Moscow Financial Weekly

For the week ending February 7, 2003
Treasury Attache's office, U.S. Embassy Moscow

Highlights

- Duma Banking Committee reviewing currency control bill, amendments to law on banks and banking
- Transkreditbank "SUP" shares transferred to the Ministry of State Property from Railroad Ministry
- MDM sells Konversbank (not to Alfa)

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/$ (MICEX) UTS	R31.8352	0.00	0.16
Monetary Base*	R879.1 bln	-1.70	-6.50**
CPI	NA	NA	2
International Reserves*	$49.3 bln	2.28	3.35
RTS Index (end of week)	353.46	2.29	-1.56%
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 the Ministry of Economy, the **external trade balance** was $45.8 billion in 2002, down by 7.7% y-o-y. Exports were $106.1 billion while imports totaled $60.1 billion. The sharp increase in world oil prices beginning in the second half of 2002 was not enough to reverse the decline in the overall trade surplus. On a brighter note, last year's decrease was not as large as the 18.6% fall in 2001, perhaps due the appreciation of the euro vis a vis the ruble.

According to Goskomstat, **GDP grew by 4.5%** during 2002. At the end of last week, Goskomstat published its first official estimate at 4.3%, but later Prime Minister Kasyanov announced that according to "verified" data from Goskomstat, the figure was 4.5%. For the first nine months of 2002 GDP growth was 4.1% and totaled R7.91 trillion. Taking into the account the slowdown in industrial production growth, the GDP increase during the 4Q of 2002 should be attributed to higher growth in the services and exports sectors. High oil prices in the 2H of 2002 increased export revenues considerably.

According to Moscow Narodny Bank's Purchasing Managers' Index (PMI), Russia's **industrial output** has contracted for the first time since 1998, with the index falling to 49.1 in January from 50.4 in December (50 indicates no change). The reasons given for the decline include: lower export orders, uncertainty over domestic demand, growing energy costs, and growing costs for imported raw materials. While the uncertainty in domestic demand seems a little odd, given the increased incomes over the past year, managers may be concerned about the flight to quality -- i.e. increased demand for imported products -- as well as the fact that spending on consumer goods and retail services fell in Russia last year from 74.4% to 72.2% of total monetary incomes, according to Goskomstat. Furthermore, spending on goods fell from 59.5% to 57.7% of total spending, due in part to increased spending on services, taxes, and investments. In any event, the results of the index highlight that those industries that lack the flexibility to restructure to increase quality and productivity will continue to face difficulties in the current business environment.

Banking sector

The **CBR** has published a recommendation addressed to all credit organizations to refrain from establishing correspondent relations with banks registered in Nauru as well as those not having physical presence in any country, and to consider discontinuing previously established correspondent relations with such banks. The document, signed by First Deputy Chairman Andrey Kozlov on January 20, refers to Financial Action Task Force (FATF) decision to apply countermeasures on Nauru, the law on the Central Bank and the anti-money laundering law.

The Duma Banking Committee opened consideration of the new version of the **currency regulation and control bill** on February 3. The government draft, submitted to the Duma on December 31, still contains a mandatory repatriation requirement as well as a requirement for mandatory sale of a portion of export revenues, but the norm for the latter, to be set by the CBR, may not exceed 30%. While the law provides for some restrictions to be lifted by 2007, the surrender requirement would remain in effect at the discretion of the CBR. The bill contains no restrictions for current transactions, defined as 180 day duration or less. However, the CBR and the GOR may impose Tobin-like tax provisioning requirements on capital account transactions (180 days or more) in case of a sharp decline in foreign reserves, instability of the ruble exchange rate or significant BOP weakening. However, there are two alternative drafts to the government bill in the Duma. The first, developed by the Union of Industrialist and Entrepreneurs and submitted by a group of Duma deputies, is more liberal than the government draft with no repatriation/surrender requirement. The other, submitted by Duma Deputy Yevgeny Ischenko, is more conservative than the government version, but the majority of members of the Banking Committee are not seriously considering this version.

