VIII. Conclusion: dealing with possible headwinds

Looking back over the period under review, there are grounds for considerable satisfaction. Given the stresses and strains placed on the global economy, its performance could have been a great deal worse. An aggressive set of stimulative macroeconomic policies, allied with a financial sector made more robust by structural reforms, proved pivotal. But looking ahead, two points should not be forgotten. Although partly attributable to unforeseen events, the actual outcomes in terms of growth, profits and employment have put us on a lower expansionary path than many had counted on. Savings plans in some countries will eventually have to be adjusted upwards in consequence. In addition, there is no guarantee that even today's more moderate expectations will be realised. There are still considerable risks and uncertainties. These will test the limits of our understanding of both economic processes and sound policies.

Around the middle of last year, many commentators were still anticipating a rapid recovery in the global economy. Today, aspirations are more restrained, with the central scenario being an unusually modest recovery from what was, in some countries, an unusually shallow downturn. Nevertheless, the process expected to underpin this recovery remains a traditional one. The strong negative inventory swing seen in many countries stops, or is even partially reversed. As production responds, income and consumer confidence increase, leading to more household spending. As profits rise in turn, investment goes up, supporting a sustainable recovery and expansion. Headwinds arising from difficulties in the financial sector are treated as being of no great importance.

It is here that questions must be raised, since the last few years have been, even leaving shocks aside, anything but normal. The upturn of the late 1990s, characterised by a boom in credit extension, asset prices and fixed investment, particularly in the English-speaking countries, was certainly anything but normal. The reversal was precipitated by a collapse in profits and investment rather than by sharply rising inflation and a commensurate policy response. Again, anything but normal. And the downturn has been anything but normal in two important respects. Consumption growth in many countries, but particularly the United States, has been maintained at remarkably high levels in spite of the economic slowdown. Fortunately, the same can also be said for productivity growth. These unusual features raise the question of how, and to what extent, the characteristics of the recent past might condition the future, either for better or for worse.

Answering such questions is not easy. An accurate projection first presumes an understanding of the way in which the fortunes of the real economy affect the health of the financial system. For example, suppose the global economy were to rebound vigorously. What effect would this have on inflation expectations and bond rates? In contrast, what would be the effect of only a moderate economic recovery on already low profits and already high equity prices? How might each of these alternative scenarios then impinge on the health of financial institutions? And to take this logic one step further, how might changes in these financial variables feed back in turn on the real economy, given a starting point at which debt levels are also unusually high? The truth is that our understanding of each link is limited, and the possibility of unexpected interactions between these various forces makes our knowledge more limited still. Things could indeed turn out quite well, in a self-reinforcing way, but they could also turn out quite messily. Sound policy advice would be to hope for the former and prepare for the latter, as is discussed below.

Future outcomes will be conditioned by unforeseen events as well as policy choices. As regards the former, some concerns rank higher than others. Further terrorist action could damage confidence and restrain consumption and investment, besides injuring an already weakened insurance industry. An escalation of the conflict in the Middle East and consequent disruptions to oil supplies would raise prices and further dampen purchasing power in most countries. Current trade tensions could worsen, to the detriment of everyone but especially the poor. Yet other unforeseen events might have very positive implications. Current technological possibilities have by no means been fully exploited, even in the most advanced countries. The spread of US productivity gains to other countries would lift boats everywhere. And the search for new technological breakthroughs and associated applications will eventually pay large dividends.

While the balance of these possibilities still seems to be tilted towards the downside, it should also be noted that public policy has considerable power both to help prevent adverse developments and to cushion the impact on the economy should they occur. Trade wars are not inevitable. The lure of using oil as a political weapon can be resisted. The underlying trend of inflation is mostly benign and a great deal of fiscal retrenchment has taken place in recent years. These latter developments increase the room for manoeuvre with respect to macroeconomic policies. Recent events also attest to the growing resilience of the financial system. In sum, while there are causes for concern looking ahead, there are also some sources of comfort.

