GLOBAL RISK REVIEW

DECEMBER 2013

The year of 2014 may bring significant changes to the global economy. Multispeed economic recovery will lead to unsynchronization of monetary policies in leading economies. Given a faster growth of the US economy the Federal Reserve have started tapering its third round of quantitative easing program, while eurozone and Japan need to adhere further to accommodative stance of monetary policy. In this environment the economic recovery in emerging markets may be hampered by heightened volatility of capital flows and increased uncertainty for economic agents.

FINANCIAL STABILITY DEPARTMENT, BANK OF RUSSIA

Major Events in December 2013

8 December	The Greek Parliament passed the country's draft budget for 2014 despite its disapproval by the 'troika' of international lenders, i.e. the European Commission, the European Central Bank (ECB), and the International Monetary Fund (IMF).
10 December	The US Federal Reserve (Fed) released the final version of the Volcker Rule developed jointly with the four other control and supervisory agencies, i.e. the Federal Deposit Insurance Corporation (FDIC), the Commodity Futures Trading Commission (CFTC), the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC).
17-18 December	Following the meeting of the Federal Open Market Committee (FOMC) the Fed decided to reduce the monthly volume of asset purchase program from $85 billion to $75 billion starting from January 2014.
18 December	The European Council, the European Union (EU) strategic body consisting of the heads of state or government of the member states, approved the single resolution scheme placing the bank into resolution (Single Resolution Mechanism, SRM).
20 December	The rating agency Standard & Poor's downgraded the EU's long-term credit rating from the highest level AAA to AA+ with outlook stable.
26 December	US President Barack Obama signed the two-year Bipartisan Budget Act of 2013 passed by the US Congress earlier this month.

Credit risks

Reduction of long-term sovereign bond yields in eurozone problem countries reflects stabilization of the European debt market. Ireland was the first country to exit the EU-IMF Economic Adjustment Programme in December 2013. However, the levels of budget deficit and government debt in European countries remain elevated, while further fiscal consolidation is a more difficult problem. It is the first time that Greece openly opposes measures demanded by the 'troika'.

Market risks

In December 2013, the dynamics of world stock indices were similar to those observed during the year. Advanced markets demonstrated considerable growth (primarily Japan and the USA), while emerging markets showed a decline caused by weaker growth expectations in China and market uncertainty associated with possible negative consequences of the US Fed's exit from the asset purchase programme.

Liquidity risks

In December 2013, the US Fed decided to exit its asset purchase programme. Reaction of money markets in other countries to the regulator's decision was moderate and did not provoke any serious growth in interest rates. China should be treated separately, since escalation of tensions in the Chinese money market is observed against the backdrop of domestic efforts to curb lending boom. In general, the global economy in 2014 may expect a gradual rise in long-term rates, while short-term rates will remain low.

Capital flow risks

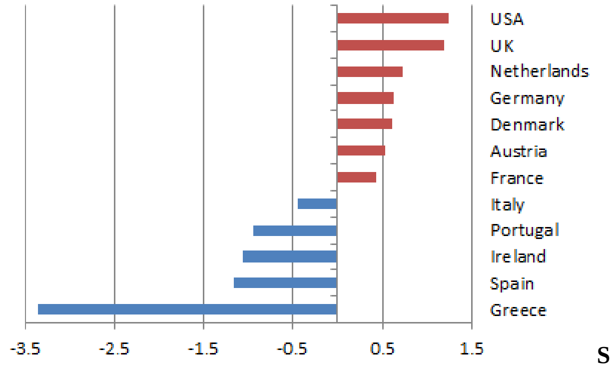
In the second half of 2013 we observed increased volatility of capital flows and exchange rates which had an adverse impact on many emerging markets. Given the US Fed's tighter policy, emerging economies may face even more serious challenges in 2014 taking into account the ongoing economic slowdown amid sufficiently high inflation.

Credit Risks

Higher Demand on Eurozone Debt Markets

Debt markets in eurozone problem countries are gradually stabilising. In 2014, investors can be expected to invest more in European debt instruments to avoid possible losses on US Treasuries, which may fall in price for the second consecutive year as the US Federal Reserve scales down its quantitative easing programme (Chart 1). Investors are also very optimistic about European bonds, expecting that the ECB will continue its accommodative policy. At the same time, considering that US Treasuries are traditionally a safe investment instrument, the volume of foreign investments in this type of assets will most likely remain high (according to the US government data, foreign holdings of US Treasuries totalled $5.65 trillion as of the end of October 2013).

