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Bank of Moscow

Financial independence: Desirable, but hard to achieve

Center of Strategic Investigations

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For the global economy, the first quarter of 2008 was marked by unexpected and even woeful outcomes – a period when conservative or moderately pessimistic forecasts were suddenly unmasked as being unjustifiably optimistic. Only the negative qualitative forecasts proved to be on target – for example, price volatility on world financial markets. But the levels "surpassed" by a number of key indicators (oil price above $100/barrel, and the dollar's slump to $1.58/€ and below ¥100) were previously seen by most analysts and market participants as too unreasonable and extreme to actually materialize.

In the current environment, steady economic growth in Russia has been sustained thanks to growing prices for raw materials cushioning the repercussions of volatile global financial markets.

Russia's economic growth model has not changed – growth is still being spurred by expanding domestic demand (final and investment) funded by the export of raw materials and capital inflows. To put it differently, the economy's growth is being underpinned by mounting consumption and externally financed investment, whereas net domestic saving is dwindling.

Now, however, the situation is changing rapidly. The world financial crisis has served to highlight at least three major problems facing the Russian economy. First, foreign borrowing has grown more expensive. Second, its volume has dropped (the so-called "country limit"). Third, foreign portfolio investment showed the first signs of slowing. Another depressant may be the likelihood of recession in the US and EU, which may eventually weigh on demand for Russian raw materials and reduce export revenues.

The above factors are already being considered in selecting Russia's economic policy – to support high economic growth rates via substitution of external resources with public finance, or to allow a slowdown for the sake of financial stability and balance. A case can be made for implementing either option, along with its pros and cons. The substitution of international funding with state finance will require spending accumulated natural resource royalties for domestic purposes. This scenario is fraught with the risks of high inflation and overheating of certain market segments. For its part, slowing economic growth will potentially allow the removal of structural disproportions and elements of "overheating" while streamlining the banking system and "beefing up" the financial markets. The choice between the two options is the systemic choice of what is more beneficial for today's Russia: to live better, but with high risks, or to live with less prosperity, but also lower risks. A political choice indeed…

In this respect, concentrating efforts on developing the national financial sector at a fundamentally new level may act as a comprise solution. This issue has been high on the agenda for a long time – suffice to mention the banking crisis of summer 2004, the formation of the Stabilization Fund, and the uncontrolled influx of foreign capital in the context of the inflationary menace of 2007. All of these developments occurred against the background of high and growing world prices for raw materials. Meantime, official inflation forecasts have been a far cry from the true state of affairs for the past five years, and the monetary authorities have stood helpless in the face of external upheavals.

If a final decision is still in the pipeline, the main direction has been already outlined – the creation of a powerful and independent financial system capable of withstanding negative external trends. The advantages are obvious, but the monetary authorities will first have to redesign policy to achieve them while efficiently resolving a host of systemic issues.

Russia's new financial policy: A move to independence?

At long last, changes in the principles underpinning Russia's financial policy have become an urgent priority. This seems wise, as given its substantial raw material export potential alongside high and growing commodities prices, Russia should not be *so vulnerable* to negative impacts from world financial markets. In principle, the choice is simple – either Russia ramps up its raw materials exports and makes the best of the current situation, all the while accumulating resources for future development and *using* them, or else the national economy will grow dependent on foreign investment flows. Eventually, if Russia's economy does become dependent on foreign investment (and not on technologies that may be acquired in exchange for petro-revenues), it must take steps to nurture an attractive investment climate, a competitive business environment, an efficient labor structure and an incentivized taxation regime. Unfortunately, these competitive advantages appear to be melting away. Today, Russia is failing to use its revenues from resource extraction to boost production, and instead has been accumulating these revenues (all of which are then moved abroad) and neglecting to foster the conditions necessary to promote foreign capital inflows.

As a result, Russia has yet to take advantage of its sizeable financial potential from raw materials exports to promote domestic growth. The aggregate foreign debt of Russian companies and banks is significant and continues to grow, while banks are still saddled with problems stemming from the liquidity squeeze and refinancing of foreign debt. All things considered, the word "inaction" is perhaps most appropriate in describing the current situation.

The Russian banking system has been growing faster than GDP – commercial banks used cheap domestic resources to stimulate consumption, and only to some extent to boost investment. With regard to the Banking System Development Program (devised by the CBR), all absolute indicators and ratios have been surpassed. That said, the viability of the banking system has weakened, and its need for refinancing by the CBR is constantly growing. Further development of the banking system as a fully-fledged participant in economic growth, providing the non-financial sector with loans to bolster investment and consumption, remains one of the most pressing priorities.

