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**THE CENTRAL BANK
OF THE RUSSIAN FEDERATION**

ANNUAL REPORT
1998

THE CENTRAL BANK OF THE RUSSIAN FEDERATION



A N N U A L 1 9 9 8 R E P O R T

Approved by the Bank of Russia Board of Directors on May 14, 1999

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Introduction

The annual report of the Central Bank of the Russian Federation, which is submitted to the State Duma on a yearly basis in compliance with the Federal Law on the Central Bank of the Russian Federation (Bank of Russia), deals in detail with all the activities conducted by the Bank of Russia to perform the functions assigned to it. This not only represents an element of control over its activity, but also allows the public at large to better grasp the motives behind the specific decisions and actions undertaken by the Bank of Russia throughout the year under review.

In accordance with the Constitution of the Russian Federation, the main function of the Central Bank of the Russian Federation is to protect the ruble and ensure its stability. This can be achieved not only by pursuing balanced monetary and foreign exchange policies, but also by enhancing the efficiency of the country's banking and payments systems.

The objectives and tasks that faced the Bank of Russia in 1998 largely arose from the results of 1997. At the same time, the increased imbalance in the implementation of economic reform, inept structural and tax policies, a chronic federal budget deficit, the accumulation of a huge foreign and domestic government debt, which became increasingly difficult to service, and a significant deterioration of the balance of payments required even at the beginning of 1998 a change in the principles of elaborating and implementing economic policy. However, such changes were not made in time. A sharp exacerbation of the problems in the sphere of government finance made monetary policy even more dependant on the budget situation, which became increasingly connected with the possibility of receiving foreign short-term loans.

The growing distrust of foreign investors in the emerging markets at the time when the world financial crisis was getting worse, a sharp reduction in foreign capital inflows against the background of the worsening economic situation inside the country and the deterioration of world market conditions led to the collapse of the economic policy pursued in Russia and made the implementation of the tasks set forward extremely difficult.

The August 17 statement by the Russian Government and Central Bank was a kind of watershed which divided the entire year, 1998, into two fundamentally different periods in terms of all indicators and tendencies. The depth and intensity of the crisis, which hit the country's economy and population in 1998, prompted the Bank of Russia to pay special attention in its report to the analysis of the causes and consequences of the economic and financial crisis in Russia.

In August—September 1998 the national currency lost much of its value, the payments system came to a virtual standstill, creating problems for the real economy, and the state of the banking system deteriorated significantly. All of that created serious difficulties for pursuing macroeconomic and social policy in the country.

In September, the Bank of Russia began to pursue a purposeful policy aimed at restoring the payments system and normalising the situation in banking. In that situation, the Bank of Russia was confronted in implementing monetary policy with the need to tackle strategic and tactical problems that sometimes were in contradiction with one another. Thus, on the one hand, the Bank of Russia had to pursue a tight monetary policy in order to prevent a further fall of the national currency and to stem inflation. On the other hand, a full-scale banking crisis and the virtual halting of the settlement system required the adoption of measures to increase banks' liquidity. After the GKO—OFZ market was frozen, Bank of Russia resources remained practically the only means of covering the budget deficit.

The Bank of Russia paid special attention to drawing up a programme for restructuring the banking system. At the same time, it provided financial support to the banks that had an important role to play in restoring the country's payments system and preventing systemic and social risks. On the one hand, the Bank of Russia sought to prevent the collapse of the banking system in order to ensure the normal functioning of the country's economy in the future; on the other hand, it liquidated banks that had lost their capital and liquidity and violated banking legislation.

The devastating consequences of the crisis principally impacted the Bank of Russia's balance sheet because of a sharp rise in the Finance Ministry's debt to the Bank of Russia, which resulted from the failure to meet its obligations. The measures implemented by the Central Bank to stabilise the macroeconomic situation in the country helped prevent hyperinflation, further destruction of the economy, sovereign default on foreign debt and the bankruptcy of the banking system. However, they had a negative effect on the structure of the Bank of Russia's balance sheet and on financial results. As a result, the Central Bank of the Russian Federation closed the year, 1998, with a loss.

Yet, thanks to the actions taken by the Bank of Russia, the macroeconomic results of the year were better than those predicted by many economists. The most pessimistic forecasts of the inflation and exchange rates did not come true.

In its report for 1998, the Bank of Russia adheres to the principle of transparency and openness with regard to its work, ensuring that the description of the results of its activity approximates international standards.

**RUSSIA'S
ECONOMIC AND
FINANCIAL POSITION
IN 1998**



I.1. AN OVERVIEW OF THE SOCIAL AND ECONOMIC SITUATION IN RUSSIA

THE PROCESSES that characterised the state of the Russian economy in 1998 unfolded under the impact of the developments connected with the outbreak and aftermath of budget and financial crisis, and an adverse situation in the world market.

Signs of macroeconomic instability, caused by both internal and external factors, appeared even in the first half of the year. It became manifest in the following trends:

- imbalances increased in the tax and budget sphere as efforts to meet budget revenue targets and, consequently, make planned expenditures and service state debt failed;
- GDP decreased;
- the financial state of enterprises deteriorated and mutual non-payments grew;
- capital investment declined;
- indicators characterising the standard of living worsened;
- a current-account deficit developed and started to grow.

On the whole, compared with 1997, GDP shrank by 4.6%; of this, added value in the manufacturing sector decreased by 6.8% and in the services sector by 1.8%.

Price dynamics was one of the main factors that determined the general economic situation and the situation in all sectors of the economy in the second half of the year as a result of the financial crisis.

Inflation in the Russian economy in 1998 resulted from the impact of several factors, such as

price movement in the sectors controlled by natural monopolies, real personal income, the correlation between consumer and producer prices in the manufacturing and services sectors, ruble exchange rate variations, psychological factors relating to consumer motivation, heavy dependence of the domestic consumer market on imports, and so forth.

From January through July 1998 the factors that determined the rates and proportions of the price dynamics caused inflation to subside.

Thus, under the influence of institutional factors, such as presidential and government decrees that were passed earlier to curb price growth in sectors controlled by natural monopolies, producer prices fell by 0.3% compared with the December level. In the same period of 1997, producer prices rose by 6.2%.

The ruble exchange rate to the dollar from January to July 1998 was relatively stable and was regarded as an “anchor” that curbed inflation. As a result, the grossly overvalued rate of the ruble against the dollar in the consumer market served as a restraint on the growth of prices of imports, which met virtually half the demand for consumer goods.

At a time when real household cash income was at a low level, limited demand had no effect on inflation growth.

As a result, in the seven months of 1998 the consumer price index fell to 104.2% from 109.6% in the same period of 1997.

The sharp exacerbation of the financial crisis in August 1998 activated the potential inflationary dangers connected with the dynamics of the ruble exchange rate. The devaluation of the ruble was the main reason why the smooth slowing down of price growth in the first seven months of the year gave way to a surge in prices. It should be noted that inflationary expectations actually became the expectations of a fall in the exchange rate.

Even in August the consumer price index (CPI) amounted to 103.7% and in September it rose to 138.4%. The producer price index increased from 98.8% to 107.5%.

At the beginning of the 4th quarter of 1998 the rate of inflation slowed down and the October CPI fell to 104.5%. Two factors were behind these developments: first, the measures taken by the Bank of Russia put an end to sharp exchange rate fluctuations of the ruble and its dynamics more or less stabilised; second, it was the result of demand restraints in the household sector.

In the next two months, however, inflation quickened to 5.7% in November and 11.6% in December.

Owing to the seasonal price growth at the end of 1998, food prices rose at a rapid rate, while service prices remained virtually unchanged from their normal level.

Owing to the September surge in prices and the accelerated CPI growth in the 4th quarter, year-on-year inflation rose to 84.4% against 11% in 1997.

In the real economy, the price situation was less dramatic: in 1998 producer prices grew by 23.2% (against 7.4% in 1997), although in the machine-building sector they rose by 29.3%.

The gap that developed between import and domestic prices by the end of 1998 created a rather favourable situation for the industries manufacturing import-substitutes. This particularly applied to the light and food industries.

Prices in capital construction went up by 12.1% year on year and freight transport became 16.7% more expensive. It should be noted, however, that as a result of the price regulation measures taken with regard to the natural monopolies the price of transporting cargo by rail fell by 19.4%.

The dynamics of household expenditures on final consumption was determined by the dynamics of personal income and consumer prices.

Nominal personal cash incomes in Russia in 1998 aggregated 1,700.5 billion rubles, an increase of 3.5%, or 57.3 billion rubles, on 1997. The household cash income to GDP ratio in 1998 decreased by 1.9 percentage points compared with 1997, to 63.3%.

Inflation was the main factor which caused a sharp fall in living standards. Compared with 1997, 1998 real household income declined by 18.9%; of this, real imputed per capita average monthly wage fell by 13.9% and real imputed monthly pension decreased by 4.8%.

The share of wage and other social benefits in personal cash income increased from 39.3% in 1997 to 42.4% in 1998 and that of earnings from entrepreneurial activities from 13% to 16.5%. The share of pensions, allowances, students' grants and other social transfers in personal cash income declined from 14.9% to 13.3%, income from property from 5.7% to 5.6% and other incomes from 27.1% to 22.2%.

Differentiation of the personal income of the population remained significant in 1998: 10% of the highest-income population received 32.8% of total cash income (32% in 1997), while 10% of the lowest-income population received 2.4% of total cash income (2.4% in 1997).

Per capita cash income rose by 3.6% from 1997 to 1998, while the per capita subsistence minimum increased by 20%. Low-income segment of the population grew by 4.3 million, or 14%, and 35 million people, 23.8% of the total population, found themselves below the poverty line.

Household expenditures and savings (consumer expenses, compulsory payments, purchase of foreign exchange, deposit growth, and purchase of bonds and other securities) in 1998 totalled 1,672.7 billion rubles, which represents an increase of 3.5% on 1997. The share of consumer expenditures in total personal cash income rose from 67.9% in 1997 to 78.3% in 1998.

In January 1998, real income began to fall, and to manage in that situation, people had to cut savings and spend more on goods and services. An upsurge of inflation at the time of the financial crisis and the scarcity of budget funds, which made it impossible to repay all debts to the popu-

CONSUMER AND INDUSTRIAL PRODUCER PRICE INDEX DYNAMICS (as % of previous month)

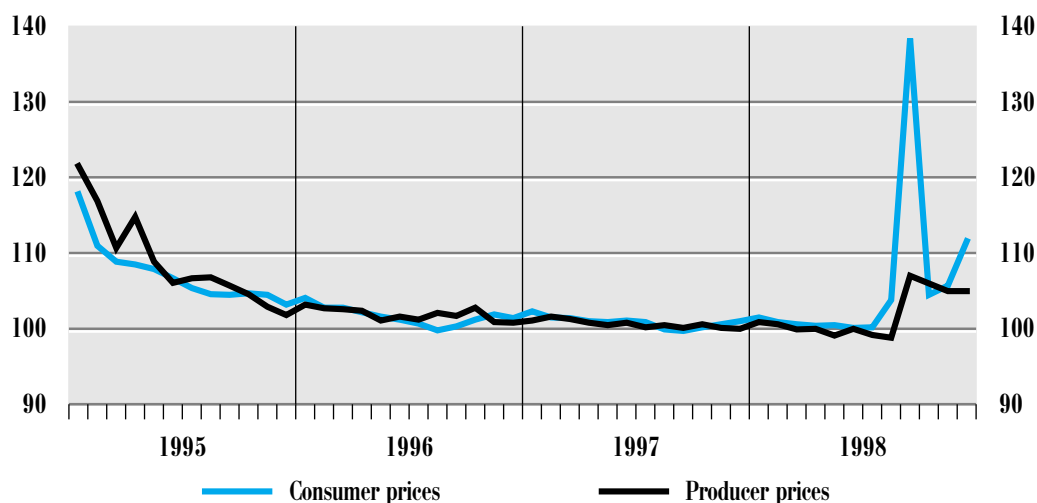


Figure 1

lation or compensate their losses from inflation, resulted at the end of the year in a further drop in real personal income. At the same time, real consumer expenditures tended to fall and that led to a reduction of household expenditures on final consumption.

The year 1998 saw a nominal year-on-year reduction in both revenues and expenditures of the consolidated budget, which began in May. A chronic imbalance between budget resources and obligations and the failure to take effective measures to increase budget revenues and balance out expenditures and revenues led to a growth in government debt. Coupled with its inefficient structure and high cost of borrowings, this provoked a budget crisis. It became impossible for the federal budget to service government debt and ensure an acceptable level of all kinds of expenditures, including those taken into account in calculating the final consumption of the public sector governance.

Despite a reduction in expenditures on household consumption in real terms, more rapid growth in consumer prices than other prices kept high the share of expenditures on consumption in the structure of utilised GDP. Compared with 1997, it rose by 1.7 percentage points to 75.9%.

Thus, Russia spent more than three-quarters of her GDP on consumption, further sapping the reproductive potential of her economy and wrecking its chances for growth in the future.

The deterioration of the economic environment in 1998 led to the reduction of the reserves of tangible working assets and gross fixed capital accumulation. As a result, the share of gross accumulation in the structure of utilised GDP shrank by 6.6 percentage points to 16.2%.

The dynamics of gross fixed capital accumulation was determined by the situation in the investment sphere. Throughout the first half of 1998, the decline in investment dynamics had a tendency to slow down, but the August crisis changed the investment situation from bad to worse. As the inflation background changed dramatically, forcing the government to cut budget support for investment programmes, the financial condition of enterprises deteriorated and the banking system had to reduce their credits. Investment in fixed capital further decreased.

In the 4th quarter, the investment decline quickened its pace and year-on-year investment fell from 5% to 6.7%; at large and medium-sized enterprises, investment declined by as much as 9.9%. It should be noted that compared with the previous year, investment in fixed capital decreased in nominal terms as well, falling to 402.4 billion rubles.

Enterprises' own funds remained the principal source of financing fixed capital investment. As before, bank loans represented a negligible source of financing investment.

REAL HOUSEHOLD DISPOSABLE INCOME DYNAMICS (as % of corresponding month of previous year)

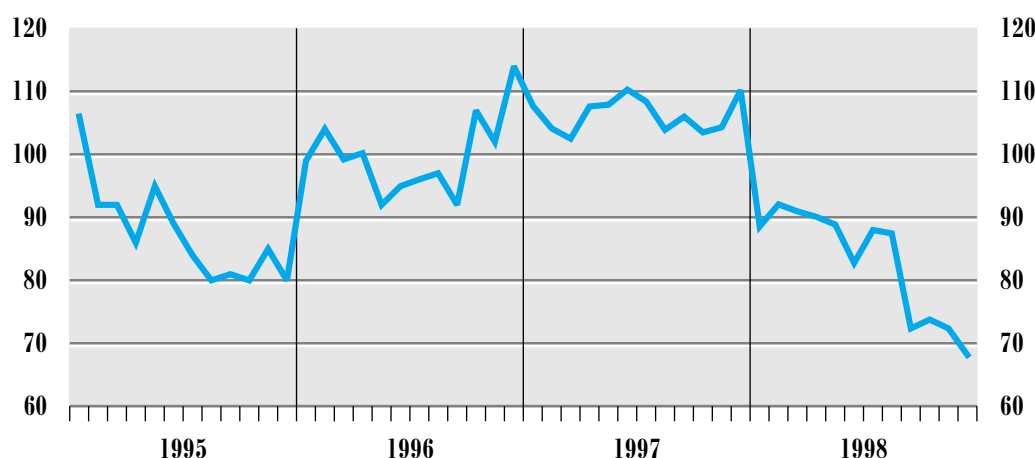


Figure 2

Despite the deteriorated investment climate and the overall reduction in investment at large and medium-sized enterprises by 12.4%, investment activity did rise in the printing, food and medical industries, the ferrous metallurgy sector and communications.

Overall, gross fixed capital accumulation in the structure of GDP use decreased by 1.8 percentage points to 17.5%.

The analysis of change in the structure of Russia's GDP during the year shows that the exacerbation of domestic problems in 1998, the worsening of the situation in production and finance and the deterioration of the world market situation changed Russia's foreign trade position, adversely affecting the balance of payments indicators in the first half of the year. After the ruble was devalued, imports started falling more rapidly than exports and year-on-year that led to a **growth in net exports**. Compared with 1997, net exports in GDP rose by 4.9 percentage points to 7.8%.

Overall, change in GDP volume in 1998 resulted from a 26% reduction in industrial production, 5% fall in agricultural output, a decrease of 7% in construction, a 16% decline in trade and the public catering sector, a 12% drop in the provision of transport services and a 12% increase in the provision of communications services.

The main factors that affected production dynamics in the real economy last year were the reduction of solvent demand in the domestic mar-

ket and the fall in the prices of products that constitute the basis of Russian exports.

Throughout the year the output of goods and services had a tendency to fall, which increased in the second half of the year as a result of the budget and financial crisis.

Industrial output in 1998 shrank by 5.2% year-on-year. The most significant decline in production was registered in the 3rd quarter when output fell by 11.8% as compared with the same period of 1997. However, in subsequent months, output increased a little and in December it exceeded the September level by more than 17%.

During the year as a whole, no Russian industry registered growth in output. However, the enterprises with access to foreign markets were better off. Production intensity in the fuel and energy sector, timber, wood-working and the pulp-and-paper industry did not change much from 1997 levels largely thanks to significant export deliveries.

Output fell significantly in the metallurgy, machine-building and metal-working sectors, chemical and petrochemical industry and also the light industry, and production decline in these sectors further accelerated after the crisis.

Enterprises oriented primarily to the domestic market (machine-building and light and food industries) could have benefited by the growth in demand caused by a significant difference in the prices of similar domestic and imported prod-

GDP AND INDUSTRIAL PRODUCTION DYNAMICS (as % of corresponding month of previous year)

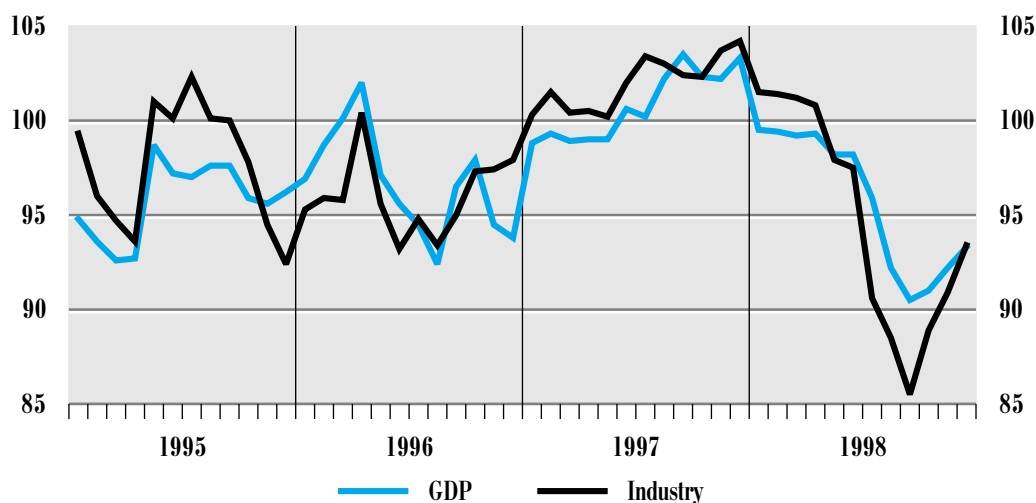


Figure 3

ucts. But they didn't because of their heavy dependence on imported raw materials.

Although the ruble devaluation greatly reduced competition from imports, Russian industry failed to make significant progress in the production of import-substitutes.

As for other sectors of the economy, mention should be made of a slight slowdown of production decline in the livestock sector of Russian agriculture. However, due to a significant fall in output in the crop-growing sector, the overall level of production in agriculture declined by 12.3%.

The production decline in the real economy accelerated the rate of recession in transport and the deterioration of railway transport performance indicators had an especially adverse effect on the overall situation in the sector.

Despite the changed economic conditions and production decline in 1998, **employment** trends did not change much from the previous year. The number of economically active population decreased over the year by 300,000 to 72.2 million, while the number of employed persons decreased over that period by 1.1 million, to 87.7% of the economically active population.

The structural changes in employment, typical of the last few years, continued in 1998. Thus, as the number of workers and employees in the

farm sector, construction, industry, research institutions and transport declined, the number of people engaged in general market-related commercial activities, the real estate business, housing maintenance and communal services, and administrative bodies at all levels, kept growing all the time. The only industry in which the number of workers continued steadily to rise was power engineering.

As the financial and economic crisis worsened, industrial enterprises and organisations wound up or curtailed their activities, especially in big cities. As a result, at the end of the year the overall number of unemployed, calculated using ILO methodology, rose by 9.8% year-on-year to 8.9 million, or 12.4% of the economically active population (at the end of 1997 Russia had 8.1 million unemployed, or 11.2% of the economically active population).

After a fairly long period of decline, in September 1998 the number of officially registered unemployed began to grow each month and at the end of the year amounted to 1.93 million, or 2.7% of the economically active population. This represents an increase of almost 10% when compared with the end of September 1998.

Some changes were registered in the dynamics of part-time employment¹. In December 1998,

¹ Part-time employment means working shorter workdays or workweeks with holidays unpaid or partly paid by employers.

UNEMPLOYMENT RATE BY ILO METHODOLOGY (as % of economically active population)

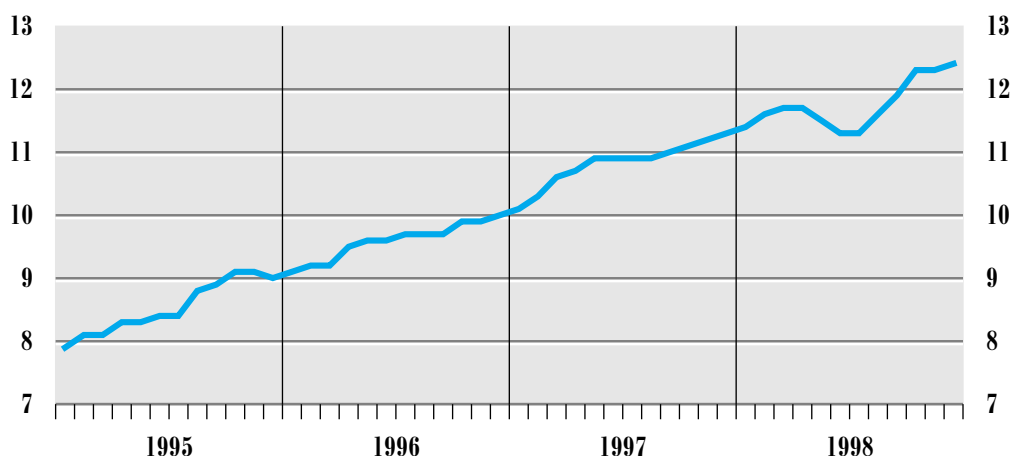


Figure 4

the number of part-time workers totalled 2 million, or 4.8% of the average workforce employed by large and medium-sized enterprises. This represents a fall of about 23% when compared to December 1997. However, the number of part-time workers and employees in the communications sector, education, health, physical culture and social welfare, culture and the arts and also in organisations engaged in general market-related commercial activities and real estate operations grew significantly.

The reduction in demand for workers by enterprises and organisations, which began in July–August 1998, continued until the end of November. At the end of December the demand for workers slightly increased, but that did not reduce the unemployment-vacancy ratio, which rose from 6 persons per vacancy at the end of 1997 to 6.6 persons per vacancy.

The average job-seeking period in 1998 was seven months, but one in five officially registered unemployed took more than a year to find a job.

The worsening of the macroeconomic situation adversely impacted the **financial performance of enterprises** even in the first half of 1998. Profit received by large and medium-sized enterprises and organisations¹ during the eight months of 1998 (that is, before the budget and financial crisis) was in nominal terms 42.2% smaller than profit received during the same pe-

riod of 1997. Compared with the end of August 1997, the proportion of enterprises operating at a loss among total enterprises increased by 3.6% in industry and 0.4% in construction.

In the latter half of the year, the financial condition of enterprises changed for the worse largely because of inflation, changes in the level and structure of expenditures and a contraction of solvent demand in the economy. From September to December 1998 positive financial results in industry were registered only in November, while trade and public catering began to function at a loss.

Overall, large and medium-sized enterprises in 1998 posted a dead loss of 34.6 billion rubles, of which a loss in agriculture amounted to 35.0 billion rubles and in trade and public catering 17.4 billion rubles.

Aggregate yearly profit in industry, construction and transport amounted to 28.3 billion rubles in current prices against 109.8 billion rubles in 1997. As for industry, it made a dead loss of 4.7 billion rubles. In December 1998, the provision of industry with orders to fill fell to a two-year low of 1.4 months. Over the year, the proportion of profit-making enterprises overall in construction and transport rose by 0.5% and 2.6% respectively, while in industry it fell by 1.9%. Consequently, the efficiency of profitable enterprises in these sectors declined.

¹ Excluding agriculture.

Debt continued to grow in 1998. At January 1, 1999, overall debt on obligations in industry amounted to 1,524.2 billion rubles, while receivables totalled 773.2 billion rubles; in transport, the respective figures were 290.0 billion and 244.3 billion rubles, and in construction 195.6 billion and 131.3 billion rubles. Debt on obligations in comparable prices, rose in construction over the year by 49.7% and receivables grew by 33.3%, in industry by 24.6% and 13.9% and in transport by 9.9% and 10.9%.

The share of nonpayments in the main types of debt of industrial, construction, transport and agricultural enterprises continued to grow and the proportion of overdue obligations was particularly big in the debt on payments to the budget and extrabudgetary funds, that is, obligations that must be met in cash only. As of December 31, 1998, these proportions were 78.8% and 82.0% in agriculture, 73.4% and 79.5% in industry, 72.3% and 77.8% in construction, and 69.2% and 67.4% in transport. The growth in the overdue part of obligations on settlements with the state is attributable, to some extent, to the imposition of fines, which is not the case with mutual debts between enterprises. Thus, as of December 31, 1998, the ratio of fines, penalties and other sanctions to the overall amount of overdue debt in a group of enterprises surveyed by the State Statistical Committee, or Goskomstat¹, was as follows: 26.6% on payments to the budget, 41.8% on payments to extrabudgetary funds and only 0.9% on settlements with suppliers and contractors.

In December 1998, large and medium-sized enterprises reduced, as they did in December of the previous years, the nominal level of their debt on payments to all budgets (by 4.2%).

From October 1998, the debt on wages and salaries, accumulated, because enterprises lacked the funds to pay, began to shrink, and in December the debt resulting from underfinancing from all budgets, especially local ones, also decreased. From October through December overall debt declined by 11.1 billion rubles, or 12.6%.

However, unlike the debt on settlements with the budget and extra-budgetary funds, that fairly solid reduction of the wage arrears of enterprises and organisations was more than a seasonal phenomenon. It could be attributable to growth in the cash asset base of enterprises: the share of cash in the structure of working assets increased from 1.9% at the end of the 1st quarter to 3.5% at the end of the year. It should be noted that this share rose particularly in the export-oriented sectors, which received a part of their earnings in foreign currency and had the opportunity to repay their ruble-denominated debt to workers by selling foreign-exchange earnings at a lower ruble exchange rate.

In 1998, debt on obligations owed by enterprises rose faster than their working assets. One of the reasons was significant deterioration of the financial performance of enterprises and, consequently, the increased importance of borrowings for production. Transport was the only basic industry that ended the year with fairly good financial results: profit fell by only 2.5% in comparable prices (railways even managed to increase profit), while the growth in debt on obligations lagged behind the growth in working assets.

In the second half of the year, the growth in debt on obligations was seriously affected by growth in the debt on loans, resulting from the increase of the ruble equivalent of loans denominated in foreign currency in the course of the ruble devaluation. In industry, this kind of obligations rose, by comparable estimate, by 2.1 times against the December 1997 level and in construction by 3.5 times. The share of debt on loans in the total debt of enterprises increased in core sectors of economy from 11% at the beginning of the year to 18% at the end; of which in industry — from 13% to 20%.

As borrowings grew faster than working assets, sector solvency, measured by the cover ratio², declined in all basic industries, except transport. In agriculture the cover ratio dropped during the year by 28.1% to 105.3% as of Decem-

¹ Russian Government Resolution No. 10, dated January 6, 1998, requires statistical monitoring of settlements effected by the major Russian taxpayers, such as the Unified Energy Systems, Gazprom, Aeroflot, federal railway transport organisations and other enterprises in the sectors controlled by natural monopolies.

² The cover ratio is calculated as the ratio of working assets to short-term liabilities. Russian Government Resolution No. 498, dated May 20, 1994, set the required cover ratio at 200%.

ber 31, 1998, in industry by 3.4% to 100.7% and in construction by 2% to 119.5%. By contrast, in transport it rose by 11.5% to 126.6%.

The state of the **foreign economic sphere** in 1998 was one of the chief factors that determined production and aggregate demand dynamics in the Russian economy.

Adverse external influences, compounded by the critical state of the Russian economy, further weakened Russia's positions in the global system of foreign economic relations. Compared with 1997, Russia's share of world trade contracted from 1.45% to 1.25%.

It should be emphasized that Russia's foreign trade turnover declined for the first time since 1991. Balance of payments data show that last year Russia's foreign trade turnover amounted to \$132.2 billion, a fall of 18% from 1997, in which trade turnover registered by the State Customs Committee made up \$114.9 billion. These trends are attributable to a fall in exports and also an almost 50% decrease in imports, registered after the August 1998 crisis.

As before, foreign economic relations played a decisive role for some sectors of the Russian economy. As was the case in the previous years, in 1998, also, production in some industries was largely oriented to foreign markets. For example, 47% of oil and 36% of gas produced in Russia was exported. Therefore, export-oriented enterprises depended to a great extent for their financial results on the effectiveness of their foreign trade activities.

In 1998, Russia continued to be critically dependent, by international standards, on the import of foodstuffs, medicines and consumer goods, but in the second half of the year the share of imports consumed started to fall. According to Goskomstat, imported goods accounted for 47—48% of retail trade turnover in the first half of the year, but in the second half it declined to 42—37%.

Foreign economic activity remained a major source of federal budget revenues. In 1998, customs duties, dues and payments, excise duties on imports and exports and other tax and non-tax receipts from foreign economic activities accounted for a large part of budget revenues.

At the same time, the critical state of the balance of goods and services in the first half of the year, when its surplus amounted to only \$150 mil-

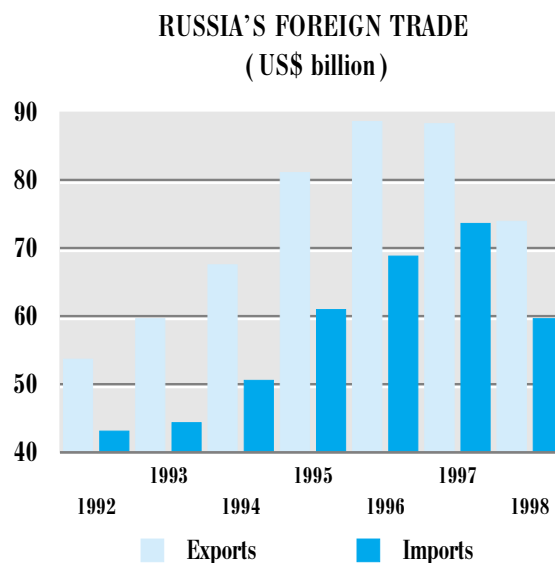


Figure 5

lion, increased pressure on the exchange rate of the ruble and eventually led to its devaluation, making it even more difficult for Russia to service its foreign debt.

Balance of payments data indicate that in 1998, Russian exports totalled \$74.8 billion, a drop of 16% compared with 1997, when registered by the State Customs Committee made up \$71.3 billion.

The main reason for negative trends in Russian exports was a fall in world energy prices. The average price of Brent in 1998 was 33% lower than its average price in 1997; also the gas prices fell by 17%. An unfavourable situation also persisted in the world's markets for non-energy products. In 1998, world market prices, weighted by the structure of Russian exports, were more than 20% lower than in 1997.

Before the August 1998 events, the adverse effect of extremely low world prices on Russian exports was made worse by the maintenance of an overvalued ruble. In that period, even the export of such highly profitable products as oil and gas yielded minimal profit. According to Bank of Russia estimates, before September 1998 from 50% to 60% of Russian exports brought no profit. Production and export costs exceeded export receipts by more than 10%. In that situation, exports survived thanks to guaranteed and timely payments in foreign exchange at the time when the domestic market was overwhelmed by nonpayments, barter and money substitutes.

BRENT BLEND OIL PRICE DYNAMICS (US dollars per barrel)

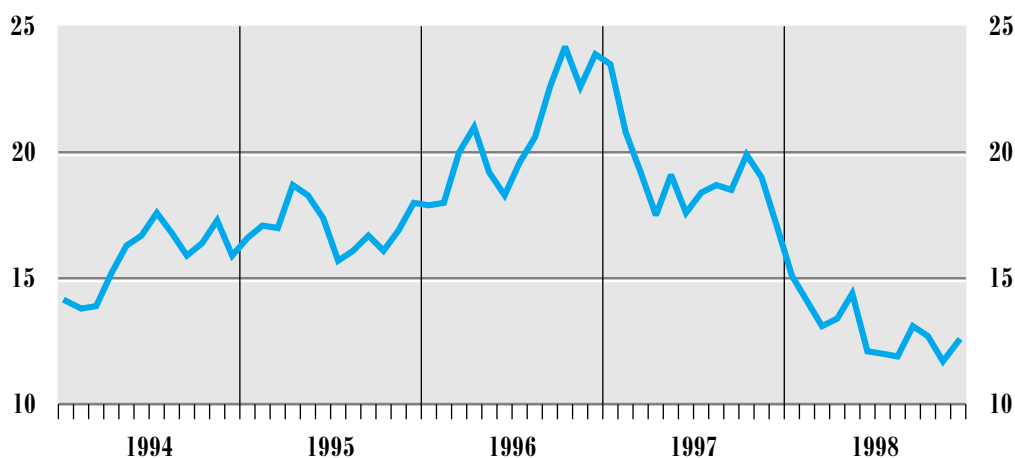


Figure 6

Export efficiency started to grow in August when the ruble was sharply devalued in real terms. According to Bank of Russia estimates, in September export earnings from the commodities surveyed exceeded aggregate cost by 50%. By the end of the year, however, the growth in the prices of principal cost components reduced this difference.

The increased competitiveness of Russian commodities in foreign markets caused no fundamental change in Russian exports and their dynamics continued to be determined by the situation in world commodity markets. A general downturn of activity in world markets in 1998 did not allow Russia to use to a full extent the competitive benefits of devaluation.

Evaluating foreign trade conditions of that period, we should note that when the world economy is hit by crisis, the governments of many countries, including the industrialised nations, increasingly resort to protectionist measures to help domestic producers. In 1998, restrictive and even discriminatory measures were widely used against Russian commodities, such as ferrous metals, chemicals and light industry products, and that also had a negative effect on Russian export volumes.

At the same time, one of the main obstacles to Russia's integration in the world economic community was removed in 1998: the EU Commission decided to delete Russia from the list of the countries with non-market economies.

As was the case in the preceding years, in 1998 the restoration and boosting of foreign trade relations between Russia and CIS countries was hampered by old debts on products delivered to CIS countries, tax problems and the lack of agreement on customs tariffs.

In the service sector, the contraction of service exports in 1998 largely resulted from the loss by Russian transport companies of their positions in foreign and domestic markets.

Balance of payments data show that imports in 1998 amounted to \$57.4 billion, a fall of 20% against 1997, of which imports registered by the State Customs Committee amounted to \$43.6 billion.

In early 1998, imports kept growing at relatively rapid rates owing to the overvalued ruble, which ensured high margins on import operations. The real devaluation of the ruble, which began in August, changed import dynamics dramatically. As foreign exchange became more expensive for Russian consumers, household disposable cash income fell and the buying power of enterprises in the real economy declined, import volumes dwindled by more than half.

The drop in imports was a mixed blessing for this country's economy. On the one hand, the ruble devaluation made imports more expensive and Russian goods more competitive, creating conditions for the expansion of facilities to produce import substitutes. On the other hand, enterprises oriented to the use of imported equip-

ment, raw materials and spare parts faced serious problems. Heavy dependence on imports created the danger of shortages of food and other staple goods.

The decline in the household purchasing power of the population after the August 1998 crisis caused a sharp fall in the import of services at the end of the year. Thus, the devaluation of the ruble brought about significant improvement in the balance of goods and of services.

Balance of payments statistics show that the balance of trade surplus in 1998 amounted to \$17.3 billion, only \$100 million less than in 1997. The balance of services deficit decreased from \$4.7 billion in 1997 to \$3.2 billion in 1998. As a result, the surplus of the balance of goods and services amounted to \$14.2 billion, exceeding the 1997 level.

As Russia's foreign exchange receipts from foreign trade increased throughout the year, the inflow of foreign currency from other major sources, including loans and investments, ran out. The dwindling of foreign exchange inflow affected all sectors of the Russian economy.

The crisis in the Russian financial market, the imbalances in its sectors, and the suspension of a portion of the country's foreign debt payments caused foreign investors to distrust the Russian economy and finance and investment risk rose sharply. International rating agencies repeatedly downgraded the ratings of Russia and its regions, companies and banks. Russia's chances to receive loans from international financial organisations worsened, and the price of placing eurobonds rose for federal and local governments. As the government securities market came to a halt, portfolio investment volume shrank significantly.

The three-month moratorium on payment of private foreign debts encouraged rather than stopped capital outflow from the banking sector.

As a result of the crisis, Russian capital investment in foreign economies decreased in 1998. There was a reduction in the volume of direct and portfolio investments by Russian companies and, to a lesser extent, in the volume of commercial loans and advances to nonresidents. Household investments in foreign exchange declined for the first time since 1995.

However, that trend came to an end in the 3rd quarter when expectations of devaluation and

the beginning of a sharp fall in the value of the ruble caused demand for foreign exchange to rise again. Increased foreign exchange control and overall reduction of foreign trade turnover in 1998 lessened capital outflow in the form of non-returnable export earnings and non-delivery of goods and services in payment for import advances.

Despite favourable dynamics of the balance of goods and services and the reduction of Russian capital investments in foreign economies, the overall decline in Russia's foreign exchange receipts in 1998 was accompanied by a growing need for foreign exchange, especially because of the growth in government and, primarily, non-government debt. As a result, the foreign-exchange position of the country deteriorated and a significant shortage of foreign-currency resources developed.

CAUSES AND CONSEQUENCES OF THE ECONOMIC AND FINANCIAL CRISIS IN RUSSIA

Summing up the results of 1998, we should make special mention of the causes and consequences of the financial crisis, which determined, to a great extent, the state of the Russian economy.

In 1998, the Russian economy functioned under difficult financial and economic conditions. Since the end of 1997, it has been adversely affected by the international financial crisis, growing investor distrust in the emerging markets, Russia included, the loss of confidence in ruble-denominated instruments and a sharp reduction of foreign capital inflow. A fall in the world prices of major Russian export commodities led to the deterioration of the country's balance of payments indicators.

However, the main causes of the deepening of the financial and economic crisis were the internal factors connected with an imbalance that had developed by that time in the implementation of economic reforms.

The weakness of the structural and tax policies, a chronic deficit of the federal budget, the accumulation of a huge foreign and domestic government debt and the lack of funds to repay it significantly exacerbated the situation inside the country. Growing problems in the field of gov-

ernment finance increased the dependence of monetary policy on the budget situation.

The budget crisis, which became manifest even in the first half of the year, was accompanied by a policy of maintaining an overvalued exchange rate of the ruble and sharp growth in interest rates. By August, the burden of servicing domestic government debt and the pressure exerted on the ruble in the foreign-exchange market increased to such an extent that the financial markets collapsed.

The crisis of the financial market was intensified by the latter's inherent problems resulting from immaturity — the range of market participants was rather narrow and credit and other financial institutions were not financially stable enough by international standards.

As the crisis worsened, a gap widened between the expectations of market participants and the official targets of regulatory bodies (the rate of inflation, exchange rate, interest rates and budget indicators). Since market participants elaborated a new market strategy on the basis of these expectations, its implementation created an imbalance between various sectors of the financial market, the market index correlations that formed under relatively favourable conditions were disrupted and the established cyclical patterns of their movement changed. As a result, the market situation became further destabilised, while the financial markets, which used to be a means of implementing the official monetary and exchange-rate policy, became a factor impeding the implementation of this policy.

By the middle of August, the banking liquidity situation had sharply deteriorated, the interbank credit and government securities markets came to a virtual halt, the payments system became paralysed, while the continued implementation of the policy of artificially keeping up an overvalued exchange rate by conducting currency interventions led to rapid depletion of the Central Bank's international reserves.

On August 17, the Bank of Russia changed the parameters of its exchange-rate policy and reviewed the limits of the so-called "currency band". It also changed the mechanism to set the ruble's exchange rate against the US dollar. The official rate of the ruble began to be set on the basis of trading on the Moscow Interbank Cur-

rency Exchange (MICEX). The refusal by the Russian government to honour its domestic government debt obligations at the time of economic uncertainty meant that investment in foreign exchange, especially the US dollar, became the most attractive form of assets practically for all economic agents, including individuals. That increased pressure on the ruble and kept devaluation expectations high.

In that situation, the Bank of Russia remained practically the only seller of foreign currency on the exchange. Panic buying of foreign exchange increased after the federal government resigned. The international reserves of the Bank of Russia continued to decrease. In July and August the Central Bank spent nearly \$9 billion from foreign exchange reserves to buttress the ruble rate, but neither currency interventions nor raising interest rates on Bank of Russia loans nor the Central Bank's efforts to withdraw liquidity by attracting funds to Bank of Russia deposits could prevent the situation from getting worse. On September 1 the Bank of Russia declared that it had given up its policy of keeping up the exchange rate by extensive currency interventions and would resort to limited interventions only to smooth over extremely sharp fluctuations of the ruble rate, and switched to a floating exchange rate regime.

The devaluation of the ruble provoked a surge of inflation, made it increasingly difficult for the economy to raise funds in the market, accelerated economic recession, increased social tension and undermined public confidence in the financial system and banks.

That situation dictated the need to review the parameters of economic policy pursued and take urgent stabilisation measures.

ANTI-CRISIS MEASURES

To overcome an acute liquidity crisis in the banking system and restore an efficient payments system, the Bank of Russia in August and September reduced and temporarily differentiated the required reserve ratios for the banks and in September and October conducted a series of multi-lateral interbank clearing operations.

Those measures made it possible to restore the payments system and identify net creditor banks and net debtor banks in order to work out an ef-

fective solution to the banking liquidity problem and thus mitigate the adverse after-effects of the crisis.

After the August 17 events, the Bank of Russia Board of Directors urgently took steps to change the existing bank refinancing mechanism in order to make it more relevant to the situation.

Since the interbank credit market and government securities market were virtually dead, the Bank of Russia had to change the mechanism to re-allocate resources in the banking sector, regulate liquidity and use new methods of securing loans lent to banks. To this end, the Central Bank decided to issue its own bonds in order to be able to continue the practice of regulating banking liquidity.

In accordance with the decisions of its Board of Directors, the Bank of Russia extended loans to back up measures to meet obligations to depositors, maintain liquidity and increase financial stability and credited banks that rehabilitated problem banks.

The measures taken by the Bank of Russia in September 1998 to restore the payments system yielded first results in October and some other favourable developments were registered by the end of the year.

The last months of 1998 were characterised by a significant rise in the level of liquidity of the banking system. Before August, the average level of balances in commercial banks' correspondent accounts with the Bank of Russia fluctuated between 10 billion and 14 billion rubles, whereas after August it exceeded 25 billion rubles.

In August, financial problems worsened to such an extent that a systemic crisis developed. It became manifest in decapitalisation and the loss of liquidity by many credit institutions, especially large banks with numerous branches throughout the country, a sharp fall in customer confidence in the banking system, virtual closure of the interbank credit market, securities market and financial derivatives market, panic-driven withdrawal of clients' funds from accounts in credit institutions, widespread delays in routing client payments and a massive transfer of clients to the banks that had retained financial stability.

In that situation, the Bank of Russia made special efforts to restore confidence in the national banking system and ensure its further develop-

ment. From this viewpoint, the Bank of Russia did the right thing when it urgently conducted multilateral interbank clearing operations, made an emergency review of the required reserve ratios and extended loans to some banks for financial rehabilitation.

In September and October, the Bank of Russia worked out quickly and began to implement a programme for pulling the banking system out of the crisis.

It introduced provisional regulating standards for banks to comply with during the financial crisis, creating favourable conditions for the formation of authorised capital by credit institutions and conducted the transfer of household deposits from a number of financially troubled banks to the Savings Bank (Sberbank).

In addition to the measures taken to restore liquidity and the payments system and normalise the work of the foreign exchange market, the Bank of Russia drew up a programme for restructuring the Russian banking system, which was approved by the Bank of Russia Board of Directors and the Russian government presidium in November 1998, initiated and took practical steps to set up an Agency for Restructuring Credit Organisations (ARCO), and provided a legal, regulatory and economic basis for its work.

In that period, the Bank of Russia considered it important to create a favourable macroeconomic environment for restoring and promoting the development of the financial and foreign exchange markets. Specifically, it took, within its competence, a series of regulatory measures to ensure that export earnings are transferred to Russian bank accounts fully and in time, providing a basis for a stable and predictable inflow of foreign exchange to the domestic market and the creation of a mechanism to regulate the foreign exchange market.

The Bank of Russia focused its efforts to achieve the following objectives:

- increase exporters' responsibility for failure to repatriate foreign exchange earnings in time;
- make simpler the technique of transferring a certificate of export delivery transaction from one bank to another;
- changing temporarily the system of trading on MICEX in order to separate trade in foreign exchange in export-import and other operations;

- tightening controls aimed at detecting violations of foreign exchange legislation, toughening penalties imposed on violators and working out measures to improve the quality of foreign exchange regulation;
- introducing in October the requirement for compulsory sale of foreign exchange earnings by exporter enterprises;
- setting limits on the conversion of nonresidents' ruble returns from operations with treasury bills (GKO) and federal loan bonds (OFZ) into foreign currency and their transfer from the country by introducing transit accounts (in November 1998).

These efforts ensured a sustained and massive inflow of foreign exchange and stabilised the repatriation of exporters' foreign exchange earnings and the amounts of compulsory sales of foreign currency at special trading sessions on inter-bank currency exchanges. In November foreign exchange receipts came close to \$4 billion, the pre-crisis mid-summer level.

The payments and settlements system was restored on the whole and the servicing of export-import operations of the banks' clients improved.

The transition to a floating exchange rate and the renunciation of massive currency interventions in the market not only ended the reduction of the international reserves, but also allowed the Bank of Russia to provide a part of its foreign exchange reserves to the Finance Ministry to repay and service foreign government debt.

Thus, within a fairly short space of time the Bank of Russia managed to restore the payments and banking systems and the foreign exchange market.

As a result of the measures taken at the government level to stabilise the financial and economic situation, the main macroeconomic indicators at the close of the year proved better than had been predicted at the height of the crisis.

The Russian Government and Bank of Russia Board of Directors drafted a document entitled "On Measures Taken by the Government and Central Bank of the Russian Federation to Stabilise the Social and Economic Situation in the Country," and in December 1998 the Government approved a Plan of Action to implement that document, which envisaged a series of measures to ensure further recovery from the crisis.

1.2. GLOBAL ECONOMIC TRENDS

GDP DYNAMICS. The crisis in South East Asia, financial upheavals, the fall in the world price of oil and other raw materials and the decline in production and domestic demand were the main causes of a slowdown in the rates of growth of world GDP in 1998. Economic and financial troubles in some developing and transitional-economy countries had caused a destabilisation of the entire world economy.

In 1998, GDP grew by 2.5% against 4.2% in 1997. In the industrialised nations GDP growth slowed from 3.2% in 1997 to 2.2%, in the developing countries from 5.7% to 3.3%, with the countries of Asia registering a slowdown in GDP growth from 6.6% to 3.8%, Middle and Near East countries from 4.4% to 2.9% and Latin America from 5.2% to 2.3%. In the transitional-economy countries GDP growth in 1998 was negative (—0.2%), whereas in 1997 it was 2.2%. In the countries of Central and Eastern Europe, excluding Belarus and Ukraine, GDP grew by 2.6% against 3.5% in 1997.

The US economy in 1998 experienced growth as it passed the upper phase of the cycle. Sustained domestic demand drove the dynamics of the economy. Exchanges registered growth in individual operations. The share of portfolio investments as a percentage of personal income rose to a level unheard-of since the early 1960s. Corporate capital investment grew, especially in information technology. However, that recovery was practically brought to nought by small growth in exports, the rise of the dollar and the decline in external demand, which caused the current-account deficit to increase. Industrial production growth was at the level of 1997, though the fall in the prices of oil and other raw materials caused the inflation rate to slow down throughout the first half of 1998. In the second half there appeared some signs of a decline in business activity, mainly because of the reduction of exports and capital investment by enterprises. Exports kept falling in the 3rd quarter because of sagging demand in foreign markets and even though the rate of economic growth in the United States had

slowed down a little by the end of the year, GDP growth over the year was 3.9%, just as in the previous year.

The economic situation in Japan remained difficult. In 1998, Japan's GDP shrank by 2.8% compared with 1997 and no government incentives could prevent further recession. The number of bankruptcies increased, exports declined and consumer and investor confidence flagged. Unresolved problems in the banking sphere and consumer and investor distrust led to a substantial fall in private expenditures. As a result of a sharp fall in land and share prices, credit conditions, which began to deteriorate in the middle of 1997, grew even worse.

In the euro-zone countries, GDP rose by 2.5% in 1998 against 2.9% in 1997. The negative impact of the Asian and Russian crises on EU countries' exports was to a great extent mitigated by improved conditions of trade, the reduction of long-term interest rates and increased demand in other markets. The implementation of convergence measures before the introduction of a single European currency considerably safeguarded these countries against the negative impact of external factors.

The euro-zone was switching to a single currency. In the last months of 1998 short-term interest rates in the euro-zone approached those in Germany, France and other countries which form the nucleus of European integration, and on December 3 the official interest rate was lowered from 3.3% to 3%. That was done because external conditions had deteriorated and made it necessary to ensure such growth in domestic demand as would shore up economic activity.

DOMESTIC DEMAND. Retail trade turnover in 1998 rose by 8% in the United States and 1.5% in the 11 member-countries of the European Economic and Monetary Union, of which France registered a growth of 1.5% and Germany 1%. In Britain, sales grew by 0.7%, in Australia 3.1% and in Canada 0.7%. In Japan sales declined by 3.7%.

In their survey for 1998, assessing prospects for economic development of Western Europe,

UN Economic Commission experts noted the slackening of business activity in Britain and cyclical recession in Germany and France. In other countries of the region business activity remained at a higher level. Although 1998 growth in domestic consumption was below forecast, it was sufficient to cover losses resulting from the decline in export demand. In the first half of the year, Western European countries registered an 11–14% rise (in dollar terms) in demand for imports from Central and Eastern Europe (compared with the same period of 1997). At the same time, Western European imports to Central and Eastern Europe in the 3rd quarter of the year declined mainly because of a fall in the world prices of raw materials, which affected exports from Russia and other CIS countries. Restrictive monetary policies pursued in those countries caused a drop in domestic demand.

Until the summer of 1998, the Asian crisis had made no significant impact on demand in Western Europe. An improvement in trade conditions, resulting from the devaluation of Asian currencies, and the fall of world prices of raw materials stimulated growth in purchasing power and domestic demand in European countries. As a result, European companies' confidence in creating new jobs was the highest in the last six years.

In Japan, 1998 saw a rise in consumer expenditure on goods and services, which was stimulated, among other things, by the implementation of a programme to allocate coupons to the population for the purchase of 770 billion yen worth of goods in the 4th quarter of 1998, although during the first nine months of the year average per family consumer expenditure fell by 1.8%.

The rate of government consumption in the industrialised nations in 1998 stayed as low as in 1997 — 1.0% against 0.9% respectively, in the EU countries it grew from 0.2% to 1.5% and in the euro-zone from 0.2% to 1.3%. After a 0.1% reduction in 1997, in 1998 government consumption in Japan increased by 0.5%. In the United States, growth in government consumption slowed from 1.3% in 1997 to 1.1% in 1998. As for the transitional-economy countries, the Czech Republic slashed government spending for several years and in 1998 it cut government expenditure by 0.5% against 1.8% in 1997, in Hungary government spending doubled (to 2%) and in Po-

land the growth in government expenditure slowed from 3.4% to 1.8%. A deep cut (by 7.0%) was made in government consumption by South Korea (in 1997 South Korean government consumption grew by 5.7%)

The rates of growth in gross fixed capital investment in the OECD countries slowed down on the whole from 4.7% in 1997 to 4.0% in 1998, in the United States last year they quickened from 7.3% in 1997 to 8.9% and Canada registered a growth of 4.9% against 11.4% in 1997.

In the European Union countries gross fixed capital investment increased significantly — to 5% in 1998 against 2.7% in 1997, and the euro-zone recorded growth from 1.9% to 4.4%. Until the middle of the year economic growth in most of the European countries was mainly ensured by the expansion of exports, whereas in the second half of 1998 it was growth in investment in the fixed capital of industrial enterprises that became more important for them, as it was designed to offset the negative impact of the Asian crisis on their exports.

After a 9.5% increase in 1996, investment in fixed capital in Japan declined for two consecutive years — by 3.5% in 1997 and 7.2% in 1998.

As for the transitional-economy countries of Central and Eastern Europe, members of the OECD, in Hungary the rate of growth in fixed capital investment accelerated from 8.8% in 1997 to 12% in 1998, in Poland it slowed down from 20.6% to 14.8%, and the Czech Republic registered a slowdown of 3.0% after a 4.9% drop in 1997.

In Mexico growth in investment in fixed capital slowed from 20.9% in 1997 to 10.7% in 1998 and South Korea in 1998 recorded a 32.3% fall after the 1997 decline of 3.5%.

INFLATION. World inflation rates continued to slow down in 1998. Consumer prices went up by 5.2% against 5.6% in 1997 and 7.5% in 1996. Consumer price growth rates in the industrialised nations slowed down to 1.4% (from 2% in 1997).

US consumer prices in 1998 rose by 1.6% against 2.3% in 1997. The rate of inflation in the United States continued to slow down throughout the first half of last year because of a fall in the prices of oil and basic commodities and cheaper imports resulting from the dollar rise.

Japan's consumer prices grew by 0.6% against 1.7% in 1997.

Inflation rates continued to slow down in EU countries, including the euro-zone. In Germany consumer price growth slowed from 1.8% to 1%, in France from 1.2% to 0.7%, in the Netherlands from 2.2% to 2% and in Spain from 2% to 1.8%. Italy's rate of inflation remained unchanged at 2%. The lowest inflation rate was in France (0.7%), the highest in Portugal (2.8%). The gap between the lowest and highest inflation rates in the euro-zone was 2.1 percentage points (0.8 percentage points in 1997). Seven out of the 11 euro-zone countries registered a slowdown in the inflation rate, in one country inflation remained unchanged, and in three countries (Ireland, Portugal and Finland) inflation rates quickened. There was a wider gap in the EU countries that are not members of the euro-zone. In Great Britain the consumer price index rose by 3.4% (3.1% in 1997), while in Sweden it slipped by 0.1% (0.5% growth in 1997). To fight inflation, Great Britain had to tighten its monetary policy, but in the second half of the year, the inflation rate started to slow down and the Bank of England began to cut interest rates.

In the developing and transitional-economy countries consumer price growth was substantial at 11.2% (11.3% in 1997). However, it was considerably slower than in the mid-1990s, but a great deal faster than in the industrialised nations. In Indonesia consumer prices soared by 57.6% from 6.7% in 1997. In other newly industrialised countries consumer price growth was less significant: 5.3% (2.7% in 1997) in Malaysia, 7.5% (4.4%) in South Korea, 8.1% (5.6%) in Thailand, and 8.9% (5.1%) in the Philippines. China saw consumer prices fall by 0.8% (after a 2.8% growth in 1997) and in Pakistan the inflation rate slowed from 11.4% to 6.2%.

In the countries of Central and Latin America consumer prices rose by 10.2% against 13.7% in 1997. Price growth accelerated in Bolivia, Paraguay and Ecuador. Tight anti-inflationary policy pursued by monetary authorities in Brazil led to a fall in prices there. In other big countries of the region inflation also declined, remaining, however, at a considerably higher level: in Mexico it fell from 20.6% to 15.9%, in Venezuela from 50% to 35.8%. In Argentina the rate

of consumer price growth did not exceed 1% for three years in a row.

In the transitional-economy countries the highest rates of inflation — more than 50% — were registered in Belarus, Romania and Mongolia. In the Czech Republic, Hungary, Poland and Estonia inflation stayed at the level of 10–15% and in Latvia, Lithuania, Slovenia and Croatia below 10%.

The major factors behind the world inflation decline were continued economic growth, the fall in world commodity prices, enhanced budget spending efficiency, especially in the industrialised nations, and the consolidation of independent Western European central banks as European integration proceeded.

EMPLOYMENT. The unemployment rate in the OECD countries in 1998 fell to 6.9% from 7.3% in 1997. In the G-7 countries unemployment fell to 6.4% from 6.6% in 1997 and in the 15 EU members it declined from 10.7% in 1997 to 10.0%. Higher-than-average unemployment rates were registered in Spain — 18.9% (20.8% in 1997), Italy — 12.3% (12.1% in 1997), France — 11.9% (12.4% in 1997), and Finland — 11.8% (13.1% in 1997), although in all these countries, except Italy, 1998 jobless rates were lower than a year ago. In the United States unemployment slowed from 4.9% to 4.5%, in Great Britain from 7% to 6.2% and in Germany from 10.0% to 9.7%; Japan registered a growth in the number of jobless from 3.4% to 4.1%, and a 0.6% fall in employment.

In the newly industrialised nations, 1998 employment declined by 1% after a growth of 1.8% in 1997, while the jobless rate jumped from 2.6% to 5.5%. In South Korea, last year's unemployment rate was up 7% against 2.7% in 1997.

GOVERNMENT FINANCE. Budget policy of the last few years restrained business activity in the industrialised nations as the OECD sought to contain growth in their budget deficits. The EU countries, in addition, had to comply with the criteria set in the Maastricht agreement as a precondition for membership of the Economic and Monetary Union in May 1998. Most of the OECD countries in 1998 continued to restrain budget spending, the only exception being Japan, which

implemented a programme to expand government expenditure and alleviate the tax burden.

Most of the OECD countries in 1998 registered low inflation rates, which made up for the negative aspects of the tight budget spending policy. Interest rates remained low or stable in most countries which reached a constant price level (US, Japan, Germany and France). In the countries which successfully fought inflation (Italy and the small Mediterranean countries) interest rates fell.

GLOBAL TRADE. Instability of the world economy, which increased after October 1997 and uneven economic growth in the industrialised nations created problems for international settlements and world trade, which are likely to persist in 1999. Last year's decline in domestic demand in Asia, a major devaluation of currencies in the countries hit by the crisis, a slowdown in the rates of growth of the world economy, a low level of commodity prices and the worsening conditions of the external financing of the countries with emerging market economies intensified competition in the export markets of the industrialised nations and reduced demand for imports in developing countries. Protectionism in trade and the imposition of trade and currency restrictions became more likely.

The Asian crisis caused the rate of growth in world trade to fall from 9.9% in 1997 to 3.3% in 1998. Imports declined significantly in South East Asian countries: Indonesia, South Korea, Malaysia, the Philippines and Thailand, the countries that were the hardest hit by the crisis, saw a 22% drop in imports, while in Japan imports declined by 7.5%. The fact that the United States and EU countries were the principal export markets for the five crisis-hit South East Asian nations was of great importance for their economic recovery. US imports grew by 11% in 1998 and EU imports by 7.5%. There is no convincing evidence yet that the five Asian countries' exports are rising because of a decline in exports from other developing nations. Raw materials exporters in Latin America, the Middle East and Africa registered losses because of the fall in world commodity prices.

In 1998 the world price index fell by 16.5% in dollar terms, plunging to a five-year low. The price of Russian oil declined by 40% from \$16 to

\$9—\$10 per barrel and on December 10 it dropped to a 12-year low of \$8.4 per barrel. Metal prices in 1998 were 45% below their peak registered in January 1995 and any growth is unlikely unless production is cut. Copper prices at the end of 1998 fell to a 12-year low and the price of nickel hit the lowest level in 11 years. Food prices at the close of the year were a third lower than their high registered in May 1997. Thanks to overproduction, the price of wheat fell to a 20-year low. For the same reason the world market price of rubber in September—December 1998 declined by 40%.

Although global economic instability provoked protectionist reactions, until recently they were relatively moderate and there was no diversion from the general tendency towards liberalisation of trade. The key factor was the position of the industrialised nations. Most countries acknowledge the benefits of free trade and its great contribution to economic growth during several preceding decades. The commitments undertaken within the framework of the WTO and regional agreements to liberalise foreign trade, cut duties and restrict the use of protectionist measures also prevented growth in protectionism.

It is macroeconomic and structural measures rather than increased protectionism in trade that should be regarded as an adequate reaction to a decline in exports or increased competition from imports. Protectionist measures are easy to impose but hard to remove. They undermine economic efficiency, increase production costs and consumer prices and reduce consumer and investor confidence. Keeping markets open is very important for restoration of sustained growth in the crisis-hit countries and the world economy as a whole.

FINANCIAL MARKETS. Late in the spring and in the summer of 1998 the second wave of the global financial crisis caused a further slowdown in the rates of world economic growth. The countries in the focus of the Asian crisis registered more significant decline in demand and production than was expected at the early stages of the crisis. Japan, their key export market, saw the economic recession deepen significantly and the banking system gripped by a systemic crisis. Pressure increased on the Chinese yuan and Hong Kong dol-

lar. Yet another factor of instability in the financial markets was inability of the governments of Russia and Ukraine to cut government expenditures and make them more commensurate with budget revenues. Some emerging-market countries in other regions experienced downward pressure on their currencies because they failed to balance their budgets together with their balance of payments.

Early in 1998 the world's financial markets stabilised to a certain extent after the IMF lent a loan to South Korea at the end of 1997. However, some factors of instability remained because the banking systems of the emerging-market countries owed a huge foreign debt and investor confidence in them was undermined. Instability was manifest in investors' flight to quality (especially securities issued by the leading industrialised nations), the widening of credit spreads and share and bond price fluctuations. The outflow of hot money was particularly intense from the financial markets of Brazil, Mexico, Russia and Poland. In late May the situation in the securities markets of the crisis-hit Asian countries and Russia deteriorated again.

A sharp fall in the ruble rate and the unilateral restructuring of Russian government debt in the middle of August caused a series of dramatic share price corrections in stock markets, an overall upgrading by investors of emerging market risks and the desire to reduce them. Yields on debt instruments of developing countries jumped on average to 1,700 basis points early in September from less than 600 basis points throughout most of 1997 and early 1998. Stock prices plummeted in both emerging and developed markets and speculative pressure on currencies of many developing and transitional-economy countries increased.

In August and September 1998 the situation in the world financial markets changed for the worse as fallout from the Asian and Russian crises reached other regions and many developing and transitional-economy countries missed their government and private debt payments. Investors posted huge losses in the financial markets of these countries and that caused a rush for the least risky securities, such as the US treasury bonds, and a significant rise in yields on government debt paper in developing countries.

A distinct feature of the Mexican crisis of 1994—1995 and the Asian crisis of 1997—1998 and the Russian crisis of 1998 is that their negative consequences spread to the neighbouring countries and even beyond their respective regions, a phenomenon that came to be known as the contagion effect.

