VIII. Conclusion: coping with risks, today and tomorrow

Everyone would hope that, by this time next year, we will be as satisfied with the performance of the global economy as we are today. The consensus forecast and those of the IMF and OECD point in this direction, reflecting the expectation that recent more balanced growth among the industrial countries will continue and that domestic demand will play an even larger role in emerging market economies. Further good news is that global inflation is forecast to remain generally subdued. Financial markets seem to have shared this optimism. Indeed, low levels of volatility, at least until very recently, even seemed to imply an unusual degree of certainty about such an outcome. The markets, moreover, seem to have viewed recent moves to tighten monetary policy in many of the advanced industrial countries as appropriate, and likely to be growth-sustaining, rather than the opposite.

What risks do we currently run?

Hopefully, the markets are right in their relatively optimistic assessment. Yet tightening credit conditions after such a long period of ease still allows for two kinds of error. First, it could be that monetary policy should have been tightened more, and earlier. One reason for believing this might be that underlying inflationary pressures are already well embedded. Another possibility is that relatively easy policies have continued to allow the build-up of a host of financial "imbalances" that are becoming increasingly dangerous as time passes. Both of these considerations would seem to call for more resolute monetary tightening. The second possible error is closely related: these imbalances might already have grown so large that monetary tightening could cause them to unwind, with negative effects on global growth and employment. This would argue for a more measured monetary response. Given significant uncertainty, and even overt disagreement among analysts as to the likelihood of either outcome, the only thing that is clear is that the coming year will not be an easy one for policymakers.

What grounds are there for believing that inflationary pressures might be greater than is currently thought? One obvious observation is that both the United States and Japan are judged by their own authorities to be close to full capacity, a traditional cause for concern. The United States, moreover, faces the risk of further substantial dollar depreciation, which could exacerbate such pressures. In addition, the global economy continues to grow exceptionally strongly, perhaps generating a dynamic that will prove hard to control. House

prices almost everywhere have been rising rapidly, and the prices of energy and other commodities have hit record levels. Wages in parts of China and some other emerging market economies have also been trending upwards, and Asia as a whole seems to be facing increasing inflationary risks.

Again, there are considerable uncertainties. To be more pessimistic, if the global disinflationary effects of lower-priced goods from emerging economies have been underestimated, then the consequences of the waning of this influence could also be unexpected. In addition, there is a great deal of uncertainty as to whether the world has hit a "tipping point" in its capacity to supply more oil and commodities, with the implication that prices might stay higher for longer than has historically been the case. To be more optimistic, there are still many lower-cost jurisdictions in the emerging market economies, not least central and western China, and production will eventually move there as well. And advancing technology could well compensate for the increased difficulty of finding new reserves of commodities. Yet both of these adjustment processes will take time. Given current levels of global demand, the risk would be continuing inflationary pressures in the interim. Moreover, to the extent that the credibility of central bankers has been enhanced by the earlier, fortuitous circumstances, this credibility could also be tested. It would, of course, need to be vigorously defended.

What grounds are there for believing that "imbalances" pose a threat to the optimistic view looking forward? It is not hard to identify a large number of significant and sustained deviations from historical norms in important macroeconomic variables. However, concerns about disruptive reversions to more "normal" values have to be qualified to the extent that such deviations can be explained and justified as being of a lasting nature. Unfortunately, recourse to such "fundamentals" does not seem adequate to explain either the extent or the duration of the unusual circumstances currently being observed. This leaves room for a complementary explanation: these phenomena might be linked to there having been such abundant global liquidity over such a long period.

