



Russia

Russia's budgetary surplus almost tripled in 2005 as the country continued to benefit from increasing prices for natural resources. EBRD investment helped to diversify the Russian economy and to support the development of the private sector.



◀ Prostor pharmacy in Moscow is one of the many enterprises to have received loans through the EBRD's Russia Small Business Fund.

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International reserves of the Central Bank reached a record high in 2005.

Investment climate

Growth in the Russian economy slipped to 6.4 per cent in 2005 from 7.1 per cent in 2004 as a result of a marked slow-down in industrial production from 7.4 per cent in 2004 to 4 per cent in 2005. Growth in oil production and exports slowed sharply. Investment growth also declined somewhat although there was some pick-up in the second half of the year. However, the slow-down has been balanced by increasing oil prices.

Government revenues remained extremely buoyant on the back of further increases in the world prices of Russia's major export commodities. The consolidated budget surplus reached US\$ 33.5 billion in the first half of the year, nearly three times higher than in the same period in 2004. Preliminary estimates indicate a full-year budget surplus of over 7 per cent of gross domestic product (GDP) against an initial target of 1.5 per cent.

Stabilisation fund assets increased to US\$ 43 billion at the end of 2005. This was despite the use of US\$ 15.1 billion of assets to pay some of the country's US\$ 40 billion Paris Club debt. The authorities also fully repaid the US\$ 3.3 billion debt to the International Monetary Fund. Inflationary pressures decreased slightly, with the consumer price index reaching 10.9 per cent by the end of 2005, compared with 11.7 per cent at the end of 2004. This reflected increased liquidity inflows and expansion of the money supply in tandem with increases in regulated prices, such as utility tariffs.

High prices for natural resources drove the current account surplus in 2005 to around 12 per cent of GDP. International reserves of the Central Bank reached another record high of US\$ 182 billion by the end of 2005. Despite remaining political uncertainties, the Central Bank of Russia estimates that gross inflows of foreign direct investment (FDI) to the non-financial sector reached a record US\$ 16.7 billion and that private external transactions recorded a net inflow over the year.

State intervention in the economy and centralisation of decision-making increased during the year. The scope of the private sector was scaled back as the state reasserted control over Gazprom (and its various banking and media holdings), Gutabank and the bulk of assets owned by the Yukos oil company. Market liberalisation also suffered a setback through a wide-ranging and selective campaign by the tax authorities to recover unpaid taxes. In addition, high-ranking state officials were appointed to the boards of state-owned enterprises and regulations were tightened in sectors considered "strategic" by the authorities.

The adverse impact of these measures on the general business climate was partially offset by the country's continued robust macroeconomic performance and the abundant liquidity stemming from substantial inflows of capital. Russia has been given an investment grade rating by the three main commercial rating institutions, and Russian companies and banks increasingly have access to international capital markets. However, the returning confidence may owe more to the surge in oil prices than to institutional reforms.



Progress in administrative reforms was mixed and judicial reform has slowed down. Corruption, according to several sources, continues to be a systemic problem, as highlighted by many of the respondents to the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS). However, significant advances were made in banking sector reform during the year. The authorities adopted a new banking strategy in April, a deposit insurance scheme was set up and international financial reporting standards have become obligatory for banks.

A new concession law was designed to boost private investment in infrastructure and to ensure effective use of state and municipally owned property. Credit bureaux have been introduced to bring about greater stability and credibility in the Russian financial market. A new law on special economic zones introduced in 2005 aims to apply favourable conditions to businesses in specific regions. This includes the waiving of custom duties for foreign manufactured goods.

EBRD investment

In 2005 the EBRD invested in 39 projects in Russia totalling €1.1 billion. This represents a 26 per cent share of the Bank's total investments for the year – a slight decline on 2004. This brings our total cumulative commitments in Russia to €7.2 billion. Gross disbursements in 2005 amounted to €681 million.

One of the year's major innovations was the launch of the Bank's first rouble bond, which raised 5 billion roubles (€140 million) in May 2005 to provide long-term loans free of exchange risk for Russian projects. The first bond and first floating-rate note launched on the domestic market by an international issuer was made possible by the creation of the Moscow Prime Offered Rate, a new transparent local money market index providing a transparent benchmark for bank loans. The demand for rouble loans has since grown substantially and the Bank is therefore expected to revisit the Russian bond market in 2006.

In line with its mandate, the EBRD once again used its investments to foster the development of the Russian private sector. As always, our projects also attracted significant additional investment from foreign investors. This trend was also reflected in syndicated co-financings where the EBRD maintained its strong position as a leader, supporting borrowers in a broad range of projects.

In the manufacturing sector the EBRD became a partner in the Toyota Motor Corporation's first Russian venture, investing €24 million in the assembly plant being built outside St Petersburg (see page 64). The deal is a good illustration of the EBRD's commitment to help diversify the Russian economy. The Bank also provided support for the first major investment in Russia by the world's largest aluminium group, lending €25 million for the refurbishment of two regional rolling mills bought by Alcoa.

