Bank of Moscow

Economic Monthly

June 2008

Growth rate: A ritual sacrifice

Center of Strategic Investigations

CONTENTS

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In May 2008 inflation in Russia reached 1.4%, or 15% y-o-y, and is about to cross the "red line", which would truly threaten not only financial stability, but also production growth. Few experts believe that inflation running at 15–20% is acceptable for a growing market, especially a raw materials economy like Russia that is exposed to external price shocks. In fact, no seasoned economist believes that economic growth involving an 8% rise in real GDP alongside 10–11% growth in real disposable income can coexist with inflation of that magnitude. It seems that a 15% inflation rate could put a brake on the investment process and aggravate financial risks and disproportions.

Russian industrial enterprises have not really benefited from the surge in inflation – the aggregate level of profitability stood at 14.8% last month. The manufacturing sector ran into losses – profitability in the first quarter of 2008 fell to 13.9% from 15.1% a year ago. This is why the 15% inflation rate is marked by a "red line". Interest rates (at least, on loans) are bound upwards in real terms, aiming to exceed inflation. If this trend is sustained, especially against the background of inflationary expectations, the cost of borrowing for enterprises will reach 17–20% p.a. That, in turn, implies a greater percentage of enterprises operating in the manufacturing sector will be unable to afford credit. Given the nearly full capacity utilization rate and growing labor constraints (stemming from demographic trends and the widening mismatch between professional competence and labor cost in Russia), the only output driver will be growing labor efficiency based on large-scale modernization of fixed capital. This process will slow considerably if bank loans become unavailable.

Reducing inflation is not the only goal in the overall effort to treat an overheated economy. The greater objective is transition to a qualitatively new level of economic growth based on manufacturing of high-value added products supported by a stable financial system, accompanied by reduced dependence on global raw materials and capital markets. Monetary policy should aim to maximize use of the "growth pause" to remove all structural imbalances and lay the groundwork for further stages of economic growth. This groundwork should be based on an understanding of both current problems and future threats. The main risk is "passing up" a chance to boost economic growth and benefit from the advantageous external economic environment. Striving to achieve balanced growth against the background of ineffective measures and general reluctance to act can easily degenerate into economic stagnation. Then, more complicated problems will prop up that will have to be resolved in worse conditions. The sacrifice would be made in vain, and could even hamper conditions for further growth.

Monetary policy

Official stance is to tighten monetary policy

The Bank of Russia (CBR) regularly acknowledges its responsibility to control inflation, while having only monetary policy instruments at its disposal to combat mounting prices. These instruments include changes to interest rates, reserve requirements and money supply constraints. Making sure to avoid a liquidity crunch (formal indicators include minimal demand from the banking sector for budgetary resources, and stable rates on the interbank market), the CBR raised its refinancing rate (to 10.75%) as well as mandatory reserve requirements.

Tighter monetary policy is aimed at restraining domestic demand as well as limiting bank lending to the non-financial sector. Certain members of the government's economic block (Ministry of Finance, CBR), international financial institutions (IMF, World Bank) and independent experts agree that the Russian economy is overheated. To some extent, it is becoming increasingly clear that high economic growth rates "cost too much", giving rise to new structural disproportions and negative repercussions, such as the risk of sagging competitiveness.