Perhaps the most important example of "fundamentals" failing to adequately explain financial market developments is the long-term bond market in the United States. As policy rates rose, the long rate fell, a development once famously described as a conundrum. More recently, the maintenance of spreads on emerging market sovereign debt at very low levels, even as long rates have moved up, might be explained in terms of generally better domestic performance. Yet the sharp narrowing of the dispersion of yields between better and much worse performers remains a puzzle. Surging equity and house prices, almost globally, seem hard to reconcile with wide differences in domestic growth prospects. The explosion in merger and acquisition activity, particularly in Europe, also seems difficult to rationalise: what evidence is there of a sudden improvement in the prospects for adding value through restructuring, particularly since there still appears to be relatively little appetite for new investment?

And, finally, the strength of the dollar until very recently, in the face of a record US external deficit and unprecedented household debt accumulation, remains hard to explain. On close examination, fashionable arguments

based on the presumed existence of "dark matter", an informal "marriage of convenience" between debtors and creditors, and the "inherent attractiveness" of highly productive US assets all fail to convince that current global imbalances are sustainable. To explain the dollar's resilience, recourse must again be had to short-term interest rate differentials, in particular the continuing low rates outside the United States. Once more, monetary conditions contribute to solving a puzzle.

Given the complexity of the situation and the limits of our knowledge, it is extremely difficult to predict how all this might unfold. On the one hand, it is easy to argue, indeed it is the consensus view, that an orderly rebalancing is still the most likely outcome. By way of example, consider today's global current account imbalances. In principle, were the dollar to fall and increase foreign demand for US-made goods, US interest rates could rise to temper domestic demand just enough to avoid either rising unemployment or rising inflation. If, in turn, domestic demand elsewhere were growing just fast enough to replace that previously emanating from the United States, then global growth and inflation would not be affected either. On the other hand, it is also easy to identify forces that might make various processes of rebalancing less smooth. Some of these could imply the end will be a "bang" of market turbulence, others a "whimper" of slow growth for an extended period. Should the expected smooth adjustment not materialise, the alternative might well be a combination of the two.

Those concerned about a "bang" of market turbulence need both a trigger and grounds for believing that price movements in various markets might get out of hand. Unfortunately, there is no shortage of candidates for either. As to the trigger, global monetary tightening might well be the catalyst. While the process of tightening has begun, and without incident, concerted monetary tightening is still as much a prospect as a reality. Another trigger might be further protectionist legislation, particularly pertaining to China or Middle East oil exporters. This could easily interfere with the smooth financing of the US current account deficit since these countries are currently the biggest purchasers of US dollar liabilities. And yet another possibility might be the sudden failure, or recourse to legal protection, of a large firm with major financial interests. These possibilities noted, it must also be recognised that the triggers for most of the financial crises observed over the last few decades were almost wholly unexpected.

There are, moreover, several market-specific reasons for concern about a degree of disorder should a process of price adjustment towards more normal levels begin. In the main industrial countries, there are many new participants in financial markets and many new financial products, of increasing complexity and opacity. Market liquidity in this environment has yet to be put to the test. The fact that carry trade speculation seems to have intensified in recent years also implies the potential for crowded trades that could, in the limit, lead to an interactive deterioration of market risk, credit risk and liquidity risk. We have in fact seen such interactions before. Similar problems could also occur in emerging market economies, and indeed might already have begun, given the sheer magnitude of capital inflows over the last year or so.

Turning to the major currency markets, there are also grounds for concern that exchange rate movements could be large and potentially disorderly. The first point to make is that the underlying trade adjustment could prove quite protracted. Even reducing the US current account deficit to 3% of GDP might require millions of workers to move from the non-tradable to the tradable sectors. This will not be accomplished overnight. Moreover, with US imports more than one and a half times exports, and with the United States still growing much faster than many other economies, a substantial increase in US competitiveness will be needed to improve the current account. The fact that exporters to the United States were able to cut costs in the face of past dollar depreciation, thus preserving margins and reducing pass-through, could, if repeated, be a further impediment to US current account adjustment. And, of course, the longer adjustment is delayed, the greater the external debt build-up and the larger the prospective debt servicing requirement. Indeed, while the US net investment income account has recorded inflows until quite recently, simple arithmetic implies substantial further deterioration in the future.

