

Macroeconomic Review and Outlook

The Kremlin,
view from the "Bolschoi
Kamenni" Bridge



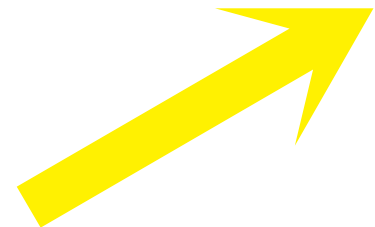
● The year 2001 was a banner year for Russia in terms of progress made in the area of reform. Against a backdrop of continued political stability and soaring presidential approval ratings, Vladimir Putin's government launched a series of wide-ranging reforms aimed at dismantling the obsolete Soviet-era legislative base and laying the foundation for a well-functioning market economy. In this context, the highlight of the past year was the Land Code, which authorised the sale of urban



*The Kremlin,
view from the "Bolschoi
Kamenni" Bridge*

land, removing the last significant ideological barrier to the free market. Other major achievements include the Labour and Criminal Procedural Codes, pension system and judicial reform, in addition to a number of initiatives aimed at easing tax burdens and improving the environment for small and medium-sized businesses. The next year should see further progress in banking sector reform, improvement of bankruptcy procedures and restructuring of Russia's natural monopolies.

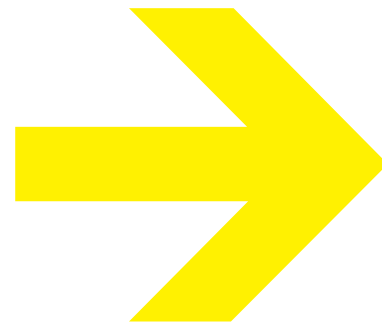
● The Kremlin's main political challenge in 2002 is likely to be the implementation of reform across the country's eleven time zones. Last year the Kremlin managed to bring the bulk of regional legislation into line with the Russian Constitution – an integral step in establishing a unified legal infrastructure throughout the country. Likewise, President Putin has evidenced the government's political will to challenge vested interests in Russia's state-controlled companies and ministries in order to restore



Economic Indicators	1998	1999	2000	2001	2002e
GDP, % yoy	-4.9	5.4	9.0	5.0	3.5
GDP, USD bn	312.6	181.6	250.8	309.2	331.7
Industrial Production, % yoy	-5.2	11.0	11.9	4.9	4.0
Capital Investment, % yoy	-6.7	4.5	18.0	8.7	7.0
CPI-Inflation eop, %	27.7	85.7	20.8	18.6	15.0
Central budget balance, % GDP	-5.4	-1.7	2.3	2.4	1.5
Exports, USD bn	74.8	75.7	105.6	103.5	101.0
Imports, USD bn	59.5	39.6	44.9	52.5	58.0
Export growth (% yoy)	-16.0	1.3	39.5	-2.0	-2.4
Import growth (% yoy)	-19.2	-33.4	13.4	16.9	10.5
Current account, US\$ bn	2.4	25.0	46.3	34.5	18.5
Current account, % GDP	0.8	13.8	18.5	11.1	5.6
Gross FX-reserves, USD bn	12.2	12.5	28.0	36.7	45.0
Interest rate (3mGKO, eop, % p.a)	—	23.4	12.8	14.7	15.0
Exchange rate / USD eop	10.2	24.8	28.1	30.1	33.0

Source: MinFin, Bank of Russia, Goskomstat, Raiffeisenbank

transparency and sound corporate governance. Progress has also been made in the drive to integrate with Western economic and political organizations, and WTO membership could become a reality in 2003. Notwithstanding the above, continued progress in strengthening Russia's judicial system is vital for the realization of Putin's vision of a "rule of law."




