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Bank of Moscow

Looking for a new direction

Center of Strategic Investigations

Several months ago, the Russian government's diagnosis was that the economy was overheating. Economic growth was sustained by rising household and corporate income, bank lending and budget spending, and was accompanied by sharp acceleration of inflation and surging imports. The CBR, taking responsibility for addressing the problem of high inflation, began to tighten monetary policy. As a result, the pace of money supply growth plunged to a record low. Interest rates increased by 1.5–2.0%, corporate and consumer loans switched into slower gear, and in time the banking system found itself on the verge of a liquidity crisis. Nevertheless, inflation continues to run high – in August and September, prices were up by 15% y-o-y.

The summer months were marked by a very sharp correction in oil prices, appreciation of the dollar (against both foreign currencies and the ruble), narrowed access by Russian companies to international financing, heightened capital outflow and a falling stock market. All of these events altered the external environment for the Russian economy, and by the beginning of autumn it faced high inflation (with inflationary expectations also remaining high) and declining production growth (with high expectations of a further downturn). Making things worse, September saw the outbreak of a crisis on Russia's financial markets. As things stand today, the key issue is no longer how to cool down the economy, but rather how to prop up economic growth.

In August, the government tabled three medium-term programs – in fact, all of the economic authorities came up with their vision of future economic development. The programs differ in substance according to the agencies that prepared them. The Ministry for Economic Development (MED) insists on expansion of investment and innovation-driven growth. The CBR is for further tightening of monetary policy (within the framework of the Main Monetary Policy Guidelines up to 2011), while the Finance Ministry (Russian Budget Strategy up to 2023) wants to keep unchanged the rates of major taxes while increasing social payments. The only thing these programs have in common is the lack of a uniform policy to support economic growth.

The contradictions of current economic policy are clear – rising interest rates and risks in the banking system make loans less accessible for enterprises and households, not to mention investment and consumption. The government is not expanding investment due to its low return as well as inflationary implications. Paradoxically, despite development of the banking system and financial markets in recent years, the share of borrowed funds in corporate investment structures remained unchanged; 41.5% of fixed capital investment is financed from profits and depreciation, while only 9% is financed from bank loans. As a result of the ongoing crisis, the role of financial markets in economic growth seems unclear. The easing of the corporate tax burden actually solidifies the "status quo" – the financial system is not functioning, forcing producers to finance their fixed capital investment from internal funds.

The direction of growth has been lost against the background of changes in the external environment and domestic policy. Hence, a new course must now be found, one that is based on balanced economic growth rather than the contradictions of government economic agencies.

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Current trends in the monetary sector

Expected impact of a tougher monetary stance

The Russian economy was considered to be overheating in late 2007–early 2008, when GDP grew quickly in parallel with rapidly accelerating inflation. Growth in the money supply, banking assets and corporate and consumer loans exceeded the pace of growth in nominal GDP, which led to substantial imbalances throughout the economy. In the real sector, manufacturing suffered from sinking profitability, whereas trading enterprises boasted healthy profits. Loans to the non-financial sector boosted consumption supported by imports, while the "quality" of banking loans was deteriorating. In addition, the financial sector was traditionally sensitive to inflows/outflows of foreign capital.

In this context, the CBR took responsibility for the pick-up of inflation and launched an initiative to combat spiralling prices. The consequences of the CBR's determination to tighten monetary policy were the following:

– increased mandatory reserve deposits and interest rates throughout the economy;

– decelerated growth in key monetary aggregates (due to surging inflation, rather than monetary policy measures);

– transition from ruble fixing to a bi-currency basket (aimed at restricting short-term speculative capital transactions).

In summer 2007, for the first time since the 2004 banking crisis, the CBR raised requirements for mandatory reserve deposits in response to the sharp increase in foreign capital outflows. Between October 2007 and January 2008, the mandatory reserve requirement was lowered by 1 percentage point to ease the liquidity crunch caused by the expanding global credit crisis. But in January 2008, mandatory reserve requirements were restored to their former level, and the CBR then raised them on three subsequent occasions. Overall, in January–July 2008, the reserve deposit fund grew by R165 billion, of which less than R70 billion was accounted for by the growing resource base of banks, and almost R100 billion was generated as a result of broadened mandatory reserve requirements[1].

Furthermore, the refinancing (discount) rate and rates on major monetary regulation instruments (REPO and deposit transactions, etc) have been raised four times this year. During this period, the overall increase in *regulated interest rates* was 1 percentage point. If in prior years such growth could be viewed as traditionally following market trends, the situation is cardinally different today. Apparently, the widening volumes of CBR operations aimed at providing liquidity to the banking system strengthen the effect of the refinancing rate on the general level of interest rates in the economy. Interest rates for available funds of federal and regional budgets as well as state corporations were also pushed up. Therefore, the cost of public funds for banks grew by 1.0–1.5 percentage points, making banking system liabilities much more expensive.

Growth in the money supply as measured by M2 noticeably slowed by the end of the summer, affected not so much by monetary policy measures, but instead by spiralling inflation. Annual growth rates of the two core money supply components most sensitive to price growth – cash and ruble-denominated household deposits – sank in July by 10–15 percentage points y-o-y compared to autumn 2007.

The crucial effect of money supply deceleration was a narrowed resource base among banks. If household ruble deposits had grown at the pace registered a year ago (17.3% instead of 13.3%), the banking sector would have received an additional R375 billion. On a yearly basis, we estimate the volume of underplaced household deposits at R440 billion

[1] On September 18, the CBR trimmed mandatory reserve requirements by 4 percentage points. We estimate the effect of this measure at R250-270 billion.

(41.5% growth as in 2007, instead of the current 31.9% y-o-y). Hence, escalating inflation will rob the banking system of more than $17 billion, which is comparable to the estimated net inflow of foreign capital to the banking system in the current year (a subsiding inflow of foreign capital is seen as a key aspect of financial instability). This was a natural outcome, as real interest rates on deposits (inflation-adjusted) dropped by more than 5 percentage points compared to last year's level.

