July 8, 2005

Russia's Balance of Payments Performance in January-June 2005

- ***A record high current account surplus and stable private capital outflow***
- ***Trade surplus hit a new record high, well compensating the services deficit***
- ***Energy supplies, above all—oil, sustained the domination in the exports***
- ***Soaring oil prices helped export growth to outpace that of the imports. In real terms, imports have been rising faster than exports since 2000. In the long run the imports to rise faster.***
- ***Outflow of the net investment income reduced, although a rise is likely due to increasing private capital inflow***
- ***The FDI jumped up to a record high***
- ***CBR's reserves soared***
- ***Private capital outflow rose nominally, but stood stable relative to the total private inflow. Private capital inflow hit a new record high. The population continued to convert foreign currency savings into the rubles. Foreign exchange rate dynamics was the most sensitive issue for the capital inflows.***
- ***Net private capital outflow dropped nominally, but its level remained relatively high***
- ***Current account and foreign trade surpluses to hit new record highs in 2005 on soaring oil prices. Forecast scenarios rest on oil prices.***
- ***The balance of payments to change its shape***

A record high current account surplus and stable private capital outflow

The Central Bank of the Russian Federation has published its preliminary estimates of the country's balance of payments in H.1 2005. The balance performance further strengthened. Moreover, along with a dramatic increase of the **current account surplus**, the level of **net private capital outflow** sustained mainly.

The **current account surplus** rose 77% YOY to a new semiannual record high of $46.4 bn.

- In 2004 Russia enjoyed current account surplus of $59.9 bn (revised down from $60.1 bn) or 10.3% of GDP. In 2000-03 the surplus level to GDP was between 8.2% and 18.0% (see chart 1 and table 1).

Chart 1

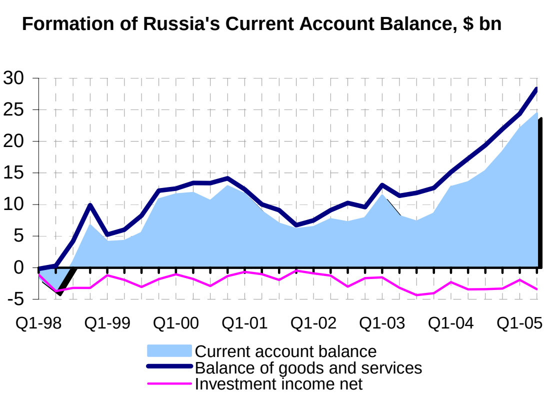
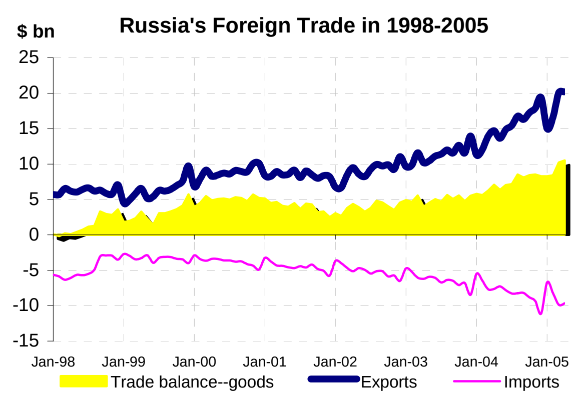


Chart 2



The **main reason** for this impressive performance was the same as in 1999-2004—**strong foreign trade balance**. In addition, the **net investment income outflow reduced** in contrast to 2003-04 (see table 1).

Another important trend of the balance of payments—**intensified private capital inflow** to the country, which, nevertheless, could not compensate completely the **capital outflow**.

