Bank of Moscow

Economic Monthly

May 2009

Future Strategy Today

Center of Strategic Investigations

CONTENTS

Bank of Moscow

Bld. 3, 8/15 Rozhdestvenka str.,
Moscow 107996, Russia

www.mmbank.ru

Center of Strategic Investigations

Vedev Alexey
Vedev_AL@mmbank.ru

Uncertainty and scale are the essential characteristics of today's global economic crisis, which has frightened everybody, from state officials to businessmen and households. The questions of how long it will last, how severe the impairment of assets and the slump in production volumes and sales will be, and how all of this will affect savings and investment activity loom large.

A great deal of analytical effort is now being devoted to investigating the "bottom" of the crisis. Investors are trying to identify the bottom for stock indexes below which share prices should not fall. Those operating on the debt markets are busy estimating the yield benchmark above which the bonds of the largest companies should not climb. Analysts of the banking sector have focused on forecasting arrears, bad debts and methods to write them off. The real sector is attempting to identify the low point of the slump for various sectors and the maximum contraction for investment programs. Finally, macroeconomic experts are providing regular estimates of potential unemployment levels, the decline in household real income and the budget deficit.

Identifying the bottom would provide a reference point for new (or revised) strategic planning. Traditionally, a crisis not only forces a government to address the resulting repercussions, but also sharpens the need to resolve structural problems neglected during previous years of growth.

The anti-crisis strategies we have seen, which range from state policy initiatives to proposals from various business associations, have much in common. All seek to minimize the negative effects of the downturn, while none assess the current position of the Russian economy or identify structural problems and ways to address them in the context of elaborating future development strategy.

The task of crisis mitigation, primarily for the public at large, resembles a populist response by the government (in a positive sense). The Russian authorities' desire to use the resources accumulated during the boom years to cushion the blow from the crisis and await a new uptrend in raw materials prices is quite understandable. Unfortunately, such an approach will not resolve the issues of the low efficiency and competitiveness of Russian companies and banks, and can only be used for as long as resources are available.

A proper development strategy must take into account the major lessons from the Russian economy's overheating between 2006 and the first half of 2008: an increase in gross economic indicators is not necessarily evidence of qualitative economic growth (i.e. the kind that is resistant to external shocks and based on increasing competitiveness). The major pitfall is that the priority of promoting innovation will remain only declarative in nature, not only now, but in the post-crisis period as well. This may very well occur if no analytical effort is made to develop a future strategy today and assure its implementation in the future.

Monetary sector

Strategic development issues of the Russian financial system in the current environment

Among the most responsive sectors, the banking system and financial markets were the first to face the repercussions of the global crisis. The depth and direction of the downturn in these sectors allows one to forecast the implications for other sectors of the economy – industry, the budget and households. The current anti-crisis programs seem to underestimate the increased significance of the financial sector for the development of the broader economy. Russia's banking system plays a key role in the national economy, addressing such issues as sustaining financial transactions, the accumulation of savings and the provision of loans and banking services. Moreover, the role of bank loans has increased substantially in recent years.

Strategic issues involved with development of the financial system cannot be confined to conditions within the banking sector alone, but must also be incorporated as much as possible into development tasks affecting the entire economy. The banking system should contribute to overcoming the crisis and, at the same time, adjust to fit the conditions in the renovated economy once the next stage of growth occurs. In this context, the following strategic tasks must be resolved:

- mitigating the repercussions of the crisis and facilitating the recovery of economic growth;
- resolving the structural problems accumulated during the period of overheated growth; and
- developing a post-crisis development strategy and parameters.

Crisis mitigation

The key stabilization measures and proposals are centered today on the top priority problems, such as ensuring stability in the banking system and capital adequacy, reining in growth in overdue debts and providing ways to restructure bank loans to companies. These and other objectives incorporate two sets of issues – sustaining normal and uninterrupted functioning of the financial system, and contributing to a recovery in growth throughout the economy.

A) Survival issues – sustaining normal functioning of the banking system

The key tasks in this area are to:

– sustain smooth settlements between enterprises;

– avoid a panic among bank depositors; and

– prevent bankruptcy and defaults on banks' domestic and foreign debts (or at least avoid a disorderly settlement process while ensuring normal functioning of the banking system).

Russia's monetary authorities seem to appreciate the importance of these issues and are acting quickly (a good example is VEB's involvement in repaying foreign debts). State financing was swiftly provided to Russia's largest banks (albeit, mainly to those with state ownership) and companies. The need to sustain the normal functioning of the financial system laid the groundwork for smooth depreciation of the ruble (unlike the sharp devaluation in Kazakhstan, for instance), the expansion of refinancing of the banking system in late 2008 and the preservation of collateral-free lending.

