RUSSIA

Quarterly Forecast Report *Q1 2001*

Report on Politics, the Economy, and Key Economic Sectors

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RUSSIA: MACROECONOMIC DATA AND FORECASTS

	1993	1994	1995	1996	1997	1998	1999	2000e	2001f	2002f
Population (mn)	148.2	148.0	148.1	147.7	147.1	146.5	145.8	145.3	144.8	144.3
Nominal GDP (RUBbn)	172	611	1,541	2,146	2,479	2,696	4,546	5,858	7,154	8,515
Nominal GDP (US$bn)	172.9	278.7	337.9	419.0	428.5	277.8	184.6	209.2	253.2	279.2
GDP per capita (US$)	1,167	1,883	2,282	2,837	2,913	1,896	1,266	1,440	1,749	1,935
Real GDP growth, % y-o-y	-8.7	-13.0	-4.0	-3.4	0.9	-4.9	3.2	6.5	3.5	3.5
Industrial production (% y-o-y, period average)	-14.1	-20.9	-3.3	-4.0	2.0	-5.2	8.1	9.5	5.0	5.0
ILO unemployment (%, end period)	6.1	7.8	9.0	10.0	11.2	13.3	12.2	10.3	10.0	12.0
Primary fiscal balance (RUBbn)	-	-	-30.6	-48.8	-65.4	-27.4	88.4	292.9	250.4	212.9
Primary fiscal balance (% of GDP)	-	-	-2.0	-2.3	-2.6	-1.0	1.9	5.0	3.5	2.5
Federal budget balance (RUBbn)	-	-	-85.2	-173.3	-183.2	-134.2	-74.2	58.6	-35.8	-42.6
Federal budget balance (% of GDP)	-	-	-5.5	-8.1	-7.4	-5.0	-1.6	1.0	-0.5	-0.5
Consumer prices (% y-o-y, end period)	839.9	215.1	131.3	21.8	11.0	84.4	36.5	20.0	17.0	14.0
Consumer prices (% y-o-y, period average)	874.6	307.6	197.5	47.7	14.7	27.7	85.7	21.0	18.0	15.0
Exchange rate (RUB/US$, end period)	1.247	3.550	4.640	5.560	5.960	20.650	27.000	28.000	29.000	32.000
Exchange rate (RUB/US$, period average)	0.992	2.191	4.559	5.121	5.785	9.705	24.620	28.000	28.250	30.500
Refinance rate (% per annum, end period)	210.0	180.0	160.0	48.0	28.0	60.0	55.0	25.0	22.0	19.0
Money supply, M2 (RUBmn, end period)	32,601	97,800	220,800	288,300	374,100	448,300	704,700	1,127,520	1,465,776	1,832,220
Money supply, M2 (% y-o-y, end period)	409.4	200.0	125.8	33.7	26.7	19.8	57.2	60.0	30.0	25.0
Customs exports (fob, US$bn)	44.3	67.5	81.1	88.6	88.2	74.2	74.7	104.5	91.4	95.1
Customs imports (cif, US$bn)	32.8	50.5	60.8	68.8	73.7	59.1	40.4	45.5	52.3	61.2
Customs trade balance (fob-cif, US$bn)	11.5	17.0	20.2	19.8	14.5	15.1	34.3	59.1	39.1	33.9
Current account balance (US$bn)	12.79	8.85	8.03	12.45	2.55	1.04	24.96	46.80	25.50	22.00
Current account (% of GDP)	7.4	3.2	2.4	3.0	0.6	0.4	13.5	22.4	10.1	7.9
Foreign debt stock (US$bn, end period)	111.73	121.48	120.44	125.17	125.65	145.00	155.00	149.00	152.00	156.00
Foreign debt stock (% of GDP, end period)	64.6	43.6	35.6	29.9	29.3	52.2	84.0	71.2	60.0	55.9
Foreign exchange reserves (US$bn)	5.8	4.0	14.4	11.2	12.9	7.8	8.5	24.5	28.0	30.0
Import cover (months)	-	0.7	1.9	1.4	1.5	1.0	1.6	4.8	4.9	4.7

e/f = BMI estimate/forecast. Source: CBR/IMF/Russian Economic Trends/Goskomstat/BMI.

chapter 1 Political Outlook

Domestic Political Outlook

All Change?

The candidates reportedly in the lead for Prime Minister Kasyanov's job in the event of a cabinet reshuffle appear to differ widely in their political and economic outlook.

Rumours of an impending change in prime minister have returned with a vengeance, prompted by President Vladimir Putin's criticism of the government's performance. Although such talk is the stock-in-trade of the Russian political scene, there is a reason for this: fact, under Putin's erratic predecessor Boris Yeltsin, often proved to be stranger than fiction. Indeed, it is only a year ago that Yeltsin put a fitting end to a decade of government sackings and reshuffles with the shock announcement of his own resignation on New Year's Eve. It is to be hoped that Putin will promote greater political stability than his predecessor, especially with a raft of economic reforms awaiting discussion and approval, but sooner or later he will want to stamp his own personal authority on the scene he inherited. It is therefore well worth considering the possible options.

It would not all be bad news if Prime Minister Mikhail Kasyanov were to be sacked. Putting to one side the inevitable interruption to government work in the short-term, this would be a key sign of the declining influence of the so-called "Family" – the nepotistic Yeltsin-era group which is believed to have brought Putin to power in an attempt to safeguard its interests. And the disruption might not even be that great, given that Kasyanov has not assumed a dominant role in economic policymaking, with Minister for Economic Development and Trade German Gref seeming to be more influential. The question is – whether any of the alternatives to Kasyanov would be more favourable.

This time around, secretary of the increasingly powerful Security Council, Sergei Ivanov (a close friend of Putin and, like him, a KGB veteran) is still seen as a leading contender to replace Kasyanov. However, Gref appears to have fallen from the reckoning (he is, after all, a very unpopular minister, especially with the Communists) and many consider Deputy Prime Minister and Finance Minister Alexei Kudrin, like Gref a liberal economist from

Putin's St Petersburg days, to be a more likely candidate. Yet in late 2000, Kudrin's star appeared to falter, culminating in his questioning by St Petersburg prosecutors over financial practices during his days as deputy mayor, although he was subsequently cleared. This appears to be the clearest sign so far that a behind-the-scenes power struggle is underway to replace Kasyanov, the generally accepted interpretation of the development being that Ivanov and his group was behind it.

Ivanov does not seem to be a particularly encouraging candidate. Although he is not a well-known public figure, his KGB background suggests a certain mind-set, and there are already concerns about a more authoritarian bent under Putin. The concern also would be that he may not be particularly favourably disposed to economic liberalisation. Although he appears at present to have the upper hand in the political jockeying, Putin may for this very reason be wary of promoting Ivanov given the administration's declared intention to pursue economic reform. The victory of Kudrin's St Petersburg group, who have had time to prove their reformist mettle, would provide a much more encouraging signal to the outside world.

Media Freedom Fears Heightened

*Media magnate Vladimir Gusinsky has handed over a dominant share of the NTV television network to **Gazprom**.*

Concerns about media freedom in Russia have been heightened by oligarch Vladimir Gusinsky's agreement to hand over a dominant 46% of the NTV television network to gas giant **Gazprom**. NTV is part of Russia's only independent media group, **Media-Most**, which has been exposed to political pressure by a US$473mn debt owed to the state-dominated Gazprom. An agreement has been reached to sell a stake in NTV to a foreign investor to prevent it falling under Gazprom's control – Gazprom is also entitled to a 19% stake in the company pledged as collateral on debts falling due in 2001 – but no apparent progress has been made on finding a buyer. The authorities have subsequently had Gusinsky arrested in Spain on the original embezzlement charges which led to his temporary incerceration in June. To cap its problems, a Moscow district tax authority has filed for NTV to be liquidated.

The future of fellow-oligarch Boris Berezovsky's 49% stake in television network ORT continues to be in doubt. In an apparent bid to outwit Kremlin pressure, Berezovsky – currently abroad in defiance of a summons to answer to charges of financial wrongdoing – had announced a plan to hand over his shares to a group of journalists, but this has subsequently been withdrawn.

