Bank of Moscow

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At the Bottom

Center of Strategic Investigations

CONTENTS

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Center of Strategic Investigations

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In early September, Russia's economic ministers presented optimistic estimates signaling the end of the recession and emerging conditions for recovery. Growth in y-o-y terms is expected to occur as soon as 3Q09, while the forecasts for 2010 also look promising, with GDP projected to increase 1.6%.

Production and investment improved in June-July thanks to oil prices bouncing back to $70/bbl, a level that suits both raw materials exporters and the budget. The global economy also showed some signs of revival, contributing to a rebound in Russian exports. As the problem of private foreign debt has been successfully resolved through restructuring, the external environment is becoming more favorable for Russia. The economic performance in June-July suggests that a new growth model is shaping in the Russian economy based on beneficial changes in the global economic environment.

The weak link in the emerging growth model is fading domestic demand. On the one hand, its major component – household income – continues to fall. On the other, declining investment activity amid conditions created by "dear money" policy cannot be underpinned by bank loans or internal corporate funds due to drastic deterioration in financial performance. The role of the budget in stimulating domestic demand is limited in both cases. Therefore, production activity and domestic demand are moving in opposite directions, while the stability of growth is becoming more vulnerable to the external environment than a couple of years ago.

Most experts expect the world economy to emerge from recession next year. However, we believe that the recovery will be gradual and protracted. This transpiring model will leave the Russian economy lingering at "the bottom" for a long time, laying the groundwork for stagnation and eventual recovery. According to official estimates based on the new growth model, Russia's economy will reach pre-crisis levels by end 2012. However, this seems an ambitious goal given the current volatility of growth.

Economic policy

Supporting growth recovery

According to the final update of the government's medium-term forecast (presented by the Economics Ministry in late August), GDP is expected to drop 8.2–8.5% this year. In the medium term, a mild economic upturn is expected, facilitating a rebound in the economy to pre-crisis levels by end 2012. To a certain extent, growth is expected to be supported by beneficial external factors and state support measures.

Russia is likely to achieve development in response to the beneficial external backdrop. First, oil prices have settled at $60–70/bbl, which seems quite acceptable for Russian producers (in 2006 and 2007, the oil price averaged $61/bbl and $70/bbl, spurring GDP growth of 7.7% and 8.1%, respectively). The projected upswing in the global economy in 2010 will help boost demand for Russian materials and semi-finished products. Judging by the results from 1H09, the problem of private foreign debt is being successfully resolved through restructuring and refinancing. In 2Q09, the non-financial sector, instead of $22 bln in external payments, registered a net inflow of $4 bln (gross borrowing totaled $26 bln). Payments by the banking sector totaled $8 bln instead of $13 bln. Overall, external factors can encourage recovery of the Russian economy, but at a pace of 1–3%, which is more typical for advanced economies.

The government has voiced its readiness to support expansion of domestic demand and the investment programs of natural monopolies. The scale and impact of these measures differ by sector. On the one hand, credit programs for agribusiness have proven to be a success. The share capital of Rosselkhozbank was increased by R45 bln so that it could provide loans to agribusiness and conduct purchase interventions. In the framework of support for the agricultural sector, R18 bln was earmarked to subsidize interest rates and reimburse part of expenditures relating to specific investment and short-term loans. According to data covering 7m09, output in the agricultural sector was up 0.3% y-o-y. There are some encouraging signs of subsidized lending to small business with the participation of Russia's national development bank Vnesheconombank (VEB).

On the other hand, support for the automotive industry has been a failure. In 7m09, automobile output plummeted more than 59%. The assembly line was stopped at AvtoVAZ from December 29, 2008 to January 30, 2009, August 1 to August 31 and on September 4. IzhAvto is officially recognized as bankrupt. The subsidized lending program failed to prevent shrinkage of the Russian automobile market by nearly half. The large-scale targeted support for Russian car makers was largely focused on motor industry giants and increasingly of a social nature, thereby demonstrating the exceptionally high price for having failed to tackle the accumulated competitiveness issues in a timely manner.

In general, early autumn saw stabilization of production and investment volumes, giving rise to hope for mild growth. Revival of production was mainly observed in export-driven industries. Over the past few months, domestic demand has remained firmly in a downward trend. The accelerating decline in household income pared inflation, but also pulled down retail turnover. Fixed capital investment, albeit on the rise compared with the rock-bottom performance of June, still lags behind the level observed during the first months of the year. Actually, there is a direct threat that industrial growth, buoyed by external factors, will be confronted with domestic demand constraints. The possible expansion of domestic demand against the backdrop of a stabilizing exchange rate can restart import growth and revive competition on the domestic market. In any case, final demand sectors, trade and services are likely to encounter serious growth constraints in 2H09.

Monetary policy

Dear money versus economic growth – first results in Russia

Confronted with the impact of the global financial crisis, Russia's monetary authorities faced the unenviable task of having to decide which anti-crisis measures to undertake. The choice was fraught with difficulty and controversy as, unlike in most countries, the production slump in Russia was accompanied by high inflation alongside currency depreciation. In this context, the strategic dilemma was either to promote a *tough monetary policy*, involving limited liquidity supply to the banking system at high interest rates, or indiscriminate *large-scale state support*. The dear money policy, achieved primarily through high interest rates on CBR loans and Finance Ministry deposits, was aimed at curbing inflation and stabilizing the ruble. On the other hand, this policy also offered maximum financial support to banks and enterprises (subsidies, direct financing, loan guarantees and other forms), which helped prevent the proliferation of bad debts, mitigate the slump in industrial output and spur demand, though it bore a high risk of stoking inflation.