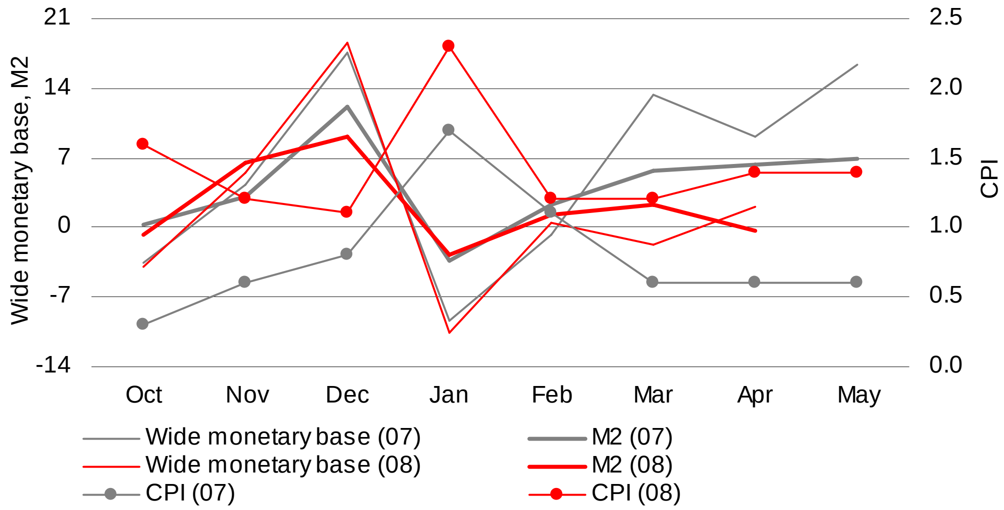
First, Russian companies have been slow to adequately respond to growing demand due to constraints in production capacities and labor. Expanding domestic demand is boosting prices for domestic goods and encouraging imports, which tends to level off economic growth. From this standpoint, "the growth pause" in domestic demand (i.e. its weakening expansion) may be more in line with the task of developing domestic industry in the medium and long terms. Coinciding with the natural time lag between investment injections and the launch of production capacities, such a "growth pause" may give the manufacturing sector the time necessary to bolster output of truly competitive products.

Second, high growth rates aggravate misbalances and risks. There is a growing gap between savings and loans to the non-financial sector, liquidity is declining, and the share of securities in banking assets is shrinking. Accelerating growth in the banking sector exacerbates the associated risks, i.e. the mismatch between the maturity and currency structure of assets and liabilities, bad debt exposures, technical defaults, etc.

Third, one of the priorities is to keep inflation at a moderate level. Leaving aside the discussion of reasons for the current spurt in inflation, we can say that rapidly growing domestic demand alongside expansion in the money supply and banking sector (by far outperforming nominal GDP) also adds to the "inflation background". This "natural" inflation background may (and should) be lower than the current one. In any event, inflation will run at a relatively high level of 5–7%, as gauged by international measures.

The CBR's available anti-inflationary steps should meet two criteria. The first is to seek a balance between financial stability and the depressive effect of tightened monetary policy on current economic growth – an effect that cannot be assessed as wholly negative and that can be instrumental in the medium term. The second is the effective use of monetary policy instruments, with statistical analysis of price growth dependence on money supply being the appropriate exercise.

Growth in monetary aggregates and consumer prices for the past 8 months y-o-y, % change on previous month



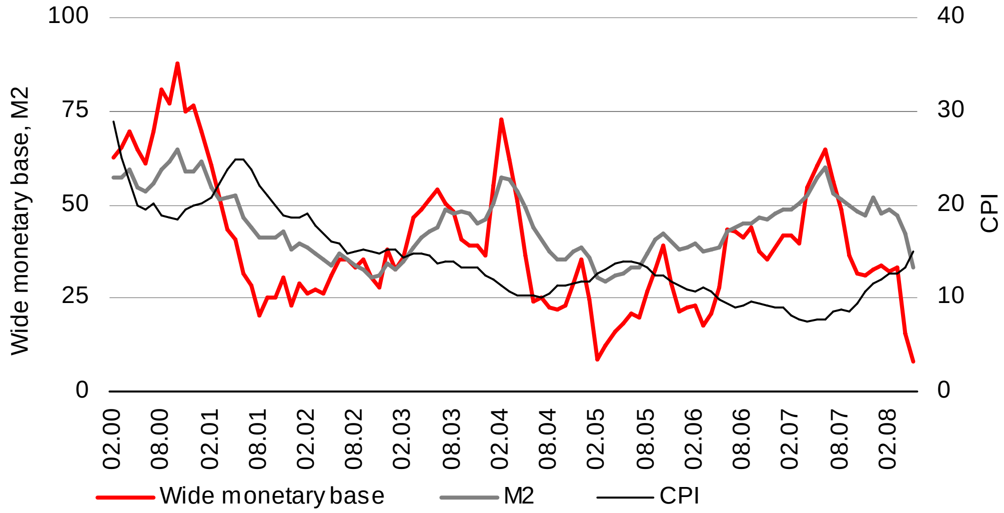
Notes: (07) – Oct 2006–May 2007, (08) – Oct 2007–May 2008.

