# 2. International Environment

*Global financial conditions have continued to improve for much of the period under review though global economic activity remains subdued and fragile. Yields stayed low in many advanced countries and yield spreads between vulnerable euro area sovereign bonds and German bunds fell further. The low yield environment and ultra-loose monetary policy in advanced economies, amongst others, supported the rally in global equity markets. However, global financial markets turned more volatile in June 2013 on expectations of a possible shift in the path of the loose monetary policy in the US. Aggressive monetary easing in Japan led to a sharp depreciation of the Japanese yen. As the regulatory framework continued to be overhauled globally, the international banking sector remained confronted with significant challenges arising mainly from subdued economic activity worldwide.*

## 2.1 Macro-Financial Developments

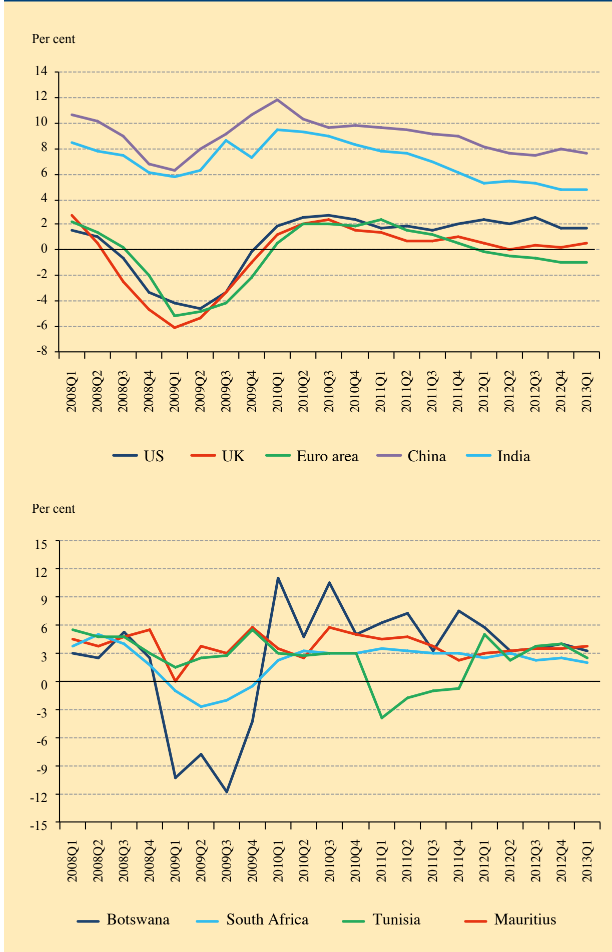
Global financial conditions have generally improved for much of the period since the February 2013 FSR but volatility increased towards the end of 2013H1 on expectations that the US Federal Reserve (US Fed) would taper its asset purchase programme. Global economic activity remained subdued and fragile, which underscored the importance of further policy actions aimed at strengthening the financial system and smoothly unwinding public and private debt overhangs. In its July 2013 WEO Update, the IMF revised downward its global growth forecast for 2013 by 0.2 percentage point to 3.1 per cent, taking into account weaker-than-expected economic activity in emerging economies and a protracted recession in the euro area. Growth is forecast to increase to 3.8 per cent in 2014.

Growth in the US is continuing at a moderate pace, with a firming-up in private demand partly offset by an acceleration of fiscal consolidation (Chart 2.1). Risks that could be a drag on the economy are a reduction in federal spending, household and public sector deleveraging and the expiration of some tax breaks that were put in place earlier this year. The euro area slid deeper into recession in 2013Q1, with weaknesses both in the periphery and core economies. France, the second largest economy of the region, fell back into recession while Germany continued to register moderate growth. The euro area may face a relatively more prolonged downturn than expected in 2013 before slowly recovering in 2014.

Elsewhere, the UK economy avoided a triple-dip recession after recording better-than-expected growth in 2013Q1, mainly on the back of robust expansion in the services sector and an upturn in North Sea oil and gas output. Nevertheless, the British economy is far from a sustainable path of recovery due to fundamental economic weaknesses, namely high fiscal deficit and inflation. Growth in Japan is expected to increase mainly as a consequence of aggressive monetary easing, a positive inflation target, fiscal stimulus and structural reforms. The significantly weak yen is expected to boost exports although the proposed reduction in fiscal deficit via sales tax hikes in 2014 and 2015 may negatively affect output growth.

