I. Introduction: an uncomfortable soft spot

The last year or so has been marked by economic disappointments. Interrelated developments in the geopolitical, economic and financial spheres held back growth and led to great uncertainty about the future. The recovery in the world economy seemed to stall. Indeed, the news got worse rather than better during most of the period under review. This was surprising to many given the high degree of policy stimulus being applied in large parts of the world. In fact, such a pattern of unrealised expectations has been the norm for at least the last couple of years, a phenomenon typically explained in terms of unexpected events like the Enron and other corporate scandals, the shock of 11 September 2001 and, albeit better anticipated, the Argentine crisis. The period under review, ending April 2003, was no exception. Uncertainties related to the Iraq war, and even the spread of the SARS virus, were cited as the principal reasons why business investment everywhere seems to have been put on hold.

War in Iraq provided an ominous background. The initial question was whether there would be war or not, and what the implications might be for oil prices. Then the question became one of timing. Subsequently, the issue was how the war might be conducted, and how it could be ended. These questions have been answered more speedily than many expected. Nevertheless, there remain lingering political uncertainties arising from the war that might prove harder to dispel. Even before these recent events, there were a number of international tensions which threatened progress in such crucial areas as the Doha round of trade negotiations and global financial reform. The recent weakening of the US dollar has also thrown into greater relief uncertainties pertaining to international saving imbalances, and how different countries might best contribute to their resolution.

Yet, as hopes regarding the global economy have repeatedly been disappointed, attention has also begun to focus on the possibility that more deep-seated forces might be at work. Developments in the United States drove global growth from the early 1990s onwards. In large part this was because Japan and Germany did not succeed in making the structural adjustments needed to deal with the legacy of the asset bubble and reunification, respectively. However, with hindsight, the US expansion of the late 1990s also fostered its own excesses of overly optimistic profit forecasts, rapid credit growth and asset price increases, and overextended balance sheets. Last year, headwinds arising from these imbalances, particularly in the corporate sector, blew strongly against the economic upturn in the United States. Moreover, given growing global linkages through trade and financial markets, to say nothing of shared confidence effects, other countries also seem to have been affected in important ways. As profits continued to be elusive, European multinationals that had previously invested heavily in the United States cut back everywhere. More broadly, the necessity to adjust to unprecedented stock market declines, with the fall from the peak in March 2000 to current levels equal to about two fifths of today's global GDP, was another restraining factor. Emerging market countries were also hit, in Asia primarily through diminished trade in high-tech goods, and in Latin America through a temporary drying-up of capital inflows.

If it was unfortunate that the more optimistic expectations for growth failed to materialise, it was fortunate that the same could also be said for the more pessimistic outlooks. Contrary to what some had feared, weak economic growth did not interact with the strains arising from the recent "bubble" period to seriously threaten the health of the global financial system. In spite of a series of shocks that eroded both capital and confidence, there was no failure of any major financial institution. Equally welcome, there have been no recent instances of significant failures in the functioning of key financial markets. That said, there was clear evidence of tightening credit standards in some jurisdictions, with the US high-yield market being particularly affected. And there were growing fears that some weakened insurance companies and pension funds might prove less willing to take on risky investments in the future. While both these developments probably represent an overdue swing back towards greater prudence, their constraining effects on credit availability cannot be desirable at this particular juncture. In this area as in many others – including fiscal restraint, loan provisioning, changes in exchange rates, structural reforms and policy paradigms – the failure to make needed changes in a timely way always bears attendant costs.

Fiscal easing and the sometimes sharp reductions in policy interest rates in many industrial countries have doubtless contributed to the resilience of the financial system to date. This has also helped to limit the downturn in the flow of capital into a number of emerging market economies still dependent on such flows to finance current account deficits. However, another possible reason for this financial resilience may have been the significant efforts made over the years both to improve the infrastructure supporting the international financial system and to increase the diversity of funding sources.

Moderating global growth and the influence of financial factors

Growth in the US economy in early 2002 recovered well from the previous recession, consistent with the strongly expansionary fiscal and monetary policies in place. Yet, more unusually, growth has since tended more to moderate than to accelerate. In addition, the nature of the recovery has been every bit as unusual as the sharp drop in profits and investment that preceded it. Consumption, whose atypical strength had helped make the downturn the shallowest recession in the postwar period, stayed strong through most of 2002 before showing signs of waning closer to the turn of the year. Corporate investment, in contrast, remained weak throughout, even though rigorous cost cutting succeeded in maintaining productivity growth at high rates, restoring the profit share of GDP to more normal levels and sharply reducing firms' external financing requirements.

