A CHANGE IN MONETARY POLICY (August 18)

With pressure in the financial markets getting ever stronger and reserves falling sharply, the Russian government was forced to abandon its strong rouble policy. This change represents a significant setback for the government, whose past policy increased trust in the rouble and led to a fall of inflation to 5%. However given the haemorrhaging of foreign currency reserves in recent weeks, the monetary authorities made the timely decision to change policy before losing all their reserves in defence of an exchange rate policy that had become untenable. The new policy attempts an ordered depreciation of the rouble against the dollar. It aims at preventing renewed high inflation, while re-establishing the groundwork for economic growth. On the 17th of August, the Russian government and the Central Bank of Russia announced a change in monetary and exchange rate policy. The measures include:

- An effective float of the exchange rate. The monetary authorities announced that the parameters and methods of setting the exchange would be revised, and the rate would be decided by the daily trading in the domestic foreign exchange markets. This replaces the old system of a pre-announced narrow daily trading corridor that the Central Bank committed to keep the exchange rate in for the day. The authorities announced that they believed that given the current policies, reserve levels and the stabilisation plan the rouble exchange rate should be able to be kept inside the R6-9.5 per US$ range.

- An indefinite imposition of controls on capital account transactions. Specifically, non-residents will not be allowed to invest into rouble assets with a maturity of less than one year, i.e. prioritising long-term investments.

- A 90-day moratorium on repayment of debt to non-residents, which is also a form of a capital control. The moratorium does not include payments on the external debt of the Russian Federation (and indeed there are no sovereign debt payments due in the period). Instead it covers all commercial activities including forward contracts, margin calls, and standard debt service.

- A lengthening of the maturity of all GKO and OFZ instruments (short and long term rouble denominated government bonds) maturing before the end of 1998. The bonds will be transformed into instruments of at present unknown maturity and interest rates. Further details regarding this will be announced later. Furthermore, the trading on the GKO/OFZ markets are to be suspended.

- The government and the CBR have expressed their support for the formation of a pool of large banks to maintain the stability of inter-bank settlements and payments. Bank of Russia intends to implement measures to restructure Russia's banking system with the involvement of healthy Russian banks and leading foreign financial institutions.

- The government intends to issue one and two week government bills and will encourage wider participation of Russian households in purchases on this new paper.

Comment

The above policies amount to a major change in the monetary, exchange rate and financial policies of the Russian government. Although the pressure in the currency and asset markets had been intense for a while, the last straw was liquidating of rouble deposits to purchase dollars by the Russian population at the end of the week ending August 14 that was the direct cause of the policy about face. On that Friday exchange points in Moscow were seen selling US dollars at a rate as high as R8 per US$ and buying them at around R6.3. This compares with the MICEX fixed rate of R 6.31. On Monday after the news of the policy change booths were selling dollars at as much as R10 per US$.

The selling pressure appears to have come from rumours and announcements of fierce liquidity pressures in some of the major deposit holding banks on Thursday and Friday. The Central Bank had given a number of them emergency liquidity to stave off open default. However queues and delayed payments - particularly in dollars - at these banks occurred leading to increased uncertainty and panic. On Monday queues and non-payments were evident at many banks.

The policy measures are aimed at staving off a systematic banking crisis coupled with bank runs and a collapse of the currency. The freezing of the GKO market on Monday ahead of its planned restructuring, the moratorium on debt repayments, and the capital controls are all aimed at shielding the rouble from large non-resident selling. The new rules banning non-residents from buying Russian assets with maturity of less that 1 year are intended to keep speculative 'hot' money out of the country. From now until capital controls are removed, the rouble market will be driven by the Russia's current account flows (exports and imports), foreign investment into long-term Russian assets and the demand for money on the part of the local population. In effect termination of the liberal capital account policy, but a continuation of a liberal current account one.

Outlook

Import growth has been outpacing growth of Russia's exports for quite some time now. This trend was exacerbated by the adverse price movements in the world commodity markets at the end of 1997 and into 1998. The country's current account balance has moved from a $2.9 bn surplus in 1997 towards a small deficit of $1.5 bn in Q1 1998 (in the first quarter of 1997 there was a $3.9 bn surplus), which implies that the rouble will have to weaken against its major trading partner currencies to equilibrate supply and demand for roubles now that capital account flows have largely been cut off. Since, however, the current account deficit is not yet large, this trade effect should only result in a small rouble depreciation.

