ICMA
International Capital Market Association

International capital markets in a time of economic shocks

by **Paul Richards**

Summary

International capital markets have had to contend with a series of different economic shocks over the past few years. This assessment reviews, in summary form and in an international context, official sector economic policy in western Europe in response to the Russian invasion of Ukraine, at a time when the international economy has not yet fully recovered from the COVID-19 pandemic. There are implications for real growth and inflation, monetary policy, fiscal policy, financial stability, the international monetary system and regulatory divergence.

Introduction

1 In financing the global economy, international capital markets have had to contend with a series of different economic shocks over the past few years: the global financial crisis of 2007/09; the ensuing sovereign debt crisis in the euro area; the EU migration crisis; Brexit between the UK and the EU; the global COVID-19 pandemic over the past two years; and now the Russian invasion of Ukraine in February 2022 – the first major war in Europe since the end of the Second World War – followed immediately by the imposition of sanctions on Russia by the US and its allies. Besides being a humanitarian tragedy, the Russian invasion of Ukraine represents both an economic shock and a geopolitical shock which has led to a much greater political focus in western Europe on defence through NATO against the perception of a common threat. The threat has led directly to the historic decisions by Finland and Sweden to apply to join NATO and to an historic change in German defence policy, as well as an increased emphasis in western Europe on energy security.[1]

2 This assessment reviews, in summary form and in an international context, official sector economic policy in western Europe in response to the Russian invasion of Ukraine, at a time when the international economy has not yet fully recovered from the COVID-19 pandemic.[2] Against this backdrop, there are implications for real growth and inflation, monetary policy, fiscal policy, financial stability, the international monetary system and regulatory divergence. It is important to recognise that official sector policy varies from one jurisdiction to another; that it is not straightforward to disentangle the different elements in official sector policy as they are all to some extent related; and that the geopolitical and economic outlook remains particularly uncertain.

Real growth and inflation

3 Although the international economy appeared in 2021 to be recovering strongly from the COVID-19 pandemic,[3] developments since the Russian invasion of Ukraine have exerted downward pressure on real growth and upward pressure on inflation in western Europe as well as the US, leading to an increasing risk of stagflation. Against a background of tightening labour markets, particularly but not only in the US, inflation rates have increased markedly as a result of energy, food and commodity shortages and supply bottlenecks.[4]

1. Olaf Scholz, the German Chancellor: "We are experiencing a watershed. History is at a turning point.": Davos, 26 May 2022.

2. The recent COVID-19 lockdowns in China have also had an economic impact internationally.

3. "In fact, in 2021 as a whole, the world economy expanded at its fastest rate in almost 50 years.": BIS Annual Economic Report 2022.

4. In its spring report, the IMF reduced its global forecast of real growth by 0.8% to 3.6% in 2022. The IMF forecast inflation of 5.7% in advanced economies and 8.7% in emerging economies in 2022.

4 In response to the Russian invasion of Ukraine, the authorities – and many corporates – in western Europe as well as the US are now giving a much higher priority to reducing external dependencies by "on-shoring" or "near-shoring" their activities, despite the potential implications for inflation.[5] In particular, the US Treasury Secretary has indicated that the US will now favour "the friend-sharing of supply chains to a large number of trusted countries" with "a set of norms and values about how to operate in the global economy."[6] But although the authorities are seeking to ensure energy self-sufficiency and diversification of supply chains from "just in time" to "just in case", it is clear that these objectives will take time and will not be easy to achieve.

