VIII. Conclusion: towards more balanced global growth

The global economy faces a fundamental dilemma which is becoming more acute with time. How can imbalances in growth and external accounts across the major economic regions be resolved while maintaining robust global growth overall? Whether investment will pick up the baton in the United States, should consumer spending fade, is not the only important element of this question. The US economy is, after all, being supported by highly expansionary monetary and fiscal policies and the recent depreciation of the US dollar. Rather, a greater concern is whether domestic demand will expand elsewhere, notably in continental Europe and Japan, after a long period of weakness. In this context, a declining US dollar constitutes both a challenge and an opportunity for countries whose real exchange rate is tending to rise. Will currency appreciation simply slow their growth, and perhaps global growth in turn, or instead trigger the underlying structural reforms and more expansionary demand management policies that could significantly improve economic performance over time?

Prospects for growth in the near future will be much influenced by two underlying economic parameters: the propensity to save and the propensity to take risks. With respect to both, there have recently been sharp changes implying significant uncertainty about future developments.

What happens to the propensity to save in the United States is of particular importance since the country has been a disproportionately large source of global demand growth for almost a decade. The secular decline in the household financial saving rate in the United States has been remarkable and, through its effect on the current account, has materially supported global demand. Similar declines have been seen in a number of other countries, often along with a significant build-up of both internal and external debt. It seems likely that such major movements will eventually reverse, at least in part, limiting domestic spending in those countries and the export potential for other economies. In Asia, where saving rates have also declined but generally remained much higher, reliance has commonly been put on export-led strategies to sustain demand growth. Maintaining such strategies in the face of rising saving rates elsewhere would clearly inhibit global growth overall. Given such an environment, with inflation levels already low, it is not inconceivable that problems of more generalised deflation might also emerge.

It is, of course, possible, if less likely, that low-saving countries could carry on spending heartily and that the flow of capital from high-saving countries to low-saving countries will continue unimpeded, or even rise. Levels of external debt matter less than the ability to service that debt out of underlying productive capacity. Key elements supporting continued flows would be relatively high rates of productivity growth, and the ability to turn

greater levels of efficiency into higher rates of return on capital. In the last few years, the performance of the United States has been remarkable in the former respect, although not so outstanding in the latter.

A second consideration shaping near-term prospects will be investor attitudes towards risk. On the one hand, improprieties in corporate governance have caused financial reports to be viewed with deep suspicion. Downside possibilities are now seen much more clearly than during the recent long expansion. In the light of past losses of capital, the vulnerabilities of risk-seeking financial institutions are now better appreciated. These changing attitudes seem likely to reduce the willingness of both creditors and debtors to take on risk and could restrain the expansion. On the other hand, the recent buoyancy in equity markets and the substantial reduction in corporate spreads could indicate that an appetite for risk will re-emerge more generally.

What can be said with much greater certainty is that longer-term prospects for more balanced growth will depend, in part, on policy changes in those industrial economies with deep-seated structural problems. Both Germany and Japan have suffered for decades from serious inflexibilities, made worse in the aftermath of reunification and the bubble respectively. In both cases, underlying supply side problems were papered over with fiscal instruments and reliance on export-led growth. Both of these expediencies may now be approaching the limits of their usefulness.

A related issue affects a much broader range of countries. The opening-up of emerging market and transition economies, with the transfer of modern production methods, has already led to startling productivity increases and downward pressure on goods prices. This is proving discomforting to many established goods producers worldwide, albeit providing sales opportunities to many others. The implication is that the secular shift towards a service-based economy in the industrial world must now accelerate. Unless job opportunities are created in new sectors, or wages adjust sufficiently, this will lead to a lingering increase in unemployment. Nor is the adjustment problem limited to the industrial world. In East Asia, for example, countries must adapt to the growing importance of China, with a liberalising India perhaps not far behind. Moreover, they too have unresolved financial problems dating from the last decade which could make lenders hesitant to underwrite these necessary changes.