General outlook – on the road to normality

● The most accurate characterisation of Russia's development over the last two or so years is that it has begun the transformation to a normal economy, with all the relevant implications for politics, corporate behaviour and financial markets. A spectacular performance of 8.3% GDP growth in 2000, was followed by a surge in GDP of

Garden,
Moscow centre





5.2% in 2001. This growth was accompanied by a continuous strengthening of Russia's finances, evidenced by:

- ▣▶ robust current account (expected at \$34 bn in 2001);
- ▣▶ high fiscal surplus (2.4% of GDP in 2001);
- ▣▶ surging corporate profits (15% of GDP, \$33.1 bn total for the first nine months of 2001);
- ▣▶ boosting of currency reserves and appreciation of the ruble, stability of the FOREX market, further monetarization of the economy.

● The major benefits of these developments, respectively, are:

- ▣▶ easing in external debt payments and suppression of inflation;
- ▣▶ skyrocketing domestic fixed-capital investment; 18% growth in 2000 was followed by 8–9% growth in 2001; and the long-awaited start of restructuring in the industrial sector;
- ▣▶ revival of Russia's banking sector and a boost for the corporate bond market.

● Economic growth, supported by growth in internal demand, and fuelled by re-investment of profits (still, however mostly generated in export-oriented industries), should continue in 2002, though its pace will be increasingly determined by the extent of the global economic slowdown — primarily falling oil prices. GDP growth in 2002 of up to 4% seems a reasonable target, emphasizing the degree to which Russia's economy has started to gain immunity from dependence on raw material exports.

Strength and risks:

Business climate

One of the major advantages of the improvements in the business climate is undoubtedly improved stability, result-

ing in greater predictability of the major economic parameters.

Progress in reforms directed towards creating a market economy

The process of reforms has commenced by focusing on the less complex issues, primarily those requiring changes in existing legislation (tax, de-bureaucratization). In 2002 the major focus should be directed towards “heavy-weight” structural reforms (land, pension, natural monopolies, banking reforms). These reforms will, however, require substantial political will to resist the vested interests associated with the areas of reform. The risk of a lack of progress in the real implementation of these reforms does, therefore, remain high.

Rational and sound fiscal policy, allowing financial stability and ensuring timely and full payment of debts

As evidenced during 2001, there has been a demonstration of a willingness on the part of the government to retire some of the country’s foreign debt in advance (\$2.5bn to IMF in November – December 2001).

Monetary policy, however, is lacking viable instruments

The primary tool of monetary policy within the country continues to be exchange rate regulation. It was only in the latter part of 2001 that the Central Bank attempted to use interest rates and open market operations as a means of monetary policy.

*Tverskaya street,
Moscow centre
on Sunday*



The major fear related to Russia's continued progress, – oil prices – remains for 2002 and beyond

Though falling prices should not be fatal for the country, they may, nevertheless, result in a substantial slowdown in restructuring and development, limiting the funds available for structural changes.

High exposure to global economic development

● The risks associated with a high level of exposure to global economic development still remain present although, as recent developments in the industrial sector and budget performance indicate, these risks are clearly diminishing. The signs of economic recovery are undoubtedly positive in the short run, however Russia is still an emerging, and, therefore, high-risk market, and its long-term growth prospects are still cause for concern.

● Along with the continuation of the process of reform, the pace of Russia's economic development and the ability of domestic industry to rally further, depend directly on the scale of investment activity and hence on the development of a trustworthy financial system. Lending by banks, and other types of credit based financing, and the presence of well-functioning financial markets as a means of providing sufficient capital mobility, are of vital importance for positive development in 2002 and beyond.