In a matter of months the Asian crisis spread from Thailand to other countries of the region and went beyond Asia: speculative attacks were made on the currencies of Latin American and Central and Eastern European countries, Russia and South Africa, which registered capital outflow at the end of 1997. The aftermath of the Russian financial crisis was even more dramatic.

From September 29 to November 17 the US Federal Reserve System cut the federal funds rate thrice and interest rate twice. As a result, the former decreased by 0.75% to 4.75% and the latter by 0.5% to 4.50%. That helped prevent crisis in the domestic financial market, halt unfavourable developments in the US economy and stabilise the situation in the world's financial markets.

After the reduction of interest rates in the United States, the Bank of England in the fourth quarter of the year cut the REPO rate from 7.50% to 6.50% and interest rates were adjusted elsewhere in Western Europe. From January to the middle of October base interest rates were slashed by 0.25—0.50% in Denmark, Ireland, Spain and Portugal, and the Bank of Italy cut the official interest rate from 5% to 4%. On December 3 the central banks of 10 out of 11 European Union member-countries made simultaneous cuts in their official interest rates, making them almost identical.

The cut in the US federal funds rate stabilised yields on US long-term treasury bills at 5.1% and yield on revaluated short-term issues rose by 0.14—0.19%. The spread between yields on three-month notes and 30-year bonds narrowed by 0.19%.

The continued inflow of capital from developing countries stimulated activity in the US stock market. As a result, in the fourth quarter the Dow Jones index rose by 17% and by January 1999 reached an absolute maximum of 9,643. In the meantime, yields on treasury bills kept falling.

WORLD FOREIGN EXCHANGE MARKET. The financial crisis in South East Asian countries and Russia destabilised the world's foreign exchange market in 1998. Nevertheless, the latter's state was determined, to a great extent, by preparations for the creation of the European Monetary Union (EMU). Persistent efforts were made to bring the currencies of the member-countries of the projected union closer to the planned conversion rates. The ecu in the second and third quarter rose against the dollar as the crisis of the emerging markets was expected to spread to the US economy and the United States eased its monetary policy. In October, the average ecu rate came close to \$1.20. However, since at the end of the year the US economy continued to grow at a rapid rate and the crisis in the world's financial markets began to subside, the ecu started to fall and at the end of 1998 dropped to \$1.17. From December 1997 to December 1998 the ecu increased by 3.3% in nominal terms and 2.7% in real terms. Although that signified a reversal of the downward trend observed in 1997, in 1998 the ecu stayed lower than in the mid-1990s.

The US dollar remained the world's most stable currency throughout 1998. Its effective rate, both nominal and real, kept rising. From the middle of 1995 to March 1998 the real effective rate of the dollar grew by 25%. In the second quarter the dollar continued to rise, reaching its highest level since the end of 1996, which is attributable to a favourable situation in the US domestic market and the increased attractiveness of the United States for foreign investors because of the deterioration of the situation in the emerging markets. However, in late August and early September the dollar took a plunge as the crisis in Russia and Latin America worsened and the dollar fall caused a decline in US blue-chip prices. From the middle of August to the beginning of October the dollar fell by almost 10% against the German mark and Japanese yen. After October 5 the dollar sank by 15% against the Japanese yen within three days (over that period the dollar slipped by less than 2% against the German mark). From September 29 to November 17 the US Federal Reserve System cut interest rates three times and the dollar eventually steadied.

In early 1998 the Japanese yen slipped down against the dollar compared with mid-1997 but

edged up against South East Asian currencies. Later, however, it continued its downward trend, which accelerated in May and early June when it became clear that negative trends in the Japanese economy would continue. By mid-June the yen hit an eight-year low against the dollar. Joint currency intervention by the US Federal Reserve System and Bank of Japan halted the yen's fall, but in late August and early September it resumed. In autumn the yen started rising as short yen-dollar trade positions were closed because of growing demand for yen at the end of the financial year, the implementation of a bank restructuring programme and the adoption in November of the largest package of budget incentives in Japan's history.

The German mark in the fourth quarter fell by 0.5% against the dollar.

By contrast, the yen strengthened against the dollar by 16%. The fourth-quarter rise of the Japanese currency was also the result of capital inflow to Japan from the emerging markets and growth in the demand for the yen owing to the summing up of performance results by enterprises at the end of the financial year at the time of low lending activity in the domestic market. In addition, the reduction of short-term interest rates in the United States brought them closer to Japanese interest rates, which were at an extremely low level for a long time.

INTERNATIONAL CAPITAL MARKET. As the situation in international bond markets stabilised a little in early 1998, Argentina and some other Latin American borrowers reappeared on them. Improvements were also registered in Asian bond markets but only until late May. The situation in the international capital market deteriorated again after the August financial crisis in Russia.

The issue of bonds, medium-term euronotes included, by the emerging markets fell from \$115.7 billion in January–September 1997 to \$67.4 billion in the first nine months of 1998. The most significant decline — from \$42.8 billion to \$9.7 billion — was registered in bonds issued by Asian countries, while Latin American bond issues declined less significantly — from \$50.6 billion to \$33.1 billion. Bonds issued by the transitional-economy countries of Central and Eastern Europe increased from \$13.1 billion to \$21.5 bil-

lion, reaching a peak in the second quarter. A sharp fall followed in July—September.

Instability in the world's financial markets, especially the Russian debt situation and the imposition by Malaysia in September 1998 of currency restrictions on capital withdrawal from the stock market, caused a widespread fall in investor confidence in the debt instruments of the transitional-economy countries. Although Russia accounted for a small portion of obligations traded in the international capital market, the August crisis sent an extremely negative signal to this market. It changed the established view that support by creditor nations and international financial institutions guaranteed bonded debt repayment by debtor countries. As a result, capital flight to less risky securities increased. Capital inflow to the transitional-market economies dropped sharply and the hardest hit were the countries of Latin America, which experienced a serious scarcity of external financing. The Asian countries that had a favourable current account balance were less affected. At the same time, mid-May brought a decline in yields on government bonds in most industrialised nations, which was caused by the deteriorating situation in some transitional-economy countries. After the Russian flare-up, the drop in yields on government bonds in the industrialised countries quickened. From the middle of August to the beginning of October it fell by 120 basis points in the United States, 110 basis points in Great Britain and 70 basis points in Germany. Spreads between government and corporate bonds and between high- and low-quality corporate bonds widened.

Overall, throughout the year the debt owed by major borrowers from the developing countries increased. The debt on loans received in international financial markets rose by \$11.2 billion in Argentina, \$5 billion in Brazil, \$3.0 billion in Mexico and \$700 million in South Korea. The debt on bond loans owed by Russia, which placed them in the world's financial markets to meet its domestic government debt obligations, in January—September 1998 increased by \$12.4 billion.

The volume of syndicated loans borrowed by countries with transitional economies in January—September 1998 was \$43.2 billion, contracting almost by half compared with the same period of 1997 (\$85.9 billion). Asian countries

registered the most significant decline in borrowing (almost four times). Latin America reduced its borrowings slightly (from \$21.4 billion to \$19.4 billion) and Middle East countries even increased their borrowings (from \$4.6 billion to \$4.9 billion) thanks to the placement of a major loan by a Saudi Arabian oil company in the third quarter of the year.

Total debt on loans lent by banks of the 18 leading industrialised nations and six major offshore centres in January—September 1998 to Argentina increased by \$1.0 billion, Mexico by \$3.0 billion and Brazil by \$600 million. South Korea, which received an IMF loan at the end of 1997 and took a series of steps to settle foreign debt, cut its indebtedness by \$24.0 billion. Russia's debt rose by \$300 million.

Volatility in the debt instruments market led to share devaluation. The third quarter of the year brought a sharp fall in the stock market indices in the developing and industrialised nations. In Japan, whose stock market was previously dominated by a downward trend in share prices, in late August and early September the stock market index fell to a 12-year low.

Over the period from January to September 1998 developing and transitional-economy countries issued \$7.1 billion worth of shares in international stock markets against \$17.7 billion in the same period of 1997. In September and October companies from these countries practically stopped placing shares and only in November the Polish government began to float shares of a national telecommunications company in the international capital market.

BALANCE OF PAYMENTS. The aggregate current-account deficit of all countries in the world increased from \$29 billion in 1997 to \$104 billion in 1998.

In the industrialised countries the favourable current-account balance decreased from \$70 billion to \$14 billion, of which the Group of Seven leading industrialised nations saw a change from a \$6 billion surplus to a \$78 billion deficit, and in the euro-zone countries the current-account surplus shrank from \$109 billion to \$90 billion.

In the developing countries, the deficit increased from \$69 billion to \$93 billion; Asian countries saw their 1997 deficit of \$4 billion

change for a \$35 billion surplus in 1998, and the newly industrialised nations registered growth in their current-account surplus from \$9 billion to \$63 billion. Latin America's deficit in 1998 amounted to \$90 billion against \$65 billion in 1997. The current-account balance of European and Middle East developing countries, which had a \$6 billion surplus in 1997, registered a deficit of \$20 billion. Africa saw its deficit rise from \$6 billion to \$18 billion.

The current-account deficit of the transitional-economy countries shrank from \$29 billion in 1997 to \$26 billion in 1998. The countries of Central and Eastern Europe in 1998 registered a current-account deficit of \$22 billion against \$20 billion a year ago and the Trans-Caucasus and Central Asian countries saw a rise in their current-account deficit from \$4 billion in 1997 to \$5 billion in 1998.

FOREIGN DIRECT INVESTMENT. Despite the continuing financial crisis in Asia and its adverse impact on the world economy, foreign direct investment in the world in 1998 rose by an estimated 10% to an all-time record of \$430bn—440bn. Most of these investments came to the industrialised nations, Latin America and Central and Eastern Europe. It should be noted that the growth followed a 19% increase (to \$400 billion) in direct foreign investment and 27% expansion (to \$424 billion) of the entire transborder financial flow in 1997.

Last year, for the first time since 1985, there was no growth in foreign direct investment in East and South East Asia, which remained at roughly the same level as a year ago when it rose by 8% to \$87 billion.

The inflow of foreign direct investment to Africa remained at a low level of \$4.7 billion a year. This represents 3% of total foreign direct invest-

ment in the developing world, or as much as Malaysia receives. At the same time, some African countries, such as Botswana, Ghana, Mozambique, Namibia, Tunisia, Uganda and Equatorial Guinea, have made noticeable progress, which is attributable, above all, to privatisation and internal political stability.

WORLD GOLD MARKET. The average price of gold on the London Metal Exchange in 1998 was 11.2% lower than in 1997 (\$294.09 per troy oz against \$331.29 per troy oz). It was the lowest level since 1978. Gold prices fell in 1998 because of a slowing in the rate of GDP growth and inflation in the leading industrialised nations, the reduction of demand for gold in financially-troubled South East Asia, the rise of the dollar and the fall of the Japanese yen against the dollar.

Gold sales from the official international reserves in 1998 accounted for one-sixth of the year's world gold production. Gold was sold from official reserves by the central banks of Australia, Belgium, the Netherlands and Canada. In September, the Central Bank of Argentina announced plans to sell the last gold reserve of \$100 million (1.5 million coins minted by the Argentine Treasury in the late nineteenth century).

The world's official gold reserves rose from 890.57 million troy oz at December 31, 1997, to 965.26 million troy oz at the end of 1998. Of this, the official gold reserves of the industrialised nations expanded from 732.47 million troy oz to 808.98 million troy oz, whereas in the developing countries they decreased from 158.10 million troy oz to 156.28 million troy oz. The growth in the world official gold reserves occurred mainly in the fourth quarter of 1998: in December alone they grew by 84.18 million troy oz, or 9.6%, and the entire growth resulted from the increase in the reserves of industrialised nations.

I.3. BALANCE OF PAYMENTS AND FOREIGN DEBT

RUSSIA'S 1998 BALANCE OF PAYMENTS

CURRENT ACCOUNT

The current-account surplus declined from \$4 billion in 1997 to \$2.4 billion. For the first time in five years the current-account surplus fell so low, mainly because of the sharply increased obligations of the economy to pay nonresidents returns on their investment. In relations with non-CIS countries the current-account balance decreased from \$2.5 billion to \$700 million and with CIS countries it slightly rose (from \$1.6 billion to \$1.7 billion).

Foreign trade turnover amounted to \$132.2 billion, a drop of 18% on a year ago. Exports fell by 16% in value and imports by 20%. As a result, the trade surplus, or the excess of exports over imports, in 1998 was only \$100 million below the 1997 level and amounted to \$17.3 billion.

The reduction in exports resulted from unfavourable market conditions throughout 1998 and imports fell because of the ruble devaluation in the second half of the year.

Commodity exports totalled almost \$74.8 billion, of which exports to non-CIS countries amounted to \$59.1 billion and exports to CIS countries \$15.7 billion. Exports to non-CIS countries fell by almost 16% and to CIS countries by 18%. The year under review was characterised by extremely unfavourable price dynamics for all major Russian export commodities, which cost the economy \$17.5 billion.

The fall in world demand (mainly owing to the crisis in South East Asia) for raw materials and products with a small share of added value provoked a fierce struggle for sales markets. Tight restrictive measures were imposed on Russian exports, which cost this country \$2 billion in estimated direct and indirect losses.

Non-CIS countries accounted for 79% of Russian exports, just as in 1997, and like a year ago, Russia's leading trading partners were Germany (8% of Russian exports), Ukraine (7.7%), the United States (7.1%) and Belarus (6.5%).

Imports amounted to \$57.4 billion, of which \$43.3 billion worth of goods were imported from non-CIS countries and \$14.2 billion from CIS countries. In value terms imports from non-CIS countries fell by 18% and from CIS countries by 24%.

Import conditions varied considerably in the first and second half of the year. In January-June the fall in world prices and the overvalued exchange rate of the ruble caused physical volumes of imports to rise by 15% and their value was 8% higher than in the same period a year ago.

In the second half of the year, imports fell by 43% compared with the same period of 1997 because of the ruble devaluation. In the third quarter imports declined by 25% and in the fourth quarter they were less than half of the October—December 1997 level.

The leading exporters of products to Russia were Germany (12.6% of Russian imports), Belarus (10.4%), the United States (9.5%) and Ukraine (7.5%).

The deficit in **the balance of services** amounted to \$3.2 billion, which represents a decline of one-third in absolute figures. The export of services declined by 9% and imports by 15%.

As in the previous years, the major components of the export and import volume and dynamics were transportation and travel-related services, which accounted for almost 75% of external turnover. Changes in these items, for their part, demonstrated close dependence on the exchange-rate dynamics.

Services provided to foreigners and related to tourism and private and business trips are estimated at \$6.5 billion, a fall of 9% from a year ago. It is highly significant that the reduction in the value of these services was registered in the second half of the year only, reflecting the drop in the cost of living for foreigners in Russia in dollar terms, and a drop in the number of foreigners travelling to Russia, especially from CIS countries.

The export of transport services declined by 11%.

The financial crisis affected even more seriously the reduction in the value of imported services, because households, which are sensitive to exchange rate fluctuations, play a significant part in such operations. As a result, travel-related imported services declined by \$1.4 billion, or 14%; in the second half of the year the reduction amounted to \$1.6 billion.

The wage balance had a deficit as usual, which amounted to \$200 million against \$300 million in 1997. Unlike previous periods, in the period under review there was no growth in the number of nonresidents temporarily employed in the Russian economy. In addition, the average nominal wage in its dollar equivalent in the sectors where mostly nonresidents were employed declined by more than one-fifth. As a result, the wages of nonresidents were below \$500 million, a drop of 18% year-on-year. Employees from CIS countries accounted for two-thirds of this amount.

Incomes of Russians employed abroad grew over the year by one-third to an estimated \$300 million.

The negative balance of income from investment amounted to \$11.2 billion against \$8.1 billion a year ago.

Income due to residents corresponded to the 1997 level (\$4 billion) and payments in the economy rose by one-quarter (\$15.2 billion). As was the case in the previous years, the lion's share of the former went to service credits extended by the former Soviet Union. Actual payments did not exceed 9% of the amounts due. The growth in income paid resulted from significant foreign capital borrowings by all sectors of the economy and increase in their cost, observed since the end of 1997. The government sector accounted for four-fifths of the incomes due.

Overall, the ratio of income due by all sectors of the economy to GDP rose from 2.8% in 1997 to 5.5% in 1998.

Current transfers registered a deficit of \$400 million against \$300 million in 1997.

CAPITAL AND FINANCIAL ACCOUNT

CAPITAL ACCOUNT

The balance of operations between residents and nonresidents, which do not imply counter flows

of economic values and are classified in the balance of payments as capital transfers (these are principally operations related to migration of population) showed a deficit of —\$400 million against —\$800 million in 1997.

As before, migration flows between Russia and other CIS countries predominated, accounting for almost 100% of the transfers received in 1998 and 45% of the transfers paid.

FINANCIAL ACCOUNT

Net foreign capital inflow (the financial account balance in analytical terms) amounted to \$500 million, which represents a decrease of almost \$6 billion from 1997.

The first half of the year saw a significant excess of \$8.1 billion of foreign capital inflow over resident investment in foreign assets, whereas the period from July through December registered a net outflow of investment worth \$7.6 billion, which resulted from the financial crisis.

Foreign obligations of the Russian economy rose by \$18 billion against a growth of \$43.8 billion in 1997. Although no radical change took place in the structure of external financing, portfolio investment began to prevail when the crisis occurred (their share rose from 39% in 1997 to 45% in the year under review), which were largely represented by bond loans denominated in foreign currency.

The government sector was the principal borrower, receiving 75% of all borrowings from abroad (49% in 1997).

Portfolio investment remained one of the chief means of raising overseas funds. It should be noted that when the crisis hit the ruble-denominated bond market (GKO—OFZ), nonresident investments in government securities, denominated in foreign currency, especially eurobonds, acquired special significance.

The Russian government placed several eurobond issues to the total amount of \$4.8 billion against \$3.6 billion in 1997.

In addition, in July it issued long-term dollar-denominated bonds in lieu of the GKO issues traded in the market: foreign market participants exchanged \$1.6 billion worth of bonds and bought with cash nearly \$400 million worth of new paper.

In the first half of 1998 the government bodies of constituent territories of the Russian Federation also placed their securities in the international capital markets — they raised \$500 million (\$900 million in 1997).

Yields on the new government foreign exchange bonds rose during the year under review, reflecting growing risk of such investment for nonresidents and the decline in investment attractiveness of the Russian stock market. In March the effective yield on eurobonds did not exceed 9.5% p.a., whereas the last issue of federal eurobonds placed last year (in June) carried a yield of 13.36% p.a.

As for the ruble-denominated securities (GKO—OFZ), over the year, as the budget crisis developed, nonresidents repeatedly rethought their investment priorities. In the first quarter, foreign market participants were still optimistic about prospects for the Russian stock market and continued making investments (net inflow of non-resident funds amounted to \$3.1 billion), but from the middle of May nonresidents began to withdraw their investments from GKO—OFZ. In the second quarter, the net outflow of foreign capital amounted to \$300 million and from July 1 to August 15, \$1.8 billion (taking into account the exchange of GKO for dollar-denominated bonds in late July). On August 17 the Russian government announced a freeze on payments on GKO—OFZ with maturities before December 31, 1999, and the forthcoming restructuring of these securities. At that time nonresidents' share of the GKO—OFZ market was about 30% and their portfolio had an estimated market value of \$11 billion.

The difficulty of attracting foreign resources to the government sector by means of issuing securities in international markets, created by the crisis, increased the importance of another financial instrument, loans (see the Loans item).

In the year under review, the Russian monetary authorities attracted new loans from nonresidents to the total amount of \$10.5 billion, a rise of 40% on the 1997 amount of \$7.6 billion; of this the Bank of Russia, borrowing for the first time from the IMF, received \$3.8 billion specially to maintain equilibrium in the balance of payments.

About \$7.5 billion was repaid on the loans received.

Massive inflow of foreign capital to the *banking sector* in 1997 (\$8.9 billion) in 1998 gave way to just as massive an outflow.

The August 17 decision of the Russian government and Bank of Russia to suspend some capital operations by residents in order to stabilise the position of commercial banks that had large debts to nonresidents and prevent foreign capital outflow from the banking sector failed to produce the desired result. In all, during the year the banking system lost foreign investment to the amount of \$6.1 billion.

It should be noted that capital outflow improved the term structure of bank liabilities: at January 1, 1998, the share of short-term debt to nonresidents was 84%, whereas by the beginning of 1999 it decreased to 70%.

Bank debt to nonresidents, which was not settled in the year under review and became overdue, is estimated at \$700 million.

The inflow of foreign direct investment to the *non-financial enterprise sector* declined more than three times compared with 1997, from \$6.2 billion to \$1.9 billion.

The projected auctions to sell large blocks of shares of the oil company AO Rosneft, communications company AO Svyazinvest and another oil company, Lukoil, to foreign legal entities never took place.

Loans became a more significant channel of incoming nonresident funds despite their decline in absolute terms (foreign liabilities shown in the Loans item increased by \$3.7 billion against \$6.1 billion in 1997). Although the main borrowers in the world's capital markets were still large exporters, whose loan agreements were largely guaranteed by commodity deliveries, the crisis did affect the dynamics of such operations: loans attracted in the fourth quarter of the year were not enough to refinance the accumulated debt and the spent-repaid balance developed a deficit of —\$100 million.

The structure of Russian resident investments **in foreign assets** did not change much. These investments grew mainly in the form of "other investments" of the non-financial enterprise sector (86% of all capital outflow).

Overall, foreign assets in the Russian economy grew by \$17.5 billion (by \$37.3 billion in 1997).

The growth in foreign assets of the *government sector* (\$1.7 billion) resulted, to a great

extent, from the accumulation of claims for unpaid interest on loans granted to foreign governments by the former USSR. Out of the \$7.1 billion (principal and interest) due, \$800 million was actually repaid.

Former Soviet republics repaid about \$100 million (out of \$1.2 billion scheduled) on loans lent by Russia.

Against the background of the financial crisis, the *banking sector* reduced foreign assets by \$400 million to \$10.1 billion as of December 31, 1998.

The net international investment position of the banking system improved considerably: from —\$7.2 billion as at the beginning of 1998 to —\$200 million at December 31, 1998.

Direct and portfolio investments abroad by the *non-financial enterprise sector* contracted in volume terms from \$2.6 billion in 1997 to \$1.1 billion. As a result of the fall in world energy prices, foreign currency earnings of Russian exporters decreased, restraining their investment possibilities (it is the exporter enterprises that make large-scale investments in the construction of gas and oil pipelines and finance joint ventures to extract minerals abroad).

The most significant form of investment by the non-financial enterprise sector is still growth in assets on foreign trade operations.

The sum of the “Commercial Loans and Advances Made” amounted to \$6.8 billion against \$6.9 billion in 1997.

Last year the amount of export earnings not received in time decreased from \$4.6 billion in 1997 to \$4.4 billion.

Non-delivery of goods under import advances also declined: from \$6.9 billion in 1997 to \$4.3 billion in the year under review.

Operations conducted by the non-banking sector of the economy (non-financial enterprises and households) with foreign cash remained one of the major operations with foreign assets.

According to a Bank of Russia estimate, foreign cash in the non-banking sector in 1998 declined by \$900 million, whereas in 1997 it increased by \$13.4 billion.

The fall in demand for foreign cash in the first quarter of the year was caused by two factors: considerable foreign currency accumulations in the non-banking sector, made in the preceding

period, the fourth quarter of 1997 (\$5.9 billion), and wider use of non-cash forms of foreign currency savings (in January—June 1998 balances in personal accounts in commercial banks grew by \$1.2 billion).

In the middle of the year the unfolding financial crisis caused the demand for foreign cash in the non-banking sector to soar: the purchase of foreign exchange in the structure of household spending in July climbed to the year's highest level, 19.6%. In September, however, after the dollar's value had increased 2.5 times over, the demand for foreign currency began to subside and the share of foreign cash purchases in household expenditures fell to 8.4%, the lowest level in several years. By the end of the third quarter, growth in foreign cash reserves in the non-banking sector was estimated at \$1.7 billion.

In October—December, as the buying power of the population decreased, foreign cash reserves in the non-banking sector diminished by \$600 million.

Due to the current account deficit, the slowing of foreign investment inflow in the first half of the year and a negative balance of capital flows in the remaining period of the year, the demand for foreign exchange in the domestic market in January—August 1998 by far exceeded supply.

To meet excessive demand, the Bank of Russia, keeping the ruble exchange rate within the currency band announced in late 1997, conducted massive interventions.

As a result, in the year under review the foreign-exchange component of the official reserves decreased by \$5.3 billion (in the corresponding period of 1997 it increased by \$1.9 billion).

As of December 31, 1998, Russia's international reserves amounted to \$12.2 billion, which was enough to finance commodity and service imports for two months, a level a little lower than the internationally accepted standard of three months and than the corresponding indicator for 1997 (2.4 months).

RUSSIAN GOVERNMENT'S FOREIGN DEBT IN 1998

The Russian government's foreign debt was estimated at \$123.2 billion at December 31, 1997.

The Soviet debt of \$91.2 billion, which had been growing in recent years because of overdue interest payments, accounted for 74% of this indebtedness. It also included Russia's debts to the official creditors within the framework of the Paris Club, which amounted to \$37.6 billion, the \$28.1 billion debt to the London Club, debts to former Comecon countries (\$14.9 billion) and other debts.

The Russian debt proper, that is, the official debt that arose after January 1, 1992, amounted to \$32 billion as of the beginning of 1998, of which \$18.3 billion were owed to international financial organisations (the IMF, IBRD and other), \$4.4 billion were owed on eurobonds issued in 1996 and 1997, and \$9.3 billion were other debts, mainly those owed under bilateral intergovernmental loan agreements.

Acute budget problems forced the Russian government in 1998 often to borrow from external sources.

In 1998, Russia took up new foreign loans worth a total of \$10.7 billion and issued an additional \$900 million worth of interest arrears

notes, or IANs, to make interest payments to the London Club. Of these, \$3.6 billion were received in the form of loans from international financial organisations and \$4.8 billion as eurobond issues. It should be noted that after the August 17 financial crisis Russia received practically nothing in foreign loans.

As for the debt-service operations, the Russian government in 1998 made payments not only on the Russian debt proper (principal payments amounted to \$3.3 billion and \$1.5 billion were paid as interest), but also paid \$3.8 billion on Soviet debt (\$1.0 billion and \$2.8 billion respectively).

Debt obligations in the amount of \$2.3 billion remained unpaid in 1998 and, consequently, became a part of overdue indebtedness (chiefly, overdue debt payments to the Paris Club).

As of December 31, 1998, the Russian government's foreign debt amounted to \$137.7 billion.

The ratio of foreign debt accumulated by December 31, 1997, to GDP increased from about 30% to 50% at the end of 1998.

I.4. GOVERNMENT FINANCE

IN ACCORDANCE with the Russian President's messages to the Federal Assembly, "Order in Power, Order in the Country," and to the Government, "On Budget Policy in 1998," and the Government programme "The Restructuring and Economic Growth in 1997—2000," the main objectives of the financial and budget policy in 1998 were to ensure sustained economic growth by creating favourable conditions for investment, guaranteeing the rights of owners and investors, implementing a vigorous industrial policy and pulling the socially-oriented sectors out of the profound crisis.

These objectives were to be attained primarily by increasing tax collection, restructuring the expenditures part of the budget and streamlining budget procedures.

However, in 1998 the Russian government failed to reverse negative tendencies in the economy and lay the groundwork for its stabilisation in the medium term. The crisis that hit the Russian economy as a whole in recent years sharply exacerbated in August 1998. As a result of the devaluation of the ruble, inflation soared, the public lost confidence in authorities and the financial system, and the possibilities for financing the economy on market principles narrowed.

The federal budget was executed in 1998, especially after August 17, under extreme economic conditions: GDP volume contracted, industrial production declined, prices jumped up in the second half of the year, federal budget revenues decreased as the sources of borrowing disappeared and, as an inevitable consequence, the financing of the federal budget required printing more money.

The Federal Budget Law for 1998 set revenues at 367.5 billion rubles, or 12.9% of GDP. According to the Russian Finance Ministry's preliminary data, federal budget revenues amounted to 302.4 billion rubles, or 11.3% of GDP, which represents a decrease of 2.3 percentage points from 1997. In the second half of the year the ratio of taxes and other compulsory payments to GDP began to decline, falling from 8.6% in July to 6.5% in October 1998. Despite seasonal

growth in the collection of taxes and other compulsory payments at the year end, especially in December (17.2% to GDP), which also resulted from settlements for the direct financing of federal budget expenditures, taxes that were undercollected during the year were never recovered. The shortfall on payments to the federal budget continued in 1998 and at December 31, 1998, amounted to 149.0 billion rubles, increasing by 55.0 billion rubles over the year. Of the total amount of the shortfall on payments to the federal budget, the shortfall on value added tax (VAT) amounted to 107.7 billion rubles, or 72.3%, the shortfall on profit tax 19.9 billion rubles, or 13.4%, the shortfall on excise duties 14.2 billion rubles, or 9.5%, and the shortfall on payments for the use of natural resources 4.9 billion rubles, or 3.3%. This is attributable, above all, to a significant decline in production, the worsened financial condition of enterprises, problems in the banking sector and certain inefficiency of tax collection agencies.

Non-tax revenues far surpassed the approved volumes and amounted to 36.7 billion rubles, or 128.7% of the amount provided for by the budget, mainly as a result of higher-than-expected receipts from the auction sale of a part of the government-owned block of Gazprom (natural gas monopoly) shares and also due to the year-end increase in revenues from foreign economic activities.

Federal budget expenditures for 1998 were set at 499.9 billion rubles, or 17.6% of GDP, but actually, according to the Russian Finance Ministry's tentative estimate, federal budget expenditures amounted to 388.9 billion rubles, or 14.5% of GDP. The financing of federal budget expenditures in 1998 was limited by actual revenues and fewer sources of financing the budget deficit. However, the shortage of resources was partly compensated for by settlements for the direct financing of federal budget expenditures.

The most significant item of expenditures in 1998 was the government debt-servicing expenditure. The restructuring of the government debt made it possible to cut federal budget expendi-

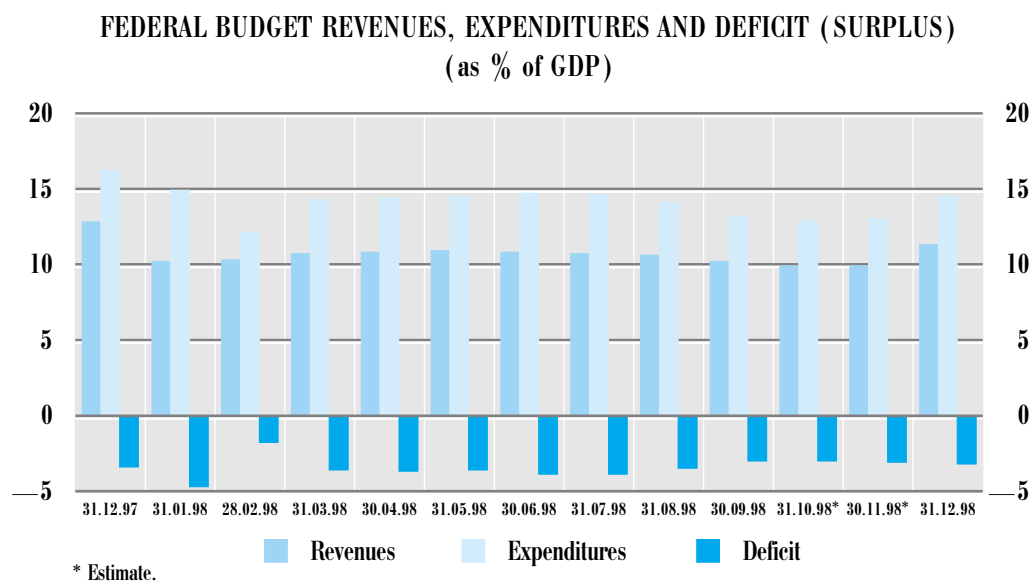


Figure 7

tures for debt servicing as a proportion of total federal budget expenditures from 36.7% in January—July to 27.4% by the end of the year and thus overcome the tendency of the last few years towards growth in the interest expenditures. However, the government did that by refusing to honour some of its debt obligations. Federal budget expenditures on the servicing of domestic government debt in 1998, calculated on the basis of the mechanism to restructure government securities and exchange them for new short-term government bonds in accordance with the procedure negotiated and agreed upon with the holders of these securities, amounted to 65.7 billion rubles, or 80.5% of the approved federal budget.

The economic situation in 1998 exacerbated the problem of financing the budget deficit and managing government debt. The actual deficit of the federal budget in 1998 amounted to 86.5 billion rubles, or 3.2% of GDP.

In the first half of 1998 (January—May) the deficit was financed primarily from internal sources, especially receipts from the sale of government securities. The worsening of the crisis in the domestic financial market made domestic borrowings for debt financing practically impossible and the emphasis was shifted to external sources. Last July GKO—OFZ were converted into 27.5 billion rubles worth of eurobonds. As a result, the budget deficit in 1998 was financed mainly from external sources (90.2 billion rubles,

or 339.5% of the approved budget). Since the August “moratorium” on treasury bills sharply reduced the possibilities for financing the deficit by borrowings, in September—December the deficit was largely financed by issuing fixed-coupon federal loan bonds (OFZ-PD), which the Central Bank acquired at their second placement (through the Savings Bank) to the total amount of 40.5 billion rubles, in accordance with the federal laws “On Urgent Measures in the Field of Budget and Tax Policy” and “On the Federal Budget for 1999.”

The 1998 Federal Budget Law set the upper limit on the domestic government debt at 755.9 billion rubles as of December 31, 1998, but the actual figure was 750.6 billion rubles, including final turnovers, according to a preliminary estimate of the Russian Finance Ministry.

Domestic government debt of the Russian Federation includes the debt on government securities (short-term government bonds, or GKO, federal loan bonds, or OFZ, government savings loan bonds, or OGSZ, and government non-market loan bonds, or OGNZ), which amounts to 480.0 billion rubles, or 63.95% of total domestic government debt. This represents an increase of 29.2 billion rubles on December 31, 1997.

In addition, the Russian Finance Ministry's debt on promissory notes amounted to 28.1 billion rubles as of December 31, 1998. This represents a fall of 3.9 billion rubles from December 31,

GOVERNMENT DEBT SERVICING EXPENDITURE DYNAMICS IN 1998
(billion rubles)

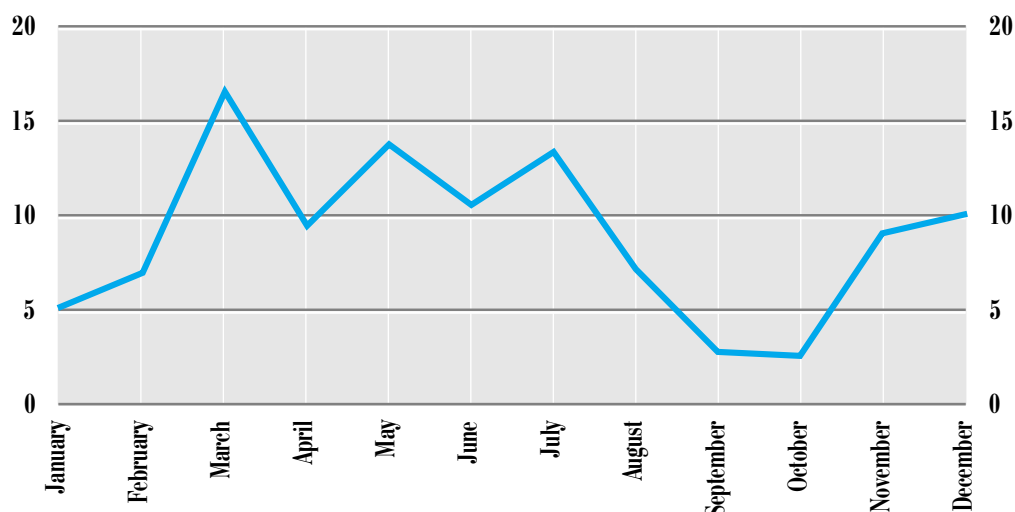


Figure 8

1997, resulting from the forthcoming exchange of the Central Bank-owned Finance Ministry notes, which matured before December 31, 1998, for fixed-coupon federal loan bonds.

The domestic foreign-exchange debt, which is counted as part of the domestic government debt of the Russian Federation, amounted to 229.7 billion rubles as of December 31, 1998, or 30.6% of Russia's total domestic government debt. In 1998 this debt increased from 67.9 billion rubles as of March 31, 1998, to 229.7 billion rubles, or 3.4 times over, as a result of a sharp fall in the ruble exchange rate against the US dollar.

The Finance Ministry's debt to the Bank of Russia as of December 31, 1998, amounted to 208.6 billion rubles (this includes the Finance Ministry's debt of 200 million rubles on domestic foreign-exchange government loan bonds), which represents an increase of 60.4 billion rubles as of December 31, 1997. The Finance Ministry's debt to the Central Bank accounted for 27.8% of total domestic government debt.

The Bank of Russia investment portfolio contained 171.5 billion rubles worth of government securities, including domestic foreign-exchange government loan bonds, but excluding Finance Ministry notes. This represents 35.8% of total volume of government securities counted as part of Russia's domestic government debt. Overdue coupon payments on government securities held by the Bank of Russia and subject to exchange

for fixed-coupon federal loan bonds in accordance with the 1999 Federal Budget Law amount to 4.1 billion rubles.

The Finance Ministry's debt to the Bank of Russia on Finance Ministry promissory notes and their unpaid interest as of December 31, 1998, amounted to 31.2 billion rubles; of that Finance Ministry debt on notes that matured in 1998 plus interest amounted to 4.85 billion rubles.

Having problems with selling government securities and unable to allocate the required federal budget funds, the Finance Ministry, when the time came for it to meet its bond commitments and pay interest income, from June ran up a debt to the Bank of Russia on operations in the government securities market, which amounted to 5.7 billion rubles as of December 31, 1998.

On August 17 the Russian government and Bank of Russia issued a statement saying that they had suspended GKO—OFZ payments and halted trading in these securities on the Moscow Inter-bank Currency Exchange (MICEX). This was because of problems in meeting principal payments in the absence of federal budget revenues from placing government securities.

Since the fourth quarter of 1998, the Finance Ministry and Bank of Russia have been working on a mechanism to restructure government securities issued before August 17 and maturing before December 31, 1999. In accordance with the Russian government's Resolution No. 1787-r,

dated December 12, 1998, a novation of government securities is being carried out in 1999.

In accordance with the procedure for conducting operations with federal budget funds, on the first working day of 1999 the balances of the 1998 federal budget funds in the federal budget accounts of the federal treasury bodies and federal budget-financed organisations were transferred to the 1998 federal budget accounts of the federal treasury bodies and these organisations.

To meet federal budget obligations to enterprises and organisations in 1998, the Finance Ministry established a procedure allowing budget fund managers and recipients to use 1998 federal budget funds allocated to them until January 26, 1999. In accordance with Federal Law No. 28-FZ, dated February 10, 1999, "On the Completion in 1999 of Operations to Execute the 1998 Federal Budget" and Federal Law of March 3, 1999, "On Amending Article 1 of the Federal Law "On the Completion in 1999 of Operations to Execute the 1998 Federal Budget," the accounting period for operations to execute the 1998 federal budget was extended until March 15, 1999.

To overcome the payments crisis in the banking sector, the Bank of Russia in September and October conducted three multilateral operations to clear the mutual obligations of credit institutions on the basis of payment documents presented to their correspondent accounts.

During the year, the Bank of Russia made sure that banks fulfilled clients' payment orders on time, including payment orders to transfer funds to various budgets. In 1998, the nonpayments to the federal budget due to a lack of funds in the correspondent accounts of credit institutions dropped against December 31, 1997 figures, by 700 million rubles, to 1.4 billion rubles. Of that nonpayments by operating credit institutions decreased by 200 million rubles to 600 million rubles. The amount of nonpayments to regional and local budgets was cut by 600 million rubles to 500 million rubles, of which nonpayments by operating credit institutions were reduced by 100 million rubles to 200 million rubles. Nonpayments to the state extrabudgetary funds (Pension Fund, Social Insurance Fund, Employment Fund and health insurance funds) declined by 200 million rubles to 600 million rubles, of

RUSSIA'S DOMESTIC
GOVERNMENT DEBT STRUCTURE
AS OF DECEMBER 31, 1998 (%)

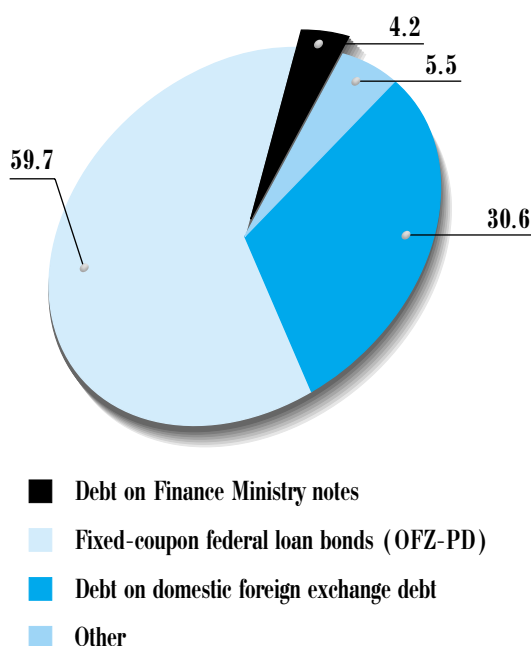


Figure 9

which nonpayments by operating credit institutions were unchanged from the beginning of the year and amounted to 300 million rubles.

To improve the management of federal budget funds, increase oversight over federal budget spending and bolster financial discipline, the Bank of Russia, guided by the 1998 Federal Budget Law, participated in the Finance Ministry's actions to expand and upgrade the treasury-based system of execution of the federal budget.

As of December 31, 1998, the local federal treasury bodies in 85 constituent territories of the Russian Federation were granted the right to conduct operations with federal budget revenue accounts and in 87 territories with federal budget accounts.

As of December 31, 1998, the federal treasury bodies in the Republic of Bashkortostan, the Republic of Tatarstan and the Evenk Autonomous Area were not granted the right to conduct operations with federal budget revenue accounts and in the Republic of Tatarstan also with federal budget accounts.

In 83 constituent territories of the Russian Federation the corresponding federal treasury

bodies have the right to transfer federal taxes collected in these territories to the financing of federal budget expenditures on these territories. In 1998 the federal treasury bodies transferred 32.3 billion rubles in federal budget revenues collected in the constituent territories of the Russian Federation to the financing of federal budget expenditures on these territories. As of December 31, 1998, this procedure is not used in the republics of Bashkortostan, Kalmykia and Tatarstan, the Kaliningrad Region and the Evenk Autonomous Area.

In 1998, budget-financed organisations and institutions continued to be transferred to financing through personal accounts opened for them with the federal treasury bodies.

According to the latest data, as of December 31, 1998, 2,205 federal treasury bodies financed budget-financed organisations and institutions through personal accounts opened for them with these bodies. This financing procedure was adopted by 36,500 out of 48,300 budget-financed organisations and institutions, 4,100 organisations and institutions adopted this procedure in part and 7,700 organisations and institutions had not switched to this procedure yet. In addition, 27,200 out of 33,200 other institutions and organisations financed from the federal budget switched to the financing procedure using personal accounts opened for them in the federal treasury bodies and 6,000 did not.

To improve payments and settlements on federal treasury accounts, federal treasury bodies in 45 regions (of these, 19 regions in 1998) were linked up with the Bank of Russia settlement network as clients, using the Bank of Russia telecommunications system.

As of December 31, 1998, the Bank of Russia institutions opened federal budget revenue accounts for 1,329 federal treasury bodies and federal budget accounts for 1,336 federal treasury bodies; Sberbank opened such accounts for 843 and 876 federal treasury bodies, and other credit institutions and their branches for 122 and 63 federal treasury bodies, respectively.

To register the amounts that were not paid in time under the payment documents presented to the federal budget accounts, the Bank of Russia on January 1, 1998, introduced reporting form No. 312, "Report on the File to Off-Balance Sheet

Account No. 90902 "Settlement Documents Not Paid in Time." As of December 31, 1998, the amount of payment documents that were not paid in time and were presented to the federal budget accounts of the federal treasury bodies and also enterprises, organisations and institutions making expenditures from federal budget funds amounted to 4.4 billion rubles in Russia as a whole. Of this, late payments to the federal budget amounted to 110 million rubles, or 2.6% of the total, to regional and local budgets, 70 million rubles, or 1.6%, to the state extrabudgetary funds (Pension Fund, Social Insurance Fund, Employment Fund and health insurance funds), 1.9 billion rubles, or 42.9%, for wages, 70 million rubles, or 1.5%, and other payments, 2.2 billion rubles, or 51.3%.

Of the total amount of payment documents not paid in time and presented to the federal budget accounts, the amount of payment documents that were not paid in time and were presented to the federal budget accounts of the federal treasury bodies totalled 700 million rubles and payment documents that were not paid in time and were presented to the accounts of enterprises, organisations and institutions making expenditures out of the federal budget amounted to 3.7 billion rubles.

To settle the issue of recovering funds from the accounts of the federal treasury bodies servicing budget fund managers, the 1999 Federal Budget Law stipulates that funds of federal budget recipients should be written off in accordance with court decisions from the accounts of the bodies of the Finance Ministry's Federal Treasury on the basis of bills of acceptance issued by the federal treasury bodies.

The execution of regional and local budgets was also complicated by undercollection of taxes and other compulsory payments. According to a Finance Ministry preliminary report, 1998 revenues of the constituent territories of the Russian Federation aggregated 397.7 billion rubles and expenditures totalled 407.1 billion rubles, creating a deficit of 9.4 billion rubles.

As of December 31, 1998, the Bank of Russia, Sberbank and credit institutions and their branches opened in the regional and local budget balance accounts 296,200 personal accounts (122,200 personal accounts were opened with

Bank of Russia institutions, 68,400 with Sberbank institutions and 105,600 with credit institutions and their branches).

Net balances in the regional and local budget accounts with Bank of Russia institutions decreased from 2.7 billion rubles as of December 31, 1997, to 2.1 billion rubles as of December 31, 1998.

To finance federal, regional and local budget deficits, reduce wage arrears and finance other urgent needs in 1998, regional and local governments in 51 constituent territories of the Russian Federation borrowed from credit institutions. In 29 regions loans were made in accordance with the decisions of the local legislative and executive bodies of power.

As of December 31, 1998, the debt of regional and local financial bodies on loans made to them by credit institutions amounted to 14.1 billion rubles and debt obligations on securities totalled 4.6 billion rubles.

Steps were taken in 1998 to improve co-operation with federal and regional extrabudgetary funds.

As of December 31, 1998, federal extrabudgetary funds opened 5,482 main accounts and 14,742 transit accounts at banks, of which 3,253 main accounts (59.3%) and 9,020 transit accounts (61.2%) were opened with Bank of Russia institutions.

Net balances in the state extrabudgetary funds' accounts with the Bank of Russia's institutions rose from 4.8 billion rubles as of December 31, 1997, to 5.2 billion rubles as of December 31, 1998.

Owing to a difficult economic situation in the country, the Bank of Russia sent down to its local branches Telegram No. 215-T, dated September 10, 1998, instructing the Bank of Russia institutions to ensure unconditional acceptance for cash settlement servicing of the accounts of the executive bodies of federal and regional extrabudgetary funds.

In 1998, Bank of Russia institutions accepted for servicing 421 main accounts, including the accounts of 17 regional branches of the Russian Pension Fund, and 4,022 transit accounts of federal extrabudgetary funds and 245 main accounts and 246 transit accounts of regional extrabudgetary funds.

In pursuance of joint instructions of the State Tax Service No. AP-6-07/219, dated April 3, 1998, Finance Ministry No. 16n, dated April 3, 1998, Federal Road Service No. FDS-14/939, dated April 1, 1998, and Bank of Russia No. 201-U, dated April 1, 1998, "On the Procedure for Transferring the Road Tax, the Tax on Fuel and Lubricant Sales and Other Receipts to the Road Funds," Bank of Russia institutions in 1998 opened transit accounts for the Federal Road Fund and transferred balances from these accounts to the Federal Road Fund's account with the Bank of Russia First Operations Department (OPERU-1). In all, 5,451 transit accounts were opened for the Federal Road Fund in 1998, of which 3,619 accounts (66.4%) were opened at Bank of Russia institutions, 1,281 accounts (23.5%) at Sberbank institutions, and 551 accounts (10.1%) at other credit institutions.

MONETARY POLICY

II

II.1. OBJECTIVES AND RESULTS OF MONETARY POLICY

MONETARY developments in 1998 were affected by a severe crisis. The first signs of crisis appeared in late 1997 when volatility in the Russian financial markets, provoked by the crisis in South East Asian markets, caused the cost of domestic government borrowings to rise and led to a drop in international reserves of the Bank of Russia. That deteriorated significantly the conditions under which the Bank of Russia began to carry out its monetary policy in 1998.

The macroeconomic policy for 1998 was elaborated, taking into account the need to cut the inflation rate to 5—8% over the year¹. GDP in 1998 was forecast at 100—102% of the previous year's level (2,840 billion to 2,930 billion rubles) and the federal budget deficit was expected not to exceed 4.7% of GDP (132.4 billion rubles).

It was believed that monetary policy would be implemented in the context of a fixed exchange-rate regime in the form of the ruble's unilateral pegging to the US dollar. The main parameters of this policy were set out at the end of 1997². The central rate of the ruble for the period of 1998 to 2001 was set at 6.2 rubles to the dollar, with maximum permissible deviations of 15% both ways. In 1998 the average exchange rate should have been 6.1 rubles to the dollar. Such exchange rate dynamics corresponded to the possible po-

tential decline in yields in the government securities market to 12—14% by the end of the year.

So, it was believed that the exchange rate would nominally anchor inflation, while money supply, which was expected to grow by 22% to 30%, became, in effect, an indicative parameter.

However, a series of crisis developments in the domestic financial market at the beginning of the year, caused by capital outflow from Russia, seriously affected the main monetary indicators: interest rates climbed and pressure on the national currency increased. In the meantime, imbalances continued to accumulate in the economy, adding to general economic instability.

The foreign trade situation also deteriorated. The fall in the prices of major Russian exports sharply reduced the foreign trade surplus in the first quarter of 1998 and created a deficit in the current-account balance. Foreign capital continued to be dominated by portfolio investments, which at the time of growing globalisation made the Russian economy heavily dependent on short-term fluctuations in global financial market conditions.

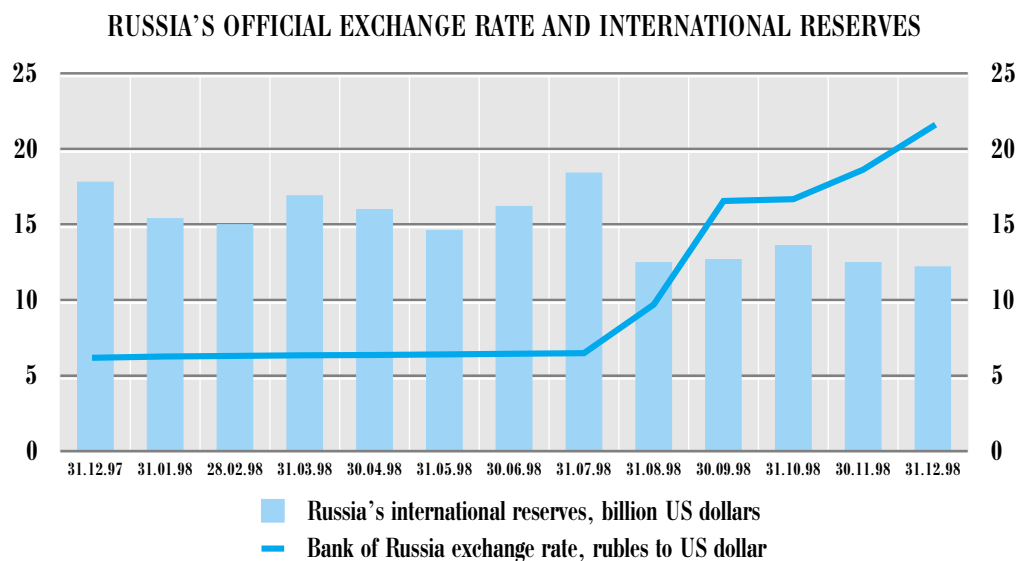
Capital outflow exacerbated the budget situation to the extreme: yields on government securities fluctuated between a low of 29.4% in January, to a high of 43.9% which occurred in May³.

Monetary regulation in that period was aimed at stabilising financial markets, halting a capital

¹ The objectives and parameters of the monetary policy are spelled out in the *Guidelines for the Single State Monetary Policy for 1998*.

² See the joint statement of the Russian Government and Bank of Russia, dated November 10, 1997, "On the Exchange Rate Policy."

³ Yield on GKO with maturities less than 90 days.

*Figure 10*

outflow and keeping within declared exchange rate limits. Monetary indicators such as money supply and interest rates became of secondary, auxiliary importance.

Changes in macroeconomic conditions upset the exchange rate balance and thus the ruble rate became overvalued. The efforts to artificially keep up with the overvalued ruble provoked expectations of a devaluation, which also led to growth in interest rates in the government securities market. The Russian government's continued borrowings at exorbitant prices, needed to meet domestic government debt commitments, further complicated the federal budget situation and added fuel to expectations of a devaluation. The Bank of Russia managed to preserve the exchange rate dynamics mainly through currency interventions in the market, which depleted Russia's international reserves. In the first six months of 1998, the ruble rate slipped by 4.03%, with inflation remaining at 4.06%, while international reserves of the Bank of Russia decreased from \$17.2 billion to \$15 billion, a drop of 12.8%.

The sense of imminent trouble was maintained by political instability and growing distrust of the political and monetary authorities, and the policy they pursued.

As expectations of a devaluation ran high and capital outflow continued, demand for M2 money fell sharply. In the first eight months of the year the M2 aggregate of money supply contracted by 8.2%.

By the end of the first half-year, the budget situation had continued rapidly to change for the worse, making the need to take urgent measures to improve the system of government finance, cut expenditures, and increase budget revenues ever more obvious. Domestic government debt-servicing in that period accounted for more than 30% of all budget expenditures. Government borrowings at market rates of interest became ineffective, that is to say that budget revenues from the market did not cover servicing of that part of government debt. The government's refusal to borrow in the market at higher rates of interest was followed by default on a portion of domestic debt and precipitated the crisis, which had been brewing for some time.

The budget crisis was accompanied by a foreign currency crisis. In summer it became clear that it was no longer possible to maintain the exchange rate dynamics as declared. On August 17, the Bank of Russia announced a new exchange rate band of 6—9.5 rubles to the dollar until the end of the year. The technique of fixing the official ruble rate to the dollar was changed: the official rate was now to be based on the results of MICEX trading.

As the flight from the ruble began, these measures could not counter mighty pressure on the exchange rate. By September 1, the dollar had broken through the upper limit of the new currency band and the Bank of Russia renounced the policy of artificially maintaining the exchange rate by currency interventions, and switched instead to a floating exchange rate. That meant a change

RATES OF GROWTH IN CONSUMER PRICES AND M2 MONEY SUPPLY (%)

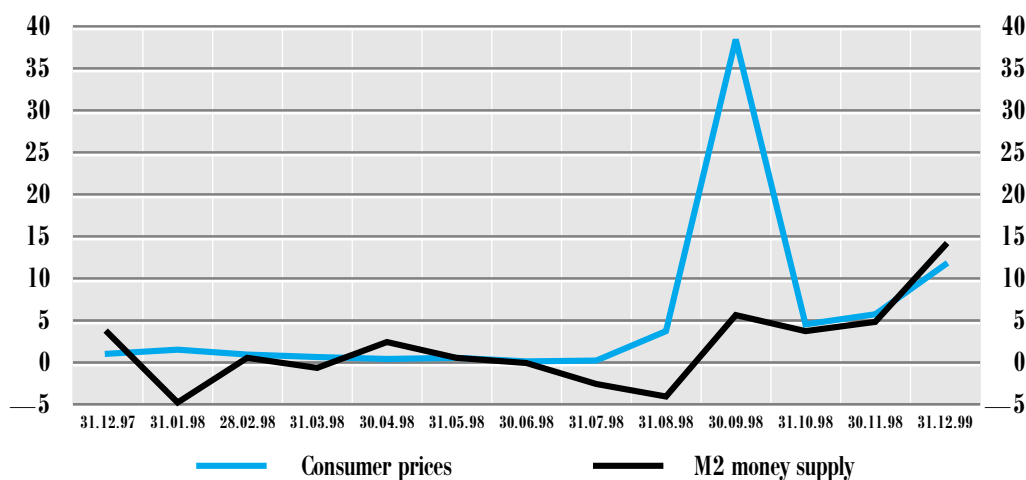


Figure 11

of the goals of monetary policy. With the floating exchange rate the control over money supply became the most important tool to contain inflation.

The budget and foreign currency crises were followed by a severe banking crisis. The freezing of the GKO—OFZ market and sharp devaluation of the ruble had a negative effect on the state of commercial banks. Their condition was further aggravated by withdrawals of household savings. The liquidity crisis that hit individual banks and their decapitalisation provoked an acute state of crisis within the banking system.

Monetary regulation in that period was aimed at overcoming the aftermath of the financial and economic crisis. The situation was compounded by the fact that the Bank of Russia had to tackle simultaneously macroeconomic problems that, in a sense, contradicted one another. On the one hand, it had to implement a policy that would stop the ruble from falling and keep inflation at bay, that is, a tight monetary policy. On the other hand, the crisis within the banking system required the Bank of Russia to support commercial banks, that is, to raise the level of liquidity within the banking system. In addition, in that period, the Russian government had serious difficulty meeting its commitments at home and abroad. After the GKO—OFZ market was frozen, Bank of Russia resources remained virtually the only source of covering the budget deficit.

The deepening of the banking crisis required the Bank of Russia to work out a series of measures to shore up the banking system. Its efforts to reduce bank nonpayments through clearing

operations, change the procedure for creating required reserves, and lend money for financial recovery made it possible to halt the spread of the liquidity crisis. To prevent a crisis of public confidence in the banking system, a portion of household deposits was transferred from commercial banks to the Savings Bank.

The money supply policy pursued by the Bank of Russia in the post-crisis period made it possible to significantly retard the rate of inflation and devaluation of the national currency. In September, inflation ran at the rate of 38.4% whereas in the remaining months of the year it averaged 7.2% a month. The exchange rate in September sank by more than 70% and in the subsequent months it declined by an average of 9% a month. Over the year the exchange rate decreased 3.5 times.

The situation in the foreign exchange market stabilised also thanks to a number of measures taken by the Bank of Russia, which changed the procedure for foreign exchange trading and improved foreign exchange regulation and foreign exchange control.

After the exchange rate fell to a new equilibrium level, the current account surplus sharply increased, allowing the Bank of Russia to finance the government's foreign debt payments practically without changing the size of the country's international reserves.

Thus, thanks to its balanced monetary policy, the Bank of Russia managed to contain the inflationary spiral, prevent a further plunge of the exchange rate and check the spread of the banking crisis.

II.2. DYNAMICS OF MONETARY INDICATORS

IN ITS EFFORTS to control the money supply and to regulate banking liquidity, the Bank of Russia in 1998 was guided by the specific targets of the single state monetary policy, taking into account the economic environment. The rate of M2 growth in 1998 as a whole practically corresponded to the parameters set in the Guidelines for the Single State Monetary Policy in 1998. Nevertheless, as a result of the financial and economic crisis, especially the situation after August 17, the dynamics of monetary and credit indicators during the year demonstrated both positive and negative changes.

High inflation and expectations of a devaluation in the middle of the year, and growing distrust in the banking system predetermined the reduction of demand for ruble assets and growth in the demand for foreign exchange by both households and corporate entities. The most significant manifestation of these trends in the middle of the year was a run on banks. In July and August alone, household and company funds in bank accounts declined by 28.5 billion rubles, or 7.6% of the money supply at the beginning of the year. Overall, from January to August, the money supply decreased by 8.2%. In the subsequent months, when the Bank of Russia switched to a floating exchange rate and took a series of purposeful measures to restore banking liquidity, the M2 aggregate of money supply grew by 30.5%. Money supply in that period grew at a rate close to that of inflation and helped to saturate the economy with money. Overall, in 1998 M2 expanded by 19.9% to 448.4 billion rubles as of December 31, 1998. However in real terms, money supply shrank by 35% in 1998.

In 1998, the composition of the money supply deteriorated because of a considerable expansion of the amount of cash.

Cash in circulation outside of the banking system in 1998 increased by 44%, to 187.8 billion rubles as of December 31, 1998. During the year, Russia put into circulation 62.0 billion rubles from its cash reserves, 34.5 billion rubles, or 2.3 times more than in 1997.

Sharp growth in the share of cash in circulation (outside of banks) in M2 over the year (from 34.9% to 41.9%) and a corresponding contraction of the share of household deposits (from 37.9% to 31.6%) were the result of inter-related processes. Although interest rates on household deposits grew, the withdrawal of personal deposits from banks, which began in June 1998, led to the reduction of household deposits in absolute terms, while the proportion of personal income spent on the purchase of foreign exchange expanded from 14% in May, to 17% in June, and 19% in July.

In addition to the effect of the above-mentioned factors, such dynamics were determined by longer-term changes in the structure of household expenditures at a time when cash income declined in real terms (in the 1st quarter of 1998 real disposable income fell to about 91% of the level of the same period of 1997, in the 2nd quarter to 87%, in the 3rd 81% and in the 4th 72%). As the inflation rate accelerated, private individuals and corporate entities tried, above all, to maintain consumption at its current level and restore the real value of their liquid assets. In addition, the highly liquid part of the money supply expanded because the pace of repayment of wage arrears and social benefits to public sector workers hastened in the last few months of the year. Therefore, while in the first half of the year cash emissions amounted to 2 billion rubles (0.4% of cash expenditure), in the second half the issue of cash in circulation increased to 60.0 billion rubles, or 8.9% of cash expenditure. Cash emissions increased particularly in September (20.9 billion rubles) and December (20 billion rubles). At the same time, the fourth quarter saw a return of household savings to banks, especially the Savings Bank, whose share of household deposits rose from almost 77% at the beginning of the year to more than 86% at the year-end. By the end of 1998, household deposits returned to the January 1 level. Over the year cash in circulation declined by 22% in real terms and household deposits by 46%.

Although in the first half of the year and in July-August ruble-denominated bank deposits of

non-financial enterprises and organisations decreased, over the year they were not only restored to their previous volumes, but also increased by 16.5% (62.7% in September—December). This resulted from the transfer of export earnings to ruble accounts and growing returns from trade at the new level of prices at home and also repayment of some of the budget debt to enterprises and organisations. This dynamics kept practically unchanged (about 27%) the share of corporate funds in total money supply.

The dynamics of corporate and household bank deposits denominated in foreign currency in 1998 was also affected by the crisis of confidence in the banking system. Over the year, the overall volume of corporate and household foreign currency-denominated deposits shrank by one-third. However, their ruble equivalent increased 2.4 times over as the national currency was seriously devalued. As a result, M2X (calculated by the monetary survey methodology, taking into account foreign currency-denominated bank deposits) demonstrated more rapid yearly growth than M2 and the relative saturation of the economy with money had increased by the end of the year. Over the year, M2X expanded by 37.5% in nominal terms.