Factors conditioning the economic outlook

One salient and welcome characteristic of the last decade has been the quiescence of global inflation. This has been particularly remarkable in countries where substantial exchange rate depreciation might have been expected to feed through to domestic prices, but did not. In no small measure, this has been due to the enhanced credibility of central banks in both industrial and emerging market countries. They have become more keenly committed to bringing inflation down and keeping it down. Inflation expectations embedded in wage and other contracts appear to have become more forward-looking and better anchored, and less likely to respond to one-time price increases.

While a legitimate source of pride for central bankers, this better inflation performance also reflects another secular force; namely, the trend for the supply side potential of the global economy to grow faster than in the past. Contributing factors include economic liberalisation in a large number of countries, not least Korea and China. Allied with an export-oriented strategy for growth, such developments have helped lower corporate pricing power everywhere. Technological advances, particularly in the United States, and rapid technological diffusion have also had a significant impact on productivity growth. Financial liberalisation has further spurred a supply side response, although not always in desirable ways. Potentially productive new ideas were easily funded, but so too were many other initiatives. There can now be little doubt that much of the investment in the IT sector everywhere will never prove profitable, and a large part of this excess capacity has yet to be fully written off. All the above forces remain in play and some are even strengthening. Allied with persistently weak demand in Japan and parts of continental Europe, the implication is that global price trends for internationally traded goods and services are likely to stay deflationary even if domestic compensation and oil price increases retain some potential for near-term inflationary mischief.

Faced with these circumstances, the English-speaking countries were effectively the global importers of last resort for much of the last decade. Interest rates were kept comparatively low in the United States, even as the economic expansion extended to record length. Both business investment and household spending rose rapidly and in both sectors there was significant recourse to debt financing. The most recent example of this, partially in reaction to the reductions in interest rates since January 2001, has been a sharp increase in mortgage debt and an even sharper one in mortgage refinancing in many countries. Much of the cash raised seems to have been used to support consumption at uncommonly high levels through the slowdown.

But the important question now is how much balance sheet considerations will come to weigh on future spending plans. On the one hand, household and corporate debt levels in a number of the English-speaking countries seem very high when measured against disposable income and cash flow respectively. Unless profits recover significantly, balance sheet constraints and high levels of excess capacity may work against a rebound of investment. Moreover, the scope for further mortgage refinancing is much lower and the stock of recently purchased consumer durables much higher. On the other hand, debt service burdens still seem manageable and the ratio of debt to assets is still relatively low. However, both these more positive indicators would deteriorate were interest rates to rise back to more usual levels. In contemplating when and how quickly to raise interest rates, assuming the current recovery continues, the possible fragility of balance sheets may need to be taken into account.

If the recent past is any guide, the near-term fortunes of the rest of the world will continue to be much affected by what happens in the English-speaking countries, especially the United States. Global trade links, more integrated capital markets and a remarkable expansion of transatlantic mergers and acquisitions are increasingly pointing continental Europe in the same direction as the North American economies. Yet the potential for dissimilar behaviour also remains high. For example, with the important exception of the telecommunications companies, there is in Europe much less evidence of the debt imbalances referred to above. Profit levels have also been relatively well maintained and, again outside the telecoms sector, there does not appear to be the level of overinvestment seen recently elsewhere. What is more worrying at the European corporate level is the pressure for higher wages. Given global competitive conditions, this seems more likely to reduce employment and growth potential than to raise prices.

In Japan, the balance sheet picture is much less positive. Private sector debt levels remain very high by international standards, even if larger Japanese corporations have had some success in restructuring and paying down debt. For such corporations, profits have also been rebounding as export receipts have risen with stronger sales abroad and a weaker yen. However, for the vast bulk of smaller firms in Japan's still largely closed economy, profits remain anaemic and excess capacity the rule. While consumers have continued to spend at a moderate pace, rising unemployment and falling confidence might yet dampen spending further.

