Moscow Financial Weekly

December 13, 2002 through January 17, 2003
Treasury Attache's office, U.S. Embassy Moscow

Highlights

- Preliminary 2002 GDP growth of 4.1%
- Financial reserve hits R209 billion ($6.6 billion)
- VEB now owns 94% of Roseximbank

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/$ (MICEX) UTS	R31.8600	0.05	5.72
Monetary Base*	R915.3 bln	-0.74	-2.66**
CPI	NA	NA	15.1
International Reserves*	$48.2 bln	0.21	0.42
RTS Index (end of week)	356.40	-0.43	-0.74%
Refinancing rate	23	0	4

*For week prior
** % chg from the abnormally high seasonal level at the end of the year.

Economic Developments

According to preliminary data, the **tax ministry transferred R136.9 billion** to the federal budget in December, which is 2.4% below the planned level of R140.3 billion. Collection of the unified social tax (UST) was better -- the Ministry received 124.7% of the target. At the same time, the Ministry announced that total 11-month tax collections were R3.9 billion lower than planned, although the shortfall was expected to have been much higher. The shortfall is ostensibly due to lower than expected profits tax receipts and lower industrial growth, particularly affecting receipts in November and December. The Ministry has noticed that increased collections of UST may be due to the fact that companies are reporting more accurately their employees' wages. Of the total sum collected, more than half comes from VAT (38%) and UST (22.5%). In late December, President Putin announced that a main policy task for 2003 would be "perfecting" tax reforms, with possible reductions in VAT and UST, with an increase in tax on the oil sector.

According to Deputy Prime Minister Aleksei Kudrin, the **financial reserve** (aimed primarily at regulating external debt obligations) finished the year at R209 billion ($6.6 billion), higher than the expected R197.4 billion. This figure doesn't include privatization receipts from the sale of the government's LUKoil and Slavneft shares. The high balance gives the government a degree of security as 2003 is a peak year for debt servicing.

According to preliminary estimates by the Ministry for Economic Development and Trade, Russia's **GDP grew in 2002 by 4.1%** and industrial production - by 3.9%. However, these are preliminary figures and usually revised upwards when final stats are announced in March.

The rating agency Standard&Poors upgraded **Russia's sovereign rating** from BB- to BB, leaving it just one step away from investment grade. Moody's followed S&P by upgrading the rating by one step from Ba3 to Ba2. Some observers who had hoped for a two-step increase were disappointed: in 2001, Moody's increased Russia's rating by two levels. However, it chose this time to be in parity with S&P, but both ratings are still one step below investment-grade. Both agencies announced that they do not expect to increase Russia's rating in 2003.

Economists were surprised by **the slowdown in industrial production** in November. According to Goskomstat, growth slowed to 0.8%, vice 3.9% in October y-o-y, while the forecasts for the month ranged from 1.6% to 3.8% y-o-y. Such a sharp and unexpected slowdown was explained as a continuing cyclical decrease in the machinery and non-ferrous metals sectors. Industries oriented to domestic demand found no support - chemical, oil-chemical, forestry and machinery were down, with the machinery sector alone making up 75% of the overall industrial slowdown. Meanwhile the fuel and ferrous metals sectors were the main drivers of growth, accounting for two-thirds of the growth in November. The Ministry of Economy had lowered its annual forecast for 2002 based on 11-month data down to 4% (previously 4.2%). However, according to preliminary Goskomstat data, even this forecast turned out to be too optimistic, as annual indutrsial growth was later estimated at 3.7%. Preliminary estimated December growth was 3.2% y-o-y.

Banking sector

According to the CBR, as of January 1, 2003, the distribution of **authorized bank capital** by size of bank is as follows:

Level of Authorized Capital	Number of Banks	Percent of Total Banks
Over R300 million	170	12.8%
R150m -- R300m	123	9.3%
R60m -- R150m	198	14.9%
R30m -- R60m	253	19.0%
R10m -- R30m	291	21.1%
Under R10m	102	7.7%

The combined authorized capital of all Russian banks as of January 1, 2003 reached R300.4 billion, a 15.1% y-o-y increase. In 2002 the total number of banks in the country increased by 10 to 1329.