Unfortunately, development of the banking system in the medium-term is associated with a number of problems. The key *systemic* problem of the Russian banking system is a dearth of internal financial resources to meet the economy's needs. Economic growth, based on expansion of domestic demand (final and investment), requires a respective increase in bank lending. In 2006 and 2007, corporate loans surged by 39% and 50%, respectively, and consumer loans – by 75% and 57% (versus nominal GDP growth of 24% and 23%, respectively). Russian banks' net foreign borrowing reached $27.6 bln in 2006 and $41.3 bln in 2007. Furthermore, apart from the banking system, Russian enterprises in the non-financial sector borrowed $7.1 bln and $43.5 bln abroad in 2006 and 2007, respectively. These figures point to *the high dependence* of the Russian banking system and non-banks on international capital markets.

This deficit of domestic financial resources is becoming more acute from year to year, as corporate and consumer loans are growing at a faster pace than corporate deposits and household savings. Corporate loans outpaced corporate deposits from R1.6 trillion in early 2006 to R3.4 trillion in early 2008. In early 2006, the volume of household deposits was 2.4 times the level of consumer loans, whereas in early 2008 household deposits exceeded consumer loans by only 60%.

Vis-à-vis domestic savings, international resources in this period had two main advantages – significantly longer maturities and fairly cheap costs. Whereas 75% of loans and deposits raised from non-residents have maturities of more than 1 year, including 40% with maturities beyond three years, domestic deposits and borrowings with maturities over 1 and 3 years account for 55% and 7%, respectively.

The deficit of domestic savings can be handled in two ways. Either *another* source of loan financing will be found, or growth in loans to non-financial sector and banking system assets, as well as economic growth, will brake sharply. The broad government and the CBR have substantial resources at their disposal – the Reserve Fund, the National Well-being Fund, the Investment Fund, balances on federal government accounts, the consolidated budget surplus, development institution funds, the Russian Pension Fund, and official gold and forex reserves. The total volume of these funds today considerably exceeds the potential volume of externally raised funds – at least $250 bln is available to be used on the domestic market.

Actually, today's discussion revolves around *choosing the course of economic policy* – maintaining high rates of economic growth, or witnessing their deceleration due to the deficit of financial resources. Both choices have their strengths and weaknesses. For example, slower economic growth may help combat inflation, strengthen the stability of the banking system (albeit via bankruptcies and acquisitions of certain banks), facilitate balanced growth of financial markets (removing "overheated" elements in a number of segments, primarily the real estate market) and eliminate disproportions in consumption and savings.

If the government decides on a policy of sustaining high rates of growth in domestic demand and lending activity in the event of a steep plunge in foreign capital inflows, it can substitute *foreign financial resources with its own funds.* In practice, that will significantly *reduce Russia's dependence* on world capital markets and contribute to the development of an *independent financial system*.

Basic requirements of a new financial policy

Key objectives of a financial policy aimed at creating a strong and independent system are the following:

- lowering inflation;
- maintaining a ruble exchange rate optimal to support production, investment inflows and financial stability;
- reducing dependence on developments in external markets;
- enhancing stability of the banking system;
- expanding the banking system's resources to support economic growth.

Achieving the above objectives and ensuring efficient functioning of the financial system will call for the following measures:

- *Reducing inflation* – to boost investment activity, inflation must be cut to at least 4–5%, imported inflation must be restricted by an effective taxation policy (changes in import and export duties), and the monetary component should be regulated by the money supply and interest rates;
- *Improving the BOP structure* – leveling the trade balance through import growth constraints (via the exchange rate and import duties) with concurrent maximal support for growth in exports of high-tech goods (including subsidization of exports, state lobbying, export insurance, and lending to external consumers through the Development Bank);
- *Managing the money supply through interest-rate policy*, and not by altering international reserves;
- *Developing the refinancing system* to increase the number of available options during periods of instability and crisis in the banking sector;

- Encouraging the banking system (at least, major banks) to pursue *a balanced policy* targeted at developing production and which is optimal for asset/liability risk management as well as effective and efficient control;
- Maintaining an *optimal institutional structure* of the banking system that preserves parity between state-owned, foreign and private banks. This parity implies a balance between the impact of foreign financial institutions and the external market environment, private banks' strategies aimed at maximizing profit, the social burden, and privileges in the provision of public financing to state-owned banks, in order to achieve effective development of the national banking system;
- *Rational use of public finance* – signifying the provision of available budgetary funds to Russian banks on an auction basis (risk-weighted), cooperation between commercial banks and development institutions in various projects, and the development of mixed-owner partnerships.

In all cases, creation of a sound national financial system immune to external shocks and productively contributing to steady growth of the Russian economy will require both extraordinary government efforts and qualitative changes in the instruments used. This is indeed the task for the next presidential term – difficult to implement, but key for ensuring future growth.

Money supply

Monetary policy tightened amidst the liquidity crisis

On February 4, despite the banking community's assurance of their readiness to provide whatever support was needed to resolve the liquidity problem, the CBR tightened monetary policy – practically all of the key interest rates were raised by 0.25 percentage point. Moreover, mandatory reserve requirements were increased starting March 1 by 1.0 percentage point on liabilities to non-resident banks and by 0.5 percentage point in respect of other liabilities.