The structure of the sources of money supply formation in 1998 repeated the tendencies of the previous years when the need to finance the federal budget deficit and the related growth in net bank credit to government bodies played a leading role in the expansion of the money supply. Over the year net bank credit increased by 341.0 billion rubles, or 89.5%. From January through August it rose by 38.8 billion rubles, mainly as a result of the borrowings made in the GKO—OFZ market to service domestic debt. The fact that by the end of 1998 net government debt to the banking system doubled, is largely attributable to the scale of the devaluation, which led to a sharp growth in this sector's foreign-currency obligations. Claims of credit institutions on the government, most of which resulted from the purchase of securities issued by the federal government, changed in volume mainly as the market price of these assets changed. After its steady growth at the beginning of the year, this indicator slipped in May and plunged in July-August. In the subsequent months of 1998, credit institu-

tions' claims on government bodies rose as the value of securities denominated in foreign currency were recalculated at the current exchange rate of the ruble.

In the period from January to August, ruble-denominated bank loans to the non-financial sector declined, while loans denominated in foreign currency rose. The overall result was slight growth. In the first eight months of 1998, bank loans to the non-financial sector rose by 12.4 billion rubles, or 4.6%. This growth resulted in its entirety from the increase in claims on private enterprises, while the debt owed by non-financial state-run enterprises declined in absolute terms. When the financial and economic crisis came to a head, bank claims on the non-financial sector began to decline noticeably both in rubles and foreign exchange (without re-calculation in rubles). However, as the value of the national currency decreased more than three times, the ruble equivalent of this indicator rose 1.3 times in September—December. Therefore, even though the aggregate bank claims on the non-financial sector decreased over the year if their foreign-currency component is calculated at the official exchange rate at the beginning of 1998, their actual yearly growth amounted to 109.6 billion rubles, or 40.6%.

The dynamics of net foreign assets of the monetary authorities and credit institutions in 1998 reflected change of the situation in the financial market from the previous year. Dramatic growth in demand for foreign exchange and capital outflow from Russia became the main signs of growing investor distrust in the country and its economic policy. In that situation, the overall volume of the banking system's net foreign assets decreased by 110.6 billion rubles over the year, with the first eight months accounting for 59% of that amount. The reduction was entirely determined by the dynamics of net foreign assets of the monetary authorities, which declined in volume terms by 158.5 billion rubles over the year (by 75.9 billion rubles in January—August). In effect, foreign assets were redistributed in favour of credit institutions, whose net foreign assets in 1998 increased by 47.9 billion rubles, or more than \$6 billion (in August alone they rose by over \$1.5 billion). So, the overall dynamics of net foreign assets held by the bank-

ing system in 1998 played a role in the decline in the money supply.

The Bank of Russia regulated the money supply by exercising control over the dynamics of the monetary base.

The broad money (cash in circulation, money in tills of credit institutions, bank funds in correspondent and reserve accounts with the Bank of Russia, bank deposits with the Bank of Russia and Bank of Russia bonds held by credit institutions) expanded by 26.0% in 1998 and as of December 31, 1998, amounted to 258.2 billion rubles. It should be noted that general factors determined the correlation between intra-year dynamics of monetary base and money supply: in January—August the monetary base declined by 10.4% and in subsequent months of the year it rose by 40.7%. Over the year, the monetary base decreased by 32% in real terms.

The structure of the monetary base underwent significant change during the year. As cash in circulation accounted for the bulk of the monetary base, it played a leading role in the dynamics of this indicator. In 1998, the share of cash increased by 9.7 percentage points, from 66.9% to 76.6%. Growing demand for foreign exchange and increased capital outflow from Russia predetermined an almost threefold decrease (from 15.3% to 5.5%) in the share of balances in the correspondent accounts of credit institutions in January—August 1998. In that critical situation, the Bank of Russia took a series of purposeful steps to increase the liquidity of the banking system and restore the settlement system. By the end of the year, this indicator had risen to 12.6% and, taking into account bank deposits with the Bank of Russia and Bank of Russia bonds held by credit institutions, it returned to the level that was at the beginning of the year (15.3%). At the same time, the measures taken (a multilateral inter-bank clearing operation with the possibility of early regulation of required reserves) led to a noticeable reduction (from 17.7% to 8.1%) in the proportion of required bank reserves in the monetary base in September—December, whereas in the preceding months this proportion had remained practically unchanged.

The growth in the monetary base in 1998 resulted from the increase in net domestic assets held by the monetary authorities: the monetary

base increased by 53.3 billion rubles and net domestic assets grew by 114.7 billion rubles, while net international reserves decreased.

The volume of net international reserves of the monetary authorities was negative as of December 31, 1998. The excess of liabilities over assets amounted to 38.9 billion rubles (at the fixed rate of 6 rubles to the dollar). Over the year, net international reserves dwindled by 61.4 billion rubles. In the first eight months they decreased by 63 billion rubles. Although from the second half of September the change of trends in the domestic currency market enabled the Bank of Russia to make up for the loss by buying foreign exchange and receiving returns from the sale of 2.5% of Gazprom shares, there was no adequate growth in net international reserves, because a large part of the foreign exchange receipts went to repay and service the government foreign debt.

The main source of growth in net domestic assets in 1998 was the growth in net credit to the federal government, which amounted to 84.3 billion rubles and resulted from the increase of the Bank of Russia's government securities portfolio. The use of the Central Bank's foreign exchange reserves for making payments on Russia's foreign debt (this required buying foreign exchange in the domestic market) was another significant factor of growth in net domestic assets in 1998.

Throughout the year, the structure of the budget deficit financing changed significantly. In the early months of 1998, the budget deficit was mainly financed by borrowings made in the domestic market. But later, borrowings from foreign sources came to play a leading role. After August, growth in funding through cash emissions became the principal source of deficit financing. From September through December, growth in Bank of Russia net credit to the federal government made up more than two-thirds of the federal budget deficit, as calculated by international standards.

Gross credit to banks in 1998 amounted to 5.8 billion rubles. Throughout the year, especially in the second half, its volume fluctuated significantly with the exigencies of quick regulation of banking liquidity. The shortage of liquidity was particularly acute in August and early September when the government refused to honour its

GKO—OFZ commitments. That refusal made illiquid a large portion of bank assets, brought about a significant and steady outflow of clients' funds from bank accounts and increased mutual distrust between banks. This sharply limited possibilities for a market-based reallocation of funds within the banking system. The problem was compounded by an imbalance between bank assets, which had lost most of their liquidity, and liabilities, which had increased as a result of the ruble devaluation and a run on banks by depositors.

From late August the Bank of Russia took steps to restore and maintain the required level of liquidity of the banking system by using practically all tools of monetary policy at its disposal. In addition to regulating required reserves, which

helped release additional financial resources of the banking system, it used bank refinancing mechanisms. The Bank of Russia also floated short-term bonds (OBR), which began to be used as security for loans to banks and in REPO operations with banks.

The aggregate reserves of credit institutions (cash in tills at banks, required reserves on attracted funds in rubles and foreign exchange, balances in deposit and correspondent accounts with the Bank of Russia, including balances in the official securities market, and Bank of Russia bonds held by credit institutions) amounted to 70.4 billion rubles as of December 31, 1998. This represented a fall of 5.5% from the beginning of the year.

II.3. MONETARY POLICY INSTRUMENTS

RESERVE REQUIREMENTS

The Bank of Russia continued actively to use reserve requirements as a major instrument of its monetary policy.

Guided by monetary policy objectives in various periods of time and seeking to even out reserve requirements for all attracted funds, regardless of the currency in which they were made and deposit terms, the Bank of Russia on February 1, 1998, set a single required reserve ratio of 11% for all borrowings made by credit institutions, keeping intact at 8% the required reserve ratio for ruble-denominated household deposits in Sberbank.

Thus, it encouraged credit institutions to expand their ruble resources and discouraged the use of the dollar in the Russian economy.

From August, Sberbank's required reserves began to be regulated in the same way as those of other credit institutions; that is, on a centralised basis at the place where the correspondent account of the head office was opened.

Reserve requirements were used especially actively after August 17 when bank liquidity sharply declined. In August and September unscheduled reviews of required reserve ratios were allowed at the request of banks.

To reduce nonpayments, especially at large banks with liquidity problems, and ensure actual payments to the budgets of all levels and the Pension Fund, the Bank of Russia on September 18 and 25 and October 2 conducted a series of multilateral interbank clearing operations while simultaneously making an extraordinary review of the required reserve ratios. Funds amounting to 7.1 billion rubles were released as a result and were used to complete settlements.

In accordance with a decision of its Board of Directors of November 16, 1998, the Bank of Russia cut to 5% the required reserve ratio on borrowings made in rubles and foreign exchange. That move was accompanied by the return of required reserves to the accounts of liquidation commissions of credit institutions.

As a result, the amount of required reserves kept by credit institutions in the Bank of Russia in 1998 decreased by 15.6 billion rubles, or 42.9%, of which the amount of required reserves on ruble-denominated accounts declined by 54.5% and on foreign-currency accounts by 6.9%. At the same time, the structure of required reserves changed (the share of reserves from borrowings made in rubles decreased from 75% to 60% and that of the reserves from borrowings made in foreign currency increased from 25% to 40% because of the ruble devaluation).

In the period from January to August 1998 most of the credit institutions deposited required reserves with the Bank of Russia fully and in time; the shortfall on the required reserves deposited by credit institutions ranged between 0.3% and 0.4% of the amount to be deposited. However, after reserve requirements were reviewed, credit institutions as of September 1, 1998, underpaid to the required reserves 2.5% of the total amount to be deposited. After the next review, credit institutions as of December 1 underpaid 18.6% of the total amount to be deposited. The main reason for underpayment of required reserves was the financial and economic crisis.

To create favourable conditions for the implementation of measures to overcome financial difficulties, the Bank of Russia decided not to recover the shortfall on required reserves after the December 1 review from the credit institutions that were involved in the multilateral clearing operations and not to fine them for the shortfall.

Using the reports they received, the Bank of Russia and its regional branches made sure that credit institutions deposited the required reserves in time and in full.

Special importance was attached to inspections designed to ensure that credit institutions complied with the required reserve ratios, calculated correctly the required reserves to be deposited with the Bank of Russia, and provided true information in their reports. A total of 6,460 inspections were conducted during the year, revealing shortcomings in creating required reserves by many credit institutions.

Credit institutions that underpaid funds to the required reserves in 1998 paid a total of 19.1 million rubles in fines, or 10.2% of the total amount of the penalties charged.

REFINANCING BANKS

The Bank of Russia made loans to banks in accordance with the approved targets of the single state monetary policy. Loans were lent to banks if the latter complied with the Bank of Russia requirements. As of December 31, 1998, the debt on Bank of Russia loans made in 1998 totalled 8.9 billion rubles, an increase of 2.4 billion rubles, or 36.9%, from December 31, 1997.

Until mid-June 1998, the Bank of Russia lent banks two types of loans:

- Fixed-rate Lombard loans against government securities in the Lombard list for a term of up to 30 days. From June 1, Lombard loans were made for a term of up to 20 calendar days at a fixed rate and up to 30 calendar days through auctions;
- Unsecured overnight settlement loans. These credits were extended only to the banks that were primary dealers in the government securities market and their amount was strictly limited (to 50 million rubles). Unsecured overnight credits were extended to 23 banks in three Russian regions in the total amount of 1.97 billion rubles.

On June 19, the Bank of Russia stopped lending banks unsecured overnight settlement loans and established a new procedure for refinancing banks in the Moscow Region and St. Petersburg, allowing them to use overnight and intra-day loans against the blocking of government securities. The new regulation on lending of secured Bank of Russia loans to banks that had signed the General Loan Agreement simplified and accelerated the loan lending procedure and the paperwork involved in it.

Lending intra-day loans to banks makes it possible to speed up the process of urgent replenishment of correspondent accounts, especially in the first part of the business day, maintain bank solvency and thus avoid a chain reaction of nonpayments in the bank settlement system.

In all, in 1998 the Bank of Russia lent Lombard and overnight loans to 170 banks in

44 regions to the total amount of 135.7 billion rubles, or 23.6 billion rubles, or 20% more than in 1997. Of these, loans worth 127.4 billion rubles, or 93.9% of the total, were repaid in time.

Lombard loans were the principal mechanism to provide short-term liquidity to banks. Lombard loans were used most actively by banks in the Moscow, Sverdlovsk, Samara, Kemerovo and Vologda Regions and the Republic of Bashkortostan.

From July 8 Lombard loan auctions have been held twice a week, on Monday and Thursday, according to the American method.

After the August 17 events, the Bank of Russia Board of Directors promptly took decisions to change the existing mechanism to credit banks, including the Lombard list, and cut from 0.9 to 0.5 the correction factor for calculating the value of Bank of Russia loan security for fixed coupon-income federal loan bonds.

From August 1998, to maintain liquidity, enhance financial stability and carry out financial rehabilitation measures, the Bank of Russia took decisions to lend secured loans to individual banks of great importance for the country's payments system on terms determined by its Board of Directors. Such loans were made to 13 banks to the total amount of 17.3 billion rubles for a term of up to one year. As the financial condition of some banks improved, by the end of the year they had repaid some of these loans in the amount of 9.3 billion rubles. As of December 31, 1998, the outstanding debt on these loans totalled 8 billion rubles, of which overdue debt amounted to 500 million rubles.

In addition to operations to refinance banks in order to maintain their liquidity, the Bank of Russia took steps to ensure the repayment of loans made in 1992—1994. This was in accordance with decisions of the Government Commission on Financial and Monetary Policy with respect to enterprises in the agribusiness, fuel and energy and timber sectors, light and textile industries, trade and other sectors, which had debts (including interest) amounting to 1,862 million rubles as of December 31, 1998.

In March, the Bank of Russia instructed its regional branches to step up efforts to recover the debt and, whenever necessary, file suits with arbitration courts.

Since a part of the debt and interest on Bank of Russia loans was unrecoverable, the Bank of Russia repeatedly requested the Government, Finance Ministry and State Duma to include this debt into domestic government debt. As a result, Federal Law No. 42-FZ, dated March 26, 1998, "On the Federal Budget for 1998," stipulated (Article 72) that unrecoverable debt should be included in domestic government debt as of January 1, 1998, on loans made in 1992—1994 to enterprises and organisations in the fuel and energy, agribusiness and timber sectors, textile and light industries and other sectors. This would apply also to organisations that carried out the government resettlement programme. Interest on the debt amounting to up to 5 billion rubles should be included as well.

The law also provided for payment compensation to banks on debt on centralised loans and interest, which were repaid to the Central Bank without any payments being made by borrower organisations, by giving banks federal loan bonds issued by the Finance Ministry.

Since the debt on centralised loans and interest was not converted into domestic government debt in 1998, Federal Law No. 36-FZ, dated February 22, 1999, "On the Federal Budget for 1999," extended the provisions of Article 72 of Federal Law No. 42-FZ, dated March 26, 1998, to 1999.

Work was carried through in 1998 to centralise Finance Ministry notes of the I-APK series in accounts with the Bank of Russia First Operations Department (OPERU-1) as the time came for the Finance Ministry to redeem these notes (not earlier than August 31, 1998). At present these notes are being subjected to expert analysis in the Finance Ministry.

In accordance with the decision of the Government Commission on Monetary Policy, the Bank of Russia granted a deferral of repayment on centralised loans made to banks to finance fuel and energy enterprises and repayment of interest charged for using these loans. Repayment of loans in the amount of 31.4 million rubles and interest accrued on loans in the amount of 202.5 million rubles was deferred in 1998.

At the request of regional branches of the Bank of Russia and a number of regional governments, the Bank of Russia Board of Directors wrote off

and transferred to off-balance sheet accounts a portion of bad debt on centralised loans and interest; also interest accrued on the balance due in correspondent bank accounts. This amounted to 259.86 million rubles. Overdue debt on centralised loans amounting to 550,000 rubles was written off at the expense of the Bank of Russia reserve fund.

Bank of Russia regional branches monitored the debt written off from the Bank of Russia balance sheet and transferred to off-balance sheet accounts and took steps to repay it.

As for the banks that were closed and deleted from the State Register of Credit Institutions, the Bank of Russia Board of Directors decided to write off 514.17 million rubles in debt on centralised loans.

INTEREST RATE POLICY

Interest rates on Bank of Russia operations are a major tool of monetary policy.

In 1998, the Bank of Russia declared as one of the objectives of its monetary policy a gradual reduction of interest rates in the economy to a level that would stimulate non-inflationary growth in the demand for borrowings. Specifically, in 1998 this process was made conditional upon the realisation of budget projections, bigger volume and longer terms of government borrowings, also the reduction of the cost of servicing them.

From January to August 1998 the Bank of Russia interest rate policy was largely determined not only by internal developments, but also the situation in the world's stock and foreign exchange markets.

To protect the domestic financial system and prop up the market for ruble-denominated assets, the Bank of Russia had to review interest rates on its own lending and deposit operations. Interest rate fluctuations increased as a result and the Bank of Russia interest rate band changed.

The Bank of Russia sought to keep up an optimal correlation (from the viewpoint of monetary policy objectives) between interest rates on its own operations and market rates and promptly changed rates whenever necessary. Specifically, it raised the refinancing rate in early February

**AVERAGE WEIGHTED MONTHLY INTEREST RATES
ON MAJOR BANK OF RUSSIA INSTRUMENTS IN 1998 (%)**

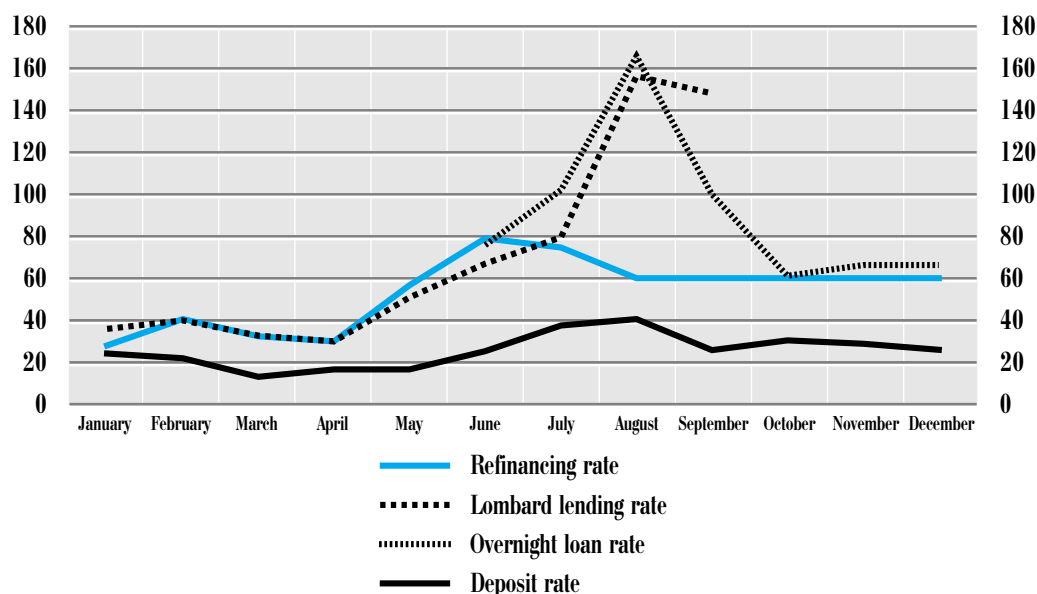


Figure 12

from 28% to 42%; during the last 10 days of May from 30% to 50%, and then to 150%, late in June from 60% to 80%. In July it cut the refinancing rate back to 60%.

The raising of the refinancing rate signalled to the market new benchmarks for yields on government securities and that helped ease pressure on the foreign exchange market. As soon as the money, foreign exchange and stock markets began to look up, the Bank of Russia cut the refinancing rate.

In addition to reviewing the refinancing rate, the Bank of Russia changed interest rates on Lombard loans, overnight loans and REPO operations and Bank of Russia deposit operations.

In 1998, the Bank of Russia began to fix interest rates on secured overnight loans and deposit operations on a daily basis. No fee was charged for using intra-day loans.

Interest rates on overnight loans ranged from 40% to 250%. The highest interest rate of 250% p.a. was announced on August 17. In the latter half of August and in September, the overnight rate fell to 40%. Since December the rate has been 55% p.a.

OPERATIONS ON GKO—OFZ—OBR MARKET

The Bank of Russia's policy in the GKO—OFZ market in 1998 was shaped by the financial crisis and its aftermath. Its main objective¹ was to prevent a sharp devaluation of the national currency. Therefore, from December 1, 1997, the Central Bank gave up supporting domestic interest rates by direct purchases of government securities. That decision helped restrict ruble liquidity, which otherwise would have gone to the foreign exchange market. The Bank of Russia also widely used REPO operations with government bonds to shore up short-term liquidity of the banking system. The range of the banks participating in these operations was broadened. Overnight REPO operations were launched for the first time on May 28, but since returns from such operations could be used in the GKO—OFZ market only, at the end of June when demand for government debt paper sank, overnight REPO deals virtually came to a halt.

The August 17 joint statement by the Russian government and Bank of Russia suspended payments on GKO—OFZ with maturities before December 31, 1999, and suspended trading in all

¹ In the first half of the year.

government bond issues in the secondary market. That brought to a halt all markets for ruble instruments, because government debt papers were the principal security for loan operations between financial market players. Foreign exchange remained, as before, the only liquid investment instrument. Therefore, market participants directed almost all their funds to the foreign exchange market. That situation required the development of new instruments that would, first, be trusted by credit institutions; second, could be used as security for loans to banks, and, third, would be yet another means of regulating banking liquidity. That is why in September 1998 the Bank of Russia began to issue its own short-term non-coupon bonds.

Maximum maturity of the Bank of Russia bonds, known by their abbreviation as OBR, was three months and their aggregate issue volume could not exceed 10 billion rubles. Only credit institutions were allowed to participate in the OBR market. In September, demand for OBRs, was extremely low because banks had practically no spare funds. In accordance with the decision of the Bank of Russia Credit Committee of September 10, 1998, a part of the restructured GKO—OFZ portfolio of credit institutions, which owed debts, including overdue debts, on Bank of Russia loans, were exchanged for OBRs and OFZ-PDs with maturities after December 31, 1999. When the Bank of Russia Board of Directors decided to lend loans to banks after September 14 against restructured GKO—OFZ, these papers could also be exchanged. As a result, counterparties of the Bank of Russia received assets which they could use to regulate their own liquidity and meet their own obligations.

On October 29, the OBR market dealers who had signed the corresponding agreement received the opportunity to participate in REPO operations with the Bank of Russia in accordance with the scheme that was used for GKO—OFZ. The first REPO auction was held on November 12. The delay resulted from technical problems (signing agreements with dealer banks) and lean market (small portfolios of market players and low market volume). In November, banks were allowed to use a short money position at OBR auctions and in secondary trading. Late in 1998, a package of documents necessary for launching a REPO

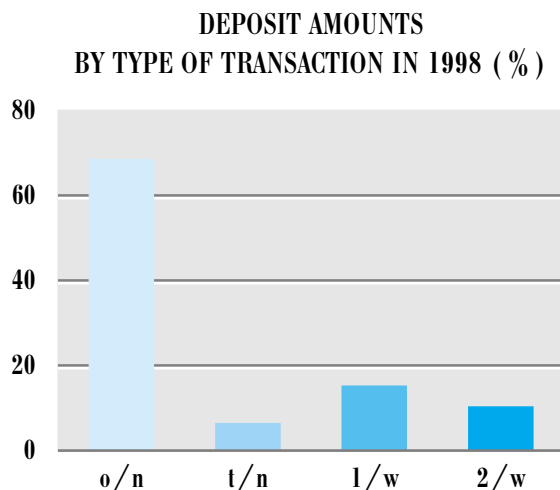


Figure 13

market for Bank of Russia bonds was ready. However, since OBR market volumes were low at the moment and the issue of new bonds was suspended, the introduction of inter-dealer REPO operations was postponed. When the novation procedure is over, a similar scheme is to be elaborated and an inter-dealer REPO market will be launched in the GKO—OFZ market. REPO deals will become an alternative to the interbank loan market, because they will make it possible to borrow against GKO—OFZ on a short-term basis (1 day or 2 days).

DEPOSIT OPERATIONS

To regulate the liquidity of the banking system and withdraw surplus money in order to ease pressure on the foreign exchange market, the Bank of Russia actively conducted deposit operations with resident banks in rubles, using the Reuters dealing system.

Bank of Russia deposit operations were conducted under standard conditions — overnight, tom-next and one week, and on October 8 two-week deposit operations were launched.

Deposit operations were conducted not only by Moscow-based banks, but also banks based in St. Petersburg, and from the fourth quarter banks based in the Ryazan and Tyumen Regions, and the Republic of Bashkortostan.

To accelerate settlements on deposit operations, regional banks transferred funds to deposit from correspondent subaccounts of their Moscow branches.

Deposits were attracted at the rates and in the amounts established by the Bank of Russia, with interest rates ranging from 3% to 80% p.a. The Bank of Russia repeatedly reduced the minimum deposit. Before October 26 the minimum deposit was 50 million rubles. From October 26 to November 23, it was 30 million

rubles, and after November 23, it was 20 million rubles.

It should be noted that overnight (o/n) deposits account for 68.4% of the total amount, one-week (1/w) deposits make up 15.1%, two-week (2/w) deposits 10.2%, and tom-next (t/n) 6.3%.

II.4. FINANCIAL MARKETS

LOAN AND DEPOSIT OPERATIONS WITH NON-FINANCIAL SECTOR OF ECONOMY

The financial market crisis of 1998, which dramatically changed practically all macroeconomic indicators, affected to the full extent the developments in the loan and deposit market. The latter's main indicators reflected a decline in nominal and real volumes of both loans and bank deposits.

Overall debt on ruble-denominated loans by all categories of borrowers¹ decreased from 178.1 billion rubles as of December 31, 1997, to 137.4 billion rubles as of December 31, 1998, or by 58.2% in real terms. Debt on loans made in foreign currency decreased from \$19.0 to \$14.7 billion.

Loans to the real economy in rubles and foreign exchange in total banking assets increased from 27.8% to 32.2%. But that is largely the result of the ruble devaluation.

The amount owed on loans made to the non-financial sector (enterprises and households) in the aggregate debt on loans declined from 79.3% to 78.5% in ruble terms but increased from 79.2% to 81.7% in terms of foreign currency.

Overdue debt on ruble loans to the real economy as a percentage of total ruble loans rose from 5.2% as of December 31, 1997, to 14.0% as of December 31, 1998, and on loans made in foreign currency from 6.3% to 10.9%.

The dynamics of nominal interest rates² on loans and deposits was upward on the whole, although there were fluctuations during the year. Thus, the average weighted rate on ruble loans to corporate entities (enterprises and organisations) rose from 29.6% in January to 47.0% in October, and in the last two months of the year slipped slightly to reach 40.2% in December. Throughout 1998, interest rates on long-term ruble loans to corporate entities were lower than on short-term loans, but the overall tendency was upward. In December, the rates on long-term

ruble loans climbed to an all-time high of 42.5%, 2 percentage points higher than on short-term ruble loans.

The average weighted rate on foreign-currency loans to corporate entities increased from 12.4% in January to 15% in July, not counting fluctuations in between, and in the second half of the year it steadily declined, hitting the year's low of 11.4% in December.

As was the case in 1997, lending volumes differed significantly from region to region, the biggest being registered in the Central Region and also in the North-West, the Volga Region, the Urals and Western Siberia. Interest rate dynamics on loans in all economic regions corresponded to that of Russia as a whole. Over the year, interest rates rose in all regions. In the North, the Central-Black Soil Region and Western Siberia rates on ruble-denominated loans for all terms almost doubled.

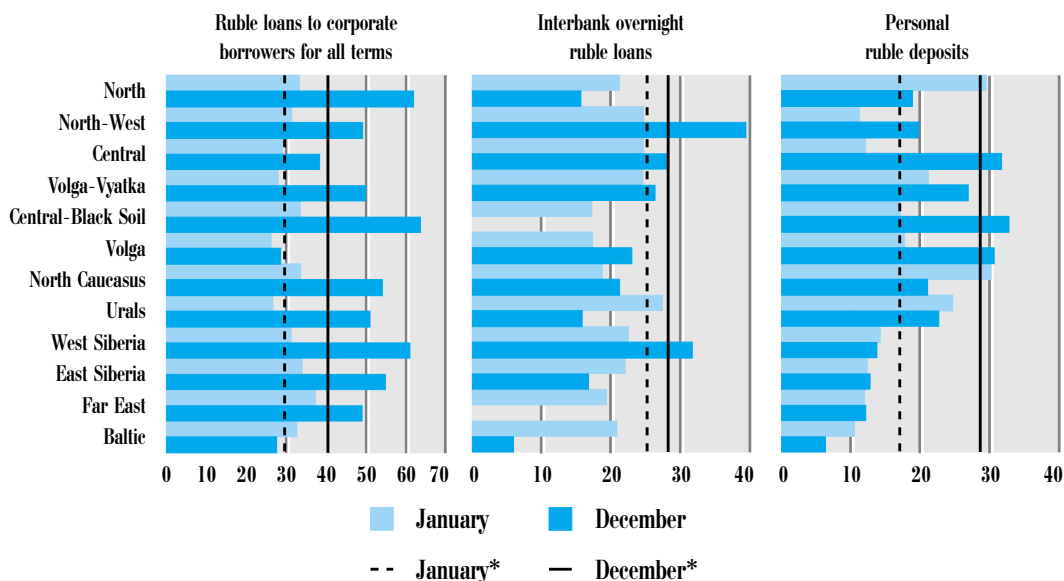
The deposit market faced one of the most serious challenges in the entire history of Russia's contemporary banking system. In the first half of the year ruble deposits attracted by banks from private individuals, both residents and nonresidents, rose by 10% in nominal terms, while in the second half, when public distrust of the banking system increased, they fell by 10.4% to 139.6 billion rubles at the end of the year (including Sberbank, but excluding Vneshekonombank). A similar situation was observed in the market for personal deposits denominated in foreign currency: from January to July their aggregate volume expanded by 35.8%, but by the end of the year they plummeted by 55.2% to \$2.9 billion.

The average weighted interest rate on ruble-denominated personal deposits in 1998 rose from 17.0% to 26.0%, despite significant fluctuations during the year. Interest rates on long-term (more than 1 year) personal deposits in rubles were a great deal higher than those on short-term deposits, but their small volumes during the year testified to public distrust in banks in the medium term.

¹ Here and below: including overdue debt less overdue interest.

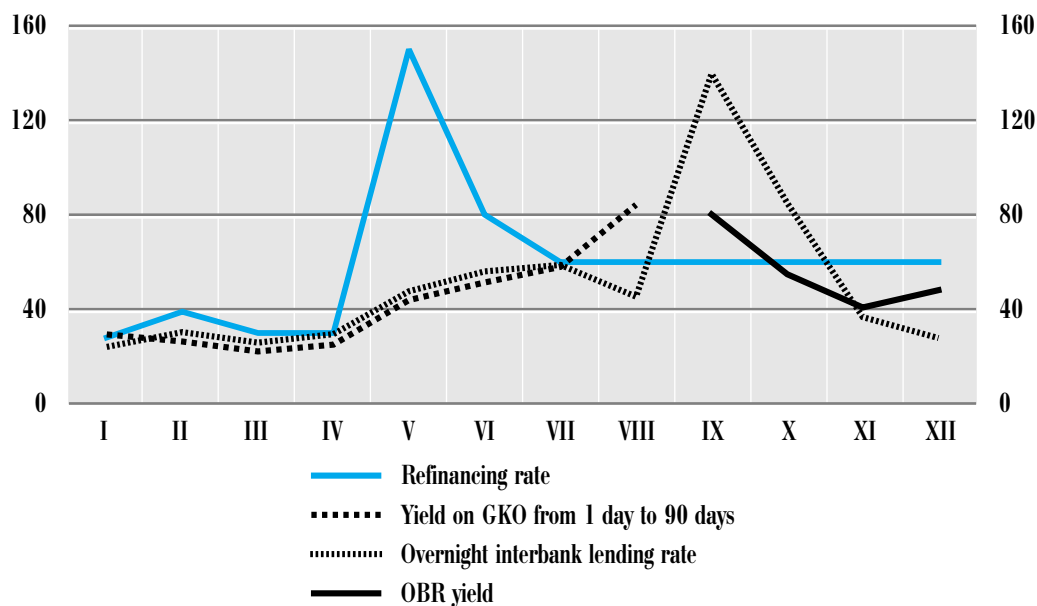
² Here and below: based on banks' reports, excluding Sberbank.

AVERAGE WEIGHTED INTEREST RATES FOR ALL TERMS BY ECONOMIC REGION IN 1998 (% p.a.)



* Russia's average.

MONEY MARKET RATES IN 1998 (% p.a.)



The rate on personal deposits in foreign exchange fell over the year from 10.1% to 6.1% p.a.

The margin on loan and deposit operations conducted by banks in rubles and foreign exchange greatly varied during the year. On ruble operations it reached its peak of 25–27 points in June–August and on foreign exchange operations it peaked to 7–8 points in October–November.

Overall, the interest-rate margin in 1998 was higher and more volatile than in 1997.

INTERBANK LOAN MARKET

Before August, the interbank loan market continued to perform the function of one of the principal regulators of banking liquidity. Balance-

sheet data show that debt on ruble-denominated interbank loans (excluding Sberbank) fluctuated between 16 billion and 18 billion rubles between January and July, or, taking inflation into account, as much as last year. Rates on the most representative overnight interbank loans jumped from 24—30% between January and April, to 46—62% from May to July. Interest rate dynamics in that period approximated the corresponding yields in the secondary market for GKO with maturities up to 90 days.

The crisis in the Russian financial market in 1998, which had been brewing since the beginning of the year, led to the escalation of tension in the interbank loan market. Banks were reluctant to lend loans to one another to safeguard themselves from defaults. In mid-August when low liquidity made it impossible for banks to withdraw their funds from government securities without losses, some banks failed to honour their obligations on interbank loans. The chain reaction of defaults brought operations to a virtual halt. From that time on, only occasional small-sum deals were registered between especially trusted counterparties. So, from August to October, the interbank market was in a state of collapse and its participants recovered from the inactivity very slowly. In this situation, the Bank of Russia had to play a more active role in the interbank deposit and loan market.

To restore the payments system and interbank relations, which were seriously damaged by the crisis, the Bank of Russia in September and October conducted several multilateral clearing operations and lowered reserve requirements, which gave banks additional ruble resources. The rise in the level of bank liquidity made it extremely important for banks to invest their spare funds. Market rates stabilised and in November—December did not exceed 40%.

The interbank foreign-exchange loans market was less affected by the turmoil in the financial sphere. At the beginning of the year, interbank foreign-exchange lending rates were just a little higher than the world's average, but as tension in the Russian financial market grew, these rates started to rise and peaked at 18.6% in September. August and September also saw the biggest decline in interbank foreign-exchange lending volumes, because nonresident banks were ex-

tremely wary of conducting operations with Russian banks. By the end of the year, rates came down a little, while volumes remained practically unchanged.

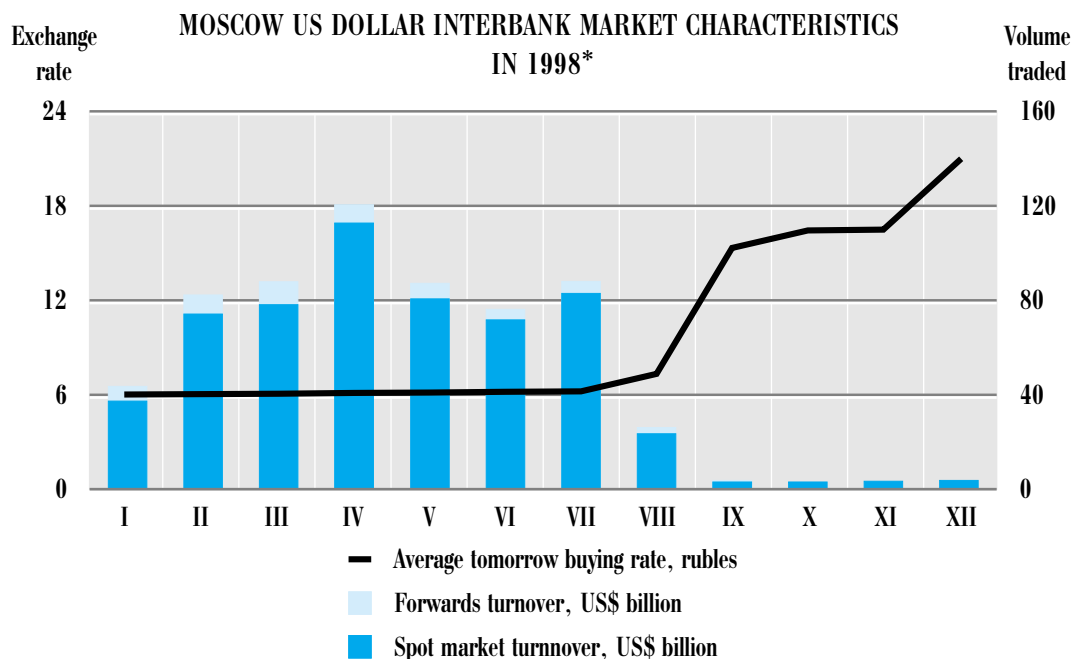
THE FOREIGN EXCHANGE MARKET

Until mid-August, arbitrage operations conducted by banks accounted for a significant part of the volume in the interbank foreign exchange market. Market liquidity was so high that banks had no problem servicing their clients' operations, including operations connected with investments in the securities market. The average daily volume of cash conversion operations in the interbank market expanded almost 1.7 times compared with the same period of 1997 and amounted to nearly \$3.7 billion, according to data reported by leading market makers. At the same time, monthly market turnover fluctuated significantly. The peak was registered in April when the aggregate turnover of cash transactions between major market operators and resident banks totalled \$113 billion.

In the forward segment of the foreign exchange market, the decline in the volume of operations and the reduction of transaction terms, which began in late 1997, continued. One of the main reasons was the crisis of confidence between banks, caused by the general deterioration of the economic situation in the country, and a large volume of mutual obligations accumulated by banks on forward contracts concluded earlier.

Nonresident operations connected with investments in government securities significantly impacted Russia's foreign exchange market in 1998. The volume of investment deals in the first seven months of the year accounted for nearly 2.1% of the entire volume of interbank spot operations and about 22% of the entire volume of client spot operations conducted by banks. Repatriation deals in that period made up almost 65% of the total volume of client forward deals. However, in the beginning of the year, a noticeable excess of outgoing nonresident funds over incoming funds was registered, whereas in February the situation changed and the volume of foreign exchange sales by nonresidents exceeded more than two times the volume of purchases.

Figure 16



* Volumes and rate of interbank conversion operations are based on reports by leading market operators.
From September SELT rate, from October SELT trading volume.

After August 17, the situation in the domestic foreign exchange market changed dramatically. From August 17 to the end of the year, the official US dollar rate to the ruble rose by 230%, and in 1998 as a whole by 246.5%. Over that period, the average daily turnover on interbank conversion operations decreased 21.6 times compared to the time period before August 17, and amounted to a lowly \$0.18 billion. The bulk of transactions moved to the authorised foreign exchange bourses, which guaranteed the execution of settlements. However, owing to a considerable imbalance between demand for foreign exchange and its supply, trading sessions with fixings were halted on MICEX on August 26 and on August 28 trading sessions with fixings were suspended for the same reason on all regional authorised currency exchanges.

The efficiency of the MICEX System of Electronic Lot Trading (SELT) made it possible to amass in this segment of the exchange market the bulk of conversion operations. Interest in trading on interbank currency exchanges as the most reliable sector of the domestic foreign exchange market grew throughout the year. By July net trading volume in the SELT on MICEX had increased more than 10 times over (from \$0.3 bil-

lion in January to \$3.1 billion in July). Right after the August crisis the volume of operations declined for some time, but in September net volume of SELT trades began to increase again. In December, it amounted to \$3.9 billion, while the number of participating banks rose from 67 in January to 226. SELT continued to grow in importance and eventually became the main rate-setting floor. The expansion of the exchange volume of trading partly resulted from the decision by the Bank of Russia to require from October the sale of 50% of export earnings at special trading sessions on currency exchanges.

The forward currency market practically closed down after August 17 as exchange rate dynamics became unpredictable.

SECURITIES MARKET

Just as in the previous years, the situation in the securities market in 1998 had the most significant effect on the Russian financial market as a whole.

GOVERNMENT SECURITIES. By the beginning of the year the GKO—OFZ market was the most important sector of the money market. It at-

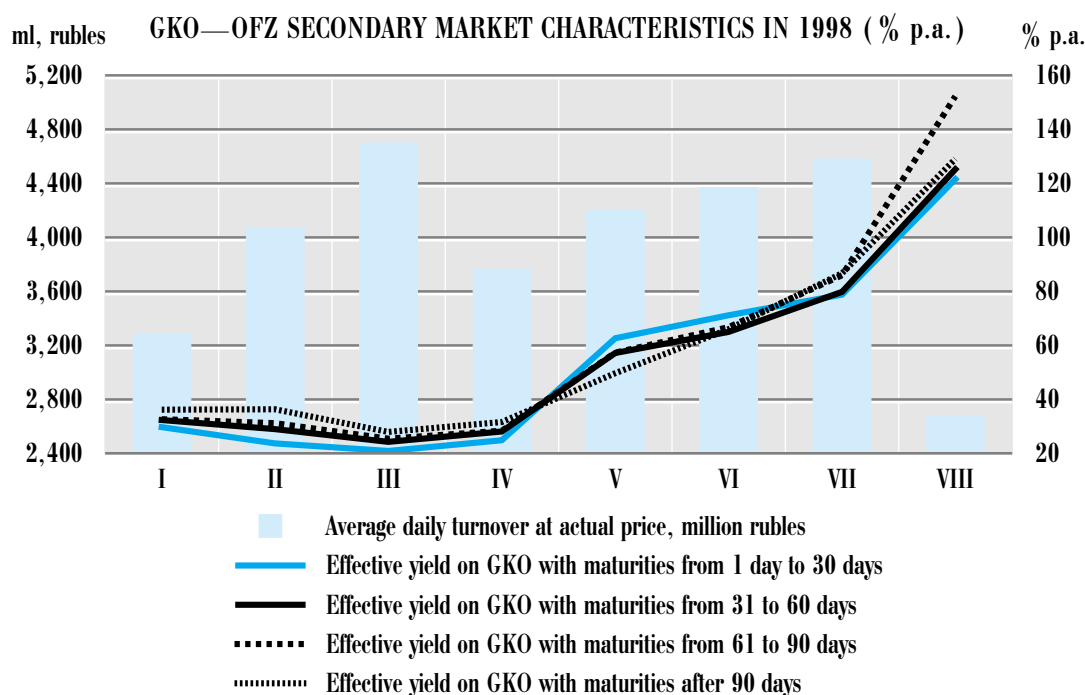


Figure 17

tracted the bulk of market participants' funds and therefore played a key role and influenced the related sectors of the market and the general economic situation in the country.

Nonresidents, whose share of the market was around 30%, exerted a strong influence on conditions in the government securities market. Their participation kept up the domestic debt market, although in 1998 their role was not as positive as it was in 1997. The presence of large foreign investments in the Russian market increased its dependence on the fluctuating conditions of international financial markets. When all restrictions on repatriation of profit made by nonresidents from operations in the GKO—OFZ market were lifted on January 1, 1998, the withdrawal of nonresident funds from the market accelerated. At the same time, as long as the domestic government debt market existed in Russia the behaviour of foreign investors was relevant to the market situation. Overall, from January to August foreign investors increased their investments in government securities. The GKO—OFZ portfolio owned by foreign investors began to decrease only in late July, partly because of the exchange of GKO—OFZ for eurobonds that occurred. The worsening of market conditions that began in April–May was pri-

marily the result of the behaviour of Russian participants.

On December 1, 1997, the Bank of Russia stopped keeping up GKO—OFZ yields exclusively by directly buying government bonds in the secondary market, realising the emission-related consequences of such operations. To regulate liquidity, it used REPO operations widely in that period, significantly increasing the REPO balance.

In February and March when the GKO—OFZ market was relatively stable, the Bank of Russia made efforts to lower the level of bank liquidity, selling bonds from its own portfolio in the secondary market. However, in the middle of April yields started to rise and kept growing until secondary trading in GKO—OFZ was suspended and a part of the domestic government debt was frozen.

In April, effective yields stabilised at 31–36% p.a., but in the middle of May money flow from the government securities market to the foreign exchange market intensified. By July GKO yield (the effective indicator of secondary market turnover) had risen to 85.4% against 35.6% in January.

As demand for new issues fell, from May the Finance Ministry made all repayments using budget funds, while auctions to place new issues were frequently cancelled. As a result, for the first time

in the history of the government securities market the volume of traded bonds, which hit a high of 437 billion rubles in June, began steadily to decline.

By the summer of 1998 the Russian government and Bank of Russia no longer had any practical means of lowering yield on government securities. In July, to reduce the short-term constituent of domestic government debt, the Government proposed a scheme of voluntary exchange of GKO for long-term (7 to 20 years) eurobonds. However, the range of participants in the proposed exchange was limited to nonresidents and big Russian banks, which had the corresponding currency licences. As a result of the exchange, the traded GKO volume decreased by 27.5 billion rubles in nominal terms. Foreign investors accounted for 60% of exchanged GKO and Russian banks made up 40%. The operation helped ease pressure on the budget a little and helped extend borrowing terms. However, more than 50 billion rubles in budget funds were used to repay debt on GKO—OFZ in January—August.

In August, the crisis came to a head and the main reason for that was the Russian government's problems repaying GKO—OFZ. There was practically no demand whatever the price because prospects for the market were bleak. Soared yields did not reflect the actual value of the government debt because very few deals were concluded at such yields. In that situation the Government and Bank of Russia on August 17 decided to review their exchange-rate policy and restructure domestic government debt. When the decision was announced, secondary trading in the GKO—OFZ market was suspended.

Initially, the restructuring plan proposed by the Government on August 25 provoked a negative reaction from GKO—OFZ holders, mostly Russian banks, non-bank financial institutions and nonresidents. The Government agreed to negotiate changes in the plan with investors and as a result of negotiations, the Russian Government on December 12 issued a resolution, "On Novation of Government Securities." The document contained the main elements of the modified procedure for restructuring GKO—OFZ, issued before August 17 and maturing before December 31, 1999. The novation was to be conducted from December 15, 1998, to March 15, 1999.

The restructuring plan provided for the exchange of 70% of frozen GKO—OFZ for four- and five-year bonds (OFZ-FD) with a fixed income of 30% during the first year, decreasing by five percentage points annually; 20% were to be exchanged for zero-coupon three-year bonds (OFZ-PD) that could be used in some financial operations, such as repaying debt on taxes or buying bank equity; 10% were to be repaid in cash and short-term GKO. Insurance companies and pension funds were allowed to exchange 30% of bonds for cash at the expense of OFZ-FD. The sum of the debt was calculated as of August 19 by discounting the nominal value of the restructured GKO—OFZs providing for 50% per annum yield until the bonds mature. In accordance with Federal Law No. 36-FZ, dated February 22, 1999, "On the Federal Budget for 1999," the GKO—OFZ portfolio held by the Central Bank will be restructured into long-term government securities bearing a coupon income of 2% p.a.

GOVERNMENT SAVINGS LOAN BOND (OGSZ) MARKET. The OGSZ market played a subsidiary role owing to its small size and the dominant position of the GKO—OFZ market. Over the year the volume of seven OGSZ issues totalled 7 billion rubles at par (half that of 1997) and OGSZ sales contributed 5.5 billion rubles to federal budget revenues. Coupon income payments, including the service fee of 1%, amounted to 3.8 billion rubles and 4 billion rubles from bonds were redeemed in 1998.

It should be noted that the OGSZ market continued to function after August, although no new issues were placed. As issue volumes remained small, the terms and conditions of servicing OGSZ bonds were not reviewed and coupon payments and redemptions were made in time. In addition, the relative stability of the OGSZ market may be attributable to the fact that the bonds were purchased by private individuals in order to accumulate savings and the absence of a developed secondary market for OGSZ prevented speculation with these bonds.

BANK OF RUSSIA BOND MARKET. After the banking system had virtually lost such a means of regulating liquidity as the GKO—OFZ market, there arose a need for a new instrument that could per-

form this function and became an alternative to investing in foreign exchange. The issue of short-term coupon-less Bank of Russia bonds (OBR) served these purposes. The bonds had maturities of up to three months and the issue volume was limited to 10 billion rubles.

Designed to manage banking liquidity, the OBR bonds were used as security for Lombard and overnight loans made to banks by the Bank of Russia. In November the Central Bank was already conducting REPO operations with OBRs.

The number of dealers registered in the OBR market constantly grew and by the end of the year had reached 214. Unlike the dealer structure of the GKO—OFZ market, where Moscow-based participants accounted for nearly 95% of turnover, the dealer structure of the OBR market was more diverse geographically. The most active OBR market players were medium-sized regional banks, which were less affected by the financial crisis, preserved their clients, and, consequently, had enough spare funds at the time.

The first successful OBR auction was held on September 30. Twelve OBR issues had been placed by the end of the year (five issues were placed by auction and seven in secondary trading) and eight issues were redeemed. The volume of four OBR issues in circulation totalled 2.3 billion rubles at par as of December 31, 1998. Although OBR yield dynamics was uneven, average monthly yields in the secondary market were lower than GKO—OFZ summer yields. The December OBR market turnover index for all terms was 50.8%.

Bank of Russia bonds played a positive role not only as an instrument to manage banking liquidity, but also because their issuance and trading ensured the continuity of trade in securities in the organised market.

REGIONAL AUTHORITIES' BOND MARKET. At the time of the crisis the market for sub-federal bonds was one of the few sectors of the financial market that continued to function, even though its volumes shrank. At the same time, budget problems of governments of all levels did not allow the sub-federal bond market to avoid serious trouble.

The market proved less susceptible to crisis not only because its borrowing volumes were smaller and, consequently, its debt-servicing problems

were less acute. Regional differences were small, because most of the trends in the development of the market coincided with those of the federal bond market.

Increased volatility and significant growth in yields were noted everywhere even in April. In August, the volume of operations declined dramatically. The market structure was dominated by St. Petersburg's floors where sub-federal bonds of many different issuers were traded. Trade turnover on the St. Petersburg exchanges amounted to 10.2 billion rubles over the year and continued to exceed by far the turnovers of other regional trading floors. Yields on the most liquid instruments, the St. Petersburg short-term municipal bonds, were 30% at the beginning of the year. In the post-August period yields peaked to 210%, but by the end of 1998 yields did not exceed 74% p.a.

However, most of the bond issuers at the end of the year had to restructure their debt one way or the other. The restructuring of regional bonds was characterised by shorter maturities on securities issued in the process of the restructuring, the absence of a debt discounting mechanism, and the exchange of a part of obligations for property or shares of regionally-owned enterprises, which helped ease the debt burden.

THE RUSSIAN FOREIGN-EXCHANGE DEBT MARKET was in crisis throughout most of 1998 because the financial crisis in South East Asia made international investors rethink their general investment strategy in financial instruments of transitional and emerging-market countries. The inflow of foreign investment to the Russian foreign-exchange debt market dwindled, while Russia's government debt-servicing expenditures rose significantly. Therefore, conditions were unfavourable for making extensive borrowings abroad, while their use by the Russian government to finance the budget deficit increased foreign debt.

A number of measures taken by the Government to create more attractive conditions for foreign investors who put their money into internal government foreign-exchange bonds, or OVGZ, such as lowering tax on profit from operations with the so-called Vnesh bonds, could not change the overall situation.

Only at the beginning of 1998 was the situation in the market relatively stable and attractive for market players. This was because there was no exchange-rate risk, and liquidity ran high. On some days OVGZ trading volumes amounted to \$100 million.

Between March and July Russia floated six eurobond issues (7-year bonds in the amount of DM1.25 billion, 5-year bonds in the amount of 750 billion Italian lire, 5-year bonds in the amount of US\$1.25 billion, 30-year bonds in the amount of US\$2.5 billion and 7- and 20-year bonds worth a total of US\$6.4 billion to be exchanged for GKO in July). In addition, Moscow placed two issues, one for DM500 million and the other for 400 billion Italian lire, and eurobonds were issued by corporate issuers, such as the Moscow City Telephone Exchange (MGTS) and electricity utility Irkutskenergo.

However, as investment activity in the world markets remained low and international rating agencies downgraded Russia's credit rating, demand for Russian securities by secondary market participants declined. Growing investor distrust in the financial policy pursued by the Russian government provoked a massive sell-off of large blocks of OVGZs in early July and yields soared to record highs. A sharp fall in prices reduced market liquidity to a minimum. From August, all categories of Russian foreign-currency bond issuers had exhausted their eurobond-issuing potential, while the ruble devaluation and other manifestations of the financial crisis made it increasingly difficult for them to service the foreign-exchange bonds they issued.

Demand for currency bonds plunged even though Russia serviced its foreign debt in time. Quotations of the third tranche of OVGZ maturing in May 1999 fell to 20–30% from 90% at the beginning of the year. The prices of the 4th to 7th OVGZ issues dropped to 5–10% of their face value from 40–55% at the beginning of 1998. PRINs and IANs declined from 70% to 10%, and the price of eurobonds issued in July for swaps with GKOs decreased to 20–30%.

After August, the Russian market for currency bonds practically lost its liquidity, while the high risk that Russia would be unable to service its foreign debt and thus it would have to be restructured became the principal rate-setting factors in the market.

BANK SECURITIES. As the crisis hit the Russian banking system in 1998, bank activity in issuing securities declined. During the year, credit institutions issued shares worth 10 billion rubles, of which 7.7 billion rubles in shares were issued to increase authorised capital.

Securities issues registered without increasing authorised capital, that is, by dilution, consolidation, share conversion and also bank mergers and acquisitions, accounted for 22.6% of all registered issues.

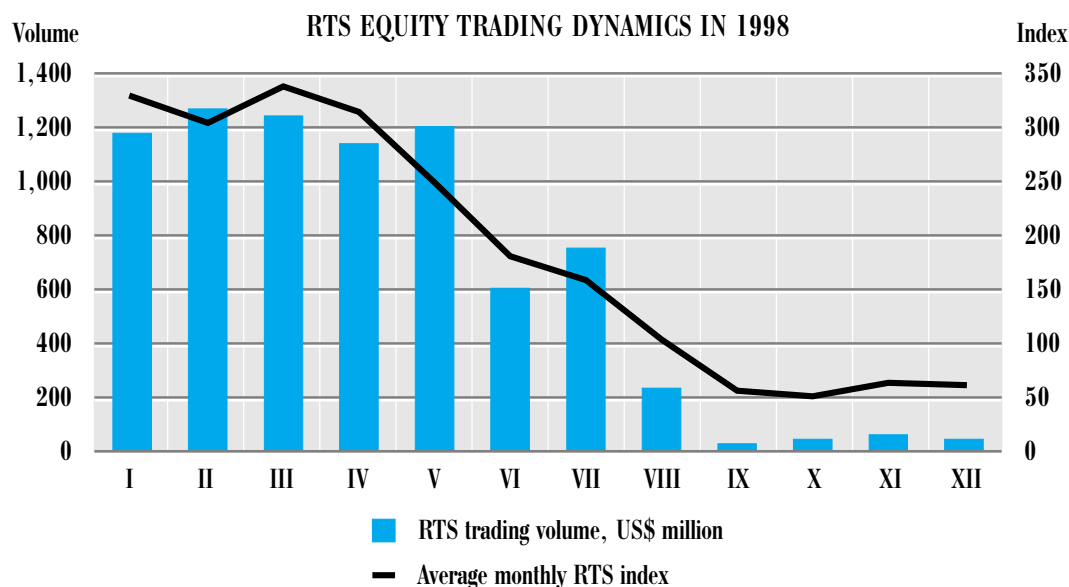
Credit institutions issued primarily ordinary registered shares. The issue of preference shares and bonds declined considerably from the preceding periods owing to change in the financial market conditions. Credit institutions issued savings certificates and certificates of deposit mainly in order to build up their resources.

CORPORATE STOCK MARKET. The 1998 situation in the corporate equity market deteriorated significantly even in comparison with a critical downfall of Russian share prices in late 1997. Russian equities lost their investor appeal mainly because the situation in the world financial and commodities markets had worsened.

The situation in the corporate stock market deteriorated synchronically with the worsening of the crisis in the government securities market and until the end of the year the corporate equity market remained practically paralysed. By late 1998 trading volumes had sunk to less than 1% of the level registered at the beginning of the year and the RTS-1 index, the price indicator in the Russian Trading System, fell by 85% over the year to 58.93 points.

The crisis showed that the Russian corporate stock market was weak and underdeveloped and that the range of issuers of these kinds of securities was too narrow.

DERIVATIVES MARKET. The derivatives market in Russia appeared only a short time ago and few of its instruments are used. In 1998, this market developed under the impact of the situation in markets for underlying assets, such as foreign exchange, precious metals and securities. Overall instability in the financial markets had an adverse effect on the over-the-counter sector, where the lion's share of deals were concluded, and the ex-

*Figure 18*

change market. The major manifestations of the crisis were smaller volumes of forward deals and their shorter terms. Before October 1997 1-year interbank currency futures contracts were quite common, whereas in the summer of 1998 most of the deals were concluded for a term of 1 month to 3 months.

Foreign exchange contracts by far dominated the derivatives market. Currency forward contracts accounted for 96—99% of all forward contracts concluded by Russian banks in 1998. The average daily volume of interbank forward contracts in the first seven months of 1998 amounted to about \$350 million, according to data reported by leading market operators. This is almost three times less than in 1997.

In the first half of the year, the volume of deals with residents exceeded the volume of those with nonresidents more than three times. The decision to allow nonresidents to participate in futures trading on MICEX (from April) contributed to market development and the expansion of the nonresident share of the futures market, but later on this share began quickly to decrease.

One of the main reasons for the crisis in the over-the-counter forward market after August 1998 was the absence of a system guaranteeing fulfilment of the deals that had been concluded. As a result, nonfulfilment of contracts became widespread and adversely affected not only the financial condition of credit institutions, but also the entire derivatives market.

**FOREIGN EXCHANGE
POLICY AND
FOREIGN EXCHANGE
REGULATION**



III.1. FOREIGN EXCHANGE POLICY AND RESERVE MANAGEMENT

IN ACCORDANCE with the Guidelines for the Single State Monetary Policy for 1998 and the joint statement by the Russian Government and Central Bank, dated November 10, 1997, “On the Exchange Rate Policy,” the Bank of Russia in 1998 continued to use a fixed exchange rate, pegging the ruble to the US dollar.

The main feature of the exchange rate policy pursued in Russia in the previous two and a half years was setting upper and lower limits on ruble fluctuations against the dollar (the so-called “currency corridor”). The principal objective of that policy was to ensure stability and predictability of the exchange rate of the domestic currency in order to help solve the following inter-related problems:

- suppressing inflationary expectations;
- stimulating real demand for money;
- making ruble-denominated financial instruments more attractive as savings;
- attracting foreign capital, first in the form of portfolio investments, then as direct investments;
- ensuring a persistent decline in interest rates.

It was believed that the attainment of these objectives would create conditions conducive to growth in investment activity in the real economy and the latter’s eventual growth. However, the successful implementation of this strategy required a balanced budget and sound fiscal policy, its co-ordination with the monetary and exchange rate policy, effective control over government spending and collection of taxes and other budget revenues, and the fixing of structural problems of the Russian economy.

At the same time, Russia’s federal budget deficit in 1996 and 1997 remained large and was financed by borrowing more at home and abroad, using the GKO—OFZ mechanism, eurobonds and loans from international financial organisations. The reduction of GKO—OFZ yields and, consequently, of the cost of servicing the newly-created domestic debt was achieved from the second half of 1996 by expanding the participation of nonresident investors in the government securities market. In the first half of 1997, for example, nonresidents’ share of the GKO—OFZ market increased from 17% to about 30%. The value of the government securities portfolio owned by nonresidents became comparable with the Central Bank’s foreign exchange reserves. Nonresident funds invested in government securities (along with other foreign borrowings) became a major source of foreign exchange in the domestic currency market, maintaining a balance between the supply of foreign currency and demand for it at a ruble exchange rate that was within the declared currency band.

Thus, the possibility of keeping the ruble exchange rate within the limits set by the Government and Bank of Russia became directly dependent on the direction of foreign capital flow. The bulk of foreign capital was concentrated in the GKO—OFZ market and represented short-term investment. In 1997, there appeared signs indicating that the Russian currency’s exchange rate was overvalued: efficiency of foreign trade operations with major Russian export commodities showed a tendency to decline and the import of consumer goods and services kept grow-

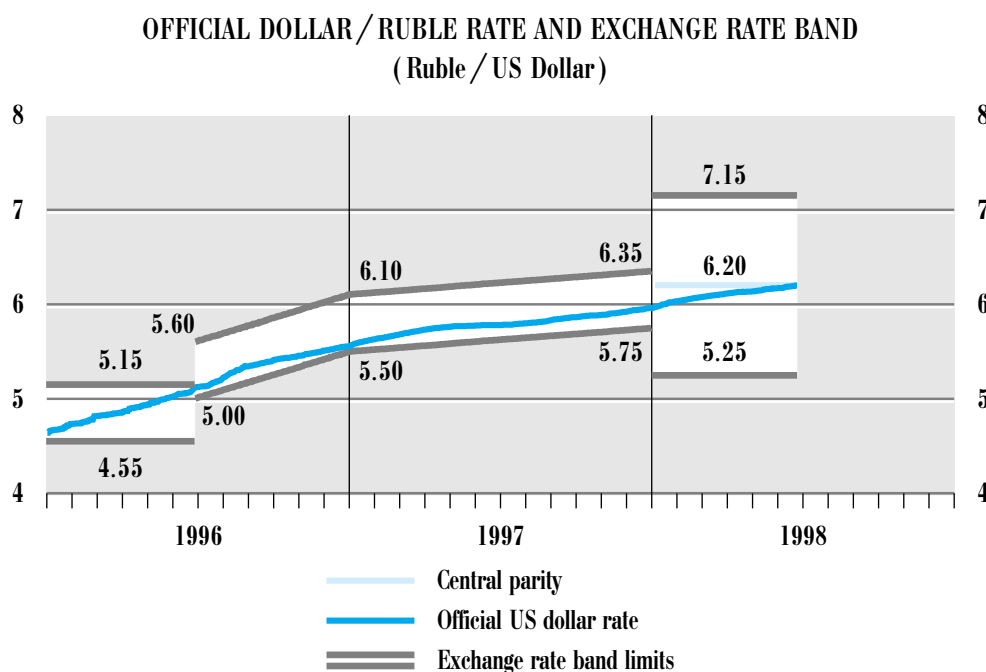


Figure 19

ing. The real rate of the ruble remained practically stable against the dollar, but rose noticeably against the currencies of Western European countries, Russia's leading trading partners (because of the drop in their exchange rates against the US dollar). As a result, the balance of trade surplus characteristic of Russia in the current decade began to demonstrate a persistent tendency to decline.

The liquidity situation in international financial markets started to change for the worse and by the autumn of 1997 when the GKO—OFZ yield had been reduced to 18—19% a year, net foreign capital inflow to the Russian government securities market virtually ceased. As a result, the situation in the Russian foreign exchange and financial markets became inherently volatile.

The world financial crisis in the autumn of 1997 demonstrated the vulnerability of the Russian financial system to crises in the world's economy. Instability in Russia resulted from imbalances in Russian government finance and its extreme dependence on foreign borrowings. November 1997 saw a significant outflow of nonresident funds from the GKO—OFZ market and over the month, the nonresident share of the market had diminished from 30.2% to 26.2%. The repatriation of nonresident funds withdrawn from Russian securities and the demand for foreign

exchange by Russian market players required the Bank of Russia to conduct massive currency interventions in the foreign exchange market. As a result, early in December 1997 the Bank of Russia had to give up its efforts to actively prop up GKO—OFZ prices by issuing money to government securities for its own portfolio. That further increased the cost of domestic government debt servicing, but foreign capital outflow from the Russian financial market was stopped for some time and the situation in the foreign exchange market stabilised.

