

**RUSSIAN ECONOMY: TRENDS AND PERSPECTIVES**  
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## The State of the Federal Budget

In the first nine months of 2003, the revenues of the state budget (cash execution) made 19.6 per cent of GDP, while expenditures made 17.1 per cent of GDP (see Table 1). Therefore, the federal budget surplus made 2.5 p. p. of GDP.

*Table 1*

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

	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	X'03
Revenues														
Corporate profit tax	1.6%	1.7%	1.6%	1.6%	1.2%	1.1%	1.4%	1.5%	1.4%	1.4%	1.4%	1.3%	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%	
VAT, special tax and excises	3.2%	3.1%	3.1%	3.1%	2.4%	2.7%	2.8%	2.9%	2.9%	2.8%	2.8%	2.8%	2.7%	
Tax on foreign trade and foreign trade operations	9.0%	8.9%	8.9%	8.9%	11.2%	10.1%	9.9%	9.6%	9.6%	9.2%	9.1%	8.9%	8.7%	
Other taxes, duties and payments	6.9%	6.9%	6.9%	6.9%	8.5%	7.4%	7.2%	7.2%	7.2%	6.9%	6.9%	6.8%	6.7%	
Total- taxes and charges	2.0%	2.0%	1.9%	2.0%	2.7%	2.7%	2.6%	2.4%	2.3%	2.2%	2.2%	2.1%	1.9%	
Non- tax revenues	2.8%	2.8%	2.9%	3.0%	3.4%	3.4%	3.4%	3.5%	3.5%	3.4%	3.4%	3.4%	3.3%	
Revenues, total	2.0%	2.1%	2.1%	2.1%	0.5%	1.7%	2.0%	2.2%	2.1%	2.0%	2.0%	2.0%	2.0%	
Expenditure	18.5%	18.6%	18.5%	18.6%	18.8%	19.0%	19.4%	19.6%	19.4%	18.8%	18.7%	18.4%	18.0%	
Public administration	1.4%	1.5%	1.4%	1.4%	17.5%	8.5%	1.3%	1.2%	1.7%	1.6%	1.5%	1.5%	1.5%	
National defense	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%	19.5%
International activities														
Judicial power	0.4%	0.4%	0.4%	0.5%	0.3%	0.3%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	
Law enforcement and security activities	2.4%	2.4%	2.5%	2.7%	1.5%	2.1%	2.6%	2.7%	2.7%	2.6%	2.6%	2.6%	2.5%	
Fundamental research	0.3%	0.3%	0.3%	0.3%	-0.3%	0.0%	0.2%	0.2%	0.3%	0.2%	0.2%	0.2%	0.2%	
Services provided for the national economy	0.1%	0.2%	0.2%	0.2%	0.1%	0.1%	0.1%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	
Social services	1.4%	1.4%	1.5%	1.7%	1.1%	1.4%	1.7%	1.7%	1.7%	1.8%	1.7%	1.7%	1.7%	
Servicing of public debt	0.2%	0.2%	0.3%	0.3%	0.1%	0.2%	0.2%	0.2%	0.3%	0.3%	0.3%	0.3%	0.3%	
Other expenditure	0.8%	1.3%	1.3%	1.5%	0.2%	0.4%	0.5%	0.6%	0.7%	0.8%	0.8%	0.8%	0.9%	
Expenditure, total	4.9%	5.5%	5.6%	5.6%	1.5%	1.8%	2.0%	2.3%	2.2%	2.2%	2.2%	2.2%	2.1%	
Loans, redemption exclusive	2.4%	2.2%	2.0%	2.0%	1.7%	2.9%	3.0%	2.3%	2.1%	2.0%	1.8%	2.0%	2.0%	
Expenditure and loans, redemption exclusive	3.8%	3.9%	3.9%	3.8%	6.6%	7.1%	7.0%	7.0%	7.1%	7.1%	7.1%	7.0%	6.9%	
Budget deficit (-)	16.9%	17.8%	18.0%	18.7%	12.7%	16.4%	17.7%	17.7%	17.7%	17.5%	17.4%	17.3%	17.1%	17.1%
Domestic financing	3.1%	2.4%	2.1%	1.4%	8.1%	4.2%	3.2%	3.3%	3.6%	3.0%	3.0%	2.7%	2.5%	2.4%
Other taxes, duties and payments	-1.2%	-0.5%	-0.2%	0.6%	-6.6%	-1.7%	-1.0%	-1.0%	-0.5%	0.3%	0.0%	0.3%	0.2%	0.1%
Total- taxes and charges	-1.9%	-1.9%	-1.9%	-2.0%	-1.4%	-2.5%	-2.2%	-2.3%	-3.1%	-3.3%	-3.0%	-2.9%	-2.7%	-2.5%
Non- tax revenues	-3.1%	-2.4%	-2.1%	-1.4%	-8.1%	-4.2%	-3.2%	-3.3%	-3.6%	-3.0%	-3.0%	-2.7%	-2.5%	-2.4%

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

As compared with the figures registered in January through September of 2002, the budget revenues decreased by 0.4 p. p. of GDP in January through September 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 0.1 p. p. of GDP and made 17.9 per cent of GDP.

VAT accounted for the major share of federal tax revenues – 37.w 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 19.5 per cent of GDP in January through October of 2003, what is by 0.7 p. p of GDP below the respective level observed in January through October of 2002. At the same time, the cash execution of expenditures made 17.1 per cent of GDP (17.8 per cent of GDP in 2002); therefore, the surplus made 2.4 per cent of GDP, the same as 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 October of 2003 made 18.0 per cent of GDP (see Table 2), while on November 1 of 2002 this indicator was at 19.2 p. p. of GDP. As a result, as the amount of aggregate revenues decreased by 0.7 per cent of GDP and made 19.5 per cent of GDP in January through October of 2003. Therefore, the surplus of the federal budget in terms of fulfilled funding in the first nine months of 2003 has increased by 0.5 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).**

	X'02	XI'02	XII'02	I'03	II'03	III'03	IV'03	V'03	VI'03	VII'03	VIII'03	IX'03	X'03
Total	20.2%	20.1%	20.1%	20.8%	20.6%	20.9%	21.0%	21.3%	20.6%	20.4%	20.0%	19.6%	19.5%
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%	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%	2.8%
International activities	0.3%	0.3%	0.3%	-0.2%	0.1%	0.2%	0.3%	0.3%	0.3%	0.3%	0.2%	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%	0.2%
Law enforcement and security activities	1.7%	1.8%	1.7%	1.9%	2.2%	2.3%	2.2%	2.2%	2.1%	2.0%	1.9%	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%	0.3%
Services provided for the national economy	1.5%	1.5%	1.5%	0.6%	0.8%	0.9%	1.0%	1.0%	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%	2.3%
Servicing of public debt	2.2%	2.0%	2.0%	1.7%	2.9%	3.0%	2.3%	2.1%	2.0%	1.8%	2.0%	2.0%	1.8%
Other expenditure	3.9%	4.0%	3.8%	6.8%	7.5%	7.3%	7.2%	7.4%	7.3%	7.2%	7.2%	7.0%	6.9%
Total expenditure	19.2%	19.4%	18.7%	16.8%	20.5%	20.9%	20.2%	19.9%	19.2%	18.8%	18.6%	18.3%	18.0%
Профицит (+) / дефицит (-)	1.0%	0.7%	1.4%	4.0%	0.2%	0.0%	0.8%	1.4%	1.3%	1.6%	1.3%	1.3%	1.5%

According to the estimates of the Revenue Ministry, in October of 2003 tax revenues of the federal budget made about Rb. 120.3 billion (without the single social tax). In real terms the revenues made 265.6 per cent of the level registered in January of 1999, while the respective indicator was at 299.7 per cent in 2002 and 237.5 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		
230,0%	229,2%	265,5%	280,4%	233,2%	240,0%	260,4%	242,6%	248,7%	265,6%		

\* 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.

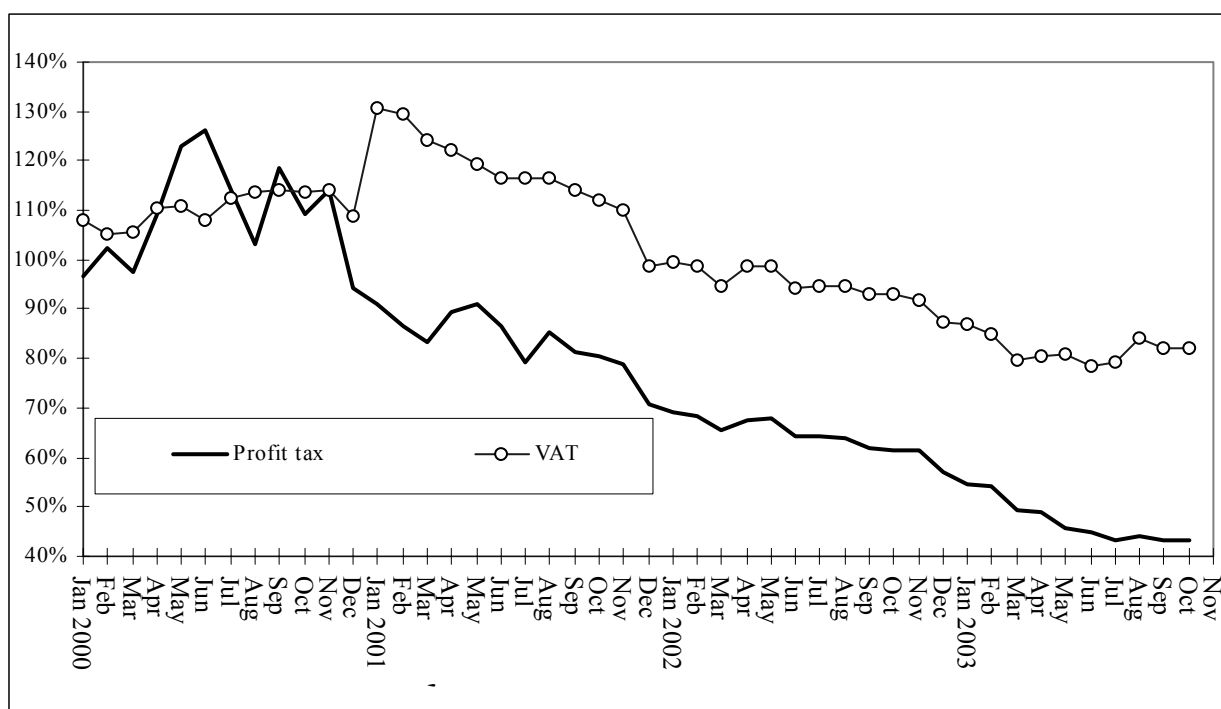


Figure 1. Rate of growth of the real tax arrears to the federal budget (in % to June of 1999)

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. 248.3 billion as on November 1, 2003, increasing by almost Rub. 1.6 billion in October of 2003, what in real terms corresponds to the level of indebtedness registered on November 1, 2002, while the arrears of the profit tax increased by Rb. 0.15 billion and made about Rb. 28.0 billion. On the whole, in spite of the stabilization of the level of accumulated indebtedness registered in the second half of 2003, 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
Taxes	20,8%	21,4%	22,6%	24,2%	25,5%	25,4%	24,9%	24,8%	24,1%	23,7%	24,0%	24,6%
Revenues	24,4%	24,8%	26,4%	28,2%	29,7%	29,7%	29,3%	29,2%	28,4%	28,0%	28,6%	30,0%
Expenditures	19,6%	21,1%	23,8%	24,8%	25,2%	25,5%	22,3%	25,1%	24,5%	24,2%	24,6%	27,0%
Deficit	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	IX	X	XI	XII
Taxes	25,6%	24,4%	25,6%	27,4%	27,1%	26,0%	26,1%	26,1%	25,7%	25,1%	25,1%	25,1%
Revenues	32,0%	30,3%	31,5%	33,4%	33,6%	32,2%	32,2%	32,2%	31,6%	31,6%	31,6%	31,0%
Expenditures	20,7%	25,3%	27,7%	28,8%	28,8%	28,6%	28,7%	28,7%	28,5%	28,5%	28,5%	28,3%
Deficit	11,3%	5,0%	3,8%	4,5%	4,7%	3,5%	3,6%	3,6%	3,1%	3,1%	3,1%	2,7%

\* Без учета ЕСН

The revenues of the consolidated budget in September of 2003 made 31.0 per cent of GDP, including tax revenues (without SST) at 25.1 per cent of GDP (see Table 4). Expenditures of the consolidated budget decreased by 0.1 p. p. in comparison with the figures registered in September of 2002 and made 28.3 per cent of GDP. As on September 1, 2003, the surplus of the consolidated budget made 2.7 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*

## **Reforming interbudgetary relations and sub-national finances**

On November 18, 2003, the RF State Duma approved in the first reading draft federal laws "On amendments of the Budget Code of the Russian Federation as concerns regulation of interbudgetary relations" and "On amendments to the Tax Code of the Russian Federation and abolishment of the RF law 'On the principles of the tax system in the Russian Federation'" introduced by the RF Government.

These bills were submitted to the Parliament in the framework of the reform of federative relations and aimed at the legislative fixation of the principles of the federative reform in the budgetary sphere worked out by the Presidential commission for elaboration of proposals concerning division of power among state authorities of different levels and local governments, by the moment reflected in the new versions of federal laws "On general principles of organization of local governments in the Russian Federation" and "On general principles of organization of legislative (representative) and executive state authorities of RF subjects."

Besides, these draft laws are aimed at the correction of existing flaws of the Budget and Tax Codes, more clear definition of certain terms pertaining to the budget and tax legislation in the sphere of interbudgetary relations, etc.

The draft law introducing amendments to the Budget Code is a rather voluminous document, which offers a large amount of novations in the respective sphere of normative and legal regulation. At the same time, in the course of the first reading, there shall be approved not individual provisions of the document, but its concept at large. Therefore, below there will be discussed the principal conceptual novations proposed by the author of the bill, while the details will be left out of the review.

The draft law on amendments to the RF Budget Code envisages the following significant changes in the legislation currently in force:

1. More clear definitions of the key terms used in the current budget legislation and introduction of new terms. The latter include such definitions as expenditure responsibilities, budget responsibilities, interbudgetary transfers.

2. Determination of the new composition of budget powers vested with all state authorities of all levels and local governments of different types.

3. More precise structuring of the RF budget system taking into account the changes in the structure of local governments – the inclusion of municipal districts, city districts, urban and rural settlements, and intra-city territories in the composition of the Russia's budget system. At the same time, the bill sets forth the principle of equality of budget rights of RF subjects and municipal entities.

4. Introduction of new principles of legislative regulation governing the determination of expenditure responsibilities of budgets of different levels. According to the new version of determination of the budget independency it is envisaged that it is inadmissible to set forth expenditure responsibilities, which should be executed simultaneously at the expense of budgets of two or more different levels, or without determination of the budget at the expense of which the expenditure responsibility should be executed.

5. Introduction of the legislative distribution of revenues from federal, regional, and local taxes among different budgets of the budgetary system (at present such stipulations are partially included in the Budget Code, laws on the federal budget for each budget year, and the tax legislation). According to the proposed criteria of distribution of tax revenues among the budgets of different levels, it is recommended to refrain from centralization of revenues generated by local and regional taxes in higher budgets, as well as the normative decentralization of revenues generated by regional taxes across local budgets. At the same time, it is envisaged to transit to the new order of distribution of tax revenues among budgets of autonomous okrugs within oblasts (krais) and respective budgets of oblasts (krais) – according to the draft law, in the case there is no agreement between the state authorities of the autonomous okrug and the respective oblast (krai), tax revenues, which should have been transferred to the budget of the RF subject as stipulated by the new version of the Budget Code, shall be transferred to the budget of the oblast (krai).

6. Introduction of the legislative regulation governing the determination of the rates of allocation of federal and regional taxes to local budgets by state authorities of the Federation. It is envisaged that regional laws shall set forth standard long term rates for all municipal entities, as well as additional short term (annual) rates of allocation of regional and federal taxes to local budgets.

7. Introduction of a principally new order of division of expenditure responsibilities vested with the Russian Federation, RF subjects, municipal entities, which would practically eliminate existing non-funded federal and regional expenditure mandates. Thus, the provisions proposed by the Government stipulate that in the case federal state authorities set forth expenditure responsibilities not vested with the Russian Federation (i.e. responsibilities of regional and local authorities), such responsibilities shall be financed at the expense of subventions from the federal budget. At the same time, federal legislative acts setting forth such responsibilities shall stipulate the order of calculation of such subventions, which should be annually effected by a federal law for each financial year on the condition that such a law approves respective subventions. It is envisaged to set forth similar stipulations as concerns expenditure responsibilities set by higher levels of authority for local budgets.

8. Introduction of a new document in the budgetary process – the register of expenditure responsibilities of state authorities and local governments defined as a set of normative and legislative acts and concluded agreements envisaging the origination of expenditure responsibilities at the expense of respective budgets.

9. Introduction of a detailed legislative regulation of the order of payments and granting of interbudgetary transfers to lower level budgets. It is proposed that the respective article of the new version of the Budget Code should stipulate the forms of interbudgetary transfers, the order of distribution of such transfers from the federal budget (as subsidies from the fund of financial support of RF subjects, federal compensatory fund). The order of distribution of the funds indicated above, which is proposed to be set forth in the Budget Code, is on the whole similar to the current practices of payments and distribution of the funds mentioned above.

At the same time, it is proposed that the Budget Code should set forth the order of distribution and provision of financial aid at the regional level. At the same time, according to the Government's proposals, the outline of the system of financial support provided at the regional level should be similar to the system of federal financial support of regional budgets (as adjusted for a more complex structure of the budget system at the subregional level). It is proposed to set forth such forms of interbudgetary transfers to local budgets as:

- subsidies from regional funds of financial support for settlements;
- subsidies from regional funds of financial support of municipal districts (city okrugs);
- subsidies from district funds of financial support of settlements;
- subventions to local budgets provided from regional compensatory funds;
- other means of financial support..

10. Introduction of a principally new type of interbudgetary transfers (in the framework of the Russian budgetary process) – so called negative transfer, i.e. a subvention from the local budget to the budget of a RF subject (municipal district); the right to receive such a transfer may arise in the case the level of budgetary security of a municipal entity significantly exceeds the average level of budgetary security of municipal entities existing in this RF subject.

Besides, it is envisaged to introduce such a type of interbudgetary transfers as subventions from budgets of settlements to the budget of a municipal district aimed to solve issues of inter-municipal nature.

11. Introduction of a new instrument of budget regulation – execution of budget powers of state authorities of RF subjects and local governments under the regime of temporary financial administration.

In accordance with the bill submitted to the State Duma, the temporary financial administration (i.e. a federal of RF subject executive authority empowered to work out and take measures aimed at the recovery of a RF subject (municipal entity) solvency, as well as execute and control execution of certain budget powers of state executive authorities of RF subjects (local governments) may be introduced for a term up to one year in the case it is ruled by a higher arbitration court (the arbitration court of a RF subject) on request of the RF Government (the head of the supreme executive authority of the RF subject). At the same time, the temporary financial administration may be introduced in the case the outstanding indebtedness of the RF subject's (municipal entity's) budget arising in the result of a decision, action, or failure to act on the part of the respective authorities, exceeds 30 per cent of the own revenues of the respective budget.

The draft law discussed in this paper sets forth the grounds and the order of introduction of the temporary financial administration and its head, the order of elaboration and contents of the plans aimed at the recovery of the RF subject's (municipal entity's) solvency, the order of execution of the RF subject's (municipal entity's) budget and control over its execution in the case the temporary financial administration is introduced.

12. Introduction of a requirement to execute all budgets in the budget system via Federal Treasury offices.

While discussing the presented draft law, it shall be noted that the necessity to reform the federal budgetary legislation across the majority of guidelines indicated above has been discussed by representatives of federal, regional, and local authorities, as well as representatives of the expert community over the last few years, therefore, the feasibility of approval of a legislative act aimed at the settlement of respective problems is obvious.

At the same time, the discussed draft law has a number of flaws of both technical and principal nature, which could be eliminated in the course of the second reading, since they are not of conceptual character. On the whole, it shall be noted that from the author's point of view the following base principles of the concept of the bill will facilitate a significant improvement in the effectiveness of fiscal federalism in Russia:

- regulation of the order governing the division of expenditure responsibilities and the declaration of intent to abstain from the use of non-funded expenditure mandates in the interbudgetary relations;

- fixation of revenues of budgets of all levels on a long term basis and the introduction of the federal regulation of the distribution of revenues generated by regulatory taxes at the level of RF subjects;

- legislative regulation of the distribution of interbudgetary transfers from the federal, regional, and local budgets based on the uniform approach to all participants of this process and objective criteria characterizing the need for financial resources;

- all three conceptual principles of the bill concept listed above, in the case they are properly implemented, will result in more independent sub-national budgets; however this enhancement of independence shall be accompanied by a possibility to apply sanctions with regard to RF subjects and municipal entities permitting a growth in their budgetary indebtedness. Therefore, the draft law sets for the regulation of the order of introduction and functioning of a temporary financial administration in a subject of the Russian Federation (municipal entity).

