The Central Bank of
the Russian Federation

GLOBAL RISK REVIEW

The situation in global financial markets continued to improve in June amid investors stronger risk appetite and the continued accommodative stance of monetary policy pursued by the world's leading central banks. Historical and expected asset price volatility reached minimum levels registered before the 2008 crisis. However, global economic recovery remains weak and market expectations may change if negative events or news emerge (as was the case in Bulgaria in the second half of June).

Due to changes in the product range of the Bank of Russia reports on financial stability issues a Global Risk Review will become an integral part of a quarterly Financial Stability Review from October 1, 2014

JUNE 2014

Main Events in June 2014

5 June	The ECB Governing Council adopted unprecedented stimulus measures at its policy meeting: the European regulator lowered the key rate on the main refinancing operations for a term of one week by 10 bp to 0.15%, the interest rate on the marginal lending facility for overnight loans by 35 bp to 0.4% and the interest rate on the deposit facility by 10 bp to -0.1%. These measures came into force on June 11, 2014. The ECB also announced that it would conduct a series of targeted longer-term refinancing operations (TLTRO) until the end of 2014.
9 June	The Central Bank of Mexico cut the key overnight loan rate by 50 bp to 3%.
13 June	S&P raised its outlook on the UK's AAA sovereign credit rating to stable from negative.
16 June	Gazprom switched to a prepayment regime for natural gas deliveries to Ukraine.
18 June	A New York court ruling came into force, obliging Argentina to make full payments to investors who refused to accept the terms of the Argentine government debt restructuring in 2005 and 2010 (Argentina owes $1.5 billion to these investors).
18-19 June	The Federal Open Market Committee (FOMC) of the US Federal Reserve (Fed) decided at its policy meeting to reduce the monthly volume of its bond purchase programme by $10 billion to $35 billion. The regulator cut the volume of Treasury bond purchases to $20 billion from $25 billion and mortgage bond purchases to $15 billion from $20 billion.
25 June	The Central Bank of Turkey lowered the one-week repo rate by 75 bp to 8.75%.
25 June	The Central Bank of Hungary cut the key rate by 10 bp to 2.3%.
26 June	The Bank of England published a draft document for consultations, tightening mortgage lending rules. Under the new rules, loans worth more than 4.5 times a borrower's income should be limited to no more than 15% of banks' total mortgage loan portfolios. The Bank of England also ordered banks to verify more strictly a borrower's ability to repay loans in case of interest rate increases by 3 pp. The new rules will come into effect on October 1, 2014.
27 June	At the EU summit the presidents of Ukraine, Moldavia and Georgia signed association agreements with the EU, envisaging the creation of a free trade zone between the EU and these countries.
30 June	The European Commission approved a 1.7 billion-euro credit line for Bulgaria to support its banking system's stability.

GLOBAL FINANCIAL MARKETS

Chart 1. Stock Index Change (%)[1]

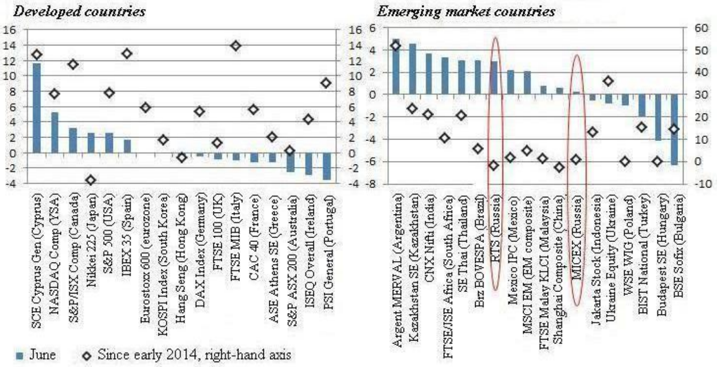


Chart 2. Equity Index Imputed Volatility (%)

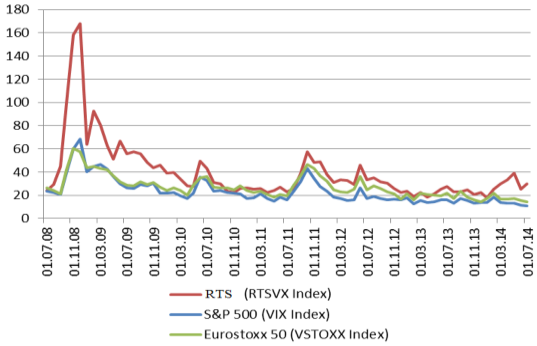


Chart 3. 10-Year Government Bond Yield Change (bp)

