

Moscow Financial Weekly

For the weeks ending June 11 and 21, 2003
Treasury Attache's office, U.S. Embassy Moscow

Highlights

- Duma approves tax reform package, lowers currency surrender requirements
- Bill on mortgage securities passes second Duma reading

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/\$ (MICEX) UTS	R30.3433	-0.74	-4.53
Monetary Base*	R1091.4 bln	2.98	16.07**
CPI	NA	NA	7.1
International Reserves*	\$63.6 bln	-1.09	33.33
RTS Index (end of week)	487.89	4.96	35.88
Refinancing rate	18	0	-3

*For week prior

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

Economic Developments

On June 21, Duma approved in a third (and final) reading a package of **tax reform** measures. The package includes a decrease of VAT from 20 to 18% starting in 2004, leaving the 10% beneficial level of VAT on "socially significant goods" in place. The package also abolishes the sales tax (which Moscow city and other regions strongly resisted) and the natural gas excise tax. To compensate for losses in federal revenue, the bill envisages a gas extraction tax of 107 rubles (\$3.52) per 1,000 cubic meters, a 5% increase in the crude oil extraction tax, and increases in various excise taxes. To compensate losses to the regions for the sales tax, the government plans to transfer revenues from taxes on small and medium enterprises, excises taxes on motor fuel, land taxes, and 50% of the alcohol excise tax. The export tariff on gas would be raised from 5 to 28%, although this does not need Duma approval. A separate bill, which passed only a first reading, would lower payroll taxes (UST) from 35.6% to 24% beginning in 2005.

Although Gazprom initially opposed the new taxes, it announced that it is satisfied with the outcome, as the gas extraction tax ended up lower than originally envisaged. The tax package is worth 2.5% of GDP over 2004-2006, and is designed to encourage growth in Russian industries outside the natural resource sectors. However, corruption is a much more significant "tax" on business that, according to some estimates, is equal to 10% of

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GDP per year. Administrative reform and uniform implementation of the deregulation laws would help reduce the onerous cost of doing business in Russia even further.

On June 13, President Putin declared that the official **external debt** problem has now been resolved, given that Russia has made its final payments on three official external bonds maturing in 2003 (MinFin IV and two Eurobond issues), which contributed heavily to the 2003 payment spike. Russia paid approximately \$5.2 billion to retire these debts this year.

Banking sector

The CBR reduced the **refinancing rate**, effective June 21, from 18% to 16%. Oleg Vyugin, CBR First Deputy Chairman, commented that the decision to cut the rate was made to encourage lending and growth in the real economy, and that it was made possible by lowering of market rates and inflation over the first half of 2003. "Reduction of refinancing rate is a signal to the market. We have noticed that after it happens banks reduce lending rates for the real sector," Vyugin said. However, he does not think that deposit rates will necessarily go down as well, which often is the case. He also does not expect another refinancing rate reduction before the end of 2003.

On June 20, just before the spring session closed, the State Duma passed in the final third reading the **amendment to the Law On Currency Regulation And Currency Control** stipulating a ceiling for surrender requirement at 30% of foreign currency proceeds. The actual norm is to be set by the CBR, but in any event the percentage may not exceed this ceiling. (Currently exporters are obliged to sell 50% of their proceeds). On June 23 the Budget Committee of the Federation Council decided to recommend the bill for approval. The Federation Council approved the bill on June 26.

Also on June 20 the Duma passed in second reading **the bill on Mortgage Securities**. The bill considers two types of securities: mortgage bonds and certificates of participation. Only specialized mortgage agencies and commercial banks may issue mortgage bonds. The bill gives the CBR the right to introduce additional prudential norms for the banks issuing mortgage-backed bonds. The GOR, more specifically the Federal Commission on Securities Market (FCSM), was strongly opposed to the provision allowing deposit-taking banks to issue such bonds, but banking lobby and the CBR succeeded in convincing the Duma. Andrey Kozlov, CBR First Deputy Chairman, said that issues of mortgage securities could be regulated in such a way that no major systemic risks would emerge. In particular, Kozlov said, the banks in which the sum of deposits exceeds its equity might be restricted from issuing mortgage-backed bonds. Only "professionals," i.e. those who have built up own portfolio of mortgages the value of which reaches about 50% of equity, might be permitted to issue.