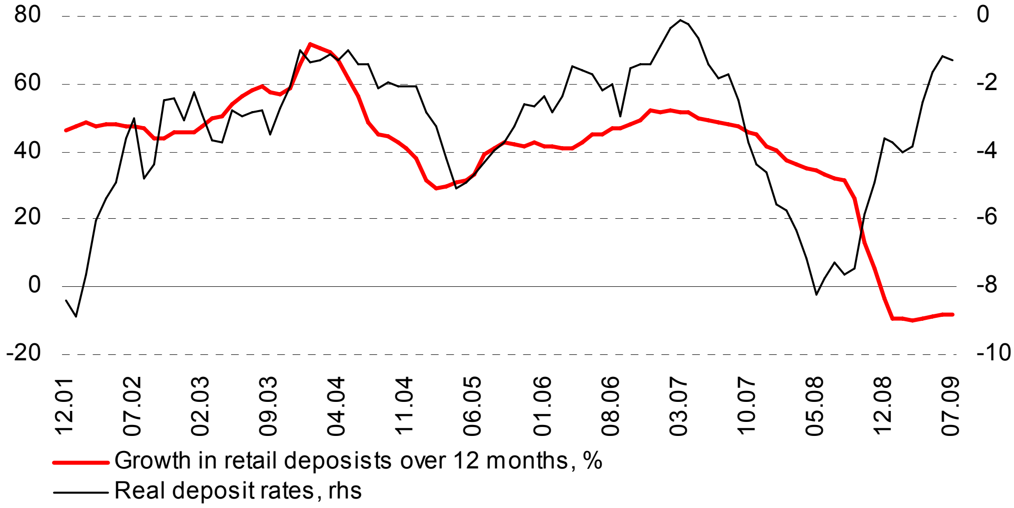
Discussion about the course of monetary policy early in the year suggested an informed choice between dear money and expansionist policies. Lowering the refinancing rate, which was persistently advocated by the banking community and the real sector, would help stimulate domestic demand and expand credit creation. The CBR and government economic authorities preferred financial stabilization to production revival. The results were swift – the ruble exchange rate stabilized and the bi-currency basket declined by 10% from its maximum level, while inflation receded to 11.7% y-o-y. However, industrial production fell 14.8% and GDP dropped 10.4% in 1H09, which are among the worst statistics registered by any country. Meanwhile, the situation involving lending and inter-enterprise settlements was so critical that most experts predicted a second wave of the crisis resulting from huge overdue debts on bank loans.

After the first signs of financial stability, the CBR began to cut the refinancing rate, but by then it was no longer an urgent step. With stabilization of banking liquidity and the interbank market, the banking system's debt to the CBR began to decrease. As of January 1, 2009, CBR loans accounted for 13% of total banking liabilities, whereas on August 1 their share had fallen to 7% and the refinancing rate is relevant only for that portion of banking sector liabilities.

By contrast, in late winter, most banks hit by funding problems raised interest rates on household deposits. Sberbank, which accounts for over half of the deposit market, set the benchmark for ruble deposits at 14–15%. Other banks were forced to at least offer higher rates, which eventually pushed them as high as 20%. Risks ballooned, and the CBR was forced by way of recommendations to constrain this growth.

The effects of this high interest policy turned out to be very poor. In past years, when real interest rates on household deposits were nearly zero (and never positive in the preceding ten years), deposits were growing at a brisk pace (up to 50–70% y-o-y). In 2009, this measure only managed to slow the outflow of deposits from the banking system: in late summer, household deposits declined 8% y-o-y versus 8% growth in ruble-denominated household deposits at the start of the year.

Real interest rates on household deposits (CPI adjusted, rhs) and y-o-y growth in ruble-denominated deposits of the banking sector, %



Source: CBR, CSI Bank of Moscow estimates.

Currently, demand for money in the non-financial sector is shrinking – in 7m09, the M2 money supply narrowed 2.8%. Overall, demand for money fairly accurately reflects the contraction in domestic demand and production activity. Cash in circulation declined 6.5% over this period, reflecting an 8.5% decrease in retail turnover.

Corporate account balances with banks provide indirect evidence of business activity. Production turnover is serviced by current ruble accounts. On August 1, this indicator was down 10.5% YTD and 12.5% y-o-y, which can be directly attributed to dwindling production volumes.

Today, most experts argue that Russia has succeeded in warding off a second wave of the financial crisis. Granted, there are some formal grounds for such optimism – liquid banking assets are climbing, interbank interest rates have settled at 5–7% and growth in overdue debts has slowed. However, preventing a second wave of the crisis does not automatically imply economic recovery. Instead, what we face now is stagnation in the industrial and financial sectors.

It became clear by autumn that the banking system was unable to underpin the expansion of domestic demand through the creation of credit. In 2003–05, mounting bank loans accounted for 20% of growth in domestic demand and in 2006–08 their share was over one third. This year, the situation looks very different. Total demand is sinking, not only because of falling incomes, but also shriveling volumes of bank loans.

Enterprises are experiencing the financial crunch, but that has not led to full-fledged demand for bank loans. First of all, profitability in the non-financial sector dropped sharply during the crisis. To be more exact, during the first six months (October 2008 – March 2009), profitability among enterprises was virtually zero (based on a corporate financial performance to turnover ratio of 0.5%). In 2Q09, it rebounded to 8.4%, but remained below the current interest and profitability levels of 2Q08, when interest rates on loans were much lower.

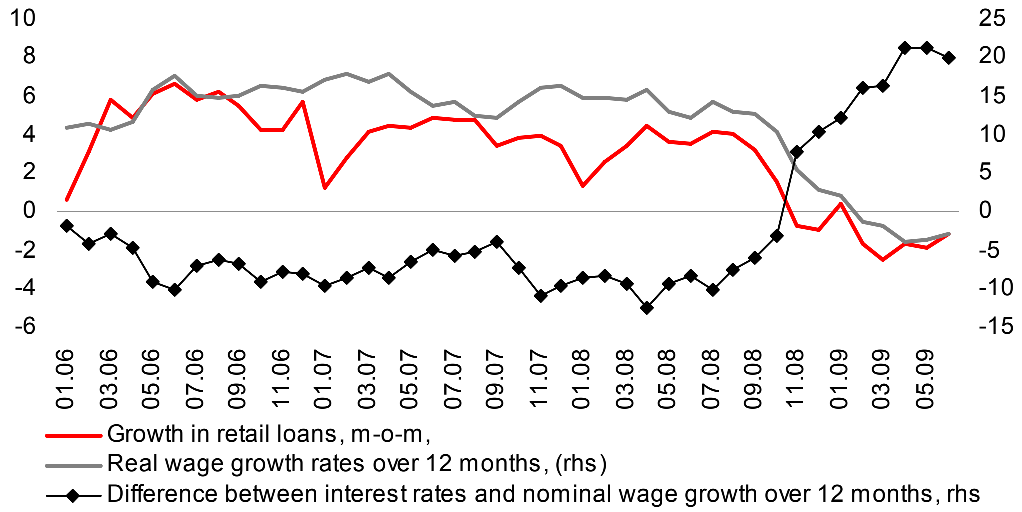
Reducing costs has been one way for companies to help ensure survival. High interest payments on loans have substantially undermined their competitive edge on the domestic market, which is suffering from contracting demand. Finally, demand for loans is largely being driven by the need to refinance old debts and not the desire to expand or modernize production, thereby leading to high credit risks. Therefore, in January-July, the volume of banks’ corporate loans rose only 3.1%, while the level of ruble-denominated loans remained practically unchanged (up just 0.6%).

Lending to households is stagnating, which is in keeping with the emerging situation in the economy. Household debts on bank loans in rubles and foreign currency are down 8.6% YTD. It is estimated that demand for loans would have dropped even if interest rates were maintained at the 2007 level. Today, after interest rates have almost doubled, bank lending is instead focused on extra risk (marginal) lending rather than credit creation to a broad range of borrowers.

