Bank of Moscow

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«Contagion» effect: test for stability or crisis redux?

Center of Strategic Investigations

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According to most experts, the credit crisis that hit global markets has had only a minor effect on Russia's financial sector. Fluctuating equity prices (the local minimum was 9% below the level of early August 2007, and in August prices slipped a mere 3%), short-lived growth in interest rates on the interbank market (up to 8.6% on intraday loans with inflation running at 8.7% y-o-y) and a number of postponed eurobond placements have been the only negative implications of the external upheaval. Moreover, some analysts pointed to a certain positive effect of the crisis on Russian finances: a moderate capital outflow ($7.5 bln) cooled the overheated domestic market fostered by a capital influx in 1H07 ($70 bln versus the expected $10-15 bln).

Indeed, the foreign capital inflow spurred by the brisk activity of state-owned companies and banks on foreign markets posed some problems for Russia's monetary authorities. An increase in international reserves and resulting growth in the money supply boosted the expansion of domestic demand fueled by a borrowing spree among households and the corporate sector. Production of goods & services and imports (which surged 37% y-o-y) lagged behind demand, thereby giving a new impetus to price growth. In the current circumstances, the government's inflation target of 8% seems more a "pacifier" of inflationary expectations than a realistic estimate.

We believe it is still too early to view Russia as a "safe haven" for global capital (although such an opinion is now becoming more popular). The oil-fed sense of wellbeing continues to hide structural problems in the economy and financial sector. Russia is not yet ready to efficiently utilize substantial foreign investment, despite its enormous resource potential. Today, Russia's economy looks fairly resistant to external financial upheaval (as long as prices for raw materials remain high and the world economy develops steadily), but the capacity of the foreign investment market is extremely low: "safe haven" status can now be applied to only a very narrow circle of participants.

The global liquidity crisis has reminded us once again of the volatility of Russia's financial sector. We reiterate our view that structural problems in the financial sector, including a deficit of domestic financial resources, a high share of foreign liabilities, dangerously high growth rates on bank loans, segmentation of the interbank market, and ill-developed financial markets will eventually destabilize the situation given sufficient external pressure.

The foreign credit crisis has had only an ephemeral negative effect on Russia's economy, and no matter how paradoxical it sounds – a positive impact on Russia's monetary authorities as well. The Bank of Russia (CBR) effectively used refinancing of commercial banks to stabilize the money market, and President Putin publicly recognized the strategic importance of the banking system. In any event, the optimal pattern for the country's finances would be a scenario by which foreign capital inflows have a stimulating effect and external volatility is effectively neutralized.

Monetary sector

External volatility: A training exercise for the monetary authorities

According to initial projections, Russia's economy in 2007 was expected to grow steadily against the background of slightly declining oil prices, a moderate inflow of foreign capital and subsiding inflation. Growth in deposits and loans was also expected to slow down mildly. Overall, 2007 was projected as a year of balanced growth and positive structural shifts bringing financial stability while encouraging investment activity and industrial growth.

The above assumptions disregarded the effects from heightened external volatility, but the current year has already seen two external shocks. The first this spring was triggered by a powerful inflow of foreign capital. International investment along with rising export revenue (while oil prices remained high and even grew) set off a steep rise in international reserves ($98.5 bln in 1H07 vs. $107.5 bln expected for all of 2007) and substantially broadened the money supply. A sizeable portion of the capital inflow (about $40 bln) was eventually localized in three major state-owned banks. This allowed the CBR to utilize its only available means of absorbing the liquidity overhang – moving funds into its deposits and bonds. State-owned banks suffered losses from this sterilization, but the CBR's "carrot" was the increase in interest rates on deposits.

The consequences of this "positive shock" were escalating inflation, expanding domestic demand and investment activity, and sustained high growth rates in banks' lending volumes.

Another negative shock was triggered by the turbulent situation on external markets. At the start of the crisis, Russia's benchmark RTS equity index plunged by more than 100 points between August 14-16 (from 1,927 to 1,820, or 6%). However, by the end of the month, the index had rebounded to its previous level (1,926 points on September 3). The shares of Russian banks appeared stress-resistant and hardly moved at all (the only exception was Vneshtorgbank, or VTB, the share price of which fell 12% between August 13-31). The crisis barely touched the Russian economy (there were no outflows of deposits from the banking system or hikes in interest rates on consumer and corporate loans), while production and investment were on the rise owing to the beneficial conditions on raw materials markets and domestic demand.

The effect of the summer shock on Russia's banking system and financial markets was more psychological in nature. Indeed, banks' investment in securities was insignificant – investment in corporate bonds accounted for 2.2% of total banking assets, while investment in equities was 1.6%. It is roughly estimated that the capital outflow from Russia was between $5.5 bln and $10 bln. At the same time, excess liquidity in the banking system absorbed by CBR accounts contracted by $38 bln. Among the main depressants we note the multiplying effect of the capital outflow, the dwindling liquidity of bonds, and the steady decrease in excess liquidity (as an after-effect of the first positive shock registered in June of this year rather than its direct impact).

