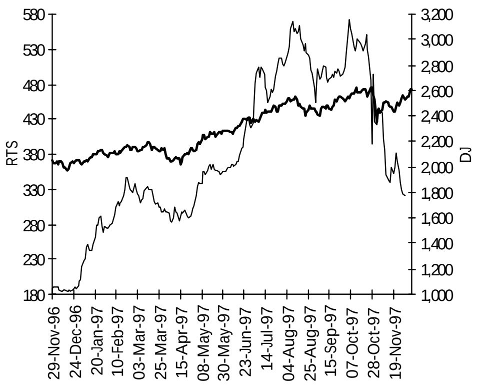
Russia

Market Update

RTS CLOSE	TARGET (1 YEAR)	RECOMMENDATION	DATE
340.28	425.04	Underweight	4 December 1997

Russian Equity Market Performance



Note: Scales are parallel

Percent change in Russian Trading System

12 mos	YTD	6 mos	3 mos	1 mo.
78.6	69.7	-9.9	-32.1	-27.3

Market Enthusiasm

Next month	Next 3 months	Next 6 months	Next 12 months
Low	Low-moderate	Moderate	High

All forecasts by NWM unless otherwise stated

Buckle your seatbelts....

The political soap opera that followed Chubais' dismissal as Finance Minister has given way to a much more serious economic one. The flurry of economic news in the last few days has seriously unnerved Russian currency and fixed-income markets, and this affliction is now rattling the equity market.

- First Deputy Prime Minister Chubais' remarks on Friday that measures would be taken to ensure that foreign capital remains in Russia were taken by most foreign currency and fixed-income traders as hints that capital controls might be imposed in Russia.

- The nervousness intensified on Monday when a much expected and important December 1 Cabinet meeting was postponed without a rescheduling date given.

- The rouble continues to be under pressure as foreigners pull out of the Russian treasury market (GKOs); as such, **the central bank (CBR) has raised the key Lombard rate across all maturities to 36%.**

- **The equity market reacted positively to news that four international banks would syndicate a US$ 2bn loan for Russia.** The long-term upside impact of loan announcements is limited since these loans are stop-gap measures until Russia successfully implements a sound fiscal policy; the downside impact of not lending to Russia, however, is limitless, since refusing aid will be taken by Russians and the international community as displaying a lack of confidence in Russian reforms.

- **December 5 is a key date to watch** since banks could have difficulty meeting cash obligations of their large positions in Vneshekonombank derivative instruments PRINs and IANs. In addition, the postponed first reading of the 1998 Budget will take place; Duma leaders are increasingly stating that they will pass the Draft Budget and move it quicker than planned to a second reading by the upper house of parliament, the Federation Council, comprised of regional governors.

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...it’s gonna be a bumpy ride!

Just as a smouldering Bette Davis stood at the top of a stairwell in all “About Eve” to warn everyone of her impending actions by curtly stating, “Buckle your seatbelts...it’s gonna be a bumpy ride,” we too have had plenty of warning signals in the last few days about the Russian markets.

The warning signals

- Chubais’ remarks interpreted as hinting capital controls
- December 1 Cabinet meeting postponed

Chubais and Yeltsin comments on Friday

Chubais’ comments on Friday that measures might be implemented to keep foreign capital in Russia were interpreted by market participants as hints that Russian monetary authorities might impose capital controls. One has to realise that many foreign Russian currency and fixed income traders began their emerging market careers trading Latin American products; consequently having been “burdened” by capital controls imposed in those countries, they are very sensitive to comments which might indicate such an action. Whilst Chubais’ power in the Russian government has lessened, his words and actions still have a significant impact abroad and on Russian markets. He tried to retract his comments on Saturday by saying that Russia does not want to limit foreign investment particularly as it still remains low. Investors, however, remain weary of the possibility of capital controls, an action which would plummet investor confidence in Russian assets to a historic low.

Yeltsin’s Friday comments that foreigners were unlikely to invest in Russia and that financing had to come from internal sources also lessened market participants’ confidence in the stability of Russian markets.

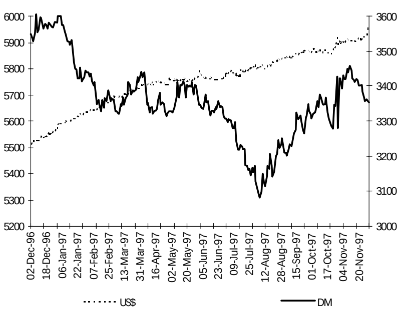
Cabinet meeting postponed

Market nervousness increased on Monday when it was announced that a December 1 cabinet meeting would be postponed for approximately 10 days. The meeting is deemed to be very important because as President Yeltsin had described, the meeting was to be “...the first reformist Cabinet account to the president.” Moreover, President Yeltsin had hinted that he might announce further cabinet replacements at this meeting. The President cited the government’s less than stellar record in tax collection to pay off long-standing wage arrears as a possible reason for further dismissals.