Prospects for the emerging market economies will also be much affected by developments in the industrial world. Broadly speaking, Asia looks set to perform much better in terms of both growth and inflation than does Latin America, with the transition economies in Europe occupying an intermediate position. Clearly, the relatively favourable position of the Asian region reflects both the size and composition of the traded goods sector. Perhaps the biggest risk to the outlook for Latin American countries comes from the external side. Should financial flows dry up, reflecting either increased risk aversion or domestic political instability, current account deficits would have to be reduced through corresponding cuts in domestic spending. This could prove painful, as we have already seen in Argentina, and before that in Turkey. But while Turkey now seems to be on a path to recovery, albeit subject to still high inflation and eroding competitiveness, the outlook for Argentina is more uncertain than ever.

Another important consideration looking forward is the extent to which difficulties and imbalances in the global financial sector itself might moderate an incipient recovery. The first point to make inclines one to optimism. While banks in most industrial countries have suffered some deterioration in the quality of their loan portfolios, the share of problem loans seems likely to remain well below the peak reached in the early 1990s. One major reason is that loans for commercial property in many countries were much more subdued in the most recent cycle than in the preceding one. The speculative financing associated with this "new era" was not provided primarily by banks, but rather was channelled through equity and bond markets, or extended directly by vendors and venture capitalists. The rate of return on capital in the financial sector has also been well maintained, in spite of recent reductions in revenues associated with investment banking, and most banks appear adequately capitalised. In sum, in most industrial countries, capital constraints on the supply of bank credit do not seem likely to be a major impediment to growth.

This good news having been stated, financial institutions are not all free of troubles. It is well known that there are major problems in the Japanese banking system (see below). In addition, there are signs that some banks in continental Europe may be becoming more hesitant in making loans, particularly to smaller firms, at the same time as they are becoming less hesitant to pull the plug on bad credits. Presumably, the judgment of equity markets about the inadequacy of traditional lending strategies is playing a role here. It should also be noted that the global insurance industry has been negatively affected by the fall in investment income as interest rates and equity prices have declined. Moreover, general insurers have been hit by a succession of natural disasters as well as the events of 11 September 2001. There has also been a tendency for some companies, in both the insurance and reinsurance businesses, to compensate by moving into new areas such as credit derivatives. At this stage, it is difficult to assess the extent to which this trend may have exposed them to significant new risks.

Turning to financial markets, these have been remarkably robust to date. Nevertheless, many concerns remain. Elevated stock prices and the value of the dollar are long-standing worries. Concerns about rising house prices and the sustainability of financing through global bond markets are of more recent vintage. Significant changes in one or other of these areas are not implausible, and such changes could conceivably feed back negatively on global economic prospects.

The correction in stock prices in the technology, media and telecommunications sectors has already been massive. Here it must be hoped that the worst is over. Elsewhere, declines have been substantial but conventional valuations still leave stocks in aggregate, particularly in the United States, looking rather highly priced. This is especially the case when measured against recent earnings, but remains so even using bottom-up expectations of future earnings. Moreover, these latter estimates seem quite optimistic when put into the broader macroeconomic context, as noted above. Another uncertainty is whether further legacy charges against profits might still materialise given the long period during which profits appear to have been heavily managed. More bad investments might have to be written off and pension funds might have to be topped up. The Enron affair underlines the possibility that artificial profits might yet be revealed elsewhere. Fortunately, a general loss of confidence does not seem likely, particularly given the promise of continued increases in productivity.

Recent worries about house prices have not arisen only because levels are high relative to fundamentals. The ratio of prices to disposable income is near record highs in some countries, although not everywhere. Equally significant is the fact that house prices have been rising rapidly in many countries and seem to be playing a crucial and potentially unsustainable role in supporting consumption. In the United States, recent trends have been fuelled by increasingly easy access to mortgage credit, including through government-sponsored enterprises (GSEs), and the sharp decline in fees charged for refinancing mortgages. Concerns have been expressed that the resulting rise in indebtedness might leave many borrowers exposed in the event of any economic difficulties.

Long-standing pessimists about the dollar, focusing largely on the size of the US current account deficit, have been continuously confounded by its strength. Successive explanations for that strength have been found wanting in the light of unfolding events. Perhaps the most convincing explanation to date involves a combination of high expected rates of return on US investments, linked to relatively fast productivity growth, and the belated move by European companies towards establishing a global presence. In practice, this portfolio rebalancing necessitated an initial move into the world's largest marketplace, the United States. Until recently, the bulk of European capital inflows into the United States were in the form of foreign direct investment and equities. Last year, however, these were replaced in very large part by bond inflows, the more conservative instrument traditionally favoured by Japanese and other Asian investors. Still more recently, perhaps under the influence of losses on previous US investments, even these have shrunk amid a renewed interest on the part of US investors in opportunities in Europe.

