Bank of Moscow

Economic Monthly

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Domestic problems outweigh external factors

Center of Strategic Investigations

CONTENTS

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It seems strange that Russia, being a net capital exporter, depends so heavily on external capital inflows. During the period from September 1 to December 1 of this year, Russia's international reserves grew by $47.5 bln, and $23.8 bln was channeled into the Stabilization Fund. Also, despite sizeable capital injections, the monetary authorities are becoming increasingly concerned about the liquidity crisis in the banking system. The main question now is what underlies the instability in the financial sector: is it structural disproportions in the banking system, faulty financial policy, or an ill-developed system of monetary regulation?

The Russian banking sector's aggregate balance for 2007 shows that there have been no radical structural misbalances in the current year. Moreover, all changes that occurred are expected to strengthen the stability of the national banking system. The equity of Russian banks expanded substantially, largely through two local and international IPOs launched by Sberbank and VTB (combined total of about $17 bln). Adding profit and proceeds from other IPOs, the equity of the Russian banking sector in 2007 will approximate R900 bln, by far outperforming recent annual figures (R415 bln in 2006 and R243 bln in 2005). In fact, 2007 can be seen as a year of *real capitalization* of the Russian banking system, though our best guess is that the achieved levels (despite optimistic capital inflow projections) will not be surpassed until at least 2011.

A logical question arises – which bottlenecks would banking sector liquidity be unable to cover? Two answers seem reasonable. First, banks have no sufficient resources to maintain such a fast pace of lending activity. The Russian banking system has indulged in excess lending – the volume of bank loans exceeds the volume of deposits by 20% (as of November 1, 2007). Russian enterprises, however, continue to act as net borrowers in respect of the banking system – corporate loans exceeded corporate deposits by R 1.4–1.5 trln in the current year (compared to the stable levels of R490 bln and R560 bln in 2005 and 2006, respectively). Savings activity on the part of households is receding, as they increasingly prefer to borrow. Banking system deposits exceeded loans by R217 bln in 2005, by R195 bln in 2006, and by only R30 bln in 2007. At best, the current year's level will be sustained in 2008. In these circumstances, even insignificant changes in external financing can give rise to interest rate fluctuations.

Another possible explanation is that because the segmentation of the banking sector is so pronounced, it no longer functions as a single integrated system. We believe that only a small number of banks were committed to balanced business development, and that "capturing" the most lucrative market niches still remains the most popular strategy. The goal is obvious – to borrow cheaply on international markets and move borrowed funds into consumer loans and bonds (below the 1st and 2nd tiers) at a high price. It appears as though many banks have elected to follow this route (disregarding optimal risk management), and the model is now being tested for viability. The channels for refinancing foreign borrowings are actually all closed; now, banks actively use short-term refinancing. Meantime, growth in the consumer loan market has slowed, and the volume of past due loans is widening. To put it differently, the model of converting foreign borrowings into consumer loans works poorly, but most Russian banks seem unprepared for any other alternative.