The markets

These red warning lights of potential trouble ahead should be seen against the recent instability in Russian currency and fixed income markets; the government has responded by raising key interest rates twice in three weeks.

Rouble Against US$ and DM

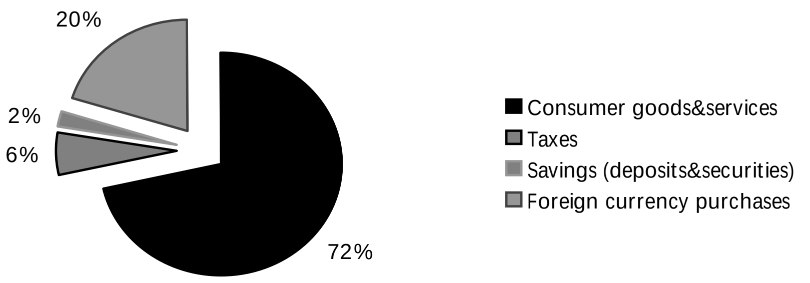


Rouble or rubble?

The Asia-caused crisis has caused foreign and local investors to sell Russian assets across the board. Interestingly, for the first time, the Russian press is covering extensively the recent pressures on the currency markets. More immediate effects have been felt in the GKO market. Foreigners would have exited earlier had it not been for the Russian law which compels foreigners to keep funds in the country for 30 days.

It is not only foreigners who are wary of the Russian currency, so are Russian citizens. Ivan Ivanovich still prefers to own hard currency. According to Goskomstat, from January-October 1997 Russians spent about RUR 256trn (US$ 43.69 bn), or 19.9% of their overall money income, on foreign exchange purchases compared to 18% in the first ten months of 1996. The Russian population's money income in January-October 1997 totalled about RUR 1,288 trillion (US$219.80 bn) against RUR 51,257trn (US$ 212.45 bn).

How do Russians spend their money?



Source: Goskomstat

Lombard and refinancing rates

Pressure on the currency and a desire to restore faith in Russian assets has compelled the CBR to raise rates twice in three weeks; there are also hints that refinancing rates may change again soon. Before discussing recent interest rate activity in Russia it is important to have a brief explanation of key rates in Russia as there is at times confusion over what these rates represent. The Lombard rate is the rate at which Russian banks can borrow from the CBR.

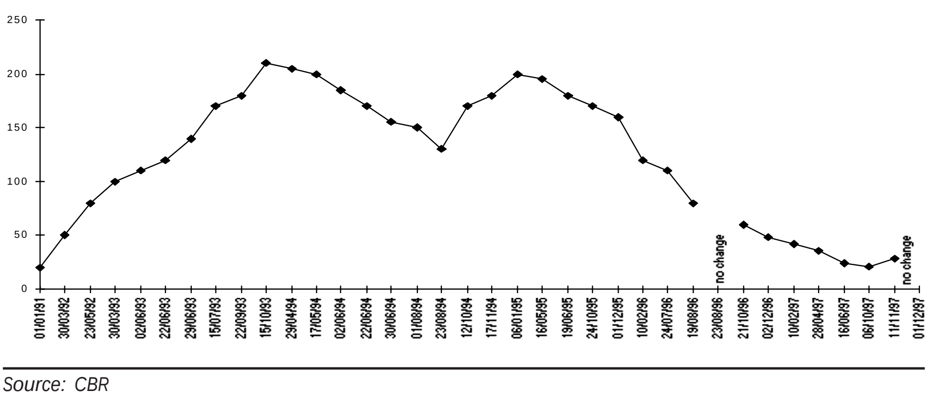
Lombard Rates			**(%)**
Date	**3-7 day**	**8-14 day**	**13-30 day**
23.08.96	30	50	62
21.10.96	20	40	50
02.12.96	24	36	48
10.02.97	nc	33	42
28.04.97	nc	30	36
16.06.97	18	21	24
06.10.97	15	18	21
11.11.97	22	25	18
01.12.97	36	36	36

Note: NC = no change

The CBR instituted auctions for Lombard credits in early 1996. The first auction was held on April 4, 1996 where the rate for seven day funds was 60%; at subsequent auctions the funds range has been 51-75%. Auctions were replaced in the summer of 1996 with three fixed-rate Lombard facilities; initially the maturities were for 7, 14, and 29 days. By February of 1997, maturities were changed to 3-7, 8-14 and 15-30 days. Lombard rates tend to follow market rates. The CBR utilises GKOs for collateral, but there is approximately a 75% limit on the quantity of GKOs that can be discounted. The use of the Lombard facility has more than tripled to RUR 529.18trn in November from RUR 8.46 trn in October; this is a sign of increased rouble liquidity.