Source: Rosstat, CSI Bank of Moscow.

According to this statistical analysis, in the period from October to February 2006–2008, monetary aggregates (broad monetary base and M2) were growing at practically the same pace. But at that time, prices were already moving up faster than a year ago. After February 2007, the money supply was widening, while inflation was set on a downward trend. Had it not been for an external shock in the second half of the year triggered by food price hikes – even despite a vigorous capital influx and expansion of the money supply– inflation in 2007 would have run at a single-digit rate. On the contrary, so far this year monetary policy has created a most conducive setting for reining in price growth – even though prices have been climbing anyway. Therefore, according to statistical analysis, we cannot state that *money supply constraints will pull down inflation.* Only substantive (qualitative) analysis shows that commodity groups with the most intensive price growth have no (or only mild) relation to the expansion of domestic demand and bank lending. Moreover, it seems unlikely that households will cut down on their consumption of food, housing and utilities services in conditions of domestic demand constraints.

Statistically, analyzing growth in prices and the money supply over a longer time interval allows one to make conclusions about certain growth cycles (those with a lag of 0.8–1.0 years). It appears this hypothesis matches only formal statistical criteria, and to change the course of monetary policy on this basis is risky, primarily because of the substantial time lag and impact of “other factors”. Nevertheless, other things being equal, the monetary authorities today have substantially reduced the monetary component of inflation. If price growth does not subside in the coming months, one could only blame the “wrong” monetary policy, not a lack of effort.

Growth in money supply and consumer price inflation, %, year-on-year



Source: CBR, Rosstat.

The banking sector's first response (in April 2008) to the tighter monetary policy was a decline in both liquidity and foreign assets. However, corporate and consumer loans continued to grow at a high rate (consumer loans +56%, corporate loans +54% y-o-y).

It seems unlikely that low money market rates and swift expansion of the money supply fueled prices for food products, gasoline and housing & utilities services for households. Moreover, the main economic growth driver in the short to medium term will be a broadening of investment in fixed capital, which is possible only at moderate interest rates on loans. For these reasons, the CBR takes responsibility for tightened monetary policy, which may fail to decelerate price growth, but could harm economic growth and expose the banking sector to higher risks.

Real sector

Prices continue on an upward path

In April, industrial producer prices moved up resolutely, growing by 4.5% over the month. Noticeable price escalation was seen in all industrial sectors, excluding electricity, gas and water supply.

Industrial producer price growth, %

	Over the month		Year-on-year	
	March 2008	April 2008	March 2008	April 2008
Industry	**0.7**	**4.5**	**27.4**	**27.3**
Mining and quarrying	-5.6	7.3	48.5	43.9
Manufacturing	3.2	4.7	22.8	23.9
investment demand sectors	1.3	1.8	19.9	20.4
intermediate demand sectors	4.8	7.5	24.5	25.4
final demand sectors	2.3	2.9	22.8	24.9
Electricity, gas and water supply	1.6	-1.2	17.9	17.0

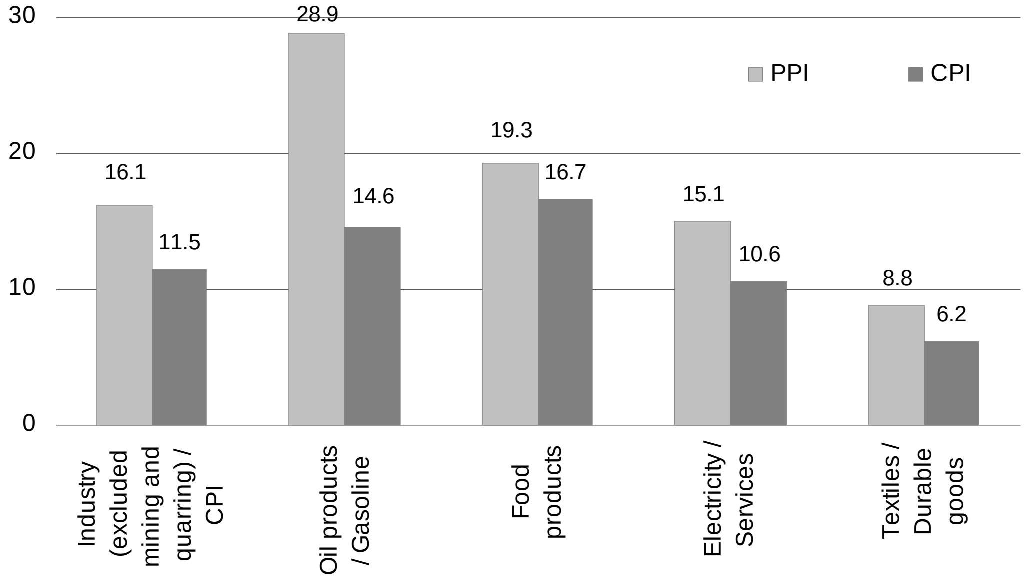
Source: Rosstat, CSI Bank of Moscow.

