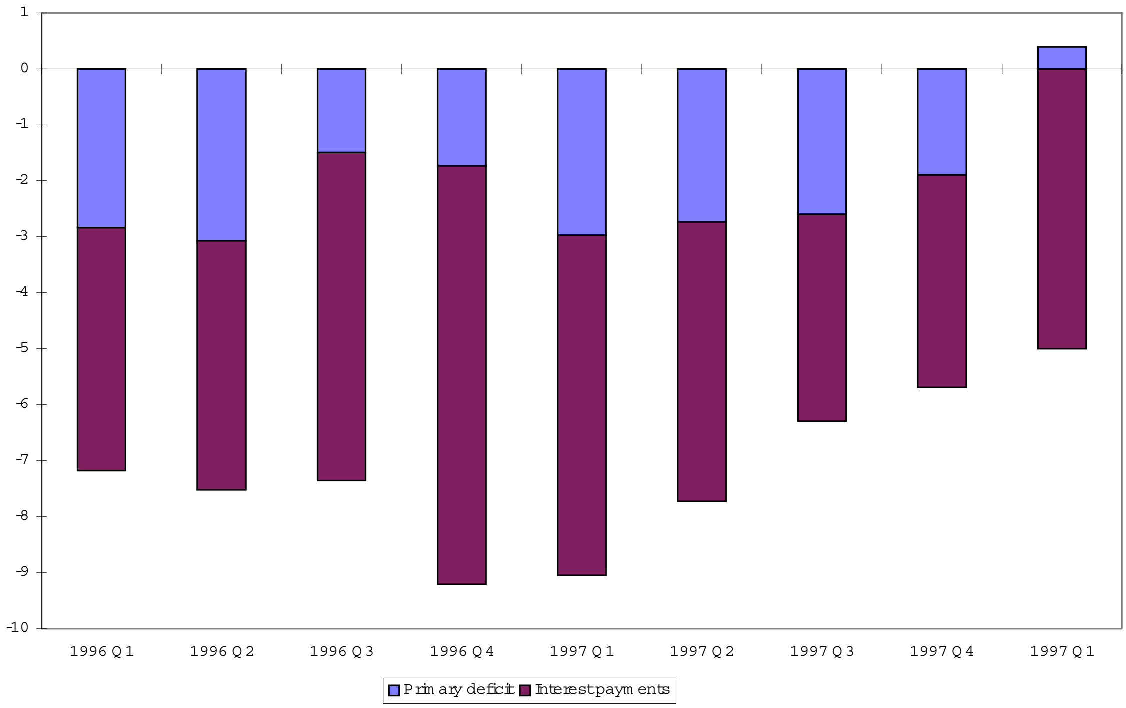
ROUBLE CRISIS, AGAIN

In May, the rouble came under more pressure than at any time since Black Tuesday in October 1994. Since the introduction of the currency corridor in 1995, the strong rouble has served as a nominal anchor for the economy, helping bring down inflationary expectations and giving foreign investors the confidence to lend to the Russian government, banks, and companies. Commitment to the rouble corridor limited the Central Bank's ability to print money, and forced the government to finance its deficits in non-inflationary ways – by borrowing on the domestic and international bond markets. Inflation has been brought down from 200 percent per year in early 1995 to 8 percent today. The anchor is now at risk, threatening to undermine Russia's hard-earned stability. This report analyses what has brought Russia's currency to the brink of devaluation.

Fiscal balances

With a low initial stock of domestic debt, the bond market did not at first impose severe constraints on government finances. But high interest rates and profligate borrowing, especially during the 1996 election season, caused the stock of GKO's to rise from 3.5% at the end of 1995 to 13.5% of GDP two years later. Most of this debt was short-term, with an average maturity of under a year. In the spring of 1997, the government began a gradual deficit reduction, assisted by falling interest rates. In the first four months of 1998, the government brought the deficit down to 4.4% of GDP by running a primary surplus (the deficit minus interest payments) of 0.5% of GDP.

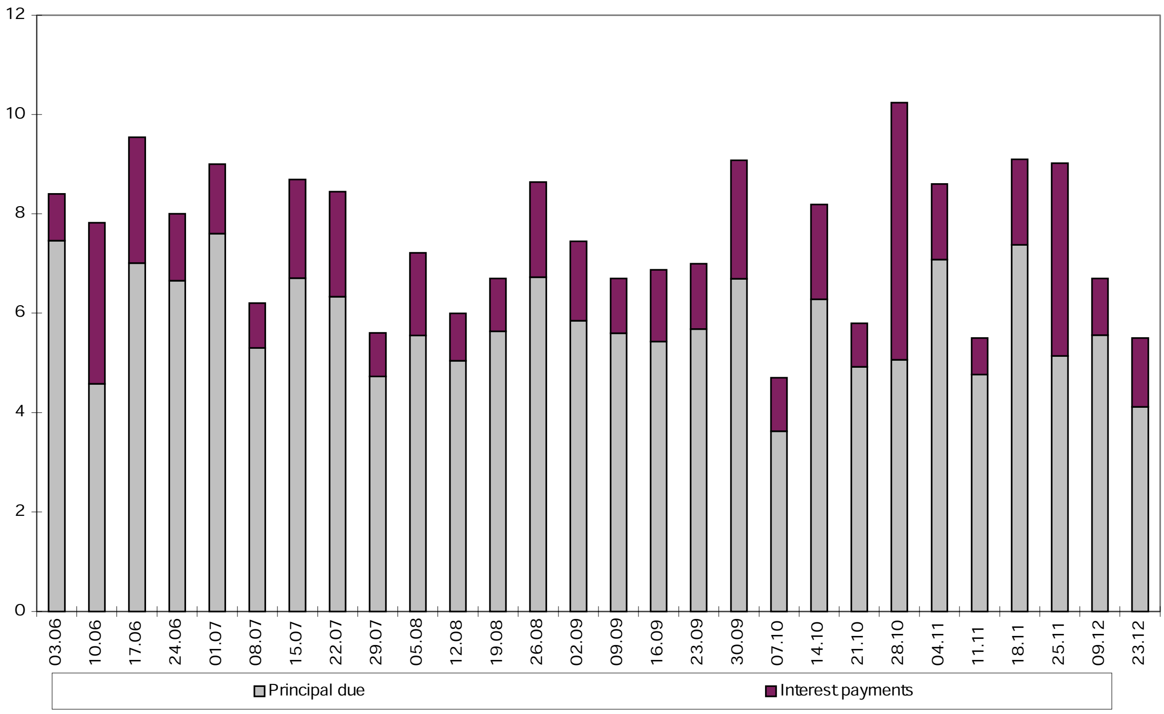
Budget deficit (%, GDP)



