

# MNB Economic Overview

## Diminishing growth expectations for 2005...

A series of developments over the past month have appear to have raised investor concerns regarding risk appetite towards Russia, namely back tax claims against Sibneft and Vimplecom. In response both equity and debt markets initially suffered, although the latter has since recovered with ongoing technical support stemming from its dual investment grade status and recently traded to reach new historic highs. Still, the latest move to impose a back tax claim from 2001 against Vimpelcom has once again raised concerns regarding the threat of systemic risk and also cast doubt on the understanding that the Yukos affair was an isolated incident. While we continue to view this form of 'event' risk as remote, as recently proved by the reports that Vimplecom's tax claim remains based on an accountancy discrepancy as opposed to a politically motivated move, it is clear that such issues will continue to constrain the country's investment profile over the near term. Moreover, with the latest batch of MNB survey and official data highlighting a further slowdown in key macroeconomic indicators, the implications of any deterioration in investor confidence are far reaching. That said, against a background of diminishing productive returns from Russia's excess oil dividends, a sustained decline in real investment will continue to hamper the country's economic growth prospects and a real GDP growth rate of around 5.8% is expected for 2005 (average Urals crude oil price of US\$30 pb assumed). A level that falls below Russia's potential growth rate and substantially short of the 7-8% annual growth required to achieve President Putin's target of doubling Russia's GDP in 10 years.

At the same time, and notwithstanding the progress achieved on the fiscal front, there is a common understanding that during 2004 Russia's wider reform agenda stalled somewhat. In view of these considerations, the call to actively advance the country's reform agenda will remain key to avoiding this growth mismatch.

## The Economy

According to latest MNB survey data the underlying rate of expansion across the Russian economy continued to ease during November with the monthly GDP indicator (derived from both the PMI surveys of business conditions in the manufacturing and service sectors) declining to 53.6 from 54.8 in October. Over the same period, the level of suggested monthly y-o-y growth fell to 4.5% from 5.0%, registering the fifth consecutive monthly decline to its lowest level since January 2003. While at 4.5% the level of suggested growth has moved further below trend, the outcome primarily reflects the magnitude of deterioration in the headline components, that is the notable contraction in the manufacturing PMI, and the ongoing easing in global tradable goods sectors. Nevertheless, for the year as a whole we still view the latest set of data as being consistent with our year-end expectations of GDP reaching 6.7%.

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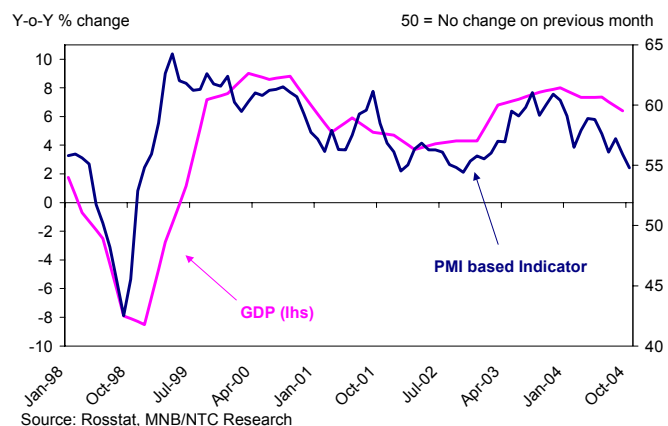
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## MNB Monthly GDP Indicator and Official Russian GDP

