

**RUSSIAN ECONOMY: TRENDS AND PERSPECTIVES**  
**October 2003**

**MONTHLY BULLETIN**

**Moscow**  
**2003**

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## The State of the Federal Budget

In the first seven months of 2003, the revenues of the state budget (cash execution) made 20.0 per cent of GDP, while expenditures made 17.3 per cent of GDP (see Table 1). Therefore, the federal budget surplus made 2.7 per cent of GDP.

*Table 1*

**The monthly execution of the federal budget of the Russian Federation  
(in % of GDP<sup>1</sup>, in comparable prices)**

	VIII'02	IX'02	X'02	XI'02	XII'02	I'03	II'03	III'03	IV'03	V'03	VI'03	VII'03	VIII'03	IX'03
Revenues														
Corporate profit tax	1.7%	1.6%	1.7%	1.6%	1.6%	1.2%	1.1%	1.4%	1.5%	1.4%	1.4%	1.4%	1.4%	1.3%
Personal income tax	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
VAT, special tax and excises	3.3%	3.2%	3.1%	3.1%	3.1%	2.4%	2.7%	2.8%	2.9%	2.9%	2.8%	2.8%	2.8%	2.8%
Tax on foreign trade and foreign trade operations	9.1%	9.0%	8.9%	8.9%	8.9%	11.2%	10.1%	9.9%	9.6%	9.6%	9.2%	9.1%	8.9%	
Other taxes, duties and payments	7.0%	6.9%	6.9%	6.9%	6.9%	8.5%	7.4%	7.2%	7.2%	7.2%	6.9%	6.9%	6.8%	
Total- taxes and charges	2.1%	2.0%	2.0%	1.9%	2.0%	2.7%	2.7%	2.6%	2.4%	2.3%	2.2%	2.2%	2.1%	
Non- tax revenues	2.8%	2.8%	2.8%	2.9%	3.0%	3.4%	3.4%	3.4%	3.5%	3.5%	3.4%	3.4%	3.4%	
Revenues, total	2.0%	2.0%	2.1%	2.1%	2.1%	0.5%	1.7%	2.0%	2.2%	2.1%	2.0%	2.0%	2.0%	
Expenditure	18.9%	18.5%	18.6%	18.5%	18.6%	18.8%	19.0%	19.4%	19.6%	19.4%	18.8%	18.7%	18.4%	
Public administration	1.4%	1.4%	1.5%	1.4%	1.4%	17.5%	8.5%	1.3%	1.2%	1.7%	1.6%	1.5%	1.5%	
National defense	20.4%	20.0%	20.2%	20.1%	20.1%	20.8%	20.6%	20.9%	21.0%	21.3%	20.6%	20.4%	20.0%	19.6%
International activities														
Judicial power	0.4%	0.4%	0.4%	0.4%	0.5%	0.3%	0.3%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	
Law enforcement and security activities	2.5%	2.4%	2.4%	2.5%	2.7%	1.5%	2.1%	2.6%	2.7%	2.7%	2.6%	2.6%	2.6%	
Fundamental research	0.3%	0.3%	0.3%	0.3%	0.3%	-0.3%	0.0%	0.2%	0.2%	0.3%	0.2%	0.2%	0.2%	
Services provided for the national economy	0.1%	0.1%	0.2%	0.2%	0.2%	0.1%	0.1%	0.1%	0.2%	0.2%	0.2%	0.2%	0.2%	
Social services	1.4%	1.4%	1.4%	1.5%	1.7%	1.1%	1.4%	1.7%	1.7%	1.7%	1.8%	1.7%	1.7%	
Servicing of public debt	0.2%	0.2%	0.2%	0.3%	0.3%	0.1%	0.2%	0.2%	0.2%	0.3%	0.3%	0.3%	0.3%	
Other expenditure	0.8%	0.8%	1.3%	1.3%	1.5%	0.2%	0.4%	0.5%	0.6%	0.7%	0.8%	0.8%	0.8%	
Expenditure, total	5.1%	4.9%	5.5%	5.6%	5.6%	1.5%	1.8%	2.0%	2.3%	2.2%	2.2%	2.2%	2.2%	
Loans, redemption exclusive	2.4%	2.4%	2.2%	2.0%	2.0%	1.7%	2.9%	3.0%	2.3%	2.1%	2.0%	1.8%	2.0%	
Expenditure and loans, redemption exclusive	3.9%	3.8%	3.9%	3.9%	3.8%	6.6%	7.1%	7.0%	7.0%	7.1%	7.1%	7.1%	7.0%	
Budget deficit (-)	17.1%	16.9%	17.8%	18.0%	18.7%	12.7%	16.4%	17.7%	17.7%	17.7%	17.5%	17.4%	17.3%	17.2%
Domestic financing	3.3%	3.1%	2.4%	2.1%	1.4%	8.1%	4.2%	3.2%	3.3%	3.6%	3.0%	3.0%	2.7%	2.3%
Other taxes, duties and payments	-1.3%	-1.2%	-0.5%	-0.2%	0.6%	-6.6%	-1.7%	-1.0%	-1.0%	-0.5%	0.3%	0.0%	0.3%	0.3%
Total- taxes and charges	-1.9%	-1.9%	-1.9%	-1.9%	-2.0%	-1.4%	-2.5%	-2.2%	-2.3%	-3.1%	-3.3%	-3.0%	-2.9%	-2.6%
Non- tax revenues	-3.3%	-3.1%	-2.4%	-2.1%	-1.4%	-8.1%	-4.2%	-3.2%	-3.3%	-3.6%	-3.0%	-3.0%	-2.7%	-2.3%

\* в % ВВП; \*\* ЕСН включен в налоговые доходы

As compared with the figures registered in January through August of 2002, the budget revenues decreased by 0.4 p. p. of GDP in January through August of 2003, while expenditures increased by 0.2 p. p. and budget surplus respectively decreased by 0.6 p. p. of GDP. At the same time, without SST the budgetary revenues increased by 0.4 p. p. of GDP and made 17.6 per cent of GDP.

VAT accounted for the major share of federal tax revenues – 34.0 per cent of the total tax revenues what is practically at the level observed in the respective period of 2002.

According to preliminary estimates, the cash execution of federal budget revenues made 19.6 per cent of GDP in January through September of 2003, what is by 0.4 p. p of GDP below the respective level observed in January through September of 2002. At the same time, the cash execution of expenditures made 17.2 per cent of GDP (16.9 per cent of GDP in 2002); therefore, the surplus made 2.3 per cent of GDP (3.1 per cent of GDP in 2002).

<sup>1</sup> Because of the estimated data on GDP, the indices may be subject to revision.

According to the preliminary estimates of the Finance Ministry, in terms of fulfilled funding<sup>2</sup> the expenditures of the federal budget in January through September of 2003 made 18.3 per cent of GDP (see Table 2), while on September 1 of 2002 this indicator was at 19.4 per cent of GDP. As a result, as the amount of aggregate revenues increased by 0.5 per cent of GDP and made 19.6 per cent of GDP. Therefore, the surplus of the federal budget in terms of fulfilled funding in the first nine months of 2003 has increased by 0.6 p. p. in comparison with the figures registered in the respective period of 2002 and made 1.3 per cent of GDP.

Table 2

**The monthly execution of the federal budget of the Russian Federation  
(in % GDP, fulfilled funding)**

	VIII'02	IX'02	XI'02	I'03	II'03	III'03	IV'03	V'03	VI'03	VII'03	VIII'03	IX'03
Total	20.2%	20.1%	20.1%	20.8%	20.5%	20.9%	21.0%	21.3%	20.5%	20.4%	20.0%	19.6%
Public administration	0.5%	0.6%	0.5%	0.5%	0.6%	0.6%	0.6%	0.6%	0.5%	0.5%	0.5%	0.5%
National defense	2.7%	2.9%	2.6%	2.5%	3.1%	3.3%	3.2%	3.1%	3.0%	2.9%	2.8%	2.7%
International activities	0.3%	0.3%	0.3%	-0.2%	0.1%	0.1%	0.3%	0.3%	0.3%	0.3%	0.2%	0.2%
Judicial power	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Law enforcement and security activities	1.7%	1.8%	1.7%	1.9%	2.2%	2.3%	2.2%	2.2%	2.0%	2.0%	1.9%	1.9%
Fundamental research	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Services provided for the national economy	1.5%	1.5%	1.5%	0.6%	0.8%	0.9%	0.9%	1.0%	1.0%	1.0%	1.0%	1.0%
Social services	5.7%	5.8%	5.7%	2.5%	2.7%	2.7%	2.9%	2.7%	2.6%	2.5%	2.4%	2.3%
Servicing of public debt	2.2%	2.0%	2.0%	1.7%	2.9%	3.0%	2.3%	2.1%	2.0%	1.9%	2.0%	2.0%
Other expenditure	3.9%	4.0%	3.8%	6.8%	7.5%	7.3%	7.3%	7.4%	7.3%	7.3%	7.2%	7.0%
Total expenditure	19.2%	19.4%	18.7%	16.8%	20.5%	20.8%	20.2%	19.9%	19.2%	18.8%	18.6%	18.3%
Профицит (+) / дефицит (-)	1.0%	0.7%	1.4%	4.0%	0.1%	0.1%	0.8%	1.3%	1.3%	1.6%	1.3%	1.3%

According to the estimates of the Revenue Ministry, in September of 2003 tax revenues of the federal budget made about Rb. 107.5 billion (without the single social tax). In real terms the revenues made 248.7 per cent of the level registered in January of 1999, while the respective indicator was at 246.5 per cent in 2002 and 235.6 per cent in 2001 (see Table 3).

Table 3

**Actual tax revenues to the federal budget, according to the data of the MTC (in % of the data for January of 1999)<sup>3</sup>.**

1999											
I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
100,0%	115,1%	122,0%	122,1%	104,5%	112,9%	127,0%	127,5%	124,3%	141,4%	160,8%	213,1%
2000											
I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
149,3%	160,5%	181,3%	205,8%	233,1%	186,9%	181,0%	186,4%	173,1%	181,1%	201,7%	254,1%
2001											
I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
204,4%	198,4%	227,6%	267,5%	252,2%	233,3%	231,9%	235,6%	219,4%	237,5%	247,3%	360,6%
2002*											
I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
218,7%	187,1%	234,8%	277,8%	239,6%	218,0%	284,4%	246,5%	254,8%	299,7%	241,0%	250,2%
2003*											
I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
230,0%	229,2%	265,5%	280,4%	233,2%	240,0%	260,4%	242,6%	248,7%			

\* Без учета ЕСН.

<sup>2</sup> The execution of the budget in terms of fulfilled (actual) financing is equal to the sum of the funds transferred to managers of budget funds, while the cash execution of the budget is equal to the sum of funds spent by managers of funds (i.e. without account of funds remained on their accounts).

<sup>3</sup> It was decided to choose January of 1999 as the benchmark in order to render the comparison more reliable. January of 1999 is not a remarkable date in terms of tax revenues.

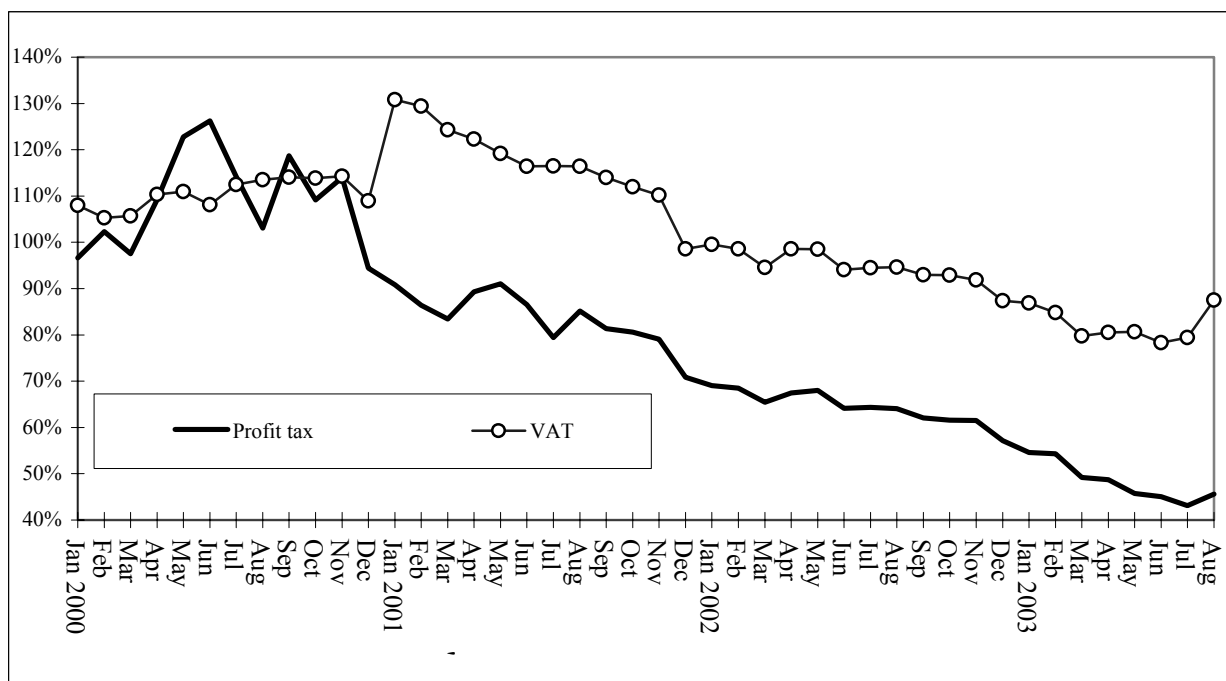


Figure 1. Real tax arrears to the federal budget (in % to July 1999)

The dynamics of real arrears relating to major taxes since January of 2000 are presented in Fig. 1. The debts related to the payments due to the federal budget made for VAT Rb. 252.0 billion as on September 1, 2003, increasing by almost Rub. 13.7 billion in August of 2003, what in real terms corresponds to the level of indebtedness registered on January 1, 2003, while the arrears of the profit tax increased by practically Rb. 0.4 billion and made about Rb. 28.1 billion. On the whole, the dynamics observed over the last 2 years still demonstrate a gradual decrease in the level of accumulated arrears as concerns not only the profit tax, but VAT as well.

Table 4

**Execution of the RF consolidated budget (in % of GDP).**

1998												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes	16,2%	17,4%	18,1%	19,3%	19,7%	19,8%	19,8%	19,4%	18,8%	18,5%	18,6%	19,6%
Revenues	18,8%	20,1%	21,2%	22,4%	23,0%	23,2%	23,2%	22,9%	22,3%	22,0%	22,0%	24,5%
Expenditures	25,3%	23,8%	27,0%	28,1%	28,6%	29,5%	29,4%	28,6%	27,4%	26,9%	27,1%	29,5%
Deficit	-6,5%	-3,7%	-5,8%	-5,7%	-5,7%	-6,3%	-6,2%	-5,7%	-5,2%	-5,0%	-5,0%	-5,1%
1999												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes	16,8%	16,6%	18,1%	19,9%	20,1%	20,5%	20,8%	20,8%	20,3%	20,2%	20,9%	22,1%
Revenues	19,2%	18,9%	20,6%	22,7%	23,2%	23,9%	24,3%	24,5%	24,1%	24,0%	24,8%	26,3%
Expenditures	18,6%	20,3%	23,6%	25,6%	26,6%	27,3%	27,4%	27,4%	26,7%	26,3%	26,7%	29,2%
Deficit	0,6%	-1,5%	-3,1%	-3,0%	-3,4%	-3,4%	-3,1%	-2,9%	-2,7%	-2,3%	-1,9%	-2,9%
2000												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Налоги	20,8%	21,4%	22,6%	24,2%	25,5%	25,4%	24,9%	24,8%	24,1%	23,7%	24,0%	24,6%
Доходы	24,4%	24,8%	26,4%	28,2%	29,7%	29,7%	29,3%	29,2%	28,4%	28,0%	28,6%	30,0%
Расходы	19,6%	21,1%	23,8%	24,8%	25,2%	25,5%	22,3%	25,1%	24,5%	24,2%	24,6%	27,0%
Дефицит	4,7%	3,7%	2,6%	3,4%	4,5%	4,3%	7,0%	4,1%	3,9%	3,8%	4,0%	3,0%

2001												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes	22,7%	23,6%	23,9%	25,4%	26,4%	26,0%	26,1%	25,9%	25,0%	24,8%	25,4%	27,1%
Revenues	25,9%	27,1%	27,4%	29,3%	30,5%	29,8%	29,9%	29,7%	28,3%	28,2%	28,8%	29,5%
Expenditures	16,8%	22,8%	23,7%	24,7%	25,1%	25,3%	25,5%	25,6%	24,9%	24,7%	25,0%	25,6%
Deficit	9,1%	4,2%	3,7%	4,7%	5,4%	4,4%	4,4%	4,1%	3,5%	3,5%	3,8%	3,9%
2002												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes	28,7%	23,6%	24,3%	26,5%	26,6%	25,9%	26,4%	25,9%	25,2%	25,4%	25,4%	25,5%
Revenues	32,9%	31,3%	31,4%	33,6%	33,6%	32,7%	33,3%	32,5%	31,7%	32,0%	32,1%	32,1%
Expenditures	18,3%	23,7%	26,0%	28,4%	28,4%	28,8%	29,1%	28,9%	28,4%	29,3%	29,7%	31,1%
Deficit	14,6%	7,7%	5,4%	5,3%	5,2%	3,8%	4,2%	3,7%	3,3%	2,7%	2,4%	1,0%
2003												
	I	II	III	IV	V	VI	VII	VIII				
Taxes	25,6%	24,4%	25,6%	27,4%	27,1%	26,0%	26,1%	25,7%				
Revenues	32,0%	30,3%	31,5%	33,4%	33,6%	32,2%	32,2%	31,6%				
Expenditures	20,7%	25,3%	27,7%	28,8%	28,8%	28,6%	28,7%	28,5%				
Deficit	11,3%	5,0%	3,8%	4,5%	4,7%	3,5%	3,6%	3,1%				

\* Без учета ECH

The revenues of the consolidated budget in August of 2003 made 31.6 per cent of GDP, including tax revenues (without SST) at 25.7 per cent of GDP (see Table 4). Expenditures of the consolidated budget decreased by 0.4 p. p. in comparison with the figures registered in August of 2002 and made 28.5 per cent of GDP. As on September 1, 2003, the surplus of the consolidated budget made 3.1 per cent of GDP, what is by 0.6 p. p. of GDP below the level observed in the respective period of 2002.

