Bank of Moscow

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New Realities for Russia's Finances

Center of Strategic Investigations

Volatile global financial markets that caused a liquidity deficit and revaluation of risks did not have an immediate impact on Russian finances, including the banking system. Banking liquidity remained high and, with the exception of the three major state-owned banks, exceeded the level observed at the start of the year. Interest rates picked up (in some periods surging to 10% per year on overnight interbank loans), but a similar upturn was also registered in autumn 2006. The formal conclusion of Russia's monetary authorities (and certain experts) was that there were no indications of any crisis in Russia.

That said, banks did not let their guard down, realizing that the situation had indeed changed –external financing will now be less in volume and higher in price. The share of foreign borrowing in Russia's banking sector comprised a sizeable 17% of total liabilities. This is a substantial portion and considerably impacts the cost of funding. Access to refinancing provided by the CBR is not sufficiently broad (and not very cheap either, at more than 6%). The bottom line is that the average cost of financing will rise, at least by the end of 1Q08.

In early 2007 we wondered whether 2006 had established a new trend in development of the banking system, or whether it was merely a statistical anomaly caused by the powerful influx of foreign capital to the banking sector. Russia's authorities apparently considered it a sustainable trend – and not only in the banking sector – and accordingly revised their forecasts for the entire economy. Thus, the expected GDP growth rate was revised upward to 7.5% from a previous 6.4%. However, it now seems clear that inflation will exceed not only the projected target, but last year's level as well. High economic growth in the current year alongside interest rate hikes provide fertile ground for a slowing of economic growth in 2008.

For us, the major challenges and threats to Russia's financial system are transparent up until 2010. Meantime, analysts will have to keep their noses to the grindstone. Certain trends crop up unexpectedly, whereas others occur as predicted. Growing costs of external financing and declining volumes, at least in the current and following years, were not expected to occur so soon. Instead, the current account balance was initially expected to decline gradually. We feel this is only the tip of the iceberg in terms of existing and new threats that a) the monetary authorities envision while devising their financial policy, and b) commercial banks are taking into account when elaborating their strategies. In all sectors, the euphoria from the first six months of the year will soon dissipate, as it is now time to adjust to the new configuration of the financial system and economic growth drivers.

CONTENTS

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Monetary Sector

"Let the Truth be Known": Russia's banking system withstood the capital outflow, but cannot develop without external capital infusions

We expect the situation to stabilize by the end of the year thanks to consistent steps by the monetary authorities in industrially advanced countries (e.g. providing banks with substantial liquidity or lowering interest rates). Meantime, stock indices in most markets have recovered their pre-crisis levels and are now set on an upward path. For Russia, however, and primarily for banks and blue chip companies, the short- and long-term repercussions are less encouraging:

- an increasing cost of borrowing on external capital markets; and
- reduction of international exposure, i.e., narrowing access to foreign capital experienced by Russian companies and banks.

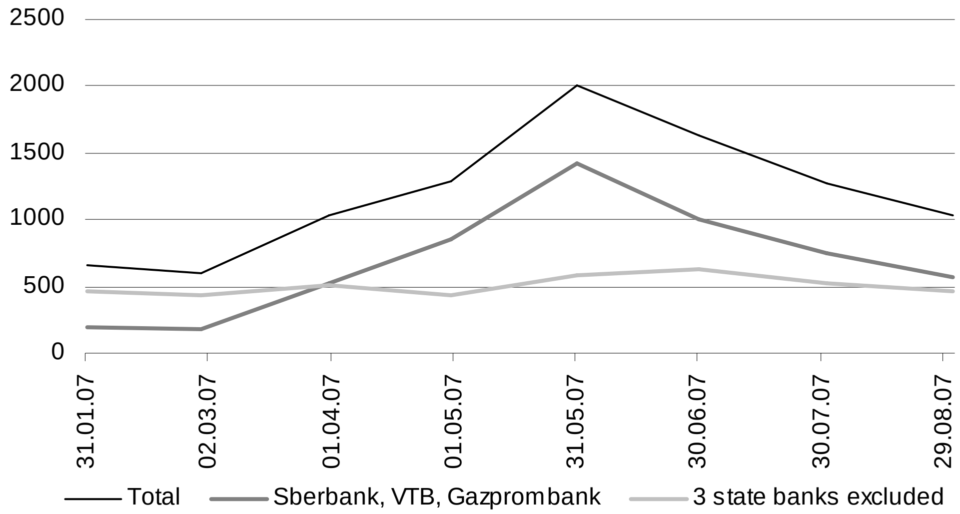
Russian banks and companies to a substantial degree depend on foreign borrowing, and more so on *capital inflows* than *outflows.* The fact that the capital outflow was rather moderate and impacted the banking sector only slightly does not imply financial stability, but rather signals that a substantial plunge in capital inflows will have a longer-term impact.

