

## Old Treatments for a New Illness

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 Central Bank of Russia (CBR) has devalued the ruble during a relatively stable period of the financial crisis. The outflow of household funds from the banking system has been halted, the prices for shares and bonds of Russian issuers have entered a trading range, and there have been no high-profile corporate defaults on domestic or foreign debt. However, the pessimistic tone in projections and forecasts for the Russian economy has become more prominent. According to recent Economy Ministry forecasts, GDP and industrial output are expected to contract by 0.2% and 5.7% in 2009, respectively. The government expects inflation to run at a level of 13%, although this now seems a very optimistic outlook.

Ruble devaluation boosts ruble proceeds to exporters and the budget from exported raw materials in the framework of unfavorable world prices, giving rise to new problems and new tasks. A cheaper ruble cannot balance the BoP, as corporate foreign debt payments are expected to total \$120 bln. It can balance the BoP only at a debt level of \$10 bln. Under an inertia-based scenario with a near zero possibility of refinancing foreign debt, the CBR's forex reserves will shrink by \$112 bln this year.

Ruble devaluation will not automatically bolster the competitiveness of Russian goods on domestic and international markets. On the contrary, it is reasonable to assume that ruble depreciation in current conditions will lift prices for Russian commodities, as investment and intermediate goods account for two-thirds of imports. Additionally, it is now clear that the government's efforts over the last five years to shape the ruble into a base currency for payments and savings have gone for naught.

It is important to understand that *ruble devaluation is not a self-sufficient stabilizing measure*. It is instead an instrument with which to implement measures aimed at improving the situation in the financial sector and supporting the real sector of the economy. In principle, devaluation changes the economic development model. In recent years, the Russian economy had been riding a wave of expanding domestic demand cultivated by favorable world markets, international borrowing and a stable exchange rate. *A new model of Russian economic growth* should now be focused on increasing labor productivity, reducing costs, expanding capital investment and improving the quality of fixed capital.

However, transition to such a new model is almost impossible due to *the high degree of uncertainty* regarding movements in the ruble exchange rate, inflation, and the content and substance of current anti-crisis measures. Only efficient government stabilization measures that are understandable to Russian businesses along with public monetary and budget policy and structural reforms (maximally oriented at promoting innovation and raising competitiveness) can help overcome the crisis with minimal losses and set the economy on a stable path of growth.

## Ruble devaluation and economic growth

### *“Saving the champions”*

Fundamental changes in the world economy, including barred opportunities for Russian banks and companies to raise new loans and refinance existing debts, capital exodus, and a steep downturn in prices for Russian exports are among the CBR’s arguments supporting “regulated devaluation” of the national currency.

Even though the crisis on world financial markets broke out in summer 2007, and prices for Russian exports began to drop in summer 2008, the regulated devaluation began only last November. Between that month and January 2009, the bi-currency basket appreciated by 31.7% (30.7% for the dollar, 32.7% for the euro), and by a further 15.0% since the start of this year. The current measure for the ruble’s outlook is the upper boundary of the bi-currency technical corridor set by the CBR at R41 (effective January 23).

Ruble stability in the ten years preceding autumn 2008 resulted in full transition to ruble settlements on the local market, substantial reduction in bank loans and deposits in foreign currency, and almost non-existent devaluation and revaluation expectations. Along with the current system of foreign trade taxation, the stable exchange rate was the main reason for the decline in the inflation component, and created the possibility for medium-term planning of foreign trade transactions, including imports of consumer and investment goods as well as intermediate goods for manufacture of locally-made products.

In fact, in the current condition of the Russian economy and financial sector, the exchange rate is by far a more effective instrument than interest rates and tax regulation.

A forced radical change in the exchange rate policy aims to “balance the current account of Russia’s BoP against the background of current prices for oil and other essential export commodities”. The upper boundary of the bi-currency basket was set on the basis of CBR and Economy Ministry estimates and was announced to be “the equilibrium exchange rate”. Questions that immediately crop up in connection with the new exchange rate setting mechanism are as follows:

- Is the current ruble exchange rate (within R41 to the bi-currency basket) truly balanced – at least in terms of the current balance of foreign exchange demand and supply – or has devaluation entered a self-replicating phase?
- What factors are behind the ruble exchange rate and the CBR’s decision to change it?
- What response can we expect from the Russian economy and financial sector to changes in the ruble exchange rate and its possible movements in 2009?
- How should the government’s economic policy be changed to minimize the negative repercussions of devaluation and to make the best of it?

Identification of the ruble exchange rate regime is key for analysis of the current forex market and forecast-making. Essentially, the tasks are to determine which economic processes and indicators fundamentally determine the exchange rate movements, as well as what governs the monetary authorities in their choice of mechanisms to manage economic processes and exchange rate policy.

Once the exchange-rate setting regime (or a combination of several regimes) is identified, it will be easier to spot the main threats to the current foreign exchange market and improve substantially the reliability of short and medium-term forecasts.

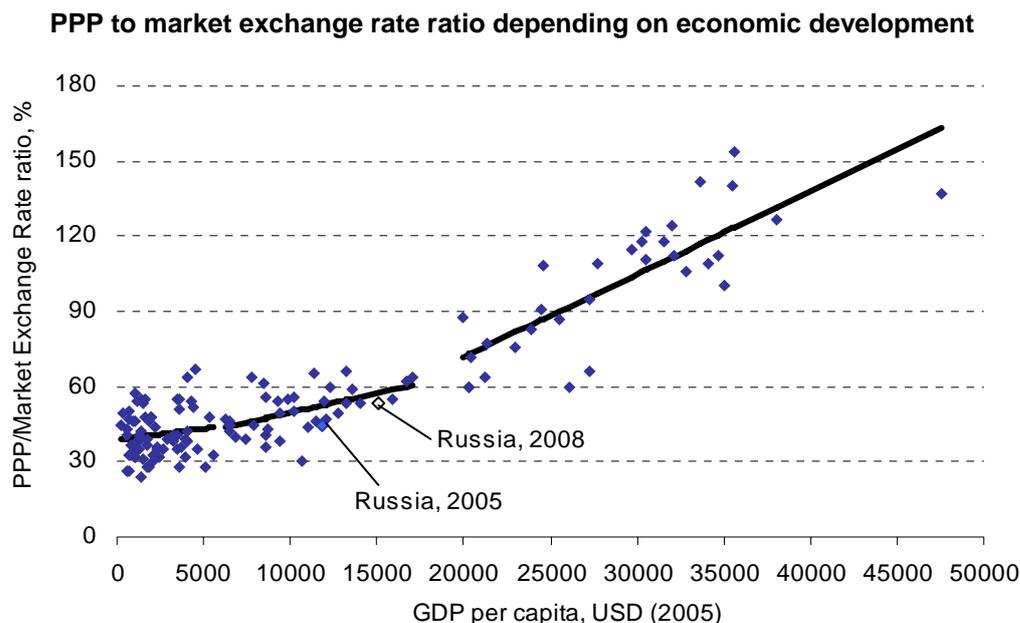
According to economic theory, the main exchange rate regimes include:

1. linkage to purchasing power parity (PPP);
2. interest rate arbitrage (exchange rate regulation through interest rates);
3. trade balance (BoP);
4. exchange rates for key export commodities (commodity price parity);
5. monetary course (currency committee or currency board);
6. tight linkage to another currency; and
7. other regimes.

By all appearances, certain exchange rate regimes cannot be used in Russia in the current environment, for example regime (2) based on interest rate arbitrage (due to the global crisis in the banking system and financial markets – primarily due to inadequate assessment of risks and market assets). Tight linkage to another currency (6) and monetary course (5) are used in case of extremely high inflation, minimal reserves and in conditions of small economies in specific conditions.

Further, considering the current status of the Russian economy, it is misleading to refer to any equilibrium value of the ruble determined on the basis of BoP (3), although we do admit that this method is widely used for growing economies. The reason lies in the fact that the ruble's impact on the BoP is limited – Russian exports are not elastic relative to the ruble exchange rate, and the desired import reduction can be achieved only through large-scale devaluation, which would have a destructive impact on both the real sector and financial stability. The impact of the ruble exchange rate on the capital account balance is not material either. Foreign debt payments in 2009 are estimated at \$120 bln, whereas international capital inflows do not actually depend on the ruble exchange rate (over the past 18 months, the capital inflow was very weak, even though the exchange rate remained stable).

The purchasing power parity (PPP) of the national currency (1) is a significant exchange rate benchmark that reflects basic characteristics of the economy's scale and structure. According to international benchmarking theory, the more developed the economy, the higher the ratio of the PPP conversion factor to the official exchange rate. Moreover, in less developed economies, nominal PPP versus the nominal exchange rate is lower. In other words, price levels in poor countries are lower compared to those in robust economies.



Our estimates based on World Bank data on PPP<sup>1</sup> and economic indicators show that the ruble's current purchasing power relative to the dollar is R18/\$. In this context, the stable ruble exchange rate can be estimated at R32–35/\$ – a level that approximates per capita GDP and price levels in the Russian economy.

It is hardly likely that the CBR relied on our PPP projections when the ruble was devalued. However, the lower ruble may be strategically more viable considering the present situation in the Russian economy.

In our opinion, *the major benchmark in ruble devaluation was commodity price parity (4)*, which for exported goods (or a commodity group) determines the *commodity exchange rate* calculated as a ratio of the domestic price of the exported commodity to its external contractual (export) price. The domestic cost of exported commodities includes the price of domestic producers for exported goods in rubles, transportation costs and indirect taxes.

At end 2008, with the market exchange rate at R26.35/\$, the exchange rate for oil was R23.3/\$ and for natural gas – R12.5/\$. Overall, these commodities account for 50% of Russia's export value, which allowed it to remain profitable. Quite a different situation was observed with regard to other export commodities. The exchange rate applied to the export of gasoline was R40.2/\$, copper – R33.5/\$, nickel – R 31.1/\$ and aluminum – R28.8/\$.

Ruble devaluation will now prop up exporters' revenues and assure respective ruble-denominated proceeds are collected by the budget in 2009, even despite declining commodity prices on world markets. In the near term, the main guidelines for the Russian economy will be shaped under a "weak ruble" policy.

<sup>1</sup> Most recent PPP data from Ring Comparison of Global PPPs for 2005 published by the World Bank in 2008.

## Main aspects of a weak ruble policy

### *Preparing to fight the previous war*

Some analysts worry that in shifting to a weak ruble policy, the actions of the monetary authorities were governed by the economic structure and stabilization experience of as far back as 1999. Our view is that it is more important to analyze the potential strong and weak points of a low ruble in today's conditions, and not relative to the 1998–99 period, when large-scale devaluation gave a powerful impetus to economic growth. Such analysis will help develop action plans in the framework of economic policy in order to mitigate the negative effects of the financial crisis in conditions of an already devalued ruble.

Traditionally, the advantages from devaluation are as follows:

#### *1. Increased exports, exporter income and budget revenues*

Sustaining ruble revenues from exports of raw materials was *the main argument* in favor of devaluation in 2008–09. The downturn in world prices for oil and other raw materials triggered a steep contraction in export earnings for both companies and the federal budget. The commodity exchange rates of the ruble (the ruble exchange rate calculated as a ratio of external contractual prices to the domestic cost of goods, including taxes and transportation costs) by major commodity groups indicate that the profitability of Russian exports in late 2008 declined dramatically. The lowering of tax rates on foreign trade operations partly solved this problem for companies, but it also reduced tax collections to the federal budget. Only exports of oil and natural gas remained profitable in late 2008, whereas to underpin the profitability of exports of oil products, ferrous and non-ferrous metals, the exchange rate should have been more than R30/\$.

The recent ruble devaluation has helped prop up the export profitability of commodities that comprise more than 70% of total exports. It should also remove from the agenda the issue of export tax levels. From this standpoint, the exchange rate of R41 to the bi-currency basket seems to represent an equilibrium allowing savings in both federal and corporate budgets under a negative scenario of raw materials price trends.