Foreign Policy

Swings And Roundabouts

Relations with the US under the new administration of George W Bush are expected to be more strained, although a thawing of ties with Western Europe has provided a certain counterbalance.

President Vladimir Putin's busy schedule of foreign travel continued apace in Q4 00, culminating in a groundbreaking visit to Cuba in December. This was the first visit by a Russian leader since the collapse of the former Soviet Union to the country which continues to a maintain a Communist regime in the face of a US trade embargo. The distinct impression is of a move under Putin to a more diverse Russian foreign policy after the Western-dominated policy of the Yeltsin years, and of a leader keeping his options open against the backdrop of a new US administration. Putin's foreign agenda also fits in with his desire to rebuild Russia's status on the world stage after ten years of pretty much constant humiliation.

All this does not necessarily mean that the West is facing a more directly threatening Russia from a security point of view, but a Russia keen to serve its self-interest. However, it does create more room for dispute with the West in cases where Russia wishes to pursue its commercial and economic interests in regions of the world deemed unacceptable by the US. Rumbling friction over Russian ties with Iran appeared to reach some kind of resolution in December when Moscow was reported to have given assurances that it would only sell defensive weapons to Tehran.

Russia, for its part, is likely to find a more difficult bed-fellow in President George W Bush than under the previous Democrat administration. In addition to a greater hesitancy to engage in the outside world in general, the Republicans have singled out the Democrats' policy towards Russia for particular criticism. Their view – for which there is some justification – is that US official involvement in Russia to promote democracy and the market has back-fired by fostering more corruption than ever in Russia's robber baron economy.

One thing that the two sides will need to address, however, is defence policy. The Russians have made it clear that they wish reductions in nuclear weaponry to be high on the agenda of the incoming US administration. An important stimulus for this is Putin's desire to reform the military. The shambolic state of Russia's armed forces has become evident after their inability to secure a victory in Chechnya and August 2000's Kursk nuclear submarine disaster. In November, the Security Council agreed to reduce the armed forces by a fifth over the next five years with the intention of creating a better-trained, better-equipped force more suitable for tackling the perceived threat from Islamic terror groups, especially in Central Asia. In this context, the size of Russia's nuclear arsenal is a clear burden. The Americans, too, have an interest in defence negotiations, with the Bush administration apparently keen to proceed with plans for a National Missile Defence (NMD) system which would supposedly shield the US from attack by so-called 'rogue states'. There is scope for a trade-off here, with Russia lifting its opposition to amending the 1972 anti-ballistic missile (ABM) treaty to allow for NMD in exchange for bilateral cuts in nuclear weapons. However, the concern is that although the Bush camp has also expressed its desire to cut nuclear weapons, it will go ahead with its NMD plans with little consultation with the Russians.

By contrast, Russia's relations with Western Europe are undergoing a thaw after the severe strains caused by the renewed Chechen conflict and Nato's 1999 campaign against Yugoslavia. The improving relations were underlined by an EU-Russia summit in October 2000, at which Russia's participation in the EU's new common security and foreign policy (seen by Moscow as a counterweight to Nato) was discussed alongside the possibility of sharply boosting Europe's imports of Russian energy *(see Key Economic Sectors)*. Indeed, the summit, and host-country France's acquiescence in the warming of ties – it has been one of the greatest critics of the Russian campaign in Chechnya – has confirmed that Europe is loath to let the war stand in the way of relations with Russia, especially with the surge in the global price of oil making it keen to find alternative energy sources to Opec.

chapter 2 Economic Outlook

Overview

IMF Yet To Be Convinced

The government has yet to convince the IMF of its ability to fulfil reform pledges.

With attention having been focused on the admittedly ground-breaking tax overhaul achieved in 2000, the multitude of other structural reforms pledged by the administration of President Vladmir Putin has been put in the background. But this needs to change. Economic growth is starting to slow, providing a poignant reminder that the Russian economy will not escape from its post-Soviet slump unless further concerted reform is undertaken.

This point has been highlighted by the IMF. In the concluding remarks of its latest Article IV consultations with the Russian authorities, the Fund praised the country's strong recovery in economic growth and greater financial stability, but emphasised that major factors behind these – in particular a favourable external environment – are essentially short-term. And, while delivering top marks to the aims of the economic programme approved by the government in June, the Fund cautioned that many of the policies had officially been in the authorities' in-tray for years, but had not been implemented due to resistance from vested interests. The message to the new government is that the onus is still very much on it to prove that it can break Russia's history of reform aversion. The IMF argued that if the government hoped to receive renewed support – withdrawn in 1999 for reform failures – it would need to implement "strong up-front measures" in areas including tax reform, restructuring of the banking sector, measures to reduce economy-wide barter and arrears, and improved governance and transparency in policymaking.

Hopes that the IMF and the Russian authorities were nevertheless moving closer were dashed by the results of an IMF mission to the country in November. The Fund is said to have been surprised that the two sides seemed unable to reach agreement on macroeconomic policy, let alone deeper structural reforms. In particular, the mission found the authorities vague on their approach to one of their main challenges: formulating a non-inflationary policy to prevent the strong current account situation from harming economic growth. As regards structural issues, slow progress in restructuring the banking sector and reforming the monopolies is said to have been a particular sticking point.

With the performance of the fiscal and external sectors so positive that the authorities are managing to meet their external debt obligations unaided, both the government and the IMF have made it clear that any new form of backing would be of a precautionary nature. The country is also strong enough to cope next year without a restructuring or rescheduling of its debt to the Paris Club of sovereign creditors *(see External Debt)*, for which the IMF's blessing is required. Nevertheless, the authorities would be extremely unwise to be complacent, given a more uncertain medium-term picture for the economy. Moreover, a reinstatement of IMF support and progress with the Paris Club would give the country a vital international blessing in the eyes of investors and, it is to be hoped, provide a further stimulus to reform, both of which are vital to the economy for the medium term.

Economic Activity

Awaiting A Slowdown

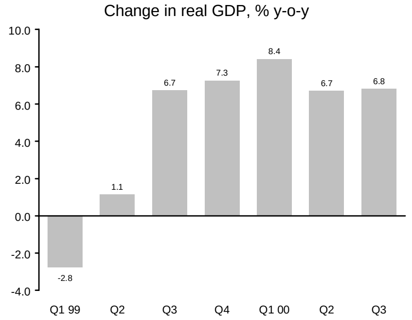
Real GDP growth will have comfortably met our 6.5% full-year 2000 forecast, but 2001 is expected to be tougher as the temporary boosts of devaluation and high oil prices wane.

The 7.3% y-o-y real GDP growth achieved in the first nine months of 2000 strongly suggests that economic growth will have comfortably met our 6.5% full-year estimate, with the government's latest 7.0% expectation not unreasonable.

Real GDP growth slowed in H2 00, as had been generally anticipated, with the base effect less favourable than earlier in the year. However, with the average price of oil – a crucial export – having jumped by around US$3/barrel from the first-half average, Q3 00 real y-o-y GDP growth was still around 6.8%, according to our calculations. This is even fractionally higher than the 6.7% Q2 rate after growth of 8.4% in Q1.

Expected To Slow

Change in real GDP, % y-o-y



Source: Russian Economic Trends, Russian government, BMI.

Reflecting the overall GDP trend, industry witnessed a slowing during the course of 2000 but nevertheless continued to post strong growth, boosted by import substitution in the aftermath of 1998's massive rouble devaluation. The State Statistics Committee (Goskomstat) put y-o-y industrial production growth at 8.6% in Q3, compared with 8.5% in Q2 and 11.3% in Q1. In the first 11 months of the year, production was up by 9.6%, less impressive than the peaks reached earlier in the year, but still robust enough to put **BMI**'s

7.3% full-year growth forecast in need of revision. A higher pace even than the 8.1% growth posted in 1999 – in the immediate post-crisis recovery – is now looking likely. We are estimating 9.5%.

