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On the road to cheap money

Center of Strategic Investigations

CONTENTS

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The Russian government's economic policy is becoming more transparent. The latest data indicate accelerating economic growth: the upturn in industrial production was triggered by a sustainable beneficial external environment (high prices for raw materials and continuing growth in the global economy) and recovering domestic demand. Obviously, relying on external demand as a growth driver, we can expect at best 3% GDP growth in 2010. The Russian government has more ambitious plans for the current year, forecasting substantial growth with inflation staying within 6%.

The apparent measures to boost economic growth include monetary policy instruments – the ruble exchange rate, interest rates and the money supply. The logical course would be as follows: the ruble exchange rate remains stable and is set on an uptrend (with increasing volatility to combat the inflow of speculative foreign capital), while cutting the refinancing rate pulls down the cost of borrowing, making bank loans more accessible for the corporate sector and households. The upshot is expanding domestic demand, thereby spurring consumption and production.

However, this "classical" model has some institutional constraints typical of the current Russian economy. Over the past ten years, each R100 of growth in domestic demand was contributed by R53-55 in price growth, R22-25 of import growth and only R20-25 of growth in domestic production. The vulnerability of this model was also underscored by the crisis – among the G-20 countries, Russia experienced the deepest production slump and the highest inflation (despite having achieved a historic low in the post-Soviet era). Producers were more inclined to curtail production rather than lower prices. In case of a steady trend, the underdeveloped competitive environment in the Russian economy leads to a situation whereby producers' response to expanding domestic demand in practically all segments of the commodity markets is to hike prices rather than increase output.

Investment activity, in many respects because of the same institutional constraints (business climate, small business activity, corruption and market competition), has been rather slow, and it seems likely that household savings, which increased during the crisis, may turn out to be "redundant" for the Russian real sector. A sizable reduction in interest rates coupled with unstable inflationary expectations adds new appeal to household consumption, including the use of cheaper bank loans. The inevitable trade-off for such economic growth will be spiralling inflation and imports, implying a lost battle for domestic producers. Today, the forced transition to a cheap money policy without substantial change to the institutional framework seems risky, to put it mildly.

Monetary policy

Institutional constraints undermine the efficiency of monetary policy

The stimulating effect of external demand on Russia's recovering economy was blunted by the rebound of high prices for raw materials and moderately growing demand in physical volumes. In these conditions, growth in real GDP in 2010 will not exceed 3%. Better performance will require expansion of domestic consumer and investment demand. All monetary policy components, such as control over the ruble exchange rate, money supply trends and interest rate regulation, are essential for this process to occur.

Until 2006, the *refinancing rate* of Russia's Central Bank (CBR) played a passive role, acting as a fiscal tool reflecting the monetary authorities' expectations of inflation and the cost of money. Such an attitude to the refinancing rate was caused by the low contribution of the financial sector to the country's overall economic output and the absence of CBR refinancing of the banking system (the CBR acted as a net borrower with respect to the banking system). In recent years, the situation has changed radically. First, the impact of the financial sector on the national economy and economic growth rates has strengthened considerably. In 2005, bank loans accounted for 20% of growth in domestic demand, whereas in 2007 their share was over 33%.

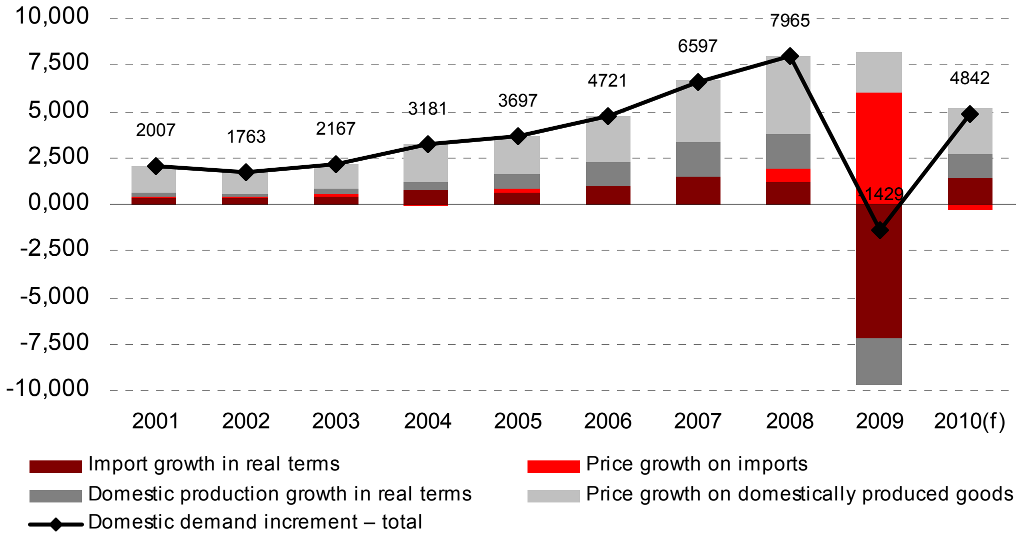
Second, the crisis in 2008–09 fundamentally altered the scale and terms of refinancing in Russia's banking system. First of all, at the peak of the crisis, the expansion of refinancing was a decisive factor in stabilizing the banking system. In early 2009, the share of CBR loans in the total liabilities of the banking sector was 12.3% and until mid-2009 the CBR remained a net creditor of the banking system. In addition, the list of financial instruments accepted as collateral against centralized loans was substantially lengthened. Thus, the potential volume of collateral instruments was increased at the beginning of the crisis to R1.5 trln. This volume subsequently expanded further owing to the rally in ruble-denominated bonds. Therefore, even in conditions of declining refinancing volumes, the cost of money in the economy may be lower due to the possibility to refinance at lower interest rates.

