Moscow Financial Weekly

For the week ending August 8, 2003
Treasury Attache's office, U.S. Embassy Moscow

Highlights

- Quality of Russian banks' loan portfolio deteriorating
- Regional Bank Association "Rossiya" comments on foreign bank branching

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/$ (MICEX) UTS	R30.3989	0.33	-4.36
Monetary Base*	R1159.7 bln	-0.44	23.33**
CPI	NA		8.7
International Reserves*	$64.4 bln	0.78	35.00
RTS Index (end of week)	473.08	4.88	31.75
Refinancing rate	16	0	-23.8

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

Economic Developments

According to preliminary Goskomstat data, **industrial production** in July grew by 7.1% y-o-y. (For June this figure was 7%.) During the first seven months of 2003, production was up by 6.8% compared to the same period of the last year. While production growth began to slow slightly during May and June, the new data suggests that perhaps the trend is reversing.

Banking sector

In 2002 Board Chairman of MDM Bank Andrei Melnichenko predicted that the next banking crisis would be a crisis of bad credit portfolios. Last week Peter Aven, President of **Alfa Bank**, told *Vedomosti* that a financial crisis of domestic loan defaults is the most likely and potentially dangerous. He does not expect any crisis to happen sooner than in 2-3 years from now, however. He said that the influx of oil revenues into the country creates an excess of liquidity, which provokes bankers to be soft on providing loans. Aven called upon the CBR to tighten supervision, with an aim to achieve full and unconditional compliance with Basel principles, as a minimum. "The Central Bank has to be tougher ... you need more control and more transparency," he said. Aven also stressed the need to level the playing field for all banks by eliminating the preferences enjoyed by state-owned banks.

Aven's concern is substantiated by the CBR statistics published also last week. What is worrying in the official data is not the absolute values, but the dynamics: the **quality of loan portfolios is deteriorating**. Even more worrying is that country's largest banks are showing worse performance than the whole banking system. As of June 1, 2003, Russian banks' loans totaled R 2,311.8 billion. The five largest banks lent more than 43% of that amount, a little over a trillion rubles. At the same time, almost two-thirds of the total volume of delinquencies reflected in bank balances was in these five banks. The share of delinquent loans at the top five banks is 50% larger than the average for the whole banking system. As of June 1, bad loans of the top five banks totaled R 29.65 billion. This is almost 3% of the total volume of their loans. For the whole banking sector respective figures are R48.3 billion and 2.0%. These are official figures, but an unnamed source at the CBR told *Vedomosti* that an estimate of the share of bad loans in the entire banking system of 10% is "closer to reality."

At the beginning of 2003, loan delinquencies accounted for 1.95% of the total volume of Russian banks' loans and for 2.5% of combined loan portfolio of the top five banks. The share of delinquencies at the top five was growing steadily from month to month, to increase between January 1 and June 1 by 0.5 percentage point, while for the whole banking system by 0.05 percentage point. Not surprisingly, both large banks and smaller ones have more problems with loans to legal entities than with loans to individuals; the share of delinquencies on consumer loans typically does not exceed 1%. Thus, the share of delinquent loans to enterprises increased since the beginning of the year from 2.1% to 2.8% at the top five banks, and from 1.8% to 2.0% for the whole banking system.

On August 7, Standard&Poors published a report that also bears out another Peter Aven's concern ("Sberbank Dominates the Russian Banking Market"). S&P's credit analyst Ekaterina Trofimova wrote that the size, funding advantages, and pricing power of **Sberbank** have a huge destabilizing influence on the competitive environment of the Russian banking sector. Among other things, Trofimova stresses that Sberbank has a high concentration of credit risks, with 21% of total credit portfolio, or 97% of equity, accounting for its ten largest borrowers.