An additional change in CBR policy in recent months was the refusal to fix the ruble against the bi-currency basket. The CBR depreciated the ruble by nearly 4% (between early August and the first ten days of September). The ruble weakened even more against the dollar – by 8.6% y-o-y, or more than 11% from the mid-July low. This trend was triggered by the downturn in oil prices (the monthly average price of Urals in August was 15% below the July level) as well as the capital outflow.

So far, depreciation of the ruble has had no inflationary effect – import prices were growing in tandem with other prices, while the exchange rate remained stable. Moreover, during the crisis on financial markets, the possibility of ruble devaluation was not even raised as an issue, ruled out by the magnitude of CBR reserves and the trade surplus. Fluctuations of the ruble exchange rate managed by the CBR lessen the attractiveness of arbitrage transactions and reduce the flow of speculative capital, thereby enhancing overall stability. It is reasonable to expect an upswing in household deposits denominated in foreign currency, which will curtail consumption and broaden the resource base of the banking system.

The current crisis broke out suddenly on Russia's financial markets. A "crisis of confidence" and market "hysteria" were cited as the main reasons behind the event. However, the underlying causes seem to have deeper roots, and had been taking shape over the past 12 months. First, risk management and lending strategies at a number of banks focused on borrowing from external markets and funnelling the money as loans to the non-banking sector. Second, the crisis on global markets cut off most Russian banks from external finance. Finally, the tightened monetary policy exacerbated by the above factors pushed up interest rates and sent banking liquidity down to dangerous levels. The response from the monetary authorities was swift and aimed at relaxing monetary policy – mandatory reserve requirements were cut significantly, and sizeable budget funds were channelled to the banking sector.

Medium-term monetary policy now takes on special significance for liquidating the crisis, stabilizing the financial system and sustaining economic growth. Now, against this background, it is an open question as to whether the package of measures will have its intended effect, or have to be radically revised.

Medium-term monetary policy (until 2011)

CBR plans to drastically contract banking liquidity

In late summer, the CBR tabled its medium-term monetary policy up to 2011. ("Main Guidelines of Uniform State Monetary Policy for 2009, 2010 and 2011"). Today, the role of the financial sector in economic growth has become much more prominent. In particular, the rapid pace of bank lending to the non-financial sector bolsters the expansion of domestic demand (accounting for 30% of its growth in 2007). The share of bank loans in the total volume of capital investment widened to 9%. Concurrently, private foreign debt is piling up significantly, changing the structure of the balance of payments for the current period as well as the medium-term.

However, as occurred a year ago, the underlying parameters (which are somewhat independent from the CBR) were combined in the MED's medium-term forecast as a basis for calculating monetary policy indicators. The basic external parameters determining the substance of various economic development scenarios are the price of oil (as well as other energy-producing materials) and foreign capital inflows. The monetary program's targets simply follow the scenario-based variables, but offer no optimal adaptation of economic and monetary policy to possible external upheaval. It seems that the main guidelines of monetary policy should be formed so as to take into account possible changes in the external environment. However, the active use of monetary regulation instruments should be attuned to the pursued economic policy with due consideration for structural problems and constraints inherent to Russia's financial sector.

An analysis of the draft medium-term monetary policy indicates the following:

1. In the medium term, the CBR will stay committed to a tough monetary stance. The options vary depending on oil price movements, and the effect of the money supply and banking system on the real sector of the economy is not estimated.

2. In all economic development options suggested by the CBR, the banking sector will experience a serious liquidity crunch starting from 2009. The volumes of liquid assets projected by the CBR are far below those required by today's banking system.

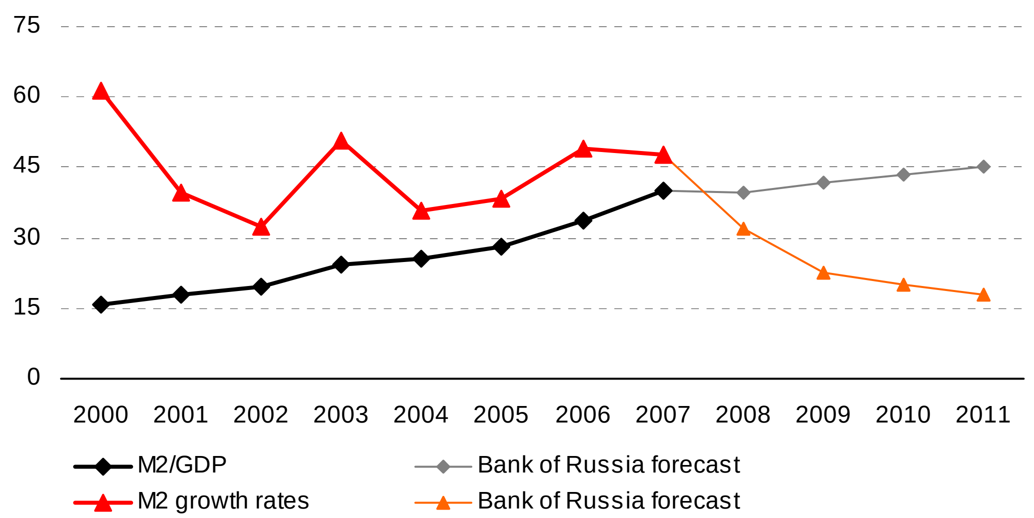
3. Regardless of the external economic backdrop, monetary authorities will have to seek substantial volumes of financing to buoy the banking sector. Under the favorable scenario, the refinancing level will be comparable to the collateral base value, and under the unfavorable scenario, the refinancing level will exceed all available financial instruments.

4. Under the planned budget policy, support for even moderate growth of bank lending in the forecast external environment will be accompanied by a deficit of financial resources in the amount of R1.5 trillion.

