GLOBAL RISK REVIEW

JANUARY 2014

The year of 2014 started with contradictory trends in the world economy. The recovery of advanced countries did not reduce volatility in global financial markets. On the contrary, the expectations of tighter conditions in financial markets are seen to have a negative impact on emerging markets. The risks evolving during a long period of highly accommodative monetary policies pursued by the leading central banks are beginning to materialise as the global economy is entering a new phase of its development.

BANK OF RUSSIA FINANCIAL STABILITY DEPARTMENT

Major Developments in January 2014

16 January	The Bank of England announced the launch of Indexed Long-Term Repo (ILTR) operations as a new instrument to provide liquidity with a six-month maturity at lower rates and against a wider range of eligible collateral.
21 January	The IMF published its World Economic Outlook Update with updated forecasts of global economic growth.
28 January	The Reserve Bank of India raised the key interest rate (the repo rate) from 7.75% to 8%.
28-29 January	The Federal Open Market Committee (FOMC) of the US Federal Reserve decided at its policy meeting to reduce the monthly volume of its bond-buying stimulus programme from $75 billion to $65 billion.
29 January	The Central Bank of Turkey raised all of its main interest rates, hiking its one-week repo rate from 4.5% to 10%, overnight lending rate from 7.75% to 12% and overnight deposit rate from 3.5% to 8%. The regulator said in a statement that the one-week repo rate would now be used as the key indicator for investors.
29 January	The South African Reserve Bank raised the key interest rate (the repo rate) from 5% to 5.5%.
31 January	The European Banking Authority (EBA) preliminarily published the key parameters of the forthcoming stress test for the EU's banking sector.

Credit risks

The yields of ten-year government bonds showed mixed dynamics in January 2014. Bond yields in advanced countries were observed to decline whereas yields in emerging market economies were seen to increase due to capital outflow. The growth of borrowing costs in emerging market countries may accelerate further as interest rates rise in advanced countries. As a result, the countries that strongly need government debt refinancing will be confronted with rising expenditures and refinancing difficulties.

Market risks

The markets were highly unstable despite the improvement of macroeconomic forecasts for advanced countries. Weak data on business activity in the US and Chinese industries caused a fairly strong decline in stock indices worldwide, while depreciation of emerging market currencies was again registered on foreign exchange markets amid expectations of further cuts in the US monetary stimulus programme.

Liquidity risks

Money market rates in advanced countries remained steadily low. Nevertheless, the expectations of their rise are growing, considering that the US Federal Reserve again made a decision to further reduce its bond-buying stimulus programme, while all the signs in the UK indicate that the time for monetary policy tightening is approaching. At the same time, the ECB will most likely have to continue its stimulus policy to overcome the risks of falling inflation and make up for liquidity shortage resulting from the repayment by European banks of their long-term loans.

Capital flow risks

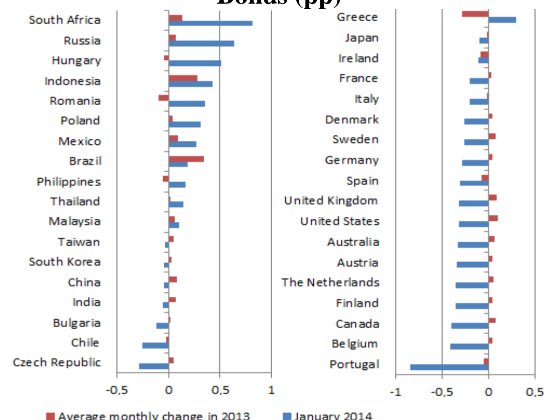
As the US Federal Reserve started to scale down its monetary stimulus programme, emerging market economies continued to experience outflow of funds from their assets.

