



Spring fever: The liquidity crisis

Center of Strategic Investigations

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The banking system in Russia has faced a liquidity crisis this spring. Technically, it has not been too severe: in previous periods liquidity shrank to 4% of assets, but this time the unstable situation on world capital markets and strong pressure from Russia's banking community forced the monetary authorities to undertake certain measures. First, the Collateral List for providing credits from the Bank of Russia was extended. Further, it was decided to deposit temporarily free budget funds to bank accounts, while funds from development institutions have already been deposited in banks. Lastly, discussion began on whether to introduce changes to the bank refinancing system allowing the Bank of Russia to provide non-collateral loans to commercial banks.

In recent years, high growth and profitability have made the banking sector attractive for investment. However, this has also created several problems. Among them are structural disproportions on the interbank market resulting from segmentation of the banking sector into three groups: state-owned, privately-owned, and foreign banks, as well as poor risk and asset management. The overwhelming majority of bank strategies assume a policy of "cheap money", i.e. wide access to relatively cheap external financial resources and negative real interest rates on the domestic market. At the same time, the credit portfolio of banks was expanding rapidly. However, the situation has now changed.

The possibility of a bank liquidity crisis was predictable. Over the past three years, the Russian banking system has become "over-borrowed": the ratio of loans to the non-financial sector to domestic deposits increased from 95% at the beginning of 2004 to 120% at the beginning of 2008. Although liquidity remained at an acceptable level, investment in securities (potential liquidity) fell from 11.5% to 7.5% of assets during the same period. The reasons are clear: there is a deficit of low-risk highly liquid financial instruments, and their real yield is negative. This has resulted in unreasonably high (from the standpoint of risk management) growth in lending, segmentation of the interbank market, and rising interest rates, raising the likelihood of bankruptcy for certain banks and threatening destabilization of the entire banking system.

The shrinking of banking liquidity to a potentially dangerous level again underscores systemic problems in the banking system, i.e. a lack of internal resources and proper risk management to ensure economic growth and maintain financial stability. In recent years, a deficit of internal resources to fuel lending was compensated by inflows of external funds. Now, it is time for Russia's monetary authorities to take action. Their actions are: in the framework of the economic policy targets, to assess the deficit of financial resources (primarily external inflows) and design a mechanism – keeping in mind the risk of accelerating inflation – to provide the banking system with necessary funds.

Banking liquidity crisis: Not for external reasons, but strategic mistakes

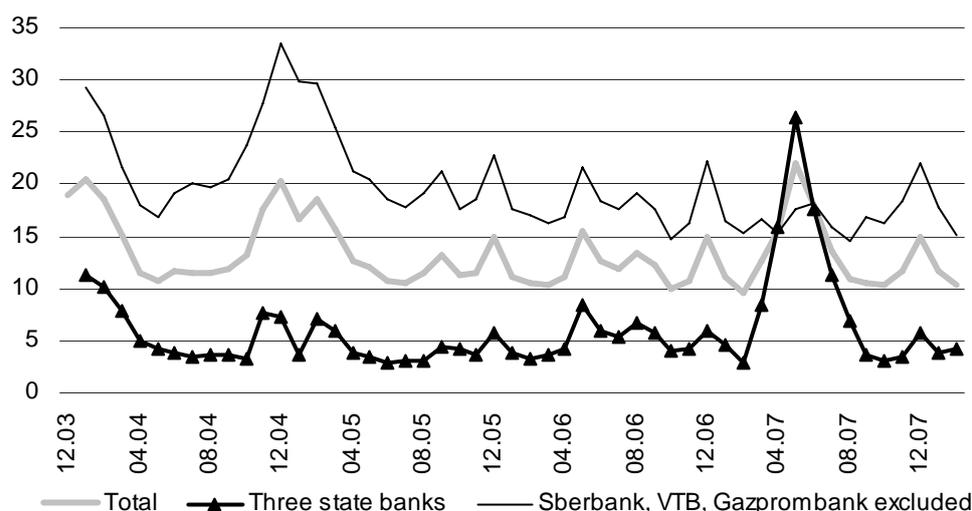
Banking liquidity (cash and accounts with the Bank of Russia) shrank noticeably during the first months of 2008, from R1.5 trln as of January 1 to R1.0 trln as of March 1. The ratio of liquid assets to total banking assets dropped from 7.4% to 4.9%, and the ratio of assets to client's deposits fell from 14.0% to 9.6%. Accordingly, interest rates on the interbank market have increased. Taking into account the schedule of external debt servicing (a local peak occurs in March) and tax payments (which increase in April), the danger of a liquidity crisis has developed.

Considering the current tense situation involving banking liquidity, there are three questions. First, what are the reasons for the liquidity squeeze? Second, what measures can be taken? Third, what consequences can be expected?

The crisis in global financial markets is believed to be the main cause. In the opinion of the banking community, for Russia this crisis implies a lower level of external borrowing and higher interest rates. However, the main volume of foreign loans (and even more so, of funds raised through IPO/SPOs and the acquisition of equity shares) falls on the largest banks. Russia's thirty largest banks are responsible for 80% of all foreign liabilities, and it is clear that commercial banks outside this group of the top 30 in fact had no access to external financing.

Furthermore, the banking community believes that only the largest banks have access to refinancing and budget funds, while mid-sized and small banks have been cut off. The chart below shows that although the trend is downward, liquid banking assets are not at a critically low level; they dropped to this level several times over the past three years, but this did not result in a crisis. Second, the largest banks are characterized by a relatively low level of liquidity, which is explained by their sizes and higher trust on the part of clients. It should be mentioned that providing budget funds to the largest banks is much less risky. And finally, according to instructions from the Bank of Russia, all commercial banks in Russia have equal access to refinancing based on collateral.