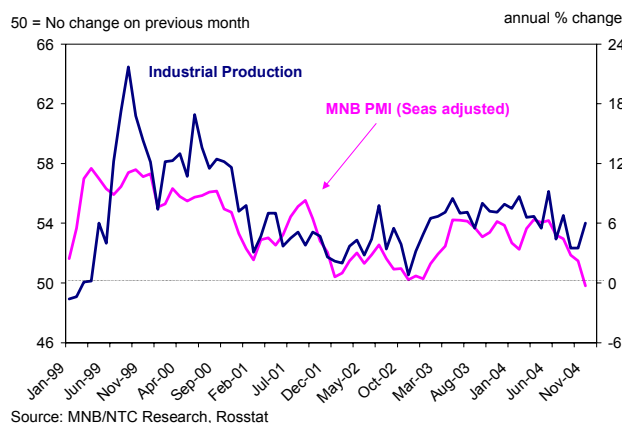


At the same time, the apparent slowdown witnessed across Russia during the second half of 2004 has led to the Ministry of Economic Development and Trade (MEDT) to further revise downwards the official GDP growth forecast from 6.9% to 6.8% for the year as a whole.

### Industrial Output

Preliminary reports indicate a modest improvement in Russia's industrial growth performance during November, with industrial production rising 6.0% y-o-y and exceeding consensus expectations of a 4.2% rise. Still, on a working-day-adjusted basis the level of output growth declined to 2.7% y-o-y, its lowest level in almost two years, from 6.6% in the previous month. With only headline information reports the component data is currently unavailable. Nevertheless, the headline data continue to reveal a slowing trend in second half of this year and with YTD growth amounting to 6.2% it confirms the underperformance of Russian industrial output in 2004 in comparison to last year's 6.9% outcome.

### MNB Purchasing Managers' Index and Industrial



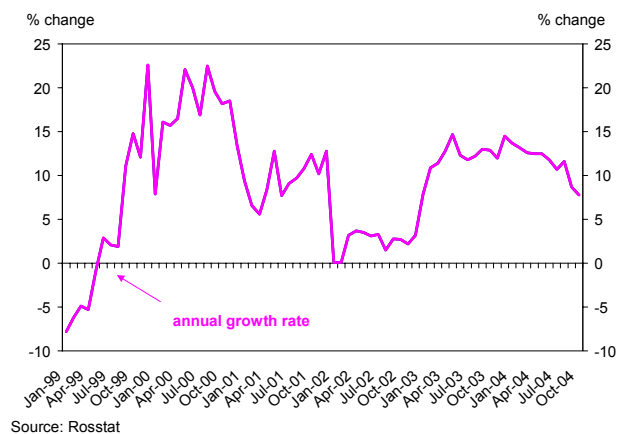
The prospects for 2005 appear less sanguine and according to latest MNB manufacturing PMI survey data the signs are far from encouraging with the headline index declining for the fifth consecutive month, down from 51.5 in October to 49.8 in November. At this level, the index signals a contraction in activity and represents the first time since 1998 that the headline PMI index has fallen below the key 50 no-change mark. With the decline influenced by weaker domestic and overseas orders and falling employment, the survey data merely reaffirms the transitory phase that is occurring across Russia's manufacturing base. Although the underlying trend remains consistent with the easing in official industrial growth and investment data, this month's survey continues to highlight widespread reports of ongoing difficulties in gaining access to working capital. With this issue remaining a common feature in the panel response over the past few years it serves to highlight the urgent need to push forward with banking sector reform and establish a functioning system of credit intermediation. In the absence of increasing the availability of credit to Russia's vast number of SMEs the process of diversifying the economic base will be further delayed and thus serve

to enhance the skewed distribution of income that is already a salient feature of Russia's economic base.

### Investment

Russia's investment profile continues to exhibit a downward trend, with annual rates of growth falling to 7.8% in October compared to 11.6% in August and nearly 14% at the beginning of the year. Indeed, on a volume basis the level of investment fell in comparison to the previous month and with a YTD growth rate of 11.5%, total investment growth is expected to fall from last year's 12.2% outcome. The outlook for 2005 is likely to be influenced by the uncertainty regarding back tax claims for the larger corporates over the near term and also the ongoing lack of access to working capital for the SMEs. With regards to the latter, the over dependency on profit retention to finance expansion plans and capital formation acts as the major constraint on overall investment levels and a return to single digit growth is firmly entrenched for 2005.