Key trend – declining banking sector liquidity

The CBR plans to put the brakes on money supply growth – even under the favorable scenario (oil prices hovering at $115–130/bbl), growth in the M2 monetary aggregate will not exceed 28% per year. In fact, this implies that the process of monetizing the economy, which has occurred throughout the entire post-crisis period, will be halted, and nominal GDP (as well as gross production output) will grow at a respective pace. Depending on the scenario, monetization (the M2 to GDP ratio) will reach only 44–47% (vs. 40.2% in late 2007). By internal measures, this is still a low level, and by comparison other emerging markets are more saturated with money resources. For example, in 2006, GDP monetization (M2) reached 50% in Hungary, 54% in Mexico, 55% in Slovakia and 62% in the Czech Republic.

Monetization of economy (M2/GDP), %



Source: CBR, CSI Bank of Moscow.

The projected money supply growth will be linked to commodity supply growth, encouraging expectations of declining inflation (or its monetary component). However, the question of the driving force behind economic growth becomes critical – there will be no accelerated bank lending spurring investment and consumption. Moreover, this will imply deceleration of growth in bank accounts and deposits of the non-banking sector, which will contribute to a continued deficit of domestic savings.

The CBR's monetary policy was more liberal than planned…

	2004	2005	2006	2007
CBR M2 growth target, %*	19–25	20–32	36–39	37–39
Actual M2 growth %	35.8	38.5	48.8	47.5

* Key Guidelines of Uniform State Monetary Policy for 2008.
Source: CBR, CSI Bank of Moscow.

It is notable that the CBR's estimates have regularly appeared far lower than the actual money supply growth (see above Table). Hopefully, the current monetary policy will be more stimulating, which is already apparent in the CBR's steps during the crisis on financial markets. However, the current CBR projections provide for reduction in banks' liquid assets[2] compared to late 2007. If at the beginning of 2008 their volume was R1,173 billon, at the start of 2009 the CBR plans a contraction to R942 billion, and by the end of 2011 – to R671–808 billion, depending on the forecast.

Money Supply Indicators until 2011, %

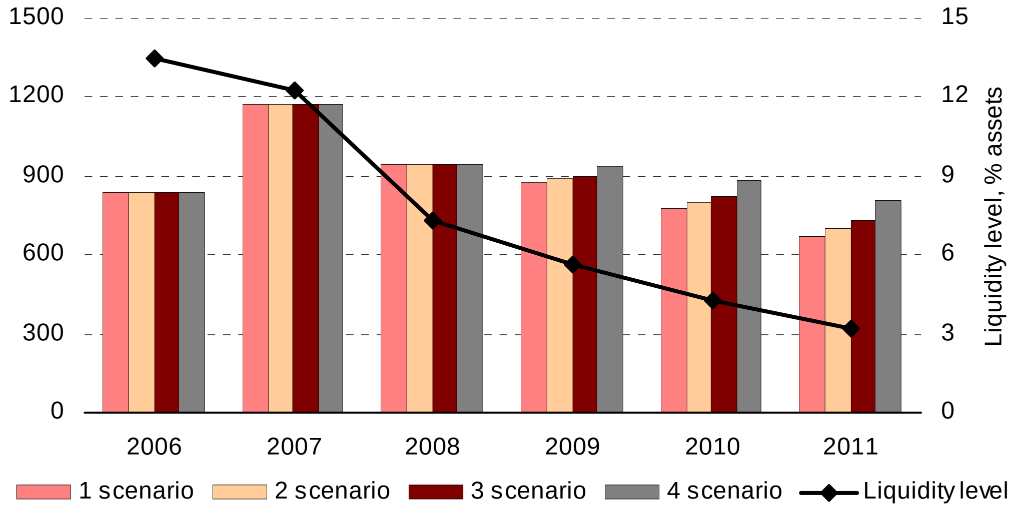
	2008	2009	2010	2011
M2 growth rate	32	19–28	16–25	14–22
Narrow monetary base growth	26	17–26	12–20	9–17
Broad monetary base growth	18	13–22	9–17	7–15

Source: CBR.

The overshoot in money supply growth versus that of the monetary base increases the money multiplier (money supply to monetary base ratio) from 2.4 as of January 1, 2008 to 2.7 as of January 1, 2009 and further to 3.3 by the end of 2011. Its growth depends directly on banks' ability to transform their liabilities into loans to the non-banking sector of the economy and *assume liquidity risks* arising from the mismatch in maturities of assets and liabilities. However, the other side of this process is the melting of liquidity in the banking sector. In the CBR's projections, the ratio of liquid assets to ruble accounts and deposits is rapidly decreasing. In 2007 the figure was 12.3%, and by the end of 2008 and 2011 it is expected to fall to 7.3% and 3.1%, respectively. It is important to note that in the medium term monetary program, the money multiplier and level of liquidity in the banking sector do not depend on the type of scenario!

[2] Liquid assets should be understood as total correspondent account and deposit balances with the CBR and investment in CBR bonds. Banks' cash on hand and the cash structure are not considered.

**Banking Liquid Assets by Monetary Program (R bln)
and Banking System Liquidity (%)**



Source: CBR, CSI Bank of Moscow

Such a low ratio of liquid assets and liabilities can be afforded by only the largest state-owned banks, which, due to the scale of their operations and high client confidence, can divert the minimum volume of resources into liquid assets. Only Sberbank can afford a decrease in liquid assets below 1% of total liabilities. For other major banks, including subsidiary banks, the liquidity level ranges between 5–10%, and for small and medium-sized banks the recommended ratio should be above 15%. In a crisis-free environment with continued operations of the banking sector, such a low liquidity target is possible only in conditions of nationalization of almost the entire banking system, with the concurrent closure of medium-sized and small banks.

The high level of the banking system's liquidity is actually the "price" for the existence of more than a thousand small and medium-sized banks. The liquidity level in relative terms should decline with the shrinking number of small-sized banks. However, even if this level by 2011 will be half that seen in 2006 (7.2% vs. 13.5%), the liquidity crunch in the banking sector under the CBR scenarios, according to our estimates, will be R480 billion in 2008 and R850–1,100 billion in 2011.