We can reasonably expect the monetary authorities to stick to their adopted stance, at least this year. Therefore, sharp depreciation of the ruble, bankruptcies among major banks and any significant defaults are unlikely. It is even possible that if the bad debt problem was to worsen further, the government would sacrifice its fight against inflation by lowering the refinancing rate and expanding the money supply.

B) Support issues – facilitating recovery in economic growth

The impact of the Russian banking system on economic growth became much stronger over the past three years. In 2005, the banking sector accounted for 20% of the expansion of total demand, but this figure rose to 34% in 2007. To a considerable extent, bank loans satisfy consumption and, to a lesser degree (11%), fixed capital investment. This year, support for domestic demand – now a key task in the government's anti-crisis strategy and other proposals – will substantially depend on development of the banking system.

In 2008, total banking assets rose 40%, which is slightly below the levels in prior years (44% in both 2006 and 2007). The key growth drivers for Russia's banking sector last year were financial support from the state and ruble devaluation. Without their impact, the Russian banking system would have grown a mere 18% – the worst result for the past decade. In 2009, growth in banking assets unsupported by the state may settle at 11% (below the most optimistic inflation forecasts of 13%). Meanwhile, corporate loans are not expected to grow by more than 13%. Thus, economic recovery is clearly out of the question this year and, given the mounting arrears, the financial deficit in the real sector will grow alarmingly.

The volumes of state support to the banking sector in 2009 will depend not on the size of accumulated savings in the respective state funds (general consensus), but also on the parameters of monetary policy. The irony lies in the fact that the available financial resources cannot be channeled to underpin the banking sector without also undermining financial stability. Hence, the scope of state financing to the banking system will be rather limited this year so as to sustain moderate inflation (below 15%) and stability of the ruble exchange rate. For this to occur, the money supply (broad monetary base) should not grow by more than 3-12% this year. Considering the expected $100-110 bln decrease in Russia's international reserves, the money supply can be expanded by only 10% of GDP without stoking inflation.

This 10% of GDP monetary stimulus is allocated between the federal budget deficit and refinancing of the banking system. In the current budget plan, the deficit is set at 8% of GDP and the CBR's volume of refinancing of the banking system is R0.2-1.5 trln, which means that the volume of refinancing for private commercial banks will range between R100-300 bln.

Sources of money supply, R trln

	2008			2009			
	Year	Jan-Aug	Sept-Dec	Monetary base growth of 3.5%		Monetary base growth of 12%	
				Deficit 8% (R3 trln)	Deficit 10% (R4 trln)	Deficit 8% (R3 trln)	Deficit 10% (R4 trln)
Change in broad monetary base	**0.07**	**-0.15**	**0.22**	**0.2**	**0.2**	**0.7**	**0.7**
including:							
change in CBR's net international reserves	-1.36	2.70	-4.06	-4.0	-4.0	-4.0	-4.0
change in net domestic assets	1.43	-2.85	4.28	4.2	4.2	4.7	4.7
change in gross lending to banks	3.79	0.12	3.67	0.0	-0.8	0.5	-0.3
bank's forex deposits in CBR	-0.76	0.00	-0.76	1.0	1.0	1.0	1.0
change in net lending to government (loans minus account balances)	-1.49	-2.80	1.31	3.2	4.0	3.2	4.0
other factors	-0.11	-0.18	0.07	0.0	0.0	0.0	0.0

Source: CBR, CSI Bank of Moscow.

Most anti-crisis strategies are built on proposals to support stability in the banking sector and financial markets while expanding lending to companies. Leaving aside their substance and adequacy, the critical issue is the source of this lending – all of the proposals are based on federal budget expenditures and expansion of refinancing by CBR. In this context, the table above offers scenario-based outcomes:

– Despite the substantial amount of financial resources accumulated by the state, these funds cannot be spent in excess of the monetary program parameters. CSI Bank of Moscow shares the view that high inflation is caused not so much by monetary factors, but to a greater degree by the weakly competitive environment in commodity markets, ruble depreciation and growth in tariffs for natural monopolies. However, expanding the money supply today (other things being equal, the struggle with inflation is nowhere in sight) will only stoke price growth.

– The 2009 estimate of "inflation-safe" spending of financial resources accumulated by the state is 10% of GDP (assuming that CPI runs at 15% this year). If this level is exceeded, inflation will pick up, other things being equal (a competitive environment will be not be created, ruble depreciation is already a fact and the tariffs of natural monopolies will not be revised in principle), despite the available state resources. These state funds will be allocated to finance the federal budget deficit and refinance the banking system. The priority of the budget is apparent and support for the banking sector, despite the monetary authorities' assertions, will be based on the "leftovers".

– State spending targets under the proposed monetary program make global financial markets inaccessible for Russian borrowers, preclude the refinancing of foreign debts and suggest a $110 bln decrease in Russia's international reserves in 2009. Any debt restructuring indicates that the state's ability to finance the budget and banking system is reduced by this amount.