On the one hand, the CBR's current policy of steadily lowering the refinancing rate aims to boost corporate demand for bank loans and underpin the economic upturn. On the other hand, such reductions dent the savings activity of households due to sinking interest rates, thereby encouraging consumption and household demand for loans.

In fact, successful implementation of a cheap money policy depends on the *economic growth model selected*, whether consumption-driven or investment-driven. The choice does not come easy due to the circumstances *outside the monetary policy instruments*. The impact of the institutional factors is very high, significantly hindering the efficiency of monetary policy instruments.

If the policy is based on economic growth driven by expanding final domestic demand (growing consumption and lending), there is a risk that a sizable portion of domestic demand growth will be satisfied by imports – especially given the ruble's appreciation. Moreover, broadening domestic demand will stoke inflation.

Graph. Domestic demand growth and its sources, R bln



Source: CSI Bank of Moscow

Estimates by CSI Bank of Moscow indicate that in the pre-crisis period, growing prices for domestic commodities and services accounted *for over half* of domestic demand growth. Rising imports accounted for 22–25% of domestic demand growth, with an insignificant contribution from growth in import prices (only 10% in 2008). This means that 75% of domestic demand growth spurred inflation and imports, while only 25% stimulated domestic production. Expected appreciation of the real ruble exchange rate in 2010 suggests that the contribution of imports to domestic demand growth may be somewhat higher than that of domestic production. Moreover, growing prices for domestic commodities and services may again generate over half of the total growth in nominal domestic demand. Evidently, monetary policy aimed at stimulating domestic demand growth will contribute only 20–25% to economic growth, with the remaining 75% exacerbating problems associated with spiralling inflation and the worsening BOP structure.

On the contrary, if the policy is based on stimulating savings, there is a risk that investment activity remains at a low level and domestic savings may become *"redundant"* for the real and banking sectors. Investment-led economic growth suggests not only growth in savings, but also boosted investment activity through an improved business climate, financial stability, tax benefits, the state's involvement and other factors. The monetary policy instruments spurring this savings may be insufficient to successfully implement this model.

Money supply trend

Sterilization in the context of high oil prices and a budget deficit

The major factors behind the money supply trends during most of 2009 were beyond the scope of monetary regulation, and the CBR simply marched in step with the emerging market trends.

In early 2009, the money supply was largely influenced by the CBR's limitations on uncollateralized bank loans and a consistent increase in minimum interest rates on such loans at auctions (with a stable refinancing rate). The cap on uncollateralized loans in 1Q09 (summing the amounts at the auctions conducted) was the same as in December 2008 (R1.9 trln). The maximum weighted-average interest rate on uncollateralized loans rose to 15.4% in March 2009 (from 9.0%, when such loans started to be provided in October 2008) with a refinancing rate of 13.0%, while interest rates actually reached 18.8%. In spring, monetary policy "eased" almost without the CBR's efforts due to the following factors:

1. In February 2009, for the first time in several years, Russia returned to a budget deficit. The budget's contribution to money supply growth in February-December 2009 is estimated at R2.7 trln, almost fully generated by spending from the Reserve Fund.

2. The external economic environment has improved compared with expectations at the beginning of the year. Adjusted for movements in banks' foreign currency accounts at the CBR, the effect of foreign economic activity on money issued from February 2009 was R1.9 trln.

Such sizable inflows of foreign currency through the BOP enabled to cut, rather painlessly for the financial system, the volume of refinancing to banks. From February 2009 until end 2009, banks' liabilities to the CBR decreased by R2.3 trln (considering the R165 bln growth in December), primarily due to sluggish demand for uncollateralized loans.

