The Central Bank of
the Russian Federation

GLOBAL RISK REVIEW

In May 2014 decline in market volatility and return of capital to emerging markets reflected increasing optimism among investors. At the same time market participants take a relatively positive view of the ongoing US Federal Reserve discussions regarding the set of instruments that may be used during the upcoming monetary policy tightening cycle.

MAY 2014

Major events in May 2014

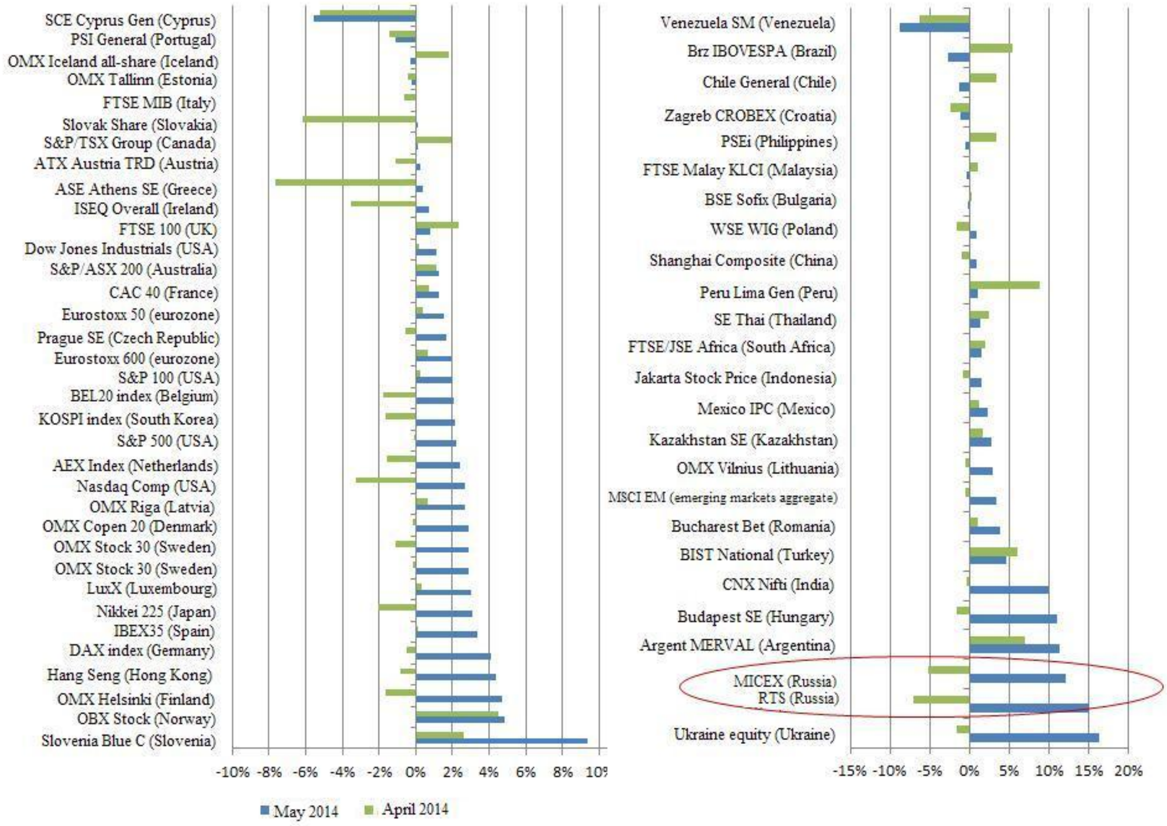
May 6	At the Eurogroup meeting, 10 European countries (Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Spain, and Slovakia) agreed on the phased introduction of a tax on financial transactions with equities and certain derivatives no later than January 1, 2016. It is expected that the specifics will be agreed upon by the end of 2014.
May 9	The China State Council published guidelines on capital market regulation that envisage the creation of a multi-tier capital market structure by 2020.
May 16	Ukraine placed $1 billion in 5-year US-backed foreign bonds at 1.844% p.a.
May 16	Chinese financial sector regulators – the People’s Bank of China (PBOC), the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), the China Insurance Regulatory Commission (CIRC), the State Administration of Foreign Exchange (SAFE) – have published a joint statement regarding tightened interbank lending requirements.
May 17	Moody’s upgraded Ireland’s long-term credit rating from Baa3 to Baa1 with a stable outlook based on the high growth rates of Ireland’s economy coupled with lower unemployment, smaller budget deficit, and the overall increasing stability in the eurozone.
May 21	EU countries (except the UK and Sweden) signed an intergovernmental agreement for the creation of the Single Resolution Fund (SRF), which will function jointly with the Single Resolution Mechanism (SRM) within the European banking union that is being created. According to the signed document, the fund will be financed by bank contributions. Each bank’s individual contribution shall be calculated according to the share of its liabilities in the total liabilities of all financial institutions in a given country, and taking into account each bank’s specific risk. The fund shall be formed over an 8-year period until it reaches the target level of 1% of all insured deposits of financial institutions operating within the banking union (approximately € 55 billion).
May 21	The heads of Russia’s Gazprom and China’s National Petroleum Corporation (CNPC) signed an agreement for natural gas supply to China via the eastern gas corridor. The 30-year contract with a total value of $400 billion envisages the annual supply of up to 38 billion cubic meters. The transaction was supported by each country’s top authorities. The head of the Russian Energy Ministry, Alexander Novak, stated that the supply of Russian gas to China can begin in 4-6 years.
May 22	A military coup was staged in Thailand, led by the Thailand Royal Army commander General Prayut Chan-Ocha following the introduction of martial law due to the ongoing political crisis. The 2007 Constitution was abolished.
May 23	S&P upgraded Spain’s long-term credit rating from BBB- to BBB with a stable outlook. The decision reflects the agency’s forecasts for accelerated economic growth and increased competitiveness of the country’s economy due to the structural reforms that have been undertaken since 2010. Fitch upgraded Greece’s long-term credit rating form B- to B with a stable outlook. The decision reflects the efforts of the Greek government to reduce the budget deficit and the emergence of favourable economic growth prospects for the first time since 2008.
May 25	Ukraine’s presidential elections were won by the former head of the National Bank of Ukraine (NBU), the former foreign affairs minister, the former minister for economic development, and the owner of the Roshen Confectionery Corp., Petr Poroshenko.