Consumer lending in Russia took shape in 2003–05 amid primary saturation of demand and the development of market infrastructure. The latter stage was completed by 2007 (including the creation of unified credit products and branch networks in the banking sector), and from that point on through 1H08, this segment of the market was in *equilibrium* in terms of demand for credit, credit supply and parameters. The interest rate was 18% (CBR), consumer loans payable rose 44% in 2007, and the net increase in debt on consumer loans was R679 bln. Overdue debts comprised 3.1% of total consumer loans.

The surge in nominal household incomes versus interest rates on consumer loans was the key driver of growth in consumer lending. For example, in 2007, nominal household incomes grew 23%, with the interest rate on consumer loans hovering at 18%. Additionally, high inflation encouraged the gravitation of households toward consumption, stimulating purchases of goods on credit terms.

Consumer lending growth factors, %

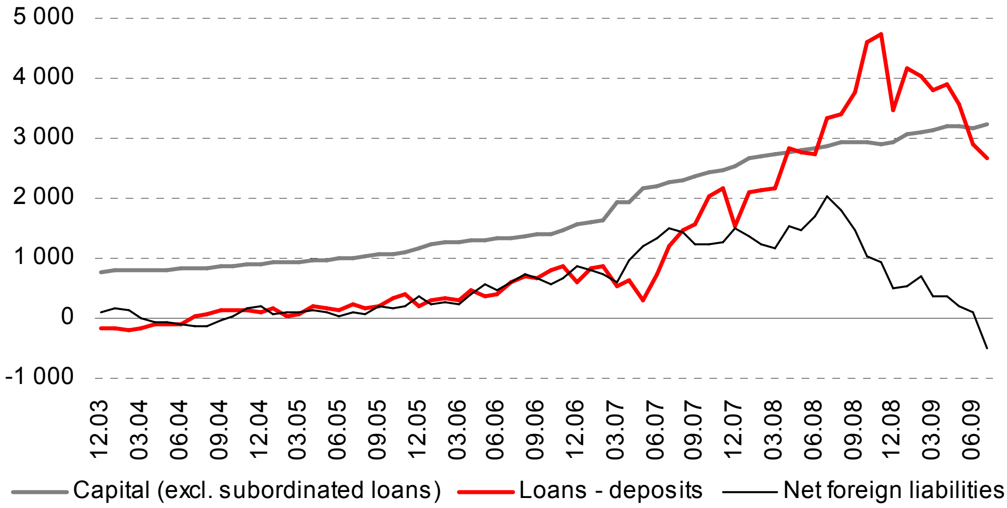


Source: CBR, CSI Bank of Moscow estimates.

Today, the situation is very different. According to optimistic forecasts, nominal household incomes will edge up 3–4%. Subsiding inflation, high interest rates on bank deposits and economic uncertainty (or even an unfavorable outlook) regarding the next one to two years has triggered household savings activity and dealt a blow to household consumption. Even formal econometric analysis shows that households today would not show large-scale demand for loans at an interest rate of 12–15%, whereas the current market rates are twice this level.

There are some positive factors, however. The emerging situation may facilitate the resolution of accumulated structural problems. The major structural disproportion is an excess of the non-financial sector's bank loans payable over its savings. The gap between the loans and deposits of the non-financial sector reached a critical level in 2008, exceeding the total equity of the Russian banking system. Today the gap is narrowing, and its removal in the long run will foster a healthy financial basis for balanced economic growth that is different from the model based on foreign borrowings. However, the "legacy" of overheated growth is still being felt – in early autumn, the non-financial sector's loans exceeded its deposits by R2.7 trln. To eliminate this loans-deposits gap, consumer loans payable to the banking sector must be cut by at least half, household savings activity should be sustained and large-scale harm to credit creation in the industrial sector should be avoided.

Chart. Excess of loans over deposits of the non-financial sector (credit gap), banks' capital and net foreign liabilities, R bln



Source: CBR, CSI Bank of Moscow estimates.

Today, therefore, recovery of the Russian economy underpinned by a favorable external environment cannot receive additional support from bank lending. The dear money policy pursued during the crisis exacerbated the systemic problem of a widening gap between demand for credit from the non-financial sector and supply from banks. Demand from the non-financial sector for increasingly expensive and short-term loans is sagging, as companies are sometimes unable to service them, guided by profitability considerations. The situation is similar in the household sector, which is discouraged by declining incomes. On the other hand, during the course of dear money policy, the cost of supplied credit resources increases in step with the cost of borrowing and borrower risks.

This represents a *systemic imbalance* between demand and supply for credit. The systemic nature of the problem lies in the principal gap between the *possibility* of the banking system providing financial resources and *the ability* of the non-financial sector to use and service these loans efficiently. In terms of supply, the cost of credit is determined by the cost of borrowing and high borrower risks. In terms of demand, the main determinants are low profitability, decreasing profitability and dwindling corporate and household incomes.

This problem cannot be eliminated quickly and may take about a year to resolve. The disparity in interest rates on the supply and demand sides will narrow in line with economic recovery (growing profitability and nominal incomes), declining inflation, a stable currency and rising savings by the non-financial sector.

In early 2009, when the crisis was in full swing, abating inflation and ruble stabilization were identified as monetary policy priorities and the dear money policy was used as an instrument to achieve them. Today, money in Russia is rather expensive and the cost cannot be reduced by lowering the refinancing rate or further CBR recommendations to commercial banks to trim interest rates on loans and deposits. Commercial banks have already assumed their obligations on expensive medium-term household deposits (from one year onwards), while the volume of government loans to the banking system is decreasing.

Today, in a situation where the Russian economy has stabilized with the help of external factors, expanding domestic demand will be critical in supporting economic recovery.

Now, however, companies must address the problems that have arisen in the past year and search for loans to refinance old debts rather than to modernize production. The downward trend in inflation, falling real disposable household incomes and low expectations of their growth in the near term boost household savings, but not consumption. As a result, “robust” domestic demand aimed at expansion of production and modernization (expected from companies) and household consumption (boosted by growing incomes) have become virtually non-existent, undermining the role of domestic demand as a growth driver.

