New constraints on liberalism

Center of Strategic Investigations

CONTENTS

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Interest-rate management is a relatively new instrument of monetary policy. In recent history, the Russian monetary authorities have pursued an active interest-rate policy only in 1997-1998, rapidly expanding the state debt market. At that time, despite growing household savings and declining inflation, this step led to a system-wide financial crisis. In this decade, on the other hand, the monetary authorities have actually ignored interest-rate policy, focusing their efforts on coping with excessive liquidity in a very liberal style. Low interest rates and the availability of substantial financial resources were underpinned by the inflow of petro-revenues and foreign loans against a background of minimal constraints imposed by the government. This course boosted production, household consumption and incomes. However, imports and foreign debt began to grow more rapidly, making Russia more vulnerable to the global financial crisis. Eventually, the safe haven turned out to be highly exposed to a global storm.

Today, advocating a liberal economic model, the Bank of Russia is trying to resolve some rather contradictory issues by managing interest rates. On the one hand, the ruble exchange rate can be stabilized and inflation slowed by a tough monetary policy involving positive real interest rates and limited money supply growth. On the other hand, the real sector of the economy can be supported only with large-scale financial infusions, including affordable loans provided at fairly low interest rates. Today, a considerable number of enterprises (including strategic entities, “backbone” enterprises, businesses carrying out modernizations, companies that use imports in their production cycle, etc.) are suffering from a production shock resulting from dwindling demand, surging prices for components and lack of access to loans. The effect of this shock was not long in coming: in January 2009, output in the manufacturing sector dropped by 25% y-o-y.

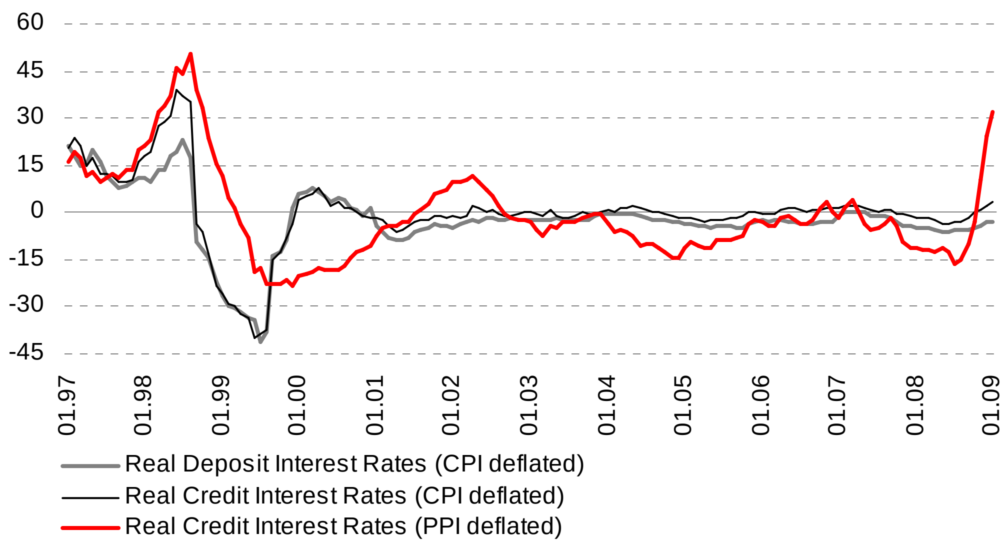
In the current environment, taking the classical approaches to the policy of “cheap” and “dear” money would have a negative outcome. Considering the current structure of the Russian economy, its structural problems and worsening global economic conditions, *purely market mechanisms* will inevitably be accompanied by costs, losses and new threats. Deciding on an interest rate policy involves looking at the pros and cons of several “bad” options and choosing one of them. The “bad” option can be improved only through administrative regulation (if we talk about allocating state savings) and active government efforts at the micro level (the business community). The ultimate solution should involve a combination of measures: either tight monetary policy with selective subsidizing of interest rates, tax benefits and direct state financing, or large-scale support of the real sector accompanied by tightened currency regulation and control over the use of state funds.