The second major source of potential rouble weakness is the possibility of major flight into dollars by the local population. Anecdotal evidence suggests that many of the rouble holders are well aware of the on-going currency crisis: the queues at exchange points are growing. The large spreads on these transactions at the booths illustrate the uncertainty and the demand for dollars. The danger here is that panic may spread among Russian citizens who would attempt to withdraw the bulk of their deposits and exchange them for foreign currency. This is the danger of a bank run.

Total household deposits at the end of June stood at R165 bn (this includes about R35 bn of foreign currency deposits). Three quarters of these are held at Sberbank. The majority of the rest is held at a few private banks (Inkombank, SBS-Agro, Most, Alpha and Bank of Moscow are the major five recipients of household deposits). The danger is that a run on these banks will exacerbate an already grave situation in the banking system. This will force the Central Bank into issuing credits to meet the outflow of liquidity. This in turn would rapidly feed through into the currency markets and quickly become inflationary.

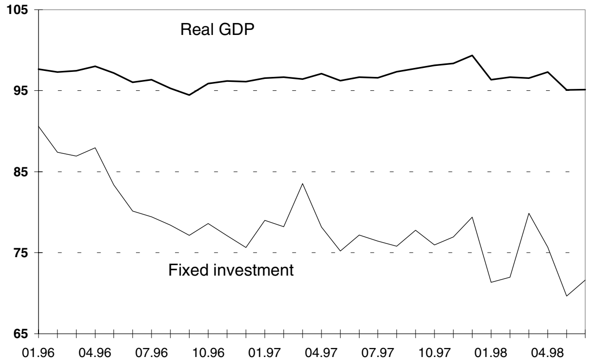
Crucial in this respect will be the policy pursued by the Central Bank and the government towards the private sector banks and the banking system as a whole. Many of these banks are now technically insolvent and many are facing dire liquidity squeezes. Which banks are allowed to go to the wall, what is done about depositors and other creditors to these banks, and which - and how - the other banks are kept alive will determine a number of important issues. The more banks are kept alive through emergency credits from the Central Bank, the more liquidity will be injected, spiking up inflation and putting downward pressure on the exchange rate. However the more banks that are allowed to go to the wall, the worse effect on depositors (although a scheme to protect them could be arranged) and more generally, on the real economy. The price of a weak domestic banking system and capital markets are now being made explicitly clear.

ECONOMIC UPDATE (August 15)

Output

In June the majority of output indicators, such as real GDP. industrial production, fixed investment, volume of construction remained unchanged from May. Nevertheless the situation in the real sector remains sluggish, and the level of output is lower than in June 1997. Namely, real GDP was 1.6% lower than a year ago, industrial production – 2.5% lower, fixed investment – 7.2% less than in the same month of 1997. The largest fall (–11.2% to June 1997) is registered in housing construction – one of the most sensitive indicators of economic activity.

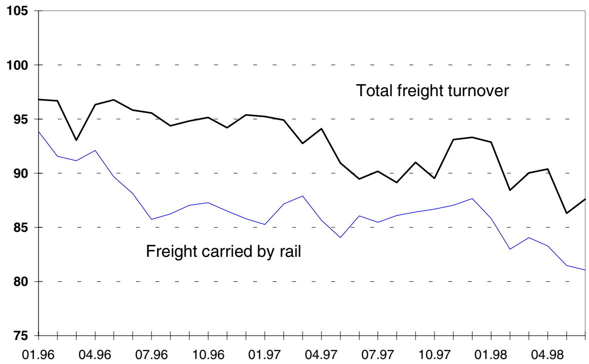
GDP and investment (1995=100, SA)



Source: Goskomstat

The overall development of the real sector is represented best of all by changes in freight transportation. In the first half of 1998 the total volume of freight transportation was falling sharply, reflecting the downward changes in its two major components transportation of oil and gas by pipelines and railroad transportation. In June total freight turnover was 2.2% lower than in June 1997 and 6.1% less than in December. The fall in railroad transportation, which was additionally affected by the actions of coal miners, was even more impressive – it fell 5.9% to June and 7.5% to December 1997.