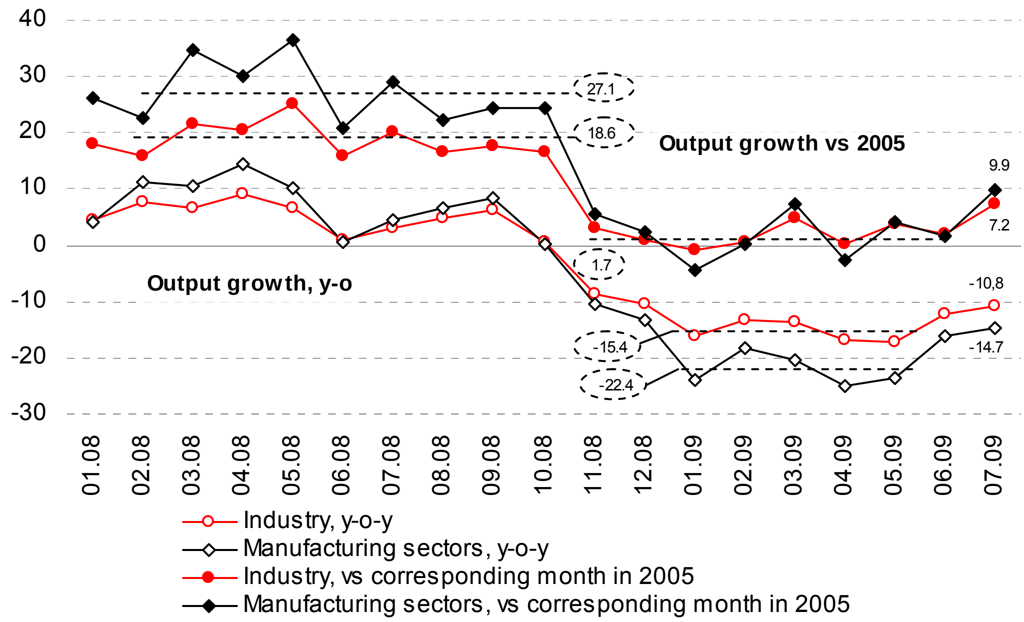
Real sector

According to the Economics Ministry, in summer 2009, the Russian economy passed the critical point of recession, embarked on a path of recovery and is expected to see growth accelerate in the near term. At a press conference in London, commenting on the meeting of BRIC finance ministers, Finance Minister Alexey Kudrin noted that “in the third quarter of 2009, the Russian economy will start its recovery from recession”.

Indeed, the official data for July (and possibly June) suggest that the worst stage of the industrial slump is over. In January-May, output in industry and the manufacturing sector dropped 15.4% and 22.4% y-o-y, respectively. In June-July, the slump decelerated to 10.8% and 14.7% y-o-y, respectively. Moreover, the figures from July clearly indicate growth in output. To use the language of our economic authorities, industry is now pulling itself out of the trough where it had been stuck for the previous eight months.

Moreover, the prospects for recovery in output are also supported by growth versus the respective levels of 2005. In our previous reports, we took 2005 as a base year marking transition from the period of balanced economic growth to one of overheated growth driven by rapid expansion of domestic demand, which in turn was fueled by record capital inflows and sky-high prices for energy-producing materials. In the final phase of industrial growth on the back of overheated demand (up until autumn 2008), growth in the manufacturing sector and industry as a whole totaled 27.1% and 18.6% versus 2005, respectively. As the current financial crisis snowballed into economic recession, output volumes in the manufacturing sector and industry were pulled down to a sustainable growth rate of 1.7% versus 2005.

Industrial production output growth in 2008 and 2009, y-o-y and vs 2005, %



Source: State Statistics Service, CSI Bank of Moscow.

In a nutshell, official statistics point to deceleration of the industrial slump in summer 2009. In this context, the obvious questions are the following.

- What industrial segment has become the base for possible growth recovery?
- What are the prospects for further recovery in terms of demand for industrial products?
- How viable is the trend that is currently forming?

Structurally, the upturn in industrial production in June-July 2009 was brought about by *the manufacturing sector*. The contribution of the mining and quarrying sector to total output was far less significant, undermined by the worsening trends in the electricity, gas and water supply sector due to dwindling volumes of energy consumption.

Industrial production output growth in January-July 2009, y-o-y, %

	Jan-May	June	July
Industry, total	**-15.4**	**-12.1**	**-10.8**
Mining and quarrying	-3.4	-4.0	-1.6
Manufacturing	-22.4	-16.0	-14.7
Final demand sectors	*-10.0*	*-8.6*	*-4.1*
Manufacture of food products, including beverages and tobacco	-3.1	-2.0	2.3
Manufacture of textiles and textile products	-21.8	-24.4	-21.3
Manufacture of leather, leather products, shoes	-11.4	-3.6	4.2
Manufacture of pulp, paper and paper products; publishing and printing	-16.2	-16.4	-15.8
Other sectors	-24.6	-27.1	-12.5
Investment demand sectors	*-38.9*	*-30.1*	*-34.0*
Manufacture of non-metallic mineral products	-32.6	-25.9	-22.3
Manufacture of machinery and equipment	-37.6	-21.3	-32.1
Manufacture of electric, electronic and optical equipment	-42.4	-28.4	-25.9
Manufacture of transport and other equipment	-37.5	-47.4	-42.1
Intermediate demand sectors	*-19.9*	*-12.0*	*-9.5*
Woodworking and manufacture of timber products	-29.0	-16.6	-15.5
Manufacture of coke, refined petroleum products	-2.1	-2.6	0.6
Manufacture of chemicals	-18.7	-8.4	-5.2
Manufacture of rubber and plastic products	-17.5	-11.7	-11.5
Manufacture of basic metals and fabricated metal products	-27.2	-20.1	-14.2
Electricity, gas and water supply	-5.3	-7.9	-9.0

Source: State Statistics Service, CSI Bank of Moscow.

The upturn in the manufacturing sector was triggered by a noticeably changing trend in the final and intermediate demand sectors. In January-May, the slump in final demand sectors totaled 10.0% y-o-y, slowing to 8.6% in June and easing further to 4.1% in July. The performance of intermediate demand sectors was even more convincing, the fall decreasing from 19.9% y-o-y in January-May to 12.0% in June and 9.5% in July. Improvement in the investment demand sectors was feeble, with output down 34.0% y-o-y in July.