Table 1

RUSSIA'S CURRENT ACCOUNT BALANCE IN 1998-2005

	1998	1999	2000	2001	2002	2003	2004	2005 f.	2004				2005	
									I	II	III	IV	I	II
CURRENT ACCOUNT BALANCE	0.2	24.6	46.8	33.6	29.9	35.4	59.9	87.9	12.8	13.5	15.3	18.3	22.0	24.4
TRADE BALANCE	12.3	31.7	53.5	38.3	36.0	49.0	73.7	102.9	15.1	17.3	19.4	21.9	24.4	28.3
Merchandise	16.4	36.0	60.2	48.1	46.6	59.9	87.1	117.8	17.7	20.5	23.8	25.2	26.9	32.0
Exports	74.4	75.6	105.0	101.9	107.6	135.9	183.5	236.8	37.3	43.2	48.5	54.5	51.7	60.8
Imports	-58.0	-39.5	-44.9	-53.8	-61.0	-76.1	-96.3	-119.0	-19.6	-22.7	-24.7	-29.3	-24.8	-28.8
Services	-4.1	-4.3	-6.7	-9.8	-10.6	-10.9	-13.4	-14.9	-2.5	-3.2	-4.4	-3.3	-2.5	-3.7
NET INVESTMENT INCOME	-11.6	-7.9	-7.0	-4.1	-6.3	-13.0	-12.4	-15.0	-2.3	-3.4	-3.4	-3.3	-1.9	-3.4
FOREIGN DIRECT INVESTMENT	2.8	3.3	2.7	2.5	3.0	8.0	12.5	15.7	4.8	-0.2	0.7	7.1	5.5	3.9
FX RESERVES CHANGE (+) decrease, (-) increase	5.3	-1.8	-16.0	-8.2	-11.4	-26.4	-45.2	-52.1	-6.8	-5.0	-6.5	-26.9	-14.4	-18.0
NET PRIVATE CAPITAL FLOW	-22.6	-21.1	-25.4	-13.3	-9.2	-1.7	-9.4	-7.4	-4.2	-6.1	-7.3	8.2	0.0	-5.6
Increase of banks' foreign obligations	-6.3	-0.9	1.5	4.6	2.4	11.2	7.4	8.0	0.4	-1.0	1.4	6.6	2.2	0.6
Increase of non-financial companies' foreign obligations	8.3	2.1	1.8	3.4	13.9	22.1	28.8	40.0	9.1	5.6	2.6	11.4	15.6	8.0
Increase of banks' foreign assets	0.3	-3.4	-3.5	-1.6	-0.5	-1.0	-3.6	-9.4	-3.6	-2.3	-0.5	2.8	-4.8	-4.6
Increase of non-financial companies' foreign assets	-15.1	-10.4	-16.1	-10.8	-19.0	-25.9	-33.6	-36.0	-6.7	-8.2	-10.7	-8.0	-8.2	-6.6
Net errors and omissions	-9.8	-8.6	-9.2	-8.8	-6.1	-8.2	-8.4	-10.0	-3.4	-0.3	-0.1	-4.5	-4.8	-3.0
Increase of overdue export receivables and non-repatriated import advances	-8.0	-5.1	-5.3	-6.4	-12.2	-15.4	-25.9	-19.0	-5.9	-7.5	-6.7	-5.8	-3.7	-3.7
NET PRIVATE CAPITAL FLOW RELATIVE TO CURRENT ACCOUNT SURPLUS, %	-10316	-85.8	-54.3	-39.6	-30.9	-4.9	-15.8	-8.5	-33.1	-45.4	-47.7	44.9	-0.1	-23.0

***Trade surplus** hit a new record high, well compensating the services deficit*

In H.1 2005 the **trade surplus in merchandise and services** increased by 63% YOY to a semiannual record high of $52.7 bn. The quarterly average surplus rose 43% compared with the quarterly average in 2004.

