Bank of Moscow

Economic Monthly

May 2008

Economic growth vs. inflation

Center of Strategic Investigations

CONTENTS

Bank of Moscow

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Continuing growth in world oil prices has once again forced the Russian government to revise its forecast of main macroeconomic indicators until 2010. It should be noted that in recent years such revisions have been undertaken regularly, and both the economic growth and inflation estimates were shifted upwards. This raises the legitimate question of whether there is a trade-off between inflation and growth rates in the Russian economy.

This is not an idle question, as the answers lie in the field of practical application of economic policy and are already being discussed in the government. Some representatives of the economic block (MinFin and CBR) reasonably suggest that the Russian economy is “overheating” and that it is necessary to slow the expansion of domestic demand (first of all lending, budget expenditures and the money supply) to arrest inflation and reach financial equilibrium. The opposite point of view calls for measures to support and preserve existing growth rates, even through increased budget expenditures and the use of government development institutions.

It is difficult to find a possible solution (or an acceptable compromise) due to the many problems faced by the Russian economy. On the one hand, the main sources of domestic demand growth are raw material export revenues (received directly or indirectly via the state budget) and bank loans supporting not only investment and production, but also consumption and imports. Economic wellbeing still depends on the situation in global markets, i.e. risks related to external debt and an increase in the amount of “bad debt”.

On the other hand, a direct campaign targeting inflation and “overheating” of the economy may bring more negative than positive results in the current environment. In our opinion, the main reasons for price growth are undeveloped competition in certain segments of the consumer market and the low efficiency of tax/customs policies. On the contrary, the money supply is growing at the slowest rate for the past five years. Thanks to efforts by the monetary authorities to suppress inflation by changing the refinancing rate and reserve ratio and supporting a higher ruble exchange rate, inflation may remain at its expected level, but growth in investment, production and banking will slow down. If one applies only the easily understood and comprehensible instruments of economic policy while ignoring the existing model of structural disproportions, this will result in suppression of business activity.

Monetary policy and inflation

A misguided attempt to solve the problem

The results of the first four months of the year clearly demonstrate that inflation is a problem that can negate all of the achievements of recent years. Inflation aggravates social problems (tighter social stratification, lower living standards for pensioners and the poorest segment of the population), affects investment activity (which had been growing in recent years) and threatens the stability of the budget process.

Discussions about the monetary and non-monetary components of inflation, which used to have the flavor of an academic debate, now have practical applications. Price growth is occurring mainly due to higher prices for food and gasoline as well as services, which is customary. The catalysts for the accelerated price growth are found in import inflation and low competition in various segments of the domestic market. The structure of household expenditure and saving is changing; interest rates on loans are increasing alongside deceleration of bank lending.

A comparison of last year's consumer prices and monetary aggregates does not reveal a clear correlation between their growth rates. This confirms the view that there is a substantial non-monetary component in consumer price growth. The money supply is growing at its slowest pace in the past several years. If we compare the current situation with 2005, we note that in the first four months of 2005 inflation was at the same level as this year (6.3%), whereas the wide monetary base contracted by 6% and M2 increased by 5.1%. This year, the same inflation rate was observed, while the monetary base shrunk by 10% and M2 increased by approximately 3.7%. The results of the previous year are even more impressive: in January-April 2007 a price rise of 4.1% was observed, while the monetary base expanded by 11.5% and M2 increased by 11.2%.

As a result, in current conditions the range of possible anti-inflationary measures that can be undertaken by the CBR is restricted. Econometric analysis shows that under current monetary policy, the inflation rate should have been 50% lower if it were strictly monetary in nature. Tighter monetary policy will make us forget about last year's growth in production and investment.

Meantime, managing the ruble exchange rate can no longer play an anti-inflationary role. In 2003–2006, allowing the ruble exchange rate to appreciate helped control inflationary pressure. It is estimated that a 1% increase in the nominal ruble rate helped, other things being equal, lower inflation by 0.3%. Today, technical analysis shows no correlation. In a situation of imported inflation, the growing share of imports on the domestic market (which is supported by a strong ruble) strengthens the impact of external markets on domestic prices even more. Furthermore, allowing the ruble to strengthen can exert downward pressure on domestic production.

