

In 1999 the main concerns of the Russian Government were: to overcome the financial crisis and the impact that it had had both on the economy and on living standards; an improvement in the real sector; and the creation of conditions for sound and socially orientated growth.

The increase in industrial output and GDP in 1999 was the result of a rise in oil and gas exports, the development of import-substitution businesses and an increase in world prices for oil and oil products. Stimulated by the improved performance of the real economy, payment mechanisms began to function normally again. Around 65% of the gain in industrial output arose through domestic demand. Import-substituting sectors are mainly producing consumer goods satisfying demand for cars, railway equipment, chemicals and machine tools. There was a significant upturn in house construction, spurred on for the most part by an increase in individual savings and a fall in property prices.

It is important to note that none of these achievements was of a stable or long-term nature and in fact had a number of negative consequences. Many import-substituting goods are produced by increasing the capacity of old industrial machinery, and employing old technology and production methods. Much of this revitalized production is many years behind western comparisons.

Russia's share of world exports does not exceed 1.37%. During the year exports declined by 14% (by 13% with non-CIS foreign countries) and imports fell by 44% (52% with non-CIS countries). These figures do not include cross-border exports and imports that did not clear customs officially. The total volumes of foreign trade (including trade not officially registered) were 23.3% lower in 1999 than in the previous year (20.7% lower with non-CIS countries). The foreign trade balance remained positive and stood at USD 21.2 billion (USD 19.8 billion with non-CIS countries) which is the highest level for the whole of the 1990s. Such a healthy trade balance (especially in the absence of foreign investment flows or external lending) allowed the country to continue servicing its external debt (albeit at a lower level) and to achieve and maintain relative stability on the currency markets.

The breakdown of exports shows a base of primarily raw materials of which 41% were oil- and gas-related (i.e. similar to 1998) and 16.4% ferrous and non-ferrous metals. After the OPEC decision in March 1999 to adopt an agreement on reducing oil extraction and export there was an increase in world oil prices, which remained stable from April 1999 onwards.

The volume of imports was restricted by the falling domestic currency, making imports more expensive. However, there was a slight rise in the volumes of imports although the prices of goods fell.

### INFLATION AND PRICE DYNAMICS

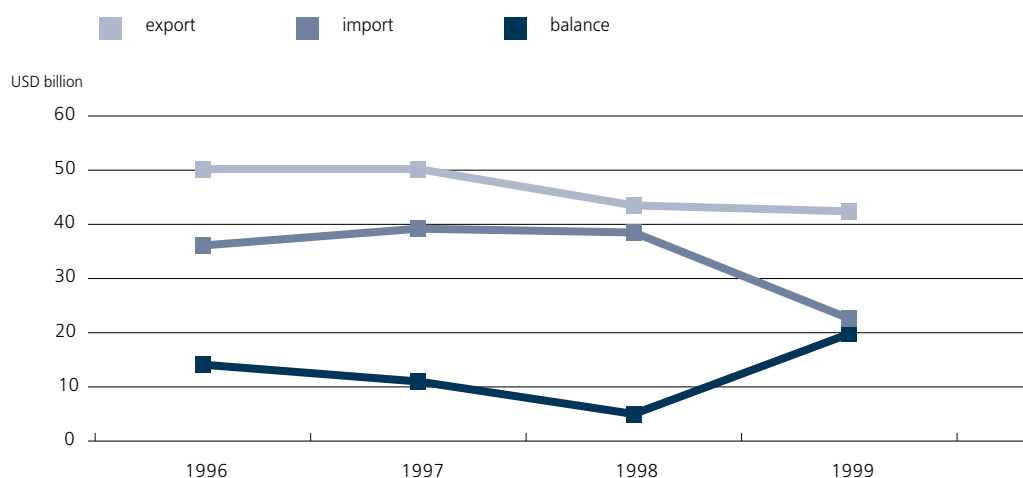
The most important goal of 1999 was to prevent high levels of inflation, which could be brought about by large budget commitments. As in previous years price dynamics were subject to seasonal variations. However, the suppression of consumer good inflation led to lower levels of inflation in industrial markets as a whole.

In certain sectors of the real economy, high levels of demand coupled with a reduction of the tax burden on producers, in favor of consumers, meant that inflation rates, as in 1998, somewhat lagged behind inflation levels in consumer goods markets. To a lesser extent than in consumer goods markets, ruble devaluation affected inflation levels in the industrial sector as a result of a lack of bank lending, high levels of barter and non-payment. Inflation had the largest effect upon import-substituting factories producing consumer goods. Changes in customs policies which reduced tariffs for imported raw materials, favored domestic producers and softened the effects of ruble devaluation in 1999.