Chart 1. 10-Year US Treasuries and European Government Bonds' Yield Change in 2013 (pp)



S ource: Bloomberg

Fiscal Risks in Eurozone

In 2013, lower sovereign borrowing costs helped eurozone problem countries save a fairly large sum of money on interest payments. Overall, considerable success was achieved in the fiscal sphere. Importantly, the first eurozone country (Ireland) officially exited the EU/IMF economic adjustment programme in December 2013. The markets also reacted very calmly to Greece's refusal to adopt more austerity measures demanded by the 'troika' of international lenders and the decision by S&P international rating agency to downgrade the EU's long-term credit rating. Nevertheless, sovereign risks in the euro area remain elevated. Many national regulators have been unable so far to lower the government debt and budget deficit to the required levels. Moreover, difficulties still persist in approving further budget consolidation measures (Table 1).

Table 1. Eurozone Problem Countries and Budget Consolidation Measures

Greece
Greece's budget adopted by the Greek parliament has not been approved by the 'troika' of international lenders. Greece wants to avoid some austerity measures needed to receive a new loan tranche (lifting a ban on mortgage foreclosures, shutting a loss-making state arms manufacturer, introducing a broad-based real estate tax and allowing mass dismissals of workers at private companies).
Portugal
Portugal's Constitutional Court once again admitted budget cuts in social spending illegal (in December, the court rejected the government's decision to cut public pensions; earlier the government was not allowed to introduce a tax on unemployment benefits and make temporary cuts in civil-service employees' wages and pensions). At the same time, the funds Portugal received under the bailout programme from the 'troika' are expected to be used up entirely in June 2014.

European Regulators' Measures

European regulators' measures in the sphere of banking supervision and regulation facilitate market confidence. The European Council, which is the EU's strategic body comprising the heads of state or government of the EU member states, approved the general approach to the Single Resolution Mechanism (SRM) in December 2013. The SRM key elements will be the Single Resolution Board (SRB) taking decisions on resolution schemes for failing financial institutions after notification by the ECB and the Single Resolution Fund (SRF) responsible for financing (Table 2). Many European parliamentarians and the ECB governors believe that the approval procedure is very complex and may complicate prompt decision-making in crisis. In the opinion of ECB head Mario Draghi, a decision on liquidation must be passed immediately, as soon as the ECB, which will become the

Table 2. SRM Operation Scheme

The SRM will cover 17 euro area member states and those non-eurozone countries that decide to join.
Decision-making
Upon notification by the ECB that a particular bank is experiencing financial difficulties, the SRB will start working out resolution schemes (the Board will determine the application of resolution tools and the use of the SRF). If the European Commission objects to the SRB-proposed scheme, it will submit a proposal to the European Council, which must react within 24 hours. Otherwise, the decisions by the SRB will come into force.
Financing
The SRM will be financed through the SRF. The SRF will be financed by bank levies raised at national level (during the initial phase, financing from the European Stabilisation Mechanism (ESM) will be possible). The Fund will equal 1% of covered deposits in the participating member states (around 55 billion euros). The SRF will start functioning as a single fund either after reaching this level or over the 10-year period.
Further Steps
The countries have committed to approve the relevant

single banking supervisory authority by late 2014, reveals that a bank is no longer able to perform financial operations. At later stages of the SRM scheme approval, the existing disagreements should be resolved. Finally, the introduction of uniform banking supervision principles in Europe should have a positive effect on market confidence.

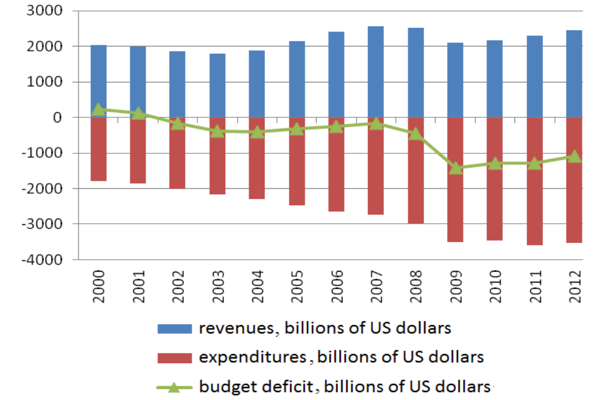
draft of regulatory measures at the intergovernmental level by 1 March 2014. European Parliament should conclude negotiations before May 2014 which imply the final adoption of SRM.
Deadlines
The SRM will enter into force on 1 January 2015.