President Putin has signed into law amendments to the **Law on the Bank of Russia** passed by legislators in late December. The bill gives the CBR the right to do a second check of a credit institution within a given reporting period to assess its financial standing and the quality of assets and liabilities.

In 2003 the **CBR may adjust the structure of its gold and forex reserves** in response to world market conditions, CBR First Deputy Chairman Oleg Vyugin said. The Board of Directors has already approved the new investment directives for 2003, Vyugin said, "but we cannot work with reserves like commercial organizations do, that is we will not be profiteering". Both current trends in the market for gold and rate dynamics of major currencies will be taken into account, he added.

According to Kommersant-daily, a partial privatization of shares to foreign banks will help **Vneshtorgbank (VTB)** overcome its main financial problem -- a $250-million mismatch between assets and liabilities. The current gap emerged after the CBR, for reasons that have not been announced, withdrew $800 million in deposits last summer. Meanwhile, Vnesheconombank (VEB) transferred part of its commercial business to VTB as part of the restructuring plan. Moreover, the CBR is going to withdraw an additional $950 million worth of deposits during this year, which will cause further imbalances. In VTB's plan, which Kommersant claims has been approved by the GOR, the EBRD will inject $300 million into VTB in the first half of this year, and the International Finance Corporation (IFC) will add $200 million in the second half. The IFIs are said to be flexible on how shares are acquired: through the purchase either of additional shares, or of subordinated bonds, or through a loan to be subsequently converted into VTB shares. However, the EBRD has said their investment is contingent upon a govement commitment to a reduction of state ownership to below 50% in the near future. The IFC has made no comment about an investment in VTB. At present, J.P. Morgan and Ernst & Young are conducting an assessment of VTB for the EBRD that should be completed by the end of February.

After **Vnesheconombank (VEB)** bought Roseximbank shares at its second issue, VEB now owns 94.637 % of its authorized capital and as well as Rosexim's banking license. According to the Association for Investors' Rights Protection, on January 5, when the payment for 90,000 common shares reached the account of Roseximbank, its assets went up by 125%, or R1.58 billion. The GOR approved VEB's action last September, when the document called "Conception of the state support for exports" was drafted. This document stipulates that Roseximbank should be assigned the function of GOR's agent servicing loans to foreign governments and should also be authorized to give loans from budget sources against foreign governments' guarantees. The takeover appears to be part of the government's effort to create a new role for VEB, which is owned by the CBR, in export guarantees and government trade finance, as well as traditional debt management functions.

Another state-owned bank, **Rosselkhozbank**, received a retail banking license from the CBR. Rosselkhozbank was created as a specialized bank for agricultural producers out of branches of the failed SBS-Agro, and as a result has one of the biggest branch networks in the country. Now the Finance Ministry and Ministry of Economic Development and Trade are worried that it will start taking household deposits and turn into just one more state universal bank instead of focusing on its primary mission. The two ministries hope to enter this issue on the agenda of one of the February GOR meetings.

The CBR has revoked **SBS-Agro's** banking license by request of the Agency for Restructuring Credit Organizations (ARCO), in whose receivership it has been since November 1999. SBS-Agro still owes R470 million to private depositors, R41.9 billion to legal entities (including R40 billion to non-resident) and R1.35 billion to the government. Only individuals may recover some of their remaining deposits: the only source for repayment is R284 million in the mandatory provisions stored in the CBR. ARCO plans to become the corporate liquidator for the bank.