– Given the low level of refinancing of the banking system, total banking assets can be expected to grow 17% in 2009. Corporate loans will increase 20-21%, which signals minimal support for current settlements rather than growth recovery within industry.

Structural problems

Structural disproportions in the financial sector, especially the Russian banking system, were accumulated during the period of overheated growth (2006-08). However, none of the anti-crisis strategies have ever identified these problems or offered approaches for their removal (even gradually). In the crisis period, these misbalances aggravate the threat to stability in the financial sector and make the anti-crisis measures more complicated and expensive.

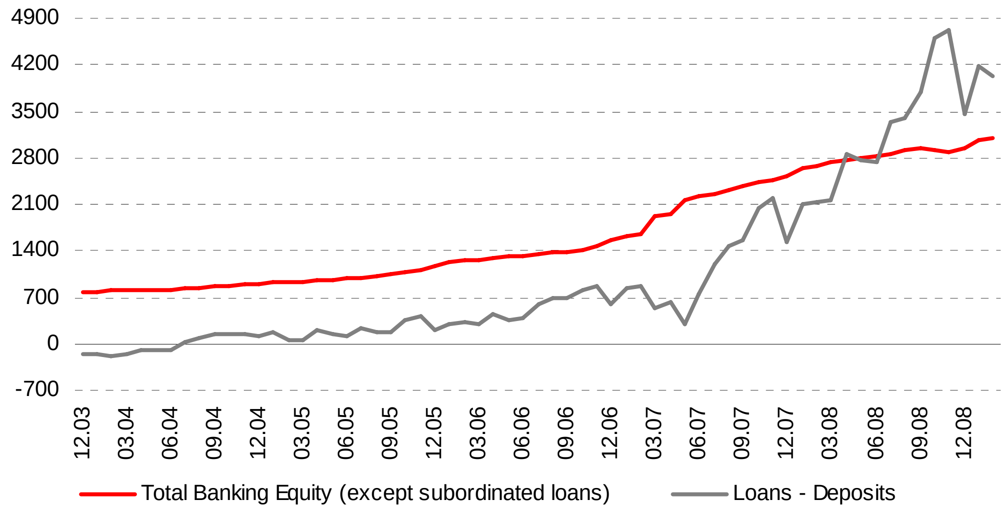
The major structural disproportions in Russia's financial sector are regularly highlighted in CSI surveys. Amid the conditions of the spreading financial crisis and the absence of appropriate measures to eliminate them, disproportions are growing to alarming levels and being exacerbated by tough monetary policy. The most dangerous aspect is that even if monetary policy is eased, the structural problems will not be eliminated. Meanwhile, radical solutions will be put off, only to then likely resurface in the post-crisis period when financial support for the real sector becomes critical during the new stage of growth. In this context, analyzing the structural disproportions and development of approaches aimed at their removal *tomorrow* is no less important than addressing the aftermath of the crisis *today*.

1. Overdue loans to non-financial sector exceed bank deposits

For the first time, loans to the non-financial sector exceeded corporate and household deposits in 2006, primarily due to the transition to growth based on expanding domestic demand. Given that the mechanism of the Stabilization Fund allowed the sterilization of growing revenues from raw materials exports, additional lending was financed with foreign loans. In mid-2008, the gap between loans and deposits in the non-financial sector exceeded the amount of all internal funds within the banking system (net of corporate bond debt to the banking sector). From that point onward, the situation spun out of control and became dependent on external financing, in the form of either foreign capital inflows or state funding.

At the beginning of 2009, the size of the "credit pit" totaled R3.5 trln, increasing by R1.9 trln y-o-y. The appearance of any shocks, such as the inaccessibility of foreign markets, outflow of depositors' funds and contraction of state support, inevitably throws the banking system off balance and triggers liquidity gyrations, payment delays and bankruptcies of credit institutions.

Gap between loans and deposits of the non-financial sector and internal funds of the banking system*



* Less subordinated loans, plus foreign currency accounts held at the CBR.
Source: CBR, CSI Bank of Moscow.

Resolving this problem is easier said than done, as it is necessary to fill the gap. One way to do so would be to slow the growth in lending and/or savings. We can already expect a sharp slowdown in consumer loans, and even their contraction in absolute terms. This measure would also help restore the accumulation model of household consumption, which will eventually boost household savings.

We can reasonably expect an increase in savings by large and medium-sized companies due to high risks in the economy, the rising cost of bank loans and their curtailed accessibility. The role of bank loans in financing fixed capital investment, already low within this group of companies (about 10%), will become negligent. At the same time, the role of mutual lending among companies and the use of money substitutes will again grow.