Liquid banking assets, as % of accounts and deposits of the non-financial sector



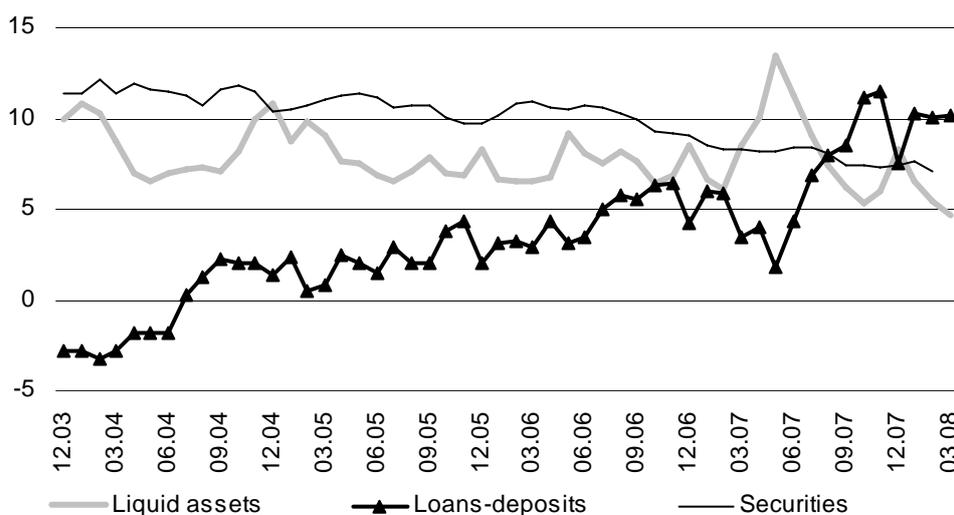
Source: Bank of Russia; Center of Strategic Investigations, Bank of Moscow.

Instability on world financial markets has not been the only or even the most important cause of the liquidity squeeze and growing risks in the Russian banking system. The main cause has been the *banking strategies of asset management*. First, the national banking system is "over-borrowed", i.e. the ratio of loans to the non-financial sector to domestic deposits increased from 95% at the beginning of 2004 to 120% at the

beginning of 2008. While the deficit of domestic banking savings to support high growth in lending was estimated in 2006 at R2,135 bln, in 2007 this amount exceeded R 1.0 trln and will continue growing this year.

At the same time, along with high growth rates of loans to the non-financial sector, banking investment in securities (potential liquidity) decreased from 11.5% of assets in 2004 to 7.5% in 2007. Here, the reasons are the deficit of liquid low-risk securities and their low yield (much lower than interest rates on household deposits). As a result, the increase in the loan-to-deposit ratio and the declining share of securities in total assets affect fluctuations of liquidity amidst a general downward trend.

Liquid banking assets, domestic loans-deposits and investment in securities, as % of assets



Source: Bank of Russia; Center of Strategic Investigations, Bank of Moscow.

Thus, due to existing trends in the asset structure, banking liquidity began to shrink. We believe there are potential solutions to this problem. The first involves refinancing provided by the Bank of Russia to address current needs. This is a short-term and, to a certain extent, “emergency” measure. We remind that the Bank of Russia is a lender of last resort ready to provide short-term loans against adequate collateral to each bank facing a liquidity crisis. In our opinion, at present there are no problems regarding refinancing of commercial banks by the Bank of Russia. About R1.5 trln is potentially available for the purposes of refinancing, while the banking system has applied for only about R300 bln in loans. In addition, the collateral list was significantly extended, and perhaps made excessively risky. As regards providing non-collateral credits to banks, we believe this assumes unreasonably high risks.

The second method involves depositing government funds to accounts in commercial banks, i.e. depositing the temporarily free budget funds and resources of state development institutions.

The consequences of such a policy may vary, and we note that the Russian banking system has once again demonstrated its vulnerability. However, this is not a question of the vulnerability of Russian banks due to their exposure to external shocks, but rather because of poor asset management. If short-term budget funds are directed to refinance longer-term credits, then another and even stronger liquidity squeeze could occur within several months.

Actually, these issues are being discussed within government circles in selecting economic policies: whether it is necessary to support high economic growth rates via high rates of bank loans, among other measures, or to allow a slowdown for the sake of financial balance. In the context of this choice, it is necessary to assess the potential resource deficit in the banking system and provide government funds within these limits.

In case of a lack of resources, the growth rates of lending and economic growth will slow. In case of an abundance of resources, inflationary pressure on the demand side will rise.

Forecast for the banking system until 2010

It is clear today that over the next two to three years the banking system will demonstrate quite different development trends than seen recently. First, it should be emphasized that external conditions have changed dramatically. If in 2005–2007 Russia had a growing financial market which was attractive to foreign investors (in a situation characterized by cheap external resources), then in 2008–2010 growth will be sustained, but its pace will be slower and the market will be less attractive due to risk re-evaluation by international investors. It is very important to estimate the potential net inflow of external capital to Russia's banking system in order to forecast its future growth.

Also, it seems important to note the growing deficit of domestic savings. It is not a question of a decreasing domestic savings ratio (within the income/expenditure balances of households and companies), but rather of an excess of demand for loans over the increment of domestic savings. We remind that economic growth over the past three years has been supported by growth in domestic demand, part of which was generated by inflows of export revenues, while about one-third was supported by an increase in loans to the non-financial sector.

Therefore, the key questions are: Will the banking system be capable in the near future of expanding its lending (and hence internal demand)? If yes, then what are the sources and what will be the consequences? Even more important, how will we estimate the contribution of bank lending to economic growth, as well as the steadiness of economic development in an environment of expanding domestic savings?

Our mid-term forecast for the banking system is based on macroeconomic estimates derived from the main scenario for Russia's economic development in 2008–2010 prepared by the Ministry of Economic Development and Trade. Key assumptions of this scenario are: high prices for oil and other raw materials, relatively high inflation rates, and growth of real household income and capital investment.

In the framework of the official macroeconomic scenario, two options for the banking system are possible that provide for an increase in lending at a level sufficient to support expected GDP growth.

Scenario 1. High (albeit slowing) net foreign capital inflow into the banking system. This scenario assumes that the net foreign capital inflow will be sustained and provided by the largest banks by way of offering bonds, attracting syndicated loans, and direct investment into capital. According to our estimates, within this scenario net foreign investment in 2008 will be at last year's level and amount to \$42 bln. In 2009, we expect this figure to drop to \$33 bln, and in 2010 decrease further to \$27 bln.

