2. International Environment

Enhanced global economic and financial settings since the publication of the February 2014 FSR helped to contain the threats to global financial stability. Volatility in financial markets has been subdued. Liquidity and credit conditions were generally easier and banks generally strengthened. Though the fragile situation in the euro area continues to be a concern, the various steps taken by the ECB should contribute to support the European financial sector and economy in general. But global risks remain, including from the divergent recovery among advanced economies and normalisation of interest rates expected in the near future. Exit from the low interest rate environment, which may have led to excessive risk-taking, may be a source of financial markets vulnerability both in advanced and emerging economies with spillover effects on output growth.[1]

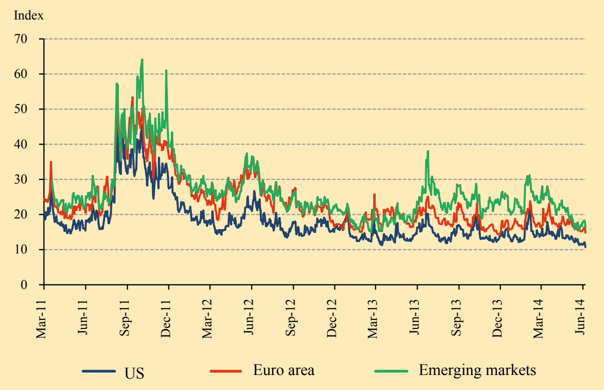
Since the issue of the February 2014 FSR, risks to global financial stability have somewhat moderated as economic and financial conditions in advanced and emerging market economies have improved. Currently, there are widespread expectations surrounding interest rate normalisation in the near future in the US and the UK, where relatively faster recovery is taking place. Normalisation would represent a key source of vulnerability both for advanced and emerging economies, though it would have different implications for them.

Advanced Economies

In major advanced economies, recovery continued though a decoupling was observed between the euro area, where growth remained sluggish, and the US and UK economies, which were rebounding more strongly. In the US, firming activity led the US Fed to further scale down its asset-purchase programme, while reviewing its forward guidance to take into account a broader set of macroeconomic variables. Concurrently, strong growth in the UK was prompting markets to anticipate an increase in the key policy rate, possibly by the end of 2014. In contrast, weak economic conditions in the euro area as well as deflation worries forced the ECB to take extraordinary steps to sustain bank lending and boost the economy in general. These included a cut of 10 basis points in the main refinancing rate; forward guidance that interest rates would remain low for an extended period; and negative interest rate on funds deposited at the ECB.

Economic recovery, accommodative monetary policy as well as improved communication on forward guidance by major central banks helped to improve market sentiment and reduce financial markets volatility (Chart 2.1). In parallel, the protracted period of low interest rates raised risk appetite across asset classes and might have led to excessive risk-taking by investors in search of higher yields. Major equity indices rebounded on favourable corporate earnings, robust growth dynamics in the US and UK, and measures taken by the ECB to boost growth and address deflation concerns. Reflecting the possibility of a shift in policy, the US and UK ten-year sovereign bond yields started trending upwards in 2014H1. In the euro area, movements in the ten-year yields were driven by the pace of recovery across countries. German bund yields evolved in line with yields

Chart 2.1: Financial Markets Volatility



Source: Thomson Reuters.

[1] *Sources: Financial Stability Reports of the ECB, BoE, RBI and SARB, Annual Reports of the US FSOC and the BIS, and July 2014 IMF WEO Update.*

in the US and UK whilst the ten-year sovereign bond yields in the peripheral euro area moved downwards (Chart 2.2).

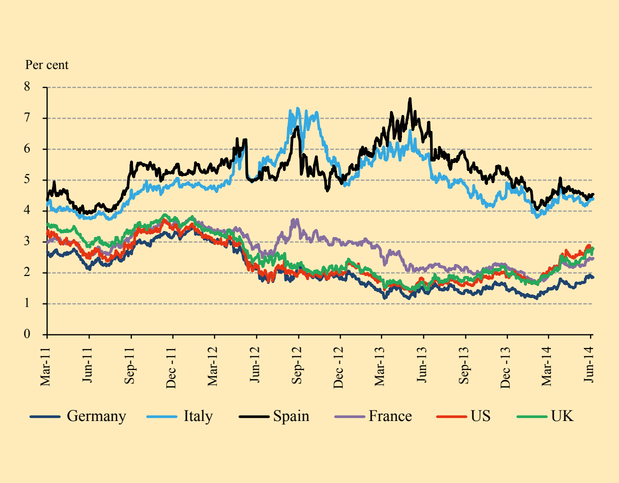
Foreign currency markets moved broadly in line with international developments. The US dollar initially depreciated against other major currencies in early 2014 on the back of weaker-than-expected data releases that fuelled fears that US economic growth might be slowing. However, it recouped losses as the economy bounced back. The euro, which had benefited from US dollar weakness, thereafter lost ground on monetary policy easing by the ECB. The Pound sterling strengthened against the US dollar amid firming growth in the UK economy and expectations of an increase in interest rate.

