Moscow Financial Weekly

For the Week Ending November 16, 2001

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Highlights This Week

- Oil prices heat up the budget
- The Duma plans for the CBR become clearer
- **1997 Redux? – Better fundamentals but watch for irrational exuberance**

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/$ (MICEX) UTS	29.7825	0.23	5.75
Monetary Base*	R670.7 bln	1.42	38.95
CPI	NA	0	15.2
International Reserves*	$38.5 bln	0	36.04
RTS Index (end of week)	212.73	-5.47	48.46
Refinancing rate	25	0	0

*For week prior

Economic news

The CBR has paid the last $347-million installment on its $2.7 billion part of the 1998 **IMF loan**. CBR Chairman Victor Geraschenko stressed that the loan that had been given by the IMF right after the 1998 financial crisis was repaid in full ahead of schedule.

The drop in the price of Urals to $15.5/barrel has turned up the heat on the debate over the **2002 budget**. The current price is $3/barrel below the minimum budgeted level of $18.5/barrel. If sustained for all of 2002, this would imply a deficit of roughly $3 billion. In this context, this week the Russian media started discussing the possibility of 2002 budget sequestration egged on by a comment by Deputy Prime Minister Ilya Klebanov who said that cuts may be necessary as early as January 2002. These comments were quickly disavowed, however. In fact, sequestration seems like the least likely measure to adjust the 2002 budget in light of lower oil prices. It appears instead that the GOR will use the low oil price to try to claw back some of the spending they added to the budget after the first reading, and possibly more. The Duma predictably is down-playing the effect of oil prices to avoid loosing spending authority. There is some small chance that this game of chicken could result in the budget being sent back to the first reading. More likely is some further compromise on spending reductions, and adjustments to borrowing or privatization assumptions to cover any contingencies.

Meanwhile the GOR submitted to the Duma a bill amending **the 2001 budget**. The bill reallocates expenditures of R12.5 billion from debt to service to other items, including

R2.2 billion for military reform, R3.5 billion to extinguish housing arrears, and R1.3 billion to regions.

Banking sector

On November 16, the Duma working group amending the **Law on the Central Bank** approved an amendment stipulating the CBR's exit from the capital of its foreign daughters ("roszagranbanks" - Eurobank, Moscow Narodny Bank and Ost-West Handelsbank). The amendment allows the CBR to quit the capital of "roszagranbanks", but subject to approval by the GOR. If passed by the Duma the bill could have implications for CBR's plan to sell these banks to VTB. Instead they could be purchased by GOR-owned Vnesheconombank rather than CBR-owned VTB.

The working group also approved amendments to the Law on the Central Bank expanding the powers of the **National Banking Council (NBC**). If these amendments are approved by the Duma, NBC would be responsible for the following issues: approval of the CBR annual report, estimate of expenses, the concepts of improving the banking system and the monetary policy, the issues of CBR's participation in the capital of credit organizations, appointing the CBR's auditor and the auditor of the CBR's annual report, approval of report of the Board of Directors and the accounting rules.

The Finance Ministry, Ministry of Economic Development and Trade, and Ministry of Antimonopoly Policy support the proposal to sell a stake in **Vneshtorgbank** (VTB) to EBRD, VTB President and Board Chairman Yuri Ponomarev said. He stressed that the issue of the size and the price of the stake had not been discussed yet, but that the EBRD had offered to buy 10-% to 20-% stake in VTB.

