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Revising the quality of growth

Center of Strategic Investigations

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The crisis that first hit Russia's financial sector has finally proliferated throughout the entire economy. The latest data from the Russian Statistics Service and various polls point to a dramatic decline in demand, falling output in a number of industries, mounting payroll debt, and outstanding settlements between enterprises. The government has channeled substantial financial resources to resolve the most critical issues (the volume of committed state financing accounts for 14% of GDP, one of the highest levels in the world). The priority tasks that must be addressed immediately are to bring money market operations back to normal, re-start bank settlements, stop the outflow of household deposits from the banking system, stabilize equity and bond prices, and ward off a string of defaults (especially on foreign debt).

The real sector is in a "real" plight today. On the one hand, growth over the past three years on the back of surging domestic demand and accelerating inflation broadened the market for domestic goods, but blunted the urge of domestic producers to enhance the competitiveness of their output. Russian enterprises stepped up their production volumes and prices, but the share of imports on the domestic market continued to widen.

On the other hand, the financial crisis erupted during the course of ambitious investment programs aimed at re-tooling production. In such conditions, enterprises are especially vulnerable – both from the standpoint of current demand for their products as well as the availability of financing to successfully complete these programs. Today we face a great risk of losing the most essential growth driver of the Russian economy. Supporting credit for Russian businesses involved in up-and-running projects is crucial for medium-term economic growth.

Finally, some outstanding issues – such as higher labor productivity growth versus wage growth rates, development of small business, and implementation of the innovation scenario – were declared priorities, but were actually sacrificed in favor of high headline growth rates. As the crisis gathers steam, it is crucial to enhance both competitiveness and efficiency, and enterprises and projects should be selected based on these criteria.

In current circumstances, economic policy should be aimed at *blanket support,* via large-scale issuance of money, for a number of industries (including resource-driven industries and a number of loss-making sectors), which would help sustain positive growth rates in 2009. Alternatively, policy should *lay the groundwork for growth of radically new quality* over the next ten years to help address the current crisis and future challenges.

In reality, state financing of the banking and real sectors at 14% of GDP already generates *blanket support* for projects, debt and investment. However, access to state funds is not the best filter for quality and efficiency, and repackaging foreign debt into domestic debt will not resolve the problem of repayment.

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Economic development scenarios

The difficulties experienced by the global financial system, including Russia's financial market, and worsening conditions in raw material markets make it more difficult to assess development prospects for the economy in 2009. This is not an idle question, as macroeconomic forecasts form the basis of the 2009–2011 federal budget plan, key guidelines for monetary policy, and development strategies for large and medium-sized enterprises.

Analysts differ widely in their forecasts of key Russian (and not only Russian) macroeconomic indicators. The common expectation is for declining growth in 2009. For example, Russia's Economy Ministry, the IMF, the World Bank and most analysts at Russian banks have made substantial downward revisions to their forecasts. That said, they all agree that growth will remain positive and the budget will be balanced. A wider range of opinion concerns the ruble, from support for the currency at current levels in order to sustain financial stability, down to sharp depreciation for "immediate" improvement of competitiveness and the structure of BOP. In our opinion, these forecasts are too inertial – they overestimate gross demand and production potential while underestimating the role of the financial sector in economic growth.

We believe there are two development scenarios for Russia's economy in 2009 depending on the course of economic policy adopted by the government. Theoretically, there is a third, more pessimistic scenario suggesting further sharp deterioration of the global financial and trade system accompanied by a severe slump in world output, a deepening crisis of the payment system, etc. Opinions differ as to the likelihood of this scenario, but all agree that those would be "very bad times". Under this scenario, there is every chance that the country might become a true "safe haven", but only in conditions of global collapse. In other words, life would be tough in Russia, but better than elsewhere.

The general consensus, however, is that Russia's economy will continue to develop in a moderately adverse environment. The basic scenario projections suggest:

- a decline in oil prices in 2009 to an annual average of $50 per barrel; and
- capital outflow from Russia in the amount of $60–70 billion.

Further, the essential requirements for the Russian economy to grow in 2009 will be:

- repayment of an estimated $150 billion in private foreign debt, if repayments in 4 quarter of 2008 would be partly refinanced using external sources; and
- keeping inflation within 10% thanks to government efforts to control tariff growth among natural monopolies.

