

## Russian Overview. May 27-June 2

### FX

- The CBR allowed the ruble to rise against USD-EUR basket after in May the ruble depreciated in real terms as inflation slowed
- CBR's FX reserves rose to a new record high

### MONEY MARKET

- Overnight interest rates stood low amid ample liquidity
- Liquidity soared due to massive USD sell-off in the FX market
- Interest rates to stay low

### ECONOMY

- Inflation was expected to stay low in May
- The government plans to downgrade ambitions in the 3-year economic forecast
- Building up foreign borrowings of state-controlled companies have become an area of concern of the government
- Financial conditions in the economy remained stable
- The May poll suggested a faster expansion in the manufacturing
- The CBR has made a step to a full ruble convertibility

### FEDERAL BUDGET

- President's budget address: development of the Stabilization Fund concept, a measured fastening of the non-interest spending and lowering inflation as a remaining priority

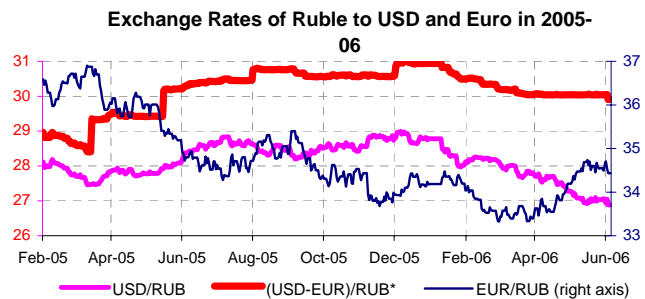
### POLITICS

- Prosecutor General's dismissal: another step to smooth succession of power

### FX

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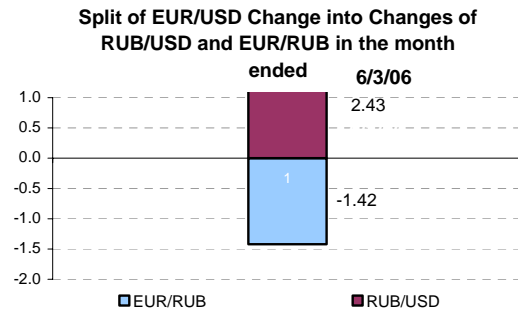
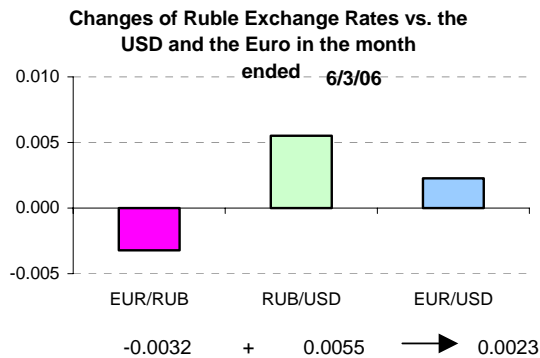
During the week under review USD/RUB followed USD dynamics against the euro. Until Friday the ruble remained stable against CBR's USD-EUR (60/40) basket (see chart), as it was since the end of March. However, on Friday the CBR allowed 0.45% appreciation of the ruble against USD-EUR (60/40) basket, so that Basket/RUB rate dropped to around 29.92 from 30.04. Thus, this year the ruble has risen 3.5% against the USD-EUR basket.



\* Euro share in the USD-EUR basket was set at 10% from 02/01/05, 20% from 03/15/05, 30% from 05/16/05, 35% from 8/1/2005 and 40% from 12/2/2005

As a result, in the week under review the ruble strengthened both against the USD and the euro that led to an **unusual split** of a **EUR/USD change** (0.23% on the left chart below) between changes in **RUB/USD** and **EUR/RUB**: in the proportion of 242/-142, respectively (right chart below). In other words, despite euro strengthening against the USD, the ruble rose not only against the USD, but against the euro, as well (the negative number -1.42 on the right chart suggests that).

