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Bank of Moscow

From surging optimism to creeping stagnation

Center of Strategic Investigations

CONTENTS

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The Russian economy has managed to sustain growth for eight consecutive years, but its growth factors have been determined by the external environment and government policies. In previous times, economic growth was driven by different growth engines – sharp ruble depreciation was the first catalyst for the industrial upturn, followed by a steep rise in world prices for oil and other raw materials. Now, the role of growth locomotive is being played by expanding domestic demand (including investment demand). At the end of the year, the current economic growth model is being tested for *effectiveness* and *acceptability*. The effectiveness benchmark is direct performance (key macroeconomic indicators), while *acceptability* is the extent of “after-effects” (inflation, banking system stability, development of financial markets).

Industrial growth has been declining for several months already. In our opinion, the third quarter of 2007 marked the transition of Russian industry to a new “investment” growth model. This model was set into motion by a single “engine” (investment demand growth) out of the three available (consumer demand growth, investment demand growth and growing world prices for energy-producing materials). Therefore, the reason why expanding domestic demand has become an ineffective catalyst for industrial growth should be sought in the government’s economic policy – ruble appreciation, tax policies, investment climate, and the level of the banking system and financial market’s development. Growth in consumer demand is being satisfied by imports (this year, growth in imports is forecast at 38–40%), while a moderate upturn in prices for energy-producing materials has been fully neutralized by the government’s tax policies.

The virtually uncontrolled inflow of foreign capital to Russia in the first half of 2007 (along with persistently high prices for raw materials) boosted domestic demand and the money supply. The direct result (as we anticipated in June) was price acceleration. This year, the government has already admitted its missteps in the financial sector, and the new official inflation projections now range between 10.5–11.0%. Poorly managed expansion of domestic demand will inevitably derail financial stability and leads one to question the *acceptability* of the existing development model – the imminent consequence of high industrial production growth rates. We do not exclude the possibility that other macroeconomic indicators (e.g. the pace of industrial growth) will be revised downward as well.

Nevertheless, the government insists on preserving the current economic development model. The authorities have pinned their hopes on public finance as a substitute for more expensive foreign capital and an expected reduction in foreign investment. At the very least, a decision has been made to expand public expenditures directly and through state development corporations. Essentially, losses brought about by the adverse external environment will be (partially or fully) patched up by public funds. Effective expansion of domestic demand remains the key issue – is it continuing to fuel imports and maintaining structural misbalances, or serving to prop up industrial growth in Russia? If the Russian government intends to save growth, direct public finance (state budget and funds from development institutions) should be used together with other growth mechanisms.

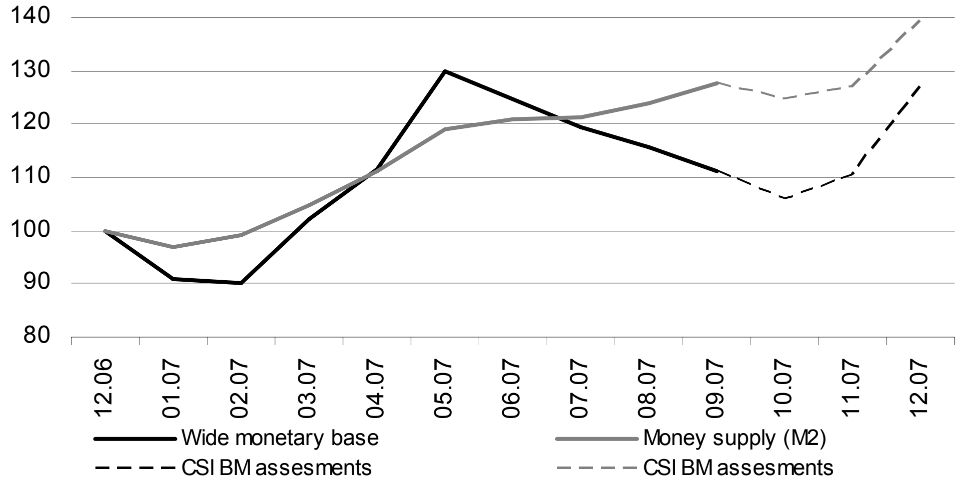
Money supply

The broad monetary base has been contracting for five straight months, but only in October did the total liquidity of the banking system approach its bottom levels. Earlier, liquidity problems in certain segments of the interbank market were veiled by the top banks' excess liquidity.

After the excess liquidity generated by the summer influx of foreign capital had been absorbed[1], it appeared that the liquidity problem affected the greater part of the banking sector. During the liquidity squeeze suffered by the banking system, Gazprombank acted as an active lender providing resources to other banks on the interbank market.

Contraction of money emission in October coincided with resumed capital inflow and growth in international reserves. However, sterilization of cash on budget accounts appeared to be too great. According to our estimates, the total increase in funds on budget accounts of all levels, including the Stabilization Fund, amounted to R780 bln in October. Seasonal tax payments were an additional dampener of the money supply.

Monetary base and money supply, to 01.01.2007



Source: CBR, CSI Bank of Moscow.