*S. Ponomarenko*

## Monetary Policy

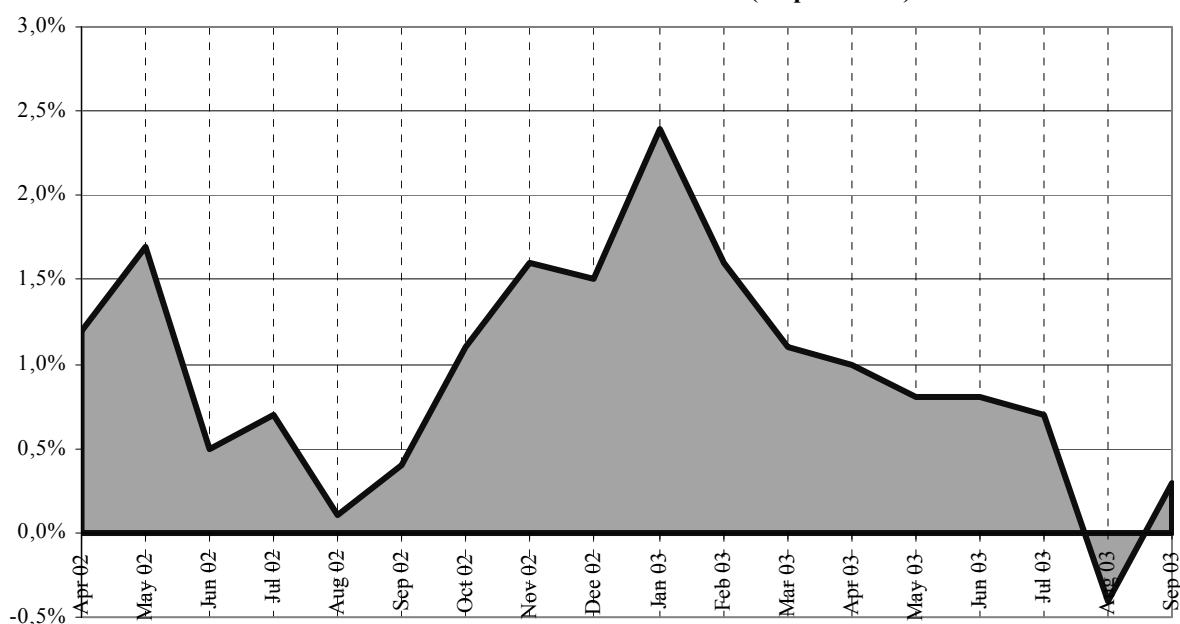
According to the State Committee for Statistics, the Consumer Price Index grew 0.3 percent in September. The international rating agency Moody's raised the rating of the Russian Federation and the Russian Eurobond rating by two grades up to the investment level. In September the trend of the previous months towards the reduction of the monetary base in the broad definition continued.

Inflation in the Russian consumer market was 0.3 percent in September (see *Fig. 1*). In the period from January till September 2003 price growth did not exceed 8.6 percent as opposed to 10.3 percent in January-September of 2002. The Base Consumer Price Index (BCPI)<sup>4</sup> that leaves out of account short-term irregular price fluctuations caused by individual factors of administrative, occasional and seasonal nature amounted to 101.1 percent in September (year to month: 107.3 percent). In Moscow consumer prices grew 0.4 percent in September (year to month: 8.5 percent), in St. Petersburg the growth was 0.9 percent (year to month: 9.3 percent).

According to preliminary estimates, the CPI will be 1.0 to 1.2 percent in October, which allows to hope that in 2003 on the whole the consumer price index in the RF will remain in the range projected by the Government and RF Central Bank (10 to 12 percent).

<sup>4</sup> Calculated by the State Committee for Statistics of the RF

**The Growth Rate of the CPI in 2002 - 2003 (% per month).**



*Fig. 1. The Rate of CPI Growth in Years 2002–2003 (% per month).*

Foreign reserves of the Bank of Russia diminished US\$ 679 million (- 1.08 percent) in September, reaching US\$ 62.073 billion on 1 October (see *Fig. 2*). This reduction was observed for two consecutive months. Thus, in the August–September period the aggregate reduction amounted to US\$ 2.381 billion or 3.7 percent. The percentage of currency reserves in the overall foreign reserves diminished by US\$ 681 million, or 1.15 percent, reaching US\$ 58.33 billion in September. The amount of gold remained practically unchanged throughout the year (US\$ 3.739 billion as at 01 January and US\$ 3.743 as at 01 October).

At the same time, in the first three weeks of October the amount of foreign reserves grew 2.7 percent, reaching US\$ 63.8 billion. This increase in the reserves may be related, among other things, to the inflow of capital in the country and the growth in the offer of foreign currency brought about by the upgrading of the Russian Federation's credit rating. In early September the international rating agency Moody's upgraded the Russian currency rating and the Eurobond rating by two steps, from Ba2 to Baa3. In addition, Moody's upgraded the rating of the Russian Rouble bonds from Ba1 to Ba3. The rating of the Internal Currency Loan Bonds (Minfin bonds) of the 6<sup>th</sup> and 7<sup>th</sup> tranches was upgraded from Ba1 to Ba3, and of the 5<sup>th</sup> tranche Minfin bonds to Ba2; forecast for all the ratings: stable.

Moody's explains the upgrading by Russia's adherence to reasonable finance and debt management policies; significant improvements in the area of debts and liquidity; formation of a stabilization fund intended for compensation of possible sharp reduction of prices in raw material markets and the lowering of political risks in the country. The rating agency points out that owing to the reduction of the regional authorities' political strength the federal center exercises less political pressure on Russian regions. Moody's also believes that political confrontation both within the central government and without it does not really pose any danger to the economic reforms in Russia and the development of the country on the whole.

In September, regardless of the reduction in foreign reserves, the monetary base (narrow definition) grew 0.2 percent, from RUR 1183.5 billion to RUR 1186 billion. During the first three weeks of October the narrowly-defined monetary base grew 2.7 percent more; at the same time the monetary base of the Russian Federation in the broad definition<sup>5</sup> diminished 1.1. percent in September, from RUR 1500.8 billion to RUR

<sup>5</sup> The Monetary Base in broad definition includes cash in circulation, the funds in mandatory reserves, funds in commercial banks' correspondent accounts with the Bank of Russia, mandatory provisions for funds in the RF currency and foreign currency attracted by credit institutions, funds of banks with the Bank of Russia, bonds of the Bank of Russia placed with credit institutions and obligations of the Bank of Russia to buy back securities.

1484.5 billion as at 01 October (the main reason being the reduction of funds placed with the Central Bank of Russia and the Central Bank's obligations on the repurchase of securities).

### Changes in the Monetary Base and in the Gold and Foreign Currency Reserves in 2002 - 2003.

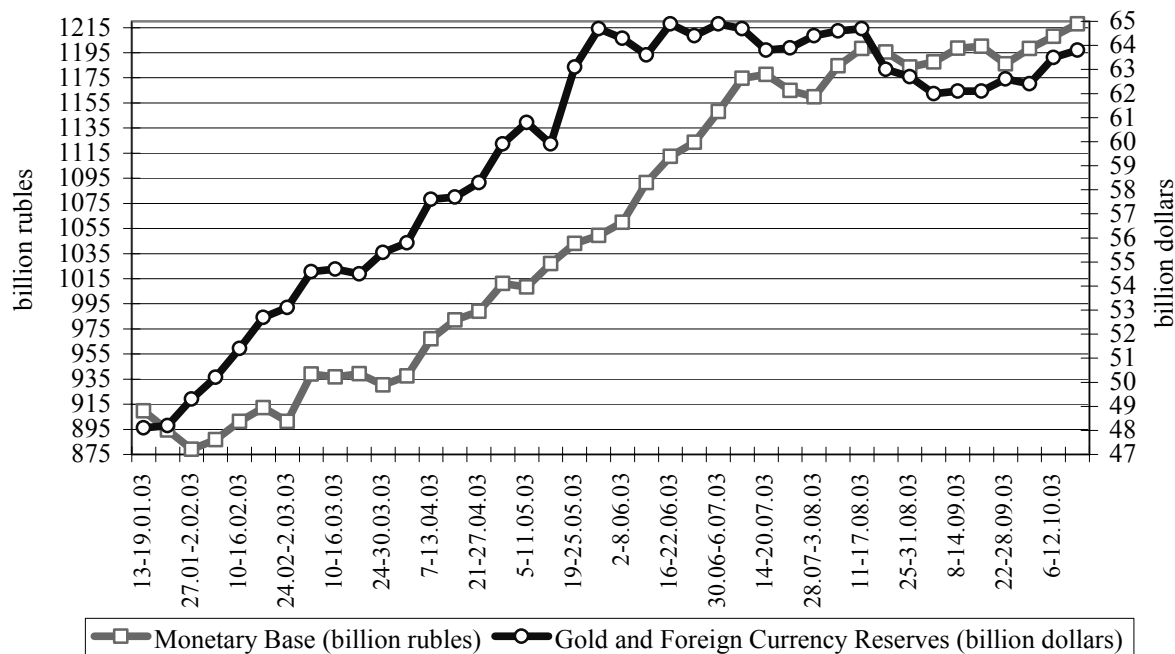


Figure 2. Changes in the Monetary Base (Narrow Definition) and Gold and Foreign Currency Reserves of the Russian Federation in late 2002–2003.

In October the amount of payments under the public foreign debt of the Russian Federation was circa US\$ 584.6 million, including US\$ 542.9 million transferred as debt repayment and US\$ 41.6 million as interest payments. This, in turn, includes US\$ 176.9 million paid to official creditor countries, banks and companies as debt repayment and US\$ 15.7 million as interest payments; payments to international financial institutions were US\$ 366 million and US\$ 25.9 million, respectively. No Russian Eurobonds were redeemed or serviced in October.

In September 2003 Russia and Thailand entered into an agreement on the regulation of the Russian Federation's US\$ 36.5 million debt before Thailand. The document was signed in the presence of the Russian Federation President Vladimir Putin and Prime Minister of the Kingdom of Thailand Thaksin Shinawatra. Under the agreement, the Russian debt of US\$ 36.5 million before Thailand will be paid out in the course of five years; in addition, the agreement stipulates a mechanism for debt repayment in the form of providing goods and services.

In September 87.6 percent of the overall volume of trade in GKO-OFZs in the secondary market (or RUR 146.6 billion, the highest value this year) fell on direct repo operations with the Bank of Russia.

In October 2003 the Interbank Currency Board of the representatives of the Central Bank of the Russian Federation and the National Bank of Byelorussia considered the main principles and most important parameters of the draft main guidelines for the monetary policy of the two countries for year 2004. The draft guidelines of the two countries for next year have been based on the principles of continuity, account for the peculiarities of the functioning of the two economies, balance and application of market monetary instruments.

Furthermore, according to a statement by the National Bank of Byelorussia, in its meeting the Board took into account the suggestion of the NBB to establish the level of the Byelorussian Rouble devaluation against the Russian Rouble during Quarter 1 of 2004 at 0.6 percent per month on average, with fluctuations plus or minus one percent per quarter. In its next meeting scheduled for Quarter 1 of 2004, the Interbank Currency Board intends to consider the unification by the Russian and Byelorussian central banks of the procedure for



and terms and conditions of granting loans to credit institutions, purchase and sale of foreign currency, operations with government securities and private bonds, attraction of credit institutions' funds and establishment of the norms of mandatory provisions and the procedure for the application of such norms.

In the near future the Board of Directors of the Central Bank of Russia does not intend to approve new investment directives and change the structure of foreign reserves in favor of the Euro, the First Deputy Chairman of the CB RF Oleg Viyugin is quoted as saying. According to Mr. Viyugin, the share of the US Dollar in the structure of the foreign reserves remains at the level of 70 percent; 25 percent fall on the Euro and 5 percent on all other currencies. At the same time, the First Deputy Minister of Finance A. Ulyukayev has declared that Russia was intending to reduce the percentage of the US Dollar in its reserves and increase the share of the Euro which was related to the importance of the European market to the Russian economy and the diminution of the US currency's exchange rate in international markets. In particular, the share of the US Dollar in the Russian foreign reserves would be reduced by 3 to 5 percentage points, and the share of the Euro would grow accordingly.

*Trounin P.*

## Financial Markets

### The Market for Government Securities

In October 2003 no clear positive or negative trend in the quotation dynamics could be observed in the Russian market for currency debts. In the beginning of the month prices for Russian currency bonds were stable; revenues were, on average, low. Nevertheless, on the day after Moody's upgraded the sovereign rating of the Russian Federation to the investment level a significant growth in quotation was marked: the yield to maturity of all securities fell on average 0.4 to 0.6 percent p.a. A statement by the representatives of Standard & Poor's who said that it was too early to upgrade the RF rating to the investment level obviously somewhat checked further growth. In addition, further worsening of the situation around the oil company YUKOS contributed to the fall in prices of the RF currency bonds that, by the end of the month, sank practically to the level of the early October: on 24 October the yield to maturity of Russian Eurobonds RUS-30 was 7.42 percent p.a. (end of September: 7.46 percent); RUS-18: 7.02 percent p.a. (end of September: 6.85 percent). Besides, on 24 October the yield to maturity of the Russian Eurobonds was: Minfin bonds, 7<sup>th</sup> tranche: 6.65 percent; Minfin bonds, 6<sup>th</sup> tranche: 4.08 percent; Minfin bonds, 5<sup>th</sup> tranche: 5.76 percent; RUS-07: 4.45 percent.

FIGURE 1.