Also on February 3, the banking committee opened consideration of an **amendment to the Law on Banks and Banking** that would regulate forward, futures and options deals between credit institutions and provide judicial support for such deals. It is planned that this bill will go through Duma readings simultaneously with respective amendment to the

Civil Code that was prepared earlier. Such a law would improve liquidity among banks and allow them to carry out risk-management operations similar to western banks.

Three Duma Deputies, Valery Zubov, Chairman of the Banking Committee, Pavel Medvedev, Deputy Chairman of the Banking Committee, and Anatoly Aksakov, Deputy Chairman of the Economic Policy Committee, introduced a bill "**On the Federal Bureau of credit histories of the Russian Federation**" on February 4. According to the bill, the unified credit bureau to be created at the CBR should collect credit histories of natural persons only and just those submitted voluntarily. Meanwhile, the Ministry of Economic Development and Trade has also finalized a draft, over a year in development, which would envisage a commercially run database under the auspices of a self-regulating organization, with no data eligible for record without the consent of the borrower. This draft has not yet been approved by the government nor presented for Duma consideration.

On February 5 the Ministry of State Property announced that it completed the transfer of all bank shares that previously were owned by State Unitary Enterprises (SUPs) to the State Property Ministry. According to the Ministry, various SUPs owned shares worth R2.5 billion. Nearly one half (R1.2 billion) of this amount accounted for 75% share in **Transkreditbank**, which was transferred to the Ministry of State Property by SUPs of the Ministry of Railroads on February 5. Transkreditbank was ranked 37th in Russia by capital (R2.24 billion) and 39th by net assets (R12.1 billion) as of October 2002. The Ministry of Railroads was loath to fulfill the GOR resolution that required it to give up the bank and, as reported earlier on December 31, 2002, even registered an additional share issue worth R1.75 billion that attempted to dilute the government's potential share in the bank. When this scheme failed as a result of strong pressure from Prime Minister Kasyanov, the Ministry of Railroads signed a strategic cooperation agreement with Baltic Construction Company, which owns 80.4% of Transstroybank, and, reportedly, transferred R450 million-worth of assets to the latter from Transkreditbank.

On February 6 MDM bank and Akademkhimbank released a joint statement announcing an agreement regarding the sale of **Konversbank**. MDM group will sell an 85% stake in Konversbank to Akademkhimbank for $65 million (which is $15 million more than the capital mentioned in the banks' joint statement). The transaction will be completed in due course, according to the press release. Vladimir Antonov, former Akademkhimbank Board Chairman, is now appointed as Konversbank Board Chairman. According to the statement, with the purchase of Konversbank, Akademkhimbank begins "creation of a universal banking group which will not be limited to servicing just sectoral enterprises of Minatom and of Russian Academy of Sciences." Reportedly, Julian Krasnopolsky, MDM bank's Deputy Chairman in charge of the bank's expansion into the regions, is going to quit MDM for Konversbank, which could indicate that MDM is no longer interested in further expansion in the Russian market.