It will be extremely difficult to stick to the former model of economic growth (i.e. seen in 2006–2008), as it would lead to unreasonable expense. That model was based on expanding domestic demand supported by foreign loans and not domestic savings. Increasing demand for consumer and investment products encouraged economic growth, but this was accompanied by accumulation of private debt. What will prevent continued use of the old model is the absence of financing to make it practicable: domestic savings have dropped below the level of outstanding domestic loans of the non-financial sector, while growth in foreign loans required to cover the gap cannot be expected anytime soon.

In this context, economic policy-makers now face a difficult choice.

On the one hand, it is necessary to preserve lower but nonetheless positive growth rates. It will be particularly important to prop up growth in investment activity, as fixed capital investment in recent years was aimed at modernizing long-term physical capital, which is a key component of future economic growth.

On the other hand, large-scale state financing of the economy will continue to target inefficient projects and industries: in the past, expanding demand allowed companies to increase their output and prices without taking any special care of their competitive standing. In this respect, a substantial portion of state funds may be spent to keep uncompetitive producers afloat.

Finally, the current level of available Government reserves may appear insufficient in certain circumstances.

The choice of economic policy will eventually determine the scenarios for Russian economic development through at least 2009.

Under the first scenario, *the existing growth model survives,* while expansion of domestic demand (investment and consumption) is supported by large-scale financial infusions from the state.

Implementation of this scenario is associated with a number of problems. Expansion of domestic demand, especially against the background of falling world prices for raw materials, can be shored up by growing bank lending. In 2007 (amidst high oil prices), 34% of domestic demand growth was brought about by surging bank loans to legal entities and households. With GDP growth of 23% (8.1% in real terms) in 2007, corporate and consumer loans leaped by 50% and 57%, respectively. According to preliminary estimates, loans to the non-financial sector must grow by at least 30% to ensure zero GDP growth in real terms. *The key issue here is to find the growth driver*.

The major structural problem of Russia's banking system today is the widening gap between the levels of loans and savings in the non-financial sector (the so-called "credit hole"). In October 2008 alone this gap broadened by R800 billion, and loans as of November 1, 2008 exceeded deposits by R4.6 trillion. The gap was R1.1 trillion higher than the total capital of the Russian banking system (including the first tranche of subordinated loans issued by Vnesheconombank (VEB) and the CBR in the amount of R275 billion in October).

Given the relative stability of the banking sector (including ongoing credibility in the eyes of households, the absence of panic among depositors, and despite expectations of sharp ruble depreciation), corporate and household deposits should grow by R2.0–2.2 trillion in 2009. Growth of 30% in loans to the non-financial sector (needed to prevent a drop in real GDP) implies credit growth of R5.0 trillion. *Therefore, the "credit hole" will widen by another R3.0 trillion in 2009.*

It is reasonable to assume that foreign capital markets will be shut to Russian companies and banks in 2009. Payments by the Russian banking system relating to foreign debt will total at least R60 billion in 2009, and debt payments by the private sector are estimated at $90 billion. Overall, *about R4.5 trillion* will be needed to repay *private foreign debt* (at an average exchange rate of R30/$).

As a result, *the banking and corporate sectors will require R7.5 trillion in state financing to avoid defaulting on their foreign debt* (R3.0 trillion to finance the gap between loans and deposits, and R4.5 trillion to repay foreign debt). It is notable that the total amount of funds placed with the Reserve Fund and the Fund for National Wellbeing amounted to R5.8 trillion as of December 1, 2008 (of which R360 billion was already channeled to VEB).

Therefore, the government's intention to preserve economic growth and the previous growth model will require financing levels that exceed the resource rent accumulated during the natural resource boom.

We believe that the quality of this growth will not change either. With such large-scale state support, access to financing will be granted to the largest companies with state interest (known as quasi-sovereign borrowers). Small and medium-sized businesses, which are more sensitive to changes in demand and could contribute to economic growth, will be offered only minor support. The same approach will apply to innovation. In all cases, state financing will prevent the selection of enterprises and investment projects based on their efficiency, and instead will reflect the degree of skill in lobbying and accessing state administrative resources.

The essence of the alternative scenario is a selective approach to support for the real sector and not domestic demand growth. As we have noted, some enterprises in the real sector were involved in modernization of fixed assets and launched investment programs. Apparently, the halt in funding of such projects will nullify the effects of the investments already made, which threatens the growth of competitive production in the future.