Credit Risks

Risks of Higher Borrowing Costs in Debt Markets

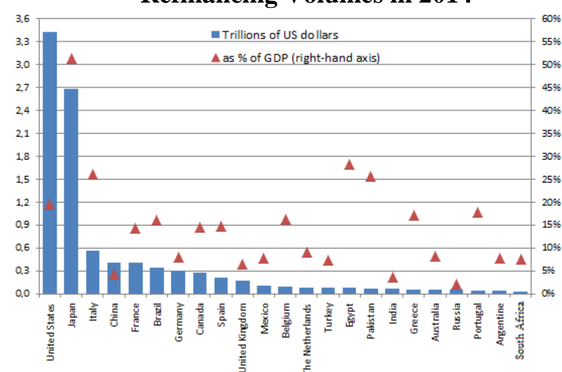
Risks associated with the growth of borrowing costs in debt markets are becoming increasingly essential as the US is tapering its bond-buying programme. The yields of 10-year government bonds of advanced countries were observed to decline in January whereas yields in emerging markets were seen to rise due to higher capital outflow (Chart 1). Emerging market countries may face a very substantial increase in borrowing costs when rates start to grow in advanced countries. In this situation, countries scheduled to make large government debt repayments may find it difficult to raise funds for government debt refinancing. Difficulties may arise for Brazil, which has to repay liabilities in 2014 equal to 16% of GDP, and also for Argentine (7.8% of GDP), Mexico (7.7% of GDP) and South Africa (7.5% of GDP) (Chart 2). China has the largest needs for government debt refinancing in absolute terms ($410 billion) but this indicator is relatively low with regard to its GDP (4.2%). Nevertheless, local banks in emerging market economies, as well as in advanced countries, will inevitably show strong demand for government bonds amid the shortage of liquid collateral and the tighter requirements for the size of liquid assets.

Chart 1. Yield Change of 10-Year Government Bonds (pp)



Source: Thomson Reuters Eikon

Chart 2. Countries with Largest Government Debt Refinancing Volumes in 2014

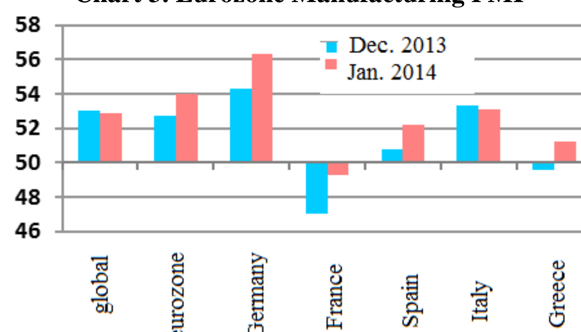


Source: IMF

Fiscal Risks in Eurozone

Despite the improvement of economic growth forecasts in eurozone countries, there are still serious risks for state finances. Multispeed economic recovery inside the euro area and the high likelihood of a recovery slowdown are the main sources of these risks. Germany remains the driver of economic growth, which can be evidenced by the Manufacturing Purchasing Managers' Index (PMI): it grew to 56.3 points in January 2014, the highest level since June 2011 (Chart 3). At the same tine, peripheral euro area countries continue to demonstrate weak economic growth and high unemployment. While fiscal consolidation programmes have been recognised as efficient, politicians in peripheral countries point to their excessively negative influence on the economy. In particular, the Greek government's measures to limit the excessive growth of its debt were accompanied by a 20% fall in GDP from 2010 to 2013 and the rise in unemployment from 13% to 28%. While an increasingly large number of countries are gaining access to markets, the situation still remains very unstable.

