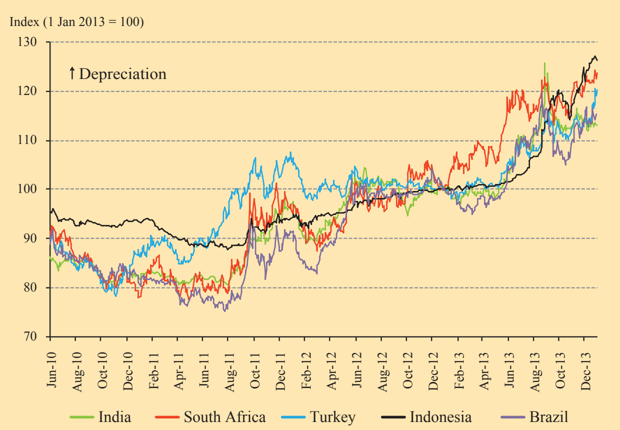
2. International Environment

Global economic and financial conditions have generally improved although a divergence was noted between emerging market economies and advanced economies. The reduction in the US Fed asset purchase programme and fears of contagion from the slowdown in China caused capital flow reversals and sharp exchange rate depreciations in some emerging market economies, which prompted central bank actions. Additional tapering by the US Fed could lead to further volatility in markets. The international banking sector continued to show progress as financial conditions generally improved[1].

Global economic and financial conditions have generally improved since the publication of the August 2013 FSR, although a divergence was noted between emerging market economies and advanced economies. Market sentiment remained positive and global risk appetite increased as monetary accommodation continued to drive financial markets, reducing fears of any disruption in the fragile economic recovery. Market volatility remained low but increased in October 2013 due to the US Government shutdown and debt ceiling negotiations.

In advanced economies, financial conditions improved as Government austerity programmes eased and the reduced uncertainty allowed growth to speed ahead. Financial conditions however tightened in emerging economies amid slowing growth and rising domestic vulnerabilities. The announcement of the US Fed in mid-2013 to reduce its asset purchase programme generated reversal of capital flows, sharp depreciation in exchange rates and volatility in stock markets in several emerging economies, especially those with weak economic fundamentals (Chart 2.1). While in December 2013, market responses to the US Fed's decision to slow down its asset purchase programme were rather muted, expectations of further scaling back of bond buying at the start of 2014 have put pressure on risky assets, especially in emerging markets dependent on external financing. The US Fed eventually reduced its asset purchase programme by a further USD10 billion in January 2014 to USD65 billion despite the turmoil in emerging markets.

Chart 2.1: Exchange Rate Movements against the US dollar



Source: Thomson Reuters.

In early 2014, fears of contagion from the slowdown in China were widespread and currencies of several emerging market economies such as India, Brazil, Indonesia, Turkey and South Africa were under significant pressure against the US dollar. Central banks in emerging markets reacted, quite aggressively, in some cases, by hiking interest rates. The central bank of Turkey, which saw a run on the lira, had to raise its one-week repo rate by 5.5 percentage points from 4.5 per cent to 10 per cent. Although higher policy rates may contain the negative impact from US Fed decisions, they could weigh on growth. Additional tapering by the US Fed could lead to further volatility in markets, as investors re-allocate their assets towards less volatile markets and away from markets vulnerable to the unwinding of quantitative easing.

In the case of those emerging markets characterised by large current account deficits and possibly overvalued currencies, the ensuing depreciation would broadly support global rebalancing. Looking ahead, economies with major surpluses, such as China and Germany, will thus need to strengthen their internal demand in order to sustain robust growth (Chart 2.2).

The IMF, in its January 2014 WEO Update, revised global growth upward to 3.0 per cent in 2013 and forecast growth to accelerate to 3.7 per cent and 3.9 per cent, in 2014 and 2015, respectively. Growth

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

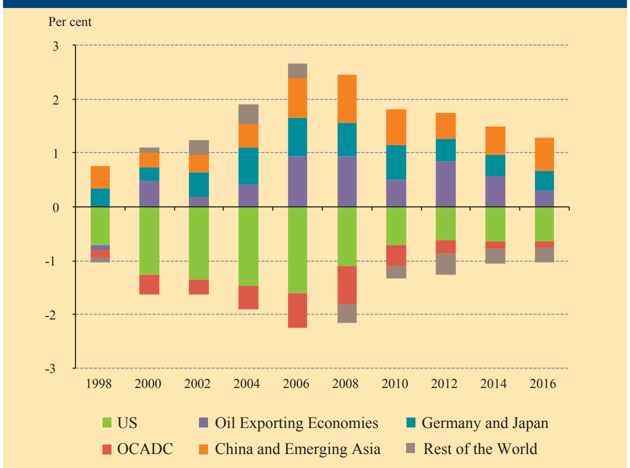
in the US is expected to speed up in 2014, driven by domestic demand and partly supported by a reduction in the fiscal drag in the wake of the recent budget agreement. The euro area pulled out of its longest recession but record unemployment, weak consumer confidence and low bank lending continued to weigh on economic activity. The growth outlook for France, a key export market for domestic goods and services, would remain fairly bleak in 2014. In the UK, growth has surprised on the upside, supported by easier credit conditions and improved confidence.