Forecast of key indicators in the banking sector until 2010, % y-o-y

| | 2006 (actual) | 2007 (actual) | 2008 (forecast) | 2009 (forecast) | 2010 (forecast) |
|--|------------------|------------------|--------------------|--------------------|--------------------|
| Assets | 44.1 | 44.1 | 29 | 24 | 21 |
| Corporate loans | 38.5 | 50.4 | 35 | 29 | 24 |
| Household loans | 75.3 | 57.0 | 46 | 37 | 30 |
| Corporate deposits | 44.9 | 52.3 | 30 | 23 | 23 |
| Household deposits | 36.4 | 35.0 | 31 | 29 | 25 |
| Net foreign capital inflow into banking sector, \$ bln | 27.5 | 45.9 | 42 | 35 | 30 |

Source: Center of Strategic Investigations, Bank of Moscow forecast.

Scenario 2. Substitution of external financing by government resources. Within this scenario, it is assumed that the net foreign capital inflow will drop significantly in 2008 to \$10 bln. The lack of resources necessary to support the growth rate of bank lending will

be supplemented by government resources via the deposit of funds from development institutions, the temporary freeing of budget funds, and the expansion of refinancing provided by the Bank of Russia.

In 2008, the difference in the amount of foreign loans between the first and second scenarios is estimated at R735 bln. Partially, this need could be met via reducing internal and external liquid assets. In order to sustain a comparable pace of growth of lending to the economy, the banking sector should receive in addition no less than R450 bln (from state institutions and the Bank of Russia).

Furthermore, a decline in capital inflows will result in slower growth of forex reserves and, hence, lead to contraction of the money supply. An additional transfer of budget funds from accounts with the Bank of Russia to the banking sector will support growth in the money supply and partially substitute emissions related to the purchase of foreign exchange. In 2009–2010, the banking sector will still need supplementary resources in the amount of R400–500 bln, even with the reduction of liquid assets.

In the two scenarios described here, the successively declining growth rates of bank loans to the corporate sector and households still remain at a level sufficient to support expansion of domestic demand and GDP growth. The calculation results are presented in the accompanying table.

Scenario 3 assumes that resources of the banking system will not be sufficient to support the above-mentioned growth rates of bank lending. This could occur because of problems in world financial markets or the government's efforts to arrest inflation by all possible means. Within this scenario, a contraction of foreign capital inflows to the banking sector will not be followed by grants of financial support to banks by the state or the Bank of Russia. As a result, in 2008, the growth rates of bank lending to the economy will slow to 30% in the corporate sector and 40% in the household sector.

This may result in slower growth of gross capital formation (by 3.4 pts) and household final consumption expenditures (by 0.9 pts). In general, the decelerated lending may lead to a decrease of 1.2 pts in GDP growth.

In addition, with slow growth in forex reserves and rigid fiscal policy, the economy will face a sharp decline in money supply growth as well as liquidity contraction. If fiscal policy remains as in Scenario 1, money supply growth may drop from 20–22% to 13–14%, which in turn may result in various manifestations of the "money famine", i.e. from a contraction of money supply (M2) to a full-scale banking liquidity crisis. In this situation, the government will need to "unseal" its reserves by allocating sufficient funds either to extend government expenditures directly or enlarge the capital of state corporations.

Key Indicators of economic development, by scenarios, for 2008

| | 2006 (actual) | 2007 (actual) | 2008 | | |
|---|------------------|------------------|---------------|---------------|---------------|
| | | | Scenario 1 | Scenario 2 | Scenario 3 |
| Banking sector | | | | | |
| Change in assets, % | 44.1 | 44.1 | 29 | 27 | 24 |
| Change in corporate loans, % | 38.5 | 50.4 | 35 | 35 | 30 |
| Change in household loans, % | 75.3 | 57.0 | 46 | 46 | 40 |
| Net foreign capital inflow, \$ bln | 27.5 | 45.9 | 42 | 15 | 15 |
| Balances of Budget funds and funds from Bank of Russia, R bln | 100.5 | 31.2 | 250 | 700 | 250 |
| Macroeconomic indicators | | | | | |
| Changes in gross capital formation, real, % | 13.7 | 21.1 | 16.0 | 16.0 | 12.6 |
| Change in household final consumption expenditure, real, % | 13.9 | 15.2 | 13.7 | 13.7 | 12.8 |
| Change in GDP, real, % | 7.4 | 8.1 | 7.5 | 7.5 | 6.3 |

Source: Center of Strategic Investigations, Bank of Moscow forecast.

Economic growth forecast: contribution of the banking sector

The model of economic growth remains the same. There are structural problems (see: *Real Sector*), though growth is still being driven by expansion of domestic demand. The contribution of loan volumes in 2007 was substantial, with about 30% of growth in domestic demand attributed to increased lending. The volume of corporate loans grew by R2.93 trln and that of household loans by R1.18 trln, totaling approximately 12.5% of GDP.

Studies carried out by Center of Strategic Investigations, Bank of Moscow resulted in quantitative estimates of the impact of changes in loan volumes on economic growth. The information basis for modeling is comprised of methodologically coordinated and integrated data on monetary statistics and national accounts. The model solutions demonstrate good stability and ensure the necessary accuracy of estimates. The key explanatory factors are the ratios of credit flows to certain expenditure variables of the system of national accounts.

The results show that, at present, an increase (decrease) of 10 ppts in growth of household loans results in at least a 1.6 ppt increase (decrease) in growth of real household final consumption expenditures. The model demonstrates an even stronger impact of changes in corporate loans on growth of gross capital formation: a change of 10 ppts in corporate loan growth may cause a change of 6 ppts in growth of gross capital formation. In general, this allows us to forecast real GDP growth rates based on banking system development indicators shown in the accompanying table.

