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# Key Economic Trends in Russia in November 1997

The autumn crisis on the world stock markets strongly affected Russia's financial markets. Even if stability is achieved on the domestic financial markets before the year's end (meaning that withdrawal of non-residents' funds from Russia would stop), the market situation will match that of the end of 1996. Government securities yields will be 30% or higher, wage arrears from the budget and tax collection problems will persist, the market for corporate stocks will be in depression. In case of a favorable situation on the foreign markets and continued internal political stability, the level of foreign investments in the Russian economy could be restored in April-May 1998, at the earliest. This means that next year's key macroeconomic indicators could, at best, match this year's indices, but not the targets of the government's optimistic scenario for 1998.

An increased demand for foreign currency in November 1997 on the domestic currency market failed to accelerate exchange-rate growth. Over the month, the on-exchange dollar gained 0.44%, and the official exchange rate rose by 0.54%. The Central Bank covered excessive demand for the US dollar by currency interventions. Experts of Econometric Unit VEDI believe that in November the Central Bank sold about 6 bln. USD. As a result of such active operations, in the past month, the Central Bank's currency reserves dropped from 18–19 to 11–12 bln. USD. The fact that the Central Bank announced the guidelines of its currency policy for 1998 and for the period up to 2000 in the conditions of persisting financial instability shows that the Central Bank is determined to exercise tight control over the exchange rate under any circumstances.

In November the situation in the GKO/OFZ market was determined by large-scale selling of government securities on the part of non-residents. Domestic banks did not have enough funds to purchase such significant amounts of government securities, and the main load of supporting government securities was borne by the Central Bank. The Central Bank took a number of measures in order to make operations with currency less attractive and to foster domestic investors' interest in investments into government securities. The most important of these

steps was the decision on November 10 to raise the refinancing rate from 21 to 28% per year.

In the conditions of market volatility the issuer significantly reduced the volume of funds attracted on the internal market, halted issuance of long-term coupon bonds and offered investors less risky short-term GKO issues. However, joint efforts of the Finance Ministry and the Central Bank failed to dramatically change the mood of market participants. A slow rise in government securities yields continued to the end of November, and in December another drop in prices sent GKO annualized yields up to 40%.

A steady growth in GKO/OFZ prices could recommence in January 1998, at the earliest, if non-residents resume purchases of government securities. Until then the issuer will probably have to confine itself to refinancing the debt. The government will have to raise funds for the budget and to pay social arrears from other sources, in particular, by resorting to additional external borrowings.

It is not surprising, that as a result of the autumn crisis on the financial markets those investors who had municipal bonds in their portfolios incurred much higher losses than holders of government securities. In November weighted average yields to maturity of regional securities increased by from 9 (for Tatarstan's bonds) to 16 (for Orenburg regional bonds) percentage points. Risk assessments of investments also changed. If, before the crisis, rates on municipal bonds were just a shade above those on government securities, during the abrupt market downturn, the yield spread increased significantly. This difference in yields is likely to remain even after stability is achieved on the financial markets and GKO/OFZ yields go down, reflecting the corrected assessments by market participants of risks inherent in investments in municipal bonds.

The November situation in the Russian financial system, in the first place, in the GKO/OFZ market, directly affected the market for bank promissory notes. Increased rates on government securities prompted a corresponding growth in promissory note yields. By the end of the month, yields

## KEY TRENDS

on prime promissory notes matched GKO yields, at 28–31% per year, against large offering and extremely weak demand. Gazprom's promissory notes that are redeemed in cash and, therefore, can be viewed as financial instruments, responded to the drop in GKO prices in a similar manner. In November their yields increased by 8%.

The market for corporate promissory notes covered by goods and services was less sensitive to the unfavorable financial situation and remained under the influence of the previous month's trends. An upward trend persisted in the market for promissory notes of oil and gas companies, while prices of promissory notes of metallurgy companies moved downwards.

The past month brought no significant changes to the situation in the MinFin market, which formed after the end-of-October crisis on the world financial markets. Liquidity of the MinFin market remained low against strong price fluctuations (of up to 2 percentage points in the course of a single day). This was due to general volatility on the world stock markets, which were closely followed by the MinFin market throughout the reviewed period. November return on buy-and-hold investments in MinFins varied from -69.3 to -2.8% per year in USD, dependent upon the issue.

December is traditionally the calmest month on the MinFin market. Due to the fact that several Russian and Western holidays are celebrated in December, trading on the MinFin market is usually slack. December 1997 will most probably be no exception to this rule. What is more, taking into account the situation, which formed in the MinFin market as a result of the world financial crisis, it can be assumed that practically no real trading will occur on the market in the second half of December.

During the first half of the month, MinFin prices will likely fluctuate by 0.3–1.5 percentage points.

On November 3, shares of 31 Russian companies got included in the IFC Investable index. Daily calculated IFC index is one of the main indicators, by which international investment companies are guided. Weighting of domestic equities in capitalization of emerging market securities included in the index was much higher than had been expected - nearly 5.6%. As a result Russia ranked sixth, trailing South Africa, Mexico, Brazil, Malaysia and Taiwan.

In spite of optimistic forecasts, IFC's decision failed to have a radical effect on the scale of investments into Russian stocks, or even to stop the increasing outflow of funds from this segment of the financial markets. At the end of the month, the decline in share prices intensified due to unofficial information about expected large-scale selling of equities by banks, which were hit by liquidity crisis. As a result, the most liquid stocks (Mosenergo, LUKoil, Rostelecom) fell to levels comparable to their prices of a year ago.

December 1997 will most probably be an ordinary last month of a year on the Russian equity market. This applies both to improvement of the market infrastructure and the current market situation. During the second half of the month, when the majority of foreign market participants will close their positions and will halt all operations on the market, the demand for Russian equities will shrink. The amount of domestic borrowed funds directed to the equity market will also decrease. Some of domestic market participants who invested in stocks at the beginning of the rise in prices could decide to take profits. As a result, at the very end of the year (December 28–31), prices for some shares could be corrected downwards (up to -5%).

# MACROECONOMY

## Macroeconomic Trends in Russia in 1997

Russia's economic development in 1997 can be split in two periods: January-October and November-December, i.e. before and after the crisis on the world stock markets. Due to a natural one-two-month delay in processing of the statistical information on major economic indicators, the effect of the crisis, which affected all segments of the domestic financial markets, on Russia's economic development will become known later. However, it is already possible to state, that even if the situation on both the world and the Russian financial markets stabilizes, after-effects of the crisis on the domestic economy will be felt for a long time to come.

Positive factors of Russia's economic development during the pre-crisis period include:

- GDP and industrial production stabilization;
- low rates of growth in prices - in the year's first nine months, inflation was even lower than the government's optimistic targets;
- a steady decline in yields on the financial markets and a corresponding decrease in interest rates on credits;
- a slow growth in the RUR/USD rate.

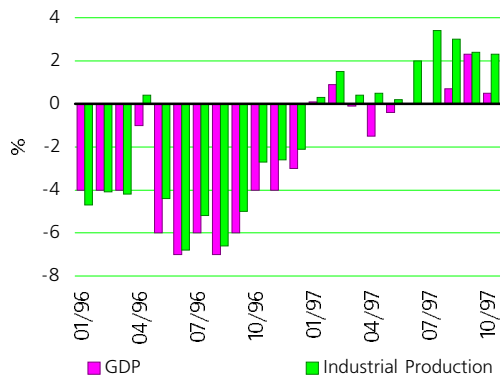
Clearly negative tendencies, however, were also seen in the country's social and economic development in January-October 1997, including:

- low tax collectability and large wage arrears from the budget;
- a drop in households' incomes, which was observed since July, as well as a stronger income-based differentiation of the population;
- a persisting high demand for the cash dollar among the population, accompanied by a decrease in deposits at Sberbank and commercial banks;
- a significant percentage of companies' overdue debts, an increasing share of barter operations, a large number of non-profitable companies (47.5%) among industrial, construction and transport enterprises.

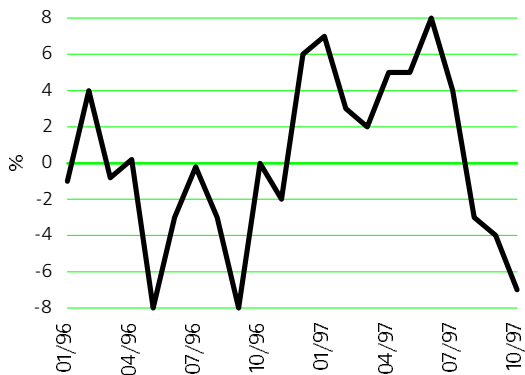
From January through October, GDP increased by 0.3%, as compared to the same period in 1996, in comparable prices. GDP monthly growth rates, however, were declining relative to 1996. If in September 1997 GDP rose by 2.3%, in October it increased merely by 0.5%. A

## MACROECONOMY

### GDP and Industrial Production Growth Rates, in % to the Correspondent Period of the Previous Year



### Rates of Growth in Households' Real Disposable Incomes, in % to the Correspondent Period of the Previous Year



similar situation was observed in the movement of industrial production volumes, the growth of which slowed down from 3.4% in June to 2.3% in October 1997. In January-October 1997, industrial production swelled by 1.5%, as compared to the same period in 1996. Production volumes increased the most in such sectors as non-ferrous metallurgy (+3.8%), machine building (+3.0%), chemistry and petrochemistry (+1.9%). Industrial output fell furthest in such sectors as production of construction materials (-5.0%), light industry (-3.5%) and, what is especially important, electric energy (-3.5%).

In October 1997, consumer prices were slightly up by 0.2%. In the first nine months of 1997, they rose by 9.3%, i.e. even less than was envisaged by optimistic official projections. Producers' prices for industrial products increased by 7.3% since the beginning of the year. In October, they edged up by 0.1%.

Shrinking households' incomes were one of the factors, which prompted a slower inflation and, in August and September, a general drop in prices. Not only real disposable monetary incomes (incomes minus compulsory payments, adjusted for consumer price index), but also households' nominal incomes have been declining since August. Thus, in September, households' real disposable incomes fell by 4.3%, as compared to the same period in 1996, and, in October, by 6.9%. As a result, in October 1997, the share of expenditures on commodity purchases and payments for services increased to 77.9% of incomes, the highest value in recent years. Private deposits at Sberbank and commercial banks, as well as volumes of foreign currency purchases, on the contrary, decreased. A rise in private consumption was accounted for by the phenomenon, which is typical in the lead up to denotation or any other monetary reform, namely, increased purchases of durable goods by the population.