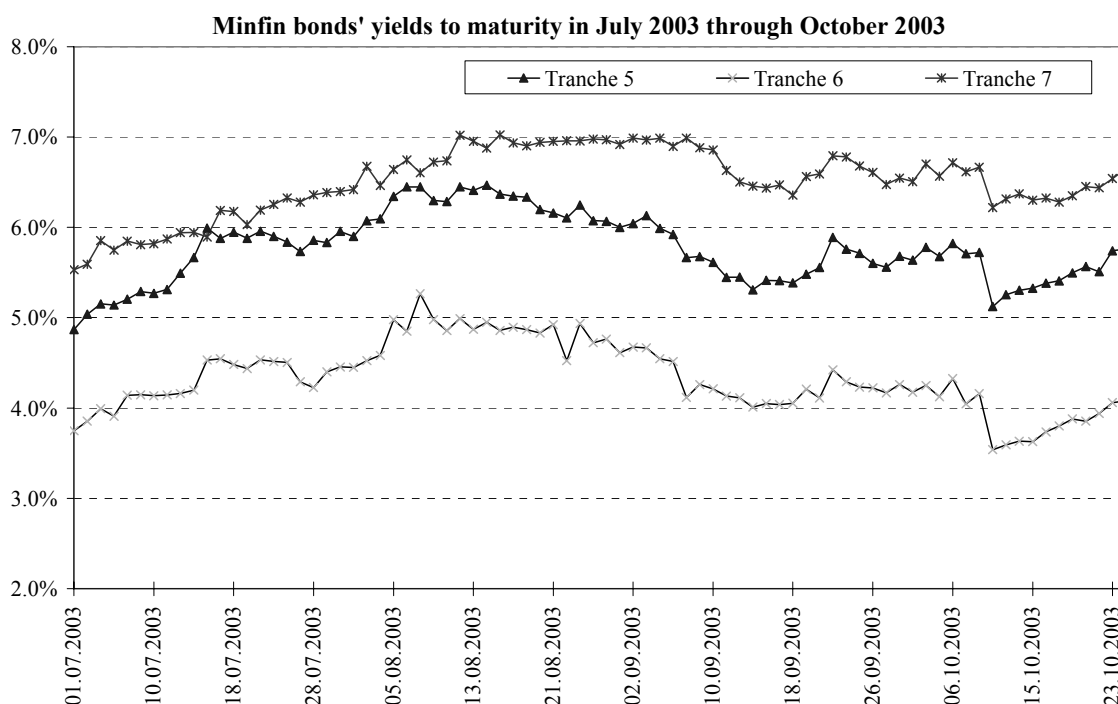
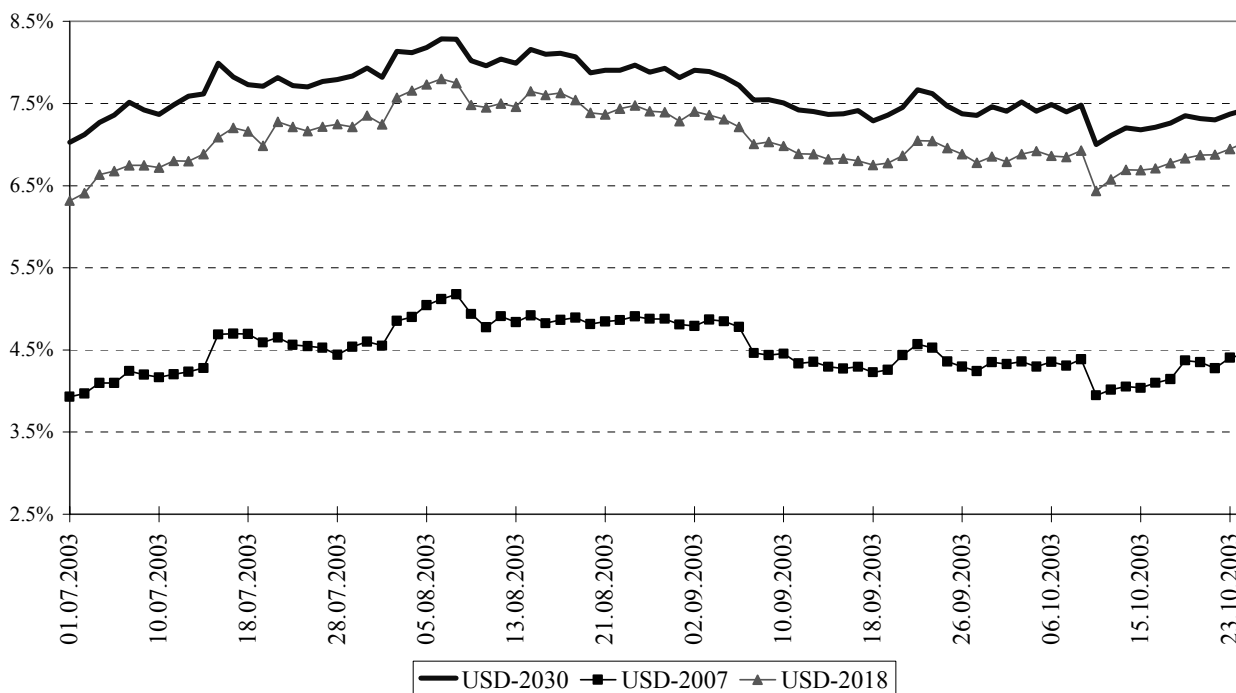


FIGURE 2.

**Yields to maturity of the Russian eurobonds with maturity in 2030, 2018 and 2007 in July 2003 through October 2003**



The market for the internal debt demonstrated, on the whole, positive quotation trends. E.g., throughout the first three weeks prices were growing against a background of a somewhat greater activity of the participants, which was caused by a number of factors. Firstly, the upgrading of the RF rating supported the market a lot; it brought about a noticeable increase in market activity and quotations. Secondly, the favorable situation in the world oil market and the lower US Dollar – Rouble rate was conducive to the growth in prices for Rouble-denominated government bills. Thirdly, the increase in Rouble liquidity in the banking sector should also be pointed out as a positive factor. In the period from 22 September through 24 October the total turnover in the GKO-OFZ market was RUR 15.3 billion, which equals a daily average turnover of RUR 635.7 million.

On 8 October GKO issue # 21171 maturing on 21 April, 2004, was placed. The demand was RUR 4.2 billion at par value; total placement volume: RUR 1.113 billion. The cutoff price was fixed at the level of 96.577 percent (the yield: 6.6 percent p.a.).

As at 28 October the volume of the GKO-OFZ market was RUR 282.12 billion at par and RUR 299.61 at the market value. The duration of the GKO-OFZ market portfolio was 886.15 days.

## The Market for Corporate Securities

### Situation in the Stock Market

During the first three weeks of October positive quotation dynamics were observed in the Russian stock market, which demonstrated that the trends prevailing in the previous months continued. It should be noted that in October the RTS index reached its maximum ever observed in its history: on 20 October its closing value hit 643.3 points. One of the reasons for this significant growth was that Moody's announced that it was upgrading the sovereign rating of the Russian Federation up to the investment level. Still, the situation around YUKOS<sup>6</sup> that followed affected the dynamics of the Russian stock market negatively: on 28 October the closing value of the RTS index was 561.45 points. Thus, within two trading days (27 and 28 October) the

<sup>6</sup> On 17 October official charges were brought against V. Shakhnovsky, Head of the Company YUKOS-Moscow. On 25 Mikhail Khodorkovsky, Head of Oil Company YUKOS was detained. He also faces charges under seven articles of the RF Criminal Code.

index fell by as many as 33.46 points. The result of the month: during the period from 30 September through 28 October the RTS index sank 5.17 points (-0.91 percent).

FIGURE 3.

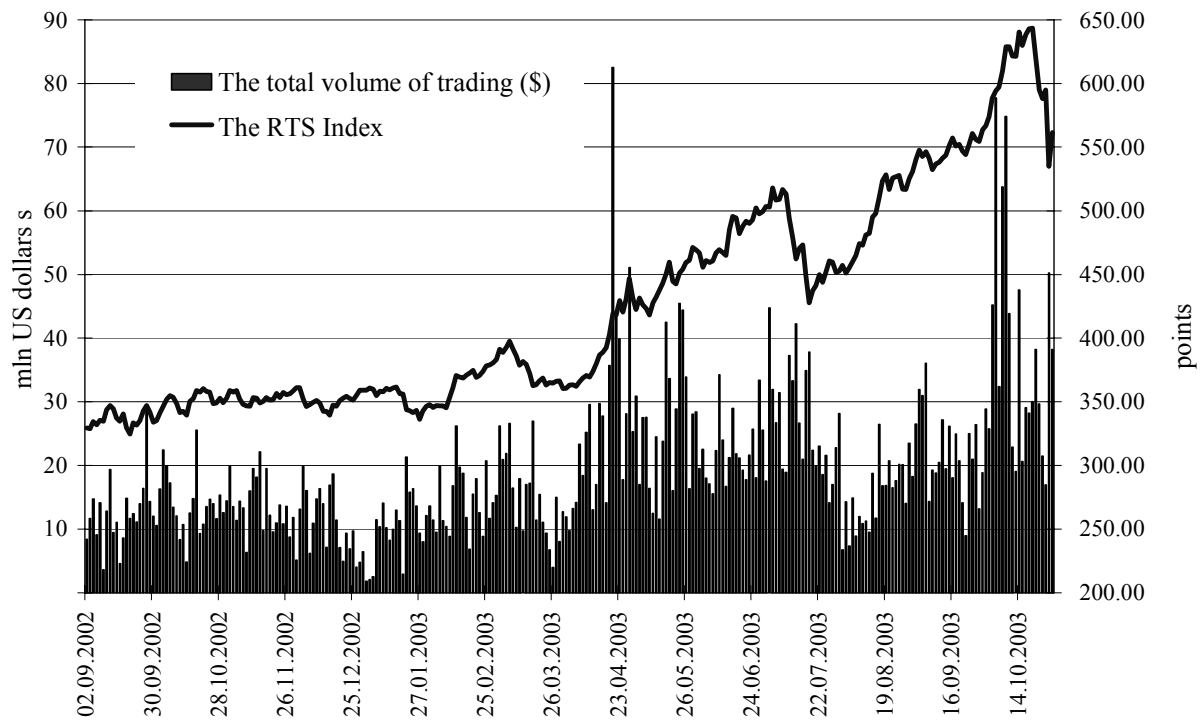
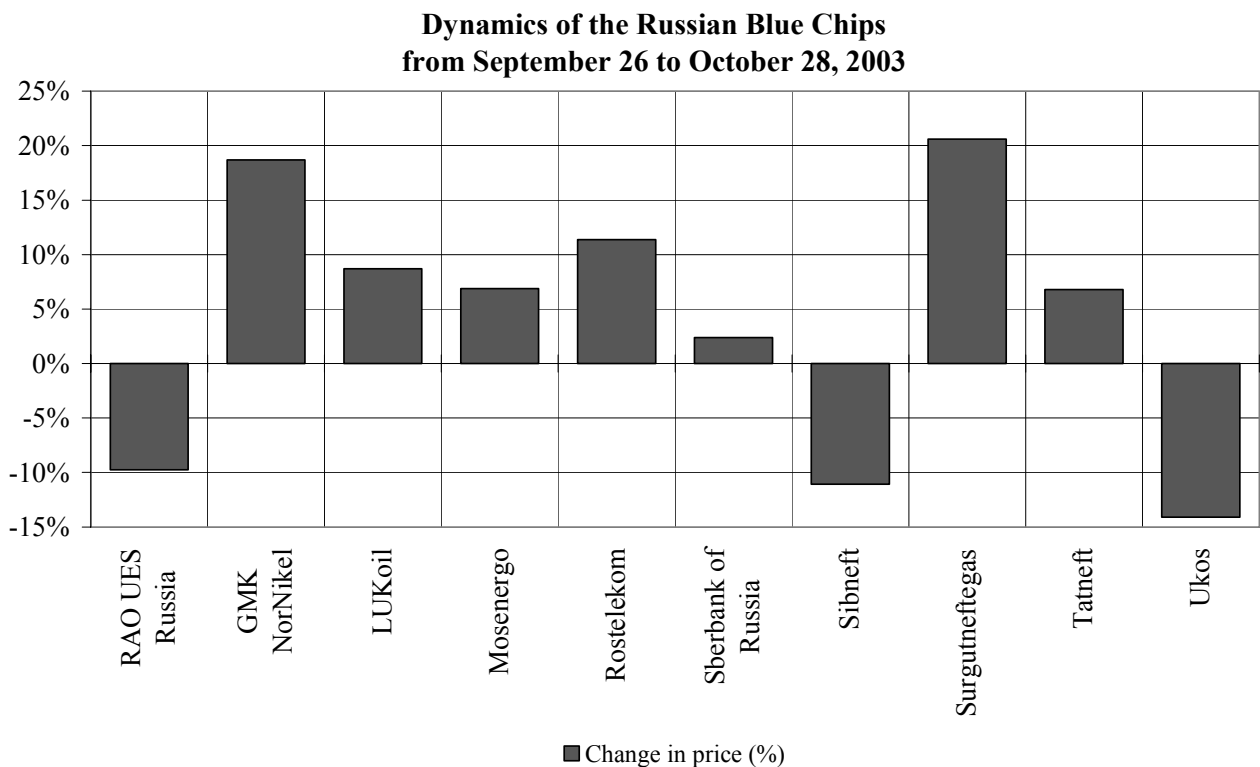


FIGURE 4.



At the same time, the turnover in the RTS trading amounted to US\$ 775 million, which is considerably higher than in the preceding month (in August the turnover in the RTS trading was US\$ 443 million). Reaching the value of US\$ 37.77 million, the average daily turnover in the RTS also demonstrated growth as

compared to the corresponding value for September 2003. The highest volume of trade in the RTS (US\$ 77.75 million) was observed on 3 October; the lowest trade volume (US\$ 16.9 million) was observed on 24 October. On the whole, throughout the month the Russian stock market demonstrated a growth in the activity of participants.

The fall in quotations caused by the situation with YUKOS that occurred in the market in the end of the month not only affected the YUKOS shares but also influenced the rates of other blue chips. Nevertheless, the shares of Surgutneftegaz that increased in price 20.59 percent were the market leader in terms of quotation growth. The shares of MMC Norilsk Nickel that grew in price 18.69 percent were the second. These were followed by the shares of Rostelecom (11.38 percent), LUKoil (8.7 percent), Mosenergo (6.87 percent) and Tatneft (6.77 percent). The stocks of YUKOS and Sibneft demonstrated the greatest fall in October: the rates of the two companies' shares fell 14.09 percent and 11.07 percent, respectively. The depreciation rate of the shares of RAO UES of Russia was less: they lost 9.74 percent during the month.

From 29 September till 24 October LUKoil shares took the top position by the volume of turnover in the RTS<sup>7</sup>: the total transactions amounted to 22.7 percent. The shares of RAO UES of Russia followed: the volume of transactions with the energy holding's shares reached approximately 21.4 percent of the total turnover. The shares of YUKOS and Surgutneftegaz follow with 15.8 percent and 8.9 percent, respectively. Thus, the percentage of transactions with the shares of the four companies was ca. 69 percent of the total traded turnover in the RTS during the period under review.

As at 28 October the top five leaders of the national stock market by capitalisation look as follows<sup>8</sup>: YUKOS: US\$ 28.6 billion, Surgutneftegaz: US\$ 18.7 billion; LUKoil: US\$ 17.98 billion; MMC Norilsk Nickel: US\$ 12.2 billion; Sibneft: US\$ 12.18 billion.

**The Market for Term Contracts.** In October the RTS market for term contracts (FORTS) again demonstrated an upsurge in the activity of participants. In the period from 01 October till 27 October the volume of trade in futures and options in the RTS amounted to RUR 22.3 billion (85.4 thousand transactions; 2.96 million contracts), which is RUR 2 billion higher than the similar value for September 2003. As usual, futures contracts account for the greatest percentage of transactions: the volume of trade in these contracts reached RUR 20.59 billion (2.7 million contracts, 82.4 thousand transactions). The greatest trade volume, RUR 1.97 billion, was observed on 8 October; the lowest value, RUR 686.68, was noted on 24 October.

**The Market for Corporate Securities.** The dynamics of the market for corporate securities on the whole copied the dynamics in other sectors of the Russian financial sector. In the beginning of the month the growing interest in Moscow bonds brought about a growth in the interest in corporate bonds because they are a kind of a benchmark for the corporate sector securities. The demand focused on the most liquid securities; the main buyers of the securities were non-residents who determine whether investing in the bonds of a Russian corporation on the basis of the spread on Eurobonds that has recently expanded to 4-5 percent and can compensate currency risks, and not on the basis of the level of interbank loan rates reflecting liquidity in the financial sector. The upsurge in quotations that occurred the following week was caused only by the upgrading of the Russian rating. Quotations of Moscow securities and first tier corporate bonds also grew on that day. This resulted in a greater spread on the 2<sup>nd</sup> and 3<sup>rd</sup> tier securities.

At the same time, a certain correction was observed in the market that was supported by the lowering of the Rouble liquidity. The YUKOS case finally affected corporate securities, too: the market demonstrated a considerable decrease in prices against a background of the falling stock market. A further decrease in prices did not occur because rather low quotation levels after the preceding fall attracted investor attention.

In the period from 22 September till 24 October the total turnover in the bond sector was RUR 12.4 billion, which corresponds to the average daily turnover of RUR 496.6 million. In October corporate bonds were placed at the MICEX; a total of RUR 5.95 billion was attracted during the auctions. In the period from 30 September till 27 October the price index of corporate bonds traded in the MICEX<sup>9</sup> grew 1.11 points (1.02 percent) and the index of ten most liquid corporate sector bonds increased 1.79 points (1.62 percent).

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<sup>7</sup> In the classical stock market.

<sup>8</sup> According to the RTS.

<sup>9</sup> The indices of corporate bonds traded at the MICEX that have been used for the calculations are calculated by Zenit Bank.