Success story

Revvng up Russia's car industry

There is no denying that some of Russia's domestically produced family cars have seen better days. It is not an uncommon sight to see drivers at the side of the road peering despairingly under the bonnets of their beloved Soviet-era Ladas that have finally given up the ghost.

Once a status symbol with a decade's waiting list, the original Fiat range of Ladas with their 1966-vintage design are now looking more like a collector's item than a means of transportation.

So the opening of the new environmentally friendly Toyota plant outside St Petersburg, in which the EBRD is making an equity investment of up to €24 million, could hardly be more timely.

Currently, only 157 Russians in a thousand are car owners, well below the Polish average of 250.

This may change when the first Toyota Camry sedan, rated the most reliable car in recent years, rolls off the assembly line in late 2007.

President Vladimir Putin has warmly welcomed Toyota Russia and its €156 million investment in St Petersburg, praising the creation of at least 500 new jobs and stressing the important contribution of the EBRD. "I would like to highlight the role of the EBRD, our long-term partner, which is taking a 20 per cent stake in this project," said the President at the press launch last year.



Analysts believe that Toyota Russia (fully controlled by Toyota Motor Corporation, now the world's second-largest car giant) has got its timing right, opening production in Russia at just the right moment to gain access to what will be a fast-developing car market, expected to be worth €29 billion a year by 2010. The initial annual run of 20,000 Camrys might well increase to 200,000 in the long term as the local plant may be expanded with further investments.

Recent changes in tariffs on imported parts mean that manufacturing on site will reduce the price dramatically from today's cost of US\$ 31,000, including the 25 per cent import tax. Yet, despite the big mark-up, Toyota sold 46,000 imported cars in Russia in 2004 via its Moscow-based sales company, nearly double the total of the previous year.

In the years to come, it is predicted that Russians will be looking for cars priced between US\$ 10,000 and US\$ 20,000 so the Camry, at around US\$ 21,000, is well-placed to succeed at the top end of the market.

Obviously, Toyota will set a high standard of good engineering, management and manufacturing practice for the domestic market to emulate. "By showing other companies the real success of Toyota, we hope to create a favourable climate for increased investment in the Russian economy, which will lead to Russia's economic growth, expansion of the automobile market and development of the auto industry in Russia," said Tokuichi Uranishi, Toyota's Executive Vice President.

The EBRD has already invested €364 million in the Russian auto sector. The Toyota project represents the Bank's second investment in a "greenfield" car production plant in Russia over the past four years.

Setting the industry benchmark

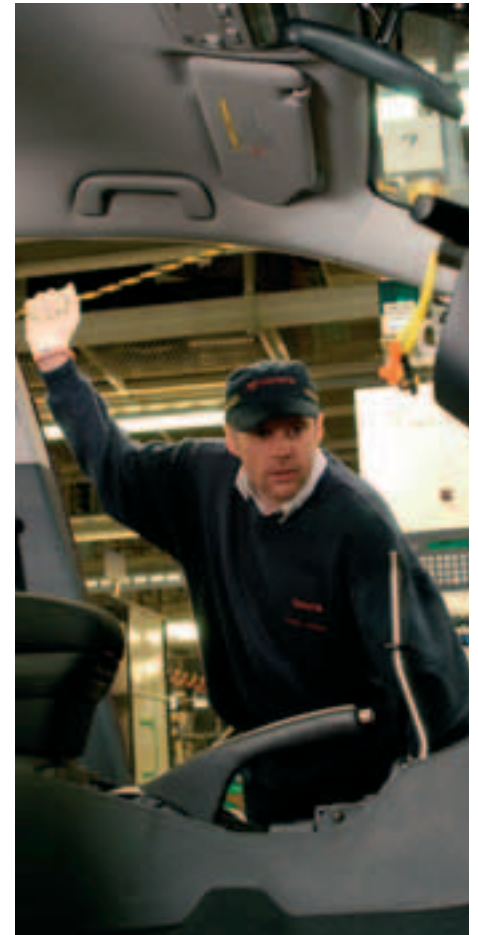
The car giant that started in 1933 as Toyoda Automatic Loom currently has production bases in 26 countries, a sales network covering more than 140 countries and more than 260,000 employees worldwide. Automotive sales reached US\$ 164 billion in 2004.

The company has been renowned for its pioneering innovation and efficiency since the introduction of the "Toyota Production System" in 1970. Many of Toyota's manufacturing practices (such as "kaizen", "jidoka", "just-in-time" and "heijunka") have become industry standards.

Kaizen or "continuous improvement" is the process of tiny incremental improvements aiming to eliminate costly waste by teaching individuals the skills to improve the process. Jidoka or "automation with a human touch" means building in quality as the materials are produced, requiring all workers to stop production whenever they see anything suspicious.