Chart 3. Eurozone Manufacturing PMI

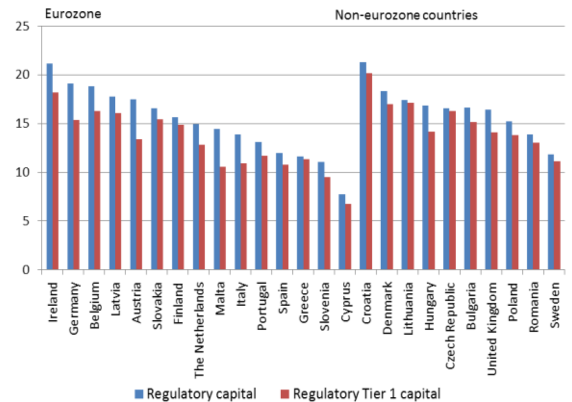


Source: Markit

European Banking Sector

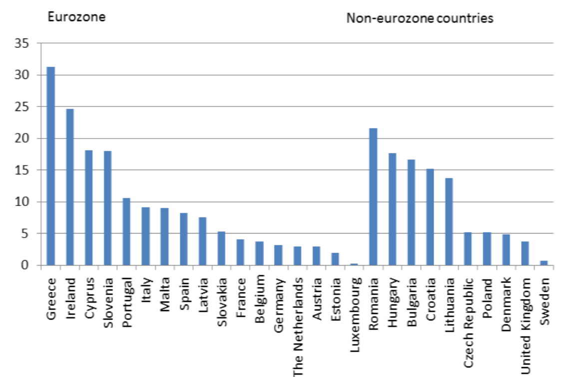
European regulators are continuing active work in banking regulation and supervision. In late January 2014, the European Banking Authority preliminarily published the key components of the forthcoming stress test for the EU's banking sector.[1] The stress test will help supervisors assess the resilience of Europe's 128 largest banks. The EBA's minimum Tier 1 capital will be set at 8% for the baseline scenario and at 5.5% for the adverse scenario. Many European banks are trying to improve their financial position ahead of the stress test (they are locking in losses, taking out new loans and strengthening their balance sheets). Nevertheless, the situation with low-quality loans is far from being ideal: calculations by Ernst&Young and PwC show that the volume of banks' problem loans in the EU grew by 100-120 billion euros in 2013 to 940-1,200 billion euros or about 8% of all loans issued by banks. Six countries account for the largest volumes of problem loans in absolute terms (over 100 billion euros for each of the following countries in descending order: Germany, the UK, Spain, Ireland, Italy and France). The risks of borrower defaults and, correspondingly, the risks of the deterioration in the quality of bank assets are especially significant in problem eurozone economies and some East European countries such as Greece, Ireland, Cyprus, Slovenia, Romania and Hungary (Chart 5).

Chart 4. Regulatory Capital in EU Countries
(as % of risk-weighted assets)



Source: IMF

Chart 5. Problem Loans in Total EU Loans, Including Eurozone



Source: IMF

[1] The final document specifying the methodology and stress test scenarios will be published in April 2014.

Market Risks

Risks of Declines in Emerging Market Stock Indices

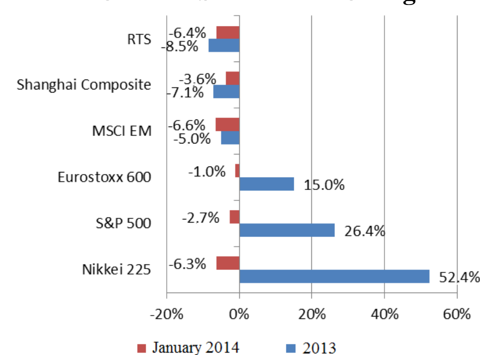
In January, the IMF raised its global economic growth outlook for 2014 to 3.7% (Table 1). As the recovery processes in advanced economies have intensified, international organisations are looking more optimistically at the prospects of the global economy since the 2008 crisis. Further recovery in advanced economies is expected to have a favourable effect on the leading stock indices, although the current indicators are not stable enough. The American S&P 500 Index demonstrated quite a strong decline after the release of weak January data on business activity in the US industry (the ISM Manufacturing Index fell to 51.3 points from 56.5 points in December 2013). The prospects of developing countries look less favourable (Chart 6), taking into account the market expectations that the US Federal Reserve will continue to scale down its asset purchase programme, and also due to the slower growth of Chinese economy. The annual growth of China's GDP slowed to 7.7% in the fourth quarter of 2013 from 7.8% in the third quarter, while the country's Manufacturing PMI calculated by HSBC/Markit fell from 50.5 points in December 2013 to 49.5 points in January 2014. This year, weak economic prospects in emerging market countries can be expected to continue exerting negative influence on local stock index dynamics.

Table 1. GDP Growth Forecast for 2014

Country	GDP growth estimate for 2013	GDP growth forecast for 2014 (as of January 2014)	Change in 2014 GDP growth forecast compared with October 2013 forecast
World	3.0	3.7	0.1
Advanced Countries	1.3	2.2	0.2
US	1.9	2.8	0.2
UK	1.7	2.4	0.6
Japan	1.7	1.7	0.4
Eurozone	-0.4	1.0	0.1
Emerging market economies and developing countries	4.7	5.1	0.0
China	7.7	7.5	0.3
India	4.4	5.4	0.2
South Africa	1.8	2.8	-0.1
Brazil	2.3	2.3	-0.2
Russia	1.5	2.0	-1.0

