The Central Bank of
the Russian Federation

# GLOBAL RISK REVIEW

Global economic prospects remain quite uncertain. While many market indices are stabilising the conjuncture may change very quickly. Uncertainty is associated with the following factors: expectations of the US Fed exit from the quantitative easing programme and the subsequent tightening of monetary policy, the risk of US stock market overheating, the absence of evident sources of economic growth in emerging market countries, the risk of a further economic slowdown in China amid first corporate defaults and, finally, the escalation of geopolitical risks over developments in Ukraine.

March 2014

# Major events in March 2014

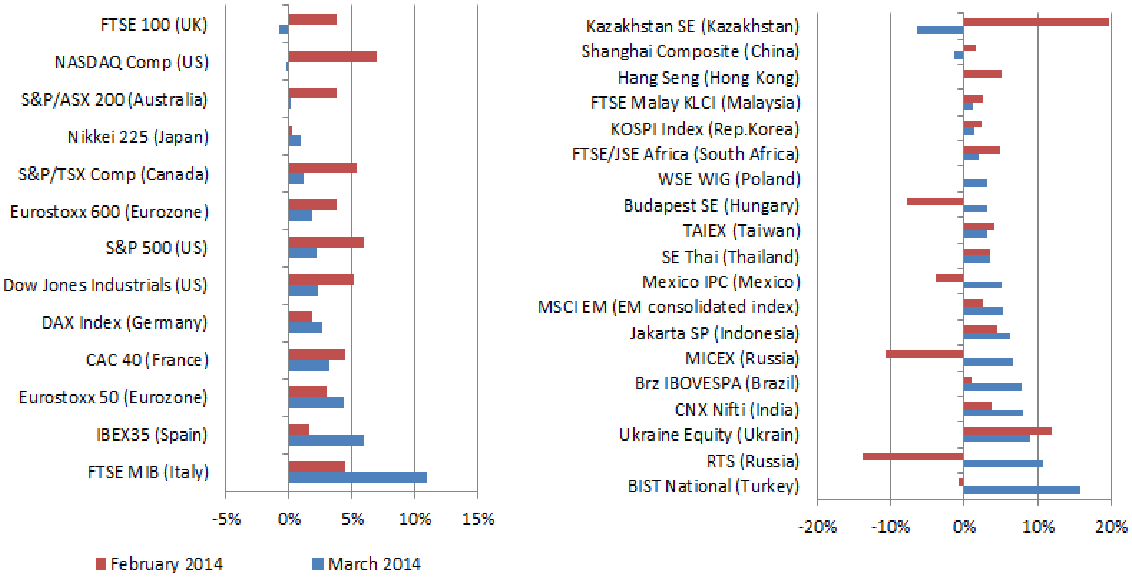
| | |
|---|---|
| 6 March | The European Union (EU) announced after its extraordinary summit that it would provide €11 billion in financial aid to Ukraine. |
| 7 March | China suffered its first domestic corporate bond default: the solar panel manufacturer Shanghai Chaori Solar Energy Science & Technology Co. announced a partial default on its outstanding bonds. |
| 10 March | The World Bank announced its readiness to provide Ukraine up to $3 billion in financial aid. |
| 13 March | The Reserve Bank of New Zealand (RBNZ) raised its key rate to 2.75% from 2.5%. |
| 17 March | The People's Bank of China (PBC) doubled the daily trading band for the yuan to 2% from a mid-point rate set by the PBC. |
| 18-19 March | The Federal Open Market Committee (FOMC) of the US Federal Reserve (Fed) decided at its policy meeting to reduce the monthly volume of its asset purchase programme from $65 billion to $55 billion from April 2014, to maintain the federal funds target rate (FFTR) within the current range of 0-0.25% and to uncouple its decision on the FFTR increase from the unemployment rate threshold of 6.5%. |
| 19 March | US Fed's chair Janet Yellen made a statement on a possible increase of the FFTR rate six months after the end of the quantitative easing programme. |
| 24 March | The US Fed published final results of stress testing for 30 largest bank holding companies. |
| 26 March | The Bank of England and the PBC made a preliminary deal on creation of clearing centre in London for renminbi clearing and settlement arrangements, the first clearing centre of such kind outside Asia. |
| 27 March | Ukraine reached a preliminary agreement with the IMF on a stand-by loan as part of a broader international aid package totalling $27 billion. |

# GLOBAL MARKETS

## Stock markets

The stock markets of both developed and developing countries continued to demonstrate a moderate growth in March 2014 (Chart 1). Market participants expect a more considerable increase in the stock indices of advanced economies this year as their economic prospects look more favourable compared with the prospects of emerging market economies. In March, Russia's RTS and MICEX stock indices grew by 10.8% and 6.7% respectively.

**Chart 1. Developed and emerging market stock index change in February-March 2014 (%)**

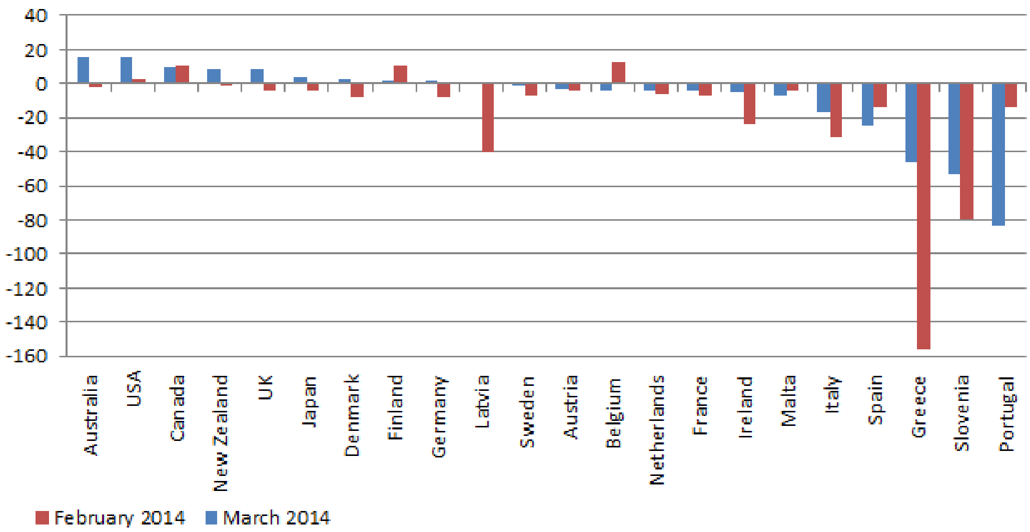



**Source: Thomson Reuters Eikon.**

## Sovereign and corporate bond markets

The debt markets of advanced economies (the USA, the UK, Australia, Canada and Japan) demonstrated some growth in the cost of sovereign borrowings in March 2014. These countries have already registered a higher level of yields on long-term government bonds as compared with the beginning of last year. At the same time, the yields of 10-year government bonds in periphery euro area countries continued to fall as the economic situation in these countries was gradually improving (Chart 2).