We expect the CBR's role in forming money supply to be minimal in 2010. Under the inertia-based projection of the annual average oil price ($74/bbl) and net capital flow to the private sector of the economy ($10 bln, including net errors and omissions), growth in *Russia's international reserves* will account for R3.0 trln of growth in the money supply.

Another important factor determining the growth trends of the monetary base will be budget operations, as it was a year before. The Law on the Federal Budget sets the amount of changes in *CBR accounts* at R2.2 trln. Therefore, thanks to the two above factors alone (transactions with the rest of the world and the government), potential growth in the monetary base may reach R5.2 trln in 2010, or 80%!

Declining bank debt to the CBR will be one of the principal depressants of monetary base growth in 2010. As of January 1, 2010, the amounts due to the CBR from the banking sector (including VEB) totaled R1.9 trln, of which R0.9 trln was issued for a term of more than one year (a subordinated loan of R500 bln to Sberbank and VEB's debt to the CBR in the amount of R373 bln). Therefore, the maximum reduction in the banking sector's liabilities to the CBR in 2010 cannot exceed R1 trln unless there are significant changes to the terms of lending for major state-owned banks. That will limit potential growth of the monetary base in 2010 to R4.2 trln (65% y-o-y). High potential rates of growth in the money supply call for a correction in monetary policy to preserve the balanced growth of the monetary sector. However, the CBR has rather few instruments to this end.

Early repayment of loans by Sberbank (the first tranche of R200 bln was repaid by Sberbank this May) and VEB may add another $900 bln of the sterilization effect, trimming the maximum growth in the money supply to R3.3 trln (51% growth in the monetary base for 2010). Under basic estimates, growth in ruble-denominated cash holdings of households in 2010 may account for 2.5% of disposable household income, or R680 bln. The total increase in ruble-denominated cash circulating outside the banking system may reach about R1.0 trln. Accordingly, reserve bank assets[1] will grow by over R2.3 trln, which would mean that total reserve bank assets will equal R4.7 trln in 2010, signifying great risks to financial viability.

One of the possible responses to such a turn of events would be the government's revision of the planned budget deficit (primarily due to a better than expected external economic environment). Higher than projected oil prices (from $58/bbl to $74/bbl) would increase federal budget revenues by nearly R900 bln, and the total effect may be over R1 trln. This would lead to reduction of the budget deficit and reduce the need [2] for disbursement of budget funds from CBR accounts to finance it.

[1] Reserve bank assets are assets included in the broad monetary base, i.e. all of its elements, except cash in circulation (M0 aggregate).

[2] It is important to note that changes to the formation of the Reserve Fund in late 2009 (until 2013 it was not projected to include budget petro-revenues) indicate that in case of a beneficial foreign economic environment and growing revenues of oil exporters (and, accordingly, tax receipts), the government would have a substantial amount of excessive funds available. Under the procedure effective in 2008, these funds would have been tied up in the Reserve Fund or the National Welfare Fund.

Furthermore, if the government cuts foreign borrowing by $5.5 bln through the Eurobond issue placed in April, the BOP account recording transactions in financial instruments will shrink by more than $10 bln (the budget law provides for $16.3 bln in foreign borrowing) and the growth in international reserves in ruble equivalent will be reduced by more than R300 bln.

Therefore, potential growth in the broad monetary base may recede from R1.3 trln to R2.0 trln. Such growth can be generated by 30–32% annual growth in the monetary base. Such a pace of growth looks very high in the context of the recovering Russian economy. Faster growth in the money supply was observed only during times of active "de-dollarization" (in 2003 the broad monetary base grew 55.3% and in 2006 by 41.5%), but this year has a different background. Obviously, such an inertia-based forecast with the threat of a sharp upturn in money supply should provide for measures to cushion the monetary shock.

One of the monetary authorities' measures may be to raise mandatory reserve requirements for banks or bolster the appeal of other instruments to absorb liquidity (deposits and CBR bonds), inevitably accompanied by interest rate hikes. Different options may be suggested in respect of exchange rate policy.

The table below presents estimates of money supply factors for two development models. The first option involves maximum potential growth in the monetary base in conditions of a beneficial external economic setting. The second is based on possible sterilization measures taken by the monetary authorities as described above (constraints on the government's foreign borrowing, limitation of budget deficit financing and early repayment of long-term CBR loans to state-owned banks).