Ill-developed financial markets aggravate the collateral issue

Traditionally, in the post-crisis period the CBR took the course of sterilizing excessive banking liquidity instead of refinancing – net borrowing of banks' funds by the CBR approached R1,123 billion[3] or 6% of total assets in 2007. The same level was registered in 2005–2006. The global financial crisis and downturn in oil prices change the trend considerably, and this has already been seen in 2008. The CBR intends to step up refinancing of the domestic banking sector. According to CBR estimates, loans to banks will reach R262 bln as of January 1, 2009. This is a very high level for the end of the year, when banks normally have no liquidity problems. For example, the maximum amount of funds provided by the CBR for the past 18 months (until September 2008) reached R325 billion in November 2007, but last year the volume of refinancing did not exceed R50 billion.

Furthermore, according to CBR estimates, the banking sector will experience a great need for refinancing. Even under the most favorable scenario (Urals oil price at $122/bbl in 2011), the volume of loans issued by the CBR to the banking system is estimated at R1.6 trillion by the end of 2011. In all other scenarios, the refinancing volumes by 2011 will exceed R4.5 trillion, and under the gloomiest forecast (oil price plunge to $60/bbl) the CBR plans to raise gross lending to banks to a level of R6.3 trillion.

[3] Net of mandatory reserve deposits and banks' cash on hand in rubles.

The refinancing of banks by the CBR will be limited by the volume of the available collateral base in banks' assets. By different estimates, the current level is about R1.5 trillion, including R0.5 trillion in RF bonds. By 2011, the collateral base may expand to R2.0–2.2 trillion, net of the debt obligations of the Russian government. Including RF bonds, the total collateral base may reach R3–3.5 trillion. *Therefore, the deficit of collateral instruments to secure the refinancing volumes projected in the monetary program may approach R3.5 trillion*. The ill-developed financial markets may pose a problem already in the near future. The inclusion of non-market assets into the collateral base for refinancing purposes will undermine the viability of the financial system and risk control (otherwise, the CBR will have to assess the risks and cost of non-market assets).

Insufficient resources to support lending activity

A decline in oil prices in the medium term (and the events of the past two months suggest the high probability of a downtrend) highlights the question of how to expand the money supply. Over the past eight years, money supply growth was nurtured by rising net foreign assets (international reserves), whereas net domestic credit was used as a sterilization tool and the volume of lending to the banking system was close to zero. Over the next three years, growth in CBR reserves will not be able to boost the money supply, even under the brightest scenario, while demand for money in the economy will be satisfied through budget funds and refinancing of the banking system.

However, the ability of the federal budget and the CBR to provide funds to the banking system is limited both by the budget plan and the collateral base. By our estimates, *all available resources* of the monetary authorities that *potentially* can be channelled into the financial system during 2008–2011 stand at R6.0–6.2 trillion. These funds come from the following sources:

1) According to the draft budget, domestic government debt at the end of 2011 will reach R3.6 trillion. About 40% of government securities are placed outside of the CBR and the banking sector, their holders being the RF Pension Fund and other institutional investors. Therefore, only about R1.9 trillion will be available to form the money supply during 2008–2011, provided that the non-banking sector retains its share of the government debt market and banks use their entire portfolio to obtain refinancing or else sell it to the CBR.

2) The funds from budgets at all levels held with the CBR as of January 1, 2008 amounted to R1.8 trillion (net of R3.8 trillion parked in the Stabilization Fund). Of this amount, R0.5 trillion represents the accounts of local budgets and non-budgetary funds. Federal budget accounts total R1.3 trillion. In the current year, based on the monetary program's projections, the CBR expects federal budget funds to grow by at least R3.1 trillion, of which R2.3 trillion should be transferred to the Reserve Fund and the National Wellbeing Fund. Therefore, other balances on federal government accounts may rise by R0.8 trillion to R2.1 trillion as of January 1, 2009.

According to the draft budget for 2009–2011, allocations to the Reserve Fund and the National Wellbeing Fund are planned at R6.2 trillion, while an increase in other federal budget accounts is not projected. Therefore, the total volume of federal budget resources not tied up in reserve funds that may be placed in the economy until 2011 stands at R2.1 trillion.

3) The refinancing of banks by the CBR will be constrained by the level of available collateral in banks' assets. By different estimates, its current volume is about R1.0 trillion (net of RF bonds). Under the most optimistic forecast, the collateral base may double in volume by 2011 to R2.0–2.2 trillion, net of RF debt obligations.

Therefore, the maximum level of money supply expansion during 2008–2011 (net of transactions with reserve assets and the increase in reserve funds) stands at R6.0–6.2 trillion (provided all budget account balances are made available to the banking system and banks use all available types of collateral for refinancing). Depending on the scenario, the CBR estimates money supply growth (broad monetary base) in the same period at a level of R3.1–5.1 trillion. These numbers look quite substantial considering the above conditions for maximum level assessment. The medium-term monetary program, however, provides for tight monetary policy. By our estimates, the money supply should broaden by R5.0–6.9 trillion to ensure growth in monetization of the Russian economy to at least 50% while sustaining banking system liquidity at a level of at least 7% by 2011. We estimate the deficit of monetary resources at R1–1.5 trillion.

Money emission and its factors in 2008–2011, R trillion

	Forecast emission volume (3rd CBR forecasts, 2nd MED projection and the draft budget)	Required money emission minimum (CSI Bank of Moscow estimates)
Growth in broad monetary base	**3.9**	**6.0**
including:		
Increase/decrease in international reserves	7.3	7.3
Growth in the Reserve Fund and the National Wellbeing Fund (including placement income)	-9.0	-9.0
Other factors	5.7	7.7
Government debt transactions	1.9	1.9
Refinancing of banks	2.2	2.2
Decrease in Federal Treasury and other budget accounts	1.8	2.1
Deficit (+) / surplus (-) of money supply sources	*-0.5*	*+1.5*

Source: CBR, CSI Bank of Moscow.