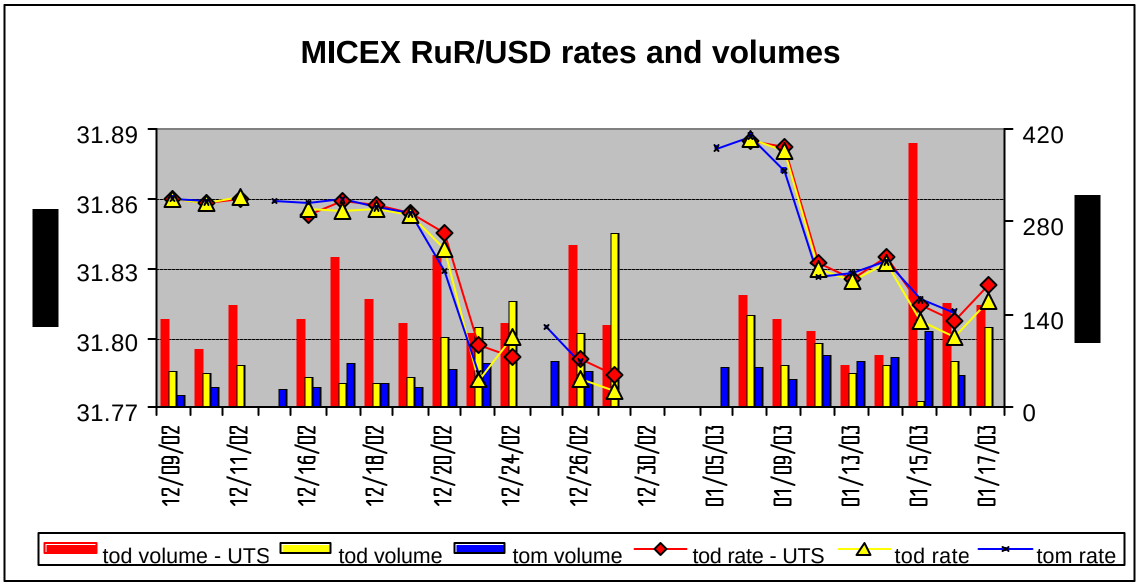
Financial markets

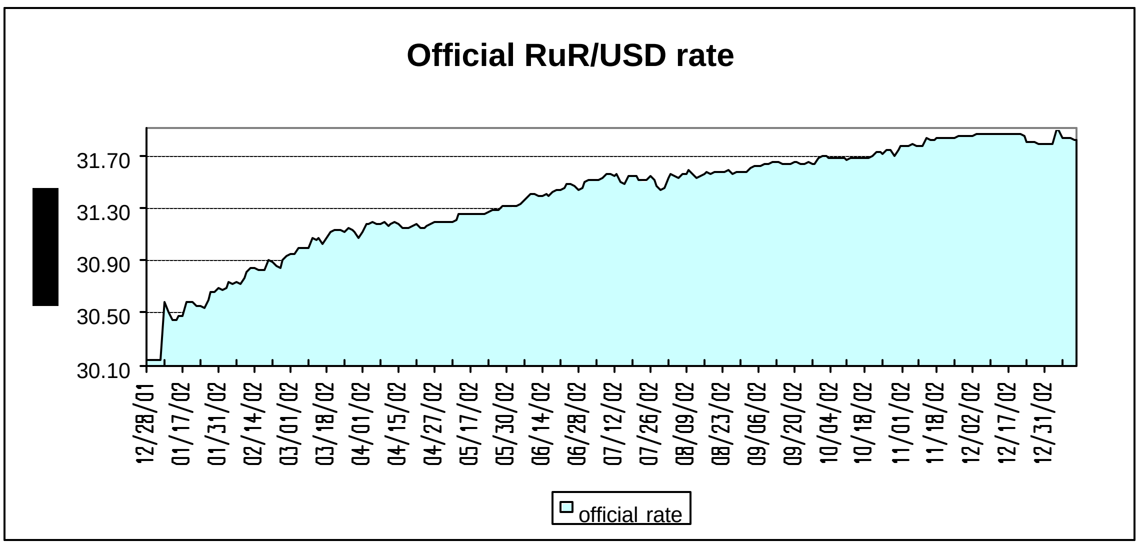
Forex Market

In the last two weeks of 2002 the ruble, unlike in previous years, strengthened slightly against the dollar without CBR intervention. Of course, demand for rubles increased at the end of the year, but this happens every year. What was different this time was exceptionally high oil prices, hence exporters' dollar revenues, plus dollar depreciation against other major world currencies. These two factors depressed demand for dollars in the Russian market.