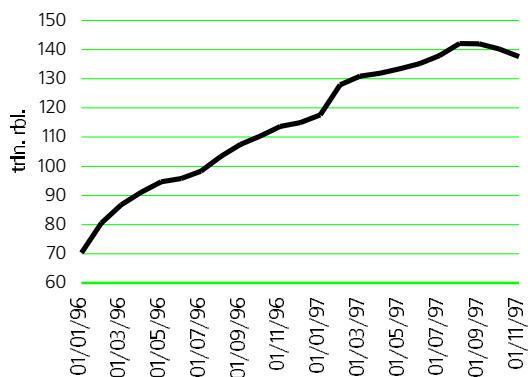
In October, the cost of non-food goods went up by 0.9%. Such an insignificant rise in prices was due to exchange rate stability.

In addition to the positive anti-inflationary effect, however, the ruble's real strengthening had a depressive influence on Russia's foreign trade turnover. In January-October, it declined by 2.1% (export dropped by 5.6%, and import increased by 2.7%). Positive trade balance equaled 14.9 bln. USD, i.e. 2 bln. USD less than the last year's level.

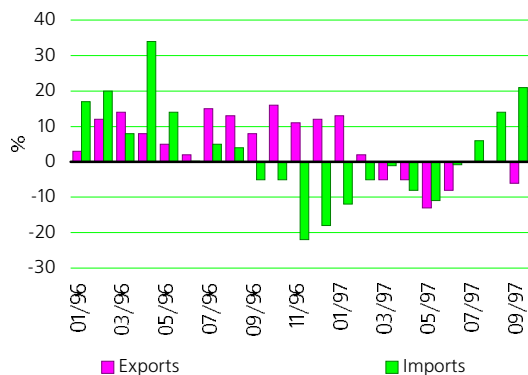
### Income Distribution of Population, %

	January-September 1997	January-September 1996
Personal Income - Total	100	100
including Data for 20 Population Percentage Groups:		
First (with the Lowest Revenues)	6.3	6.4
Second	10.4	10.7
Third	15.1	15.4
Fourth	21.7	22.5
Fifth (with the Highest Revenues)	46.5	45
GINI Coefficient	0.370	0.376
Most to Least well-to-do Population Ratio, Times	12.6	12.7

**Private Deposits**



**External Trade, in % to the Correspondent Period of the Previous Year**



The downturn on the world stock markets in the autumn of 1997 not only had a destructive effect on all segments of the domestic financial markets, but will continue to affect Russia's general economic development in the medium-term (at least, for the next six months). The following arguments support this opinion.

This year's financial stabilization was achieved due to a sizeable inflow of foreign investments, the bulk of which were put into short-term government securities. A relatively low cost and large volumes of these funds allowed to significantly decelerate rates of growth in prices, to reduce GKO/OFZ yields and to stabilize the exchange rate.

In October and November 1997, however, the downturn was seen on the world financial markets. At times of financial crises investors redistribute securities in their portfolios in two directions. First, funds are moved from emerging markets to markets of economically developed countries. Second, funds are withdrawn from stocks and are invested in bonds. That is, during crises, large financial institutions, small investors and individuals give preference to the least risky fixed-income securities. Therefore, it was not surprising, that the crisis, which hit the world financial markets in October-November 1997, caused an outflow foreign funds previously invested on the domestic financial markets.

Withdrawal of non-residents' funds from Russian government securities and equities and selling of these securities prompted a drop in their prices. At the same time the demand for foreign currency went up, and the Central Bank was compelled to make large-scale interventions on the currency market in order to prevent a sharp fall in the ruble. This raises the main question, which was on the minds of financial agents in November 1997 (and will probably still stand in December), of whether the Central Bank's currency reserves will last until full financial stabilization is achieved. At that the priority task was not to allow a sharp devaluation of the ruble. Control over government securities yields became a matter of secondary importance.

All the aforesaid shows that the situation in the Russian financial markets at the end of 1997 is such that prospects of Russia's economic development in 1998 are uncertain. Budget planning, as well as elaboration of the 1998 monetary policy guidelines, were based on implementation of the government's optimistic scenario of social and economic development. In accordance with that scenario, by the end of 1997, government securities annualized yields were expected to drop to 14–16%, inflation was not supposed to exceed 12%, and the Central Bank was to maintain a high level of currency reserves against stable exchange-rate dynamics. Next year was supposed to be the starting point of steady economic growth, including a 2% rise in GDP, low inflation rates and an increase in foreign investments. It was assumed that non-residents' participation on the GKO/OFZ market would be expanded to 50% of the market volume, and a sharp increase in foreign investments into corporate stocks was expected.

However, even if the situation in the domestic financial markets stabilizes before the year's end (meaning that withdrawal of non-residents' funds from Russia would stop), the state of Russia's finances will be the same as at the end of 1996. Government securities yields will be 30%

or higher, wage arrears from the budget and tax collection problems will persist, the market for corporate stocks will be in depression. In case of a favorable situation on the foreign markets and continued internal political stability, the level of foreign investments in the Russian economy could be restored not earlier than in April-May 1998.

This means that next year's key macroeconomic indicators could, at best, match this year's indices, but not the targets of the government's optimistic scenario for 1998.

# FIXED INCOME MARKET

## **GKO/OFZ Market**

The world stock market crisis in late October - early November seriously affected the market for Russia's internal debt. Reduction and stabilization of rates on government securities in the first half of 1997 was largely due to large-scale GKO and OFZ purchases on the part of non-residents. When the situation on foreign stock exchanges aggravated, Russian government securities became directly dependent upon the extent of foreign capital outflow from the market. At that, representatives of the monetary authorities said it had been known in advance, at the time when securities had been purchased, that non-residents planned to withdraw some of their funds from the market in 1997. Due to the stock market crisis, however, the amount of withdrawn funds increased by several billion dollars.

On October 28, with the first plunge in GKO prices, the government securities market entered a period of the strongest volatility for some time past. By many indices, in particular, by amplitude of price fluctuations for government securities and by a relative (at the beginning of December more than two-fold) increase in interest rate levels, the crisis was comparable to the situation of the spring-summer 1996, before the presidential elections. The main difference between the present situation in the market and the market situation in 1996 is that last year, in spite of a certain progress achieved by the monetary authorities in late 1995 - early 1996, Russia's financial system still was in a difficult situation as the domestic economy was only half-way through to stabilization, and the task of pulling down interest rates remained one of the main problems after transition to a regulated exchange-rate growth within the currency corridor. This goal was practically achieved in the summer of 1997. Since June, GKO weighted average annualized yields stayed at 17-19%, which made it possible to say that, at least on the market for internal debt, stability was achieved.

However, as had to be expected, due to significant non-resident presence on the market (30% of bonded debt), its stability turned out to be extremely sensitive to emergencies on the world stock exchanges. Trading in GKOs has been nervous practically throughout November - when it became obvious that non-residents were going to actively withdraw funds from the market many investors were primarily concerned about how low government securities prices were going to fall. From the very first days of the crisis, the largest losses were incurred by those market participants who had invested their funds in long term OFZ-PDs, having placed their faith in the financial

stability achieved in mid-summer. Holders of six-month and twelve-month securities also suffered significant losses, which will hardly be fully compensated before the year's end.

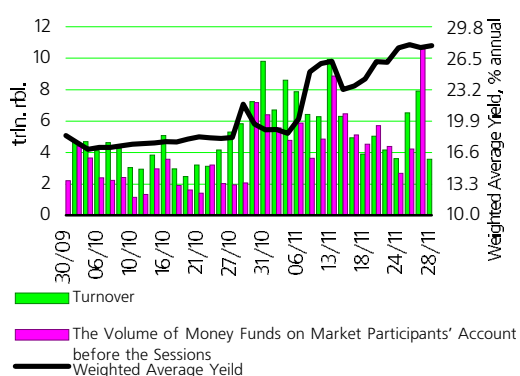
Tension at GKO trading sessions was intensified by difficulties in predicting actions of the monetary authorities. After the Central Bank increased the refinancing rate it remained unclear how long the Central Bank was going to support the RUR/USD rate and the internal debt market, and whether this was going to exhaust its currency resources and, as a result, provoke devaluation of the ruble. In such a nervous situation some domestic investors decided to follow the example of non-residents and withdraw some of their funds from government securities in order to purchase foreign currency. In the second half of November, when in spite of all their efforts to support government securities the Ministry of Finance and the Central Bank had to make concessions at auctions (yields at lowest accepted prices outstripped the refinancing rate), tension at GKO trading sessions mounted anew. Though previously the monetary authorities claimed that an increase in the discount rate was unacceptable, during the period in question, market participants were faced with the threat of a new plunge in prices due to the Central Bank's unwillingness or inability to buy out securities at prices ensuring yields at the level of the refinancing rate.

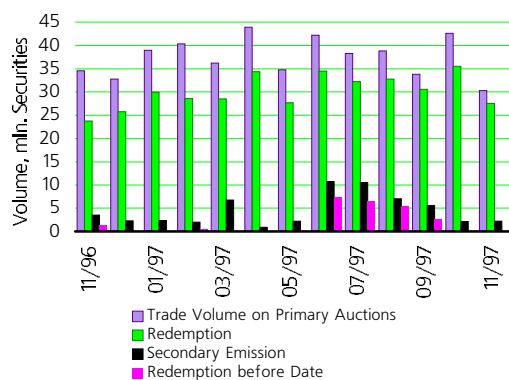
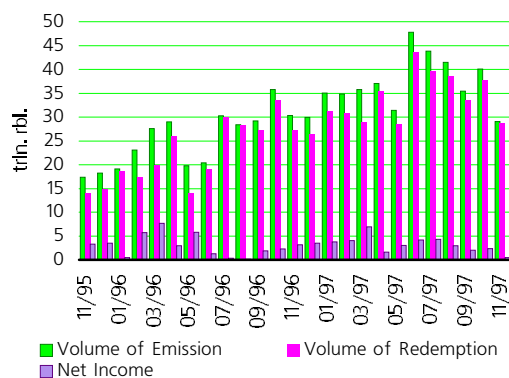
The November crisis clearly split domestic investors in several groups. Some of them tried to guess the direction of the market and carried out risky, but sometimes highly profitable speculative operations with government securities. Others who sold GKO and OFZs at low prices were completely disoriented and nearly panicked. The most conservative group assumed a wait-and-see attitude and purchased only short-term securities, hoping that the crisis would eventually be overcome, and that the situation in the internal debt market would stabilize in the 1st quarter of 1998.