GLOBAL MARKETS

Stock markets

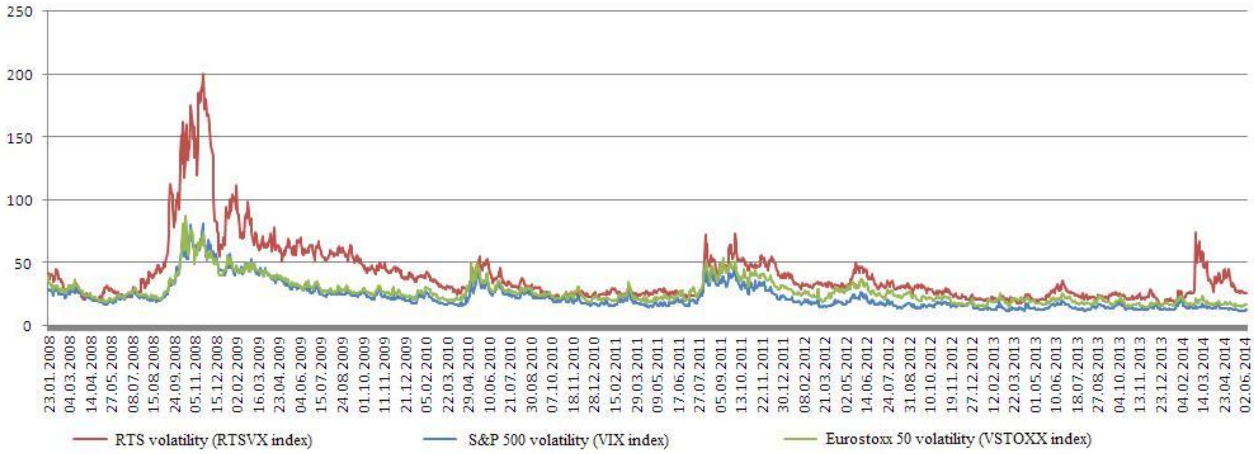
Stock markets in both developed and emerging market economies showed continued growth in May 2014 (Chart 1). The S&P 500 index reached a new high, while market participants continue to expect low volatility of US stocks prices (Chart 2). The Russian stock market indices, RTS and MICEX, grew by 15% and 12% respectively in May.

Chart 1. Stock indices in developed and emerging market economies in April-May 2014 (%)[1]



Source: Bloomberg.

Chart 2. Implied volatility of S&P 500, Eurostoxx 50, and RTS indices (%)



Source: Bloomberg.

[1] Here and further on, the breakdown of countries into developed and emerging market economies is done in accordance with the IMF classification.

Sovereign debt markets

The yields of sovereign bonds issued by the world's largest economies reached new lows in the wake of the latest statements by the heads of the leading central banks regarding continued monetary stimulus measures. It is expected that even despite the US monetary policy tightening, US 10-year Treasury yields shall remain below 2007-2008 averages (4.7%). Ten-year US Treasury and UK Gilt yields reached record lows for the past six months (2.5% and 2.6% respectively). The yield on the equivalent Bundesbonds reached a record low for the past year (1.4%) (Chart 5).

The cost of sovereign debt also continued to decline in peripheral eurozone countries, although the deterioration of a number of macroeconomic indicators (in particular those related to business activity) caused an increase in volatility (Chart 4). The overall improving economic growth prospects have led the leading rating agencies to raise the sovereign credit ratings of Spain and Greece.

Chart 3. 10-year government bond yields in developed economies in April-May 2014 (bp)

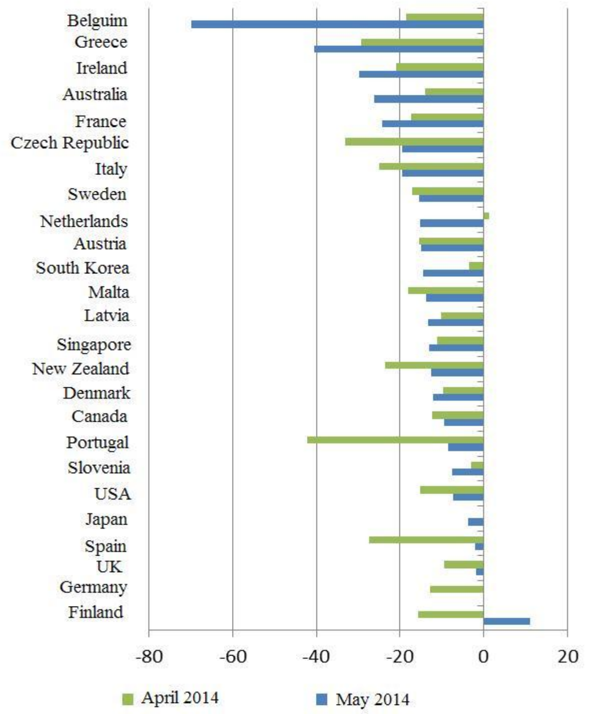
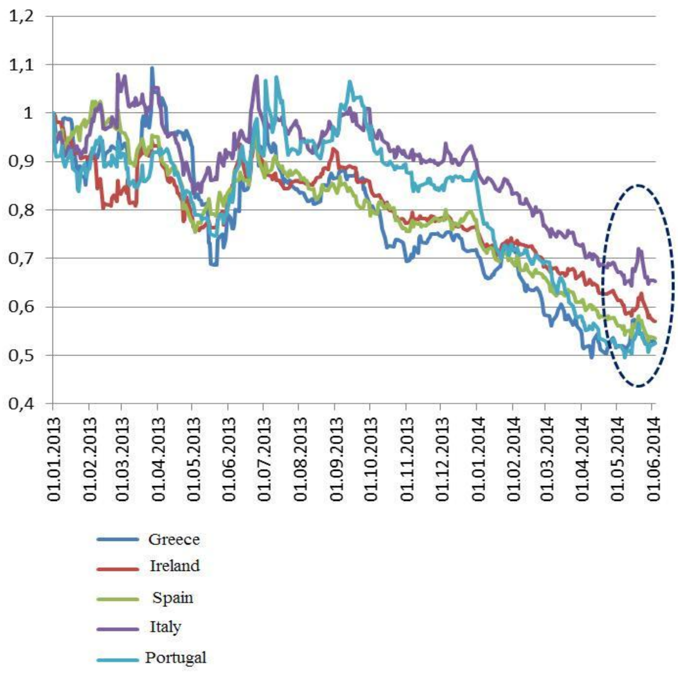


Chart 4. 10-year bond yield indices for peripheral eurozone countries (01.01.2013 = 1)



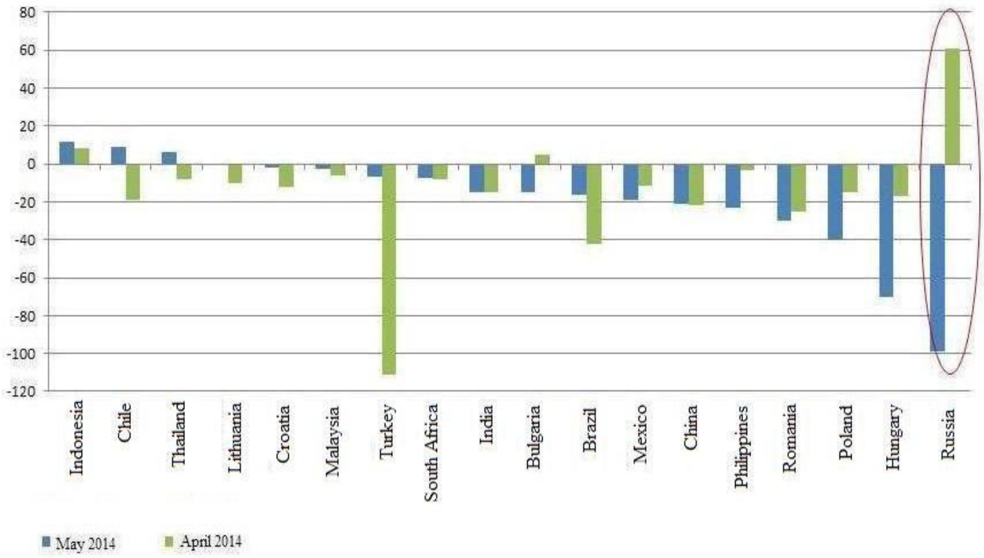
Source: Thomson Reuters Eikon.

