20100906 Bank for International Settlements: Latest Quarterly Review discusses how mixed outlook for economic growth affected investor confidence

Source: Bank for International Settlements

The BIS Quarterly Review for September 2010, released today, attributes the decline in bond yields to investor concerns about the outlook for economic growth, particularly in the United States.

The September issue also provides highlights from the latest BIS data on international banking and financial activity.

In addition it features four articles. (more detailed abstracts follow):

•Credit dynamics after the crisis: if history is any guide, we would expect to see continued reductions in private sector debt, particularly of households.
•The collapse of international bank finance during the crisis: evidence from syndicated loan markets suggests that supply constraints aggravated the sharp decline of international lending.
•The risk of a sudden shortage of foreign currency in the banking system: we examine how governments and central banks may obtain the assurance of having access to foreign currency if and when they need it.
•The role of banks in the transmission of financial shocks across countries: we show how data on banks' consolidated balance sheets should be complemented with other information to provide a geographically disaggregated picture of financial system risks.

Overview: growth concerns take centre stage

The period from early June to late August saw investors shift their attention from the funding problems of European sovereigns to the diverse global growth outlook and the implications for asset prices. In the early part of the period, improved access to funding for a number of European sovereigns and the reduced uncertainty following the release of the EU bank stress tests contributed to lower risk premia for most sovereigns and larger banks. Credit spreads declined and equity prices rose across the globe. Bank equity prices also responded favourably to a series of national and international regulatory announcements.

Starting in late July, increased evidence of economic weakness in the United States led to lower inflation expectations and falling bond yields. During August, the decline in yields accelerated and equity prices fell as evidence of slower growth in a number of advanced economies mounted.

These developments contrasted with continued strong albeit somewhat lower economic growth in China, as well as in a number of Asian and Latin American economies. Inflationary pressures in faster-growing emerging economies, accompanied by rising asset prices, led some central banks to tighten policies. With higher interest rates, capital inflows rose and currencies appreciated.

Highlights from the BIS statistics

The contraction of BIS reporting banks' international balance sheets that began in the fourth quarter of 2008 came to an end during the first three months of 2010. Led by sizeable increases in international claims on residents of the United Kingdom and the United States, the turnaround was also boosted by continued acceleration in cross-border claims on Asia-Pacific and Latin America and the Caribbean. In the second quarter of 2009 these were the first two regions to experience positive post-crisis growth in international lending. Meanwhile, claims on the euro area and on emerging Europe continued to decline at the same time that internationally active banks increased their exposures to Greece, Ireland, Portugal and Spain. The latter was mainly a result of rising derivatives and credit commitments.

Activity in the primary market for international debt securities fell sharply in the second quarter of 2010. Completed gross issuance fell by 23% to $1,664 billion, the lowest since late 2005 and well below the levels seen during the financial crisis. With stable repayments, net issuance dropped by 83% to $99 billion, the lowest since the late 1990s. Financial institutions took the brunt of the hit. They recorded net redemptions of $55 billion, after net issues of $292 billion in the first three months of the year.

Growth in activity on the derivatives exchanges fell somewhat in the second quarter of 2010, compared to the buoyant first quarter. Turnover measured by notional amounts of futures and options on interest rates, stock price indices and foreign exchange increased by 8% quarter on quarter to $555 trillion between April and June, compared to a 16% rise in the previous three months. The relatively modest increase reflected divergent developments in the United States and Europe.

Special features

Debt reduction after crises

Financial crises tend to be followed by a protracted period of debt reduction in the non-financial private sector. Garry Tang and Christian Upper (BIS) find that what goes up tends to come down. A period of debt reduction followed 17 out of 20 systemic banking crises that were preceded by surges in credit. Debt/GDP ratios fell by an average of 38 percentage points, returning to approximately the levels seen before the increase. If history is any guide, we should expect to see a much more significant reduction in private sector debt, particularly of households, than has so far taken place after the recent crisis. The costs of this process in forgone output are difficult to pin down, but there are reasons to believe that they need not be high provided that the banking sector problems that led to the crisis are fixed.

The collapse of international bank finance during the crisis: evidence from syndicated loan markets

This article by Michael Chui, Dietrich Domanski, Jimmy Shek (BIS) and Peter Kugler (University of Basel) examines developments in syndicated loan markets during the financial crisis. Changes in deal structures and purposes suggest that credit supply constraints aggravated the sharp decline of syndicated lending. An econometric analysis confirms that balance sheet constraints of international banks played a significant role.

Options for meeting the demand for international liquidity during financial crises

The financial crisis has heightened the awareness of the risk of a sudden shortage of foreign currency. Governments and central banks are thus looking for ways to obtain "liquidity assurance", ie the assurance of having access to foreign currency if they need it. William Allen (Cass Business School) and Richhild Moessner (BIS) discuss how such assurance might be provided. They contrast multilateral measures, such as reserve pooling or structures such as the IMF, with bilateral means, such as swap arrangements, and unilateral action by building up foreign exchange reserves. The various solutions each have advantages and disadvantages, and a diversity of approaches therefore seems likely. If international arrangements are deemed to be inadequate, unilateral actions will continue.

Bank structure, funding risk and the transmission of shocks across countries: concepts and measurement

The feature by Ingo Fender and Patrick McGuire (BIS) outlines a broad framework for assessing system-wide funding risks and analysing banks' role in the transmission of financial shocks across countries. The article highlights the need to complement data on banks' consolidated balance sheets with information that provides a geographically disaggregated picture of those balance sheets. The authors go on to discuss how far the BIS international banking statistics, which have several though not all of the desired statistical properties, can go in providing measures of system-wide funding risk.

To view the the Quarterly Review click here.

NovaRes Team