Finally, it is necessary to expand lending to small and medium-sized enterprises. This group critically depends on the availability of financial resources and can respond fast to the changing environment while acting as a driver of growth, inter alia, in the field of innovation as well. Moreover, the investment projects of small businesses are rather short term and moderate in scope, which will help ease the pervasive demand for long money in the Russian economy.

2. Segmentation of the Russian banking system

Segmentation of the Russian banking system (i.e. the growing differences between major banks mainly controlled by the state and foreign banks, on the one hand, and medium-sized and small banks, on the other) is demonstrated in:

– different requirements for liquidity levels (to underpin stable functioning of credit institutions);

– different access to external financing (in terms of price and volume);

– different access to domestic finances;

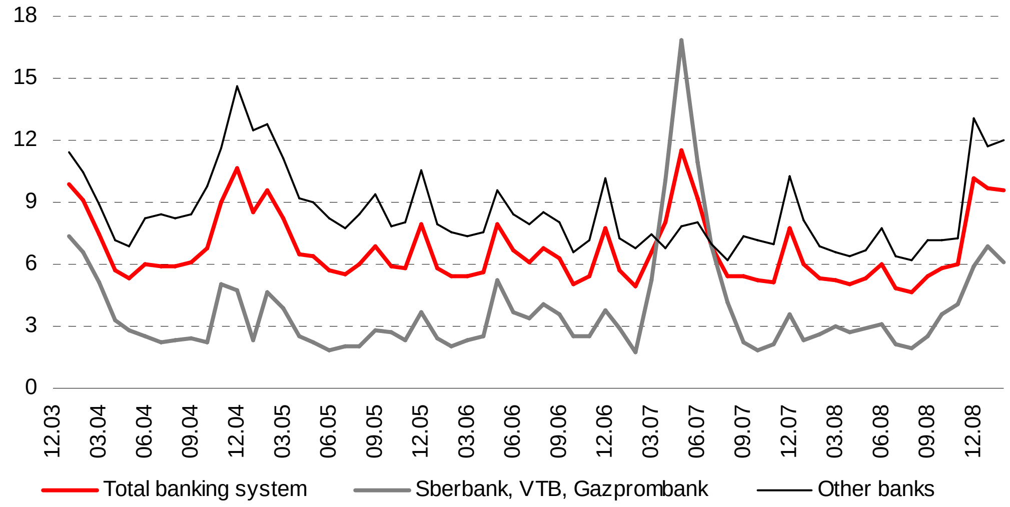
– cost of liabilities relating to domestic demand; and

– different policies for asset and risk management.

During implementation of the anti-crisis measures, the Russian government viewed the banking sector as a single segment. As a result, the efficiency of state support turned out to be far less than expected. The resources allocated by the state were used to replenish banking sector liquidity and boost growth in foreign assets (partially for repayment of foreign debts), and only a small portion was actually provided to companies.

To sustain stability, it is crucial to determine the "*normal level of liquidity*" in the banking sector. Statistical analysis of this indicator over the past ten years shows that it should total 5-6% of assets and that the largest state-owned banks have lower liquidity owing to their scale and business diversification, as well as the degree of client confidence (2-3% of assets).

Movements in liquid assets by bank group, % of assets



Source: CBR, CSI Bank of Moscow.

Big private banks (i.e. those without controlling interest held by non-residents) can sustain liquidity at a level of 5-7% of assets, medium-sized banks at 8-12% and small banks at 10-15% and above, depending on their size, market environment and development strategy. On the eve of the crisis (autumn 2008), medium-sized and small banks (below the top 100) accounted for one third of liquid assets and only 14% of total banking assets. Therefore, the liquidity excess brought about by this segment of the banking system can be estimated at 20% of its total volume. Russia's monetary authorities should bear in mind that their toughened monetary stance has led to a liquidity crunch among small and medium-sized banks.

3. Efficient relationships between enterprises and banks

Since 2004, Russia's banking system has resolutely stepped up its level of foreign borrowing. On January 1, 2004, private foreign debt amounted to $80 bln, but by January 1, 2008 it had zoomed to $417 bln (over fivefold growth). Russian banks compensated the deficit of financing through foreign borrowing *with a substantial excess*. This surplus transpired in a concurrently increasing outflow of capital (increase in foreign assets) and rising bank deposits with the CBR. The supposition that gross capital outflow was growing in proportion to gross capital inflow is not borne out in the data (if that were true, then we could speak about outward foreign investment). In actuality, we faced a bleak picture reflecting the risks and structural problems of the banking sector. For example, *only 15-25% of total foreign investment in 2005-2007 was channeled into loans to the non-financial sector*, whereas the remaining part could be traced to capital outflow and swelling accounts with the CBR. In essence, the growth rates demonstrated by the Russian economy could have been achieved with one fourth of the actual growth in foreign debt.