Source: European Council

Weaker Political Risks in the US Fiscal Sphere

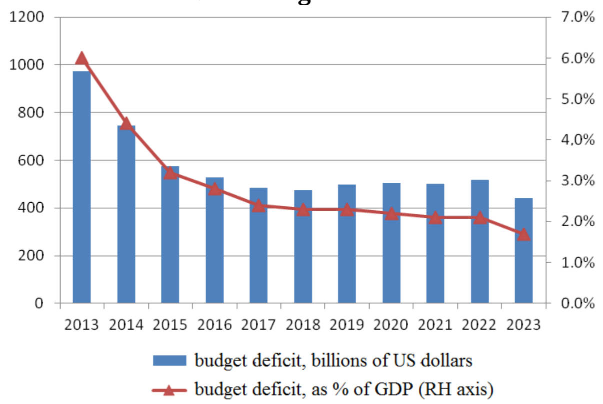
In December 2013, Republicans and Democrats managed to reach a two-year compromise budget deal in the US Congress. The Budget Act[1] authorises an increase in US government overall discretionary spending in fiscal year 2014, which began in October 2013, by $62-63 billion to $1.01 trillion (the increase is evenly divided between defence and non-defence expenditures). The deal is a compromise between the budget level of $1.058 trillion demanded by Democrats in Senate and the budget level of $967 billion supported by Republicans in House of Representatives. Despite higher expenditures, the US budget deficit is expected to narrow. The deal envisages that the spending increase will be offset by higher revenues from alternative fiscal measures (non-tax revenues). According to the US Office of Management and Budget (OMB) data, the budget deficit will reduce to under 2% of GDP over the next ten years (by 2023) (Chart 3), although estimates made by the US Congressional Budget Office (CBO) as of December 2013 show that the US budget deficit will drop to 2.1% of GDP already in 2015 under the baseline scenario, after which it will start to grow again (Chart 4). Thus, the bill approved by the US Congress partially restores expenditures sequestered in March 2013 and helps avoid another shutdown of the US federal government from 15 January 2014 when the October budget accords expire. However, some key issues, in particular, a plan for raising the government debt ceiling and social insurance programme cuts remained outside the scope of the deal. A temporary agreement between Democrats and Republicans may be disrupted in the course of debt-ceiling negotiations in early 2014, which will possibly prompt a revision of budget items. Republicans will try to impose their demands of deeper cuts in government spending and basic social security programmes as a condition for raising the nation's debt ceiling.

Chart 2. US Federal Budget Revenues, Expenditures and Balance



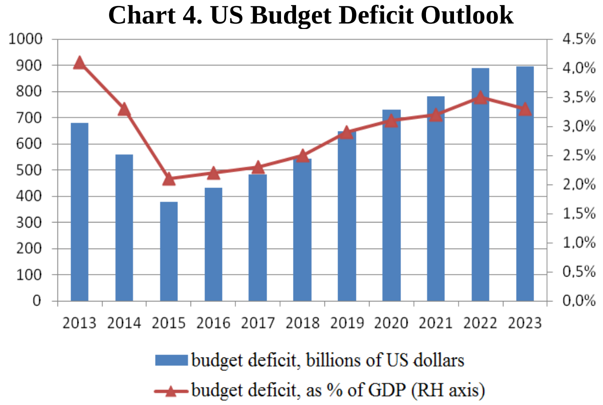
Source: CBO

Chart 3. US Budget Deficit Outlook



Source: OMB (Fiscal Year 2014 Budget)

Chart 4. US Budget Deficit Outlook



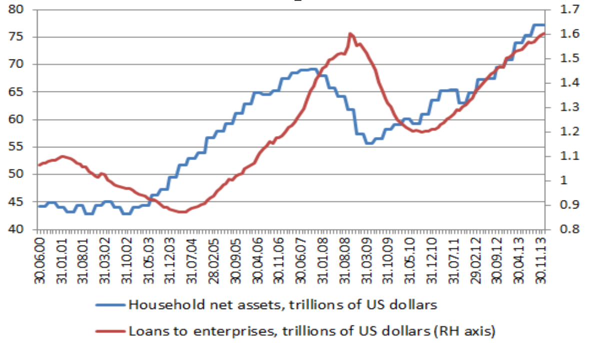
Source: CBO

[1] The Bipartisan Budget Act of 2013.