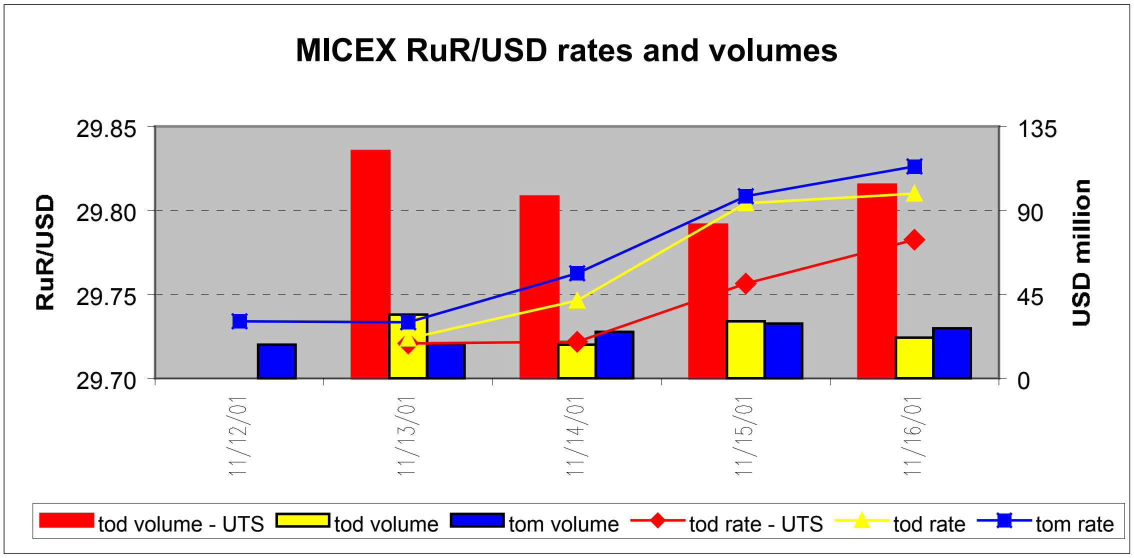
In the currency auction for **S-account** holders that took place on November 13, the CBR offered $50 million and demand totaled $83 million. The cut-off price was set at R30.09 and the average price appeared to be R31 per dollar. CBR confirmed that in December there would be another currency auction in which the CBR might offer more than $50 million.

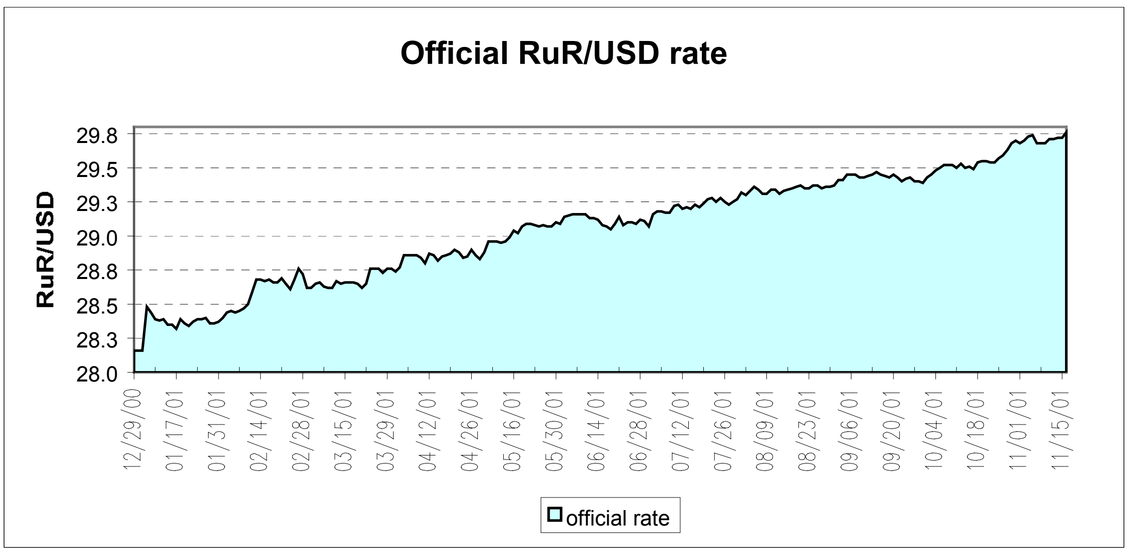
Financial markets

Forex Market

The ruble started weakening against the dollar on Monday afternoon. Ruble depreciation accelerated in the second half of the week on speculative demand fueled by OPEC's announcement that caused a drop oil prices. CBR Chairman Geraschenko made a controversial statement that the CBR would not support the ruble at the expense of reserves, but the ruble is not likely to fall below R30/$ by the end of this year. After this statement, the demand for dollars seemed to increase. In the last two days of the week the ruble lost more than 6 kopeks against the dollar.