The problem of how to repackage corporate debt to the banking sector (when private foreign debt is restructured as debt to the state) is still outstanding. The efficient use of state funds aimed at spurring a recovery in growth is critical. Bank loans were traditionally used by companies mainly to finance their current production activities. If the sector's loan portfolio does not change (its main distinction today is the tiny share of loans to small and medium-sized enterprises), expanded bank lending will underpin current consumption, but its contribution to laying the basis for future economic growth will be insignificant.

Course of post-crisis development

Measures to stabilize production volumes and bolster domestic demand are the centerpiece of the currently proposed anti-crisis strategies. However, none of them discuss the key direction of economic policy aimed at achieving a new quality of growth, reducing dependence on raw materials, boosting the competitive edge of Russian industry and enhancing the innovative component. What is included is a declarative promise to adhere to the priority tasks of the government's long-term economic program (until 2020). However, this program will now have to be implemented in a radically changed environment, including the financial sector. The parameters of the new financial system should meet the goals and tasks of the country's long-term development and assist in their resolution rather than dampen growth and heighten risks.

The key direction of the banking system's post-crisis development will be determined by the new financial and economic setting, as well as the lessons from its development in the past. Although it is difficult today to determine the configuration of the new financial system, the experience of Russia's banking system gained over the past ten years suggests some conclusions. It is important to develop a medium-term development strategy for the national banking system not only on the basis of global experience, but also on the successes and mistakes of the preceding growth period, primarily the overheated growth cycle of 2006-07.

Evaluation of the results of banking system development in 2006-07 shows that the overheated growth was accompanied by an accumulation of threatening structural disproportions. Various external shocks (both positive, associated with large-scale foreign capital inflow and growing export revenues, and negative, triggered by the global crisis) only exacerbated the structural crisis, adding to volatility on financial markets, instability in the banking system and the cost of anti-crisis measures.

The retrospective forecast for 2006-07 prepared by CSI Bank of Moscow reflects the potential development of Russia's banking system and economy in the same external conditions but with a preserved balance between savings and loans of the non-financial sector as the key financial policy target. We elaborated a scenario under which the economy is growing without overheating of the financial sector.

Major growth rates of Russia's financial sector, %

	Actual			Balanced scenario		Actual/ Scenario	
	2005	2006	2007	2006	2007	2006	2007
Household deposits	35.17	36.35	35.01	36.41	34.95	-0.05	0.05
Corporate deposits	37.91	44.90	52.33	37.24	37.40	7.66	14.93
Consumer loans	90.54	75.29	57.04	60.00	50.00	15.29	7.04
Corporate loans	30.85	38.53	50.43	32.09	36.52	6.44	13.91
Broad monetary base growth	23.36	41.38	33.96	35.62	24.95	5.76	9.01
M2 growth	36.70	48.78	41.49	44.63	33.45	4.15	8.05
Banking assets	36.00	43.69	44.22	34.46	34.88	9.23	9.34
Banking assets, as % of GDP	43.32	50.26	58.84	47.03	51.49	3.23	7.34
GDP growth rates	**6.4**	**7.4**	**8.1**	**6.7**	**6.1**	**0.7**	**2.0**

Source: CBR, CSI Bank of Moscow.

Our estimates indicate that a balance between loans and savings of the non-financial sector could have been achieved through slower growth in corporate loans in 2006 and 2007 (by 32% and 37%, compared with the actual figures of 39% and 50%, respectively). Growth in consumer loans would have been 10 pp lower and the overall increase in banking assets 9 pp lower. As a result, expansion of total domestic demand would have contracted and GDP growth declined to 6.7% in 2006 (versus the actual 7.4%) and 6.1% in 2007 (8.1%).

Despite a certain slowing of GDP growth, the financial system's parameters would have remained more balanced, especially in the context of the global crisis. Private foreign debt would have totaled $250 bln in early 2008 (compared with the actual $417 bln), and Russia's international reserves would have been only $60 bln less than the actual level. Importantly, this scenario suggests slower growth rates for the money supply, which would have helped combat inflation (in actuality, sharp acceleration occurred starting in mid-2007).

We can reasonably assume that the above estimated percentage points sacrificed for the sake of greater stability would have trimmed the current costs of crisis liquidation and helped achieve higher economic growth rates.

Russian foreign debt and international reserves, $ bln

	2005	2006	2007
Actual			
Foreign debt	175.1	261.9	417.2
Banks	50.1	101.2	163.7
Companies	125.0	160.7	253.5
Russian international reserves	182.2	303.7	476.4
Balanced scenario			
Foreign debt	175.1	229.1	251.5
Banks	50.1	68.4	82.7
Companies	125.0	160.7	168.8
Russian international reserves	182.2	295.1	408.5

Source: CBR, CSI Bank of Moscow.