US Banking Sector Risks

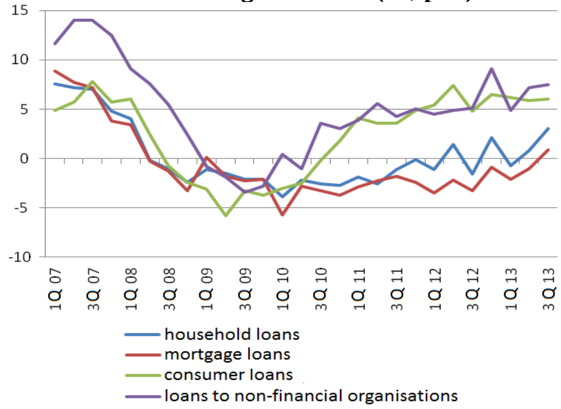
Economic recovery in the United States has positive impact on the US banking sector: the volumes of commercial loans have reached pre-crisis figures, while the net asset value of US households and non-profit organisations has exceeded the level registered before the crisis (Chart 5, Chart 6). In this situation, US regulators are actively advancing measures to raise banking sector resilience to possible risks in the future. These measures include further reforms in implementation of tighter capital adequacy and liquidity standards under Basel III and the approval of the Volcker Rule by five US control and supervisory agencies in December 2013 after prolonged period of discussions (starting from 2010). The Volcker Rule bans proprietary trading, when a bank uses its own funds for trades in financial markets, and limits banks' investments in hedge funds and private equity funds. The Volcker Rule will be fully in place from mid-2015. However, some small banks with the larger part of their revenues and capital depending on securities trading (including securities issued by trusts) may suffer big losses. Banks may start to dispute actively the Volcker Rule before it comes into force.

Chart 5. US Households Net Assets and Loans to Enterprises



Sources: US Federal Reserve, Bloomberg

Chart 6. Lending to US Households and Non-financial Organisations (%, p.a.)



Source: US Federal Reserve

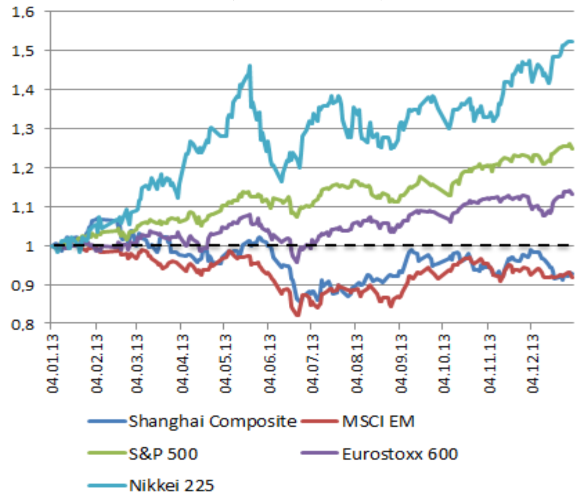
Market Risks

Conjuncture on Stock Markets

Share prices in advanced stock markets increased considerably by the end of 2013. The largest increase was demonstrated by the Japanese and US stock market indices: Nikkei 225 grew by 54%, while S&P 500 climbed by 25% in 2013. The rapid growth of Nikkei 225 was facilitated by the Bank of Japan's intense monetary stimulus programme. Meanwhile, S&P 500 stock index hit a new record high on the back of an economic upswing in the United States (the US Department of Commerce revised upward its estimate of third-quarter GDP growth to an annualised 4.1%) and budget agreement. Meanwhile market participants feel increasingly optimistic due to the IMF plans to improve its forecast of the US economic growth in January 2014. The European stock market composite index (Eurostoxx 600) also grew in 2013 (by 15%), though GDP growth in the euro area remains weak (the eurozone's GDP expanded by 0.1% in the third quarter of 2013 compared with the previous quarter and fell by 0.4% compared with the same quarter of the previous year). The euro area still remains fragmented: peripheral countries (Spain, Italy and Greece) are substantially behind the eurozone's core countries (Germany) by both financial and economic indicators.

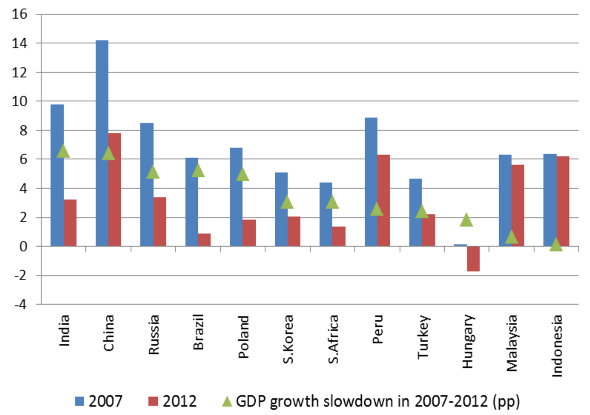
Emerging market stock indices are demonstrating downward dynamics as economic growth continues to slow down largely due to the fall in investment and low production activity amid capital outflow (Chart 8). In 2013, the MSCI Emerging Markets stock index lost 5%, while China's Shanghai Composite shed 7%, ending the year in negative territory for the third time in the past four years. Estimates of China's State Council also show that the country's GDP will slow to 7.6% in 2013 from 7.8% in 2012 (Chart 9). Apart from economic slowdown in China, investors are also concerned over the rapid growth in lending provided by China's shadow banking system. In this respect, it is very important how large-scale economic reforms aimed at stimulating domestic demand will proceed in China. These reforms are designed to boost long-term economic growth but may slow it in the short-term. Considering significant structural problems in emerging markets, advanced countries may be expected to drive economic growth in 2014.