Monetary policy

5 While the ECB has recently debated the precise definition of its inflation target for the euro area, the commitment to an inflation target – with operational independence in seeking to achieve it – is not currently in doubt.[7] The question is how the inflation target is going to be achieved, given the current conjuncture. A period of subdued inflation during the COVID-19 pandemic, accompanied by low – and, in the euro area, negative – official interest rates, supported by the monetary stimulus provided by extensive and prolonged quantitative easing (QE), has now given way to mounting evidence of a pronounced rise in inflation well above central bank target levels. There is increasing acceptance that the rise in inflation can no longer be regarded as solely transitional. Once inflationary expectations become embedded, they are more difficult to root out. Inflation could persist for some time.[8]

6 The rise in inflation well above target levels has left central banks in the US, euro area and UK with the difficult task of taking steps to control inflation without causing recession.[9] In response, the Federal Reserve has led the way by introducing quantitative tightening (QT)[10] and by making significant increases in short-term interest rates, with the market expecting further increases in the period ahead. The Bank of England has recognised that the inflationary outlook represents the biggest test of its monetary policy framework for 25 years.[11] And the ECB has recognised that "inflation in the euro area is undesirably high and projected to stay that way for some time to come", signalling that it is willing to act in "a determined and sustained manner".[12] Even so, some central bankers have drawn attention to the risk that a delayed policy response now will require a greater policy response later;[13] and doubts have been raised in the market about whether central banks can fight inflation effectively if short-term interest rates remain negative in real terms.

7 The prospect of a sustained rise in short-term interest rates potentially represents a structural – and not just a cyclical – change in the outlook for fixed income markets, following a long period of declining bond yields over much of the past 40 years. Accompanied by the end of QE, the rise in short-term rates also risks leading in the euro area to national fragmentation as a result of a significant widening of sovereign bond spreads (eg between German bunds and Italian BTPs), with implications also for borrowing rates in the corporate sector. The ECB is working on an "anti-fragmentation" scheme to limit the rise in spreads (eg through intervention). This would need to address both the monetary consequences of the scheme and the risk of legal challenges.

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5. See, for example, Larry Fink: "The Russian invasion of Ukraine has put an end to the globalisation we have experienced over the last three decades. ... Companies and governments will be looking more broadly at their dependences on other nations. This may lead companies to on-shore or near-shore more of their operations, resulting in a faster pullback from some countries. A large-scale reorientation of supply chains will inherently be inflationary.": Letter to BlackRock shareholders, March 2022.

6. Janet Yellen, US Treasury Secretary: [The US will now favour] "the friend-sharing of supply chains to a large number of trusted countries" with "a set of norms and values about how to operate in the global economy": April 2022.

7. There may be a risk of political interference in the future if central banks fail to keep inflation under control.

8. See Agustin Carstens, General Manager, BIS: "The forces behind high inflation could persist for some time. Central banks will need to adjust, as some are already doing. No one wants to repeat the 1970s.": speech in Geneva, 5 April 2022.

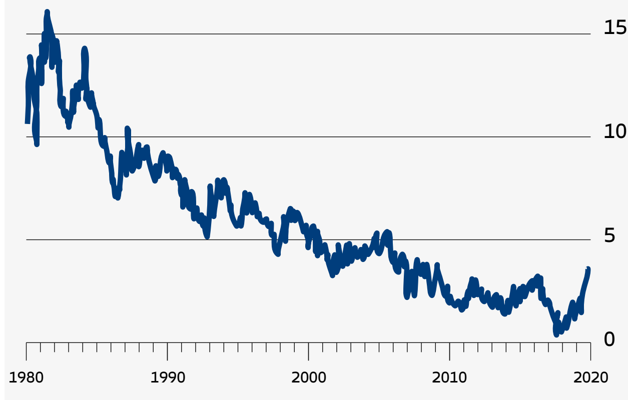
9. Consumer price inflation: 8.6% in the US, 9.1% in the UK and 8.1% in the euro area: May 2022 on a year ago.

10. This would include a process of "run-off" under which the Federal Reserve would not reinvest the proceeds of maturing securities.

11. Andrew Bailey, Governor of the Bank of England: "This is the biggest test of the monetary policy framework for 25 years." [ie since operational independence in 1997]: 16 May 2022.

12. Christine Lagarde, President of the ECB: [The ECB needed to act] "in a determined and sustained manner, incorporating our principles of gradualism and optionality." She said that there were "clearly conditions in which gradualism would not be appropriate." 28 June 2022.

13. "As historical experience has shown time and again, the long-term costs of allowing inflation to become entrenched far outweigh the short-term ones of bringing it under control.": BIS Annual Economic Report 2022.



