## Contents

Letter of transmittal ................................................. 1

I. Introduction: resilience to mounting strains .................... 3
Meeting the challenges of recent success .......................... 4
Structural change and policy regime shifts ......................... 9

II. The global economy ............................................. 11
Highlights .......................................................... 11
Overview of the global economy ..................................... 12
Continued buoyant growth and low inflation ..................... 12
Signs of a more balanced economic expansion .................... 13
Outlook and risks .................................................. 15
Inflation and wage setting behaviour in the global economy .... 16
Global inflation trends .............................................. 16
Wage setting behaviour and globalisation .......................... 18
Outlook .............................................................. 21
Private sector saving and investment ................................ 21
Trends ................................................................. 21
Corporate profits and investment .................................... 23
Residential investment and housing markets ....................... 25
Fiscal policy .......................................................... 28
Challenges to fiscal sustainability ................................... 29
Current account developments ....................................... 31
External imbalances widen further .................................. 31
Global rebalancing and oil revenue recycling ..................... 32

III. Issues in emerging market economies ............................ 34
Highlights .......................................................... 34
Macroeconomic overview ............................................. 34
Pattern of demand ................................................... 35
Rising inflation pressures ........................................... 38
Outlook and risks ................................................... 38
Two major external challenges ....................................... 40
Shifts in the terms of trade ......................................... 40
Strong demand for emerging market assets ....................... 42
Fiscal policy .......................................................... 46
How much fiscal adjustment? ....................................... 46
Issues in revenue and expenditure adjustment ..................... 47
Issues raised by commodity price increases ....................... 49
Debt reduction and sustainability ................................... 50
Monetary and exchange rate policy ................................ 51
Implications of relative price shocks ............................... 51
Responding to exchange rate appreciation pressures ............ 53
Policy responses and regimes ...................................... 54
Consequences of policy responses .................................. 56
### IV. Monetary policy in the advanced industrial economies

- **Highlights**

- **Review of developments**
  - United States
  - Euro area
  - Japan
  - Inflation targeting countries

- **Globalisation and monetary policy**
  - Globalisation, central bank incentives and price stability
  - Globalisation and traditional monetary policy guideposts
  - Globalisation, the transmission mechanism and the policy room for manoeuvre
  - Challenges, risks and possible policy responses

### V. Foreign exchange markets

- **Highlights**

- **Developments in foreign exchange markets**
  - Foreign exchange market conditions
  - Trends in official reserves

- **Exchange rate movements: determinants**
  - Growth and interest rate differentials
  - The US external imbalance
  - Exchange rate policies in Asia

- **Net income and the sustainability of the US external position**
  - Trends and determinants of net income
  - The sustainability of the US external balance

### VI. Financial markets

- **Highlights**

- **Long-term yields remained low**
  - Flattening yield curves in the United States and the euro area
  - Subdued inflation expectations
  - Low volatilities and term premia
  - Institutional demand factors: pension funds and insurance companies
  - Foreign demand factors: Asian reserves and petrodollars

- **Equity markets shrugged off rate increases**
  - Macroeconomic outlook underpinned equity gains
  - Releveraging and mergers accelerated
  - Conflicting signals about valuations

- **Credit markets proved resilient**
  - Divergent appetites for different risks
  - Corporate balance sheets remained strong
  - Vulnerability of credit markets to a repricing

- **Emerging market spreads at historical lows**

### VII. The financial sector

- **Highlights**

- **The performance of the financial sector**
  - Commercial banks
  - Investment banking
  - Hedge funds
  - Private equity
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance companies</td>
<td>127</td>
</tr>
<tr>
<td>Pension funds</td>
<td>129</td>
</tr>
<tr>
<td>Vulnerabilities</td>
<td>130</td>
</tr>
<tr>
<td>Potential sources of pressure on bank profitability</td>
<td>130</td>
</tr>
<tr>
<td>Exposure to property markets</td>
<td>132</td>
</tr>
<tr>
<td>Financial reporting and financial risk management</td>
<td>134</td>
</tr>
<tr>
<td>Financial reporting and prudential policy</td>
<td>138</td>
</tr>
</tbody>
</table>

VIII. Conclusion: coping with risks, today and tomorrow .................... 140

What risks do we currently run? ........................................... 140
How might current risks be reduced? ..................................... 144
What to do if risks materialise? ......................................... 147
Can we avoid similar risks in the future? ................................ 151

Organisation, governance and activities ..................................... 155
Board of Directors and senior officials .................................... 184
BIS member central banks .................................................... 187
Financial statements ................................................................ 189
Report of the auditors ............................................................ 225
Five-year graphical summary .................................................... 226