Real sector

Industrial production. Official data remain the most important "source" of growth acceleration

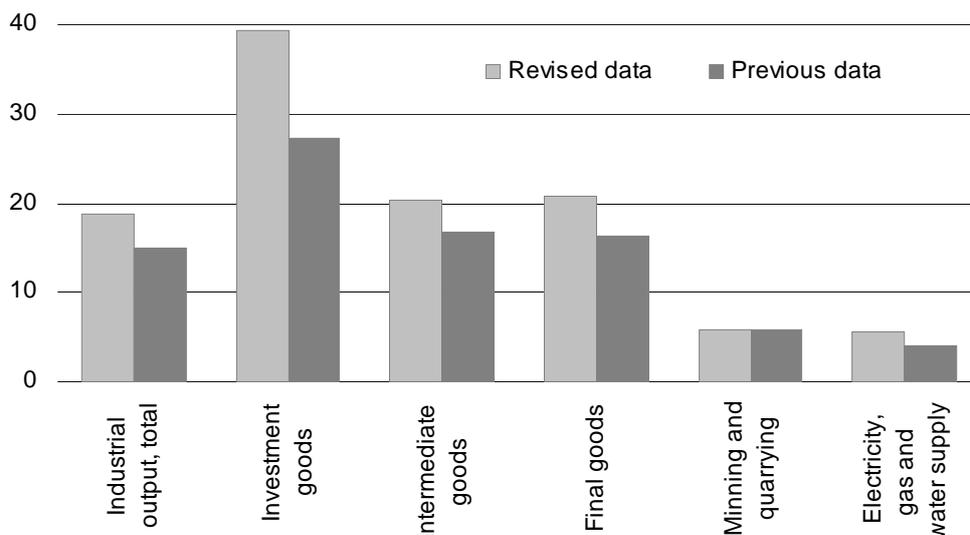
Rosstat was yet again a news maker in the month of March after it published revised data on growth rates of Russian industrial production in 2005–2007. According to these figures, the growth rate in this segment in the past three years was actually much higher (by 3.9%) than previously believed. Whereas in the mining and quarrying sectors the adjustment was minor, and in electricity, gas and water supply it was rather moderate (1.6%), in the intermediate and final goods production a much larger adjustment was made (about 4%). However, the largest change was introduced to the growth rate of investment goods production¹ (more than 12%). For example, the 2005–2007 growth in manufacturing of machinery and equipment was underestimated by approximately 1.5x (previously 26.6% and now more than 40%).

¹ Consumer goods production: production of food products, production of textiles and textile products, leather, leather products, shoes; production of pulp, paper and paper products; publishing and printing

Investment goods production: production of other non-metallic mineral products; production of machinery and equipment

Intermediate goods production: woodworking and timber products; production of coke, refined petroleum products; production of chemicals; production of rubber and plastic products; production of basic metals and fabricated metal products.

Industrial Production Output Growth in 2005–2007, % vs. 2004



Source: Russian Statistics Service; Center of Strategic Investigations, Bank of Moscow.

As Rosstat does not usually comment on revisions to their statistical data on the economy, one can only speculate about the reasons for the high industrial production growth rates in recent years. That said, it seems likely that the significant revision of results for the machine building sector was caused by the low quality of primary data on enterprises with a long production cycle and/or flawed statistical processing of this data.

However, output in other sectors where it is less difficult to interpret statistically was also noticeably adjusted: rubber and plastic products by 10–11% per year in 2005–2006; textiles and textile products, leather, leather products, shoes by 2.9–5.5% in 2005–2006 (impressive considering their low output growth in general); and chemical products and timber products by 1.5–3.0% per year (also rather high compared with their historical growth rates).

The growth trend of industrial production now looks rather different, following the pattern of low 4% growth in 2005–2006 with visible acceleration up to 6.3% in 2007, but showing persuasive 5.1% growth in 2005 reaching 6.3% in 2006 and remaining at this rate in 2007. Now, instead of a dip in the annual growth rates in 2005–2007 (5.7% – 4.4% – 9.4%), we observe steady growth (7.6% – 8.3% – 9.5%).

The main contribution to this growth came from investment goods production, which appeared to have grown steadily at more than 10% per year in 2005–2006 and even faster in 2007 (14.2%). In accordance with the revised Rosstat data, growth in Russia's investment goods production in 2005–2006 was comparable with that of investment in the Russian economy, whereas industrial production growth in these sectors had previously been estimated at a level of 2.9–7.4% per year.

**Industrial Production Output Growth in 2005–2007, % y-o-y,
before and after revision**

| | 2005 | | 2006 | | 2007 | |
|---|-------|--------|-------|--------|-------|--------|
| | after | before | after | before | after | before |
| Industrial production | 5.1 | 4.0 | 6.3 | 3.9 | 6.3 | 6.3 |
| Mining and quarrying | 1.4 | 1.3 | 2.5 | 2.3 | 1.9 | 2.0 |
| Manufacturing | 7.6 | 5.7 | 8.3 | 4.4 | 9.5 | 9.4 |
| <i>Investment goods production</i> | 10.8 | 7.4 | 10.1 | 2.9 | 14.2 | 15.0 |
| including: | | | | | | |
| machinery and equipment | 12.0 | 8.3 | 8.7 | 1.0 | 15.3 | 15.8 |
| other non-metallic mineral products | 4.9 | 3.5 | 15.7 | 10.8 | 10.3 | 11.9 |
| <i>Intermediate goods production</i> | 6.4 | 5.0 | 8.6 | 6.7 | 4.2 | 4.1 |
| including: | | | | | | |
| coke, refined petroleum products | 4.4 | 5.4 | 7.1 | 6.1 | 2.9 | 2.6 |
| basic metals and fabricated metal products | 7.0 | 5.7 | 9.8 | 8.8 | 2.1 | 1.8 |
| other sectors (woodworking, chemicals, rubber and plastic products) | 7.0 | 3.4 | 7.9 | 3.6 | 9.6 | 9.9 |
| <i>Final goods production</i> | 5.9 | 3.4 | 7.5 | 5.8 | 6.0 | 6.3 |
| including: | | | | | | |
| food products | 6.6 | 4.4 | 7.0 | 5.4 | 6.1 | 6.4 |
| textile and textile products, leather, leather products, shoes | 3.1 | -1.7 | 13.6 | 8.7 | -1.1 | -0.1 |
| pulp, paper and paper products; publishing and printing | 3.6 | 1.2 | 7.0 | 6.4 | 9.1 | 8.9 |
| Electricity, gas and water supply | 0.9 | 1.2 | 4.9 | 4.2 | -0.2 | -1.3 |

Source: Russian Statistics Service; Center of Strategic Investigations, Bank of Moscow.