However, devaluation cannot boost growth in volumes of Russian raw materials exports. Instead, this is determined by external demand and transportation constraints (for transportation of crude and natural gas). Other exports are largely regulated by arrangements of the Russian government (such as armaments and aerospace contracts) and are only very weakly linked to the current ruble exchange rate.

Finally, physical volumes of Russian exports strongly depend on the global economic environment as well as Russian transportation infrastructure and its cost (in global prices). The ruble exchange rate has only a minimal impact on changes in the value and physical volumes of Russian exports.

#### *2. Containing (limiting) import growth*

In recent years, imports grew by 30–45% in dollar terms (15–17% in volume). According to various estimates (primarily, Economy Ministry projections), Russian imports can be roughly divided into three groups: consumer, investment and intermediate goods.

As a result of the devaluation, imports fell by 37–40% in dollar terms and by 30% in volume. Exports are expected to lose over 60% in value, though this will help sustain a trade surplus (+\$80 bln) and keep the current account virtually balanced (+\$9 bln). However, apart from the positive effects for the BoP structure, the shrinking of imports will have an adverse effect on the Russian economy.

The downtrend will first of all impact the import of investment and intermediate goods for locally made products that are not produced on the domestic market. That will lift prices and/or reduce the output of competitive Russian goods on both domestic and

international markets. Additionally, the contraction in fixed capital investment will be accompanied by declining quality – modern foreign equipment will be less accessible to domestic manufacturers who seek to upgrade their operations. This negative effect can be mitigated only through selective state support involving tax benefits and subsidized interest rates for imports of essential commodities.

### *3. Declining cost of raw materials and labor on the domestic market*

A weaker ruble, other things being equal, reduces the production costs of Russian companies and makes them more competitive on both domestic and international markets. In theory, this should boost the production and sales of Russian goods, also through acceleration of the import substitution process.

However, the effects of import substitution seen in 1999 will be hard to repeat today. In 1999–2000, imports were replaced by Russian substitutes (the simplest process from a technical standpoint) in practically all sectors. This process can be repeated only if propped up by expanding innovation and investment, and these costs can be afforded only if cheap, long-term bank loans are available and financial support from the state is guaranteed. Moreover, ten years ago there was plenty of excess production capacity, whereas today there is virtually none.

Large and medium-sized companies have traditionally been rather slow in altering their production and investment programs, and in the current year, it will be almost impossible for them to adapt their operations to the new ruble exchange rate given the backdrop of financial volatility.

Small businesses are best positioned to take advantage of the ruble devaluation in terms of price competitiveness versus foreign producers. However, the major obstacle here is the narrow accessibility of bank loans.

### *4. Protecting CBR forex reserves*

A steep contraction in the CBR's forex reserves in the second half of 2008 was brought about by a decline in forex supply (resulting from a decreased current account surplus and the absence of external borrowing) in tandem with a spike in demand from banks, enterprises and households. In conditions of mounting devaluation expectations, demand for foreign currency was mostly spurred by speculation and hedging transactions.

The key positive effect of the ruble's devaluation on the currency balance is a reduced volume of imports. Additionally, if the authorities succeed in convincing the market of their ability to prevent further significant devaluation, speculative demand for foreign currency would be shut down.

Nevertheless, even if the monetary authorities succeed in achieving a zero current account balance, the balance of capital flows in 2009 is likely to remain negative. Banks and enterprises are scheduled to repay \$120 bln in foreign debt in 2009. New borrowings will be harder to raise, not only because of the situation on global financial markets, but also due to growing finance costs in ruble terms associated with internal debt service, which will challenge companies oriented to the domestic market. Low raw materials prices will create a similar problem for exporters.

**Main forex flows and changes in Russia's international reserves, \$ bln**

	2007	2008	2009-1	2009-2
<b>Forex proceeds</b>	<b>721.5</b>	<b>773.9</b>	<b>280</b>	<b>406</b>
Exports of goods	354.4	469.0	280	280
Oil and oil products	173.7	240.3	108	108
Gas	44.8	69.0	45	45
Other	135.8	159.7	127	127
New loans	263.8	253.7	0	86
Banks	107.7	91.5	0	28
Other sectors	156.1	162.2	0	58
Decrease in assets	29.5	6.2	0	0
Equity participation and other transactions	73.8	45.0	0	40
Banks	20.0	-2.0	0	4
Corporations	53.9	47.0	0	36
<b>Outflow of foreign currency</b>	<b>-572.6</b>	<b>-819.2</b>	<b>-523</b>	<b>-525</b>
Imports of goods	-223.5	-292.5	-211	-211
Repayment of loans	-122.0	-199.1	-131	-131
Banks	-56.7	-80.5	-52	-52
Other sectors	-65.3	-118.6	-78	-78
Increase in assets	-162.3	-236.0	-110	-110
Banks	-38.9	-66.4	-20	-20
Corporations	-75.6	-89.6	-35	-35
Households	0.0	-31.0	-15	-15
Hidden outflows	-47.7	-49.0	-40	-40
Other current transactions (services, income, compensation of labor, transfers)	-54.7	-77.6	-70	-72
Other capital transactions (capital transfers, government, monetary authorities)	-10.1	-14.0	-2	-2
<b>Balance (transactions in international reserves)</b>	<b>148.9</b>	<b>-45.3</b>	<b>-243</b>	<b>-119</b>
Trade balance	130.9	176.5	70	70
Services balance	-19.8	-25.8	-24	-24
Investment income balance	-23.5	-34.2	-34	-36
Other current transactions	-11.4	-17.6	-12	-12
Capital transfers	-10.2	0.6	0	0
Operations of the public sector	0.1	-14.6	-2	-2
Banks	45.8	-57.4	-72	-40
Other sectors	37.0	-72.8	-168	-75
<b>Scenario conditions</b>				
Export oil price	64.3	91.1	41	41
Export price for oil products	63.3	91.1	41	41
Gas price	232.5	349.3	228	228
Average R/\$ exchange rate	25.6	24.9	36	36

Note: Scenarios -1 and -2 for 2009 differ by volume of new foreign borrowings.

Source: CSI Bank of Moscow, CBR.