Higher interest rates will help slow down lending and, hence, reduce the expansion of domestic demand. However, it should be noted that domestic demand is the main factor driving economic growth. Second, interest rates are growing in any event, and here the CBR is merely following the market. Because of the global credit crunch, the inflow of external funds to the banking system decreased, and accelerated inflation led to a smaller inflow of savings to household bank accounts. Deposit rates have increased in almost all banks, but they are still below the level of inflation. At the same time, interest rates for foreign currency accounts are already higher than those for liquid, low-risk bonds (e.g. Russia-28 and Russia-30), which determines the requirements for yield and risk rates of assets in an environment of such expensive liabilities.

Correspondingly, the situation on the assets side has started to change. The increase in interest rates and fundamental risk revaluation has led to a sharp decrease in asset growth. In spite of the consumer boom, households and banks are looking for a certain "balance of interests" that assumes reliable borrowers and interest rates responsive to inflation. This has immediately led to reduce volumes of consumer loans, and we believe this trend will continue. We also expect slower growth in corporate loans.

We believe an adequate assessment of the current situation is very important in terms of elaborating monetary policy. As we mentioned earlier, traditional measures that tighten monetary policy will not help reduce inflation. Moreover, higher interest and ruble exchange rates will weigh on economic growth. It does appear that moderate softening of monetary policy and better control over the ruble exchange rate (i.e. preventing excessive strengthening) will help promote investment, reduce growth of imports and support the competitiveness of domestic producers. The latter pay close attention to signals from the monetary authorities before deciding whether to expand production on a new technological basis (i.e. when the extensive factors of production growth have been exhausted). In fact, it is a question of transiting from a policy of “cheap money” to one of “reasonably accessible” money with regard to the profitability of producing important goods and services. Exercising control over money supply growth should not narrow the flow of financial resources or reduce the accessibility of loans to key sectors of the economy.

Economic growth and inflation

Future growth: From the control of producers to the control of consumers?

The control of producers (sellers) has become a reality on the Russian market and threatens its further growth. This is a classical case when expansion of internal demand leads to noticeable price growth and a moderate increase in production imposed by producers. Such a situation is explained not only by external factors (i.e. sharp increases in global oil and food prices), but also by very important internal factors. These include continuing growth of investment in the economy and expansion of internal demand; a high utilization ratio of production capacity, large and/or growing concentration in some sectors and development of trade networks; low quality of anti-monopoly regulation of commodity markets; lagging agricultural production, etc.

In such circumstances, a strategy to increase production slowly while imposing the maximum producer prices the market can bear is followed. Such an approach is explained by possible constraints on production capacity, as well as weak competition among sellers with strong competition among buyers and high inflationary expectations in the economy.

Bearing in mind that, in the end, it is consumers who pay, we can say that *industrial growth in Russia in 1Q08 was very expensive for Russian consumers*. In January-April 2008 the official inflation rate, which only partially reflects actual price rises, was reported at 6.3%, and this was only an immediate response to the sharp increase in consumer prices. It is also very important to note that high price growth for intermediate and investment goods generates a *price overhang* through the high cost of new capacities. In the medium and long term, this price overhang will inevitably manifest itself in higher prices for consumer goods and faster inflation in general.

Speaking of the *future growth* of Russian industrial production, one should keep in mind that there are serious, almost “tectonic” structural shifts occurring in the world economy. Increasing demand for food and energy products leading to price growth that spreads to other products has triggered changes in consumption patterns throughout the world. This will result in noticeable structural shifts in global production of goods and services. For each country, the negative impact of these shifts on consumers reflected in the scope of inflation and the time needed to reach a new economic equilibrium depends on the initial level of equilibrium and internal stability of the economy. Furthermore, it is very important for an economy to receive immediate and reliable signals about actual changes in demand for certain goods and services, as this will not only shorten the adjustment process, but also prevent inefficient investment in non-competitive production.

