



Bank of Russia

The Central Bank of the Russian Federation



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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 – 6 November 2018;

'Foreign exchange and stock market' section – 31 October 2018.

'Credit and deposit market' section – 1 October 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, an analysis of the effectiveness of the Bank of Russia's monetary policy operational procedure should take into account required reserves averaging periods. In October 2018, this is the period between 10 October 2018 and 6 November 2018.

A soft copy of the information and analytical material is published on the Bank of Russia website (<http://www.cbr.ru/DKP/>).

Please send your comments and suggestions to svc_analysis@cbr.ru.

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

- *In October, the structural liquidity surplus continued to decline as the Bank of Russia suspended fiscal rule-based foreign currency purchases in the domestic market.*
- *The Bank of Russia's key rate decision was expected by market participants and therefore didn't significantly affect their expectations with regard to the key rate trajectory.*
- *Interbank lending rates remained close to the Bank of Russia key rate. Downward pressure on rates was exerted by the operations of individual banks, that resulted in excess liquidity in the banking sector during most of the averaging period.*
- *Interbank lending rates and FX swap spreads remained close due to persistently high current account revenue which was not spent on foreign currency purchases by the Bank of Russia in the domestic FX market under the fiscal rule.*
- *The Russian financial market remained stable in October despite a certain decline in asset prices in most segments. As of the end of the month, foreign investors were net buyers of OFZs in the on-exchange market.*
- *In the third quarter, rate and yield growth in the stock and money markets amid changing external conditions, coupled with the September key rate revision, drove higher rates in a number of segments of the credit and deposit market. The increase was moderate and the trends registered in the first six months of the year sustained through the third quarter (recovery in lending and substitution of FX transactions with ruble-denominated ones).*

Banking sector liquidity and money market

Ruble liquidity. In October, just like in the previous month, the structural liquidity surplus declined due to the suspension of fiscal rule-based foreign currency purchases in the domestic market by the Bank of Russia.

Liquidity outflow was partially offset as Russian regional budgets and the Federal Treasury increased the volume of temporarily available funds placed with banks.

Money market. Interbank rates stayed close to the Bank of Russia key rate. As in the previous month, the downward pressure was exerted by operations of certain banks that raised their borrowings from the Bank of Russia and correspondingly decreased their demand in the interbank lending market. Excess funds were, in part, redistributed in favour of repo and FX swap segments and afterwards, during most of the averaging period, remained in banks' correspondent accounts with the Bank of Russia. As a result, the average spread between interbank lending interest rates and the key rate averaged -25 bp. Since banks maintained high balances in their correspondent accounts at the beginning of the averaging period, their demand for liquidity decreased closer to the period end. Fine-tuning deposit auctions conducted by the Bank of Russia at that time supported the interest rates. By the end of 2018, the spread may further tighten due to diminishing structural liquidity surplus

amid the suspended fiscal rule-based foreign currency purchases by the Bank of Russia.

FX liquidity. The interest rates spread in the interbank and FX swap (basis) segments remained close to zero due to FX liquidity improvements. This was supported by persistently high current account revenue which was not spent on foreign currency purchases by the Bank of Russia in the domestic FX market under the fiscal rule. As a result, in the first half of October, banks providing services to exporters increased their foreign currency lending via FX swaps.

Compared with the forecast presented in the previous issue, **the assessment of the structural liquidity surplus as of year-end 2018** remained unchanged at 1.7-2.1 trillion rubles. The structural liquidity surplus as of year-end 2019 is forecast at 1.9-2.6 trillion rubles (Table 1). This estimate was made assuming exclusively for calculation purposes that foreign currency purchases in the domestic market under the fiscal rule, suspended in 2018, will be implemented evenly in 2019-2021. That said, the decision to resume regular foreign currency purchases in the domestic market under the fiscal rule will be taken in accordance with the actual situation in the financial markets.

In October, the predicted key rate path did not see any significant changes. This was related to the fact that the situation in the financial market remained stable and the Bank of Russia's decision to keep the key rate unchanged was expected by the market.

Table 1

Structural liquidity surplus forecast remained unchanged

<i>(trillions of rubles)</i>	October 2018	January-October 2018	2018 (estimate)	2019 (forecast)
1. Liquidity factors (supply)	-0.2	0.6	[-0.2; 0.1]	[0.3; 0.6]
- changes in balances of general government accounts with the Bank of Russia, and other operations*	-0.4	0.3	[0.1; 0.3]	[1.0; 1.2]
- change in cash in circulation	0.1	-0.2	[-0.8; -0.7]	[-0.7; -0.6]
- Bank of Russia interventions in the domestic FX market and monetary gold purchases**	0.1	0.6	0.6	0.0
- regulation of bank required reserves with the Bank of Russia	0.0	-0.1	-0.1	0.0
2. Change in free bank reserves (correspondent accounts) (demand)	0.0	0.1	[0.3; 0.4]	0.1
3. Change in banks' claims on deposits with the Bank of Russia and coupon OBRs	-0.2	0.9	[-0.7; -0.2]	[0.2; 0.5]
4. Change in outstanding amounts on Bank of Russia refinancing operations (4 = 2 + 3 - 1)	0.0	0.4	[0.0; 0.1]	0.0
Structural liquidity deficit (+) / surplus (-) (as of the period-end)	-2.9		[-2.1; -1.7]	[-2.6; -1.9]

* 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.

** Forecast values of the indicator correspond to the actual volume of operations conducted.

Source: Bank of Russia calculations.

Table 2

Expected interest rate path based on market instruments remained practically unchanged

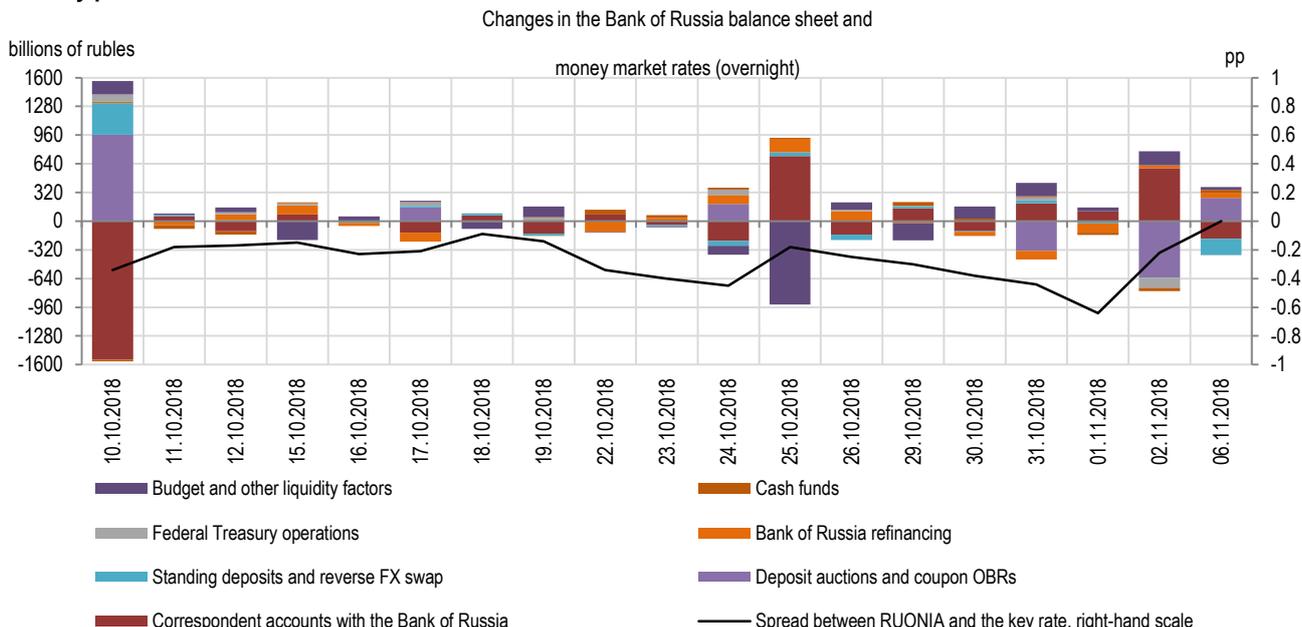
1. Expectations based on market indicators* interest rate (instrument)	January 2019	April 2019	July 2019
- MosPrime 3M (FRA)	8.56 (8.86)	8.73 (7.73)	9.08 (8.08)
- RUONIA (ROISfix)	7.58 (7.93)	7.93 (8.35)	8.55 (8.35)
- RUONIA (futures)	7.70 (7.86)	8.04 (8.10)	8.45 (8.20)
2. Analysts' expectations for the key rate*	As of 31.12.2018	As of 31.03.2019	As of 30.06.2019
- Bloomberg survey	7.5 (7.5)	7.5 (7.5)	7.5 (7.38)
- Reuters survey	7.5 (7.5)	7.5 (7.5)	7.5 (7.5)
3. Implied inflation rate (OFZ-IN) (until 16 August 2023)		5.13 (5.27)	