Both private and public sector purchasers of US dollar liabilities might, at some point, lose patience in such a situation. The foreign private sector holds the bulk of dollar-denominated US liabilities, and even moderate covering could have big effects on currency values. As for public sector holdings, while these are much more likely to display stable behaviour, prospective strains can still be identified. Even modest declines in the dollar could lead to heavy capital losses for large reserve holders, and this might become a matter of some political sensitivity. Moreover, reserves are now flowing more to energy-exporting countries for which pure risk-return considerations might weigh more heavily in investment decisions. The likelihood that perceived changes in official behaviour might reinforce changes on the private side also seems consequential.

The upshot of all these considerations is that markets "priced to perfection" retain a significant potential for reversion to more normal levels. Moreover, given the interrelationships among all these markets, both domestic and international, there is a reasonable likelihood that if one market were to come under significant stress, it would spill over to others. Consider, for example, a sharp fall in the value of the dollar. One possibility, in this environment, is that the risk premium for holding US dollar-denominated assets might rise. One likely manifestation of this would be higher long-term interest rates, which would, in turn, have an impact on other markets, including that for housing. Another example has to do with the still relatively low cost of purchasing protection against market volatility. Were such costs to rise significantly, as some markets came under stress, virtually all markets would be affected.

While many would doubtless dispute the likelihood of a sudden market "bang", the possibility also remains of a real side "whimper". That is, the various imbalances referred to above might well work themselves off gradually, but in a way that weighed heavily on global spending over a long period. Not least is the potential for record low household saving ratios to rebound in many countries, particularly in the United States. This could be a spontaneous precautionary response to higher debt levels, or to fears among baby boomers

that earlier pension commitments, both private and public, were less likely to be fully honoured. Alternatively, it could be a reaction to rising interest rates, market stress and uncertainties about future asset values. The fact that house prices have risen to such high levels in so many countries, and that this "wealth" effect does seem to have encouraged more spending, increases the likelihood of such an outcome. The reality is that, for a country as a whole, the wealth associated with house price increases is in very large part illusory. Being a relative price shift, its benefits to gainers are largely offset by the costs to losers. When the losers finally begin to adjust in response, it will generate significant economic headwinds.

Other kinds of imbalances have the potential for similar mischief. In China, the principal concern must be that misallocated capital will eventually manifest itself in falling profits, and that this will feed back on the banking system, the fiscal authorities and the prospects for growth more generally. After a long period of credit-fuelled expansion, this would be the classic denouement. Indeed, this was very much the path followed earlier by Japan. Moreover, such an outturn might have even more severe effects on the industrial countries than is currently thought. In such circumstances, China's already formidable and fast-growing manufacturing potential would surely be directed still more towards export markets. Were this to occur, just at the time that other countries were retrenching, the resulting interactions – economic, political and social – would present a great challenge for both the public and private sectors.

We are, of course, currently not in a situation in which we have to confront such problems, and the likelihood of their occurring remains low. The consensus forecast is still the best bet. Yet the potential economic costs, should such risks materialise, would seem great enough to warrant some reflections on how policymakers might best respond. Such reflections do not constitute a forecast, but rather an exercise in prudence. There is nothing inconsistent in expecting the best but planning for the worst, particularly if the costs of the unexpected might well be high.

How might current risks be reduced?

Today we face not only the normal uncertainties associated with responding to incipient inflationary pressures, but also concern about various financial imbalances, both internal and external. These imbalances are the by-product of a decade or more of robust increases in global supply, lagging domestic demand in large economies other than the United States, and an over-reliance on easy monetary policies to reduce output gaps. Understanding how we got to where we are is crucial in choosing policies to reduce current risks.