Although external sector dynamics (high oil prices, import substitution) clearly provided the key to 2000's economic expansion, recovery also spread to domestic demand. Since first rising in year-on-year terms in October 1999, real consumption of goods and services has been on an accelerating trend, and increased by 8.5% in January-August 2000. Consumption has been encouraged by rising wages: the real average monthly wage due rose by 24.0% y-o-y in the first eight months of 2000, and both the government and the enterprise sector have been reducing wage arrears. The unemployment rate has also been moderating, standing, according to the International Labour Organisation (ILO) definition, at 10.0% in October, down from 12.0% in January and 12.1% a year previously. Nevertheless, consumption still remains around 13% lower than its pre-1998 crisis level, and in mid-year 27.6% of the population was deemed to be living below the subsistence level, compared with 22.5% two years previously.

The rise of investment has been more impressive yet. Positive growth in real expenditures on new construction and equipment kicked in in mid-1999 and has also been on a rising trend. In the first eight months of 2000, it was up by 17.3% on the year, making it around 20% higher than the pre-crisis level.

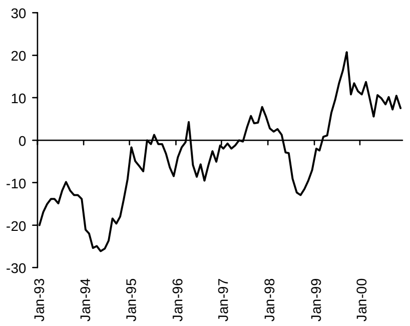
However, the authorities may not have long to bask in the reflected glow of by far the highest level of economic growth since the collapse of the Soviet system (indeed, 2000 will have been only the third year in post-Soviet Russia in which positive growth has been recorded). In October, **Moscow Narodny Bank**'s Purchasing Managers' Index, which is intended as a leading indicator for the economy as a whole, was at its lowest since the beginning of the year in October. Although the survey indicated that the manufacturing sector is continuing to grow, the bank concluded that expansion is beginning to slow, and attributed this to slowing demand for Russian exports (albeit somewhat offset by robust domestic demand) and increasing input prices

GROWTH AND OUTPUT							
	1996	1997	1998	1999	2000e	2001f	2002f
Nominal GDP (RUBbn)	2,146	2,479	2,696	4,546	5,858	7,154	8,515
Nominal GDP (US$bn)	419.0	428.5	277.8	184.6	209.2	253.2	279.2
GDP per capita (US$)	2,837	2,913	1,896	1,266	1,440	1,749	1,935
Real GDP growth, % y-o-y	-3.4	0.9	-4.9	3.2	6.5	3.5	3.5

f = BMI forecast.

Boosted By Import Substitution

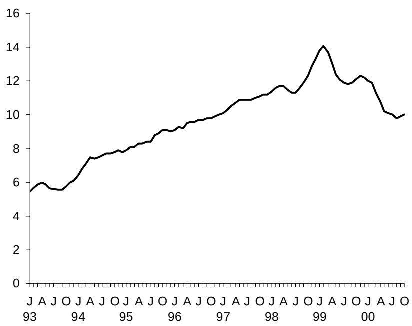
Industrial production, % change y-o-y



Source: Russian Economic Trends, Goskomstat.

Coming Down

ILO unemployment, %



Source: Russian Economic Trends, Goskomstat.

(reflecting oil and other commodities' prices).

The survey provides further support for the slowdown in economic growth which is widely anticipated in 2001. While household consumption and investment should continue to recover, we are anticipating a deterioration in the external accounts in 2001 due largely to the likely fall in oil prices, although imports growth will also pick up moderately.

Fiscal Policy

2000 Budget Comfortably On Track …

Data for the first 11 months of 2000 indicate that the authorities should have easily attained their budget targets.

Public finances continue to blossom, boosted by the high oil price and strong economic growth in general. The budget posted a RUB144.4bn surplus in the first 11 months of 2000, according to preliminary Finance Ministry figures, equivalent to 2.7% of GDP. The primary surplus was an impressive RUB309.2bn, or 5.7% of GDP. The authorities should therefore have significantly bettered the 2000 budget's 1.0% of GDP deficit target and may even have improved on the 1.0% surplus which **BMI** has estimated (using the broader IMF definition).

… 2001 Out-turn More Uncertain

The outlook for 2001 is more uncertain, given the importance of oil prices, the unknown impact of the tax reform and failure so far to secure a rescheduling of Paris Club debt.

The government's 2001 budget proposal with both revenues and expenditures targeted at RUB1,194bn received the approval of the lower house of parliament (Duma) in a fourth and final reading in mid-December, its generally problem-free passage again emphasising the markedly more constructive relationship between the legislature and the executive under Putin. The budget should therefore be in place by the end of 2000, providing that the regional governors sitting in parliament's upper house, the Federation Council, do not sabotage it out of pique at Putin's reduction of their powers.

2000's positive budget out-turn sets a favourable backdrop to the achieve-

FISCAL DEFICIT

	1996	1997	1998	1999	2000e	2001f	2002f
Primary fiscal balance (RUBbn)	-48.8	-65.4	-27.4	88.4	292.9	250.4	212.9
Primary fiscal balance (% of GDP)	-2.3	-2.6	-1.0	1.9	5.0	3.5	2.5
Federal budget balance (RUBbn)	-173.3	-183.2	-134.2	-74.2	58.6	-35.8	-42.6
Federal budget balance (% of GDP)	-8.1	-7.4	-5.0	-1.6	1.0	-0.5	-0.5

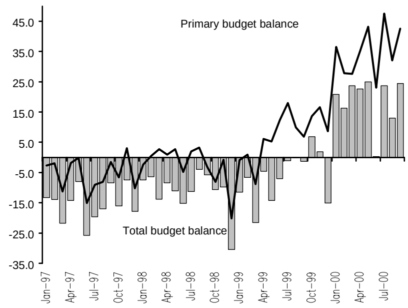
f = BMI forecast.

ment of the 2001 target, but there is cause for uncertainty for a number of reasons. On the one hand, the 2001 revenue forecast is widely considered to be conservative, given that the average price of oil looks likely to be higher than the US$18-19/b assumed by the government (**BMI** is forecasting US$22/b). The budget's 12% end-year consumer price inflation forecast is also looking on the low side (we are expecting it to be nearer 17%), which should boost revenues. This sunny outlook has prompted the IMF to warn the government against an uncontrolled increase in spending, and that additional funds should be used to implement reforms and paying off debt.

However, against this must be set the uncertainty surrounding the impact of the tax reform to be implemented from the start of 2001. Moreover, there is the possibility that the government will not reach an agreement with the IMF or Paris Club; the budget assumes US$4.8bn in foreign credits and makes no allowance for the roughly US$3bn due to the Paris Club in 2001. Some of the shortfall could be made up for by higher-than-expected oil-related revenues, (although the current deal with the Duma is that extra revenues below RUB70bn should be divided equally between paying foreign debt and domestic spending, and that any amount above RUB70bn would be cut up 70-30). Nevertheless, the government has said that it may be forced to revise the budget.

Improvement Is Dramatic

Primary & total federal budget balance, RUBbn



Source: Russian Economic Trends.

Monetary & Exchange Rate Policy

Disinflation Momentum May Falter

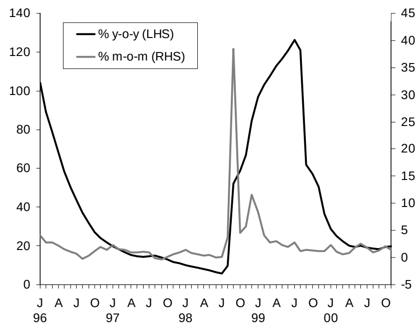
Consumer price inflation should have ended 2000 more or less in line with recent expectations – significantly down from 36.5% at the end of 1999 and in the general region of the 18% assumed in the 2000 budget. Nevertheless, this will have been a poorer out-turn than had seemed possible earlier on in the year.

In 2001, the authorities risk failing to build on 2000's disinflation unless a more concerted policy for sterilisation is implemented.