Thus, in November 1997, the situation in the GKO/OFZ market was determined by large-scale selling of government securities from non-residents' portfolios. Experts of Econometric Unit VEDI put the month's drop in volumes of securities on foreign investors' accounts at over 15 trln. rbl. (at par). According to the monetary authorities, the outflow of foreign capital from Russia totaled from 5 to 9 bln. USD. Domestic banks either did not have or did not wish to spend the funds required to purchase such a large amount of government securities. As a result, the main burden of supporting government securities was borne by the Central Bank. Practically throughout November, the balance of the Central Bank's operations at GKO/OFZ secondary trading sessions was negative, and, by the end of the month, fell to a record low value of -16.4 trln. rbl. On some days, trades with the Central Bank's participation accounted for more than half of the on-exchange turnover. Some experts believe that, as a result, in November the Central Bank's government securities portfolio increased by a quarter to 40% of the market volume.

The Central Bank took a number of steps in order to mitigate the negative consequences of foreign capital outflow from the internal debt market and to foster stability of government securities. The most important of these measures was the decision to raise the

**GKO Turnover, Weighted Average Yield and Volume of Funds Reserved by Market Participants, in Secondary Auctions in 1997**



**GKO/OFZ Emission**

**GKO/OFZ Market Development**


refinancing rate from 21 to 28% from November 11. This automatically lifted government securities yield ceiling, which was supposed to make GKO and OFZs more attractive to domestic investors due to additional «premiums» paid on auctions. At the same time, compulsory reserves on currency funds attracted by banks were increased. In November, the Central Bank also changed some of the conditions for primary dealers' operation on the market, i.e. raised borrowing limits at repo auctions and reviewed and expanded the list of GKO/OFZ issues, the market for which was to be made by primary dealers.

Steps taken by the monetary authorities to prevent aggravation of the crisis on the internal debt market can generally be regarded as timely and justified. Investors' reaction to the news about the planned increase in the refinancing rate announced on November 10, was hardly surprising. GKO and OFZ prices experienced their sharpest fall in 1997 of up to 5–9 percentage points for some issues. Though yields to maturities of zero-coupon securities closely approached the new refinancing rate, they did not rise above it. During the next two weeks, the rise in government securities prices alternately resumed and halted, which was followed by fluctuations of GKO weighted average annualized yields to maturity within the interval of 23–28%. In spite of the difficulties the issuer encountered in the second half of the month when placing government securities at primary auctions, coordinated efforts of the monetary authorities allowed to keep GKO yields at 28% up to the end of November.

In November, in the conditions of market volatility, the Ministry of Finance materially changed the structure of GKO/OFZ issuance. Gradual replacement by the issuer of zero-coupon securities with long-term coupon bonds became significantly lesser in scale. No new OFZ-PD series were sold in the past month, but only additional tranches of the issues, which already circulated on the market. Issuance of twelve-month GKO was practically stopped, and the bulk of securities placed in November were three- and six-month issues. Nevertheless, for the fifth month running, the Ministry of Finance used proceeds from OFZ sales to redeem some of GKO. In November, net proceeds from GKO were negative, at -1.6 trln. rbl., while the amount of funds raised on the government securities market for

**Structure of Monthly GKO/OFZ Issues (November 1997)**

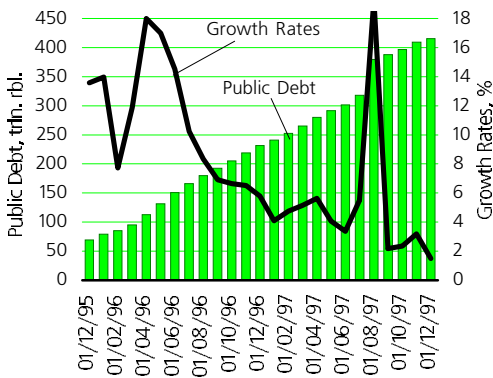
	mln. Bonds			trln. rbl.		
	GKO	OFZ	Total	GKO	OFZ	Total
Monthly Issues — Total	28.667	3.806	32.473	25.943	3.122	29.065
including:						
Primary Issues	26.483	3.806	30.289	23.813	3.122	26.935
Additional Issues	2.184		2.184	2,130*		2.130
Payments - Total	27.522		27.522	27.522	1.102	28.624
including:						
at Maturity	27.522		27.522	27.522	1.102**	28.624
before Maturity						
Net Income				-1.579	2.020	0.441

\* — Assessments on Average Prices on Trade Session

\*\* — Dividend Coupon Payments on OFZ

# FIXED INCOME MARKET

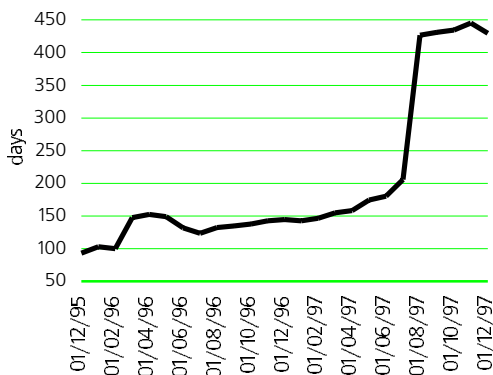
## Public Debt on Bonds and Its Growth Rates



financing the budget deficit totaled 441 bln. rbl. The past month's more than five-fold drop in net proceeds was accounted for by the fact that the issuer was compelled not to put additional pressure on the internal debt market during the crisis and merely refinanced the existing bonded debt.

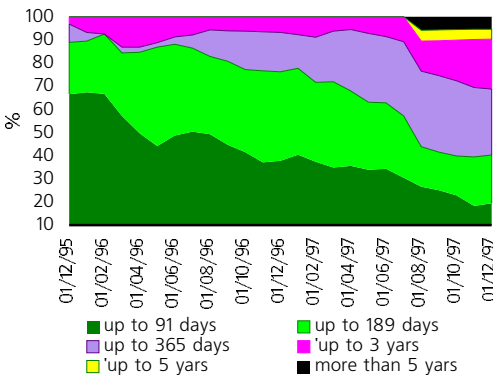
In spite of increased government securities yields, in November, the debt on GKO/OFZs (including known coupon payments) swell by 6.1 trln. rbl., or only 1.5% (12.6 trln. rbl. and 3.2% in October). As previously, the debt on OFZ-PDs grew the fastest, while the debt on GKOs remained practically unchanged. As of December 1, the debt on government securities totaled 415 trln. rbl., 64.5% of which were accounted for by GKOs, 11.5% by OFZ-PKs, 15.6% by OFZ-PDs and 8.4% by coupon payments (mainly on coupons of fixed-yield bonds). The all-time low rates of growth in debt volumes on the government securities market seen in the past month were due to two reasons. First, it was a small amount of payments on previous loans planned for November (less than 29 trln. rbl. instead of the traditional 33–38 trln. rbl.) and, therefore, a smaller issuance of securities required to refund them. The second reason already mentioned above was that in November the Ministry of Finance practically did not attract funds for the budget, and limited the month's issuance to the amounts required to make redemptions.

## Average Term of State Bonds Debt



The November reduction in issuance of long-term securities deteriorated the debt time structure. In the past month, average maturity calculated for all securities and coupon payments decreased from 445 to 430 days. By the beginning of December, average GKO maturity declined to the mid-summer level of about 160 days. Due to November issuance of securities with up-to-three-month maturities, the share of redemptions due in the next 91 days was also somewhat up. Nevertheless, in general the past month's issuance of government securities by the Ministry of Finance turned out to be a relatively balanced one, and the distribution of redemption volumes practically did not change. Moreover, the share of redemptions due in the next six months has stayed at 40% of the debt volume for three months. The share of securities maturing in from six months to three years also remained unchanged - they account for precisely a half of the issuer's debt on GKOs/OFZs.

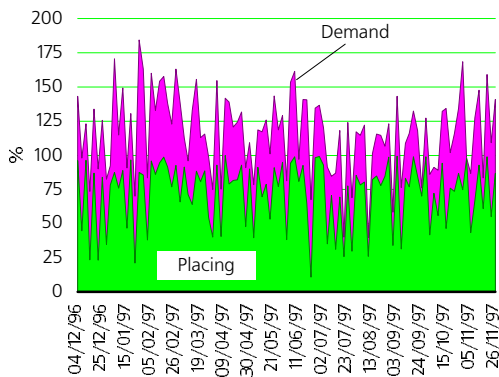
## Structure of State Bonds Debt



Characteristics of government securities placed at November auctions depended on the market situation rather than on the issuer's plans to restructure internal debt, which it had consistently implemented in January-October 1997. In the past month, the Ministry of Finance offered investors three issues of short-term GKOs (previously that many tranches of short-term securities had been issued during a single month only in April 1996), the last one of which was a 63-day issue. Similarly to the previous month, two six-month issues were auctioned in November, but only one twelve-month issue. The bulk of OFZ-PDs were placed at the beginning of the month before the market situation aggravated. In the last weeks of the month, no coupon bonds were sold.

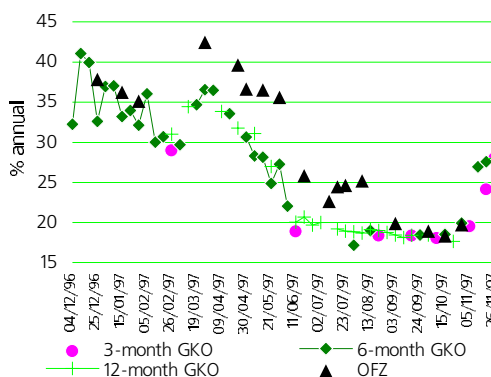
At the end of November, investors obviously favored short-term securities, which previously were much less popular among investors.

**Auction Demand and Placing of the GKO/OFZ in % of Declared Issue**



The month's last two auctions, at which the Ministry of Finance experienced serious problems when determining the costs of borrowing, were of special importance. Thus, on November 19, yields at the lowest honored price, which the issuer was forced to set for a six-month issue, were 1 percentage point higher than the refinancing rate. A week later, on November 26, the situation at the auction was an even more dramatic one: most investors who participated in the auction aimed at 30% or higher GKO annualized yields. The Ministry of Finance, however, decided to give a display of power and satisfied only non-competitive bids, setting the rates on government securities at the level of 28% per year. As funds received from sales of government securities at such prices were obviously insufficient to fully redeem the relevant GKO issue, the issuer had to take 1.7 trln. rbl. it lacked from the Treasury (in other words, from the budget). Though the day after the auction, this sum was raised by additional GKO placements at the secondary trading session, subsequent events showed that the Finance Ministry's tough stance at the auction failed to impress market participants - selling of government securities continued and their yields kept growing.