Estimates of the growth rates for final goods production have also changed. After the revision, it was determined that these sectors have not been benefiting from the uptrend in growth, as was stated earlier (3.4% – 5.8% – 6.3% in 2005–2007). Their growth peak was passed in 2006 and, despite expanding consumer demand, in 2007 demonstrated a slower rate of growth closer to that seen in 2005 (5.9% – 7.5% – 6.0% in 2005 – 2007).

Concluding our comments on this new picture of Russian economic growth, we emphasize that the disappointingly low quality of statistical data – an increasingly clear problem – is alarming, particularly given the ongoing discussion at the state level of how best to modernize the country's industrial production sphere.

The revised data on growth rates and the structure of Russia's economy have demonstrated, with a significant delay, the so-called "overheating" of the real sector, which has been widely discussed recently. This situation is characterized by very fast growth in investment goods production, driven by an increase in investment, and by a downtrend in growth in final goods production amidst a general rise in prices.

Thus, we emphasize the growing significance of qualitative analysis of the Russian economy as opposed to relying on quantitative estimates. In spite of large-scale revision of statistical results, we note the substance and timeliness of our comments on the economic processes in Russia. As early as the middle of the last year we noted that the Russian economy had completed its transition to an investment-oriented growth model characterized by slowing growth in final goods production, a widening gap with intermediate goods production, and administrative restriction of growth in mining and quarrying. It was clear to us at that point that *structural disproportions* were being aggravated, economic growth was being driven solely by investment flows, and the stimulating effect of expanding consumer demand on domestic production growth was being exhausted. Taken together, these processes ultimately raised the risk that overall industrial production would be unable to sustain a stable growth trend. Today, the revised official data fully confirm our prior suspicions and conclusions.

February 2008: Much better rates of industrial production in the leap-year

In February, Russian industrial production output increased 7.5% y-o-y, which exceeds not only the January rate (4.5%), but also the monthly rates of 2H07. Accordingly, over the first two months of 2008, industrial output grew 6.0%, and industrial production has practically returned to last year's growth trend (6.3% in 2007).

However, we believe it is too early to conclude that industrial production growth has accelerated and will continue to do so at a stable high rate. Relatively higher rates of industrial production in February 2008 and, accordingly, in January-February 2008 were largely caused by the extra work day of February 29.

Our estimates show that, if we adjust for the "calendar factor", the growth rate of industrial production in February would slow to 2.1%. For the two-month period, an increase in output of only 3.1% would be demonstrated, which is half the level of last year.

Industrial Production Output Growth in January-February 2008, % y-o-y

| | Direct data | | Leap-year adjustment | | | Ref: 2007 |
|---|-------------|------------------|----------------------|----------|------------------|--------------|
| | February | January-February | January | February | January-February | |
| Industrial production | 7.5 | 6.0 | 4.5 | 2.1 | 3.1 | 6.3 |
| Mining and quarrying | 2.3 | 1.4 | 0.6 | -2.8 | -1.3 | 1.9 |
| Manufacturing | 11.2 | 7.7 | 4.0 | 5.6 | 4.8 | 9.5 |
| <i>Investment goods production</i> | 12.7 | 7.7 | 2.6 | 7.0 | 4.8 | 14.2 |
| including: | | | | | | |
| machinery and equipment | 12.4 | 7.7 | 2.9 | 6.8 | 4.8 | 15.3 |
| other non-metallic mineral products | 13.5 | 7.7 | 1.8 | 7.8 | 4.8 | 10.3 |
| <i>Intermediate goods production</i> | 9.7 | 7.1 | 4.5 | 4.2 | 4.2 | 4.2 |
| including: | | | | | | |
| coke, refined petroleum products | 6.1 | 4.4 | 2.7 | 0.8 | 1.6 | 2.9 |
| basic metals and fabricated metal products | 9.5 | 6.0 | 2.6 | 4.0 | 3.1 | 2.1 |
| other sectors (woodworking, chemicals, rubber and plastic products) | 13.5 | 11.7 | 9.9 | 7.8 | 8.7 | 9.6 |
| <i>Final goods production</i> | 9.7 | 6.7 | 3.6 | 4.2 | 3.8 | 6.0 |
| including: | | | | | | |
| food products | 9.5 | 6.3 | 3.0 | 4.0 | 3.4 | 6.1 |
| textile and textile products, leather, leather products, shoes | 8.6 | 5.5 | 2.2 | 3.2 | 2.6 | -1.1 |
| pulp, paper and paper products; publishing and printing | 10.8 | 8.8 | 6.7 | 5.3 | 5.9 | 9.1 |
| Electricity, gas and water supply | 2.0 | 7.4 | 12.8 | -3.1 | 4.5 | -0.2 |

Source: Russian Statistics Service; Center of Strategic Investigations, Bank of Moscow.

Electricity, gas and water supply demonstrated higher growth rates than last year (4.5% in January-February 2008 vs. near stagnation in 2007). Intermediate goods production has grown at the same rate as last year (4.2% y-o-y). Mining and quarrying demonstrated negative growth rates in January 2008 (-1.3%) after rather slow growth in 2007 (1.9%).

Compared with January, in February a spark of activity was seen in manufacturing sectors serving final and investment demand. The adjusted growth rate in investment goods production (adjusted for the leap-year) was estimated at 7.0% vs. 2.6% in January. In the consumer goods production, the rates were respectively 4.2% and 3.6%.

On the other hand, the slowdown of growth rates in final and investment goods production remains rather steep, with their two-month output growth rates well below those observed last year. In January-February 2008, manufacturing sectors serving investment demand demonstrated a growth rate of industrial production output almost three times below the average for 2007 (down to 4.8% vs. 14.2%), while manufacturing sectors serving consumer demand demonstrated a slowdown of industrial growth to 3.8% vs. 6.0% in 2007. These figures underscore the serious structural disproportions in Russian industrial production and warn of a growth slowdown due to "overheating".

Producer prices for industrial products: two on paper, three in mind

In January-February 2008, producer prices for industrial products rose 2.2%. Such a moderate price increase at the beginning of the year is explained mostly by the price decline in mining and quarrying (-0.6% in Jan-Feb) and only a slight rise in manufacturing (0.7%). Meantime, natural monopoly prices increased as planned: electricity, gas and water supply prices rocketed by 16.9% over the two-month period.

