

**COMMENTARY
RUSSIA IN CONTEXT**

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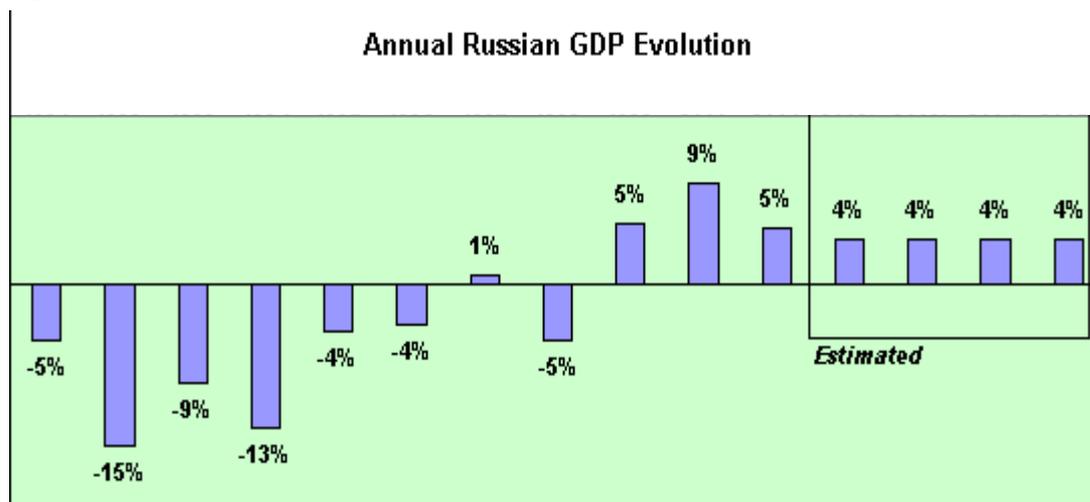
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Russian Market and Investment Opportunity

GDP Growth



Source: Economist Intelligence Unit, Goskomstat

During the past three years, Russian economic growth has been substantial, with GDP increases of 5.4, 9, and 5 percent in 1999, 2000, and 2001 respectively. This is largely attributable to the

remaining impact of import substitution after the 1998 devaluation, high world prices for Russia's export commodities, the first fruits of Putin's economic restructuring, sound fiscal and monetary policies and the recovery in private consumption and investment. The GDP is expected to grow by an average 3 to 4 percent (depending on world oil prices) in 2002-2005, spurred by increased investment and private consumption. The Russian GDP in 2001 was \$309 billion at the official exchange rate and \$1,235 billion at PPP.

Putin's team is committed to push for the restructuring of the economy. Russia is enjoying political and economic stability after the Yeltsin years of turmoil. The Duma is compliant and constructive. Capital investment and personal consumption are up. Barter is down. After 7 years of slow progress, movement towards WTO accession has accelerated. With huge foreign trade and current account surpluses, and with comfortable Central Bank reserves, the economy is less vulnerable to external shocks.

Credit ratings

By the end of May 2002, Russia's credit ratings had been substantially upgraded:

- Standard and Poor strengthened its outlook for Russian debt from "stable" to "positive".
- Moody's had already upgraded Russia to Ba3 in November.
- Fitch put Russia at BB- in May 2002.

Foreign Direct Investments (FDI)

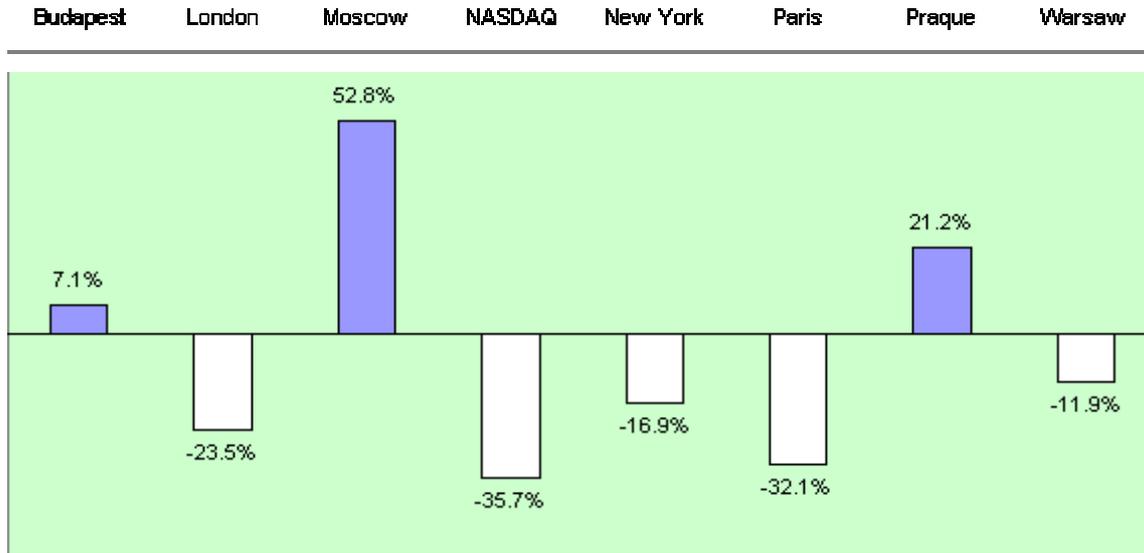
Foreign investments to Russia in the first half-year 2001 have made 6.7 billion dollars, having increased by almost 40 % in comparison with the first half of 2000. The volume of direct foreign investments in January - June 2001 has made \$2.5 billion, that is 40.5 % higher than the level of the appropriate period of 2000, the volume of portfolio investments has made \$238 million (increase in 4.7 times). Other investments have made \$3.94 billion, that 33.8 % higher than the level of the appropriate period of the last year. The total saved up volume of foreign investments to Russia has reached \$33.84 billion, of which direct investments make \$17.6 billion (compared with over \$350 billion in China during the same period), portfolio - about \$1 billion, others - \$15.3 billion. FDI in Russia in 2000 amounted to \$4.4 billion, out of a global total of \$1,270 billion, and declined to \$4 billion in 2001 and to \$830 million in 1Q/2002. We expect a rapid growth of FDI into Russia in the coming years despite the global slowdown.

