Lull before the storm: What inflation should we expect this year?

Center of Strategic Investigations Bank of Moscow

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In the past five years the Russian economy has developed steadily. Despite a substantial share of raw materials in Russian exports, economic growth has been fairly stable with an oil price corridor of $45-60 p/bbl. Oil price fluctuations have a more telling impact on budget revenues than on corporate profits, but general economic growth within the emerged oil price corridor will range from 5.5-6.5% annually. Within the set cycle, steadfast development of the economy is already a positive factor, and whether it develops at a pace of 6.0% or 7.0% is not that important.

On the contrary, growth rates in consumer prices (despite inconsistencies in the applied measurement technique) have a sizeable political weight – up to a fraction of a percentage point. All of the President's addresses have referred to inflation and reducing the inflation target. Lowering inflation was identified as the key objective of the CBR's monetary policy. The Ministry of Finance constantly points to the inflation threat – in terms of limitations on budget expenditures and sterilization of oil revenues.

The start of the year looked optimistic to Russia's monetary authorities – consumer prices grew at a much slower pace than a year ago. However, the influx of foreign capital generated by companies and banks under state control fueled the money supply, threatening to propel inflation beyond last year's level.

Price growth picked up speed in June, posting 8.5% growth in the last 12 months and crossing the "red line" of the government target for the current year. Accelerating inflation is only half of the problem. What is worrisome is that it was caused by other factors (e.g. escalating prices for food products). Monetary factors have not yet had any impact – "excess money" is placed with the CBR. However, injections of foreign capital into the economy will inevitably spur inflation and imports.

The inflation threat emerged when the pre-election campaign was in full swing. This scenario was predicted by most analysts – everybody expected "populist growth" in budget expenditures, but few anticipated the poorly reasoned economic steps of the public sector in foreign markets. The efficiency of the State as owner remains out of focus, and the need for well-coordinated steps in raising, using and neutralizing external borrowing remains high on the agenda. Inflation is mounting, but the extent of its sustainability depends on the State.

Monetary program

Forecast without strategy

In late June, the CBR tabled a new version of Monetary Policy Guidelines for 2008 – the document setting the principles and substance of monetary policy for the medium term. The previous version was returned by the State Duma for revision. The situation in the Russian financial sector has changed so radically that principal revisions of the monetary program and balance of payments were required. The reason for this was the powerful influx of capital in the second quarter – net capital inflow in the first six months totaled $67 bln versus the official forecast $35 bln for the year. Logically, other financial sector performance indicators have been eclipsed.

The key targets were revised as follows:

- net international reserves at the end of 2007 were revised upwards (by $22 bln to $418 bln);
- voluntary reserves with the CBR were revised upwards to R1,547 bln as of January 1, 2008 (by R469 bln, or $18 bln);
- the scope of banking system refinancing has been expanded in 2009-2010;
- money supply (M2) growth was revised upwards from 32-34% to 37-39%;
- the net capital inflow forecast was revised upwards by $35 bln in the current year and $10 bln in subsequent years up to 2010;
- the Russian merchandise and services export forecast was slightly revised upwards (by $8.5 bln) and the merchandise and services import forecast was substantially revised upwards (by $18.4 bln).

The last adjustments mean a faster decline in the trade balance than was projected two months ago. In these circumstances, the main source of international resources may be only capital transactions. It is still unclear what will spur foreign investors to increase their investment in Russian assets against the background of a weakening ruble. Seemingly, the CBR “has planned” a capital inflow to make up for the failures in foreign trade. The planned expansion of refinancing of banks is expected to remove the deficit of the resource base and trim banks’ foreign borrowing needs by 2010. According to Bank of Moscow statistical center, if the refinancing mechanism is launched as targeted in the Main Guidelines, the net foreign capital inflow by 2010 may drop to $3-5 bln. Therefore, the capital inflow can be bolstered only by direct investment and borrowing by Russian companies.

What catches the eye is the ease with which the CBR revisits the key parameters of the monetary program and the selective approach to such revision. Thus, the inflation target remained the same (at the upper limit of 8%) and the forecast of key MEDT indicators also remained unchanged, including the forecast of the nominal exchange rate implicitly used by the CBR. A logical question arises: how will the inflation target, which was set when the money supply was growing by 33%, be achieved with the money supply growing by 39%?