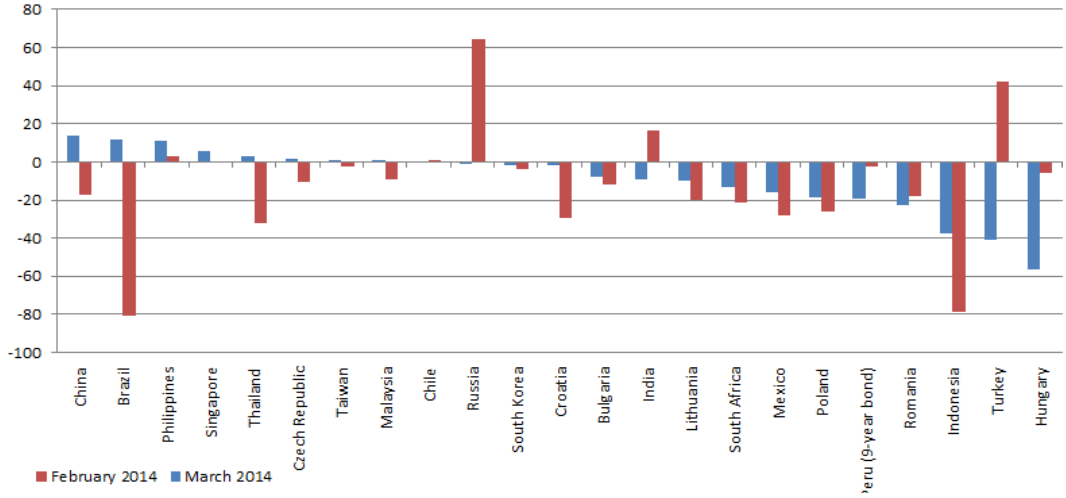
**Chart 2. Developed markets' 10-year government bond yield change in February and March 2014 (bp)**




**Source: Thomson Reuters Eikon.**

The yields of 10-year government bonds of emerging market countries also declined insignificantly (Chart 3). Overall, the Bloomberg USD Emerging Market Composite Bond Index shows that average borrowing costs for emerging market issuers have stayed at around 5% since June 2013 (the index climbed to this level from 4% as of early 2013). The yields of Russia's 10-year federal government bonds also changed slightly in March (they fell by 2 bp).

**Chart 3. EM 10-year government bond yield change in February and March 2014 (bp)**




**Source: Thomson Reuters Eikon.**

## Foreign exchange markets

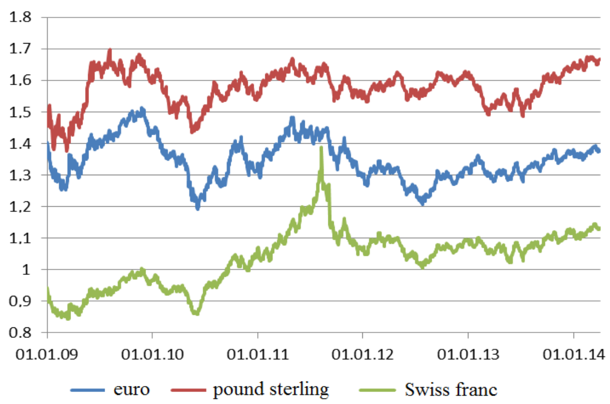
### *Appreciation of the leading European currencies against the US dollar*

The leading European currencies (the euro, the pound sterling and the Swiss franc) are strengthening against the US dollar. The euro and the Swiss franc rose to their highest levels against the US dollar since October 2011, while the pound sterling climbed to the level fixed in 2009 after the global crisis (Chart 4). The appreciation of the European currencies is mainly explained by the desire of many countries to diversify their foreign exchange reserves amid an expected interest rates growth in the United States and a negative revaluation of US assets.

Stronger demand for the European currencies is primarily demonstrated by China, which has the world's largest foreign exchange reserves ($3.82 trillion). The People's Bank of China (PBC) increased its foreign exchange reserves by $324.6 billion in the second half of 2013, whereas its investments in US Treasury bonds shrank from $1.316 trillion as of end-November 2013 to $1.273 trillion as of end-January 2014 (Chart 5).

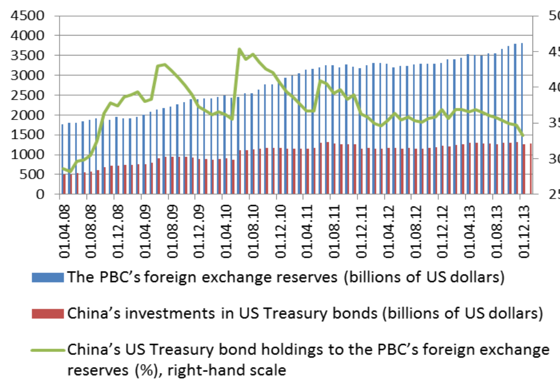
However, there is a risk that a further appreciation of the European currencies may reduce the competitiveness of European goods in world markets and will impede the recovery of economic growth.