**Weighted Average GKO and OFZ Yield in Primary Auctions**

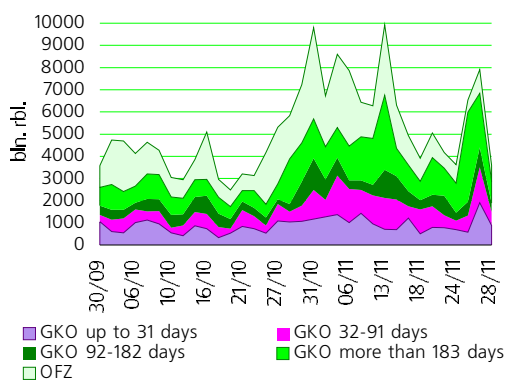


In November, volumes of operations with GKO/OFZs at secondary trading sessions varied from 3.6 to 9.9 trln. rbl. The latter figure, which was registered on November 13, is a new all-time record high on-exchange government securities turnover. Market participants were the most active during the past month's first two weeks when trading volumes did not go below 6 trln. rbl. When the first surge of government securities selling, which continued from the end of October to mid-November, ebbed away, the market experienced a short-lived period of calm when volumes of transactions did not exceed 4-5 trln. rbl. During the last week of November, however, first in the lead up to the auction and then due to its results, tension at trading sessions mounted and dealers became more active. In November, secondary market turnover amounted to over 91.8 trln. rbl. (6.1 trln. rbl. per trading session, on average), i.e. was 13% higher than in October (though, due to holidays, the number of trading sessions was smaller). As opposed to previous months, in November, securities with near maturities never were deal volume leaders. It was generally rather difficult to single out the category of securities dealers gave preference to. As prices of coupon securities fell the most as a result

**Bond Auctions (November 1997)**

№ of Issue	Date of		Issue Volume, trln. rbl.	Raised Proceeds, trln. rbl.	Selling Price as % of Face Value		Yield to Redemption, % annual	
	Auction	Redemption			Floor Price	Weighted Average	at Floor	at Weighted Average
21099	05/11/97	04/02/1998	6.5	6.039	95.00	95.36	21.11	19.52
25020(2)	05/11/97	25/10/2000	4.5	1.615	82.00	82.62	21.41	21.04
21100	12/11/97	13/05/1998	7.5	4.411	87.94	88.15	27.50	26.96
25019(3)	12/11/97	13/10/1999	2	1.506	80.10	80.21	27.42	27.32
21101	19/11/97	03/06/1998	8	4.230	86.55	87.10	28.94	27.58
21084(2)	19/11/97	11/02/1998	3	2.812	94.57	94.74	24.95	24.12
21102	26/11/97	25/11/1998	7	3.006	78.05	78.17	28.20	28.00
21081(2)	26/11/97	28/01/1998	4	3.316	95.39	95.39	28.00	28.00

**Trade Volume of GKO (for Maturity Date) and OFZ in 1997**



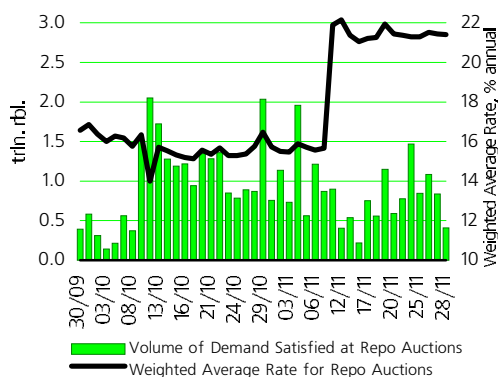
of the crisis, and due to the fact that the Central Bank obviously bought out a portion of OFZs from non-residents, the share of these securities in trading turnovers shrank in November from 35–40 to 15–20%.

If in October the Central Bank additionally placed coupon bonds at the Finance Ministry's instructions, in November, due to a fall in OFZ prices, the issuer had to refrain from such operations on the secondary market. It was equally difficult to make additional placements of zero-coupon securities in the conditions when sellers dominated at trading sessions. As a result, only three additional placements took place in November. The first two ones were carried out at the beginning of November before the fall in GKO prices and brought to the budget about 380 bln. rbl. The third additional placement, one of the largest in scale in recent times, was carried out on November 27 in order to compensate negative proceeds from the previous day's auction. Maximum maturities of securities sold on that day equaled two months. Nearly a quarter of proceeds from additional placements were accounted for by GKO maturing in less than two weeks.

In November, against exacerbating crisis, a certain stability was seen in the results of daily repo auctions. If, since mid-October, when volumes of morning repo deals began to exceed 1 trln. rbl., rates on these operations stayed at 15–16% per year, after the increase in the refinancing rate, interest rates on this type of securitized credits rose to 21–22%. It is worth noting, that the difference between repo rates and the refinancing rate remained practically at the same level. In November average annualized repo rates (weighted to volumes of satisfied auction demand) rose to 19.55% (15.57% in October). Overall volumes of repo deals slimmed in the past month to 15.9 trln. rbl.

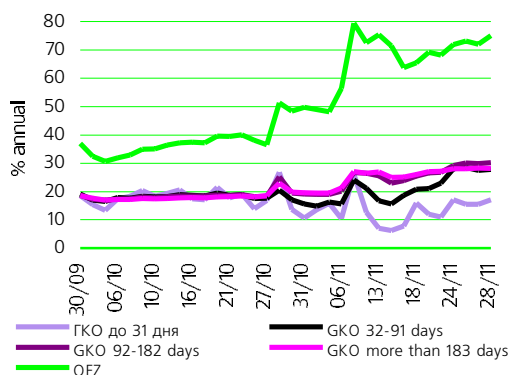
In November, a nervous situation at secondary trading sessions prompted more significant fluctuations of yields to maturity of both short-term and long-term GKO. Thus, having reached 24–26% per year on the day when the rise in the refinancing rate was announced, yields on GKO maturing in up to three months fell back to early-October levels, but soon resumed their growth. Rates on six-month and twelve-month GKO changed more smoothly. Yields on these securities are the main indicator of the market and the Central Bank, in the first place, tried to support long-term GKO and almost succeeded in so doing. During the last week of November, rates on all government securities maturing in more than one month stayed within a relatively narrow band of 28–30% per year.

**Repo Auction Results in 1997**

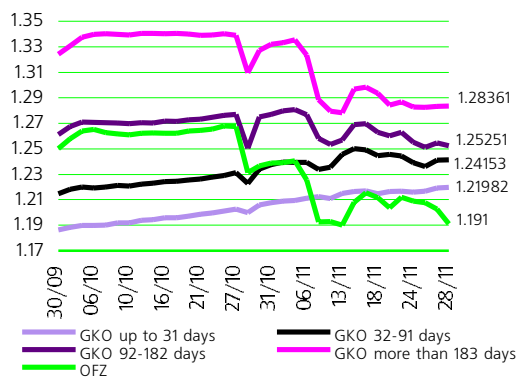


As had to be expected, in November, price indices of GKO maturing in from six to twelve months fell furthest. These securities lost 3.6%, on average. Holders of short-term securities, maturing in up to 30 days, could draw an about 1% monthly profit. Investors' average losses from the November drop in GKO prices exceeded 2%. The month's top profit from government securities purchases of over 1.1% was brought by the GKO issue, maturing in the first week of December. The November movement of coupon bond prices divided these securities into two groups: if OFZ-PK prices declined by the same percentage as long-term GKO, the fall in some of OFZ-PD was a record low one - the longest-term seven- and eight-year bonds lost nearly a quarter of their price. At the month's last trading session,

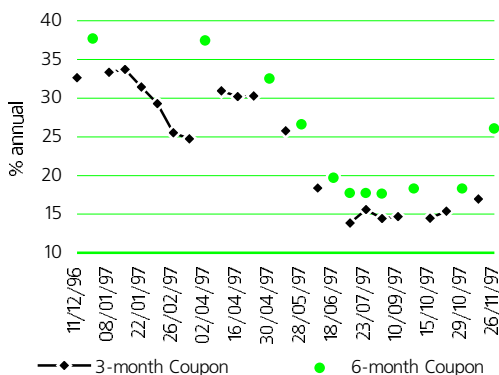
**Yield of Return on GKO (for Maturity Date) and OFZ in 1997**



**Price Index of GKO (for Maturity Date) and OFZ in 1997**



**OFZ Coupon Rate**



their net prices (i.e. not adjusted for accrued coupon yields) did not exceed 50% of nominal. However, in spite of the general downward trend in OFZ prices, on some days, price fluctuations allowed lucky speculators to draw monthly profits, which could be even higher than from GKOs.

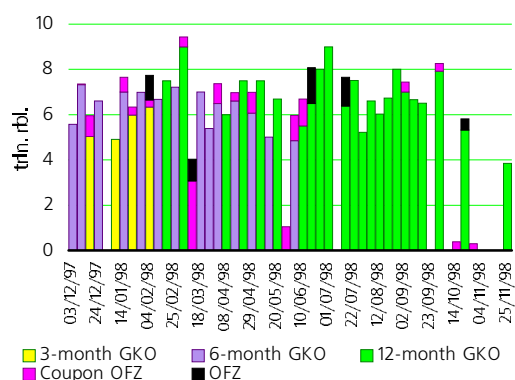
**Forecast**

In December, the volume of redemptions will be 25.5 trln. rbl., i.e. 3.1 trln. rbl. less than in November. As previously, the Ministry of Finance intentionally structured government securities issuance in such a way so as to ease the debt refinancing load on market participants at the year's end. According to the information available as of the beginning of the winter, a significant portion of the debt on GKOs/OFZs (about 63%) has been put off to 1998. Redemption payments of 81, 84 and 86 trln. rbl. are planned for the first three quarters of the year, respectively. Having been forced to boost issuance of short-term GKOs, in the last months the issuer filled practically all blanks in the redemptions schedule for the first half of 1998. Therefore, if, in the near future, the situation in the government securities market does not stabilize, investors do not show interest in the purchase of long-term securities, and the issuer continues to place three- and six-month GKOs, the Ministry of Finance will be faced with the following choice. It will either keep issuance of short-term securities at the level of 3–4 trln. rbl., and on some Wednesdays in 1998 will have to put up with higher redemption volumes of up to 10 trln. rbl., while, on average, they will approximate 7 trln. rbl. (in 1997 the volume of redemptions exceeded 10 trln. rbl. only once - in June). Or, trying to achieve a more or less evenly distributed schedule of redemptions, the issuer will hold more auctions for small additional tranches of securities already circulating on the market (The way it did in January 1997, when issuance of taxable GKOs was delayed).