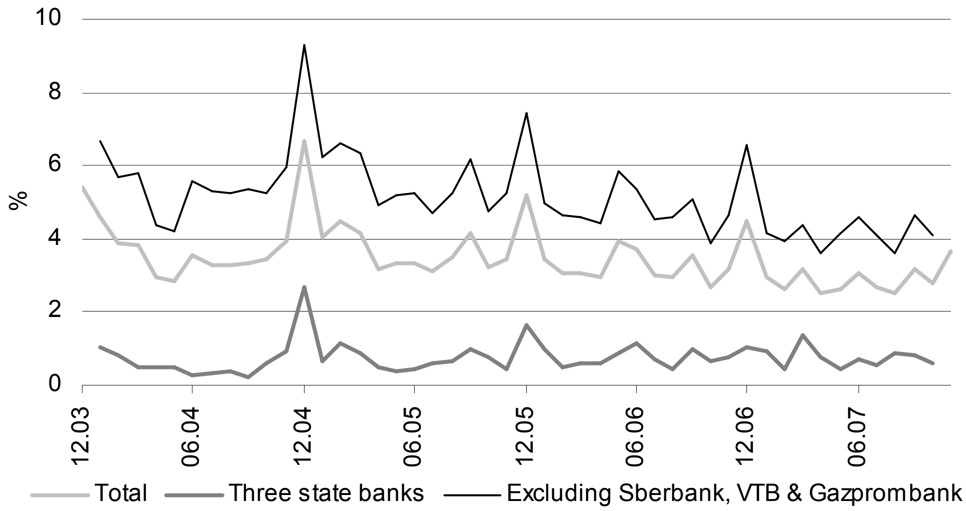
Monetary sector

November marked a turning point in the money supply trend. In the first half of the year, the broad monetary base increased for the first time. The decline in banks' liquid assets placed with the CBR was reversed by $160 bln growth over the month. The level of liquidity with respect to total banking assets rose marginally from 4.9% to 5.7%, but this is still *a critically low level* of saturation with liquid assets. This indicator has not been below 6% since 2002, and during the crisis of 2004 it ranged from 6.5–7.0%.

Key money market indicators also point *to enormous misbalances* in the banking system in terms of available resources. In November, the overnight interbank interest rate did not sink below 5.25% per annum (in October it dropped below 4%). Daily turnover in direct REPO transactions was higher than R50 bln during the month (in October banks borrowed less than R5 bln from the CBR for almost ten days). On November 28, transactions involving this refinancing instrument hit record levels, as banks received a record high R300 bln.

A low admissible level of liquid assets for banks affiliated in some way with the State is one of the peculiarities of the banking sector's segmentation. For Sberbank, typical balances on correspondent accounts with the CBR comprise less than 1% of total assets. The balances of the top twenty banks with the CBR should amount to 1.5–2.0%, and those of the smaller banks should be 3–5% or even higher.

Ratio of Correspondent Account Balances with CBR to Total Assets, %



Source: CBR, CSI Bank of Moscow.

The share of the top banks in aggregate indicators is so great that any changes they experience can sometimes considerably distort the general picture in the banking sector, obscuring the real state of affairs among second and third tier banks. Partly, these distortions are patched up by large banks supplying liquidity on the interbank market. However, the high level of liquidity in the banking system in general does not signify the *absolute absence of liquidity problems*. This is clearly seen in situations when top banks for certain reasons divert their funds from the domestic money market. Almost all episodes of sharp interest rate hikes on the *domestic* interbank market in the past two years were accompanied by a capital exodus to *international* capital markets.

In December, the general level of liquidity is expected to grow. December is traditionally a month of energetic government spending filling the economy and, consequently, the banking sector with money. This year, the capitalization of state-owned corporations will be an additional catalyst for liquidity volumes. In late November, a total of R300 bln was funneled from the Stabilization Fund to the share capital of state-owned corporations Bank For Development Bank and Foreign Economic Affairs (Vnesheconombank), Russian Nanotechnology Corporation, and Investment Fund of the Russian Federation.

As such, a substantial amount of resources cannot be used in a single stroke; instead the banking sector will dispose of its considerable portion over a relatively long period of time. According to Finance Minister Kudrin, $40 bln from this amount was immediately directed by Vnesheconombank to the interbank market. A significant chunk of available funds held by development corporations is likely to be moved, as a temporary measure, into deposits of Russia's top banks – Sberbank, VTB and Gazprombank. How this situation will impact the resolution of liquidity problems experienced by smaller participants on the interbank market and second-tier banks will depend on the money management strategy of the “Big Three”.

Inflation

At first glance, prices in September were pushed up by a number of external factors and "non-recurrent" events on international markets, e.g. the withdrawal of subsidies from European agricultural producers and an upturn in world grain prices. At the time, it seemed to be a one-off leap in food prices setting the basis for higher but stable prices. Moreover, the Russian government took belated but reasonable measures to increase export duties and cut import duties on a number of food products. It was logically expected that inflation in 2007 would run higher than the projected level, but also that it would not be a trend heralding a new wave of consumer price acceleration. Accordingly, the Russian government, while admitting its failure to bring down inflation in the current year (8%), continues to stick to its medium-term targets that were used as a basis for the medium-term program of Russia's economic development and budget plan until 2010.

