GLOBAL RISK REVIEW

FEBRUARY 2014

The situation on global financial markets improved in February as compared with the previous month: key stock indices resumed their growth and the devaluation of most of emerging market currencies came to a halt. However, emerging market countries remain extremely vulnerable as their macroeconomic positions have weakened while the tightening of conditions on financial markets is just at the initial stage.

FINANCIAL STABILITY DEPARTMENT, BANK OF RUSSIA

Major Events in February 2014

6 February	The European Central Bank (ECB) and the Bank of England kept their key rates unchanged (at 0.25% and 0.5%, respectively).
11 February	The National Bank of Kazakhstan announced the devaluation of the tenge from 155.5 to 184.5 per US dollar (by 19%).
15 February	US President Barack Obama signed legislation on debt ceiling hiking the limit from $16.7 trillion to $17.2 trillion (about 99% of GDP) through March 2015.
18 February	The US Federal Reserve published final “Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking”. Global financial companies may be required to raise considerable additional capital.
22 February	The opposition’s actions in Ukraine caused a change of power in the country. The Supreme Rada (Parliament) appointed presidential elections for May 25, 2014. Arseniy Yatsenyuk was appointed as Ukraine’s prime minister.

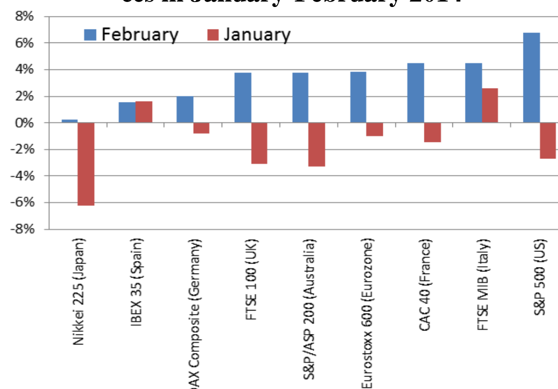
DEVELOPED COUNTRIES RISKS

MARKET SITUATION

Stock market growth

The stock markets of developed countries started to recover. Key stock indices registered growth in February as compared with the previous month. S&P 500 climbed by 6.8%, Eurostoxx 600 went up by 3.8% and FTSE 100 rose by 3.7%. Positive stock index dynamics in developed countries reflect an improvement of current macroeconomic indicators and forecasts of economic growth in the coming years. In particular, the eurozone manufacturing PMI climbed to the levels registered in mid-2011 before a flare-up of the sovereign debt crisis in the euro area. In general, the difference between the rates of growth in emerging market and developed economies is expected to be minimal since 2001 and amount to just 3 percentage points.

Chart 1. Change in Developed Economies' Stock Indices in January-February 2014

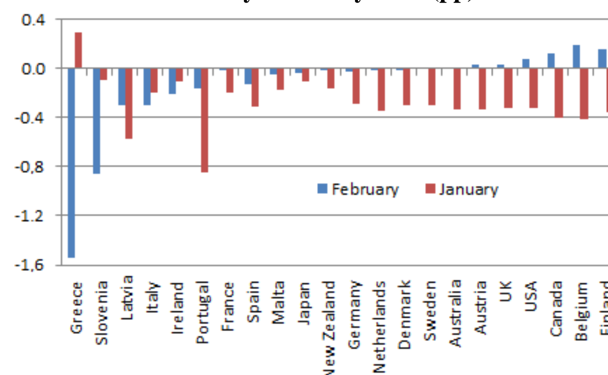


Source: Thomson Reuters Eikon

Fall in 10-Year Government Bond Yields

The borrowing costs on sovereign debt markets of problem European countries is observed to decline (Chart 2), despite the decision taken by the Federal Reserve in December 2013 to start scaling back its asset purchase programme. A slight growth in 10-year government bond yields in February was registered in Austria, the UK, the United States, Canada, Belgium and Finland.