The selective approach implies more attention to *small business*. According to polls, small businesses have suffered less from the financial crisis, which is quite understandable considering its limited access to borrowing. Additionally, the development of small business may substantially cushion the social repercussions of the current crisis through job creation.

Further, implementation of this selective scenario requires the removal of structural disproportions *in the financial sector*.

First, it is necessary to *put the brakes on spiraling net debt of the non-financial sector.* The steadily growth in net debt complicates the task of its subsequent repayment, and the current repackaging of foreign debt into domestic debt only delays the timeline for debt service.

Naturally, a growing economy requires bank loans. However, the proportion between the volume of savings and borrowing is very important for sustaining financial stability. Moreover, implementing a risk-fraught credit policy (excessive growth in loans to the non-financial sector versus deposit growth) does not propel the pace of economic growth to heights justifying the risk of disrupting the stability of the banking system.

We have made an historical projection of possible development of the Russian economy in 2006–2007 under a more balanced credit policy. Our estimates show that if the balance between loans and savings of the non-financial sector had been preserved and foreign borrowing had remained moderate, GDP growth would have decreased by 0.7 percentage points in 2006 (from 7.4% to 6.7%) and by 2.0 percentage points in 2007 (from 8.1% to 6.1%). But in this case, the Russian economy could have avoided the problem of over-lending, and foreign private debt would have totaled only $250 billion in early 2008 (instead of the actual figure of $417.2 billion). Finally, more balanced growth would have at least allowed a cut in spending on anti-crisis measures while preserving positive economic growth today.

The elimination of structural disproportions implies decelerated growth of lending alongside increased savings. The most effective policy allowing the achievement of such a balance is an “expensive money” policy. Economic growth rates, however, will have to be sacrificed. In this context, the *general negative effect may be mitigated by a selective approach to subsidizing interest rates.*

Second, it is necessary to create *a banking system structure that would measure up to “current challenges”*. Today, the Russian banking system is heavily segmented, characterized by a large number of banks and low capitalization. The first refinancing experience has shown that the system is inefficient: money transfers to enterprises are complicated, the interbank market is regaining its poise too slowly, and efforts to reduce the social costs of the financial crisis for households (many of which have already obtained loans) are impractical. Moreover, the CBR is noticeably relaxing its requirements for credit organizations regarding the quality of collateral against refinancing, thereby heightening risks in the financial system.

Although the alternative scenario allows for an economic slump, the key objective will be to revise the quality of growth compared to that seen in recent years. Such a revision should be based on two criteria – efficiency and competitiveness. Efficiency is a measure indicating the extent to which banks can increase savings and provide loans to reliable borrowers, as well as how the real sector can optimize production plans. Competitiveness shows the extent to which domestically-produced goods can be competitive on domestic and external markets. Actually, we are referring to the selection of enterprises and banks, which can develop effectively in new conditions of expensive loans, subsidization of demand and worsening price conditions. This selection process will be rather costly: by our estimates, economic growth will not only slow, but even contract by 1.5–2.0% in 2009, regaining a positive level of 0–2% in 2010. But if such a selection is successfully made, the Russian economy will enter a new phase of growth at a higher level of quality for the coming decade.

Real sector

The last few months have been marked by *noticeable deceleration of industrial growth under pressure from the spreading financial crisis*.

Industrial growth driven by overheated demand will no longer see a situation in which nearly 10% growth in the manufacturing sector – even with minimal growth in the mining & quarrying sector and modest growth in the electricity, gas and water supply sector – generated a 6.5% increase in industrial output.

Russian industry has instead entered a new stage of growth – one characterized by contracting domestic demand – and its indicators have worsened considerably. By our estimates, between June and October, industrial growth slowed by nearly half compared to January-May (3.3% vs. 6.9%, respectively). Despite unchanged growth in mining & quarrying and electricity, gas and water supply, the manufacturing sector embarked on a steep downtrend.