It should be recalled, however, that at the outset of the crisis an attempt was made to ease excessive control over exchange rate dynamics, which had been exercised in the previous period to achieve financial stabilisation, but had resulted in an overvalued ruble. In November 1997 the Russian Government and Bank of Russia announced the establishment of medium-term (three-year) targets for the exchange rate. The central rate was set at 6.2 rubles to the dollar and the ruble was allowed to deviate from it by 15% in either direction. The new band exceeded by far the limits of that of previous years. The authorities also promised to permit greater exchange rate flexibility within the declared band as a reaction to possible changes in the economic situation at home and abroad. Subsequent develop-

BANK OF RUSSIA FOREIGN EXCHANGE RESERVES AND NONRESIDENT
GKO—OFZ PORTFOLIO IN JANUARY 1997 — AUGUST 1998 (US\$ billion)

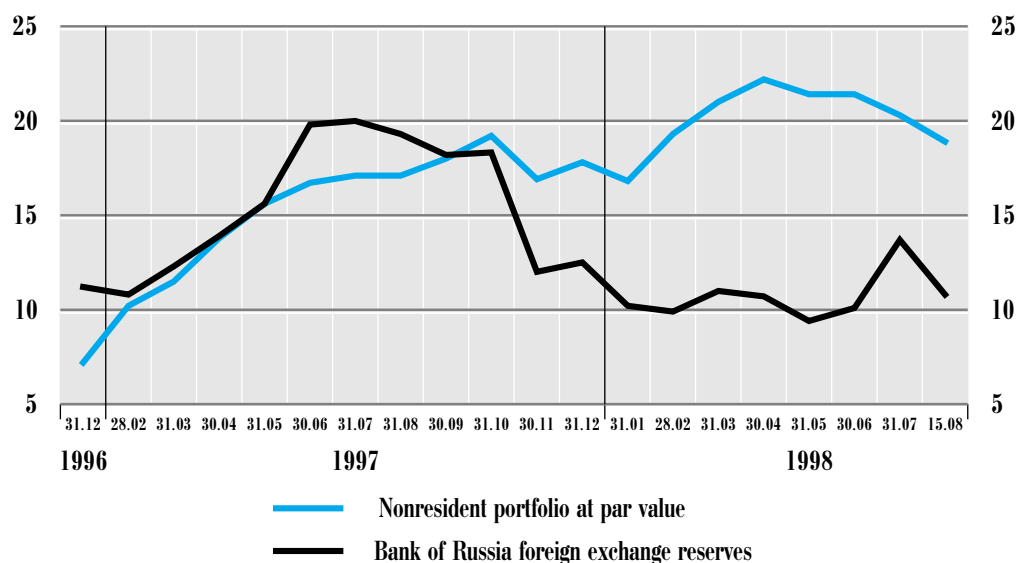


Figure 20

ments showed, however, that the new policy failed to take fully into account all the potential threats to its implementation and so it was not put into practice in 1998.

Efforts made by the Bank of Russia in early 1998 to speed up the pace of decline in the ruble exchange rate destabilised financial markets. Russian corporate equity prices tumbled, while GKO—OFZ yields soared. The situation was compounded by a fairly tense situation in the forward segment of the domestic foreign exchange market. In January, the dollar rose by 1.1%, or 14% a year. Extrapolated to the whole year, the emerging tendency showed that the rate of ruble devaluation far surpassed the one that commercial banks took into account in calculating the price of forward contracts that would be settled in 1998.

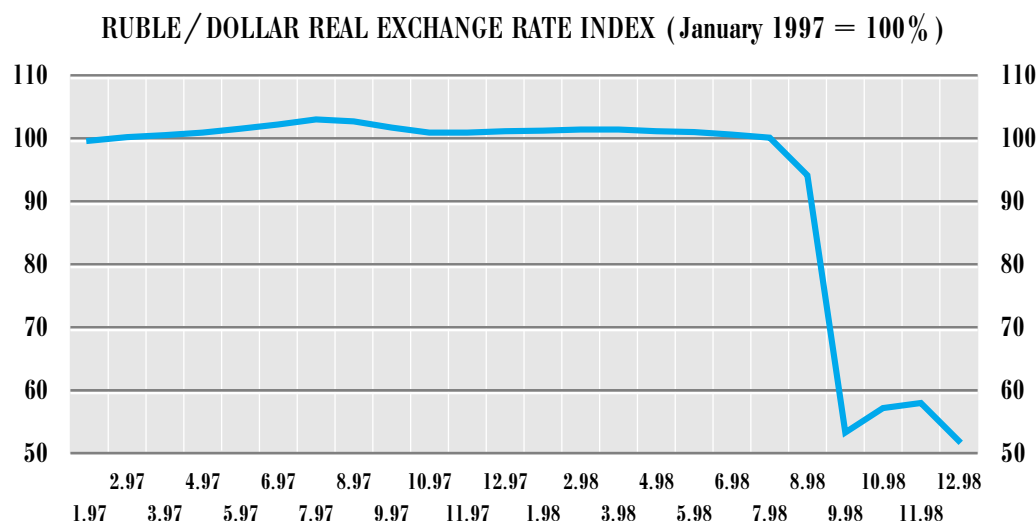
Many banks that specialised in forward operations and had unreasonably large open forward positions faced the prospect that they might incur losses and might not be able to meet their obligations on forward contracts. That situation, for its part, provoked expectations of a major devaluation of the ruble, especially among western investors who had concluded forward contracts to hedge the exchange rate risk of their GKO—OFZs.

As a result, in January the nonresident share of the GKO—OFZs traded in the market declined from 27.5% to 25.9%, while nonresident pur-

chases of foreign exchange through S-type accounts exceeded sales by more than \$600 million. Over the month the Bank of Russia sold more than \$3 billion in the foreign exchange market. The situation was stabilised only in early February when the refinancing and Lombard lending rates were hiked from 28% to 42%.

The subsequent period of 1998 (until the middle of May) was relatively calm. Yields on government securities stayed in the range of 28—35%, which made it possible to cut the refinancing rate. The nonresident share of the GKO—OFZ market was restored to about 30%. The brief periods during which the Bank of Russia had to conduct currency interventions to keep the exchange rate dynamics smooth alternated with periods when it managed to increase official international reserves by buying foreign exchange in the domestic currency market.

However, in the spring of 1998 a potential for destabilization continued to build in the Russian financial system. More and more Russian and foreign experts, and financial market participants came to realise that the economic policy pursued and the methods by which it was implemented could not normalise or stabilise the situation in the foreign exchange and financial sphere. Therefore, as soon as it became known in May 1998 that a crisis had broken out in Asian markets, the

*Figure 2.1*

situation in the Russian market was completely destabilised. The prices of Russian government and corporate securities resumed their fall and regular currency interventions by the Bank of Russia became the permanent condition of balancing foreign exchange demand and supply in the domestic market. Interest rates, which rose to more than 100% p.a. against the background of a still low inflation rate, clearly showed that they had already taken into account a major devaluation of the ruble. By the summer there had developed a persistent tendency towards outflow of ruble-denominated household deposits from commercial banks and conversion of these savings into foreign exchange, or their transfer to foreign-exchange bank deposits. The steep rise in the refinancing rate and other tight monetary policy measures taken by the Bank of Russia only brought about temporary improvements.

The worsening of the Russian foreign exchange and financial crisis, which had profound internal economic causes, was also caused by some external economic factors:

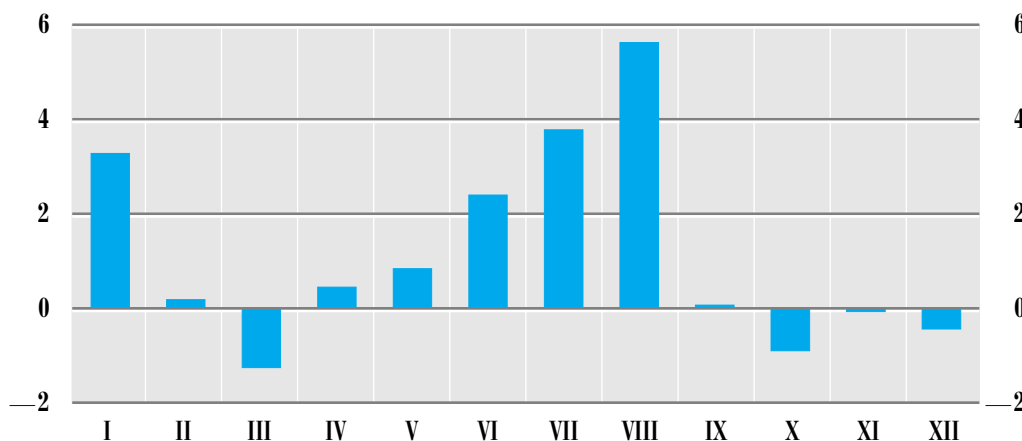
- The financial crisis that began in some countries of South East Asia and later became a global crisis made international investors review their policy on emerging market investments, including the Russian market, which became depressed and eventually experienced an exodus of foreign investments;
- The fall in world prices of major Russian exports, especially oil, caused Russia's foreign trade surplus to decline significantly.

The deterioration of foreign trade conditions and the unsatisfactory state of the revenues side of the federal budget exacerbated the problem of managing domestic government debt. Expenditures to redeem government securities and pay interest, and the need to guarantee repatriation of short-term foreign capital became an unbearable burden for the federal budget and began significantly to deplete Russia's international reserves. Even the decision in July by the International Monetary Fund's Executive Board to give Russia another large loan, and the disbursement late in July of nearly \$4.8 billion in IMF money directly into the accounts of the Bank of Russia to build up foreign exchange reserves, could not change the situation for long. Net sales of foreign exchange by the Bank of Russia in the domestic foreign exchange market amounted to \$800 million in May, \$2.4 billion in June and \$3.8 billion in July, whereas in the first half of August Bank of Russia currency interventions rose to almost \$3.2 billion.

It was inevitable in that situation that Russia should make fundamental changes in its foreign exchange policy. To prevent further unjustified spending of international reserves, the Russian Government and Bank of Russia on August 17 announced their decision to abandon the exchange rate policy parameters they declared earlier and switch to a floating exchange rate regime.

In the period from January 1 to August 17, 1998, the official US dollar rate to the ruble had risen by 5.5%, from 5.96 rubles to 6.29 rubles

BANK OF RUSSIA CURRENCY INTERVENTIONS IN 1998 (US\$ billion)*



* Net interventions in all sectors of the domestic foreign exchange market; “+” means foreign exchange sale, “—” foreign exchange purchase.

Figure 22

to the dollar. In real terms, that is, taking inflation into account, the exchange rate of the ruble declined by 2.2%. To maintain ruble rate stability in that period, the Bank of Russia sold almost \$13 billion (net) in the domestic foreign exchange market. One of the consequences of keeping the ruble rate overvalued was, in addition to spending Bank of Russia currency reserves, the reduction by 4.2 times (from \$9.6 billion to \$2.3 billion) of the trade balance surplus in the first half of 1998 compared with the same period of 1997.

After August 17, the situation in the domestic foreign exchange market changed dramatically. This became particularly manifest in a virtually complete halting of operations in the over-the-counter sector of the interbank market. In a bid to prevent a precipitous fall of the ruble, the Bank of Russia in the second half of August continued massive currency interventions, selling about \$2.5 billion. However, as other sectors of the financial market had collapsed, the banking system was struck by a profound crisis and capital flight intensified. The Bank of Russia became virtually the only seller of foreign exchange in the domestic market, while the further expenditure of currency reserves only led to their unjustified depletion without even temporarily stabilising the situation. By September, the exchange rate had passed the 10-ruble mark to the US dollar and the Bank of Russia abandoned the practice of conducting massive currency interventions, using this instrument only when it was necessary to prevent extremely sharp fluctuations of the ruble rate.

In September, the MICEX System of Electronic Lot Trading (SELT) became a major segment of the Russian foreign exchange market, where the principal volume of conversion operations was concentrated. During the first 20 days of September, the foreign exchange market was further affected by expectations of a further worsening of the financial and economic crisis and the absence of clear price signals for market participants as well as high exchange rate volatility. Ruble rates fluctuated from 20.825 rubles to the dollar on September 9 to 8.6707 rubles on September 15. At the end of the month the subsequently increased rate of the dollar was stabilised at about 16 rubles.

The normalisation of the foreign exchange market that followed was largely the result of a restrained monetary policy and the adoption by the Bank of Russia of a number of foreign exchange regulation and control measures. The most significant part was played by the change in early October of the procedure for compulsory sale of foreign exchange earnings by exporters and the opening on MICEX and other authorised currency exchanges of special trading sessions (STS). It is at the STS that exporters were required to sell 50% of their foreign exchange earnings. The right to buy foreign exchange sold at the STS was granted only to the Bank of Russia, importers, resident corporate entities (to pay dividends and repay loans lent under guarantees of foreign government export loan insurance organisations), and banks to meet their obligations on foreign exchange deposits. As the interbank foreign exchange market was

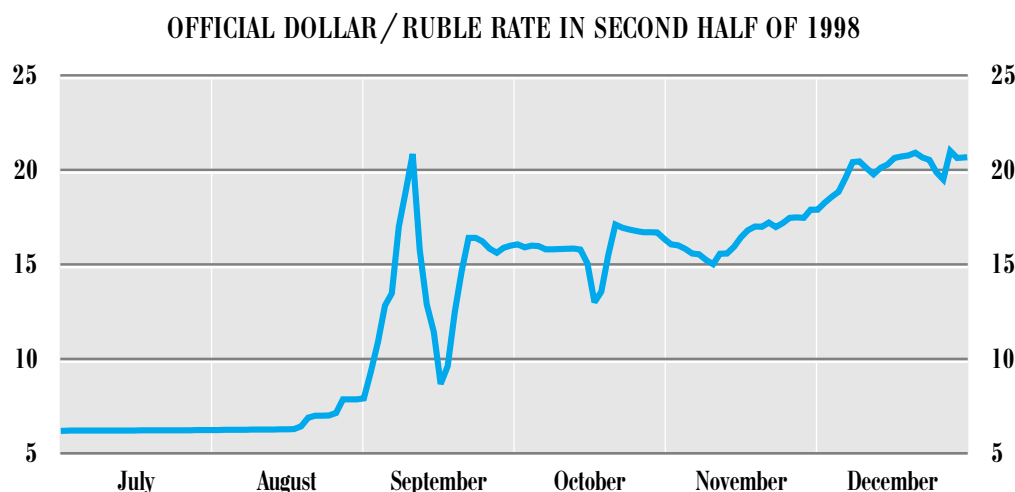


Figure 23

disorganised and its turnovers tumbled, the introduction of the STS became a forced but necessary anti-crisis measure designed to meet Russia's needs in foreign exchange. Aggregate trading volumes at the STS rose from \$1.83 billion in October to \$2.63 billion in December. In that period the difference between the STS average weighted rate and the rate at the free-access MICEX sessions tended to narrow, although it was still significant and averaged 3.8% in December.

As a result of a sharp fall in the ruble exchange rate in August and September, when the ruble also lost much of its value in real terms, its rate became undervalued from the viewpoint of fundamental economic indicators, mainly under the impact of negative expectations of market participants and capital outflow from the country.

The exchange rate was seriously affected by the purchase of foreign exchange in the domestic market by the Bank of Russia to finance payments of foreign government debt. In September–December \$2.3 billion was allocated for this purpose from the Bank of Russia's foreign exchange reserves. From the second half of September until the end of the year net purchases of foreign exchange by the Bank of Russia in the domestic market totalled \$1.9 billion.

From August 17 to December 31 the official US dollar/ruble rate rose by 230%, from 6.29 to

20.65 rubles to the dollar. In real terms, that is, counting inflation, the ruble fell by 46%.

Overall, in 1998 the official US dollar/ruble rate rose by 246.5%, from 5.96 to 20.65 rubles to the dollar. In real terms the ruble lost 47.6% of its value.

From January to the middle of August, the Russian foreign exchange market sharply fluctuated and pressure on the Bank of Russia's international reserves increased from time to time. The latter had a negative dynamics and their amount and structure became increasingly difficult to predict even in the short term.

The disbursement of loans for Russia from international financial organisations in July faced the Bank of Russia with a number of new problems relating to risk management, because for the first time the Central Bank was registered as the official recipient of credit.

The IMF tranche received by the Bank of Russia in July went to replenish the investment portfolio of the Central Bank's international reserves. This ensured the preservation and growth in value of reserves in the long term so as to maintain confidence in the ruble and Russian financial markets, and to create favourable conditions for Russia's external borrowings. This would enable the country to meet its obligations under agreements with international financial organisations¹.

¹ Unlike the operating portfolio, which serves to ensure Bank of Russia liquidity on current operations, primarily stabilisation of the ruble rate in the domestic foreign exchange market, the investment portfolio funds are put into relatively longer-term and, consequently, higher-yield instruments of the international money market, especially US and German government bonds.

In July the Bank of Russia Board of Directors made a number of amendments to the “Main Principles of Managing International Reserves of Bank of Russia,” pertaining to the portfolio and currency structure of reserves and the list of instruments and transactions permitted for use. These amendments reflected a new, broader range of tasks involved in the management of international reserves.

In September and December, the Board of Directors made several new amendments to the Main Principles, necessitated by the extraordinary nature of international reserve management in the context of an acute debt crisis and the introduction from January 1, 1999, of a single European currency (the euro). It also concerned the statutory size and currency structure of the operating and investment portfolios of international reserves.

The volume of the Bank of Russia’s international reserves changed significantly during 1998. Reserves were spent to conduct interventions and replenished by the purchase of foreign exchange by the Bank of Russia in the domestic foreign exchange market and from the Finance Ministry. They were also replenished as a result of the transfer of IMF loan funds directly to Bank of Russia accounts. In the last three months of the year, international reserves had decreased significantly because they were used to finance Russian foreign debt payments. In the year as a whole, foreign exchange reserves of the Bank of Russia decreased from \$12.8 billion to \$7.8 billion, while its gold and hard currency reserves declined from \$17.2 billion to \$12.1 billion.

PRECIOUS METALS MARKET

In 1998 the Bank of Russia continued to implement a policy aimed at building a domestic mar-

ket for precious metals, providing a legislative framework for it, expanding the range of market participants and increasing the volume of operations. It actively traded in precious metals with Russian credit institutions.

One of the major documents designed to promote the development of the precious metals market, which was drafted with direct participation of the Bank of Russia, is the Russian government resolution regulating the activities of precious metals and precious stones exchanges. The implementation of this document will help credit institutions step up their activity in this sector of the market and greatly broaden the range of services they provide.

The Federal Law on Precious Metals and Precious Stones lifted major restrictions on transactions with refined precious metals in Russia. Amendments to previous rules and regulations and favourable trends in the development of the domestic market for precious metals allowed Russian credit institutions to finance and buy a large amount of precious metals produced in 1998. The leading players in the Russian precious metals market are banks of the Moscow and Sverdlovsk Regions and Krasnoyarsk and Khabarovsk Territories.

Last year, 11 Russian banks took part in the international precious metals market, selling 57.3 tonnes of gold and 182 tonnes of silver.

Despite the world economic crisis, the decline in the industrial consumption of precious metals and, consequently, a relative reduction in their world prices, gold remained a stable and liquid asset.

Realising the need to increase the country’s gold and currency reserves, the Bank of Russia in 1998 bought 34.3 tonnes of gold in the domestic precious metals market.

III.2. FOREIGN EXCHANGE REGULATION AND FOREIGN EXCHANGE CONTROL

IN PURSUANCE OF the state monetary and foreign exchange policy in 1998, the Bank of Russia, being the main foreign exchange regulating body and one of the bodies of foreign exchange control under the Federal Law on Foreign Exchange Regulation and Foreign Exchange Control, dated October 9, 1992, continued to upgrade and refine rules and regulations in this area and enhance the efficiency of foreign exchange control. Its aims and tasks in this field were dictated by the state of the financial sector and the country's economy and the need to maintain the ruble's stability and implement measures to prevent capital outflow. At the time of the crisis, which created imbalances between various segments of the financial market, the use of foreign exchange regulation and control tools proved effective and helped stabilise the domestic foreign exchange market.

The Bank of Russia made big efforts to balance demand and supply in the domestic foreign exchange market, especially by ensuring full and timely repatriation of export earnings and reducing advance payments for imports that were not accompanied by the delivery of goods and services.

To overcome the aftermath of the August financial crisis, the Bank of Russia intensified its legislative activity. In the period of September to December it adopted more than 20 rules and regulations relating to operations in the domestic foreign exchange market and establishing more effective controls over foreign exchange operations conducted by residents.

The September delays in repatriation of export earnings caused a significant reduction in the supply of foreign exchange in the domestic market and provoked sharp fluctuations in the ruble rate against the US dollar. In this situation, taking into consideration that export earnings sold by exporters were the only source of foreign exchange supply, the Bank of Russia issued emergency regulations to ensure full and timely repatriation of export earnings. The Bank also estab-

lished a new trading procedure on interbank currency exchanges.

In September the Bank of Russia and State Customs Committee confirmed that failure to return export earnings within the deadlines set by contracts constituted a violation of customs rules and, in accordance with Article 273 of the Customs Code of the Russian Federation, was punishable by a fine ranging from 100% to 200% of the value of the goods delivered.

Seeking to create conditions that would facilitate the receipt and sale of export earnings, the Bank of Russia in October simplified the procedure for transferring exporters' certificates of transaction from financially-troubled authorised banks to other authorised banks using permits issued by regional branches of the Bank of Russia. The use of this procedure helped normalise settlements in implementing foreign trade transactions.

The Bank of Russia also changed the procedure for trading in foreign exchange on the interbank currency exchanges, creating a more economically sound rate-setting mechanism by separating trade in foreign exchange on foreign trade operations from other transactions. The introduction of temporary two-sector trading on interbank currency exchanges was necessary because foreign exchange was in short supply. Small trading volumes and, as a consequence, the strong influence of speculative capital on the ruble exchange rate made this more necessary. The above-mentioned regulatory document stipulated that export earnings subject to compulsory sale must be sold at special trading sessions only, while authorised banks could buy foreign exchange at these sessions for specific purposes only.

Seeking to find a comprehensive solution to this problem, the Bank of Russia tightened controls over authorised banks when they bought foreign exchange in the domestic market with rubles to fill client orders. This was to make sure that the foreign exchange purchased was not misused. On November 1, the Bank of Russia introduced new rules for resident corporate entities

who bought foreign currency on interbank currency exchanges. They stipulated that the right to buy foreign exchange with rubles could not be granted sooner than seven days before the payment date and that this foreign exchange must be resold in the domestic market upon the expiration of that term, if residents were unable to meet their obligations to foreign counterparties. Authorised banks acting as agents of foreign exchange control were required to exercise a documentary control and maintain records of such operations.

The Bank of Russia prohibited banks from buying foreign exchange at clients' request at the special trading sessions to pay for the import of services. This was to forestall possible negative effects of increased demand for foreign exchange after lifting on November 14 of the freeze on foreign exchange payments by residents wishing to fulfil obligations to nonresidents. It also prevented speculative demand for foreign exchange for import contracts that were not covered by the customs and banking control system.

Taking into consideration that the adoption of sound decisions depends to a great extent on the availability of up-to-date and authentic information, the Bank of Russia began to monitor on a daily basis cash movement in residents' foreign exchange transit accounts and sales of export earnings on interbank currency exchanges.

The use of regulating measures and controls ensured the implementation by the end of the year of the most urgent task of increasing foreign exchange supply thanks to repatriation of export earnings. This helped stabilise the domestic foreign exchange market. Foreign exchange sales by exporters at MICEX special trading sessions rose from \$1.7 billion in October to \$2.5 billion in December.

To insure the immediate enforcement of the Federal Law on Urgent Measures in the Field of Budget and Tax Policy of December 29, 1998, which increased the proportion of export earnings subject to compulsory sale from 50% to 75% and reduced the sale period from 14 to 7 days, the Bank of Russia on December 31 made the necessary amendments in its rules and regulations to bring them into conformity with that law.

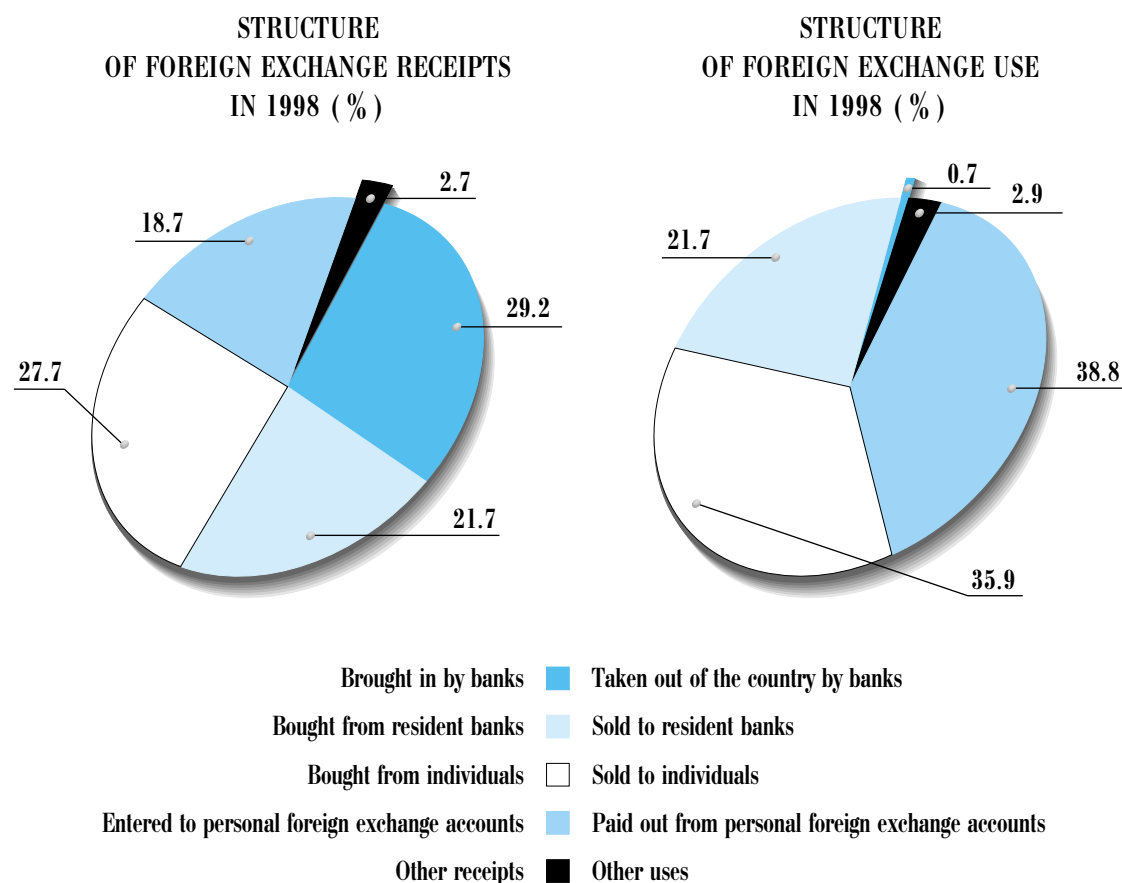
Exercising its functions as a foreign exchange control body, the Bank of Russia and its regional

institutions stepped up their activity in monitoring compliance with foreign exchange legislation by authorised banks and the implementation by the latter of foreign exchange control over currency operations conducted by their clients. Regional institutions conducted more than 53,000 inspections of credit institutions and other corporate entities, which is almost twice the number inspected in 1997. Nearly 5,000 orders to take corrective action were sent as a result of the inspections. Fines became more frequently used against violators of foreign exchange laws and regulations. The sum of fines charged and recovered from authorised banks and other corporate entities increased from 27 million rubles in 1997 to 89 million rubles in 1998.

In the fourth quarter of the year specialists with Bank of Russia regional institutions in all regions conducted jointly with customs officers comprehensive inspections of exporters and the authorised banks that serviced them to make sure that export earnings were repatriated fully and in time. Over 1,000 joint inspections were conducted from October to December and 1,330 orders to take corrective action were sent to exporters as a result.

From the middle of October, about 150 Moscow-based authorised banks were inspected to make sure that they and their clients complied with the requirements of foreign exchange legislation. As a result of the inspections, 26 banks were penalised by being temporarily barred from foreign exchange trading on MICEX.

Control over resident export-import operations was exercised by the Bank of Russia and State Customs Committee within the framework of the customs and banking oversight system, which is designed to verify and check the correspondence of the dates, volumes and value of goods moved across the border with the payments made. This system covers all foreign trade transactions involving export-regime transfer of goods from the customs territory of the Russian Federation, on which settlements between residents and nonresidents are made in currencies other than the Russian currency. It also covers the import of goods in customs regimes such as "issued for free circulation" and "re-import", on which settlements are effected wholly or in part in foreign exchange. In 1998 customs and banking con-

*Figures 24, 25*

trol was extended to cover commodity deliveries under contracts concluded within the framework of inter-governmental agreements and also as repayment of Soviet debt. In addition, specific provisions were made for customs and banking control over the export of refined gold and silver by credit institutions.

According to the State Customs Committee, the customs and banking control system in 1998 covered exporters' foreign exchange operations in the amount of \$49.1 billion, or about 70% of Russian commodity exports. Non-repatriation of export earnings decreased from 7% in 1997 to 5% in 1998.

Imports coverage by the customs and banking control system in 1998 was at the level of 65% of the total value of Russian goods imports.

Steps were taken to regulate operations conducted by nonresidents in rubles in the domestic foreign exchange market. To stabilise this market, the Bank of Russia amended Instruction No. 16, dated July 16, 1993, to prohibit cash

withdrawal from ruble correspondent accounts of nonresident banks (authorised banks were exempted from the ban).

The foreign cash market in 1998 saw all its parameters decline. Net foreign cash imports (import-export balance) by authorised banks amounted to \$15.7 billion against \$37.1 billion in 1997. In September—December 1998 the average monthly amount of foreign exchange brought into the country decreased four times when compared with January—August. This was a result of a sharp fall in the demand for cash dollars by households, which were hard hit by the financial crisis.

The exacerbation of the financial market crisis in August—September 1998 upset the balance between aggregate domestic demand for foreign cash and its external supply. As a result, some authorised banks began to conduct speculative operations with foreign cash, setting the buying rate too low and the selling rate too high. In response to these tendencies, the Bank of Russia

set the maximum spread between buying and selling rates in the exchange offices at 15%. In the meantime, its regional branches stepped up control over operations conducted by authorised banks in the foreign cash market. From September 1998 each exchange office has been inspected eight times (more than 80,000 additional inspections were conducted), whereas in the preceding years each exchange office was checked twice a year on average.

Control over foreign exchange operations connected with capital flow was conducted by licensing most of such operations. In 1998 the Bank of Russia and its regional branches issued 1,344 permits to conduct foreign exchange operations connected with capital flow to the amount of \$17.3 billion against \$29.4 billion in 1997. After the August events, capital flow declined dramatically. In September—December the total amount of licensed operations connected with capital flow decreased seven times compared with January—

August. It should be noted that while the decline in capital imports to Russia resulted from the wait-and-see position taken by nonresidents, the drop in capital exports was largely the consequence of the efforts made by the Bank of Russia to limit the scale of foreign currency outflow abroad.

Controlling the export of banking capital, the Bank of Russia issued 11 permits to authorised banks allowing them to transfer up to \$18 million in foreign exchange as payment to authorised capital of foreign-based credit institutions. This was three times less than in 1997.

To enhance control over the export of banking capital, the Bank of Russia in April 1998 changed the procedure for granting permits to authorised banks, enlisting its regional institutions in the process. In addition, it formulated clear requirements to qualify authorised banks for such permits and the reasons for refusing to issue a permit.

III.3. INTERACTION BETWEEN THE BANK OF RUSSIA AND INTERNATIONAL FINANCIAL ORGANISATIONS

IN 1998 the Bank of Russia continued to develop co-operation with leading international financial institutions, such as the **International Monetary Fund (IMF)**, the **International Bank for Reconstruction and Development (IBRD)** and the **Bank for International Settlements (BIS)**. Discussions were held within the framework of these institutions on ways to strengthen the national financial systems in countries hit by the crisis and create a more stable global financial system. Standardised mechanisms were developed to regulate national financial markets, including effective risk control. The globalisation of financial markets and the increased share of international operations in the activities of credit institutions made it necessary, especially in times of crisis, to introduce agreed upon “rules of the game” in the national markets and arrange the broader exchange of information and closer interaction between supervisory authorities of different countries.

A meeting of finance ministers and central bankers of 22 countries (G-22, Russia included), held in Washington in April 1998 with the participation of leading international financial organisations, focused on three major areas of activity: increasing the level of transparency of financial information and reporting, strengthening financial systems and improving the methods of preventing financial crises. The corresponding three working groups were formed at the Bank for International Settlements (BIS). The Bank of Russia took part in the work of two of them (on strengthening financial systems and on improving crisis-prevention methods).

Work continued under the aegis of the BIS within the framework of the Basle Committee on Banking Regulation and Supervisory Practices. In November 1998, the Bank of Russia officially announced its decision to join the Basle Committee-drafted Basic Principles of Efficient Banking Supervision, a document containing international banking supervision criteria and standards.

Bank of Russia senior executives regularly participated in the meetings of central bankers of the BIS shareholder countries, at which the most urgent issues of monetary policy, crisis prevention and other matters were discussed. The Bank of Russia also took part in the work of BIS committees and commissions, in which working consultations were held on the issues mentioned above and on other matters relating to the activities of central banks. Russia provided the BIS with up-to-date information on the national foreign exchange market, derivatives market, methodology of calculating financial market indices and prudential banking supervision.

These data, characterising Russia’s role in the world financial system by key indicators, were used, for example, in materials prepared for the annual meeting of BIS shareholders in 1998.

The participation of Bank of Russia executives in the meetings of the Group of Eight finance ministers and central bankers has a great role to play in enhancing the efficiency of Russia’s co-operation with international financial institutions. These meetings give us an additional opportunity to explain our positions and make known our wishes to our partners who largely determine the policy of the above-mentioned institutions. During the year under review the Bank of Russia Chairman took part in the Washington meeting of the Group of Eight finance ministers and central bank governors, held in October, on strategic issues related to upgrading the international monetary system.

A major stage in the Bank of Russia’s co-operation with the IMF and IBRD was the meetings of the Interim Committee of the IMF Board of Governors and the Development Committee of the IMF and IBRD. Also important was the annual meeting of the IMF and IBRD Boards of Governors, held in Washington in October. These gatherings discussed issues related to the global financial crisis and ways to strengthen the architecture of the international financial system, including an “orderly” liberalisation of capital flow,

which would give the IMF more powers in monitoring the state and dynamics of the national economies of the member-countries, and so on.

In the period under review Russia's Governor in the IMF and in the **European Bank for Reconstruction and Development (EBRD)** was the Chairman of the Bank of Russia.

At regular meetings with the IMF missions the sides discussed issues relating to the restructuring of the Russian banking system, money and credit dynamics, GKO restructuring, monetary programme indicators for 1998, the exchange rate policy, the quantitative aspects of the moratorium on foreign debt payments, balance of payments dynamics and the management of international reserves. The IMF was provided with reports and other information envisaged in agreements between Russia and the Fund. The Bank of Russia collaborated with the Russian Government in preparing Russia's accession to the IMF Special Data Dissemination Standard and increasing Russia's quota in the Fund's capital. The Bank of Russia worked together with the IMF Institute to prepare a seminar on financial programming and macroeconomic policy for employees of Russian financial and economic agencies. Bank of Russia employees participated in seminars conducted by the Fund.

To maintain the stability of the national currency, the Bank of Russia received funds in foreign currency and participated jointly with the Russian Finance Ministry in negotiations with the IMF on the financing of the Russian economic programme for 1998, which was agreed by Russia and the Fund. On July 20 the IMF Executive Board decided to increase the credit line for Russia and extend her SDR3.6 billion (about \$4.8 billion) under three loan programmes: Compensatory and Contingency Financing Facility, Extended Arrangements and Supplemental Reserve Facility. These funds were included in the Bank of Russia foreign exchange reserves. In August SDR768.4 million within the framework of the Extended Arrangements were transferred to the Russian Finance Ministry.

The Bank of Russia met all its obligations in servicing the funds it received. Interest payments (in August and November) were made in accordance with the terms and conditions of IMF loans.

A series of meetings were held in 1998 with the joint IMF/IBRD mission to discuss banking liquidity, concentration of bank capital, criteria for bank bailouts and recapitalisation of viable banks, and the restructuring of the Russian banking system.

In the year under review Russia continued to co-operate with the **World Bank**, notably, within the framework of a permanent working group under the Russian Interdepartmental Commission on Co-operation with International Financial and Economic Organisations. In November, an extraordinary survey of the World Bank's portfolio of projects for Russia was made and it was decided to review it in the context of the changed conditions. The Bank of Russia also took part in discussing the project "World Bank Strategy in Russia: Changes in the New Situation." When the financial crisis broke out, the Bank of Russia deemed it necessary, within the framework of cooperation with the IBRD, to re-channel a part of the funds allocated by IBRD and EBRD to finance the restructuring of the banking system, specifically, to finance the activities of the Agency for Restructuring Credit Organisations, improving supervisory and reporting practices and accounting standards, and evaluating the gravity of insolvency problems of the system-building banks.

Steps were taken to set up an Inter-Agency Coordinating Committee (ICC) for Banking Sector Development in Russia and, more specifically, co-ordinate assistance in this area from the IBRD, IMF, EBRD, the European Union and its member-countries, and other countries concerned. The first meeting of the ICC was held in March 1999. In 1998 the **International Finance Corporation** offered to participate in the authorised capital of two Russian banks, Garanti Bank-Moskva and Toribank. The Bank of Russia gave its tentative consent for such participation.

Despite the continuing financial crisis, in 1998 Russia remained a major country of EBRD operations, accounting for 24% of the EBRD's loan portfolio.

The EBRD Board of Directors in 1998 approved 10 projects for Russian borrowers, worth about 800 million euro. As a result, the overall value of approved projects for Russia exceeded

the 1997 level by 7.5% and amounted to about 11 billion euro. The sum of the EBRD's own investments in Russian projects amounted to 3.44 billion euro as of the end of 1998, an increase of 13% over 1997. Of these, loan and investment agreements with Russian borrower enterprises and organisations were concluded in the amount of ECU2.841 billion, including agreements in the amount of ECU441 million signed in 1998.

In April, a Russian delegation led by the Bank of Russia Chairman, a EBRD Governor from Russia, took part in the seventh annual meeting of the EBRD Board of Governors in Kiev, Ukraine, which discussed as its main topics, ways to encourage investment in Russia and development of the Russian financial sector.

The Bank of Russia co-ordinated the drafting of reports on the EBRD's loan projects for Russia and took action to mitigate the consequences of the crisis for the EBRD's activities in Russia.

In the year under review, the Bank of Russia continued to co-operate with the **Black Sea Trade and Development Bank (BSTDB)**, whose task is to finance trade and investment projects in the region.

The Bank of Russia also participated in the discussion of prospects for Russia's admission to the **Asian Development Bank** and **Inter-American Development Bank**, which is important for improving the situation in the Russian real economy and increasing engineering and other Russian exports to these dynamically developing regions of the world.

Assistance was provided to the **International Bank for Economic Co-operation (IBEC)** and **International Investment Bank (IIB)**, whose major borrower and shareholder is Russia. Specifically, the sides tackled problems relating to the settlement of debt claims and obligations of the IBEC and IIB and legalisation of their presence in Russia.

In the year under review the Bank of Russia continued to participate in the activities organised by the Russian government to prepare Russia's admission to the **Organisation for Economic Co-operation and Development (OECD)**, one of the most authoritative international organisations on regulation of economic and financial relations between industrial countries.

In July 1998, the Bank of Russia staged a presentation of a survey of the Russian financial market at a meeting of the OECD Committee on Financial Markets to help Russia gain observer status in the Committee. However, the August crisis made the OECD Council postpone its decision on the matter until October 1999.

The Bank of Russia is represented in the Interdepartmental Commission on Co-operation with the OECD and the Russia-OECD Liaison Committee. In 1998 the Bank of Russia took part in the Financial Policy Section of the Fourth Annual Programme for Russia's Co-Operation with the OECD, participated in preparing a programme for 1999 and held a series of consultations with OECD missions.

As part of preparations for Russia's admission to the **World Trade Organisation (WTO)**, the Bank of Russia, which headed the subgroup on financial services of the Government Commission for the WTO, in November 1998 drafted and submitted to the Russian Trade Ministry proposals for Russia's initial position on talks with the WTO on financial services.

Negotiations on these issues did not begin in 1998, so it is not ruled out that these proposals will have to be reviewed, taking into account the Russian government's medium-term programme being elaborated at the moment.

Co-operation with the **Asia-Pacific Economic Co-operation (APEC)** is a new field for the Bank of Russia. In 1998 this country became a member of this international organisation and therefore must meet some international obligations in the economic sphere, including financial and banking services.

The Bank of Russia was involved in drafting Russia's corresponding proposals for the APEC summit in October 1998 and its efforts in this area are closely linked with the activities conducted within the framework of the negotiations on Russia's admission to the WTO. Membership in APEC requires Russia to take steps on the domestic front that would indicate its compliance with international obligations and participate in the corresponding working bodies of APEC. This is a question to be decided in 1999.

In October 1998, the Bank of Russia adopted and began to carry out a plan which is a part of the Russian government's long-term plan to

implement the Agreement on Partnership and Co-Operation Between Russia and the European Union.

The Bank of Russia took part in the work of the Subcommittee on Financial and Economic Issues and Statistics of the Russia-EU Co-operation Committee.

In October, the Bank of Russia and representatives of the EU and Russian government agencies concerned held in Moscow an international conference, "The Euro and Russian Financial System," which helped the Bank of Russia later

to formulate a number of standards and regulations connected with the adoption of a single currency by the 11 EU member-countries.

Working contacts were established with the **European Central Bank** and agreement was reached to hold bilateral consultations in 1999. The Bank of Russia set up a working group on the euro and headed the Interdepartmental Working Group that should draft in the first half of 1999 a report for the Russian government on implications of the introduction of the euro for Russia.

III.4. RELATIONS WITH CENTRAL (NATIONAL) BANKS OF CIS AND OTHER COUNTRIES

THE BANK OF RUSSIA in 1998 co-operated with the central (national) banks and member-countries of the Commonwealth of Independent States (CIS) in several areas:

- on a bilateral basis;
- within the framework of the Russia-Belarus Union;
- on the basis of the Treaty Between the Russian Federation, the Republic of Belarus, the Republic of Kazakhstan and the Kirghiz Republic on Deepening Integration in Economic and Humanitarian Areas, dated March 29, 1996;
- within the framework of the Commonwealth as a whole.

In organising interstate and interbank settlements with CIS countries, emphasis was made on upgrading the system of mutual settlements.

In lieu of the correspondent accounts of CIS central (national) banks with the Bank of Russia that had serviced current operations of CIS economic agents but were closed on December 31, 1997, CIS central (national) banks were offered the opportunity to open new correspondent accounts enabling them to make settlements on operations that are the exclusive functions of the central (national) banks.

Ruble accounts of this kind were opened in 1998 by the central (national) banks of Belarus, Kazakhstan, Kirghizia, Turkmenistan and Ukraine.

The Bank of Russia continued to upgrade the legal framework for interstate settlements, by which the authorised banks of Russia and other CIS countries are guided in servicing foreign trade relations inside the Commonwealth. Specifically, an agreement was signed in May with the National Bank of Ukraine on interbank settlements and co-operation between the banking systems of the two countries.

In 1998 the Bank of Russia each day set the official exchange rates of the national currencies of Kazakhstan and Ukraine on the basis of their quotations on Russia's exchange and over-the-

counter markets. The Belorussian ruble was also quoted on a daily basis. However, the Bank of Russia on March 24 stopped setting the official rate of the Belorussian ruble against the Russian currency after the National Bank of Belarus imposed restrictions on nonresident operations with Belorussian rubles. Since there was no liquid interbank market for other CIS currencies in Russia, their official rates were set monthly on the basis of their quotations on the national currency markets.

The main problem in Russia's settlements and payments with CIS countries in 1998 was a low level of monetisation (the use of money and its forms) of settlements and predominant use of freely convertible currencies rather than national currencies, especially the Russian ruble. As a result, goods and services are overpriced, tax revenues fall, while overheads, including bank service fees, rise. Throughout the year, the Bank of Russia worked together with CIS countries to gradually solve these problems. The August crisis undermined confidence in the ruble by CIS countries and their economic agents and the role of barter arrangements in trade increased.

In September—December 1998 the Bank of Russia did everything to reduce to a minimum the consequences of the August crisis for Russia's co-operation with other CIS countries.

Within the framework of the Russia-Belarus Union, it worked together with the National Bank of the Republic of Belarus to harmonise foreign exchange regulation and foreign exchange control practices of the two countries.

To prevent a decline in trade turnover between them in the post-crisis period and implement the Russian government's plans, the Bank of Russia and the National Bank of the Republic of Belarus took part in drafting an agreement on clearing settlements in Russian rubles in bilateral trade.

On December 25, 1998, Russia and Belarus signed an agreement to create equal conditions for economic agents and a protocol, that envis-

aged harmonisation of legislation of both countries, that govern the central banks. The Bank of Russia began to do its part of the job in 1998, specifically, it started to draft proposals on the introduction of a single currency in Russia and Belarus in the future.

The following documents were drafted and signed with the participation of the Bank of Russia to implement the provisions of the Treaty Between the Russian Federation, the Republic of Belarus, the Republic of Kazakhstan and the Kirghiz Republic on "Deepening Integration in the Economic and Humanitarian Areas," dated March 29, 1996:

- the agreement to ensure private individuals free and equal rights to cross the borders of the member-countries of the Customs Union and carry with them without any restrictions goods and foreign exchange;
- the protocol to simplify procedure for cash transfers by private individuals of the member-countries of the above-said Treaty.

The Bank of Russia actively participated in the work of the Government Commission for the CIS, relating to the expansion of co-operation in banking and the improvement of settlements with the CIS countries, and took part in international banking congresses and "roundtable" discussions organised within the framework of the CIS. It devoted particular attention to drafting proposals for a special interstate forum on CIS reform, which were later taken into account in the course of the corresponding multilateral negotiations between CIS countries in Moscow and in Minsk.

In 1998, the Chairman of the Bank of Russia was the Chairman of the Interstate Bank's Board, which has 10 CIS countries as its members. The Bank of Russia was responsible for being a liaison with the Interstate Bank on questions proposed by its President. Proposals were drafted and submitted to the Russian Government in 1998 for implementation by the Interstate Bank of clearing settlements between Russia and Belarus.

The Bank of Russia took steps to transfer to Vneshekonombank the right to conduct and record operations to service and repay Russia's interstate loans to CIS countries and to transfer to the bank's balance sheet the debt on interstate loans made in 1992—1997, and the documents on the servicing and repayment of this debt.

The Bank of Russia continued to make efforts to improve settlements and payments between Russia and some other countries. Its fundamental goal in the matter is to gradually adopt internationally accepted forms of settlements in national and freely convertible currencies. Special attention was paid to settlements with China, because the Soviet-era system of payments, designed for the servicing of centralised foreign trade relations, does not fit in with the current market relations and therefore requires a major overhaul.

One of the positive developments was the creation in 1998 of a working group of the central banks of Russia and China on interbank co-operation. Its first meeting, held in Beijing on May 25 and 26, 1998, was devoted to studying the possibility of using the national currencies in settlements and payments between the two countries. In accordance with the agreements reached, the Bank of Russia elaborated and in August sent to the People's Bank of China a draft agreement on using the national currencies in settlements on commercial operations between Russia and China.

In 1998 the Bank of Russia and the State Bank of Vietnam signed an agreement on foreign trade settlements, which is designed to create conditions for the development of bilateral ties between Russian and Vietnamese commercial banks in order to broaden mutual trade and economic co-operation. The agreement also enables the sides to discuss the possibility of using in settlements their national currencies in addition to hard currency.

The Bank of Russia also took part in the negotiations, held in Tripoli from October 2 to 9, on improving settlement process and interbank co-operation within the framework of the inter-governmental Russian-Libyan commission on trade, economic, scientific and technological co-operation. In the course of the talks, the sides reached agreement on the possibility of signing an interbank agreement.

In addition, to eliminate problems in settlements, payments and interbank co-operation, Russia proposed that these countries set up special working groups in 1999 similar to the one Russia formed with China. This occurred at the 1998 meetings of the intergovernmental commissions on trade and economic cooperation with Vietnam and Syria.

**THE STATE OF THE RUSSIAN
BANKING SYSTEM,
BANKING SUPERVISION
AND INSPECTION**

IV

IV.1. AN OVERVIEW OF THE RUSSIAN BANKING SYSTEM AND THE MEASURES TAKEN TO RESTRUCTURE IT

1998 WAS the most dramatic year for the Russian banking system. The banking crisis was provoked by problems accumulated by the banking sector and the economic crisis, especially the collapse of the government securities market and an abrupt downward change in the exchange rate.

The principal internal causes of the banking sector's high vulnerability to the economic crisis were as follows:

1. A low level of capitalisation of the banking system in absolute terms and from the viewpoint of the losses caused by the crisis. Aggregate banking capital to GDP was 4.0% as of December 31, 1996, 4.3% as of December 31, 1997, and 4.6% as of July 31, 1998. Before the crisis Russia's aggregate banking capital (119.2 billion rubles as of July 31, 1998) was smaller than that of any of the top 20 western banks and practically equalled the volume of the frozen GKO—OFZ (119.6 billion rubles). The financially-troubled real economy and government hampered the raising of additional shareholder funds to augment banking capital for achieving financial stability and creating a potential for further development. The 6% growth in aggregate banking capital from December 31, 1997, to July 31, 1998, principally resulted from the increase in the large banks' own funds (banks with capital in excess of 5 million euro) and the revocation of the licences of banks with negative capital.

2. Meagre internal resources and the dependence of banks on external borrowings. As the financial state of the real economy got worse, banks practically had no other sources to borrow from. From December 31, 1997, to July 31, 1998, bank borrowings from enterprises, organisations and households declined by 18.6 billion rubles and their share of liabilities narrowed from 43.7% to 42.1%. At the same time, by 1998, Russian banks had accumulated substantial obligations to non-resident banks on foreign exchange loans (9.7% of liabilities), which remained in 1998. As non-resident loans were usually provided against government securities, Russian banks became increasingly dependent on the situation in the government debt market.

3. Russian banking capital had a narrow domestic market in the real economy. Loans accounted for 37.9% of bank assets as of December 31, 1997, and 38.6% as of July 31, 1998, while the share of bank investments in government debt instruments (GKO—OFZ) fell from 19.2% to 15.9%, respectively. Before the crisis, the ratio of loans and government securities to bank assets had been growing gradually (from 193% as of December 31, 1996, to 209% a year later), but the level of 242% reached by July 31, 1998, still predetermined significant dependence of the quality of bank assets on the state of government finance.

4. Heavy dependence of banks' financial condition on fluctuations of two parameters of the financial market.

Firstly, returns from investment in government securities were a major source of income for credit institutions. Revenues from this kind of investment made up 31.6% of banks' total income in the first quarter of 1998 and 21.5% in the second.

Secondly, banks, particularly big ones, were hedging the currency risk of nonresident investors in GKO—OFZ by concluding currency forward contracts with them. In so doing, both sides were guided by the exchange rate fluctuation limits set by the Bank of Russia. The overall volume of obligations of Russian banks (excluding Sberbank) under currency forward contracts with nonresidents amounted to \$22.7 billion as of July 31, 1998, a figure which exceeded their aggregate capital by 1.4 times. At the same time, leading Russian banks were hedging their currency risk by concluding deals with small banks, whose risks also had gone beyond all sensible levels.

5. Mismanagement of banks. High administrative costs (7% of total costs in the first half of 1998), in some cases close ties with dishonest founders, and inadequate internal risk control (specifically, bank managers underestimated market risk, including risk involved in operations in the government securities and foreign-exchange markets) became fully manifest during the crisis.

6. The absence of a system to guarantee household deposits and the lack of an adequate legislative framework for bank rehabilitation, restructuring and bankruptcy. This included the legal responsibility of management and owners for their banks' performance.

7. The lack of a comprehensive system of banking supervision. When the crisis broke out, some of requirements of the Bank of Russia were either in the process of being phased in (reserves for possible loan losses and other standards), or being tested (such as consolidated reporting) or drafted (capital adequacy requirements to cover risks of loans made on futures contracts as well as other market risks). Bank reporting practices and methods of analysing bank performance were also in need of improvement.

Price fluctuations in the GKO—OFZ market caused banks' significant losses and a sharp fall in their profitability even early in the year. Profits earned by banks (excluding Sberbank) in the first half of 1998 decreased more than seven times

when compared with the first half of 1997 and as of June 30, 1998, amounted to only 1.0 billion rubles (including retained profit/loss of the preceding years). At the same time, the profitability of assets decreased from 1.4% as of June 30, 1997, to a lowly 0.2% as of June 30, 1998, while the profitability of their funds (capital) declined from 9.4% as of June 30, 1997, to 1.0% a year later.

By mid-1998, the financial condition of banks became increasingly differentiated and negative trends prevailed. The proportion of problem banks in the total number of banks rose from 32.4% as of December 31, 1997, to 36.7% as of July 31, 1998, while their share of aggregate banking assets grew from 6.8% to 12.1%.

The quality of loan portfolios deteriorated, bearing witness to increased credit risk and serving as a disincentive for bank lending. According to the banks' own reports, the share of standard loans dwindled from 89.3% as of December 31, 1997, to 82.9% as of July 31, 1998, while the proportion of bad loans rose from 3.6% to 6.8%, respectively.

Thus, by mid-year the first signs of financial instability within the banking system had appeared. The mounting expectations of a pending crisis required banks to counter the negative trends. First, banks began to reduce the excess of foreign exchange obligations over foreign exchange assets. The difference between the banks' aggregate on balance-sheet foreign exchange liabilities and assets (excluding Sberbank) fell from \$4.1 billion as of December 31, 1997, to \$500 million as of July 31, 1998. Over that period, the share of foreign exchange assets in total banking assets (excluding Sberbank) increased from 32.7% to 35.7%, while that of foreign exchange liabilities in total bank liabilities declined from 37.0% to 36.3%. At the same time, many banks were unable (or late) to rearrange active and passive operations mainly because they were unwilling to sell government securities at market prices, which they considered too low.

Second, to reduce the potential risk, banks cut back on their operations in the futures market. From January to July 1998 the total volume of bank obligations under forward contracts (excluding Sberbank) declined 2.7 times on ruble obligations and 2.4 times on obligations in for-

foreign currency. Nevertheless, at July 31, 1998, it still amounted to 445 billion rubles on ruble obligations and the equivalent of \$71.9 billion on foreign-exchange obligations.

As they were not completed, those actions could not prevent the entire destructive impact of the crisis on the financial state of banks. On the other hand, they precipitated a crisis in the financial markets, especially through demand in the foreign-exchange market, and in this sense the aims set by banks could not be achieved in principle.

The financial crisis, which erupted in August 1998, dealt a heavy blow to the stability of the banking system. Russian banks sustained obvious losses in all main parameters of their activities. The GKO—OFZ swap plan announced in August resulted in a virtual freeze of 15.9% of total banking assets. It should be borne in mind here that it is the GKO—OFZ that were used by banks as the principal means of regulating current liquidity and served as a major source of their incomes. A sharp fall in the exchange rate of the ruble made it far more difficult for banks to honour their foreign exchange obligations, especially under forward contracts. Aggregate banking capital (calculated by Bank of Russia methodology) shrank from 119.2 billion rubles as of July 31, 1998, to 76.5 billion rubles as of December 31, 1998, or 35.8%, and in foreign currency terms, from \$19.1 billion to \$3.7 billion, that is, a decrease of 5.2 times.

The crisis of confidence in individual banks and the banking system as a whole after August 17 led to the suspension of operations in the interbank money market, made it impossible to effectively redistribute funds in the financial sector of the economy and provoked a massive shift of clients from one group of banks to another. In August—December 1998 the volume of interbank credits and deposits contracted by 9.3 billion rubles, or 45.4% in rubles and \$4.5 billion, or 33.6%, in foreign currency.

The situation in the banking system was compounded by a withdrawal of household deposits. From August to December household deposits in commercial banks (excluding Sberbank) decreased by 16 billion rubles, or 47.6%, in rubles, and \$2.3 billion, or 58%, in foreign exchange. It should be noted that a significant amount of per-

sonal deposits (12% of their total volume outside Sberbank) was transferred from a number of commercial banks to Sberbank. Overall, household deposits in banks over that period fell by 11.2 billion rubles, or 7.4%, in rubles, and \$3.6 billion, or 55.2%, in foreign currency.

The crisis of confidence in the national banking system and contraction of the stock market made it increasingly difficult for banks to raise funds by issuing debt obligations. From August to December the volume of debt obligations issued by banks decreased by 49% in foreign exchange and by 1% in rubles.

At the same time, the problem of resources for credit institutions was partly mitigated by inflationary growth in ruble balances in the settlement accounts and current accounts of enterprises and organisations. Over August—December 1998 they increased by 32.1 billion rubles, or 38.5%; foreign exchange in settlement and current accounts declined over that period by \$100 million, or 2.2%.

As a result, borrowings from enterprises and organisations in the structure of ruble-denominated borrowings by banks (excluding Sberbank) expanded from 46% as of July 31, 1998, to 63% as of December 31, 1998, the share of household deposits decreased from 21% to 12%, the proportion of debt obligations declined from 16% to 13%, that of interbank loans from 11% to 7%, and the share of balances in correspondent accounts fell from 6% to 5%.

In the structure of borrowings made by banks (excluding Sberbank) in foreign currency, the share of borrowings made from enterprises and organisations increased from 29% as of July 31, 1998, to 37% as of December 31, 1998. That of household deposits declined from 14% to 8%, debt obligations from 7% to 5%, and interbank loans from 46% to 45%, of which loans provided by nonresident banks decreased from 40.4% to 32.4%. The share of balances in correspondent accounts rose from 4% to 5%.

So, the crisis changed for the worse all main positions held by credit institutions on practically all sources of resources, except for the ruble-denominated balances in settlement and current accounts. The proportion of household deposits contracted most of all.

The crisis brought down the scale of banking activity dramatically. Aggregate banking assets

**BANKING SYSTEM ASSETS BY CREDIT INSTITUTIONS
CLASSIFIED IN TERMS OF FINANCIAL STABILITY (billion rubles)**

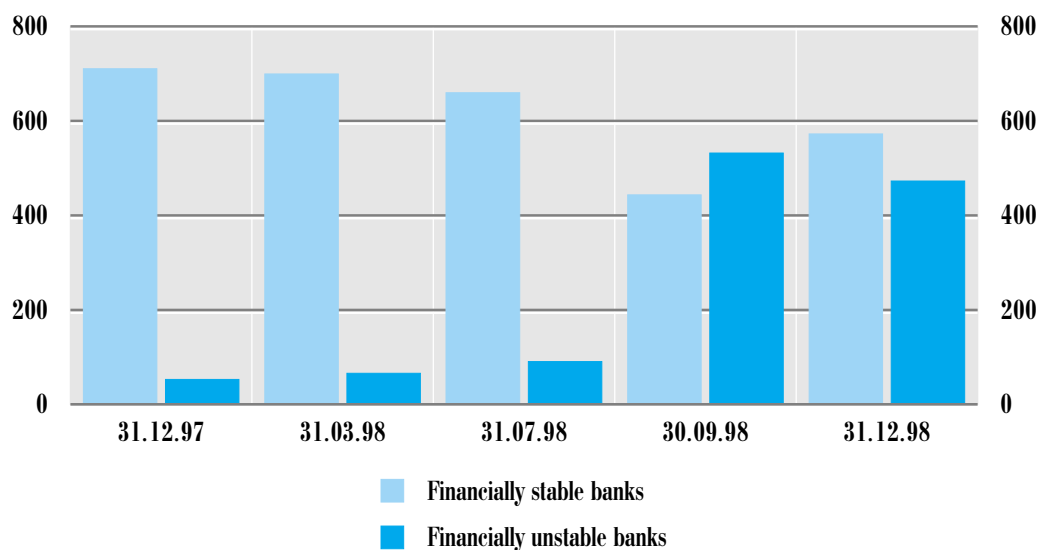


Figure 26

(in real terms, taking into account the changed ruble rate) declined over the period from July 31, 1998, to December 31, 1998, by 114.8 billion rubles, or 15.4%. The contraction of the resource base of credit institutions and growth in all risks suspended lending to the real economy. Ruble loans provided by banks to enterprises and organisations dropped by 14.5 billion rubles, or 12.7%, and loans denominated in foreign exchange declined by \$4.3 billion, or 29.3%. The scarcity of profitable spheres for capital investment increased at the same time and the growth in cash balances at banks and in correspondent accounts with the Bank of Russia bears this out. Cash balances at banks rose by 26% from December 31, 1997, to December 31, 1998, their share of assets expanding from 1.4% to 2.2%, and balances in correspondent accounts with the Bank of Russia increased by 6% over that period, their share of assets growing from 3.9% to 5.2%.

The quality of bank assets deteriorated. Overdue debt on bank loans (in real terms, taking into account the changed ruble rate) increased from 17.5 billion rubles as of July 31, 1998, to 27.0 billion rubles as of December 31, 1998, a rise of 57.1%. Its share of total loans grew from 6% to 11%. Lower quality of the loan portfolio (the share of standard loans in total debt on loans decreased from 82.9% as of July 31, 1998, to 75.4% as of December 31, 1998, while that of bad loans

rose from 6.8% to 11.3%, respectively) presages more failures to repay loans and interest and, consequently, bigger losses for the banking system. In addition, potentially the problem is far more serious owing to the significantly increased share of loans denominated in foreign currency as a percentage of total amount of loans (38.9% as of December 31, 1997, 43.9% as of July 31, 1998, and 68.9% as of December 31, 1998).

The scarcity of profitable areas for capital investment and expectations of a ruble devaluation led to a further expansion of the share of foreign-currency assets and liabilities of banks. The proportion of foreign-currency assets in total banking assets rose from 30.4% as of July 31, 1998, to 56.2% as of December 31, 1998 and that of foreign-currency liabilities from 29.5% to 47.1%, respectively. As a result, as of December 31, 1998, the positive difference between foreign exchange assets and liabilities exceeded \$4.6 billion, which became an additional source of profit for banks as the dollar rate rose. The main source of income for banks (nearly 64.6% of fourth-quarter total income) became foreign exchange operations, whereas in the first half of the year, just as in 1997 as a whole, the principal source of income for the banking system was derived from investments in government securities.

