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Russian & Baltic Economies
The Week in Review

Yearbook 2003

Russian and Baltic Economies -
The Week in Review is a brief
compilation of leading economic
news items in Russia and the Baltics.

Bank of Finland
Institute for Economies in Transition, BOFIT

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- Russia's WTO membership talks to be accelerated.
- Estonia continued to enjoy robust economic growth.
- Lithuanian GDP grew 6.8 % in the third quarter of 2002.
- Lithuania to hold presidential runoff election on Sunday.

Week 2/2003

- The Duma accepts CBR's monetary policy guidelines for 2003.
- Putin signs Duma election act into law.
- Russian oil companies preliminarily agree on construction of new oil terminal and two new pipelines.
- EU Commission sets grain import quotas for 2003.
- Brisk rise in Baltic wages continued in third quarter of 2002.
- IMF gives positive appraisal of Latvian economic development.
- Paksas victory in Lithuania's presidential race surprises many.
- Lithuanian pension reforms to be launched next year.

Week 3/2003

- Russia's realised 2002 federal budget surplus close to original forecast.
- Russia reduced its foreign debt in 2002.
- Russian crude oil production and export increased in 2002.
- Russia sets common export tariff on oil products from the beginning of 2003.
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- Putin signs revised presidential election law.
- Baltic inflation remained slow in 2002.
- Overview of Baltic transport sector in 2002.

Week 4/2003

- Russia's current account surplus shrank slightly in 2002.
- Russian industrial output growth slowed in 2002.
- Russian share prices rose in 2002.
- Russia ends tax on foreign currency purchases.
- Russia now collects social tax contributions from foreigners.
- Russian arms exports in 2002.
- Baltic bourses in 2002.
- Baltic central bank gold and foreign exchange reserves grew in 2002.
- Monopoly on fixed phone line services end in Latvia and Lithuania.

Week 5/2003

- Russian economic growth slowed in 2002.
- Rouble's real exchange rate weakened slightly in 2002.
- Russian real incomes continued to rise in 2002, wage arrears persist.
- Russian government sets meat import quotas.
- Operation of private pension funds broadened in Russia.
- Russia lowers export tariffs on oil and oil products.
- Estonia's new bankruptcy law.
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- Privatisation agency makes another attempt at privatisation of Lithuanian shipper KTL.
- Lithuania plans to privatise national air carrier.

Week 6/2003

- Prices of services in Russia continue to climb rapidly.
- Russian government decides on debt restructuring for agricultural producers.
- Russia wants to reduce inspection bureaucracy for small firms.
- Russian government approves forestry development program for 2003 – 2010.
- Estonian exports down slightly in 2002.
- Latvian state to sell its shares in Latvijas Krajbanka.
- Lithuania privatises four distilleries.
- Mazeikiu Nafta's losses narrow in 2002.

Week 7/2003

- Preliminary figures say Russian GDP grew 4.3 % in 2002.
- Russian exports grew quickly in fourth quarter, as Western imports slowed.
- Russian government wants to improve administration of state property.
- Russian government considers cutting taxes to boost economic growth.
- BP makes large investment in Russia.
- Russia's WTO membership talks continued.
- Baltic industrial output growth slowed in 2002.
- Baltic inflation remains low.

Week 8/2003

- Russia eases rules on taking cash out of the country.
- Russia continues to accumulate currency and gold reserves.
- CBR increases euro holdings in foreign currency reserves.
- EU countries accounted for a greater share of imports to Russia in 2002.
- Russia approves patent law changes.
- Latvia's 2003 budget proposal foresees deficit of 3 % of GDP.
- Latvian exports rose 12 % in 2002.
- Lithuanian exports and imports up 10 % last year.
- Estonia sells three UMTS licences.

Week 9/2003

- Growth in Russian industrial output accelerates.
- Russia continues to liberalise currency control regime.
- Rouble strengthens on forex markets.
- CBR lowers interest rates.
- Progress in reform of Russian power sector.
- Russian unemployment on the rise.
- Russia readies draft for nationalisation act.
- Estonia posts largest Baltic current account deficit.
- Estonia's parliamentary elections to be held on Sunday.

Week 10/2003

- Russian inflation remains high in February.
- Russian companies borrow more on international markets.
- Russian cabinet discusses 2002 – 2003 privatisation.
- Russian government submits deposit insurance proposal to Duma.
- Six parties win seats in next Estonian parliament.
- Latvian parliament approves 2003 budget.
- Lithuania's recent 10-year eurobond issue draws strong interest.
- Plans for March selection of Latvia's president scrubbed.

Week 11/2003

- Russia's federal budget surplus shrank in 2002.
- Russia's 2002 consolidated regional budget in the red.
- Largest growth seen in Russian fuel exports and machinery imports in 2002.
- Putin streamlines bureaucracy.
- Intense talks continue on Russia's WTO membership.
- Russia and Belarus to inaugurate currency union at start of 2005.
- Baltic states prepare for referendums on EU membership.
- Low inflation in Estonia and Latvia in February, deflation persists in Lithuania.

Week 12/2003

- Russian industrial output growth accelerates.
- Russian government seeks to reduce tax burden.
- Russian government outlines 2003 – 2005 debt policy.
- Growth of Russian bank deposits accelerated towards the end of 2002, while growth in lending slowed.
- Russian government raises oil export tariffs.
- Estonian 2002 budget showed surplus, while Latvian and Lithuanian budgets ended year in the red.
- Brisk growth continues in Baltic bank lending.

Week 13/2003

- Russian economic growth accelerates in January and February.
- Russia's crude oil production and exports continues to climb.
- Despite progress in reforming relations between Russia's centre and regions, further steps may be difficult.
- Duma accepts second reading of housing policy act.
- Federation Council approves reform package for electrical power sector.
- Inspection of Russian banks' capital to start.
- Latvian GDP grew 6.1 % in 2002.
- Transneft still not shipping oil via Latvia's Ventspils terminal.

Week 14/2003

- Russian current account surplus continues to rise in first quarter.
- Further changes of deposits and credit concentration in Russia last year.
- Reform of Russia's natural gas sector considered, state reacquires majority stake in Gazprom.
- Russia seeks to create economic area with Ukraine, Belarus and Kazakhstan.
- Estonian GDP increased 5.8 % in 2002.
- Lithuanian GDP was up 6.7 % in 2002.

Week 15/2003

- Russian inflation remains high.
- IMF lowers its forecast for Russian economic growth.
- Duma approves modified federal housing policy bill in third reading.
- Russia modifies production-sharing rules.
- Russian population diminished further in 2002.
- FDI inflows in 2002 down in Estonia, up in Latvia and Lithuania.
- Modest improvements in country-risk ranking of transition economies.

Week 16/2003

- Rouble's external value continues to strengthen.
- Russia concludes intensified round of WTO talks.
- Impacts of Iraq conflict on Russian economy.
- Russia seeks to trim budget spending while reforming taxation.
- Rise in oil prices drives up Baltic consumer prices in March.
- Juhan Parts heads Estonia's new centre-right government.
- 25 % stake in Latvian Savings Bank to be auctioned next month.
- Ten future members sign EU accession treaties at Athens summit on April 16.

Week 17/2003

- Russian economic growth remains strong.
- Russian government proposes lowering tax rates.
- CBR reminds of website postings of bank financial information.
- After three years of wrangling, customs code reappears before Duma.
- Yukos and Sibneft agree on merger.
- Russian RTS index climbs.
- Baltic share indices up since start of the year.
- Gazprom keeps investing in Lithuania.
- Latvian natural gas prices set to rise.

Week 18/2003

- Russian statistics committee revises calculation of GDP.
- Russian cabinet reviews medium-term economic scenarios.
- Initial findings from Russia's 2002 population census.
- Russian cabinet considers reform of the armed forces.
- Duma approves bill on public service.
- Lithuania initiates privatisation of electricity companies.
- Privatisation of Lithuanian Airlines hits further snags.

Week 19/2003

- Russian inflation remains high.
- Russia pursues tight fiscal stance.
- Growth in Russian banking sector concentrated in large and small banks last year
- Russia's private pension funds still essentially unregulated.
- Russian and US agriculture ministers agree on cooperation and sanitary issues.
- Further delays seen in the reform of Russia's natural gas sector and Gazprom.
- IMF expresses concern about Estonia's current account deficit.
- Sale of Lietuvos Dujos stake postponed again.

Week 20/2003

- IMF praises Russia's economic policy.
- Fitch raises Russia's credit rating.
- Russian export earnings grow strongly as imports moderate in the first quarter.
- Russia introduces compulsory car insurance from July 1.
- Russia takes Latvia off offshore list.
- Lithuanians vote for EU membership.
- Latvia posts highest Baltic inflation.

Week 21/2003

- Russia's rapid industrial output growth continues.
- Investment inflows to Russia on the rise.
- Highlights of president Putin's annual state-of-the-nation address.
- Growth in bank deposits accelerates, growth of credit also brisk.
- Baltics sustain robust industrial output growth.
- Baltic exports to Western Europe continue to rise.
- Privatisation of Latvian Savings Bank proceeds.

Week 22/2003

- Russian government approves energy ministry proposal on long-term energy strategy.
- Russian budget remains in surplus in the first quarter of 2003.
- Russian cabinet ponders administrative reforms.
- Russia, EU and US sign accord on cleaning up sub-fleet nuclear waste.
- Russian Duma finally ratifies border treaty with Lithuania.
- Current account deficits rise in Estonia and Latvia, fall in Lithuania.
- EU membership brings changes to Latvia's constitution.

Week 23/2003

- Russian economic growth continues to accelerate.
- Russian cabinet sets 2004 tariff hikes for gas, electricity and rail transport.
- Consensus on reform of Russia's electrical power monopoly.
- Russian government proposes nominal 33 % increase in public sector wages from the start of October.
- Russia-EU summit in St. Petersburg.
- Russia-China summit in Moscow.
- Privatisation of Ventspils oil terminal continues.
- Baltic transport sector performance in first four months of the 2003.

Week 24/2003

- President Putin sets out 2004 budget policy framework.
- Russian government approves main budget parameters for 2004.
- Russian inflation down slightly in May.
- Slight changes in structure of Russian industrial investment in the first quarter of 2003.
- Russia's new customs code enters into force at the start of 2004.
- Highlights of G8 summit.
- Baltic inflation in May.
- Latvian first-quarter GDP growth beats forecast.
- Poland votes for EU membership.

Week 25/2003

- Russia has already paid the bulk of its debt servicing for 2003.
- Russia approves new production-sharing rules.
- Russian oil exports continued to climb in first quarter.
- Duma approves amendments to telecommunications act in second reading.
- Wages rise in the Baltics, increased purchasing power supports retail sales.
- Estonian parliament approves 2003 supplementary budget.
- Latvia to hold presidential election on Friday.
- Poland's finance minister Grzegorz Kolodko resigns.

Week 26/2003

- Russia currently one of the world's fastest growing economies.
- Russian central bank lowers refinancing rate.
- Russian Duma approves numerous changes in the tax code.
- Russian Duma amends foreign currency act.
- Changes in structure of bank deposits and lending concentration continued in first quarter of 2003.
- Russia becomes FATF member.
- Latvian president Vaira Vike-Freiberga wins second term.
- Latvian parliament approves supplementary budget.
- IMF mission commends Lithuania's economic development.

Week 27/2003

- Russian government approves state's borrowing program for next year.
- Russia imposes higher import duties on used cars to protect its domestic car industry.
- Hitch in plans for Russia-Belarus currency union.
- Energy issues head discussions in Russian president's UK visit.
- Euro's role grows in foreign cash exchange operations of Russian bank.
- St. Petersburg mayor Vladimir Yakovlev appointed Russian deputy prime minister.
- Estonian GDP growth slows slightly.
- Lithuania enjoys strong GDP growth at the start of the year.
- Baltic countries see different time frames for euro introduction.

Week 28/2003

- Russian inflation continues to outpace government's target.
- CBR lowers sales requirement for export earnings to 25 %.
- Putin finalises busy legislative season.
- Status of Russia's small farmers defined, plot cultivation exempt from taxes.
- Statistics Committee figures on household income growth may overshoot.
- Maturities on Russian bank deposits and credits continue to lengthen.
- June inflation figures for the Baltic countries.
- Baltics improve their rankings in two major development surveys.

Week 29/2003

- Russia continues to enjoy robust industrial production growth.
- Russia's WTO membership talks continue.
- Progress in Russian pension reform.
- Putin approves amendments to act on regional administration.
- Privatisation of Lithuanian energy companies proceeds.
- Numerous Lithuanian privatisation projects stumble.
- Latvian pulp mill project assessed.

Week 30/2003

- Russian firms post higher profits in first five months of 2003.
- Suspicions around Yukos clearing.
- Privatised companies still face big problems in acquiring or leasing their lots.
- Russian government approves ceiling on export guarantees for industrial products in 2004.
- Russian banks to begin preparations to IAS accounting next year.
- Fitch raises Latvia's credit rating.
- Baltic share prices up for the year so far.
- Interest rates continue to drop in Estonia and Lithuania.

Week 31/2003

- Russian stock markets volatile, rouble strengthens in the first half of 2003.
- Russian government approves privatisation program for 2004 - 2006.
- Pensions boosted in Russia.
- Business conditions vary greatly among Russian cities.
- Russian government sets stage for shift to all-volunteer army, Putin issues decree on alternative civilian service.
- Central bank currency and gold reserves for Russia and Baltic countries.
- Standard & Poor's lifts outlooks for Latvia and Lithuania.

Week 32/2003

- Russia enjoyed robust economic growth in the first half.
- Russian inflation shows no signs of slowing.
- Russia's current account surplus rises in the first half.
- Poor weather reduces outlook for Russian grain harvest this year.
- President Putin suspends reforms of security agencies.
- Latvian government presents initial version of 2004 budget.
- IMF mission gives positive assessment of Estonian economy, warns of widening current account deficit.

Week 33/2003

- Slowing growth of Russian exports and imports in second quarter.
- Rise in Russian producer prices slows from last year.
- Growth of rouble deposits and cash accelerated in the second quarter.
- Russian railways to become corporation, railways ministry to be eliminated.
- Industrial output growth still strong but slowing throughout the Baltics.
- Baltic inflation figures for July.
- Ventpils oil pipeline from Russia to Latvia still shut down.

Week 34/2003

- Russian cabinet finalises 2004 federal budget proposal.
- Russian government decides 2004 rate hike ceilings for natural monopolies.
- Russian government wants larger share of CBR profits.
- Russian government approves 2004 privatisation program, the auction of telecom shares postponed.
- Yukos-Sibneft merger moves ahead.
- Estonian and Latvian exports up, Lithuanian exports down.
- Preliminary data indicate Baltic current account deficits remain large.

Week 35/2003

- Continued brisk growth in Russian industrial output.
- Russia still posts fair budget surplus in the first half of 2003.
- Russian government considers economy ministry forecast for 2003-2006 and CBR monetary policy program for 2004.
- Major energy-sector merger gets go-ahead.
- The monopoly of state-owned Estonian oil shale mining ends.
- Lithuanian bourse and securities depository to be privatised.
- Baltic income levels continue to converge with the EU average.

Week 36/2003

- Russian fuel exports and machinery and equipment imports rose in second quarter.
- Russian companies borrow more from abroad – FDI inflows to Russia grow slower.
- Export tariff on Russian natural gas upped to 30 %.
- Major share deal in the Russian oil sector.
- Baltic states' construction activity up.
- Integration of Lithuanian and Polish electrical grids moves ahead.
- Wages in Baltic states in the second quarter of 2003.

Week 37/2003

- Russian economic growth accelerated in the second quarter.
- Russian inflation slowed slightly in August.
- Private firms chosen for managing Russian pension savings.
- President Putin gets involved in defining relations between the state and business.
- Russian and Finnish foreign trade figures give conflicting views of trends in Russian imports.
- Baltic inflation in August.
- Latvian economic growth remains robust.
- Estonia and Latvia vote on EU membership.

Week 38/2003

- Slight shifts in Russia's investment structure.
- Gradual diversification of bank deposits and lending in Russia continued in first half.
- Russian central bank eases repatriation of S-account funds.
- Russian Duma convenes autumn session ahead of December parliamentary election.
- Rapid growth in Baltic states banking sectors.
- Estonians vote yes on EU membership.
- No state support for Latvian pulp mill project.

Week 39/2003

- Slight slowdown in Russian economic growth.
- Performance of Russian regional and local budgets in the first half of 2003.
- Russian 2004 federal budget passes first Duma reading.
- Russian government approves decree on setting up railways corporation.
- Estonian parliament starts to consider 2004 budget.
- Latvians vote for EU membership.
- Sale of Lithuanian power distributors arouses buyer interest.

Week 40/2003

- Russia and Belarus discuss currency union and energy cooperation.
- Russia, Ukraine, Belarus and Kazakhstan sign agreement on common economic space.
- Russian Duma approves bill on local administration.
- Russian government approves fishing industry development strategy extending through 2020.
- Finnish-Russian economic commission meets in Helsinki.
- Baltic employment situation continues to improve.
- Estonian economic growth continued to slow in the second quarter.
- Lithuanian GDP rose 6.7 % in the second quarter.

Week 41/2003

- Moody's upgrades Russia's creditworthiness.
- RTS index hits all-time high of 629 points on October 8.
- Russian inflation continues to decelerate slightly.
- Russian current account surplus remains large, capital outflows rise in third quarter.
- Government again postpones consideration of program to reform Russia's natural gas sector.
- Baltic inflation figures for September.
- Cargo volumes at the largest Baltic ports.

Week 42/2003

- Russian Duma approves revenue-expenditure structure for 2004 budget.
- Russian Duma and Federation Council disagree on taxation changes.
- Russian government's foreign debt falls; corporate foreign debt rises.
- Rouble's real exchange rate relatively stable during first nine months of 2003.
- 2004 budget bill submitted to Lithuanian parliament.
- Lithuanian government accepts Gazprom's bid for Lietuvos Dujos.
- Euromoney and Institutional Investor publish country risk rankings.

Week 43/2003

- Russian economic growth remains brisk.
- Russian unemployment higher than last year.
- Russian Duma approves supplementary budget for 2003.
- President Putin encourages cooperation of APEC countries and eastern parts of Russia.
- Submission deadline for Duma candidate lists passes.
- Current account deficits continue to rise in Estonia and Latvia.
- Transparency International releases 2003 Corruption Perceptions Index.

Week 44/2003

- Arrest of Yukos chief and freezing of assets increase worries about Russian policies.
- Russian share prices fall in response to Mikhail Khodorkovsky's arrest.
- IMF mission concludes Russia needs to tighten fiscal policy.
- Limited competition begins tomorrow in Russia's wholesale markets for electricity.
- Retail sales growth continues in the Baltics.
- Latvian electricity rates to rise.
- EU Commission stays with its economic growth forecasts for acceding countries.

Week 45/2003

- New developments in the Yukos case.
- Russia's WTO membership negotiations could conclude in a year.
- Russia ranks low in international competitiveness.
- EU gives positive appraisals on Baltics' readiness for accession.
- IMF expects Latvia's brisk economic growth to continue.

Week 46/2003

- Yukos uncertainty slams Russian share prices.
- Russian government rolls out anti-corruption program.
- Regulated prices in Russia rise slower than prices generally.
- Topics of EU-Russia summit include creation of common economic space and energy issues.
- 23 national party lists qualify for next month's Duma election.
- Baltic inflation figures for October.
- Robust growth in industrial output throughout the Baltics.

Week 47/2003

- Russia posts good showing in export and import growth in the third quarter.
- Duma approves additions to the budget code on the new stabilisation fund.
- Russian cabinet considers ways to develop financial markets.
- Polls suggest United Russia may be opening up lead over Communists.
- Estonian government parties divided over income tax reduction.
- Baltic countries' exports continue to boom.
- Latvian parliament adopts 2004 budget and second 2003 supplementary budget.

Week 48/2003

- Brisk economic growth continues in October.
- Russian companies borrowing more from abroad, FDI inflows also up.
- Rise in real wages slows from last year.
- President Putin approves further tax code changes.
- Russia establishes anti-corruption council.
- Baltic current account deficits.

Week 49/2003

- Merger of Yukos and Sibneft on hold.
- Duma approves act on deposit insurance for private individuals.
- Russia's currency reserves still substantial.
- Duma approves 2004 federal budget act, implementation of stabilisation fund.
- Russian regions lose right to grant tax relief.
- Lowering of Estonia's income tax rate postponed.
- Lithuanians eager to participate in voluntary pension funds.
- Lithuania begins talks on privatisation of one power grid operator, while sale of the other is halted.

Week 50/2003

- Putin-supporting parties win Duma election.
- Russian inflation slows.
- Russian parliament approves amendments to Act on Currency Regulation and Currency Control.
- Growth of Russian oil exports accelerates in third quarter.
- Bank of Estonia takes measures to restrain credit growth.
- Latvian economic growth remained brisk in third quarter.

Week 51-52/2003

- Russian economic growth remains high in third quarter.
- Growth of bank deposits and credits in Russia accelerated in third quarter.
- Russia's federal budget surplus remains solid throughout the first nine months of 2003.
- Russian government approves investment programs for natural monopolies in 2004.
- Energy issues top discussions in Kasyanov's Japan visit.
- Latvia continues to post highest Baltic inflation figures.
- Estonian parliament passes balanced 2004 budget.
- Lithuanian parliament approves 2004 budget.
- Moody's upgrades Lithuania's creditworthiness.



Russian consumer prices rose 15.1 % in 2002. While inflation exceeded the government's target range of 12 – 14 % for 2002, prices for food and most other goods rose only 11 % last year – less than in 2001. Goods experiencing the greatest rise in prices included gasoline (up 20 %) and pharmaceuticals (15 %). Prices of services rose an average of 36 % in 2002, about the same as in 2001. The strongest rise was in housing and municipal services (49 %), telecommunications services (38 %), child day care (34 %), cultural services (33 %) and health care services (31 %). Prices for educational services and transportation services rose 26 %. Excluding housing and municipal services, the prices of other services mentioned above rose faster in 2002 than in 2001.

Russian government sets limits for natural monopoly tariffs for 2003, approvals of most investment programs still ahead. At a December meeting, the government voted to keep 2003 tariff increases in line with its policy guidelines approved last summer. From the start of this year, the wholesale price of natural gas is increased 20 %, rail freight tariffs 12 % and electrical energy tariffs 14 %. Railway passenger fares, excluding local train fares, will be raised an average of 12 % in mid-January. Economy minister German **Gref** said there would be no further tariff increases in 2003, except in special circumstances. The economy ministry estimates that the impact of natural monopoly tariff hikes on inflation last year was about four percentage points.

At its meeting, the cabinet also reviewed 2003 investment program proposals by natural monopolies. The government signed off the main points of a €4 billion railway investment program, but rejected Gazprom's investment program until it is revised in accordance with the economy ministry's €5.5 billion proposal. Electrical power monopoly UES was also requested to further detail its €0.7 billion investment proposal.

Pace of reform of Russia's natural monopolies varies. Fastest progress has been made in reform of the country's railways, with the Duma passing four rail system-related bills at the end of December. The government program approved in spring 2001 seeks to restructure Russia's railways by 2010 in three phases. The Russian Railways corporation will be established to take care of railway operations. Subsequently, several independent subsidiaries will be created to handle specific businesses (e.g. freight and passenger transport). In the program's final phase, shares of the subsidiaries will be offered, a move intended to bring investment, and eventually competition, to the field.

The second Duma readings of six laws related to reform of the electrical power sector have been postponed several times, most recently in December. There is still no decision on when the Duma will consider the bills.

The government's program for reforming the electricity sector was approved in summer 2001. It seeks to increase competition and investment, as well as deregulate prices.

Reform of the gas sector has proceeded far more slowly. Presently, there is no agreement on a modernisation program. A program was scheduled for submission to the government at the end of 2002.

Government works to relax Russian currency controls. The government is drafting an extensive overhaul of the act on foreign currency regulation and control, aimed at substantially liberalising the current regime. Under the revised system, there would be practically no supervision of regular foreign payments or most capital movements. In special situations, however, the central bank would be authorised to restrict capital movements. The Duma is expected to take up the bill this spring.

In response to appeals from several foreign organisations, the government last autumn submitted to the Duma a proposal, whereby non-residents could, like Russian residents, take up to \$1,500 in foreign currency out of the country without having to show receipts for cash brought into the country or foreign currency purchased in Russia. In December, when discussing the bill the Duma voted to increase the cash amount to \$10,000, after which the Federation Council rejected the Duma's figure, saying the limit was too high. The government, presidential administration and central bank expressed fears that the increase would encourage large outflows of foreign currency. The bill now moves on to a parliamentary conciliation committee.

Russia's WTO membership talks to be accelerated. In December Russia held a series of bilateral talks with WTO members, as well with the 66-member working group on Russia's WTO accession (deputy prime minister Alexei **Kudrin** participated in the first part of this meeting). The working group proposed that the next three meetings of the group be held already within the first quarter of 2003. Observers said no substantial progress was made in the December talks.

Russian representatives said that talks at the start of this year will focus on agriculture, the energy sector, customs tariffs and access to service markets. The chairman of the WTO accession working group said the key negotiation issues are Russia's two-tier energy pricing (i.e. administratively set domestic prices), limits on foreign ownership of Russian companies involved in finance and telecommunications, and Russia's large body of legislation that has yet to be harmonised with WTO guidelines. Further reports on the December meeting noted criticism of Russia's two-tier system of railway tariffs, whereby more is charged for foreign freight than domestic freight.

Estonia continued to enjoy robust economic growth.

Estonian real GDP grew 6.7 % y-o-y in the third quarter and 5.7 % y-o-y in the first nine months of 2002. Growth was driven by strong domestic demand and growth in exports, which took off in July. In the third quarter, a combination of higher employment, higher wages and increased borrowing helped lift consumer spending 12 % y-o-y. Fixed investments rose 20 %. Goods exports grew 23 % y-o-y and services exports 8 % y-o-y.

Growth continued in all production sectors except agriculture and health care. Strongest growth in the third quarter was in the hotel and restaurant sector (19 %). Added value produced by the construction sector was up 18 % y-o-y due mainly to an increase in infrastructure projects such as roads and highways. Manufacturing grew 11 %, trade 12 % and the financial sector 10 %. Growth in the transport and communications sector slowed to 1 %.

Lithuanian GDP grew 6.8 % in the third quarter of 2002.

In the first nine months of 2002, Lithuanian real GDP grew 6.1 % y-o-y. Growth continued strong in several sectors of the economy in 3Q02. Highest growth was in agriculture and the forest industries, which saw value added rise 15 % y-o-y. Construction rose 9 %, as non-housing construction increased. Trade, a key aspect of the service sector, grew 7 % y-o-y, while transport and communications were up 4 %.

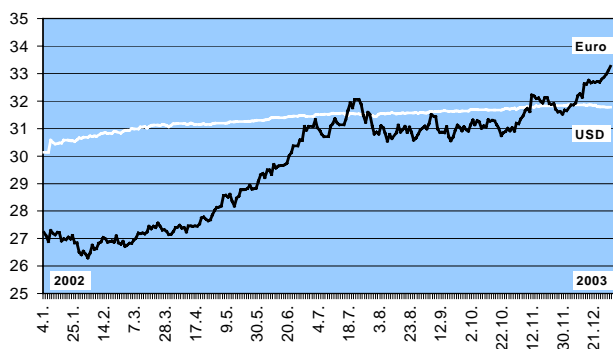
Both domestic and international demand sustained demand-side growth. Private consumptions grew 7 % and public consumption 6 %. Fixed investments were up 14 % y-o-y in the third quarter. Over 60 % of investment went to construction and infrastructure. Most investments were made in manufacturing and the transport sector. Exports of goods and services grew 15 %.

Lithuania to hold presidential runoff election on Sunday.

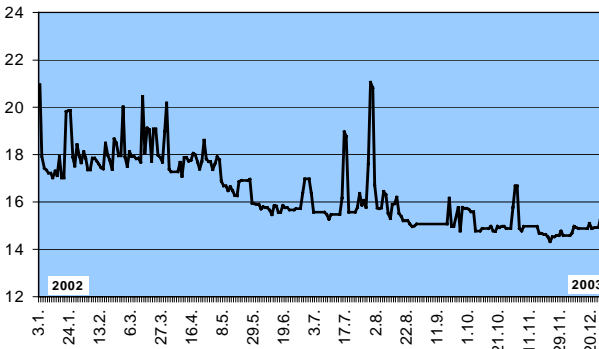
Voter turnout in the December 12 presidential and local government council elections was around 50 %. A second-round presidential runoff election will be held on Sunday (Jan. 5) as no candidate won a simple majority. Incumbent president Valdas **Adamkus** led the first round, garnering 35.5 % of the vote. This weekend he faces runner-up Rolandas **Paksas**, the chairman of the centre-right Liberal Democratic Party and former prime minister. Paksas took 19.7 % of the vote in the first round.

The Social Democratic Party, led by prime minister Algirdas **Brazauskas**, were the big winners in the local government council elections, taking 332 seats on local councils out of a total of 1,560 seats available. The conservative Homeland Union won 193 seats, while the leftist Union of Farmers and New Democracy took 190 seats. The next term for local government council members starts in March and April.

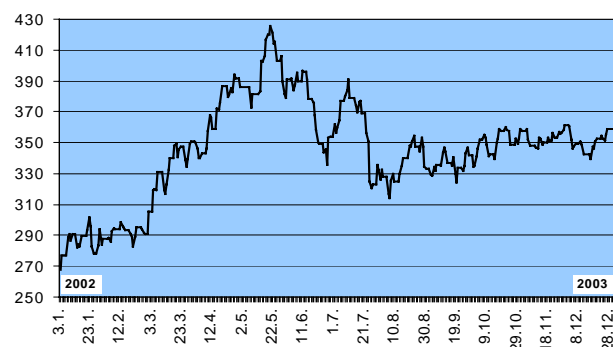
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



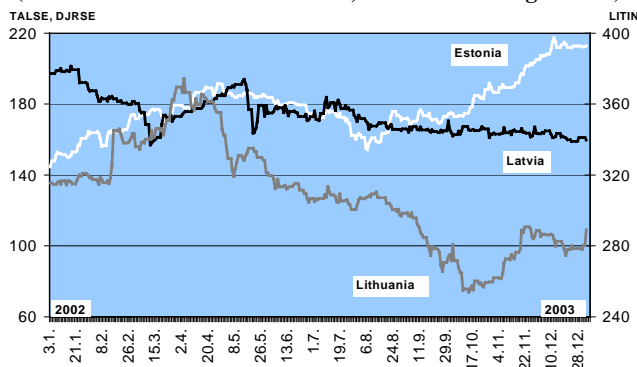
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





The Duma accepts CBR's monetary policy guidelines for 2003. The program approved last month relies on the same economic development assumptions as the 2003 budget act. The Russian economy is expected to develop largely at the same rate as in 2002: GDP should rise 4.0 – 4.2 % this year, industrial output 3.9 – 4.3 %, retail sales 8 – 9 % and investment 2.5 – 3.5 %. Uncertainty over world energy prices is seen as the biggest threat to Russian economic development.

The Central Bank of Russia's monetary policy will be consistent with last year's approach. It foresees continued weakening of the rouble's nominal external value with the year's average exchange rate falling to 33 roubles to the dollar. At the end of 2002, the exchange rate was about 31.8 roubles to the dollar. The rouble's real exchange rate, however, is expected to strengthen this year 4 – 6 % in relation to a basket of currencies of Russia's key trading partners. The CBR considers development of Russia's banking and finance sector crucial to improving its ability to implement monetary policy. Financial sector development will focus on establishing a deposit insurance scheme for private individuals, tougher requirements for establishing banks and reforms in the bookkeeping of financial institutions.

Putin signs Duma election act into law. The revised election act entered into force on December 25. It has been harmonised with related acts on political parties and citizen voting rights. The biggest change concerns the threshold share of the vote national party lists need to win to gain at least one Duma seat. Starting with the 2007 elections, the threshold rises to 7 %, as long as at least four parties achieve that threshold. The current 5 % threshold applies to this year's parliamentary elections.

Under the new act, Duma deputies are selected as before, i.e. 225 from national party lists and 225 from one-deputy districts. Candidates for the national party lists can field registered political parties that have activities in at least half of Russia's 89 administrative regions or election blocs that include at least one political party that meets the above national party criterion. Anyone can stand for a candidate in a one-deputy district.

The act heeds lessons learned. The new law includes a list of factors that may disqualify a candidacy and a requirement that a court must decide any disqualification.

Russian oil companies preliminarily agree on construction of new oil terminal and two new pipelines. At end-November, four of Russia's largest oil companies (YUKOS, LUKoil, Sibneft and Tyumen Oil) signed a framework agreement to construct in Murmansk an oil terminal with an annual capacity of 80 million tonnes. Murmansk is Russia's only Arctic port that remains ice free in winter. The plan calls for the construction of a 1,500-kilometre pipeline from Siberian oil fields to Murmansk. With the US seeking to reduce its dependence on Middle Eastern oil, Russia's rising oil production and oil

exports capacity stretched to its limits Russian companies believe opening of the Murmansk terminal would readily create new export opportunities. The new oil pipeline should be completed in 2007.

On December 16, Russia, Belarus, Croatia, Hungary, Slovakia and Ukraine agreed on the construction of a pipeline running from the Russian town of Samara to Croatia's Adriatic coast. The 3,200-kilometre pipeline would tie Eastern Europe's Druzhba oil pipeline network into southern Europe's Adria network.

EU Commission sets grain import quotas for 2003. The Commission's decision limits imports of average and poor-quality wheat to below three million tonnes, from which an approximately 19 % share is set aside for US producers and a 1 % share for Canadian producers. An import duty of 12 euros per tonne will be levied on grain under the quota. The rate climbs to 95 euros per tonnes for grain outside the quota. Russia and Ukraine have yet to agree to the EU quotas. Ahead of the Commission's decision, Russia demanded a five million tonne quota for itself, while Ukraine sought three million tonnes. The quotas are designed to reduce grain imports to the EU; European producers have suffered from low prices caused by cheap grain imports. In what was generally considered a response to the EU quotas, economy minister German Gref announced Russia might impose quotas on poultry, pork and beef imports from the EU.

Brisk rise in Baltic wages continued in third quarter of 2002. The average monthly wage in 3Q02 was 5,900 kroons (370 euros) in *Estonia*, 170 lats (290 euros) in *Latvia* and 1,100 litas (330 euros) in *Lithuania*. The one-year nominal rise in wages for the quarter was 10 % in *Estonia*, 7 % in *Latvia* and 8 % in *Lithuania*.

In *Estonia*, the highest wages were paid in the financial sector, where the average monthly wage was 12,500 kroons (800 euros). The lowest wages were paid by the fishing industry, 3,100 kroons (200 euros). The biggest y-o-y rise in wages, 27 %, was seen in jobs involving real estate, leasing and business operations.

In *Latvia*, the average wage was 28 % higher in the public sector than in the private sector. Average gross salaries in the public sector rose 10 % y-o-y and 4 % in the private sector.

In *Lithuania*, the average public sector wage was 2 % higher than in the private sector. Wages in the private sector rose 8 % y-o-y, while wages in the public sector rose 4 %.

IMF gives positive appraisal of Latvian economic development. The IMF's mission to Latvia last month reports that the country's economic growth remains strong despite weakness in export markets. The IMF said it expects the favourable economic conditions to persist in the coming years, due e.g. to successful structural reforms and memberships in the EU and NATO. The IMF sup-

ports Latvia's plan to keep the lat pegged to the SDR until EU membership, after which joining ERM II will become topical.

Latvia's large current account deficit remains the biggest threat to economic development. Latvia's deficit needs to be restrained by tight fiscal policy and the public sector deficit should not exceed 1.8 % of GDP this year. To ensure a small deficit the Fund wants Latvia to postpone cuts in corporate and social taxes planned for early this year. The IMF encouraged Latvia to make budget plans for the medium term and increase administrative capacity to take advantage of EU funds. It stressed the importance of improving the business environment, fighting corruption and keeping labour markets flexible to sustain economic development.

Last October, Latvia's government announced it was ending its ten-year transition cooperation with the IMF on economic programs and standby credit facilities. The last program ended in December and from now on Latvian cooperation with the IMF will be no different from that of any industrialised country.

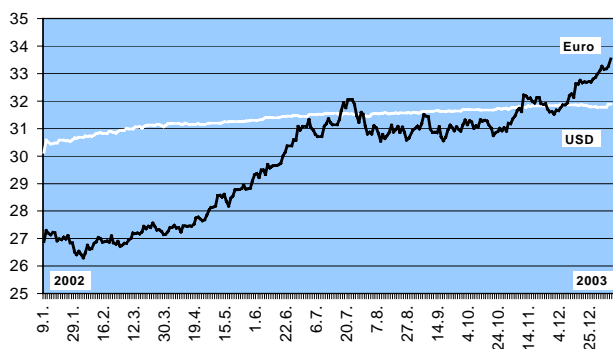
Paksas victory in Lithuania's presidential race surprises many. Former prime minister and Liberal Democratic Party chairman, Rolandas **Paksas** (46) garnered 55 % of the vote in last Sunday's runoff election, overcoming the sizeable lead of incumbent president Valdas **Adamkus** (76) in the first round vote. Voter turnout for

the runoff was only about 52 %. As soon as the race was decided, Paksas gave assurances that Lithuania's current EU and NATO policies will continue. Paksas' inauguration takes place at the end of next month, when he will begin a five-year term.

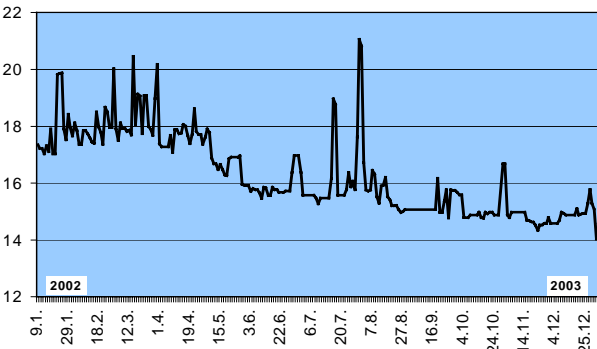
Lithuanian pension reforms to be launched next year. The Lithuanian parliament has approved a bill allowing workers to voluntarily contribute to pension funds from January 2004. In the first year, workers would be allowed to contribute 2.5 % of their salary. Contributions would be increased incrementally to 5.5 % from 2007 onwards. Lithuanian officials expect about 6 % of the workforce to participate in the funds. In the first years, the reform is expected to cost the state an additional LTL 20 million (€ million) annually.

Pensions in Lithuania are currently funded by a pay-as-you-go system, so that contributions of workers currently in the workforce are used to pay the current pensions. This arrangement is inadequate to deal with an aging population, so the creation of matched voluntary funds is hoped to make the pension system more robust in future years. The government previously considered establishing mandatory pension funds, which would have increased annual government spending by about LTL 500 million. The Lithuanian parliament rejected that proposal last spring.

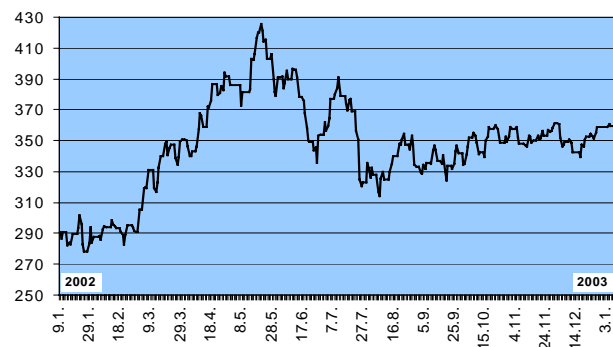
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



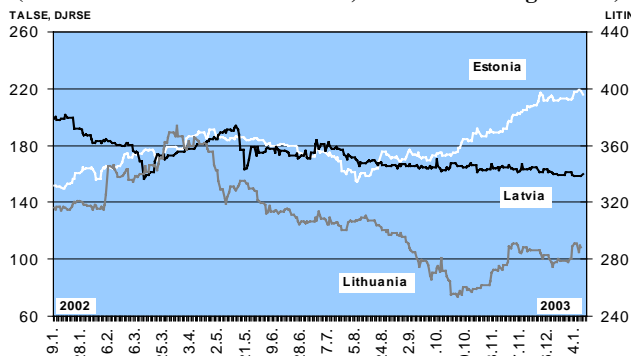
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russia's realised 2002 federal budget surplus close to original forecast. According to preliminary figures released by the finance ministry, federal budget revenues last year amounted to about RUB 2,200 billion (€65 billion), or 20.1 % of GDP. Expenditures were RUB 2,044 (€61 billion), or 18.7 % of GDP. The budget figures include the unified social tax, which is channelled through the budget to the national Pension Fund. Excluding the social tax, revenues last year corresponded to 17 % of GDP (17.6 % in 2001).

The realised surplus amounted to 1.4 % of GDP, or slightly less than the 1.6 % projected in the 2002 budget act. The primary budget surplus, which does not include debt-servicing costs, was 3.5 % of GDP. Russia's federal budget has remained in surplus since 2000 and peaked at 3 % of GDP in 2001. As 2002 wore on, it became clear that the original budget surplus target was in jeopardy. Measures to cut costs other than interest were introduced in December. The measures, in combination with a rise in revenues from higher oil prices in the second half of 2002, helped preserve much of the surplus.

Russia reduced its foreign debt in 2002. The Central Bank of Russia reports that the foreign debt of the Russian Federation amounted to about \$106 billion at the end of September 2002. Thus, Russia's foreign debt fell about \$7 billion in the first nine months of 2002. The debt is comprised of \$57 billion in Soviet-era debt and \$48 billion in current liabilities. Most of the latter consists of government bonds issued in various currencies and debt owed to international lenders such as the IMF and the World Bank. The Soviet-era debt consists mainly of inherited debt to the Paris Club of sovereign creditors. Russia's finance ministry estimated Russia's foreign debt at end-September 2002 at \$119 billion. The discrepancy in foreign debt estimates mainly reflects differences in how the CBR and finance ministry classify foreign debt.

In addition to reducing its foreign debt principal about \$7 billion, Russia made all scheduled interest payments on foreign debt last year (also about \$7 billion). This year, the federal government expects its debt-servicing costs to reach \$17 billion. The reserve fund set up to smooth debt servicing peaks held about RUB 200 billion (\$6 billion) at the start of this year. The fund's reserves are expected to soon reach nearly \$8 billion when earnings from two large privatisation sales at the end of 2002 are deposited.

Russian crude oil production and export increased in 2002. Russia's energy ministry reports Russian crude oil production in 2002 rose to nearly 380 million tonnes and that output averaged of about 7.6 million barrels a day. Growth from the previous year was nearly 9 %. The largest producers last year were LUKoil (75 million tonnes), YUKOS (70 million tonnes), Surgutneftegaz (49 million tonnes) and Tyumen Oil (38 million tonnes). 2002 was the fourth consecutive growth year for the oil industry,

and observers expect output to further increase this year 5 – 8 %.

Russia exported 157 million tonnes of crude oil last year, contributing about 3.1 million barrels a day to world markets. The volumes include oil from Azerbaijan and Kazakhstan transported via Russia. Last year, Russian oil exports rose 4 % y-o-y. Oil exports are expected to further rise this year even in the face of capacity constraints. Infrastructure expansion plans by state-owned Transneft, which operates Russia's oil pipelines, should help boost exports at least 16 % this year. The Russian government has yet to approve an expansion plan, however. Russian oil companies have requested that Transneft improve the efficiency of its transport capacity, e.g. by increasing the volume of shipments moving through Latvia's Ventspils oil transshipping terminal. Shipments moving through the Gulf of Finland via the Primorsk oil terminal completed last year have substantially decreased shipments via Ventspils, and Transneft has no plans to use Ventspils in the first quarter of this year.

Russia sets common export tariff on oil products from the beginning of 2003. Since the start of the year, a unified export tariff on all crude oil-based products has been \$26.80 dollars per tonne. The export tariff on oil products as well as the tariff on crude (currently \$29.80 per tonne) is reviewed by the Russian government every other month. A range of export tariffs on various oil products was applied earlier.

Russia and Japan strengthen their economic relations. On January 10 in Moscow, Russian president Vladimir Putin and Japanese prime minister Yunichiro Koizumi signed an action plan on developing bilateral economic cooperation. Among the topics discussed by the two leaders was construction of a 4,000 km oil pipeline from Siberia to the Pacific Ocean that would help Japan reduce its dependence on oil from the Middle East. Japan has expressed willingness to help finance the estimated €5 billion pipeline project. The pipeline could also facilitate deliveries of Russian oil to the US west coast. Russia previously agreed with China to study the possibility of building a 2,500 km oil pipeline from Siberia to Manchuria. It is unlikely both pipelines will be built.

Putin signs revised presidential election law. The main goal of reforming the presidential election act was to bring it into conformance with the new political parties act and citizens' voting rights act. Candidates for presidential office now must be at least 35 years old and reside continuously in Russia during the ten years preceding the election. Presidents may serve no more than two consecutive four-year terms in office. Under the new law, candidates endorsed by political parties or election blocs that took seats in the previous Duma election can now stand for office without having to collect supporter signatures. Candidates of parties or election blocs without

Duma seats, as well as independent candidates, can also stand for election if they collect at least two million signatures.

Baltic inflation remained slow in 2002. Despite rising domestic demand, inflation slowed last year in all Baltic countries. For December, the on-year increase in consumer prices was 2.7 % in *Estonia* and 1.4 % in *Latvia*. Prices fell 1.0 % in *Lithuania*. Factors such as increased competition tended to dampen inflation. Both the Estonian kroon and Lithuanian litas are now pegged to the euro; thus the euro's rise against the dollar subdued growth in import prices. Administered prices in Latvia were increased just 0.6 %.

In *Estonia*, regulated prices were adjusted up 7.4 %, while other prices rose just 0.8 %. The largest price rises last year were seen in health care (up 14 %) and housing (9 %), reflecting the national health care reform and the increase in electricity prices. Food prices, however, were down 1.4 % y-o-y in December.

In *Latvia*, the costs of education and transport rose fastest, each up about 5 % y-o-y. Latvian food prices were up 0.7 %.

In *Lithuania*, the largest increases were seen in transportation costs (up 9 %). In many fields, however, prices fell last year, e.g. food prices were down 5 % y-o-y.

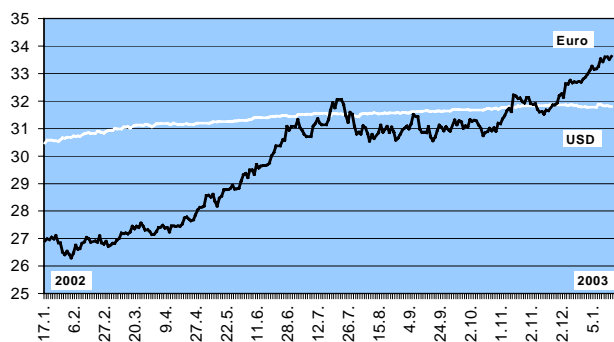
Overview of Baltic transport sector in 2002. *Estonia* – The volume of cargo handled by the Port of Tallinn rose to nearly 38 million tonnes last year, an on-year increase

of about 17 %. Two-thirds of that was transit shipments, which rose 22 %. The volume of liquid cargoes rose to 24 million tonnes. The volume of rail freight rose to 42 million tonnes, an increase of 14 % from 2001. Most of the freight volume was oil (29 million tonnes).

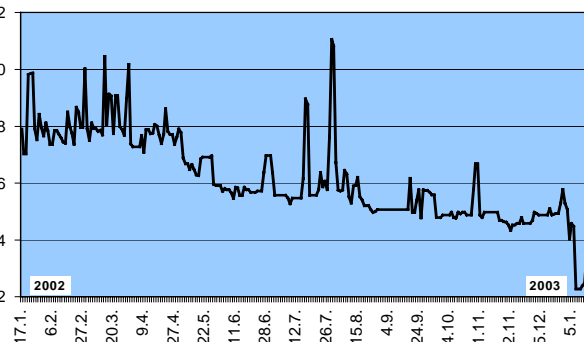
Latvia – The country's largest port, Ventspils, suffered a 38 % drop in oil transshipments last year. The total volume of cargo handled at Ventspils fell to 29 million tonnes, about a quarter less than the previous year. Some 70 % of freight was crude oil or oil products (see previous page). In addition to oil and oil products, also the amount of metals, ammonium, coal and fertilisers handled in Ventspils declined. Latvia's second largest harbour, the Port of Riga, saw its freight volumes rise to 18 million tonnes, an increase of about 20 % from the previous year. The largest rise was seen in coal shipments. The Port of Liepaja handled 4 million tonnes of cargo last year, an increase of about a third from 2001. The volume of Latvian rail freight rose 6 % y-o-y to 40 million tonnes, most of which was transit cargo.

Lithuania – The volume of freight passing through the Port of Klaipeda reached 20 million tonnes in 2002, an increase of 15 % from the previous year. Growth was driven primarily by oil shipments. Last year the railways transported 36 million tonnes of freight, up 22 % from 2001. A direct rail connection between Klaipeda and the Ukrainian port city of Odessa is scheduled to start operating in February. The new connection is expected to divert some of the current freight flows through the Black Sea to the Baltics.

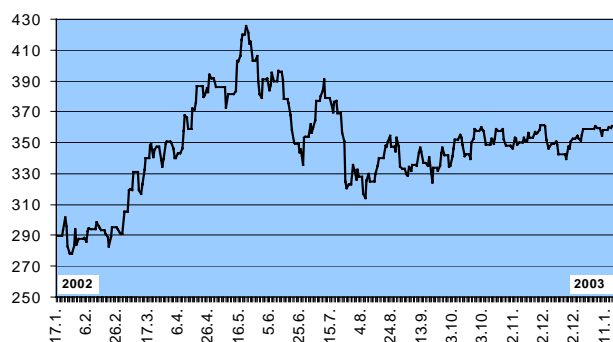
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



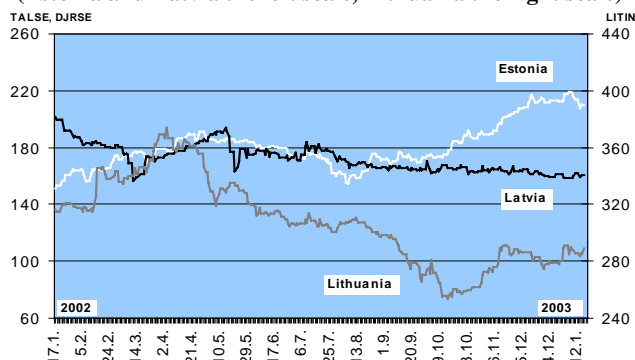
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russia's current account surplus shrank slightly in 2002. Preliminary balance-of-payments figures from the Central Bank of Russia indicate a current account surplus for 2002 of nearly \$32 billion or about 9 % of GDP (down from \$35 billion or 11 % of GDP in 2001). The goods surplus fell to \$45 billion from \$48 billion in 2001. The services deficit also rose slightly to almost \$9 billion.

Russia's earnings on goods exports rose over 4 % to \$106 billion. Revenues from exports of crude oil and oil products increased about 15 %, while earnings from natural gas exports fell over 10 % due to lower prices internationally. Export earnings on other goods rose 2 %. Russia's services exports climbed 20 % to nearly \$13 billion. Export earnings in 4Q02 rose 20 % overall from the year earlier due mainly to the price rise of crude oil and oil products and higher export volumes.

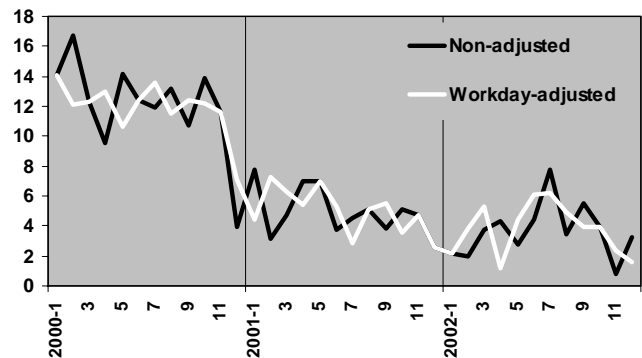
Russian spending on imports rose both for goods (\$61 billion) and services (nearly \$22 billion) in 2002 – a rise of 13 % in dollar terms and 7 % in euro terms. Spending on travel rose over 20 % to more than \$12 billion. In the last quarter of 2002 the overall growth in imports continued strong in dollar terms, but slowed to about 5 % in euro terms.

The financial account deficit contracted last year slightly from 2001 to about \$5 billion. The CBR's gold and foreign exchange reserves increased to over \$11 billion and stood at \$47.8 billion at the beginning of this month.

Preliminary balance of payments data show the net outflow of capital from the corporate and banking sector declined last year to less than \$4 billion (over \$4 billion in 2001). The errors and omissions item shrank to less than minus \$9 billion (minus \$10 billion in 2001), which reflects smaller unrecorded net capital outflows. Foreign direct investment in the Russian enterprise sector (excluding banks) was estimated to have risen slightly in 2002 to \$2.6 billion (\$2.4 billion in 2001).

Russian industrial output growth slowed in 2002. The workday-adjusted figure for industrial output in 4Q02 was up 2.6 % y-o-y and slightly less than 2 % y-o-y in December. For 2002 overall, industrial output grew 3.8 % y-o-y (5 % in 2001). Fastest growth in major industrial sectors in 2002 was seen in the fuel and food industries, as well as nonferrous metallurgy (6 – 7 %). Ferrous metallurgy, building materials, forest industry and manufacturing of machinery and equipment grew 2 – 3 %, while the chemicals industry grew less than 2 %. Russian crude oil production rose nearly 9 % last year, while natural gas production rose over 2 % and electricity production fell slightly.

Russian industrial output, % change from 12 months previous, January 2000 – December 2002



Russian share prices rose in 2002. The RTS index ended up 38 % for the year at 359. The index followed trends on international markets, peaking at 425 in May and falling thereafter. The excellent performance of Russian stock markets mainly reflects the performance of energy companies, whose results were boosted by high oil prices on world markets. Of the top ten RTS companies in terms of their market valuations, seven are involved in energy production. The market valuation of the tradable shares of the three largest companies (YUKOS, Gazprom and LUKoil) is two-thirds of the value of all listed shares (nearly \$86 billion). The biggest RTS movers last year were the oil company Sibneft (up nearly 200 %) and the savings bank Sberbank (up about 150 %).

Russia ends tax on foreign currency purchases. From the beginning of the year, buyers of foreign currency no longer have to pay a 1 % tax on the purchase price. The tax's impact on budget revenues was negligible, but it had substantial costs associated with its collection.

Russia now collects social tax contributions from foreigners. At the beginning of the year Russia eliminated an exemption in the second part of the tax code (§ 239-2), which previously freed employers from mandatory unified social tax contributions for foreign workers. Despite the compulsory payment of social taxes, foreigners will only be eligible for pension, health care, and social benefits on a limited basis. The tax take from the rule is estimated to amount to around \$400 million a year, and will be used to fund Russian pensions. One reason for the revised practice was to harmonise the labour costs.

Russian arms exports in 2002. Russian arms export deliveries last year exceeded \$4 billion, down slightly from 2001, when the post-Soviet record of \$4.4 billion was set. The largest buyers of Russian arms were India

and China, which purchased e.g. fighter aircraft, helicopters, tanks and missiles. According to the information agency of Russian defence sector, Russia's total defence industry output rose nearly 23 % y-o-y in the first nine months of 2002, with the aircraft industry up 41 % and the weapons industry up 26 %.

The Russian government on January 16 approved state orders for the defence industry in this year worth nearly RUB 110 billion (\$3.4 billion), a third more than in 2002. About half this sum will be used on R&D, while the other half will go to procurement of weapons and equipment.

Baltic bourses in 2002. The market value of shares listed on the *Tallinn* stock exchange at the end of 2002 was €2.3 billion or about 35 % of Estonian GDP. The TALSE index rose nearly 50 % for the year, driven largely by the share prices of largest firms – Hansapank and Eesti Telekom. There are 15 companies listed on the Tallinn bourse. The value of shares traded in 2002 was €70 million.

The market value of shares listed on the *Riga* stock exchange at the end of 2002 was nearly €700 million or slightly less than 10 % of Latvian GDP. The DJRSE index was down 24 % for the year due to a drop in all three companies in the main list – Latvijas Gaze, LASCO and Ventspils Nafta. There are 63 companies listed on the Riga stock exchange. About €120 million worth of shares were traded last year.

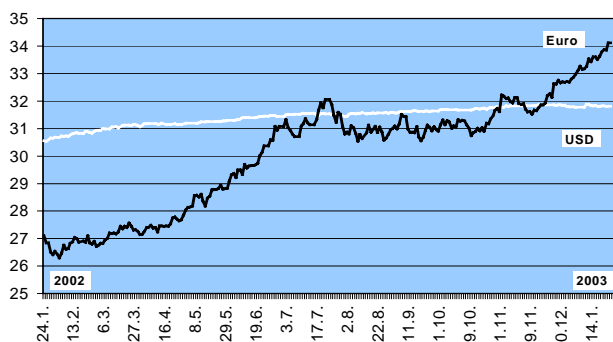
On the *Vilnius* bourse, the market value of listed shares at year's end was €1.4 billion or about 10 % of Lithuanian GDP. Of the 40 companies listed on the exchange, the market valuation of Lietuvos Telekomas was

by far the largest. The LITIN index fell 13 % last year. The value of shares traded on the Lithuanian bourse was about €190 million.

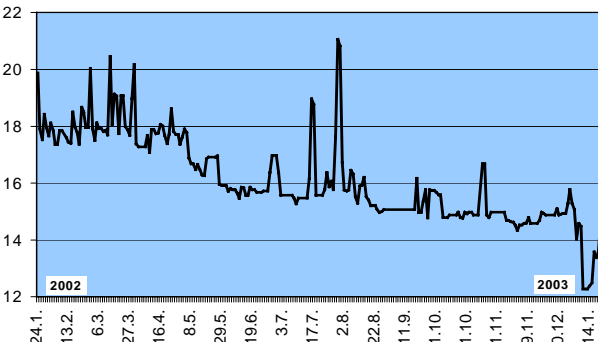
Baltic central bank gold and foreign exchange reserves grew in 2002. Estonia's gold and foreign exchange reserves stood at €60 million at year's end, up 3 % from a year earlier. The reserves were sufficient to cover two months of imports of goods and services to Estonia. Latvian foreign reserves at year's end stood at €1.3 billion, an increase of 9 % in dollar terms. The reserves were sufficient to cover three months of imports. Lithuanian reserves at the end of the year were €2.3 billion, or about 20 % more than a year earlier. The largest contribution to the increase in reserves came from purchases of foreign currency from commercial banks. The reserves were sufficient to cover over three months worth of goods and services imports.

Monopoly on fixed phone line services end in Latvia and Lithuania. Lattelekom and Lietuvos Telekomas relinquished their monopoly status at the start of the year, when competition opened up on the market for fixed-telephone-line services in compliance with EU regulations. Some 22 new operators have applied for permits to offer telephone services in Latvia. Eight new companies have expressed interest in offering telephone services in Lithuania. Lietuvos Telekomas has yet to make an interconnection agreement with any of the new companies that would define how much they would reimburse Lietuvos Telekomas for the use of its telephone network.

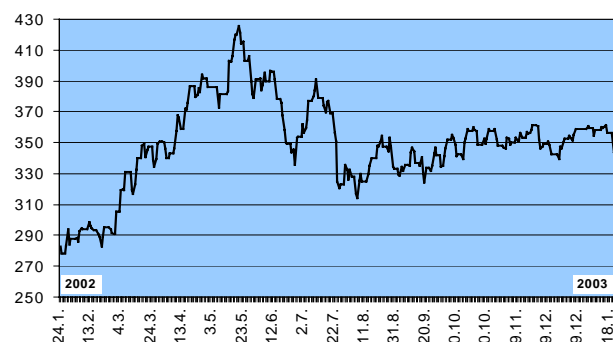
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



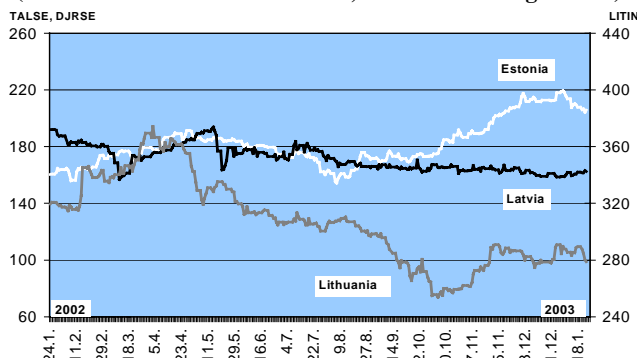
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Russian share prices (RTS)



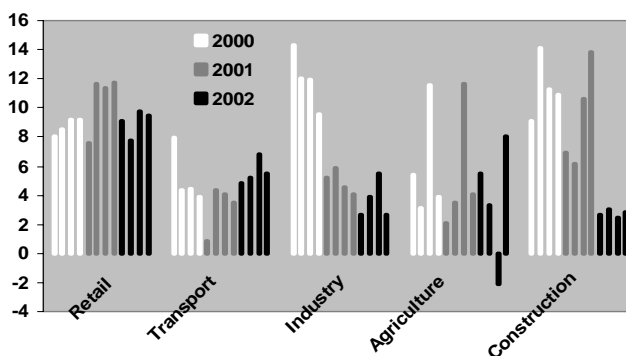
Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian economic growth slowed in 2002. The indicator of Russian economic growth, which is based on the performance of five key sectors, rose 3.9 % in 2002 and was down from 5.7 % in 2001. The indicator also held steady at 3.9 % y-o-y in 4Q02. The volume of retail sales last year rose over 9 % and growth continued strong throughout the year. Transport experienced growth of 5 – 6 % both on-year and in the fourth quarter. Increasing agricultural production, which, however, grew less than 2 % for the year, also supported the growth in the fourth quarter. Construction growth slowed last year to an overall rate of 2.7 % y-o-y, although growth recovered slightly in the fourth quarter. Total investment in Russia only rose by 2.6 %.

Growth in Russia's key economic sectors, 2000 - 2002, (percentage change from four quarters previous)



Rouble's real exchange rate weakened slightly in 2002.

The rouble's nominal exchange rate weakened by 5.5 % from December 2001 to December 2002 with respect to the US dollar, which the Central Bank of Russia uses as its reference currency. Because inflation in Russia was higher than in the US, the rouble's real exchange rate to the dollar strengthened almost 6 %. However, the dollar has weakened substantially against the euro since last spring, which caused the rouble's nominal value in relation to the euro to fall 17 % between December 2001 and December 2002. The decline against the euro was reflected in an over 10 % drop in the rouble's nominal exchange rate – and over 2 % in real terms – against a basket of currencies of Russia's main trading partners.

Russian real incomes continued to rise in 2002, wage arrears persist. The real disposable incomes of Russians grew about 9 % in 2002, an increase quite similar to that of 2001. Real wages rose 17 %, compared to 20 % registered in 2001. Monthly wages in 2002 averaged about 4,400 roubles (148 euros). The highest wages, which exceeded the average wage by several times, were again paid in the oil and gas industry and the financial sector.

At the beginning of 2003, wage arrears in Russia were nearly RUB 31 billion (€9.9 billion). Of that, nearly 90 % was owed by the enterprise sector. The remaining wage arrears were owed by various public sector budgets,

mainly regional and local budgets. In January 2002, wage arrears stood at about RUB 30 billion.

Russian government sets meat import quotas. The government recently approved three decrees that restrict imports of beef, pork, and poultry from April. The import quotas are 315,000 tonnes for beef and 335,000 tonnes for pork. The tariff on imports under quota is 15 %, while import tariffs over the quota rise to 60 % for beef and 80 % for pork. The import quota on poultry is 744,000 tonnes, and no imports exceeding the quota will be allowed. The quotas for beef, pork and poultry will be shared among foreign companies based on their average meat exports to Russia during the past three years. A 10 % import quota will also be auctioned to foreign companies who have not exported meat to Russia previously. Quotas on poultry are allocated also by country: about 75 % of the quota is reserved for US producers, 19 % for producers in EU countries, nearly 5 % for Brazilian producers and less than 1 % for Chinese producers.

Agriculture minister Alexei **Gordeyev** said the new import quotas were not a response to recent EU restrictions on grain imports, rather the new quotas were needed to assure adequate food self-sufficiency. In 2002, food imports to Russia rose 12 %. The import quotas are expected to reduce imports of beef, pork and poultry by 16 – 30 %, while increasing domestic production by 5 – 20 %. Russia is also considering applying quotas to imports of rice and certain dairy products.

Operation of private pension funds broadened in Russia.

Amendments to the act on non-governmental pension funds allow private pension funds, starting from the beginning of 2004, to compete for investments of the "savings contribution" or third pillar of the new pension scheme. The change in the law gives private pension funds the right to invest pension savings in domestic and foreign securities. Head of the Russian Pension Fund Mikhail **Zurabov** estimates that only 20 % of Russians that pay savings contribution would move their accounts to private pension funds in the early phase of the new scheme. The labour ministry reports that Russia currently has nearly 300 private pension funds, yet only eleven qualify under the amendment to invest the savings contributions of individuals. The law sets minimum requirements on e.g. length of operating experience in the private pension market, number of clients and capitalisation.

Russia's new pension scheme, launched at the beginning of 2002, is still not fully operational. The new rules on investment of pension savings are expected to substantially improve the situation. Under the new scheme, personal pensions will be made up of three pillars. First, all pensioners receive an equal-sized basic payment funded from the federal budget. Second, workers must contribute an amount, which varies according to the worker's earnings and years in the labour force. Finally, workers contribute a percentage of their income as a sav-

ing, paying a smaller percentage as they approach retirement. Until now, the savings contribution has been administered by the Russian Pension Fund, which has invested these savings automatically in government bonds. Under a government decision, state-owned Vnesheconombank will handle in the future investment of savings contributions in the event the worker decides not to participate in a private pension fund.

