MACROECONOMICS TRENDS AND MONETARY POLICIES IN TIME OF THE GLOBAL FINANCIAL STABILITY[1]

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Abstract:
The strengthening of the global recovery from the Great Recession is evident. However, growth is not yet robust across the globe, and downside risks to the outlook remain. In advanced economies, continued and in some cases, greater support for aggregate demand and more financial sector and structural reforms are needed to fully restore confidence, foster robust growth, and lower downside risks. Many emerging market economies face a less forgiving external financial market environment; their growth has slowed; and they continue to face capital flow risks that they must manage. Spillovers, especially if downside risks were to materialize, could pose further challenges. Boosting medium-term growth is a common challenge throughout the world, and difficult structural reforms are a priority.

Keywords:
financial stability, monetary policy, macroeconomic risks, capital flow, public and private debts, market turbulence.

JEL classification: E 58, F 34, G 15, G18, H 60

Introduction

In the wake of the global financial crisis, policymakers in most countries established a supportive macroeconomic environment to facilitate the repair of over-leveraged balance sheets that were exposed by the crisis. Accommodative monetary and liquidity policies have been an essential element of this response, aimed at minimizing the economic damage wrought by impaired financial systems, weakened companies, and stressed sovereign balance sheets. But the scaling back of certain extraordinary policy supports has not been accompanied by adequate preparations for a new environment of normalized, self-sustaining growth. Many advanced economies have been unable to sufficiently reduce precrisis debt loans -indeed; in general they have increased public indebtedness.

In the United States, green shoots are evident from the economic recovery under way, holding out the promise of self-sustaining growth, but further medium-term fiscal consolidation is required. Japan needs to complement its central bank's additional monetary stimulus by enacting structural reforms to boost growth and reduce debt-related risks. Emerging market economies face growing domestic vulnerabilities along with a heightened sensitivity to global conditions. The euro area is confronted by the headwinds from the continued weakness of some corporate and bank balance sheets, as the incomplete repair of bank balance sheets and the corporate debt overhang in some economies are hampering both financial integration and the flow of credit to the real economy.

1. Financial Stability Overview

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Over the last year, the financial stability has improved in the advanced economies and deteriorated somewhat in emerging market economies. In the euro area, a pickup in growth has brightened prospects, although high debt, low inflation, and financial fragmentation still present downside risks. However, the growth outlook for emerging market economies has been somewhat lowered by tightening external conditions coupled with some tightening of policy rates amid rising domestic vulnerabilities. Together, these developments leave macroeconomic risksunchanged[1].

The firming up of the recovery in the United States hasallowed the Federal Reserve to begin scaling back monetarystimulus. As a result, overall monetary and financialconditions have tightened, especially in emerging market economies, as real interest rates have increased. Tighter external conditions and rising risk premiums have risen market risks in emerging market economies as a number of them address macroeconomic weaknesses and shift to a more balanced and sustainable framework for financial sector activity.Credit risks have declined as vulnerabilities in banking systems have been reduced. Table 1 shows current debt levels of selected advanced economies by categories[2].

	Canada	Japan	United Kingdom	United States	Euro area	Belgium	France	Germany	Greece	Ireland	Italy	Portugal	Spain
Government													
Gross debt	89	243	90	105	95	100	94	78	174	123	133	129	94
Net debt	39	134	83	81	72	82	88	56	168	100	111	118	60
Primary balance	-2,6	-7,6	-4,5	-4,1	-0,4	0,4	-2,2	1,7	1,5	-3,4	2,0	-0,7	-4,2
Household liabilities													
Gross financial	94	73	95	81	71	58	68	58	71	109	56	98	84
Net financial	-155	-261	-195	-292	-137	-217	-140	-126	-74	-91	-181	-138	-90
Nonfinancial corporates													
Gross debt	47	78	73	54	68	-	68	43	66	118	78	118	99
Bedt to equity (%)	54	69	50	48	47	-	31	55	130	-	87	67	64
Financial institutions													
Gross debt	51	196	242	83	153	101	165	95	24	699	105	45	109
Bank capital to assets (%)	5,0	5,5	5,0	12,0	-	6,2	5,2	5,2	7,3	7,3	5,5	6,9	5,7
External liabilities													
Gross	146	88	597	158	208	439	322	209	240	2 060	157	294	233
Net	4	-64	-6	25	13	-46	21	-46	117	108	29	117	98
Current account balance	-3,2	0,7	-3,3	-2,3	2,3	-1,7	-1,6	7,5	0,7	6,6	0,8	0,5	0,7

Table (1)Indebtedness and Leverage in Selected Advanced Economies (% of 2013 GDP)