- Using various proportions in the translation of EUR/USD changes into changes of the exchange rates of the ruble against the USD and the euro, the **CBR can make adjustments** in a pace of the real effective exchange rate (REER) change of the ruble, other things being equal.



*...in May the ruble depreciated in real terms as inflation slowed*

By our estimates, **real effective exchange rate (REER)** of the ruble **appreciated** 5.9% in **January-May** y-t-d. At the same time, in real terms, the ruble appreciated 9.5% against the USD and 3.0% against the euro. In contrast to the general appreciation trend in **May** REER of the ruble **depreciated** (0.6%) that was a result of dramatically slowed inflation (expected at around 0.5% in May after 0.4% in April) and the strengthening euro.

- Given the **prevailing euro share** in the currency basket, used for the REER change calculations (56% for the euro, 24% for the USD and 20% for other currencies, by our estimates), REER appreciation of the ruble decreases, when the euro strengthens against the ruble (accordingly, USD weakens normally against the ruble during these periods) and vice versa, other things being equal.

The CBR considers that REER appreciation up to 9% is acceptable for the economy in 2006. However, in April First Deputy Governor of the CBR Alexei Ulyukaev, commenting CBR's efforts to meet inflation target (not higher than 8.5%), did not rule out that this goal **might require greater appreciation of the ruble this year**. The CBR sees positive role of ruble strengthening in acceleration of imports rise, which results in a reduction of the foreign trade surplus and correspondingly, in an amount of foreign inflow purchases by the CBR (which in such a way prevents further ruble appreciation) that in turn, reduces associated ruble supply and hence, inflationary pressure on the economy.

At the same time, the monetary authorities weight threats to economic growth, associated with ruble appreciation. That is why the CBR maintained stable nominal Basket/ruble rate during April-May. However, some retreat in REER appreciation of the ruble in May has provided an **extra room** for the authorities in applying one of the main tools for lowering inflation—ruble appreciation. On June 2 the CBR took this occasion.

During the week under review USD/RUB moved in the **range** of 26.75-27.10, reflecting EUR/USD movements between 1.2730 and 1.2935. On **Friday** the ruble traded mostly around the level of 26.90, although it dropped to 26.75 at the end of the day on USD weakening.

**CBR's USD/RUB rate** decreased by 0.5% and was fixed at RUB26.8868 for June 5. The MICEX average daily **trading volume** decreased by 31% to \$2.5 bn.

FX MARKET	6/2/06	Change,%				YTD Average	Expected	
		1-week	1-month	YTD	YTD Real*		Average	End of Year
USD/RUB (UTS)	26.8953	-0.5	-0.4	-6.1	-9.25	27.76	27.31	26.78
Volume-MICEX, USD million	3121.2	37.5	609.8	82.3		2237.6		
CBR's FX and gold reserves, USD bn	243.3	2.8	12.1	33.5				260

\*Estimate. For reference: real RUB/USD change YTD 10.19%

**The market to continue watching EUR/USD dynamics, and CBR's interventions**

In the coming week the market will continue watching USD dynamics in the world market and CBR's interventional behavior. In case of a EUR/USD fall to 1.25, USD/RUB can be seen around 27.20, should EUR/USD rise to 1.31, USD/RUB will tend to 26.60.

**RUBLE EXCHANGE RATE FORECASTS for 2005-08**

	Jul-06	Sep-06	Dec-06	Mar-07	Jun-07	Dec-07	2006*	2007*	2008*	2009*
USD/RUB, eop	26.96	26.99	26.78	26.58	26.47	26.47	27.31	26.81	26.12	26.03
EUR/RUB, eop	34.46	34.42	34.28	34.42	34.68	34.68	34.21	34.84	35.79	35.92

\*Average for the year

As of 2-Jun-06 ZAO Citibank Moscow

**CBR's FX reserves rose to a new record high**

In the week ended May 19 the **FX and gold reserves of the CBR** (excluding CBR's short-term obligations) increased by \$6.6 bn to a new record high of \$243.3 bn. The next reserves' reading due on the coming Thursday is likely to show their further increase by several billion USDs.

