The Central Bank of
the Russian Federation

GLOBAL RISK REVIEW

The global financial markets have stabilised but the risks of further volatility are still high. The US is demonstrating moderate growth rates, despite improvements achieved on the labour market. The eurozone continues to experience some problems, including low inflation, high unemployment and considerable levels of budget deficit and government debt. China is still confronted with high uncertainty over the impact of financial policies on economic growth while the Ukraine crisis negatively affects the prospects of Central and East European countries.

APRIL 2014

Major events in April 2014

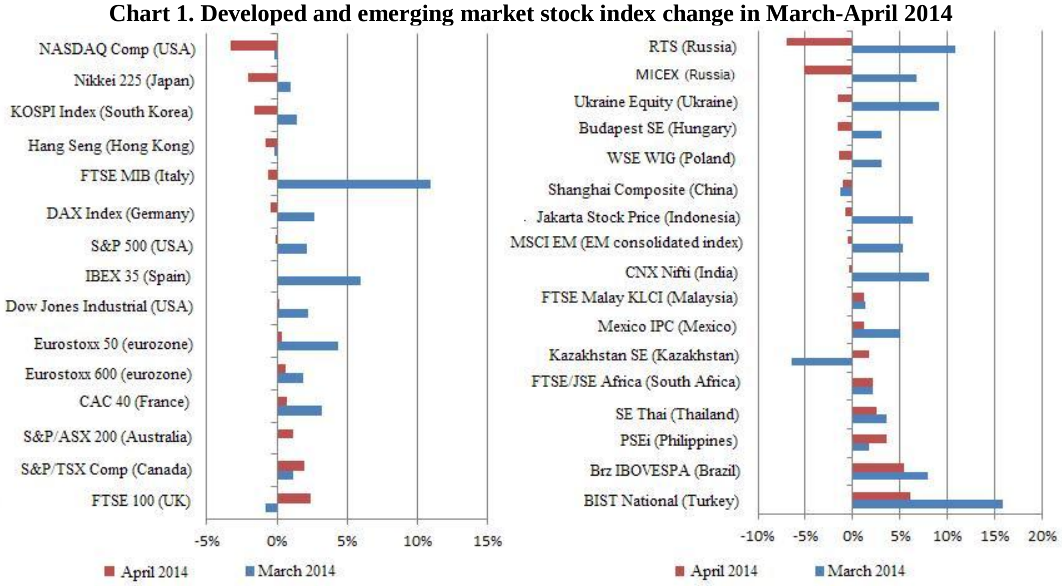
1 April	Eurozone finance ministers (the Eurogroup) agreed to disburse the next €8.3 billion loan tranche to Greece.
3 April	The Central Bank of Brazil raised the key interest rate by 25 basis points to 11%.
4 April	The international rating agency Moody’s downgraded Ukraine’s sovereign credit rating by one notch to Caa3 over the country’s weakening fiscal strength.
8 April	The US Office of the Comptroller of the Currency (OCC), the US Federal Reserve System (the Fed) and the Federal Deposit Insurance Corporation (FDIC) set the leverage ratio for large bank holding companies at 5%. The requirement will come into force from January 1, 2018.
14 April	The US signed a $1 billion loan guarantee agreement for Ukraine allowing the government to issue Eurobonds worth this amount.
15 April	The National Bank of Ukraine (NBU) implemented some interest rate policy measures, including the decision to raise the discount rate to 9.5% from 6.5%.
25–29 April	The international rating agency S&P downgraded the sovereign rating of the Russian Federation and the credit ratings of VTB Bank and the Russian six largest companies to BBB- from BBB.
29–30 April	The Federal Open Market Committee (FOMC) of the US Federal Reserve decided at its policy meeting to reduce the monthly volume of its quantitative easing programme by $10 billion to $45 billion.
30 April	The Executive Board of the International Monetary Fund (IMF) approved the disbursement of a $17 billion loan to Ukraine.

GLOBAL MARKETS

Stock markets

Trends on the stock markets of both developed and emerging market countries were less favourable in April 2014 than in the previous month, although stock index fluctuations were not too strong (Chart 1). In April, Russia's RTS and MICEX stock indices fell by 7% and 5%, correspondingly.

Chart 1. Developed and emerging market stock index change in March-April 2014



Source: Thomson Reuters Eikon.

Sovereign bond markets

The debt markets of advanced economies registered some decline in the cost of sovereign borrowings. The yields of 10-year government bonds issued both by key economies (the USA, Canada, the UK, Germany, France, Australia and Japan) and eurozone peripheral countries (Italy, Spain, Portugal and Greece) fell by 10-60 bps in April (Chart 2) amid the persistence of relatively good macroeconomic indicators. The spread between the yields of 10-year US Treasuries and German bonds reached the highest level for almost the past eight years amid expectations that the ECB would maintain its key rate at a record low for a long period.

While the US Federal Reserve keeps trimming its quantitative easing programme, investors continue to show strong demand for US Treasuries. According to data released by the US Department of Treasury, the investor bid book exceeded the amount of bond placements by about three times at auctions held since the beginning of 2014 (the same trend was registered in 2013).