In emerging market economies, although domestic weaknesses and capital flow volatility remain a concern, growth is forecast to increase in 2014, driven by stronger external demand from advanced economies. In China, growth is expected to moderate while in India, growth is projected to increase on stronger structural policies supporting investment. The IMF has noted that a higher-than-expected rise in interest rates could pose risks to asset markets and the corporate sector given its rising leverage and exposure to foreign currency liabilities. Emerging market economies could face sharp capital outflows and exchange rate pressures in the wake of the looming reduction in US stimulus and economic slowdown in China.

Against the backdrop of strengthening economic activity, credit conditions improved in some advanced economies. In the US, the October 2013 Senior Loan Officer Opinion Survey on Bank Lending Practices indicated that domestic banks, on balance, eased their lending standards but experienced little change in the demand for loans over the past three months. Owing to increased competition, banks eased their lending policies for commercial and industrial loans. The survey results also indicated that banks in general did not substantially change standards or terms on lending to households. The results of the October 2013 Bank Lending Survey carried out by the ECB confirmed the on-going stabilisation in credit conditions for firms and households in the context of still weak loan demand. The recovery of the banking sector was accompanied by a further easing of credit conditions in the UK in the third quarter of 2013. The BoE Credit Conditions Survey showed that credit conditions of larger corporates improved but lending spreads were rather unchanged for smaller businesses. The survey also showed a marked improvement in the credit conditions for households (Chart 2.3).

The US financial system continued to improve with higher capital and liquidity levels. Market discipline has facilitated regulatory efforts to promote the conduct of financial transactions in a rather transparent and standardised approach. Implementation of the Dodd-Frank Act and the G-20 reform priorities have helped in establishing resilience and stability in the financial system. Despite these positive developments, the US financial system remains subject to financial stability risk in terms of potential asset price bubbles and fiscal imbalances, among others.

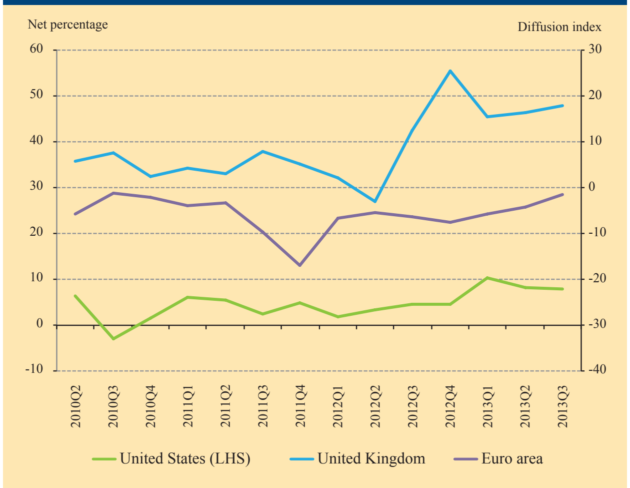
Chart 2.2: Current Account Balance as a Share of World GDP



Note: OCADC includes Bulgaria, Croatia, Czech Republic, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Slovakia Republic, Slovenia, Spain, Turkey and United Kingdom.

Source: IMF.

Chart 2.3: Credit Conditions



Note: Net percentage refers to the fraction of lenders that reported having loosened less the fraction of lenders that reported having tightened. Diffusion index weights the fractions according to the intensity of loosening/tightening. A positive (negative) level indicates a loosening (tightening) in lending standards.

Sources: BoE, ECB and US Fed.