Industrial Producer Price Growth in 2008, y-o-y, %

	January-May (actual)	June-October (estimate)	January-October (actual)	2008 (estimate)*	*For reference:* 2007 (actual)
Industrial production, total	**6.9**	**3.3**	**4.9**	**4.3–4.6**	**6.3**
Mining and quarrying	*0.5*	*0.5*	*0.5*	*0.5*	*1.9*
Manufacturing	10.2	4.3	7.0	6.0–6.5	9.5
Final demand	5.8	0.8	3.0	1.8–2.6	6.0
Investment demand	13.2	6.5	10.6	9.3–9.7	14.2
Intermediate demand	9.4	3.1	4.0	3.6–3.8	4.2
Electricity, gas and water supply	*4.1*	*4.1*	*4.1*	*3.9–4.1*	*-0.2*

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.
* Estimate is based on the realistic scenario under which the growth rates in November-December will remain low at the levels of September-October 2008 and the optimistic scenario projecting moderate growth in November-December at the levels observed in the period of growth slowdown (June-October 2008).
Source: Russian Statistics Service, CSI Bank of Moscow.

The first effects of the crisis are:

- Decelerated growth and contracted output of *final demand sectors*, which can be seen as the result of a pullback in consumer demand.

Dwindling output compared to last year's volumes was observed in the manufacturing of food products (in the past month); in the manufacture of pulp, paper and paper products, as well as publishing and printing (in the past three months); and in the manufacture of textiles and textile products (in the past four months).

- Decelerated or continuing slow growth in a number of *investment demand sectors* due to shrinking investment activities.

Production of building materials shrank by more than 1.5% in August-October and is likely to sink further as a result of spreading pessimism in the construction and development business. Currently, production of interior finishing materials is propping up the output of building materials and preventing a more severe contraction. Therefore, finalization of ongoing projects and the bleak outlook for new construction projects will further depress the output of building materials.

Declining investment demand has also had an immediate dampening effect on the *production of machinery and equipment:* the near 25% growth in output in January-May tumbled to only around 2% in June-October.

Additionally, the output of *transport equipment* – the growth engine of Russian industry in the past few months – has switched into slower gear after a steady 16% rise in January-September, increasing by only 3.6% in October. Even though most car manufacturers in Russia are highly committed to their expensive investment programs and strongly motivated to spur production, they too must revise their production plans in response to fading demand.

Finally, the production of *electrical equipment* is also sagging, indicating the delayed implementation of investment programs by natural monopolies, primarily enterprises in the newly reformed electricity sector.

- Noticeable deceleration of growth in *intermediate demand sectors* (woodworking, manufacture of chemicals, manufacture of basic metals) resulting from sinking output growth in the investment and final demand sectors as well as dwindling profitability of exports due to the unfavorable world economic environment and growing domestic costs.

Today, Russian industry faces a problem of growth in conditions of severely faltering or even halted demand growth and mounting competition with imports on the domestic and international markets.

Further deceleration of domestic demand on the Russian market will be determined:

- for consumer demand – by expected redundancies in the economy, payroll cuts necessitated by high inflation and slowing consumer lending;

- for investment demand – by subsidization of investment activity due to a lack of proprietary funds for investment purposes, deteriorating conditions for bank lending, and contraction of foreign investment.

Furthermore, a real threat is posed by falling demand for domestically-manufactured products, which continue to lose market share to imports. Risks remain that price niches in which domestic goods now compete with imports may become more expensive as a result of forced price hikes driven by growing production costs. The CBR’s policy of mild devaluation may temporarily mitigate the issue of domestic goods’ competitiveness versus imports on the Russian market, but will not resolve the problem. In all likelihood, what we can expect in the short term is 1) a certain decline in prices of imported goods due to changes in their product range and more flexible pricing policy of foreign producers still keen to work on the Russian market, and 2) further price hikes for Russian products due to growing costs.

The reason is *that during the previous beneficial period of high domestic demand, no institutional or legal system was established to encourage new producers or spur competition on commodities markets*.

On the contrary, high administrative “money-wringing” constraints and endemic corruption continue to limit the volume of business activity, undermine the investment climate, and foster conditions for monopoly production on commodity markets. All of these factors indirectly help prices for domestic goods grow faster than those for imported products. The situation is exacerbated by *the fact that there are no mechanisms of control over monopoly price-setting in commodity markets*, which results in an immediate and virtually uncontrollable shift of the burden of rising producer costs onto domestic consumers. Finally, during the previous economic upturn in Russia, *no financial stimulus was created to encourage growth in re-tooling of production*. Therefore, the existing institutional environment does not foster conditions for growing competitiveness of domestic goods. Moreover, it discourages producers from becoming competitive, thereby contributing to the technological backwardness of Russian industry.