The growing influence of financial factors on spending decisions in the United States became more apparent in the period under review, even if the corporate and household sectors differed markedly in their sensitivities. In the former, the principal concern was to restructure corporate balance sheets in the light of historically high debt levels. This led to both cuts in investment expenditures and reductions in outstanding debt, where possible. The process of retrenchment was also consistent with financial market conditions that remained very challenging. Continued sharp falls in equity prices and very high, if recently narrowing, bond spreads meant that only high-quality credits benefited fully from the earlier reduction in policy rates. The fact that the US dollar finally fell on an effective basis, reflecting both lower interest rates and growing concerns about the US trade deficit, provided some support to repatriated earnings. However, this was nowhere near enough to overcome the underlying corporate pessimism arising from concerns about balance sheets and uncertainties about the world political environment.

These difficult financial circumstances might also have been expected to restrain household spending. In fact, and paradoxically given surveys showing weaker consumer confidence, US households continued to spend vigorously. Consumer durables and housing services were particularly favoured as both benefited from lower policy rates as well as special financial factors. The willingness of producers of durable goods to provide zero interest financing, at a cost to their own profits, helped sustain automobile sales in particular. More significantly, a combination of lower mortgage rates, rising house prices and reduced transactions costs led consumers to refinance massively. While proceeds were used in part to pay down higher-cost consumer debt, a substantial portion was used to finance more consumption, or to trade up in the housing market. Since this latter trend reinforced upward pressure on house prices, the process may to some extent have developed a dynamic of its own. Moreover, a similar phenomenon reflecting the greater availability of credit has been seen in recent years in the United Kingdom and Australia as well as in a number of Asian and continental European countries. While US household debt continued to rise throughout the period under review, this elicited no obvious precautionary response from consumers. Debt service costs remained relatively low, even though the ratio of debts to assets rose significantly due primarily to declines in equity prices.

Growth in Japan, and particularly in continental Europe, also failed to measure up to earlier forecasts. But the disappointment was all the greater given that Europe was seen as exhibiting only a few of the expansion-related imbalances evident in the United States, and Japan had already suffered many years of effective stagnation. Cautious behaviour in the corporate sector was not much different from that seen in the United States, and for essentially similar reasons of weak profits and high debt levels. Rather, the major difference in performance compared to the United States was on the consumption side, with patterns of household spending in continental Europe and Japan not diverging much from previous cycles. While house prices in 2002 rose even faster in many continental European countries than in the United States, there seemed to be neither the desire nor the practical means to transform this higher housing wealth into increased spending.

It is hard to attribute the persistent sluggishness of growth in Japan and the larger continental European countries, especially Germany, to macroeconomic policies. These were generally accommodative, albeit not excessively so, over the period under review. Instead, the evidence points more in the direction of structural weaknesses in labour, product and even financial markets. In Germany, for example, unemployment rose again last year as earlier reductions in the "tax wedge" affecting employment were partially reversed. Investment plummeted at the same time to postwar lows in the context of a further decline in the corporate profit share. Moreover, deregulation in Japan and many European countries did not proceed rapidly enough to allow an orderly reallocation of labour in the face of international competition. Last year, the long-standing pressure on prices and profits in goods-producing industries eased only slightly, and such pressures could well intensify given China's accession to the WTO. Finally, in Japan and Germany, financial institutions appear to have tightened credit conditions last year, affecting the investment decisions of small and medium-sized enterprises in particular. On the one hand, this could be interpreted as a welcome response to the secular problem of persistent underpricing of risky loans to businesses. On the other hand, to say that this change in behaviour came at an awkward time would be to put it mildly.

Given the difficulties faced by the major industrial countries, it is perhaps surprising that the emerging market and transition economies grew as fast as they did. Latin America suffered for much of the period from jitters in global financial markets, but also from domestic concerns that reduced capital inflows. Currency depreciation, recession and inflation threatened simultaneously. Fortunately, as time wore on, the commitment of the new Brazilian president to prudent macro policies, the ending of a major strike in Venezuela, and signs of an upturn in Argentina all contributed to a better regional atmosphere. Greater confidence in the efficacy of adjustment efforts, associated support from the IMF in many cases, and increased investor demand for emerging market debt tended to narrow sovereign spreads, which nevertheless often remained uncomfortably high.

In Asia and central and eastern Europe, growth generally stayed quite robust throughout the period under review, reflecting both external and internal factors. Asian countries benefited from a major expansion in intraregional trade, increasingly with China, whereas the European economies in transition succeeded in diversifying their export markets. In both regions, capital inflows continued to be sufficiently strong to pose policy dilemmas that were only partly allayed by official intervention and substantial increases in foreign exchange reserves. As a by-product of such actions, the official sector also ended up making a large contribution to the financing of the ever expanding US current account deficit. Fortunately, significant efforts were also made in both regions to stimulate domestic demand in order to begin redressing this external imbalance as well as to increase growth. Unlike in Latin America, a number of countries in these regions had sufficient credibility to allow the authorities to ease fiscal and monetary policies. Moreover, in some cases, structural changes contributed to a marked expansion of household credit to finance purchases of both consumer durables and houses. However, Korea, which had advanced furthest in this regard, also experienced significant financial turmoil in the spring of this year. For outside observers at least, this was a useful reminder of the potential pitfalls inherent in all restructuring processes, particularly those involving the financial system.