These steps didn't have any significant impact on liquidity, and the increase in mandatory reserve requirements was partially compensated by the averaging ratio (giving wider opportunities to use a portion of funds on correspondent accounts as mandatory cash balances). The main emphasis of these moves was placed on their psychological and political message. The CBR demonstrated that lowering inflation remains a higher priority task than supporting banking sector liquidity, and that the regulator was prepared to more actively use the entire spectrum of available instruments (interest rates and mandatory reserve requirements) in shaping money supply.

The need to develop alternative money supply instruments was felt already in February, a month that saw the highest monthly increase in refinancing volumes to banks – between February 1 and March 1 the volume of banking sector liabilities to the CBR increased by R189 bln, totaling more than R230 bln as of March 1. At the same time, record-high daily liquidity injections seen last August and November (R272 bln and R300 bln, respectively) were not exceeded. In other words, the potential for short-term money infusions was not fully exhausted.

In this context, however, growth in international reserves as a traditional source of money supply was rather moderate. The ruble equivalent of international reserves decreased due to the dollar's precipitous fall, but even the currency-adjusted contribution of international reserves to monetary emission (the so-called emission effect) was less than R60 bln (i.e. less than one-quarter of growth in the monetary authorities' assets).

As a result, for the second time since last August, a peak in banks' refinancing activities coincided with a shrinking of currency flows from foreign economic transactions and ensured the lion's share of money emission, thereby preventing the money supply from contracting. In conditions of tax payments and growing budget accounts with the CBR, the monetary base widened by only R23 bln in February.

In the near term, we expect similar situations in which the CBR will have to broaden the range of money supply instruments. In January-February 2008, even with a huge trade surplus ($18.3 bn in January, an all-time high), international reserves grew modestly, gaining $5 bln over the two months (net of currency conversion adjustments). That is tantamount to $20–25 bln in capital outflow during this period. Therefore, even extremely advantageous external conditions for Russian exports cannot ensure a stable source of money supply.

Real sector

Slower industrial growth in January, albeit exaggerated, does not instill optimism

In January, Russian industrial output rose 4.8% y-o-y. Deceleration of industrial growth (versus 5.6% y-o-y in 4Q07) did not come as a surprise, but its scale and structure make one less optimistic about short-term industrial growth projections.

Industrial Production Output Growth, % y-o-y

	2007			January 2008
	IIIQ	IVQ	December	
Industrial production	**4.9**	**5.6**	**6.5**	**4.8**
Mining and quarrying	0.8	0.8	0.6	0.6
Manufacturing	7.2	7.8	8.4	4.6
Investment demand sectors	*13.8*	*12.7*	*12.9*	*5.1*
Including:				
Manufacture of machinery and equipment	14.4	13.7	14.4	5.8
Manufacture of other non-metallic mineral products	10.0	5.6	3.2	1.9
Intermediate demand sectors	*3.3*	*4.1*	*5.9*	*4.2*
Including:				
Manufacture of coke, refined petroleum products	1.9	0.7	3.4	2.7
Manufacture of basic metals and fabricated metal products	-0.5	0.2	3.5	2.3
Other sectors (woodworking, manufacture of chemicals, manufacture of rubber and plastic products)	9.6	10.6	10.0	8.0
Final demand sectors	*4.2*	*6.1*	*5.6*	*4.6*
Including:				
Manufacture of food products	4.1	5.8	4.2	3.1
Manufacture of textiles and textile products, leather, leather products, shoes	-4.7	-3.0	-2.6	2.3
Manufacture of pulp, paper and paper products; publishing and printing	9.3	10.4	10.3	6.8
Other sectors	3.5	6.1	8.8	8.8
Electricity, gas and water supply	**3.2**	**4.3**	**8.3**	**12.8**

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.

In January, the downswing in industrial output was triggered by a sharp braking of growth in the manufacturing sector: the 6.3–9.0% growth rate posted in 4Q07 weakened to 4.6% in the first month of 2008.

The downturn swept throughout almost all of the manufacturing industries. Interim demand sectors registered 4.2% growth (vs. 5.9% in December). Growth in final demand sectors declined to 4.6% (vs. 5.6% a month ago and 6.1% in 4Q07). The performance of investment demand sectors was shocking: their growth plunged to minus 5.1% in January after a steady 13% rise in 2H07.

Below we set forth *our key assumptions* regarding the structure and scale of slower growth in the manufacturing sector and the entire industry in January 2008.

In qualitative terms, January's performance may indicate that capacity limitations (for investment demand sectors) and demand constraints (for final demand sectors) are becoming the most significant barriers to growth in the manufacturing sector and industry as a whole.