Industrial Producer Price Growth, %

| | February 2008 / December 2007 | February 2008 / February 2007 |
|---|----------------------------------|----------------------------------|
| Industrial production, total | 2.2 | 26.8 |
| Mining and quarrying | -0.6 | 50.6 |
| Manufacturing | 0.7 | 20.3 |
| <i>Investment goods production</i> | 4.3 | 17.9 |
| including: | | |
| machinery and equipment | 4.5 | 13.1 |
| other non-metallic mineral products | 3.8 | 33.9 |
| <i>Intermediate goods production</i> | -0.2 | 21.8 |
| including: | | |
| coke, refined petroleum products | -10.2 | 47.6 |
| basic metals and fabricated metal products | 2.7 | 4.7 |
| other sectors (woodworking, chemicals, rubber and plastic products) | 7.4 | 21.0 |
| <i>Final goods production</i> | 3.1 | 19.8 |
| including: | | |
| food products | 3.3 | 23.4 |
| textile and textile products, leather, leather products, shoes | 3.0 | 10.9 |
| pulp, paper and paper products; publishing and printing | 3.4 | 11.6 |
| Electricity, gas and water supply | 16.9 | 16.9 |
| Consumer prices | 3.5 | 12.7 |
| Ref: URALS, \$/bbl | 3.8 | 72.1 |

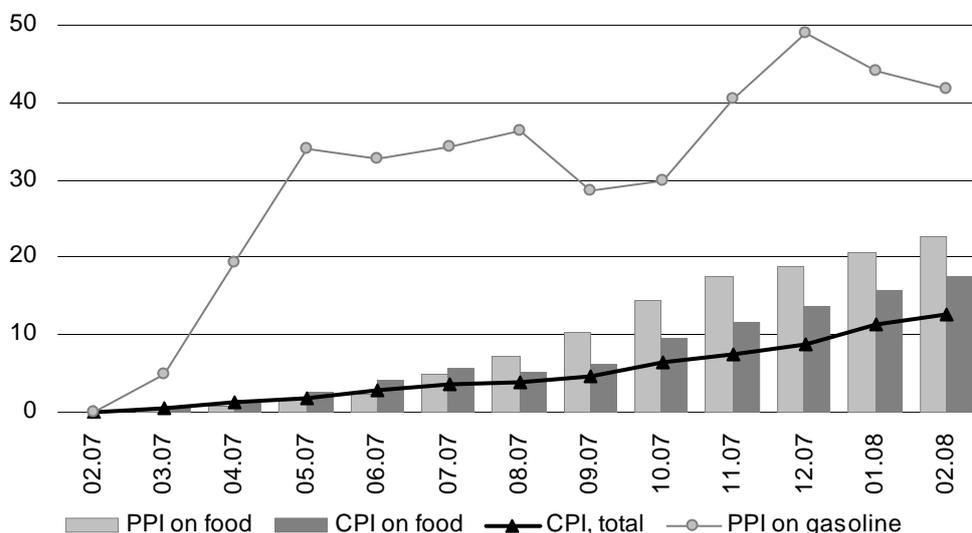
Source: Russian Statistics Service; Center of Strategic Investigations, Bank of Moscow.

According to our estimates, the increase in producer prices in January-February 2008 was somewhat under-reported by official data. Considering the price changes in certain manufacturing sectors, the total price increase in manufacturing should have been much higher (approx. 1.9% vs. the official 0.7%), which will affect the total price index for industrial production. Our calculations show that producer prices rose 3.0% in January-February 2008.

A price overhang continues to develop in industrial sectors: the annual producer price index (February/February) approached 27% compared to 25.1% in December. In terms of manufactured goods, the price growth in main sectors (investment, consumer and intermediate demand) was uniformly high, increasing from 17.9% to 21.8% per year.

Spiraling inflation in industrial production pushed by external factors (the sharp increase in world prices for fuel and food products) as well as internal factors (overheating of the economy, faster demand growth) caused further growth in consumer prices. This was primarily illustrated by the price trends for food and petroleum products.

Growth in consumer and producer prices for certain industrial products, % vs. Feb. 2007



Source: Russian Statistics Service; Center of Strategic Investigations, Bank of Moscow.

As regards food products and gasoline, a slowdown or even halt in the producer price increase is neither a trend (because of growing world prices and the expected removal of food price controls) nor a forerunner of a slowdown in respective consumer prices, as the latter will continue growing due to the already accumulated price overhang.

The reported consumer price growth of 1.2% in March (4.8% in 1Q08) alongside a 2.0% rise in food product prices (5.7% in 1Q08) and 1.7% growth in gasoline prices (3.2% in 1Q08) illustrates this price overhang and makes the target of containing annual inflation at a single-digit rate unrealistic.

Financial results from January: Profit of Russia's economy increased thanks to fuel & energy and trade

Profits generated by enterprises in Russia in January 2008 reached R498 bln (vs. R342 bln in January 2007). The profit center has noticeably shifted towards such sectors as trade and fuel & energy: in January 2008, 60% of profit was generated in these sectors, compared to only 49% in January 2007. The nominal increase in profits in the fuel & energy and trade sectors in January amounted to 53–86%.

The main sources of the increased profits in the oil & gas sector and trade were extremely high world prices for exported fuels (up 60–70% y-o-y in the December 2007–January 2008 period) and an almost 150% y-o-y expansion of Russia's foreign trade turnover in January 2008.

Furthermore, in spite of the noticeable shrinking of the manufacturing sectors' contribution to the profit of the Russian economy (down to 23.2% in January 2008 vs. 26.1% in January 2007), we see certain improvement in their corporate financial performance. In nominal terms, their profit increased 30%, which, adjusting for the growth rates of their output and producer prices, indicates higher profitability.