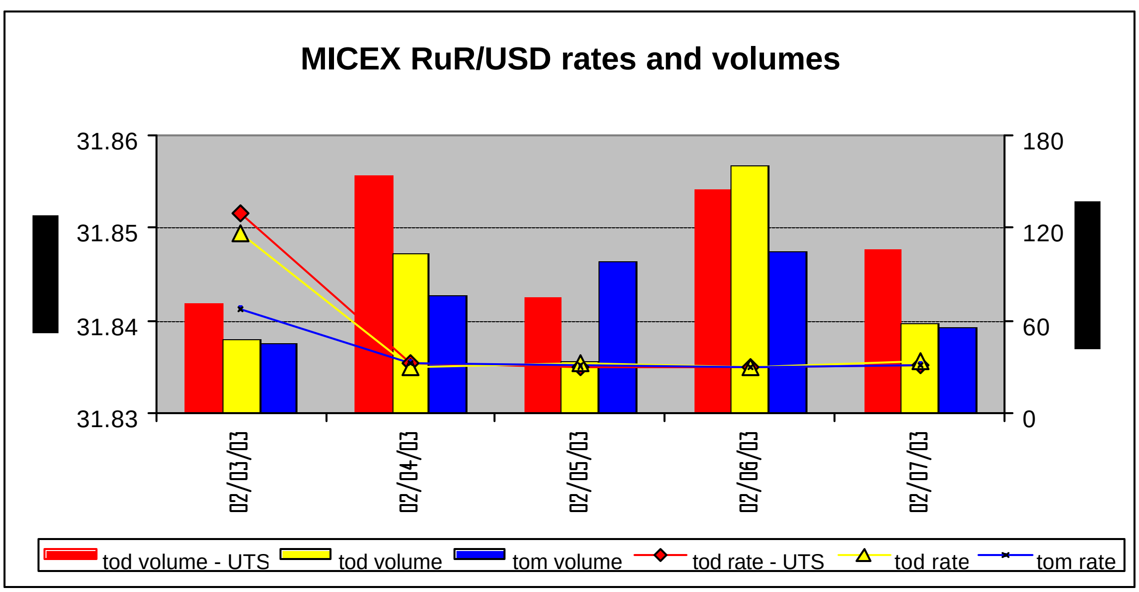
Recently, **cash exchange points** in Moscow significantly reduced, up to a ruble in some cases, the price they pay for dollars. Their formal explanation is that individuals now prefer to purchase euros rather than dollars. However, the real reason for this may be in the elimination of the 1% tax on purchases of foreign cash that came into effect on January 1. Last year the dollar was far more popular in Russia than the euro, and the typical buy/sell spread at Moscow exchange points was 1-5 kopeks (while on euros it used to be, and still remains, in the range of several dozens of kopeks). However, although exchange points always collected the 1% tax from the buyer, in vast majority of cases they kept it as "profit" instead of transferring it to the government (which is one of the reasons why it was politically so easy to abolish this tax). The exchange booths could now be using the relative weakness of the dollar on international markets as an excuse to increase the spread between buy and sell rates, thus compensating exchange bureaus for the now-abolished tax they used to illicitly retain.

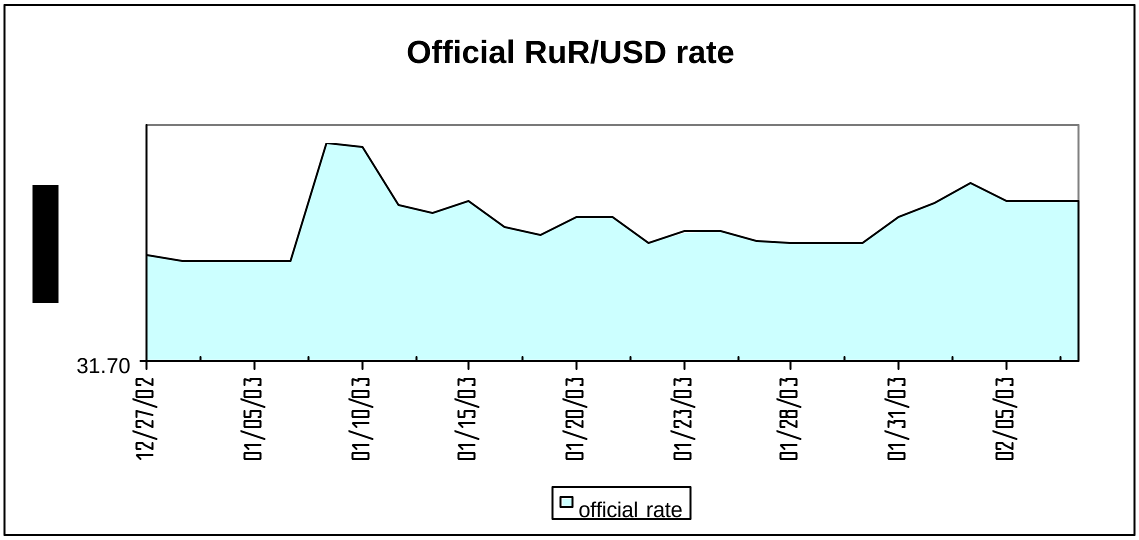
Financial markets

Forex Market

On Monday the ruble weakened 0.05% against the dollar in the MICEX UTS in response to a relative firming of the dollar on international forex markets and to a simultaneous 10% increase of balances in correspondent accounts with the CBR. However, the next day the dollar weakened against the euro and the sum of correspondent account balances fell 11%, pulling all three MICEX dollar rates down. Virtually at the same level where the previous Friday UTS closed, at R31.835/$, the CBR started interventions both in MICEX and in interbank trading and went on maintaining this rate through the rest of the week.