Conditions of Russian industrial recovery in June-July 2009
Industrial output growth, y-o-y, %

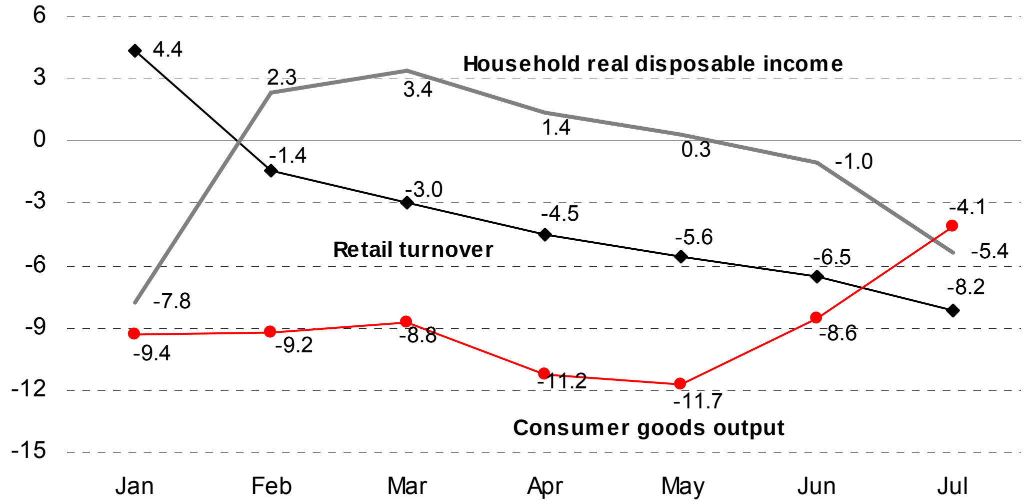
	Jan-May	June	July
Retail turnover	-2.2	-6.5	-8.2
Real disposable household incomes	-0.4	-1.0	-5.4
Fixed capital investments	-17.7	-20.1	-18.9
Exports*	-47.5	-44.6	
Imports*	-42.3	-45.8	
Industry, total	-15.4	-12.1	-10.8
Manufacturing sector	-22.4	-16.0	-14.7
Final demand sectors	-10.0	-8.6	-4.1
Investment demand sectors	-38.9	-30.1	-34.0
Intermediate demand sectors	-19.9	-12.0	-9.5

* – Exports and imports are data for January-May and June-July, respectively.
Source: State Statistics Service, Federal Customs Service, CSI Bank of Moscow.

It is important to note, however, that the upswing in Russian industry in June-July *was neither caused nor accompanied* by improving performance in retail trade, real household incomes or investments. The June-July data show substantial deterioration of major demand indicators, indicative of ongoing or even growing contraction of domestic demand. Exports, however, picked up slightly, bolstered by expanding demand for Russian goods on world markets as the global economy turned the corner.

In fact, the upturn in the *final demand sectors* in June-July was accompanied by accelerating contraction of household incomes and retail turnover. Judging by production trends demonstrated by these sectors in previous months, it would be more logical to witness a further deepening of the slump. It may be that the production upsurge in final demand sectors in June-July was caused by the replenishment of retail inventories. However, regardless of this fact, the uptrend in the final demand sectors in June-July 2009 can be viewed as sustainable only in the event of considerable growth in household incomes, which is not expected in the near term.

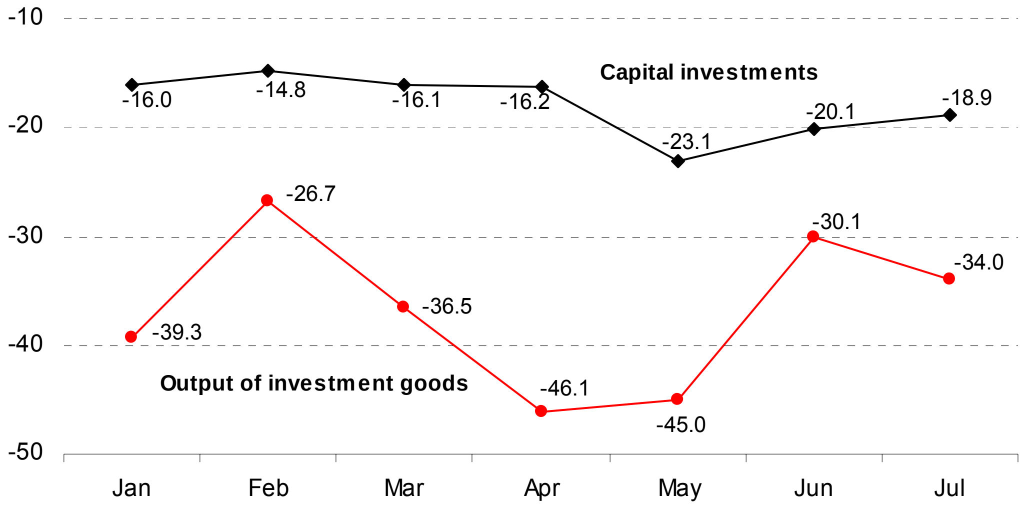
Growth in final demand sectors, retail trade and income in January-July 2009, y-o-y, %



Source: State Statistics Service, CSI Bank of Moscow.

The *investment demand sectors* are exhibiting trends directly traceable to movements in fixed capital investment.

Growth in investment demand sectors and fixed capital investments in January-July 2009, y-o-y, %



Source: State Statistics Service, CSI Bank of Moscow.

Recovery in these sectors will be possible only if it is underpinned by growing *equity-based* investment by enterprises, or if they have more opportunities to fund their investments from borrowed funds.

- The scale of equity financing as a source of funding fixed capital investment has contracted substantially due to dismal financial performance: in 1H09, corporate financial performance among Russian companies totaled R1.6 trln (versus R3.2 trln a year ago). Incomes in the economy dropped in step with spiraling profit concentration in the fuel and energy segment (FES), which includes mining and quarrying of energy-producing materials, manufacture of coke and refined petroleum products, pipeline transportation, electricity generation supply and distribution. For non-FES sectors of the economy, the slump in profit was even more dramatic, plunging to R0.8 trln in January-June 2009 from R2.1 trln a year ago. In this context, the upsurge in fixed capital investments based on equity financing seems to be a remote prospect for Russian companies.

Corporate financial performance

	1H08	1H09
Economy total, R bln	**3,240**	**1,634**
Economy total, corporate financial performance structure, %	100	100
Fuel and energy	34.5	50.0
Mining and quarrying of energy producing materials	16.4	23.0
Manufacture of coke, refined petroleum products	13.1	12.4
Electricity supply	1.9	7.9
Transport via pipelines	3.0	6.7
Industry, non-FES	28.2	6.5
Construction, real estate, renting and services	8.6	7.5
Trade	21.5	24.1
Transport (excluding pipelines) and communications	8.2	9.4