- Foreign trade surplus (**merchandise**) of $58.9 bn was 55% higher than a year ago
- Deficit of the trade balance in **services** increased by 9% YOY to $6.2 bn

Energy supplies, above all—oil, sustained the domination in the exports

The Russian foreign trade continued to benefit from **favorable export prices** on energy supplies (chart 6). In H.1 2005 in the world market, the average **price** on Urals blend crude oil rose to $45.4 p/b compared with $34.7 p/b on average in 2004. As a result, the **share of the energy supplies** in the total Russian exports of goods rose from 40% in 1998, 42% in 1999, around 50% in 2000-02, 55% in 2003-04 to 59% in January-June 2005 (charts 3-4). The **crude oil** share amounted to 34%, **oil products** 12% and **natural gas** 13% of the total exports.

Chart 3

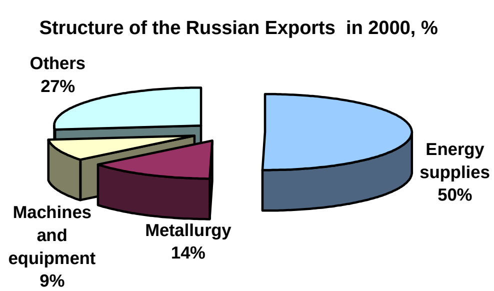
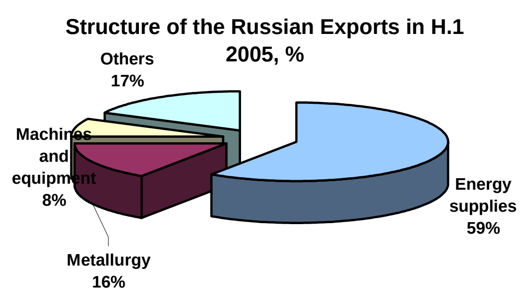


Chart 4



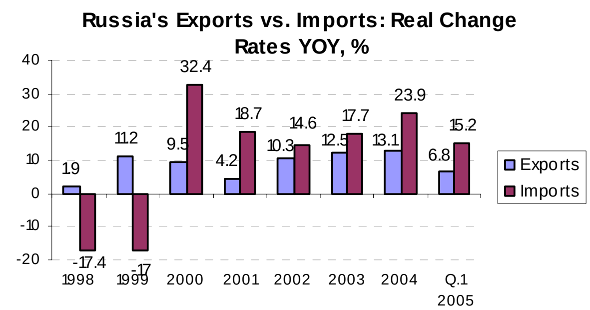
Soaring oil prices helped export growth to outpace that of the imports

In Q.1 2005 an **export rise well outpaced** an **import rise** (40% vs. 27% YOY), continuing the trend of 2003-04 and being a result of skyrocketing oil prices. The latter helped to reverse the tendency of the faster growth rates of imports, which emerged in 2001 and extended in 2002.

- The changes **in 2001-02** happened after a dramatic drop in the imports in the post-crisis months of 1998 and in 1999 and sharp growth in the exports in 2000. On the one hand, the volume of the **imports** fell 30% in 1999 and increased by only 14% in 2000 due to precipitous ruble devaluation in 1998. On the other hand, in 1999 the **exports** remained effectively at the level of 1998, and in 2000 the exports jumped up 41% YOY, as the energy supplies prices soared.
- **In 2003** growth of **exports accelerated** due to increasing world **prices** on traditional items of the Russian exports, as well as their export **volumes**—crude oil, oil products, natural gas, metals and timber. These products made up around 65% of the total exports. The **imports rose** due to economic growth in Russia (7.3%) that was accompanied by real ruble appreciation against the USD (19%).
- Similar factors influenced the Russian foreign trade **2004**. Particularly, the average **export price** on Urals blend oil rose 30%, oil export **volume**—15% YOY, **GDP** grew 7.1%, while the **ruble appreciated** in real terms 14.0% against the USD and 5.3% against the euro.
- In **H.1 2005** the average export **price** on Urals blend oil rose 46%, and the **ruble appreciated** in real terms around 3% against the USD and 15% against the euro

In real terms, imports have been rising faster than exports since 2000

At the same time, the Federal Statistics Service's GDP data suggests that **in real terms**, the import rates have been outpacing those of exports since 2000. In Q. 2005 in real terms, the imports rose over 15% compared with 7% for the exports, while for 2000-04 the rates were 60% and 163%, respectively.



