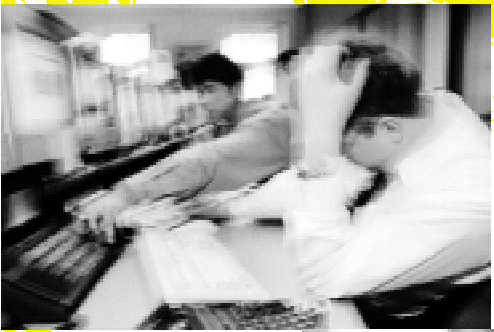
pre-payments basis. So far, these measures combined with a relatively tight monetary approach, allowed the CBR to maintain a fairly stable nominal rouble /dollar rate.

Moreover, according to estimates of the Ministry of Finance (MoF), the real rouble rate even strengthened somewhat by year-end, exhibiting a 1.4% appreciation (annualized) based on estimates for a Real Effective Exchange Rate (REER). Russia's gross international reserves, although declining slightly within the first 10 months of the year, recovered by year-end, reaching $12.5 bln (as opposed to $11.6 bln at the start of 1999). Consumer price inflation for the year was 36%, not far above the targeted level of 30%.



Tight fiscal policy

With the Russian government's gradual understanding of the need to implement a balanced budget policy, expenditures actually began to match revenue targets in 1999, resulting in the first primary budget surplus of the year – 2.2% of GDP and 0.2% above expectations – for the whole of 1999. Revenues collected were also higher than planned, attaining 13.7% of GDP. A significant trend was the decline in non-monetary transactions, resulting in an increased inflow of cash. Still, 1999 ended with a deficit of 1.4% of GDP, as expenditures amounted to some 15% of GDP. Notwithstanding Russia's default on former Soviet debt due in 1998-1999, the government continued to honor Russian Federation external debt in full and on time. In 1999, the government's tight budget policy combined with the continued economic recovery – spurred by the import substitution effect and surging oil prices – allowed for greater stability and consistency in the fiscal realm. With its credibility marginally improved, the government was able to partly restore the investor confidence lost as a result of the 1998 crisis. A remarkable achievement of the previous year was an increase in foreign direct investment (FDI), which grew from $3.6 bln to $4.3 bln during 1999. Nevertheless, aggregate foreign investment in Russia – consisting of FDI, portfolio investment and loans – fell in 1999. Any governmental efforts to stimulate domestic and foreign investment in Russia would provide a welcome impetus to the country's still-fragile economic growth.

Conclusion

There is every reason to expect the positive economic trends of 1999 to continue, and 2000 is likely to be another good year for Russia, as far as the economy is concerned. But, keeping one's fingers crossed for high oil prices will not be enough. For Russia to embark on the path of sustainable economic growth, it is imperative to improve the investment climate – the Russian economy needs investment like an organism needs oxygen – and to create conditions promoting growth as a prerequisite to structural reforms. What is needed are the usual well-known but difficult-to-achieve prescriptions: a strengthening of Russia's weak state institutions, protection of property rights, ensuring a level playing-field in business, improving the tax system, increasing domestic and foreign investment, restructuring the banking system, implementing workable land reform and reviving the financial markets.

Russian Banking Sector
Overview

Russia's Banking System – New Landscape & New Challenges

The Russian banking system is currently undergoing the largest structural shift in its history. The post-crisis picture of the Russian banking landscape is significantly different from that which existed before the August 1998 crisis. New banking groups appeared in place of old financial-industrial groups which were swept away by the rouble devaluation and the government's default on its domestic debt. There is renewed competition in the current environment, presenting huge opportunities for foreign and state-owned banks, which are likely to continue to increase their market share at the expense of Russian private banks.

The 'Seven Dwarfs': Russian banks are small

While there are over one thousand banks in the Russian banking sector, there is still plenty of room for growth both in terms of size and quality.