Hampered access to external resources is putting the brakes on growth in bank loans. One direct implication will be decelerated growth in domestic demand and, consequently, slower economic growth. Surging foreign borrowing costs may lead to the following situation in the Russian financial sector:

- Mounting borrowing costs will push up interest rates on loans. In these circumstances, the structure of bank loans is expected to change. First, there will be a shift from major to small- and medium-sized corporate borrowers and households (with a more rigorous analysis of the latter's solvency). Second, banks will increasingly gravitate toward transactions in high-risk securities. The change in the banking loan structure will inevitably heighten the risks of the banking system as a whole.
- Against the background of decelerated lending to corporate customers, a number of promising sectors of the economy may be hit again by a financing deficit, raising the issue of underfinancing of structural changes in the Russian economy caused by divergence of funds to lessen oil dependence. If things unfold in such a fashion, structural reform in the economy may soon come to a halt.

We admit the possibility of crisis in the real estate market. By most estimates, 20–40% of real estate is now purchased for investment purposes. A downturn in prices on the real estate market, by our estimates, may be offset by financial institution sales of real estate to replenish their liquidity. Considering the market structure, this may trigger a domino effect. The role of households in this process will be insignificant, but a price decline of 10–20% by year's end seems quite plausible.

Banking System Liquid Assets, R bln



Note: Liquidity volume volatility was due to three biggest state banks – Sberbank, VTB and Gazprombank. Liquidity volume of other banks was relatively stable in August 2007 (about 500 R bln, or $20 bln) and corresponded with the beginning of this year.

Source: CBR, banks' reports, CSI Bank of Moscow.

Medium-term scenarios of banking system development

A year ago, CSI Bank of Moscow put together two basic scenarios for banking system development – *accelerated growth* and *balanced development*. These scenarios were constructed based on the existing systemic factor – a deficit of internal resources and two possible options for deficit financing (through external or internal sources). Clearly, the more risky scenario is for accelerated growth, which entails a vigorous inflow of foreign capital and rapid growth in bank lending. Under this scenario, domestic demand will expand dramatically and the economy will grow rapidly. Among the possible threats are high inflation, volatility of the banking system (resulting from the possibility of a bad-debt crisis) and ill-developed financial markets. In this context, the balanced development scenario has more appeal in terms of financial stability, but it also constrains economic growth (at least for the next few years).

Since 2004, Russia has been experiencing a chronic deficit of *internal financial resources* to support economic growth. The deficit of internal resources means that the volume of loans and securities is higher than the volume of corporate and household deposits. Foreign borrowings and/or the funds of monetary authorities (the government and the CBR) may be viewed as sources of deficit financing. The crunch in internal resources is gradually widening. In 2005, the deficit amounted to R170 bln, whereas in 2006 it jumped to R303 bln. The percentage of loans to deposits for the Russian banking system equaled 103% in 2006 (excluding liquidity, securities and foreign assets) and is broadening further, pointing to a high credit load versus the internal base.

Deficit ("-" – surplus) of the internal Resource Base and Sources of Financing, R bln

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Initial deficit	**-149**	**-195**	**29**	**-104**	**-4**	**72**	**170**	**303**	**469**
Sources of financing ("-" – influx):									
International donors	-101	-75	22	45	246	26	232	602	706
Federal government	22	20	4	5	-2	59	-36	46	27
CBR	-70	-139	3	-154	-247	-13	-25	-344	-265

Note. Estimates for 2007 were made at the start of the year, disregarding the strong capital inflow in the first six months of 2007 and the liquidity squeeze on global markets. It is possible that the final result may change if adjusted for the above factors.

Source: CSI Bank of Moscow.

Russia's monetary authorities face a strategic choice between balanced (i.e. less risky, slower) and accelerated growth. Both scenarios are practicable, and the choice is dictated more by political considerations than sound economic sense. In other words, it has more to do with political cycles than medium-term planning. However, the monetary authorities must make a conscious choice – until now their movements between the two scenarios were spontaneous and driven more by external circumstances.