Seemingly, the medium-term monetary program should reflect the Russian monetary authorities' vision of the banking system and financial markets development as well as their contribution to and impact on economic growth. Moreover, monetary policy principles and BOP targets require projections of capital inflow/outflow, external debt status (including private debt), debt service possibilities and related risks. Actually, the monetary program covers key issues related to the stability of the ruble and the assessment of investment financing sources. In this context, the monetary program should not be a nominal package of anti-inflationary measures, but instead should be seen as an action plan for facilitating economic growth and supporting the competitiveness of national producers.

Real sector

Turning point

The rapid and industry-wide growth in industrial output at the start of the year (in January–May industrial output growth in Russia was close to 7% y-o-y) nearly came to a halt in June–July at a level of 2% (below the 1% y-o-y in June and 3.2% y-o-y in July).

Industrial Production Output Growth IN 2008, % y-o-y

	January-May	June-July	January-July
Industrial production, total	**6.9**	**1.8**	**5.4**
Mining and quarrying	0.5	-0.5	0.2
Manufacturing	10.2	2.6	7.8
Electricity, gas and water supply	4.1	4.6	4.2

Source: Russian Statistics Service, CSI Bank of Moscow.

Over the past five and a half years, such a sharp deceleration of output was seen only twice. In early 2006, a steep production slump was triggered by extremely low temperatures and restricted power supply to a number of enterprises. In August–September 2007, the rebound of inflation interfered with the plans of both consumers and industrial producers. With the exception of these two dramatic declines, however, Russian industry moved resolutely forward at a pace of 5–10% y-o-y.

Noting the strong and industry-wide output growth during the previous months accompanied by mounting producer prices in all sectors of industrial production, the monetary authorities diagnosed the economy as overheated and introduced a number of tough monetary regulations to induce a cool-down. Today, the precipitous fall in industrial growth raises questions about the wisdom of these monetary measures as well as the prospects for industrial growth.

Official data on industrial production in June-July prevent us from *accurately estimating* the extent of deceleration or output slump by economic activity. It is highly probable that in the coming month or two they will change substantially. Therefore, at this point of time, we can only provide a *qualitative assessment* of the new phase in growth of Russian industry.

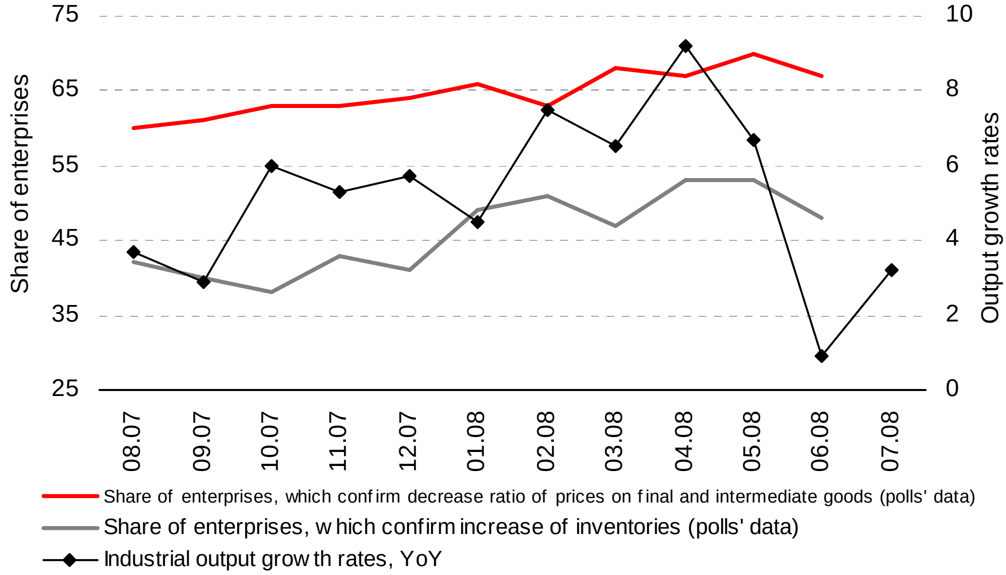
First. Industrial production growth in June-July slowed noticeably compared to the prior period. However, it may be that the downturn is not as *dramatic* as official data seem to indicate.

According to official numbers, this slowdown was dramatic and sweeping in scope. However, the quality of this data prevents us from making a qualitative analysis and identifying the industrial sectors that underwent such a steep fall in output. In our opinion, the industry-wide deceleration prompts the conclusion that industrial growth in spring 2008 was somewhat overstated, and that the severe plunge was partly due to the effect of statistic correction. Moreover, it is possible that despite the gloomy forecasts for output growth in August made by management of Russian industrial enterprises, the official numbers for that month will turn out to be better than in June-July and cushion the statistical collapse.

Second. Industrial output grew faster than demand in January-May. Therefore, the growth slowdown in June-July can be viewed as *a natural correction of the growth strategy.*

Fuelled by heightened expectations of both demand growth and volumes, industrial output grew even faster. According to REB, in January–May 2008 over half of the polled CEOs of industrial enterprises confirmed an increase in finished goods inventory (compared to less than 44% a year ago). Hence, this situation might have dented confidence that there was potent demand for manufactured products within the established price niches, and production plans were corrected accordingly.

Industrial Output Growth, Finished Goods Inventory and Prices, in Relative Terms



Source: Russian Statistics Service, REB, CSI Bank of Moscow.

Third. One of the dampeners of the rapidly rising industrial output may have been *worsening financial performance.*

High industrial growth rates in January-May were accompanied by a worsening ratio of prices for crude, materials and spare parts to prices of manufactured goods. The costs incurred by enterprises outperformed the prices for manufactured goods. Hence, despite accelerating producer prices, the profitability of most enterprises has dropped.