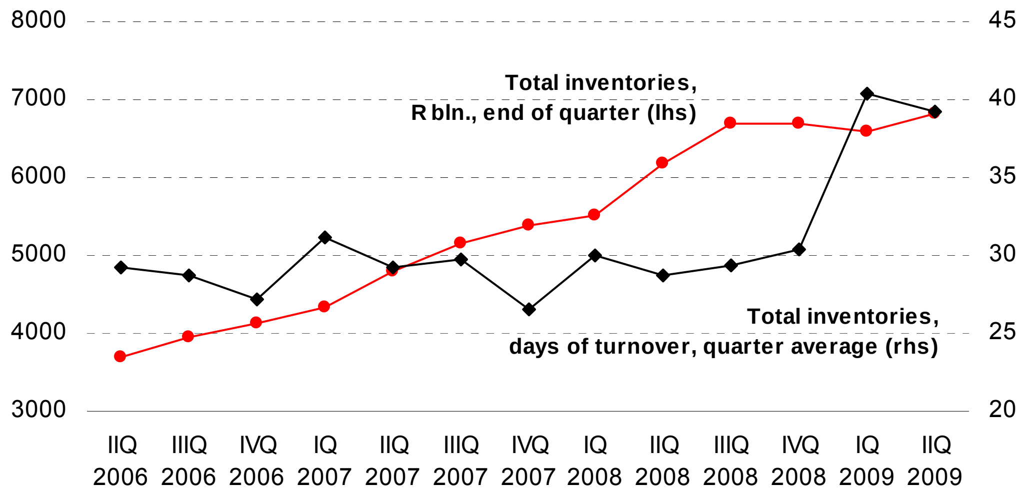
Source: State Statistics Service, CSI Bank of Moscow.

- The possibility of using debt financing to fund fixed capital investment is also limited by the reduced volumes of lending to corporate clients. Based on 2Q09 results, corporate loans due to banks and non-banks edged down to R16.6 trln as of July 1 from R16.7 trln on April 1. The need to finance fixed costs, even in conditions of subsided business activity, coupled with high interest rates on loans reduced the volumes of borrowing that could have been used by companies to finance long-term investment projects. Budget funds remain the main source of boosting fixed capital investment, but are hardly likely to be available considering the sizable budget deficits at different levels.

Therefore, the prospect for recovery in investment demand sectors in the near term looks rather bleak, hindered by the sluggish investment activity of Russian companies.

Apart from the downtrends in key domestic demand indicators, *inventories of Russian companies* show no sign of reduction. During 3Q09, the value of corporate inventories was estimated at R6.7 trln, a figure that seems unlikely to decrease. In the context of falling turnover, inventory volumes in relative terms more than tripled compared with 2006–08. In 1Q09, inventory turnover was 40 days (30 days in the first quarter of 2006–08). In the second quarter, the ratio was the same: 39 versus 29 days.

Inventories of Russian companies



Source: State Statistics Service, CSI Bank of Moscow.

In conditions of sinking domestic demand and illiquid inventories, *exports* begin to play an important role for industry as a growth driver. Considering the competitiveness of Russian goods produced by the manufacturing sector, it is largely exports that are stimulating the *intermediate demand sectors*.

Indeed, the output trends in the manufacturing sector in June-July were influenced by an upturn in the intermediate demand sectors. In 5m09, their output sank nearly 20% y-o-y, whereas in June-July the decline in output was a milder 11%. An important growth driver was the reviving demand for Russian products on global commodity markets, marking the end of the global economic recession. Russian metals exports in June-July declined 17% y-o-y (versus 24% in January-May), while exports of timber and timber products dropped 26% y-o-y (42%). However, exports of chemicals increased 7.4% y-o-y after a 23.5% slump in 5m09.

Intermediate demand sectors: output and exports growth in January-July 2009, y-o-y, %

	Jan-May	June-July
Exports, physical volumes		
Chemical products (ammonia, methanol, rubber, mineral fertilizes: nitric, potassium and mixed)	-23.5	7.4
Wood and timber products (sawn timber and logs, plywood)	-41.6	-25.8
Metal products (ferrous metals, copper, nickel, aluminum)	-24.0	-17.1
Output, total intermediate demand sectors	-19.9	-10.8
Manufacture of chemicals	-18.7	-6.8
Woodworking and manufacture of timber products	-29.0	-16.1
Manufacture of basic metals and fabricated metal products	-27.2	-17.2
Manufacture of coke, refined petroleum products	-2.1	-1.0
Manufacture of rubber and plastic products	-17.5	-11.6

Source: State Statistics Service, Federal Customs Service, CSI Bank of Moscow.

In short, official data covering Russian industry indicate that the worst phase of the slump is now over. In June-July, industry switched over to a path of recovery. However, the main components of domestic demand – final and investment demand – continue to suffer. With shriveling domestic demand and plentiful inventories, the transpiring uptrend in Russian industry can hardly be treated as viable or long term. Therefore, we can expect a spell of *short "corrective" growth* determining a new bottom for Russian industry that is slightly above that registered in November 2008.

Another possible scenario is a new growth model for industry and the broader economy oriented toward *external and not domestic demand*. In this case, the pace of growth will be determined exclusively by demand for key Russian export commodities. Intermediate demand sectors will be the leaders of this industrial growth, and their impact on domestic demand and other manufacturing sectors will be insignificant and delayed. In any event, further re-focusing of growth on manufacturers of semi-finished products will barely add any competitive edge to Russian industry.

Official assessments of growth prospects for Russian industry also differ. According to Finance Minister Kudrin at the London press conference, "it is too early to say that the economy is on track for stable recovery and that short-term downswings are not expected in the near term". However, in his view, Russian GDP will reach its pre-crisis level in 2012. In this context, it is important to understand that such positive estimates cannot be directly projected to industrial production trends. Achievement of the pre-crisis level, signifying 23% growth in the manufacturing sector and 16% growth in industry over three years (from the bottom, which lasted almost eight months), would be reminiscent of the recent overheated growth. In 2008, output in the manufacturing sector and industry overall exceeded the 2005 levels by 27.1% and 18.6%, respectively. However, in 2006–08, domestic demand was a strong growth driver buoyed by a capital influx and spiking prices for energy producing materials. The growth model for 2010–12 is forming in the opposite direction, largely gravitating toward external demand. It is far less effective in terms of growth rates and the competitive strengths of Russian industry.

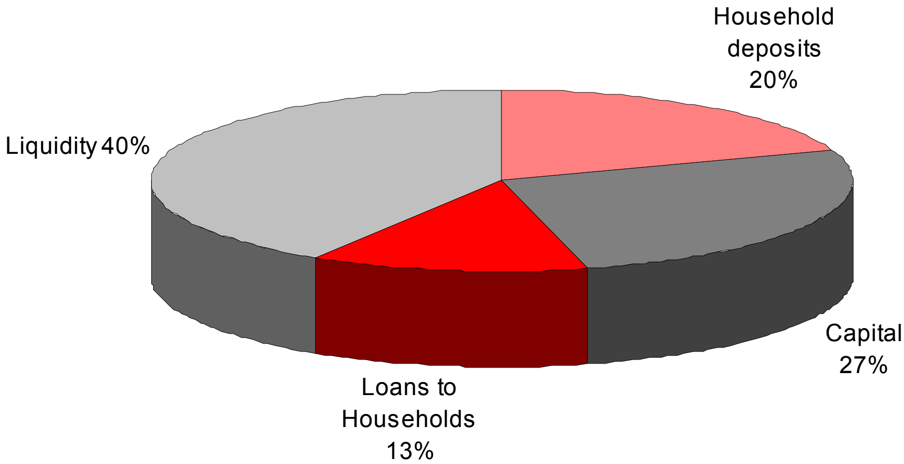
Banking sector

Russia's banking sector has been stagnating this year. The primary function of financial intermediation, which is to move resources and savings into loans and borrowing, is being performed with extremely low efficiency. The main financial flows through the banking system today are comprised of the repayment of liabilities to foreign investors and monetary authorities with liquid assets accumulated at the start of the year, and owners' contributions to share capital.