Actually, the forecast revision is not underpinned by any medium-term monetary strategy – or at least a monetary program strategy. Such a strategy should not be passive (the monetary program depends on external circumstances, and their change leads to revision of the program). It should be active, i.e. targets are set (money supply, inflation and exchange rate) for the medium term, and the methods to achieve them change in response to the shifting external environment.

Money supply

Case study – possible consequences of foreign capital inflow

The key peculiarity of monetary policy in the first six months of 2007 was a strong influx of foreign capital to Russia. Net capital inflow according to Russia's BOP amounted to $70.3 bln in the first six months of 2007 ($10.4 bln in the first six months of 2006). It is notable that $55 bln was generated in the second quarter. The gross capital inflow totaled $108.9 bln, increasing 2.5-fold versus last year. The bulk of this inflow was generated by the non-financial sector amounting to $71.1 bln ($27.4 bln in the respective period a year ago), whereas the banking sector raised $37.8 bln versus $16.0 bln a year ago.

This extraordinary inflow of foreign capital created a problem for the monetary authorities regarding how to manage the money supply. The deteriorated trade balance somewhat alleviated the pressure – the trade balance in the first six months of 2007 fell to $58.9 bln versus $74.1 bln a year ago.

So far, the foreign capital inflow was temporarily localized (but not sterilized) by the CBR – growth in corporate deposits (banking system liabilities) was matched by growth in bank deposits with the CBR (banking system assets). This situation continued in May-June and did not exert direct influence on inflation (monetary components). Actually, it was a potential monetary overhang, and the ways in which it will be handled may lead to different consequences in the monetary sector. The first signal that this threat may materialize will be a reduction in banks' voluntary reserves with the CBR (and the first signs are already visible). Let us now consider possible scenarios for movement of these funds.

Scenario 1. Funds are moved from CBR accounts into the economy

Under this scenario, domestic demand will expand *pro rata* the foreign capital inflow boosted by growth in bank loans to enterprises and households. It is evident that the expansion of domestic demand in the short term (several months) will spur imports and push up producer prices for final demand products. Even with a steep rise in imports of investment, local enterprises will be unable to enhance their production capacities in such a short period of time.

In money terms, imports in the first six months of 2007 grew 39% y-o-y, and we see no reasons for a slowdown in growth. In the revised version of the monetary program, merchandise and services imports are expected to increase by 30% (20% in the old version), which appears to be a conservative forecast. Additional infusions of $40-50 bln through expanding domestic demand to be covered by imports will raise the growth of imports to a dangerous 50%.

It is obvious that this scenario will not bring down inflation through ruble appreciation. Appreciation of the ruble's nominal exchange rate by 3% may pull inflation down by 1%, but will also give investors an interest premium equal to the same 3%. Undoubtedly, this premium will attract capital (as portfolio investments), further spurring the money supply. Moreover, ruble appreciation will further buoy imports. Therefore, price hikes and growing imports are inevitable under this scenario.

Scenario 2. Sterilization of foreign capital inflow

Under this scenario, foreign capital flows into the economy in restricted volumes, and most of it is sterilized. Foreign capital can be sterilized in two ways – capital outflow and/or capital parked on CBR accounts.

Capital outflow is quite possible based on the experience from 2006. At that time, out of $48.5 bln in gross foreign capital inflow to the banking system, only 20% (about $10 bln) was used to provide credits to the non-financial sector of the economy and the remaining portion was moved into foreign assets ($23.4 bln) and placed on CBR accounts ($13.2