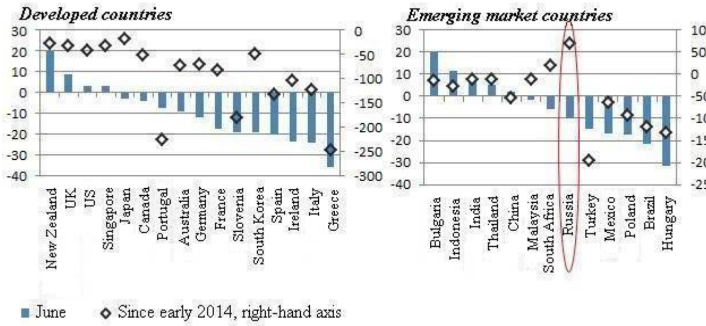


Chart 4. 10-Year Government Bond Yields (%)

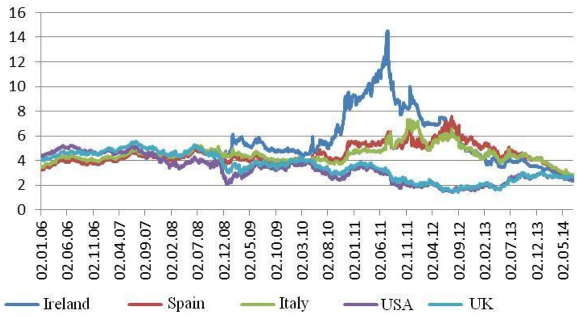


Chart 5. Corporate EM/US Spread Change and Current Spreads (bp.)*

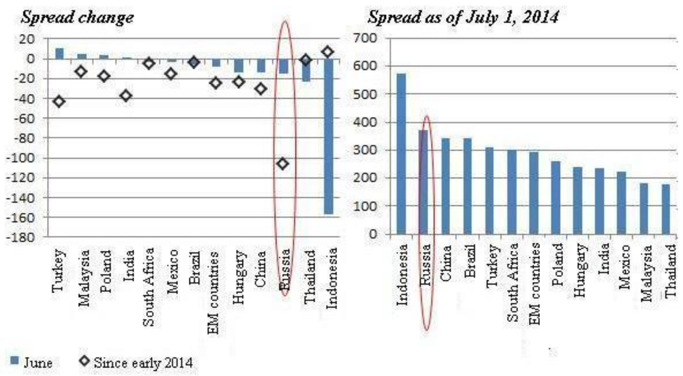
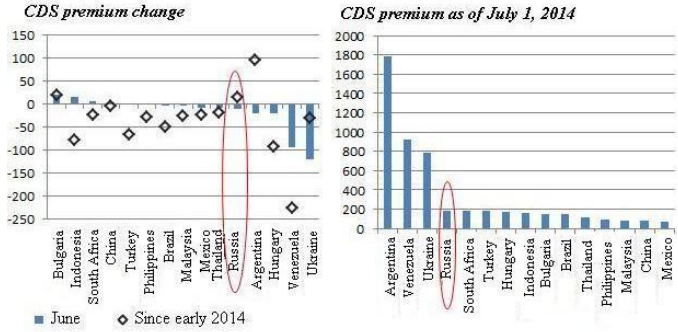


Chart 6. EM 5-Year Sovereign CDS Premium Change and Current Levels (bp)



The JP Morgan Corporate EMBI Broad Composite Blended Spread and similar EM composite indices for individual countries.

Chart 7. EM Foreign Exchange Rate to US Dollar (%) and Change in Difference between Imputed Call and Put Option Volatility (bp)