### 5. Growing appeal of Russian assets among foreign investors

Ruble devaluation knocked down the prices for Russian assets, thereby creating additional opportunities to raise foreign capital, primarily FDI. This FDI is longer term in nature and can (along with revival of foreign investment on the Russian corporate securities market) improve the BoP structure.

Meanwhile, the ruble's devaluation also has certain *negative implications*:

*1. Higher inflation*

The situation in the Russian economy and developments on global markets are conducive to a sizable reduction of inflation this year. The downswing in world prices together with the sharp pullback in domestic demand already cut producer prices in the manufacturing sector by 15.5% in the last four months of 2008.

We estimate that with a stable ruble exchange rate and moderate (i.e. lower than projected in May 2008) growth in tariffs of natural monopolies, consumer prices in Russia would have grown by 5–6% in 2009. Now, as a result of the devaluation and expansion of the exchange rate corridor spelling transition to an inflation targeting policy, inflation in the current year should settle at around 15%.

*2. Prevailing growth in foreign asset investment versus ruble targets, encouraging capital outflow and "dollarization" of the economy*

Appreciation of the ruble over the past five years heightened the appeal of ruble-denominated assets and savings. The share of loans and deposits in foreign currency had been shrinking steadily, and net sales of foreign currency by households were observed in 2007 and the first half of 2008. Now, however, the devaluation has nullified the efforts of the monetary authorities to convert the ruble into a reliable currency. Even if the ruble exchange rate remains stable until year end, the share of ruble savings will not increase due to persistent devaluation and inflationary expectations.

*3. Mounting risks in the banking system*

Russia's banking system will face substantial structural changes and related risks. Within the liabilities of the banking sector, the share of funds in foreign currency will rise considerably (corporate and household deposits). Within the asset structure, demand for new loans in foreign currency will be limited, and risks of timely repayment of existing forex-denominated loans will increase. Additionally, we believe the CBR will strive to preserve control over growth in foreign banking assets, and therefore banks will have to share forex risks.

*4. Dwindling demand caused by falling household income in dollar terms*

Ruble devaluation and contraction of domestic demand will pull down prices and lead to a sizable slump in output of non-tradable goods (i.e. goods and services that are not exposed to competition with imports, such as construction, transport and services). Stagnation in these sectors will contribute to further deceleration of economic growth. Efforts to underpin these sectors artificially through state financing will only exacerbate the effects of the crisis and structural disproportions accumulated in 2006–08.

*5. Growing prices for equipment imports hampering modernization*

Fixed capital investment will drop in nominal terms this year. A great number of new projects will be delayed, and projects that have been started will be financed with lower than initially planned amounts. In this context, the imported equipment that has become much more expensive will only make the completion of projects a more distant prospect – if cheaper substitutes are chosen, investors will have to sacrifice the competitiveness of future goods already at the planning stage.

*6. Growing cost of borrowing and foreign debt service*

Large enterprises feel additional negative pressure from ruble devaluation in connection with servicing foreign debt. During the devaluation, enterprises and banks (late 2008 – early 2009) bought excessive amounts of foreign currency. We estimate, however, that the purchased volumes do not exceed 30% of foreign debt repayments in the current year. Other things being equal, as a result of the devaluation, Russian companies will have to withdraw more than R1 trln from circulation in 2009 to finance the repayment of

foreign debt. Additionally, the increased ruble burden in foreign debt servicing increases the likelihood of default in the banking and non-bank sectors.

Therefore, the ultimate impact of ruble devaluation looks more negative than positive.

*Among the positive factors* are sustained cash flows (in ruble terms) for exporters and the budget against the background of a dramatic drop in world prices for raw materials. Increased ruble payments to the budget and several large companies somewhat compensate for declining nominal income in the current year under the negative scenario.

*Among the negative implications* are accelerating inflation, problems with foreign debt repayment, the “dollarization” of savings and, probably most importantly, growth in inflationary and devaluation expectations. The possibility of achieving a new quality of economic growth as a result of the devaluation will depend entirely on transitioning to a new model that stimulates growing labor productivity and reduced costs. However, successful functioning of this model is possible only in conditions of renewed stability in the financial sector and the resuscitation of investment activity aimed at improving the quality of fixed capital.

### Real sector

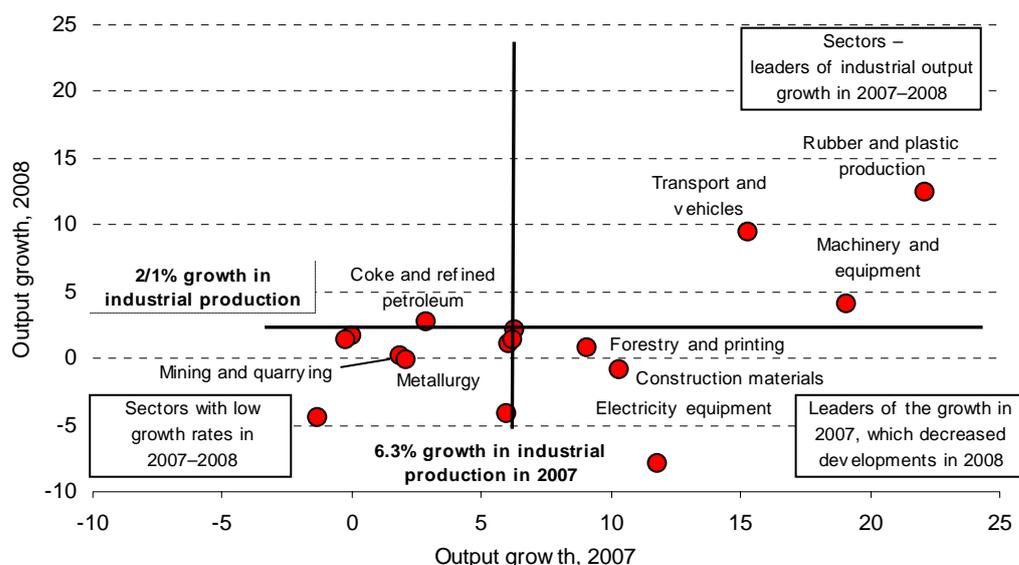
Russian industrial growth decelerated threefold in 2008: output grew just 2.1% compared to the 6.3% achieved in 2007.