In the first UTS session of 2003, the dollar rose 10 kopeks (0.32%) against the ruble, but in the following days ruble liquidity started shrinking and the ruble strengthened again. At the beginning of the week of January 13, the rates on interbank overnight ruble loans peaked around 20%, while the supply of dollars sharply decreased. The winners of the auction for Slavneft were in the process of raising the ruble equivalent of $1.86 billion, which resulted in a severe ruble strain and a temporary decline in the supply of dollars because they (and other exporters as well) did not want sell their earnings at a low rate. Finally, the retained export revenues poured on the market on January 15, when UTS trading volume surged to almost $400 million, the highest since the first session of 2002. The dollar slipped further against the ruble and somewhat recovered only on the last day of the week, when the CBR started buying dollars at R31.82/$.

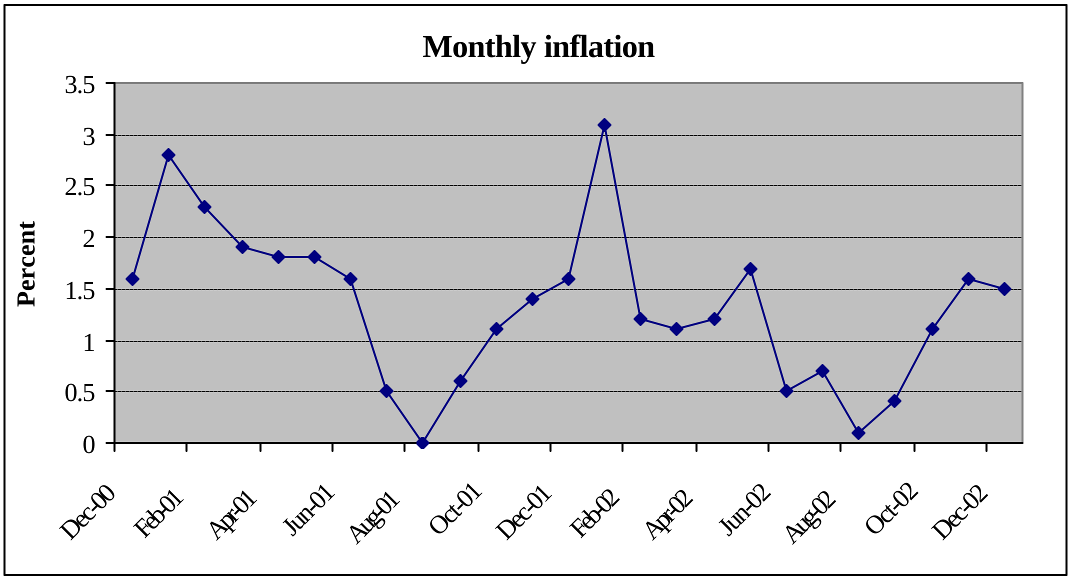
For the week of January 13, the ruble firmed 0.03% against the dollar, closing in the UTS on Friday at R31.8224/$. MICEX weekly trade volumes were $855.10 million, $299.39 million and $233.05 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.





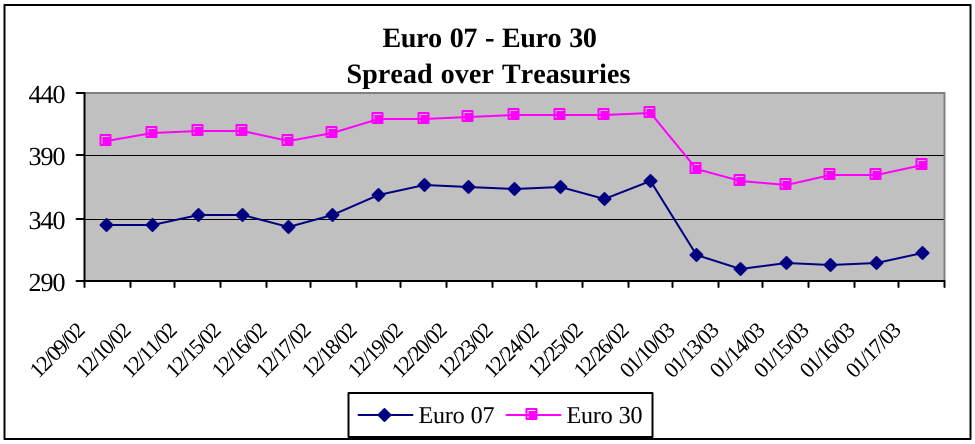
Prices

According to Goskomstat, inflation during December was 1.5%, compared to 1.6% in November. Annual inflation for 2002 was 15.1%, which is higher than government projections of 14% but lower than inflation in 2001, which was 18.6%. (The Central Bank claims that it did not take fully into account the price effect from the depreciation of the dollar/euro exchange rate, thus raising prices of European imports in the market.) While inflation has been decreasing over the past several years, keeping the trend going in 2003 may prove to be a challenge, given lower planned fiscal surpluses to sterilize incoming dollar flows and the desire to keep the ruble/dollar exchange rate slowly appreciating in real terms.