Overall, in January-May 2008, the profitability of industrial production increased versus last year (by 16.0% and 15.3%, respectively). Profitability grew in those sectors that deal with energy-producing materials – mining and quarrying of energy-producing materials, manufacture of coke, refined petroleum products, manufacture of chemicals and mining of metallic ores. In all other sectors, profitability shrank substantially.

Fourth. Trading companies and not industrial enterprises benefited the most from surging industrial output and industrial producer prices.

The seeming paradox of rapidly escalating producer prices and sinking profitability explains the substantial increase in profits of trading companies. In January–May, their profits jumped by 88% y-o-y (in industry – 36%). Now the share of trading companies in the Russian economy's profit is 23% (versus 16.5% a year ago).

Therefore, the trading sector was the main beneficiary of industrial output growth in conditions of an overheated Russian market: winners were both those who worked on the retail market warmed up by inflationary expectations, as well as those engaged in wholesale deliveries to industrial enterprises. At the same time, the overwhelming majority of manufacturing sectors on the eve of the slowdown in June-July were in worse financial condition than a year ago.

Corporate Financial Performance in January-May 2008

	Profitability *,%		Share in corporate financial performance, %	
	January-May 2007	January-May 2008	January-May 2007	January-May 2008
Industrial production, total	**15.3**	**16.0**	**59.8**	**60.3**
Mining and quarrying of energy-producing materials and chemical sector	*21.2*	*26.1*	*25.4*	*34.3*
mining and quarrying of energy-producing materials	17.3	20.7	13.1	16.9
manufacture of coke, refined petroleum products	38.5	43.9	9.7	12.8
manufacture of chemicals	13.4	22.2	2.6	4.6
Metals sector	*27.6*	*23.6*	*19.4*	*14.0*
manufacture of basic metals and fabricated metal products	26.6	21.2	17.2	11.4
mining of metallic ores	38.0	48.6	2.2	2.6
Other intermediate demand sectors	*3.5*	*2.4*	*0.4*	*0.2*
woodworking and manufacture of timber products	3.6	1.1	0.2	0.0
manufacture of rubber and plastic products	3.4	3.3	0.2	0.2
Investment demand sectors	*7.7*	*7.0*	*5.5*	*4.7*
manufacture of machinery and equipment	5.1	4.4	2.7	2.2
manufacture of building materials	15.3	13.4	2.8	2.6
other mining and quarrying	18.6	16.0	0.7	0.6
manufacture of other non-metallic mineral products	14.4	12.8	2.1	2.0
Final demand sectors	*5.5*	*4.8*	*3.0*	*2.5*
manufacture of food products	5.6	5.2	2.3	2.1
manufacture of textiles and textile products, leather, leather products, shoes	1.8	0.7	0.1	0.0
manufacture of pulp, paper and paper products; publishing and printing	6.5	4.6	0.6	0.4
Electricity, gas and water supply	*9.9*	*8.0*	*5.2*	*3.7*
Other sectors	*8.0*	*8.9*	*1.0*	*0.9*
Construction and real estate			**4.8**	**7.4**
Transport and communications			**14.7**	**11.7**
Trade			**16.5**	**23.0**

* Profitability – ratio of corporate financial result to the cost of goods shipped, %.
Source: Russian Statistics Service, CSI Bank of Moscow.

In a nutshell, industrial output in January–May 2008 was not only surging in an overheated market – it actually overshot the demand. Trading companies capitalized most on the price escalation and soaring output. It may be that on the wave of mounting demand, industry was set to earn profits not on markups, but on sales volumes. In other words, it was prepared to slightly trim its profits, also on the back of faster growth in prices for purchased goods, in order to boost output. However, the scale of suppliers' markups not only pulled down the profitability of industrial production, it also propelled manufactured products to an excessively high price niche as a result of a forced increase in ex-works prices, thereby dampening their competitiveness. Mounting inventories of manufactured and unsold goods, on the one hand, alongside a noticeable deterioration of financial performance, on the other, may be a good argument for revisiting production plans. From this standpoint, the deceleration of industrial output in June–July may be interpreted either as a temporary decline in output to pare finished goods inventory (followed by the resumption of growth) or transition from the euphoric confidence in unfailing demand for produced goods to a more sober assessment of their competitive strengths. We thus may see industrial growth rebound in the coming months, but the upturn will be more moderate than in January–May 2008.

In our opinion, most Russian industrial enterprises have reached a *turning point* where one of two strategies must be selected. Their choice will, to a considerable extent, determine the competitiveness of Russian industry in the medium-term at a minimum. Alongside the temptation to continue with ambitious output growth plans (*first strategy*) as opposed to slower growth, production modernization and transition to stable but more modest growth rates (*second strategy*), the high price backdrop is still in place alongside shrunken volumes of available internal resources to finance current production and investment activities.

The numbers for June–July point to the ongoing acceleration of producer prices – overall, producer prices outperformed last year's level by 30.8%, leaping 10.6% over the two-month period. The net effect of rising world prices was a very high rate of price growth in Russia as well.

Industrial Producer Price Growth, y-o-y, %

	Year-on-year average		For the period
	January-May 2008	June-July 2008	January-May 2008
Industrial production, total	**26.7**	**30.8**	**10.6**
Mining and quarrying	44.6	44.0	23.5
Manufacturing	22.2	28.7	7.1
Final demand	23.8	26.6	2.3
Investment demand	17.6	19.2	3.3
Intermediate demand	24.5	37.3	13.3
Electricity, gas and water supply	16.0	15.5	0.8

Note. Final demand sectors: manufacture of food products, manufacture of textiles and textile products, leather, leather products, shoes, manufacture of pulp, paper and paper products; publishing and printing.
Investment demand sectors: manufacture of other non-metallic mineral products, manufacture of machinery and equipment.
Intermediate demand sectors: woodworking and manufacture of timber products, manufacture of coke, refined petroleum products manufacture of chemicals, manufacture of rubber and plastic products, manufacture of basic metals and fabricated metal products.
Source: Russian Statistics Service, CSI Bank of Moscow.