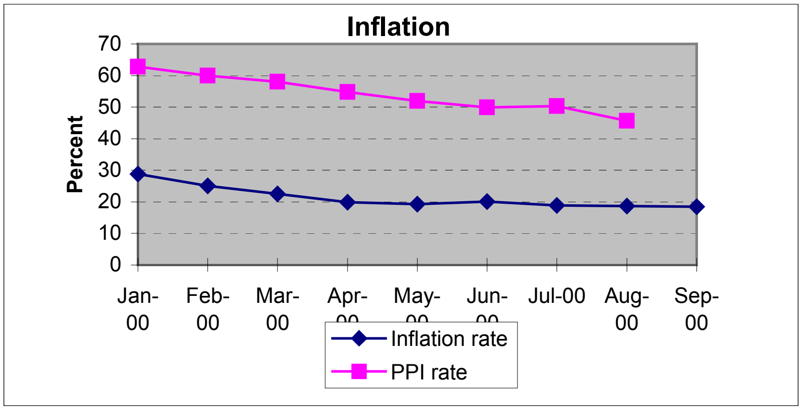
For the week, the ruble weakened 0.23%, closing in the UTS on Friday at 29.7825/$. MICEX weekly trade volumes were $405.36 million, $104.45 million and $117.54 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.





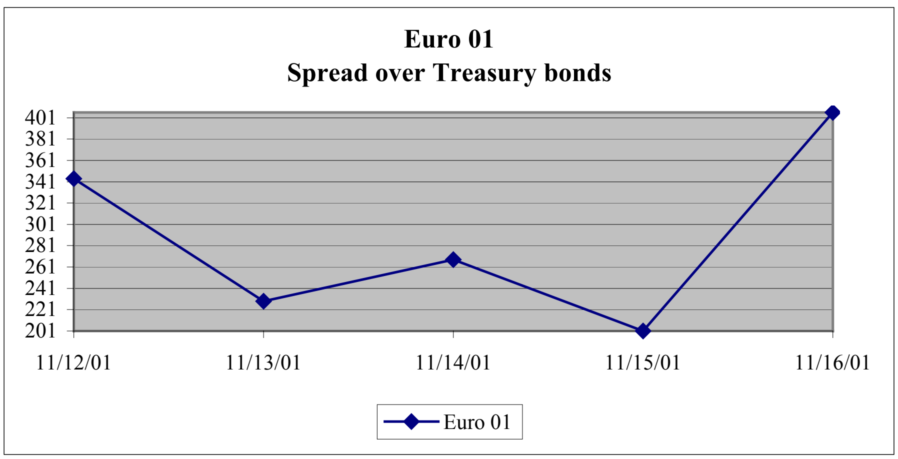
Prices

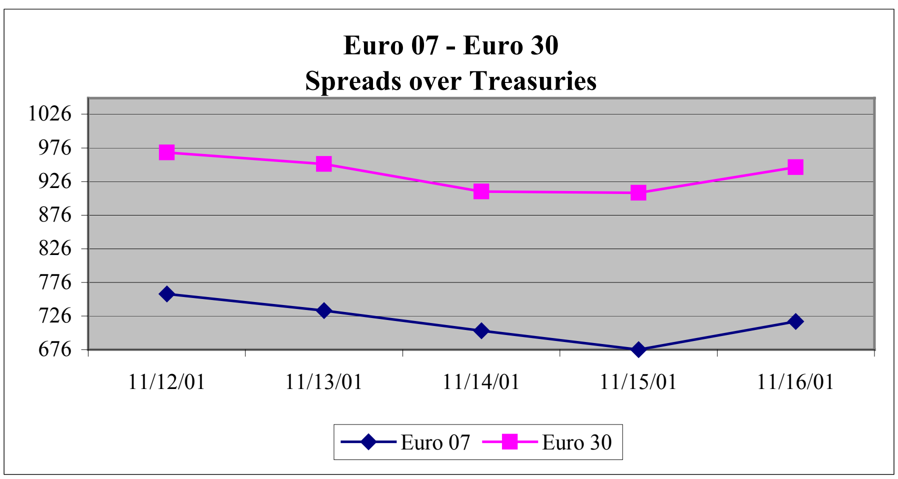
No new information on prices this week.