At the same time, in spite of the fact that the draft law contains a number of conceptual approaches, implementation of which, from the author's point of view, will have a positive impact, it is necessary to further elaborate the bill along certain guidelines. For instance, it is necessary to point out the following flaws of the discussed document:

1. In spite of the stipulations of the document aimed against possible use of non-funded expenditure mandates with regard to lower level budgets, the mechanism of practical implementation of these provisions is not quite clear. Thus, the legislation currently in force contains a large number of stipulations vesting non-financed or partially financed responsibilities with regional and local budgets. In accordance with the provisions of the document under discussion, in the case the law on the federal budget does not contain



provisions allocating subventions for financing of such responsibilities, while the law setting forth the responsibilities does not contain criteria pertaining to the calculation of such subventions, the respective provisions can not be applied in the current period.

It shall be noted that the draft law fails to indicate both the necessity to abolish laws currently in force, and the necessity to approve new legislative acts meeting the requirements set forth in the new version of the Budget Code, and the order of execution of such responsibilities at the moment the law is enacted. On the one hand, this situation will facilitate the cessation of the majority of responsibilities mentioned above at the moment of enactment of this draft law (in the case its present version is approved). On the other hand, it may provoke both the refusal to abolish non-funded mandates in the process of discussion of the bill in the State Duma, and mass litigations concerning the refusals to finance responsibilities set forth by the law due to the introduction of the new stipulations of the Budget Code.

The previous practice of suspension of provisions concerning budgetary responsibilities, resulting from different branch laws, in annual laws demonstrated, that such a suspension, according to the Constitutional Court, is possible only with regard to responsibilities assumed after the enactment of stipulations aimed to suspend responsibilities, what renders this provision practically inapplicable. As a result, it becomes apparent that it is necessary to further elaborate the issues pertaining to the transition to the new order of transfer of expenditure responsibilities to lower level authorities and financing of such responsibilities.

2. Alongside with the reform of the order of distribution of expenditure responsibilities among the budgets of the budgetary system, main discussions may arise with regard to the values of rates of tax generated revenues, at which they should be shared among budgets. It is necessary to note that the existing evaluations of sufficiency of tax revenues of regional and local budgets formed in accordance with the proposed standards for financing of own expenditure responsibilities differ very much. According to the estimates presented by the RF Government, nationwide there will be ensured the balance of budgets; however, other assessments demonstrate that there may arise both excessive security, and insufficient security of budgets.

From the author's point of view, in the situation of such great shifts as envisaged by this reform, an important role will be played not by the concrete rates of distribution of tax revenues, but by principles, on which they will be set forth. Taking into account the changes not only in the composition of expenditure responsibilities, but the principles on which their distribution is based, as well as the principles underlying the distribution of tax revenues and interbudgetary transfers, any estimate of sufficiency of tax and non-tax revenues at the level of individual RF subjects and municipal entities will be very inaccurate.

As a result, it seems that the rates of distribution of tax and non-tax revenues proposed by the RF Government should be approved in the first reading taking into account the possibility to adjust them later after expenditure responsibilities are determined more precisely and main guidelines of the tax reform are set more clearly.

3. In spite of the fact that the draft law formally complies with the requirements concerning legislative regulation of the order of distribution of financial support at the federal and regional levels, the order of distribution of interbudgetary transfers from budgets of RF subjects proposed by the RF Government contains a number of significant flaws.

While reviewing possible guidelines of the regulation of the order in which interbudgetary transfers are granted to municipal entities, the following circumstances shall be taken into account. Firstly, the federal legislation shall contain provisions aimed at ensuring of implementation of uniform formal criteria of distribution of subsidies for equalization of budget security applicable to all participants of interbudgetary equalization, as well as implementation of uniform objective criteria and approaches with regard to the distribution of other types of financial aid. Secondly, there shall be taken into account the independency of RF subjects as concerns the determination of main guidelines of budget policies at the regional level.

The reasonable combination of the two principles mentioned above, according to the author, shall result in the federal legislation containing the requirements concerning the general outline of the interbudgetary equalization construction and the system of granting of interbudgetary transfers at the subregional level, which would include the requirements concerning the uniform nature of applied methods, objective character of indicators used for the calculation of the amount of interbudgetary transfers, inadmissibility of symmetrical withdrawal of municipal revenues in the case their tax revenues grow due to objective factors, etc. At the same time, as concerns the legitimacy of the use of federal laws, a significant role in the interpretation of their stipulations shall be played by the bodies of the judicial system.

Unfortunately, the authors of the draft law preferred a different way, which presupposes a detailed regulation of the interbudgetary relations at the level of RF subjects. On the one hand, it takes into account

the present state of the judicial system and the current situation where the majority of RF subjects discriminate certain municipal entities in the course of budget equalization. On the other hand, such an approach significantly limits regional and local authorities as concerns the creation of efficient systems of budgetary equalization in regions, which would take into account regional specifics, the existing practices of interbudgetary relations, etc. Moreover, the system of calculation of interbudgetary transfers amounts envisaged by the draft law not always permits to objectively distribute financial support sometimes allowing to apply various adjustments, differentiation of coefficients, etc.

It seems that this article of the draft law dedicated to the principles of the distribution of interbudgetary transfers (especially, from RF subjects' budgets) requires a significant elaboration, although its key principles set forth by the authors of the bill shall be retained.

4. The stipulation of the draft law concerning the possibility to apply negative transfers needs a thorough analysis and significant elaboration.

On the one hand, the necessity to withdraw a part of budgetary revenues of municipal entities with high budgetary security is the reverse side of the decision to broaden the revenue base of municipal entities – in the situation where the degree of inter-municipal differentiation of tax bases is high and there is no efficient tax on real estate the increase in the rates of allocation of other tax revenues (in particular, income taxes) to local budgets will result in extra revenues of certain municipal entities, while in other municipalities an increase in revenues will be rather low. As a result, in order to equalize budgetary security there arises the necessity to redistribute budgetary revenues of municipalities not only using interbudgetary transfers and differentiated rates of allocation of regulatory taxes, but also by the method of centralization (withdrawal) of a portion of revenues of “rich” municipal entities.

On the other hand, in contradistinction to the detailed order of distribution of grants, subventions, and subsidies to local budgets from the budget of the RF subject, the discussed draft law does not contain a similarly thorough elaborated order of calculations and collection of negative transfers. For instance, the draft law permits to rather arbitrary apply this instrument of interbudgetary regulation not exceeding the limits it sets forth (the use of negative transfers with regard to the municipalities where rated per capita tax revenues two times and more exceed the average regional level, the calculation of the amount of negative transfer in proportion to the excess of rated tax revenues over the twofold average regional level, the impossibility of the situation where the amount of the negative transfer would exceed a half of the difference between the rated per capita tax revenues and the twofold average regional level of rated per capita tax revenues).

As a result, there is forming a situation, where the draft law, in addition to the insufficiently efficient system of regulation of interbudgetary transfers from RF subjects' budgets to local budgets, provides an additional instrument permitting at whim to withdraw extra revenues of local budgets. It is apparent that in certain cases this situation creates incentives for the use of the new system for purposes of revenue discrimination of certain municipal entities, what is an evidence of the necessity to considerably elaborate this section of the draft law.

5. No doubt that the order of introduction of and execution of certain budgetary powers on the part of the temporary financial administration envisaged by the draft law on amendments to the Budget Code to a greater degree answers the criteria of efficiency than the variants discussed in the course of elaboration of this bill. However, nevertheless, it seems that this section of the draft law also requires further elaboration aimed at the attainment of the following objectives:

- higher degree of attention to the interests of creditors of regional and local budgets both in the course of formation of temporary financial administration, and in the course of elaboration and implementation of measures included in the plan of recovery of a RF subject's (municipal entity's) solvency;
- higher degree of participation of judicial bodies in the process of introduction and functioning of the temporary financial administration.

At the same time, it seems that the concept of formation and functioning of the temporary financial administration proposed by the RF Government is justified.

6. It does not seem necessary to retain the requirement set forth by the draft law that all budgets of the budgetary system shall be executed via the Federal Treasury offices. Taking into account the general considerations about the budgetary independency of regional and local authorities, as well as the current practices of execution of budgets of different levels, the system of budget execution shall, according to the author, be more decentralized and base on the following principles:

- federal legislation shall contain a set of requirements (standards) pertaining to the execution of budgets of all levels, as well as requirements concerning the execution of federal budget via the Federal Treasury offices;

- federal legislation shall envisage the right of RF subjects' authorities and municipal entities to create their own bodies executing the budget (treasuries); at the same time it would be possible to vest the federal authorities (the Federal Finance Ministry) with powers concerning the monitoring of compliance with the standards on the part of regional and local treasuries and their certification;

- federal legislation shall envisage the cases where regional and local budgets are executed via Federal Treasury offices basing on respective agreements stipulating the paid character of such services (with the exception of cases where execution of regional and local budgets via Federal Treasury offices is mandatory);

In any case, it seems necessary to renounce the stipulation concerning the mandatory execution of all budgets within the budgetary system via Federal Treasury offices as set forth by the draft law. This provision, from the author's point of view, is one of the most serious flaws of the bill under discussion.

7. The draft federal law on amendments to the RF Budget Code fails to take into account the problem of the budgetary status of closed administrative and territorial entities (CATEs). Proceeding from the general logic of the draft law, it is envisaged that their budgetary status should be equal to the budgetary status granted to urban settlements or city districts. This decision seem to be a feasible variant, however, in the case it is approved it is necessary to introduce a number of amendments to the legislation aimed at the transformation of the special status granted to the closed administrative and territorial entities.

On the other hand, such a change in the CATEs status may be unfeasible from the viewpoint of ministries and departments responsible for certain CATEs.

In any case, the discussed draft law shall in detail regulate the place and status of closed administrative and territorial entities under the new circumstances of the functioning of the Russian budgetary system.

8. In spite of the fact that the draft law under discussion was elaborated as a bill aimed at the implementation of the stipulations of the new versions of laws "On general principles of organization of local governments in the Russian Federation" and "On general principles of organization of legislative (representative) and executive state authorities of RF subjects," a number of its provisions do not comply with the stipulations of the laws mentioned above. In a number of cases (for instance, as concerns the regulation of the system of interbudgetary equalization at the level of RF subjects), the presence of similar stipulations in the law "On general principles..." does not seem feasible.

Discussing the draft law on amendments to the Tax Code, the proposed novations of this document envisage the following:

1. More precise definitions of federal, regional, and local taxes. Division of power between local governments of settlements and city okrugs (municipal districts) as concerns imposition of local taxes.

2. Introduction of changes in the list of federal, regional, and local taxes. Out of the whole set of taxes forming the tax system of Russia, it is envisaged to define the following taxes as regional ones: tax on property of organizations and on gaming business. The local taxes shall include the land tax, tax on the property of individuals, transport tax, and trade related fees. The powers to introduce transport tax and trade related fees shall be vested only with local authorities of city okrugs (municipal districts).

3. More precise formulation of the stipulations set forth in the Tax Code as concerns regulation of special tax regimes, introduction of the requirement to enter all tax payments on accounts of the Federal Treasury offices aimed at their further distribution among the budgets of the budgetary system.

4. Abolishment of the law "On the principles of the tax system in the Russian Federation" and stipulations of a number of other normative and legislative acts.

On the whole, it shall be noted that the draft law on amendments to the Tax Code is to a considerable degree of technical nature with the exception of the stipulations regulating the composition of federal, regional, and local taxes. It is proposed to make only one significant amendment to this section of the Code – the transport tax shall be transferred from regional to local level (the right to introduce this tax shall be vested with local authorities of city okrugs and (or) municipal districts). It shall be noted that taking into account the rejection of the normative decentralization of 50 per cent of revenues generated by the tax on property of organizations in local budgets this change in the status of the transport tax looks feasible.

A significant flaw of the draft law under discussion is the lack of prerequisites for the introduction of the tax on real estate, which is the major revenue source of sub-national budgets across the majority of countries. However, the problem of transition to the tax on real estate seems to be outside the conceptual framework of

the discussed bill and most probably will become the subject of discussions at the time of the second reading of the draft law.

Therefore, the approval of amendments to the Budget and Tax Codes shall be accompanied by amendments to laws “On general principles of organization of local governments in the Russian Federation” and “On general principles of organization of legislative (representative) and executive state authorities of RF subjects.”

I. Trounin

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## **Monetary Policy**

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According to the RF State Committee for Statistics, inflation rates on the Russian consumer market accelerated and made 1 per cent (0.3 per cent in September of 2003, 1.1 per cent in October of 2002, see Figure 1). Over the period from January through October of 2003, the Consumer Price Index (CPI) grew by 9.7 per cent as compared with 11.5 per cent registered in January through October of the preceding year. It attracts attention that prices of food products (without fruits and vegetables) grew at a significantly higher rate. The respective index reached 101.8 per cent as compared with 101.1 per cent in September and 100.8 per cent in October of 2002. No significant increase in inflation rates was registered across other consolidated product groups. The growth in prices on the consumer market was restrained by the seasonal decrease in prices of fruits and vegetables, since, traditionally, October is the last month when the respective prices are low. The price index in this product group made 94.4 per cent. The administratively regulated tariffs on paid services increased at a moderate rate over the last months - 100.7 per cent in August, 100.0 per cent in September, 100.6 per cent in October (including 101.0 per cent in housing and public utilities).

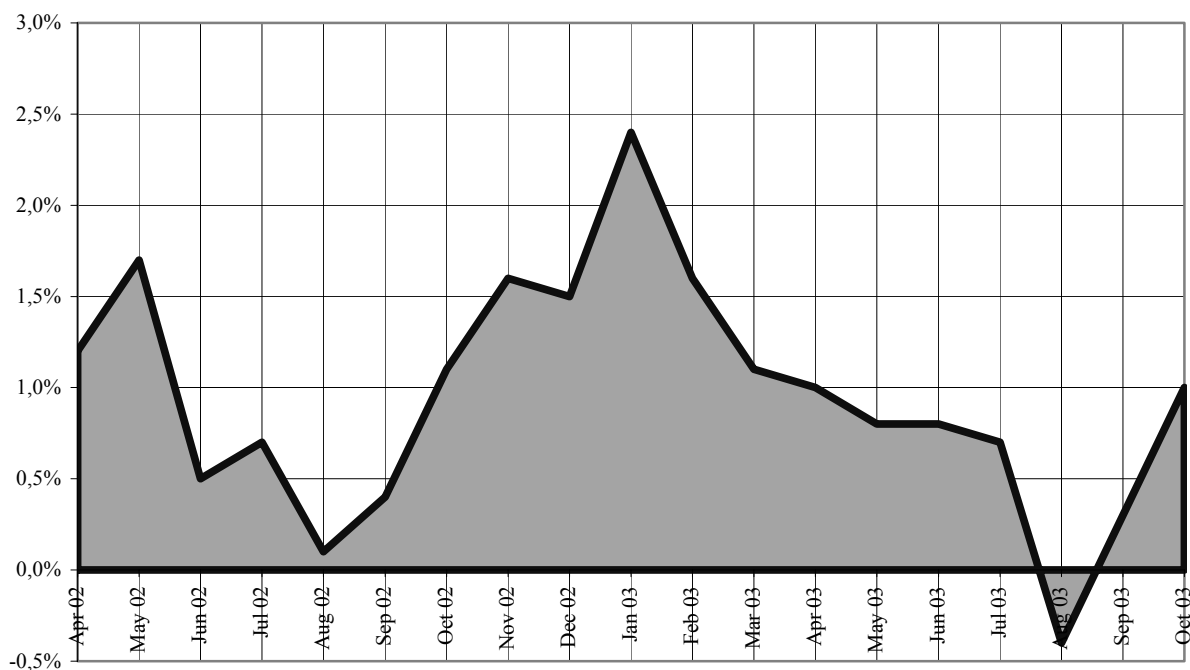
The specific feature of October of 2003 was the growth in base inflation<sup>4</sup>. Its index reached 101.4 per cent, the highest value of this indicator registered since the beginning of 2002 (100.7 per cent in August, 101.1 per cent in September). This development might be caused by the combination of two factors: an increase in money supply and a growth in purchase prices in agriculture.

According to the authors' evaluations, in November the growth in consumer prices will not exceed 1.1 per cent and in December – 1.3 per cent. Therefore, the preliminary forecast of annual inflation rates makes 12.3 per cent, what exceeds the highest limit of inflation set by the governmental forecast by 0.3 per cent.

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<sup>4</sup> The Base Consumer Price Index (BCPI) is an indicator reflecting the inflation rate on the consumer market. It leaves out of account the seasonal (prices of fruits and vegetables) and administrative (tariffs on regulated types of services etc.) factors, calculated by the State Committee for Statistics of the RF.

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



Source: RF Goskomstat

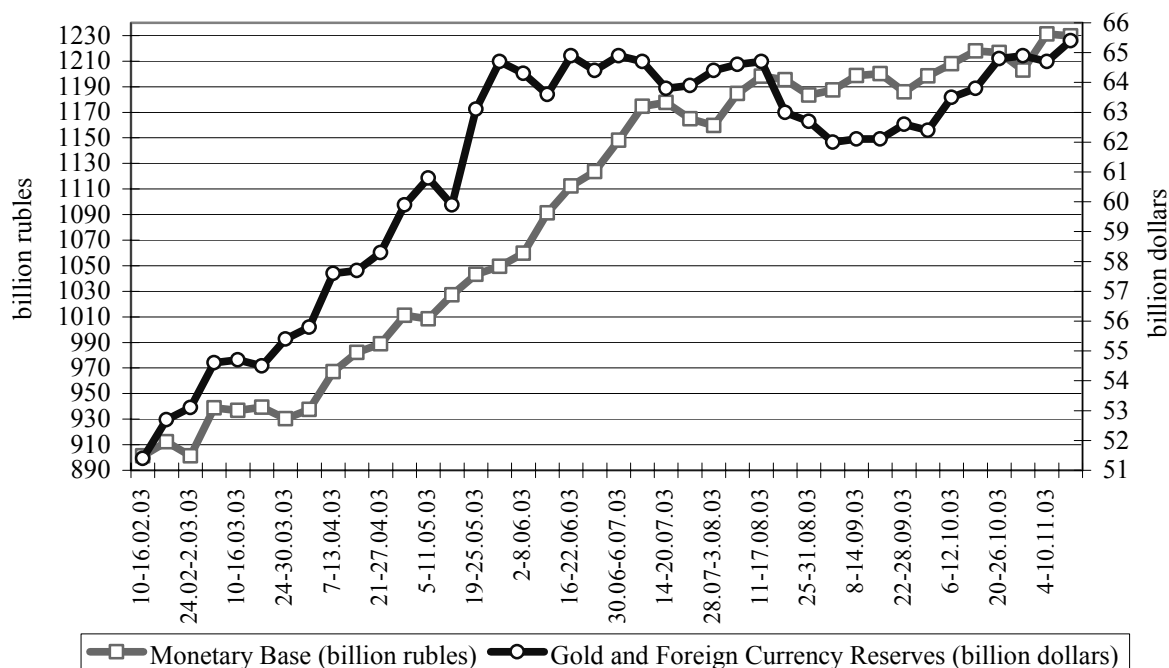
Gold and foreign exchange reserves of the Bank of Russia increased by US \$ 2.9 billion (4.6 per cent) in October, reaching US \$ 64.9 billion as on November 1 (see Fig. 2). Therefore, by the end of October, this indicator returned to its historical maximum at which it was registered at the end of June and beginning of July (US \$ 64.9 billion). Over the two preceding months there was observed a reduction of reserves. Thus, in August they diminished by US \$ 1.7 billion and in September by US \$ 0.7 billion. Over the 10 months of this year, the growth in reserves made US \$ 17.1 billion, or 35.85 per cent. It shall be noted that the reserves were at US \$ 47.8 billion as on January 1. The percentage of foreign exchange reserves in the overall foreign reserves increased by US \$ 2.9 billion, or by 4.9 per cent, reaching US \$ 61.2 billion. On the whole, foreign exchange reserves increased by US \$ 17.1 billion, or by 38.9 per cent over 10 months of this year. In the first two weeks of November, gold and foreign exchange reserves increased by 0.8 per cent reaching the new historical high of US \$ 65.4 billion. At the same time, the amount of gold and foreign exchange reserves as registered on the last reporting date was only by US \$ 500 million above the level observed yet on June 20, i.e. almost 5 months ago. Taking into account this fact, there may be drawn the conclusion that the rate of growth in gold and foreign exchange reserves decelerated in the second half year of 2003.

The structure of the CBR gold and foreign exchange reserves remained practically unchanged throughout the last months in spite of the fluctuations of exchange rates on the world market. At the same time, the distribution of reserves across currencies was stable (US \$ - 70 per cent, Euro – 25 per cent, British pound sterling and other currencies - 5 per cent). At the same time, there were registered moments, when the share of US \$ in the reserves declined to about 66 per cent.