Producer price growth settled at the March level year-on-year (27.4%), but the rate is clearly accelerating. New price hikes were observed in the manufacturing industries (23.9% in April from 22.8% in March, y-o-y), and indeed throughout the entire economy, including industries serving different types of demand. The marginal slowing of price growth in the mining and quarrying sector (to 43.9% y-o-y from 48.5% in March) was only a temporary setback: steep growth in world prices for energy-producing materials in May will bring this indicator close to 50% y-o-y again. It is too early to view the slight price downturn in the electricity, gas and water supply sector as a trend. Rather, it is likely that price deceleration will be corrected by May's performance in this sector as well.

It is also premature to forecast a downtrend in growth of prices for industrial products. The price rally in this segment is in full swing, making it harder to rein in growth and buck the uptrend.

In terms of inflation, a current and deferred price overhang is taking shape. We estimate that the current price overhang forming in final demand sectors reached at least 2.5% in early May. For the eight months from September 2007 – a period marked by aggressive growth in prices of consumer-demand oriented producers and gasoline prices – consumer prices jumped by 11.5%. Comparing consumer price components and those of producers manufacturing similar products highlights an accumulated and still unrealized price overhang: even if prices for the respective industrial products were to stop growing, consumer price growth would likely reach at least 9.0% from the start of the year (+6.3% in January to April).

Growth in consumer and producer prices, September 2007 – April 2008, %



Source: Rosstat, CSI Bank of Moscow.

Accelerating growth in prices of producers satisfying intermediate and investment demand not only reduces the real return on investment in the Russian economy, but is already laying the groundwork for sky-high prices on the consumer market in the future. And, as always, the consumer will bear the brunt of the consequences.

Meantime, *this price growth has not improved the financial performance of companies in Russia's industrial sector*. The profitability of industrial production, according to first quarter data, was sustained at last year's level (14.7%) only thanks to the mining and quarrying sector, whereas the profitability of the manufacturing industries and the electricity, gas and water supply sector decreased noticeably.

Corporate financial performance, %

	Profitability		Share in the economy's profit	
	1Q07	1Q08	1Q07	1Q08
Industrial production	**14.7**	**14.8**	**59.4**	**56.4**
Mining and quarrying	15.3	19.9	12.9	18.2
Manufacturing	15.1	13.9	38.7	32.7
Electricity, gas and water supply	12.4	10.1	7.8	5.5
For reference: Trade and repairs			19.6	21.5

Source: Rosstat, CSI Bank of Moscow.

Contraction in the economy's profit generated by these industries against the background of growing profit in the trading sector is another sign that the government has effective tools to control inflation. The first is antimonopoly regulation, e.g. control over growth of retail chains and pricing on the non-competitive (by regional sector) market for oil products. It is still unclear what level of authority should track monopolistic trends on the retail markets, let alone the specific procedures to prevent monopolies from developing.

Despite the extremely high level of oil prices on global markets, reform of taxation of the oil extraction industry is not even raised as a point of discussion. At present, the severance tax increases in proportion to growing world prices for Russian oil and is levied on the total amount of extracted oil, including that processed for Russian consumers. Russian consumers continue to be affected by these taxes, and oil companies have a rock solid argument justifying hikes in retail prices for oil products. In such a situation, changes to the severance tax system, such as introducing tax holidays for the development period until certain output levels are reached and increasing the non-taxable Urals output minimum from $9 to $15 per barrel, may bolster investment in oil development and extraction, but will have no visible effect on retail prices for oil products.