The refinance rate was established on January 1991 and is a symbolic benchmark for interbank lending and usually serves as the effective cap on GKO yields; primary dealers in the GKO market can borrow overnight funds from the CBR at the refinancing rate, but the CBR has and utilises discretion over whether to allow banks to borrow at the refinancing rate.

Refinance Rate, %

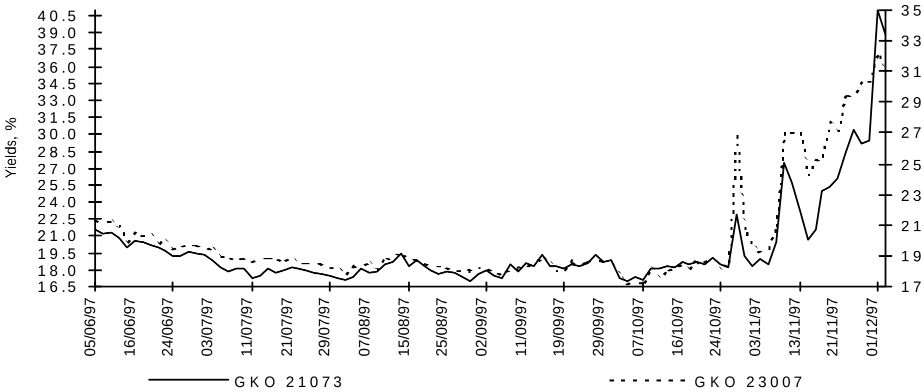


Source: CBR

GKOs

GKO yields have reflected market pressures and in some maturities the rates have risen to over 40%. The GKO market (particularly) weakened significantly on Monday because the Central Bank of Russia stepped away from its practice of trying to support the market at the refinance rate of 28% or at least slightly below 30%. At the end of Monday's session 3 month GKOs were trading at a yield of over 10% above 12 month issues, making the yield curve very inverted.

GKOs (86 and 170 Days to Maturity)



Source: NWM
Note: Scales are parallel.

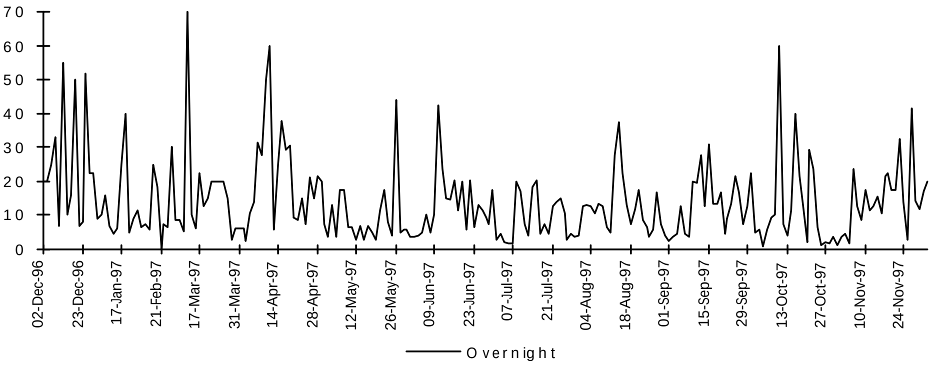
Russian monetary authorities raised refinance and Lombard rates on November 11 respectively from 21 to 28% and to 22-28%, from 15-21%; on December 1, in a shock move raised all Lombard rates, regardless of maturity, to 36%. The CBR left the refinance rate unchanged, creating some degree of confusion in the market. It is the Lombard rate which has more economic importance as this is the rate at which banks are likely to borrow funds from the central bank, whereas the refinance rate is more the politically important as it shows the CBR's monetary policy stance and displays the discretionary power of Russian monetary authorities in inter-bank loan pricing. To add clarity to its monetary policy stance, CBR officials stated that they might change the refinancing rate in the near future, giving rise to speculation that the rate might also be increased.

Another significant symbol of financial markets pressure is the cancellation of six-month GKO placements at the Wednesday auction. Investors are too nervous to invest in longer-dated maturities; as such the Ministry of Finance plans to increase its three-month GKO issuance while not issuing six-month or longer dated paper.

In conjunction with the central bank's deflating activities in the fixed income market, in the foreign currency market it has adopted a parallel stance. The CBR allowed the rouble to decline to RUR 5.960/US$ and widened its daily intervention band to RUR 84 in comparison to RUR 14 on Friday.

The CBR has also attempted to support the rouble by announcing the rates at which it will drain roubles from the interbank market, offering the market 25% for deposits, in comparison to 15% in mid-November. This is an incentive for market participants to sell foreign currency in exchange for the domestic currency.