* Data as of the end of previous month are given in brackets.

Source: Bank of Russia calculations.

Chart 1

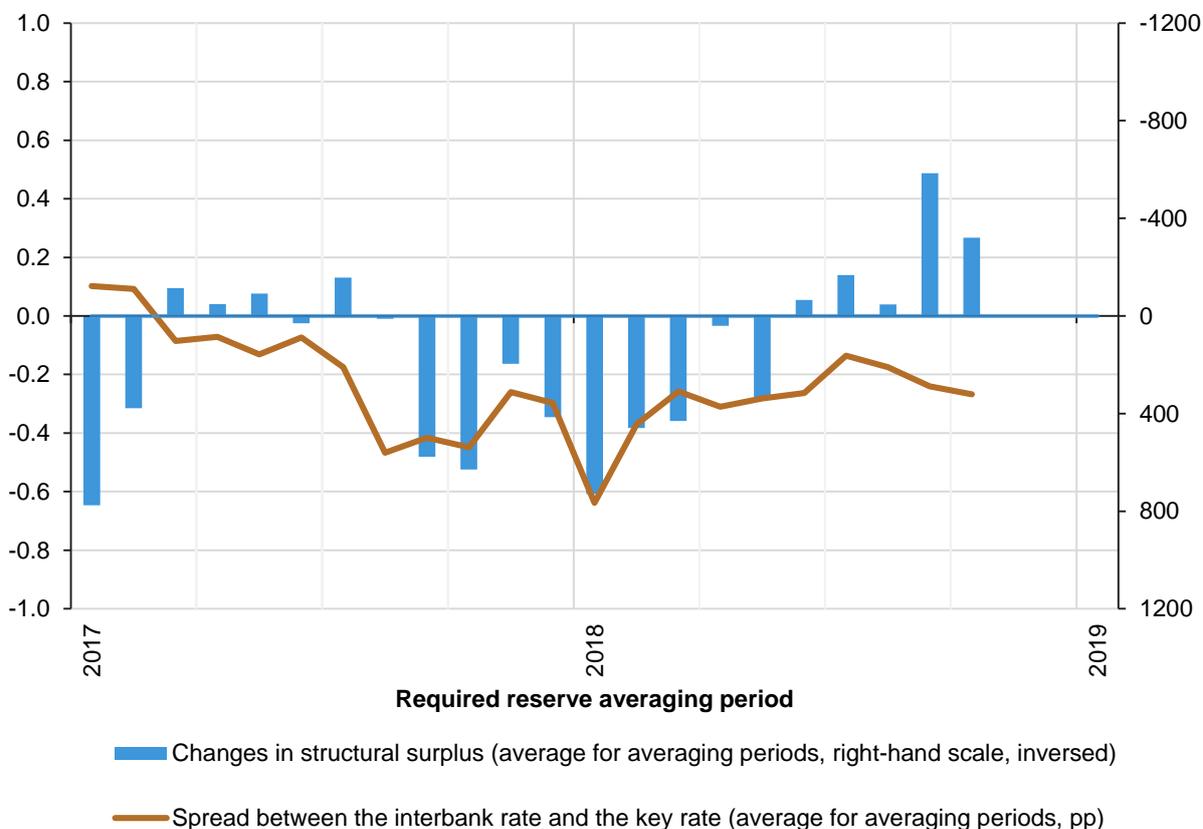
October 2018 saw an outflow of funds from banks through the budget channel as the Bank of Russia suspended foreign currency purchases in the domestic market under the fiscal rule



Source: Bank of Russia calculations.

Chart 2

By the end of 2018, the narrowing of the spread between the interbank lending rate and the key rate may be assisted by a reduction in the structural liquidity surplus



Source: Bank of Russia calculations.

Chart 3

In the October averaging period, the interbank interest rate stayed close to the key rate but in the lower half of the interest rate corridor