Source: Ministry of Finance

The fiscal tightening is an important achievement, and has reduced the government's need for new financing. But even though it is currently not borrowing to finance its current spending, the government must still raise an average of 8 billion roubles each week to roll over the existing domestic debt as it matures. Each week, as the debt comes due, investors decide anew whether to keep their capital in rouble assets. The government must therefore constantly work to retain confidence both in its own creditworthiness and in the rouble's on-going stability. When investors grow less willing to hold roubles, the government must offer higher interest rates. These higher interest rates increase the government's debt burden and feed investor concerns about whether the government will be able to pay them back.

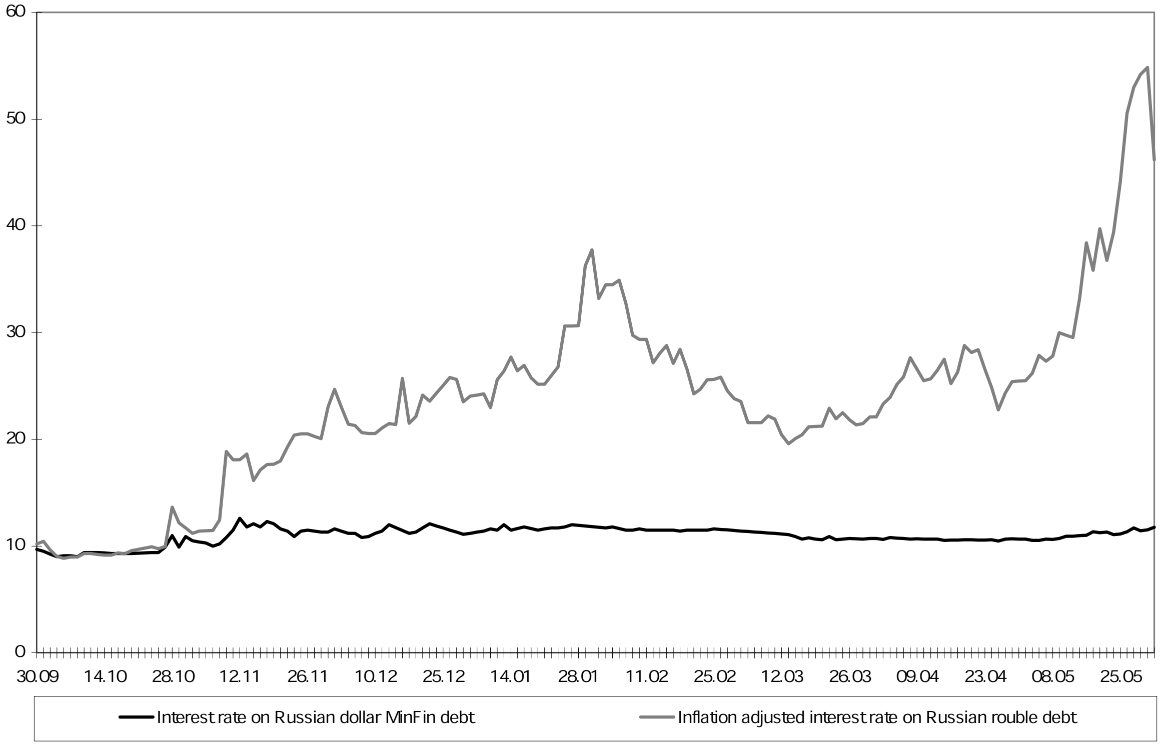
Existing GKO/OFZ debt coming due for repayment during 1998 (R bln)