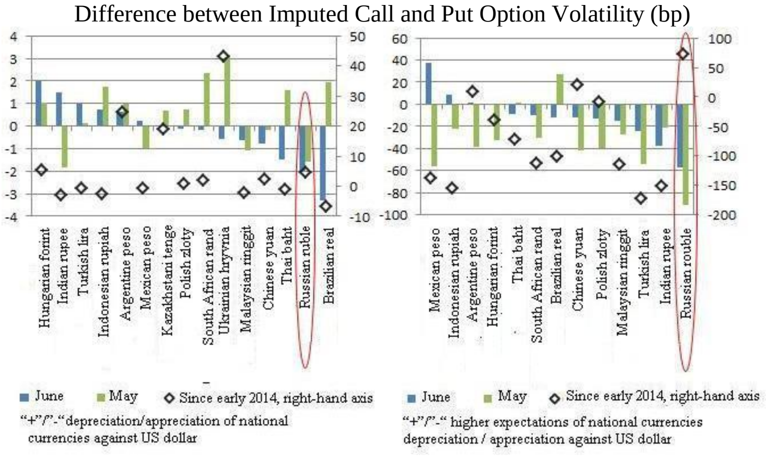
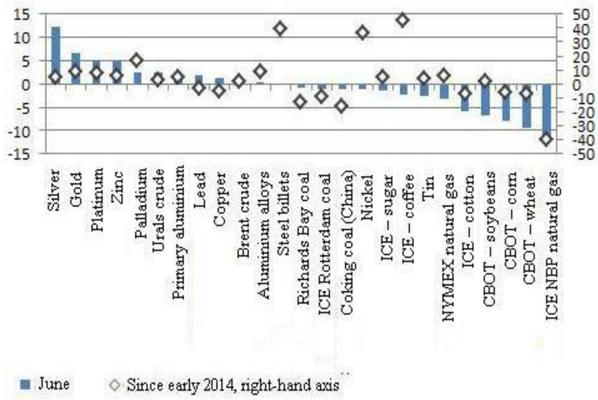


Chart 8. Commodity and Raw Material Price Change (%)



[1] Here and below the country breakdown into developed and emerging market countries is given in compliance with the IMF classification.

RISKS OF SOME DEVELOPED COUNTRIES

Risks of US stock market overheating

The demand for manufactured goods in the United States is growing due to an increase in consumer spending and business investment, and the situation in the real estate market is also improving (Box 1). The US Fed lowered its estimate of the unemployment rate in 2014 to 6-6.1% while the inflation forecast was actually unchanged (at 1.5-1.6% for core inflation and 1.5-1.7% for headline inflation). The US GDP is expected to grow by 2.1-2.3% in 2014 (the growth outlook was slightly downgraded after the estimate of the GDP decline in the first quarter of 2014 was revised to 2.9% from 1.1% on an annual basis).

In this situation, the US Fed continues to taper its quantitative easing programme. The Fed reduced the monthly volume of bond purchases by $10 billion for the fifth consecutive time to $35 billion. At the same time, the Fed has stated that its monetary policy will remain accommodative even after the asset purchase programme is over. The regulator has lowered its long-term outlook for the federal funds target rate to 3.75% from 4% in the situation of full employment and price stability. Most Fed officials expect the rate to equal no more than 1.25% by late 2015 and stand at 2.5% and higher by the end of 2016.

Meanwhile, the US stock market is increasingly demonstrating the signs of overheating. The US S&P 500 stock market index continues to register new record highs. The S&P 500 equity market value exceeded 100% of the country's GDP early this year (97% before the 2008 subprime mortgage crisis). The expected S&P 500 equity price volatility reflected in the price of options (the VIX index) has fallen to the lowest levels observed before the 2008 crisis (Chart 2).

The US stock market has demonstrated this dynamic growth in the past few years amid the US Federal Reserve's highly accommodative monetary policy. The Fed's final exit from its quantitative easing programme and the subsequent rate hikes may push equity prices down, especially if the US economy fails to demonstrate sufficiently high growth rates.

UK business investment recovery amid persisting risks of housing market overheating

In its quarterly Credit Conditions Survey[2], the Bank of England noted an increase in demand for corporate loans and the expectations of its further growth (Chart 9). Companies obtain funding mostly to finance mergers and acquisitions, as well as investments in commercial real estate. The Bank of England anticipates that recovery in demand for loans from enterprises will provide support to the UK economy and its growth will accelerate in the second half of 2014.

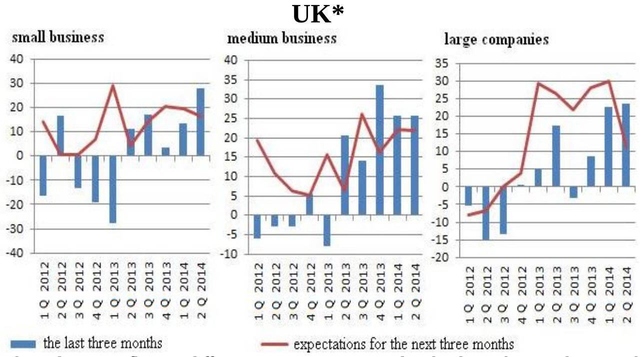
At the same time, the risks of overheating persist in the UK housing market: the demand for mortgage loans surged considerably in the second quarter of 2014. In order to prevent excessive borrowings for residential home purchases, the Bank