Noticeable recent foreign investments in Russia include General Motors \$350m deal with Autovaz car maker, Heineken \$400m acquisition of Russian brewer Bravo, Anglo American's \$252m controlling stake acquisition in Russian paper company Syktyvkar Forest Enterprise, \$250m ADR listing at NYSE by Russian dairy and juice producer Wimm-Bill-Dann. These followed other signs of a renewal of Western interest in Russia: the return of Pizza Hut and Kentucky Fried Chicken to Moscow, the announcement of a Ford plant in Vsevolozhsk, the first steps towards a massive LNG plant on Sakhalin-Royal Dutch/Shell plans to invest about \$800 million there in 2002- and the first installment of Exxon Mobil's massive Sakhalin-1 project. In April 2002, BP raised its stake in Sidanko to 25 percent plus one share, despite an acrimonious battle with TNK over Sidanko's assets three years earlier. In May 2002, TotalFinaElf purchased a 52 percent stake in the Vankor oilfield in Eastern Siberia. And the information technology sector is expected to attract over \$2 billion in FDI in 2002.

Stock market

Russian stock market has given portfolio investors an exciting ride. The RTS index rose in one year by over 300 percent to 571 points on October 6, 1997, then plunged to 46 points by September 29, 1998. Whereas \$8.3 billion of 10 The Russian Economy in June 2002 portfolio investment flowed inward in 1998, \$900 million flowed outward in 1999. By January 3, 2001, the index had fallen to 130 points, then peaked at 227 on June 22, before dropping to the 170 range in August 2001, and rising to around 450 in April 2002 before dropping to 391 on June 3. The RTS Index is a stellar performer - the RTS index was up by nearly 80 percent in 2001 - and was posting a 52% annual gain at the end of July 2002.

Stock Market Movements - August 2001 to July 2002



Undervaluation of Russian Stocks

As an illustration of the undervaluation of some Russian equities, in August 2001 Gazprom had a market value of \$12.4 billion, compared with \$299 billion for Exxon Mobil Corp. (By May 2002, Gazprom's market capitalization had risen to \$26.8 billion). If Gazprom had been valued at the same level as Exxon per barrel of hydrocarbon reserves, it would have been valued at \$1.8 trillion, or 145 times its market price at that time. In another illustration, a megawatt of generating capacity at UES was worth \$52,000 (market capitalization, plus debt, minus cash on hand, divided by megawatts owned), while the comparable figure for Duke Energy was \$3 million. In February 2002, it was said that Russian oil companies were valued in the stock market at four times their 2001 earnings, while international majors were valued at 12 times. This substantial undervaluation suggests that portfolio investment into Russia may be a star performer in the coming months, despite the known risks, in an otherwise relatively subdued world equities market.

The Russian Economy - Highlights

- Federal budget revenues in 2001 were 1.6 trillion rubles (\$54.9 billion) and expenditures almost 1.4 trillion rubles (\$48 billion). The primary surplus was 4.9 percent, and the overall surplus was 2.4 percent, of GDP. Defense expenditures were set at 218.9 billion rubles, or \$7.3 billion at the official rate of exchange. The federal budget for 2002 sees revenues of 2,126 billion rubles and expenditures of 1,947 billion rubles, with defense expenditure (including military reform) at 300 billion rubles (\$9.5 billion, or 2.7 percent of GDP).
- The federal budget for 2001 projected an inflation rate of 12 percent, but an increase of 18.6 percent was registered. An inflation rate of 11 to 13 percent is assumed for 2002, although consumer prices had risen by over 8 percent by May 31.

