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Economic growth – potential scenarios

Center of Strategic Investigations

CONTENTS

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At the start of Russia's economic crisis in late 2008, forecasts of the slump in production ranged from 0% to 5%. Then, when it became clear that the global crisis was long-term in nature, official projections and independent estimates were revised downward to a drop of 8–10%. Fixed capital investment was forecast to plunge 17–25%.

Today, most experts agree that economic growth in Russia is inevitable in 2010 and thereafter. Opinions differ only with respect to economic growth rates. The skeptical minority suggests a weak recovery of 1.5–2.0%, while official forecasts are more optimistic, projecting GDP growth of 3% in 2010. The brightest forecasts come from investment bank analysts, who expect 5–7% growth.

The major arguments in favor of economic expansion are as follows. First, the world economy is recovering. Second, prices for raw materials will stay at current levels and may increase slightly. Finally, economic growth will be measured against the low base of the previous year.

There are some counter-arguments, however. First, although demand for Russian raw materials and semi-finished goods had rebounded by the middle of last year, it will only support output and not act as a growth driver. Second, prices for raw materials were already high last year and did not contribute to economic growth. Third, the banking system is stagnating, and we see no reason to expect an upswing in loans to the non-financial sector.

There is only a loose connection between the economic growth projections and anti-crisis measures. External factors and domestic demand for goods are expected to become the growth "locomotives". However, the effect of external factors is rather limited – they can support demand for raw materials at current (or somewhat higher) levels and help restructure external debt, payments of which this year are fairly substantial. Expanding domestic demand, as has been shown over the last 10 years, will spur imports – especially if the ruble, given high oil prices, remains stable or even appreciates. The important thing to note is that investment growth is not expected in any of these scenarios. In this context, we can only assume that even 3% economic growth this year will create a high base for stagnation in 2011.

Economic policy

Russia experts were optimistic on the eve of the economic crisis. Seemingly, the Russian economy, with its plentiful mineral deposits and third-highest international reserves, could only be expected to slow and would never face an industrial and investment slump comparable with the one registered 10 years ago.

As it turned out, however, Russia failed to act as "the safe haven" during the global crisis after the G20 was hit hardest by the slump. But unlike in 1998, forecasts for the Russian economy began to sound optimistic again only 18 months after the outbreak of the crisis and before signs of its end had appeared. We can assume that most analysts are investment-minded, i.e. they are eager to hear good news. Even some of the monetary authorities expressed hope that economic growth would be above the official estimates. In late 2009, the Economic Development Ministry (MED) presented current year projections calling for GDP growth to vary from 1.3% to 3.5%. However, many experts, especially those representing major banks and investment companies, expect GDP growth of 5–7%.

These estimates are very important, as unjustified optimism can mislead investors and lead to systemic and costly mistakes in strategic planning. In order to more accurately forecast the least obvious aspects of GDP, CSI Bank of Moscow tested a range of projections and assumptions based on the GDP structural balance[1].

Detailed GDP projections are complicated by the State Statistics Service's recent decision to revise the industrial producer price index, which has led to changes in the initial official data. It was announced that the transition to new dynamic rows in industry would be completed by mid-2010, which of course makes industrial trend and production-based GDP forecasting more difficult.

However, the currently available data suggest that real growth in industrial production may reach about 3% in 2010. The official MED forecast is 1.7–3.1%, taking into account the fact that even conservative industrial growth projections of 3% fully depend on the viability of the global economic recovery (for more details, see the section entitled "Real Sector"). As an upturn in construction, a major sector of material production, can hardly be expected, it is *most unlikely that GDP growth will exceed 3.5% in 2010.*

In forecasting *GDP consumption*, we should first consider possible trends in *gross fixed capital formation*.

On the one hand, gross fixed capital formation is accompanied by stagnating investment processes brought about by uncertainties surrounding economic development in the coming years. As the top executives of major companies and banks do not always share the optimism of market analysts, the investment programs for 2010 designed during the peak of the crisis were in most cases left unchanged or reduced in nominal terms. Even if prices for products of investment demand sectors stop growing (which is not expected even by the MED in any of its scenarios), the real volume of investment programs will contract in any event. Furthermore, according to the MED's forecast, government fixed capital investment will be cut from 3.5% to 3.3% of GDP. Considering the expected growth in nominal GDP, this would be tantamount to an unchanged level.

On the other hand, the investment programs will be hampered by a direct deficit of respective resources. The sources of gross fixed capital investment are unlikely to change in volume in 2010. Indirect projections of trends in *corporate equity* as an

[1] CSI Bank of Moscow uses the method of macroeconomic forecasting based on the *GDP structural balance*, applying a comprehensive approach to three aspects of economic development – production, revenue formation and spending on consumption and accumulation. The main instrument is linking projected GDP components under all three computation methods – production, consumption and revenue. During the first stage, initial projections of separate components are made using autonomous estimates. Then, these projections are continually adjusted during the course of an iterative process, complying with requirements for balanced structural characteristics.

important source of funding for investment can be obtained from the forecast gross profit within GDP. Projections by revenue source show that this GDP component will rise in 2010 to about R14 trln at a pace half that in pre-crisis years. According to estimates of inter-sector financial flows, growth in *corporate loans* fell by half. The sharp deceleration of growth in gross profit and corporate loans in 2010 signals that the nominal volume of investment financing under the optimistic forecast will edge up a modest 1–2%.

Even if we assume that prices for products of investment demand sectors remain flat (the MED optimistically projects the deflator at 101.5–102.5%), *real growth in investment and, accordingly, fixed capital formation will be almost zero in 2010, which is an optimistic forecast.*

In the current economic context, we can expect the average Urals price to settle at $70/bbl. The average annual exchange rate will hover at R29–30/$. As the ruble is likely to appreciate, real growth in imports of goods and services in 2010 can be estimated at 15–16% (the MED expects dollar-denominated imports to grow 9–19%, depending on the scenario). These estimates are part of the scenario providing for GDP growth of 1.3–3.5%.

