I. Introduction: unexpected resilience to unexpected events

The global economy and financial system have shown, over the last year or so, enormous resilience in the face of successive shocks. Taken as individual events, the continuing stock market correction, the attacks of 11 September, the war against terrorism, the failure of Enron, the collapse of Argentina's currency board and the conflict in the Middle East might each have been expected to have unpleasant economic side effects. Taken together, their cumulative impact could have been far more serious – interactions frequently generate outcomes greatly exceeding the sum of the parts. Moreover, these events came on top of a global economic downturn that, for a time, threatened to gather significant momentum.

Compared with what might have been expected, it is remarkable how well the system has coped. Far from continuing to contract, the global economy appears to have begun expanding again. And it is the United States that seems once more to be leading the way, in spite of its many perceived imbalances. The financial sector too has responded flexibly to these recent developments. Payment and settlement systems coped well, even with such an extreme event as the terrorist attack on the New York financial district itself. Credit has also generally continued to flow freely, albeit more expensively to those now judged to be less creditworthy. Explanations for this good performance would certainly include supportive macroeconomic policies, notably monetary policy. But we should also acknowledge the possibility that the many years of effort put into promoting financial stability have at last begun to bear fruit. In particular, the infrastructure underpinning the global financial system, and associated plans for continuity and backup, were vastly improved as a result of the attention they received prior to the turn of the millennium.

In spite of these very welcome developments, and the expectation that they are likely to continue, it would be premature to conclude that all must now be well. Some of the concerns raised above may yet be realised, and a number of last year's shocks may prove to have longer-lasting implications. One effect which is already all too evident has been a deep erosion of that sense of trust, in both market information and people, which fundamentally underpins a well functioning economy. In the Enron case, it became clear that the profit and debt figures were not at all what they seemed. This has led in turn to a growing distrust, not just of innovative accounting at other firms, but even of some of the accounting conventions themselves. These suspicions have already weighed heavily on the share prices of a number of companies, but could yet bear down further on overall market valuations. Moreover, the Enron developments called into serious question the professional competence and even ethical standards of many people in positions of great responsibility. Not one but a whole host of internal and external levels of governance failed. Conflicts of interest played a role at each level, but the common thread was the all too human reluctance to ask the right questions when the going was good.

In the case of Japan, the doubts have focused on the accuracy of current estimates of non-performing loans in the banking system, as well as on the reliability of market prices subject to government interventions of various sorts. In Argentina the sense of trust was also violated, not only by the depreciation and associated sovereign default, but by the particular way in which these events were handled. By choosing to rewrite legislation in ways that explicitly discriminated against creditors, the government raised fundamental questions about the applicability of the rule of law itself. In the light of all this, it will inevitably take some time before an appropriate degree of confidence and trust can be re-established.

Yet even here it is possible to see a silver lining around some of the economic clouds of last year. If, paradoxically, there may actually have been an excess of trust in recent years, the Enron affair has at least put paid to that. The Argentine experience also provides a salutary lesson about how the costs of failing to carry out needed policy changes can rise dramatically over time. And finally, it is notable that the Enron failure and the Argentine debt default were allowed to happen without the massive public sector intervention often seen in the past. It should now be crystal clear when confronting such troubled circumstances that the choice will no longer be between bailout and workout. Rather, the practical choice is between an orderly and a disorderly workout. Insofar as sovereign crises are concerned, this latter debate has arguably progressed further in the course of the last 12 months than in the last five years.

A down year for the global economy

The recent economic cycle has been unusual in several respects. The expansion in a number of industrial economies, but particularly in the United States, was underpinned by evidence supporting belief in a “new era” of higher productivity growth and associated increases in profits. Credit growth, asset prices and capital investment all rose rapidly, especially in those sectors thought likely to benefit the most from recent technological developments. When the economic downturn finally came, it too was unusual in that it was not primarily due to a classical tightening of monetary policy in the face of accelerating inflationary pressures. Rather, it was led by a sharp decline in profits in the United States reflecting limited pricing power and increases in employee compensation. In effect, the real gains in productivity ended up being appropriated by the household sector. Confronted with such circumstances, and further buffeted by rising energy prices, the corporate sector in the industrial economies liquidated inventories and cut capital investment on a massive scale in 2001.

The downturn was, however, attenuated by the extraordinary resilience of consumer spending. This was remarkable in that, globally, the consumer sector had become more exposed to the risks of a corporate downturn. There has been a marked expansion in the holdings of financial assets by households, not least in the form of defined contribution pension plans, which have lost no small part of their value since the spring of 2000. In many countries there has also been a shift towards employment contracts which make it easier to lay off workers and lower compensation in downturns. These contractionary influences seem to have been offset by continued increases in house prices in many countries, as well as the fact that the prices of many financial assets are still well above levels seen five or 10 years ago.