Given the track record of forecasts in this area, speculation about the effects of these recent changes would seem risky. Even given the recent weakness of the dollar, it would be naive to simply extrapolate this trend into the future. However, it is a matter of simple arithmetic that for every year the United States runs a large current account deficit, its external debt mounts. Should the United States also experience the most robust recovery among the major industrial nations, as many now expect, this arithmetic will apply with increasing force. The fact that so many investment portfolios, both public and private, seem weighted heavily towards dollars could also provide some scope for rebalancing should the period of dollar strength seem definitely over. Europe now has financial markets in euros that match those in the United States in many key respects. Efforts to hedge dollar positions might also have effects on the domestic value of assets denominated in dollars, particularly if they were considered to be highly priced in their own right.

The last general cause for concern in this area has to do with some of the downsides of modern financial markets. The most obvious one is that access to more sources of credit can facilitate overborrowing. Experience teaches us that consumers, companies and even sovereigns are not always good judges of their capacity to service debt. Nor indeed are those who lend to them. Moreover, as Argentina's current woes so clearly indicate, what is manageable under one set of circumstances may not be manageable under another.

A closely related problem is that markets can be subject to sudden shifts in sentiment which can lead to herd-like behaviour and the sudden drying-up of liquidity in key sectors. The continuing increase in concentration in financial markets, while probably implying better risk management overall, nevertheless could still be a source of concern. For example, the most important over-the-counter derivatives markets are dominated by a very small number of firms whose ratings have been trending downwards. Nor is it comforting that the US GSEs referred to above rely on such a small number of firms in the complicated business of hedging themselves against market risk, in particular mortgage prepayment risk. Carrying out the huge volumes of transactions required, in an environment where most participants have similar and predictable strategies, could potentially lead to disruptive price movements. Moreover, a material change in the circumstances of one of these major participants could have widespread implications for financial markets as a whole. Problems would be aggravated by the growing trend for big to trade with big.

Finally, a market-related question of a more conjunctural nature should also be asked. Will bond markets remain as welcoming to borrowers, including those of lower quality, as they have been in the recent past? Aside from the most risky bonds, spreads have stayed quite low. Presumably this reflects the view that the expected economic recovery will materially reduce the likelihood of default. Were this view to change, however, firms and sovereigns might easily find themselves facing financial market conditions that would make a robust upturn even less likely.

Policies and practices to support sustainable growth

Whatever the economic processes playing out at any point in time, good policies and practices can improve future prospects. Through such efforts, growth trends can be increased. Cyclical variability can be reduced. Financial crises can be made both less numerous and less severe. To these ends, there is a role for both macroeconomic and macroprudential policies, the latter being defined as policies to strengthen financial stability. Structural reforms have an important role to play too, not only in making markets more efficient, but also in cleaning up the economic and financial mess left from past crises. This continues to be a problem in a number of countries.

Exchange rate regimes and macroeconomic policies

Before turning to macroeconomic policies, it is worth discussing the exchange rate framework within which they operate. Fewer and fewer emerging market countries are opting for fixed or adjustable peg regimes, and with good reason. Such regimes invite destabilising speculation and crises, as seen recently in Turkey and Argentina. Moreover, they encourage local residents to borrow in foreign currencies, commonly at lower rates of interest, leaving the corporate sector and potentially the financial system of the country exposed to huge losses should the currency ultimately depreciate. While floating is one preferred option, another might be an immutable fix to some other larger currency, or the establishment of a regional currency. In the light of the highly successful introduction of the euro, such issues are being discussed more seriously in transition economies and virtually all emerging market regions. Whatever the macroeconomic advantages, the microeconomic costs associated with scores of separate currencies are being increasingly appreciated.