Unfortunately, developments in September-November showed that the price trends do not exactly fit in with the government's projections. As it appears now, a new acceleration trend was mistakenly taken for an externally-generated price spurt. In December, Prime Minister Zubkov instructed the government to design measures to curb consumer price growth. Clearly, it will be a case of "chasing a train that has already left the station", as inflation and inflationary expectations have already risen to a new level.

In November, consumer prices edged up by 1.2%. This represented minor growth compared to the price surge of October (1.6%), but was expected to be even lower given the swift intervention of the government, which established a moratorium on prices for staple food products (end of October) and gasoline (mid-November).

Consumer Price Growth in 2007, %

	m-o-m growth			November 2007 to December 2006	*For reference:* November 2006 to December 2005
	September	October	November		
Consumer price growth index	**0.8**	**1.6**	**1.2**	**10.6**	**8.2**
including:					
Food products	*1.0*	*3.3*	*1.9*	*13.7*	*7.5*
Fruit and vegetables	-8.8	0.9	6.2	15.7	6.5
Food products, excluding fruit and vegetables	1.7	3.5	1.5	13.5	7.6
Butter	9.4	12.7	4.3	37.6	5.6
Milk and milk products	7.2	9.6	3.7	27.3	7.3
Pasta	2.5	3.1	3.3	21.2	4.4
Cereals and beans	2.1	2.9	2.9	22.7	10.6
Sunflower oil	13.5	26.3	2.3	51.4	-1.3
Bread and bakery products	1.6	1.0	0.4	21.7	10.3
Non-food goods	*0.8*	*0.9*	*0.9*	*5.8*	*5.5*
Paid services to households	*0.4*	*0.1*	*0.6*	*12.4*	*13.0*

Source: Russian Statistics Service.

Such targeted measures to combat food price hikes helped trim the growth in food prices (excluding fruit and vegetables) to 1.5% per month, slightly below the September level (1.7%) that urged the government to initiate these measures in the first place. Despite a certain deceleration in price growth, food products continue to grow more expensive: in November, prices for milk and butter grew by almost 4%, and for cereals and pasta – by 3%. Bread prices inched forward 0.4%.

Even before the traditional rise in prices at year's end, the growth in food prices was remarkable: over the first eleven months of 2007, prices for cereals, bread and pasta grew by 22%, prices for sunflower oil more than doubled, and prices for milk and butter climbed by 27–37%. Growth in prices for staple food products was brought about by a near doubling of growth in food prices as a whole. If in January to November 2006 prices for food products increased by 7.5%, this year they rose by 13.7%. The traditional upswing in prices for food products in December, accentuated by inertial price growth in autumn, will only widen the gap.

It is notable that food price hikes are only part of this year's inflation story. Over the first eleven months of 2007, prices for non-food products grew faster than a year ago (5.8% versus 5.5%). Service prices, which have grown 12.4% more expensive since January (versus 13.0% a year ago), have additionally spurred inflation.

All said, projected consumer price growth remains at 11.5–12.0% in 2007. After the 9.0% inflation recorded in 2006, this represents a fiasco on the part of the Russian government.

Therefore, the events rounding out this year have clearly outlined the problems of economic growth and financial stability that will challenge the country in 2008. Over the past two years, economic growth was shored up by expanding domestic demand, in both the consumer and investment sectors. Persistent inflation will have a direct impact on interest rates for deposits and loans. It is clear that upwardly bound interest rates will dampen demand for loans from households and corporate customers, inevitably impacting investment and consumer activity. However, considering the slowdown in lending to the non-financial sector accompanied by subsiding foreign capital inflows (among other things, due to capital flow controls), we can expect prices to pick up by 7–8% in 2008.

Real sector

Industrial production in 4Q07: another renaissance?