The headline inflation rate rose in November for the second month in a row, to 19.7% from 19.4% in October, according to our calculations, and, if Goskomstat's forecast for December is accurate, will have remained at roughly the same level in December. **BMI** estimates a 20% end-2000 rate. Although the worst fears about a money supply-induced rise in inflation did not materialise in 2000, the IMF has argued that the Central Bank of Russia (CBR)'s sustained intervention in the foreign exchange market to contain the rouble's current account-led appreciation has been "associated with some uptick in inflation".

Can Disinflation Continue?

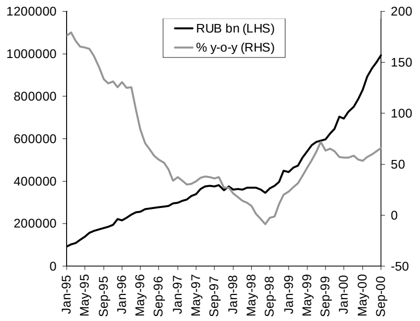
Consumer price inflation



Source: Russian Economic Trends, Goskomstat, BMI.

Starting To Be A Problem

M2 money supply



Source: Russian Economic Trends.

The concern now is for inflation trends in 2001. Money supply growth has continued to rise: the y-o-y increase in M2 reached 66.1% in September 2000, up from 63.3% a year previously. The IMF has expressed concern that the government and the CBR have not overcome differences to implement a concerted policy on sterilising foreign currency inflows. Indeed, it appears that no final decision has been reached on restructuring the Finance Ministry's debts to the CBR into marketable securities. In addition, the CBR still does not have the right to issue its own bonds. In light of the lack of progress on such issues, the IMF is said to be forecasting an end-2001 inflation rate of up to 20%.

Balance Of Payments

Projections Modified – For The Better

***BMI** has revised its expectations for the 2000 current account surplus upwards slightly to 22.4% of GDP, incorporating a significant upwards revision of expected exports growth. Our forecast for the 2001 current account surplus is virtually unchanged at 10.1% of GDP.*

The current account surplus fell to US$10.8bn in Q2 00 from US$12.2bn in Q1. Nevertheless, it was still equivalent to a massive 20% of GDP, according to **BMI**'s calculations. This compares with 25% in Q100 and 10% (US$4.2bn) in Q2 99.

The current account situation has been turned around abruptly by the 1998 economic crisis. In the latter part of 1998 and in 1999, the dramatic improvement was propelled overwhelmingly by an immediate and sharp fall in imports in reaction to the rouble devaluation. Indeed, exports only showed their first positive year-on-year growth since the crisis in Q3 99. High international prices for several of Russia's main exports such as oil, gas and metals have, however, been the key to the real take-off of the current account surplus in 2000. Q2 exports jumped by 45.6% y-o-y, down moderately from 56.2% in Q1. Imports, meanwhile, have continued to be constrained and increased by just 2.8% y-o-y in Q2, following 8.3% growth in the previous quarter.

Given their exceptionally robust performance, we have raised our expecta-

INFLATION AND EXCHANGE RATES

	1996	1997	1998	1999	2000e	2001f	2002f
Consumer prices (% y-o-y, end period)	21.8	11.0	84.4	36.5	20.0	17.0	14.0
Consumer prices (% y-o-y, period average)	47.7	14.7	27.7	85.7	21.0	18.0	15.0
Exchange rate (RUB/US$, end period)	5.560	5.960	20.650	27.000	28.000	29.000	32.000
Exchange rate (RUB/US$, period average)	5.121	5.785	9.705	24.620	28.000	28.250	30.500

f = BMI forecast.

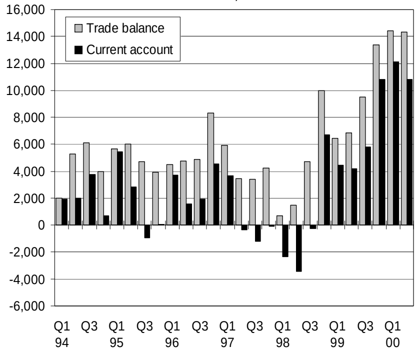
tion for full-year 2000 exports growth to 40% from 20%, which should have taken them to around US$105bn. Also, given marginally higher-than-expected expansion, we are estimating full-year imports growth of 12.5%, up from our previous 10% forecast. This suggests a US$59bn merchandise trade surplus. Making adjustments for balance of payments purposes and factoring in a poorer showing than in 1999 from the remaining current account components, the 2000 current account surplus is likely to have been in the region of US$46.8bn, or a startling 22.4% of GDP, up again from 1999's record 13.5% surplus.

In 2001, **BMI** is expecting the average Opec basket oil price to fall to US$22/b (revised upwards from US$20/b), down from the US$28/b now expected for 2000 (revised upwards from US$25/b). After 2000's oil revenue-related surge, and with a slowing of economic growth in key export markets and real exchange rate appreciation, we are anticipating a year-on-year fall in exports of around 13%. Imports have already turned around significantly in 2000 from the massive 20% fall seen in 1998. We are expecting import growth to increase moderately to 15% in 2001, taking the merchandise trade balance down to US$39.1bn, and the current account surplus to US$25.5bn or 10.1% of GDP.

The latest balance of payments figures confirm that foreign direct investment (FDI), meagre at the best of times, has yet to recover from the additional blow imparted by the 1998 economic crisis. In Q2 00, direct investments into Russia amounted to a paltry US$517mn, down from US$751mn in Q2 99. Following an equally poor performance in the first quarter of the year, foreign investment fell to US$1.086bn in H1 00 from US$1.393bn a year previously. A certain time delay before improved sentiment towards Russia filters through into investment on the ground was to be expected, and **BMI** is still expecting a rise in FDI in 2001. Even assuming that political and economic stability continues, and that the government pursues the economic and legal reforms needed to make Russia a less risky destination for foreign investment, a jump in foreign investment to levels more commensurate with Russia's size and natural resources still hinges on the government improving

Surplus To Remain High In 2001

Current account, US$mn



Source: Russian Economic Trends, Central Bank of Russia.

CUSTOMS TRADE AND BALANCE OF PAYMENTS	1996	1997	1998	1999	2000e	2001f	2002f
Customs exports (fob, US$bn)	88.6	88.2	74.2	74.7	104.5	91.3	95.1
Customs imports (cif, US$bn)	68.8	73.7	59.1	40.4	45.5	52.3	61.2
Customs trade balance (fob-cif, US$bn)	19.8	14.5	15.1	34.3	59.1	39.1	33.9
Current account balance (US$bn)	12.45	2.55	1.04	24.96	46.80	25.50	22.00
Current account (% of GDP)	3.0	0.6	0.4	13.5	22.4	10.1	7.9

f = BMI forecast.

the legislation surrounding production sharing agreements (PSAs), with particular relevance for the oil sector *(see Key Economic Sectors)*.

External Debt

Paris Club Deal Still Elusive

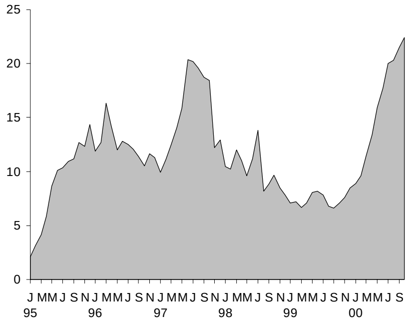
Slow progress in negotiations with the IMF is delaying talks with the Paris Club of sovereign creditors on rescheduling Russia's debt.

The government's slow progress in reaching an agreement with the IMF has clear implications for the external debt situation. Without such an agreement, the Paris Club of sovereign creditors is markedly less likely to heed Russia's overtures for another debt rescheduling like that agreed for 1999-2000, let alone a restructuring, which was the authorities' original hope.

There has been no suggestion that the Russians would turn their backs on their debt obligations if negotiations with the IMF and the Paris Club fail. The speculation has been made, however, that, providing relations with the IMF and the Paris Club are making progress, the authorities might make a technical default when the first large Paris Club payment falls due in February 2000, on the assumption that the Paris Club would be understanding. This would not best serve the country in its attempts to boost its reputation as a borrower, especially in light of its surging economic performance which has given it the ability to pay, and with the rating agencies gradually improving their assessment of the country. Paying off foreign debts would also help in the fight to sterilise strong foreign currency inflows.

