

RTS CLOSE	TARGET (1 YEAR)	RECOMMENDATION	DATE
342.85	425.04	Neutral	24 March 1998

A FIGment of our times

Whilst President Yeltsin has a history of strong statements or unexpected policy actions (usually after returning from vacation or illness absences), today's dismissal of the entire cabinet came as a complete shock to market and Kremlin observers.

It is not the first time, however, that Yeltsin has admonished or dismissed officials, while then reshuffling the Cabinet and reinstating the same reformers he dismissed. Within three hours of the dismissal, Yeltsin quickly named Fuel and Energy Minister Sergei Kiriyenko as Acting Prime Minister and promised that a permanent prime minister would be named soon. As long as Yeltsin moves quickly to appoint reformers to the Cabinet, ideally including the prime ministerial post, **we feel that continued improvement in the Russian economy, coupled with recent developments in international oil prices, should lend the equity market strong support.**

The Dismissals

Over the weekend, Russian newspapers had carried stories that Yeltsin upon his recent return to the Kremlin would be chastising the cabinet for its inability to resolve the growing wage arrears problem; Yeltsin has staked his reputation on resolving this critical issue. Utilizing the wage arrears issue as a guise to shake up the government, Yeltsin removed Chernomyrdin, which was interpreted by some observers as a shocking dismissal given that **Chernomyrdin had a history of serving as a very effective bridge** between the Communist hard-liners in the Duma and the young reformers in the Cabinet. Some observers also stated that Chernomyrdin's removal was an attack on the Financial Industrial Groups (FIGs).

In reality, however, we believe that Chernomyrdin's removal was actually encouraged by some FIGs so that Chernomyrdin can dedicate himself to heading his party, Our Home is Russia, and preparing for the presidency. Had he remained as Prime Minister, he would not have been able to run for the presidency as part of a party but would have had to run as an independent. President Yeltsin in fact praised Chernomyrdin's work; it is our belief that Yeltsin will continue to support the former prime minister. In the last few months, **Yeltsin has been giving Chernomyrdin a lot of support.** Significantly, Chernomyrdin has the backing of Gazprom and very powerful FIGs that in turn will give him support

- The entire cabinet has been dismissed
- Yeltsin has acted constitutionally
- Kiriyenko is Acting Prime Minister
- Chernomyrdin will prepare for the presidency
- Kiriyenko or a regional governor is likely to be nominated prime minister
- FIG backed individuals are likely to be named to various government posts

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The favorite scapegoat....

The most disliked politician

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through their newspaper and television holdings. **Chernomyrdin, himself, announced that he intends to focus on the 1999 Duma and 2000 presidential elections; he has already been preparing to run for the presidency.** Moreover, while the Russian government continues the enormous challenge of improving Russia's economy, **Chernomyrdin might actually benefit by being away from the government** during the painful reform process. Hence, he might increase his chances that the electorate will not blame him for its economic problems.

First Deputy Prime Minister Anatoly Chubais was dismissed but is likely to stay with the government in some capacity. The famous Russian reforms' architect has long been Russia's favorite scapegoat. He has survived various dismissals and demotions, the most recent being in November 1997, when it came to light that he had received payment for his book on privatization from a publishing house closely connected to Oneximbank, the FIG that has benefited handsomely from privatization transactions. Chubais was also dismissed as First Deputy Prime Minister in 1992 before being reinstated in 1996. **Chubais has been recently nominated as UES Board of Directors' Chair.** If he does not remain within the Cabinet, we believe that he has a strong chance of moving to UES, **a move that the market would interpret as positive, since UES and the utilities sector are in significant need of more in-depth reform.**

Minister of the Interior Kulikov, who was also a deputy prime minister and a strongly disliked politician, was dismissed. Kulikov's reputation stems largely from his hard-line stance that Russia should continue fighting in Chechnya despite repeated humiliations by separatist forces before a cease-fire in August 1996. Kulikov has survived several Cabinet reshuffles in the past, but is unlikely to be retained in government. Reaction to his dismissal has been from neutral to positive.