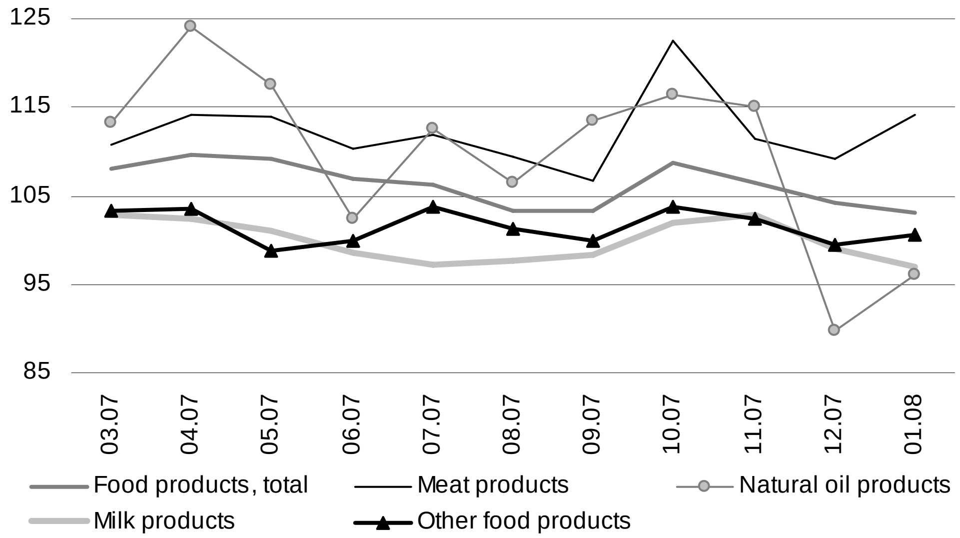
The unusually slow pace of growth in manufacturing of building materials and ebbing growth in output of machinery and equipment, both of which were already trending downward in 4Q07, can be attributed to the exclusively high level of existing capacity utilization. This assumption is also evidenced REB polls[1] showing that manufacturers of machinery, equipment and building materials are the leaders among other industrial producers in terms of capacity utilization (82–83%). Considering the high growth rates demonstrated by these industries throughout 2007, their performance this year might appear quite modest. *But in actuality, January's results can be viewed as a signal that due to transpiring under-capacity, this manufacturing segment is not prepared for further growth of investment in the Russian economy. This may eventually lead to a deficit of such products, as well as spiraling prices and/or growing imports of foreign substitutes*.

Subsiding the stimulative effect of consumer demand growth on growth of respective industries is another key depressant of growth for the manufacturing sector and industry in general. Most of all, this is seen in the manufacturing of food products, textile products and shoes. The output of textile, leather, and textile and leather products shrank steadily during 2H07 (in this context, the unexpected upturn in January 2008 calls for further analysis based on performance in the coming months). The output of food products contracted for a third consecutive month. *Fading competitiveness in the respective price niche (which was entered owing to persistent acceleration of prices for manufactured products) remains a serious challenge for further growth in manufacturing sectors serving final demand.*

Inefficient state administration, which often aggravates the disproportions within Russian industry and generates risks to its further growth, is another growth barrier. The situation in manufacturing of food products seems the most vivid example. The state's ineffective method of regulating prices for certain food products has robbed manufacturers of market signals spelling out their products' quality and demand. The last few months of 2007 and January 2008 supported our assumption that consumer price regulation would not have even a short-term positive impact on production: in October 2007 the output of food products rose 8.8%, whereas in November-December the rate began falling and dropped to 3.1% in January. It is particularly important to note the stagnant output of food product groups essential for the socially vulnerable segment of the population, including milk products, butter and others (bread, bakery and confectionery products, pasta, mayonnaise, sugar, tea and coffee).

[1] REB – Russian Economic Barometer – Long-term scientific research program implemented by the Center for Research in Transitional Economies of the Institute of World Economy and International Relations with the Russian Academy of Sciences since December 1991. Research is based on REB's industrial sample consisting of 800 economic entities. Each month about 200 questionnaires are processed.

Growth in output of food products, % y-o-y



Source: Russian Statistics Service, CSI Bank of Moscow.

The “non-aggression pact” (an agreement between the federal authorities and top retail chains to fix prices for staple products) is in essence a substitute for the widely applied international practice of control by regional authorities over the food market with a wider product mix and prevention of monopolistically high prices. The failure of the selected measures is manifest in market monopolization, accelerating growth in prices for food products, and a continuing slow pace of production growth in this industry.

In qualitative terms, industrial growth in January suggests the following main conclusions:

- Manufacturing sectors serving investment demand are entering a phase of undercapacity. This situation may result in a deficit of products in the context of ambitious investment plans, and could spur prices and/or imports of foreign substitutes.
- Manufacturing sectors serving final demand have lost much of their competitive clout in the struggle with imports as a result of spiraling prices for products they manufactured.
- Growth in manufacturing sectors serving interim demand shows only weak correlation with trends in other sectors and is quite moderate.
- The impact of the state as owner and moderator of economic processes on industrial growth is not indisputably optimal, particularly with regard to regulating the manufacture of food products, and in mining and quarrying, which is actually sliding into stagnation.