Broadly put, the need to be able to respond flexibly to prospective developments has never been greater – all the more so since the alternative might be a relapse into protectionism. Concerns in this regard have been heightened by the limited progress made to date in the Doha round of trade negotiations and by various transatlantic frictions. Deflationary pressures and the need for painful adjustment to post-bubble realities would further exacerbate such insular tendencies. We have, in fact, seen such a reaction before, in the early 1930s, and it was not a pretty sight.

Against this historical background, policymakers need to be reminded of two things. First, since we are all in the same economic boat, more cooperation is needed at the national level – between monetary, fiscal and prudential authorities – and at the international level as well. Second, quick

fixes almost always have longer-run costs as well as shorter-run benefits. Policy frameworks that blend the capacity to respond flexibly to short-run difficulties with sustainability over the medium term thus have a great deal to recommend them.

Opportunities and vulnerabilities looking forward

The end of the war in Iraq should reduce some of the uncertainties holding back the economic expansion. Both consumer demand and private fixed investment might be expected to benefit, particularly in countries where such spending has been atypically weak. In addition, the desire to rebuild business inventories from very low levels, not least to improve the security of supply chains, could also contribute to demand growth. Nevertheless, future spending propensities must also be evaluated against the backdrop of the extraordinary optimism of the late 1980s in Japan and the late 1990s in the United States. Both left a residue of high debt levels, excess production capacity and deflated equity valuations.

The Japanese experience teaches us that such excesses can feed back on the health of the financial system and even culminate in deflation. However, the US upswing differed from that in Japan in at least three significant ways. One welcome difference is that there was no comparable run-up in the commercial property market in the United States. A second difference, equally welcome, is that, whereas the Japanese boom was financed almost entirely through the banking system, the sources of funding in the United States were much more diversified. A third difference may have less benign implications, though not necessarily to the disadvantage of the United States. While Japan financed its expansion domestically, indeed running a significant current account surplus as well, the US expansion was to a large degree financed from abroad. Many countries relied for growth on exports to the United States, for which they provided ample financing via the capital account.

Should the dollar fall further, for whatever reason, it is the creditors who would this time have to bear a double burden of adjustment. They would first have to generate more domestic spending to keep demand up and unemployment down. And, at the same time, they would have to recognise declines in the domestic value of their dollar-denominated financial assets, reflecting both lower market prices and the fall in the value of the dollar itself. In contrast, the recent decline in the dollar strengthens prospects for growth in the United States and lessens the probability of deflation there.

Beginning in the latter half of 2000, investment in the United States was cut back unusually sharply. However, partly because of aggressive monetary easing, US consumption remained resilient. The principal questions now are whether investment will continue to recover, and whether consumption might falter. The wide variance in current forecasts for the United States reflects a simple fact: neither of these crucial components of spending has recently been behaving as expected on the basis of postwar experience.

In some respects, the outlook for US investment appears to be brightening a little. In spite of weak growth overall, profits and cash flows have recovered

somewhat and interest coverage remains high. Yet it would seem rash to call for a strong revival in US corporate investment, especially with capacity utilisation levels at 20-year lows and debt levels still high. Caution about other possible claims on future profits, not least unfunded pension liabilities and higher costs for insurance and healthcare, could lead companies towards still more balance sheet cleansing. Indeed, this might be what the financial markets expect. While other interpretations are possible, the recent sharp decline in corporate credit spreads is consistent with a market belief that corporate managers will take the steps required to cut costs and reduce the probability of defaults in the future.

Increased corporate investment in ever more productive capital was an important component of the "new era" story in the United States. Not only did such spending stimulate demand directly, it also led to perceptions of increased wealth that boosted spending indirectly. Indeed, as a share of nominal GDP, household spending has been trending upwards for many years, recently quite strongly. In this important respect, and despite the decline in stock prices, the boom cannot yet be said to have ended. Lower mortgage rates, the continued rise in house prices, and financial innovations that have made it easier to withdraw equity as cash to spend, have all contributed to the strength of household spending.

The practical manifestation of this behaviour is that US households have also been prepared to push up debt to record levels. Debt service requirements have also risen in spite of very low interest rates. However, balance sheet exposures might yet become a greater source of concern were employment levels to come under further pressure, and were stock prices and pension fund values to decline still more. In any event, the sustaining effect on spending of mortgage refinancing must at some point diminish. House prices are rising less rapidly and, unless mortgage rates fall substantially further, much of the refinancing that could be done profitably has probably been done already.