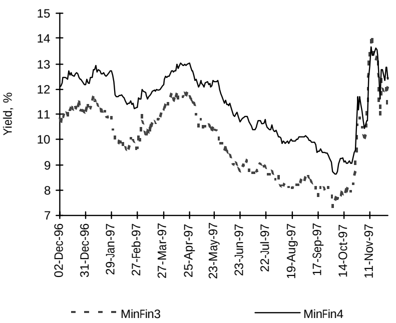
Short-Term Deposits



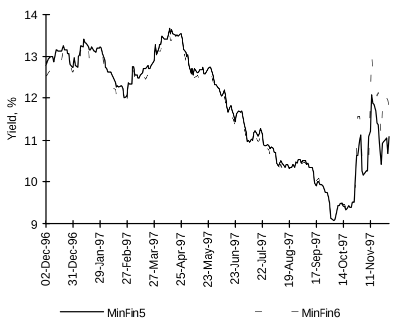
Source: Reuters

Rather than selling foreign currency, local investors have been selling GKOs in exchange for the roubles they need. Foreigners, for their part, have stayed away from the GKO market. Estimates are that foreigners have wanted to take out about US$5bn from the GKO market; this is a significant figure given that GKO placements by foreigners in the first half of 1997 were about US$ 8.2 bn. Chubais has been arguing that foreign funds are still leaving Russia. US$ denominated Ministry of Finance (MinFin) bonds have also been under pressure but have eased since the announcement of the December 2 London Club deal closure. Andrei Kostin, Chairperson of the Vneshekonombank, along with most market participants, however, does not expect US$ debt to rebound fully until the first half of 1998.

Ministry of Finance Bonds: Tranches 3 & 4



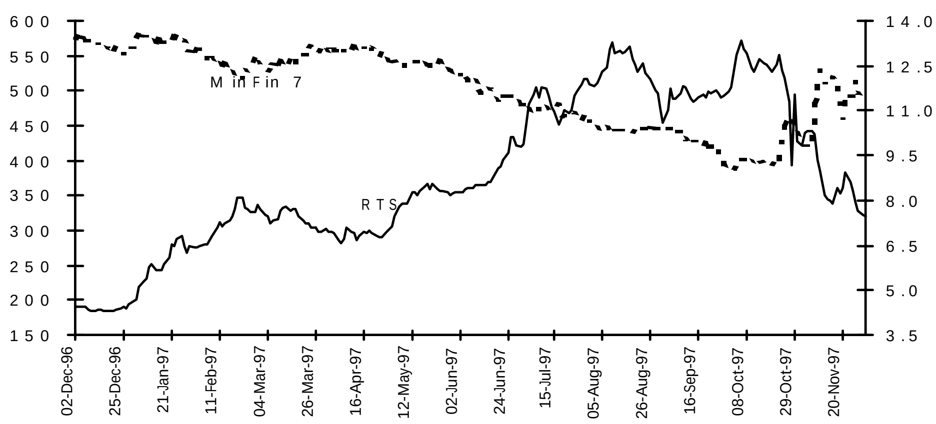
Ministry of Finance Bonds: Tranches 5 & 6



Equity market

The equity market has been feeling spill-over pressure from FX and fixed-income markets. Very little corporate news has been coming out and it is evident that the market's decline owes much to the portents from the currency and fixed-income markets.

(RTS/Eurobond)



Source: Reuters
Note: Scales are parrallel; end date December 2

Expect further pressure

- Banks
- Workers' arrears
- Revenue Raising Measures
- The Central Bank of Russia

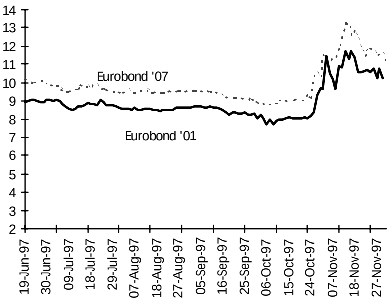
Banks

Paying cash will pressure some banks

Traders, particularly fixed-income ones, are focusing on December 5 as a date in which Russian banks could experience inordinate pressure, because derivatives for Russian debt, principal (PRINs) and interest (IANs) to the London Club will be settled on that day. The agreement on restructuring Russia's debts to the London Club closed officially on December 2. The entire debt will be converted into Vneshekonombank bonds (the Soviet-era foreign exchange bank bonds).

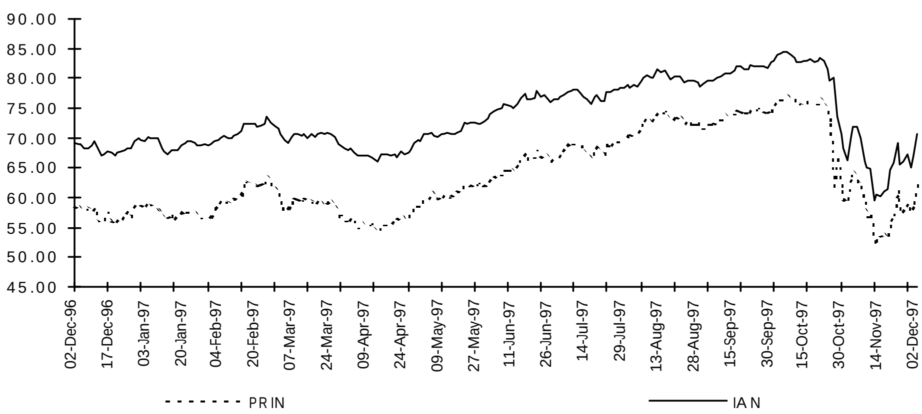
This debt is made up of about $24 billion in principal and $7-8bn in interest. Interest in arrears will be honoured both in bonds and cash. The interest repayment has been building up at a special account at the Bank of England for the last two years. The Bank of England transferred the balance of the account, which now contains $2 billion, to Deutsche Bank, which is the agent for closing the agreement. Chase Manhattan Bank had been appointed as agent to service the interest bonds, which will be listed on the Luxembourg Bourse.