Monetary policy

Ruble depreciation has become a reality (since August 2008, the ruble has plummeted by 40% versus the bi-currency basket). While advantages and disadvantages of this depreciation are still being discussed, the weakened ruble has *already* brought about changes in the currency of household and corporate savings and triggered price hikes on the domestic market, and it continues to fuel expectations of devaluation and inflation. All the Russian monetary authorities' diligent efforts over the last five years to turn the ruble into a currency of settlements, savings and investment were thwarted by the two-month devaluation. In many respects, the ruble's recovery will depend on the Bank of Russia interest rate policy, the implementation of which will be complicated by the ongoing financial crisis and economic recession.

In a broad sense, interest rate policy can be divided into the restrictive (involving a restricted money supply and a higher cost of borrowing) and expansionist (which entails boosting the money supply and lowering interest rates). *Dear and cheap money policies* are identified by the level of interest rates and inflation, as well as inflationary expectations. There are no rigid definitions of these types of monetary policy. For the Russian economy, which has had high inflation over the last twenty years, the division into "dear" and "cheap" money can be based on real interest rates.

Change in real interest rates (CPI and PPI, adjusted)



Source: Bank of Russia, CSI Bank of Moscow.

According to the chart above, over the last 12 years a *dear money policy* was conducted only in 1997-1H1998. The aim of this policy was to put inflation in a straitjacket and maintain a steady ruble exchange rate, and its instrument was the yield on short-term government bonds. The period was marked by *falling inflation, a stable ruble and growing household savings* (nevertheless, this policy set off a system-wide financial crisis).

In the 2000s, on the contrary, the Russian government pursued a *cheap money policy*, which was supported by an inflow of petro-revenues and foreign borrowings with minimal state constraints. As a result, the *cheap money policy* changed the growth model, turning expanding domestic demand into *a major growth engine*.

The macroeconomic tasks facing the Russian government and the Bank of Russia today can be formulated as follows:

- overcoming the recession;
- keeping inflation at acceptable levels (below 15%);
- stabilizing the ruble exchange rate and BOP;
- supporting living standards;
- cutting unemployment;
- supporting the stability of the banking system;
- maintaining a minimum level of lending to the real sector.

The solutions to the above tasks are *contradictory* in terms of monetary and economic policy in general. Additional factors involved in choosing the optimal policy are:

- in monetary policy: the change in instruments that has occurred in the last few months. In the few years leading up to the financial crisis, the Bank of Russia was not involved in any significant refinancing of the banking sector, and the Russian Finance Ministry placed only limited quantities of securities. Now the situation has changed radically: the Bank of Russia actually determines the value of money in the economy by its *refinancing rates*.

- in economic policy: the worsening of the “HR crisis.” Deciding which enterprises and projects will receive financing, subsidies, guarantees, etc. is complicated by a lack of competent staff, as well as the “human factor.” In this respect, a search is under way to find universal market mechanisms that will enable the authorities to fine-tune economic policy and correct the behavior of economic agents.

Therefore, *purely market mechanisms* are inevitably accompanied by costs, losses and new threats. Several pros and cons make the choice of a specific interest-rate policy difficult – in fact, the choice is limited by a set of “bad” options.

Dear money policy

The restrictive dear money policy (targeted at restricting the expansion of the money supply) involves high interest rates and is classically viewed as a tool of combating inflation.

Today, the dear money policy could be chosen to address the following tasks:

- Keeping the ruble stable and trimming demand for foreign currency;

- Restraining and reducing inflation.

The dear money policy suggests raising (or keeping flat) interest rates on financial resources provided by the Bank of Russia and the government, and putting constraints on the money supply. The effects of this policy vary.

Positive effects:

– bolstering the savings of the non-financial sector (resulting from rising interest rates on deposits and the stabilization of expectations of inflation and devaluation);
– selecting enterprises based on the efficiency of their business (only the enterprises that are operating efficiently in *today’s* conditions can raise expensive loans).