In the long run the imports to rise faster

We expect that **in the long run** the imports will increase faster than exports. However, this year the export volume should hit another record high, given an expected rise of the average export price on crude oil compared with the previous year.

Chart 5

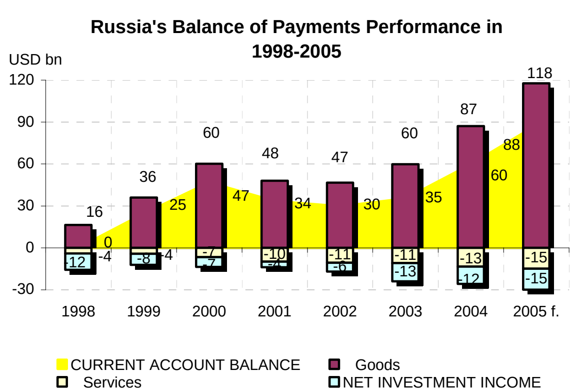
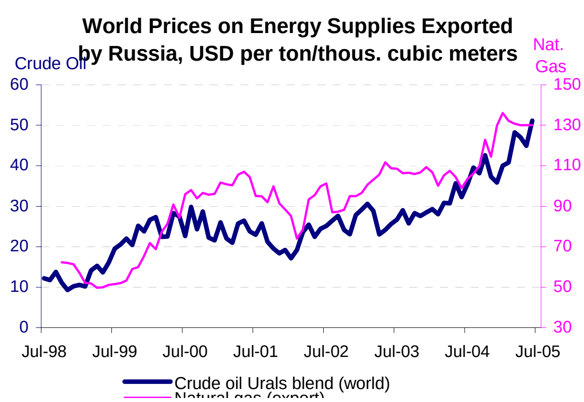


Chart 6



Outflow of the net <u>investment income</u> reduced, although…

In H.1 2005 the outflow of **net investment income** reduced by 6.9% to $5.3 bn. Its quarterly average volume was $2.7 bn compared with the quarterly average of $3.1 bn in 2004 and $3.3 bn in 2003.

- The net investment income outflow dropped to $4.1 bn in 2001 from $11.6 bn in 1998, but rose to $6.3 bn in 2002 and $13.0 bn in 2003 (see chart 5 and table 1).
- During the crisis of 1998 Russia announced that it would service only the post-Soviet debts, while seeking restructuring former Soviet Union's debts. In 2000 Russia succeeded to restructure its $32 bn **debts to the London Club** into $21.5 bn 10- and 30-year Eurobonds with a 7-year grace period. In 2002, similarly, it restructured the first portion of the **former Soviet commercial debts** (total of $6.0 bn) and issued $159 million Eurobonds 2010 and $1.155 bn Eurobonds 2030.
- Since 2000 Russia has paid all its foreign debts due. Moreover, in January 2005 Russia paid out early a $3.3 bn debt to the **IMF**, while in May it reached a $15 bn deal on the debt prepayment to the **Paris Club** of sovereign creditors in June-August. In **2004** the government paid about $15 bn scheduled foreign debts including the $6 bn debt service. **This year** it should pay around $17 bn foreign debts, including the $7 bn debt service.

…a rise is likely due to increasing private capital inflow

In 2005 the net investment income outflow is expected at $15 bn due to increasing **interest payments of private borrowers**, as their foreign debts have been rising intensively since 2002, as well as dividend payments to non-residents.

The FDI jumped up to a record high

The **foreign direct investments (FDI)** jumped up to a semiannual record high of $9.4 bn compared with $4.6 bn a year ago. Their average quarterly level rose to $4.7 bn in 2005 from $3.1 bn in 2004 and $2 bn in 2003. We expect that the FDI will approach $16 bn in 2005 after $12.5 bn (revised up from $11.7 bn) in 2004. Overall, we see **long-term prospects for a strong FDI inflow** to Russia.