Table. Factors affecting money creation, R trln

	2007	2008	2009	2010	
				Scenario 1	Scenario 2
Money issued (increase in broad monetary base)	**1.39**	**0.07**	**0.89**	**4.2**	**2.0**
Growth in monetary base, %	*33.7*	*1.2*	*15.9*	*65*	*31*
Factors affecting money creation					
Changes in international reserves	3.81	-1.59	0.02	3.0	2.7
including changes in:					
trade balance	3.34	4.39	3.46	4.2	4.2
net capital inflow/outflow from the private sector	2.13	-3.67	-1.80	0.3	0.3
other BOP transactions	-1.66	-2.32	-1.64	-1.5	-1.8
Accumulation/disbursements of funds on account with the CBR		-0.78	0.83	0.2	0.2
Changes in gross lending to banks	0.01	3.79	-1.95	-1.0	-1.9
Changes in balances on budget accounts with the CBR	-2.04	-1.48	2.38	2.2	1.2
Other factors	-0.38	0.12	-0.38	-0.2	-0.2

Source: CBR, Finance Ministry, CSI Bank of Moscow estimates

In short, this year the money supply will be determined by the international economic environment and state budget execution parameters. In case of an excessively advantageous environment (i.e. oil prices substantially outperform the level projected in the budget and capital inflows to the private sector resume), the money supply may become excessive and the monetary authorities will not have effective sterilization tools at their disposal. As a result, the more than R2.0 trln in money issued will have to be sterilized to sustain annual growth of the broad monetary base in 2010 at a fairly high level of 30–35%.

Real sector

Recovering world economy guarantees only weak and unstable growth

Industrial production grew 10.4% y-o-y in April. *Russian industry is clearly picking up pace* – industrial output rose 5.7% y-o-y in March and 5.8% y-o-y in 1Q10. Statistically, industrial production growth almost doubled in April, triggered by *a strong upswing in the output of manufacturing industrie*s (15.7% y-o-y after 5.2% y-o-y in 1Q10). However, some deceleration in output growth was observed in the mining and quarrying sector and electricity, gas and water supply.

Partially, the upturn in industrial production in April can be attributed *to the base effect* – an industry-wide and uneven slump in output in winter–spring 2009. Considering this effect, April's accelerated growth signifies an apparent, albeit moderate, recovery in production. If in 1Q10 industrial output was 9.3% below the pre-crisis level of 1Q08, in April the gap narrowed to 8.3%.

Table. Industrial production output growth, January-April 2010

	y-o-y		Change vs same period in 2008		Maximum production slump, Apr-May 2009
	Jan-March 2010	Apr 2010	Jan-March 2010	Apr 2010	
Industry, total	**5.8**	**10.4**	**-9.3**	**-8.3**	**-17.0**
Mining and quarrying	6.7	5.0	2.6	3.1	-2.6
Manufacturing	5.2	15.7	-16.7	-13.3	-24.4
Electricity, gas and water supply	7.1	2.6	1.6	-0.1	-6.1

Source: State Statistics Service

Therefore, in the period of corrective growth (June 2009 – April 2010), *industrial output recovered by half*. During the peak of the economic crisis in November 2008 – May 2009, industrial production bottomed out, registering the worst indicator of –17% in April-May 2009. In April 2010, the production slump was reduced by nearly half: industrial production is now 8.3% below the respective pre-crisis level (April 2010 vs April 2008).

The recovery of industrial output *is not an even process*: the electricity, gas and water supply sector reached its pre-crisis level and mining and quarrying exceeds its pre-crisis figure by approximately 3%. Accelerating growth in April 2010 beefed up the manufacturing industries, but their output remains dramatically below the pre-crisis level – down 13.3% versus April 2008.

In manufacturing, the performance of interim and investment demand sectors improved in 2010, output rising 11–12% in 1Q10 on an annualized basis, and then quickening in April to 18.4% and 22% y-o-y, respectively. At the same time, the scale of the slump in output of building materials and the mechanical engineering sector (peaking at 40% in April-May 2009) was substantially corrected by growth in investment demand sectors. In April 2010, the slump in these sectors versus the pre-crisis level exceeded 26% (April 2010 versus April 2008) and was only slightly above the performance in 1Q10 (–27.3%).

Production output growth in the manufacturing sector, %

	y-o-y		Change on same period in 2008	
	Jan-March 2010	Apr 2010	Jan-March 2010	Apr 2010
Manufacturing	**5.2**	**15.7**	**-16.7**	**-13.3**
final demand sectors*	4.9	4.2	-2.5	-1.1
intermediate demand sectors*	11.3	18.4	-11.7	-3.3
investment demand sectors*	11.9	22.0	-27.3	-26.1
Reference data:				
Real disposable household income	7.4	3.7	8.2	6.2
Retail turnover	1.3	4.2	1.7	0.4
Exports of products manufactured by the intermediate demand sector (physical terms)	13.2		6.9	
including				
metals, chemicals and woodworking	20.5		-7.3	
oil products	6.0		17.1	
Fixed capital construction	-4.7	2.3	-21.2	-19.1
Construction	-8.1	-6.2	-25.8	-21.5

* Final demand sectors: manufacture of food products, manufacture of textiles and textile products, leather, leather products, shoes, manufacture of pulp, paper and paper products, publishing and printing
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
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
Source: State Statistics Service, Federal Customs Service, CSI Bank of Moscow

Therefore, the upturn in Russian industry in April 2010 may be summarized as follows:

- Mining and quarrying exceeds the pre-crisis output level by about 3%.
- Final demand sectors and electricity, gas and water supply are approaching their pre-crisis levels.
- Output in the intermediate demand sectors is approximately 3% below the pre-crisis level.
- Output in investment demand sectors considerably lags (by 26%) their pre-crisis level.