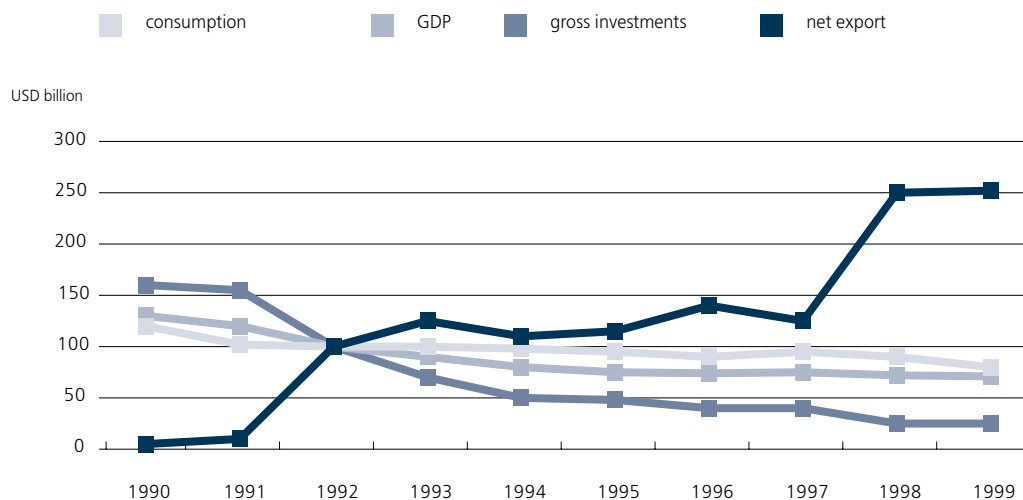
The weakening of inflation was to a large extent a result of the Central Bank's well balanced monetary and credit policy (growth rates of money in circulation were roughly equivalent to inflation rates). This was coupled with the strengthening of the real ruble exchange rate (control for production from natural monopolies; and a drop in the population's spending power). The average monthly inflation rate in 1999 was 2.2% or 30% for the year as a whole. Money supply (M2) increased during the year by 33%.

During the year prices of industrial producers rose by 49.1%, exceeding inflation rates in the consumer goods market (see table). The increase in industrial prices is explained by the reaction of manufacturers to ruble devaluation at the end of 1998 (as distinct from the jump in consumer prices), together with a widening demand for domestically manufactured products as a result of active import substitution; an increase in world prices for raw materials; and an increase in exports of raw materials.

### Russia's foreign trade (excluding CIS countries)



### GDP dynamics and its components (1992 = 100%)



## INCOME AND EMPLOYMENT

Following a sharp drop in the population's income in August to September 1998, the period of recovery was extremely slow and indeed still continues. Meanwhile, as the decline in consumer demand hampers the new economic growth, real disposable income remained low, with 1999 levels standing at 83% of 1998 levels. This is because the standard of living of those on a fixed income was very slow to recover. In the period following the crisis, spending patterns changed significantly. In 1999 a high proportion (over 80%) was spent on buying goods and paying for services while the proportion of income spent on food also increased.

Wage arrears have declined significantly. Total arrears as of 31 December 1999 stood at around RR 55 billion, down by 29% from the previous year. Pension arrears, which stood at RR 26 billion at the start of the year, were fully paid by September 1999. The income of the population in nominal terms was 1.7 times higher in 1999 than in 1998. Nevertheless, the total repayment of pension arrears and the partial repayment of wage arrears did not compensate for the significant decline (by 15-16%) in real disposable income.

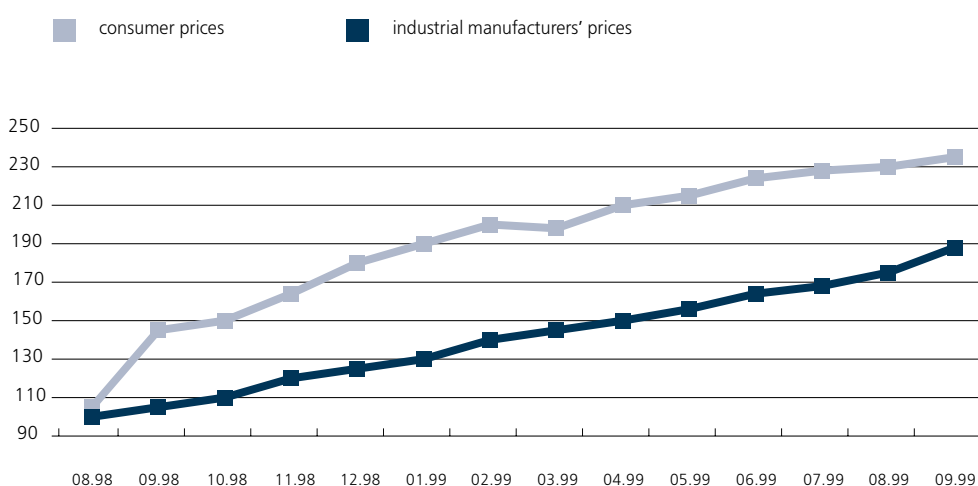
Positive changes in the general economic outlook and above all in industrial output dynamics were dependent on an improvement in the labor market although the situation as a whole remains quite difficult. Total unemployment (calculated using the methodology of the International Labor Organization) at the end of 1999 stood at 9 million or 12% of the active population against 9.73 million (13.3%) at the end of 1998.