Box 1. US macroeconomic data

- The US Conference Board Leading Economic Index increased by 0.5% in May (by 0.3% in April).
- US industrial output grew by 0.6% in May month on month (it fell by 0.3% in April).
- The Empire Manufacturing Index rose to 19.28 points (it climbed to 19.01 in May).
- Retail sales grew by 0.3% in May compared with the previous month (they expanded by 0.5% in April).
- The CPI grew by 0.4% in May month on month, the fastest pace since February 2013, and by 2.1% on an annual basis. The Core CPI excluding the prices of energy products and foodstuffs grew by 0.3% in May month on month and by 2% year on year.
- The University of Michigan Consumer Sentiment Index increased to 82.5 points in June from 81.9 points in May.
- The Consumer Confidence Index calculated by the Conference Board grew to 85.2 points in June, its highest level since January 2008 (from 82.2 points in May).
- The real estate market registered a surge in home sales in May (sales grew by 4.9% in the secondary housing market compared with the previous month while new home sales increased by 18.6% month on month, the fastest pace since May 2008).

Source: Bloomberg.

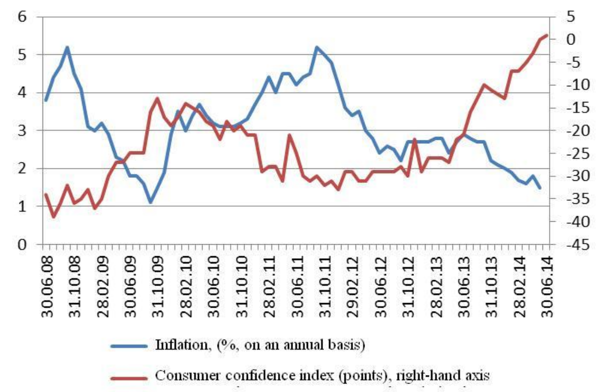
Chart 9. Change in Demand for Corporate Loans in UK*



**The indicator reflects a difference in points assigned to lenders who noted a growth in demand and lenders who noted a fall in demand. The indicator ranges from – 100 to + 100 points.*

Source: Bank of England.

Chart 10. UK Inflation and Consumer Confidence Index



Source: Bloomberg.

---

[2] Bank of England, Credit Conditions Survey, 2014 Q2.

of England has limited the loan to income ratio in mortgage lending (mortgage loans made at or greater than 4.5 times a borrower's income should not exceed 15% of the total volume of bank's total mortgage loan portfolio).

Pre-requisites are emerging in the UK for a key rate hike earlier than it was expected by the market. While the annual inflation rate fell in May to its minimum level since October 2009 (1.5%), the UK consumer confidence index hit its highest level in nine years (Chart 10).

Risks of slower growth / lower business activity in key eurozone countries

Eurozone macroeconomic risks are rising amid slowing business activity in key eurozone countries. The manufacturing Purchasing Managers Index (PMI) of the 18 eurozone nations fell in June for the second consecutive month to 51.8 points while France registered a decline in business activity (the manufacturing PMI decreased to 48.2 points) (Chart 11). Germany's manufacturing PMI fell inconsiderably (to 52.0 points) while the IFO business confidence index deteriorated to 109.7 points in June, the lowest level since December 2013. Germany's ZEW investor confidence index for the next six months fell to 29.8 points in June, its lowest level since January 2013. The eurozone composite business and consumer confidence index declined to 102 points in June 2014 from 102.6 points in May.

As the eurozone demonstrated weak recovery in business activity and low inflation (0.5% in June, according to Eurostat's preliminary data), the ECB implemented stimulus measures (Box 2) and intensified rhetoric about its ongoing stimulus course. The ECB revised downward its GDP growth outlook for 2014 from 1.2% to 1%, raised its forecast for 2015 from 1.5% to 1.7% and confirmed its estimate for 2016 at 1.8%. The European regulator lowered its inflation forecasts for all the three years: from 1% to 0.7% for 2014, from 1.3% to 1.1% in 2015 and from 1.5% to 1.4% in 2016.