Despite the substantial devaluation impact in January, banking assets shrank 0.7% in nominal terms and 3.0% on a currency adjusted basis in 7m09. Contraction of banking sector resources was the major depressant of lending activity. Year to date, the banking sector has been deprived of R1.5 trln in borrowing (currency adjusted), or 7.0% of the total volume as of January 1, 2009.

The only sector of the economy to generate an inflow of funds to the banking sector in 2009 was households. Since February, they have been gradually increasing their savings in the banking sector. Stabilization of the ruble and the rise in interest rates funneled more than R600 bln in household savings to the banking sector in January-July.

Formation of banking sector assets and liabilities in January-July 2009 (increase in liabilities and decrease in assets)



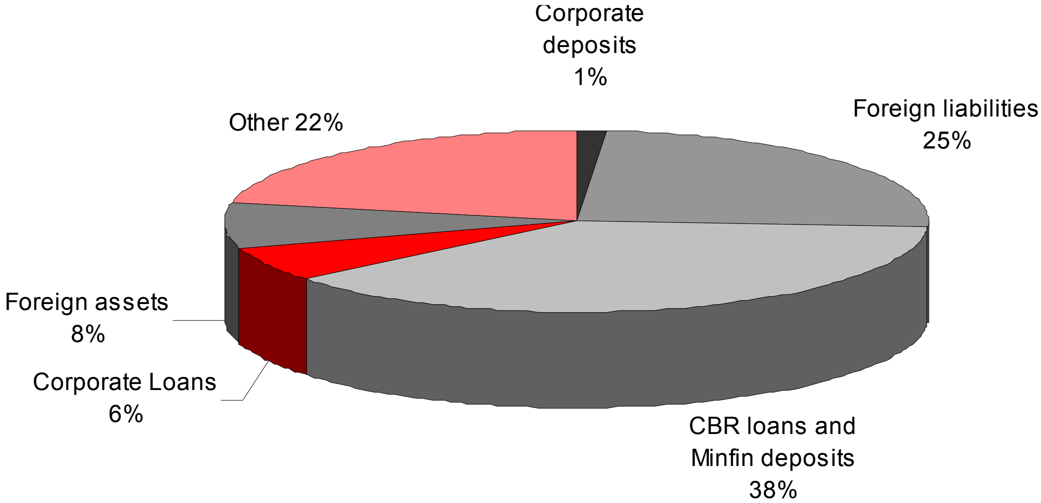
Source: CBR, CSI Bank of Moscow estimates.

The smaller volumes of retail lending also generated fund flows from households. Repayments of old loans continue to exceed the volume of new loans issued. Hence, year to date, banks have released more than R400 bln, which indicates that so far in 2009, households have moved more than R1 trln to the banking sector.

Other types of bank borrowing cannot no longer be treated as a banking sector resource. Conversely, banks must direct sizable volumes of funds to repay loans raised earlier. Year to date, net repayment of foreign liabilities has already surpassed R785 bln ($25 bln). The repayment of funds borrowed from the monetary authorities in late 2008 was even more impressive: banking sector liabilities to the CBR have decreased by R1.4 trln YTD.

In conditions of contracting resources, banks have been supported by their owners. Year to date, share capital and additional paid-in capital have risen by more than R310 bln, or 19%. During the same period in 2008 (i.e. prior to the crisis peak), the overall share capital of Russian banks climbed a modest 7%. The reason for the capital support was the need to recover losses relating to provisions for bad debts and other assets rather than boost a weakened resource base. Year to date, banks have increased their loan-related provisions by R544 bln (63%). As of August 1, provisions for corporate loans amounted to 8.1% of the total loan portfolio (with the share of past due loans at 5.2%) and 8.5% (6.0%) for consumer loans. Total bad debt and impairment provisions grew by R645 bln in the same period (i.e. more than doubled), exceeding owners' contributions to share capital.

Use of banking sector resources in January-July 2009 (increase in assets and decrease in liabilities)



Source: CBR, CSI Bank of Moscow estimates.

A contracting resource base, other things being equal, could be a sufficient reason for banks to curtail their asset-related transactions. However, not all payments made by banks adhered to a tight schedule. The major outflow of funds from the banking sector was triggered by the repayment of CBR loans. According to the CBR's report to the State Duma, 33% of collateral-free loans were repaid by banks ahead of schedule in 1H09. If the payment schedule was strictly followed, the banking sector's liabilities to the banking sector as of August 1 would have increased by R732 bln. However, it does not pay to have expensive liabilities on the balance sheet. The weighted average cost of collateral-free loans as of August 1 reached 14.9%. Meanwhile, banks had no opportunity to move their expensive liabilities into lucrative targets with a sensible risk level (see section on monetary policy), as they were constrained by the dear money policy pursued at the beginning of 2009.

Structure of Russian banking liabilities, end of month, % of total

	12.05	12.06	12.07	03.08	06.08	09.08	12.08	03.09	04.09	05.09	06.09	07.09
Liabilities (R bln)	**9696**	**13963**	**20125**	**21323**	**23059**	**24572**	**28022**	**28527**	**28048**	**27407**	**27776**	**27829**
Capital	15.4	14.3	15.3	15.7	15.3	15.2	14.1	15.6	16.4	17.0	17.1	17.6
Bank of Russia loans	0.2	0.1	0.2	0.7	0.2	0.9	12.0	11.5	10.1	8.3	7.2	7.0
Interbank transactions	4.0	3.4	4.1	4.3	4.1	3.5	4.4	4.3	4.3	4.3	4.5	4.5
Foreign liabilities	13.7	17.1	18.1	17.2	18.3	19.0	16.4	16.2	15.7	15.0	14.8	14.4
Household deposits	28.9	27.6	26.2	25.4	25.5	24.5	21.5	22.1	22.8	23.4	23.8	24.2
Corporate deposits	24.4	24.4	25.8	26.2	25.5	24.0	23.6	22.6	22.5	23.4	24.0	24.0
Deposits of federal and local governments	2.0	2.2	1.5	1.7	2.5	5.0	1.0	1.2	1.9	2.2	2.4	2.2
Issued securities	7.6	7.2	5.8	5.5	5.7	5.0	4.1	3.7	3.8	3.7	3.6	3.7

Source: CBR, CSI Bank of Moscow estimates.