Helping Improve Russia's Credit Rating

Gross international reserves (excluding gold), US$bn



Source: Russian Economic Trends.

As we had anticipated, **Moody's** credit rating agency has followed **Fitch IBCA**'s Q3 upgrade of Russia's long-term foreign currency credit rating. In November, it announced a one-notch upgrade to B2 from B3 and awarded it a stable outlook. This puts Moody's rating on a par with Fitch's B rating, leaving only **Standard & Poor's** (S&P) one level below on B-. With the exception of a possible S&P upgrade to match the other two major agencies (with the stable outlook on its current rating suggesting that such a move is not imminent), **BMI** is not expecting any further upgrades soon. While noting the significant economic recovery since the 1998 crisis and the beginnings of structural reform, Moody's emphasised the large number of

FOREIGN RESERVES

	1996	1997	1998	1999	2000e	2001f	2002f
Foreign exchange reserves (US$bn)	11.2	12.9	7.8	8.5	24.5	28.0	30.0
Import cover (months)	1.4	1.5	1.0	1.6	4.8	4.9	4.7

f = BMI forecast.

reforms still to be undertaken and, that in its assessment of Russia, it would be focussing on “the restructuring of the banking system, the affects on the real economy of policies which determine the exchange rate and rate of inflation, and the private sector’s rate of fixed capital formation”. And, while uncertainties remain about the latter two factors, it can be said unequivocally that restructuring of the banking sector is going nowhere fast. Fitch was also wary, when announcing its upgrade, of assuming that a new era of economic reform is assured in Russia.

chapter 3 Key Economic Sectors

Overview

Mixed Fortunes

The external sector was the driving force of economic growth in 2000. Imports remained limited by the 1998 rouble devaluation, but exports also grew much more rapidly than initially expected, and their growth was to a large extent due to soaring oil prices. With the price of oil already beginning to fall, we therefore examine in this issue how far the industry has taken the opportunity to prepare itself for harder times. External price developments in 2000 were not favourable for all sectors of Russia's commodity-based economy. Consequently, we follow with a look at how the gold industry has coped after global prices fell to 20-year lows in 1999.

External factors brought mixed fortunes for Russia's sectors, the key beneficiary in 2000 having been the oil industry.

The opportunities and challenges facing the Russian economy from beyond its borders have not just been related to prices, and we finish our review with the aluminium sector, in which monumental changes were inspired in 2000 by the waning of the 'tolling' system which had allowed the sector to reorient itself to the external market in the immediate post-Soviet period.

Oil

Starting To Invest

The rouble devaluation and the soaring global price of oil have been a huge boon for the Russian oil sector, and a small share of the windfall profits is beginning to find its way into investment. Chronic post-Soviet under-investment is one of the greatest challenges facing the oil industry, although this was due to oligarchs buying up the sector in the 1990s and diverting earnings to other interests, rather than to underlying unprofitability, as has been the case with many other sectors of the economy. Output had fallen to 6.18mn b/d in 1999 from 11.14mn b/d ten years previously, and there have been warnings of a further significant decline.

Windfall profits reaped from the rouble devaluation and the high global price of oil are finally being invested, but this is only the beginning of what is needed.

With most costs in roubles and earnings in US dollars, the oil sector has been the prime beneficiary of the 1998 devaluation, and has reaped further rewards from rising world oil prices since 1998. The country's second largest oil company, **Yukos**, reported net profits of US$1.37bn in H100 (according to generally accepted accounting principles, or GAAP) against US$1.15bn for full-year 1999. Oil companies have tried to take advantage of rising prices by ramping up production and exports as much as possible – domestic prices are significantly lower than international ones – but there is limited room for manoeuvre. The concern is what happens now that oil prices are beginning to fall again. Some companies are beginning to invest for the future. Oil major **Sibneft** has announced that it will nearly triple capital expenditure to US$595mn in 2001. Yukos has also attributed an increase in production in the first nine months of 2000 in part to increased investment. Nevertheless, greater amounts are needed, with some estimates putting the amount of investment required by the sector over the next five years at US$25-40bn. This compares with total investment in 1999 of just US$3bn. Companies are aware of the need for foreign capital, from the international markets and in the form of direct investment.

Share Plans Turn Thoughts To Transparency

The major companies' plans to list their shares abroad is providing an incentive to introduce greater transparency.

A number of Russia's largest oil companies have announced plans to issue shares abroad. This has necessitated moves to clean up their act, and transparency and corporate governance have become the new buzz-words for the industry. Yukos has announced plans to issue American Depositary Receipts (ADRs) by June 2001 – following a consolidation of the company by the beginning of 2001 – possibly for around 5% of the stock. The company is recovering from a severe setback during the 1998 crisis, when its shares were used as collateral against doomed **Menatep Bank**. It is attempting to make its finances more transparent and improve investor relations – a long-running feud with US investor Kenneth Dart had been a significant drain on sentiment, although its resolution still leaves many investors unconvinced. **Tyumen Oil Company** (TNK – recently declared to be the world's best oil company in 2000 by the *Financial Times Group*) has also said that it plans to sell ADRs in late 2001 or early 2002, perhaps for as much as 10-15% of the company or US$600mn, after consolidating by as early as mid-2001. This is to be accompanied by the issue of rouble-denominated bonds and Eurobonds over 2001-02.

However, although there are notable exceptions such as **Surgutneftegaz**, Russia's oil sector is still a murky world, including in terms of ownership (of all the oil majors, the ownership structure of Sibneft is probably the least transparent, although it is believed that oligarchs Boris Berezovsky and

Roman Abramovich are important shareholders). The country's largest oil company, **LUKoil**, has declared its intention to list on the New York Stock Exchange, but surging profits appear to have persuaded its management that the procedure can be delayed until autumn 2001. It apparently, therefore, felt in no rush to adopt GAAP (a trend initiated by Sibneft and one of the preconditions for a listing), but seems to have backed down in response to shareholder disquiet, and has said that the GAAP reports should be ready by the end of 2000.

Moves towards greater transparency in the Russian oil sector have been set in motion. However, just how much transparency the listings will guarantee, for example, is another matter: gas monopoly **Gazprom** has been releasing financial statements in line with International Accounting Standards (IAS) since 1998, and is one of the most secretive companies in Russia.

FDI Needs More Encouragement

The key to realising the potential of foreign direct investment lies with the Production Sharing Agreements.

Russia has failed to realise its potential to attract foreign direct investment (FDI) to its oil sector, and there have been some high-profile cases of foreign companies having their fingers badly burned. However, some of the country's largest oil concerns are looking for foreign partners, and Russia is becoming a more attractive proposition in light of the high price of oil and an improving investment climate. Of particular importance is the government's intention to improve legislation on Production Sharing Agreements (PSAs), which provide tax breaks for foreign companies involved in exploiting Russia's natural resources. The aim is to simplify and speed the procedure and reduce the risks for foreign companies.

The potential of the PSA to attract foreign investors has been illustrated recently by the UK's **BP Amoco**'s revelation that it is engaged in tentative discussions with state-owned oil company **Rosneft** over purchasing some of the latter's 40% stake in the far eastern Sakhalin 1 project. The project is covered by a PSA, providing BP Amoco with much more certainty than it has had in its previous Russian investments (BP's disastrous investment in one of Russia's other leading oil companies, **Sidanko**, has become something of a *cause celebre*, and has yet to be resolved). Nevertheless, given the importance of the industry at stake, it cannot be guaranteed that progress will be easy on the PSAs.

A potentially revolutionary factor for the development of Russia's oil sector is Western Europe's interest in Russian energy supplies as an alternative to Opec. The plan currently being put forward by EU Commission President Romano Prodi would see a 20-year deal under which Europe would help upgrade Russia's oil production and transportation systems – Russia's crumbling pipeline system is a serious hindrance to the sector's development – with a view to doubling the EU's imports of Russian energy. However, plans are at an early stage, and it is not clear how far the EU's increased dialogue with Russia is designed to put political pressure on Opec.

Government Pursues Tougher Line

Government policy is having mixed implications for the sector, promoting greater transparency, but keen to capitalise on high oil prices by raising taxes.