Just-in-time requires all areas of production to be ready to move on to the next stage at all times to meet variations in customer demand. Heijunka or "evening out the production schedule" is a process of monitoring the volume and mix of produced items to eliminate any unnecessary production.

As well as raising the bar for production processes in the car industry, Toyota is at the forefront in setting environmental standards. The company is, for example, the first car manufacturer to mass-produce hybrid cars, which run on both a rechargeable battery and fuel, making them the environmentally friendly car of the future.



A major innovation in 2005 was the launch of the EBRD's first rouble bond.

In the infrastructure sector, 2005 saw the completion of the St Petersburg Southwest Waste Water Treatment Plant, inaugurated by the Presidents of Russia and Finland and the Prime Minister of Sweden. The beneficiaries of this international project to cut the amount of untreated sewage water pouring into the Baltic Sea are the 50 million people living around its shores. Of the plant's total cost of €138 million, the EBRD lent €35 million, which was earmarked to fund construction work. In 2005 the Bank also lent €20 million for the construction of a similar plant at the northern edge of St Petersburg. A €9 million loan to renew the water and heating systems in the Siberian city of Surgut was the first new project to use funds raised by the groundbreaking EBRD rouble bond.

In the energy field the EBRD lent the rouble equivalent of €147 million to Russia's electricity transmission monopoly, the Federal Grid Company, as part of the Bank's continuing support for the wide-ranging reform of the power sector launched in 2001. The project will significantly increase electricity flows from Siberia and the Urals in the east towards central Russia, and will make it possible to provide greater power supplies for the Caucasus region.

In addition, the Bank lent the rouble equivalent of €85 million to Mosenergo, Russia's largest electricity generating company, mainly to help it refurbish the plants which provide heat and power for Moscow and the surrounding region (see page 19). Both projects will contribute to reducing losses and increasing

the quality and reliability of supply, a key issue highlighted by the major blackout which hit Moscow and its surrounding region in May 2005.

In the financial field the EBRD is now working with 35 financial institutions in Russia, including some of the largest nationwide banks. Support was provided in 2005 through loans and equity investments and through a number of innovative financing mechanisms.

Among the firsts for the EBRD and the financial market in 2005 were the Bank's participation in a Russian securitisation transaction with Russian Standard Bank (see page 15), a €44 million loan to Promsvyazbank in local currency and a syndicated loan arranged by the EBRD for a specialist mortgage institution, DeltaCredit Bank. Support for developing the residential mortgage industry was also provided through a €27 million loan to Rosbank and a €43 million framework to help smaller banks introduce mortgage products, particularly in the regions.

The EBRD continued to invest in banks, with an equity participation in Hansa Bank and capital increases to support the strong growth of Sibacadembank and Center-Invest Bank. Loans were provided to new regional bank partners in Vladivostok, Ekaterinburg and Kazan. The EBRD's ability to provide rouble funding was a key factor for such banks, whose small business clients do not generally have access to hard currency earnings.

EBRD investments in 2005

€1.1
billion

Share of the Bank's total investments in 2005

26%

Total EBRD investments since 1991

€7.2
billion

The EBRD also continued to provide support to micro and small enterprises (MSEs) through the Russia Small Business Fund (RSBF), which has now disbursed over 290,000 loans totalling more than €2.2 billion. Funding for the RSBF consists of EBRD financing and donor grants from the G-7 governments, the European Community and Switzerland. With the help of the RSBF, specialist MSE finance departments have been set up in over 270 bank branches and outlets in 144 cities across Russia.

Further support for small business was provided through the EBRD's TurnAround Management (TAM) and Business Advisory Services (BAS) Programmes, which are active in north-west Russia and the Russian Far East. During 2005, 10 TAM projects and 99 BAS projects were started. In north-west Russia, BAS is focusing its support outside St Petersburg. In Far East Russia the BAS Programme operates in Sakhalin and Khabarovsk in addition to Vladivostok.

Looking ahead

The EBRD remains committed to helping Russia's progress towards an efficient market-based economy and the country's integration into the world economy. Promoting the modernisation and restructuring process as well as the diversification of the Russian economy continue to be important priorities. The Bank also seeks to promote a broader reform agenda through our investments and our policy dialogue with the authorities. EBRD investments in Russia are projected to be €1.2 billion in 2006.

Providing feedback to the authorities on the investment environment, enhancing corporate governance, stimulating transparency, strengthening competition and encouraging good business conduct will be important ways of furthering Russia's reform programme.

Specific challenges include strengthening the financial system and stepping up efforts to support renewable energy by financing key hydro facilities and helping to develop a renewable energy regulatory framework. Strengthening the regional focus of our operations in Russia remains a top priority and the EBRD expects to open a local office in the city of Samara during 2006 and another in the south of Russia.