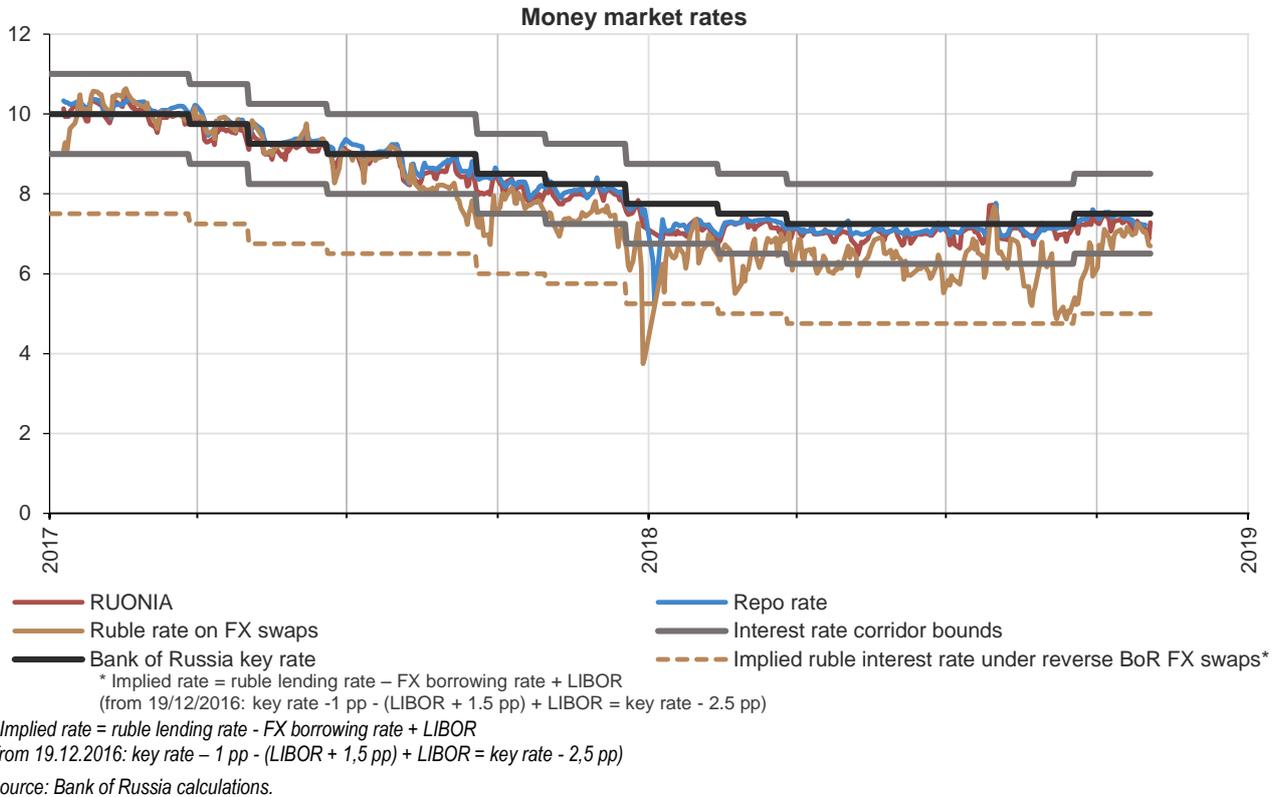


Chart 4

Money market turnover remained stable

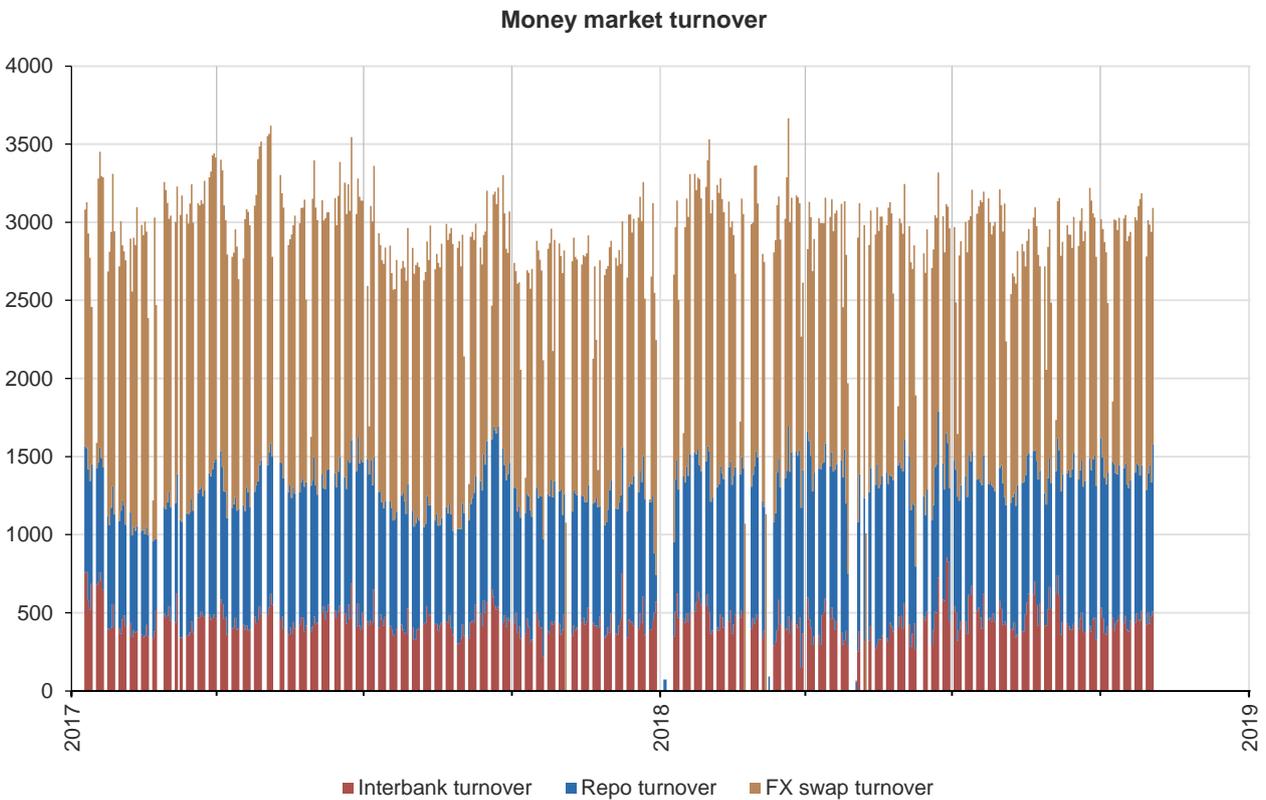


Table 3

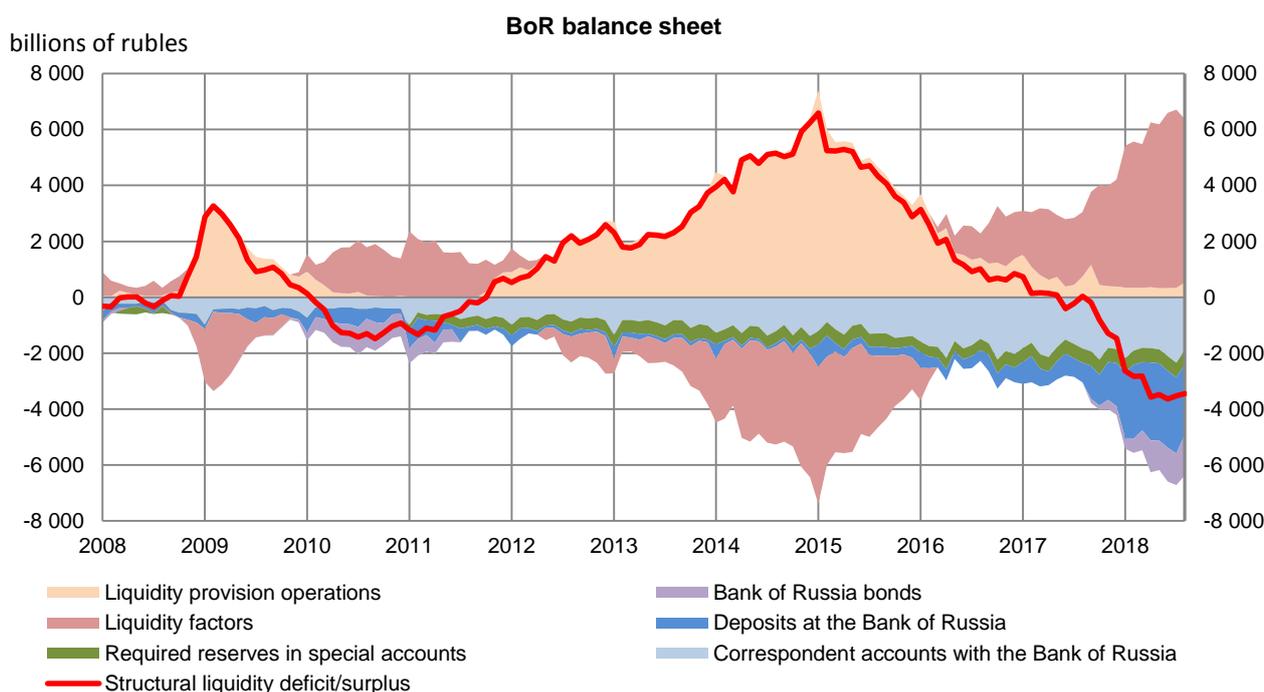
In October 2018, the banking sector's structural liquidity surplus decreased