FIGURE 5

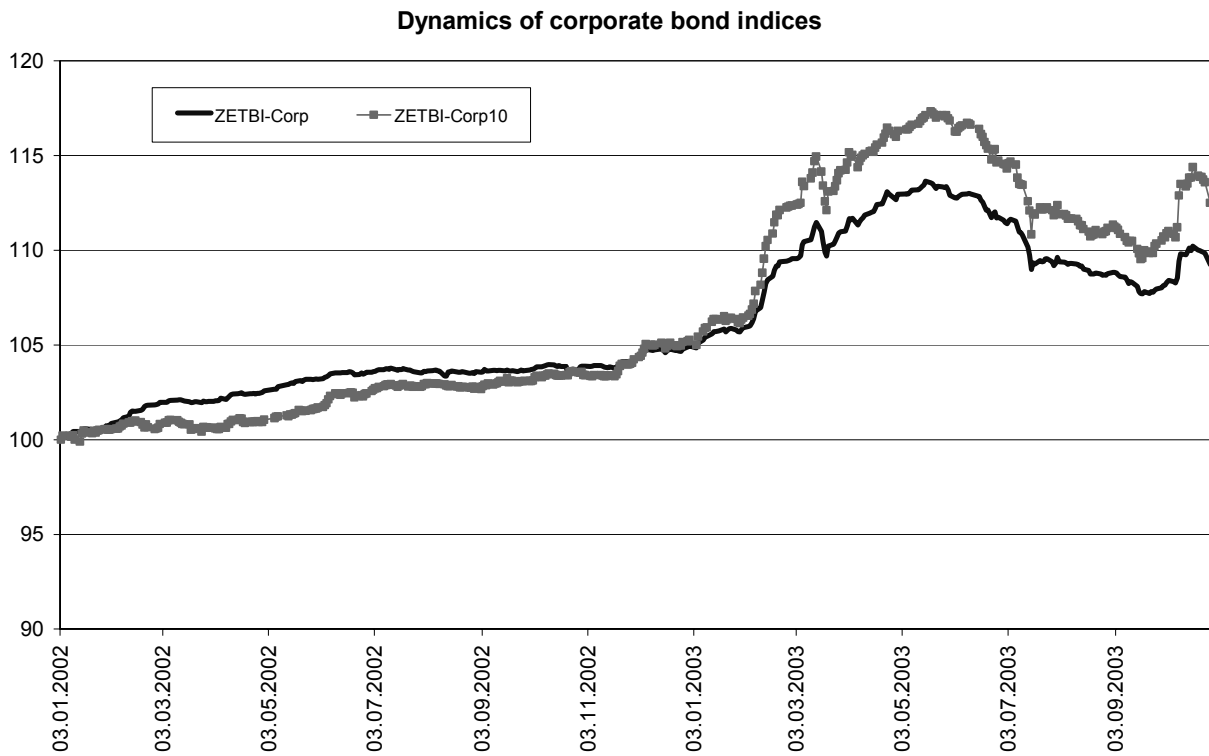
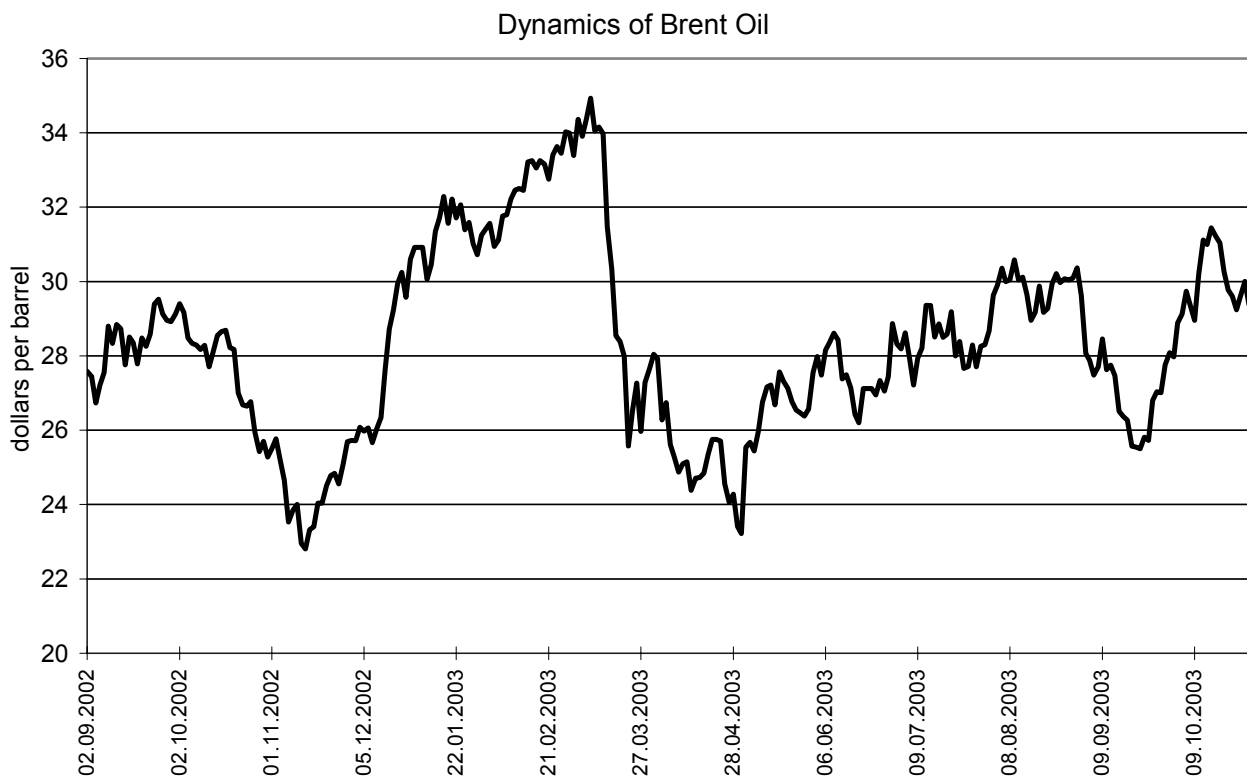


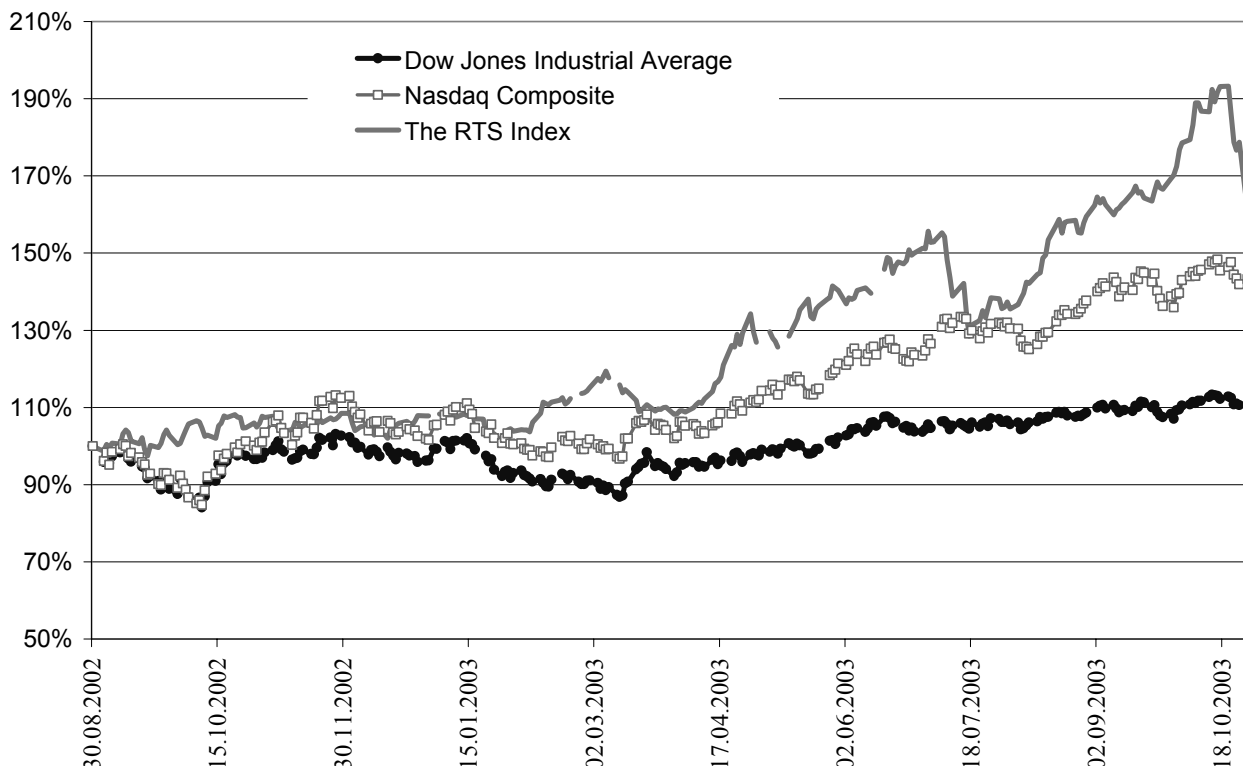
FIGURE 6.



**External Factors affecting the Russian Stock Market.** In October prices in the world oil market grew after OPEC reduced the oil production quotas. According to the International Energy Agency, the policy that OPEC has been pursuing lately contributes to the fixing of oil prices the level of 30 US\$/ bbl. E.g., on 10

October quotations for Brent exceeded the 30 US\$/ bbl level, and prices did not go below this mark for ten days. OPEC declared that, if the cartel's oil basket would be traded for more than 28 US\$/ bbl in the course of 20 days, the next OPEC summit could take a decision on increasing the quotas. Nevertheless, a certain correction in quotations followed that was accompanied by a lowering of the market prices. On 28 October the price for Brent at the world market was 29.37 US\$/bbl. Thus, in October the price for Brent grew by 1.61 US\$/bbl, which corresponds to a growth of 5.8 percent.

FIGURE 7.



In October a stable rise in quotations was observed in stock markets. The rates of shares both in the markets of developed and developing countries demonstrated positive growth. E.g., the growth of US stock indices NASDAQ and S&P500 was 82% (39.30%) and 5.01% (15.21%) during the month (year), respectively, while DJIA grew 4.67% (13.33%). European stock indices also demonstrated positive dynamics: FTSE 100 (UK) grew during the month (year) by 2.79 percent (6.69 percent), DAX 30 (Germany), by 7.88 percent (15.97 percent), CAC-40 (France), by 4.21 percent (5.15 percent). In Asian markets the main stock indices also demonstrated growth. E.g., Nikkei-225 (Japan) grew 2.35 percent (21.21 percent) during the month (year), and Seoul Composite (South Korea), 11.18 percent (17.28 percent). In the developing countries a rise in quotations could also be observed. This is demonstrated by a growth of the composite index calculated by the agency MSCI that rose 8.08 percent (28.57 percent) during the month (year).

The positive dynamics of the US stock market in October was caused by the favorable macroeconomic situation and positive corporate news. E.g., the growing employment in the US economy was the most significant factor that demonstrated that positive trend were gaining more and more strength: according to the information published, the number of new applications for unemployment benefits was going down. In addition, an overwhelming majority of companies either confirmed or exceeded the analysts' forecast: the absolute majority of corporate financial results for Quarter 3 of 2003 were positive. Revenues and profits grew in all sectors of the US economy. Further correction in the US stock market was purely technical because investors preferred to fix the profits.

The situation in European markets was to a great extent determined by the Euro-Dollar dynamics during the past month. Despite the fact that the stocks of export-oriented and oil companies were increasing against a background of improving situation in the US economy and growing world oil prices, the strengthening of

the Euro against the Dollar checked the growth in European stock indices. According to a report by Deutsche Bank, a 10 percent growth of the Euro means for European companies a fall in the profits of 5 to 6 percent.

### **Corporate News**

#### *Oil Company LUKoil*

In the beginning of October the international rating agency Moody's assigned OAO LUKoil the long-term rating Ba2 and the rating of unsecured public placements in foreign currency Ba3; forecast: stable.

On 9 October the company published its US GAAP consolidated financial statements for three and six months. In the first half of 2003 LUKoil's net earnings were US\$ 2.36 billion as opposed to US\$ 840 in the first six months of 2002, i.e. they grew more than three times. EBITDA reached US\$ 3.18 billion in the reporting period as opposed to US\$ 1.66 billion in the same period of 2002. Oil production in Quarter 2 of the current year grew 3.5 percent, which is more than twice the figure for year 2002.

#### *OAO Sibneft and Oil Company YUKOS*

On 3 October the main shareholders of OAO Sibneft and Oil Company YUKOS completed the previously announced merger of the two companies. As a result, the greatest private Russian oil and gas company YUKOS-Sibneft was established. On 3 October Oil Company YUKOS received 72 percent plus one share of OAO Sibneft in exchange for 26.01 percent of the charter capital of YUKOS.

#### *OAO Gazprom*

During the first three months of 2003 the company's earnings from the sales of gas grew 32 percent in comparison to the similar period, reaching RUR 195.03 billion. The growth in earnings was mainly caused by increasing prices for and deliveries of gas both in Europe and in the Russian Federation. Earnings from the sales of gas condensate and oil processing products grew RUR 7.19 billion or 60 percent in comparison to the same period of 2002. During the period under review operational expenses grew 26 percent in comparison to the same period of last year, reaching RUR 157.5 billion. The increase was mainly caused by a growth in expenses on depreciation charges, transit costs, labour costs and processing services. Net earnings in Quarter 1 of 2003 were RUR 55.97 billion (as compared to the net losses in Quarter 1 of 2002), exceeding the total net earnings in year 2002.

#### *OAO Oil Company YUKOS*

In October the company published its US GAAP consolidated financial statements for Quarter 2 and the first six months of 2003. In the 2<sup>nd</sup> Quarter net earnings from sales and other income received from the main activity grew up to US\$ 3.8 billion, which is 49.3 percent more than the figure for the same period of 2002. This is explained by a growth in the production volume and selling prices. In the first six months of 2003 the amount of earnings from sales and other income from the main activity was US\$ 7.7 billion as opposed to US\$ 4.5 billion in the first half of 2002.

EBITDA in Quarter 2 of 2003 were US\$1.24 billion as compared to US\$ 1.008 billion in Quarter 2 of 2002. The indicators for the first six months of 2003 and 2002 were US\$ 2.9 billion and US\$ 1.68 billion, respectively. Net earnings of the oil company in Quarter 2 were US\$ 955 million as opposed to US\$ 758 million in the 2<sup>nd</sup> Quarter of 2002. In the first half of 2003 this indicator amounted to US\$ 2.22 billion (2002: US\$ 1.22 billion).

#### *OAO Rostelecom*

On 21 October the company published its IAS statements for the first six months of 2003. OAO Rostelecom's IAS consolidated revenues for the first half of 2003 grew 10.6 percent i. EBITDA amounted to US\$ 175.8 million, which corresponds a growth of 1.7 percent as compared to the first six months of 2002. Net income grew 42.1 percent as opposed to the similar indicator for the previous year, amounting to US\$ 29.7 million.

#### *OAO Slavneft*

In October in the extraordinary meeting the shareholders of OAO Slavneft-Megionneftegaz approved the receipt of a loan worth RUR 1.325 billion to be granted by OAO Slavneft to replenish the current capital of OAO Slavneft-Megionneftegaz. The interest-free loan is extended till 27 May 2004.

Table 1

### Dynamics of the World's Stock Indices

As of 28 October 2003	Value	Changes during the month (%)	Change since the beginning of the year (%)
RTS (Russia)	561.45	1.29%	55.62%
Dow Jones Industrial Average (USA)	9748.31	4.67%	13.33%
NASDAQ Composite (USA)	1932.26	7.82%	39.30%
S&P 500 (USA)	1046.79	5.01%	15.21%
FTSE 100 (UK)	4272.90	2.79%	6.69%
DAX-30 (Germany)	3586.93	7.88%	15.97%
CAC-40 (France)	3352.15	4.21%	5.15%
Swiss Market (Switzerland)	5185.20	1.05%	5.83%
Nikkei-225 (Japan)	10561.01	2.35%	21.21%
Bovespa (Brazil)	18228.00	15.29%	57.14%
IPC (Mexico)	7928.72	1.83%	26.79%
IPSA (Chile)	1370.04	0.00%	32.99%
Strait Times (Singapore)	1736.1	6.67%	29.57%
Seoul Composite (Korea)	775.36	11.18%	17.28%
ISE National-100 (Turkey)	14673.4	6.65%	35.39%
Morgan Stanley Emerging Markets Free Index	407.075	8.08%	28.57%

### Foreign Exchange Market

In October the dynamics of the forex market were mainly determined by the upgrading of the Russian Federation's sovereign rating to the investment level and the expectations of an inflow of foreign investments. Owing to these two factors, market participants became much more active and, as a result, the US Dollar/Rouble rate fell: on 22 October the Dollar rate fell below the 30 Rouble mark at the MICEX. At the same time, the market participants' reaction to Mikhail Khodorkovsky's arrest was rather sharp: on 27 October the Dollar grew approximately 18 kopeks during the trade session at the MICEX. Then the situation stabilized, though. On the whole, the rate of the US currency fell 75 kopeks in October (-2.46 percent) down to RUR/US\$ 29.86.

In the period from 22 September till 24 October the total volume of trade in the US Dollar at the SELT was US\$ 14.4 billion, which more than twice exceeds the value reached during the previous month (September: US\$ 6.64 billion). During the period under review the highest volume of trade in the US Dollar, US\$ 1.56 billion, was observed on 9 October (September: 838.9 million); the lowest results, US\$ 312.9 million, were observed on 22 September. Thus, in the reporting period a considerable increase in the activity of participants was observed.

Rouble liquidity in the banking sector somewhat decreased in October of 2003 as compared to the September level, which continued the tendency of the previous months: on 29 October balances in credit institutions' accounts with the Bank of Russia were RUR 90.4 billion (RUR 125.2 billion on 30 September, RUR 121.8 billion on 29 August).



FIGURE 8.