Worsened financial performance in industry suggests a deficit of resources to finance current production and investment activities as well as the curtailed possibility to utilize bank loans. That situation increasingly reduces companies' opportunities to modernize production and make the transition to manufacturing new products with higher competitive potential.

The main *barriers to the first strategy* (temporary growth downturn, decline in finished goods inventory and growth resumption) are the methods used by the monetary authorities to cool the overheated economy and the tariff-setting policy for electricity, gas and railways: these measures contain demand growth and force the abandonment of production that is becoming obsolete.

Tight monetary policy aiming at curbing inflation and cooling the overheated economy exacerbated by the effect of external factors actually blocks the second strategy (production modernization and slower but more stable growth rates). Today, such issues as investment financing, a sustainable and favorable investment climate, the fostering of competition on commodity markets, and efficient anti-monopoly legislation seem an increasingly remote prospect.

Banking system

Lending slowdown is inevitable

July brought the worst news from the banking system, save for the seasonal downturn in January. Banking assets edged up by just 1.0% over the month and annual growth rates declined to 33.9%. In January–July, growth in the banking sector (15.7%) was the slowest since 2004 (11.1%). This can be viewed as an indicator of the condition of the banking sector and liquidity, as the Stabilization Fund – a powerful instrument of liquidity sterilization – was introduced that year.

Decelerating growth in banking assets in 2008 was triggered by the downtrend in borrowed and own funds. At the same time, last year saw record growth in banking sector capital, and in many respects the decline in banks' own funds can be attributed to the base effect. During the first seven months of 2008, the growth rates of banking sector capital were comparable to the similar period in 2006 and were noticeably higher compared to 2004–2005.

Borrowing had a major negative effect on the movement of banking assets. Practically all types of banking sector borrowing grew at a slower pace than a year ago, and growth in certain segments (household and corporate accounts) from the start of the year was even slower than in 2004. For the first seven months of 2008, household accounts and deposits rose by 13.3% (vs. 17.3% in 2007 and 15.8% in 2004), while corporate accounts and deposits rose by 7.7% (vs. 24.8% in 2007 and 13.1% in 2004).

Households slashed their savings, discouraged by accelerating inflation and high inflationary expectations. Escalating growth in foreign currency deposits did not change the situation in general, though the slowdown in growth of household deposits was not as dramatic as the slump in their ruble-denominated component. In any case, one thing is absolutely clear: this segment of the banking system is facing a medium-term downtrend.

Major Banking Liabilities (end of month) % of total

	12.05	12.06	03.07	06.07	09.07	12.07	03.08	04.08	05.08	06.08	07.08
Liabilities (R bln)	**9696**	**13963**	**15516**	**17113**	**18131**	**20125**	**21323**	**21725**	**22433**	**23059**	**23282**
Capital	15.4	14.3	15.5	15.9	16.1	15.3	15.7	15.7	15.6	15.3	15.4
CBR loans	0.2	0.1	0.1	0.1	0.0	0.2	0.7	0.4	0.2	0.2	0.3
Interbank transactions	4.0	3.4	3.3	3.1	2.9	4.1	4.3	4.6	4.3	4.1	4.3
Foreign liabilities	13.7	17.1	16.3	17.0	17.6	18.1	17.2	17.8	18.0	18.3	19.1
Household deposits	28.9	27.6	26.3	25.9	26.0	26.2	25.4	25.7	25.7	25.5	25.6
Corporate deposits	24.4	24.4	25.3	25.6	24.9	25.8	26.2	24.1	24.6	25.5	24.0
Accounts and deposits of federal state authorities and local governments	2.0	2.2	2.6	2.4	2.6	1.5	1.7	2.6	2.8	2.5	3.0
Issued securities	7.6	7.2	6.4	5.8	5.3	5.8	5.5	5.7	5.7	5.7	5.5

Source: CBR, CSI Bank of Moscow.

Compared to retail business, the slowdown of corporate accounts growth was even more prominent. At the same time, we cannot be certain that this trend will persist. First, corporate account balances surged last summer due to the borrowing activity of corporate customers on international markets and auctions in connection with Yukos assets. Second, with the transition to a new schedule of tax payments in July, banks saw an exodus of funds from corporate accounts. These circumstances distort the general trend of corporate accounts held with banks. In our opinion, development of this segment of the banking system resource base can be viewed as stable.