The performance of emerging economies has been mixed although they have continued to register higher growth rates compared to advanced economies. Indian

**Chart 2.1: Y-o-y Growth Rates of Selected Economies**




*Sources: Trading Economics and Statistics Mauritius.*

economic growth edged up in 2013Q1 after having bottomed out in the previous quarter while growth in China eased slightly. Challenges facing several emerging economies remain volatile capital inflows and their impact on exchange rates. The Indian rupee depreciated significantly against the US dollar in 2013H1, weighed down by a slowdown in growth and mounting current account deficit, among other factors.

Reflecting the relative stabilisation in financial conditions, there were few sovereign rating downgrades during 2013H1, with little impact on market sentiment. The UK lost its triple-A sovereign debt rating after it was downgraded by Moody's and Fitch in February 2013 and April 2013, respectively, as the country faced prolonged economic weakness and rising debt. However, Fitch reviewed UK's outlook to stable, removing the threat of any further rating downgrade, at least in the near term. In April 2013, Fitch cut China's credit rating to A-plus from AA-minus with a stable outlook based on concerns about the risks that excessive local government borrowing posed to the wider economy and financial risks stemming from rapid credit expansion. While Moody's maintained China's government's bond rating of Aa3 given continued robust economic growth, strong central government finances and an exceptionally strong external payments position, the rating agency cut the country's outlook to stable from positive on credit concerns. On the positive side, reflecting the relatively better state of the US economy, Standard & Poor's lifted the long-term rating outlook on the US to stable from negative in June 2013, citing retreating fiscal risks and the authorities' willingness to support sustainable economic growth. India's sovereign outlook was also revised to stable from negative by Fitch in June as a result of measures taken by the government to contain the budget deficit and revive economic growth.

## 2.1.1 Global Financial Markets

For much of 2013H1, market sentiment remained upbeat as monetary policy continued to be supportive of growth in advanced economies. Some central banks loosened policy further, namely the European Central Bank (ECB) and the Reserve Bank of Australia, both cutting their key interest rates by 25 basis points in May 2013. Market volatility stayed at generally low levels but increased in June 2013 after the US Fed announced it might start reducing its unprecedented bond-buying programme this year and end it entirely by mid-2014 if the economy continues to improve and achieve a sustainable growth pace (Chart 2.2). Going forward, there are risks that the diverging paths of monetary policy in major economies may negatively impact on financial market volatility in the medium term.

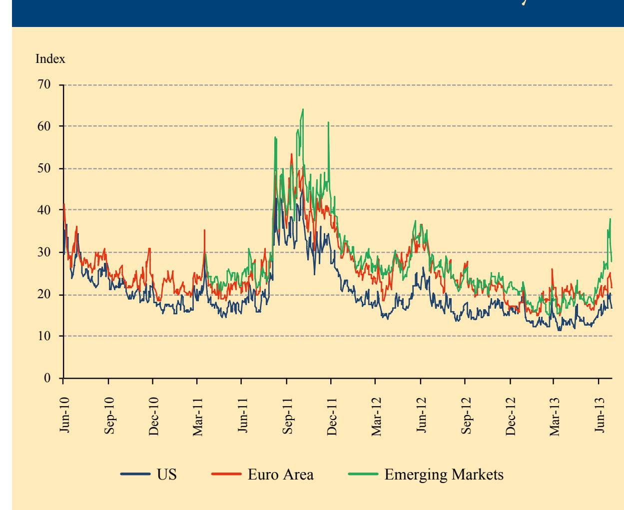
### *Developments in Bond Markets*

As financial markets continued to benefit from positive sentiment arising from the ECB's policy measures, market pressures about Eurozone sovereign risks eased further. Spreads between vulnerable euro area sovereign bonds and German bunds fell, in some cases, to levels last seen in 2011, such that Ireland and Portugal were able to take advantage of improved market conditions to issue debt (Chart 2.3). The cost of default protection of some of these countries' sovereign debt, as measured by credit default swaps, also decreased despite a number of adverse events, including an inconclusive election in Italy and controversial negotiations to resolve the sovereign debt and banking crisis in Cyprus. Meanwhile, yields on government bonds in many advanced economies remained near historically low levels for most of 2013H1. Yields on UK gilts continued to benefit from their safe and highly liquid status notwithstanding UK's loss of its triple-A rating and rising government debt-to-GDP ratio. Towards the end of the semester, yields rose in most economies as expectations of tighter monetary policy in the US grew.