The persistent slump in the mechanical engineering and building materials sectors is directly ascribed to the continuing investment *pause* in the Russian economy. After a 16-month downtrend, fixed capital investment inched up 0.7–2.3% y-o-y in March-April 2010. However, these sectors are still underperforming their pre-crisis levels by 19–21%.

The robust recovery in *intermediate demand sectors* is largely based on *climbing exports of their respective products*. In 1Q10, exports of oil products, metals, chemicals and timber products increased 13% y-o-y and were 7% above their respective pre-crisis levels.

As before, stable and moderate growth *in final demand sectors* stems from the *low purchasing activity of households* (with household savings growing faster). Domestic output in this sector is growing at a far slower pace than real disposable household income. Compared with the pre-crisis level, real disposable household income rose 8.2% in 1Q10 and 6.2% in the period between April 2010 and April 2008, respectively, while domestic output of consumer products is only nearing its own pre-crisis level.

The following factors should be taken into account to assess the *viability, prospects and sources of Russia's industrial recovery in the short term*.

Low investment activity in the Russian economy remains the main growth depressant for the Russian economy. An unfriendly investment and business climate, low optimism regarding the prospects for business activity, the inability of most companies to finance investment activity with internal funds, the traditional non-accessibility of long-term cheap bank loans at low interest rates – all such factors will contribute to the slow pace of output recovery in the mechanical engineering and building materials sectors.

Slow growth in the mechanical engineering sector and the manufacture of building materials will result in *slowly recovering demand for products of interim demand sectors on the domestic market*. In 1Q10, growth in the output of interim demand sectors significantly underperformed the growth in exports of their respective products. Global demand for products in these industries is increasing at a much faster pace than domestic demand. Thus, exports of ferrous metals picked up 25% and copper exports grew 6%, while exports of nickel and aluminium did not change in 1Q10 (y-o-y). Meanwhile, the manufacture of basic metals and fabricated metal products rose 7.9%.

Recovery in the global economy *will be a reliable but limited resource for growth in* intermediate demand sectors and industry as a whole. The growth model focused on external demand with weak domestic demand as a backdrop is not only the inherent reason for instability and relatively low production growth, it also provides poor leverage for boosting competitive high-tech production.

Final demand sectors are hardly likely to contribute to acceleration of growth in industry. Their growth is currently being slowed by change in the consumption funding model: aggressive consumer demand that surged on the back of expanding consumer lending gave way to increased household savings and restrained buying activity. At the same time, the potential upswing in domestic demand boosted by the monetary authorities via interest rate cuts does not guarantee any sizable improvement in the output trends of the respective industries. Rather, growth in consumer demand will trigger price hikes and higher inflation instead of growth in output of final demand sectors due to the slack competition of producers in the Russian market.

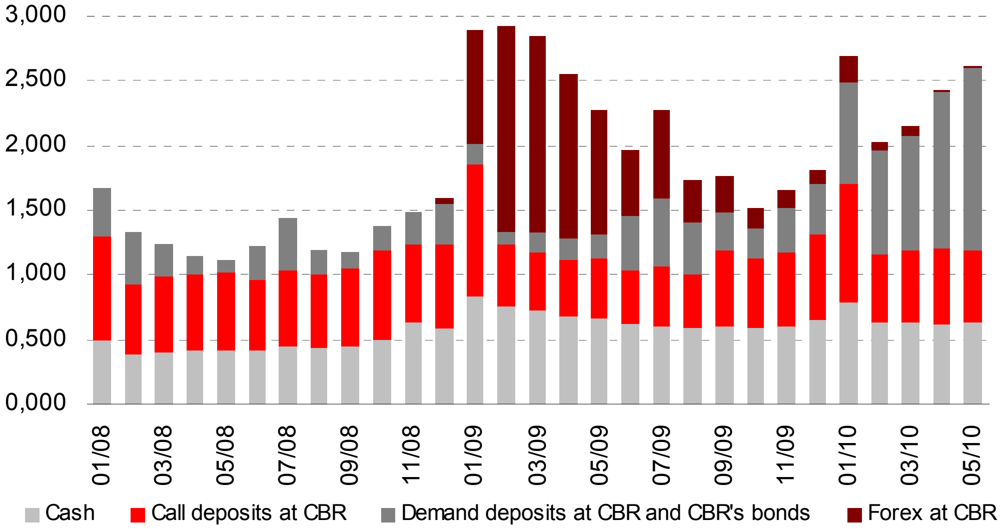
Therefore, *the main factor* weighing on the growth of Russian industry, and the economy as a whole, is that *the quality of Russian institutions does not match the requirements for output recovery, let alone the objectives of total modernization and ambitious growth*. The substantial problem of corruption, high barriers to access business, unresolved social problems shifted onto companies, and an ambiguous judicial system dent the stimulus and entrepreneurial performance while reining in economic growth. The crisis and the recovery period vividly demonstrated the costs stemming from the institutional backwardness of Russia's economy. The inevitable expansion of domestic demand in the context of interest rate cuts, the gradual reduction of state economic support programs, and the implementation of large-scale economic modernization programs will eventually have an effect within the existing institutional framework. Today, however, there are very few reasons for optimism.