On June 19 the Board of Directors of the International Finance Corporation approved a \$200-million convertible loan to **Vneshtorgbank**.

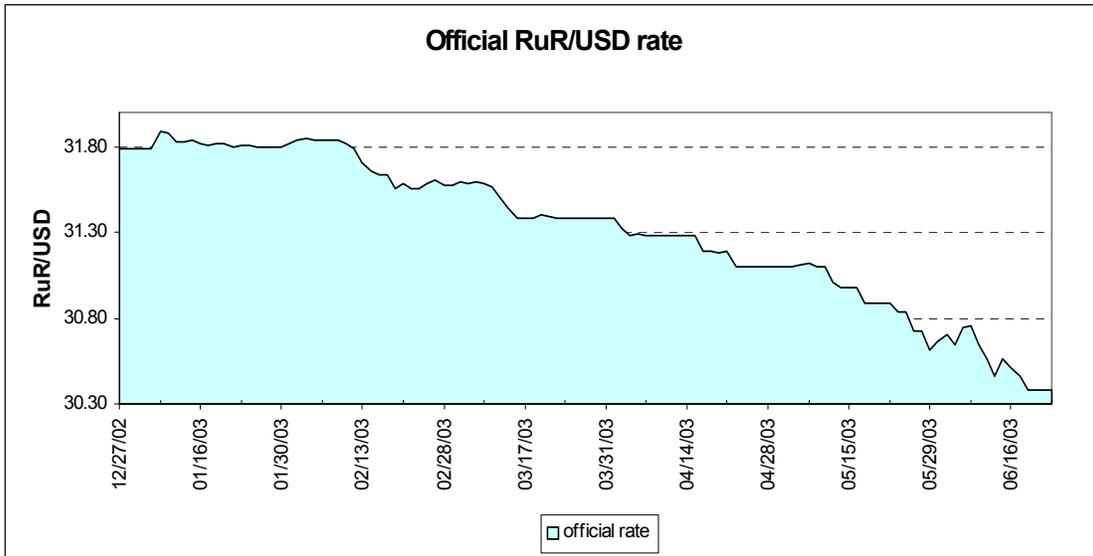
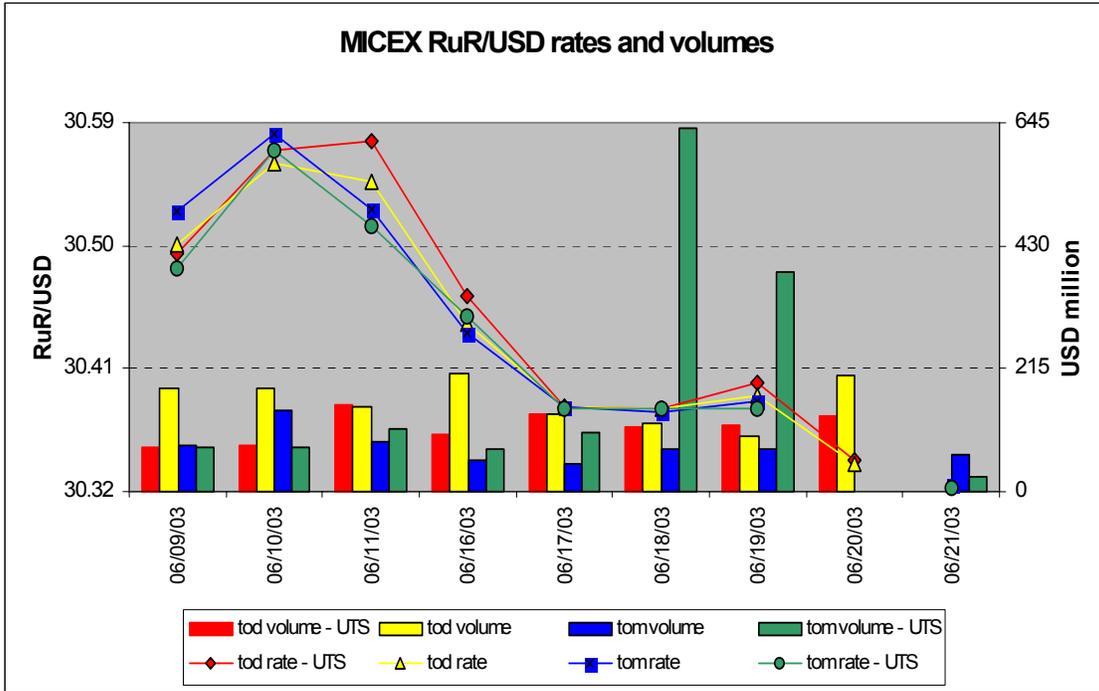
The Finance Ministry has drafted regulations governing the **tender for commercial banks to service accounts of the Federal Treasury**. Anton Siluanov, head of MinFin's Department of Macroeconomic Policy and Banking, said that the document must be approved by the end of the year, probably in the form of a MinFin order, rather than a GOR resolution. Siluanov explained that commercial banks are admitted to treasury accounts in the cities that are not capitals of subjects of the Federation and smaller municipalities. Typically these are banks with state participation, in most cases - Sberbank. Siluanov said that the new regulation would require that a bank meets N1 capital adequacy norm, instant and current liquidity requirements, is current on mandatory reserves (provisioning) requirement and has a branch network. In addition, there will be a minimal equity threshold, but Siluanov declined to produce the exact figure for it. The regulations are intended simply to clarify what is happening currently, and does not signal a change in policy.