'01 & '07 Maturity Eurobonds



Government experts earlier estimated that Russian banks had lost $500 million on debts to the London Club after the world financial crisis. Bank losses could rise as they will now have to pay for their PRIN and IAN positions with international banks in cash. On the announcement of the London Club deal closure PRINs and IANs prices rose about 4.7%, whilst the benchmark Eurobond 2007 tightened sharply to about 515 basis points over US Treasuries from 600 basis point on Monday.

PRIN and IAN Price Movements



Source: Reuters

Previously these derivative instruments were traded on a when-issued basis. There is serious concern that banks might not be able to raise the money to fulfil those obligations. In addition, banks are likely to be affected by the declining worth of their equity holdings and losses they have had in their GKO positions. Some temporary respite might come from a recent CBR order that banks can account for their 1997 GKO losses in 1998, again only a stop-gap measure.

Some articles in the Russian press have been very alarmist; Moskovsky Komsomolets ran an article stating that "the current situation on Russian financial markets is worse than October 1994 when the rouble lost about 30 percent of its value – today the whole banking system is on the brink of collapse." Whilst collapse might not be around the corner, Russian monetary authorities and market analysts have long agreed that of the approximately 2,500 banks in Russia many should merge or disappear to prevent a contagion effect where the action of weak banks infects the healthier ones.

Workers' arrears

Yeltsin: staking his reputation

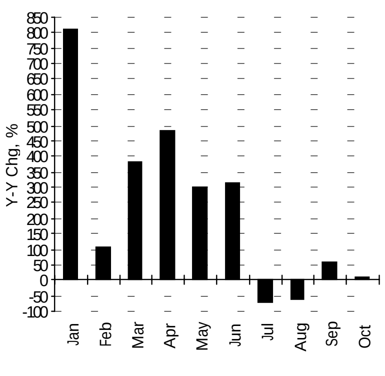
Although as of late President Yeltsin has almost staked his reputation in paying workers' wage arrears, it is unlikely that he will meet the January 1, 1998 deadline. Press reports indicate that Chubais has asked a number of international banks for a US$ 2bn package, primarily for the purpose of covering the budget deficit and to meet wage arrears; more details will be forthcoming later in the week.

Estimates as to the wage arrears' levels vary. Deputy Prime Minister Oleg Syusyev and Goskomstat estimate the federal payroll wage arrears at RUR 10,200 trillion (US$ 1.2bn) whilst Chubais puts the federal arrears level at US$ 2.2bn. It must be remembered that regardless of which figure is right, it only encompasses federal arrears to workers. There are also regional wage arrears to workers of about US$ 2.2bn.

Russians can endure, but for how long?

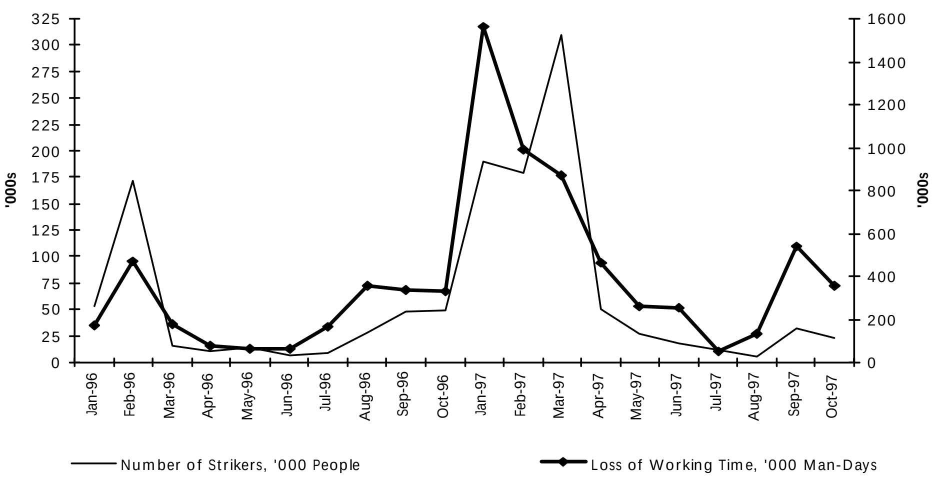
Whilst history and literature demonstrates that Russians have an enormous capacity to endure (please see "Comrade, can you spare a rouble?" September 1997), even their patience has a limit. Although grass roots movements in Russia are relatively nascent, Russian workers, particularly in the mining sector, have increasingly resorted to strikes to have their demands met. There is no doubt that while it may be difficult to quantify, worker strikes have a significant impact on morale, not to mention on production levels in Russia.