Individually and collectively, these factors pose a serious threat in the short term to stable and high growth rates in industry.

Finally, the contraction of industrial growth in January to 4.8%, following the more successful performance in 2H07, may be slightly exaggerated due to the base effect (extremely high official growth figures in January-February 2007) and will be adjusted somewhat over the next few months.

Yet in our view, these refinements will not change the general industrial growth trend or shorten the list of its major threats. This year will clearly be more difficult for Russian industry, which, together with the entire economy, faces the challenge of transiting to a fundamentally new model of development.

Producer and consumer prices are racing ahead

The growth trends involving producer and consumer prices in January provide further proof of the conclusions and speculations set forth above. Prices for industrial products in January continued to rise at the pace observed in 2007: 1.6% in January corresponds to 21% growth on an annualized basis. Producer price hikes in January were brought about by the upturn in world prices for energy-producing materials: prices in mining and quarrying climbed by 4.2% over the month. At the same time, it is important to note the sustained uptrend in general prices, i.e. the high rates of growth in prices for products significant for investment (investment projects) and final demand.

Industrial Producer Price Growth, %

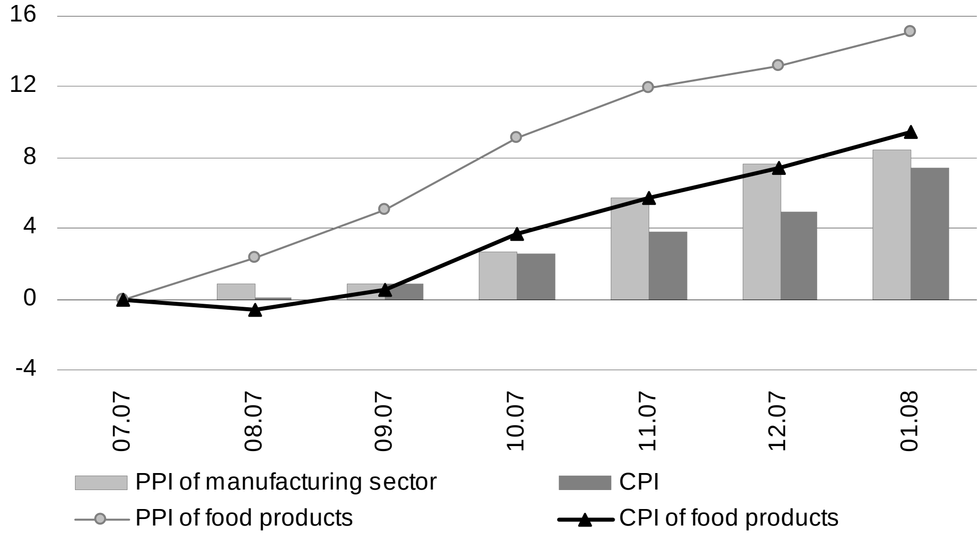
	Price growth		Output growth
	January 2008/ December 2007	January 2008/ January 2007	January 2008/ January 2007
Industry, total	**1.6**	**25.2**	**4.8**
Mining and quarrying	4.2	48.4	0.6
Manufacturing	0.7	19.5	4.6
Including:			
manufacture of machinery and equipment	2.2	11.6	5.8
manufacture of other non-metallic mineral products	2.1	34.0	1.9
manufacture of coke, refined petroleum products	-3.9	45.9	2.7
manufacture of food products	1.7	22.4	3.1
manufacture of textiles and textile products, leather, leather products, shoes	1.6	10.7	2.3
Electricity, gas and water supply	0.8	12.1	12.8
Consumer prices	**2.3**	**12.6**	
food products	1.9	16.7	
non-food products	0.6	6.7	
paid services	5.4	14.1	

Source: Russian Statistics Service, CSI Bank of Moscow.

In January, producer prices in the investment sector rose by more than 2%. Prices grew at a much faster pace compared to late 2007. In our opinion, accelerating prices in tandem with sagging output is the only plausible growth scenario for most manufacturing sectors in the near term. This process is encouraged by demand for goods produced by these industries due to mounting investment, while the production capacities of most enterprises will be unable to maintain supply levels required by the market. The most obvious illustration of this phenomenon is the manufacture of building materials (other non-metallic mineral products). Over the year, producer prices in this industry shot up by more than one-third, while growth in output fell to 1.9% y-o-y.

Producer prices in industries satisfying final demand, such as food products, textiles and shoes, are also growing rapidly: in January they increased by 1.6–1.7%, thereby fuelling further growth in consumer prices for these products. January's upturn in consumer prices for food products outpaced their respective producer prices, which can actually be treated as partial recovery of the statistically upset status quo in 4Q07 (official data indicated low growth in consumer prices).

Growth in consumer and producer prices in manufacturing industries, as % to July 2007



Source: Russian Statistics Service, CSI Bank of Moscow.