Chart 2. Developed markets' 10-year government bond yield change in March-April 2014 (bp)

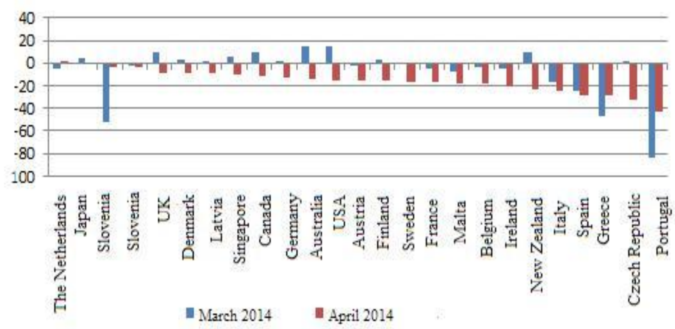
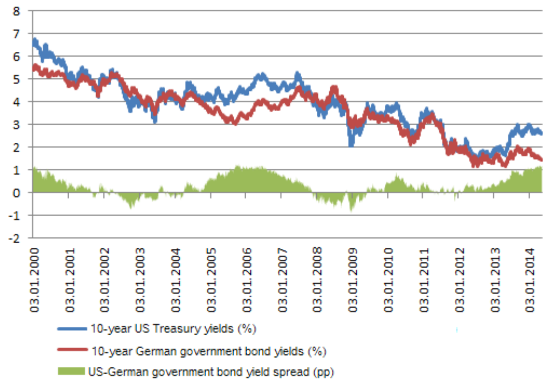


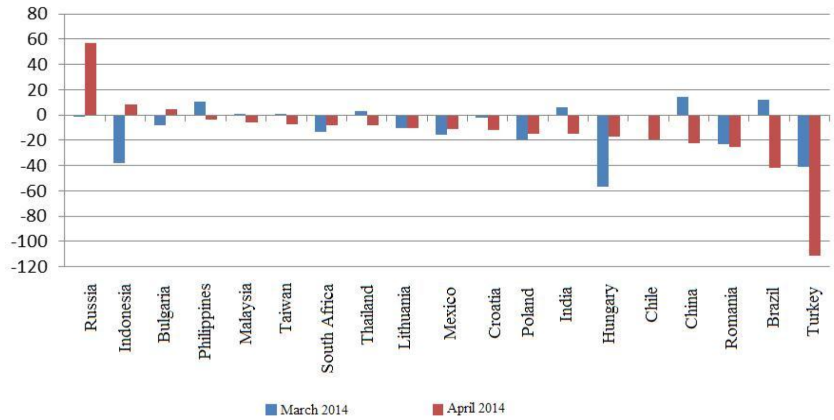
Chart 3. 10-year US Treasury and German bond yield spread



Source: Thomson Reuters Eikon.

The yields of 10-year government bonds in most emerging market economies were also observed to decline, with the largest yield fall registered in Turkey (Chart 4). The yields of Russia's 10-year federal loan bonds grew by 57 bps in April.

Chart 4. EM 10-year government bond yield change in March-April 2014 (bp)



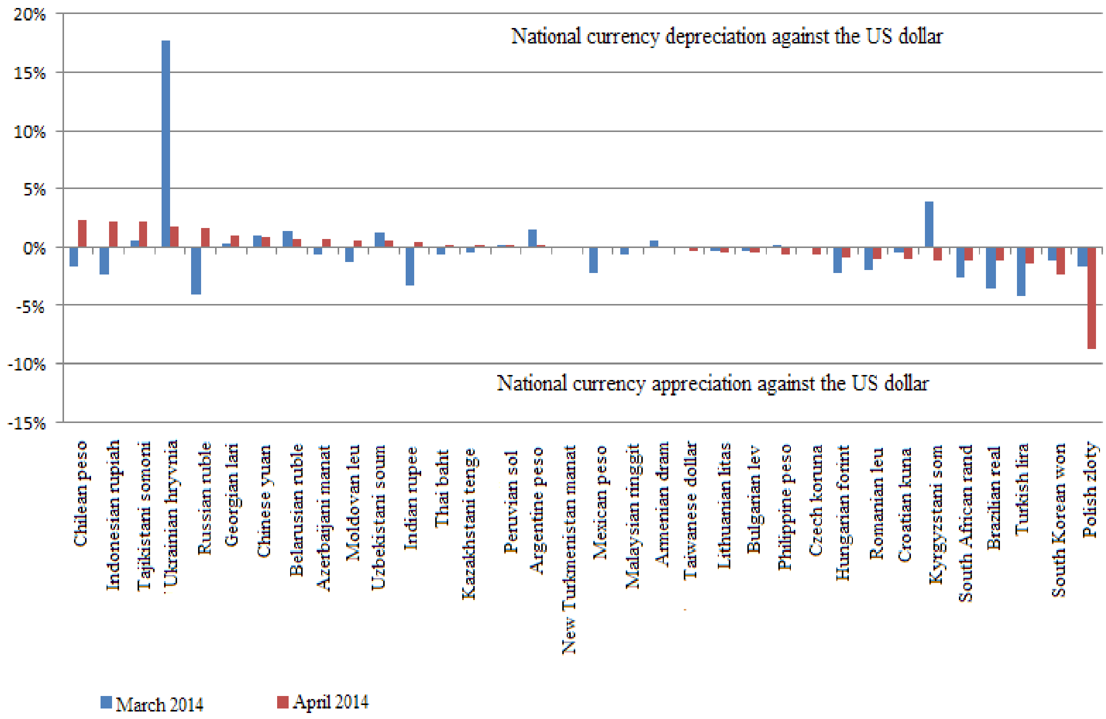
Source: Thomson Reuters Eikon.