Chart 2. 10-Year Government Bond Yield Change in January-February 2014 (pp)



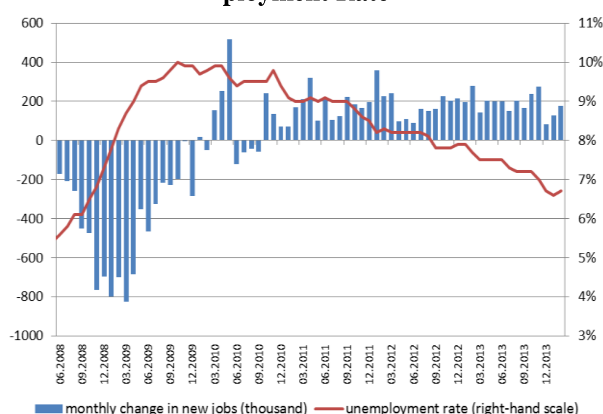
Source: Thomson Reuters Eikon

RISKS OF SOME DEVELOPED COUNTRIES

Continuation of the Fed's monetary stimulus tapering

Mixed trends persist on the US labour market: the number of nonfarm payrolls grew by 175,000 in February 2014 as compared with 129,000 in January 2014 whereas the unemployment rate rose from 6.6% to 6.7% (Chart 3). Nonetheless, Janet Yellen who took office as the new head of the Federal Reserve from February 1 already stated that the Fed would continue scaling back its quantitative easing (QE) programme at the Fed's coming sessions. At the same time, the money market rates are expected to be moderate. It follows from the minutes of the FOMC January meeting that the Federal Reserve will maintain low interest rates, even if the unemployment rates declines below the 6.5% target.

Chart 3. US Nonfarm Payroll Change and Unemployment Rate



Source: US Bureau of Labour Statistics, Bloomberg

Fed's Regulatory Tightening

Under the Dodd-Frank Act on financial regulatory reform passed in 2010, the Fed tightened requirements for the subsidiaries of global financial companies operating in the

Requirements for US Operations of Foreign Financial Companies

(the US Federal Reserve's document entitled: "Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking")

- Tighter requirements apply to those subsidiaries of foreign financial organisations operating in the United States, which have assets of

United States. The new rules, which will come into force in July 2016 (see the Box on the right-hand side), will impose Fed's capital and liquidity requirements on foreign subsidiaries with assets of over $50 billion. They will also have to pass annual stress tests. The regulator is seeking to prevent the situation observed in 2008 when after a collapse of US investment bank Lehman Brothers, many foreign banks, including Dexia, Erste Group and Royal Bank of Scotland, took advantage of the Fed's discount window lending to obtain multi-billion loans.

over $50 billion

- A foreign banking organisation will be required to establish an intermediate holding company over its US subsidiaries
- An intermediate holding company will be required to establish a risk committee
- Intermediate holding companies will be subject to the same capital and liquidity standards applicable to US large bank holding companies
- Foreign subsidiaries will be subject to capital planning (instead of relying on parent support, they will be required to raise additional capital on their own) and stress testing requirements
- The Standards will come into force on June 1, 2016

Eurozone fiscal risks

The eurozone debt markets continue to improve amid economic growth recovery. Economic growth resumed in France in 2013 Q4: GDP expanded by 0.3% compared to the previous quarter as a result of higher corporate investments and consumer spending while Germany's economy grew by 0.4% quarter on quarter on the strength of larger exports.

Eurozone peripheral economies are also recovering. The European Commission's forecasts indicate that GDP will decline only in Cyprus and Slovenia in 2014 (Table 1). For the first time since 2011, Italy's economy registered growth in 2013 Q4 (by 0.1% as compared with the previous quarter), which prompted Moody's rating agency to upgrade its outlook on the sovereign credit rating from "negative" to "stable." In February, Moody's also raised Spain's sovereign credit rating to Baa2 with a positive outlook, noting progress made in implementing pension reform and improvements on the labour market.

Greece's GDP fell by 3.7% in 2013 while the country's primary budget surplus reached one billion euros and was far above expectations. Considering these factors, the Greek authorities believe that Greece may not need a third package of international aid. Nevertheless, they hope that the EU will delay redemptions of loans from the previous aid packages until after May's elections to the local bodies of power and the European Parliament. Otherwise, radical forces may take the upper hand in the country, which may cause political disagreements on future reforms.

In general, it is important to note that the persistence of the high unemployment rate in the eurozone will impede economic growth recovery in the coming years.