Banking sector

Growth in credit creation will not add to investment activity

By steadily lowering the refinancing rate, the monetary authorities aim to foster bank lending to the non-financial sector. The liabilities of the banking system are expanding rapidly (annual growth is expected to reach 15%). However, bank lending to corporate clients and households continues to stagnate, adding to the volume of "non-performing" liquid assets. Banking sector liquidity rose above R2.5 trln, which is comparable with last year's levels, when banks moved their funds into forex assets against the background of "smooth" depreciation. At that time, the foreign currency liquidity could potentially generate income as translation gains, but now these assets do not generate any income. A sizable portion of free funds is tied up in state-owned banks (45% of all liquid assets). The liquidity level is comparable for all groups of major banks, and even decreased slightly for small banks in recent months. Actually, this means that reallocation of these funds in the form of loans to the economy is decided by three or four state-owned banks. The share of liquid assets at Sberbank grew by over 11%, whereas in the pre-crisis period it accounted for just 3% of total assets (a reserve of R650 bln). However, according to executives of these state-owned banks, corporate lending risks are still high and have hardly subsided.

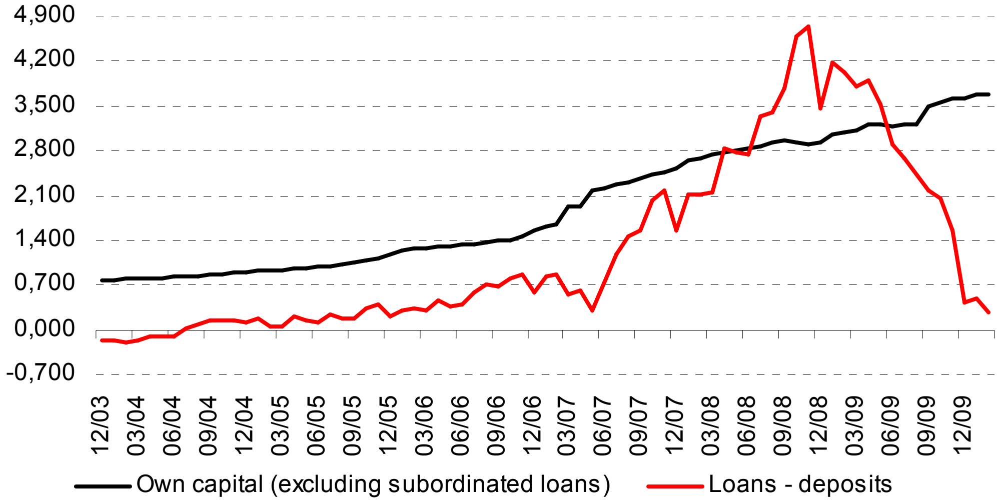
Graph. Liquid assets of the banking system and their structure



Source: CBR, CSI Bank of Moscow

The Russian banking system is potentially ready to resume lending to the non-financial sector. In 2009, household deposits grew 25% and corporate deposits rose 15%, while the loan portfolio shrank over the same period. That helped balance the ratio of loans to deposits in the non-financial sector, with the gap standing at less than 5% of the banking sector's equity. Net bank lending to companies settled at R4.1-4.3 trln (the level observed in early 2008), while households' net credit to banks widened noticeably, from R2.0 to R4.1 trln.

Graph. Excess of loans over deposits of the non-financial sector (net of bonded debt) and total equity capital of the banking system, R bln



Source: CBR, CSI Bank of Moscow

The major obstacle to growth in credit creation in 2010 is the systemic gap between the parameters determining credit supply and demand. The Russian banking system has relatively costly and short-term liabilities. In the period of economic and financial crisis, commercial banks re-directed their attention to domestic resources. The share of household deposits in total banking liabilities increased from 21% to 26% in 2009. At the same time, foreign borrowing (traditionally cheaper and longer-term) dwindled from 17% to 12%. The funds provided by the monetary authorities to the banking system as anti-crisis measures were also very expensive and short term (the exception was a CBR loan to Sberbank in the amount of R500 bln for 10 years at 8.5% per annum. However, the latest news is that Sberbank intends to make early repayment of this debt to its shareholder).