The Putin administration's policies have had mixed implications for the industry. September's privatisation of the smaller **Onako** oil company was a landmark for the economy as a whole, sending an important signal that the days of sell-offs to well-connected businessmen at knockdown prices are on the wane. It raises the hope that the next oil sector privatisations will also be transparent, thereby increasing interest in them. The government is intending to complete the privatisation of LUKoil, and has estimated that the disposal of a 4.5-7.0% stake in the company could raise US$1bn. It also plans to dispose of a blocking stake of 25% plus one share in **Rosneft** and 19.7% of **Slavneft** (the last two big oil companies to be privatised).

The government is also mulling the introduction of an oil export quota system in order to increase transparency in the sector, where the award of export quotas is at the moment to a large extent conducted behind the scenes. The main oil companies have raised objections to changing the system, and are also up in arms over the government's keenness to capitalise on the high oil price by raising taxes. Export duties on both crude oil and refined products were raised several times in 2000, the latest, effective from November, taking the tariff on crude up to EUR34/tonne from EUR27/tonne. To the horror of the oil companies, it looks like further hikes are on the way, but it is worth noting that Russian duties are below the norm in other countries.

Gold

Global Trends Are Not Encouraging

Against a poor outlook globally for gold, Russia has managed to raise output.

The global outlook for the gold sector is poor. In recent years, the metal has increasingly lost its traditional role as ultimate store of value, as central banks have sold off their reserves and investment demand has faltered against a strong US$ and the attraction of bond and stock markets. The price of gold has plummeted, reaching a 20-year low of US$252.8 an ounce in summer 1999. Even the September 1999 agreement between 15 European central banks to restrict gold sales has only had a limited impact in raising prices: towards the end of 2000 it was around US$271 per ounce. And, although non-investment demand for gold – such as for jewellery-making and industrial uses – is expected to rise in the short-term, the key investment demand seems unlikely to rebound unless there is a sharp rise in global economic uncertainty.

Against this unfavourable backdrop, the Russian gold sector has managed to raise output. In 1999, production increased – contrary to initial expectations – for the first time in two years, rising by 10% to 126 tonnes. Output is expected to have risen by a further 15% to around 145 tonnes in 2000 – its highest level in years – and is forecast to remain broadly at this level in 2001. There is scope for a further considerable rise in output. Russia is the sixth-largest producer of gold in the world, but its reserves are second only to South Africa's. However, a shift to more expensive production methods is required. At present, a large share of total output comes from alluvial sources, the so-called 'placers'. These are running out, although they are estimated to provide 60-70 tonnes of gold annually for the next 10-15 years. There are, on the other hand, large unexploited underground gold reserves, which will require considerable investment to develop.

Foreign Investment: Battling Against The Odds

With domestic funds limited, the obvious source of funds to exploit Russia's considerable untapped potential is foreign investment.

Domestic sources of investment are limited, and the Union of Gold Producers recently blamed the 5% export tax imposed in April 1999 for exacerbating the situation. An obvious source of funds is foreign investors. These have already made their mark on the sector. Canadian companies, for example, are estimated to have invested US$500mn in Russia's natural resource sector, 90% of which in gold. And there are plans for more: the **Nevyansk Mining Company** joint venture between Russia's **Uralelektromed** and Canada's **Placer Dome** has announced its intention to raise US$200mn to develop the Nevyansk gold field in the Sverdlovsk region. A further US$60mn of the venture's own funds is to be invested in the project. However, as is the case with so many other sectors, foreign investment faces its problems. The number of Canadian companies working in Russia is reported to have halved to nine from 18 since 1995, with problems related to taxation, unequal treatment of foreigners and the complicated procedure for exporting having been cited (under the current system, the vast majority of joint venture gold exports have to be conducted through Russian banks).

Increase Achieved

Gold production, tonnes

Source: Union of Gold Producers.

The drawn-out saga over the Sukhoi Log deposit in the Irkutsk region perhaps best illustrates the difficulties faced by foreign investors. A licence to develop the deposit – estimated to be the largest yet to be developed in Eurasia – was originally awarded to Australia's **Star Mining Corp.** in partnership with Russia's **Lenzoloto**. Yet when the latter's privatisation was ruled illegal in 1997, the stake was revoked. More recently, a dispute has emerged between the Ministry of Natural Resources and the Irkutsk administration over whether foreign investors should be allowed to participate at all in a new tender for the deposit. The ministry has said that it does not favour foreign investment in the gold sector at the moment, and that Russian producers should be supported. However, the local authorities believe that domestic companies will be unable to come up with the necessary finance for the project, which has been estimated by Placer Dome and fellow Canadian **Barrick Gold** (both potential bidders) at US$1.5bn. The low gold price has also led to delays in the tender process.

Aluminium

Aluminium Sector Rings The Changes

The aluminium sector has undergone substantial consolidation in 2000, precipitated by the ending of internal tolling.

2000 was a year of consolidation for one of Russia's most important industries. The process was topped in September with the registration of **SUAL Holding**, which brings together producers **Siberian-Urals Aluminium Company** (SUAL) and **Trastkonsalt**. Through its control of four of the country's largest smelters – Irkutsk, Urals, Bogoslovsky and Kandalaksha – SUAL Holding will account for 20% of Russia's total aluminium production. The move follows the ground-breaking formation in April of **Russky Alyuminy** by **Sibirsky Aluminium Group** and a group of shareholders in oil major **Sibneft**. Russky Alyuminy accounts for a massive 80% of the country's output through its control of another four of the country's largest smelters: Bratsk (the largest), Krasnoyarsk, Sayansk and Novokyznetsk. Who actually owns the companies is harder to discern. The whole process, like much of Russian business in the 1990s, has been murky. **Sibirsky Aluminium Group**, which brought the Sayansk smelter and Ukraine's Mykolayivsky alumina plant to Russky Alyuminy, has said recently that it is 70% owned by its president, Oleg Deripaska, and 20% by **MDM Bank** (it did not account for the remaining 10%). Sibneft has said that its shareholders acted in a private capacity when, earlier in 2000, they bought controlling stakes in Bratsk, Krasnoyarsk and the Achinsk alumina plant, apparently from UK-based **Trans-World Group**. However, it can be of no significance that Sibneft is controlled by leading oligarch Roman Abramovich. The issue is further complicated by the fact that in early 2000, a controlling share in Novokyznetsk was bought by **LogoVaz**, a car dealership chain controlled by oligarch Boris Berezovsky, who is also believed to have an interest in Sibneft. The mergers have at various stages required the blessing of the anti-monopoly ministry, suggesting high-level political contacts.

What is certain is that foreign investors have been largely excluded from the industry, with Trans-World Group having sold its stakes in the sector and announced that it will no longer market Russian aluminium.

Investment Plans Detailed

The sector looks likely to now receive some of the much-needed investment which has been denied it during the 1990s.

Although the Russian aluminium sector is profitable, there are important challenges facing the refashioned industry. It has managed to reorient itself extremely successfully to the external sector after the post-Soviet collapse of domestic demand, to the extent that in 1999 about 3.12mn tonnes, or 99% of the 3.15mn tonnes produced were exported. As a result, in 1999 aluminium was Russia's most important export after oil and gas, accounting for 4.9% of total shipments. But, the sector's adaptation to the new conditions was achieved through the practice of 'tolling', under which cash-strapped producers turned in the 1990s to foreign metals traders, such as Trans-World Group, to pay for raw materials such as bauxite and alumina. The trader would then sell the aluminium subsequently produced on the international market and pay the smelter for the processing. The problem was that the foreign trader kept the lion's share of the profit, leaving the Russian smelters – as with much of the rest of the country's industry – without the means to invest. The sector's other weaknesses are that it cannot rely on cheap energy supplies forever, and the shortage of domestic raw materials (around 60% of aluminium exports use imported alumina). The Putin administration's avowed intent to reform the 'natural monopolies' could, therefore, present a problem if the net result is a rise in energy and transportation costs, given the sector's energy-intensive nature (energy accounts for around 30% of the cost of production).