Days Lost, 96-97



Source: Interfax

Working days are lost!



Source: Interfax

Revenue-raising measures

- Taxes
- Privatisation
- Foreign borrowing
- Multilateral agencies and the international financial community

Taxes

Tax collection continues to be absymal. Unfortunately collection levels are likely to remain low throughout the winter.

Privatisation

Privatisation efforts have had setbacks. Approximately two weeks ago the Duma demanded a moratorium on all privatisation sales; their reasoning is that a new privatisation law is needed. The President's Administration countered by arguing that privatisation activities are a Cabinet responsibility and not the Duma's. While this haggling continues, the unfortunate issue is that further funds will not be raised; consequently the coffers hold only paltry treasures given that tax collection has been pretty low. Although privatisation sales have raised about US$ 2bn, as a percentage of GDP 0.44%. (Privatisation revenues have never reached even 1% of GDP.)

Another sign of mounting government difficulties is that some officials would like to return to the much maligned shares-for-loans programme. This was the programme under which Russian financial institutions lend the government funds in exchange for temporary control of over a state owned entity's shares. In the past, institutions involved have always done well out of this. This program is damaging for Russia because it would again shed the spotlight on unfair competitive practices; the company involved is also hurt significantly as the winning bidder is not necessarily the best one to influence the company's strategy.

Foreign borrowing

Real cost of capital is crowding out necessary borrowing and investment

The Ministry of Finance has announced recently that it would like to raise the limit on foreign borrowing from US$ 9.8-10.9bn. This proposal, if passed, would be an amendment to the 1997 Budget law which would reduce by 55% the domestic funding of the originally planned budget deficit, and would raise external source funding by 28%. This action is increasingly necessary, since domestic borrowing has become very expensive. When GKO yields were 25-27%, this meant that the real cost of domestic borrowing was about 16-18%; with yields now ranging between 30-50% across the various maturities, the real cost of domestic borrowing is about 28%, the current refinancing rate. There is fear that gains from lower inflation and a previously stable rouble will be reduced significantly from the crowding-out taking place as borrowing is too expensive for the corporate sector; in addition, international market conditions have hindered Russian companies from previously planned Eurobond or syndicated loan issues.

Inflation

Source: CBR

The Russian government hopes to increase its World Bank borrowing by 70% to US$ 1.95bn and to raise its limit on the international capital markets by 5.9% to US$ 3.6bn. Given current market conditions, it is unclear when Russian financial authorities would intend to explore forays into international capital markets.

In the mind of Russian authorities, strong signs of support from the IMF and World Bank would help Russia survive the current financial crisis.

Mutilated agencies and the international financial community

IMF is likely to release tranche

The new IMF mission to Moscow this week is focusing on Russian proposals to tighten controls over spending and revenue items and continue talks on the shape of the 1998 budget. Early this week, the IMF announced that it would allocate a $700 million tranche by the end of this year under a program to bolster state finances. Russia received its last tranche of $696.7 million on May 23. The IMF approved the last quarterly tranche of $700 million in September, but the tranche's release was suspended in November because Russia had failed to reach its budget revenue and expenditure targets.

According to a press release issued by the Central Bank of Russia (CBR), the foundation for this release is that the IMF looked at and gave a favourable evaluation to a government-drafted program to revitalise state finances. This press release was largely a response to placate rumours that the trip to Washington had been to ask for emergency funds from the IMF and the World Bank.

The European troika

Weekend meetings between good friends President Yeltsin and Chancellor Kohl have prompted speculation that Russia will be seeking loans from Germany. Whilst neither leader would confirm or deny whether loans would be transacted, Chancellor Kohl did state that the issue had been discussed. They did agree that they would like to hold a three country summit with France next year; Kohl gave a lukewarm response to the "troika" idea (Russian word meaning three and often used like the word triumvirate). Yeltsin's main aim for this meeting is to begin a relationship which would counterbalance US influence in Europe. Kohl, however, is weary of creating the impression of creating a new power bloc.

Russia must learn "to fish"

It is important to note that all these loans are stop-gap measures. Whilst Russian authorities have made amazing progress in the last few years, its fiscal reforms remain slow at best, particularly as tax collection rates remain very low and the Duma continues to stall the New Tax Code.

