

Contents

Letter of transmittal	1
Overview of the economic chapters	3
I. When the future becomes today	7
The global economy: salient developments in the past year	9
The global economy: interpretation and risks	11
Interpretation: a movie	11
Secular stagnation – or financial booms gone wrong?	14
Risks	16
The global economy: policy	17
Towards a macro-financial stability framework	17
What to do now?	20
In defence of central banking	22
Conclusion	22
II. Global financial markets: between uneasy calm and turbulence	25
A year of alternating calm and turbulence	25
Low-rate environment drives asset valuations	29
Box II.A: The transmission of negative policy rates: initial experience	30
Box II.B: Liquidity in fixed income markets	35
Market anomalies spread	37
Box II.C: Understanding the cross-currency basis: why does covered interest parity not hold?	40
III. The global economy: realignment under way?	43
The missing rotation	44
Box III.A: The concept and measurement of the financial cycle	46
Large shifts in relative prices require big adjustments	48
Commodity prices continued to fall	48
Floating (and sinking) exchange rates	51
Box III.B: Exchange rates: stabilising or destabilising?	54
Changing interdependence	55
Increasing trade spillovers from EMEs	55
Larger spillovers and spillbacks through the financial channel	56
A dose of growth realism	57
Slower growth of supply	58
Is demand structurally deficient?	60
The reality of slower growth, unless...?	60

IV. Monetary policy: more accommodation, less room	63
Recent developments	63
Monetary policy normalisation delayed further	63
Inflationary cross-currents	66
Box IV.A: Global value chains and the globalisation of inflation	68
Shifting from domestic to external monetary policy channels	69
The diminishing effectiveness of domestic channels... ..	70
...and the rising prominence of external channels	71
Monetary policy frameworks: integrating financial stability	74
Factoring in domestic financial cycle considerations	74
Box IV.B: Analytical case for a “leaning against the wind” monetary policy	76
Box IV.C: The financial cycle, the natural rate of interest and monetary policy	78
Factoring in exchange rate considerations	80
V. Towards a financial stability-oriented fiscal policy	83
The historical record	83
The financial sector as a source of sovereign strains	84
The sovereign as a source of financial strains	86
The doom loop	87
Protecting the financial sector from sovereign risk	88
Bank exposures to sovereign risk	89
Treatment of sovereign risk in prudential regulation	90
Protecting the sovereign from financial sector risk	93
Recognising and measuring the flattering effect of financial booms	93
Box V.A: Fiscal balances and the financial cycle	94
Can fiscal policy be used to contain financial sector risks?	95
Removing the bias towards debt accumulation	95
Box V.B: Fiscal room for manoeuvre?	96
Box V.C: Debt bias in taxation, firm leverage and the cost of financial crises	100
VI. The financial sector: time to move on	103
Coping with a challenging environment	103
Banks: dealing with stiff headwinds	103
Box VI.A: Bank capital and lending behaviour: empirical evidence	105
Box VI.B: Digitalisation in the financial sector: opportunities and challenges	110
Other financials: more of the same?	111
Box VI.C: Solvency II: overview of key elements	114
Finalising the post-crisis reforms	115
Finishing the job on banking regulation	115
Macroeconomic impact	116
Shifting the prudential focus	118
Box VI.D: The long-term economic impact (LEI) of stronger capital and liquidity requirements	119
Statistical Annex	123

Organisation of the BIS as at 31 March 2016	134
The BIS: mission, activities, governance and financial results	135
BIS member central banks	166
Board of Directors	167
Five-year graphical summary	173
Financial statements	175
Independent auditor's report	246

Graphs

I.1	The global economy is not as weak as the rhetoric suggests	7
I.2	Interest rates remain exceptionally and persistently low	8
I.3	Global debt continues to rise and productivity growth to decline	10
I.4	Unusually accommodative global monetary conditions	12
II.1	Alternating calm and turbulence in markets	26
II.2	Chinese equities nosedive and renminbi depreciates	27
II.3	Commodity price rout continues and commodity producers suffer	27
II.4	Dollar stays strong as policy outlook continues to diverge	28
II.5	Banks under pressure	29
II.6	Negative bond yields continue to spread	31
II.7	A historical perspective on record low interest rates and yields	32
II.8	Term premia estimates continue to sink to unusually low levels	33
II.9	Ten-year bond yields sink below nominal GDP growth rates	34
II.10	Elevated equity valuations	36
II.11	Credit spreads rise as default cycle starts turning	37
II.12	Credit spreads react to the exchange rate	38
II.13	Swap spreads, Treasury bond flows and interest rate hedging costs	39
III.1	Emerging market economies and commodity exporters slow, but others do well	44
III.2	Financial cycles: turning down in major EMEs and up in many crisis-hit economies	45
III.3	The unwinding commodity supercycle is hurting exporters	48
III.4	Risks have built up for commodity producers	50
III.5	The risk-taking channel of exchange rates	52
III.6	Trade spillovers from China have increased, and remain large from the United States	56
III.7	The US dollar is the dominant global funding currency	57
III.8	Fewer workers means less growth shared among more consumers	59
IV.1	More global accommodation as inflation stays low	64
IV.2	Policy rates stay very low for long as central bank balance sheets soar	64
IV.3	Inflation concerns heavily influenced policy rate decisions	65
IV.4	Wedge between headline and core inflation persists, reflecting near-term factors	67
IV.5	Core inflation supported by cyclical factors and anchored inflation expectations	69
IV.6	Domestic channels of monetary policy may have become weaker	70
IV.7	Unconventional monetary policies seemingly deliver less “bang for the buck” ..	72
IV.8	External channels of monetary policy appear to grow in importance	73
IV.9	FX reserve holdings used to influence exchange rates	74
IV.10	Currency mismatches led to FX and deleveraging feedback loops	81
V.1	General government debt increases substantially after a crisis	85
V.2	Public finances and bank risk are highly interdependent	88
V.3	Banks’ sovereign exposures vary significantly across countries and over time ...	89
V.4	Can fiscal policy prevent the build-up of financial sector risks?	98
V.5	Government subsidies encourage private sector leverage	99
V.6	Corporate sector taxes and leverage	101
VI.1	Banking systems are becoming more resilient	104
VI.2	Market valuations flag concerns about bank profitability and balance sheet risks	106
VI.3	Ultra-low interest rates squeeze traditional income sources	108