Conditions in the banking sector in advanced economies were reflective of their economic situation. Large banks in the US continued to recover and recorded higher profits. Results of the Comprehensive Capital Analysis and Review for US bank holding companies released in March 2014 showed that projected losses in the adverse and severely adverse scenarios were around 30 per cent and 50 per cent of banks' Tier 1 capital, respectively. Credit conditions were generally easier. The April 2014 Senior Loan Officer Opinion Survey on Bank Lending Practices showed that, on balance, banks eased their lending policies on business loans and experienced stronger demand for these types of credit (Chart 2.3). Results with regard to household loans were mixed, with banks loosening standards on consumer credit card and auto loans but tightening conditions on mortgage facilities.

In the UK, strengthening economic activity bolstered banks' resilience and credit conditions. Their capital positions largely improved as they sought to rectify shortfalls identified by the Financial Policy Committee. Nonetheless, UK banks' average profitability was relatively subdued as costs related to past misconduct remained a drag on their profits. The BoE Credit Conditions Survey showed that demand for credit by households and corporates increased significantly in 2014Q2. Banks expected to increase the supply of mortgages and business loans in 2014Q3.

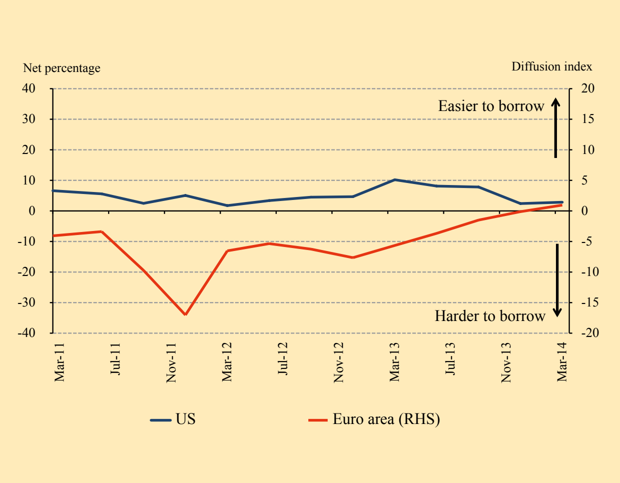
Banks in the euro area consolidated their capital positions while funding markets continued to strengthen. However, profitability remained weak, weighed down by rising loan loss provisioning, high litigation costs faced by some banks, and marked declines in trading revenues. With deterioration in asset quality mostly recorded by banks in stressed countries, progress in balance sheet repair remained uneven. The Bank Lending Survey carried out by the ECB in April 2014 indicated that cross-country disparities in lending supply conditions remained substantial although demand in general could pick up as a result of banks applying more favourable lending standards.

Chart 2.2: 10-Year Yields on Government Bonds



Source: Thomson Reuters.

Chart 2.3: Credit Conditions in US and Euro Area



Sources: ECB and US Fed.

The outlook for euro area financial institutions is still uncertain given the possibility of renewed stress. The recent financial difficulties faced by one bank in Portugal and resulting collateral damage revived concerns about the health of European banks. In-depth reforms towards the creation of a banking union are nonetheless on-going. The agreement reached in April 2014 on the proposed Single Resolution Mechanism should help to reinforce the regulatory and supervisory framework by reducing the link between banks and their sovereigns.

Emerging Economies

In emerging economies, the bouts of financial markets turbulence caused by the reduction of the US Fed asset-purchase programme at the beginning of 2014 abated. Markets reacted positively to counter-policy measures adopted by affected countries to mitigate the fallouts from tapering. Emerging markets equity indices recovered somewhat while exchange rates stabilised. However, prospects for growth in emerging economies remained muted, with the July 2014 IMF WEO Update pointing to a less optimistic outlook for several of these countries.