In the euro area, banks have strengthened their capital positions amid ongoing deleveraging, resulting in higher price-to-book ratios and tighter spreads on credit default swaps. Despite a moderate deterioration in overall corporate credit quality, corporate spreads have narrowed. Better central bank communication regarding the process of normalizing U.S. monetary policy has helped quell the associated market volatility. With improved access to market funding for banks and nonfinancial corporations, market and liquidity risks remain broadly unchanged. The appetite for credit Instruments and other risk assets remains firm, but the decline of demand for emerging market assets leaves overall risk appetite unchanged. Since the global financial crisis, advanced economies have made uneven progress in deleveraging private balance sheets while generally increasing their public indebtedness. Table 2 illustrates the varying degrees of progress in reducing debt loans from their post crisis peaks (presented numbers are in % of GDP).

	Canada	Japan	United Kingdom	United States	Euro area	Belgium	France	Germany	Greece	Ireland	Italy	Portugal	Spain
Government	0,0	0,0	0,0	0,0	0,0	0,0	0,0	4,4	0,0	0,0	0,0	0,0	0,0
Household	0,0	6,3	12,3	16,3	1,8	0,0	0,6	6,9	5,0	22,7	0,6	7,7	8,6
Nonfinancial corporates	2,9	4,7	9,8	0,0	5,6	-	1,1	6,6	7,3	9,8	4,7	1,3	21,1
Financial institutions	6,4	4,0	40,4	35,6	7,5	25,7	13,8	38,1	51,2	50,1	4,9	24,1	16,7
External liabilities	0,0	0,0	167,3	10,0	8,2	48,6	0,0	27,6	0,0	24,4	1,1	18,1	5,1

Table (2)Reduction in Gross Debt Levels in Selected Advanced Economies from the 2009-2013 Peak

The broad results are as follows:

- Financial institutions have generally been the most successful in reducing their debt rations. Debt has declined most sharply in Greece, Ireland, the United Kingdom, and the United States. But debt levels continue to be at the upper end of the range for the sample in Ireland, Japan, and the United States. Bank capital positions have improved in stressed euro area economies, but credit conditions remained strained.
- Household have sharply reduced their debt levels (as a share of GDP) since 2009, especially in program countries as well as in Japan, the United Kingdom, and the United States. But gross household debt remains high in Ireland, Portugal, and the United Kingdom. Despite optimism in banks and sovereigns, the net asset position of households remains weak in Greece, Ireland, and Spain.
- Although leverage among nonfinancial firms has come down from its peak in many economies, the corporate sector in parts of the euro area is still highly leveraged because countries have been slow to address the corporate debt overhang. In the U.S., while corporate leverage is relatively low, firms have increased their loans in recent years.
- Current account deficits have reversed sharply in southern Europe amid rapid import compression and improving competitiveness, even with significant public borrowing needs. But net foreign liabilities remain high in Greece, Ireland, Portugal, and Spain.
- The substantial progress made in repairing private balance sheets has come at the cost of public indebtedness, which is now at peak levels for many major economies. With the exception of Germany, government debt levels trended higher in 2013 for most economies. Among the sample economies, it remained highest in Greece, Italy, Japan, and Portugal even as Greece and Italy posted primary surpluses.
- In sum, still-high debt leaves balance sheets in some cases weak and less resilient to the higher interest rates that will come with monetary normalization. The corporate debt overhang in parts of the euro area needs to be resolved to complete the transition from financial fragmentation to integration. Emerging market economies that releveraged in the wake of the global financial crisis may now find it difficult to bring their financial systems in balance as volatility rises, growth slows, and exchange rates come under pressure.

Generally, emerging market debts are seen as being higher risk, since non-mature or smaller countries have been perceived as more likely to experience sharp economic swings, political upheaval, and other disruptions not typically found in countries with more established financial markets. But, the latest development shows changing trend in investor mood, as there are able to book higher volumes of emerging markets debts, compare to pre crises levels. The increased trust of investors is connected also with higher yields of issued debts, taking into account historically low interest rates offered on US or European markets. In spite of relatively high growth of debts after the year 2009, there are still on acceptable level, looking into cumulative debt of OECD markets, what is presented later on. The second important fact judged by investors is much smaller number of official defaults' of emerging markets in latest ten years, and therefore acceptable sovereign risk of emerging markets. The following figure 1 illustrates the emerging markets debt development since the year 2000.