The synchronous downturn in the global economy and the apparent common recovery have been interpreted by some as evidence of increased globalisation. In a profit-driven cycle, one would indeed expect Europe and North America to move more in tandem, particularly given the scale of transatlantic mergers and acquisitions over the last decade. Furthermore, as noted above, common shocks have been a key feature of recent events in the industrial countries. Nevertheless, before concluding that the world has fundamentally changed, it should be recalled that synchronous cycles were also common in the 1970s and 1980s. Moreover, the long-standing recession in Japan could for a time give the illusion of a synchronous downward movement even if other economies had turned down for completely independent reasons.

Economic developments in emerging markets were largely explicable in terms of the same contractionary forces affecting the industrial countries. However, the size of the impact varied significantly. The negative effect on East Asia was particularly evident given the heavy reliance of many countries on exports of IT-related products. Latin American economies, with the notable exception of Mexico, are more closed and felt the external forces less keenly. Many central European countries seemed almost immune to the slowdown, while growth in Russia was actually stronger than expected under the influence of structural reforms and continued high oil revenues.

At the same time, developments in emerging markets had many idiosyncratic features, some for the better and others for the worse. The former would certainly include the sustained rapid growth in China and the slower but still substantial expansion in India. Even in Indonesia there were tentative signs last year that the economy might be regaining strength. These fortunate developments provided material benefits to a vast number of people, many still desperately poor. At the other end of the spectrum, the economic crises affecting Turkey and Argentina were both very costly but they exhibited some differences as well as fundamental similarities.

In Argentina as well as Turkey, the fundamental problem of long standing was the government's fiscal position. Moreover, in both cases it was the way in which an overly rigid exchange rate regime interacted with a banking system vulnerable to exchange rate changes that actually triggered the crisis of confidence. This led to a flight of capital, both domestic and foreign. In the Turkish case an acceptable and essentially traditional policy framework was quickly agreed with the IMF. However, the Argentine case has proved much more intractable given the high degree of dollarisation, the size of the debt default and the conflicts between the various arms of the Argentine government. The erratic and disruptive way in which the government then intervened in the operations of the banking system, largely foreign-owned, effectively brought both the payment system and the economy to their knees.

Financial resilience in the face of shocks

With these dramatic events as backdrop, it is hardly surprising that the global economy experienced a cyclical slowdown in 2001. Nevertheless, the picture emerging late in the first half of 2002 is that the downturn was relatively mild and that a broad-based global recovery may already be under way. Such signs are clearest in North America but are also evident in East Asia and Europe, and have been accompanied by upward revisions to the consensus forecast. While inventory swings, particularly in the IT sector, have played a crucial role both on the way down and on the way up, there are early indications that final demand may also be picking up along with productivity and profits. It is also noteworthy that there was very limited contagion from the Turkish and Argentine shocks to other emerging market economies. Some explanations for this, as well as other positive developments in the period under review, are considered below.

One reason for the positive economic outturn was the resilience of the global financial system. First of all, the infrastructure of the system proved strong. The events of 11 September affected the US equity, fixed income and repo markets for a week or so, but the global system functioned effectively, even in the immediate aftermath of massive disruptions in a leading global financial centre. Similarly, after the collapse of Enron, one of the world's biggest energy traders, the energy market continued to function normally. And in spite of all the extraordinary events referred to, the legal integrity of a whole range of new financial instruments, including special purpose vehicles and credit risk transfer mechanisms, proved robust.

The reaction in individual financial markets was also consistent with a sober assessment of changing circumstances. There was no panic flight to liquidity like that seen after the LTCM and Russian crises in 1998. Major equity markets in North America and Europe continued their long decline up until autumn last year but, soon after the post-11 September plunge, began to rise again as economic prospects brightened. Moreover, the rally persisted into 2002 before stalling, at very high historical valuations, under the joint influence of the Enron revelations and increasingly gloomy news on the profits front. Most other markets on both sides of the Atlantic showed similar gyrations. They fell, rose and then fell again as optimism about the US economy waxed and waned, while divergent European prospects were largely ignored. The overall effect, however, was that nominal borrowing costs in corporate bond markets fell to historically low levels last September and have changed remarkably little since.

In some other markets there were clearer signs of stress. The US commercial paper market was most affected, with lower-tier credits being effectively frozen out and others being asked to pay higher rates of interest. The decline in outstanding non-financial commercial paper over the last year has been the steepest on record. Yet many firms were still able to fall back on prenegotiated arrangements with their banks, even though banks were feeling increasingly uncomfortable in view of the credit losses they had already suffered in the downturn. The corporate bond market, however, was an even more willing provider of funds and bond issues rose to record levels. These long-duration bond issues, while more expensive than shorter-term paper, should help ease corporate liquidity concerns for some time.