Major Banking Assets (end of month), % of total

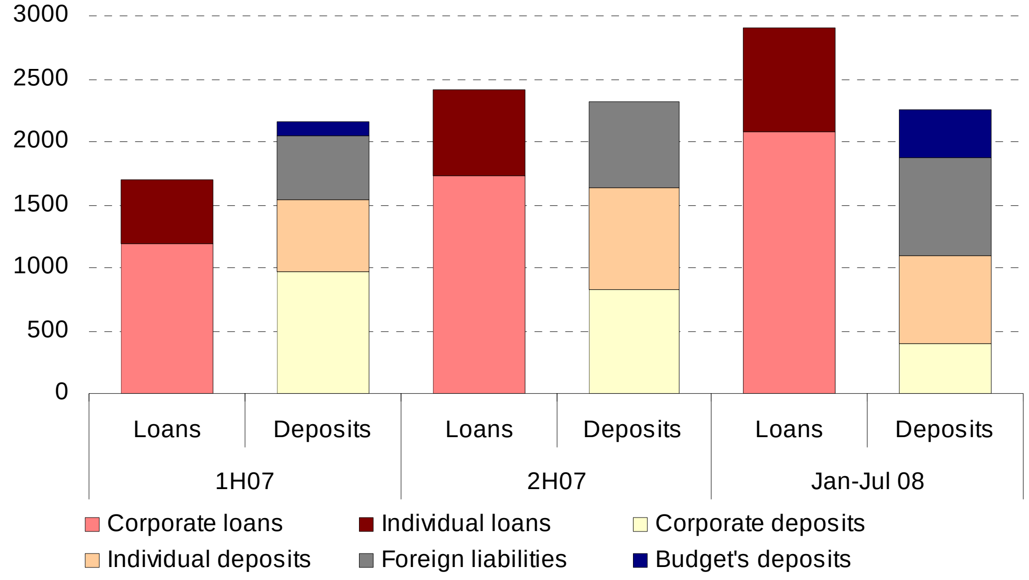
	12.05	12.06	03.07	06.07	09.07	12.07	03.08	04.08	05.08	06.08	07.08
Assets (R bln)	**9696**	**13963**	**15516**	**17113**	**18131**	**20125**	**21323**	**21725**	**22433**	**23059**	**23282**
Cash and precious metals	2.7	2.6	1.8	1.8	1.9	2.5	1.9	1.9	1.9	2.0	1.9
Accounts with CBR	7.3	7.5	8.0	10.9	6.1	6.9	5.1	4.8	5.1	5.8	4.9
Interbank transactions	6.3	5.8	5.4	5.3	4.7	5.4	6.2	6.5	5.9	5.9	6.2
Foreign assets	9.1	9.9	11.5	8.4	10.0	9.8	10.8	9.9	10.6	9.9	9.5
Households	12.1	14.7	14.4	14.9	16.0	16.1	16.4	16.8	16.8	17.0	17.5
Corporate sector	47.0	45.3	44.8	45.0	47.2	47.2	48.8	49.3	49.0	49.1	49.7
Government	6.6	5.2	5.0	4.7	4.1	4.1	3.3	3.3	3.4	3.4	3.2
Property	2.4	2.4	2.4	2.3	2.2	2.2	2.2	2.2	2.1	2.1	2.1

Source: CBR, CSI Bank of Moscow.

Faltering growth in the banking system loan portfolio became clear over the past three months. From last autumn through the end of April, the annual growth in total consumer and corporate loans ranged from 53–55%. By late July, however, loan growth declined from 54.6% to 49.1% y-o-y: growth in the retail segment dropped from 55.9% to 52.0%, and in the corporate segment from 54.1% to 48.0%. The deficit of resources to sustain the former pace looms larger now.

Over the first seven months of 2008, bank loans to legal entities and individuals increased by R2.9 trillion. Household and corporate account balances (including deposits) grew a modest R1.1 trillion. Therefore, the deficit of internal resources over this period reached R1.8 trillion. By comparison, last year this deficit was R0.9 trillion, or half the level of this year (total loan growth of R4.1 trillion versus an increase in domestic deposits of R3.2 trillion).

Growth in Banking Loans and Resources by Major Category (R bln)



Source: CBR, CSI Bank of Moscow.

In 2007 the deficit was funded by external borrowing. Foreign liabilities of the banking sector last year reached almost R1.2 trillion. During the first seven months of 2008, growth in foreign liabilities was less than R0.8 trillion and can compensate for less than half of the domestic funds deficit. State support for the banking sector in the form of additional infusions of budget funds to commercial banks is apparently insufficient to sustain the earlier achieved growth of the loan market.

Continuing deceleration of growth in bank lending seems inevitable. The trend may be reversed only by radical changes in state policy with respect to the banking sector and a large-scale inflow of foreign capital.

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	42.6	50.2	59.1	69.5
$ bln	764	992	1 289	1 746	1 894	2 111	2 356
Real GDP, % y/y	6.4	7.4	8.1	7.1	6.4	6.7	7.2
Industrial production, % y/y	5.1	6.3	6.3	5.1	5.0	5.0	5.2
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	11.0	10.0	12.0	13.0
Exports real, % y/y	6.5	7.3	6.4	6.4	5.7	5.5	5.6
Imports real, % y/y	16.6	21.9	27.3	26.6	17.2	14.4	12.4
Monetary Aggregates							
M0 (year end), % y/y	30.9	38.6	32.9	25.0	23.0	20.0	19.0
M2 (year end), % y/y	38.5	48.8	47.5	30.5	26.7	23.7	22.0
M2X (year end), % y/y	36.3	40.6	44.2	29.3	25.7	23.0	21.5
Total banking assets, % GDP	44.8	51.9	61.0	63.0	65.0	67.0	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	14.0	11.8	10.5	9.5
Core CPI (year end), %S	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	22.5	21.2	19.8	19.0
Federal budget expenditures, % GDP	16.3	15.9	18.1	16.8	17.5	17.4	16.7
Federal budget balance, % GDP	7.5	7.4	5.4	5.7	3.7	2.4	2.3
Consolidated budget balance, % GDP	8.1	8.4	6.1	6.4	4.1	2.7	2.6
Reserve fund, year end, $ bln	43.0	89.2	156.5	167.1	184.6	205.2	233.2
National wealth fund, year end, $ bln				50.1	73.8	102.6	128.3
Balance of Payments							
Exports, $ bln	244	304	354	490	480	470	470
Imports, $ bln	125	164	223	305	380	460	540
Current account, % GDP	11.1	9.5	6.1	7.2	2.1	-2.4	-5.5
Net capital inflow/outflow, $ bln	2.0	41.9	82.9	25	35	40	45
International reserves, year end, $ bln	182	304	476	618	675	653	560
External Debt							
Foreign public debt, % GDP	10.0	5.2	3.5	2.3	2.0	1.6	1.4
Foreign private debt, % GDP	3.9	3.8	3.8	3.8	4.1	4.6	5.1
Exchange Rate							
R/$:							
end of period	28.8	26.3	24.6	25.5	27.2	28.8	29.8
year average	28.3	27.1	25.6	24.4	26.5	28.0	29.5
Exogenous Parameters							
Urals, $ p/bbl	50.4	60.9	69.6	105	90	80	72
$/€	1.24	1.26	1.37	1.50	1.40	1.37	1.35

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

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