Russia lowers export tariffs on oil and oil products. In response to a drop in the world market price for crude oil late last year, the Russian government lowered the oil export tariff from \$29.80 to \$25.90 a tonne. The reduction enters into force at the beginning of February and applies to exports to non-CIS countries during February and March. The export tariff on crude-oil-based products was lowered from \$26.80 to \$23.30 a tonne. Since the beginning of the year, Russia has adopted the practice of charging a tariff on oil products that corresponds to 90 % of the prevailing crude oil export tariff.

Estonia's new bankruptcy law. On January 23, the Estonian parliament approved a new bankruptcy act. The legislation seeks to accelerate the bankruptcy process and improve supervision of trustees. The new law also gives insolvent companies better opportunities to reorganise before they go into liquidation.

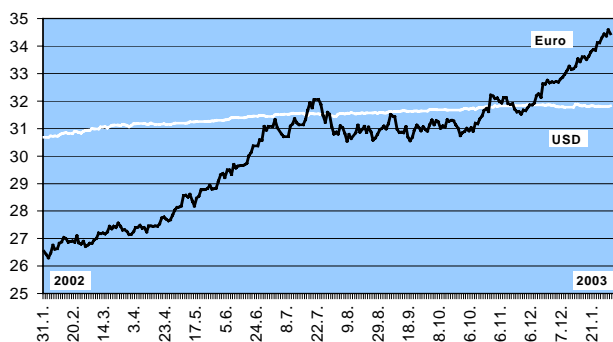
Lithuania revises its law on sales of agricultural land. On January 23, the Lithuanian parliament approved a constitutional amendment that allows the sale of agricul-

tural land to foreigners starting seven years after Lithuania joins the EU. Lithuania, like other EU accession candidates, won a seven-year transition period on sales of agricultural land. The transition period does not apply to resident foreigners who have farmed in Lithuania for at least three years before Lithuania's EU membership.

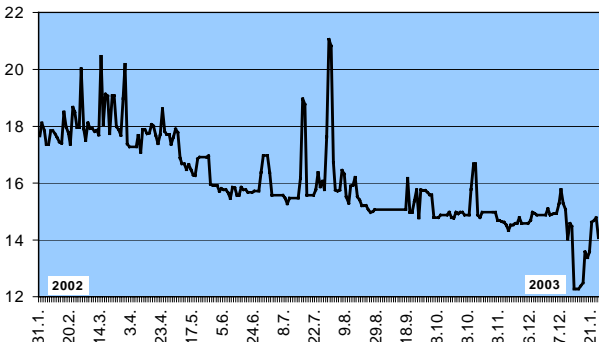
Privatisation agency makes another attempt at privatisation of Lithuanian shipper KTL. Lithuania's state property fund is making its third attempt at selling Klaipėdos Transporto Laivynas (KTL), a company engaged in shipping and ship leasing. The state property fund reported that one bid had been submitted by the deadline, although the identity of the bidder was withheld. The starting bid for an 81 % stake in KTL was LTL 49 million (€4 million). The second privatisation sale of KTL stumbled due to a lack of bidders, while the first failed because the winning bidder couldn't come up with the money.

Lithuania plans to privatise national air carrier. In the first phase, a 34 % stake in Lithuanian Airlines will be sold. The buyer will have two years to acquire another 32 % of the company's shares, whereby the state would retain a 34 % stake. The nominal value of the 66 % stake is LTL 12.3 million (€3.6 million). Interested buyers must declare their intention to participate in the bidding at the beginning of February.

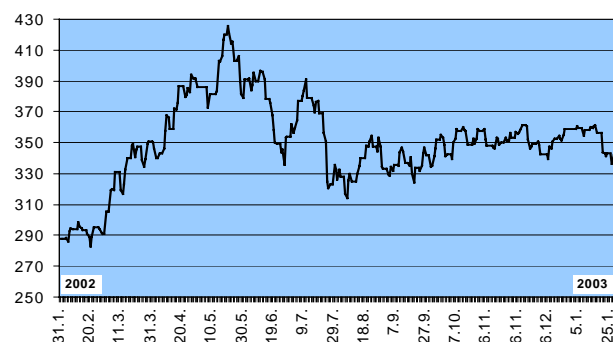
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



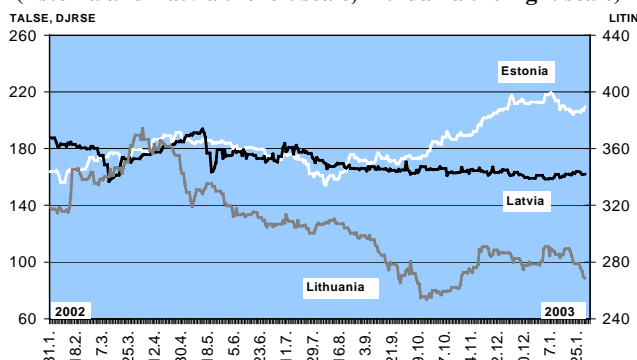
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Prices of services in Russia continue to climb rapidly.

As is usual for the beginning of the year, the increase in consumer prices accelerated in January 2003, driving on-month inflation up to 2.4 %. The rise was mainly due to hikes in rents, municipal services and mass transit fees introduced at the start of the year. Although inflation was lower than in January 2002, it still outstripped the authorities' expectations. During the past twelve months consumer prices rose 14.3 %. Officials expect 12-month inflation to slow to around 10 – 12 % by the end of this year.

The State Statistics Committee also published a figure for base inflation for the first time. The new number describes the change in consumer prices omitting the effects of price changes from one-time administrative decisions and seasonal factors. Russia's base inflation rate in January was 1.2 %.

Russian government decides on debt restructuring for agricultural producers.

The government's decree divides producers into five classes based on their economic circumstances and allows the debtor to postpone debt repayment for at least five and no more than seven years. Thereafter, the loan must be paid back within five to six years. The decree applies to the debts of agricultural producers to budgets at various administrative levels and providers of goods and services. The agriculture ministry puts the indebtedness of agricultural producers at about RUB 340 billion (€10 billion), of which half is currently in default. Producers are only eligible for debt restructuring if they pay their taxes and liabilities in full during the three months prior to the start of the restructuring.

Agriculture minister Alexei **Gordeyev** said the approved debt restructuring measures are the most significant ones during Russia's economic reforms. He believes Russia will increase its annual grain production from the current 85 million tonnes to 100 – 110 million tonnes, which would give the country the opportunity to export about 20 million tonnes annually. In 2002, Russia exported 12 million tonnes of grain. Gordeyev stressed that reaching the goal means that along with the debt restructuring measures, the transport infrastructure needs to be improved and the insurance systems for agricultural producers developed. He said increasing the amount of land under cultivation, which has fallen in recent years, would also increase grain output.

Russia wants to reduce inspection bureaucracy for small firms.

A study by Russia's economy ministry found that legislation introduced in 2001 – 2002 designed to reduce administrative barriers to small business activity had failed to reduce inspection bureaucracy. The operation of dozens of inspection bodies has created a tremen-

dous amount of redundancy and allowed many inspections to be made solely for the purpose of getting money from entrepreneurs. The militia was most eager to make inspections. The economy ministry said the entrepreneurs' burden should be lightened through elimination of unneeded inspections, investigations with mandatory fees and redundant inspections.

Russian government approves forestry development program for 2003 – 2010.

The program's framework, which was approved in summer 2002 (see Week in Review 28/02), has now been given its final shape. By nature, the program is general, specifying e.g. the goals and tasks of developing Russia's forestry and measures to make its administration more effective. The program also considers issues of financing and international cooperation. The aims are to establish a sustainable, economically viable forest economy, and to increase Russia's role in the global forest industry. The program is based on state ownership of forests until 2010. Russian government aims to encourage leasing of forests by competitive bidding for longer periods up to 49 years.

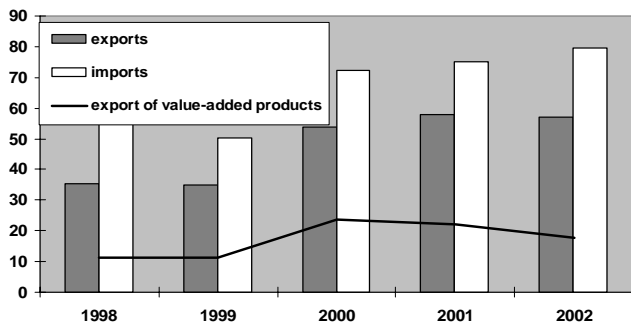
In November 2002, the government approved a separate forest industry development program that extends to 2015. Further, a bill on revising the 1997 forestry act should be submitted to the government by the end of March 2003 for consideration.

Estonian exports down slightly in 2002.

The state statistics office reports Estonian exports fell 2 % overall in 2002, following a rough first half of the year. The drop in exports was due to a 20 % reduction in exports in the crucial machinery and equipment product group (mainly mobile telephones and related components). Exports of timber and wood products and refined metals and metal products rose over 10 % last year. Exports of textiles and textile products grew only 2 %. About a third of Estonian exports consisted of value-added products, the most important of which were mobile phones, clothing and metal products. Nearly 70 % of Estonian exports went to the EU. About a quarter of exports went to Finland (down from 34 % in 2001), 15 % (14 %) to Sweden and 10 % (7 %) to Germany. Russia's share of Estonian exports rose to nearly 4 % (3 %).

Imports to Estonia grew 6 % last year despite the fall in imports of value-added products in the early months of 2002. Machinery and equipment, textiles and metals were the leading import product groups. Vehicle imports rose strongly, exceeding 10 % of Estonia's total imports. Finland, Germany, Sweden and Russia are the main sources of imports to Estonia. The growth in imports was accompanied by a ballooning trade deficit – over 20 % of estimated GDP.

Estonia's foreign trade, EEK billion



Latvian state to sell its shares in Latvijas Krajbanka.

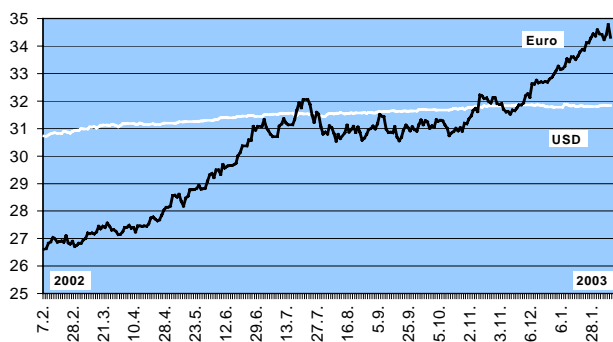
On Tuesday (Feb. 4), the Latvian government approved the economy ministry's proposal to divest the state's 32 % holding in Latvijas Krajbanka (Latvian Savings Bank). 25 % of the bank's shares will be sold at auction. The starting price for one share was set at 1.81 lats, which translates to LVL 4.1 million (€6.7 million) for the 25 % stake. The other 7 % of the bank's shares held by the state will be sold to the bank's current employees and bank pensioners at a price of one lat per share. Krajbanka is Latvia's ninth largest bank with total assets of LVL 170 million (€280 million) at the end of 2002. The bank showed a profit of about LVL 2 million last year. About a third of Krajbanka's shares are held by the Ventspils-based transport companies Ventbunkers, Ventamonjaks and Kalija Parks. Private investors hold the remaining third.

Latvia is the only remaining Baltic country where the state holds assets in the banking sector. In addition to its Krajbanka holdings, the Latvian state owns Latvijas Hipoteku un zemes banka (Mortgage and Land Bank of Latvia).

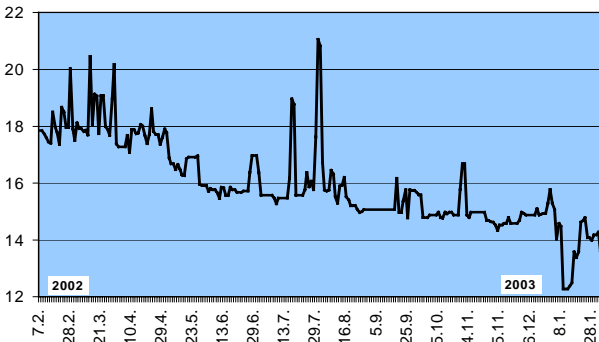
Lithuania privatizes four distilleries. On Monday (Feb. 3), the Lithuanian government decided to sell at public auction majority stakes in four distilleries: Stumbras, Alita, Anyksciu Vynas and Vilniaus Degtine. The government wants to sell the companies before July, when the state monopoly on production of strong beverages ends. The minimum asking price for all four companies is LTL 172 million (€50 million).

Mazeikiu Nafta's losses narrow in 2002. Lithuanian oil company Mazeikiu Nafta showed a loss of LTL 123 million (€6 million) for 2002 under the US GAAP accounting standard. The loss was less than half of company's 2001 loss of LTL 270 million. For 4Q02, the company showed a profit of LTL 52 million as oil supplies from Russia increased. The increase in oil supplies reflects last autumn's ownership change, when the Russian YUKOS assumed a majority stake in Mazeikiu Nafta. Last year, the Mazeikiu Nafta refinery processed 6.6 million tonnes of crude oil, slightly more than half of its estimated annual capacity of 12 million tonnes. Mazeikiu Nafta also owns the Butinge oil terminal, which handled 7.3 million tonnes of oil last year.

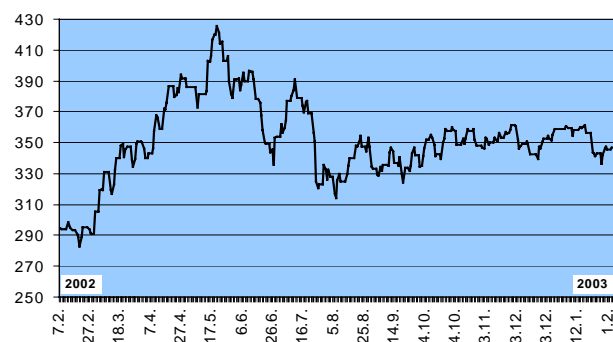
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



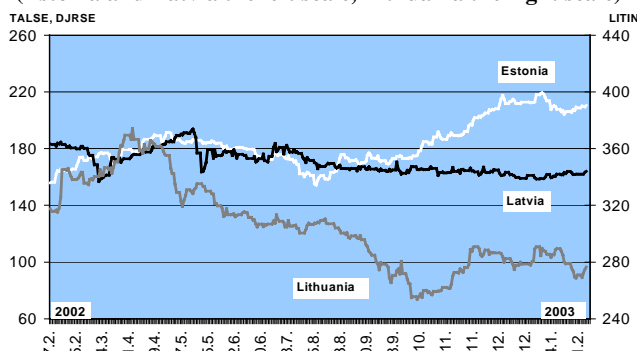
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)

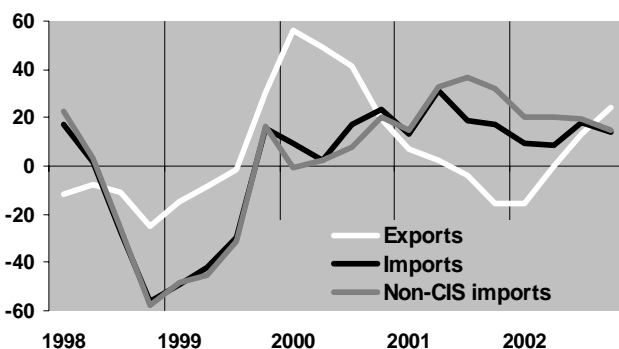




Preliminary figures say Russian GDP grew 4.3 % in 2002. Growth slowed slightly last year from a pace of 5 % in 2001. Services continue to account for a growing share of economic activity. Last year, services output was 60 % of GDP against 40 % for goods production (57 % and 43 %, respectively, in 2001). Also the spending structure of GDP changed: the share of consumption last year grew three percentage points to 68 % of GDP. The growth occurred at the expense of investment and net exports. Fixed investments fell to 18 % of GDP, while inventories were 3 % and net imports 11 %.

Russian exports grew quickly in fourth quarter, as Western imports slowed. The Central Bank of Russia reports that Russia's earnings on export goods rose 24 % y-o-y in 4Q02. The increase mainly reflects higher world oil prices and higher oil export volumes. Goods imports to Russia rose 14 % y-o-y in the fourth quarter, which was slightly off the third-quarter pace. Imports from CIS countries, on the rise since the third quarter, increased 10 % y-o-y. Imports from non-CIS countries grew 15 % in the fourth quarter, slightly below early 2002 rate. Growth slowed to 3 % in euro terms.

Russian goods exports and imports, US\$, percentage change from four quarters previous



Russian government wants to improve administration of state property. Economy minister German Gref reports that the public sector still accounts for half of Russia's GDP. Because state organisations tend to operate inefficiently and strain budget resources, the government now seeks to substantially reduce the state's role and retain only those state assets that necessarily require public ownership. The state currently administers 37,000 offices, nearly 10,000 businesses and over 4,000 joint stock companies. Through divestment, the state should be in a better position to focus administration of the remaining property, i.e. strategic state interests and property related to maintaining a defence capability and securing civil rights.

Russian government considers cutting taxes to boost economic growth. At a cabinet meeting on tax reform, prime minister Mikhail Kasyanov said the room to manoeuvre in state finances should be used for lowering tax rates to spur economic growth during the next few years. In 1999 – 2002, tax revenues represented 32 – 34 % of GDP. The proposal seeks to lower that share to below 31 % already this year.

The government gave a warm reception to a joint proposal from Russia's finance, economy and tax ministries broadly outlining tax changes in coming years. Under the proposal, the unified social tax would be lowered from 35.6 % to about 30 % and the value-added tax would be cut from its current 20 % to 15 – 17 %. Property taxes, in turn, would be targeted to play a greater role in funding regional and local budgets. Property taxes (including land tax) in 2002 accounted for about 13 % of revenues to consolidated regional budgets. A measure allowing firms to deduct a quarter of the value of their long-term investments is also intended to increase investment. The proposal stresses reform of imbursement for use of natural resources. The government hopes to return to the tax reform issue at the end of this month.

BP makes large investment in Russia. British Petroleum plc agreed with the Russian investors Alfa Group & Access-Renova on the creation of a jointly owned energy industry venture. Two Russian oil companies, Tyumen Oil (TNK) and Sidanco, will be consolidated under the new enterprise together with oil exploration rights and refining capacity in Russia. Before the deal BP already held a stake in Sidanco. BP announced the new venture would produce about 1.2 million barrels of oil a day, making it Russia's third largest oil producer.

BP will own 50 % of the new company. It will pay \$3 billion in cash and \$3.75 billion in BP shares in instalments over the next three years. The deal represents the largest single foreign investment ever in Russia. The deal has yet to receive approval from EU and Russian competition officials.

Russia's WTO membership talks continued. In addition to completing another round of bilateral talks earlier this month, Russian representatives met with the WTO-accession working group. Russia's lead negotiator, acting deputy economy minister Maxim Medvedkov, said demands by some WTO members for raising domestic energy prices in Russia have become stronger. Also, Russia's currency controls, including mandatory repatriation of a portion of foreign-currency export earnings, were taken up in negotiations. Russia's press office for the WTO talks said the working group also discussed Russia's tax system, privatisation, and technical barriers

to trade, as well as free trade and the customs union to which Russia belongs. The next round of discussions will be held at the beginning of March.

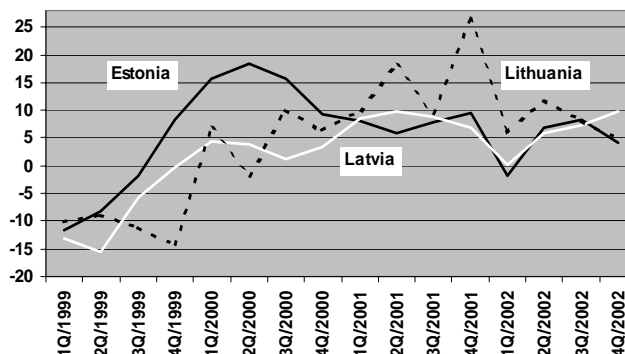
Baltic industrial output growth slowed in 2002. *Estonia:* Industrial output grew 4.5 % in 2002, compared to 7.8 % in 2001. Output rose 4.2 % in the fourth quarter. Among the country's largest industries, the food industry grew only 0.4 % last year as production fell in the fishing and dairy products. Growth was fairly slow in mechanical wood processing (4 %) and the furniture industry (4 %). Production of metals (37 %) and textiles (14 %) grew briskly. Among smaller industries, highest growth was seen in paper and paper products (20 %), as well as manufacturing of electrical devices and equipment (20 %) and office equipment (24 %).

Latvia: Industrial output grew 5.8 % in 2002 (6.9 % in 2001). Growth accelerated towards the end of the year to 10 % y-o-y in the fourth quarter. Production in a key industry, food processing, rose 7 % y-o-y. In other major industries, growth was 8 % in furniture production, 6 % in mechanical wood processing (mainly sawn goods) and 3 % in textiles. Highest growth was seen in minor sectors, including electrical devices and equipment, construction supplies and chemical products.

Lithuania: Industrial output measured by sales was up 7.5 % y-o-y. Growth slowed considerably from the 2001 pace, when output rose 16 %. In the final quarter of 2002, output growth slowed to 4.8 %. Oil refining was down

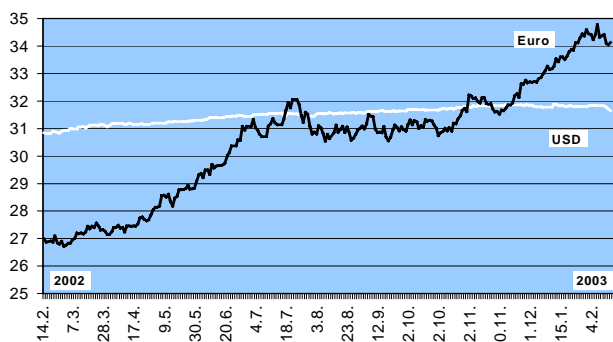
7 % due to reduced oil deliveries to Mazeikiu Nafta's refinery last year. Food processing rose 6 %, textile production 10 %, mechanical wood processing 23 %, chemical products (mostly fertilisers) 20 % and furniture production 31 %.

Baltic industrial output, 12-month change, %

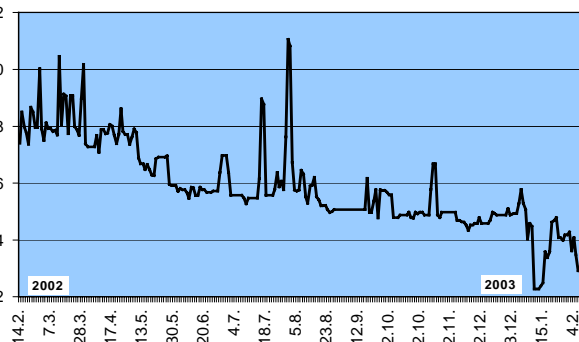


Baltic inflation remains low. January consumer prices rose 2.6 % y-o-y in *Estonia* and 1.4 % in *Latvia*. Deflation continued in *Lithuania*, with prices 2 % lower last month than in January 2002. The monthly rise in prices in January was 1.1 % in *Estonia*, reflecting a 12 % hike in phone rates. January prices rose 0.9 % m-o-m in *Latvia*, and remained unchanged in *Lithuania*.

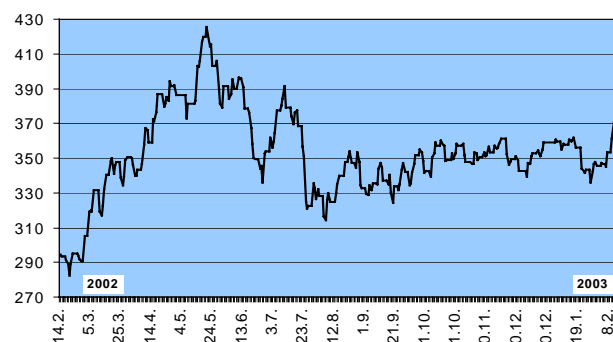
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



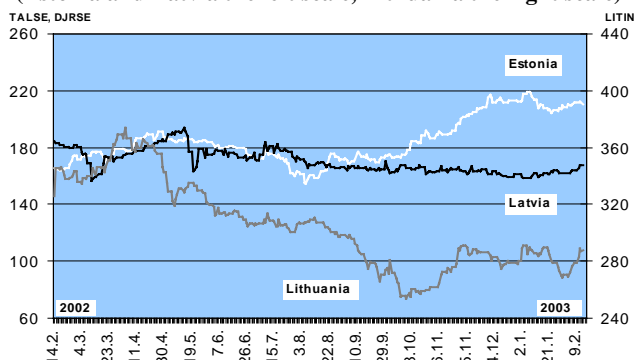
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russia eases rules on taking cash out of the country.

On February 7, the Duma approved a third and final reading of an amendment to the foreign currency act. The change allows anybody to take up to \$3,000 worth of foreign currency out of the country without having to make a customs declaration. Travellers can take up to \$10,000 in cash as long as they declare it with customs. Amounts exceeding \$10,000 must be expatriated either via bank transfer or when declared must be accompanied with a document stating the origin of the money. The amendments apply both to residents and non-residents.

This was the second time that the Duma held the third reading on the bill. The version presented and approved by the Duma at the third reading in December allowed for the expatriation of up to \$10,000 in cash without a declaration. The Federation Council rejected this version. A reconciliation committee representing both the upper and lower houses of parliament produced the final version of the legislation. The Federation Council accepted this new version on February 12.

Currently, Russian residents are only allowed to take \$1,500 dollars out of the country without declaring it, while non-residents have to produce a document declaring the origin of any currency they take out of Russia.

Russia continues to accumulate currency and gold reserves.

The value of the foreign currency and gold reserves held by the Central Bank of Russia hit an all-time peak of \$51.4 billion on February 14. Russia's strong oil export earnings were behind the increase together with the fact that Russian companies in recent weeks have begun to borrow more from international capital markets. Russia's currency reserves are presently sufficient to cover about seven months' worth of imports, a level considered quite good by international standards. Russia's large foreign currency reserves and a string of budget surpluses have also helped stabilise the outlook for the Russian economy. The country would be able to service its foreign debt this year even if the price of oil falls substantially.

CBR increases euro holdings in foreign currency reserves.

The CBR, which holds Russia's foreign currency and gold reserves, has during the past year changed the structure of the reserves by increasing the share of the euro at the expense of the dollar. At the start of 2002 about 90 % of the CBR's currency reserves were dollars and about 10 % euros. A year later, the reserve portfolio held about 75 % dollars and about 20 % euros. Holdings in English pounds and Swiss francs also increased. The CBR reports the modified composition of its reserve portfolio better reflects the structure of Russia's foreign debt and proportionality with the currencies in which it conducts foreign trade. The diversification of currency reserves also helps hedge against strong movements of individual currencies.

EU countries accounted for a greater share of imports to Russia in 2002.

State Customs Committee figures show the share of imports from EU countries to Russia rose to 40 % (37 % in 2001). The share of exports from Russia going to EU countries fell slightly to 35 %. Countries set to join the EU in spring 2004 saw their share of imports to Russia rise above 7 % while their share of Russian exports fell to 13 %. CIS countries saw their share of imports to Russia fall substantially to 22 %. The share of Russian exports to CIS countries remained at 15 %. The main importers to Russia last year were Germany (14 % of total imports), Belarus, Ukraine, United States and China. The main destinations for Russian exports were Germany, Italy, the Netherlands, China, Ukraine, Belarus and Switzerland. Due to imports not registered with customs, the Customs Committee's figure for total imports is almost a quarter less than the corresponding CBR figure (the difference was a couple percentage points larger than in 2001). The difference is due to the fact that the CBR adds its own estimate for unregistered imports to the total imports figure of the Customs.

Russia's main trading partners by region and country in 2002 (region and country data from Russia's State Customs Committee)

Country	Imports, USD billion	Import growth, %	Exports, USD billion
Total (CBR)	60.5	13	106.9
Total (Customs)	46.0	10	105.8
EU	18.2	18	37.4
Germany	6.6	13	8.0
Italy	2.2	29	7.4
France	1.9	23	2.6
Finland	1.5	17	2.9
Great Britain	1.1	11	3.7
Netherlands	1.1	24	7.2
Sweden	1.0	39	1.0
EU entries 2004	3.3	24	13.6
Poland	1.3	34	3.7
Baltics	0.6	29	4.1
CIS countries	10.2	-9	15.6
Belarus	4.1	2	5.8
Ukraine	3.2	-16	5.8
Kazakhstan	1.9	-4	2.4
Others	14.2	13	39.2
United States	3.0	-9	4.0
China	2.4	45	6.8
Brazil	1.3	41	0.2
Japan	1.0	12	1.8
South Korea	0.9	27	1.3
Turkey	0.7	39	3.3
Switzerland	0.4	6	5.3

Russia approves patent law changes. Early this month, president Vladimir **Putin** signed into law amendments to the 1992 patent act. The changes are designed to harmonise Russian law with international practice. Economy minister German **Gref** said the remainder of a legislative

package on protection of intellectual property should be enacted during this year.

Latvia's 2003 budget proposal foresees deficit of 3 % of GDP. The projected deficit is the largest since 1999, when it reached 4 % of GDP. The government expects to reduce the deficit gradually starting next year and get the deficit below 1.5 % of GDP by 2007. Preliminary figures show the country's public sector deficit in 2002 amounted to 2.5 % of GDP, which exceeds the target of 1.8 % of GDP agreed with the IMF. The government said the budget overrun was due to high deficit of the City of Riga and one-time commitments made by the previous government. These included drought compensation to farmers and grants to the organisers of the Eurovision Song Contest.

This year's budget foresees revenues of LVL 1.7 billion (€2.7 billion) and expenditures of nearly LVL 1.9 billion. Public sector expenditures will rise 11 % from 2002, while revenues will grow 8 %. Preparations for memberships in NATO and the EU will increase state spending by nearly LVL 60 million. The parliament commenced its budget review on February 20 and the approval on the budget is expected on February 28.

Latvian exports rose 12 % in 2002. Export growth recovered substantially in 2H02 as exports to EU countries recovered. Some 60 % of Latvian exports went to EU countries while 10 % went to CIS countries. The most important export destinations were Germany, Great Britain and Sweden. Among Latvia's main exports, mechani-

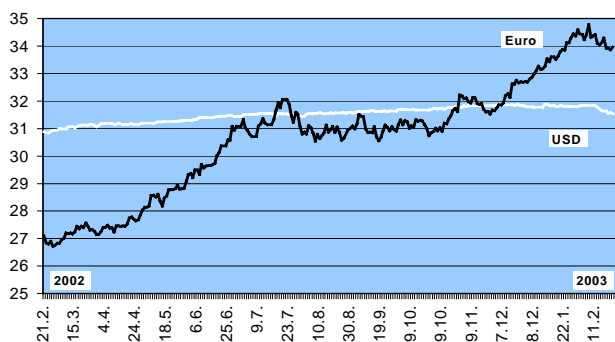
cal wood products were up 11 %, basic metals 16 %, food exports 39 % and textiles just 2 %.

Imports to Latvia rose 10 %. Although exports grew faster than imports, the trade deficit still swelled 6 %. The main imports to Latvia were machinery and equipment, vehicles, chemical and metal products, oil, natural gas and electricity.

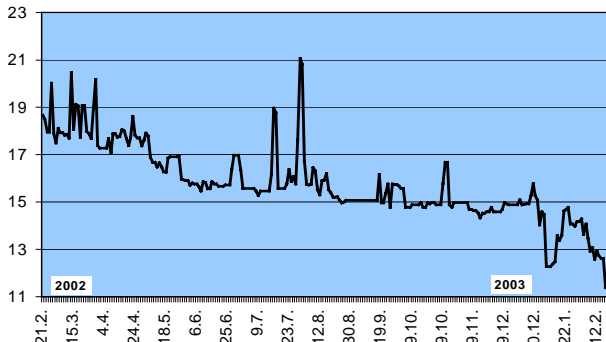
Lithuanian exports and imports up 10 % last year. The trade deficit rose 12 %. Growth in exports accelerated in the last quarter of 2002 as exports to EU countries increased. Out of the key export products the export of vehicles and related parts nearly doubled in 2002. About half of these were transit exports to Russia of used cars originally produced in Central Europe. Exports of metal products also rose briskly (up 41 %). Exports of textiles and machinery and equipment grew just 2 %. Exports of refined oil products declined 10 %. Half of Lithuanian exports went to EU countries and just under a fifth went to CIS countries, mainly Russia. Some 45 % of Lithuanian imports originated in EU countries, particularly durable goods such as machinery and equipment and cars. Russia's share of imports was 21 %, of which over half was oil.

Estonia sells three UMTS licences. The Estonian parliament approved a proposal to sell licences for broadband wireless networks (UMTS) to three operators (EMT, Tele2 and Radiolinja) for a price of EEK 70 million (€4.5 million) per licence. A fourth license will be auctioned later.

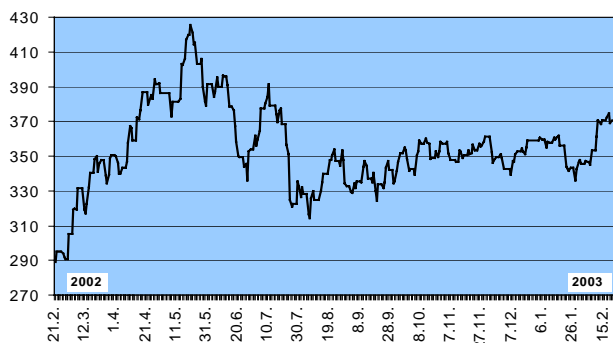
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



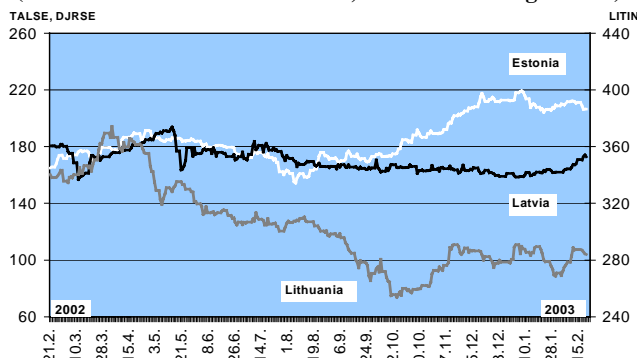
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Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Growth in Russian industrial output accelerates.

Workday-adjusted industrial output in January was up 4.9 % y-o-y, a significant gain from December's growth of less than 2 % y-o-y. Highest on-year growth was seen in exporting industries: non-ferrous and ferrous metallurgy saw production rise 13 – 15 %, while the fuel sector experienced growth of 9 %. Machine-building and light industry, which mainly serve the domestic market, saw output fall 2 – 3 %.

Despite on-year growth, industrial output was down 4.5 % m-o-m in January, which is usual for the start of the year. Monthly growth was seen only in non-ferrous metallurgy, which jumped 11 % m-o-m.

Russia continues to liberalise currency control regime.

On 10 February, the Central Bank of Russia reduced its advance deposit requirement under an import contract from 100 % to 20 % of the value of the goods. The advance deposit requirement was introduced after the 1998 financial crisis and was designed to reduce fictive import contracts used to transfer foreign currency illegally out of Russia. In transactions where the import goods are paid for in advance, the importer must make a deposit in a commercial bank, which is released back to the importer when the goods clear Russian customs.

In addition to reducing the amount of money tied up in such escrow accounts, the CBR also relaxed regulations on return of deposits in cases where the import deal somehow falls through. The reforms ease import by reducing costs. It is expected that the entire system of advance deposits for imports will be abolished when the new currency control reform is approved by the Duma. Under the proposed reform, the CBR would lose its right to force importers to make advance deposits.

Rouble strengthens on forex markets. The rouble's appreciation against the US dollar in the past two weeks follows an announcement by CBR chairman Sergei Ignatiev that the central bank will alter its monetary stance to place greater emphasis on reducing inflation at the expense of supporting the rouble's external value. The aim is to bring annual inflation down into a range of 10 – 12 % by the end of the year. (Inflation was running at 15 % y-o-y at the end of 2002.) By the same token, the rouble's real value would be allowed to appreciate 4 – 6 % in relation to the basket of the currencies of Russia's main trading partners. Last year, the rouble weakened over 2 % in real terms against the currency basket.

One reason for high inflation is Russia's large export earnings, which, when repatriated, increase the amount of roubles in circulation. The CBR, in accordance with its revised monetary policy, will not be as active as earlier in attempting to suppress rouble appreciation through the purchase of dollars earned from exports and will increasingly allow the market to guide formation of the rouble's exchange rate. As a result of the change, the rouble has strengthened slightly against the dollar. On Friday (Feb.

28), the rouble's exchange rate was 31.58 roubles to the dollar – approximately the same level as in September 2002.

CBR lowers interest rates. On February 17, the CBR lowered its reference rate from 21 % to 18 %. While the reference rate has little impact on monetary policy, it is used to set late payment penalty interest and certain taxation values. The CBR simultaneously lowered several interest rates it actively uses in effecting monetary policy. The overnight deposit rate it pays to commercial banks was lowered by one percentage point to 1 % and its one-week deposit rate to 2 %. The overnight credit and currency swap rates were kept at 18 %.

Progress in reform of Russian power sector. Last week, the Duma approved a package of six bills on reform of Russia's electrical power sector. The bills, first taken up by the Duma in spring 2002, seek to increase competition in the field and enhance investment by breaking up the electrical power monopoly UES into smaller private power generation companies. Also deregulation of prices is envisaged. The state would stay as a majority owner of the power grid and power transmission companies. The legislative package would also give the government greater authority to decide on the timing and details of reform. Price regulation will likely continue in the wholesale market for electricity at least until July 2005, while the price of electricity sold to consumers would continue to be regulated until 2008. Before price deregulation, price formation in deregulated markets will be tested in several regions.

Russian unemployment on the rise. The State Statistics Committee reports that Russia's unemployment rate, which slowed in the first part of 2002, has been rising since September 2002. The Committee said that since September 2002, it has revised its unemployment figures based on a separate study. However, the Committee gave no further details on the effect of these changes on unemployment statistics. In August 2002, the number of unemployed persons calculated according to ILO methodology was 5.2 million. At the end of 2002, the number of unemployed has risen to 6.2 million. The number of persons officially registered as unemployed, however, was only 1.3 million in December 2002. The ILO unemployment rate was about 9 %.

Russia readies draft for nationalisation act. Last week (Feb. 20), the Russian government approved a proposed draft of a nationalisation act designed to govern situations where private property is taken as state property. Such nationalisation could only be invoked where national defence or security are at stake, and involves strategic property, which may include land, structures, machinery, devices, equipment, raw materials and processed goods. Upon taking, the owner must be fairly compensated for

the property and any related loss. Funds for such takings must be incorporated into the upcoming year's budget, but would be secret under a national security clause. Moreover, information on the property to be taken would also remain secret. The legal basis for the taking would, if need, be established in court. The final decision to nationalise property is made by the federal government.

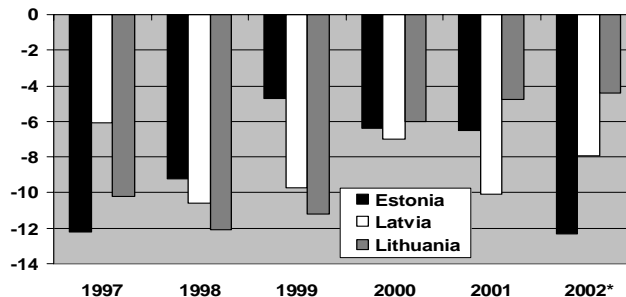
First deputy state property minister Alexander **Braverman** said the nationalisation act would improve Russia's investment climate as it clarifies the Russian constitution's takings clause by providing precise instructions. The government will submit its proposal to the Duma in March. The act is planned to go into force at the beginning of 2004.

Estonia posts largest Baltic current account deficit. Estonia's current account deficit rose last year to over 12 % of forecast GDP. The widening of the current account deficit was driven by a yawning trade deficit. Despite the success of the transportation sector, the services surplus decreased slightly due to increased tourism from Estonia. FDI inflows to Estonia shrank to EEK 5.6 billion (€360 million) and were sufficient to cover 43 % of the current account deficit. FDI outflows from Estonia amounted to EEK 2.5 billion.

Latvia's current account deficit fell below 8 % of GDP as current transfers (mainly EU subsidies) increased substantially. The trade deficit rose slightly as did the services surplus. FDI inflows to Latvia amounted to LVL 270 million (€440 million), which was enough to cover 68 % of the current account deficit.

Lithuania's current account deficit was about 4.5 % of GDP. The goods trade deficit rose 12 %, but was covered by a corresponding rise in the services surplus. As in the other Baltic countries, the income balance remained in deficit, due, among other things, to the repatriation of FDI earnings. The LTL 2.4 billion (€690 million) in FDI inflows to Lithuania were enough to completely cover the current account deficit.

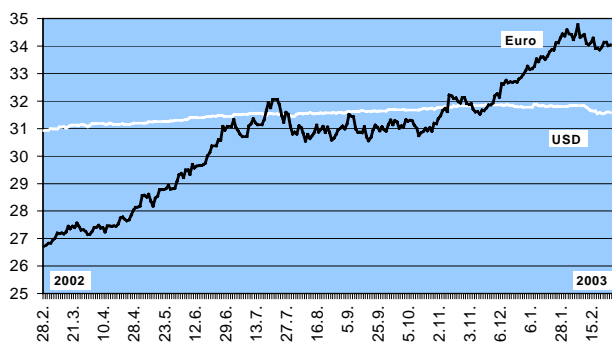
Baltic states' current account deficits, % of GDP



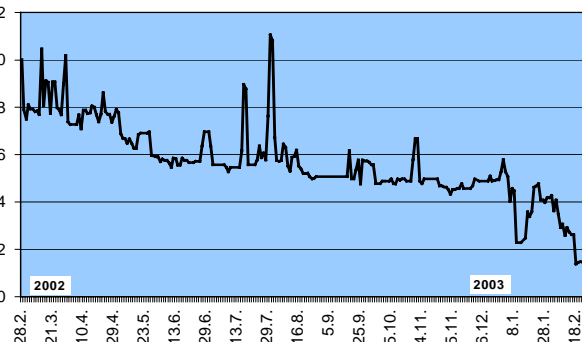
*) Preliminary data

Estonia's parliamentary elections to be held on Sunday. The March 2 elections will decide the composition of Estonia's 101-seat riigikogu. Eleven party lists contain most of the 963 candidates. The biggest winner in the 1999 parliamentary elections was the Centre Party, which took 28 seats. Current opinion polls favour the Centre Party to retain its status as the country's largest party.

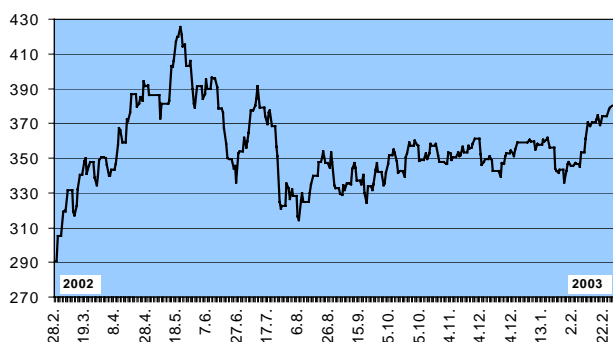
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



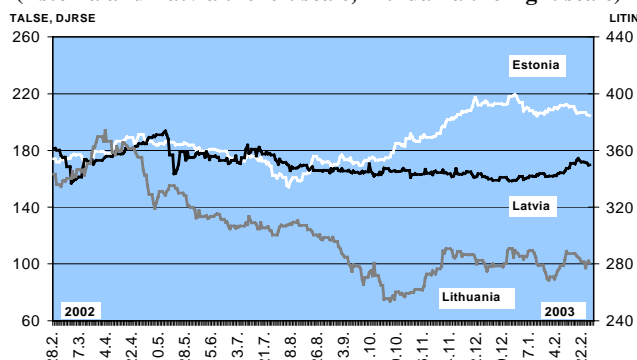
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





BANK OF FINLAND

BOFIT

March 7, 2003

Russian & Baltic Economies

The Week in Review

10•2003

Russian inflation remains high in February. Consumer prices rose 1.6 % m-o-m in February. The brisk inflation rate was again driven by rising housing costs and prices of municipal services, which increased 7.3 % m-o-m. The 12-month rise in consumer prices was 14.8 %.

The on-month change in base inflation was 0.9 % in February. The figure for base inflation omits the impacts of administratively set prices and seasonal effects.

Russian companies borrow more on international markets. The State Statistics Committee reports that foreign investment inflows to Russia last year climbed to \$19.8 billion, a 39 % increase over 2001. The rise was due almost entirely to increased borrowing, which amounted to \$15.3 billion, a 56 % increase from the previous year. The stock of loans with maturities exceeding 180 days more than doubled, while the stock of shorter-term credits diminished. Trade credits went up 22 %. Foreign direct investment inflows to Russia amounted to \$4 billion, approximately the same amount as in 2001. Portfolio investment rose slightly from 2001 to nearly \$500 million.

The growth in lending to Russian enterprises and the lengthening loan maturities reflect improvements in the country's creditworthiness and increased confidence in Russia on the part of international investors. Uncertainty elsewhere in the global economy has also made investment in Russia relatively attractive. In late February, gas monopoly Gazprom floated a ten-year eurobond on the London market. The issue was received with such overwhelming demand that it was increased from an original \$1 billion to \$1.75 billion. The issue was one of the largest ever offered on international markets by company from an emerging market country. The yield is 9.6 %.

Russian cabinet discusses 2002 – 2003 privatisation. At last week's meeting, cabinet members accepted in principle amendments proposed by the finance ministry to the 2003 privatisation program and discussed last year's achievements in privatisation. The original 2003 privatisation program approved in August 2002 was complemented with lists of new companies for privatisation. Assuming the government gives its final approval to the lists, the 2003 program will consist of approximately 2,000 share blocks and affect about 1,000 state unitary enterprises. The state property ministry said privatisation sales this year should bring in about RUB 60 – 70 billion (about €2 billion) to the federal coffers. Some RUB 35 billion was raised from privatisation sales in 2002.

The largest privatisation sales in 2002 involved the sale of a 75 % stake in Slavneft and an approximately 6 % stake in Lukoil. The government hopes this year to sell a 25 % stake in Svyazinvest and 26 % of insurer Rosgosstrakh. The government will also make a special effort to clear its books of holdings in small, low-value companies. Of the over 4,000 joint stock companies in which the state holds stakes, over half of these positions are less

than 25 %. The government holds stakes of less than 2 % in nearly 400 enterprises. The government said it also wants to reduce direct and indirect state ownership in banks.

Russian government submits deposit insurance proposal to Duma. The government last November initially considered proposed legislation on insuring deposits of private individuals in banks operating in Russia. Bank accounts in every bank would, under the proposed scheme, be guaranteed up to a certain limit in the event the bank either had its licence revoked or the CBR imposed a payments freeze on the bank. The maximum full compensation per a person's accounts in one bank would be 20,000 roubles (about 600 euros). Above that limit assets would be guaranteed to 75 % of their value with a maximum compensation of 95,000 roubles (about 3,000 euros). Anything above 120,000 roubles would not be insured. Compensation would be paid out from a deposit insurance fund administered by Russia's Agency for Restructuring of Credit Organisations (ARCO), which was created in the wake of the 1998 financial crisis. Banks participating in the deposit insurance scheme would set aside an amount of money specified by ARCO. Under normal conditions, this would amount to no more than 0.15 % of the value of deposits subject to coverage. ARCO is also required to provide the fund's initial capitalisation. Any possible underfunding could be made up from the federal budget.

Participation in the deposit insurance scheme would require that banks operate in compliance with specified criteria and disclose their true owners. Compliance would be decided by the CBR on the basis of bank inspections. Banks operating outside the deposit insurance scheme would forfeit their right to take new deposits (they could hold earlier deposits, however). Sberbank, which is majority-owned by the CBR and holds two-thirds of all deposits of private individuals, will participate in the deposit insurance scheme. Up to the beginning of 2007, Sberbank will continue to provide its current state-backed and unlimited 100 % deposit guarantee on accounts held by a private individual.

Six parties win seats in next Estonian parliament. Although the Centre Party led by Edgar Savisaar held on to its 28-seat bloc in the *riigikogu*, it must now share the honour of largest parliamentary bloc with right-wing newcomer Res Publica. Res Publica, which is led by Juhan Parts, also took 28 seats. As part of its campaign strategy, Res Publica sought to distance itself from the established parties and emphasised the need to fight corruption and crime. Res Publica's winning ways were foreshadowed by its strong performance in last October's municipal elections, when it took 15 % of the vote. The Centre Party's coalition partner, the Reform Party, netted one seat, raising its representation to 19. The People's Union party, which has its strongest support in rural areas,

won 13 seats (a net gain of 6 seats). The biggest losers were the Pro Patria and Moderates, which each lost 11 seats and managed to hold on to the 7 and 6 seats, respectively. President Arnold **Rüütel**, after discussions with the largest parties, must name a prime minister candidate within two weeks after the election.

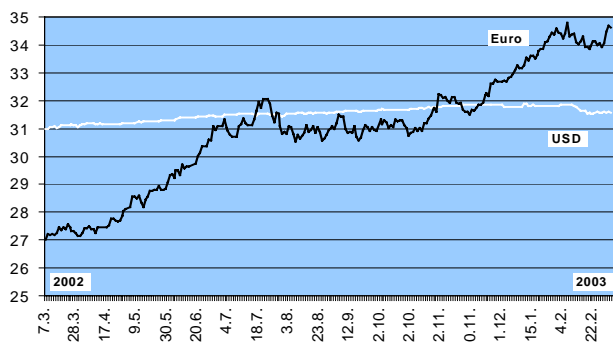
Latvian parliament approves 2003 budget. Under the budget, the public sector deficit will rise this year to 3 % of GDP. The budget rather optimistically assumes GDP growth of 5.5 % this year. The IMF and the Bank of Latvia criticised the government for the large budget deficit. The rising deficit was enhanced by the earlier-agreed cuts in the corporate profit tax from 22 % to 19 %, as well as a lowering of employers' mandatory social security contributions from 26 % to 24 %. State expenditures are expected to increase by LVL 135 million (€20 million) this year to LVL 1.8 billion (€ billion). NATO membership will boost spending by LVL 36 million. Preparations for EU membership (e.g. the budgets of the environmental and justice ministries) will add a further LVL 21 million, while improvements in public administration will cost LVL 15 million. The transportation ministry budget will grow by LVL 19 million, while police salaries will be increased by LVL 11 million. Health and social spending will rise nearly LVL 30 million, due e.g. to increases in the minimum wage and support paid to families.

Lithuania's recent 10-year eurobond issue draws strong interest. On February 20, Lithuania offered for subscription a €400 million bond with a record-low coupon rate of 4.5 %. The emission was clearly oversubscribed and the most interested buyers included German and Austrian investors.

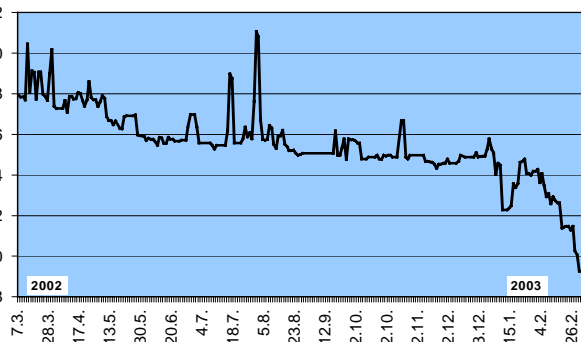
On February 17, the international credit ratings agency Standard & Poor's upgraded Lithuania's long-term currency rating from BBB to BBB+. S&P said Lithuania has improved its public sector balance and managed to secure brisk export growth in the face of tough global economic conditions. S&P expects Lithuanian economic growth to continue robust due to strong domestic demand, supported e.g. by greater access to credit and an increase in real disposable incomes of households.

Plans for March selection of Latvia's president scrubbed. Yesterday (Mar. 6) the Latvian government backed away from its plans for an early presidential election on March 12. There were worries that the early election, set by the parliament only last Monday (Mar. 3) might have been unconstitutional. The term of incumbent president Vaira **Vike-Freiberga** ends July 7 and it is now likely that the election will be held in June, as usual. As of Thursday, Vike-Freiberga was the only declared candidate. All four of the parties in the government coalition and the largest opposition party have announced their support for the re-election of Vike-Freiberga.

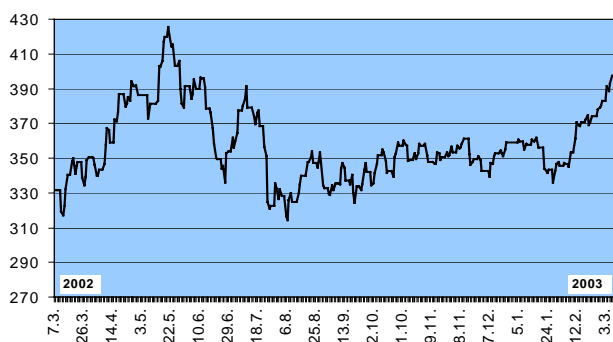
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



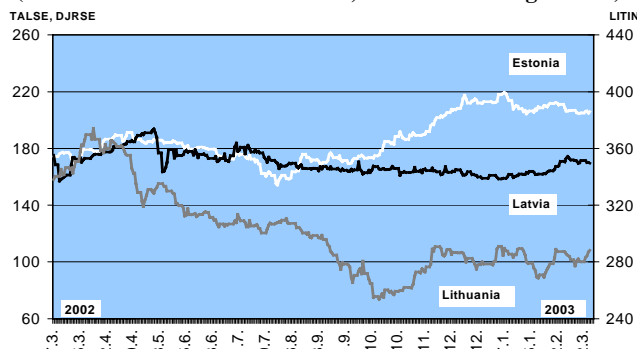
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russia's federal budget surplus shrank in 2002. While the federal budget realised its third surplus in a row last year, the State Statistics Committee figures show the 2002 surplus was only 1.5 % of GDP (revenues 20.3 % and expenditures 18.8 % of GDP) compared to 3 % of GDP in 2001. This year's budget surplus is projected to hit 0.5 % of GDP. The shrinking surplus reflects reduced revenues and increased expenditures relative to GDP.

The largest revenue stream to the federal budget, the value-added tax, last year comprised over a third of total revenues and equals the combined value of the next three largest revenue streams (customs and foreign trade duties, natural resource extraction fees and excise taxes). The largest revenues drops compared to 2001 were seen in the profit tax and customs and foreign trade duties. Revenues from natural resource extraction fees increased many times. Most revenues were applied as transfers to regional and local budgets. Such transfers represented nearly 16 % of total federal expenditures. Defence spending remained at the 2001 level and represented 14 % of expenditures, while the share of spending going to the social and culture sector rose to 14 %. The social tax, which goes into and is distributed out of the national pension fund, represented about 15 % of both revenues and expenditures.

Russia's 2002 consolidated regional budget in the red. The consolidated regional budget, a combination of all regional and local budgets, showed a deficit in 2002 comparable to 0.4 % of GDP (revenues 14.8 % and expenditures 15.2 % of GDP). In comparison, the 2001 consolidated regional budget was balanced, while the 2000 budget produced a surplus equal to 0.5 % of GDP.

The largest revenue sources for the 2002 consolidated regional budget were the income tax (22 % of total revenues), transfers from the federal budget (19 %) and the profit tax (18 %). The relative share of nearly all taxes grew in comparison to 2001. The big exception was the profit tax, which had a 23 % share in 2001. Spending rose faster than revenues in 2002, but the structure of expenditures was the usual. The three largest spending items were education, housing and health care, which together consumed about 50 % of budget expenditures. Nearly all expenditure items increased. The largest spending increase was in education.

Largest growth seen in Russian fuel exports and machinery imports in 2002. Russia's export earnings rose 5 % last year, mainly as a result of a 14 % increase in the volume of crude oil exports (over 10 % in 2001) and a 19 % increase in the volume of oil products exported (13 %). After two years of decline, the volume of natural gas exports also rose 2 %. The average export prices of crude oil and oil products rose only slightly from their 2001 levels, while the export price of natural gas fell about 20 %. The export volumes of certain metals and basic forest industry products also grew. Wheat exports from Russia increased six-fold. Crude oil's share of Russian

goods exports last year rose to 27 % and oil products to 10 %, while the share of natural gas fell to 15 %. The export share of metals, metal products and precious stones remained at 19 %. The share of machinery and equipment fell to below 10 %, while chemical products had a 7 % share. The export share of the forest sector rose slightly, but remained below 5 %.

The State Customs Committee reports the increase in goods imports (up 13 % in dollar terms) was driven by a 16 % increase in machinery and equipment (excl. passenger cars). Imports of food and food ingredients rose 13 %, while forest sector products were up about 20 %. Clothing imports doubled. Imports of machinery and equipment (excl. passenger cars) represented a third of imports registered last year by the Russian customs. The share of food and food ingredients remained at 22 – 23 %. It remains difficult to form an accurate picture of the structure of imports, because the State Customs Committee does not record many imports. Comparison with CBR import figures indicates that about a quarter of all imports went unrecorded by the customs last year.

Putin streamlines bureaucracy. The shake-up announced this week carries through on earlier promises to streamline Russia's public sector and eliminate bureaucratic redundancy. Under presidential decrees, the tax police was eliminated and its duties were transferred to the interior ministry. The federal border guard service was placed under the Russian federal security service FSB. The duties of the federal agency for government communications and information FAPSI were divided between the security service and the defence ministry. The president also moved to establish new state committees for control of narcotic substances and for state defence procurement. The president announced that he had submitted bill proposals on the new arrangements to the Duma. Mr. Putin also announced several personnel changes in the federal government. First deputy prime minister Valentina **Matviyenko**, who is responsible for social issues, was appointed as presidential envoy to Northwest Russia.

Intense talks continue on Russia's WTO membership. In late February and early March, bilateral talks dealt with access of goods and services to the Russian market, while multilateral talks focused on agriculture, the energy sector and Russia's recent imposition of quotas on meat imports. In addition, the meeting of WTO accession working group reviewed Russian legislation and the working group's draft report. Russia's lead negotiator, deputy economy minister Maxim **Medvedkov**, noted progress in the latest round of talks. Talks will continue this month and next and will include multilateral talks on technical barriers to trade, agriculture, import quotas and health and measures against invasive plant species. The next meeting of the accession group is set for the first half of April.

Russia and Belarus to inaugurate currency union at start of 2005. If the formation of the Russia-Belarus union proceeds as envisioned in political treaties and public announcements, the Belarus rouble would be pegged to the Russian rouble at the start of 2004. Moreover, under a November 2000 treaty, the Russian rouble would become the official currency in both countries from the start of 2005, when the Belarus rouble would be replaced with the Russian rouble at a mutually agreed exchange rate. For the start, Russia will provide Belarus with Russian roubles by providing a non-interest loan worth some \$300 million.

The currency emission has been a particularly thorny issue. Arguments have been raised for having the CBR handle the entire emission, both central banks working together and even the creation of a separate joint emission authority.

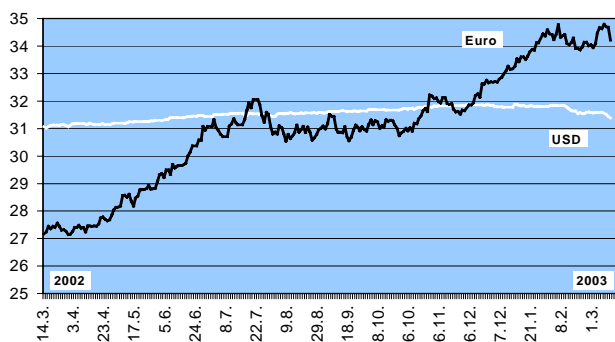
Adoption of a common currency requires large unification of national legislations and deep economic integration.

Baltic states prepare for referendums on EU membership. *Lithuania* votes on EU membership on May 10 – 11, *Estonia* on September 14 and *Latvia* on September 20. In Lithuania and Latvia the referendum result is binding, and acceptance requires a voters turnout of at least 50 %. The Estonian referendum is non-binding and there is no requirement on voters turnout. Recent opinion polls showed EU membership was supported by 68 % of Lithuanians, 57 % of Estonians and 52 % of Latvians.

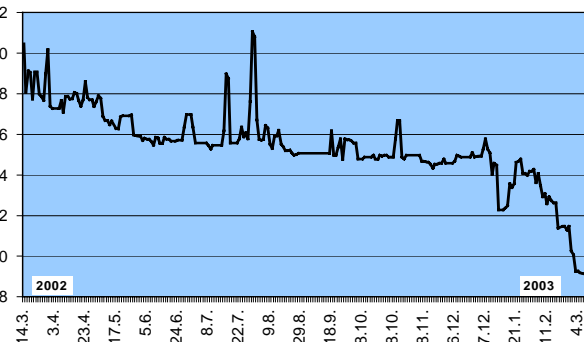
Low inflation in Estonia and Latvia in February, deflation persists in Lithuania. On-year inflation in February was 2.4 % in *Estonia* and 2.1 % in *Latvia*. The deflationary trend that began in *Lithuania* last August continued with consumer prices down 2 % y-o-y.

The on-month rise in prices in February was 0.3 % in both Estonia and Latvia, while prices fell 0.3 % in Lithuania. Prices were up throughout the Baltics in the transport sector due to higher fuel prices. Lower prices for food, clothing and footwear drove deflation in Lithuania.

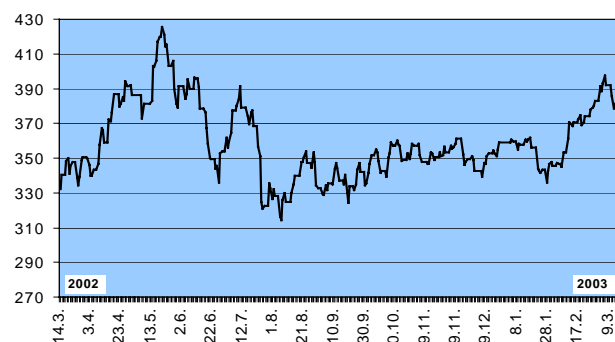
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



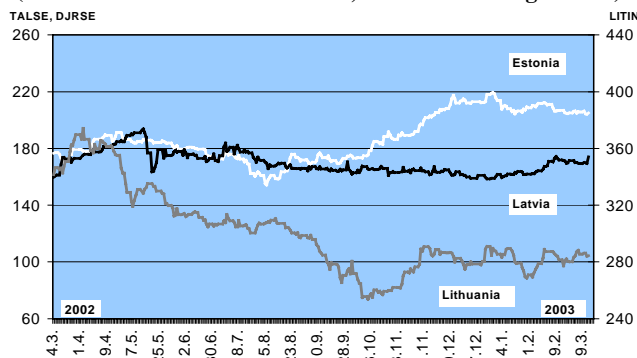
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian industrial output growth accelerates. The State Statistics Committee reports that the workday-adjusted industrial output rose 6.5 % y-o-y in February, up from 4.9 % y-o-y in January. Growth continued strongest in key export sectors, i.e. energy and metallurgy. Machine building also witnessed an above-average increase in production. High growth was registered in crude oil production (up 11 % y-o-y in February), as well as excavation of coal (13 %) and iron ore (15 %). The largest contraction was seen in passenger car production, which fell 27 % from February 2002.

Russian government seeks to reduce tax burden. Last week (Mar. 13), the government considered tax reform measures for 2003 – 2005. Prime minister Mikhail **Kasyanov**, however, felt the finance ministry’s proposals still needed some work and gave the ministry until the beginning of April to hone their proposals and add exact assessments of the economic impact of the proposed measures. Kasyanov said that, the government’s goal was to lower taxes on value-added industries, which calls for retaining federal budget spending on non-interest items on this year’s level in 2004. For commodity producers, the tax burden would remain the same or be increased. The government has also discussed lowering the value-added tax and unified social tax, two of its most significant tax revenue streams.

Russian government outlines 2003 – 2005 debt policy. At the beginning of March, the government approved the framework of a finance ministry proposal on debt policy. Russia has substantially reduced government debt in recent years, and now the proposal focuses mainly on changing the structure of government borrowing. At the beginning of 2003, the government debt, according to the finance ministry, was about \$145 billion (43 % of GDP), of which foreign debt accounted for nearly \$124 billion (83 % of government debt) and domestic debt \$21 billion (17 %). In coming years, the government seeks to increase the share of domestic debt so that by 2006 it would be about \$30 billion. That amount would correspond to 27 % of the estimated government debt (\$113 billion) at the beginning of 2006. The finance ministry said favouring domestic debt over foreign borrowing would lower currency risk and help soak up excess roubles from the market during times of heavy foreign currency inflows.

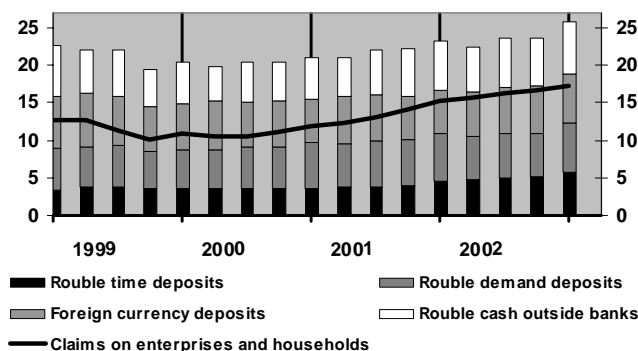
As part of its debt program, Russia proposed the conversion of its debt to the Paris Club of sovereign creditors. At issue is the approximately \$40 billion debt Russia inherited from the Soviet Union. Deputy finance minister Sergei **Kolotukhin** reported that several Paris Club countries had already reacted positively to a proposal to convert up to 10 % of the Paris Club debt, about \$4 billion, to government bonds. Opponents to the move include Germany, the US, the UK and France. The Paris Club had no comment on the plan.