Import volumes depend directly on the GDP amount. So, based on projections of radically high GDP growth of 5–7%, we can expect imports to grow at even greater rate in real terms, by 20–22%. At the same time, even moderate growth of imports decelerates net exports within GDP (substantial negative growth) and therefore slows the pace of GDP growth. Additionally, the euro's current depreciation versus major world currencies can further contribute to the import volumes.

The above factors – *zero investment growth and negative net export growth – signify that household final consumption expenditure (HFCE) in real terms must increase at least 13–14% in 2010 to achieve the 5–7% GDP growth rate!* But this scenario is hardly workable, based simply on the anticipated trends in household monetary income.

The GDP forecast by revenue source is used as a basis to estimate household monetary income. Compensation of employees (CEO), a component of GDP and a major source of household monetary income, places certain constraints on their possible volumes.

Thus, the share of CEO in GDP cannot go far beyond 50%. In Russia, it has persistently stayed below 50% and only in 2009, the year of the crisis, did it reach 51.8%. Besides, growth rates of nominal household monetary income depend on nominal GDP growth rates (and only during 2009 did household income rise amid contracting nominal GDP). That exceptional trend in 2009 can be easily explained: the government was taking anti-crisis measures involving social payments and administrative regulation of employment. Attempts by federal and regional authorities to restrain unemployment negatively affected labor productivity, which *declined* by 6% in 2009.

All of the above factors indicate that growth in nominal household monetary income in 2010 can be reasonably expected at 9–11%. The forecast for banking system development suggests that growth in consumer loans under the optimistic scenario can be expected at 5–7%. Therefore, *HFCE growth in real terms in 2010 can be projected at 3–5%, which is far below the 13–14% required to achieve 5–7% GDP growth*. These estimates complement the GDP forecast, revealing stagnation in construction and trade.

The above structural analysis of various GDP components cools off the unjustified (albeit desired) optimism. We estimate *nominal GDP in 2010 at R43 trln and y-o-y growth at 2.8–3.0%*. These forecasts are optimistic and inertia-based. The inertia stems from the fact that the Russian government has no time in the current year for radical improvements (infrastructure and modernization projects, as well as business climate improvement initiatives, are only at the stage of discussion). Optimism is encouraged by the expected improvement in the external environment and the absence of shocks on domestic and world markets.

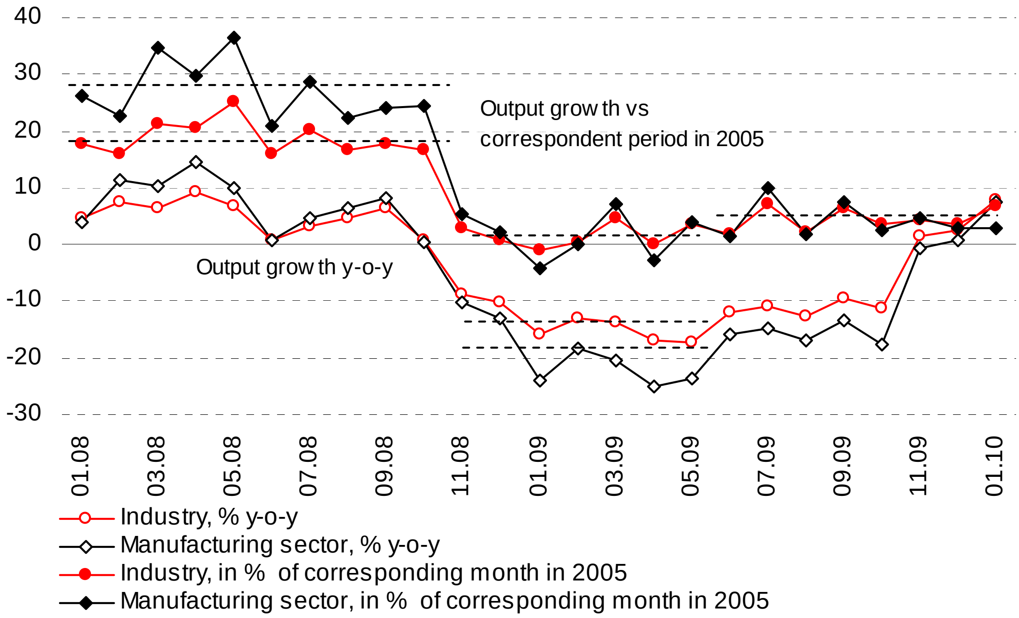
Real sector

Between November 2009 and January 2010, Russian industry grew y-o-y and its recovery in statistical terms sped up. Growth totaled 1.5% y-o-y in November 2009, 2.7% y-o-y in December 2009, and 7.8% y-o-y in January 2010.

Formally, these figures breathe optimism into Russian industry growth projections for 2010. Taking into account the extent of the downturn at the peak of the crisis and the mild correction in output in June-December 2009, Russian industrial production is ready for virtually any growth scenario – from a protracted correction to a more energetic expansion. Apparently, the decisive factor for growth in Russian industrial output in 2010 will be the base effect. In this context, improvements in formal statistics will be misleading. Of more importance will be the structure of the recovering growth, its drivers and sustainability, and conditions for a long-term and stable uptrend supported by the strengthening competitiveness of industrial production.

In the first months of the economic crisis, the output of the manufacturing sector and industry as a whole plunged sharply to the level registered before the onset of the Russian economy's overheated growth cycle.

Production output growth in the manufacturing sector and industry as a whole, 2008 to January 2010, %



Source: Rosstat, CSI Bank of Moscow.