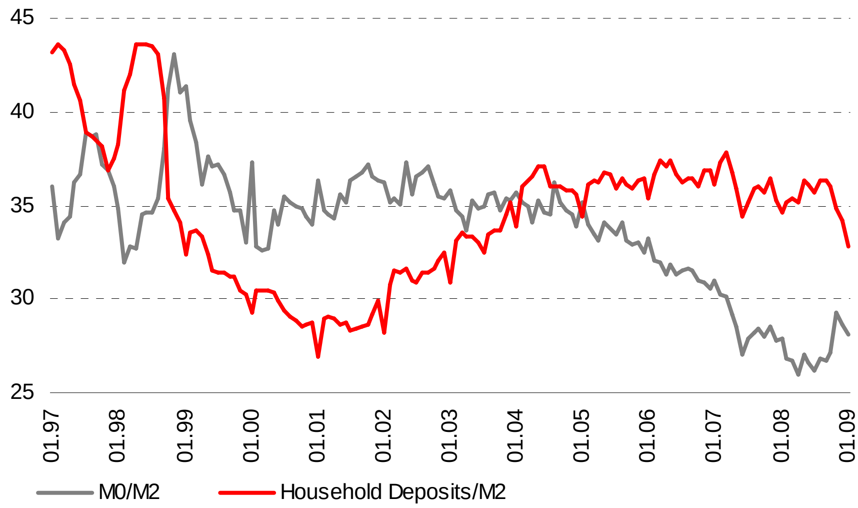
Negative effects:

– shrinking lending volumes and deepening recession;
– mounting costs associated with rising financing costs and spurring *cost-push inflation*;

– eroding the stability of the banking system;

– aggravating bad debts.

Share of ruble-denominated household deposits and cash in circulation (M0) in the money supply (M2), as % of total



Source: Bank of Russia, CSI Bank of Moscow.

Therefore, the dear money policy boosts households' bank savings. However, given a stable exchange rate and falling inflation, a cheap money policy may also see cash in circulation contract and household savings climb.

Expected results in the current year:

– stabilization of the ruble exchange rate;

– growth in household savings;

– a slowdown in lending growth;

– inflation maintained at the current level owing to devaluation, inflationary expectations and risk premiums (inflation will not rise, but it will not decline, either);

– rising defaults on foreign and domestic loans;

– dwindling demand and production volumes;

– subsiding investment activity;

– an increasing number of bankruptcies among enterprises and banks.

Overall, a dear money policy would allow the ruble to remain within the declared corridor and maintain inflation at about 20%. This policy will also allow the gap between the loans and savings of the non-financial sector to narrow.

A dear money policy would make it more difficult for the real sector to take out loans. Only a small number of efficiently-operating enterprises can afford a bank loan today, as most are seeing their profitability fall. Lower profitability indicates that companies are having more difficulty staying afloat, the outlook for industrial production is worsening and the government has no support programs in place.

Profitability of Goods Production, %

	2007	Ist half 2008	IIIQ 2008	IVQ 2008
Goods, total	**11.7**	**14.1**	**10.9**	**-0.8**
Industry	12.9	15.5	12.1	-1.7
- manufacturing	12.7	15.4	12.2	-2.6

Note. Profitability is calculated as the ratio of net revenues to turnover.
Source: Russian Statistics Service, CSI Bank of Moscow.

As a market-based selection tool, the dear money policy is useful and strategically meaningful only in a stable economy with a moderate dependence on external risks, stable growth rates and steady (without sharp rises or falls) investment growth. Under a dear money policy, addressing the structural imbalances of Russian industry and reviving growth are possible only through targeted government programs.

For instance, financial and growth indicators are deteriorating in the mechanical-engineering industry, which has been the engine of Russian industrial growth for the last few years. This is all the more significant because the industry is driven by innovation, and it stimulates innovation in related industries. The glaring problems in mechanical engineering, the sector that will have the most important role in determining the future of Russian industry, call for an energetic state policy aimed at supporting investment in enterprises and current production activities, using both credit facilities and measures aimed at stimulating demand.

Cheap money policy

The expansionist cheap money policy (aimed at increasing the overall money supply), based on low interest rates, is a classical tool for reducing (or containing) unemployment during a recession.

Today, the cheap money policy may be chosen to perform the following tasks:

- boosting domestic demand and production (including sustaining employment levels);
- maintaining the stability of the banking sector.

Positive effects of this policy:

– mitigating a production slump,
– supporting employment,
– maintaining the stability (in part temporary and seeming) of the banking system.

Negative effects of this policy:

- continuing threat of further ruble depreciation;
- high risk of rising inflation;
- structural imbalances remain in place.

Possible outcome in the current year:

- rising demand will slow production slump;
- issue of “bad debt” will be put off until subsequent years;
- inflation will remain high;
- the ruble will continue to depreciate;
- public funds will contract substantially
- the profitability and competitiveness of Russian enterprises and banks will remain low.