Eurobonds

The Russian eurobond market grew at the beginning of the week but the drop in oil prices and the slide in the Russian stock market later in the week forced eurobonds to fall. However, the fall was very slight and the Russian sector of the market remained calm with low price volatility.

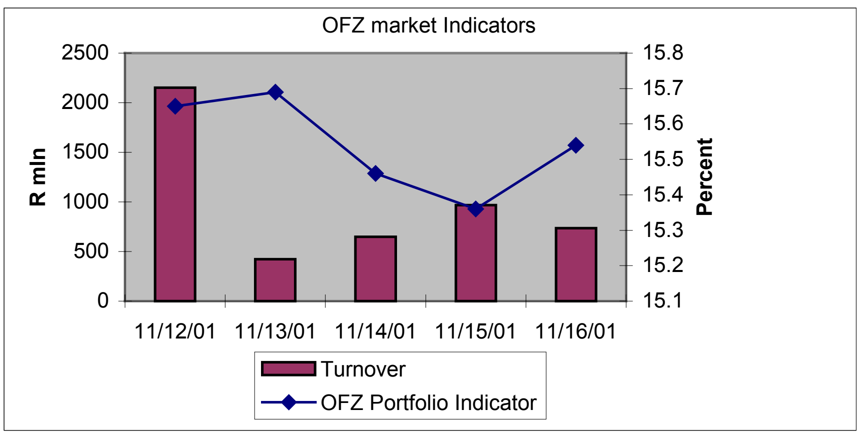




Interest/Bond Market

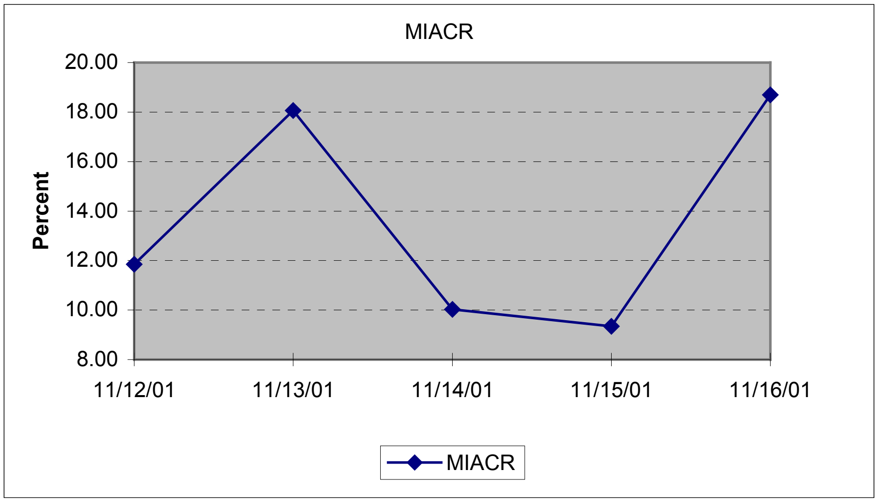
Bonds/Bills

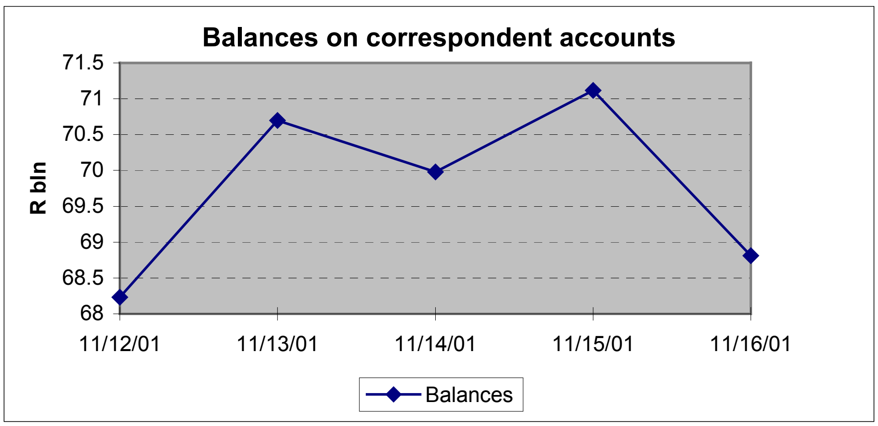
The secondary OFZ market was down on Monday on increased volume of R2.3 billion, almost 10 times higher than the daily averages. This is because of foreign selling on the expectation of the CBR's currency auction last week. Of this amount, five major deals made up the majority of the volume; excluding these, the trade volume was quite normal - R300 million. Later on in the week foreign selling stopped but domestic