Source: CBR

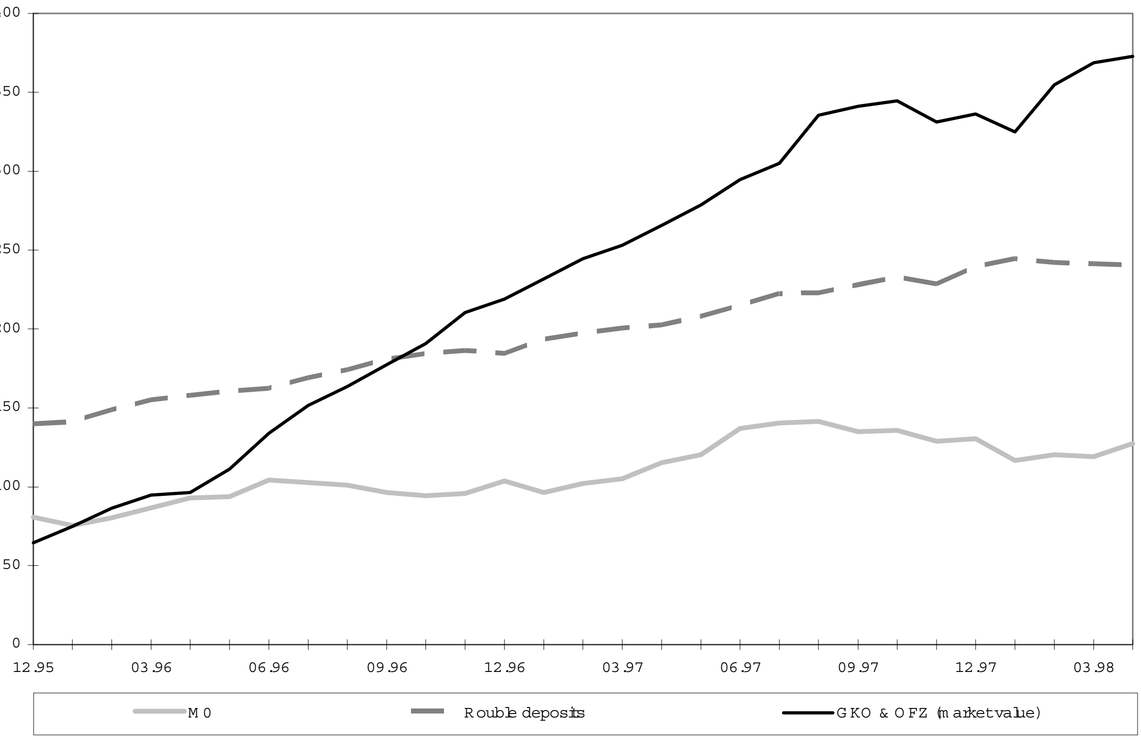
The concern is not that the government will actually default on its debt obligations. Rather, investors fear that if interest rates rise to punitively high levels – both for the government and for companies in the real economy – the Central Bank will be tempted to loosen monetary policy in an attempt to lower interest rates. In the process, the real value of the debt would fall, but the rouble would be sacrificed. During the recent crisis, yields on rouble-denominated debt have soared, while dollar-denominated debt yields have hardly moved, evidence that investors are concerned about the currency rather than the government's likelihood of default.

Interest rates on dollar and rouble debt



Source: Moscow Times, Troika Dialog

GKO's, Rouble deposits and M0 (R bln)



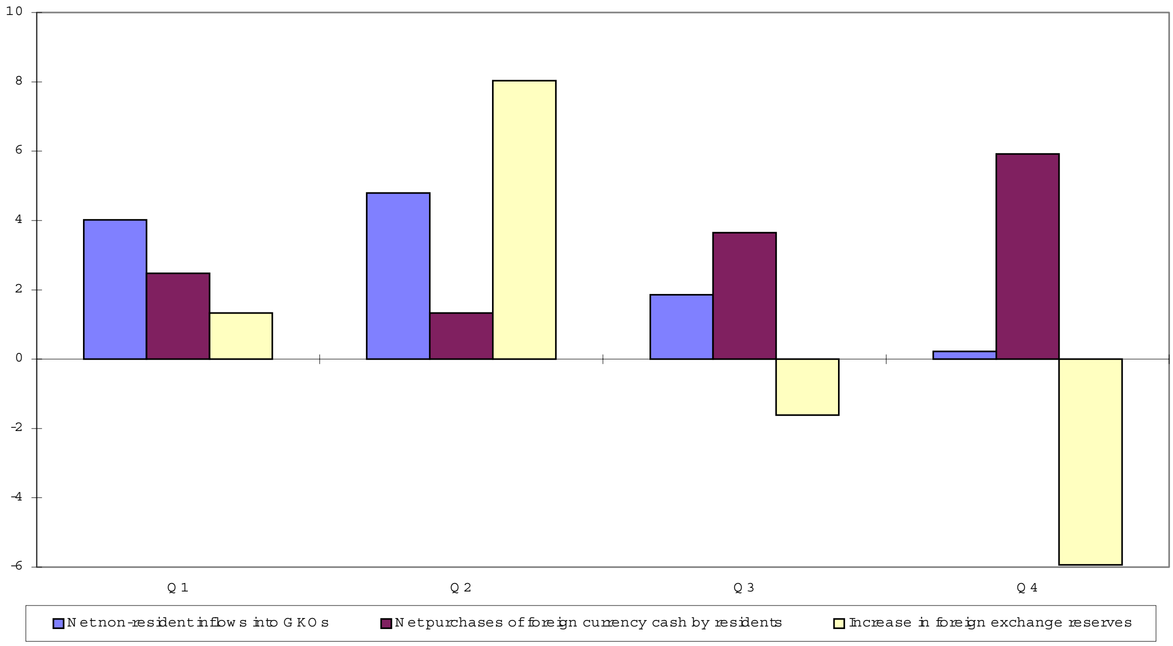
Source: CBR

Demand for rouble assets

Russia's domestic debt is not high by international standards. The trouble is that Russian households and companies, for a variety of reasons, have been unwilling to keep their capital in roubles. The stock of rouble-denominated government debt has grown larger than the total stock of rouble deposits in commercial banks.

With the slight economic recovery in 1997, the financial health of Russian companies improved, and corporate rouble deposits grew. But households, who saw the real value of their deposits wiped out during the 1992 inflation, remain unwilling to commit their savings to rouble assets. Russians are also discouraged from holding roubles by inefficient banks offering low interest rates and few services to depositors, and by ever-inquisitive tax inspectors. Instead, the preferred instrument both for savings and for many transactions remains dollar cash. In the second half of 1997, household rouble deposits increased by $1.2 bln, with time deposits actually falling by $0.9 bln, while Russians bought a net $9.6 bln of foreign currency cash, perhaps driven by fears that the January 1 re-denomination would be confiscatory. Household purchases of foreign cash in the last quarter of 1997 were $5.9 bln, exactly matching the decline in Central Bank foreign exchange reserves over the same period.