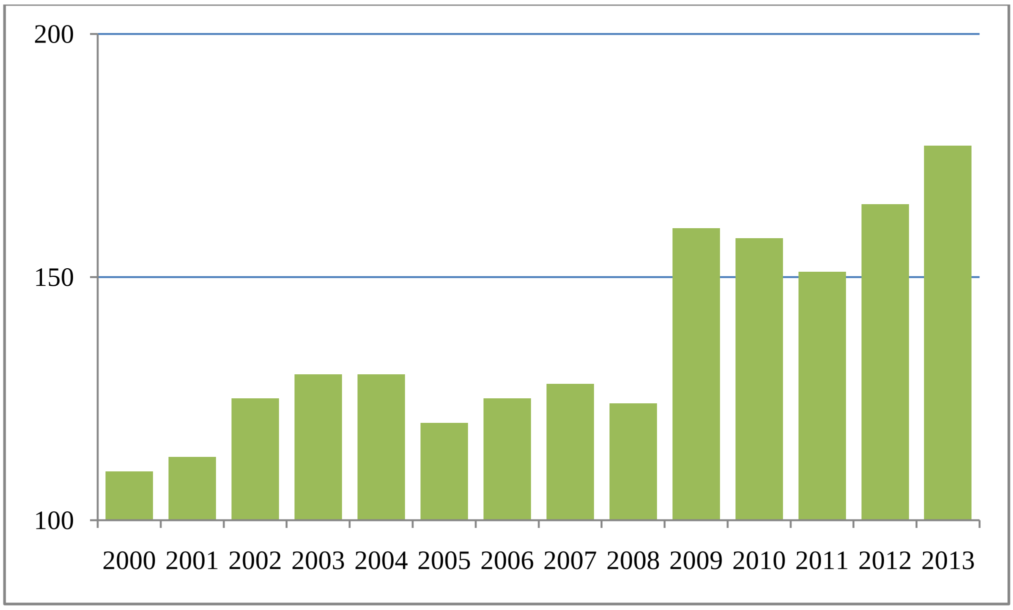

Figure (1) Emerging Markets Debt Development (in % of GDP).

The current credit cycle[2] differs from previous cycles in important ways. Debt issuance is much higher because corporations are borrowing opportunistically to take advantage of low interest rates and lengthening their debt maturities and pushing out refinancing risk to take advantage of investor appetite for debt. Balance sheet leverage has also risen via debt-financed buybacks of equity to boost shareholder returns. Thus, increased borrowing has not yet translated into higher investment by nonfinancial corporations, whose depressed capital expenditures are taking up a smaller share of internal cash flows than in previous cycles. Corporate leverage (the ratio of net debt to GDP) is higher at this point of the cycle than during previous episodes, yet corporate default rates remain low. These characteristics of corporate balance sheets are typically seen at a much later stage of the credit cycle, suggesting that firms are more vulnerable to downside risks to growth than in a normal credit cycle.

The prolonged period of accommodative policies and low rates has led to a search for yield, which boosts asset prices, tilts the market balance in favor of borrowers, and sends funds into the nonbank financial system. All of these developments are part of the intended effects of extraordinary monetary policies, designed to support corporate and household balance sheet repair and promote the recovery. But these developments also have the potential side effect of elevating credit and liquidity risks. Robust risk appetite has pushed up U.S. and European equity prices. The largest contribution to the strong U.S. equity returns in 2013 came from a decline in the equity risk premium. In contrast, equities in emerging market economies stagnated, and in Japan, yen depreciation boosted earnings and returns. Further liquidity-driven boosts in asset prices could force overvaluation and lead to the development of bubbles [3].Looking ahead, markets risk disappointment - especially in an environment of rising interest rates - unless equity valuations become better supported by rising earnings, capital investment, and demand.

[2] Credit cycles are identified based on actual default rates. They start when the default rate on high-yield corporate bonds, tracked by Bank of America Merrill Lynch, peaked in June 1991, January 2002, and October 2009, and cover the four-year period afterward. All variables are measured against internal cash flows over the four-year period, except for net debt, which is measured against GDP at end of the period.

The search for yield has allowed U.S. companies, including those rated as speculative, to refinance and recapitalize at a rapid pace. High-yield issuance over the past three years is more than double the amount recorded in the three years before the last downturn. This trend is accelerating, with gross issuance of high yield corporate bonds reaching a record USD 378 billion in 2013. Similarly, USD 455 billion in institutional leveraged loans were issued in 2013, far exceeding the 2007 levels, what could beseen below in Table 3[4].