In addition, the *central aspect of the cheap money policy is providing funding*. We have ample evidence to expect that Russia’s public finances will be soon exhausted. Then, the major source of the money supply will be refinancing the banking system and increasing money creation by issuing government securities, which poses great risks to financial stability.

Conclusions

In the current environment, the classical interpretations of both the cheap and dear money policies would produce a negative outcome. The key tasks of economic policy are to overcome the crisis and resolve Russia’s accumulated structural problems. These are aggravated by the absence of efficient government institutions and executives capable of effective and efficient management in a period of economic turmoil (bearing in mind that the available financial resources are at the disposal of the state).

The dear money policy is aimed at underpinning financial stability and selecting enterprises based on their business efficiency. However, bank loans will be unaffordable for a considerable number of enterprises (strategic entities, “backbone” enterprises, businesses carrying out modernizations and that use imports in their production cycle, etc.). Therefore, this policy should be accompanied by selective subsidizing of interest rates, tax benefits and direct state financing. However, the option of providing support to the real sector is complicated by the government’s institutional and personnel crises.

The cheap money policy provides for expanding demand and production activity, but it does so while fuelling inflation and depreciation. This policy is aimed at boosting growth in all sectors of the economy, but it does not select enterprises based on efficiency (2006-2007), which only adds to the problems and imbalances piled up during the period of rapid growth. The cheap money policy should be accompanied by strengthened currency controls and monitoring of the use of state funds. The major threat to the successful implementation of this policy is the depletion of state reserves. As soon as they are exhausted, the cheap money policy will be supported by money creation and foreign borrowings. Additionally, to avoid an inflation-generated overheating, it is necessary to develop the government-securities market, allowing it to absorb excess liquidity.

The Russian government’s interest-rate policy will be the key component of its financial policy and ant-crisis package in the coming months. Interest rates constitute the central part of financial policy, as they determine the value of money provided to the banking system and whether it is affordable for Russian enterprises. If the banking system, in shaping the demand for state financing, is largely oriented towards return on investments, margins (the difference between raised and borrowed funds) and risks, the real sector concentrates on business profitability, while households focus on inflation. The various ways in which institutional agents look at the value of money provide the main source of disagreement in discussions of interest rate policy.

The ongoing crisis (in the financial and non-financial sectors) leaves the government with little time to decide on and clarify financial policy guidelines. The liberal policy of high interest rates currently being implemented will in the short term confront policymakers with its obvious aftereffect: the growth of “money substitutes” in inter-enterprise settlements (expansion of commercial paper and barter, as well as mounting arrears). The real sector has not yet responded to this policy with a surge in “bad debts,” as it is still reassured by the expectation of financial assistance from the state. If such assistance is not forthcoming and interest rates stay at their current high levels, then increasing arrears and a deficit of working capital will aggravate the production slump, which was observed in January 2009.

Real Sector

For quite a long time domestic demand, fuelled by petro-revenues and inflows of foreign loans, spurred steady growth in output, allowing Russian producers to raise their ex-works prices. Import prices, on the contrary, grew at a snail's pace, while import volumes rose much faster than domestic production. The positive effect of expanding consumer and investment demand was dented by sluggish competition on the domestic commodity market. Rising world energy prices and accelerating capital inflows, which boosted domestic demand, were the main drivers of the persistent growth in domestic industrial output. By the time the government switched to a dear money policy, Russian industrial production had already seen its growth begin to slow, and companies started to revise their production strategies.

Annual change of industrial production output, %

	2008					January 2009
	I HY	III Q	October	November	December	
Industrial production						
Industry, total	5.8	4.7	0.6	-8.7	-10.3	-16.0
Mining and quarrying	0.5	0.6	0.8	-1.6	-2.3	-3.6
Manufacturing	8.4	6.4	0.3	-10.3	-13.2	-24.1
Electricity, gas and water supply	4.1	4.9	2.6	-9.3	-6.1	-7.0
For reference:						
Real disposable monetary incomes	6.9	6.0	3.5	-6.1	-11.6	-6.7
Retail turnover	15.5	14.5	12.4	8.0	4.8	2.4
Fixed capital investments	16.9	9.8	6.9	3.9	-2.3	-15.5
Import volumes	28.4	28.3				
Average import prices (in R terms)	4.9	10.0				
PPI of the manufacturing sector	23.3	29.1	23.0	11.1	1.9	-0.2
URALS, $/bbl	105.0	113.5	72.5	51.4	39.1	41.1
Bi-currency basket value, R	29.64	29.75	30.37	30.65	32.57	36.41

Source: Russian Statistics Service, Federal Customs Service of Russia, Bank of Russia, Platts, CSI Bank of Moscow.