(start of business, trillions of rubles)	01.11.2018	01.10.2018	01.01.2018
Structural liquidity deficit (+) / surplus (-)	-2.9	-3.1	-2.6
Bank of Russia standard monetary policy instruments			
Bank of Russia claims on credit institutions	0.4	0.4	0.0
• Auction-based facilities	0.0	0.0	0.0
- repos and FX swaps	0.0	0.0	0.0
- secured loans	0.0	0.0	0.0
• Fixed interest rate facilities	0.4	0.4	0.0
- repos and FX swaps	0.0	0.0	0.0
- secured loans	0.4	0.4	0.0
Credit institutions' claims on the Bank of Russia	3.6	3.8	2.7
• Deposits	2.1	2.3	2.4
- auction-based	2.0	1.8	2.1
- fixed interest rate	0.2	0.5	0.2
• Bank of Russia bonds	1.5	1.5	0.4
Standing reverse facilities other than Bank of Russia standard monetary policy instruments*			
• Net claims of credit institutions and the Bank of Russia	0.3	0.3	0.1

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

Source: Bank of Russia calculations.

Chart 5



Source: Bank of Russia calculations.

Foreign exchange and stock market

The Russian financial market remained stable in October despite a certain decline in asset prices in most segments. Prices declined mainly on the back of a general downturn in demand for risky assets in the global market.

Foreign exchange rate. The exchange rate of the ruble against the US dollar saw virtually no changes as of the end of the month. The same is true for the currencies of most emerging market economies (hereinafter, EMEs). The EMCI index tracing the dynamics of several EME currencies dropped by 0.9% in October (with the ruble falling by 0.5%). The second half of the month saw increased demand for foreign currency from foreign investors, however large sales of FX revenues by exporters helped stabilise ruble exchange rate dynamics.

Country risk premium. As of month-end, Russia's CDS spread reached 147 bp (+4 bp). At the same time, CDS spreads of other emerging market economies grew 10 to 20 bp. The difference in CDS spread dynamics can be explained by a slight decline in the 'sanction' premium, including amid the news on a possible meeting of the Russian and the US presidents. Another factor behind lesser sensitivity of Russia's CDS spread to the declining risk appetite is a

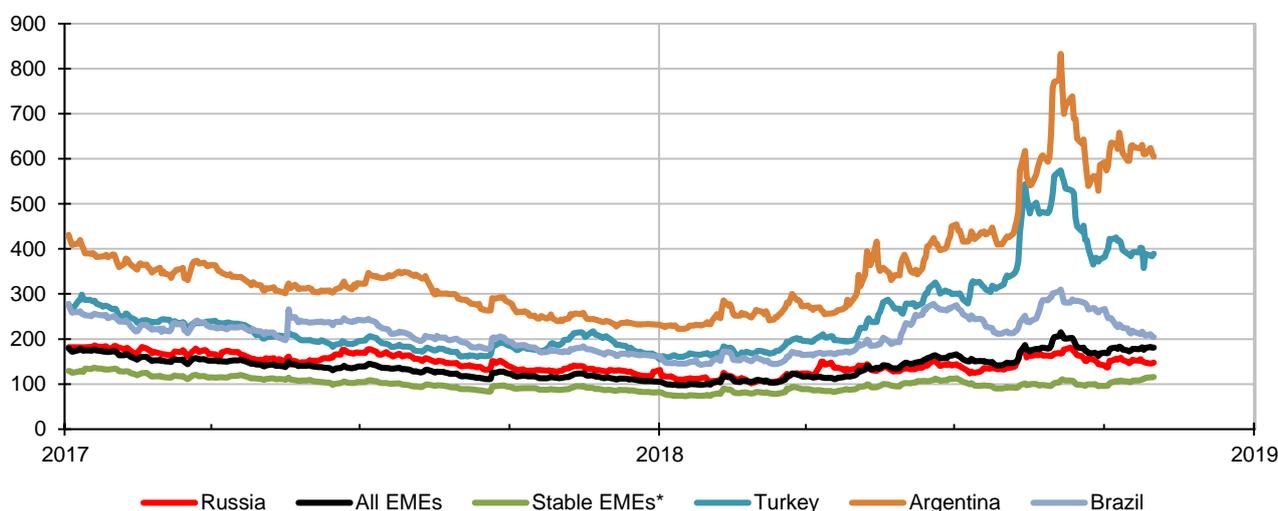
more stable macroeconomic situation in the country compared to other EMEs.

OFZ. The situation in the government bonds market is gradually improving. The Russian Minfin resumed regular OFZ placement auctions, however volumes offered are still way below than in the first half of the year. The exchange data show that in October foreign investors (both non-residents and Russian subsidiaries of foreign banks) were net buyers and increased their OFZ holdings by 7 billion rubles (in the primary and secondary markets). Despite the emerged foreign investors' demand, OFZ yields continued to grow (see Chart 7). At the same time, the spread between 10-year and 2-year bonds tightened by 36 bp due to the growth at the short end of the curve.

Stocks. The Russian equity market declined in October with the MOEX index falling 5% and the MSCI Russia index dropping 5.3%. Stock markets of other EMEs faced an 8.8% drop on average (according to MSCI EM). Despite a lesser decline, we can say that the Russian market followed the EME trend as the elasticity of MSCI Russia to MSCI EM fell to 0.7-0.8 in the last 18 months (see Chart 9). It means that a 1% drop in MSCI EM leads to a 0.7-0.8% decline of this index for Russia.

Chart 6

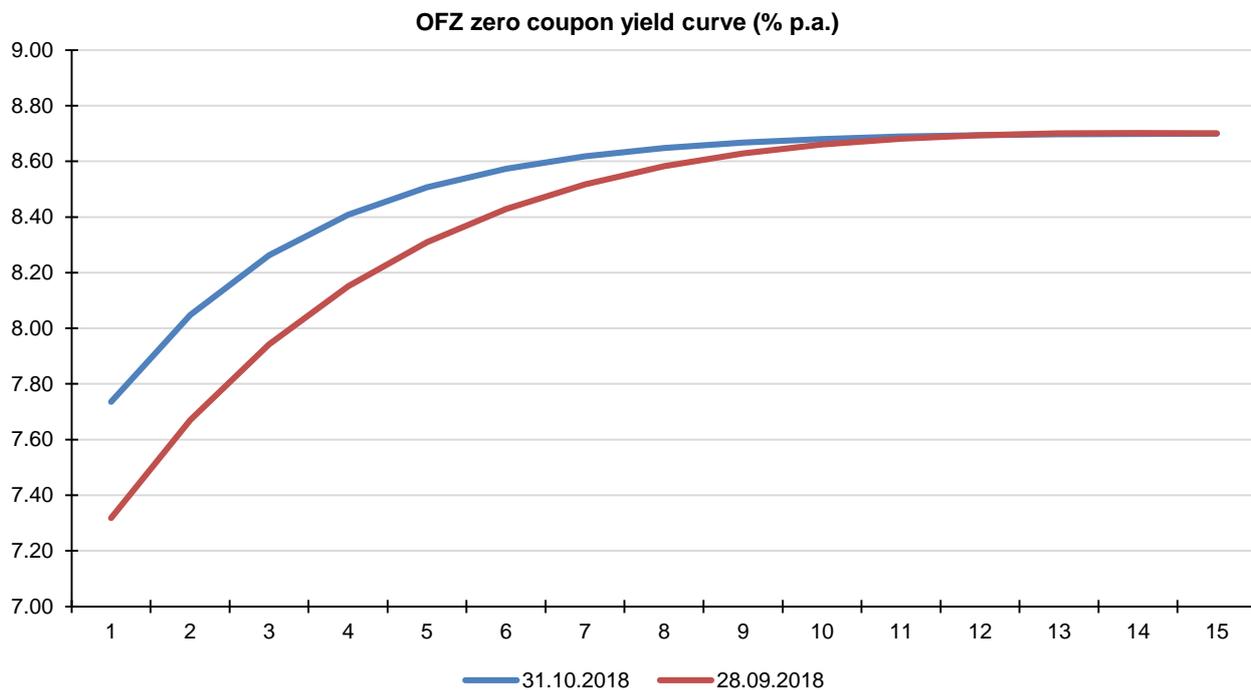
Russia's CDS spread grew less than that of other EMEs