	High-Yield Bond Rating					Leveraged loans	Weaker Underwriting of Leveraged Loans	CLOs
	BB	B	CCC	Not rated	Total			
2007	31,8	67,0	50,6	4,4	153,8	388,8	145,3	93,1
2008	14,1	25,7	12,9	2,5	55,2	72,4	5,5	18,0
2009	58,9	103,5	14,9	2,2	179,5	38,3	4,3	0,6
2010	80,1	177,7	39,3	6,6	303,7	158,0	12,9	4,2
2011	80,4	131,9	39,8	5,3	257,4	231,8	66,1	13,2
2012	103,6	195,5	57,3	9,3	365,7	295,3	114,7	55,5
2013	128,8	172,4	72,9	4,2	378,3	454,9	308,0	82,2

Note: CLOs = collateralized loan obligations

Table (3)Issuance Trends for U.S High-yield Bonds and Loans (in billions of USD)

In the face of such strong demand and favorable pricing, issuers have more frequently been able to issue debt with less restrictive conditions and fewer protections for lenders. The proportion of bonds with lower underwriting standards is on the rise, as it was before the financial crisis, and this could contribute, as it did then, to higher default rates and lower recoveries as the credit cycle turns. The normal risk premium of 30-35 basis points for covenant-lite loans has dwindled; despite their lower historical recovery rates, they now trade on par with comparable loans with stronger protections. Debt in highly leveraged loans now amounts to almost seven times EBITDA (earnings before interest, taxes, depreciation, and amortization), close to levels last seen in the 2006–08 period. U.S. bank regulators have publicly expressed concern about the increased incidence of leveraged loans with weaker underwriting standards, and market participants report increased regulatory scrutiny of loans to borrowers with debt in excess of six times EBITDA.

Related to international flow of capital, advanced economies' assets have become relatively more attractive, while emerging market economies have experienced lower capital inflows and currency depreciation, and these trends could intensify, because of upside risks to growth in advanced economies [5].Longer-term U.S. interest rates rose immediately after the May 2013 tapering related announcement by the Federal Reserve but have broadly stabilized since. Rates in the core euro area economies and Japan have increased by a fraction. Equity markets have been buoyant, with price-to-earnings ratios back to precrisis levels. Spreads on Italian and Spanish bonds have continued to decrease.

Financial conditions in emerging market economies have tightened recently in response to a more difficult external financial environment. As recent developments show, economies with domestic weaknesses and vulnerabilities are often more exposed to market pressure. A number of these weaknesses have been present for some time, but with better return prospects in advanced economies, investor sentiment is now less favorable toward emerging market risks. Bond rates and spreads have increased, and equity markets have moved sideways. Gross capital inflows have declined, and exchange rates have depreciated. Overall, the cost of capital in emerging market economies has increased, which will dampen investment and growth, although increased exports to advanced economies are expected to provide some offset.

Private capital in case of Germany and sovereign funds in case of China and Saudi Arabia, represent the major net exporters of capital, while U.S still play significant role in attracting the capital inflow[3].The Figure 2 and Figure 3 illustrate the major net exporters and importers of capital [6].

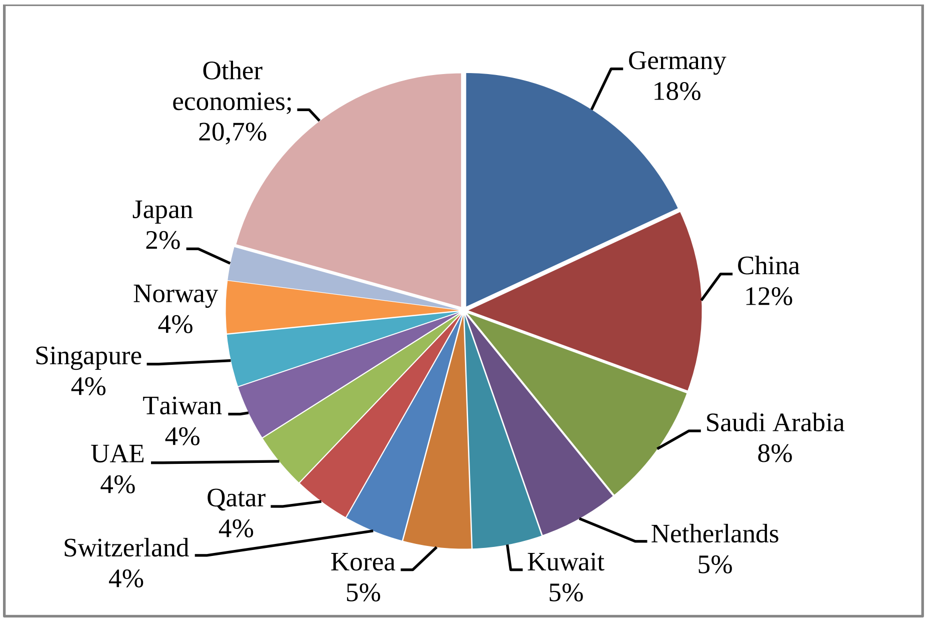

Figure (2) Major Net Exporters of Capital, 2013.