Given the uncertainty surrounding economic prospects in the United States, it would be comforting if a quick rebound in demand elsewhere seemed likely. Unfortunately, identifying alternative poles of growth is not easy. Continental Europe was initially expected to benefit from having fewer financial imbalances than the United States. In fact, it has been Europe that has more consistently failed to meet growth forecasts and, in the light of recent negative surprises, forecasts have been revised sharply downwards. The outlook in Germany seems particularly problematic, with personal saving rates, along with unemployment, rising after a number of years of steady decline. Virtually everywhere in continental Europe, confidence has been weakening. This possibly reflects losses suffered by European investors, who financed a large part of the US expansion, as well as the surge in telecommunications investments in Europe itself. Nor have higher oil prices and political uncertainties, both at home and abroad, been helpful. Fortunately, looking forward, some of these problems seem to be receding, especially given the recent decline in oil prices.

In other parts of the world, the outlook is also quite mixed. After so many years of slow growth in Japan, due in large part to investment cutbacks, it

takes a leap of imagination to envisage any improvement. Nevertheless, it should also be noted that the degree of corporate debt reduction has been remarkable and that the operating profits of many larger firms have risen appreciably. The turning point must come sometime, even if predicting when is never easy. In China and India, the consensus now is that the recent norm of steady, quite rapid growth will be maintained. Elsewhere in Asia, regional demand is expected to make an increasing contribution to robust expansion. The SARS epidemic could, however, yet significantly hamper production in China and consumer confidence in other countries. The outlook for the major Latin American economies also seems better, as greater political stability and renewed confidence in financial markets have contributed to some recovery from the earlier downturn.

How individual regions fare over the next year or so will depend in part on currency movements, in particular against the dollar. In principle, creditor countries should be prepared to accept currency appreciation to allow debtor countries, like the United States, to adjust. In practice, given uncertain prospects for domestic growth, some creditor countries in Asia have already begun to resist this outcome using a variety of means, both conventional and unconventional. On the one hand, this might be thought desirable if it implies lower interest rates which would increase domestic demand. On the other hand, such resistance to appreciation in Asia implies that the burden of exchange rate adjustment is likely to fall disproportionately on those currencies that are truly floating, like the euro. Another factor that could potentially affect the relative value of the major currencies would be an erosion of the willingness of creditor countries to hold their reserves, as they currently do, overwhelmingly in dollars.

Currency movements do not only affect output; they also affect price levels. The direct effects of currency pass-through to prices seem to have declined in recent years, in both industrial and emerging market countries. This is probably the result of better policies of inflation containment, augmented by an increased consolidation of inflation expectations at low levels. However, indirect effects on domestic prices, reflecting changes in output due to trade substitution and asset valuation effects, still appear substantial. Appreciation might then seem particularly unwelcome in countries like Japan and China, where deflation is already a reality. But it might also complicate life in the growing number of countries where inflation is already so low that deflation cannot be ruled out. Well known sampling biases in the measured CPI in many countries, together with a tendency for the consensus to overestimate future inflation, also indicate that this possibility of deflation needs to be taken seriously.

It should be recognised that deflation is not necessarily a bad thing if it reflects positive supply shocks superimposed on an initially (and desirably) low inflation rate. But problems can surface when other conditions are in place. One of these would be strong resistance to nominal wage cuts. Thus, if price declines were greater than increases in productivity, unit labour costs would rise and employment would suffer. A second problem arises from the zero bound on nominal interest rates, implying a dangerous dynamic where

expected real rates might rise as deflation increases. Finally, inflation falling below the level anticipated when interest rate contracts were struck tends to raise the cost of debt servicing in real terms. The higher the level of indebtedness, of course, the greater the burden on the borrower. The difficulty at the present juncture is that many of the prior conditions needed for deflation to become a problem seem to be in place. In many countries, policy rates are already at low levels, debt levels have never been so high, and nominal wage cuts seem unlikely.