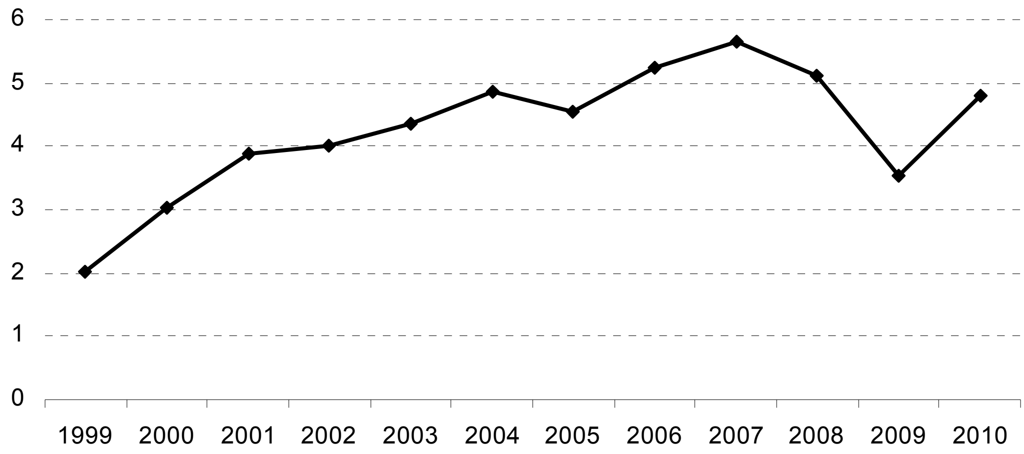
Low demand for loans is brought about by low profitability in industry and the uncertainty of the emerging environment, including economic growth and inflation. Substantial demand is observed for refinancing debts from prior years, but this demand for loans is fraught with high risks.

Thus, the gap is gradually narrowing – if loans do not become longer term, at least they are being offered at lower interest rates. Profitability in industry is growing in step with the improving economic environment. However, the debt of companies operating in the real sector in the form of bank loans did not change in 2009, growing a slight 0.3%. In January-April 2010, there were no movements either (with ruble-denominated loans inching up 1.25%).

Lending activity is expected to pick up in 2010. According to our projections, growth in corporate debt to the banking system will total 15% and differ by loan structure.

Growth in *ruble-denominated corporate loans with maturity of up to one month* is expected to be significant and reach about 50%. During 2009, there was a deficit of working capital and current assets. Recovery in these segments began only at year end and will continue in 2010. Following this trend, the level of debt in the form of ruble-denominated bank loans with maturity of more than one year is expected to reach at least the level of 2006.

Graph. Correlation of short-term ruble-denomiated corporate loans and gross output in the economy, %



Note: Short-term ruble-denominated bank loans finance current business turnover, and their level is proportionate to gross output.
Source: CBR, CSI Bank of Moscow, State Statistics Service, AL Vedi estimates

Ruble-denominated corporate loans with maturity of more than one year will grow a less noticeable 6-7% in 2010. In 2009, there was an opposite trend – long-term loans climbed 24%, whereas short-term loans dropped 33%. Such movements were not generated by expanding investment activity (fixed capital formation fell 18.2% in real terms and 14.5% in nominal terms). Long-term loans were issued to prospectively viable enterprises to restructure their prior-year debts. Concurrently, enterprises in the non-financial sector experienced a deficit of working capital and current assets (arising from uncertainties and risks in the economy and high interest rates). Moderate growth in corporate loans with maturity of more than one year will depend on improvement in the general economic environment, growth in corporate profitability, and interest rate cuts. This process may liven up investment activity.