The sharp contraction in this growth coincided with an *industry-wide slowdown* of industrial production alongside *preservation of the growth model* in industry as a whole.

As before, *investment demand sectors* were the main engines of growth. In terms of output, the manufacturers of machinery, transport and other equipment, as well as of rubber and plastic products, were the star performers last year. This continued the growth pattern of 2007, when these sectors also ranked among the growth leaders. However, in 2008, the group of growth leaders did not expand into new production sectors, and even lost major producers operating in investment demand sectors: the double-digit growth rates of 2007 demonstrated by manufacturers of electrical equipment and building materials were reversed and gave way to output contraction 2008.

The feeble growth in *the mining and quarrying and metals sectors*, forming the growth base of Russian industry and being the key generator of export revenues and federal budget proceeds in 2007, gave way to stagnation in 2008. Growth indicators in sectors manufacturing chemical products, coke and refined petroleum products also worsened.

Russian industrial output growth, % change y-o-y



Source: Russian Statistics Service, CSI Bank of Moscow.

The growth trends in *final demand sectors* (manufacture of food products, textiles, textile products and shoes) remained modest in 2008. Despite expansion of demand until autumn 2008, production of domestic goods was growing only very slowly. Hightened consumer demand simplified competition with imports for Russian producers. And as occurred in 2007, growth in consumer demand lifted prices in 2008 instead of production output.

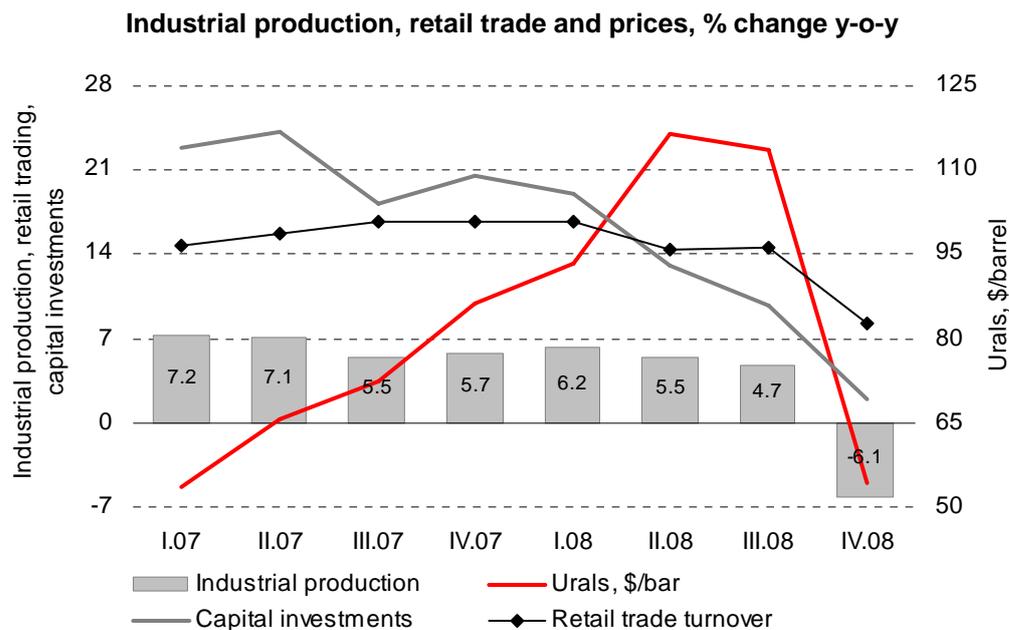
Finally, manufacturing industries in *intermediate demand sectors* demonstrated moderate growth in 2007–08 loosely related to the growth dynamics of other manufacturing industries. This underscores the increasing degree of structural disproportions in industry.

In sum, industrial growth in 2008 inherited all of the essential features of the 2007 growth model, in particular:

- **Weak motivation among producers to create competitive products, and the presence of monopoly producers on the domestic market.** The obvious manifestation of this was the response among producers to rising demand. Instead of expanding the market by launching new products and competing with imports, they chose to raise prices.
- **Fewer opportunities to modernize production with borrowed funds, weak credit support for investment, and the inability of most enterprises to access credit for investment purposes.** The dominating share of equity financing in corporate investments constrained the competitiveness of Russian industry and limited the scale of production planning.
- **High dependence on world prices for traditional export commodities.** The mining and quarrying and metals sectors, which are the main contributors to budget revenues, grew only slowly. In conditions of a worsening price environment and the need for a moderate budget deficit, devaluation of the ruble was almost inevitable.
- **Division of production into industries showing dynamic and revenue-earning industrial indicators.** As in 2007, mechanical engineering remained the locomotive of Russian industrial growth in 2008, and all of this industrial growth was based on expanding domestic demand. The growth model in industry remained oriented toward slow-moving export-driven sectors. Growth in industrial output was only weakly related to actual enhancement of competitiveness (and, therefore, revenues).
- **Continuing structural disproportions in industry**, including a widening gap between the competitive manufacturing sectors and intermediate demand industries, which, due to technological backwardness, cannot produce high-quality analogues of imported components. The resulting high import volumes for a number of competitive mechanical engineering plants in conditions of a weaker ruble will substantially constrain their growth.
- **A low degree of product processing in the mining and quarrying sector** (amid tighter competition in commodities markets) and a low quality of goods produced by intermediate sectors will curtail demand significantly on global markets in conditions of price and demand fluctuations.

In other words, in 2007–08, Russian industry grew in conditions of misbalanced structure and heavy dependence on both exports and imports due to slow modernization of industrial production. The high degree of production capacity utilization achieved in the post-devaluation period, as well as restricted resources for modernization of existing and development of new production capacities, weakened the effect of an improved economic environment and growing domestic demand on Russian industrial growth.

Under such a growth model, relatively high growth rates (around 8% in manufacturing sectors and 5% in industry as a whole) can be shored up by a *strong external catalyst* – growing export revenues (rising world prices for energy-producing materials) and expanding consumer demand (household income and, especially, consumer lending).