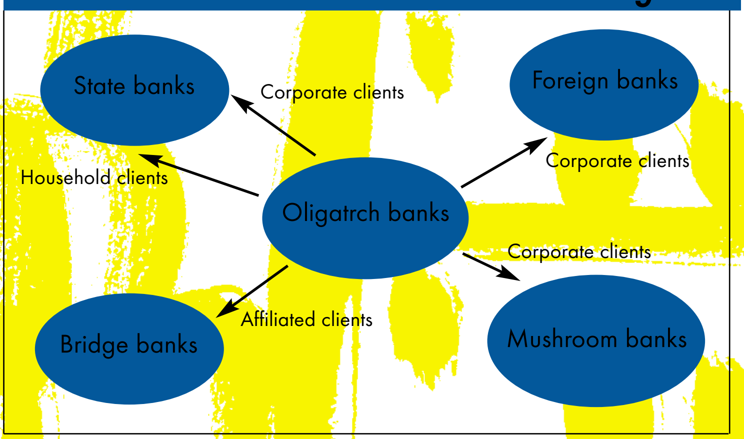
The size of the biggest Russian banks is still extremely small compared to Russia's huge industrial companies. Even state-owned Sberbank – the largest Russian bank – was ranked 172 in terms of capital in the September 1999 issue of The Banker. The four other Russian banks present in the list were somewhere in the 300s. Thomson BankWatch, in its December 1999 review of the Russian banking system, notes that, by a net asset comparison, Sberbank is smaller than the average regional bank in the United States, while other Russian banks are simply ants within the global financial system. The huge imbalance between Russia's industrial behemoths and its dwarf-like banks is explicitly illustrated by statistics: banking intermediation in Russia, as a proportion of loans to GDP, stood at a level of just 10% for 1999, and the share of banking assets to GDP was only 32% as of November 1999.

The number of banks in Russia is nevertheless large: even after the Central Bank revoked 224 banking licenses in the aftermath of the 1998 financial crisis, the total number of licensed Russian banks remains at 1349 as of December 1999. Such a large number can be partly attributed to the sheer size of the country in geographical terms, and in part, to the poorly-regulated wave of bank creations in the early 1990s. The process of creating new banks was effectively put to a stop by the Central Bank in the mid-1990s – since 1996, the number of Russian banks fell about 1000 from nearly 2500. In our view, this trend is set to continue for the foreseeable future – according to the Central Bank, one out of six currently "functioning" institutions is considered insolvent, with many still officially "solvent" banks having simply lost all their business.

Trading places – customer migration

Among the biggest losers, we can find almost all of Russia's pre-crisis Top 20 financial institutions – where all the best Russian corporate accounts and the majority of non-Sberbank household deposits were concentrated. The competition between "survivor" banks for business was the major focus in 1999. Migrating customers, which have transferred their business from such pre-crisis titans as SBS Agro, Inkombank, MENATEP, UNEXIMbank and others, have strengthened three major banking groups – state-owned banks, foreign banks and a group of "mushroom" banks. However, the business of companies affiliated with collapsed banks was shifted to "bridge" banks – yet another new concept on the Russian banking scene.

Customer Migration



The new environment – new roles for old banks

State-owned banks

The major post-crisis development in the banking sector is the renewed dominance of the state-owned banks, primarily Sberbank, Vneshtorgbank, Vnesheconombank, and some newly-emerged state banks (such as Rosselkhozbank, Russian Development Bank/Rossijsky Bank Razvitija and others). Sberbank, in which the Central Bank holds a 58% stake, is the undisputed leader in retail deposits with an 80% market share, mopping up the majority of household deposits from collapsed banks. Vneshtorgbank is currently a leader in the export-import market. In late 1999, its charter capital was increased by RUR 14 bln by the Central Bank, its majority shareholder with a 99% stake. Vnesheconombank, another state-owned giant, managed to acquire the accounts of some partially state-owned companies (i.e. weapons exporters).

"Bridge" banks

Bridge banks – Rosbank, MENATEP-St. Petersburg, Impexbank and others – emerged from the shell structures of the bankrupt, oligarch-related banks, taking with them their remaining performing assets and affiliated client base. The emerging entities are:

- UNEXIMBank / Rosbank
- SBS-Agro / 1-OVK
- Rossijsky Kredit / Impexbank
- MENATEP / MENATEP St. Petersburg

The strengths of the bridge banks derive primarily from the advantages inherited from their parent companies, in particular, a strong clientele, sophisticated infrastructure and management expertise. One example is MENATEP-St. Petersburg, which inherited 45 branches of the former MENATEP, allowing the bank to expand its network in 40 Russian regions.