The Central Bank of Russia (CBR) took some steps to mitigate the worrying situation in the banking sector. Mandatory reserves were pared by one percentage point, releasing about R90 bln of free cash into the banking sector. The collateral roster was broadened, thereby increasing the potential security base for REPO transactions by R150 bln.

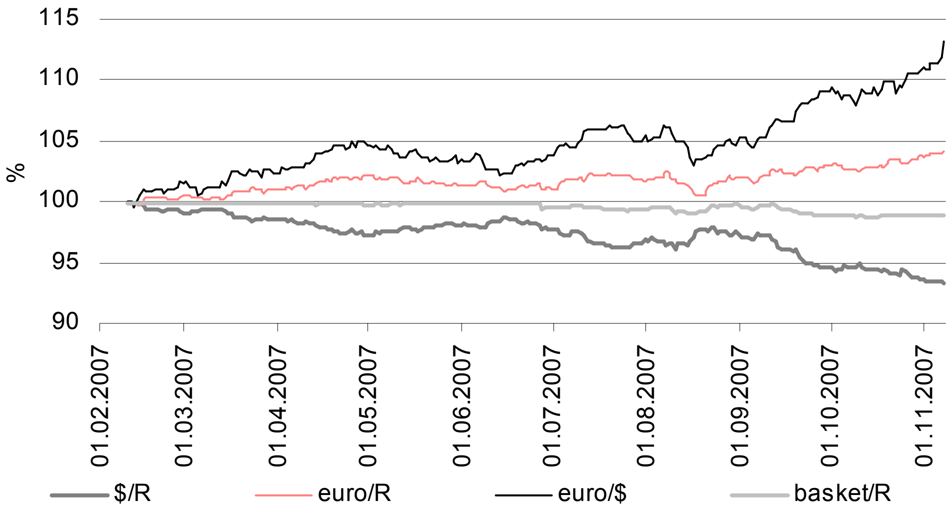
As we see it, this is only a temporary liquidity crunch. By the end of the year, we expect a sharp leap in the money supply fueled by mounting budget spending and the capitalization of state-owned corporations. As a result, aggregate liquidity indicators of the banking sector will improve as well. But obvious disproportions in the allocation of budget funds (state-owned banks will remain the major recipients) will lay the groundwork for high interest rates on the interbank market, reflecting the needs of certain banks for additional refinancing from the CBR.

[1] In late October, more than R450 bln was disbursed from Gazprom accounts to repay Yukos debts.

Exchange rate

The free-fall of the greenback against the euro did not alter the CBR's policy of controlling the ruble exchange rate in relation to the bi-currency basket. The ruble's strengthening versus the bi-currency basket was less than 0.1%. We have every reason to expect that by the end of the year, the ruble exchange rate against the major currencies will fluctuate in relation to the global forex market. It is hardly likely, in our view, that the monetary authorities will use the ruble exchange rate as an anti-inflationary instrument.

Exchange Rate Movements, 09.02.2007=100%[2]



Source: CBR, CSI Bank of Moscow.

[2] The current bi-currency structure of €0.45 versus $0.55 in line with the CBR's Monetary Policy Guidelines has been in effect since February 9, 2007.

Inflation

Price shock or the first signs of an uptrend?

Data supplied by the Russian Statistics Service confirmed our worst fears: consumer price growth in October settled at 1.6%, while prices for food products grew by a record 3.3%. Over the first ten months of 2007, inflation approached 9.3%. In 2007, the government failed to both meet the projected target of 8.0% and curb the pace of inflation (9.0% in 2006).

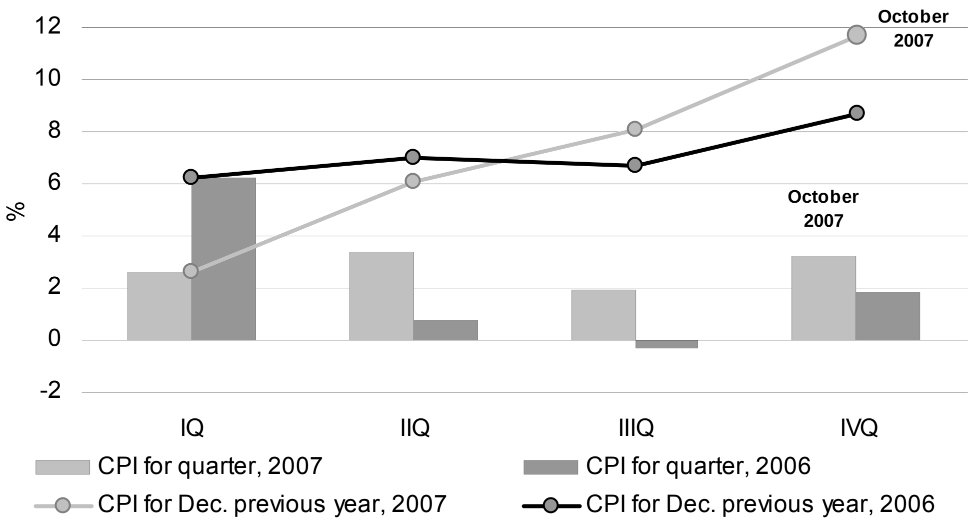
Consumer price growth (for the period), %

	2007 г.			January-October		2006
	October	September	January-August (monthly average)	2007	2006	
Consumer prices, total	**1.6**	**0.8**	**0.8**	**9.3**	**7.5**	**9.0**
Food products	3.3	1.0	0.8	11.6	6.7	8.7
Non-food products	0.9	0.8	0.4	4.9	5.0	6.0
Paid services to households	0.1	0.4	1.3	11.7	12.5	13.9

Source: Russian Statistics Service, CSI Bank of Moscow.