Obviously, following the financial crisis, a new direction for economic growth must be determined. The most rational one would involve a model combining the advantages of fast growth with stability and resistance to external shocks. Ideally, this economic growth should not entail structural disproportions, but instead improve the structure of institutional financial flows, implying the ability of the country's financial sector to ensure smooth growth.

Real sector

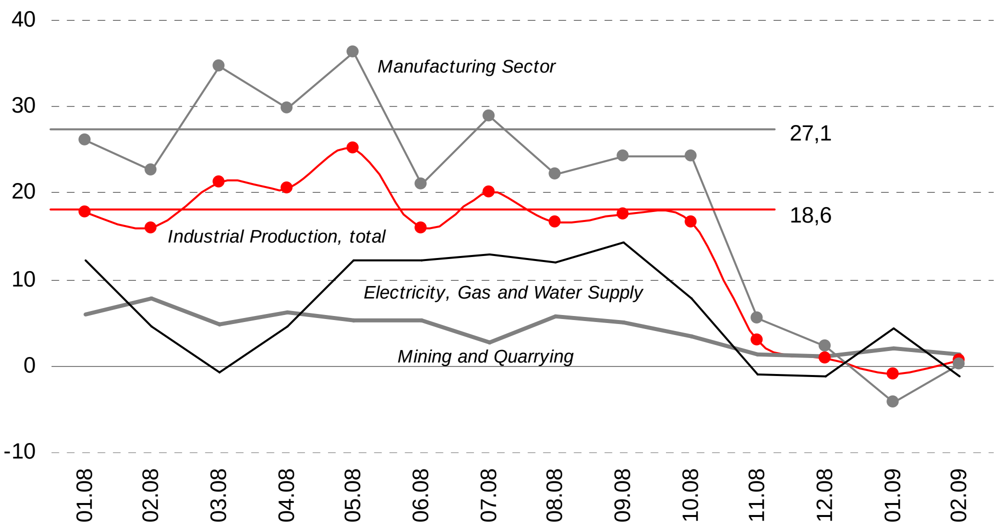
Looking for the "bottom" – but more questions than answers

Industrial output dropped 13.2% y-o-y in February 2009 and 14.6% y-o-y over the first two months of the year. Contraction of industrial production volumes has been registered for four consecutive months. An opinion has been voiced increasingly of late that the bottom of the slump has been reached and the priority task now is to resume economic growth. In this context, a question arises about how deep this "bottom" actually is and what resources are available for Russian industry to embark on a path of growth recovery.

Assessing the depth of the potential fall requires determination of the base year. We assume that 2005 can be taken as a base year, as this was the last year of the growth cycle (2001-05) that demonstrated balanced growth. During this period, oil prices were rising within a range of $25-50/bbl. There was a net capital inflow to the country, albeit rather moderate. Overall, in 2001-05, net capital inflow to the banking sector totaled $23.5 bln, equaling the capital inflow in 2006 alone. It is important to note that bank savings by the non-financial sector exceeded the amount of corporate and consumer loans. Balanced growth in 2006 gave way to accelerated growth fueled by spikes in oil prices and export revenues amid large-scale borrowing on the global financial market. Such accelerated growth led to financial disproportions, the consequences of which impact both the banking and real sectors. Hence, the year 2005 is, in a certain sense, a "pre-crisis benchmark" characterized by moderate oil prices and mild capital inflows.

During January-October 2008 (until November 2008, when industry for the first time demonstrated output contraction on an annual basis), industrial output steadily outperformed the levels observed in the respective months of 2005 by 18.6%. Growth in output of the mining and quarrying sector totaled 5% *over three years* and more than 27% in the manufacturing sector.

Industrial output growth versus respective month of 2005, %



Source: Russian Statistics Service, CSI Bank of Moscow.

This means that over the course of three years (up until the moment of dramatic deceleration and subsequent slump), Russian industry was growing at a rate of 6% per year alongside an annual 8.3% increase in output of the manufacturing sector.

The sharp and painful "landing" that followed vindicated the repeated warnings of unstable growth based on external positive shocks – high world prices for energy-producing materials and foreign capital inflows. With the removal of these shocks from the scene, industrial production instantly returned to the 2005 level that marked the end of the balanced growth period.

Therefore, if we consider the level to which industrial production dropped in the past few months to be “the bottom”, this would be equivalent to the production output of 2005. More precisely, industrial output in early 2009 exceeded the respective monthly production volumes of 2005 by less than 1%.

If we look at the production volumes of 2005 as a forced industrial production benchmark for the coming months, the calculations confirm the Russian government’s view that we have passed the bottom. Indeed, if the basis for comparison is 2005, then we can expect the further decline in output (versus the respective months of 2008) to be less severe than in January-February.