The chapters of this Report went to press between 1 and 9 June 2006.
Graphs

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>II.1</td>
<td>Contributions to world growth</td>
<td>12</td>
</tr>
<tr>
<td>II.2</td>
<td>Oil and commodity prices and terms of trade</td>
<td>13</td>
</tr>
<tr>
<td>II.3</td>
<td>Financing conditions and credit growth</td>
<td>14</td>
</tr>
<tr>
<td>II.4</td>
<td>Global inflation</td>
<td>16</td>
</tr>
<tr>
<td>II.5</td>
<td>Trends in relative prices</td>
<td>18</td>
</tr>
<tr>
<td>II.6</td>
<td>Inflation, wages and wage share</td>
<td>18</td>
</tr>
<tr>
<td>II.7</td>
<td>Globalisation and wages</td>
<td>19</td>
</tr>
<tr>
<td>II.8</td>
<td>Import penetration and wages by industry sector</td>
<td>20</td>
</tr>
<tr>
<td>II.9</td>
<td>Corporate investment cycles</td>
<td>24</td>
</tr>
<tr>
<td>II.10</td>
<td>Private sector assets and debt</td>
<td>25</td>
</tr>
<tr>
<td>II.11</td>
<td>House prices and private consumption</td>
<td>27</td>
</tr>
<tr>
<td>II.12</td>
<td>Fiscal developments in different growth periods</td>
<td>30</td>
</tr>
<tr>
<td>II.13</td>
<td>Balance of payments indicators of oil-exporting economies</td>
<td>33</td>
</tr>
<tr>
<td>III.1</td>
<td>Contributions to real GDP growth</td>
<td>36</td>
</tr>
<tr>
<td>III.2</td>
<td>Household credit</td>
<td>36</td>
</tr>
<tr>
<td>III.3</td>
<td>External positions</td>
<td>40</td>
</tr>
<tr>
<td>III.4</td>
<td>Exports</td>
<td>41</td>
</tr>
<tr>
<td>III.5</td>
<td>Elements of demand for emerging market assets</td>
<td>44</td>
</tr>
<tr>
<td>III.6</td>
<td>Public finance developments</td>
<td>47</td>
</tr>
<tr>
<td>III.7</td>
<td>Government revenues, primary expenditures and public debt</td>
<td>48</td>
</tr>
<tr>
<td>III.8</td>
<td>Changing relative prices and inflation</td>
<td>52</td>
</tr>
<tr>
<td>III.9</td>
<td>Real policy rates</td>
<td>53</td>
</tr>
<tr>
<td>III.10</td>
<td>Real effective exchange rates</td>
<td>55</td>
</tr>
<tr>
<td>III.11</td>
<td>Financial market conditions</td>
<td>57</td>
</tr>
<tr>
<td>IV.1</td>
<td>Economic indicators for the United States</td>
<td>60</td>
</tr>
<tr>
<td>IV.2</td>
<td>Yield spread, inflation and business cycles in the United States</td>
<td>61</td>
</tr>
<tr>
<td>IV.3</td>
<td>Economic indicators for the euro area</td>
<td>62</td>
</tr>
<tr>
<td>IV.4</td>
<td>Monetary analysis and monetary policy in the euro area</td>
<td>63</td>
</tr>
<tr>
<td>IV.5</td>
<td>Economic indicators for Japan</td>
<td>64</td>
</tr>
<tr>
<td>IV.6</td>
<td>Interest rates in Japan</td>
<td>65</td>
</tr>
<tr>
<td>IV.7</td>
<td>Inflation targets and policy rates</td>
<td>67</td>
</tr>
<tr>
<td>IV.8</td>
<td>Import prices and inflation</td>
<td>69</td>
</tr>
<tr>
<td>IV.9</td>
<td>Global inflation</td>
<td>70</td>
</tr>
<tr>
<td>IV.10</td>
<td>Key indicators of globalisation</td>
<td>71</td>
</tr>
<tr>
<td>IV.11</td>
<td>Volatility of growth and inflation in advanced industrial countries</td>
<td>71</td>
</tr>
<tr>
<td>IV.12</td>
<td>Flattening Phillips curves in advanced industrial countries</td>
<td>73</td>
</tr>
<tr>
<td>IV.13</td>
<td>Global factors determining domestic inflation</td>
<td>73</td>
</tr>
<tr>
<td>IV.14</td>
<td>Non-accelerating inflation rates of unemployment</td>
<td>74</td>
</tr>
<tr>
<td>IV.15</td>
<td>Monetary policy and global liquidity in advanced industrial countries</td>
<td>76</td>
</tr>
<tr>
<td>IV.16</td>
<td>Monetary policy and global liquidity in emerging market economies</td>
<td>77</td>
</tr>
<tr>
<td>V.1</td>
<td>Exchange rates, implied volatilities and risk reversals of the dollar,</td>
<td>80</td>
</tr>
<tr>
<td></td>
<td>euro and yen</td>
<td></td>
</tr>
<tr>
<td>V.2</td>
<td>Exchange rates of other industrial countries</td>
<td>81</td>
</tr>
<tr>
<td>V.3</td>
<td>Exchange rates in emerging markets</td>
<td>81</td>
</tr>
<tr>
<td>V.4</td>
<td>Current real effective exchange rates in a long-term perspective</td>
<td>82</td>
</tr>
<tr>
<td>V.5</td>
<td>Exchange rates and interest rate differentials</td>
<td>84</td>
</tr>
<tr>
<td>V.6</td>
<td>Exchange rates and Sharpe ratios</td>
<td>85</td>
</tr>
<tr>
<td>V.7</td>
<td>US current account balances and net foreign assets</td>
<td>86</td>
</tr>
<tr>
<td>V.8</td>
<td>Spot and forward exchange rates of the Chinese renminbi</td>
<td>88</td>
</tr>
<tr>
<td>V.9</td>
<td>Net equity and net debt</td>
<td>90</td>
</tr>
<tr>
<td>V.10</td>
<td>Income yields of US direct investment assets and liabilities</td>
<td>91</td>
</tr>
<tr>
<td>V.11</td>
<td>US foreign direct investment</td>
<td>93</td>
</tr>
<tr>
<td>V.12</td>
<td>US external position scenarios</td>
<td>95</td>
</tr>
<tr>
<td>V.13</td>
<td>Net portfolio debt assets and income of the United States</td>
<td>96</td>
</tr>
</tbody>
</table>
VI.1 Interest rates ................................................. 99
VI.2 Forecasts for 2006 and inflation compensation measures ........ 99
VI.3 Forward curves ........................................... 100
VI.4 Implied volatilities and term premium estimates .................. 101
VI.5 Pension funds and bond spreads ................................ 103
VI.6 Investment in long-term US securities .......................... 104
VI.7 Equity prices .............................................. 105
VI.8 Shareholder-friendly actions .................................. 107
VI.9 Mergers and acquisitions ..................................... 108
VI.10 Valuations and volatility in equity markets ....................... 109
VI.11 US valuations and earnings ................................... 110
VI.12 Corporate bond spreads ...................................... 111
VI.13 Risk appetite in credit markets ................................ 112
VI.14 Corporate leverage .......................................... 114
VI.15 Outlook for corporate credit quality ............................. 115
VI.16 Emerging market bond spreads and credit ratings .............. 117
VI.17 Predicting sovereign ratings and spreads ....................... 118

