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Banking sector liquidity and financial markets

Facts, assessments and comments

Moscow

Cut-off date:
'Banking sector liquidity and money market'* section – 4 September 2018;
'Foreign exchange and stock market' section – 31 August 2018.

* Reserve requirements are an important part of the Bank of Russia's set of tools for managing banking sector liquidity and money market rates. Therefore, analyses of the effectiveness of the Bank of Russia's monetary policy operational procedure should take into account required reserves averaging periods. In August 2018, this is the period between 8 August 2018 and 4 September 2018.

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Banking sector liquidity and financial markets: facts, assessments and comments
(August 2018)

- ***The structural liquidity surplus was virtually unchanged in August: the impact of liquidity factors was close to neutral.***
- ***Short-term interbank lending rates stayed close to the Bank of Russia key rate and their absolute deviation from it declined compared to the previous averaging period.***
- ***Developments in the Russian financial market in August were chiefly shaped by external factors. Of these, the most impactful was an overall decline in demand for emerging market assets, combined with a tightening in anti-Russia rhetoric over sanctions.***
- ***Foreign investors' OFZ sell-off and forex purchases pushed the ruble down, triggering a rise in the risk premium on Russian assets. This made market participants review in August their expectations as to the future Bank of Russia key rate path: some of them did not rule out a hike in it before the end of the year.***

Banking sector liquidity and money market

The structural liquidity surplus was virtually unchanged in August. Growth in banks' liabilities on Federal Treasury operations was offset by the liquidity outflow caused by tax payments and the transfer of public companies' dividends to the budget amid a temporary halt in Bank of Russia foreign currency purchases in the domestic FX market under the fiscal rule implementation. Despite the fact that the volume of tax payments in August was lower than a month before due to seasonal factors, at the end of the averaging period some banks could not settle their demand for funding in the money market and raised liquidity from the Federal Treasury and the Bank of Russia through standing loans secured by non-marketable assets.

Short-term interbank lending rates in August stayed close to the Bank of Russia key rate, slightly tilting to the downside. As the banking sector continued to adapt to a considerable growth in the structural liquidity surplus in 2017 H2 - 2018 H1, banks' increased activity at one-week deposit auctions conducted by the Bank of Russia was conducive to the narrowing of the spread between the aforementioned rates.

The local widening of the spread between interbank lending rates and the key rate in the middle of the averaging period was associated with the current excess liquidity. This results from the fact that the volume of credit institutions' bids at the one-week deposit auction held on 14 August turned out to be largely lower than the set limit. The volume of bids at the next auction (21 August) approached the limit. However, as the date of transfer of large-scale taxes to the budget fell on the end of the operational week (27 August), the current excess liquidity held on for the most of it. In the following days tax payments and the ensued outflow of funds, as well as fine-tuning deposit auctions at the end of the averaging period underpinned interbank lending rates. As a result, **their absolute deviation from the Bank of Russia key rate declined in August compared to the previous averaging period.**

The basis (spread between FX swap rates and interbank lending rates) widened slightly in August. This was due to low supply of foreign currency by exporter-servicing major banks in the FX swap segment resulting from the outflow of customer deposits. The FX liquidity situation also deteriorated somewhat amid OFZ[1] sales by non-residents. The reduction in non-residents' long ruble positions and the related shrinkage in foreign currency borrowings in the FX swap segment partially offset the negative impact on the basis. The FX liquidity situation will improve in September on the back of the Bank of Russia's decision to suspend foreign currency purchases in the domestic FX market under the fiscal rule implementation until the end of 2018 to subdue volatility in the financial market. The said decision by the Bank of Russia made it possible to lower the assessment of the structural liquidity surplus as of year-end 2018 by 2.0 trillion rubles to 1.7-2.1 trillion rubles.

[1] See Section 'Foreign exchange and stock market'.