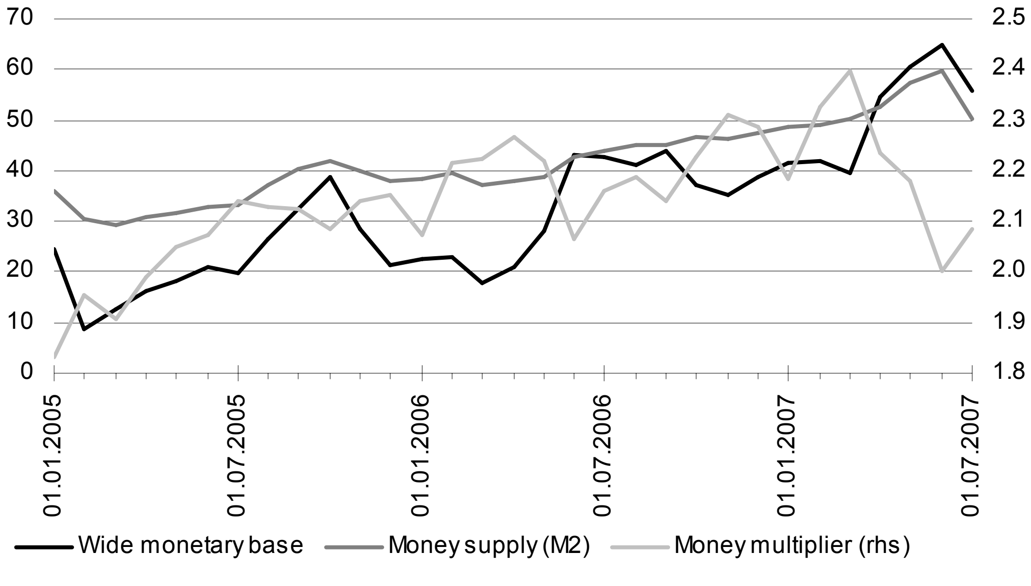
bln, or R344 bln). In the first six months of 2007, the situation unfolded differently – with sizeable growth in gross capital inflow to the banking system, the gross outflow comprised only $0.7 bln (the target was $9.1 bln). Things may change in the second half of the year should Russian banks step up their activities on external markets (for example, possible penetration into the CIS, as stated by VTB), but cardinal shifts seem unlikely.

The implications of this scenario will be contradictory. On the one hand, the net capital inflow will return to the earlier forecast of $40 bln, and the money supply (M2) will return to 29-33%. Inflation will not exceed 8%. On the other hand, a return to the previous monetary program option suggests even now a drop in international reserves (to $396 bln), which, along with capital outflow, jeopardizes stability of the ruble exchange rate.

A more likely option is that most external funds will be accumulated on CBR accounts. The feasibility of this scenario is supported by the updated version of the monetary program – banks' balances with the CBR as of January 1, 2008 should amount to R1,547 bln (R469 bln growth compared to the previous version, or by more than $18 bln). In this way, the CBR makes clear its intention to keep the excess liquidity frozen. By all evidence, the remaining funds will be directed into the economy during the year. We note that state revenues from the sale of YUKOS assets (about R500 bln) are planned to be funneled into public expenditures, and it would not be appropriate to view this amount as additional sterilization.

Form a macroeconomic standpoint, this variant is expected to broaden the net capital inflow in 2007 to $70-80 bln, but the growth in money supply (M2 aggregate) will constitute the old 29-33% due to administrative regulation of the monetary multiplier.

Money multiplier and money aggregates growth rates, in % Y-o-Y



Note. «Administrative» decrease of money multiplier assumes the money supply growth limitation along with increase of banking deposits in Bank of Russia.

Source: CBR, CSI Bank of Moscow.

Inflation

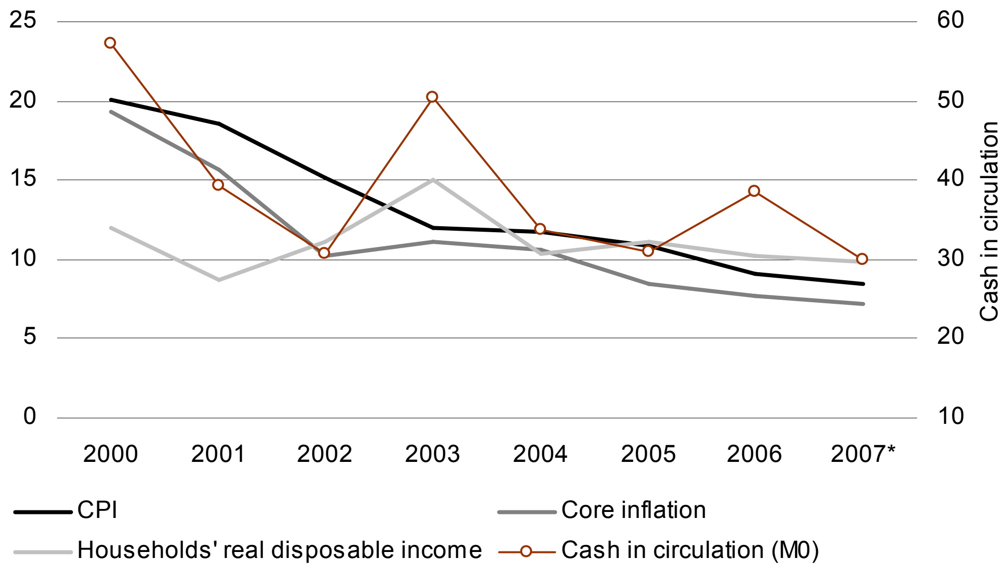
The euphoria of the monetary authorities fed by the decline of inflation at the start of the year has been replaced by anxiety and confusion. Price growth in June totaled 1%, which is the highest indicator in the past five years. Since the start of the year, prices have picked up by 5.7% (vs. 6.2% a year ago). For the past twelve months consumer price inflation stood at 8.5%, which is already ahead of the government target.