Foreign exchange market

Stabilisation of emerging market exchange rates

Emerging market currencies were less volatile against the US dollar in April than in the previous month (Chart 5). The Ukrainian hryvnia, the leader in depreciation in March, fell by only 1.8% in April, despite the persistently complex political and economic situation in the country. The Russian ruble weakened by 1.6% against the US dollar in April.

Chart 5. EM exchange rate change to US dollar in March-April 2014



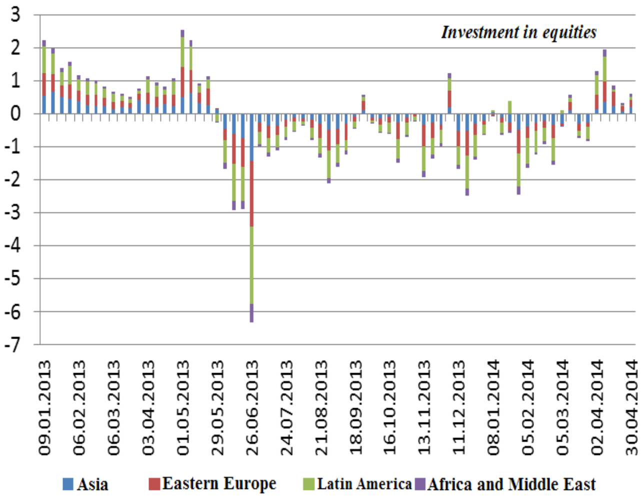
Source: Thomson Reuters Eikon.

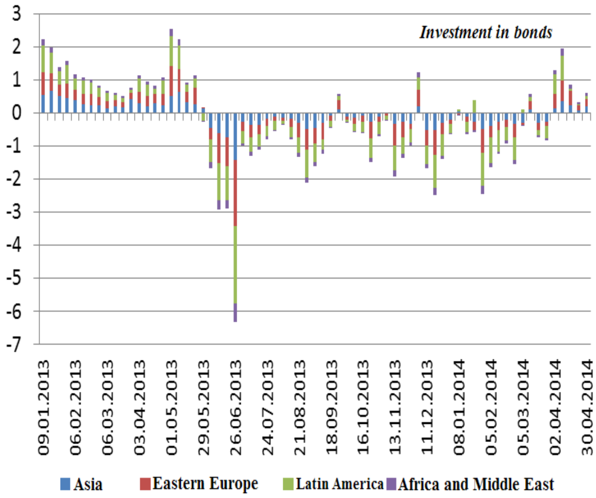
International capital markets

Capital inflow in emerging market assets

In April 2014, capital outflow from funds investing in emerging market assets gave way to capital inflow amid a calmer market situation. From March 26 to April 30, 2014, net capital inflow in Asia, Eastern Europe, Latin America, Africa and the Middle East totalled $12.7 billion, of which investments in equities amounted to $7.7 billion and investments in bonds equalled $5.0 billion. Asian countries accounted for almost a half of investments in equity funds while capital inflow into bond funds was distributed relatively evenly among the regions (Chart 6). Over this period, the funds investing in Russian equities and bonds registered a net inflow of $0.51 billion and $0.45 billion, respectively.

Chart 6. Capital inflow/outflow from funds investing in EM assets
(weekly data, billions of US dollars)





Source: EPFR.

Commodity markets

In April 2014, the global commodity markets did not register any significant fluctuations (Chart 7). Industrial metal prices slightly increased (Chart 9) as a result of higher nickel, zinc and lead prices, although the S&P GSCI Industrial Metals Index continues to demonstrate negative dynamics since early 2014, while the most rapid growth has been registered in agricultural prices.

The prospects of the precious metals market look ambiguous. Gold prices were observed to grow until recently as the US Federal Reserve carried out several rounds of its quantitative easing programme but this trend was reversed in 2013. However, the growth of gold prices resumed from early 2014 amid the Ukraine crisis.

Chart 7. Commodity price change in Q1 2014 and in March and April 2014 (%) *

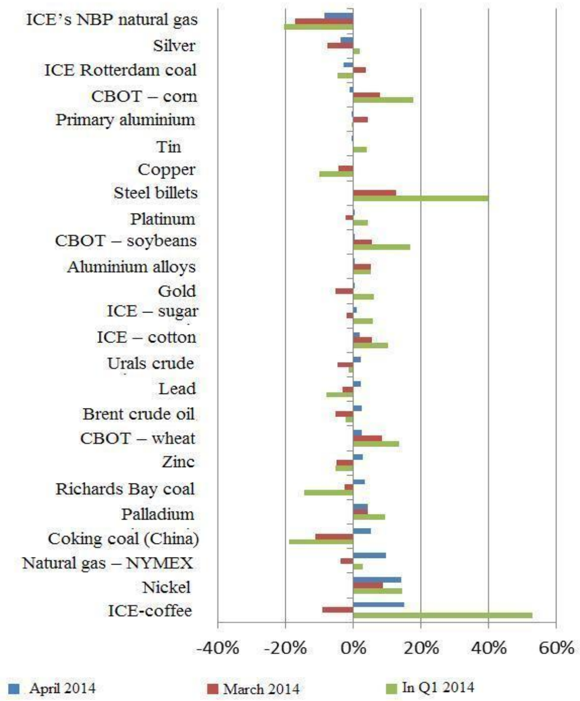
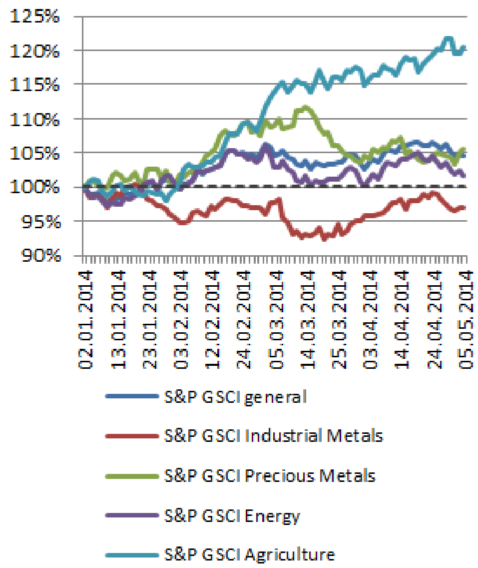