The outlook for the global aluminium industry would seem to be good, provided that production costs can be cut, because, although it has a number of advantages over other metals in relation to weight and versatility, aluminium is expensive. It was the scrapping of the 'internal' tolling system (where the foreign group supplies domestically-produced raw materials) at the beginning of 2000 that led to the withdrawal of Trans-World Group and subsequent consolidation. And there are indications that the new aluminium giants are at least intending to invest and are coming up with development strategies. SUAL Holding has said that it aims to invest US$170mn over the next two years and to increase the share of value-added products. Russky Alyuminy has said that it will invest around US$120mn during the next 10 years to modernise the Krasnoyarsk smelter and expand production by 29,500 tonnes/year over the period (the plant produced 836,500 tonnes in 1999). The company will spend a further US$12mn in 2000-2001 on rebuilding a plant that produces high-quality aluminium, so as to boost output by a further 20,700 tonnes. Russky Alyuminy has yet to detail its plans for the Bratsk plant, but the chief aim is to make it more resource efficient. Even larger output increases are envisaged from the group's alumina holdings. US$40mn is to be invested in the Mykolayivsky plant in Ukraine over the next two years to lift production, which is seen rising to 1.5mn tonnes from 920,000 in 1999, while the Achinsk producer is to benefit from US$14mn in investment. Importantly, although Russky Alyuminy expects aluminium exports in 2001 to be around the same level as this year's, it intends to lift the share of alloys and semi-fabricated products to 15% from the 5% anticipated for this year. SUAL Holding also intends to increase the share of value-added products – a key to boosting the sector's prospects.

chapter 4 Global Assumptions

Global Growth Outlook

Global Economy Starts To Slow

Economic conditions within the G7 area have become less favourable and this trend is likely to continue in 2001. It is increasingly probable that the growth rate peaked in H1 00 and that the global economy is now entering a cyclical slowdown. Indeed, while retail spending remains firm, consumers are being hit by the combination of higher energy prices and interest rates. Asset price falls have primarily been limited to the high-tech sector, but this will still have some impact on consumer confidence and spending growth is likely to slow. The evidence at this stage is still mixed, however, with money supply growth still above the long-term average. This could suggest that there is still potential for above trend growth in 2001 and a significant inflation threat.

A cyclical slowdown in the developed economies is under way and is likely to last until end-2001. Global recession should be avoided, however, especially as interest rates look close to peaking.

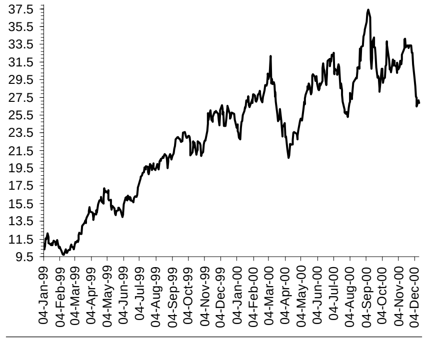
Credit Concerns Will Increase

The severity of any downturn will also be influenced by the credit and banking cycle, particularly in the USA. Credit conditions have tightened and fears of a full-scale credit crunch have increased. The banking sector will continue to be a major focus during H1 01 amid fears of rising bad loans.

There is a risk of a hard landing, reflecting concern over deteriorating credit quality. Oil prices need to remain below US$30/b by Q2 01 to minimise the threat. Developments in the USA will remain crucial to the global economy.

The downturn will also be sharper than expected if oil prices remain high. Although they fell below US$30/b in early-December, there is still a risk of winter spikes. While Opec has not ruled out a further increase in output in H1 01 if market conditions tighten, this is now less likely and **BMI** expects to see a gradual contraction of Opec supply in 2001. A fall in oil prices fall in H1 01, will go some way toward cushioning the global economy from a potential hard landing. In these circumstances, consumption patterns will be little changed. However, should prices remain high – due to a larger-than-warranted supply withdrawal from Opec, or stronger-than-anticipated global growth – the downturn in the industrial sector could be compounded by weaker private consumption.

On A Downward Curve?
Brent Crude, US$/b



Source: Reuters/BMI.

United States

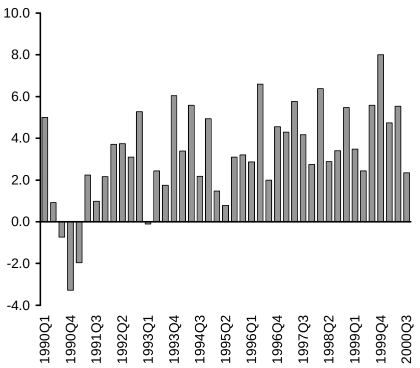
US Investment Set To Slow

A cooling in investment spending and less buoyant stock market conditions will slow the US economy. At present, the odds still favour a soft landing, given the improved underlying performance, but there are risks to this favourable outcome.

GDP rose at a revised annualised rate of 2.4% in Q3 00 compared with an original 2.7% estimate and 5.6% in Q2. Government spending accounted for 0.6% of growth in Q3 compared with a net addition of 0.8% in Q2. Housing construction fell sharply and growth in corporate profitability and housing investment was also the slowest for more than a year. A key foundation for the extended US expansion has been the positive influence of rising profits and investment on productivity and growth. The US economy has performed remarkably well over the past few years, proving resilient to changing circumstances, but there will now be greater concern that this favourable cycle is starting to wane.

The Slowdown Has Arrived

Quarter-on-quarter GDP growth, annualised rate, %



Source: Bureau of Economic Analysis, BMI.

The signs of potential difficulties in the corporate sector have continued to intensify, particularly in the high-yield junk bond market. Yield spreads over US Treasuries have increased to around 700 basis points, wider than that seen during the 1998 market turbulence. There has also been a substantial increase in the number of credit downgrades and a tightening of lending standards. Companies will find it more difficult to raise funds for expansion and this will restrict their ability to invest. Commercial banks have been reporting a rise in problem loans at a time of strong GDP growth and record profitability. This suggests that lending standards were poor during the heyday of the boom and that, although they have been tightened up more recently, banks have accumulated large stocks of loans that will turn bad when the US economy slows. It also points to serious stresses within the banking sector if the US economy does suffer a recession.

Interest Rates Should Have Peaked

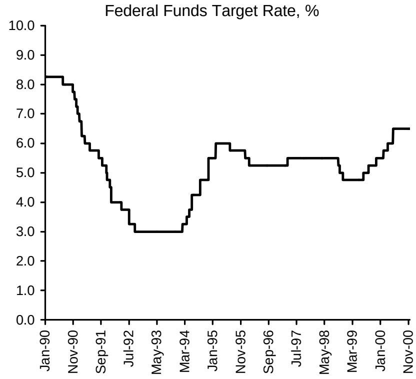
The Federal Reserve should be able to avoid a further increase in interest rates, but cuts could be delayed until the second quarter, especially if the dollar weakens.

Consumer inflation remained at a five-year high of around 3.5% in October, but there has still been relatively little increase in the core inflation rate. There is now evidence that the labour market is softening slightly, with weekly jobless claims rising to an 18-month high. The Federal Reserve remains concerned at the potential impact of a tight labour market on wages and inflation, but these fears should ease during the next year. There is increasing market optimism that the Fed will be able to cut interest rates early next year and there should be a shift to a neutral bias at the next Federal Open Markets Committee meeting.

The Fed will need to tread carefully as it has been criticised for creating the impression that it will put a floor under share prices. It will not want rate cuts to be used as a tool aimed at preventing a sharp decline in asset prices as this could perpetuate artificially high market valuations. If the US currency fell sharply, it is possible that the Fed would have to put up rates in an attempt to curb inflation. Historically, however, the Fed has preferred to let the dollar depreciate during a downturn and it will be reluctant to sanction a credit tightening to defend the currency.

Downhill From Here

Federal Funds Target Rate, %



Source: Federal Reserve, BMI.

Legal Battles Undermine Presidency

The incoming US president, George W Bush, will have a weak mandate and legal battles surrounding the hotly-contested presidential election result will undermine his legitimacy. Historically, this has not usually posed significant difficulties, but the position this time will be complicated by the near deadlock in congress. There is a 50-50 tie in the senate and the Republicans only have a tiny majority in the House of Representatives. The line of least resistance would be to push ahead with tax cuts, but also boost social spending. This could compromise the budget position, especially if the US economy suffers a hard landing. The markets have generally welcomed congressional inertia over the past four years as it has prevented the adoption of controversial policies. It is doubtful, however, whether markets would respond so well to paralysis.