operators continued to push prices upward. The trend was due to reinvestment of proceeds from the GKO redemption and OFZ coupon payments. On Thursday, trading volume was up to R930 million, R520 million of which were OFZ 25030 deals. (This is the issue to be exchanged to new OFZs and GKOs. Players interested in these swaps are currently forming their portfolios.)



Overnight rates

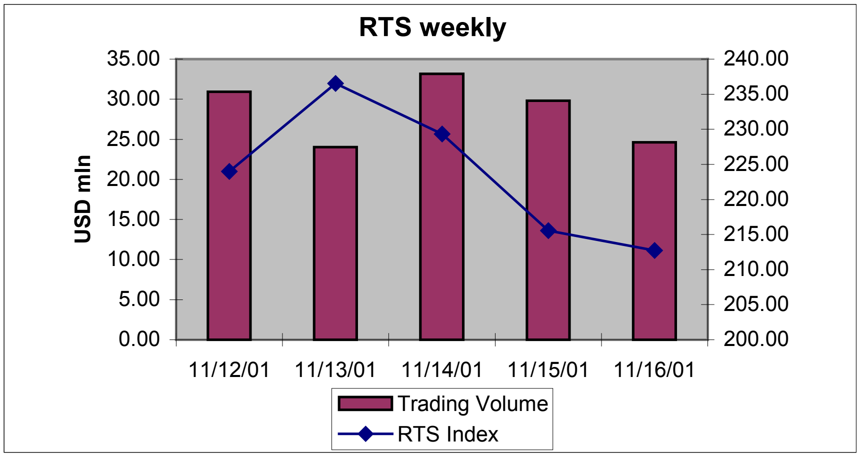
Banks built ruble liquidity at the beginning of the week due to mandatory tax payments made by banks for their clients. Balances on banks' correspondent accounts were down to R68-70 billion in the beginning of the week while the overnight rates on the short-term interbank market were up to 25% p.a. on Tuesday. Starting from Wednesday, the situation eased and the rates came down to 3-4% p.a. and then stabilized at levels of 6-12% p.a. for overnight rates.