In this regard, general producer price growth and the high pace of consumer price growth in Russia threaten to disorient the industrial sector and impede the determination of truly competitive enterprises. The situation becomes even more complicated when we consider that consumer demand continues to expand due to inflationary expectations, competition among producers on some markets is weak, and administrative regulation is inefficient. Shifting domestic production to more expensive niches and, as a result, re-orienting demand to imported goods poses another threat. In particular, fast growth of imports reported at the end of 2007 and the beginning of 2008 stemmed from the import of machinery and equipment, which adds to the level of competition for Russian manufacturers. At present, in a high demand environment, this is not yet considered a significant threat, but a slowdown in demand expansion will aggravate the problems of competitiveness and further growth of the domestic industrial sector.

Therefore, restricting price growth and preventing another price surge are the *main tasks* for making Russian manufacturers more competitive and ensuring stable high growth for the industrial sector. It is very likely that the pace of industrial growth demonstrated in 2007 and 1Q08 was close to the maximum possible in the given situation involving the commissioning of new capacities. In the present situation of fast price growth, even preserving the pace of production growth at the same level, not to mention its acceleration, may contradict the objective of achieving balanced industrial growth in the medium and long run.

Deceleration of demand, now heated by inflationary expectations, may weigh on growth in industrial sectors and once again aggravate the problem of their competitiveness. It is therefore necessary to comprehend in a timely fashion all of these threats and elaborate adequate strategies.

Current inflation

Main outcome of the "price suppression pact"

In April 2008 inflation was reported at a level of 1.4%, and consumer prices have increased by 6.3% YTD. As was expected, maximum price growth was reported for food prices, up 2.2% in April and 8.0% YTD. Another unpleasant fact was high price growth in other segments of the consumer market. Prices for non-food items continued to grow at twice the rate of the previous year, while services, after having undergone a price surge in April, later returned to the 2006–2007 trend.

Consumer price index, %

	April			January-April		
	2006	2007	2008	2007	2006	2008
Consumer price index, total	**0.4**	**0.6**	**0.4**	**0.6**	**0.4**	**0.6**
Food products	0.3	0.8	0.3	0.8	0.3	0.8
Non-food items	0.3	0.4	0.3	0.4	0.3	0.4
Services	0.6	0.5	0.6	0.5	0.6	0.5

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

Service prices are largely determined by the tariffs of national monopolies regulated by the government. Therefore, their stable high growth rates, especially following the approval of an accelerated increase in national monopoly tariffs, can be seen as indirect acknowledgement by the authorities that it is impossible to bring inflation down to the levels observed in industrially developed countries.

For non-food products, acceleration of price growth lagged the first hike in food prices. In our opinion, this was largely the result of growing inflationary expectations in the economy.

Much attention is still being paid to *food product pri*ces. The end of the price-freeze period[1] initiated by the authorities to prevent sharp increases in food product prices allows us to draw some conclusions regarding the results of this endeavor.

During the six months (November 2007 to April 2008) of the "price suppression pact" involving the prices of certain food items, consumer prices for food products increased by approximately 11.9%. In annual terms, this implied price growth of more than 25%. Such local peaks for food prices were reached in a situation wherein authorities at all levels actively interfered in the pricing and even direct distribution of food products[2]. Here, an apparent question arises: how much faster would prices have grown without government interference dictated by pre-electoral political considerations? In our opinion, the short-term impact of this interference has been next to nothing, and its long-term effect will be rather negative.

Acceleration of consumer prices for food products has been largely determined by an increase in world prices for dairy products, vegetable oil and grain, as well as the subsequent growth of domestic prices for similar products and derivative processed foods. *Administrative measures failed to prevent imported inflation*: for most key food products, growth of consumer prices was comparable with growth of import prices and even exceeded this level. Russian food producers and trading companies appropriated almost all trade margins generated by the rise of world prices, while market volumes of almost all goods remained the same.

[1] For the period between the end of October 2007 until May 1, 2008, the largest retail networks and food producers agreed not to increase prices for some socially important food products.
[2] Introducing food coupons for poor families in Sakhalin region allowing purchases of some socially important food products at fixed prices.

Prices, production, and imports of the most important food products, %, y-o-y

	Consumer prices	Producer prices	Import prices (in ruble equivalent)	Production	Imports
	January-March 2008	January-March 2008	December 2007 – February 2008	January-March 2008	December 2007 – February 2008
Milk		62		3.5	
Whole milk products	39			-0.1	
Milk and condensed cream			26		16 times
Butter	44		46	5.4	-1.2
Vegetable oil	55		51	-23.3	15.3
Bread, rolls and buns of wheat flower of highest grade	28			-3.1	
Wheat and maslin*			143*		-20.4*
Wheat		51			
Food products, total	**17.8**				

* Exports.