Sovereign risks of eurozone peripheral countries

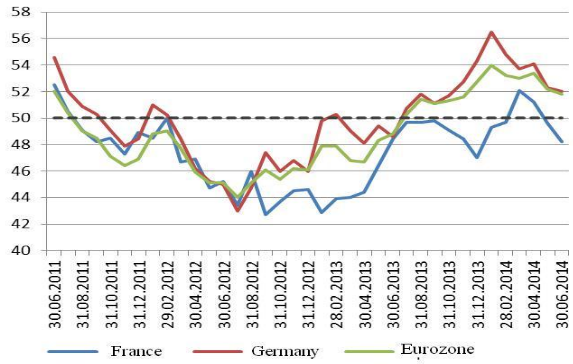
Eurozone peripheral countries are demonstrating some improvements, which help further narrow sovereign debt yield spreads.

Euro area peripheral countries are returning to the international debt market. Cyprus placed five-year bonds worth $750 million at 4.85% p.a. for the first time since May 2011. Earlier, in April 2014, Greece returned to the debt market after a four-year absence, selling bonds worth €3 billion. Before that, Ireland and Portugal restarted regular debt auctions.

The Eurogroup approved the next €600 million loan tranche to Cyprus in July.

The situation in Greece continues to improve. The international rating agency Moody's revised upward its outlook for Greece's GDP growth in 2014 to 0.4% from 0%. China is showing active interest in Greece: both countries have signed a number of investment agreements worth $6.5 billion (3.5% of the Greek GDP). China has also signalled its interest in Greek bonds.

Chart 11. Eurozone PMI



Источник: Bloomberg.

Box 2. Measures unveiled by ECB

ECB lowered key rates

1) The ECB was the first among the world's leading central banks to cut the deposit rate from zero to minus 0.1%.
2) The European regulator lowered the interest rate on the main refinancing operations for a term of one week by 10 bp to 0.15%.
3) The ECB cut the interest rate on the overnight marginal lending facility by 35 bp to 0.4%.

The ECB announced the targeted longer-term refinancing operations (TLTRO) programme.

1) *Basic terms for banks to borrow from the ECB under the TLTRO programme:*

- Any eurozone bank may borrow in TLTRO from the ECB.
- The borrowing limits in the TLTRO will be calculated on the basis of the outstanding amounts of loans to euro area non-financial corporations (small, medium and large businesses) and households, excluding mortgage loans.
- The TLTRO fixed rate is 10 bp above the base rate (0.15%).
- All TLTRO loans will mature in September 2018.

2) *Banks are allowed to borrow an amount that cumulatively does not exceed 7% of the total amount of their loans to non-financial firms and households, excluding mortgage loans, outstanding on April 30, 2014, in two TLTRO auctions to be conducted in September and December 2014. Euro area banks will be able to borrow a maximum of €400 billion in two successive TLTRO auctions.*
3) *During the period from March 2015 to June 2016, banks will be allowed to borrow in TLTRO on a quarterly basis. The borrowing allowance will be limited to three times the cumulative amount of net lending to non-financial firms and households, excluding mortgage loans (net of loan redemptions), provided between April 30, 2014 and the latest reference date (two months prior to an auction) in excess of a specified benchmark.*

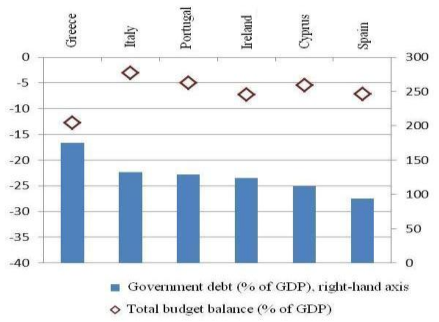
- The borrowing limit at each new auction will exclude any amounts previously borrowed in TLTRO that take place in the period from March 2015.
- The benchmark will be set at zero for banks that show positive net lending (lending growth) in the twelve months to April 30, 2014. For banks that show negative net lending (a decrease in lending volumes) in the twelve months to April 30, 2014, the benchmark will be equal to the average monthly net lending achieved in the twelve months to April 30, 2014 multiplied by the number of months from May 2014 to the month when the latest net lending data are available (two months prior to an auction date). This rule, however, has been set only for the first two quarterly auctions in March and June 2015. For subsequent auctions, the benchmark is set at zero.
- Banks have to fulfill the requirements of targeted use of funds; otherwise they will be required to pay back the full amount of borrowings from the ECB (including the first two auctions) in September 2016. Early repayment will be required, if net lending in the period from May 2014 to April 2016 is lower as of June 2016 than net lending provided in the twelve months to April 30, 2014. If the benchmark is larger but borrowings in six rounds of quarterly TLTRO exceed the borrowing limit calculated for the last auction, banks will be required to repay the amount of the excess to the ECB.