The hardest hit by the crisis were the leading multi-branch banks, owing to the structure of

STRUCTURE OF BANKING SYSTEM ASSETS

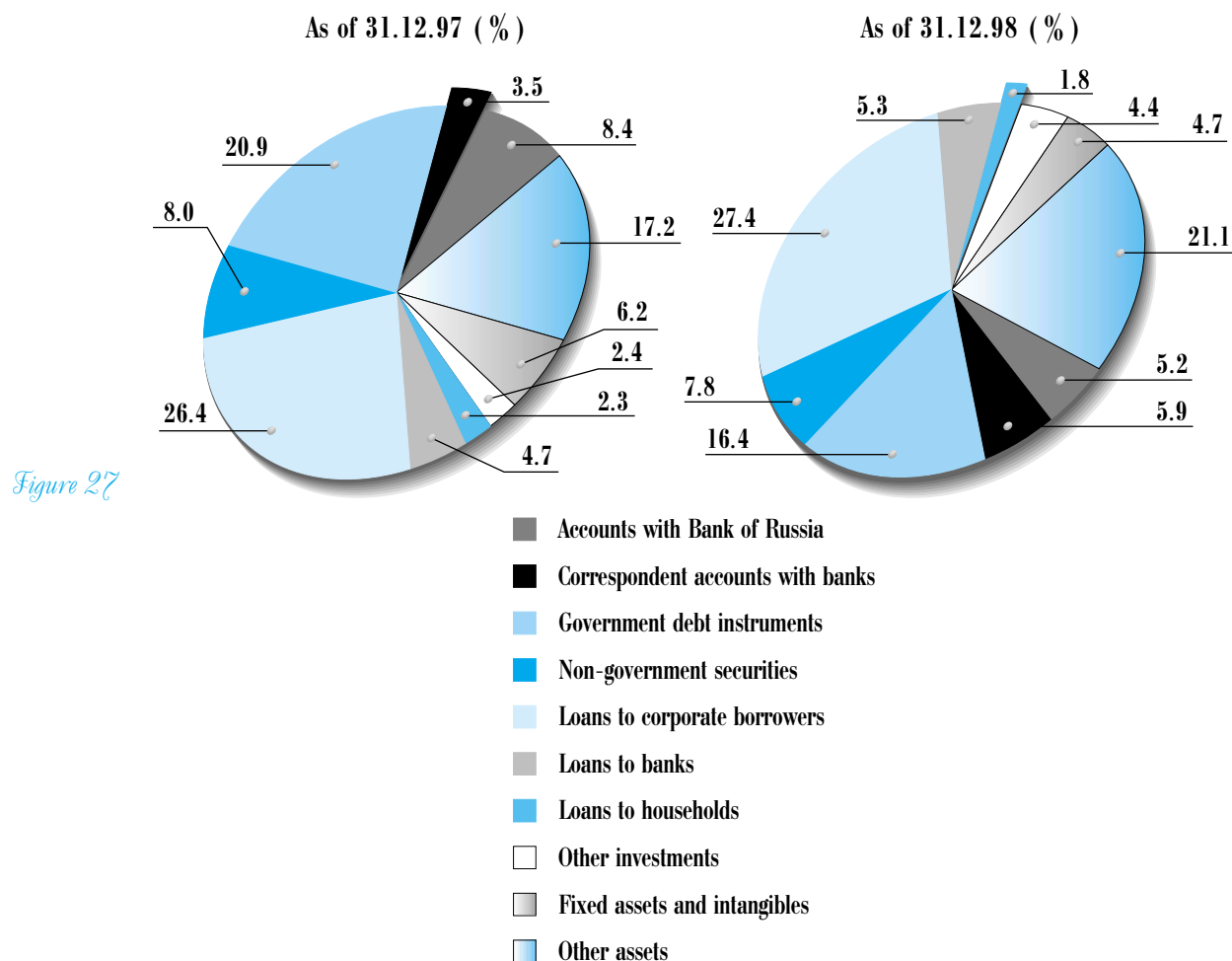


Figure 27

their operations (vast investments in the GKO—OFZ market, a significant volume of futures contracts in the foreign-exchange market, borrowing in foreign exchange and vigorous attraction of household deposits). In August—December 1998, assets of the top 29 banks (in real terms, taking into account the changed US dollar rate) declined by 19.3% and capital by 57.3%. Losses amounted to 18.2 billion rubles as of December 31, 1998, or 39.6% of total losses suffered by operating credit institutions.

In the meantime, small and medium-sized regional banks (with capital of less than 30 million rubles) did not lose much as a result of the crisis. In August—December 1998 their capital remained practically unchanged, aggregating 5 billion rubles, and their financial conditions even improved. The share of financially stable banks in the total num-

ber of small and medium-sized regional banks increased from 49.6% as of July 31, 1998, to 60.6% as of December 31, 1998.

Overall losses of the banking system (not counting Sberbank's financial results) amounted to 45.9 billion rubles as of December 31, 1998, against a profit of 13.4 billion rubles as of December 31, 1997, while the proportion of banks which suffered losses as a percentage of total number of banks rose from 16% to 24%. Assets of the banks in critical financial condition made up 25.7% of total banking assets as of December 31, 1998, against 5.7% as of July 31, 1998.

These negative trends in banking activities in 1998 had no significant impact on the institutional characteristics of the banking system owing to the latter's inertia. In 1998 the number of operating credit institutions fell by 229 to 1,476 as of De-

STRUCTURE OF BANKING SYSTEM LIABILITIES

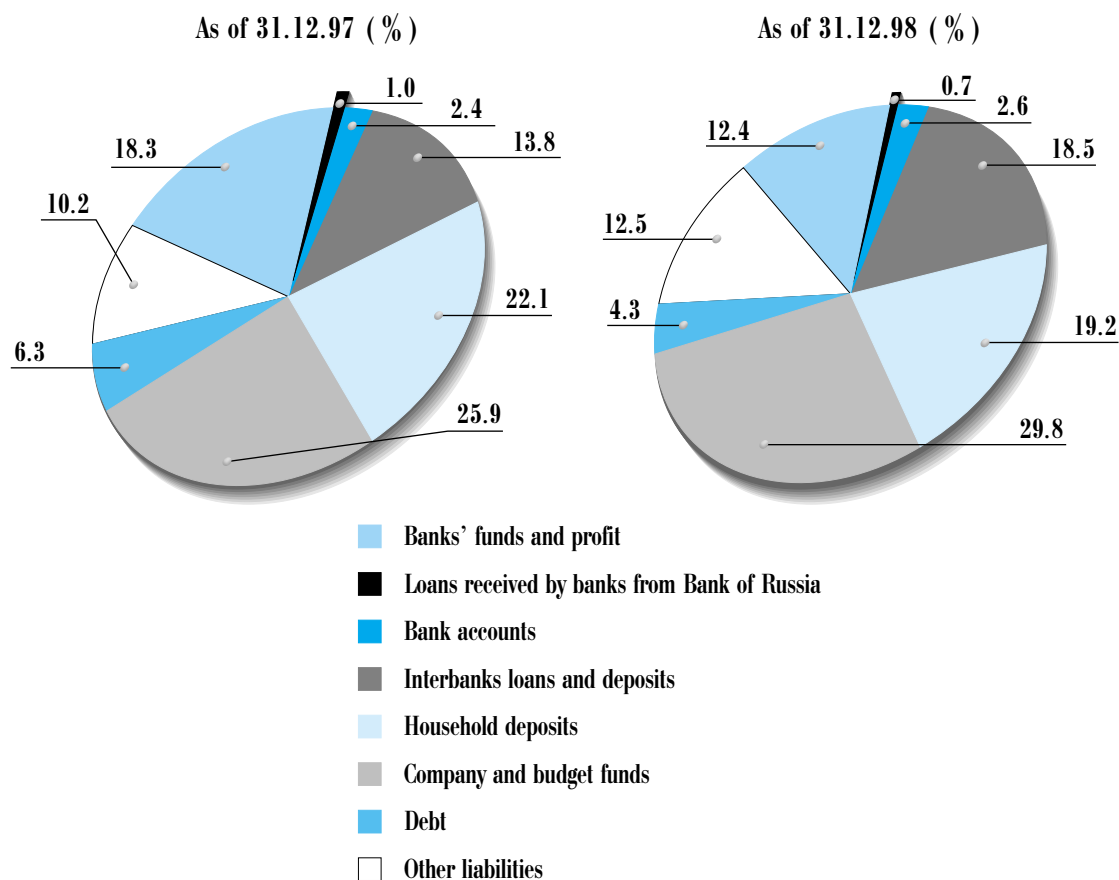


Figure 28

December 31, 1998 and in the second half of the year the tendency towards reduction in the number of credit institutions intensified.

For the first time, the banking crisis led to revocation of the banking licences of leading banks. In 1997 and the first seven months of 1998, none of the top 20 banks lost their banking licence, whereas from August through December 1998 three banks in this group had their banking licence revoked.

The reduction in the number of credit institutions was accompanied by an increased concentration of assets into banks still operating. The share of the top 20 banks in total banking assets rose from 60.2% as of December 31, 1997, and 61.0% as of July 31, 1998, to 66.0% as of December 31, 1998. The proportion of banks with capital in excess of 30 million rubles increased from 24.7% as of December 31, 1997, to 29.2% as of July 31, 1998, and 33.0% as of December 31, 1998. Most economic regions registered banking asset concentration in leading banks.

Despite the financial problems of a number of Moscow-based large multi-branch banks, the tendency towards concentration of financial resources continued in the Moscow Region in 1998 too. As of December 31, 1997, there were 44.0% of all credit institutions in the Moscow Region, whereas by December 31, 1998, their proportion had increased to 47.6%. The share of assets of the banks based in the Moscow Region rose from 84.7% to 87.4% of total banking assets.

As a result of the crisis, clients of less stable banks began to shift to more stable ones and interbank competition increased. From July 31, 1998, to December 31, 1998, the list of top 50 banks in terms of assets changed by one-third.

The banking crisis increased the role of Sberbank because of its reliability, which was enhanced by the Bank of Russia participation in its capital. Sberbank's share of total banking assets and household deposits expanded. It should

be noted that this expansion resulted, to some extent, from the transfer of household deposits from some commercial banks to Sberbank after a corresponding decision of the Bank of Russia's Board of Directors. The total sum of obligations accepted by Sberbank from these commercial banks amounted to 7.1 billion rubles as of December 31, 1998. Sberbank's share of total funds attracted by banks to corporate settlement, current and deposit accounts also grew, from 8.6% as of December 31, 1997, to 16.2% as of December 31, 1998. Sberbank significantly increased its presence in the Russian interbank market: its investments in the interbank loan market rose from 5.7% as of December 31, 1997, to 8.4% as of December 31, 1998.

Banks controlled by foreign capital are coming to play an ever growing role in the Russian banking system. The number of banks controlled by nonresidents (with nonresident interest in authorised capital exceeding 50%) increased by four in 1998, from 26 to 30, and their share of total banking assets grew from 8.9% to 13.6%. In the group of top 50 banks by assets, the number of banks controlled by nonresidents rose from 10 to 12 over the year. The financial crisis had an extremely adverse effect on the performance of this group of banks, which in some aspects were affected more seriously than the banking system as a whole. The GKO—OFZ revamp plan, announced in August 1998, led to a virtual freeze of nearly 25% of assets of these banks.

IV.2. REGISTRATION AND LICENSING OF BANKING ACTIVITIES

NINE new credit institutions were registered in 1998 (12 in 1997), of which five were banks and four non-bank credit institutions, including three clearing houses effecting settlements between players on inter-bank currency exchanges. Three of the newly created and licensed banks had foreign interest in their capital.

The total number of credit institutions registered by the Bank of Russia decreased over the year from 2,552 to 2,481 (2.8%) and the number of operating credit institutions fell from 1,697 to 1,476 (13.1%).

Aggregate registered authorised capital in the banking system grew over the year by 60% and as of December 31, 1998, amounted to 52.5 billion rubles.

The most intense dynamics was registered in the most different groups of banks: the share of banks with authorised capital of less than 500,000 rubles decreased by half over the year, that of banks with authorised capital of 20 million rubles to 40 million rubles increased 1.6 times and the proportion of banks with authorised capital in excess of 40 million rubles rose 1.75 times.

The financial crisis has not yet had any noticeable influence on the buildup of authorised capital of banks. During the last four months of 1998 more than 190 banks registered changes in their founding documents relating to increase in authorised capital. This represents one-third of the total number of banks which increased their authorised capital during the year. It should be noted that the sum of the increase in authorised capital by banks in September–December 1998 made up about 30% of the year's increase in authorised capital.

In the second half of the year the Bank of Russia preserved the minimum authorised capital requirements for the newly-created banks at the pre-crisis level and fixed them in their ruble equivalent. Only for the newly-created subsidiary credit institutions of foreign banks a euro equivalent

was set for the minimum authorised capital requirement.

The branch network of credit institutions experienced significant change. At the end of 1998 the total number of branches of operating banks in Russia amounted to 4,453, which represents a fall of 30.0% from December 31, 1997. The number of Sberbank branches, which make up 42% of all bank branches, fell by 4%.

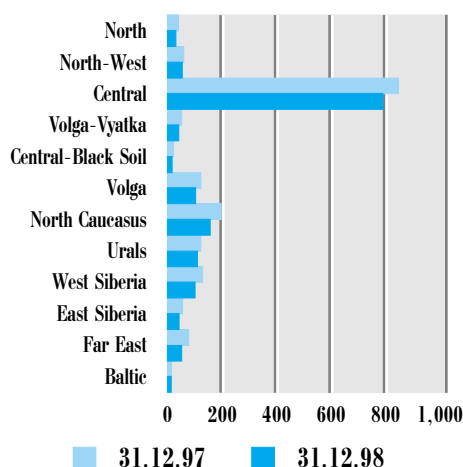
Banks with authorised capital in excess of 40 million rubles were particularly active in rebuilding their branch networks. They accounted for nearly 80% of all newly-opened branches and 73% of closed ones.

The tendency towards the reduction of the branch network, which appeared in previous years, intensified in 1998 owing to the general economic situation and the revocation of licences from a number of large multi-branch banks. In addition, banks realised the benefits of the right granted to them to open internal structural subdivisions rather than branches, especially additional offices which can also conduct some banking operations. The need to cut costs and reduce the volume of banking operations compelled credit institutions to close 1,695 branches, 4.8 times more than in 1997.

Most of the new bank branches were opened in the Tyumen Region (12 branches were set up there, five by local banks and seven by banks from other regions), the Moscow Region (10 branches were opened, all by banks from other regions), the Rostov Region (11 branches were established, three by local banks and eight by banks from other regions), St. Petersburg (9 branches were opened, three by local banks and six by banks from other regions), and the Samara Region (nine branches were set up, two by local banks and seven by banks from other regions).

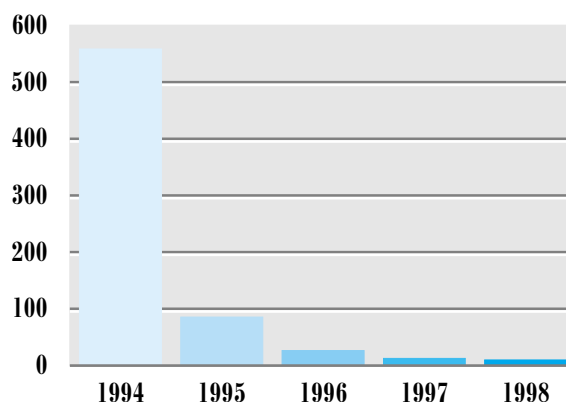
The network of banks' representative offices also narrowed. At December 31, 1998, there were 199 representative offices of banks, a third less than a year ago. The number of representative

NUMBER OF OPERATING CREDIT INSTITUTIONS BY REGION



Figures 29, 30

NUMBER OF CREDIT INSTITUTIONS REGISTERED BY BANK OF RUSSIA IN 1994—1998



offices of Russian banks in non-CIS countries decreased by half.

Reorganisation of credit institutions intensified last year. Seven banks were reorganised by merger, of which four became branches of other banks. Reorganisation of 53 banks was registered, of which 50 banks created in the form of limited liability companies (limited partnerships) were transformed into joint-stock companies.

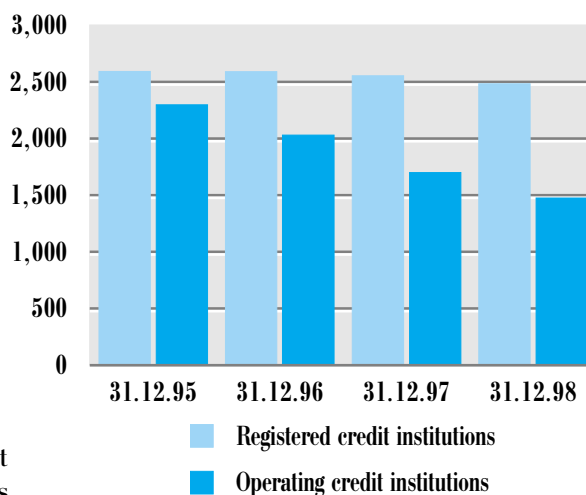
Figure 31

As of December 31, 1998, 47% of all credit institutions in Russia were joint-stock companies (they accounted for 46.3% of registered authorised capital).

During the year the Bank of Russia monitored the process of bringing the founding documents of credit institutions, created in the form of limited liability companies, into compliance with the Federal Law on Limited Liability Companies. Guided by that law, 160 credit institutions agreed upon with the Bank of Russia the necessary changes and amendments to their legal documents and the rest are expected to complete this work later this year.

As of the end of the year under review there were 142 banks in Russia, whose authorised capital was formed with foreign participation (145 at the beginning of the year). In 30 banks, the nonresident share of authorised capital exceeds 50% and 18 of these banks have 100% nonresi-

NUMBER OF CREDIT INSTITUTIONS

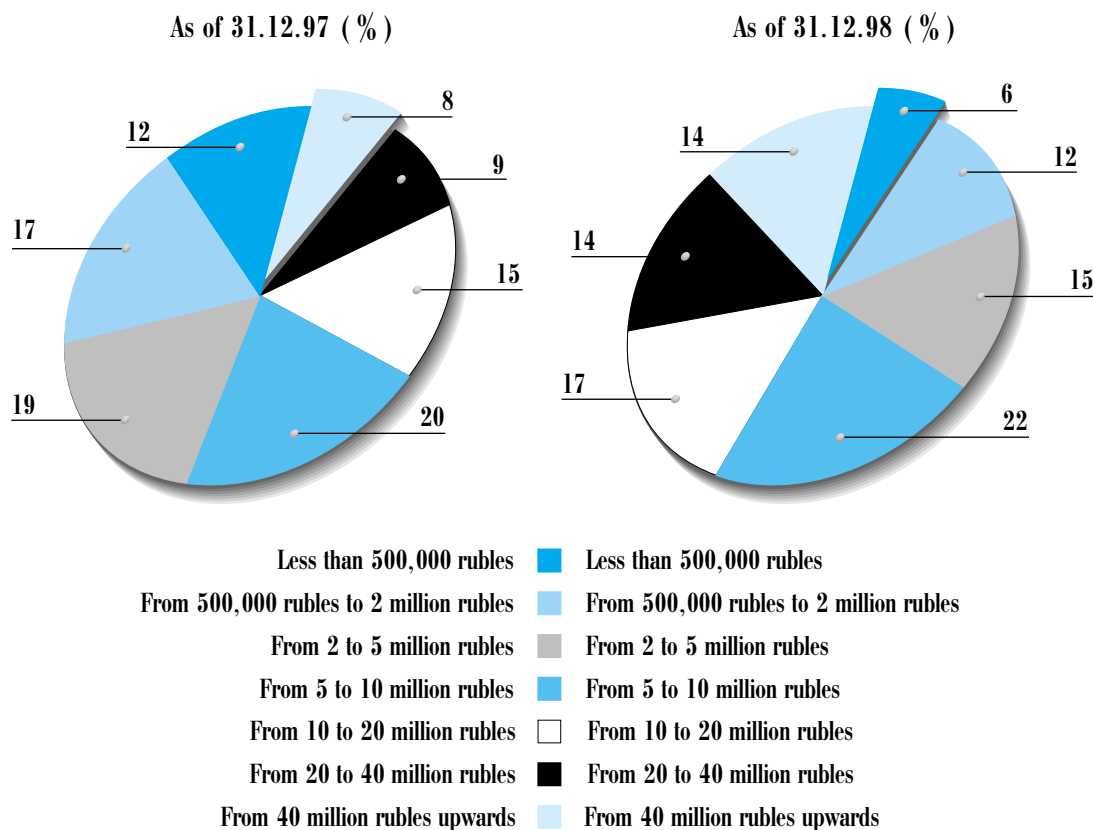


dent capital. The lion's share of authorised capital paid up by nonresidents is owned by US (514.5 million rubles), German (513.1 million rubles) and Austrian (240.6 million rubles) investors.

As of December 31, 1998, 634 (43%) out of 1,476 credit institutions with Bank of Russia licence to conduct banking operations had the right to effectuate operations in rubles and foreign exchange, 263 banks (17.8%) had general licence and 136 banks (9.2%) had the right to conduct operations with precious metals. Ninety-three per cent of banks had the right to attract household deposits.

To encourage financially sound banks with their own funds amounting to an equivalent of

STRUCTURE OF OPERATING CREDIT INSTITUTIONS IN TERMS OF REGISTERED AUTHORISED CAPITAL



Figures 32, 33

less than 1 million euro, the Bank of Russia in October 1998 lifted restrictions that had previously limited this group of banks from attracting foreign exchange deposits from corporate entities either on their own behalf or for their own account. These banks were allowed to establish direct correspondent relations with foreign banks and 75 decided to do so.

In 1998, the Bank of Russia carried through a lot of work to upgrade and streamline rules to regulate the state registration of credit institutions and licensing of their activities.

Bank of Russia Instruction No. 75, dated July 23, 1998, "On the Procedure for Applying Federal Laws Regulating the Procedure for Registering Credit Institutions and Licensing Their Activities" was issued to replace earlier Instruction No. 49.

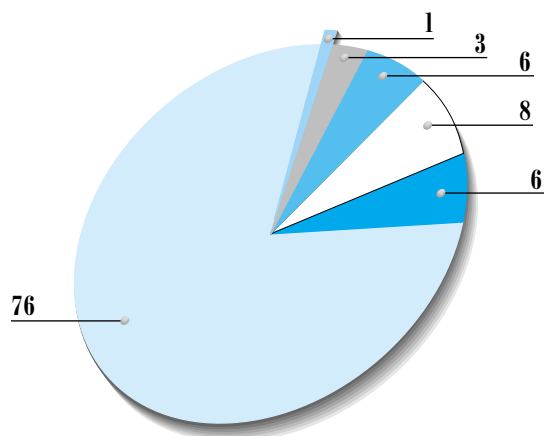
In addition to that Instruction, the Bank of Russia issued an order, dated October 23, 1998, "On the Purchase by Private Individuals of Stakes

(Shares) in Authorised Capital of a Credit Institution," which updated the list of documents that could be regarded as confirmation of satisfactory financial condition of individuals (partners in credit institutions) and the legality of payment by them of their stakes (shares) in authorised capital of a credit institution.

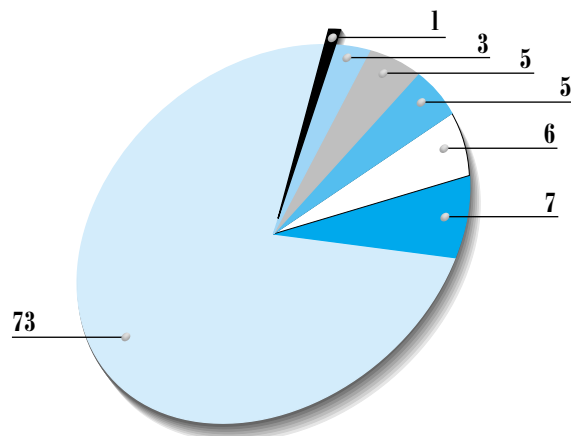
To form a liquid structure of authorised capital and set a uniform procedure for expert evaluation of the tangible assets contributed by partners as payment of their stakes (shares) in authorised capital, the Bank of Russia issued Instruction No. 243-U, dated June 1, 1998, "On the Registration of Shares in Authorised Capital of Credit Institutions, Formed by Contributing Tangible Assets, and Uniform Application of the Legislation on the Protection of the Rights of the Participants of Credit Institutions."

A series of steps were taken after the eruption of the financial crisis to mitigate its consequences and rehabilitate the banking system.

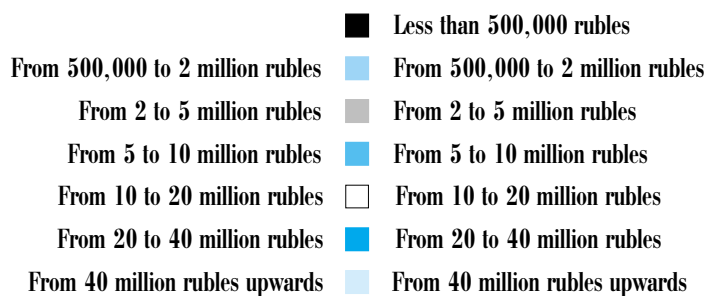
**BRANCHES REGISTERED
IN 1998 AND GROUPED BY SIZE
OF AUTHORISED CAPITAL
OF PARENT CREDIT INSTITUTIONS (%)**



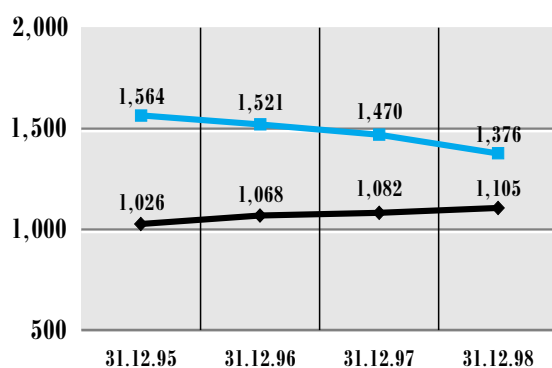
**BRANCHES CLOSED
IN 1998 AND GROUPED BY SIZE
OF AUTHORISED CAPITAL
OF PARENT CREDIT INSTITUTIONS (%)**



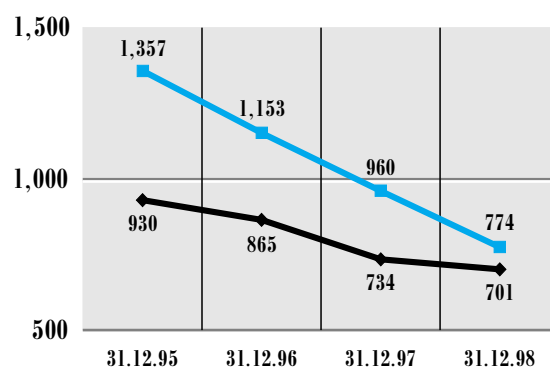
Figures 34, 35



**DYNAMICS OF CREDIT INSTITUTIONS
REGISTERED IN 1996—1999
(by status)**



**DYNAMICS OF OPERATING
CREDIT INSTITUTIONS IN 1996—1999
(by status)**

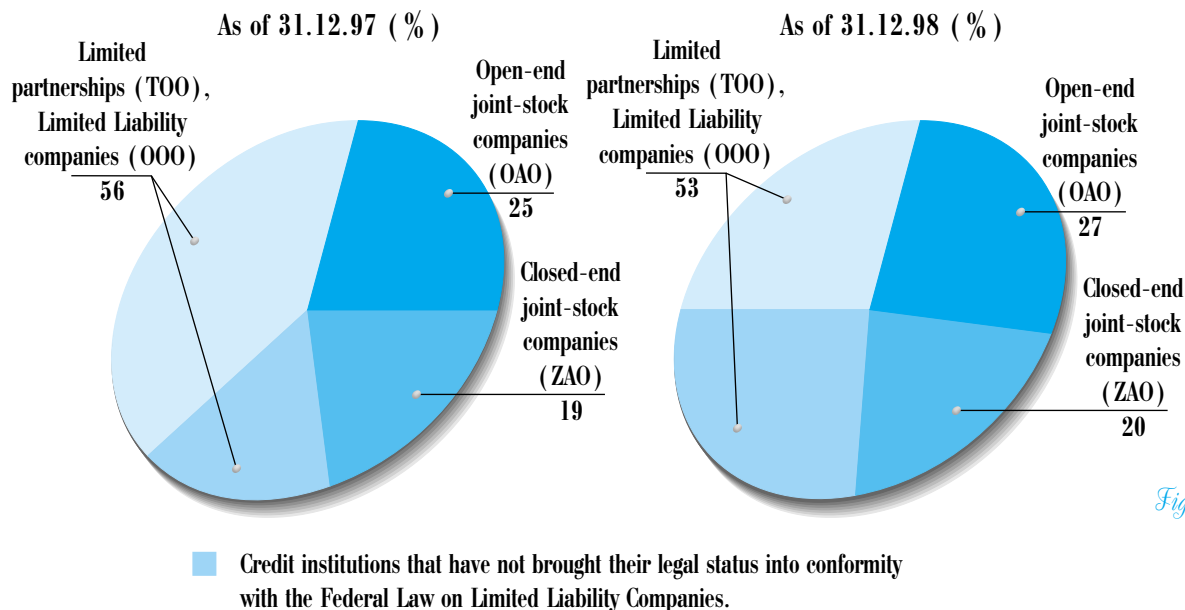


Figures 36, 37

The fee for the state registration of new credit institutions and the duty for the opening of a branch were cut 10 times (Order No. 421-U, dated No-

vember 24, 1998, “On the Reduction of the Fee for the State Registration of a Credit Institution and the Duty for the Opening of a Branch”).

STRUCTURE OF OPERATING CREDIT INSTITUTIONS BY STATUS



Figures 38, 39

The Bank of Russia also lifted the ban on payment of contributions to authorised capital of credit institutions in foreign currency (Order No. 365-U, dated September 30, 1998). Partners (shareholders) in operating credit institutions were granted the right to pay any increase in their authorised capital in part or wholly with tangible assets, such as the bank building (premises) where the credit institution is housed (or would be housed), except unfinished construction projects. In addition, the document provides

for the possibility (in accordance with the decision of the Bank of Russia Board of Directors) of paying up authorised capital of an operating credit institution with other assets owned by investors.

In accordance with the functions accorded to it by the legislation, the Bank of Russia in 1998 kept the State Register of Credit Institutions and published general information on credit institutions in its official publications and in the Bank of Russia site in the Internet.

IV.3. REGULATION OF CREDIT INSTITUTIONS

THE AIM of regulation of credit institutions by the Bank of Russia in 1998 was to create conditions for reducing banking risks by making supervisory requirements match international standards and countering the growing negative after-effects of the financial crisis.

The establishment on January 1, 1998, of a new procedure for creating and using reserves for possible loan losses made it possible to determine more precisely bank losses from bad loans. The basis for creating this reserve was expanded and criteria for loan portfolio assessment were specified in order to ensure conditions for fuller coverage of credit risk by banks. At the same time, the Bank of Russia considerably broadened the rights and responsibility of credit institutions in classifying debts on loans. Banks were allowed, for example, to classify some loans, including inadequately secured and unsecured loans, as belonging to a lower risk group than they should have done in accordance with the formal criteria set by Bank of Russia Instruction No. 62a, dated June 30, 1997, "On the Procedure for Creating and Using Reserves for Possible Loan Losses," but not lower than the risk group established for secured loans (Bank of Russia Directive No. 226-U, dated May 12, 1998).

To prevent the adverse effect of the growing credit risks on the financial condition of banks, the Bank of Russia raised requirements for the quality of banking capital. The methodology of calculating it rests upon the division of capital into two tiers, making it more difficult for banks to increase their own funds from unsound sources encumbered with potential obligations and, at the same time, reducing the volume of risks assumed by banks.

The Bank of Russia set a procedure for including in the capital adequacy count credit risks on off-balance sheet instruments and (this proved especially important for Russia) term transactions. Work on the corresponding document was completed in September 1998 and the procedure was enacted on February 1, 1999.

Introducing the requirements for consolidated reporting by credit institutions (No. 29-P, dated

May 12, 1998) and setting the procedure for using data reported by credit institutions in compiling consolidated reports (No. 47-P, dated July 30, 1998), the Bank of Russia created a regulatory framework for more accurate assessment of the volume of risks assumed by a bank, which is the necessary condition of effective supervision at the time when banking and industrial capital become increasingly intertwined.

In addition, to mitigate the crisis in the financial markets, the Bank of Russia in early 1998 set a limit on the amount of funds raised by banks in international markets and increased the transparency of data on the financial condition of banks. Bank of Russia Order No. R-444, dated August 26, 1998, stipulated that beginning from the reports as of June 30, 1998, a consolidated statistical report on the top 30 banks would be published monthly in the Bank of Russia site on the Internet. At the same time, these data are published in the Bank of Russia Bulletin (*Vestnik Banka Rossii*). Taking into consideration that only one-tenth of Russian credit institutions had their sites on the World Wide Web, the Bank of Russia allowed banks to use its site for reporting their activities.

However, despite the measures taken by the Bank of Russia, many banks were unable to withstand the negative effect of the financial crisis.

Implementing bank stabilisation measures, the Bank of Russia adopted special procedures for regulating credit institutions in time of crisis. To impose additional limits on credit risks assumed by credit institutions and ease pressure on the foreign-exchange market, it set a limit on the size of the position that credit institutions could take in conversion operations against the Russian ruble on any given trading day (Bank of Russia Directive No. 357-U, dated September 23, 1998). Bank of Russia Directives No. 387-U, dated October 29, 1998, and Nos. 392-U, 393-U, 394-U, 395-U, 396-U and 397-U, dated October 30, 1998, set up the procedure for calculating required economic ratios in absolute terms, made some changes in the calculation of individual economic ratios and established the procedure for

taking corrective action. Specifically, the Bank of Russia rethought its policy on risks assumed by banks and tightened the following requirements:

- It introduced a 10% risk ratio for bank investments in government securities of countries other than the industrially developed economies, Russia included (beginning from reports as of November 30, 1998);
- The mix of government securities regarded as liquid assets was limited to the trade portfolio (beginning from reports as of November 30, 1998);
- It set the requirement for covering with liquid assets possible claims on banks relating to an additional variation margin on loans received and REPO deals (beginning from reports as of November 30, 1998);
- Restrictions were imposed on bank investments in government securities of countries other than the industrially developed economies, Russia included (beginning from reports as of March 31, 1999);
- The aggregate sum of a bank's claims on the borrower (ratio N6, "Maximum Risk per Borrower or Group of Related Borrowers") included securities accepted by the bank as collateral for its loans, issued by one corporate entity or a group of related corporate entities of countries other than the industrially developed economies (beginning from reports as of March 31, 1999).

These measures allowed banks that were hit by the crisis but had good chances for recovery to assume risks based on their capital position on July 31, 1998; that is, without taking into account the consequences of the August crisis. In addition, banks received the opportunity to recalculate the funds they borrowed and lent in foreign currency before August 14, 1998, at the exchange rates set by the Bank of Russia for August 14, 1998.

Using this comprehensive system, the Bank of Russia, even during the crisis, retained the possibility of controlling the main parameters of banks'

activities, while banks received the opportunity to normalise their relations with customers. The deadline for the special regulation regime was set for July 1, 1999.

Documentary supervision in 1998 allowed the Bank of Russia to detect the following violations of supervisory requirements:

- 1,149 credit institutions failed to meet the required economic ratios;
- 808 credit institutions presented inaccurate reports;
- 826 credit institutions failed to meet reporting deadlines;
- 164 credit institutions pursued risky lending policies;
- 736 credit institutions failed to comply with reserve requirements;
- 424 credit institutions violated the procedure for creating reserves for possible loan losses;
- 1,499 credit institutions committed other violations.

Corrective actions were taken against violator banks. Meetings with management of 321 credit institutions were held to discuss the shortcomings discovered in their work and ways to rectify them; 1,271 credit institutions were served with orders to take steps to rectify the faults discovered in their work; and 445 credit institutions were ordered to comply with the required economic ratios. The Bank of Russia placed limits on some operations conducted by 498 banks, 415 banks were prohibited from conducting some operations and 284 banks were denied permission to open branches. Credit institutions that failed to comply with federal laws and Bank of Russia regulations or meet their obligations to creditors and depositors had their banking licence revoked. In the interests of creditors and depositors the Bank of Russia also took steps to accelerate the process of closing credit institutions whose licence had been revoked. It believed that revoking licence from hopeless banks as soon as possible was a major means of preventing a systemic banking crisis. In 1998 the Bank of Russia revoked 229 banking licences.

IV.4. PARTICIPATION OF CREDIT INSTITUTIONS IN THE SECURITIES MARKET AND CONTROL OVER THEIR ACTIVITIES

CONTROL over the activities of credit institutions in the financial markets in 1998 aimed to fulfil the tasks set in the Guidelines for the Single State Monetary Policy in 1998, and was implemented in compliance with the requirements of the applicable legislation and Bank of Russia standards and regulations.

The Guidelines say that the growth in banks' own funds (capital) was one of the chief factors that maintained financial stability in the banking system.

At the same time, the Bank of Russia controlled credit institutions by registering and monitoring their securities and share issues. The registering bodies tightened controls over the authorised capital payment practices to prevent investors from buying shares with borrowed money. Effective control was established over the use of budget funds as payment to authorised capital of credit institutions and the participation of federal and municipal civil servants in the management of credit institutions.

To restructure the banking system and create favourable conditions for its work, the Bank of Russia adopted a number of standards and regulations broadening the range of sources of increase in authorised capital, especially with foreign exchange.

The Bank's regional branches increased control over the registration of terms and conditions of the savings certificates and certificates of deposit issued by credit institutions.

Last year they cancelled 231 terms and conditions of savings certificates and certificates of deposit issued by 96 credit institutions (against 43 terms and conditions of 22 credit institutions in 1997).

To ensure transparency of trade in securities, the Bank of Russia took steps to create a public information disclosure system in compliance with its Provision No. 43-P, dated July 2, 1998, "On the Disclosure of Information by the Bank of Russia and Credit Institutions Participating in the Financial Markets." At the same time, it be-

gan to download into the Bank of Russia server on the Internet the register of securities of credit institutions operating in Russia and the register of terms and conditions of the savings certificates and certificates of deposit issued by credit institutions as of the 1st and 15th day of each month.

To ensure the state regulation of credit institutions in the securities market, the Bank of Russia licensed credit institutions to operate in the securities market in accordance with the general licence it was granted by the Federal Securities Commission. The main kinds of professional activity conducted by credit institutions in the securities market last year were brokering, dealing and depository business. In 1998 the Bank of Russia licensed 353 securities market professionals, of which 129 were licence renewals. However, in the second half of the year, an increasing number of licences of credit institutions were suspended or revoked, because at the time of the financial crisis banks no longer complied with the requirements set by the securities legislation for professionals participating in the securities market. Thirty-seven credit institutions were stripped of their licences and seven had their licences suspended last year.

Implementing its functions as a plenipotentiary licensing body, the Bank of Russia prepared and submitted to the Federal Securities Commission on a monthly basis the following reports:

- a register of issued, suspended and revoked licences of professional securities market participants, which is disclosed once in three days in the Bank of Russia server on the Internet;
- information on scheduled and unscheduled inspections of professional securities market participants licensed by the Bank of Russia.

The Bank of Russia arranged and constantly improved the exchange of information with the FSC on inspections of credit institutions operating in the securities market and on handling complaints and other statements by securities holders.

In addition, the Bank of Russia and FSC co-operated in drafting rules and standards to regulate the securities market.

Last year the Bank of Russia, seeking to tighten controls and supervision over credit institutions, drafted a series of documents relating to violations of securities market legislation by credit institutions which participated in the securities market, and the use of corrective actions and penalties against them.

Bank of Russia Directive No. 319-U, dated August 19, 1998, and Provision No. 49-P of the same date stipulated the creation of special commissions to examine violations of the securities market legislation. These commissions consider breaches of the securities market law by credit institutions and their reports serve as a basis for corrective measures, which include the suspension or revocation of licences.

Within the framework of the aforementioned regulations, the Bank of Russia developed an automated database on detected violations of the securities law, which became operational in 1999. This database is designed to track down specific violations of professional standards in the securities market and monitor the situation throughout the country.

To raise the standard of inspections of credit institutions in the financial markets, methodological recommendations were prepared for conducting inspections of specific activities.

Implementing control over trust management operations, the Bank of Russia in the year under review kept a register of common bank-managed funds, which were disclosed once in three days on the Bank of Russia server on the Internet. The Bank of Russia Bulletin carried monthly a report on the registered common bank-managed funds in Russia, including information on the volume of assets managed by common bank-administered funds and the number of registered common bank-managed funds. Last year, 99 credit institutions conducted trust management operations, but by the end of the year their number had fallen to 89; 30 credit institutions registered the General Conditions of the Creation and Trust Management of Common Bank-Administered Funds Property (67 common bank-managed funds were registered last year).

Taking into account contemporary banking practices and recommendations of credit institutions, the Bank of Russia elaborated amendments to its Provision No. 509, dated August 28, 1997, "On Organising Internal Control at Banks," and

eventually issued Directive No. 427-U, dated November 30, 1998, "On Amending Bank of Russia Provision No. 509, dated August 28, 1997, "On Organising Internal Control at Banks."

Taking into account these amendments, banking practices and changes in securities market regulations, the Bank of Russia established a procedure for organising and conducting internal control over compliance with the financial market legislation.

To organise an effective system of control over the activities of credit institutions in the financial markets and train Bank of Russia specialists in modern methods of control, the Bank of Russia continued to co-operate with the corresponding regional control centres set up in 1997. These centres were directly involved in the elaboration of a number of regulatory documents, including documents relating to the inspection of the activities of credit institutions in the securities market.

Some requirements set by the Bank of Russia for operations conducted by credit institutions are limited to purely economic ratios and standards. Since there are some problems which the Bank of Russia cannot solve within the limits of its controlling functions, a very important role is played by self-regulating organisations, professional specialised organisations ensuring normal conditions in the market through the self-organisation of its participants.

Therefore, the Bank of Russia participates in drafting standards and other internal documents of self-regulating and other specialised organisations, designed to minimise financial market risks. This is especially important for credit institutions today.

To protect investor interests in the securities market, the Bank of Russia used the securities market automated research, staff training and supervision system (SMARTS), designed to confirm controversial trades and the circumstances which caused clients to complain to the Bank of Russia or were detected by inspection of the professional activities of credit institutions. Owing to the suspension of trading in government securities on MICEX and a sharp fall in volume and turnover that followed it, in the fourth quarter of the year SMARTS lost some of its importance as a daily market monitor, but it nevertheless remains a source of information when violations committed throughout 1998 are discovered and examined.

IV.5. INSPECTION OF CREDIT INSTITUTIONS

BANKS were inspected in 1998 in accordance with the annual summary plan of inspections. A total of 4,415 inspections were conducted, of which 1,032 inspections were comprehensive. This represents an increase on the number of inspections conducted in the previous years.

Inspections were conducted by the inspection divisions of all regional Bank of Russia institutions.

Guided by the general objectives of bank inspection in 1998, inspectors conducted comprehensive inspections of credit institutions, analysed various aspects of the financial condition of banks, the quality of their credit portfolio and accuracy of the reports they presented to the Bank of Russia, and examined other banking activities.

In the first half of the year, practically all banks were inspected to make sure that they correctly used the new chart of accounts and conducted banking operations in the period when both old and new money was in circulation. Special attention in organising inspections was paid to the system-building banks and problem banks. The principal objective of such inspections was not only to detect irregularities and shortcomings, but also to find ways to rectify them as soon as possible and give credit institutions relevant advice and practical assistance.

For the first time, bank inspectors in 1998 conducted inspections of credit institutions which had participated directly in the securities market. In the year under review, 422 such inspections were conducted by inspection divisions in collaboration with securities divisions.

Inspection results show that the most common violations committed by credit institutions in conducting operations with securities were the failure to comply with the Bank of Russia requirement to create a reserve to hedge against the depreciation of securities and violations related to securities accounting and reporting.

The situation in the financial market after August 17 required the use of new forms of inspection, such as constant control over individual banking operations conducted by credit institu-

tions. More than 1,800 inspections were conducted for this purpose.

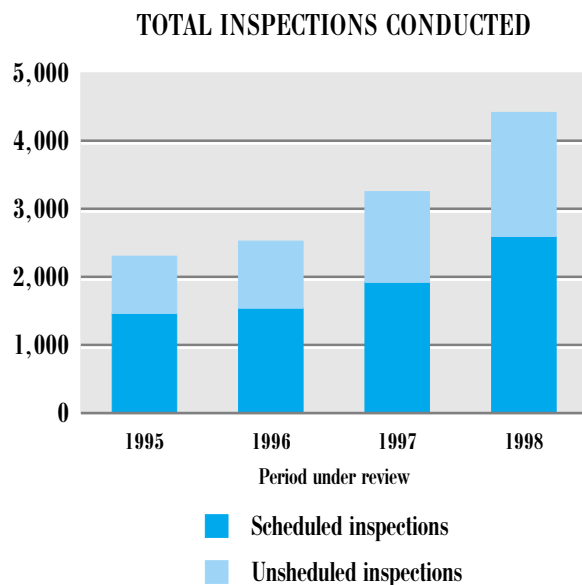
To conduct express analysis of operations conducted by banks, the Bank of Russia set up in some Moscow-based banks and their branches bank inspection and supervision groups, which examined information on the nature and volume of banking operations, the violations detected, the amount of deposits accepted from, and paid out to, private individuals, and other activities.

Some regional institutions of the Bank of Russia inspected, on a daily basis, deposit operations in rubles and foreign exchange, the amounts of money paid out from and entered to, deposit accounts and the dynamics of requests for cash withdrawals.

In compliance with Government Order No. 1229-R, dated August 29, 1998, inspections were conducted in all regions jointly with tax authorities to make sure that credit institutions executed their clients' orders in time and entered funds to their clients' accounts without delays. More than 500 inspections of this kind were conducted, using a specially developed methodology.

In pursuance of the Bank of Russia Board of Directors' decision of September 1, 1998, "On Measures to Protect Household Savings at Banks," 200 credit institutions and their branches were inspected.

In the period under review, considerable attention was paid to conducting inspections of credit institutions to how they carried out their functions as foreign exchange control agents, especially on how they complied with the established procedure for transferring foreign exchange abroad. Inspections of credit institutions in the Moscow Region showed that some banks violated foreign exchange legislation to make illegal profit at the MICEX special trading session. In addition, some resident corporate entities were found to be illegally transferring foreign exchange to offshore zones, using dubious import contracts. Some nonresident individuals (citizens of CIS countries) were found to be buying large sums of foreign cash. Responding to inspection results, the Bank of Russia barred



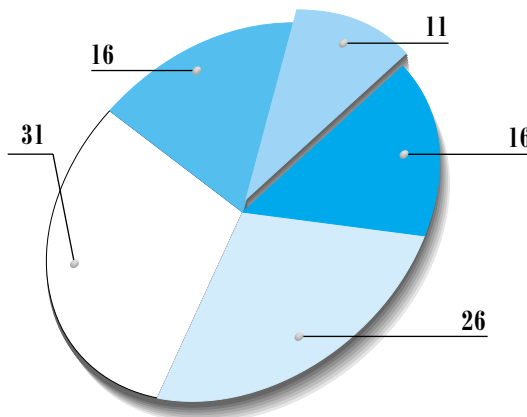
some banks from participating in the MICEX special trading session.

Inspections were conducted to make sure that credit institutions of the Komi Republic and Kemerovo and Rostov Regions transferred funds to coal mines in time. Inspections were conducted jointly with the Finance Ministry to ensure that foreign-currency funds allocated for specific purposes from the federal budget to some territories of the Russian Federation were not misused. The results of the inspections were made known to the Government.

In conducting on-site inspections of credit institutions and their branches, Bank of Russia inspectors uncovered 52,528 violations of applicable legislation and standards and regulations set by the Bank of Russia. These included accounting and reporting standards, rules regulating foreign-exchange and deposit operations, and procedures for making loans and securing repayment; creating required reserves to be deposited with the Bank of Russia and reserves for possible loan losses and operations with securities.

Banks continued to pursue risky lending policies, such as making loans without regard to the financial condition of borrowers and their ability to repay in time and in full. Debt on loans accumulated, as a rule, with a small number of borrowers (banks failed to diversify their loan portfolios). A number of credit institutions used settlement systems that bypassed the borrowers' settle-

**STRUCTURE
OF UNSCHEDULED INSPECTIONS
OF CREDIT INSTITUTIONS
(as % of total inspections)**



Figures 40, 41

- Inspections of compliance with settlement and payment deadlines
- Inspections of fulfilment of obligations to budgets of all levels
- Inspections in response to official requests
- Inspections to verify compliance with measures to protect household savings
- Inspections of specific activities, including inspections at the request of depositors and creditors

ment account when loans and interest were repaid. Bank promissory notes and third-party notes, which were often illiquid, were commonly used for this purpose.

Violations of the Bank of Russia's loan loss reserve requirements were most common, and significant in terms of their impact on the accuracy of the accounts and financial results of credit institutions. The attempts to underrate credit risk adversely affected the financial condition of credit institutions.

The results of the analysis of violations discovered by inspections of credit institutions and collections of explanations on issues concerning the competence of the inspection of Bank of Russia regional institutions were published in the Bank of Russia Bulletin.

The methodology of bank inspections became more effective last year.

**STRUCTURE OF VIOLATIONS DISCOVERED BY INSPECTIONS
OF CREDIT INSTITUTIONS IN 1998 (%)**

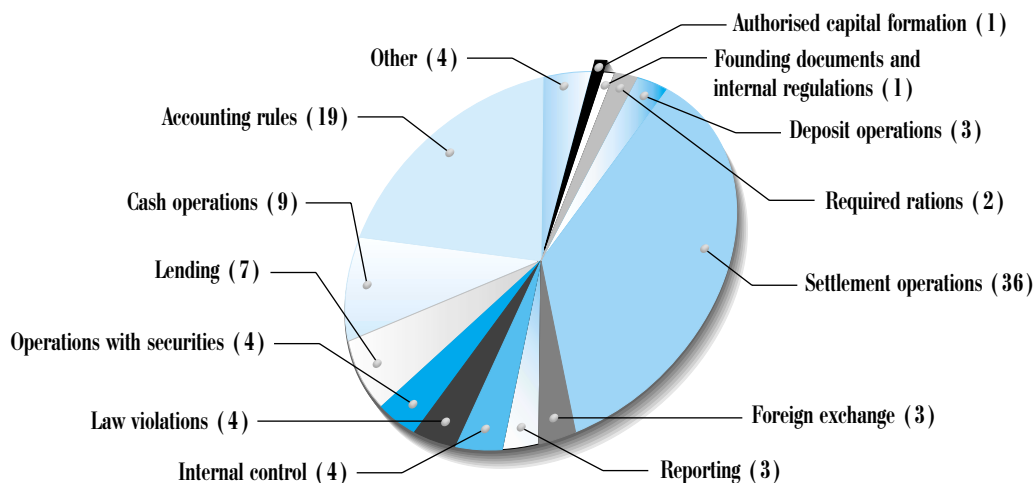


Figure 42

Taking into consideration that credit risk is one of the main factors affecting the financial condition of credit institutions, the Bank of Russia elaborated and sent to its regional branches a set of methodological recommendations on the inspection of the loan portfolio of a credit institution and worked out a number of methodological recommendations on the inspection of specific banking operations.

These materials will help the inspection divisions to evaluate and predict more accurately the

stability and credibility of credit institutions and their financial state.

In 1999, banks will be inspected on the basis of a summary plan of inspections of credit institutions, designed to ensure the implementation of the Guidelines for the Single State Monetary Policy in 1999, the joint document of the Russian Government and Bank of Russia "On Measures to Restructure the Banking System of the Russian Federation" and Bank of Russia regulations on banking supervision.

IV.6. REHABILITATION OF CREDIT INSTITUTIONS

THE BANK OF RUSSIA in 1998 analysed the activities of credit institutions in order to detect threats to the legitimate interests of creditors and investors and stability of the banking system as a whole. It demanded, therefore, that financially troubled credit institutions work out rehabilitation measures and monitored their implementation.

Last year, the Bank of Russia demanded financial rehabilitation plans from 320 credit institutions (303 credit institutions in 1996 and 386 in 1997) which had inadequate own funds (capital) or failed to meet in time their commitments to creditors or capital borrowings from the Bank of Russia. During the year, rehabilitation plans presented by 43% of credit institutions were approved as realistic, and the financial condition of 72 credit institutions, whose rehabilitation plans were approved by Bank of Russia regional institutions, is improving.

To ensure compliance by credit institutions with the requirements set in point 4 of Article 90 and point 4 of Article 99 of the Civil Code of the Russian Federation, the Bank of Russia took remedial action with regard to the banks whose own funds (capital) were smaller than their registered authorised capital. Eighteen banks decided to reduce their authorised capital to the level of their own funds (capital).

Owing to significant deterioration of the financial condition of some leading banks and the emergence of a real threat to the legitimate interests of creditors and investors in a crisis situation, the Bank of Russia Board of Directors (guided by Article 79 of the Federal Law on the Central Bank of the Russian Federation (Bank of Russia)) decided on September 1 to assume some of the obligations of these banks: SBS-AGRO, Menatep, Mosbiznesbank, Most-bank, Promstroibank and Inkombank, under bank deposit contracts concluded before September 1, 1998, and up to the amount of obligations at the time the decision was adopted. As of December 31, 1998, the sum of the household deposit obligations transferred from these banks (excluding Inkombank) to Sberbank amounted to 4,416.6 million rubles.

Whenever necessary, the Bank of Russia, guided by Article 75 of the Federal Law on the Central Bank, appointed provisional administrations to problem banks.

In 1998, provisional administrations were appointed to six credit institutions, five of them based in Moscow (10 and 5 credit institutions in 1997 and 8 and 3 in 1996). The main tasks of provisional administrations were to evaluate the real financial position of credit institutions and their prospects for the future. Three credit institutions under provisional administration had their banking licence revoked as it was impossible to restore their solvency and liquidity.

Guided by Article 75 of the Federal Law on the Central Bank of the Russian Federation (Bank of Russia) and Articles 20 and 23 of the Federal Law on Banks and Banking Activities, the Bank of Russia in 1998 revoked the licences of 229 credit institutions, including five banks whose banking licences were revoked after their founders (partners) had decided to liquidate them. Most licences were revoked from credit institutions registered in Moscow (45), the Republic of Dagestan (11), Krasnodar Territory (11) and the Republic of Sakha (Yakutia) (11).

In some cases, the licence revocation procedure was suspended as credit institutions took steps to rehabilitate themselves financially. There were 25 such cases in 1998. In 12 cases, the licence revocation process was stopped as the credit institutions concerned improved their financial position.

The Bank of Russia believes that enhancing the effectiveness of these liquidation procedures (by starting liquidation proceedings sooner and concluding them within a shorter period) is a major guarantee of the rights and legitimate interests of creditors and depositors. To this end, the Bank of Russia institutions, guided by Articles 62 and 63 of the Civil Code, Articles 20 and 23 of the Law on Banks and Banking Activities, Articles 38 and 76 of the Federal Law on the Central Bank, and Bank of Russia regulations, controlled the winding up of credit institutions and agreed the appointment of liquidation commis-

sions and intermediate and final liquidation balance sheets.

Quite a few credit institutions that were stripped of their banking licences were subjected to liquidation procedures. As of December 31, 1998, decisions were made to liquidate 867 credit institutions, or 86.3% of all credit institutions subject to liquidation (649 credit institutions, or 76.2%, as of December 31, 1997). The decision to liquidate 132 credit institutions (15.6%) was made by their partners or their partners jointly with their creditors (136 credit institutions, or 21.0%, as of December 31, 1997).

As of December 31, 1998, the arbitration courts had passed 732 decisions (84.4%) to liquidate credit institutions, including 557 decisions (64.2%) to initiate bankruptcy proceedings (as of December 31, 1997, 513 liquidation decisions, or 79%, including 365 decisions, or 56.2%, to initiate bankruptcy proceedings). The arbitration courts had not yet decided in 40 liquidation cases.

As of December 31, 1998, liquidation commissions or receivers were appointed to 702 credit institutions (468 as of December 31, 1997) and 248 intermediate liquidation balance sheets and 38 final liquidation balance sheets were agreed in accordance with the established procedure. Of these, 30 credit institutions were in the final stages of liquidation (the arbitration courts had ruled that the bankruptcy proceedings had been completed and that materials for making an entry on liquidation in the State Register of Credit Institutions were being prepared).

In 1998, the Bank of Russia introduced reporting on the state of liquidation procedures in credit institutions whose banking licences had been revoked. This reporting included the evalu-

ation of the performance of liquidation commissions and receivers (liquidators). Bank of Russia institutions established control over the appropriateness of decisions regarding methods of closing credit institutions, streamlined the process of running credit institutions from the point of revocation of their banking licences to the appointment of liquidation commissions or receivers (liquidators); and determined the specifics of drawing up intermediate and final liquidation balance sheets.

When founders (partners) of credit institutions which had lost their banking licences evaded liquidation, the Bank of Russia would appeal to the arbitration courts. In 1998, 14 such appeals were filed, including four cases in which the courts were asked to declare credit institutions insolvent (bankrupt). When the partners in a credit institution failed to comply with the court's decision to liquidate, appeals were filed in the arbitration courts to put 126 credit institutions in receivership. That practice helped accelerate close-out procedures and better protect the interests of creditors and depositors.

Seventy-three credit institutions were struck out from the State Register of Credit Institutions (85 as of December 31, 1997), of which 50 credit institutions were struck off the Register following the arbitration court's decision that bankruptcy proceedings had been completed. Twenty-one credit institutions were struck out from the Register after their founders (partners) had completed voluntary liquidation, and two institutions were struck off the Register because they were one year late in initiating operations. Most credit institutions were closed out in Moscow (12) and in the Rostov Region (7).

IV.7. BANKING AUDIT

THE NUMBER of audit firms and self-employed auditors licensed to audit banks rose by almost 6% in 1998, to 160 as of December 31, 1998; of these, 82 audit firms and auditors had their licences extended in accordance with Bank of Russia Letter No. 311-T, dated November 4, 1998, "On Extending the Term of Banking Audit Licences." This was for the period up until the Russian Government regulated requirements to the level of licensing charges and fees in compliance with the Federal Law on the Licensing of Certain Kinds of Activity.

The number of auditors holding certificates qualifying them to audit banks increased over the year by 12.6%, to 902.

Last year, 1,499 banks and 19 non-bank credit institutions were audited on their activities in 1997; 178 banks and three non-bank credit institutions (11%) were not audited because their financial condition left them unable to pay for audits. Of these, 147 banks in 1998 either had their banking licences revoked or were in the process of losing their licences; the remaining banks were subjected to other sanctions and penalties.

Audits for 1997 confirmed the authenticity of accounts in 1,157 banks and 17 non-bank credit institutions. Gross violations of accounting standards were discovered in one in four credit institutions and the authenticity of the reports they published was confirmed only when they made the corresponding corrections in their current reports. Five banks failed to have the authenticity of their reports confirmed.

Formed by Bank of Russia Order No. 02-102, dated July 15, 1994, the Central Audit Certification and Licensing Commission of the Bank of Russia in 1998 examined applications for licences from 64 audit firms and seven self-employed auditors and more than 300 auditors' requests for issuing and extending the terms of their qualification certificates.

Upon examination, licences were granted to 61 audit firms and three self-employed auditors.

The Bank of Russia attaches great importance to the quality of audit reports. Audit firms (auditors) that conducted inferior-quality audits were

subjected to the following penalties: in four cases they were denied their licence, in 27 cases, licence terms were cut short, and two firms had their licences revoked.

In 1998, auditors received 103 qualification certificates and had 188 certificates extended.

The analysis of the work conducted by Bank of Russia regional institutions with auditors shows that the former were beginning to pay more attention to this matter. The reports presented by Bank of Russia regional institutions contained detailed information on their work with audit firms (auditors) and on co-operation with other regional institutions, which allowed them to evaluate in a more comprehensive way the quality of auditors' work.

The Bank of Russia made analysis results known to its regional institutions, drawing their attention to the shortcomings and the proposals on ways to eliminate them.

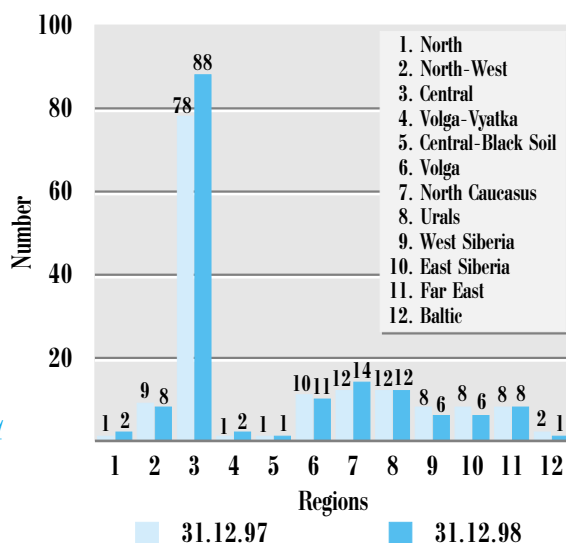
To provide methodological aid to auditors, the Bank of Russia in early 1998 formed an Expert Committee on Banking Audit, which focused its efforts on drafting proposals for the elaboration of bank audit standards and studying and disseminating auditing expertise. At its meetings, the Committee discussed issues relating to the confidentiality of audit reports and statements with regard to government bodies, statutory regulation of the procedure for refusing and cancelling audit licences, improvement of co-operation between audit firms and the Bank of Russia and the raising of the professional level of bank auditors and their qualification requirements.

The Bank of Russia, in collaboration with audit firms, elaborated Audit Rule (Standard) No. 1, "The Procedure for Compiling Auditors' reports on the Authenticity of Annual Accounts of Credit Institutions," which the Expert Committee approved in September 1998 and recommended for use in compiling the corresponding audit reports.

To improve the organisation of bank audits, the Bank of Russia drafted and issued the following documents:

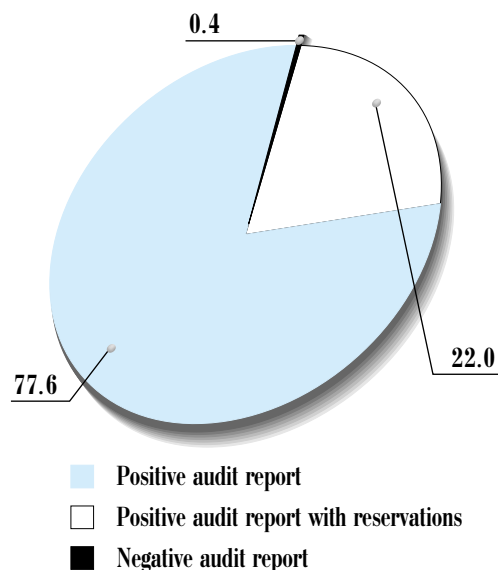
— Bank of Russia Letter No. 19-T, dated January 15, 1998, "On the Procedure for Submit-

NUMBER OF AUDIT FIRMS
AND SELF-EMPLOYED AUDITORS
BY REGION



Figures 43, 44

AUTHENTICITY STRUCTURE
OF BANK REPORTS AND ACCOUNTS (%)



ting to the Bank of Russia a Detailed report in Accordance with Paragraph 4.12 of Provision No. 10-P, dated December 23, 1997, on the Procedure for Compiling and Presenting to the Bank of Russia Auditors' reports on the Results of Auditing the Activities of a Credit Institution During the Year;"

- Bank of Russia Letter No. 54-T, dated February 9, 1998, "On the Specifics of Conducting Audits of Multi-Branch Banks;"
- Bank of Russia Directive No. 238-U, dated May 26, 1998, "On Amending Provision No. 64, dated September 10, 1997, on Audit in the Banking System of the Russian Federation."

At its meeting in December 1998, the Russian President's Commission on Audit approved the measures taken by the Bank of Russia to improve the regulatory framework for bank audit, taking into consideration the enactment of Federal Law on Licensing Certain Kinds of Activity, and the elaboration of Audit Rule (Standard) No. 1.