Chart 7. Major Stock Market Indices
(04.01.2013 = 1)



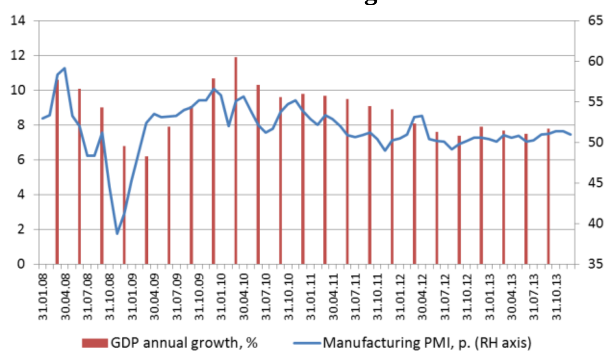
Source: Bloomberg

Chart 8. Annual GDP Growth Rates in Emerging Market Countries, 2007and 2012



Source: Reuters Eikon

Chart 9. China's Annual GDP Growth and Manufacturing PMI

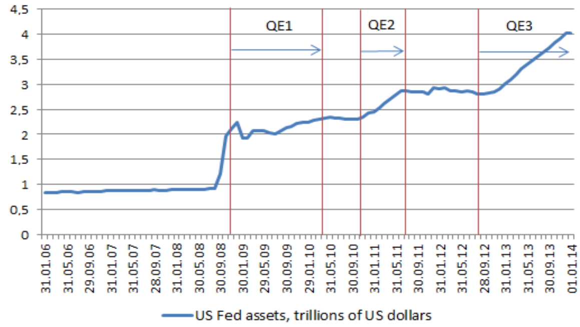


Source: Reuters Eikon

QE Tapering by the US Federal Reserve

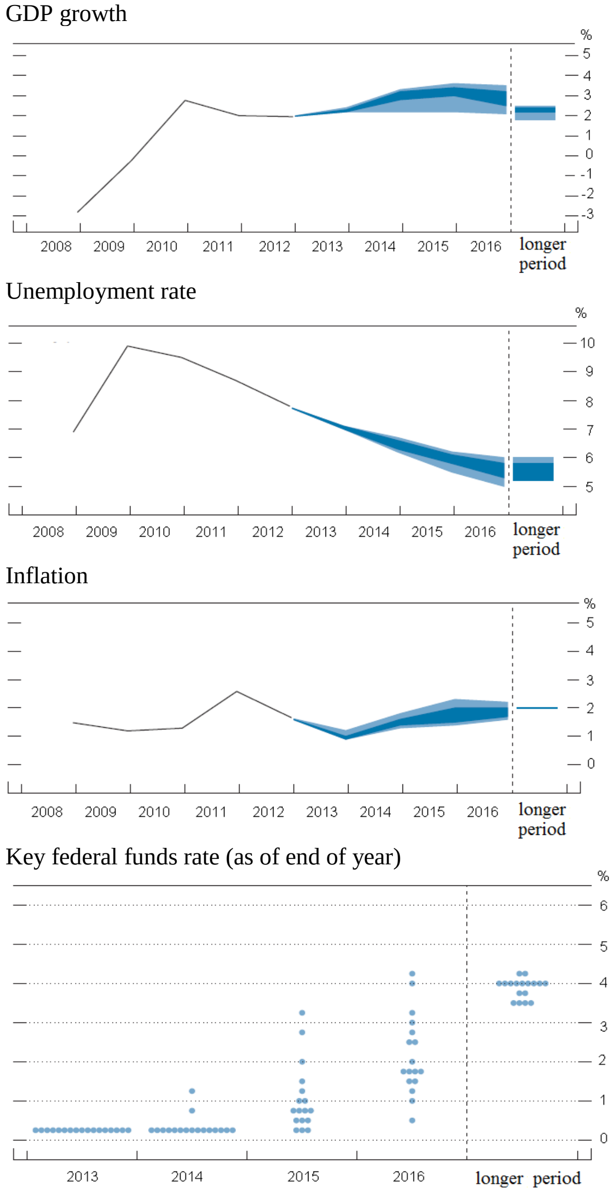
The US Federal Reserve's highly accommodative monetary policy in recent years, including the three rounds of quantitative easing (QE), increased its balance sheet to $4 trillion (Chart 10), which started to prompt fears of the emergence of asset market bubbles. At present, the US economy is gradually recovering and the labour market is improving (the unemployment rate fell to 7%). At the same time, the positive effect of asset purchases is becoming less expressed because the US Fed decided quite reasonably at a meeting of the Federal Open Market Committee (FOMC) on 17-18 December 2013 to start scaling down its QE programme. From the beginning of 2014, monthly asset purchases are reduced to $75 billion from $85 billion (Treasury bond purchases are lowered to $40 billion and mortgage-backed securities purchases to $35 billion). The regulator's press release notes that despite the decision to reduce bond purchase volumes, the Fed's still sizeable purchases of longer-term bonds will continue to put downward pressure on longer-term interest rates and will support the mortgage bond market. Moreover, it is emphasised that the Fed's monetary policy will remain highly accommodative, even when the bond purchase programme ends (by late 2014, as expected). The Fed extended its forward guidance criteria indicating that the federal funds rate would stay in the range of 0-0.25% as long as the unemployment rate remained above 6.5% and inflation for one-two years ahead was projected to be no more than 0.5 percentage points above the Fed's 2% longer-run goal. The regulator emphasises that these indicators are guidelines rather than threshold triggers for automatic rate hikes. The FOMC will take into account a broader range of labour market, inflation and financial sector indicators in its decisions on rate increases. The current target range for the federal funds rate may remain unchanged even when the unemployment rate falls below 6.5%, especially if projected inflation continues to run below the Fed's 2% longer-term objective. In his statement after the FOMC meeting, outgoing Fed Chairman Ben Bernanke noted that the unemployment rate would reach the target level of 6.5% already by late 2014 and fall below 6% in 2015, a year earlier of the previous plan. The Fed governors expect the first increase in interest rates only in 2015 and by late 2016 the rates will probably come close to 2% (Chart 11).