The third quarter of 2008 was still marked by persistently high world oil prices and a relatively stable national currency, on the one hand, and declining growth in investments and consumer demand on the other (owing to the shift in raw material price trends and the halt in inflows of foreign capital). That period saw a record upswing in local manufacturing-sector prices (over 29% y-o-y) against a background of noticeable deceleration in output growth (6.4% y-o-y versus 8.4% y-o-y in the first half of the year). Imports continued to rise at a pace of over 28%, while ruble prices for imported goods grew moderately, by 10% y-o-y.

Even before serious problems began to loom in the Russian financial sector, it became apparent that marked changes in demand and rising competition for consumers required companies to revise their production growth models. The model based on increasing external revenues and loans had probably not been completely exhausted by that time and could have been useful for some time yet. However, economic growth under such a model cannot be stable (as it is directly exposed to external factors) and drives up inflation. Falling capital inflows in the third quarter of 2008 and the downturn in oil prices in the fourth quarter made clear to companies *the necessity of changing their growth model*, shifting its focus to domestic demand and enhancing their competitive edge by modernizing production and adjusting pricing (cost-structure optimization). However, companies had neither the time nor the means to cushion themselves against the traumatic effect of shifting to another growth model. In the fourth quarter of 2008, most manufacturing industries experienced declining growth and shrinking output. As a result, production volumes in the manufacturing sector fell by 7.7% in the quarter, and in January 2009 they plummeted by 24.1% y-o-y.

Annual change of industrial production output in the manufacturing sector, %

	2008					January 2009
	I HY	III Q	October	November	December	
Manufacturing	**8.4**	**6.4**	**0.3**	**-10.3**	**-13.2**	**-24.1**
Final demand goods	*6.7*	*2.4*	*-1.5*	*-9.2*	*-8.4*	*-9.5*
Food products, including beverages and tobacco	5.0	1.7	-2.8	-6.7	-6.5	-3.6
Textiles and textile products	2.1	-2.1	-7.4	-18.7	-20.5	-28.1
Leather, leather goods and shoes	7.6	5.1	2.0	-8.4	-13.5	-26.0
Pulp, paper and paper products; publishing and printing	6.9	1.2	-2.8	-15.0	-15.9	-21.1
Other goods	13.8	6.6	5.6	-11.1	-5.9	-16.0
Intermediate demand goods	*3.7*	*2.4*	*2.7*	*-11.9*	*-9.9*	*-24.3*
Woodworking and manufacture of timber products	13.3	2.4	-6.1	-18.6	-22.9	-33.4
Coke and refined petroleum products	3.3	2.9	7.8	-0.1	-3.6	-4.3
Chemicals	3.4	1.8	-9.1	-25.8	-28.9	-32.9
Rubber and plastic products	15.7	19.0	15.6	-4.6	-7.1	-26.7
Basic metals and fabricated metal products	2.0	0.5	3.4	-13.3	-6.1	-30.1
Investment demand goods	*8.5*	*8.1*	*-0.5*	*-11.7*	*-18.8*	*-40.1*
Non-metallic mineral products	8.9	0.2	-4.1	-14.9	-21.7	-34.3
Machinery and equipment	10.4	11.6	4.6	-15.0	-17.3	-45.9
Electric, electronic and optical equipment	-7.7	-1.4	-8.9	-17.0	-13.1	-47.1
Transport equipment	16.8	16.4	3.6	-4.8	-21.2	-36.0

Source: Russian Statistics Service, CSI Bank of Moscow.

Concurrently, financial performance in all sectors of the economy was deteriorating. In the fourth quarter of 2008, Russian enterprises' chalked up a net loss of R442 bln. Sagging world prices for energy-producing materials and shrinking business activity led to a financial meltdown in the oil and gas sector (in the fourth quarter of 2008 losses amounted to R155 bln), the metals sector (losses of R34 bln) and trade (losses of R393 bln, excluding retail trade, which posted a quarterly profit).

However, the slump in profits was registered in other sectors of the economy as well: in 2007-1H2008, revenues were around R500 bln a quarter, whereas in the fourth quarter they shrank to R138 bln.