The Association of Regional Banks "Rossiya" sent a letter to the CBR stating that **foreign bank branching** in Russia would have negative consequences for the Russian banking system. First, Rossiya notes that the CBR is not in a position to set mandatory provisioning requirements for foreign branches. Also, foreign bank branches would have more opportunities to optimize taxes, since they will not be accountable to Russian tax authorities. Rossiya is also concerned that branches would be supervised by regulators from the bank's country of origin, and disparities in prudential and other regulatory norms would lead to special advantages for branches when executing certain transactions. Finally, the presence of foreign bank branches may result in large-scale transfers of speculative capital that would destabilize local financial markets and increase banking risks. The bottom line, in Rossiya's view, is that foreign branches would have a comparative advantage over domestic banks. If foreign branches are allowed in Russia, Rossiya would like the CBR to sign a cooperation agreement on supervision with regulators of the home country for each bank that opens a branch here. They advise that only banks with AA rating from S&P (or similar from Moody's) should be eligible to open branches, and that the reciprocity principal should be applied to the fullest extent. Rossiya's letter is probably a response to the CBR call for comments on the statement of the Financial Leaders Working Group and Bundesverband Deutcher Banken (German banking association), in which they urge the CBR to let foreign banks open branches in Russia.

The Ministry of Finance has drafted an amendment to the **Law on the Central Bank** according to which the CBR would be required to surrender 80% of its after-tax profit to the federal budget. Currently, the CBR has to transfer 50% of after-tax profits to the budget, and prior to 2003 it was 50% of the pre-tax profit. Reportedly, the draft 2004 budget that was submitted to the GOR at the end of last week is calculated on the assumption that the amendment is already in effect. Oleg Vyugin, CBR First Deputy Chairman, spoke out against the amendment arguing that the CBR still needs a lot of money to restore its capital to the pre-crisis level. He also pointed that such an expansionary move would have negative inflationary impact. Duma deputies from the banking and budget committees are split around this issue, but supporters of the amendment seem to outnumber opponents, so it is likely to be passed simultaneously with the 2004 budget bill.

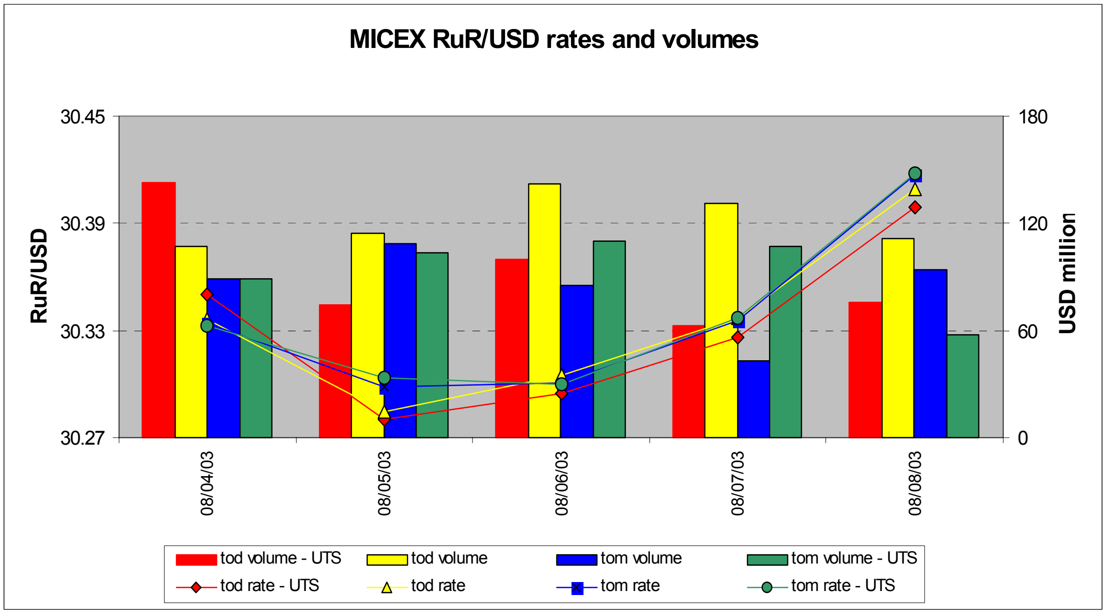
According to the CBR statistics, in June 2003 for the first time ever, **authorized banks exported more foreign cash** than they imported. Almost 40% of the total exports accounted for US dollars. Banks imported $75.8 million and exported $850.4 million. As for euros, the situation was the opposite: $547.9 million worth was imported, and just $1.2 million worth was exported. Total net exports for all currencies amounted to $226 million. Foreign cash flow through authorized banks is mainly determined by the behavior of individuals, rather than firms. In particular, the CBR commented that the increase in the supply of foreign cash by individuals is driven by expectations of further weakening of the dollar against the ruble.