Selling of government securities resumed by non-residents at December's first trading session and the Central Bank's decision to stop supporting government securities (only in the last week of November the Central Bank had to buy out securities for 8.7 trln. rbl.) resulted in a new upward spiral of GKO yields (36–42% per year). The decision to let government securities prices and yields be determined by market mechanisms, which was taken by the monetary authorities at the peak of the crisis, could have a favorable effect on the mood of both domestic and foreign investors. If no bad news is received from the world financial markets, high yields on Russian government securities could give a new impetus to non-residents' investments in GKOs. Rates on government securities, which formed at the beginning of the winter, could turn out to be quite attractive to non-residents, even if a possible doubling of the dollar's growth rates in 1998 is taken into account.

Experts of Econometric Unit VEDI believe, that, in the second half of 1997, non-residents' share on the internal debt market shrank from 30 to 25%. If the assumption, that the past months' large-scale sales of government securities were due to outflow from the market of speculative capital (the bulk of which has already been withdrawn from government securities) and that the remaining foreign GKO

## Weekly Schedule of Coming Repayments



holders are long-term investors, is correct, then the situation in the government securities market could noticeably stabilize already by the end of December. Taking it into account, that even at the peak of their growth GKO yields were only a shade higher than the double of the previous refinancing rate (set during the period of stable development of the GKO/OFZ market), by the end of 1997, rates on government securities could be 25–35% per year. Nevertheless, the crisis on the internal debt market could be fully overcome in mid-January, at the earliest.

The first two winter months could be decisive for determining the prospects of the government securities market development in 1998. During the period in question, the issuer will probably have to confine itself to refinancing the debt. The government will have to raise funds for the budget and to pay social arrears from other sources, in particular, by additional external borrowings. Adoption by the State Duma of the 1998 draft budget with a possible correction of some of its items (taking into account possible consequences of the stock market crisis), including the items related to internal borrowing, could become an important milestone on the road to expected stabilization of Russia's financial system. As of mid-autumn, GKO annualized yields still could be expected to decline from 14 to 11% in 1998. It was on the basis of this scenario that the FM experts projected the debt on government securities on January 1, 1999 at up to 490 trln. rbl. and put the debt servicing expenditures (interest payments) at up to 60 trln. rbl. (which easily fitted the targets of the government's 1998 draft budget). However, at the beginning of the winter, the situation changed dramatically. New calculations show that, if in 1998 GKO rates steadily decline from 30 to 20% and if the issuer's net proceeds remain at the 1997 levels, by the end of 1998, the debt on GKO/OFZs could swell to 540 trln. rbl., while expenditures on its servicing could constitute nearly 70 trln. rbl. This is higher than the budgeted targets. What is more, this scenario does not take into account a possible growth in the debt volumes if the Central Bank sells on the market long-term coupon securities from its portfolio. Let us note that in case of relatively low interest rates (up to 30–40% per year) debt growth rates depend on the amount of funds attracted to the budget by the issuer rather than on yields on placed securities. The calculation also shows that in order for non-residents' share on the GKO/OFZ market to be restored by the middle of 1998 (to the maximum 1997 level of 31%), in the next seven months the inflow of foreign capital to Russia should exceed 4.6 bln. USD.

A stable growth of GKO/OFZ prices could recommence in January 1998, at the earliest, and only if non-residents resume government securities purchases. As before, a lot will depend on the Finance Ministry's budget deficit funding needs. As tax collectability is not likely to improve dramatically in the near future, the traditional for the recent years aggravation of the situation in the internal debt market could be expected in the early spring.

## Municipal Bond Market

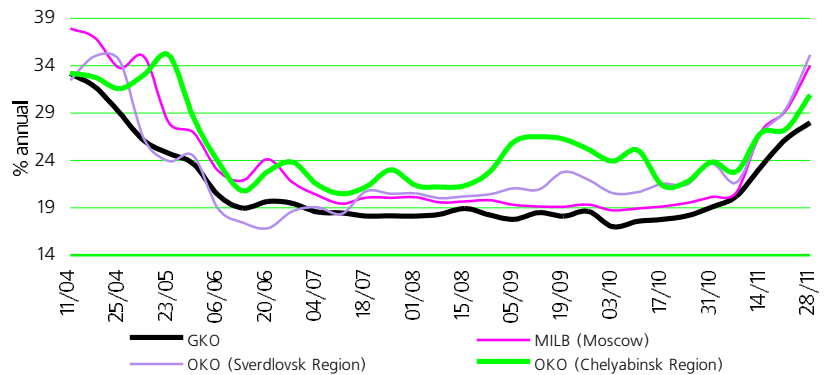
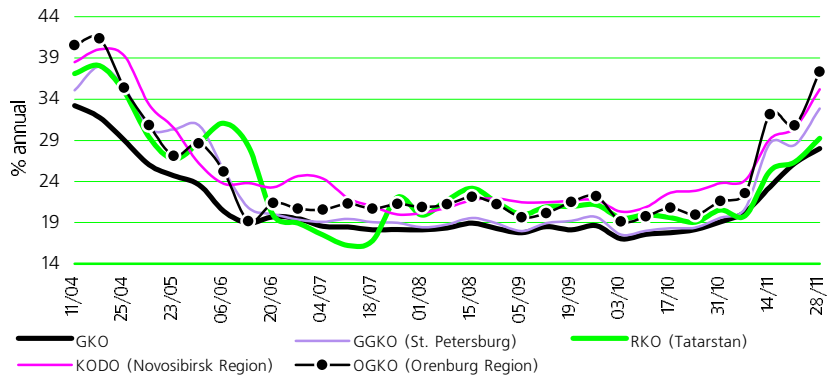
The key factor which determined the situation in the municipal bond market in November 1997, was the world financial crisis. A significant fall in GKO/OFZ (government state bonds) prices prompted a similar trend in the Russia's federal subjects bond market. Moreover, in November, prices on the municipal bond market fell more significantly than on the government securities market, since on the municipal bond market there is no operator capable of controlling the market situation and promoting its stability (on the GKO/OFZ market this is successfully done by the Central Bank). As a result the yield gap between GKOs/OFZs and most municipal bonds noticeably widened and municipal bond liquidity declined.

In November weighted average yields to maturity of regional securities increased by from 900 (Tatarstan's bonds) to 1600 (for bonds of the Orenburg Region) basis points. On average, municipal bond trading turnovers were down by 20–25%, as compared to October levels.

A narrowing of the gap between yields to maturity of St. Petersburg bonds (GGKOs) and GKOs, which had been observed since July, stopped in November. The yield «premium» of St. Petersburg bonds over GKOs rose during the reviewed period to 200–250 basis points for twelve-month bonds. The yield «premium» on short-term securities equaled up to 400 basis points.

At the end of the month, GGKO weighted average annualized yield was 32.87% (+13%). Trading volumes for St. Petersburg bonds

### GKO and Municipal Bonds Average Weighted Return in 1997



shrank in November by about one fourth, as compared to the previous month, to less than 400 bln. rubles. GGKO liquidity was also down: average daily trading turnover was 19 bln. rubles, or merely about 0.6% of the debt volume. At the end of November, yields to maturity of St. Petersburg bonds were 34.06% per year for twelve-month securities, and 33.93% per year for longer-term bonds.

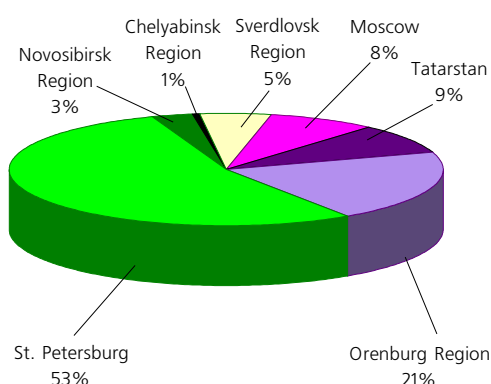
In the past month, the St. Petersburg administration offered eighteen-month zero coupon bonds and three-year fixed-coupon bonds with the annual rate of 13% of nominal for a total of 120 bln. rubles. GGKO redemption payments amounted to 250 bln. rubles. Thus, by the end of November, St. Petersburg's internal debt decreased to 3,105 bln. rubles. Due to weak auction demand and low prices of competitive bids, the issuer managed to place only a small volume of securities, yields on which, however, were below the secondary market levels.

The Orenburg regional government placed its bonds (OGKO) using a different strategy. The issuer sold a more or less significant percentage of its securities at weighted average yields, which outstripped the secondary market levels. As a result, over the month, weighted average

### Auction Results of on Municipal Bonds (November 1997)

№ of Issue	Issue Region	Date of Auction	Issue Volume, bln. rbl.	Term, days	Lowest Price Accepted, % of Par Value	Weighted Average Price, % of Par Value	Weighted Average Yield to Maturity, % annual	Proceeds, bln. rbl.
00143-025	Irkutsk Region	12/11/97	-	91	93.47	93.60	27.43	19.68
00143-026	Irkutsk Region	19/11/97	-	91	93.40	93.71	26.92	3.25
00143-027	Irkutsk Region	26/11/97	-	91	91.65	92.89	30.70	5.88
32027	Novosibirsk Region	05/11/97	10	182	88.63	88.73	25.47	0.93
32028	Novosibirsk Region	26/11/97	10	182	84.60	84.80	35.95	1.10
4202A	Chelyabinsk Region	05/11/97	10	182	89.33	89.43	23.70	2.60
3203ДА	Chelyabinsk Region	19/11/97	10	182	89.51	89.51	23.50	0.35
33003	Orenburg Region	20/11/97	25	259	81.27	81.55	31.88	12.85
33006	Sverdlovsk Region	19/11/97	35	273	81.68	82.06	29.23	25.06
34008*	Novosibirsk Region	19/11/97	10	365	88.06	89.74	-	1.00
4301Б	Chelyabinsk Region	05/11/97	5	365	82.31	82.31	21.49	0.08
34005	Orenburg Region	06/11/97	40	371	81.35	81.56	22.24	20.63
35010	St. Petersburg	26/11/97	70	560	65.00	68.88	29.45	28.85
24000301	Moscow	26/11/97	50	687	82.48	83.42	34.01	1.00
24000301	Moscow	19/11/97	50	694	86.90	87.31	29.82	1.05
24000301	Moscow	12/11/97	50	701	86.20	87.62	29.24	4.04
24000301	Moscow	05/11/97	50	708	94.32	95.42	22.37	3.39
37004	St. Petersburg	05/11/97	50	1092	85.30	85.83	19.75	21.71

### Structure of Municipal Bonds Turnover, November 1997



yield to maturity for Orenburg bonds rose by 1600 basis points to 37.31% per year. The yield «premium» on OGKOs relative to St. Petersburg bonds also increased and, by the end of November, was 330 basis points (in October the «premium» did not exceed 250 basis points).