The "Bottom Level 1", which exceeded the respective industrial output level of 2005 by a mere 1.1–1.6%, was observed from November 2008 to May 2009. The correction that began in June 2009 brought Russia's industrial output to the stable "Bottom Level 2" (up 4.0% versus 2005), though this failed to act as a springboard for industrial growth despite the formal increase in November-December 2009. Likewise, the industrial output figures from January 2010 do not suggest that stagnation in industrial production is over.

Indeed, industrial output increased 7.8% y-o-y in 2010 (up 6.7% versus January 2005). However, these figures should not be interpreted as the onset of a growth cycle. Apart from the substantial base effect (the 16% y-o-y contraction of output in January 2009 was the local maximum), this improved performance is also attributed to non-recurrent factors with no long-term effect. These include *the exceptionally cold winter of* 2009–2010 (which led to 8.4% y-o-y growth in electricity, gas and water supply) and the *recovery of natural* *gas exports* as a result of the Russian-Ukrainian gas crisis in January 2009 (which lifted mining and quarrying output by 6.9% y-o-y and 9.1% versus January 2005 – the best indicators for the past four years).

Industrial production output growth, 2009 – January 2010, %

	Y-o-y				Versus the same period in 2005			
	Jan-May 2009	June-Dec 2009	2009	Jan 2010	Jan-May 2009	June-Dec 2009	2009	Jan 2010
Industrial Producer Price Index	**-15.4**	**-7.4**	**-10.8**	**7.8**	**1.6**	**3.9**	**2.9**	**6.7**
Mining and quarrying	-3.4	0.2	-1.2	6.9	2.5	4.0	3.4	9.1
Manufacturing	-22.4	-11.2	-16.0	7.6	1.1	4.0	2.8	3.0
Electricity, gas and water supply	-5.3	-4.4	-4.8	8.4	0.5	1.4	1.1	13.1

Source: Rosstat, CSI Bank of Moscow.

At the same time, output in the manufacturing sector remained high in January 2010, clutching to the level achieved in June-December 2009 but exceeding the respective indicator for 2005 by a full 3%. With output volumes dwindling in January 2009 by a record-low 24.1% y-o-y as a backdrop, the 7.6% y-o-y growth in output in January 2010 should not breed any illusions. Russia's manufacturing sector is currently at the level from which it moved to accelerated growth in 2006 bolstered by expanding domestic demand on the back of active international borrowing and spiraling world prices for energy-producing materials.

By the start of the economic crisis in autumn 2008, the above-mentioned growth model contributed to the 27.0% jump in industrial output versus 2005 and the 18.6% growth in industry overall while average annual growth rates totaled 8.3% and 5.9% for the manufacturing sector and industry as a whole, respectively. This trend was largely underpinned by the 18% annual growth in fixed capital investment, the 11% annual average increase in household real disposable income and the 65% surge in consumer lending, supporting the 15% annual expansion of retail turnover. Additionally, exports were increasing at an average rate of 29% fueled by rising oil prices and increasing volumes of other Russian exports – by 23% on average on an annual basis.

Conditions for Russian industrial recovery, 2009 – January 2010, %

	Jan-May 2009	June-Dec 2009	2009	Jan 2010
Retail turnover	-2.2	-7.5	-5.5	0.3
Real disposable household monetary income	1.2	2.2	1.9	7.1
Fixed capital investment	-17.7	-16.5	-17	-8.7
Traditional exports* (physical terms)	-11.4	6.3	-1.9	
Traditional exports* (in dollars)	-50.9	-30.7	-39.0	
Exports, in dollars	-47.5	-27.3	-35.6	
Imports, in dollars	-42.3	-34.2	-37.3	

* Products of the fuel and energy, woodworking, chemical, petrochemical and metals sectors.
Source: Rosstat, CSI Bank of Moscow.

The context for the recovery in Russian industry in 2009–2010 is different in principle. Unlike in the previous industrial production growth model, *fixed capital investment* has been declining for the past 15 months. In 2009, fixed capital investment slid 17.0% and another 8.7% in January 2010, even measured against the low base of January 2009.

Growth in *real disposable household monetary income* was negligible. Between October 2009 and January 2010, the seemingly rapid growth in real household monetary income was actually a rebound from the severe downturn of a year ago (as the economic crisis was gaining steam in October 2008 – January 2009). Therefore, in the coming months we can expect a less enthusiastic performance. The absence of plausible prospects for economic recovery (and income growth) naturally pushes up the savings rate. In conditions of slashed or tightened consumer lending programs among banks, consumer demand and retail turnover will fall. *When real disposable household monetary income grew 1.9% in 2009, retail turnover dropped 5.5*%. This correlation differs cardinally from the one registered during the economic growth cycle of 2006 to September 2008, when consumer demand (retail turnover) outperformed real disposable income, boosted by aggressive consumer lending programs among Russian banks. Today, the minimal growth in household income is financing previous (repayment of consumer loans) and future (growth in savings) consumer demand, but is not facilitating current growth in demand for goods and services.

Therefore, industrial output is undergoing a correction in the context of suppressed domestic demand and is primarily being determined by the growing demand for Russian commodities on global markets, i.e. the pace of global economic recovery.

Since June 2009, Russian exports have been gradually recovering in monetary and physical terms. In January-May 2009, exports fell by nearly half (down 47.5% y-o-y), while in June to December 2009 the decline decelerated to 27.3%. During the correction, traditional export volumes (products of the fuel and energy, woodworking, chemical, petrochemical and metals sectors) climbed 6.3% y-o-y. Therefore, the actual structure of recovery in the manufacturing sector is largely being determined by the trends in intermediate demand sectors.