Financial markets

Forex Market

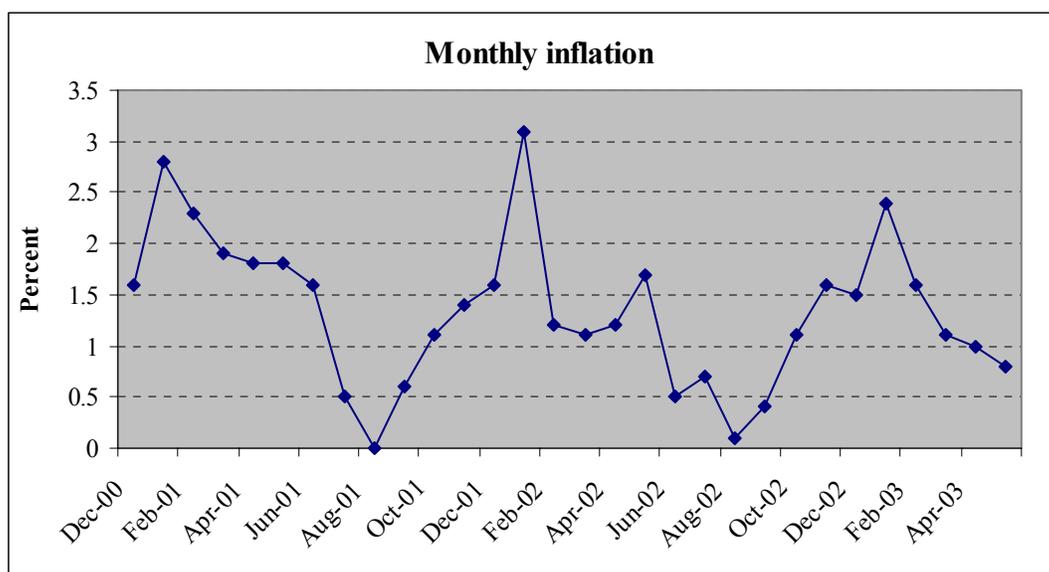
During the period June 9 -June 21 the ruble/dollar market continued to experience increased volatility with exchange rate fluctuating with a magnitude of up to 10 kopeks over a general dollar-weakening trend. Thus, on Monday, June 9, the dollar weakened more than 7 kopeks, but the next morning surged 10 kopeks up and was stopped only when the CBR intervened at R30.58/\$. On Wednesday, June 11, the intra-day rate fluctuations were even more considerable: UTS "tom" session opened at R30.64/\$, but by its close the dollar fell to R30.46. After the four-day Russian holiday weekend, the dollar continued losing ground: it weakened by 5 kopeks on Monday, June 16, and by another 8 kopeks on Tuesday, June 17, when the CBR stepped in again, this time supporting the dollar by the bid at R30.38/\$. The CBR kept its bid at the same level all through Thursday. When on Friday the bid was removed, the dollar resumed its decent, finishing the longer week on Saturday at around R30.325 for T+1 deals. Interestingly, the situation in the international forex market lately has been having impact on the ruble/dollar rate only when the dollar is weakening against the euro. When the dollar gains, the Russian market ignores this news, and the dollar remains slightly weaker against the ruble than the cross-rates dollar/euro and euro/ruble would suggest.