Chart 10. US Federal Reserve Assets



Source: Bloomberg

Chart 11. FOMC Outlook of Economic Indicators

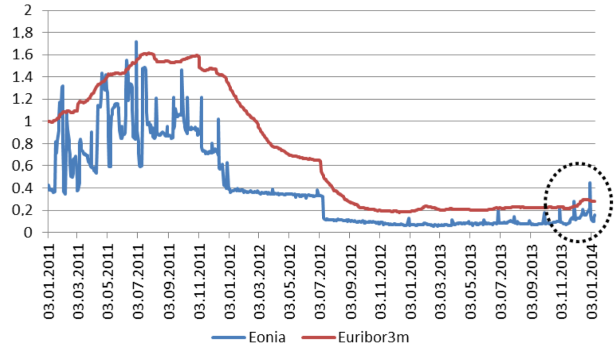


Source: US Fed

Interest Rate Risks in Advanced Countries

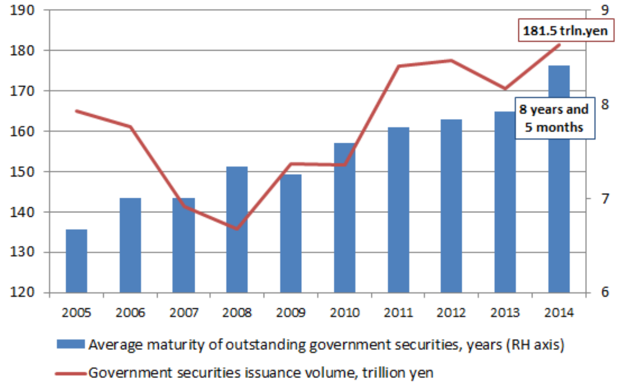
Although the US Fed eased its forward guidance criteria, it is evident that normalization of interest rate levels in advanced countries becomes a closer perspective. At the same time, in the coming years in conditions of multi-speed economic recovery policy tightening will be unsynchronised. The euro area is still a long way off from returning to the sustainable growth path. Higher interest rates as a result of monetary policy tightening in the US will increase debt service costs for both the private and public sectors, having most negative impact on the eurozone countries. Considering that these countries have already reduced government expenditures and further budget cuts are undesirable for political reasons, the reduction of borrowing costs may require additional stimulus measures, to bring inflation to normal levels as well. Moreover, stimulus measures may be required if tension returns to the interbank lending market (Chart 12). Japan is also exposed to interest rate risks especially considering a large volume of sovereign borrowings. In recent years the Japanese government has extended average maturity of government bonds to reduce refinancing risks (Chart 13). However, the amount of government securities emissions will remain at high level, as Japan implements stimulating measures to support national economy and achieve inflation target. In December 2013, Japan adopted new economic measures aimed at stimulating infrastructural projects and providing social support to the population to compensate for the expected negative effect of the consumption tax increase from 5% to 8% in April 2014.