The Central Bank of Russia and its reserves

Fate should not be tempted

The Russian government believes that since its foreign reserves this year have risen by more than $7 billion, or 60%, this should allow them to handle the current crisis; it must be remembered that reserves have risen largely due to investments in GKOs and the equity market. When the dust settles, we could see this rise wiped out. Whilst for now, the CBR has about US$21bn in foreign reserves exchange and gold reserves, it has spent significant funds in the last few weeks to defend its currency. Unfortunately it is difficult to tell how much currency has been lost as the CBR tends not to release that data. What we do know is that overall reserves declined 6.11% from the beginning to the end of November. We only need to look at the efforts of Nordic and ERM central bankers in the early 90s to realise that currency intervention and even steep rises in interest rates are only stop-gap measures. For the CBR to think that it can be more powerful than the market is to tempt fate!

The CBR believes that the rouble will remain stable and that the exchange rate by the end of the year is forecast not to exceed RUR 6,000/US$. The currency, however, has been trading close to its upper band. Barring any unforeseen disasters, the CBR should be able to enact the planned rouble redenomination and implement the new fluctuating band on January 1. **An area of concern is that the more the CBR states that it will not restrict the exchange of roubles for hard currency, *the more nervous the market is likely to get.***

Summary

Liquidity is drying up

From a technical trading perspective, it is important to note that on the forward curve, liquidity has almost dried up, with very few quotes past this month. We expect interest in rouble and GKO markets to be minimal until liquidity improves. For increased and long lasting confidence to ensue, investors would need to see significant moves in fiscal policy and on the 1998 Budget and the New Tax Code, coupled not only with a relatively small IMF US$ 700m tranche, but significant monetary commitment from European countries such as Germany and France or international banks.

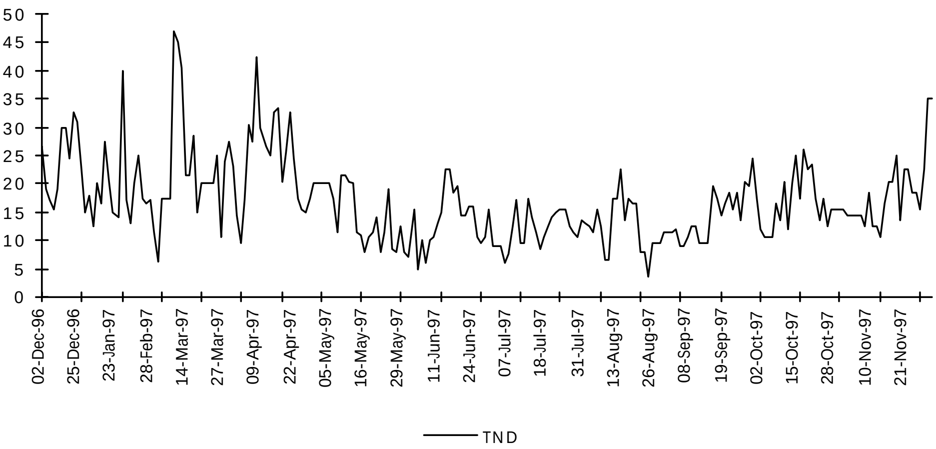
Cabinet meeting is important

Last week's comments and events highlight the importance of the upcoming cabinet meeting. Chubais has been hinting that the government has prepared a number of measures to improve the financial situation in the country and tighten control over budget spending, particularly in light of the need to raise confidence among domestic and international investors in Russian assets. Some of these measures probably include abolishing the system of mutual offsets starting January 1. The government plans to demand that recipients of budget funds submit monthly reports about their payables and make the heads of ministries and departments personally responsible for expenses not secured by federal budget funds. Whilst other tight fiscal measures are expected, officials have not elucidated them further. When the government submits its proposals to President Yeltsin within a week at the latest, the proposals, if approved could be in the form of a presidential decree. While waiting for strong announcements from the Cabinet and the international financial community, please keep your seatbelts buckled!