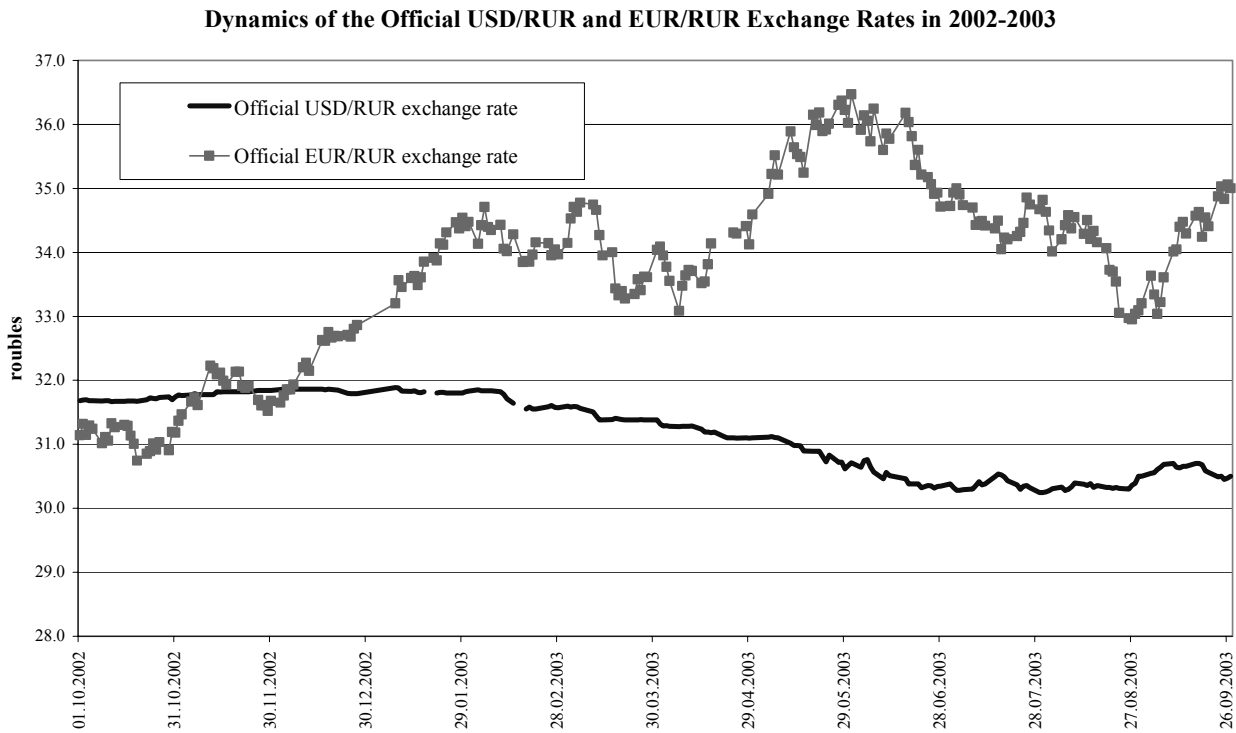
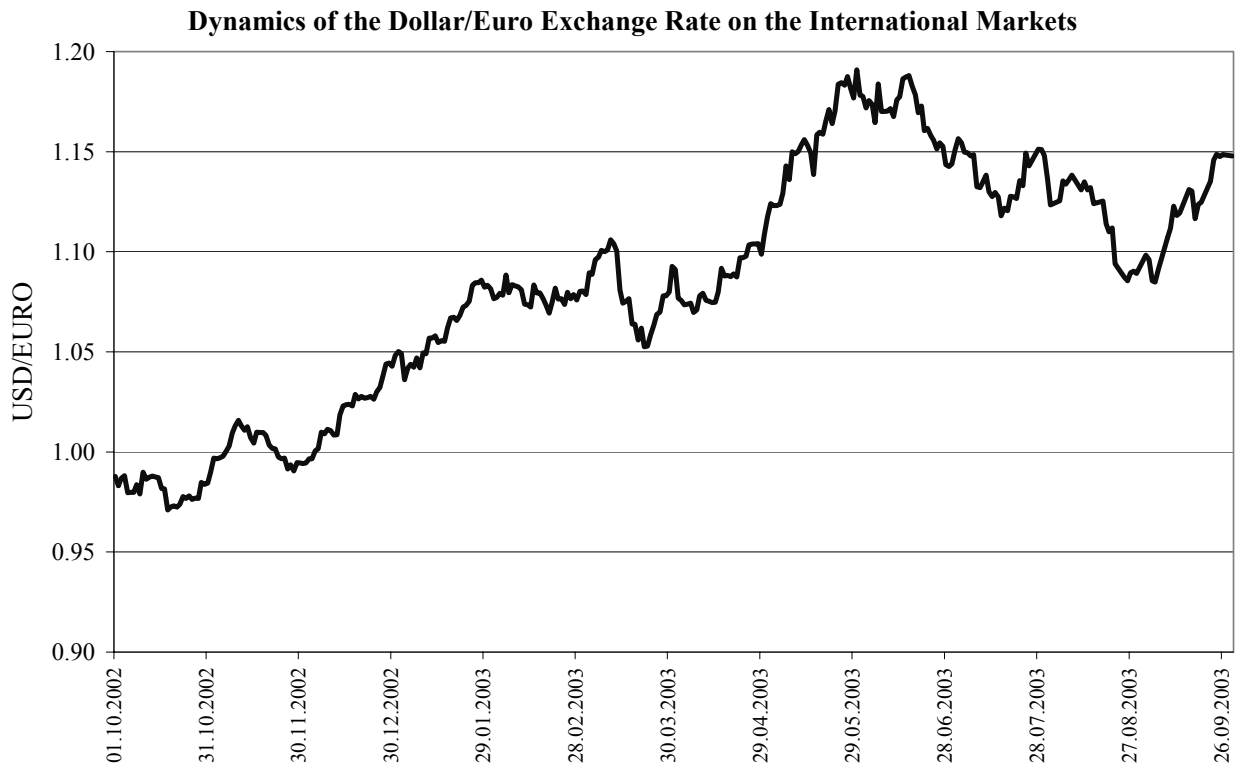


FIGURE 9.



In the world forex markets the rate of the Euro grew noticeably against the Dollar (1.8 cents or 1.6 percent), reaching at 28 October the level of US\$/ Euro 1.175. In the first half of the month a small growth of the Euro rate could be observed in the market: a certain rate correction occurred against a background of favorable macroeconomic statistics in the USA. Nevertheless, the rate grew again during the last week of the month.

The dynamics of the Euro-Rouble rate were mainly determined by the trends in the global market. The strengthening of the Euro against the US Dollar in the world markets was followed by an increase in the Euro-Rouble rate. In the period from 30 September till 28 October the European currency grew from RUR/Euro 35.07 to RUR/ Euro 35.34, or 27 kopeks (0.77 percent). The total turnover of trade at the SELT amounted to Euro 153.9 million in the period from 22 September till 24 October (in September: Euro 84.16 million). The highest trade volume of Euro 7.67 million was observed on 2 October, and the lowest, Euro 4.95 million, on 16 October.

*Table 2*

### Financial Market Indicators

Month	June	July	August	Septem.	October
Monthly inflation rate	0.8%	0.7%	-0.4%	0.3%	1.1%
Inflation rate annualized on the basis of this month's trend	10.03%	8.73%	-4.70%	3.66%	14.03%
CB RF refinancing rate	16%	16%	16%	16%	16%
Annualized yield to maturity on OFZ issues	5.31%	7.11%	6.54%	6.15%	7.4%
Volume of trading in the secondary GKO-OFZ market for the month (RUR billion)	40.12	17.08	13.00	12.87	14.4
Yield to maturity on Minfin bonds at the end of the month (% p.a.)					
5 <sup>th</sup> tranche	4.90%	5.90%	6.00%	5.68%	5.8%
6 <sup>th</sup> tranche	3.79%	4.45%	4.61%	4.26%	4.1%
7 <sup>th</sup> tranche	5.61%	6.42%	6.92%	6.55%	6.7%
8 <sup>th</sup> tranche	4.20%	5.32%	5.60%	4.96%	5.1%
Yield to maturity of Eurobonds at the end of the month (% p.a.)					
2005	2.74%	3.13%	3.35%	2.93%	3.0%
2007	3.97%	4.55%	4.81%	4.35%	4.5%
2010	5.37%	5.86%	6.09%	5.70%	5.9%
2018	6.35%	7.24%	7.28%	6.85%	7.1%
2028	6.91%	7.76%	7.64%	7.26%	7.3%
2030	7.13%	7.82%	7.81%	7.46%	7.5%
INSTAR-MIACR rate (% p.a.) on interbank overnight loans at the end of the month	1.4%	4.1%	3.9%	22.0%	15.0%
Official RUR / US\$ exchange rate at the end of the month	30.3483	30.2596	30.5036	30.6119	29.8584
Official RUR / Euro exchange rate at the end of the month	34.7124	34.6291	33.2001	35.0751	34.8657
Average annualized growth in RUR / US\$ exchange rate	-1.17%	-0.29%	0.81%	0.36%	-2.46%
Average annualized growth in RUR / Euro exchange rate	-4.81%	-0.24%	-4.13%	5.65%	-0.60%
Volume of trading at the stock market in the RTS for the month (US\$ million)	442.10	600.12	329.97	490.78	850
Value of RTS-1 Index at the end of the month	503.51	457.02	530.94	566.62	530
Change in value of RTS-1 Index during the month (%)	7.15%	-9.23%	16.17%	6.72%	-6.5%

\* Estimate

*D. Polevoy*

## Modeling investment of pension savings on the stock market: the results

All management companies, which won the right to invest the funds relating to the cumulative part of the retirement pension via the tender, have already made agreements with the Pension Fund of Russia. However, the transfer of funds from the cumulative accounts to private asset managers shall be effected since the end of March, 2004, after which date the managing companies may enter the stock market. Securities offered by Russian issuers are a class of assets permitted for investment of pension savings. It is of interest, what impact these funds would have on the stock market. The federal law "On investment of funds for financing of the

cumulative part of the retirement pension in the Russian Federation” does not set forth the maximal levels of management companies’ investment of pension savings in equity. These limitations were set forth by the Resolution of the RF Government No. 379 “On introducing additional limitations on investment of pension savings in certain classes of assets and determination of the maximal share of certain classes of assets in the investment portfolio in accordance with Articles 26 and 28 of the federal law ‘On investment of funds for financing of the cumulative part of the retirement pension in the Russian Federation.’”

As set forth by Resolution No. 379, up to 40 per cent of pension savings may be invested in equities issued by Russian public joint stock companies in 2004. Over the three next years, the share of stocks in the investment portfolio of management companies may be increased up to 65 per cent. At the same time, the law stipulates that only management companies chosen by insured persons shall have the right to make such investments. Pension savings of insured persons who did not choose an investment portfolio (management company) may not be invested in corporate stocks. These guidelines set forth in the federal law “On investment of funds for financing of the cumulative part of the retirement pension in the Russian Federation” render the prognostication of demand for equity on the part of management companies trusted with the pension savings funds rather uncertain taking into account the fact that it is still unknown what share of pension savings will be transferred to management companies in accordance with applications of insured persons concerning their choice of investment portfolio (management company).

The modeling calculations were carried out according to 3 variants where insured persons entrust management companies with 5 per cent, 20 per cent, or 1/3 of pension savings at the end of the first year the cumulative system is in operation.

According to the data contained in federal law No. 197 of December 31, 2002, “On the budget of the Pension Fund of the Russian Federation for year 2003,” as on January 1, 2003, the amount of pension savings temporarily invested in the types of assets eligible in accordance with the legislation of the Russian Federation made Rub. 39.95 billion.

Therefore, depending on the scenario, management companies may dispose of Rub. 2.0, 8.0, or 12.3 billion.

For the purposes of carrying out modeling calculations, there shall be reviewed two variants of investment in corporate stocks:

- 1) the aggregate share of investment in equities of all management companies is limited to 20 per cent of the total amount of entrusted funds;
- 2) management companies invest in stocks the maximal amount of funds set forth in the first year (i.e. 40 per cent of the transferred funds).

Taking into account these assumptions, there were elaborated 6 scenarios.

The calculations were adjusted for the fact that according to the requirements set forth by Resolution No. 379, investment of pension savings entrusted with management companies in stocks shall be limited to the issuers included in the stock quotations. However, other relevant requirements in fact limit this list to shares included in the quotation of the highest level. As on September 1, 2003, the capitalization of the issuers meeting this criterion made US \$ 120.5 billion, or 69 per cent of the aggregate capitalization<sup>10</sup>.

The aggregate amount of trade with stocks included in the quotation of the highest level A1 over 9 months of 2003 made 80 per cent of the total amount of trade with stocks at MICEX. The respective RTS indicator made about 60 per cent over the same period<sup>11</sup>. In the course of modeling it is also necessary to take into account the specifics of trade operations involving equities of leading issuers. For instance, not all issues of shares of issuers included in the top listing are traded. Therefore, in the course of calculations there was taken into account the total amount of trade with the shares of a concrete issuer at MICEX notwithstanding of what its issues were included in the quotation of the highest level.

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<sup>10</sup> According to the information agency Red-Stars/Financial, the capitalization of Russia’s issuers made US \$ 174.4 billion as on September 23.

<sup>11</sup> The calculations took into account the aggregate amount of trade on the classical and stock markets of RTS.

Table 1

**Amounts of trading at RTS and MICEX with shares included in A1 quotations in January through March of 2003 (including Gazprom shares circulated at RTS).**

Month	RTS turnover, Rub. billion	MICEX turnover, Rub. billion	Aggregate turnover	Excluding RAO UES shares		
				RTS turnover, Rub. billion	MICEX turnover, Rub. billion	Aggregate turnover
Jan.03	8.1	63.5	71.5	4.7	10.3	15.0
Feb.03	11.6	64.9	76.5	7.4	17.3	24.7
Mar.03	14.6	84.6	99.2	10.8	26.2	37.1
Mean	11.4	71.0	79.4	5.0	30.3	25.6

Besides, the organization of trade with RAO Gazprom shares resulted in certain difficulties of modeling calculations. The only exchange where these shares are included in the A1 quotation is MSE, however, the respective trading is irregular. The bulk amount of trading is carried out at the St. Petersburg Stock Exchange (where the bonds are included in the quotation B). The St. Petersburg exchange is in terms of technology closely linked to RTS, which has not a formal permission to trade with these securities, however, the results of trading with Gazprom shares are included in the aggregate turnover of RTS (see Table 2).

Table 2

**Gazprom share in the amount of trading with securities included in the RTS A1 quotation.**

Month	Share of Gazprom stocks in RTS turnover, %	
	Including RAO UES stocks	Excluding RAO UES stocks
Jan.03	18.23	31.08
Feb.03	35.50	70.39
Mar.03	44.75	71.51
Mean	32.83	57.66

Yet another circumstance to be taken into account is a very high share of only one issuer – RAO UES – in the turnover of stocks (see Table 3). The share of RAO UES stocks in the turnover of both trading floors fluctuated from 37.3 per cent at RTS in March of 2003 to 83.8 per cent at MICEX in January over the period under observation. Therefore, Table 1 includes the data on the aggregate turnovers of securities included in the top listings at MICEX and RTS with and without amounts of trading with RAO UES stocks.

The decision about carrying out additional calculations excluding the data on trading with RAO UES shares from the aggregate turnover of securities was taken because of the fact that although there was observed a trend towards a decrease in the share of stocks issued by RAO UES, the average values registered over three months of 2003 turned out to be rather high (75.37 per cent at MICEX and 45.47 per cent at RTS), what may result in an incorrect interpretation of the results of the calculations. The Gazprom stocks were not excluded, since their share in the aggregate turnover of MICEX and RTS was significantly less than the respective indicator of RAO UES.

Table 3

**The share of RAO UES stocks in the amount of trading with stocks included in the A1 quotations of MICEX and RTS.**

Month	Share of RAO UES stocks in turnover, %	
	MICEX	RTS*
Jan.03	83.80	41.36
Feb.03	73.32	36.58
Mar.03	68.98	25.85
Mean	75.37	34.60

\* Note. The trading turnover at RTS consists of the data on ordinary and preferred stocks, the amount of trading with Gazprom stocks including.

## The results of the modeling calculations

### Scenario 1.1.

The resources entrusted by the Pension Fund with management companies selected via the tender make 1/3 of the total amount of pension savings (Rub. 13.3 billion) by the end of 2002.

The maximal amount permitted to be invested in equities (proceeding from the 40 per cent limit) makes Rub. 5.33 billion.

In the case the investment of pension savings was carried out in the respective month of 2003, the invested amount (Rub. 5.33 billion) would make the following percentage of the turnover of the trading floors:

Months, in which shares were purchased	Invested amount, Rub. billion	Investment of MC in % of the turnover	
		Total	Without RAO UES stocks
Jan.03	1.78	2.5	11.8
Feb.03	1.78	2.3	7.2
Mar.03	1.78	1.8	4.8
Mean	1.78	2.2	7.9

### Scenario 1.2.

The resources entrusted by the Pension Fund with management companies selected via the tender make 1/3 of the total amount of pension savings (Rub. 13.3 billion) by the end of 2002.

The amount invested in stocks (20 per cent of the total savings) makes Rub. 2.66 billion..

In the case the investment of pension savings was carried out in the respective month of 2003, the invested amount (Rub. 2.66 billion) would make the following percentage of the turnover of the trading floors:

Months, in which shares were purchased	Invested amount, Rub. billion	Investment of MC in % of the turnover	
		Total	Without RAO UES stocks
Jan.03	0.89	1.2	5.9
Feb.03	0.89	1.2	3.6
Mar.03	0.89	0.9	2.4
Mean	0.89	1.1	4.0

### Scenario 2.1.

The resources entrusted by the Pension Fund with management companies selected via the tender make 20 per cent of the total amount of pension savings (Rub. 8.0 billion) by the end of 2002.

The maximal amount permitted to be invested in equities (proceeding from the 40 per cent limit) makes Rub. 3.2 billion.