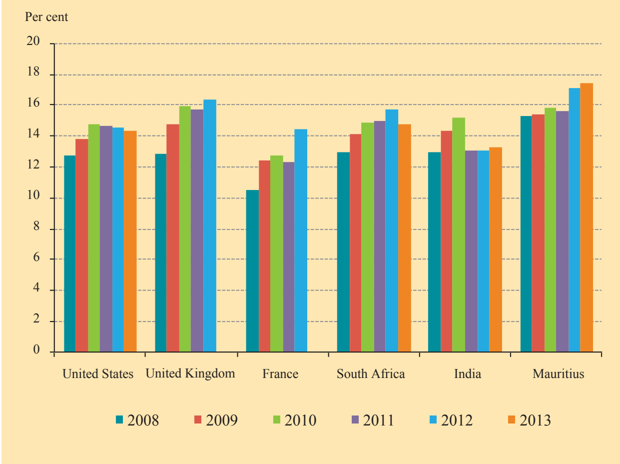
In the euro area, there has been further strengthening of the regulatory and supervisory framework with the adoption of enhanced global standards for capital and liquidity under Basel III. In December 2013, Eurozone finance ministers' agreement on financing for closing down banks paved the way for the completion of a Eurozone 'banking union' to restore confidence in the financial sector and boost growth. Funding situation has normalised, with an improvement in funding cost.

However, financial institutions still face a challenging economic and financial environment. The profitability of large euro area banks was rather subdued in the first three quarters of 2013 as revenue growth remained sluggish from weak growth in lending as well as low interest rates. Weak macroeconomic prospects hampered performance, and elevated levels of loan loss provisioning dragged down banks' profits. Asset quality continued to diverge among banks of different size, with higher NPL reported among smaller entities. Looking ahead, concerns still remain regarding asset quality and profitability in a weak economic environment. Real and financial fragmentation may continue to weigh on financial stability.

In the UK, there was further evidence of improvement in bank resilience. UK banks continued to enhance their capital positions following recommendations of the Prudential Regulatory Authority to rectify capital shortfalls identified earlier in 2013. Profitability increased and impairment charges fell although banks recorded GBP3 billion of regulatory fines.

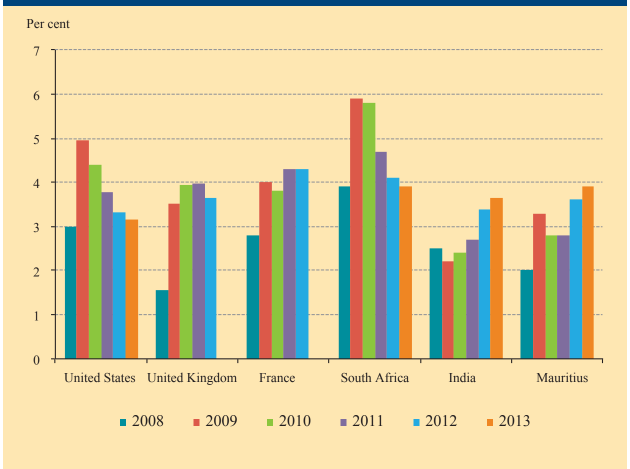
With regard to some emerging markets of concern to us, risks to the banking sector in India have increased. While the regulatory capital to risk-weighted assets ratio has stabilised, there is a serious concern over asset quality. Banks' NPL have increased, reflecting mainly the economic slowdown as well as persistent policy impasses, delayed clearances of various projects and aggressive expansion by corporates during the boom phase. The profitability of banks dropped mainly due to the lower growth in net interest income, higher risk provisions and write-offs. The South African banking sector remained well capitalised and profitable. Loans and advances increased further and the quality of assets generally improved. Charts 2.4-2.6 provide some financial ratios in selected countries.

Chart 2.4: Regulatory Capital to Risk-Weighted Assets



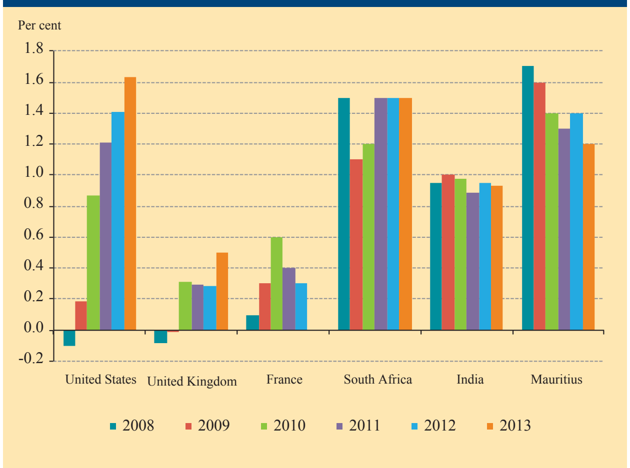
Source: IMF.

Chart 2.5: Bank Non-Performing Loans to Total Loans



Source: IMF.

Chart 2.6: Bank Return on Assets



Source: IMF.