Countries that choose to float their currency cannot in practice ignore what happens to its value. Indeed, it is clear from recent experience that many emerging market countries have chosen to manage their float quite carefully. One obvious reason is that exchange rate changes affect domestic prices. In such cases, the logical recommendation would be to use monetary policy not to control the exchange rate per se, but to moderate its movements in order to achieve some domestic inflation objective. However, the problem can easily become more complicated. The exchange rate may fail to respond as expected to changes in policy rates, a realistic possibility to judge from the behaviour of the G3 currencies in recent years. Or there may be legitimate concerns about other effects of exchange rate changes: the implications for competitiveness and financial stability, or the possibility of disorderly market conditions and self-fulfilling crises. Indeed, such concerns might have greater legitimacy in emerging market economies than in industrial ones. In such circumstances, other policy instruments should be considered. In ascending order of intrusiveness, they would range from verbal intervention through actual intervention to measures to limit speculation or capital movements. Whatever decisions are taken, due consideration must also be given to the longer-term costs of interfering with market processes and the motivation for all such policies should be clearly explained to the public.

The greatest task for monetary authorities over the last decade has been to achieve and maintain low inflation. This task has been carried out with considerable success and the result has been better economic performance overall. Nevertheless, this welcome state of affairs also poses new challenges of which policymakers are becoming increasingly aware. The first has to do with judging when it is time to tighten monetary policy. The second has to do with easing, and in particular the constraints imposed by the zero lower bound for nominal interest rates.

Consider first the question of tightening policy. If it is true that inflation expectations are better anchored around official inflation objectives, it may also be the case that underlying demand-supply imbalances can gradually build up unnoticed. At a certain point, inflationary pressures could emerge, perhaps necessitating a stronger policy response than otherwise. Such a situation would be more likely if perceived supply side increases turned out to be only a temporary phenomenon due, say, to a strengthening exchange rate or lower commodity prices which subsequently reversed. Of course, none of this would be a practical problem for monetary policy if central bankers had reliable measures for such concepts as the potential growth rate of the economy and the natural rate of unemployment. The problem, obviously, is that they do not.

A different, and perhaps more likely, complication concerning tightening can arise when inflation and interest rates are low and confidence is high. In such circumstances, leverage becomes more tempting. It could also become easier and credit growth could accelerate sharply, potentially spilling over into asset markets, wealth and spending. Resulting declines in the cost of capital might also prompt increases in investment that would themselves contribute to maintaining low inflation. However, were spending subsequently to falter, a period of excess supply and even deflation could follow, with potential feedback effects on the financial system. This kind of boom and bust cycle was seen in Japan in the late 1980s and in East Asia in the second half of the 1990s. In both cases, there was no overt inflation but a crisis emerged nonetheless.

It is far easier to describe these problems than to say what to do about them. Deciding to raise interest rates when there are no overt inflationary pressures is difficult, whether or not asset prices are rising rapidly at the same time. There are two good explanations for this. First, given all the economic and measurement uncertainties, there is a very reasonable chance in either set of circumstances that tightening would actually prove to be the wrong policy. Second, convincing the public and politicians of the need for such a policy would be very difficult. Yet, should the economy actually be on a path to boom and bust, the longer the expansion were allowed to proceed, the greater would be the ultimate reckoning.

How to ease monetary policy, when the economy is weakening and the level of inflation is already low, poses further interesting questions since a situation of deflation could easily arise. Given that nominal policy rates cannot fall below zero, deflation raises real interest rates and compounds the deflation problem. Moreover, the extent to which the problem is aggravated varies directly with the level of outstanding debt to which the miracle of compound interest applies.

Some would argue for a very vigorous easing of policy rates to prevent the emergence of deflation. The added dangers posed by high debt levels, particularly relevant to policymaking in the English-speaking countries, lend further support to such an approach. However, others would recommend a more measured response in pursuit of the same objective. One tactical motivation would be to establish a set of expectations that rates would continue to go down and then stay down. This would help long rates to fall and actively stimulate spending as a result. Such logic might apply in much of continental Europe, where long rates traditionally matter more and there is currently less excess capacity to constrain investment. A further argument for caution was first voiced in the 1930s. If the problem is one of boom and bust, very low interest rates may impede the necessary process of reducing excess capacity. Of course, this argument carries much less weight if there are other mechanisms, say active bankruptcy courts and vigilant bankers, to ensure that unviable companies are restructured nonetheless.