Chart 8. S&P GSCI by category (02.01.2014 = 100%)



Источник: Bloomberg, Thomson Reuters Eikon.

** Chart 7 shows the spot prices of Urals and Brent crude oil; the spot price of coking coal (China); the prices of monthly future contracts on the ICE Rotterdam and Richards Bay coal; the prices of future contracts on the ICE and NYMEX natural gas for delivery in June 2014; the spot prices for precious metals (gold, silver, platinum, palladium); the price of three-month forward contracts on base metals at the London Metal Exchange (primary aluminium, aluminium alloys, copper, zinc, nickel, lead, tin, steel billets); the price of agricultural commodity futures for delivery in July 2014 (corn, wheat, soybeans, coffee, sugar and cotton).*

RISKS OF DEVELOPED COUNTRIES

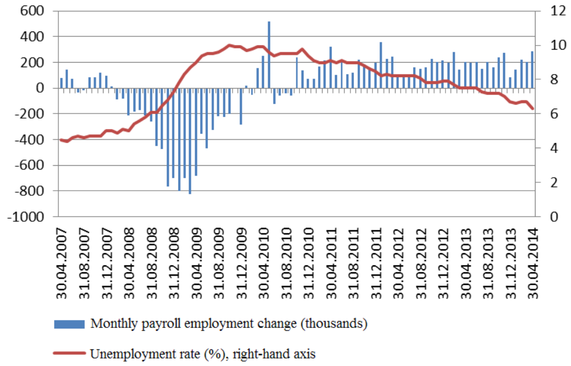
USA

QE tapering

According to the US Department of Commerce preliminary estimates, the US GDP grew by just 0.1% in January-March 2014 on an annualised basis due to the extreme cold weather. Nevertheless, the US Federal Reserve took a decision to continue tapering its quantitative easing programme. The Federal Open Market Committee (FOMC) decided at its policy meeting on April 29-30 to cut the volume of its monthly bond purchases by $10 billion for the fourth consecutive time to $45 billion. From May 2014, the Fed has cut the monthly purchases of Treasury bonds from $30 billion to $25 billion and mortgage-backed securities from $25 billion to $20 billion.

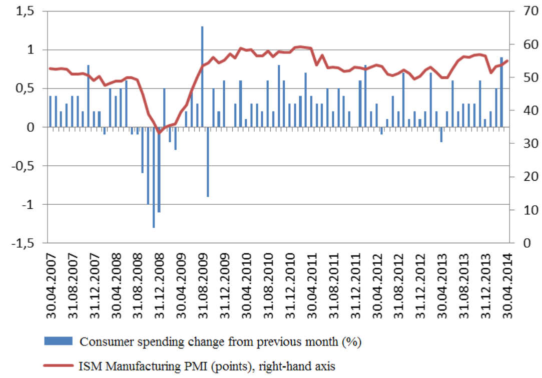
The decision on further stimulus tapering was made taking into account the continued improvement in the labour market and a rebound in consumer sentiment. The US unemployment rate fell to 6.3% in April, the lowest level since September 2008, while the number of new jobs rose by 288,000 (Chart 9). Consumer spending surged by 0.9% in March from the previous month, demonstrating the fastest growth since August 2009. Manufacturing production was also observed to increase. The US ISM Manufacturing PMI rose to 54.9 points in April (Chart 10). Therefore, many indicators point to the potential for further US economic recovery.

Chart 9. Monthly payroll employment change and unemployment rate



Source: Bloomberg.

Chart 10. Consumer spending change and ISM Manufacturing PMI



Source: Bloomberg.

Improvement in banking sector sustainability

The US regulators are tightening the prudential capital requirements for large bank holding companies (Box 1) to enable them to cope with potential crises in future without government assistance. The Fed, the OCC and the FDIC have set the leverage ratio at 5%, well above the 3% threshold required under the Basel III. The banks' compliance with the new regulatory requirements may restrict the growth of banking operations but the risks are limited. Citigroup, State Street Corp. and Bank of America Corp. have already announced that their leverage ratios correspond to the 5% requirement. According to data of the US Federal Reserve, the US 18 largest banks have raised additional capital worth over $500 billion since 2008.

Box 1. US Leverage ratio requirements

1) The minimum leverage ratio for the US biggest bank holding companies with more than $700 billion in consolidated total assets or more than $10 trillion in assets under custody and assets held by their depository institution subsidiaries covered by the FDIC deposit insurance system is set at 5%.

2) Depository institution subsidiaries of large bank holding companies must maintain a minimum leverage ratio of 6%.

3) The compliance with the leverage ratio standard will allow large US banks to avoid restrictions on payments to shareholders and bonus payments.