**MONEY MARKET**

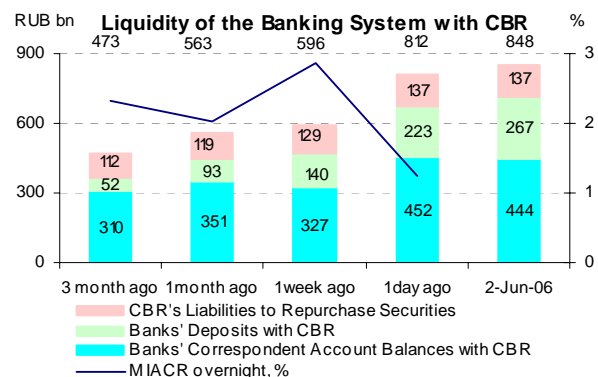
**Overnight interest rates stood low amid ample liquidity**

The **average overnight interest rates** stood within a normal range of 1.5-3.0% despite end-of-month tax payments. The daily average commercial banks' correspondent account **balances with the CBR** increased to RUB428 bn from RUB341 bn a week ago. On Friday the balances stood at RUB444 bn that was enough to **provide comfortable liquidity** in the market.

Date	MONEY MARKET	Current Value	Average			
			1-week	1-month	YTD	1-year
6/1/06	MIACR overnight, %	1.24	1.81	2.17	2.88	2.15
	MIACR 1-month, %	4.13	3.54	3.15	3.70	3.15
6/2/06	Commercial banks' balances with CBR, RUB bn	444.0	427.8	350.3	341.0	313.9
	Commercial banks' deposits with CBR, RUB bn	267.0	245.2	211.5	116.9	88.1

**Liquidity soared due to massive USD sell-off in the FX market**

By Friday the total amount of commercial banks' **funds, attracted by the CBR** (through deposits, reverse repo deals and OBRs), **increased** by RUB135 bn compared with the previous week to RUB404 bn (\$14.5 bn). The **total liquidity with the CBR** (in the correspondent account balances and attracted by the CBR through deposits, reverse repo deals and OBRs) **increased** by RUB252 bn for the week to RUB848 bn (\$30.5 bn). This **liquidity** hike reflected inflow from the FX market, where banks sold the USDs massively to the CBR.



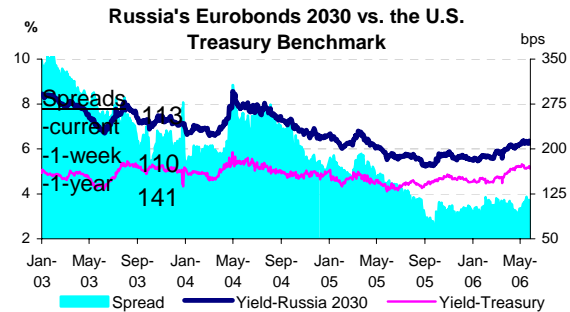
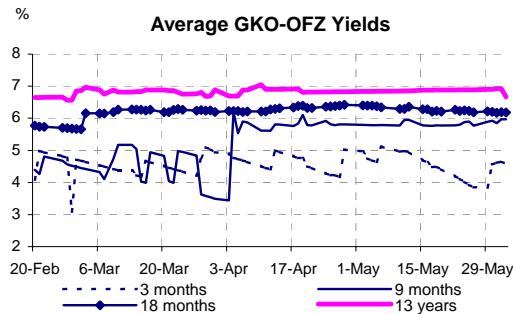
*Interest rates to stay low* **In the coming week** overnight interest rates are expected to stay at 1.5-2.5% amid ample liquidity.

## FIXED INCOME SECURITIES

The government **ruble bonds** stood mostly stable (see table and chart below). The OFZs volume outstanding amounted to around \$30 bn.