The key catalyst for inflation was growth in prices for fruits and vegetables, and amongst the arguments explaining this growth were a drought in Russia's southern regions and the expulsion from markets of vendors who are not Russian citizens (a measure initiated by the government). In our opinion, the major threat lies in the fact that inflation has already accelerated while the effect of money supply growth is not yet being felt. Core inflation (i.e. adjusted for administratively regulated services and seasonal factors, which are most sensitive to the effect of monetary factors) remained at a relatively low level in June (0.4%).

Let us once again look to the old version of the monetary program setting forth the inflation and money supply targets. Two months ago the politically suitable level of 6.5-8% was backed up by 32-34% growth in money supply.

The situation has now changed – the money supply picked up speed, and the inflation target remained the same. Scenarios are possible in which accelerating money supply will not significantly impact inflation. However, the planned growth of cash in circulation is set at 30% this year, and this indicator has a direct effect on price growth. Naturally, households do not save cash and use it as a transacting tool. We estimate that with real disposable household income and retail turnover growing by 10% and 11.8% respectively, core inflation in the current year will settle at 7.0-7.2%. With accumulated inflation of 5.7% in the first six months of 2007, it will be impossible to keep price growth below 8%, either via prices of regulated utilities or other monopolies, or by a strengthening ruble.

Core inflation and affecting factors growth rates, in % Y-o-Y



* – CSI Bank of Moscow forecast.

Source: Russian Statistics Service, CSI Bank of Moscow.

The money supply may contract in certain months, ensuring compliance of money supply growth with the initially planned level. But one of the inflation paradoxes is that a subsiding money supply does not lead to deflation. As a result, tactical mistakes (e.g. a money supply upswing followed by a downswing) result in the same money supply but a different level of inflation than if the money supply had been realized gradually and according to the plan. With identical end results, the inflation levels are different. Indeed, planning and coordination of effort is sometimes more essential than a rainless spell in the south of Russia.

Inflation and Monetary Indicators, in % to previous period

	2006		2007		January-June 2006	January-June 2007
	May	June	May	June		
CPI	0.5	0.3	0.6	1.0	6.2	5.7
Food	0.5	0.0	1.0	1.7	7.0	6.1
Agricultural produce	2.6	-0.6	7.8	12.2	31.5	38.6
Non-food goods	0.4	0.3	0.4	0.3	2.3	2.2
Gasoline prices	0.3	0.3	0.9	0.3	2.6	0.5
Services	0.6	0.7	0.5	0.6	10.0	9.8
Core inflation	0.4	0.3	0.3	0.4	3.9	3.0
Monetary indicators						
Money supply	5.2	6.0	7.0	0.2	17.3	19.2
Currency in circulation	3.4	6.5	1.3	4.6	11.2	8.8
Exchange rate	-1.1	0.4	0.8	-0.3	-5.9	-2.0

Source: Russian Statistics Service, CBR, CSI Bank of Moscow.

Real Sector

Official statistics dispel some gloom over Russian industry

The shamefully low production growth in April (a mere 4.6% y-o-y) was reversed in May by the resolute 6.7% upturn in industrial output. The rebound was largely triggered by recovered growth in electricity, gas and water supply (2.2% in May versus a respective contraction in April) and radical acceleration in the output of manufacturing sectors (from 7.0% in April to 9.4% in May), whereas growth in output of the mining and quarrying sector remained moderate (2% in April and May).