Growth of Russian bank deposits accelerated towards the end of 2002, while growth in lending slowed. The stock of deposits held by banks in Russia at the end of 2002 increased nearly 18 % y-o-y in real terms (13 % y-o-y growth at the end of 2001). Rouble deposits climbed 16 % y-o-y, thanks mainly to rapid growth (32 % y-o-y) in rouble-denominated time deposits. The growth of foreign-currency deposits picked up considerably in the fourth quarter (up over 20 % y-o-y). The amount of rouble deposits rose to 12 % of GDP (€40 billion), and the amount of foreign-currency deposits to nearly 7 % of GDP (€2 billion). Rouble cash in circulation at year’s end had increased over 13 %, and corresponded to 7 % of GDP (€3 billion).

Growth in Russian domestic bank credit slowed in 4Q02. While bank credit extended to private enterprises and households at year’s end was up 17 % in real terms from a year earlier, its increase actually slowed from mid-year, when it was up by nearly a third. Bank credits to publicly held corporations, which correspond to just 6 – 7 % of credit to the private sector, grew 33 % y-o-y. At year’s end, bank credit to the private sector corresponded to 17 % of GDP (€7 billion).

The number of banks licensed with the CBR fell in 2002 to below 1,800. The number of operating banks, however, rose slightly to nearly 1,300.

Deposit and credit stocks of banks operating in Russia and rouble cash in circulation Jan. 1, 1999 – Jan. 1, 2003 (per cent of annual GDP)



Russian government raises oil export tariffs. From the beginning of April to the end of May, the tariff on crude oil exported to non-CIS countries will rise to \$40.30 (currently \$25.90) per tonne, while the tariff on oil products will go up to \$36.30 (\$23.30) per tonne. The bimonthly review of export tariffs seeks to adjust export tariffs based on the world price of Urals-grade crude.

Since the beginning of this year, the export tariff on oil products has been defined as 90 % of the prevailing tariff on crude oil. Prime minister Mikhail **Kasyanov**, however, wants the economy ministry to investigate the possibility of unlinking the oil product tariff from the crude oil tariff to allow the government to determine the oil product tariff separately. The prime minister said the

change would give the government better possibilities to assess the oil product tariff in light of the domestic economic situation.

Estonian 2002 budget showed surplus, while Latvian and Lithuanian budgets ended year in the red. *Estonia's* public sector surplus last year was 1.2 % of forecast GDP (0.4 % in 2001). The state budget surplus was 1.9 % of GDP, while the consolidated municipal budget deficit was 0.7 % of GDP. Higher-than-expected tax income and a social fund surplus swelled the state surplus. In particular, revenues from the value-added tax and corporate profit tax surpassed expectations. State spending was also slightly below forecast. The surplus is to be transferred to the national stabilisation fund.

Latvia's public sector deficit in 2002 was 2.6 % of forecast GDP (1.4 % in 2001), well exceeding the ceiling of 1.8 % of GDP agreed last summer with the IMF. The state budget deficit was 2 % of GDP, and the overall public sector deficit was also boosted by local budget deficits, including the City of Riga. State expenditures grew substantially at the end of last year after the outgoing government last autumn increased one-time spending items.

According to preliminary figures, *Lithuania's* public sector deficit last year corresponded to 1.2 % of GDP (1.9 % in 2001). If correct, it would mean the deficit was below the 1.5 %-of-GDP ceiling agreed with the IMF. Consolidated revenues of municipalities were 4 % greater than forecast, while state revenues were slightly below the budget forecast. Despite rapid consumption growth, reve-

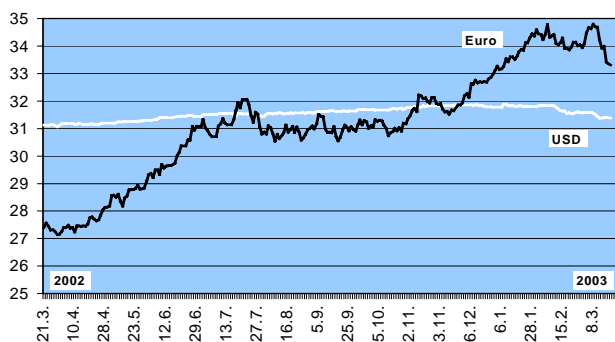
nues from value-added taxes and corporate profit taxes were below projects. This indicates Lithuania still has problems with tax collection.

Public sector debt at the end of 2002 amounted to 5 % of GDP in Estonia, 15 % in Latvia and 26 % in Lithuania.

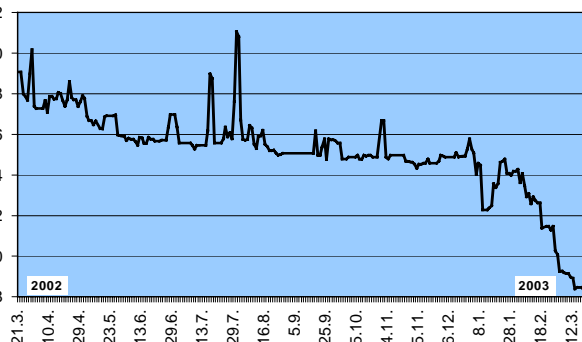
Brisk growth continues in Baltic bank lending. As of end-January, the on-year increase in the nominal value of bank loan stocks was 24 % in *Estonia*, 33 % in *Latvia* and 23 % in *Lithuania*. The growth in loan stocks was driven by rapid growth in lending to the private sector. Fastest growth was seen in housing loans. As of end-January, total loan stocks amounted to EEK 51 billion (€3.3 billion) in Estonia, LVL 2 billion (€2 billion) in Latvia and LTL 12 billion (€3.4 billion) in Lithuania.

Interest rates fell rapidly last year throughout the Baltics. In January, these rates, which quite closely track EURIBOR rates, levelled off until early this month, when they began to fall again. Three-month interbank lending rates as of March 19 were 3.22 % in Estonia, 3.68 % in Latvia and 3.46 % in Lithuania. Credit interest rates have fallen an average of two percentage points over the past twelve months. Interest rates on foreign-currency-denominated loans remain about two percentage points lower than interest rates on loans denominated in domestic currencies. About 80 % of the loan stock in Estonia is denominated in foreign currencies, while the share is just over 50 % in Latvia and Lithuania.

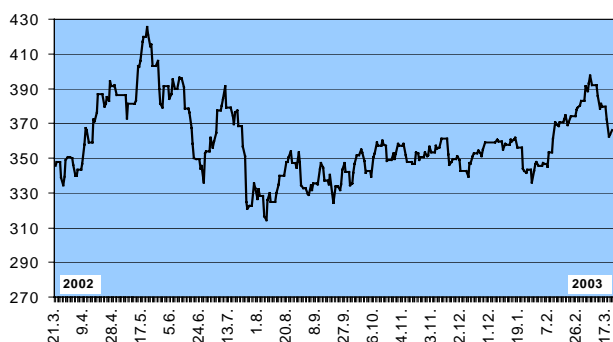
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



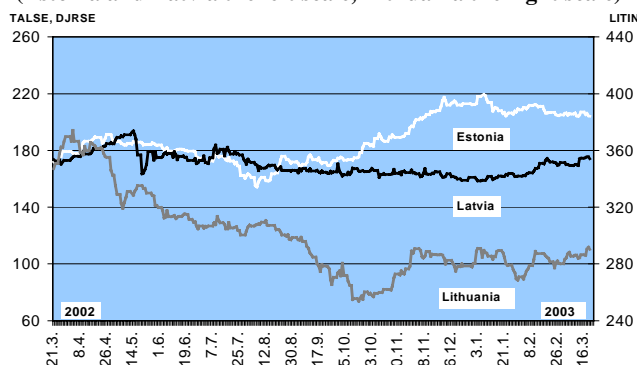
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian economic growth accelerates in January and February. The composite index of economic output based on five key sectors (industry, construction, agriculture, transport and retail trade) was up over 6 % y-o-y for the first two months of 2003. For the period January-February, industrial production increased 6 % y-o-y, freight transport 7 %, retail trade 8 % and construction 14 %. Agricultural output was up slightly over 1 % y-o-y.

The rapid increase in incomes and investment continued to lift production: both real wages and investment rose 10 % y-o-y in January-February. There was a notable increase in the pace of investment, which, for all of last year, was slightly below 3 %. Some of this year's growth spurt, however, reflects the fact that the first two months of 2002 provide a low reference point.

Russia's crude oil production and exports continues to climb. During January and February, Russia's crude oil output (including liquefied petroleum gas) climbed to 65 million tonnes, an increase of 11 % from the same period a year earlier. The country's daily oil output averaged 8.1 million barrels during the period. The government expects oil production to increase by 8 – 10 % this year.

Russian crude oil exports were up 6 % y-o-y in January. With production ratcheted up, oil producers were prepared to export even more oil, but were limited by the lack of pipeline capacity. A certain amount of oil can be shipped by rail, but it is more expensive than piping oil. Operations at oil export ports have also been hampered this winter by unusually severe weather conditions in the Gulf of Finland and the Black Sea.

The economy ministry estimates that oil exports will rise 13 – 14 % this year. The state-owned Transneft pipes the lion's share of Russian oil, and the government agreed last week on investment plans for increasing pipeline capacity. Modernisation of pumping stations to increase pipeline throughput should raise capacity already this year. The government has also decided that, starting next month, it will permit the shipping of regular Urals grade crude oil through pipelines previously dedicated to high-quality Siberian Light grade. The move is expected to raise Russia's annual oil export volumes about 5 %. However, the use of dedicated pipelines means that companies producing higher-grade Siberian Light will receive a lower-than-normal price for their product. Transneft, after suspending its pipeline deliveries to Latvia's Ventspils oil terminal at the start of this year, still has no plans to resume deliveries.

The most significant capacity increase in the near future will occur at Russia's Primorsk harbour, situated on the Gulf of Finland, along with the extension of pipelines serving Primorsk. The goal is to increase Primorsk's capacity by 2005 from the current 240,000 barrels a day (12 million tonnes a year) to 600,000 barrels a day (30 million tonnes a year). Russia is also considering plans to construct new oil pipelines to other directions.

Despite progress in reforming relations between Russia's centre and regions, further steps may be difficult. Although the Duma last month approved the first readings of two bills on reform of regional and local administration, opposition of certain principles of the reform remains, particularly at the regional level. Under the proposed laws, higher administrative levels must refrain from interfering in the use of resources at lower levels, except to the extent they have transferred funds for a specific purpose. In the event that such resources are not applied properly higher administrative authorities can have lower-level administrators fired. The higher administrative level can also temporarily take over the responsibilities of a lower-level administrative unit when it becomes overly indebted.

The committee to draft the reforms, led by Dmitri Kozak, is expected to publish early next month a detailed proposal on allocation of tax revenues at different administrative levels. The proposal deals with one of the reform's most central and most disputed issues, i.e. that revenue sources at any administrative level are adequate to cover costs of performing the tasks delegated to that particular level. Under the original proposal, the reform was to be introduced at the start of 2005. However, the drafting of the legislation is running behind schedule.

Duma accepts second reading of housing policy act. The housing policy bill, which has been under preparation for long and gone through many revisions, was approved in its second reading only on the fourth try – and only by a single-vote margin. Due to this year's parliamentary election the issue of housing reform has become a major campaign theme and several parties want to water down the reform. The approved changes grant greater decision-making authority to regions regarding the housing sector. In practice, this means housing reform will progress at different speeds in different regions. It may also mean that the reform's original purpose, i.e. the transfer of the housing cost burden away from the state to residents, will be realised to varying extents in different regions. The Duma's third reading of the changes lies ahead.

Federation Council approves reform package for electrical power sector. On Wednesday (Mar. 26), Russia's upper-house of parliament approved the last of six bills on reform of Russia's electrical power sector. The Federation Council had rejected the bill, which deals with energy savings measures, in February. The bill was passed after a parliamentary reconciliation commission proposed elimination of the requirement that the government administer separate energy savings funds. The approved version now says that such funds will be managed at the regional level.

Inspection of Russian banks' capital to start. New CBR regulations require banks, if needed, to tidy up their

capital statements to rid them of artificially inflated capital based on assets or guarantees granted to third parties. The new regulations enter into force at the end of March. The head of CBR's banking supervision department Alexei **Simanovski** says the central bank will inspect the capital of all banks during the next two years.

Latvian GDP grew 6.1 % in 2002. Economic growth picked up towards the end of last year, and in the fourth quarter Latvia's GDP was up 8.1 % y-o-y. Produced value-added rose fastest last year in the trade sector, up 13 %. Manufacturing grew 7 %, construction 11 % and the agricultural sector 4 %. The financial sector, as well as real estate and business services each rose over 5 %. The transportation sector suffered from the drop in oil shipments last year, and its produced value-added grew just 2 %. The service sector accounted for over 70 % of GDP, while manufacturing represented some 15 %. Agriculture and forestry accounted for nearly 5 % of GDP.

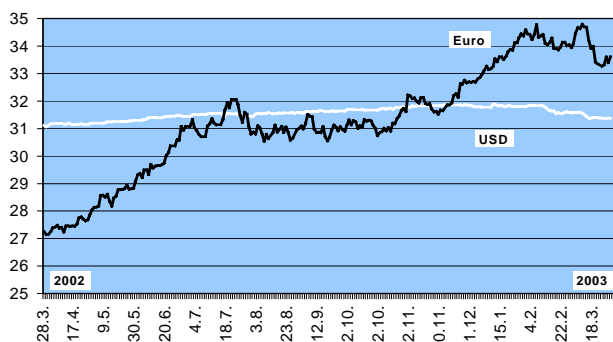
Rising exports and strong domestic demand supported economic growth. A brisk rise in nominal wages, higher employment and growth in credit helped boost consumption by households. Fixed investments and goods exports each rose 12 % last year. Investments increased, particularly in the industry and transport and communications sector, as well as in real estate and business services.

Transneft still not shipping oil via Latvia's Ventspils terminal. Transneft, the state operator of Russia's oil pipeline grid, announced this month that it will not resume oil shipments via the Ventspils terminal at least

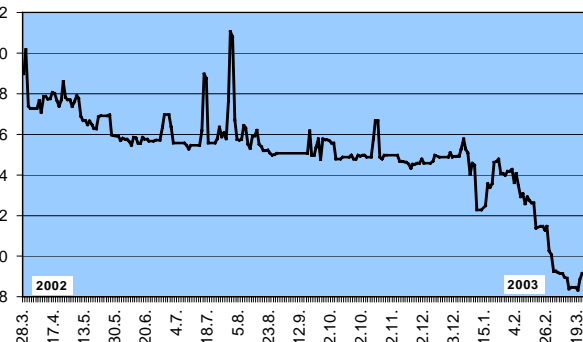
through the second quarter of this year. Already a year ago, Transneft cut back on the volume of crude oil it shipped via Ventspils. At the start of this year, it suspended deliveries completely. Transneft claims its decision is based on the fact that it is cheaper to ship oil via the Primorsk oil terminal (see above). Moreover, Transneft says its oil pipeline capacity is insufficient to simultaneously supply both the Primorsk and Ventspils terminals. The common perception, however, is that the suspension of oil shipments is connected to Transneft's desire to purchase a stake in Ventspils Nafta. The Latvian state currently holds a 43 % stake in Ventspils Nafta. Of that, a 5 % share is reserved for the private company, Latvijas Nafta Tranzits, which currently holds a 47 % stake in Ventspils Nafta. The Latvian government considers the sale of its stake in Ventspils Nafta this year.

The impact of reduced oil transshipment on the Latvian economy is difficult to calculate. It is commonly estimated that oil transshipment directly accounts for 2 – 3 % of Latvian GDP. However, there are also substantially higher figures for the impact. To ensure its survival, Ventspils Nafta began to take oil shipments by rail at the end of last year. This approach apparently provides Latvia with higher value-added than oil brought in by pipeline. However, in January-February, the volume of oil transhipped through Ventspils was one-third less than a year earlier. The situation for the Latvian economy is partly offset by the fact that the volume of freight moving through the country's other large ports, Riga and Liepaja, has increased.

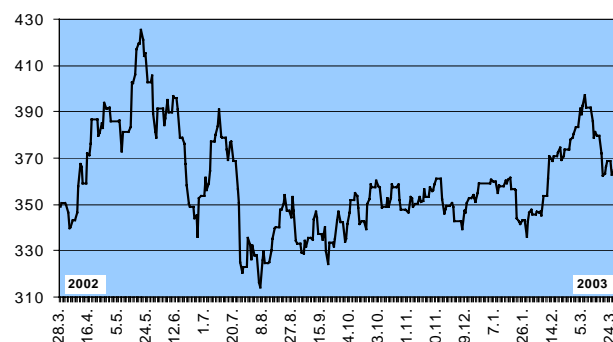
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



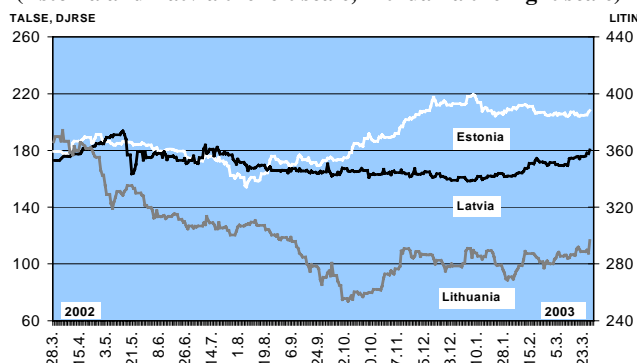
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian current account surplus continues to rise in first quarter. Preliminary Central Bank of Russia figures indicate a surplus of \$11.9 billion for 1Q03, an increase of 75 % from 1Q02. High world energy prices and increased energy exports propelled the rise. The trade surplus grew to \$14.6 billion for the quarter. The value of exports increased 38 % y-o-y, while the value of imports rose 24 % y-o-y. The deficit in services persisted, increasing 11 % over the past four quarters to \$2 billion. The value of imported services increased faster than growth in the value of exported services.

Russia retired \$1.9 billion in public foreign debt in the first quarter, while the net foreign borrowing of Russian companies and financial institutions amounted to \$4.9 billion (mainly loans, but also FDI and portfolio investment). Public sector foreign claims, mainly overdue payments, increased by \$1.4 billion. The foreign claims of companies and financial institutions increased by \$4 billion, over half of which was income not received for exports or payments for imports that never materialised. This figure possibly reflects illegal currency flight. The first quarter figure is slightly smaller than the quarterly average last year. The errors and omissions item in the balance of payments was minus \$1.3 billion, also slightly less than last year's quarterly average. The figure can also be used in estimating unregistered foreign currency exports.

The CBR's foreign currency and gold reserves, after growing \$11.4 billion for all of 2002, grew by a record \$8.1 billion in the first quarter.

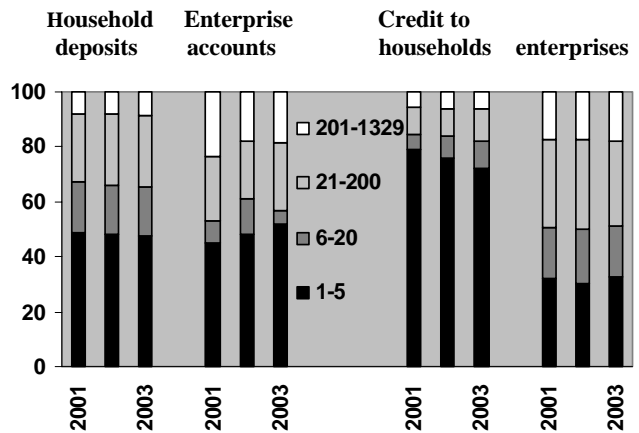
Further changes of deposits and credit concentration in Russia last year. CBR figures show that the stock of bank deposits of households at the end of 2002 rose over 30 % y-o-y in real terms. Deposits in Russia's largest bank, Sberbank, rose more slowly (21 %) and its share of deposits fell to around two-thirds of the total. Deposits with the 19 next-largest banks in terms of total assets increased 80 %, which, in turn, boosted overall share of these banks to 15 %. Among the approximately 1,280 smallest banks, deposits rose 40 – 60 %.

Enterprise accounts grew 10 % overall. Growth was concentrated among the five largest banks (up nearly 20 %), which saw their share of accounts rise to a third. Enterprise accounts increased faster than the average also at the approximately 1,280 smallest banks.

At year's end, the stock of bank credit to companies was up 18 % y-o-y in real terms. Credit granted by Sberbank grew about 15 %, and its share of the total credit stock fell to just over 30 %. The next 19 largest banks increased their lending to enterprises by 20 %, so that their share at year's end was nearly 35 %. The 1,280 smallest banks saw their lending grow 23 – 30 %, increasing their share to 23 %. Credit to households grew 30 %. In Sberbank's case, growth exceeded 50 % and its share of the market rose to 37 %. Credit to households

also rose rapidly (35 – 60 %) for small banks. Their share of the market rose to 38 %.

Deposit and credit shares of 1,329 banks operating in Russia at the beginning of 2001 – 2003, % (banks ranked by total assets)



Reform of Russia's natural gas sector considered, state reacquires majority stake in Gazprom. The Russian government has asked the economy ministry to compare two proposals on reform of the natural gas sector and present its conclusions by the beginning of May. According to unofficial information, one plan seeks deregulation of markets and promotion of competition, while the other would continue with regulation of prices by the state and recognise only gas transport as a separate activity.

Many observers consider reform of the gas sector more challenging than reform of Russia's rail system or electrical power sector, where the Duma has already approved reform measures. President Vladimir **Putin** does not support splitting up Gazprom into smaller companies. Elimination of "ring fence" rule that prevents foreigners from owning more than 20 % of the company has recently been discussed. The ownership is limited to the use of ADRs (American Depositary Receipt); i.e. foreigners can only own Gazprom shares indirectly. In view of the discussion on eliminating the rule, Gazprom announced that the state has increased its ownership stake to above 50 %. The majority position assures the state ultimate say-so in company matters, even in the case of increased foreign ownership.

Russia seeks to create economic area with Ukraine, Belarus and Kazakhstan. Russia's latest cooperation project was launched last February in Moscow. One goal of the plan is to coordinate future member country petitions to the WTO. Russia's economy minister German **Gref** already earlier urged all CIS countries to harmonise their customs practices ahead of WTO membership.

After the break-up of the Soviet Union, Russia entered into several cooperation arrangements with former

Soviet republics (excluding Estonia, Latvia and Lithuania) under the auspices of the *Commonwealth of Independent States, CIS*. This cooperation format has produced few concrete achievements.

Russia carries out economic cooperation also in the *Eurasian Economic Community, EurAsEC*, (formed by Russia, Belarus, Kazakhstan, Kyrgyzstan and Tajikistan), which was founded in May 2001 on the basis of the customs union treaty between the states.

Under the *Collective Security Treaty* signed in 1992, Russia has engaged in joint security efforts with Armenia, Belarus, Kazakhstan, Kyrgyzstan and Tajikistan. Furthermore, Russia is in the *Shanghai Cooperation Organisation*, whose members also include China, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan. The group's main goal is collective security action against Islamic fundamentalism, separatism and terrorism.

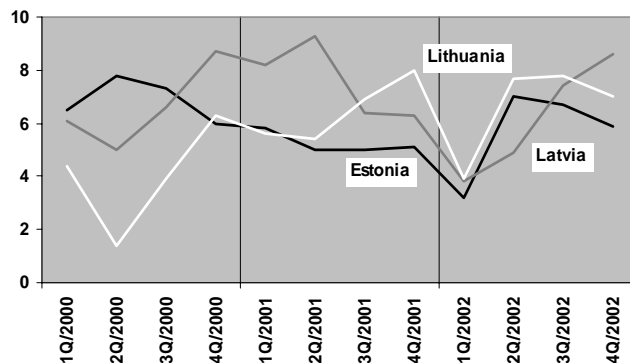
Estonian GDP increased 5.8 % in 2002. After a hiccup in the first quarter, Estonian growth, sustained by strong domestic demand, rose steadily throughout the year. Household consumption rose 8 % last year, while fixed investments grew 18 %. Services exports increased 10 %, while goods exports increased just 3 %.

A 15 % increase in construction reflected higher investment. Service sector growth was led by hotels and restaurants (up 13 %) and trade (10 %). Manufacturing output increased 10 %, while agricultural output fell 5 %.

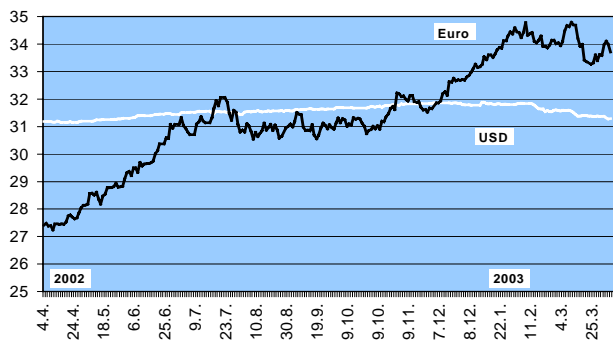
Lithuanian GDP was up 6.7 % in 2002. Services enjoyed strong growth over 2002, with the transportation and communications sector up 13 % and the finance sector 11 %. Construction rose 13 %. The agriculture and forestry sector, and manufacturing sector each had 6 % growth.

Increased exports of goods and services (19 %) and higher fixed investment (12 %) stoked growth in demand. Household consumption and the public sector spending both rose 4 %.

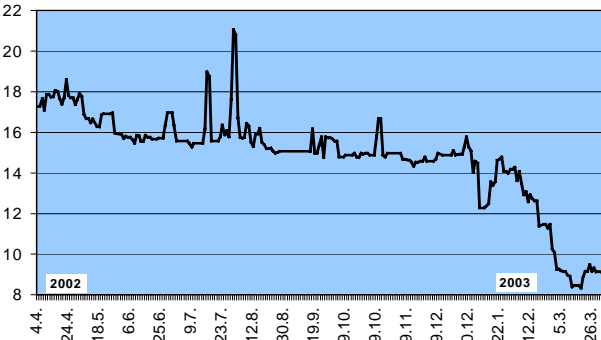
Real GDP of Baltic countries, percentage change from four quarters previous



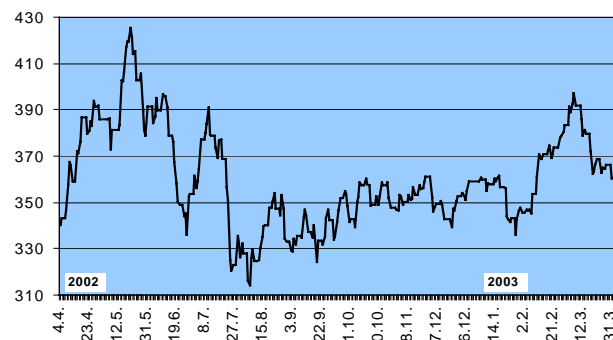
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



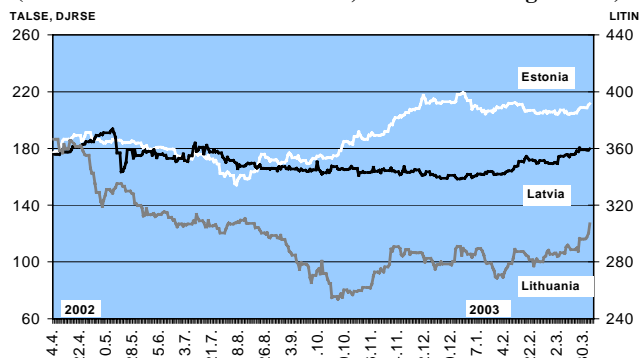
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian inflation remains high. Consumer prices in March rose 1.1 % m-o-m and 14.8 % y-o-y. Despite the government's commitment to lowering 12-month inflation this year to the 10 – 12 % range, prices have already risen 5.2 % since the end of December. The Central Bank of Russia's first deputy chairman Oleg **Vyugin** said early this week that inflation would be running at 13 – 13.5 % at the end of this year unless the finance ministry tightens its fiscal stance by setting aside a larger share of oil export earnings in a state fund. CBR chairman Sergei **Ignatyev** last week proposed modification of the current method for determining oil export tariffs so that when oil prices are high such tariffs would increase more steeply than under the current system. The IMF, among others, has expressed concern about Russia's rising budget expenditure on items other than debt servicing. Non-interest expenditures rose over one percentage point last year to nearly 14 % of GDP. The central bank has also tolerated nominal rouble strengthening since February in order to reduce the inflationary impact of large export earnings. However, the CBR's instruments of monetary policy are too feeble to overcome prevailing inflationary pressures.

IMF lowers its forecast for Russian economic growth. In the IMF's *World Economic Outlook*, published this week, the Fund reduces its forecast for Russian GDP growth this year from the 4.9 % figure it gave last autumn to 4 %. The IMF expects the Russian economy to grow 3.5 % in 2004. In the Fund's view, the lowering was justified by the fact that Russia has made inadequate progress in implementing key structural reforms needed to create sustainable economic growth. Most expert organisations tracking the Russian economy expect growth in the range of 4 – 5 % this year. A few, however, suggest over 6 % growth may be possible given the rapid increase in the pace of investment in the early part of this year.

Duma approves modified federal housing policy bill in third reading. Housing sector reform has risen to the top of the Duma agenda, thanks in part to ongoing problems with providing heat and water in recent winters and approaching Duma elections. The government also helped make the bill more palatable by postponing consideration of a highly controversial part of the reform – the complete transfer of the housing costs to residents in coming years. Above all, the reform seeks to encourage maintenance and repair of housing in accordance with the financial capacity of residents and housing associations, and the profitable operation of power, water and gas utilities. The shift away from subsidised housing would occur incrementally. Needy residents, in turn, would receive financial support from the federal budget. The money would be directed to them via regional and local budgets.

Housing owned by the state and municipalities will continue to make up much of Russia's housing. In the future, the government will regulate housing costs, and rents and fees for municipal services will only be possible to raise once a year in connection with the budget process.

The main responsibility for housing matters will increasingly shift to the local level.

Russia modifies production-sharing rules. The Russian government says Russia no longer needs to make production-sharing agreements with foreign companies. Under the act on production-sharing agreements (PSAs) introduced in the mid-1990s, foreign companies involved in developing extraction of Russia's natural resources, mainly oil deposits, were entitled to special tax breaks and allowed to pay the taxes to the Russian state in product. Today, PSAs have failed to deliver a promised investment boom in Russia's extractive industries and Russian oil companies have convinced the government that they are themselves capable of handling Russia's oil production, and that there is no apparent reason to grant foreign companies production-sharing agreements with competition-distorting tax breaks.

Under the government's amendment submitted to the Duma, licences for exploitation of mineral, oil and gas resources would be auctioned and subject to normal taxation. The production-sharing option would only be made allowed in cases where willing licence buyers were otherwise unavailable.

The proposed changes have raised criticism that Russian policy lines are inconsistent and may foreshadow deterioration in the investment climate. Deputy prime minister Viktor **Khristenko** responded with assurances that the five current approved production-sharing projects would continue in any case.

Russian population diminished further in 2002. Preliminary State Statistics Committee figures show the Russian population at the end of 2002 was 143.1 million, which translates into a loss of nearly 860,000 persons or 0.6 % of the population from a year earlier. On the positive side, the 2002 birth rate increased for the first time in ten years to 9.8 births per thousand persons. Morbidity, on the other hand, was the highest since the post-WWII period with 16.3 deaths per thousand. Cardiovascular failure was the leading cause of death (56 % of all deaths), followed by accidents and poisonings (14 %) and cancer (13 %).

Net immigration in 2002 was nearly 78,000 persons. Most immigrants came from Kazakhstan (42,000 persons), Uzbekistan (24,000) and Ukraine (16,000). The most popular emigration destination was Germany (40,000).

Russia's population has fallen about 5 million since the early 1990s and the average male life expectancy has dropped from 64 to 57 years. In the same period, the average female life expectancy fell by two years to 72.

FDI inflows in 2002 down in Estonia, up in Latvia and Lithuania. Foreign direct investment in *Estonia* fell last year to EEK 5.2 billion (€330 million), a drop of 45 % from 2001. Moreover, unlike in Latvia and Lithuania, most FDI was reinvested earnings. While investment fell

in several segments of the economy, it held up in finance, transportation and communications sectors, as well as trade, real estate and industry. As in previous years, the leading investors by far were Finnish and Swedish firms. FDI outflows from Estonia fell to EEK 2 billion, although investment continued to flow to Latvia and Lithuania and there was a substantial capital outflow to Cyprus-based companies.

FDI inflows to *Latvia* more than doubled last year to LVL 250 million (€10 million). Most investment went to real estate and consulting services. In earlier years, in addition to the aforementioned fields, investment went to trade, communications, the finance sector, and several industrial segments. As before, the leading investors continue to be companies based in Germany, Sweden or Denmark.

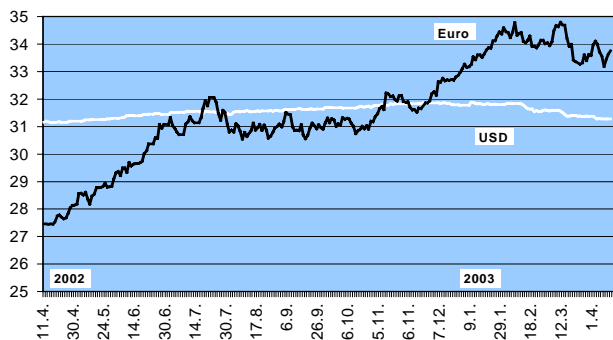
FDI inflows to *Lithuania* last year climbed to LTL 2.8 billion (€800 million), an increase of nearly 60 % over 2001. The biggest investments were directed at acquisition of companies, notably natural gas distributor Lietuvos Dujos and Agriculture Bank. The new ownership arrangement at Mazeikiu Nafta also multiplied by several times the amount of Russian capital invested in Lithuania. The largest providers of FDI to Lithuania were companies in Sweden, Denmark and Estonia. Much of the FDI coming from Estonia involves international companies expanding their operations from Estonia to other Baltic countries. Most investment went to trade, the communications sector, oil refining, and the food, beverage and tobacco industries.

Modest improvements in country-risk ranking of transition economies. *Euromoney* magazine's semi-annual country-risk survey ranked, as earlier, 185 countries, while *Institutional Investor*'s survey now covered 151 countries. Belarus, Slovakia and the Czech Republic showed the largest improvements during the six-month period surveyed. Russia also climbed six places on Institutional Investor's list.

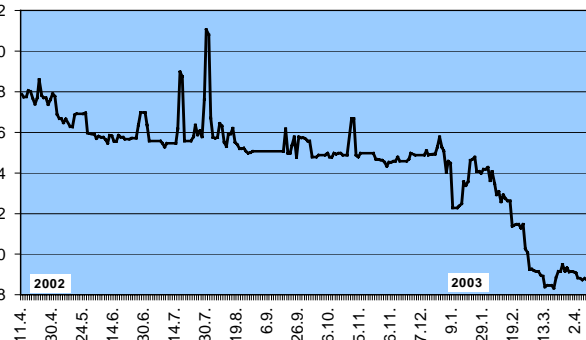
Select country-risk rankings, March 2003, September 2002 and March 2002

	Euromoney			Institutional Investor		
	3/03	9/02	3/02	3/03	9/02	3/02
Slovenia	30	30	33	30	26	28
Hungary	34	35	36	31	30	30
Czech Rep.	37	40	37	33	34	35
Poland	41	42	41	37	37	36
Estonia	44	45	45	40	38	43
Latvia	50	53	52	53	53	56
Slovakia	52	56	46	52	55	54
Lithuania	58	60	62	55	56	58
Bulgaria	71	68	74	67	68	69
Romania	75	73	79	79	79	84
Russia	76	77	98	64	70	80
Ukraine	113	103	120	96	99	104
Belarus	128	128	144	128	139	134

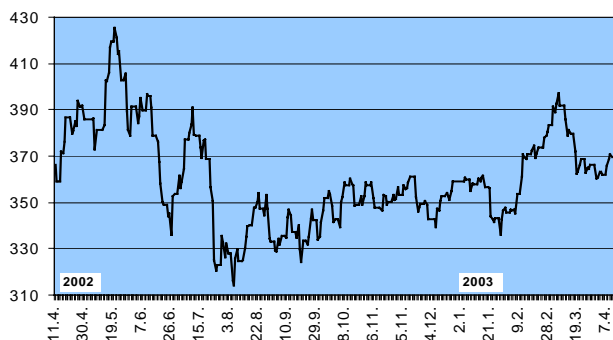
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



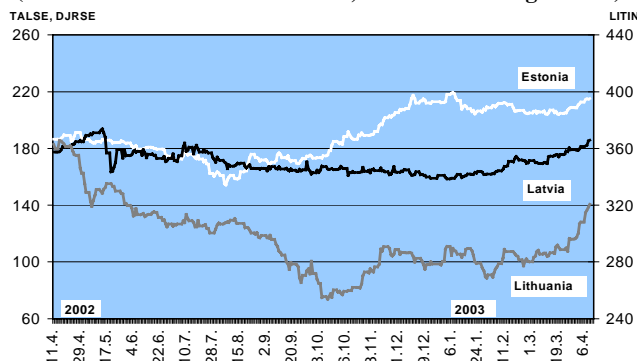
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Rouble's external value continues to strengthen. Since February, when the Central Bank of Russia cut back on its dollar buying and let the market play a greater role in determining the exchange rate, the rouble's value vis-à-vis the dollar has continued to climb. Today's (Apr. 17) rate was 31.19 roubles to the dollar. The rouble-dollar exchange rate was last at this level in May 2002. The rouble has strengthened against the dollar nearly 2 % in nominal terms since the beginning of this year. Although the rouble has also recently gained a bit against the euro, it remains nearly 1 % below its value at the start of the year.

The CBR reports that in the first three months of the year the rouble strengthened 5 % against the dollar in real terms (i.e. taking into account inflation rates in Russia and the US). The value of the rouble against a basket of currencies of Russia's main trading partners strengthened 1.6 % in real terms during the same period.

Most of Russia's exports are priced in dollars, while most imports are priced in euros. Thus, the rouble's strengthening against the dollar has tended to moderate the impact of rising oil prices on rouble export earnings. Conversely, the sharp strengthening of the euro last autumn pushed up rouble import prices.

Despite the CBR's reduced dollar buying, Russia's gold and foreign currency reserves continue to grow. On April 4, the CBR's reserves stood at \$55.8 billion, up from \$47.8 billion at the start of the year.

Russia concludes intensified round of WTO talks. The third round of talks this year, held during the first half of April, included multilateral discussions on sanitary and phytosanitary measures, access of services to the Russian market, import tariff quotas and agriculture, as well as bilateral talks on access of goods and services to the Russian market. The 19th official session of the WTO working party on Russia's WTO accession was also held. In the latest round, the first bilateral agreement on access of goods to the Russian market was signed.

Russian chief negotiator, deputy economy minister Maxim **Medvedkov**, noted that the most controversial topics lie ahead, i.e. agricultural subsidies, EU demands that Russian domestic energy prices be better aligned with world market prices, access to Russian markets for telecommunications, finance, and transportation services markets, as well as demands that Russia accede to a voluntary agreement governing trade in civil aircraft. Medvedkov also stated that the government in March had submitted to the Duma the last draft law included in the government's WTO package. The next draft of the working party's report should be distributed in mid-May and the next meeting of the working party is scheduled for late June or early July.

Impacts of Iraq conflict on Russian economy. Russia has been one of the few countries benefiting economically from the uncertainty related to the Iraq conflict and high oil prices. Before the war broke out world market oil price averaged over 32 dollars a barrel and this week the price has remained rather steady at below 25 dollars a barrel. Future price developments will depend on how quickly the situation in the Persian Gulf stabilises, how well OPEC and other oil producers, including Russia, succeed in limiting oil production as Iraq's output returns to normal levels, and when the global economic picture starts to brighten. Although lower oil prices obviously affect Russian economic development, the federal budget is designed to withstand direct adjustment pressures unless the oil price falls substantially below 20 dollars a barrel.

The Soviet Union and its successor Russia have been important trading partners for Iraq. However, Russia's poor competitiveness may make it difficult for Russia to retain this prominent position. The Russian state inherited the responsibility for collecting some \$8 billion in Soviet loans to Iraq. The US has raised the idea that the debt should be forgiven. It is also unclear whether the old contracts of Russian oil companies with Iraq are still binding, and perhaps more importantly, what role Russian firms will play in the reconstruction of Iraq. It currently looks as though American companies will oversee restoration of Iraq's oil production capabilities. Given the scale of these potential losses, the 5,000 Volga automobiles destined for Iraq and now sitting in the GAZ car company's storage facilities seem a minor problem.

Russia seeks to trim budget spending while reforming taxation. Mikhail **Kasyanov**'s cabinet has long wrestled with the problems of tax reform and is now also considering measures to restrain budget spending. The commission for optimising budget expenditure, led by deputy prime minister Alexei **Kudrin**, has proposed cutting federal spending by RUB 1 billion (€30 million) this year, almost RUB 29 billion next year and nearly RUB 9 billion in 2005. Among other things, the goal is to reduce the state's direct participation in production. An attempt will be made to shift part of the federal spending burden to the local level. The reductions do not apply to support of national defence, law and security, education, science and small business.

The government seeks to lower the tax burden from the start of 2004 from the current 35 % to 33 % of GDP. It is discussing the lowering of the value-added tax, a major revenue source, from 20 % to 18 %. There is also a proposal to cut the regressive social tax maximum from 35.6 % to 33.6 %, or, under a separate proposal, introduce a universal rate of 28 %. It plans to introduce taxes on

corporate assets, inheritance taxes and gift taxes at the start of 2004. At the start of 2005, the state would start collecting property taxes from private individuals, as well as a land tax. In 2006, property taxes and the land tax would be combined into a single real estate tax.

Rise in oil prices drives up Baltic consumer prices in March. Consumer prices in March rose 2.4 % y-o-y in *Estonia* and 2.2 % in *Latvia*, while they fell 1.1 % y-o-y in *Lithuania*. The on month rise in prices in March was 0.3 % in Estonia and Lithuania and 0.5 % in Latvia. The transport sector saw the fastest rise in prices, reflecting higher oil prices.

Juhan Parts heads Estonia's new centre-right government. Estonia's new coalition government comprises the Res Publica Party (which is led by the 36-year-old Parts), the Reform Party and the People's Union. The government parties control 60 of the riigikogu's 101 seats. Res Publica and the Reform Party each got five ministers in the government, while People's Union got four.

The government's program includes increased emphasis on improvement of education and general security and lowering the income tax. The government seeks to lower the income tax gradually from the current 26 % to 20 % by 2006. At the same time, the untaxed share of monthly income would rise to 2,000 kroons (128 euros). The new government has no plans to divest stakes in strategically important enterprises such as the Port of Tallinn or power utilities.

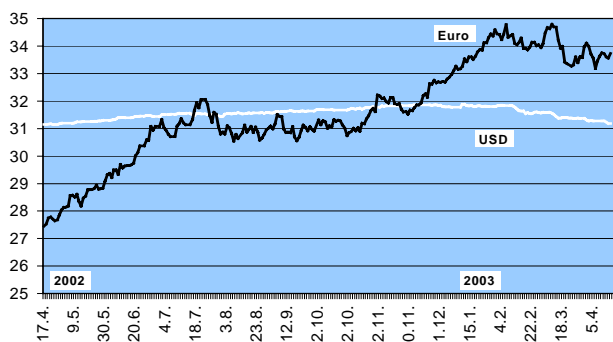
25 % stake in Latvian Savings Bank to be auctioned next month. On 17 May, Latvia's privatisation officials will auction a 25 % stake in Latvian Savings Bank (*Latvijas Krajbanka*). The state will divest its remaining 6 % stake this spring and early summer through directed sales to the bank's current and former employees.

Ten future members sign EU accession treaties at Athens summit on April 16. The accession treaties, which still must pass national referendums and ratification, enter into force on May 1, 2004. Several aspects of the upcoming enlargement may affect the functioning of the EU: incomes in the new member states are lower than the EU average, EU decision-making will become more complex, the EU budget will face increased pressures. Possible effects may also arise from the different historical legacies of old and new members.

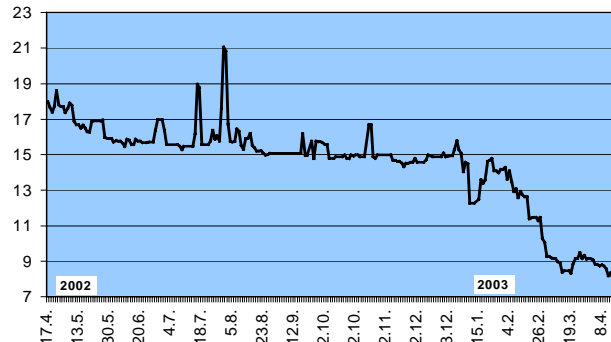
Many see the accession of former socialist countries as recognition that they have been successful in transition to a market economy, democracy and open society.

The focus in EU's foreign policy will shift to relations with its new neighbours – Moldova, Ukraine and Belarus – for which a new proximity policy has to be designed. EU expansion, in turn, will in the first stage focus on southeast Europe. A wider region, extending "from Murmansk to Marrakech," will be developed under the "Wider Europe" and "Common European Economic Space" policy concepts.

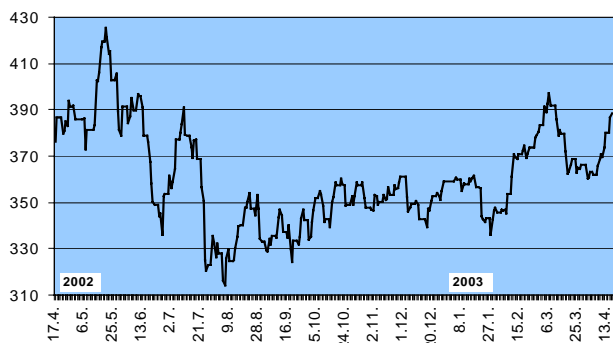
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



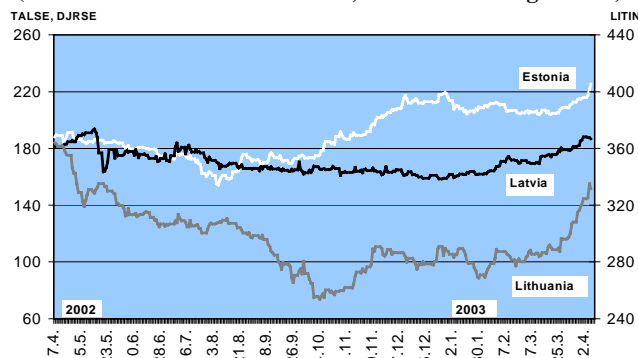
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian economic growth remains strong. The aggregate production in five primary sectors of the Russian economy, which can be used as advance information on GDP evolution, increased nearly 7 % y-o-y in the first quarter. Construction growth led with a 14 % rise, followed by retail trade (9 %), transport (7 %) and industry (6 %). Agricultural output rose 1 % y-o-y. Investment showed large gains, due in part to the low comparison level of a year earlier. In any case, preliminary data indicate investment grew 10 % y-o-y in the first quarter. Given the size of the economy and Russia's investment needs, investment remains modest, less than 20 % of GDP.

The industrial output volume was up nearly 7 % y-o-y in March. Moreover, the pace of growth has accelerated steadily since December. Several export areas continued to enjoy high growth, while growth in home market production was generally lower. This trend implies little progress has been achieved in diversifying Russia's production structure. The increase in output was particularly strong in the energy sector, where crude oil output leaped 11 % y-o-y and coal 15 %. Machine building and metal products saw growth accelerate to 7 % in March, while light industry rose just 1 %.

Russian government proposes lowering tax rates. On Wednesday (Apr. 23), the government proposed lowering the value-added tax at the start of 2004 from its current 20 % to 18 %. The government also wants to lower the tax percentage on the unified social tax, which is regressive. Instead of the current maximum 35.6 %, a 26 % social tax would be paid on annual earnings up to 300,000 roubles (9,000 euros) from the beginning of 2005. The government believes lowering the social tax will encourage more wage payments to be declared for tax purposes. The social tax is mainly used to finance pension, health insurance, and social funds. The government also suggests elimination from the start of next year of the 5 % sales tax that regions collect, as well as the excise tax on natural gas.

To counter-balance the lost revenue, the government would increase the export tax on natural gas from 5 % to 20 %, and raise the tax on crude oil and natural gas extraction. The government estimates its proposed tax structure would lower the effective tax rate next year by 1.75 percentage points of GDP, while boosting GDP growth by 0.5 – 1 percentage points over the coming three years.

CBR reminds of website postings of bank financial information. Last week, the CBR released a list of banks that voluntarily publish information on their balance sheets and operating results on the CBR website using standards of the CBR. This system has been in use for five years. The CBR now plans to update its bank list on a monthly basis. Nearly all of the 198 banks presently on the list release monthly balance sheet figures. Only half

of Russia's 30 largest banks are on the list. Notably missing are Russia's number-one and number-two banks, i.e. Sberbank, in which the CBR holds a majority stake, and Vneshtorgbank. The CBR transferred its ownership in Vneshtorgbank to the government last autumn.

After three years of wrangling, customs code reappears before Duma. The proposed customs code had its first reading in the Duma at the end of 1999. Since re-drafting of the code commenced at the end of 2001, thousands of amendments have been considered. The code was approved in its second Duma reading on April 18. One of the code's main objectives is to rein in the authority of customs officials, which has been rather wide-ranging under the 1993 customs code. The new code shortens the maximum time for customs clearance from ten days to three, while allowing for longer clearances in special circumstances. Although the paperwork required for customs clearance has been defined in greater detail than earlier, some observers note that customs officials may still demand other documents not defined in the code. The new code also abolishes the licensing of commercial customs-related services. The code's third reading is expected in May.

Yukos and Sibneft agree on merger. The core shareholders of Yukos and Sibneft announced the principles of the merger on Tuesday (Apr. 22). Yukos will initially purchase 20 % of Sibneft shares from Sibneft's core owners for a price of \$3 billion. Sibneft's core owners, who hold over 90 % of the company, will swap their remaining stakes for holdings in YukosSibneft, the new entity formed by the merger. YukosSibneft will also make a purchase offer to Sibneft's minor shareholders at a price recommended by an external investment bank. The merger should be complete by the end of this year. YukosSibneft's combined production would amount to around 2.3 million barrels a day, making it the world's fourth largest private oil company. It would also be the world's largest private oil company in terms of proven reserves (approx. 18.4 billion barrels) and the seventh largest in terms of market capitalisation (approx. \$35 billion).

Among other things, it is hoped that the merger will increase the two companies' competitiveness with respect to international oil companies, as well as create better possibilities to expand and invest in Russia and abroad. YukosSibneft also plans to raise its debt ratio.

In February, British Petroleum and the Russian Alfa Group also announced creation of a major joint oil company in Russia.

Russian RTS index climbs. Since the beginning of April, the RTS index of Russian shares has risen 17.5 %. At the end of trading on Wednesday (Apr. 23) the RTS stood at 429, its highest level since 1997. This week the price of Russian companies rose on the news of the

merger of Yukos and Sibneft. Shares of the Surgutneftegaz oil company, for example, climbed 17 % on Tuesday, when the merger was announced. The total market capitalisation of listed Russian companies is presently about \$123 billion, or about 33 % of Russia's GDP. The trading volumes have also increased; this week, daily trading volumes have exceeded \$1 billion (includes trading on domestic bourses and trading in internationally listed ADRs).

Baltic share indices up since start of the year. The Tallinn stock exchange's TALSE index rose to its highest level in five years (225 points) on April 16. Between January 1 and April 23, the TALSE index was up 3 %, while Riga's DJRSE index rose 18 % and the Vilnius LITIN index 14 %. Most shares listed on Baltic exchanges have risen this year. The uptick reflects robust economic development in the Baltics, which in turn has boosted the financial performance of most companies. The approach of EU membership has also spurred investor interest and confidence in Baltic shares.

Baltic bourses are, of course, tiny in comparison to the major stock markets in the EU. The market value of shares listed on the Tallinn stock exchange as of April 23 was €2.4 billion (35 % of GDP). The value of shares listed on the Riga bourse was €0.8 billion (9 % of GDP), while the value of shares listed on the Vilnius exchange was €1.7 billion (11 % of GDP).

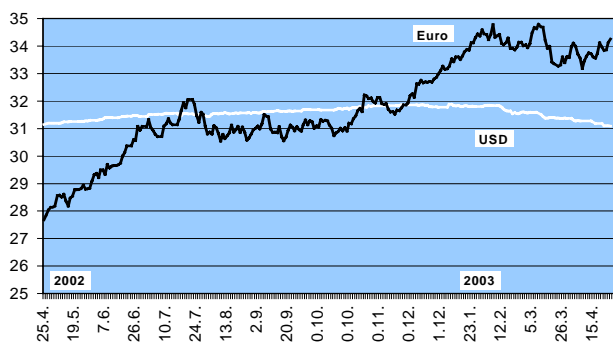
Gazprom keeps investing in Lithuania. The Russian Gazprom purchased the municipal cogeneration plant at

Kaunas from Kauno Energija for LTL 117 million (€34 million). Kauno Energija will use most of the money from the sale to retire debt.

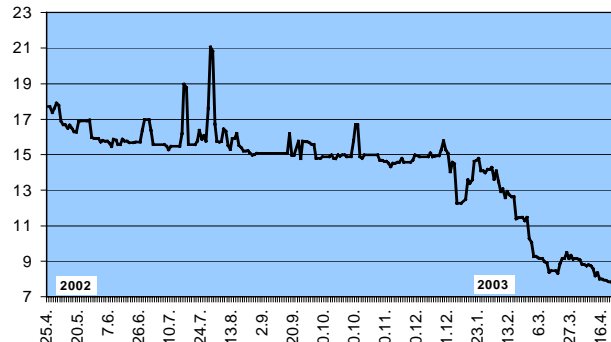
On April 11, Gazprom also submitted a final bid on a 34 % stake in the Lithuanian gas company, Lietuvos Dujos. The government has yet to accept the offer and Lithuania's privatisation authorities have not yet published the details of the offer. Gazprom's initial offer of LTL 80 million (€23 million) was a disappointment, considering that only a year earlier the German companies Ruhrgas and E.ON Energie paid LTL 116 million for a 34 % share as well as committed to investing at least LTL 70 million in Lietuvos Dujos over the next six years.

Latvian natural gas prices set to rise. The public utilities commission of Latvia has accepted Latvijas Gaze's petition for increases in natural gas rates. Under the ruling, the price of gas (excluding VAT) will go up 16.5 % incrementally over the coming three years. The largest increase, 12.5 %, will take effect on July 1. The Bank of Latvia calculates the hike will increase the inflation rate by two-tenths of a percentage point this year. Latvijas Gaze, which enjoys monopoly status, requested a substantial increase in the gas price last year, but the public utilities commission rejected the hike. Latvijas Gaze's largest shareholders are the Russian Gazprom, the Florida-registered Itera, and the German companies, Ruhrgas and E.ON Energie.

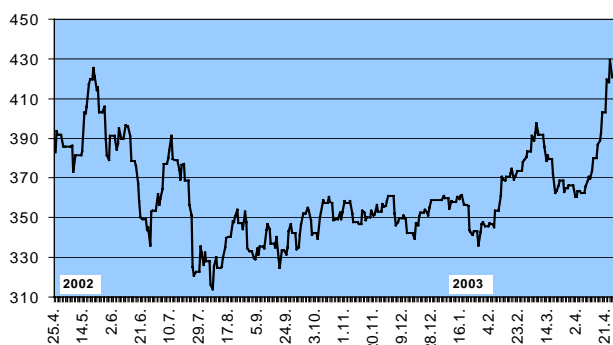
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



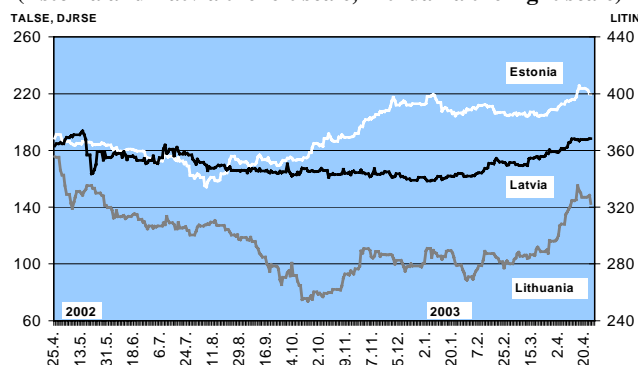
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)



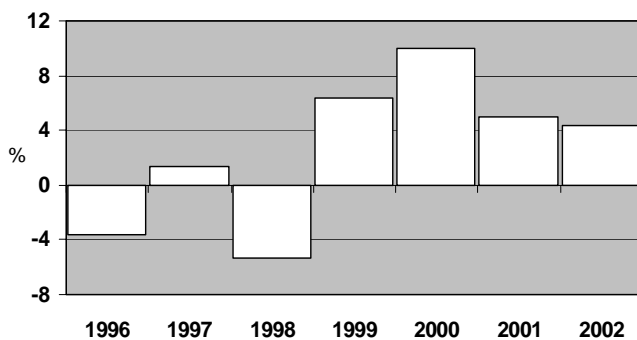


Russian statistics committee revises calculation of GDP. On Tuesday (Apr. 29), the State Statistics Committee released revised time series for 1995 – 2002, adjusted according to a new methodology designed to improve statistical quality of several factors affecting GDP. The modified statistical principles affect e.g. measurement of immaterial production and its allocation among various economic sectors. The GDP growth figures for 1996 – 2000 changed somewhat after revision. The growth figures for 1999 and 2000 rose one percentage point, as the changes in growth of fixed investment and private consumption were substantial. Based on the new data, real GDP has risen nearly 19 % since 1995 (earlier figures put growth slight below 17 %).

The State Statistics Committee also released figures on export and import volumes for the first time. The figures indicate that the volume of Russian exports rose nearly 40 % during 1999 – 2002, and last year alone rose 10 %. After the collapse in imports caused by the 1998 financial crisis, the volume of imports rose over 50 % during 2000 – 2002. The volume of imports rose nearly 20 % last year.

GDP grew 5.2 % y-o-y in the fourth quarter of 2002. Growth accelerated steadily from a rate of 3 % y-o-y in the first quarter. Also in 4Q02, private consumption continued to grow at a rate above 9 %, while exports rose nearly 13 % and imports over 20 %.

Annual change in Russian GDP, 1996 – 2002, %



Russian cabinet reviews medium-term economic scenarios. Last week the economy ministry presented the government with its revised version of the 2004 – 2006 economic program. The program focuses on achieving sustainable growth through diversifying Russia's production structure and reducing the country's dependence on energy exports. The world price of crude oil remains one of the most critical factors determining Russian economic growth. Under one scenario, the Russian economy would grow at an annual rate of 3.8 – 4.9 % during 2004 – 2006 if the price of oil averages \$18.50 a barrel (for Russia's Urals blend). In another, wherein the oil price averages \$22.00 a barrel in 2004 and then rises incrementally to

\$23.50 a barrel in 2006, annual GDP growth would increase to a range of 4.7 – 5.4 % per year. For both scenarios, the annual growth rate would accelerate by 0.3 – 0.7 percentage points, if the government's proposed changes to the tax system are implemented. Under the tax reform, the total tax rate would go down, as well as shift the tax burden from value-added industries to raw material producers. The government is expected to revisit the program in June.

Initial findings from Russia's 2002 population census.

Preliminary results published by the State Statistics Committee show that slightly more than 145 million Russian citizens lived in Russia in October 2002. In other words, Russia's population shrank by about 1.8 million persons since the previous census in 1989. The population figure, however, was over one million larger than the State Statistics Committee's running figures at the beginning of 2002. Persons not detected in the running figures tended to be found in central and southern federal regions, while in the other five federal regions the census figures were smaller than the running figures. One surprising finding was that about 17,000 of Russia's 160,000 rural jurisdictions had no officially registered inhabitants.

Russian cabinet considers reform of the armed forces.

Last week (Apr. 24), the government considered the defence ministry's proposed 2004 – 2007 reform program, under which a 176,000-man all-volunteer service is to be created. The defence ministry put the cost of the program at RUB 138 billion (€4 billion). The largest item is the construction of military housing. The first units of the all-volunteer army would be created in 2004 – 2005 in the North Caucasus region. The ministry said that all-volunteer armed forces would also attract citizens from other CIS countries. Such volunteers would be eligible for Russian citizenship after three years of service. Prime minister Mikhail **Kasyanov** said Russia's universal conscription would remain in place even as the volunteer service was built up, but conscripts would see the time of obligatory service reduced from two years to one starting in 2008. The final program proposal will be presented to the government this month.

The Union of Rightwing Forces (SPS) has made a competing proposal, whereby the costs of reforming the military would reach just RUB 91 billion (€2.6 billion). Under the SPS proposal, no housing would be built for the all-volunteer military. The party criticised the defence ministry's proposal for its costliness and the fact that most spending was earmarked for items not actually connected with military reform.

Duma approves bill on public service. The third reading of the bill took place on April 25. The bill is a part of president Vladimir **Putin's** reform of government administration. The proposal divides public service into federal and regional civil service, as well as federal military and

judicial appointments. All offices would be handled on the basis of an official employment contract. Since the Duma rejected a proposal that officials must have no political affiliations, federal office holders will continue to be allowed to belong to political parties.

Lithuania initiates privatisation of electricity companies. First on the agenda is the privatisation of the country's two power distribution companies, Rytu Skirstomieji Tinklai (RST) and Vakarų Skirstomieji Tinklai (VST). The Lithuanian government hopes to finalise the details of the privatisation of RST and VST by June 18 and complete the sale this year. The state presently owns 86 % stakes in both firms. According to the plan, majority stakes in the companies would be sold to foreign buyers. Buyers would further have to meet trans-Atlantic integration demands, meaning that Russian firms would be excluded from the bidding.

The restructuring of the Lithuanian power sector began in the beginning of 2002, when the monopoly Lietuvos Energija was divided into five separate companies. The electricity sector reform follows harmonisation demands of EU membership. Lithuania seeks full liberalisation of its electricity markets by 2010. Presently, only firms that use over 9 million kilowatt hours per year are free to select their electricity supplier. 25 firms meet this criterion; they account for about a quarter of Lithuania's power consumption.

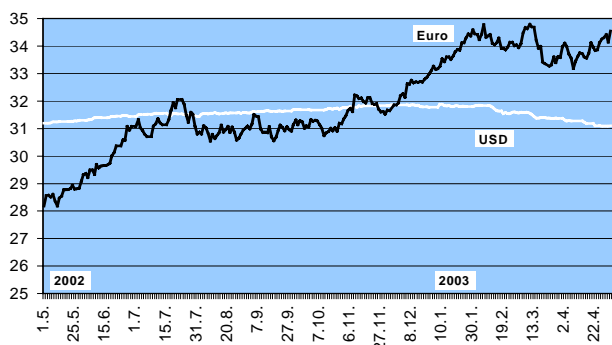
Thirteen independent power companies operate in

Lithuania. The largest by far is the state-owned Ignalina nuclear power facility. There are no plans to privatise Ignalina, and one condition of Lithuania's EU membership is that both of Ignalina's reactors, which the EU considers a hazard, are decommissioned by 2005 and 2009. In addition to exporting significant quantities of electricity, Ignalina over recent years has produced nearly 80 % of the electricity consumed in Lithuania. The State Control Commission for Prices and Energy sets ceilings on prices of electricity produced at Ignalina, as well as transmission prices. Only those electricity buyers free to choose where they purchase electricity can contract independently with the owners of the transmission grid on the transmission price of electricity.

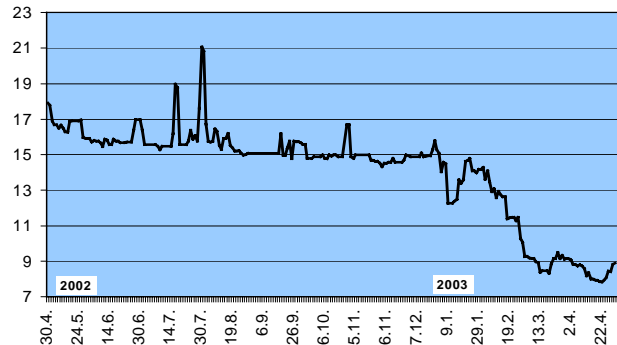
Privatisation of Lithuanian Airlines hits further snags. SAS, the only declared party expressing interest in the purchase of a stake in Lithuanian Airlines (Lietuvos Avialinijos or LAL), announced last week it would not submit a bid. LAL's sole owner, the Lithuanian state, initially planned to sell a 34 % stake in the airline. Lithuanians fear that without a strategic investor, LAL will not survive in the competitive environment after EU membership next year. LAL presently has seven planes and 820 employees.

The other Baltic states privatised their airlines earlier. Maersk Air owns 49 % of Air Estonia, while the Estonian state holds 34 % and Baltic Cresco Investment Group 17 %. The Latvian state owns 53 % of its national carrier airline and SAS owns 47 %.

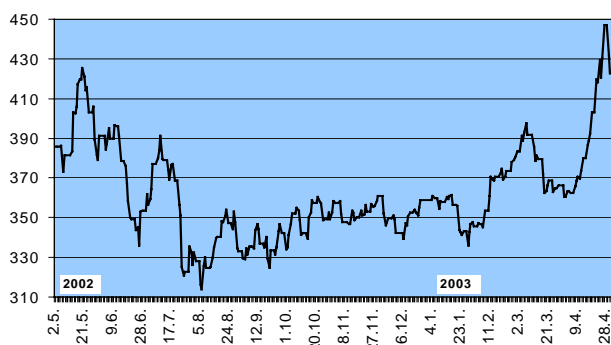
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



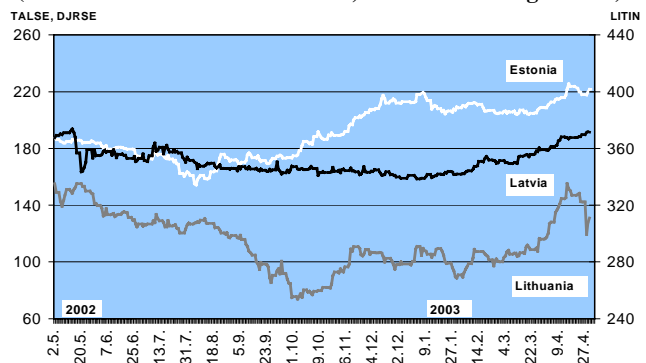
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian inflation remains high. Consumer prices in April rose 1 % m-o-m and 14.6 % y-o-y. The figures for both rates were almost identical to those in March. Prices have risen 6.2 % since the start of the year. Highest growth was again seen in administratively set prices for services (particularly housing and municipal services). The government's stated policy is to increase such prices gradually to near cost-recovery levels. High oil prices have also helped feed high inflation, as the Central Bank of Russia is unable to soak up fully the additional liquidity in the markets caused by large export earnings.