### *Global Stock Markets*

Global equity markets have generally exhibited robust performance since the beginning of the year as the ultra-loose monetary policy of major central banks and low yields in core bond markets as well as better-than-expected corporate results boosted market

**Chart 2.2: Financial Markets Volatility**




*Source: Thomson Reuters.*

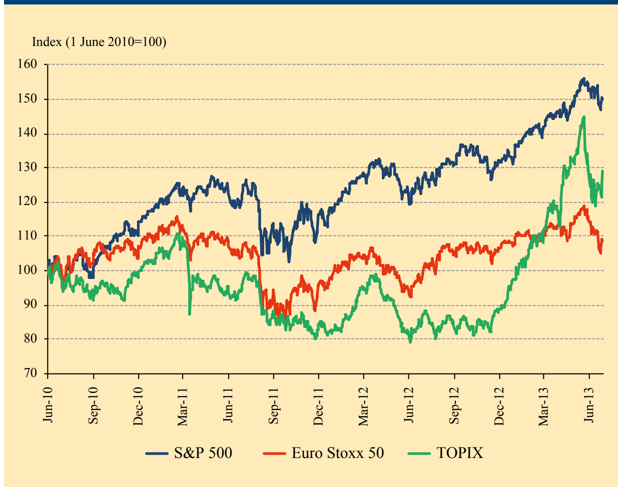
sentiment and increased global risk appetite. By mid-May 2013, US stock indices rose to record peaks while Japanese share prices reached five-year highs, driven to some extent by aggressive monetary easing (Chart 2.4). In June 2013, however, the rally came to a halt and stock markets tumbled as the US Fed possible exit from quantitative easing affected sentiment. Equity markets were also dragged down by weaker-than-expected economic data from China and a liquidity crunch in the Shanghai interbank money markets.

*Evolution of Major Currencies*

The evolution of major currencies also reflected shifting investor sentiment during 2013H1 (Chart 2.5). As investors moved into riskier assets, the US dollar tumbled in January 2013 given its safe-haven appeal. It thereafter recouped its losses on encouraging data releases from the US and expectations of a possible change in the path of monetary policy in the US.

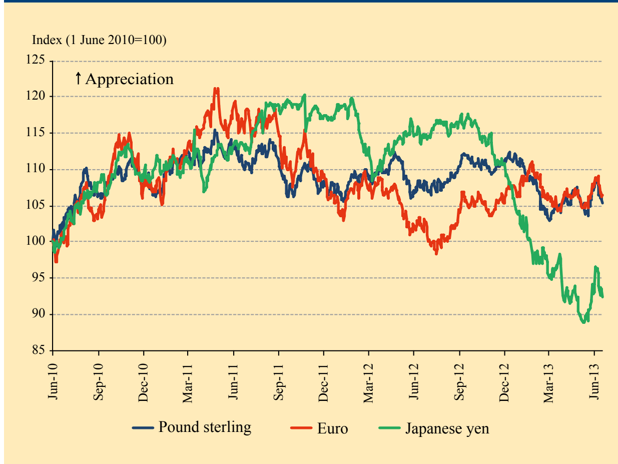
The euro was supported at the start of 2013 as market tensions eased and the ECB gave little indication it would cut interest rates further. However, the appreciation of the euro was capped on concerns about the health of the euro area and political uncertainties in some Eurozone countries. The single currency remained on the defensive following a controversial bailout plan for Cyprus and the ECB's decision to cut its key refinancing rate to an all-time low of 0.5 per cent in May 2013 and moved within ranges thereafter. The Pound sterling generally tracked euro movements amid broad-based US dollar strength. It remained pressured on concerns that the Bank of England (BoE) could ease monetary policy further.