In the case the investment of pension savings was carried out in the respective month of 2003, the invested amount (Rub. 3.2 billion) would make the following percentage of the turnover of the trading floors:

Months, in which shares were purchased	Invested amount, Rub. billion	Investment of MC in % of the turnover	
		Total	Without RAO UES stocks
Jan.03	1.07	1.5	7.1
Feb.03	1.07	1.4	4.3
Mar.03	1.07	1.1	2.9
Mean	1.07	1.3	4.8

**Scenario 2.2.**

The resources entrusted by the Pension Fund with management companies selected via the tender make 20 per cent of the total amount of pension savings (Rub. 8.0 billion) by the end of 2002.

The amount invested in stocks (20 per cent of the total savings) makes Rub. 1.6 billion.

In the case the investment of pension savings was carried out in the respective month of 2003, the invested amount (Rub. 1.6 billion) would make the following percentage of the turnover of the trading floors:

Months, in which shares were purchased	Invested amount, Rub. billion	Investment of MC in % of the turnover	
		Total	Without RAO UES stocks
Jan.03	0.53	0.7	3.5
Feb.03	0.53	0.7	2.2
Mar.03	0.53	0.5	1.4
Mean	0.53	0.7	2.4

**Scenario 3.1.**

The resources entrusted by the Pension Fund with management companies selected via the tender make 5 per cent of the total amount of pension savings (Rub. 2.0 billion) by the end of 2002.

The maximal amount permitted to be invested in equities (proceeding from the 40 per cent limit) makes Rub. 0.8 billion.

In the case the investment of pension savings was carried out in the respective month of 2003, the invested amount (Rub. 0.8 billion) would make the following percentage of the turnover of the trading floors:

Months, in which shares were purchased	Invested amount, Rub. billion	Investment of MC in % of the turnover	
		Total	Without RAO UES stocks
Jan.03	0.27	0.4	1.8
Feb.03	0.27	0.3	1.0
Mar.03	0.27	0.3	0.7
Mean	0.27	0.3	1.2

**Scenario 3.2.**

The resources entrusted by the Pension Fund with management companies selected via the tender make 5 per cent of the total amount of pension savings (Rub. 2.0 billion) by the end of 2002.

The amount invested in stocks (20 per cent of the total savings) makes Rub. 0.4 billion.

In the case the investment of pension savings was carried out in the respective month of 2003, the invested amount (Rub. 0.4 billion) would make the following percentage of the turnover of the trading floors:

Months, in which shares were purchased	Invested amount, Rub. billion	Investment of MC in % of the turnover	
		Total	Without RAO UES stocks
Jan.03	0.13	0.2	0.9
Feb.03	0.13	0.2	0.5
Mar.03	0.13	0.1	0.4
Mean	0.13	0.2	0.6

As it is demonstrated by the result of the modeling calculations in accordance with Scenario 1.1, where the investments of management companies in equities were made proceeding from the maximal permitted share of stocks in the investment portfolio, on the average they make only 2.5 per cent of the aggregate amount of trading (in the case RAO UES – 9.1 per cent – is excluded). These results were affected by both the fact that the stock segment of the market is more developed than the segment of corporate bonds and that the permitted limit on investment in stocks was below the limit set on the investment of pension savings in corporate bonds (40 per cent of the investment portfolio as concerns investment in stocks). The practical implementation of such a scenario<sup>12</sup> can not destabilize the stock market, especially taking into account the growth in the amount of trade in the consequent months of 2003. Other scenarios do not have a significant impact on the major trends on the stock market at all. The impact of the developments in the case of implementation of Scenario 3.2 (the resources entrusted by the Pension Fund with management companies selected via the tender make 5 per cent of the total amount of pension savings (Rub. 2.0 billion), while the amount invested in stocks (20 per cent of the total savings) makes Rub. 0.46 billion) is absolutely insignificant (0.2 per cent of the amount of trading). At the same time, the probability that the situation will develop according to the third scenario is rather high not only judging by preliminary polls, but also because of technological factors (problems related to mailing of applications concerning the choice of the investment portfolio (management company) to the Pension Fund and their processing by the stipulated deadline).

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## **Investment in the Real Sector**

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In January through September of 2003, the positive dynamics of investment in the real sector of the economy persisted. The amount of investment in fixed assets from all sources of financing made Rub. 1409.6 billion, or 112.1 % in comparison with the figures registered in the respective period of the preceding year. The share of investment in fixed assets in the GDP increased by 1 percentage point and made 14.5 per cent as compared with the figures observed in January through September of 2002.

The increasing intensity of investment activity in the real sector of the economy in 2003 is observed at the background of changes in the sectoral structure of investment. The total amount and dynamics of investment are mainly determined by natural monopolies, oil industry, housing and public utilities. The share of investment in fixed assets of manufacturing industries has increased by 1.4 percentage points in comparison with the figures registered in the preceding year and made 51.8 per cent. The proportions of investment across the sectors of the economy was practically completely determined by the increase in investment demand of industry. As compared with the figures registered in January through September of 2002, the share of investment in industry decreased by almost 1.5 p. p., while the specific weight of investment in transport, communications, and trade.

This year, the rather moderate dynamics of investment expenditures in the fuel complex had a significant impact on the nature and dynamics of investment demand. According to the preliminary figures, in January through September of 2003 investment in the fuel complex made 24.5 per cent of the total investment in fixed assets across all sectors of the economy, what is by 1.5 and 0.8 p. p. below the respective indicators observed in the preceding year. Taking into account the fact that transport, communications, and the fuel complex account for almost ½ of the total amount of investment in the national economy, it becomes evident that the business activity of these industries has the most strong impact on the dynamics and structure of investment demand.

In spite of the fact that in 2001 through 2003 there was observed a certain increase in the share of investment in the manufacturing sector of the economy, it shall be noted that investment industries and industries belonging to the consumer sector account for 7.6 per cent and 9.3 per cent of the total amount of investment in industry respectively. Under the existing age, technology, and reproduction structure of fixed assets, low rates of investment in manufacturing industries are a factor slowing down the rates of economic growth.

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<sup>12</sup> The overwhelming majority of management companies which made agreements with the Pension Fund of the Russian Federation have introduced the maximal permitted limit in their investment declarations. In the case the companies which declared several portfolios are excluded, only one management company indicated 10 per cent as the maximum.

The accelerating rates of economic growth have had a positive impact on the changes in the structure of the sources of financing of investment in fixed assets. This year, at the background of a 5.1 p. p. decrease in the share of own funds in investment in fixed assets, there is observed a trend towards an increase in the share of bank credits by 0.5 p. p. and borrowings of enterprises by 2.4 p. p.

This year, a positive factor of the investment process is the increasing share of credits issued by foreign banks in the financing of investment (by 0.3 p. p. as compared with the figures registered in the preceding year). Since the high rates of economic growth persist this year, there is observed the recovery of positive dynamics of foreign direct investment in the Russia's economy. By the end of the first six months, the increase in foreign investment made 51.3 per cent as compared with the figures registered in the respective period of the preceding year, while direct investment grew by 35.3 per cent, what almost three times exceeds the rates of growth in investment expenditures from own financing sources. Besides, there persists the trend towards a decline in amounts of capital outflow.

On October 8, 2003, the international ranking agency Moody's Investors Service announced that it raised Russia's credit ranking to the Baa3 level. The change in the national credit ranking provided an opportunity to review the credit rankings of Russian banks and corporations. On October 9, Moody's stated that four Russian banks (Bank Alba Alliance, Alpha Bank, Bank Zenit, and MDM Bank) were put on the observation list for the probable improvement of their credit rankings.

Since the ranking has been raised up to the investment level, it may be expected that the conditions of borrowings on the international market of capitals will improve. To a certain extent, this development may abate the impact of temporary peak payments related to the foreign debt on the dynamics of the economic growth. At the same time, there arise real opportunities for an increase in the inflow of funds at the disposal of institutional portfolio investors, whose operations are regulated by the requirement to invest only in the instruments with the investment ranking. In the case the Russia's GDP grows at about 6 per cent a year, the Russian market looks attractive enough for foreign investors. However, the issues of political stability, as well as economic risks relating to the dynamics of prices of staple Russian exports become of the crucial importance.

According to the methods used by other leading ranking agencies, Russia is still one or two levels below the investment ranking. Moreover, certain representatives of these agencies have voiced an opinion that it is too early to confer the investment ranking on Russia. According to the international agency Fitch, the long-term ranking of the forex-denominated Russian financial instruments is at BB+, with stable prospects. Standard & Poor's taking into account the low level of the diversification of the Russia's economy and its strong dependence on world prices of energy resources sets its ranking at BB level, also stating that the prospects are stable.

It shall be noted that according to the Moody's classification, Baa ranking is the lowest of the investment ranking levels and bonds of such an issuer have some features of securities of the speculative level. Therefore, although the Moody's ranking is an important event on the Russia's financial market, it does not mean a safe transition to another category, since foreign investors usually take into account the rankings of at least two agencies.

*O. Izryadnova*

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## **The Real Sector: Factors and Trends**

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According to the preliminary data, the amount of GDP made Rub. 9714 billion in January through September of 2003 and was by 6.5 per cent above the level registered in the respective period of the preceding year. The dynamic expansion of final demand positively affected the dynamics of GDP this year. In 2003, across practically all sectors of the economy and industry there was observed an acceleration of growth rates as compared with the preceding year. The increase in output of products and services of the base sectors of the economy made 6.8 per cent in January through September of 2003 outpacing the rates registered in the respective period of the preceding year by 2.8 percentage points. The acceleration of the rates of growth in the sector of services based on the intensive expansion in the amounts of supply of communications, transport, and trade services. The freight turnover increased by 7.3 per cent in comparison with the figures observed in January through September of 2002, while the retail trade turnover grew by 8.2 per cent. In January through September of 2003, the average monthly rates of increase in communications services increased by 2.25 per cent as compared with 1.45 per cent registered in the respective period of 2002. The specific feature of this year is the rates of growth in investment demand which outpace consumer



demand. According to the results of three quarters of 2003, investment in fixed assets increased by 12.1 per cent as compared with 2.5 per cent registered in the respective period of the preceding year.

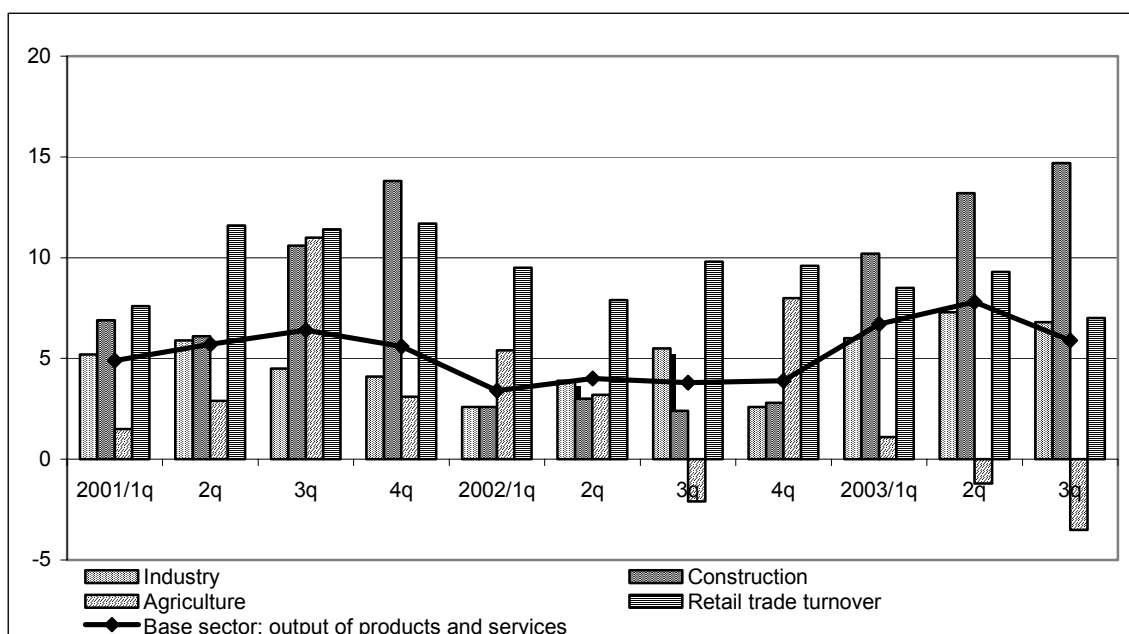


Figure 1. Changes in the rates of growth across sectors of the economy in 2001 through 2003, in % of the figures registered in the respective period of the preceding year

In 2003, there was observed a growing influence of the export oriented sector of the economy. Because of the exceptionally favorable world prices on raw materials markets, exports grew across practically all range of goods. In January through August of 2003, exports increased by 25.9 per cent, while in the 3<sup>rd</sup> quarter there was registered an acceleration of the growth rates in comparison with the figures observed in the preceding year. While in the first six months of 2003 the export of oil was by 11.4 per cent above the levels registered in the preceding year, in July and August of 2003 the export of crude oil exceeded the respective figures of these months in the preceding year by 52 per cent. The specific weight of major fuel and energy resources in the total amount of exports increased by almost 3.5 percentage points in comparison with the figures registered in the respective period of the preceding year. In January through August of 2003, there was observed an acceleration in the rates of growth in export of iron ore and concentrates, ferrous metals, and aluminum. The growth in output of industries oriented towards the foreign market had the dominating impact on the dynamics and structure of the industry. The highest rates of growth in January through September of 2003 were registered in fuel industry (by 109.6 per cent), including a 111.5 per cent increase in oil extracting industry, and in ferrous metallurgy (by 109.3 per cent).

An intensive growth in export oriented industries has initiated expanding demand for services and a growth in profits in the related sectors of the economy. As compared with the figures registered in January through August of 2002, the balanced financial result of fuel industry, main pipeline transport, and foreign trade has increased 1.95 times, while the respective indicator for the economy at large grew 1.58 times and 1.55 times in the industry.

The industries forming the domestic demand are characterized by more moderate dynamics of development and financial results of their operations. As concerns the complex of investment sectors, in January through September of 2003 the general index of production there made 106.9 per cent of the level registered in the respective period of the preceding year. The increase in output of mechanical engineering and construction materials industry made 8.1 per cent and 5.4 per cent respectively in January through September of 2003.

The output across the industries of the mechanical engineering complex fluctuated rather considerably. Among the negative factors affecting the dynamics of mechanical engineering this year, there may be mentioned the permanent overproduction crisis in motor manufacture, as well as the persisting trend towards contraction of investment demand of fuel industry for domestic types of equipment and machinery at the background of growing export returns. The rather high rates of growth in production of machinery and

equipment in 2003 was supported mainly at the expense of expanding demand for production of railroad related mechanical engineering, instrument making, and communications equipment industry. Over the past four years, there persisted a stable increase in demand for equipment to be used in the industries belonging to the consumer complex. However, in spite of almost twofold acceleration of the rates of growth in output of capital goods, this year there is observed a growing gap between the dynamics of investment demand and supply of domestically manufactured equipment and machinery. The expansion of demand both on the investment and consumer markets is taking place at the background of outpacing increase in import of goods as compared with the dynamics of domestic production. In comparison with the figures registered in January through September of 2002, the import of equipment and machinery grew by 22.6 per cent, while the share of imported equipment in the structure of investment in machinery and equipment made almost ¼.

*Table 1*

**Dynamics of output across industries of mechanical engineering in January through September of 2000 through 2003, in % of the respective period of the preceding year**

	2000	2001	2002	2003
Mechanical engineering and metal working	116,0	107,7	103,1	108,1
Including by branch:				
Metallurgical mechanical engineering	144,1	90,8	70,1	104,8
Chemical and petrochemical mechanical engineering	123,0	125,6	87,8	87,0
Hoisting and transport mechanical engineering	148,1	123,5	92,3	80,8
Railroad mechanical engineering	105,2	121,1	123,4	132,0
Electrical engineering	139,3	113,7	94,4	102,7
Machine tool and tool industry	117,3	98,0	85,0	92,2
Instrument making	136,1	100,6	92,8	150,1
Motor industry	104,0	98,6	103,3	100,8
Tractor and agricultural mechanical engineering	153,8	134,9	82,2	71,8
Mechanical engineering for light and food industries	108,9	104,3	115,7	106,4
Communications equipment industry	430	85,6	169,2	128,8

Source: RF Goskomstat

The expansion of consumer demand was determined by an intensive growth in household incomes. In January through September of 2003, the increase in the real disposable cash household incomes made 13.3 per cent, while real wages and salaries grew by 9.1 per cent. In January through September of 2003, the turnover of retail trade exceeded the level registered in the respective period of the preceding year by 8.2 per cent. The saturation of the consumer market with goods mainly corresponded to the effective demand of households for major types of food and non-food goods.

The increasing scale of imports has significantly impacted the dynamics of development of the consumer complex industries. While in the first six months of 2002 domestically manufactured goods accounted for about 60 per cent of the structure of the commodity resources of the retail trade turnover, in 2003 their specific weight declined by 5 percentage points. As the growth rates in food industry decelerated to 4.7 per cent in January through September of 2003 as compared with 7.8 per cent registered in the respective period of the preceding year, the share of imports in the commodity resources of the food market grew by almost 1 percentage point. It shall be noted that while competing imports make a considerable share in the structure of commodity resources of retail trade turnover, imports squeeze out domestically manufactured goods as concerns non-food commodities. According to estimates of the Ministry of Economic Development, the share of imports in the structure of commodity resources of non-food goods has increased by 3.4 percentage points since the beginning of the year. While the downfall of output of light industry persists, the increase in import of jersey and textile apparel made 6.6 per cent as compared with the figures registered in the respective period of 2002, at the same time the import of cotton fabrics increased by 82.7 per cent. A factor behind the declining competitiveness of Russian goods in comparison with similar imports has been the low technical and technological level of the production apparatus. The persisting trend towards the lower rates of renovation of fixed assets observed in light industry places it in the group of manufacturing industries characterized by critical levels of wear and tear of fixed assets.