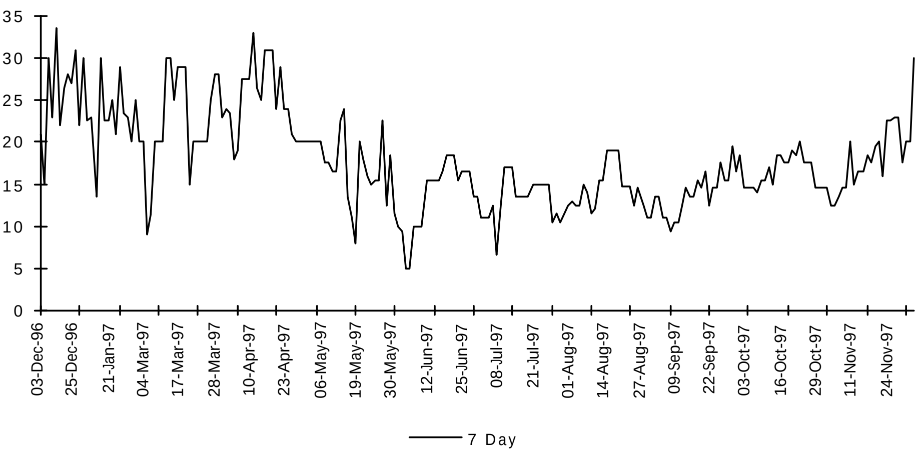
Appendix I

CBR deposit rates, %

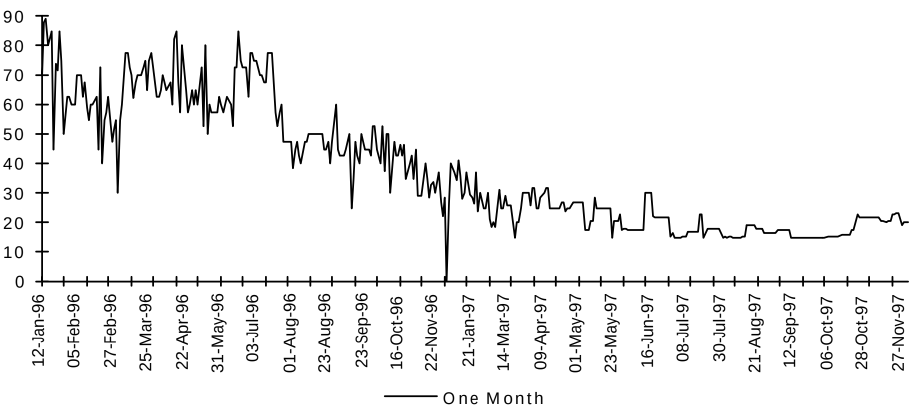
Tomorrow Next Deposits



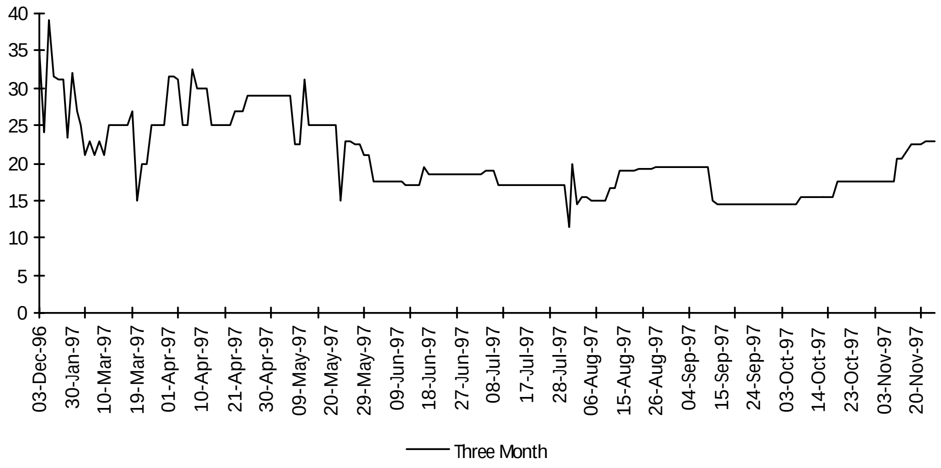
Seven Day Deposits



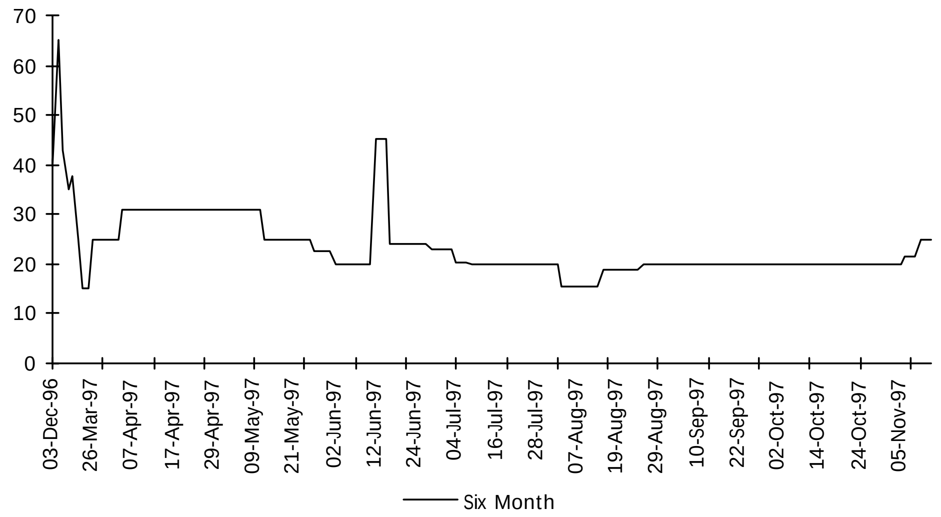
One Month Deposits



Three Month Deposits



Six Month Deposits



One Year Deposits