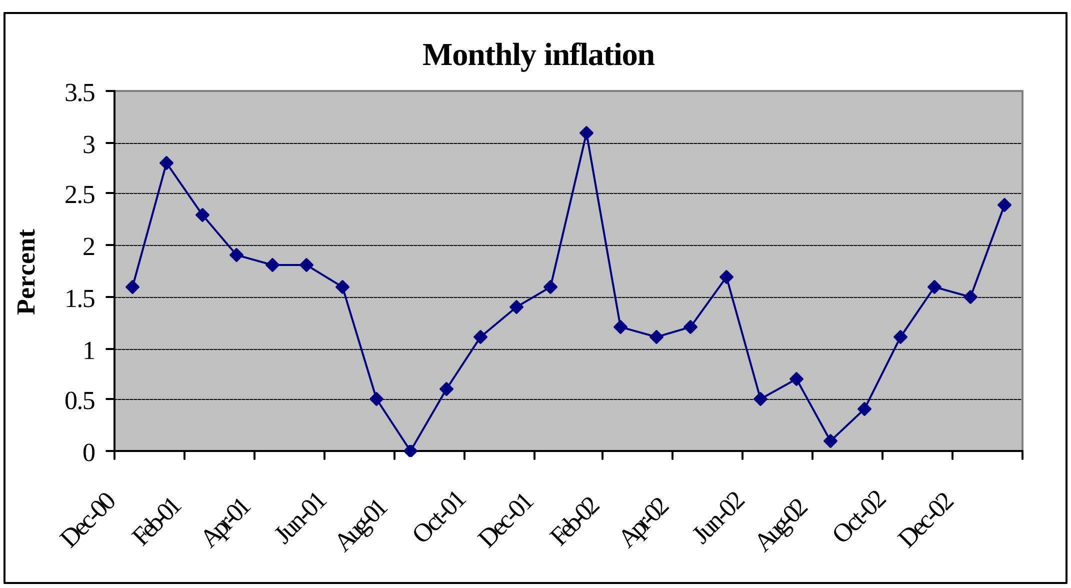
For the week, the ruble practically did not change its value against the dollar, closing in the UTS on Friday at R31.8352/$. MICEX weekly trade volumes were $553.49 million, $406.11 million and $384.35 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.