The low competitiveness of industries of final demand and orientation towards traditional positions on the world markets of raw materials and fuels determines the dependence of economic growth rates on the external economic situation.

The present level of prices of hydrocarbons and minerals the estimated increase in GDP will make 106.0 to 106.2 per cent, while the growth in investment in fixed assets may make 111.0 to 112.0 per cent.

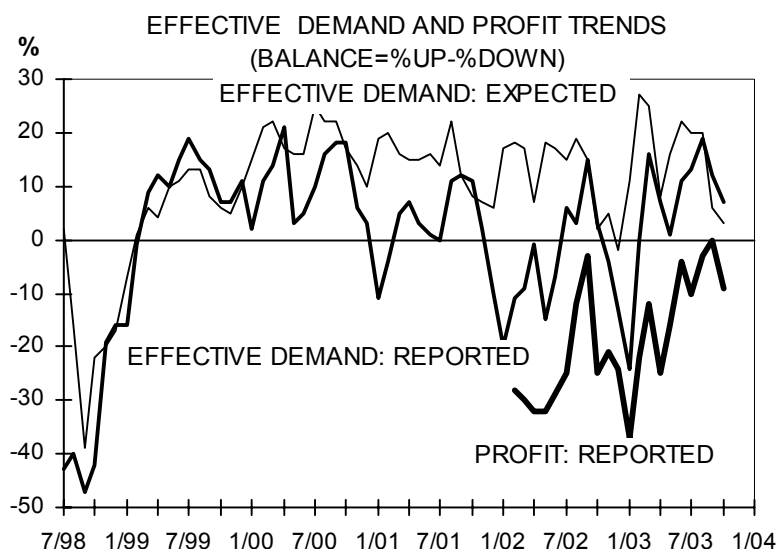
*O. Izryadnova*

## IET Business Survey: Industry

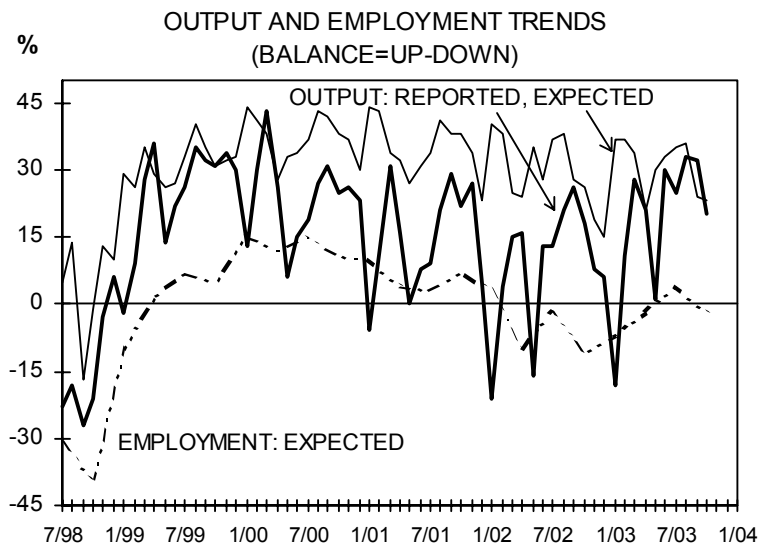
In the beginning of the 4<sup>th</sup> quarter, the negative trends in the dynamics of base indicators characterizing the business situation in the Russia's industry continued to grow. The persisting deceleration of the rates of growth in sales made enterprises to slow down the rates of industrial output. The real profits of enterprises has started to decline again. Forecasts of demand, output, and employment continue to become less optimistic.

According to the evaluations of the Center for Macroeconomic Analysis and Short Term Prognostication (CMASTP), the economic growth observed in the 3<sup>rd</sup> quarter was of a clear export and raw material nature. There was registered a sharp increase in the rates of growth in production of energy resources – up to 0.5 per cent a month as compared with 0.1 per cent observed in the 2<sup>nd</sup> quarter. As a result, the contribution of fuel industry in the total growth in industrial output has reached 40 per cent as compared with 20 per cent registered in the 2<sup>nd</sup> quarter. At the same time, the dynamics of output in manufacturing industries declined two times – down to 0.4 per cent a month. The respective contribution of these industries in the total growth in industrial output decreased to 34 per cent (as compared with 48 per cent registered in the 2<sup>nd</sup> quarter). An accelerated increase in imports (2.3 per cent as compared with 1.6 per cent observed in the 2<sup>nd</sup> quarter due to the Ruble appreciation) has limited the possibilities for expansion of production in manufacturing industries.

In the beginning of the 4<sup>th</sup> quarter, the negative trends in the dynamics of base indicators characterizing the business situation in the Russia's industry continued to grow.



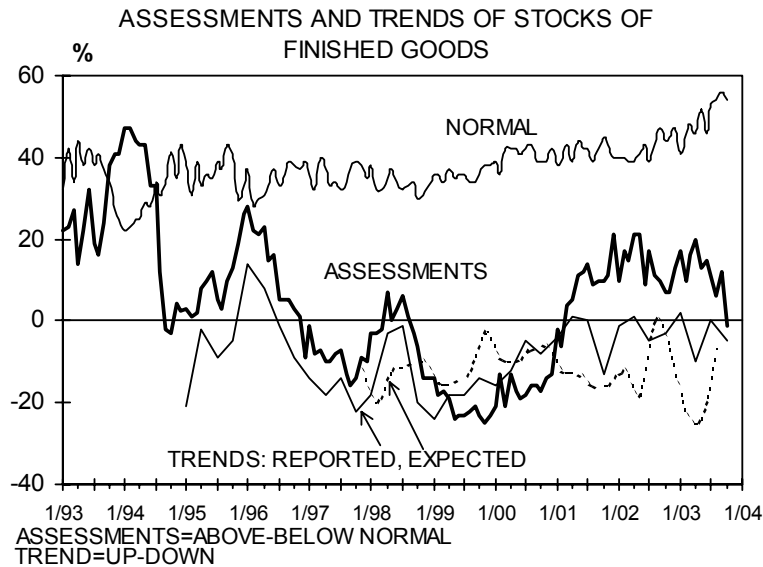
First, the rates of growth in effective demand declined by yet 5 points. The general decrease of this indicator made 12 p. p. in September and October. A deceleration of rates of growth in sales was registered across all industries with the exception of power engineering (the seasonality) and food industry. In construction industry, chemistry and petrochemistry, there was already observed an absolute decline in demand: in these industries the share of enterprises reporting about a fall in sales exceeds the share of enterprises, which increased their amounts of sales. As a result, the balance of this indicator became negative. In other industries, the balances retain positive values. However, the autumn slowdown in the rates of growth in sales does not considerably disturb enterprises yet. The share of “normal” assessments of demand is still above 50 per cent. This development was for the first time registered three months ago, and since that time the majority of Russia's industrial enterprises have been satisfied with the amounts of effective demand for their products. Over this period, the highest results were obtained in metallurgy (84 per cent), the forestry complex and construction industry (64 per cent each), as well as in food industry (58 per cent). The minimal levels of satisfaction with demand were registered in mechanical engineering (47 per cent) and light industry (46 per cent). A certain decline in the balance of evaluations of demand (above norm – below norm), which occurred in September and October, has not principally affected the overall picture.



Second, the clearly pronounced deceleration of growth in sales made enterprises to slow down the rates of industrial output. While in September the rates of growth stabilized, in October they declined by 12 points. A deceleration of rates occurred across all industries with the exception of power engineering and food industry. However, from the point of view of the relationship between the dynamics of output and the dynamics of demand, the situations in these two industries are principally different. While in October in food industry the correspondence of changes in production and sales was registered at 63 per cent of enterprises and only 32 per cent increased output “outpacing” cash demand, in power engineering only 26 per cent of enterprises matched output with demand and 74 per cent “outpaced” cash demand. The last figure means that the majority of enterprises in the industry have to increase output without receiving cash payments for their products. In October of 2002, a similar situation was registered at 53 per cent of enterprises of power engineering, in October of 2001 this was true for 64 per cent of enterprises. It shall be noted that October is the most difficult month for this industry as concerns payments. Later the situation begins to improve, and already by February only 10 to 18 per cent of enterprises have to operate providing services against future payments. As concerns mechanical engineering, there the ratio between output and demand is not subject to such seasonal fluctuations. In 2002, on the average only at 28 per cent of plants the dynamics of output outpaced the dynamics of demand. Over the first 10 months of 2003, this indicator in the industry was at 27 per cent.

Third, according to enterprises’ estimations, the real profits in the industry has begun to diminish again. While in September this indicator stopped to decline (there was registered a zero balance of growth rates), in October the balance decreased to –9 per cent. Negative changes were registered across all industries with the exception of power engineering.

The dynamics of assessments of finished stocks underwent certain unexpected changes. For the first time since March of 2002, a shortage of finished stocks has been registered in the Russia’s industry. At the same time, the balance of evaluations dropped over the month by 13 points (from + 12 to –1 per cent). The excessive finished stocks were exhausted (or, at least, sharply decreased) across practically all industries. Only in light industry the balance increased, however, it remained within the traditional for this industry band of fluctuations in 2003. In the Russia’s industry, the finished stocks are frequently used as a means to iron out sudden shifts in demand, what in turn allows to smooth the dynamics of output and immediately meet requirements of new buyers. Therefore, behind such a jump in assessments there may be two factors: a rather intensive growth in sales observed in the late summer exhausted finished stocks in warehouses, while the replenishment was not sufficient to meet the possible future demand. This assumption is confirmed by a growth in the balance of forecasts of changes in finished stocks. In the 4<sup>th</sup> quarter this indicator increased by 17 points at once, although remaining negative. At the moment, enterprises are planning only to diminish the rates of decrease in their finished stocks. Since the forecasts of changes in demand indicate that in the next 1 or 2 months the industry does not expect any increase in the rates of sales, the finished stocks are most probably needed to meet new orders likely to be made in the future.



The assessments of changes in effective demand became less optimistic (losing 3 points) in October. Altogether, this indicator dropped by 17 p. p. over the last 2 months. As a result, at the moment the balance of forecasts of sales makes only + 3 per cent. No such moderate forecasts of effective demand has been registered since the beginning of the year. Diminishing optimism (and in certain cases prevalence of pessimism) was registered across practically all industries. A growth in optimism of forecasts concerning sales was registered only in non-ferrous metallurgy and mechanical engineering.

The assessments of changes in output practically did not change in October in spite of continuing decrease in optimism with regard to the forecasts of demand. As a result, the correspondence of these two indicators diminished from 71 to 66 per cent. At the same time, the share of enterprises forecasting an outpacing growth in output as compared with demand reached 26 per cent.

The balance of forecasts concerning the changes in employment became negative: enterprises expecting a growth in unemployment again prevail across industries. The increase in the optimistic expectations registered in the 3<sup>rd</sup> quarter (+ 4 per cent) was reversed under the pressure of negative trends observed in the dynamics of demand and output.

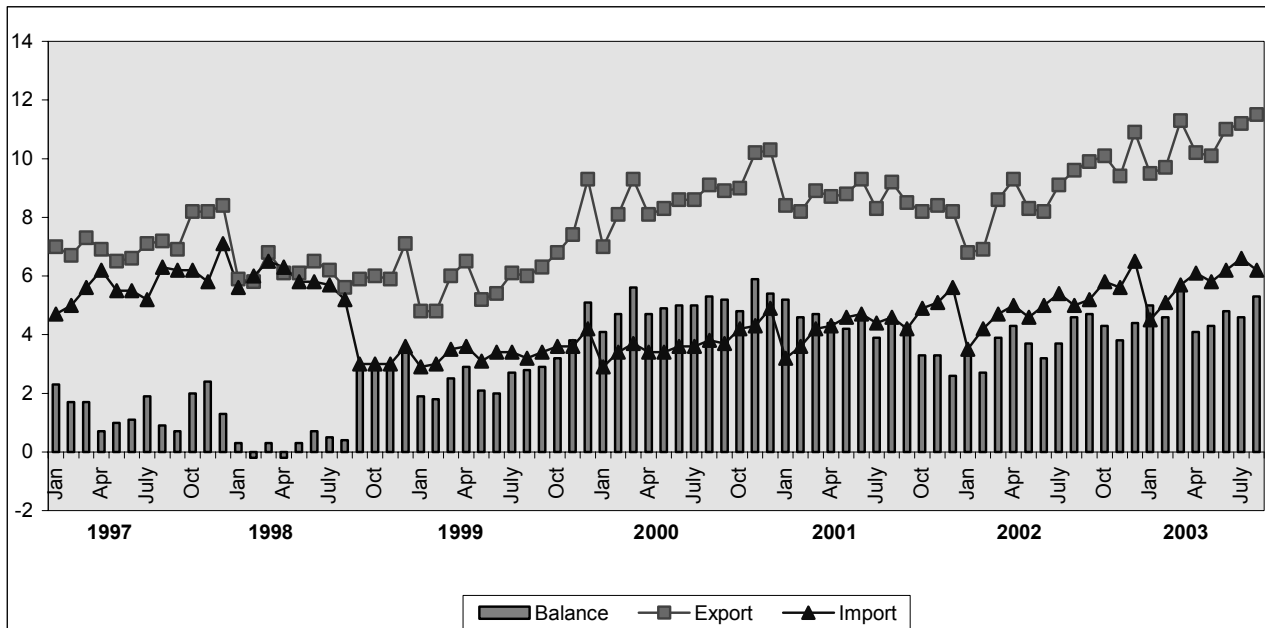
*S. Tsukhlo*

## Foreign Trade

In August of 2003, the Russia's foreign trade turnover grew by 19.7 per cent in comparison with the figures registered in the respective month of the preceding year and made US \$ 17.7 (according to the balance of trade methodology). In August, export of goods and services reached US \$ 11.5 billion (an increase by 16.3 per cent as compared with the figures registered in August of 2002), while imports grew by US \$ 6.2 billion (an increase by 20.5 per cent). In spite of the significant growth in imports, the active balance of trade remains at a high level (US \$ 5.3 billion, what is by 15.2 per cent above the level observed last August).

Both the increase in the volume of exports and the price factor accounted for the growth in the amount of exports. However, exactly the influence of the price factor was the determining one because of the exceptionally favorable price situation on the world markets of energy resources and non-ferrous metals.

For instance, in August of 2003 the average URALS oil price made US \$ 29.0 per barrel (a growth by 7.8 per cent in comparison with the July figures), while BRENT prices were at US \$ 29.9 per barrel (a 5.2 per cent growth in comparison with the July figures). In the eight months of this year, the average URALS and BRENT oil prices exceeded the respective indicators of 2002 by 21.3 per cent and 21.8 per cent respectively. The upward price trend was determined by a low level of oil reserves in a number of countries, for instance, in the USA, a record demand for oil on the part of China, continuing enforcement of the previously made OPEC agreements on the limitation of oil extraction, as well as uncertainty relating to the recovery of the Iraq oil exports on the world market.



Source: RF Goskomstat

Figure 1. Main indicators of Russia's foreign trade (in US \$ bln.)

This August, the average contract price of Russian natural gas diminished by 5.9 per cent in comparison with the figures registered in July, however, it increased by 27 per cent as compared with the figures observed in the first eight months of the preceding year.

In August, there was observed a price hike on the world market of ferrous and non-ferrous metals. The average European export prices of major types of merchant rolled shapes increased by 3 per cent in comparison with the figures registered in July, while the prices of sheet rolled products grew by 1.7 per cent. The average August prices exceeded respective July figures by 1.7 per cent (aluminum), 2.9 per cent (copper), 6.7 per cent (nickel). The average nickel price registered over the past 8 months exceeded the figures observed in the respective period of the preceding year by 28.6 per cent, copper – by 6.6 per cent, aluminum – by 3.7 per cent.

Table 1

**The average monthly world prices in August of the respective year**

	1996	1997	1998	1999	2000	2001	2002	2003
Oil (Brent), USD / barrel	21,04	18,25	12,5	20,2	29,4	25,7	27,2	29,9
Natural gas, USD /1 mil Btu	2,856	2,121	1,858	2,8	4,437	2,91	2,999	4,888
Gasoline, USD / gallon	0,6299	0,5941	0,4128	0,6476	0,9021	0,776	0,834	0,935
Copper, USD / metric ton	2001,4	2481,7	1627,4	1646,6	1941,7	1499,4	1480,0	1731,0
Aluminum, USD / metric ton	1480,1	1563,7	1345,4	1421,1	1546,4	1374,9	1292,0	1457,0
Nickel, USD / metric ton	7100,4	6737,3	4137,1	6430,8	8092,9	5554	6720,0	9365,0

Source: calculated in accordance to the data presented by London Metal Exchange (UK), International Oil Exchange (London)

Import of goods on the whole also demonstrated high dynamics. The factors behind this development were mainly the growing effective household and enterprises' demand, and the Ruble appreciation. In January through August, the real Ruble appreciation with regard to US \$ made 11.6 per cent, while on the whole the real effective Ruble exchange rate appreciated by 4.7 per cent. The negative impact of the Ruble appreciation on the competitiveness of Russian goods as compared with imports was somewhat mitigated due to more favorable Ruble / Euro dynamics – the respective real Ruble appreciation made only 2.2 per cent over the 8

months of this year (it shall be taken into account that about 1/3 of the total Russia's imports are from the Euro zone).