In October, industrial production output shot up by 6.1% (y-o-y), double the dismal result posted in September (3.0% y-o-y). In the context of stagnating output in the electricity, gas and water supply sector (-0.1% y-o-y) and a slight output blip in the mining and quarrying sector (1.4% y-o-y), surging output in the manufacturing sectors remains the driving force behind growth in Russian industrial output (9.0% y-o-y).

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

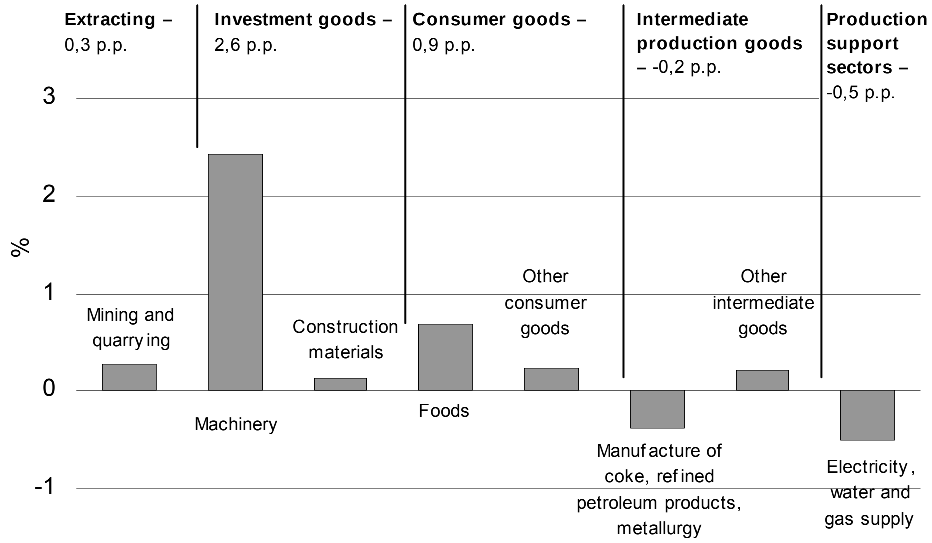
	II Quarter	July-August	September	October
Industrial production	**6.7**	**5.8**	**3.0**	**6.1**
Mining and quarrying	2.0	0.9	0.2	1.4
Manufacturing	9.5	8.9	4.0	9.0
Final demand sectors	*7.4*	*4.9*	*3.0*	*7.4*
Including:				
manufacture of food products	7.8	4.8	3.2	8.8
manufacture of textiles and textile products, leather, leather products, shoes	3.0	-2.8	-8.0	-3.3
manufacture of pulp, paper and paper products; publishing and printing	6.6	9.7	8.6	10.4
other sectors	8.5	4.0	1.3	4.3
Intermediate demand sectors	*4.4*	*3.7*	*3.0*	*2.4*
Including:				
Manufacture of coke, refined petroleum products	2.7	2.2	1.2	-3.7
Manufacture of basic metals and fabricated metal products	1.6	-0.6	-0.2	-1.8
Investment demand sectors	*17.1*	*16.7*	*5.1*	*16.1*
Including:				
Manufacture of machinery and equipment	17.5	17.0	4.6	16.8
Manufacture of other non-metallic mineral products	13.5	11.1	6.5	7.7
Electricity, gas and water supply	1.0	2.7	4.1	-0.1

Source: Russian Statistics Service, CSI Bank of Moscow.

In October, Russian industrial growth bounced back to the rates registered in the period from April to August 2007 (6.0–6.5% y-o-y) against the background of moderate growth in the mining and quarrying, and electricity, gas and water supply sectors (averaging about 1.5% y-o-y) as well as fast-track manufacturing sectors (9% growth y-o-y).

Industrial growth was fueled (+3.1 ppts in October versus September) by the investment and final demand sectors as well as the mining and quarrying sector. Together the two contributed 3.8 ppts to industrial growth. Intermediate demand and the electricity, gas and water supply sectors were the main growth depressants, pulling down industrial growth by 0.7 ppt. We correctly guessed that industrial growth would be able to rebound primarily thanks to an upsurge in the machinery and equipment sector (4.6% in September to 16.8% in October y-o-y), which propelled industrial growth by 2.4 ppts.