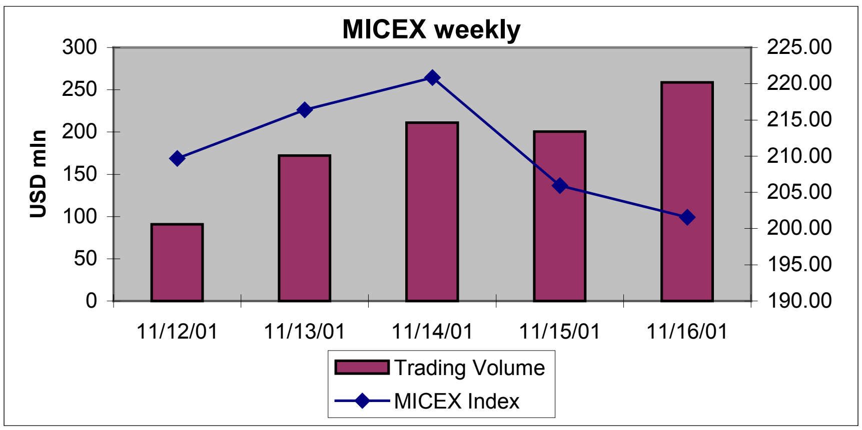


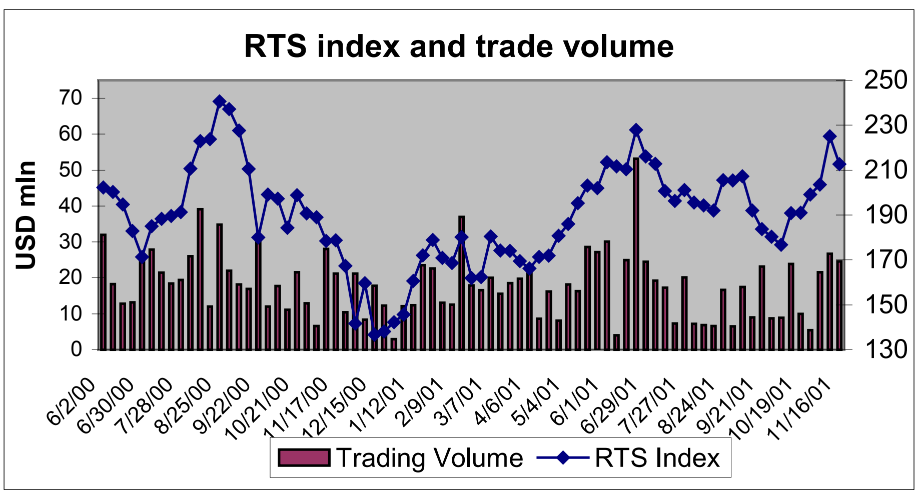


<u>Stock Market</u>

The RTS index grew at the beginning of the week and reached the year high of 243.14 on Tuesday though it finished the day at 236. Players were expecting downward price corrections given such a rally, and prices started to slide on Thursday: the RTS index was down by 6% during the day. The market seemed to be overbought, especially in oil shares, which took another hit on the news from OPEC that lowered world oil prices. However, telekoms and utilities were down as well. By Friday, the RTS index was down by 5.47% in dollar terms. The downward slide was for the most part expected and market participants on the whole are very positive about future market prospects. Last week, traders showed interest in the second-tier shares -- a very positive sign -- as well as participation in the market by US institutional investors. Some participants noted trading was more of an investment, rather than speculative nature last week.