* The average CDS spread calculated based on CDS for China, Indonesia, Panama, Colombia, Chile, Peru, Mexico, Malaysia and the Philippines
Sources: Bloomberg, Bank of Russia calculations.

Chart 7

OFZ yields continued to grow in October



Source: Moscow Exchange.

Chart 8

Russian stock indices declined in line with the global markets

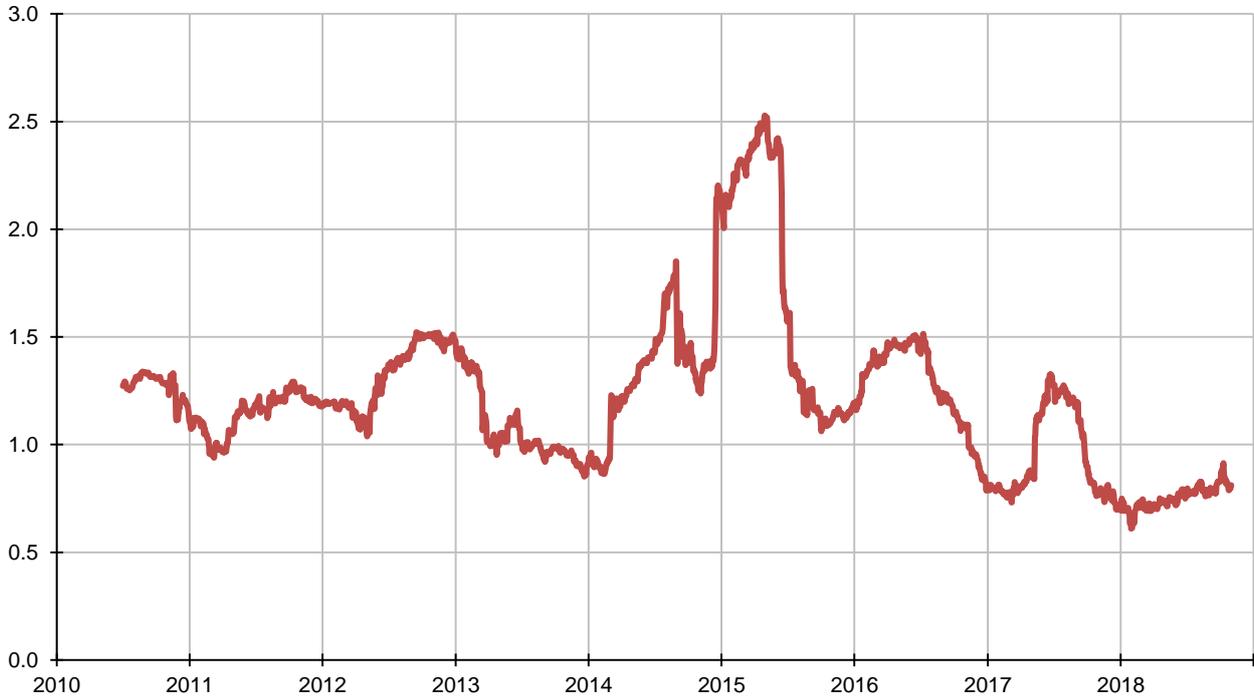


Source: Bloomberg, Bank of Russia calculations.

Chart 9

The elasticity of MSCI Russia to MSCI EM is at 0.7-0.8

Elasticity of MSCI Russia to MSCI EM

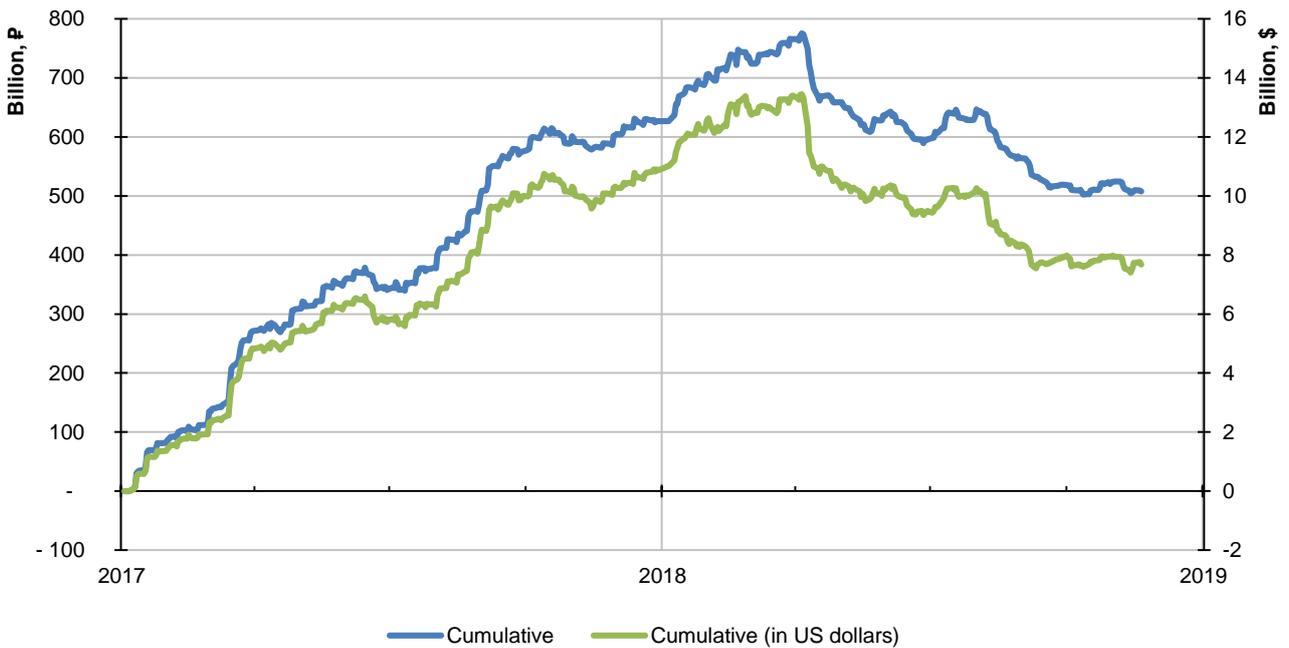


Source: Bank of Russia calculations.