Increased supply has largely arisen from the re-entry into the global framework of previously closed economies, supported by improved communications and technology everywhere. To this must be added ongoing increases in productivity growth, in the United States in particular. Continuing deregulation of markets, for both goods and factor inputs in the industrial countries, constitutes another explanation for the positive supply shocks seen over the last decade or so.

As for lagging demand, we have observed in Asia the high saving rates typical of people faced with the massive uncertainties of structural change, but also the effects of the time needed to adapt spending habits to rapidly rising income levels. The latter problem also confronts governments in countries exporting oil and other commodities. In the industrial countries, two structural deficiencies can also be identified. The first has been the long-standing failure of Germany and Japan to recover fully from the stresses imposed by reunification and the bubble period respectively. In neither case was the nettle of structural change quickly or fully grasped. The second deficiency has been the protracted failure of fiscal policy almost everywhere to resolve the problems associated with the excesses of the 1970s and early 1980s. The industrial countries, bar Japan, were subsequently left with little room for fiscal manoeuvre in downturns, and now even Japan finds itself in the same situation. For many countries, particularly in Europe, this problem would long since have been overcome had they tightened fiscal policy much more aggressively in those years when the economy was growing robustly.

Against this background, monetary policy was left to address not only the secular trend of deficient demand, but also periodic crises associated with disturbances in the financial system. To date, policymakers have managed the task remarkably well. Growth has been held up and inflation has been held down. Yet, over time, unwelcome side effects have also become increasingly apparent. Whenever shocks have threatened growth, lower interest rates have encouraged spending, as intended, but this has increasingly been associated with a progressive build-up of debt, first corporate but now also household. The growing liberalisation of financial systems has reinforced this transmission mechanism, with the countries most sophisticated in financial matters being allowed to run large current account deficits as well. In effect, the successful countercyclical use of monetary policy in each instance has made subsequent tightening more risky, and subsequent easing less likely to work.

What can still be done to reduce the risks we face in the continuing global upswing? The first and obvious point is that global monetary policies need help if disruptive changes in interest rates and exchange rates are to be avoided. In particular, they need help from those specific policies that have been so deficient in the past, namely fiscal policy and structural reforms.

Fiscal policy should be generally tightened in both the industrial countries and the emerging markets. This will also help restore the room for manoeuvre looking forward. The need for fiscal restraint is particularly great in the United States, as well as those other countries facing both high government and current account deficits. A credible, medium-term package of fiscal restraint in deficit countries would also reassure foreign creditors that their longer-term interests are being protected. Indirectly, it would also be a welcome source of support for an orderly adjustment of the US dollar.

Given the size of global trade imbalances, structural changes aimed at facilitating the transfer of resources between the tradable and non-tradable sectors would seem highly desirable. This would also help reduce the need for large movements in nominal exchange rates that could prove disruptive. Revitalising the traded goods sector in the United States will be challenging

since, for some products, the industrial base has been much reduced. Nevertheless, the renowned flexibility of the US economy gives grounds for optimism. In addition, current tax subsidies could be reduced to restrain activity in housing, an archetypal non-traded good, and some form of consumption tax could help raise the household saving rate, which lies at the heart of the US current account deficit. Elsewhere, steps need to be taken to encourage the consumption and production of non-tradables. In many countries, most strikingly China but also Germany and Japan, there remains too great a reliance on export-led growth. Government regulations and other incentives that work in this direction need to be rethought, particularly since rapidly ageing populations in all three countries put a premium on increasing productivity in the domestic services sector.

The appropriate path for global monetary policy in the current circumstances should also be towards tightening. Whether one is more concerned with rising inflationary pressures in the short term, or with the threat from imbalances to sustained growth over time, both sets of indicators point in the same direction. That said, different countries are facing different degrees of pressure from these two sources. For example, in continental Europe levels of excess capacity are still higher, and financial imbalances less in evidence, than in the United States and a number of inflation targeting industrial countries, where the more advanced degree of tightening consequently appears appropriate. This conclusion is further reinforced by their respective external positions. Countries with external deficits need less domestic spending, and higher interest rates are one way to achieve this.