Chart 12. European Overnight and Three-Month Interbank Loan Rates



Source: Bloomberg

Chart 13. Japan's Debt Obligations
(data for the fiscal year beginning on 1 April;
2005-2012 – actual data,
2013-2014 – draft budget data)

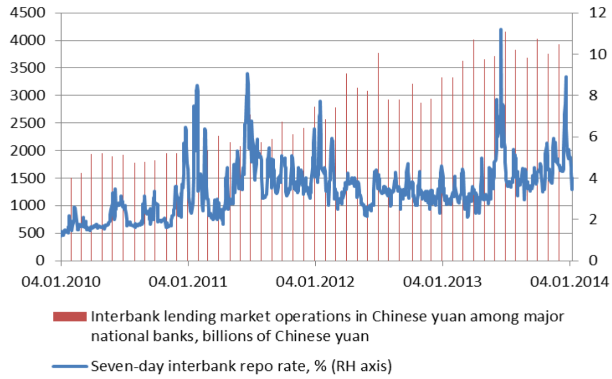


Source: Japan's Ministry of Finance

Rising Tension in China's Money Market

In December 2013, China's key money market rate climbed to a six-month high (Chart 14). Such tensions take place on the market due to reforms implemented by the People's Bank of China (PBOC) in the banking sector in the past six months (domestic rate liberalisation, limiting off-balance sheet lending, introducing a ban on Bitcoin operations). In recent years, Chinese banks have masked lending to businesses as interbank loans to evade tighter lending limits, which caused a dynamic growth of interbank loans. In such conditions, the PBOC's measures will possibly result in higher borrowing costs in the money market in 2014.

Chart 14. Interbank Lending Market Volume and Seven-Day Repo Rates



Source: Bloomberg

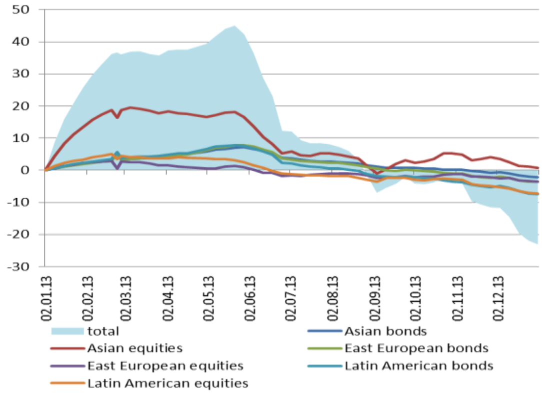
Capital Flow Risks

Higher Risks of Capital Outflow from Emerging Markets

Constant switches between risk-off and risk-on sentiments among investors after the 2008 crisis, and also unconventional monetary policies implemented by the leading central banks have caused high capital flow and exchange rate volatility. As a result, emerging markets faced significant challenges for their monetary policies. Now that the US Fed has started to scale down its asset purchase programme, these challenges may become increasingly complex and contradictory, considering that economic growth is slowing amid fairly high inflation. Capital outflow started to intensify already in the summer of 2013 when the Fed first mentioned the possibility of monetary policy tightening. As a result, the cumulative indicator of investment in emerging market equity and bond funds turned negative in 2013 (Chart 15). Net capital outflow from the securities funds totalled \$11.6 billion in December 2013, including \$4.5 billion of capital outflow from Asian countries, \$2.5 billion from Latin America and \$4.6 billion from Eastern Europe (Chart 16). Capital outflow was accompanied by a significant devaluation of national currencies. While currency depreciation in emerging markets may bring about some short-term positive effect, improving exporters' competitiveness in external markets (Chart 17), structural reforms will be required in the longer run to strengthen the economies and enhance resilience to external risks.

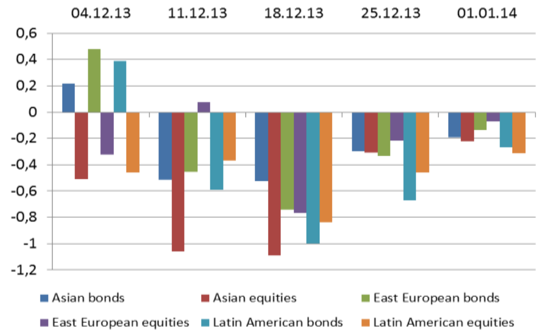
Significant risks may arise due to the end of the so-called commodity price super-cycle, when demand exceeds supply, especially for countries with a large share of commodity exports. Innovation-driven development, the use of new technologies and over-production in some heavy industries (especially in China), resulting in larger supply in markets, are expected to bring commodity prices down, which may become a very serious challenge for certain countries, including Russia.