In November, OGKO secondary market trading volumes were 146 bln. rubles – 44% below October levels. Shrinking trading turnovers against swelling debt volumes prompted a sharp decline in market liquidity. If in October average daily trading turnover was 1.4% of the debt volume, in November it fell below 0.9% (about 7 bln. rubles).

The debt on Tatarstan's bonds (RKO) dropped in November to 395 bln. rubles (-90 bln. rubles). Average daily trading turnover amounted to about 0.8% of outstanding bonds. Thus no noticeable decline was seen in the turnover rate for these securities.

Weighted average RKO yields climbed in November by 900 basis points, reaching by the end of the month 29.27% per year. Purchase of twelve-month bonds provided 26–28% yields to maturity. Purchase of shorter-term bonds bought up to an annualized 32%.

In November, Tatarstan's government held two auctions for twelve-month (issue volume – 35 bln. rubles) and six-month (30 bln. rubles) bonds. In spite of high weighted average yields, which outstripped the secondary market interest rates approximately by 200 basis points, the percentage of bonds sold at auctions was low (about 35% of issue volumes). Weighted average annualized yields of twelve-month and six-month RKO were 27.52% and 30.66%, respectively. The issuer's net proceeds were negative. The issue volume having been 65 bln. rubles, the issuer was to redeem 120 bln. rubles worth of bonds. 27 bln. rubles worth of bonds (at par) were actually placed in November.

Novosibirsk regional government was in a better situation, as no redemptions of its bonds (KODO) were due in November. The volume of securities placed at three auctions was 3.5 bln. rubles at par. In November, their secondary market turnover dropped by 35%, as compared to the previous month, (to 21.5 bln. rubles). Weighted average annualized yields of Novosibirsk bonds climbed by 1150 basis points to 35.18%.

In the past month, volumes of trading in Moscow bonds (OVMZs) were down by 9%, relative to October, to 56.4 bln. rubles. The structure of OVMZ on-exchange turnover also changed dramatically. The share of Moscow Central Stock Exchange (MCSE) dropped sharply

### Schedule of Future Municipal Bond Redemptions

	Issuer				
	St. Petersburg	Republic of Tatarstan	Orenburg Region	Novosibirsk Region	Moscow
December 1997	280	65	40	30	0
1st Quarter of 1998	480	135	60	85	0
2nd Quarter of 1998	530	120	160	85	1150
3rd Quarter of 1998	570	45	110	52.5	410
4th Quarter of 1998	300	30	200	10	0
1999	745	0	255	0	550
2000	200	0	0	0	0
Redeemed in November, 1997 (for reference)	250	120	40	0	0

from 71% in October to 26%, the share of Moscow Stock Exchange (MSE) remained practically unchanged, at about 16%. Trading in OVMZs was the most active on the St. Petersburg Currency Exchange, the share of which in the OVMZ turnover increased in November from 15 to 58% of the overall trading volume.

Since Moscow bonds had been launched, the bulk of trading turnover had been accounted for by MCSE. Thus, from August through October 1997, 70–80% of all OVMZs were traded on this trading floor due to the largest number of dealers accredited on the exchange. The November changes could be due to the fact that some investors who work on SPSEX and, therefore, can carry out operations with three municipal securities (Moscow, St. Petersburg and the Orenburg Region) restructured their portfolios in favor of OVMZs as less risky securities, comparing to Orenburg bonds.

During the month, weighted average annualized yields on Moscow bonds rose by 1400 basis points, reaching by the end of November 34.85%. Thus yield «premium» on Moscow bonds over GGKOs was about 200 basis points.

Four auctions for additional placements of two-year coupon OVMZs with annual coupon rates of 17% of nominal were held in November. The declared issue volume at each auction was 50 bln. rubles. Overall volume of securities placed at four auctions totaled merely 11 bln. rubles (at par). No OVMZ redemptions took place during the reviewed period.

### **Forecast**

We believe that the past month's events predetermined a number of important changes in the future development of the municipal bond market. In November, the municipal bond market was linked to the GKO/OFZ market to a much lesser extent than during the pre-crisis period. This was evidenced, in the first place, by a more significant growth of municipal bond yields to maturity, as compared to government securities, and shrinking secondary market turnovers for regional bonds.

The clear dependence of the municipal bond market upon the situation in the GKO/OFZ market, which existed during the periods of relative calm in the financial markets, made investments into municipal securities less risky from the point of view of predictability of changes in municipal bond price levels. The past month demonstrated that during a crisis investments in municipal bonds become much more risky, as compared to GKOs/OFZs.

This is, first of all, due to changes in the risk-to-yield ratio for operations with regional securities. When yields on government securities were 18–19% per year, investors were ready to buy municipal securities with 21–22% yields. However, when GKO/OFZ yields rose to 35–40% per year, in order to compensate investment risks municipal bond yields had to be about 50% per year, i.e. their price levels declined much more significantly.

Second, pyramid-like structure of federal subjects' borrowings, when new securities are issued to redeem old bonds, which worked well when the financial markets were stable, creates certain problems in

case of a crisis. The demand for new securities drops sharply and the issuer cannot attract the necessary funds to refund its debts even at the expense of a significant yield «premium».

Third, during periods of volatility, market liquidity decreases sharply: the demand for securities is extremely small, against large supply, trading volumes tumble and it is difficult to sell securities even at a significant loss.

Regional issuers have a limited ability to support their securities, in the first place, from the financial point of view. In order to bring the situation in the market back to normal the federal government can use such methods like unlimited purchases of government securities by the Central Bank. Resources that the monetary authorities of Russia's federal subjects have at their disposal are much smaller and include budget revenues, bank credits and financial help of the federal government. Implementation of budget revenues in the majority of Russia's regions, as well as of the federal budget revenues, is unsatisfactory. It is not possible to count on bank credits (interest rates on which were fairly high even before the crisis). The federal government is not likely to help in the situation when many regions may be faced with such problems, the more so, as these problems will be even more acutely felt on the federal level.

Therefore, it was only natural that as a result of the autumn crisis on the financial markets, investors who had municipal bonds in their portfolios suffered greater losses than holder of government securities. Risk assessments of investments also changed. If, before the crisis, rates on municipal bonds were just a shade above those on government securities, during the abrupt market downturn, the yield spread increased significantly. This difference in yields is likely to remain even after stability is achieved on the financial markets and GKO/OFZ yields go down, reflecting the corrected assessments by market participants of risks inherent in investments in municipal bonds.

In November, regional issuers had to cut new issuance to the levels insufficient to refinance their debts. At the same time, during the period in question, all redemptions were made in a timely manner, which is a plus for the issuers' credit histories (delays in redeeming some issues, which occurred in the first half of 1996, for a long time after affected investment ratings of relevant regions). However, if the crisis persists on the Russian financial markets for some time to come, debt redemption will become an even more acute problem for federal subjects.

As far as prospects of the municipal bond market are concerned, the November instability in the financial sphere will likely result in a smaller number and smaller volumes of new issues. Issuers will more seriously approach the matter of attracting funds on the financial markets, which is bound to have a positive effect on the municipal bond market.

In the coming months, municipal bond yield «premium' over GKOs/OFZs will be quite high, which will make municipal securities a more attractive investment. It should also be taken into account that it could take more time for municipal bond yields to go down, as compared to government securities. Therefore, at the moment, medium-term and long-term investments in municipal bonds should be considered.

# SECURITIES MARKET

## Equity Market

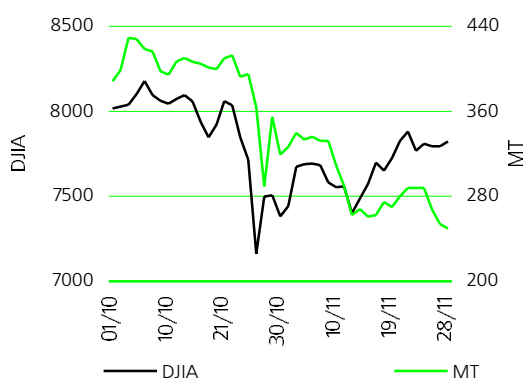
In spite of a dynamic character of November events on the Russian equity market, no significant changes occurred on the market. Investment activity of market participants was low (against practically non-existent demand for securities of small and medium companies), and the market was inert in its development. The latter was evidenced by the market's indifference to such events in the domestic economic life as government reshuffles, debates on the 1998 budget, negotiations with the IMF about granting to Russia of the next tranche of its credit, an increase in the refinancing rate by the Central Bank, etc.

The most remarkable thing was that the market failed to react to an event, anticipations of which had been behind the main trends in the equity market since the spring of 1997. Let us remind, that the expected inclusion of Russian shares in the aggregate investment index (IFC Investable) by IFC for a number of months remained the main driving force of the domestic equity market development in the medium-term (four-six months). Daily calculated IFC index is one of the main indicators, by which international investment companies are guided. This was why, in May-October, on the back of a growing Western and domestic demand, liquidity of the equity market increased by 2–3 times, and share prices climbed by more than 90%. After the October crisis, many market participants pinned on the IFC's decision their hopes for an improvement of the market situation.