In October of 2003, the monetary base of the Russian Federation in the broad definition<sup>5</sup> diminished by 1 per cent and made RUR 1500.2 billion as on November 1, 2003. The amount of cash in circulation (as adjusted for cash balances of crediting organizations) made RUR 1033.6 billion (by 1.9 per cent less than the figure registered in September). The amount of accounts of crediting organizations with the Central Bank of Russia diminished by 8.3 per cent (to RUR 142 billion) in October, the mandatory reserves reached RUR 263.6 billion (+ 3.5 per cent). The amount of banks' deposits in the Bank of Russia increased by RUR 0.4 billion making RUR 5.5 billion. The amount of the CBR liabilities concerning repurchase of securities was at RUR 55.5 billion (diminished by RUR 0.4 billion in October) as on November 1, 2003.

<sup>5</sup> The Monetary Base in broad definition includes cash in circulation, the funds in mandatory reserves, and funds in commercial banks' correspondent accounts with the Bank of Russia.

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



In November, the amount of payments pertaining to the public foreign debt of the Russian Federation was circa US \$ 237.5 million, including US \$ 167.7 million transferred as debt repayment and US \$ 69.8 million as interest payments. This, in turn, includes US \$ 61.6 million paid to official creditor countries, banks and companies as debt repayment and US \$ 13.6 million as interest payments. In November, payments to international financial institutions made US \$ 106 million and US \$ 36.2 million, respectively. In November, about US \$ 20 million were transferred as the payment of coupon yields on forex denominated domestic debt bonds (OVVZ) issued in 1999. No Russian Eurobonds were redeemed or serviced in October.

According to the preliminary estimates of the RF Government, by the end of 2003 the public foreign debt of RF shall diminish to US \$ 119 billion, or 27.5 per cent of GDP as compared with US \$ 122 billion, or 35 per cent of GDP in 2002. The ratio between Russia's payments aimed at the settlement and servicing of the public debt and the export of goods and services decreased and was at a level below 11 per cent as compared with 12 per cent registered in 2000, while the amount of servicing payments in relation to own budget revenues made less than 12 per cent this year. At the same time, the key aim of the government's debt policy remains the maintenance of the amount of the public debt at a safe level and ensuring of repayment and servicing of liabilities by established deadlines. The RF Government refrains from additional foreign borrowings except those relating to refinancing of debts and combines repayment of foreign debt at the expense of partial refinancing and borrowings on the domestic public debt market.

In November, the RF CBR announced that it considers it necessary to transit to the floating exchange rate. According to the Bank of Russia, the objective appreciation of the national currency will be a factor facilitating inflow of investment for modernization of the Russia's economy.

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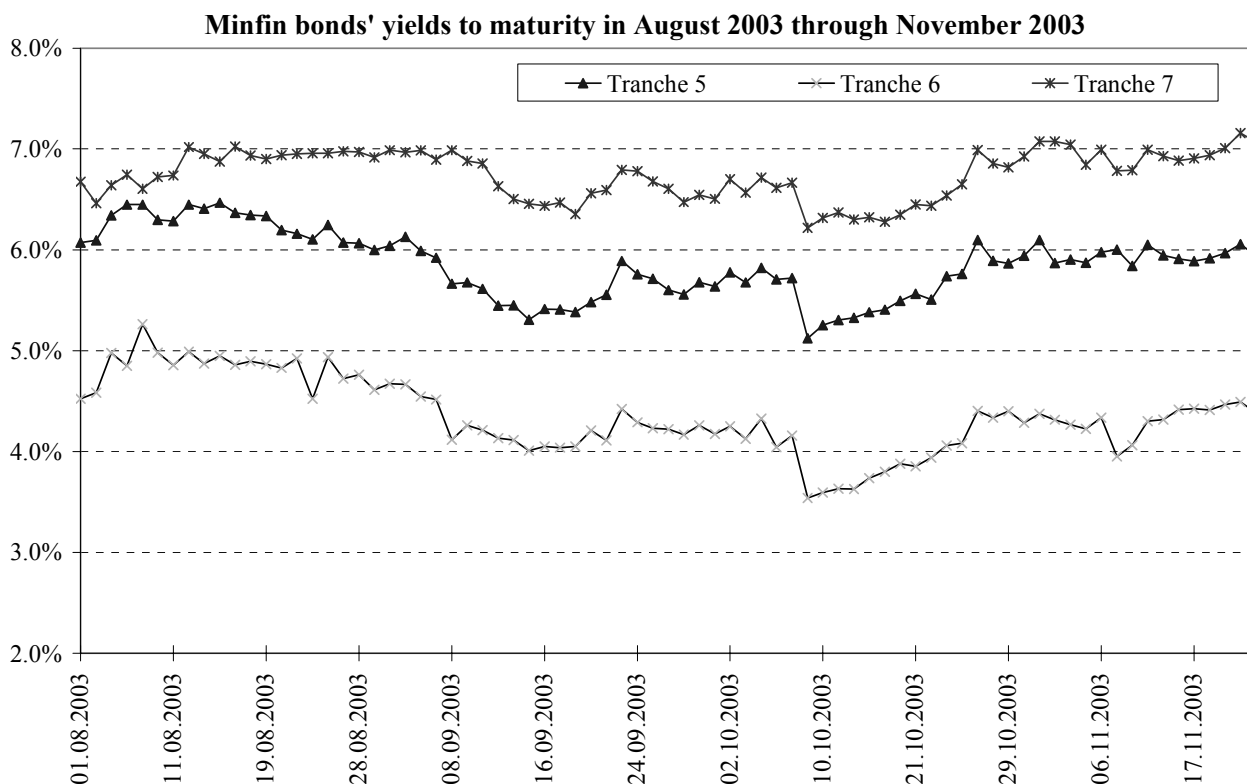
## Financial Markets

### The Market for Government Securities

Over the first three weeks of November of 2003, no clearly pronounced trends in quotations were observed on the market of Russian forex-denominated bonds. By the middle of the month the market was somewhat supported by a decline in the yields on the market of US government bonds as the yields of US

Treasury bills decreased to 4.23 per cent per annum due to the statements of FRS representatives that no increase in the federal funds rates should be expected in the nearest future. The quotations of Russian forex-denominated bonds grew somewhat, however, already by the end of the month they sunk practically to the previous levels. As it seems, the most significant constraints on the market still were the unclear situation around the oil company YUKOS and M. Khodorkovsky, as well as forthcoming Parliamentary elections. Thus, on November 21 the yield to maturity of Russian Eurobonds RUS-30 was 7.46 per cent p.a. (end of October: 7.59 per cent); RUS-18: 7.09 per cent p.a. (end of October: 7.26 per cent). Besides, on November 21 the yield to maturity of the Russian Eurobonds was: Minfin bonds, 7<sup>th</sup> tranche: 7.07 per cent; Minfin bonds, 6<sup>th</sup> tranche: 4.39 per cent; Minfin bonds, 5<sup>th</sup> tranche: 5.94 per cent; RUS-07: 4.58 per cent. Therefore, the results of the first three weeks of November demonstrate that the levels of yields of Russian Eurobonds RUS-30 and RUS-18 somewhat decreased, while the yields of other bonds remained practically at the level registered in end-October of 2003.

Figure 1.



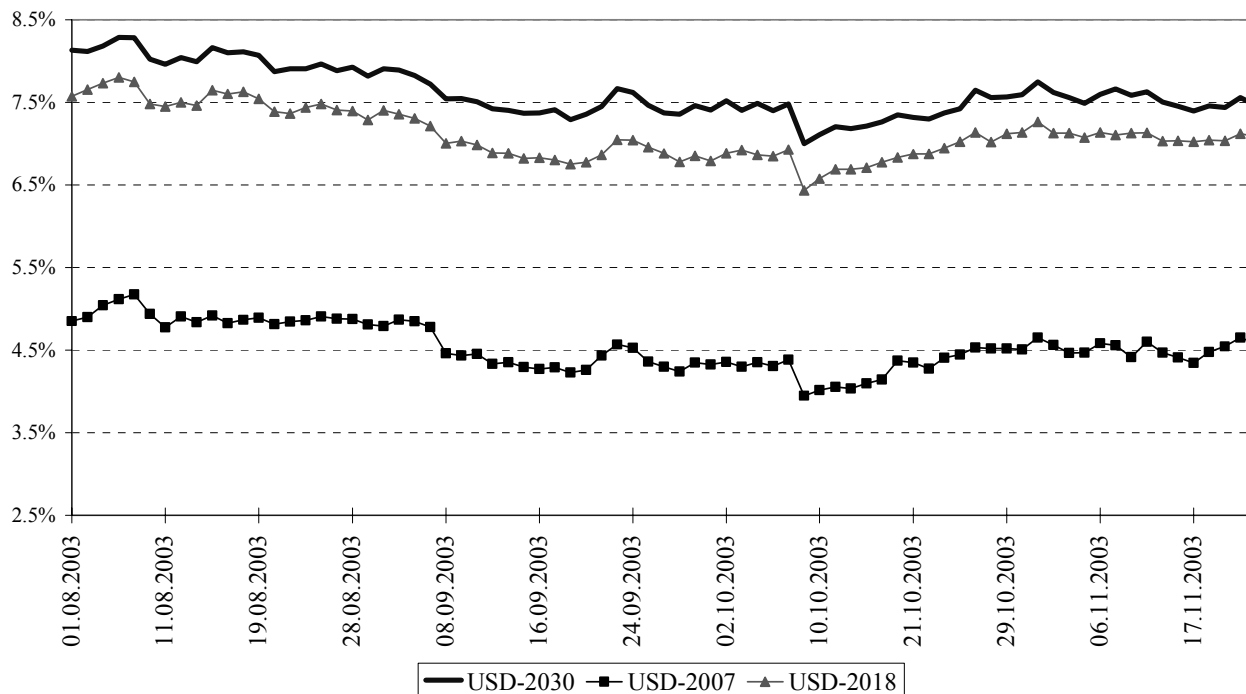
In spite of a certain improvement of liquidity in the banking system observed in early November, in the sector of public Ruble-denominated debt the quotations of securities fluctuated in a comparatively narrow band. In the beginning of the month, the decrease of interest rates on the market of inter-bank credits from 10 to 11 per cent per annum to 3 – 4 per cent per annum provided a significant support to Ruble-denominated instruments. Besides, there became available the funds received as the result of repayment of GKO 21169 and coupons of OFZ 27015 and OFZ 27017, what was conducive to a growth in the amount of sales. However, already in the course of the second week of the month the activity of investors significantly declined – the average daily turnover of the market made about RUR 150 million, what was three times below the respective indicator registered during the preceding week. Over the period from November 1 to 21, the aggregate turnover of the market made about RUR 6.5 billion, while the average daily turnover was at RUR 467 billion. In the same period, there were placed two additional issues of OFZ - AD.

The par value amount of OFZ – AD 45001 and 46001 placements made RUR 2.5 billion each. At the auction where the additional issue of OFZ – AD 46001 was placed the demand was registered at RUR 1.4 billion, while the actual amount of placement made RUR 892.16 billion. The cutoff price was set at the level of 109.04 per cent of the face value (income of 8.4 per cent per annum), while the weighed average yield registered after the completion of the auction was at 8.25 per cent. As concerns the results of the auction for OFZ – AD 45001 issue, the demand was registered at RUR 2.1 billion, while the amount of placement made

RUR 1.2 billion. The cutoff price was set at the level of 106.83 per cent of the face value (7.8 per cent), while the weighed average yield registered at the end of the auction made 7.67 per cent.

Figure 2.

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



As on November 25, the amount of the GKO – OFZ market made RUR 281.77 billion at par and RUR 301.5 billion at the market value. The duration of the GKO-OFZ market portfolio was 909.17 days.

## The Market for Corporate Securities

### Situation on the stock market.

A sharp downfall in quotations was observed on the stock market in October and November. The major factor behind these developments was the situation of the oil company YUKOS. The arrest of M. Khodorkovsky, as well as the arrest of a large block of shares in the company and the ruling of the Moscow Basmany court, which left in force the measure of restraint as concerns M. Khodorkovsky, all these factors were an evidence of significantly greater political risks of investment in stocks of Russian issuers, and resulted in sales of shares, or, at best, in hesitation on the part of investors. Besides, an important role for investors played the uncertainty related to the forthcoming Parliamentary elections. Obviously, in this situation investors preferred to abstain from active operations on the market, what also was a factor behind a downfall in quotations.

The decline was so sharp that by the end of October the RTS index decreased below the psychologically important mark of 500 points (October 31, 496.66 points at the close of the exchange). Over the following period, the RTS index again exceeded the 500 points mark; however, on the whole on the market there was observed a downward trend in quotations dynamics. Already on November 18, the index was again below 500 points and at the closing moment was at 480.63 points mark, i.e. again sinking to the level registered in early August. Later there was observed a certain adjustment, and on November 24 the index made 515.75 points declining by 9.63 points since end-October (-1.9 per cent).



Figure 3.

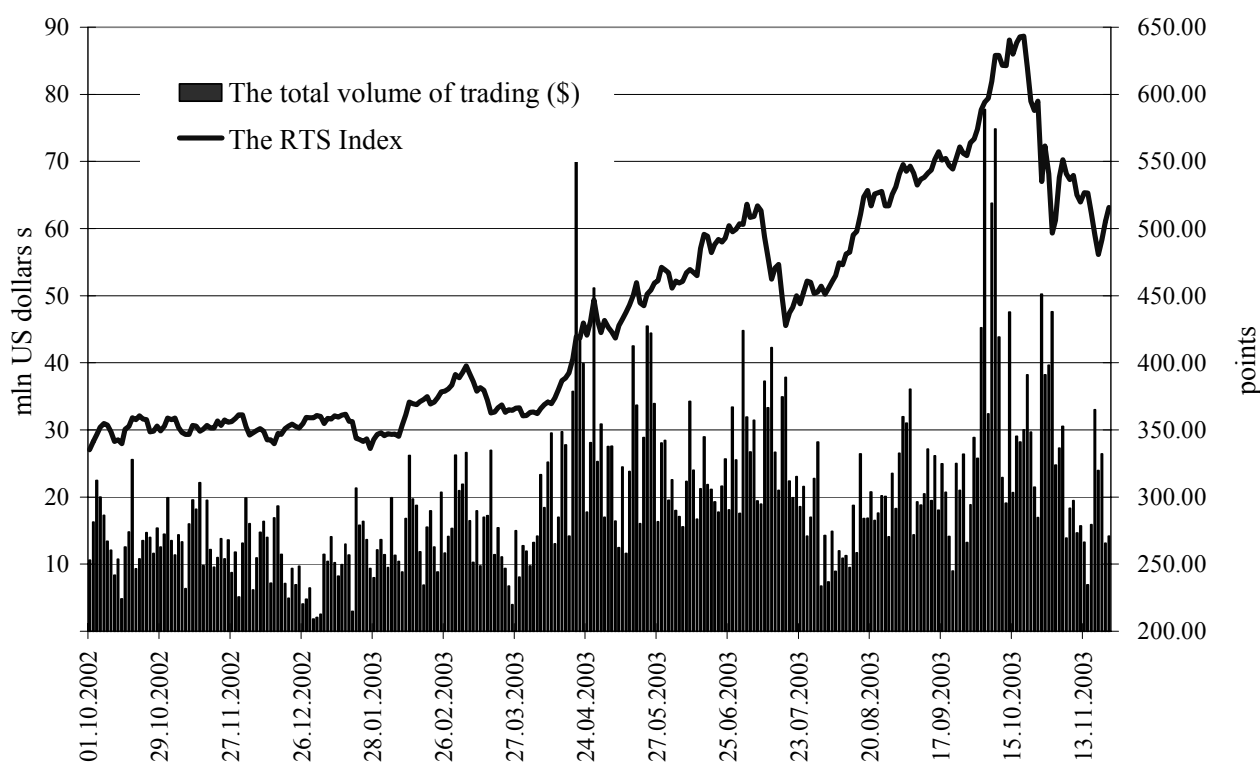
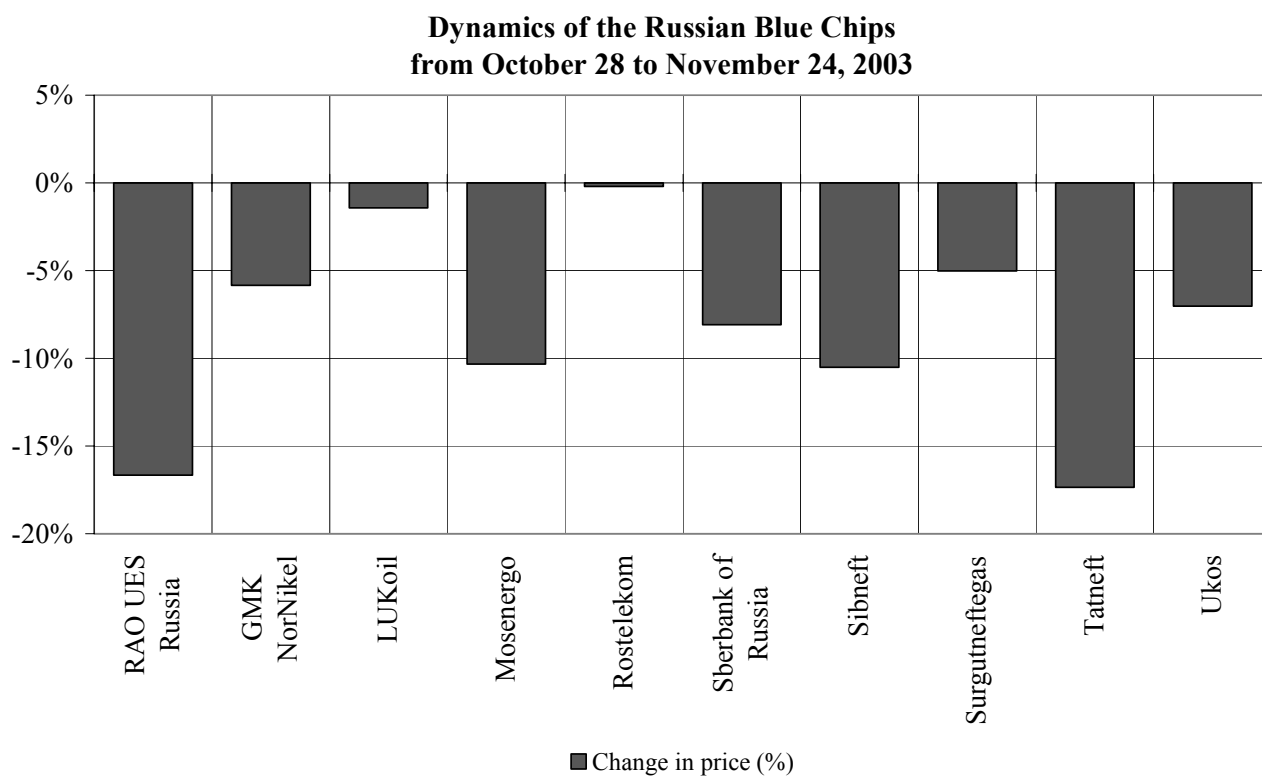


Figure 4.



In the period from November 1 to 24, the turnover in the RTS trading amounted to US \$ 286 million (in the first three weeks of October, the turnover in the RTS trading was about US \$ 520 million). The average daily turnover at the RTS also declined in comparison with the respective indicator registered in this October

and made US \$ 20.4 million (US \$ 37.77 million in October). The highest volume of trade at the RTS (US \$ 33.77 million) was observed on November 18; the lowest trade volume (US \$ 6.9 million) was observed on November 14. Therefore, the figures referred to above demonstrate a significant decline in attractiveness of shares in Russia's issuers for investors, what was characterized by a noticeable drop in activity of market operators.

It is worth a special mentioning that according to the results of the month there was observed a decline in the market value across all blue chips (as on November 24 in comparison with the figures registered on October 28). Thus, the leaders of the downfall in prices were shares in RAO UES of Russia and Tatneft, whose quotations fell by 16.66 per cent and 17.35 per cent, respectively. These stocks were followed by shares in Mosenergo and Sibneft, the market value of which declined by 10.34 per cent and 10.51 per cent respectively over this period of time. The quotations of shares in Sberbank of RF and YUKOS declines somewhat less (-8.09 per cent and -7.04 per cent respectively). The most stable were stocks of Rostelekom, their market value decreased only by 0.2 per cent over the period under observation.

Over the first three weeks of November, the LUKoil shares took the top position by the volume of turnover in the RTS<sup>6</sup>: the total transactions amounted to 21.29 per cent. The shares of RAO UES of Russia followed: the volume of transactions with the energy holding's shares reached 21.14 percent of the total turnover. The shares of YUKOS and Surgutneftegaz follow with 17.39 per cent and 7.95 per cent, respectively. Thus, the percentage of transactions with the shares of only these four companies was 67.77 per cent of the total traded turnover on the classical RTS stock market during the period from November 3 to November 21.

As on November 24, the top five leaders of the national stock market by capitalization look as follows<sup>7</sup>: YUKOS: US \$ 31.5 billion, Surgutneftegaz: US \$ 17.9 billion; LUKoil: US \$ 17.78 billion; MMC Norilsk Nickel: US \$ 11.49 billion; Sibneft: US \$ 10.9 billion.