Since prices and tariffs for non-food products and paid services to households grow more slowly than a year ago, the pressing issue in 2007 has been the sector-wide acceleration of food prices. The first signs of the price upswing turned up in April, but it took the autumn price spurt before the government began regulating consumer price movements. Actually, in the second and third quarters of 2007, prices for food products grew faster than a year ago, and October's price hikes almost doubled the growth registered in the fourth quarter of 2006.

Growth in prices for food products



Source: Russian Statistics Service, CSI Bank of Moscow.

In April to October 2007 – a period of spiraling prices for food products – prices jumped by 8.8% (vs. 0.5% in the same period of 2006). Therefore, *consumer prices for food products between April and October 2007 rocketed 20x y-o-y*. Consequently, inflation in April to October 2007 hit 5.7%, well above last-year's 2.4% and rendering virtually unachievable any slowdown of the projected target.

The situation was not made any clearer by the government's reasoning on the scale and causes of this price growth, or the archaic methods meant to curb the price hikes. It is also unclear at what time, to what extent, and in which way the authorities could have corrected the price-setting processes in what is supposed to be a free-market economy.

In our opinion, the *sector-wide upswing in prices* for food products was the most distinctive feature of the food price uptrend: consumer prices accelerated in all of the staple and largest product groups – milk, bread, and fruit and vegetables. Consumer prices for milk and butter shot up by 28–30% between April and October, and for cereals and pasta – by 15–17% (vs. 2.0% a year earlier). Prices for bread leapt 20% (vs. 4.2% a year ago) and for sunflower oil – by almost 1.5x (vs. a 1.2% drop a year ago). Moreover, in 2007 the seasonal downswing in prices for vegetables was minimal: prices for potatoes in October were virtually unchanged compared to March levels, and cabbage prices were substantially higher.

Consumer Price Growth: Food prices (for the period), %

	April-October		Biggest price hikes* (2007)		
	2007	2006	April-June	July-August	September-October
Consumer prices for food products, total	**8.8**	**0.5**	**3.4**	**0.8**	**4.3**
Whole milk pasteurized, sterilized, 2.5–3.2% of fat content	27.7	2.1			23.1
Butter	30.3	1.6			23.5
Sunflower oil	48.1	-1.2			43.6
Bread and bakery products of premium-grade wheat flour	19.5	4.2		13.1	3.2
Polished rice	17.1	1.2		5.8	5.9
Pasta made of premium-grade wheat flour	14.8	2.0		7.7	5.3
Potatoes	0.9	-28.1	24.4		
Fresh cabbage	10.1	-46.9	127.5		

**The significant values only*

Source: Russian Statistics Service, CSI Bank of Moscow.

Historically, the upswing in prices for food products was triggered by rising prices for fruits and vegetables (second quarter of 2007), and starting from July this trend was underpinned by growing prices for bread, cereals and pasta. Later, in September-October 2007, the trend was further stoked by soaring prices for milk and butter.

Formally, these inflationary waves were generated by the following factors:

- Enactment of a law on April 1, 2007 banning all foreign migrants from retail trade as sellers. As a result, labor grew more expensive, making *fruit and vegetables* in the markets more costly as well, which enabled retail chains to push up prices for these products;

- Growth in world *wheat* prices, buoyed by expansion of global consumption, poor crops in the Southern Hemisphere and declining world stocks. In July-August 2007, export prices for Russian wheat totaled $238 per ton, which is nearly twice the level of the previous year and one-third higher than prices in the second quarter of 2007. These price movements evidently boosted exports, which in July-August 2007 were 13% higher than last year's level. Mounting export deliveries and an imbalance on the Russian wheat market brought about by weak government participation laid the groundwork for a surge in producer prices: domestic wheat prices in July-August rose by almost one-fourth together with prices for bread and bakery products (+13.1%);

- Poor *sunflower* harvest in Russia in 2007, which suppressed production of sunflower oil. Despite increasing imports of sunflower oil, the aggregate supply of this product on the Russian market in the summer and September 2007 contracted by 10% y-o-y against the background of 1.5x growth in demand y-o-y, which naturally spurred prices for this product;

- Rising world prices for *milk products*, resulting from expanding global demand and scrapped government subsidies to agricultural producers in a number of EU countries. In July-August 2007, average import prices for milk sprang up by 30% compared to the second quarter of 2007 and grew by 2.4x y-o-y. For imported butter, these indicators were 50% and 1.7x, respectively. As the Russian market is substantially dependent on the import of milk products (until the third quarter of 2007, the share of imports was one-third of the Russian hard cheese and butter market, and at times the share of imported milk constituted one-fourth of the cost of materials used by Russian producers of cottage cheese and sour milk products). This global trend is to blame for the rapid acceleration of producer prices for milk products.