Non-resident purchases of GKO's, resident purchases of foreign cash and changes in reserves, 1997 ($ bln)

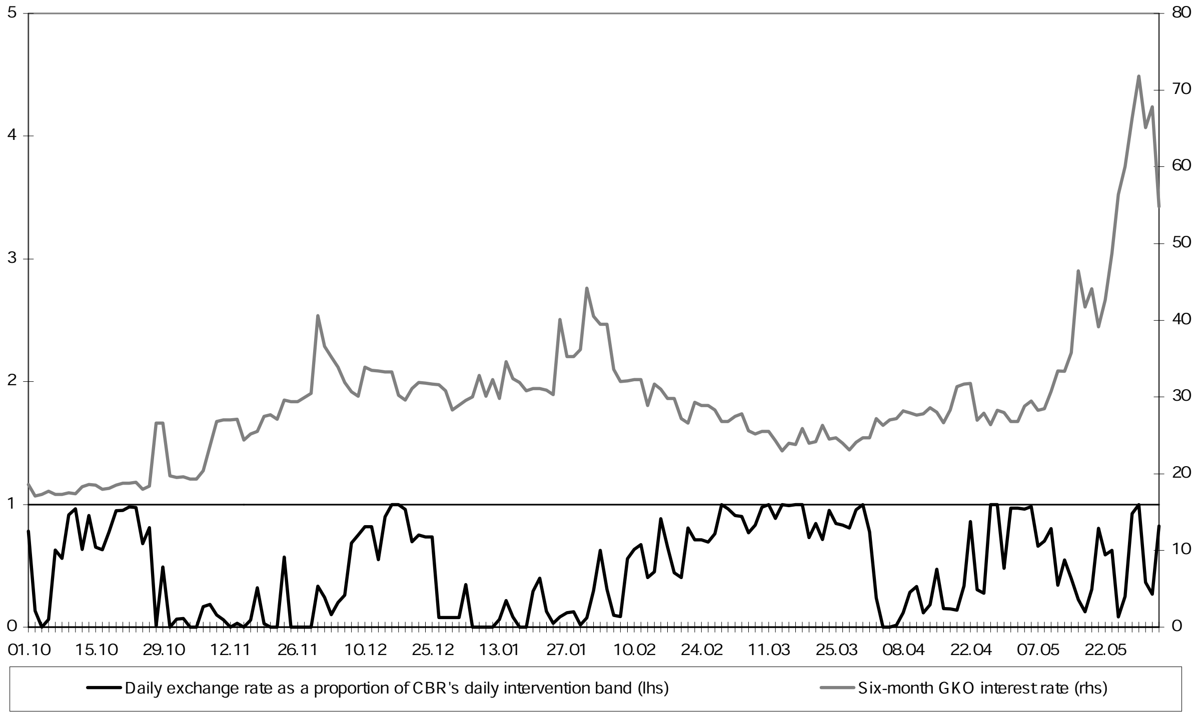


Source: CBR

It is foreigners who have made up the difference. Their holdings of GKO's and OFZ's increased sharply during the late 1996 and the first half of 1997, a period when emerging debt markets were buoyant around the world. Foreigners' share of the government rouble debt market increased to roughly 30% in the summer of 1997. Then in July, Thailand devalued the Baht, setting off a chain of events that was to lead to a sea change in market sentiment. Russia as a large emerging market borrower was severely hit. Investors became much more cautious about taking on Russian risk, and demanded a higher interest rate to do so. Since the Russian debt markets are dependent on foreign participation, the CBR had to let interest rates rise sufficiently to keep the foreign investors in the market and thus to assure the stability of the rouble.

Higher interest rates have turned out to be sufficient to stem the outflow of foreigners, who continue to own almost a third of the market. Even in the last quarter of 1997, when the sell-off was particularly severe, there was a net inflow of $0.2 bln into GKO's. Foreign investors have been price sensitive, coming into and out of the market depending on the interest rate level and the perceived “fundamental” risk. The graph below shows that periods when the exchange rate was at the top of the CBR’s daily intervention band (i.e. when the CBR was purchasing dollars and so replenishing reserves) coincided with periods of falling GKO interest rates, and vice-versa.