**The market for term contracts.** In November, the RTS market for term contracts (FORTS) demonstrated a decrease in the trading activity of participants. Thus, in the period from November 1 till November 24 the volume of trade in futures and options at the RTS amounted to about RUR 17.6 billion (82.2 thousand transactions; 2.57 million contracts), what was somewhat below the respective indicators registered in October of 2003 (RUR 22.3 billion, 85.4 thousand transactions, 2.96 million contracts). As usual, futures contracts account for the greatest percentage of transactions: the volume of trade in these contracts reached RUR 16.69 billion (2.44 million contracts, 79.07 thousand transactions) over the first three weeks of November. Options were in a much lower demand: the respective amount of trading made about RUR 938 million. The maximum trading volume was observed on November 3 and made RUR 1.64 billion (as compared with RUR 1.97 in October), while the minimum trading volume (RUR 701.6 million as compared with RUR 686.68 million in October) was registered on November 14.

**Corporate bond market.** The activity of investors on the corporate bond market was at a rather low level. Even the Ruble appreciation and the improvement of the Ruble liquidity situation did not facilitate a growth in demand for securities at the background of persisting "political factor." A slight upward adjustment, which occurred at the end of the second week of November, did not last for a long time. The sales characterized by rather small amounts prevailed on the market, what resulted in a decrease in quotations.

In the period from October 27 till November 21 the total turnover in the bond sector of MICEX was RUR 11.7 billion (the average daily turnover mad RUR 616.1 million), what was somewhat below the respective figures registered in October. In the period from October 31 till November 24 the price index of corporate bonds traded at the MICEX<sup>8</sup> decreased by 0.61 points (-0.56 per cent) and the index of ten most liquid corporate sector bonds decreased by 0.31 points (-0.27 per cent).

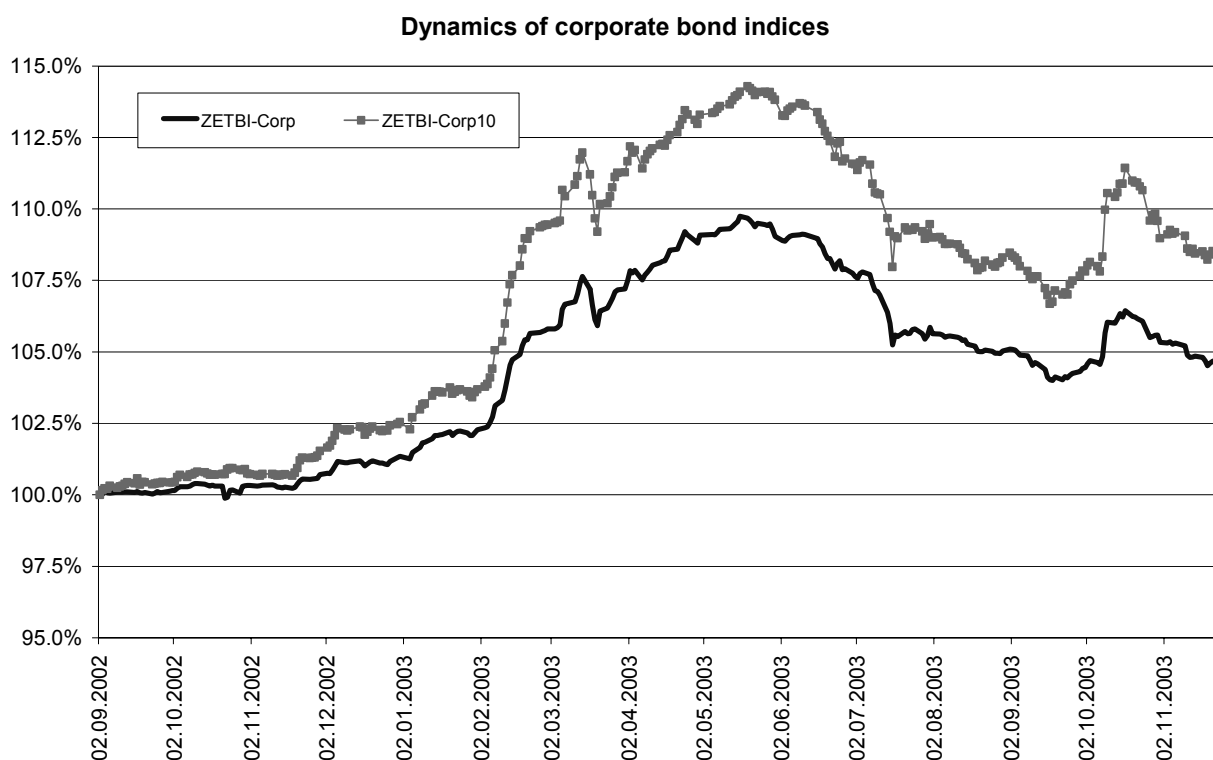
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<sup>6</sup> On the classical stock market.

<sup>7</sup> According to the RTS.

<sup>8</sup> The indices of corporate bonds traded at the MICEX that have been used for the calculations are calculated by Zenit Bank.

Figure 5



**External factors affecting the dynamics of the Russian stock market.** In November, an upward trend in quotations was observed on the world oil market. After the maximum (US \$ 30 per barrel) was registered on October 27, the market experienced a decline in prices, which continued for about 7 days. According to the data for November 5, Brent oil was at US \$ 27.3 per barrel. In particular, this development could be explained by a growth in US fuel reserves occurring at the background of high volumes of import. However, the market evaluated terrorist acts in Iraq and Saudi Arabia as a possibility that there would occur a break in supplies of oil from the Middle East region. Besides, certain US officials stated that the launch of the Kirkuk - Ceyhan export oil pipeline in Iraq would be delayed until its security is guaranteed. These factors, as well as the published positive US macroeconomic statistics resulted in the fact that on the last day of the first week of the month quotations began to rise. For instance, on November 6 they stopped at the level of US \$ 27.89 per barrel.

The beginning of the second week of the month was characterized by the persisting upward trend in quotations, what was caused by a number of factors. Firstly, a complicated political situation in Saudi Arabia and Iraq accounted for high political risks. Secondly, the data on US fuel reserves proved to be worse than expected, while reserves of crude oil declined.

The terror acts in Turkey provided a certain support to the market in the third week of November: the apprehension of a possible destabilization of the situation in the Middle East made funds to take long positions on the market. Besides, the majority of OPEC officials expressed their opinion that official quotas should remain unchanged. According to these officials, the current level of quotations was still too low to increase quotas. However, as soon as such high levels are reached, there most frequently occurs an adjustment caused by the wish of investors to fix their profits. As a result, by the end of the week there was observed a certain adjustment of prices. On the whole, over the period from November 3 till 24, the world Brent prices grew by US \$ 1.91 per barrel, what corresponded to an increase by 6.85 per cent.

Figure 6.

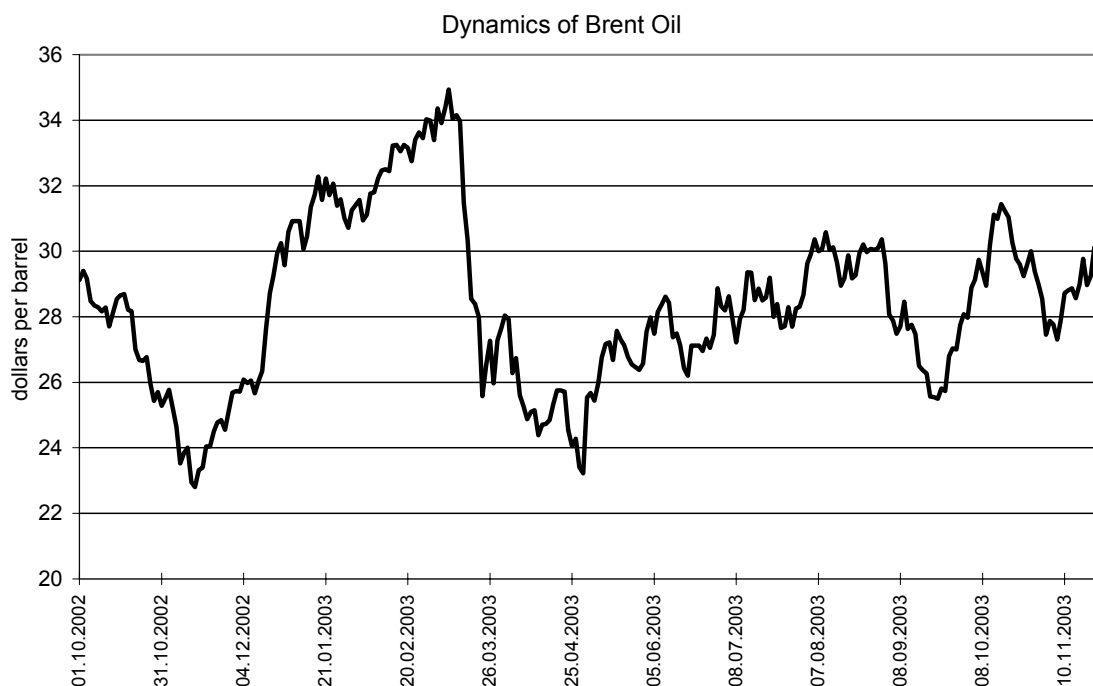
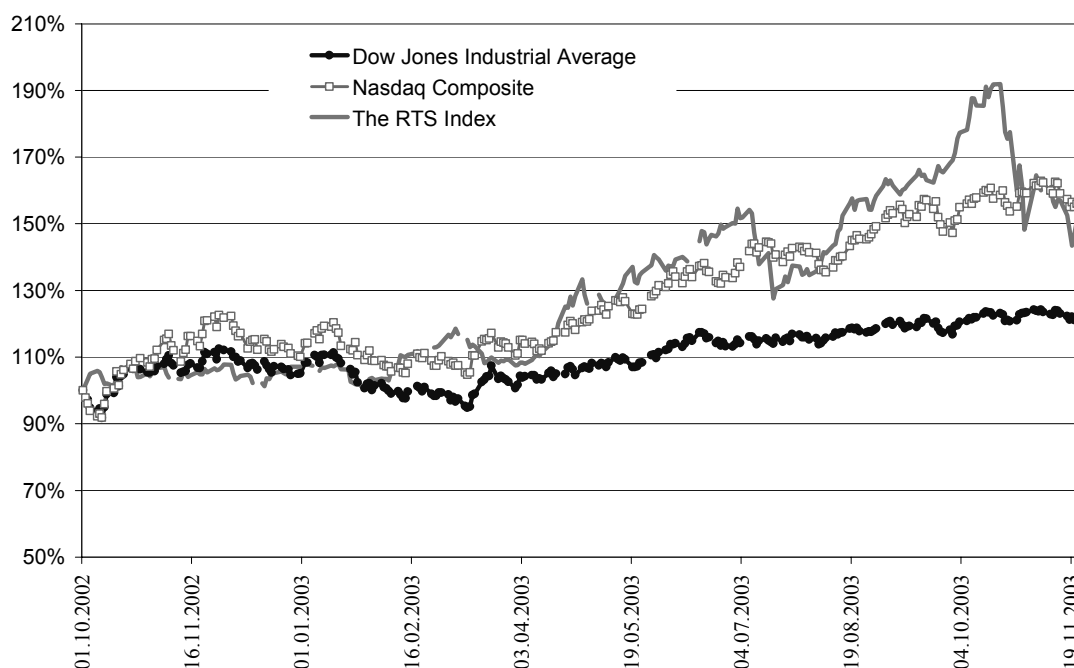


Figure 7.



In November, the dynamics of world stock markets were characterized by different trends. For instance, according to the results of three weeks of the month (year) the US stock indices NASDAQ and S&P500 changed insignificantly as their respective growth made 0.77 per cent (40.38 per cent) and 0.51 per cent (15.79 per cent), while DJIA index somewhat decreased – the rate of increase according to the results of the month (year) made -0.01 per cent (13.32 per cent). European stock indices demonstrated positive dynamics: FTSE 100 (UK) grew during the month (year) by 2.56 per cent (9.43 per cent), DAX 30 (Germany), by 3.51 per cent (20.05 per cent), CAC-40 (France), by 1.79 per cent (7.03 per cent). On the contrary, on Asian stock markets there prevailed downward trends. For instance, Nikkei-225 (Japan) changed by -5.69 per cent (14.31 per cent) during the month (year), while Seoul Composite (South Korea), by -2.8 per cent (14.00 per cent). On the markets of developing countries there was observed a certain worsening of the business situation,

what was demonstrated by a decrease in the composite index calculated by the agency MSCI – according to the results of the month (year) it decreased by 1.8 per cent (+ 26.66 per cent).

According to the results of the first trading week of the month, the US stock market grew somewhat. Among the factors which contributed to growth of the US stock market indices were publications of a number of positive statistical reports and corporate financial results for the 3<sup>rd</sup> quarter of the current year. It shall be noted that more than 90 per cent of US corporations published the results of their operations. In its turn, the economic statistics data pointed to the fact that the American economy grew at a faster rate. Over the next trading week, on the whole on the market there was observed a decline in quotations. Although the majority of financial statements were positive, the companies in the retail trade sector disappointed investors. The economic statistics were of contradictory nature. Later, the decline in indices continued in spite of the improvement of economic indicators and favorable financial results of companies. This fact could be explained by the wish of investors to fix their profits, as well as the impact of a number of negative factors: a growth in prices of energy resources, declining US \$ exchange rate, and the situation in the Middle East.

## Corporate News

### *The NK LUKoil*

In the beginning of November, the company LUKINTER FINANCE B. V., which belongs to the LUKoil group completely redeemed the convertible bonds with maturity in November of 2003 remaining in circulation (the issue amounting to US \$ 350 million was placed in November of 1997). On November 3, 2003, there were paid off bonds amounting to US \$ 51.48 million (at par value) and the respective interest.

The amount of trading with NK LUKoil ADRs at the London stock exchange increased by 121.4 per cent in October of 2003 as compared with the respective figures registered in September of this year and made over US \$ 1.8 billion.

On November 21, in Geneva there was held a meeting of the NK LUKoil Board of Directors, which approved the Program of strategic development of the LUKoil group for years 2004 – 2013. The program envisages an increase in the base financial indicators 2 to 2.5 times and a growth in extraction of hydrocarbons 1.8 times, while investment shall make more than US \$ 25 billion.

### *The OAO Sibneft*

On October 30, the company made public the financial results of its operations in the first six months of 2003. The net profits of the OAO Sibneft calculated in accordance with the US GAAP standards increased almost threefold in the first six months of 2003 and made US \$ 1.38 billion (as compared with US \$ 476 million registered in 2002). In the first six months of the year, the company's proceeds made US \$ 3.4 billion as compared with US \$ 1.9 billion registered in the respective period of the preceding year, thus it grew by 73 per cent. The amount of earnings before profit tax, interest, and depreciation (EBIDTA) increased by 139 per cent and made US \$ 1.7 billion (US \$ 743.8 million in 2002).

The record highs of financial indicators of Sibneft resulted from the growth in output by 23 per cent up to 15 million metric tons (616 thousand barrels a day) as compared with 12.5 million metric tons (499 thousand barrels a day) the company extracted in the first six months of 2002, the favorable business situation on the world oil markets, and successful investment. Besides, there continued the process of cost optimization. Sibneft still leads in terms of the growth in extraction of oil. According to Ye. Shvindler, the Sibneft President, the record financial indicators of the first six months of 2003 are the results of the work on creation of the first class Russian oil company YukosSibneft.

### *The OAO Gazprom*

On November 21 of 2003, OAO Gazprom presented the non-audited consolidated intermediate reports for three and six months of 2003. Over the first six months of this year, the sales earnings (minus VAT and customs payments) increased by RUR 115.3 million, or by 38 per cent as compared with the figures registered in the respective period of the preceding year. Over the same period of time, the operating costs of the company increased by 22 per cent in comparison with the figures registered in the respective period of the preceding year, what was primarily caused by a growth in expenditures for transit, labor, processing, purchase of natural gas, as well as a growth in amortization. The amount of net profit in the first three and six months of 2003 made RUR 47.789 million and RUR 103.761 million respectively.

*The OAO GMK Norilsk Nickel*

At its meeting taking place on November 13, 2003, the Board of Directors of the company took the decision to recommend the extraordinary meeting of the shareholders of the OAO GMK Norilsk Nickel to pay interim dividends at RUR 42.1 per share according to the results of the first 9 months of 2003.

*The OAO NGK Slavneft*

The shareholders of the OAO NGK Slavneft were recommended to approve the payment of the interim dividends at RUR 0.78 per share (with face value of 0.1 kopeck). The total amount planned for dividends makes RUR 3.71 billion. This decision was taken during the meeting of the Board of Directors, which was held on November 20.

*The RAO UES of Russia*

On November 11, the RAO UES of Russia published the financial statement of the RAO UES of Russia Group for the first six months of 2003 (IAS). The aggregate assets of the Group made RUR 1.075 billion as on June 30, 2003, the earnings from the core business made RUR 300.8 billion, what was by RUR 59.6 billion above the figures registered in the respective period of the preceding year. The expenditures relating to the core activities increased by RUR 35.9 billion, what was primarily caused by an increase in costs of fuel and purchased electrical power. The net profits of the RAO UES of Russia made RUR 16.9 billion in the first six months of 2003, what was below the respective indicator registered in 2002.

*The OAO NK YUKOS*

At its meeting held on October 28, 2003, the Board of Directors of the NK YUKOS recommended the extraordinary meeting of the company's shareholders to pay dividends for the first 9 months of 2003 in amount of RUR 59.9 billion. The amount of recommended dividends is unprecedented for Russian companies. In the case its decision is approved, the amount of dividends for the first nine months of this year will make RUR 26.78 per one ordinary share in the NK YUKOS.

*The OAO Rostelecom*

The international rating agency *Standard&Poor*'s increased the long-term credit rating of the company from B- to B with a positive forecast.

In the first nine months of 2003, the company's earnings made RUR 20749 million increasing by 36.7 per cent in comparison with the figures registered in the respective period of the preceding year. Over the same period, the profit from sales increased by 12.1 per cent reaching the level of RUR 6859 million. Net profits decreased by 2.4 per cent as compared with the figures registered over 9 months of 2002 and made RUR 4781 million.

*Table 1*

**Dynamics of International Stock Market Indices**

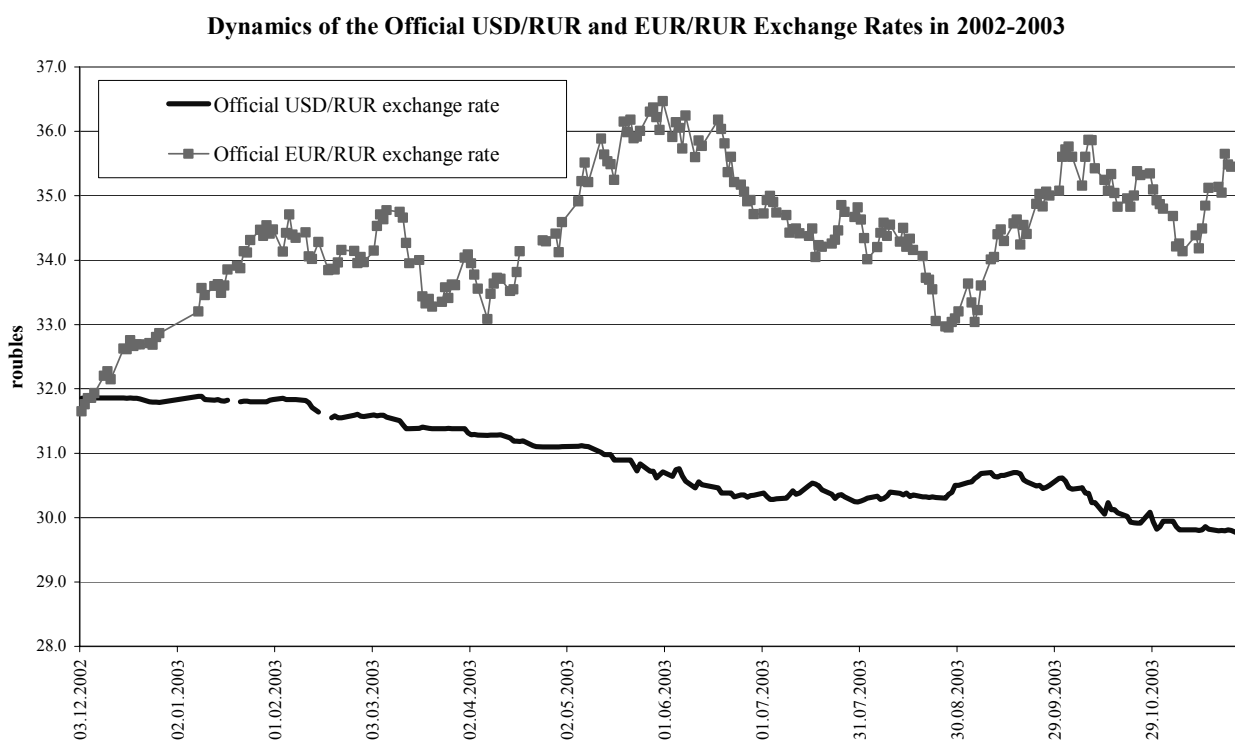
<b>Data as of November 24, 2003</b>	<b>Value</b>	<b>Change within the month (%)</b>	<b>Change since the beginning of the year (%)</b>
RTS (Russia)	515.75	-8.14%	42.95%
Dow Jones Industrial Average (USA)	9747.79	-0.01%	13.32%
Nasdaq Composite (USA)	1947.17	0.77%	40.38%
S&P 500 (USA)	1052.08	0.51%	15.79%
FTSE 100 (UK)	4382.40	2.56%	9.43%
DAX-30 (Germany)	3712.98	3.51%	20.05%
CAC-40 (France)	3412.05	1.79%	7.03%
Swiss Market (Switzerland)	5304.6	2.30%	8.27%
Nikkei-225 (Japan)	9960.20	-5.69%	14.31%
Bovespa (Brazil)	19691.00	8.03%	69.75%
IPC (Mexico)	8164.73	2.98%	30.57%
IPSA (Chile)	1422.50	3.83%	38.08%
Straits Times (Singapore)	1666.93	-3.98%	24.40%
Seoul Composite (South Korea)	753.65	-2.80%	14.00%
ISE National-100 (Turkey)	14617.53	-0.38%	34.88%
Morgan Stanley Emerging Markets Free Index	401.04	-1.48%	26.66%

**The Foreign Exchange Market.** During the month, there was observed a decline in the US \$ / RUR exchange rate. In the beginning of the month, the macroeconomic situation seemed to be favorable for normalization of the situation on the forex market. By the end of the second week of the month a certain decrease in the indicators of liquidity in the banking system facilitated a Ruble appreciation. By the end of the month, as banks needed more Ruble liquidity in connection to tax payments, Ruble further appreciated. The increase in the world oil prices also facilitated Ruble appreciation on the domestic market. Throughout the period from October 31 till November 25, the US \$ exchange rate decreased by 12 kopecks making RUR 29.73 per US \$.