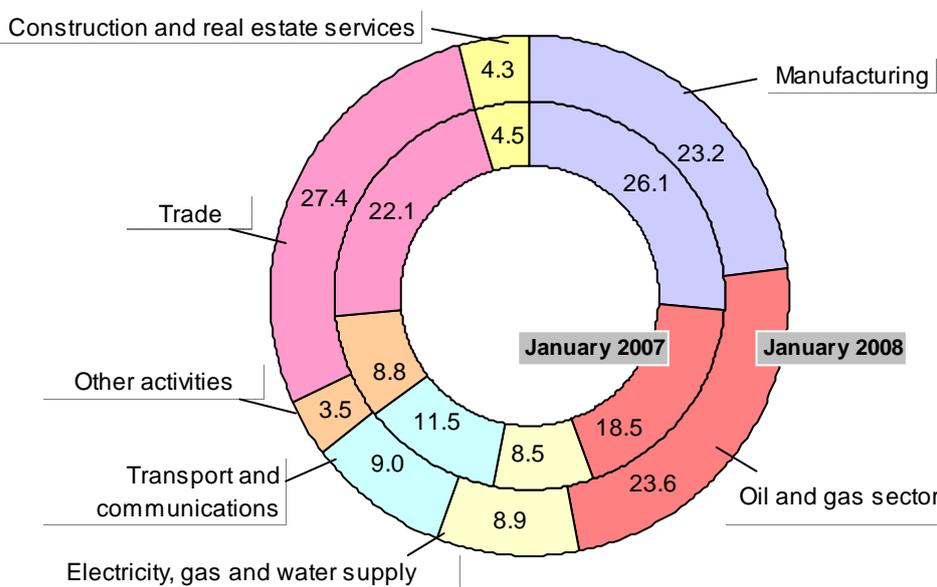
Corporate Financial Performance, %

| | Structure | | Profit growth |
|---|--------------|--------------|-----------------------------|
| | January 2007 | January 2008 | January 2008 / January 2007 |
| Economy, total | 100.0 | 100.0 | |
| Top profit kinds of economic activity | 49.1 | 59.9 | 78 |
| Trade and repairs | 22.1 | 27.4 | 80 |
| Fuel and energy (Oil and gas production and pipeline transportation; Electricity, gas and water supply) | 27.0 | 32.5 | 76 |
| including: | | | |
| Oil and Gas (Oil and gas production and pipeline transportation) | 18.5 | 23.6 | 86 |
| Electricity, gas and water supply | 8.5 | 8.9 | 53 |
| Other kinds of economic activity | 50.9 | 40.1 | 15 |
| Manufacturing | 26.1 | 23.2 | 30 |
| The rest kinds of economic activity | 24.8 | 16.8 | -1 |
| <i>Ref:</i> | | | |
| Profit of the economy, bln rbl | 342 | 498 | 46 |
| Producer price growth, % | | | 24.7 |

Source: Russian Statistics Service; Center of Strategic Investigations, Bank of Moscow.

In January, corporate financial performance in the construction and service sectors was unexpectedly poor (with the exception of trade and pipeline transport): their profits decreased even in nominal terms. In view of the general price rise for goods and services in Russia, this result can only be explained by the sharp increase in infrastructure costs (electricity, leasing, etc.). However, the financial losses of these enterprises were large enough so as to require further analysis.

Corporate Financial Performance Structure, %



Source: Russian Statistics Service; Center of Strategic Investigations, Bank of Moscow.

Banking system

This year, the traditional start-of-the-year slowdown in the banking sector had some peculiarities, and was more severe than in previous years. During the first two months of 2008, total assets increased by 3.0%, whereas for the respective period in 2007 they grew 3.1% (3.4% in 2006).

Second, this deceleration can be explained not only by seasonal factors, but also negative trends in key sources of fundraising. Household accounts and deposits have slowed for several consecutive months. Deposits grew by only 1.2%, or R60 bln, marking the slowest pace for the respective period in recent years. The reasons appear to be the rise in consumer prices alongside respective shifts in the household savings model.

The accumulation of foreign liabilities is slowing due to the unfavorable situation on global markets. Moreover, in order to maintain last year's growth rates, there is a need for much larger new loans due to economies of scale.

Consequently, two of the three main sources of the resource base will continue to slow in the medium-term as well.

The third source, corporate deposits, has demonstrated faster growth thus far. Relative to March 1, 2007, corporate deposits grew 57%, or above the growth rate of foreign liabilities. However, this is clearly insufficient to support growth in the banking sector at last year's rate.

On the assets side, the priorities of lending activities have gradually shifted from the retail sector to the corporate sector. The growth rates are gradually approaching each other, but in terms of the increments in volume (which correlate well with volumes of new loans), the corporate sector is far ahead of the household sector. In January-February 2008, the volume of loans to the corporate sector was larger than that to the household sector by a factor of 4.5x.

Major Banking Liabilities (as of month's end), % of total

| | 12.04 | 12.05 | 12.06 | 03.07 | 06.07 | 09.07 | 12.07 | 01.08 | 02.08 |
|--|-------------|-------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Liabilities (R bln) | 7101 | 9696 | 13963 | 15516 | 17113 | 18131 | 20125 | 20146 | 20733 |
| Capital | 16.2 | 15.4 | 14.3 | 15.5 | 15.9 | 16.1 | 15.3 | 16.2 | 15.9 |
| Bank of Russia loans | 0.3 | 0.2 | 0.1 | 0.1 | 0.1 | 0.0 | 0.2 | 0.2 | 0.2 |
| Interbank transactions | 4.2 | 4.0 | 3.4 | 3.3 | 3.1 | 2.9 | 4.1 | 3.8 | 4.1 |
| Foreign liabilities | 10.9 | 13.7 | 17.1 | 16.3 | 17.0 | 17.6 | 18.1 | 18.1 | 17.8 |
| Household deposits | 28.4 | 28.9 | 27.6 | 26.3 | 25.9 | 26.0 | 26.2 | 25.9 | 25.7 |
| Corporate deposits | 23.7 | 24.0 | 24.0 | 24.9 | 25.1 | 24.5 | 25.5 | 25.1 | 25.2 |
| 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 | 1.6 |
| Issued securities | 9.0 | 7.6 | 7.2 | 6.4 | 5.8 | 5.3 | 5.8 | 5.6 | 5.5 |

Source: Bank of Russia; Center of Strategic Investigations, Bank of Moscow estimates.