In any event, the latest external shock forced the monetary authorities to more closely examine the problems in the financial sector. The most glaring problems are segmentation of the banking system (and the interbank market), a high share of foreign liabilities, dependence on the global capital market, and ill-developed refinancing instruments.

For the first time in the post-Soviet era, President Putin voiced public support for the Russian banking system (during his visit to Australia in September). His statement is of paramount significance, as he referred to the banking system as a strategically important sector of the economy. On the other hand, the President directed the CBR to develop the refinancing system as much as possible. This Presidential support is crucial for the banking sector, as the monetary program to 2010 projects steady growth in refinancing of the banking system (the money supply cannot be expanded only through net international reserves) and the existing system is inefficient.

The CBR handled the liquidity crisis in a competent, timely and efficient manner by sharply increasing refinancing of the banking system. At the height of the crisis (in late August, when the liquidity shortfall coincided with corporate tax payments), the volume of REPO transactions reached R270 bln ($10.5 bln). In addition, the CBR expanded the list of assets that can be pledged as collateral. As a result, the banking system's assets include R1.4 trln of securities that may be used for refinancing purposes. By all measures, this is a very meager number, as by the end of 2010 gross credit to banks (net of possible market fluctuations) should reach R670-1,014 bln. Moreover, these securities are not proportionally distributed among banks, and most are concentrated in the portfolios of major Russian banks.

Monetary Indicators and Exchange Rate

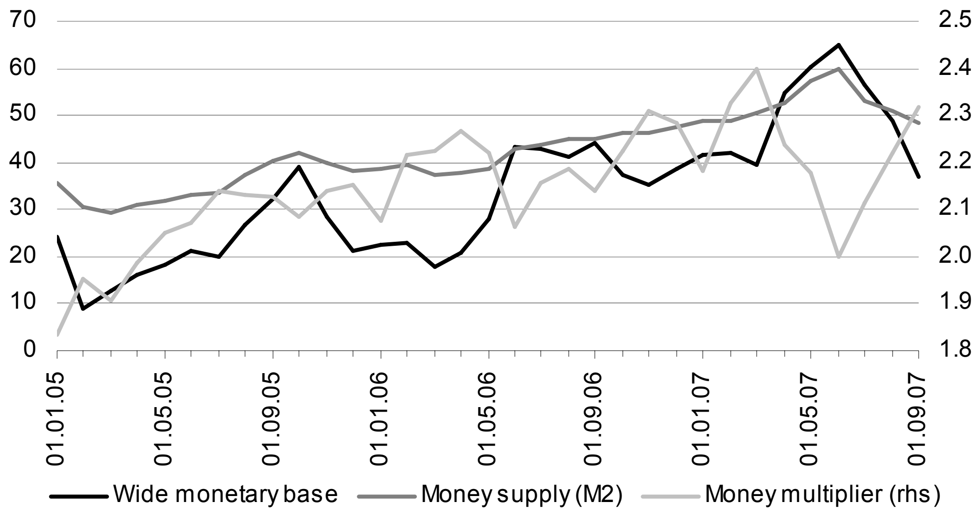
Double shock effect sends monetary indicators back to their planned trajectory

Whereas a strong influx of foreign capital in 1H07 ($70 bln) drove up the money supply and raised doubts about the viability of Russia's financial sector, its ebbing tide in August, according to state officials, cooled the overheated market. All monetary indicators grew at a slower pace, and conditions were in place for a return to their targeted levels.

Growth in the money supply (i.e. the broad monetary base) settled back to its medium-term rate. As of September 1, year-on-year growth of the broad monetary base dropped an estimated 37%. In January to August 2007, the money supply grew slower than in the same period a year ago: 15.7% in 2007 vs. 19.5% in 2006.

In summer, the M2 money supply inched up on average by 1.1% each month versus 6.3% in the period from March to May 2007. Consequently, annual growth rates returned to last year's levels: in the year from September 1, 2006 its growth is estimated at 48.4%.

Money Multiplier and Money Aggregates Growth Rates, % monthly change y-o-y



Source: CBR, CSI Bank of Moscow.

In the remaining months of this year, the capital inflow to Russia is expected to decline. According to CBR estimates, the current account balance will total $50.7 bln in 2007, which is $12 bln below the projected level. The net foreign capital inflow to Russia for the first eight months of 2007 amounted to $59 bln, and the CBR does not expect any growth until the end of the year.

Based on the above assumptions, we had projected ruble appreciation against the dollar at a level of R26.0-26.2/$ (at a USD/EUR rate of 1.3/€). However, the rapid depreciation of the US currency on forex markets and changes in the CBR's exchange rate policy call for revision of this forecast.