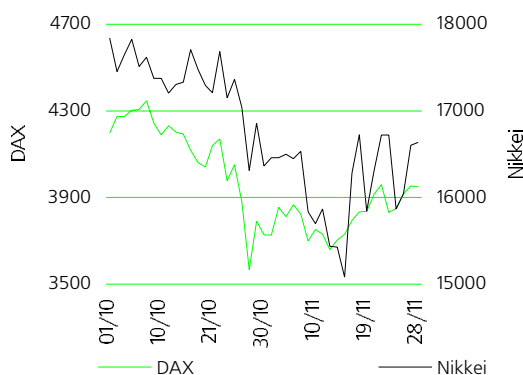
On November 3, in spite of the well-known force majeure circumstances, shares of Russian companies got included in the IFC Investable index. These 31 companies were: LUKoil, EES Rossii, Surgutneftegas, Mosenergo, Rostelecom, Noyabrskneftegas, Yuganskneftegas, Purneftegas, Megionneftegas, Irkutskenergo, Norilsk Nickel, St. Petersburg Telephone, KamAZ, Chernogorneft, Bashkirenergo, Chelyabenergo, Chelyabinskvyazinform, GAZ, Krasnoyarskenergo, Kubanelectrosvyaz, Lenenergo, Nizhegorodsvyazinform, Orenburgneft, Permenergo, Sakhalinmornerftegas, Sberbank, Sverdlovskenergo, Trade House GUM, Moscow Telephone, Tatneft, Tomskneft.

Weighting of domestic equities in capitalization of emerging market securities included in the index was much higher than had been expected - nearly 5.6%. As a result Russia ranked sixth, trailing South Africa, Mexico, Brazil, Malaysia and Taiwan. This means that from now on investment funds, which operate on emerging equity

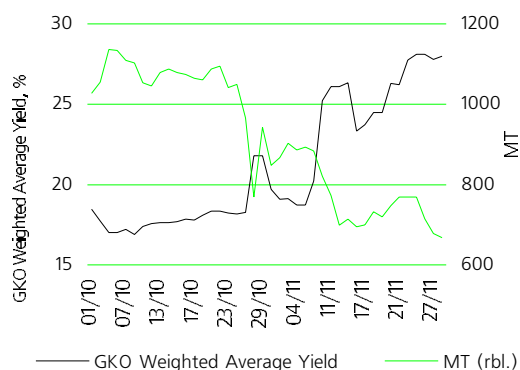
MT and DJIA Indices  
in October–November 1997



DAX and Nikkei Indices  
in October–November 1997



**MT Indices and GKO Weighted Average Yield in October–November 1997**



markets, will put in Russian stocks at least the relevant percentage of their capital (currently 5.6%).

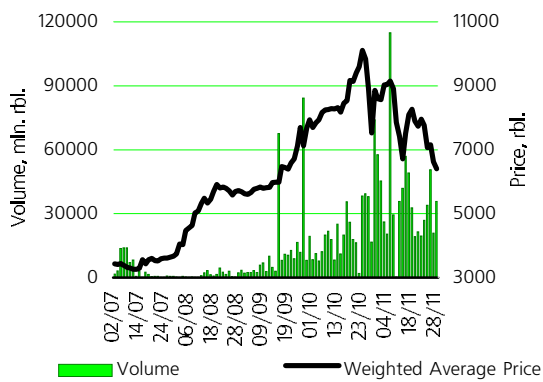
However, as we have already mentioned, in spite of optimistic forecasts IFC's decision failed to have a radical effect on the scale of investments into Russian stocks, or even to stop the increasing outflow of funds from this segment of the financial markets. Trends, which appeared when the financial crisis began (October 24–30), persisted in November. Non-residents continued to withdraw funds from emerging markets (including the Russian market) and to invest them in fixed-income securities of economically developed countries (in the first place, US T-Bills). Domestic investors restructured their portfolios in favor of the currency market and the government securities market.

The following three periods can be singled out in the development of the situation in the equity market in November – early December under the influence of the above mentioned trends.

The first period (November 3–14). At the time, equity prices moved downward (-3%, on average). In the first half of November, average levels of share prices dropped by nearly 19% due to active selling of stocks on the part of non-residents and increasing sales of securities by domestic commercial banks. The sharpest plunge in prices (-9.25%) was seen on November 12. On that day, the bodies, which regulate stock market operation, for the second time in the market history had to resort to extraordinary measures: the morning trading session on MICEX was halted, and the results of a shortened evening trading session were cancelled.

The second period (November 17–21). The decline was, as usually, followed by a certain improvement of investment climate in the middle of November. The situation became favorable for speculations for the rise due to two circumstances. First, it was a significantly improved situation in the world stock markets, which was evidenced by five days of a steady growth in the world stock indices: the US DJIA - 3.36%, the German DAX - 2.8%, the Japanese Nikkei - 5%, Hong Kong's Hang Seng - 2%. The second reason was a low level of prices for the most liquid domestic shares (since the beginning of the financial crisis they had declined by more than 33%). Efficiency of operations increased by several times under the influence of positive local events including information about syndicated loans granted to

**Results of RTS Trading in Gazprom Shares in 1997**



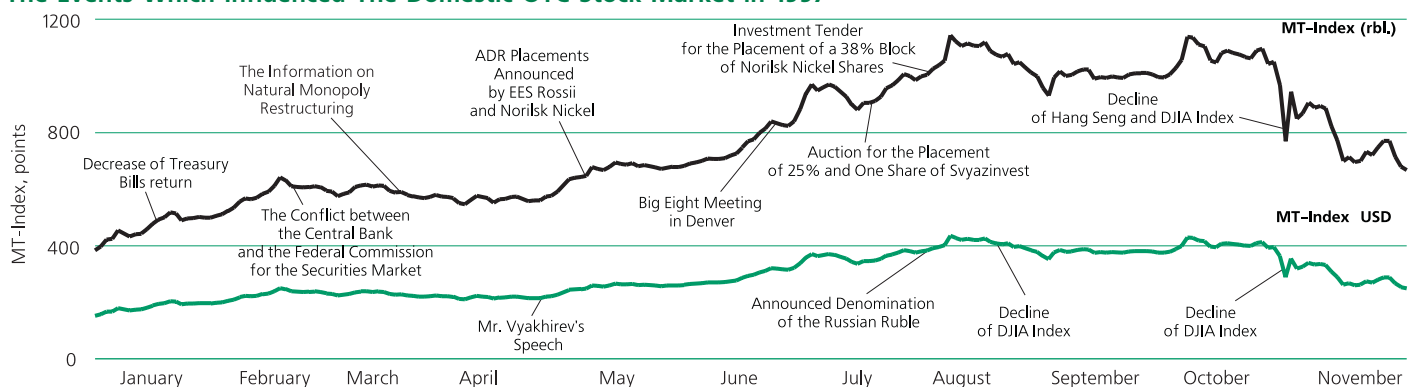
a number of Russian companies by Western financial institutions, as well as the news about optimistic prospects of domestic issuers' industrial and investment development. Thus announcements about the strategic alliance formed by Gazprom and Shell, as well as about Shell's intention to invest in early 1998 up to 1 bln. USD in Gazprom's convertible bonds provoked a 6% increase in Gazprom's stocks on the domestic market and a 20% rise in its ADSs on the international markets. The news about the intention of British Petroleum to purchase a 10% stake of oil holding company SIDANCO for 571 mln. USD sharply sent up shares and ADRs (by 39.4 and 20%, respectively) of SIDANCO's subsidiary Chernogorneft. Information that LUKoil, YUKOS and Tatneft fully discharged their debts to the federal budget pushed prices for their shares up by 20, 13 and 17.4%, respectively. During the reviewed period, average price levels for domestic stocks increased by 12%.

The third period (November 24 - early December). At the end of the month, the equity market was influenced by three factors - bankruptcy of a largest Japanese broker Yamaichi Securities, Thanksgiving Day in the US and a more acute liquidity crisis experienced by Russian commercial banks. The effect of these events on the movement of share prices was negative. Depression on the world financial markets, which was aggravated by the news about the Japanese broker's bankruptcy, caused on November 24-25 an intensive decline in prices for shares of most domestic companies (by about 10%). At the end of the month, the decline in share prices intensified due to unofficial information about expected large-scale selling of equities by banks, which were hit by liquidity crisis. As a result, the most liquid stocks (Mosenergo, LUKoil, Rostelecom) fell to levels comparable to their prices of a year ago.

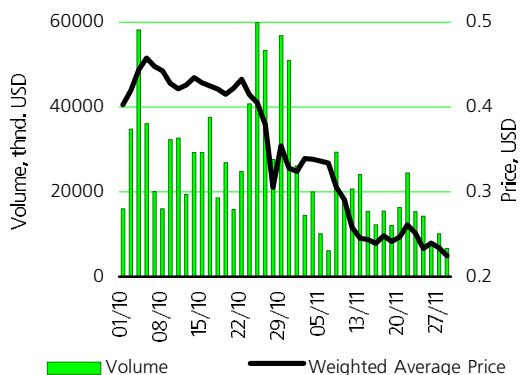
During the first days in December, a surge in government securities yields, as well as problems experienced by a number of Russian banks with meeting their liabilities provoked another wave of stock selling. The main blow was dealt to second-tier securities, which form a significant portion of banks' long-term portfolios. During just two trading sessions, prices on the relevant stock market segment fell by about 20%, while some stocks plunged by 20-35% (Tuimentelecom, Lenenergo, Electrosvyaz (the Rostov region), Chelyabenergo, etc.)

On December 2, the course of events on the equity market reversed due to two circumstances. The first one was a rise in the DJIA index to

**The Events Which Influenced The Domestic OTC Stock Market in 1997**



**Results of RTS Trading in EES Rossii Stock in 1997**



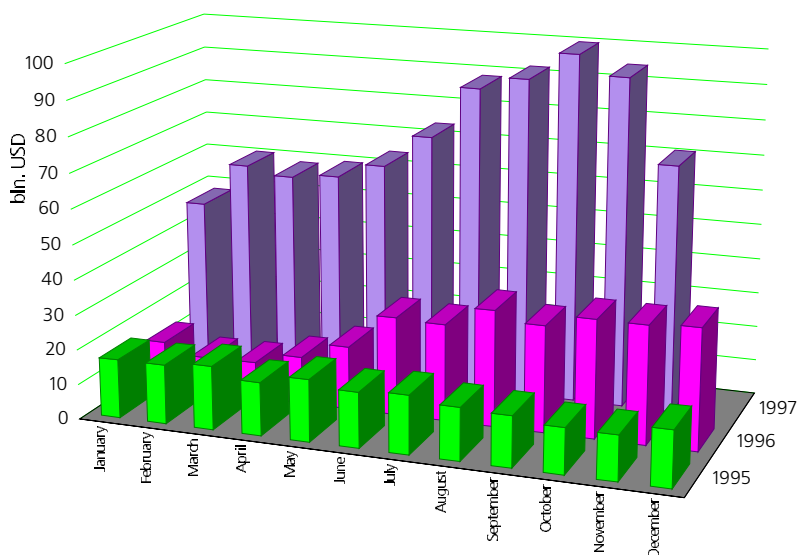
over 8000 points. The second one was an extremely low level of Mosenergo's prices: at the very start of the trading session real trades were made at prices of 1.0–1.01 USD, which matched price levels observed in June, September and December 1996. These events had a strong psychological effect on the mood of foreign market participants and triggered an intensive upward spiral of prices and a multiple increase in trading volumes. As a result, by December 5, the market recovered to the early November levels.