These specific processes were exacerbated by systemic problems related to slow growth of Russian agribusiness and the production of staple products (in the first three quarters of 2007, milk production edged up by 1.1%, wholemilk products – by 1.2%, and butter – by 1.8% y-o-y) compared to the much faster growth in consumption of food products (for the same period, the consumption of butter rose by 4.4%, margarine – by 18.1% and hard cheese – by 38.8% y-o-y). Expanding consumption of food products underpinned by growing household incomes cannot be satisfied through enhanced output of domestic products and is mostly saturated by mounting imports, aggravating the Russian market's dependence on world price fluctuations.

Furthermore, rapidly developing retail chains are turning into important players on the Russian food market. Using their dominant position, these chains can have a significant impact on food price movements.

Addressing the issue, the government argued that trade firms should be blamed for the unprecedented rally in food prices. As a result of subsequent commitments of the largest Russian trading companies, retail prices for staple products (rye and wheat bread, milk with fat content at least 1.5%, kefir with 1% fat content, sunflower oil, hen eggs) will not grow until January 31, 2008. Prices for these products will be fixed by their suppliers for the same period.

We do not believe it is constructive to shift responsibility for escalating prices to trade companies and food producers, as any business strives to earn profits by legal means in the legal environment outlined by the state authorities. The method chosen to resolve the economically and socially complicated issue *suggests that the government is not yet ready* to admit the systemic nature of the problem, map out any measures to overcome the problem, or design mechanisms to prevent its reoccurrence.

Apart from the global task of heightening food security by means of developing agribusiness and food product manufacturing, and apart from the problem of surging growth in household income, it can be argued that the government should have undertaken tactical measures. For example, the adverse economic effect from the law banning all foreign migrants from retail trade as sellers, which unleashed prices for fruit and vegetables, was not thought through properly or prevented. Despite the government's awareness of tax reforms in the EU early this year, import duties on milk products were not cut, while their reduction could have cushioned the effect of growing prices. Despite the beginning of an uptrend in domestic prices for grain and bread, mounting exports were not contained in time by the raising of export duties, and grain interventions were not used either. The proliferation of retail chains is not traced effectively by the anti-monopoly authorities, thereby preventing the government from receiving timely signals regarding "moderation" of trade markups and leaving ample opportunity for direct cartel collusion, as occurred on October 24 (when representatives of four production associations and 26 companies led by the Agricultural Ministry signed an agreement to freeze prices for six types of food products).

Yet despite the arrangements made between the authorities and the heads of Russian food businesses, we believe the price upswing seen between July and October will continue. First, everybody understands that freezing prices for staple products will only boost prices for products outside this category. Second, there are a number of products that lag noticeably, e.g. meat products, which are eventually expected to grow more expensive due to surging prices for grain (used as fodder) and anticipated limitations of imports from Argentina (statements to that effect have already been made by that country's new president). Furthermore, the traditional year-end buying spree is likely to boost food prices as well. Lastly, we already see the threat that accelerating prices for certain food products may grow into a price rally involving other products, simply due to overall momentum.

We think the price shock of 2007 driven by external factors and the government's mistakes ultimately stem from an outbreak of accumulated structural and institutional problems demonstrating that Russia is still unprepared to be considered an open economy, in both the trading sector and in terms of capital flow management. Currently, liquidity shortfalls on world markets make it increasingly difficult to stabilize the price situation in Russia – even at the new price levels. Russia's monetary authorities face two challenges – either focus all efforts on stabilizing the banking system (by increasing budget expenditures, including financing of development institutions and expansion of banking system refinancing), or combating inflation (constraining budget expenditures, appreciating the ruble, administrative measures, etc.) Considering the extent of the viability of Russia's financial infrastructure and methods used for operational management of the economy, it will not be easy to make such a trade-off.

Real sector

September 2007 heralded a further slowdown in Russian industry

In September, Russian industrial output inched up 3.0% y-o-y, representing the lowest monthly performance so far in 2007.

The near 50% deceleration of growth (vs. 5.8% in July-August y-o-y) in the last month of the third quarter was behind the modest results for the entire quarter. The output of Russian industry in July to September 2007 rose a mere 4.9% y-o-y.

The qualitative changes in Russian industrial growth that we highlighted starting from July 2007 have now crystallized into discouraging statistics.