4) The new requirements will come into force from January 1, 2018.

Europe

Eurozone economic trends: key risks

The eurozone economy grew by 0.2% in January-March 2014 compared with the previous quarter and by 0.9% compared with the same quarter of the previous year. Among the eurozone member states, Germany posted an economic growth of 0.9% compared with the previous quarter while GDP in France remained unchanged and in Italy and Portugal it shrank by 0.1% and 0.7%, respectively.

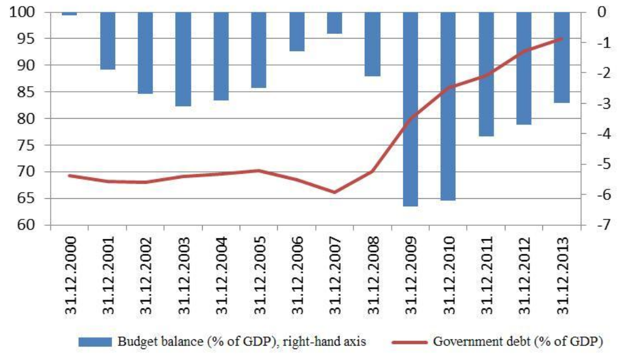
The weak GDP growth data indicate that downside risks continue to persist in the eurozone economy. These risks include a longer period of low inflation, high unemployment, weak domestic demand, insufficient implementation of structural reforms, weaker export growth, the negative effect of developments in global financial markets, as well as geopolitical risks. Further appreciation of euro against US dollar may have a restraining effect on economic growth.

Considering these conditions, the ECB chief Mario Draghi reiterated readiness to use unconventional instruments. These measures may include longer-term refinancing operations to support bank lending and the regulator's decision to intensify its asset purchase programme. The ECB may also adapt its stimulus package to the specifics of individual eurozone countries with a focus on particular types of assets. The ECB also did not rule out a negative interest rate on its deposit facility for banks.

Fiscal and debt sustainability risks

The aggregate euro area budget deficit fell below the threshold level of 3% of GDP in 2013 for the first time since 2008 (Chart 11). However, fiscal and debt sustainability risks remain high. The eurozone government debt is growing incessantly: the aggregate debt reached a record 95% of GDP in 2013. At the same time, many eurozone countries have to continue budget spending cuts. Greece needs to further implement fiscal and structural reforms, despite progress achieved in improving its state of economy (Box 2). In France, the government unveiled plans in April for 4 billion euros of extra budget cuts to reduce the budget deficit to the permissible level. The French government's updated estimates indicate that the country's budget deficit will reach 3% of GDP in 2015.

Chart 11. Eurozone budget balance and government debt (% of GDP)



Source: Bloomberg, Eurostat.

Box 2. Greece economy overview

The Eurogroup approved the allocation of the next 8.3 billion-euro loan tranche to Greece, considering the country's progress in fulfilling the terms of the international financial assistance programme. Of this amount, 6.3 billion euros were transferred in April while the release of the second and third loan instalments worth 1 billion euros each depended on Greece's further fulfilment of certain conditions set by the 'troika' of international lenders. Greece needs financial assistance to avoid a default in May when it has to repay liabilities worth 12.5 billion euros. Greek Finance Minister Yannis Stournaras is confident that Greece will not require a third international rescue package, if the Greek economy continues to recover.

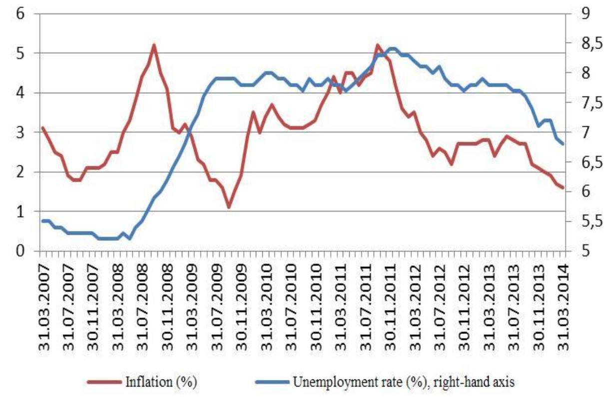
Greece's improved economic performance can be evidenced by a current account surplus posted in 2013 for the first time on record. The European Commission estimates that Greece's GDP will expand by 0.6% in 2014.

Greece has also returned to the long-term debt market, selling bonds worth 3 billion euros in April, its first bond issue since January 2010. The five-year bonds with 4.95% p.a. yield drew heightened investor demand: the volume of bids was eight times the amount, which the Greek government had expected to raise (investor orders amounted to over 20 billion euros compared with the government's offer of bonds worth 2.5 billion euro). Almost 90% of the bonds were purchased by foreign investors.

UK

Like in the USA, noticeable improvements are observed in the UK labour market. In January-March 2014, the unemployment rate fell to 6.8%, the lowest level since February 2009 (Chart 12). Back in February, the UK jobless rate fell below the 7% threshold, a target set by the Bank of England in August 2013 for raising the interest rate and abandoned by it in early 2014. At the same time, UK consumer prices rose by only 1.6% in March 2014 year on year, the lowest annual rate since October 2009.

Chart 12. UK unemployment and inflation rate



Source: Bloomberg.