The **spread** on the Russian sovereign **Eurobonds** 2030 stood at 113 bps (as of 6:00 p.m. Moscow time on June 2), being noticeably lower than a year ago—141 bps. Market expectations over a further interest rate policy in the U.S. remained the driver of the spread.

OFZ	6/2/06	Average, %			
		1-week	1-month	YTD	1-year
Yield 3-month, %	4.58	4.30	4.49	4.08	3.70
Yield 9-month, %	5.97	5.88	5.83	5.04	4.88
Yield 18-month, %	6.18	6.19	6.27	6.04	5.83
Yield 15-year, %	6.67	6.89	6.86	6.76	7.09
Trading volume, RUB million	851.6				1835.1
Date of a New Issue	Maturity Date	Volume at Face Value, RUB bn			Average Yield, %
		Auctioned	Demand	Placed	
6/2/06	1/9/19	7.5	0.0	1.0	7.03



## STOCK INDEX

RTS-INTERFAX STOCK INDEX as of 5:40 p.m.	Current Value	Change, %			
		1-week	1-month	YTD	1-year
6/2/06	1533.48	2.6	-11.1	28.8	126.8

## ECONOMY

*The monetary base expanded* The **monetary base** expanded 0.2% to RUB2381.6 bn in the week ended May 29. It increased by 10.2% y-t-d and 31.4% y/y, compared with 10.2% and 19.6%, respectively, previous year.

- The slowdown in the expansion of the aggregate in 2004 (that also influenced the expansion rate in 2005), above all, was related to a radical cut of reserve requirements to commercial banks.

The CBR forecasts that in **2006** the monetary base will rise 17-23%.

**MONETARY BASE, RUB bn**

5/29/06	2006			5/29/05	2005		
	Change, %				Change, %		
	1-week	YTD	Y/Y		1-week	YTD	Y/Y
2381.6	0.2	10.2	31.4	1812.1	1.4	10.2	19.6

***Inflation was expected to stay low in May***

The Economy and Trade Ministry has estimated **inflation** in the first 20 days of May at 0.3% and expected it at 0.4-0.5% for the whole month compared with 0.4% in April and 0.8% a year ago. The government endeavors to bring inflation below 9% for the whole year after 10.9% in 2005. We forecast inflation at around 0.5% in May and 9.8% for the whole year.

***The government plans to downgrade ambitions in the 3-year economic forecast***

On May 29 the government budget panel revised main parameters of the macroeconomic forecast for 2007-09. Particularly, the new projections provide for **slower economic growth** (by 0.1-0.3 percentage points)—at 5.6-5.7% annually, **higher inflation** (by 0.5 percentage points)—from 6.5-8.0% in 2007 to 4.5-5.5% in 2009 and **stronger ruble appreciation** (by 0.2-2.3 percentage points)—between 5.1% in 2007 and 0.9% in 2009. The forecast is based on a **higher average world price on Urals blend oil** (by \$2-9 p/b), which is expected to decrease to \$48 p/b in 2009 from \$62 p/b in 2006 and \$58 p/b in 2007.

**SCENARIOS OF SOCIAL AND ECONOMIC DEVELOPMENT PROGRAM OF THE RUSSIAN FEDERATION IN 2006-09, by the Government Budget Panel (March vs. May 2006 versions)**