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

	September	July-August	III Quarter	II Quarter
Industrial Production Growth Index	**3.0**	**5.8**	**4.9**	**6.7**
Mining and quarrying	0.2	0.9	0.8	2.0
Manufacturing	4.0	8.9	7.2	9.5
Final demand sectors	*3.0*	*4.9*	*4.2*	*7.4*
including:				
Manufacture of food products	3.2	4.8	4.1	7.8
Manufacture of textiles and textile products, manufacture of leather, leather products, shoes	-8.0	-2.8	-4.7	3.0
Intermediate demand sectors	*3.0*	*3.7*	*3.3*	*4.4*
including:				
Manufacture of coke, refined petroleum products	1.2	2.2	1.9	2.7
Manufacture of basic metals and fabricated metal products	-0.2	-0.6	-0.5	1.6
Investment demand sectors	*5.1*	*16.7*	*13.8*	*17.1*
including:				
Manufacture of machinery and equipment	4.6	17.0	14.4	17.5
Manufacture of other non-metallic mineral products	6.5	11.1	10.0	13.5
Electricity, gas and water supply	4.1	2.7	3.2	1.0

Source: Russian Statistics Service, CSI Bank of Moscow.

In our opinion, the third quarter of 2007 saw the final transition of Russian industry to the “investment” growth model driven by only a single “engine” (investment demand growth) out of the three available (consumer demand growth, investment demand growth and growth in prices for energy-producing materials).

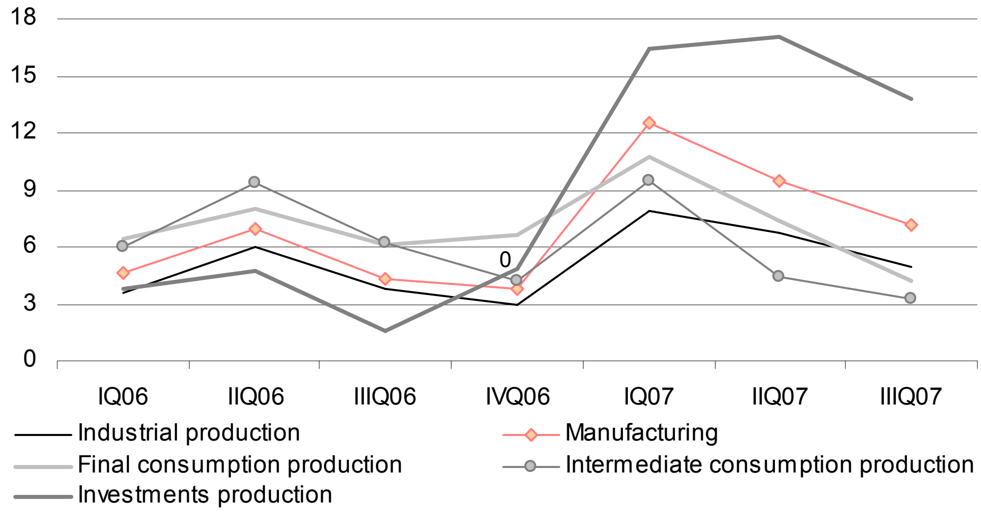
The upturn in prices for energy-producing materials ceased to be a catalyst for Russian industrial growth as far back as 2005 (with the ushering in of the progressive tax scale and the YUKOS confiscations). Despite the persistent growth in world oil prices, the mining and quarrying industry has sunk into stagnation: growth sagged to only 0.8% y-o-y in the third quarter, demonstrating a clear downturn versus the preceding quarter (2.0% y-o-y) and, naturally, a more severe slump compared to the first quarter (4.2% y-o-y). The downswing also hit the manufacturers of coke and refined petroleum products: quarterly output growth (1.9% y-o-y) fell to a two-year low.

In mid-2007, *consumer demand growth* was no longer viewed as a growth factor for the respective manufacturing sectors. As we noted in our previous publications, between June and September 2007, the number of industries with faltering growth was widening, and output growth in the final demand sectors was resolutely set on a downward path. In September, the output of food products rose by just 3.2% y-o-y, a two-year low, while the output of the former light industry (textile, textile products and shoes) contracted by 8% y-o-y. The last time such a poor result was observed was in spring 2005. The output of other consumer goods inched up just 1.3% y-o-y, itself a two-year low. Finally, output in the final demand sectors grew a slight 3% y-o-y in September 2007 and by 4.2% y-o-y in the third quarter, representing the worst growth performance for the past two years.

Investment demand growth is currently the main and only locomotive driving Russian industry. In the third quarter of 2007, investment demand sectors sustained fairly high growth rates (13.8% y-o-y) and actually pulled the industry average up to 4.9% (y-o-y). At the same time, September can hardly be called a "lucky month" for this group either: the growth indicators in manufacturing of machinery and equipment (except transport) and manufacturing of building materials deteriorated noticeably. Whereas in July and August investment demand sectors managed to sustain decent 17% growth, September's results were worrying and suggest a more reserved assessment of Russia's industrial growth outlook in terms of the current model.

Apart from the abovementioned features, this growth model has obvious disproportions within the manufacturing sectors, as manifest in the evident and progressing growth slowdown of intermediate demand sectors. Their growth rates plunged in the third quarter, despite the investment sector performance, with output edging up by 3.3% (y-o-y).

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



Data for the first quarters of 2006 and 2007, accordingly, are adjusted for climate factors.

Source: Russian Statistics Service, CSI Bank of Moscow.

We see major threats to the industrial production growth model in terms of an unavoidable downturn in growth (the investment sector alone cannot shore up industry-wide growth at an ambitiously high level), heightened growth risks (due to industrial growth slanting towards investment growth in the Russian economy), and deep-seated, aggravating disproportions in industry and the entire economy.

