes in credit quality over the business cycle were not adequately recognised ex ante, forward-looking provisioning might still have little practical impact. Notwithstanding these difficulties, this approach seems worthy of further exploration, as do proposals for supervisors to require some form of automatic provisioning at the origination of a loan.

Along with sound institutions, efficiently functioning capital markets are a second key requirement for a stable financial system. During the period under review, many worried that several structural and other developments had the potential to reduce market liquidity, in the sense of the ability to carry out large trades without significant effects on prices. Among these developments were an apparent reduction and concentration in the risk capital dedicated to market-making, the withdrawal of hedge funds from arbitrage activities, the standardisation of risk management practices across firms, the growing use of electronic broking (in which there are generally no market-makers) and the shrinking supply of "risk-free" government debt. Recent shocks have not in fact had the pervasive effect on market functioning seen in 1990 and the third quarter of 1998. Yet it must also be borne in mind that the earlier shocks involved a major credit event in the form of the collapse and near collapse of a significant market player, Drexel Burnham Lambert and LTCM respectively. Given that no such event has occurred recently, it could be that the availability of liquidity under stress has not actually been fully tested. Conversely, it could also be argued that these earlier episodes led to a reduction in the use of leverage which in itself has made markets less likely to seize up under stress.

Although the jury is still out, a number of practical suggestions have nevertheless been made to help ensure the continued smooth functioning of financial markets. Further progress in developing and enforcing standards with respect to collateral and documentation is expected to increase the ability of the swaps market to take on many of the functions previously performed by government bonds. In Europe, rapid implementation of the recommendations contained in the Lamfalussy Report would have the welcome effect of helping integrate markets that are currently fragmented. In addition, as experience has shown how quickly concerns about counterparty risk can feed back on market liquidity, further steps to improve disclosure should be encouraged. Finally, major financial institutions, particularly those which might be thought of as providers of liquidity themselves at times of stress, are being urged to carry out stress tests for liquidity risk as onerous as those they are increasingly applying to market risk and credit risk.

The third platform needed to support a stable financial system is an adequate financial infrastructure. In addition to the accounting and legal underpinnings already referred to, payment and settlement systems that continue to function, regardless of the stresses put upon them, are a crucial requirement. Great progress has been made in the area of wholesale payment systems in recent years, in particular the widespread introduction of real-time gross settlement. Moreover, the publication of the Core Principles for Systemically Important Payment Systems has provided a useful set of standards for the IMF and the World Bank to apply in assessing countries worldwide. And, at last, real progress has been made towards establishing the CLS (Continuous Linked Settlement) Bank to ensure that the clearing and settlement of foreign exchange transactions in the major currencies will no longer involve Herstatt risk. After 25 years of temporising with this recognised global exposure, the last few steps towards a robust solution need to be vigorously pursued.

Cooperation in the pursuit of financial stability

While there are some difficult problems in the area of international cooperation, there is at least one equally difficult question to be addressed domestically. What should be the respective roles of monetary authorities and regulators with regard to financial stability? This is a live issue even where the central bank has responsibility for supervision. However, the question is becoming still more pertinent with the growing trend towards consolidating in independent agencies the responsibility for regulatory oversight of financial institutions and securities markets.

Whatever one's view about this trend, it at least serves to highlight that there may well be two complementary approaches to the financial stability problem, one institution-specific and the other system-wide. Traditional supervisory practices have generally focused on the health of individual institutions as the key to keeping the system as a whole healthy. In contrast, monetary authorities have tended to put more weight on the likelihood of shared shocks and cycles affecting the financial system as a whole. If both of these approaches are judged valid, then, in the interests of crisis prevention, it would seem normal that there be ongoing dialogue and cooperation between all parties concerned. They must exchange views about vulnerabilities if they are to do something about them. Such a process would, in addition, ensure the open lines of communication and the trust across agencies that are essential in managing crises when they do occur. Those involved in managing crises should agree in advance how responsibilities are to be shared to make sure that needed decisions are taken at the appropriate time.

Cooperation at the international level in pursuit of financial stability is taking place in a number of forums, some of quite recent origin. Indeed, it could even be argued that there is actually too much of this kind of dialogue. Senior officials have to attend a bewildering series of meetings, with the attendant danger that repetitive discussions will drive out pertinent analysis and weaken the will to take concrete measures to help prevent financial crises. The establishment of the Financial Stability Forum initially raised concerns that it would only add to this problem. In practice, however, it has proved very successful in bringing together key official players from the major financial markets to identify financial vulnerabilities, overlapping work and remaining gaps in addressing financial stability, and to set priorities. And, while feeling obliged to undertake part of this work itself, the Forum has relied primarily on existing bodies to move the cooperative agenda forward.

In particular, the Financial Stability Forum is increasingly focused on encouraging the domestic use of internationally agreed codes and standards to support financial stability. Achieving this objective needs at least four steps: setting standards; assessing how far countries comply; implementing the standards; and then regularly updating them in the light of practical experience. While much progress has been made in each respect, helped by the willingness of the IMF and the World Bank to work closely with national expert groups of standard setters, a great deal still remains to be done. In particular, some emerging markets continue to question the legitimacy of codes essentially drawn up by a small number of developed countries. At the least, they contend that standards should recognise the reality of different levels of development. As for implementation, it is clear that rating agencies and lenders must be made more aware of existing codes if they are to actively use them to reward compliance. And it is also clear that many emerging market countries will need technical assistance on a potentially large scale.

Further analysis and agreement is also required on how best to manage and resolve financial crises. There needs to be greater consensus on basic principles about how to restructure weak banks when the whole system is unhealthy. In addition, the ongoing process of financial consolidation and globalisation is creating larger, more complex and more international institutions whose activities often spread over many supervisory jurisdictions. While the quality of management is generally very high, further thought needs to be given to the modalities of dealing with such institutions should they seem to be getting into trouble. Recognising how interconnected many of these institutions have become has lent further urgency to this task. Finally, broader agreement on the appropriate role of the IMF in managing sovereign liquidity crises would be desirable. Some continue to argue that large financing packages are required to complement conditionality. They point to the unacceptable harshness of pure market solutions and the dangers of destabilising political and social tensions. Others emphasise the likelihood of encouraging imprudent behaviour, particularly on the part of creditors, and have suggested that debt standstills and other legal incentives could be used to encourage negotiated settlements with private creditors.

There is no right answer to this last question, which will continue to be debated decades hence. However, there does seem to be a growing consensus on how to move forward on many of the other issues raised above with implications for both crisis prevention and crisis management. Expeditious action in such areas would seem highly desirable lest unfolding events in the financial sphere reveal, once again, that too little had been done, too late.