Global inflation has remained essentially stable at low levels over the last year or so, although higher commodity prices, especially for oil, did for a time raise fears of an inflation rebound. In the industrial countries, the trend was more down than up, with Europe tending to have the biggest price rises, Japan in outright deflation and the United States somewhere in between. A general phenomenon, observed particularly in countries with appreciating currencies, was that goods prices either fell or rose much less than the prices of services. Increased international competition and productivity differentials presumably played a leading role in this change in relative prices, and probably had a broader disinflationary effect as well. One background factor supporting the maintenance of low inflation in the industrial countries was an increasingly firm set of expectations, after some years of low inflation, that similar conditions would prevail well into the future.

The price picture was decidedly more mixed in the emerging market and transition economies. Latin America was clearly the worst performer. Inflation rose sharply in many countries and explicit inflation targets were often missed. Yet it was also notable that, even after significant depreciations, there was no return to hyperinflation, as in the past. In part this reflected the broader global pattern, but it also depended upon supportive policies by the relevant authorities, who insisted that inflation should and would be reduced. Still more welcome was the fact that inflation did decelerate over the review period in most countries outside Latin America, even in India, where the fiscal deficit remained high.

At the same time, a new trend appeared in a few emerging markets in Asia that was unwelcome in some cases and puzzling in others. As to the former, deflation deepened in Hong Kong SAR and reappeared in Singapore. These developments were in part the fallout from their earlier property and high-tech booms respectively. However, deflation also re-emerged in China, where there had been no boom, and occurred in spite of substantial fiscal stimulus by the government and very rapid rates of credit growth. One possible reason might be massive increases in labour productivity and hence in supply capacity reflecting foreign direct investment. The failure to close state-owned enterprises for fear of the social and political implications also contributed to excess capacity in many sectors.

The appearance of deflation in these countries, along with Japan, triggered a discussion of whether deflation might be a possibility elsewhere and, if so, whether it is a cause for concern. The observed pause in economic growth further fuelled this debate, since existing levels of excess capacity were threatening to become larger, which would put downward pressure on an inflation level that is already quite low. Such developments might even interact with vulnerabilities in the financial system to further disinflationary effect. All these forward-looking considerations are returned to in the following chapters and the Conclusion.

Preserving financial stability and the influence of public policy

Given the macroeconomic difficulties in the industrial countries, it was perhaps not surprising that corporate defaults and rating downgrades rose sharply last year to levels well beyond those seen in the last recession. In association with diminished prospects for profits in surviving firms, this also led to a third consecutive year of heavy losses in stock markets. Yet, in contrast to both this corporate experience and earlier episodes of economic downturn, the financial system seemed, on the surface at least, to remain relatively robust. While clear signs of strain did begin to emerge, they were limited to certain sectors and countries and appeared essentially manageable.

The greatest source of satisfaction was the resilience of banking systems in most industrial countries. With Japan a notable exception, losses on the corporate side and reduced revenues from capital market activities were at least partially offset by solid gains on the household side. This was particularly the case in the United States, where mortgage refinancing and consumer credit generated high levels of both net interest and fee income. In Germany, the story was somewhat different as corporate defaults rose unusually sharply, and chronically low interest margins provided inadequate compensation. Nevertheless, capital ratios improved for German banks, as indeed they did in many other jurisdictions, and remained well above minimum regulatory requirements. In addition, in both North America and many European countries, significant steps continued to be taken to cut costs and diversify income sources. As subsidised competition from state-sponsored financial enterprises in Europe is gradually removed, the positive results of these restructuring efforts on profits should be seen more clearly.

At the same time, performance elsewhere in the global financial system was less satisfactory. Some old problems remained unresolved and some new problems emerged. Among the former, bank balance sheets in Japan and a number of other Asian countries – Malaysia being a marked exception – continued to suffer from high proportions of non-performing loans. Nor was any definitive progress made over the last year in devising, still less in implementing, a strategy to deal with unsustainable debt problems in both the corporate and banking sectors. Insurance companies and pension funds emerged as new problem cases. Caught up earlier in the rhetoric of the "new era", and confronted with new competitive pressures, European institutions in particular had invested heavily in volatile equities rather than the long-term bonds which are the natural counterpart to their contractual liabilities. Many European and Japanese insurance companies suffered as well from having issued liabilities with relatively high guaranteed rates of return. In response, a number of larger European companies have taken steps to recapitalise themselves, have raised insurance premiums and have begun to withdraw from unprofitable lines of business. For their part, pension funds almost everywhere have turned to their corporate sponsors to deal with their underfunding problems. As an unpleasant side effect, however, this has hurt profit expectations and ratings, which has in turn depressed share prices still further and increased the degree of underfunding.