The dominant influence of the manufacturing sectors on Russian industry growth, the slump in growth of some of the manufacturing sectors in April, and controversial growth trends in some of the manufacturing sectors in April and May prompt us to review Russian industry growth for the first two months of the second quarter.

By our estimates, industrial output increased 5.6% y-o-y in April and May. That is a fairly good performance, considering the stagnation in the electricity, gas and water supply sector and the already typical 2% growth in the mining and quarrying sector. The manufacturing sectors slackened their pace from the record highs of the first quarter, but sustained growth at a robust 8.2% (April-May 2007 versus April-May 2006).

Industrial Production Output Growth in January to May 2007, % Y-o-Y

	April-May (actual)	I Quarter	
		Estimate*	Actual
Industrial Production Growth Index	**5.6**	**7.4**	**8.4**
Mining and quarrying	2.0	3.3	4.2
Manufacturing	8.2	11.8	14.5
Final demand sectors	*9.1*	*10.4*	*13.3*
Manufacture of food products	9.4	10.3	13.7
Manufacture of textiles and textile products, manufacture of leather, leather products, shoes	6.4	11.0	12.1
Manufacture of pulp, paper and paper products; publishing and printing	6.1	7.4	10.8
Other sectors	14.1	12.8	12.9
Investment demand sectors	*11.8*	*17.1*	*22.1*
Manufacture of other non-metallic mineral products	15.8	13.4	25.8
Manufacture of machinery and equipment	11.1	17.5	21.1
Intermediate demand sectors	*4.7*	*8.8*	*9.4*
Woodworking and manufacture of timber products	9.3	9.8	11.0
Manufacture of coke, refined petroleum products	1.5	5.5	6.0
Manufacture of chemicals	7.5	9.3	10.6
Manufacture of rubber and plastic products	23.4	24.1	24.1
Manufacture of basic metals and fabricated metal products	2.8	7.8	8.2
Electricity, gas and water supply	-0.2	0.2	-5.7

* – Adjusted for climate factor.

Source: Russian Statistics Service, CSI Bank of Moscow.

In April-May the growth structure of the manufacturing sectors was as follows:

- Investment demand sectors were the growth leaders (in our previous Overview we viewed statistical deceleration in their growth in April as a major threat to steady industrial growth);
- Final demand sectors demonstrated high growth rates;
- Growth of intermediate demand sectors plunged tenfold.

Fears that the faltering growth in *investment demand sectors* would result in new price hikes for their products have proven unsupported so far. Manufacturing of building materials in April-May 2007 rose by 15.8% y-o-y, and output in the machinery and equipment sector picked up by 11.1%. High growth rates in April-May were observed only in manufacturing of transport (18%) and machinery & equipment (8.6%), while the output of electrical equipment inched up by 4.4%, which clearly marks underperformance relative to the investment program implemented by the Russian electricity sector.

In April-May the output of *final demand sectors* increased a convincing 9.1%, or only slightly below the successful growth rate achieved in the first quarter. Sustainable growth was demonstrated only by the food and consumer goods industries, with output of the former light industry slowing each month, signaling the end of production growth in this segment shored up by consumer demand.

Slow growth in *intermediate demand sectors,* including the largest metals producers and oil refineries (the output of which grew a mere 2.8% and 1.5% y-o-y in April-May) not only emphasizes the successful performance of industrial production as a whole, but is actually a reserve for growth acceleration. Current deceleration of growth in these industries may be seen as corrective, caused by a substantial upswing in output in April-May 2006. However, we cannot exclude the impact of industrial policy on growth in the manufacturing of refined petroleum products and metals, which has caused a local imbalance. Intensive growth in transport equipment does not encourage growth in intermediate demand sectors (e.g. metals), as it is oriented towards imported components. Meantime, the oil and gas sector is only weakly responding to the radically improved world prices, losing market incentives for production growth.

In short, Russian industry has confidently resumed growth at a moderate pace. The growth structure is increasingly determined by the policy of the government as owner (putting the brakes on growth in mining and quarrying output, resulting in slower manufacturing of refined petroleum products) and moderator of production ties (faltering growth in intermediate demand sectors). This spring saw the first negative signs of fading consumer demand in its role as catalyst for growth in the output of respective industries. With mounting investment demand still beneficial for final demand sectors and with growing world prices for energy-producing materials, the growth indicators of Russian industry can be assessed as fairly good, but not encouraging in the context of the above risks.