Source: IMF

Chart 6. Stock Index Change

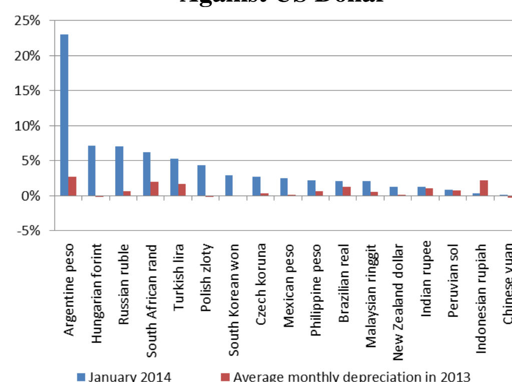


Source: Bloomberg

Emerging Market Currency Depreciation

In January 2014, emerging market countries witnessed a new wave of the depreciation of their national currencies, testifying to their high sensitivity to risks associated with the US Federal Reserve's monetary policy tightening. The most considerable currency depreciation in January 2014 was registered in Argentine, Hungary, Russia, South Africa and Turkey (Chart 7). In their attempts to limit the scope of devaluation, the central banks of Turkey and South Africa raised their key rates in January. The key rate was also increased in India, although there was no considerable fall in the exchange rate of the Indian rupee. The key rate had been raised on many occasions in the country lately as part of the efforts to bring inflation down to the target level. As a whole, the situation in India is improving: the current account deficit has been declining since the second half of 2013, although it is still considerable. Current account deficits and, correspondingly, high exposure to capital outflow risks are also typical of Brazil, Indonesia, India, Turkey and South Africa.

Chart 7. National Currency Depreciation Against US Dollar



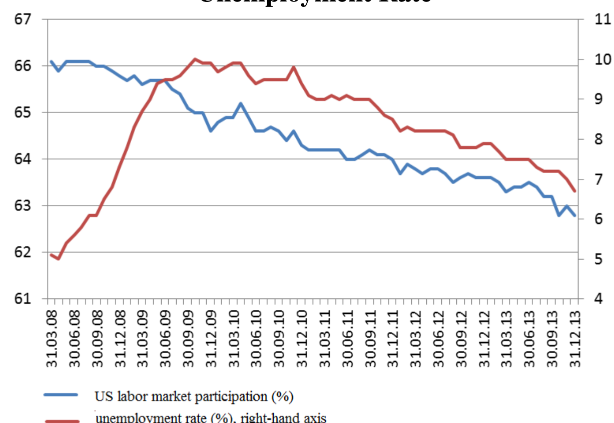
Source: Thomson Reuters Eikon

Liquidity Risks

The Fed's Further Stimulus Reduction

The US Federal Reserve continued to scale down its stimulus programme in January 2014. At the January 28-29 FOMC meeting, the Fed decided to reduce the monthly volume of the asset purchase programme from $75 billion to $65 billion. The regulator's decision was expected by most investors. At the same time, the Fed's assessment of the current state and the prospects of the US economy did not improve as labour market indicators were mixed. While the unemployment rate fell from 7% to 6.7% in December 2013 to a fresh low from November 2008, the US labor market participation was observed to decline (Chart 8). The number of jobs in the US economy rose by only 74,000 in December 2013 after their growth by 241,000 a month earlier (the minimum increase since January 2011). These trends, however, did not halt the process of the Fed's QE tapering. US Fed new head Janet Yellen who took office from February 2014 faces the uneasy task of continuing this policy without damaging the economy.