**Chart 4. US dollar to euro, pound sterling, Swiss franc (US dollars per unit of each currency)**




**Source: Bloomberg.**

**Chart 5. The PBC's foreign exchange reserves and China's investments in US Treasury bonds**

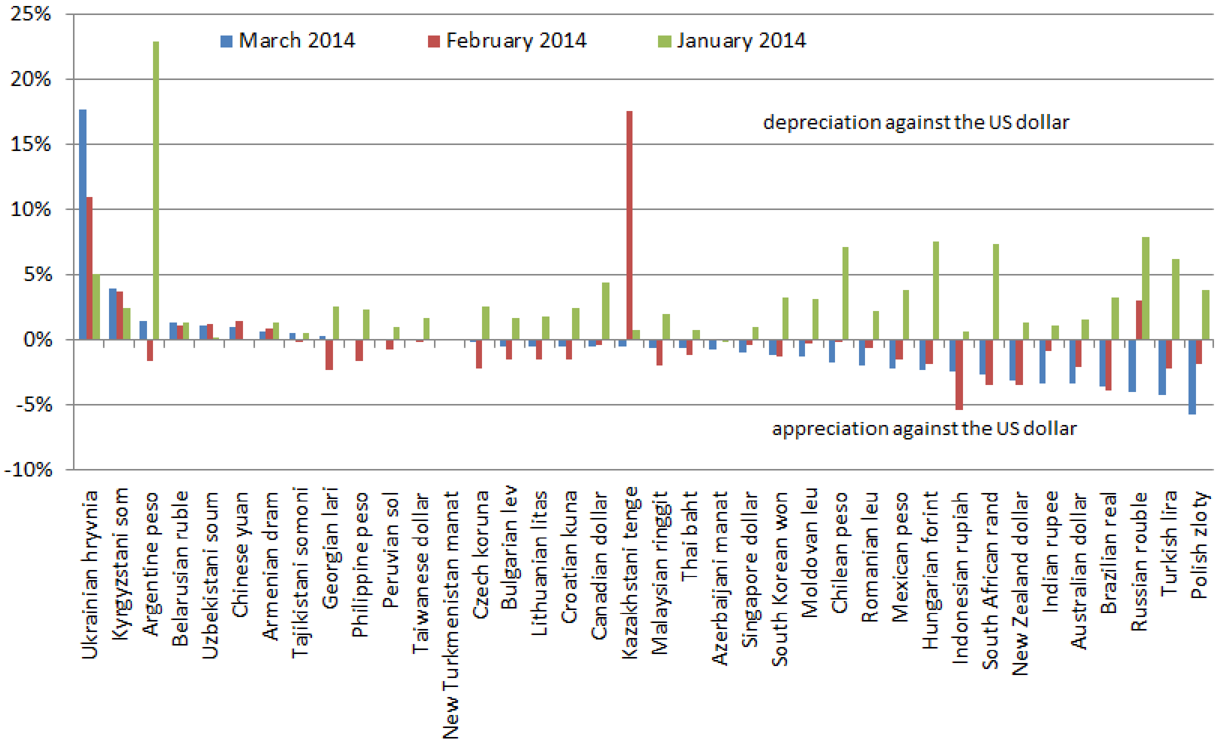



**Sources: Bloomberg, US Department of the Treasury.**

### *Recovery of EM currencies after a sharp depreciation in January 2014*

Emerging market currencies are gradually returning to the levels observed before their devaluation in January 2014 (Chart 6), except for the Ukrainian hryvnia as the political and economic situation in Ukraine continues to be tense. The Russian rouble strengthened by 4.1% against the US dollar in March 2014.

**Chart 6. EM foreign exchange rate change to US dollar in February-March 2014**



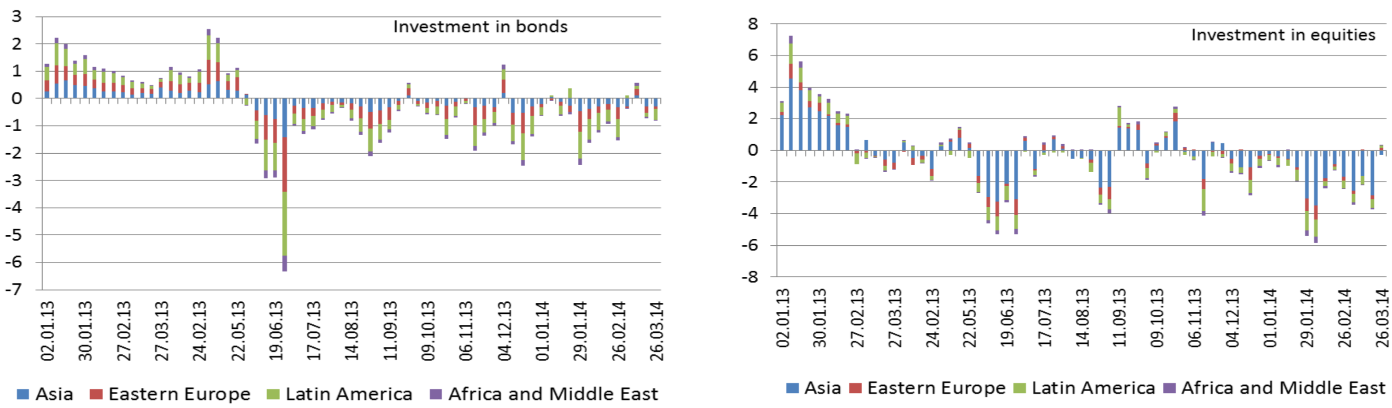

**Source: Thomson Reuters Eikon.**

## International capital markets

### *Continued outflow of investors' capital from emerging market equities and bonds*

Foreign capital outflow from funds investing in emerging markets is continuing amid the US Fed's tapering of its accommodative measures. From 26 February to 26 March 2014, net capital outflow from equity and bond funds of Asian countries, Eastern Europe, Latin America, Africa and the Middle East reached $10.5 billion ($9.2 billion from equity funds and $1.3 billion from bond funds). Asian countries registered the largest capital outflow ($8 billion) (Chart 7). Over this period, net capital outflow from Russian bond funds totalled $124.4 million, while net capital outflow from Russian equity funds reached $37.3 million.

**Chart 7. Investment in EM equity and bond funds (weekly data, billions of US dollars)**




**Source: EPFR.**

## Money markets

Short-term money market rates remain low in developed countries: the Libor interbank offered rates on three-month loans in US dollars, Canadian dollars, the Japanese yen, the pound sterling, Swiss francs and euros are staying below the values observed before the 2008 crisis (Chart 8).

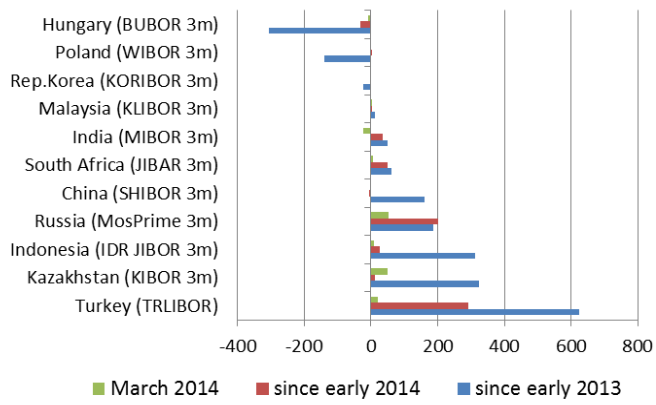
At the same time, some emerging market countries are witnessing growth in money market rates amid increased cross-border capital flow volatility. From early 2013 to 1 April 2014, interbank loan rates for a three-month maturity showed quite a considerable rise, which ranged from 50 bp in India to over 600 bp in Turkey. Specifically, interest rates are rising as some of these countries are tightening their interest rate policies.

The MosPrime reference rate for three-month rouble loans (deposits) offered in the Moscow money market rose by 168 bp from early 2013 to 1 April 2014 (in March 2014, the MosPrime Rate grew by 54 bp).