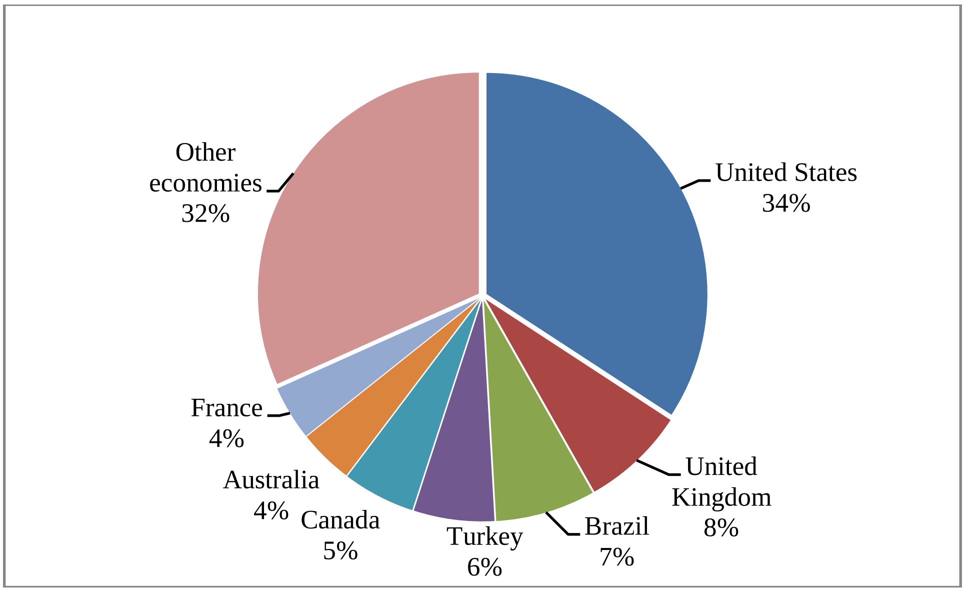

Figure (3) Major Net Importers of Capital, 2013.

[3]Foreign investors hold around 45% of outstanding Treasury bonds and federal agencies securities. China and Japan account each for over 20% of the Treasury holdings by non-residents, while Caribbean banking centres and oil exporting countries together for nearly 10%. Foreign investors are dominated by official institutions (primarily central banks and government pension funds), which hold around three-quarters of total Treasury bonds and half of agency bonds held by non-residents. The opposite is true for the corporate bond market, where private non-resident investors dominate over official institutions, accounting for nearly 95% of total holdings by non-residents.

2. U.S. Monetary Policy

In May 2013, global markets were plunged into turmoil by the Federal Reserve's announcement of its plans to taper the bond purchases that constituted one element of its extraordinary policies - quantitative easing. U.S. Treasury yields surged, and expectations for the eventual liftoff of the target policy rate were foreshortened. Global rates and volatility spiked, and emerging market economies came under substantial pressure. Since then, the Federal Reserve has persuaded markets that its decisions to reduce quantitative easing are independent of any decisions to hike policy rates [7].

The improved communication reduced market volatility in the United States even as Treasury yields rose, and short-term rates somewhat decoupled from long rates. Indeed, during the first few months of 2014, volatility in emerging market economies was driven more by local conditions than by concerns about Federal Reserve tapering. Under the smooth exit scenario, the first hike in the target policy rate is assumed to take place in the second quarter of 2015, the timing of which is broadly in line with market expectations and the FED projections [8].However, unexpected developments may result in either the faster exit scenario or the delayed exit scenario. Based on these assumptions, the expected short-term rate (defined as the average target policy rate over the next 10 years) would evolve the level of 4 % p.a. and the nominal constant maturity 10-year Treasury rate is predicted at 1 % p.a. These expectations are highly sensitive to incoming data and changes in the perception of how the Federal Reserve may react to them.

The withdrawal of monetary accommodation by the Federal Reserve may be setting the stage for a smooth transition from liquidity-driven to growth-driven markets, but pockets of vulnerabilities may be emerging in credit markets [9].Potential shocks include a repricing of credit risks, a sudden increase in policy rate expectations, and a term premium shock. Potential amplifiers of these shocks could include weak market liquidity and redemption runs arising from an implicit mispricing of liquidity risks. These shocks are not independent, they could combine to produce an overshooting of rates and credit spreads and wider spillovers that would block a smooth transition.

3. Changes in Japan Monetary Policy

When the Bank of Japan initiated its program of quantitative and qualitative monetary easing (QQE) in April 2013, it expected the program to affect the financial system through three channels: a further decline in long-term interest rates ("interest rate channel"); a rise in expected inflation ("expectations channel"); and a shift in the portfolios of financial institutions from Japanese government bonds to other assets, such as loans, stocks, and foreign securities ("portfolio rebalancing channel").