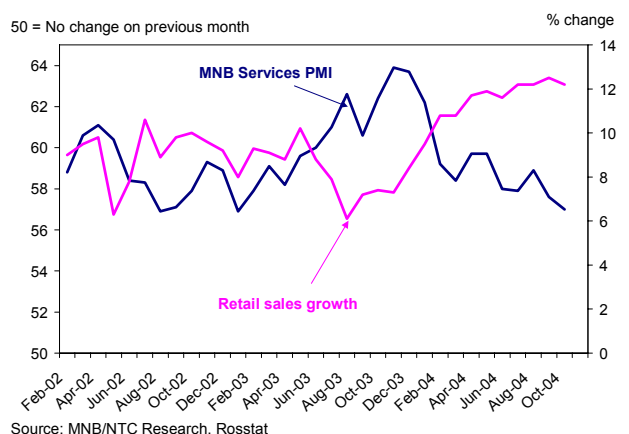
### Investment Growth in Russia



### Services and Retail Sales

With consumer spending remaining a primary growth driver, the Russian services sector continues to prosper, as is evident in latest MNB survey data and retail sales growth. Indeed, Russian service providers continue to benefit from robust incoming orders and robust confidence levels as the MNB services PMI headline index reached 56.9 in November compared to 57.0 in October.

### Russian Services Sector

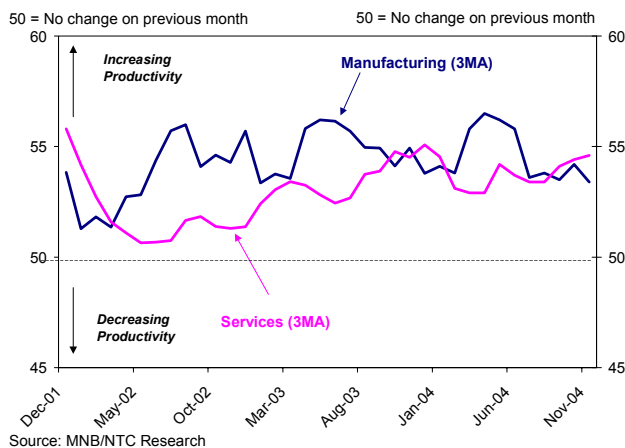


At the same time, retail sales growth continues at pace with latest official data indicating a 12.2% y-o-y increase in October, down from 12.5% y-o-y growth in the previous month. On a YTD basis the level of retail sales growth amounts to 11.5% and surpasses by a wide margin the 8.2% growth attained in 2003. Despite the loss in purchasing power from those employees paid in US dollars, the Russian consumer remains underleveraged and with both real disposable income rising and substantial consumer credit expansion taking hold, we anticipate a slight moderation in growth levels during 2005. Moreover, the MNB business expectations index, an indication of the degree of optimism regarding future prospects in Russia's service sector, reached its highest level in almost three years in November.

**Productivity and Employment**

Latest MNB survey data continue to post a divergent trend in employment conditions across the manufacturing and services sectors. The latter continues to exhibit signs of job creation, albeit at a slower pace, while the manufacturing employment index has registered a contraction for three consecutive months, citing weaker production growth and efforts to reduce costs as the principal factors. The overall trend was evident in latest official data, which shows the unemployment rate rising to 7.5% in October compared to 7.4% in September. With firms in the manufacturing sector reporting the utilisation of spare capacity to successfully deal with work backlogs the easing in manufacturing productivity offset the gains across the service sector and the overall 3-month MA productivity measure fell from 54.0 in November from 54.3 in the previous month. The productivity measures are derived from respective labour and output indices from the PMI surveys and have remained above the key 50 no-change mark throughout survey history. Sustainability of such levels of productivity will remain key over 2005 and the longer-term, particularly given the increasing need to deal concurrently with an appreciating Rouble exchange rate and diminishing capital stock.