Russia pursues tight fiscal stance. After an intense debate this spring, progress in drafting federal fiscal policy moved ahead at the end of April with the government's approval of a budget plan for 2003 – 2005. Under the plan, federal spending will be restrained in 2004 and 2005 to keep the budget in balance as long as Russian crude oil fetches \$20 a barrel on world markets. Given the likelihood that world crude oil prices will actually be higher, the federal budgets for both years are expected to show surpluses. The surplus should amount to 0.6 % of GDP in 2004 and 0.9 % of GDP in 2005. The budget surpluses will be transferred to a special stabilisation fund. Finance minister Alexei **Kudrin** estimates that this year's budget surplus will reach 1.4 % of GDP.

The tax cuts approved by the cabinet two weeks ago (see Week in Review 17/2003), in combination with the newly approved budget targets, mean that budget spending will have to be cut. Primary federal budget expenditure, which excludes debt-servicing costs, is expected to amount to 13 % of GDP this year. The government's goal is to reduce that expenditure to 11.9 % of GDP in 2005.

Growth in Russian banking sector concentrated in large and small banks last year. According to CBR data, the total assets of the Russian banking sector grew 14 % y-o-y in real terms in 2002. The total assets at the end of last year exceeded RUB 4,100 billion (about €125 billion), or 38 % of GDP (60 – 100 % in nearly all transition countries joining the EU next year). The information, however, is based on Russian accounting standards, which often overstate a bank's total assets in comparison to internationally accepted accounting practices. On the other hand, CBR data do not include the commercial activities of Vneshekonombank, which also handles servicing of Russia's foreign debt.

Russia's largest bank Sberbank, in which the CBR holds the majority stake, increased its total assets over 20 % in real terms to nearly €34 billion at year's end. Russia's number-two bank, government-owned Vneshtorgbank, saw its total assets rise about 3 % to nearly €6 billion. The third and fourth largest banks, Alfabank and Gazprombank, saw their total assets increase over 20 % to €4.8 billion and €4.5 billion, respectively. High growth in total assets was also seen among Russia's

group of 1,279 small banks, whose total assets climbed to €33 billion, or about €25 million per bank.

Russia's private pension funds still essentially unregulated. The new act on private pension funds entered into force in January. Under the act, private funds will be permitted to operate from the beginning of 2004 and may compete with mandatory pension funds for investment of "savings component" contributions. The act sets certain requirements to these funds concerning e.g. how long they have operated in the private pension market, the number of participants in their fund and the amount of capital they manage. Deputy economy minister Mikhail **Dmitriyev** said implementation of the act still requires over 30 new regulations, the details of which have yet to be agreed. Dmitriyev estimates that by the end of this year the state pension fund will have about RUB 85 billion (€2.5 billion) available for investment.

Vyacheslav **Batayev**, head of the government agency that oversees Russia's private pension funds, said that in coming years his main job is to get the pension insurance markets into compliance with the new laws. Due to the stricter regulations, the number of pension funds is expected to fall substantially from the current level of around 300 funds. Pensions under the new system will begin to be paid out in 2012.

Russian and US agriculture ministers agree on cooperation and sanitary issues. At a meeting of agriculture minister Alexei **Gordeyev** and US agriculture secretary Ann **Veneman**, it was agreed that the countries would hold regular bilateral talks on agricultural policy and investment, agricultural research and education, as well as economic and ecological problems related to agriculture.

The row over broiler chickens was also resolved. At the end of 2002, Russia suspended for one month the import of broilers produced in US plants, because it felt that the meat's quality was too poor to meet Russian hygiene standards. Russia was then allowed to make health and quality inspections at US broiler plants. Russia has now announced the inspections will be finished by the beginning of July. Most plants have already implemented the stricter health and safety measures required by the Russians. Russia, however, refused to end the quotas it imposed in April on imports of beef, pork and poultry (see Week in Review 5/2003).

Further delays seen in the reform of Russia's natural gas sector and Gazprom. Members of the Russian government appear starting to support postponing reforms intended to liberalise Russia's natural gas markets and raise domestic rates for gas. Gazprom, too, has given the economy ministry's reform proposal the cold shoulder. In Gazprom's view, the plan would not create real competition in the gas sector due to constraints in gas pipeline capacity.

Indeed, the economy ministry and Gazprom are at odds over several aspects of the reform, including the notion of separating the natural gas distribution grid from the rest of Gazprom and dividing the grid into smaller units. Another difference of opinion has to do with how much capacity Gazprom might make available to third-party gas distributors. The ministry says monitoring should be independent of Gazprom. The third quarrel has to do with the economy ministry's proposed elimination of Gazprom's virtual monopoly on natural gas production.

IMF expresses concern about Estonia's current account deficit. An IMF staff visit to Estonia (Apr. 28 – May 2) provided IMF representatives with an opportunity to meet members of the new government. In their concluding statement, the Fund representatives stated that Estonia's economic outlook continues to be favourable. The Estonian economy has however become more vulnerable due to the weaker global economic outlook and rapid expansion of domestic credit. The rapid growth in credit, according to the IMF, was supported by low interest rates in the euro area, the narrowing interest margins and increased competition among banks.

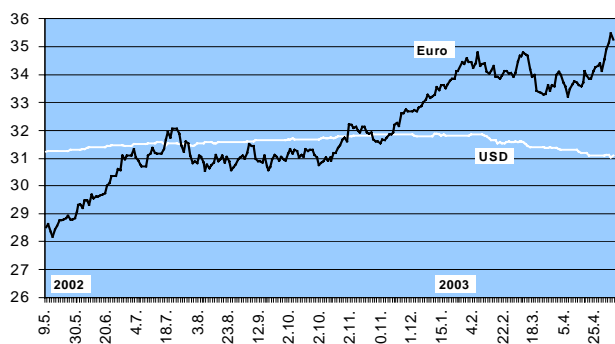
The Fund was particularly concerned about Estonia's large current account deficit. In order to correct the economic imbalance, the IMF stressed the importance of

fiscal policy in Estonia, where the currency board arrangement restricts the central bank's room for action. The IMF encouraged the new government to increase the fiscal surplus with its higher-than-expected revenues rather than spend the money on a supplemental budget as currently planned. Such a move would help reduce the current account deficit and help the country move towards ERM2 and EMU membership. While the IMF was understanding of the new government's efforts to lower the income tax, it said such tax cuts should not be allowed to weaken the budget balance. Excessive tax cuts at this point are inadvisable in the face of EU membership that brings about increased budget expenditure.

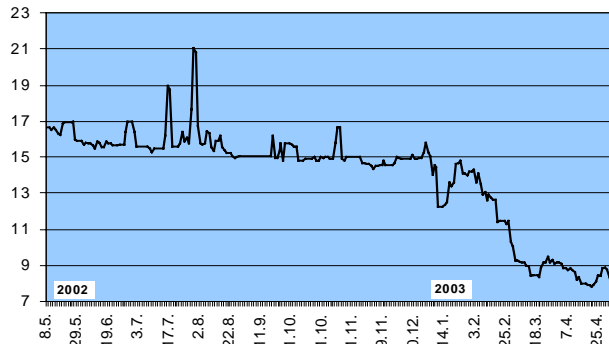
Earlier this spring, the IMF slightly lowered its annual GDP growth forecast for Estonia to 4.9 %.

Sale of Lietuvos Dujos stake postponed – again. The Lithuanian government has requested that the Russian Gazprom increase its offer for a 34 % stake in Lithuania's national natural gas distributor Lietuvos Dujos. Gazprom must submit its revised bid by May 23. Gazprom's "final" offer, submitted last month, reportedly was only LTL 80 million (€23 million). The government would like to see an offer of at least LTL 116 million, the amount two German firms paid for a 34 % stake last year.

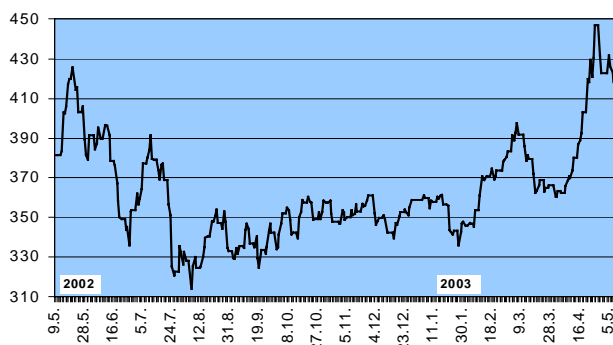
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



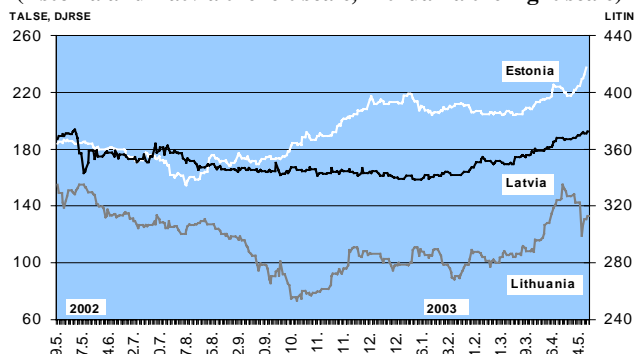
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





IMF praises Russia's economic policy. In its recent Article IV consultation with Russia, the IMF noted that government's prudent economic policies and high world energy prices have contributed decisively to the country's positive developments. Russia continues to display strong GDP growth, sizeable current account and budget surpluses, rising international reserves and a reduction of its public sector debt.

The Fund warned, however, that the Russian economy is still susceptible to threats. Pursuit of the two goals of economic policy – low inflation and a stable exchange rate – is difficult and the results to date have been rather poor. The IMF regards subduing inflation as top priority of Russia's monetary policy and for this the Central Bank of Russia will need to develop its range of monetary policy instruments. Swings in the exchange rate will become larger than earlier. Fiscal policy needs to be tightened to curb strengthening of the rouble. The IMF warned that recently planned tax cuts would loosen the fiscal stance unduly, unless they are offset by measures to broaden the tax base and reduce budget spending.

The IMF expressed disappointment with the recent slowdown in the pace of structural reforms, which are needed to secure sustainable long-term economic growth even in an environment with lower energy prices. The main goals of structural reform should be improving the investment climate, diversifying production, raising productivity and continuing growth of real wages.

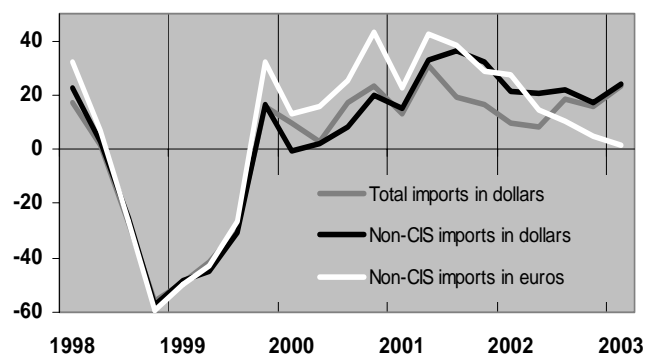
The IMF assessment for the Russian economy was released last week. The IMF prepares an annual economic assessment for every member country.

Fitch raises Russia's credit rating. On May 13, the international credit rating agency Fitch boosted its rating for Russia's long-term sovereign debt by two notches. Fitch justified the higher rating by noting Russia's strong economic growth and consistent economic policies that have led to growth in real incomes and reduced indebtedness to such an extent that current debt-servicing risks are small. Moreover, Fitch expects Russia's favourable economic situation and robust economic growth to continue for the rest of this year. However, Fitch remained cautious over medium and long-term development due to the structural weaknesses in the economy. Structural reforms are unavoidable if Russia is to achieve sustainable economic development.

Russia's new sovereign rating lifts it into the same class as Egypt, Kazakhstan and the Philippines. The Fitch classification is presently one notch higher than the sovereign ratings of Standard & Poor's and Moody's, which upgraded Russia's ratings in December. Fitch rating is still one notch below "investment grade." An investment-grade rating means, for example, that large institutional investors such as pension funds can hold such investments without facing excessive risk.

Russian export earnings grow strongly as imports moderate in the first quarter. CBR figures show Russia's earnings on goods exports rose an impressive 40 % y-o-y in the first quarter. Part of the leap, of course, reflected the weakening of the dollar, which is used in measuring Russia's foreign trade. In addition, the world price of crude oil was much higher than a year earlier and crude oil exports from Russia were up. Russian goods imports grew in the first quarter about 25 % in dollar terms. Imports from non-CIS countries grew in the first quarter at the same rate in dollar terms, but in euros slowed to just 1 % y-o-y.

Russian goods imports, percentage change from four quarters previous



Russia introduces compulsory car insurance from July 1. On May 7, the Russian government approved the pricing structure for compulsory car insurance. Given that presently just over 10 % of vehicles are insured, the act on compulsory car insurance, approved in April 2002, will have a profound impact on the Russian insurance industry. Under the new law, any motor vehicle or heavy machinery used in traffic must be insured. Failure to carry insurance will be a misdemeanour from the start of 2004. The size of insurance premiums will be determined according to e.g. vehicle type, cylinder volume, the main geographic area where the vehicle is used, the driver's age, years driving and propensity for accidents. In Moscow, the average rate will be about 4,000 roubles (110 euros) a year. The maximum amount paid out under a claim is limited to 400,000 roubles (11,000 euros).

Many Duma deputies wanted to postpone the inauguration of compulsory car insurance until summer 2004 and they disagreed on whether the level of premiums was too high or too low. The law was also criticised for failing to require insurance on state-owned vehicles and that insurance premiums in Moscow will be higher than anywhere else in Russia.

Russia takes Latvia off offshore list. The CBR removed Latvia from its list of offshore banking destinations and will no longer enforce special supervision and reporting requirements imposed in spring 1999 on Russian banks in their dealings with Latvia. The offshore list initially contained 46 countries and territories.

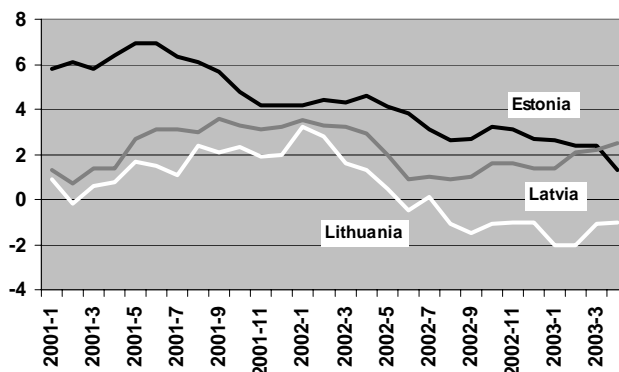
Lithuanians vote for EU membership. In the national referendum held May 10 – 11, higher-than-expected voter turnout surprised everybody. Among the 63 % turnout, 91 % voted for membership in the EU.

There are ten accession candidates. *Malta* (54 % for EU membership), *Slovenia* (90 % for) and *Hungary* (84 % for) have held national referenda. The referendum in *Slovakia* gets under way today (May 16 – 17). *Poland* and the *Czech Republic* will hold their EU votes next month, while the referenda in *Estonia* and *Latvia* are scheduled for September. *Cyprus* has no plans to arrange a national vote on EU membership.

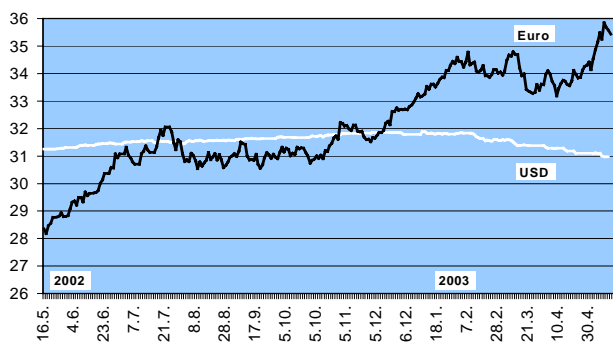
Latvia posts highest Baltic inflation. In the period from mid-2000 to last month, the highest 12-month inflation in the Baltics was posted by *Estonia*. However, Estonian 12-month inflation slowed in April to 1.3 % (2.4 % in March), while in *Latvia* inflation accelerated to 2.5 % (2.2 % in March). Deflation continued in *Lithuania* with consumer prices down 1.0 % y-o-y (-1.1 % in March).

The slowing of inflation in *Estonia* was due in part to the fact that the hike in electricity prices implemented a year ago was no longer covered by the observation period. Prices of phone calls and gasoline also fell in April. In *Latvia*, April prices were driven by higher prices for clothing and housing. *Lithuanian* deflation came about as last year's exceptionally high food prices corrected back to the price level of previous years. In addition, the rise in import prices in Lithuania and Estonia was limited by the rise in the euro (to which both the litas and kroon are pegged) against the dollar.

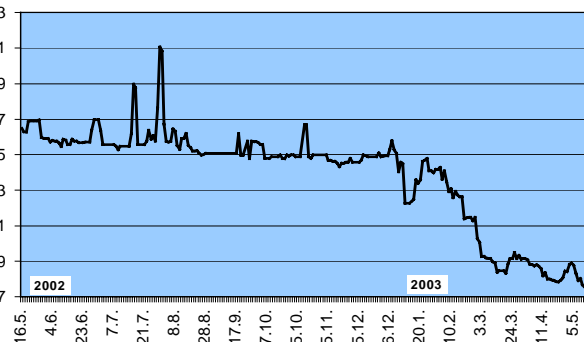
Consumer prices in the Baltic states, 12-month %-change



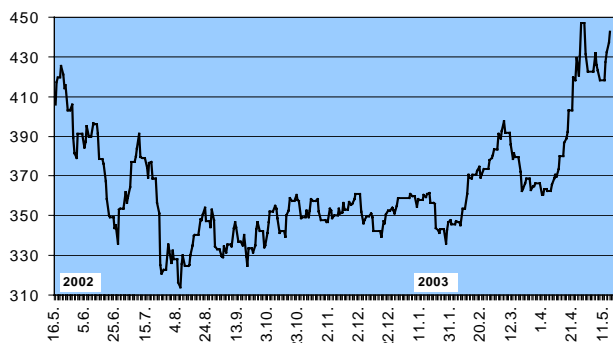
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



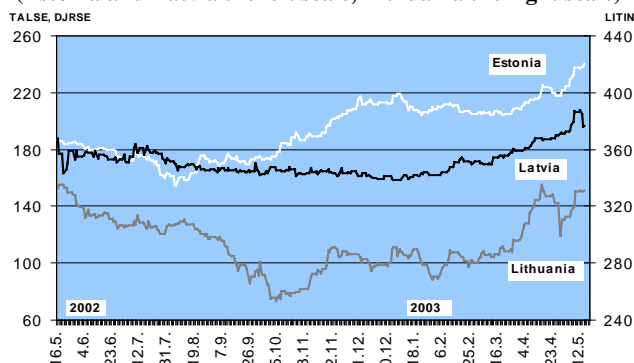
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russia's rapid industrial output growth continues. In April, industrial output rose 7.1 % y-o-y, extending the steady acceleration in growth since December. For the first four months of this year, industrial output was up 6.3 % y-o-y. The workday-adjusted figures were even higher: 8.7 % y-o-y for April and 6.7 % y-o-y for the January-April period.

During January-April, the fuel industry, electricity production, and metallurgy all witnessed above-average growth. Production fell in light industry, printing and microbiologicals.

Coal (up 15 % y-o-y), crude oil (11 %) and iron ore (10 %) led commodity growth in the first four months of the year. Many industries serving mainly the domestic market also saw growth accelerate. For example, pharmaceutical production was up 13 %. Producers of certain construction materials and machinery and equipment (e.g. ceramic flooring, floor coverings, refrigerators and buses) have also enjoyed higher growth in recent months. Growth in the food industry (4.2 % y-o-y) was below average.

Investment inflows to Russia on the rise. The State Statistics Committee reports that foreign investment inflows into Russia during the first quarter amounted to \$6.3 billion – a 70 % increase from 1Q02. Some 83 % of investments were in the form of international loans and trade credits (the fastest growing category). FDI accounted for nearly 17 % of total investment while portfolio investment was less than 1 %. FDI inflows were up 25 % y-o-y.

International lending and credits now account for 52 % of the total foreign investment stock in Russia. FDI comprises 45 % and portfolio investment 3 %. Russia's leading investor countries are Germany, the US, Cyprus, the UK, France, the Netherlands and Italy. These countries together account for 77 % of total investment and 76 % of FDI.

Investment outflows from Russia in the first quarter amounted to \$3.1 billion, a decrease of 29 % y-o-y.

Highlights of president Putin's annual state-of-the-nation address. In his speech to the Russian parliament last Friday (May 16), president Vladimir **Putin** emphasised the importance of a Russian united society. Without it, said the president, reforms aimed at social development, economic growth and higher living standards cannot be implemented. Russia must integrate further with the international community, promote democracy and a national identity and continue the struggle to eliminate bureaucracy.

In laying out his economic vision, Putin called for support of Russian entrepreneurship, a doubling of GDP within ten years, full convertibility of the rouble within a few years, and a simpler, fairer tax system.

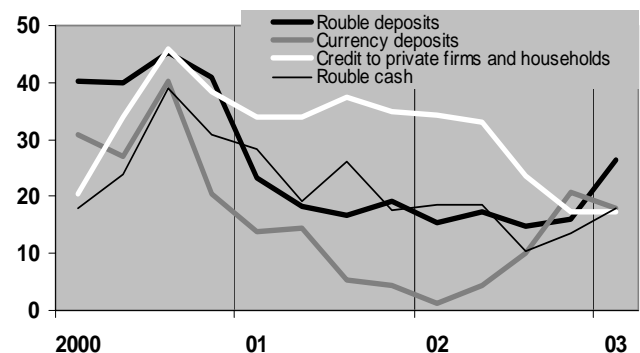
One surprising development in domestic policy was the president's announcement that he supports a cabinet

based on the parliamentary majority. In foreign policy, Putin returned to traditional themes that included respect for international justice, effective diplomacy and national defence, as well as major roles for the UN and Security Council.

Growth in bank deposits accelerates, growth of credit also brisk. The stock of household and enterprise deposits in authorised banks in Russia was up 23 % y-o-y in real terms at the beginning of April. Growth in the amount of rouble cash in circulation also accelerated to 18 %. Rouble deposits were up 26 % y-o-y due to a continued rapid expansion of rouble time deposits (33 %) and the return to fast growth for other rouble deposits (20 %). Growth in foreign currency deposits (18 %) held near the earlier pace. The amount of rouble deposits rose to 13 % of GDP at the beginning of April. The amount of foreign currency deposits slightly exceeded 7 % of GDP. The amount of rouble cash in circulation also remained at 7 % of GDP.

Domestic bank credit in Russia continued to grow at the same pace as at the end of 2002. Bank lending to enterprises and households at the beginning of April was up 17 % y-o-y in real terms. Banks' outstanding claims on state-owned enterprises grew a surprising 38 % (although they still only account for 6.5 % of total bank claims on the private sector). Bank claims on private sector exceeded 18 % of GDP.

Deposits and credits of banks in Russia and rouble cash, real percentage change from four quarters previous



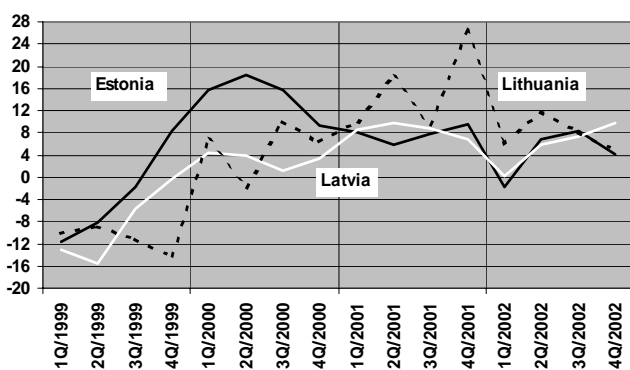
Baltics sustain robust industrial output growth. *Estonian* industrial output rose 11 % y-o-y in the first quarter. Among major industrial fields, the leaders in growth were the textile industry and the mechanical forest industry. Other field displaying rapid increases in growth included construction supplies, metals, office machines, and manufacture of electrical equipment and devices.

Latvian industrial output in the first quarter was up 9 % y-o-y. Production rose in nearly all industrial fields. On-year growth was fastest in the key mechanical wood refining industry, as well as in smaller fields e.g. metals

products, furniture, electronic equipment and devices, and production of rubber and plastic products.

Lithuanian industrial output in the first quarter was up 16 % y-o-y measured in sales. Most fields of industry experienced brisk growth. Production increased in all major fields, i.e. the food industry, oil refining, and manufacture of furniture, passenger vehicles, and machinery and equipment.

Industrial output growth in the Baltics, percentage change from four quarters previous



Baltic exports to Western Europe continue to rise. The value of *Estonian* exports in the first quarter rose 7 % y-o-y. Growth reflected increased exports to EU countries. Exports of electrical devices and equipment grew 15 % and furniture exports 14 %. Exports also grew

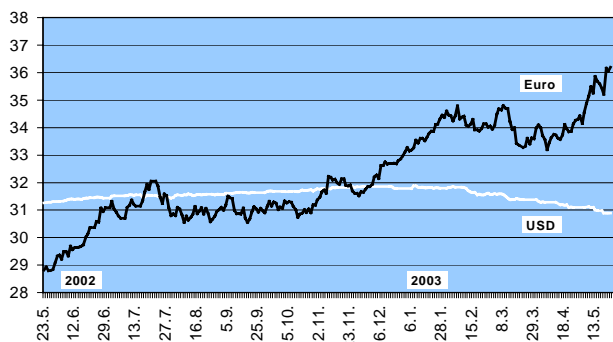
briskly in some smaller fields. Exports of textiles, as well as wood and wood products grew slower. Imports to Estonia increased 16 %. The main drivers were higher oil prices and the growth in car imports.

Latvian exports rose 17 % y-o-y in the first quarter. Exports of metals and metal products grew 45 %, textiles 25 %, chemical products 23 % and wood and wood products 45 %. Exports to EU countries grew 22 %. The value of imports was up 22 % y-o-y, mainly in response to higher oil prices.

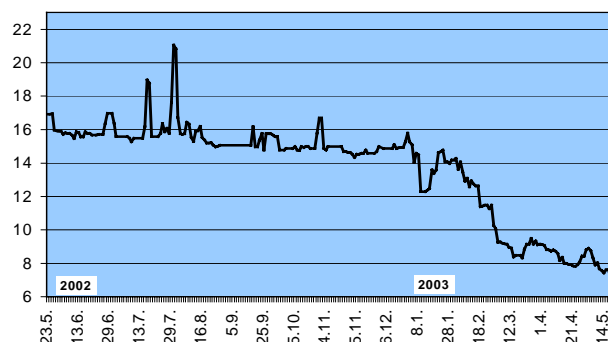
Lithuanian exports in the first quarter were up 21 % y-o-y, while imports rose 11 %. Exports of oil raffinates increased 60 %. Large increases were also seen in exports of electricity, metals and metal products, as well as exports of vehicles and related components. Lithuania's main export destination is now Switzerland, reflecting the transfer of oil refinery export operations to a Swiss firm. Accordingly, the share of Lithuanian exports going to EU countries fell from 52 % to 41 %.

Privatisation of Latvian Savings Bank proceeds. Last Saturday (May 17), a 25 % stake in Latvian Savings Bank (Latvijas Krajbanka) was sold at an auction arranged by Latvia's privatisation agency. The sole bidder, UK-based DOXA FUND Ltd (domiciled in the Virgin Islands) purchased the stake for the starting price of LVL 4.1 million (€6.3 million). The state's remaining 7 % stake in the bank will be sold to the bank's current and former employees.

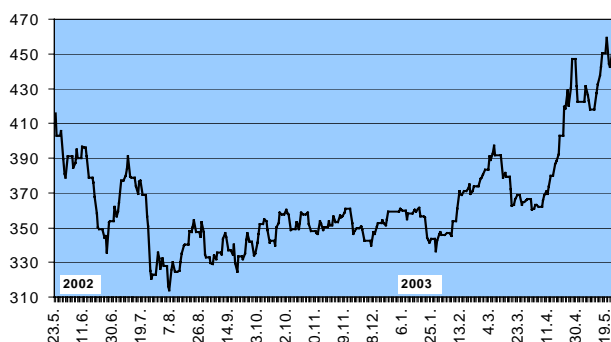
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



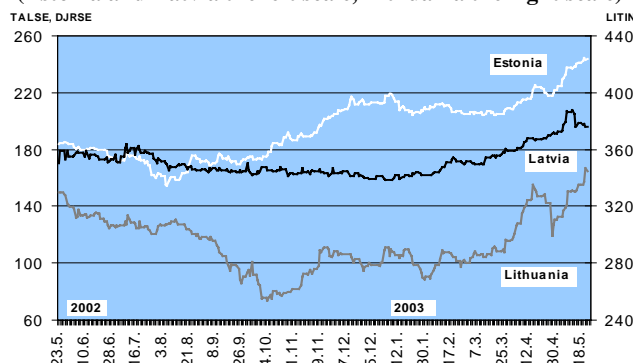
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian government approves energy ministry proposal on long-term energy strategy. The program, extending to 2020, replaces a 1999 program that failed to anticipate the sharp rise in world energy prices and rapid growth in Russian energy production. The main goals of the strategy are to increase energy production and promote efficient energy use in Russia in order to enhance GDP growth. The goals will be achieved through the formation of a functioning energy market in which the state plays a diminished role as market participant and an increased role as market regulator.

The energy strategy foresees steady growth in both energy production and energy exports in coming years. Annual crude oil output is expected to reach 450 – 520 million tonnes by 2020, up from about 380 million tonnes in 2002. The rate of growth will depend on the state of the global economy and development of the Russian economy. Energy exports are expected to increase 35 – 56 % by 2020, which will require construction of new transport capacity in the northern, eastern and southern parts of Russia. This most probably means the implementation of all currently planned oil pipeline projects.

The strategy does not go into detail on current reforms in the natural gas and electricity sector. The magnitude of hikes in natural gas prices also remains open. The government is expected to receive a completed version of the energy strategy next month.

Russian budget remains in surplus in the first quarter of 2003. For 1Q03, Russia's federal budget showed revenues of RUB 581 billion (20.6 % of GDP) and total expenditures of RUB 490 billion (17.4 % of GDP). Thus, the budget surplus was RUB 91 billion or 3.2 % of GDP, a decline from 4.6 % of GDP in 1Q02. Budget expenditures were pushed up mainly because of higher spending on defence and transfers to regions.

The anticipated overall surplus is 0,6 % of GDP under this year's budget act. The development has been better than expected because the first quarter economic growth (according to minister Mikhail Kasyanov 6,4 %) exceeds the budget act's target (4,4%). IMF estimates that Russia's overall budget surplus in 2003 will reach 1,5 % of GDP if oil averages 25 a barrel this year.

Russian cabinet ponders administrative reforms. The government is dissatisfied with the results of the recent "cleanup of bureaucracy" initiative. The results from a 2002 package of three laws to improve business conditions (business registration, limiting the state's role in corporate oversight and reduction of the amount of activities requiring permits) have been unimpressive. For example, enterprise registration with the tax ministry and mandatory funds has not occurred in the five-day time frame set by the law nor is such registration possible under the "one stop" practice envisioned by the law. According to prime minister Mikhail Kasyanov, the government wants from now on to concentrate its efforts

on reducing the state's administrative and regulatory presence in the economy rather than focus on the reform of administrative bodies and number of bureaucrats. The Russian Union of Industrialists and Entrepreneurs, RSPP, which represents big industry, has made its own reform proposal, suggesting e.g. the abolition of sector ministries and establishing an ombudsman's office to oversee the activities of government officials. RSPP also wants the act on official transparency enacted as soon as possible. The government proposal, prepared by the economy ministry, incorporates RSPP's suggestions, including increased official transparency and the establishment of criteria for assessment of official actions.

The reform in *regional and local administration* that passed its first Duma reading in February will probably get new boost, too. In mid-May, the finance ministry submitted to the government related amendments to the budget act. Amending the budget act is intended to alter the budgetary allocations at the federal, regional and local levels, as well as set forth the principles for bailing out over-indebted regional administrations. Observers point out that local and regional administrations currently do not have enough possibilities to decide their own budgets and administrations lack equal footing in budget matters.

Russia, EU and US sign accord on cleaning up sub-fleet nuclear waste. Numerous countries and agencies, at the initiative of Nordic countries, met on May 21 in Stockholm to sign on to the Multilateral Nuclear Environmental Programme for Russia (MNEPR). The accord covers problematic nuclear waste in Northwest Russia (the legacy of about hundred mothballed nuclear-powered submarines, which contain a total of 300 nuclear reactors), to secure proper handling and prevention of nuclear materials from falling into the wrong hands. The accord took several years to formulate. One obstacle, for example, was the insistence of Russian officials that foreign firms pay VAT on work they do in Russia under the program. In April, Russia agreed to exempt from taxes contractors on work under MNEPR.

The MNEPR relates to a global initiative to prevent the spread of weapons of mass destruction that was agreed last year at the G8 summit in Canada. Russia, Belgium, Denmark, Finland, France, Germany, the Netherlands, Norway, Sweden, the UK, the US, the EU and EurAtom are signatories to the MNEPR.

Russian Duma finally ratifies border treaty with Lithuania. The Duma ratified the treaty just five weeks before July 1, the expiry date for ratification of the treaty, after which a relaxed transit regime for Russian citizens moving between the Kaliningrad enclave and the rest of Russia should begin. Russia and Lithuania signed the border agreement in October 1997. It was subsequently ratified by the Lithuanian parliament in 1999. Ratification of the border treaty by the Duma is expected

to promote political and economic relations between Lithuania and Russia.

Current account deficits rise in Estonia and Latvia, fall in Lithuania. Monthly figures indicate *Estonia's* current account deficit in the first quarter climbed to a record 18 % of estimated GDP (14 % of GDP in 1Q02). The widening of the deficit was driven by a huge trade deficit as imports grew 16 % y-o-y compare to 7 % for exports. Increases in transit freight volumes and tourism slightly boosted the services surplus. Foreign direct investment was sufficient to cover over half of Estonia's current account deficit. The difference was financed with a Hansapank eurobond issue.

Latvia's current account deficit has also risen in the past year from 3 % of GDP in 1Q02 to about 5 % of estimated GDP in 1Q03. The increase was driven by Latvia's trade imbalance as imports grew 22 % against a 17 % rise in exports. Despite difficulties in the oil transport sector, Latvia's services surplus remained at the 2002 level. Moreover, the minor drop from last year in FDI inflows was still adequate to cover 85 % of the current account deficit.

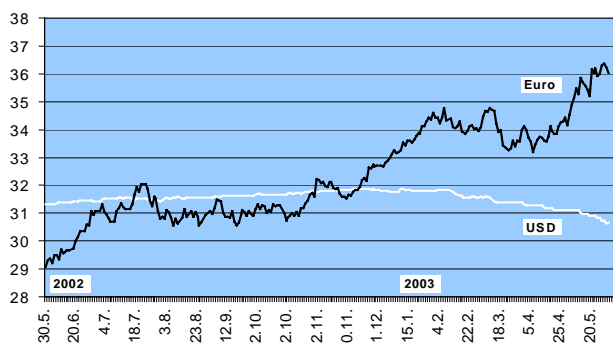
Lithuania's current account deficit in the first quarter was just 1 % of GDP (5 % of GDP in 1Q02). The trade

deficit shrank considerably as exports grew 21 % against a rise of 11 % in imports. The services surplus, in contrast, fell slightly. FDI inflows were more than double the current account deficit.

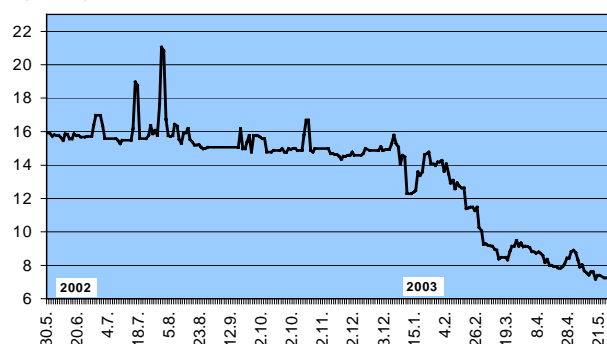
EU membership brings changes to Latvia's constitution. On May 8, the Latvian parliament approved the constitutional amendments necessary for EU membership. The changes allow some of the powers of the Latvian government to be shifted to international institutions. Significant changes in the conditions of the country's EU membership will also have to be approved by a national referendum.

The amendments further give the Latvian parliament the right to set the date of national referendum on the EU and the minimum percentages of the vote needed for approval. A national referendum will be considered binding and legitimate as long as voter turnout reaches at least half of the turnout for the most recent parliamentary election (35.7 % of registered voters). EU membership can be approved or rejected on the basis of a national referendum as long as a majority of voters approve or reject EU membership. A recent poll indicated 53.8 % of Latvian citizens support EU membership.

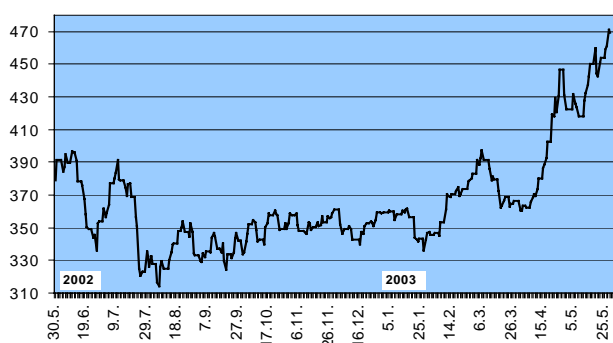
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



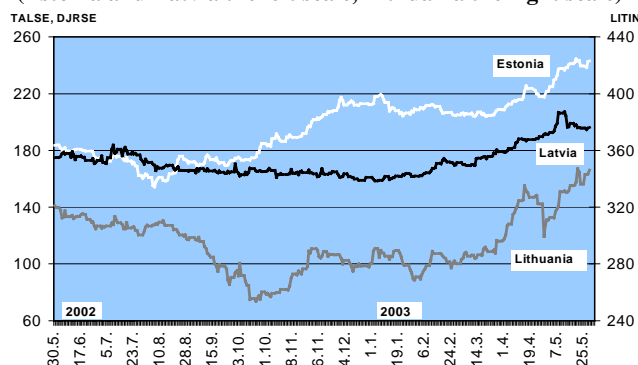
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian economic growth continues to accelerate. The combined production index of five base sectors of the Russian economy (industry, agriculture, construction, freight transport and retail trade) rose 6.9 % y-o-y in the first four months of the year, accelerating to 7.5 % y-o-y in April. The economy ministry estimates that Russian GDP grew 6.4 % y-o-y in the first quarter. The official figure for first quarter GDP from Goskomstat has yet to be published.

Goskomstat reports construction output grew 14 % y-o-y in January-April, while the volume of retail sales was up 9 % and freight transport 7 %. Industrial output grew 6 % y-o-y, while agricultural production increased just 1 %. Among transport sectors, rail freight transport grew fastest, due largely to increases in the transport of oil (up 16 %) and coal transport (15 %).

Domestic demand remains an important factor in economic growth. The volume of fixed investments in January-April was up 11 % y-o-y. Investments rose nearly 13 % y-o-y in April.

Russian cabinet sets 2004 tariff hikes for gas, electricity and rail transport. Under the cabinet decision, the rates for natural gas will go up 20 %, electricity 16 % and rail transport 12 % next year. The corresponding hikes for 2003 were 20 %, 14 % and 12 %, respectively. In his state-of-the-nation address last month, president Vladimir **Putin** criticised the cabinet for allowing rates charged by natural monopolies to rise faster than prices in other sectors of the economy. The rate hikes agreed on by the cabinet exceed the government's inflation target for next year (8 – 10 %). The economy ministry, which drafted the proposal, justifies the hikes by changes in the taxation and structural reforms of natural monopolies, which increase their costs. Also, hikes are a way to offset the higher costs incurred by other natural monopolies (e.g. higher electricity prices will raise the operating costs of railways).

Consensus on reform of Russia's electrical power monopoly. UES's board voted unanimously on May 23 for the methods and timetable for reforming the national power monopoly. Preparation of the final phases of the UES break-up plan took over a year and caused bitter infighting among various shareholder groups. The decision of the UES board follows the legislative reforms of the energy sector passed by the Duma in February. The reform plan of UES will break up the national electricity monopoly into ten privately held, competing power generating companies serving the wholesale market. In addition, several independent regional power generating companies (with the UES board setting the actual number of them) will be separated from UES. The power grid would remain fully state-owned, while the five regional power transmission companies to be created will be partly state-owned. The reform would be implemented by 2008.

One of the most disputed aspects of the reform was the basis for share distribution among current UES shareholders. Portfolio investors, in particular, were concerned

about the fate of their stakes, which was reflected in the UES share price last year. The price of UES shares rebounded after the announcement of the board's decision. Under the decision, current shareholders will receive shares in the wholesale generation companies on a pro rata basis. The various interest groups generally have seen the board's decision as a rather successful compromise. The Russian state is the largest shareholder in UES with a 52 % stake. Strategic investors hold 23 % of UES shares, while 18 % are held by domestic and foreign portfolio investors and 7 % by private individuals.

Russian government proposes nominal 33 % increase in public sector wages from the start of October. Given that this is parliamentary election year, a measure to increase the pay of some 15 million low-paid public workers (including teachers, medical doctors, social workers, scientists and researchers, and persons working in the arts and culture) will likely find little resistance in the Duma. With inflation currently running at about 15 %, the value of increase is substantially less in real terms. After the increase, the lowest scale wage will be 600 roubles (17 euros) a month, i.e. official minimum wage. According to Alexei **Kudrin**, who holds the posts of deputy prime minister and finance minister, the cost of the measure is about RUB 160 billion (€4.5 billion). Nearly half of this amount will be paid directly out of the federal budget.

Russia-EU summit in St. Petersburg. President **Putin** invited representatives of the EU's current 15 members as well as the ten accession states to attend last weekend's celebrations of St. Petersburg's 300th anniversary. The summit communiqué emphasised deeper cooperation between Russia and the EU and promotion of European integration. The summit decided to transform the cooperation council between EU and Russia into a Permanent Partnership Council. To facilitate development of a common European economic space, a high-level working group is to formulate a proposal for the next EU-Russia summit in November. The EU repeated its promise to support Russia's WTO membership. The parties promised to focus on problems that are likely to emerge next year in association with the EU's eastern enlargement. The parties further committed to investigate the conditions for visa-free travel between Russia and the EU as a long term perspective.

According to observers, the meeting was characterised by a "holding operation", as none of the attendants wanted to vent their differences with Russia. The EU contingent thus was seen as supporting the western-minded **Putin** as he prepares for next year's presidential election.

Russia-China summit in Moscow. China's recently inaugurated president, **Hu Jintao**, chose to make his first official international trip to Russia (May 26 – 28). During the visit, **Hu** and president **Putin** signed a long-term bilateral energy agreement designed to increase significantly

Russia's oil and gas exports to China. The Russian oil company Yukos and China's National Petroleum Corp. had already agreed that China would purchase 700 million tonnes of oil from Russia between 2005 – 2030. The parties have studied the possibility of constructing an oil pipeline from Siberia to China for several months. Russia is also investigating with Japan the possibility of constructing an oil pipeline running to the Pacific coast. Experts expect only one of the competing Far East pipeline projects to be implemented.

Privatisation of Ventspils oil terminal continues. Latvia's privatisation agency allowed Latvijas Naftas Transzits (LNT), the largest shareholder in the Ventspils Nafta oil terminal, to exercise its option to purchase a further 5 % stake for LVL 4.7 million (€7.2 million) in the terminal. The deal makes LNT the majority holder of Ventspils Nafta shares. The Latvian state retained a 38 % stake, which it plans to divest this year.

Ventspils Nafta has also aroused the interest of Russia's state-owned oil pipeline operator Transneft. Early last month Transneft proposed that it would invest \$143 million in the Ventspils terminal in exchange for a 50 % stake. At the beginning of this year, Transneft stopped transshipping oil via Ventspils at least until the end of June 2003. To compensate for the loss of oil shipped by pipeline, Ventspils Nafta began to ship oil by rail at the end of last year.

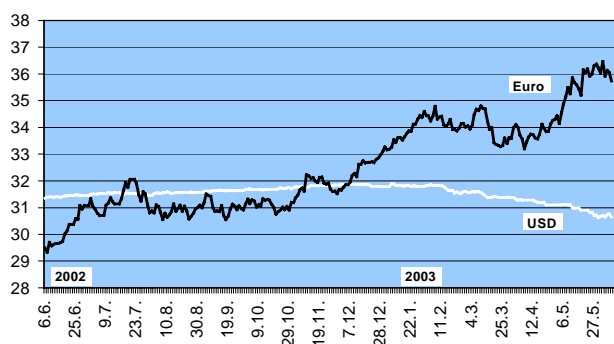
Baltic transport sector performance in first four months of the 2003. Estonia's largest port, the Port of

Tallinn, handled some 13 million tonnes of freight in January-April, a 1 % increase over the same period a year earlier. Of that, some 10 million tonnes was transit freight, a slight drop from last year. Liquid cargoes accounted for 64 % of the port's throughput. The volume of rail freight increased 5 % y-o-y in January-April. The modest growth figures reflected the harsh winter; Tallinn's harbour froze, which slowed activity throughout the country's transport sector.

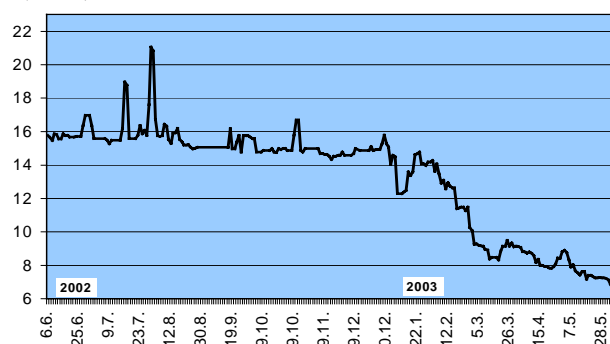
Latvia's largest port, Ventspils, suffered from a decline in oil shipments in the first four months of the year. The port handled some 10 million tonnes of freight during the period, an 18 % decline from January-April 2002. The volume of freight handled by the Port of Riga rose to 6 million tonnes, an increase of 12 % y-o-y. Freight moving through the Port of Liepaja rose 44 % y-o-y to 2 million tonnes. The total volume of freight moving through Latvian ports in January-April was 18 million tonnes, a decrease of 6 % y-o-y. The drop in freight volumes was due in part to problems at Ventspils and in part to a shift in metal shipments from Latvian ports to Russian ports. Latvia's railways carried 16 million tonnes of freight, a 22 % y-o-y increase from January-April 2002. Oil was the most-transported item. Transit freight dominated the field, increasing 29 % y-o-y for the period.

Lithuania's Port of Klaipeda handled 7 million tonnes of freight in January-April, a 12 % increase from the same period in 2002. The increase was driven mainly by oil shipments, which constitute most transit freight. The volume of rail freight transport rose to 13 million tonnes in January-April.

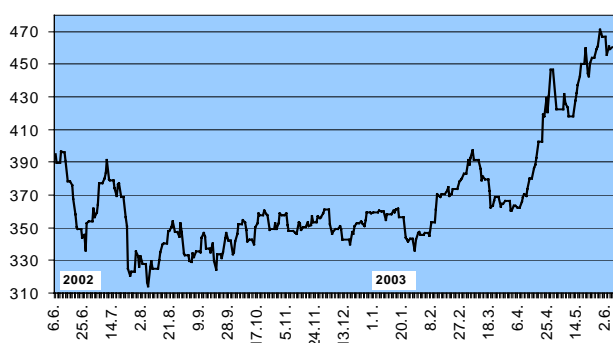
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



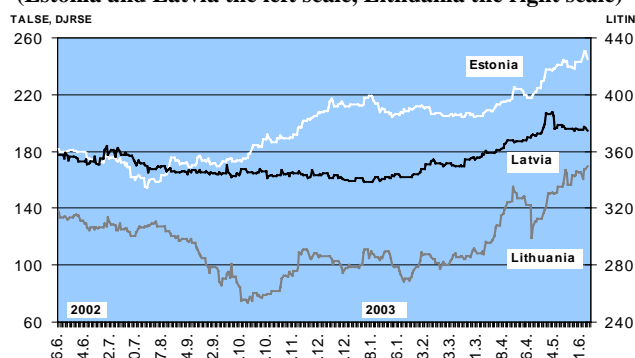
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





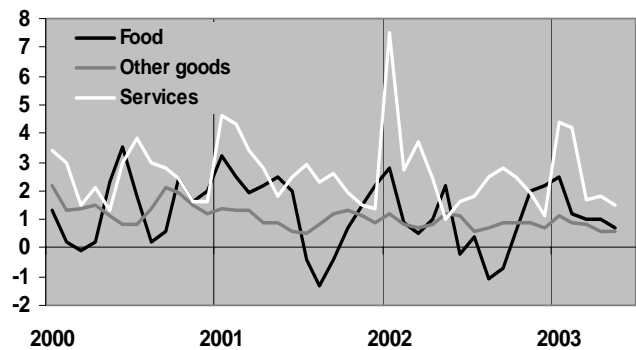
President Putin sets out 2004 budget policy framework. The president noted numerous accomplishments in 2002 and early 2003, including budget surpluses, a large financial reserve, higher wages for public sector workers and reduction of the foreign debt. He added that Russia's 2004 budget policies would support sustained economic growth and rising living standards.

Putin said the 2004 budget policy would aim at continued reform of the tax system, reform of relations between the centre and the regions, and cutting costs. The purpose of the tax reform is to encourage investment and create conditions for sustained economic growth through a reduction of the tax burden. The president said he supported lowering the value-added tax and unified social tax, reforming property taxes, as well as reorganising tax administration and inspections. He also said that this year two bills should be passed in the parliament in order to redefine relations between the centre and the regions. The framework legislation gives regions greater independence in exchange for assuming greater responsibility in budget matters. Cost-cutting measures should take inventory and reappraise federal sector responsibilities, as well as the elimination of unfunded mandates for the regions.

Russian government approves main budget parameters for 2004. Next year's budget proposal assumes economic growth of 5 %, an average exchange rate of 31.9 roubles to the dollar and an oil price of 22 dollars per barrel. Using these assumptions, the budget yields a surplus of 0.6 % of GDP (i.e. budget revenues amounting to 17.7 % of GDP and expenditures of 17 % of GDP). The surplus of nearly RUB 100 billion (€2.8 billion) would be transferred to a stabilisation fund to be created to replace the current financial reserve. The plan also foresees that the finance ministry would oversee the stabilisation fund, and that the fund's assets would be used more strictly to counter the effects of external economic cycles. The financial reserve was about RUB 230 billion (€6.4 billion) in April 2003. In accordance with president Putin's policy guidelines, the government plans to lower the average tax burden from 34.4 % to 33.5 % of GDP in 2004. Domestic financing, income from privatisation sales, and sales of land and precious stones will be the main sources of external debt financing.

Russian inflation down slightly in May. May consumer prices were up 0.8 % m-o-m. The slow-down in inflation in May mainly reflected a subdued rise in food prices. The 12-month rise in prices was less than 14 % in May, when prices for food and other goods rose about 10 % y-o-y. Further hikes in the prices of services (up 31 % y-o-y in May) exceeded the average pace of inflation. In the past twelve months, prices of housing and municipal services have risen 45 %, while prices for public transport, education, and health care were up about 20 %.

Russian consumer prices, percentage change from previous month



Slight changes in structure of Russian industrial investment in the first quarter of 2003. Total investment in Russia rose about 10 % y-o-y in the first quarter (although in 1Q02, the comparison basis, investments were exceptionally low due to the elimination of certain investment-related tax breaks at the start of 2002). A greater share of investments, about half of total investment, went to industry. There was also a substantial increase in the relative importance of investments in natural gas production (7 %) and food industries (almost 5 %). The relative shares of the oil industry (19 %), ferrous metallurgy, machinery and equipment, agriculture and telecommunication, all fell substantially. A slight drop was seen in the transport sector's share (15 %), while the housing sector remained at just below 15 %. Nearly 60,000 new dwellings (an increase of 10 % y-o-y) were completed in the first quarter of 2003.

Russia's new customs code enters into force at the start of 2004. Handling of the customs code was put on the fast track after its second Duma reading in April. President Vladimir Putin signed the bill into law at the end of May. The code i.e. shortens the maximum time for customs clearance and better defines documentation required by the customs authorities (see Week in Review 17/2003). Customs Committee head Mikhail Vanin said the new customs code limits the authority of the Customs Committee to make special rules. Over 3,000 such rules exist under the current code.

Highlights of G8 summit. Last week, Russian president Vladimir Putin joined leaders of industrialised nations in Evian, France. At the end of the summit, the participants approved a Declaration in Support of Economic Growth and a Responsible Market Economy that fosters more efficient world markets, justice and transparency. The leaders also approved the G8 Plan of Action in the Field of Trade. Heads of state from China, India and several African states also attended as observers.

Baltic inflation in May. *Estonian* inflation was subdued in May as consumer prices rose just 0.6 % y-o-y (1.3 % y-o-y in 1Q03). Consumer prices were down 0.3 % from April, due mainly to lower fuel prices. Food prices climbed slightly.

Latvian consumer prices in May were up 2.5 % y-o-y. The monthly rise in consumer prices averaged 0.2 % (0.3 % m-o-m in April). The largest increases were seen in the prices of clothing, fruit, medicines and potatoes. Fuel prices fell.

Deflation continued in *Lithuania*, with consumer prices declining 0.9 % y-o-y in May (-1.0 % in April). Consumer prices fell 0.2 % m-o-m in May. The largest price declines were seen in vehicle and transport costs and prices for food and non-alcoholic beverages. Prices for services rose slightly.

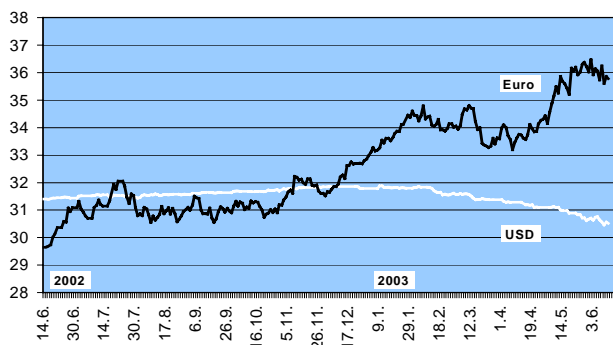
Latvian first-quarter GDP growth beats forecast. Latvian GDP rose 8.8 % y-o-y in real terms in the first

quarter of 2003. Strong domestic demand and rapid export growth since last year drove the acceleration in economic growth. Growth occurred in all sectors of the economy. Highest growth (17 %) was registered in trade and construction. Manufacturing output rose 10 %. Despite a fall in oil shipping, the transport and communications sector grew 7 %.

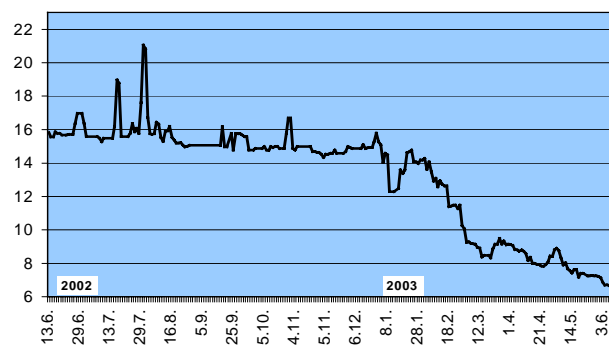
Poland votes for EU membership. Poland's national referendum on EU membership was held last weekend (June 7 – 8). Over 77 % of voters supported membership, and turnout was nearly 59 %.

Malta, Slovenia, Hungary, Lithuania and Slovakia have already voted for EU membership. The Czech Republic holds its national referendum today and tomorrow (June 13 – 14). Next in line is Estonia on 14 September, followed by Latvia on September 20. Cyprus, the tenth accession candidate, will skip the national referendum.

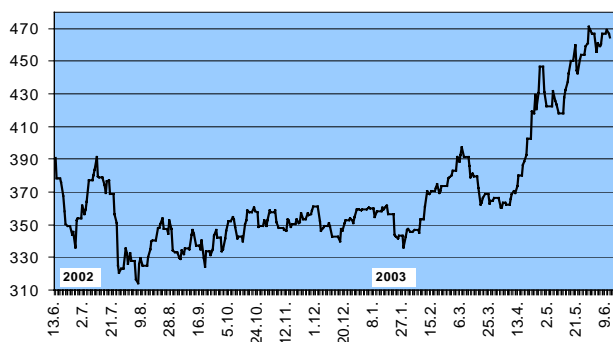
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



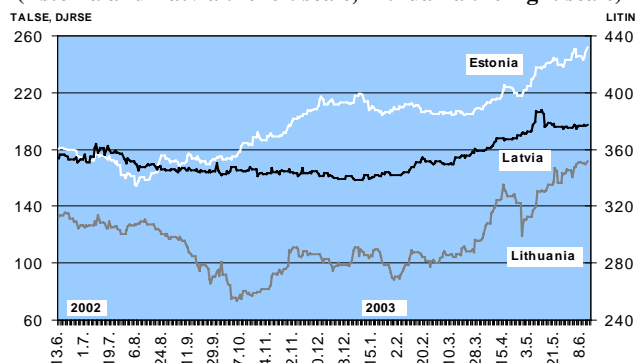
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russia has already paid the bulk of its debt servicing for 2003. Russia has already paid out a total of \$9.5 billion this year on scheduled payments of principal and interest on its foreign public debt. This year, total debt servicing costs will reach slightly more than \$17 billion. Initially, Russia's planned debt servicing costs for 2003 exceeded \$20 billion, which led to doubts as to whether the country could meet its repayment obligations. In anticipation of this upcoming peak in debt payments, Russia began to pay down debt ahead of schedule a couple of years ago. This policy was possible thanks to higher-than-expected revenues from oil exports due to high world oil prices. Today, few doubt Russia's abilities to handle its debt servicing.

The finance ministry reports Russia's public-sector foreign-currency-denominated debt stood at \$124.8 billion at the end of March. Although the Russian government has not resorted to any new foreign borrowing this year, the weakening of the US dollar has raised the valuation of public foreign debt from \$123.5 billion at the start of this year.

Russia approves new production-sharing rules. In May, the Duma and the Federation Council approved amendments in the tax code and act on production-sharing agreements that restrict natural resource extraction on the basis of production-sharing agreements. The amendments entered into force on June 10. Foreign investors participating in projects on the basis of production-sharing agreements receive tax breaks (see *Week in Review 15/2003*). The new changes are intended to give domestic and foreign investors a level playing field (and likely were initiated by large Russian companies involved in natural resource extraction). Under the new regulations, production-sharing agreements can be formed only when normal tax treatment is insufficient to attract willing bidders at auction. Current production-sharing agreements will remain in force with certain changes. In addition, some hydrocarbon deposits, e.g. on Russia's continental shelf and in the area of the Caspian Sea under Russian jurisdiction, as well as projects based on international agreements, will be allowed into the production-sharing system without an auction procedure.

Russian oil exports continued to climb in first quarter. The volume of crude oil exports increased over 8 % y-o-y in 1Q03, while oil products exports rose 6 %. Natural gas exports increased 2 %. The strong growth in export earnings was, however, due mainly to high world fuel prices. In current dollars, the price of Russian crude oil was about 50 % higher than in 1Q02; fuel oil prices were up 65 – 70 %. Natural gas prices were also up over 20 %. The share of crude oil, oil products and natural gas in Russian goods export earnings rose to 60 % in the first quarter. Grain exports, which boomed last year, were up a further 160 % y-o-y in the first quarter.

Imports grew about 25 % in dollar terms (and over 10 % when measured with a basket of currencies of Russia's main trading partners). Imports of machinery and equipment and transport vehicles grew slightly slower than imports overall; their share of recorded imports was 35 %. Food products accounted for 23 % of all imports.

Duma approves amendments to telecommunications act in second reading. After years in the Duma, over 400 Duma deputies voted in support of the second reading of revisions to the telecommunications act. Nearly all amendments proposed after the first reading were rejected, which means that the bill remains essentially unchanged from the original proposal of telecommunications ministry. Observers say that the modified act in itself is unlikely to improve the Russian telecommunications market significantly even if permit granting practices are clarified and competition and transparency increase somewhat. On the other hand, the changes give subscribers the opportunity to select between a service agreement priced at a fixed monthly rate or based on the actual amount of talk time. Because the change is expected to reduce operators' revenues, hikes in phone rates are anticipated.

Under the bill, operators must establish a universal services fund that will be used to finance expansions of telephone networks into remote areas. Every suburban area will be required to install at least one payphone and every village with at least 500 residents provide a public Internet connection. Russia's phone networks currently cover 46 % of inhabited areas. Fund opponents view the mandatory contributions as a new tax, consider the fund's administration rules unclear and find that the universal services provided under the fund would be inadequate.

Under the bill, foreigners would be allowed to own telecommunications companies within limits set by Russian legislation. The bill would guarantee foreign-owned telecoms the same benefits as domestic companies.

Wages rise in the Baltics, increased purchasing power supports retail sales. Nominal gross wages in *Estonia* rose on average 11 % y-o-y in the first quarter. Wages also increased an average of 10 % in *Latvia* and 3 % in *Lithuania*. The average monthly wage was 6,333 kroons (405 euros) in *Estonia*, 178 lats (271 euros) in *Latvia* and 1,125 litas (326 euros) in *Lithuania*.

Wages in *Estonia* are highest in the financial sector, averaging 19,600 kroons a month. Finance sector wages have also risen fastest. The lowest average monthly wage, 3,800 kroons, was paid in the agriculture and forestry sector. Average wages in the public sector were 20 % higher than in the private sector in *Latvia* and 4 % higher in *Lithuania*. The minimum monthly wage rose to 2,331 kroons in *Estonia* and 70 lats in *Latvia* (a 17 % increase from 1Q02 in both cases). The minimum monthly wage in *Lithuania* remained at 430 litas.

The rise in real wages has boosted the purchasing power of Baltic households, which has long supported the expansion of retail sales. In the first quarter of this year, the growth in the retail sector slowed slightly, but was still impressive (9 % y-o-y in Estonia, 13 % in Latvia and 8 % in Lithuania). In particular, sales of motor vehicles, clothing, textiles, home appliances and furniture have developed favourably. Tighter competition among retailers has cut into their overall profitability, however.

Estonian parliament approves 2003 supplementary budget. Higher-than-forecast revenues in the first months of the year justified the increased budget spending. The EEK 1.1 billion (€71 million) supplementary budget was approved with the support from all parties in the governing coalition. The additional spending will go e.g. to assisting the education sector (EEK 145 million) and regional administration (EEK 107 million). Construction of the Pärnu hospital (EEK 263 million) and the Northeast Estonia Prison (EEK 87 million) will be financed out of the state budget reserves.

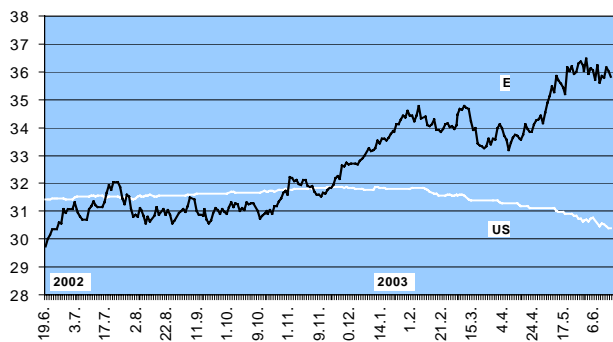
Latvia to hold presidential election on Friday. The term of Latvian president Vaira **Vike-Freiberga** ends on June 30. She is currently the only candidate standing in tomorrow's (June 20) presidential elections. To win the presidency, a candidate must receive a simple majority endorsement from Latvia's 100-member parliament. Both the ruling coalition parties and the largest opposition party have declared their support for Vike-Freiberga's re-election. A poll in May also showed that 75 % of Latvians support her.

Poland's finance minister Grzegorz Kolodko resigns. Finance minister Kolodko resigned on June 11 after serving eleven months in the cabinet of prime minister Leszek **Miller** (social democrat). Miller sparked the resignation after announcing that he was transferring responsibility for economic policy from Kolodko to economy minister Jerzy **Hausner**. Former deputy finance minister Andrzej **Raczko** (who has been actively involved in Poland's EU accession negotiations) was named the new finance minister.

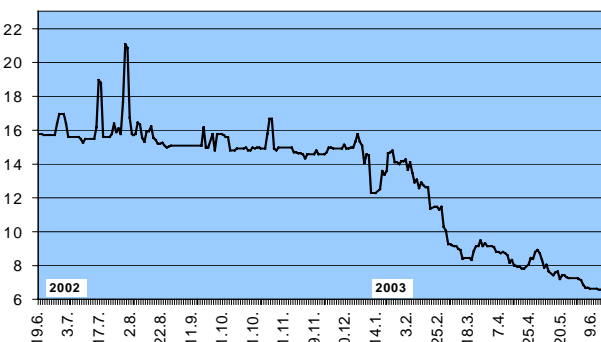
Kolodko fought to reduce Poland's budget deficit to the level required for joining EU's Economic and Monetary Union, which, in turn, would allow Poland to adopt the euro already in 2007. The deficit reductions were to be accomplished through cuts in public spending, reduction of tax breaks and social benefits, and through the transfer of 9 billion zlotys (\$2.4 billion) in central bank assets to the budget. After the ministerial shake-up, Miller's government narrowly won a parliamentary confidence vote (236 – 213) on June 13 in Poland's 460-seat parliament. Miller's government has operated as a minority coalition for the past three months.