Economic growth prospects

For the first eight months of this year, Russia's economy grew much faster than originally projected. GDP growth for the current year was revised upward from 6.4% to 7.3%, the industrial production growth target – from 5.2% to 6.0%, and the investment growth target – from 12.8% to 18.2%. However, the projections were revised only for the current year, whereas the medium-term forecasts remained unchanged. This is an indication that only the key targets for the current year were revisited without any fundamental revision of the medium-term trends. In turn, this means that the underlying guidelines of economic policy remain the same, and that economic growth proved stronger due to the current economic environment.

Economic growth was spurred by a greater than expected expansion of domestic demand, largely driven by two factors – sustained high oil prices and fast-growing bank loans. It should be noted that next year these two growth catalysts may turn into depressants – prices for raw materials may drop slightly, while growth in bank loans is likely to slow. Furthermore, there is a base effect referring to the high output growth so far this year. All things considered, growth rates in 2008 will stay at the current year's level at best, and are more likely to fall below this level.

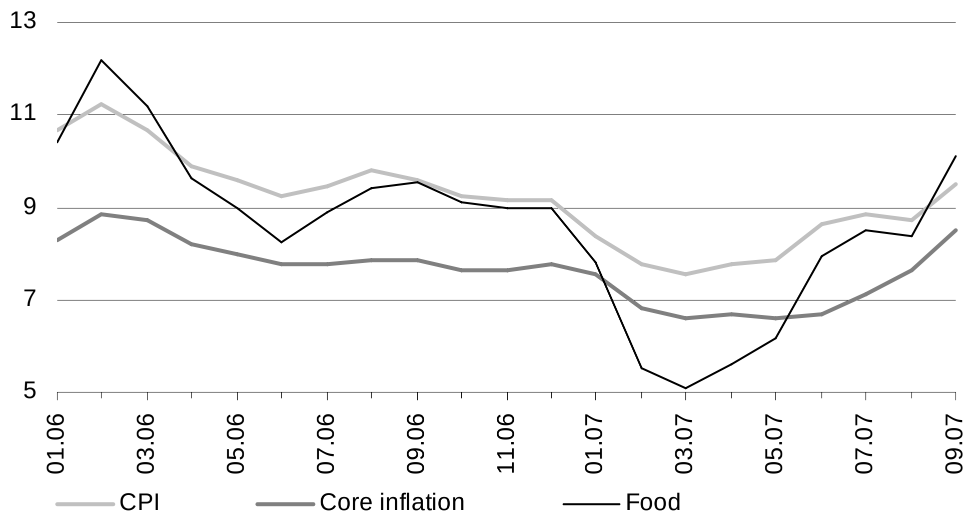
Inflation

Principal issue – the extent to which the government target will be exceeded

The price rally in September was shocking only to the Russian government, as it was already crystal clear that the annual inflation target would not be met. Year-to-date through September, consumer prices rose by 7.5% y-o-y (vs. 7.2% in 2006). Last year, consumer price inflation ran at 9%, and this target was met owing to government efforts to control gasoline prices and ruble appreciation. In the current year, the government has so far failed to cope with spiraling world prices for food products. Gasoline prices remain stable, posting 2.3% growth for the nine months vs. 12.2% a year earlier. The ruble will hardly budge against the bi-currency basket until the end of the year (i.e. this anti-inflationary tool will be rather ineffective until year's end), and occasional fluctuations versus major global currencies will be caused only by the situation on global markets.

Therefore, the government has practically no levers with which to restrain inflation. For the first eight months of this year, cash in circulation rose a modest 13.8% (vs. 17% a year ago), and money supply constraints will not improve the situation. Moreover, pensions were raised starting from October 1, which, despite the social importance of this measure, increases pressure on the food products market. In the run-up to the elections, budget expenditures will either be increased or incurred strictly to the time budget, and shifts in the schedule cannot be used in the current year (last year only 19% of annual budget spending was implemented, and price growth was partially rescheduled for January). All said, we estimate consumer price inflation this year at 9.5–9.7%.

Consumer Price Index, % Change on the Month of a Year Ago



Source: Rosstat, CSI Bank of Moscow estimates.