Industrial producer prices growing faster than a year ago

In May, industrial producer prices rose by 5.3% m-o-m. As we expected in our previous Overview, total growth in industrial producer prices for the first five months of the year was higher than in the same period last year. The only surprise was the scale of the price overshoot. In January-May 2006, industrial producer prices rose 8.5%, whereas in the first five months of 2007 they jumped 11.7%.

Industrial Producer Price Growth in January–May 2007

	M-o-M growth, %			5-month growth to last December, %	
	May 2007	April 2007	January - May 2007, monthly average	April 2007	May 2007
Industrial Producer Price Index	**5.3**	**4.2**	**0.6**	**11.7**	**8.5**
Mining and quarrying	15.7	10.7	-0.9	24.5	12.3
Manufacturing	2.4	3.4	0.3	6.8	6.9
final demand sectors	0.7	0.8	0.8	3.8	5.1
intermediate demand sectors	3.4	4.3	0.1	8.4	10.0
investment demand sectors	1.7	1.2	1.0	6.0	5.9
Electricity, gas and water supply	1.0	-1.1	4.9	14.4	9.9
CPI	**0.7**	**0.6**	**1.1**	**4.7**	**5.9**

Note. Final demand sectors: manufacture of food products, manufacture of textiles and textile products, leather, leather products, shoes, manufacture of pulp, paper and paper products; publishing and printing and other sectors.

Investment demand sectors: manufacture of other non-metallic mineral products, manufacture of machinery and equipment.

Intermediate demand sectors: woodworking and manufacture of timber products, manufacture of coke, refined petroleum products manufacture of chemicals, manufacture of rubber and plastic products, manufacture of basic metals and fabricated metal products.

Source: Russian Statistics Service, CSI Bank of Moscow.

Price movements in April-May demonstrated once again that unlike with consumer prices, escalation in producer prices may be treated as a positive sign of the industrial production trend.

The spurt in industrial producer prices was primarily triggered by growth in world prices for energy-producing materials. After a hard spell for oil exporters in late 2006-early 2007, world prices resumed their growth. As a result, in April-May producer prices in the mining and quarrying sector leapt 28.1%, determining the scale of growth in prices for industrial products in general (9.7% in April-May).

The primary implication of price growth in the mining and quarrying sector will be cardinal improvement of financial indicators in the second quarter. Along with a growing value of exports, revenue growth will be determined on the basis of the lowest export duty rates in the last 18 months for exported oil and petroleum products, set on the basis of lower prices for Russian oil in January-February. Therefore, acceleration of industrial producer prices in April-May signifies growth in the Russian economy's revenue and collections to the budget.

Sustained moderate growth in prices for products of final demand sectors (about 0.75% monthly from January to May) can also be viewed as a positive impact from growth in industrial producer prices in April-May. Price growth in these sectors, despite lagging behind last year's level, lays the groundwork for slower growth in consumer prices.

Notable in the growth of industrial producer prices in April-May was the preserved pattern from last year of price growth in investment demand sectors. Against the background of spiraling investment in the Russian economy, producers of these goods can build up production volumes and regularly push up prices for their products. Parallel growth in output and producer prices in the investment demand sectors indicate not only a fair level of competitiveness of Russian industries and success in competing with investment imports, but also sizeable growth potential if producer prices are nudged up slowly.

Finally, the adverse effect from producer price growth is exceptionally fast growth in prices for products in intermediate demand sectors. A steep rise in prices in the petroleum products and metals sectors (by 21.3% and 6.6% in April-May, respectively) was accompanied by noticeable deceleration in output in these sectors. Even if accelerating growth in prices for their products is now being spurred by growing values of export contracts, the high monopolization of these sectors will signify growing prices for domestic consumers. The contradictory trend in growth of prices and output of the largest industries of the intermediate demand sectors points to stratified growth in the manufacturing sectors and may jeopardize growth in the Russian manufacturing sector and industry as a whole.

Banking system

IPOs: A blank shot

In May 2007, activity in the banking sector continued the trend seen in March, the only difference being the substitution of one of the two key players.

In March, the state-controlled Sberbank and Gazprombank accounted for 62% of growth in total banking assets. In May, Sberbank was outflanked by VTB, which, together with Gazprombank, accounted for a 59% increase in banking operations. It is notable that the share of the above three banks in total banking assets as of June 1 was barely above 40%.