Price overhang persists despite dwindling producer prices

On the formal side, industrial producer prices in September were "dead calm": the price drop averaged just 0.6%. Ephemeral 0.1–0.3% growth was observed in the manufacturing and the electricity, gas and water supply sectors, while the mining and quarrying sector suffered a 2.6% downswing.

Stumbling growth of industrial producer prices in September and the third quarter of 2007 (2.2% in July-September following a healthy 12.7% in the second quarter of 2007) *are not positive signals,* and mark the end of the price overhang in Russia's economy and selection by Russian producers of an optimal growth trajectory.

The most crucial issue is that of accelerating producer prices in final demand sectors. If in the first and second quarters they rose by 2.4% and 2.8%, respectively, price growth in the third quarter soared to a record 5.2%. This trend propelled inflation beyond the originally projected target: consumer prices grew 1.7% in the third quarter (vs. 0.9% a year ago), and left behind last year's indicator for the first nine months (7.5% and 7.2%, accordingly). It is equally important that producers' tactical steps to raise prices have already led to a strategic repercussion – a slowing of output. In fact, the price upturn either *pushes Russian producers into a more expensive price niche* (where their products can hardly compete with imported analogues (textile, textile products and shoes: in the third quarter prices for these goods grew by 2.7–4.1% against the background of shrinking output), or *punctures demand for these products* (e.g. food products, the producer prices of which climbed 7.6% in July-September alongside substantial growth in prices for imported staple food products). Both factors contributed to a further slowdown of output in the final demand sectors as noted above.

Industrial Producer Price Growth (for the period), %

	2007 г.			January-September	
	III Quarter	II Quarter	I Quarter	2007 г.	2006 г.
Industry, total	**2.2**	**12.7**	**1.6**	**17.0**	**15.2**
Mining and quarrying	2.6	36.7	-2.8	36.4	25.8
mining and quarrying of energy producing materials	2.6	41.8	-3.4	40.5	26.3
Manufacturing	2.1	7.2	0.9	10.5	12.7
final demand sectors	5.2	2.8	2.4	10.6	6.6
investment demand sectors	4.6	4.5	3.0	12.5	10.3
intermediate demand sectors	-2.1	9.9	0.4	8.2	19.5
intermediate demand sectors , excluding manufacture of coke and refined petroleum products, and manufacture of basic metals and fabricated metal products	2.5	2.0	2.6	7.2	11.4
Manufacture of refined petroleum products	3.7	20.4	-10.2	12.1	28.3
manufacture of basic metals and fabricated metal products	-4.9	10.2	2.3	7.2	21.5
Electricity, gas and water supply	1.3	0.5	13.5	15.6	10.4
Consumer prices	**1.7**	**2.2**	**3.4**	**7.5**	**7.2**
Urals	5.4	9.8	18.5	37.1	7.3

Note. 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.

In the first three quarters of 2007, producer and consumer prices grew faster than a year ago. But more importantly, the more rapid growth in prices of industrial goods was triggered by sizeable acceleration of prices in the consumer (10.6% in January-September 2007 vs. 6.6% a year earlier), electricity, gas and water supply (15.6% vs. 10.4%), and mining and quarrying of energy-producing materials (40.5% vs. 26.3%) segments. In this context, the price overhang already shaped in Russian industry can broaden further on the back of rising prices for coke and refined petroleum products (which still considerably lag behind prices in mining and quarrying of energy-producing materials). Furthermore, the problem of consumer price hikes observed in September, which so far have only acquired a contour corresponding to the actual price overhang, may become even more acute.

Heavier dependence of the declining Russian economy's profit on the oil and gas sector looms large

In July-August 2007, the Russian economy's profit totaled R744 bln. The start of the third quarter appeared to be far less profitable than the previous quarter (in the second quarter the average monthly profit of enterprises totaled R424 bln, whereas in July-August the figure slid to R372 bln).

Corporate Financial Performance in 2007

	July-August	II Quarter	I Quarter
Economy's average monthly profit, total, R bln	**372**	**424**	**331**
The economy's profit structure, %			
Economy, total	100	100	100
Mining and quarrying of energy-producing materials and pipeline transport (oil and gas sector)	22.4	20.4	14.9
Economy, excluding mining and quarrying of energy-producing materials and pipeline transport	77.6	79.6	85.1
Profit growth as % to a similar period of 2006			
Economy, total	20	36	16
Mining and quarrying of energy-producing materials and pipeline transport (oil and gas sector)	32	20	-29
Economy, excluding mining and quarrying of energy-producing materials and pipeline transport	17	40	31
Manufacturing sectors	25	50	32
Electricity, gas and water supply	-19	-25	-4
Trade	5	17	-14
Communications and transport excluding pipeline transport	24	33	137
Construction and real estate	10	68	61

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

The Russian economy's profit is becoming increasingly dependent on the oil and gas sector: in the first half of 2007, enterprises operating in this sector earned 18% of the economy's profit, whereas in July-August their share widened to 22.4%.