Two other features of recent events also underline the resilience of the global financial system. The first was the extent to which consumers in many industrial countries gained greater access to consumer and mortgage credit. Moreover, they availed themselves of such credit to pay down more expensive debt as well as to increase consumer expenditures. While significantly less well advanced, a similar phenomenon has arisen in a number of large emerging market economies, including China, India, Korea and Mexico. In countries with initially low domestic saving rates, such developments had to be financed, in part at least, by inflows from abroad. In the United States in particular, government-sponsored mortgage agencies were extremely successful in selling bonds directly to foreigners.

The second remarkable aspect of recent financial events was also related to international capital flows. In global circumstances likely to increase investor risk aversion, external financing for countries with current account deficits might suddenly have proved harder to obtain. In fact, this was not the case. Among the industrial countries, the external funding requirements of the United States continued to be easily met. This was generally true for emerging market economies as well. To be sure, banks further reduced their cross-border lending. However, there had been a long-standing tendency for internationally active banks to rely increasingly on a domestic presence and domestic funding to extend credit in emerging markets. In contrast, most of those seeking funds in the international bond markets still had ready access. Sovereign spreads actually narrowed over the period under review for countries such as Korea and Mexico, deemed to have sound policies, although the opposite was true (and sometimes dramatically so) for countries like Turkey, Argentina and Venezuela. Moreover, foreign direct investment continued to flow into a number of favoured countries, in particular Brazil, China and Mexico, while equity prices in a range of emerging market countries were also on the rise. In sum, the outcome was – thankfully – a far cry from the indiscriminate contagion that some feared would arise from the Turkish and Argentine crises.

Factors supporting the resilience of the global economy

Why were the global economy and financial system so resilient? Policy initiatives appear to provide at least part of the answer. Stimulative macroeconomic policies clearly helped sustain aggregate demand. Perhaps more speculatively, the measures taken to promote financial stability over the past few years may have begun to prove their effectiveness. And, albeit still more in the background, many countries have acted in recent years to free up labour and product markets and improve productivity. The benefits of this were always expected to include more stable growth, as well as faster growth on average.

The most obvious policy measure was the sharp monetary easing almost everywhere. While the lagged effects of earlier oil price increases remained a source of concern for some, underlying inflationary pressures were generally viewed as subdued. This gave monetary authorities substantial room for manoeuvre which, moreover, many exploited aggressively.

Nowhere was this more evident than in the United States, where the policy rate was cut forcefully and repeatedly during 2001, and has been maintained at a record low level since. One conditioning factor may have been the perception that a number of the traditional channels through which monetary policy works were not operating as expected. As short rates fell, long rates dipped but then rose again, and the effective value of the dollar also appreciated. Equity prices continued to weaken, although presumably less rapidly than if policy had not eased. Even while recognising that some of these developments were also signs of the market's optimism about the future, the Federal Reserve clearly felt it had grounds for aggressive action. A second conditioning factor may have been lessons learned from the experience of Japan. There, with prices falling and nominal interest rates effectively at the zero lower bound, cumulative increases in real rates and debt deflation have become a real possibility. Moreover, a variety of other, less common monetary policy responses, including escalating levels of bank reserves, have so far failed to turn the Japanese situation around.

The ECB also cut its policy rate in response to the economic situation. The absolute reduction was, however, more limited in view of headline inflation which stayed stubbornly above target. In addition, for most of 2001, there was a rather more moderate deceleration of growth in the euro area than in the United States. The picture was similar in most of the inflation targeting industrial countries, as well as in many emerging market economies. In the latter, the spread of floating exchange rate regimes (albeit heavily managed in some cases) provided a new channel through which monetary easing might become effective. Of course, the extent to which this new freedom could be exploited depended very much on the credibility of the policy regimes in the countries in question. Broadly stated, and largely reflecting historical experience, central banks in Asia were less constrained than those in Latin America.

Stimulative fiscal policies also helped support the global economy. As a general rule, countries with a better fiscal track record were able to do more, while those with a less satisfactory history of debt accumulation had to content themselves with less. The spectrum ranged from significant structural deficit increases in the United States to active restraint in the case of Japan. Countries in the euro area felt able to complement the flexibility of the Stability and Growth Pact with tax cuts without compromising their long-run commitment to a broadly neutral fiscal stance. A similarly diverse state of affairs prevailed in emerging markets. While many governments in Asia eased fiscal policy significantly, a number of Latin American countries were constrained by exchange rate pressures or legislation directed towards ensuring fiscal responsibility after years of laxity. Mexico, for example, although much affected by the sagging US economy, had to match declining tax receipts due to lower oil prices in 2001 by expenditure cuts.