Source: Russian Statistics Service, CSI Bank of Moscow.

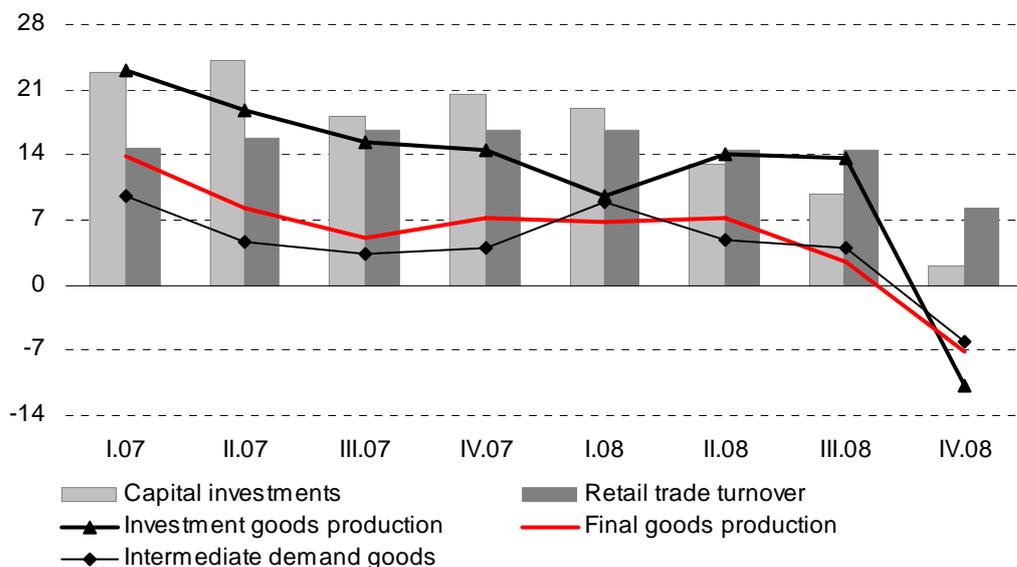
The respective 7–10% and 5.5–7% growth rates in the manufacturing sector and industry as a whole between 2007 and the first half of 2008 occurred in the following conditions:

- a doubling of world prices for Russian oil (from \$54/bbl in 1Q07 to \$116/bbl in 2Q08);
- a doubled volume of consumer loans to households (the volume of issued loans rose from R0.55 trln in 1Q07 to R1.06 trln in 2Q08; total liabilities on loans increased from R1.6 trln to R2.6 trln);
- persistently high growth rates of consumer demand (16–17% increase in retail turnover through 1Q08); and
- accelerating investment demand (investment growth of around 20% from 2007 through 1Q08).

As it turns out, *the response of industrial production to the improved global economic environment and expansion of domestic demand* was rather lukewarm. The factors that could have, in principle, facilitated quality-focused and fast industrial growth actually brought about inertial growth on the back of overheated demand. One of the reasons for this was slow growth of production modernization and competitiveness, which occurred when the competitive status of manufactured goods was not adequately assessed by producers. Ultimately, the economy ended up with high inflation and inflationary expectations, as well as dramatic deceleration (and eventual contraction) of production growth in response to much more moderate slowing (but not decline) of demand in 2H08.

The trends in the manufacturing industries of the three major sectors (consumer, investment and intermediate demand) against the background of consumer and investment demand do not provide an opportunity to assess demand for a particular product, its competitive standing or the market ambitions of its producer, but they do outline a vector for a possible production upswing.

**Manufacturing industry output, fixed capital investment and retail turnover volumes, y-o-y growth, %**



Source: Russian Statistics Service, CSI Bank of Moscow.

In 2007–08, industries in the *final demand sector* registered rather modest growth rates (compared to retail turnover), responding immediately to a slight slowing of growth in turnover. The energetic rise in consumer demand was the major catalyst for growth in manufacturing industries operating in this sector. Hence, the shifts in consumer behavior in 2H08 had a direct negative impact on this sector.

Boosting the final demand sector with greater consumer lending is ineffective, as it concurrently spurs imports of similar goods. On the other hand, the outlook for such growth seems rather doubtful due to the low competitiveness of manufactured products. Growth prospects for this sector depend directly upon tighter competition, which would bolster the market incentives of producers and underpin inflationary processes.

Thus, the only effective tool with which to boost this sector is support for *SME* creation, which, among other things, would enhance the innovative nature of the final demand sector and create new jobs.

The output upturn in investment demand, on the contrary, was comparable in scale to the growth in capital investment in the Russian economy. Fixed capital investment was growing in step with expanding production of construction materials and products of the mechanical engineering industry. Judging by their performance in 2007–08, producers in the investment demand sector have managed to preserve their positions on the Russian market. For example, prices for construction materials and their output picked up considerably until 2H08.

The production of machine-building equipment is also quite competitive on the Russian market considering the acceptable level of quality and lower maintenance costs. This segment of manufacturing is largely challenged by worsening investment demand, a high degree of production capacity utilization on the verge of a slump, and restricted access to external resources to finance modernization and launch new production capacities. Therefore, the main tasks to stimulate growth are to cultivate the grounds for *revival of investment activity* (improvement of the investment climate and provision of credit resources for investment) and *target demand stimulation* using state procurement and, possibly, private subsidization of respective purchases by Russian enterprises and individuals.

Finally, the systematic lag in growth of the intermediate demand sector and its weak ties with the investment and final demand sectors point to grave disproportions in the

production structure and constitute a substantial growth acceleration reserve for industry and the economy as a whole. The only effective growth scenario for these sectors is radical modernization – higher value added (timber industry and oil refining) and production of state-of-the art innovative products (metal and chemicals sectors, manufacture of rubber and plastic products) that would open broader opportunities for competition on global markets and involve them in the technological chains of Russian producers forced to import these respective products. However, this course of modernization is the most expensive and requires the development of *government programs* as well as application of effective forms of co-financing.