**Chart 8. Three-month interbank loan rates in developed countries (bp)**


**Source: Bloomberg.**

**Chart 9. EM three-month interbank loan rates (bp)**

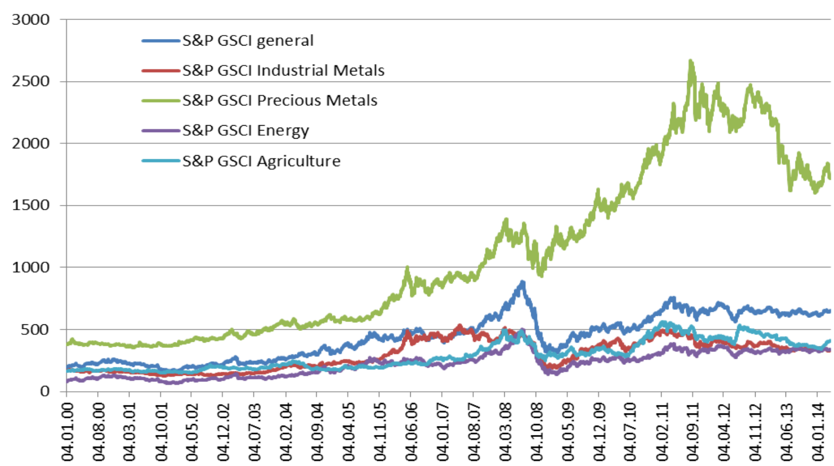



**Source: Bloomberg.**

## Commodity markets

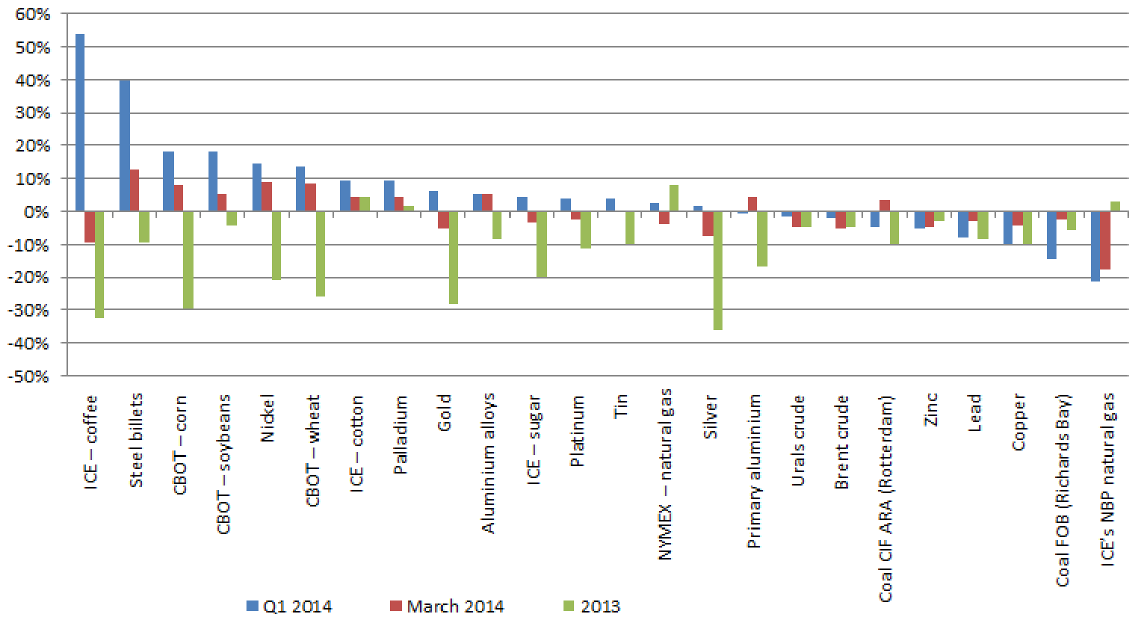
The prices of most commodities declined in 2013: the S&P GSCI composite index of global commodity markets fell by 4.9% (Chart 10). Considering that commodity prices have been falling since 2011 amid a global economic slowdown, many analysts hold the opinion that the upward phase of the so-called commodity price supercycle is over. However, the steady recovery of developed economies this year may partially normalise the situation. Commodity prices were stable enough in Q1 2014, while steel and nickel prices started to grow (Chart 11). World commodity market trends in 2014 will largely depend on how strongly the situation may deteriorate in emerging market countries, which account for considerable demand for commodities (especially China).

**Chart 10. S&P GSCI in world commodity and raw material markets by category**




**Source: Bloomberg.**

**Chart 11. Commodity and raw material price change***




**Source: Bloomberg.**

** Chart 11 indicates spot prices for Urals and Brent crude; the prices of futures contracts on natural gas and coal for delivery in May 2014; 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 May 2014 (corn, wheat, soybeans, coffee, sugar and cotton).*

# RISKS OF SOME DEVELOPED COUNTRIES

## USA

### *First signals of rate hike in 2015*

Despite its less optimistic economic outlook as compared with December forecast (Table 1), the US Fed decided to further cut the monthly volume of bond purchases from $65 billion to $55 billion, including the reduction of Treasury bond purchases from $35 billion to $30 billion and mortgage-backed security purchases from $30 billion to $25 billion. The Fed also updated its forward guidance, uncoupling its decision on a change in the federal funds target rate (FFTR), which is currently maintained within the range of 0-0.25% p.a., from the unemployment rate threshold of 6.5%. In its further assessments, the regulator will take into account "a wide range of information," including measures of labour market conditions, indicators of inflation pressures and inflation expectations, and financial developments.

Importantly, US Fed Chair Janet Yellen indicated in a statement that the Fed could raise the target rate six months after the end of its asset purchase programme (namely, in mid-2015 at the current pace of tapering). This statement signals that the date when the US Fed is expected to start raising interest rates is coming ever closer. Most FOMC members expect the first rate hike in 2015 (Chart 13).

Heightened expectations of an increase in the FFTR rate can be evidenced by a more considerable growth in the yields of shorter-term Treasury securities (Chart 14). The difference between the yields on ten-year Treasury bonds and five-year bonds narrowed from 114.6 bp as of late February to 98.7 bp as of late March.