Source: Refinitiv/FT May 2022

8 In the floating rate market, the authorities have for some time planned the permanent cessation of LIBOR, on the grounds that LIBOR poses clear risks to global financial stability, as the market for unsecured wholesale term lending between banks is no longer sufficiently active to support such a widely used reference rate. Instead, the authorities have encouraged the market to adopt near risk-free reference rates, where the volume of underlying market transactions is greatest. Panel bank LIBOR ceased permanently at the end of 2021 in 24 of the 35 LIBOR settings in the five LIBOR currencies, with a change in methodology in three sterling and three Japanese yen settings from panel bank to synthetic LIBOR. The remaining five panel bank US dollar LIBOR settings will continue only until the end of June 2023.[14]

9 The rise in short-term interest rates, particularly in the US, has also led to a strengthening of the US dollar in the foreign exchange market. For many emerging markets, the combination of a rising dollar in terms of local currency, rising interest rates and public debt and much higher food and energy prices, is having a substantial economic impact, particularly in those emerging markets already most vulnerable as a result of the impact of the COVID-19 pandemic.

Fiscal policy

10 In response to the COVID-19 pandemic, government budget deficits in the western world rose very substantially, as governments used fiscal policy in an attempt to limit the pandemic's economic impact. In the EU, fiscal rules on government budget deficits were suspended in response to the pandemic. Large government budget deficits in the EU remain. There is not yet a consensus on whether to return to the fiscal *status quo ante*, and if not, what the alternative should be. So the European Commission is proposing that the suspension should be extended until the end of 2023. But the pandemic *has* led to agreement on joint debt issuance by the EU to fund the recovery and climate change.[15]

11 It is not yet clear whether the EU will broaden its role in joint debt issuance, for example to finance the need for an increase in EU defence spending and energy self-sufficiency. But, since the Russian invasion of Ukraine, there has been increasing attention in the EU to possible ways of speeding up EU decision-making:[16] eg by replacing unanimity by qualified majority voting, though this would require a change in the EU Treaty. In addition, the re-elected French President has proposed the creation of a broad political community of European democracies to include the Ukraine and Balkan countries which do not currently qualify to join the EU,[17] while Ukraine and Moldova have now been accepted by the European Council as candidates for accession to the EU.[18]

Financial stability[19]

12 The resilience of the international banking system has been strengthened as a result of the global reforms introduced by the authorities in response to the 2007/09 global financial crisis, both in the form of capital increases and liquidity buffers for banks.[20] They have been stress-tested regularly by central banks and have proved sufficiently resilient so far both to withstand the impact of the COVID-19 pandemic and to limit the financial disruption arising from the war in Ukraine. Capital markets – and their underlying market infrastructure – have also continued to be resilient and to function in an orderly way, despite volatility.

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14. High levels of inflation have also reinforced the role of bonds index-linked to measures of inflation.

15. A programme of €750 billion of funding entitled *Next Generation EU*.

16. See, for example, Mario Draghi, Prime Minister of Italy: "We need a pragmatic federalism: one that encompasses all the areas affected by the transformations taking place, from the economy, to energy, to security.": address to the European Parliament on 3 May 2022.

17. Speech by President Macron to the European Parliament, 9 May 2022. He suggested that countries which have left the EU (ie the UK) would also be eligible to join.

18. European Council on 23 June 2022.

19. "Financial stability authorities must focus on what *could* happen rather than just what is most *likely* to happen.": Sir Jon Cunliffe, Deputy Governor of the Bank of England for Financial Stability: *Recollections on Financial Stability,* 2 March 2022.

20. Sam Woods, Head of the UK Prudential Regulation Authority, has proposed more flexible prudential rules for UK regulated banks: "My simple framework revolves around a single, releasable buffer of common equity, sitting above a low minimum requirement.": City Week, 26 April 2022.