For the two weeks the dollar weakened 0.74% against the ruble, closing in the UTS "tod" on June 20 at R30.3433/\$. MICEX trade volumes were \$910.01 million and \$1485.45 million, \$1267.10 million and \$627.07 million for the UTS "tod" and "tom" sessions, and SELT "tod" and "tom" sessions, respectively.



Prices

According to the Deputy Minister of the Economic Developments and Trade Arkady Dvorkovich, inflation in June will be approximately 0.5%. Annual inflation forecasted by Mr. Dvorkovich is 12% plus or minus 1%.



Eurobonds

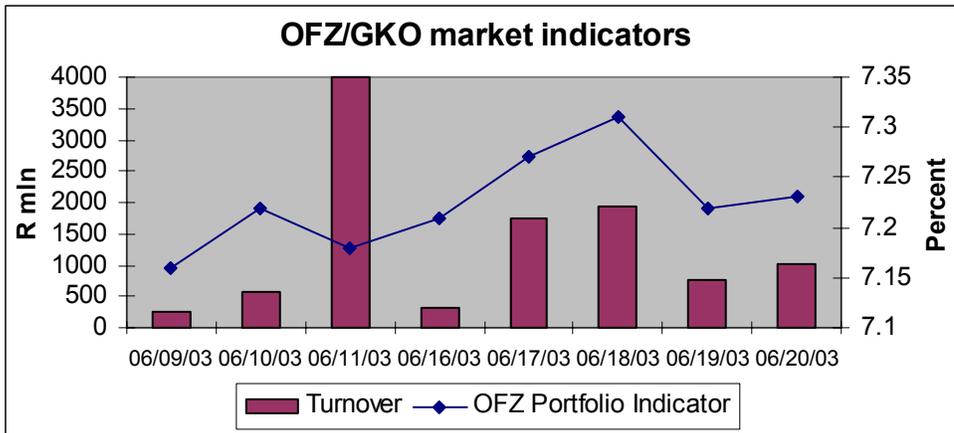
During the first week observed, prices in the Russian eurobond market continued their upward trend. The price of the most liquid issue, Euro-30, climbed over the par that week, affected by declining U.S. Treasury yields and active foreign buyers. During the week of June 16, however, the market experienced downward price corrections, bringing yields of the longest issues down by approximately 2.5-3%, with the Euro-30 dropping to 98 1/4 by the end of the week. Again, activity in the U.S. Treasury bond market effected the Russian market, as yields on U.S. Treasuries were higher that week.