Chart 10

In October, foreign investors were net buyers of OFZs

Foreign investors' net purchases in the OFZ market
(according to exchange data)



Source: Moscow Exchange, Bank of Russia calculations.

Table 4

Most segments of the Russian financial market saw price downturn

Stock market indicators					
Segment	Indicator	As of 31/10/2018 COB*	Change**		Average 2017*
			month	monthly average	
Equity market	MICEX index	2352.7	-5.0	0.2	2039.8
	RTS index	1126.2	-5.5	2.8	1101.9
Bond market	OFZ	8.41	18.0	-11.8	7.9
	Corporate bonds	8.84	90	-6.1	8.9
	Regional bonds	8.48	-8.0	-23.0	8.5
Foreign market	Russia-43	5.50	23.1	3.2	4.9
	UST-10	3.14	8.2	16.1	2.3
Risk appetite indicators	RVI	27.6	3.7	1.4	21.3
	EMBI+ Russia	190.0	-7.0	-29.0	145.1
	EMBI+ EM	383.3	-0.8	-28.5	326.6
	CDS	147.4	4.1	-12.8	156.0

* Points for equity and RVI indices, % p.a. for bonds, basis point (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.

Credit and deposit market

In the third quarter, the rate growth in the stock and money markets related to external conditions drove **higher rates in the principal segments of the credit and deposit market** (see Chart 11). The September hike of the Bank of Russia key rate supported the credit and deposit rates growth. In the third quarter, these factors did not fully feed through to banking operations; there is still potential for further growth of bank interest rates. According to the preliminary data, a number of large banks raised the rates for their deposit and standardised credit products in October. Due to the moderate character of growth of interest rates on banking operations in September, it failed to produce any significant effect on their attractiveness for banks' clients. The most important trends observed in the credit and deposit market in the first half of the year persisted in the third quarter.

Credit market. The demand of clients for bank loans continued to increase (see Chart 16), which prompted further acceleration of growth of Russian banks' loan portfolio. As in the previous quarters, the retail segment of the credit market demonstrated outpacing growth. Sustained improvement of the quality of the retail loan portfolio (see Chart 13) allowed banks to maintain moderately soft policy with regard to household loans. In these circumstances, the consumer lending segment continued to grow accounting for over 50% of household lending growth at the end of the third quarter (see Chart 14). However, the recovery potential of this market segment had already manifested itself to a large degree. As the effect of Bank of Russia measures to mitigate retail lending risks (including regulating the effective interest rate) materialises, we can expect a slowdown in the retail lending.

In the corporate segment, credit activity is recovering more slowly. In part, this can be explained by banks' quite conservative credit policy amid a significant share of overdue corporate loans in their portfolios (see Charts 13 and 16). However, the third

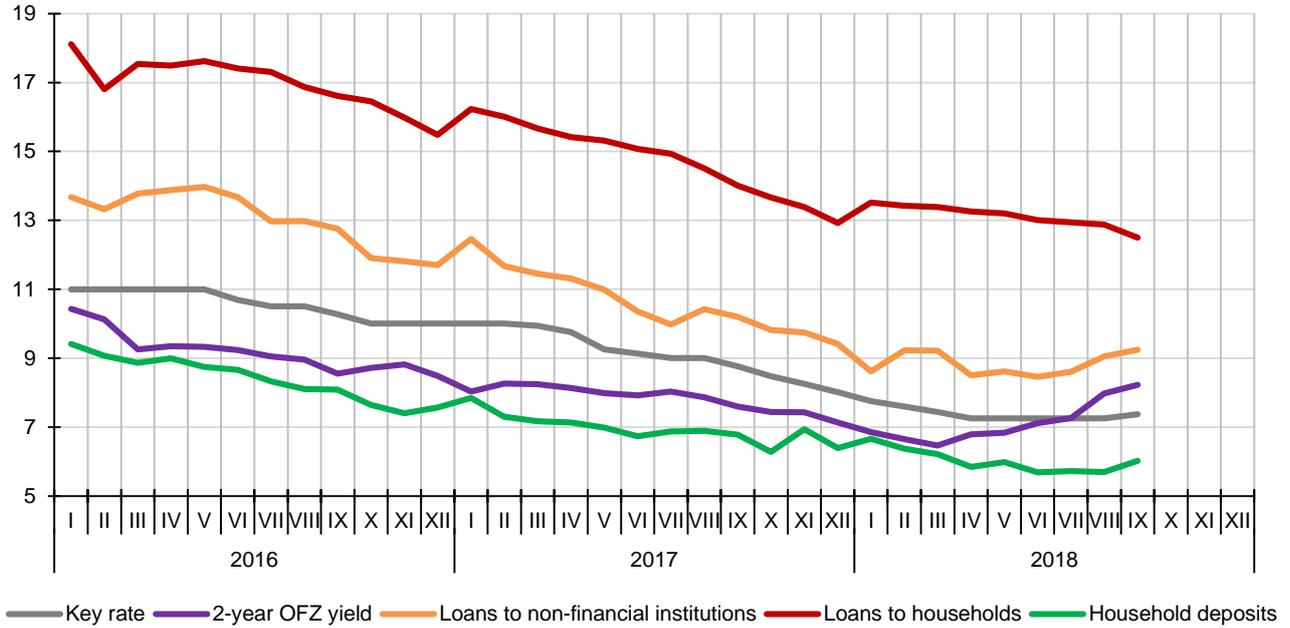
quarter saw signs of recovery in the corporate market segment. During this period, the portfolio of corporate loans extended by Russian banks grew by 3.4% (more than in the previous four quarters). Manufacturing enterprises (chemistry, metallurgy) as well as transport and telecommunication companies demonstrated the highest growth in the third quarter. The preliminary data show that, in October, corporate lending growth rate was comparable to the third quarter figures.

Deposit market. In August-September 2018, a decline in household deposits in banks was observed, which resulted in lower annual growth rates for deposits. However, according to the preliminary data, this outflow was short-lived, and household deposits resumed growth in October. That said, during the period of outflow of household funds from bank deposits, foreign currency-denominated deposits declined faster than ruble-denominated ones, whereas only the latter demonstrated growth in October. This created conditions for further dedollarisation of household deposits. The small growth of FX deposits, observed in the end of the third quarter, was only caused by FX revaluation.

Banks' financial performance. Expansion of banks' credit portfolios led to further growth of their net interest income, which reached historic highs in the third quarter (see Chart 15). The quality of banks' assets remained stable. Loss provision deductions that were the main driver behind the worsening of banks' financial performance in the second quarter significantly declined in July-September, and the banking sector's profit continued to grow. As a result, during the first two months of the third quarter, banks' capital not only grew by more than 250 billion rubles but also its structure improved (the proportion of Tier 1 capital went up from 70 to 73%). These capital dynamics support financial stability of the banking sector and improve Russian banks' capabilities with regard to further lending expansion.

Q3 saw moderate growth of credit and deposit rates

Rates on banks' long-term ruble transactions, % p.a.