One welcome aspect of recent developments has been the relative resilience of the global financial system, particularly banks. Nevertheless, some strains have already begun to appear, and these would be likely to worsen were the anticipated expansion to falter. Presumably, equity prices would be affected to some degree since current prices, especially in the United States, can only be justified by expectations of an economic rebound and sharp increases in profits. These negative effects would be greater still if equity risk premia were to rise in this altered environment. Credit spreads might also be affected, since they normally rise as equity prices fall, and they have recently fallen quite significantly. Finally, property prices might also decline, or at least stop rising in the case of housing. In a number of countries, current house prices remain at record levels, whereas historical experience indicates that they should, with some delay, have followed equity prices downwards. All of these price effects would further impair corporate and household balance sheets, tending to restrain spending.

Even if such a combination of events might be thought unlikely, it would surely be prudent for policymakers to reflect on its possible effects on the health of the financial system. In a number of countries, the proportion of bank loans related to real estate has been rising steadily, indicating a growing exposure to price decreases. Further declines in the prices of financial assets would prove particularly uncomfortable for banks in Germany and Japan, since both are struggling to raise operating profits. For banks in emerging market countries, many of which have less experience of such events in a liberalised market environment, a further bout of economic weakness would also prove uncomfortable. In Asia, banks are predominantly domestically owned and, in many countries, the bad debt problems from the last crisis have still not been resolved. In Latin America and eastern Europe, while the banks are largely foreign-owned, this also means that retrenchment in the industrial countries could threaten credit availability elsewhere.

Further declines in the prices of financial assets might also cause difficulties for insurance companies and pension funds that have already been hard hit. Concerns about the ability of such institutions to honour long-standing contracts might be expected to affect consumer confidence and the propensity to save. Insurance and reinsurance companies have also taken on credit risk exposures, of as yet undetermined size, through credit risk transfer instruments. Were they, for prudential reasons, to take steps to reduce their involvement this could impair the functioning of the credit risk transfer market and, perhaps, the willingness of originators to provide financing in the first place.

The implications of further pension fund losses would be rather different. In the case of defined benefit schemes, losses first constitute a claim on the profits of the parent company. At the extreme, parent companies could be downgraded or even forced into bankruptcy if the losses were large enough. Since lower profits imply lower share prices, this feeds back onto other pension funds in a fashion similar to direct cross-shareholding. While these problems seem to affect only a limited number of long-established companies, they do include some of the world's most famous brand names.

Compared to the concerns associated with possible further economic weakness, other financial vulnerabilities looking forward seem less worrisome. One set of concerns, which has received attention in connection with the New Basel Capital Accord, relates to operational risk in the financial system. As systems, particularly for risk mitigation, grow ever more complex, legally challenging and technology-dependent, the likelihood that something will go wrong clearly rises. Moreover, at the tail end of a boom period, all sorts of fraudulent or at best dubious behaviour are typically revealed, inviting litigation and potentially costly settlements. A second set of concerns has to do with increased volatility in financial markets, and the possibility that some financial institutions might have insufficient means in place to protect themselves. A concrete example might be the possibility of sudden, sharp increases in long-term interest rates and the effects on institutions that essentially borrow short and lend long. Finally, a third set of concerns is connected with recent trends towards consolidation in certain financial markets. With large firms increasingly trading among themselves, perceived difficulties with one counterparty might very quickly involve others. Moreover, large players can move markets in ways that could affect the cost and availability of needed hedging. In this way, idiosyncratic shocks could conceivably turn systemic.

The stability of the financial system to date has commonly been ascribed to its having become a more market-oriented system. In the United States in particular, the share of total lending provided by banks has shrunk dramatically. Markets are more complete, in that they now offer borrowers a growing diversity of channels through which financing can be obtained. By the same token, they also seem more resilient. Losses are now more widely dispersed across the financial markets, most recently through the growing use of instruments for credit risk transfer. The fact that shocks are shared across interrelated markets might also make them easier to absorb. Information about value is now easier and cheaper for users to obtain and evaluate, which presumably reduces counterparty risk and helps keep markets functioning even under stress.