Japan

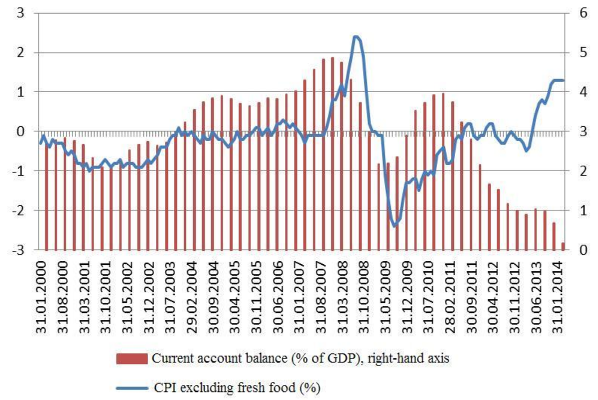
Corporate optimism over inflation growth

The Bank of Japan has achieved successes in stimulating inflation growth. Consumer prices excluding fresh food (an indicator, for which the BoJ has set a 2% inflation target) rose for the 10th consecutive month in March 2014, increasing by 1.3%, year on year, the highest rate since October 2008.

Japanese companies are showing more optimism about further inflation growth, which can be evidenced by a poll of inflation expectations published by the BoJ for the first time. The survey was conducted from February 24 to March 31, 2014 and covered 10,000 Japanese firms. The companies said that they expected Japan's inflation to accelerate to 1.5% in 2014 and consumer prices to rise at an average annual rate of 1.7% in the next three and five years. The forecasts of a faster growth in Japan's consumer prices are a sign of weakening deflationary pressure in the country, although they remain below the central bank's 2% inflation target.

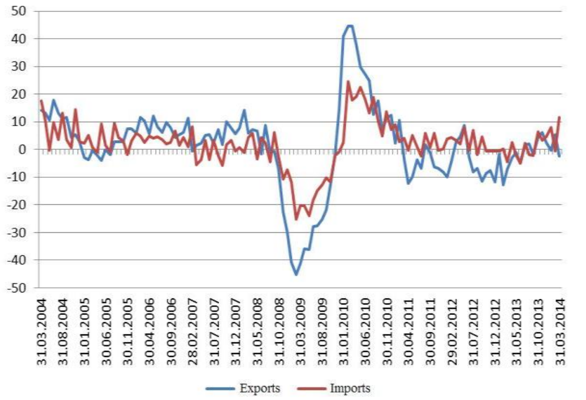
The BoJ believes that the inflation expectations of large companies are the key to gauging deflation risks. The survey results indicate that the BoJ's policy has been quite successful. Japan will possibly be able to avoid additional stimulus measures in the near future. At its April policy meeting, the BoJ decided to keep its monetary policy stance unchanged.

Chart 13. Japan's current account balance and CPI excluding fresh food



Source: Bloomberg.

Chart 14. Japan's annual export and import growth rate (%)



Source: Bloomberg.

RISKS OF EMERGING MARKET COUNTRIES

China

Risks of slower economic growth

China's economic growth continues to slow down: the country's GDP grew by 7.4% in the first quarter of 2014 compared with 7.7% in the fourth quarter of 2013, increasing risk for China to fall short of its 7.5% target for 2014. Chinese annual industrial production growth weakened to 8.7% in April 2014, its lowest level since April 2009 (Chart 15). Business activity continued to decline: China's Purchasing Managers' Index (PMI) stood at 48.1 points in April.

China's economy is slowing amid the government's measures to restrain the credit boom. The annual rates of growth in the volume of lending and the M2 money supply indicator are close to their lowest levels registered before 2008 (Chart 16).

If the economy continues to slow down, the Chinese authorities will possibly have to take additional stimulating measures or restrain the pace of reforms aimed at economic liberalisation. This statement was made in April by Governor of the People's Bank of China Zhou Xiaochuan.

In April the Chinese authorities also announced the launch of a mini stimulus programme for railway infrastructure projects, larger spending on redevelopment of run-down urban areas and tax breaks for small business. Chinese officials have repeatedly stated that the creation of new jobs is a more important indicator compared to economic growth rates.

Chinese yuan depreciation

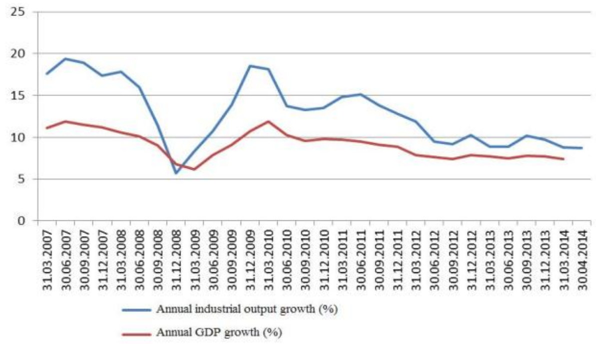
The Chinese yuan continued to weaken against the US dollar amid the government's measures to liberalise the financial market. The Chinese currency began to weaken in February 2014, registering the biggest quarterly loss since 1994 when China unified its official and market exchange rates (Chart 17). The yuan fell by a record 3.3% in February-April 2014.

