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Russia: What Now For Structural Reforms? - Steady Progress

With the approaching political season (Duma elections in December 2003, presidential elections in March 2004), it is generally expected that the pursuit of economic-structural reforms will pause. In this note we look into this issue, as well as present key reform “road posts” to look out for in the autumn/winter 2002-03. Our analysis points to a different perspective, suggesting that while some specific reform areas will most likely not be pursued at the pace they otherwise might have, others will be pursued. In conclusion, the enforcement of approved reforms will continue and progress in certain established reform priorities could be expected. Taken together, the reform process will continue to motivate a constructive view on Russian financial assets.

- **What can be said about Russia’s economic-structural reform pursuit is the following: Over the last 2.5 years progress has been a lot *more* than what was generally expected but *less* than what was targeted. Over the coming 1.5 years, it is likely that progress will be *more* than *now* generally expected, but also *less* than what optimally could be wished for. When the next presidential elections are concluded in the spring of 2004, the period between now and then will most likely be looked at as a period when Russia’s ambitious reform project on balance continued, in a steady albeit gradual way, i.e. that Russia’s “convergence project” has continued.**
- **This multi-speed, continuation of economic-structural reforms we expect will continue to motivate a constructive view on Russian assets. This is especially so in the context of preserved macroeconomic stability, a strong external balance, a continuous falling debt burden and a conservative debt strategy, fiscal control and economic growth and ongoing broadening of the domestic investor base.**

Russia: Selected Key Reform “Road Posts”, Autumn/Winter 2002-03

Reform area	Event
UES/energy sector reforms	First Duma reading on October 9, ambition to have all three Duma readings this winter
Civil service/administrative reforms	Draft laws and reform programs to be presented October-November
Financial system reforms: Law on Deposit Insurance	The government to discuss the Law on October 24, then to be submitted to the Duma
Financial system reforms: Law on Currency Regulation and Currency Control	The government to discuss the Law on October 17, then to be submitted to the Duma for readings in November
Financial system reforms: the 2003 monetary policy program	To be approved by the Duma by December 1 (already submitted to the Duma)
Pension reforms: private pension fund legislation	Concluding full Duma approval of pension reform legislation, particularly that with regards to the role of private pension funds
WTO reforms: the new Customs Code	The second Duma reading scheduled for November, third by year-end.
Business de-bureaucratization: the new Law on Technical Regulation	Approved in a first reading in June 2002, remaining readings during the autumn session
The 2003 budget	Approved in a first reading on September 25, second reading on October 18, targeting all required readings by early December
Gas sector reforms	Government meeting on December 3 to discuss draft gas sector reform program

Source: The Russian government, The Ministry of Finance, the Ministry for Economic Development and Trade, SSSB.

- **In particular, we would expect ongoing and increasingly visible progress in financial system reforms over the coming 1-2 years (this autumn: Duma approval of laws establishing a deposit insurance system and liberalizing currency market regulation), pushed by the ambitious new Central Bank leadership. Also, we expect the eventual approval of the controversial UES/energy sector reforms (with implementation stretched out over a longer time period). We expect the completion of drafting civil service/administrative reform programs and the presentation of new laws in this issue, the full approval of the 2003 budget, the full Duma approval of a new Customs Code as well as of the business de-bureaucratization Law on Technical Regulation, and the completion of pension reform-related laws. Finally, it is likely that a gas sector reform program draft will be put on the table by early December. On the other side, reforms where we would expect less progress than what otherwise could have been expected, or little movement at all, include natural monopoly tariff-re-balancing, municipal reforms, army reforms and social system reforms.**
- **We are though not proposing complacency with regards to assessing Russia's ongoing structural reform effort. Rather, we would point to real risks being less obvious. Political-economic dynamics complicating important reforms *could* (but might not) emerge from a confluence of issues usually seen as *only* beneficial for Russia: very high oil prices and the passing of the debt service peak. For example, the confluence of very high oil prices and the passing of the debt service peak could imply political momentum to press ahead with certain reforms moderate, which is especially important as these factors also coincide with an increasing need to reform budget expenditures. It will be difficult to cut the tax burden further in a couple of years' time, if not budget expenditure are restructured and reformed.**

1. Russia's economic-structural reforms and the political cycle

A mainstream assumption is that the approaching electoral cycle (Duma elections in December 2003, presidential elections in March 2004) means that the pace of reforms will overall slow down already from this winter. Certainly, it is not unusual that political-economic dynamics in electoral periods tend to close or postpone reform windows for certain reforms. Russia will be no exception, and Russian policy-makers also recognize this. However, our analysis, based on in-depth discussions with a broad spectrum of policy-makers, suggests a less obvious situation and outlook.