Eurobonds

In mid December Russian Eurobonds were quite stable. Negative news (the decrease in international reserves by $400 million and the increased annual inflation forecast) was outweighed by positive news (rapidly increasing oil prices). Later in the month a short-term downward correction took place in the market. With all the negative news priced into the market by the end of the year, January began with a nice rally on Russian paper. High oil prices, low interest rates in the States and increasing prices of Brazil Eurobonds supported Russian bonds. The most liquid Russian instrument, the Euro-30, already hit maximums in early January on news that OPEC planned production increases would not be enough to lower oil prices considerably. Also, the market benefited at the start of the new year when investment managers form new positions.

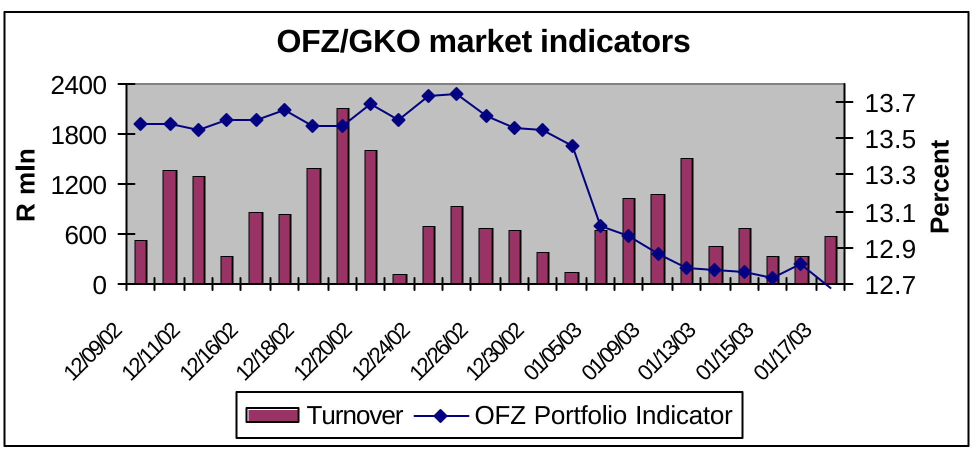


Interest/Bond Market

Bonds/Bills

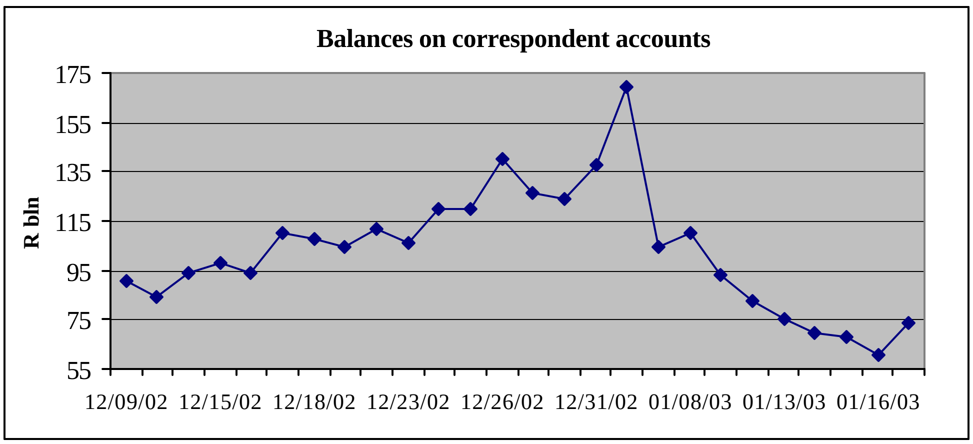
In the middle and end of December there were two offsetting factors present on the market that led to an increase in trade volumes with narrow price fluctuations. Some players were taking profits for the year and leaving the market, while others were forced to purchase due to increased ruble liquidity. In the beginning of the year, money which left the market earlier returned, and a new wave of price increases began. The sharpest increase took place on January 5. Later, the yields decreased at a smoother pace but still supported by higher than average volumes. Paper from all segments of the market was in demand.