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

Therefore, while market capacity changed only marginally, fast growth in consumer prices was observed proportional to the increase in respective import prices. The short-term effect of the administrative regulation was minimal, while its medium-term impact could be negative. One of the obvious outcomes may be a weakening of the positions of small independent producers and sellers who may leave the market (which will lower competition), creating the precedent of a “collusion” of authorities with certain market participants, granting them *carte blanche* for further (even less justified) price increases after the price freeze period is over. It is also worth noting that the expansion of trade networks is still outside the attention of the anti-monopoly authorities. The common international practice of such bodies is to prevent price controls and support fair prices acceptable to consumers. This is not an occasional PR campaign, but rather their usual practice.

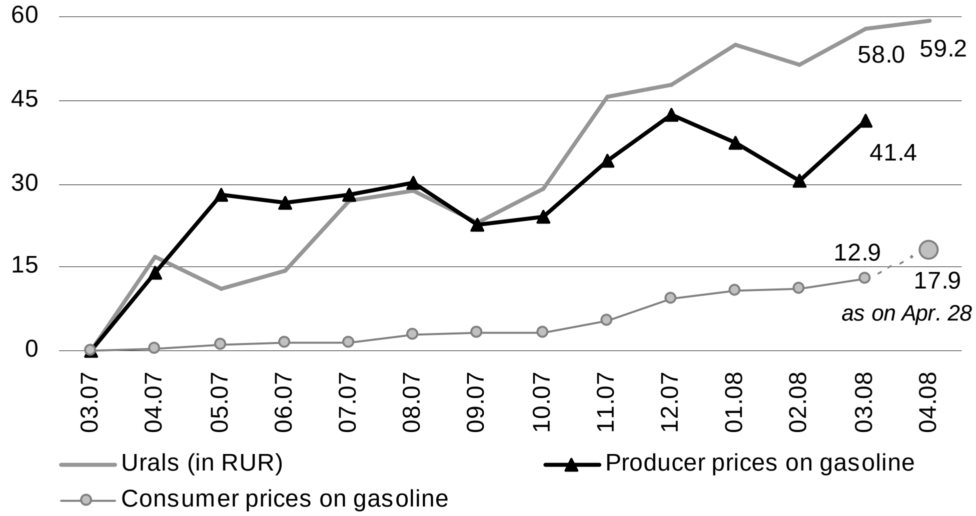
Summing up, we can say that the situation involving consumer prices for food products and their regulation have demonstrated once again that the Russian economy has little immunity against external shocks, and there are no adequate instruments to weaken external shocks and mitigate their negative impacts.

A revision of inflation estimates for 2008 (10% according to the MinEcon and MinFin, and around 13% by our estimates) is explained not only by the reported 6.3% growth of consumer prices in four months, but by other important factors as well.

In addition to continuing growth in food prices, prices for *petroleum products* surged. In March-April, retail gasoline prices grew by more than 6%, and one can expect further increases. First, this is related to the increase in producer prices for gasoline caused, among other things, by higher world prices for Urals crude and a respective increase in the mineral replacement tax (imposed on the total production of crude, including volumes to produce gasoline for the domestic market).

Second, because of very weak competition in retail markets and direct state ownership in the oil production and refining sector, retail gasoline prices have traditionally been moderated by the government (here, it should be noted that in March-October 2007, when gasoline producer prices rocketed by 24%, retail prices increased by only 3.2%). However, failure with administrative regulation of food prices may delay the next slowing of growth in retail gasoline prices. During the period from October 2007 to April 2008, retail gasoline prices increased by 14.2% (producer prices grew by 14.0% in October-March). New price records for Urals may accelerate not only growth in retail gasoline prices, but also consumer prices in general.

Gasoline and Urals prices, in % to March 2007



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

Another important inflationary factor is *expanding consumer demand*. One obvious consequence of high inflationary expectations is increased consumption: the share of private consumption in household incomes reached 75.4% in 1Q08 vs. 74.1% last year. In addition, despite a slowdown in household bank lending, the increase in loans exceeded the increase in household deposits by more than R100 bln.