Production output growth in the manufacturing sector, 2009 – January 2010, %

	Jan-May 2009	June-Dec 2009	2009	Jan 2010
Manufacturing	**-22.4**	**-11.2**	**-16.0**	**7.6**
final demand sectors	-6.4	-1.2	-3.4	5.0
investment demand sectors	-38.0	-29.0	-33.5	2.1
intermediate demand sectors	-19.6	-2.7	-10.4	12.6

Final demand sectors: manufacture of food products, including beverages and tobacco, manufacture of textiles and textile products, leather, leather products, shoes, manufacture of pulp, paper and paper products, publishing and printing

Investment demand sectors: manufacture of other non-metallic mineral products, manufacture of machinery and equipment, manufacture of electric, electronic and optical equipment, manufacture of transport and other equipment

Intermediate demand sectors: woodworking and manufacture of timber products, manufacture of coke, refined petroleum products, manufacture of chemicals, manufacture of rubber and plastic products, manufacture of basic metals and fabricated metal products.

Source: Rosstat, CSI Bank of Moscow.

While investment demand sectors were stuck in protracted recession and performance in consumer demand sectors improved only slightly, output in intermediate demand sectors staged an impressive recovery. As a result, the output slump in the manufacturing sector decreased by nearly half, from -22.4% (Bottom Level 1 in January to May 2009) to -11.2% (Bottom Level 2 in June to December 2009).

After the balanced growth model (2002–2005), the overheated growth model (2006 to September 2008) and the peak of the economic crisis (late 2008 – May 2009), the current economic and industrial growth model is heavily oriented toward *external demand*. At the start of 2010, which will hopefully mark the beginning of an industrial upturn, the post-crisis production structure was as follows.

Industrial production growth, 2006–2009, % change versus 2005

	2006	2007	2008	2009
Industrial production	**6.3**	**13.0**	**15.4**	**2.9**
Mining and quarrying	2.5	4.4	4.7	3.4
Manufacturing	8.3	18.6	22.4	2.8
final demand sectors	8.3	14.7	16.3	9.4
investment demand sectors	10.2	26.0	29.0	-12.1
intermediate demand sectors	8.8	13.3	14.0	3.4
Electricity, gas and water supply	4.9	4.7	6.2	1.1

Source: Rosstat, CSI Bank of Moscow.

The output of *final demand sectors* is hovering at the 2006 level, exposed to greater pressure from imports (during the crisis period in 2009, the cost of imports was 22% higher than in 2006). The output of *intermediate demand sectors* and *mining and quarrying,* as well as export earnings (around $302 bln in 2006 and 2009), also recovered to the levels of 2006–2007.

The output of *investment demand sectors* tumbled to the levels of 2004, prior to the reform of the Russian automotive industry and its subsequent rapid growth. The output of the utilities sector (electricity, gas and water supply) settled at the level of 2005.

The evolved structure of Russian industrial production and its growth factors for the near term are not conducive to ambitious plans calling for a switch to higher growth. Growth in the manufacturing sector will be slow due to suppressed and declining domestic demand. Moreover, even conservative projections forecasting industrial growth of 3% fully depend on external factors and the viability of the global economic recovery.

At the same time, this structure clearly brings forth the huge growth potential based on expansion of domestic demand. First, there is substantial untapped growth potential in investment demand sectors in manufacturing, with production capacities capable of exceeding current output by nearly 40%. Moreover, investment demand sectors that underwent large-scale modernization prior to the crisis are now more technologically competitive. The uncertain prospects for post-crisis economic development, company deficits in equity resulting from their worsening financial position during the crisis, limited access to bank loans that could be used for long-term investment purposes, and the state’s ineffective stimulation of corporate modernization programs remain the key depressants of growth in investment activity. At the same time, the creation of conditions and leverage for implementation of modernization projects in Russian industry may have an *immediate and significant impact* on attaining stable and high growth rates in industrial production and the economy overall.

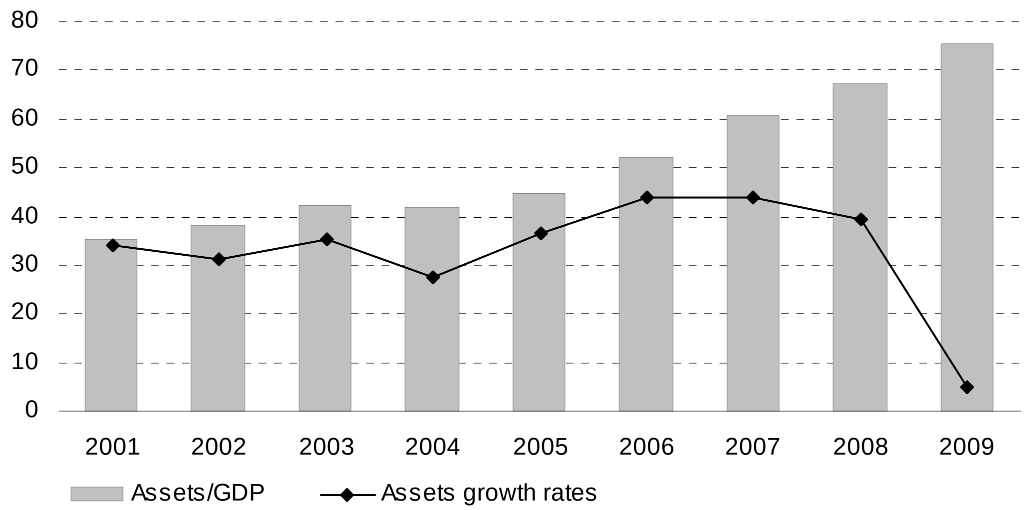
The current structure of industrial production and growth drivers makes industrial production highly sensitive to the government’s economic policy. In the current economic setting, the economic policy that is devised (or absent) will determine the growth pattern in the short term and shape the configuration of Russian industry, at least in the medium term.

Banking system

The Russian banking system has been struggling through hard times. The sweeping growth in banking assets over the past ten years has now slipped into stagnation. Banking system assets expanded just 5.0% in 2009, down substantially on the level observed in 2000–2008 (36.8%).