As expected, the start of the new phase of Russian industrial growth has been sudden and painful. What was not anticipated is that the new phase is marked not only by fiercer competition with imports in conditions of overpriced domestic goods, but also (and unexpectedly) the possibility of significant structural and price changes in demand, which may create serious threats to further growth in Russian industry.

Russia is not the only country challenged by the impact of the spreading financial crisis on the real sector. However, the scale of losses suffered by different economies and their social consequences depend on the extent of the economy's viability and health, its adaptability to external shocks, and the quality of the institutional environment shaping the investment climate and stimulating business activity. By all evidence, as was the case in the past year marked by spiraling prices and inflationary processes, the new phase may bring more serious problems to Russia. In the medium term, this implies all of the negative after-effects of unresolved institutional problems.

In our opinion, the most realistic scenario for Russian industrial growth in the short term may be the following: slimming of household incomes, a pause in investment, and declining demand for Russian goods on the world markets, all of which will depress the output of final demand sectors and lead to a noticeable slowdown of production growth in investment and intermediate demand sectors. Therefore, in 2009 the output of manufacturing sectors may inch forward by only about 0.6%. Decelerated output growth will be accompanied by dropping power consumption and, respectively, slower growth in the electricity, gas and water supply sector. Given the current growth rates in the mining and quarrying industry, it will be reasonable to expect growth throughout Russian industry as a whole at just 0.6% (vs. 6.3% in 2007 and 4.3% in 2008).

We should mention that this pause in projected near-term production growth does not imply catastrophe. Given the circumstances in the global financial and trade sectors, it can be viewed as a natural consequence, particularly given the previous pace of growth. The more important thing to consider is the cardinal revision of the competitive level of Russian industry and the capacity to develop in conditions of changing demand and mounting competition with imports. The revision and selection processes currently underway in the financial sector will embrace the real sector as well. But the results will not only reflect the status quo, they will also determine the future landscape and growth trend of the Russian economy.

Many competitive enterprises were hit by the financial crisis at a time of dynamically unfolding investment to modernize production, large-scale operation of investment projects, and high volumes of outstanding bank loans raised for these purposes. In such a situation, companies are especially vulnerable – in terms of demand for their products, the sufficiency of resources to complete modernization projects, and resistance to external shocks (including hostile mergers). The process of market selection is fraught with the risk of losing the important growth drivers of the Russian economy in the medium and long terms.

This may be prevented only by an efficient government policy providing for a set of reasonable measures encompassing protection of the domestic market, purposeful molding of demand for domestic goods, financial support for investment projects, tax benefits, and steps involving modernization of the institutional environment for business development.

However, the steps that have already been taken within the framework of this strategy may have only ambiguous or blunted effects due to the growing presence of the state in the economy as a regulator of economic processes, i.e. the owner and moderator of the new course of growth. The financial crisis brought about state expansion into key sectors of the Russian economy when the state was forced to assume more responsibility for new lines of Russian business. A direct consequence will be the increasing likelihood of conflicts of interest between economic and monetary authorities, the threat of inefficient use of resources, and the loss of criteria governing economic competitiveness.

Hence, Russia's real sector is entering a phase of stagnation. The sharp fall in growth, despite the safety margin of Russia's economy declared in the pre-crisis period, suggests the first important conclusion. Implementation of ambitious plans to modernize the economy, encourage innovative breakthroughs and maintain stable growth rates is impracticable given current institutional and business conditions. Improving the business environment (buttressing the legal and regulatory framework, fighting corruption, relaxing barriers for business establishment and development, combating monopolistic trends on commodity markets, and expanding state support for economic modernization) was less of a priority than maintaining headline economic growth, which dealt a blow to efforts to enhance competitiveness.

Amidst the sweeping global financial crisis, measures taken by the government to mitigate its effect on the Russian economy (refinancing and funding of the banking system, implementing tax innovation and social measures) are, in many respects, symptomatic in nature. Programs to reform the systemic business environment (including those mentioned above) have been moving ahead only very slowly.