The incoming president will face near deadlock in congress and the strong fiscal performance could be squandered.

Euro-Zone

Euro-Zone Growth Will Level Out

Latest figures for the euro-zone economy continue to suggest that the growth rate is slowing. The German IFO index slipped to 97.2 in October from 98 the previous month and euro-zone GDP growth slowed to an annual rate of 3.4% in Q3 00 from 3.7% in Q2. There has been a downturn in French confidence and the Italian economy is also struggling to make any headway. There is still momentum in the peripheral countries such as Ireland and Finland, but these countries have a small weighting in the overall euro-zone economy. Domestic demand is still relatively firm and in the short term at least the manufacturing sector will be able to take advantage of the weak euro.

Growth in the euro-zone will moderate, especially with high energy prices, but monetary policy is not overly restrictive and a rapid slowdown is unlikely.

Consumer inflation remains above the European Central Bank's (ECB's) 2% target, at 2.7% in October. Energy prices are still high but, although the core inflation has edged up to 1.5%, there is still no sign of a serious increase in the underlying inflation rate. Money supply growth has also peaked at around 5.5%, close to the ECB's target range. Provided the euro can be stabilised, there is now a reduced threat of further aggressive monetary tightening by the ECB. A 0.25% rate increase is possible early next year, but rates should now be capped at 5%.

US Slowdown Will Help Euro

Reduced enthusiasm for the US economy and assets will improve the prospects of a sustainable euro rally, although the single currency still faces major hurdles.

The ECB has continued to intervene to protect the value of the euro, but there has been no further assistance from the USA. Market sentiment towards the euro has strengthened to some extent, reflecting increasing evidence that the US economy is slowing. Indeed, it is probable that the euro-zone growth rate was stronger than the US in Q3 00. Even if the USA can secure a soft landing, its growth rate is unlikely to be significantly higher than the euro-zone in 2001, in sharp contrast to the position since 1998. There have been further portfolio capital outflows from Europe, but there has certainly been a deceleration.

There will be less take-over activity in the telecoms sector, especially as

GLOBAL ASSUMPTIONS

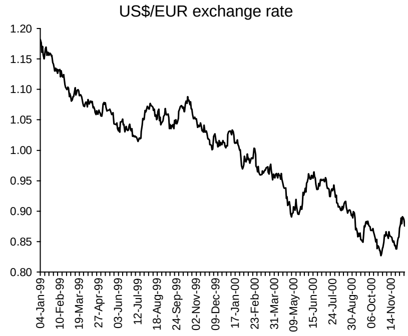
		1997	1998	1999	2000	2001	2002
Real GDP growth (%)	USA	3.9	4.3	4.2	5.2	3.3	3.0
	Euro-Zone	2.7	2.7	2.5	3.4	3.0	2.9
	Japan	1.4	-2.8	1.0	1.7	1.8	2.0
Consumer inflation (average)	USA	2.3	1.6	2.1	3.4	3.0	2.8
	Euro-Zone	2.0	1.2	1.2	2.6	2.1	1.9
	Japan	1.4	0.6	-0.3	-0.5	0.1	0.6
Current Account (US$ bn)	USA	-144	-221	-331	-450	-420	-380
	Euro-Zone	95	87	15	20	25	15
	Japan	95	121	107	95	100	75
Short-term Interest rates	USA	5.6	5.4	5.2	6.4	6.1	5.7
(3-mth average)	Euro-Zone	3.3	3.5	3.0	4.5	4.8	4.0
	Japan	0.6	0.7	0.3	0.3	0.6	1.0
Long-term Interest rates (10-yr average)	USA	6.3	5.3	5.6	6.1	6.5	6.3
Exchange rates (end year)	US$/EUR	1.13	1.18	1.00	0.90	1.05	1.12
	JPY/US$	121	113	102	112	105	125
Commodity prices (average)	Gold - US$/oz	331	294	279	275	270	280
	Oil - Opec basket US$/b	18.77	12.28	17.47	28.0	22.0	18.0
	Copper - US cents per lb	103.1	75	71.4	83.6	88	85

Source: BMI.

financing has become tighter, and the downturn in US markets should curb enthusiasm for US assets. The more favourable capital flow trend should, therefore, be sustained over the next few months. The euro will still face major challenges over the next few years, but the euro-zone is not suffering from serious imbalances and there is a greater probability that there will be a sustainable rally in the euro.

The Only Way Is Up, Surely

US$/EUR exchange rate



Source: Reuters.

Japan

Deflation Will Persist In Japan

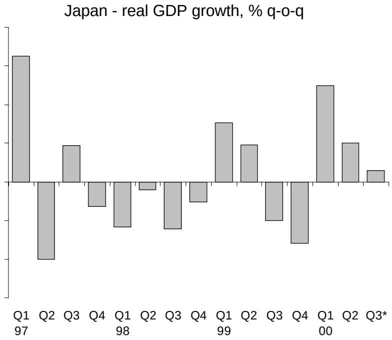
The Japanese economy is still stuck in a low growth cycle and the risk of deflation persists.

GDP growth estimates for fiscal year 1999/2000 have been revised to 1.4% from 0.5% after the adoption of revised calculation methods, which give greater emphasis to technology spending and diminish the impact of traditional industries. The economy is, however, still struggling to achieve a sustainable growth rate above 2% and there is little evidence that the position will change in the short term. The industrial sector is still performing relatively well and manufacturers will gain from the weaker yen, but output growth has slowed to 3.4% with a monthly dip in October.

Household consumption is still falling at an annualised rate of around 4% and consumer confidence remains weak. GDP recorded annualised growth of 1.0% in Q3. There is little prospect of a short-term increase in business investment and the economy is still gripped by deflation. Tokyo prices fell 1.1% in the year to November and the Bank of Japan expects consumer prices to fall over the next year. This price weakness is even more surprising given that energy prices have risen sharply and the yen has weakened. The deflationary threat has raised fears that the economy will sink back into recession during 2001. The Bank of Japan is still being criticised for its August monetary tightening and the government has threatened to strip the bank of its autonomy on interest rates. It will also push for Governor Masaru Hayami to be dismissed if the economy falters again. There will be further progress on economic reform; but, if the pace does not accelerate, it is most likely that any beneficial impact will be overshadowed by a cyclical slowdown.

Dragged Down By Weak Consumption

Japan - real GDP growth, % q-o-q



**Calculated using a new method that excludes the effect of leap years and includes software investment. Source: IMF/Economic Planning Agency.*

In the short term, the government will retain an expansionary fiscal policy. The government has passed a JPY4.78trn supplementary budget package and it will also issue an additional JPY2trn in bonds. Total bond issuance this year is likely to be at least JPY87trn. The debt/GDP ratio will be comfortably above 130% in 2001 and it will reach 150% by 2003. The government has had no difficulty in financing the deficit and government bond yields are still below 2%. There is, however, little prospect of the government sustaining the expansionary fiscal policy in the medium term. The economy will, therefore, need another force to drive growth within the next two years. In the long term, a shift to an expansionary policy and weaker yen will be needed.

Weak Government Will Slow Reform

Weak government is set to continue in the short term, despite increasing evidence of longer-term reform momentum.

Prime Minister Yoshiro Mori has survived the latest challenge to his leadership despite very weak internal and external support. Mori's approval ratings are stuck below 20% and these levels have usually signalled an early change of government. Reformist Koichi Kato's challenge failed, however, as he eventually abstained from the no-confidence motion after his rebel group were threatened with dismissal from the Liberal Democratic Party (LDP). Mori's victory primarily reflected the party's desire to avoid a potentially fatal split rather than confidence in the prime minister. The LDP is too weak to govern with any conviction, but is also still too strong to be removed from power. There is some sign that reform momentum is gathering pace and a generational shift in Japanese politics is underway. Radical political and economic reform is, however, still unlikely in the short term.