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Macroeconomic comments by Dr. Dieter Wermuth to the article “Russia cuts bank reserve requirements” by Catherine Belton as of 10 October, 2007:

Original article:

Russia cuts bank reserve requirements

By Catherine Belton in Moscow

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Russia's central bank is to lower minimum reserve requirements for banks from Thursday as it battles a growing liquidity squeeze in the Russian banking system following the US subprime crisis. The decision comes as part of a number of measures designed to fend off a potential liquidity crisis during the next few months. Alexei Ulyukayev, Russia's first deputy central banker, on Wednesday told reporters the central bank had also accepted banks' credits as collateral for loans for the first time as part of a package to boost liquidity. Mr Ulyukayev said the first such loan was extended to state-controlled VTB, which received Rbs6.9bn (\$277m) at an annual rate of 7.5 per cent, taking the bank's credits to state-run Rosneft as collateral. Analysts and bankers say Russia's giant state-controlled banks are set to play a crucial role in staving off a crisis by buying up the credit portfolios of smaller players harder hit by the liquidity squeeze. VTB has said it is in talks with three consumer lenders on buying up their credit portfolios. The central bank has been pumping about \$2.5bn into the system every day via one-day repo auctions since the last week in September, when monthly tax payments fell due. Liquidity started to dry up in the system in August after global investors fled Russian money markets in the wake of the US subprime crisis and the global credit squeeze. The central bank registered a net private capital outflow of \$9.4bn in the third quarter of 2007 compared with a capital inflow of \$52.7bn in the previous quarter. Russian banks, especially consumer lenders, have funded rapid growth by borrowing heavily on international markets. "There isn't enough funds available to support normal operations so the banks need to borrow every day via repo operations," said Natalya Orlova, chief economist at Alfa Bank in Moscow. Mr Ulyukayev has warned refinancing demands could rise to \$12bn-\$15bn per day in October and November. Renaissance Capital calculates \$7.15bn in eurobond issues and about Rbs40bn [\$1.5bn] in ruble bond issues have been postponed since the crisis hit. Some bankers and analysts have warned that smaller and less well known companies and banks could default unless state banks intervene. Mr Ulyukayev has said the central bank can meet refinancing demand for up to Rbs1,500bn. But analysts said many of the bonds that could be used as collateral for repo or refinancing operations were held on the accounts of state banks and could not be traded. Fitch, the international ratings agency, yesterday downgraded the rating of Russian Standard Bank, Russia's top consumer lender, from BB to BB-.

Comments by Dr. Dieter Wermuth: The situation of the Russian banking sector is quite heterogeneous. Banks with large deposits now hesitate to supply funds to banks without such deposits (whose credit rating is going down). This aggravates the problems caused by the new difficulty of borrowing abroad. The Russian central bank has thus been forced to cut reserve requirements (which frees liquidity sitting in central bank accounts) and to launch large-scale liquidity injections. The standard applied to the collateral has significantly been reduced, as the article says. In the euro area, only high-grade tradable securities are accepted, but the CBR is even accepting regular loans. This shows that some banks are in deep trouble and will probably go under. This is good because a lot of fly-by-night banks have been founded recently (even though Russia, as a country, is not overbanked yet). But the problem is that this, in turn, could cause bank runs. Deposit insurance covers only a small portion of deposits. Another effect could be a flight to safe euro and dollar assets which would tend to weaken the rouble, ie reverse its appreciation against the dollar and accelerate its depreciation against the euro. It is likely, though, that the CBR will try to contain this (for price stability reasons) by selling foreign currencies and buying roubles. Still, the situation is clearly dangerous, in spite of sound macro fundamentals. It could also be that the Russian real estate sector which has been rather bubbly is in for some price declines. Since a large portion of house and apartment purchases has been in the form of cash, the effect on banks is probably limited. There is a lack of transparency in this regard, however. As a minimum, the Russian banking sector now faces a new wave of consolidation. Real GDP growth which is in the order of 8% will probably cool somewhat, as will inflation.