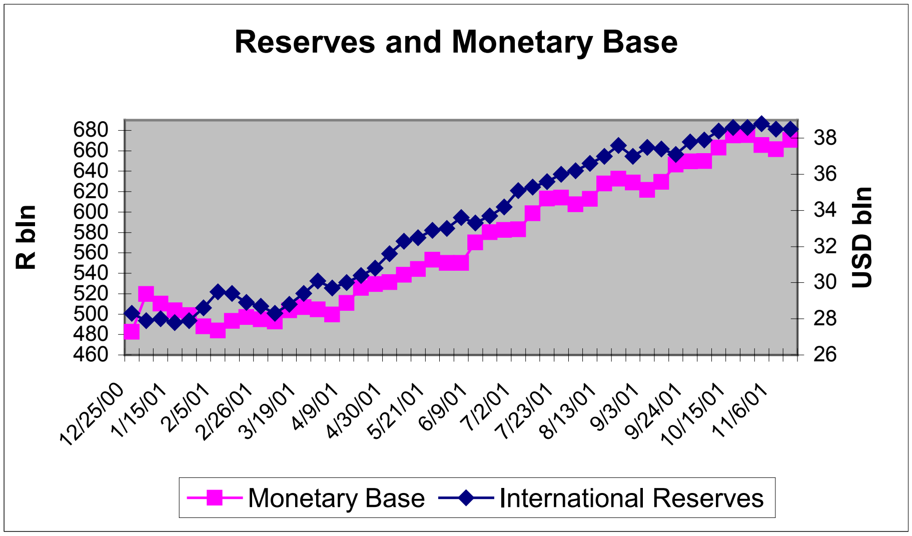






International Reserves and Monetary Base

On November 9, international reserves stayed the same as the previous week and totaled $38.5 billion, while the monetary base increased by R9.4 billion or 1.42% to R670.7 billion.


Reserves and Monetary Base
R bln
USD bln
680
660
640
620
600
580
560
540
520
500
480
460
38
36
34
32
30
28
26
12/25/00
1/15/01
2/5/01
2/26/01
3/19/01
4/9/01
4/30/01
5/21/01
6/9/01
7/2/01
7/23/01
8/13/01
9/3/01
9/24/01
10/15/01
11/6/01
Monetary Base
International Reserves

<u>Weekly Focus:</u> 1997 Redux? – Better fundamentals but watch for irrational exuberance

In the past few months, investors seem have done an about-face on their views of the Russian market. Whereas the watch words this summer were "wait and see" and "corporate governance", now a healthy stream of foreign investors are talking much more about low P/E ratios, "opportunities in the regions" and (until this week) "oil play". Warmer relations with the West clearly have opened eyes to the fact that under Putin Russia has made major inroads on structural reform and has maintained macroeconomic stability. The downturn in other emerging markets and the cuts in US interest rates also have caused Russia to seem like a relative safe haven. The 10% rise in the RTS last week, apparently driven largely by foreign inflows, which temporarily put the market up +58% for the year, had a genuinely 1997-ish feel. Last Friday's drop back after the OPEC announcement let some air out of the balloon, but highlighted that inflows were hot money flows akin to those before the crash. With at least the first signs of a return to the go-go days, we wanted to look at what has changed and what hasn't since 1997 and whether the new buzz is justified.

<u>What's changed for the better</u>

The macro picture in 2001 could not be more different from 1997:

- In 1997, real GDP grew 1%, at the time considered a great achievement after years of decline. Current GDP growth forecasts of 5.5% are considered mundane after last year's 8.3%.
- The real effective exchange rate is only 75% of where it was in 1997 despite significant real appreciation in the last two years.
- The budget deficit in 1997 was 7.1% of GDP on a commitments basis. Russia is currently running a surplus of 3.5% of GDP and we no longer talk about "commitments vs. cash basis". Revenues in 1997 were 12% of GDP and falling; now they are running at nearly 17%.
- Domestic debt in 1997 was 22% of GDP and rising rapidly; now it is 6%. (External debt to GDP provides a poor comparison because of the huge swing in the exchange rate. Still the number has been steadily falling since 1999.)
- The current account was $2 billion in 1997. In 2001 it is forecast at $36B.
- Gross reserves were $17 billion and falling. Now they are $38.5 billion and rising (except when CBR prepays its IMF debt…how many people in 1997 thought that would happen).
- Capital flight, one of the best indicators of domestic business sentiment, was running at $2 billion a month even without a current account surplus. In fact, one of the most telling signs in 1997 was that domestic capital and foreign capital were headed in opposite directions. Now, despite huge inflows, capital flight appears to be running at under a billion/month on a net basis. Cyprus is now the number one source of foreign investment.
- Over 50% of industrial transactions were non-cash, now only around 15% are.

- Ironically, as of today, the one indicator that hasn't changed much is oil. Urals averaged $12/barrel vs. the current $15/barrel, which could go lower. (The average for 2001 will still likely be in the mid-20's, however.)