A decrease in enterprises' own funds (resulting from falling profits) makes it harder for them to secure funding for current production activities and to finish production-modernization projects. The decline in profitability makes clear that the enterprises are neither well-positioned to overcome the crisis without borrowings nor able to service their loans, which are becoming more expensive. It is clear that completing ongoing investment projects and launching new programs are now out of the question.

Profitability by sector, %

	2007	2008		
		I HY	III Q	IV Q
Economy, total	**9.7**	**9.4**	**6.1**	**-2.2**
Goods	*11.7*	*14.1*	*10.9*	*-0.8*
Construction	3.4	3.4	3.4	3.0
Agriculture and fishery	10.9	11.0	10.8	2.7
Industrial production	12.9	15.5	12.1	-1.7
oil and gas, coke, refined petroleum products	20.7	27.5	22.1	-9.6
metals	23.6	24.6	21.4	-3.9
final demand goods	5.7	5.7	7.6	2.7
intermediate demand goods (net of metals, coke and refined petroleum products)	9.7	16.6	9.1	0.9
investment demand goods	7.2	6.3	3.7	-1.8
– machinery and equipment	5.0	5.7	5.9	1.2
– electric, electronic and optical equipment	6.3	4.5	5.2	4.7
– transport equipment	4.0	3.1	-1.5	-8.0
Services	*8.1*	*6.0*	*2.5*	*-3.3*
Wholesale and retail trade and repairs	3.9	4.5	2.9	-4.5
Transport and communications	14.6	14.9	12.1	1.3
Real estate	27.2	15.1	2.2	3.4

Note. Profitability is calculated as the ratio of net revenues to turnover.
Source: Russian Statistics Service, CSI Bank of Moscow.

Dwindling consumer and investment demand on the domestic and world markets is not the only reason for the rapid, economy-wide slump in industrial output. The higher cost and lower accessibility of bank loans have also exacerbated enterprises' economic woes.

Today, the dear money policy is hindering production development, as it has become difficult for most enterprises to obtain funding for current production activities (consumer loans, funding of cash gaps, etc.). In the future, the dear money policy will not only make business practices less "civilized," encouraging enterprises to use money substitutes, but it will also hinder companies' efforts to modernize production and enhance their competitive edge.

The dearth of long-term and reasonably priced bank loans, as well as limited opportunities for loan-funded modernization, have always been among the main hurdles faced by Russian industry. The high share of equity in investments has undermined the competitiveness of products, both directly (by constraining investment activity) and in terms of price competition (owing to the backdrop of high inflation faced by Russian industry). The price of manufactured goods included the cost of future modernization. In fact, today's buyers subsidized future customers. During the period of expanding demand, this model of financing production and growth worked, though not very well. In the current economic and financial downturn, this vehicle of modernization has ceased to exist. Against the background of rising interest rates, Russian industry has few opportunities for technological upgrading. By the time the crisis is over and the global economy enters another growth cycle, Russian industry may be even less competitive than it is today.

The major argument in favor of the dear money policy is that it favors efficient businesses rather than projects arbitrarily chosen by government officials. It thereby encourages the further growth of profitable companies. This market-based selection mechanism is an effective tool *in a stable economy*, with moderate exposure to external risks, stable (but not necessarily high) growth rates and a sizeable, stable middle-class.

However, the structural imbalances of Russian industry and the credit crunch (long-term credit facilities) it faces *ruled out* any possibility of balancing the structure and reviving growth with the help of high interest rates even before the crisis. Moreover, a sharp increase in borrowing costs may rob the Russian economy of the growth potential it acquired in the pre-crisis period: investment programs being implemented by Russian enterprises may come to a halt owing to the unavailability of affordable credit resources. As a result, *truly competitive industries and entities*, which are naturally more vulnerable (irrespective of the external financial and economic environment) while they are modernizing and expanding production, will be eliminated by the market-based selection mechanism.

Current monetary policy is not conducive to creating potential for future economic growth. Interest rates, which are far higher than the profitability of Russian industry, are damaging the current operations of Russian enterprises and their potential for future growth. On the other hand, growth potential would also be destroyed by the financial chaos into which the Russian economy could sink if financing were lavished on all who ask for it.