Chart 8. US Labor Market Participation and Unemployment Rate

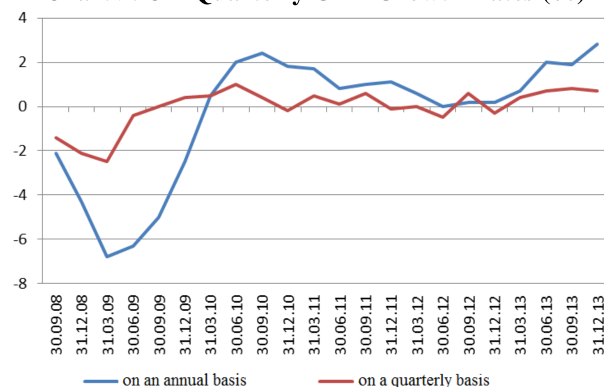


Source: US Labor Department, Bloomberg

Change in Bank of England's Forward Guidance

According to preliminary estimates, the UK GDP growth accelerated to 1.9% in 2013, the highest level since 2007. In 2013 Q4, the UK GDP increased by 0.7% quarter on quarter and by 2.7% year on year (Chart 9). The improving of the economic situation brings closer monetary policy tightening not only in the United States. The Bank of England is reluctant to start increasing interest rates, referring to the need of ensuring stable jobs growth. In February 2014, the Bank of England revised its forward guidance system, uncoupling the interest rate from unemployment. Meanwhile, the central banks of advanced economies are considering anti-crisis support measures. The Bank of England is implementing measures announced last year to maintain banking sector liquidity. In January, the Bank of England launched Indexed Long-Term Repo (ILTR) operations as a new instrument to provide liquidity with a six-month maturity at lower rates and against a wider range of eligible collateral. Liquidity will be provided through auctions, with the amount of liquidity available increasing automatically, if there is greater demand.

Chart 9. UK Quarterly GDP Growth Rates (%)

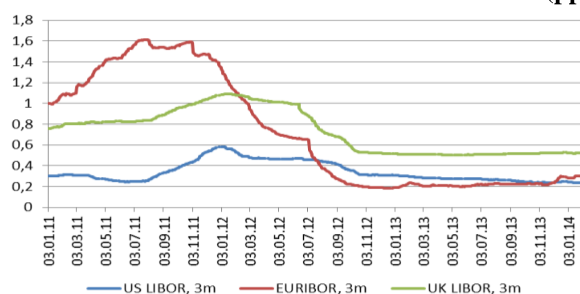


Source: Bloomberg

Eurozone Liquidity Risks

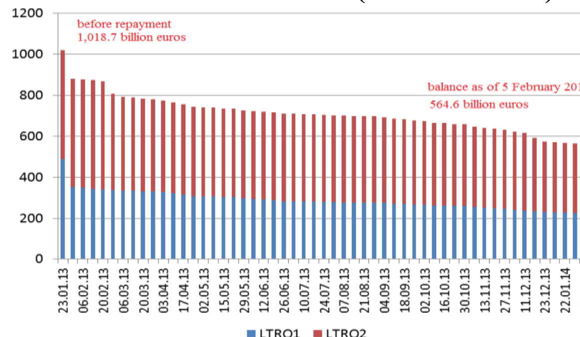
While money market rates in advanced countries have been steadily low (Chart 10), preconditions are emerging in the euro area for increased demand for liquidity. Money market participants are, first of all, cautious in the wake of QE tapering commenced by the US Federal Reserve. Meanwhile, liquidity in the European money market is actually shrinking as European banks have to repay three-year loans obtained at the ECB's two long-term refinancing auctions. The amount of outstanding loans has almost halved to 565 billion euros (Chart 11). Liquidity is declining amid the slowing growth of prices, which is falling to deflation in some problem eurozone countries (Chart 12). The declining rates of price growth are a signal of falling domestic demand in the euro area. In 2014, eurozone countries are characterised by low inflation rates: Eurostat preliminary estimates show that price growth equalled 0.7% on an annual basis in January 2014 compared with 2% in January 2013. Indicatively, even Germany as the eurozone's largest and most successful economy is demonstrating the inflation rate below the target of 2%. Germany's inflation amounted to 1.2% in December 2013, the slowest price growth in the country since 2010. ECB head Mario Draghi said that the eurozone may face a long period of low inflation. Therefore, a possible rise in money market rates in the wake of monetary policy tightening in the United States and, to all appearances, in the UK, the approaching dates of long-term loan repayments by European banks and the risks of a protracted period of low inflation in the eurozone may prompt the need for the ECB to implement additional stimulus measures already in the near future.