Despite significant gyrations in the ruble exchange rate in 2009, the currency's fluctuations affected banking assets only slightly – their growth adjusted for asset revaluation totaled 3.7%. The decline in nominal GDP widened the banking assets/GDP ratio to 75%.

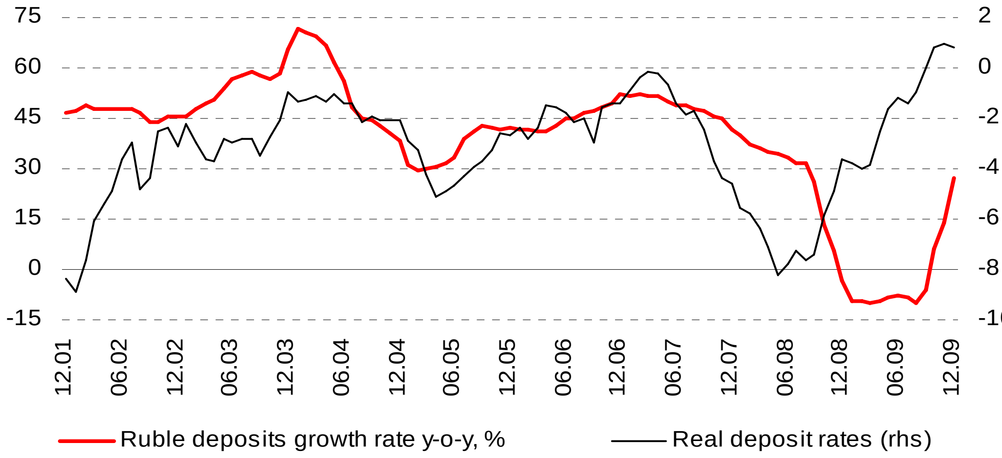
Russian banking assets/GDP ratio, %



Source: Rosstat, CBR.

The key trend in forming the banking system's resource base in 2009 was the focus on savings of the non-financial sector. Corporate deposits rose 15.2% over the year (ruble-denominated deposits increased 18.4%, while foreign currency deposits rose 6.5%). The most active group was households, which increased their savings 26.7% in response to the sharp increase in interest rates on household deposits in late winter to address the aggravated situation with funding in the banking system. Sberbank, which accounts for over half of the deposit market, actually set the benchmark for ruble deposits at 14–15% per annum. As a result, other banks had to offer higher interest rates. This fueled competition on the deposit market, pushing interest rates up to 20% per annum. The risks became so high that the CBR was forced to cap interest rates on deposits by issuing a respective recommendation.

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

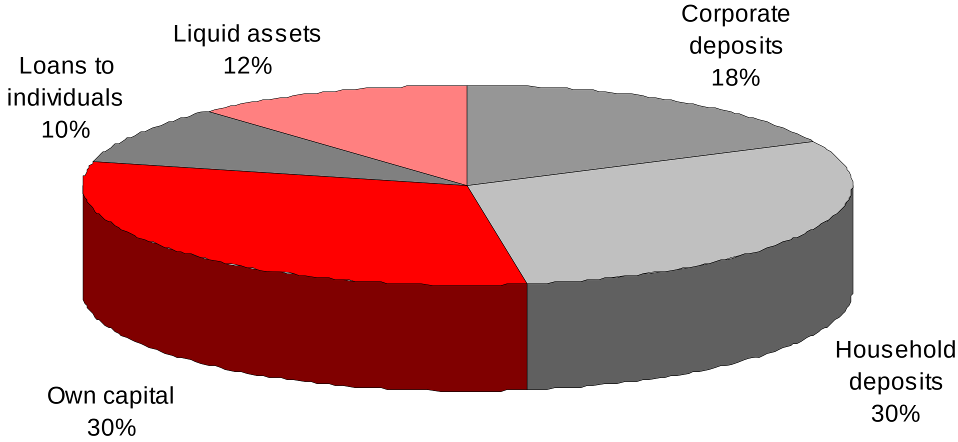


Source: CBR, Rosstat, CSI Bank of Moscow estimates.

Declining inflation, stable deposit rates and high interest rates on consumer loans in 2009 changed the household consumption model. Households switched from borrowing activities to savings. Consumer loans due declined 11.3% over the year. At the same time, the structure of household income and spending has changed, the savings rate growing noticeably in 2009. Over the year, households moved 5.6% of their monetary income to banks (R1.5 trln), which is much closer to the pre-crisis level of 2007 (6.7%) than the crisis year 2008 (2.2%). The return to the pre-crisis savings rate in 2010 against the background of 10% growth in nominal household monetary income may generate an inflow of almost R2 trln to household deposits.

The viability of this consumption model will depend on household expectations of income growth and real interest rates. According to CSI Bank of Moscow's base forecast, growth in nominal household monetary income is not expected to be more than 15% (which is well below the pre-crisis level of 23–25%) over the next few years. Household expectations of improvement in their well-being will be moderate, and a new "loan boom" similar to the one that occurred in 2006–2007 is a very remote possibility. We do not believe in a stable downtrend in inflation either, as interest rates on bank loans are already decreasing. The return of real interest rates on deposits to negative territory will mark the end of the dear money period. That may slightly rein in growth of the deposit base, but will help cut the cost of borrowing.

Banking sector resources in 2009 (growth in liabilities and contraction of assets)



Source: CBR, CSI Bank of Moscow estimates.

After the peak of the crisis in October 2008 – January 2009, the banking system recovered from the liquidity crunch, and it became obvious that state support to the banking sector had been excessive. Repayment of debt to the CBR was the main use of funds by banks in 2009. To this end, about R1.9 trln was allocated, representing 60% of the debt at the beginning of the year. The share of funds from the monetary authorities fell to below 5% of total banking liabilities by early 2010 versus 12% a year ago. In early February, except for CBR subordinated loans, amounts due to the CBR decreased to R0.6 trln.