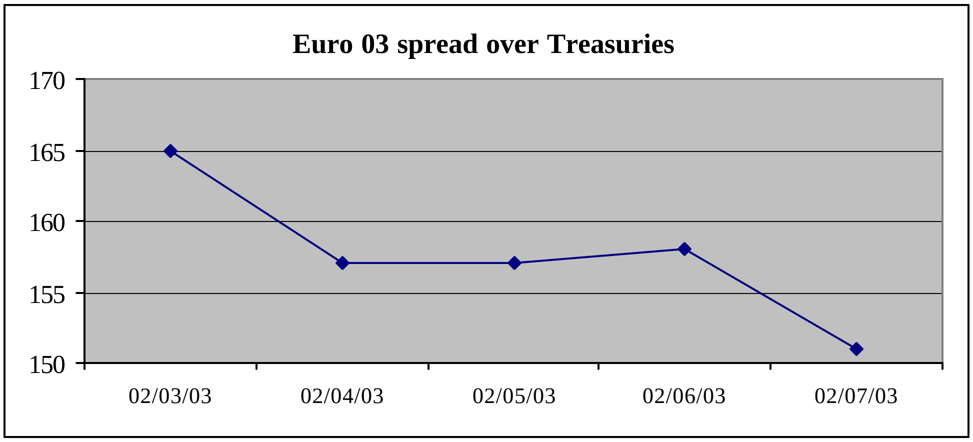
Prices

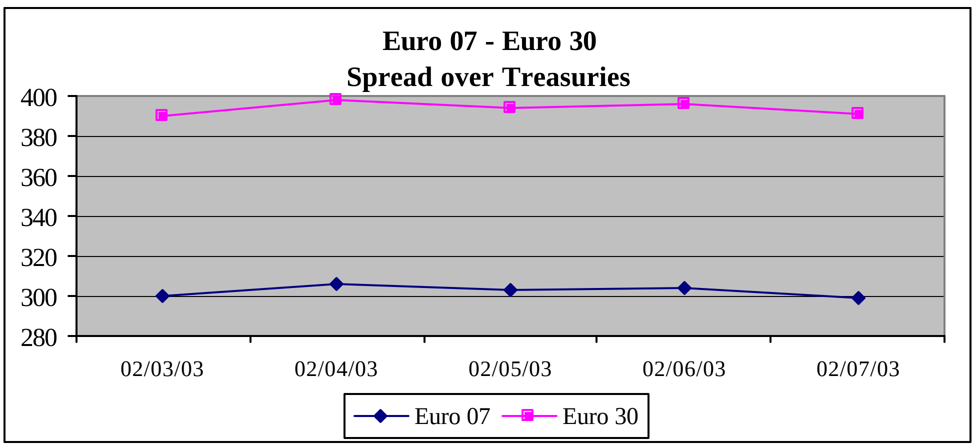
According to Goskomstat data, the inflation rate was 2.4% in January. In January of 2001, prices rose 3.1%, so this year the seasonal spike was considerably lower, ostensibly due to the sequestration of unspent government monies to the financial reserve. However, the 2003 January rate is indicative of the problem of maintaining price stability in the face of continued high dollar inflows from oil exports and increases in communal housing and other natural monopoly tariffs. Last month, foodstuff prices were up by 2.5%, with fruits and vegetable prices going up by 13.1%. Public services tariffs increased by 4.4%. Inflation in the non-foodstuffs sector was quite modest - 1.1%, despite a surprising 5.2% increase in gasoline prices, 8.1% in housing costs, and 6.9% in communal services.



Eurobonds

Spreads in the Russian Eurobonds sector were generally decreasing last week. The Iraq situation is still adding uncertainty to the market.