Basis for Industrial Production Acceleration to 6.1% in October versus 3.0% in September (y-o-y):



Source: Russian Statistics Service, CSI Bank of Moscow.

Additionally, unexpectedly high growth was demonstrated by manufacturers of food products (8.8% y-o-y in October versus 3.2% in September, which added 0.7 ppts to overall industry growth). The significance of growth trends in the manufacture of food products for industry as a whole puts the issue of sources and sustainability of high growth in this sector high on the agenda. Accelerating growth staged by manufacturers of food products was brought about by fast growth in production of meat and meat products, processed and canned fish and sea products, beverages and milk products.

On the one hand, escalating growth in the manufacture of food products in October can be attributed to a statistical impact. For instance, the 12.5% y-o-y growth in production of processed and canned fish and sea products (after a period of stagnation/output contraction in January to September 2007) can be ascribed to the base effect: in October 2006 output in this sector shrank by more than 7% y-o-y following the stagnation suffered in January to September. Growth in production of meat and meat products also seems statistically exaggerated: the output leap in October, by 22.5% y-o-y from 6.8% in September, was triggered almost exclusively by a huge jump in production of poultry by a record 79.9%. On the other hand, rising production of a number of food products was the result of their plunging imports dampened by the appearance of a gap in prices between global and local producers. Among these products are dry milk and cream, butter and cheese, and sunflower oil.

Therefore, accelerating output of food products in October is probably slightly overestimated, but quite economically plausible from the standpoint of an expanding niche of locally-made food products: administrative constraints put on food prices and their slower growth on the Russian market versus a sizeable upswing in world prices trimmed imports and stoked demand for domestic food products.

In terms of the prospects for sustaining high growth in the manufacturing of food products and, accordingly, high growth of Russian industry up to the end of 2007, we offer some comments on a number of points.

In our opinion, the impetus given to the manufacturing of food products by resorting to administrative resources in price-setting *cannot boost growth* in this sector, even in the short term. As a non-recurrent measure (localized to the fourth quarter of 2007), it can potentially speed up the output of domestic analogues of imports and lay the groundwork for higher growth rates throughout the industry. In terms of industrial dynamics, the value of this process is fairly high, especially since during periods of food price hikes the volumes purchased by wholesalers continued to increase at a pace achieved prior to the price spurt. High growth in the manufacturing of food products may be dented in the coming months only by rebounding imports as a result of pared import duties on milk, milk products and cheese, effective from October 15.

Therefore, the October trend is likely to persist in the fourth quarter of 2007. Industrial growth, however, will hover between 6.0–6.5% y-o-y alongside slow growth in the mining and quarrying and electricity, gas and water supply sectors (within 1.5% y-o-y) with fast growing (9% y-o-y) manufacturing sectors as a backdrop. High growth in the manufacturing sectors will be underpinned by fast growing investment demand sectors and resumed growth in final demand sectors – primarily the manufacturing of food products, printing and publishing. Owing to the specific nature of the 2007 pre-election campaign and more active use of administrative resources in all fields of the economy, the annual performance of Russian industry was boosted by a few percentage points.

The price paid for the “value added” will crystallize half a year after the price moratorium is lifted. The search by market operators for a new status quo in prices may reveal fresh imbalances in Russian industry.

Industrial producer prices: price overhang is shaping

In October, industrial producer prices remained almost unchanged at 99.9% of the September level. Prices for products of the manufacturing sectors picked up substantially (1.7%), their upturn offset by a price downturn in the mining and quarrying (-3.9%) and electricity, gas and water supply sectors (-0.3%).