VI.4	Improving cost efficiency in a challenging environment	109
VI.5	Pension funds and insurance companies struggle with low interest rates	112
VI.6	Market activity and liquidity risks continue to migrate to new players	113
VI.7	Additional bank capital yields sizeable economic benefits	118

Tables

VI.1	Profitability of major banks	107
VI.2	Profitability of major insurance companies	113
VI.3	Aggregate bank capital ratios and capital shortfalls	117
A1	Output growth, inflation and current account balances	123
A2	Residential property prices	124
A3	Fiscal positions	125
A4	Early warning indicators for stress in domestic banking systems	126
A5	Annual changes in foreign exchange reserves	127

The economic chapters of this Report went to press on 15–17 June 2016 using data available up to 30 May 2016.

Conventions used in the Annual Report

\$	US dollar unless specified otherwise
mn	million
bn	billion (thousand million)
trn	trillion (thousand billion)
% pts	percentage points
bp	basis points
lhs, rhs	left-hand scale, right-hand scale
sa	seasonally adjusted
yoy	year on year
qoq	quarter on quarter
...	not available
.	not applicable
–	nil or negligible

Components may not sum to totals because of rounding.

The term “country” as used in this publication also covers territorial entities that are not states as understood by international law and practice but for which data are separately and independently maintained.

Country codes

AR	Argentina	IN	India
AT	Austria	IS	Iceland
AU	Australia	IT	Italy
BA	Bosnia and Herzegovina	JP	Japan
BE	Belgium	KR	Korea
BG	Bulgaria	LT	Lithuania
BR	Brazil	LU	Luxembourg
CA	Canada	LV	Latvia
CH	Switzerland	MK	Macedonia, FYR
CL	Chile	MX	Mexico
CN	China	MY	Malaysia
CO	Colombia	NL	Netherlands
CY	Republic of Cyprus	NO	Norway
CZ	Czech Republic	NZ	New Zealand
DE	Germany	PE	Peru
DK	Denmark	PH	Philippines
DZ	Algeria	PL	Poland
EA	euro area	PT	Portugal
EE	Estonia	RO	Romania
ES	Spain	RU	Russia
EU	European Union	SA	Saudi Arabia
FI	Finland	SE	Sweden
FR	France	SG	Singapore
GB	United Kingdom	SI	Slovenia
GR	Greece	SK	Slovakia
HK	Hong Kong SAR	TH	Thailand
HR	Croatia	TR	Turkey
HU	Hungary	TW	Chinese Taipei
ID	Indonesia	US	United States
IE	Ireland	ZA	South Africa
IL	Israel		

Advanced economies (AEs): Australia, Canada, Denmark, the euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States.

Major AEs (G3): The euro area, Japan and the United States.

Other AEs: Australia, Canada, Denmark, New Zealand, Norway, Sweden, Switzerland and the United Kingdom.

Emerging market economies (EMEs): Argentina, Brazil, Chile, China, Chinese Taipei, Colombia, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand and Turkey.

Global: All AEs and EMEs, as listed.

Commodity exporters (countries whose average share of commodities in export revenues in 2005–14 exceeded 40%): Argentina, Australia, Brazil, Canada, Chile, Colombia, Indonesia, New Zealand, Norway, Peru, Russia, Saudi Arabia and South Africa.

Country aggregates used in graphs and tables may not cover all the countries listed, depending on data availability.

86th Annual Report

*submitted to the Annual General Meeting
of the Bank for International Settlements
held in Basel on 26 June 2016*

Ladies and Gentlemen,

It is my pleasure to submit to you the 86th Annual Report of the Bank for International Settlements for the financial year which ended on 31 March 2016.

The net profit for the year amounted to SDR 412.9 million, compared with SDR 542.9 million for the preceding year. Details of the results for the financial year 2015/16 may be found on pages 170–1 of this Report under “Financial activities and results”.

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 120.0 million in payment of a dividend of SDR 215 per share, payable in any constituent currency of the SDR, or in Swiss francs.

The Board further recommends that SDR 14.6 million be transferred to the general reserve fund and the remainder – amounting to SDR 278.3 million – to the free reserve fund.

If these proposals are approved, the Bank’s dividend for the financial year 2015/16 will be payable to shareholders on 30 June 2016.

Basel, 17 June 2016

JAIME CARUANA
General Manager