This year will be rather difficult for Russian industry, which, after a period of growth driven by overheated demand, was confronted by decelerating (and even contracting) demand. The ruble's devaluation is unlikely to spark the explosive growth observed in 1998 – it is more moderate in scale, of longer duration, narrows the planning horizons of production and investment activities, and does not resolve the issue of competition with imported goods that cannot be substituted by local producers. Recovery of industrial production can hardly be expected until the end of the active devaluation phase, but already today it is clear what methods would put it on a new path of growth, and an adequate government program should be put in place.

## Banking sector

### Government's gift to the banking system

In 2008, the assets of the Russian banking sector unexpectedly grew a healthy 39.2%, which was down slightly on the 44% performance of the previous two years. This growth was surprising for the following two reasons. First, in 2008, high annual growth rates resulted from a huge leap in December, which accounted for 26% of annual asset growth, marking a record monthly high since the 1998 crisis. In prior years, December accounted for 20% of annual asset growth. Second, annual growth in the banking system's traditional resources embarked on a downtrend that was also observed in December. Growth in borrowing was generated by two steps of the monetary authorities: large-scale injection of state funds to the banking sector (primarily, CBR loans) and ruble devaluation that led to revaluation of assets in foreign currency.

State support provided to the banking sector in August-December 2008 totaled R4 trln. Of this amount, around R3.4 trln represented various refinancing instruments of the CBR, and the remaining amount came from the federal government (R400 bln from the National Wellbeing Fund placed with VEB). As a result, the share of CBR loans in banking sector liabilities exceeded 12%, accounting for over 40% of growth in total banking liabilities. Without such a powerful refinancing campaign, the liabilities of the Russian banking sector would not have increased by more than 23% in 2008.

### Major banking liabilities, as of last day of month, % of total

	12.05	12.06	03.07	06.07	09.07	12.07	03.08	06.08	09.08	10.08	11.08	12.08
<b>Liabilities (R bln)</b>	<b>9696</b>	<b>13963</b>	<b>15516</b>	<b>17113</b>	<b>18131</b>	<b>20125</b>	<b>21323</b>	<b>23059</b>	<b>24572</b>	<b>25276</b>	<b>25924</b>	<b>28022</b>
Capital	15.4	14.3	15.5	15.9	16.1	15.3	15.7	15.3	15.2	15.1	15.4	14.7
CBR loans	0.2	0.1	0.1	0.1	0.0	0.2	0.7	0.2	0.9	4.7	8.2	12.0
Interbank transactions	4.0	3.4	3.3	3.1	2.9	4.1	4.3	4.1	3.5	4.0	5.2	4.4
Foreign liabilities	13.7	17.1	16.3	17.0	17.6	18.1	17.2	18.3	19.0	18.5	17.5	16.4
Household deposits	28.9	27.6	26.3	25.9	26.0	26.2	25.4	25.5	24.5	22.3	21.7	21.5
Corporate deposits	24.4	24.4	25.3	25.6	24.9	25.8	26.2	25.5	24.0	22.4	21.6	23.6
Accounts and deposits of federal state authorities and local governments	2.0	2.2	2.6	2.4	2.6	1.5	1.7	2.5	5.0	5.8	3.3	1.0
Issued securities	7.6	7.2	6.4	5.8	5.3	5.8	5.5	5.7	5.0	4.7	4.6	4.1

Note: December 2008 – estimate.

Source: CBR, CSI Bank of Moscow

Ruble devaluation sped up the "paper" growth rates of the Russian banking sector. Only in December 2008 did the revaluation of assets denominated in foreign currency increase, adding at least R500 bln to their year-end value. Overall, in August-December 2008, the growing cost of assets denominated in foreign currency fattened banks' liabilities by at least R1.4 trln, which is tantamount to 7.5 pts of annual growth in banking sector liabilities. Considering the ruble appreciation in the first half of 2008, banking sector liabilities zoomed by R1.2 trln on an annual basis owing to the devaluation, constituting 6.3 pts of the total growth.

Therefore, state support for the banking sector combined with ruble devaluation accounted for 50% of the growth in banking sector liabilities. In the absence of these measures, the banking sector would have grown by less than 18% in 2008, touching a ten year low.

Initially, the CBR's loans were intended to underpin banking liquidity and finance foreign debt repayment. Over the last five months of 2008, net foreign borrowing dwindled by nearly \$70 bln. Apart from \$31 bln in respect of foreign debts, in late 2008, banks' assets swelled by R38 bln. In addition, we estimate that more than R25 bln was placed with the

CBR in foreign currency accounts and deposits. As a result, foreign currency reserves of the banking sector as of January 1, 2009 can be estimated at R60–65 bln.

#### Major banking assets, as of last day of month, % of total

	12.05	12.06	03.07	06.07	09.07	12.07	03.08	06.08	09.08	10.08	11.08	12.08
<b>Assets R bln)</b>	<b>9696</b>	<b>13963</b>	<b>15516</b>	<b>17113</b>	<b>18131</b>	<b>20125</b>	<b>21323</b>	<b>23059</b>	<b>24572</b>	<b>25276</b>	<b>25924</b>	<b>28022</b>
Cash and precious metals	2.7	2.6	1.8	1.8	1.9	2.5	1.9	2.0	2.0	2.5	2.3	3.0
Accounts with CBR	7.3	7.5	8.0	10.9	6.1	6.9	5.1	5.8	4.2	3.5	3.8	7.5
Interbank transactions	6.3	5.8	5.4	5.3	4.7	5.4	6.2	5.9	4.8	4.9	5.9	5.2
Foreign assets	9.1	9.9	11.5	8.4	10.0	9.8	10.8	9.9	12.2	13.5	13.2	13.8
Households	12.1	14.7	14.4	14.9	16.0	16.1	16.4	17.0	17.8	17.5	16.9	15.5
Corporate sector	47.0	45.3	44.8	45.0	47.2	47.2	48.8	49.1	49.0	48.2	47.8	44.5
Government	6.6	5.2	5.0	4.7	4.1	4.1	3.3	3.4	3.0	2.7	2.6	2.0
Property	2.4	2.4	2.4	2.3	2.2	2.2	2.2	2.1	2.1	2.0	2.0	1.9

Source: CBR, CSI Bank of Moscow

This reserve can be viewed as preparation for the repayment of foreign debt in 2009. According to the CBR, the banking sector must repay \$60 bln in principal and interest on foreign loans.