The QQE program has so far had more success in the interest rate and expectations channels than in the portfolio channel. Yields on Japanese government bonds (JGBs) have remained low despite the rise in bond yields in other advanced economies. Near-term inflation expectations have risen over the last year, although long-term expectations are still below the central bank's 2 % target. But progress on portfolio rebalancing remains incomplete. Although JGB purchases by the Bank of Japan (BoJ) have helped major domestic banks shift out of JGBs and have reduced interest rate risk, both major and regional banks have accumulated large excess reserves at the BoJ, which could undermine their profitability. Moreover, outward portfolio investments (that is, net purchases of foreign securities) have picked up since mid-2013, but so far the trend appears to be limited mainly to banks and public pension funds. Japanese insurance companies and private pension funds continue to maintain a strong home bias and appetite for JGBs.

Under QQE, domestic banks have been the main sellers of JGBs to the central bank. Japanese banks sold about 20 trillion yen of JGBs between March and December 2013. All of Japan's top three banks reduced their JGB portfolios during this period, and the selling continued also in 2014. The resulting decline in holdings of government debt by the major banks weakened bank-sovereign linkages. Domestic lending is picking up, having risen during 2013 by 2 % for major banks and 3 % for regional banks. As lending picks up further, this could partly pare banks' excess reserves at the BoJ, which are accumulating especially quickly for the major banks at a near zero interest rate.

Japanese banks continue to expand their overseas loan portfolios, which exceed USD 500 billion for the first time in 15 years. Most of the rise in overseas loans reflects expansion into Association of Southeast Asian Nations countries, including Indonesia and Thailand. About 60 % of external loans are financed through external deposits, the rest are financed through foreign-currency-denominated bonds and short-term lending instruments, such as foreign exchange swaps, to hedge foreign exchange risk. A significant portion of their portfolios include U.S. Treasury securities, whose yields now significantly exceed those of JGBs; the trend toward foreign bonds could continue if such differentials remain high.

Insurance and private pension funds maintain a strong home bias and an appetite for JGBs. Outward portfolio investments by insurance companies have not raised substantially since March 2013. But they have raised for public pension funds, spurred by the recent shift in the asset allocation targets of the largest pension fund - the Government Pension Investment Fund[4] - from JGBs to foreign securities, which portends further such investments.Should they persist, these trends have three majorimplications for financial stability[10]:

- First, the rapidgrowth of excess reserves could create a substantialdrag on bank profitability. This risk is more prominentfor major banks, which already have 8 % of assetsin excess reserves earning near-zero interest rates. Butthe risk also exists for regional banks, whose profitabilitywas low to begin with. A further pickup in lendingwould partly offset this drag, but such a pickupdepends on raising credit demand in the economy,including through structural reforms.
- Second, the increase in cross-border activity ofJapanese banks is welcome but poses foreign exchange funding risks and cross-border supervisory challenges.Further progress in securing stable and long-term foreignexchange funding is needed for Japanese banks toreduce their reliance on foreign exchange hedges.
- Third, the recent outward orientation of the largestpublic pension fund is a positive step. But, at USD 2trillion, assets in all public pension funds are only onethirdthe size of assets held by private pension funds andinsurance companies. QQE could become much moreeffective if those private sector asset managers were alsoto reduce their home bias and contribute to an overallportfolio rebalancing. Moreover, such an expansion ofrebalancing could significantly boost the capital inflows of the recipient countries, especially if it were directedto those with relatively small markets[5].

4. The Turbulence in Emerging Market Economies

Emerging market economies have suffered bouts of market turbulence since May 2013. This turbulence reflects a general reprising of external conditions and domestic vulnerabilities, as well as the new uncertainties for growth [11].Last May, as the Federal Reserve signaled steps toward normalizing monetary policy, changes in term premiums and in expectations about the path and timing of adjustment in U.S. rates had a profound impact on global markets. Exchange rates depreciated and interest rates rose sharply. Credit default swap (CDS) spreads jumped broadly across emerging markets - no one was spared from the anticipation of exit from extraordinary monetary policies in the United States.

[4]In late 2013, the Government Pension Investment Fund (with more than $1 trillion in assets under management)changed the portfolio weight of foreign securities from 17 % to 23 %. Over time, this could lead to capital outflows of more than USD 60 billion.

[5]For example, a 1 % point shift of allocations by Japanese private sector asset managers to emerging market economies could boost their capital inflows by USD 60 billion.