The assumed benchmark bottom of the slump in industrial production allows us to assess the scale of production contraction in 2009 if this downtrend is not reversed. This contraction can be viewed as a zero level above which improvement can be attributed to successful implementation of anti-crisis measures to boost the Russian economy.

By our estimates, if the trends that transpired at the beginning of year persist, then the slump in output in 2009 may total 12.4% y-o-y (in January-February, industrial output declined 14.6% y-o-y). Inertial contraction of Russian industrial output may lead, on an annual basis, to a decrease in mining and quarrying of 2.7% year on year (versus 4.5% in January-February) and a 5.4% decline in the electricity, gas and water supply sector (6.4%).

Industrial production output growth in 2006-08 and projected 2009 performance provided output remains at the “bottom” level, %

	Actual growth on a year ago (versus respective period of prior year), %				Projected growth in 2009, %	
	2006	2007	2008	Jan-Feb 2009	versus 2008	versus 2005
Industrial production, total	**6.3**	**6.3**	**2.1**	**-14.6**	**-12.4**	**1.0**
Mining and quarrying	2.5	1.9	0.2	-4.5	-2.7	1.8
Manufacturing	8.3	9.5	3.2	-21.0	-17.2	1.3
Final demand sectors	8.3	5.9	1.4	-10.0	-6.2	9.2
Investment demand sectors	10.2	14.3	2.4	-33.9	-25.1	-3.4
Intermediate demand sectors	8.8	4.2	0.6	-22.5	-15.9	-4.1
Electricity, gas and water supply	4.9	-0.2	1.4	-6.4	-5.4	0.5

Source: Russian Statistics Service, CSI Bank of Moscow.

The slump in the manufacturing sector may exceed 17%, with the maximum downward pressure (-25%) borne by the investment demand sectors. Output in the interim demand sector may shrink by nearly 16% y-o-y and in the final demand sector by 6% y-o-y.

By all evidence, the industrial slump has bottomed out and is expected to be less severe in future periods. The output level registered in recent months can be viewed as a bottom against which future growth in industry will be measured and that approximates industrial volumes seen in 2005. If output continues at the bottom level until end 2009, then industrial output may drop 12.4% versus 2008 and the decline in the manufacturing sector my reach 17.2% y-o-y.

In the context of the country’s current financial and economic environment (characterized by factors such as dwindling household incomes, contracted consumer lending and suspension of investment projects), the government’s anti-crisis measures aimed at boosting demand are the only conduit through which to revitalize growth in industry. The production slump will undoubtedly be mitigated by an increase in state purchases, support for investment programs implemented by state companies, stimulation of consumer demand through subsidized purchases of certain products, allocation of credit facilities to the banking system for targeted financing of companies and the issuance of state guarantees. The positive effects from the anti-crisis measures will be manifest in a milder than expected contraction of industrial output, and their efficiency will be measured in terms of the price paid for this result.

What we can say now with certainty is that in early 2009, industrial output hit the mark preceding the recovery of growth driven by fueled demand. But today, industry will be growing in much more challenging conditions, and not only due to the global economic crisis that has shaped the environment in which Russian industry will be trying to resume its growth, the low level of demand on global markets or pessimistic forecasts of capital inflow. *The problem is the tougher domestic setting* – excessive growth in costs, low labor productivity, and competition with and dependence on imports.

Over the past four years, prices for products of manufacturing industries operating in the investment and final demand sectors soared by nearly 50% (February 2009 versus February 2005). Consumer prices rocketed by more than 53%. The dollar exchange rate relative to the ruble appreciated by approximately 25% (27.4% in February 2009 versus 2005 and 25.6% in March). These figures spell out *less comfortable price conditions for Russian finished products versus imports*.

Production costs also grew considerably. For instance, over these four years, the average monthly salary rose by more than 2.3 times, while producer prices in the electricity, gas and water supply (heat power) sector grew 63%. Naturally, the excessive growth in costs implies a lower level of corporate profitability. Furthermore, *higher utility and labor costs are creating unfavorable conditions for the start-up of new businesses and are less attractive for foreign investors.*

That said, *a number of modern industrial companies created* on the basis of existing production facilities or from scratch are the result of investment activities in prior years and are the undoubted advantage of today's industry. However, the modernization period for such enterprises either ended just before the outbreak of the global crisis or was interrupted by the deficit of financing. Contracting demand and debt on loans raised for modernization purposes make these strategically important companies particularly vulnerable. The viability of such enterprises decreases due to the weakening ruble, as modern technologies require materials and components that are currently not produced in Russia. The high dependence on imports of Russia's most competitive businesses *exacerbates the collision of managed devaluation of the ruble,* the depreciation of which supports traditional Russian producers in competition with imports on the domestic market, exporters and the budget while aggravating the current situation and prospects of companies that have managed to complete their modernization.