"Mushroom" banks

These are banks that were less invested in the risky GKO and forward markets than other large non-state banks, and did not seek foreign financing. This category includes Alfa Bank, Guta Bank, MDM Bank, Sobinbank, IMB, and IIB. Not only did they survive and avoid a run on their deposits, but their ratings improved (in terms of both assets and capital), their client base expanded significantly, and they are currently in the process of expansion.

Banks within this group have expanded actively, increasing their branch networks in the regions. Alfa Bank, one of the biggest success stories among Russia's private commercial banks, received substantial credits from ARCO, the state-owned bank restructuring agency, for its regional expansion and increased its branches from 3 to 14. Guta Bank, after acquiring Moscow region's Unikombank (which lost its banking license), now has 30 branches in the regions (up from 2) and tripled its staff following a decision to purchase the defunct Inkombank's branch network. Another example is Bank of Moscow, which acquired Mosbusinessbank's branch network, as well as some small banks, and is now operating in over 30 regions. Promstroybank St. Petersburg expanded as a result of its purchase of some SBS Agro and Inkombank infrastructure.

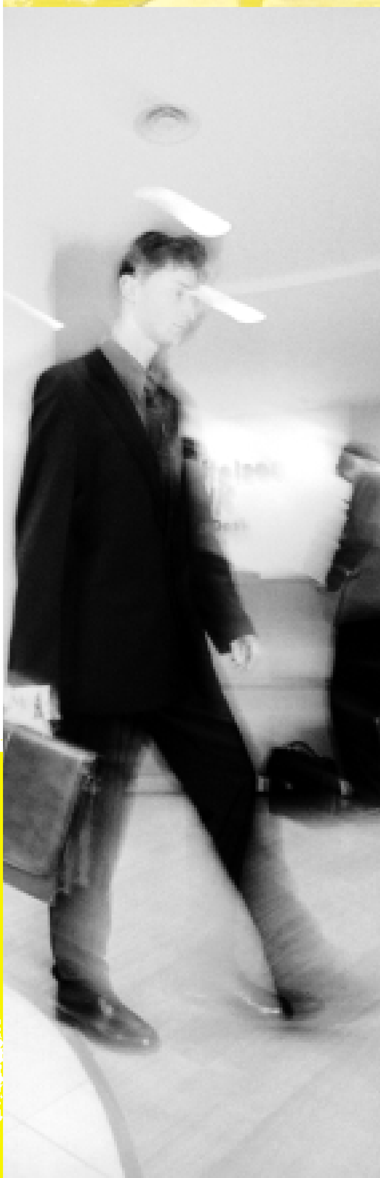
Foreign banks

Foreign bank subsidiaries were also hit by the 1998 crisis, but with the assistance of parent institutions, have been recapitalized and renewed their attack on the Russian market. Most foreign banks benefited directly from the crisis as Russian clients fled from domestic banks to safer havens, leading to a large increase in banking business. The share of foreign banks' capital within the banking system rose from 6.5% to nearly 12% in 1999, and the number of foreign bank subsidiaries increased from 18 to 21.

Regional and other banks

Russian banks in the regions were, for the most part, severely hit by the 1998 crisis. Initially, after the crisis, regional banks had hoped to receive financial support from regional governments. However, given the budget deficits existing in most regions, any plans for regional banks to enjoy a greater role in the Russian banking system are unlikely to materialize in the foreseeable future.

As far as other private banks are concerned, it is worth noting the 'pocket' banks, the most important of which is Gazprombank, servicing the operations of Gazprom, Russia's largest company.



Competition – the major trends

Not only did we see a number of new banking groups appear on the scene in 1999, but also the evolution of a totally new competitive framework. Below is a brief outline of the major trends we believe are likely to impact on the Russian banking sector over the next few years.

The role of government to remain important

The state-owned banks will continue to increase their market share. While the positions of Sberbank and Vneshtorgbank are not likely to be seriously challenged in the next several years, other state and quasi-state banks may enter the market. Vnesheconombank will likely continue with its aggressive client policy; in 1999, the bank gained many state or state-affiliated clients. Several new entrants are likely to appear, such as Rosselkhozbank, specializing in agricultural loans, and Russian Development Bank (Rossijsky Bank Razvitija) focusing on state investment programs. In addition to these, the Russian government – through ARCO – will retain control over an extensive network of ARCO-controlled regional banks as well as some larger banks (e.g. SBS Agro, Rossijsky Kredit). These banks will have the advantage of easy access to companies affiliated with the government and/or regional administrations.