Table 1. Eurozone Real GDP Growth and Unemployment Rate

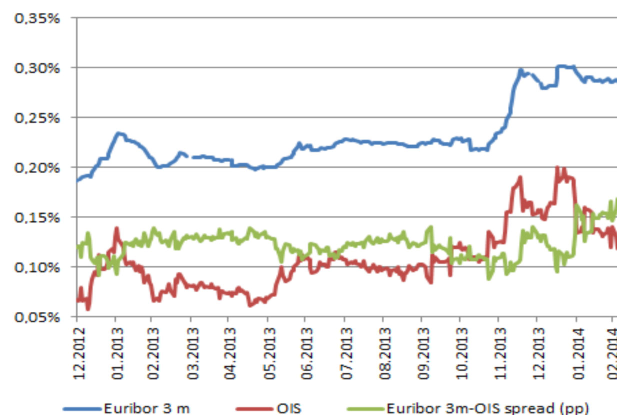
	Real GDP growth (%)			
	2012	2013 (estimate)	2014 (forecast)	2015 (forecast)
Belgium	-0.1	0.2	1.4	1.7
Germany	0.7	0.4	1.8	2.0
Estonia	3.9	0.7	2.3	3.6
Ireland	0.2	0.3	1.8	2.9
Greece	-6.4	-3.7	0.6	2.9
Spain	-1.6	-1.2	1.0	1.7
France	0.0	0.3	1.0	1.7
Italy	-2.5	-1.9	0.6	1.2
Cyprus	-2.4	-6.0	-4.8	0.9
Latvia	5.2	4.0	4.2	4.3
Luxembourg	-0.2	2.1	2.2	2.5
Malta	0.9	2.0	2.1	2.1
Netherlands	-1.2	-0.8	1.0	1.3
Austria	0.9	0.3	1.5	1.8
Portugal	-3.2	-1.6	0.8	1.5
Slovenia	-2.5	-1.6	-0.1	1.3
Slovakia	1.8	0.8	2.3	3.2
Finland	-1.0	-1.5	0.2	1.3
Eurozone	-0.7	-0.4	1.2	1.8

	Unemployment rate (%)			
	2012	2013 (estimate)	2014 (forecast)	2015 (forecast)
Belgium	7.6	8.4	8.5	8.2
Germany	5.5	5.3	5.2	5.1
Estonia	10.2	8.8	8.3	7.7
Ireland	14.7	13.1	11.9	11.2
Greece	24.3	27.3	26	24
Spain	25	26.4	25.7	24.6
France	10.2	10.8	11	11
Italy	10.7	12.2	12.6	12.4
Cyprus	11.9	16	19.2	18.4
Latvia	15	11.9	10.5	9.2
Luxembourg	5.1	5.9	6	5.9
Malta	6.4	6.5	6.4	6.4
Netherlands	5.3	6.7	7.4	7.2
Austria	4.3	4.9	4.8	4.7
Portugal	15.9	16.5	16.8	16.5
Slovenia	8.9	10.2	10.8	10.7
Slovakia	14	14.2	13.9	13.4
Finland	7.7	8.2	8.3	8.1
Eurozone	11.4	12.1	12	11.7

Increased volatility on European money market

The ECB is actively discussing a possibility of additional stimulus measures amid declining inflation rates and serious deflation risks, as well as a higher volatility on the European money market (Chart 4). ECB head Mario Draghi has stated the ECB's readiness to take corresponding measures, if necessary. The ECB may consider launching an asset purchase programme and introducing a negative deposit rate. According to Draghi, quarterly economic forecasts, which will be published in March, will provide the regulator with more information on the economy state (including inflation) to consider the expediency of implementing additional stimulus measures.