Source: ECB.

Nevertheless, eurozone peripheral countries remain considerably vulnerable to a resurgence of sovereign risks. As the US Fed is tightening its monetary policy, the yields of peripheral countries government bonds can be expected to rise, considering their high sensitivity to changes in US Treasury bond yields. The situation is aggravated by the existence of a large amount of government debt in these countries (Chart 12).

Investors are possibly excessively optimistic about peripheral eurozone countries. The yields of ten-year government bonds in Spain (rated at BBB by S&P), Italy (rated at BBB by S&P) and Ireland (rated at A- by S&P) have come to match yields of similar securities in the UK (rated at AAA by S&P) (Chart 4).

Chart 12. Peripheral Eurozone Government Debt and Budget Deficit



Source: Bloomberg.

RISKS OF SOME EMERGING MARKET COUNTRIES

Signs of growth recovery in China

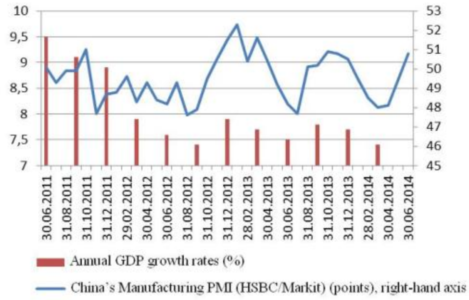
China's Manufacturing PMI calculated by HSBC and Markit Economics grew to 50.8 points in June (49.4 points in May), registering a seven-month high and showing higher business activity in industry for the first time in six months (Chart 13). Nevertheless, analysts polled by Bloomberg expect China's GDP growth to weaken to 7.3% in the second quarter of 2014 from 7.4% in the first quarter and reach 7.3% in 2014 as a whole, which will be both below the 7.5% target set by the Chinese authorities and the worst result since 1990.

In this situation, some Chinese financial and economic authorities insist on lowering the key rate. The People's Bank of China (PBC) has so far refrained from taking this decision as the expansion of cheap lending may increase indebtedness levels and intensify an inflow of funds into the real estate market. It cannot be ruled out, however, that the PBC will decide on the rate cut, considering that the consumer price growth in China remains below the planned level of 3.5% for this year (2.5% in May).

At the same time, China's financial regulators continue to implement targeted stimulus measures designed to make lending and other funding sources more available to small and medium business, as well as measures to liberalise the financial market (Box 3).

However, China's opaque shadow banking sector remains a key risk. Lending by trust companies serving riskier borrowers and conducting operations, which banks cannot carry out because of the need to comply with regulatory ratios, is estimated at about 12% of GDP (Chart 14).

Chart 13. China's Manufacturing PMI and Annual GDP Growth



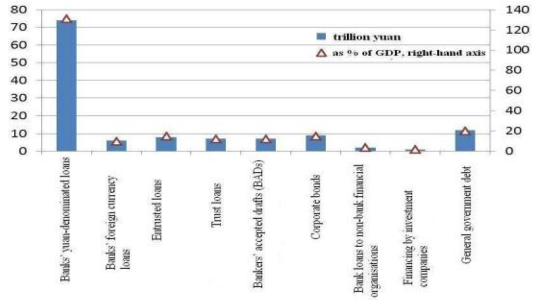
Source: Bloomberg.

Box 3. Measures unveiled in China in June

- From June 16, the PBC lowered the reserve requirement ratio by 0.5 percentage points for some financial organisations, including banks engaged in lending to the agricultural sector, financial leasing companies and firms providing auto loans.
- The China Banking Regulatory Commission (CBRC) announced about the implementation of measures aimed at easing the terms of lending. In particular, the regulator changed the methodology of calculating the loan-to-deposit ratio, for which a 75% limit is stipulated, while SME loans were excluded from the LDR's numerator.
- As part of its measures to liberalise interest rates, the PBC lifted interest rate caps on foreign currency deposits in the Shanghai free trade zone. Earlier this year, the PBC cancelled the maximum permissible rate on foreign currency deposits of less than $3 million.
- The PBC allowed direct trading between the yuan and the British pound. China and the UK signed trade agreements worth $24 billion to strengthen bilateral cooperation.

Source: Bloomberg.