However, the inflation outlook for next year looks more optimistic. First, money will be more expensive, leading to growth of interest rates, including those on household deposits. This factor will boost savings activity among households. Further, the cost of consumer credits will rise, and the current consumer boom will be cooled to some extent. Growth in tariffs for utility services will remain at the level of prior years (hikes in prices for natural gas and electricity will impact producers, but their effect on households will be milder). If the balanced budget policy is pursued, we have every reason to expect a drop (albeit fractional) in inflation next year.

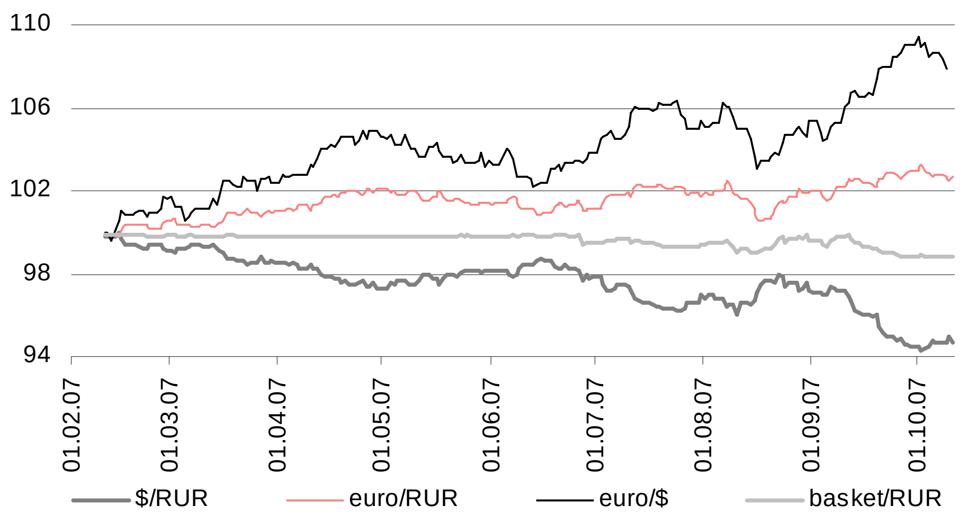
Exchange Rate

Since July, the CBR has been exercising a more flexible exchange rate policy (see our previous Monthly Report). In September, the ruble appreciated by nearly 1% versus the bi-currency basket. This ruble strengthening was accompanied by depreciation of the US dollar versus the euro on the global forex market.

Appreciation of the Russian currency against the dollar allowed the CBR to demonstrate once again its efforts to combat inflation. In addition, this step was viewed as a countermeasure targeting capital outflows from the Russian economy – yields on ruble-denominated instruments restated into foreign currency picked up. The euro's firming against the ruble may impede import growth only marginally, as a considerable part of Russian imports are from eurozone countries (according to the Federal Customs Service, imports from non-CIS countries soared 49.8% in January through August).

We expect a certain correction in the dollar-euro exchange rate to $1.35–1.37/€ by year's end. It makes no sense to use the ruble exchange rate as a means of combating inflation in the current year, whereas a substantial leap in imports is a real menace to the balance of payments and the competitiveness of Russia's economy. We expect the ruble to appreciate versus the bi-currency basket by no more than 0.5% until year's end. In these conditions, the dollar will fluctuate against the ruble within a range of R25.2–25.5/$.

Exchange Rate Movements (February 9, 2007[1] = 100%)



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

[1] The current bi-currency structure of 45% in euros and 55% in dollars, in line with the CBR's Monetary Policy Guidelines, has been in effect since February 9, 2007.

Real Sector

Industrial production slowdown in August – cold shower or statistical anomaly?

Russian industrial output grew just 3.8% y-o-y in August, which not only sharply contrasts with its rally in June and July, but also marks the worst monthly performance this year.

Acceleration of output was observed only in the manufacture of rubber and plastic products, as well as other non-metallic mineral products, electrical, electronic and optical equipment. Some manufacturers noticeably decreased their output versus August 2006 (manufacture of textiles and textile products, manufacture of leather, leather products, shoes, manufacture of basic metals, manufacture of machinery and equipment, transport equipment and other products). Most industries were hit by the slowdown.