- The exchange rate was 31.31 rubles/dollar on June 1. The average exchange rate in 2001 was 29.2 rubles/dollar. The effective exchange rate in 2001 grew by about 12 percent. The competitive advantage gained from the August 1998 devaluation has been reduced by nearly 80 percent. Governor of the Central Bank of Russia, Sergei Ignatiev expects the year-end exchange rate to be 33 rubles/\$1.
- Real disposable incomes rose by 9 percent in 2000, 6 percent in 2001, and 9.5 percent year-on-year in the first 4 months of 2002. During the fourth quarter of 2001, 34.8 million people, or 24 percent of the population, were living below the poverty line of 1,574 rubles (\$51) a month. The average monthly calculated nominal wage due in March 2001 was 4,172 rubles (\$134).
- By April 1, wage arrears had fallen to 34.4 billion rubles. Enterprise arrears by November 2001 had fallen to 1,744 billion rubles.
- In 2001, only 27,800 man-days were lost in strikes.
- Foreign trade surpluses of \$20.2 billion, \$19.8 billion, \$14.5 billion, \$15.1 billion, \$36.1 billion, \$60.7 billion, and \$49.4 billion were registered in 1995-2001.
- The current account surpluses were \$3.5 billion, \$1 billion, \$24.7 billion, \$46.4 billion (19 percent of GDP) in 1997-2000 and \$35.1 billion in 2001.
- The Central Bank's reserves on May 24 were \$41.7 billion, including \$4.1 billion in gold, a record high.
- On January 1, 2002, Russia's external debt amounted to \$130.1 billion, including \$41.2 billion owed to the Paris Club.
- WTO director general Mike Moore expects Russia to join the organization by late 2003.
- More than three years after the August 1998 crash that left most major banks technically insolvent, few banks have been restructured.
- The share of pure barter transactions fell to 1.6 percent in 2001.
- After a decade of continuous decline, gross capital investment in 1999 rose by 5.3 percent to 670 billion rubles (\$28 billion) or 15 percent of GDP, and then grew by nearly 18 percent in 2000, and by 8.7 percent in 2001 (to nearly 17 percent of GDP), much of it in the energy and transportation sectors. Fixed capital investment growth during the first 4 months of 2002 slowed to 1.6 percent.
- The age of Russian manufacturing plant and equipment is, on average, more than three times higher than in the OECD. To update or replace it and the infrastructure will take trillions of dollars. This will not be available solely from domestic sources. FDI is expected to grow fast-it may well double by 2005.

Natural Resources

Russia has a tremendous wealth of natural resources, producing 17% of the world's crude oil, 25-30% of its natural gas, and 10-20% of all non-ferrous, rare and noble metals mined across the globe. The wealth of Russian natural resources is estimated at US\$30,000 bn.

Oil

The world's 8nd largest oil reserves: 49-55 bn barrels or 10% of total world's reserves The 2nd largest oil exporter (4.6m bbl/d) behind only Saudi Arabia.

Natural Gas

The world's largest gas reserves: 1,700 trillion cubic feet (Tcf) or 33.3% of world's total. The largest natural gas exporter with 6.8 Tcf in net gas exports on total production of 20.8 Tcf or 25% of world's total.

Coal

The world's 2nd largest coal reserves: 173 billion short tons in reserves or 11% of world's total with 276 Mmst produced in 2000 or 7% of world's total.

Metals and Minerals

Russia has 26% of world's ferrous metals and produces 8% of world's total.

Russia's world ranking for production of selected mineral commodities is as follows: 1) nickel, 2) platinum group metals, 3) potash and diamonds, and 4) gold and copper.

Tables

Economy Annual % change										
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Gross domestic product	-14.5	-8.7	-12.7	-4.2	-3.5	0.9	-4.9	5.4	9.0	5.0
Industrial production	-18.8	-14.6	-20.6	-3.0	-3.5	1.9	-6.6	11.0	11.9	4.9
Agricultural production	-9.0	-4.0	-12.0	-8.0	-5.1	0.1	-12.3	2.4	3.0	6.8
Consumer prices	2,650	940	320	131	22	11	85	37	21	19
Real disposable income	-41.0	14.0	-8.0	-13.0	5.0	2.5	-13.8	-15.1	9.6	5.9

Federal budget, as % of GDP										
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Revenue	16.6	14.5	14.1	13.7	12.5	12.1	11.3	13.7	16.2	17.7
Expenditure	27.7	15.9	18.1	16.6	15.6	15.3	14.5	15.0	13.7	15.4
Balance excl debt service	-11.1	-1.4	-4.0	-2.9	-3.3	-3.2	-3.2	2.2	2.5	4.9
Balance incl. debt service	na	-6.5	-11.4	-5.4	-7.9	-6.8	-7.2	-1.3	1.3	2.4

Life expectancy at birth, years										
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Men	62	59	57	58	60	59	59	60	60	na
Women	74	72	71	72	72	71	71	72	72	na

Sources: Derived from Goskomstat and IMF reports; *Russian Economic Trends*, quarterly and monthly updates; Bank of Finland, *The Russian Economy: The Month in Review* and *The Russian Economy: The Week in Review*, various issues.