		2005	2006		2007		2008		2009	
			Mar-06	May-06	Mar-06	May-06	Mar-06	May-06	Mar-06	May-06
<b>GDP</b>	<b>y/y %</b>	6.4	6.0	6.1	5.7	5.7	5.8	5.6	6.0	5.7
<b>CPI change</b>	<b>%</b>	10.9	8-9	8-9	6.0-7.5	6.5-8.0	4.0-5.5	4.5-6.0	4-5	4.5-5.5
<b>Real effective exchange rate of the ruble change, Dec/Dec</b>	<b>%</b>	10.5	6.5	6-7	2.8	5.1	1.1	1.3	0.4	0.9
<b>USD/RUB eop</b>	<b>RUB</b>	28.8	27.4	26.9	27.60	26.50	27.80	26.90	28.00	27.30
<b>Crude oil price (Urals blend) average</b>	<b>USD p/b</b>	50.6	54.0	62.0	49.0	58.0	46.0	53.0	46.0	48.0
<b>Upper limit of a tariff/price rise:</b>										
- natural gas	<b>y/y %</b>	23.0	11.0	11.0	8.0	15.0	7.0	14.0	6.0	13.0
- electricity	<b>y/y %</b>	9.5	7.5	7.5	6.5	10.0	5.5	9.0	5.0	8.0
- railways	<b>y/y %</b>	12.8	7.5	7.5	7.5	8.0	5.5	6.0	5.0	5.5

The higher rates of inflation became the result of **lifting the upper limit of tariff rise** on natural gas to 13-15% annually (from 6-8%), electricity to 8-10% (from 5.0-6.5%) and railway tariffs to 5.5-8.0% (from 5.0-7.5%). The greater ruble appreciation may be considered as a measure to curb inflationary pressure, which will come due to projected higher oil prices. The government justifies the higher tariff rises on natural gas by recommendations of the WTO to make the tariffs in the local market high enough at least to break even. Moreover, more expensive resources will stimulate their saving in the economy. The new version of the forecast also provides for a **decreasing level of the state investments**: from 2.4% of GDP in 2007 to 1.76% in 2009. The government plans to consider the new version of the forecast at a meeting on June 7. **We have forecasted** GDP growth at 6.1% in 2006 (the same as the current government forecast) and at 6.1-6.2% in 2007-09. The latest government USD/RUB forecast has effectively concurred with ours for 2006-07 (around 26.90 and 26.60, respectively) and has also leaned to our forecasts for 2008-09 (26.15-26.20).

*Building up foreign borrowings of state-controlled companies have become an area of concern of the government*

According to the CBR, of the total **Russia's consolidated foreign debt** (debts owed to non-resident creditors) of \$258.8 bn (29.8% of GDP), the debt of the **state sector** amounted to \$148.7 bn (19.5% of GDP), including the \$66.5 bn (8.7% of GDP) debt of **companies, controlled by the state** (like Gazprom), while the debt of the purely **private sector**—\$109.8 bn (14.4% of GDP). At the same time, the **short-term portion** of the state companies' foreign debt remained quite low—just \$3.7 bn, while in the private sector—\$22.3 bn, including \$16.9 bn in the banking sector.

This has been for the first time, when the debt of the companies, controlled by the state, had been disclosed separately from the private sector's debts. Rapidly increasing foreign debts of the state companies (they rose 33% in Q.4 2005) have become an **area of concern for the government**. The Finance Ministry plans to seek a right to control borrowing programs of such companies in order to avoid excess mounting foreign debts, which among others, facilitate further undesirable ruble appreciation and generate extra inflationary pressure on the economy.

Meanwhile, the **Finance Ministry** has estimated the **state foreign debt** (foreign currency denominated debts of the government) at \$75.2 bn as of April 1, 2006, down from \$76.5 bn at the end of 2005 and from \$114.1 bn at the end of 2004. In 2006 the government is seeking the early repayment of the bulk of \$22 bn debt to the Paris Club.

*Financial conditions in the economy remained stable*

According to the Federal Statistics Committee, in January-March the **aggregate financial result** (profits less losses) of the Russian businesses increased by 36.4% y/y to RUB901.7 bn (\$32.2 bn). Overall, this increase continued to outpace nominal GDP growth (25%). Changes in the financial result by sectors were as follows:

❖ Mining.....	47.3%
❖ Manufacturing.....	15.5%
❖ Production and distribution of electricity, natural gas and water.....	13.5%
❖ Trade and repair of motor vehicles and durable goods.....	92.9%
❖ Transport and communication .....	26.5%
❖ Construction .....	-70.6%
❖ Operations with the real estate.....	-20.3%

There were 53,000 of businesses (excluding small ones, as well as agricultural, financial, insurance and budget entities), which had **profits** (RUB1036.0 bn). At the same time, 36,300 of businesses had losses (RUB134.3 bn). The share of the businesses, which had **losses**, decreased by 1.4 percentage points y/y to 40.7% of the total.