This general recommendation having been made, choosing the contours of that tightening path will not be easy. Not the least of the problems to be faced is exactly which inflation measure to use in gauging underlying inflation trends, and here opinions vary widely. At the heart of the problem in the industrial countries has been a major and sustained shift in relative prices, with house and energy prices rising sharply and prices of manufactured goods being much more subdued. Should policymakers assume that currently higher headline inflation will, over time, recede to core levels, or the opposite? Emerging market countries face similar problems, made worse by the relative importance of another volatile component, food. In such a world, perhaps the only conclusion to draw is that policymakers should put even more emphasis on longer-term inflation trends rather than focusing narrowly on achieving shorter-term quantitative targets.

Another complication is that the guideposts used by central banks to set interest rates are also being shifted. As globalisation proceeds, indicators of global slack are likely to become increasingly useful complements to more traditional domestic measures of inflationary pressures. At the same time, reflecting growing concerns about the effect of financial imbalances on both growth and inflation, more attention needs to be paid to such financial measures. There has been, in addition, a growing recognition that economic processes might well have non-linear characteristics; sticky inflation expectations could become unstuck, seemingly benign imbalances could suddenly result in a sell-off in financial markets, and so on. Finally, in a more globalised world,

what other policymakers are doing takes on greater importance. Were there to be a simultaneous and significant tightening in all the major financial centres, it might produce a disinflationary result substantially greater than the sum of its parts. Thus, while monetary restraint seems desirable almost everywhere, it will have to be done in a careful and measured way.

How monetary policy is conducted in most countries will also be influenced to some degree by the external imbalances problem, and how it eventually affects exchange rates. One concern that has been raised repeatedly is that this process might turn disorderly, particularly in the main currency markets where the bulk of trading is carried out. The probability of such an outcome would be reduced if the burden of upward currency adjustment were to be broadly shared in line with the size of current account surpluses. In particular, this implies that Asian currencies must appreciate further. Fortunately, there are some signs that Asian central banks recognise this, not least the fact that many of them have scaled back their interventions in the foreign exchange markets. China, however, remains an important exception in that it accumulated a further $200 billion plus of reserves in the course of 2005. In China, as elsewhere in Asia, greater currency flexibility might also allow more scope for monetary tightening. This would be welcome given general concerns about domestic overheating, as well as worries about investment misallocations in the case of China.

Observing the policies in place, or even credibly promised, it would clearly be a mistake to say that the risks associated with external adjustment have been effectively eliminated. Many of the main protagonists are still focused almost exclusively on domestic priorities, some economic and some political, the upshot being that external imbalances are still expected to widen further. What is needed in the light of all this is a cooperative solution through which, for the common good, the main countries would each make domestic compromises in return for similar compromises made by others. Most of the policies required are not hard to identify and have already been alluded to above.

The real problem is that of implementation. As a prerequisite, all of the major players need first to recognise that the ultimate costs of inaction are likely to be much greater than the costs of a cooperative solution. A sharply lower dollar could raise inflation in the United States and threaten the balance sheets and growth prospects of European and Asian creditors. And it could aggravate already undesirable protectionist tendencies worldwide. Recognition of these possibilities should foster a more cooperative spirit which, with a little luck, might suffice to guide us around the pitfalls which still lie ahead.

What to do if risks materialise?

It is impossible to predict where and when the risks implicit in current imbalances might materialise. Nevertheless, as described above, two kinds of scenario seem reasonable. The first would be a short, sharp shock affecting international financial markets. The second would be an extended period of slow global growth as imbalances gradually unwind. In reality, elements of both scenarios could emerge together.