## BUDGET AND TAXES

Russia is a country in which the state budget accounts for less than one third of gross domestic product (31.4%). The Russian Federation's consolidated budget deficit in 1999 was estimated at between 4% and 6%, while the provisional surplus for 2000 is around 5%. According to IMF forecasts, the Russian budget surplus in the first half of 2000 will be 4.7%. In 1999 there was a signifi-

### Indexes of consumer and industrial manufacturers' prices.

August 1998–September 1999 (July 1998 = 100%)



cant improvement in tax collection while wage and pension arrears were significantly cut. The collection rate of National Insurance contributions did not exceed 65.2%. Capital investment levels over the year were practically unchanged. The proportion of capital provided by the government comprised 17.3%, while that provided by other sources comprised 62%. A low level of investment activity is an indicator of the general level economic activity and in particular of the activity in the financial sector. Political and economic risks remain and are the main factors for low confidence among potential investors, inadequate activity on the part of banks and high rates of interest on loan financing.

Significant capital flight continues to plague the country. Due to a very high level of non-payment within the economy, barter and other non-cash forms of payment remain widespread. The decline in the agricultural sector output was caused, for the most part, by a crisis in the animal-rearing industry. Poor climatic conditions resulted in a very low grain harvest. The need to increase purchases of animal feed became a further burden on the federal budget.

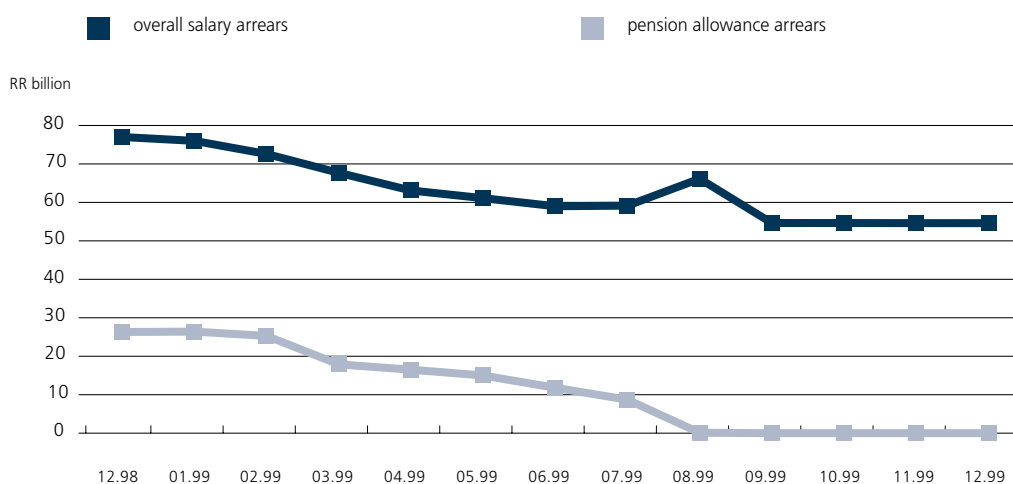
#### BANKING SECTOR: CURRENCY AND DEBT MARKETS

The situation in the country's banking sector is complex. The future of the former large and influential banks remains uncertain. The Bank of Russia and ARKO have not reached a final decision on possible restructuring or the need to initiate bankruptcy proceedings.

The share of loans to the real sector economy in aggregate assets of the banking system has steadily declined from 32.2% in January to 26.1% at the end of the year.

During the past year, the refinancing rate gradually decreased (in March 2000 to 38%). Unlike western markets where changes in interest rates normally have a significant impact on the economy, a fall in the refinancing rate in Russia has not yet stimulated any significant investment activity. Counterparties continue to prefer barter. At the beginning of 1999, the total amount of capital attracted by commercial banks, including Sberbank, came to RR 255 billion. The volume of deposits subsequently grew reaching a level of RR 316 billion at the beginning of 2000. Russia's gold deposits increased to USD 13.6 billion but were subject to considerable fluctuation in the gold price.

#### Salary and pension allowance arrears (as of the end of period)



The situation in the currency markets was characterized by a significant increase in supply of foreign currency, caused to a large extent by a major improvement in foreign economic activity and the resultant healthy trade balance. Favorable trends in the ruble exchange rate were due mostly to import substitution, increased export earnings, lower interest rates and a deceleration of inflation. Supported by limited intervention policy on the part of the Central Bank of the Russian Federation, the current ruble exchange rate has remained at a level of 28-29 RR/USD since the end of 1999.

### Banking asset-liability structure (in %)

	1996	1997	1998	1999
<b>ASSETS</b>				
liquid assets	17.4	13.6	16.4	21.6
loans to the economy	28.7	31.8	32.0	29.6
loans to government structures	20.9	21.6	17.2	13.8
<b>LIABILITIES</b>				
private individuals deposits	24.3	22.3	19.9	19.3
corporate deposits	18.2	19.0	20.5	26.4
capital	20.5	17.1	8.5	9.3

### Federal budget deficit and current operation account balance