Chart 10. Three-Month Interbank Loan Rates (pp)



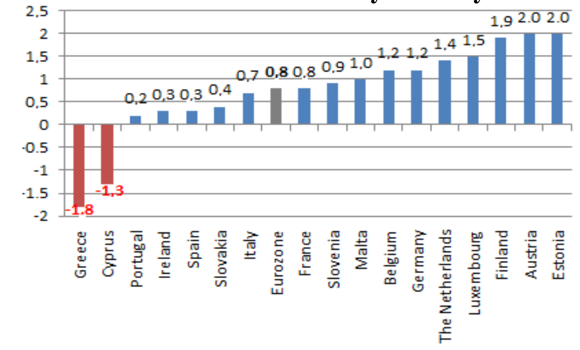
Source: Bloomberg

Chart 11. Outstanding Debt on Three-Year Loans from ECB's Two Auctions (billions of euros)



Source: Bloomberg

Chart 12. Eurozone Price Growth in December 2013 on an Annual Basis* by Country



*The data on Ireland are given as of November 2013

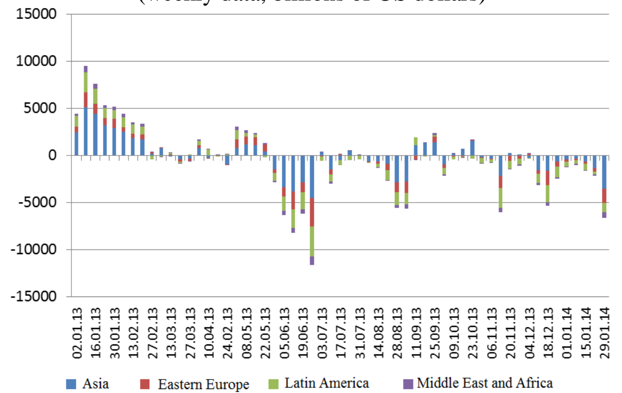
Source: Eurostat

Capital Flow Risks

Continued Emerging Market Capital Outflow

The direction of capital flows in international markets is changing as the Fed has started to scale down its QE programme. Investors are quitting emerging markets, preferring to invest in the assets of advanced economies. Net capital outflow from the emerging market securities funds totalled $11.3 billion in January 1-29, 2014, including $5.8 billion of capital outflow from Asian countries, $2.3 billion from Latin America, $2.3 billion from Eastern Europe and $900 million from the Middle East and Africa (Chart 13). Considering the prospects of policy tightening in advanced countries, on the one hand, and the weakness of many emerging economies, on the other hand, emerging market assets can hardly be expected to become increasingly attractive in the foreseeable future.

Chart 13. Investment in EM Equity and Bond Funds
(weekly data, billions of US dollars)

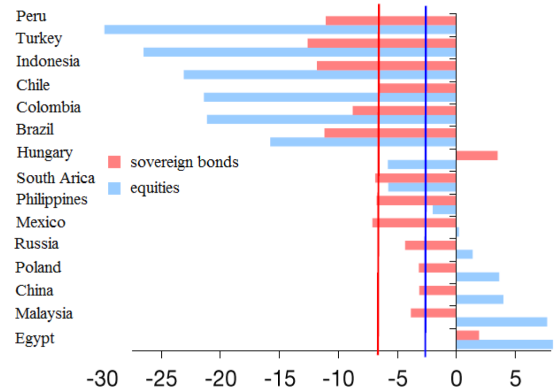


Source: EPFR

Shift in Investor Preferences Towards Advanced Countries' Equities in 2014

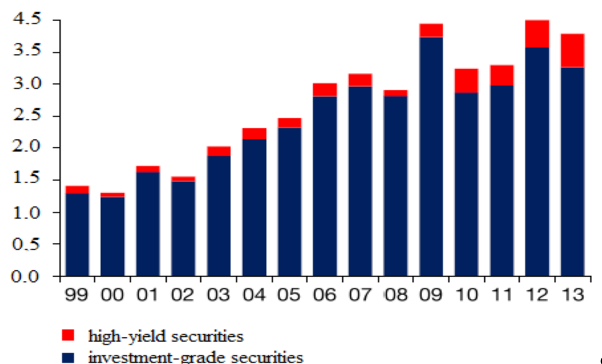
Amid the expectations of the Fed's monetary policy tightening, starting from QE tapering, investors have been seen not only to withdraw capital from the assets of emerging markets in favour of advanced countries but also to shift their preferences towards the equities of advanced economies. Investor losses from emerging market investments averaged 7% on sovereign bonds and 3% on equities in 2013 (Chart 14). The holders of corporate bonds, except for high-yield securities, also sustained losses. The global issue of high-yield corporate bonds reached a record $523 billion in 2013, exceeding the 2012 level by 20% (Chart 15). However, their attractiveness (with yields of 8% in 2013) is declining compared with the equities of advanced countries. Investments in the equities of advanced economies (the MSCI Index) produced yields of almost 30% in 2013. Bloomberg's January poll confirmed the shift in investor preferences towards equities: 53% of respondents expected this type of assets to bring the highest yields in 2014. Only 3% of those polled named bonds as the most attractive asset but 39% of the respondents expected the lowest yields from this investment. Real estate came second after equities as the most attractive asset (16% of the respondents).