VII.1 Credit growth ............................................... 122
VII.2 Indicators of investment banking activity ........................ 123
VII.3 Hedge fund size, performance and leverage ...................... 124
VII.4 Size of private equity funds ................................... 126
VII.5 Private equity: cash flows and performance ...................... 126
VII.6 LBO loan size and risk ....................................... 127
VII.7 Insurance companies: equity holdings and performance .......... 128
VII.8 Pricing of risk in syndicated loan and bond markets ............ 131

Tables

II.1 Growth and inflation ........................................... 11
II.2 2006: an unusual year .......................................... 15
II.3 Contribution of a common factor to inflation in advanced economies 17
II.4 Global saving and investment trends ................................ 22
II.5 Profit indicators for selected global industry sectors .............. 23
II.6 Construction sector in selected economies ........................ 26
II.7 Recent fiscal performance and medium-term fiscal projections .... 28
II.8 Global current account balances ................................ 31
III.1 Output growth and current account balance ....................... 35
III.2 Fixed investment ............................................. 37
III.3 Consumer prices ............................................. 39
III.4 Net private capital flows to emerging market economies ........ 43
III.5 Foreign exchange reserves ..................................... 55
III.6 Policy indicators under different policy regimes .................. 56
V.1 Annual changes in official foreign exchange reserves .............. 83
V.2 US external assets and liabilities, 2004 ............................ 89
V.3 Foreign direct investment, 2000–04 ................................ 92
V.4 US external position ............................................. 94
VII.1 Profitability of major banks ..................................... 121
VII.2 Sensitivity of income to cyclical conditions ....................... 130
VII.3 Commercial property prices ................................... 132
VII.4 Residential property prices and mortgage debt ................... 133
Conventions used in this Report

lhs, rhs  left-hand scale, right-hand scale
billion   thousand million
...      not available
.        not applicable
$        US dollar unless specified otherwise

Differences in totals are due to rounding.
Ladies and Gentlemen,

It is my pleasure to submit to you the 76th Annual Report of the Bank for International Settlements for the financial year which ended on 31 March 2006.

The net profit for the year amounted to SDR 599.2 million, compared with SDR 370.9 million for the preceding year. Details of the results for the financial year 2005/06 may be found on pages 180–2 of this Report under “Net profit and its distribution”.

The Board of Directors proposes, in application of Article 51 of the Bank’s Statutes, that the present General Meeting apply the sum of SDR 132.4 million in payment of a dividend of SDR 245 per share, payable in any constituent currency of the SDR, or in Swiss francs. This year’s proposed amount compares to the dividend of SDR 235 per share paid out last year.

The Board further recommends that SDR 46.7 million be transferred to the general reserve fund, SDR 6.0 million to the special dividend reserve fund and the remainder – amounting to SDR 414.1 million – to the free reserve fund.

If these proposals are approved, the Bank’s dividend for the financial year 2005/06 will be payable to shareholders on 3 July 2006.

Basel, 9 June 2006

MALCOLM D KNIGHT
General Manager