Judging by the facts below, the **monetary policy** framework should **combine** a variety of options:

a) current interest rates on bank loans are becoming a major drag on business activity and an obstacle to the modernization (and, therefore, the competitiveness) of the economy in the future;

b) public funds are limited and insufficient to support the economy;

c) in the current period of financial volatility (with high inflation and self-perpetuating devaluation), the real sector of the economy will not be able to develop effectively even with large-scale financial support.

Theoretically, the dear money policy could simultaneously bring financial stability, pave the way for economic recovery and facilitate the implementation of social programs. But for this to happen, the dear money policy must be combined with targeted state support programs. Decisions on where to direct such state support should be based on an assessment of which enterprises are best able to survive until demand begins to rise again. Support should also be given to enterprises that will contribute to a resumption of qualitatively new growth in the future. A clear understanding of the strategic tasks to be performed during the crisis, the resources that should be used for this purpose and the positive and negative effects of anti-crisis measures will not only lay the groundwork for a more consistent and effective government policy, but will also send the right signals to the business community and substantially improve the investment and business climate in Russia.

Banking sector

All else being equal, the banking system is neutral to interest rate levels. Theoretically, banks earn income through margins, which can be sustained if movements in the value of assets are matched by movements in the value of liabilities. In the current environment, the dear money policy adversely impacts the banking system. First of all, the key challenge in ensuring viability of the banking sector this year will be to neutralize the threat of steep growth in overdue debts and a deterioration in the quality of debt servicing.

Dwindling profitability means that current interest rates are unaffordable for most enterprises. Against this background, Russian enterprises are unable to service bank loans. Growing borrowing costs do not only prevent new borrowings but also narrow the chances that companies will be able to refinance their existing loans. Therefore, the tight monetary policy significantly undermines the quality of corporate debts, which account for 42% of the banking system's total assets (net of corporate bonds). Concurrently, as borrowing costs rise, demand for loans to finance current production activities, let alone fixed capital investments, is contracting.

In the retail lending segment, the downturn in business activity, which had pushed up unemployment and slashed wage and salary levels (not only in real terms, or currency-adjusted, but also in nominal terms), is making it harder for individuals to make regular payments on bank loans (as of 1 February 2009, loans to households totaled R4.3 trillion, or 15% of banking assets). This problem cannot be resolved even with the help of savings, as the ratio of household loans to household deposits exceeds 70% (the internationally accepted ratio is 30-40%). With money becoming more expensive, it is getting more complicated for households to restructure their indebtedness.

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

	12.05	12.06	03.07	06.07	09.07	12.07	03.08	06.08	09.08	12.08	01.09
Liabilities (R bln)	**9696**	**13963**	**15516**	**17113**	**18131**	**20125**	**21323**	**23059**	**24572**	**28022**	**29757**
Capital	15.4	14.3	15.5	15.9	16.1	15.3	15.7	15.3	15.2	14.1	14.4
Bank of Russia loans	0.2	0.1	0.1	0.1	0.0	0.2	0.7	0.2	0.9	12.0	12.3
Interbank transactions	4.0	3.4	3.3	3.1	2.9	4.1	4.3	4.1	3.5	4.4	4.3
Foreign liabilities	13.7	17.1	16.3	17.0	17.6	18.1	17.2	18.3	19.0	16.4	17.3
Household deposits	28.9	27.6	26.3	25.9	26.0	26.2	25.4	25.5	24.5	21.5	20.9
Corporate deposits	24.4	24.4	25.3	25.6	24.9	25.8	26.2	25.5	24.0	23.6	22.0
Accounts and deposits of federal state authorities and local governments	2.0	2.2	2.6	2.4	2.6	1.5	1.7	2.5	5.0	1.0	1.2
Issued securities	7.6	7.2	6.4	5.8	5.3	5.8	5.5	5.7	5.0	4.1	4.4

Source: Bank of Russia, CSI Bank of Moscow.

The dear money policy is already giving rise to medium-term problems in the banking sector. Facing a shortage of ruble-denominated borrowings and assuming that this crunch will continue, banks have raised interest rates on corporate and household deposits with terms of one year or longer. In January 2009, the average interest rate on term deposits denominated in rubles was 11.5% per annum, only two percentage points below the consumer price index. Moreover, in February 2009 interest rates on collateral-free loans for banks exceeded 18% per annum, including those on long-term six-month loans. Therefore, the loans obtained at such rates will be issued at rates of at least 23-25% per annum. In the event monetary policy is eased, most banks will sustain "costly agreed liabilities" and, therefore, will not be able to cut interest rates on loans or will operate at a loss.

