Economics

June 26, 2012

Review of BIS Annual Report

The Bank for International Settlements (BIS) with the release of its annual report has called the attention of governments and central banks across the world towards balancing fiscal and monetary channels to stimulate growth, in order to avoid generation of distortions that could lead to price and financial instability in the future.

Both advanced and emerging economies are currently facing structural challenges, which are interacting and feeding back with greater severity.

On the one hand, ***advanced economies*** are characterised by -

- disarray in government finances,
- failing attempts at cutting budget expenditure,
- sectoral misallocations negatively impacting yields on financial assets

and on the other, ***emerging economies*** have to deal with –

- substantial drop in rate of economic activity,
- varied nature of domestic bust and boom cycles
- constraints in management of spill-over effects

The Vicious Circle

High commodity, particularly energy, prices had kept inflation elevated in 2011 and for some part in 2012. Weak macro-economic indicators such as high unemployment rate, declining manufacturing output and declining asset prices (especially, equity and housing) have weakened income profiles and inherent creditworthiness of households and firms. This has in turn, increased the probability of default, with largely un-hedged positions of households being at risk. With greater number of loans given by banks turning to non-performing assets (NPAs), credit flows in the financial sector have thinned, whilst simultaneously, capital adequacy requirements for banks jumping up.

This has necessitated monetary support from banks and fiscal intervention from governments. Fiscal trajectories of central governments have turned rather unsustainable, with tax receipts moderating and expenditures ballooning, against stimulus packages and increased committed expenses. This has increased the demand for consolidation, which in turn is lowering opportunities for income growth across economies. Inevitably then, this has left already burdened monetary authorities to shoulder weakening economic and financial systems.

The BIS notes that, at about US $18 trillion, aggregate assets of all central banks now stand at roughly 30% of global GDP. Furthermore, real policy interest rates (nominal rates adjusted for headline inflation) remain substantially negative in most major advanced economies, highlighting attempts at cheap credit provision. For instance, the Euro 1 trillion bail-out program alone increased the Euro-system central bank balance sheet by roughly Euro 500 billion but was perhaps the single most important factor halting the freeze in banks' funding markets. The sustainability of these measures though is highly questionable.

The Side-Effects

Prolonged monetary accommodation in the form of near zero policy rates combined with abundant and nearly unconditional liquidity support, have weakened the incentive for the private sector to repair balance sheets; problems which are masked by stimulus. Low rates of interest could also prompt excessive risk taking at low costs, which further distorts the financial system and places added burdens on asset quality. Flattened yield curves with regard to government securities (which are gradually losing their safe haven status as sovereigns are no longer perceived as risk-free) coupled with protracted low rates of interest have moreover lowered interest income and hence profitability for banks.

With major economies attempting to transit towards tighter capital adequacy norms prescribed under Basel III, provisioning for assets assumes greater magnitude. BIS notes that, in effect, ***only an estimated 70% of the common equity that banks currently hold and report under Basel II would qualify as common equity under Basel III.***

Furthermore, fiscal authorities have also limited and/or delayed efforts at fiscal prudence. Since the beginning of the financial crisis in 2007 government debt in the advanced economies (as a percentage of GDP) has increased on average from about 75% to more than 110%. Average government deficits simultaneously have ballooned from 1.5% to 6.5% of GDP during the same period.

In most advanced economies, the fiscal budget excluding interest payments would need 20 consecutive years of surpluses exceeding 2% of GDP, starting 2012, just to bring the debt-to-GDP ratio back to its pre-crisis level.

Conclusion: key observations by BIS

- Long-term inflation expectations have remained stable and close to the central banks goals, indicating high central bank credibility. This could be interpreted as availability of leg-room for monetary accommodation, however unconditional liquidity support has its drawbacks.
- Up to mid-2012, equity prices signalled general scepticism about the banking sector. Relative to a broad index, bank valuations have improved little and, in certain cases, even worsened since end-2008.
- Perceptions of relative credit risk have shifted base from US in 2008 to the euro-zone now.
- Sovereigns are losing their priced risk-free status, as reflected in limited access to financial markets, rising borrowing costs for governments, widening CDS spreads and credit-rating downgrades.

Contact:

Madan Sabnavis
Chief Economist
madan.sabnavis@careratings.com
91-022-67543489

Krithika Subramanian
Associate Economist
krithika.subramanian@careratings.com
91-022-67543521