Other emerging market economies

Need for rate hike

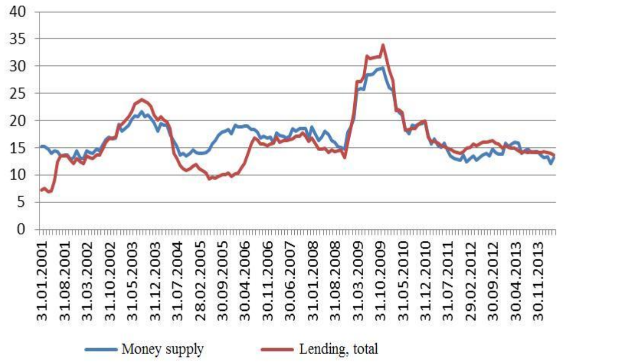
Emerging market countries continue to tighten their monetary policies in the wake of increased inflation pressure. The Central Bank of Brazil raised its benchmark Selic rate by 25 bps to 11% (the highest level since January 2012) (Chart 18). The rate was raised at the ninth straight meeting. Overall, the Central Bank of

Chart 15. China's annual industrial output and GDP growth (%)



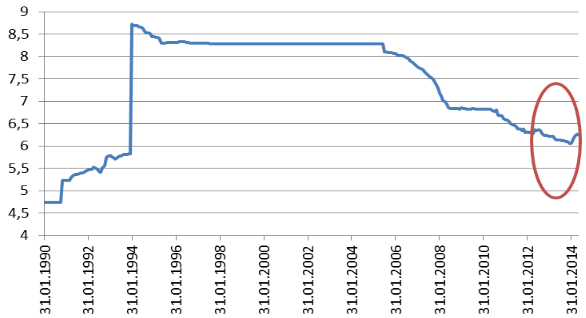
Source: Bloomberg.

Chart 16. Annual lending and money supply growth (%)



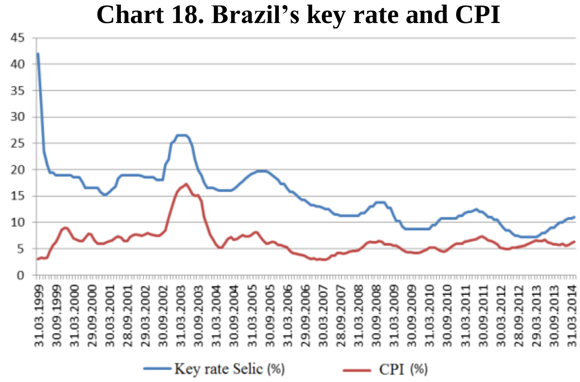
Source: Bloomberg.

Chart 17. Yuan/US dollar rate (yuans per US dollar)



Source: Bloomberg.

Chart 18. Brazil's key rate and CPI

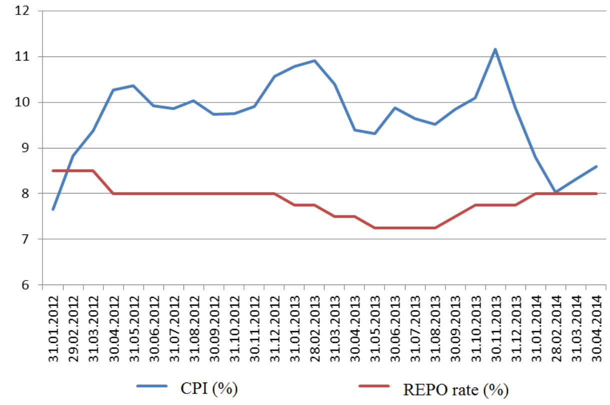


Source: Bloomberg.

Brazil has raised the rate by 375 bps since April 2013.

Inflation growth is also accelerating in India. Consumer prices started to grow faster year-on-year in March-April 2014. The Reserve Bank of India has raised the repo rate three times since it launched its tightening cycle in September 2013 to curb inflation. Last time the rate was raised in January 2014 to 8% (Chart 19). If inflation continues to accelerate, the regulator will probably have to raise the rate again.

Chart 19. India's repo rate and CPI



Source: Bloomberg

Ukraine

Economic forecasts

The Ukrainian economy is currently in recession: in March 2014, Ukraine's industrial production plummeted by 6.8%. The IMF expects Ukraine's real GDP to contract by 5% in 2014 amid weak investor and consumer confidence.

In this situation, the country is carrying out structural reforms required for receiving international financial aid. The programme agreed with the IMF focuses on maintaining a flexible exchange rate of the hryvnia; strengthening the financial system, including measures to recapitalise banks; reducing the fiscal deficit; turning the Ukraine's Naftogaz into a profitable company by 2018 and implementing structural reforms.

In April, the Ukrainian government implemented the following measures:

1) amendments were made to the law on the state budget, reducing budget revenues and expenditures, providing for a possibility to issue government bonds for the purpose of banks' recapitalisation and stipulating the issuance of bonds to cover debt on VAT refunding;

2) a new exchange rate-setting mechanism for the hryvnia was defined;

3) interest rates were raised (Box 3).

Approval of international aid package for Ukraine

The IMF Executive Board approved a 2-year $17.01 Billion Stand-by Arrangement for Ukraine to support the Ukrainian authorities' economic programme aimed at restoring macroeconomic stability and ensuring economic growth recovery. The approval enabled the immediate disbursement of $3.19 billion, including $2 billion allocated to finance the budget deficit. The second and third disbursements will be based on bi-monthly reviews of the programme performance criteria while the remainder will be disbursed following the results of standard quarterly reviews.