It is important to note that measures to mitigate the effect of the global financial crisis on the Russian economy, primarily through direct state financial support and reduction of the tax burden, dovetail with the state’s growing presence in the economy as an owner. Expanding the role of the state may help private Russian owners preserve certain lines of business, enable implementation of the previously declared investment programs, and enhance the innovative nature of certain economic sectors. However, the price for this is expected to be exceptionally high. As a result of the ongoing financial crisis, concurrent reductions in budget revenues and mounting public expenditures to resolve pressing social issues and business tasks may lead to a fiscal crunch in the foreseeable future.

Finally, the Russian economy has many times in the past demonstrated its ability to capitalize on external shocks – whether favorable (world oil prices), ambiguous (foreign capital inflows) or negative (default and currency depreciation). The ability to translate these shocks into growth is undoubtedly one of the often over-looked resources of the Russian economy. Hopefully, it will not be the only one.

Development of the monetary sector

The global crisis has radically altered the structure of money supply in Russia. In the period from 2004–2007, expanding international reserves accounted for the lion's share of growth in CBR assets. The pace of money supply growth depended largely on the level of budget resources placed with the CBR – an increase in such "sterilization" reduced the monetary base as compared to its higher potential volumes if all issued rubles were channeled into the economy. The formation of the Stabilization Fund ate up the effect from growth in export prices for energy-producing materials. In 2006–2007, money supply growth was underpinned solely by capital inflows to Russia.

In 2008, despite changes to mechanisms governing the formation of reserve funds[1], the former mechanism governing the creation of money supply could not ensure its growth. In January-August 2008, the current account BOP reached a record high of $85 billion compared to $76 billion in 2007 (as total). However, the increase in balances on budgetary accounts with the CBR (R2.8 trillion) exceeded the money supply due to an increase in international reserves (R2.6 trillion). Even the inflow of currency from capital transactions ($23 billion over 8 months) and expanded refinancing of banks (by R123 billion in January-August) failed to generate positive growth in the money supply. The broad monetary base *contracted* between January and August by 2.8%.

Since September 2008, conditions for expanding the money supply have worsened substantially. The decline in CBR reserves between September and November in ruble terms exceeded R2.5 trillion. Respectively, the monetary base was reduced by -3.0% despite contracted budgetary accounts with the CBR (about R500 billion) and unprecedented growth of lending to banks (by R2.0 trillion).

Developments in the monetary sector this past autumn are likely to reflect a general trend in 2009. That is, money supply movements in the coming year will be determined exclusively by the CBR's capacity to refinance banks as well as the government's ability to increase expenditures and to provide financing to state corporations.

We project a decrease in CBR reserves by $90 billion in 2009. At an average annual exchange rate of R30/$, this equals a reduction in CBR assets of R2.7 trillion. In these conditions, growth in the broad monetary base of 13–15% will require at least R3.6 trillion in internal sources of money supply. Depending on the mechanisms of budget and monetary policy implementation in 2009, that volume may be split between CBR lending to banks, an increase in budget expenditures, and the acquisition by the CBR of government securities.

In the "Key Guidelines of Uniform State Monetary Policy for 2009 and the period from 2010 to 2011" (October 2008 version), the worst scenario for development of the monetary sector (with an average annual oil price of $66 per barrel) implies growth in gross lending volumes to banks of R0.7 trillion. Under a more realistic forecast for the average annual oil price in 2009 ($50 per barrel), the required level of lending to banks to shore up the money supply should be revised upward, by our estimates, to R2.5 trillion.

CBR transactions with state debt are restricted by the volume of domestic borrowing. According to the "Law on the Federal Budget for 2009", domestic state debt is projected to grow by R430 billion. This source, however, can satisfy at best 10–12% of money supply requirements. The remaining resources required for money supply creation should be channeled to the financial system directly from budgetary funds.

The money supply targets determine, to a considerable extent, the path of development of the Russian banking system in 2009 – under this scenario, the banking sector will receive at least R3.0 trillion from the Russian government and the CBR.

Therefore, the state will be the main source of financial resources raised by the banking system. By our estimates, the share of state funds (resources from the CBR and budgets

[1]Starting February 1, 2008, the Stabilization Fund was split into the Reserve Fund and the Fund for National Wellbeing.

at all levels) in total banking sector liabilities will soar from 1.8% in early 2008 to 16.5% as of January 1, 2010.