The banking sector across emerging economies continued to face a number of challenges. As growth slowed in China, borrowers' ability to service their debt weakened and non-performing loans increased considerably. Nevertheless, by drawing on reserves, Chinese banks were able to absorb credit losses and maintain high capital ratios. In India, liquidity and profitability pressures continued to weigh on the banking sector, although marginal improvement was noted in asset quality and capital adequacy levels. In addition, efforts towards balance sheet repair were maintained via deceleration of credit growth and a decline in Tier 1 leverage ratios of commercial banks. In South Africa, profitability of banks generally declined since the onset of the global financial crisis. Credit growth remained strong despite declines in the ratio of impaired advances to total loan book.

Within Sub-Saharan Africa, various initiatives have been undertaken to consolidate financial stability in the region. Box I provides details.

Box I: Regional Initiatives in Sub-Saharan Africa

The outbreak of the global financial crisis exposed several fault lines in the financial system that required intervention. This triggered an ambitious programme of reforms by international standard setters. However, as emerging markets and developing economies were at varying levels of development and had different specificities, it was widely recognised that a-one-size- fits-all approach would be counter-productive.

Against this backdrop, in November 2010, the Financial Stability Board (FSB), which is an emanation of the G-20, took the decision to extend outreach beyond its membership and announced the formation of Regional Consultative Groups (RCGs). In 2011, six RCGs were set up, among which the RCG for Sub-Saharan Africa, of which Mauritius is an active member. The objective was to create a level playing field by taking on board the diversity of the different regions and financial systems in the formulation of global policy measures. The voice of each RCG is heard through its co-chairs at the FSB Plenary Session. A few RCGs have already formed working groups to address region-specific issues and presented their reports to the FSB Plenary. In Sub-Saharan Africa, a working group has been set up to address the deficiencies in home-host cooperation and information sharing which have been identified as potential risks for the region.

In July 2013, the Governor of the Bank of Mauritius was appointed co-chair of the RCG for Sub-Saharan Africa for a period of two years. So far, five meetings of the RCGs have been held.

Discussions within the RCG have focused on vulnerabilities and financial stability issues in the region. They included, *inter alia*, the impact of US Fed tapering on Sub-Saharan Africa; the rise of Pan-African banking groups and their associated risks; constraints in ensuring effective supervision of these groups; and deficiencies in home-host cooperation as well as information sharing.

The main reforms in which the FSB is engaged, namely, 'ending the too-big-to-fail issue', 'transforming shadow banking', 'making derivatives markets safer', and 'reducing reliance on credit rating agencies', are of direct relevance to Mauritius. The Bank drew extensively from the work of the FSB and the Banking Committee on Banking Supervision for setting guidelines for dealing with domestic systemically important banks. A reference system is now in place in Mauritius to assess the systemic importance of our banks. The workshop organised for members of the RCG for Sub-Saharan Africa in May 2014 to provide guidance on the key attributes of Effective Resolution Regimes for Financial Institutions will be very beneficial to us in modernising our existing resolution framework.

Our participation in the meetings has enabled us to benefit from the sharing of experiences with other jurisdictions in the region on a range of issues. Other issues that have been discussed earlier related to the benefits of the regulatory reforms and the main challenges and constraints facing Sub-Saharan Africa in their implementation.

In addition, the FSB has provided guidance on other important issues such as compensation practices, international cooperation and information exchange. Lately, the FSB has come up with a Legal Entity Identifier which assigns a unique identification code to financial market participants and provides an accurate picture of their exposures.

At each meeting, a session is earmarked for regional financial stability issues. The topics for discussions include, *inter alia*, the impact of the US Fed tapering on Sub-Saharan Africa, the rise of Pan-African banking groups and the associated risks and constraints in ensuring effective supervision of these groups. The participation of the International Monetary Fund enhances the debate by offering a macro perspective of the vulnerabilities and issues related to financial stability.

Challenges Ahead

Looking ahead, risks to global financial stability remain. Exit from non-conventional monetary policy in some major advanced economies, and the subsequent normalisation of interest rates might exacerbate vulnerabilities in the global financial system. There are signs that the low interest rate environment might have increased demand for higher risk investments in financial markets. Moreover, debt and property prices increased rapidly in several economies and there are associated concerns about borrowers' ability to repay when interest rates rise.

In its 2014 Spillover Report, the IMF highlighted the risks that uneven recovery across countries could pose to global financial stability. In particular, there is a risk that the normalisation process could increase financial markets volatility, which would impact negatively on vulnerable emerging markets. This might in turn affect advanced economies through trade and financial channels. In addition, the decoupling of growth paths and divergent monetary policy in the US and UK, on the one hand, and the euro area, on the other, may have repercussions on major currencies. These might cause problems for economies with balance sheet vulnerabilities and significant foreign exchange exposures.