It is expected among the political elite that the *established* reform agenda will continue to be pursued and approved reforms implemented as planned this autumn/winter and into 2003, while no *new*, major reform package should be expected to be launched. At the same time, some specific reform areas will most likely see progress moderate. In particular, the reforms where the pace is expected to be lower than what it otherwise might have been are tariff re-balancing/UES reforms, municipal services reforms, and army reforms. Also, while we do expect eventual Duma approval of the UES/energy sector legal reform package, the implementation of the UES reforms will most likely be stretched out over a longer time period. But otherwise there is an expectation that the established reform agenda will be pursued more or less as has been planned. For further details on what we expect, see below.

When assessing this situation, it is important to stress this is a rather "benign" political cycle. It is not as if Russia is faced with the threat of reform stop, reform derailment, implosion or reversal. The electoral-political cycle now approaching is not about reform direction (see further below). Thus, the "slowdown influence" the electoral cycle has on reform pursuit does not stem from a specific political agenda to halt reforms, but from an inherent tendency of electoral periods to slow things down – well-known also to developed countries.

In the Russian case, these more or less traditional political dynamics coincide with the presence of a key Russian reform constraint: the historically inherited, cumbersome, overly formalistic and slow-moving bureaucracy. Elections or not, the inflexible bureaucracy does complicate the pursuit of reforms, especially complex structural reforms, and it can be the source of individual frustration at times among reform-minded ministers¹.

Furthermore, even if there had been no elections approaching, and even if the bureaucracy was not a problem, the reform challenges at this stage are significant. Russia has now embarked on ambitious, deep, far-reaching second- and third-generation structural and institutional reforms, and some will inevitably and necessarily take time to work through the system². While the structural and institutional reforms can in principle be compared to Central and Eastern Europe, the scale, depth and magnitude of Russia's inherited challenge can not. It is against this background that the progress recorded over the last 2.5 years is particularly impressive. Indeed, the strategic situation facing Russian reforms when this year started, was the coming together of the implementation phase of previously approved reforms from 2000-2001, while at the same time moving forward on the next set of reform priorities.

However, we are not proposing complacency with regards to assessing Russia's ongoing structural reform effort. Rather, we would point to the real risks being less obvious and less obvious. In particular, political-economic dynamics complicating important reforms could emerge – but might not if policy-makers press ahead with the right choices - from a confluence of issues usually seen as *only* beneficial for Russia: very high oil prices and the passing of the debt service peak. Essentially, the confluence of very high oil prices and the passing of the debt service peak could imply political momentum to press ahead with certain reforms moderate, which is especially important as these factors also coincide with an increasingly pressing need to reform budget expenditures³. It will be difficult to cut the tax burden further in a couple of years' time, if not budget expenditure are restructured and reformed.

2. Reforms and the political landscape

As noted, the approaching political cycle is not mainly about reform direction or reform agenda or reform reversal. It is about party formation, political consolidation and the further development of political institutions. Following the 2003-04 political cycle, the Putin regime is likely to be further strengthened, from an already strong position. This means that a yet *stronger* window for further reforms could open up from spring 2004, probably heralding a serious push for such fundamental Russian reform challenges as army reforms, municipal reforms and social system reforms. Such a process is based on an already existing political and business elite consensus (outside the Communist party) regarding Russia's overall direction⁴, Putin's still overwhelmingly strong domestic support (70-78% regularly in approval ratings), the lack of an elite interest in generating a new crisis, and the further political consolidation which is likely. In addition, recent political and sociological studies have showed that the flip side of Putin's high personal approval rating is that there is a broad support across the electorate/population for the modernization, convergence and integration direction in which Russia is now heading⁵.

¹ In this sense, one can say, as Professor Mau eloquently has outlined, that there is again a need for a reform spurt of Russia's "political" institutions – the bureaucracy/civil service, the legal system and so on, in order to keep up with the pace of economic reforms. Put differently, the economic reforms and the economic transformation is faster and runs deeper than the political-institutional transformation.

² For an excellent and in-depth analysis giving the proper context for assessing Russia's post-Communist reform progress, the real challenges at hand and realistic versus unrealistic expectations, see Prof. E. Gaidar, *Subyektivnye i obyektivnye faktory v postsotsialisticheskikh ekonomicheskikh reformakh*, April 2002, mimeo.

³ This analysis is in line with that outlined by Professor Mau, Head of the Academy of the National Economy, and formerly Head of the Government's Working Centre for Economic Reforms.