Chart 4. Euribor 3M-OIS Spread



Source: Bloomberg

EMERGING MARKET RISKS

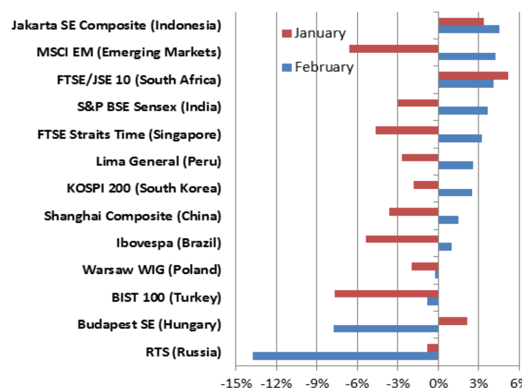
MARKET SITUATION

Growth of most stock indices

The stock indices of most of emerging market countries changed their vector and moved into positive territory in February: the MSCI EM climbed by 4.3%, the FTSE/JSE 10 by 4.1%, the S&P BSE Sensex by 3.6%, the FTSE Straits Time by 3.2% and the Shanghai Composite by 1.5% (Chart 5).

Nevertheless, emerging markets remain unstable, especially in the wake of the latest events in Ukraine. They continue to be exposed to changes in external conjuncture.

Chart 5. EM Stock Index Change



Source: Thomson Reuters Eikon

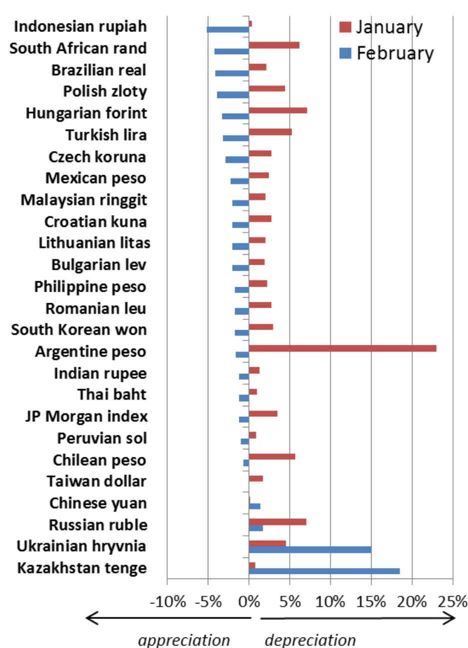
High foreign exchange risks persist despite appreciation of most currencies

The foreign exchange markets of emerging market countries showed some improvement in February (Chart 6). The JP Morgan consolidated index of emerging market currencies calculated against the US dollar grew by 1.2% in February after it fell by 3.5% in January.

Some countries, however, could not avoid an escalation of negative trends. The National Bank of Kazakhstan announced the devaluation of the tenge by 19% against the US dollar. The Ukrainian hryvnia is demonstrating record rates of depreciation amid political and economic instability (by 20.7% in January-February).

Meanwhile, many central banks have already spent considerable amounts of foreign exchange reserves on interventions to prop up national currencies. In Ukraine, international reserves plummeted to $15 billion from $20.4 billion in late 2013 and $24.5 billion in early 2013.

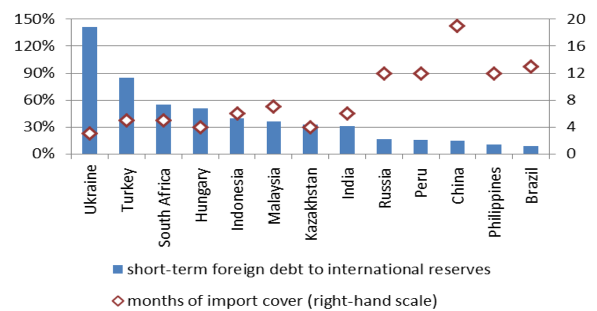
Chart 6. EM Foreign Exchange Rate Change against US Dollar in January-February



Source: Thomson Reuters Eikon

Ukraine, Turkey and South Africa registered some of the lowest indicators of international reserve sufficiency to cover short-term foreign debt and imports (Chart 7). As pressure on exchange rates will increase owing to US monetary policy tightening, some countries may be confronted with considerable difficulties in managing their foreign exchange and credit risks and, consequently, their task of ensuring financial stability will become more complicated.