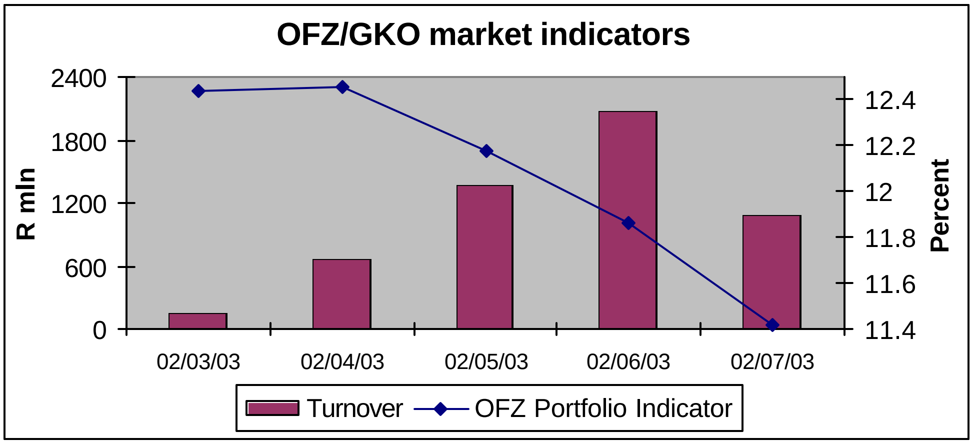


Interest/Bond Market

Bonds/Bills

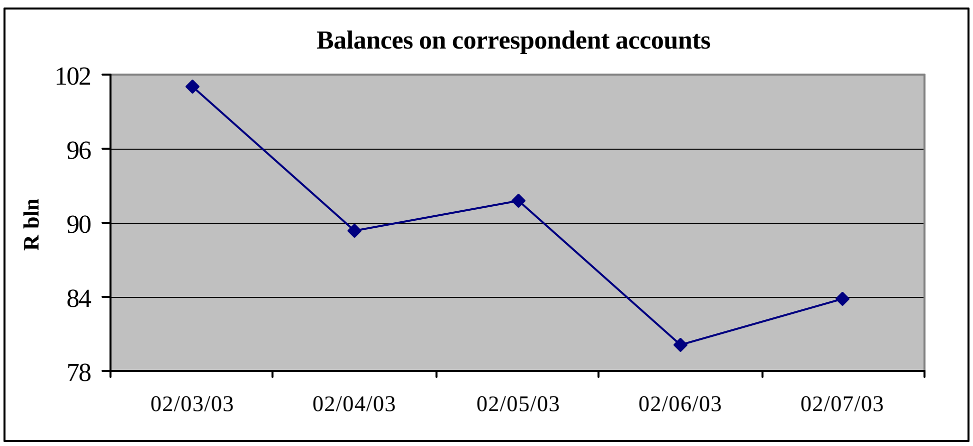
In the beginning of the week activity on the secondary OFZ/GKO market was relatively low, as traders were preparing for the upcoming OFZ auction on Wednesday. In a significant step forward for the development of domestic debt markets, the Ministry of Finance offered the longest OFZ issue to date -- R 11 billion ($346 million) with a duration of 6.1 years, maturing in August 2012. (to date the longest duration was 3.7 years). Demand for this longer-term bond was twice as high as the offer, due to higher liquidity in the banking sector and the less attractive rates in currency markets. The weighted average placement yield was 12.94%, with the maximum yield 13.05%. (However with inflation for 2003 expected at 12%, the real interest rate is close to zero.)

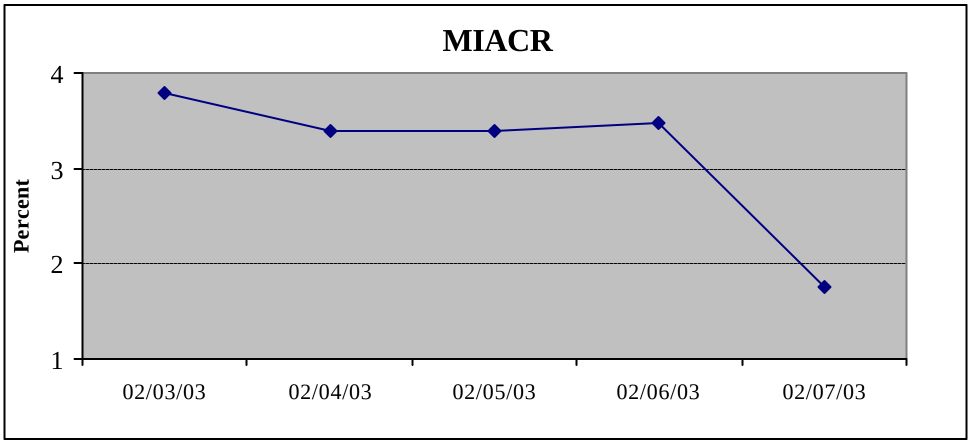
Overall activity and prices in domestic debt markets in February increased at the same steady rate as seen in early January, with yields dropping to historic lows. The yields of issues with the longest maturities fell to below 12%. In addition, for the first time MinFin was able to place R1 billion ($31 million) of six-month GKOs at 9.99%, lower than market yields for similar bonds.