**Chart 2.4: Global Equity Indices**



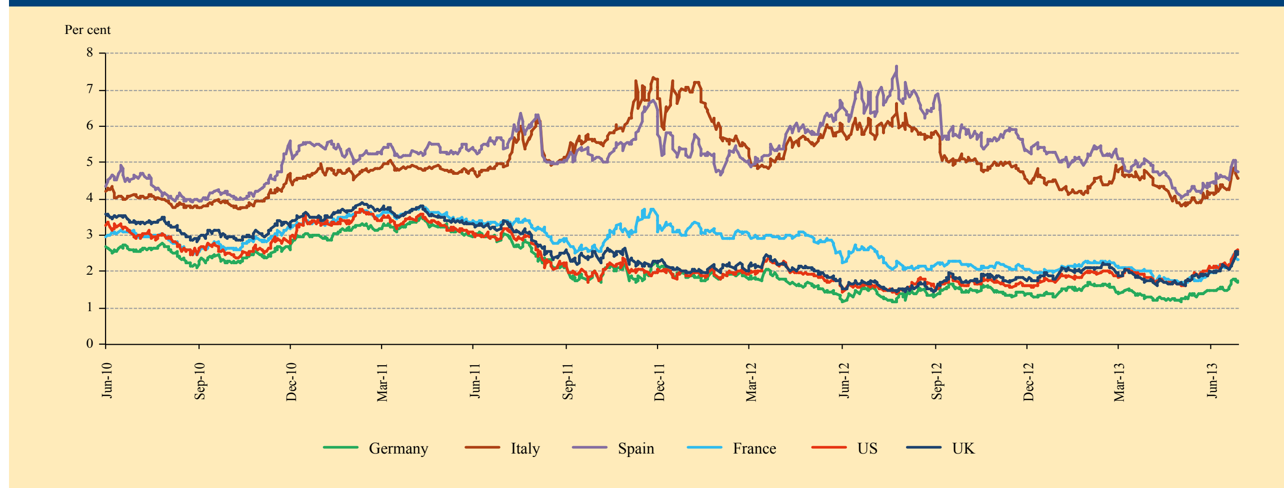

*Source: Thomson Reuters.*

**Chart 2.5: Exchange Rate Movements against the US Dollar**




*Source: Thomson Reuters.*

**Chart 2.3: 10-Year Yields on Government Bonds**




*Source: Thomson Reuters.*

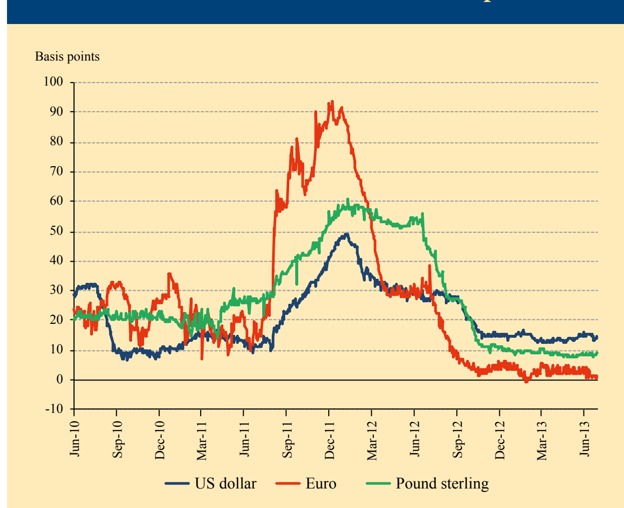
In sharp contrast, the Japanese yen maintained its downward trend and crossed the 100 mark against the US dollar in May 2013, driven by the Bank of Japan's (BoJ) aggressive monetary easing. Ample liquidity with the monetary stimulus encouraged carry trades in currency markets and the Japanese yen gained some support as it became an attractive funding currency. The yen also benefited from its safe-haven status as global equity markets retreated in June 2013.

## 2.2 International Banking Sector

The international banking sector remained confronted with significant challenges arising from weak economic activity worldwide. The financial performance of banks was rather muted in affected areas. Credit conditions continued to diverge across countries and credit risk increased as weak economic activity took a toll on banks' asset quality. Though funding conditions generally improved in 2013H1, some banks remained vulnerable (Chart 2.6). The regulatory framework continued to be overhauled globally.

In the US, enhanced levels of capital and liquidity as well as improving asset quality and stricter regulation of banks continued to support the outlook for the banking industry. Trends in regulatory capital positions and asset quality took positive turns and US banks have been largely successful in adapting to the legislative and regulatory challenges. Tougher regulation generally contributed to stronger capital buffers and liquidity positions and the performance of US banks continued to improve. Banks eased lending standards as competition intensified and loan demand advanced. The latest bank stress tests, which were published in March 2013, suggested that aggregate levels of capital among the major US banks were sufficient to withstand a severe financial stress, with only one institution judged to be under-capitalised following the stress scenario. As the US Fed prepares to introduce Basel III in January 2014, analysis conducted by the Federal board staff suggests that banks will have to find an extra US$4.5 billion of common equity.