The IMF stated, however, that the agreed $17 billion arrangement could be insufficient, considering the

Box 3. Reforms implemented in Ukraine

Budget situation

- The Law "On Making Amendments to the Law 'On the 2014 State Budget of Ukraine'" came into force on April 3, 2014.
- State budget revenues were reduced by 22.37 billion hryvnias (by 5.7%) to 372.93 billion hryvnias while budget expenditures were cut by 25.45 billion hryvnias (by 5.5%) to 436.76 billion hryvnias. The minimum subsistence level was frozen throughout 2014 at the level of 1,176 hryvnias per month and the minimum wage at 1,218 hryvnias per month.
- Considering these changes, the reviewed 2014 state budget based on the forecast of a 3% GDP contraction and inflation growth of up to 14% projects revenues to grow by 9% from the previous year and expenditures to rise by 7.6%.
- The 2014 state budget financing was reduced by 3 billion hryvnias to 65.56 billion hryvnias. The government's projected external borrowings in 2014 were increased by 38.16 billion hryvnias to 90.34 billion hryvnias while domestic borrowings were lowered by 2.23 billion hryvnias to 109.1 billion hryvnias. As a result, the Ukrainian government's borrowings are expected to increase by 22% or by 35.93 billion hryvnias in 2014 to 199.43 billion hryvnias. The estimate of the government's debt payments in 2014 was raised by 14.2 billion hryvnias to 155.16 billion hryvnias, of which foreign debt repayment accounts for 35.6%. Government debt service payments are projected at 46.01 billion hryvnias, with 29.9% of the funds planned to be channeled into foreign debt service. Additional external loans will be spent on making increased government debt payments and covering the deficit of Ukraine's Naftogaz, which has grown by 22.27 billion hryvnias to 33.34 billion hryvnias.
- Owing to a revised estimate of its borrowings and the hryvnia average yearly exchange rate, the government intends to raise the direct government debt limit from 585.48 billion hryvnias to 664.01 billion hryvnias as of the 2014. As before, the law stipulates a possibility for the government to issue loan guarantees; however, the size of these guarantees is cut from 50 to 25 billion hryvnias. The government is also allowed to issue domestic government bonds (OVGZ) above the borrowing and government debt limits stipulated in the

uncertain situation in the country. The IMF estimates Ukraine's financing requirements at $27 billion over the next two years.

Banking sector developments

The situation in the Ukrainian banking sector remains tense. After a long period of their growth, bank deposits stopped to grow in March (-1%), registering an outflow of funds from deposits denominated in the national currency into foreign currency deposits. Households withdrew 7 billion hryvnias worth of bank deposits in the national currency, while simultaneously increasing their investment in deposits denominated in US dollars and euros (a 3% growth for each currency), and also in Russian rubles (an increase of 2%). The change in the deposit currency structure was largely explained by the depreciation of the Ukrainian hryvnia in the last few months. The share of household deposits in foreign currency rose from 41.4% as of February 1, 2014 to 49.3% as of April 1, 2014.

The actual capital adequacy ratios are staying above the required minimum level so far but some indicators are demonstrating negative dynamics: the ratio of regulatory capital to risk-weighted assets (N2) has fallen from 18.3% to 15.2% in the first four months of 2014 while the regulatory capital to total assets ratio (N3) has declined from 13.98% to 12.5% over the same period. The share of overdue debts jumped from 7.7% to 9.3% in the first quarter of 2014.

In early April 2014, the National Bank of Ukraine announced plans to hold stress tests of the country's 15 largest banks to determine their requirement for additional capital. The IMF estimates that three state-owned banks (Ukreximbank, Oschadbank and Ukrgasbank) may need an additional capital of $15 billion.

Ukraine crisis impact on Central and Eastern Europe

The Ukraine crisis has deteriorated economic growth prospects for Central, Eastern and South-East European countries. The IMF has downgraded its growth outlook for the region's 22 countries from 2.7% to 1.9% in 2014 and from 3.3% to 2.6% in 2015.

law in order to recapitalise banks. The law also stipulates the issuance of five-year OVGZ bonds to cover the debt on the refund of VAT declared as of January 1 and acknowledged by audits.

Parameters of hryvnia exchange rate-setting

- Ukraine has also changed the hryvnia exchange rate-setting mechanism. The official hryvnia/US dollar exchange rate is calculated as the average weighted exchange rate of sellers and buyers recorded on the current business day based on the data from the system of confirming transactions on the interbank foreign exchange market. The new rule is stipulated by Resolution No. 180 of March 31 issued by the Board of the National Bank of Ukraine.
- Under the previous rule that had been in effect from September 2004, the National Bank of Ukraine calculated the official hryvnia/US dollar exchange rate on the basis of interbank foreign exchange market quotes, and also considering data on the effective official exchange rate and transactions for the purchase/sale of foreign exchange included in the 1st group of the currencies classifier, and also data on exchange rate and price changes on world financial and commodity markets, other indicators that could influence the Ukrainian foreign exchange market. This formula allowed the NBU to set the exchange rate that differed considerably from the exchange rate on the interbank market. As part of its agreements with the IMF, the NBU limited the deviation of the official exchange rate from the market rate to 2% but started to breach this commitment at the end of 2013 and early 2014.

Rate hikes

- In order to restrain inflationary processes and stabilise the situation on the money market, the NBU is taking measures to increase the value of the national currency through interest rate policy measures.
- From April 15, the NBU raised the discount rate from 6.5% to 9.5% p.a. and its overnight rate on refinancing loans secured by government securities from 7.5% to 14.5%; it lowered the refinancing rate at six-month liquidity-providing tenders from 19.5% to 10% p.a. and limited the supply volume to 1.5 billion hryvnias. The NBU also increased the rate on its overnight certificates of deposit from 1.5% to 4.5% p.a. and the rates at certificate of deposit tenders by 3 pp.