Chart 5. 10-year US, UK and German government bond yields (%)

Source: Thomson Reuters Eikon.

The cost of sovereign debt also declined in most emerging markets (Chart 6). The most significant decline in 10-year government bond yields was observed in Russia: the yields on Russian 10-year federal government bonds dropped by almost 100 bp in May.

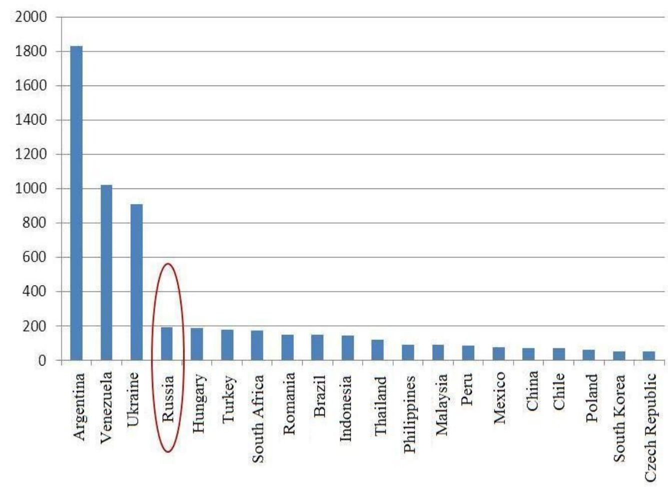
Chart 6. EM 10-year government bond yields in April-May 2014 (bp)



Source: Thomson Reuters Eikon.

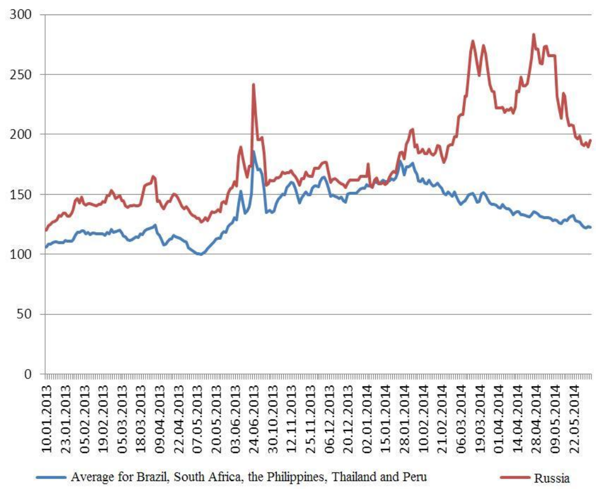
Argentina, Venezuela and Ukraine have the highest sovereign risks among emerging markets, as shown by the high cost of insurance against sovereign default reflected in credit default swap (CDS) premiums (Chart 7). Russia's CDS premiums increased during the peak of the Ukraine crisis but declined back to early 2014 levels in May and are gradually returning to the average level for countries with a similar credit rating (Chart 8).

Chart 7. EM 5-year CDS premiums (bp)



Source: **Bloomberg.**

Chart 8. 5-year CDS premiums for Russia and the average for countries rated BBB +/- 1 n. by S&P (Brazil, South Africa, the Philippines, Thailand, Peru), bp



Source: **Bloomberg.**

Corporate debt markets

Declining market volatility in May also led to declining corporate bond spreads relative to US corporate bond yields. The increase in Russian corporate spreads in January-April 2014 in the wake of the Ukraine crisis was effectively balanced out by the decline in May, and the respective JP Morgan CEMBI Broad Blended Spread index approached the average for emerging markets.

Chart 9. EM corporate bond spreads as of 02.06.2014 (bp)*

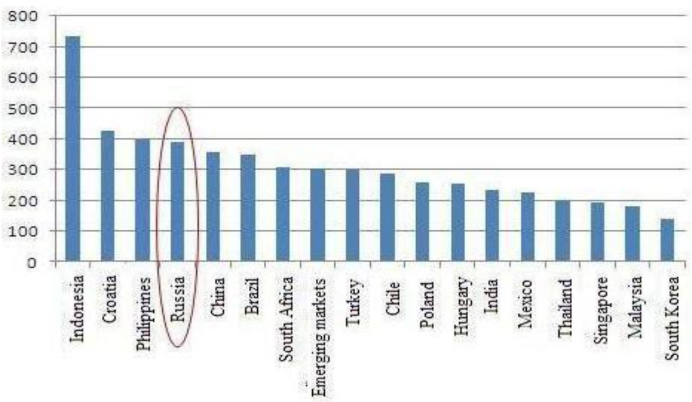
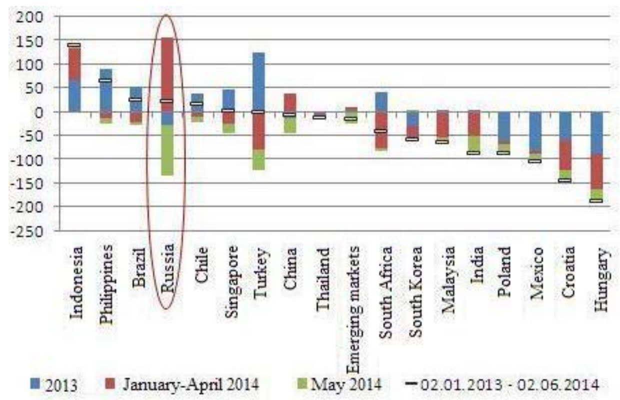


Chart 10. EM corporate spread changes (bp)*



The aggregate JP Morgan Corporate EMBI Broad Composite Blended Spread index for emerging markets and similar indices for specific countries.

Source: Bloomberg.

Source: Bloomberg.

Foreign exchange markets

Mixed trends in developed countries

The euro depreciation increased in May (by 2%) due to expectations regarding ECB policy related to additional stimulus measures. Prior to that, there had been no significant changes in the euro-dollar exchange rate despite the stimulus tapering in the US: the euro strengthened by 0.7% in January-April 2014.

In general, developed economy forex markets are witnessing mixed trends: on the one hand, the US dollar weakened relative to European currencies in view of the gradual start of European economic recovery between the beginning of 2013 and June 2014; on the other hand, the US dollar appreciated against the yen in the wake of the accommodative measures implemented by the Bank of Japan. Overall, the aggregate DXY index measuring US dollar performance relative to a currency basket comprising the euro, pound sterling, Swiss franc, Norwegian krone, Canadian dollar and Japanese yen, did not show significant changes in the above period. US dollar strengthening against the DXY basket amounted to only 0.7% from the beginning of the reduction of the Federal Reserve asset purchase program in 2014.