The destructive nature of spiraling consumer and producer prices underscores the urgency of mitigating inflationary expectations in the Russian economy. Authorities should take practicable and reasonable steps to cool the overheated market. Until then, both consumers and industrial producers will have no informed ideas about the competitiveness and vector of Russian economic growth.

Industrial production: A new spurt of growth

In April, Russian industrial output grew a record 9.2% y-o-y (+6.2% in the first quarter of 2008) on the back of a steep rise in output of the investment and intermediate demand sectors. This cushioned deceleration in output of the mining and quarrying, electricity, gas and water supply, and final demand sectors.

Industrial production output growth in January-April 2008, % y-o-y

	January-March	April	January-April	*For reference:* 2007
Industrial production	**6.2**	**9.2**	**6.9**	**6.3**
Mining and quarrying	0.7	0.4	0.6	1.9
Manufacturing	8.7	14.5	10.2	9.5
Investment demand sectors	9.2	22.3	12.5	14.2
including:				
manufacture of machinery and equipment	9.3	24.4	13.1	15.3
manufacture of other non-metallic mineral products	8.6	14.6	10.3	10.3
Intermediate demand sectors	8.5	12.5	9.5	4.2
including:				
manufacture of coke, refined petroleum products	5.0	-0.8	3.6	2.9
manufacture of basic metals and fabricated metal products	8.6	13.4	9.8	2.1
other sectors (woodworking, manufacture of chemicals, manufacture of rubber and plastic products)	11.1	18.5	13.2	9.6
Final demand sectors	6.4	5.4	6.1	6.0
including:				
manufacture of food products	6.4	5.5	6.1	6.1
manufacture of textiles and textile products, leather, leather products, shoes	3.3	1.8	3.0	-1.1
manufacture of pulp, paper and paper products; publishing and printing	7.8	6.7	7.5	9.1
Electricity, gas and water supply	5.6	0.2	4.5	-0.2

Source: Rosstat, CSI Bank of Moscow.

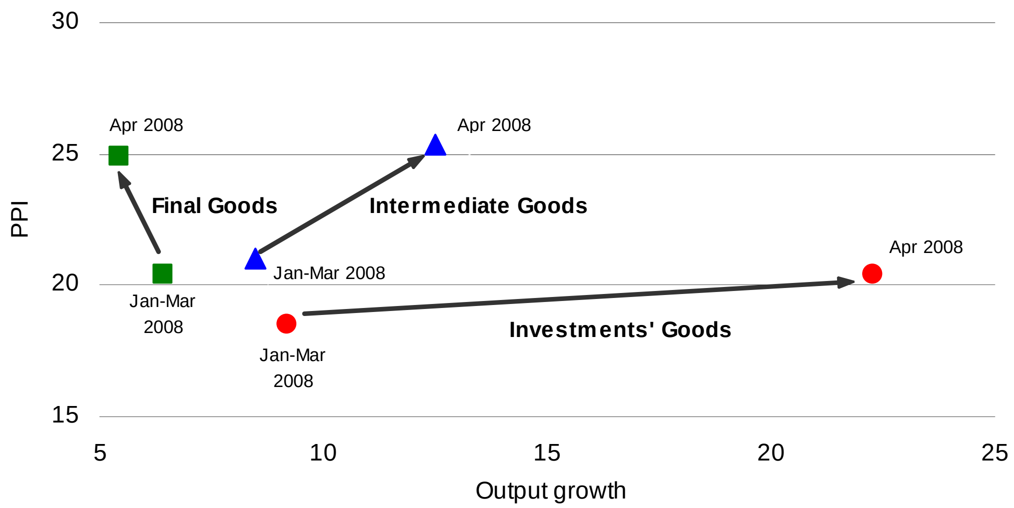
Output growth figures covering Russian industry in January to April 2008 do look impressive. Industrial growth rates increased to 6.9% y-o-y from 6.3% in 2007. The growth structure has also become more balanced. Growth rates switched from near zero to more robust numbers in the electricity, gas and water supply sector (4.5% y-o-y in January to April 2008 from 0.2% in 2007) and intermediate demand sectors (9.5% and 4.2%, respectively). Investment demand sectors demonstrated moderately high growth (12.5% in January to April y-o-y, and 14.2% in 2007). Output in final demand sectors (about 6.0% y-o-y) grew at more modest, but quite acceptable rates. The only negative trend in Russian industry was the near stagnation in the mining and quarrying sector (+0.6% y-o-y in January to April 2008 vs. +1.9% in 2007), but this sector has long been unresponsive to market regulatory tools.