Real sector

Industrial production in 1Q08: A manageable "overheating"?

The acceleration of industrial production growth in March (up to 6.5% y-o-y) returned it to last year's trajectory. In 1Q08, industrial production grew 6.2% y-o-y, which is comparable to the annual growth rate for last year (6.3%).

Industrial production growth in 1Q08 appeared to be more balanced than last year. High rates of growth were demonstrated by the production of investment goods (9.2% y-o-y) and intermediate goods (8.5% y-o-y)[3], while the production of final goods grew at a faster pace than last year (6.4% y-o-y vs. 6.0% in 2007). Noticeable acceleration of growth was observed in electricity, gas and water supply (5.6% y-o-y in 1Q08, after -0.2% in 2007). Deceleration in mining and quarrying fits the trend of low growth in this sector. However, the drop in the growth rate to 0.7% in the first quarter (y-o-y) should not be considered a collapse, as it may have occurred due to the "denominator" effect (in 1Q07, rather high growth rates were observed in this sector). The growth rates in this segment are still between 1.5 and 2.5%.

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

	January-February	March	January-March	*Ref:* 2007
Industrial production	**6.0**	**6.5**	**6.2**	**6.3**
Mining and quarrying	1.4	-0.7	0.7	1.9
Manufacturing	7.7	10.4	8.7	9.5
Investment goods production	*7.9*	*11.7*	*9.2*	*14.2*
including:				
machinery and equipment	8.0	12.1	9.3	15.3
other non-metallic mineral products	7.7	10.1	8.6	10.3
Intermediate goods production	*7.0*	*11.3*	*8.5*	*4.2*
including:				
coke, refined petroleum products	4.4	6.2	5.0	2.9
basic metals and fabricated metal products	6.0	13.4	8.6	2.1
other sectors (woodworking, chemicals, rubber and plastic products)	11.0	11.5	11.1	9.6
Final goods production	*6.7*	*5.9*	*6.4*	*6.0*
including:				
food products	6.3	6.4	6.4	6.1
textile and textile products, leather, leather products, shoes	5.5	-0.2	3.3	-1.1
pulp, paper and paper products; publishing and printing	8.8	6.2	7.8	9.1
Electricity, gas and water supply	**7.4**	**1.7**	**5.6**	**-0.2**

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

After a short slowdown between the end of 2007 and February 2008, industrial production growth rates recovered to the high levels of last year. At the same time, this growth became more balanced, which raises the questions of why there was improvement and how stable this growth will be.

[3] Hereafter:
Final goods production: manufacture of food products, manufacture of textiles and textile products, leather, leather products, shoes, manufacture of pulp, paper and paper products, publishing and printing.
Investment goods production: manufacture of other non-metallic mineral products, manufacture of machinery and equipment.
Intermediate goods production: 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.

Compared with 2007, Russia's growth in industrial production output in the first months of 2008 was accompanied by much faster price growth. In 1Q08, producer prices grew at a rate of 25.7%, or twice the level of 1Q07 (in annual terms), while average annual price growth in 2007 was estimated at 11–12% (y-o-y). To a large extent, the faster growth in producer prices in 1Q08 was caused by rocketing world energy prices and subsequent acceleration of prices in mining and quarrying as well as the production of coke and refined petroleum products. Significant acceleration of price growth (by factors of 1.3x to 2.0x) was also observed in other manufacturing sectors.