⁴ Regarding the vital area of Putin's foreign policy re-orientation and its role in Russia's overall domestic transformation, the leading authority is Dmitri Trenin. See e.g. D. Trenin, "Novy kurs" Putina: povorot zakreplen. *Chto dalshe?*, Carnegie Moscow Centre, Briefing, Nr.6, 2002.

⁵ See especially the work of the leading Russian sociologist-political scientist Professor Igor Klyamkin. A recent poll showed that

The consensus among politicians and political analysts is that over the next two Duma elections (December 2003 and December 2007), the Russian political spectrum will increasingly form in a traditional European left-centre-right model. More specifically, it is expected that there will be a process of consolidation in the pro-Kremlin centre (this “project” has the name *Edinaya Rossiya*, United Russia, and includes four centrist Duma political factions), a process of consolidation on the right/liberal wing (a merger maybe, or at least deeper co-operation between the Union of Rightwing Forces and Yabloko), whereas a process of renewal is expected on the left-wing (continued erosion of the Communist Party, the emergence of new, more “modern” leftist parties - of a Socialist or Social Democratic tendency, like the new party recently launched by Duma Speaker Seleznyev). Variations on this general consensus outlook of political dynamics are that there could be some fringe parties added on either the left-side or the right-side, and that maybe the centre will be composed of a left-of-centre bloc and a right-of-centre bloc.

The key question is if these political dynamics will be first of all able to sustain politically the now initiated reform and European convergence process over the next 4-6 years, and second of all if it will be able to induce a process of elite renewal. Based on the above outlook of the political spectrum, it seems that indeed the political landscape will coalesce around continued support for Putin’s modernization agenda. While it appears clear that the pro-Kremlin political centre (whether left-of-centre or right-of-centre) will continue to strengthen and possibly on its own dominate already the next Duma, it will always be very important that there is a viable right-wing/liberal bloc, to make sure there is that constant attention to economic and structural reforms as well as to the further development of political institutions, and to avoid inertia (hence the crucial importance of the Union of Rightwing Forces). The more difficult challenge will be elite renewal, especially in the regions and in the “power ministries”.

Alongside of all of this, how to promote reforms across Russia’s regions will be one of the most important strategic challenges facing the Russian leadership over coming years. Importantly, President Putin concluded in September his most substantial trip in Russian regions since taking office. He went to a number of politically sensitive regions, with several vested interests, from the Far East, to the coal mining regions and on to Tatarstan, perhaps the single most powerful ethnic Russian republic. In all of these regions, there were plenty of temptation to “hand out” subsidies, special deals and the like. However, in contrast to this predecessor, Putin specifically refrained from handing out special deals. The message to coal miners, to the Far Eastern fleet, to Tatarstan was basically that there will be no special deals, no subsidies, but the Kremlin will listen to what various vested interests say and then try to deal with the issues within an overall effort at creating and promoting market-solutions to problems.

3. Structural reforms and the Duma autumn/winter 2002-2003 session

Supporting our analysis that reforms will on balance continue is the fact that overall the process is moving forward. Indeed, both the Duma spring session and the start to the Duma autumn session are encouraging.

Regarding the spring legislative session, the Duma concluded this busy session on July 1, approving in the last weeks many of the government’s prioritized initiatives (in total during the spring session, some 390 legal initiatives were reviewed and 108 new laws adopted). In the very last days of the session, the focus was mainly on corporate sector liberalization, through the full approval of the new Law on Bankruptcy (subsequently approved again with presidential amendments at the start of the autumn session, see below), a new Criminal-Procedural Code and a new Arbitration-Procedural Code (which among other

when asked the question “What kind of Russia do we need?”, 76% choose the answer that what was needed was a country where the interest of the individual comes first, his well-being and opportunity for development. See the very interesting report by T. Kutkovets and I. Klyamkin, *Normalnye lyudi v nenormalnoi strane*, MN, July 3, 2002.

things should end the wanton use of legal institutions to pursue business rivals), and a package of small business taxation reforms. Other highlights of the spring session included the approval of the Law on trade in agricultural land, various securities market reforms, and the approval of an alternative military draft system (linked to army reforms).

The Duma autumn session is no less ambitious. During some 25 plenary sessions, the parliament is scheduled to review a massive 548 legal initiatives, of which 150 are of a prioritized nature (27 in constitutional and state-institutional matters, 29 on economic policy, 25 on social policy, and 20 on budget and tax policy). Of the prioritized initiatives, 18 are submitted by the Kremlin and 78 by the government.