Industrial Production Output Growth in 2007, % y-o-y

	August	June-July	June-August	April-May
Industrial Production Growth Index	**3.8**	**9.4**	**7.5**	**5.9**
Mining and quarrying	0.5	1.6	1.2	2.0
Manufacturing	5.5	14.1	11.1	8.4
Final demand sectors	*3.5*	*6.1*	*5.2*	*9.3*
Manufacture of food products	3.4	6.6	5.5	9.4
Manufacture of textiles and textile products, manufacture of leather, leather products, shoes	-4.8	-0.8	-2.2	6.6
Manufacture of pulp, paper and paper products; publishing and printing	9.5	9.2	9.3	6.1
Other sectors	2.3	4.6	3.8	14.1
Investment demand sectors	*9.5*	*25.9*	*20.3*	*12.0*
Manufacture of other non-metallic mineral products	12.2	9.9	10.7	15.8
Manufacture of machinery and equipment	9.0	28.6	21.9	11.4
Intermediate demand sectors	*2.1*	*3.7*	*3.1*	*4.8*
Woodworking and manufacture of timber products	2.5	2.4	2.4	9.3
Manufacture of coke, refined petroleum products	1.9	4.3	3.5	1.5
Manufacture of chemicals	5.3	8.5	7.4	7.5
Manufacture of rubber and plastic products	26.7	22.0	23.6	23.4
Manufacture of basic metals and fabricated metal products	-1.2	0.2	-0.2	2.8
Electricity, gas and water supply	2.2	3.1	2.8	-0.2

Source: Russian Statistics Service, CSI Bank of Moscow estimates.

The slump in growth in most industries, which demonstrated fairly good growth rates just a month ago, prompts us to be more cautious in interpreting official data. The direct message is that the official figures conveniently fit in with the current political situation in Russia and provide quantified evidence of deceleration in Russian industry. The numbers cry out for a new impetus, and thus leave ample room for “dramatic statistical improvement” on the eve of the elections. In our opinion, it is too early to dramatize the scale of the slowdown in industrial output or view the August performance as a turning point in the industrial growth trend. The base effect may be a more plausible explanation of this phenomenon (August was the most successful month for the period from June to December 2006, which, to a certain extent, devalues industrial performance in August 2007 on a year-on-year basis). Furthermore, August’s performance may be seen as a sort of correction following the industrial growth in June and July (which was almost too good to be true), and marks the industry’s transition to a quieter but still solid growth rate (about 7.5% y-o-y). Finally, September’s numbers may radically alter the general picture of Russian industry performance. As we see it, despite the shocking figures for August, the structure of industry growth should be a matter of much greater concern. The industrial production indicators for August underscore the concerns we expressed in our previous overviews.

- Growth in mining and quarrying sectors continues to slow sharply (0.5% in August after 1.2% in July and 2.0% in April-June), which is putting the brakes on growth throughout the industry. Stagnation (0.3% in August after 1.7% in April-July) in the mining and quarrying of energy producing materials segment alongside a vast expansion of the state's ownership role cannot be reversed, despite the upswing in world prices for energy-producing materials.

- Manufacturing sectors oriented towards final demand are indeed losing momentum. Even without fixing their growth deceleration in August as a turning point (3.5% in August after 6.1% in June-July and 9.3% in April-May), it seems clear that the downtrend is strengthening and that all of the main production is mired in slowdown (manufacture of food products, manufacture of textiles and textile products, manufacture of leather, leather products, shoes, consumer goods).

- Manufacturing sectors oriented towards intermediate demand are demonstrating low and declining growth rates affected by the downturn in base metals production and shrinking growth in manufacture of coke and refined petroleum products.

- Manufacturing sectors oriented towards investment demand have therefore become the only industry segment with steadily high growth rates. Worsened indicators in those sectors in August (9.5% y-o-y, a level that may be viewed as satisfactory in the context of the industry-wide growth trend) were largely triggered by the performance of machinery and equipment manufacturers and do not signal, in our opinion, any important trend, considering their growth in preceding months.

All said, industrial performance in August was discouraging not because of the sharp plunge in output (which might be reversed in the coming months), but rather because Russian industry has switched over to a new growth model. Of its three growth drivers – rising prices for exported energy-producing materials, expanding consumer and investment demand – the former is absorbed by the state, while the role of the second driver in spurring the output of respective production is fading away. Industry growth is increasingly localized in investment demand sectors. This model not only preconditions slower growth rates of Russian industry than could be sustained if the balance of the three growth drivers had been preserved, it also inevitably leads to reproduction of an unbalanced (or, at least, non-optimal) industrial production structure. For the near term, it appears to be a more serious hazard in sustaining steady growth in industry and the economy in general.