With mounting pressure on the exchange rate resulting from the capital outflow, the CBR switched from a bi-currency basket ($0.55 and €0.45) to a more market-oriented exchange rate setting mechanism. From early February, when the current correlation between the currencies in the basket was formed, up until the end of June the ruble did not fluctuate by more than one basis point, whereas in July-August 2007 intraday movements of the ruble against the basket reached 0.3% and the maximum fluctuation totaled 1%. Such a policy allows the CBR to respond more flexibly to exchange rate movements, while increasing volatility of the ruble impairs the effectiveness of speculative cross-border capital transactions.

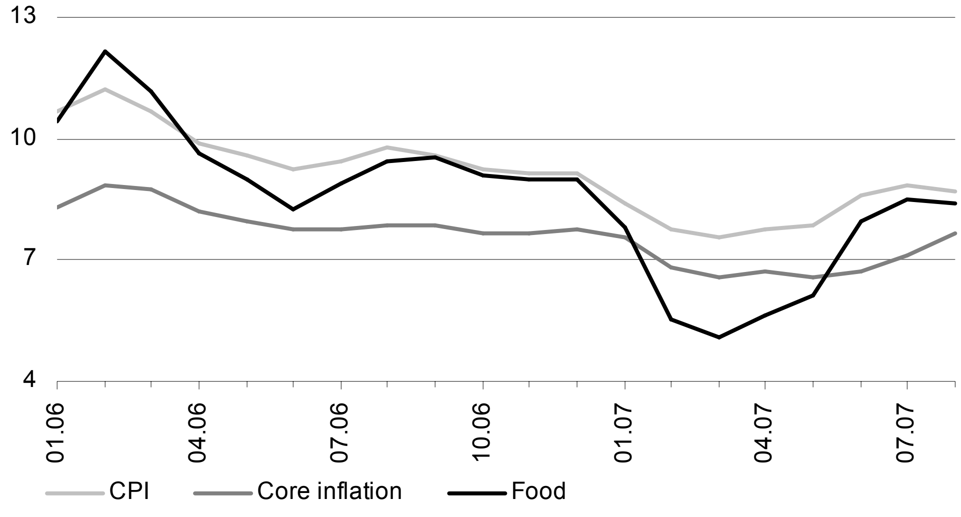
We do not expect the ruble's real effective exchange rate to appreciate by more than 5% this year, and the nominal ruble in respect of the bi-currency basket is likely to hover within 1-1.5% of the current value.

Inflation

Over the first eight months of 2007 the consumer price index reached 6.7% (7.1% y-o-y). The Russian economy was spared the deflation expected by the Russian government in August. The consumer price index in August settled at 0.1%, despite a 16.1% downturn in prices for fruit and vegetables. Since the start of the year, prices for fruit and vegetables have risen 18.7%, and prices for food products have increased 7%. In addition, services grew more expensive, registering an 11.1% increase notwithstanding slower growth in prices for services in the housing and utilities sector (13.2% vs. 16.7% a year ago).

Therefore, the government has only a very slim chance to meet its consumer price inflation target of 8% in the current year. To make this happen, in the remaining four months prices should not grow by more than 1.1-1.2%. For comparison, in September to December 2006 inflation ran at a rate of 1.8%. Rapidly expanding domestic demand is propping up growth in prices for non-food products at last year's level. However, gasoline prices rose a mere 2.1% during the eight months, whereas a year ago they grew 9.3% despite certain administrative constraints at the end of the year. Tempted by the advantageous international environment, Russian producers of refined petroleum products are unlikely to be so sensitive to domestic demand.

Consumer Price Index, % change on the month of a year ago



Source: Russian Statistics Service, CSI Bank of Moscow.

Another catalyst is that core inflation was sustained at a rather low level of 5% for the first eight months of 2007. In July-August this core rate picked up to 0.9-1% versus 0.3-0.5% in previous months. Year-on-year core inflation reached 7.7%, which is rather close to last year's level (7.8%). We project core inflation in 2007 at 7.0-7.3% in anticipation of growth for the following months of at least 2%. Hence, the final inflation figure may approach 9%, unless it is pushed up by fresh external volatility.

Real Sector

June – July 2007: Reversal of growth deceleration in Russian industry

Growth of industrial production in July 2007 reached a robust 7.8% y-o-y. The growth rate demonstrated by Russian industry over the past two months (10.9% in June) indicates that in summer, Russian industry overcame its spring slowdown.

The upturn in Russian industrial production did not change its growth structure:

- Mining and quarrying industries are growing slowly and continue to depress output growth (1.2% in July after 2.0% in 2Q07 and 4.2% in 1Q07);
- The electricity, gas and water supply sector has resumed growth (around 3.0% in June – July after 0.2% in April – May and 5.7% output contraction in 1Q07);
- Manufacturing industries are growing rapidly and remain the key engine for growth in industrial production. In June and July 2007 their output grew 15.6% and 12.5% y-o-y, respectively. A similar rally in the manufacturing sector was observed in early 2007. However, unlike in January and February 2007, when record-high indicators in the manufacturing industries required a substantial adjustment for the climate factor, the successful performance in June and July was an unambiguous achievement on the part of Russian industry.