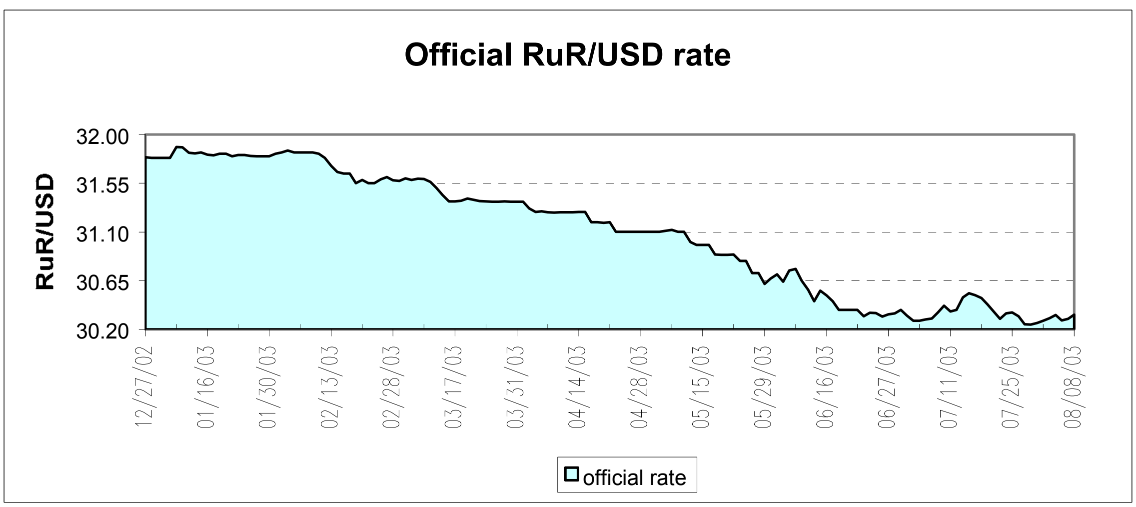
Financial markets

Forex Market

The dollar strengthened in Monday morning UTS trading on the previous week's momentum, but slowed down the same afternoon and even weakened against the ruble by close of business, following its own dynamics on the international forex market. When it reached the local minimum on Wednesday morning, the CBR appeared in the market with a bid at R30.25/$. This demonstration of support to the dollar was enough to momentarily reverse the trend. For the rest of the week the dollar was once again moving up against the ruble, this movement being backed by another wave of dollar firming against the euro. The supply of dollars went down by the end of the week, probably because exporters were holding them, hoping to sell later at a better price.