Initially, funds from the CBR were predominantly concentrated in state-owned banks. In early 2009, at the peak of the crisis, state-owned banks accounted for 60% of all CBR loans. In February 2010, their share exceeded 72%. Long-term subordinated loans to Sberbank comprised the bulk of their debt to the CBR. Net of these loans, state-owned banks accumulated about 50% of short-term refinancing. Meanwhile, private banks were actively ridding themselves of expensive state support. By February 2010, almost 80% of their debt had been repaid, whereas state-owned banks had repaid only 63%.

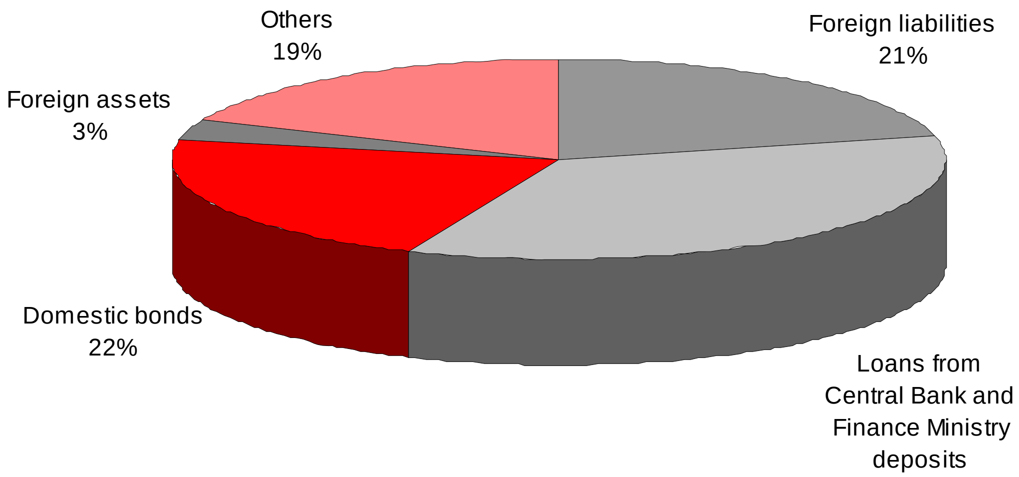
Even in a falling interest rate environment (in 2009, the CBR cut the refinancing rate from 13.00% to 8.75% per annum), banks did not resort to refinancing their debt to the CBR at lower interest rates. In most cases, demand at CBR loan auctions turned out to be well below the established limits, which provides additional proof that banks did not experience any financial squeeze for most of last year.

The large amount of foreign debt was considered to be a major threat to the banking system's stability in 2009. Total foreign debt of the banking sector as of January 1, 2009 was $166 bln, with almost a third ($53 bln) due to be repaid in 2009. Early last year, foreign liabilities were recycled into more than 16% of banking assets. During the year, however, banks managed to refinance about 40% of their foreign debt payments. Part of these payments was rescheduled to 2010, and by year end the extent of foreign debt refinancing rose to 50%.

At the beginning of 2010, the banking sector's foreign debt was estimated at $125 bln and foreign liabilities accounted for 12% of total banking liabilities. In 2010, banks' foreign debt payments will be more moderate than a year ago – about $30 bln, or less than one fourth of the total foreign debt. Against the background of gradual recovery of external financing, under a very pessimistic scenario we can expect banks' foreign liabilities to contract by no more than $10 bln.

The shrinking debt of Russian banks to the CBR and international lenders shows that banks will not have to divert funds in 2010 to repay loans and other debts. In 2009, Russian banks spent more than R3 trln to repay foreign debts and CBR loans, exceeding by 20% the amount of corporate and household deposits attracted by banks last year and accounting for 57% of total financial resources reallocated through the banking system. In 2010, the amount earmarked for this purpose will not exceed R1.3 trln (provided that all CBR loans are repaid, except loans to Sberbank, and that refinancing of foreign loans remains at the level registered in 4Q09).

Use of banking sector resources in 2009 (growth in assets and contraction of liabilities)



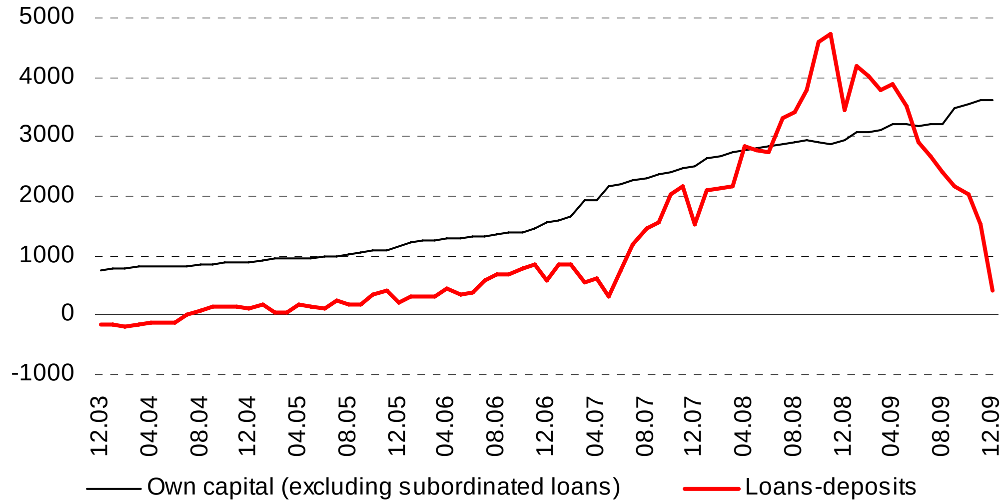
Source: CBR, CSI Bank of Moscow estimates.

Therefore, banks will be exposed to greater pressure from a growing resource base due to their being redundant on the credit market. However, growth in other borrowing by the banking sector will depend on the financial condition of the business and household sectors of the economy.