13 But a major outstanding issue in the EU is the need to complete Banking Union, which would involve a common EU safety net for depositors to complement national schemes, diversification of banks' sovereign exposures, improvement in the management of failing banks and the development of a true Single Market in banking services.[21] A renewed attempt is being made by the authorities in the EU to resolve these outstanding issues. Progress is also being made towards the complementary EU objective of Capital Markets Union through a number of useful initiatives under the CMU Action Plan (eg relating to the ESAP, and the AIFMD, ELTIF and MiFID II/MiFIR reviews). But some underlying issues (eg a common approach to the treatment of debtors and creditors under corporate insolvency laws) have for a long time proved very difficult to resolve.

14 While the resilience of the banking system has been strengthened, there is still official concern about the resilience of the non-bank financial sector and its vulnerability to external shocks. This follows the "dash for cash" during the crisis in March 2020 at the beginning of the COVID-19 pandemic, when extensive central bank intervention was provided to support the market and restore order. There is also official concern to ensure that the financial system is sufficiently resilient to address operational risk.[22] In particular, the authorities have emphasised that they regard an orderly corporate bond market as critical to the needs of the real economy, and they consider that the crisis at the beginning of the COVID-19 pandemic raises questions about market functioning and whether improvements could be made to bolster liquidity.[23]

The international monetary system

15 The US dollar has been at the centre of the international monetary system for a very long period: at least since 1971, when the dollar went off the gold exchange standard, and in practice for most of the past hundred years. The dollar still represents nearly 60% of global central bank foreign reserves and is the most widely used currency in international trade.[24]

16 In response to the Russian invasion of Ukraine, the decision by the US authorities to freeze the foreign reserves of the Central Bank of the Russian Federation in the US, accompanied by similar action by allied governments, has, on the one side, demonstrated the important role of the dollar as the focal point in the international monetary system while, on the other side, it has led to a debate about whether this will change in future and to what extent. That would require an international consensus about the emergence of any potential alternatives, and it could run the risk of leading to a more fragmented international monetary system in the future than in the past. The evidence so far is that officials responsible for managing central bank foreign reserves continue to view the dollar as their safe haven currency of choice.[25]

Regulatory divergence

17 The Russian invasion of Ukraine has intensified international cooperation between the US and its allies in response, and they have taken a common approach to imposing sanctions. But there is no precedent for imposing such a wide range of sanctions – in a successive series of intensifying measures – on a G20 member state. So it is not surprising that, in the short term, the sanctions imposed have been complex for firms operating in international capital markets to interpret and implement in different jurisdictions. For example, questions have arisen about how to handle settlement fails caused by agreed transactions frozen as a result of becoming subject to sanctions, either directly or indirectly; and about how to mark to market when there is no market.[26] The US authorities and allies have also faced difficult decisions: for example, about whether to use sanctions to block the servicing of Russian sovereign foreign currency debt interest and principal due in US dollars, thereby risking a default with a potential impact on non-sanctioned market firms; and about how to assess the legal implications of confiscating frozen Russian assets to help finance the rebuilding of Ukraine after the war if sanctions are not lifted.[27]

18 In the longer term, there is a risk that the global financial system becomes increasingly divided in practice into a number of separate trade and payment blocs. If so, this could have substantial repercussions for international capital markets by making them less open and integrated. It could also make it more difficult for global political bodies – like the G20 – to pursue a global approach to policy in future, and for

21. See Pascal Donohoe, President of the Eurogroup and Ireland's Minister of Finance: *Banking Union is Essential if the EU is to Ride Out Future Crises,* FT 15 March 2022.

22. See, for example, Sir Jon Cunliffe: Recollections on Financial Stability, 2 March 2022.

23. Martin Moloney, Secretary General of IOSCO: "Orderly corporate bond market functioning is critical to the needs of the real economy. But the events of March 2020 raise questions about market functioning and whether improvements could be made to bolster liquidity.": April 2020.

24. The US dollar represented 59% of central bank foreign reserves at the end of 2021, compared with 71% in 1999, when the euro was launched. The euro represented 20% at the end of 2021. Source: IMF.

25. Poll by *Central Banking* based on responses from 82 reserve managers managing 48% of the global total. The poll was conducted in February and March 2022.