CBR's reserves soared

CBR further raised its **FX and gold reserves** by $32.4 bn. to a historical high of $151.8 bn .

Private capital outflow rose nominally, …

The **private capital outflow** (both legal and illegal) rose to a record high of $32.1 bn compared with $24.5 bn in H.1 2004. The average quarterly outflow rose to $16 bn in 2005 from $11.4 bn in 2004 and $8.8 bn in 2003.

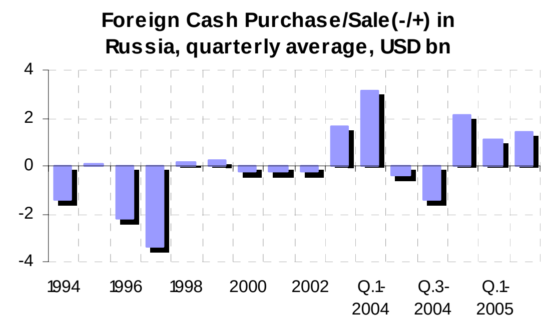
…but stood stable relative to the total private inflow

At the same time, the 44% **level of the private capital outflow relative to the total private inflow** (by means of the capital inflow and current account surplus) stood effectively at the level of 2004 (44%) compared with 51% in 2003 and 51-87% in 1999-2002.

Private capital inflow hit a new record high

The **private capital inflow** of $26.4 bn was also a record high. Its quarterly average reached $13.2 bn compared with $9.0 bn in 2004 and $8.3 bn in 2003, being considerably higher than the quarterly average in 1998-2002—$1.6 bn. At the same time, in Q.2 2005 the private capital inflow dropped to $8.6 bn from $17.8 bn in Q.1 that was still much higher than in Q.1 2004—$4.6 bn.

The **conversion of foreign cash**, held mostly by the population, into the rubles, continued in Q.2 2005, when the net foreign currency sales rose to $1.4 bn from $1.1 bn in Q.1. It was one of the major sources of the private capital inflow in 2003 ($6.6 bn), but reduced in 2004 (to $3.4 bn).



The population continued to convert foreign currency savings into the rubles

- The latter was a consequence of the interruption of nominal ruble appreciation trend in April-September 2004, as well as of the micro-crisis of confidence in the banking system in June-July. However, the resumption of ruble strengthening and the normalization of the situation in the banking system encouraged a new wave of foreign currency sales by the population in Q.4, which has extended into 2005.

The net sales of foreign cash, as a source of the capital inflow, has had a **further potential**, as the volume of cash USD savings by the Russian population is estimated at $30-40 bn.

- In contrast to 2003-04, in **2000-02** the population was a net buyer of foreign cash, hence, contributing $800-900 million per year to the capital outflow
- In **1996-97**, when "dollarization" of the economy reached its peak, the foreign cash purchases amounted to $9-13 bn

In **2005** de-dollarisation (here, the conversion of foreign currency savings into the rubles) of the economy is likely to continue, given expected further ruble strengthening.

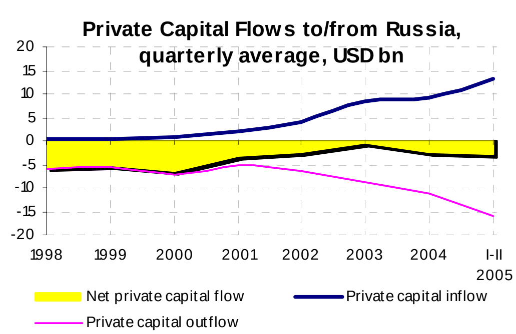
Foreign exchange rate dynamics was the most sensitive issue for the capital inflows