Chart 11. Key foreign exchange rates to US dollar

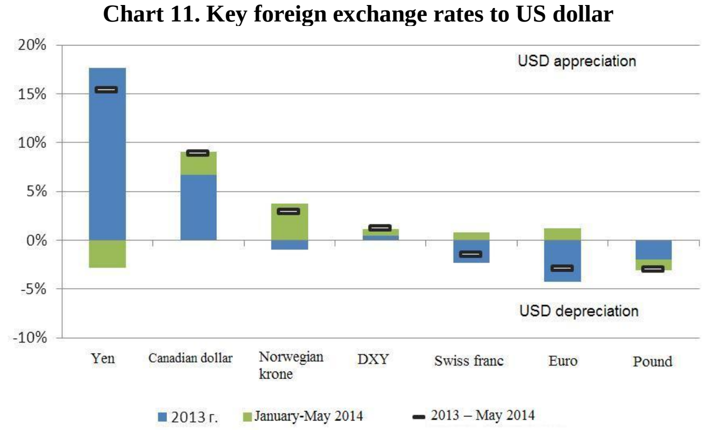
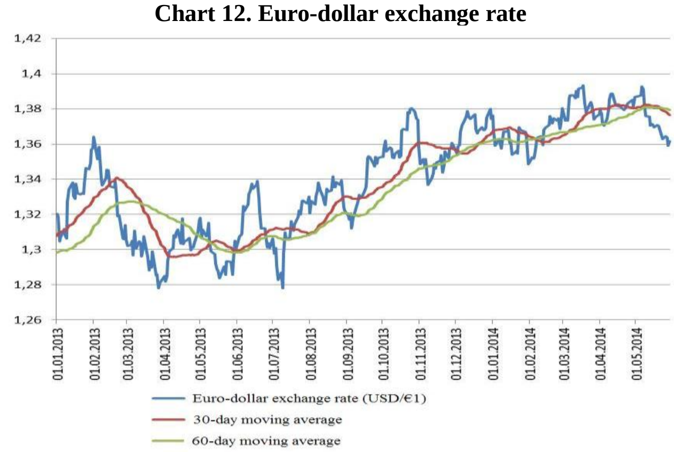


Chart 12. Euro-dollar exchange rate



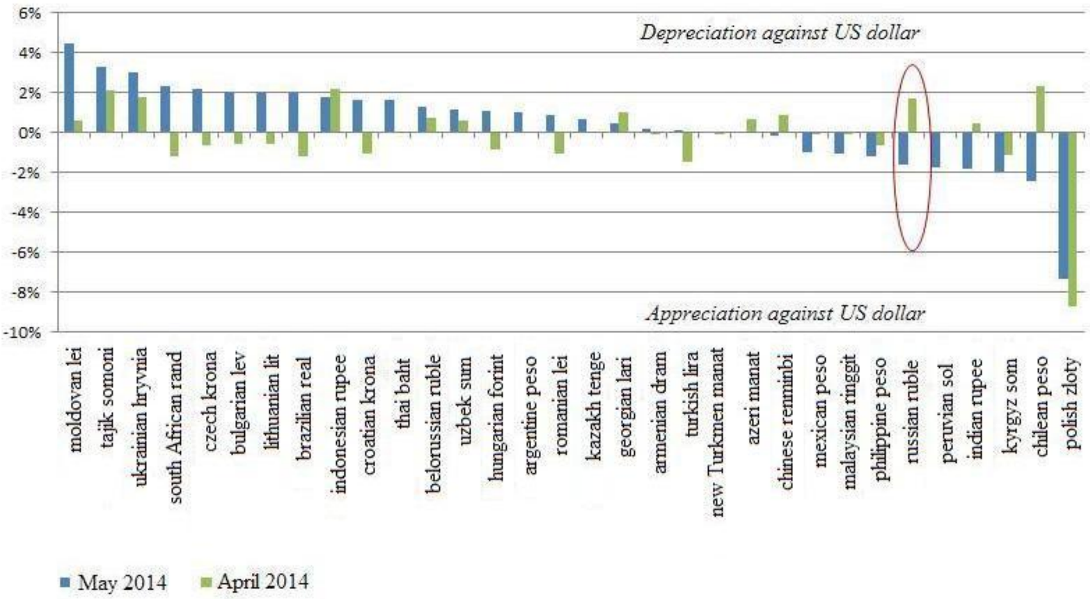
Source: Bloomberg.

Source: Bloomberg.

Decreased forex market volatility in emerging markets

Emerging market foreign exchange rates saw insignificant fluctuations in May, similar to the preceding month (Chart 13). The Russian ruble appreciated against the US dollar by 1.6% in May.

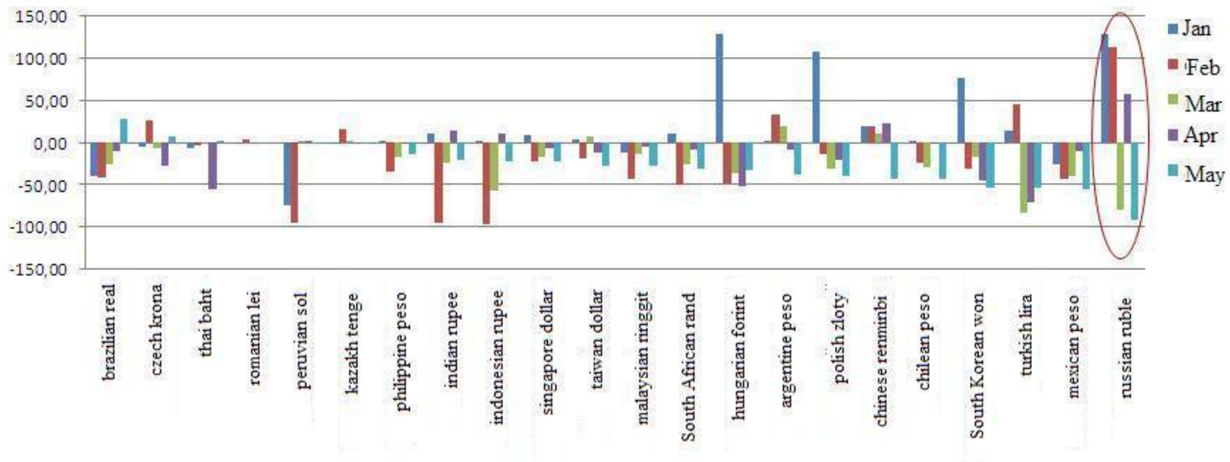
Chart 13. EM foreign exchange rates to US dollar in April-May 2014



Source: Thomson Reuters Eikon.

Forex markets in emerging market economies also experienced a decline in volatility reflected in the narrowing spread between implied 3-month call option volatility and implied 3-month put option volatility (Chart 14).

Chart 14. Spread between implied 3-month call option volatility and implied 3-month put option volatility for EM currencies paired against US Dollar in 2014 (bp)



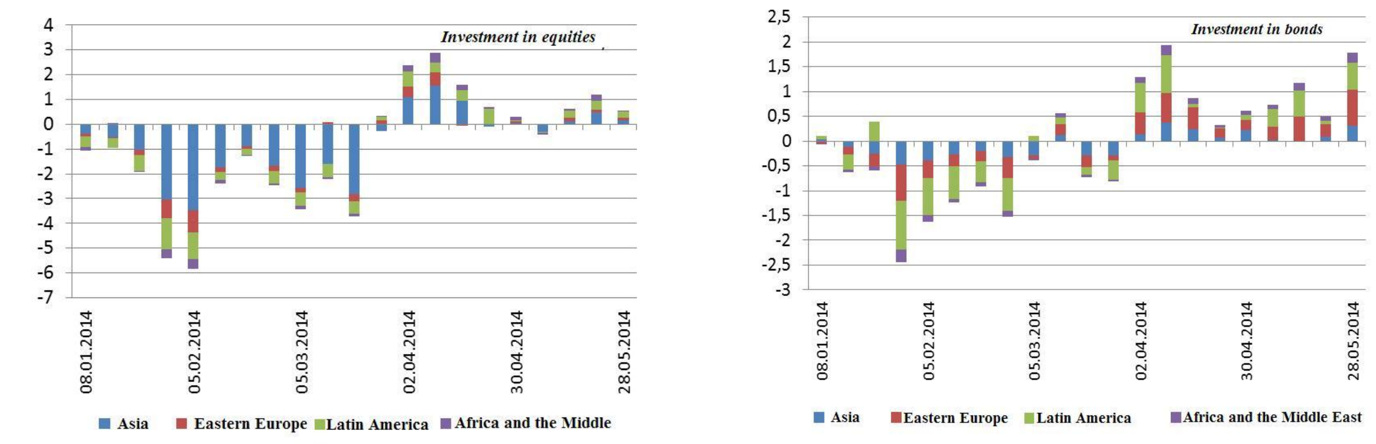
Source: Bloomberg.