Table 1

Structural liquidity surplus forecast reviewed downwards due to a halt in foreign currency purchases under the fiscal rule

(trillions of rubles)	August 2018	January-August 2018	2018 (forecast)
1. Liquidity factors *(supply)*	0.0	1.0	[-0.2; 0.1]
- changes in balances of general government accounts with the Bank of Russia, and other operations*	-0.1	0.8	[0.3; 0.5]
- change in cash in circulation	-0.1	-0.3	[-0.7; -0.6]
- Bank of Russia interventions in the domestic FX market and monetary gold purchases	0.1	0.4	0.4
- regulation of bank required reserves with the Bank of Russia	0.0	0.0	-0.1
2. Change in free bank reserves (correspondent accounts) *(demand)*	0.0	0.0	[-0.7; -0.2]
3. Change in banks' claims on deposits with the Bank of Russia and coupon OBRs	-0.2	0.8	[-0.5; 0.1]
4. Change in outstanding amount on Bank of Russia refinancing operations (4 = 2 + 3 – 1)	-0.2	0.0	[0.0; 0.1]
Structural liquidity deficit (+) / surplus (-) (as of the period-end)	-3.4		[-2.1; -1.7]

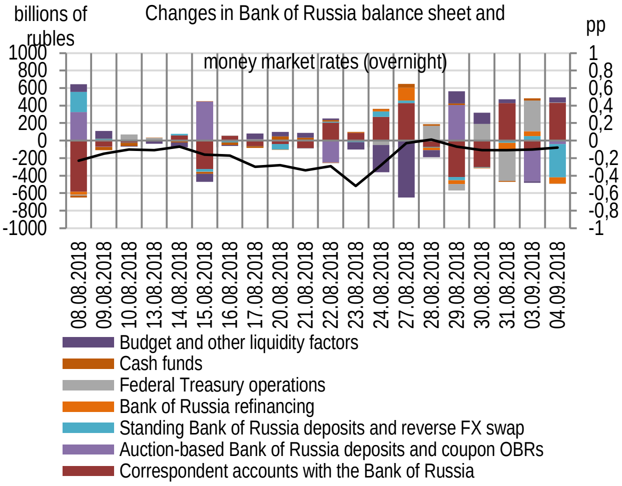
** Including operations to buy (sell) foreign currency in the domestic FX market under the fiscal rule implementation, settlements on the Bank of Russia's USD/RUB FX swaps, and other operations.*

Source: Bank of Russia calculations.

In August, some market participants began to review their expectations as to the future Bank of Russia key rate path. Market quotes indicated that market players did not rule out an increase in the key rate by 25 bp before the year-end 2018 due to elevated inflation risks caused, inter alia, by the ruble depreciation. Meanwhile, Reuters and Bloomberg analysts' surveys in August did not register any change in their estimates.

Chart 1

In August 2018, the impact of liquidity factors was close to neutral



Source: Bank of Russia calculations.

Inflation expectations derived from OFZ-IN rose considerably. However, the major part of growth may be explained by the specific structure of owners of OFZ[2] various issues rather than expectations of inflation acceleration.

Table 2

Expected interest rate path based on market instruments increased noticeably in August

1. Expectations based on market indicators* *interest rate (instrument)*	*October 2018*	*December 2018*
- MosPrime 3M (FRA)	6.95 (7.34)	7.85 (7.39)
- RUONIA (ROISfix)	7.31 (7.01)	7.53 (6.97)
- RUONIA (futures)	7.37 (7.03)	7.53 (7.04)
- RUONIA (OFZ-PK)		7.34 (7.27)
2. Analysts' expectations for the key rate*	*As of 25 October 2018*	*As of 31.12.2018*
- Bloomberg survey	7.13 (7.13)	7.13 (7.13)
- Reuters survey	7.25 (7.25)	7.25 (7.25)
3. Imputed inflation rate (OFZ-IN) (until 16 August 2023)		5.16 (4.61)