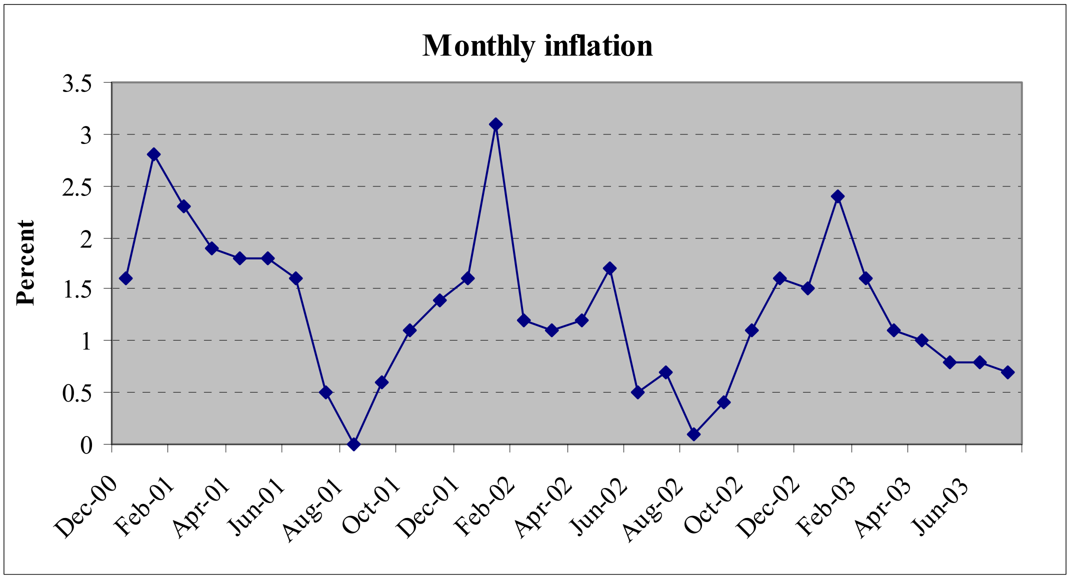
For the week the dollar firmed 0.33% against the ruble, closing in the UTS "tod" on Friday at R30.3989/$. MICEX trade volumes were $455.16 million and $467.02 million, $606.83 million and $420.02 million for the UTS "tod" and "tom" sessions, and SELT "tod" and "tom" sessions, respectively.





Prices

Inflation in July was 0.7%, which was above the State projections of 0.5-0.6%. The main driver of inflation in July was a rise in prices for communication services and passenger transportation. The annualized figure now stands at 13.9% while the annual forecast by the Government is still 12%. In early August, MEDT Minister Gref confirmed that the Government's forecast remains unchanged. However, to reach the target, deflation would need to be registered in August. The Government hoped for the deflation in July as well; however, these expectations were not realized.



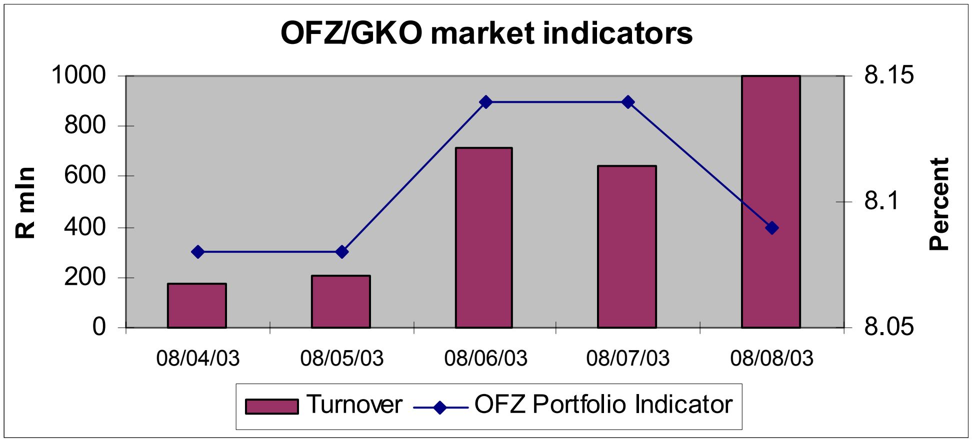
Eurobonds

The downward trend dominated on the market in the beginning of the week; however, the situation reversed later in the week, and most Russian Eurobonds were able to close the week with gains. For instance, the yield of the most liquid Euro-30 went down to 7.7% p.a. after reaching 8% in the middle of the week. By Friday, the Euro-30 price quotes were 90.4% of par value. The domestic news was neutral last week and the emerging markets peers did not affect the Russian Eurobond market last week. Movements in U.S. Treasury bonds remain the main source of market fluctuations.