Poland's current problems include sluggish economic growth, low investor confidence, an unemployment rate of nearly 19 % and a series of high-profile corruption scandals. Prime minister Miller's economic program seeks e.g. 5 % annual economic growth, a reduction in unemployment, tax cuts and fewer obstacles to business.

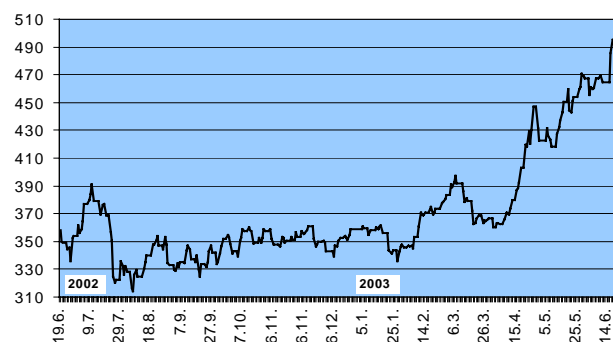
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



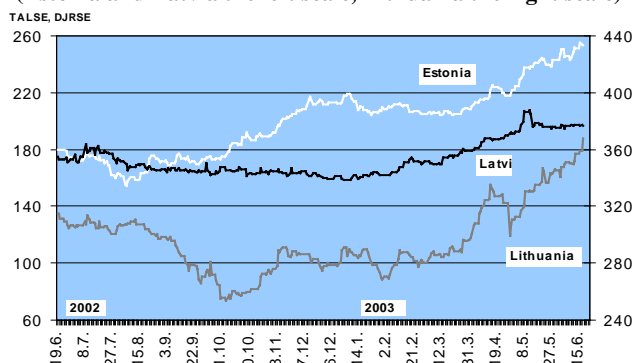
Russia: 31 – 90 days interbank rate (Mibor), % p.a.



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russia currently one of the world's fastest growing economies. Official Goskomstat figures show Russian GDP rose 6.8 % y-o-y in the first quarter, only to accelerate further in the next two months. The combined production index of five base sectors of the economy was up 7.2 % y-o-y for the first five months of the year. For May, the index of five base sectors rose 8.5 % y-o-y. Due to the good showing, the government is expected to raise its forecast for economic growth this year about one percentage point from the current 4.5 %. Certain economic research institutions are now forecasting economic growth could reach as much as 7–7.5 % this year.

The workday-adjusted figure for industrial output rose 7.1 % y-o-y in the first five months of 2003. Above-average growth was registered in fuel and electricity production, as well as nonferrous and ferrous metallurgy. It is a positive sign that machine building and metal fabrication (7.5 % y-o-y) and the pharmaceutical industry (17 %) also posted strong growth.

Russian central bank lowers refinancing rate. Effective from last Saturday (June 21), the CBR lowered its refinancing rate from 18 % to 16 %. The CBR lowered the refinancing rate three percentage points last February. The rate now stands at its lowest level in its eleven-year history. The refinancing rate plays a very minor role as a monetary policy tool and is substantially higher than prevailing interbank lending rates. This month, interbank lending rates for 8 to 30 days are running just under 6 %.

Russian Duma approves numerous changes in the tax code. On the last day of the spring session (June 21), Duma deputies voted to decrease the *value-added tax* from 20 % to 18 %, effective from the start of 2004. VAT of 10 % will continue to be imposed on certain staples. The losses from the tax cut, which are expected to reduce federal budget revenues by RUB 96 billion (EUR 2.7 billion), will be compensated for with increase in the *oil extraction tax* and the introduction of a *natural gas extraction tax*. The *excise tax on natural gas* will be eliminated, but the *export tax on natural gas* will be raised to 20 %. The Duma also approved the government's proposed elimination of the 5 % *sales tax*, which has produced a significant revenue stream for regional budgets. The government will make up for the lost revenues, e.g. by shifting a larger share of *company profit taxes* to regional budgets.

In the same session, the Duma also agreed to raise the maximum *company property tax* to 2.2 %. Regional officials, however, retain the discretion to set the tax rate lower if they choose. Social infrastructure will be exempt from the company property tax. In addition, the Duma approved changes in the act that governs monitoring of personal wealth. Under the bill, banks and other credit institutions would no longer be required to report large transactions or purchases to the tax authorities.

The amendments to the tax code passed in all three Duma readings. The changes still require Federation Council approval and the president's signature. Pushing the tax cut through the Duma before the start of the summer holidays allows the government to get to work drafting the 2004 budget.

Russian Duma amends foreign currency act. Also last Saturday (June 21), the Duma voted to lower the mandatory sales requirement for export earnings from 50 % to 30 %. Under the bill, the central bank may decide to lower the currency requirement even further. The goal of lowering the requirement is to reduce inflation and limit the strengthening of the rouble against the US dollar. CBR rules imposed after the 1998 financial crisis originally called for mandatory sales of 75 % of a company's foreign currency earnings. The purpose of the requirement was to prop the devalued rouble and inhibit capital flight from Russia. The bill still requires approval of the Federation Council and the president's signature to become law.

Changes in structure of bank deposits and lending concentration continued in first quarter of 2003. The CBR figures show that real value of the stock of bank deposits of households rose over 30 % y-o-y in the first quarter. Deposits with Sberbank, Russia's largest bank, grew over 20 %. Sberbank's share of household deposits was 66 % (down from 70 % a year earlier). The growth in deposits was above 40 % for all other categories of banks ranked according to total assets. The fastest rise (over 80 % y-o-y) was seen in next four largest banks in terms of total assets, with their share of total deposits rising above 5 %.

The stock of credits to enterprises was up 20 % y-o-y in real terms at the end of the first quarter. Credit granted by Sberbank and the four next largest banks grew slightly over 15 %. The group's share of lending fell to 47 %. The growth in credit was fastest (about 30 %) among the next 15 largest banks. This group's share of lending rose to nearly 20 %.

Growth in credits to households continued at a brisk 37 % pace. Highest growth (over 60 %) was seen in the group of banks ranked 51 to 200 in terms of assets. This group accounted for more than 20 % of the lending stock. The next highest growth (over 50 %) was in credits to households from the five largest banks. This group dominated, accounting for over half of the lending stock.

Russia becomes FATF member. The Financial Action Task Force (FATF) on money laundering, an independent organisation housed at the OECD, approved Russia as a member on June 19. Russia managed to get its name expunged from the FATF's blacklist last October and since then participated under observer status at the international body. The FATF noted that Russia had substantially revised its legislation and become more active in combating

money laundering, the drug trade, tax evasion and the financing of international terrorism. According to the FATF, Russia needs to follow through with implementation of reforms, including the elimination of the threshold sum, below which laundering is not considered a serious criminal activity. Membership is expected to improve Russian international reputation and creditworthiness. South Africa was also accepted as an FATF member at the same time as Russia.

Latvian president Vaira Vike-Freiberga wins second term. Last Friday (June 20), 88 members of Latvia's 100-seat parliament supported giving incumbent president Vaira Vike-Freiberga (65) her second four-year term. Vike-Freiberga ran uncontested in last week's presidential election. Her second term commences on July 8.

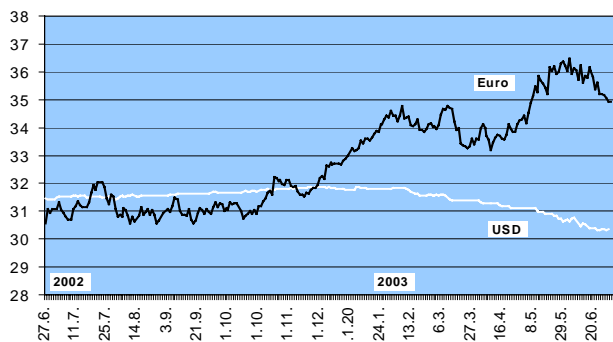
Latvian parliament approves supplementary budget. Last Friday (June 20), the parliament approved an LVL 32 million (EUR 48 million) supplementary budget for 2003. The largest additional spending item, about LVL 13 million, will go to the health care sector. Local administration (LVL 5 million) and the state highways fund (LVL 5 million) will also receive a sizeable share of the extra spending. LVL 4 million will go to agricultural subsidies and LVL 2 million to the national silvaculture program. LVL 4 million will also go to raising teachers' salaries.

IMF mission commends Lithuania's economic development. An IMF mission visited Lithuania at the beginning of the month as part of its annual Article IV evaluation of the country's economic situation. The Fund's representatives had special praise for economic stability achieved through the country's currency board arrangement and Latvia's prudent fiscal policies, noting economic growth remains robust and driven by investment and exports. Inflation in Latvia remains low.

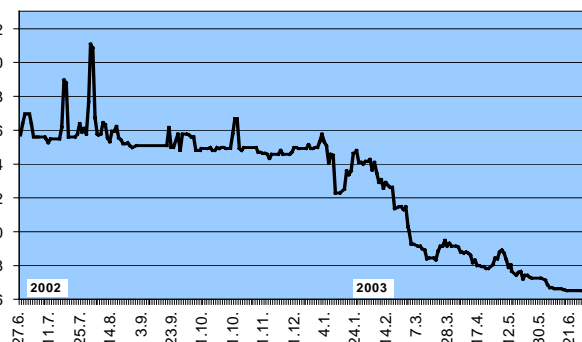
To maintain the credibility of its economic policies, the IMF encouraged Lithuania to restrain public sector spending. However, increasing the budget deficit temporarily to cover the costs of EU membership is acceptable. Structural reforms to promote competition and growth, as well as continuation of privatisation programs and improvements in supervision of the banking and insurance industries are also required. Public administration needs to become more efficient; corruption needs to be reduced.

The IMF also warned of the threats to the economy posed by external shocks, high unemployment and ageing of the population. The mission expressed special concern about the decline in tax revenues as a share of GDP, and encouraged the government to seek new revenue sources. Nevertheless, as long as Lithuania pursues prudent fiscal policies and continues to implement structural reforms, the outlook for the country is excellent in the medium term. The IMF raised its forecast for Lithuania's 2003 economic growth to 5.8 %.

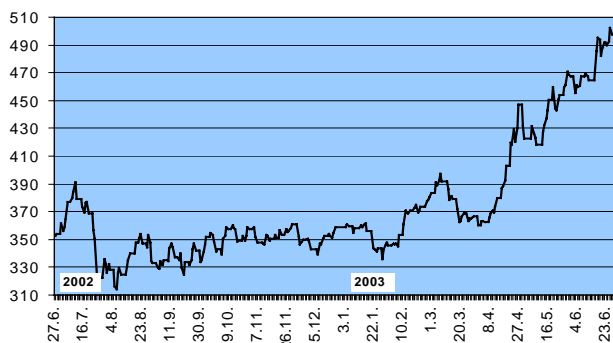
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



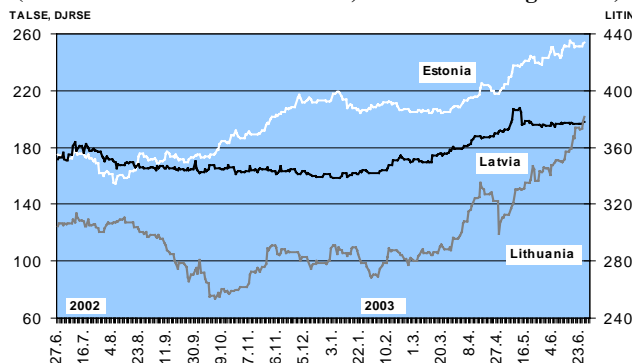
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian government approves state's borrowing program for next year. The borrowing plan is part of the preparation of the 2004 budget. Next year's borrowing policy aims to substitute foreign debt with domestic debt in order to reduce currency risk, extend the average maturity of government bonds and increase their supply on the domestic market. The third goal is intended to provide domestic financial markets with a greater volume of government debt instruments with a view to assisting the ongoing pension system reform. Pension funds are expected to invest pension savings in first-rate domestic securities, including government papers. Concern has been expressed in some quarters over a possible lack of suitable debt instruments on domestic markets when the investment funds launch their operations next year.

Under the plan approved on June 26, the state would in net terms raise from the domestic market this year RUB 145 billion (USD 4.8 billion), i.e. nearly three times the amount planned for this year. Gross borrowing would amount to RUB 263 billion, of which RUB 118 billion would go to retiring existing debt. The plan represents a substantial shift from borrowing abroad to borrowing from domestic markets. As of end-March, the state's rouble-denominated debt was RUB 674 billion (USD 22.3 billion) and foreign-currency debt USD 124.8 billion.

Russia imposes higher import duties on used cars to protect its domestic car industry. On June 21, the Russian government raised tariffs on used (3-7 years old) foreign-made cars imported by private individuals. The tariff is based on engine capacity. The move nearly doubles the average tariff charged to private individuals, and brings them more into line with tariffs charged to legal entities (previously as much as 2.5 to 4 times higher). The higher tariffs raise the prices of imported cars for private use on average 10-20%. The increase is seen as a means for protecting Russia's production of new cars against foreign imports and encouraging foreign carmakers to invest in Russia.

Hitch in plans for Russia-Belarus currency union. Belarus president Alexander **Lukashenko** decided at the last minute not to sign the legislation that would have allowed the parallel circulation of the non-cash Russian rouble with the Belarus rouble in Belarus from July 1. The payment systems of both countries had been readied for the launch and the Belarus government had already approved the project. The matter is now likely to be taken up in state-level discussions between Russia and Belarus.

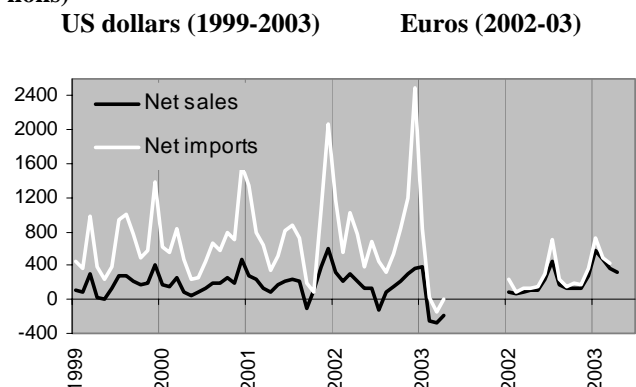
The parallel circulation of the non-cash Russian rouble in Belarus is seen as a step towards establishment of a full-fledged Russia-Belarus currency union. Under current plans, the Belarus rouble would be pegged to the Russian rouble at the start of 2004. The Russian rouble would become the sole official currency of Belarus from the start of 2005.

Energy issues head discussions in Russian president's UK visit. President Vladimir **Putin's** state visit to the UK at the end of June was the first official visit by a Russian or Soviet head of state since Tsar Alexander II's visit in 1874. During the visit, president Putin and prime minister Tony **Blair** announced that they had put behind them their differences over the war in Iraq.

Energy matters dominated the economic discussions. The two leaders signed a memorandum of cooperation, whereby the countries agreed to cooperate in construction of a gas pipeline extending from Russia under the Baltic Sea to western Europe. The project is valued at nearly USD 6 billion, although certain issues such as financing and gas export volumes remain unresolved. The memorandum, however, does not bind the UK to participation in the gas pipeline project. During the visit, British Petroleum also signed a detailed agreement, whereby BP and the Russian TNK Group formed a new giant consortium company for oil production in Russia. The deal, whereby BP will invest nearly USD 7 billion in Russia, was finalised in February (see Week in Review 7/2003).

Euro's role grows in foreign cash exchange operations of Russian banks. The Bank of Russia figures indicate that the net sales of cash dollars involving Russian banks and private individuals, as well as net imports of cash dollars through banks turned exceptionally negative in the first months of this year. This was due to a sharp increase in dollar purchases by banks. Because banks were selling large amounts of cash euros, euro imports in January-April were up sharply from the same period a year earlier. The euro's share of foreign cash sales rose to 35% in January-April and accounted for nearly 60% of total cash currency imports (compared to 30% and 20%, respectively, for all of 2002). Among the factors contributing to the increase were growing Russian tourism in the euro area and the 15-month decline of the dollar against the euro.

Net sales of cash currency by Russian banks to private individuals and net foreign currency imports (in millions)



St. Petersburg mayor Vladimir Yakovlev appointed Russian deputy prime minister. Last month, president **Putin** named Vladimir **Yakovlev** as deputy prime minister in charge of housing and municipal services, as well as urban planning, construction and the transport sector. Despite a decade of efforts to reform housing and municipal services, the results to date have been disappointing. Observers expect Yakovlev will have his hands full until the Duma elections in December, when his term will come to an end. Mayoral election will be held in St. Petersburg in October or November. In the interim, first deputy mayor Alexander **Beglov** will act as mayor.

Estonian GDP growth slows slightly. In the first quarter of 2003, Estonia's GDP grew 5.2 % y-o-y in real terms. Fastest growth was registered in the finance (17 %) and manufacturing (11 %). Electrical power generation, natural gas distribution and water supply posted 10 % increase. Estonia's economic growth was driven by domestic consumption, which grew 12 %. Fixed investments rose an impressive 33 % and private consumption 7 %. Exports increased 5 %, while imports were up 16 %.

Lithuania enjoys strong GDP growth at the start of the year. In the first quarter of this year, Lithuanian GDP rose 9.4 % y-o-y in real terms. Production grew in almost all economic sectors. Exports of goods and services climbed 15 % y-o-y, while imports were up 10 %. Private consumption grew 5 % and fixed investment 6 %.

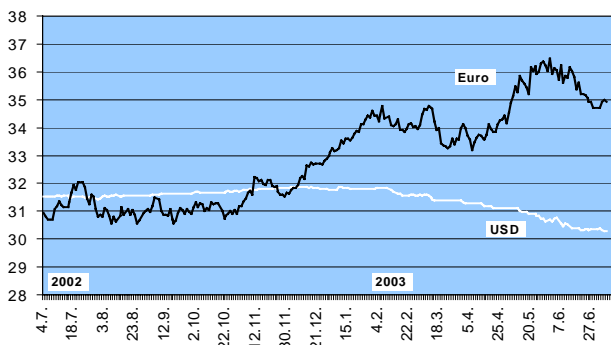
The higher-than-forecast economic growth was driven by strong expansion in the energy sector (27 %). High growth was also recorded in construction (18 %) and manufacturing (16 %).

Baltic countries see different time frames for euro introduction. Bank of *Estonia* governor Vahur **Kraft** says his country wants to make the changeover to the euro as soon as possible. Estonia's goal is to join ERM-2 immediately on May 1, 2004 – the first day of Estonia's EU membership. Thus, after the requisite two-year ERM-2 participation, Estonia would introduce the euro as its official currency in summer 2006.

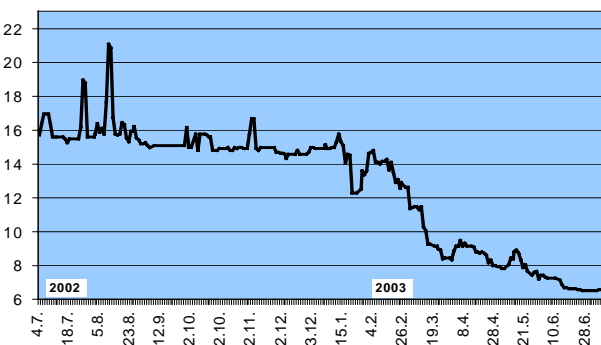
The Bank of *Lithuania* plans on adopting the euro at a slightly more relaxed pace. Governor Reinoldijus **Sarkinas** also expects Lithuania to begin participation in ERM-2 in conjunction with EU membership, but hold off on introduction of the euro until 2007.

Bank of *Latvia* governor Ilmars **Rimsevics** predicts his country will only be ready to join ERM-2 at the start of 2005. In summer 2007, the country's readiness for euro will be evaluated. Thus, a realistic aim for switching to the common currency is January 1, 2008. One reason for the slower shift to the euro is that (unlike Estonia and Lithuania, which have pegged their currencies to the euro) Latvia's currency is pegged to the IMF's SDR currency basket. Hence, entry into ERM-2 is anticipated to cause more changes for business life in Latvia than in other Baltic countries.

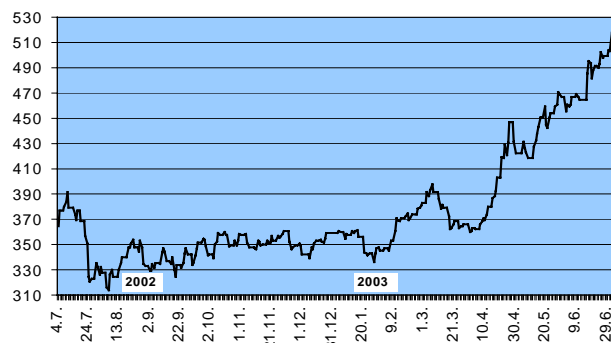
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



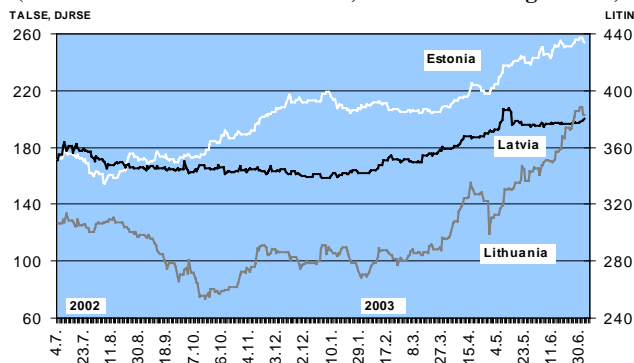
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian inflation continues to outpace government's target. The on-year change in consumer prices in June was 13.9 %. For the month, prices were up 0.8 %, i.e. higher than the on-month increase registered in June 2002 (0.5 %) and matching May's 0.8 % rise. Inflation rate was sustained in particular by increasing prices for services and foodstuffs. The sharpest price growth in June was seen in bread and other grain products, a reflection of poor harvest prospects. The government's inflation target for this year remains 12 %. Few observers believe this target can be met as long as prices continue to rise at the current pace. Consumer prices in Russia rose 15.1 % last year.

CBR lowers sales requirement for export earnings to 25 %. The latest version of the foreign currency act lowered the ceiling on mandatory requirement for export earnings to 30 % and gave the CBR the option to lower the requirement even further. Using its new powers on July 9, the CBR lowered the limit to 25 %. CBR deputy chairman Oleg **Vyugin** noted that firms typically still exchange over 60 % of their foreign currency earnings for roubles because most of their expenses are denominated in roubles.

Putin finalises busy legislative season. By the beginning of this month, president Vladimir **Putin** had approved numerous legislative amendments. They include a lowering of the value-added tax from 20 % to 18 %; elimination of excise taxes on natural gas and crude oil along with an increase in production taxes; increases in excise taxes on liquid fuels, alcohol beverages and tobacco; abolition of the 5 % federal sales tax; imposition of an excise tax on passenger vehicles based on engine capacity; increased tax support for owner-occupied housing; elimination of monitoring by tax officials of large purchases by private persons; extension of the companies' register act to include private entrepreneurs; and clarification of the status of political parties, associations and election unions in federal and local elections.

Status of Russia's small farmers defined, plot cultivation exempt from taxes. President **Putin** last month signed into law acts redefining the legal status of small farms and cooperative farms. A small farm was earlier considered as a distinct agricultural entity while only the farmer himself was considered as a private entrepreneur. This situation complicated relationships with banks, tax officials and commercial partners. The new *act on small farms* defines the small farm operation on the basis of property. The farm has the same rights as other agricultural producers, but lacks the status of a legal person. Between one and five persons can establish a small farm. They may be Russian citizens or foreigners. Amendments to the *act on agricultural cooperatives* deal with such matters as farm administration, membership, membership fees and ownership relations.

In its final spring session (June 21), the Duma decided not to classify production on personal plots as a business activity and therefore exempt from taxation. Regional statutes will dictate the maximum area of land on which a person can practice plot cultivation. Regional and local officials will decide on the types of cultivation considered commercial operations. It is estimated that a third of all Russians practice plot cultivation. These plots account for a substantial amount of the country's production of e.g. potatoes, vegetables, meat and milk.

Statistics Committee figures on household income growth may overshoot. Although the quality and applicability of Statistics Committee statistics has clearly improved in recent years, specification of some crucial figures remains problematic. One recurring difficulty is the quantification of household earnings.

Statistics Committee figures show that the real incomes of households rose 16 % y-o-y in the first quarter of 2003. Few Russian researchers trust the figure, however, given that real wages only grew 11 % and retail sales 9 % in the same period. Due to the lack of actual income figures, Statistics Committee calculates real incomes of households indirectly using data for – inter alia – wages, savings and consumption. Two Moscow-based economic research institutes (the Development Center and Center for Macroeconomic Analysis) argue that Statistics Committee's figures are distorted by the use of gross figures for currency exchange by private individuals and by the failure to include changes in foreign currency deposits of private individuals. This, in turn, leads to an overestimation of growth in household incomes. The institutes' own estimates indicate real incomes of households increased 9–11 % in the first quarter.

Statistics Committee is considering modification of its statistical method. Applying its current methodology, real incomes in Russia grew 14 % y-o-y in the period January-May, when real wages and retail sales grew only 9 %.

Maturities on Russian bank deposits and credits continue to lengthen. Household deposits (both rouble and foreign currency) were up 30 % y-o-y in real terms as of end-March. The share of foreign currency deposits in the total deposit stock was 37 % at the end of the first quarter. The fastest growth was in rouble and foreign currency deposits for longer than six months. The share of time deposits over one year rose to 39 % of deposits.

Foreign currency credits granted by banks to firms expanded considerably faster in the first quarter (nearly 30 % y-o-y in real terms) than rouble credits (less than 20 %). The share of foreign currency credits rose to 35 % of the entire lending stock at the end of 1Q03. Fastest growth was in foreign currency loans of over one year and in short-term credits under one month (both rouble and foreign currency). The share of loans granted for over one year rose to 32 % of the entire lending stock.

June inflation figures for the Baltic countries. Inflation in *Estonia* fell to 0.3 % y-o-y in June (0.6 % y-o-y in May). June consumer prices fell 0.4 % m-o-m, driven by falling prices for fuels and communications services. Prices of alcoholic beverages and tobacco, as well as hotel and restaurant services, rose slightly.

Consumer prices in *Latvia* were up 3.7 % y-o-y in June (2.5 % in May). Inflation reached its highest pace since April 2000. The on-month rise in prices in June was 0.7 %, due particularly to higher prices for fruit and vegetables. Prices were also higher for cars, medicines and certain services. Clothing, meat and mobile phone services were cheaper.

Lithuanian deflation continues. Consumer prices in June were down 0.4 % y-o-y (0.9 % in May). On month, however, June prices were up 0.1 %. The largest price increases were seen in foodstuffs, alcohol, tobacco, and hotel and restaurant services. Transport costs, as well as prices for communications services, fell.

Baltics improve their rankings in two major development surveys. All three Baltic countries improved their Human Development Index (HDI) of the United Nations Development Programme (UNDP). *Estonia's* HDI rank rose one notch to 41st place. *Lithuania's* ranking was bumped up four places to 45th, and *Latvia* moved up three places to 50th. *Russia* dropped three places to 63rd. The HDI survey compared living standards in 175 countries based on 2001 figures for life expectancy, quality of health care and education, and personal income. Norway continued to hold the top spot as the world's most developed nation in HDI terms.

Estonia also placed well in the Canada-based Fraser Institute's "Economic Freedom of the World" survey, rising an impressive 25 places to rank as the world's 16th freest economy. *Latvia* rose four notches to 51st place, and *Lithuania's* ranking dropped one place to 69th. *Russia* climbed six places to 112th. The 2003 Economic Freedom survey encompassed 123 countries and employed data from 2001. Factors measured included institutions essential to ensuring the rule of law, property rights, the size of the public sector, and freedom to trade and compete. Hong Kong was rated the world's freest economy.

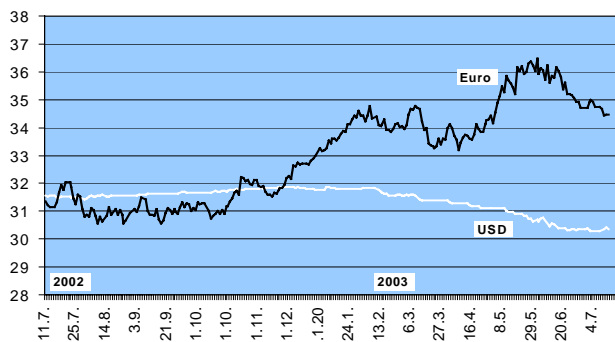
Transition economy rankings in two development indices

Year	Human Development Index ¹		Economic Freedom ²	
	2003	2002	2003	2002
Slovenia	29	29	73	77
Czech Rep.	32	33	39	43
Poland	35	37	77	81
Hungary	38	35	35	52
Slovakia	39	36	77	70
Estonia	41	42	16	41
Lithuania	45	49	69	68
Latvia	50	53	51	55
Belarus	53	56	-	-
Bulgaria	57	62	103	101
Russia	63	60	112	118
Romania	72	63	116	115
Ukraine	75	80	117	118

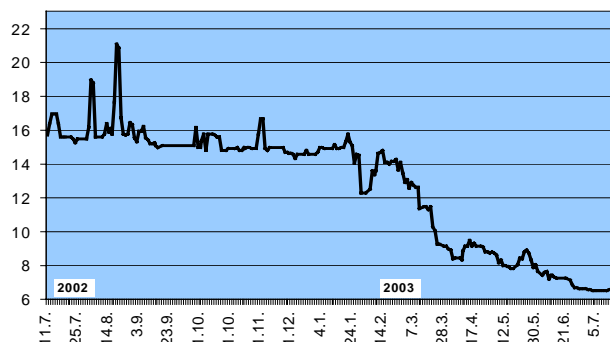
¹Human Development Report, UNDP (2001 and 2000 data)

²Economic Freedom, Fraser Institute (2001 and 2000 data)

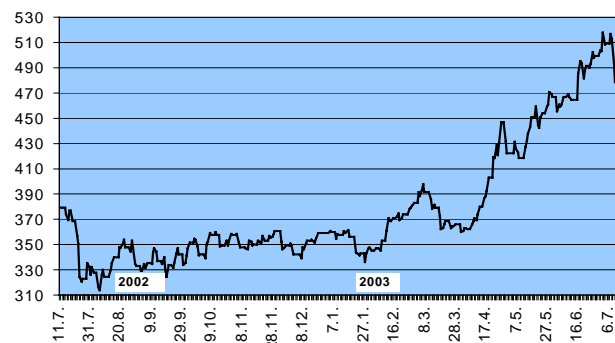
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



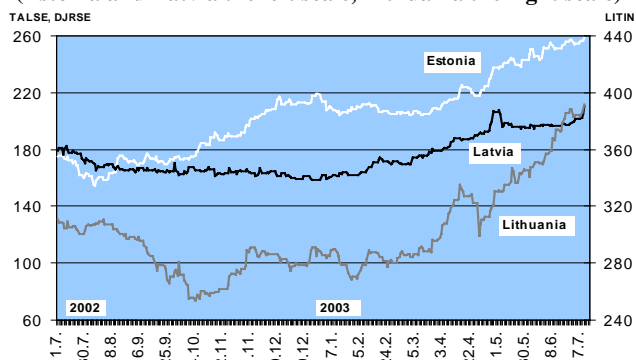
Russia: 31 – 90 days interbank rate (Mibor), % p.a.



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russia continues to enjoy robust industrial production growth. The state statistics committee reports Russian industrial output was up 7.0 % y-o-y in June and 6.8 % y-o-y in the first half of this year. Workday-adjusted growth figures for June and 1H03 were 5.3 % and 6.8 %, respectively. Above-average growth in the first half was seen in several major industrial sectors including export-oriented fuels (10.0 %), metallurgy (9.5 %) and machine building (7.6 %). In machine building, the growth in recent months has been led by investments. The highest industrial output growth in 1H03 occurred in the pharmaceutical industry (16.5 %), which mainly serves Russia's domestic market. Production fell in three sectors: light industry, book printing and the microbiological industry. Growth in the foodstuffs industry remained below average (4.3 %).

Russia's WTO membership talks continue. The 20th official meeting of the working group on Russia's accession to the World Trade Organisation took place last week. The group considered the third draft of its report on conditions Russia must meet to join the WTO. To smooth the accession group's future work, negotiation topics were divided into three categories, based on how much progress has been achieved and how much work remains. Additionally, Russia held numerous bilateral negotiation rounds on access of goods and services to the Russian market.

Russia's lead negotiator, deputy economy minister Maxim **Medvedkov**, said progress has been achieved in goods and services, as well as issues related to tariff quotas on imports. Negotiation talks remain divided on financial markets, currency controls, and especially the energy sector. Medvedkov added that his country was still unready to entirely open up its financial markets to foreign competition and that it would not give up its competitive advantages in the energy sector. Russia still rejects the condition of WTO membership calling for Russia to bring domestic energy prices into line with world market prices.

The accession working group for Russia will meet again in October. Medvedkov said it could be possible for Russia to complete the talks by 2004 and to pursue WTO membership in 2005. Russia continued talks on WTO membership issues this week with the EU in Brussels.

Progress in Russian pension reform. On June 30, the government decided to revise criteria imposed on private pension funds. The act on private pension funds entered into force in January this year. It states that private insurers can compete with state-owned company in investing the "savings portion" of workers' mandatory pension contributions. The June amendments include elimination of the requirement that private insurers demonstrate five years of experience in the field and raise the requirement on own capital from RUB 40 million to RUB 50 million (EUR 1.5 million). The competition that will decide which private insurers get to administer part of the assets of Russian pension funds began July 9. The competition

will select both the private pension investment companies and a company to oversee them. Tentatively, the competition results will be published at the beginning of September. The choice will be based on the private pension investment firm's operating experience, capitalisation, client base and level of indebtedness.

This month Russians will get information from the State Pension Fund about the amount of their pension saving as of end-2002. Every citizen has the opportunity to designate by October 15 an investment company they wish to handle the savings portion of their pension starting from the beginning of 2004. Citizens that do not designate a choice will automatically have their savings portion administered by Vnesheconombank, which handles state pension investments. Vnesheconombank's investment possibilities, however, are more limited than those of private investment companies.

Putin approves amendments to act on regional administration. The amendments are intended to create a regional administrative system in Russia, whereby each region's relations with the central government is based on a consistent statutory and fiscal basis. The law entered into force on July 8. Statutes governing the financing of regional administration tasks will only enter into force on January 1, 2005, if necessary changes in tax and budget codes concerning budget relations of different administrative levels have been implemented. The amendments are intended to help to establish a stable financial base, which as much as possible is in the regions' control. Regional administrators currently complain that the central government has in recent years modified its policies to reduce the regions' share of tax revenues. The issue is recurring debate theme in the Duma.

The amendments to the other piece of legislation crucial to administrative reform, the act on local administration, was approved by the Duma in the second reading early this month. The Duma delayed the law's entry into force a year (the beginning of 2006). Work on the bill will continue in the autumn.

Privatisation of Lithuanian energy companies proceeds. The Lithuanian government has approved privatisation plans for two state-owned electrical power grid operators, *RST* and *VST*. The initial selling price for a 71 % stake in RST is LTL 422 million (EUR 122 million) and the price for a 77 % stake in VST is LTL 359 million (EUR 104 million). The privatisation process officially begins on July 21, and the bids must be submitted by mid-September. The state wants to complete the sales this year.

The initial selling price for an 86 % stake in electrical power generator *Mazeikiu Elektrine* is LTL 15 million (EUR 4.3 million). Bids must be submitted by mid-September. Since Lithuania's sole oil refinery, *Mazeikiu Nafta*, depends on the power plant's operation, the refinery's largest owner, the Russian oil company YUKOS, is

considered a potential buyer. A 12 % stake in Mazeikiu Nafta will probably be sold to the EBRD.

Numerous Lithuanian privatisation projects stumble.

Lithuania's largest privatisation sales this year involve the electrical power distributors *RST* and *VST*, and four state-owned distilleries. Competitive bidding on the distilleries ended at the beginning of May and the state is currently in talks with prospective buyers. The sale of the distilleries is part of the government's policy of relinquishing of its monopoly on production of spirits. The monopoly was originally scheduled to end at the beginning of April. Due to ongoing negotiation, the monopoly's termination has been extended to the beginning of 2004.

Competitive bidding on the *Lietuvos Juru Laivinkyste* shipping company was arranged last winter. Although three companies showed interest in the company, a deal has not been finalised yet. Another shipper, *Klaipėdos Transporto Laivynas*, was sold last month for LTL 49 million (EUR 14 million) to the Lithuanian freight company Limarko. It was the largest privatisation sale so far this year.

Privatisation of certain companies has proven exceptionally difficult in Lithuania. For example, SAS, the sole bidder, abandoned plans to purchase *Lithuania Airlines*. Gazprom's efforts to acquire 34 % of the gas grid operator *Lietuvos Dujos* grind along. The sale was originally to have been completed by the end of 2002, but no agreement on price has yet been reached.

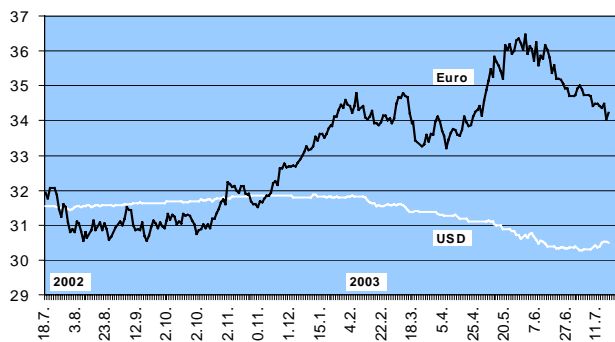
Lithuanian officials have been criticised for their inability to complete privatisation sales. The state property

fund is hoping to raise LTL 898 million (EUR 260 million) from privatisation sales this year. As of end-June, the state had raised just LTL 109 million.

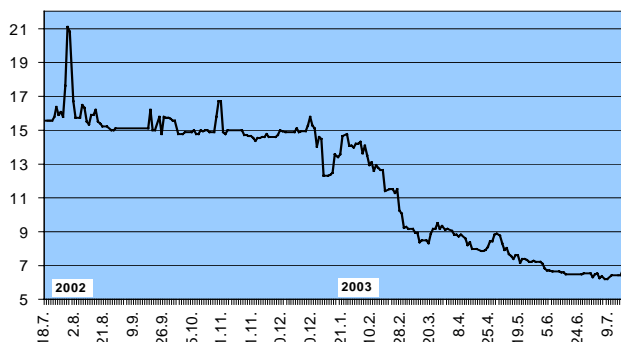
Latvian pulp mill project assessed. The Latvian government and the Finnish forest company Metsäliitto have reached initial agreement on construction of a pulp mill near Jekabpils. If completed, the project would be the largest investment in Latvia's history. However, several important issues remain to be resolved before the final agreement, including the size and duration of tax breaks granted to Metsäliitto, as well as assessments of the project's impacts on the environment and the Latvian economy.

Metsäliitto also wants Latvia to implement a comprehensive forest development policy and provide assurances that the mill will have sufficient access to cutting in state-owned forests. With a construction cost of nearly a billion euros, Metsäliitto also expects smooth raw material deliveries. The project was originally to be handled by the Baltic Pulp consortium held by the Swedish forest company Södra (33 %), the Latvian state (33 %) and Metsäliitto (34 %). Södra abandoned the project, however, and gave its interest to Metsäliitto. The Latvian government also plans to leave the consortium, making Metsäliitto solely responsible for the investment. Once the final contract is agreed, implementation of the project would be handled by Metsäliitto's subsidiary Metsä-Botnia.

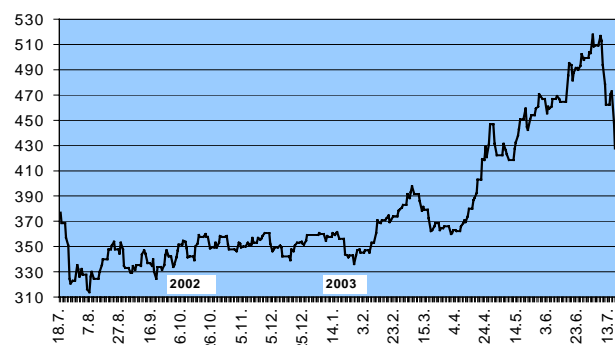
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



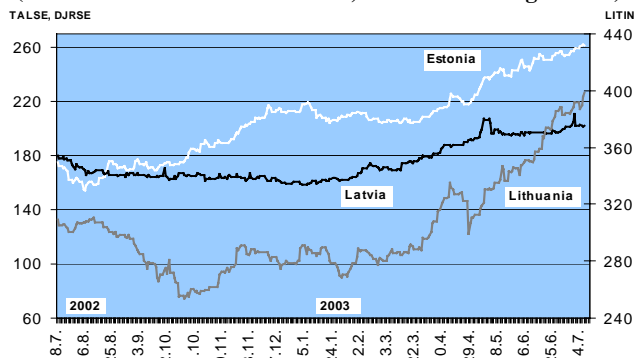
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian firms post higher profits in first five months of 2003. The State Statistics Committee reports that this year in the period January-May the profits of large and medium-sized firms in Russia were up nearly 65 % from the same period in 2002. Strong surges in profits were seen in export-oriented companies involved in energy, as well as electrical power and commerce. The improved profits were driven by increased private consumption, higher world oil prices and lower interest rates than in 2002. The only drops in revenues were seen in housing and municipal services. The share of profitable Russian firms was 57 %, the same level as in 2002.

In 2002, sales volumes of Russian oil companies rose, but their profits were eroded slightly by higher production taxes and shipping costs, as well as lower world oil prices. When calculated according to US GAAP accounting standards, Lukoil's sales rose from \$13.4 billion in 2001 to \$15.3 billion in 2002, while its profits sank from \$2.1 billion to \$2.0 billion. Under US GAAP, Yukos had sales of \$11.4 billion in 2002 (\$9.5 billion in 2001) and net profits of \$3.1 billion (\$3.2 billion).

Using International Accounting Standards (IAS), gas giant Gazprom's net sales in 2002 fell 5 % to \$19.2 billion. Lower tax rates helped boost the company's net profit from \$373 million in 2001 to \$857 million in 2002, but profit before taxes fell due to higher operating costs. In IAS terms, Sberbank, Russia's largest bank, showed little change from 2001 with net sales of \$3.7 billion and a net profit of \$970 million in 2002.

Suspicious around Yukos clearing. On July 18, Russia's General Prosecutor's Office announced it was investigating seven counts of possible criminal acts involving Yukos, Russia's largest oil company, and its owners. Platon **Lebedev**, chairman of the MENATEP group and one of Yukos' largest shareholders, has been arrested as a suspect of malfeasance in conjunction with the 1994 privatisation of the Apatit company. Several Yukos subsidiaries are also accused of tax evasion. The state prosecutor is also investigating possible Yukos involvement in five criminal homicides associated with past commercial and ownership disputes. Interrogation of the company's leading management and the investigations of company offices have received wide publicity and raised the possibility that the state may revoke certain privatisation deals or apply stricter supervision of companies' operations. These events helped drive down the Moscow stock exchange's RTS index 13 % in the past two weeks; Yukos shares were down more than 17 %.

Russian government officials have had mixed reactions to the Yukos scandal. Prime minister Mikhail **Kasyanov** emphasised that Russia's gains from privatisation are "indisputable" and stated that past privatisation would not be revisited. However, Alexander **Braverman**, deputy minister in charge of privatisation, said specific incidents could be revisited when there is evidence of criminal acts.

President Vladimir **Putin** has had no comment on the matter.

Privatised companies still face big problems in acquiring or leasing their lots. The large-scale privatisation of the past decade transferred the buildings and structures of former state companies to new owners, while the land on which these structures sat remained under state ownership. These privatisation sales only conferred a right of occupancy to the new owner. Under the implementation act of the land code, which entered into force in October 2001, firms are obliged to acquire or lease their lots from local officials by the start of 2004. The authority to set the purchase or leasing price was given to local officials. The law calls for price setting formula based on the annually adjusted land tax, rather than prevailing market prices. The Russian Union of Industrialists and Entrepreneurs (RSPP) has criticised the law's tight schedule and the above-market purchase and lease prices dictated by officials. The RSPP estimates that the lots to be transferred constitute only about one-thousandth of Russia's total land area, but the purchase price asked for these lots corresponds to 8 to 10 % of Russia's annual GDP.

The Russian government took up the lot issue on July 10 and promised to try and get a one to two-year extension on lot purchase and lease agreements, as well as incorporate new principles for determining lot prices into the law, set ceiling on lease rates and lengthen the limit of a single lease period to 49 years. The government is also conceding to company demands that lot purchases be payable incrementally, e.g. over a period of five years.

Russia's underdeveloped land markets, the lack of land use planning and attempts by local officials to take advantage of the situation further complicate resolution of the lot issue.

Russian government approves ceiling on export guarantees for industrial products in 2004. Russian companies that export industrial products will be entitled in 2004 to up to \$500 million in export guarantees and interest subsidies of \$50 million. By providing export guarantees, the government seeks to increase Russian exports to countries lacking OECD rankings or with rankings below Russia's. These include the CIS countries and many countries in Asia and Latin America. Rosximbank will function as the state export guarantee office, and its board will be supplemented with representatives from the finance, economy and industry ministries.

Russian banks to begin preparations to IAS accounting next year. A CBR press release states that from January 1, 2004 Russian banks must transform their financial statements from Russian standards to an IAS version. The CBR will publish the transformation rules later this year. Starting in 2004, an independent external auditor will also have to approve banks' financial statements. Officially

banks are obliged to use the IAS standards from the start of 2005. Russian accounting standards will coexist with the international ones until the beginning of 2006.

Fitch raises Latvia's credit rating. On July 21, the international credit rating agency Fitch Ratings upgraded *Latvia's* ranking for long-term foreign-currency loans one notch from BBB to BBB+. The ratings boost reflects the country's robust economic development, progress in implementing structural reforms, the strengthening of its banking sector and ability to attract foreign investment. Latvia's large current account deficit received the only negative comment from Fitch. It said Latvia's economic outlook was stable.

Fitch's rating of long-term foreign-currency loans is currently A- for *Estonia* and BBB for *Lithuania*. Standard & Poor's classifies Latvia's long-term foreign-currency loans BBB+, while Moody's gives a rating of A2.

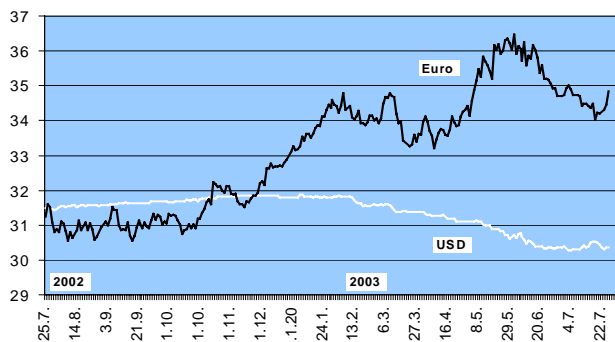
Baltic share prices up for the year so far. *Tallinn's* TALSE index has risen about 22 % since the start of the year. This month the index rose above 260 points for the first time since April 1998, reaching 261 on July 23. On the same day, *Riga's* DJRSE index was up about 30 %

since the start of the year, standing at 208 points. *Vilnius' LITIN* index stood at 397 points July 23, up 37 % since the start of the year. Each index is calculated in local currency.

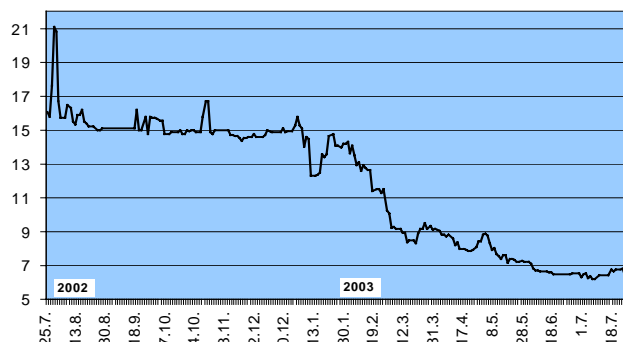
Baltic share prices have risen due to the faster economic growth in the Baltics than in EU counties or other EU acceding countries. With the advent of EU membership and continued progress in structural reforms, investor interest in Baltic stock markets continues to climb. Baltic bourses are nevertheless minuscule in comparison to the exchanges of present EU countries.

Interest rates continue to drop in Estonia and Lithuania. *Estonia's* three-month Talibor rate had fallen from 3.47 % at the start of the year to 2.67 % on July 18. *Lithuania's* interest rates, like Estonia's, have fallen substantially; the three-month Vilibor was 2.57 % on July 22, while the interest rate at the beginning of the year was 3.48 %. *Latvia's* interest rate has basically remained steady since the start of the year; the three-month Rigibor started the year at 3.79 %, and after slight fluctuations, reached 3.82 % on July 22. The three-month Euribor has fallen from 2.86 % at the start of the year to a current level of 2.13 %.

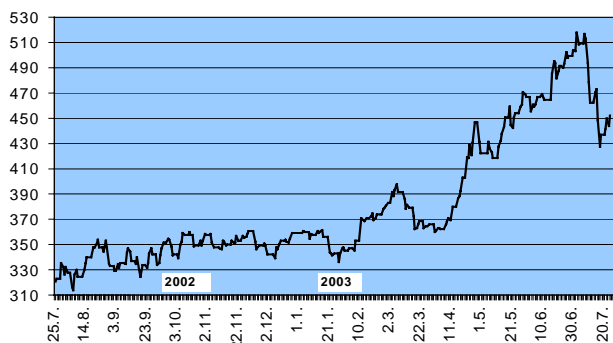
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



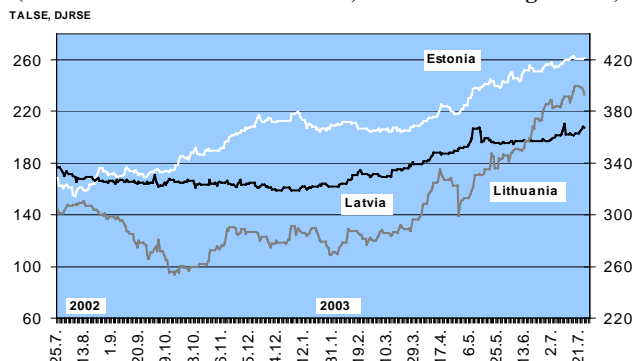
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian stock markets volatile, rouble strengthens in the first half of 2003. On July 30 the RTS index, which tracks key share prices on the Moscow Stock Exchange, stood at 453 points. The RTS is up about 25 % since the start of this year. The RTS hit 518 in early July, but fell back on uncertainty caused by the announcement of criminal investigations in connection with the Yukos oil company (see Week in Review 30/2003). The RTS dropped 17 % in two weeks to 428 points. Although the index has recovered somewhat at the end of July, investors remain cautious due to uncertainty on the market.

The rouble appreciated 11 % in real terms against the US dollar in the first half of 2003. The rouble also strengthened 1.5 % in real terms against a basket of currencies of Russia's main trading partners during the same period. With the exception of the euro, the rouble strengthened against major currencies (dollar, yen, and pound), especially in the second quarter.

Russian government approves privatisation program for 2004 - 2006. The plan approved on July 17 calls for privatisation of companies in which the state owns up to 25 % in 2004, companies in which the state owns 25-50 % in 2005, and finally companies in which the state's share exceeds 50 % in 2006. The privatisation of "strategic" enterprises will be decided separately. According to deputy minister in charge of privatisation Alexander **Braverman** the state is planning to sell, for instance, its 7.6 % stake in the LUKoil oil company in 2004 either as a whole or divided into several lots, as long as the business cycle is advantageous.

The government expects to raise about RUB 35 billion (EUR 1 billion) a year from privatisation sales and hopes to have most of the privatisation process completed by 2008. Russia currently operates nearly 10,000 state unitary enterprises, as well as complete or partial ownership of 4,000 enterprises.

Pensions boosted in Russia. Under president Vladimir **Putin's** June decree, the basic component and the insurance component of Russian pensions go up 8 % starting August 1. The average increase is 131 roubles a month, making the average old-age pension now RUB 1,890 (EUR 55). Although the hike increases the outlays of the state pension fund by RUB 4.5 billion a month, pension fund manager Mikhail **Zurabov** does not expect the new spending to strain the fund.

Business conditions vary greatly among Russian cities. According to a survey released in May by the Russian rating agency Expert RA, uncertain conditions, complex regulatory environment and undeveloped financial markets are restraining growth of Russia's corporate sector in many cities. The study was based on interviews with Russian and international experts involved in investment and consulting, as well as business leaders from 108 of Russia's largest cities. The interviews were used to rank cities according to their conditions for doing business (transport

and commuter connections, political and social stability, regulation of commercial activities, telecommunications services, infrastructure and standard of living) as well as the intensity of business development (corporate sector development, market institutions and investments).

Moscow, Russia's unchallenged centre of business life, boasts good commuter connections and infrastructure, a high standard of living, proximity to officials, as well as a diverse range of business support services. Moscow's main drawbacks for companies were problematic regulations (rank 87th), weak social and political stability (88th) and, somewhat surprisingly, telecommunications (50th). Financial market development in recent years has been particularly strong in cities with major raw material industries such as Salehard, Surgut and Saransk. Such cities, thanks to large Russian companies, have managed to attract investment, private firms and institutions. The study found that St. Petersburg, Russia's second most important business centre, failed to make it even into the top 20 Russian cities for financial markets. St. Petersburg remains the business capital of northwestern Russia and is better than Moscow when it comes to the regulatory environment. However, the city was seen as unstable in political and social terms (rank 59th).

Russia's most business-friendly cities are typically regional capitals and centres of commerce (e.g. Krasnodar, Perm, Samara, Yaroslavl, Novgorod and Nizhny Novgorod). In these cities, as well as smaller cities, the various factors affecting the operating environment are quite unevenly developed, which in turn discourages growth of the corporate sector. The relatively well-developed infrastructure of many cities is inadequate to compensate for social problems. The stable conditions in the southern city of Sochi have attracted Moscow-based travel agencies and insurance companies, but the city has yet to spawn its own local entrepreneurs.

Russian government sets stage for shift to all-volunteer army, Putin issues decree on alternative civilian service. Under the government's proposal, 80 units (about 148,000 soldiers) would be funded for the years 2004 to 2007. The government, however, slashed program spending by about half of the defence ministry's original proposal. The budget is now RUB 79 billion (EUR 2.3 billion), of which RUB 15 billion would go to improving battle readiness, and RUB 64 billion to housing, pay and other social contributions. Under the government's proposal, conscripts would not need to be sent to combat zones after 2004 and the period of mandatory military service would be reduced at the start of 2008 from two years to one. At the same time the government wants to increase recruitment of volunteers and improve military service morale.

On July 21, president Vladimir **Putin** issued a decree on civilian service. The right to perform civilian service in lieu of military service will be granted by the defence ministry and those in civilian service will have their post-

ings arranged by the labour ministry. The act on alternative civilian service was passed in July 2002 and enters into force at the beginning of 2004. The act applies to men between the ages of 18 and 27. The time for alternative civilian service would be 1.5 to 1.75 times the regular military service depending on the posting. Despite earlier government opposition, a clause in the act calling for postings outside the home district was accepted. This will raise the costs of civilian service considerably.

Central bank currency and gold reserves for Russia and Baltic countries. At the end of June, the foreign currency and gold reserves of the Central Bank of *Russia* stood at about \$64 billion, up 49 % from a year earlier. The reserves corresponded to about nine months of imports of goods and services.

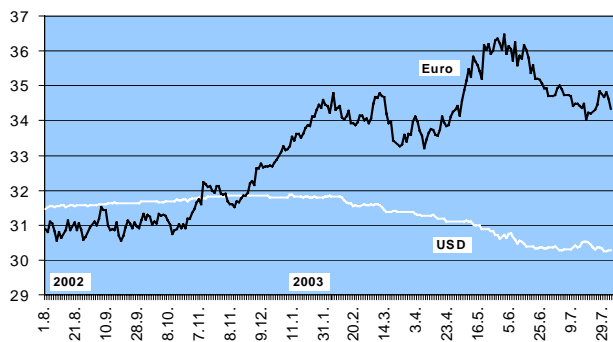
Also at end-June, the Bank of *Estonia's* foreign currency and gold reserves were about EUR 980 million, up 6 % y-o-y, and were sufficient to cover more than two months of imports of goods and services to Estonia. The Bank of *Latvia's* reserves were about EUR 1.7 billion, which, at the lat's current exchange rate, is an increase of about 12 % from a year ago. Latvia's reserves were sufficient to cover over four month's worth of imports. The Bank of *Lithuania's* reserves in June were about 26 % higher than a year ago, i.e. EUR 2.2 billion. The reserves could cover over three months of imports of goods and services to Lithuania.

Standard & Poor's lifts outlooks for Latvia and Lithuania. The international credit ratings agency Stan-

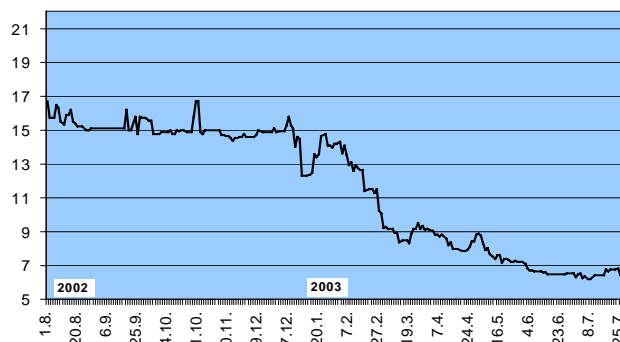
dard & Poor's upgraded its outlook for *Latvia's* foreign currency loans from 'stable' to 'positive.' Latvia's credit ratings, however, remained unchanged. The rating for long-term foreign currency loans is currently BBB+. S&P said it raised the outlook on the basis of macroeconomic developments strongly focused towards participation in EMU and official commitment to implementation of structural reforms. Total output is expected to rise about 6 % in the medium term due to strong investment inflows and approaching EU membership. Furthermore, S&P noted the healthy footing of Latvia's public debt and budget situation. S&P expects Latvia to be ready for EMU membership already in 2007, even if the Bank of Latvia currently expects to join in 2008. The country's gaping current account deficit negatively affected Latvia's credit rating.

S&P also upgraded its outlook of *Lithuania* from 'stable' to 'positive.' Again, bond credit ratings remained unchanged. Lithuania's long-term foreign currency loans are currently rated BBB+. Lithuania's economic outlook appears promising, given its low indebtedness and strong economic growth. In addition, S&P noted that improved competitiveness has boosted exports, and commended the country's favourable investment climate and relatively low current account deficit. S&P expects economic growth in the range of 5-6 % in the medium term, thanks mainly to the country's progress in structural reforms. Although EU membership and pension reform will involve extra costs in 2004, public debt and the budget deficit remain modest. S&P believes Lithuania will join the EMU in 2007 or 2008.

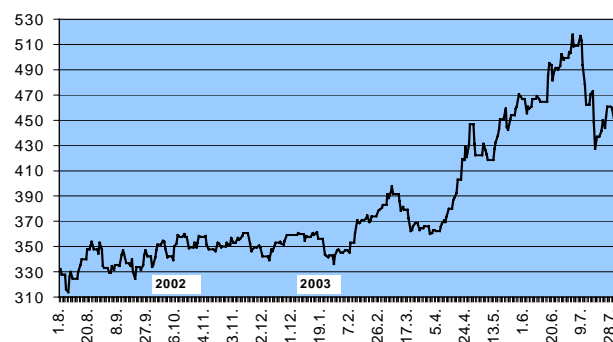
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



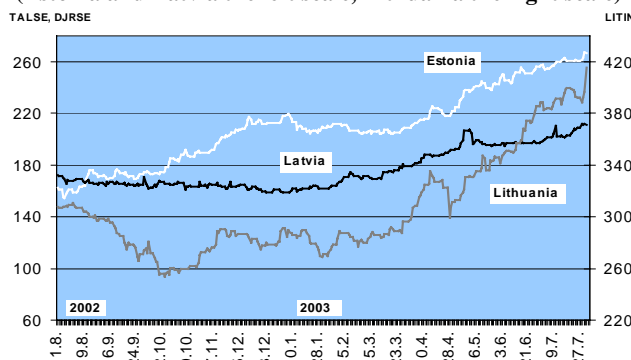
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russia enjoyed robust economic growth in the first half. The combined production index of five base sectors of the economy rose 7.2 % y-o-y in the first half of 2003. Construction increased 14 %, followed by 9 % growth in retail sales and 7 % growth in freight transport and industrial output. There was no growth in agricultural output.

The main domestic drivers of growth were investment and consumer demand. Fixed investments in the first half climbed 12 % y-o-y. Also strong export growth, based primarily on high world energy prices, boosted economic growth.

Russian inflation shows no signs of slowing. Consumer prices in July were up 13.9 % y-o-y, matching the pace of June and accelerating slightly from May. Consumer prices have risen as much as 8.7 % between the start of the year and end-July, while the government's inflation target for all of 2003 is 10 - 12 %. Hikes in the administratively set prices of public services have sustained the high inflation rate. Prices for housing and municipal services, for example, were up 42 % y-o-y in July.

Inflation is also driven by growth of the money supply caused by large inflows of export earnings, increased credit and a gradual relaxation of fiscal policy over the past two years. In June, broad money (rouble cash and bank deposits) was up 49 % y-o-y. Growth of the money supply has accelerated steadily since January, when it grew at a rate of 32 %. The monetary policy tools currently at the disposal of the Central Bank of Russia are ineffective at reducing the money supply. On the other hand, some of the growth indicates an increased preference by Russian households to hold roubles rather than weakened dollars.

Russia's current account surplus rises in the first half. Preliminary figures of the Central Bank of Russia show that Russia's current account surplus in the first half of 2003 exceeded \$21 billion (11 % of GDP), compared to less than \$15 billion (about 10 % of GDP) in 1H02. The trade surplus in the same period climbed above \$28 billion as earnings from goods exports rose 28 % y-o-y. High world prices and increased export volumes drove up earnings over 40 % on crude oil exports, over 50 % on oil products and nearly 30 % on natural gas. The combined share of these energy products accounted for some 57 % of total goods exports. Spending on goods imports also rose over 20 % y-o-y. However, weakening of the US dollar, the traditional measure of Russian trade, caused part of this growth. Using a weighted basket of the currencies of Russia's main trading partners, imports rose about 10 %. The services account deficit grew slightly to \$4.5 billion, although the growth of service imports slowed.

The financial account deficit shrank below one billion dollars in the first half. The net capital outflow from the government sector was about \$8 billion and consisted

mainly of foreign debt repayments. The banking sector, in contrast, saw its net capital imports rise to nearly \$5 billion. Companies also increased their net capital imports to nearly \$3 billion as company borrowing exceeded \$4 billion and foreign direct investment in Russia reached more than \$2 billion. On the other hand, the figure for "non-repatriation of exports proceeds and non-supply of goods and services against import contracts" represented a net capital outflow of over \$5 billion. The net errors and omissions item in the balance of payments figures showed minus \$4.5 billion, a figure substantially higher than for the same period a year earlier. The increase may reflect greater unrecorded capital flight. The large current account surplus helped boost the CBR's foreign currency and gold reserves by nearly \$16 billion in the first half. During June and July, the CBR's reserves hovered in the range of \$63 - 64 billion, enough to cover about eight or nine months of imports.

Poor weather reduces outlook for Russian grain harvest this year. Russia's agriculture ministry estimates unfavourable weather would reduce this year's net grain harvest to about 70 million tonnes. The 2002 net grain harvest was 87 million tonnes. The wheat harvest has been particularly hard hit and could reach just 36 million tonnes (compared to 50 million tonnes last year). As Russia's own grain needs are in the range of 72 - 75 million tonnes, it seems highly unlikely that Russia will be able to repeat its performance as a grain exporter like in the previous two years (see Week in Review 43/2002). As of end-July, Russian farmers had harvested about 10 million tonnes of grain.

Despite the lousy growing season, Russia has promised to deliver this month 200,000 tonnes of grain as emergency aid to Ukraine, which has experienced even worse weather. In the coming twelve months the total amount of grain deliveries could well exceed a million tonnes, as the August delivery will only cover a small part of Ukraine's grain shortage. President Vladimir **Putin** said Russia is prepared to supply Ukraine with as much grain as it needs. Observers warn, however, that Russia may itself face a grain shortage this year.

President Putin suspends reforms of security agencies. The act on reform of the tax police, federal border guard service, federal security service and various other security agencies, spawned by presidential decrees last March (see Week in Review 11/2003), entered into force at the beginning of July. Speaking at a Kremlin ceremony for appointing and awarding higher-ranking officers at end-July, the president declared further reforms were not needed. As a result, the proposed consolidation of prosecutorial offices at different agencies into a single bureau made two years ago by deputy head of the Russian presidential administration Dmitri **Kozak** will not take place.

Latvian government presents initial version of 2004 budget. Latvia's finance ministry currently estimates state revenues next year will reach LVL 1.9 billion (EUR 2.9 billion), a 12 % increase from 2003. Following prime minister Einars **Repse's** assurance that the state budget deficit shall not exceed 2 % of GDP, the government approved spending of LVL 2 billion in next year's budget. The 2004 budget proposal includes lowering the company tax from 19 % to 15 %. The government says the priority of next year's budget is integration with the EU and NATO.

The government's proposal calls for a cut in funding of 6.5 % (total LVL 51 million) for nearly all ministries and government agencies. The only bodies spared spending cuts are the defence ministry, culture ministry, parliament and the court system. The government will submit its proposed 2004 budget to Latvia's parliament, the *saeima*, in autumn.