The Contenders

Under Article 111 of the 1993 Russian constitution, President Yeltsin has to nominate a prime minister and present all cabinet nominations to the Duma within two weeks; the Duma then has one week to approve the nominees. An April 1997 law calls for dismissal of the entire government if the prime minister is dismissed, but **Yeltsin has asked cabinet ministers, including Foreign Minister Primakov and Defense Minister Sergeyev to carry out their responsibilities until a new cabinet is name officially.** If the Duma rejects Yeltsin's nominations three times, the president then has the power to dismiss the entire Duma. **At present we do not envision such drastic actions** as Yeltsin has moved swiftly to at least name an Acting Prime Minister. Moreover, **Chernomyrdin has left gracefully and has emphasized that both economic and political reforms will continue.**

As soon as the Cabinet was dismissed, market watchers mentioned six possible Chernomyrdin replacements: First Deputy Prime Minister Boris Nemtsov, Fuel and Energy Minister Sergei Kiriyenko, Saratov Governor Dmitrii Ayatskov, Samara Governor Konstantin Titov, Girgorii Yavlinsky head of the reformist party Yabloko and Yegor Stroyev, Chairman of the Federation Council, the upper house of parliament. **Most of these replacements, with the exception of Stroyev, would be very effective prime ministers,** particularly Ayatskov, Kiriyenko and Titov, would also serve as reliable bridges to the Duma.

NATWEST MARKETS

Tough and flexible politician

Given Nemtsov's youth and his close alignment with Chubais, at this point we believe that Kiriyenko or someone from the regions has a better chance of being nominated to the prime minister post. What will be key is that whoever is nominated can carry out reforms and be an effective asset with the difficult Duma. Parallel to the naming of the new prime minister, **investors should watch closely how the powerful Financial Industrial Groups (FIGs) push their choices into a new cabinet.**

Titov

The Samara Region in the middle Volga area is led by Konstantin Titov, a tough and flexible politician in the mold of Yeltsin. Titov gained notoriety when he was able to calm the region after two directors in a row from Samara's largest refinery were killed during 1993-94. He also kept his largely working class constituency from embracing communism during the 1996 presidential elections. **Winning in a swing region, like Samara, was key to Yeltsin's success.**

Samara's results in 1996 Presidential Election

Candidate	First Round, %	Second Round, %
Yeltsin	36.13	51.95
Zyuganov	35.17	42.69
Lebed	11.65	
Zhirinovskiy	5.55	
Yavlinskii	6.16	
Overall Turnout (Samara Oblast)	69.85	71.35
Overall Turnout (Russia)	69.67	68.79

Source: OMRI, Russian Regional Report

Samara remains one of the top ten regions based on a number of measures: a strong GDP contributor, significant industrial output per capita, and very strong natural resource development potential. In 1997, Samara's GDP grew 1.2% in comparison to the Russian average of 0.4%; the Region is expected to grow by 3% in 1998. The Region also met tax targets in 1997. Samara is planning a \$500m three-year Eurobond in the first half of 1998. Samara has Ba2 and BB ratings respectively from Moody's and S&P. Moody's describes the region as pursuing a conservative fiscal policy whilst minimizing its budget deficit and external borrowing. Both the Russian business magazine Expert and the TACIS Russian Economic Trends give the Region high marks.

Crime and corruption fighter**Ayatskov**

Dmitrii Ayatskov was appointed as governor of the Saratov Region (858 km southeast of Moscow) by President Yeltsin in April 1996, replacing Yurii Belykh who was dismissed for misuse of budgetary funds. Previously, Ayatskov was a deputy mayor of Saratov and deputy chairman of the city commission on combating crime. Since becoming governor he has become well-known in Russia, in part for his aggressive removal of half of the local administration heads, many of whom were charged with corruption.

Historical land privatization

In addition on March 5, history was made in Balakovo, Saratov where an open land auction took place for the first time anywhere in Russia in 80 years. Even though communists heckled during the two hour auction, 20 plots of land were sold very successfully. President Yeltsin and the Duma have yet to see eye-to-eye on Russia's land code. The differences mainly are centered on sections of the statute concerned with the purchase and sale of land. **The Saratov Region circumvented the problem by approving its own land legislation that permits unrestricted purchase and sale of land.**

Strong Yeltsin supporter

Whilst at times the Saratov administration or the residents have not been strong Yeltsin supporters, Ayatskov has always been a strong Yeltsin supporter. On October 12, 1996 he dismissed the local administration when it refused to abide by Yeltsin's declaration that the Supreme Soviet was unconstitutional.

Good technocrat and does not make waves

Too aligned to Chubais and is anti-FIG

On the rise...

Saratov's results 1996 Presidential Election

Candidate	First Round, %	Second Round, %
Yeltsin	28.38	44.08
Zyuganov	41.59	49.94
Lebed	12.76	
Zhirinovskiy	7.09	
Yavlinskii	5.28	
Overall Turnout (Saratov Oblast)	73.46	73.83
Overall Turnout (Russia)	69.97	68.97

Source: OMRI, Russian Regional Report

Kiriyenko

Fuel and Energy Minister Sergei Kiriyenko was named quickly to be the Acting Prime Minister. Whilst **Kiriyenko is known as a reformer and closely aligned with Nemtsov** as they have known each other since they were both in Nizhny Novgorod, Kiriyenko does not provoke opposition in the Duma as do Chubais and (even often) Nemtsov. President Yeltsin had appointed Kiriyenko as Minister of Fuel and Energy on November 20, 1997.