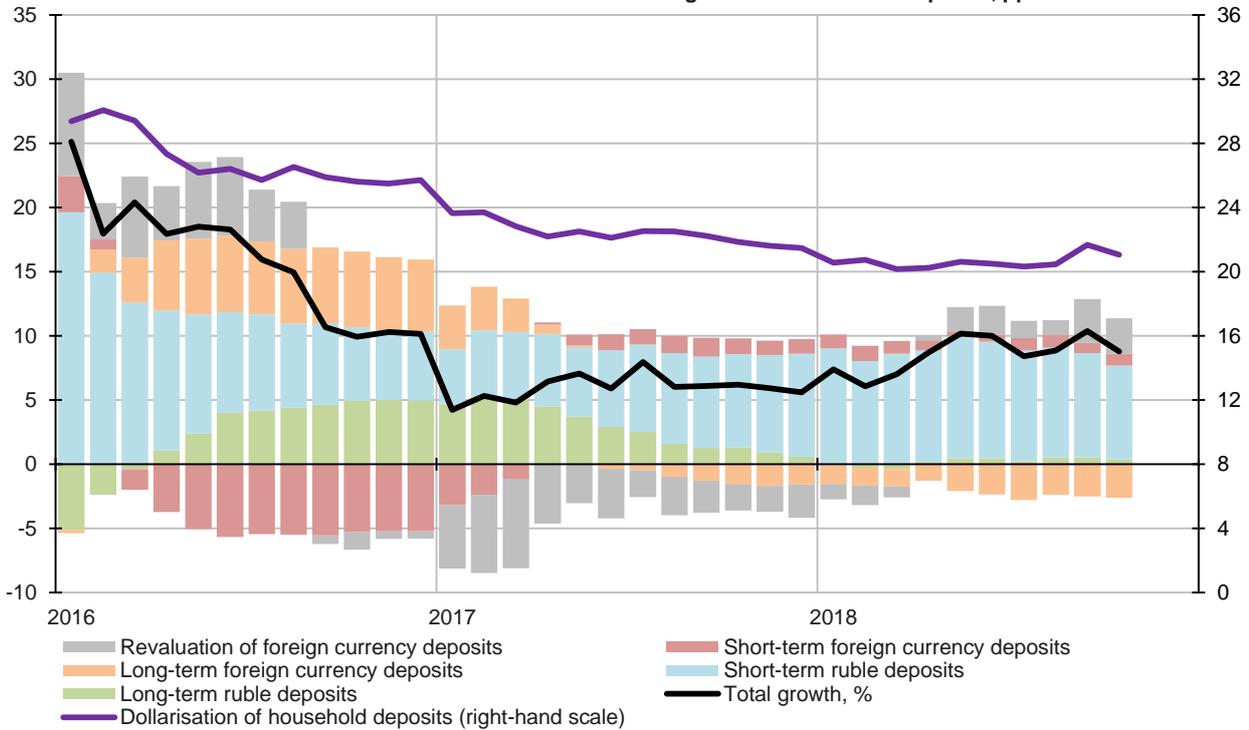


Source: Bank of Russia calculations

Chart 12

Depositors continued to replace FX deposits with ruble-denominated ones

Contribution of individual elements to annual growth of household deposits, pp

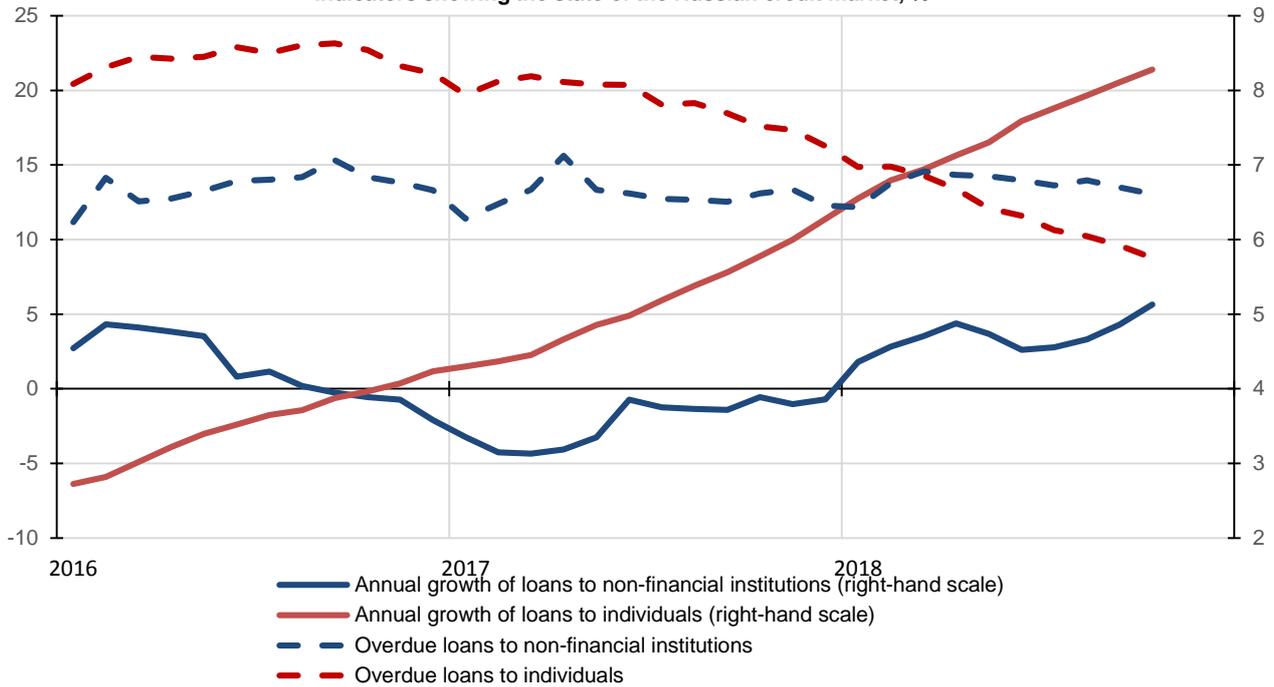


Source: Bank of Russia calculations

Chart 13

Recovery of the retail segment of the credit market continued amid improvement of retail loans portfolio quality