Chart 14. Domestic debt on loans and bonds in China



Monetary policy easing in some emerging market countries

The downgrade of macroeconomic forecasts for this year and the weakness of basic indicators influencing domestic demand (consumer spending and business investment) compel the central banks of many emerging market countries to decide on relaxing their monetary policies. In June, the central banks of Mexico, Turkey and Hungary cut their key interest rates. The Central Bank of Brazil announced its intention to extend the programme of currency swap auctions until December 31, 2014 from July 1, 2014.[3] As part of the currency swap programme, the central bank will sell $200 million worth of swaps every business day. Meanwhile, the fall in the rate on one-year interest rate swaps below the Selic key overnight rate suggests that markets expect a cut in the Selic key rate (Chart 15).

Intensification of sovereign default risks in Argentina and potential consequences for other countries

Argentina went into technical default in June after it missed a June 30 deadline for payment of $1.5 billion to investors who had refused to participate in the Argentine government debt restructuring in 2005 and 2011[4] pursuant to a New York federal court ruling. The Argentine government has 30 days in accordance with law (the so-called grace period) for negotiations with investors; otherwise Argentina will enter real default. S&P downgraded Argentina's sovereign credit rating to CCC- from CCC with a negative outlook. S&P has said it may cut Argentina's rating to a default level.

Argentina is in a very difficult situation now. If the country's authorities ignore the New York court's ruling, they will create a dangerous precedent when the confidence of other countries to Argentina will be undermined. If Argentina agrees to payouts, other dissenting creditors may also make their claims and the amount of liabilities may reach $15 billion. Meanwhile, Argentina's foreign currency reserves have dropped to a seven-year low of $29 billion (Chart 16).

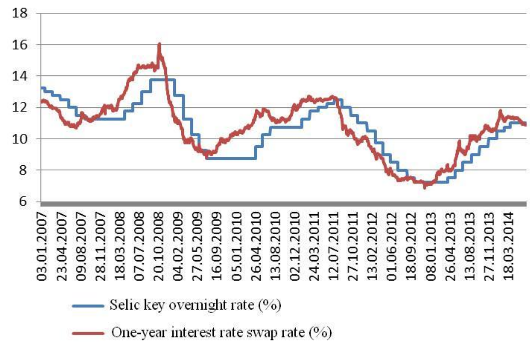
Argentina's default will lead to the loss of investor confidence and, as a result, to capital outflow from the country and further depreciation of the national currency. The Argentine peso has been among the most rapidly depreciating emerging market currencies since early 2014, weakening by 25% against the US dollar. This trend creates a threat of stronger inflationary pressure and the unemployment rate will rise, which will slow down the country's GDP growth.

Argentina's default is likely to have limited economic consequences for other countries due to actual isolation from international financial markets after its default in 2001. Nevertheless, a risk exists that foreign creditors may have less inclination to participate in debt restructuring of other emerging market countries, which will complicate such procedures in the future.

Exacerbation of Bulgarian banking crisis and potential risks for other European economies

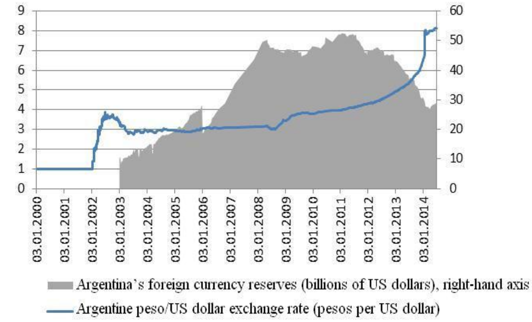
The liquidity of the Bulgarian banking sector deteriorated in June. Media reports about dubious deals conducted by Corporate Commercial Bank (CCB), the country's fourth biggest lender by assets, and its largest shareholders caused a mass run on its deposits. The Bulgarian authorities were forced to temporarily close down the CCB and place it under the management of the National Bank of Bulgaria. If CCB shareholders do not replenish capital by July 21, the state will assume control of the bank through additional capital

Chart 15. Interest Rates in Brazil



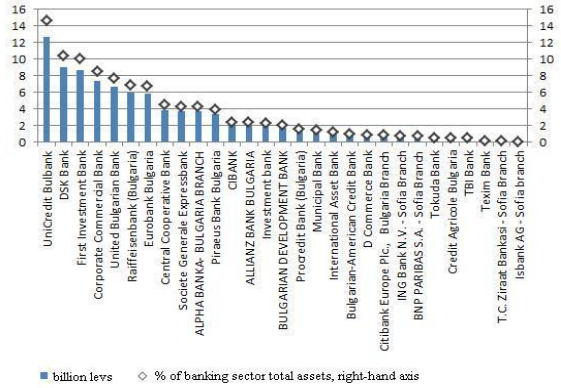
Source: Bloomberg.