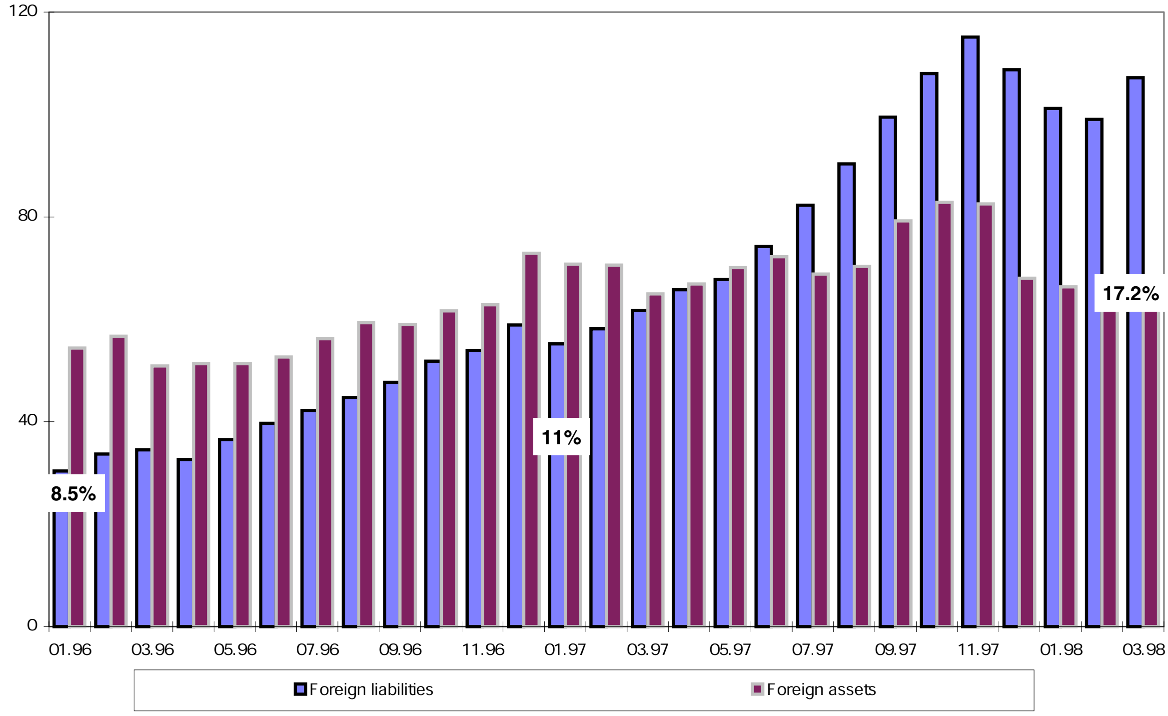
Interest rates and capital movements*



** The lower line is the position of the MICEX daily rate inside the daily intervention band of the CBR. Periods when it is at the top of the band are those where the CBR is buying dollars and so building reserves. At these times of capital inflows interest rates on GKO's are falling (the upper line). Periods when the exchange rate is at the bottom of its daily band are those where the CBR is supporting the rouble by selling dollars for roubles. At these time of capital outflows the interest rate on GKO's is increasing.*
Source: CBR, Troika Dialog

In the euphoric investment climate of the first ten months of 1997, Russian banks took the opportunity to borrow heavily in the syndicated loan and Eurobond markets. Foreign liabilities of the banking system increased from 11% of total liabilities at the beginning of 1997 to 17.5% at the end of the year. The banks used these foreign funds to invest in Russian assets: treasury bills, regional and corporate bonds, loans to the private sector, and equity. During the course of 1997, Russian banks saw their foreign liabilities overtake their foreign assets. By the end of March 1998, foreign liabilities exceeded foreign assets by about $6.5 bln, not including off-balance sheet rouble forward exposure.

Foreign assets and liabilities of commercial banks (R bln)

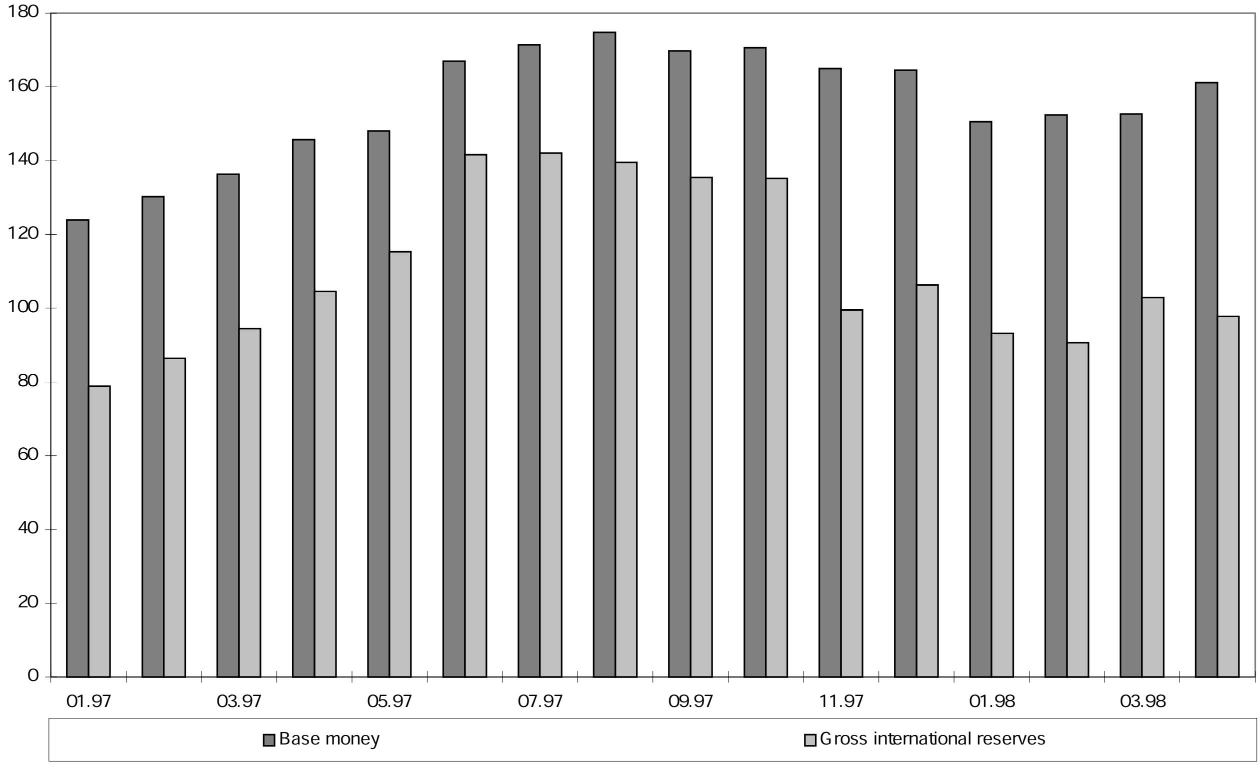


Note: percentages refer to the share of total bank liabilities. Liabilities do not include off-balance sheet items such as rouble forwards.
Source: CBR