Yet it would be naive to suppose that this system does not have its own shortcomings. The fact that borrowers can go through a wide variety of channels to obtain credit could easily tempt them to overextend themselves. This would seem especially likely if credit originators dispense with due diligence, on the assumption that even bad loans can be passed on via market mechanisms to someone else. The resilience that is presumed to arise from a

shifting of risks, particularly out of the banking system, depends on the risks becoming more widely dispersed and ending up in the hands of those who can best bear them. There is, in fact, very little hard evidence to support either hypothesis. Interrelated markets may dampen shocks on the one hand, but they may, on the other, expose already troubled sectors to new difficulties sufficient to push them over the edge of insolvency. Finally, good information about value is costly for producers to generate. If efficient markets prevent information providers from making profits, the quality of the information collected could deteriorate, leading in turn to market mispricing and resource misallocations. Arguably, this is exactly what was observed in the last few years of the 1990s. In short, a reasonably satisfactory performance to date should not lull us into complacency about financial stability, nor monetary stability for that matter.

Policies to achieve monetary and financial stability

In retrospect, the last decade reveals something of a paradox. Policies to achieve monetary stability, defined as a low level of inflation, appear to have been very successful in most industrial countries and in large parts of Asia. Even in Latin America, Africa and central and eastern Europe, measured inflation rates have moved sharply downwards. In addition, the volatility of output growth seems to have diminished in many regions, consistent with what those championing low inflation would have expected. At the same time, the incidence of financial disruptions and outright crises appears to have increased. A number of countries seem to have suffered from excessive optimism and credit expansion, asset price and spending bubbles, and balance sheet problems that subsequently rebounded on the financial system. Clearly, the achievement of price stability, with its unquestioned merits, has not been sufficient to ensure the avoidance of financial instability. The possibility of deflation, with all its potential downside risks, further supports this conclusion.

It is important to ascertain the cause of increasing financial instability in recent years. One explanation might be that it is simply a by-product of the deregulation and liberalisation of financial systems seen in many countries. Viewed pessimistically, such reformed systems would be judged to be allocatively more efficient at any moment in time, but more procyclical over time and more prone to crises. Viewed more optimistically, the recent high incidence of financial crises may not be inherent in a liberalised financial system, but rather a temporary by-product of the process of deregulation itself. The fact that the global economy has been in transition from a high-inflation to a low-inflation environment may also have contributed to raising the likelihood of crises. As inflation came down, expectations might have been generated of more stable growth and less variance in projected income streams. This would have lowered risk premia on investments. At the same time, as both nominal and real rates declined from higher levels, investors might have judged them inadequate and adopted more aggressive investment strategies. With time, experience and continuing low inflation,

these private sector tendencies to excess should diminish, while the public sector's capacity to moderate them should increase.

Regardless of whether problems of financial instability are assumed to be permanent, or only temporary, features of the landscape, how to lower the likelihood and costs of such disruptions remains an important policy question. One possibility that has been widely debated is that monetary policy might be used pre-emptively to moderate credit cycles. Tightening, with CPI inflation initially under control, would probably mean undershooting CPI objectives in the short term. However, such a policy could be rationalised as a means of reducing the risk of an even bigger undershoot later, once the financial imbalances had unwound. Interpreted in this way, such pre-emptive behaviour on the part of the monetary authorities could even be justified as the lesser evil within an inflation targeting framework. Unfortunately, other problems remain. An increase in interest rates sufficient to offset wildly exuberant expectations in some sectors of the economy could wreak havoc elsewhere. Convincing the public of the need for such a policy would also be difficult. In this context, having more reliable indicators of prospective future crises would be very useful both for formulating policy decisions and for justifying pre-emptive policy moves to the public.