Another source of concern during the period under review was sharp swings in sentiment and volatility in financial markets. In addition to the soft outlook for profits, a negative factor affecting equity markets in 2002 was the unprecedented number of "fallen angels", highly rated corporations that suffered a series of downgrades in rapid succession and sometimes even defaulted. Together with earlier revelations of accounting and other irregularities, this left investors disorientated and increasingly unwilling to bear risk. These sentiments also manifested themselves in credit spreads, which rose sharply for much of the period, reaching record levels in late 2002. Fortunately, long-term government bond yields fell markedly, reaching in the spring of 2003 levels not seen in over 20 years. The net effect was that borrowing costs did not rise as much as might have been expected. A surprising but welcome development around the turn of the year was that credit spreads began to narrow, even though other indicators of market sentiment stayed quite negative. While this could have been due in part to the unwinding of an earlier overshoot, the market apparently saw grounds for believing that corporations were succeeding in their efforts to restructure balance sheets and to reduce their vulnerability to potential shocks.

The fact that the financial system, and in particular the banking system, has functioned as well as it has can be explained by both cyclical and structural factors. Perhaps the most important cyclical factor in many countries was something that did not happen. This recent downturn was not preceded by a sharp increase in lending on commercial real estate that subsequently went sour. Rather, the incomes of financial institutions were often sustained, in the face of corporate and financial market weakness, by the relative buoyancy of the residential housing market and the consumer sector. This in turn was partly a by-product of the aggressive easing of monetary policy in many jurisdictions, made possible by continuing good inflation performance.

Structural developments have also fostered financial stability. Financial institutions generally, and banks in particular, seem to have become more conscious of the risks they run and the need to manage risks more carefully. One aspect of this has been the trend to transfer risk out of the banking system into financial markets and then on to non-bank financial institutions. This trend has been supported by the rapid growth of the high-yield market, particularly in the United States, and the development of European bond markets since the advent of the euro. Banks have increasingly used such vehicles as syndicated loans, asset-backed securities, collateralised debt obligations and credit default swaps to transfer credit risk to other institutional investors. The presumption, borne out to date, is that a greater dispersion of credit risk is helpful to stability. As an adjunct, the fact that those needing to borrow could tap a more diversified set of creditors helped to avoid the kind of liquidity problems that, in the past, had often led to disruptive insolvencies.

In addition to its timely adjustment of macroeconomic policies, the public sector can take some credit for these relatively positive financial developments. National authorities, in association with international financial institutions and the Financial Stability Forum, have for many years focused intently on improving standards of prudent behaviour in the financial system. In the period under review, particular attention was paid to the weaknesses in market foundations revealed by recent corporate scandals. While many initiatives were undertaken very quickly in the wake of these events, most appear nonetheless to have been well thought out in close collaboration with market participants themselves. Moreover, while essentially national in their legislative origins and scope, many of the initiatives have been drawn up to reflect high-level principles agreed internationally after intensive consultations. Since these principles embody the lessons drawn from recent national experiences, this interactive process should eventually lead to a substantial degree of international convergence on best practices.

A particularly important development was the recent release by the International Organization of Securities Commissions of a set of principles for auditor independence (to avoid conflicts of interest) and public oversight of audit firms. These efforts attempt to address what is increasingly seen as a major weakness, namely the lack of both leadership and will in the audit industry to reform itself and its practice standards in the light of past shortcomings. Progress was also made towards international agreements on principles in the areas of accounting and disclosure. In the first area, the Memorandum of Understanding between the US authorities and the International Accounting Standards Board, agreeing to move towards a single set of accounting standards, was a major step forward. Another important development was the review begun last year of the OECD Principles of Corporate Governance, with a view to strengthening the principles themselves as well as providing more guidance on how they should be interpreted, applied and enforced worldwide. Finally, it was increasingly acknowledged that international standards are needed to help minimise inherent conflicts of interest in the financial services industry more generally. While attention has focused recently on the interaction between equity analysts and underwriters, a whole host of other conflicts can easily be identified.

To date, the global financial system has proved resilient to the economic strains that have become increasingly evident. This should be a source of comfort. So too should the progress being made in strengthening the underpinnings of the financial system. Being comforted, of course, should not distract policymakers from addressing the shortcomings which still remain. Nor should it blind them to further challenges. It may be that significant strains in the financial system exist, but are yet to be discovered. What the financial effects of an extended period of slow global growth might be, particularly if aggravated by shocks in the political or trade arenas, cannot be confidently predicted. These forward-looking issues, and possible policy responses, are the focus of attention in the Conclusion of this Annual Report.