Industrial Production Output Growth in 2007, % y-o-y

	I Quarter	April-May	June	July
Industrial Production Index	**8.4**	**5.9**	**10.9**	**7.8**
Mining and quarrying	4.2	2.0	2.0	1.2
Manufacturing	14.5	8.4	15.6	12.5
Final demand sectors	*13.1*	*9.3*	*6.1*	*6.2*
Manufacture of food products	13.7	9.4	6.9	6.2
Manufacture of textiles and textile products, manufacture of leather, leather products, shoes	12.1	6.6	-0.9	-0.5
Manufacture of pulp, paper and paper products; publishing and printing	10.8	6.1	8.5	9.9
Other sectors	12.9	14.1	3.3	5.9
Investment demand sectors	*21.8*	*12.0*	*29.6*	*21.8*
Manufacture of other non-metallic mineral products	25.8	15.8	10.0	9.9
Manufacture of machinery and equipment	21.1	11.4	32.9	23.8
Intermediate demand sectors	*9.3*	*4.8*	*3.6*	*3.8*
Woodworking and manufacture of timber products	11.0	9.3	1.4	3.4
Manufacture of coke, refined petroleum products	6.0	1.5	6.3	2.6
Manufacture of chemicals	10.6	7.5	7.2	9.9
Manufacture of rubber and plastic products	24.1	23.4	18.7	25.3
Manufacture of basic metals and fabricated metal products	8.2	2.8	0.4	0.1
Electricity, gas and water supply	-5.7	-0.2	2.9	3.3

Source: Russian Statistics Service, CSI Bank of Moscow.

Manufacturers of machinery and equipment have become the unquestioned leaders of industrial growth, staging unexpectedly high growth in the manufacturing sector and industry as a whole in June and July 2007. Production of machinery and equipment leaped 52.3% y-o-y over this period, manufacture of electrical and optical equipment jumped 27.8%, and manufacture of transport equipment increased 14.8%. Sustainable high growth was demonstrated by producers of construction materials (manufacture of other non-metallic mineral products grew on average by 10.0% in June-July). On the back of continued investment infusions to the Russian economy, *investment demand* sectors increased their output in June-July by more than 25%.

On the other hand, the decelerating *final demand* sector added new names to its roster in June-July. Based on May data, we mentioned as a possible threat the weakened effect of consumer demand as a growth catalyst for the respective industries, judging by the trends in the textiles and textile products industry. In June-July 2007, a severe slump hit the manufacturers of food products and consumer goods (other sectors). Manufacturers of leather products and shoes also slipped into recession in July. Even with the industry's convincing growth rates as a backdrop, the trends demonstrated by the light, food and consumer goods industries in June and July give rise to concern: the output of food products rose 6.6% (versus about 9.4% in the preceding months of 2007), the output of light industry even edged lower by 0.8% (versus the respective growth indicator in January-May of at least 6.6%), and the output of other sectors rose a modest 4.6% (the lowest level in 18 months).

Finally, by our estimates, in June and July 2007 industrial output grew 9.4% y-o-y, which is even a better performance than the first quarter result, which was slightly overstated due to the climate factor (8.4%). At the same time, accelerating growth in Russian industry is accompanied by an increasing misbalance in the growth structure. Among the negative factors we note:

- **The protracted slowdown in output of the mining and quarrying sector.** In conditions of growing world prices for energy commodities, the current strategy underscores the non-market nature of this segment and lays the groundwork for domestic energy price hikes.

- **Faltering growth in final demand sectors.** This may be a sign that mounting consumer demand, which acted as a powerful growth driver of Russian industry in 2006 and 1Q07, is becoming less oriented towards domestic products and is losing its stimulating effect on Russian industry.

- **Localization of industry growth exclusively in the investment segment.** The rate of growth in the manufacture of machinery & equipment and non-metallic mineral products is becoming a major determinant of the general growth trend in Russian industry.

- **Low and declining growth in intermediate demand sectors.** Against the background of escalating growth in investment demand sectors, such trends in industries supplying products to the growth leaders indicates serious structural imbalances in domestic industrial production.

June and July 2007 saw the transition of Russian industry to a new growth model. By 2006, Russian industry had matured from the growth driver of rising demand for mining and quarrying products, and last year its growth was nurtured by accelerating consumer and investment demand. Now, out of the three possible growth boosters, investment demand is the only one that works. Meanwhile, investment demand as a key growth catalyst of Russian industry may turn out to be a strategically and tactically wrong bet due to the lopsided growth in Russian industry (lagging growth of intermediate demand sectors) and the inherent capacity limitations of the machinery and equipment sector.