Another option might be to put more reliance on the prudential framework. While it might be possible to minimise the excesses, a more important objective would be to keep the financial system functioning properly even after a credit or asset price bust. If much of the economic damage arises from bad credits feeding back on the financial system, such a prudential approach would have obvious attractions. Implementation of the New Basel Capital Accord, with its associated culture of improved risk management, would be an important step in the right direction. Looking further ahead, changes to provisioning or other procedures to foster the build-up of capital in good times would also seem to have merit. Again, however, there are inherent limitations to such an approach. Excesses at supervised financial institutions are easier to moderate than credit extended through financial markets, but it is this latter source of credit that is becoming increasingly important. Moreover, information on how credit risks have been shifted across the financial system is still in very short supply. In any event, financial regulators will need encouragement to focus less on consumer protection and more on system-wide risks and what they might do to mitigate them. The need for more formal interaction between central bankers and regulators in this area of shared interest would also need to be more explicitly recognised.

What is not subject to caveats is that the institutional underpinnings of the financial system require further strengthening. A number of recent reports have made suggestions that warrant serious consideration. The remaining risks in the cross-border settlement of securities transactions were the topic of an insightful G30 report. The recent agreement to work towards a compatible set of international accounting standards awaits implementation. National oversight boards for auditing firms, operating subject to internationally agreed principles, need to be established. And conflicts of interest in the

governance structure of firms in general, but financial firms in particular, should be identified and dealt with. If trust in the integrity of the capitalist system is crucial to its proper functioning, then it is important that wrongdoers are punished and are seen to have been punished. Given the flagrant excesses of recent years, it is by no means clear that enough has yet been done to re-establish trust in the system.

The preceding comments mostly have to do with preventive actions to moderate the build-up of economic and financial imbalances and thereby preserve monetary and financial stability. Yet, in the current circumstances, it would also seem appropriate to ask how public policy might best be used in the aftermath of such excesses, in effect shifting the focus from prevention to cure. In this spirit, and in the light of the Japanese experience in particular, it would also seem useful to discuss the policy options in the case of outright deflation. In such a situation, certain instruments may lose their potency while others may come into their own. The question of complementarities and packages of policy responses also comes to the fore.

Monetary authorities primarily focusing on the objective of price stability could face a dilemma in the aftermath of a boom. As they watch the previous imbalances unwind, or become increasingly concerned about the threat of this happening, they will see the need to ease monetary policy sharply to take out insurance against a possible undershoot of their price objectives. The behaviour of the Federal Reserve over the last two years seems to reflect such concerns. If financial instability is also an immediate issue, this tendency to easing will be further accentuated, as seems to have been the case in Japan. The same conclusion follows if the channels of transmission of an easier monetary policy are judged to have become compromised in some way. For example, during 2001 and much of 2002, substantially lower policy rates in the United States were met with higher corporate bond rates, weaker equity prices and further increases in the value of the US dollar. This gave added justification for the sharp easing of policy by the Federal Reserve.

The dilemma arises only if such easing threatens to further stimulate imbalances, whether in old markets or new ones. The problem of old imbalances confronted the Bank of England and a number of other central banks in the period under review. While many indicators seemed to call for ease, concerns about still further price increases in the housing market pointed in the opposite direction. The problem of new imbalances has, more arguably, surfaced in the United States, where monetary easing, first in the wake of the LTCM crisis and then following the collapse in stock prices, may have contributed to further price increases in the housing market. While the associated increase in spending has been clearly desirable, given the cyclical position of the US economy, it could also be the case that any eventual downturn will be more severe because of the debt build-up encouraged in the interim.

In the light of the recent Japanese experience, it also seems worth asking how demand might be stimulated by monetary policy in a situation where policy rates have run into the constraint of the zero lower bound. In this environment, unconventional means of expanding liquidity might be required.

The central bank might choose to broaden the range of assets it is prepared to purchase: first and foremost financial assets, but if necessary also real ones. This would, however, raise some delicate issues, not least concerning inter-agency cooperation and the independence of the central bank.

It would seem normal for the central bank first to contemplate large-scale purchases of longer-term government bonds. To the extent that long rates fell, this would have a welcome stimulative effect on the economy. However, should long rates ultimately reverse, the central bank might find itself bearing heavy losses and be obliged to seek recapitalisation from the government. Purchases of unconventional domestic assets would pose similar problems since they would imply an absorption by the central bank of private sector risk, and again the possibility of losses. Indeed, since the magnitude of purchases required to reverse expectations of future price movements could be very large, the potential losses might also be very large.