### *Banking sector's higher resilience*

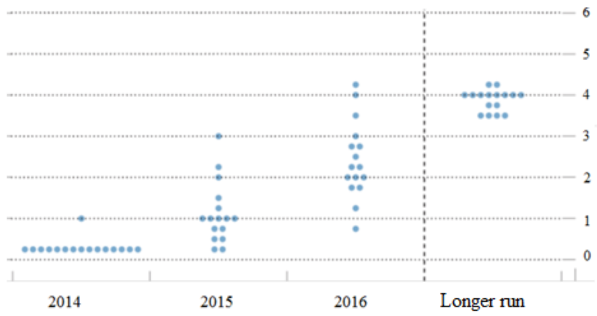
The US Fed published the results of the fourth round of its annual stress tests on the country's 30 largest bank holding companies (in the previous years, the regulator estimated the financial stability of 18 banks with consolidated assets exceeding $50 billion). The stress test showed the robustness of the US banking sector in a severely adverse scenario envisaging a fall in GDP by 4.75% between Q3 2013 and Q3 2014, a slowdown in inflation rate to less than 1%, a rise in the unemployment rate to 11.25% by mid-2015, a decline in equity prices by 50% and a decrease in house prices by 25%. Tier 1 common equity capital adequacy ratio for the 30 banks would fall from 11.5% in Q3 2013 to the minimum level of 7.6% in the hypothetical stress scenario compared with 7.4% under last year's stress test (the actual Tier 1

**Table 1. US Fed's March outlook on major economic indicators**

| | 2014 | 2015 | 2016 | Longer run |
|---|---|---|---|---|
| GDP growth rates (March 2014) | 2.8-3.0 | 3.0-3.2 | 2.5-3.0 | 2.2-2.3 |
| December forecast | 2.8-3.2 | 3.0-3.4 | 2.5-3.3 | 2.2-2.4 |
| Unemployment rate (March 2014) | 6.1-6.3 | 5.6-5.9 | 5.2-5.6 | 5.2-5.6 |
| December forecast | 6.3-6.6 | 5.8-6.1 | 5.3-5.8 | 5.2-5.8 |
| Inflation rate (March 2014) | 1.5-1.6 | 1.5-2.0 | 1.7-2.0 | 2.0 |
| December forecast | 1.4-1.6 | 1.5-2.0 | 1.7-2.0 | 2.0 |

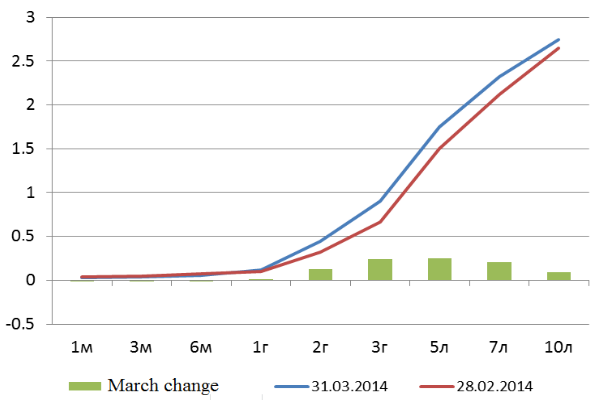
**Source: US Federal Reserve.**

**Chart 13. Distribution of FOMC participants' projections of the key rate level by year-end**




**Source: US Federal Reserve.**

**Chart 14. US Treasury bond yield curve**




**Source: Bloomberg.**

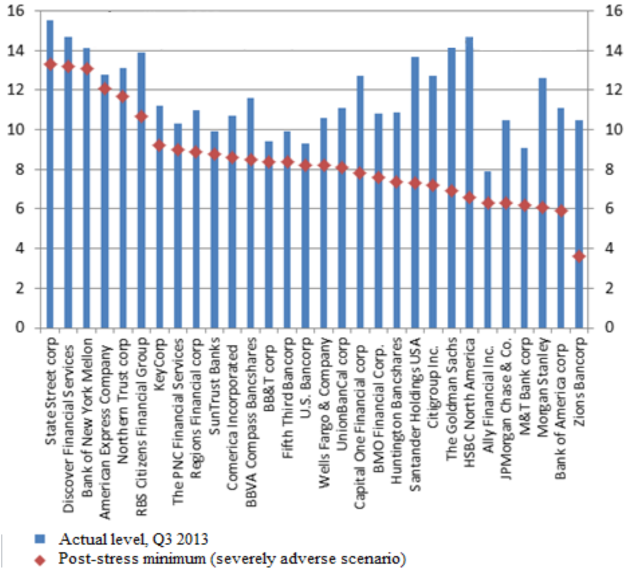
common equity capital adequacy ratio measured 5.5% in 2009). Only Zions Bancorporation failed to meet the minimum threshold of 4.0%, showing a post-stress Tier 1 capital of 3.6% (Chart 15). Like in the previous year, the largest US banks (Bank of America, Citigroup, Goldman Sachs, JP Morgan, Chase and Morgan Stanley) showed the largest losses and the biggest drop in their Tier 1 common equity under the stress scenario.

### *Risks of stock market overheating*

There are more signs indicating that the US stock market is approaching a dangerous stage of overheating and an emerging bubble may sooner or later burst. The US stock market looks overvalued, which can be evidenced by the increase in the so-called Buffett indicator (market cap-to-GDP ratio), which measures the ratio of stock market capitalisation to GDP. This indicator calculated for S&P 500 stocks soared to a record high of 130% before the dotcom crisis in 2000; it equalled 97% before the 2008 subprime mortgage crisis and by now it has already surpassed 100%. For the entire US stock market, this ratio is 143%.

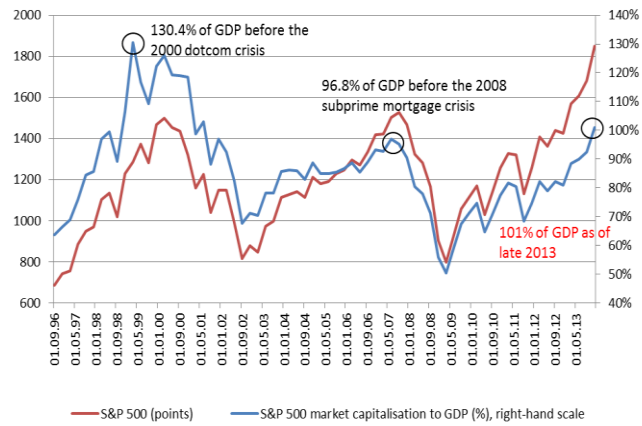
The growth of the US stock market in the last few years resulted from the Fed's highly accommodative monetary policy and had no fundamental grounds as the US economy was slowing down. In view of this, the Fed's final exit from its quantitative easing programme (expected in the fourth quarter of 2014) may trigger the start of sell-offs and, correspondingly, a fall in stock prices. At this stage, the market can be expected to see higher price volatility, i.e. a trend reversal in the dynamics of the VIX Index (Chart 17), which measures investor expectations of the S&P 500 Stock Index volatility over the next 30 days (calculated by the Chicago Board Options Exchange). This index currently stays at minimum levels observed before the 2008 crisis.