International capital markets

Inflow of capital into funds investing in emerging market assets

May 2014 witnessed a continuing inflow of capital into funds investing in emerging market assets. Between April 30 and May 28, 2014, the net inflow of capital in Asian, Eastern European, Latin American, African and Middle Eastern equities and bonds amounted to $6.1 billion, including $1.9 billion invested in equities and $4.2 billion invested in bonds. Equity fund investors were targeting Eastern European (42%) and Latin American countries (36%). The largest volume of bond fund investments was made in funds targeting Latin America (45%) (Chart 15). The same period also witnessed a net inflow of capital into Russian equities and bonds amounting respectively to $167 million and $453 million.

Chart 15. Inflow/outflow of capital from EM investment funds (weekly data, $billions)



Source: EPFR.

Commodity markets

The agricultural commodity price trend reversed in May: the aggregate S&P GSCI Agriculture index declined by 6.7%. At the same time, industrial metal prices continued to grow, with the respective index increasing by 4.2% in May, driven by nickel, copper, and aluminium prices. The increase in metal prices is mostly due to market participants' fears regarding the sustainability of metal supply by key emerging market producers, including those in Russia. There were no significant changes in the precious metal and energy markets.

Chart 16. Commodity price changes*

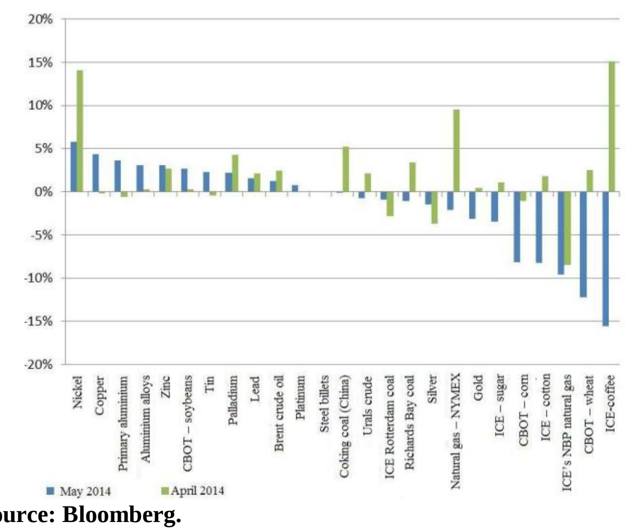
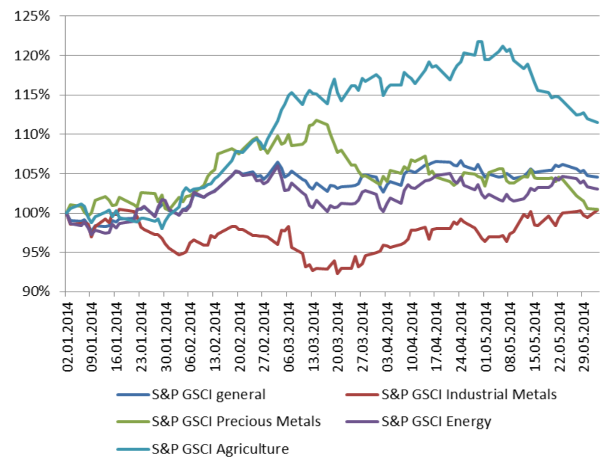


Chart 17. S&P GSCI in commodity markets by category (02.01.2014 = 100%)



Source: Bloomberg.

**Chart 16 shows Urals and Brent crude oil spot prices, spot coke prices (China); monthly ICE future contract prices for coal in Rotterdam and at Richards Bay; ICE and NYMEX future contract prices for natural gas for June 2014 delivery; spot prices for precious metals (gold, silver, platinum, palladium); the price for three-month forward contracts for base metals at the London Metals Exchange (primary aluminium and aluminium alloys, copper, zinc, nickel, lead, tin, steel ingots); the price for agricultural commodity futures for delivery in July 2014 (corn, wheat, soybeans, coffee, sugar, cotton).*

RISKS OF DEVELOPED COUNTRIES

USA

Inflation approaching target level

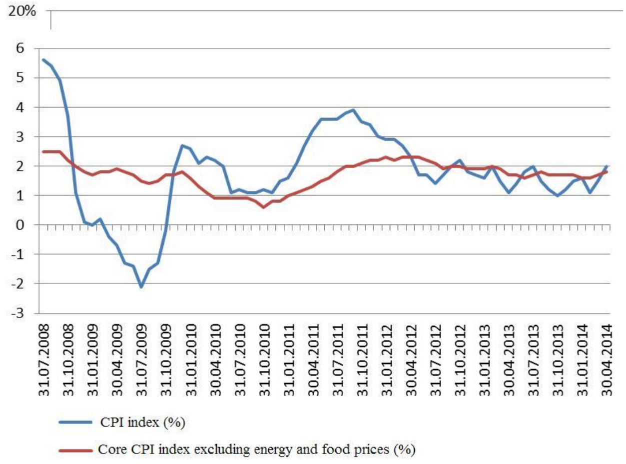
The US CPI index grew by 2% year-on-year in April 2014, the greatest increase since June 2013. The core CPI index (excluding energy and food prices) grew by 1.8% in April 2014 compared to April 2013 (Chart 18). Thus inflation approached the Federal Reserve target of 2%, which argues in favour of continued asset purchase reduction.

At the same time the US Department of Labor revised its estimate of the 1Q 2014 GDP growth rate downward, from an initial estimate of 0.1% augmentation to a 1% reduction. Sustainable economic growth in the US requires more robust salary growth and job creation compared to current indicators (Chart 19). Household spending makes up approximately 70% of the US GDP. In May Janet Yellen, the head of the Federal Reserve, stressed the important role small businesses play in the US economic recovery, as more than half of the jobs created since employment growth resumed in 2010 have emerged in companies with a total workforce of fewer than 250 employees.

The Federal Reserve has been increasingly signalling the end of the quantitative easing program this year. In her statement to the US Congress, Janet Yellen declared that the program would finish in late 2014.