In 2004 a certain slowdown of the private capital inflow and acceleration of the outflow was triggered by the **interruption of nominal ruble appreciation** against the USD, which lasted more than a year until February 2004, and after a period of stability the ruble weakened from April to August. This ruble weakening was a result of **deliberate measures of the Russian monetary authorities** (rather than a deterioration of any economic fundamentals), which committed not to allow excess ruble appreciation and to limit real effective ruble appreciation by 7% in 2004. Particularly, the monetary authorities announced certain restrictions on short-term speculative foreign capital inflow to the country. The process of a gradual **increase of interest rates in the U.S.** also contributed to the acceleration of the capital flow out of Russia and the slowdown of the inflow.

However, the **resumption of a nominal ruble rise** against the USD and the quick **market accommodation** to the relatively gentle regulatory restrictions led to a **new wave of the foreign capital inflow** in Q.4 2004 and Q. 1 2005. In the **second quarter 2005** a slowdown (which, we believe, was temporary) of the capital inflow could be again related to a ruble weakening against the USD, as a reflection of the global USD strengthening. At the same time, the ruble rose against the euro, reflecting EUR/USD trend and continuing to appreciate in real terms against a trade-weighted foreign currency basket.

***Net private capital outflow** dropped nominally, but its level remained relatively high*

As a result, in H.1 2005 the **net private capital outflow** from Russia dropped to $5.6 bn compared with $10.4 bn in H.1 2004. The quarterly average net outflow rose to $2.8 bn compared with $2.4 bn previous year, being considerably lower than the quarterly averages in 1998-2002 ($2.3-5.6 bn), although higher than in 2003 ($0.4 bn) (table 1).



In January-June the net private capital outflow from Russia dropped **relative to the current account surplus** to 12% from 39% in H.1 2004 and 16% on average in 2004, although being higher than the record low level of 2003—4.9%. In 1999-2002 the net outflow was between 31-86% of the surplus.

We **expect a further increase of the private capital flow to Russia** at the expense of, above all, longer-term investments including the FDI. In 2005 we expect the capital inflow of at least $48 bn and a reduction of the net outflow to around $7 bn from $9.4 bn in 2004.

<u>Current account and foreign trade surpluses</u> to hit new record highs in 2005 on soaring oil prices

We have revised our **current account surplus and foreign trade surplus forecasts 2005** up to $88 bn from $69 bn and $118 bn from $99 bn, respectively (table 1 and chart 5) due to the revision of the average Urals blend crude oil price, expected this year, up to $47 p/b from $42 p/b and the revision up of the expected export volume for some important export items (iron ore, pig iron, steel products and timber).

- The base scenario implies a higher (than in 2004) average world price on the main export item—crude oil—$47 p/b (see also below)
- Along with higher exports, other factors—continuing **economic growth** in Russia and real **ruble appreciation** are likely to stimulate further intensive growth of the import volumes
  - ❖ In 2005 GDP growth is expected at 5.8%. The ruble is likely to appreciate in real terms by 8% against the USD in addition to 76% in 2000-04, and around 15% against the euro after 5.3% in 2004.
- An increase in the **net private investment income outflow** will restrain only to a small extent, the current account surplus rise

Forecast <u>scenarios</u> rest on oil prices

Depending on the average crude oil price (Urals blend) in the world market, we **forecast the current account surplus** as follows:

- $71 bn (10%) at the price of $40 p/b
- $88 bn (12%) at the price of $47 p/b (base scenario)
- $104 bn (13.9% of GDP) at the price of $54 p/b

Under the same scenarios, the **foreign trade surplus** is forecasted at $102 bn, $118 bn and $134 bn.

The balance of payments to change its shape

Overall, in the mid-term Russia's balance of payments is likely to demonstrate a gradual **substitution** of a net foreign **inflow through the current account for** a net foreign **capital inflow**. This is more typical for the growing economy with the appreciating national currency, fiscal and political stability and improving credit ratings.