The problem of the price overhang in industry pushing up consumer prices grew worse in summer 2007, when food prices embarked on a steep upward spiral. An administrative effort to regulate prices for a number of staple products was introduced in October 2007, fixing this price overhang with respect to food products at 5.8%. A pattern by which consumer prices have lagged producer prices has been in place for the past four months and may be taken as a minimum projection of consumer price growth, assuming the state authorities return to a market-based pricing model.

Russian economy's profit: Statistics as a key growth resource

Based on the financial performance of Russian enterprises in 2007, the profit of Russia's economy reached R5.73 trillion (vs. R4.87 trillion in 2006).

A distinctive feature of the financial results achieved last year was their unexpected size: in January–November 2007, corporate financial performance totaled only R4.52 trillion (vs. R3.55 trillion a year ago) and the annual indicator incorporating the previous results and their adjustments as well as December's performance appeared higher by R1.20 trillion (vs. R1.32 trillion for 2006).

Corporate Financial Performance

	Corporate financial performance, R bln		Annual indicator excess over the 11-month performance		Corporate financial performance structure, in % terms	
	2006	2007	2006	2007	January-November 2007	January-December 2007
Economy, total	**4865**	**5726**	**1319**	**1202**	**100.0**	**100.0**
Material production sector	*2425*	*2973*	*230*	*287*	*59.4*	*51.9*
Industrial production	2299	2766	212	242	55.8	48.3
Mining and quarrying	718	907	38	106	17.7	15.8
Manufacturing	1463	1739	145	109	36.0	30.4
Electricity, gas and water supply	117	120	30	27	2.0	2.1
Agriculture, fishing and fish farming	56	98	6	17	1.8	1.7
Construction	71	109	12	28	1.8	1.9
Services	*2440*	*2754*	*1089*	*915*	*40.6*	*48.1*
Communication	181	297	14	38	5.7	5.2
Transport	215	363	-31	-5	8.1	6.3
Wholesale and retail trade; repairs	868	1011	152	195	18.0	17.7
Real estate, renting and services	902	763	764	521	5.4	13.3
Other	273	320	191	167	3.4	5.6

Source: Russian Statistics Service, CSI Bank of Moscow.

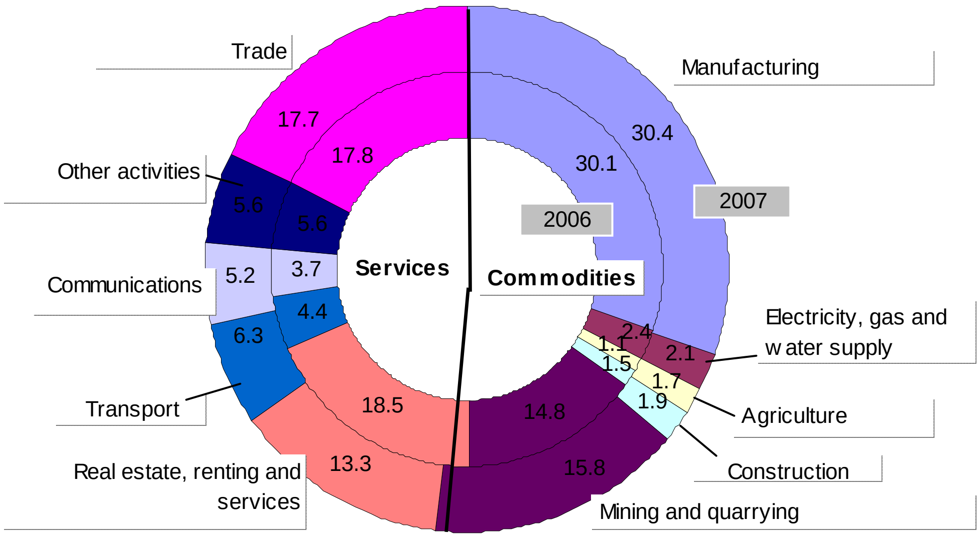
The profit leap in December (by 27% for calculating the 2007 indicator, and by 37% for adjustment of the 2006 results relative to performance for the 11-month period) has the same roots as GDP growth in December: as a result of the revision, the 2006 GDP growth rate increased from 6.7% to 7.4%.

According to official data, the profit earned from real estate transactions and other economic activities has increased substantially. Corporate financial performance of real estate dealers and enterprises engaged in other economic activities totaled R20 bln and R396 bln for the first eleven months of 2006 and 2007, respectively, while the annual indicators were R1,175 bln and R1,084 bln, respectively.

The introduced adjustments fundamentally altered the structure of the Russian economy's profit. Based on the 11-month performance, the material production sector (59.4% of the economy's profit) was the unquestionable profit center. Judging by the annual data, contributions from the industrial production sector and services to profit formation have noticeably narrowed the gap. Radical revision of the service sector's contribution was not caused by traditional services with broad market niches (trade, transport, communication), but rather by real estate transactions and other services: their contribution to the economy's profit widened from 8.8% in 11M07 to 18.9% for 2007 as a whole.