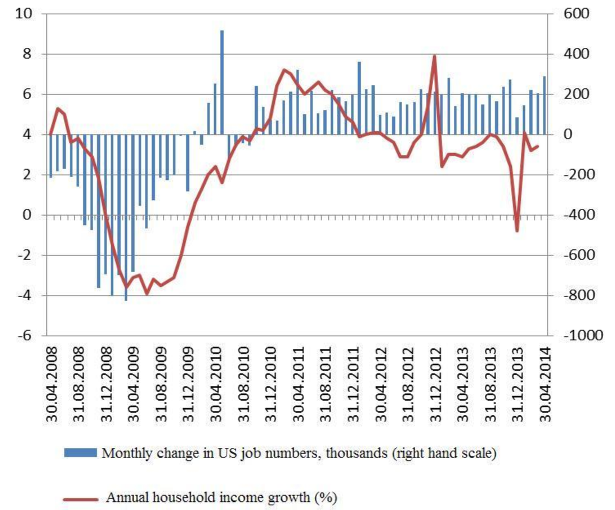
The Fed is also actively discussing further steps aimed at policy tightening considering the very high asset volume on its balance for the first time in history. In the April 29-30 FOMC meeting minutes published on May 21st, the Fed listed the instruments that could be used in various combinations as the monetary policy stabilizes. In addition to the federal funds target rate, the toolkit includes the interest rate on excess reserves, fixed-rate overnight reverse repo transactions, forward reverse repo transactions, and Federal Reserve term deposits.

Chart 18. Annual changes in the US Consumer Price Index



Source: Bloomberg.

Chart 19. Annual household income growth rates and change in job numbers in the US economy



Source: Bloomberg.

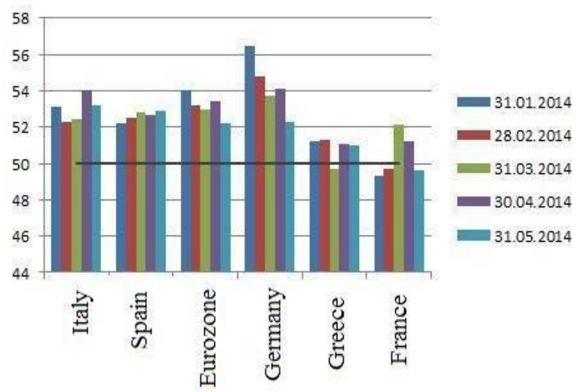
Europe

Slowdown in industrial production growth

The eurozone industrial production volume shrank in March 2014 by 0.3% month-on-month and by 0.1% year-on-year. The most significant month-on-month increase was registered in Ireland (+5.6%) while the most significant decline happened in Portugal (-4.8%). The March volume fell by 0.2% month-on-month in Germany, by 0.7% in France, by 0.6% in Spain and by 0.6% in Italy.

Manufacturing PMI (Purchasing Managers Index), the

Chart 20. Manufacturing PMI change



Source: Bloomberg.

aggregate business activity index, declined from 53.4 points in April to 52.2 points in May, with decreases registered in both Germany (down to 52.3 points) and France (down to 49.6 points). Business activity in manufacturing declined in France for the second consecutive month (Chart 20). Moreover, the index of investor and analyst expectations regarding the German economy over the next six months (confidence index) calculated by the ZEW research institute fell from 43.2 points in March to 33.1 points in April. The index reached a record high of 62 points in December 2013 but has been declining since then.

Low inflation risk and accommodative measures

According to Eurostat estimates, the eurozone consumer price inflation declined from an annualized 0.7% in April 2014 to 0.5% in May (Chart 21). Given these developments, the ECB decided at its meeting in early June to continue with policy easing: the key refinancing rate has been lowered from 0.25% to 0.15%, a negative deposit interest rate (-0.1%) has been set for the first time in history, and plans have been announced for several rounds of long-term targeted refinancing operations.

A protracted period of low inflation may put negative pressure on the eurozone economy, complicating the recovery in peripheral economies, among other things. The negative impact will be greater in case of mutual reinforcement of the lower inflation expectations and declining lending volumes. Furthermore, many eurozone countries are still experiencing a high debt burden.

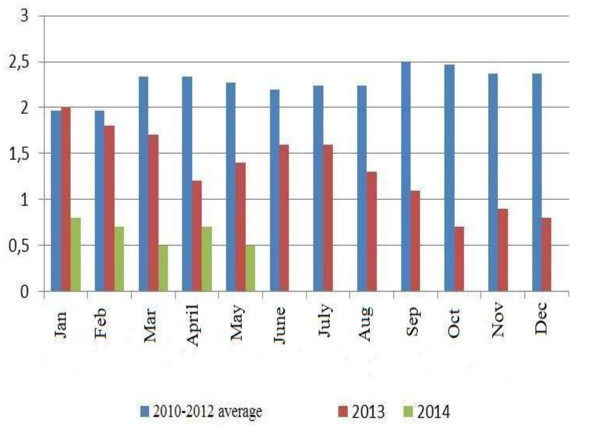
However, the aggregate business and consumer confidence index for the eurozone economy and the consumer confidence index are showing positive trends at present (the aggregate index grew to 102.7 points and the consumer confidence index improved to -7.1 points in May) (Chart 22).

UK

Key macroeconomic indicator forecasts

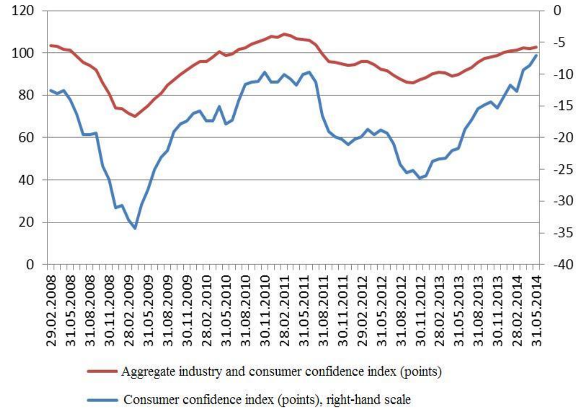
The Bank of England presented new GDP, inflation and unemployment estimates in its 1Q 2014 inflation report (Table 1). The UK economic situation continues improving. GDP growth for 1Q 2014 has amounted to 0.8% quarter-on-quarter and to 3.1% year-on-year (the best result since 4Q 2007). It is expected that inflation in the next two years will be slightly below the 2% target and unemployment will further decline from 6.8% as of 1Q 2014 (the lowest rate since the beginning of 2009) to 5.9% in 2Q 2016. Market participants don't expect the Bank of England to raise the interest rate until 2Q 2015.

Chart 21. Eurozone inflation (HICP all items index), %



Source: Eurostat.

Chart 22. Eurozone economy confidence indices



Source: Bloomberg.

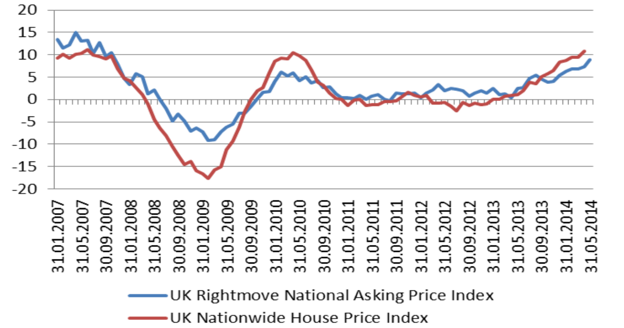
Table 1. Key UK macroeconomic indicator forecast (May 2014)*

	Actual	Forecast		
	1Q2014	2Q2015	2Q2016	2Q2017
Annual GDP growth rate (%)	3,1	2,9	2,8	3,0
Unemployment rate (%)	6,8	6,1	5,9	5,9
Annual CPI increase (%)	1,6	1,7	1,9	2,0

**Based on market expectations regarding interest rate changes and continued asset purchase volume of GBP 375 billion.*

Source: Bank of England.