Overnight rates

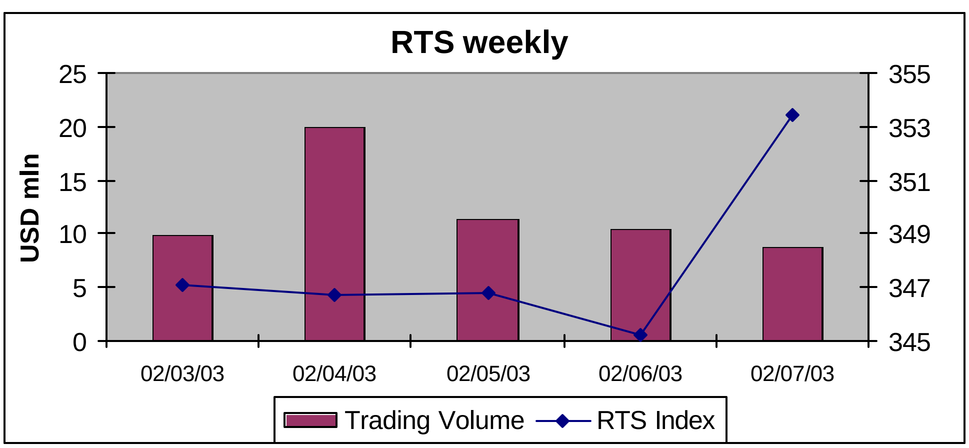
Banks did not experience ruble shortages last week. Balances on banks' correspondent accounts at the CBR remained at above-average levels. Overnight rates fluctuated in the range of 3-5%, increasing slightly by the end of the week due to transfers to the mandatory reserve fund as well as OFZ and CBR depository auctions.