** As of the last working day of the month. Data as of the end of previous month are given in brackets.*

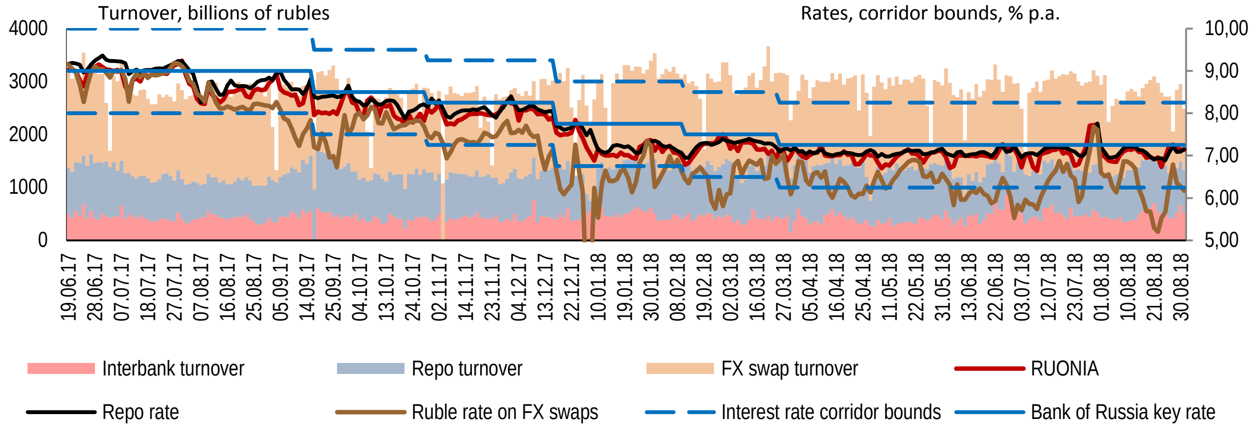
Source: Bank of Russia calculations.

[2] For details see information and analytical commentary 'Banking sector liquidity and financial markets' No. 26, April 2018.

Chart 2

In August 2018, short-term interbank lending rates stayed close to the Bank of Russia key rate, albeit slightly tilted to the downside

Overnight ruble money market rates



Source: Bank of Russia calculations.

Foreign exchange and stock market

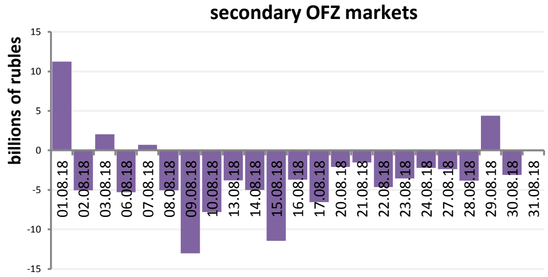
External factors still determined the state of the Russian financial market in August. These include the declining demand for risk assets caused by problems in some emerging market economies (hereinafter, EMEs) and a tightening in anti-Russian rhetoric over sanctions.

A new draft bill published in the US in early August and aimed at tightening anti-Russian sanctions made foreign investors to reassess risks of Russia and led to the ruble depreciation. Foreign investors sold OFZs, bought foreign currency in the spot market and reduced long ruble positions in the FX swap market. According to exchange data, foreign investors stepped up OFZ sales from 2 August, when the first news about the sanctions draft bill appeared, and built them up on 8 August, when the full text of the document was released. Overall, OFZ net sales over the month amounted to roughly 71 billion rubles.

Chart 3

Influenced by external factors foreign investors sold OFZs during the major part of the month

Non-residents' net purchases in the primary and secondary OFZ markets

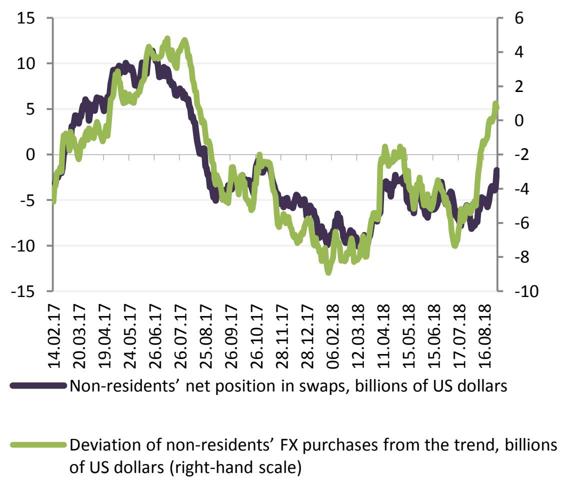


Source: Bank of Russia calculations.