Chart 23. Annual UK real estate price growth rates (%)



Source: Bloomberg.

Main threat comes from the overheated real estate market

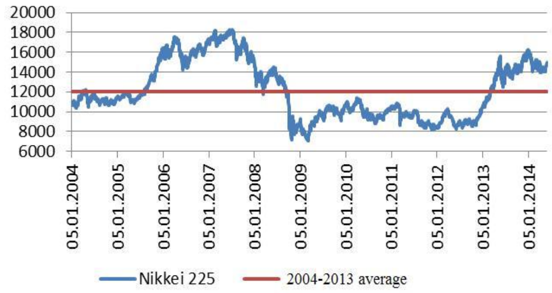
The Bank of England is increasingly concerned about the real estate market. Mark Carney, the Governor of the Bank of England, stated in May that the growth of real estate prices exceeding 10% (Chart 23) is a major threat to financial stability and economic recovery in the UK. In case of a continuing risk growth, the Bank of England may undertake various measures including an increase in mortgage loan loss provisions and introducing DTI and LTV limits. The Bank of England may also recommend that the government abandon or limit the housing Help to Buy Scheme.

Japan

Risk of declining banking sector profitability

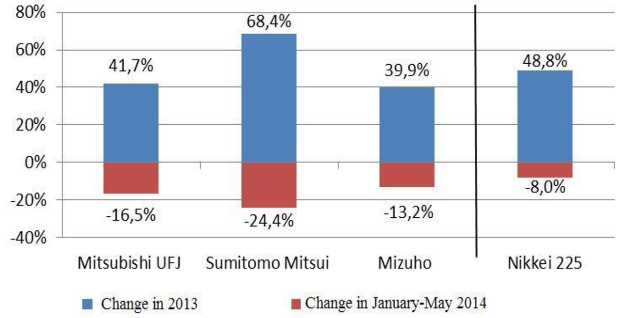
Japanese banks received significant profits for the fiscal year ending March 31 2014 as stock market indices reached a 6-year high (Chart 24). The net profit at Mitsubishi UFJ, Japan's largest bank by market capitalization, increased by 15.5% and amounted to JPY 984.8 billion, while profits at Japan's second and third largest banks, Sumitomo Mitsui and Mizuho, grew by 5.2% to JPY 835.4 billion and by 22.8% to JPY 688.4 billion respectively. However, falling stock prices may result in a downward revaluation of securities portfolios and declining profits in the current fiscal year. The Nikkei 225 index fell by 8% in January-May 2014 while Sumitomo Mitsui stock lost 24.4% of its value, Mitsubishi UFJ stock lost 16.5% and Mizuho stock lost 13.2% (Chart 25). Moreover, low lending interest rates are coupled with declining net interest margins at Japanese banks, which totalled only 1.32% (Chart 26).

Chart 24. Nikkei 225 index



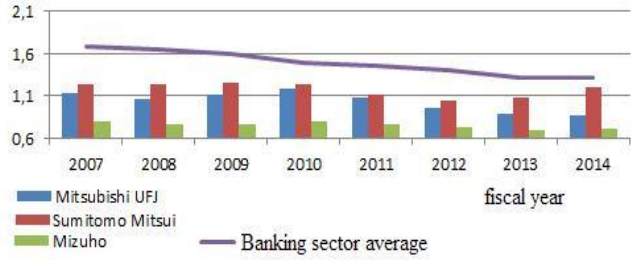
Source: Bloomberg.

Chart 25. Stock prices for Japan's largest banks by market capitalisation



Source: Thomson Reuters Eikon.

Chart 26. Net interest margin* (%)



* The net interest margin is the ratio of the margin between a bank's interest (commission) income and expenses to its interest-bearing assets.

Source: Thomson Reuters Eikon.

RISKS OF EMERGING MARKET COUNTRIES

China

Decline in industrial production

China's Manufacturing PMI index calculated by HSBC/ Markit increased to 49.7 points in May due to some growth in industrial order books. This is a positive sign. At the same time the indicator remains below the neutral 50-point mark, signifying reduced production activity. China's export growth rates remain low (Chart 27) despite the weakening Renminbi raising exporter competitiveness.

Lending market outlook

China's financial regulators continue tightening requirements applicable to the banking sector: 1) banks must report detailed information about interbank transactions; 2) the volume of loans granted to any financial institution must not exceed 50% of Tier I capital while interbank borrowings must not exceed one-third of the bank's total liabilities; 3) accounting requirements for non-standard loans on banks' balances, often consisting of loans to trust companies (a key "shadow" banking sector funding mechanism), have been tightened; 4) repo and interbank market transactions guaranteed by third-party banks have been banned; 5) all data on interbank transactions must be stored at the bank's head office.

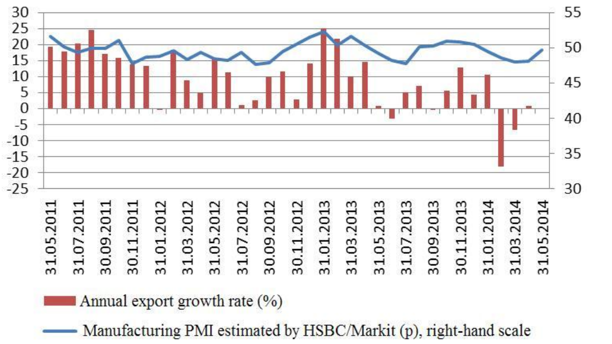
The measures adopted by the Chinese financial sector regulators have a positive effect limiting the "shadow" banking sector. Annual growth rates for non-bank financing declined from 36% in April 2013 to 19% as of the end of April 2014 (Chart 28). Annual lending growth rates for lending by banks and non-bank financial institutions, reflected by the Total Social Financing indicator, amounted to 16% in April, the lowest level since the end of 2005.

At the same time, despite the tightening banking sector policy, China's money market rates are not showing significant fluctuations and are below the 2013 average levels (Chart 29).

Potential risks of key banking sector indicators' deteriorarion

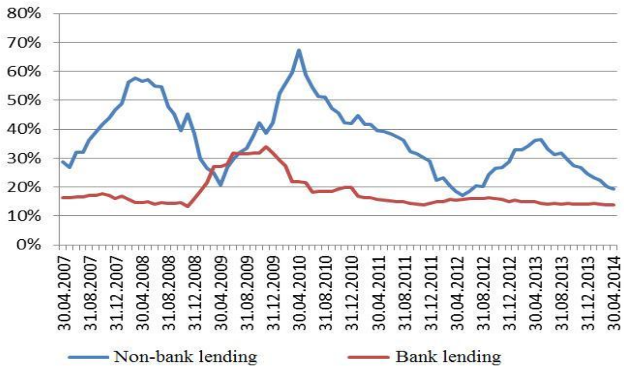
China's banking sector is witnessing an increase in the share of "bad" loans. According to the China Banking Regulatory Commission (CBRC), the share of problem loans increased from a minimum of 0.94% in March 2012 to 1.04% as of the end of March 2014. While this is a low level by international standards, problem loans amount to a significant volume in absolute terms, totalling Renminbi 646.1 billion ($104 billion). A further increase in the share of problem loans may lead to a

Chart 27. China's PMI trends and annual export growth



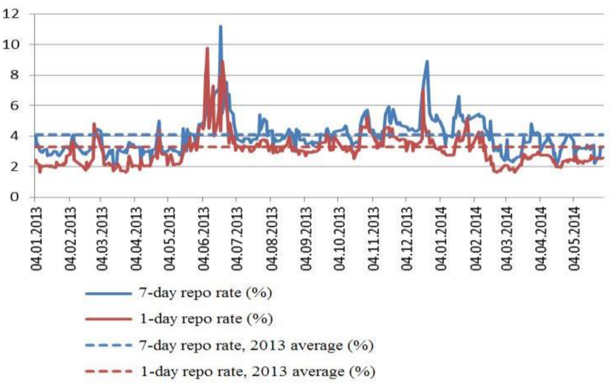
Source: Bloomberg.