The base effect is undoubtedly a significant factor behind this growth, as the first quarter was a fiasco for the Russian oil and gas sector, battered by sinking prices for Russian oil and delayed reduction of the export duty rate. Partly this explains the relatively low contribution of the oil and gas sector to the economy's profit in the first quarter (14.9%) and slimmed profits posted by this sector compared to last year (down 29% on the first quarter of 2006).

At the same time, it would be a mistake to view growing world prices for energy-producing materials as the only reason for the growing dependence of the Russian economy's profit on profits generated by the oil and gas sector. It is notable that in July-August, the performance of enterprises operating in other sectors of the economy *substantially worsened*. In the first and second quarters of 2007, the profits of non-oil and gas enterprises stood 31–40% above last year's respective indicators, whereas in July-August the correlation narrowed to 17%. Deceleration of profit growth is being observed in practically all sectors of the economy.

In July-August, profit in the manufacturing sectors grew by 25% y-o-y (vs. 50% growth in the second quarter of 2007), and in communications and transport (excluding pipelines) by 24% y-o-y (vs. 33% growth in the second quarter of 2007). Profits earned by the construction and real estate sectors faltered to 10% (y-o-y) compared to the robust 61% and 68% registered in the first and second quarters, respectively. Profit in the electricity, gas and water supply sector is declining – over the past five months it has dropped well below last year's level. Profits in the trading sector have been stagnant and show almost no upward movement versus last year.

All in all, the performance of the Russian economy mirrors the aggravation of its major systemic problems hindering growth, and has brought to the forefront its most glaring issue – structural imbalance.

Banking system

Chronic instability – search for new benchmarks

The Russian banking system remains unstable. State officials are emphatic in their denials of any crisis manifesting in the banking system (though it should be remembered that only a short time ago they would not listen to any talk of a spike in inflation). Russian banks are trying to adapt themselves to the new situation (heightened risks and interest rates) caused by changes in the structure and growth rates of assets and liabilities.

The first results of the search were seen in slowing lending to households and corporate clients and growing foreign assets of banks (against the background of high interest rates on the interbank market). Monthly growth of banking assets slumped by almost half, from 2.8% in August to 1.5% in September. Until now, the resource base of the Russian banking system has not suffered any capital exodus. The accounts of the corporate sector and households are still broadening. Arguably, interest rate hikes initiated by a number of top banks encouraged banks' customers. Foreign liabilities of the banking sector grew by about $5 bln, i.e. a level typical for the past five months.

Demand for ruble debt instruments shrank sharply, battered by rising interest rates. In early October, MDM Bank had to buy back all of its bonds of the third issue, and subsequently placed them at a higher rate of 11% instead of 8.5%. TKS bank managed to sell less than 20% of the planned issue volumes during the debut placement of their bonds, despite the declared yield of 18%, which is an extraordinarily high cost of financing, even for retail lending.

Major Banking Assets (as of the first day of the month), % of total

	01.05	01.06	01.07	04.07	07.07	08.07	09.07	10.07
Assets, R bln	**7138**	**9751**	**14047**	**15600**	**17204**	**17477**	**17959**	**18231**
Cash and precious metals	2.8	2.7	2.6	1.8	1.8	1.8	1.8	1.9
Accounts with CBR	9.8	7.3	7.5	8.0	10.9	9.1	7.3	6.1
Interbank transactions	6.2	6.3	5.8	5.4	5.3	5.3	5.0	4.7
Foreign assets	7.8	9.1	9.9	11.5	8.4	8.0	8.7	10.0
Households	8.7	12.1	14.7	14.4	14.9	15.3	15.7	16.0
Corporate sector	49.8	47.0	45.3	44.8	45.0	46.0	46.5	47.2
Government	8.0	6.6	5.2	5.0	4.7	4.8	4.6	4.1
Property	2.6	2.4	2.4	2.4	2.3	2.3	2.2	2.2

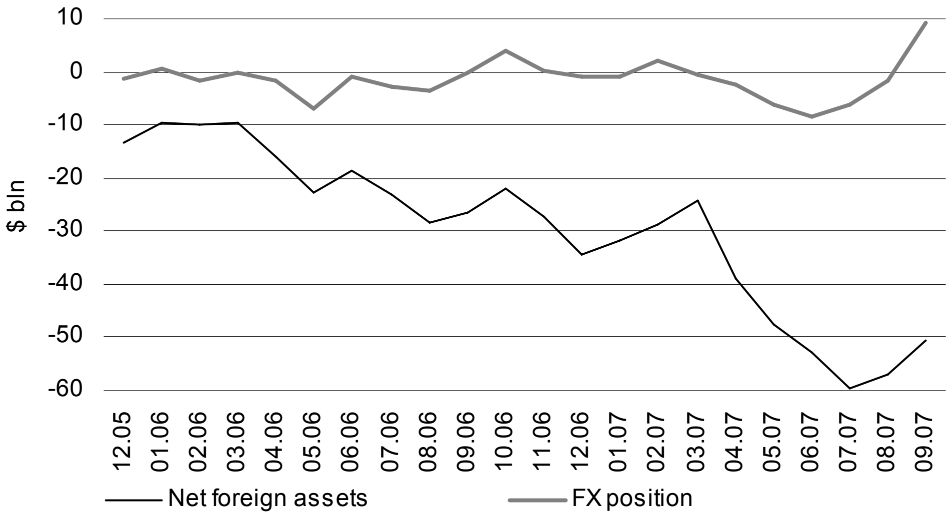
Source: CBR, CSI Bank of Moscow.