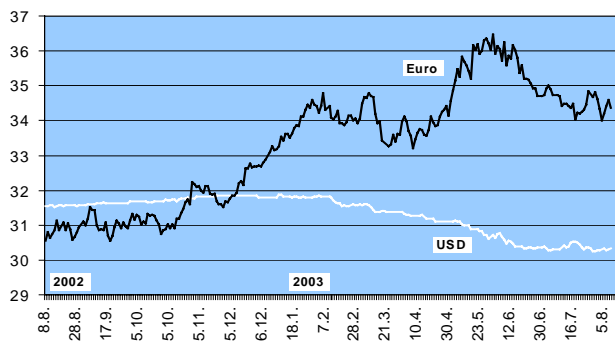
IMF mission gives positive assessment of Estonian economy, warns of widening current account deficit. On the basis of its annual Article IV consultation with Estonia, the IMF now projects that the country's economy will grow 4.5 % this year and 5.5 % next year. Inflation is expected to rise from 1.1 % this year to 3 % next year,

mainly as a result of EU tax harmonisation and strong demand from the euro area.

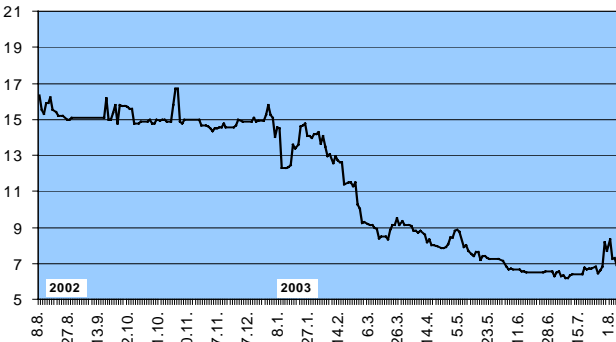
The IMF considers Estonia's yawning current account deficit as the main economic threat; it expects the deficit to reach 12.8 % of GDP this year and remain high in 2004. The situation is further destabilised by the fact that a substantially larger part of the current account deficit will be financed through debt rather than foreign direct investment. Because of Estonia's currency board arrangement, tight fiscal policy is essentially the only tool the government has to fight the current account deficit. The IMF advised Estonia to hold back on supplementary expenditure this year. The implementation of tax reforms next year and increased support to families with small children could threaten budgetary balance, and may therefore have to be postponed. The IMF praised Estonia for practising prudent, transparent fiscal policy in recent years and encouraged the government to continue with similar policies.

To preserve stability of the banking system, the IMF urged officials to carefully monitor the rapid growth of credit, and if needed, to increase market supervision and reserve requirements. The mission also supported Estonia's planned "fast track" changeover to the euro.

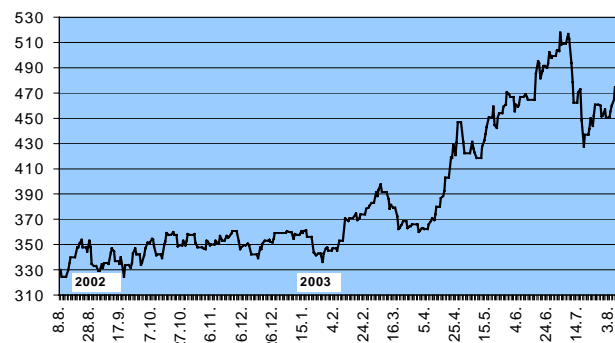
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



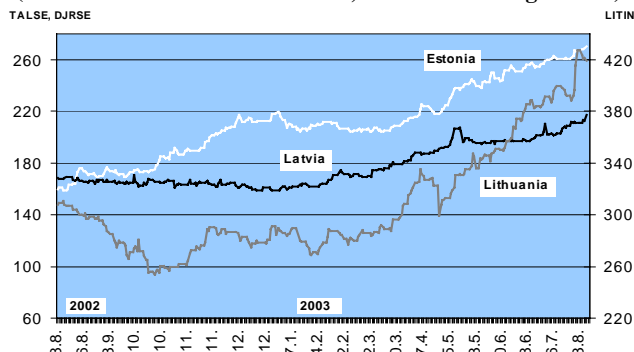
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



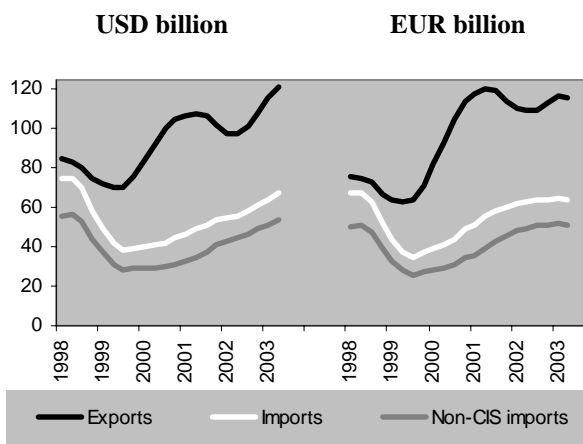
Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Slowing growth of Russian exports and imports in second quarter. Central bank figures show that earnings on exported Russian goods were up 20 % y-o-y in dollar terms in the second quarter of this year, substantially off the pace of the first quarter. Russian goods imports (both overall and from non-CIS countries) rose over 20 % y-o-y in 2Q03. In euro terms, however, there was virtually no on-year change for non-CIS imports. Import growth measured in a basket of currencies of Russia's main trading partners remained at about 10 %.

Russian goods exports and imports, four quarters' moving sum 1Q98–2Q03



Rise in Russian producer prices slows from last year.

Producer prices were 5 % higher in June 2003 than at the start of the year (during the respective period of 2002 the increase was 8 %). Growth was brisk in ferrous metallurgy, which saw June producer prices increase 47 % y-o-y. One of the largest jumps was in industrial pipe prices, reflecting a boom in crude oil pipeline construction. Producer prices for electricity rose 23 % y-o-y in June, while producer prices for non-ferrous metallurgy rose 15 %. A building boom drove up prices of construction materials 20 %.

Producer prices grew slower in the fuel industry (with some prices even falling). Natural gas prices were down 6 % y-o-y in June. Producer prices for crude oil were up 4 % and coal 9 %. The moderate growth in crude oil prices reflects the fact that production has increased faster than domestic demand. Due to limitations in pipeline and port capacity it is impossible for Russia to export all additional production.

Freight shipments were 16 % more expensive than a year earlier. The cost of rail freight drove the increase (18 %), followed by pipeline transport (15 %).

Growth of rouble deposits and cash accelerated in the second quarter. The growth in deposits of households and companies with banks operating in Russia strengthened slightly in the second quarter. Real growth of the deposits stock was 24 % y-o-y in June. Growth in rouble

deposits picked up to 35 % y-o-y, as growth in rouble time deposits accelerated to 40 % and to over 30 % for other rouble deposits. Growth in currency deposits slowed sharply to 5 %. Growth in the amount of rouble cash in circulation accelerated to nearly 25 % in real terms (18 % as of end-March). At the end of the second quarter, rouble deposits were an amount equivalent to 14 % of GDP, while currency deposits fell to 6 % of GDP. The amount of rouble cash in circulation equalled nearly 8 % of GDP.

After slowing in the winter, growth in domestic bank credit revived in the second quarter. Credit extended by banks to private firms and households was up 22 % y-o-y in real terms at the end of June. The amount owed by publicly owned entities grew at approximately the same pace. Bank credits to the private sector and publicly owned enterprises amounted to nearly 20 % of GDP.

Russian railways to become corporation, railways ministry to be eliminated.

A decree signed by president Vladimir Putin on August 8 paves the way for privatisation of Russia's national railways and removes any remaining statutory obstacles to reform of Russia's railway sector. In spring 2001, the government approved a program to separate the commercial and administrative functions of the railways ministry in order to foster competition and investment. According to railways minister Genady Fadeyev a state-owned railways holding corporation that will assume the commercial functions of Russia's railways would be established this year. The holding company, in turn, will establish independent subsidiaries for different sectors (e.g. freight and passenger transport) to be privatised at a later stage. Deputy prime minister Vladimir Yakovlev added that the administrative functions of the railways would be shifted to the transportation ministry and the railways ministry would be eliminated.

The Russian government has long planned the consolidation of the functions of the railways and transportation ministries as part of its administrative reform agenda. Due to the wide scope of the project and the myriad of changes involved, key decisions have been postponed several times. Ministry representatives have presented highly divergent views on the project's implementation schedule. A final decision on combining the ministries is expected by the end of this year.

Industrial output growth still strong but slowing throughout the Baltics.

Estonian industrial output climbed 7 % y-o-y in the second quarter, down from 12 % growth in the first quarter. Among the key production sectors, high output growth was seen in electricity generation and distribution of water and natural gas, as well as industrial chemicals, metals and textiles. Output was down in manufacturing of machinery and equipment as well as the mining industry.

Latvian industrial output also grew in 7 % y-o-y in the second quarter. Strong growth was registered in the important mechanical wood processing industry, as well as

lesser fields such as radio, television and communications equipment and furniture. Production of chemicals and textiles was down from last year.

Lithuanian industrial output, measured in sales, grew just 3 % y-o-y in the second quarter, a substantial slowing from the 21 % growth posted in the first quarter. Reasons for the drop include scheduled maintenance at the Mazeikiu Nafta oil refinery, which caused a substantial drop in oil refining activity in comparison to 2Q02. Production of textiles and basic metals shrank as well. Strong growth was seen in electricity generation and the distribution of water and natural gas, as well as manufacture of electrical equipment and furniture.

Baltic inflation figures for July. *Estonian* inflation accelerated slightly in July to 0.8 % y-o-y (0.3 % in June). Consumer prices in July were up 0.2 % m-o-m, due in particular to higher prices for telecommunications services.

The prices of goods and services in *Latvia* in July were up 3.8 % y-o-y (3.7 % in June). Consumer prices fell, however, 0.3 % m-o-m, reflecting clothing sales and lower food prices, despite an 11 % hike in administratively set natural gas rates.

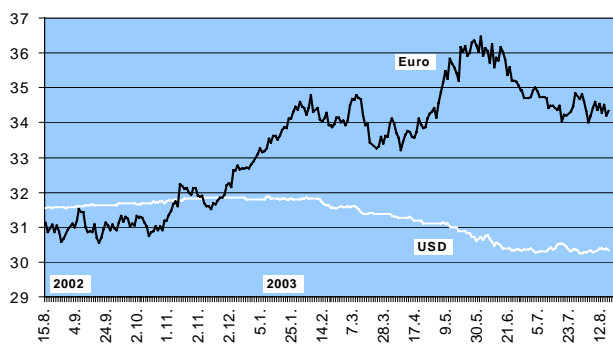
Deflation continued in *Lithuania* with consumer prices falling 1 % y-o-y in July (-0.4 % in June). The monthly deflation rate was 0.8 %, largely a reflection of cheaper

food and clothing and lower rates for telecommunications services.

Ventspils oil pipeline from Russia to Latvia still shut down. Transneft, the state company that operates Russia's pipelines, will continue its suspension of oil deliveries to Ventspils Nafta's (VN) oil terminal. Russia's deputy prime minister Viktor **Khristenko** said no oil would be transported via the Ventspils pipeline at least in the third quarter of this year. Transneft ended deliveries at the start of this year, explaining that it was shifting its shipping operations to less costly terminals (e.g. the Russian port of Primorsk on the Gulf of Finland). The more likely explanation is that Transneft seeks to pressure the Latvian government into selling its stake in Ventspils Nafta to Transneft.

VN has been supplying oil to Ventspils via rail since the late last year. VN's president Janis **Adamsons** does not expect the Transneft oil pipeline to open this year, so VN will make efforts to raise the volume of its rail shipments. The company has already made substantial infrastructure investments. The total volume of cargo moving through the Ventspils port fell 10 % y-o-y in the first half of 2003. Crude oil deliveries to the Ventspils fell 73 % y-o-y in the first half. Delivery of oil products, however, rose 29 %.

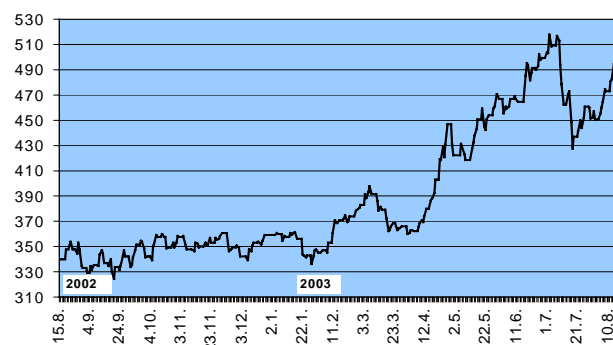
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



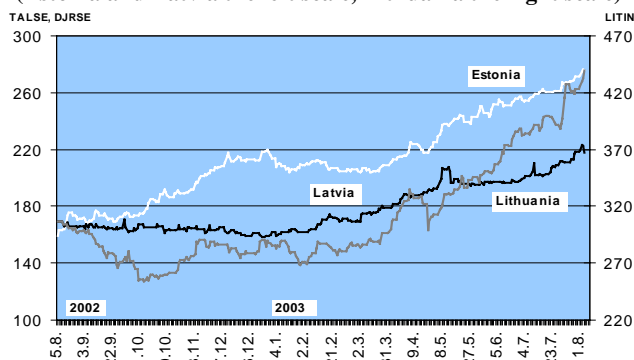
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian cabinet finalises 2004 federal budget proposal.

The government's proposal anticipates a budget surplus for the fifth year in a row. The surplus target of 0.5 % of GDP is less than in previous years. Several observers, including the IMF, have warned Russia against relaxing its fiscal stance in the current robust economic climate. Budget expenditures, excluding debt-servicing costs, have grown in relation to GDP over the past few years. Next year they are forecast to reach 12.6 % of GDP. Spending will increase in the key budget sectors of security, defence, health care, culture and the justice system. Total budget spending, which includes debt servicing and contributions to the social fund, will hit 17.4 % of GDP next year under the cabinet proposal.

Tariffs on the production and export of oil and natural gas presently constitute about 35 % of total federal budget revenues. 2004 budget spending is pegged to a world market price for Urals-grade crude of 20 dollars a barrel. Any additional oil revenues will be transferred to a newly created off-budget stabilisation fund, which acts as a buffer against swings in global energy prices. Fund assets would be used to cover spending in years when energy prices are low.

The proposed budget assumes 5.2 % GDP growth next year. Consumer price inflation is expected to slow to a range of 8 - 10 % next year.

The Duma will take up the budget act in the first reading on September 19 with a goal of completing the fourth and final reading by late November, when the current session ends.

Russian government decides 2004 rate hike ceilings for natural monopolies.

On August 14, in conjunction with its discussions of the 2004 budget proposal, the cabinet set the 2004 ceilings on rate hikes for products and services provided by natural monopolies (electricity, natural gas and rail transportation). The proposed limits on increases are 20 % for natural gas rates, 13 % for electricity and 12 % for rail transportation.

Rate increases for 2003 are limited to 20 % for natural gas, 14 % for electricity and 12 % for rail transportation. Notably, electricity rates have exceeded the government-set ceilings for several years because regional commissions that set rates have been able to increase them independently. Now the rate-setting powers of local authorities have been curbed.

Russian government wants larger share of CBR profits.

In connection with the 2004 budget proposal, the cabinet submitted to the Duma an amendment to the central bank act that would allow for 80 % of the Central Bank of Russia's profits to be transferred to the federal budget starting next year. Currently 50 % of CBR's annual profits are channelled to the federal budget. The CBR opposes the government's proposal and fears that the additional budget revenues will loosen fiscal policy and spur inflation. The government responded with the

suggestion that CBR profits could be transferred to the stabilisation fund and not used to finance budget expenditures.

Russian government approves 2004 privatisation program, the auction of telecom shares postponed.

Under the 2004 program, nearly all entities in which the state holds a maximum of 25 % stake will be sold off. The goal is to divest about 1,050 utilities as well as over 600 state holdings in corporations. The government estimates that the sales will raise a total of about RUB 35 billion (EUR 1 billion) for the federal budget. The biggest privatisation event of the year will be the sale of a 7.6 % stake in LU-Koil. The privatisation program will be submitted to the Duma as an appendix to the government's 2004 budget proposal. The whole privatisation process should be completed by the end of 2008 (see Week in Review 31/2003).

The government postponed its planned sale of the state's 25 % stake in the Svyazinvest telecom company until the market recovers. It expected its stake would currently fetch USD 350 million at most, a far cry from the cabinet's hoped-for price of USD 1 billion. According to most market watchers postponing the privatisation would not increase the value of state holdings, rather it will only hinder much needed reforms in Russia's telecom sector. The only sales of assets next year will involve small state holdings in four Svyazinvest regional operations.

Yukos-Sibneft merger moves ahead.

On August 14, Russia's anti-monopoly ministry gave its acceptance to the merger of the Yukos and Sibneft oil companies on three conditions. First, the new company cannot abuse its dominant market position by preventing the entry of other companies into local markets. Second, YukosSibneft must accept crude oil pumped by other companies for processing at its refineries, provided that it has extra refining capacity. Third, the new company must let willing companies participate jointly in pipeline construction as long as they pay their share of construction and maintenance costs. In April, Yukos and Sibneft signed an agreement calling for completion of the merger by the end of 2003 (see Week in Review 17/2003). The new entity would be the world's fourth largest oil company in terms of production volume.

The other major development in Russia's oil industry is the joint venture of British Petroleum and the Russian Alfa-Group (see Week in Review 7/2003). Russia's anti-monopoly ministry was supposed to rule on the merger last week, but postponed its decision referring to the complexity of the matter. EU and Ukrainian competition authorities have already cleared the joint venture.

Estonian and Latvian exports up, Lithuanian exports down.

In the second quarter, *Estonian* exports and imports both rose 9 % y-o-y. Exports of machinery and equipment, a key export category, increased 8 %. Exports

of wood and wood products increased 20 %. Exports of metals and metal products also grew a brisk 35 %, reflecting the new steel galvanization plant in Tallinn. While exports to Russia rose 41 %, Finland and Sweden remain the leading destinations for Estonian exports.

The value of *Latvian* exports showed strong growth in the second quarter and was up 16 % y-o-y. Exports to EU countries climbed 29 % (64 % share of total exports) and 16 % to CIS countries (10 % of exports). Exports of wood and wood products, a key export category, grew 32 %. Metal and metal products exports increased 13 % and textile exports 11 %. Imports to Latvia rose 20 %. Oil imports increased most in value terms.

Lithuanian exports contracted 8 % y-o-y in the second quarter. This was mainly due to a maintenance break at the Mazeikiu Nafta oil refinery. As a result, exports of refined oil products, which are critical to Lithuanian exports, fell sharply. Exports of textiles also fell and the growth of exports slowed in several fields. About 43 % of Lithuanian exports went to EU countries, while 17 % went to CIS countries. Imports to Lithuania fell 2 % due to reduced demand for raw materials.

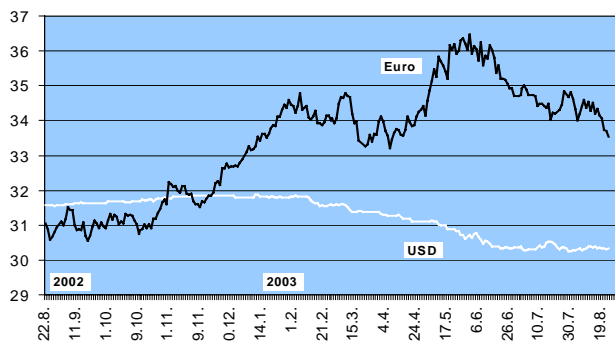
Preliminary data indicate Baltic current account deficits remain large. In the second quarter of this year, *Estonia's* current account deficit was about 10 % of forecast GDP. The deficit widened slightly from a year ear-

lier, but was smaller than in the first quarter of this year. For January-June, the current account deficit exceeded 15 % of GDP. The large trade deficit drove the current account deficit in the second quarter. The services balance continued to show a large surplus, while the income balance remained negative. Net foreign direct investment inflows were sufficient to cover nearly a third of the current account deficit.

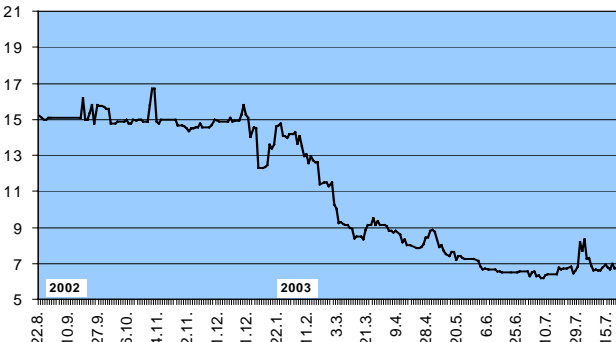
Latvia's current account deficit increased from last year. The deficit was 10 % of forecast GDP in the second quarter and 8 % of forecast GDP in the first half. The fact that imports grew faster than exports had much to do with the growing current account deficit. The income deficit grew, while the services surplus shrank. On the other hand, increased transfers from the EU restrained growth the current account deficit. FDI inflows into Latvia remained steady and were sufficient to cover nearly half of the current account deficit in the second quarter.

Lithuania's current account deficit rose to 7 % of forecast GDP in the second quarter. In the first half of 2003, the deficit reached 6 % of GDP. The trade deficit grew in the second quarter as exports fell. The service surplus remained at the same level as in 2Q02, while transfers from the EU increased. FDI inflows to Lithuania fell in the second quarter and they were sufficient to cover 30 % of the current account deficit.

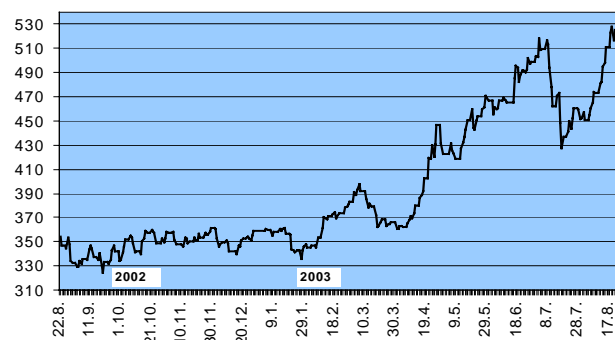
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



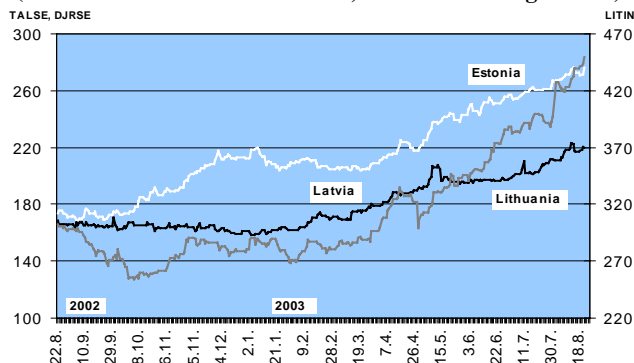
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Continued brisk growth in Russian industrial output. Goskomstat reports Russian industrial output was up 7.1 % y-o-y in July and 6.8 % y-o-y for the first seven months of 2003. July growth was slower than the second quarter pace (7.5 %), but higher than the first quarter (6.0 %). Highest growth among major industries in January-July was seen in the fuel industry (9.9 %), ferrous metallurgy (9.4 %), machine building (7.5 %) and pharmaceuticals (9.9 %). Output continued to slide in light industry, the microbiological industry and book printing.

On-year growth remained robust as measured by the production index of the five main sectors of the Russian economy. The combined output volume of industry, construction, agriculture, transport and retail sales in January-July grew 7.1 % y-o-y and was up 6.2 % y-o-y for July. Growth was particularly strong in construction, where output rose over 14 % in January-July and about 15 % y-o-y in July. Only agricultural output fell. Investment continued its rapid growth (12 % for both January-July and July).

Russia still posts fair budget surplus in the first half of 2003. In the first half of this year, federal budget revenues were equivalent to 20.6 % of GDP, while expenditures were 17.5 % of GDP. The share of social tax contributions transferred via the federal budget to state pension fund fell. Thus, the actual federal budget revenues in the first half of this year were up nearly one percentage point of GDP from 1H02, and amounted to nearly 18 % of GDP. Budget expenditures also rose slightly. The budget surplus was 3 % of GDP, compared to 2.6 % in 1H02.

The value-added tax continued to generate the largest revenue stream to the federal budget in the first half (nearly 7 % of GDP). Export duties were the foremost growing category, with revenues from export and import duties reaching 3.4 % of GDP. The next two growing categories were fees for use of natural resources (just under 2 % of GDP) and leases and other charges for state property. The share of tax revenues from enterprise profits fell. Under financing items, privatisation proceeds jumped dramatically to nearly 1.5 % of GDP, reflecting the sale of the state's shares in the Slavneft and LUKoil oil companies at the end of 2002.

Interest expenditure on domestic and foreign debt fell. Non-interest expenditure, which does not include interest on debt and social tax transfers to the state pension fund, reflected a looser fiscal stance, with its share increasing 0.7 percentage points of GDP from 1H02. The spending growth was due largely to higher spending on law enforcement and internal security, as well as increased transfers to regional budgets and higher defence spending.

Budget revenues and the surplus this year are running substantially ahead of forecast due to high world oil prices and higher-than-expected growth of the Russian economy. The IMF, nevertheless, recommends Russia

rein in its budget spending in anticipation of upcoming tax cuts and the possibility that world oil prices may fall to more normal levels.

Russian government considers economy ministry forecast for 2003–2006 and CBR monetary policy program for 2004. The economy ministry forecasts GDP growth will slow next year. It noted that this year's growth of about 6 % would be sustained by high oil prices, which it expects to slow to about 5 % in 2004 and about 6 % in 2005, assuming the price of Urals-grade crude stays in the range of \$22 to \$23 a barrel. Alternatively, should the price during the next two years average \$18.50 a barrel, GDP growth would fall below 4 % in 2004 and below 5 % in 2005. Investment growth is also expected to slow from over 9 % this year to 7–8 % in 2004. Despite economic growth, unemployment is expected to stay at around 8 % in the coming years.

With anticipated lower oil prices of \$22 to \$23 a barrel and despite an increase in export volumes of crude oil and natural gas, the Ministry projects export earnings next year to remain unchanged. The nominal exchange rate of the rouble to the dollar is also expected to remain at the same level as in the first half of this year or possibly weaken slightly (1–2 %). Consumer price inflation should be subdued next year (8–10 %), while the rouble's real exchange rate would strengthen 3–5 % in relation to a basket of the currencies of Russia's main trading partners. If the world oil price remains substantially higher than forecast, the CBR will try to hold the rise in real exchange rate to under 7 %. Growth in imports is expected to slow to about 10 % or slightly less in 2004 and 2005. The value of imports in 2005 would be 35–40 % higher than in 2002.

Major energy-sector merger gets go-ahead. On August 25, Russia's Anti-monopoly Ministry approved the merger of British Petroleum and Tyumen Oil (TNK), which is co-owned by the Russian Alfa Group and Access/Renova. The merger is expected to be finalised sometime in September or October, but still requires a few clearances of competition authorities outside the EU. The companies announced the merger last February and signed the merger agreement at the end of June (see Week in Review 7/2003 and 27/2003). Under the deal, BP commits to invest nearly EUR 7 billion in Russia, which will be one of Russia's biggest foreign investments. Observers say the oil reserves of the TNK-BP merger will exceed 5 billion barrels and its production should average about 1.2 million barrels a day. The new corporation would be Russia's third largest oil company and the world's eighth largest oil producer.

The monopoly of state-owned Estonian oil shale mining ends. Estonia's environment ministry has granted mining rights to Merko Kaevandused (Merko Mining, a

subsidiary of Estonia's largest construction company Merko Ehitus) to excavate oil shale in East Virumaa county until 2028. Merko is the first private company to acquire oil shale mining rights in Estonia. Merko has announced it would invest EEK 80–150 million (EUR 5–10 million) in the mine. Because the state does not allow more than one permit per mining site, the state-owned oil shale mining company Eesti Põlevkivi will lose its mining rights for East Virumaa site.

Under the licence conditions, the company must excavate no less than 400,000 tonnes and no more than 1 million tonnes annually. Merko plans to start mining within two years. Oil shale is used as a fuel and as raw material in the chemical industry. It is the main fuel used in generating electrical power in Estonia.

Lithuanian bourse and securities depository to be privatised. Lithuania's government has decided to sell a 44 % stake in the National Stock Exchange of Lithuania (NSEL) and 32 % of share in the central securities depository. Potential buyers include the Warsaw stock exchange and the Helsinki stock exchange parent company HEX, which also holds majority stakes in the Tallinn and Riga exchanges. The NSEL is currently owned by the Lithuanian state, commercial banks and broker-

ages (28 %), legal persons (15 %) and natural persons (12 %). The other owners in the securities depository are the Bank of Lithuania (60 %) and the NSEL (8 %).

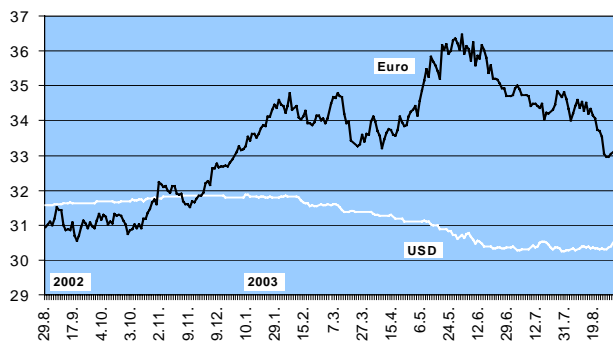
Baltic income levels continue to converge with the EU average. Eurostat figures show that the Purchasing Power Standard (PPS) adjusted GDP per capita of *Latvia* has considerably approached the EU average in recent years. The rise in relative income levels for *Estonia* and *Lithuania* has been somewhat slower.

PPS-adjusted GDP per capita, EU-15=100

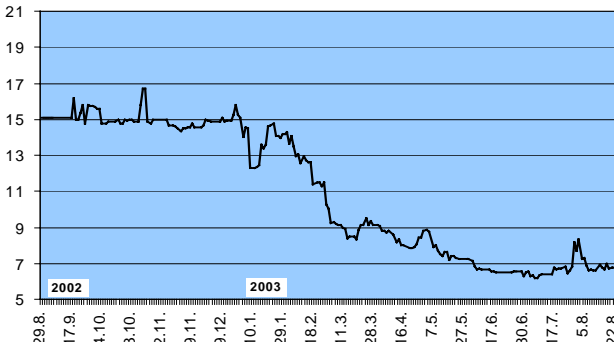
	1998	1999	2000	2001	2002
Slovenia	67	68	70	72	74
Czech R.	60	59	56	59	60
Hungary	48	49	50	53	57
Slovakia	50	49	46	47	47
Estonia	39	39	40	40	41
Poland	38	39	40	40	39
Lithuania	37	34	35	38	39
Latvia	28	29	31	34	35
Bulgaria	28	28	26	25	25
Romania	25	24	23	24	25

Source: Eurostat

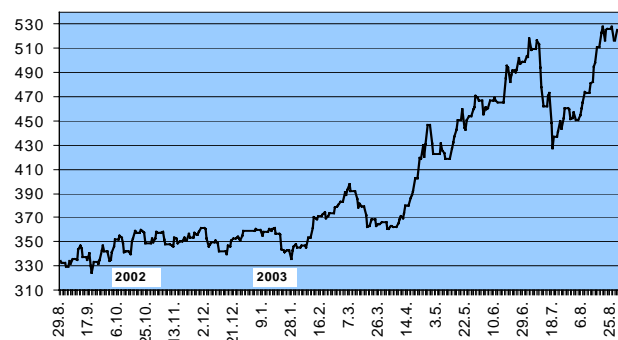
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



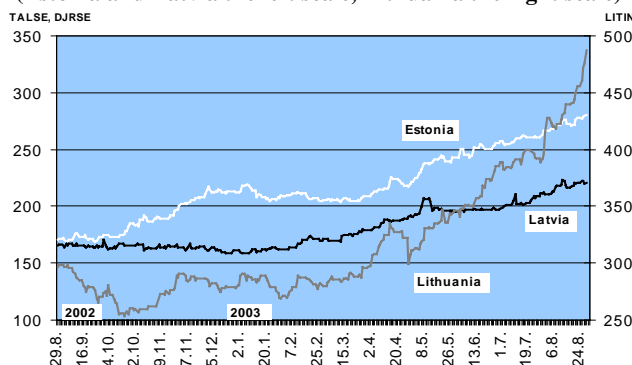
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)

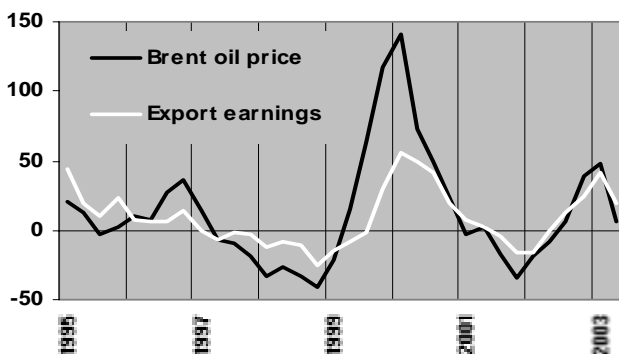




Russian fuel exports and machinery and equipment imports rose in second quarter. The State Customs Committee figures indicate that, due mainly to a dampened rise in oil prices, growth in export earnings slowed in the second quarter to about 20 % y-o-y. While the export price for Urals-grade crude in the second quarter was just a few per cent higher than a year earlier, the increase in the first quarter was about 50 % y-o-y. Growth of export earnings in the second quarter was supported by the fact that natural gas prices were still up 35 % y-o-y, and growth in the volume of crude oil exports accelerated in the second quarter, raising growth for the first half overall to over 10 %. The volume of oil products exports increased 7 % on average. The volume of natural gas exports overall rose 2.5 % and 8 % to non-CIS countries.

Growth in imports of machinery and equipment to Russia accelerated slightly in the second quarter. For the first half of 2003, the trend paralleled all imports, i.e. machinery and equipment imports (including passenger cars) grew 23 % y-o-y in dollar terms. There was practically no growth in the first half, however, in euro terms, reflecting a substantial drop in the dollar's external value. According to the State Customs Committee, the share of machinery and equipment (including passenger cars) in imports from non-CIS countries grew to 39 %, while the share of food and basic food ingredients fell notably to 23 %. The relative shares of chemical products and textile products increased. In any case, the customs figures do not reveal the actual structure of import: comparison with CBR figures for the first half reveals that, as usual, about a quarter of all imports go unrecorded.

Russian export earnings and crude oil price (Brent), dollar value % change from four quarters previous



Russian companies borrow more from abroad – FDI inflows to Russia grow slower. Goskomstat figures show foreign investment in Russia in the first half of 2003 climbed to \$12.7 billion, an increase of 51 % y-o-y. Some of the leap reflects the weakening of the dollar in relation to the euro, as the bulk of investments originate in Europe.

Loans and trade credits compose 80 % of foreign investment in Russia. These were also the fastest growing

forms of investment, increasing 60 % y-o-y in the first half. FDI constituted 20 % of foreign investment in Russia, gaining 35 % y-o-y. Only 0.3 % of foreign investments were in the form of portfolio investment.

Of the total \$48 billion stock of foreign investment in Russia, 36 % are made in industry, 35 % in trade and 9 % in telecommunications. The largest investor countries are Germany (22 % of the investment stock), Cyprus (14 %), Great Britain (12 %), USA (12 %) and the Netherlands (6 %).

The total stock of Russian investment abroad as of end-June was valued at \$4.4 billion. Some 16 % of total investment were made in Cyprus. The next most important investment destinations were Belarus (15 %), Iran (13 %), the Netherlands (11 %) and the Virgin Islands (6 %).

Export tariff on Russian natural gas upped to 30 %.

Following last month's government decree, the export tariff on natural gas will rise from the current 5 % of the declared value to 30 % from the start of 2004. Simultaneously, the excise tax on natural gas will be abolished and replaced with a new gas production tax, which, under an act passed by the Duma in July, is set at 107 roubles (about 3 euros) per 1,000 cubic metres.

Major share deal in the Russian oil sector.

British Petroleum (BP) is set to acquire a 25 % stake in the Russian oil company Slavneft from Tyumen Oil (TNK). It will then transfer the shares to a jointly owned company with TNK. BP will pay \$1.35 billion for its stake in the venture, which will raise BP's investment in the merger to nearly \$8 billion. After the transfer TNK-BP will hold half of Slavneft shares and its oil reserves will climb to nearly 7 billion barrels. This should strengthen BP's role in international oil markets. The remaining 50 % of Slavneft shares will be held by the newly merged entity YukosSibneft, with which TNK-BP is currently negotiating the allocation of Slavneft's business activities.

Competition authorities in Russia, the EU and Ukraine have given the green light to the TNK-BP merger, but separate approvals on joining Slavneft shares to TNK-BP are still forthcoming from authorities in Russia, the EU and Belarus.

Baltic states' construction activity up.

The volume of domestic and foreign construction by Estonian companies rose 4 % y-o-y in the first half, with the nominal value of construction climbing to EEK 9 billion (EUR 580 million). Construction activity was strongest in industrial and commercial building.

Construction activity was up 13 % y-o-y in the first half in Latvia. The value of production was LVL 190 million (EUR 300 million). Strongest growth was seen in construction of commercial structures, roads and housing.

The output of Lithuanian construction firms rose 26 % y-o-y in the first half. The nominal value of con-

struction was LTL 1.5 billion (EUR 430 million). Construction activity rose for apartments and commercial structures.

Despite the fast growth in construction, there was almost no change in construction costs. Costs in the second quarter were up 4 % y-o-y in Estonia and 1 % in Lithuania. Costs fell 2 % in Latvia.

Integration of Lithuanian and Polish electrical grids moves ahead. The state power companies of Lithuania and Poland, *Lietuvos Energija* and *Polskie Sieci Elektroenergetyczne*, have agreed on establishing a working group to plan the integration of the two nations' electrical grids. After years of planning, the project has been revived by the possibility of EBRD funding. Indeed, an EBRD-ordered study recently recommended that the Estonian and Latvian grids should also be included in the project. The creation of a unified energy market is further justified by the fact that it could eventually be integrated with Western Europe's electrical grid. The study suggests that the total costs of the project could reach EUR 430 million. The prime ministers of Lithuania and Poland, Algirdas **Brazauskas** and Leszek **Miller**, have requested the EU and the EBRD to fund the project with EUR 260 million.

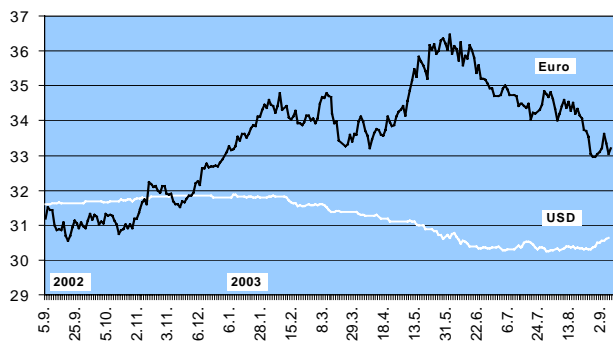
The two-way grid shared by Lithuania and Poland would have a capacity of 1,000 megawatts and construction would commence some time in 2007. Lithuania, which is scheduled to decommission its Ignalina nuclear power plant in 2009, faces the choice of increasing its participation in Western European power markets or increasing its dependence on Russian energy.

Finland, Estonia and Latvia are also considering energy cooperation. Discussions on a power cable running under the Gulf of Finland should be completed within the next few months. Estonia and Latvia would be able to export electricity to the Nordic countries via a two-way cable, as well as increase the reliability of electricity supply.

Wages in Baltic states in the second quarter of 2003. Average gross wages in *Estonia* rose 9 % y-o-y in the second quarter. The average monthly wage in Estonia increased to 6,900 kroons (440 euros). *Latvian* wages measured in local currency rose 12 % to 190 lats (300 euros). *Lithuanian* average monthly wage rose 5 % to 1,160 litas (340 euros).

The minimum monthly wage in Estonia in July was up 17 % y-o-y to 138 euros. Latvia's minimum wage rose 17 % to 108 euros. Lithuania's minimum wage remained at 125 euros.

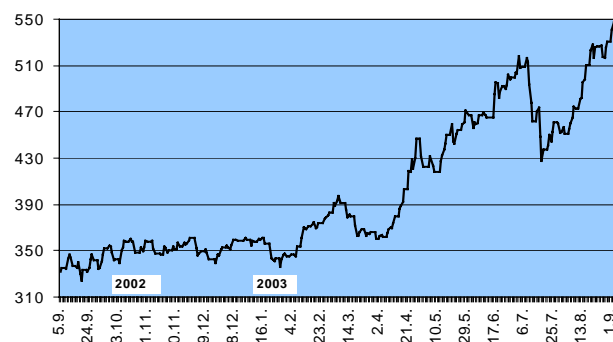
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



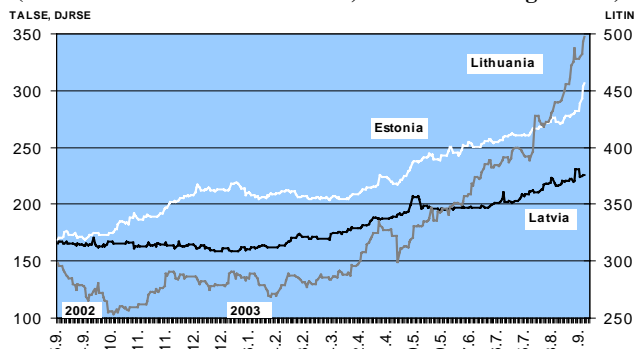
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)

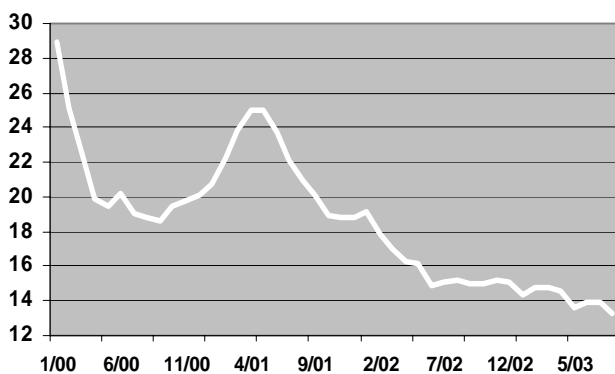




Russian economic growth accelerated in the second quarter. Goskomstat reports GDP grew 7.2 % y-o-y in the second quarter of 2003, outpacing first quarter growth of 6.8 %. The government currently forecasts GDP will rise about 6 % for all of this year. Last year GDP grew 4.3 %.

Russian inflation slowed slightly in August. Consumer prices were up 13.3 % y-o-y in August. The increase was about a half percentage point less than in June and July. August consumer prices fell 0.4 % m-o-m – the first on-month price decline since 1997. While the drop was mainly due to seasonal fluctuations in food prices, it also reflected the fact that rates for municipal services, which have been rising briskly earlier, remained unchanged in August.

12-month change in Russian consumer prices, %



Private firms chosen for managing Russian pension savings. The finance ministry last week listed the private investment firms that will get licenses to invest the so-called savings component of compulsory pension insurance contributions. Out of a total of 60 license applicants, 55 received approvals. The better-known management companies include Troika Dialog, Alfa Capital and Aton. The entry of private pension investment firms is part of ongoing reform of Russia's pension system.

About 40 million Russians must decide by mid-October whether to turn over the management of the savings component to private firms or leave it with the state-owned Vnesheconombank. As Vnesheconombank's investment activity is stricter regulated, it has to pursue a more conservative strategy than private investment firms. While this may lead to smaller returns, the related risks will also be lower. At the end of August, ODK, a subsidiary of the state-owned Vneshtorgbank, was picked to supervise the activities of pension investment firms.

At the start, the program is planned to accumulate pension savings of RUB 40 billion (EUR 1.2 billion) to be invested. By 2010, pension savings are estimated to reach RUB 1,300 billion (EUR 38 billion). The operations of private pension investment firms would commence at the beginning of 2004. One recent study found

that only about 5 % of employees plan to shift the savings component to a private manager in the first phase of the reform.

President Putin gets involved in defining relations between the state and business. Under a presidential decree issued this summer, administrative reforms in 2003–2004 will focus on reducing regulatory and supervisory intervention by the state in business activities, and elimination of bureaucratic duplication of work. The decree also aims at improved definition of state-provided services to enterprises and citizens, and completion of the reallocation of responsibilities between the federal and regional levels of administration. The president ordered the establishment of a new oversight commission, composed of representatives of the presidential administration and the government, regional and local governments, and Russia's business community. Under the decree, commission chairman, deputy prime minister Boris **Alyoshin** reports directly to the president on the progress of the reforms. Despite years of attempts at administrative reform in Russia, reductions in the number of civil servants, bureaucracy and corruption have failed to materialise as hoped.

Russian and Finnish foreign trade figures give conflicting views of trends in Russian imports. Significant fluctuation in the exchange rate of the euro against the dollar made monitoring of Russian foreign trade particularly problematic in the first half of 2003. Russian customs figures, which are denominated in dollars, show imports rose by a fifth in January-June, yet imports fell a couple of percent in euro terms.

There are also other problems that become visible when comparing Finnish and Russian foreign trade figures. Finnish customs show that in the first half of 2003 Finnish exports to Russia (over EUR 1.5 billion) rose 6 % in euro terms and 30 % in dollar terms. Simultaneously, Russian customs figures show imports from Finland (about EUR 700 million) fell 6 % in euro terms. Although some of the statistical differences may be attributed to different timing of transaction recording, exchange rate movements, differences in recording of purchases by private persons, and differences in interpretations of country of origin for goods, much of the difference may still be attributed to circumvention of custom tariffs by Russian importers. The practice has continued for years despite official efforts to correct the matter.

The difference in figures for Russian exports (Finnish imports) for the first half of the year was substantially smaller.

Baltic inflation in August. *Estonian* inflation accelerated slightly in August with consumer prices rising 1.3 % y-o-y (0.8 % in July). The consumer price index in August remained unchanged from July as prices for

health care, alcoholic beverages and tobacco rose and food prices declined.

August consumer prices in *Latvia* were up 3.5 % y-o-y (3.8 % in July). On-month August consumer prices fell 1.1 % due mainly to lower prices for food and clothing.

Deflation continued in *Lithuania* with August consumer prices falling 1.1 % on year (1 % in July) and 0.7 % on month. The largest price drops were registered for food and clothing.

Latvian economic growth remains robust. Latvian real GDP grew 6.2 % y-o-y in the second quarter of 2003. In the first half growth was 7.5 %. Strong domestic demand and exports continue to support brisk growth.

The service sector grew 6 % y-o-y in the second quarter, and its share of Latvian GDP is now 72 %. The fastest growing services were found in retail trade (9 %) and the transportation sector (7 %). Strong growth was also registered in manufacturing (8 % y-o-y) and construction (10 %). Agricultural output fell 8 %.

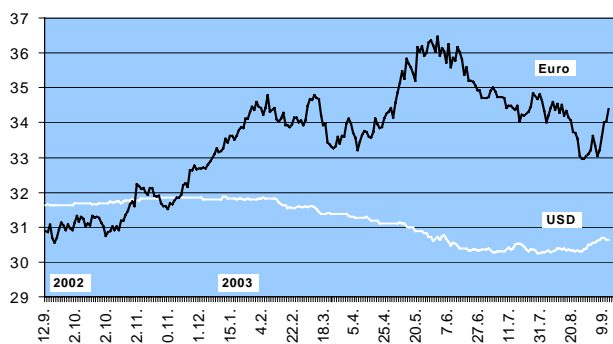
Estonia and Latvia vote on EU membership. *Estonia's* national referendum on EU membership is set for Sep-

tember 14. Preliminary voting (Sept. 8–10) was heavier than expected and opinion polls now predict that voter turnout overall could reach around 70 %. Three recent surveys found support for EU membership running between 52 % and 69 %, with about a quarter of Estonians still undecided. The results of Estonia's referendum are non-binding and no minimum on voter participation has been set.

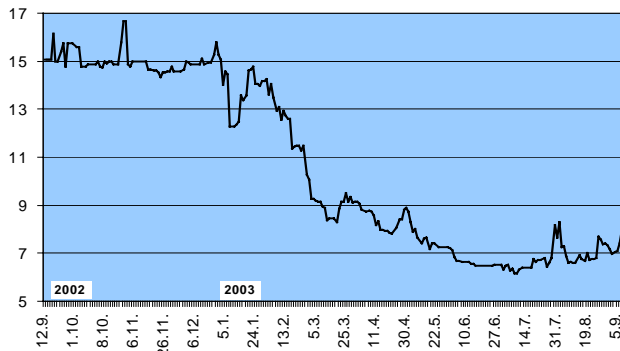
Latvia's national referendum is scheduled for next week (Sept. 20–21). The referendum is binding on the government as long as at least half the number of people who turned out for last autumn's parliamentary elections (71.4 %) vote. Opinion surveys predict that about 80 % of Latvia's registered voters plan to participate in the referendum. An August survey found that slightly over half of voters favoured joining the EU, nearly a third planned to vote against membership and about 14 % were still undecided.

Estonia and Latvia are the last of the ten accession countries to hold votes on EU membership. *Lithuania's* referendum carried with 91 % of voters in favour of membership. All seven referenda to date have favoured membership. *Cyprus* will not hold a national vote on EU accession.

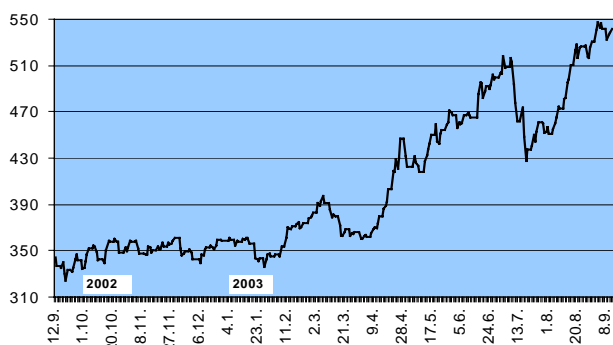
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



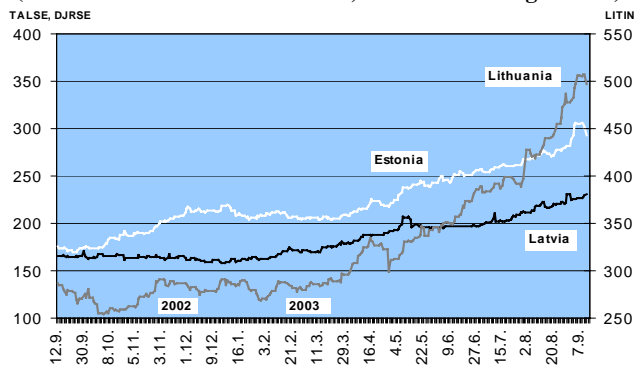
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Slight shifts in Russia's investment structure. Goskomstat reports that fixed investments rose 11.9 % y-o-y in the first seven months of the year. It also released figures for the first half of 2003 on the structure of investment. Construction's share of all fixed investments increased slightly from a year earlier with 8 % of investment going to housing construction and 50 % to other construction. Machinery and equipment accounted for 34 % of investment. Other investments had an 8 % share.

The breakdown of investment by sectors of the economy showed that transportation received the largest share with 17 % of investment. Next were oil production and refining, and housing and utilities, both with 16 % shares. Natural gas had 6 % and the food industry 4 % of investment, while construction, nonferrous metallurgy and machine building each accounted for 3 % of investment. Compared to the first half of 2002, the largest increases were seen in the shares of housing and utilities, the food industry and construction. There was a particularly large drop in transportation's share.

Russian companies have grown a bit less dependent on financing their investments out-of-pocket or with public money. In the first half of this year, companies financed 47 % of their fixed investments out-of-pocket, down from 52 % in 1H02. The largest external financing sources were federal and regional budgets, which accounted for 18 % of total investments. Some 14 % of fixed investment were financed by parent companies and organisations. The undeveloped state of Russia's financial sector was reflected in the fact that less than 5 % of investment was financed with bank loans.

Gradual diversification of bank deposits and lending in Russia continued in first half.

At the end of the first half of 2003, the stock of household deposits in Russia's largest bank, Sberbank, was up 20 % y-o-y in real terms, compared to 30 % in the same period for the banking sector as a whole (over 1,300 banks). Growth of household deposits was above average in all other groupings of banks according to their size. The highest growth in deposits continued in the group containing Russia's second to fifth largest banks (over 85 %). Sberbank held 65 % of deposits at the end of the first half, meaning that it lost nearly six percentage points of its share of deposits compared to a year earlier. For Russia's second to fiftieth largest banks, the collective share of deposits rose to 20 %. Funds in company bank accounts rose 30 % y-o-y overall, with the bulk of growth focusing on the five largest banks, which together held a third of company funds.

The stock of credits extended to companies grew fastest (37 % in real terms) among Russia's 6th to 20th largest banks, as well as among the grouping containing over 1,000 small banks. The 6th-20th group saw their share of lending to enterprises rise to about 20 % at the end of the first half. The share of the largest five banks fell to 45 %. The stock of loans granted to households, which rose over 50 %, was concentrated among the five largest banks and

the grouping of the 51st to 200th largest banks (65 % growth for both). The five largest banks accounted for 55 % of the loan stock.

Russian central bank eases repatriation of S-account funds. The Central Bank of Russia's decision to release foreign investors' funds frozen in special S-accounts held in commercial banks after the 1998 financial crisis entered into force in mid-September. Repatriation of funds still must go via conversion accounts, but the wait on receipt of funds has been cut from several months to a couple of days.

Between 1999 and 2002, the main way to repatriate assets in S-accounts was to use roubles in the accounts to bid for foreign currency offered at special central bank auctions, where the exchange rates offered were worse than the prevailing market rates. Interest waned in the last few currency auctions held for holders of S-accounts. The CBR does not expect the release of the remaining money to cause any significant capital outflow.

Russian Duma convenes autumn session ahead of December parliamentary election.

On September 17, the Duma approved the first reading of a legislative package from the government concerning deposit insurance. In addition to the deposit insurance act, the package includes amendments to the civil and tax codes, the banking act, the central bank act, the act governing credit institution bankruptcies and the insurance act.

The Duma on September 19 began consideration of the 2004 federal budget. It hopes to complete the fourth and final reading of the budget bill by the end of November. Some 70 bills are expected to go before the Duma ahead of the December 7 parliamentary election. These include amendments to the budget act related to the reform of regional and local administration, harmonisation of the forests code with the revised land code (including private ownership of forests) and amendments to the land code on conveyance of plots occupied by enterprises. The agenda also includes consideration of a unified agriculture tax, changes in the act on state regulation of foreign trade, the import protection and anti-dumping act and the mortgage act.

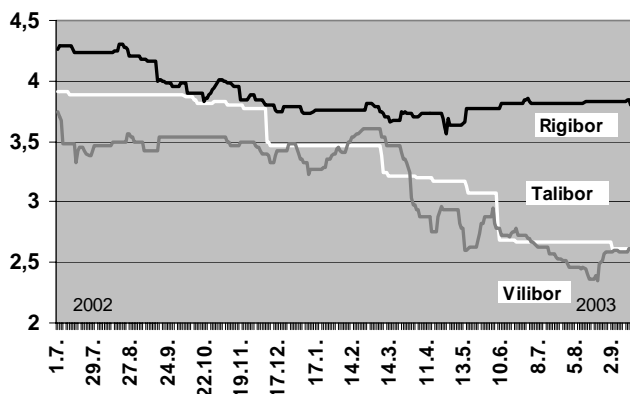
Rapid growth in Baltic states banking sectors. The consolidated total assets of banking systems at end-July amounted to EEK 89 billion (EUR 5.7 billion) in *Estonia*, LVL 4.9 billion (EUR 8.0 billion) in *Latvia* and LTL 19 billion (EUR 5.4 billion) in *Lithuania*. Total assets rose 17 % y-o-y in *Estonia*, 31 % in *Latvia* and 20 % in *Lithuania*.

At end-July, the stock of loans granted to the private sector grew 24 % y-o-y in *Estonia*, 42 % in *Latvia* and 50 % in *Lithuania*. Lending both to households and businesses continued to boom. The particularly high credit growth in Lithuania was partly due to credits granted to the Mazeikiu Nafta oil company. Low interest rates also

increased loan demand in the Baltics. Lending rates have fallen about two percentage points over the past twelve months. Interest rates on foreign currency loans averaged two percentage points less than rates for loans in domestic currencies. Foreign currency loans represented 82 % of all loans in *Estonia*, 54 % in *Latvia* and 56 % in *Lithuania*.

Growth of deposits has substantially lagged credit growth. At end-July, the on-year growth of deposits was 6 % in *Estonia*, 23 % in *Latvia* and 15 % in *Lithuania*. A substantial share of deposits (30–50 %) was denominated in foreign currencies.

Baltic 3-month interbank rates, %

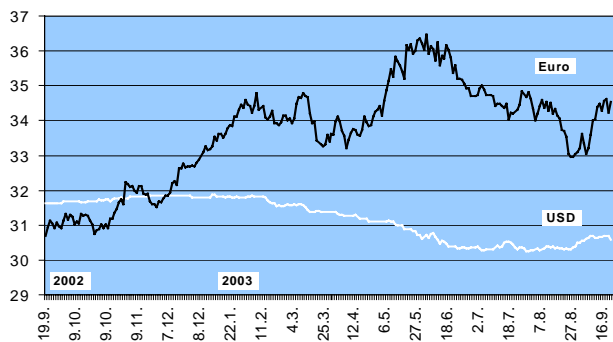


Estonians vote yes on EU membership. Voter turnout in last Sunday's (Sept. 14) national referendum on EU membership was slightly less than forecast and 63 % of Estonians exercised their right to vote. 67 % of voters favoured EU membership, while 33 % opposed. Strongest support for accession was in Tartu and Tallinn, while the lowest support was in East Virumaa county and southerly Võrumaa county. The outcome in Estonia is expected to boost the "yes" vote in Latvia's EU referendum on Saturday (Sept. 20).

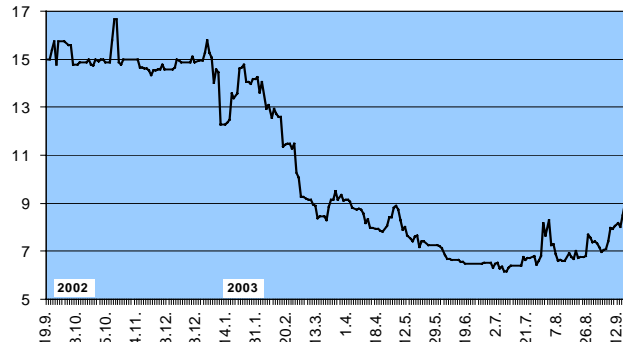
No state support for Latvian pulp mill project. The Latvian government's pulp mill project working group decided not to grant state support to the Finnish Metsäliitto's planned construction of a pulp mill near Jekabpils (see Week in Review 29/2003). The pulp mill project working group said that, due partly to the mill's potential environmental impacts, the state was reluctant to grant Metsäliitto tax breaks to support the investment. The working group's assessment was also influenced by Metsäliitto's decision to abandon its plans to build a paper mill in conjunction with the pulp mill.

In any case, the working group's assessment presents no barrier to construction of the pulp mill without state support. Metsäliitto is currently reviewing the project's profitability without support and will decide about the investment later. If built, the EUR 900 million pulp mill would be the largest investment project in Latvia.

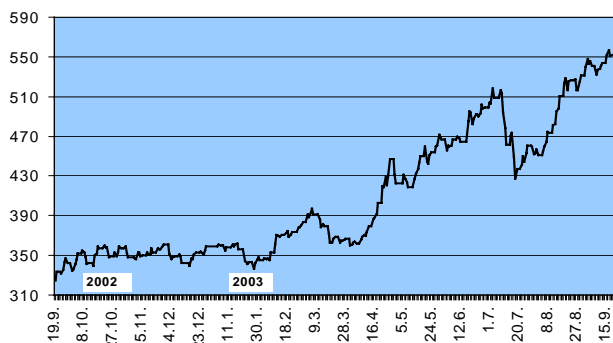
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



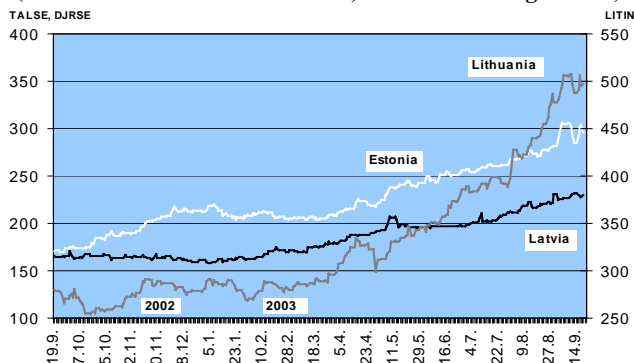
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Slight slowdown in Russian economic growth. The combined production index of five base sectors of the economy rose 4.2 % y-o-y in August, declining from 6.2 % growth in July. Production was up 6.6 % y-o-y in the first eight months of this year. The slowing growth partly reflected the fact that economic growth was higher in the second half of 2002 than in the first half, so that the basis for comparison was higher for the second half. Real appreciation of the rouble against a basket of currencies of Russia's main trading partners also fuelled strong demand for imported goods.

Workday-adjusted industrial output climbed nearly 7 % y-o-y in January-August. Growth in energy production remained particularly strong. Crude oil production increased 11 %, coal 10 % and natural gas 4 %. Among industries focused mostly on the domestic market, especially the food industry improved its position. Foodstuff production rose nearly 5 % in January-August. Declines were registered in light industry (down 3 %) and car manufacturing (down 7 %). Both industries mainly serve Russia's domestic market.

The IMF raised its estimate in September on growth of the Russian economy this year from 4 % to 6 %. The new figure matches the Russian government's current forecast.

Performance of Russian regional and local budgets in the first half of 2003. The main revenue streams for Russia's 89 administrative regions in the first half were transfers from the federal budget (nearly 27 % of total revenues), profit tax (19 %) and income tax (16 %). The largest spending items were transfers to local budgets (25 % of total expenditures). Another 12 % of expenditures went to industry, the energy sector and construction. The structure of revenues and expenditures was, with a few exceptions, virtually unchanged from 1H02. The significance of income taxes as a revenue source increased and spending on industry, the energy sector and construction doubled in relation to GDP. Among the smaller revenue streams, the largest jump was seen in excise taxes. The combined regional budgets in the first half showed a small surplus equal to 0.4 % of GDP (i.e. revenues 10.9 % and expenditures 10.5 % of GDP).

Half of local budget revenues were taxes and over 40 % were transfers from federal and regional budgets. As in 2002, the main tax revenue sources were income tax and profit tax, which together accounted for a third of total revenues. About 70 % of spending went to education, housing and health care. The expenditure structure has remained essentially unchanged for years. Like last year, local budgets were slightly in deficit (-0.2 % of GDP) in the first half (i.e. revenues 6.1 % and spending 6.3 % of GDP).

Russian 2004 federal budget passes first Duma reading. The Duma accepted the first reading of budget bill in a vote of 246-180. The first reading established the reve-

nue and expenditure targets for the 2004 budget, as well as the economic indicators on which the budget is based. Revenues in 2004 are projected to be RUB 2,743 billion, about EUR 80 billion (the equivalent of 17.9 % of GDP) and expenditures of RUB 2,659 billion (17.4 % of GDP). The resulting surplus of RUB 83 billion (0.5 % of GDP) would be transferred to a separate stabilisation fund. The first reading also involved additions to the budget code on operation of the stabilisation fund.

On the revenue side, the budget assumes that the price of Urals-grade oil will average \$22 a barrel next year. The budget is balanced with a price of \$20 a barrel. Both assumptions are below the current world price for Urals-grade oil. Currently, over a third of revenues comes from the sale of oil, oil products and natural gas. GDP is expected to grow 5.2 % next year and inflation to be in the range of 8-10 %. The rouble's exchange rate next year is expected to average 31.3 roubles to the dollar. The second reading of the budget bill is set for October 17. Duma leaders hope to complete the final two readings of the budget before adjourning for the December 7 parliamentary election.

Russian government approves decree on setting up railways corporation. Creation of the new corporation is part of the reform of Russia's railways. The commercial functions of the railways ministry will be incorporated, while the administrative functions will remain with the ministry. Deputy prime minister Vladimir **Yakovlev** said that the railways ministry would become a department within the transportation ministry by the end of the year. Gennadi **Fadeyev**, who until recently was railways minister, will lead the new railways corporation.

The new corporation will be fully state owned and will inherit from the ministry all passenger and freight rolling stock, as well as social assets such as schools, hotels and hospitals. If reform of the railways proceeds as planned, all non-core activities of the railways will eventually be privatised. The corporation will later be divided into independent subsidiaries responsible for various functions and the shares in these subsidiaries will be traded.

Estonian parliament starts to consider 2004 budget. The Estonian government approved budget expenditures of EEK 46.6 billion (EUR 3 billion) and revenues of EEK 46.5 billion. The budget deficit would amount to less than 0.1 % of GDP. Budget revenues are expected to rise 17 % over this year's budget. The budget assumes GDP growth of 5.6 % next year and an inflation rate of 3.8 %.

The main changes on the revenue side are a lowering of the income tax from 26 % to 24 % and an increase in monthly tax-exempt income to 1,400 kroons (89 euros). These moves are expected to reduce tax revenues by EEK 1.5 billion. In compensation, EU subsidies will increase by about EEK 3 billion and the excise taxes on

alcohol and tobacco will be boosted. The biggest spending increases will be on support paid to students and parents with small children, as well as wage hikes for public workers in the education and cultural fields.