Industrial Producer Price Growth in 2007 Growth (for the period), %

	April-June	July-August	September	October
	Monthly average			
Industrial producer prices, total	**4.2**	**1.4**	**-0.6**	**0.0**
Mining and quarrying	12.2	2.7	-2.6	-3.9
Manufacturing	2.4	1.0	0.1	1.7
final demand sectors	*0.9*	*1.6*	*1.9*	*2.1*
including manufacture of food products	0.6	2.4	2.7	3.8
investment demand sectors	*1.5*	*1.5*	*1.4*	*1.4*
intermediate demand sectors	*3.3*	*-0.3*	*-1.5*	*0.9*
intermediate demand sectors, excluding manufacture of coke and refined petroleum products	2.7	-1.0	-1.2	0.0
manufacture of coke and refined petroleum products	6.6	3.1	-2.2	3.7
Electricity, gas and water supply	0.2	0.5	0.3	-0.3
Consumer prices	**0.7**	**0.5**	**0.8**	**1.6**
Urals, $/bbl	3.3	-1.3	8.2	13.6

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.

Sustainable high price growth in the investment sector (1.4–1.5% per month over the past seven months) supported growth in prices in the manufacturing sectors. Prices for products of final demand sectors continued to climb (by 2.1% in October versus 1.9% in September) pushed by a steep rise in food prices (3.8% in October versus 2.4–2.7% in 3Q07). The extent of the price hikes in the manufacturing sector in October depended on the interim demand sectors (0.9% price growth after the downturn in 3Q07). Price escalation in this industrial group was triggered by resumed growth (3.7% during October) in prices of manufacturers of coke and refined petroleum products.

Therefore, the administrative measures targeted at stabilizing prices for a number of food products (late October) and gasoline (November) were implemented not only in conditions of a shaped price overhang, but also at a time of unusually fast price growth in the respective sectors. This economic setting once again underscored the specific nature of the government's radical interference in the price-setting process and identified the possible scale of misdirection in some sectors, as they will be unable in the next six months to respond adequately to market signals about their efficiency amidst mounting risks that prices will become less predictable.

Nominal growth in the Russian economy's profit was lower in the third quarter than growth in prices for industrial products

Statistics covering the corporate financial performance of Russian enterprises for the first nine months of 2007 introduced substantial adjustments to the economy's profit. Judging by the eight month results, we can see simple deceleration of profit growth, whereas September's results point to reduction of profit in real terms: in the third quarter of 2007, the Russian economy's profit grew by 11.3% and prices for industrial products rose by 13.6%.

Corporate Financial Performance

	2007			January-September	
	I Quarter	II Quarter	III Quarter	2007	2006
Economy, total, R bln	**992**	**1273**	**1216**	**3480**	**2883**
Profit growth, y-o-y, %					
Economy, total	16.2	35.7	11.3	20.7	
Mining and quarrying of energy-producing materials and pipeline transport (oil and gas sector)	-28.8	19.8	0.8	-2.4	
Economy, excluding mining and quarrying of energy-producing materials and pipeline transport	30.7	40.5	14.1	27.4	
Industrial producer price growth, y-o-y, %	8.6	13.0	13.6	11.7	
The economy's profit structure, %					
Economy, total	100	100	100	100	100
Mining and quarrying of energy-producing materials and pipeline transport	14.9	20.4	18.7	18.2	22.6
Economy, excluding mining and quarrying of energy-producing materials and pipeline transport	85.1	79.6	81.3	81.8	77.4
Manufacturing	31.7	39.4	37.4	36.5	33.6
Electricity, gas and water supply	6.0	1.1	-1.8	1.5	2.2
Trade	19.8	17.3	16.4	17.7	20.5
Communications and transport excluding pipeline transport	10.4	8.6	11.3	10.1	8.2
Construction and real estate	4.6	6.0	7.7	6.2	5.1

Source: Russian Statistics Service, CSI Bank of Moscow.

The sharp slowdown in the economy's profit growth was caused by stagnating profits in the Russian oil and gas sector – nominal profits earned in the first six months and third quarter of 2007 match last year's levels. In the third quarter, growing profits of enterprises operating in other sectors of the economy, though down compared to the first half of the year, stood above the level of inflation. The performance for the first nine months of 2007 indicates that the state-owned oil and gas sector weighed significantly on the Russian economy's growth, slashing its own contribution to profit growth (18.2% in January to September 2007 versus 22.6% for the first nine months of 2006).