Consider first a discrete event which, if it occurred, would disrupt financial markets. What might be done in advance to prepare for such an eventuality? One important step would be to ensure the integrity of domestic lines of communication among core financial firms, their supervisors, the central bank and the operators of systemically critical parts of the financial infrastructure. Another would be to ensure similar openness at the international level. Current discussions on "home-host" issues between regulators in different countries are moving this dialogue forward, as are various memoranda of understanding on who will do what, and when. International "war games" to simulate stressful incidents requiring a public sector response have already been carried out in a number of European forums and have yielded useful lessons. At the global level, the Financial Stability Forum, which brings together central bankers, regulators and treasury officials from many large economies as well as representatives of the international financial institutions and specialised committees, has already made a material contribution to crisis prevention. Presumably, it could play a useful role in crisis management and resolution as well.

However, many improvements are still possible and desirable. National legislation which impedes international sharing of time-critical information remains an important obstacle to crisis management. And perhaps even more important, there is no agreement about international burden-sharing in the event of trouble. Whether it be deposit insurance, emergency liquidity facilities or the restructuring of an internationally active bank, the ultimate costs could be substantial. Without prior agreement about the allocation of such costs, effective crisis management could easily be hampered by national authorities acting in response to what they see as their own national interests.

In principle, the readiness of financial institutions to deal with such problems could also be assessed in advance. Stress testing is now almost universal in financial firms, which is highly desirable. Yet stress tests are based on simplifying assumptions that necessarily fail to match the complexity of real world events. Firms should recognise such limitations as they try to ensure their preparedness for prospective difficulties and the adequacy of their capital. Perhaps most importantly, financial firms should consider the implications for market dynamics of other institutions reacting in the same way to given shocks, perhaps even reflecting regulatory advice, and should prepare themselves accordingly. Regulators, too, might reflect on this possibility. At the least, there should be more sharing of the results of such tests among counterparties and regulators.

Making such preparations in advance of trouble would complement the wide variety of other measures which have been taken over the years to improve the underlying health of financial institutions, markets, and payment and settlement systems. A more recent suggestion that merits greater attention is the possibility of setting up "off the shelf banks" in advance of difficulties. The idea is to establish a legal entity that would be able to assume, at very short notice, the vital functions of a failed financial institution and thus mitigate the knock-on effects of closure. This would be another way to limit regulatory forbearance, which has often been a problem in the past.

What might policy do in the thick of a crisis? The traditional response would be to inject liquidity to targeted institutions. However, this raises some questions in a rapidly changing world. One is the issue of who should be supported in a more market-driven financial system: domestic banks only, or also foreign banks, regulated financial institutions, special purpose vehicles issuing asset-backed securities, or others still? Another is the question of appropriate collateral, in particular the legality of accepting cross-border paper and the possibility that the value of collateral might be seriously reduced in a crisis. A third issue is whether a set of conditions should be agreed in advance to determine whether liquidity support would be provided. Whereas not very long ago it used to be standard to speak of the need for "constructive ambiguity" to avoid moral hazard, there is now increasing talk in central banking circles of "constructive clarity". This really comes down to encouraging banks themselves to take all reasonable steps to ensure their soundness, if they wish to be able to turn to the authorities for support in extremis.

In a more market-driven world, it is in fact more likely that generalised infusions of liquidity and lower interest rates would be the chosen policy response to any serious financial incident. Indeed, we have observed this reaction a number of times in the recent past. One complication could be divergent movements across countries which could entail undesired exchange rate movements. Better communication among central banks as to how they might react to shocks would seem part of the solution in this case. Another set of problems can arise when interest rates are kept low for an extended period, well beyond the time required to restore more normal functioning to markets. These latter issues are better addressed in the context of the second set of potential problems, related to a potentially long period of slow global growth, possibly but not necessarily accompanied by distress in the financial system.