Freight transportation (1995=100, SA)

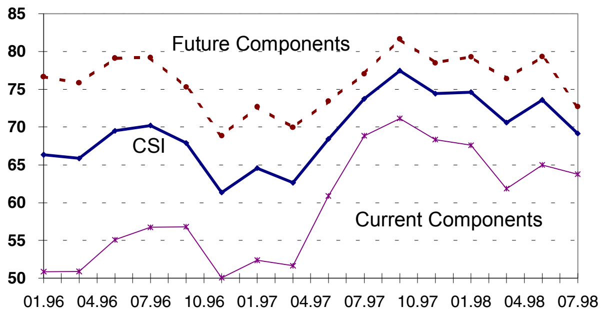


Source: Goskomstat

Aggregate demand

Consumer demand still remains the only source of strength in the Russian economy. In June, the volume of retail trade was 2.7% higher than a year ago. But six months of falling income (in June real personal income was 15% lower than a year ago) undermined consumer confidence. In July the Consumer Sentiment index dropped to the lowest level in a year. People are losing confidence in the future and the strong consumption pattern looks more and more like transfer of money savings into tangible assets.

Consumer sentiment index

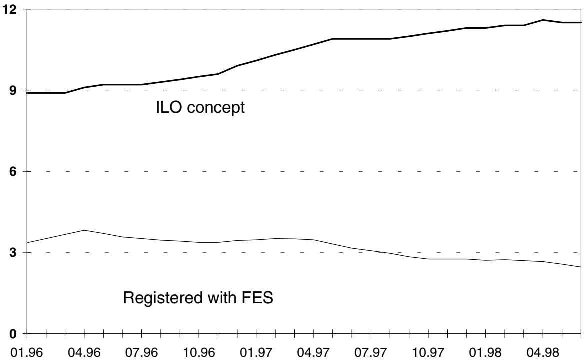


Source: VCIOM

Unemployment

Unemployment, measured in line with the ILO definition, remained at 11.5% of the labour force in June, same as in the previous month. The amount of unemployed registered with the Federal Employment Service continued to stay very low at 2.5%. Fast accummulation of wage arrears in May and June resulted in a continued epidemics of strikes around the country, which contributed to weak performance of the real sector in June.

Unemployment, % labour force

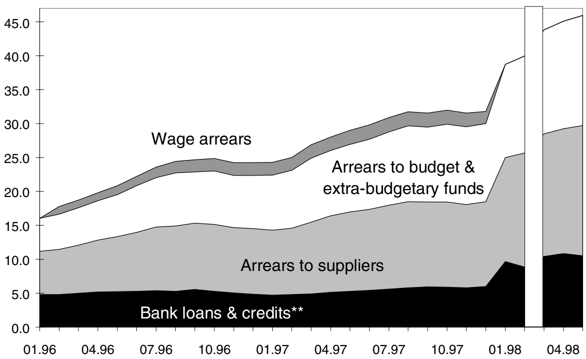


Source: Goskomstat

Enterprise Finances

May and June witnessed accelerated growth of government wage arrears, especially in health, education and culture & art sectors. In 4 main sectors of the economy, enterprise wage arrears also went up faster than in previous months, driven primarily by transport sector. Wage arrrears in 4 main sectors and 5 'social' sectors totalled R 70 bn in June compared to R 67 bn in May. Accumulation of debts to the budget and off budget funds slowed down slightly in May. In attempt to impose tax payment discipline and improve revenue flows, on August 6, State Tax Service ordered to seize assets of some of the biggest tax debtors: Sidanko, Eastern Oil and ONAKO oil companies. Fuel and Energy Ministry also announced its intentions to cut off Sidanko and ONAKO's pipeline access. The tight monetary conditions of late spring were reflected in a R5 bn fall in the stock of bank loans and credits to enterprises to R 274 bn in May (data for 9 sectors of the economy).