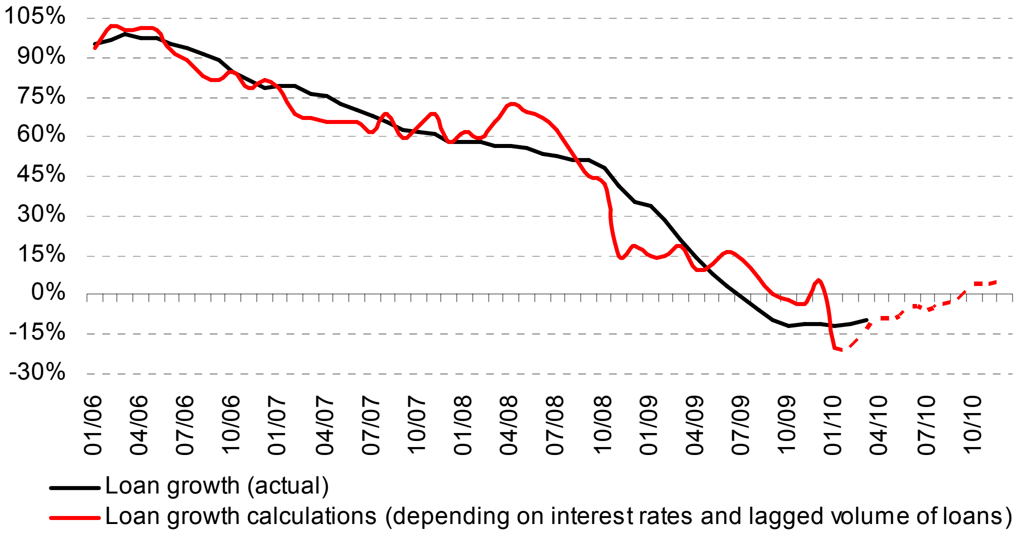
Overall, ruble-denominated corporate loans will grow 21% in 2010, while corporate loans in foreign currency are expected to decline 2%. Therefore, the amounts due from Russian companies on bank loans in 2010 will rise 15% in the context of upward bound ruble-denominated loans and declining debt on loans in foreign currency. Short-term loans (which fell in 2009) will move up again, and long-term loans will be growing at a slower pace. In general, corporate loans will be issued to underpin current production activities and, to a minimum extent, investment activity. Forecasts call for the growth model to be driven by external demand and not investment.

There are two reasons for the decline in consumer loans: weak economic growth and changes in household credit activity.

Household debt on bank loans shrank 11.8% in 2009, which, other things equal, is facilitating its growth in the current year due to the base effect. We do not expect any upswing in this segment of the credit market in 2010 and, based on annual performance, this indicator will vary from –2% to +4%, which is tantamount to stagnation.

The low activity of the consumer lending market will be determined by such factors as slowing growth in nominal household income (versus the pre-crisis level) and changes in the borrowing activity of households. The projection, based on moderately optimistic changes in household income and interest rate reductions, should be viewed as the *upper limit* for possible estimates for the current year. The respective estimates indicate that growth in consumer loans can hardly go beyond 3-4% in 2010.

Graph. Growth in consumer loans, % change y-o-y



Note: The graph shows that the loan growth curve is calculated on the basis of movements in household income and interest rates and describes rather accurately the actual increase in loans. The macroeconomic factors suggest that nominal household income will grow 10-11% in 2010, underperforming the current interest rates on loans.
Source: CBR, CSI Bank of Moscow

An interesting situation is emerging. In 2008, Russia's non-financial sector acted as a net borrower of the banking sector. The amount of borrowing was R2,255 bln. In 2009, companies and households were already net creditors of the banking sector, moving R2,585 bln into banks. In 2010, the banking sector, no matter how paradoxical it may seem, will remain a borrower of the non-financial sector, with the amount of borrowing equal to R860-870 bln. This means that even with growth in lending to the non-financial sector in the current year, the banking system will raise substantial funds from companies and households to be used for other purposes, for example to spur banking liquidity and foreign assets, investment in the financial market or repayment of the CBR's foreign debt.

Forecast of key economic indicators

	Actual				Forecast		
	2006	2007	2008	2009	2010	2011	2012
Macroeconomic indicators							
Nominal GDP:							
R. trln	26.9	33.3	41.4	39.1	44.0	48.0	54.1
$ bln	993	1 299	1 664	1 232	1 492	1 714	1 805
Real GDP, % y/y	7.7	8.1	5.6	-7.9	4.1	3.3	5.1
Industrial production, % y/y	6.3	6.3	2.1	-10.8	6.3	5.0	5.0
Retail turnover, real, % y/y	13.9	15.2	13.5	-5.5	4.1	4.5	6.5
Gross fixed investments, real, % y/y	13.7	21.1	9.8	-17.0	4.5	5.0	6.0
Exports, real, % y/y	7.3	6.4	0.6	-4.8	5.1	1.3	0.9
Imports, real, % y/y	21.3	26.6	14.9	-30.9	19.0	12.4	1.6
Monetary Aggregates							
M0 (year end), % y/y	38.6	32.9	2.5	6.4	15.2	12.5	18.5
M2 (year end), % y/y	48.8	47.5	1.7	16.3	18.6	21.3	18.4
M2X (year end), % y/y	40.6	44.2	14.6	16.4	13.6	18.8	19.2
Total banking assets, % GDP	51.9	60.8	67.9	75.4	74.6	80.5	86.6
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	370	390	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	1.26	1.30	1.35

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

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