**Chart 2.6: Three-Month Libor-OIS Spreads**




*Source: Thomson Reuters.*

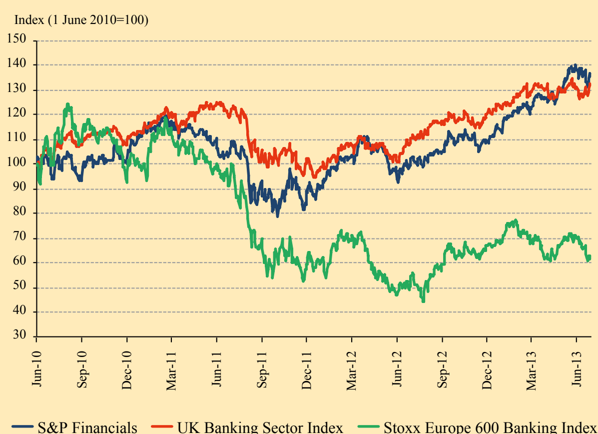
In the euro area, the financial performance of banks remained muted against the backdrop of a weak economic environment that has dampened earnings and increased credit risk. Bank funding conditions improved both in terms of access and cost although a certain degree of financial fragmentation persisted due to still important funding costs in some vulnerable countries. According to the ECB's Bank Lending Survey, euro area banks had improved access to both retail and wholesale funding in 2013Q2, but expected a marginal deterioration in wholesale funding conditions for several market segments in 2013Q3.

Contagion risk from the banking crisis in Cyprus was rather contained as continued monetary accommodation and ECB's readiness to purchase sovereign bonds through Outright Monetary Transactions, coupled with the longer-term refinancing operations, helped to keep conditions stable across markets. With the Eurozone economy set to contract this year, there is considerable uncertainty associated with the banking sector as the asset quality outlook remains negative and financial stability risks significant. This has seemingly dampened the off-take of financials' equities compared to their US counterparts (Chart 2.7). Looking ahead, the establishment of the single supervisory mechanism and the adoption of the *Capital Requirements Regulation and Directive* that aim to implement the Basel III capital and liquidity framework are expected to consolidate the banking sector.

In the UK, major banks recorded a rise in profits in 2012 though conduct redress and regulatory fines remained a drag on profits. As banks are in the process of transitioning to Basel III capital standards, the newly established Prudential Regulatory Authority (PRA) noted a capital shortfall of £27.1 billion as at end-2012. According to the PRA, UK banks were underestimating the risks they hold in their balance sheets, under-reporting likely losses, and ignoring the rising cost of compensation pay-outs for past

misdeeds. The largest banks were accordingly advised to bolster their balance sheets. The BoE 2013Q2 Credit Conditions Survey showed some signs of improvement in credit availability but pointed out that banks were not prepared to increase loans to small businesses. The survey also revealed that households were being offered more credit following an increase in demand for mortgages by home-buyers and buy-to-let landlords.

Chart 2.7: Financial Indices




*Source: Thomson Reuters.*

## Box I: Risks from Ultra-Loose Monetary Policy

Central banks in many advanced economies have adopted unprecedented policy measures in the aftermath of the global financial crisis to avert near term economic disaster and restore financial stability. In addition to bringing down interest rates to historic lows, they have implemented a number of unconventional policies, ranging from liquidity provision and credit facilities to banks to asset purchases. Though the ultra-loose monetary policy has helped to stabilise financial markets and support macroeconomic conditions to some extent, it entails potentially undesirable longer run consequences if it stays for too long.

Looking back at financial markets developments since the implementation of quantitative easing, it is easily seen that the exceptional measures adopted by four major central banks in advanced economies, namely the US Fed, ECB, BoE and BoJ, have boosted confidence and buoyed financial markets across the world. Ample liquidity together with a firm commitment on the part of policymakers to maintain appropriate conditions in financial markets gradually gave rise to more risk-taking.