Interest/Bond Market

Bonds/Bills

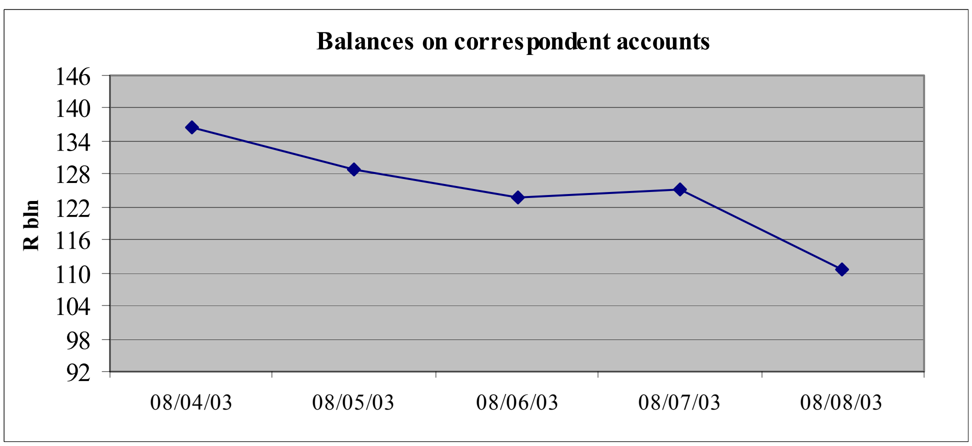
After quite a sharp increase in the market at the end of July initiated by the purchases of the big players, the market corrected downward last week. The yields became unattractive for the most players, after dropping a week before, and there was no clear-cut trend on the market on the lowered volumes. The decreased prices on the Russian Eurobonds sector in the beginning of the week added to the negative mood of the domestic market. The Wednesday GKO primary auction did not affect the market and revealed continued muted demand for government papers by the market. It should be noted that there also was no strong selling pressure, due to increased ruble liquidity. At the end of the week, the market rose given purchases of a large investor (normally Sberbank, pension fund, etc.).

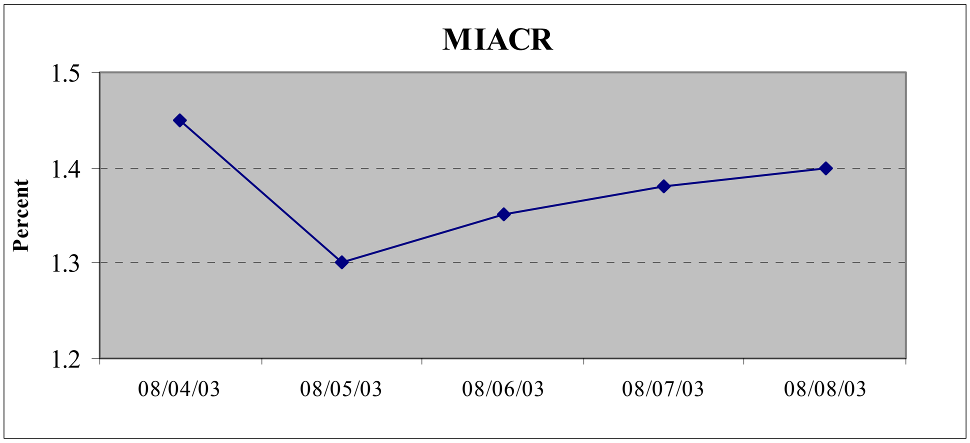


Overnight rates

The situation with ruble liquidity stabilized last week. After jumping to R144 billion by the end of the previous week, balances on banks' correspondent accounts at the CBR decreased to more moderate levels. Average daily balances stood at R124.98 billion on August 8.