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And the changes are not just on the macro side. Companies, particularly the energy companies that represent the bulk of the stock market's capitalization, are showing significant profits and in some cases even sharing some of it with their minority shareholders. Companies such as Sibneft have seen their stock shoot up after paying big dividends, even when the vast majority went to the majority shareholder. Recent good corporate profit announcements from Rostelcom, Norilsk Nickel, Surgutneftegaz, and others (many based on GAAP) have raised expectations of bigger dividend payments and capital gains.

What hasn't changed

Despite the unequivocal good news on the macro side, the real life business climate on the micro level hasn't changed nearly as fast.

Although a voluntary corporate governance code has been lauded and endorsed around Moscow, there are constant signs that many companies continue to operate by their own rules. The proof may be in the way Russian offshore money is returning. According to local brokers, it is almost exclusively in the form of majority or super-majority stakes, where the buyer eliminates any corporate governance risk by gaining full control of his/her investment. 1997 should provide a cautionary tale for non-Russian foreign investors who take a more optimistic view of Russian assets then do Russians themselves.

Structural reforms also have improved the investment climate in some tangible ways (such as tax) but for the most part reforms are either still in the pipeline or are only legislative changes that haven't yet shown that they can have their intended effect. This is not an indictment of the Putin regime; it certainly appears to be forging ahead. Still, in Russia implementation often proves the weak link. For a company wanting to invest in Russia today based on expected improvements, it still has to deal with an unreliable legal system, a rapacious bureaucracy, organized crime, a dubious banking system and hidden subsides for its competitors. Improvements may come soon or they may not.

Finally, one of the pillars of most transition economies – small business creation – still seems somewhat of an afterthought for the reform plan. What's more it depends primarily on how a critical mass of structural reforms play out in thousands of regions and municipalities and thus is hard to drive from Moscow. The jobs created by new firms are needed to provide a cushion for the eventual restructuring of Russia's non-competitive Soviet industrial legacy. New companies are also the answer to diversifying Russia's economy particularly in high tech. Though small business is not the first issue on the mind of portfolio investors looking at the 10 large companies that dominate the RTS, it is key to the long-term sustainablity of the macro factors that underlie the current growth.

Are Russian assets undervalued?

If the best story is on the macro side this should favor bonds. So far this has been the trend as over the last two years, Russian bonds have been some of the best performing in the world. Spreads on Russian eurobonds have fallen from 2650 bps in April 1999 (Eurobond '07) to 870 bps in November 2001 (Eurobond '10). Russian oil companies are now apparently moving back into the eurobond market as well on the back of high profits, strong cash positions and thus high ratings. Recently Rosneft issued $150 million Eurobond, the first corporate Eurbond since the 1998 crisis. Sibneft announced its plans to issue $250 million in Eurobonds, and TNK also announced plans for a new corporate bond and ADR issues. In some sense though the upside on fixed income is more limited. Things are about as good on the macro side as they can be and if oil prices fall for a sustained period weakness could begin to undermine the outlook.

For equities, P/E ratios remain attractive and looking at Russian companies compared to their international peers is bound to be tempting. But corporate governance remains a concern – higher profits only matter if they are shared with investors. While there are undoubtedly companies who have truly changed their approach, there equally likely to be those for whom corporate governance is window dressing for a hot market. The recent changes on the corporate governance front have not yet been tested in a down market. As prices rise, the corporate governance discount may fail to reflect real risks. Investors who to don't carefully differentiate among companies, may relive some of the pain of their predecessors.

Overall though, what should give investors pause is that the things that have improved are mostly the things Russia has least control over, while the things it has the most control over are only beginning to change. For example, while no one denies that the GOR is doing a much better job of controlling its fiscal situation, it ability to collect taxes probably has more to do with the devaluation and oil prices than with improved collection methods or even the improved compliance incentives from lower rates. On the other hand, rationalizing the regulatory structure, which while not easy is at least a direct function of government, is proving a tough road to hoe. Russia's position is therefore fragile. Russia and investors can hope the external environment keeps the window open for structural reform to eventually take hold and solidify the current economic gains. But don't put all your money on it.

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). "$-tod" price is the price of the dollar with same day delivery. "$-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.