Chart 16. Argentine Foreign Currency Reserves and Argentine Peso Exchange Rate



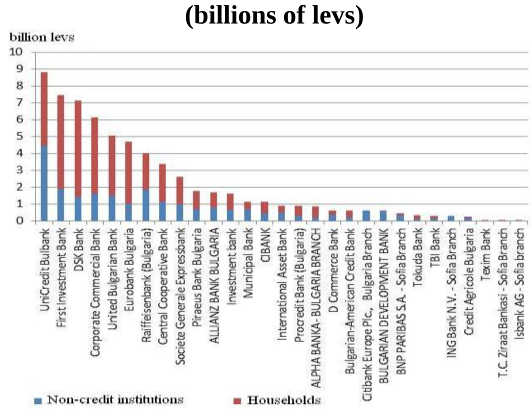
Source: Bloomberg.

Chart 17. Bulgarian Banks' Assets as of March 31, 2014



Source: National Bank of Bulgaria.

Chart 18. Bulgarian Banks' Deposits (billions of levs)



Source: National Bank of Bulgaria.

[3] The programme was launched in August 2013.
[4] Argentina restructured 93% of its sovereign debt to the amount of almost $100 billion.

contributions by the Bulgarian Development Bank and the Deposit Insurance Fund.

A week after, an information attack was made on the country's third largest bank by assets – First Investment Bank (FIB) (10.1%), which also caused a mass run on its deposits. During one day on June 27, depositors withdrew 800 million Bulgarian levs ($556 million). The FIB is Bulgaria's second largest bank by the volume of deposits held by households and non-credit institutions (7.4 billion Bulgarian levs).

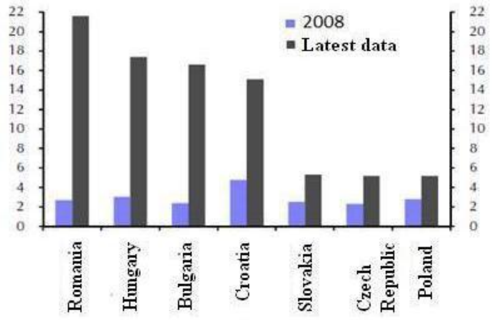
The National Bank of Bulgaria issued special bonds worth 1.3 billion Bulgarian levs as part of anti-crisis measures to provide liquidity to the affected banks and eased collateral requirements in liquidity provision operations. The European Commission approved an emergency credit line worth 3.3 billion Bulgarian levs (1.7 billion euros) for Bulgaria.

The National Bank of Bulgaria said in its press release published on June 30 that the crisis in the country's banking system had been resolved. Nevertheless, risks persist that the situation in the banking sector may aggravate amid rising public distrust. The situation is further aggravated by political uncertainty in the wake of the dissolution of the country's parliament and government.

A growth in public distrust may cause a mass withdrawal of deposits not only from national but also from foreign banks, which account for about 70% of the Bulgarian banking system's assets. The Bulgarian banking system is part of the common European market, like the local banking systems of other East European countries. Therefore, a panic in the domestic market may spill over to other European countries.

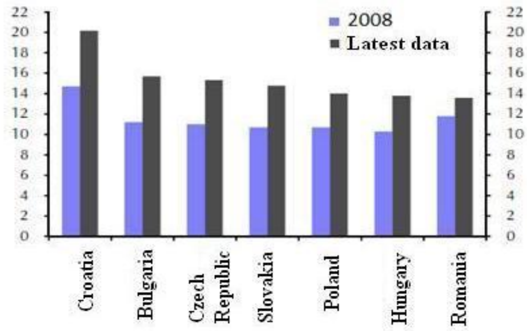
At the same time, even in the absence of contagion risks, the Bulgarian scenario may materialise in other East European countries with a large volume of non-performing loans (Chart 19), considering that bank capital adequacy levels are even lower in some countries (Chart 20).

Chart 19. Non-performing Loans in Total Loans (%)



Source: Capital Economics, IMF.

Chart 20. Tier 1 Capital Adequacy (%)



Source: Capital Economics, IMF.