What would be the appropriate policy response were headwinds to threaten future growth prospects? An analysis of the historical record indicates that four factors can interact to produce truly bad outcomes. First, real interest rates can remain too high to reflate the economy, all the more so when nominal rates hit the zero lower bound and prices are falling. Second, real wages can rise and profits fall. This outcome is again made more likely if nominal wages are sticky downwards and prices are falling. Third, high levels of indebtedness can impose onerous debt service burdens which cut into spending. Fourth, weakness in the real economy can feed back on the financial system, leading in turn to credit restrictions and still further downward impetus to spending. The question then becomes how policy might be used to help short-circuit each of these channels, recognising that each recommended policy is likely to have a downside as well as an upside.

In a potential future downturn, it would seem perfectly natural to reduce interest rates to stimulate aggregate demand. However, given the high debt levels built up in response to earlier easing, this approach might not work smoothly. In Japan, unprecedented monetary and fiscal easing did not suffice to turn the economy around in the 1990s. In the United States, despite similarly unprecedented easing after 2001, the subsequent upturn was among the weakest in the postwar period, particularly in fixed investment and employment.

It must also be recognised that very low nominal interest rates can also have substantial negative side effects, not least on aggregate supply. After a period of excessive spending, low borrowing costs can allow "zombie companies" to roll over debts and survive, as they did in Japan, to the detriment of the more healthy. They also provide strong encouragement to merger and acquisition activity, even though the historical record shows this is more likely to destroy value than create it. Low rates also constitute a transfer from creditors to debtors, which reduces saving and capital formation over time and eventually becomes a threat to higher living standards. The negative side effects of low interest rates on financial markets also need to be taken into account. The search for yield can lead to serious distortions, and the potential for future instability, as investors both purchase inherently riskier assets and use increased leverage to do so. Moreover, finding an "exit strategy" from such policies is not easy. We are currently experiencing such difficulties, and they will be even worse the next time around if debt levels rise further.

Such considerations imply that, if a sustained period of weak global growth were to occur, a policy of monetary and fiscal easing should be complemented by other, more structural measures. Given that sustained corporate profitability is a necessary condition for a revival of investment spending, measures to restrain wages and increase productivity have their attractions. Again, however, there are downsides. First, as with easier monetary policy, they might not work. In Japan, wage growth was very restrained for years, but investment stubbornly failed to recover until quite recently. Second, paying lower wages to fewer workers initially implies a smaller wage bill, and therefore less household income and spending. In Japan, household spending was cushioned from these effects by a large decline in the household saving rate. This might be less likely in a future downturn in countries where the saving rate is already very low, as it currently is in the United States.

Dealing directly with the overhang of debt can also make a contribution to avoiding longer-term problems. Indeed, the trend towards securitisation of debt, together with new instruments for credit risk transfer, could already be increasing the incidence of corporate bankruptcies as opposed to "orderly workouts" orchestrated by friendly banks. An early determination that a debtor is effectively insolvent, and an early resolution, are suggestions that have a great deal to recommend them. In this fashion, much uncertainty can be removed from the system. Moreover, putting processes in place to ensure maximisation of the value of the remaining assets has obvious appeal. If, in so doing, production capacity could also be removed from industries where profits have been pushed down to very low levels, this too would help redress supply side imbalances built up earlier.

As with the other policy responses just discussed, explicit debt reduction also has its downsides. The first and most obvious is moral hazard, though bankruptcy laws can be designed to help reduce this. The second problem is that an early and explicit recognition that debts cannot be serviced could feed back on the health of the banking system. In current circumstances in the industrial countries, with debt having been so widely securitised, this

would seem to be less of a problem. However, property loans and loans to households could still be an eventual source of disruption. Moreover, for the banking systems in emerging market countries, widespread debt relief or recourse to bankruptcy procedures could still threaten the solvency of individual institutions and perhaps the viability of the system as whole.