In such circumstances, the usefulness of fiscal policy would have to be actively considered. If monetary policy were increasingly "pushing on a string", the principal insight from Keynesian analysis is that fiscal policy could still have an important role to play. Nevertheless, reckless government spending over more recent decades has also taught other important lessons.

The first is that the form of fiscal stimulus also matters. In Japan, for example, very heavy government investment in regional infrastructure over the last decade has been in large part wasted. Stuck with future liabilities but no matching assets, it is not surprising that Japanese consumers, who are also taxpayers, have remained cautious. Redirecting expenditures in Japan towards unemployment insurance and other social safety net provisions could help materially to foster the structural changes that Japan now so desperately needs.

The second lesson must be the need for fiscal prudence in normal times, to allow room for flexibility in less normal times. The governments in many industrial countries, but most notably in continental Europe, have been remiss in this regard – particularly if future pension obligations are taken fully into account. In Asia, the fiscal costs of bank restructuring may yet raise debt ratios to dangerously high levels. A corollary to this call for prudence can also be proposed. Should the deficit have to rise for cyclical reasons, a medium-term plan to restore fiscal stability over time is also needed. Indeed, legislation to ensure such an outcome has already been passed in a number of emerging market countries.

Structural and macroprudential reforms

The prospects for faster and less variable growth would in many countries also be enhanced by further attention to structural reforms. In Japan, the principal problems have to do with deep-seated impediments to the restoration of an adequate level of profits. This will not be easy to address. In continental Europe, while the functioning of labour and product markets has improved more than many people realise, there is still a long way to go before the reality of change matches up to the political promise of the Lisbon Summit. Unfortunately, impending elections in a number of countries, together with resistance from organised labour, have recently been interacting to slow needed progress. Similar comments – significant recent progress but nowhere near enough – could be made about China, India, Russia and a whole host of other emerging market countries. The reality appears to be that structural reforms are inherently difficult. Governments must commit themselves to the long haul and expect intense opposition from vested interests.

Policies to improve the efficiency and stability of the financial system would also be of great help in supporting sustainable growth. In many countries, the principal task is to clean up the residue from previous financial crises, or from a long period of misdirected and underpriced lending. After years of hesitation, the Japanese authorities have only just begun to address the structural problems affecting both the corporate and banking sectors. The recent special examinations of suspected weak credits by the Financial Services Agency will prove useful if they induce the banks to stop providing credit to the uncreditworthy. This in turn would force a market-driven corporate restructuring which would tackle the underlying problem of inadequate profits. However, this process of recognising losses could also reveal the undercapitalisation of some Japanese banks and the need for some form of further government intervention. If the authorities feel this is likely, they should be preparing the public now for possible increases in the government deficit. Without these domestic improvements, a global upturn cannot be expected to have anything more than a palliative effect in Japan.

Unfortunately, similar problems arising from past mistakes also seem to be lingering on in a number of emerging market countries. For example, domestic credit growth in Mexico has never recovered from the 1994 crisis, and credit growth in a number of Asian countries – Indonesia in particular – has remained similarly restrained. If this is due to supply side constraints, as still weak banks refuse to lend to still weak corporate customers, the influence of these headwinds could well reduce the prospects for economic recovery. And this point applies all the more to both Turkey and now Argentina, which previously had one of the strongest banking systems in Latin America. It should, of course, be pointed out as well that significantly greater progress seems to have been made in countries such as Korea and Malaysia. Close study of their experiences, as well as lessons from the earlier restructurings in the Nordic countries, could well bear fruit for others.

Steps to recover from past financial errors must go hand in hand with efforts to avoid new ones. As noted in the Introduction, many helpful steps have been taken to strengthen individual financial sectors, the functioning of markets, and the infrastructure supporting the global financial system. Nevertheless, a number of initiatives and processes already under way need to be brought to a successful conclusion. Moreover, there are new suggestions that merit attention from the official and the private sector alike.