In recent months, the three biggest banks set the general trend of development in different areas of the banking system. Sberbank and VTB, ranking among the five largest international share issuers, accounted for 85% of growth in banking system equity, including more than 90% growth in shares and additional capital. Over the past three months, corporate deposits with Gazprombank rose by R836 bln, or almost fourfold, boosting corporate accounts in the banking system by 70%.

Major Banking Liabilities, % of total

	01.01.05	01.01.06	01.01.07	01.03.07	01.04.07	01.05.07	01.06.07
Liabilities (R bln)	**7138**	**9751**	**14047**	**14490**	**15600**	**15904**	**17032**
Capital	17.1	16.3	15.2	15.5	15.9	15.8	16.1
CBR loans	0.3	0.2	0.1	0.1	0.1	0.1	0.1
Interbank transactions	4.2	4.0	3.4	3.4	3.3	3.3	2.8
Foreign liabilities	9.9	12.8	16.1	15.9	15.3	15.4	15.3
Household deposits	28.4	28.9	27.6	27.6	26.3	26.6	25.3
Corporate deposits	23.7	24.0	24.0	23.0	24.9	24.7	26.6
Accounts and deposits of federal state authorities and local governments	2.9	2.0	2.2	2.4	2.6	2.6	2.7
Issued securities	9.0	7.6	7.2	6.8	6.4	6.0	5.7

Source: CBR, CSI Bank of Moscow.

Nevertheless, this dynamic growth in the bank's resource base did not bring about a respective expansion of performing banking assets.

Average monthly growth in corporate loans picked up from 2.8% in the first quarter to 3.4% in April-May. This upturn was mainly triggered by growth in short-term loans (with maturity of up to 90 days) issued by Gazprombank. This can hardly support a long-term uptrend in lending.

Of the above three banks, retail credit is a key line of business only for Sberbank. Trends in Sberbank's retail banking after the SPO have not changed considerably. The share of Sberbank in this market continues to decline (by almost 1.5 ppts from March 1 to June 1), despite an overall slowdown in consumer loans alongside interest rate cuts.

The only noticeable effect from placements conducted by Sberbank and VTB was growth in their investment in shares of the non-financial sector. In the post-SPO period, Sberbank increased its portfolio of corporate issuers sevenfold, from R6 bln to R42 bln. VTB's portfolio of corporate issuers rocketed 70% in May, from R34 bln to R58 bln.

Major Banking Assets, % of total

	01.01.05	01.01.06	01.01.07	01.03.07	01.04.07	01.05.07	01.06.07
Assets (R bln)	**7138**	**9751**	**14047**	**14490**	**15600**	**15904**	**17032**
Cash and precious metals	2.8	2.7	2.6	1.9	1.8	1.9	1.7
Accounts with CBR	9.8	7.3	7.5	5.6	8.0	9.5	13.1
Interbank transactions	6.2	6.3	5.8	5.7	5.4	5.2	4.6
Foreign assets	7.8	9.1	9.9	10.9	11.5	9.3	8.3
Households	8.7	12.1	14.7	14.8	14.4	14.7	14.3
Corporate sector	49.8	47.0	45.3	46.0	44.8	45.0	43.6
Government	8.0	6.6	5.2	5.3	5.0	4.9	4.8
Property	2.6	2.4	2.4	2.5	2.4	2.4	2.2

Source: CBR, CSI Bank of Moscow.

Almost all of the abnormal growth in the resource base was absorbed by the CBR. Over the past three months, banking assets expanded by R1.4 trln.

The three top banks accounted for more than R1.2 trln of this growth, or 90% of the total increase, including R460 bln brought by Sberbank and VTB. This sum exceeds the overall volume of their share placements.

Thus, the largest IPOs held by Russian banks appeared to be extremely ineffective. Although it would have been unreasonable to expect two banks – even among the top three – to handle investment in excess of $16 bln, they did prepare for their placements an entire year, which is ample time to think over their development strategies.

Moreover, in the months to come, we expect the greater part of resources that are raised from the market to be sterilized on CBR accounts. This is the only effective tool to control the accelerating inflation currently confronting monetary regulators.