Industrial producer prices: Growth rebound after July pause

Industrial producer prices picked up 2.1% in August, resuming their growth after a lukewarm July, when prices inched up 0.7%.

The major engines of price growth in industry are the gradually escalating producer prices of final demand and investment sectors (while prices for products of intermediate demand sectors are set on a downward path), as well as resumed price growth in the electricity, gas and water supply sector.

Apart from the above background factors that establish the general price growth trend, the decisive component underlying industry's zig-zag price movements is growth in prices of the mining and quarrying sector.

Accelerating prices for industrial products in August were primarily pushed up by higher prices for energy-producing materials (in mining and quarrying of energy-producing materials and manufacture of refined petroleum products) and utility services (electricity, gas and water supply).

Industrial Producer Price Growth for the Period, %

	Average monthly growth			January-August	
	August 2007	June-July 2007	August 2007	2007	2006
Industry, total	**2.1**	**1.6**	**4.9**	**17.7**	**13.7**
Mining and quarrying	5.5	3.3	13.2	40.1	22.2
including mining and quarrying of energy producing materials	5.9	3.6	14.9	44.9	22.3
Manufacturing	0.8	1.3	2.9	10.4	11.6
final demand sectors	1.6	1.5	0.7	8.5	6.4
investment demand sectors	1.7	1.5	1.4	11.0	9.1
intermediate demand sectors	-0.2	0.8	3.9	9.8	17.6
including manufacture of refined petroleum products	3.0	1.2	10.1	18.4	26.1
Electricity, gas and water supply	0.6	0.1	0.3	15.2	10.1
Reference:					
Consumer prices	0.1	0.9	0.6	6.7	7.1
Urals, $/bbl	9.0	3.2	9.3	34.4	33.0

Note. Final demand sectors: manufacture of food products, manufacture of textiles and textile products, manufacture of leather, leather products, shoes, manufacture of pulp, paper and paper products; publishing and printing, other sectors.
Investment demand sectors: manufacture of other non-metallic mineral products, manufacture of machinery and 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: Russian Statistics Service, Bank of Moscow.

It is notable that the growth in final demand and investment demand sectors has been uneven in recent months, which illustrates the degree of maneuver these industries have to revitalize and sustain their output growth.

Growth *in investment demand sectors* is mostly driven by manufacturers of non-metallic mineral products (construction materials), which is currently the most successful production segment and leads in terms of output and prices. Last year, steady price growth was demonstrated by manufacturers of machinery and equipment, as well as producers of transport equipment. Considering the actual progress in their output, we project their growth at a fairly high level. Finally, growth in prices of manufacturers of electric, electronic and optical equipment is switching into slower gear, which is largely due to the base effect and thus cannot act as a barrier to a further increase in output of this equipment. Therefore, in the short term and in the event of an inertia-based scenario, *the growth prospects of investment demand sectors look quite positive.*

In *final demand sectors*, spiraling prices are fuelled largely by mounting prices of food producers, manufacturers of pulp, paper and paper products, and producers of publishing and printing products. At the same time, producer prices in the manufacturing of textiles and textile products, leather, leather products, shoes and consumer goods have braked sharply in recent months. In terms of output growth, the steadiest developers are manufacturers of pulp, paper and paper products and producers of publishing and printing products shored up by demand that enables this industry to build its output and hike prices simultaneously. Decelerated growth in manufacture of food products coupled with accelerating food prices create an opportunity for a production upturn assuming industrial producers satisfy their price appetites. Finally, the concurrent slowdown in output and price growth in manufacturing of textiles and textile products, leather, leather products, shoes and consumer goods signify that the growth potential fed by increasing consumer demand has been exhausted. In all likelihood, in case of the inertia-based scenario, these industries will be sidelined at the periphery of industrial growth, and can be revived only by sizeable investment and production of competitive goods.

Financial performance: Manufacturing sectors at the forefront of the economy's profit

In July, the Russian economy's profit totaled R388 bln (vs. R309 bln a year ago). The profit continues to grow compared to last year's indicators, but its growth in July fell noticeably versus the second quarter (by 1.26 and 1.36 times, accordingly). The main depressants were sinking growth in profits in the construction and real estate sectors and shrinking profits in trade and repair.