This period gave way to greater differentiation among economies as investors narrowed their focus to those economies with large external financing needs and/or other macroeconomic imbalances. Much of the attention was on Brazil, India, Indonesia, South Africa, and Turkey. Sovereign CDS spreads generally reversed, partly as a result of improved communication by the Federal Reserve. Mid-January 2014 saw an outbreak of additional turmoil, this time triggered by idiosyncratic factors and several country-specific vulnerabilities. For instance, there were no broad-based market moves that would suggest increased concerns because the Federal Reserve had started to taper its bond purchases, nor did CDS markets signal a new round of emerging market credit stress. What stands out are market concerns about credit risk, a reprising of political risks in Thailand, concerns about policy vulnerabilities in Argentina, political risks in Turkey, and further pressure on South African markets. Importantly, though, countries that had taken policy actions since 2013 showed increased resilience, with little pressure on India and Indonesia, for example.

Equity markets are signaling continuing concerns about growth prospects in emerging market economies. Initially, the downturn related to concerns about tighter external conditions, but in more recent periods the focus has shifted to greater uncertainty surrounding growth prospects, even as the U.S. economy recovers and U.S. equities are in positive territory [12].

Geopolitical risks in Russia and Ukraine have so far had limited spillovers to broader markets.Thefinancial impact of these political tensions has largelybeen confined to local markets, triggering an increasein Russian and Ukrainian sovereign credit risk, a sharpdepreciation of the ruble and the hryvnia, and a risein local bond yields. As direct economic and financiallinkages of most European countries with Russia andUkraine are limited outside the energy sector, spilloversh ave been modest so far. However, CIS countries, and to a lesser extent the Baltics, have strong links through trade, remittances, FDI, and bank flows to Russia and are likely to see a more significant impact. Greater spillovers to activity beyond neighboring trading partnerscould emerge if further turmoil leads to a renewed bout of increased risk aversion in global financial markets, or from disruptions to trade and finance.

The recent bouts of turmoil in emerging markets have reverberated in mature markets, through several channels. Outflows have supported some safe haven assets - such as U.S. Treasury securities and Japanese government bonds - while advanced economy equity markets and inflows to the euro area have appeared to respond to emerging market weakness (notably in May–June 2013 and January–February 2014). The strength of these responses suggests that policymakers in advanced economies will increasingly need to take into accountthe spillover of their policies to emerging markets and the potential impact of these spillovers on their own economies [13].

5. Debt growth vs. interest rates policies

The economies are dependent on unconventional measures of central banks. During the last years central banks set up an unsound dependency of economies upon non-standard measures [14].It will be very difficult to get rid of them.Low interest rates could be danger, while in times of booming economy and expansion will create bubble and raise financial instability.

The volume of money in circulation and the financial system itself are not neutral. Financial factors and the debt ratio could increase cyclical fluctuations, as they influence investment decisions, capital stock development, and therefore also the future economic fundaments. The growth of capital stock in booming times could mitigate the inflation increase and the pressure on more tightening monetary policy. But the financial boom also triggers the increase of asset prices and channels the investments towards most growing sectors. The long-term influence of such development is visible in a recession time. The total debt growth and bed asset allocations are the consequences, those removals takes a long time.

Low interest rates could be a consequence of the slow growth of the economy and the long-term stagnation. More stimulation could support economy growth from the short-term point of view, but could be also dangerous, if such policy is applied in a long-term perspective. On the other side, central banks are not an owner of increased debt presented in the figure above. The issued debt must be booked on the investor side as an asset. The presented trend also means that the saving rate has changed in some market subjects and countries as well. But the debtors could not raise the new debts forever and investors would not accept the embedded risk. This situation is a result of market development and indirectly caused by central banks measures.The Figure 4 illustrates the sharp growth of public and private debt, while real and nominal interest rates falls.