Producer Prices and Industrial Production Output, %, y-o-y

	Producer price growth		Output growth	
	1Q08	2007	1Q08	2007
Industrial production	**25.7**	**11.3**	**6.2**	**6.3**
Mining and quarrying	49.2	10.5	0.7	1.9
Manufacturing	20.9	11.7	8.7	9.5
Investment goods production	*18.5*	*13.0*	*9.2*	*14.2*
including:				
machinery and equipment	12.9	9.6	9.3	15.3
other non-metallic mineral products	33.9	26.7	8.6	10.3
Intermediate goods production	*21.0*	*11.7*	*8.5*	*4.2*
including:				
coke, refined petroleum products	49.4	3.6	5.0	2.9
basic metals and fabricated metal products	5.2	18.5	8.6	2.1
other sectors (woodworking, chemicals, rubber and plastic products)	20.2	10.4	11.1	9.6
Final goods production	*20.4*	*10.4*	*6.4*	*6.0*
including:				
food products	23.7	11.5	6.4	6.1
textile and textile products, leather, leather products, shoes	11.0	5.1	3.3	-1.1
pulp, paper and paper products; publishing and printing	11.8	12.1	7.8	9.1
Electricity, gas and water supply	**15.6**	**14.4**	**5.6**	**-0.2**

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

Within reasonable limits, price growth is a necessary "lubricant" that contributes to intensive development of industrial production, as it spurs demand for industrial products (competitiveness) while encouraging output growth. However, the scale of the price surge taking place in many sectors of industrial production indicates that *in the first quarter of 2008, industrial production growth in Russia was supported by a huge injection of price doping.*

Producer prices: Imported price growth or growth acceleration thanks to internal resources?

Energy and food products became the epicenter of a high and global inflationary wave because of the huge increase in world prices. A proportional rise in food prices and delayed but still high growth of petroleum product prices in Russia were caused by integration of the country into the global economy as well as internal factors.

For food products, importing global inflation became possible not only thanks to the low growth in domestic agricultural production, but also the inefficient policies of authorities at various levels (e.g. the delayed reduction of import duties on food products and the restriction of grain exports, as well as the absence of anti-monopoly regulation). An additional factor was weaker competition among sellers on domestic food markets (strengthening of trade networks and exclusion of small independent sellers), a situation that became even more obvious as a result of the "price suppression pact" affecting certain food products between October 2007 and April 2008.

Growth of domestic petroleum product prices was caused by the sharp increase in world energy prices, as the former are tied to the mineral replacement tax, itself directly bound to the price of Russian crude in the world market, as well as the low competition of producers and sellers on the retail markets.

Prices of manufactured goods grew in an environment of high *investment demand* (for machinery & equipment and construction materials) demonstrated by both private and state-owned companies, the latter being less sensitive to prices of equipment procured for their investment programs. This situation was aggravated by increasingly noticeable *capacity constraints* on the production of investment goods.

As a result, inflationary expectations generated by the expansion of internal demand, significant price acceleration in various industrial sectors, and the authorities' inability to control and mitigate non-monetary factors of price growth induced a *general increase of producer prices* in industrial sectors.

Faster and more universal producer price growth alongside smoother growth of industrial production is a manifestation of *overheating* of the Russian economy.

In a situation of general price increases, a certain degree of "euphoria" is apparent: some market participants are disoriented and misunderstand the competitive targets and actual demand for produced goods. It is doubtful that domestic industrial production remains competitive in a situation of contracting internal demand.

At present in Russia, growth rates of industrial production are rather high, but the underlying price acceleration is so strong that it is again time to ask the already forgotten question: "Is Russian industrial production developing along the path of improving its medium- and long-term competitiveness?" It is likely that the growth rate of industrial production is losing its importance as one of the indicators of economic growth, while the issues of arresting inflation and gaining real competitiveness are becoming increasingly important.

Banking system

The key trends in the development of Russia's banking sector in 1Q08 were deceleration of asset growth, an increased share of corporate loans, and contraction of banking liquidity.

In March 2008, bank assets grew at the same pace as in February (2.9%), while the first-quarter growth rate was reported at 6.0% (in annual terms[4] it declined to 37% as of April 1, whereas it stood at 44% as of January 1). Deceleration was explained by the "denominator effect": in March 2007, total bank assets increased substantially thanks to Sberbank's SPO and the large inflow of foreign loans. Therefore, the observed fall merely reveals the level of "natural" growth in the banking sector in recent months. This indicator may reflect the actual growth of the banking sector in May even more adequately if we eliminate the effect of the IPO held by VTB. Taking this into consideration, we estimate that asset growth in annual terms should decline to 31–33%.

Almost all components of banking liabilities grew at a slower pace than last year (with the exception of corporate accounts and deposits).