Another important trend in 2007 has been consolidation of the manufacturing sectors as the Russian economy's profit center: in January to September, enterprises operating in these sectors accounted for 36.5% of the economy's profit (versus 33.6% a year earlier).

It is also notable that in January to September, manufacturing enterprises as well as wholesale and retail traders accounted for 54.2% of the economy's profit – posting the same result as a year ago. During these first nine months, however, profits of trading companies were falling.

Banking system

In October, growth in the banking sector almost touched zero, as banking assets inched up a fractional 0.3% (the lowest level since summer 2004). The downtrend was brought about by two factors.

First, the banking sector is increasingly feeling pressure from the liquidity crunch on global markets and, as a consequence, contraction of external sources of financing. In October, growth in foreign liabilities plunged to $3.3 bln (from $5.7 bln in September).

Second, large-scale tax collections traditional for October were complemented by the transfer of YUKOS balances to the state budget (as we mentioned in our previous Overview). Therefore, corporate account balances shrank by 3.2% over the month, or almost R150 bln. As a result, the total amount of funds borrowed by banks did not change in October. The increase in banking assets was underpinned only by banks having built up their equity. But this growth factor cannot be viewed as viable either, as equity growth was sustained (2.0% in October) by the solid profits of Sberbank (R36.9 bln with equity increasing by 4.8%). Sberbank's new CEO German Gref has indeed inherited a good business. The return on assets for the first ten months of 2007 reached 4.0%, whereas the return on total banking assets was registered at 3.1%.

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	11.07
Liabilities (R bln)	**7138**	**9751**	**14047**	**15600**	**17204**	**17477**	**17959**	**18231**	**18248**
Capital	17.1	16.3	15.2	15.9	16.2	16.4	16.3	16.4	16.7
CBR loans	0.3	0.2	0.1	0.1	0.1	0.0	0.0	0.0	0.1
Interbank transactions	4.2	4.0	3.4	3.3	3.1	3.2	3.1	2.9	2.9
Foreign liabilities	9.9	12.8	16.1	15.3	16.1	16.5	16.7	16.8	17.0
Household deposits	28.4	28.9	27.6	26.3	25.9	26.0	25.9	26.0	26.3
Corporate deposits	23.7	24.0	24.0	24.9	25.1	24.0	23.9	24.5	23.7
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	2.6
Issued securities	9.0	7.6	7.2	6.4	5.8	5.7	5.5	5.3	5.4

Source: CBR, CSI Bank of Moscow.

Banking liabilities might have dwindled had it not been for the steep rise in corporate *term deposits* (versus movements in correspondent accounts), which rocketed 20% in October, or R285 bln. Unsurprisingly, state-owned banks not burdened by any liquidity problems (Sberbank and VTB) accounted for the lion's share of this upturn (R203 bln).