Kiriyenko was born on July 26, 1962 and was graduated from the Gorky (now Nizhny Novgorod) Institute of Marine Transport. He also completed two years of study in banking and finance management at the Academy of the National Economy. His career has been very varied. He worked as a supervisor at the Krasnoye Sormovo shipyard, was a first secretary in the Gorky Komsomol (communist youth) organization, a deputy to the regional Soviet, and then began entrepreneurial activities. He was a founder of the Guarantiya Public Commercial Bank in Nizhny Novgorod and a charter board member from January 1994. In November 1996, he became president of Norski Oil. Since May 13, 1997, he was named first deputy minister of fuel and energy. An important highlight of his career, thus far, is that he played a key role in negotiations on transportation of Caspian oil through the Baku-Grozny Novorossiisk pipeline.

Nemtsov

If First Deputy Prime Minister Boris Nemtsov were to be nominated as prime minister, there would probably be strong resistance within the Duma because he is seen as too closely aligned with Chubais, is seen as "not having enough gray hair" to run the government, and even more importantly is seen as an anti-FIG politician. In addition, **Nemtsov's personal background makes it unlikely that the hard-liners in the Duma would be supportive** of him. International markets, however, would react favorably since Nemtsov is famous as being a leading reformer in the cabinet and as one of the first reformist governors when he was in power in Nizhny Novgorod. **However, even if not nominated as prime minister, Nemtsov is likely to retain some kind of post in the government.**

Yavlinskii

Grigory Yavlinskii, previous presidential contender and current head of the liberal pro-reform, opposition party, Yabloko, is also being mentioned as a possible nominee. Yavlinskii is also well-known for his involvement in Nizhny Novgorod reforms during 1992-93 when Lady Margaret Thatcher was involved in Novgorod's advisory reform board. Whilst Yavlinskii is unlikely to be named prime minister, given his recent alignment with a strong FIG, **he is likely to receive a higher role in the Cabinet such as becoming a deputy prime minister.** Markets would not react positively to his appointment as prime minister since he believes in economic measures that would be inflationary; he is also viewed by some Russian government officials as being "too" ambitious.

Still too communist**Stroyev**

Yegor Stroyev, from the Our Home is Russia Party and current chairman of the Federation Council, the upper house of parliament, has also been named as a possible nominee. Stroyev is also the governor of Orlov Region. Communists and nationalists, including the infamous Zhirinovskiy would be supportive of a Stroyev nomination. His nomination for prime minister would not be received positively by the markets as he is still considered a communist and anti-reformist.

Equity market fell but ended up!**Market Reaction****Russia**

On a day when market participants were expecting a very strong equity market on the back of the Saudi Arabian, Venezuelan and Mexican announcement of cutting back on oil production by as much as 1.6-2.0m barrels daily, Russian stocks declined over 5% even before the market opened officially. However, because Yeltsin was quick to hint that he would name good and energetic cabinet replacements and then named Kiriyenko as Acting Prime Minister, downward pressure on all Russian assets was stemmed. **The RTS actually closed with a 2.1% rise on above-average volume of \$155.6m.**

Watch the FIGs!

In addition to the general direction of economic reforms, what concerns equity investors, specifically, is what a new prime minister and cabinet mean to corporate governance. Concerns over violations of minority shareholders have been particularly strong this quarter. At present, we believe that if Ayatskov, Kiriyenko, Nemtsov or Titov, were appointed, the current strengthening of the Federal Securities Commission would continue. **FIGs' in-fighting will be extremely important for equity investors to observe.** Reportedly, Oneximbank is likely to come under pressure in the very near term; we could see their privatization transactions scrutinized very carefully.

Leaders are giving the market a sense of direction

We remain optimistic about the equity market since we continue to see improving economic fundamentals in the country. Late last week, a slew of economic data was released confirming our views of improvement, albeit slow in some areas, in the economy. Monthly inflation on consumer goods was 0.8%, in mid-March, down from 0.9% in February. GDP in February was at the same level as February 97 but on an inflation-adjusted basis has increased 0.7% year-to-date. Industrial output also continues to improve and is up 1.4% year-to-date.