The share of the Russian Eurobonds in the Emerging Market Bond Index (EMBI+) is now the largest for the first time in history, compared to the weights of the rest of 18 emerging market countries. This means that the Russia has reached the highest market capitalization, with its share totaling 21.63% as of June 6 compared to 21.57% for Brazilian bonds.

Interest/Bond Market

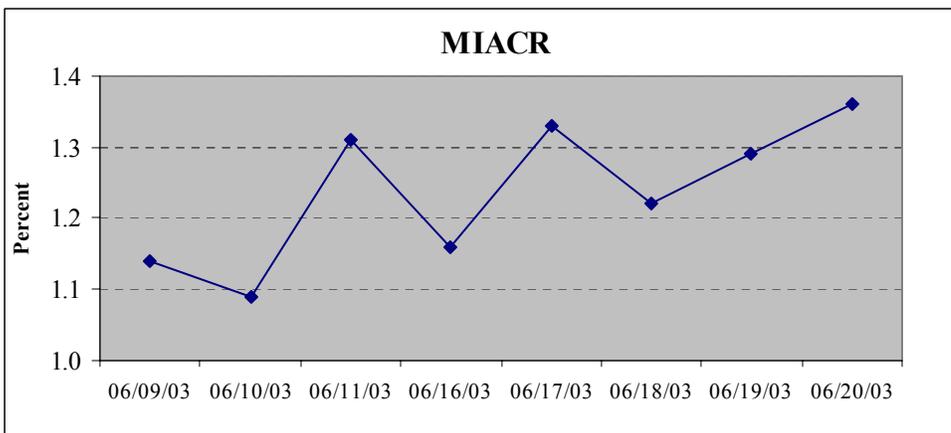
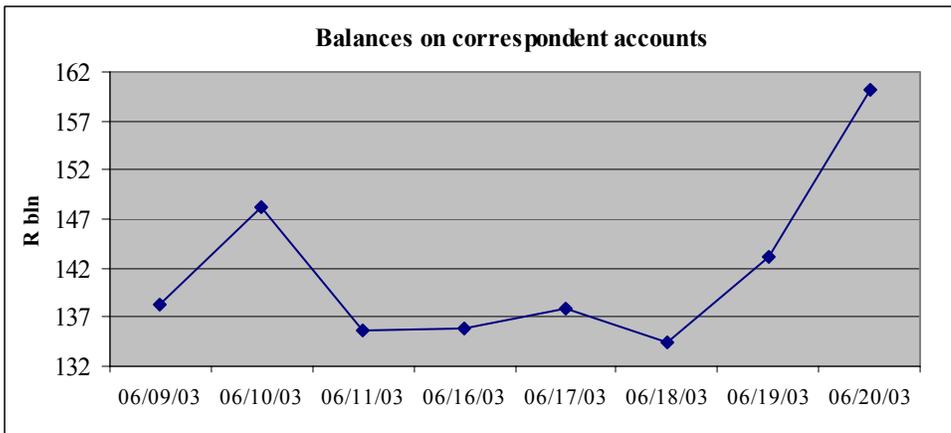
Bonds/Bills

Prices of most issues on the secondary OFZ/GKO market ended the week higher, during the first short week observed. While demand was high the last day before Russian holidays on June 12, it abated slightly during the following week, causing a slight downward price correction. This may be due to an overactive market, as well as expectations for a large wave of new ruble corporate bond issues which are scheduled over the next 2-3 months.