Another disparity between the funds borrowed and used is a result of the mismatch in the currency structure of assets and liabilities due to growth in the banking sector's liabilities denominated in foreign currency. Thus, the share of household deposits in foreign currency broadened from 13.4% to 29.4% over the past 12 months, and the share of corporate accounts widened from 14.5% to 32.9%. Overall (adjusted for the outflow of foreign liabilities), total banking liabilities in foreign currency rose by $28 bln over the year.

Risks associated with lending in foreign currency increased noticeably (versus last year) due to volatility in the ruble exchange rate. Accordingly, foreign currency-denominated loans are also stagnating. Corporate loans in foreign currency have risen by $9 bln (9.4%) over the past 12 months, including $4 bln (3.9%) year to date. Retail lending is shrinking, both in rubles and foreign currency.

Major banking assets (end of month), % of total

	12.05	12.06	12.07	03.08	06.08	09.08	12.08	03.09	04.09	05.09	06.09	07.09
Assets (R bln)	**9696**	**13963**	**20125**	**21323**	**23059**	**24572**	**28022**	**28527**	**28048**	**27407**	**27776**	**27829**
Cash and precious metals	2.7	2.6	2.5	1.9	2.0	2.0	3.0	2.4	2.4	2.2	2.2	2.1
Accounts with CBR	7.3	7.5	6.9	5.1	5.8	4.2	7.5	6.7	5.8	5.0	6.3	4.4
Interbank transactions	6.3	5.8	5.4	6.2	5.9	4.8	5.2	5.1	5.2	5.2	5.1	5.1
Foreign assets	9.1	9.9	9.8	10.8	9.9	12.2	13.8	14.2	13.7	13.8	13.8	15.7
Households	12.1	14.7	16.1	16.4	17.0	17.8	15.5	14.6	14.6	14.7	14.3	14.3
Corporate sector	47.0	45.3	47.2	48.8	49.1	49.0	44.5	46.1	47.3	48.0	47.1	47.0
Government	6.6	5.2	4.1	3.3	3.4	3.0	2.0	3.1	3.1	3.2	3.3	3.4
Property	2.4	2.4	2.2	2.2	2.1	2.1	1.9	2.3	2.4	2.5	2.4	2.5

Source: CBR, CSI Bank of Moscow estimates.

At the same time, placements by Russian banks in foreign currency were restricted until July 2009 by CBR recommendations1. The only possible way to conduct a placement in foreign currency was via foreign currency accounts held at the CBR, permitted during the peak of the crisis. This asset enabled hedging of currency risks, but did not generate any income. As these recommendations were repealed on July 2, banks increased their income-generating investments in foreign currency. During July, foreign currency-denominated assets of the banking sector increased by $16 bln, marking the first change in the banking system's balance of transactions with non-residents in favor of foreign assets since 2004. Net foreign assets of the banking sector hit an all-time high of $17 bln.

Therefore, the effective transformation of household savings and other financial resources of the banking sector into loans suggests a need for change in the price and currency structure of borrowed funds, which should be brought in line with demand for credit facilities from the non-financial sector.

[1] CBR letters of 28.10.2008 No. 01-13-1/5713, 27.11.2008 No. 01-15/6980, 25.12.2008 No. 01-15-3/7850 and 31.03.2009 No. 01-15-3/1629.

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	39.8	45.6	52.1
$ bln	764	993	1 293	1 680	1 230	1 383	1 510
Real GDP, % y/y	6.4	7.4	8.1	5.6	-8.3	1.6	2.9
Industrial production, % y/y	5.1	6.3	6.3	2.1	-10.0	0.5	3.0
Retail turnover, real, % y/y	12.8	13.9	15.2	13.5	-5.5	1.5	3.5
Gross fixed investments, real, % y/y	10.9	13.7	21.1	9.8	-19.0	0.0	3.5
Exports, real, % y/y	6.5	7.3	6.4	0.5	-10.8	7.2	3.1
Imports, real, % y/y	16.6	21.3	26.6	15.0	-26.1	7.6	4.6
Monetary Aggregates							
M0 (year end), % y/y	30.9	38.6	32.9	2.5	6.9	16.0	17.0
M2 (year end), % y/y	38.5	48.8	47.5	1.0	10.1	17.3	18.9
M2X (year end), % y/y	36.3	40.6	44.2	13.8	13.5	18.1	19.3
Total banking assets, % GDP	44.8	51.9	60.8	67.3	81.0	86.2	94.3
Inflation							
CPI (year end), %	10.9	9.0	11.9	13.3	11.0	10.0	9.0
CPI (year average), %	12.5	9.8	9.1	14.1	12.2	9.8	9.5
Core CPI (year end), %	8.3	7.8	11.0	13.7	11.0	9.5	8.5
Budget							
Federal budget revenues, % GDP	23.7	23.3	23.5	22.2	18.3	15.8	16.0
Federal budget expenditures, % GDP	16.3	15.9	18.1	18.1	24.4	22.1	19.7
Federal budget balance, % GDP	7.5	7.4	5.4	4.1	-6.1	-6.3	-3.7
Reserve fund, year end, $ bln	43.0	89.2	156.5	137.0	56.8	0.0	0.0
National wealth fund, year end, $ bln				74.3	87.5	74.6	71.4
Balance of Payments							
Exports of goods, $ bln	244	304	354	472	310	340	360
Imports of goods, $ bln	125	164	223	292	200	220	240
Current account, % GDP	11.0	9.5	5.9	6.1	3.4	3.6	3.1
Net capital inflow/outflow, $ bln	2.0	41.9	82.8	-132.7	-37	10	30
International reserves, year end, $ bln	182	304	479	427	427	474	538
External Debt							
Foreign public debt, % GDP	10.0	5.2	3.5	2.4	3.0	3.8	3.3
Foreign private debt, % GDP	3.9	3.8	3.8	3.9	5.1	5.9	6.8
Exchange Rate							
R/$:							
end of period	28.8	26.3	24.6	29.4	32.0	33.5	35.0
year average	28.3	27.1	25.6	24.8	32.3	33.0	34.5
Exogenous Parameters							
Urals, $ p/bbl	50.4	60.9	69.6	94.4	58.9	59.5	60.7
$/€	1.24	1.26	1.37	1.47	1.38	1.42	1.40

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

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