Arrears and Bank Credits & Loans, % of GDP*

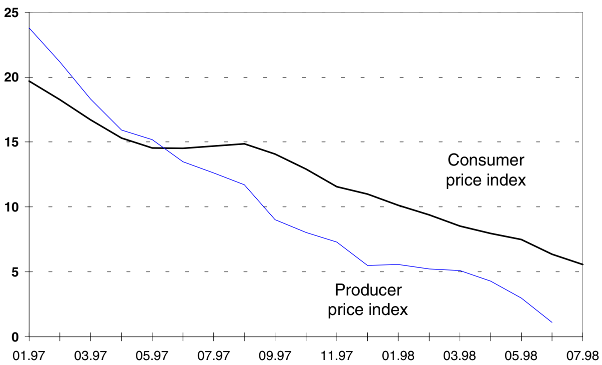


** Data is for 4 sectors of the economy (industry, agriculture, transport & construction) prior to January 1998 and for 9 sectors from January 1998. Data for wage arrears is not available for the same 9 sectors. See Table 7 statistical appendix for the list of 9 sectors.*
Source: Goskomstat

Prices

Inflation rates continues to fall. In July the annual increase of consumer prices was 5.6% compared to 6.4% in June. Composite producer price index in June grew by only 1.1% at an annual level. In a month producer price index actually fell by 2.0%, mainly because of the sharp reduction of railroad freight transportation tariffs. Ministry of transportation in June reduced freight transportation tariffs by 18.3% as a part of the government program of price regulation in the so-called "natural monopoly" sectors.

Inflation rates, % per year

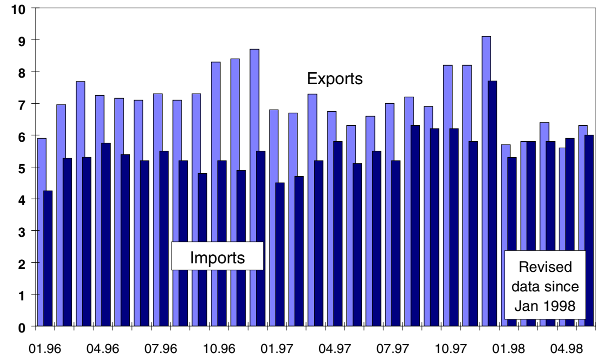


Source: Goskomstat

Foreign Trade

In June, Goskomstat changed its methodology for calculating trade flows, making its estimates more in line with those included in the CBR's Balance of Payments. Most importantly, this implies that Goskomstat figures will now include a higher estimate of unofficial import activity. The data for 1997 are currently being revised in line with the new methodology. Exports, especially those to non-CIS countries, showed slight improvement in May compared to the previous month, but were still down relative to the May 1997. In attempt to collect more revenues, the government will raise duties on all imports currently by 3% effective August 15. The measure will stay until the end of 1999, and the government hopes it will bring it additional $1.5 bn in revenues.

Merchandise exports and imports ($ bn)

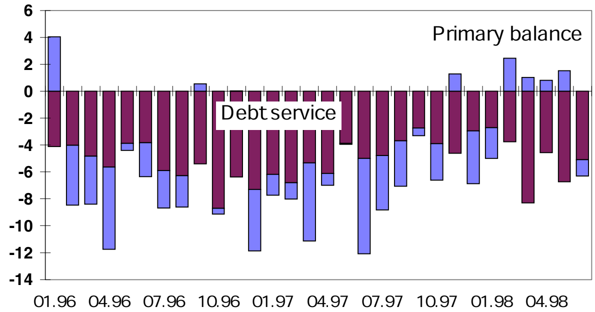


Source: Goskomstat

The budget

The financial crisis which started in the end of 1997 continues to take its toll. Due to an increase in interest payments in the second quarter of 1998 the fiscal balance deteriorated. According to the IMF definition the federal deficit January to June reached 4.9 percent (R57.4 bn). In June alone the federal budget deficit amounted to 6.3 % of GDP, up from 5.2 % the previous month. The primary deficit for the first half of the year was 0.4% of GDP. Regional budgets ran a combined deficit of 0.7 % in the first five months of 1998 (data for June not yet available).