This August, the turnover of Russia's trade vis-à-vis CIS countries made US \$ 3.21 billion, at the same time, the exports grew by 30.6 per cent in comparison with the figures registered in the respective period of the preceding year, and made US \$ 1.86 billion, while imports increased by 28.9 per cent and made US \$ 1.35 billion.

In October, Ukraine started the implementation of antidumping measures against import of matches from Russia, the new customs duties rates were set at 8.8 per cent.

The most pressing problem in the Russia – Belorussia relations was again the debts relating to natural gas deliveries. The debt accumulated by Belorussia in 1999 through 2002 makes over US \$ 120 million. In 2003, Russia delivered more than 60 per cent of the targeted annual volumes of natural gas at its internal prices (US \$ 28 per 1 thous. m<sup>3</sup>), however, since next January, the price shall increase up to US \$ 50. At the same time, the Belorussian party took the decision to rise the tariffs on transit of Russian natural gas to Western countries two times.

In October of 2003, the State Duma passed the draft law “On principles of state regulation of external economic activities,” introduced by the RF Government, in the second reading. This draft law was a component of a package of laws necessary to be adopted for Russia's accession to the World Trade Organization.

The basic idea of the bill is to «adapt the legislation governing the RF legislation on external economic operations to the new legal and economic realities. In the course of elaboration of the draft law, there were taken into account the principal stipulations of the general WTO agreements on tariffs and trade, trade in services, as well as the WTO agreements concerning the procedures governing import licensing.” The respective law currently in force does not answer the international regulations, although its last version was enacted only in 1999, besides, it includes too many contradicting provisions, therefore, even the current stipulations often can not be implemented in practice.

The draft law clearly defines basic terms used in the legal and regulatory documents, as well as offers definitions of a number of terms new for the Russia's legislation (free trade zone, customs union, transit). The law vests the RF Government with the right to introduce temporary limitations on exports aimed at the prevention of the “critical shortage” of food and other goods critically important for the domestic market. Protectionist measures may be also implemented in order to maintain the balance of payments and prevent the danger of decline in currency reserves.

The law stipulates the exhaustive list of cases, where it is permitted to introduce the procedure of licensing of export and import activities. For the first time there is introduced a rule according to which the sum of all payments, with the exclusion of customs duties, shall not exceed the value of a good.

The bill significantly limits the powers of RF subject relating to external economic activities in comparison with the law currently in force. After the enactment of the new law, regional authorities shall have no right to give additional financial guarantees to participants of foreign trade activities, registered in their territories, as well as establish insurance and pledge funds aimed to attract foreign loans and credits.

In October of 2003, there took place the eighth meeting of the Russia – EU cooperation committee, where there were discussed the consequences of the EU enlargement for Russia and the problem of Russia's accession to WTO.

On May 1, 2004, the European Union will be significantly enlarged – ten new members, some of the direct neighbors of Russia, shall join the present fifteen member countries. The EU enlargement sets many problems to Russia. For instance, Russian exporters of aluminum, steel, mineral fertilizers, and a number of other goods will suffer considerable losses because of the (naturally, upward) equalization of customs duties of the new EU member countries at the all-European level.

According to the WTO regulations, its member countries may not unilaterally worsen the conditions of access to their domestic markets for any country even in the case it is required by a certain association (with the exception of dumping). However, since Russia is not a WTO member, it has no right to demand that the current customs duties on steel and aluminum are maintained by the countries joining EU.

At the same time, EU remains one of the most difficult partners in the course of the negotiations on the conditions, on which Russia will join WTO. Yet last year, Russia expected to settle the only issue discussed at that time – i.e. the equalization of internal and export prices of Russian electrical power and natural gas. Since the start of the reform of the power engineering practically all issues seemed to be resolved, however, the list of requirements concerning natural gas only expanded. According to the latest proposals, the

Europeans expect that in the course of joining WTO Russia will abolish cross-subsidizing and set domestic prices at a level covering internal costs of Gazprom. Besides, EU demands to liquidate the Gazprom's export monopoly and ensure free transit of natural gas via the Russia's territory, allow foreigners to participate in construction of pipelines, equalize tariffs on delivery of natural gas to domestic consumers and on export supplies, as well as abolish export duties on natural gas deliveries.

The meeting resulted in the mutual understanding that while some EU requirements are not related to the accession to WTO, for instance, the monopoly of Gazprom, some of them are relevant (for instance, export duties) and certain issues shall be additionally elaborated by Russian authorities in legal terms (for instance, transit of natural gas).

The negotiations with EU on issues not related to power engineering were more successful. The list of requirements concerning the tariffs on agricultural produce could be significantly reduced, although the problems of meat, sunflower oil, and vine, imported from EU, were scheduled for a further discussion. The Europeans also recognized the customs duties on furniture and motor vehicles proposed by Russia.

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### **An experiment in the system of mandatory medical insurance**

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This year, the necessity to develop medical insurance became a priority for the top echelons of the RF leadership as it was mentioned in the annual address of the RF President to the RF Federal Assembly. A special meeting of the RF State Council held in March of 2003 was dedicated to medical insurance. The Government adopted Resolution No. 158 of March 17, 2003, "On additional financing of expenditures related to the rendering of targeted medical services to non-working retired persons in 2003." Since May, in a number of pilot regions there has been initiated an experimental testing of a new mechanism for payments related to the mandatory medical insurance of the non-working population with participation of the RF Pension Fund.

These measures were undertaken because of the growing awareness of the fact that it is necessary to modernize the system of mandatory medical insurance (MMI), first introduced in the early 1990s, and active work of the RF Pension Fund, which proposed a new mechanism aimed to settle the long neglected problems.

The key problem of the existing MMI system is the lack of clearly defined rules governing insurance payments on behalf of non-working population from local and regional budgets.

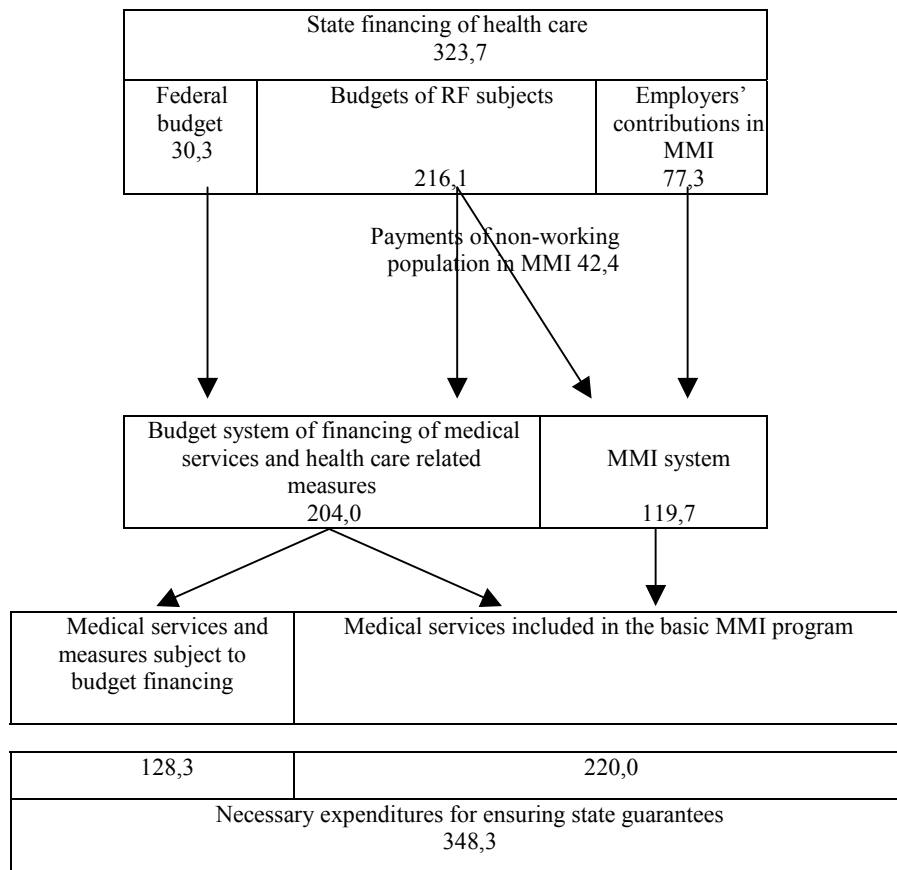
Only one third of state financing of health care is concentrated in the MMI system, while it would be necessary to increase this figure up to two thirds (see the Fig.). This results from the fact that RF subjects and local governments prefer not to make contributions on behalf of non-working population to the MMI system, but, as before, directly finance medical facilities. As a result, these facilities simultaneously receive financial funds for compensation of the same costs via two channels: budget financing and MMI. The current eclectic combination of elements of the insurance and budget financing does not create incentives for enhanced effectiveness of the use of resources while facilitating the reproduction of the existing extravagant type of management.

The fact, that the basic MMI program is in a state of imbalance with the financial resources accumulated in the MMI system aggravates the problem of the general imbalance of the state financing of health care and the costs of implementation of the federal program of state guarantees of free medical services to RF citizens (see the Fig.).

The ways to change the current situation have been intensively worked out by the RF Government over the few last years. For instance, there were elaborated proposals aimed at the creation of a system of mandatory medical and social insurance with the participation of the federal budget in the co-financing of insurance payments on behalf of non-working population. However, no decisions were taken primarily due to the attitude assumed by the RF Finance Ministry. While supporting the necessity of medical insurance and modernization of the existing MMI system, the Finance Ministry in fact dragged out the approval of any certain decisions. The proposals under discussion did not bring any tangible positive results for the Finance Ministry. The problems associated with the imbalances of the MMI programs, eclectic combination of the budget and insurance systems of financing, ineffective utilization of state funds in the health care system are not viewed by the Finance Ministry as the priority problems from the point of view of its departmental interests. On the contrary, for the Finance Ministry the discussed variants of the MMI modernization mean that an additional expenditure item – financing of mandatory medical insurance contributions on behalf of



non-working population - will be introduced in the federal budget. The Finance Ministry believes that control over the expenditures aimed at the prevention of mishandling of funds in the MMI system would be much less effective than in the budget system, while viewing the participation of non-state insurers in MMI as an activity creating conditions for their enrichment rather than improvement of health care services. Therefore, the Finance Ministry has adopted a wait and see attitude on the issue of the MMI reform.



Source: RF Goskomstat, author's calculations.

Figure 1. State financing of health care in 2002 (Rub. billion)

Since the second half of 2002, the RF Pension Fund has started actively promote its proposals concerning the reform of the MMI system. The Fund has initiated the discussion of these proposals at the meetings of the RF State Council and the RF Government taking place in March of 2003. The essence of the new mechanism proposed by the Pension Fund and approved by the aforementioned resolution of the RF Government is as follows: the Pension Fund using its own resources makes additional payments to the MMI on behalf of non-working pensioners. It was decided that in 2003 the Pension Fund could spend Rub. 1.5 billion for these purposes.

The Pension Fund takes part in the financing of insurance payments on behalf of non-working pensioners in the RF subjects who concluded agreements with the Pension Fund and the Federal MMI Fund about financing of such expenditures. The insurance payment made by the administration of an RF subject participating in the agreement shall be at or above the amount of the insurance payment made in 2002 and not less than the insurance payment made by the Pension Fund.

The list of pilot regions, where this new mechanism of financing is tested, was formed from March till the mid-year. As a result, 11 RF subjects took part in the testing:

- Belgorod oblast;
- Vladimir oblast;
- Kaliningrad oblast;

- Kaluga oblast;
- Kostroma oblast;
- Moscow oblast;
- Orel oblast;
- Tambov oblast;
- Tver oblast;
- Tomsk oblast;
- Chuvash Republic.

The role of the Pension Fund in the experimental financing mechanism is not reduced to the assignation of the aforementioned resources. The Pension Fund requested the pilot regions to reconcile the indicators of the territorial MMI programs, approve the system of medical and economic norms governing the remuneration of medical services rendered to pensioners by hospitals and dispensaries (outpatient polyclinics – according to the number of visits, hospitals – by completed cases of medical treatment), and vest it with the right to make random inspections of the operations conducted by insurers and medical organizations in the territorial MMI system. The Pension Fund has also launched an initiative that pensioners be annually informed about the actual cost of medical services rendered to each of them at the end of the year.

No doubt that this experiment is a considerable step along the way of modernization of the MMI system, and it most probably positively affect the MMI effectiveness in the pilot regions. However, the mechanisms under testing are insufficient for the settlement of the key MMI problems. In order to achieve this goal, there are required more profound transformations of the functions performed by both insurers and insured, what would be possible only if a new law on the mandatory medical insurance is adopted.

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### **Forecasting certain macroeconomic indicators<sup>13</sup>**

Below are presented the results of the model based estimations of future monthly amounts of the foreign trade turnover and indicators of the size of employment in the economy and the total number of the unemployed in the period from November of 2003 till January of 2004.

#### **Monthly amounts of the foreign trade turnover**

The model based estimations of the forecasted values of exports, exports to countries outside CIS, imports, and imports from countries outside CIS were obtained basing on the models of time series evaluated in the interval from September of 1998 till August of 2003 in accordance with the data published by the RF CBR<sup>14</sup>. The results of prognostication are presented in Table 1.

*Table 1*

#### **The results of calculations: forecasted amounts of foreign trade turnover.**

	<b>Exports, total</b>	<b>Export to countries outside CIS</b>	<b>Imports, total</b>	<b>Import in countries outside CIS</b>
<b>ARIMA model based forecast (US \$ billion)</b>				
November 2003	12.22	9.95	6.79	5.43
December 2003	13.22	11.08	7.72	6.29
January 2004	11.25	9.07	5.02	3.91
<b>ARIMA model based forecast in per cent of the actual data obtained in the respective period of 2002 - 2003</b>				
November 2003	129.69%	126.55%	118.16%	117.85%
December 2003	118.07%	116.79%	118.72%	120.05%
January 2004	119.09%	112.08%	111.07%	109.18%

<sup>13</sup> For the purposes of this presentation, a forecast is defined as an estimate of the future values of the indicator obtained basing on a model with the best statistical qualities. For more details of the modeling of time series see, for instance: S. Sinelnikov-Murylev, R. Entov, S. Drobyshevski, V. Nosko, A. Yudin (2001) "Econometric Analysis of Time Series of Key Macroeconomic Indicators," Moscow, IET.

<sup>14</sup> RF CBR calculated the data pertaining to the foreign trade turnover in accordance with the payment balance methods in US \$ billion.

The forecasted average growth in November, December of 2003 and January of 2004 as compared with the figures registered in the respective period of 2002 and 2003 as concerns the indicators of exports, export to countries outside CIS, imports, and import from countries outside CIS will make approximately 22 per cent, 19 per cent, 16 per cent, and 16 per cent respectively. The forecasted mean real growth (as adjusted for the annual inflation rate at 12.3 per cent by October of 2003) in these indicators will make about 10 per cent, 7 per cent, 4 per cent, and 4 per cent respectively.

**Indicators of the size of employment in the economy and the total number of the unemployed**

In order to estimate the future values of the indicators of the size of employment in the economy and the total number of the unemployed, there were used models of time series evaluated over the period from October of 1998 till August of 2003 in accordance with the RF Goskomstat data<sup>15</sup>.

*Table 2*

**The results of calculations: forecasted values of the indicators of the size of employment in the economy and the total number of the unemployed**

Period	Size of employment in the economy (million persons)	Total number of the unemployed (million persons)
<b>ARIMA model based forecast</b>		
November 2003	66.94	5.48
December 2003	66.90	5.47
January 2004	66.93	5.44
<b>Actual values in respective periods of the preceding year</b>		
November 2002	65.80	6.20
December 2002	65.20	6.30
January 2003	64.70	6.40
<b>Estimated rates of growth in comparison with the figures registered in the respective period of the preceding year (%) (calculated basing on the forecasted values)</b>		
November 2003	1.73	-11.61
December 2003	2.61	-13.17
January 2004	3.45	-15.00

On the whole, the obtained forecasts indicate the persistence of the positive trends in the dynamics of the indicators of the size of employment in the economy and the total number of the unemployed. According to ARIMA models (see Table 2), the average monthly increase in the indicator of the size of employment in the economy makes 2.6 per cent over the forecast period as compared with the figures registered in the respective period of the preceding year. At the same time, it may be expected that the number of the unemployed will diminish (in terms of increases in comparison with the figures observed in respective periods of the preceding year): the forecasted average monthly increase in this indicator is negative and makes (- 13 per cent).

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<sup>15</sup> The indicator was calculated in accordance with the International Labor Organization (ILO) methods, the respective figures are as by the end of a period.