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

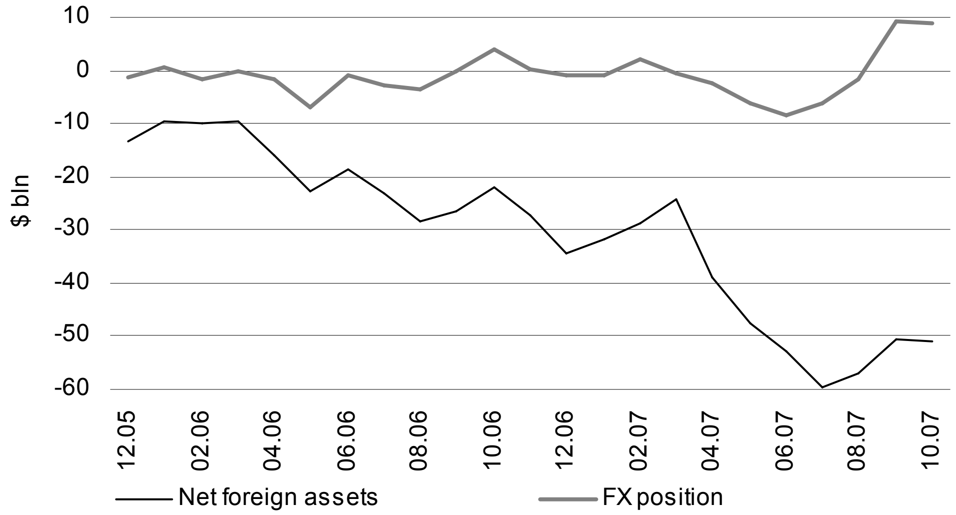
	01.05	01.06	01.07	04.07	07.07	08.07	09.07	10.07	11.07
Assets (R bln)	**7138**	**9751**	**14047**	**15600**	**17204**	**17477**	**17959**	**18231**	**18248**
Cash and precious metals	2.8	2.7	2.6	1.8	1.8	1.8	1.8	1.9	1.9
Accounts with CBR	9.8	7.3	7.5	8.0	10.9	9.1	7.3	6.1	4.7
Interbank transactions	6.2	6.3	5.8	5.4	5.3	5.3	5.0	4.7	4.6
Foreign assets	7.8	9.1	9.9	11.5	8.4	8.0	8.7	10.0	10.4
Households	8.7	12.1	14.7	14.4	14.9	15.3	15.7	16.0	16.5
Corporate sector	49.8	47.0	45.3	44.8	45.0	46.0	46.5	47.2	49.0
Government	8.0	6.6	5.2	5.0	4.7	4.8	4.6	4.1	3.7
Property	2.6	2.4	2.4	2.4	2.3	2.3	2.2	2.2	2.3

Source: CBR, CSI Bank of Moscow.

In conditions of a declining resource base, banks jettisoned their most liquid assets, i.e. accounts with the CBR and investments in securities. As a result, CBR liquidity has been sinking for five straight months. In October, account balances with the CBR decreased by another 15%, or $166 bln. Moreover, banks “unbundled” nearly R80 bln in government bonds.

These logical steps dictated by the liquidity squeeze were accompanied by unexpected *upswing in foreign assets* by $3 bln as well as banks’ investment in the shares of corporate issuers and debt securities of resident banks. Banks have been exporting capital for three months already starting from August 2007, coinciding with the instability on global markets. The volume of funds funneled abroad accounted for 90% of contracted liquidity. The September mismatch in the banking sector’s net foreign currency position continued in October – assets denominated in foreign currencies exceeded their respective liabilities by almost $9 bln.

Banks’ currency position and transaction balances with non-residents



Source: CBR, CSI Bank of Moscow.

Faltering growth in the banking sector has thus exacerbated all major risks inherent in the banking system: *currency* (due to a mismatched FX position), *market* (due to shifts in the securities portfolio structure towards higher risk instruments) and *credit* (the aggravation of which was actually dressed up by the write-off of a sizeable amount of uncollectible loans by Russky Standart (about $5 bln). Consequently, the share of overdue household loans payable declined from 3.3% to 3.2%.

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	32 566	38 991	46 222	53 895
by market exchange rate, $ bn	592	764	987	1 272	1 547	1 798	2 018
Real GDP, % y/y	7.2	6.4	6.7	7.7	6.9	6.8	6.0
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	11.7	8.5	8.0	7.5
CPI, year average, %	11.0	12.5	9.8	9.1	9.9	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	345	390	400	405
Imports, $ bn	96	125	165	220	270	305	360
Current Account, % GDP	10.0	10.9	9.7	6,9	5,0	2,6	-0,3
Net Capital Inflow/Outflow, $ bn 3	-8.4	0.7	41.7	85	50	45	40
International Reserves, year end, $ bn 5	125	182	304	470	590	675	700
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 (year average), $ p/bbl	34.6	50.4	60.9	70	75	73	70
$/€ (year average)	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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