**Russian Productivity**

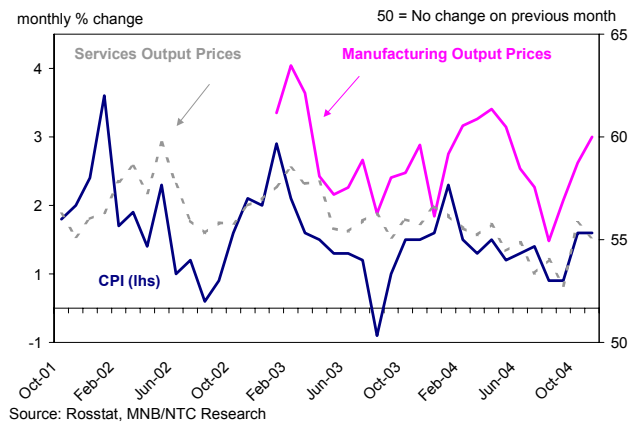


**Inflation**

While latest official inflation data reaffirm that the official year-end target was exceeded, the uncertainty remains as to the magnitude of the margin. Indeed,

with CPI rising 1.1% m-o-m in November the cumulative YTD level amounts to 10.5% and given the seasonal price pressures associated with end-year fiscal spending, we expect CPI to reach 11.6% at best for the year as a whole. The impetus for the recent strength in consumer prices stems from the volatile food component, up 1.5% m-o-m compared to 0.7% for non-food and 0.8% for service sector prices. While official concerns regarding the failure to meet the 10% year-end target have resulted in the authorities' attempts to engineer a modest appreciation of the rouble exchange rate, short-term factors suggest that such price pressures are likely to persist into 2005. That is, fiscal policy is anticipated to loosen somewhat both towards year-end and as prescribed in the 2005 budget and net private capital inflows are also expected to resume during Q4 and into next year. From this perspective and in the absence of extensive sterilisation tools, next year's upper inflation target of 8.5% will prove once again challenging. While not underestimating the importance of monetary policy credibility in attaining such targets, in our view it remains paramount that the inflation target serves as a credible anchor in containing inflationary expectations. Achievement of the latter under current circumstances will prove equally beneficial for domestic policy.

**Russian Price Levels**

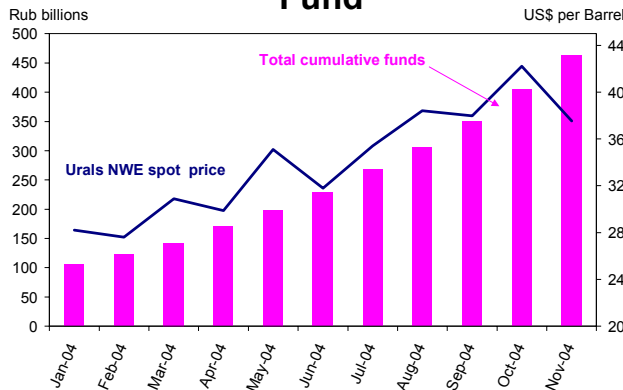


**Fiscal**

Preliminary data show continuing improvements in Russia's underlying fiscal position with the budget surplus over the January to November period amounting to Rub540.1 billion (US\$19.2 billion), equivalent to around 3.6% of GDP. Over the same period, the primary surplus reached Rub730.3 billion (US\$25.9 billion), equivalent to around 4.9% of GDP. As a result of these favourable financial developments, the Oil Stabilisation Fund (OSF) continues to benefit from the additional revenues and over the past month total funds increased Rub58.2 billion to reach Rub462.6 billion (US\$16.4 billion), as at the beginning of December. This move occurred despite the 11% decline in average monthly Urals crude oil prices and compares favourably to the Rub106 billion level witnessed in January. With the OSF widely expected to surpass the key Rub500 billion level next month the focus has shifted as to how the authorities will utilise the excess proceeds. In

a positive move, it seems that the government is very close to reaching an agreement with the Paris Club regarding the pre-payment of external debt in 2005, with the preferred option being a cash based settlement as opposed to the issuance of new sovereign eurobonds. While the reduction in interest payments and principal obligations bode well for Russia's overall external financial position, the key challenge will remain on the domestic front and focus on maintaining greater fiscal discipline so as to avoid the build up in excessive inflationary pressures.