On the whole, growth of Russian industry over the first four months of 2008 was quite impressive. However, a closer look reveals the situation is not so optimistic.

First, the leveling off and acceleration of Russian industrial growth in March-April occurred against the background of rapidly mounting demand for industrial products (and producer price hikes). It remains unclear to what extent this growth will match the competitiveness of manufactured products in the medium term after the overheated demand fades away.

March and April were marked by convincingly high growth rates and balanced structure. The growth trend in the manufacturing sector may significantly undermine industrial output in the future. Growth bounced back in investment demand sectors accompanied by considerable producer prices hikes. Final demand sectors are still testing the patience of consumers following the raising of prices instead of sustainable moderate output growth. Finally, growth in the intermediate demand sectors is accelerating in line with producer prices. This is already being felt, and will continue to have a negative impact on the industry's financial performance.

Growth in output and producer prices in manufacturing industries, January-April 2008, % y-o-y



Source: Rosstat, CSI Bank of Moscow.

Therefore, stable growth of Russian industry and its competitiveness in the medium term (after the period of overheating has passed) will largely depend on successful resolution of the following key tasks: placing a cap on price growth, reversing inflationary expectations, and reducing inflation substantially.

Banking system

In April 2008, growth in banking sector assets decelerated to 1.9%, reaching 37% y-o-y. The slowing of growth compared to previous months affected banks' own and borrowed funds. Borrowed funds increased by 2.0% m-o-m (March – 3.1%, February – 3.2%), and own funds grew by 1.4%, the *lowest level* for the past 12 months.

The key dampener of growth in the banking sector resource base in April 2008 was the noticeable contraction of *corporate* accounts and deposits, while other segments of borrowing expanded rapidly.

Despite accelerated prices (in April inflation ran at 15% y-o-y), household deposits grew 3% in April. Apart from the traditional seasonal inflow of deposits in December, this is the highest growth rate since last summer.

Such robust growth rates were posted despite the rather modest performance of the country's biggest retail bank: deposits at Sberbank grew by only 2.2% over the month. Deposits at other banks grew by 3.8% as a result of a more active interest rate policy.

Corporate accounts dwindled by 6.2%, or almost R350 bln. Substantial tax payments at the end of the month were the main reason for this slump. Corporate term deposits, however, continued to increase despite tax collections, which grew 3.4% m-o-m. The corporate sector has not yet experienced a dearth of funds, and a temporary reduction of settlement accounts will be offset by new revenues of enterprises in the next month, primarily by export earnings.

Against the background of slimmer corporate accounts, the more than 150% growth in budgetary *accounts and deposits* with commercial banks became even more prominent, totaling R210 bln, of which only R40 bln can be attributed to growth in bank accounts of the Ministry of Finance and the Federal Budget, including funds sold at deposit auctions. The remaining part was generated by growing accounts and deposits of federal authorities and local governments. Therefore, local budgets comprised a greater portion of budgetary funds placed with the banking sector.

In these circumstances, lukewarm interest on the part of banks towards budgetary auctions is understandable – credit institutions have already received the necessary state funds, and for a longer period as well. Deposits with terms varying from 91 to 180 days accounted for about 40% of the growth in accounts and deposits of local governments ($70 bln). However, banks affiliated with the state were the main recipients of budget funds. Sberbank and VTB accounted for two-thirds of growth in budgetary accounts (R144 bln of R212 bln rubles).