Chart 7. International Reserve Sufficiency



Source: World Bank

Continued outflows from equity and bond funds

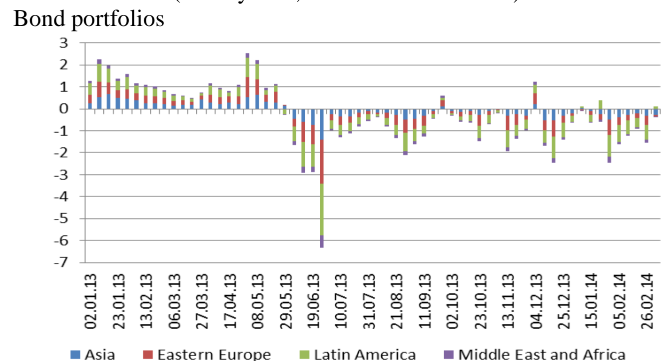
Capital outflows from emerging market equity and bond funds continued in February. From January 29 to February 26, 2014, net capital outflow from Asian countries, Eastern Europe, Latin America, Africa and the Middle East reached $17.3 billion (Chart 8). These trends indicate that emerging market countries are very vulnerable to monetary policy tightening in advanced economies as they were the recipients of large volumes of foreign capital during the period of quantitative easing.

However, the scope of capital outflow is relatively moderate so far, therefore the value of assets, which have appreciated in the past few years through carry-trade operations, is still exposed to significant negative revaluation risk. In this situation, a further increase in capital outflow may cause a more considerable fall in the value of assets compared to mid-2013 and early 2014 as local bond markets in emerging market countries have mainly developed through the expansion of non-resident presence in recent years while the domestic investment base remains underdeveloped to absorb capital outflow.

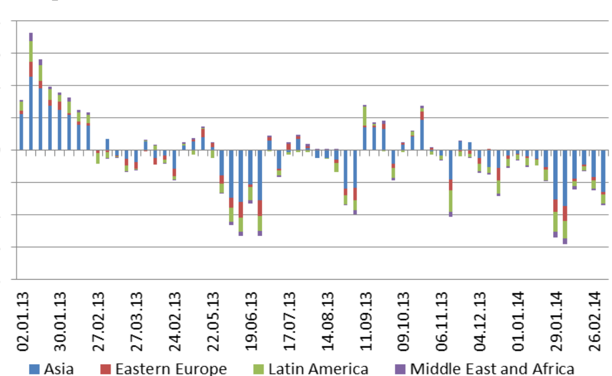
Chart 8. Portfolios of EM Equity and Bond Funds

(weekly data, billions of US dollars)

Bond portfolios



Equities portfolios



Source: EPFR

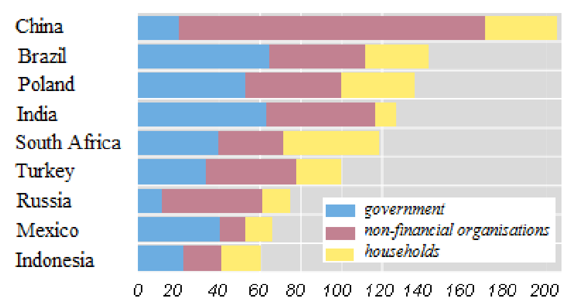
Risks of Some Emerging Market Economies

Risks of lengthy adaptation to new financial environment

International financial organisations, in particular, the Financial Stability Board (FSB) are increasingly drawing attention to the fact that emerging market countries may face considerable risks, if adaptation to new and tighter financial conditions turns into a long drawn-out process.

High capital adequacy ratios may fail to ensure banking sector stability amid mass sell-offs. The banking sector of emerging market countries is considerably exposed to the risks of non-financial organisations, the debt burden of which has risen significantly (Chart 9) while some countries (Turkey, India and Indonesia)

Chart 9. EM Non-Financial and Government Debt (as % of GDP)



Source: FSB

are extremely vulnerable to foreign exchange risk due to large debts denominated in foreign currency (including outstanding Eurobonds). In this situation, unforeseen defaults by highly leveraged businesses are possible.