**Chart 15. Pre-stress and post-stress Tier 1 common equity capital adequacy ratios**



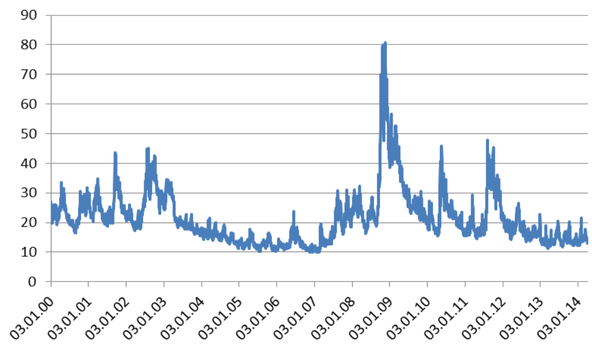

**Source: US Federal Reserve.**

**Chart 16. S&P 500 Index and S&P 500 market capitalisation to US GDP in current prices**




**Source: Thomson Reuters Eikon.**

**Chart 17. VIX Index**




**Source: Bloomberg.**

## Europe

### *Business activity recovery in the euro area*

Purchasing Managers' Indices (PMI) show that business activity continues to grow in the euro area, although the Manufacturing PMI fell by 0.2 points to 53.0 points in March 2014. The fall of the indices in Germany (to 53.7 points), the Netherlands (to 53.7 points) and Austria (to 51.0 points) was offset by the PMI growth in Spain (to 52.8 points), Italy (to 52.4 points) and France (to 52.1 points). In France, business activity in the manufacturing industry started to grow for the first time in the past two years (Chart 18).

In Germany, the IFO Business Climate Index for industry and trade, like the PMI, started to demonstrate negative dynamics after a four-month growth (this indicator fell from 111.3 points in February to 110.7 points in March, Chart 19), which may be related to the political crisis in Ukraine.

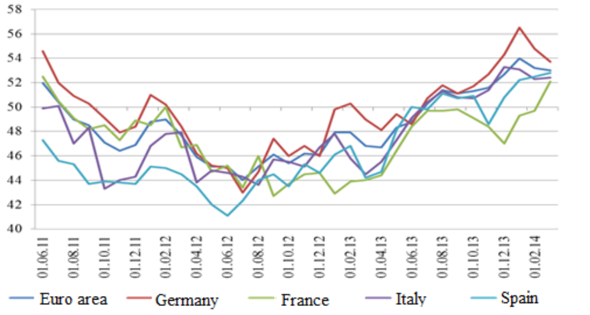
### *Persisting risks of low inflation in the euro area*

The euro area will continue to grow at a moderate pace in the coming years. In March, the ECB slightly revised its forecasts of GDP growth for 2014 and 2015, and also presented a forecast for 2016 (Table 2). Low inflation will remain a key risk for the euro area. Amid the expected fall in oil prices and the stable euro exchange rate, the ECB lowered its 2014 inflation forecast to 1%. Despite some acceleration, inflation will stay below the target level of 2% (Table 2). Eurostat data indicates that the annual rate of inflation equalled 0.5% in March 2014.

### *Macroeconomic imbalances*

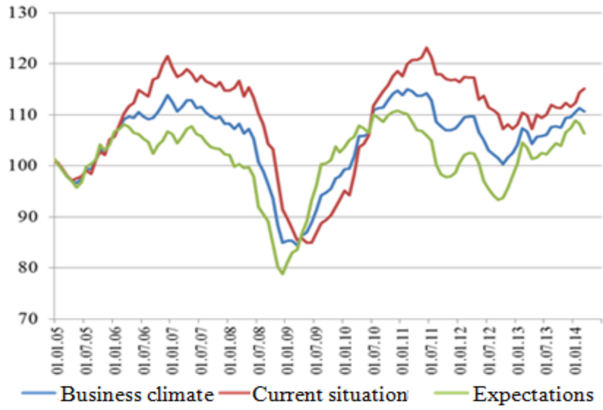
In its regular review of macroeconomic imbalances, the European Commission identified 14 out of 27 EU member states with imbalanced economies. The largest imbalances were noted in Croatia, Italy and Slovenia. The European Commission also drew attention to Ireland, Spain and France where imbalances call for resolute measures. France and Italy need to implement structural reforms, fiscal consolidation and reduce the excessive government debt. In their fiscal consolidation efforts, the governments of these countries are seeking to employ a balanced approach facilitating economic growth (Box 1).

**Chart 18. Seasonally adjusted euro area manufacturing PMI**




**Source: Bloomberg.**

**Chart 19. German IFO indexes, 01.2005=100**




**Source: Bloomberg.**

**Table 2. ECB's economic forecasts in March 2014 (December 2013)**

| | GDP growth | Inflation | Core inflation |
|---|---|---|---|
| 2014 | 1.2 (1.1) | 1 (1.1) | 1 (1.1) |
| 2015 | 1.5 (1.6) | 1.3 (1.3) | 1.4 (1.4) |
| 2016 | 1.8 (-) | 1.5 (-) | 1.7 (-) |

**Source: ECB.**

**Box 1. Measures announced in Italy and France to stimulate economic growth**

Italy's new Prime Minister Matteo Renzi who took office in February outlined a comprehensive reform plan containing measures to restructure state institutions' €68 billion debt to the private sector by July, reform the labour market, cut taxes for low-income employees by €10 billion to be funded by an increase of taxation on capital gains and some budget spending reductions.

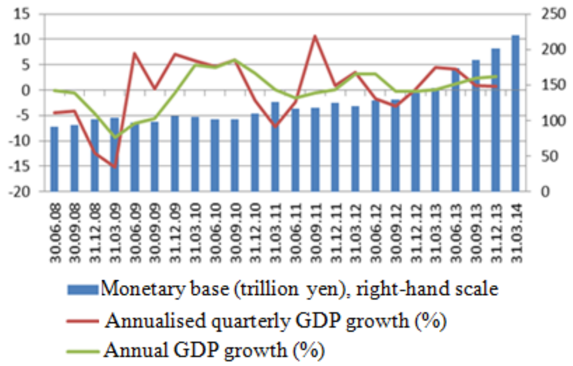
In January, President of France Francois Hollande launched a large-scale programme of reforms and measures to stimulate economic growth, which envisage payroll tax cuts by €50 billion to be funded by budget spending reductions.

## Japan

### *Risks of decline in Abenomics efficiency*

Japan's quarterly GDP growth slowed to an annualised 0.7% in Q4 2013 (from 4.5% in Q1 2013 and 4.1% in Q2 2013). This means that the effect of Abenomics[1] may not be strong enough to pull the country from a 15-year period of stagnation. In April 2014, the country's consumption tax increase from 5% to 8% came into force, which may restrain GDP growth. In this situation, it is quite possible that the Bank of Japan (BOJ) will have to boost the volume of stimulus measures. The BOJ's ongoing policy envisages an annual expansion of the monetary base by 60-70 trillion yen (to 270 trillion yen in 2014 from the current 220 trillion yen (Chart 20). It is probable that in the coming months the BOJ may decide on boosting the growth of this indicator to an annual pace of 100 trillion yen.