Growth in industrial producer prices:
Second-quarter records give way to a July pause

The 2.5% growth in industrial producer prices in June propelled Russian industry to a new price record: in 2Q07 industrial producer prices rose 12.7%. However, in July their growth braked sharply to just 0.7%. In general, accelerated growth in prices for products of final and investment demand sectors and deceleration of prices for products of intermediate demand sectors have been the typical price trends of Russian industry in recent months. The key determinants of these price gyrations were movements in global energy prices and the surge in prices of mining and quarrying of energy producing materials.

Industrial Producer Price Growth for the Period, %

	Year 2007				January – July 2006
	I Quarter	II Quarter	July	January - July	
Industry, total	**1.6**	**12.7**	**0.7**	**15.3**	**11.3**
Mining and quarrying	-2.8	36.7	-0.1	32.8	17.6
including mining and quarrying of energy producing materials	-3.4	41.8	-0.2	36.8	17.5
Manufacturing	0.9	7.2	1.1	9.5	9.4
final demand sectors	2.4	2.8	1.6	6.8	5.8
investment demand sectors	3.0	4.5	1.3	9.1	8.2
intermediate demand sectors	0.4	9.9	-0.4	10.0	13.1
including manufacture of refined petroleum products	-10.2	20.4	3.0	14.9	17.1
Electricity, gas and water supply	13.5	0.5	0.4	14.5	10.1
Consumer prices	3.4	2.2	0.9	6.6	6.9
Urals, $/bbl	-3.2	19.8	6.4	23.3	23.5

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

Escalating prices for products of the *mining and quarrying of energy producing materials* sector constituted the principal intrigue and growth catalyst for producer prices in 2Q07. Their growth trend in this period was predictable in the context of a near 20% hike in world prices for Russian oil. However, the scale of the price growth in this sector was a shocking 41.8% in the second quarter. Apparently, the appetite of Russia's oil industry represented by the vertically-integrated companies helped to improve financial performance after their significant financial disappointments in 4Q06 and 1Q07, on the one hand, and to further squeeze out independent oil refineries from the market, on the other. With such a steep price rise in mining and quarrying, growth in prices for refined petroleum products by a "mere" 20.4% in 2Q07 did not look abnormal, and the threat of their continuing growth spurred by steadily rising prices for Urals crude forced the government to make tough pronouncements regarding administrative measures to contain growth in prices for petroleum products. In this context, the sharp slowdown in producer prices of the mining and quarrying sector and of refined petroleum product manufacturers appeared quite logical, despite the ongoing growth in world prices for energy-producing materials.

Another distinctive feature of this producer price growth was a surge in prices *for final demand products*, embarking on the growth path of last year. In the second quarter, the prices for these products rose 2.8% (equal to the rate in 2Q06), and in July they rose 1.6% (vs. 0.4% a year ago). It is notable that over the past four months, producer prices in most of these industries grew much faster than a year ago.

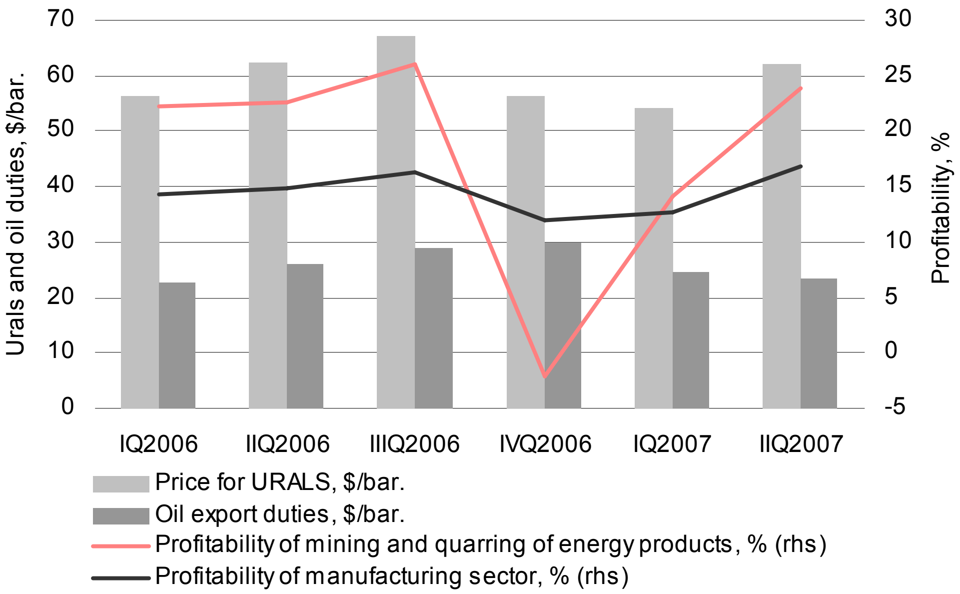
Therefore, the industry awaits a price overhang resulting from rapid growth in prices for refined petroleum products and final demand products, which is already manifest in escalating growth of consumer prices (1.8% in June-July 2007 versus 0.9% in the same period a year ago) and is likely to persist.