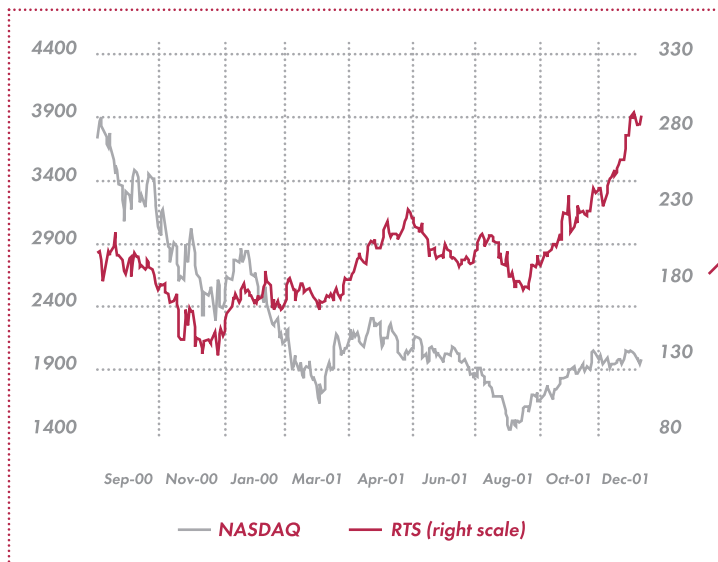
● Russia's sovereign rating was upgraded 6 times by Standard & Poor's during the period from 1 January 2000 till January 2002, from CCC/SD to B+.

● Sentiment for Russia's assets over 2001 remained positive, supported by in excess of two years of strong economic performance, and recent improvements in the country's foreign and domestic political situation. As market sentiment has become more favourable for the Russian government, investors have significantly revised country risk assessments, which is in turn reflected in the dynamics of sovereign yields and spreads.

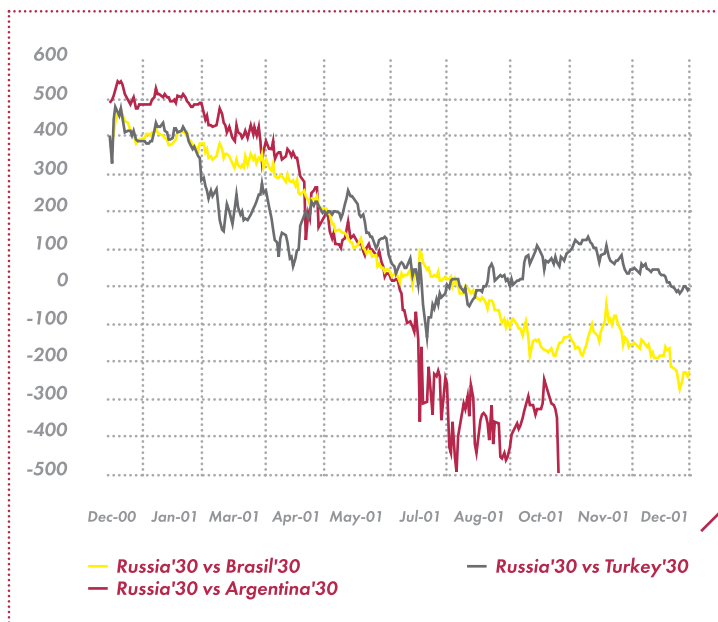
● Russian Eurobonds have posted spectacular performance during 2001 in general, and in particular during the latter months of 2001. Spreads of Russia's sovereign

Financial markets

Russia's asset performance:



Russia's stock market performance
Source: Reuters



Russian Eurobonds performance versus Argentina, Brazil, and Turkey
Source: Reuters



Petrovski Passage,
Moscow centre

Eurobonds within the year have tightened by 400-700 bps, and an even more remarkable performance was shown by MinFin bonds (OVVZs).

- This trend is set to continue in 2002 as well, albeit at a slower pace, and a further narrowing of 100-150 bps in spreads for the longest issues should be seen as an achievable target.

Stock market

- In 2001 the RTS index demonstrated outstanding performance by any standards, appreciating by 98.5%.

- A significant element of this growth was witnessed in the last quarter of 2001, with the index skyrocketing from 179.9 on October 1 to 260.05 by year-end, an increase of 44.6%.

- Corporate expectations for 2002 are falling, however, many companies have downgraded their economic outlook.

We believe that the primary driver

behind the flourishing stock market has been a dramatic fall in yields on Russian government bonds.

- We would, however, like to express a word of caution. In our view, the recent upsurge may have gone a little too far, and the current level may not be sustainable based on fundamentals. Whilst we do not view the current situation as a bubble set to burst, it is probable that a fair correction should not come as a surprise.

Tverskaya street,
Moscow centre at night