**Chart 20. Japan's GDP growth rates and monetary base**

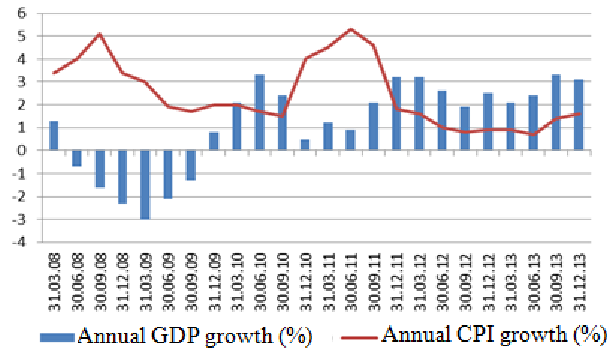



**Source: Bloomberg.**

## Other developed countries

New Zealand switched to interest rate policy tightening. The Reserve Bank of New Zealand increased the key rate to 2.75% from a record low of 2.5% set in March 2011. The key rate was raised amid a quick economic growth (expected to reach 3.3% on an annualised basis in Q1 2014) driven by rising domestic demand, the booming construction industry and real estate market, the growing prices of food exports and accelerating inflation (1.6% in December 2013, Chart 21).

**Chart 21. New Zealand's annual GDP and CPI growth**




**Source: Bloomberg.**

[1] Aggressive anti-deflation and economic stimulus policies pursued by Japan's Prime Minister Shinzo Abe.

# RISKS OF SOME EMERGING MARKET COUNTRIES

## China

### *Risks of slower economic growth*

China has set its GDP growth target for 2014 at 7.5%, matching the target for 2013. However, it is likely that the country for the first time will fail to reach the goal. According to estimates of China's finance minister, the country's GDP may grow by 7.2-7.3%. A slower growth can be explained by a decline in industry clearly evidenced by the Manufacturing PMI. This index calculated by Markit/HSBC slipped below 50 points in Q1 2014 (it stood at 48 points in March) largely due to a contraction in order books amid weak domestic demand. China's export-oriented sector also failed to lend support to industry: in February export volume declined by 18.1% on an annualised basis. Experts, however, explain this sharp decline by the celebration of the New Year and the transfer of a considerable share of export settlements to January.

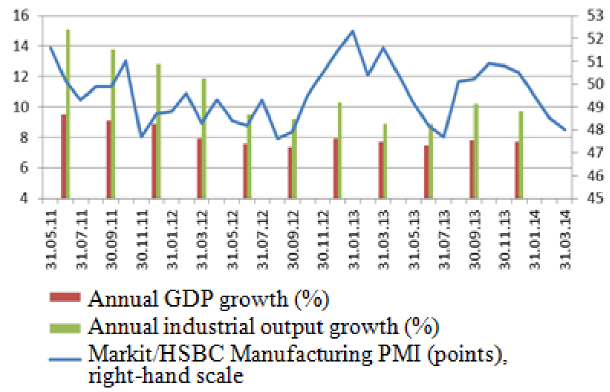
### *First corporate defaults*

The number of non-financial companies with corporate debts exceeding more than two times the size of their equity capital is rapidly rising in China. According to Bloomberg data, the number of such firms has grown by 57% since 2007 to 256 (out of over 4,000 businesses). The financial leverage of 63 companies exceeds 400% compared with the average level of 73%. Data of the Bank for International Settlements (BIS) show that the volume of Chinese non-financial firms' outstanding loans reached record $14 trillion in Q3 2013 (Chart 22). Their debts on bonds exceeded $1 trillion (Chart 23). In March 2014, China suffered first corporate defaults. The solar panel manufacturer Shanghai Chaori Solar Energy Science & Technology Co. announced a partial default on its outstanding bonds. Faced with difficulties in raising financing, the company failed to make coupon payments worth $10.7 million and $14.7 million. The next company to default was the developer Zhejuang Xingrun Real Estate Co., which was unable to repay its $566.6 million debt. Analysts fear a chain reaction of defaults as many Chinese companies have incurred losses in recent years and may lose access to the bond market. Potential bankruptcies may include steel enterprises amid contracting book orders and a drop in output.

### *Chinese yuan weakening amid financial market liberalisation reform*

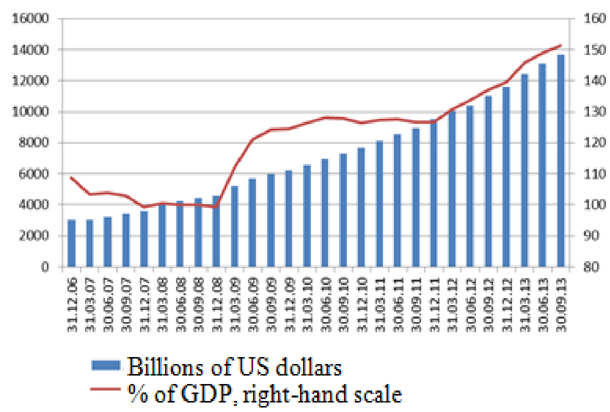
As part of its financial market liberalisation reform, the PBC doubled the daily trading band for the yuan/US dollar exchange rate to 2% from a mid-point rate set by

**Chart 22. China's key economic indicators**



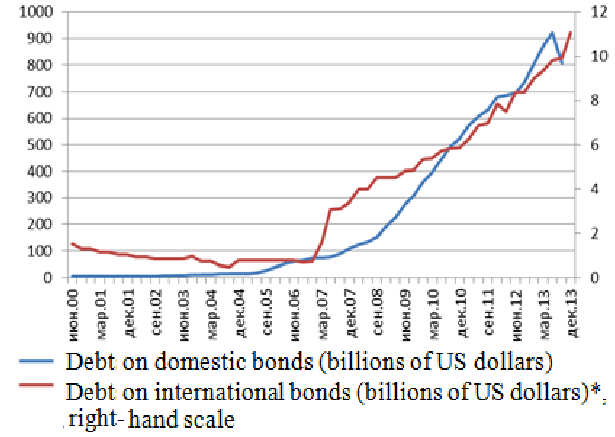

**Source: Bloomberg.**

**Chart 23. Chinese non-financial sector's debt on bank and non-bank financial companies' loans (as of end-period)**




**Source: BIS.**

**Chart 24. Chinese non-financial sector's debt on bonds (as of end-period)**



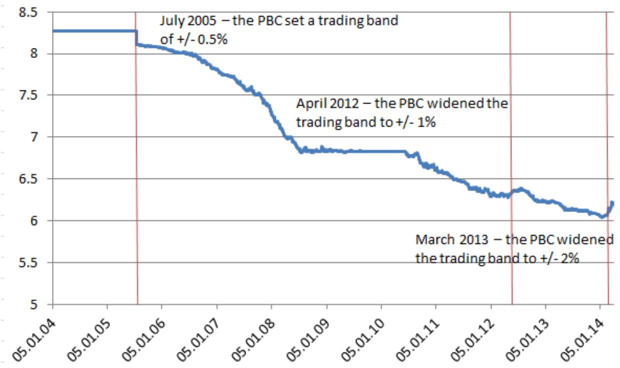

* International bonds issued by Chinese residents.