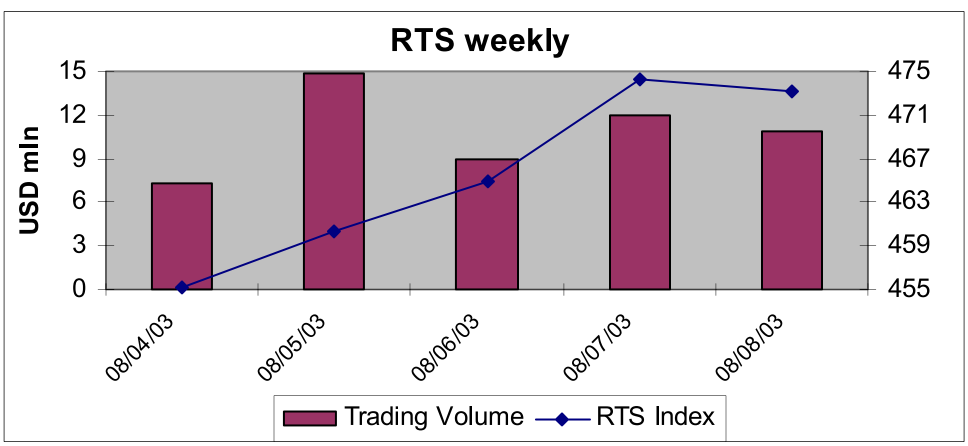
The interbank short-term ruble loan rates decreased to a familiar narrow range of 1-2% p.a. for overnights as a result of the increased quantity of rubles on the market.