The Duma autumn session encouragingly got off to a good start (see the table below). In the first week of the Duma autumn session (week of September 9), the parliament immediately approved in the final readings a number of important capital markets and investor protection legislation. In particular, the Duma approved amendments to the Law on the securities market and to the Law on non-commercial organisations. These changes have an impact on the regulation of securities issuance, the registration of securities and the activities of financial institutions on the securities markets. A key novelty introduced in Russian securities market legislation through these changes is now “price manipulation”. The now approved amendments empower the relevant authorities to deal adequately with such practices. Furthermore, the profile Duma committees already within two weeks of the Duma autumn session recommended for approval the new version of the new Law on Bankruptcy, including the President’s recent amendments, and on September 27, with an overwhelming majority of 293 votes, the parliament approved it. Also, the UES/energy sector legal reform package was re-submitted to the Duma in the week of September 16, and a first reading is scheduled for October 9. Finally, a very large majority approved the 2003 budget on September 25 in a first reading.

Russia: Reform Action In The First Weeks Of The Duma Autumn Session, Weeks of September 9-23

Approved in third reading a series of capital markets and investor protection legislation, such as amendments to the Law on the Securities Markets and to the Law on non-commercial organizations. (In the week of September 9)
The UES/energy sector reform package submitted to the Duma, and date for first reading set as October 9. (In the week of September 16)
Approval, by an overwhelming majority of 308 votes, of the 2003 budget in a first reading on September 25.
Approval, by an overwhelming majority of 293 votes, of the amended new Law on Bankruptcy, on September 27.

Source: The Russian government, the State Duma.

4. Key structural reform road posts autumn/winter 2002-2003

Given the above analysis, the table below summarizes a select number of key structural reforms, which will be in focus this autumn and winter and for which we would expect progress. In some sense, these could make up a series of “road posts” for Russia’s reform pursuit over coming quarters⁶. The expected progress is concentrated in what we would argue are four vital areas in terms of laying the foundations for sustainable and high medium- to long-term growth: Civil service/administrative reforms (including easing the bureaucratic burden on the corporate sector, and especially working towards opening up opportunities for the small- and medium-sized business sector), legal reforms implementation (an ongoing issue, with most of the reforms already approved), financial system reforms (driven by the new CBR leadership), and business sector/de-bureaucratization reforms (WTO-related reforms such as a new Customs Code would be part of this area)⁷.

⁶ We stress that these points are merely a selection of key themes. The list of reform priorities for this autumn/winter is ambitious and long, a fact often ignored in the mainstream debate. In addition to the key themes mentioned, there are initiatives planned in fields from yet further capital market reforms to implementation of land reforms as well as tax reforms (e.g. PSA-related) and many other. Indeed, the internal government legislative plan for the second half of 2002, outlining exactly the legislative-reform initiatives planned and when certain actions are scheduled to be taken, runs into some 41 pages. See *Plan – zakonoproektnoi deyatelnosti Pravitelstva Rossiiskoi Federatsii na vtoroe polugodie 2002 g*, Pravitelstva Rossiiskoi Federatsii, August 20, 2002.

⁷ The theme of further business sector reforms is especially important, whether through de-regulation, de-bureaucratization and

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UES/energy sector reforms	First Duma reading on October 9, ambition to have all three Duma readings this winter.
Civil service/administrative reforms	Draft laws and reform programs to be presented October-November.
Financial system reforms: Law on Deposit Insurance	The government will discuss this benchmark Law on October 24 (on October 9 the final draft will be submitted to the government by the Ministry for Economic Development and Trade), and then submitted to the Duma.
Financial system reforms: Law on Currency Regulation and Currency Control	The government will discuss the Law on October 17 (the final draft submitted to the government week of September 30), then to be submitted to the Duma for readings in November. If approved, an initial consequence will be that the export revenue repatriation rule is lowered to 35% from the current 50%.
Financial system reforms: the 2003 monetary policy program	To be approved by the Duma by December 1 (already submitted to the Duma), includes outline of efforts to re-develop monetary policy instruments and the structural banking reforms.
Pension reforms: private pension fund legislation	Concluding full Duma approval of pension reform legislation, particularly that with regards to the role of private pension funds.
WTO reforms: the new Customs Code	The second Duma reading scheduled for November.
Business de-bureaucratization: the new Law on Technical Regulation	Approved in a first reading in June 2002, the remaining readings during the autumn session.
The 2003 budget	Approved in a first reading on September 25, second reading on October 18, targeting all required readings by early December.
Gas sector reforms	Government meeting on December 3 to discuss draft gas sector reform program.
Legal reforms	The bulk of the reform program is approved, so focus is now on implementation, which will play out gradually over time.

Source: The Russian government, The Ministry of Finance, the Ministry for Economic Development and Trade, SSSB.