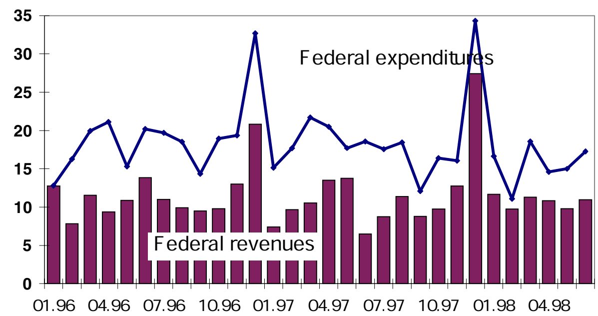
Federal budget deficit, % GDP



Source: Ministry of Finance

The federal government collected R105.3 bn worth of taxes in the first half of 1998, equal to 8.9 % of GDP, representing 83.2 % of total revenues. Although tax collection has remained below target, tax revenue as share of total revenue has increased during 1998. Total federal revenue January to June amounted to R126.6 bn, or 11 % of GDP, using the IMF definition. The Kiriyenko government and the recently appointed director of the Federal Tax Service Boris Fyodorov have committed themselves to large spending cuts and tax increasing measures to improve the fiscal situation, something that is becoming increasingly urgent. In the end of June the government presented an anti-crisis programme to the Duma, supported in July by a $22.6 bn stabilisation package to be disbursed over two years from IMF and other lending agencies and governments.

Federal revenues and expenditures, % GDP



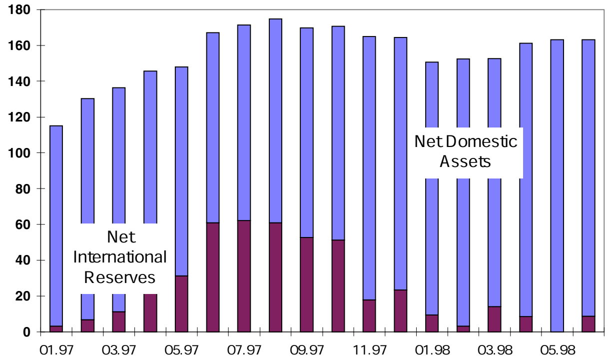
Source: Ministry of Finance

Money

With the financial crisis reaching in George Soros's words "its terminal phase", the ratio of reserves to base money becomes vital. Gross reserves of the monetary authorities at the end of July were $18.4 bn. The monetary base on the same day was R160.8 bn. At that day's closing exchange rate the monetary base was worth $25.6 bn. Soros's solution of setting up a currency board would either need more reserves or require a drop of the exchange rate to R8.7 per US$ to equalise the stock of the two currencies. Since then reserves have fallen further. In the first week of August reserves fell by $1.4 bn and last week reserves must have fallen still further given the severity of the crisis. It is now likely that reserves are back down to levels seen before the IMF agreed its $22.6 bn package.

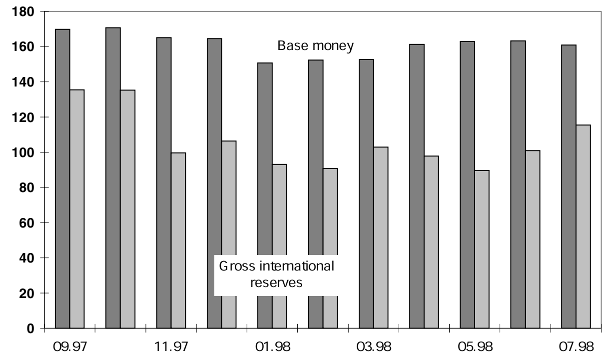
Not only are these calculations historic but are now somewhat spurious. For – as Soros pointed out – the Central Bank is faced with two conflicting interests: bailing out the banking system and defending the currency. The first requires the issuance of credits to the ailing banks (as they admitted they did last week to SBS Agro) so *increasing* the money supply. The second requires reducing liquidity and so *decreasing* the money supply. So without new funds these two objectives are incompatable. If the former is pursued then an exchange rate collapse is inevitable. But if the currency is defended to the hilt bank runs and bank bankruptcies are inevitable. However a collapse of the exchange rate forces most banks into bankruptcy (Finance Minister Zadornov is reported to have said in June that a devaluation would leave only about 30 of the countries 1500 banks standing). In other words unless new foreign funds are fast added to the system a banking sector collapse is inevitable and a devaluation almost certain.