Why did financial markets respond as effectively as they did in the period under review? Lower policy rates surely contributed to this. But, in addition, financial markets in many countries are now much more varied and flexible due to deregulation over many years. Corporations, particularly in North America and Europe, had access to alternative sources of funds when initial sources dried up in the course of last year. Households in many countries were also able to alter the timing of their lifetime consumption path by tapping new markets to raise funds. This was in part a welcome by-product of rising house prices and the greater availability of collateral. However, it also reflected the increased capacity of financial institutions to use risk transfer instruments to lay off the exposures arising from these new credits. Moreover, derivatives markets, in particular rapidly growing markets for the transfer of credit risk, also allowed many economic agents to share with others the ramifications of the various shocks to which they had recently been subjected.

More broadly, financing needs have in the recent past been met more through markets than through financial intermediaries such as banks. This has limited the likelihood of collateral damage from shocks through the payment system, though it clearly did not eliminate it. The terrorist attacks of 11 September might conceivably have led to a complete collapse of market functioning had not the Federal Reserve, and in lesser measure other central banks, intervened with ample injections of liquidity to ensure that payment obligations could be met.

A closely related issue is why there was so little market contagion from the Turkish and Argentine crises. The principal reason must surely be the widespread adoption of floating exchange rate regimes. In addition, both crises built up over a rather lengthy period, allowing investors dedicated to emerging markets to reallocate their funds in a relatively orderly way. It also appears that, in the wake of earlier crises, there were far fewer highly leveraged investments in emerging market economies than before. This may have been related to the declining importance of large macro-directional hedge funds in recent years. But another important factor seems to have been the growing capacity of investors to discriminate between good and bad credits and to allocate funds accordingly.

This greater capacity to discriminate between borrowers reflects another fundamental change that has affected the behaviour of financial institutions over the last few years, and improved the functioning of markets in consequence. Financial institutions generally appear to have become much more risk-conscious, particularly as regards the dangers posed by lending on commercial property. They have developed new and better methods of measuring risk and have made significant progress in implementing systems to manage risk effectively. In countries where they had been pricing risk more accurately for some time, their balance sheets were significantly better prepared to withstand the economic slowdown.

Some of the credit for this change in risk culture must go to the Basel Committee on Banking Supervision, and associated efforts by its counterparts in the insurance and securities sectors. While the Core Principles for Effective Banking Supervision will continue to be reviewed and revised, and the New Basel Capital Accord is not yet finalised, the interactive process of developing these standards has already been immensely helpful. The active participation of the IMF and the World Bank Group in assessing compliance with such standards in emerging markets, and assisting their governments in making needed improvements, has been no less valuable. And complementary steps have also been taken to strengthen both market functioning and market infrastructure. That being noted, a great deal of work is yet to be done to address the financial vulnerabilities that remain. This issue will be returned to in the Conclusion of this Report.

Other means to improve cooperation among officials with an interest in financial stability, both nationally and globally, were also explored last year. The G10 central bank Governors and their non-central bank supervisory counterparts have begun to interact more regularly than before. A major expected benefit is better mutual understanding of the merits of focusing not only on the health of individual institutions, but also on the extent to which the system as a whole might be exposed to common shocks. These discussions are also a useful complement to those taking place in the Financial Stability Forum, which has established a still wider international network of officials concerned with such issues. Last year, the FSF also began organising regional meetings. One important purpose was to share views about vulnerabilities and the ways in which the adoption of international financial standards might help reduce them. A central idea behind the Forum's work has been that individual countries would derive enormous advantages from having efficient and stable domestic financial systems. It is this self-interest, rather than the need to contribute to some vague international effort, that is thought likely to provide the primary motivation for domestic financial reform. Nevertheless, the Forum is also working to improve the market's understanding of the importance of these standards so that it will, over time, increasingly reward the compliant and penalise the non-compliant.

Finally, and as paradoxical as it might seem in the light of the developments in Argentina, some progress was also made last year in establishing more orderly procedures for resolving sovereign liquidity crises. Indeed, the chaotic events in Argentina may well have contributed to this progress. After many years of disagreement between some of the major industrial countries, the most recent G7 and G10 communiqués indicate that a substantial degree of consensus now exists on how to move forward. While full agreement and implementation could well take years, and – as always – the devil is in the detail, there now appear to be greater grounds for optimism about achieving practical results than has been the case for some time.