In the period from October 27 till November 21, the total volume of trade in the US Dollar at the SELT was US \$ 9.1 billion (the average daily turnover made US \$ 483.8 million over this period), decreasing by 5.3 billion as compared with the figures registered in October. During the period under review the highest volume of trade in the US Dollar, about US \$ 1 billion, was observed on October 27 (September: 1.56 million); the lowest results, US \$ 157.3 million, were observed on November 11. Thus, in the reporting period there was observed a decrease in the activity of forex market operators.

Ruble 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 November 24 the balances in credit institutions' accounts with the Bank of Russia were at RUR 105 billion, what was somewhat below the average levels registered in October.

*Figure 8.*



On the world forex markets, during the month on the whole there was observed a depreciation of US \$ against Euro. In the first week of the month, US \$ appreciated considerably against the majority of world currencies, first of all, Euro, at the background of positive economic news from the USA. Forex market operators believe that as the macroeconomic situation in the USA considerably improves, foreign investors will return to the market, what may result in a growth in demand for US \$. However, significant deficits of the current account and budget do not allow to hope that US \$ will retain its positions during a long period of time. Therefore, there was observed a significant depreciation of US \$ against Euro, the respective exchange rate reached its historical minimum. According to the data presented by the Finance Ministry, in September foreign investors purchased the minimum of US securities over the last 5 years.

On the world forex markets, the rate of the Euro grew noticeably against the Dollar by 1.3 cents (by 1.18 per cent as compared with the US \$ / Euro exchange rate registered on October 31) and according to the data as on November 25 made US \$ / Euro 1.176.

The dynamics of the Euro - Ruble rate were mainly determined by the trends on the global market. The strengthening of the Euro against the US Dollar in the world markets was followed by an increase in the Euro - Ruble rate observed in October. In the period from October 31 till November 25 the European currency grew by 53 kopecks (1.54 per cent) from the level of RUR / Euro 34.86 to RUR / Euro 35.40. The total turnover of trade at the SELT amounted to Euro 117.4 million in the period from October 27 till November 21 (in October: Euro 153.9 million). The highest trade volume of Euro was registered on October 27 at Euro 9.21 million, and the lowest, Euro 4.45 million, on November 3.

Figure 9.

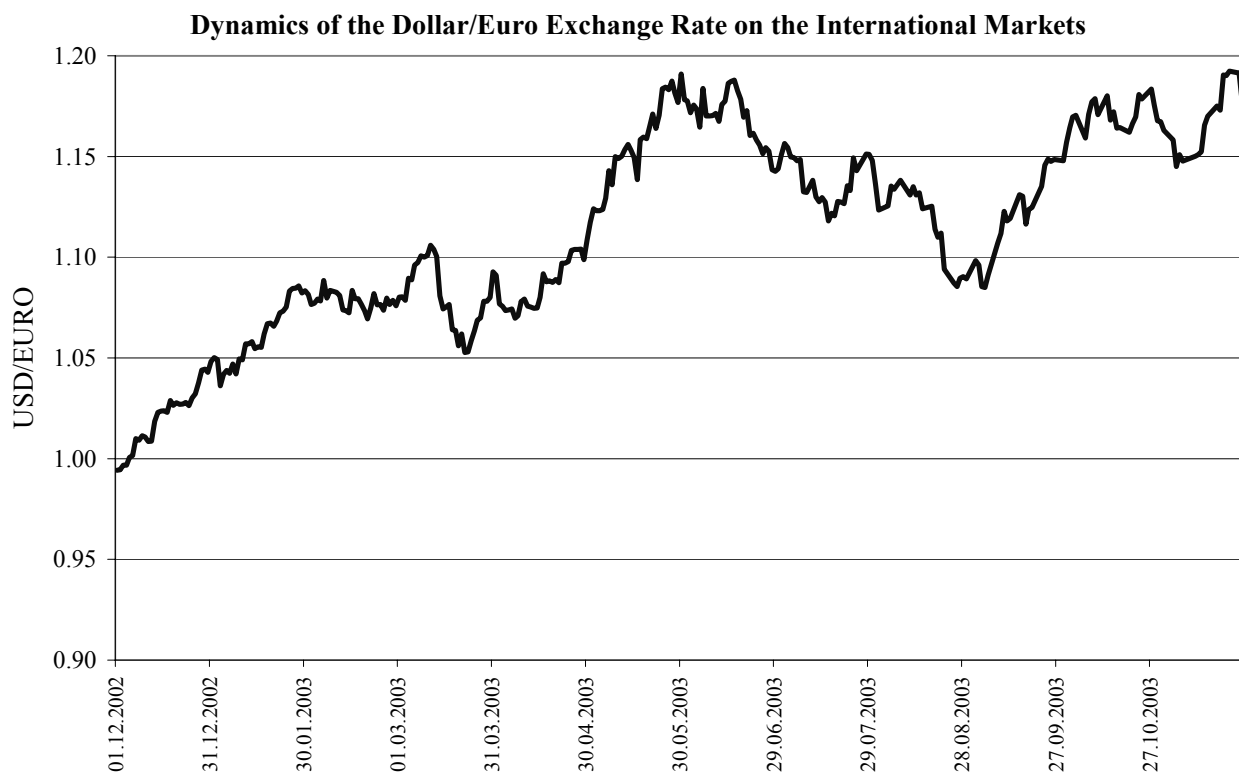




Table 2.

### Financial Markets Indicators

Month	July	August	September	October	Nov.*
Monthly inflation rate	0,7%	-0,4%	0,3%	1,0%	1,1%
Inflation rate annualized on the basis of this month's trend	8,73%	-4,70%	3,66%	12,68%	14,03%
CB RF refinancing rate	16%	16%	16%	16%	16%
Annualized yield to maturity on OFZ issues (%)	7,11%	6,54%	6,15%	7,26%	6,8%
Volume of trading in the secondary GKO-OFZ market for the month (RUR billion)	17,08	13,00	12,87	14,60	5,5
Yield to maturity on Minfin bonds at the end of the month (% p.a.)					
5 <sup>th</sup> tranche	5,90%	6,00%	5,68%	6,10%	5,9%
6 <sup>th</sup> tranche	4,45%	4,61%	4,26%	4,38%	4,3%
7 <sup>th</sup> tranche	6,42%	6,92%	6,55%	7,08%	7,0%
8 <sup>th</sup> tranche	5,32%	5,60%	4,96%	5,17%	5,1%
Yield to maturity of Eurobonds at the end of the month (% p.a.)					
2005	3,13%	3,35%	2,93%	3,22%	3,0%
2007	4,55%	4,81%	4,35%	4,65%	4,5%
2010	5,86%	6,09%	5,70%	5,98%	5,8%
2018	7,24%	7,28%	6,85%	7,26%	7,0%
2028	7,76%	7,64%	7,26%	7,57%	7,4%
2030	7,82%	7,81%	7,46%	7,75%	7,4%
INSTAR-MIACR rate (% p.a.) on interbank overnight loans at the end of the month	4,1%	3,9%	22,0%	9,76%	5,0%
Official RUR / US\$ exchange rate at the end of the month	30,2596	30,5036	30,6119	29,8584	29,74
Official RUR / Euro exchange rate at the end of the month	34,6291	33,2001	35,0751	34,8657	35,5
Average annualized growth in RUR / US\$ exchange rate	-0,29%	0,81%	0,36%	-2,46%	-0,4%
Average annualized growth in RUR / Euro exchange rate	-0,24%	-4,13%	5,65%	-0,60%	1,82%
Volume of trading at the stock market in the RTS for the month (US\$ million)	600,12	329,97	490,78	867,33	400
Value of RTS-1 Index at the end of the month	457,02	531,00	568,97	513,96	535
Change in value of RTS-1 Index during the month (%)	-9,23%	16,19%	7,15%	-9,67%	4,1%

\* Estimate

D. Polevoy

### Modeling investment of pension savings on the corporate bond market

In the spring of 2004, there shall be given start to the new stage of the reform of the cumulative component of the pension system Pension savings, according to the choice of citizens, shall be transferred to management companies for investment. Private management companies are permitted to invest pension savings in such a class of assets as bonds issued by Russian companies. Below there are presented approaches to the evaluation of the impact these funds may have on the market of corporate bonds. The calculations are based on the comparison of amounts management companies could have invest in this sector of the stock market in the case pension savings were transferred to them in the beginning of 2003 with amounts of trade with corporate bonds over this period.

As in the case of shares, the maximum level of management companies' investment of pension savings in bonds issued by companies is set forth by 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,’” according to which up to 50 per cent of the amount of pension savings may be invested in bonds issued by Russian companies in 2004. Over the three next years, the share of stocks in the investment portfolio of management companies may be gradually increased up to 80 per cent.

Since 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 bonds), in order to assess the amounts which may be invested in this sector by management companies selected via tenders there were used the same assumptions as in the case of the modeling calculations of investment of pension savings in stocks<sup>9</sup>:

In accordance with the applications of insured persons, they 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.

The total amount of transferred pension savings, in the case the transfer were made in the beginning of 2003 would make Rub. 39.95 billion<sup>10</sup>. Therefore, depending on the assumption, management companies may dispose of Rub. 2.0, 8.0, or 13.3 billion.

Apparently, the maximum limitation set by the law not necessarily is a guideline for investment strategies of management companies (the maximal declared share of corporate bonds in the investment statements of management companies makes 50 per cent). The calculations are carried out for two variants of investment in corporate bonds:

1) the aggregate share of investment in equities of all management companies is limited to 25 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. 50 per cent of the total transferred funds).

At the same time, it was assumed that management companies invest the funds not momentarily, but evenly purchasing bonds over three months of 2003.

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

1.1. The share of pension savings transferred to management companies according to applications of insured persons makes 1/3 of their total amount, 50 per cent of the transferred amount are invested on the market of corporate bonds.

1.2. The share of pension savings transferred to management companies according to applications of insured persons makes 1/3 of their total amount, 25 per cent of the transferred amount are invested on the market of corporate bonds.

2.1. The share of pension savings transferred to management companies according to applications of insured persons makes 20 per cent of their total amount, 50 per cent of the transferred amount are invested on the market of corporate bonds.

2.2. The share of pension savings transferred to management companies according to applications of insured persons makes 20 per cent of their total amount, 25 per cent of the transferred amount are invested on the market of corporate bonds.

3.1. The share of pension savings transferred to management companies according to applications of insured persons makes 5 per cent of their total amount, 50 per cent of the transferred amount are invested on the market of corporate bonds.

3.2. The share of pension savings transferred to management companies according to applications of insured persons makes 5 per cent of their total amount, 25 per cent of the transferred amount are invested on the market of corporate bonds.

According to some sources, the total amount of corporate bonds circulating by the end of 2002 was estimated to be at Rub. 109 billion (at par value)<sup>11</sup>. However, management companies have a much narrower choice of instruments for investment. According to the requirements set forth by Resolution No. 379, investment of pension savings entrusted with management companies in bonds shall be limited to the issuers included in the stock quotations and meet a number of other requirements. Taking into account these requirements, by mid-2003 the aggregate amount of circulation of such bond issues made, according to our estimates, 27 per cent of the total amount of corporate bonds (at face value) circulating on the market. All

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<sup>9</sup> See the IET monthly for October of 2003

<sup>10</sup> See federal law No. 197 of December 31, 2002, “On the budget of the Pension Fund of the Russian Federation for year 2003.”

<sup>11</sup> According to the data published by the information agency Cbonds ([www.cbonds.ru](http://www.cbonds.ru))

these bonds are included in the A1 quotation at the MICEX. On the average, in January through March the amount of trade with these issues at the MICEX made 74 per cent of the aggregate amount of secondary trading in the corporate bonds segment of MICEX.

The data on the amount of trade at the MICEX in the 1<sup>st</sup> quarter of 2003 taking into account the limitations mentioned above are presented in Table 1..

*Table 1.*

**Amounts of trading with shares included in A1 quotations at MICEX in January through March of 2003**

<b>Month</b>	<b>Amount of trade, Rub. billion</b>
Jan.03	1.71
Feb.03	3.12
Mar.03	3.11
Mean	2.64

**Scenario 1.1.**

The resources transferred to management companies 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 corporate bonds (proceeding from the 50 per cent limit) makes Rub. 6.7 billion.

In the case the investment of pension savings was carried out in the respective month of 2003, the invested amount would make from 71 per cent to 130 per cent of the MICEX turnover (see Table 2):

*Table 2.*

**The results of calculations based on scenario 1.1.**

<b>Months, in which shares were purchased</b>	<b>Invested amount, Rub. billion</b>	<b>Investment of MC in % of the turnover</b>
Jan.03	2.22	130.14
Feb.03	2.22	71.18
Mar.03	2.22	71.49
Mean	2.22	83.98

MC – management companies

**Scenario 1.2.**

The resources transferred to management companies make 1/3 of the total amount of pension savings (Rub. 13.3 billion) by the end of 2002.

The amount invested in bonds (25 per cent of resources) makes Rub. 3.33 billion.

In the case the investment of pension savings was carried out in the respective month of 2003, the invested amount would make from 41 per cent to 74 per cent of the MICEX turnover (see Table 3):

*Table 3.*

**The results of calculations based on scenario 1.2.**

<b>Months, in which shares were purchased</b>	<b>Invested amount, Rub. billion</b>	<b>Investment of MC in % of the turnover</b>
Jan.03	1.27	74.45
Feb.03	1.27	40.72
Mar.03	1.27	40.90
Mean	1.27	48.04

**Scenario 2.1.**

The resources transferred to management companies make 20 per cent of the total amount of pension savings (Rub. 8 billion) by the end of 2002.

The maximal amount permitted to be invested in corporate bonds (proceeding from the 50 per cent limit) makes Rub. 4 billion.

In the case the investment of pension savings was carried out in the respective month of 2003, the invested amount would make from 43 per cent to 78 per cent of the MICEX turnover (see Table 4):

*Table 4.***The results of calculations based on scenario 2.1.**

<b>Months, in which shares were purchased</b>	<b>Invested amount, Rub. billion</b>	<b>Investment of MC in % of the turnover</b>
Jan.03	1.33	77.97
Feb.03	1.33	42.64
Mar.03	1.33	42.83
Mean	1.33	50.31

**Scenario 2.2.**

The resources transferred to management companies make 20 per cent of the total amount of pension savings (Rub. 8 billion) by the end of 2002.

The amount invested in bonds (25 per cent of resources) makes Rub. 2 billion.

In the case the investment of pension savings was carried out in the respective month of 2003, the invested amount would make from 22 per cent to 39 per cent of the MICEX turnover (see Table 5):

*Table 5.***The results of calculations based on scenario 2.2.**

<b>Months, in which shares were purchased</b>	<b>Invested amount, Rub. billion</b>	<b>Investment of MC in % of the turnover</b>
Jan.03	0.67	39.28
Feb.03	0.67	21.48
Mar.03	0.67	21.58
Mean	0.67	25.35

**Scenario 3.1.**

The resources transferred to management companies make 5 per cent of the total amount of pension savings (Rub. 2 billion) by the end of 2002.

The maximal amount permitted to be invested in corporate bonds (proceeding from the 50 per cent limit) makes Rub. 1 billion.

In the case the investment of pension savings was carried out in the respective month of 2003, the invested amount would make from 11 per cent to 19 per cent of the MICEX turnover (see Table 6):

*Table 6.***The results of calculations based on scenario 3.1.**

<b>Months, in which shares were purchased</b>	<b>Invested amount, Rub. billion</b>	<b>Investment of MC in % of the turnover</b>
Jan.03	0.33	19.35
Feb.03	0.33	10.58
Mar.03	0.33	10.63
Mean	0.33	12.48

### Scenario 3.2.

The resources transferred to management companies make 5 per cent of the total amount of pension savings (Rub. 2 billion) by the end of 2002.

The amount invested in bonds (25 per cent of resources) makes Rub. 0.5 billion.

In the case the investment of pension savings was carried out in the respective month of 2003, the invested amount would make from 5 per cent to 10 per cent of the MICEX turnover (see Table 7):

Table 7.

**The results of calculations based on scenario 3.2.**

<b>Months, in which shares were purchased</b>	<b>Invested amount, Rub. billion</b>	<b>Investment of MC in % of the turnover</b>
Jan.03	0.17	9.97
Feb.03	0.17	5.45
Mar.03	0.17	5.47
Mean	0.17	6.43

As it is demonstrated by the result of the modeling calculations in accordance with Scenario 1.1, where the investments of management companies in corporate bonds were made proceeding from the maximal permitted share of bonds in the investment portfolio, on the average they make more than 50 per cent of the aggregate amount of trade with corporate bonds at the main trading floor, while the investment in stocks according to a similar scenario make only 7.9 per cent of the aggregate amount of trading (in the case the amount of trade with RAO UES shares is excluded).

These results were affected not only by the fact that the segment of stocks is much more developed in comparison with the bond market, but also by a considerably less share of bonds meeting the criteria set forth by Resolution No. 379 in the total amount of corporate bonds in circulation (27 per cent of their aggregate capitalization in comparison with 69 per cent as concerns stocks) and 74 per cent of the aggregate amount of trade (in comparison with 80 per cent as concerns stocks).

Besides, the higher limits on investment of pension savings in bonds (50 per cent of the investment portfolio as compared with 40 per cent set on investment in stocks). The practical implementation of such a scenario may have a destabilizing impact on the stock market. What is more, the rapid growth in primary placements of corporate bonds issues was not accompanied by an adequate growth in trade on the secondary market (according to our estimates based on the statistics of trade with corporate bonds at MICEX, the amount of secondary trading with bonds included in the A1 quotation in September remained at the level registered in March of 2003 making about Rub. 3.1 billion over the month). On the whole, it may be concluded that in the initial period of the formation of the cumulative pension system it would be feasible to set the limitation of the maximal share of corporate bonds in the investment portfolios of management companies at a lower level.

According to other scenarios, the share of investment on the part of management companies, which made agreements with the Pension Fund in the amount of trade with corporate bonds at the MICEX is also rather high and would imminently significantly affect the indicators of market volatility and price dynamics. Only investment answering the conditions set by Scenario 3.2 (the resources transferred to management companies make 5 per cent of the total amount of pension savings, while the amount invested in bonds makes 25 per cent of these resources) does not apparently affect the existing trends on the market of corporate bonds.

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

Year 2003 is characterized by a dynamic development of practically all sectors of the economy and industry. The growth in output of products and services of base economic sectors in January through October of 2003 made 6.9 per cent increasing by 3.0 p. p. in comparison with the figures registered in the respective period of the preceding year. The specific feature of the current year is the outpacing rates of growth in investment demand in comparison with the dynamics of GDP and consumer demand. In January through

October of 2003, investment in fixed assets increased by 12.2 per cent as compared with 2.5 per cent registered in the respective period of the preceding year. An intensive expansion of amounts of services rendered by communications, transport, and trade was a factor behind the increase in the rates of growth in the sector of services by 2.7 p. p. as compared to figures observed in January through September of 2002. The freight turnover increased by 7.3 per cent in comparison with the figures observed in January through October of 2002, while the retail trade turnover grew by 8.1 per cent.