After the Asian crisis hit Russia in October 1997, the flow of foreign money came to a halt. Nonetheless, Russian banks must continue to find foreign currency to service these loans, and may find themselves needing to repay the principal as well if their creditors refuse to roll the loans over when they come due. These rollovers have been thrown into doubt by the sharp decline in the value of banks' assets, which has made them much less attractive credit risks. Banks have been forced to sell off assets at extremely low prices to meet their obligations. Fears about the solvency of Russian banks have come to a head since the Central Bank placed Tokobank, one of the top twenty banks and a heavy borrower from foreigners, into administration when it became clear that it would be unable to make payments to its creditors.

The drop in Central Bank foreign exchange reserves – driven by the outflow of households and the reduced inflow of foreign capital – led the monetary authorities to raise interest rates, causing an actual decline in base money. Without any new inflows of capital into the banking system, this has made credit extremely tight and further driven down asset prices.

Base money and Gross International Reserves of the CBR (R bln)



Source: CBR

Outlook

Falling GKO yields late this week may mean that the worst of the current crisis has past. But points of weakness remain. To avoid a renewed crisis, the government must take a number of steps. First, the federal government must continue to cut its deficit, both by forging ahead with its plan to cut expenditures and by drawing on other sources of revenue – most importantly, by recovering revenue that has been lost to wasteful regional governments. Second, the government should consider conducting a greater proportion of its borrowing in foreign currency at longer maturities. Third, Russians must be convinced to hold more roubles. Currency stability is necessary but not sufficient. Russia needs a more efficient, trustworthy banking system. International experience of banking reform show that introducing foreign competition into the retail banking sector is the most direct way of improving bank efficiency and reducing dependence on volatile foreign capital flows.

In the short term, the need to maintain confidence in the rouble will impose a straightjacket on the government's behaviour. The need to roll over billions of roubles of GKO's each week puts economic policy under constant scrutiny from foreign and domestic investors. Any sign of wavering from the course of reform by the government would incur immediate punishment from the bond market, and would put the rouble in jeopardy once again.

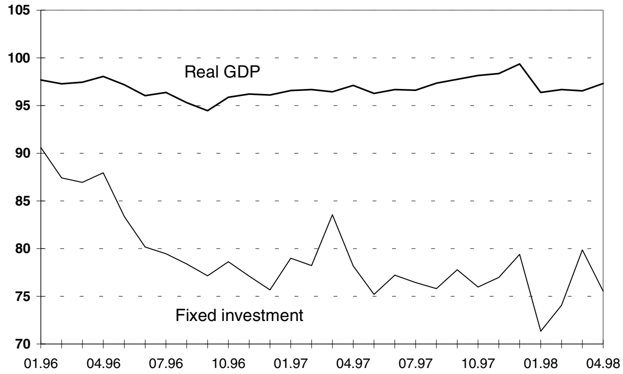
ECONOMIC UPDATE

Output

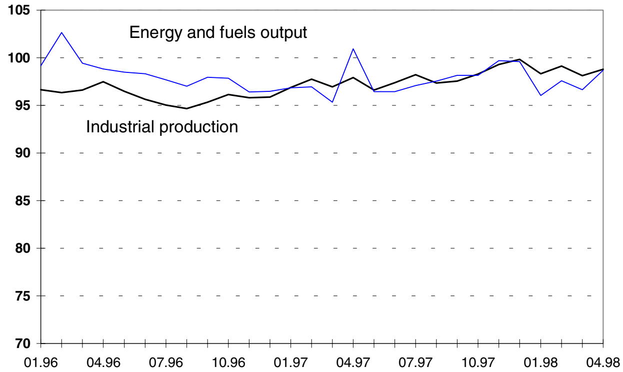
There is now GDP data for the first four months of 1998. However, that data is likely to be revised which makes comparisons with 1997 difficult to interpret. Revisions to 1998 data are likely to imply a flat economy more or less. A definite verdict has to await further work by Goskomstat. More generally, growth is likely to falter this year due to repeated periods with turmoil on Russian markets. High interest rates and lack of funding will again delay the long-awaited recovery of the economy.

Industrial production numbers show some moderate growth. The January-April average was about 0.8 % higher than the average for 1997 as a whole. Agricultural production increased by about the same amount. Indicators of activity in the construction sectors were inconclusive. While, real construction works were down by 0.8 % in January-April 1998 over the full-year 1997 number, dwellings completed were up by 2.7 %. Freigth transportation turnover went down by 1.4 %.

GDP and investment (1995=100, SA)



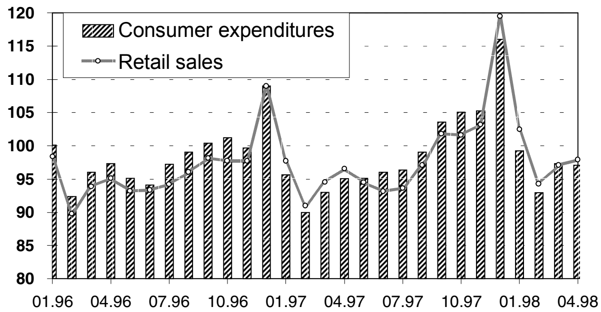
Industry (1995=100, SA)



Aggregate demand

The demand indicators suggest less gloom. Real wholesale trade was 1.4 % higher in January-April than in the same period in 1997. Meanwhile, real retail sales went up by 3.2 %. By contrast, real paid services went down by 0.7 %. Thus, demand seems to be increasing although real incomes have been falling. In the first four months of this year, real disposable household income was down by 7.4 % over the same period in 1997.