26. See Leland Goss, *Russia-Ukraine: Sanctions Effects on Markets,* ICMA Quarterly Report for the Second Quarter 2022.

27. See, for example, *Frozen Assets:* FT, 18 May 2022.

global financial institutions in the official sector – like the IMF and the World Bank – and global financial committees in the official sector – like the FSB, IOSCO, BCBS and CPMI – to pursue a global policy in future on financial regulation and supervision.[28] In addition, global bodies may need longer in future to reach a consensus before taking decisions. For example, it remains to be seen whether, and if so how soon, the agreement reached in the OECD on a global minimum level of corporate tax will be fully implemented; and whether the World Trade Organisation can be reformed in a way which improves the process of resolving trade disputes.[29]

19 While the remit of these official institutions and the agreements that they reach are potentially global in scope, it is also important to recognise that the legislation arising generally needs to be implemented in different jurisdictions (eg the US, the EU and the UK) separately. The power to take decisions about whether, when and in what form to introduce legislation lies ultimately with the regional or national governments concerned, and they frequently need to take account of distinct local factors.[30]

20 The global transition from LIBOR to risk-free rates is a recent example. The FSB Official Sector Steering Group has the common objective of overseeing the transition from LIBOR to risk-free rates globally. But the legislation needed to implement this has had to be introduced separately in the US, UK and the EU, among others. The authorities in each jurisdiction are aware of the importance of avoiding a conflict of laws between them.

21 The use of regional or national legislation to address financial stability risks internationally can also give rise to scope for market fragmentation. For example, post-Brexit, the EU has granted regulatory equivalence to UK CCPs until mid-2025. The UK authorities consider that these arrangements should persist permanently. But drawing a comparison with the EU's over-dependence on energy imports from Russia, the EU Financial Services Commissioner has argued that it is not sustainable for the EU to be heavily dependent on a third country for clearing. "We do not rely this strongly on other jurisdictions in any other area. It is a risk for the EU and that risk must be addressed."[31] The ECB is following a broadly similar approach to the activities of banks which it supervises.[32]

ICMA's role in international capital markets

Against this international background, ICMA continues to have an important role to play in international capital markets. See the Foreword by Bryan Pascoe, ICMA's Chief Executive, to the current edition of the ICMA Quarterly Report.

In his Foreword to the ICMA Quarterly Report for the Second Quarter, Jérôme Haegeli of Swiss Re, and a member of the ICMA Board, drew attention to three issues in particular: divergence; digitalisation; and decarbonisation:

"*Divergence* within and between countries is a huge concern as it creates different paths for economic recovery, economic inequality and socio-economic opportunity. Our path forward has to be socially inclusive.

Digitalisation – inclusive digital transformation – is essential to "future proof" the world economy, make businesses more resilient and reduce divergence.

Decarbonisation, the transition to a net-zero carbon emission world, is needed to end carbon emissions and stop climate change. ICMA's work in this field is already innovative and influential, such as the Green Bond Principles. Decarbonisation of energy supplies has been given fresh impetus by the latest geopolitical developments, as well as the energy price crisis. The drive for energy security may accelerate this transition."[33]

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28. Financial Stability Board, International Organization of Securities Commissions, Basel Committee on Banking Supervision and Committee on Payments and Markets Infrastructures.

29. However, the International Sustainability Standards Board (ISSB) has been set up following agreement at COP26 in Glasgow.

30. There are also a number of cases in which legislation in one particular jurisdiction is intended to have an extra-territorial effect in others.

31. Speech by Mairead McGuinness, EU Financial Services Commissioner, at the ECB, 6 April 2022. She said that she expects to propose legislation in October 2022 that would include incentives for bodies to use clearing houses inside the EU and penalties for using clearing houses located in London.

32. Andrea Enria, Head of Supervision, ECB: "We want to ensure that incoming legal entities have onshore governance and risk management arrangements that are commensurate, from a prudential perspective, with the risk they originate.": 19 May 2022.

33. Jérôme Haegeli, Swiss Re, Foreword to ICMA Quarterly Report for the Second Quarter 2022.