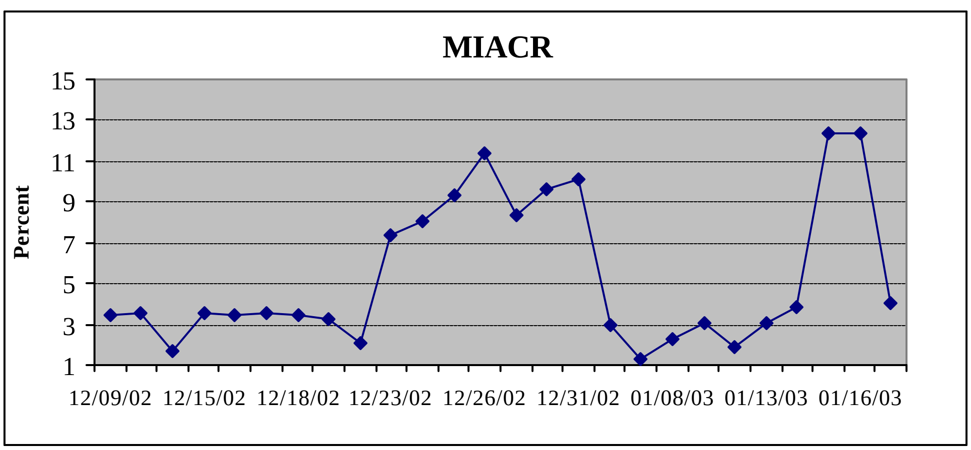
On January 16, the government approved its domestic borrowing plan for 2003. Min Fin will borrow up to R169.52 billion in the domestic market, as planned in the 2003 budget. It will redeem R112.89 billion worth of domestic debt and repay R32.46 billion in other borrowings. Thus net domestic borrowings could reach R24.17 billion. The government will allow the CBR to restructure R300 billion of OFZ's held by the bank, with about R265 billion swapped into non-market issues, to be used by the CBR for reverse repo operations.



Overnight rates

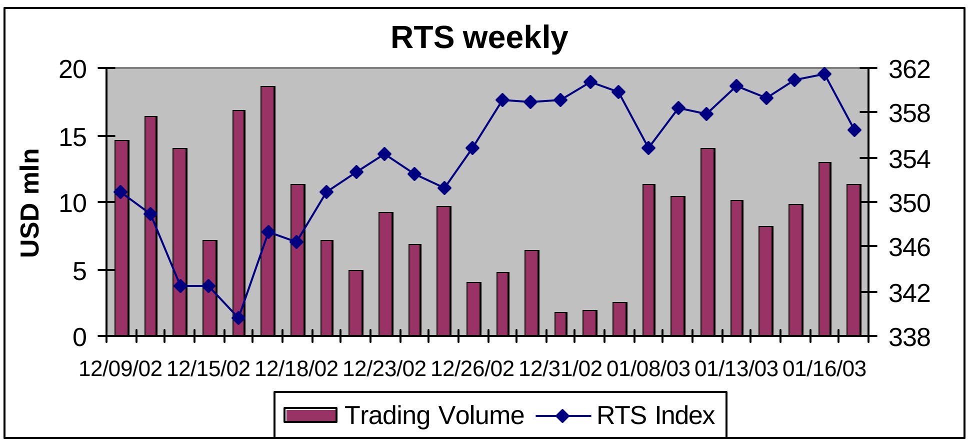
Banks started to accumulate rubles in correspondent accounts at the CBR from the beginning of December. From December 17 onward, the balances on banks' correspondent accounts at the CBR have not fallen below R100 billion. They hit all-time highs at the beginning of the year, with a record R170 billion on January 4 -- the first work day of 2003 -- and then began to slide quite sharply. Last week the daily average stood at R69.94 billion rubles, a quite modest level for the accounts. However, it should be noted that banks were making obligatory tax payments for their clients last week, which helped overnight rates rise to 12% for a couple of days (MIACR). Overall, as a result of banks' preparation for the holiday season, overnight rates remained only slightly higher than average, which differs from last year's tight liquidity situation when overnight ruble credit rates rose to 50% on some days at the end of the year.