Chart 15. Investments in Emerging Market Equity and Bond Funds in 2013
(cumulative amounts, billions of US dollars)



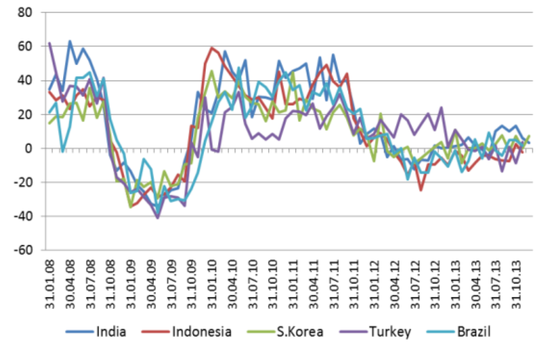
Source: EPFR

Chart 16. Investments in Emerging Market Equity and Bond Funds in December 2013
(weekly amounts, billions of US dollars)



Source: EPFR

Chart 17. Annual Export Growth Rates (%)



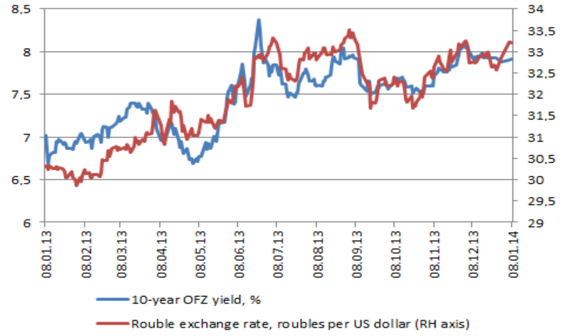
Source: Bloomberg

Current Global Risk Impact on Russia

Market Response to the US Federal Reserve's QE Tapering

The Russian financial market is stable enough despite quantitative easing (QE) tapering launched by the US Federal Reserve. The yields of 10-year government bonds (OFZs) and the rouble exchange rate against the US dollar did not register any significant changes in December 2013 (Chart 18). It was noted above that unsynchronised policy tightening by the leading central banks might destabilise capital flows, which could complicate economic growth pick-up in emerging market economies. But for Russia this problem is not so essential considering that the country has seen steady net capital outflow in recent years (Chart 19). Russia is implementing financial market liberalisation measures, which are expected to help reduce net capital outflow by private sector. In 2013, these measures were implemented in the OFZ market (as a result, the share of foreign investors in the OFZ market rose from 7% as of mid-2012 to 26% as of 1 November 2013). In 2014, liberalisation will be spread to the corporate securities segment.

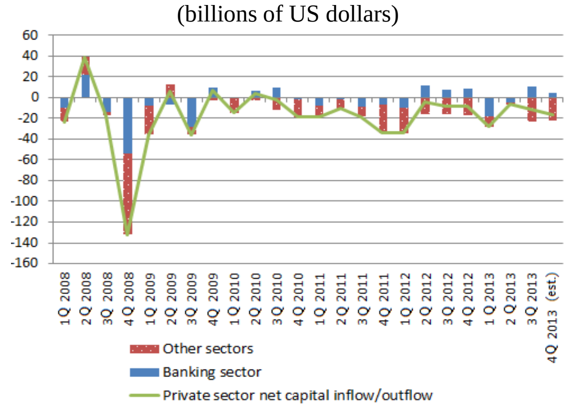
Chart 18. 10-Year OFZ Yields and Rouble Exchange Rate



Source: Bank of Russia

Chart 19. Private Sector Net Capital Outflow/Inflow

(billions of US dollars)

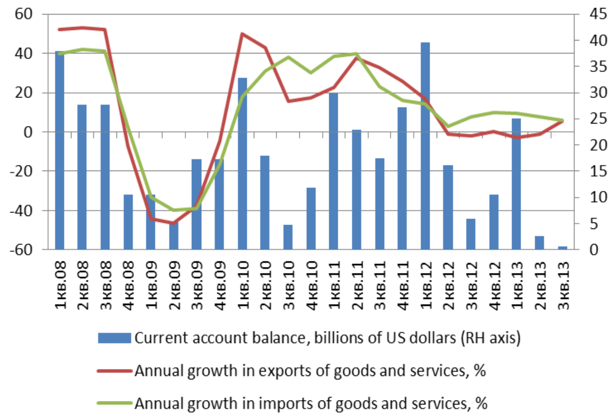


Source: Bank of Russia

Current Account Risks

Some concern is associated with the fall of Russia's current account surplus (Chart 20). This indicator totalled $28.3 billion in January-September 2013, registering a 54% decline compared with the same period of 2012 (largely due to the increase in the deficit of non-trade items). The current account reduction had negative impact economic growth in Russia in 2013. According to the updated December estimates of Russia's Economic Development Ministry the country's annualised GDP growth will amount to 1.4% in 2013. However, we expect that Russia's balance of payments will improve in the first half of 2014, taking into account both the seasonal factor and the Winter Olympic Games in Sochi.

Chart 20. Russia's Current Account Balance



Source: Bank of Russia