Growth in household deposits continues to slow, up 1.7% in March and 2.9% in 1Q08 (in 2007 growth rates were 2.5% and 5.7%, respectively). In annual terms, growth rates declined to 32.1%, which was the minimum level reported in mid-2005. Adjusting for inflation, the increase in household accounts and deposits over the past 12 months was the same as in 2004, when there was a large slowdown in deposits as a result of the summer crisis.

Growing consumption and purchases of foreign exchange have become alternatives to savings accounts. In January-February, net purchases by the public of foreign exchange from banks reached $6 bln, whereas for all of 1Q07 net purchases amounted to only $840 mln.

A moderate increase in foreign exchange deposits was observed. In 1Q08 they grew by $ 3 bln (the same amount as for 2007 as a whole) and their share in total household bank deposits stopped decreasing.

Assets of the corporate sector remain the main source of growth for the banking sector. In March alone they grew by 6.3%, or R330 bln. In 1Q08 they increased by 8.3%, or R430 bln, which provided over one-third of the total increase in banking assets. The contribution of the corporate sector to growth of banking assets was 50% higher than the increase in banks' own assets and 200% above the increase in household savings.

Additional support for the banking sector was provided by the transfer of some corporate accounts from the Bank of Russia. In March, corporate accounts with the Bank of Russia decreased by R136 bln, or about 40% of the monthly increase in corporate accounts in the banking sector.

[4] Compared to the respective data of the previous year.

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

	12.05	12.06	03.07	06.07	09.07	12.07	01.08	02.08	03.08
Liabilities (R bln)	**9696**	**13963**	**15516**	**17113**	**18131**	**20125**	**20146**	**20733**	**21323**
Capital	15.4	14.3	15.5	15.9	16.1	15.3	16.2	15.9	15.7
Bank of Russia loans	0.2	0.1	0.1	0.1	0.0	0.2	0.2	1.0	0.7
Interbank transactions	4.0	3.4	3.3	3.1	2.9	4.1	3.8	4.0	4.3
Foreign liabilities	13.7	17.1	16.3	17.0	17.6	18.1	18.1	17.8	17.2
Household deposits	28.9	27.6	26.3	25.9	26.0	26.2	26.0	25.7	25.4
Corporate deposits	24.4	24.4	25.3	25.1	25.0	25.8	25.5	25.6	26.4
Accounts and deposits of federal state authorities and local governments	2.0	2.2	2.6	2.4	2.6	1.5	1.9	1.6	1.7
Issued securities	7.6	7.2	6.4	5.8	5.3	5.8	5.6	5.5	5.5

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

Growth of bank lending to the non-financial sector of the economy accelerated compared with 1Q07 in spite of slower expansion of the resource base. The total volume of loans to the economy increased in January-March by 9.8%, while in the same period of last year it grew by only 8.7%. Annual growth rates increased from 50.4% to 53.6%.

The structure of bank lending (retail vs. corporate loans) remained nearly unchanged last year, whereas in previous years the household loan market grew much faster than that of corporate loans. Moreover, in the first quarter household loans grew much slower than corporate loans (7.6% vs. 10.6%).

The acceleration of lending amidst slower expansion of the resource base affected banking liquidity, which contracted by almost 50%, or R500 bln, in the first quarter. The ratio of liquid assets to client accounts and deposits (household and corporate sectors) dropped to a critical level of 10.3%.

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

	12.05	12.06	03.07	06.07	09.07	12.07	01.08	02.08	03.08
Assets (R bln)	**9696**	**13963**	**15516**	**17113**	**18131**	**20125**	**20146**	**20733**	**21323**
Cash and precious metals	2.7	2.6	1.8	1.8	1.9	2.5	1.9	1.9	1.9
Accounts with Bank of Russia	7.3	7.5	8.0	10.9	6.1	6.9	5.8	5.1	5.1
Interbank transactions	6.3	5.8	5.4	5.3	4.7	5.4	5.7	5.9	6.2
Foreign assets	9.1	9.9	11.5	8.4	10.0	9.8	10.5	11.0	10.8
Households	12.1	14.7	14.4	14.9	16.0	16.1	16.3	16.3	16.4
Corporate sector	47.0	45.3	44.8	45.0	47.2	47.2	49.2	48.4	48.8
Government	6.6	5.2	5.0	4.7	4.1	4.1	4.2	3.9	3.3
Property	2.4	2.4	2.4	2.3	2.2	2.2	2.2	2.2	2.2

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

Banking investment in securities decreased significantly, by more than R220 bln in the first quarter. The largest reduction, by R120 bln, was observed in the least risky segment of government bonds. Thus, in addition to contraction of the most liquid assets, the potential collateral base against which banks may receive refinancing from the Bank of Russia shrank.