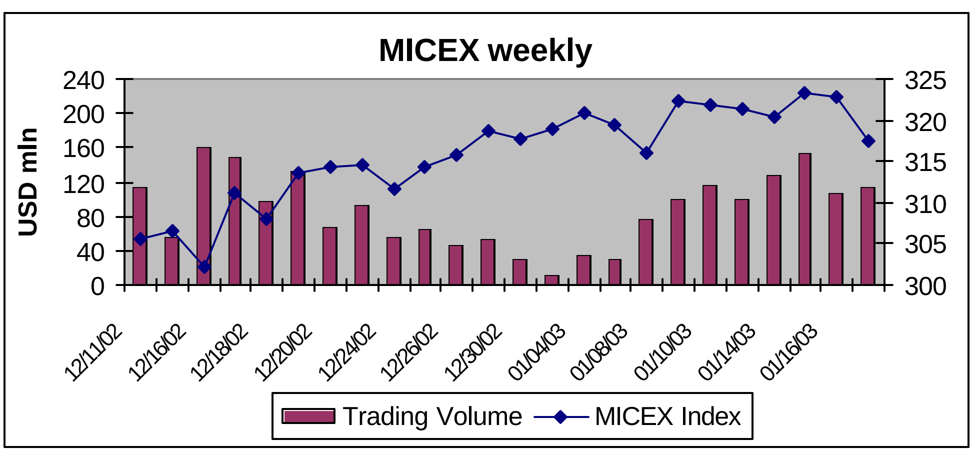


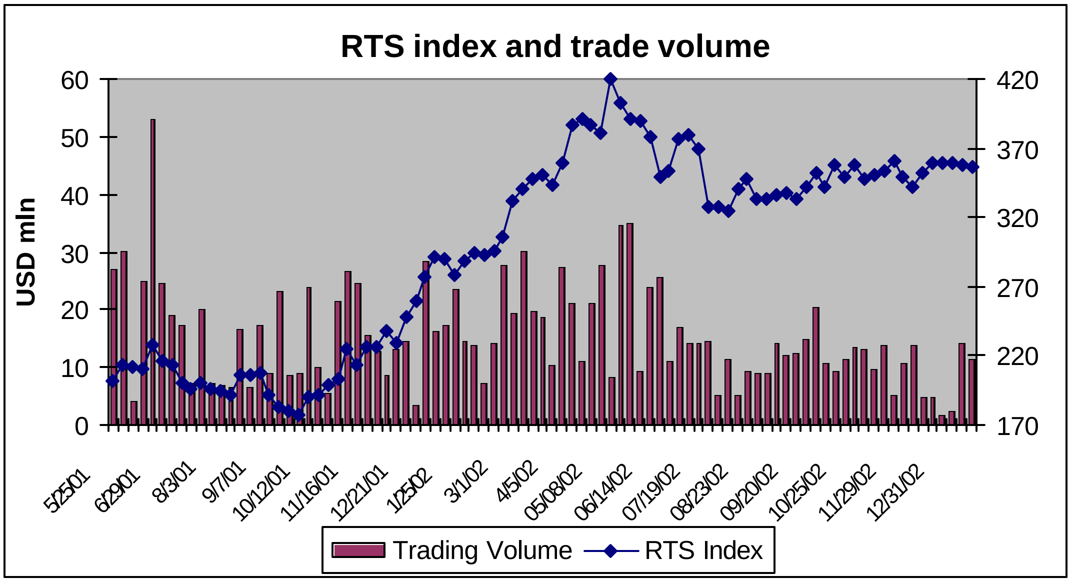


Stock Market

In the middle of the December, the market reached a 2-month minimum because of negative news from both world markets and domestic oil companies. Since then, buying has picked up because of attractively low prices. However, trade volumes were very low, due to seasonally lowered activity. A supporting factor for the market was the sale of the government's shares in Slavneft that took place at about that time. At the end of December, trade volumes became even lower, as many traders left right after December 25 and it became clear that it would be very difficult to break the strong resistance level of 360 without foreign money. Therefore, the long-expected and predicted end-of-the-year rally did not take place at the end of 2002. In the beginning of this year, the market pierced through the 360-level on increased volumes, but wasn't able to hold the position. During the next few days the fluctuations had no clear-cut trend. Volumes remained at lower than average levels, indicating the absence of fresh money. Last week, the market grew in three trading sessions out of five, staying close to the 360-level. However, the usual technical downward price correction on Friday became a massive sell-off on the news of the shaken U.S. market. As a result, the RTS index was down by 0.43% for the week in dollar terms.





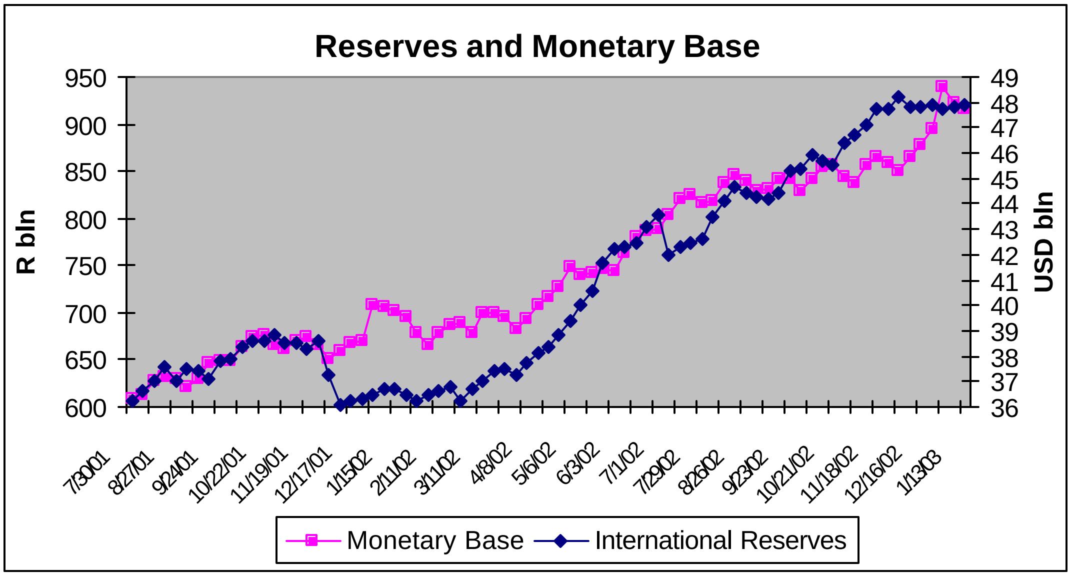


International Reserves and Monetary Base