**Source: BIS.**

the PBC. Following this move, the yuan is demonstrating a record weakening after it reached its highest level since 2005 (Chart 25). Considering the absence of fundamental reasons for the yuan appreciation in the near term, as well as the efforts by the Chinese authorities to raise the role of market factors in the economy, the yuan exchange rate will most likely continue to weaken. It cannot be ruled out that the PBC may allow wider yuan fluctuations.

At the same time, China continues to strengthen the yuan positions in offshore markets (yuans circulating outside continental China). An agreement signed between the Bank of England and the PBC on establishing the first clearing and settlement centre in London for yuan transactions turns London into the main hub for offshore yuan trades in the West. Until now, Hong Kong was an indisputable leader in offshore yuan trades. London already controls over 60% of transactions in offshore yuans outside Greater China (mainland China, Hong Kong, Macau and Taiwan).

**Chart 25. Yuan/US dollar exchange rate (yuans per US dollar)**




**Source: Bloomberg.**

## Ukraine

### *Economic decline and heavy burden of reforms*

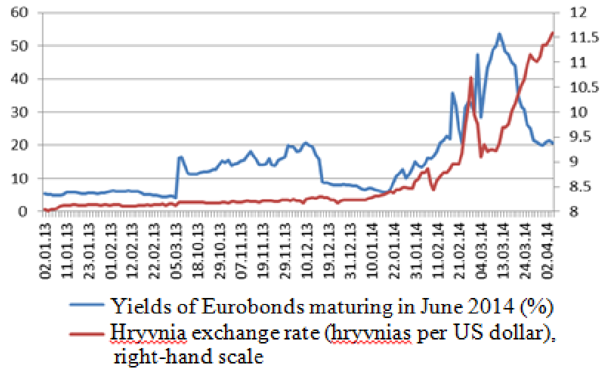
After political upheavals of the last few months, Ukraine is entering a period of economic decline. Verkhovna Rada-appointed Ukrainian Prime Minister Arseniy Yatsenyuk estimates a potential GDP contraction in 2014 at 3% and inflation at 12-14%. With significant foreign debt repayments looming in the coming years, Ukraine has no access to international debt markets. Aside from this, the hryvnia continues to depreciate, adversely affecting all the sectors of the economy (Chart 26).

In this situation, Ukraine needs international financial assistance, which will require, however, painful and unpopular reforms. Specifically, the Ukrainian government has prepared a plan for a budget reduction through social spending cuts to halve the state budget deficit (4.5% of GDP in 2013). A contraction in domestic demand, however, will adversely affect the economy as a whole.

### *Terms of international financial assistance*

A tentative agreement with the IMF stipulates the provision of a $27 billion multilateral loan to Ukraine under a stand-by arrangement in the next two years, of which assistance from the IMF will range from $14 billion to $18 billion. The agreement is subject to approval by the IMF Executive Board in April, following the adoption by the Ukrainian authorities of a comprehensive package of prior actions aiming to stabilise the economy and create conditions for sustained growth. The Ukrainian authorities' actions should focus

**Chart 26. Ukrainian hryvnia/US dollar exchange rate and yields of Eurobonds maturing in June 2014**




**Source: Bloomberg.**

**Box 2. Required economic policy measures in Ukraine (excerpts from the IMF mission statement)**

**Monetary policy** will target domestic price stability, while maintaining a flexible exchange rate. This will help eliminate external imbalances, improve competitiveness, support exports and growth, and facilitate the gradual rebuilding of international reserves. The NBU plans to introduce an inflation targeting framework over the next twelve months to firmly anchor inflation expectations.

**Financial sector reforms** will focus on ensuring that banks are sound, liquid and well-capitalised; upgrading the regulatory and supervisory framework of the National bank of Ukrain, including compliance with international best practice and supervision on a consolidated basis, and facilitating resolution of non-performing loans in the banking sector.

**Fiscal policy** will secure priority spending during the coming months and implement deeper fiscal adjustment over the medium term. The initial stabilisation in 2014 will be achieved through a mix of revenue and expenditure measures. For 2015-16, the programme envisions a gradual expenditure-led fiscal adjustment – proceeding at a pace commensurate with the speed of economic recovery– aiming to reduce the fiscal deficit to around 2.5% of GDP by 2016.

on reforms in the following areas: monetary and exchange rate policy; the financial sector; fiscal policies; the energy sector; governance, transparency and the business climate (Box 2).

The World Bank intends to allocate up to $3 billion to Ukraine to support economic reforms. The United States is ready to provide $1 billion in the form of loan guarantees, while Japan will offer $1.5 billion. The EU will provide an aid package of €11 billion, including €3 billion from the EU budget in the next few years under macro-financial and development assistance (of which €1.6 billion in loans and €1.4 billion in grants) and up to €8 billion from the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD).

**Energy sector reforms** will focus on reducing this sector's fiscal drag, while attracting new investment and enhancing efficiency. A key step is the commitment to conduct a step by step energy reform to move retail gas and heating tariffs to full cost recovery. This will be accompanied by scaled up social protection to mitigate the impact on the most vulnerable. Over time, the programme will focus also on improving the transparency of Naftogaz's accounts and restructuring of the company to reduce its costs and raise efficiency.

**Reforms to strengthen governance, enhance transparency and improve the business climate** will be central elements of the programme. Policy measures in these areas will include adoption of a new procurement law to close loopholes allowing evasion of a competitive procedure; measures to facilitate VAT refunds to businesses and an independent quarterly audit of the Naftogaz accounts. The above and other measures will be fully developed with the assistance of the World Bank, EBRD and other international financial organisations and will help increase transparency of government operations and remove barriers to growth. Moreover, the IMF will prepare a comprehensive diagnostic study that will cover the anti-corruption and governance framework, the design and implementation of laws and regulations, the effectiveness of the judiciary and tax administration.