Chart 14. Profit (Loss) from Investment in EM Bonds and Equities in 2013 (%)



Source: IIF

Chart 15. Global Volume of Outstanding Corporate Bonds, Including Finance Companies' Bonds (trillions of US dollars)



Source: IIF

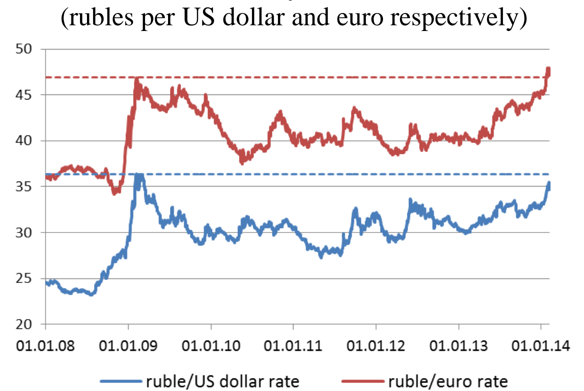
Current Global Risk Impact on Russia

Factors Influencing Ruble Exchange Rate Dynamics Amid Global Trends

The Russian foreign exchange market was among the leaders in volatility in January 2014: the ruble fell by 7% against the US dollar and by 4.4% against the euro (Chart 16). High volatility in Russia and some other emerging markets was mainly caused by investors' fundamental re-assessment of their risks and economic prospects. The ruble depreciated amid weak statisical data on Russia. Economic growth in Russia slowed from 3.4% in 2012 (an average of 4.1% for 2010-2012) to 1.3% in 2013. Russia's current account surplus more than halved in 2013 compared with 2012.

Chart 16. Ruble/US Dollar and Ruble/Euro Exchange Rate Dynamics

(rubles per US dollar and euro respectively)



Source: Bank of Russia

Assessment of Banking Sector Losses if Market Risks Materialise

In the current situation, emerging market countries are highly exposed to market risks. In the short term, bank losses may arise, first of all, from stock portfolio negative revaluations. According to Bank of Russia estimates, the Russian banking sector is generally resilient to stock market shocks. In a stress scenario envisaging a 20% fall in stock indices and the growth in government and corporate bond yields by 200 bp, stock portfolios may depreciate by 6% (Table 2). The banking sector's capital adequacy ratio is expected to fall slightly after the stress: from the actual level of 13.5% as of 1 January 2014 to 12.9%. Banks' exposure to foreign exchange risks can be assessed using revaluations of short open foreign currency positions (OFCP) in the short term and the estimate of losses from the growth of overdue debts in foreign currency in the medium term. According to Bank of Russia estimates, the Russian banking sector can resist a foreign currency shock via these channels (Table 3). The capital adequacy ratio for banks that are most of all exposed to risks related to OFCP revaluations and the growth of overdue debts in foreign currency is estimated to fall from 13.9% to 11.5%.

Table 2. Estimate of Banks' Stock Portfolio Depreciation from Materialised Market Risk and Its Impact on N1 Ratio

(as of 1 January 2014)

Shock parameters	Estimate of banks' stock portfolio deprecation, %	N1 after stress, %
Stock index fall by 20% Bond yield growth by 200 bp	-6.0	12.9

Source: Bank of Russia

Table 3. Estimate of Losses for 20 Largest Banks from Ruble's 20% Devaluation

(as of 1 January 2014)

Losses due to OFCP revaluation	122 billion rubles
Losses due to growth of overdue debts in foreign currency	94 billion rubles
TOTAL	216 billion rubles

Source: Bank of Russia