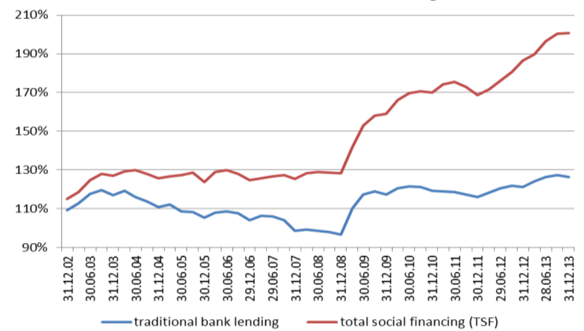
China's rising financial risks

China registered new record lending levels (Chart 10). Total social financing (TSF), which includes lending by banks and non-bank institutions, surged to 2.58 trillion yuan in January 2014 from 2.54 trillion yuan a year earlier. In late 2013, TSF reached 200% of China's GDP[1] and the share of non-bank loans continues to rise in its structure. In this situation, the Chinese government is tightening regulatory requirements to raise the transparency of "shadow banking" and ensure stability of the financial system as a whole. As the People's Bank of China noted in February, money markets may see an increased volatility (Chart 11) until rates reach an optimal level to allocate resources and adjust market player behaviour.

In February, the China Banking Regulatory Commission (CBRC) set tighter liquidity requirements as compared with Basel III. Under these rules, China's banks will have to increase their liquidity coverage ratio (LCR) to 100% by 2018 (Basel III requires banks to reach this level by 2019). This measure specifically aims to increase the resilience of small banks as the regulator found last year that regional banks were exposed to increased risks (now they are required to pass quarterly stress tests).

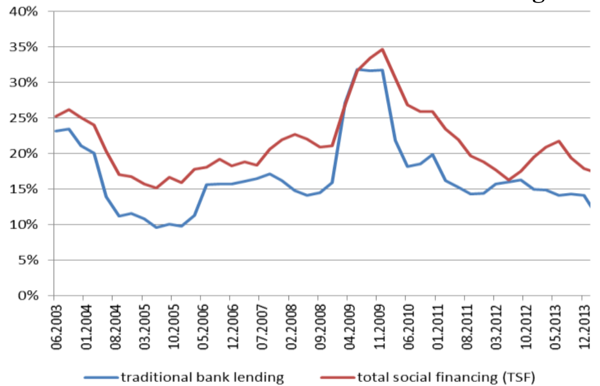
Owing to their unstable deposit base, the cost of funding for small banks is more expensive. They are increasingly raising funds on the interbank loan market, and are also offering their clients higher-yield alternatives called wealth management products (WMP) and making investments in more risky assets. These factors make them especially vulnerable to the risks of a higher cost of borrowings. The financial system may come under more pressure from the risks of potential defaults (in January, China Credit Trust Co. avoided a default of its trust fund, after reaching a last-minute deal with investors.). Overall, an increased volatility on Chinese financial markets is creating some tension, which may impede economic growth in China.

Chart 10. China's TSF and Bank Lending, as % of GDP



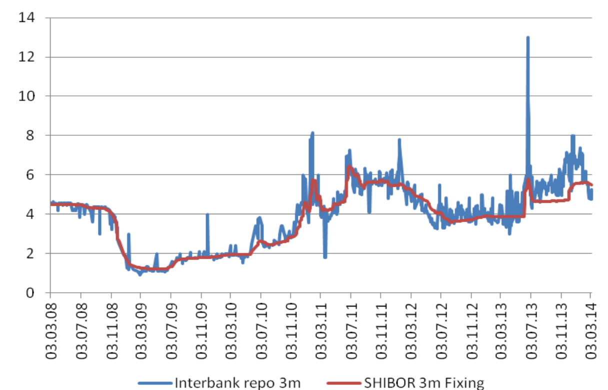
Source: Bloomberg

Chart 11. China's Annual TSF and Bank Lending Growth



Source: Bloomberg

Chart 12. China's Interbank Loan Rates (%)



Source: Bloomberg

[1] As TSF statistics have been available only since 2002, cumulative TSF calculations are based on the assumption that non-bank lending was virtually absent before 2002 (its share was about 5% in 2002). Proceeding from this assumption, TSF reached 114 trillion yuan at the end of 2013.

Ukraine's higher risks of default on government bonds

Ukraine's political instability has brought the country to the brink of an economic disaster. Without an international financial assistance (from the EU and the IMF), Ukraine faces the threat of a default on its foreign debt. Ukraine's government and guaranteed state debt totalled $73.2 billion (39.6% of GDP) as of January 31, 2014, of which the government's foreign liabilities amounted to $37.3 billion (20.2% of GDP). Ukraine's total foreign debt reached $140 billion (80% of GDP) as of December 31, 2013, including short-term foreign debt of $65 billion.