These perceived inter-agency problems should not act as a limitation on public policy. Ideally, the government would decide how much risk it was prepared to take on, and it would then be decided how that risk should be apportioned between the government and the central bank. Concerns that the central bank's independence would be politically constrained, and remain so even after better times returned, might be mitigated through the explicit introduction of some framework for inflation targeting. The purpose of the framework would not, however, be to fight deflation, but rather to ensure that inflation was kept under control once unconventional methods of injecting monetary reserves began to take effect.

A decision by the central bank or government to expand domestic liquidity by intervening in markets to purchase foreign exchange would pose another, intergovernmental, problem. Such a policy could be interpreted as a managed depreciation, as is sometimes suggested for the yen. Or it could be a means of resisting appreciation, as some currently suggest for the euro. In either case, the effects on other currencies might not be welcomed by other governments. Clearly, some sort of dialogue to avoid attempts at competitive devaluation, perhaps even leading to protectionism, would be desirable. In the case of the euro area, where policy rates are still well above zero, the response to an excessively disinflationary appreciation of the euro would presumably be lower interest rates rather than intervention.

Reference to the increased need for cooperation between the monetary and fiscal authorities, when the effectiveness of monetary policy is constrained, raises directly the question of fiscal policy. Fiscal easing would be useful, as long as the economy is not too open, but its advisability should depend on initial debt levels and levels of taxes rather than the size of the fiscal deficit. Thus viewed, the fiscal room for manoeuvre varies across Europe, with some large countries now facing the painful implications of having failed to tighten adequately during the good times. In Japan, the problems of mounting government debt are even more severe. In the United States and a number of Asian countries, the potential for expansionary measures seems greater, although the stimulative effects would be enhanced by nesting them in a credible medium-term framework for ensuring fiscal

sustainability over time. In this latter regard, the recent changes in US tax legislation have not been helpful.

How the government stimulates the economy also makes a difference. For example, wasteful expenditures – bridges to nowhere – would seem less likely to instil confidence and support spending than expenditures with a positive social rate of return. Finally, how an increase in the deficit is financed can also be crucial. The "helicopter drop" of money, sometimes recommended by academics, essentially comes down to some kind of fiscal stimulus financed by a central bank purchase of government liabilities. Again, inter-agency cooperation seems key to a successful outcome.

While the degree of cooperation has been less than optimal in Japan to date, it cannot be denied that there has been massive monetary and fiscal stimulus. The fact that it has not succeeded in generating self-sustaining growth points to a further complication influencing developments in any post-bubble period. This complication might be better characterised as a supply side problem, though it manifests itself as weak demand. In particular, given high levels of excess capacity and associated debts, the prospects for profits can remain poor for many years. In this environment, investment cannot recover. What is needed to deal with this is a speedy recognition of those firms whose debt would not be viable under normal circumstances. In some cases this might result in insolvency and a withdrawal of production capacity, in other cases simply an agreement by creditors to write down debt levels. Since economic recovery also requires a financial system willing to extend new credit, such a writing-off of corporate losses would, in the Japanese case, have necessitated recapitalisation of the financial system along with measures to ensure its future profitability. Looking at the adaptability of the US corporate sector, and at the resilience of the US financial sector, it is a source of significant solace that these Japanese problems do not appear to have been replicated in the United States.

Structural changes, whether on the economic or financial side, are always politically difficult to push through. This is unfortunate, because more flexible economies grow faster, have lower unemployment rates and adapt better to shocks. Were these benefits already being seen in continental Europe, there would be the added advantage of increased absorption in these countries. This would counter the likely future need for disabsorption in the United States, to resolve its looming problems of external deficits and inadequate household saving. If Asian countries took further steps to foster stronger domestic demand, this too would help. Indeed, the burden of adjustment of international imbalances should rightly fall more heavily on creditor countries as a group, once deflation comes to be more feared than a resurgence of inflation. Recent statements by governments in both Asia and Europe indicate clearly that they are very aware of the benefits of structural reform. They are, however, facing vigorous opposition from those without the vision to discern the common benefits, as well as those who see their own personal potential for loss all too clearly. What is required now is primarily the political courage to see the needed reforms through.