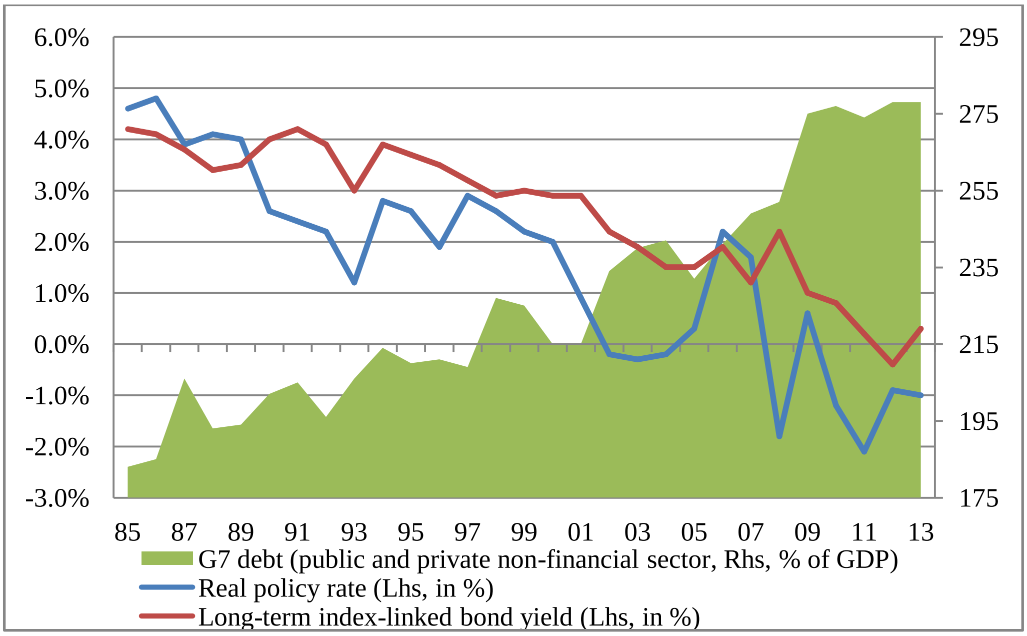

Figure (4) The Dependence between private and public debt development and interest rates movements

The latest development in euro area shows optimistic mood of investors, what could be seen on government bond yields, risk premiums and capital flows. But the amount of public debt still remains in almost all countries at high levels. Such a high debt is sustainable only in case of low interest rates. If sometime in the future comes inflationary shock, followed by rapid growth of interest rates, the public debt moves on unsustainable trajectory. Such situation will once more time bring to further debt crises in a whole euro area.

The second reason is the inconsistency of the individual euro area Member countries. The differences between them as a result of previous crises have increased. In the states, in which the deindustrialization takes place, will thrive to maintain external balance only by limiting of the living standard. It comes therefore to the deepening of income inequality between the Member countries. As soon as it will come to an unsustainable level, it will lead to a political crisis in the euro area.

Economic and monetary union may lead to the optimization of the production factors and the allocation to improve the fortunes of the union as a whole. But at the same time, there may be a decline in regions that do not have optimal conditions for production. Without federal transfers, which would correct this disadvantage, it will result in a decrease of living standard. For the most affected countries this would mean a continued fall into poverty.

The first half 2014 weak economy growth in the euro area just confirms the previous theory. Indeed, there are a number of factors, which hinder the recovery. These include the continued debt reduction within the private sector, insecurity, which restricts the spending of companies, too strong euro, long-term real rates, which are still higher than the rate of growth, stagnation in real wages and low productivity growth and global trade.Compare this situation with the u.s. economy shows that the dollar is relatively weak, real rates are lower than the growth rate, spending of corporates are picking up, the manufacturing sector is rebounding, and the same is true about the growth of productivityThe euro area as a whole may grow faster, just in case; it will appear a warhorse of growth. To find it, is difficult, in particular with regard to the tightened fiscal and monetary policy and subdued growth in productivity.

5. Results and Discussions

Over the past five years, monetary policy in the euro area and the main OECD countries has been highly expansionary. Central banks have kept policy interest rates at or close to their effective lower bounds, expanded balance sheets to record high levels (and in some cases still continue to do so), eased collateral policies and provided forward guidance aimed at strengthening expectations about interest rates remaining low for long. This extraordinary stimulus has supported the recovery and risk-taking, thereby affecting asset prices. Such accommodative policies will have to be unwound in due course to prevent overheating and associated risks of asset price bubbles and higher inflation. This process will become necessary as slack diminishes and inflation increases to or above the target. A smooth exit would ultimately imply a better global economic performance, even if it causes temporary headwinds and adjustments of exchange rates and international capital flows. However, it involves risks of disorderly asset price movements and disruptive international spillovers.

The pace of monetary policy normalisation in the United States and its pass-through to long-term interest rates and other domestic asset prices will determine the direct impact on the real economy and prices as well as financial stability [15].As in previous upturns, the normalisation of monetary policy and the associated re-pricing of financial instruments will act as a headwind for the economy, all other things being equal. However, as long as this process is gradual and motivated by a strengthening of activity, it should not excessively restrain growth or risk unsettling financial stability and should prevent new imbalances to build up.

Emerging market economies have benefited from favorable external financing conditions and strong credit growth, but these tailwinds have now reversed. Several emerging market economies facing market pressure took appropriate policy actions last year to facilitate macroeconomic rebalancing and preserve financial stability. The challenges facing many emerging market economies as they adjust to tighter external financing conditions and greater domestic vulnerabilities vary considerably from economy to economy but can be generally summarized as follows. First is the greater leverage on private and public balance sheets. Second is the increase in macroeconomic imbalances for a number of economies, including in China's nonbank financial sector, and the greater tendency of investors to differentiate between and reprise assets according to these imbalances. Third is the additional capital flow pressure from the increased presence of foreign portfolio investors together with changes in underlying market structures that have reduced market liquidity. Geopolitical risks related to Ukraine could also pose a more serious threat to financial stability if they were to escalate.

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