Therefore, the annual financial performance of Russian enterprises may be summed up as follows. Corporate profit in 2007 surged by 17.7% y-o-y in nominal terms and by 3.2% in real terms (PPI-adjusted). A shift of the profit center to the material production sector was observed throughout 2007. According to statistical updates, in 2006 the service and industrial production sectors earned approximately the same amounts of profit, whereas in 2007 the material production sector accounted for 51.9% of the Russian economy's profit.

Corporate Financial Performance Structure, %



Source: Russian Statistics Service, CSI Bank of Moscow.

The expanding contribution of industrial production to the economy's profit in 2007 was brought about by the mining and quarrying industry, the share of which grew by 1.0 percentage point, while the share of the manufacturing industries remained stable. This was a rather unexpected outcome, as over the year the center of the Russian economy's profit was shifting towards manufacturing industries.

In short, 2007 turned out to be a financially successful year for Russia, at least technically. Profit continued to grow in nominal and real terms, and was generated in roughly equal amounts by the industrial production and service sectors: a slight deviation was triggered by surging output in the mining and quarrying sector, which was quite predictable in the context of spiraling world prices for energy-producing materials.

The contribution of industrial production to the economy's profit expanded to 48.3% (+1.0 ppt vs. 2006), with the profitability level of industrial production almost unchanged compared to last year (15.0% and 14.7% for the first eleven months of 2006 and 2007, respectively). Profitability in the most profitable industrial sectors – mining and quarrying, manufacturing of coke and refined petroleum products, manufacturing of basic metals and fabricated metal products – dropped from 25.1% to 23.8% (for the first eleven months of 2006 and 2007, respectively). The less profitable industries, on the contrary, improved their performance, with their profitability rising from 6.5% to 7.2%.

All of that said, the unpredictability of official data remains the main source of skepticism. Unexpected and far-fetched results that only remotely resemble the real trends (e.g. CPI) and which are fantastically overstated and lacking any comments or explanation (not to mention upward revisions of GDP and profit) make it more difficult to track on a current basis the situation in the economy and significantly constrain opportunities to adjust the development vector in the short and medium term. In our opinion, such "misleading" statistics of real processes in the economy are a serious impediment to successful implementation of the ambitious tasks and objectives set forth by the Russian authorities.

Banking system

In January, the traditional seasonal slowdown in the banking sector was more severe than in previous years. Over the month, assets inched up a mere 0.1% (vs. 0.6% in January 2007, and 0.2% in January 2006). The main reason for this deceleration was stagnation of the main sources of fundraising. Borrowing and customer deposits in banks shrank by 0.8% during the month: corporate accounts and deposits dropped by 1.3%, and household deposits fell by 0.6%.

Hence, the downswing in the banking sector was largely caused by external factors and can to a greater extent be explained by the behavior of economic agents. Contraction of corporate accounts and deposits was triggered by a capital outflow, which in January was estimated at $10–12 bln, with non-banks accounting for nearly half of the total amount.

Households, it appears, are reducing their savings for fear of substantial price hikes and impairment of their deposit value in real terms. Interest rates on most types of household deposits are considerably lower than official price growth projections.

In these conditions, the natural reaction among banks seeking to preserve their resource base will be to raise interest rates. In March, Sberbank raised its interest rates on deposits by 0.5 percentage point.

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

	01.05	01.06	01.07	04.07	07.07	10.07	01.08	02.08
Liabilities (R bln)	**7101**	**9696**	**13963**	**15516**	**17113**	**18131**	**20125**	**20146**
Capital	16.2	15.4	14.3	15.5	15.9	16.1	15.3	16.2
CBR loans	0.3	0.2	0.1	0.1	0.1	0.0	0.2	0.2
Interbank transactions	4.2	4.0	3.4	3.3	3.1	2.9	4.1	3.8
Foreign liabilities	10.9	13.7	17.1	16.3	17.0	17.6	18.1	18.1
Household deposits	28.4	28.9	27.6	26.3	25.9	26.0	26.2	25.9
Corporate deposits	23.7	24.0	24.0	24.9	25.1	24.5	25.5	25.1
Accounts and deposits of federal state authorities and local governments	2.9	2.0	2.2	2.6	2.4	2.6	1.5	1.9
Issued securities	9.0	7.6	7.2	6.4	5.8	5.3	5.8	5.6

Source: CBR, CSI Bank of Moscow.

At the same time, banks' equity (reserves, profit, capitalized earnings, etc.) grew a noticeable 5.0%. This growth had a stabilizing effect on the banking sector's development and allowed it to sustain a positive growth trend.

According to our estimates, the capital adequacy ratio in January rose from 15.5% to 16.0%.