Subsiding business activity coupled with high interest rates helped resolve one of the key structural problems of the Russian banking system – bridging the gap between loans and deposits of the non-financial sector. This gap reached a critical dimension in autumn 2008. As of January 1, 2008, loans to the non-financial sector exceeded customer accounts and deposits by R4.5 trln, or nearly 1.5 times banks' equity.

In early 2010, the gap nearly disappeared due to stagnant lending and steady growth in the deposit base. As of January 1, 2010, the loan/deposit gap of the non-financial sector narrowed to R0.4 trln, or 12% of banks' equity, settling at the 2005 level. This situation creates a healthy financial basis for balanced economic growth – unlike the model slanted toward foreign borrowing.

Excess of loans over deposits of the non-financial sector ("loan-deposit gap" or loans to deposits ratio) and banking equity, R bln



Source: CBR, CSI Bank of Moscow estimates.

In 2009, investments in securities were chosen by banks as a major alternative to lending activity. Total bank investment in bonds rose by R1,488 bln over the year. Apart from high liquidity, investment in bonds has an additional advantage over credit creation – it is easier for banks to obtain refinancing from the CBR via direct repo transactions or Lombard loans.

However, debt securities have not become a real substitute for bank loans among corporate borrowers. Bonds of the non-banking sector accounted for only one fourth (R399 bln) of the total increase in the banking bond portfolio. Government securities (federal and municipal) and CBR bonds were the main investment instruments for banks in 2009. These three banking portfolios increased by R870 bln (almost 60% of total growth in banking investment in bonds) during the year. Purchases of bonds issued by other banks rose by another R120 bln, representing the funds that did not trickle from the banking sector but were funneled into interbank lending and collateral base expansion.

The volume of bonds issued by non-banks almost tripled y-o-y in 2009, from R251 bln to R737 bln. Nevertheless, the bond market remains negligible compared with volumes on the loan market, constituting a modest 4% of new loans issued in 2009.[2] Therefore, it is too early to expect bonds to become a plausible alternative to lending.

Major banking liabilities, end of month, % of total

	12.05	12.06	12.07	03.08	06.08	09.08	12.08	03.09	06.09	09.09	12.09
Liabilities (R bln)	9696	13963	20125	21323	23059	24572	28022	28527	27776	28182	29430
Capital	15.4	14.3	15.3	15.7	15.3	15.2	14.1	15.6	17.1	18.8	19.3
Bank of Russia loans	0.2	0.1	0.2	0.7	0.2	0.9	12.0	11.5	7.2	5.6	4.8
Interbank transactions	4.0	3.4	4.1	4.3	4.1	3.5	4.4	4.3	4.5	4.4	4.8
Foreign liabilities	13.7	17.1	18.1	17.2	18.3	19.0	16.4	16.2	14.8	13.4	12.1
Household deposits	28.9	27.6	26.2	25.4	25.5	24.5	21.5	22.1	23.8	24.2	25.9
Corporate deposits	24.4	24.4	25.8	26.2	25.5	24.0	23.6	22.6	24.0	24.7	25.9
Deposits of federal and local governments	2.0	2.2	1.5	1.7	2.5	5.0	1.0	1.2	2.4	2.4	1.0
Issued securities	7.6	7.2	5.8	5.5	5.7	5.0	4.1	3.7	3.6	3.8	4.1

Source: CBR, CSI Bank of Moscow estimates.

Therefore, the crisis year 2009 helped Russian banks resolve the structural problems that piled up during the overheated growth cycle.

The expected upturn in loans in 2010 will be accompanied by fewer resource constraints. At the same time, bank loans are not easily accessible for companies. There is still a gap between the actual demand and supply levels stemming from low profitability among companies and their demand for long-term borrowing, on the one hand, and the short-term costly liabilities of banks, on the other. Reduced borrowing costs somewhat cushioned the price gap in demand and supply of bank loans to the real sector, but the problem has not been eliminated. Moreover, there is a gap in the maturities of loans offered to and demanded by the real sector.

Although the current external environment is beneficial for Russian economic recovery and single-digit inflation was a major achievement in 2009, banks remain reasonably cautious about long-term investment in the real sector. Pessimism, among other things, is based on doubt that the slowing of inflation is a steady trend. Considering the government's annual hikes in tariffs for products of natural monopolies (nudging up producer costs) and its ineffective attempts to improve the business climate (leading to low competitiveness on commodity markets), deceleration of inflation was brought about almost exclusively by sharp contraction of domestic demand. The upswing in entrepreneurial activity and consumer demand (resulting from growing incomes and expansion of lending activity) will inevitably spur inflation, thereby lowering the efficiency of long-term and relatively cheap loans issued in conditions of low inflation.

[2] Bank loans to corporate borrowers totaled R19.1 trln in 2009. However, the amount of debt has not changed due to the matching volumes of repayments and prolongations.

Therefore, today's recovery of the Russian economy and its possible innovative breakthrough can count only on grudging support from banks. The cautious attitude among banks to long-term lending in the Russian economy can be dispelled only if institutional problems related to improving the business climate are resolved and adequate state financing meeting the requirements of economic growth is provided. Adequate supply of bank loans to the recovering real sector should become a priority for state economic policy.