Overnight rates

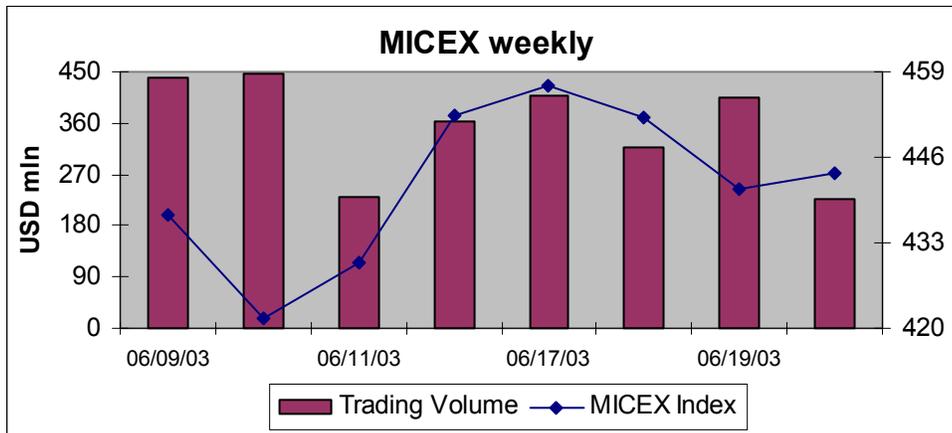
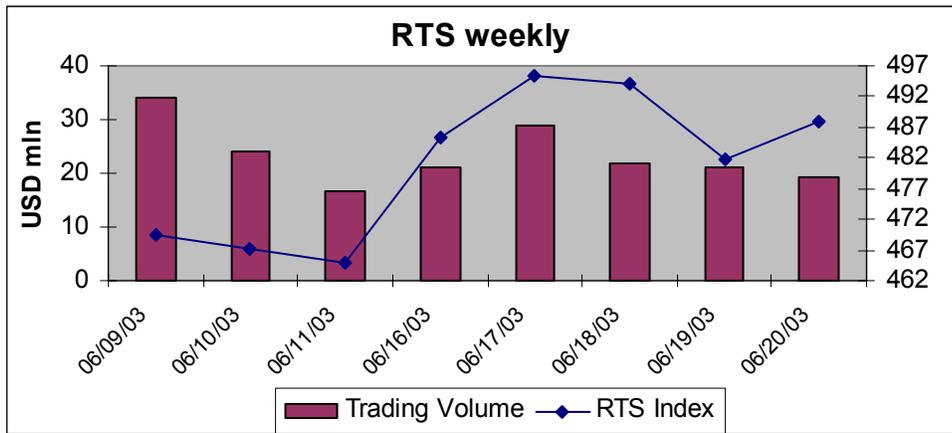
During the period observed, overnight ruble credit rates fluctuated in a narrow range of 1-2.5% p.a. Balances on banks' correspondent accounts at the CBR were quite high, increasing to R160.1 billion rubles at the end of the week of June 16.