Among the initiatives awaiting completion, none ranks higher than the proposed New Basel Capital Accord. This exercise is designed to improve the stability of national banking systems by redefining minimum capital requirements, by strengthening the role of supervisory agencies and by encouraging the exercise of market discipline. The most important change with respect to the minimum capital requirements is that required capital will now be much more directly linked to the bank's overall risk profile. This welcome, indeed inevitable, step mirrors the broader evolution of capital markets towards the more efficient pricing of risks of all sorts. A variety of methodologies, depending on the risk management sophistication of the bank concerned, are proposed for evaluating credit risk. Moreover, the capital requirements are designed to provide incentives for banks to graduate from more rudimentary to more sophisticated methods of credit evaluation. This having been said, there is nothing in the New Accord that forces banks, particularly in emerging market economies, to move to more complicated methodologies before they feel comfortable about doing so.

The New Accord has been the subject of extensive consultations with both supervisory authorities and industry representatives from around the world. For that reason, it has already been years in the making. These consultations will continue into 2003, with full implementation being planned for 2006 in order to provide a sufficient preparatory period for both banks and supervisors. A number of open issues in the Accord are still being actively addressed, but in most areas agreement on how to proceed seems near at hand.

A broader issue has to do with the inherent procyclicality of market-based financial systems, and how the New Accord might affect it. As discussed in the previous chapter, credit conditions often ease as a cycle matures and then tighten after the economy begins to head downwards. This has always been the case, including under the existing Accord, but concerns have been expressed that this tendency could become accentuated under the New Accord. Having risk-sensitive capital weights clearly improves the relative evaluation of different credits. However, credit evaluations that can change relatively can also change absolutely over time. This opens the way for capital requirements to drift down in good times and back up in bad times, with procyclical effects on bank lending.

The Basel Committee has been looking into this issue carefully, recognising that the supervisory pillar has a potential role to play. Forward-looking or dynamic provisioning schemes are also being investigated in a number of countries. But perhaps the greatest consolation is that the culture of risk management appears to have been much improved by the Basel process, and seems likely to improve further. A crucial aspect of such an improved risk culture would be a more systematic recognition that the future can differ from the past, that cycles will recur, and that good credits can easily turn bad. Analogous to the call for fiscal prudence above, bankers should accumulate capital in good times to run it down in bad. Were they to do so, fears of heightened financial procyclicality would be much reduced.

A further set of opportunities and challenges will arise from the process of financial liberalisation, both internal and external, which is now well under way in many emerging market countries. The benefits should include higher-quality financial services, higher levels of savings and better allocation of real resources. However, the recurrent financial crises of recent decades also teach some practical lessons. It matters how liberalisation is carried out, particularly with respect to the capital account. Moreover, the transition period itself can be particularly hazardous.

In addition to measures to strengthen banking systems in emerging market countries, a high priority should be given to developing domestic financial markets. This would improve the operation of monetary policy and also help avoid credit crunches should the banking system come under stress. Better developed domestic markets would also mean there would be practical alternatives to borrowing abroad, which has often led borrowers to take on dangerous amounts of foreign currency exposure. Capital inflows of this sort can also have other unwelcome macroeconomic implications, as the Asian crisis made all too clear. Finally, measures might also be proposed to improve the functioning of financial markets in the industrial countries. However, these issues are perhaps better examined in the context of three crises that remain even fresher in our minds.

Some lessons from recent crises

The events with the most wide-ranging set of implications for financial markets were arguably those surrounding the failure of corporate governance at Enron and, as subsequently revealed, at a host of other firms. Two main lessons seem suggested. Sadly, neither is new. The first is that high levels of leverage are dangerous, and easily disguised. Nevertheless, even in the case of Enron, the extent of its exposures could have been ascertained if the right questions had been asked. The problem is that no one asked, presumably because things seemed to be going so well and formulating good questions requires hard work. Unfortunately, little can be done about human nature, from which this reluctance to delve springs.