### Russia's Oil Stabilisation Fund

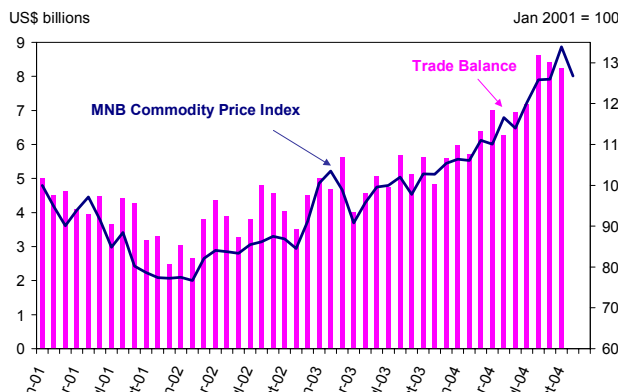


Source: Ministry of Finance, Bloomberg

### External Sector

Foreign trade data released by the CBR show a modest decline in Russia's monthly trade surplus, down from US\$8.41 billion in September to US\$8.25 billion in October. Despite exports reaching near record levels of around US\$16.7 billion the level of imports increased by over 5% m-o-m to reach the highest monthly amount yet, at around US\$8.4 billion. On a YTD basis the trade surplus amounts to US\$75 billion and is almost equal to the total surplus registered for 2003 as a whole.

### Russia's Trade Performance



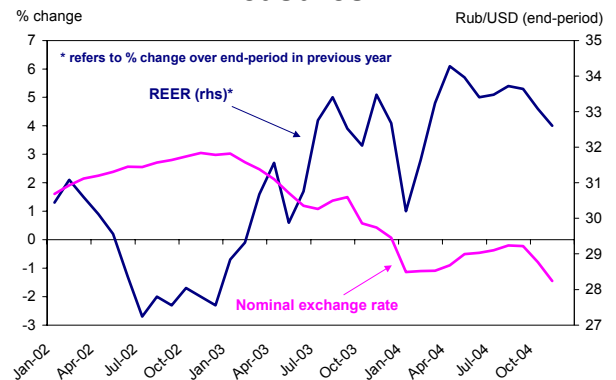
Source: MNB, CBR

Taking into consideration the continuing rise in Russia's import bill, the threat that most commodity driven sectors will incur capacity constraints in 2005 year and a lower trajectory for international oil prices we anticipate a moderation in Russia's trade surplus next year to around US\$62 billion.

### Monetary Policy and Exchange Rate

Latest CBR data show Russia's gross forex reserves increased US\$4.5 billion over the week ending 3 December to reach a new all-time high of US\$121.6 billion. A level that surpasses the CBR's upper target of US\$120 billion and elevates Russia's level of reserves to the fifth highest in the world. Moreover, the latest surge in holdings (US\$8.8 billion over past 4 weeks) contributes to a YTD accumulation of US\$44.5 billion and at current levels exceeds the total stock of Russia's external debt. While the accumulation in reserves has surpassed most optimistic expectations this year, both the reduction in mandatory conversion requirement on hard currency export proceeds (down from 25% to 10%) and a stronger exchange rate suggest that the pace of accumulation in forex holdings is expected to slow in 2005.

### Russian Exchange Rate Measures



Source: CBR

Despite the apparent ongoing interventionist activities undertaken by the authorities to stem the appreciation of the RUB, the need to contain inflationary pressures has resulted in the RUB appreciating to its highest level since late 1998, at 27.99 against the USD. Moreover, in view of the higher EUR/USD rate further upside pressures are expected and 27.5 remains the key target over the short-term. At the same time, the YTD appreciation in the REER reached 4.0% in October and is expected to fall safely within the government's upper target of 7%. An outcome that provides a consolatory boost to policy credibility for 2004.

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