Taking all aspects into account, the type of reform progress one can expect might be along the following lines. First, further steps forward in the promotion and preparation of *financial system reforms*, driven to a large extent by the new Central Bank leadership. This includes Duma approval of the benchmark banking system reform Law on Deposit Insurance, which the government will discuss on October 24, and then to be submitted to the Duma. It also includes the new Law on Currency Regulation and Currency Control, which would codify a certain path for currency market liberalization (the government will discuss this law on October 17).

Also, we would expect some progress in approving the UES/energy sector legal reform package, while implementation of UES reforms will most likely be stretched out over a longer time period, 2003-04/05. This is perhaps one of the most politically sensitive issues this winter. The Duma will on October 9 hold a first reading of the postponed and now amended UES/energy sector legal reform package. The legal package for UES/energy sector reforms was due for Duma readings this spring, but was postponed in the last minute to this autumn. During the summer, a "conciliatory" commission, composed of government, Duma and Federation Council representatives, re-negotiated aspects of this legal package. In September, an amended package was submitted to the Duma. Nevertheless, the principals in the government most involved in UES reforms, Minister for Economic Development and Trade Gref and his team, do estimate that chances to have the amended reform package approved by the end of the year are quite high, despite the "high" political temperature surrounding this issue.

A third area in which we expect movement is with regards to civil service/administrative reforms. From a medium- to long-term perspective, this is seen as one of the more important, but also one of the most complex, structural reform priorities, both from the government's and the Kremlin's perspective. Nevertheless, there is some momentum in this issue, and we

civil service reforms. For the most comprehensive, in-depth analysis of the importance and challenge of business sector de-regulation/de-bureaucratization in the Russian current context, see Prof. Mau et al (IET), *Deregulirovanie rossiiskoi ekonomiki: mekhanizm vosproizvodstva izbytochnovo regulirovaniya i institutsionalnaya podderzhka konkurentsii na tovarnykh rynkakh*, IET, May 2002.

are likely to see codification of reform programs and presentation of legal initiatives this autumn/winter. As a political signal that President Putin specifically prioritizes such reforms, Putin on August 12 signed a presidential decree on the main principles of government service, setting out some parameters of reforms. These reform efforts are being prepared along a number of different lines. President Putin has made both Prime Minister Kasyanov and First Deputy Chief of the Presidential Administration Medvedev in charge of working out a civil service/bureaucracy reform concept. The inter-departmental working group chaired by Medvedev is getting ready to submit to the Duma this autumn an underlying, framework law for these reforms, a new Law On The System of Government Service, which essentially would be like a Code of Civil Service Governance. From Gref's Ministry, First Deputy Minister for Economic Development and Trade Dmitriev (also in charge of pension reforms) is a strong advocate of liberal, transparent and modern civil service reforms. Separately, Kasyanov's Chief of Staff (the government's Chief of Staff) Shuvalov has been mandated to also work on a reform concept for the government bureaucracy. Furthermore, Deputy Chief of the Presidential Administration Kozak is working on reforming and clarifying federal-regional political jurisdiction and responsibilities, and chairs a commission for this purpose (the Kozak commission.).

Among other reforms of relevance for decreasing the weight of bureaucracy on the business sector and thus improve further the business climate (civil service/administrative reforms are part of this area), **we would also expect full approval of the *de-bureaucratization reform Law on Technical Regulation***. Furthermore, as part of WTO-related reforms and convergence, Russia can be expected to conclude full approval of **a new *Customs Code***, which would also have a positive effect on the business climate. Finally, one should expect a full approval of ***the 2003 budget***, possibly already by early December.

On the other side, reforms where we would expect less progress than what otherwise could have been expected, or little movement at all, include *natural monopoly tariff-re-balancing, municipal reforms, army reforms and social system reforms*. On natural monopoly tariff re-balancing, the government has followed a rather cautious approach to tariff increases, seeking to limit tariff increases. The government has focused on the need to push the natural monopolies to cut inefficiencies first, before getting more notable tariff increases. For 2003, the government has preliminarily suggested a ceiling for gas tariff increases of 20% and for electricity tariffs of 14%. However, a final decision of the path of tariffs has not yet been made, as the Ministry for Economic Development and Trade continues to analyse the budgets the natural monopolies have been urged to submit to the Ministry. The Duma has also recently (last week) approved in third reading a new Law on the setting of electricity tariffs. This Law establishes that electricity tariffs will be set annually before the federal and regional budgets are approved. According to this law, any changes to the tariff path proposed during the year will have to be implemented through legal amendments. This step decreases flexibility in the tariff re-balancing issue, but is possibly part of a compromise to get the Duma to vote for the controversial overall UES/energy sector reform program (see above).

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