Depreciation of the ruble can be viewed as an additional resource for an upturn of growth in industry owing to the rising profitability of exports and the import substitution effect. However, export growth in the near term will be constrained by contracted demand in global commodity markets. On the other hand, import substitution has now been practically exhausted by Russian industry following the almost fourfold depreciation of 1998. Domestic goods indeed squeezed out some imports from the Russian market, but those were products that are not manufactured with the use of advanced technologies. The ruble's latest depreciation versus the dollar was less dramatic, at approximately 25% of the 2005 level, or by one third versus the July 2008 level. In conditions of contracting demand, lukewarm competition on the Russian commodity market and the absence of resources to modernize the production base (for manufacturing of products that can substitute for imports), the advantages of the recent devaluation will be mostly translated by producers into price growth, and only a tiny share will be directed to output and market expansion.

Given the current technological level of Russian industry, it is practically impossible to realize most of the advantages provided by the devaluation, especially as regards high-precision and power equipment, pharmaceuticals, etc. The organization of certain production processes requires not only substantial volumes of resources, but also long-term project implementation. Therefore, the instant effect from import substitution (due to the devaluation of 2008-09) should be very feeble, and the medium-term impact (associated with innovation processes) is not obvious.

Therefore, the growth cycle in Russian industry will objectively start in worse conditions than the previous one, which was underpinned by foreign capital inflows and high oil prices. The new (assumed and expected) growth will be largely sustained by resources accumulated by the state in prior years. Despite its many weak points, the previous growth cycle provided businesses with clearer market signals of demand and the competitive standing of manufactured products than can be expected today or in the near future.

Measures with a weak market focus to pull industry from the “bottom” pose a number of critical questions: How sustainable, durable and intensive will this growth be, and what is the price? How long will financial infusions and other methods of government stimulation of the economy be the principal measures, how long will the resources accumulated by the government last, and when can we expect a response from Russian and foreign investors? Finally, how effective will the selected vector of the anti-crisis measures be from a strategic standpoint, and what is the target configuration of Russian industry and the economy as a whole?

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	41.7	41.3	48.0	55.8
$ bln	764	993	1 293	1 680	1 179	1 263	1 394
Real GDP, % y/y	6.4	7.4	8.1	5.6	-3.4	2.6	2.8
Industrial production, % y/y	5.1	6.3	6.3	2.1	-9.0	1.0	3.0
Retail turnover, real, % y/y	12.8	13.9	15.2	13.5	-4.0	2.0	4.0
Gross fixed investments, real, % y/y	10.9	13.7	21.1	9.8	-12.0	2.0	4.0
Exports, real, % y/y	6.5	7.3	6.4	11.8	-6.8	5.5	3.8
Imports, real, % y/y	16.6	21.3	26.6	23.3	-32.6	4.3	7.4
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	1.4	4.6	11.7	12.4
M2X (year end), % y/y	36.3	40.6	44.2	14.3	10.8	15.5	15.5
Total banking assets, % GDP	44.8	51.9	60.8	67.3	79.5	83.1	88.4
Inflation							
CPI (year end), %	10.9	9.0	11.9	13.3	15.5	11.0	10.0
CPI (year average), %	12.5	9.8	9.1	14.1	14.0	13.0	10.5
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	22.2	16.2	15.5	15.4
Federal budget expenditures, % GDP	16.3	15.9	18.1	18.1	23.5	19.5	18.4
Federal budget balance, % GDP	7.5	7.4	5.4	4.1	-7.3	-4.0	-3.0
Reserve fund, year end, $ bln	43.0	89.2	156.5	137.0	44.4	30.6	34.2
National wealth fund, year end, $ bln				74.3	57.4	43.6	31.1
Balance of Payments							
Exports of goods, $ bln	244	304	354	470	290	320	340
Imports of goods, $ bln	125	164	223	290	200	210	240
Current account, % GDP	11.0	9.5	5.9	6.1	2.7	2.9	2.2
Net capital inflow/outflow, $ bln	2.0	41.9	82.8	-133	-113	0	20
International reserves, year end, $ bln	182	304	479	427	321	348	392
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	35.0	38.0	40.0
Exogenous Parameters							
Urals, $ p/bbl	50.4	60.9	69.6	94.4	48.0	50.0	53.0
$/€	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.

Center of Strategic Investigations Bank of Moscow

Vedev Alexey

Vedev_AL@mmbank.ru

Berezinskaya Olga

Berezinskaya_OB@mmbank.ru

Kovaleva Marina

Kovaleva_MA@mmbank.ru

Kosarev Andrey

Kosarev_AE@mmbank.ru

Khromov Michael

Khromov_MY@mmbank.ru