Major banking liabilities (as at the first day of the month), % of total

	12.05	12.06	03.07	06.07	09.07	12.07	01.08	02.08	03.08	04.08
Liabilities (R bln)	**9696**	**13963**	**15516**	**17113**	**18131**	**20125**	**20146**	**20733**	**21323**	**21725**
Capital	15.4	14.3	15.5	15.9	16.1	15.3	16.2	15.9	15.7	15.7
CBR loans	0.2	0.1	0.1	0.1	0.0	0.2	0.2	1.0	0.7	0.4
Interbank transactions	4.0	3.4	3.3	3.1	2.9	4.1	3.8	4.0	4.3	4.6
Foreign liabilities	13.7	17.1	16.3	17.0	17.6	18.1	18.1	17.8	17.2	17.8
Household deposits	28.9	27.6	26.3	25.9	26.0	26.2	26.0	25.7	25.4	25.7
Corporate deposits	24.4	24.4	25.3	25.1	25.0	25.8	25.5	25.6	26.4	24.3
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	2.6
Issued securities	7.6	7.2	6.4	5.8	5.3	5.8	5.6	5.5	5.5	5.7

Source: CBR, CSI Bank of Moscow.

Despite the reduction in deposits, lending activity in the banking sector persisted in both the retail and corporate sector. In total, the share of loans in banking sector assets jumped to an all-time high of 63%. Credits to the economy were propped up only through a reduction in other assets. In April, banks' foreign assets dropped by about $10 bln, primarily short-term interbank loans with foreign banks. As a result, the banking sector spent almost all of its foreign currency liquidity reserve accumulated over the past two months.

As reserve assets (funds placed with the CBR) are currently at the minimum permissible level, the banking sector liabilities base has no "safety margin" to withstand any serious upheaval. However, the trends in liquidity, interbank market rates and banks' demand for refinancing from the CBR and Federal Budget in May suggest that the resource base is at least not deteriorating.

Major banking assets (as of the first day of the month), % of total

	12.05	12.06	03.07	06.07	09.07	12.07	01.08	02.08	03.08	04.08
Assets (R bln)	**9696**	**13963**	**15516**	**17113**	**18131**	**20125**	**20146**	**20733**	**21323**	**21725**
Cash and precious metals	2.7	2.6	1.8	1.8	1.9	2.5	1.9	1.9	1.9	1.9
Accounts with CBR	7.3	7.5	8.0	10.9	6.1	6.9	5.8	5.1	5.1	4.8
Interbank transactions	6.3	5.8	5.4	5.3	4.7	5.4	5.7	5.9	6.2	6.5
Foreign assets	9.1	9.9	11.5	8.4	10.0	9.8	10.5	11.0	10.9	9.9
Households	12.1	14.7	14.4	14.9	16.0	16.1	16.3	16.3	16.4	16.8
Corporate sector	47.0	45.3	44.8	45.0	47.2	47.2	49.2	48.4	48.8	49.3
Government	6.6	5.2	5.0	4.7	4.1	4.1	4.2	3.9	3.3	3.3
Property	2.4	2.4	2.4	2.3	2.2	2.2	2.2	2.2	2.2	2.2

Source: CBR, CSI Bank of Moscow.

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
Balance of Payments							
Exports, $ bln	244	304	355	510	550	595	645
Imports, $ bln	125	165	223	305	380	465	540
Current account, % GDP	11.1	9.5	6.1	8.2	5.0	2.3	1.0
Net capital inflow/outflow, $ bln	1.9	42	80.7	40	35	40	45
International reserves, year end, $ bln	182	304	476	661	801	896	966
External Debt							
Foreign public debt, % GDP	10.0	5.2	3.5	2.2	1.7	1.3	1.0
Foreign private debt, % GDP	3.9	3.8	3.8	3.8	3.9	4.1	4.2
Exchange Rate							
R/$:							
end of period	28.8	26.3	24.6	23.3	23.6	23.7	23.9
year average	28.3	27.1	25.6	23.5	23.6	23.7	23.8
Exogenous Parameters							
Urals, $ p/bbl	50.4	60.9	69.6	115	121.0	127.0	133.0
$/€	1.25	1.26	1.37	1.56	1.52	1.50	1.48

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

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