After reaching a record high at the beginning of December, reserves declined, as had been predicted by market observers. The first drop of $400 million was sharp enough to make the market slightly nervous. However, during the next five weeks, reserves fluctuated in the range of $47.7-9 billion, reaching $47.9 by the middle of January. In December reserves fell by $400 million as a result of the CBR interventions to support the ruble. This was the highest monthly drop in reserves in 2002. However, during 2002, reserves grew by $11.2 billion -- the highest annual growth since the end of the USSR.

CBR Deputy Chairman Konstantin Korishenko announced in January that the majority of Russian foreign exchange reserves are invested in U.S. Treasury notes and German government bonds. The rest of the reserves are held in CBR accounts at major U.S., UK and Swiss banks. The CBR receives annual yield of 2-3% on those investments.

The monetary base grew continuously since the beginning of December and reached a record high of R940.3 billion on December 30. The growth was seasonal and is explained by increased budget and end of year salary expenditures during this time of the year. The base declined in January after the sharp spike, and by the second week of January dropped to R915.3 billion.



EXPLANATORY NOTES

1. **EXCHANGE RATES**: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which exporters have to sell 50% of the repatriated currency. UTS fix (rounded) becomes the "official" ruble rate for the next day. "$-tod" price is the price of the dollar with same day delivery. "$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is $100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. INTEREST RATES: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. STOCK INDICES: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. **LOMBARD CREDITS**, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.