Chart 28. Annual bank and non-bank lending growth (%)



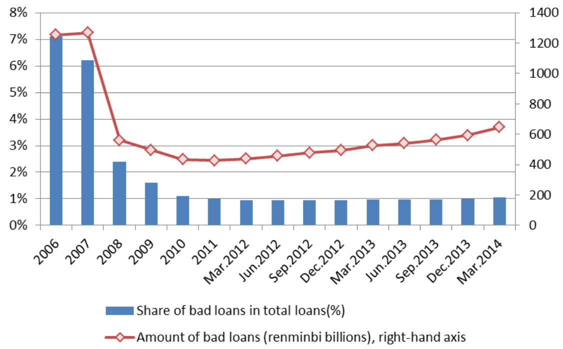
Source: Bloomberg.

Chart 29. China interbank lending rate



Source: Bloomberg.

Chart 30. The volume and share of "bad" loans in China's banking sector



Source: CBRC.

decrease in Chinese bank capital adequacy. According to the PBOC Financial Stability Review, a fivefold increase in the volume of problem loans will cause a decrease in the capital adequacy of China's 17 systemically important banks from 12% as of year-end 2013 to 10.5%.

Other emerging markets

Risks of economic growth slowdown or reversal

The decrease in domestic demand and industrial production is affecting economic growth in a number of emerging markets, resulting in a downward revision of economic forecasts for the current year by national regulators.

South Africa showed a GDP decline for the first time since 2009: the indicator declined by 0.9% in annualized terms in 1Q 2014 due to a decline in mining output and in industrial output in general. The South African Reserve Bank revised the 2014 economic growth forecast from 2.6% to 2.1%.

Thailand's GDP fell by 2.1% quarter-on-quarter and by 0.6% year-on-year in 1Q 2014 due to a decline in domestic demand and investments. The country witnessed continuing anti-government protests for more than half a year and a military coup in May. The 2014 GDP growth forecast has been revised from 3-4% down to 1.5%-2.5%.

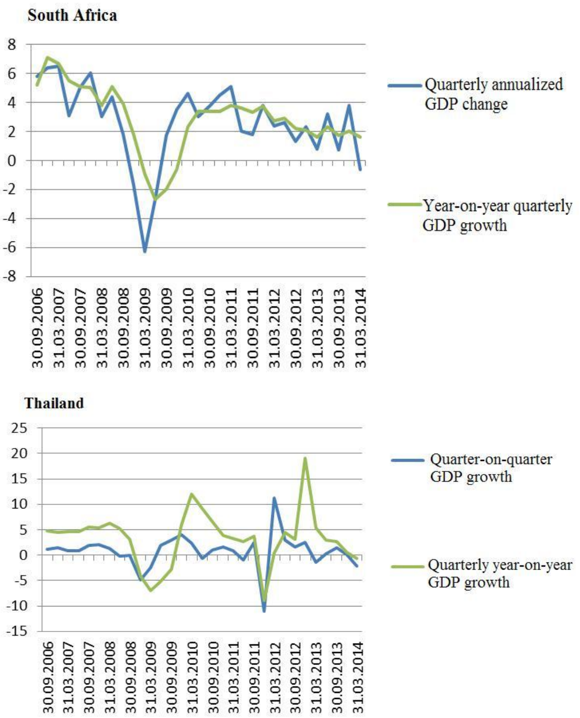
Central Bank of Mexico lowered the country's 2014 economic growth forecast from 3-4% to 2.3%-3.3%.

Ukraine

Ukraine banking sector risk assessment

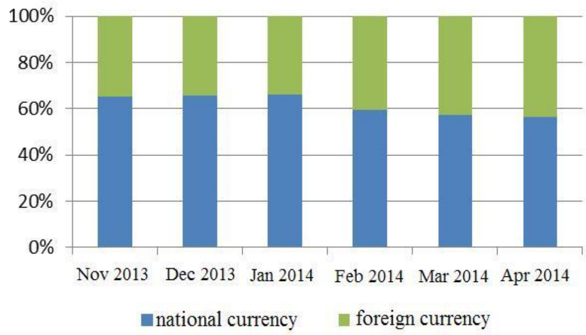
The Ukrainian banking system growth prospects continue to be bleak. Moody's review indicates the risk of an increasing share of problem loans as one of the key banking sector risks considering the high proportion of foreign exchange-denominated loans (Chart 32). Problem loans in the Ukrainian banking sector amounted to 37.5% of capital and 13.3% of total loan volume in 1Q 2014 (Chart 33). Further growth in problem loans in 2014 cannot be ruled out in the wake of the hryvnia devaluation (by 44.4% in January-May 2014) that significantly affected borrower debt servicing capacity. Moody's estimates that banks will need to make additional provisions amounting to 19% of the gross loan portfolios in order to cover the expected losses in 2014.

Chart 31. GDP growth in selected countries (%)



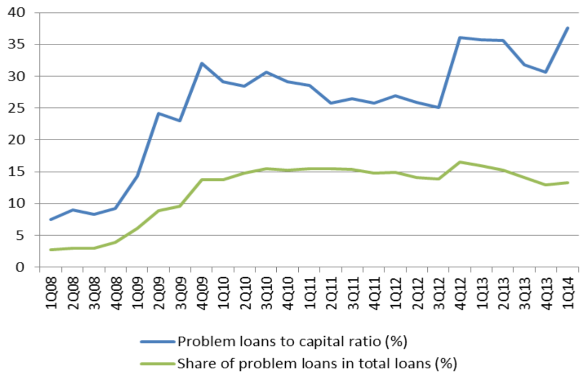
Source: Bloomberg.

Chart 32. Currency breakdown of loans to non-financial sector borrowers



Source: National Bank of Ukraine (NBU).

Chart 33. Problem loans at Ukrainian banks



Source: NBU.

Outlook for key economies

The quarterly Bloomberg Global Investor Poll[2] held in late April 2014 shows international investors' optimism regarding global economic prospects, albeit to a lesser extent compared to early 2014 due to the Ukraine crisis, fears regarding deflation in Europe, and a number of other risks.

According to 40% of the respondents, the global economy is improving (compared to 59% in January, the highest level since the end of the global recession in 2009), while 43% regard the outlook as stable and 12% noted a deterioration.

The favourable global economic prospects are primarily due to the improving economic outlook in the US. It is expected that US assets will be the most attractive investment targets over the next year, followed by the EU where the economy is also expected to recover. Only 13% of investors included Japan on the list of the best investment markets compared to 23% in January 2014 and 33% in May 2013.

Almost half of the participants believe that the Chinese economic outlook is deteriorating.

[2] The poll is held on a quarterly basis starting from October 2009 among traders, bank employees and asset managers who use Bloomberg terminals.