Financial performance: Oil companies regain their footing, but what about others?

Profits earned by Russian enterprises in 2Q07 totaled R1,273.6 bln. The second quarter turned out to be much more profitable than the preceding one, when the profit of the Russian economy stood at R991.5 bln. Financial performance also improved versus last year's results: in April-May, profits picked up 20% in real terms (y-o-y, deflated for PPI), whereas in the first quarter the Russian economy's profit registered only 7% growth.

The anticipated improvement of the financial position in the mining and quarrying sector bolstered by growing world prices for energy-producing materials and a low export duty rate for oil led to a doubling of profit in the mining and quarrying sector (versus 1Q07) and enhanced profitability reaching 24.3% – the level observed before the downturn in world prices for Russian oil.

World Prices and Export Duties for Russian Oil*
Industrial Production Profitability

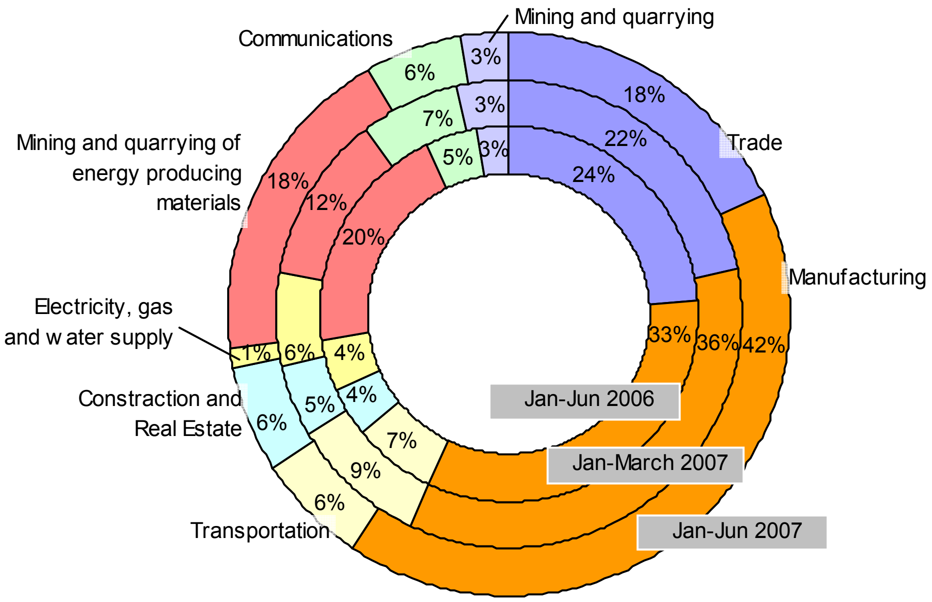


* The average quarterly price for Urals grade oil is calculated based on a one-month lag.

Source: Russian Statistics Service, State Customs Committee, Reuters, CSI Bank of Moscow.

Eventually, the performance of the mining and quarrying sector in April-May practically restored the status quo in the structure of profits earned by Russian enterprises. Whereas in the "unsuccessful" 4Q06 and 1Q07 the share of the Russian economy's profit contributed by the mining and quarrying sector was about 14%, in 2Q07 this share rose to 20%, practically rebounding to last year's level.

Russian Economy Profit Structure in 1st Half 2006–2007*



* Net of profit of enterprises engaged in "other" economic activities.
Source: Russian Statistics Service, CSI Bank of Moscow.

At the same time, even the widening share of the economy's profit accumulated in the mining and quarrying sector could not prevent a shift of the profit center to the manufacturing industries, and the financial successes of the manufacturing industries are, in fact, a major surprise of 2Q07. In April to June, the manufacturing sector accounted for almost 40% of the Russian economy's profit. Alongside widening output, the record-high profitability level of 16.2% posted in 2Q07 was also a springboard for the manufacturing sector to radically entrench its position, and may be viewed as a strong source of growth in this segment.

Industrial Production: Profitability*
and Share in Profit of the Russian Economy, %

	Profitability		Share in the economy's profit	
	II Quarter 2006	II Quarter 2007	II Quarter 2006	II Quarter 2007
Industrial production	14.9	16.7	60	61
Mining and quarrying of energy producing materials	22.7	23.9	19	18
Other mining and quarrying	27.7	27.4	3	3
Manufacturing	13.5	16.2	36	39
Electricity, gas and water supply	4.7	3.0	2	1

* Profitability is calculated as the ratio of corporate financial performance to the cost of goods shipped.
Source: Russian Statistics Service, CSI Bank of Moscow.

Furthermore, the increasing concentration of profit in the manufacturing sector was accompanied by noticeable deterioration of financial performance of enterprises operating in the trading niche: the profit of these enterprises in real terms declined over the entire first half year of 2007 and accounted only for 18% of the Russian economy's profit in this period (vs. 23% a year ago). Against the background of rising profits of industrial producers, this downturn in the trade sector may be a sign of resumed interest on the domestic market in home-made products, and provides further evidence that Russian industry has ample room for growth.