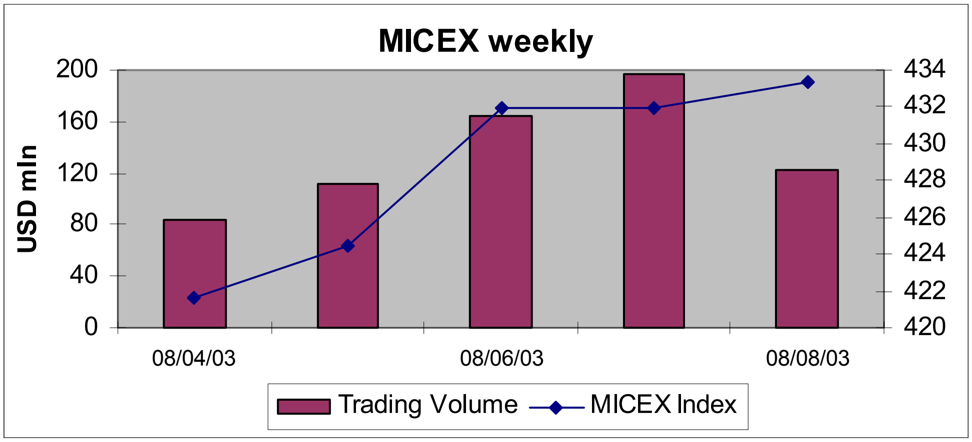


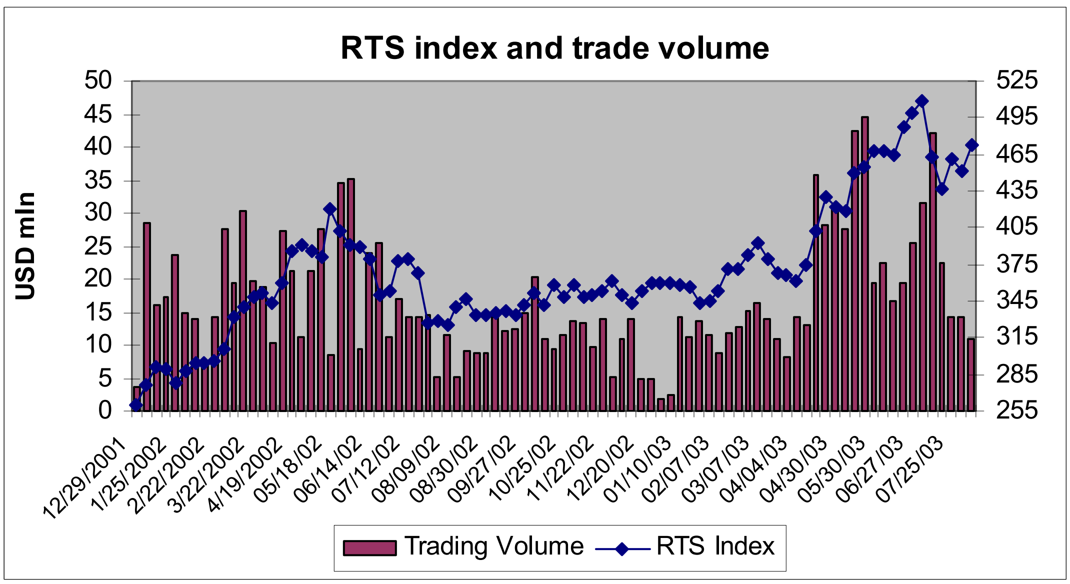


Stock Market

After a week of sliding, the Russian stock market experienced a nice rally last week, brining it back to levels of the middle of July. Trading volumes remained modest, which is traditional during August. Oil shares were the main driving forces due to the increased world oil prices. The market was also stimulated by the confirmation of the rumors about the planned record high dividend payments by the unified company “YukosSibneft”. Yukos and Sibneft became the leaders of the week, up by 9.1% and 12.2%, respectively. The substantial selling pressure experienced by these two shares in July have brought the prices to the attractive levels, which was another factor causing the sharp increase last week. The RTS index grew for four consecutive session and slightly corrected downward on Friday due to the profit fixing before the weekend. The RTS index was up by 4.88% in dollar terms for the week.



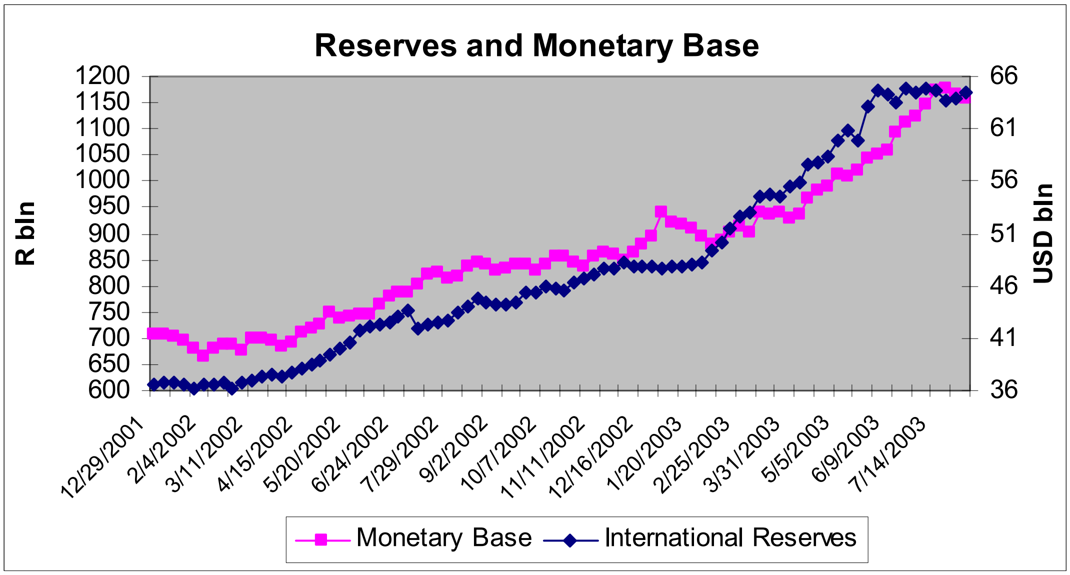




<u>International Reserves and Monetary Base</u>

Reserves grew by $500 million, for a total of $64.4 billion as of August 1, 2003.

The monetary base continued to decrease for the second week in a row and totaled R1159.7 billion as of August 4 which is R5.1 billion lower than the week before.



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 "tom" weighted average as of 11:30 becomes the "official" exchange 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.