In September, the retail credit market grew a mere 3.5%. This slowdown in lending activity affected most of the key players. Bank Russky Standart suspended the issue of new credits during the last ten days of September, trimming its retail credit portfolio by 2.5% over the month. Retail lending will switch into slower gear in the near future. On an annualized basis, we expect loans to households to increase by 60% (versus 75% in 2006).

Decelerated growth in the total retail credit portfolio highlights its quality aspect (high growth rates had previously overshadowed this problem). Excluding Sberbank, the share of past due accounts totaled 4.5% in early October 2007, and in certain leading banks overdue debts exceeded 10% (Alfa Bank – 11.1%, Russky Standart – 17.5%, HCF Bank – 21.1%).

The liquidity crunch eased slightly in September compared to the prior month. Liquid assets placed with foreign banks leaped sharply. Short-term loans to non-resident banks in September ballooned by R180 bln (nearly $8 bln). All in all, banks' foreign assets swelled by $12 bln over that month, and significant shifts were observed in banks' currency positions – assets denominated in foreign currencies exceeded foreign currency liabilities by more than $9 bln.

Banks' currency position and transaction balances with non-residents



Source: CBR, CSI Bank of Moscow.

In the near term, the banking sector will attempt to strike a viable balance between the structure of transactions and the cost of resources. For several months, the uptrend in the cost of financing for all resources and of asset transactions may continue, but their movement will be determined not only by the situation on external markets, but also by high inflation – a problem that has come back to haunt Russia.

Major Banking Liabilities (as of the first day of the month), % of total

	01.05	01.06	01.07	04.07	07.07	08.07	09.07	10.07
Liabilities, R bln	**7138**	**9751**	**14047**	**15600**	**17204**	**17477**	**17959**	**18231**
Capital	17.1	16.3	15.2	15.9	16.2	16.4	16.8	17.0
CBR loans	0.3	0.2	0.1	0.1	0.1	0.0	0.0	0.0
Interbank transactions	4.2	4.0	3.4	3.3	3.1	3.2	3.1	2.9
Foreign liabilities	9.9	12.8	16.1	15.3	16.1	16.5	16.7	16.8
Household deposits	28.4	28.9	27.6	26.3	25.9	26.0	25.9	26.0
Corporate deposits	23.7	24.0	24.0	24.9	25.1	24.0	23.9	24.5
Accounts and deposits of federal state authorities and local governments	2.9	2.0	2.2	2.6	2.4	2.7	2.9	2.6
Issued securities	9.0	7.6	7.2	6.4	5.8	5.7	5.5	5.3

Source: CBR, CSI Bank of Moscow.

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	6.4	6.7	7.3	6.8	6.8	5.9
Industrial Production, %, y/y	8.3	4.0	4.4	6.0	4.5	4.8	5.0
Retail Turnover, real, %, y/y	13.3	12.8	13.9	14.0	13.0	11.5	10.0
Gross Fixed Investments, real, %, y/y	10.8	10.9	13.7	18.2	15.0	13.0	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	30.0	27.5	21.0	20.5
M2, year end, % y/y	35.8	38.6	48.8	38.0	31.0	22.0	19.5
M2X, year end, % y/y	33.7	37.4	40.5	33.0	26.0	20.0	21.0
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	10.7	8.5	8.0	7.5
CPI, year average, %	11.0	12.5	9.8	9.0	9.5	8.2	7.7
Core CPI, year end, %	10.6	8.3	7.8	10.0	7.5	7.0	6.5
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, % GDP1	-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, % GDP2	-4.5	-7.7	-7.7	-6.0	-3.7	-3.3	-3.0
Balance of Payments							
Exports, $ bn	184	244	304	355	390	400	405
Imports, $ bn	96	125	165	230	270	305	360
Current Account, % GDP	10.0	10.9	9.7	6.9	4.6	3.1	-0.2
Net Capital Inflow/Outflow, $ bn 3	-8.4	0.7	41.7	70	50	45	40
International Reserves, year end, $ bn 5	125	182	304	460	565	650	680
External Debt							
Foreign Public Debt, year end, % GDP	18.6	10.6	5.1	3.7	2.9	2.3	2.0
Foreign Private Debt, year end, % GDP6	4.4	3.9	3.8	3.2	2.7	1.9	0.8
Exchange Rate							
R/$:							
end of period	27.8	28.8	26.3	24.7	25.5	26.0	27.4
year average	28.8	28.3	27.1	25.6	25.2	25.7	26.7
Exogenous Parameters							
Urals, $ p/bbl	34.6	50.4	60.9	70	75	73	70
$/€	1.24	1.25	1.26	1.37	1.38	1.35	1.32

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

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