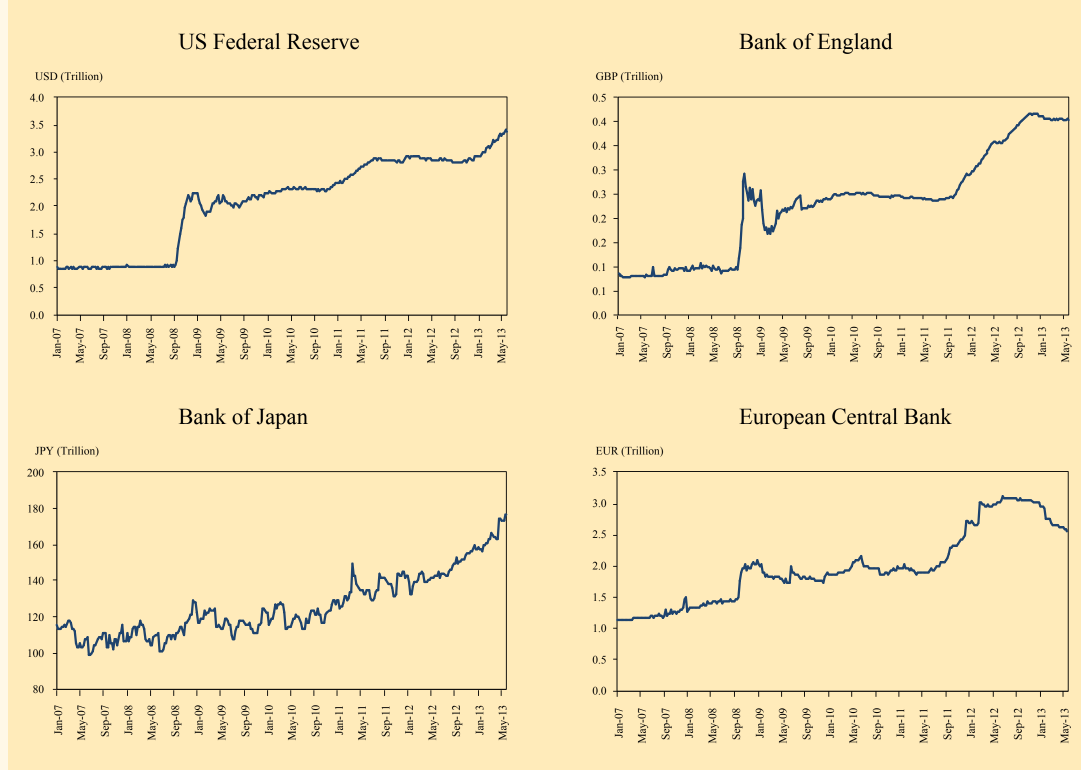
However, the low interest rate environment may induce banks to take unwarranted risks in search of higher yield, spur household indebtedness and may eventually lead to a costly misallocation of financial resources. As a result, the soundness of financial institutions may be threatened and the intertwined functioning of financial markets may provide negative feedback loop to the real economy. Moreover, the ultra-loose monetary policy does not appear to have produced a major turnaround in economic activity in so far as weak growth still persists.

Central bank funding has altered the size - both in absolute terms and as a ratio of GDP - and composition of central banks' balance sheets, with total assets surging to record highs, and raising credit and market risks. Over the period end-2007 to mid-2013, balance sheet assets of the US Fed, ECB, BoE and BoJ have soared by around 380 per cent, 174 per cent, 438 per cent and 167 per cent, respectively (Chart I). Expanded balance sheets expose central banks to potential losses, and inadequate management of the balance sheet assets of these central banks could generate risks to financial stability. The central bank's independence and credibility could also be undermined should these risks materialise.

In terms of spill-over effects to other economies, the unconventional policy measures have resulted in excessive capital flows into emerging market economies and increasing domestic financial vulnerabilities. Such flows have put upward pressure on their currencies and contributed to a surge in private sector credit and property prices in some countries. This may trigger in asset price bubbles if the market value of some assets exceeds their true value.

## Box I: Risks from Ultra-Loose Monetary Policy (Continued)

### Chart I: Central Bank Assets




*Source: Bank for International Settlements.*

The accommodative monetary policies also carry with them risks related to their eventual exit. On the one hand, early withdrawal may pose significant costs to major economies as it may threaten their recovery and undermine investor confidence if the financial system is not yet fully repaired. For emerging economies, an earlier exit may result in a sudden reversal of capital flows with significant impact on exchange rates. On the other hand, exiting too late may generate excess liquidity in the system and contribute to inflationary pressures. Central banks will therefore need to strike the right balance between the risks of a premature exit and the risks associated with postponing exit as the challenges will become more significant the longer accommodative measures remain in place.

Among major central banks, the US Fed was the first to signal that it might start tapering its asset purchase programme later in 2013. The mere anticipation of the US Fed exit generated large capital outflows, a slump in stock markets and exchange rate depreciations in several emerging markets. This underlines the importance for any exit strategy to be accompanied with transparent communication by central banks to dampen negative spill-over effects on emerging economies.

In order to deal with risks arising from unconventional monetary measures, both micro- and macroprudential policies could be implemented, namely, strong capital standards, improved liquidity requirements and well-designed dynamic and forward-looking provisioning. These policies would reduce potential risks to financial stability and pave the way for monetary policy to support price stability and growth.

**References:**

- *International Monetary Fund Global Financial Stability Report, April 2013.*

- *Bank for International Settlements Publications.*