In May 1998, the Bank of Russia-sponsored Fifth National Bank Audit Day was held in

St. Petersburg on the following subject: "Current Problems of Banking Audit." Its participants noted progress in the development of the regulatory framework of bank audit and closer professional ties between the Bank of Russia and the Russian auditors' community.

The Bank of Russia also held a number of conferences with audit firms and representatives of auditors' organisations on key issues of bank audit regulation.

In the year under review, the Bank of Russia contributed numerous materials to the journal *Auditorskiye Vedomosti* (Audit News), of which it is a founder, on questions related to organisation and improvement of bank audit.

It took part in the drafting of the Federal Law on Audit. The adoption of this law and amendments to the Russian Government's Resolution No. 482, dated May 6, 1994, "On Endorsement of Audit Regulating Documents in the Russian Federation," including the amendments made in compliance with the Federal Law on Licensing Certain Kinds of Activity, will help create in this country a civilised audit services market.

THE STATE OF RUSSIA'S PAYMENTS SYSTEM



V.1. THE DEVELOPMENT AND UPGRADING OF THE RUSSIAN PAYMENTS SYSTEM

IN 1998, Russia continued to upgrade its payments system, which comprises the Bank of Russia payments system and the payments systems of credit institutions, in order to enhance the efficiency and reliability of the settlement services provided to the participants in settlements.

As was the case in the previous years, most of the non-cash payments (59%), made by credit institutions on behalf of their customers, on their own behalf and on behalf of Bank of Russia clients other than credit institutions (51.7% in 1997), were effected through the Bank of Russia settlement network.

The volume of payments made through the settlement systems of credit institutions — intrabank settlement systems, credit institutions' settlements on correspondent accounts opened with other credit institutions, and settlements effected through non-bank settlement credit institutions—made up respectively 31.7%, 9.1% and 0.2% of the payments turnover (36.5%, 11.7% and 0.1% in 1997).

Payments made through different settlement systems fluctuated in volume terms throughout the year because of the economic situation in the country. Their growth in the first half of the year was followed by a fall in August, and in September payment volumes plunged to an all-time low.

During the banking crisis when credit institutions had difficulty implementing payments, the Bank of Russia not only quickly organised a multilateral clearing of mutual obligations of credit institutions, which made it possible to implement

delayed payments of more than 30 billion rubles, but also increased the number of serviced accounts opened by corporate entities in a number of specified cases, demonstrating its ability quickly to respond to the changing economic conditions in the country. From October, payment volumes acquired positive dynamics.

In December, payments made through all settlement systems (the Bank of Russia settlement network, intrabank settlement systems, credit institutions' settlements through correspondent accounts opened with other credit institutions and settlements through non-bank settlement credit institutions) increased when compared with December 1997.

The main objectives of the Bank of Russia's policy are to modernise settlements, upgrade banking technologies, introduce new payment instruments, improve the standard of services provided to credit and other institutions and create conditions for managing liquidity.

The Bank of Russia conducted methodological and organisational work, stepped up efforts to introduce electronic paper handling, continued building an optimal network of its settlement divisions and developed an advanced automated real-time settlement system.

It also phased in a system to pass and process accounting information using fundamentally new software and telecommunications medium.

As of December 31, 1998, there were 1,195 Bank of Russia settlement divisions in the country, which serviced credit institutions

(branches) and non-credit organisations, and one settlement centre which provided services to non-credit organisations only.

Federal Law No. 65FZ, dated April 26, 1995, "On the Central Bank of the Russian Federation (Bank of Russia)," allowed the Bank of Russia to provide banking services to legislative and executive government bodies, local self-governments and their institutions and organisations, state extrabudgetary funds, military units, servicemen and other persons in the cases stipulated by federal laws.

It also can service customers that are not credit institutions in regions where there are no such institutions.

The Bank of Russia settlement divisions provided cash settlement services to 1,590 credit institutions and 2,930 branches of credit institutions, 684 liquidation commissions and more than 100,000 organisations that were not credit institutions.

The consolidation of correspondent accounts with the head offices of institutions and regional branches of major credit institutions, and the reorganisation of smaller banks into branches of other banks (or reorganisation of branches into additional offices of the same credit institution), led to a reduction in the number of correspondent accounts (subaccounts) of branch credit institutions serviced by the Bank of Russia settlement divisions.

During the year, 1,809 correspondent accounts (subaccounts) of branch credit institutions were closed, of which 340 accounts and 694 accounts respectively were closed due to the liquidation of the parent institutions and its branches. 775 accounts were closed as a result of the consolidation of correspondent subaccounts.

A number of improvements were registered in the overall structure of payments made through the Bank of Russia settlement network in 1998:

- the share of electronic payments in the total volume rose from 3.5% in 1997 to 55.3% in 1998;
- the share of reduced-format electronic payments (i.e., payments that only contain the required data for conducting operations on accounts and which are followed by payment documents on paper) decreased from 82.9% to 38.5%;

— the share of telegraphic payments fell from 9.1% to 4.5%;

— the share of postal payments declined from 4.5% to 1.7%.

Such significant growth in electronic payments, which help reduce settlement times (taking into consideration that there are 11 time zones in Russia and that different software systems are used, electronic settlements made in one region are effected on the same day and not later than the next day between regions), resulted from the creation of the corresponding regulatory framework and the expansion of the range of regional Bank of Russia institutions and settlement divisions linked up with the interbank electronic settlement system.

The Bank of Russia defined the term "signature analogue", which is used to sign electronic payment documents, making it possible to use in implementing settlements electronic documents on a par with the hand-signed payment documents on paper (Bank of Russia Directives No. 17P, dated February 10, 1998, and No. 20P, dated March 12, 1998).

An exchange of electronic documents between credit institutions and other Bank of Russia customers, and the Bank of Russia was organised in accordance with Bank of Russia Directive No. 304-U, dated July 30, 1998, "On the Preparation of Bank of Russia Institutions for the Exchange of Electronic Documents with Credit Institutions and Other Clients of the Bank of Russia."

In most regions, the electronic exchange of documents is already in place or is about to be put into operation. As of December 31, 1998, 84% of regional institutions and 53% of settlement divisions were linked up with the system at the inter-regional level and 94% and 90%, respectively, at the intra-regional level.

According to data reported by the Bank of Russia regional institutions, by the beginning of this year 707 cash settlement centres exchanged documents electronically with 1,082 organisations, including 1,015 branch credit institutions.

A format was developed for the implementation of partial payments between credit institutions and Bank of Russia institutions to accelerate the transfer of funds to budgets at all levels.

A full-format electronic exchange of documents, making it possible to enter funds to clients' accounts within one bank business day (four sessions), was introduced in the Moscow Region, where the bulk of Russia's payment turnover is concentrated and which has adequate telecommunications and computer facilities.

The information transmission technology, including that of inter-regional electronic settlements made through the Bank of Russia settlement network, was modernised.

Measures were carried out to reduce settlement times for the paper documents processed through the Bank of Russia settlement network.

The Bank of Russia constantly monitored contract compliance by specialised services and oversaw its own services that forwarded settlement documents. As a result, settlement times on operations conducted through the Bank of Russia settlement network were reduced significantly. Compared with 1997, the number of settlement operations conducted within 1—3 days increased by 26.6%, while the number of operations conducted within 4—7 days decreased by 26.6%.

The actual average settlement times in 1998 were as follows: 78.7% of settlements (by sum) took 1—3 days, 20.2% of settlements 4—7 days and 1.1% more than 7 days.

In the year under review, the Bank of Russia continued to make efforts to ensure the safety of settlement operations conducted through its settlement network. It increased the security of large-sum payments, installed advanced banking information protection software systems and quickly took additional security measures when conducting settlement operations in some regions of the Russian Federation.

A high level of security of banking information allowed the Bank of Russia to totally preclude theft when conducting settlement operations through its settlement system and to reduce to a minimum the number of attempts to use false and fraudulent letters of advice.

The Bank of Russia continued to create a regulatory framework for non-cash settlements, designed to increase reliability, stability, efficiency and the security of its settlement network and the payments system as a whole.

To provide information support for its efforts to upgrade the payments system, evaluate the ef-

iciency of its settlement network and change its architecture, the Bank of Russia approved the Provision on the Information and Analysis System of the Settlement Network.

In line with the strategy for the development of the payments system, the Bank of Russia continued to make efforts to reduce the amount of cash in circulation.

It elaborated rules and standards to regulate the issue and acquisition of bank cards by credit institutions, settlement procedures and procedures for recording operations involving the use of bank cards, and also procedures for issuing pre-paid financial products by credit institutions and distributing payment cards (pre-paid financial products) produced by other issuers.

By the end of the year under review, Russia had registered 374 credit institutions that had issued their own bank cards and 80 credit institutions distributing payment cards produced by other issuers. Payment cards enable their holders to receive cash and buy, without using cash, goods and services in Russia and abroad. In 1998, the number of bank cardholders in Russia exceeded 5 million.

Bank cards were acquired by 294 credit institutions, which built an infrastructure for cash payments to cardholders and for the implementation of settlements with trading enterprises and service establishments.

Credit institutions used payment cards to pay wages and social welfare allowances by making transfers to cardholders' bank accounts.

The financial crisis brought about a sharp fall in the number of bank cardholders and reduced the volume of non-cash settlements on retail payments. However, by the end of 1998 the volume of operations using payment cards in the trade and services sector began to return to pre-crisis levels.

To create conditions conducive to the development of alternative services in the private sector, including the servicing of small-sum payments, the Bank of Russia in 1998 began to charge credit institutions for the settlement services provided by its settlement divisions. Fees were charged for a specific range of settlement operations, which did not include the transfer of any budget funds and state extrabudgetary funds from the accounts opened with Bank of Russia institu-

tions, the transfer of taxes and other compulsory payments to the budget and state extrabudgetary funds, provided that they were entered to accounts opened with Bank of Russia institutions, credit institutions' settlement operations with the Bank of Russia, and some other operations.

The charging of fees made many credit institutions create their own intrabank settlement systems, transfer branches to settlements through the correspondent account of their head office or regional branch and close their branches' correspondent subaccounts with the Bank of Russia. This enabled such credit institutions to complete a greater number of payments between customers inside their own structures, thus reducing payment risk to a minimum.

Fifty-six per cent of all transfers through the Bank of Russia settlement network were made for a fee.

Settlement charges in 1998 totalled 205 million rubles, or 0.04% of total income made by credit institutions (in September and October, the Bank of Russia did not charge credit institutions for settlement services in order to shore up their liquidity and accelerate payments).

The Bank of Russia intends to continue to improve its fee policy and methodology of providing fee-based services.

It encouraged its regional institutions to cooperate with credit institutions and improve interbank and inter-enterprise settlements and make sure that credit institutions complied with the applicable settlement rules.

Reports indicate that on the whole, the regional branches and national banks followed the Bank of Russia's settlement policy in accordance with the Provisions on the Regional Institution of the Bank of Russia, conducted research in the field of settlements, analysed and summarised the experience gained by Bank of Russia settlement

divisions and commercial settlement systems, and used analysis results in their subsequent work.

At the same time, the economic crisis and the banking crisis that followed it created problems for settlements, and a large number of credit institutions failed to meet their obligations.

The Bank of Russia in 1998 conducted inspections of credit institutions to find out how they fulfilled bank account agreements and whether they met deadlines in transferring funds to their customers' accounts, budgets of all levels and state extrabudgetary funds, and complied with Bank of Russia Provision No. 5-P, dated November 25, 1997, "On the Implementation of Non-Cash Settlements by Credit Institutions in the Russian Federation," requiring that the sums in correspondent accounts (subaccounts) in a credit institution (branch) and in the Bank of Russia settlement network were recorded identically.

When violations were discovered, the Bank of Russia ordered the management of the violator branch credit institutions to take remedial action and informed the tax authorities and local self-government bodies so that they could join forces in rectifying the shortcomings.

Using a special report form, it constantly monitored the payment by branch credit institutions of settlement documents to their accounts.

As of December 31, 1998, the sum of unpaid settlement documents that arose from the shortage of funds in correspondent accounts (subaccounts) of credit institutions and their branches amounted to 32.5 billion rubles, or 1.4% of the total sum of the settlement documents that were not paid in time, in accordance with the consolidated balance sheet of the Russian banks.

Over the year under review the sum of the settlement documents unpaid because of the liquidity shortages experienced by credit institutions increased threefold.

V.2. CASH AND ISSUE OPERATIONS

CASH AND ISSUE operations in 1998 were aimed at facilitating the attainment of the objectives set in the Guidelines for the Single State Monetary Policy in 1998.

On January 1, 1998, Russia redenominated its currency: banknotes and coins of the 1993—1995 issue were to be replaced by new ones at a rate of 1,000:1.

Old currency in the amount of 134,398.0 million rubles at the new nominal value was withdrawn from circulation, and 196,373.8 million rubles in new currency of 1997 denomination were put into circulation.

Cash in circulation increased over the year by 61,976.0 million rubles, or 45.2%, and as of December 31, 1998, amounted to 199,018.3 million rubles¹, including 2,644.0 million rubles in old currency. In the total amount of cash of the new issue that was in circulation as of December 31, 1998, there were 193,717.7 million rubles worth of banknotes (98.6%) and 2,656.6 million rubles worth of coins (1.4%).

The Bank of Russia analysed the note structure of cash in circulation and made sure that it fully met the needs of the economy and population. There were no delays in the provision of cash by Bank of Russia institutions in the year under review.

Bank of Russia institutions provided cash services to 118,000 clients, including 90,953 budget-financed organisations (31.555 of them had personal accounts with federal treasury bodies), 1,348 federal treasury bodies, 7,125 credit institutions and their branches and additional offices, and 18,574 other organisations.

The Bank of Russia took steps to improve cash issue management in Bank of Russia institutions and credit organisations, raise the standard of cash services provided to customers, increase control over cash operations, and co-ordinated the activities of its regional divisions and the Bank of Russia Central Depository in supplying regions with banknotes and coins of the 1997 issue and removing old currency taken out of circulation.

It issued some regulatory documents which helped improve cash services provided to credit institutions and refined the procedure for transferring cash from reserve funds to cash turnover.

The Bank of Russia continued to organise the provision of cash services to the federal treasury bodies, which had federal budget accounts opened with Bank of Russia institutions, and budget fund managers, whose personal accounts were kept in the federal treasury bodies. The number of budget-financed organisations that received cash services in the cash settlement centres through federal treasury accounts increased by 48% over the year.

There were cash recounting offices in 767 Bank of Russia institutions (64% of the total) and 234 institutions prepared cash in advance for transfer to the cash recounting offices, saving time for recounting office workers when they accepted cash from officials responsible for the safe keeping of valuables.

In 1998 cash workers at Bank of Russia institutions committed 9,173 shortages totalling 139,900 rubles, including five shortages, each in excess of 500 rubles, totalling 3,900 rubles.

The balance of debt owed to the Bank of Russia on cash shortages amounted to 230,400 rubles as of December 31, 1998.

In the year under review, the Bank of Russia continued to make efforts to bring cash units of the cash settlement centres into conformity with its technical safety requirements. Its regional divisions made capitalised repairs of their security and fire alarm systems and installed security and surveillance television systems.

Bank of Russia specialists conducted more than 5,000 inspections to check the technical safety of cash units in credit institutions and their divisions.

The Bank of Russia actively co-operated with Interior Ministry bodies in detecting counterfeit notes and withdrawing them from circulation. In 1998, Bank of Russia institutions and credit organisations detected 12,538 coun-

¹ Taking into account cash in vaults of the Bank of Russia and credit institutions.

BANKNOTE DENOMINATIONS STRUCTURE AS OF DECEMBER 31, 1998 (%)

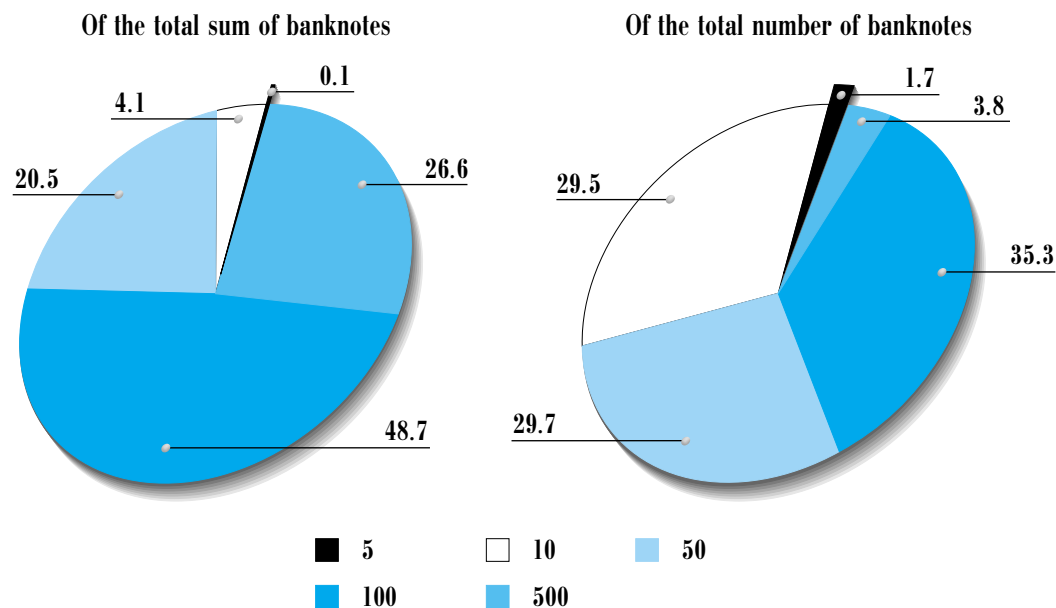
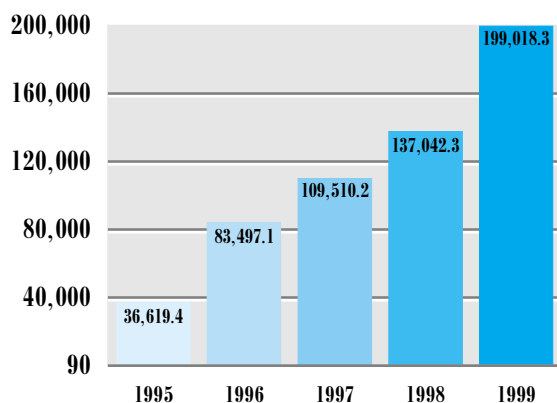
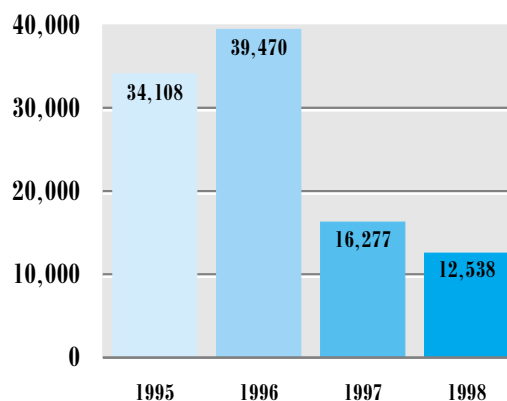


Figure 45

CASH IN CIRCULATION
AS OF END OF YEAR
(million rubles)*

* At new nominal value.

DYNAMICS OF DETECTION
OF COUNTERFEIT
BANK OF RUSSIA BANKNOTES
(number of banknotes)

Figures 46, 47

terfeit Bank of Russia notes of different denomination to the amount of 640,700 rubles (16,277 counterfeit Bank of Russia notes in the amount of 909,000 rubles were discovered in 1997). Most of the forged banknotes were discovered in the Moscow Region.

As was the case in the previous years, the US dollar remained the most frequently forged foreign currency, accounting for 96.6% of all counterfeit foreign banknotes. Last year, 8,076

counterfeit US dollar notes in the amount of \$731,500 were discovered. Counterfeit \$100 notes accounted for 83.5% of all forged US banknotes. Offset printing was the principal method of making counterfeit US dollar notes.

The Bank of Russia exchanges specimens of banknotes and coins and information on changes in cash turnover with 97 banks in non-CIS countries and 14 banks in CIS countries.

DYNAMICS OF DETECTION OF COUNTERFEIT FOREIGN BANKNOTES (number of banknotes)

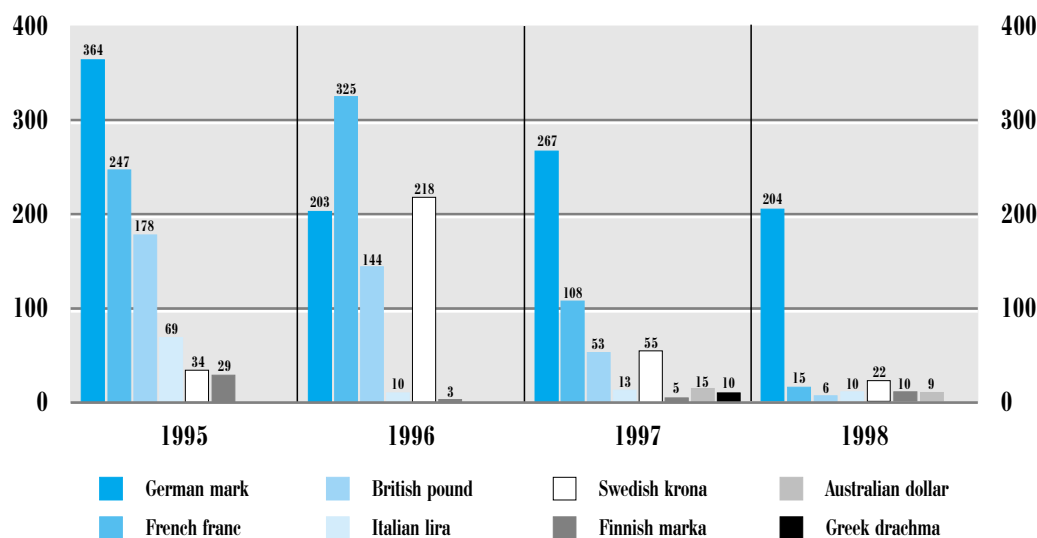


Figure 48

When counterfeit Bank of Russia coins of the 1997 issue were discovered, the Bank of Russia prepared for practical use by banks methodological materials on expert examination of Bank of Russia coins.

It continued to develop new types of mechanisms and automated systems to process cash in Bank of Russia institutions and sought to improve the technique of destroying and recycling banknotes withdrawn from circulation.

In 1998, Bank of Russia institutions received a lot of new machinery, including note counting and sorting machines, new note counters, counterfeit note detectors, equipment for vacuum

packing of banknotes and facilities for storing and moving valuables.

Last year, the Bank of Russia issued 22 commemorative silver coins, but owing to the re-denomination of the Russian ruble, the number of commemorative coins minted in Russia decreased almost by half when compared with 1997.

The banking crisis also had a negative effect on the domestic market for commemorative coins. At the beginning of 1998, commemorative coins were distributed by more than 50 credit institutions in many regions, but after August 1998, Sberbank became practically the only distributor of commemorative coins in Russia.

V.3. RE-DENOMINATION OF THE RUBLE AND ITS IMPACT ON THE PAYMENTS SYSTEM AND CASH TURNOVER

BY MID-1997, for the first time in a fairly long period, Russia's GDP had begun to demonstrate a tendency towards growth in real terms, as compared with the same period of 1996. Some industries registered production growth; retail trade turnover increased and household cash incomes rose. Inflation declined significantly and stabilised at a minimum and strictly controlled level, and the ruble rate against the US dollar and other freely convertible currencies stayed within the band set by the Bank of Russia.

All these developments made it possible to change the nominal value of the Russian currency and the standard of price in order to normalise money circulation. An additional argument in favour of re-denomination was that currency in its earlier denomination had become inconvenient as a means of paying for goods and services in cash.

On August 4, 1997, the Russian President signed Decree No. 822, "On Changing the Nominal Value of the Russian Currency and Standard of Price," and, in pursuance of this Decree and Decision No. 32 passed by its Board of Directors on the same day, the Bank of Russia began to carry out a set of measures to prepare a re-denomination of the Russian currency.

The main principle of the action was to preclude any losses for the population and to replace old money gradually in the course of its normal circulation.

Launched on January 1, 1998, the re-denomination procedure provided for simultaneous circulation of old and new money throughout the year.

Bank of Russia notes and coins of the 1993—1995 issue, Soviet and Bank of Russia coins of the 1961—1996 issue and Soviet 1-, 2- and 3-kopeck coins minted prior to 1961 were accepted as legal tender in 1998 by all organisations, regardless of their legal status, and credit institutions accepted them for deposit, current, settlement and other accounts without any restrictions at one-thousandth of their nominal value. As old

banknotes and coins reached the cash departments of Bank of Russia institutions, they were taken out of circulation.

New Bank of Russia notes of the 1997 issue that were put into circulation in Russia had 5-, 10-, 50-, 100- and 500-ruble denominations and Bank of Russia coins of the 1997 issue had 1-, 5-, 10- and 50-kopeck and 1-, 2- and 5-ruble denominations. For the convenience of the general public, and to ensure a gradual transition to a new currency, the overall appearance of the new money remained the same, except that its nominal value decreased 1,000 times and the new notes contained a few additional security elements.

The Bank of Russia took prompt measures to saturate circulation with new coins in the amounts that were necessary to ensure uninterrupted settlements. To this end, from January to June each time the Bank of Russia paid out new money to credit institutions and other clients, at least 2% of the overall amount was paid out in coins. Bank of Russia institutions and credit institutions were permitted to exchange their clients' old coins for new banknotes and coins, and exchange for corporate entities old small-denomination banknotes coins for new coins.

As a result, small change was introduced into the payments turnover and as of December 31, 1998, it accounted for 1.4% of the total amount of cash in circulation against 0.1% as of December 31, 1997.

As of December 31, 1997, there were 137,042,261.7 million rubles of the old denomination, or 137,042.3 million re-denominated rubles in circulation. From January to August, the replacement of old-denomination money with re-denominated notes and coins proceeded at the rate predicted by the Bank of Russia. As the amount of new denominations issued came more into line with the amount of old denominations redeemed, the overall amount of cash in circulation remained practically unchanged.

DYNAMICS OF OLD CURRENCY REDEMPTION AND ISSUE OF 1997 CURRENCY (billion rubles)

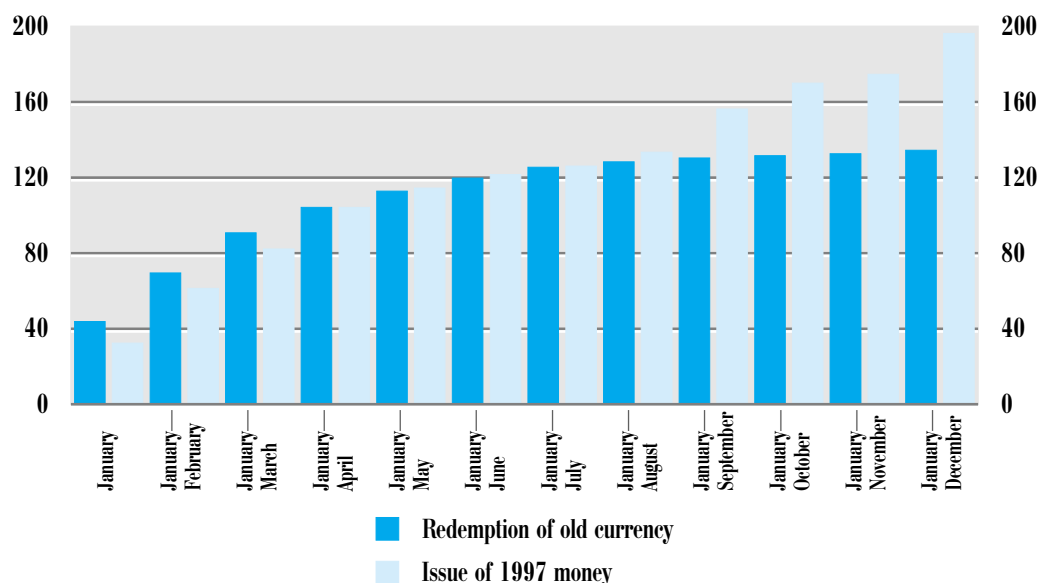


Figure 49

From September, cash in circulation began to increase significantly and by December 31, 1998, amounted to 199,018.3 million rubles, including 2,644.0 million rubles of old denominations.

To ensure the success of the re-denomination programme, the Bank of Russia did the necessary preparatory work.

It had written in advance and had made known to the regions instructions on how Bank of Russia institutions and credit institutions would work in the period when old and new denominations would circulate in parallel and organised seminars with managers and chief accountants of Bank of Russia regional institutions and credit institutions on matters related to the implementation of the Bank of Russia's instructions concerning the re-denomination of the ruble and the change in the standard of setting a price.

Re-denomination centres were set up with the Bank of Russia's main regional branches in the Khabarovsk and Krasnoyarsk Territories, the Perm Region and the Republic of Ingushetia, and at the national banks of the Republic of Dagestan and the Kabardin-Balkar Republic. These operated from December 30, 1997, to January 6, 1998. Also, working groups composed of specialists from the Bank of Russia's central administration were formed and sent to work in these centres.

The most important thing done during the preparations for the re-denomination was to determine how many new banknotes and coins of each denomination had to be issued to replace all money in circulation as of December 31, 1997, and ensure that reserves were sufficient.

The Bank of Russia signed contracts with the Goznak Company and its money-printing enterprises and mints for the manufacture of banknotes and coins of the 1997 issue. It drew up plans for the delivery of new money to Bank of Russia institutions and established strict control over compliance with these plans.

Old money was removed from Bank of Russia institutions, recounted and destroyed also according to plan. To ensure the quick removal of old money, the Bank of Russia in the period from January 1 to October 1, 1998, introduced reports on the balances of old banknotes and coins in reserve funds in terms of value and number.

Control over the redemption of old money from circulation and the issue of new denominations was exercised on the basis of daily reports by Bank of Russia regional institutions.

The Bank of Russia began to prepare well in advance a pool of counting and sorting machines for new banknotes and coins and had the existing equipment readjusted to the new currency. New machines were developed and additional equip-

ment, devices and materials were delivered for processing both new and old money.

Thanks to its efforts, the Bank of Russia was able to fully supply the payments turnover with cash of the 1997 issue. It created the necessary reserves of new banknotes and coins, enabling cash departments of banks to pay out new-denomination money without delays, and ensured rapid removal of old money from Bank of Russia institutions.

In December, the Bank of Russia set up the procedure for conducting cash operations with old money in its institutions and credit institutions

as its circulation ended from January 1, 1999, and also the procedure for exchanging until the year 2002, old money held by citizens for new denominations without any restrictions.

In a sense, the ruble re-denomination had a favourable effect on currency circulation: the nominal amount of money involved in the payments turnover decreased, and new money made it easier to pay for goods and services, as well as account for operations conducted with or without cash. The re-denomination brought back a familiar monetary system and coins reappeared during the payments turnover.

**IMPROVING
THE ORGANISATION OF
THE CENTRAL BANK OF
THE RUSSIAN FEDERATION**

VI

VI.1. ORGANISATIONAL STRUCTURE OF THE CENTRAL BANK OF THE RUSSIAN FEDERATION

AS OF DECEMBER 31, 1998, the organisational structure of the Bank of Russia was composed of the central apparatus, 60 regional branches, 19 national banks, 1,195 cash settlement centres, 13 banking schools, a training methods centre in Tver, personnel training centre at Klyazma, and 19 organisations controlled by the Central Bank. The approved staffing totalled 97,356 employees, of which the number of actually employed was 90,438. This was an increase of 3,272 employees, or 3.4%, over the previous year.

The approved staffing level of the central apparatus was 2,612 employees as of December 31, 1998, a rise of 147 employees, or 5.6%, on 1997.

The structure of the central apparatus did not change much in 1998, but efforts continued to improve its organisation.

The following structures were set up in 1998:

- The Financial Department (on the basis of the Financial Division and the accounting office of the Administrative Department);
- The Main Real Estate Division (on the basis of the Construction and Logistics Division);
- The Research and Information Department (on the basis of the Research, Information and Statistics Department);
- External and Public Relations Department (on the basis of the Department of Public Relations and External Relations Division).

In addition, it was decided to set up a Department for International Financial and Economic Relations.

The Special Communications Division was disbanded and its functions passed to the Main Security and Information Protection Division.

The following structures were reorganised:

- The Department for Information Technology was restructured in connection with the creation of the Division for Co-ordination and Backup of Automated Banking Systems;
- The Legal Department was restructured in connection with the creation of the labour law section, and legal and linguistic expertise section;
- The Telecommunications Department was reorganised in connection with the creation of the Telecommunications and Information Technology Development and Integration Division.

In accordance with the Bank of Russia Board of Directors' decision, the Second Operations Department (OPERU-2) was reorganised in September and its functions and staff were transferred to the Central Bank's Regional Branch for Moscow.

There was no significant change in the standard structure of the main regional branches (national banks) and other organisations controlled by the Bank of Russia.

As of December 31, 1998, the regional branches (national banks) had a total approved staff of 28,257.5, an increase of 1,764.5, or 6.2%.

VI.2. STAFFING AND PERSONNEL TRAINING

IN 1998, the staff of the Central Bank of the Russian Federation continued to change for the better in terms of age and educational standing. The number of executives and specialists with a higher education in the most productive age bracket (30 to 50 years) increased, while the proportion of employees of pension age declined from 4.1% to 3.2%.

The proportion of employees with 3- to 10-years experience in finance and banking rose to 51% of the total, while the share of employees with work experience of less than 3 years declined to 22%.

In its personnel policy, the Bank of Russia put an emphasis on the development of existing personnel.

It elaborated a programme for personnel development in 1998—2000, which set the following strategic goals: upgrading the system of personnel motivation through evaluation, raising the level of managerial competence of division heads, and personnel development.

Most of the Bank of Russia regional institutions made wide use of the advanced methods of evaluating personnel. Evaluation becomes a normal employment procedure and its results are taken into account by division managers when determining bonuses, promotions or demotions, planning advanced training of personnel and placement of employees on the reserve list for promotion.

In 1998, the Bank of Russia conducted for the first time a comprehensive evaluation of personnel and motivation in the workplace in the Bank Inspection Department, Banking and Audit Licensing Department and Foreign Exchange Regulation and Foreign Exchange Control Department. In the central apparatus 215 employees, including 63 executives of different levels, were subjected to various evaluation procedures. The results of the evaluation allowed the Bank to work out recommendations on ways to improve the organisational structure of departments and placement of personnel, create a reserve for promotion to executive positions and specify areas for advanced training of employees.

The results of the evaluation procedures, which characterise professional and managerial competence, performance and employee potential, make it possible to draw a far more detailed picture of personnel. In 1998, the Bank of Russia began to build a database on personnel employed in the central administration, which took into account results of various evaluations and would allow the Bank to conduct personnel monitoring at a qualitatively new level.

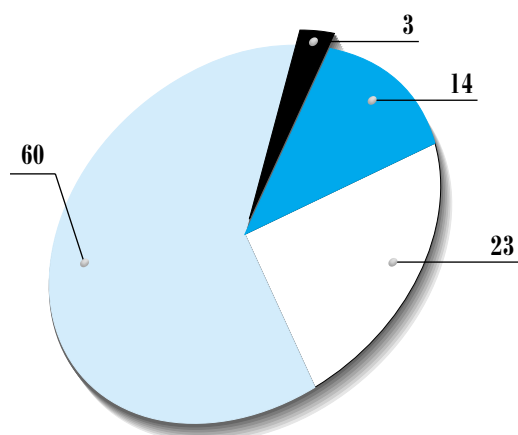
The Bank of Russia last year issued a number of regulatory documents which helped to raise the performance standard of personnel departments in the Bank of Russia regional institutions. These include the Standard Provision on the Personnel Section (Department) of the Regional Branch/National Bank of the Central Bank of the Russian Federation and the Standard Provision for Creating and Preparing Reserve Personnel for Promotion to Senior Executive Positions.

The use of performance evaluation procedures and intensive training methods helped increase the efficiency of reserve personnel in the regional institutions. As a result, the number of reserve employees appointed to various executive positions in 1998 increased by 30%.

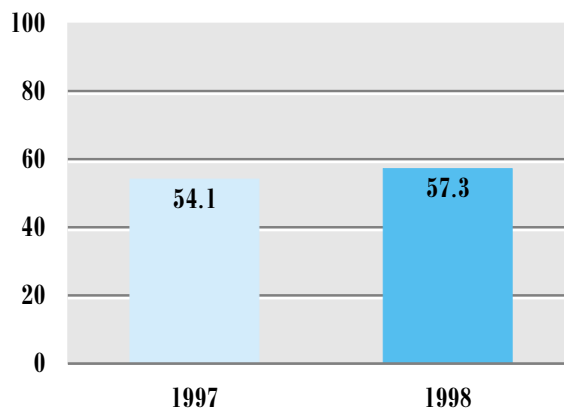
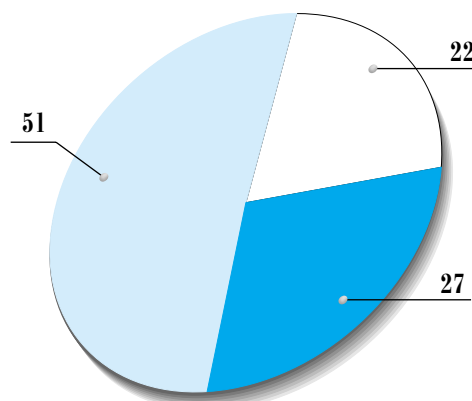
In accordance with its programme for personnel development in 1998—2000, the Bank of Russia took steps to improve the system of advanced training of senior executives and specialists. Last year, 37,300 Bank of Russia employees received various kinds of training under the Bank's training programmes. The main areas of training were advanced banking and information technologies, restructuring of the banking system, modern accounting practices, foreign exchange regulation and financial markets.

Considerable attention in specialist training was paid to economic analysis and one of its latest trends, such as the monitoring of enterprises.

The Bank of Russia completed the state examination and certification of banking schools, whose results were approved by the collegium of the Ministry of Education of the Russian Federation. Efforts continued to reorient banking schools to the implementation of complementary voca-

BANK OF RUSSIA
EMPLOYEES BY AGE (%)

□ Under 30
 ■ From 30 to 50
 ■ Over 50
 ■ Pension age

NUMBER OF SPECIALISTS
WITH HIGHER EDUCATION (%)BANK OF RUSSIA EMPLOYEES
BY LENGTH OF SERVICE (%)

□ Less than 3 years
 ■ From 3 to 10 years
 ■ More than 10 years

Figures 50, 51

tional training programmes and advanced training programmes for banking school instructors. During the year, more than 9,400 Bank of Russia employees, or 49% more than in 1997, received re-training or advanced training at banking schools.

Figure 52

The dual system of advanced training gained further acceptance. The number of specialists enrolled for this kind of training at the Moscow, St. Petersburg, Omsk and Oryol banking schools increased almost three times over and amounted to 404.

Measures were taken to organise training directly by Bank of Russia regional institutions, specialists from leading economic institutions of higher education and banking school instructors were enlisted in this effort. Nearly 15,000 people received this kind of training last year. To help the advanced training councils, set up with most regional branches/national banks, the Bank of Russia provided them with "Recommendations for Organising Personnel Training by Bank of Russia Regional Institutions."

Great attention was paid to the training of specialists involved in the development and introduction of advanced information technologies and

communications. Last year, 2,300 specialists in information technology, telecommunications and the protection of banking information received training in specialised training centres of leading Russian and foreign R&D enterprises and also at Bank of Russia instruction centres.

Methodological support for all training programmes implemented in 1998 improved. Teaching aides and methodologies developed by the Bank of Russia Methodology and Training Centre and Personnel Training Centre helped increase the effectiveness of training provided by regional institutions.

The Bank of Russia continued to study the experience and expertise of foreign central banks: 1,200 Bank of Russia executives and specialists received training at seminars and consultations held in other countries with the participation of experts from western central banks and international banking organisations. Of these, 900 Bank of Russia executives and spe-

cialists received training at Bank of Russia instruction centres.

Last year the Bank of Russia implemented a programme for training senior executives and specialists of eight CIS central banks, facilitating the exchange of information and professional contacts between specialists in the long-term interest of the CIS countries.

VI.3. IMPROVING BANKING LEGISLATION

THE BANK OF RUSSIA in 1998 made vigorous efforts to improve and upgrade banking legislation, drafting proposals for making amendments to applicable federal laws and Bank of Russia standards and regulations.

The Russian parliament approved amendments and additions to the federal laws On the Central Bank (Bank of Russia) and On Banks and Banking Activities, elaborated with the participation of the Bank of Russia. These amendments specified the procedure by which the Bank of Russia would implement its supervisory functions and improved the methods of dealing with credit institutions after the revocation of their banking licences.

The Federal Law on Amending the Federal Law "On the Central Bank of the Russian Federation (Bank of Russia)" and the Federal Law on Amending the RSFSR Law "On the Central Bank of the RSFSR (Bank of Russia)" specified the provisions of Article 7 of the Federal Law on the Central Bank of the Russian Federation (Bank of Russia), stipulating that the ban on Bank of Russia participation in the capital of credit institutions did not apply to its participating in the capital of the Savings Bank (Sberbank), Foreign Trade Bank (Vneshtorgbank) and some credit institutions set up in other countries (Russia's overseas banks). This law explained how the Bank of Russia should manage its interest in the capital of Russian overseas banks.

The Russian parliament passed the Federal Law on the Insolvency (Bankruptcy) of Credit Institutions, drafted with the active participation of the Bank of Russia. This law aims to create legal conditions for implementing measures and procedures to prevent the bankruptcy of credit institutions, declare banks the bankrupt and liquidate banks in the process of bankruptcy proceedings.

The law emphasizes measures to prevent bankruptcy before the revocation of a licence.

Taking into account the international practice of restoring the solvency of banking systems, Russia established the Agency for Restructuring Credit Organisations (ARCO). To legally regulate its activities, a draft Federal Law was elabo-

rated with the participation of the Bank of Russia, "On the Restructuring of Credit Institutions," designed to provide a legal framework for the restructuring of the banking system with direct participation of the state in this process.

To determine priorities for the Bank of Russia and legislative and executive power bodies in restructuring and rehabilitating the banking system, the Bank of Russia drafted a policy document, "On Measures to Restructure the Banking System of the Russian Federation," which the Bank of Russia Board of Directors approved on November 17, 1998, and the Presidium of the Russian Government endorsed on November 21, 1998. Taking into account the real financial possibilities of the government and Bank of Russia for bailing out Russian banks, the experience gained by the Central Bank in rehabilitating financially troubled banks, the methods of restructuring banking systems used in other countries and specialists' recommendations, including recommendations of international financial organisations, this document represents a starting point for planning and implementing the rehabilitation of the banking system.

In overcoming the crisis of the banking system, which affected the ability of a number of large banks to meet fully and in time their obligations to depositors, the Bank of Russia has the task of restoring public confidence in bank savings and the banks' ability to safeguard depositors' interests. Therefore, the Bank of Russia pins special hopes on the early adoption of the Federal Law on Personal Bank Deposit Guarantees, which should be drafted in accordance with Article 840 of the Civil Code of the Russian Federation and Article 38 of the Federal Law On Banks and Banking Activities. This law aims to guarantee private individuals the return of their bank deposits and provides for the creation of a Federal Reserve Corporation for this purpose. When the system of deposit guarantees is put in place, it will be important to explain to depositors how this system works.

To allay the negative consequences of the financial crisis for the population, the Bank of Rus-

sia took a number of decisions to protect household savings at banks. Their aim was to protect the largest group of individual depositors who hold accounts in the largest banks. Since these banks topped the list in terms of the amount of household deposits, their inability to meet all their obligations on household deposits at the time of the financial crisis could aggravate the already difficult social and economic situation.

In September-November 1998 the Bank of Russia enacted a number of regulations which set the following procedures:

- The procedure for organising the work of a group of observers in the banks that have signed an agreement with Sberbank on the transfer of obligations on personal deposits;
- The procedure for the commission formed to examine complaints and reports by depositors of the banks who transferred their household deposit obligations to Sberbank;
- The accounting procedure for individual operations relating to the transfer of household deposit obligations from banks to Sberbank;
- The procedure for transferring to Sberbank the required reserves deposited with the Bank of Russia by the banks transferring their household deposit obligations to Sberbank.

As the financial crisis destabilised the foreign-exchange market and caused the ruble devaluation, the Bank of Russia paid special attention to the work on the laws designed to control and regulate foreign exchange. Specifically, it enacted Provision No. 57-P, dated September 28, 1998, "On the Procedure for and Conditions of Conducting Trade in US Dollars for Russian Rubles at Special Trading Sessions," setting rules for trade in dollars on interbank currency exchanges.

To further stabilise the situation in the foreign-exchange market, the Bank of Russia issued Directive No. 383-U, dated October 20, 1998, "On the Procedure for Conducting Foreign-Exchange Purchase and Re-purchase Operations by Resident Legal Entities in the Domestic Foreign-Exchange Market of the Russian Federation."

Thanks to the Bank of Russia's active participation, the Federal Law On Budget and Tax Policy Priorities included a clause regulating the procedure for selling residents' export currency earnings in the domestic foreign exchange market. This provision is designed to normalise the

situation in the foreign exchange market and ensure a long-term stability of the ruble rate.

THE REPORT OF CLAIMS AND SUITS HANDLED BY BANK OF RUSSIA INSTITUTIONS IN 1998

In 1998 the Central Bank's regional institutions took action to protect the rights and legitimate interests of the Bank of Russia.

Last year's economic, banking and financial crisis in Russia could not fail to affect the activities of the Bank of Russia as a body implementing monetary policy.

In the period under review, the number of claims and suits increased significantly. Compared with the previous period reviewed, the number of claims made against Bank of Russia institutions rose by 39% and suits increased by 57%, while the number of claims and suits met remained unchanged from 1997.

The number of claims made by Bank of Russia regional institutions increased by 79% compared with 1997 and the number of suits rose by 39%. A total of 3,139 claims in the amount of 634,230,000 rubles and 3,358 suits in the amount of 689,541,000 rubles were met.

In 1998, 248 claims in the amount of 4,283,879,100 rubles and 909 suits in the amount of 17,346,056,000 rubles and \$19,664 were brought against the Bank of Russia. Only 14 claims in the amount of 3,305.96 rubles were met, most of them connected with economic activities of Bank of Russia institutions.

Courts ruled in favour of the claimants in 109 cases, ordering the payment of 27,812,800 rubles, but actually only 19,697,800 rubles were eventually paid in 33 cases following appeal.

A large part of the suits brought against the Bank of Russia concerned banking operations connected with settlements and lending (87 claims were made and 413 suits were brought on these grounds).

Of these, 29 suits in the amount of 13,431,000 rubles were met by courts, but actually 15,343,000 rubles were paid on eight suits.

In all, 78 claims in the amount of 4,210,409,500 rubles were made to the Bank of

Russia on settlement operations, of which only two claims in the amount of 28,400 rubles and 174 suits in the amount of 12,101,294,000 rubles were met. The recovery of 810,110 rubles on four suits was enforced.

Seventy-nine suits in the amount of 49,069,000 rubles were brought against the Bank of Russia on lending operations, none of which were satisfied.

A slight rise in the number of suits on banking operations resulted from the banking crisis and delays in the transfer of the funds of clients (mainly private individuals) of credit institutions.

A large part of the suits involving settlements are actions taken to enforce the payment of fines by Bank of Russia regional institutions in connection with the latter's failure to fulfil court decisions. Such suits are rejected because credit institutions that keep accounts in various divisions of the settlement network do not have enough money to ensure the enforcement of court decisions, while Bank of Russia institutions are not to blame for the non-fulfilment of court decisions.

It is necessary, therefore, to legislatively regulate the priority of payments and the correlation between the arrest of funds and priority of payments and to settle questions connected with the arrest of funds in correspondent accounts.

Credit institutions frequently appealed against the decisions taken by the Bank of Russia, especially the decision to use sanctions in accordance with Article 75 of the Federal Law On the Central Bank of the Russian Federation (Bank of Russia) and Article 14 of the Law On Foreign Exchange Regulation and Foreign Exchange Control and to revoke banking licences. Three claims were made and 37 suits were brought against the Central Bank on these grounds, of which only five suits were satisfied. As a result of appeals made by the Bank of Russia, no payments were enforced in 1998.

The number of appeals filed with the Supreme Court of the Russian Federation against Bank of Russia rules and regulations increased in the year under review and this should serve as a warning to the Bank of Russia that it should improve the quality of its regulatory documents.

In implementing their supervisory and controlling functions, Bank of Russia institutions also made claims and brought suits against credit in-

stitutions. This involved the use of sanctions against them in accordance with the applicable laws. They made 2,709 claims in the amount of 162,624,000 rubles and brought 1,139 suits in the amount of 16,235,000 rubles, of which 2,897 suits and claims in the amount of 70,227,670 rubles were met. Most of the suits were brought on these grounds against the Bank of Russia's regional branch for Moscow.

Compared with 1997, the number of suits brought on these grounds more than doubled, while the number of claims decreased.

Since the Federal Law On the Central Bank of the Russian Federation (Bank of Russia) stipulates that the Bank of Russia may fine credit institutions for violating banking legislation, but does not establish an irrevocable and unconditional procedure for the collection of fines, the Bank of Russia often has to appeal to the courts to enforce its decisions.

There were some changes in 1998 in the category of cases in which Bank of Russia institutions participated as defendants.

New disputes on settlements arose, involving divisions of the Russian Finance Ministry's federal treasury and connected with irrevocable and unconditional charge-offs on the accounts of these divisions against debts owed by personal account holders. This controversy has been resolved in the 1999 Federal Budget Law.

Acting as defendants in these cases on behalf of the Bank of Russia were the National Bank of the Kabardin-Balkar Republic and the Republic of Khakassia and the Bank of Russia regional branches for the Arkhangelsk, Volgograd, Kaliningrad, Tver, Tomsk, Tyumen, Samara and Sverdlovsk Regions.

Last year saw a significant increase in the number of suits brought against the Bank of Russia by individuals because of the failure of credit institutions to honour obligations under bank deposit agreements. Claimants argued that the Bank of Russia, whose duty is to license and supervise banks, failed to revoke, in time, the banking licences of these institutions. The Bank of Russia's regional branch for the Kursk Region, for example, had its representatives participated in court hearings in 98 of such cases.

No collections were made from the Bank of Russia on any of the suits brought against it.

As the number of claims and suits against Bank of Russia divisions connected with delays in settlements decreased in 1998, new kinds of suits appeared in that period. They concerned, among other things, operations to enter payers' funds to Pension Fund accounts, and presentation to credit institutions of writs of execution by individual recoverers in pursuance of the Federal Law On Execution Proceedings.

A new category of cases emerged when Bank of Russia regional branches started to appeal against actions of bailiffs in pursuance of the Federal Law On Execution Proceedings.

Many Bank of Russia claims and suits concern the forced liquidation of credit institutions in accordance with Article 61 of the Civil Code of the Russian Federation and Article 20 of the Federal Law on Banks and Banking Activities. In the period under review, the Bank of Russia

brought 106 forced liquidation suits, of which 95 were met.

The number of appeals made to arbitration courts to rule insolvent or bankrupt banks increased. Five claims and 114 suits were brought last year to declare credit institutions insolvent (bankrupt), of which 112 were satisfied.

Previously, the applicable law on insolvency (bankruptcy) allowed the Bank of Russia to take such action only if it was a creditor and that restricted the Central Bank's role in the bankruptcy process. The passing of the Federal Law On Insolvency (Bankruptcy) of Credit Institutions gave the Bank of Russia the right to appeal to the arbitration courts even when it was not a creditor. Moreover, this Federal Law stipulated that in some cases the Bank of Russia was duty-bound to take court action to declare credit institutions insolvent (bankrupt).

VI.4. INTERNAL AUDIT AND INSPECTION IN THE BANK OF RUSSIA

THE BANK OF RUSSIA Chief Auditor's Service in 1998 was guided in its activities by plans approved by the heads of the corresponding Bank of Russia divisions. These plans laid special emphasis on the implementation of comprehensive audits of the financial and economic activities of Bank of Russia institutions and organisations and control over compliance with the Russian legislation and Bank of Russia rules and regulations.

Comprehensive documentary examinations were conducted in 42 regional branches (national banks) and 1,322 cash settlement centres, field divisions, safe deposit vaults, banking schools and other institutions. The audit departments of Bank of Russia regional institutions conducted 632 specific inspections, including those relating to the organisation of work of various administrative units of Bank of Russia regional institutions. Eight audits were conducted on request of law enforcement authorities.

Judging by the results of audits and inspections, most of the regional Bank of Russia institutions fulfil in good faith their duties in compliance with Bank of Russia rules and regulations. Not a single case of theft or major cash error or other serious abuses by Bank of Russia employees were discovered.

However, in the year under review, just as in the previous years, some Bank of Russia institutions and organisations committed violations of Bank of Russia standards and regulations and made errors in conducting banking operations.

All audit and inspection materials were examined by the heads of higher-instance Bank of Russia institutions, in 182 cases on site, and in 162 other cases, executives of the audited institutions were invited to a higher-instance organisation.

Depending on the nature of the violations and shortcomings discovered, different corrective actions were taken. Letters were sent to 1,108 ex-

ecutives of audited institutions and organisations, demanding and recommending specific remedial actions. In 197 cases, orders were issued to penalise 259 executives, of whom 238 were reprimanded, nine dismissed and 12 demoted. The results of these audits were taken into account when 2,431 Bank of Russia employees had their bonuses and other benefits cut by 30% to 100%.

Audit results were used in working out proposals on ways to improve the performance of individual divisions. Regional institutions received letters containing performance surveys of the cash settlement centres under their control, pointing out the most common violations committed in cash operations, accounting, interbank settlements, etc., and giving the corresponding recommendations.

Various forms of instruction were used to raise the professional level of the staff of the Chief Auditor's Service, such as conferences and seminars and studying Bank of Russia regulatory documents; some employees studied internal audit and inspection practices in the central banks of Austria and Germany.

In June 1998, the heads of all departments of the Chief Auditor's Service gathered at the Bank of Russia inter-regional training centre in Tula to discuss the current state of internal audit in the Bank of Russia and receive clarifications on all controversial issues and recommendations.

At the beginning of 1999, the Bank of Russia Chief Auditor's Service had a staff of 673, of whom 46 worked in the central apparatus and 627 in the audit departments (divisions) of the Bank of Russia regional institutions.

The Internal Audit and Inspection Department took steps to improve the work of the Chief Auditor's Service and implement recommendations of the Bank of Russia's external auditor in order to enhance the effectiveness of audits and inspections.

VI.5. INTERACTION WITH RUSSIAN CREDIT INSTITUTIONS AND OTHER ORGANISATIONS AND RUSSIA'S OVERSEAS BANKS WITH BANK OF RUSSIA INTEREST IN THEIR AUTHORISED CAPITAL

THE BANK OF RUSSIA participates in the authorised capital of Russian credit institutions and other organisations in compliance with the Federal Law On the Central Bank of the Russian Federation (Bank of Russia).

It attaches particular importance to its participation in the capital of Russia's system-building banks, such as the Savings Bank (Sberbank) and Foreign Trade Bank (Vneshtorgbank), which are open-end joint-stock companies. Federal Law No. 34-FZ, dated March 4, 1998, On Amending the Federal Law On the Central Bank of the Russian Federation (Bank of Russia) and Federal Law On Amending the RSFSR Law on the Central Bank of the RSFSR (Bank of Russia), reaffirmed the right of the Bank of Russia to hold an interest of at least 50% plus one voting share in the authorised capital of Sberbank and Vneshtorgbank.

In the year under review, the Bank of Russia constantly monitored and directly participated in the elaboration of the financial policy of Sberbank and Vneshtorgbank. It did so through its representatives on the supervisory boards of these banks.

Taking into account the possibility of its direct involvement in the elaboration of the strategy of these credit institutions, the Bank of Russia considered co-operation with Sberbank and Vneshtorgbank as the necessary means of influencing the Russian financial market.

Sberbank is the largest universal credit institution in Russia with a traditional core business in retail banking.

When the economic crisis broke out in August 1998, the Bank of Russia, Sberbank's principal shareholder, issued a statement urging the Russian banks to create a system of mutual guarantees of household deposits. In support of that move, Sberbank signed agreements with a num-

ber of leading credit institutions on the transfer of deposits from these banks to Sberbank.

In 1998, the Bank of Russia increased its interest in Sberbank's authorised capital from 54.64% to 57.66% by buying an additional issue of Sberbank's ordinary shares.

Sberbank's balance-sheet profit in 1998 amounted to 15.4 billion rubles against 4.5 billion rubles in 1997, and its return on assets rose from 1.3% in 1997 to 2.4% in 1998.

Because of the financial crisis, Vneshtorgbank's performance in 1998 (mainly related to extending foreign exchange and ruble loans to banks and other sectors of economy, conducting operations in international financial and foreign exchange markets and attracting foreign investment in the Russian economy) was worse than in 1997. Its losses last year totalled 1.98 billion rubles, whereas in 1997 the bank turned in a profit of 970 million rubles.

Bank of Russia participation in the authorised capital of the Moscow Interbank Currency Exchange (MICEX) is necessary and very important for the Bank of Russia, because, in accordance with federal legislation, it conducts operations in the organised foreign-exchange market and government securities market.

In 1998, MICEX increased its authorised capital from 54.6 million to 104.4 million rubles owing to capitalisation of dividends due to shareholders for 1997.

The Bank of Russia is a co-founder of the non-profit partnership National Depository Centre, which was set up to provide depository services to the trading system of the organised government securities market and assist partnership members and their clients in the securities market. The National Depository Centre should also assist in creation and development of the securities market infrastructure in Russia, promote Russia's inte-

gration with the international capital market and provide information, methodological and technical support for partnership members and organised securities market players in conducting depository and clearing operations and effecting mutual settlements in the organised securities markets.

CENTRAL BANK'S CO-OPERATION WITH RUSSIA'S OVERSEAS BANKS

The system of subsidiary credit institutions of the Bank of Russia abroad, known as the Russian overseas banks, comprises the following five banks: Ost-West Handelsbank (Frankfurt-am-Main), Eurobank (Paris), Moskovsky Narodny Bank (London), Donau-bank (Vienna) and East-West United Bank (Luxemburg).

These banks are incorporated and operate in compliance with the host-country legislation, which means that in accordance with Russian legislation, they are nonresident banks. For decades Russia's overseas banks have been the only Russian banks operating in the major financial centres of Europe.

In accordance with the tasks assigned to them and their goals in the current situation, Russia's overseas banks act as intermediaries between Russian and western financial markets, providing the entire range of banking services, including settlement and documentary services, crediting Russian and western foreign trade banks and companies and implementing investment projects in Russia and other CIS countries.

Thanks to their successful commercial operations and consolidation of their positions in the Russian and foreign financial markets, Russia's overseas banks improved their financial condition and with the participation and support of the Bank of Russia stabilised their performance and began to make profit. By early 1998 they had built up their borrowing volumes, restored limits on foreign exchange and deposit operations, carried out a number of joint projects with western and Russian banks to finance Russian borrowers and formed Russian securities portfolios.

Thanks to their financial success, Ost-West Handelsbank AG in 1998 paid its shareholders a 7% dividend and Donau-bank AG a 3% dividend for 1997.

Federal Law No. 34-FZ, dated March 4, 1998, On Amending the Federal Law on the Central Bank of the Russian Federation (Bank of Russia) and Federal Law On Amending the RSFSR Law on the Central Bank of the RSFSR (Bank of Russia) confirmed the right of the Bank of Russia to participate in the authorised capital of Russia's overseas banks and set its minimal interest in the capital of Ost-West Handelsbank, Eurobank and Moskovsky Narodny Bank at 50% plus one voting share. It also allowed the Bank of Russia to withdraw from the capital of Donau-bank and East-West United Bank after notifying the State Duma.

The strengthening of the Bank of Russia's legal status in relation to the overseas banks increased its responsibility as the majority shareholder for their financial stability and sound development strategy for the future. Guided by these principles, the Bank of Russia elaborated and began to implement a new strategy of managing the system of overseas banks, based on the creation of two banking groups, the European group, comprising Mosnarbank (Moskovsky Narodny Bank), Eurobank and Ost-West Handelsbank, and the Vneshtorgbank group, including Vneshtorgbank's subsidiaries Donau-bank, Russian Commercial Bank (Limassol) and Russian Commercial Bank (Zurich).

In addition, in the year under review, the Bank of Russia continued to increase its interest in Ost-West Handelsbank, which amounted to 82% as one of the shareholders sold its stake, and bought shares of a new issue. The Bank of Russia's stake in Eurobank rose from 77.75% to 77.80% after a number of small shareholders had sold their equities to the Bank of Russia.

In the first half of 1998, the Russian overseas banks continued their expansion in close co-operation with the Bank of Russia and with its assistance. They provided loans to Russian commercial banks against government securities and participated in attracting nonresident funds to the GKO—OFZ market, keeping up the latter's liquidity. The Bank of Russia continued to finance Russian overseas banks in the form of deposits, which allowed them to retain their presence in western money markets with the view to increase their ratings and consolidate their positions in the market.

As they were largely oriented to operations with Russian banks and companies and sovereign debt of Russia and the former USSR (this orientation arises from the aims and conditions of the work of these banks as a link-up between Russia and Western Europe), the Russian overseas banks experienced the full impact of the economic crisis in Russia, which became especially manifest after August 17.

The main problems faced by Russian overseas banks in the second half of 1998 were as follows:

- Depreciation of the assets of Russian overseas banks as a result of the collapse of the Russian government securities market;
- Unbalanced liquid position resulting from Russian borrowers' failure to meet their obligations to the Russian overseas banks and closure or significant reduction by western banks of their limits of credit for Russian overseas banks;
- The tightening by host-country banking authorities of reserve requirements for Russian debt;
- A number of unsettled ruble/dollar forward contracts with Russian and foreign partners.

In that situation, the Bank of Russia, as the majority shareholder of the Russian overseas banks, assured the host-country banking authorities that it was absolutely in its interest that its subsidiaries recovered from the crisis as soon as possible and reaffirmed its responsibility for their financial condition and further activity.

In addition, the Bank of Russia provided assistance to the Russian overseas banks by granting them additional liquid assets and redrafting conditions under which its funds had been placed with these banks earlier, increasing in some cases the banks' capital base. All funds extended as financial assistance were provided for a fee and on the condition that they should be returned.

It is clear that the Russian economic crisis had negative effect on the Russian overseas banks and cut short the favourable trends registered in their development in 1996, 1997 and 1998. However, resolute action taken by the Bank of Russia mitigated the destructive effect of the crisis and helped preserve the system of overseas banks.

At the same time, the crisis that hit the Russian banking system opened up some new opportunities for the Russian overseas banks, which have experience of working in western financial markets and have advanced banking technologies and highly-qualified personnel. As the Russian financial market has a shortage of high-quality banking services, Russian overseas banks have a realistic opportunity to expand their customer base by providing services to a broad range of Russian clients, who had lost confidence in the Russian banking structures.

Despite the losses they sustained, the Russian overseas banks remain along with Sberbank and Vneshtorgbank, a major element of the Russian banking system.

THE LIST OF MAJOR ACTIONS UNDERTAKEN BY THE BANK OF RUSSIA IN PURSUANCE OF THE SINGLE STATE MONETARY POLICY IN 1998

1. RESERVE REQUIREMENTS, INTEREST-RATE POLICY, REFINANCING RATE, DEPOSIT OPERATIONS AND EXCHANGE OF INFORMATION

FROM FEBRUARY 1, 1998, the Bank of Russia set a single reserve requirement ratio of 11% for credit institutions and Sberbank on borrowings in rubles and foreign currency, regardless of the term of borrowing (Bank of Russia Directive No. 156-U, dated January 30, 1998), and retained the required reserve ratio of 8% for ruble-denominated household deposits in Sberbank (set by Bank of Russia Directive No. 44-U, dated December 1, 1997).