Transition from financial speculation to traditional commercial banking

While foreign banks did indeed benefit from the additional "free" clientele looking for a new home, Russia's financial markets were devastated by the 1998 crisis. With more exotic financial instruments no longer available, banks were forced to concentrate on traditional banking business – corporate lending. This shift coincided with a surge in Russian domestic industrial production, which resulted in increased demand for rouble loans by domestic producers. Rouble-denominated lending of Russian banks to Russian companies – which, in the immediate aftermath of the August crisis had fallen by 13.1% to end-1998 – nearly doubled in nominal terms from January to October 1999. In the meantime, the share of securities as a percentage of total banking assets dropped from the pre-crisis level of 30% to 22% (as of November 1999). Over the same period, the share of equities and promissory notes as a proportion of total banking assets also declined, from 9% to just 6%. This trend is likely to continue in 2000 and beyond, while a revival of financial speculation on the pre-crisis scale is now considered unlikely. Therefore, banks with traditional banking experience and highly skilled management expertise – mostly foreign and bridge banks – are likely to enjoy major advantages over the other banks.

Retail banking – the low-risk approach to dominate

In the retail banking sector, the competitive environment was also radically altered in the year following the crisis. After the run on bank deposits in August-September 1998, household rouble and dollar-denominated deposits increased by 31% and 15%, respectively, from January to November 1999. However, their share of total bank liabilities did not return to the pre-crisis level of 25%, reaching approx. 20% on November 1, 1999.

Clearly, the retail market has huge growth potential. According to various estimates, Russians keep only 5-20% of their savings in bank deposits, which translates into at least $50 bln kept "under the mattress". With this figure in mind, the leading role of Sberbank (which recently increased its share of the retail deposit market to 80%) does not look all that impressive after all.

The favored slogan in the retail deposit market now seems to be "low risk" – diametrically different from the "high yield" approach which held sway for many years. A low-risk approach offers opportunities for foreign banks, which aggressively entered this market segment in late 1999. Foreign banks are now attracting the higher-end of the retail clientele – high net worth individuals, whom we are able to offer an unrivaled set of services in Russia. In our view, foreign banks will dominate the high-end retail deposit segment, while Sberbank will lead at the lower end of the market.

However, the competitive picture in the retail market might yet again be radically changed within the next several months, if the Russian parliament finally approves the State Guarantee Program for Household Deposits. The consensus is that such legislation will likely be adopted if not this year, then certainly in 2001. With the Program's adoption, Sberbank and other banks under ARCO management will lose their competitive advantage over other Russian banks in competing for low-end clients.

Access to foreign financing will be limited to a few banks

While foreign financing is likely to be the major source of recapitalization for the Russian banking sector, access to the international capital markets will be restricted for the majority of Russia's banks. We see the option of tapping the debt markets as viable only for those banks which have honored their forward contracts. This group includes all foreign banks, Sberbank and Vneshtorgbank, but virtually no bank from any other group.

Despite their formally clean balance sheets, the new-born "bridge" institutions are well-known in the market due to their predecessors tainted reputations. Negative sentiment towards them on the part of the western banking community is likely to disappear only in the medium to long term, so there is at present little likelihood that the international capital markets will be open to them.

Another wave of Russian bank failures coming?

While some of the larger Russian banks managed to survive the crisis due to their low exposure to both hard currency financing and government securities, the third major problem – their high proportion of non-performing loans as assets – is still in place. Such banks, which are mainly concentrated in the "mushroom" bank category, are likely to collapse in the near future, once again freeing up new clients.

Conclusion

For a dynamic development strategy in the existing Russian banking sector environment, management must be prepared to offer a wide range of high-quality services for corporate and individual clients, with particular attention to limiting risk. Successful Russian companies, along with high net worth Russian individuals and foreign companies operating in Russia, represent the major target client groups for the development of a successful banking business in Russia.