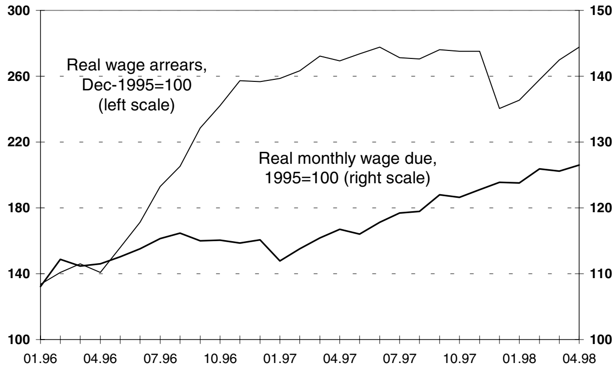
Consumer expenditures and retail sales (1995=100)



Wages

The trend towards higher accrued wages has continued so far in 1998. In April, the average monthly wage was 8.3 % higher than in April last year. The increase between the first four months of 1997 to the first four months of 1998 was even higher at 9.5 %. However, this development has been matched by a further unwelcome runup of wage arreas. Nominal wage arrears amounted to R 50.1 bn at end-April compared to R 39.7 bn at end-1997 and R 36.7 bn at end-April 1997.

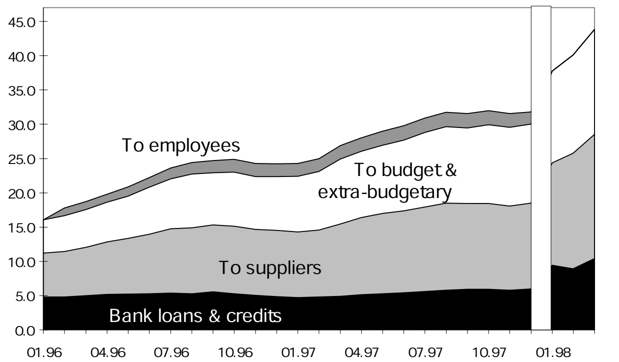
Real wages and wage arrears



Arrears

March figures for non-payments were again disappointing, with all types of arrears, including government wage debt, rising by 4- 5.5% compared to the previous month. In an attempt to collect some of the nearly hopeless tax debts, the government issued a new resolution on May 22. It aims at centralising all of state claims to the companies at the Federal Bankruptcy Service and introduces a 'quick bankruptcy' procedure which attempts to raise money for creditors through a sale of an enterprise as a going concern. This option may make bankruptcy more acceptable to local authorities, as it softens social implications of insolvency procedure.

Arrears and Bank Credits & Loans, % of GDP*

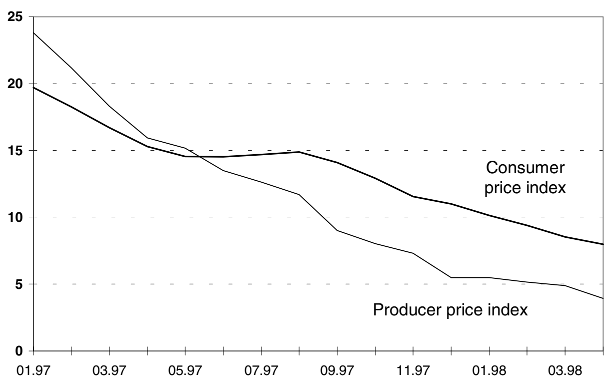


**Data is for the four sectors of the economy (industry, agriculture, transport & construction) prior to January 1998 and for the whole of the economy from January 1998*

Prices

Inflation has been declining steadily. The twelve-month increase in the CPI amounted to only 7.9 % in April, down from 15.3 % in April of the year before. As before, service prices rose particularly fast, increasing by 16.5 % as compared to 6.5 % for food and beverages, and 6.3 % for non-food goods. Producer price inflation has decelerated even more rapidly and is now running at only 3.9 %. This favorable trend attests to the success of the authorities in taming inflation. However, inflation is not likely to fall much further, while it would rise again if the rouble would weaken in a major way.

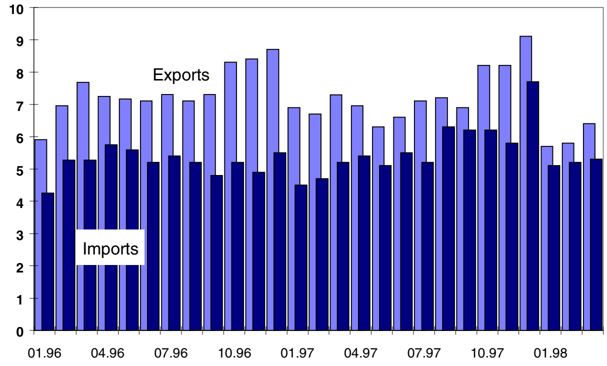
Inflation rates, % per year



Foreign Trade

The trade surplus showed the usual seasonal improvement in March, reaching $ 2.3 bn in the first quarter of 1998. Still, exports were 14% lower than in March 1997. Price of Russian oil continued to fall, with exporters trying to off-set these effects by charging above-the-market prices on exports to CIS countries, a reverse of the situation that prevailed before 1998. Last year's balance of payments figures published by the CBR showed 1997 current account surplus shrinking to $3.3 bn, or 0.7% of GDP from $12.1 bn in 1996 on the back of falling trade surplus and widening deficit in interest and dividends payments. Foreign direct investment increased 2.5 times last year reaching $6.2 bn.