The second lesson may lead to more practical suggestions. Conflicts of interest can seriously erode the process of corporate governance. In the Enron case and elsewhere, there were many layers of governance and in virtually every case a conflict of interest can now be identified. How these conflicts might have affected the behaviour of management, the board, internal auditors, external auditors, lenders, institutional shareholders, security analysts and rating agencies is currently receiving close attention. A whole host of competing solutions have already been proposed for dealing with the problems identified at each layer. Meanwhile, markets seem to be self-correcting in many areas. In the light of this, decisions as to the regulatory actions required should only be taken after due reflection. Defining a proper set of incentives to induce appropriate behaviour is a subtle business indeed, and haste could easily lead to unforeseen consequences.

This last observation also applies to the lessons to be learned from the second crisis, that of Argentina. Aside from some obvious conclusions as to how not to manage a crisis, the overriding lesson from this affair is again not new. Forbearance in the face of untenable situations materially increases the ultimate costs. This raises the issue of possible new incentive systems, for both debtors and creditors, which would lead to an earlier shared acceptance of the need for debt restructuring.

Debtors would more easily face up to reality if the costs of doing so were less and the benefits more tangible. In theory, the main costs would seem to be litigation and a denial of access to credit markets in the future. However, recent experience shows these costs may not be so great in practice. In contrast, the attractiveness of restructuring to debtors would be materially enhanced if the restructuring were to be accompanied by greater access to "new money", and if it yielded material benefits in terms of future debt service. As for creditors, they would be more willing to accede to an early restructuring if they could be convinced that it was truly necessary. That is to say, they must come to an earlier realisation that their only practical choice is between half a loaf and no bread. Clearly, the potential for unlimited access to someone else's resources impedes such a realisation. Finally, both debtors and creditors ought in principle to respond positively to processes that make a workout more orderly.

These broad principles may appear uncontroversial, but translating them into practical action raises many questions. There is currently no agreed and robust methodology for determining when a country needs debt restructuring. Does this imply that practical judgments cannot be made on a case by case basis? Creditors who have just written off debts will not be much inclined to provide new money. Does this imply a greater catalytic role for the IMF?

Agreements to adopt international legal conventions binding on all sovereign nations are notoriously difficult to negotiate. Does this imply that some more informal process should be turned to? To these practical questions, many others can be added.

So where do we stand now? What does seem generally agreed is that the IMF is right to generate expectations that the size of its emergency loans to countries in crisis will be more limited. This will remove the expectation that a whole loaf might yet be on the table. Unusual cases requiring more discretionary financing will still occur, but the decision to make such sums available will presumably involve more demanding and more transparent criteria. Research should also proceed into how a more formal international workout procedure might operate; such research is indeed being pursued at the Fund, as well as under the aegis of the G7 and other groups. Since the practical results of these labours are likely to be a long time in coming, steps are also being taken to see how both existing and new lending contracts might be altered to facilitate orderly workouts, even when there is a wide variety of creditors to deal with.

The third and most dramatic crisis was that of 11 September 2001, the salient features of which are all too well known. For the financial community, the principal lesson has to do with the operational risks engendered when financial institutions, markets and infrastructure are highly concentrated geographically. Moreover, when the firms involved are few in number, but account for a very high proportion of the global business, the risks of a massive, systemic shutdown are clearly compounded. Faced with the reality of economies of scale and scope in the provision of many financial services, it would not be easy to roll back the tendency towards concentration. However, at the very least, firms must be forced to equip themselves with the redundant systems needed to ensure business continuity in a crisis. A second important lesson is that contingency plans, including assured communications facilities, need to be put in place and regularly updated. Furthermore, these plans should not assume that only individual firms might find themselves in crisis, but that a number of them might be affected simultaneously. The need for backup facilities to be able to communicate with each other is crucial in such circumstances.

Turning the lessons from recent crises into practical policy suggestions is one thing. Implementing such suggestions is another, particularly given the need for political compromises both nationally and internationally. The resilience of the global financial system to date testifies to the benefits of past efforts in this regard. It should not blind us to the fact that further policy actions might still be needed if an adequate level of financial and economic stability is to be assured in an increasingly complex world.