The worsening quality of loan portfolios decreases banking sector profitability. Bad debt provisions have been banks' major expense item during the last few months. Between 1 October 2008 and 1 February 2009, banks set aside a total of R469 bln in provisions.

These expenses were partially compensated for by gains on the revaluation of accounts in foreign currency, which totaled R340 bln for the same period. However, we expect the ruble to stabilize in the coming months. Today, we can also expect further growth in credit risks and continuing deterioration in the profitability of the banking sector. Equity-funded provisions may require owners to contribute additional funds to banks' capital.

However, the dear money policy has had some positive effects on the Russian banking system, especially by removing structural misbalances:

- Narrowing the gap between loans to the economy and borrowings (the "credit hole") by spurring domestic savings and restricting the growth of credit portfolios;
- Encouraging banking system consolidation, which is vital for enhancing banks' business efficiency, diversifying their business and encouraging a more rational use of liquidity;
- Increasing the share of ruble-denominated liabilities in total banking liabilities and mitigating the risk of non-repayment of FOREX loans owing to ruble stabilization.

Additionally, a sudden switch to the cheap money policy is fraught with the following risks:

- Structural problems will continue until public resources are exhausted, signifying that the existing imbalances will last for the next 1-2 years and increase in scale by at least 1.5 times;
- The most efficient businesses and projects will not be selected, which will encourage growth of potentially bad debts;
- The ability to repay foreign loans will be undermined owing to continuing devaluation;
- Savings in the non-financial sector, especially the ruble-denominated segment, will decline.

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

	12.05	12.06	03.07	06.07	09.07	12.07	03.08	06.08	09.08	12.08	01.09
Assets (R bln)	**9696**	**13963**	**15516**	**17113**	**18131**	**20125**	**21323**	**23059**	**24572**	**28022**	**29757**
Cash and precious metals	2.7	2.6	1.8	1.8	1.9	2.5	1.9	2.0	2.0	3.0	2.6
Accounts with the Bank of Russia	7.3	7.5	8.0	10.9	6.1	6.9	5.1	5.8	4.2	7.5	7.4
Interbank transactions	6.3	5.8	5.4	5.3	4.7	5.4	6.2	5.9	4.8	5.2	5.0
Foreign assets	9.1	9.9	11.5	8.4	10.0	9.8	10.8	9.9	12.2	13.8	14.8
Households	12.1	14.7	14.4	14.9	16.0	16.1	16.4	17.0	17.8	15.5	14.6
Corporate sector	47.0	45.3	44.8	45.0	47.2	47.2	48.8	49.1	49.0	44.5	44.6
Government	6.6	5.2	5.0	4.7	4.1	4.1	3.3	3.4	3.0	2.0	1.9
Property	2.4	2.4	2.4	2.3	2.2	2.2	2.2	2.1	2.1	1.9	2.1

Source: Bank of Russia, CSI Bank of Moscow.

Selecting the key parameters of monetary policy, taking into account their impact on the Russian banking system and the economy as a whole, is complicated by a controversial combination of tasks and threats. These tasks and threats are associated with ensuring financial stability and mitigating the production slump. The key tasks are to provide financial backing for production activity and to address the growth of overdue debts, a problem that may be resolved only by providing increased and less costly financing to the real sector. Strengthened control and increased competition on commodity markets could help keep the ruble stable and bring down inflation.

Forecast of key economic indicators

	Actual				Forecast		
	2005	2006	2007	2008	2009	2010	2011
Macroeconomic indicators							
Nominal GDP:							
R. trln	21.6	26.9	33.1	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
Monetary Aggregates							
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
Inflation							
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
Budget							
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
Balance of Payments							
Exports of goods, $ bln	244	304	354	469	280	290	320
Imports of goods, $ bln	125	164	223	293	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	426	305	261	223
External Debt							
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
Exchange Rate							
R/$:							
end of period	28.8	26.3	24.6	29.4	36.5	39.0	41.0
year average	28.3	27.1	25.6	24.8	36.0	38.0	40.0
Exogenous Parameters							
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, Bank of Russia, Russian MOF, CSI Bank of Moscow forecast.

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