Merchandise exports and imports ($ bn)



Source: Goskomstat

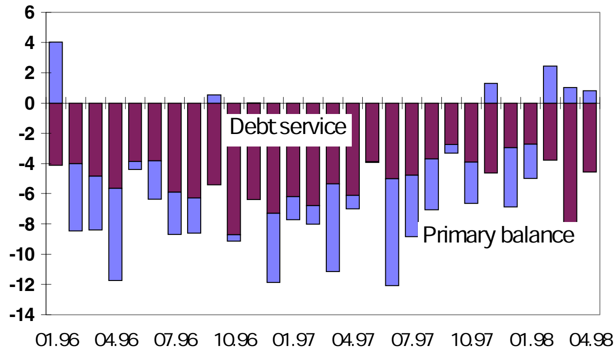
The budget

In the first four months of 1998, the federal budget ran an IMF-definition deficit of 4.4% of GDP, down from 8.5% in the first four months of 1997. The primary budget, not including debt service expenditures of 4.9% of GDP, ran a surplus of 0.5% of GDP in the same period. The primary surplus in the month of April was 0.8% of GDP, meaning that the federal government has run primary surpluses for an unprecedented third consecutive month.

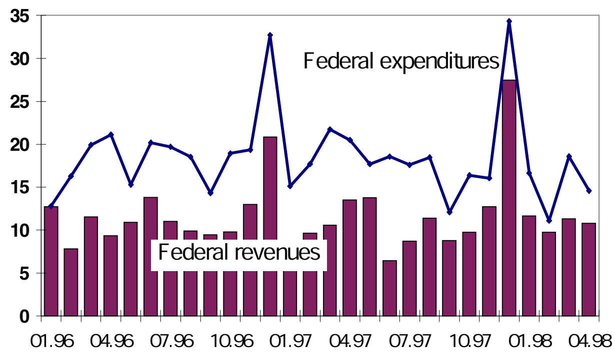
The deficit reduction was achieved by reducing federal spending to 15.3% of GDP in the first four months, down from 18.9% in the same period of 1997. Major cuts have occurred in spending on subsidies to industry and agriculture and on aid to other CIS countries. Regional governments have also begun to pay back the loans they took from the federal government in late 1997 to settle wage arrears to their employees.

Federal tax collection slipped in April to 9.2% of GDP, down from 9.5% in March and 12% of GDP in the same month of 1997. Revenue for the first four months rose to 10.9% of GDP between January and April, up from 10.4% in the first four months of 1997, but remained below the government's budget target. Regional and local revenues were a robust 11.8% of GDP in the first quarter, slightly higher than the same period of the previous year.

Federal budget deficit, % GDP



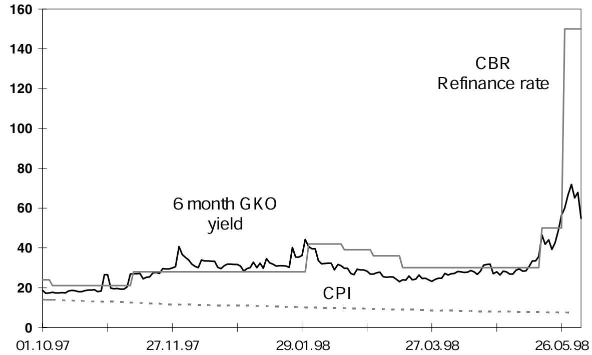
Federal revenues and expenditures, % GDP



Interest rates

The CBR increased interest rates three times in May. The final rise brought the Refinance rate and the Lombard rates to 150% on May 29. This is the highest level since February 1996, a time at which inflation in the preceeding 12 months had been 90%. In the year to April 1998, the inflation rate was down to just about 8%. The level of the refinance rate reveals the severity of the crisis that hit Russian markets in May.

Interest rates and inflation, % per year



Source: Troika Dialog, CBR

Financial markets

The Russian stock market suffered its worst falls in May. It was down 40% in the month, hitting lows at levels that occurred in between the two rounds of the presidential elections in June 1996. Markets were very thin and sentiment very bearish. One of the main futures exchange collapsed. Rumours of bank and brokers losses abounded. By the end of May, the Moscow Times was 70% below its peak of the summer of 1997.

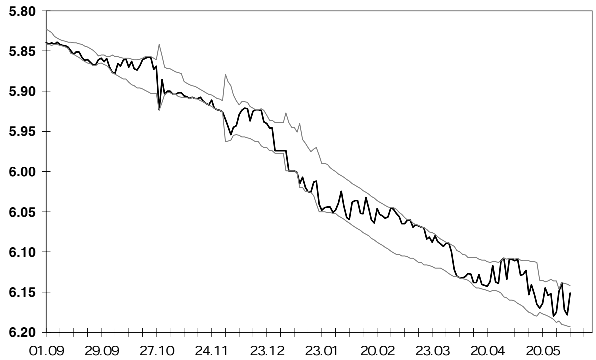
Moscow Times $ Index 1997-1998

Source: Moscow Times

The exchange rate

As discussed in the special section to this report, at the center of the crisis was the stability of the rouble. Though it fluctuated inside the Central Bank's daily intervention band over the course of the month, the rate did not change much more than normal. Indeed, in the month, it fell by its usual average of 0.5% against the dollar. However the pressure on it was severe, with the CBR using about $1.5 bn of reserves to defend its stability. This reduced reserves to $14.6 bn at the beginning of June.

The rouble exchange rate and daily intervention band (R/$)*



** MICEX exchange rate*
Source: CBR