Banking System

After a strong rally in spring, the banking sector switched into slower gear in June-July 2007. In June and July, total banking assets inched up 1.0% and 1.6%, respectively, whereas in March-May banking assets increased on average by 5.5% per month. Over the year, growth in banking assets slowed from 52.4% as of June 1 to 49.0% as of August 1.

Deceleration was observed in both the borrowed and own funds of banks. Whereas in June and July banking capital grew in step with last year's levels (1.9% in June and 2.4% in July versus average growth of 2.5% in 2006), growth in borrowing and customer accounts slowed more noticeably: 0.9% in June and 1.4% in July 2007 versus average growth of 3.2% in 2006.

Over June and July, funds of the non-financial sector were flowing out of the banking system. In June, the outflow was apparently generated by finalization of auction sales of YUKOS assets. Corporate accounts shrank 8% during the month unadjusted for the YUKOS effect, or rose 6.3% net of the YUKOS factor. In July, the outflow was more prominent. Even net of the YUKOS factor, corporate accounts contracted 2.3%. The exodus was aided by heightened volatility on the financial market and the outflow of investors' funds from the Russian market.

Major Banking Assets, % of total

	01.05	01.06	01.07	04.07	05.07	06.07	07.07	08.07
Assets, R bln	**7138**	**9751**	**14047**	**15600**	**15904**	**17032**	**17204**	**17477**
Cash and precious metals	2.8	2.7	2.6	1.8	1.9	1.7	1.8	1.8
Accounts with CBR	9.8	7.3	7.5	8.0	9.5	13.1	10.9	9.1
Interbank transactions	6.2	6.3	5.8	5.4	5.2	4.6	5.3	5.3
Foreign assets	7.8	9.1	9.9	11.5	9.3	8.3	8.4	8.0
Households	8.7	12.1	14.7	14.4	14.7	14.3	14.9	15.3
Corporate sector	49.8	47.0	45.3	44.8	45.0	43.6	45.0	46.0
Government	8.0	6.6	5.2	5.0	4.9	4.8	4.7	4.8
Property	2.6	2.4	2.4	2.4	2.4	2.2	2.3	2.3

Source: CBR, CSI Bank of Moscow.

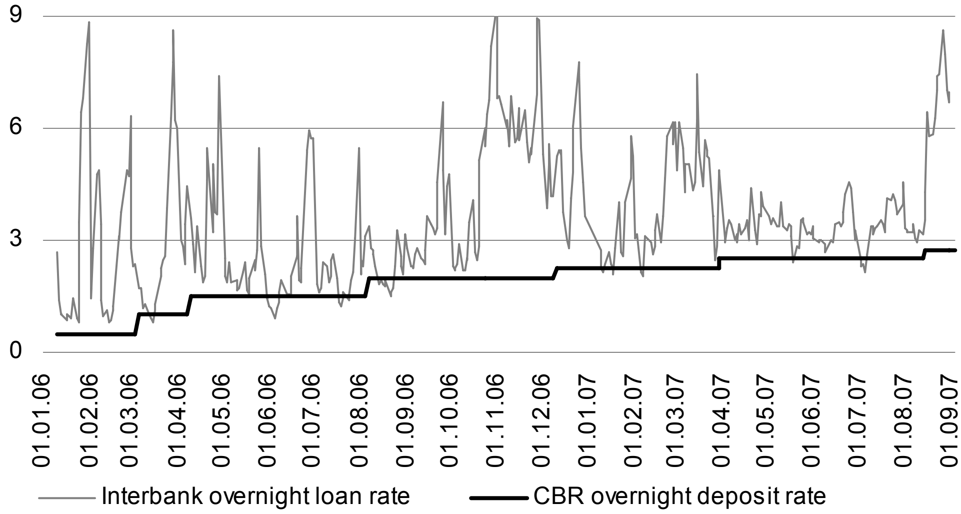
Major Banking Liabilities, % of total

	01.05	01.06	01.07	04.07	05.07	06.07	07.07	08.07
Liabilities, R bln	**7138**	**9751**	**14047**	**15600**	**15904**	**17032**	**17204**	**17477**
Capital	17.1	16.3	15.2	15.9	15.8	16.1	16.2	16.4
CBR loans	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.0
Interbank transactions	4.2	4.0	3.4	3.3	3.3	2.8	3.1	3.2
Foreign liabilities	9.9	12.8	16.1	15.3	15.4	15.3	16.1	16.5
Household deposits	28.4	28.9	27.6	26.3	26.6	25.3	25.9	26.0
Corporate deposits	23.7	24.0	24.0	24.9	24.7	26.6	25.1	24.0
Accounts and deposits of federal state authorities and local governments	2.9	2.0	2.2	2.6	2.6	2.7	2.4	2.7
Issued securities	9.0	7.6	7.2	6.4	6.0	5.7	5.8	5.7

Source: CBR, CSI Bank of Moscow.