Indicators showing the state of the Russian credit market, %

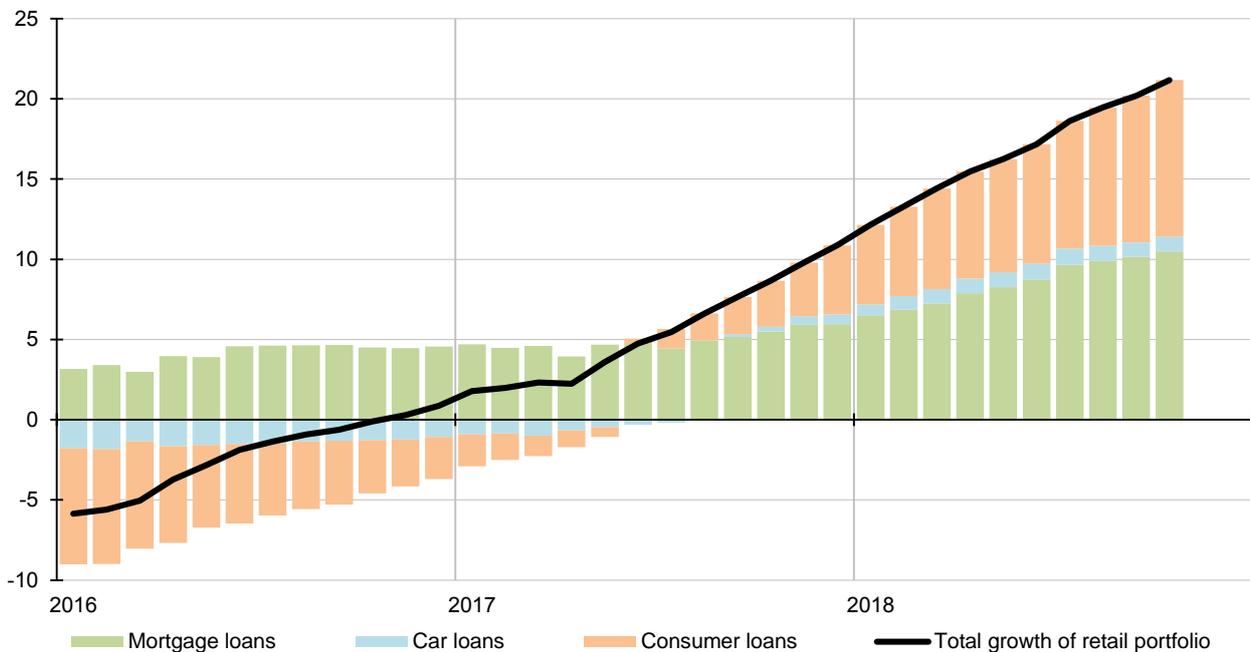


Source: Bank of Russia calculations

Chart 14

By the end of 2018, the contribution of consumer lending in the retail lending growth drew close to that of mortgage

Contribution of individual components to annual growth of retail loan portfolio, pp

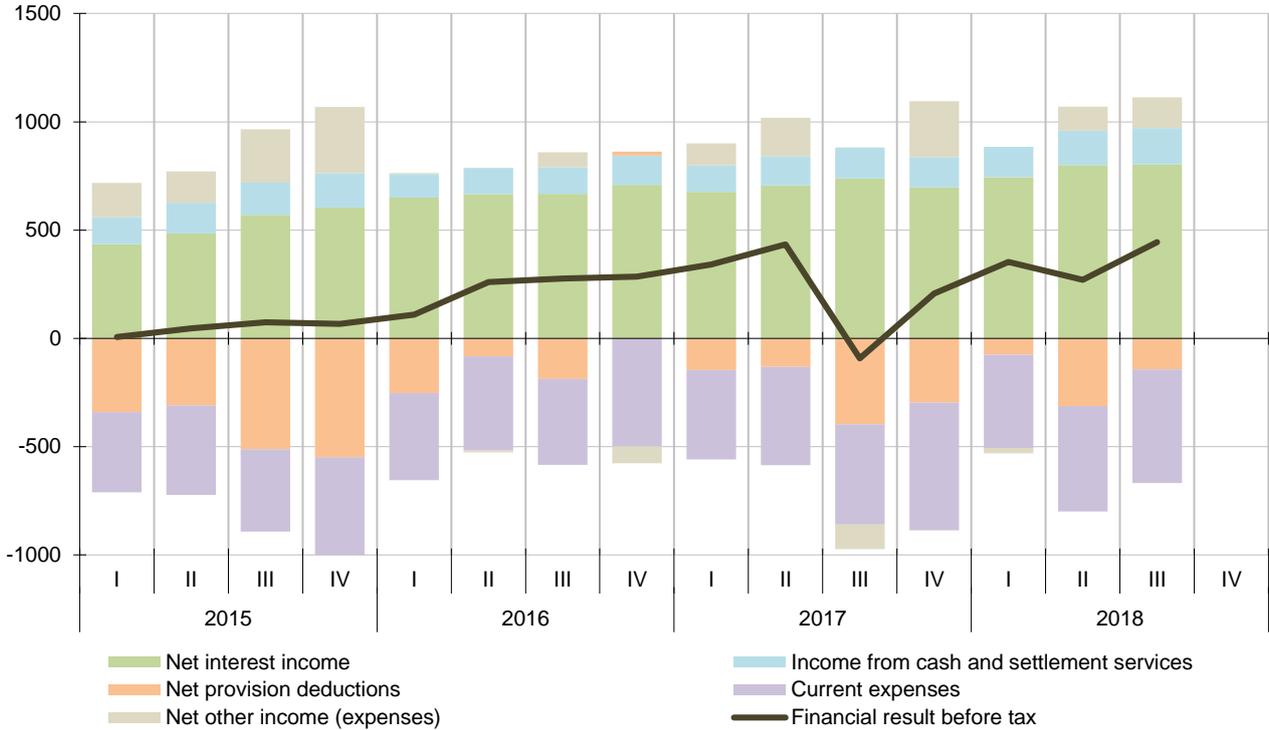


Source: Bank of Russia calculations

Chart 15

Due to lower loss provision deductions, the financial performance of the Russian banking sector was close to historic highs

Financial performance of Russian banks (billions of rubles)

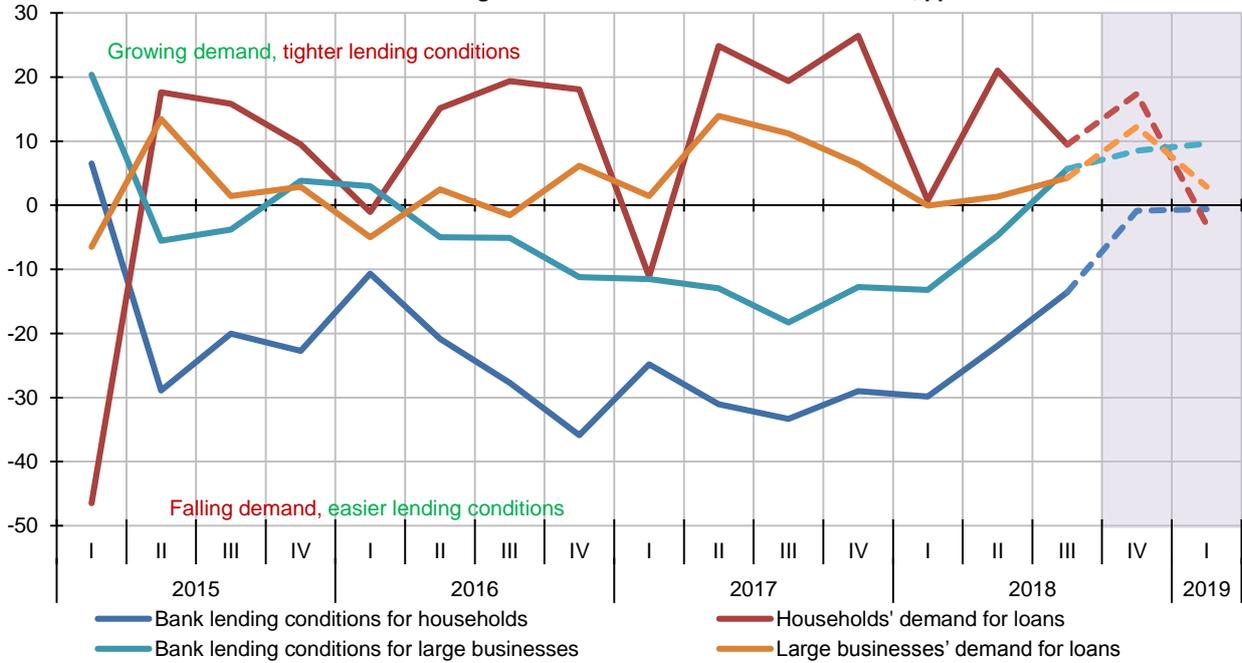


Source: Bank of Russia calculations

Chart 16

In 2018 Q3, demand for loans continued to grow

Lending conditions and demand for loans indices, pp



Source: Bank of Russia calculations