This challenge accepted, it also presents an opportunity. To the extent that losses are borne by the banking system, and explicitly recognised as losses, the by-products of earlier excesses are consolidated and can be more easily addressed. In particular, the banking system can be recapitalised and steps can be taken to ensure that banks will operate profitably in the future. Such a restored system could then play its full part in financing renewed expansion. The experience of the Nordic countries, faced with such problems at the end of the 1980s, shows what might be done given the requisite political will.

Can we avoid similar risks in the future?

No one today would question the substantial economic benefits associated with reducing inflation from the high levels it reached in the 1970s. Yet, with the passage of time, it is all too easy to forget how difficult that task looked in prospect. Policymakers in the 1960s and 1970s were generally of the view that the unemployment costs of reducing inflation would be both large and long-lasting, substantially outweighing the benefits. They were wrong. New analytical insights highlighted the role of inflation expectations, and how credible policies could ratchet those expectations down, and keep them down, at a much lower cost than initially expected. The generally excellent economic performance of the industrial countries over the last 20 to 30 years confirms the wisdom of those who decided to put that insight to the test.

However, it would also fly in the face of historical fact to contend that a climate of low inflation is sufficient to avoid all macroeconomic problems. In recent decades, we have witnessed all sorts of disruptive incidents related in part to the removal of constraints in previously repressed financial systems. Consider the Mexican financial crisis of 1994, the Asian crisis of 1997, the Russian debt default and the events surrounding the failure of LTCM in 1998, and the stock market crash of 2001. None of these events was preceded to any significant degree by overt inflation. Looking further back in history, neither in the United States during the 1920s nor in Japan during the 1980s were strong inflationary pressures apparent. Evidently, low inflation, while highly desirable, has not always been sufficient to ensure good economic performance.

In a similar vein, recent evidence also confirms that not all incidents of falling prices lead to serious macroeconomic problems. The source of the price decline matters. Increases in productivity and global competition over the last few years have reduced pricing power, but profit shares have actually risen nonetheless. This evidence also concurs with longer historical studies which reveal many periods where deflation and rapid growth coexisted easily. Indeed, such studies show that the appalling experience of the Great Depression in the United States was effectively unique.

Taken together, these considerations imply that the current conventional approach to the pursuit of price stability might need refinement. The risk is that, given a forecast which shows inflation to be well under control, over the one- to two-year forecast horizon normally used by central banks, policy rates might be maintained at very low levels relative to expected rates of return on investment. Positive supply shocks increase this risk by both keeping inflation down and raising the spirits of economic agents. This in turn would be expected to prompt entrepreneurs to increase their recourse to credit in order to purchase financial assets and invest in physical capital and commodities. Similarly, low policy rates and hence borrowing costs could induce consumers to bring purchases forward in time, including the acquisition of houses and consumer durables. To a significant degree, of course, the effects of such processes on spending and job creation could be deemed highly welcome. But beyond a certain point danger lurks, as rising asset prices both encourage more speculation and provide the collateral for the related borrowing. All of the historical episodes of "boom and bust" noted above share these dynamic characteristics in very significant measure.

To reflect such possibilities, the Keynesian analytical framework, which remains the workhorse in the stable of most central bankers, needs modification. A much richer set of indicators is now needed to guide the setting of interest rates, in particular indicators of financial imbalances, both internal and external. Over longer time periods, such imbalances can pose an even greater and more dangerous threat to price stability, on the downside, than shorter-term and more conventional inflationary "pressures" such as output gaps. Recognising this fact implies that we should lengthen the horizon over which we assess the success of monetary policy in stabilising prices, in order to see its full effects. Raising interest rates in some circumstances might temporarily push inflation below desired levels, but this might still be preferable to a boom-bust scenario in which the eventual undershooting of the inflation target is both larger and more lasting. Alternatively, there could be scope for reducing this trade-off dilemma by using other instruments, of a more regulatory nature, to help reduce the build-up of credit-financed imbalances in the first place. Such suggestions would, however, require a significant change in both the regulatory culture and the nature of the relationship between central banks and other public agencies.

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