Monetary base (R bn)



Source: CBR

Monetary base and gross reserves (R bn)



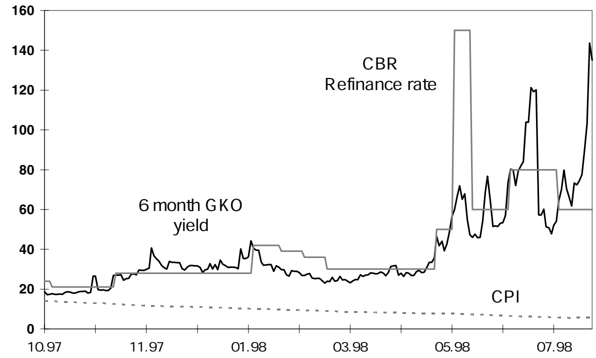
Source: CBR

Interest rates

Interest rates on Russian debt intstruments are now at levels that indicating that markets are pricing in the probabiltiy of default. However trading volumes on the rouble GKO market are now so low that the interest rates quoted hardly indicate real prices. It is now impossible to find a bid on any significant volume even though interest rates are at between 150-170%. In effect the market has broken down, indicating that default is considered a likely outcome.

On the dollar debt markets the story is not quite the same. Interest rates are between 25% on the longer maturing debt up to close to 50% on the shorter maturities. Given that these are in dollars this shows that the default risk is perceived to be significant.

Interest rates and inflation, % per year



Source: Troika Dialog, CBR

Financial markets

The IMF led package bought some respite to the precipitous falls in Russia's financial markets that have occurred since the bubble burst in late October 1997. But that respite lasted just a week. Now the equity markets stand at levels last seen in spring 1996 before Yeltsin's re-election. The Moscow Times index has fallen 82% from its peak. The 1998 US federal budget surplus could be used to buy the whole of the Russian equity market at these prices.

But as mentioned above the markets are now hardly functioning. There is little trading given all the counterparty risk and lack of liquidity. And brokers, banks and investment funds are laying off staff. The crash in Russia has been markedly different from those that came in Asia because the collapse has come without a devaluation. Instead the crash has almost forced the devaluation.

Moscow Times $ Index

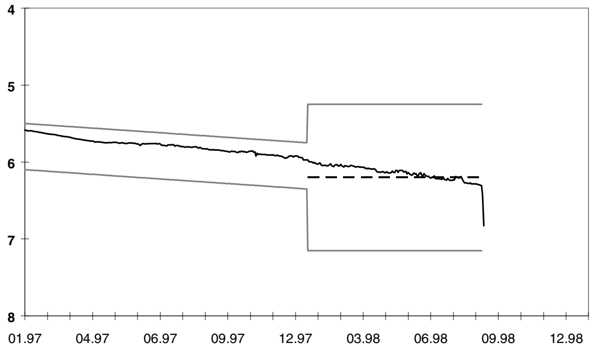
Source: Moscow Times

The exchange rate

The rouble is now under unbearable pressure. Though the official exchange rates do not yet show a devaluation, on the streets of Moscow on Friday 14th of August and over the weekend the exchange booths are telling a different story. Where they are open and have dollars to sell, the rates are as high as R7 per dollar.

A drop in the exchange rate is undesireable for the capital account as it is likely to induce a large outflow of capital. But from the perspective of the current account it would be useful. In the first quarter of 1998 Russia ran a deficit on the current account of $1.5 bn, compared to a surplus of $3.9 bn in the first quarter of 1997. On such trends a deficit of about $12 bn seems likely for the year as a whole. With capital flight continuing and little private capital inflow occurring that leaves a large gap for the international community and reserves to finance.

The rouble exchange rate and the corridor (R/$)*



** MICEX exchange rate*
Source: CBR