Forecast of Key Macroeconomic Indicators for 2007–2010

	Actual			Forecast			
	2004	2005	2006	2007	2008	2009	2010
National Accounts							
Nominal GDP, R bn	17 046	21 620	26 781	30 517	34 868	39 921	45 695
Nominal GDP by market exchange rate, $ bn	592	764	987	1 171	1 326	1 468	1 631
Real GDP, % y/y	7.2	6.43	6.7	6.8	6.2	6.0	6.1
Industrial Production, %, y/y	8.3	4.0	4.4	5.2	5.0	5.2	5.2
Retail Turnover, real, %, y/y	13.3	12.8	13.9	11.8	10.6	7.6	8.2
Gross Fixed Investments, real, %, y/y	10.8	10.9	13.7	15.7	9.3	9.2	10.8
Exports real, % y/y	11.8	6.4	5.8	4.6	4.8	4.6	3.4
Imports real, % y/y	23.3	17.0	19.7	22.8	15.5	7.8	6.8
Monetary Aggregates							
M0, year end, % y/y	33.8	30.9	38.6	29.0	25.3	19.7	17.4
M2, year end, % y/y	35.8	38.6	48.8	39.0	27.5	21.9	19.5
M2X, year end, % y/y	33.7	37.4	40.5	30.2	20.7	19.6	21.3
Total Banking Assets, year end, % GDP	41.9	45.1	52.8	63.0	70.5	77.4	82.4
Inflation							
CPI, year end, %	11.7	10.9	9.0	8.2-8.5	7.8	7.2	6.8
CPI, year average, %	11.0	12.5	9.8	8.3	8.1	7.5	7.0
Core CPI, year end, %	10.6	8.3	7.8	7.0-7.2	6.6	6.4	6.1
Budget							
Federal Budget Revenues, % GDP	20.1	23.7	23	22.1	20.9	20.4	19.7
Interest Payments, % GDP	1.2	1.0	0.6	0.5	0.5	0.4	0.4
Non-Interest Expenditures, % GDP	14.6	15.3	15.5	17.4	18.2	18.1	18.0
Federal Budget Balance, % GDP[1]	-4.3	-7.5	-7.4	-4.2	-2.2	-1.9	-1.4
Reserve Fund, year end, $ bln	18.8	43.0	89.1	152.9	130	145	161
Future Generations Fund, year end, $ bln					42.4	43.6	38.9
Investment Fund, year end, $ bln			2.6	7.0	11.0	14.5	18.2
Consolidated Budget Balance, % GDP[2]	-4.5	-7.7	-7.7	-4.4	-2.4	-2.1	-1.6
Balance of Payments							
Exports, $ bn	184	244	304	319	316	314	324
Imports, $ bn	96	125	165	230	269	293	316
Current Account, % GDP	10.0	10.9	9.7	4.0	0.3	-1.2	-2.0
Net Capital Inflow/Outflow, $ bn [3]	-8.4	0.7	41.7	71.0	52.1	48.9	55.0
FDI (inflow), $ bn [4]	11.8	12.6	26.2	31.8	37.0	43.3	49.7
International Reserves, year end, $ bn [5]	125	182	304	411	453	471	481
External Debt							
Foreign Public Debt, year end, % GDP	18.6	10.6	5.1	3.8	3.0	2.5	2.1
Public Domestic Debt, year end, % GDP[6]	4.4	3.9	3.8	4.3	4.0	3.3	2.6
Exchange Rate							
R/$, end of period	27.8	28.8	26.3	25.8	26.8	27.6	28.4
R/$ Rate, year average	28.8	28.3	27.1	26.1	26.3	27.2	28.0
Nominal Effective Ruble Rate, year average, % y/y	0.1	0.1	-3.3	-1.6	0.5	0.6	0.3
Real Effective Ruble Rate, year average, % y/y	-6.1	-8.1	-9.4	-4.4	-2.7	-2.2	-1.9
Exogenous Parameters							
Urals, $ p/bbl	34.6	50.4	60.9	60	56	53	53
$/€	1.24	1.25	1.26	1.33	1.34	1.32	1.30

Note. [1] surplus (-); [2] incl. extra-budget funds; [3] Net capital inflow/outflow – banks, corporations and households; [4] corporations; [5] incl. foreign exchange and gold revaluation; [6] due to non-residents, excluding foreign direct investment.

Source: Russian Statistics Service, CBR, Development Center, CSI Bank of Moscow forecast.