In conjunction with the budget negotiations, the government also approved legislative amendments for the coming years as part of tax reform. Estonia wants to sustain rapid economic growth by shifting the taxation emphasis from labour and capital to taxation of consumption. The income tax will be incrementally reduced to 20 % and the tax-exempt monthly earnings will be raised to 2,000 kroons over the next three years. The loss of tax revenues to municipalities will be compensated by letting them retain a larger share of income taxes.

The drafters of the 2003 budget anticipated a deficit equivalent to 0.3 % of GDP. Thanks to higher-than-forecast tax revenues, this year's budget is now on target to produce a surplus of 0.4 % of GDP.

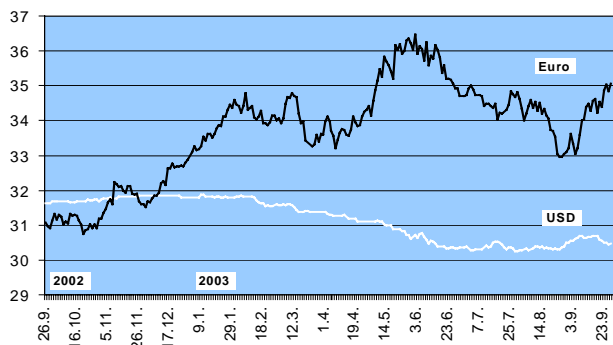
Latvians vote for EU membership. On September 20, in national referendum 67 % of voters supported Latvia's EU accession and 32 % opposed. Voter turnout reached nearly 73 %. In Riga, support for EU membership was lower (59 %,) while support was strong in the port cities

of Liepaja and Ventspils. Latvia's national referendum was the last of nine held by EU accession candidate countries since last spring. Like Latvia, the other eight had voted for EU membership. Cyprus will not hold a referendum on EU membership.

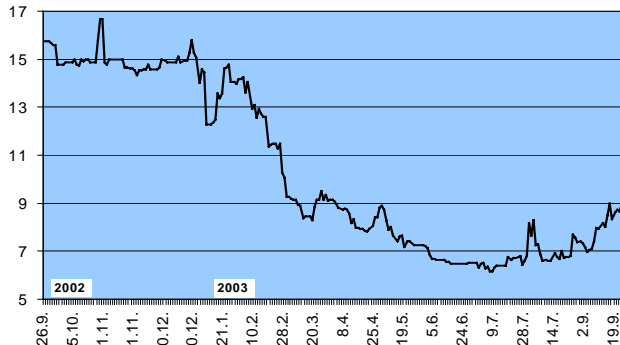
Sale of Lithuanian power distributors arouses buyer interest. More than ten companies submitted initial bids on majority stakes in the Lithuanian power distributors (RST that operates the eastern area and VST that operates the western area; see Week in Review 29/2003). Officials said eight of the bidders qualified, although their names were not publicly announced. The conditions for a buyer include an annual turnover of at least LTL 450 million (EUR 130 million) and headquarters domiciled in a country that is a member of the EU, OECD, EFTA or NATO. In addition, the company that acquires VST must already have business activities in Lithuania. Although one firm can submit bids on both operators, it can only take a stake in one company.

Companies qualifying for the second round should submit their final bids by November 7. Officials hope to complete the sales of both companies by the end of this year.

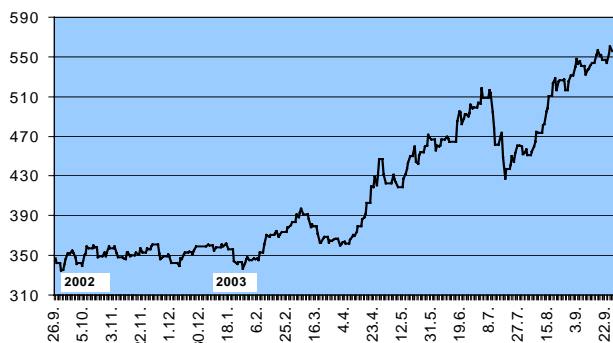
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



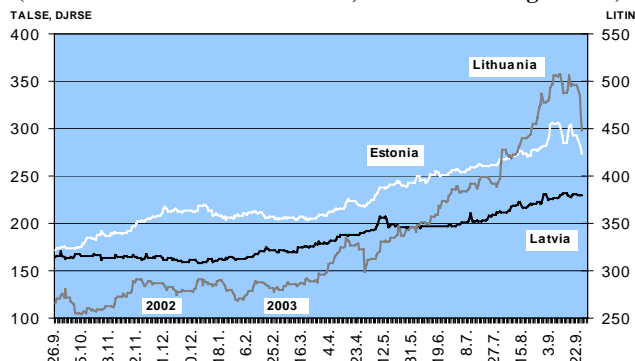
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russia and Belarus discuss currency union and energy cooperation. Presidents Vladimir **Putin** and Alexander **Lukashenko** confirmed in September their countries' aim to establish a currency union at the beginning of 2005. Belarus was to introduce the Russian rouble as an accounting currency alongside its own rouble on October 1, but due to new conditions imposed by president Lukashenko, the introduction date of the Russian rouble has been postponed again.

On October 1, the Council of Ministers of the Union of Russia and Belarus failed to reach a common understanding on the currency union agreement. The Russian side was unprepared to accept Belarus' demand for \$2.1 billion in compensation for indirect costs caused by the currency union, as well as commit at this time to other conditions laid down by Belarus.

According to the IMF, the success of the currency union will require major reforms in Belarus, which has a population of ten million. These reforms include a substantial lowering of inflation, tighter fiscal and monetary policy, harmonisation of the Belarus tax code with Russia's, as well as numerous structural reforms affecting e.g. the energy sector, finance, business and agriculture. Belarus GDP is about 3 % of Russian GDP. The annual inflation rate in Belarus was nearly 35 % in 2002.

Russia has also threatened to increase the price of natural gas deliveries to Belarus from 30 dollars per thousand cubic metres to 80 dollars from the start of 2004. However, prime minister Mikhail Kasyanov announced that Russia is considering sale of natural gas at domestic prices as long as it sees progress in establishing a pipeline company to be jointly held by Gazprom and Beltransgaz. In recent weeks, the energy cooperation of the two countries has been further troubled by interference by Belarus officials with assets of Russian oil companies located in Belarus.

Russia, Ukraine, Belarus and Kazakhstan sign agreement on common economic space. On September 19 in Yalta, representatives of the four nations signed an agreement aimed at creation of a common economic space in three phases: a free-trade agreement would first be implemented, followed by harmonised legislation on customs and competition, as well as the implementation of unified customs tariffs. In the third phase, policies promoting the free movement of goods, services, capital and labour would be put into practice. The detailed documents on the measures to be taken should be ready for signing by December. Ukraine, the most reluctant member, joined only after receiving special concessions that allow some countries to integrate more slowly than the others. The Ukrainian opposition claims that the supranational bodies created by the common economic space agreement contradict the country's constitution. Ukraine earlier announced it was seeking EU membership.

Russia, Belarus, Kazakhstan, Kyrgyzstan and Tajikistan are members of the Eurasian Economic Community. Ukraine participates in the GUUAM union, which includes Georgia, Uzbekistan, Azerbaijan and Moldova.

Russian Duma approves bill on local administration.

The bill is part of a larger reform of relations between the central government and the regions. It aims at establishing efficient local administrations that provide high-quality services to residents. The bill specifies the duties of local administrations and seeks to guarantee their financing. A substantial amount of functions mandated to the regional and local levels are currently unfunded and therefore not performed. The bill requires that the shares of federal taxes allocated to local administrations will be determined in the budget code for a longer period so that it is easier for local administrators to prepare budgets and forecast revenues. Publication of local budgets is also intended to increase citizen participation in local decisionmaking. The act will enter into force at the beginning of 2006.

Russian government approves fishing industry development strategy extending through 2020.

The strategy approved at the beginning of September is designed to improve employment in the fishing industry and increase the supply of fish and fish products available on the market. According to a government study, Russia's total fishing catch last year was just 3.3 million tonnes, well off the catch of 7 million tonnes in 1991. The fishing industry employed 370,000 people last year, or 33 % fewer than in 1991.

In the first phase of the strategy (2003–2005), new legislation would be drafted, fishing waters will be inventoried, a transparent system of allocating fishing rights will be developed, taxation on fishing will be introduced, and measures to protect fish stocks and regulate the market and competition will be developed. In the second phase (2006–2010), international cooperation will be broadened, support will be made available for domestic construction of fishing vessels, fishing in international waters will be increased, fish farming will be developed along with improvements in infrastructure. The third phase (2011–2020) will emphasise development of mechanisms for protection, supervision and regulation, as well as the exploitation of new fishing areas.

Finnish-Russian economic commission meets in Helsinki.

At last week's (Sept. 24–25) meeting, the topics discussed by Russian economy minister German **Gref** and Finnish foreign trade minister Paula **Lehtomäki** included Russia-EU relations, Russia's WTO membership talks, development of Finnish-Russian trade and cooperation between customs authorities, a still unsigned agreement on investment protection, possible Finnish assistance in drafting of Russia's new forests act, a high-speed rail line between Helsinki and St. Petersburg, Finland's acquisition of a fifth nuclear reactor and security of Baltic sea traffic.

Baltic employment situation continues to improve.

Unemployment figures based on ILO methodology show that unemployment in the second quarter was 10.7 % in *Estonia*, 10.6 % in *Latvia* and 12.9 % in *Lithuania*. The on-year change in unemployment showed reductions in Latvia and Lithuania, and an increase in Estonia. How-

ever, the rise in Estonia's unemployment rate was due to an increase in the size of the labour force rather than a loss of jobs. The number of people working increased in all Baltic countries from 2Q02, although growth of employment slowed from the start of the year.

Estonian economic growth continued to slow in the second quarter. Estonian real GDP grew 3.5 % y-o-y in the second quarter. Some of the slowing can be attributed to the record growth posted in 2Q02 (7 %), which made the comparison figures relatively high.

The economic slowing from the first quarter affected several economic sectors. Agricultural output contracted 5 %, while the transport and communications sector shrank 1 %, reflecting such factors as lower passenger numbers and lower freight volumes at ports and on the railways. The largest boost to overall GDP growth in the second quarter came from manufacturing, which registered 7 % growth. The finance sector, as well as production of electricity, gas and water grew 17 %. Retail trade and construction both increased 5 %.

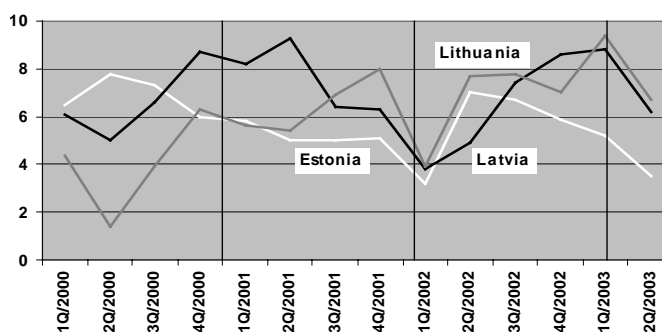
The transport sector's problems were also reflected in the 13 % y-o-y drop in service exports. Goods exports rose just 3 %, making the 6 % rise in domestic private consumption particularly important in sustaining economic growth. Investment growth slowed to 4 %.

Lithuanian GDP rose 6.7 % in the second quarter. While the rate of Lithuanian economic growth still exceeded forecasts, it slowed from the first quarter.

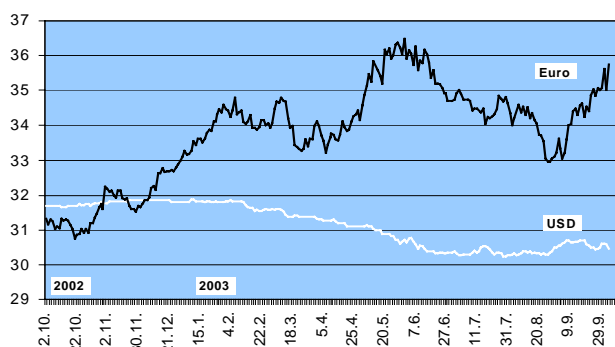
Some of the factors driving growth in the second quarter included an 8 % jump in household consumption and a 14 % rise in fixed investments. Exports fell 5 %, primarily the result of a maintenance break at the Mazeikiu Nafta oil refinery.

The increases in consumption and investment benefited construction (16 % y-o-y) and trade (9 % y-o-y). Production of electricity, gas and water rose 29 %, mainly due to increased output at the Ignalina nuclear power plant. The agriculture sector also revived, growing at a rate of 10 % y-o-y. Growth in manufacturing and the transport and communications sector slowed to 5 %.

GDP growth in Baltic countries, percentage change from four quarters previous



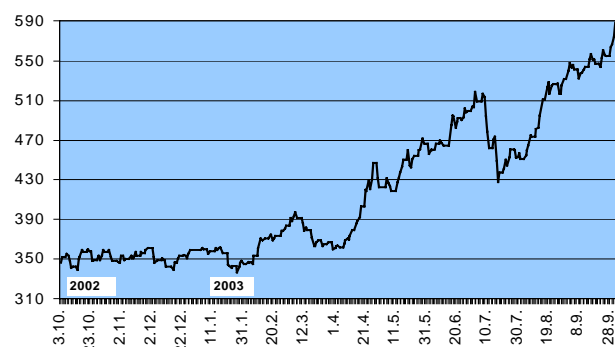
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



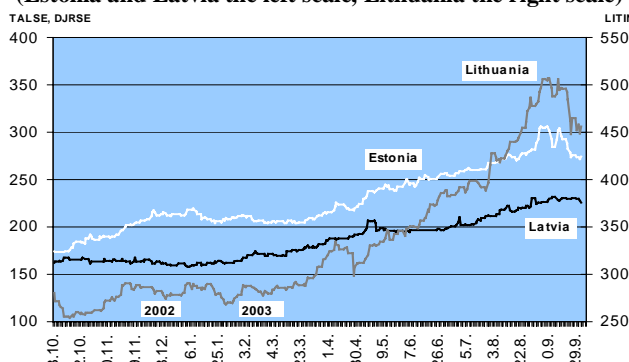
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Moody's upgrades Russia's creditworthiness. On October 8, the international credit rating agency Moody's lifted Russia's credit rating two notches to Baa3 – the first time Russian bonds and notes achieved the lowest level of investment-grade status. Moody's decision to upgrade Russia's creditworthiness before the March 2004 presidential election surprised many observers. The two other large credit ratings agencies, Standard & Poor's and Fitch, are not expected to raise Russia's credit ratings very soon.

Moody's said its upgrade reflected Russia's successful fiscal policies and ability to service debt, as well as the creation of a state stabilisation fund. Russia's finance ministry reports that the state's foreign-currency-denominated debt is presently \$121 billion or about 30 % of GDP. Moody's stated that Russia has effectively exploited high world oil prices and the devaluation advantage created by the 1998 financial crisis. It also noted that Russian political risk has diminished.

The boosting of Russian sovereigns to investment grade opens up Russia to a new group of international investors. Pension funds, for example, are expressly limited in their bylaws to investments in countries with strong credit ratings. Russia and Russian companies also benefit from the upgrade as the costs of borrowing on international markets will be lower.

RTS index hits all-time high of 629 points on October 8. Last week the RTS index surpassed its former all-time high of 572 points set in October 1997. Since the beginning of this year, the RTS index has risen 75 %. Trading volume has also increased. For example, the combined volume last Friday (Oct. 3) for Moscow's RTS and MICEX exchanges, as well as foreign-listed ADRs was about \$1 billion. The market capitalisation of listed firms has risen in recent weeks on rumours that Western oil companies are interested in Russian firms. Analysts, however, don't agree on whether shares in Russian firms are already overpriced. The aggregate market capitalisation of listed firms is currently about \$185 billion, or 45 % of GDP.

Russian inflation continues to decelerate slightly. Consumer prices were up 13.2 % y-o-y in September, a slight slowing from August's rise of 13.3 %. Between the beginning of the year and end-September, prices increased 8.6 %. The government aims to get inflation down into the range of 10–12 % by the end of this year. In 2002, consumer price inflation was 15.1 %.

Russian current account surplus remains large, capital outflows rise in third quarter. Preliminary figures released by the Central Bank of Russia show that the cumulative current account surplus for the first nine months of this year was \$29 billion, or more than 9 % of GDP. During the same period last year, the surplus was \$21 billion (slightly less than 9 % of GDP). The trade

surplus grew to over \$43 billion as earnings on goods exports rose by nearly 25 % from a year earlier. Export earnings on crude oil, oil products and natural gas increased about 30 %. Other exports grew 16 %. The growth of exports slowed notably in the third quarter, however. The value of imported goods grew over 20 % y-o-y both for the first nine months of 2003 and for the third quarter. On the other hand, part of the growth pace can be attributed to the decline since last year of the exchange rate of the US dollar, which is the unit of measurement in the Russian balance of payments. The service deficit was around \$8 billion, about the same size as a year ago. Russian service exports grew nearly 20 % and service imports 10 %. The deficit of the investment income balance increased to almost \$6 billion, mainly due to higher interest payments incurred by Russian firms.

In January-September, Russia's net capital exports abroad were over \$9 billion. In the state sector, the net capital outflow abroad exceeded \$10 billion, due mainly to the paying down of foreign debt. The net inflow of banking capital was less than \$1 billion; the first half saw a net inflow of nearly \$5 billion, while the third quarter saw a net outflow of nearly \$4 billion. The recorded net capital inflow of companies in January-September exceeded \$1 billion, even though the direction reversed to produce a slight capital outflow in the third quarter. The foreign-currency borrowing of companies rose to nearly \$10 billion in January-September. FDI of \$4 billion went to Russia's enterprise sector. On the other hand, non-repatriated exports proceeds and non-supply of goods and services against import contracts exceeded \$11 billion. The balance of payments' errors and omissions was more than \$6 billion to the negative, a larger figure than a year earlier, indicating that unrecorded capital outflows may have increased.

Due to the large current account surplus, the central bank's foreign currency and gold reserves swelled by \$13 billion during January-September, but dropped by \$2 billion in the third quarter due to a deficit in the financial account.

Government again postpones consideration of program to reform Russia's natural gas sector. Although the government was slated to consider on September 26 a program drafted by the economy ministry on gas sector reform, it dropped the topic from the agenda at the last minute. The previous postponement was in December 2002. It is now expected that the government will not return to discussion of reforming the gas sector until after the parliamentary and presidential elections.

In the first phase of the gas sector reform proposed by the economy ministry, Gazprom would be broken up to create a company dedicated solely to gas transport, while its production units would be formed into independent companies. The reform also aims at increasing transparency of Gazprom operations and assuring all market

participants of uniform access to the gas pipeline grid and uniform gas transport tariffs. Gazprom opposes the reforms on the grounds that they will lead to lower gas production and discourage investment.

President **Putin's** economic adviser **Andrei Il'iarionov** announced that the president's administration is preparing an alternative reform program that seeks to first increase stability of the gas sector by creating competing production, transport and distribution companies. Only thereafter would reform of Gazprom be initiated.

Baltic inflation figures for September. September consumer prices increased 1.4 % y-o-y (1.3 % in August) in *Estonia* and 3.1 % (3.5 %) in *Latvia*. In both countries, the largest rises were seen in health care services. Prices of housing, as well as alcoholic beverages and tobacco also rose. Food prices grew in 2.5 % in Latvia, but fell 0.3 % in Estonia. Deflation persisted in *Lithuania*, where consumer prices were down 0.8 % y-o-y in September (-1.1 % in August), reflecting lower prices for e.g. food, clothing, footwear and phone calls. On-month September prices were up 0.2 % in *Estonia* and 0.5 % in *Latvia*, but down 0.4 % in *Lithuania*.

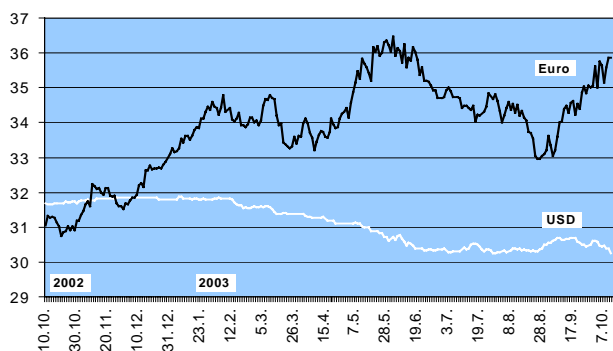
Cargo volumes at the largest Baltic ports. During the first nine months of this year, *Estonia's* largest ports handled a total of 28 million tonnes of cargo, about the

same amount as during the same period a year earlier. Some 77 % were transit shipments. Nevertheless, there was a slight drop in them from the same period a year earlier, reflecting a 3 % decline in oil shipments, the most important cargo product. The volume of container cargo grew fastest (11 %), although its share of total cargo handled was less than 3 %. Passenger volume fell 2 % y-o-y in January-September. The largest drop, 5 %, was seen in passengers travelling between Helsinki and Tallinn.

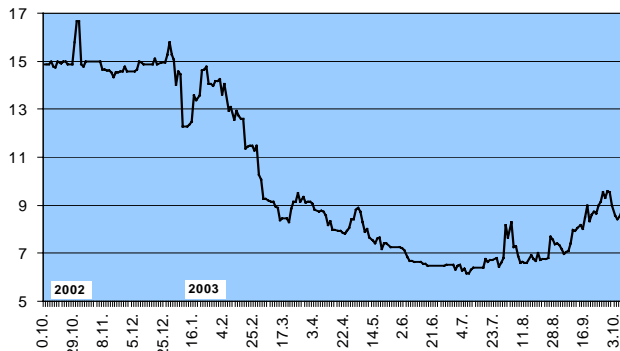
The volume of cargo handled at Ventspils, *Latvia's* largest port, fell 5 % in January-September, mainly the result of a drop in crude oil shipments. During the period January-September, 22 million tonnes of cargo were handled at Ventspils, of which 54 % was oil products, 29 % bulk cargo and 12 % crude oil. Some 14.5 million tonnes of freight passed through the Port of Riga in January-August, an increase of 23 % y-o-y. The volume in the main cargo category, bulk cargo, grew 42 %.

In the first eight months of the year, *Lithuanian* ports handled 22 million tonnes of cargo, or 38 % more than a year earlier. Cargo volumes at Klaipeda, the country's largest port, grew 12 % to 14 million tonnes. About a third of freight were oil products, the volume of which fell slightly. Some 7 million tonnes of oil (21 % more than in all of 2002) moved through the Butinge oil terminal, which is owned by Mazeikiu Nafta.

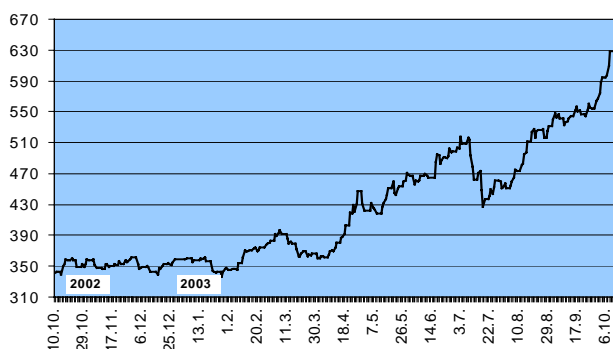
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



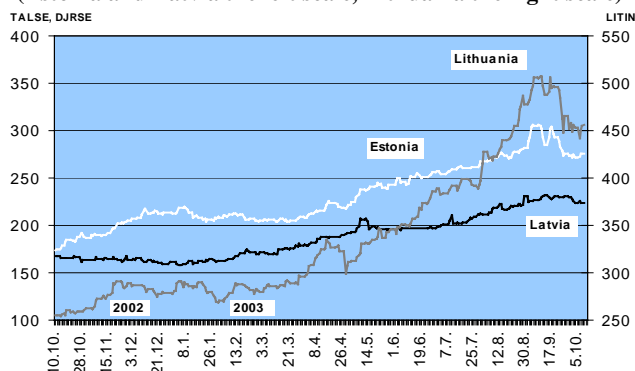
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian Duma approves revenue-expenditure structure for 2004 budget. On October 15, the Duma voted 236–157 to approve the second reading of the 2004 federal budget act. The required simple majority was exceeded by just ten votes.

The rough allocation of spending for various budget categories was decided in the second reading. Transfers to regional and local budgets (30 % of total expenditures) constitute the largest spending area. However, the category includes unified social tax transfers, which account for over half of total spending for the category. The actual share of transfers to regional and local budgets will fall next year in relation to forecast GDP and total budget expenditure. Other significant spending categories include defence (16 %), law enforcement and national security (12 %) and interest payments on debt (11 %). Social policy will get 6 % of total spending.

Russian Duma and Federation Council disagree on taxation changes. The Duma approved amendments to the Russian tax code that affect the corporate property tax and the unified agriculture tax. The Federation Council, however, rejected amendments to the corporate property tax and decided to convene a reconciliation commission made up of Duma, Federation Council and government representatives. The Federation Council, which consists of representatives of the regions, is concerned that the tax amendments will cut into regional revenues. Under the amendments approved by the Duma, the corporate property tax would remain regional tax, with its size determined by the regions (but limited to no more than 2.2 %). The current corporate property tax is 2 %, but the tax base is broader than envisioned in the draft bill.

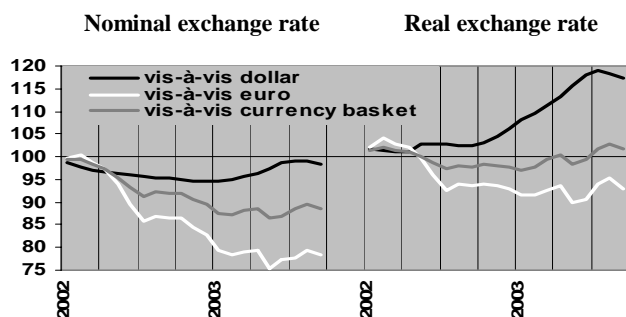
The amendments to the agriculture tax have yet to be considered by the Federation Council. The amendments are supposed to help correct the current situation, whereby agricultural producers receive varied tax treatment. Under the draft bill, the shift to a 6 % unified agriculture tax would be voluntary. To be eligible for the new tax arrangement, however, an agricultural producer must demonstrate that it produces at least 70 % of the raw materials used in its products. The tax will be levied on income after deductions and replaces several other taxes (including the profit/income tax, corporate profit tax and VAT).

Russian government's foreign debt falls; corporate foreign debt rises. Finance ministry figures show that as of end-June foreign-currency-denominated federal debt had fallen to \$121 billion, or about 30 % of GDP. Over \$6 billion of this amount is government debt to the central bank. The CBR reports that Russia's government debt to foreign lenders fell to \$99 billion, or 26 % of GDP. The foreign debt borrowed by the state after the break-up of the Soviet Union contracted to \$43 billion, while the debt inherited from the Soviet Union remained at \$55 billion (of which \$41 billion is owed to Paris Club creditors). Russia's banking sector foreign debt rose to nearly \$19 billion at end-June. Corporate borrowing abroad rose

briskly from \$34 billion at the start of this year to over \$40 billion at end-June.

Rouble's real exchange rate relatively stable during first nine months of 2003. After strengthening nearly continuously from the start of the year, the rouble's nominal exchange rate against the dollar weakened substantially around end-August. The CBR said the shift mainly reflected capital movements within the banking sector. Since early September, the rouble has again faced some appreciation pressure from e.g. the on-going current account surplus. During the summer, the dollar's appreciation against the euro lifted the rouble's exchange rate against the euro, but in September the rouble weakened against the euro. During January-September, the rouble strengthened 4 % against the dollar, but fell 6 % against the euro and 1 % against a basket of currencies of Russia's main trading partners. Russian price competitiveness is to a degree reflected in the rouble's real exchange rate, which comprises the nominal exchange rate and the inflation differences between Russia and the benchmark countries. The rouble's real exchange rate strengthened in January-September 10 % against the dollar, 2 % against the euro and 4 % against the currency basket.

Rouble's exchange rate January 2002– September 2003



2004 budget bill submitted to Lithuanian parliament.

The Lithuanian government's proposed state budget features revenues of LTL 11.7 billion (€3.4 billion) and expenditures of LTL 13.6 billion. Under the draft 2004 budget, revenues will rise 23 % and expenditures 26 % in comparison to this year's budget. The budget deficit would thus be LTL 1.9 billion (€60 million) or about 3.3 % of forecast of GDP. When municipal budgets are included revenues will increase next year to LTL 13.3 billion and expenditures to LTL 15.2 billion. The budget assumes 6.2 % GDP growth in 2004.

Lithuania's upcoming EU membership generated the most budget changes. Lithuania's contribution to the EU budget will be LTL 440 million, but it will get back LTL 1.6 billion. The budget sets aside LTL 1.9 billion for investments, including those with EU participation. Direct subsidies to agriculture increased many fold to LTL 580 million. LTL 200 million will go to wage increases for teachers, librarians and health care workers. Spending on the social services and health care sector will rise by LTL

860 million. In the first half of 2003, the public sector deficit was 0.6 % of GDP. For all of 2003, however, the deficit is expected to approach the forecast of 2.4 % of GDP.

Lithuanian government accepts Gazprom's bid for Lietuvos Dujos. Gazprom submitted an upwardly revised bid of LTL 91 million (€26 million) for a 34 % stake in Lietuvos Dujos, as well as committed to pay an additional LTL 9 million if Lithuania increases the number of firms classed as large consumers and abolishes price regulations for large consumers. The final sale agreement will be signed next spring. The Lithuanian government and Gazprom are also expected to finalise this year a gas supply agreement extending through 2015.

Since Lithuania's privatisation rules for Lietuvos Dujos specify that a 34 % stake must go to a Western strategic investor and an identical stake to a Russian natural gas producer, Gazprom was effectively the sole bidder. Even so, talks on selling the stake to Gazprom took more than a year as the Lithuanian government tried to get the Russians to match the LTL 116 million a German consortium paid for its stake last year. Additionally, the Germans committed to pay another LTL 34 million if they reach agreement with the government on regulation of the natural gas market.

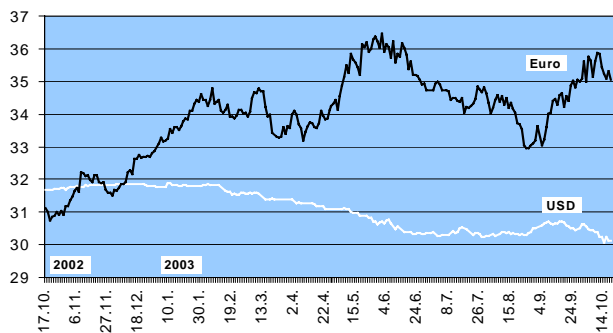
Lithuania's gas market was opened to competition in 1992. Lietuvos Dujos owns most of the country's natural gas distribution grid and controls 22 % of the domestic gas market. Lietuvos Dujos posted a profit of LTL 57 million in 2002.

Euromoney and Institutional Investor publish country risk rankings. *Euromoney's* September country risk survey ranked 185 countries; *Institutional Investor's* rankings covered 172 countries. Ukraine, Lithuania, Romania and Bulgaria climbed most in both rankings in the six months since the previous surveys. Russia also improved its rankings in both surveys. Belarus' ranking dropped substantially in both surveys.

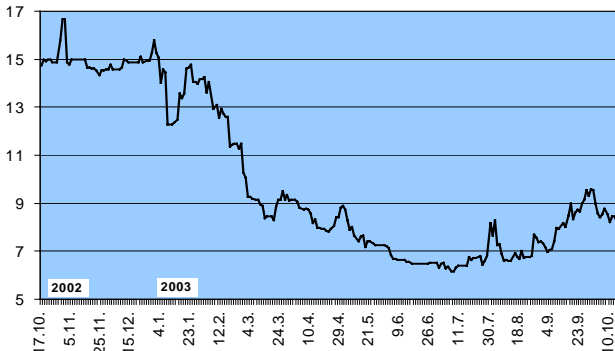
Select country risk rankings (Sept. 2003, March 2003, Sept. 2002)

	Euromoney			Institutional Investor		
	9/03	3/03	9/02	9/03	3/03	9/02
Slovenia	28	29	30	27	30	26
Hungary	35	34	35	31	31	30
Czech Rep.	42	37	40	30	33	34
Estonia	44	44	45	38	40	38
Poland	45	41	42	39	37	37
Latvia	47	50	53	56	53	53
Lithuania	48	58	60	47	55	56
Slovakia	56	52	56	43	52	55
Bulgaria	66	71	68	60	67	68
Romania	69	75	73	68	79	79
Russia	72	76	77	62	64	70
Ukraine	94	113	103	82	96	99
Belarus	133	128	128	138	128	139

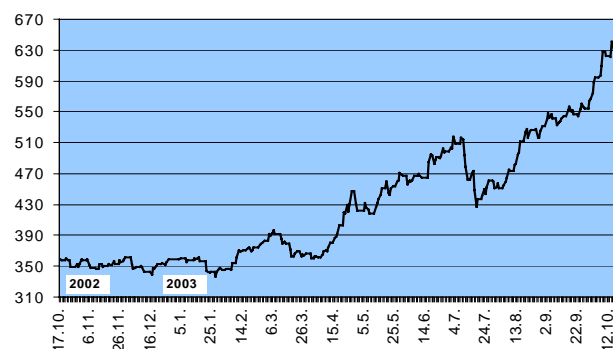
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



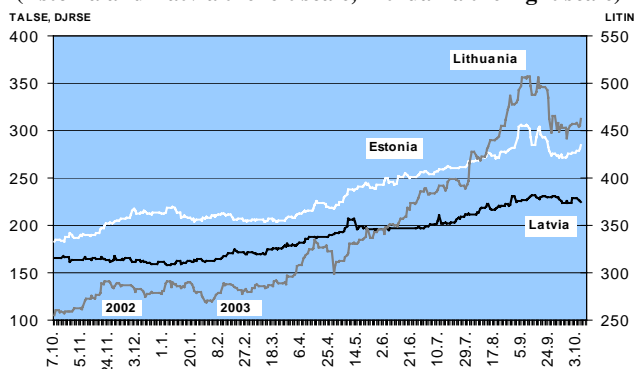
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian economic growth remains brisk. The combined production index of five base sectors of the economy, which is used for estimating GDP growth, rose to 8.3 % y-o-y in September. Production increased 7 % y-o-y in the first three quarters of this year. Industrial output and freight transport both grew 7 %, retail sales were up 8 % and construction 14 %. Agricultural output fell 2 %.

Industrial output growth was higher than average in crude oil production (12 %), ferrous metallurgy (9 %), and machine-building and metal processing (8 %). Transport of crude oil and oil products (up 16 %) was the fastest growing sector in freight transport due to increased oil production. The agricultural sector was affected by a diminished grain harvest caused by poor weather. In gross volume, 65.5 million tonnes of grain had been harvested by the end of September – 24 % less than at the same time last year.

Russian unemployment higher than last year. Russia had 5.5 million unemployed persons at the end of August. The unemployment rate calculated with ILO methodology was 7.7 %, up from 7.2 % in August 2002. After falling for three consecutive years, the number of unemployed persons began to rise at the end of last year. The unemployment increase in the face of brisk economic growth is seen as an indication that only select sectors of the Russian economy are benefiting from that growth.

Russian Duma approves supplementary budget for 2003. Last Friday (Oct. 17), the Duma approved in three readings a supplementary spending bill proposed by the government. The bill increases federal budget expenditure during the remainder of 2003 by nearly RUB 70 billion (about \$2 billion) or 0.5 % of GDP. A quarter of the spending will go to defence and national security, and a nearly equal share to transfers to regional budgets. A fifth of the spending will go to international operations. Other spending categories include road administration, agriculture and state investments. Even with the increased spending, the budget surplus is expected to exceed the original assumptions in the 2003 budget act. Including the supplementary budget, federal revenues are estimated to reach RUB 2,563 billion (19.3 % of GDP) against expenditure of RUB 2,414 billion (18.2 % of GDP). The resulting RUB 150 billion surplus is more than double the amount foreseen in the 2003 budget. However, the 2002 budget surplus was larger, i.e. RUB 148 billion, or 1.4 % of GDP. The budget surplus will be transferred to a stability fund, which is estimated to have amassed about RUB 170 billion (\$5.8 billion) by the end of this year. High oil prices have had the strongest impact on boosting revenues this year.

President Putin encourages cooperation of APEC countries and eastern parts of Russia. At the APEC (Asia-Pacific Economic Cooperation) summit in Bang-

kok this week, president Putin addressed national leaders on modernising and developing the Trans-Siberia highway system and his country's willingness to help countries in Asia and the Pacific region meet their energy needs. Noting an earlier initiative, he said Russia also seeks to create better conditions for trade in non-ferrous metals with APEC members. APEC countries currently account for 15 % of Russian exports and nearly 20 % of Russian imports. Russia's largest APEC trading partners are China, the US, Japan and South Korea.

Submission deadline for Duma candidate lists passes.

The fourth parliamentary election since the break-up of the Soviet Union will be held on December 7. At stake are 450 deputy seats in the lower-house Duma. Half of Duma representatives are elected from all-nation party lists. Seats are allocated to each list on a proportionate basis as long as the list garners at least 5 % of the total vote. The remaining 225 seats go to outright winners in single member districts. Recent polls anticipate that the parties positioned to exceed the 5 % threshold in the upcoming election are the centre-right United Russia bloc (which supports the Kremlin), the Communist Party, and the Liberal Democrats (led by Vladimir **Zhirinovski**). In earlier Duma elections, the parties most successful at winning single member districts have been the Communists, the centre-left Fatherland-All Russia Party and the Agrarian Party.

Observers note low voter turnouts in recent regional elections and expect the Duma elections to draw a turnout below 60 % (61.8 % in 1999).

Support for major parties in Duma elections, %

	2003 est. (Public Opin- ion Foundation 16.10.03)	1999 (of Duma seats)	1995 (of Duma seats)
United Russia	20	16	1)
Communist Party	18	25	35
Liberal Democrats	7	4	11
Union of Right Forces	4	6	1)
Yabloko	4	4	10
Agrarian Party	2	9	4
Fatherland-All Russia	2	15	1)

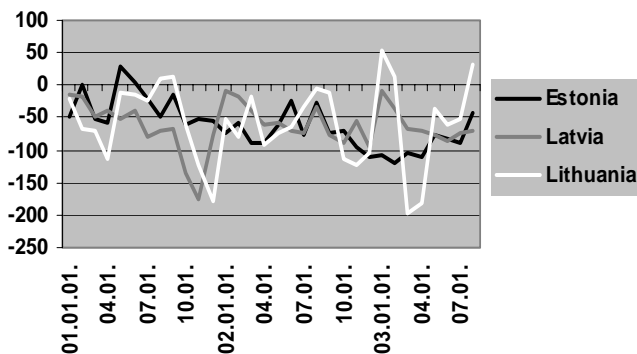
1) not formed yet

Current account deficits continue to rise in Estonia and Latvia. *Estonia's* current account deficit in the first half of 2003 climbed to the equivalent of 16.5 % of GDP (EEK 9.4 billion, €601 million). *Latvia's* current account deficit in 1H03 amounted to 8.2 % of GDP (LVL 222 million, €347 million). *Lithuania's* corresponding figure was 5.9 % of GDP (LTL 1.5 billion, €37 million). In 2002, *Estonia's* current account deficit reached 12.4 % of GDP, *Latvia's* 7.8 % and *Lithuania's* 5.3 %.

Estonia's current account gap widened further in July and August; the deficit was EEK 11.5 billion (€733 mil-

lion) for the first eight months of the year. The trade deficit grew, while the services surplus remained relatively unchanged compared to the same period a year earlier. *Latvia's* current account deficit also rose in July and August. During the first eight months of 2003 the current account deficit amounted to LVL 315 million (€92 million). The trade deficit ballooned, but the services surplus remained essentially unchanged from the same period in 2002. Direct transfers to *Latvia* increased markedly. The current account deficit in *Lithuania* during January-August was LTL 1.6 billion (€459 million), i.e. practically unchanged from the same period in 2002. Exports increased faster than imports, reducing the trade deficit.

Baltic countries' current account deficits/surpluses, million euros

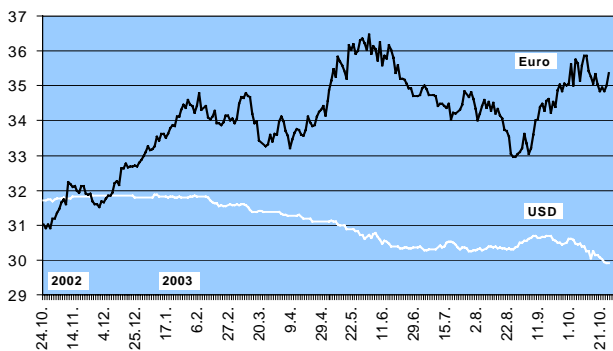


Transparency International releases 2003 Corruption Perceptions Index. The Corruption Perceptions Index charts perceived corruption levels in 133 countries based on interviews with business people, academics and analysts. Ukraine, Poland, Belarus and Russia dropped substantially in the rankings. For most countries, a decline in rankings in part reflects the addition of 32 new countries to this year's rankings.

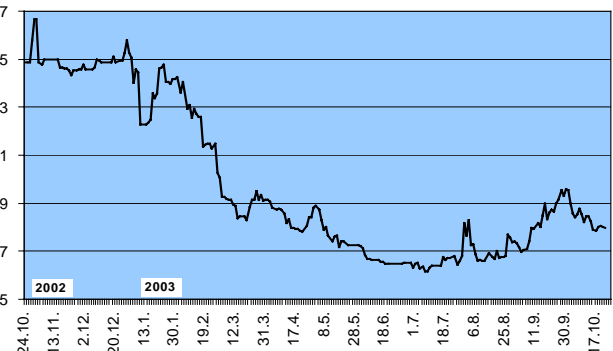
Select CPI rankings, October 2003 and August 2002 (from least to most corrupt)

	10/2003	8/2002
Slovenia	29	27
Estonia	33	29
Hungary	40	33
Lithuania	41	36
Belarus	53	36
Bulgaria	54	45
Czech Rep.	54	52
Latvia	57	52
Slovakia	59	52
Poland	64	45
Romania	83	77
Russia	86	71
Ukraine	106	85

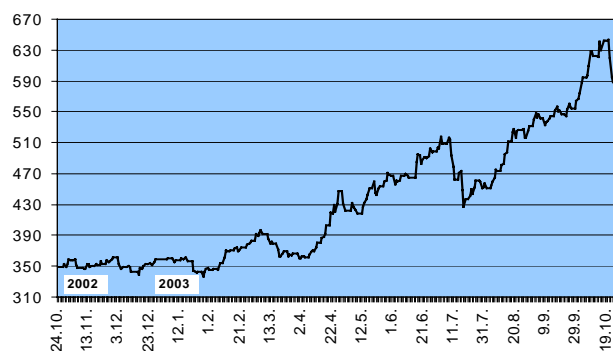
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)

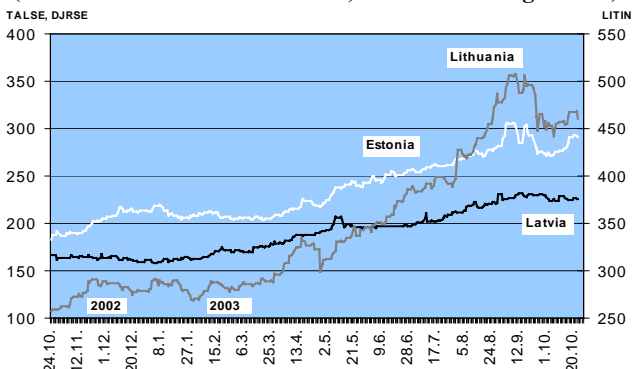


Russian share prices (RTS)



Baltic share prices

(Estonia and Latvia the left scale, Lithuania the right scale)





Arrest of Yukos chief and freezing of assets increase worries about Russian policies. Yukos chief executive Mikhail **Khodorkovsky** was arrested on Saturday (Oct. 25). His charges include tax evasion, document forgery and embezzlement. The charges stem in part from privatisation of large corporations in the mid-1990s, when Khodorkovsky and other Russian oligarchs built their fortunes. The behaviour of officials in the Yukos investigation has also raised questions about Russia as a law-abiding state; some of the measures taken by officials are considered to fall outside the law.

Russia's privatisation sales in the 1990s rarely adhered to the letter of the law or legal principles, so, in principle, many people involved in the privatisation of large enterprises could be similarly charged. The dispute has incited questions on whether investigations of other companies will be launched and whether privatised property could even be re-nationalised. Earlier this autumn, president **Putin** gave assurances that privatisations would be allowed to stand.

Observers note that the arrest of Khodorkovsky could have been provoked by Yukos support for opposition parties in the upcoming Duma election. They also suggest that the arrest may stem from aspiration to keep ownership of natural resources in Russian hands, as Yukos had recently entered into discussions with American oil companies interested in acquiring large stakes in Yukos. The importance of the aim of securing the ownership of natural resources was highlighted by interior minister Boris **Gryzlov** who on Wednesday underscored that Russia's natural resources belong to all citizens, "The fact that the use rights of natural resources are granted to private companies does not mean that such companies may simply keep all profits from the deal."

The situation escalated further on Thursday, when the Prosecutor General authorised the freezing of 53 % of Yukos shares allegedly belonging to Khodorkovsky, but actually owned by foreign entities. According to market sources, the sale and transfer of the shares have been prevented, but the shares have not been confiscated. Representatives of Yukos immediately proclaimed the act an unlawful taking.

Observers comment that the events surrounding Yukos indicate the rise in importance within the Kremlin of the group of people with background in power structures (security service, the military). This group emerged in Kremlin under president Putin and is in opposition with the reformist group, including oligarchs, which emerged during the **Yeltsin** era. The severity of disagreements in the Kremlin was reflected by the fact that Kremlin chief of staff Alexander **Voloshin** resigned in protest to Khodorkovsky's arrest.

Khodorkovsky's arrest and the freezing of Yukos assets has damaged Russia's reputation among international investors and has clouded the very efforts of Mr. Putin to improve Russia's image internationally as a transparent business environment.

Russian share prices fall in response to Mikhail Khodorkovsky's arrest. Yukos shares are a large component of the RTS index. On Monday (Oct. 28), the RTS fell 10 %, while Yukos shares fell 17 % on the day. On Tuesday, the RTS rose 5 %, then fell nearly 4 % on Wednesday. On Thursday, the RTS fell 8 % on the announcement that Khodorkovsky's Yukos shares had been frozen.

The rouble weakened 17 kopeks on Monday to 30.08 roubles to the dollar, but has strengthened since. On Friday, the Central Bank of Russia's exchange rate was 29.86 roubles to the dollar.

IMF mission concludes Russia needs to tighten fiscal policy. An IMF mission finished up last week its annual visit to Russia to review economic trends and outlooks, especially the state budget, and economic reforms. In a statement, the mission said it expects Russian GDP to grow over 6 % this year and about 5 % next year, if, as assumed, the world price for oil declines slightly.

The IMF encouraged Russia to aim for the low end of its inflation target for 2004 (8–10 %), which means focusing monetary policy on inflation. This could, in turn increase exchange rate flexibility. Russia now needs to tighten its fiscal policy, because it has been relaxed in the past two years. This year's supplementary budget has relaxed the fiscal stance further. Also the draft budget for 2004 does not imply any measurable attempts at tightening fiscal policy.

The Fund representatives also expressed concern over slow progress in economic structural reforms this year, especially in the banking sector, natural monopolies and reform of public administration.

Limited competition begins tomorrow in Russia's wholesale markets for electricity. On October 24, prime minister Mikhail **Kasyanov** signed a decree permitting electrical power producers to sell up to 15 % of their output on the open wholesale market during a transition time. Buyers can correspondingly purchase up to 30 % of their calculated consumption needs on the open market. Under the prevailing legislation from spring 2003, the transition time will continue at least till July 2005. The initial transition arrangement includes 60 of Russia's 89 regions.

Retail sales growth continues in the Baltics. Retail sales rose in the Baltics during the current year due to such factors as higher wages, increased employment and brisk credit growth. State transfers also rose slightly.

In *Estonia*, retail sales rose 9 % y-o-y in nominal terms in January-July, a slowing from last year's retail sales growth of 15 %. Sales of motor vehicles and parts increased 15 % this year. In addition, clothing and footwear sales were up 15 % and food sales 14 %.

The value of *Latvian* retail sales in January-August grew 12 % y-o-y. Growth in Latvian retail sales also slowed from last year, when the value of sales climbed 18 % y-o-y. High growth this year was led by clothing and

footwear (36 %), and sales of furniture, home appliances and construction materials (25 %).

In *Lithuania*, the retail sales growth stayed at last year's level and sales were up 12 % y-o-y in January-August. The strongest gains in Lithuania were seen in sales of furniture and home appliances (45 %), clothing and footwear (24 %), and motor vehicles (18 %).

Latvian electricity rates to rise. Latvia's regulatory officials approved Latvenergo's proposal to increase electricity rates by 13 % on average from the beginning of next year. The price for households of a kilowatt-hour will rise 15 % to 0.045 lats (0.07 euros). The rate charge to companies connected to low-voltage grids will rise more than 30 %, while the rate for companies connected to high-voltage grids will fall 22 %. Electricity rates were last adjusted in 1998; the new prices better represent the cost structure of electrical power.

EU Commission stays with its economic growth forecasts for acceding countries. According to the latest forecasts of the EU Commission, economic growth in acceding countries will accelerate to 3.1 % this year. Last year, economic growth in those countries was 2.3 %.

The average growth forecast matches the figure published last March. Among individual countries, however, Lithuania saw a major upward revision. After forecasting 4.5 % growth in 2003 last spring, the Commission now expects real GDP to rise 6.6 % this year. In addition, the outlook for Poland improved substantially. On the other

hand, the forecast figures were revised downwards for e.g. Slovenia, Hungary and the Czech Republic.

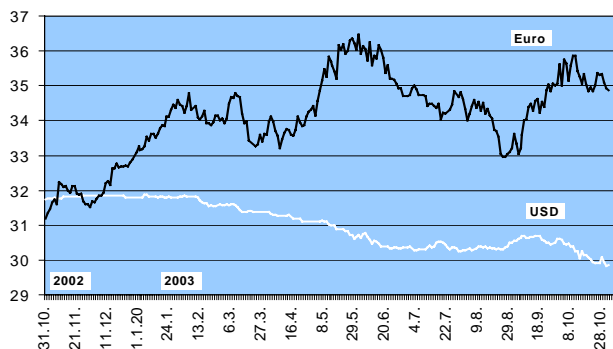
The higher economic growth will be driven by growth in both exports and domestic demand. Domestic purchasing power will increase along with higher wages and slowing inflation. Growth in coming years is also expected to accelerate a bit due to EU membership, which will increase investment rates. Export growth should also accelerate as global demand recovers.

The European Commission mentioned that some of the biggest problems faced by new members are large current account deficits, public sector shortfalls and widespread unemployment. The Commission noted that the unemployment rate is unlikely to decline from last year's rate of 14.8 % in the coming three years.

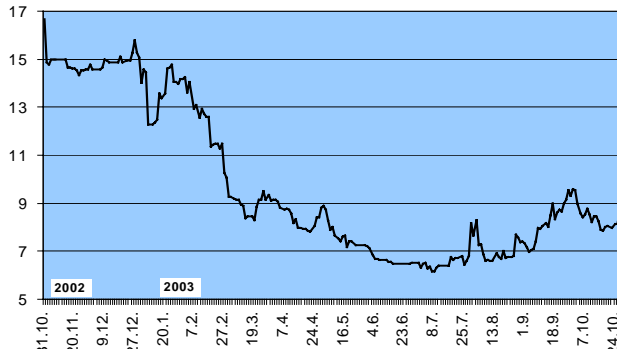
European Commission forecasts for economic growth in accession countries, 2003-2005.

	Annual GDP growth, %			Annual inflation, %		
	2003	2004	2005	2003	2004	2005
Czech Rep.	2.2	2.6	3.3	0.0	3.3	2.6
Estonia	4.4	5.6	5.1	1.6	3.9	3.7
Hungary	2.9	3.2	3.4	4.6	6.1	4.1
Latvia	6.0	5.2	5.7	2.5	3.0	2.9
Lithuania	6.6	5.7	6.0	-0.9	2.3	2.6
Poland	3.3	4.2	4.8	0.7	1.9	2.7
Slovakia	3.8	4.1	4.3	8.5	8.2	5.0
Slovenia	2.1	3.1	3.7	5.9	5.2	4.3
Weighted average	3.1	3.8	4.2	2.3	3.7	3.3

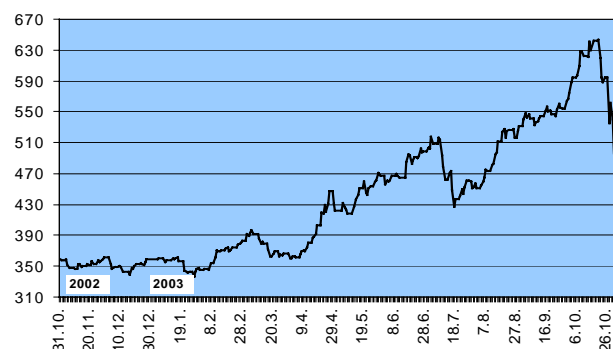
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



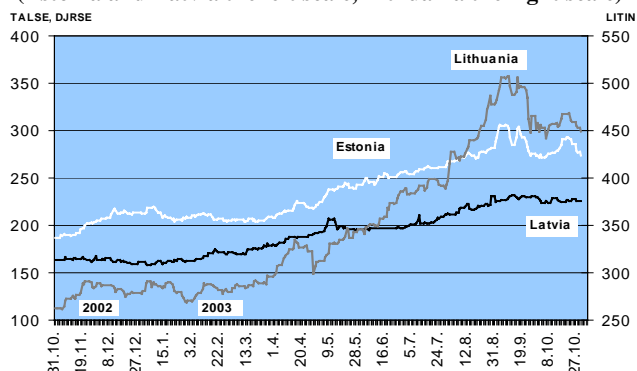
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





New developments in the Yukos case. The events surrounding oil company Yukos took a new turn on November 3, when Mikhail **Khodorkovsky** announced he was resigning as Yukos chairman to protect the firm from charges against him. Simon **Kukes**, the former president of the Tyumen Oil Company (TNK), was named the new chairman of Yukos. Kukes then announced that Yukos was not seeking foreign partners. Prior to Khodorkovsky's arrest, Yukos was engaged in talks with US oil companies seeking to acquire large stakes in Yukos.

After the October 31 resignation of chief of staff Alexander **Voloshin**, which was seen as a protest to Khodorkovsky's arrest, president **Putin** nominated in his place deputy chief of staff Dimitri **Medvedev** (38). Medvedev, a St. Petersburg lawyer, lacks an intelligence service background. Observers consider his appointment an indication that Mr. Putin is trying to balance the two countervailing forces in the Kremlin – the “power” structures and representatives of reformist circles. In his first statement, Medvedev warned of the possible economic damage from Khodorkovsky's arrest. Some critical voices have been heard also from the government. Prime minister Mikhail **Kasyanov** criticised the freeze on Yukos shares, while deputy economy minister Arkady **Dvorkovich** asked foreign investors to take into consideration when planning investments in Russia the possibility that Russian companies' past may be investigated.

On several recent occasions, president Putin has stressed that the investigation only targets Khodorkovsky and his business partners, not Yukos or other large enterprises. However, natural resources minister Vitaly **Artyukhov** said on November 5 that some of Yukos' oil-drilling licenses could be revoked if the company is found to have failed to operate fully within the scope of the licences, or if it is incapable of doing so under the current circumstances. The statement caused unrest in the financial markets and a drop in the price of Yukos shares on the Moscow stock exchange. On November 6, Putin stated that he was not happy with the measures suggested by Artyukhov.

Russia's WTO membership negotiations could conclude in a year. Russia has continued bilateral negotiations with several WTO members. Talks with the US touched on import duties and Russian customs operations, domestic energy pricing, intellectual property rights and tariff quotas on Russian meat imports, which, according to Russia's lead negotiator and deputy economy minister Maxim **Medvedkov** should be kept in place until 2009. The economy ministry also reported that China still had a long list of proposals to discuss. Russia and Kyrgyzstan have concluded their bilateral talks.

Last month, the EU and Russia engaged in intense negotiation rounds led by economy minister German **Gref** and EU trade commissioner Pascal **Lamy**. Among the items most pressing in access to goods markets were tariffs on automobiles, aircraft, furniture and agricultural products. Customs practices, standards and intellectual

property rights were also discussed. Regarding the service sector, Russia wants to block the establishment of foreign bank branches in Russia and preserve Rostelekom's monopoly on international and domestic long-distance telecommunications until 2009. The talks also included such topics as access of consulting and transport services to the Russian market. Lamy said that agreements on overflight fees of Siberia, for which domestic and non-European airlines have paid less than European airlines (or nothing), must be resolved either bilaterally or in connection with Russia's WTO process. The energy sector has become a core topic, with the EU setting out a six-part proposal list with transition schedules, i.e. increase of the domestic price of natural gas in Russia at least to the level of production costs, elimination (or at least a substantial reduction) of export tariffs on gas and oil, free movement of transit shipments of natural gas in Russian pipelines, the right of foreign firms to construct energy pipelines in Russia, elimination of Gazprom's export monopoly, and elimination of the price difference on transporting natural gas for export and for domestic use. Prime minister Mikhail **Kasyanov** said that Russia will not give up Gazprom's export monopoly. President Vladimir **Putin** stated that an abrupt hike in domestic energy prices could destabilise the Russian economy, and, moreover, Russia is unprepared at this point to negotiate on incremental hikes in domestic gas prices in conjunction with its WTO membership talks. Putin added that Russia will also retain control of the natural gas grid and Gazprom.

Multilateral talks held at the end of October dealt with agriculture, financial and telecommunications services, and Russia's requests for derogations from most-favoured-nation treatment of services. According to Medvedkov, harmonisation of Russian legislation with WTO rules should be complete this year, and noted that the next meeting of the working group is scheduled for late January or early February. Medvedkov predicts that Russia should conclude its membership talks during the winter of 2004–05 and become a WTO member within two or three years.

Russia ranks low in international competitiveness. The World Economic Forum's *Global Competitiveness Report 2003* measures competitiveness by two indices: the Growth Competitiveness Index (GCI) measures a country's ability to sustain economic growth over the medium and long term, while the Business Competitiveness Index (BCI) measures factors underpinning productivity. The indices are compiled from statistical data and corporate surveys. This year 102 countries (compared to 80 in 2002) were covered in the report, boosted in large part by the addition of 17 more African nations.

Finland ranked first in both indices. Next were the *US* and *Sweden*. *Russia* ranked 70th in the CGI (66th in 2002) and 65th in the BCI (58th in 2002). *Estonia's* ranking were 22nd in the GCI and 27th in the BCI, *Latvia* 37th and 28th, and *Lithuania* 40th in both indices.

In a related report, Russia received a good assessment of its macroeconomic stability. On the other hand, Russia's technological development, measured in terms of innovation and technology transfer, as well as the extent of use of information and communications technology was seen as insufficiently high in light of the country's aim to accelerate economic growth. Moreover, economic growth is further impaired by weak compliance with the law and international agreements and widespread corruption.

EU gives positive appraisals on Baltics' readiness for accession. On November 5, the European Commission released its final monitoring reports for ten acceding countries. While the laws in all ten countries were found to comply for the most part with the requirements of the *acquis*, each country still needs to make some legislative adjustments. Most countries also were not yet set to make efficient application and use of structural funds.

Ahead of membership, *Estonia* needs to enhance its preparations for mutual recognition of qualifications for health care personnel with EU standards. Equal treatment of women and men and labour law also need to be improved. The Estonian economy's largest problems are the large current account deficit and high unemployment.

The EU wants *Latvia* to immediately adopt further legislation on mutual recognition of qualification demands for certain professions. The Commission also demands improvements in monitoring of animal diseases and changes in tax laws (particularly value-added tax). Changes are also needed at the customs and in the justice

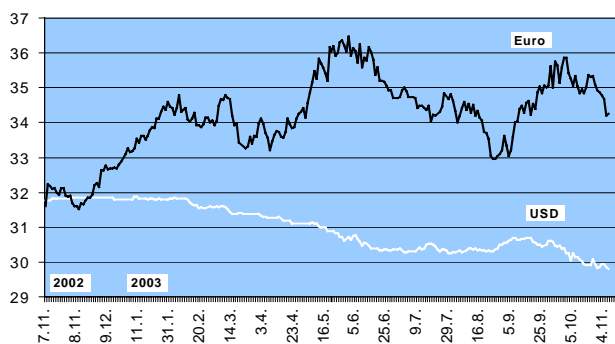
system. The Commission sees anti-corruption activity as particularly important. Latvia was admonished to increase the flexibility of its labour market and improve the operating environment for new companies.

Lithuania's legislation also needs further harmonisation of qualification requirements for professions. Greater supervision of the national fishing fleet was also called for. The Commission encourages Lithuania to make a fundamental fiscal strategy, and notes that more needs to be done to lower unemployment, implement pension reform and fight corruption.

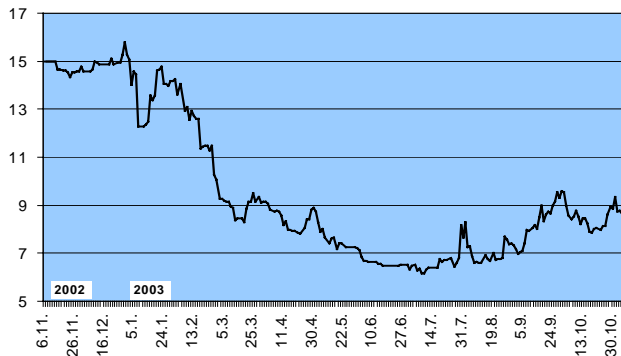
IMF expects Latvia's brisk economic growth to continue. An IMF mission visited Latvia in October to survey economic developments. In the mission's statement, Fund experts forecast that Latvian GDP growth this year will exceed last year's 6.1 % growth rate. However, because of strong domestic growth, the IMF also expects the current account deficit to widen towards the end of this year.

The mission encouraged Latvia to keep within its budgetary framework in the final months of 2003. Thanks to favourable economic development, Latvia's budget deficit according to the IMF would have come in below the target of 3 % of GDP without a second supplementary budget, which is set to be adopted soon. The IMF supports Latvia's goal of bringing the deficit down to 2 % of GDP next year. The IMF wants Latvia to make special efforts to prioritise medium-term budget spending. The IMF will publish a broad analysis of Latvia's economic development in February-March.

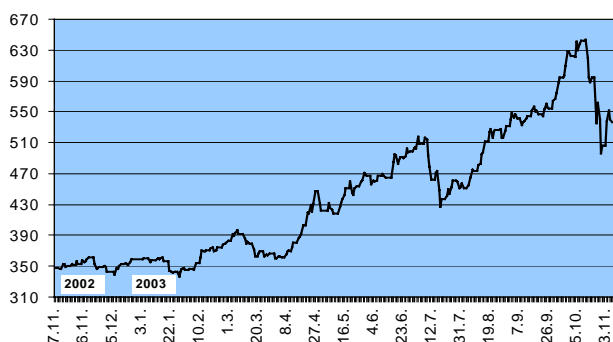
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



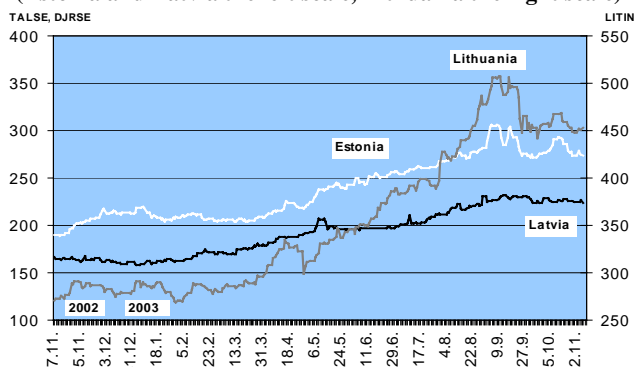
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Yukos uncertainty slams Russian share prices. On Thursday (Nov. 13), the Moscow Stock exchange's RTS index was off 11 % from its level of October 24, the day before Yukos former CEO Mikhail **Khodorkovsky** was arrested. In the same period, Yukos shares depreciated 19 %, and the shares of Yukos merger partner Sibneft fell 21 %.

The slide in share prices was precipitated by several factors, including the launch of investigations by the chief prosecutor's office together with the natural resources ministry as to Yukos' compliance with the terms of its oil drilling licences. While licence reviews are a routine aspect of the Russian oil business, this time the review concerns all licences and also the chief prosecutor's office is involved in the matter. Observers note that it is rather unlikely that any oil company would be in complete compliance with the terms of its drilling licences, in part due to vague and poorly drafted legislation. So far, few licences have been revoked.

The judge in a court hearing in Moscow on November 11 denied Khodorkovsky bail and ordered that he be kept under arrest at least until the end of the year.

Russian government rolls out anti-corruption program. Following **Khodorkovsky's** arrest, president Vladimir **Putin** asked his cabinet to prepare an anti-corruption program. Keeping to a tight timeframe, the program was devised by several ministries and assembled by the economy ministry. The cabinet program calls for setting up a committee specialised in fighting corruption. Under the program, regulation of the economy would be reduced and the actions of public officials would be more strictly regulated. The program includes dozens of measures for oversight of administrative bodies, officials and activities that are particularly susceptible to bribery. Additionally, any ministry or committee would be banned from performing both regulatory and supervisory functions. According to observers, the program's measures do not essentially differ from administrative reform measures drafted by the economy ministry three years ago, but then shelved. The Duma also approved a year ago the first reading of an anti-corruption bill that has not proceeded to further readings.

Regulated prices in Russia rise slower than prices generally. Consumer prices were up 1 % m-o-m in October, the fastest rise in six months. Higher food prices, particularly higher prices for grain products, drove up the consumer price index. Prices for services rose more slowly than prices generally, and have continued to slow since summer. During the first half of this year, prices for services rose much faster than other prices, driven by the rapid climb in regulated prices for housing and municipal services. The rise in regulated prices has slowed in recent months, perhaps due to the approaching parliamentary election.