As most repayments on Ukraine's debt have to be made in the coming five years (Chart 13), the probability of a default in the short term is very high. Ukraine has to repay slightly over $5 billion in 2014, including $2.8 billion of debt repayment to the IMF (Chart 14).

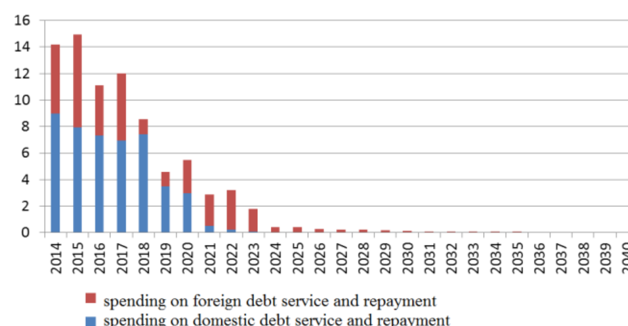
High debt risks are also evidenced by a sharp growth in the yields of Ukrainian Eurobonds maturing in June 2014 (worth a total of $1 billion): they soared from 8% in early January to 52% at the beginning of March 2014. Government bonds denominated in US dollars with maturities in 2023 are trading at 82.4% of their par value with yields of 10.7% (as of March 3, 2014). The hryvnia's record depreciation against the US dollar (by 20.7% in January-February) and depositors' runs on banks are making things worse.

The National Bank of Ukraine (NBU) has already taken some measures to stabilise the foreign exchange market and support the banking sector:

- the NBU widened liquidity support to banks;
- the NBU set a zero reserve rate on short-term external loans;
- certain restrictions were imposed on the execution of bank client orders, limiting them to client current account balances available as of the beginning of an operational day;
- temporary limits were imposed on certain transactions for the purchase of foreign currency on Ukraine's interbank foreign exchange market;
- certain time limits were set for foreign currency purchases by authorised banks on orders from legal entities and individual entrepreneurs, etc.
- the share of reserves, which banks are required to hold on a special account with the NBU, was reduced from 40% to 20% of their volume for the previous reporting period of reserve formation;
- the minimum amount of required reserves, which should be kept daily as of the start of an operational day on banks' correspondent accounts with the NBU, was reduced from 60% to 50% of their volume for the previous period of reserving;
- from February 21, 2014, limits were lifted on the

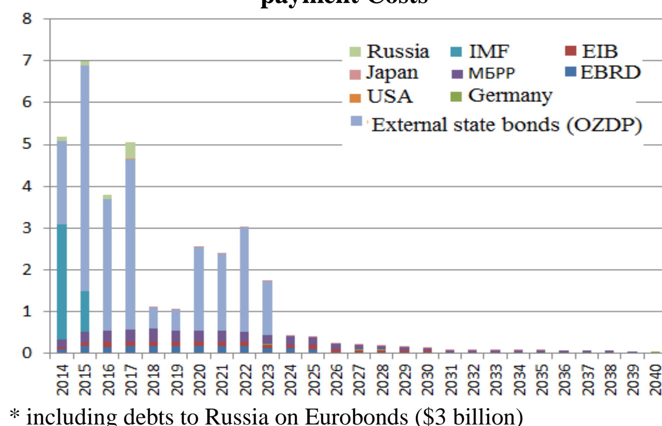
Chart 13. Ukraine's Government Debt Service and Repayment Costs

(data as of February 6, 2014, billions of US dollars, calculated at the exchange rate as of February 6, 2014)



Source: Finance Ministry of Ukraine

Chart 14. Ukraine's Government Debt Service and Repayment Costs



* including debts to Russia on Eurobonds ($3 billion)

Source: Finance Ministry of Ukraine

number of banks' possible requests for overnight refinancing loans (previously, banks were allowed to apply to the NBU no more than twice a week for overnight refinancing loans secured by collateral and no more than once a week for overnight loans without collateral).

Considering the low level of international reserves ($15 billion), the regulator will find it highly difficult to ensure financial stability in the country.