Despite the shrinking resource base, lending activity in the banking sector sustained the high growth rates of the previous year. Loans to the non-financial sector picked up by 3.4% (52.8% growth y-o-y) and consumer loans edged up by 1.2% (+57.2% y-o-y).

Therefore, on the one hand, Russian banks succeeded in maintaining their lending activity despite a melting resource base mainly thanks to liquid assets. On the other hand, in such circumstances, the potential for further balanced growth in the banking sector is narrowing: the misbalance between internal resources and loans to the economy is mounting, while reserve assets are declining.

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

	01.05	01.06	01.07	04.07	07.07	10.07	01.08	02.08
Assets (R bln)	**7101**	**9696**	**13963**	**15516**	**17113**	**18131**	**20125**	**20146**
Cash and precious metals	2.8	2.7	2.6	1.8	1.8	1.9	2.5	1.9
Accounts with CBR	9.8	7.3	7.5	8.0	10.9	6.1	6.9	5.8
Interbank transactions	6.2	6.3	5.8	5.4	5.3	4.7	5.4	5.7
Foreign assets	7.8	9.1	9.9	11.5	8.4	10.0	9.8	10.5
Households	8.7	12.1	14.7	14.4	14.9	16.0	16.1	16.3
Corporate sector	49.8	47.0	45.3	44.8	45.0	47.2	47.2	49.2
Government	8.0	6.6	5.2	5.0	4.7	4.1	4.1	4.2
Property	2.6	2.4	2.4	2.4	2.3	2.2	2.2	2.2

Source: CBR, CSI Bank of Moscow.

Forecast of Key Economic Indicators

	Actual				Forecast		
	2004	2005	2006	2007	2008	2009	2010
Macroeconomic indicators							
Nominal GDP:							
R. trln	17.0	21.6	26.9	33.0	40.0	47.5	55.5
$ bln	592	764	992	1 289	1 639	1 885	2 110
Real GDP, % y/y	7.2	6.4	7.4	8.1	7.0	6.8	6.5
Industrial Production, % y/y	8.3	4.0	6.3	6.3	4.5	4.8	5.0
Retail Turnover, real, % y/y	13.3	12.8	13.9	15.2	13.0	11.5	10.0
Gross Fixed Investments, real, % y/y	13.7	10.9	13.7	21.1	18.0	15.0	13.0
Exports real, % y/y	11.8	6.5	7.3	7.4	4.8	4.0	3.1
Imports real, % y/y	23.3	16.6	21.6	30.4	25.0	18.0	15.0
Monetary Aggregates							
M0 (year end), % y/y	33.8	30.9	38.6	32.9	27.5	23.0	21.0
M2 (year end), % y/y	35.8	38.6	48.8	47.5	29.0	26.0	24.0
M2X (year end), % y/y	33.7	37.4	40.5	44.2	26.0	25.0	24.0
Total Banking Assets, % GDP	41.9	45.1	52.4	61.4	65.8	69.1	73.7
Inflation							
CPI (year end), %	11.7	10.9	9.0	11.9	10.0	9.0	8.0
CPI (year average), %	11.0	12.5	9.8	9.1	11.9	9.3	8.5
Core CPI (year end), %	10.6	8.3	7.8	11.0	8.5	7.0	6.0
Budget							
Federal Budget Revenues, % GDP	20.1	23.7	23.4	23.6	20.1	18.3	17.0
Federal Budget Expenditures, % GDP	15.8	16.3	15.9	18.1	17.3	17.4	16.3
Federal Budget Balance, % GDP	4.3	7.5	7.4	5.4	2.9	0.9	0.7
Consolidated Budget Balance, % GDP	4.5	8.1	8.4	6.1	3.2	1.0	0.8
Reserve Fund, year end, $ bln	18.8	43.0	89.2	156.5	143.1	167.0	184.0
National Wealth Fund, year end, $ bln					68.3	67.4	64.9
Investment Fund, $ bln			2.6	7.0	11	14.5	18.2
Balance of Payments							
Exports, $ bln	184	244	304	355	440	435	460
Imports, $ bln	96	125	165	223	290	350	410
Current Account, % GDP	10	11.1	9.5	5.9	5.2	0.5	-1.7
Net Capital Inflow/Outflow, $ bln	-8.4	0.7	41.7	82.1	40	35	40
International Reserves, year end, $ bn 5	125	182	304	476	596	636	636
External Debt							
Foreign Public Debt, % GDP	19.3	10.0	5.2	3.5	2.4	2.0	1.6
Foreign Private Debt, % GDP	4.4	3.9	3.8	3.8	4.0	4.2	4.6
Exchange Rate							
R/$:							
end of period	27.8	28.8	26.3	24.6	24.6	25.8	26.8
year average	28.8	28.3	27.1	25.6	24.4	25.2	26.3
Exogenous Parameters							
Urals, $ p/bbl	34.6	50.4	60.9	69.6	90	85	90
$/€	1.24	1.25	1.26	1.37	1.48	1.40	1.35

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

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