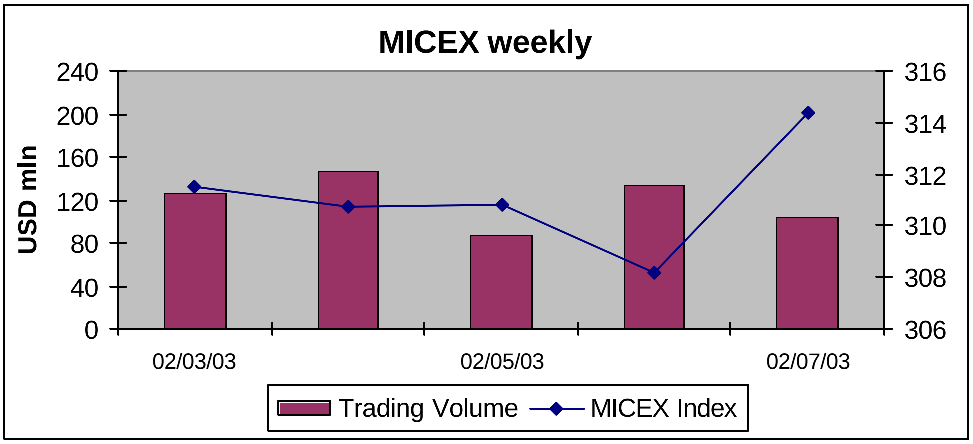


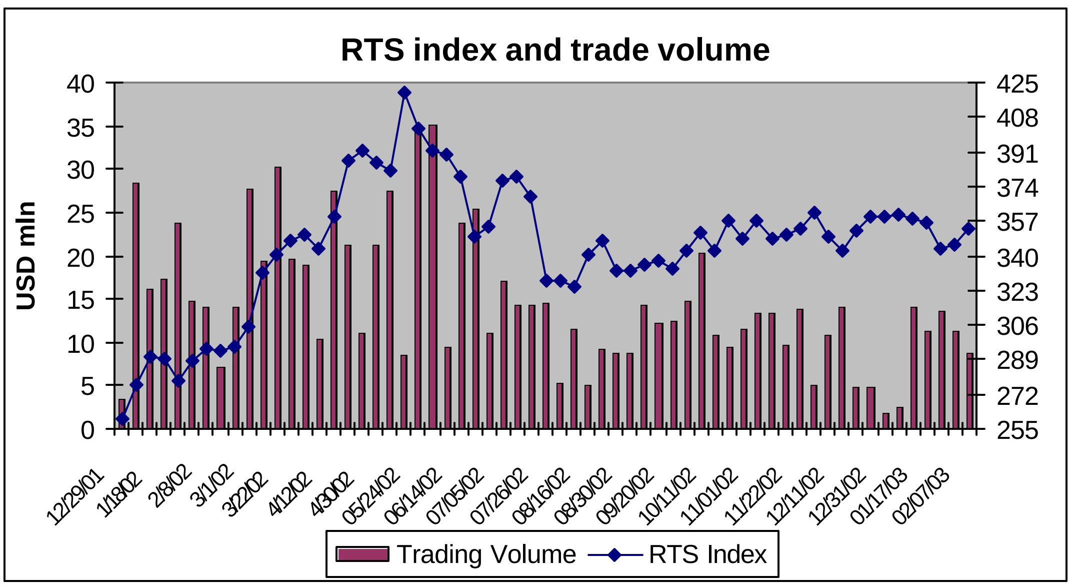


Stock Market

Even though world oil prices remained at quite high levels, oil shares were anemic at the beginning and in the middle of last week due to negative corporate news from Surgut and LUKoil. However, RAO UES, local energos and Norilsk Nickel showed quite positive dynamics. On Thursday, RTS had to stop trading at the end of the day because of activity in Lenenergo. Its common shares shot up by 12% in half an hour, while its preferreds were up by 10.7%. The shares were viewed as considerably undervalued, given that the positive news about the company was not reflected in its share price. The trigger was the news that western investment funds are ready to cooperate with Lenenergo. On Friday, oil shares improved, supported by the 2-year maximums on the world oil market. This pulled the market up, and it rose above the 350 level. Many players still preferred to stay on the sidelines last week, though, because of uncertainty over Iraq. The RTS index was up by 2.29% in dollar terms for the week.



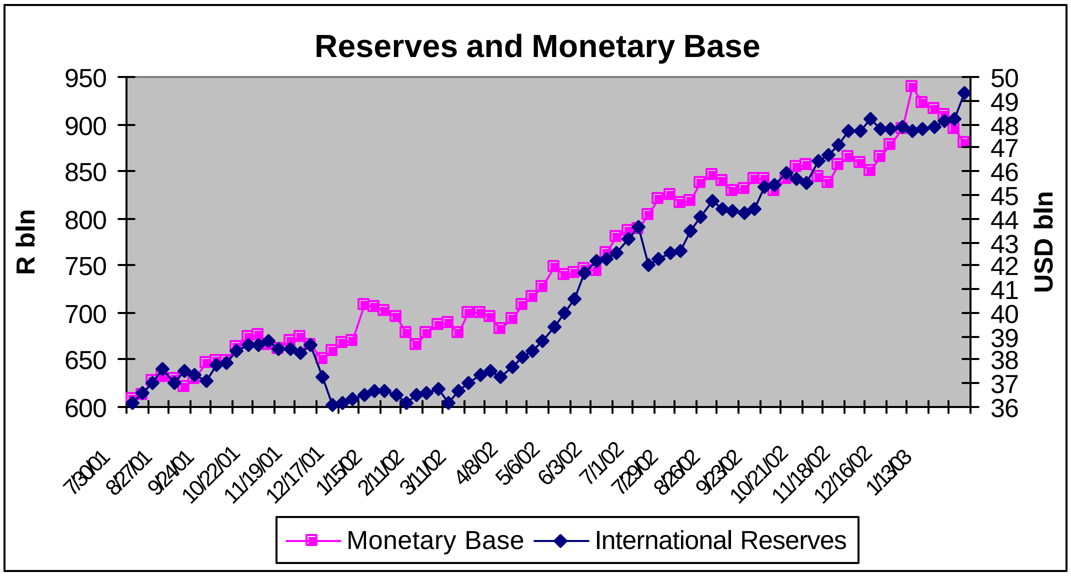




<u>International Reserves and Monetary Base</u>

International reserves of the CBR were up by $1.1 billion for the week ending January 31, reaching $49.3 billion. This is the highest level of reserves in 20 years. Last time the reserves rose by that amount was in May of 2002. The increase in reserves was due to higher oil prices and a correspondingly higher inflow of export proceeds to the country.

The monetary base continued to dropped by R15.2 billion last week , finishing the week at R879.1 billion. This is the same level as in the middle of December.



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.