The exchange rate dynamics in August were also influenced by the overall decline in EME currencies. Thus, the EMCI index tracing the dynamics of several EME currencies dropped by 5.8% in August. The reason for this was the declining demand for risk assets caused by investors' concerns that given the macroeconomic instability in Turkey and Argentina problems may arise in other EMEs. Moreover, the ongoing risks of trade wars escalation had an adverse impact on investors' sentiments.

Chart 4

Non-residents reduced long ruble positions considerably, including amid toughening sanctions and the overall decline in demand for EME assets



Source: Bank of Russia calculations.

Against the backdrop of tougher sanctions Russia's credit default swap (CDS) quotes grew by 30 bp in early August and stayed at this level till the end of the month. Meanwhile, CDS of other EMEs were growing during the entire month, which resulted in a slight reduction in the spread between Russia's CDS and EMEs' CDS as compared with the peak of 10 August. Therefore, as of month-end the sanction premium in Russia's CDS stood at about 20 bp. In other words, if the situation with new sanctions goes back to normal (i.e., the draft bill published on 14 August will not be approved and other sanctions against Russia will not be imposed), Russia's CDS may decline to 150 bp from 168 bp as of late August.

The third ten days of September are expected to see Russia's CDS growth of 10-15 bp due to the following factor: a new five-year contract will become a benchmark each quarter since the actual duration of the former contract equals 4.75 years. This gap in 0.25 years specifies growth in CDS premium, since, as a rule, the longer the term of the contract, the higher the premium. According to historical data, CDS increases by 10-15 bp on average due to the contract change and then goes down to previous values in the course of one to two weeks.

Table 3

In August 2018, the banking sector's structural liquidity surplus remained practically unchanged

(opening, trillions of rubles)	01.09.2018	01.08.2018	01.01.2018
Structural liquidity deficit (+) / surplus (-)	-3.4	-3.4	-2.6
Bank of Russia standard monetary policy instruments			
Bank of Russia claims on credit institutions	0.0	0.2	0.0
• Auction-based facilities	0.0	0.0	0.0
- repo and FX swap	0.0	0.0	0.0
- secured loans	0.0	0.0	0.0
• Fixed interest rate facilities	0.0	0.2	0.0
- repo and FX swap	0.0	0.0	0.0
- secured loans	0.0	0.2	0.0
Credit institutions' claims on the Bank of Russia	3.8	4.0	2.7
• Deposits	2.3	2.5	2.4
- auction-based	2.1	2.2	2.1
- fixed interest rate	0.2	0.2	0.2
• Bank of Russia bonds	1.4	1.5	0.4
Standing reverse facilities other than the Bank of Russia's standard monetary policy instruments*			
• Net claims of credit institutions and the Bank of Russia	0.3	0.3	0.1

** These transactions include the Bank of Russia's specialised refinancing instruments, Bank of Russia loans issued under irrevocable credit lines, and USD/RUB and EUR/RUB FX swaps.*

Source: Bank of Russia calculations.

Table 4

Russia's CDS increased considerably in August due to tougher sanctions and weaker risk appetite in the international financial market

Stock market indicators					
Segment	Indicator	As of 31.08.2018 COB*	Change**		Average 2017*
			month	*monthly average*	
Equity market	MICEX index	*2,345.9*	1.1	-0.7	*2,039.8*
	RTS index	*1,092.3*	-6.9	-5.9	*1,101.9*
Bond market	OFZ	*8.4*	83.0	31.8	*7.9*
	Corporate bonds	*8.74*	91.0	63.2	*8.9*
	Regional bonds	*8.51*	86.0	59.0	*8.5*
Foreign market	Russia-43	*5.37*	26.4	20.8	*4.9*
	UST-10	*2.86*	-10.0	0.5	*2.3*
Risk appetite indicators	RVI	*24.7*	2.0	3.4	*21.3*
	EMBI+ Russia	*225.0*	40.0	23.1	*145.1*
	EMBI+ EM	*436.0*	58.7	22.8	*326.6*
	CDS	*167.5*	36.0	23.6	*156.0*

** Points for equity and RVI indices, % p.a. for bonds, basis points (bp) for other indicators.*

*** In % for equity indices, points for RVI, and basis points (bp) for other indicators.*

Sources: Bloomberg, Moscow Exchange, Cbonds.ru, Bank of Russia calculations.