An additional impetus to economic growth was expanding external demand for mineral and raw material resources, as well as the development of processes of transformation of earnings from external economic activities in domestic demand. In January through October of 2003, according to the RF Ministry of Economic Development, export of goods made US \$ 107.7 billion increasing by 34.6 per cent in comparison with the figures registered in the respective period of the preceding year. At the same time, the increase in volumes of export accounted for about 47 per cent of the growth in amount of exports, while 53 per cent of increase occurred at the expense of the price factor. Over the same period, the import of goods made US \$ 58.8 billion and was by 20.7 per cent above the level observed in the respective period of 2002. Increase in the volumes of imports accounted for the bulk of growth in imports. In the 3<sup>rd</sup> quarter of 2003, the share of imports in the structure of commodity resources of retail trade increased by 1 percentage point in comparison with the figures registered in the respective period of the preceding year and made 43 per cent. According to the Central Bank of Russia, this August the share of imports in the total amount of resources to be used on the domestic market increased by 3.1 p. p. as compared with the figures observed in the respective period of 2002 (in prices of August of 2002).

In January through October, the average monthly active balance of trade made US \$ 5 billion, what may be compared with the record levels observed in 2000. Due to the exceptionally favorable business situation on world markets of energy resources, the impact of external demand became the determining factor of expansion of production in these industries.

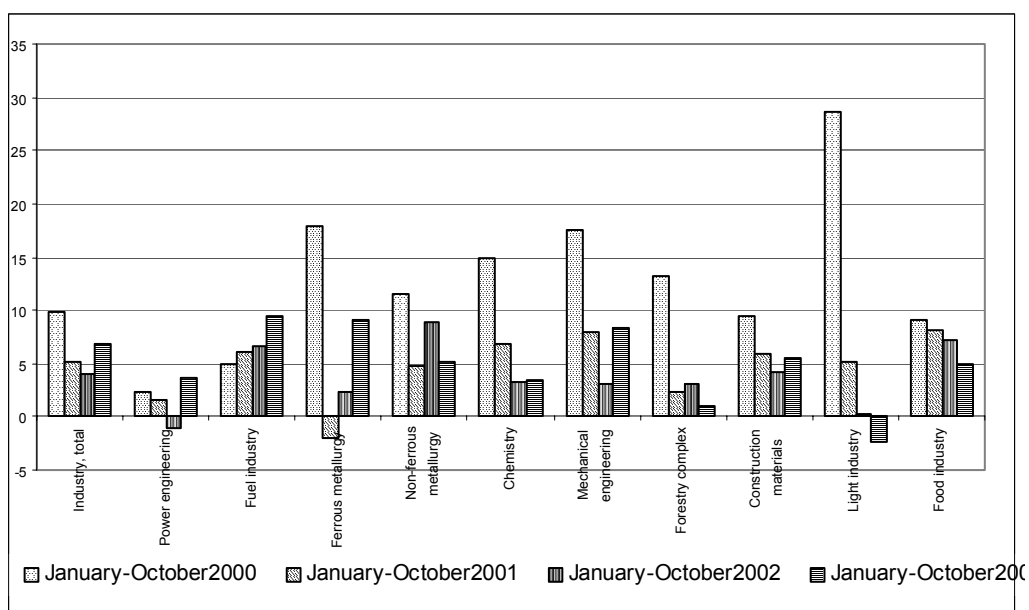


Figure 1 Changes in output dynamics across industries in January through October of 2001 through 2003, in % of the figures registered in the respective period of the preceding year

In 2003, the export oriented industries contributed most significantly in the growth in the total industrial output. As the amount of industrial output increased by 6.8 per cent in comparison with the figures registered in January through October of 2002, the increase in production of export oriented industries made about 8.0 per cent and was by almost 2.5 p. p. above the level observed in the preceding year. As compared with January through September of 2002, the amount of balanced profits in export oriented industries increased by 16 per cent, while the growth in this indicator in the industry at large made 13.3 per cent.

The continuing growth in extraction and export of oil and oil products at the background of persisting favorable external economic situation positively affects the dynamics of industrial output. A characteristic feature of the recovery economic growth in 2000 through 2003 has been outpacing rates of growth in

external demand for oil and oil products as compared with the dynamics of production and domestic consumption. It shall be noted that due to the saturation of demand on the domestic market there is observed an increase in the specific weight of export not only of crude oil, but also processed oil products. As compared with the figures registered in 2000, the share of exported products in the output of motor gasoline and diesel fuel increased by 9.5 p. p. and 26.4 p. p. respectively. Due to the favorable price situation on external markets as concerns hydrocarbon raw materials and processed products, the rates of growth in the amounts of export of gasoline and diesel fuel have considerably outpaced the respective indicator pertaining to crude oil. It shall be admitted that the impact of this trend on the general industrial indicators is insignificant due to the relatively small amount of export of oil products as compared with export of crude oil. The analysis of these developments is of interest from the viewpoint of trends towards transformation of the exports structure in the direction of increase of the share of products processed in much higher degree. Due to the fact that processing of crude oil at domestic enterprises brings less profits in comparison with export of crude oil, the oil processing industry is characterized by moderate development dynamics. In January through October of 2003, the growth in production of oil processing industry made 111.4 per cent as compared with 8.5 per cent registered in the respective period of the preceding year, while in oil extracting industry these indicators were at 2.3 per cent and 2.6 per cent respectively.

*Table 1*

**Dynamics of production and export of oil and certain oil products in January through October of 2000 through 2003, in % of the figures registered in the respective period of the preceding year.**

	Rates of growth in volumes						Specific weight of exports in production		
	Production			Exports					
	Oil	Gasoline	Diesel fuel	Oil	Gasoline	Diesel fuel	Oil	Gasoline	Diesel fuel
2000	105,6	102,5	105,5	105,5	210	98,7	41,5	7,3	32,4
2001	107,5	101,2	101,9	111,9	80,0	105,5	48,9	12,2	57,1
2002	108,5	103,2	103,6	112,8	104,7	114,5	49,5	8,8	58,0
2003	112,2	101,3	102,0	117,1	117,4	112,4	61,3	16,8	59,0

Source: RF Goskomstat

This year, non-ferrous metallurgy lost its dominating influence on the dynamics of industrial growth in the metallurgy complex. In January through October of 2003, the increase in output of non-ferrous metallurgy made 5.1 per cent and was by 3.8 p. p. below the respective indicator of the preceding year. The general trend towards a decrease in the rates of growth in the industry was negatively affected by sinking demand for staple export goods. Over three quarters of 2003, an increase in exports was registered only as concerns unprocessed aluminum (10.6 per cent).

Ferrous metallurgy became the leader of the complex as it demonstrated rates of growth at the level of 109.5 per cent in comparison with the figures registered in January through October of 2002. The increasing rates of growth in production observed in ferrous metallurgy were supported by the simultaneous growth in domestic and external demand. As investment activity in the national economy intensified, there was registered an increase in demand for construction materials. In January through October of 2003, sales of rolled ferrous metals on the domestic market increased by 17.9 per cent in comparison with 7.0 per cent registered in the respective period of the preceding year. Favorable changes in business climate and the price situation on the world markets gave an additional impetus to the growth in metallurgy and other industries manufacturing producer and technical durables. Export of ferrous metals and ferroalloys increased by 31.2 per cent and 27.7 per cent respectively in comparison with the levels registered in January through August of 2002. According to the results of the first three quarters of 2003, the balanced profits of ferrous metallurgy increased 3.4 times.

Industries engaged in production of intermediate goods demonstrated growth rates at 105.3 per cent and accounted for less than  $\frac{1}{4}$  of the total growth in industry on the whole. In chemistry, the rates of increase in output remained at practically the same level as registered in January through October of 2002 making 3.4 per cent. It shall be mentioned that the low rates of growth observed in the mining and chemical industry and chemistry were compensated by increasing output of highly processed goods: products of organic synthesis, plastic products, chemical fibers, and tires. The decrease in the rates of growth registered in the forestry complex (by 2.1 p. p.) in comparison with the figures registered in January through October of 2002 may be

explained by the downfall in output of lumber and wood working industries by 6.2 per cent and 2 per cent respectively as compared with the levels registered in January through October of 2002.

The dynamics of growth in industries manufacturing final products formed at the background of structural shifts. In 2002, the intensity of production of final goods was determined by the rates of growth in consumer complex industries. As industrial output increased by 4.0 per cent in January through October of 2002, the growth in production of the consumer complex made 6.5 per cent, at the same time it outpaced the rates of growth in the investment complex and export oriented complex by 2.9 p. p. and 1.0 p. p. respectively.

In 2003, the situation radically changed. Similarly to the period of 2000 through 2001, the investment complex responded to the acceleration of growth rates and earnings of the export oriented complex with an intensive increase in production of capital goods. The index of production observed in the investment complex in January through October of 2003 exceeded the respective indicator of 2002 by 3.6 p. p. making 107.2 per cent. Volumes of production in mechanical engineering and construction materials industry grew by 8.3 per cent and 5.5 per cent as compared with 3.1 per cent and 4.2 per cent registered in January through October of 2002. However, even in spite of these high rates of growth in output of capital goods the intensively expanding investment demand was satisfied at the expense of growth in import of machinery and equipment outpacing the dynamics of domestic production.

This year, the index of growth pertaining to the complex of consumer industries decreased to the minimal rate of increase registered over the period of recovery growth and made 2.4 per cent as compared with 6.5 per cent registered in January through October of 2002. In January through October of 2003, the rate of growth in food industry made 105.0 per cent as compared with 107.2 per cent and 108.2 per cent observed in January through October of 2002 and 2001 respectively. In light industry after the growth in production by 5.2 per cent registered in 2001 and stabilization observed in 2002 there was again registered a 2.8 per cent decline in production. Furniture industry also demonstrate a contraction of output this year. The narrow raw materials base on the one hand, and deteriorating competitiveness of domestic goods in comparison with imports at the current exchange rate on the other hand result in expanding niches for imported products. The complex of industries manufacturing consumer goods failed to maintain higher rates of growth over a long period of time without making serious qualitative changes in the technology and structure of production.

*O. Izryadnova*

## **IET Business Survey: Industry in November**

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In November, IET surveys registered a further slowdown of growth rates in effective demand. The balance decreased by 5 points more and was practically at zero, since an increase in amounts of cash sales almost stopped. After August, when there was registered the highest rate of growth in the last three years, this indicator declined by 17 points. In ferrous metallurgy, chemistry, petrochemistry, construction, and light industry there has been already registered an absolute decrease in sales. Only power engineering, nonferrous metallurgy, and food industry report about high rates of growth. It is quite natural that this situation in the dynamics of sales resulted in changes in assessments of amounts of demand on the “above norm – below norm” scale. Over three months, the balance of this indicator has declined from 54 per cent to 48 per cent in the industry at large, from 59 per cent to 36 per cent in light industry, and from 47 per cent to 40 per cent in mechanical engineering. The highest degree of satisfaction with demand was registered in nonferrous metallurgy, where the average value of the indicator over 11 months makes 70 per cent, while in July and November these figures made 96 per cent and 91 per cent respectively.

The growth in output also continued to slow down. In November, the balance of changes in output declined further by 6 points, the total decrease from August making 19 points. In light and food industries, as well as industry of construction materials, there started an absolute decline in output. In November, In industry on the whole the intensity of growth in output was higher than the intensity of growth in demand (+14 per cent as compared with +2 per cent). However, the calculations based on micro-data demonstrate that in November the majority of enterprises (64 per cent) could retain the balance between dynamics of demand and output. The outpacing growth in output as compared with effective demand was reported by 25 per cent of enterprises both in October and November. The most wide gap between output and cash demand exists in ferrous metallurgy (57 per cent), power engineering (38 per cent), and light industry (28 per cent).

According to 48 per cent and 47 per cent of enterprises respectively, insufficient demand and shortage of working capital (see the Figure) still remain the major obstacles to growth of output in the Russia's industry. The third factor is the lack of skilled labor. As compared with the figures registered in the 3<sup>rd</sup> quarter, the



frequency of reports indicating this obstacle increased by 10 points; at the moment 31 per cent of enterprises experience a shortage of labor preventing an increase in their output. In light industry this indicator makes 51 per cent, in the forestry complex – 39 per cent, in mechanical engineering – 35 per cent. At the same time, enterprises of power engineering did not mention the problem of the lack of skilled labor at all, the most pressing problems in this industry were non-payments on the part of consumers (72 per cent) and insufficient demand (61 per cent). At the least degree low demand limits output of chemistry, petrochemistry, and the forestry complex (30 per cent). In spite of the Ruble appreciation, domestic enterprises has begun to mention competitive import as a hindrance to growth in output less frequently: 16 per cent as compared with 21 per cent registered in the 3<sup>rd</sup> quarter. At the moment, this obstacle is most important for enterprises of ferrous (50 per cent) and non-ferrous (26 per cent) metallurgy, and light industry (24 per cent). In mechanical engineering the frequency of reports mentioning this obstacle makes 18 per cent, while the post-default maximum (25 per cent) in this industry was registered in the 2<sup>nd</sup> quarter of 2003.

The rate of decline in profits did not change in November; similarly to the situation registered in the preceding month, in the Russia's industry there prevail enterprises, where real profits decrease. The most clearly this prevalence was demonstrated in construction industry, light industry, and ferrous metallurgy. Only enterprises of power engineering and non-ferrous metallurgy planned an increase in profits.

In spite of the clear slow down in growth of sales and absence of increase in profits, enterprises were able to improve their financial and economic standing. Since the beginning of the year, the balance of evaluations "good – bad" has increased by 16 points and reached the absolute maximum in the 4<sup>th</sup> quarter. However, its values remain negative – the number of answers "bad" still exceeds the number of answers "good." The bulk of enterprises assess their standing as "satisfactory" (see the Figure below). However, by the end-year the share of such evaluations has noticeably decreased mostly because of the growth in the share of answers assessing enterprises' standing as "good."

The forecasts of changes in demand have stopped to become less optimistic. In September and October they declined by 17 points and reached the minimum of 2003. By October, in a number of industries the balances became negative: the enterprises in these industries already expected an absolute decrease in sales. By this moment the situation has stabilized because of the reports of enterprises of mechanical engineering, power engineering, and ferrous metallurgy. However, no turn in the negative trends was registered in other industries.

Similar changes were observed in the plans of changes in output. The respective forecasts lost in optimism 13 points over two months, however, in November they became more optimistic (by 3 p. p.) in the industry on the whole. At the level of individual industries a growth in optimism of assessments was registered in metallurgy, mechanical engineering, and the forestry complex.

In the nearest future, a growth in purchases of machinery and equipment is possible only in mechanical engineering and the forestry complex. In other industries there prevail enterprises planning a decrease in investment activity.

*S. Tsukhlo*

## **Regions: Dynamics of Industrial Output**

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While the average national growth in industrial output in January through September of 2003 continued at the same rate as in the first six months of the same year (6.8 per cent), the number of RF subjects where there was observed a decline in industrial output also remained the same. There were registered 14 such regions, 6 of which were autonomous okrugs. Therefore, only the autonomous okrugs specializing in oil and natural gas extraction (out of 10 AOs registered in Russia) demonstrated a growth in production: Khanty Mansi, Yamal Nenets, Evenk, and Nenets AOs. The latter was the leader among all other Russia's regions As concerns the rates of growth, which made 40.1 per cent in January through September of 2003 as compared with the figures registered in the respective period of the proceeding year.

Beside the autonomous okrugs, economically underdeveloped Republics (Altai, Ingushetia, Kalmykia) are also among the regions where the was observed a decline in industrial output (see Table 1). At the same time, Kalmykia is a graphic illustration of instability of industrial output dynamics in small national autonomies: by the end of the first six months of 2003, the Republic was among the regions demonstrating the highest rates of industrial output.

Table 1

**Regions demonstrating the most and least favorable industrial output dynamics in January through September of 2003\***

Regions demonstrating most significant rates of growth in industrial output	IOI, first six months of 2003 in % of first six months of 2002.	Regions demonstrating a decline in industrial output	IOI, first six months of 2003 in % of first six months of 2002
Republic of Mordovia	121,2	Tula oblast	99,0
Republic of Buryatia	120,1	Republic of Sakha (Yakutia)	99,0
Leningrad oblast	119,4	Kirov oblast	98,8
Arkhangelsk oblast	118,6	Samara oblast	98,8
City of Moscow	117,9	Republic of Kalmykia	97,8
Orenburg oblast	117,9	Magadan oblast	87,3
Moscow oblast	117,3	Republic of Altai	84,4
City of St. Petersburg	117,1	Republic of Ingushetia	80,7
Kursk oblast	116,9		
Tomsk oblast	115,3		
Kaliningrad oblast	114,8		
Yevreyskaya AO	112,5		
Karachayev-Cherkess Republic	111,8		
Republic of Mari El	110,8		
Omsk oblast	110,8		
Tyumen oblast	110,3		

\* without autonomous okrugs  
IOI – industrial output index

Table 2

**Regions leading in terms of their share in the national volume of industrial output in January through September of 2002 and 2003\***

Regions	Share in industrial output, January through September of 2003, in %	Regions	Share in industrial output, January through September of 2002, in %
Tyumen oblast	11,41	Tyumen oblast	11,54
City of Moscow	5,47	City of Moscow	6,00
Sverdlovsk oblast	4,41	Sverdlovsk oblast	4,37
Moscow oblast	4,11	Samara oblast	4,36
Samara oblast	4,07	Moscow oblast	4,06
Chelyabinsk oblast	3,74	Republic of Tatarstan	3,88
City of St. Petersburg	3,63	City of St. Petersburg	3,37
Republic of Tatarstan	3,55	Krasnoyarsk krai	3,35
Krasnoyarsk krai	3,21	Chelyabinsk oblast	3,25
Republic of Bashkortostan	2,78	Republic of Bashkortostan	2,86
<i>Total top 10</i>	<i>46,39</i>	<i>Total top 10</i>	<i>47,04</i>
Kemerovo oblast	2,73	Nizhni Novgorod oblast	2,49
Perm oblast	2,62	Kemerovo oblast	2,44
Nizhni Novgorod oblast	2,48	Perm oblast	2,43
Irkutsk oblast	1,98	Irkutsk oblast	2,07
Vologda oblast	1,97	Vologda oblast	1,78
<i>Total top 15</i>	<i>58,17</i>	<i>Total top 15</i>	<i>58,26</i>

\* without autonomous okrugs

On the whole, the composition of RF subjects characterized by the most and least favorable dynamics of industrial output remained unchanged as compared with the first six months of the year. Alongside with Kalmykia, the Ulyanovsk, Chita, Sverdlovsk, and Chelyabinsk oblasts were removed from the list of the leaders, at the same time, indicators demonstrated by the Mari El and Tyumen oblast somewhat improved. The Khabarovsk krai and Karelia have managed to reverse decline in industrial output, while the opposite processes took place in Kalmykia (as it was indicated above) and Yakutia.

The list of regions most significantly contributing in the national industrial output in January through September of 2003 remained the same as in January through September of 2002 (see Table 2), although the places RF subjects took in the list have somewhat changed. Among the top 5 regions, there shall be mentioned the Moscow and Samara oblasts, what is the quite natural result of oppositely directed dynamics of industrial production in these regions. In the course of comparison of indicators registered in the first six months of this and preceding years, there may be clearly observed a growth in the shares of RF subjects specializing in ferrous metallurgy (the Vologda, Sverdlovsk, Chelyabinsk oblasts).

As concerns federal okrugs, the leaders there were the okrugs most favorably situated in the economic and geographical terms – the Central and North West federal okrugs (see Table 3), in spite of the fact that they demonstrated relatively modest rates of growth in industries oriented towards the domestic market as compared with the national averages. At the same time, it is interesting to note that the share of the Central federal okrug in the national amount of industrial output has decreased, i.e. output of comparatively cheap products accounts to a considerable degree of growth in production.