Nevertheless, the banking sector is gradually adjusting to the low level of liquid assets and a decelerating resource base. One indication of this adjustment is the more active interbank money market. The total volume of assets deposited at other banks has increased by more than R200 bln YTD.

Forecast of Key Economic Indicators

	Actual			Forecast			
	2005	2006	2007	2008	2009	2010	2011
Macroeconomic indicators							
Nominal GDP:							
R. trln	21.6	26.9	33.0	43.1	52.1	62.3	74.5
$ bln	764	992	1 289	1 834	2 208	2 629	3 130
Real GDP, % y/y	6.4	7.4	8.1	7.6	7.1	6.8	7.1
Industrial Production, % y/y	5.1	6.3	6.3	6.0	5.6	5.3	4.7
Retail Turnover, real, % y/y	12.8	13.9	15.2	15.0	13.0	12.0	11.0
Gross Fixed Investments, real, % y/y	10.9	13.7	21.1	17.0	14.0	12.0	11.0
Exports real, % y/y	6.5	7.3	6.4	4.8	4.0	3.1	3.1
Imports real, % y/y	16.6	21.9	27.3	26.0	20.0	15.0	10.0
Monetary Aggregates							
M0 (year end), % y/y	30.9	38.6	32.9	29.0	24.0	22.0	21.0
M2 (year end), % y/y	38.6	48.8	47.5	32.5	28.0	24.5	24.0
M2X (year end), % y/y	37.4	40.5	44.2	31.0	26.0	23.5	23.0
Total Banking Assets, % GDP	44.8	51.9	61.0	62.0	64.0	66.0	68.0
Inflation							
CPI (year end), %	10.9	9.0	11.9	13.5	11.0	10.0	9.0
CPI (year average), %	12.5	9.8	9.1	13.8	12.1	10.5	9.5
Core CPI (year end), %	8.3	7.8	11.0	12.0	9.7	8.5	7.8
Budget							
Federal Budget Revenues, % GDP	23.7	23.4	23.6	21.9	20.1	18.5	17.3
Federal Budget Expenditures, % GDP	16.3	15.9	18.1	16.2	16.8	16.6	16.0
Federal Budget Balance, % GDP	7.5	7.4	5.4	5.7	3.3	1.9	1.3
Consolidated Budget Balance, % GDP	8.1	8.4	6.1	6.4	3.7	2.1	1.5
Reserve Fund (, year end, $ bln	43.0	89.2	156.5	185.0	220.8	262.9	311.7
National Wealth Fund, year end, $ bln				64.7	103.8	128.8	140.3
Investment Fund, $ bln							
Balance of Payments	244	304	355	510	550	595	645
Exports, $ bln	125	165	223	305	380	465	540
Imports, $ bln	11.1	9.5	6.1	8.2	5.0	2.3	1.0
Current Account, % GDP	1.9	42	80.7	40	35	40	45
Net Capital Inflow/Outflow, $ bln	182	304	476	661	801	896	966
International Reserves, year end, $ bn 5							
External Debt	10.0	5.2	3.5	2.2	1.7	1.3	1.0
Foreign Public Debt, % GDP	3.9	3.8	3.8	3.8	3.9	4.1	4.2
Foreign Private Debt, % GDP							
Exchange Rate							
R/$:	28.8	26.3	24.6	23.3	23.6	23.7	23.9
end of period	28.3	27.1	25.6	23.5	23.6	23.7	23.8
year average							
Exogenous Parameters	50.4	60.9	69.6	115	121.0	127.0	133.0
Urals, $ p/bbl	1.25	1.26	1.37	1.56	1.52	1.50	1.48
$/€	21.6	26.9	33.0	43.1	52.1	62.3	74.5

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

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