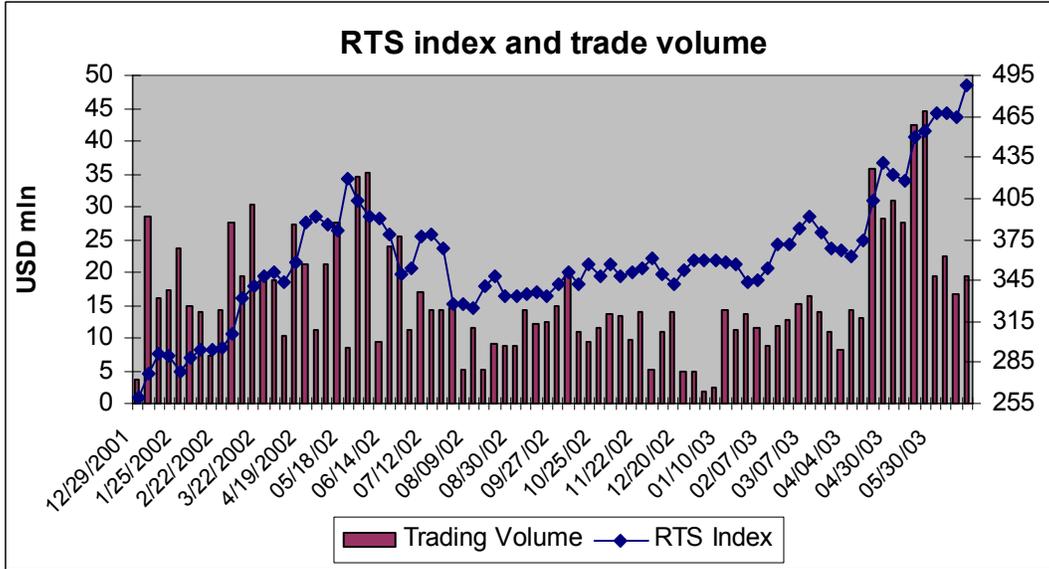


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Stock Market

During the first short week observed, the RTS index was down for 0.48% on slightly increased trade volumes. RAO UES preferred stock was among the leaders, gaining 6.5% for the week, and Norilsk Nickel stock was up by 2.5%. Last week, the market gained significantly with the RTS index rising by 4.96% for the week in dollar terms. Norilsk Nickel saw further gains, along with YUKOS stock rising 10% on rumors of possible dividends. However, the market rally was accompanied by lower trading volumes.

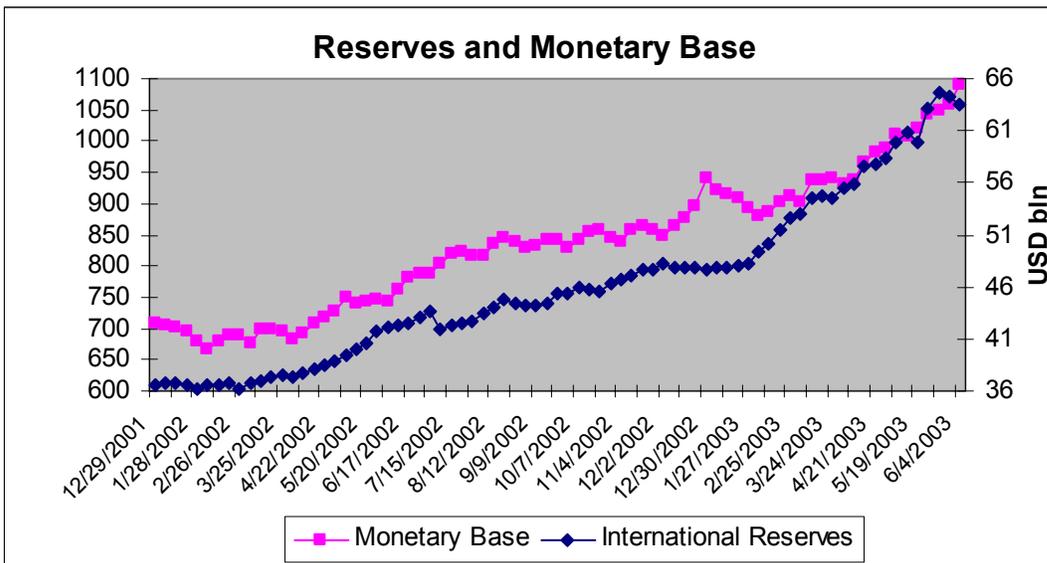




International Reserves and Monetary Base

International reserves of the CBR fell during the weeks of June 2 and June 9. As of June 13, reserves totaled \$63.6 billion, which is \$1.1 billion or 1.7% lower than the historic high level of \$64.7 billion achieved two weeks ago. Last week the reserves dropped by \$700 million or 1.09%. These results are ostensibly due to redemption of the dollar-denominated Eurobond for \$1.25 billion during the week of June 9.

The monetary base increased for the fifth week in a row, and now stands at R1091.4 billion as of June 16. This represents a 2.98% increase from the previous week. During the two weeks observed the monetary base increased by 3.99%



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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.