On August 24, 1998, the required reserve ratios were cut from 11% to 10% and that on ruble-denominated household deposits in Sberbank was reduced from 8% to 7% (Bank of Russia Directive No. 324-U, dated August 21, 1998).

Bank of Russia Directive No. 335-U, dated September 1, 1998, set the following differentiated reserve requirements:

- 5% for credit institutions which had 40% of their working assets and more invested in government securities (GKO—OFZ) as of August 1, 1998;
- 7.5% for credit institutions which had 20% to 40% of their working assets invested in government securities (GKO—OFZ) as of August 1, 1998;
- 5% for Sberbank on ruble-denominated borrowings from corporate entities and foreign currency-denominated borrowings from corporate entities and individuals.

Bank of Russia Directive No. 342-U, dated September 3, 1998, cut the reserve requirement ratio on ruble-denominated household deposits with Sberbank from 7% to 5%.

In accordance with the decision of the Bank of Russia, from August 25, 1998, Sberbank be-

gan to form its required reserves on centralised basis at the place where its head office opened its correspondent account (Bank of Russia Directive No. 326-U, dated August 25, 1998).

In August and September, the Bank of Russia complied with the request of credit institutions to make an unscheduled review of reserve requirements (Bank of Russia Directives No. 175-T, dated August 19, 1998, No. 324-U, dated August 21, 1998, and No. 221-T, dated September 14, 1998).

From September 17, foreign currency-denominated borrowings were recalculated for the purpose of setting the required reserve ratios at the exchange rate set by the Bank of Russia as of August 14, 1998 (Bank of Russia Directive No. 349-U, dated September 17, 1998, for Sberbank and Directive No. 350-U, dated September 17, 1998, for other credit institutions).

To reduce the backlog of nonpayments, the Bank of Russia conducted multilateral clearing operations three times (on September 18 and 25 and on October 2, 1998), while making unscheduled changes in reserve requirements. The funds thus released were used to complete settlements.

In November, the Bank of Russia decided to set from December 1 a single required reserve ratio of 5% for ruble and foreign-currency borrowings by all credit institutions, including Sberbank, and recalculate foreign currency-denominated borrowings at the current exchange rates fixed by the Central Bank (Bank of Russia Directive No. 414-U, dated November 17, 1998).

At the same time, it decided not to recover underpaid amounts of required reserves (at the reserve ratios set as of December 1) and not to

impose penalties for underpayments on credit institutions which participated in the multilateral clearing operations conducted by the Bank of Russia on September 18 and 25 and October 2, using the right to make unscheduled changes in reserve requirements (Bank of Russia Directive No. 414-U, dated November 17, 1998).

Bank of Russia Directive No. 426-U, dated November 27, 1998, set the procedure for transferring to Sberbank required reserves deposited with the Bank of Russia by banks that were transferring to Sberbank their obligations on household deposits.

Bank of Russia Directives No. 156-U, dated January 30, 1998, No. 175-U, dated February 25, 1998, and No. 446-U, dated December 18, 1998, amended Bank of Russia Provision No. 37, dated March 30, 1996, "On Required Reserves of Credit Institutions Deposited with the Central Bank of the Russian Federation," and Bank of Russia Directive No. 176-U, dated February 25, 1998, amended Bank of Russia Provision No. 51, dated November 4, 1996, "On Required Reserves of the Savings Bank of the Russian Federation Deposited with the Central Bank of the Russian Federation."

Bank of Russia Directives No. 68-T, dated February 27, 1998, and No. 294-T, dated October 19, 1998, amended the methodological recommendations on conducting inspections in credit institutions to make sure that they correctly calculate and report the required reserves that must be deposited with the Bank of Russia.

The Bank of Russia pursued a well-balanced interest-rate policy, taking into consideration the economic and financial situation in the country, the state of the financial markets and the level of inflation.

In 1998 it repeatedly changed the refinancing rate (discount rate):

- As of January 1, 1998, the refinancing rate was 28% p.a. (it was set by Bank of Russia Directive No. 13-U, dated November 10, 1997);
- From February 2, 1998, the refinancing rate was set at 42% p.a. (Bank of Russia Directive No. 154-U, dated January 30, 1998);
- From February 17, 1998, the refinancing rate was set at 39% p.a. (Bank of Russia Directive No. 170-U, dated February 16, 1998);

- From March 2, 1998, the refinancing rate was set at 36% p.a. (Bank of Russia Directive No. 181-U, dated February 27, 1998);
- From March 16, 1998, the refinancing rate was set at 30% p.a. (Bank of Russia Directive No. 185-U, dated March 13, 1998);
- From May 19, 1998, the refinancing rate was set at 50% p.a. (Bank of Russia Directive No. 234-U, dated May 18, 1998);
- From May 27, 1998, the refinancing rate was set at 150% p.a. (Bank of Russia Directive No. 241-U, dated May 27, 1998). Such a dramatic rise of the discount rate was caused by the deterioration of the situation in South East Asian financial markets and economies and its aim was to protect the national currency against short-term speculative operations in the Russian financial markets;
- From June 5, 1998, the refinancing rate was set at 60% p.a. (Bank of Russia Directive No. 252-U, dated June 4, 1998);
- From June 29, 1998, the refinancing rate was set at 80% p.a. (Bank of Russia Directive No. 268-U, dated June 26, 1998);
- From July 24, 1998, the refinancing rate was set at 60% p.a. (Bank of Russia Directive No. 298-U, dated July 24, 1998).

As the refinancing rate (discount rate) changed from the beginning of the year to July 1998, the interest rate on Lombard loans also changed within the limits of the newly-set refinancing rate and only from the beginning of 1998 to February 2, 1998, the Lombard rate surpassed the refinancing rate by 8 percentage points (36% and 28% p.a., respectively). From July 8 the Bank of Russia Board of Directors decided (Decision No. 31, dated July 8, 1998) to stop extending Lombard loans at a fixed rate and ruled that Lombard loans could be provided to banks for a term of up to 7 calendar days by U.S. auction in accordance with the procedure established by Bank of Russia Directive No. 119-T, dated May 26, 1998.

Overnight loan rates were announced by the Bank of Russia daily.

Interest rates on loans extended by the Bank of Russia (to banks rehabilitating ailing banks and in support of efforts to repay debts to depositors, maintain liquidity and increase the stability of banks) were set by the Board of Directors.

The Bank of Russia carried out measures to improve the bank refinancing mechanism.

Its Board of Directors changed the correction index applied to the market value of government securities accepted as collateral for loans (Directives No. 231-U, dated May 15, 1998, and No. 343-U, dated September 4, 1998).

Changes were made in the Lombard list of securities accepted by the Bank of Russia as collateral for its loans (Directives No. 341-U, dated September 2, 1998, and No. 343-U, dated September 4, 1998).

The following directives were sent to the Bank of Russia regional branches:

- On abolishing prior redemption of Lombard loans (Directive No. 231-U, dated May 15, 1998);
- On changing the procedure for extending Lombard loans (Letters No. 03-13/595, dated February 19, 1998, and No. 03-13-3/1119, dated March 26, 1998);
- On the procedure to repay overdue debt on Bank of Russia loans owing to the impossibility of selling mortgaged securities (Letters No. 03-13-5/3762, dated September 4, 1998, No. 04-13-5/4202, dated September 29, 1998, and No. 03-13-5/5020, dated November 3, 1998, and Directive No. 303-U, dated September 29, 1998);
- On the accounting of operations to extend and repay Lombard loans, intraday loans and overnight loans (Directives No. 449-U, No. 450-U and No. 451-U, dated December 25, 1998);
- On extending to banks secured Bank of Russia loans (Directive No. 333-T, dated November 26, 1998).

The following directives were sent to the Bank of Russia regional branches in connection with the introduction of a new Chart of accounts:

- On the accounting of Finance Ministry notes of the APK series and transferring their balances to the corresponding second-order accounts of balance account No. 512 as the note redemption deadlines approach (Directive No. 17-T, dated January 16, 1998);
- On the accounting of Finance Ministry notes of the I-APK series due not earlier than August 31, 1998, in balance account No. 51209 “Promissory Notes of Federal Authorities, In-

cluding Guaranteed, Overdue and Unprotested Notes” (Directive No. 187-T, dated August 28, 1998);

- On the procedure for centralising Finance Ministry notes of the I-APK series in the Bank of Russia First Operations Department (OPERU-1) as they mature and must be presented to the Finance Ministry for payment (Letter No. 9589/K, dated September 4, 1998).

In pursuance of Article 72 of Federal Law No. 42-FZ, dated March 26, 1998, on the Federal Budget for 1998, the following directives were sent to the regional branches of the Bank of Russia:

- Joint directives of the Bank of Russia and Finance Ministry on the procedure for restructuring outstanding unrecoverable debt as of January 1, 1998, on centralised loans extended in 1992—1994 to enterprises and organisations in the fuel and energy sector, agribusiness sector, timber industry, textile and light industries and other sectors of the economy and interest charged on them and including it in the domestic government debt under the corresponding guarantees of the regional authorities (Directive No. 254-U, dated June 5, 1998, and Letter No. 136, dated July 27, 1998);
- Directives on the procedure for debiting the debt on centralised loans extended to enterprises and organisations in the fuel and energy sector, agribusiness sector, timber industry, textile and light industries and other sectors of the economy and interest charged on them and restructured in accordance with the aforementioned article of the Federal Law (Letter No. 8756/K, dated July 27, 1998);
- On measures being taken locally to restructure the debt on centralised loans and interest on them and on the reasons for delays in restructuring it (Letter No. 13-3-1/1747, dated September 4, 1998).

In addition, the Bank of Russia sent its regional branches instructions urging them to be more active in recovering debts owed by banks to the Bank of Russia on centralised loans and interest on them and not to be late in filing suits against them with arbitration courts to recover

these debts from debtor banks (Directive No. 22-T, dated March 20, 1998).

The Bank of Russia continued to optimise information flows in the banking sector. It conducted a systemic review of all bank reporting and drafted proposals for gradually reducing the reporting load on credit institutions, taking into account the proposals by Bank of Russia regional branches, banks and banking associations.

To improve economic management in its regional branches and streamline data collection, processing and analysis, the Bank of Russia sent them recommendations on economic management in their economic departments (Letters No. 03-13-1/428, dated February 6, 1998, and No. 13-1-1/2594, dated December 24, 1998).

Considerable attention was paid to improving the exchange of information with the bodies of state power and administration. In compliance with Russian Government Order No. 1773-r, dated December 20, 1997, the Bank of Russia regularly provided information to the Economics Ministry for the purpose of monthly monitoring of social and economic developments. It also signed an agreement on co-operation in the field

of information with the State Statistical Committee (Bank of Russia approved it by Order No. OD-195, dated April 21, 1998) and sent its regional branches instructions on the methods of calculating indicators included in the list of statistical data provided by the Bank of Russia to the State Statistical Committee under the aforesaid agreement (Bank of Russia Letter No. 13-6-3/883, dated May 14, 1998).

A number of measures were carried out last year to enhance the effectiveness of the Bank of Russia's information policy. The structure and contents of the Bulletin of Banking Statistics were overhauled and a procedure was set for collecting and preparing materials for the Bulletin to make its presentation of statistical data more convenient for foreign readers (Bank of Russia Order No. OD-637, dated December 28, 1998). The Bank of Russia began to present the Bulletin on its site in the Internet and in September started to publish major data on the financial sector and foreign trade in accordance with the requirements of the IMF Special Data Dissemination Standard. A procedure for publishing these data was approved (Bank of Russia Directive No. 301-U, dated July 28, 1998).

2. RELATIONSHIP WITH THE FEDERAL BUDGET

TO MEET federal budget obligations to enterprises and organisations, the Finance Ministry established the procedure enabling budget fund managers and recipients to use funds allocated to them from the 1998 budget until January 26, 1999. Federal Law No. 28-FZ, dated February 10, 1999, "On the Completion in 1999 of Operations to Execute the Federal Budget for 1998" and the Federal Law of March 3, 1999, "On Amending Article 1 of the Federal Law on the Completion in 1999 of Operations to Execute the Federal Budget for 1998" extended the accounting period for operations to execute the 1998 federal budget until March 15, 1999.

In June 1998 when the Finance Ministry failed to allocate federal budget funds to redeem its bonds and pay interest on them, it

ran up a debt to the Bank of Russia on operations in the government securities market, which amounted to 5.7 billion rubles as of December 31, 1998.

In accordance with the August 17 statement by the Russian Government and Bank of Russia and taking into account the difficulty of repaying the principal debt when the federal budget no longer received any revenues from government securities placements, GKO—OFZ payments and trading on MICEX were suspended.

From December 1998, in accordance with the Russian Government's enactments adopted after the joint statement by the Russian Government and Bank of Russia, dated August 17, 1998, the Russian Government began the restructuring of its debt on securities issued before the aforesaid statement and due before De-

cember 31, 1999, and the 1999 Federal Budget Law provided for the restructuring of the Finance Ministry's debt on its securities held by the Bank of Russia.

In accordance with the Federal Law on Budget and Tax Policy Priorities and the 1999 Federal Budget Law, the Bank of Russia in September—December 1998 purchased in the secondary

market (through Sberbank) 40.5 billion rubles worth of fixed-coupon federal loan bonds.

The Finance Ministry's debt to the Central Bank amounted to 208.6 billion rubles as of December 31, 1998 (including the Finance Ministry's debt on internal state currency loan bonds), an increase of 60.4 billion rubles over the year, accounting for 27.8% of Russia's domestic government debt.

3. FOREIGN EXCHANGE REGULATION AND FOREIGN EXCHANGE CONTROL

TO IMPROVE the foreign exchange regulation and foreign exchange control system, the Bank of Russia in 1998 implemented the following measures:

- Stepped up controls over the repatriation of foreign exchange earnings from exports and increased exporters' responsibility for the failure to enter these earnings to accounts with authorised banks within the deadlines set in the customs and banking control documents (Joint Letter of the Bank of Russia and State Customs Committee No. 242-T and No. 01-42/19930, dated September 23, 1998, "On Responsibility for the Failure to Enter to Accounts Foreign Currency Exports Returns");
- To normalise payments and settlements on export contracts, the Bank of Russia simplified the procedure for transferring exporters' certificates of transactions from financially-troubled authorised banks, which might fail to meet in time their obligations to transfer foreign exchange export returns, to other authorised banks (Bank of Russia Directive No. 377-U, dated October 7, 1998, "On the Temporary Procedure for Transferring Export Contracts from the Authorised Bank That Issued Certificates of Transactions for These Contracts to Another Authorised Bank");
- Changed the foreign exchange trading system on interbank currency exchanges in order to build a more economically sound price-setting mechanism by separating foreign exchange trading on foreign trade operations from other deals (Bank of Russia Provision No. 57-P, dated September 28, 1998, "On the Procedure for and Conditions of Trading in US Dollars for Russian Rubles at Special Trading Sessions on Interbank Currency Exchanges");
- To increase control over the directed use of foreign exchange bought in the domestic foreign exchange market, the Bank of Russia established new rules for resident corporate entities buying foreign exchange on interbank currency exchanges and set the requirement of its compulsory re-sale in the domestic foreign exchange market (Bank of Russia Directives No. 383-U, dated October 20, 1998, "On the Procedure for Selling and Reselling Foreign Exchange by Resident Corporate Entities in the Domestic Foreign Exchange Market of the Russian Federation," and No. 409-U, dated November 12, 1998, "On the Procedure for Conducting Operations in the Domestic Foreign Exchange Market of the Russian Federation");
- Organised daily statistical monitoring of cash flow in resident foreign exchange transit accounts and sales of export currency earnings on interbank currency exchanges;
- Tightened controls over banking capital taken out of the country (Bank of Russia Provision No. 27-P, dated April 29, 1998, "On the Procedure for Granting Permission by the Central Bank of the Russian Federation to Authorised Banks to Participate in Authorised Capital of Credit Institutions Abroad."

4. GKO—OFZ MARKET

TO IMPROVE monetary policy instruments, the Bank of Russia in 1998 carried out the following measures in the GKO—OFZ market and the Bank of Russia bonds (OBR) market.

In accordance with the decision of the Bank of Russia Credit Committee, dated December 26, 1997, ordinary dealers who had signed a general agreement on REPO operations with the Bank of Russia from March 16, 1998, could have a limit established on their short money positions. Thus, they received the opportunity to participate in the second REPO session to close their short money positions.

In accordance with the decision of the Bank of Russia Credit Committee, dated May 21, 1998, the Bank of Russia from May 28 began to hold 1-day REPO auctions at the same time as 2-day REPO auctions.

In accordance with the decision of the Bank of Russia Credit Committee, dated June 25, 1998, the Bank of Russia from July 23, 1998, allowed ordinary dealers who had their own market portfolio of basic issues worth at least 100 million rubles at market value to participate in REPO auctions.

In accordance with the Russian Government's Resolution No. 1007, dated August 25, 1998, "On the Redemption of Short-Term Couponless Government Bonds and Fixed- and Variable-Coupon Federal Loan Bonds Due Before December 31, 1999, and Issued before August 17, 1998",

secondary trading in the GKO—OFZ market was suspended until the restructuring.

As an alternative to the GKO—OFZ market, the Bank of Russia issued its own short-term debt obligations, which were floated in accordance with Bank of Russia Provisions No. 52-P, dated August 28, 1998, "On the Procedure for Issuing Bonds of the Central Bank of the Russian Federation" and No. 53-P "On Floating of Bank of Russia Bonds".

In accordance with the decision of the Bank of Russia Credit Committee, dated September 10, 1998, the Bank of Russia in September exchanged a part of the restructured GKO—OFZ portfolio of credit institutions that had debts, including overdue debts, on Bank of Russia loans for Bank of Russia bonds (OBR) and fixed-income federal loan bonds (OFZ-PD) with maturities after December 31, 1999.

Bank of Russia Directive No. 374-U, dated October 5, 1998, "On Conducting REPO Operations," made it possible to resume from October 8 REPO operations in the OBR market with dealers whose portfolios of basic issues were worth at least 10 million rubles at market prices. The first deals were struck on November 12.

In November, the Bank of Russia drafted regulatory documents to launch an inter-dealer REPO market for Bank of Russia bonds. However, this project could not be realised in December 1998 as the issue of Bank of Russia bonds ran into some legal problems.

**FINANCIAL REPORTS
AS OF DECEMBER 31, 1998**

VII

INTRODUCTION

THESE financial reports represent all operations conducted by the Bank of Russia to implement its main objectives and functions as stipulated by the Federal Law on the Central Bank of the Russian Federation (Bank of Russia).

The main objectives of the Bank of Russia are as follows:

- Protecting the ruble and ensuring its stability, including its purchasing power and exchange rate against foreign currencies;
- Developing and strengthening the Russian banking system;
- Ensuring effective and uninterrupted functioning of the settlements system.

The Consolidated Balance Sheet and Profit and Loss Account presented below reflect the Bank's financial condition as of December 31, 1998, and its performance in 1998.

In September—December 1998 the Bank of Russia carried out a series of measures to prevent hyperinflation and further devaluation of the national currency, support credit institutions in order to restore the country's payments system, and, as the creditor of last resort, provided foreign exchange for payment of Russia's foreign debt. The impact of economic conditions on the Central Bank's financial reports is explained in more detail in Note 2.

CONSOLIDATED BALANCE SHEET AS OF DECEMBER 31, 1998

Assets	Note	Million rubles	Liabilities	Note	Million rubles
1. Precious metals	3	40,841	1. Cash in circulation	8	199,018
2. Foreign exchange and foreign currency-denominated securities placed with non-residents	4	158,920	2. Funds in accounts with Bank of Russia, of which:	9	116,656
			2.1. Russian government's funds		32,903
3. Loans and deposits, of which:		69,207	2.2. funds of resident credit institutions		64,068
3.1. to resident credit institutions	5	9,347	3. Funds in settlements	10	4,717
3.2. for government debt servicing		49,925	4. Other liabilities, of which:	11	122,036
4. Securities, of which:	6	235,335	4.1. IMF loan		70,182
4.1. Russian government securities		202,466	5. Capital, of which:		118,113
5. Other assets, of which:		56,237	5.1. authorised capital	12	3
5.1. fixed assets	7	27,825	5.2. reserves and funds		145,939
			5.3. accounting year's losses		(27,829)
Total		560,540	Total		560,540

Chairman, Bank of Russia

(V.V. Gerashchenko)

Chief Accountant, Bank of Russia

(L.I. Gudenko)

PROFIT AND LOSS ACCOUNT FOR 1998

Revenues		million rubles
1. Revenues from interest on Bank of Russia loans		2,771
2. Revenues from government securities operations		8,421
3. Revenues from foreign exchange operations		6,431
4. Share dividends received		224
5. Other revenues		17,480
7. Total revenues		35,327
Expenditures		
8. Administrative expenses		8,601
9. Operating and sundry expenses		26,633
10. Excess of negative differences over positive differences in securities revaluation		27,922
11. Total expenditures		63,156
12. Financial result: losses		(27,829)

The item "Other revenues" includes revenues from operations with precious metals in the amount of 12,069 million rubles.

The item "Operating and sundry expenses" includes expenses on interest payment on deposits in the amount of 799 million rubles, expenses on operations with government securities in the amount of 482 million rubles and on foreign-exchange operations in the amount of 1,626 million rubles, and also allocations to provisions for the Bank of Russia's individual active operations in the amount of 12,537 million rubles.

NOTES TO ACCOUNTING REPORT

1. ACCOUNTING AND REPORTING BASICS

The accounting and reporting basics of the Central Bank of the Russian Federation are laid down in the Federal Law on the Central Bank of the Russian Federation (Bank of Russia), Federal Law on Accounting, Bank of Russia Accounting Rules No. 66, dated September 18, 1997 (with subsequent amendments), and other regulatory documents of the Bank.

(a) Accountancy principles

This accounting report was compiled on a cost basis, except for the revaluation of buildings and other fixed assets. The accounting, recording and reporting principles are set out below.

(b) reporting principle

This financial report includes balance-sheet data of the regional branches, national banks, field institutions and other organisations that form the Bank of Russia system.

Russian and foreign subsidiary and associated banks are not consolidated into this financial report (see Note 5).

This financial report was compiled in millions of Russian rubles.

(c) Precious metals

Precious metals are given at their acquisition price.

(d) Foreign-exchange assets and liabilities

Foreign-exchange assets and liabilities are reported in the Bank of Russia balance sheet in Russian rubles at the Central Bank official rates of exchange as of the date the balance sheet was compiled. They are revalued on a daily basis at the official rates of exchange published by the Bank of Russia. Revenues and expenses on foreign-exchange operations conducted by the Bank of Russia are reflected on the balance sheet in rubles at the official rate of exchange as of the transaction date.

Positive and negative exchange-rate differences from recalculating foreign-exchange assets and liabilities were recorded as "Accumulated exchange-rate differences" and are not included in the Profit and Loss Account.

The official rates of exchange used in recalculating foreign-exchange assets and liabilities as of December 31, 1998, were 20.65 rubles to the US dollar and 12.346 rubles to the German mark.

The Central Bank's debt on the IMF loan received in July 1998 in Special Drawing Rights (SDR) as of December 31, 1998, is given in the balance sheet in rubles at the exchange rate set for the period from December 1 through 31, 1998, at 24.7854 rubles to SDR1.

(e) Securities

Government securities are issued by the Finance Ministry. In accordance with the Federal Law on the Central Bank, the Bank of Russia may buy and sell government securities in the open market. The following accounting principles are used:

- Government securities (GKO/OFZ) with market quotations are discounted at the last market price as of August 14, 1998;
- Government securities (GKO/OFZ) without market quotations are shown on the balance sheet at their acquisition price;
- Finance Ministry notes are recorded at the acquisition price.

In addition, the following accounting principles are used with regard to other securities in the Bank of Russia portfolio:

- Notes of credit institutions are recorded at their acquisition price;
- Principal debt papers, or PRINs, and interest arrears notes, or IANs, are discounted at their market value as of December 31, 1998.

(f) Investments

The Central Bank's investments in the authorised capital of subsidiary banks located in Russia and abroad are recorded on the Bank of Russia balance sheet at the prices at which the shares of these banks were acquired.

(g) Loans to credit institutions

In 1998 the Bank of Russia extended loans to banks in accordance with the approved guidelines for the single state monetary policy (Lombard loans, overnight settlement loans, etc.).

From August 1998 the Bank of Russia Board of Directors approved the granting of secured loans to banks of crucial importance for the country's payments system in order to maintain liquidity, increase financial stability and implement financial rehabilitation and to prevent systemic and social risks.

Loans to banks are shown as part of the principal debt.

(h) Provisions for possible losses on Bank of Russia operations

Taking into consideration the adverse effect of the financial crisis on the economic situation in the country, the Bank of Russia Board of Directors, guided by generally accepted banking practice, decided to make provisions for the operations conducted by the Central Bank. The amount of the provisions reflects the risk assessment for Bank of Russia operations, including lending to Russian credit institutions.

(i) Fixed assets

Fixed assets are shown in the consolidated balance sheet at their residual value (acquisition price, taking into account revaluation, less depreciation charged by the linear method).

Some categories of fixed assets are revalued on a yearly basis in accordance with the applicable indices calculated by the State Statistical Committee in line with the Russian Government's Resolution No. 1442, dated December 7, 1996, "On the Revaluation of Fixed Assets in 1997".

Depreciation is charged after a project is put into operation. Below are the principal annual rates of depreciation, used in accordance with the USSR Council of Ministers' Resolution No. 1072, dated October 22, 1990, "On the Standard Rates of Depreciation Deductions for the Complete Restoration of Fixed Assets in the Economy of the USSR:"

	%
Buildings	1.2—3
Equipment (including computers, furniture, transport, etc.)	5—20

(j) Cash in circulation

The Bank of Russia is the sole issuer of currency and manager of cash circulation. Banknotes and coins issued are shown in the balance sheet at par value.

(k) Capital and reserves, and distribution of profit

In accordance with the Federal Law on the Central Bank, the Bank of Russia has authorised capital of 3 million rubles.

Article 26 of this Law requires the Bank of Russia to transfer to the federal budget 50% of its actual balance profit for the year following the approval of the Bank of Russia's Annual report by the Board of Directors. In accordance with the latter's decision, the Bank of Russia may create reserve and social funds from the remaining profit at its disposal.

(l) Acknowledgement of revenues and expenditures of the Bank of Russia

Revenues and expenditures are shown in the profit and loss account on a cash basis, that is, after the actual receipt of revenues and the implementation of expenditures.

2. THE IMPACT OF THE ECONOMIC ENVIRONMENT ON THE FINANCIAL CONDITION OF THE CENTRAL BANK OF THE RUSSIAN FEDERATION

The destructive consequences of the crisis and the implementation by the Bank of Russia of measures to overcome them had a negative effect on its financial performance and balance sheet indicators.

The impact of the crisis on the Bank of Russia balance sheet became particularly manifest in the dramatic growth in the Finance Ministry's debt to the Central Bank.

GKO—OFZ payments and trading were suspended following the joint statement by the Russian Government and Bank of Russia on August 17, 1998, that the Finance Ministry could no longer make payments on the principal domestic government debt. The Finance Ministry in 1998 failed to repay a part of its debt to the Central Bank on government securities, coupon income and interest on promissory notes.

As the Finance Ministry lacked the necessary resources, the Bank of Russia had to provide a part of its foreign-exchange reserves for servicing Russia's foreign debt.

To normalise the work of the country's payments system, perform its functions as the creditor of last resort and prevent the bankruptcy of the banking system, the Bank of Russia provided credit support to banks. The crisis also required it to provide financial aid to Russian and foreign subsidiaries and associated banks.

The measures taken by the Bank of Russia to stabilise the macroeconomic situation in the country, which helped prevent hyperinflation, further economic recession, sovereign default on foreign debt and the bankruptcy of the banking system, and the increase in the volume of operations conducted by the Bank of Russia to prop up the national currency at the time when the Finance Ministry's ability to service its debt was constrained by budget restraints, worsened the structure of the Central Bank's balance sheet and financial results.

The Bank of Russia's accounting report is drawn up on the assumption of continuous operation and the belief that government debt and related debts will be restructured and converted into new debt instruments. It will take years to improve the current situation.

3. PRECIOUS METALS

	million rubles
Precious metals	40,841

4. FOREIGN EXCHANGE AND FOREIGN CURRENCY-DENOMINATED SECURITIES PLACED WITH NONRESIDENTS

	million rubles
Foreign government securities	103,674
Loans made to and deposits placed with the Central Bank's subsidiary banks abroad	40,081
Balances in correspondent accounts and deposits placed with nonresident banks	15,165
Total	158,920

Foreign government securities are mainly US Federal Treasury debt instruments and German government debt papers, which represent highly liquid assets of the Bank of Russia and are recorded at the acquisition price.

Loans extended to and deposits placed with the Central Bank's subsidiary banks abroad are the Bank of Russia's long-term investments, made to maintain liquidity of these banks.

5. LOANS AND DEPOSITS

	million rubles
Funds provided for servicing the government foreign debt	49,925
Deposits with resident banks (in foreign exchange)	9,253
Loans made to resident credit institutions (in rubles)	9,347
Other	682
Total	69,207

In pursuance of Federal Law No. 192-FZ, dated December 29, 1998, "On Budget and Tax Policy Priorities," Article 5, the Bank of Russia provided resources to Vneshekonombank for servicing Russia's foreign debt.

Ruble-denominated loans to resident banks and foreign-exchange deposits with resident banks are funds provided to Russian credit institutions to maintain their liquidity, enhance financial stability and conduct financial rehabilitation.

6. SECURITIES

million rubles

Russian government securities	
Government securities (GKO/OFZ) with market quotations as of August 14, 1998 (regardless of the date of acquisition)	82,316
Government securities (GKO/OFZ) without market quotations	88,713
Finance Ministry notes	31,218
Other	219
Total	202,466
Notes of credit institutions discounted by Bank of Russia	4,308
Securities (PRINs and IANs)	1,473
Subtotal	5,781
Shares of subsidiary and associated banks (Bank of Russia stakes)	27,088
Total	235,335

In accordance with Federal Law No. 36-FZ, dated February 22, 1999, "On the Federal Budget for 1999," government securities owned by the Bank of Russia are to be restructured into long-term government securities with a coupon income of 2% p.a.

Finance Ministry notes were passed to the Bank of Russia before the year under review in connection with the restructuring of the debt on centralised loans and interest on them, extended in 1992—1994 to banks for crediting agribusiness organisations and consumers' co-operatives and organisations making deliveries to the Far North in compliance with the Russian President's Decree No. 2218, dated December 29, 1994, and Federal Law No. 46-FZ, dated April 24, 1995. In addition, the Bank of Russia acquired from banks before the year under review Finance Ministry notes of the APK series in pursuance of the Russian Government's Ordinance No. 1031-r, dated July 24, 1995.

In accordance with the decision of the Bank of Russia Board of Directors, made in compliance with Article 79 of the Federal Law on the Central Bank, and seeking to protect depositors' interests, the Bank of Russia bought promissory notes passed to Sberbank by other banks. Sberbank is making payments on accepted household deposits.

Securities (principal, or PRINs, and interest arrears notes, or IANs) were acquired by the Bank of Russia as a result of the restructuring of the Soviet debt to foreign commercial banks and financial institutions, members of the London club of creditors. PRINs fall due on December 15, 2020, and IANs on December 15, 2015.

Bank of Russia shares of the authorised capital of Russian and foreign subsidiary and associated banks are as follows:

	%
Vneshtorgbank	97
Sberbank	58
Moskovsky Narodny Bank, London ¹	89
Eurobank, Paris ¹	78
Ost-West Handelsbank, Frankfurt-am-Main ¹	82
Donau-bank, Vienna ²	49
East-West United Bank, Luxemburg ¹	49

¹ The Bank of Russia signed comfort letters with regard to these banks, assuming the obligation to maintain their stability and liquidity.

² The remainder 51% of Donau-Bank's shares are owned by Vneshtorgbank.

7. OTHER ASSETS

	million rubles
Fixed assets	
Buildings	18,180
Equipment (including computers, furniture, transport, etc.)	9,645
Total	27,825
Other assets	
Sundry settlements with Finance Ministry	5,708
Unfinished construction projects	5,478
Investments in government securities at the expense of funds set apart for additional pension payments to Bank of Russia employees	4,120
Settlements with CIS banks	3,890
Other	9,216
Subtotal	28,412
Total	56,237

In accordance with Article 1 of Federal Law No. 192-FZ, dated December 29, 1998, "On Budget and Tax Policy Priorities," the Finance Ministry's debt of 5.7 billion rubles to the Bank of Russia on open-market operations with securities is to be included in domestic government debt as the Finance Ministry will pass to the Central Bank 2.85 billion rubles in permanent-coupon federal loan bonds due in 2009 and 2.85 billion rubles due in 2010 at the interest rate of 5% p.a. to be paid annually in May and November.

The item "Settlements with CIS banks" shows the balance of mutual claims on CIS interstate settlements for 1992—1993.

In accordance with Article 101 of Federal Law No. 36-FZ, dated February 22, 1999, "On the Federal Budget for 1999," the 2.4 billion ruble debt on technical loans granted by the Bank of Russia to CIS countries is to be restructured in 1999 into Russia's domestic government debt as the Finance Ministry will pass to the Bank of Russia interest-free federal loan bonds to be redeemed by equal annual instalments within 10 years beginning from 2000.

8. CASH IN CIRCULATION

	million rubles
Cash in circulation	199,018

This item represents the total amount of money (banknotes and coins) put into circulation by the Bank of Russia.

9. FUNDS IN ACCOUNTS WITH THE BANK OF RUSSIA

	million rubles
Russian government's accounts	32,903
Credit institutions' funds in correspondent accounts	38,512
Required reserves deposited with the Bank of Russia	20,803
Credit institutions' deposits with the Bank of Russia	4,656
Other	19,782
Total	116,656

In accordance with Article 23 of the Federal Law on the Central Bank, the Bank of Russia conducted without commission operations with the federal budget, state extrabudgetary funds and regional and local budgets.

The item “Other” includes the balances in accounts opened to record republic, territorial, regional, city, district and village budget funds, extrabudgetary funds and funds of other customers of the Bank of Russia.

10. FUNDS IN SETTLEMENTS

	million rubles
Funds in settlements	4,717

This item shows funds in settlements within the Bank of Russia payments system.

11. OTHER LIABILITIES

	million rubles
IMF loan	70,182
Other liabilities	
Deferred income from lending operations	14,621
Provisions made by the Bank of Russia [see Note 1 (h)]	12,537
Funds for additional pension benefits for Bank of Russia employees	5,119
Deferred income from government securities	6,001
Ruble-denominated Bank of Russia bonds	2,280
Bank of Russia bonds issued as aid for Donau-bank	2,231
Other obligations	9,065
Total	122,036

The Bank of Russia’s debt on the SDR-denominated loan from the IMF as of December 31, 1998, is recorded in the balance sheet in ruble terms at the exchange rate set for the period of December 1 through 31, 1998, at 24.7854 rubles per SDR1. The loan was received in the amount of SDR3,600 million, of which SDR768.43 million were passed to the Finance Ministry.

Deferred income on lending operations represents overdue interest on centralised loans extended by the Bank of Russia in the early 1990s and restructured into Finance Ministry notes (see Note 6 “Securities”).

Guided by Article 89 of the Federal Law on the Central Bank (Bank of Russia) and taking into consideration that Bank of Russia employees are not civil servants and are not covered by the guarantees provided for civil servants and emulating the international central bank practice, the Bank of Russia in 1996 set up additional pension funds.

12. CAPITAL

	million rubles
Authorised capital	3
Accumulated exchange-rate differences	126,806
Reserves	9,717
Fixed capital revaluation fund	8,556
Social security fund	617
Other funds	243
Accounting year’s losses	(27,829)
Total	118,113

The accumulated exchange-rate differences on foreign exchange operations resulted from revaluation of active and passive balance-sheet items in foreign exchange.

Owing to the losses incurred by the Bank of Russia in 1998, no allocations were made to the reserve and social security funds.

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Statutory Audit Report

**OF THE INDEPENDENT AUDIT FIRM “COOPERS & LYBRAND”
ON THE FINANCIAL STATEMENTS OF THE CENTRAL BANK
OF THE RUSSIAN FEDERATION, PREPARED IN CONFORMITY
WITH STATUTORY REQUIREMENTS IN RESPECT OF ITS BUSINESS
ACTIVITY FOR THE YEAR ENDED 31 DECEMBER 1998**

FINAL PART

- 1 We have audited the financial statements of the Central Bank of the Russian Federation (hereinafter — the Bank of Russia), comprising the consolidated balance sheet at 1 January 1999, the Profit and Loss Account for the year ended 31 December 1998 and the related Notes included in Section VII of the Annual report (pages 208 to 218¹) presented by the Bank of Russia to the State Duma (hereinafter — the financial statements).

Basis of Preparation of Financial Statements

- 2 The financial statements of the Bank of Russia have been prepared by management of the Bank of Russia in accordance with the Federal Laws “On the Central Bank of the Russian Federation (the Bank of Russia),” “On Accounting” and the Accounting Rules for the Central Bank of the Russian Federation (the Bank of Russia) of 18 September 1997 No. 66 (with subsequent amendments and addenda). The financial statements prepared in accordance with the said legislation and Rules differ from the financial statements prepared in accordance with International Accounting Standards in particular, with respect to valuation of assets, recognition of liabilities, calculation of income and disclosure of information.

¹ As in the original text. In this edition this corresponds to pages 143 to 150.

- 3 During 1998, the Russian Federation entered a period of severe financial and economic difficulty, which culminated in the announcement by the Government of the Russian Federation and the Bank of Russia on 17 August 1998 of default on most of its internal and external debt which was generally represented by borrowed funds in the form of debt obligations of the Government of the Russian Federation. The detailed description of these difficulties and the impact on the Bank of Russia's financial position are set out in Note 2 to the financial statements. There has been a sharp increase in the amounts due from the Ministry of Finance of the Russian Federation. The ability of the Ministry of Finance of the Russian Federation to service its debt is subject to budgetary restrictions. The financial statements have been prepared on a going concern basis, on the assumption that Government-related debts will be rescheduled into new debt instruments on maturity.

Respective Responsibilities of the Management and the Audit Firm

- 4 The management of the Bank of Russia are responsible for maintaining accounting records, and the preparation of the financial statements which disclose with reasonable accuracy the financial position of the Bank of Russia. They are also responsible for safeguarding the assets of the Bank of Russia and hence for taking reasonable steps for the prevention of fraud, breaches of the law and accounting regulations. This will include establishing a suitable system of internal procedures and controls and ensuring their correct operation. Our responsibility is to express an independent opinion on the proper preparation in all material aspects of these financial statements based on our audit.

Basis of Audit Opinion

- 5 We conducted our audit in accordance with the requirements of the "Rules of Audit Activity in the Russian Federation" approved by the Decree of the Russian President of 22 December 1993 No. 2263 ("Regulation No. 2263"), and the Rules (Standards) on Auditing, approved by the Commission on Audit Activity with the President of the Russian Federation. In accordance with these Rules and Standards we planned and performed our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Bank of Russia management, as well as evaluating the overall financial statements presentation to check their compliance with regulations of the Russian Federation. We believe, subject to the limitation of scope referred to in para 6 of the present Audit report, that our audit provides a reasonable basis for our opinion on these financial statements.

Limitation of Scope

- 6 The scope of our work and the Audit report were limited in respect of certain transactions and balance sheet accounts to which our access was restricted under Federal Law of 21 July 1993 No. 131-FZ “On State Secrets”. In accordance with the State Duma Decree No. 3618-II GD of 5 February 1999, these accounts and transactions should be audited by the Counting Chamber of the Russian Federation. These transactions and accounts comprised precious metals and field departments in the total amount of RR 42,404 mln on assets and RR 1,441 mln on liabilities, as well as income of RR 12,110 mln and expenses of RR 166 mln.

Audit Conclusion

- 7 In our opinion, leaving aside any adjustments which might have been necessary had there not been a limitation on the scope of our work as referred to in para 6 above, the financial statements of the Bank of Russia have been properly prepared to present, in all material respects, the assets and liabilities of the Bank of Russia as at 1 January 1999 and the financial results of its operations for the year ended 31 December 1998 in accordance with the Federal Laws “On the Central Bank of the Russian Federation (the Bank of Russia),” “On Accounting” and the Accounting Rules for the Central Bank of the Russian Federation (the Bank of Russia) of 18 September 1997 No. 66 (with subsequent amendments and addenda).
- 8 We also reviewed the other information included in the Annual report of the Bank of Russia, which does not form part of the financial statements as defined in paragraph 1 of this Audit report. In the course of our review we paid attention to Table 18 “Dynamics of International Reserves of the Russian Federation for 1998”, included in the section “Statistical Addendum” of the Annual report. In calculation of the above reserves the Bank of Russia has included certain deposits placed with the Bank of Russia subsidiaries located abroad (where there were significant limitations as to the use of such deposits). As at 1 January 1999 these deposits totalled approximately USD 845 mln. In our opinion the reserves should only include the amounts available for use at any time. Nothing else came to our attention, that causes us to believe that the other information included in the Annual report is inconsistent, in all material respects, with the financial statements.

Coopers & Lybrand, Moscow, Russia
26 May 1999

Translator’s Explanation Note: The above translation of the Audit report is provided as a free translation of the report in Russian, which is the official and binding version.

Closed Joint-Stock Company “Coopers & Lybrand” (ZAO “Coopers & Lybrand”). The firm is an authorized licensee of the tradename and logo of PricewaterhouseCoopers.

**The Audit Chamber
of the Russian Federation**

121901 Moscow, GSP-2, 2 Zubovskaya St.
May 21, 1999 No. 06-150

**TO COOPERS & LYBRAND,
THE AUDITOR OF THE BANK OF RUSSIA ANNUAL REPORT FOR 1998**

IN ACCORDANCE with the 1999 plan of the Audit Chamber of the Russian Federation and Resolution No. 3618-II GD, dated February 5, 1999, of the State Duma of the Federal Assembly of the Russian Federation, the Audit Chamber of the Russian Federation has audited Bank of Russia accounts covered by the State Secrets Law, for the period of December 31, 1997, to December 31, 1998.

The results of the audit were considered at a meeting of the Collegium of the Audit Chamber of the Russian Federation on May 21, 1999 (Protocol No. 16 (167)).

The Bank of Russia presented the list of accounts covered by the State Secrets Law of the Russian Federation, and the Audit Chamber of the Russian Federation audited these accounts.

The audit was planned and conducted with the purpose of ascertaining with a sufficient degree of confidence the fairness of financial statements of the Bank of Russia, the legality and soundness of operations conducted by the Bank of Russia on the accounts examined and their proper accountancy recording.

It should be noted that the accounting policy of the Bank of Russia is set by the Bank of Russia itself, so the legality and correctness of the accountancy recording of Bank of Russia operations were judged inasmuch as they complied with the regulatory documents of the Bank of Russia.

The drafting and presentation of the financial statements and documents which confirm the annual consolidated statements and the inclusion of specific accounts, Bank of Russia operations and financial reports and documents in the category covered by the Russian Federation State Secrets Law are the responsibility of the Bank's management.

The Audit Chamber herein confirms the following data of the Bank of Russia balance sheet:

	Assets	(million rubles)
1.	Precious metals	40,841.2
2.	Foreign-exchange funds placed with nonresidents	1,284.7
3.	Loans	61.4
	of which:	
3.1.	Loans to resident credit institutions	16.1
4.	Securities	0
	of which:	
4.1.	Russian government securities (except securities acquired on REPO basis)	0
5.	Other assets	216.2
	TOTAL	42,403.5

The above statement by the Audit Chamber takes into account the amendments made in the Chamber's Letters No. 06-155, dated May 25, 1999, and No. 06-161, dated May 28, 1999.

Liabilities		(million rubles)
1.	Cash in circulation	0
2.	Funds in accounts with Bank of Russia, of which:	911.5
2.1.	Russian government funds	190.4
2.2.	Funds of resident credit institutions	1.6
3.	Funds in settlements	514.8
4.	Capital	4.1
4.1.	Authorised capital of Bank of Russia	0
4.2.	Accretion to property value from revaluation	4.1
5.	Other liabilities	11.1
TOTAL		1,441.5

These balance-sheet data were received by consolidating Bank of Russia balance-sheet accounts covered by the Russian Federation State Secrets Law, using the Bank of Russia methodology of consolidating its balance sheet for 1998. These balance-sheet data are presented in the form of the balance sheet published by the Bank of Russia in the open press and not included by the Bank of Russia in the category of data covered by the Russian Federation State Secrets Law.

The Audit Chamber also confirms the following data on the Bank of Russia's financial results:

Revenues		million rubles
1.	Revenues from interest on Bank of Russia loans	20
2.	Revenues from operations with government securities	—
3.	Revenues from foreign-exchange operations	—
4.	Dividends received from stakes and shares	—
5.	Commission and other revenues	12,090
5.1.	including revenues from operations with precious metals	12,069
6.	Итого доходов	12,110

Expenditures		
7.	Administrative expenses	94
8.	Operating and sundry expenses	72
9.	Excess of negative differences over positive differences in revaluation of government securities	—
10.	Total expenditures	166
11.	Financial result: profit	11,944

Overall, audit results have shown that the audited financial reports of the Bank of Russia are compiled in compliance with Bank of Russia standards and regulations. No distortions or errors in reporting or disparities of the synthetic and analytical analysis that could affect the accuracy of these

reports, compiled in accordance with the accounting policy adopted by the Bank of Russia, have been discovered.

At the same time, the Audit Chamber of the Russian Federation does not agree with the accounting policy adopted by the Bank of Russia in representing the cost of precious metals in the balance sheet at their acquisition price.

In the opinion of the Audit Chamber of the Russian Federation the accounting policy adopted by the Central Bank for recording operations with precious metals does not adequately show the actual state of the Bank's assets and leads to significant distortion of its balance-sheet total.

We request you to refer to the Audit Chamber's viewpoint on this issue in your comments on the Bank of Russia balance sheet for 1998.

E.V. Mitrofanova

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Table 1

DYNAMICS OF KEY MACROECONOMIC INDICATORS
(as % of previous year)

	1996	1997	1998
Gross domestic product	96.6	100.9	95.4
of which:			
Goods production	93.6	100.4	93.2
including:			
industry	96.0	102.0	94.6
agriculture and forestry	94.8	102.5	87.9
construction	84.4	94.0	92.3
other manufacturing sectors	96.0	83.6	95.9
Production of services	99.6	101.3	98.2
of which:			
transport and communications	95.5	98.1	96.3
trade and public catering	101.7	105.4	97.3
other market services	99.2	102.3	100.1
non-market services	100.2	98.0	99.4
GDP deflator index, times	1.44	1.17	1.12
Consumer price index (December-on-December), times	1.22	1.11	1.84
Labour productivity	97.3	102.9	96.9
Business activity index	92.6	96.4	95.2
Fixed capital investment	82.0	95.0	93.3
Retail trade turnover	96.0	104.7	95.5
Unemployment rate by ILO methodology, as % of economically active population, year's average	9.6	10.8	11.8

Note. Tables 1—5 are based on calculations made by Bank of Russia and State Statistical Committee (as of May 15, 1999); Tables 6—10 are Bank of Russia calculations based on data reported by State Customs Committee (as of May 15, 1999); Table 11 is based on data reported by CIS central (national) banks (as of May 15, 1999).

Table 2

GDP PRODUCTION STRUCTURE (%)

	1996	1997	1998
Gross domestic product	100.0	100.0	100.0
of which:			
Goods production	41.6	39.5	39.3
including:			
industry	27.0	25.9	26.7
agriculture and forestry	6.4	5.8	5.3
construction	7.7	7.2	6.6
other manufacturing sectors	0.5	0.6	0.7
Production of services	49.9	52.0	52.7
including:			
transport and communications	11.2	11.4	10.4
trade and public catering	16.5	16.0	18.5
other market services	9.5	11.2	12.0
non-market services	12.7	13.4	11.8
Net taxes on products and imports	8.5	8.5	8.0

Table 3

STRUCTURE OF GDP USE IN ACTUAL PRICES (%)

	1996	1997	1998
GDP used	100.0	100.0	100.0
Expenditure on final consumption	71.4	74.2	75.9
of which:			
by households	48.8	50.6	55.9
by government agencies and non-profit organisations providing services to households	22.6	23.6	20.1
Gross fixed capital accumulation	21.0	19.3	17.5
Change of inventories	3.4	3.6	—1.2
Net exports of goods and services	4.1	2.9	7.8

Table 4

GDP ALLOCATION BY INCOME (%)

	1996	1997	1998
GDP produced	100.0	100.0	100.0
of which:			
wage	49.6	49.3	49.3
net taxes on production and imports	13.5	14.2	14.8
gross profit and gross mixed income	36.9	36.5	35.9

Table 5

HOUSEHOLD INCOME AND EXPENDITURE BALANCE IN RUSSIA (million rubles)

	1997	1998	1998 as % of 1997
Cash income	1,643,212.6	1,700,487.0	103.5
wages & salaries	645,799.6	721,700.0	111.8
% share	39.3	42.4	
social transfers	245,484.1	226,700.0	92.3
% share	14.9	13.3	
other incomes	751,928.9	752,087.0	100
% share	45.8	44.2	
Cash expenditures	1,232,271.5	1,440,016.1	116.9
consumer expenses	1,115,370.5	1,331,551.6	119.4
% share	90.5	92.5	
taxes and other expenditures	116,901.0	108,464.5	92.8
% share	9.5	7.5	
Growth in bank savings and cash in hand, foreign currency purchase	410,941.1	260,470.9	63.4
organized savings	35,998.1	18,991.3	52.8
% share	8.8	7.3	
foreign currency purchase	347,454.2	213,644.9	61.5
% share	84.6	82.0	
cash in hand	27,488.8	27,834.7	101.3
% share	6.7	10.7	
For reference:			
Share of cash income, %			
consumer expenditures	67.9	78.3	
organized savings	2.2	1.1	
foreign exchange purchases	21.1	12.6	
cash	1.7	1.6	
taxes and other payments	7.1	6.4	
Disposable cash income	1,539,731.8	1,602,326.9	104.1
% share of			
consumer expenditures	72.4	83.1	
organized savings	2.3	1.2	
foreign exchange purchases	22.6	13.3	
cash	1.8	1.7	

Table 6

RUSSIA'S FOREIGN TRADE

		1997			1998			1998 as % of 1997		
		total	countries		total	countries		total	countries	
			Non-CIS	CIS		Non-CIS	CIS		Non-CIS	CIS
Turnover	\$bn	138.1	107.2	30.8	114.9	90.0	24.9	83.2	83.9	80.6
Exports		85.1	68.4	16.7	71.3	57.7	13.6	83.8	84.3	81.6
Imports		53.0	38.8	14.2	43.6	32.3	11.3	82.3	83.3	79.6
Turnover	%	100.0	77.7	22.3	100.0	78.4	21.6			
Exports		100.0	80.4	19.6	100.0	80.9	19.1			
Imports		100.0	73.2	26.8	100.0	74.2	25.8			

Table 7

RUSSIA'S TRADE WITH MAJOR TRADING PARTNERS OUTSIDE CIS IN 1998

	Turnover		Exports		Imports		Balance	1998 as % of 1997		
	\$m	%	\$m	%	\$m	%	\$m	Turnover	Exports	Imports
Total	90,005	100.0	57,681	100.0	32,324	100.0	25,357	83.9	84.3	83.3
Germany	11,203	12.4	5,718	9.9	5,485	17.0	233	85	87.6	82.6
USA	9,195	10.2	5,070	8.8	4,125	12.7	945	107.7	113.1	101.7
Italy	5,045	5.6	3,227	5.6	1,818	5.6	1,409	81.3	90.5	68.9
Holland	4,907	5.5	3,993	6.9	914	2.8	3,079	85.2	87.7	75.8
China	4,331	4.8	3,169	5.5	1,162	3.6	2,007	82.6	79.6	92.1
Great Britain	4,189	4.7	2,969	5.1	1,220	3.8	1,749	96.8	104.2	82.4
Switzerland	3,537	3.9	3,114	5.4	423	1.3	2,691	87.0	87.9	80.8
Finland	3,515	3.9	2,071	3.6	1,444	4.5	627	75.6	74.7	77.1
Poland	3,238	3.6	2,192	3.8	1,046	3.2	1,146	83.7	87.2	77.2
France	3,051	3.4	1,454	2.5	1,597	4.9	—143	94.7	89.4	100.1
Japan	2,996	3.3	2,177	3.8	819	2.5	1,358	76.4	74.2	83.2
Other	34,798	38.7	22,527	39.1	12,271	38.0	10,256	78.6	77.5	80.8

Table 8

RUSSIA'S TRADE WITH CIS COUNTRIES IN 1998

	Turnover		Exports		Imports		Balance	1998 as % of 1997		
	\$m	%	\$m	%	\$m	%	\$m	Turnover	Exports	Imports
Total	24,854	100.0	13,587	100.0	11,267	100.0	2,320	80.6	81.6	79.4
Belarus	9,178	36.9	4,623	34.0	4,555	40.4	68	97.3	98.3	96.3
Ukraine	8,753	35.2	5,483	40.4	3,270	29.0	2,213	78.0	75.7	82.1
Kazakhstan	3,788	15.2	1,903	14.0	1,885	16.7	18	72.6	77.0	68.7
Uzbekistan	1,094	4.4	563	4.1	531	4.7	32	57.9	64.3	52.3
Moldova	836	3.4	325	2.4	511	4.5	—186	68.4	85.3	60.8
Azerbaijan	323	1.3	150	1.1	173	1.5	—23	67.2	68.2	66.4
Kirghizia	265	1.1	133	1.0	132	1.2	1	83.9	79.1	89.3
Georgia	171	0.7	106	0.8	65	0.6	41	57.3	71.6	43.2
Armenia	167	0.7	128	0.9	39	0.3	89	107.9	134.2	65.7
Turkmenia	140	0.6	95	0.7	45	0.4	50	33.1	35.8	28.5
Tajikistan	139	0.6	78	0.6	61	0.5	17	74.1	87.5	62.0

Table 9

RUSSIA'S EXPORTS STRUCTURE (%)

	Non-CIS		CIS*		1998 as % of 1997	
	1997	1998	1997	1998	Non-CIS	CIS
Exports, total	100.0	100.0	100.0	100.0	84.3	81.6
Minerals	47.1	39.5	53.5	52.4	70.8	79.9
of which fuel	46.3	38.5	51.9	50.6	70.2	79.5
Ferrous and non-ferrous metals and products, including:	23.4	24.0	7.7	9.0	86.6	94.5
— ferrous metals and products	10.9	10.3	6.0	7.1	79.5	96.3
— non-ferrous metals and products	12.4	13.4	1.2	1.2	91.6	85.5
Machinery and equipment	8.3	9.5	19.5	17.0	96.2	70.9
Chemicals	8.5	8.4	9.3	9.4	84.2	82.3
Gemstones and semiprecious stones, precious metals and articles made from them	4.6	7.0	0.1	0.1	129	124.6
Wood and timber products	4.1	4.6	2.3	2.5	96.2	88.5
Non-food raw materials and industrial products	1.2	1.4	1.9	1.7	98.1	74.2
Industrial goods and raw materials for their production	1.2	1.1	3.5	4.0	78.5	93.8
Other commodities	1.8	4.4	2.1	3.8	208.6	150.3

* Commodity structure of exports was recalculated to include data on Belarus as it was reported by Belorussian statistical agency.

Table 10

RUSSIA'S IMPORTS STRUCTURE (%)

	Non-CIS		CIS*		1998 as % of 1997	
	1997	1998	1997	1998	Non-CIS	CIS
Imports, total	100.0	100.0	100.0	100.0	83.3	79.4
Machinery and equipment	39.1	38.4	24.6	24.8	81.8	79.9
Foodstuffs and raw materials for their production	25.6	25.5	22.2	18.3	83.1	65.5
Chemicals	16.2	15.8	11.5	15.0	81.3	103.8
Ferrous and non-ferrous metals and products	4.3	4.4	14.3	14.0	84.9	77.5
of which:						
— ferrous metals and products	2.6	2.7	12.1	11.8	86.9	77.6
— non-ferrous metals and products	1.1	1.1	1.8	1.7	82.0	78.2
Wood and timber products	3.0	2.9	1.4	1.9	80.0	105.5
Minerals	2.8	2.6	14.3	13.3	77.4	73.9
including fuel	1.9	1.9	10.9	9.6	83.5	69.8
Non-food raw materials and industrial goods	3.2	2.5	7.6	6.3	64.5	65.9
Gemstones and semiprecious stones, precious metals and articles made from them	0.2	0.0	0.1	0.2	16.6	117.9
Other products	5.6	7.9	3.9	6.2	117.6	126.2

* Commodity structure of imports was recalculated to include data on Belarus as it was reported by Belorussian statistical agency.

Table 11

KEY ECONOMIC INDICATORS ON CIS COUNTRIES IN 1998 (as % of the same period of 1997)

	Azerbaijan	Armenia	Belarus	Georgia	Kazakhstan	Kirghizia	Moldova	Russia	Tajikistan	Turkmenia	Ukraine
Gross domestic product	110	107.2	108	102.9	97.5	101.8	91.4	95.4	105.3	105	98.3
Industrial output	102.2	97.5	111	97.3	97.9	108.3	89	94.8	108.1	107	98.5
Retail turnover	109.1	106.1	120.6	111.8	117.9	108.4	87.1	95.6	108.2	117	94.6
Consumer price index (December as % of previous December)	99.2	98.7	281.7	110.7	101.9	118.4	118.3	184.4	102.7	119.8	120
Producer price index (December as % of previous December)	87.6	108.2	296.3	112.1	94.5	126.3	115.1	123.2	105.9	110.3	135.3
Official unemployment rate as % of economically active population (end of year)	1.4	8.9	2.3	4.2	3.7	3.1	...	2.7	3.7
Refinancing rate (end of period), %											
— December 1997	12	50	40	48.1*	18.5	23.51**	16	28	81	35	35
— December 1998	14	39	48	—*	25	32.91**	...	60	41	30	74.2
Official exchange rate against US dollar set by Central (National) Bank											
— as of December 31, 1997	3,888 manats	500.02 drams	30,740 bel. rubles	1.3040 laris	75.55 tenge	17.3750 soms	4.661 leis	5,960.0 rubles***	747.0 taj. rubles	4,165.0 manats	1.90 hrivnas
— as of December 31, 1998	3,890 manats	522.03 drams	107,000 bel. rubles	1.8000 laris	83.80 tenge	29.3759 soms	8.3226 leis	20.65 rubles	985.0 taj. rubles	5,200.0 manats	3.43 hrivnas
No. of registered commercial banks											
— as of December 31, 1997	99	30	36	53	82	20	21	2,526	26	67	227
— as of December 31, 1998	79	31	37	43	71	23	20	2,451	19	67	214

* Average weighted interest rate on National Bank of Georgia's loans from 30 to 90 days.

** The National Bank of the Kirghiz Republic sets the interest rate on the basis of average weighted yield on 3-month government treasury bills.

*** Non-redenominated rubles.

Table 12

MAJOR WORLD ECONOMIC INDICATORS (% growth of previous year)

	1997	1998*
World GDP	4.2	2.5
Industrialised nations	3.2	2.2
Group Seven	3.0	2.2
United States	3.9	3.9
Japan	1.4	—2.8
Germany	2.2	2.8
France	2.3	3.1
Italy	1.5	1.4
Great Britain	3.5	2.1
Canada	3.8	3.0
Other industrialised nations	4.2	2.1
Euro zone	2.5	2.9
Newly industrialised nations	6.0	—1.5
Developing countries	5.7	3.3
Asia	6.6	3.8
China	8.8	7.8
India	5.5	5.6
ASEAN-4*	3.8	—9.4
Africa	3.1	3.4
Middle and Near East	4.4	2.9
Latin America	5.2	2.3
Brazil	3.2	0.2
Economies in transition	2.2	—0.2
Central and Eastern Europe	3.1	2.4
Excluding Belarus and Ukraine	3.5	2.6
Russia	0.8	—4.8
Caucasus and Central Asia	2.4	2.0
Consumer prices		
Industrial economies	2.1	1.6
Developing countries	9.4	10.4
Economies in transition	28.2	20.8
LIBOR rate on 6-month deposits (%)		
US\$	5.9	5.6
Japanese yen	0.7	0.7
in euros	3.5	3.7

* Indonesia, Malaysia, Thailand and the Philippines.