Table 3

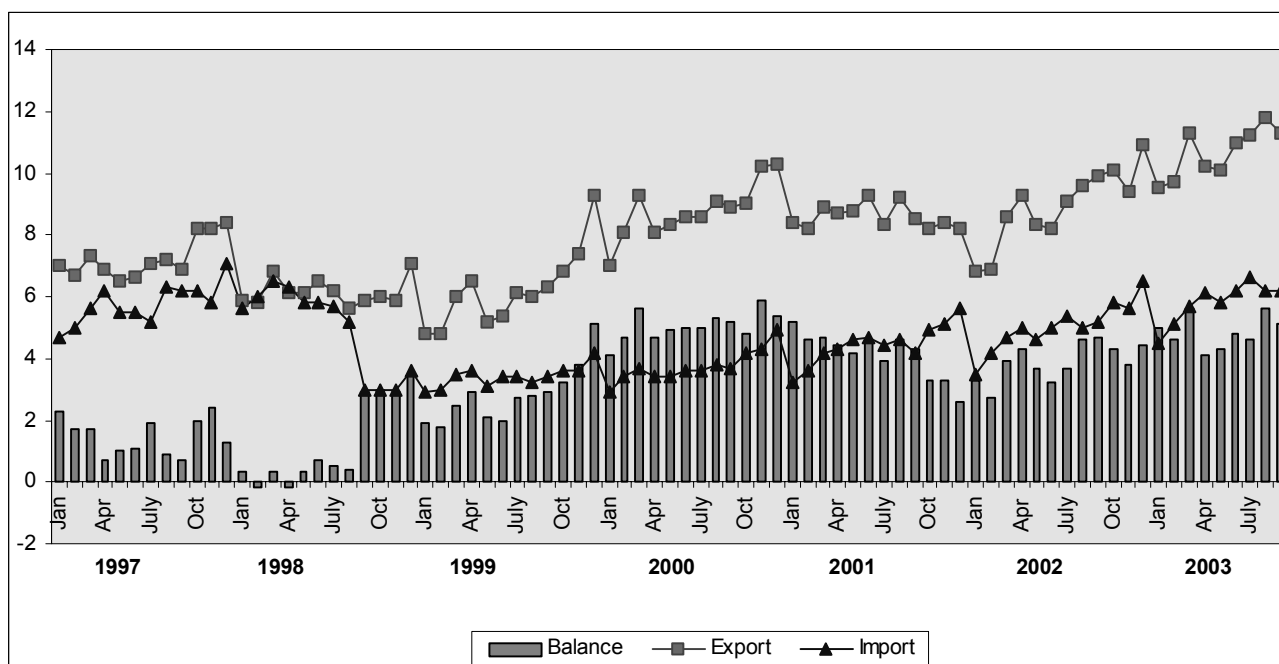
### Characteristics of industrial output across federal okrugs

Federal okrugs	IOI, January through September of 2003 in % of January through September of 2002	Share in the national industrial output (in %)	
		January through September of 2003	January through September of 2002
Central federal okrug	111,7	22,08	22,24
North West federal okrug	113,3	11,95	11,45
Southern federal okrug	104,0	6,37	6,52
Privolzhski federal okrug	105,4	22,40	22,99
Ural federal okrug	109,7	19,85	19,48
Siberian federal okrug	106,1	12,24	12,00
Far East federal okrug	103,2	5,11	5,32
<b>Russian Federation</b>	<b>106,8</b>	<b>100,00</b>	<b>100,00</b>

*O. Kuznetsova*

### Foreign Trade

In September of 2003, the Russia's foreign trade turnover grew by 17.9 per cent in comparison with the figures registered in the respective month of the preceding year and made US \$ 17.5 decreasing in comparison with August figures by 2.9 per cent (according to the balance of trade methodology). In September, the amount of exports made US \$ 11.3 billion (an increase by 15.2 per cent as compared with the figures registered in September of 2002). At the same time, imports exceeded the respective indicator of 2002 more considerably (by 20.7 per cent) reaching US \$ 6.2 billion. The active balance of trade increased in September making US \$ 5.1 billion as compared with US \$ 4.6 billion registered in the respective period of the preceding year.



Source: RF Goskomstat, Central Bank of Russia

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

The growth in exports was to a considerable extent determined by high world prices of staple raw materials exported from Russia, especially energy resources.

Over 9 months of 2003, high prices persisted on the world market most of the time. However, in September there was registered a certain drop in prices: the average Urals oil price made US \$ 25.7 per barrel (a 11 per cent fall in comparison with the August figures), while the Brent oil price was registered at US \$ 27.1 per barrel (by 9.4 per cent below the price of August). The major factor behind this September drop in prices was a growth in world production of hydrocarbons, for instance, because of increasing oil extraction in Iraq. Besides, an important downward factor was an increase in US commodity reserves.

In September and October of 2003, the prices of Russian oil made US \$ 26.95 per barrel, or US \$ 196.735 per metric ton. As a result of the decreasing prices, on December 1, 2003, the rates of export customs duty on crude oil will be decreased by 7.7 per cent in comparison with the rate in force since October 1 and will make US \$ 31.2 per metric ton. From October 1, 2003, to November 30 was US \$ 33.8 per metric ton. the duty on oil products was set at US \$ 30.4 per metric ton (from August 1 to September 30 it was at US \$ 25.1 per metric ton). The export duty on oil products shall be US \$ 30.4 per metric ton since October 1, 2003 (the preceding duty was at US \$ 22.6 per metric ton).

At the end of September, OPEC member countries took the decision to decrease oil extraction by 900 thous. barrels per day since November 1, 2003, what again caused a growth in oil prices. The further course taken by OPEC member countries with regard to decrease in oil extraction quotas and seasonal factors will affect the price situation on the oil market until the end of the year.

The prices of Russian natural gas remained high. For instance, over 9 months of the year the average contract price increased by 27.5 per cent in comparison with the figures registered in the respective period of the preceding year.

On the world market of ferrous metals the upward price trend prevailed over 9 months of the year. This September, the prices of rolled products, beams and bars, cold rolled steel, and reinforcing steel increased on the average by 45 per cent, 38 per cent, 4 per cent, and 5 per cent respectively. On the average, over 9 months of this year prices of ferrous metals grew in comparison with the figures registered in the respective period of 2002 by 20 to 35 per cent.

The recovery of the world economy facilitated a growth in prices on the market of non-ferrous metals. The nickel prices grew especially significantly. The average nickel, copper, and aluminum prices increased over

9 months of the year in comparison with the figures observed in the respective period of the preceding year by 31 per cent, 8 per cent, and 4.3 per cent respectively.

*Table 1*

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

	1996	1997	1998	1999	2000	2001	2002	2003
Oil (Brent), USD / barrel	22,9	18,12	13,1	22,6	32,15	26,18	28,26	27,1
Natural gas, USD /1 mil Btu	2,743	2,251	1,858	2,62	5,118	2,204	3,625	4,678
Gasoline, USD / gallon	0,648	0,579	0,421	0,683	0,941	0,757	0,797	0,832
Copper, USD / metric ton	1932,6	2032,7	1676,4	1876,8	2037,5	1452,9	1498,3	1816,4
Aluminum, USD / metric ton	1428,3	1544,6	1391,3	1493,6	1600,2	1342,6	1294,7	1415,0
Nickel, USD / metric ton	7426,4	6523,6	4229,8	6932	8654,3	5040,9	6592,5	9996,1

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

In January through September, the prices of staple Russian exports grew by 15.7 per cent as compared with the indicators observed in the respective period of 2002. However, the favorable price dynamics were not the only factor behind the record highs of Russia's exports, since volumes of export also constantly grew. The index of volume of export made 107.5 per cent in January through September of 2003.

The index of import volume made 121.2 per cent, while the price index decreased to 97.7 per cent. The key factors behind the increase in imports were primarily growing effective household and enterprises' demand, and the Ruble appreciation. In January through September, the real Ruble appreciation with regard to US \$ made 10.5 per cent, on the whole, the real effective Ruble appreciation made 3.8 per cent. At the same time, the effective Ruble exchange rate fell by 1 per cent (the real Ruble / US \$ exchange rate decreased by 0.8 per cent for the second month running, the real Ruble / Euro exchange rate depreciated by 1 per cent). On the whole, since the beginning of the year 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 1.4 per cent over the 9 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).

In September, Russia had the active balance of trade vis-à-vis CIS countries at US \$ 0.5 billion. For the first time since the beginning of the year, in September the increase in import of goods from CIS countries to Russia exceeded the growth in exports and made 30.0 per cent (the increase in exports made 22.6 per cent) as compared with the figures registered in September of 2002. At the same time, it shall be noted that while amount of exports grew primarily because of increasing prices, imports grew in volume. The amount of exports made US \$ 1.84 billion, while imports were at US \$ 1.34 billion.

In November, there took place a meeting between representatives of the RF State Customs Committee and the Kazakh Agency for customs control. The participants discussed the major guidelines of unification of customs procedures and control, and the problems of mutual customs payments with regard to the further development of the EvrAzES (its member countries include Belorussia, Kazakhstan, Kirgyzia, Tadzhikistan, and Russia) customs legislation.

In November the problem of limitation of import of pipes from Ukraine had to be discussed again. The aggregate quota for 2003 applicable to Ukraine producers was set at 620 thous. metric tons of pipes, including the large diameter pipes quota amounting to 135 thous. metric tons. However, Ukraine took up these quotas and obtained the permission to import 120 thous. metric tons of pipes more.

Until now, the annual demand for pipes on the part of Russian companies grew by 7 to 8 per cent a year. This development is related primarily to the activities of oil companies and Gazprom interested to increase exports and, therefore, develop respective transportation systems. However, in 2002 and 2003 Russian producers missed orders amounting to 710 thous. metric tons because of the dumping on the part of Ukraine.

The only plant in the CIS countries designed to manufacture large diameter pipes for main pipelines located in the territory of the former Soviet Union was the Khartsyzsk pipe plant situated in the Donetsk oblast. Besides, the government of Ukraine in fact subsidizes national pipe producers by writing off penalties and fines and granting tax breaks.

Taking into account all these factors, a new agreement with Ukraine should be made as concerns the regulation of pipe exports in the framework of the common economic space, which would fix the amounts of respective Ukrainian exports to Russia. Besides, it would be feasible to have the possibility, in the case supplies of certain pipes increase, to reduce supplies of other types of pipes thus maintaining the total

Ukrainian quota unchanged. The situation may improve for Russian producers in the case they start to manufacture large diameter pipes for Gazprom.

In November of 2003, the State Duma passed in three readings at once the amendment to the law "On customs tariff," which abolished the limitation set on the Government as concerns the rates of customs duties. Eighteen months ago, the Duma approved amendments to the law "On customs tariff" stipulating that since January 1, 2003, the maximum rate of export customs duties should be at or below 90 per cent of the rate of the customs duty on crude oil. Since that time, the Government has many times attempted to restore the previous mechanism of customs duties regulation, primarily with regard to oil products, but failed. The Government had no instrument to prevent export of diesel fuel, even at the time of sowing and harvest campaigns. At the same time, domestic prices of diesel fuel grew by 16.4 per cent, while the increase in gasoline prices made 12.7 per cent. At last, the Government was able to restore its right to set customs duties on oil products, what shall result in more flexible regulation of export of products in this commodity group.

On December 11, 2003, there were introduced new duties on import of cars manufactured 7 and more years ago. The rate of the import duty on cars manufactured seven and more years ago were set at 2 Euro per 1 cubic cm of motor capacity. It shall be reminded that on August 30, 2003, there were enacted rates varying from Euro 1.4 to Euro 3.2 depending on motor capacity. Import duties on newer cars with motor capacity from 1800 to 2300 cubic cm. remained without change and makes 25 per cent of their customs values, but not less than Euro 1.8 per 1 cubic cm.

The last change in the regulations governing clearance procedures was effected in the middle of summer of 2003. While before July 25, 2003, there were two rates of the duty (for cars with less and more powerful motors), since the end of July the Government grouped duties in 6 categories depending on motor capacity. As a result, the respective payments relating to cars with average motor power manufactured 3 to 7 years ago increased almost twofold.

The changes in rates of customs duties on cars imported to Russia were introduced in the framework of the concept of development of the domestic motor vehicle industry. According to the concept, in 2005 import duties on cars manufactured more than 7 years ago will make up to 35 per cent of their customs value. These measures should assist Russian producers to improve their competitiveness and attract foreign motor manufacturers.

It is expected that since 2010 duties on cars imported to Russia will yearly decrease by 5 per cent. Now two foreign car producers already operate in Russia: Ford Motor Co., which built a plant in the Leningrad oblast and organized there production of Ford Focus cars, and the joint venture "GM-AvtoVAZ" located in Tolyatti, which manufactures Chevrolet Niva cars.

*N. Volovik N. Leonova*

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## **Forecasting base macroeconomic indicators for year 2004**

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Below are presented the estimations of base macroeconomic indicators: GDP, tax revenues, CPI, export, import, nominal exchange rate, gold and foreign exchange reserves, real exchange rate. The forecast is based on the system of structural econometric equations. For each of the indicators listed above, there was specified and evaluated an equation, including variables and respective lags, which have a significant and answering economic logic impact on the explained variable. Respective dummy variables permitting to take into account the quarterly seasonality of the used variables and structural shifts in their dynamics were also added to the equations, there were also used moving average terms permitting to eliminate the autocorrelation of residuals. 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.

The calculation of forecasted values of the macro-indicators was carried out proceeding from the set scenarios of the Brent oil prices, investment in fixed assets, and money aggregate M2. On the whole, the obtained forecasts presuppose that the major trends of economic development will persist in the whole forecast interval.

### **Scenario 1:**

In 2004, the average Brent oil price is between US \$ 24 to 25 per barrel, what is approximately by US \$ 4 below the respective average price registered in 2003. By the end of 2003, the growth in money aggregate M2 makes 30 per cent in comparison with the respective level registered at the end of 2002, the average

increase in the money aggregate M2 over 2004 is below 20 per cent. The annual rates of increase in investment in fixed assets by the end of 2003 make 9.3 per cent, in 2004 – about 8 per cent.

### Scenario 2:

The average Brent oil price is at US \$ 28 per barrel in the whole prediction interval, what approximately corresponds to the respective indicator registered in 2003. By the end of 2003, the growth in money aggregate M2 makes 35 per cent (30 per cent in 2004). The annual rates of increase in investment in fixed assets by the end of 2003 make 9.3 per cent, in 2004 – about 8 per cent.

	Scenario 1			Scenario 2		
	Oil price	M2	Investment	Oil price	M2	Investment
I quart. 2003	31.4	2208500	10.2%	31.4	2208500	10.2%
II quart. 2003	26.1	2604500	13.1%	26.1	2604500	13.1%
III quart. 2003	28.4	2732100	12.1%	28.4	2732100	12.1%
IV quart. 2003	28.0	2755480	9.3%	28.0	2861460	9.3%
I quart. 2004	26.0	2893254	8.0%	28.0	3076070	8.0%
II quart. 2004	25.0	3031028	8.0%	28.0	3290679	8.0%
III quart. 2004	24.0	3168802	8.0%	28.0	3505289	8.0%
IV quart. 2004	23.0	3306576	8.0%	28.0	3719898	8.0%

### Gross Domestic Product.

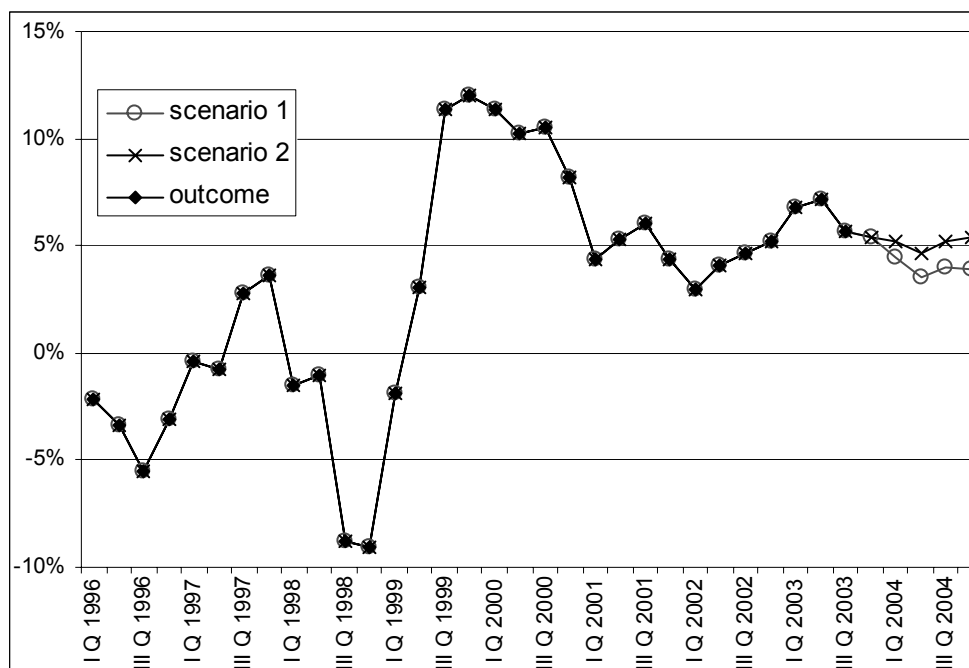


Figure 1. Real growth rate of GDP.

Table 1.

### Scenario based forecast: real quarterly rates of growth in GDP.

	Scenario 1	Scenario 2
I quart. 2003	6.8%	6.8%
II quart. 2003	7.2%	7.2%
III quart. 2003	5.7%	5.7%
IV quart. 2003	5.4%	5.4%
I quart. 2004	4.5%	5.2%
II quart. 2004	3.6%	4.7%
III quart. 2004	4.0%	5.2%
IV quart. 2004	3.9%	5.4%

The forecasted values were calculated for the interval from the 4<sup>th</sup> quarter of 2003 till 4<sup>th</sup> quarter of 2004. As Table demonstrates, in the case the Brent oil price remains at the level of US \$ 28 per barrel in 2004, the average growth rates in the forecast interval make about 5.1 per cent. At the same time, according to Scenario 1, in the case oil prices gradually decline to US \$ 21 per barrel by the end of 2004, average rates of growth in GDP will be below 4 per cent in 2004.

**Index of Industrial Production.**

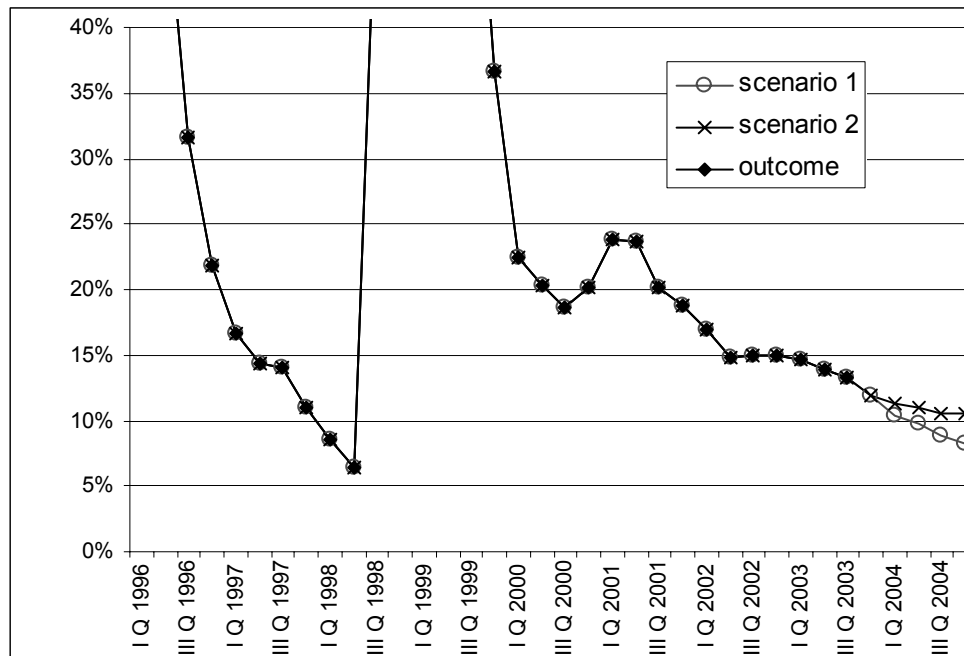


Figure 2. Growth rate of CPI.

Table 2.

**Scenario based forecast of consumer price index.**

	<b>Scenario 1</b>	<b>Scenario 2</b>
I quart. 2003	14.7%	14.7%
II quart. 2003	13.9%	13.9%
III quart. 2003	13.2%	13.2%
IV quart. 2003	11.9%	11.9%
I quart. 2004	10.4%	11.2%
II quart. 2004	9.7%	11.0%
III quart. 2004	8.8%	10.6%
IV quart. 2004	8.3%	10.5%

The forecasted values were calculated for the interval from the 4<sup>th</sup> quarter of 2003 till 4<sup>th</sup> quarter of 2004. The major factor explaining the difference between scenario based forecasts of CPI are the dynamics of the money aggregate M2. Therefore, as the rates of growth in M2 from 20 per cent to 40 per cent, the rates of inflation in 2004 increase from 8.3 per cent to 10.5 per cent, respectively.