However, it would be a mistake to attribute the expansion of banks' foreign assets solely to growth in the foreign currency reserves of the banking sector. The end of the year saw a sharp jump in corporate foreign currency accounts and deposits, which expanded by R25 bln over this period. Therefore, the increase in forex savings of corporate clients accounted for 40% of the growth in banks' foreign currency reserves. During that time, banks' foreign currency reserves should be viewed as total foreign currency reserves of the non-public sector of the Russian economy (net of cash).

Additionally, in late 2008, foreign currency deposits of households (which are not liable on foreign debts) shot up by \$20 bln. The total reserves for foreign debt payments of the banking and non-bank sector amounted to less than \$50 bln in early 2009. Overall, the private sector must repay more than \$150 bln on foreign borrowings in 2009 (\$130.6 bln in principle and \$21.9 bln in interest). In this case, available reserves can only cover 30% of upcoming payments.

Furthermore, the accumulation of foreign currency liquidity in late 2008 – early 2009 was a forced step. First, as we mentioned before, there was a steep rise in customers' foreign currency accounts. Growth in domestic foreign currency resources outpaced foreign debt repayment volumes, and banks were forced to beef up their foreign currency assets in order to preserve the currency balance.

Second, the opportunities to place foreign currency assets on the domestic market have also narrowed. Ruble devaluation noticeably reduced the ability of banks to service their foreign currency liabilities. In the second half of 2008, the ruble/dollar exchange rate (and the corresponding ruble equivalent of dollar-denominated instruments) rose by more than 25%. In this context, bank customers, the majority of which earn ruble incomes (most households and enterprises are oriented towards the domestic market) have largely exhibited demand for ruble-denominated loans. In turn, banks are also interested in supporting the solvency of their borrowers. For example, a number of major banks suggested that their clients convert their mortgage loans into rubles. Therefore, expansion of foreign assets was the only tool with which banks could mitigate their currency risks.

This year, development of the banking sector will be determined by the same factors: ruble exchange movements and government policy. Until the exchange rate and devaluation expectations stabilize, lending to the economy can be boosted only by command methods. In the context of prevailing foreign currency savings, bank lending involves mounting risks. Growth in ruble assets is associated with heightened foreign

currency risks for the banking system, and lending in foreign currency aggravates the risks of borrower insolvency.

From this standpoint, the most important element of state policy in the near term will be to ensure transparent formation of the exchange rate, with ruble stability as the final goal. In current conditions, the CBR's task is not only to keep the ruble's movements against the bi-currency basket within the established corridor, but also to convince market operators of its capacity to do so.

**Forecast of key economic indicators**

	Actual			Forecast			
	2005	2006	2007	2008	2009	2010	2011
<b>Macroeconomic indicators</b>							
Nominal GDP:							
R. trln	21,6	26,9	33,1	41,5	41,9	48,7	57,8
\$ bln	764	993	1 293	1 675	1 164	1 281	1 445
Real GDP, % y/y	6,4	7,4	8,1	5,6	-1,2	2,3	5,6
Industrial production, % y/y	5,1	6,3	6,3	2,1	-7,0	1,0	3,5
Retail turnover, real, % y/y	12,8	13,9	15,2	13,0	-4,0	4,0	8,0
Gross fixed investments, real, % y/y	10,9	13,7	21,1	9,1	-9,0	4,0	7,0
Exports real, % y/y	6,5	7,3	6,4	0,2	-6,3	2,3	3,0
Imports real, % y/y	16,6	21,3	26,6	17,7	-32,9	5,3	8,2
<b>Monetary Aggregates</b>							
M0 (year end), % y/y	30,9	38,6	32,9	2,5	4,9	13,8	15,4
M2 (year end), % y/y	38,5	48,8	47,5	1,5	5,4	11,7	13,3
M2X (year end), % y/y	36,3	40,6	44,2	14,6	11,6	15,1	15,7
Total banking assets, % GDP	44,8	51,9	60,8	67,9	81,5	85,0	88,0
<b>Inflation</b>							
CPI (year end), %	10,9	9,0	11,9	13,3	18,0	12,0	11,0
CPI (year average), %	12,5	9,8	9,1	14,1	15,3	14,5	11,5
Core CPI (year end), %	8,3	7,8	11,0	13,7	16,0	11,0	10,0
<b>Budget</b>							
Federal budget revenues, % GDP	23,7	23,3	23,5	22,3	15,6	15,3	14,8
Federal budget expenditures, % GDP	16,3	15,9	18,1	18,2	20,6	19,2	17,8
Federal budget balance, % GDP	7,5	7,4	5,4	4,1	-4,9	-4,0	-2,9
Reserve fund, year end, \$ bln	43,0	89,2	156,5	141,3	94,0	79,9	83,1
National wealth fund, year end, \$ bln				76,6	63,2	49,9	37,4
<b>Balance of Payments</b>							
Exports, \$ bln	244	304	354	470	280	290	320
Imports, \$ bln	125	164	223	290	210	230	260
Current account, % GDP	11,0	9,5	5,9	5,9	-0,4	-1,3	-2,1
Net capital inflow/outflow, \$ bln	2,0	41,9	82,9	-130	-115	-20	0
International reserves, year end, \$ bln	182	304	476	409	288	244	206
<b>External Debt</b>							
Foreign public debt, % GDP	10,0	5,2	3,5	2,4	3,2	2,7	2,3
Foreign private debt, % GDP	3,9	3,8	3,8	3,9	4,9	5,6	6,2
<b>Exchange Rate</b>							
R/\$:							
end of period	28,8	26,3	24,6	28,5	36,5	39,0	41,0
year average	28,3	27,1	25,6	24,8	36,0	38,0	40,0
<b>Exogenous Parameters</b>							
Urals, \$ p/bbl	50,4	60,9	69,6	94,4	40,0	45,0	48,0
\$/€	1,24	1,26	1,37	1,47	1,29	1,25	1,22

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

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