Table 13

WORLD TRADE IN GOODS AND SERVICES (% growth of previous year)

	1997	1998
Total	9.9	3.3
Imports		
Industrial economies	9.1	4.7
Developing nations	11.2	—0.7
Economies in transition	9.3	1.2
Exports		
Industrial economies	10.3	3.2
Developing nations	11.4	2.2
Economies in transition	6.2	4.1
World market prices		
Oil (in US dollars)	—5.4	—32.1
Raw materials (in US dollars)	—3.3	—14.8

Table 14

FOREIGN CASH FLOW IN 1998 (billion US dollars)

	Q1	Q2	Q3	Q4	1998	For reference: 1997
1. Brought into Russia by	5.8	5.6	6.8	2.5	20.7	43.2
banks	4.9	4.4	5.3	1.5	16.2	38.3
migrants	0.1	0.2	0.2	0.2	0.8	0.9
tourists	0.5	0.7	1.2	0.8	3.2	3.1
unregistered traders	0.2	0.2	0.1	0.1	0.5	0.8
2. Taken out of Russia by	6.4	6.9	5.1	3.2	21.6	29.7
banks	0.1	0.1	0.1	0.1	0.4	0.8
migrants	0.1	0.3	0.2	0.1	0.7	0.9
tourists	1.4	1.9	1.9	1.1	6.2	7.3
unregistered traders	4.0	3.9	2.6	1.8	12.4	17.2
other	0.7	0.7	0.4	0.2	2.0	3.6
3. Growth (+), reduction (—) in foreign currency held by residents (1—2)	—0.6	—1.3	1.7	—0.8	—0.9	13.4
at banks	0.2	—0.2	0.1	—0.1	—0.1	0.1
outside banks	—0.8	—1.1	1.7	—0.6	—0.9	13.4

Table 15

RUSSIA'S BALANCE OF PAYMENTS FOR 1998. ANALYTICAL PRESENTATION (US\$ million)

	Q1	Q2	Q3	Q4	1998	For reference: 1997
Current Account	—1,508	—3,587	900	6,640	2,446	4,049
Balance of trade	908	1,584	4,814	10,000	17,306	17,440
<i>Exports</i>	<i>18,617</i>	<i>18,846</i>	<i>18,112</i>	<i>19,177</i>	<i>74,751</i>	<i>89,038</i>
<i>Imports</i>	<i>—17,709</i>	<i>—17,262</i>	<i>—13,298</i>	<i>—9,176</i>	<i>—57,445</i>	<i>—71,599</i>
Balance of services	—1,045	—1,293	—652	—159	—3,150	—4,688
<i>Exports</i>	<i>2,907</i>	<i>3,329</i>	<i>3,690</i>	<i>3,011</i>	<i>12,937</i>	<i>14,158</i>
<i>Imports</i>	<i>—3,952</i>	<i>—4,622</i>	<i>—4,343</i>	<i>—3,171</i>	<i>—16,087</i>	<i>—18,846</i>
Wage balance	—89	—71	—32	29	—164	—342
Balance of investment income (interest, dividend)	—1,142	—3,663	—3,201	—3,188	—11,195	—8,069
<i>Receivable from nonresidents</i>	<i>2,426</i>	<i>760</i>	<i>503</i>	<i>310</i>	<i>3,999</i>	<i>4,140</i>
of which due to government sector	2,013	332	135	95	2,575	2,772
<i>Payable to nonresidents</i>	<i>—3,569</i>	<i>—4,423</i>	<i>—3,704</i>	<i>—3,498</i>	<i>—15,194</i>	<i>—12,209</i>
of which by government sector	—2,716	—3,519	—3,029	—2,897	—12,161	—9,825
Balance on current transfers	—139	—144	—28	—41	—351	—291
Capital and Financial Account	3,285	4,578	158	—7,858	164	5,702
Capital account (capital transfers)	—92	—189	15	—116	—382	—797
Financial account (except reserve assets)	3,377	4,767	143	—7,741	546	6,498
Liabilities (— down, + up)	7,053	8,009	3,826	—886	18,001	43,813
<i>Government sector operations</i>	<i>4,536</i>	<i>4,465</i>	<i>3,588</i>	<i>971</i>	<i>13,560</i>	<i>21,404</i>
Portfolio investment	3,434	4,143	147	—288	7,436	44,107
<i>Ruble-denominated securities (GKO—OFZ)</i>	<i>3,098</i>	<i>—331</i>	<i>—2,267</i>	<i>—862</i>	<i>—362</i>	<i>10,882</i>
<i>Foreign currency securities</i>	<i>336</i>	<i>4,474</i>	<i>2,414</i>	<i>574</i>	<i>7,798</i>	<i>33,226</i>
federal eurobonds	680	4,121	0	4	4,805	3,603
eurobonds issued by local governments	0	500	0	0	500	897
bonds issued under agreement with London Club	—193	411	0	521	739	28,000
bonds involved in GKO—OFZ restructuring	0	0	2,012	0	2,012	0
Finance Ministry's domestic government foreign currency loan bonds (OVCVZ)	—83	—557	402	49	—190	726
other	—68	0	0	0	—68	0

End

	Q1	Q2	Q3	Q4	1998	For reference: 1997
Loans	748	51	1,939	—1,013	1,724	2,714
used	1,695	1,630	2,750	671	6,747	7,616
repaid (by schedule)	—1,418	—2,049	—1,411	—2,265	—7,142	—8,002
deferred	470	470	600	580	2,120	3,100
Overdue debt	333	239	1,474	2,265	4,311	—24,457
Other liabilities	20	32	28	7	88	—960
<i>Bank of Russia operations (with regard to IMF loans)</i>	0	0	3,781	0	3,781	0
<i>Banks' operations</i>	288	1,861	—5,022	—3,251	—6,124	8,901
<i>Operations by other sectors</i>	2,230	1,682	1,479	1,394	6,784	13,508
Direct investment	457	399	471	610	1,937	6,156
Portfolio investment	149	12	—3	672	831	1,279
Loans	1,680	1,154	930	—70	3,695	6,137
Commercial loans and advances	—57	117	81	181	322	—64
Other liabilities	0	0	0	0	0	0
Assets, except reserve assets (+ down, — up)	—3,676	—3,241	—3,683	—6,855	—17,455	—37,314
<i>Government sector operations</i>	<i>—1,298</i>	<i>—56</i>	<i>—327</i>	<i>—20</i>	<i>—1,701</i>	<i>—755</i>
Loans	2,213	2,509	603	354	5,679	7,522
Overdue debt	—3,677	—2,665	—395	—400	—7,137	—8,865
Other assets	167	100	—535	26	—243	587
<i>Banks' operations</i>	<i>528</i>	<i>—1,143</i>	<i>1,360</i>	<i>—390</i>	<i>355</i>	<i>—1,263</i>
<i>Operations by other sectors</i>	<i>—2,907</i>	<i>—2,042</i>	<i>—4,715</i>	<i>—6,445</i>	<i>—16,109</i>	<i>—35,296</i>
Direct and portfolio investment	—248	—252	—253	—306	—1,060	—2,584
Foreign cash	842	1,061	—1,655	639	887	—13,384
Commercial loans and advances	—70	—1,157	—1,199	—4,385	—6,810	—6,948
Nondelivery of export earnings	—2,399	—448	—481	—1,039	—4,367	—4,588
Non-delivery of goods and services in repayment of import advances	—996	—1,202	—1,026	—1,034	—4,257	—6,870
Other assets	—36	—44	—102	—319	—501	—922
Net errors and omissions	—2,669	—1,759	—3,655	168	—7,914	—7,815
Change of foreign exchange reserves (+ down, — up)	892	768	2,596	1,050	5,305	—1,936

Table 16

INTERNATIONAL INVESTMENT POSITION OF RUSSIAN CREDIT INSTITUTIONS (CONSOLIDATED)
AS OF DECEMBER 31, 1997, AND DECEMBER 31, 1998* (million US dollars)

	Balance as of December 31, 1997	Change from operations	Change from revaluation	Other changes**	Total changes	Balance as of December 31, 1998
Assets	12,078	57	—546	—1,505	—1,995	10,083
Direct investment abroad	458	—12	—6	—88	—106	352
Shareholding and reinvested income	321	—43	—7	—30	—79	242
Other capital	137	31	1	—58	—27	110
Portfolio investment	1,310	220	—189	—145	—114	1,196
Shareholding	11	11	0	—6	5	16
Debt securities	1,298	209	—188	—139	—118	1,180
long-term	631	281	—172	—184	—74	557
short-term	667	—72	—17	45	—44	623
Other investment	10,310	—152	—352	—1,272	—1,775	8,535
Foreign cash and deposits	6,416	—668	—157	—264	—1,089	5,327
Foreign cash in tills	662	—63	—25	—16	—104	558
Current accounts and deposits	5,754	—605	—133	—247	—985	4,769
long-term	607	—187	6	—2	—183	424
short-term	5,147	—418	—139	—245	—802	4,345
Loans	3,610	—39	—45	—663	—747	2,864
long-term	764	799	—2	—99	698	1,462
short-term	2,847	—838	—43	—564	—1,445	1,402
Overdue debt	40	151	—5	—143	3	43
Other assets	244	405	—145	—202	57	301
long-term	21	—1	0	—16	—17	4
short-term	223	406	—145	—187	74	297

End

	Balance as of December 31, 1997	Change from operations	Change from revaluation	Other changes**	Total changes	Balance as of December 31, 1998
Liabilities	19,236	—6,195	—1,067	—1,722	—8,983	10,253
Direct investment in Russia	970	246	—849	—10	—613	358
Shareholding and reinvested income	970	246	—849	—10	—613	358
Other capital	0	0	0	0	0	0
Portfolio investment	887	—196	—232	—77	—504	383
Shareholding	241	33	—218	—20	—204	36
Debt securities	647	—229	—14	—57	—300	347
long-term	73	12	—19	—27	—35	38
short-term	574	—241	5	—30	—265	309
Other investment	17,379	—6,245	14	—1,635	—7,866	9,513
Current accounts and deposits	7,298	—2,906	—519	—264	—3,690	3,608
long-term	195	749	—2	—29	717	912
short-term	7,103	—3,655	—517	—235	—4,407	2,696
Loans	9,499	—3,326	—20	—1,158	—4,504	4,994
long-term	1,605	536	8	—375	170	1,775
short-term	7,894	—3,862	—28	—784	—4,674	3,219
Overdue debt	0	693	—3	—1	690	690
Other liabilities	583	—706	555	—211	—362	221
long-term	5	1	—2	0	—1	4
short-term	578	—707	557	—211	—361	216
Net international investment position	—7,159	6,252	521	216	6,989	—170

* + means net growth in assets or liabilities; — means their net decrease. This use of the symbols differs from their use in the balance of payments statistics.

** Including assets and liabilities of credit institutions stripped of banking licence in the period under review.

Table 17

STRUCTURE OF RUSSIAN INVESTMENT ABROAD (EXCLUDING OPERATIONS WITH RESERVE ASSETS) IN 1998
(million dollars) *

Type of investment	1st half 1998	2nd half 1998	1998	For reference: 1997
Direct	0.6	0.4	1.0	2.6
Portfolio	0.6	—0.3	0.3	0.2
Other	5.8	10.4	16.2	34.6
Total	7.0	10.5	17.5	37.3

* Net growth in residents' foreign assets.

Notes.

1. "—" means a decrease in residents' foreign assets.
2. Other investment includes an adjustment for reserve assets.

Table 18

DYNAMICS OF RUSSIA'S INTERNATIONAL RESERVES IN 1998 (million US dollars)

Indicator	Balance as of												
	Dec 31, 1997	Jan 31, 1998	Feb 28, 1998	Mar 31, 1998	Apr 30, 1998	May 31, 1998	Jun 30, 1998	Jul 31, 1998	Aug 31, 1998	Sep 30, 1998	Oct 31, 1998	Nov 30, 1998	Dec 31, 1998
Reserve assets (including Finance Ministry assets)	17,784	15,375	15,034	16,859	15,953	14,627	16,169	18,409	12,459	12,709	13,572	12,480	12,223
Monetary gold*	4,889	4,895	4,822	4,948	4,996	5,002	5,008	4,604	4,262	3,869	3,916	4,306	4,422
Special Drawing Rights	122	1	3	3	3	3	253	13	0	0	64	1	0
Reserve position in IMF	1	1	1	1	1	1	1	1	1	1	1	1	1
Other foreign exchange assets	12,771	10,477	10,208	11,906	10,952	9,621	10,906	13,791	8,196	8,839	9,590	8,172	7,800

* Gold is estimated at \$300 per troy oz.

Table 19

STRUCTURE OF FOREIGN INVESTMENT IN RUSSIA IN 1998*

Type of investment	1st half-year		2nd half-year		1998		For reference: 1997	
	\$bn	% share	\$bn	% share	\$bn	% share	\$bn	% share
Direct	1.1	7	1.1	38	2.2	12	6.2	14
Portfolio	7.9	52	0.1	4	8	45	17.3	39
Other	6.1	41	1.7	58	7.8	43	20.3	47
Total	15.1	100	2.9	100	18	100	43.8	100

* Net growth in obligations to nonresidents.

Table 20

RUSSIAN GOVERNMENT FOREIGN-CURRENCY BOND ISSUES IN 1998

Issuer	Date of issue	Life, years	Currency	Volume at par, bn currency units	Effective yield at placement, % p.a.
Federal government					
1. Eurobonds					
Finance Ministry	March	7	DEM	1.25	9.45
Finance Ministry	May	5	ITL	750	9.11
Finance Ministry	June	5	USD	1.25	12.43
Finance Ministry	June	30	USD	2.5	13.36
2. Bonds issued in exchange for GKO					
Finance Ministry	July	7	USD	2.97	15.44
Finance Ministry	July	20	USD	3.47	15.75
of which for cash				0.5	15.75
Regional governments					
1. Eurobonds					
Moscow government	April	3	DEM	0.5	9.18
Moscow government	May	3	ITL	400	10.01

Table 21

STRUCTURE OF RUSSIA'S DOMESTIC GOVERNMENT DEBT (according to Finance Ministry's data, billion rubles)

	December 31, 1997	December 31, 1998 (preliminary data)	\$ share at December 31, 1998
GDP	2,521.9	2,684.5	
Russia's debt (total)	499.55	750.55*	100.00
Russia's domestic government debt as % of GDP	19.81	27.96	
of which:			
1. Russian debt obligations (total)	450.85	479.97	63.95
of which:			
Short-term government bonds	272.61	14.64	1.95
Variable-coupon federal loan bonds	47.62	0.09	0.01
Government savings loan bonds	13.08	14.64	1.95
Fixed-coupon federal loan bonds	115.77	447.96	59.68
Non-market loan bonds	1.77	2.64	0.35
2. Finance Ministry promissory notes (total)	32.01	28.09	3.74
of which:			
Finance Ministry notes issued when restructuring debt on centralised loans and interest charged of agribusiness organisations and organisations delivering goods to the Far North	25.00	22.00	2.93
Agribusiness sector's debt converted in Finance Ministry promissory notes	3.92	3.36	0.45
Finance Ministry notes exchanged for debt owed by Ivanovo textile mills on centralised loans and other debt	2.55	2.24	0.30
Guaranteed promissory notes passed to Agroprombank	0.54	0.49	0.07
3. Government guarantees	3.47	0.88	0.12
4. Russia's domestic government debt succeeded from USSR	0.19	0.19	0.03
5. 1990 targeted directed loan	2.04	1.91	0.25
6. 1991 RSFSR government loan	0.08	0.08	0.01
7. 1992 government loan	0.11	0.13	0.02
8. Directed deposits and car-purchase cheques	3.30	2.97	0.40
9. Debt on technical loans extended to CIS countries	2.41	2.41	0.32
10. Debt owed by energy and fuel sector and other sectors on centralised loans	5.00	4.18	0.56
11. Debt owed by agribusiness enterprises of Chelyabinsk Region and Joint-Stock Company Cherkeigesstroi on centralised loans and interest on them	0.09	0.09	0.01
12. Debt on domestic foreign-currency loan		229.65	30.60

* This figure takes into account OFZ-PD federal loan bonds owned by the Bank of Russia as of December 31, 1998, in accordance with the 1999 Federal Budget Law No. 36-FZ of February 22, 1999.

Table 22

FINANCE MINISTRY DEBT TO CENTRAL BANK (million rubles)

	At December 31, 1998
Total	208,642.68
— agribusiness sector's debt on bank loans included in Russia's domestic government debt in 1991	69.2
— Russia's debt obligations	171,456.56
of which:	
— domestic government foreign-currency loan bonds	209.58
— Russia's debt obligations acquired in repo operations	208.31
— promissory notes issued and guaranteed by federal authorities	31,217.84
— debt on operations in organized securities market	5,707.65
— domestic government debt of former USSR	191.43

Table 23

MONEY SUPPLY (billion rubles) *

Indicators	December 31, 1997	March 31, 1998	June 30, 1998	September 30, 1998	December 31, 1998
Money supply (M2), total	374.1	360.4	368.6	365.8	448.4
— cash in circulation (M0) **	130.4	119.1	129.8	154.2	187.8
— non-cash funds	243.7	241.3	238.8	211.6	260.5

* Excluding credit institutions which lost their licence.

** Cash in circulation outside banking system.

Table 24

M2 STRUCTURE*

Indicators	At December 31, 1997		At December 31, 1998		Growth index for 1998
	bn rubles	%	bn rubles	%	
Money supply (M2), total	374.1	100.0	448.4	100.0	1.20
Including:					
— cash in circulation**	130.4	34.9	187.8	41.9	1.44
— non-cash funds	243.7	65.1	260.5	58.1	1.07
of which:					
— non-financial organisations' funds	101.9	27.2	118.7	26.5	1.17
— household deposits	141.8	37.9	141.8	31.6	1.00

* Excluding credit institutions which lost their licence.

** Cash in circulation outside banking system.

Table 25

MONETARY BASE AND ITS STRUCTURE

	At December 31, 1997		At December 31, 1998		Growth index for 1998
	bn rubles	%	bn rubles	%	
Monetary base (in broad definition)	204.9	100.0	258.2	100.0	1.26
of which:					
— cash in circulation, including cash balances in tills*	137.0	66.9	197.9	76.6	1.44
— banks' correspondent accounts with Central Bank**	31.4	15.3	32.6	12.6	1.04
— required reserves***	36.4	17.8	20.8	8.1	0.57
— bank deposits at Central Bank	0.05	0.0	4.7	1.8	93.1
— Bank of Russia bonds held by banks	0.0	0.0	2.3	0.9	—

* Excluding cash in tills of Bank of Russia institutions.

** Ruble accounts, including cash balances in the organized securities market.

*** On funds attracted to ruble and foreign-currency accounts.

Table 26

ANALYTICAL ACCOUNTS OF CREDIT INSTITUTIONS (million rubles)

	31.12.97	31.01.98	28.02.98	31.03.98	30.04.98	31.05.98	30.06.98	31.07.98	31.08.98	30.09.98	31.10.98	30.11.98	31.12.98
Reserves	72,974.5	64,215.4	58,757.3	64,229.7	57,609.5	59,055.2	58,700.6	60,670.8	48,755.2	51,076.5	57,750.2	68,663.9	73,747.8
Foreign assets	72,717.3	67,497.6	68,905.0	68,262.9	69,588.5	70,210.3	73,121.4	74,983.2	87,739.7	154,655.1	159,519.9	184,283.4	219,580.2
Claims on government	194,689.0	191,101.2	202,485.6	210,601.8	215,089.1	202,668.1	207,822.4	193,571.4	187,962.7	205,760.3	203,452.8	236,420.4	259,401.6
including claims on regional and local governments	18,691.8	20,086.4	21,074.1	23,039.6	23,501.8	24,230.1	24,035.1	24,552.8	24,528.2	25,222.4	23,995.6	24,623.7	24,445.6
Claims on non-financial public enterprises	33,217.4	32,000.5	31,325.4	29,405.4	29,403.1	30,281.9	30,104.3	30,160.3	29,558.0	38,545.4	35,775.8	32,019.6	33,078.8
Claims on non-financial private enterprises and households	236,438.4	230,725.7	236,099.8	239,196.4	246,583.3	245,696.7	249,255.8	245,049.4	252,346.5	335,444.3	314,118.4	325,683.7	345,962.6
Claims on other financial institutions	8,075.9	6,214.4	7,490.5	6,272.9	5,761.5	5,269.0	5,005.1	5,455.6	6,418.6	7,601.6	7,056.5	7,926.6	7,270.7
Demand deposits	162,532.1	151,248.5	145,583.6	142,683.4	137,165.8	138,380.0	136,711.3	129,132.3	116,127.7	116,522.3	118,880.5	130,976.7	149,468.4
Time and savings deposits and foreign-currency deposits	158,714.8	156,055.4	164,373.7	169,347.7	173,582.6	176,214.1	175,346.9	176,076.6	181,546.3	244,803.9	231,018.4	247,583.1	283,995.9
of which foreign-currency deposits	80,454.7	68,578.2	73,160.5	75,886.6	76,034.9	78,669.1	77,561.4	79,597.9	93,567.0	163,367.4	147,403.7	161,057.6	190,872.5
Limited-access deposits	6,270.5	10,651.7	11,085.2	12,281.8	16,298.0	16,176.7	18,238.4	15,990.8	22,270.4	31,773.1	29,545.5	20,872.2	22,595.1
Money-market instruments	42,435.9	29,736.3	38,930.0	38,765.0	39,634.3	37,520.5	38,911.8	39,084.0	37,407.5	37,028.8	32,914.8	33,814.6	43,311.9
Foreign liabilities	104,197.4	102,735.8	101,918.9	103,579.8	103,394.5	104,552.9	105,389.7	101,041.9	108,527.0	196,126.9	180,096.9	194,157.6	203,122.6
Government deposits	18,236.1	21,512.3	18,847.6	17,956.8	20,020.6	17,424.2	15,139.8	14,950.8	15,210.7	17,002.8	19,257.7	20,693.4	20,676.5
of which regional and local government deposits	9,139.9	11,010.0	10,899.3	10,015.8	11,616.4	11,738.2	9,409.9	8,761.9	8,463.4	8,977.8	10,634.4	11,643.5	10,148.2
Obligations to monetary authorities	8,779.8	4,388.2	3,219.4	4,442.8	5,987.9	8,544.0	10,450.9	2,527.7	19,931.9	18,850.6	17,201.4	37,529.8	71,893.6
Capital accounts	143,909.4	137,949.4	148,588.1	153,007.6	155,093.6	143,708.9	156,156.3	159,341.7	148,575.9	139,854.5	147,339.1	158,269.6	157,594.7
Other (net)	—26,963.5	—22,522.6	—27,482.7	—24,095.9	—27,142.1	—29,340.1	—32,335.5	—28,255.1	—36,816.8	—8,879.8	1,419.3	11,100.8	—13,617.0

This table is based on credit institutions' accounts and includes both ruble and foreign-currency accounts.

Table 27

MONETARY SURVEY (million rubles)

	31.12.97	31.01.98	28.02.98	31.03.98	30.04.98	31.05.98	30.06.98	31.07.98	31.08.98	30.09.98	31.10.98	30.11.98	31.12.98
Net foreign assets of monetary authorities and credit institutions	16,428.0	—5,411.5	—5,386.0	4,668.7	222.4	—7,674.2	373.6	—8,917.5	—48,777.1	—105,086.0	—75,303.0	—80,924.5	—94,166.6
Domestic credit	659,245.1	637,228.7	666,117.2	677,552.4	693,422.3	674,750.4	683,409.7	683,838.5	708,802.9	970,334.8	951,027.9	1,023,827.5	1,109,108.4
Net credit to government	381,187.0	367,776.4	390,693.8	402,173.5	411,175.5	393,017.0	398,567.2	402,704.0	419,991.0	588,178.4	593,472.7	657,604.7	722,234.6
Claims on non-financial public enterprises	33,263.2	32,161.5	31,486.1	29,566.2	29,563.6	30,442.3	30,262.9	30,313.2	29,710.9	38,698.1	35,928.0	32,170.9	33,228.4
Claims on private enterprises	236,719.0	231,076.4	236,446.8	239,539.8	246,921.7	246,022.1	249,574.5	245,365.7	252,682.4	335,856.7	314,570.7	326,125.3	346,374.7
Claims on other financial institutions	8,075.9	6,214.4	7,490.5	6,272.9	5,761.5	5,269.0	5,005.1	5,455.6	6,418.6	7,601.6	7,056.5	7,926.6	7,270.7
Money	298,289.2	272,668.9	270,400.5	266,021.5	269,489.1	271,838.7	270,254.8	261,566.6	252,356.1	274,115.2	289,195.3	302,827.1	342,816.3
Quasi-money	158,955.0	156,767.4	165,962.9	170,147.5	174,648.6	177,133.2	177,645.5	176,241.0	181,936.3	245,937.7	232,550.5	250,089.1	285,823.5
Limited-access deposits	6,270.5	10,651.7	11,085.2	12,281.8	16,298.0	16,176.7	18,238.4	15,990.8	22,270.4	31,773.1	29,545.5	20,872.2	22,595.1
Money-market instruments	42,435.9	29,736.3	38,930.0	38,765.0	39,634.3	37,520.5	38,911.8	39,084.0	37,407.5	37,028.8	32,914.8	33,814.6	43,311.9
Capital accounts	213,461.6	206,293.0	216,798.3	217,247.4	220,751.7	209,358.6	221,883.8	225,245.1	211,441.5	202,523.8	210,069.5	220,956.3	275,707.6
Other (net)	—43,739.2	—44,300.2	—42,445.6	—22,242.2	—27,177.0	—44,951.6	—43,151.0	—43,206.5	—45,386.1	73,870.2	81,449.4	114,343.8	44,687.4

This table is based on analytical accounts of monetary authorities and credit institutions and includes both ruble and foreign-currency accounts.

Table 28

MAJOR GKO—OFZ MARKET INDICATORS IN 1998 (January—August)

Month	Outstanding volume at par*	Outstanding volume at market value*	Exchange monthly turnover at par	Exchange monthly turnover in money terms	Over-the-counter monthly turnover at par	Over-the-counter monthly turnover in money terms	Daily average turnover index**	Average market portfolio duration***
	billion rubles						%	days
January	390.9	324.87	51.84	45.97	4.66	4.18	1.04	317.0
February	402.26	354.73	74.15	65.12	6.36	5.53	1.27	302.8
March	415.71	368.7	90.05	79.84	7.63	6.79	1.40	316.8
April	429.37	372.65	74.94	63.92	5.40	4.59	1.12	315.6
May	435.31	328.05	79.94	62.98	4.97	4.23	1.30	313.6
June	436.05	316.75	97.38	74.25	0.00	0.00	1.31	299.9
July	394.27	289.86	123.58	94.86	0.00	0.00	1.40	310.2
August****	387.05	231.81	34.18	26.75	0.00	0.00	0.88	315.9

* Trading volume as of last day of month.

** The ratio of daily trade turnover to outstanding volume at par.

*** Average time to redemption of all GKO and OFZ issues, weighted by outstanding volume at market value.

**** Data for August 1 to 14, 1998.

Table 29

MAJOR GKO MARKET INDICATORS IN 1998 (January—August)

Month	GKO outstanding volume		Monthly average GKO market portfolio index*		Monthly average GKO turnover index**		Monthly average GKO share of outstanding volume***	Monthly average GKO share of turnover	Average GKO market portfolio duration
	at par	at market value	simple	effective	simple	effective			
	billion rubles		% p.a.						
January	277.81	239.61	32.95	35.52	33.40	35.57	71.01	85.47	134.5
February	285.82	257.84	32.09	34.43	33.56	35.40	71.17	83.76	134.7
March	288.74	261.95	25.57	26.92	26.58	27.56	69.97	77.92	144.3
April	290.46	259.19	28.69	30.27	30.31	31.26	68.54	77.87	149.2
May	292.47	229.17	45.32	49.84	46.74	50.37	67.21	74.58	151.0
June	281.39	218.94	59.19	66.61	59.36	65.48	66.10	69.83	143.3
July	223.90	183.37	71.48	84.49	71.12	85.34	60.92	74.09	133.3
August	216.68	140.61	99.99	129.00	97.13	131.58	56.36	88.20	128.6

* Average yield weighted by maturity and outstanding issue volume at market value.

** Average yield weighted by maturity and secondary market turnover.

*** Average share in outstanding volume is calculated as the average monthly share of outstanding GKO at market value in overall GKO—OFZ market volume.

Table 30

MAJOR OFZ-PK MARKET INDICATORS IN 1998 (January—August)

Month	OFZ-PK volume		Average OFZ-PK market portfolio index*				Average OFZ-PK turnover index**				OFZ-PK average % share of		Average OFZ-PK market portfolio duration
	at par	at market value	simple		effective		simple		effective		volume	turnover	
			on taxexempt issues	on taxable issues	on taxexempt issues	on taxable issues	on taxexempt issues	on taxable issues	on taxexempt issues	on taxable issues			
	billion rubles		% p.a.										days
January	42.22	38.58	57.62	162.15	51.49	45.60	60.55	120.93	34.12	89.59	12.26	5.38	298.5
February	42.22	42.21	32.41	115.08	32.97	48.61	28.51	77.86	31.23	48.39	11.78	4.55	308.9
March	42.22	44.29	31.14	57.69	25.82	33.82	26.64	75.09	25.94	33.62	11.17	5.11	314.4
April	42.22	44.11	43.13	60.29	26.04	35.80	31.09	59.22	26.96	35.94	10.80	3.42	325.8
May	42.22	40.64	40.66	109.16	47.50	49.33	45.25	146.32	61.35	49.32	10.50	1.40	305.3
June	42.22	39.86	65.20	219.51	62.51	77.05	64.34	225.54	56.94	78.68	10.28	1.95	308.2
July	42.22	43.37	140.31	109.11	130.03	98.24	85.58	79.27	133.33	98.41	10.30	2.71	327.4
August	42.22	40.41	75.40	143.15	105.10	113.00	75.42	169.53	104.97	114.16	10.94	1.39	314.0

* Average yield to coupon payment weighted by coupon maturity and outstanding volume.

** Average yield to coupon weighted by coupon maturity and secondary market turnover.

Table 31

MAJOR OFZ-PD MARKET INDICATORS IN 1998 (January—August)

Month	OFZ-PD outstanding volume		Average effective OFZ-PD market portfolio index*	Average effective OFZ-PD turnover index**	Average OFZ-PD share of outstanding volume	Average OFZ-PD share of turnover	Average OFZ-PD market portfolio duration
	at par	at market value					
	billion rubles						
January	65.47	41.26	33.39	33.39	16.73	9.35	1,102.2
February	69.92	50.18	36.83	36.83	17.06	11.69	1,069.5
March	81.41	58.90	29.70	29.70	18.86	16.97	984.6
April	93.35	65.85	32.05	32.05	20.66	18.72	961.8
May	97.27	54.81	35.87	35.86	22.30	24.03	929.3
June	110.67	56.19	58.12	58.12	23.62	28.23	968.5
July	127.65	62.58	79.63	79.59	28.78	23.19	898.2
August	127.65	50.28	77.85	77.53	32.70	10.40	870.2

* Average effective maturity- and outstanding volume-weighted yield to redemption.

** Average effective yield to redemption weighted by maturity and secondary market turnover.

Table 32

GKO—OFZ PRIMARY MARKET OPERATIONS IN 1998 (billion rubles)

Month	Auction placements				Redemption volume		Amount of coupon payments	
	GKO		OFZ-PD		GKO	OFZ-PK	OFZ-PK	OFZ-PD
	volume at par	returns	volume at par	returns				
January	29.78	24.26	0.83	0.57	25.04	0.00	1.01	0.00
February	35.45	27.63	4.45	3.00	27.78	1.09	0.32	0.00
March	34.79	27.94	8.30	6.40	32.61	0.96	0.07	3.51
April	34.62	26.68	7.33	4.94	32.16	0.00	1.27	1.14
May	27.24	20.98	3.51	2.21	27.25	0.00	1.04	0.00
June	15.79	11.64	11.52	6.04	28.93	1.58	1.43	2.64
July	2.93	2.50	8.92	4.80	34.69	1.27	1.65	1.11
August	0.00	0.00	0.00	0.00	9.97	0.00	0.50	0.00

Table 33

ADDITIONAL GKO AND OFZ SALES AND PRIOR REDEMPTION IN SECONDARY MARKET IN 1998 (billion rubles)

Month	Additional placements in secondary market				Secondary market redemption	
	GKO		OFZ-PD		GKO	
	volume	returns	volume	returns	volume	costs
January	0.45	0.38	0.00	0.00	0.00	0.00
February	0.34	0.27	0.00	0.00	0.00	0.00
March	3.57	3.00	3.19	2.39	2.83	2.70
April	0.26	0.20	4.61	3.18	1.01	0.96
May	3.73	3.03	0.41	0.32	1.71	1.66
June	2.06	1.55	1.88	1.04	0.00	0.00
July	1.81	1.58	8.06	4.46	0.00	0.00
August	2.75	2.71	0.00	0.00	0.00	0.00

Table 34

GKO—OFZ-RELATED BUDGET REVENUES AND EXPENDITURES (billion rubles)

Month	Volume placed	Returns	Volume redeemed	Costs
January	31.06	25.21	25.04	25.04
February	40.23	30.90	28.87	28.87
March	49.85	39.73	36.40	36.27
April	46.82	35.00	33.16	33.12
May	34.89	26.55	28.96	28.91
June	31.26	20.27	30.51	30.51
July	21.72	13.34	35.96	35.96
August	2.75	2.71	9.97	9.97

Table 35

REPO OPERATIONS IN GKO—OFZ MARKET

Month	First-session average overnight repo rate	First-session average 2-day repo rate	Second-session average repo rate	First-session overnight repo volume	First-session 2-day repo volume	Second-session repo volume
	% p.a.			billion rubles		
January	0.00	32.57	36.33	0.00	6.78	1.52
February	0.00	36.10	40.58	0.00	9.35	0.49
March	0.00	22.38	32.43	0.00	5.81	0.52
April	0.00	25.16	30.00	0.00	7.34	1.10
May	151.77	50.70	47.50	0.66	6.86	5.17
June	80.31	73.36	85.88	3.13	5.05	1.80
July	96.12	75.44	80.96	0.96	4.33	2.56
August	102.13	71.29	74.00	0.28	1.49	1.03

Table 36

MAJOR OBR MARKET INDICATORS IN 1998

Month	OBR outstanding volume*		Secondary trade turnover		Monthly average OBR market portfolio index**		Monthly average OBR turnover index***		Average OBR market portfolio duration
	at par	at market value	at par	at market value	simple	effective	simple	effective	
	billion rubles				% p.a.				
September	1.63	1.55	1.86	1.74	80.13	116.64	63.13	89.99	27.8
October	1.94	1.87	1.97	1.90	54.92	71.12	52.28	68.44	34.7
November	1.98	1.92	1.54	1.50	40.82	49.58	41.32	50.30	24.9
December	2.27	2.20	3.05	2.93	48.10	60.15	50.79	64.13	20.5

* Outstanding volume as of last day of month.

** Average yield weighted by maturity and outstanding issue volume at market value.

*** Average yield weighted by maturity and secondary market turnover.

Table 37

REPO OPERATIONS IN OBR MARKET

Month	First-session average repo rate	Second-session average repo rate	First-session repo volume	Second-session repo volume
	% p.a.		million rubles	
November	25.38	53.08	1,075.58	0.00
December	29.29	59.47	240.16	1.19

Table 38

FOREIGN CASH OPERATIONS BY RUSSIAN AUTHORISED BANKS IN 1998* (US\$ bn)

Type of Operation	1998					For reference: 1997
	Q1	Q2	Q3	Q4	Year total	
Total foreign cash brought into Russia	16.0	16.2	15.9	7.1	55.1	104.3
of which:						
— brought in by banks and entered to cash accounts	4.9	4.4	5.3	1.4	16.1	37.5
— bought from resident banks	3.6	3.6	3.4	1.4	11.9	27.1
— bought from individuals and accepted for conversion**	4.3	4.7	3.9	2.3	15.3	27.3
— accepted from individuals to be entered to their currency accounts**	2.7	3.1	2.8	1.6	10.3	9.6
Total foreign currency spent	15.8	16.4	15.8	7.2	55.2	104.2
of which:						
— taken out of Russia by banks and written down from cash accounts	0.1	0.1	0.1	0.1	0.4	0.4
— sold to resident banks	3.7	3.6	3.3	1.4	12.0	29.0
— sold to individuals and paid out through conversion**	6.1	6.1	5.1	2.5	19.8	56.2
— paid out to individuals from their currency accounts**	5.4	6.2	6.9	2.9	21.4	15.8

* Based on form I-N reports, except for foreign cash operations that are part of interbranch turnover.

** Including operations with resident and nonresident individuals.

Table 39

BALANCE OF RESIDENTS' AND NONRESIDENTS' FOREIGN CASH OPERATIONS IN 1998 (billion US dollars)

	1998					For reference: 1997
	Q1	Q2	Q3	Q4	Year total	
Bought by individuals and received through conversion	6.1	6.1	5.1	2.5	19.8	56.2
Withdrawn by individuals from their foreign-currency accounts	5.4	6.2	6.9	2.9	21.4	15.8
Total	11.6	12.3	12.0	5.4	41.2	72.0
Sold by individuals and passed for conversion	4.3	4.7	3.9	2.3	15.3	27.3
Deposited by individuals in their foreign-currency accounts	2.7	3.1	2.8	1.6	10.3	9.6
Total	7.1	7.8	6.7	3.9	25.6	36.8
Net household operations	4.5	4.5	5.2	1.5	15.7	35.2

Table 40

FOREIGN EXCHANGE OFFICES OF AUTHORISED BANKS AND THEIR BRANCHES REGISTERED IN RUSSIA IN 1998

	1998					For reference: 1997
	Q1	Q2	Q3	Q4	Year total	
No. of exchange offices in operation as of end of accounting period	10,857	10,804	10,560	10,306	10,306	11,295
No. of exchange offices registered during accounting period	642	852	695	987	3,176	4,219
No. of exchange offices closed during accounting period	1,080	905	939	1,241	4,165	4,629

Table 41

**STRUCTURE OF LICENCES AND PERMITS ISSUED BY BANK OF RUSSIA AND ITS REGIONAL BRANCHES
FOR FOREIGN EXCHANGE OPERATIONS RELATED TO CAPITAL FLOW
(registered in the electronic database as of December 31, 1998)**

	No. of permits issued	Amount of payments permitted, billion dollars	For reference: 1997	
			No. of permits issued	Amount of payments permitted, billion dollars
Permits to place funds abroad, total	723	3.36	731	3.10
of which:				
— Direct and portfolio investments	56	0.01	109	0.19
— Commercial (trade) loans	604	1.17	559	1.87
Permits for making borrowing from abroad, total	429	9.22	864	22.19
of which:				
— Direct and portfolio investments	51	0.60	436	0.79
— Financial loans	247	8.20	350	19.75
Permits providing for capital movement under certain conditions	192	4.74	168	4.10
of which:				
— Guarantees and warranties	34	4.45	35	4.10

Table 42

BANK REHABILITATION BY BANK OF RUSSIA REGIONAL BRANCHES

Region	No. of operating institutions as of December 31, 1998	No. of credit institutions requested to present rehabilitation plans in 1998						No. of credit institutions which presented rehabilitation plans in 1998		No. of credit institutions whose financial condition improves thanks to rehabilitation plans agreed with regional CBR branches	No. of credit institutions that decided to reduce authorised capital
		Total	of which credit institutions with inadequate capital (NI<2) and a backlog of unpaid settlement documents as of 31.12.1998	credit institutions with inadequate capital (NI<2) as of 31.12.1998	credit institutions with a backlog of settlement documents unpaid for more than 30 days as of 31.12.1998	credit institutions with NI<2 capital inadequacy as of 31.12.1998 but without settlement documents unpaid for more than 30 days	No. of credit institutions with licences revoked as of 31.12.1998	Total	including those required to present rehabilitation plans in 1998		
Republic of Adygeia	5	3	0	0	1	0	0	3	3	2	1
Republic of Altai	5	1	0	0	0	0	0	2	1	0	0
Altai Territory	10	2	0	0	0	0	0	4	2	1	0
Amur Region	6	2	0	0	2	0	0	3	2	3	0
Arkhangelsk Region	6	1	0	0	0	0	0	4	1	0	0
Astrakhan Region	5	0	0	0	0	0	0	0	0	0	0
Republic of Bashkortostan	16	8	0	0	3	0	2	9	8	0	0
Belgorod Region	8	1	0	0	0	0	0	1	1	0	0
Bryansk Region	3	1	0	0	0	0	0	1	1	0	0
Republic of Buryatia	6	3	0	2	0	0	0	4	1	1	0
Vladimir Region	3	2	0	0	1	0	1	2	2	1	0
Vologograd Region	7	2	0	0	1	0	2	4	1	0	0
Vologda Region	12	1	0	0	0	0	0	2	1	0	1
Voronezh Region	4	3	1	1	1	1	0	3	3	0	0
Republic of Daghestan	52	0	0	0	0	0	0	0	0	0	0
Jewish Autonomous Region	0	1	0	0	1	0	1	1	1	0	0
Ivanovo Region	6	1	0	0	0	0	0	2	1	1	0
Ingush Republic	4	2	2	2	2	2	0	2	2	0	0
Irkutsk Region	14	7	0	0	4	0	2	7	7	0	0
Kabardino-Balkar Republic	6	6	0	0	0	0	2	3	3	1	1
Kaliningrad Region	14	1	0	0	1	0	0	2	1	1	1
Republic of Kalmykia	4	6	0	1	1	0	3	4	4	0	0
Kaluga Region	7	3	0	1	0	0	0	4	3	0	0
Kamchatka Region	8	1	1	1	1	1	0	1	1	1	0
Karachai-Cherkess Republic	8	1	1	1	1	1	0	1	1	0	0
Republic of Karelia	1	1	0	0	1	0	1	1	1	0	0
Kemerovo Region	17	4	2	2	2	2	0	4	4	0	1
Kirov Region	3	0	0	0	0	0	0	1	0	0	0
Republic of Komi	8	0	0	0	0	0	0	3	0	0	0

Cont.

Region	No. of operating institutions as of December 31, 1998	No. of credit institutions requested to present rehabilitation plans in 1998						No. of credit institutions which presented rehabilita- tion plans in 1998		No. of credit institutions whose financial condition improves thanks to rehabilitation plans agreed with regional CBR branches	No. of credit institutions that decided to reduce authorised capital
		Total	of which credit institutions with inadequate capital (N1<2) and a backlog of unpaid settlement documents as of 31.12.1998	credit institutions with inadequate capital (N1<2) as of 31.12.1998	credit institutions with a backlog of settlement documents unpaid for more than 30 days as of 31.12.1998	credit institutions with N1<2 capital inadequacy as of 31.12.1998 but without settlement documents unpaid for more than 30 days	No. of credit institutions with licences revoked as of 31.12.1998	Total	including those required to present rehabilitation plans in 1998		
Kostroma Region	6	2	1	1	1	1	0	3	2	2	0
Krasnodar Territory	30	7	1	1	3	1	0	7	6	2	0
Krasnoyarsk Territory	14	5	0	0	3	0	1	4	4	0	0
Kurgan Region	6	3	1	1	2	1	0	3	3	2	0
Kursk Region	1	1	0	0	0	0	1	1	1	0	0
Leningrad Region	4	0	0	0	0	0	0	0	0	0	0
Lipetsk Region	2	2	0	0	0	0	0	2	2	0	0
Magadan Region	3	1	0	0	0	0	0	1	1	2	1
Republic of Marii El	1	0	0	0	0	0	0	0	0	0	0
Republic of Mordovia	7	4	0	0	0	0	1	3	3	1	0
Moscow	667	78	11	13	27	9	3	101	51	19	0
Moscow Region	35	4	0	0	2	0	3	3	2	0	2
Murmansk Region	3	2	0	0	1	0	1	2	2	0	0
Nizhni Novgorod Region	22	0	0	0	0	0	0	4	0	0	2
Novgorod Region	3	0	0	0	0	0	0	1	0	0	0
Novosibirsk Region	16	2	0	0	1	0	0	2	2	0	0
Omsk Region	9	2	0	0	0	0	0	2	2	2	0
Orenburg Region	11	4	0	0	2	0	0	4	4	3	0
Orel Region	2	0	0	0	0	0	0	0	0	0	0
Penza Region	3	0	0	0	0	0	0	0	0	0	0
Perm Region	13	4	0	0	2	0	1	4	3	0	0
Primorski Territory	11	5	0	1	2	0	0	5	5	0	0
Pskov Region	5	0	0	0	0	0	0	0	0	0	0
Rostov Region	25	13	0	0	5	0	5	11	10	2	0
Ryazan Region	7	3	0	0	0	0	1	2	2	0	0
Samara Region	25	6	0	0	2	0	0	6	4	2	2
St. Petersburg	41	11	1	1	2	1	0	9	7	0	0
Saratov Region	21	1	0	0	0	0	0	7	1	3	2
Republic of Sakha (Yakutia)	10	6	0	0	4	0	0	6	6	4	0
Sakhalin Region	6	0	0	0	0	0	0	0	0	0	0
Sverdlovsk Region	33	12	2	6	3	2	0	12	12	0	0
Republic of North Ossetia — Alania	9	3	0	0	0	0	0	2	2	2	0
Smolensk Region	4	0	0	0	0	0	0	0	0	0	0
Stavropol Territory	14	4	0	0	2	0	3	4	4	0	0
Tambov Region	2	1	0	0	0	0	0	1	1	1	0

End

Region	No. of operating institutions as of December 31, 1998	No. of credit institutions requested to present rehabilitation plans in 1998						No. of credit institutions which presented rehabilita- tion plans in 1998		No. of credit institutions whose financial condition improves thanks to rehabilitation plans agreed with regional CBR branches	No. of credit institutions that decided to reduce authorised capital
		Total	of which credit institutions with inadequate capital (N1<2) and a backlog of unpaid settlement documents as of 31.12.1998	credit institutions with inadequate capital (N1<2) as of 31.12.1998	credit institutions with a backlog of settlement documents unpaid for more than 30 days as of 31.12.1998	credit institutions with N1<2 capital inadequacy as of 31.12.1998 but without settlement documents unpaid for more than 30 days	No. of credit institutions with licences revoked as of 31.12.1998	Total	including those required to present rehabilitation plans in 1998		
Republic of Tatarstan	28	10	3	3	3	2	0	10	8	0	2
Tver Region	10	7	1	2	2	1	0	7	7	3	0
Tomsk Region	5	4	0	0	2	0	1	3	3	0	0
Tula Region	9	4	0	0	0	0	0	3	3	0	0
Republic of Tuva	3	0	0	0	0	0	0	1	0	0	0
Tyumen Region	37	15	1	1	2	1	0	15	9	1	0
Udmurt Republic	14	10	0	0	5	0	0	8	7	3	0
Ulyanovsk Region	7	4	0	0	3	0	3	4	3	0	0
Khabarovsk Territory	7	4	0	0	1	0	1	1	1	1	1
Republic of Khakasia	2	0	0	0	0	0	0	0	0	0	1
Chelyabinsk Region	13	2	0	0	1	0	0	2	2	2	0
Chita Region	3	1	0	0	0	0	1	1	1	0	0
Chuvash Republic	8	6	0	1	2	0	2	6	6	2	0
Yaroslavl Region	11	3	1	1	2	1	0	1	1	1	0
Total	1,476	320	30	43	110	27	42	352	249	72	18

Table 43

CONTROL OVER LIQUIDATION OF CREDIT INSTITUTIONS

Region	Licences revoked*		Deleted from State Register		Subject to liquidation	Liquidation decisions taken				No. of liquidation commissions set up (receivers appointed)		No. of liquidation balance sheets approved			
	total	in 1998	total	in 1998		total		in 1998		total	in 1998	interim		final	
						inl. compulsory liquidation		inl. compulsory liquidation				total	in 1998	total	in 1998
Republic of Adygeia	7	2	0	0	7	7	7	5	5	7	6	2	1	0	0
Republic of Altai	8	2	1	1	7	7	4	3	1	7	3	3	3	1	1
Altai Territory	17	7	0	0	17	14	12	5	4	11	3	3	1	1	1
Amur Region	5	3	1	0	4	4	4	4	4	4	4	0	0	0	0
Arkhangelsk Region	8	3	2	1	6	2	2	0	0	2	0	2	1	0	0
Astrakhan Region	8	1	0	0	8	7	1	1	0	5	1	2	0	0	0
Republic of Bashkortostan	16	3	2	2	14	12	11	3	2	12	7	7	6	2	2
Belgorod Region	3	1	0	0	3	3	3	1	1	3	1	1	0	0	0
Bryansk Region	7	1	2	0	5	5	4	2	2	5	2	3	1	0	0
Republic of Buryatia	5	4	0	0	5	3	2	2	2	3	2	0	0	0	0
Vladimir Region	4	3	0	0	4	3	3	2	2	3	2	0	0	0	0
Volgograd Region	21	5	6	4	15	12	12	2	2	13	7	6	4	1	1
Vologda Region	7	1	3	2	4	4	4	1	1	4	2	3	1	0	0
Voronezh Region	3	0	3	2	0	0	0	0	0	0	0	0	0	0	0
Republic of Daghestan	54	11	0	0	54	41	34	25	21	17	15	0	0	0	0
Jewish Autonomous Region	4	2	1	1	3	2	2	1	1	2	2	0	0	1	1
Ivanovo Region	3	0	0	0	3	3	3	1	1	3	1	2	2	0	0
Ingush Republic	1	0	0	0	1	1	1	0	0	1	1	0	0	0	0
Irkutsk Region	9	2	0	0	9	7	4	3	3	6	3	3	1	0	0
Kabardino-Balkar Republic	6	1	1	1	5	4	2	3	2	4	4	3	2	0	0
Kaliningrad Region	15	1	2	2	13	13	10	4	4	13	7	2	1	0	0
Republic of Kalmykia	9	4	1	1	8	6	4	2	2	6	3	4	0	0	0
Kaluga Region	8	0	1	1	7	7	7	1	1	7	3	3	2	0	0
Kamchatka Region	4	0	1	0	3	3	0	0	0	3	0	3	0	0	0
Karachai-Cherkess Republic	6	1	3	1	3	2	2	0	0	2	1	0	0	0	0
Republic of Karelia	5	1	2	1	3	2	2	1	1	2	1	0	0	0	0
Kemerovo Region	7	1	0	0	7	7	7	2	2	7	3	3	1	0	0

Cont.

Region	Licences revoked*		Deleted from State Register		Subject to liquidation	Liquidation decisions taken				No. of liquidation commissions set up (receivers appointed)		No. of liquidation balance sheets approved			
	total	in 1998	total	in 1998		total		in 1998				interim		final	
						inl. compulsory liquidation		inl. compulsory liquidation		total	in 1998	total	in 1998	total	in 1998
Kirov Region	8	1	0	0	8	8	1	2	0	8	2	7	3	0	0
Republic of Komi	8	2	2	0	6	4	4	1	1	4	1	2	1	2	2
Kostroma Region	7	3	0	0	7	7	3	4	3	7	4	3	1	1	1
Krasnodar Territory	42	11	7	2	35	32	31	12	11	31	15	18	9	2	2
Krasnoyarsk Territory	15	3	2	2	13	12	12	3	3	12	6	3	3	4	4
Kurgan Region	3	0	1	0	2	2	2	2	2	1	1	1	0	0	0
Kursk Region	5	2	2	2	3	3	1	2	0	3	3	0	0	0	0
Leningrad Region	4	1	0	0	4	4	2	1	0	4	1	2	1	0	0
Lipetsk Region	6	2	1	0	5	5	4	4	3	4	4	2	1	0	0
Magadan Region	5	0	2	0	3	3	3	1	1	3	1	1	0	0	0
Republic of Marii El	9	0	2	1	7	7	7	1	1	6	1	6	2	0	0
Republic of Mordovia	4	2	0	0	4	4	3	2	2	4	2	1	0	0	0
Moscow	355	45	20	12	335	286	279	132	132	162	104	21	16	12	11
Moscow Region	17	7	4	2	13	7	7	5	5	6	4	1	0	0	0
Murmansk Region	9	2	0	0	9	9	8	3	3	8	4	2	0	1	1
Nizhni Novgorod Region	10	5	0	0	10	8	7	3	3	7	2	3	1	0	0
Novgorod Region	2	1	0	0	2	2	1	1	0	2	1	1	1	0	0
Novosibirsk Region	20	0	2	2	18	18	15	6	6	18	14	4	4	0	0
Omsk Region	9	4	1	1	8	8	8	7	7	8	8	2	2	0	0
Orenburg Region	15	4	3	1	12	12	4	5	1	12	6	10	4	0	0
Orel Region	1	1	0	0	1	1	1	1	1	1	1	0	0	0	0
Penza Region	5	2	1	0	4	2	0	0	0	2	0	2	0	0	0
Perm Region	8	2	0	0	8	7	6	4	3	7	4	1	0	0	0
Primorski Territory	14	7	0	0	13	10	7	5	4	10	8	3	1	0	0
Pskov Region	6	1	2	1	4	4	2	1	0	4	1	4	2	0	0
Rostov Region	31	8	14	7	17	11	10	5	4	11	6	1	1	1	1
Ryazan Region	3	1	0	0	3	3	2	3	2	3	3	1	0	0	0
Samara Region	16	0	1	0	15	15	15	2	2	15	3	10	2	2	2
St. Petersburg	16	1	3	2	13	12	10	2	2	11	1	2	0	0	0
Saratov Region	14	3	4	4	10	8	6	3	2	8	3	5	5	2	2

End

Region	Licences revoked*		Deleted from State Register		Subject to liquidation	Liquidation decisions taken				No. of liquidation commissions set up (receivers appointed)		No. of liquidation balance sheets approved			
	total	in 1998	total	in 1998		total		in 1998				interim		final	
						inl. compulsory liquidation		inl. compulsory liquidation		total	in 1998	total	in 1998	total	in 1998
Republic of Sakha (Yakutia)	18	11	1	1	18	15	4	11	3	13	10	8	7	0	0
Sakhalin Region	17	1	2	0	15	15	9	2	1	15	4	14	7	0	0
Sverdlovsk Region	22	1	4	3	18	16	13	4	4	16	7	4	1	0	0
Republic of North Ossetia — Alania	3	0	0	0	3	2	2	0	0	2	0	2	1	0	0
Smolensk Region	7	0	3	3	4	4	0	0	0	4	0	4	1	0	0
Stavropol Territory	21	5	1	0	20	21	19	11	9	2	10	2	1	0	0
Tambov Region	3	0	1	1	2	2	2	0	0	2	2	1	1	0	0
Republic of Tatarstan	15	2	4	0	11	9	6	4	4	9	5	5	1	0	0
Tver Region	11	2	2	0	8	8	6	1	0	8	4	2	0	0	0
Tomsk Region	13	6	4	1	10	8	8	5	5	8	5	1	1	2	2
Tula Region	4	2	0	0	4	3	0	1	0	3	1	0	0	0	0
Republic of Tuva	1	0	0	0	1	0	0	0	0	0	0	0	0	0	0
Tyumen Region	28	2	2	0	26	24	19	14	14	22	16	5	1	1	1
Udmurt Republic	9	3	2	1	7	7	6	3	3	7	4	3	1	0	0
Ulyanovsk Region	12	4	1	1	11	8	5	3	2	8	4	6	4	1	1
Khabarovsk Territory	14	3	1	0	13	12	8	3	2	12	4	4	2	0	0
Republic of Khakasia	3	0	0	0	3	3	3	0	0	3	0	3	1	0	0
Chelyabinsk Region	7	0	3	2	4	4	4	0	0	4	0	4	3	0	0
Chechen Republic	18	0	18	0	0	0	0	0	0	0	0	0	0	0	0
Chita Region	7	3	1	0	6	4	3	1	0	4	2	1	0	0	0
Chuvash Republic	8	3	0	0	8	5	5	2	2	6	3	3	2	1	1
Yaroslavl Region	4	0	2	1	2	2	2	0	0	2	1	2	1	0	0
Total	1,162	229	158	73	1,004	867	732	362	317	702	381	248	123	38	37

* Data on credit institutions with revoked licences include credit institutions on which licence-revocation procedure was halted.

Table 4.4

NOTE STRUCTURE OF BANK OF RUSSIA 1997-ISSUE CURRENCY IN CIRCULATION AT DECEMBER 31, 1998

Denomination, rubles	Amount in circulation, million rubles	Percent share
500	51,438.90	26.6
100	94,390.70	48.7
50	39,770.30	20.5
10	7,897.10	4.1
5	220.7	0.1
Total banknotes in circulation	193,717.70	100.0

Table 45

DYNAMICS OF OLD CURRENCY WITHDRAWAL FROM CIRCULATION AND 1997 CURRENCY ISSUE

1998	Withdrawal of old currency, billion rubles	1997 currency issued, billion rubles
January	43.9	32.5
January—February	69.5	61.6
January—March	90.8	82.2
January—April	104.2	104.3
January—May	112.8	114.4
January—June	119.7	121.6
January—July	125.4	126.1
January—August	128.4	133.5
January—September	130.3	156.3
January—October	131.7	170.0
January—November	132.7	174.7
January—December	134.4	196.4

Table 46

QUALITY CHARACTERISTICS OF BANK OF RUSSIA SENIOR EXECUTIVES AND SPECIALISTS (%)

Personnel quality characteristics	Bank of Russia system as a whole		of which:									
			Regional branches (National Banks)		Cash settlement centres		Central apparatus		Organisations		Banking schools	
	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998
Staffing levels	95.5	95.7	94.5	95.9	98.4	98.3	87.1	83.2	91.0	94.9	98.2	98.7
Specialists with higher and specialised secondary education	90.8	92.2	94.2	95.0	87.9	91.8	91.4	92.6	90.0	85.1	95.1	96.5
Specialists with higher education	54.1	57.3	73.3	74.9	33.6	38.6	82.0	83.8	58.5	53.4	80.9	76.7
Length of work less than 3 years	24.8	23.0	30.1	24.5	10.9	8.9	30.9	28.0	59.7	55.8	17.8	22.2
Length of work 10 years and more	29.0	27.6	25.7	25.4	36.4	36.0	23.7	24.0	12.3	10.7	37.1	37.7
Aged under 30	23.8	23.3	21.7	21.3	27.5	27.4	24.2	24.0	17.6	17.7	15.5	15.9
Aged over 50	12.6	13.7	13.9	15.1	8.5	8.5	22.5	23.1	18.7	18.8	29.7	35.6
Pension age	4.1	3.2	4.1	3.4	3.5	2.3	6.4	6.5	4.1	3.7	9.4	7.3
Staff reduction	2.8	4.7	2.5	2.7	2.8	3.2	4.2	5.7	3.7	7.8	4.8	10.8
Voluntary reduction	2.1	2.5	2.0	2.2	1.9	2.7	3.0	3.4	2.7	2.5	4.2	5.5

Table 47

CLAIMS AND SUITS BROUGHT AGAINST BANK OF RUSSIA REGIONAL BRANCHES IN 1998 (thousand rubles)

Subject of dispute	Claims				Suits								
	Total		Met		Total		Met		Decisions disputed			Total recovered	
	number	amount	number	amount	number	amount	number	amount	appeal	cassation	supervision	number	amount
Banking operations	87	4,229,114.8	2	28.4	413	14,247,742+\$15,376	29	13,431	28	46	6	8	15,343
of which:													
Settlements	78	4,210,409.5	2	28.4	174	12,101,294	18	9,061.5	18	14	2	4	810.11
Lending					79	49,069			1	1			
Entry reversal					2	1,089.2	1	5.66	1			1	5.66
False Russia Cheques					1	120.5			1				
False letters of advice													
Other	9	18,705			153	1,969,836+\$15,376	10	4,364	6	27	4	3	14,528
Economic activities	117	43,445.4	7	32.7	132	2,401,926.19	38	12,222	26	36	7	18	4,218.1
of which:													
Lease	5	810.7	1	1.8	9	2,319,131	1	17.5	4	3	1		
Property reclamation	1	1,707.5			7	2,165.9	1	72.4				1	72.4
Contracts	10	581.04	2	10	14	1,941.6	2	280.38		1		1	4.18
Taxes	68	35,168			70	72,110	30	11,796	18	19	2	14	4,115.6
Other	33	5,178.2	4	20.9	32	6,577.8	4	56.3	4	13	3	2	26
Appeals against Bank of Russia decisions	3				37	62	5	118	13	14	5		
of which:													
Refusal of licence													
Use of sanctions under Article 75 of Central Bank Law	3				9		1		5	6	1		
Licence revocation					7		3		4	4	2		
Labour disputes	3	3.9			82	1,707.24	22	710.57	1	32	4	7	136.65
of which:													
Reinstatement in one's job					28	598.63	11	186.43		10	1	2	3.51
Other	3	3.9			54	110,861	11	522.836	1	22	3	5	133.136
Other not included in points 1—4	38	11,315	5	3,244.86	245	694,618.345+\$4,288	15	1,331.2	23	27	2		
Total:	248	4,283,879.1	14	3,305.96	909	17,346,056+\$19,664	109	27,812.8	91	155	24	33	19,697.8

Table 48

CLAIMS AND SUITS BROUGHT BY BANK OF RUSSIA REGIONAL BRANCHES IN 1998 (thousand rubles)

Subject of dispute	Claims		Suits					Total suits met	
			Brought		Appealed against by defendants				
	No.	amount	No.	amount	appeal	cassation	supervision	No.	amount
Banking operations	118	256,545.6	96	250,265.3	4	4		162	199,428.49
of which:									
Settlements	90	34,883	32	57,299	3	2		110	38,225
Lending	25	221,148	64	192,966	1	2		49	160,688
Economic activities	185	22,636.16	81	27,781.77	15	4	1	149	25,323
of which:									
Lease	92	11,290	19	7,598.9	5	1	1	50	5,304
Purchase-sale, delivery	65	44,791	18	2,878.8	1			54	3,086.3
Property reclamation	7	4,229.1	21	16,644	6	2		24	16,656
Commercial banks	2,709	162,624	1,139	16,235	45	32	3	2,897	70,227.67
of which:									
Bankruptcy (insolvency) disputes	5	250	114	237.5	18	17	2	112	470
Use of sanctions under Article 75 of Central Bank Law	2,695	141,895	914	7,622.7	18	11	1	2,680	50,202
Compulsory liquidation			106		9	4		95	
Other	127	192,424	137	408,156	12	11	1	150	394,562
Total:	3,139	634,230	1,453	702,438	76	51	5	3,358	689,541

Table 49

AUDITS OF BANK OF RUSSIA INSTITUTIONS, ORGANISATIONS AND ENTERPRISES IN 1998

Type of institution, organisation or enterprise	Total number of institutions, organisations and enterprises as of December 31, 1997	Of these audited in accounting year	
		No.	% of total
Regional branch (national bank)	79	42	53
Cash settlement, cash and settlement centres	1,328	1,046	79
Computer centres	30	15	50
Policlinics (health centres)	47	40	85
Banking schools	13	7	54
Holiday hotels and centres	26	14	54
Children's summer camps	2	1	50
Motor pools	2	2	100
Public catering establishments	54	39	72
Other	8	6	75
Inter-regional depositories	17	17	100
Field institutions	147	136	93
Total	1,753	1,365	78

Table 50

SUBJECTS OF AUDITS CONDUCTED BY THE CHIEF AUDITOR'S SERVICE IN 1998

Subject of audit	Number
Fulfilment of Bank of Russia Orders Nos. 02-35 and OD-12 on settlements related to money and valuables collection	25
Transition to new chart of accounts after ruble re-denomination	86
Availability of approved regulations on structural subdivisions and office instructions for personnel, paperwork management	2
Legality of loans extended to employees, bonus payments for results of work in 1997—1998	39
Capital expenditure on construction, contracts and payments to contractors	15
Compliance with interbank settlement rules; operations with budget funds at all levels	9
Use of cars and related expenditures	3
Compliance with staff remuneration rules; salaries and other payments, travelling expenses and their accounting	15
Cash issue management; safe keeping of cash and other valuables in cash departments and store-rooms	13
Income reporting by banks	3
Licensing banks in the securities market	1
Admittance and internal security procedures	2
Compliance with Bank of Russia Letter No. 08-17/2,012, dated May 29, 1998	8
Compliance with valuables accounting rules	14
Cash issue and accounting, bank expenditures in field institutions	128
Personnel management, transition to treasury system of budget execution in field institutions	42
Remedial action on shortcomings discovered by previous audits	80
Total	485

Table 51

BANK OF RUSSIA SHARES IN OVERSEAS BANKS' AUTHORISED CAPITAL AS OF DECEMBER 31, 1998

Bank	Currency	Total voting shares (stakes) held by Bank of Russia as of December 31, 1997	Total voting shares (stakes) held by Bank of Russia as of December 31, 1998	Bank of Russia % share of authorised capital as of December 31, 1998	Bank of Russia % share of voting stock as of December 31, 1998
Ost-West Handelsbank, Frankfurt-am-Main	DM	48,600,000.00	106,600,000.00	82.0	82.0
Eurobanque, Paris*	FrF	945,302,903.65	945,852,903.40	77.8	77.8
Moskovsky Narodny Bank, London**	£	480,309,444.00	480,309,444.00	88.9	88.9
Donau-Bank, Vienna	ATS	490,000,000.00	490,000,000.00	49.0	49.0
East-West United Bank, Luxemburg	LuxF	605,000,000.00	605,000,000.00	49.0	49.0
Yurasko Bank, Zurich***	SwF	997,500.00	0.00	0.0	0.0

* By a certificate issued to the Bank of Russia.

** Excluding the shares of nominal shareholders recorded in the Bank of Russia balance sheet.

*** Bank of Russia withdrew from the capital of Yurasko Bank AG, Zurich, in accordance with the requirements of Article 7 of the Federal Law on the Central Bank of the Russian Federation (Bank of Russia).

Table 52

BANK OF RUSSIA SHARES IN AUTHORISED CAPITAL OF RUSSIAN CREDIT INSTITUTIONS AND OTHER ORGANISATIONS (thousand rubles)

Name of organisation	As of December 31, 1997	As of December 31, 1998		
	Amount of shares (stakes) held by Bank of Russia (at nominal value)	Amount of shares (stakes) held by Bank of Russia (at nominal value)	Bank of Russia % share of authorised capital	Bank of Russia % share of voting stock
Sberbank	382,500.05	432,500.20	57.66	61.78
Vneshtorgbank	617,403.00	617,403.00	96.89	96.89
Interstate Bank	2,500.00	10,000.00	50.00	50.00
MICEX	3,858.00	7,371.00	7.06	7.06
Non-profit partnership National Depository Centre	7,750.00	12,750.00	44.35	46.58

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