## Tax revenues of the RF consolidated budget

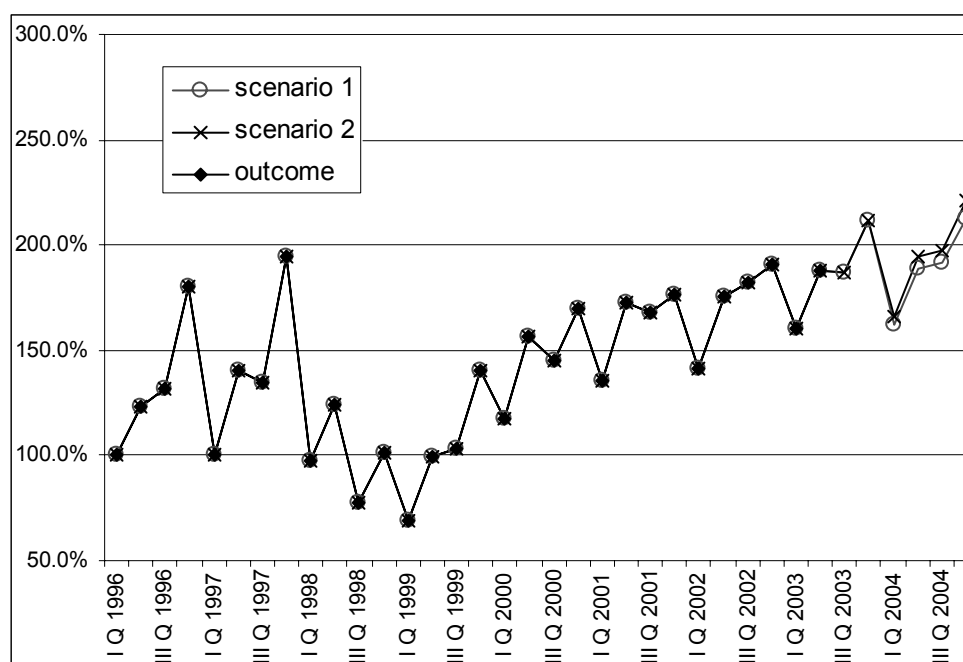


Figure 3. Consolidated budget tax revenue (in % to I quarter 1996).

Table 3.

### Tax revenues of the RF consolidated budget (in % of GDP, running total since the beginning of the year).

	Scenario 1	Scenario 2
I quart. 2003	24.6%	24.6%
II quart. 2003	26.2%	26.2%
III quart. 2003	25.1%	25.1%
IV quart. 2003	25.7%	25.7%
I quart. 2004	24.5%	24.7%
II quart. 2004	25.8%	26.0%
III quart. 2004	24.9%	25.1%
IV quart. 2004	25.5%	25.8%

The forecasted values were calculated for the interval from the 4<sup>th</sup> quarter of 2003 till 4<sup>th</sup> quarter of 2004. According to Scenario 2, the share of taxes in GDP, on the average, exceeds the similar predictions made according to Scenario 1 by 0,2 to 0.3 per p. p. of GDP. On the whole, it may be explained by the contraction of the tax base occurring at the background of low oil prices, as well as by the reduction of the maximum taxation rate (the tax on extraction of mineral wealth (TEMW) and export duties, which make about 30 per cent of the total amount of tax revenues).

Similarly to tax revenues of the RF consolidated budget there was obtained the forecast of revenues of the RF federal budget: according to Scenario 1 the revenues of the federal budget make about Rub. 2 800 billion (18.8 per cent of GDP) in 2004, in the case the current oil prices remain unchanged, revenues increase to Rub. 2940 billion (19.1 per cent of GDP). Taking into account the expenditures targeted in the draft federal budget for 2004 (amounting to Rub. 2659.4 billion), according to our estimates, in 2004 the surplus of the federal budget shall be at Rub. 140 billion in the case of Scenario 1 and Rub. 280 billion in the case Scenario 2 is realized. At the same time, the federal law on the federal budget for 2004 sets the surplus at Rub. 83 billion.

## Gold and foreign exchange reserves.

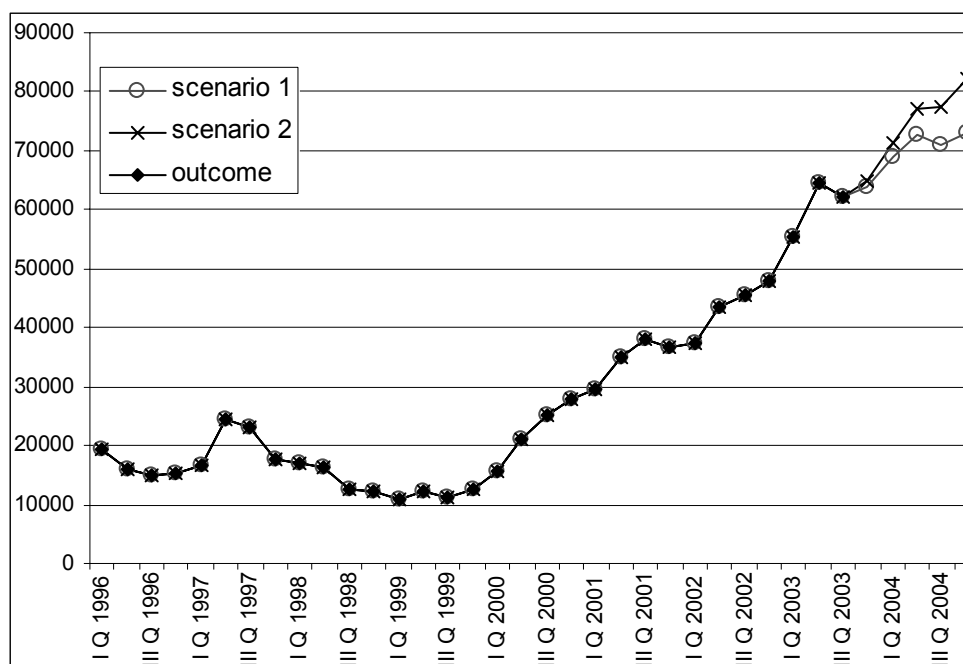


Figure 4. Foreign reserves (bill. \$).

Table 4.

### Scenario based forecast of gold and foreign exchange reserves (US \$ billion).

	Scenario 1	Scenario 2
I quart. 2003	55525	55525
II quart. 2003	64430	64430
III quart. 2003	62073	62073
IV quart. 2003	63945	64993
I quart. 2004	68813	71321
II quart. 2004	72635	76952
III quart. 2004	71053	77531
IV quart. 2004	73073	82062

The forecasted values were calculated for the interval from the 4<sup>th</sup> quarter of 2003 till 4<sup>th</sup> quarter of 2004. According to Scenario 1, the growth in gold and foreign exchange reserves will make about US \$ 9.1 billion by the end of 2004 as compared with the amount of reserves registered at the end of the 3<sup>rd</sup> quarter of 2003. According to Scenario 2, the respective value shall make about US \$ 17.1 billion. This difference is directly explained by the difference in the dynamics of oil prices, which, in turn, affect the inflow of foreign currency resulting from export of oil determining alongside with dynamics of exchange rate the amount of the balance of trade.

## Nominal exchange rate.

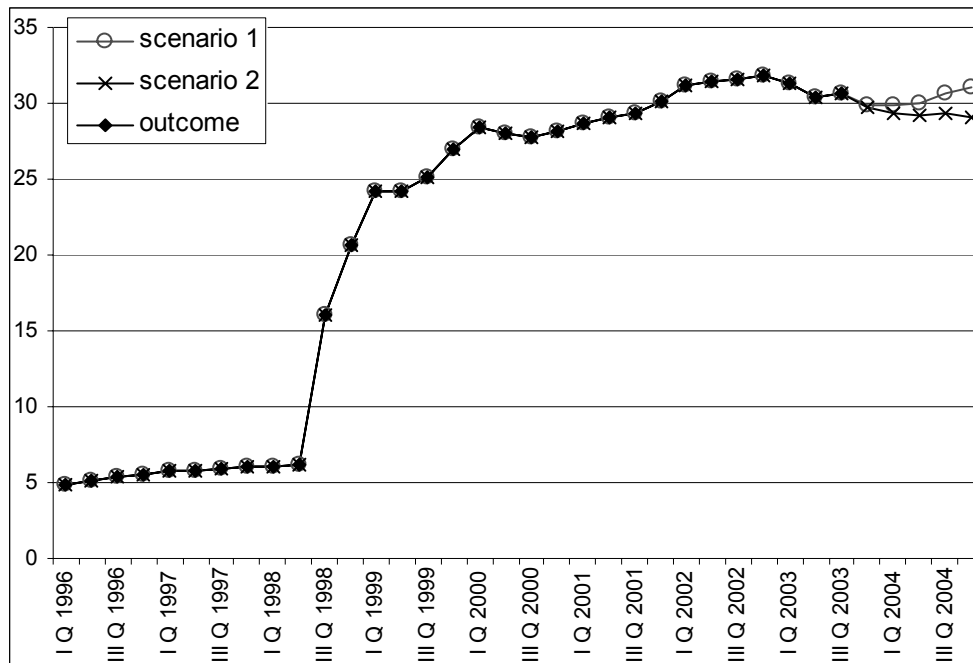


Figure 5. Nominal exchange rate (rub. to \$).

Table 5.

### Nominal exchange rate (Rub. to \$).

	Scenario 1	Scenario 2
I quart. 2003	31.4	31.4
II quart. 2003	30.3	30.3
III quart. 2003	30.6	30.6
IV quart. 2003	29.9	29.7
I quart. 2004	29.8	29.4
II quart. 2004	30.0	29.2
III quart. 2004	30.7	29.3
IV quart. 2004	31.0	29.0

The forecasted values were calculated for the interval from the 4<sup>th</sup> quarter of 2003 till 4<sup>th</sup> quarter of 2004. According to Scenario 1, the nominal exchange rate will make about Rub. 31.0 per US \$ by the end of 2004, at the same time, according to Scenario 2, the nominal exchange rate will decline to the level of Rub. 29.0 per US \$ by the end of 2004 in the case the given rates of monetization of the balance of trade persist.

## Real effective exchange rate.

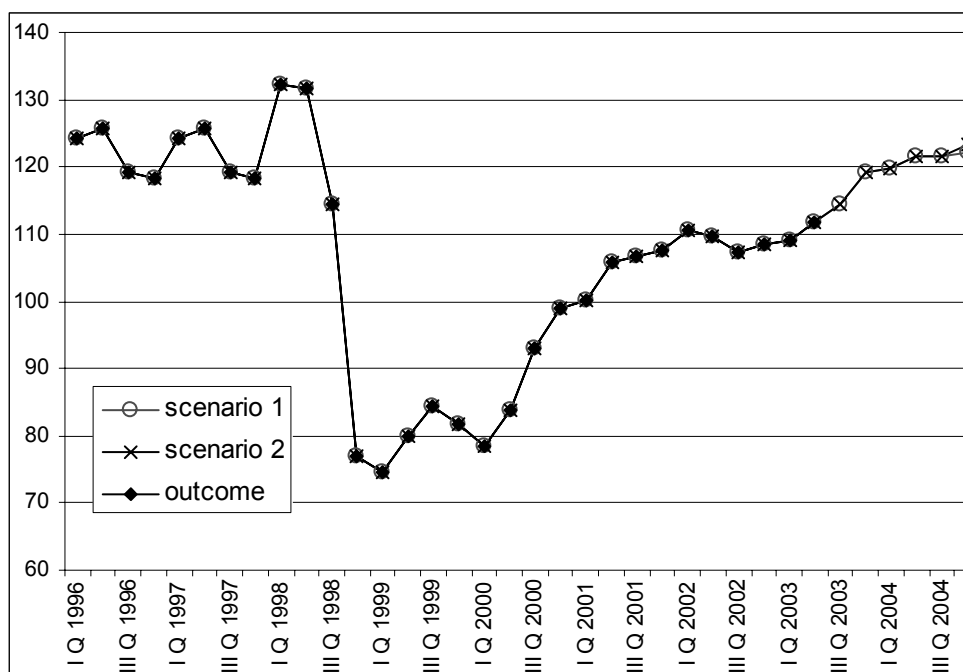


Figure 6. Real effective exchange rate.

Table 6.

**Scenario based forecasts of real effective exchange rate (the ratio between the growth rates and the figures registered in the respective quarter of the preceding year).**

	Scenario 1	Scenario 2
I quart. 2003	-1.3%	-1.3%
II quart. 2003	2.0%	2.0%
III quart. 2003	6.5%	6.5%
IV quart. 2003	9.9%	9.9%
I quart. 2004	9.9%	9.9%
II quart. 2004	8.8%	8.8%
III quart. 2004	6.3%	6.3%
IV quart. 2004	2.5%	3.6%

The forecasted values were calculated for the interval from the 4<sup>th</sup> quarter of 2003 till 4<sup>th</sup> quarter of 2004. According to Scenario 1, the rate of growth (appreciation) of the real exchange rate in the 4<sup>th</sup> quarter of 2004 as compared with the respective values registered at the end of the 4<sup>th</sup> quarter of 2003 makes 2.5 per cent. At the same time, according to Scenario 2, i.e. in the case high oil prices persist, the respective value will make 3.6 per cent. Therefore, according to the both scenarios the trend towards appreciation of Ruble exchange rate in real terms will persist in 2004.

## Export.

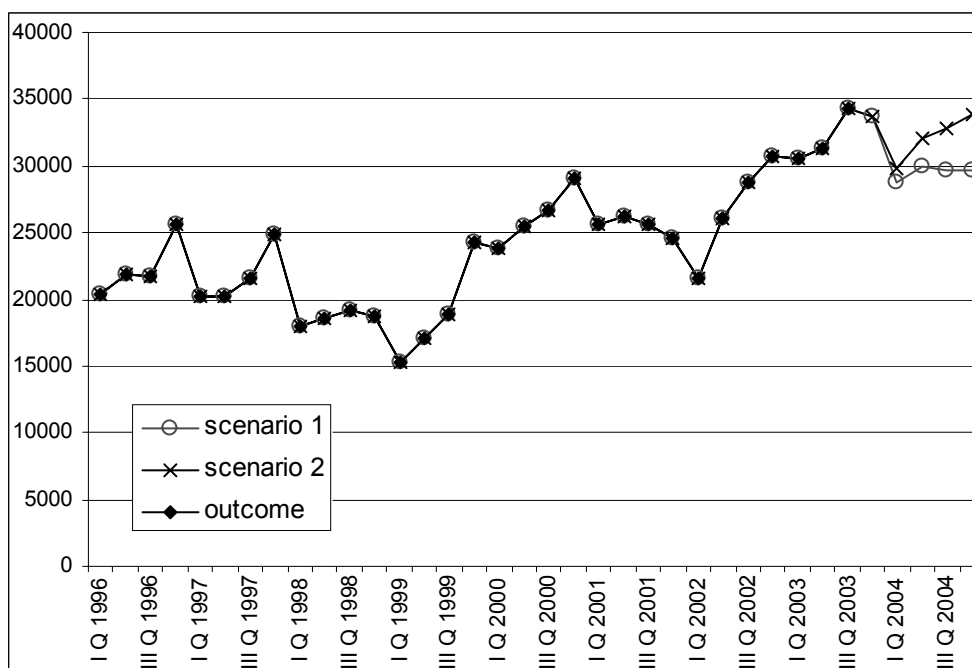


Figure 7. Export (bill. \$).

Table 7.

### Export (US \$ billion, running total since the beginning of the year).

	Scenario 1	Scenario 2
I quart. 2003	30618	30618
II quart. 2003	61953	61953
III quart. 2003	96227	96227
IV quart. 2003	129879	129879
I quart. 2004	28761	29844
II quart. 2004	58741	61936
III quart. 2004	88405	94720
IV quart. 2004	118072	128505

The forecasted values were calculated for the interval from the 4<sup>th</sup> quarter of 2003 till 4<sup>th</sup> quarter of 2004. As Table demonstrates, in the case the Brent oil price remains at the level of US \$ 28 per barrel (Scenario 2), in 2004 the amount of exports will decrease by about US \$ 1.4 billion as compared with the figures registered in 2003. At the same time, in the case the average Brent oil price is between US \$ 24 to 25 per barrel in 2004 (Scenario 1), the amount of exports will decline by US \$ 11.8 billion as compared with the figures observed in 2003. This decline in the amount of exports may be primarily explained by the persisting trend towards Ruble appreciation and the positive growth in GDP.

## Import.

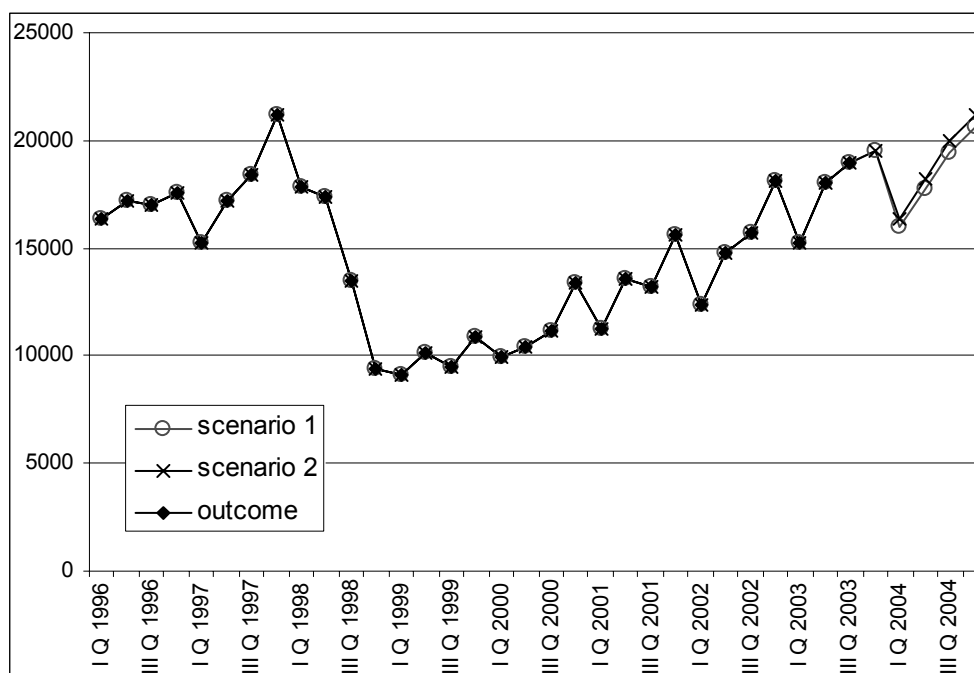


Figure 8. Import (bill. \$).

Table 8.

### Import (US \$ billion, running total since the beginning of the year).

	Scenario 1	Scenario 2
I quart. 2003	15276	15276
II quart. 2003	33285	33285
III quart. 2003	52286	52286
IV quart. 2003	71822	71822
I quart. 2004	16000	16319
II quart. 2004	33748	34559
III quart. 2004	53216	54524
IV quart. 2004	73845	75745

The forecasted values were calculated for the interval from the 4<sup>th</sup> quarter of 2003 till 4<sup>th</sup> quarter of 2004. According to Scenario 1, the growth in the amount of imports will make about US \$ 2 billion as compared with the figures registered in 2003, the respective growth in accordance with Scenario 2 will make about US \$ 4 billion. The persisting trend towards Ruble appreciation results in an increase in imports in both cases under observation.

### Comparison with the forecast presented by the RF Ministry for economic development.

One of the scenarios of development of the Russia's economy presented by the RF Ministry for economic development presupposes the persistence of the existing trends in economic development and average Urals oil prices at US \$ 22 to 23 per barrel. Proceeding from these assumptions, the rates of growth in investment in fixed assets (according to the forecast of the RF Ministry for economic development) shall make 9.3 per cent in 2003 and 8 per cent in 2004. Taking into account the fact that the rates of growth in the money aggregate M2 planned by the RF Central Bank shall be below 40 per cent in 2003 and below 20 per cent in 2004 respectively, this forecast of the RF Ministry for economic development on the whole corresponds to Scenario 1, which is presented in this paper.

Table 9.

**Comparison of the obtained forecasts with the forecast presented  
by the RF Ministry for economic development.**

	RF Ministry for economic development		IET		
	Estimate for 2003	Forecast for 2004	Estimate for 2003	Forecast for 2004	Forecast for 2004
CPI (annual growth rates in %)	10-12.	8-10.	11.9	8.3	10.5
GDP (annual growth rates in %)	5.9	5.2	6.3	4.0	5.1
Export (US \$ billion)	124.9	125	129.9	118.1	128.5
Import (US \$ billion)	71	78.4	71.8	73.8	75.7
Reserves (increase in US \$ billion)		7-15.	8.4-9.5	9.1	17.1
Real exchange rate (annual growth rates in %)		4-5.		2.5	3.6

As it is demonstrated by *Table 9*, the evaluation of annual inflation rates in 2003 (11.9 per cent) and the forecast for 2004 (8.3 per cent) are in the band planned by the RF Ministry for economic development. The predicted increase in gold and foreign exchange reserves in 2003 shall make about US \$ 9 billion, what also corresponds to the figures of the RF Ministry for economic development estimations (from US \$ 7 billion to US \$ 15 billion). At the same time, in comparison with the estimations of the RF Ministry for economic development the rates of growth in GDP according to the IET forecasts are by 0.4 per cent higher in 2003 and by 1.2 per cent lower in 2004. According to the obtained results, the amounts of export and import will make about US \$ 118 billion and US \$ 73.8 billion in 2004, what is by US \$ 7 billion and US \$ 4.6 billion respectively below the figures presented by the RF Ministry for economic development. The forecasted according to Scenario 1 rates of real Ruble exchange rate appreciation are on the average lower by 2 per cent, at the same time, even according to the most optimistic scenario (Scenario 2) the rates of Ruble appreciation are by 1 per cent below the figures predicted by the RF Ministry for economic development. It is apparent that the forecast of base macroeconomic indicators based on the system of structural econometric equations and corresponding to the scenario presented by the RF Ministry for economic development on the whole matches the estimates of the RF Ministry for economic development.

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