Growth in other borrowing for the national banking system in conditions of closed access to external markets will be determined by the development of the Russian economy. The share of foreign liabilities in total banking sector liabilities will narrow from 18.1% in early 2008 to 13.3% as of January 1, 2010. As we noted at the outset ("Economic Development Scenarios"), household and corporate deposits may increase by R2.0–2.2 trillion. Growth in bank loans in the economy will be limited by 25% (slightly over R4 trillion), and this slower pace of loans will act as a further drag on economic growth.

Changes in the principles governing creation of the money supply accompanied by substantially expanded participation of the state in the banking system will require changes to the structure of the banking sector. The existing system of refinancing is "attuned" to large credit institutions with a relatively high level of capitalization and diversified client base. Consolidation of banks under this development scenario will be a natural way for the banking sector to survive, and is one likely to be an evolutionary process, rather than directed by regulators.

Consolidation is already gaining momentum in the banking sector in different forms. For instance, large banks are taking over smaller banks, or the client base is shifting to credit institutions involved in the rehabilitation of insolvent banks. The most vivid recent example is the announced merger of MDM-Bank and URSA Bank, which will result in the largest private bank in Russia.

Consolidation of banks is the only way for the banking sector to overcome this period of slow money supply growth and squeezed liquidity. It can be assumed in coming years that the liquidity of the banking sector will hover at 4–5% of total assets. This level is far lower than the 15–20% observed in recent years for Russian banks outside the Top 100, and also well below the banking system average of 8–10%. It seems that financial support for such an inefficient banking system will be an "inexcusable luxury".

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	42.8	43.5	51.0	59.9
$ bln	764	992	1 289	1 727	1 449	1 545	1 663
Real GDP, % y/y	6.4	7.4	8.1	6.8	-1.4	2.7	3.2
Industrial production, % y/y	5.1	6.3	6.3	4.3	-1.0	2.9	3.2
Retail turnover, real, % y/y	12.8	13.9	15.2	14,2	4.0	4.5	5.0
Gross fixed investments, real, % y/y	10.9	13.7	21.1	12.0	-5.0	0.0	5.0
Exports real, % y/y	6.5	7.3	6.4	6.1	-2.8	1.8	2.1
Imports real, % y/y	16.6	21.9	27.3	26.6	-16.3	2.2	4.2
Monetary Aggregates							
M0 (year end), % y/y	30.9	38.6	32.9	8.1	20.0	21.0	19.0
M2 (year end), % y/y	38.5	48.8	47.5	8.8	15.0	20.0	22.0
M2X (year end), % y/y	36.3	40.6	44.2	13.2	18.0	22.0	22.4
Total banking assets, % GDP	44.8	51.9	61.0	62.5	75.0	77.0	80.0
Inflation							
CPI (year end), %	10.9	9.0	11.9	13.5	11.5	11.0	10.5
CPI (year average), %	12.5	9.8	9.1	14.2	12.0	11.3	10.8
Core CPI (year end), %	8.3	7.8	11.0	13.7	11.0	10.5	10.0
Budget							
Federal budget revenues, % GDP	23.7	23.4	23.6	21.4	19.5	19.3	18.7
Federal budget expenditures, % GDP	16.3	15.9	18.1	17.3	20.8	20.2	18.9
Federal budget balance, % GDP	7.5	7.4	5.4	4.0	-1.3	-1.0	-0.2
Reserve fund, year end, $ bln	43.0	89.2	156.5	129.8	130.1	129.6	129.0
National wealth fund, year end, $ bln				73.7	73.8	73.5	73.2
Balance of Payments							
Exports, $ bln	244	304	354	470	310	330	360
Imports, $ bln	125	164	223	310	260	280	300
Current account, % GDP	11.1	9.5	6.1	5.7	-1.3	-1.4	-2.0
Net capital inflow/outflow, $ bln	2.0	41.9	82.9	-75	-70	20	40
International reserves, year end, $ bln	182	304	476	458	378	365	364
External Debt							
Foreign public debt, % GDP	10.0	5.2	3.5	2.3	2.6	2.2	2.0
Foreign private debt, % GDP	3.9	3.8	3.8	3.8	4.7	5.3	5.9
Exchange Rate							
R/$:							
end of period	28.8	26.3	24.6	28.5	31.0	35.0	37.0
year average	28.3	27.1	25.6	24.8	30.0	33.0	36.0
Exogenous Parameters							
Urals, $ p/bbl	50.4	60.9	69.6	95	45	52	57
$/€	1.24	1.26	1.37	1.48	1.30	1.29	1.26

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

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