The outflow of customer accounts resulted in a decrease of liquid assets. If in June only major banks suffered from shrinking liquidity, in July the entire banking sector experienced a liquidity problem. Even net of the major banks, the volume of liquid assets declined by more than 10% in July. In August, the liquidity squeeze became more acute. Even though the situation remained rather beneficial, if gauged by aggregate indicators, the ratio of liquid assets held as cash on hand and with the CBR to customer accounts and deposits was estimated at 15% as of September 1 (last year this ratio ranged between 12.6% and 17.6%). However, rising interest rates on the interbank loan market and large-scale refinancing moves by the CBR indicate that liquid assets are distributed unevenly in the banking sector.

Money Market Interest Rates, % annual



Source: CBR.

One of the key depressants of liquidity in June and especially July was the flow of funds released by Savings Bank of Russia (Sberbank) and VTB following their IPOs and subsequently moved into real sector lending. Loans issued by Sberbank in June and July rose 11.7%, while loans issued by VTB in the same period jumped 23.8%. Accelerated lending activity was demonstrated by Sberbank only three months after its shares were sold on the market. VTB acted much faster, unwinding its lending activity immediately.

Accelerated lending by Sberbank was largely long-term in nature. Growth in loans over the past two months was brought about by loans with maturity of more than one year, ensuring almost one-half of the growth in total long-term loans of the banking sector to the real sector of the economy. Accelerated lending hampered the capital adequacy ratios of these banks. However, except for Sberbank and VTB, the capital adequacy ratios of the banking sector remained stable at 15.3-15.5%.

Therefore, the trends in the banking sector in recent months were established by steps taken by Russia's major banks.

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	31 180	35 659	40 539	45 929
by market exchange rate, $ bn	592	764	987	1 210	1 394	1 566	1 721
Real GDP, % y/y	7.2	6.43	6.7	7.3	6.8	6.8	5.9
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	14.0	12.3	10.6	8.2
Gross Fixed Investments, real, %, y/y	10.8	10.9	13.7	16.9	14.5	9.1	12.5
Exports real, % y/y	11.8	6.4	5.8	4.8	4.8	4.0	3.1
Imports real, % y/y	23.3	17.0	19.7	25.6	23.1	11.3	16.5
Monetary Aggregates							
M0, year end, % y/y	33.8	30.9	38.6	29.0	25.7	20.9	20.7
M2, year end, % y/y	35.8	38.6	48.8	37.3	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	59.5	68.2	74.8	82.7
Inflation							
CPI, year end, %	11.7	10.9	9.0	8.5-8.7	7.8	7.2	6.8
CPI, year average, %	11.0	12.5	9.8	8.4	8.2	7.5	7.0
Core CPI, year end, %	10.6	8.3	7.8	7.3-7.5	6.6	6.4	6.1
Budget							
Federal Budget Revenues, % GDP	20.1	23.7	23	23.7	21.8	21.4	21.0
Interest Payments, % GDP	1.2	1.0	0.6	0.5	0.4	0.3	0.3
Non-Interest Expenditures, % GDP	14.6	15.3	15.5	17.4	17.9	17.9	17.9
Federal Budget Balance, % GDP[1]	-4.3	-7.5	-7.4	-5.8	-3.5	-3.1	-2.8
Reserve Fund, year end, $ bln	18.8	43.0	89.1	163.0	138	156	168
Future Generations Fund, year end, $ bln					64.1	82.3	88.5
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	-6.0	-3.7	-3.3	-3.0
Balance of Payments							
Exports, $ bn	184	244	304	338	354	354	358
Imports, $ bn	96	125	165	230	271	304	359
Current Account, % GDP	10.0	10.9	9.7	4.8	2.1	0.2	-2.9
Net Capital Inflow/Outflow, $ bn [3]	-8.4	0.7	41.7	71.0	52.1	48.9	55.0
International Reserves, year end, $ bn [4]	125	182	304	447	549	616	623
Public Debt							
Foreign Public Debt, year end, % GDP	18.6	10.6	5.1	3.7	2.9	2.3	2.0
Internal Public Debt, year end, % GDP	4.4	3.9	3.8	4.0	4.5	5.0	5.5
Exchange Rate							
R/$:							
end of period	27.8	28.8	26.3	25.4	25.8	26.0	27.4
year average	28.8	28.3	27.1	25.8	25.6	25.9	26.7
Exogenous Parameters							
Urals, $ p/bbl	34.6	50.4	60.9	60	56	53	53
$/€	1.24	1.25	1.26	1.35	1.35	1.33	1.30

Note. [1] surplus (-); [2] incl. extra-budget funds; [3] Net capital inflow/outflow – banks, corporations and households; [4] incl. gold.
Source: Russian Statistics Service, CBR, Development Center, CSI Bank of Moscow forecast.