*The May poll suggested a faster expansion in the manufacturing*

In May Russia's **Manufacturing Purchasing Managers' Index (PMI)** increased to 54.0 from 53.7 previous month. This was the fastest expansion rate in the sector since December 2005.

- The index is calculated by the British NTC research company for the Moscow Narodny Bank (MNB) and is based on a poll of 300 Russian purchasing managers. The index reading above 50 suggests economic expansion, while below 50—decline. The index rise was provided by a faster expansion of the output and a robust rise in new local orders, while export orders dropped. Inflationary pressure remained a serious constraining factor for further acceleration of economic growth.

*The CBR has made a step to a full ruble convertibility*

Following President Putin's announcement of the coming full **ruble convertibility**, CBR's Board of Directors has decided to abolish the requirements for non-residents to reserve a portion of their funds (against investments in the Russian securities or short-term loans to the Russian companies) with the CBR from July 1, 2006. Earlier First Deputy Governor of the CBR Alexei Ulyukaev has estimated the total amount of such reserve deposits in the CBR at RUB8-9 bn.

## FEDERAL BUDGET

*President's budget address: development of the Stabilization Fund concept, a measured fastening of the non-interest spending and lowering inflation as a remaining priority*

On May 30 in the annual **Budget Address**, President Putin proposed to split the oil **Stabilization Fund into two parts**—the reserve or base one to be fixed as a percentage of GDP and the fund of future generations. Not going into details, he, nevertheless, said that the Fund's resources in excess of the base part must be spent exclusively for the replacement of foreign financing of the budget deficit or early payments of the state foreign debt. This corresponded to the conservative position of the Finance Ministry regarding the utilization of the Stabilization Fund. At the same time, this could imply the approval of investing the future generations fund (at least partially) into not only high-rating bonds, but also in top-ranking shares.

Moreover, President pointed out that rates of the **non-interest federal budget spending** have to be "adequate" to GDP growth. Later President Administration's economic expert Arkady Dvorkovich has clarified this as an option to raise the level of such spending by around a percentage point of GDP. In 2005 the level of non-interest spending to GDP rose to 15.3% from 14.7% in 2004. At the same time the federal budget surplus rose to 7.5% from 4.1% of GDP that suggested that the spending increase was not too serious. The surplus, although decreasing, is expected to sustain in 2006-07. President also reiterated that **lowering inflation** had remained among the priorities of the government.

## POLITICS

*Prosecutor General's dismissal: another step to smooth succession of power...*

On June 2 the Federation Council relieved Prosecutor General Vladimir Ustinov of his post at a request of President Putin and at his own request. There have been no more details available. There has not been an announcement on a candidacy of the new Prosecutor. In the meantime First Deputy Prosecutor General Yuri Biryukov will serve as acting Prosecutor General.

Among **possible nominees** on the post there are Dmitry Kozak, close Vladimir Putin's ally, mastermind of legislative reform and former Head of Presidential Administration, currently serving as President's representative in the Southern region and Alexander Kononov, recent prosecutor of Bashkortostan, who at the end of 2005 was appointed by President's representative in the Volga region.

While there were no any specific obvious reasons for the dismissal of Vladimir Ustinov, among the possible ones, not the last one could be the state of health. At the same time, this decision corresponds to the obvious efforts of the Kremlin to improve the **image** of the state power, not talking about rising its **efficiency** before the elections to the Duma in December 2007 and of President in March 2008. Having the reputation of hardliner, Vladimir Ustinov, naturally, could not be treated as a country's favorite. Moreover, lack of a progress in fighting corruption has made the Prosecutor's office one of the main candidates for a reshuffle in such a crucial period.

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