Moreover, unlike other times particularly during the Asia crisis where the country was experiencing a serious leadership vacuum, **Yeltsin, his dismissed cabinet, and monetary authorities have been quick to state that economic reforms will continue.** Supportive comments have also come from international entities. The **IMF announced that at present, it sees no reason why it would not approve an economic program for Russia during 1998, so long as the government continues current economic reforms.** Also, this morning, **the rating agency IBCA has announced that thus far it has no intention of changing its country rating.**

Positive sector developments

From a sector point of view, **the OPEC arrangements over the weekend lend support to our house view that oil prices are expected to rise;** we would expect Russian oil stocks to benefit from these developments and continue to favor LUKoil, Surgut, and Sidanco. **We continue to expect either Chubais, Brevnov or a reformer to become UES Board of Directors' Chairman** in the upcoming April meeting. Given that oil and utility stocks represent approximately 89% of the market capitalization of the most liquid stocks, the aforementioned issues underlie our increasing optimism about equities.

CBR is still strong

Whilst the ruble and all Russian fixed-income instruments came under pressure immediately following the cabinet dismissal, they all recovered pretty quickly. Moreover, other emerging market currencies' and fixed income instruments' buoyancy did not cease due to Russia's political upheaval. The ruble declined to RUR 6.088 against the dollar from its 6.075 close but bounced back to 6.083. GKO (Russian treasuries) yields rose sharply to 32% on the initial news but declined to 29% levels. **We expect GKO yields to continue their downward trajectory; this should encourage investors to enter the Russian equity market in search of better profits.** Exhibiting strong leadership to calm ruble and fixed-income markets, central bank authorities stated that ruble stability and economic reforms continue to be paramount in Russia. **So long as current central bank leaders are kept in place, we remain confident of central bank policies as the bank retains a good reputation in the global central banking community.** Nonetheless, the Ministry of Finance is not likely to issue a sovereign German mark Eurobond until the political situation is further clarified.

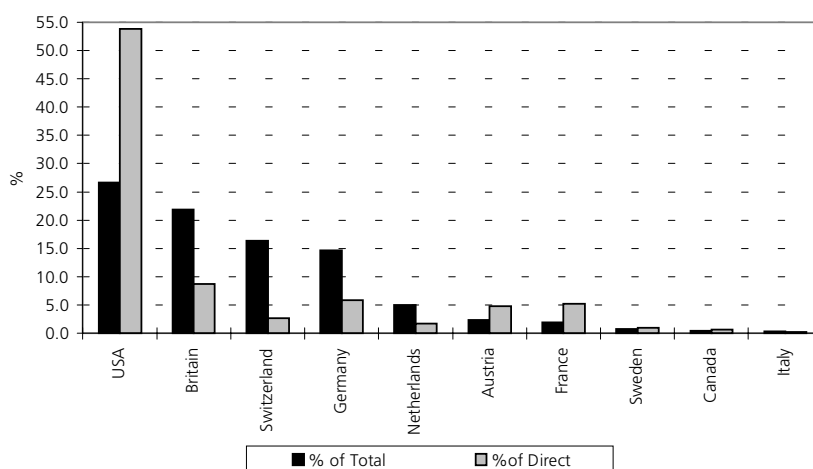
The World

While European markets are not so shaken by Russian events as they were in the early 90s (particularly during the August 1991 coup), the German market was not wholly immune. On the news of the Cabinet dismissal, the mark declined to DEM/\$1.8373 from Friday's close of 1.8302; against the Swiss franc the Germany currency declined to 81.58 pfennigs from 81.77.

Whilst some people quoted in the press stated that Germans send significant exports to Russia, exports to Russia only represent about 1.5% of total German exports, which is only about one-quarter of what Germany exports to Asia. What continues to have an effect on Germany is German banks' loan exposure to Russia. BIS data show large German exposure to the Former Soviet Union, Russia in particular. **At the end of 1996, German banks had \$31.7bn exposure to Russia, about 64.3% of the country's total exposure to Eastern Europe.**

In addition, Germany is increasingly involved in Foreign Direct Investment (FDI) into Russia. Recently released Goskomstat data show that Germany is in the top three countries in terms of foreign direct investment into the country.

Major countries' investment into Russia



Source: Goskomstat
 Note: Total includes portfolio investments

On the whole comments from US, Japanese, German, Polish and NATO leaders indicate that **they are confident that neither the Russian economy nor the country's foreign policy stance will be affected adversely.** Yeltsin still has plans to meet with Kohl and Chirac this coming Wednesday. Whilst there will be a flurry of news in the coming days, we believe that Russian and foreign leaders have acted swiftly to assuage market fears. So long as Yeltsin continues to uphold the Constitution and if he appoints reformers to the high cabinet positions, **we believe that reforms will remain on track.**