This is quite natural in circumstances of slowing growth in the resource base and increasing risks: transactions with large corporate clients are usually less risky and less costly than those in the retail market.

One more indication of higher risks could be the sharp increase in foreign assets, which grew by \$14 bln in January-February to \$92 bln. As the near 80% increase in foreign assets was caused by an increase in short-term deposits (up to 30 days) with foreign banks, this can be explained both by accumulating reserves for making foreign loan repayments (in March, banks were supposed to repay around \$1.5 bln) and, probably, non-economic reasons.

Major Banking Assets, as of month's end, % of total

| | 12.04 | 12.05 | 12.06 | 03.07 | 06.07 | 09.07 | 12.07 | 01.08 | 02.08 |
|------------------------------|-------------|-------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Assets (R bln) | 7101 | 9696 | 13963 | 15516 | 17113 | 18131 | 20125 | 20146 | 20733 |
| Cash and precious metals | 2.8 | 2.7 | 2.6 | 1.8 | 1.8 | 1.9 | 2.5 | 1.9 | 1.9 |
| Accounts with Bank of Russia | 9.8 | 7.3 | 7.5 | 8.0 | 10.9 | 6.1 | 6.9 | 5.8 | 5.1 |
| Interbank transactions | 6.2 | 6.3 | 5.8 | 5.4 | 5.3 | 4.7 | 5.4 | 5.7 | 6.0 |
| Foreign assets | 7.8 | 9.1 | 9.9 | 11.5 | 8.4 | 10.0 | 9.8 | 10.5 | 10.9 |
| Households | 8.7 | 12.1 | 14.7 | 14.4 | 14.9 | 16.0 | 16.1 | 16.3 | 16.2 |
| Corporate sector | 49.8 | 47.0 | 45.3 | 44.8 | 45.0 | 47.2 | 47.2 | 49.2 | 48.4 |
| Government | 8.0 | 6.6 | 5.2 | 5.0 | 4.7 | 4.1 | 4.1 | 4.2 | 3.9 |
| Property | 2.6 | 2.4 | 2.4 | 2.4 | 2.3 | 2.2 | 2.2 | 2.2 | 2.2 |

Source: Bank of Russia; Center of Strategic Investigations, 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 | 40.9 | 49.4 | 58.7 |
| \$ bln | 592 | 764 | 992 | 1 289 | 1 718 | 2 084 | 2 456 |
| Real GDP, % y/y | 7.2 | 6.4 | 7.4 | 8.1 | 7.6 | 7.1 | 6.5 |
| Industrial Production, % y/y | 8.3 | 4.0 | 3.9 | 6.3 | 5.5 | 5.2 | 5.0 |
| Retail Turnover, real, % y/y | 13.3 | 12.8 | 13.9 | 15.2 | 15.0 | 13.0 | 12.0 |
| Gross Fixed Investments, real, % y/y | 13.7 | 10.9 | 13.7 | 21.1 | 17.0 | 14.0 | 12.0 |
| 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 | 32.0 | 26.0 | 23.0 |
| M2X (year end), % y/y | 33.7 | 37.4 | 40.5 | 44.2 | 30.5 | 24.6 | 21.9 |
| Total Banking Assets, % GDP | 41.7 | 44.8 | 51.9 | 61.0 | 63.5 | 65.2 | 66.4 |
| Inflation | | | | | | | |
| CPI (year end), % | 11.7 | 10.9 | 9.0 | 11.9 | 11.2 | 9.5 | 9.0 |
| CPI (year average), % | 11.0 | 12.5 | 9.8 | 9.1 | 12.9 | 9.8 | 9.2 |
| Core CPI (year end), % | 10.6 | 8.3 | 7.8 | 11.0 | 10.0 | 8.4 | 7.8 |
| Budget | | | | | | | |
| Federal Budget Revenues, % GDP | 20.1 | 23.7 | 23.4 | 23.6 | 19.7 | 17.6 | 16.0 |
| Federal Budget Expenditures, % GDP | 15.8 | 16.3 | 15.9 | 18.1 | 16.9 | 16.8 | 15.4 |
| Federal Budget Balance, % GDP | 4.3 | 7.5 | 7.4 | 5.4 | 2.8 | 0.9 | 0.6 |
| Consolidated Budget Balance, % GDP | 4.5 | 8.1 | 8.4 | 6.1 | 3.2 | 1.0 | 0.7 |
| Reserve Fund (, year end, \$ bln | 18.8 | 43.0 | 89.2 | 156.5 | 151.0 | 181.0 | 207.5 |
| National Wealth Fund, year end, \$ bln | | | | | 72.1 | 73.1 | 72.5 |
| Investment Fund, \$ bln | | | 2.6 | 7.0 | 11.0 | 14.5 | 18.2 |
| Balance of Payments | | | | | | | |
| Exports, \$ bln | 184 | 244 | 304 | 354 | 455 | 475 | 510 |
| Imports, \$ bln | 96 | 125 | 165 | 225 | 305 | 370 | 440 |
| Current Account, % GDP | 10 | 11.1 | 9.5 | 5.9 | 4.9 | 1.4 | -0.6 |
| 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 | 656 | 676 |
| External Debt | | | | | | | |
| Foreign Public Debt, % GDP | 19.3 | 9.8 | 5.2 | 3.6 | 2.3 | 1.8 | 1.4 |
| Foreign Private Debt, % GDP | 4.4 | 3.9 | 3.8 | 3.8 | 4.0 | 4.1 | 4.3 |
| Exchange Rate | | | | | | | |
| R/\$: | | | | | | | |
| end of period | 27.8 | 28.8 | 26.3 | 24.6 | 23.6 | 23.8 | 24.0 |
| year average | 28.8 | 28.3 | 27.1 | 25.6 | 23.8 | 23.7 | 23.9 |
| Exogenous Parameters | | | | | | | |
| Urals, \$ p/bbl | 34.6 | 50.4 | 60.9 | 69.6 | 95 | 97 | 105 |
| \$/€ | 1.24 | 1.25 | 1.26 | 1.37 | 1.54 | 1.52 | 1.50 |

Source: Russian Statistics Service; Bank of Russia; Russian MoF; Center of Strategic Investigations, Bank of Moscow forecast.

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