Major banking assets, end of month, % of total

	12.05	12.06	12.07	03.08	06.08	09.08	12.08	03.09	06.09	09.09	12.09
Assets (R bln)	9696	13963	20125	21323	23059	24572	28022	28527	27776	28182	29430
Cash and precious metals	2.7	2.6	2.5	1.9	2.0	2.0	3.0	2.4	2.2	2.1	2.7
Accounts with CBR	7.3	7.5	6.9	5.1	5.8	4.2	7.5	6.7	6.3	3.9	6.9
Interbank transactions	6.3	5.8	5.4	6.2	5.9	4.8	5.2	5.1	5.1	5.0	5.4
Foreign assets	9.1	9.9	9.8	10.8	9.9	12.2	13.8	14.2	13.8	16.0	14.1
Households	12.1	14.7	16.1	16.4	17.0	17.8	15.5	14.6	14.3	13.8	13.1
Corporate sector	47.0	45.3	47.2	48.8	49.1	49.0	44.5	46.1	47.1	46.8	44.5
Government	6.6	5.2	4.1	3.3	3.4	3.0	2.0	3.1	3.3	3.7	4.2
Property	2.4	2.4	2.2	2.2	2.1	2.1	1.9	2.3	2.4	2.5	2.7

Source: CBR, CSI Bank of Moscow estimates.

Another important task for Russian banks in the coming years will be to clean their balance sheets of bad debt. Data indicate that the share of overdue loans has broadened over the past year. Overdue corporate loans grew 6% and the increase in overdue consumer loans reached almost 7%. The ratio of provisions for possible losses to loans (more accurately reflecting NPL value than past due debt) reached 9.9% for consumer loans and 10.8% for corporate loans. In 2009, over 80% of the banking sector profit was allocated to provisions for possible losses (versus 52% in 2008 and 20% in 2007). However, neither banks nor borrowers have a clear picture of the actual extent of bad debts, as a significant portion of loans issued last year was channeled into debt refinancing in hopes of economic recovery and improvement in the financial position of borrowers – the latter hardly a realistic prospect for all.

Thus, in 2010, we expect only minor changes in banking sector indicators. According to our estimates, total banking assets may surge 10–12%. Like a year ago, customer accounts and deposits will be the main source of financing. Household deposits may rise 20–25%, depending on the economic scenario, while corporate deposits and accounts could increase 15–20%. Growth in foreign liabilities of the banking sector will stay near zero, and amounts due to monetary authorities will decline by 1.5–2.0 times. Growth in equity will be underpinned by the need for additional provisioning for the loan portfolio, and therefore will depend on how efficiently the bad debt issues are handled.

Based on these parameters of growth in financial resources, the banks will have at their disposal around R2.0–2.5 trln of available funds. This amount will be able to increase the total loan portfolio by 13–17%. However, the efficient use of these funds for lending to the economy and their allocation between the retail and corporate sectors will depend on the movement of bad debt, the quality of economic recovery, the pace of growth in real household disposable income, and other factors. Loans will be competing with bonds, primarily government and foreign (as the main direction of forex-denominated investment). In all likelihood, consumer loans due will grow 5–8% and corporate loans due by 12–15% in 2010.

Forecast of key economic indicators

	Actual				Forecast		
	2006	2007	2008	2009	2010	2011	2012
Macroeconomic indicators							
Nominal GDP:							
R. trln	26.9	33.1	41.3	39.0	43.2	47.2	53.4
$ bln	993	1 293	1 660	1 230	1 464	1 687	1 778
Real GDP, % y/y	7.4	8.1	5.6	-7.9	3.0	3.2	5.4
Industrial production, % y/y	6.3	6.3	2.1	-10.8	4.0	5.0	5.0
Retail turnover, real, % y/y	13.9	15.2	13.5	-5.5	3.5	4.5	6.5
Gross fixed investments, real, % y/y	13.7	21.1	9.8	-17.0	1.0	5.0	6.0
Exports, real, % y/y	7.3	6.4	0.6	-4.8	5.9	1.4	0.7
Imports, real, % y/y	21.3	26.6	14.9	-30.9	17.0	12.2	3.0
Monetary Aggregates							
M0 (year end), % y/y	38.6	32.9	2.5	6.4	15.2	18.4	19.4
M2 (year end), % y/y	48.8	47.5	1.7	16.3	16.7	20.8	18.9
M2X (year end), % y/y	40.6	44.2	14.6	16.4	14.9	19.1	20.1
Total banking assets, % GDP	51.9	60.8	67.9	75.4	76.1	83.6	89.7
Inflation							
CPI (year end), %	9.0	11.9	13.3	8.8	7.2	7.5	6.5
CPI (year average), %	9.8	9.1	14.1	11.7	6.5	7.5	7.0
Core CPI (year end), %	7.8	11.0	13.7	8.5	6.8	7.0	6.2
Budget							
Federal budget revenues, % GDP	23.3	23.5	22.4	18.2	18.1	18.0	17.5
Federal budget expenditures, % GDP	15.9	18.1	18.3	25.5	22.9	19.9	18.1
Federal budget balance, % GDP	7.4	5.4	4.1	-7.2	-4.8	-1.9	-0.7
Reserve fund, year end, $ bln	89.2	156.5	137.1	60.5	37.8	67.2	87.4
National wealth fund, year end, $ bln			88.0	91.6	95.5	98.9	90.8
Balance of Payments							
Exports of goods, $ bln	304	354	472	304	380	400	420
Imports of goods, $ bln	164	223	292	192	230	270	290
Current account, % GDP	9.5	5.9	6.2	4.0	5.2	3.0	2.5
Net capital inflow/outflow, $ bln	41.9	82.8	-132.7	-56.6	20	40	50
International reserves, year end, $ bln	304	479	427	439	524	604	686
External Debt							
Foreign public debt, % GDP	5.2	3.5	2.4	3.1	3.6	4.1	4.9
Foreign private debt, % GDP	3.8	3.8	3.9	5.4	6.2	7.2	6.8
Exchange Rate							
R/$:							
end of period	26.3	24.6	29.4	30.2	29.0	28.0	30.5
year average	27.1	25.6	24.9	31.7	29.5	28.0	30.0
Exogenous Parameters							
Urals, $ p/bbl	60.9	69.6	94.4	60.7	73.8	77.5	81.4
$/€	1.26	1.37	1.47	1.39	1.42	1.39	1.35

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

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