Consumer prices in October were up 13.1 % y-o-y. The on-year rise in prices slowed slightly from September, when it was 13.2 %.

Topics of EU-Russia summit include creation of common economic space and energy issues. At last week's (Nov. 6) meeting in Rome, work was declared to continue on creation of a common EU-Russia economic space. An interim report of the working group set up two years ago states that the goal of this space is an open market based on mutually agreed rules and ultimately covering substantially all economic sectors. The economic space must comply with both Russia's and the EU's WTO commitments. The space would apply to trade in goods and services, the establishment and operation of firms and the related movement of personnel. The working group is to prepare within a year an action plan, based on its groundwork in numerous areas and forms of cooperation.

Themes in the EU-Russia energy dialogue included a review of both sides' long-term energy strategies. A common goal is to identify conditions to integrate the EU's and Russia's electrical power grids. Progress has occurred in eliminating the territorial restrictions in the natural gas contracts that violate EU competition law. The European Commission, Gazprom and the Italian ENI agreed earlier this autumn that ENI could sell gas to other countries under its current purchasing contract with Gazprom. Gazprom, in turn, will be allowed to sell gas to other buyers in Italy. The European Commission is also looking into a couple of other Gazprom gas contracts with buyers in EU countries. In 2002, Gazprom agreed on eliminating regional restrictions in all future gas contracts. The summit also noted Russia's support for an EU proposal banning single-hull tankers from sea traffic.

Summit discussions also touched on the economic and trade impacts of EU enlargement. After the summit, president **Putin** said that experts still continue from the current position, whereby the Russians expect Russian exports to the acceding countries to fall while the EU experts do not agree. Maxim **Medvedkov**, Russia's lead negotiator in WTO membership talks, pointed out that Russia has no legal basis to demand compensation for any negative effects of EU enlargement since Russia is not yet a WTO member.

The EU and Russia plan to continue their discussions on conditions for eliminating visa requirements in the long term, including negotiations on a mutual treaty on the readmission of illegal refugees.

23 national party lists qualify for next month's Duma election. The central election commission has approved the national party lists for the upcoming Duma election. Observers say that oil company Yukos, currently under investigation, is not the only large Russian enterprise interested in winning Duma seats. About 20 % of party list candidates are comprised of corporate representatives.

Observers point out that the situation reflects recognition of the Duma's increased role in decision-making and the shift in power from the regions to Moscow during president **Putin's** term. They also note that the enthusiasm of corporate representatives for Duma posts may indicate that some candidates understand the job includes immunity from prosecution while they are in office.

Baltic inflation figures for October. In *Estonia*, 12-month inflation slowed in October to 1.0 % (1.4 % in September). On-month, October consumer prices were up 0.2 %. Lower food prices helped subdue inflation.

In *Latvia*, consumer prices in October rose 3.3 % y-o-y (3.1 % in September). October prices were up 0.9 % m-o-m. Inflation has picked up substantially in Latvia during this year. The sharpest rises were in housing and health care.

Although *Lithuanian* consumer prices were up 0.1 % from September to October, they were 1.4 % lower in October than a year earlier (also down 0.8 % y-o-y in September). Drops were seen in prices for phone calls, home appliances, furniture, food and beverages, clothing and footwear.

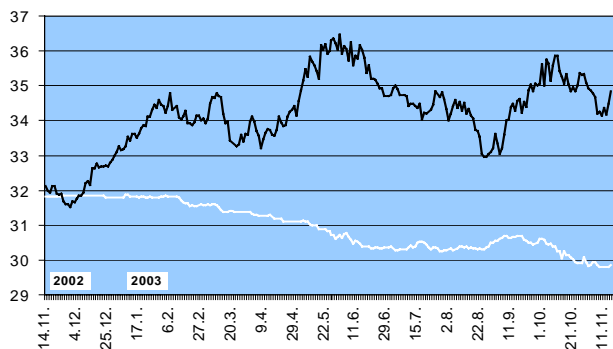
Import prices have fallen on-year in Estonia and Lithuania, reflecting the appreciation of the euro (to which both the kroon and litas are pegged) against the dollar.

Robust growth in industrial output throughout the Baltics. *Estonian* industrial output rose 9 % y-o-y in the first three quarters of 2003. Production of metal, rubber, plastic and chemical products increased rapidly throughout the period. Electricity exports to Latvia helped to boost electrical power generation. Among key industries, food processing and production of wood and wood products remained at the 2002 level. Growth in textiles and furniture has slowed substantially from the beginning of the year.

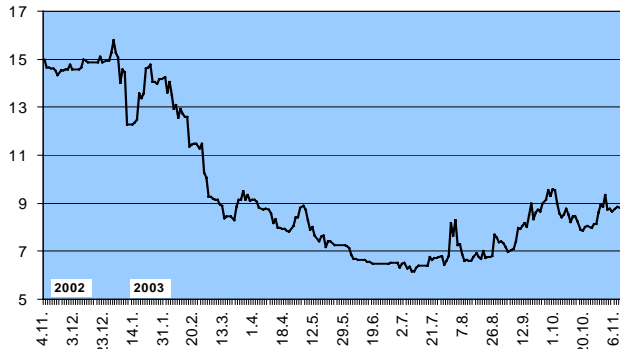
Latvian industrial output has enjoyed steady growth this year. Production was up 7 % y-o-y during the period January-September. Production of wood and wood products increased 16 %, rubber and plastic products were up 8 %, and furniture and food and beverages both grew 7 %. Textiles fell 5 %.

Lithuanian industrial output returned to rapid growth in the third quarter after the completion of scheduled maintenance at the Mazeikiu Nafta oil refinery. In the period January-September, Lithuanian industrial output was up 15 % y-o-y. Among the country's major manufacturing fields, furniture production grew fastest (up 28 % y-o-y) as well as food and beverage production (10 %). Oil refining volumes matched the levels of a year earlier. As with the other Baltic countries, Lithuania's textile industry suffered from the drop in Western European demand.

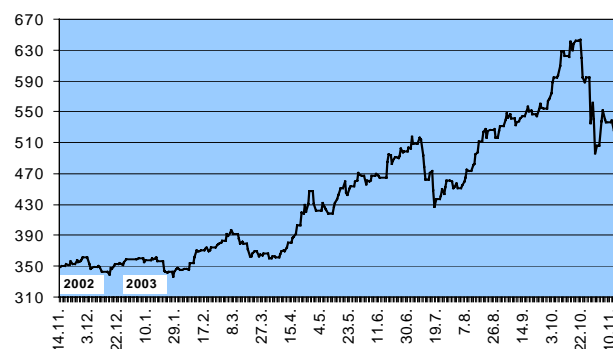
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



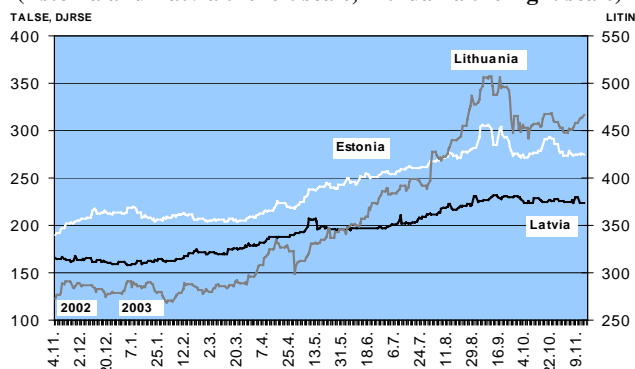
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



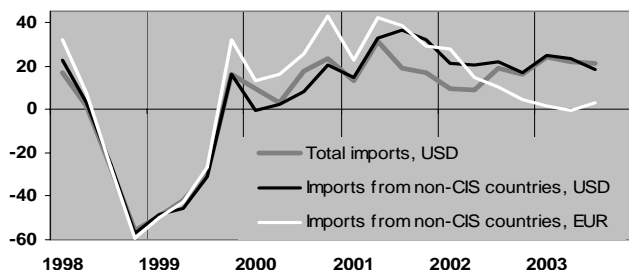
Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russia posts good showing in export and import growth in the third quarter. Figures released by the Central Bank of Russia show earnings on *goods exports* in the third quarter increased over 20 % y-o-y, when measured in dollars. Growth matched the pace of the second quarter. Russian *goods imports* also rose over 20 % in the third quarter. The figure includes imports from non-CIS countries, which grew slightly less than 20 %. In euro terms, imports from non-CIS countries grew about 2 %, about the same pace as in the first half. Growth was around 10 % when measured in a basket of the currencies of Russia's main trading partners.

Russian goods imports, percentage change from same quarter a year earlier



Duma approves additions to the budget code on the new stabilisation fund. The Duma approved the second reading of a bill that establishes a new stabilisation fund to be funded mainly from export tariffs on oil and oil products and oil extraction taxes when the price of Urals-grade oil exceeds 20 dollars a barrel. In turn, when world oil prices are low, fund assets can be used to cover budget deficits. The funds can also be applied to other uses if the fund exceeds RUB 500 billion (\$17 billion). Although the stabilisation fund is regulated under the budget code, on any given year the amount of money to be used from the fund is determined in the federal budget. The Russian government will report quarterly on the amount of money paid into the fund, as well as placement and application of the funds. The stabilisation fund will be inaugurated at the start of next year as long as the amendments to the budget code are approved in their third reading before the end of this year.

Russian cabinet considers ways to develop financial markets. Economy minister German Gref, at last week's cabinet meeting, stated that reform of Russia's financial markets first requires a regulatory reform. Measures needed include replacing the current general laws and a massive number of official regulations with directly applicable laws and unifying rules of the various parts of the financial sector. The coordination of the current six supervisory authorities needs to be improved soon and then possibly combined in a single super-agency for supervising the financial markets. Taxation on financial instruments should also be lowered (for example, elimination of

VAT on financial instrument trades and lowering of the tax on securities emissions) as well as reducing official bureaucracy in the financial sector and reducing reserve requirements. Financial instruments should also be developed to include a simplified process for realisation of collateral. To promote competition in the financial field, the state should divest its holdings. The state securities commission recommended central bank shareholdings be limited to exemptions provided in the legislation. Gref added that regulations discriminating against foreign investors operating in the Russian financial sector should be abolished.

The government ordered the supervisory authorities in the financial sector to draft a detailed action plan within a month. Within two months, the government also wants a new strategy for developing the banking sector and a proposal on whether the CBR's holdings in the Moscow Interbank Currency Exchange (MICEX) should be retained.

Polls suggest United Russia may be opening up lead over Communists. A total of about 1,500 candidates, representing 18 parties and five blocs, are vying on national party lists in the December 7 Duma election. In addition, about 3,000 candidates are seeking election in single-representative districts.

Estimates of support for larger political parties in Dec. 7, 2003 parliamentary election, % of registered voters

	Nov. 16 VCIOM-A ¹⁾	Nov. 5 FOM ²⁾	Oct. 28 VCIOM-A ¹⁾
United Russia	23	21	21
Communist Party	16	16	16
Liberal Democrats	6	6	5
Union of Right Forces	5	4	4
Yabloko	5	4	4

¹⁾ VCIOM-A = VCIOM Analytic Agency

²⁾ FOM = Public Opinion Foundation

Estonian government parties divided over income tax reduction. On November 19, representatives of the People's Union, which is part of the coalition government, voted in the *riigikogu* against the government's proposed income tax cut from 26 % to 24 %. After the vote, prime minister Juhan Parts proposed a compromise to government parties, whereby the income tax would be lowered just one percentage point, rather than two as proposed. Parts gave the parties until Saturday to think about the future of government cooperation. The lowering of the income tax is one of the main points written into the government's program last spring. In addition to the tax issue, cabinet parties are divided over the amount of support to be paid to new parents.

Baltic countries' exports continue to boom. Estonia's foreign trade deficit rose again in the third quarter as a

13 % y-o-y increase in imports outstripped 8 % growth in exports. For the first nine months of the year, Estonian imports grew 13 % and exports 9 %. Imports climbed in nearly all sectors. Exports boomed during January-September in base metals and base-metal products (23 %), furniture (15 %), wood and wood products (12 %), and machinery and equipment (11 %). Exports of textile products fell, however. Exports to EU countries grew 10 %. Although exports to CIS countries rose an impressive 34 %, they only account for 6 % of Estonian exports.

Latvia's trade gap has widened rapidly this year due to a brisk rise in imports. In January-September, Latvian exports grew 13 % y-o-y (July-September 9 %) and imports 20 % (21 %). Exports to EU countries increased 22 % and CIS countries 14 %. All three main export industry categories saw growth: wood and wood products exports were up 26 %, base metals and base-metal products 18 %, and exports of textiles and textile products 15 %. Among imports, fastest growth was in mineral products and machinery and equipment.

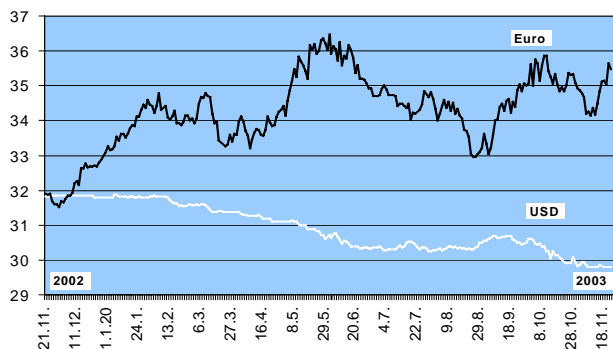
Lithuania's trade deficit contracted in January-September as export growth (8 % y-o-y) outpaced the growth in imports (5 %). In the third quarter, both exports and imports increased 7 %. In January-September, furniture exports increased 39 % y-o-y, electrical machinery and equipment exports 19 %, and fertiliser exports 15 % y-o-y. The top export product, refined oil was up 11 %. Exports increased to most important export destinations, although exports to Russia were down 11 %.

Latvian parliament adopts 2004 budget and second 2003 supplementary budget. The 2004 budget act assumes that GDP will grow 6.1 % next year and forecasts that the public sector deficit will contract to 2 % of GDP. Both budget revenues and expenditures are planned to rise 13 % in nominal terms next year. Spending will rise to LVL 2.1 billion (€3.2 billion), driven mainly by EU and NATO memberships. Latvia will contribute LVL 50 million (€80 million) to the EU budget in the form of various payments. Latvian co-financing of EU projects is LVL 30 million, plus another LVL 10 million for increased administrative costs related to EU membership. NATO membership will also require the country boost defence spending to 2 % of GDP. Health care costs will rise just 3 %, while no increase is planned for spending on education. The biggest tax change is a reduction of the corporate profit tax from the current 19 % to 15 %.

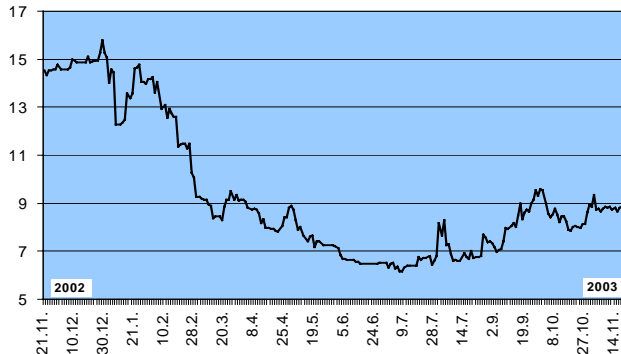
The supplementary budget approved in November was the second this year. It increased state spending LVL 19 million (€30 million), or about 1 %. The supplementary budget will be used to increase harvest compensation paid to farmers and subsidies to municipalities for schools, hospitals and road maintenance. Although the supplementary budget will slightly increase the fiscal deficit, it is still below the forecast 2.8 % of GDP (earlier 2.94 %) due to higher-than-expected economic growth.

The favourable economic development this year has pumped up tax revenues to both the state and municipalities. Thus, the public economy defied forecasts and showed a slight surplus in January-September. Traditionally, Latvia's fiscal deficit increases at the end of the year.

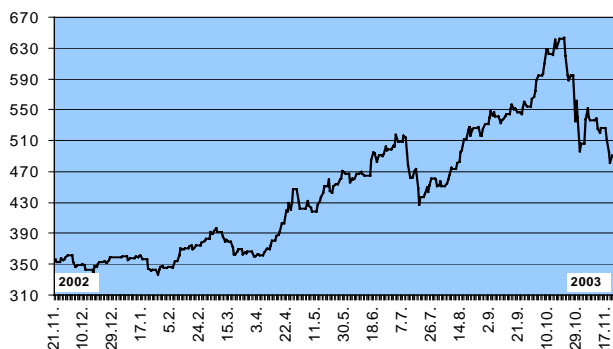
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



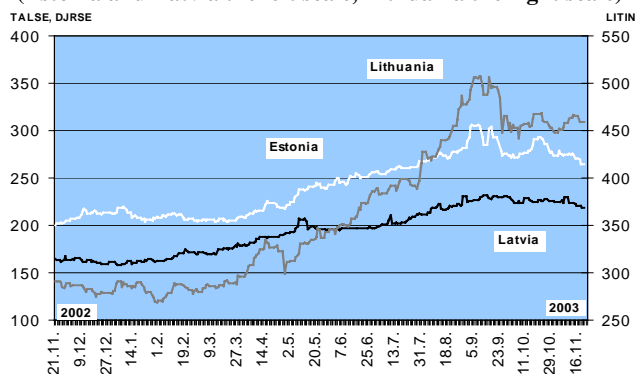
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Brisk economic growth continues in October. The combined production index of five base sectors of the Russian economy, which reflects the GDP growth, rose in October 8.5 % y-o-y, the same pace as in September. For the first ten months of 2003 production increased nearly 7 % y-o-y. Construction grew almost 15 %, including in October. Retail sales increased 8 %, although the pace of growth has slowed slightly in recent months (to about 7 %). Industrial output and freight shipments grew 7 % in first ten months of the year, and slightly faster in October. A strong pick-up in growth in September and October increased agricultural output slightly for the ten-month period.

In the industrial sector, above-average growth was seen in the January-October period in crude oil production (11 %), ferrous metallurgy (9 %), and machine-building and metal products (over 8 %), lifted in part by a doubling in the production of rail freight cars. The growth of production of construction materials has accelerated since last spring. Oil production boosted both pipeline transports and rail shipments of crude oil and oil products (up 16 %). The poor performance of agriculture in summer was made up somewhat by a substantial increase in crops other than grain. While the grain harvest grew slightly in October, the total amount of grain harvested as of end-October was still 23 % less than at the same point in 2002.

Russian companies borrowing more from abroad, FDI inflows also up. Goskomstat reports that for the first three quarters of 2003, foreign investment in Russia (excluding investment in the banking sector) amounted to nearly \$21 billion. This increase of more than 60 % y-o-y partly reflects the dollar's substantial on-year depreciation against the euro. About \$16 billion in foreign investment (up 60 % y-o-y in January-September) came in the form of loans taken by Russian companies. Foreign direct investment inflows into Russia were nearly \$5 billion, an increase of 77 %. Just \$80 million in portfolio investment flowed into Russia.

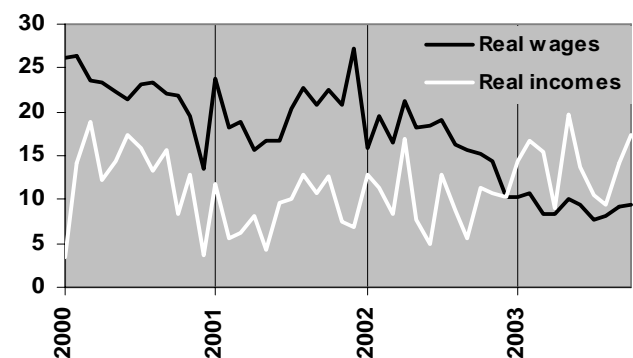
The breakdown for FDI inflows to Russia in January-September showed that nearly 45 % went to trade-related businesses, including a quarter to the foreign trade sector. Over a third of FDI went to industry. At the end of September, the total stock of FDI in Russia was nearly \$25 billion. The leading investor countries were the US and Cyprus (each with 19 % shares). The next most important sources of FDI were the Netherlands, Great Britain and Germany (each with shares of 10–11 %).

Rise in real wages slows from last year. Goskomstat reports that real incomes of Russian households grew 14 % y-o-y in first ten months of 2003. Third quarter growth slowed to 11 %, but accelerated in October. However, the actual growth in real incomes was probably lower than the figures indicate (see *Week in Review* 28/2003). This is further evidenced by the figures for real

wages and private consumption as reflected in the growth of retail sales. Real wages grew 9 % y-o-y in January-October. In recent months, the rise has been fairly steady.

Nominal wages were up 24 % y-o-y in October, averaging slightly more than 5,700 roubles (about 160 euros) a month. The average monthly wage in industry in September was 200 euros, with highest average wage paid in the oil and gas industry (550–650 euros) and the lowest in the textile, clothing, footwear and leather-working industries (90 euros). In other sectors, the average wage figures also varied considerably, e.g. the average monthly wage in the financial services and insurance industries was 360 euros, while it was 230 euros for the transport sector. Wages in the trade sector, as well as in public health and education averaged just 90 euros a month.

Real wages and real incomes, 12-month change, %



President Putin approves further tax code changes. A new chapter on the corporate property tax was added to Part 2 of the Tax Code. The amendment enters into force at the beginning of 2004. The tax base will shrink and no longer cover company goods inventories, construction investments or intangible property. To compensate for the diminished tax base, the ceiling on the corporate property tax rate will be raised from 2 % to 2.2 %. The actual tax rate is determined by regions and may vary according to the category of taxpayer and property.

A second amendment involves taxation of agricultural producers. From the beginning of 2004, agricultural enterprises, private entrepreneurs and small farms can voluntarily switch to a unified 6 % agriculture tax, which would replace the income/profit tax, property tax and value-added tax, as well as the unified social tax. Agricultural enterprises that shift to the unified agriculture tax would continue to pay VAT on imported goods in accordance with the customs code. For those agricultural enterprises that do not move to the unified tax, the profit tax will rise incrementally by 2015 from zero to the general 24 % level.

Russia establishes anti-corruption council. The new council, established by presidential decree, is intended to

implement public administration reforms promoted by the president and crack down on corruption in order to improve Russia's image internationally. The high-power council includes the prime minister, the speakers of both houses of the parliament and the chiefs of all three supreme courts. The council, in turn, will preside over the operation of a newly created anti-corruption commission and a conflicts-of-interest commission. Some observers criticise these new entities as lacking influence and expect they will be fairly impotent in Russia's current environment.

Early this month, the Russian government presented an anti-corruption program, including about 100 longer- and shorter-term measures. The latest corruption perception index published by *Transparency International* ranked Russia 86th out of 133 countries surveyed. About 62 % of Russia's population considers the country's political system very corrupt.

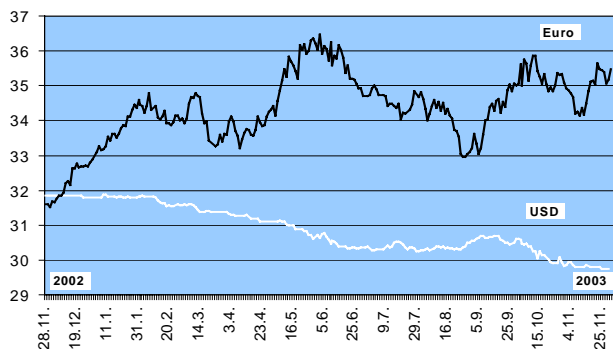
Baltic current account deficits. According to monthly statistics, *Estonia's* current account deficit in the third quarter was 14 % of GDP. For the first nine months of the year, it was 16 % of forecast GDP. This year's current account gap is substantially wider than last year mainly due to a large trade deficit caused by higher growth in imports than exports. Growth in service exports was restrained by slow growth in the transport and

tourism sectors. The current account deficit was also boosted by growth in production factor compensation paid abroad. FDI inflows to Estonia were clearly higher than a year ago, and in net terms were sufficient to cover 55 % of the current account deficit in January-September. The remainder was financed mainly through bank borrowing from abroad.

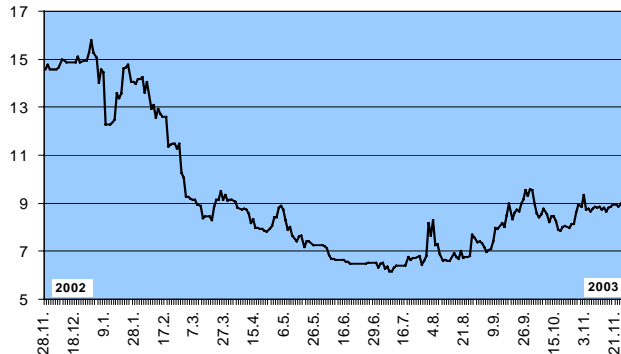
Preliminary figures indicate *Latvia's* current account deficit in the third quarter was about 10 % of GDP. For the period January-September, it was 9 % of GDP. *Latvia's* trade deficit increased from last year as growth in imports outpaced export growth. Growth of the current account deficit was slowed, however, by the growth of services surplus and increased current transfers to Latvia. FDI inflows to Latvia were down compared to a year earlier. They were sufficient to cover almost 40 % of the current account deficit in January-September. The remainder was financed by bank borrowing from abroad.

Lithuania's current account deficit in the third quarter was 3 % and in January-September 5 % of GDP according to preliminary figures. The trade deficit shrank in January-September compared to the same period a year earlier, when import growth remained slow. The service surplus shrank slightly. FDI inflows were down from a year earlier and were sufficient to cover less than 60 % of the current account. The rest of the deficit was covered mainly through the issue of government paper.

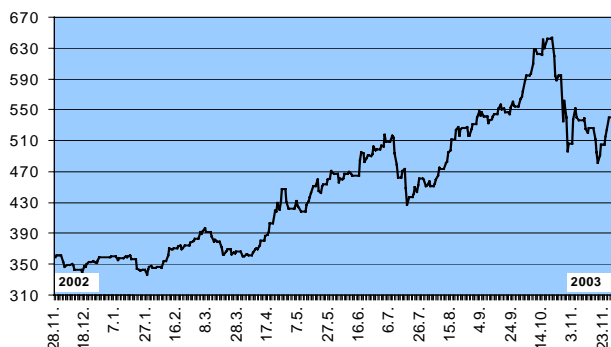
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



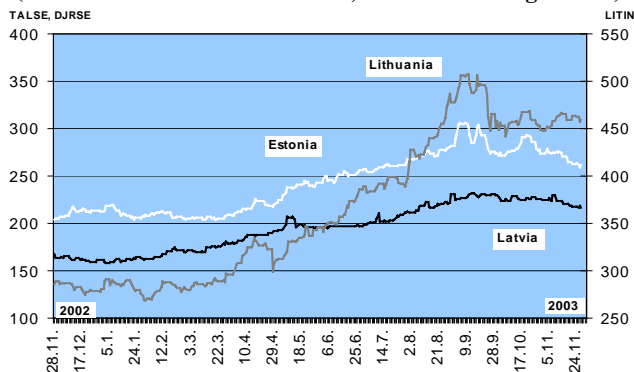
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Merger of Yukos and Sibneft on hold. At the end of November, Sibneft announced that it was bailing out of the merger agreement it entered into with Yukos last spring. Sibneft said the deal breaker was differences over allocation of board and highest management positions in the new enterprise. Sibneft's announcement surprised the markets, which now believe that the merger will be called off for good. Some observers think Sibneft wants to avoid involvement with the ongoing troubles and falling share value of Yukos. Others report a rumour that the main personalities behind Sibneft, including Roman **Abramovich**, are attempting a take-over of Yukos. According to further rumours, the Kremlin may have been involved. The markets saw the merger break-off as a further manifestation of the uncertainty gripping the Russian business environment. The merged YukosSibneft entity would have been the world's fourth largest oil company in terms of output.

Duma approves act on deposit insurance for private individuals. The government submitted the bill last February. During its three readings, various amendments were made. In its current form, private account holders would be fully compensated for their losses up to 100,000 roubles (about 2,800 euros) per bank when the central either revokes the bank's operating licence or invokes a payment moratorium on the bank. The bill does not cover e.g. deposit certificates to an unnamed account holder or entrepreneurs using commercial accounts, but not operating as a registered company.

A deposit insurance fund under the management of a new agency will be established to handle claims. Banks will quarterly pay into the fund a certain amount of the bank's total deposits, which the agency will decide. The amount would normally not exceed 0.15 % of the deposits covered under the scheme, but could in certain situations temporarily rise as high as 0.3 %. The ceiling would be lowered to 0.05 % once the fund's total value reaches 5 % of total deposits, and payments would be eliminated once the value of the fund exceeds 10 % of total deposits. At the start, ARKO, the agency for restructuring of credit organisations, will transfer RUB 2 billion to the fund (the amount compares to 0.15 % of the current bank deposits of private individuals), as well as RUB 1 billion for establishing the new deposit insurance agency. Possible shortfalls in the fund will be financed out of the federal budget. Banks will be required to meet several criteria supervised by the central bank to participate in the deposit insurance scheme.

Banks with the CBR as a shareholder will enjoy their current full coverage of deposits until the beginning of 2007. Their payments to the deposit insurance fund will be kept in a separate account until their share will decrease to 50 % of total deposits of private individuals, or no later than the start of 2007. In practice, the move mainly affects Sberbank, in which the CBR holds the majority stake.

Russia's currency reserves still substantial. At the start of 2003, the Central Bank of Russia reported that the value of its gold and foreign currency reserves were \$47.8 bil-

lion. By early summer, the reserves had risen to \$65 billion, and as of November 28 stood at \$68.1 billion. This autumn, the CBR began to publish a monthly break-down of its gold and currency reserves. As of mid-November, some \$3.7 billion (6 %) of the total reserves were held in gold. Of the currency holdings, 69 % was dollars, 26 % euros and 4 % British pounds. The remaining 1 % consisted of other currencies. The CBR has boosted its euro holdings in recent months, while diminishing its dollar position. The euro's strengthening against the dollar on international forex markets only partly accounts for the rise in Russian reserves, which are denominated in dollars. High world oil prices, which have boosted export earnings, is the main reason for the growth in reserves.

Duma approves 2004 federal budget act, implementation of stabilisation fund. Ahead of the parliamentary election on December 7, the Duma finished out its last session with approvals of the 2004 budget act and amendments to the tax code facilitating the implementation of the new stabilisation fund from the beginning of 2004. As in previous years, the 2004 budget will show a surplus. However, unlike in previous years, the surplus will be transferred to the stabilisation fund. The budget's largest expenditure categories are defence (16 % of total spending), transfers to regions (14 %), law enforcement and national security (12 %), and interest payments on debt (11 %).

Federal budgets for 2003 and 2004

RUB billion (% of GDP), unless otherwise specified

	2004	2003
Revenues	2,743 (17.9)	2,418 (18.5)
Expenditures	2,659 (17.4)	2,346 (17.7)
<i>interest payments on debt</i>	(1.9)	(2.1)
Surplus	83 (0.5)	72 (0.6)
Average exchange rate (roubles per dollar)	31.30	33.70
Inflation (% at year-end)	8-10	10-12
Average price of Urals-grade crude (dollars per barrel)	22.00	21.50
GDP	15,300	13,050

Russian regions lose right to grant tax relief. A change in the tax code approved at the end of November eliminates regional authority to exempt corporations from the regional and local components of the profit tax. The authority, which was granted to regions in 2001, will be eliminated from the start of 2004. A company receiving the full benefit of the exemption has seen its profit tax rate lowered from 24 % to just 6 %.

The tax break was originally intended to give companies incentive to invest in regions. In fact, companies often registered in regions giving the tax relief, but invested elsewhere. Tax relief has been granted in a couple dozen regions, but about 90 % of the total value of the tax relief has been granted in Mordovia, Kalmykia and Chukotka. In particular, domestic oil companies and also foreign-owned companies have taken advantage of the benefit. In the

future, it will be left to the regions to decide how to compensate companies for the loss of tax relief originally promised for several years.

Lowering of Estonia's income tax rate postponed. The parties in Estonia's coalition government (Res Publica, the Reform Party and People's Union) voted on November 27 to continue cooperation. The governing parties ran into conflict when the People's Union opposed in parliament a government proposal on November 19 to lower the income tax next year by two percentage points (see *Week in Review* 47/2003). The drop in the income tax will now be postponed until 2005, and the government's planned overall lowering of the income tax rate from 26 % to 20 % will be implemented during 2005–2007. As a result, tax revenues are expected to increase next year by about 0.7 % of GDP. The tax-exempt monthly income will rise next year as planned from 1,000 kroons to 1,400 kroons. The 2004 budget proposal will also devote more money than originally planned to education, regional development, culture and family support. The parties also decided to set a ceiling at three times the average monthly wages on support paid to parents with young children.

Lithuanians eager to participate in voluntary pension funds. Reform of *Lithuania's* pension system begins next year with the introduction of voluntary pension funds. The new approach will complement the existing pay-as-you-go system (i.e. contributions of current workers in the system are used to pay the benefits of current pensioners). From the beginning of next year, those who wish may contribute

2.5 % of their earnings to a pension fund of their choice in lieu of the state social security fund. The percentage of earnings allowed for the voluntary fund will rise steadily until 2007 when it will reach 5.5 % of earnings.

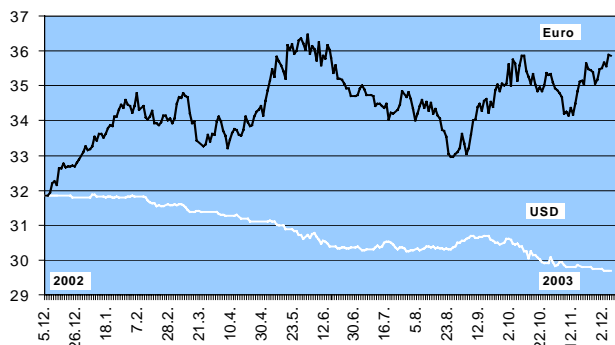
Over 420,000 temporary workers had enrolled in the pension fund by the deadline, the beginning of December. The new funds' popularity has clearly exceeded expectations. Pension reform is expected to cost the state an additional LTL 60 million (€17 million) next year. Money to pay for the reform will be taken out of the state's auxiliary fund.

Similar voluntary funds in *Estonia* were launched at the beginning of this year. About 238,000 workers had enrolled as of the beginning of June. In *Latvia*, it is compulsory for young workers to participate in pension funds.

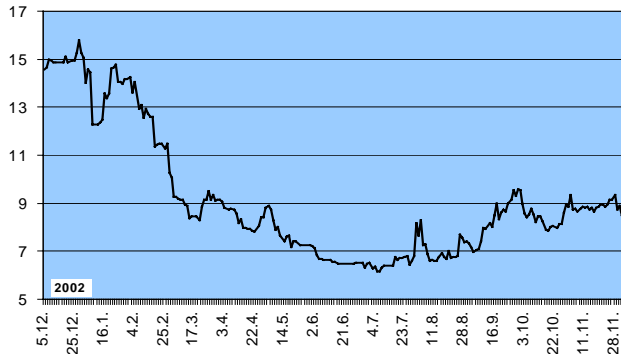
Lithuania begins talks on privatisation of one power grid operator, while sale of the other is halted. Two Lithuanian buyers submitted final bids on VST, the operator of Lithuania's western power grid. The winning bid was submitted by VP Market, which owns the largest retail chain in the Baltics. VP Market is owned by nine Lithuanian businessmen. VP Market's final offer for the 77 % stake was LTL 539 million (€156 million). The starting bid for the stake was LTL 359 million. Talks on the final details of the sale with VP Market are under way.

Lithuania's privatisation bureau and the government have also decided to put on hold the divestiture of RST, the eastern power grid operator. The Estonian Eesti Energia was apparently the only company reported to have submitted a qualified bid for the company.

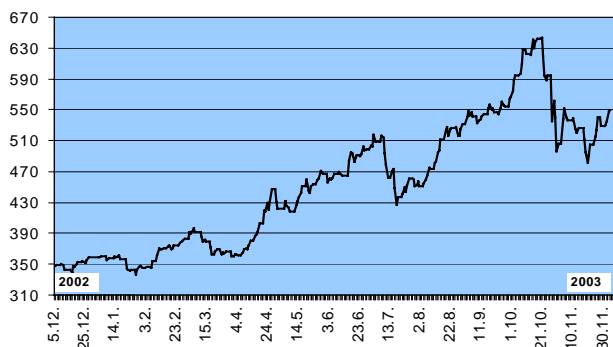
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



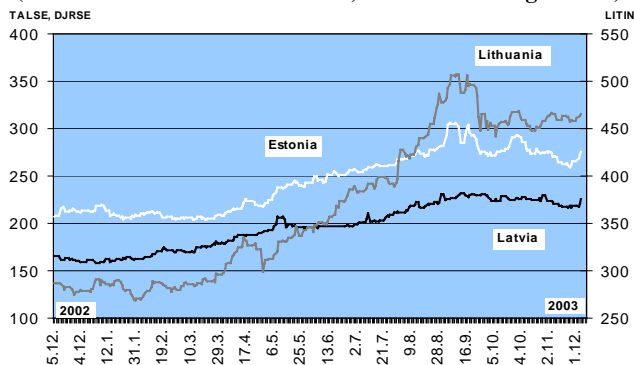
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Putin-supporting parties win Duma election. The centrist United Russia (UR) Party, which is led by interior minister Boris **Gryzlov** and is supportive of the policies of president Vladimir **Putin**, took 37 % of the vote in Sunday's (Dec. 7) election. The win matched the combined performance of the new party's predecessors (Unity and Fatherland–All Russia) in the 1999 parliamentary election. UR is set to garner over 220 seats in the next Duma. Vladimir **Zhirinovskiy's** Liberal Democratic Party of Russia (LDPR) took nearly 12 % of the total vote and doubled its seats to 40. Perhaps the biggest upset was scored by the Communist Party's newly formed competitor, the leftist-patriotic Motherland (Rodina) Party, led by Sergei **Gla-zyev**. In its first time out, Motherland captured 9 % of the votes on national party lists. The Communist Party (Gen-nady **Zyuganov**), Russia's largest opposition party, saw its support fall below 13 % (compared to 24 % in the 1999 parliamentary election). The party will retain just 50 seats in the next Duma (compared to over 80 seats in 1999). Observers generally expect the new Duma to consolidate the positions of Putin and the "power structures." On the other hand, deputies include a number of representatives of large enterprises as well as influential regional leaders.

Half of the Duma's 450 seats are selected from national party lists, from which only the mentioned four parties won seats. The right-leaning liberal party Yabloko (Grigori **Yavlinsky**) and the Union of Right Forces (Boris **Nemtsov**) failed to agree on an election alliance. As a result, neither party reached the 5 % of the vote threshold needed to win seats on national lists. Their seats will come from victories in individual district races, the route by which the remaining half of Duma deputies are elected. Preliminary figures from the central elections board indicate voter turnout was about 50 %.

The position of small parties will become more tenuous in 2007, when the vote threshold for national party lists rises to 7 %.

Under Russia's constitution, the government does not disband at the time of the Duma election results are announced, but remains in place until after the presidential election in March.

Last Sunday (Dec. 7), eleven gubernatorial elections and six regional parliamentary elections were also held. Moscow mayor Yuri **Luzhkov**, who represents United Russia, also won his re-election by a support of nearly 75 %. Six regional governors were re-elected in the first round, while four regional governorships will be decided in runoffs.

Russian inflation slows. The on-year rise in November consumer prices was 12.4 %, compared to 13.1 % in October and 13.2 % in September. Although it seemed unlikely just a couple months ago, it now appears December inflation will come in close to the high end of the government's target range of 10–12 % for this year. Inflation slowed during the autumn (in particular, regulated prices for housing and municipal services) with the run-up to the

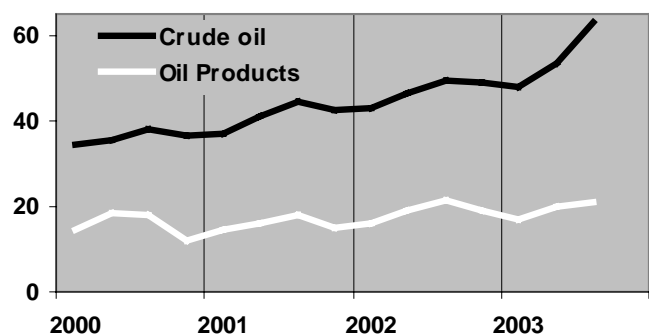
Duma and presidential elections. Earlier this year, regulated prices for housing and municipal services rose much faster than average.

Russian parliament approves amendments to Act on Currency Regulation and Currency Control. Under the new act approved by the Duma and the Federation Council, the 100 % repatriation requirement on foreign currency earnings will remain in place. The act limits the ceiling on mandatory currency sales at 30 % of total hard currency earnings. The CBR may reduce the requirement as it sees fit (the current mandatory sales requirement is 25 %). The central bank can, with the government's approval, set deposit requirements on certain foreign currency revenue and expenditure. Several of the regulations on capital movements, e.g. mandatory sales of foreign currency, will remain in force until the start of 2007. The new act will enter into force six months after its publication.

Growth of Russian oil exports accelerates in third quarter. Russian export earnings rose approximately 20 % y-o-y in the third quarter, due mainly to increased exports of crude oil. The export volume of crude oil was up 27 % y-o-y in the third quarter; for the period January-June the change was 18 % y-o-y. Exports of oil products grew just 3 % in January-September. The export price of Urals-grade crude oil in the third quarter, as in the second quarter, was just a few percentage points higher than a year earlier. The export price of natural gas, on the other hand, was up 23 % y-o-y. The volume of natural gas exports increased less than 2 % overall in the first nine months of this year, while exports to non-CIS countries grew 6 %. The export prices of several metals have risen since spring. The export volumes of certain metals have also increased.

In dollar terms, Russian goods imports of machinery and equipment (including passenger vehicles) rose in the first nine months of 2003 at about the same rate as imports generally, i.e. 22 % y-o-y. Measured in euros, import growth was just a few per cent. The share of machinery and equipment (including passenger vehicles) in registered imports from non-CIS countries was nearly 40 %. The share of foodstuffs and food ingredients in total imports fell to 22 %.

Exports of crude oil and oil products from Russia, Millions of tonnes per quarter



Bank of Estonia takes measures to restrain credit growth. In cooperation with the government and the financial support authority, Estonia's central bank attempts to restrain country's rapid credit growth – one reason for Estonia's large current account deficit. The Bank of Estonia encourages banks to keep a sharp eye on loan quality. The reserve requirement for credit institutions will remain at the current level of 13 % and the cash on hand at banks will no longer be included in mandatory reserves. In its quarterly economic policy comment, the Bank of Estonia said that maintaining a balanced state budget or preferably a surplus is of pivotal importance from the point of view of maintaining the credibility of the country's economic policy. The Bank of Estonia also recommended keeping the state credit and export guarantee fund KredEx out of the housing finance market. Under current practice, KredEx's collateral makes it possible for people to take out loans with just 10 % of self-financing, instead of the standard 34 % when buying new residential space or renovating existing housing. According to the central bank, facilitating housing loans through reducing the level of self-financing has ceased to be an appropriate policy at the current interest rate level. In the present situation, tax deductions on housing loan interest only distort the market.

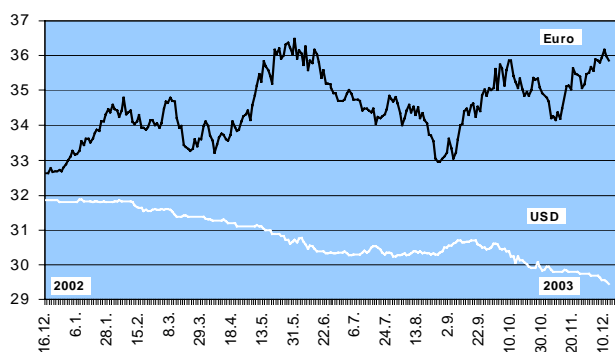
As of end-October, the amount of credit granted to households was up 47 % y-o-y, while credit to companies

was up 16 %. At the same time, households' bank deposits grew just 10 %. Increased borrowing has also contributed to the rapid rise in domestic consumption and imports. The combination of strong growth in imports and weak growth in exports has helped widen the current account deficit, which for the first nine months of the year reached 16 % of GDP. Under the currency board arrangement, the Bank of Estonia cannot use interest rates as a monetary policy tool.

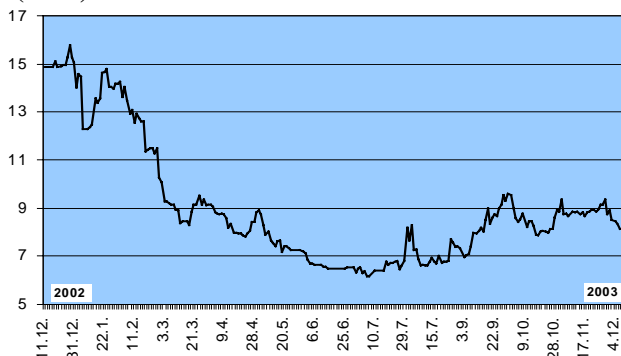
In its forecast published at the end of November, the central bank said it expected economic growth of 5.2 % next year. It cautioned, however, that growth could slow to 2.5 – 3.5 % in the event that export volumes do not grow as expected and the external imbalance is not corrected.

Latvian economic growth remained brisk in third quarter. Latvian real GDP grew 7.3 % y-o-y on the third quarter of 2003 and 7.4 % y-o-y for the first nine months of the year. Growth continued in all main sectors of the economy. For the first nine months of 2003, retail trade increased 11 % and manufacturing 9 %. The transportation and communications sector (up 8 %) benefited from increased rail cargo and freight handling at the country's ports, as well as in increase in tourism. Construction rose 16 %, while activity in the hotel and restaurant field was up 17 % y-o-y. Only agricultural output contracted (down 5 % y-o-y) compared to the January-September 2002 period.

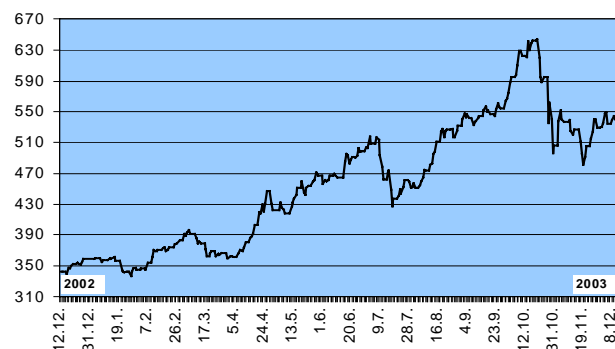
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



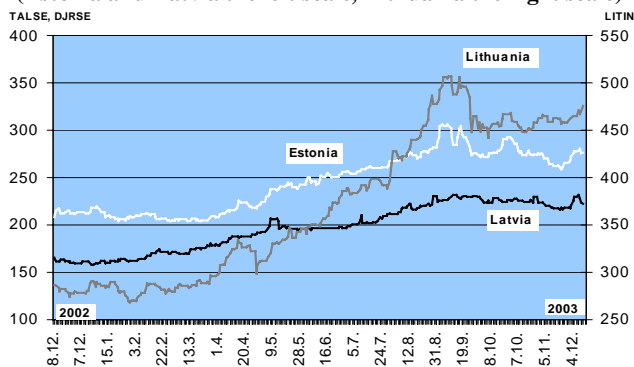
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)





Russian economic growth remains high in third quarter. Preliminary Goskomstat figures show GDP grew 6.2 % y-o-y in the third quarter. For the first nine months of 2003, GDP was up 6.7 % y-o-y.

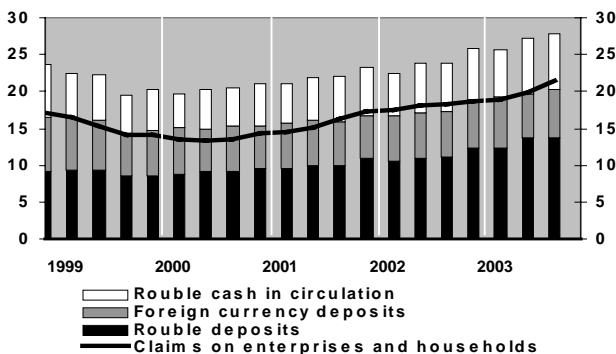
The Russian economy extended its brisk expansion into the fourth quarter. In November, industrial output was up 7.1 % y-o-y. For January-November, industrial output was up 6.8 % compared to the same period in 2002. Industrial output growth was led by approximately 9 % growth posted in fuel production, ferrous metallurgy, machine building and metal products.

Most observers expect Russian GDP to rise nearly 7 % this year.

Growth of bank deposits and credits in Russia accelerated in third quarter. The stock of bank deposits of households and enterprises was up 25 % y-o-y in real terms. While growth in rouble deposits slowed in the third quarter, rouble deposits were still up nearly 35 % y-o-y. Foreign currency deposits recovered considerably, growing 14 % y-o-y. The growth in rouble cash in circulation slowed, but still rose over 25 %. As of end-September, rouble deposits were just under 14 % of GDP. Foreign currency deposits rose nearly 6 %. Rouble cash in circulation remained at around 7.5 % of GDP.

The growth in domestic bank lending accelerated in the third quarter. As of end-September, bank claims on enterprises and households were up nearly 30 % y-o-y in real terms. Claims on publicly owned enterprises rose 20 %. Bank claims on enterprises and households climbed to about 21 % of GDP.

Deposits and claims of banks operating in Russia, as well as rouble cash in circulation, % of GDP



Russia's federal budget surplus remains solid throughout the first nine months of 2003. Goskomstat figures show revenues equivalent to 19.5 % of GDP (20 % of GDP in January-September 2002) and expenditures 17.1 % of GDP (16.8 %) for the first three quarters of 2003. As revenues in relation to GDP fell while expenditures grew, the federal budget surplus contracted compared to same period in 2002 and as of end-September stood at 2.5 % of GDP. The value-added tax continued to generate the largest revenue stream, accounting for a third

of all federal budget revenues. The share of customs duties and other tariffs on foreign trade was about 17 % and excise taxes some 10 %. Compared to January-September 2002, the share of the value-added tax in relation to GDP fell, while revenues from customs duties and other tariffs on foreign trade grew substantially. Federal budget spending focused on transfers to regions (19 % of the total expenditures), defence (15 %) and the social sector (12 %). The social sector, national security and law enforcement, and transfers to regions enjoyed the highest spending growth relative to GDP.

Russian government approves investment programs for natural monopolies in 2004. By a government decree, gas giant Gazprom can next year invest up to RUB 230 billion (€6.4 billion), electrical power monopoly UES up to RUB 21.5 billion (€6 billion) and the recently established Russian Railways corporation up to RUB 130 billion (€3.6 billion). These amounts do not include investments by monopoly subsidiaries. Gazprom investments are expected to focus on construction of gas pipelines, while UES investments will be directed mainly at building power plants. Russian Railways will invest in developing its international connections, as well as rail construction in Northwestern Russia and replacement of rolling stock.

Financing of investment programs will largely be based on the government's earlier approved tariff hikes for natural monopolies: hikes in gas rates in 2004 are limited to 20 %, electricity rates 13 % and rail freight rates no more than 12 %. Prime minister Mikhail **Kasyanov** said that in the future natural monopolies need to increase their reliance on borrowing.

Energy issues top discussions in Kasyanov's Japan visit. During his visit to Japan, prime minister **Kasyanov** nuanced the proposed construction of a pipeline from the East Siberian city of Angarsk to the Pacific port city of Nakhodka. He said that the pipeline project, which is supported by Japan, would complement, rather than compete with, an alternative plan to build a pipeline from Angarsk to Daqing, China. China supports the second pipeline. Officially, the matter remains unresolved and experts see it unlikely that both projects can be implemented. In Russia, proponents of the Angarsk-Nakhodka alternative include the national oil pipeline grid operator Transneft and the state-owned oil company Rosneft. Japan gave its commitment to finance the oil pipeline's construction, as well as development of oil fields in Southern Siberia. The strongest Russian proponent for building a pipeline to Daqing has been the Yukos oil company.

At the meeting of prime ministers, both countries agreed to get moving on signing their WWII peace treaty, which has been delayed by a long-running dispute over territorial sovereignty of four of the Kuril islands. The prime ministers emphasised the importance of increasing

mutual trade and investment, and resolved to establish an organisation specialised in the matter.

Latvia continues to post highest Baltic inflation figures. In November, consumer prices were up 1.0 % y-o-y in *Estonia*. During the year, prices have risen fastest for health care, phone calls, alcoholic beverages and tobacco. In *Latvia*, consumer prices were up 3.6 % y-o-y in November. Administratively set prices (e.g. health care and housing costs) rose fastest. Food prices were up 2.7 %. Deflation continued in *Lithuania* in November, when consumer prices were down 1.0 % compared to a year earlier. The main deflationary factors were falling food prices (down 1.3 %), lower import prices and increased domestic competition.

Estonian parliament passes balanced 2004 budget. The budget approved on Wednesday (Dec. 17) by the Riigikogu foresees revenues and expenditures next year of EEK 48 billion (€ billion). Much of the 20 % budget increase reflects Estonia's impending EU membership. According to the government's November proposal, the tax-exempt monthly income will rise at the beginning of next year from 1,000 kroons to 1,400 kroons, while the gradual lowering of the income tax will not begin until 2005 (see *Week in Review* 49/2003). The budget assumes GDP growth of 5.6 % next year.

Lithuanian parliament approves 2004 budget. Next year's budget for the most part reflects the government's original proposal (see *Week in Review* 42/2003). The

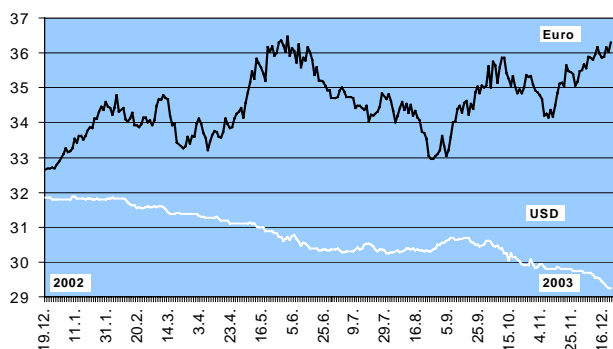
parliament, however, boosted social security spending by LTL 90 million (€26 million), as well as pension reform by LTL 45 million.

Consolidated state and municipal revenues next year will rise to LTL 13.5 billion (€3.9 billion), while expenditures will rise to LTL 15.3 billion. The upcoming EU membership will cause both expenditures and revenues to rise over 20 % next year. Lithuania hopes to hold its public sector deficit below 3 % of GDP, one of the Maastricht criteria placed on countries planning to join EMU. The budget foresees GDP growth of 6.2 % in 2004.

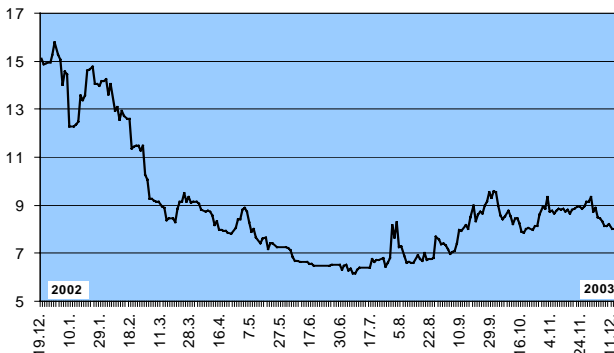
Moody's upgrades Lithuania's creditworthiness. In response to improvements in Lithuania's management of its public finances and reduction of the state budget deficit, Moody's raised its ratings on Lithuania's long-term domestic and foreign currency debt one notch to A3, making the country a relatively low credit risk. A Moody's press release noted that the upgrade also reflected improved regulation of the financial system, a healthier business climate, favourable economic trends, and the rapid approach of EU membership. Latvia's rating of A2 is a grade above Lithuania's; Estonia's A1 rating is two steps better.

Happy New Year 2004! From the start of next year, BOFIT's *Week in Review* shifts its focus: we will begin coverage of developments in China's economy and end our reporting on the Baltic economies. Our monitoring of trends and events in Russia will continue as usual.

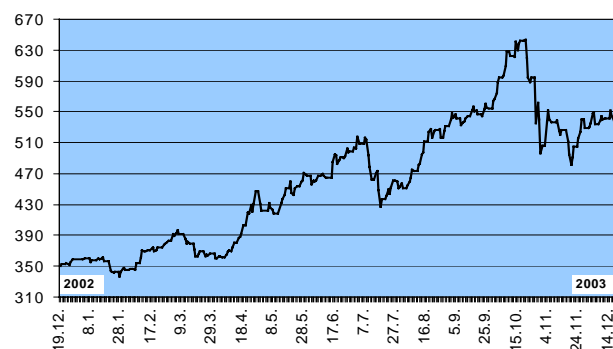
Russia: RUB/EUR & RUB/USD exchange rates (CBR)



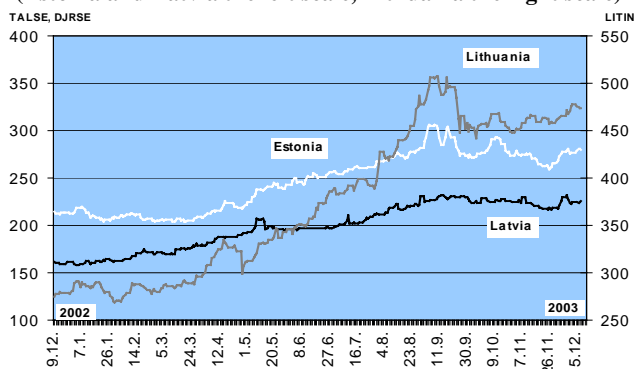
Russia: 31 – 90 days interbank rate (Mibor), % p.a. (CBR)



Russian share prices (RTS)



Baltic share prices (Estonia and Latvia the left scale, Lithuania the right scale)



Central Bank of Russia

Currency rates year 2003

Source: http://www.cbr.ru/eng/currency_base/dynamics.asp

	USD	Euro
1.1.	31.78	33.27
5.1.	31.78	33.15
6.1.	31.78	33.18
9.1.	31.88	33.26
10.1.	31.88	33.54
11.1.	31.83	33.43
14.1.	31.83	33.61
15.1.	31.84	33.61
16.1.	31.81	33.52
17.1.	31.81	33.64
18.1.	31.82	33.79
21.1.	31.82	33.87
22.1.	31.80	33.85
23.1.	31.81	34.12
24.1.	31.81	34.12
25.1.	31.80	34.31
28.1.	31.80	34.44
29.1.	31.80	34.37
30.1.	31.80	34.60
31.1.	31.82	34.44
1.2.	31.83	34.43
4.2.	31.85	34.24
5.2.	31.84	34.42
6.2.	31.84	34.78
7.2.	31.84	34.31
8.2.	31.84	34.38
11.2.	31.82	34.42
12.2.	31.78	34.09
13.2.	31.71	34.04
14.2.	31.66	34.13
15.2.	31.64	34.30
18.2.	31.64	33.92
19.2.	31.55	33.92
20.2.	31.58	33.86
21.2.	31.55	33.97
22.2.	31.55	34.14
26.2.	31.59	34.14
27.2.	31.61	34.01
28.2.	31.58	34.05
1.3.	31.57	33.94
4.3.	31.60	34.08
5.3.	31.58	34.48
6.3.	31.59	34.68
7.3.	31.59	34.63
	USD	Euro
8.3.	31.56	34.79

12.3.	31.51	34.70
13.3.	31.44	34.69
14.3.	31.38	34.22
15.3.	31.38	33.92
18.3.	31.39	33.99
19.3.	31.41	33.42
20.3.	31.40	33.36
21.3.	31.38	33.32
22.3.	31.38	33.28
25.3.	31.38	33.32
26.3.	31.38	33.61
27.3.	31.38	33.40
28.3.	31.38	33.62
29.3.	31.38	33.59
1.4.	31.38	33.98
2.4.	31.32	34.11
3.4.	31.29	34.00
4.4.	31.29	33.71
5.4.	31.28	33.57
8.4.	31.28	33.19
9.4.	31.28	33.46
10.4.	31.28	33.64
11.4.	31.28	33.75
12.4.	31.28	33.73
15.4.	31.23	33.61
16.4.	31.19	33.56
17.4.	31.19	33.73
18.4.	31.18	34.12
19.4.	31.19	33.97
22.4.	31.10	33.84
23.4.	31.10	33.86
24.4.	31.10	34.13
25.4.	31.10	34.26
26.4.	31.10	34.30
29.4.	31.10	34.42
30.4.	31.10	34.14
1.5.	31.10	34.55
6.5.	31.11	34.88
7.5.	31.12	35.14
8.5.	31.10	35.49
9.5.	31.10	35.25
13.5.	31.01	35.85
14.5.	30.98	35.69
15.5.	30.98	35.59
16.5.	30.98	35.43
17.5.	30.89	35.20
20.5.	30.89	36.16
21.5.	30.89	36.04
22.5.	30.89	36.19
23.5.	30.83	35.92
24.5.	30.83	36.01
27.5.	30.72	36.30
	USD	Euro
28.5.	30.72	36.37
29.5.	30.62	36.22
30.5.	30.67	36.02

31.5.	30.71	36.47
3.6.	30.64	35.91
4.6.	30.74	36.14
5.6.	30.76	36.05
6.6.	30.65	35.73
7.6.	30.57	36.24
10.6.	30.46	35.60
11.6.	30.56	35.85
12.6.	30.51	35.77
17.6.	30.46	36.18
18.6.	30.38	36.03
19.6.	30.38	35.81
20.6.	30.38	35.36
21.6.	30.38	35.60
22.6.	30.32	35.21
23.6.	30.32	35.21
24.6.	30.35	35.17
25.6.	30.35	35.06
26.6.	30.32	34.91
27.6.	30.34	34.93
28.6.	30.35	34.71
29.6.	30.35	34.71
30.6.	30.35	34.71
1.7.	30.38	34.72
2.7.	30.33	34.93
3.7.	30.28	35.00
4.7.	30.28	34.90
5.7.	30.29	34.73
6.7.	30.29	34.73
7.7.	30.29	34.73
8.7.	30.30	34.70
9.7.	30.36	34.43
10.7.	30.42	34.48
11.7.	30.36	34.49
12.7.	30.38	34.42
15.7.	30.50	34.37
16.7.	30.53	34.49
17.7.	30.52	34.05
18.7.	30.49	34.23
19.7.	30.43	34.21
22.7.	30.36	34.25
23.7.	30.30	34.32
24.7.	30.35	34.46
25.7.	30.36	34.85
26.7.	30.32	34.75
29.7.	30.25	34.67
30.7.	30.25	34.82
31.7.	30.26	34.63
1.8.	30.28	34.34
2.8.	30.30	34.01
	USD	Euro
5.8.	30.33	34.20
6.8.	30.28	34.42
7.8.	30.30	34.58
8.8.	30.34	34.37
9.8.	30.40	34.55

12.8.	30.38	34.29
13.8.	30.35	34.50
14.8.	30.38	34.21
15.8.	30.33	34.33
16.8.	30.35	34.15
19.8.	30.32	34.06
20.8.	30.33	33.73
21.8.	30.31	33.70
22.8.	30.33	33.54
23.8.	30.31	33.05
26.8.	30.30	32.97
27.8.	30.36	32.95
28.8.	30.39	33.04
29.8.	30.50	33.09
30.8.	30.50	33.20
2.9.	30.55	33.63
3.9.	30.55	33.34
4.9.	30.60	33.04
5.9.	30.64	33.22
6.9.	30.68	33.61
9.9.	30.70	34.01
10.9.	30.64	34.04
11.9.	30.63	34.40
12.9.	30.66	34.47
15.9.	30.66	34.29
16.9.	30.70	34.57
17.9.	30.70	34.63
18.9.	30.68	34.24
19.9.	30.59	34.54
22.9.	30.56	34.40
23.9.	30.49	34.87
24.9.	30.50	35.03
25.9.	30.45	34.83
26.9.	30.47	35.06
29.9.	30.50	35.00
30.9.	30.61	35.08
1.10.	30.61	35.60
2.10.	30.57	35.00
3.10.	30.47	35.76
6.10.	30.44	35.65
7.10.	30.46	35.15
8.10.	30.38	35.60
9.10.	30.38	35.87
10.10.	30.24	35.86
13.10.	30.24	35.42
14.10.	30.06	35.24
15.10.	30.23	35.08
16.10.	30.12	35.33
	USD	Euro
17.10.	30.13	35.04
20.10.	30.07	34.83
21.10.	30.02	34.96
22.10.	29.93	34.83
23.10.	29.92	35.00
24.10.	29.92	35.38
27.10.	29.92	35.32

28.10.	30.08	35.34
29.10.	29.93	35.09
30.10.	29.82	34.93
31.10.	29.86	34.87
3.11.	29.95	34.80
4.11.	29.94	34.68
5.11.	29.86	34.21
6.11.	29.81	34.26
10.11.	29.81	34.14
11.11.	29.81	34.38
12.11.	29.80	34.18
13.11.	29.81	34.49
14.11.	29.86	34.85
17.11.	29.82	35.12
18.11.	29.80	35.13
19.11.	29.80	35.05
20.11.	29.80	35.65
21.11.	29.81	35.48
24.11.	29.80	35.45
25.11.	29.74	35.40
26.11.	29.74	35.06
27.11.	29.74	35.18
28.11.	29.74	35.47
1.12.	29.74	35.50
2.12.	29.70	35.66
3.12.	29.70	35.57
4.12.	29.70	35.90
5.12.	29.70	35.87
6.12.	29.63	35.82
9.12.	29.55	35.95
10.12.	29.55	36.16
11.12.	29.54	35.99
12.12.	29.44	35.87
16.12.	29.39	35.90
17.12.	29.30	36.16
18.12.	29.25	36.02
19.12.	29.25	36.30
20.12.	29.25	36.34
23.12.	29.27	36.29
24.12.	29.25	36.28
25.12.	29.25	36.30
26.12.	29.25	36.43
27.12.	29.25	36.47
30.12.	29.45	36.69
31.12.	29.45	36.82