**Forecast**

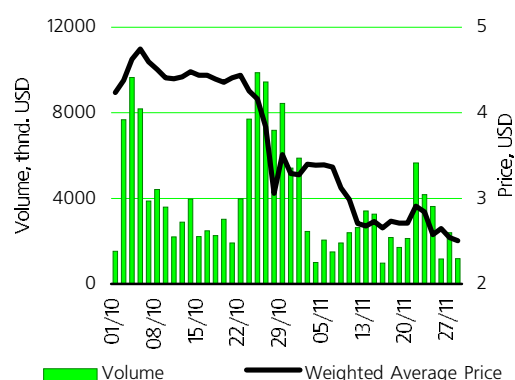
December 1997 will most probably be an ordinary last month of a year on the Russian equity market. This applies both to improvement of its infrastructure and the current market situation. The main influencing factors during the period will be as follows:

- the status of the world financial system. Leading international experts claim that favorable conditions are there for the world financial system to get back to normal. Improvement of the situation on the domestic equity market seems realistic against rising world markets;
- the situation on alternative domestic financial markets. Early December yields on government securities (30–42% per year) seem too high, and a further rise in yields is unlikely. Therefore, developments on the GKO/OFZ market in the short-term are not likely to have a strong negative effect on the equity market;
- the end of the fiscal year (on the microeconomic level). During the period, a number of companies traditionally publish preliminary results of their industrial and financial activities. Previous years have shown that at the end of the year managers of these companies do not announce negative results. Therefore, the effect of such publications on the market will most likely be positive;

**Domestic Stock Market Capitalization**



### Results of RTS Trading in Rostelecom Shares in 1997



- approaching Christmas holidays. As holidays draw nearer, foreign market participants will close their positions and volumes of operations on the market will tumble.

Due to the fact that the most important events on the Russian equity market (investment tenders and auctions for shares of strategic companies of the oil and energy complex, placements of Russian companies' international securities on the Western markets) have been put off to 1998, local and macroeconomic events (a possible increase in the refinancing rate by the Central Bank, granting by the IMF of another tranche of its loan, approaching denomination, etc.) are not likely to influence the mood of market participants at pre-holiday trading sessions.

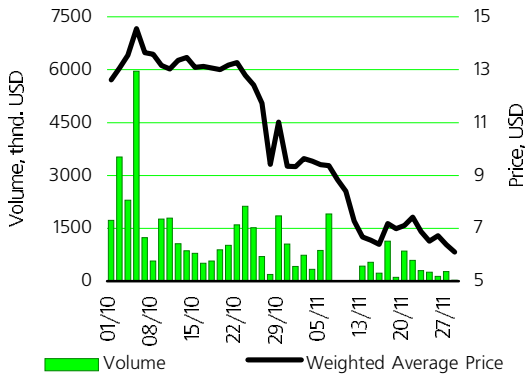
Experts of Econometric Unit VEDI believe that though as a result of the upturn on the equity market in the first week of December, the domestic stock market indices recovered to the early November levels, it would be premature to speak about a dramatic improvement of the situation. On the one hand, stock prices formed by December 5 match end-of-July and end-of-October levels, that is are 30% below their

### Yield of Return on the Most Liquid Shares in October–November 1997, in USD

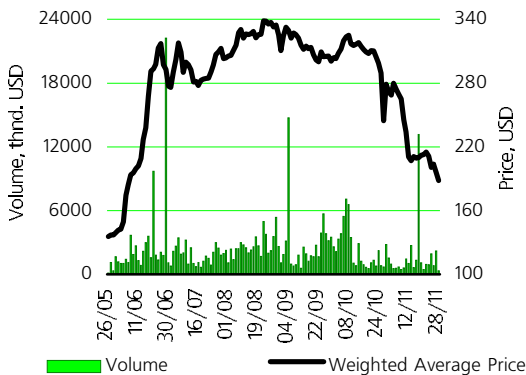
Company	November		October		Weighted Average Price in USD on November 28, 1997
	% per month	% annual	% per month	% annual	
Nizhneartovskneft	0.85	10.23	-7.37	-88.42	35.50
LUKoil	-11.35	-136.23	-12.65	-151.76	18.99
Surgutneftegas	-13.16	-157.89	-17.06	-204.76	0.17
Chernogorneft	-14.68	-176.19	-6.53	-78.40	10.75
Tatneft	-15.03	-180.32	-7.63	-91.53	123.69
LUKoil (Preference Stock)	-18.53	-222.37	-16.21	-194.56	13.10
Yuganskneftegas	-23.00	-276.01	-28.07	-336.82	13.50
Rostelecom	-23.47	-281.65	-21.81	-261.70	2.51
Orenburgneft	-23.75	-284.95	-8.60	-103.19	5.70
Mosenergo	-24.55	-294.57	-10.43	-125.11	1.09
Noyabrskneftegas (Preference Stock)	-24.71	-296.55	-22.49	-269.93	3.28
Tomskneft	-24.72	-296.67	-3.74	-44.92	13.55
Irkutskenergo	-25.74	-308.82	-15.38	-184.60	0.21
Surgutneftegas (Preference Stock)	-26.24	-314.83	-9.27	-111.28	0.09
Rostelecom (Preference Stock)	-27.76	-333.16	-13.93	-167.16	1.67
Noyabrskneftegas	-29.43	-353.13	0.51	6.12	8.63
CB RF	-29.88	-358.55	-11.52	-138.27	188.51
EES Rossii	-30.78	-369.32	-19.06	-228.72	0.22
Slavneft-Megionneftegas	-30.80	-369.57	-16.34	-196.14	4.78
Norilsk Nickel	-34.72	-416.65	-25.73	-308.72	6.10
Purneftegas	-37.05	-444.55	7.89	94.70	6.90
Lenenergo	-38.66	-463.92	-6.22	-74.59	0.60
Norilsk Nickel (Preference Stock)	-43.27	-519.24	-12.24	-146.92	5.21
EES Rossii (Preference Stock)	-44.19	-530.27	-18.44	-221.25	0.14
Purneftegas (Preference Stock)	-51.36	-616.27	6.31	75.68	2.15

# SECURITIES MARKET

## Results of RTS Trading in Norilsk Nickel Shares in October–November 1997



## Results of RTS Trading in CB RF Shares in 1997

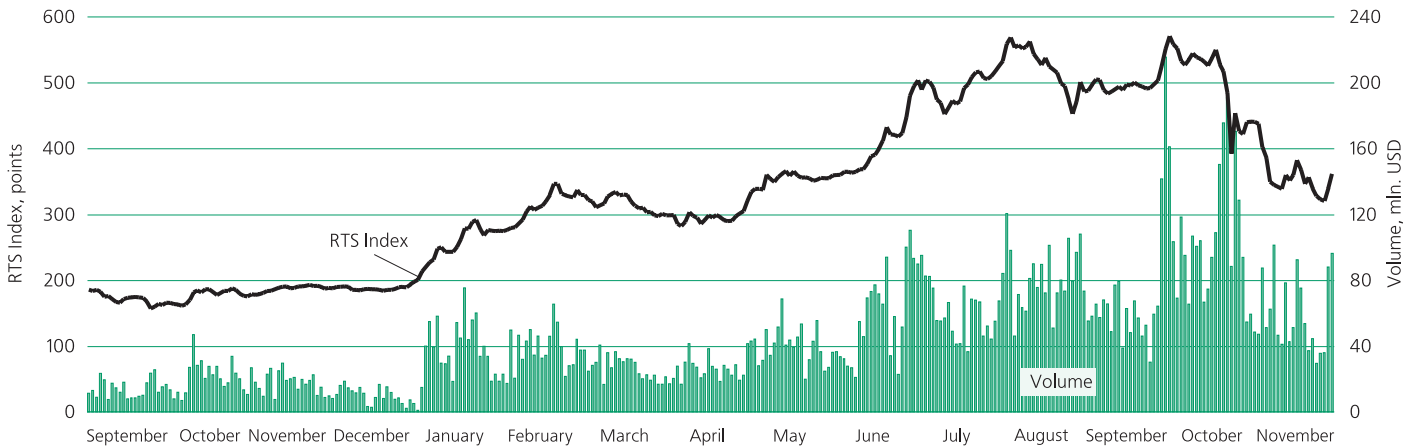


1997 high reached in August and, therefore, have a significant growth potential. On the other hand, price indicator for Russian shares is 50% above its this year's low observed in January and a further decline in prices is also quite likely in December. What is more, liquidity of the majority of stocks, including first-tier stocks, remains low. This is evidenced by a large spread indicator (the average market index of 0.5% is nearly three times higher than the liquidity indicator observed before the crisis in October 1997) and low stock market trading volumes (average daily trading volumes of 45 mln. USD observed on the RTS in November are 1.5–2 times below October's trading volumes).

Thus, at the end of 1997, non-residents will most likely stick to the good old principle «Russia is too large to be ignored and is not stable enough for big money to be invested in it». In case of the most favorable for the equity market combination of influencing factors (stability of the world financial system and stabilization of GKO yields), in mid-December, execution of non-residents' orders for purchase of corporate securities could be expected to continue. (Those will mainly be orders, which were received during the first days in December, but were not satisfied, as well as a small amount of new Western orders). The traditional before the New Year holidays trend to restructuring of portfolios in favor of the least risky shares is likely to be seen during the period in question. Relevant stocks are expected to gain 7–10%.

In the second half of the month, when the majority of foreign market participants will close their positions and will stop all operations on the market, the demand for Russian equities will shrink. The amount of domestic borrowed funds directed to the equity market will also decrease. Some of domestic market participants who invested in stocks at the beginning of the rise in prices could decide to take profits. As a result, at the very end of the year (December 28–31), prices for some shares could be corrected downwards (up to –5%).

## Sales in Russian Trade System in 1996–1997



## The Share of RTS-Listed Stocks the Prices for which Rose (Dropped)