At the same time, the profit of industrial production in July maintained the pace set in the successful second quarter of 2007 (1.37 times). More importantly, the manufacturing sectors are sustaining exclusively high growth rates: in the past half year their profits exceeded last year's indicators by 1.5 times.

The share of industry in the Russian economy's profit is broadening steadily (61% in April-July versus 59% a year ago), largely due to the entrenched position of the manufacturing sectors, which in April-July 2007 earned 40% of the Russian economy's profit (versus 36% a year ago).

Moreover, growing financial benefit from industrial production in terms of the economy's profit was brought about not only by surging output, but also by enhanced profitability. In July 2007, the profitability of industrial production totaled 15.1%, which is below the second quarter's performance but substantially above last year's indicators (14.6% in April-July 2006).

Industrial Production: Profitability and Share in Profit of the Russian Economy, %

	Profitability, %			Share in the economy's profit	
	July 2007	April-July 2007	April-July 2006	April-July 2007	April-July 2006
Industrial production	**15.1**	**16.3**	**14.6**	**61**	**59**
Mining and quarrying of energy producing materials	20.4	22.9	22.2	18	20
Other mining and quarrying	29.1	27.9	27.7	3	3
Manufacturing	14.8	15.8	13.3	40	36
Electricity, gas and water supply	-3.1	1.7	3.1	1	1

Note. Profitability is calculated as the ratio of corporate financial performance to the cost of goods shipped.

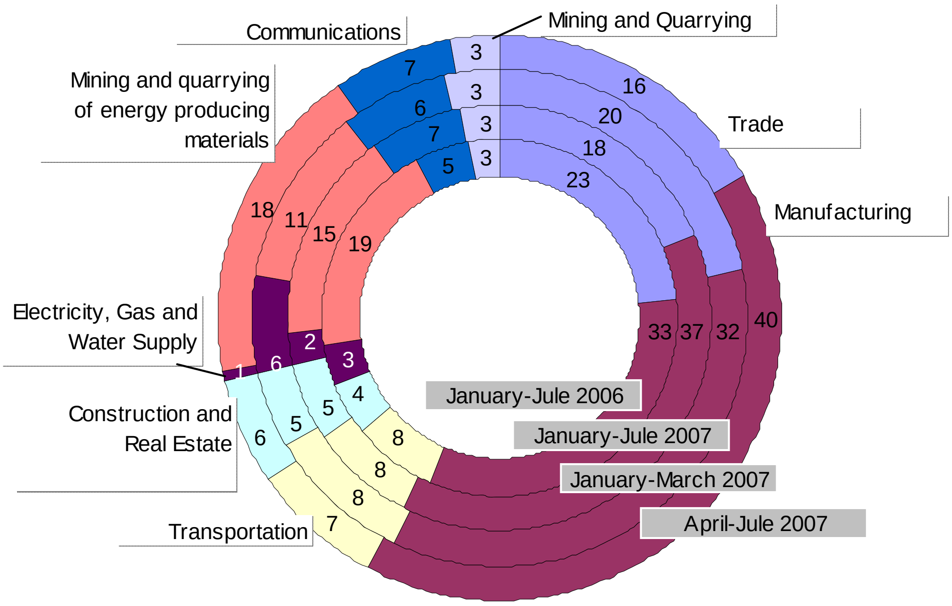
Source: Russian Statistics Service, CSI Bank of Moscow.

Rising profitability of industrial production in the past few months was by and large bolstered by profitability performance in the manufacturing sectors. As profitability in the mining and quarrying sector changed slightly versus last year's relatively high indicators, while profitability in the electricity, gas and water supply sector dropped, the increasing profitability of the manufacturing sector (from 13.3% to 15.8% in April-July of 2006 and 2007, respectively) was the major profitability catalyst in Russian industry.

Output and profitability of the manufacturing sectors are expanding against the background of clear deterioration of financial performance in trade: the profit of trade enterprises is now declining in both real and nominal terms (R48.4 bln in July 2007 vs. R62.7 bln a year earlier).

By all appearances, the manufacturing sectors are building up their growth potential, manifest in fattening profits and enhanced profitability. On the other hand, the concurrently declining profit in trade may indicate domestic market interest in locally produced products or be a consequence of re-directed financial flows: if earlier the greater part of profit was accumulated with trade intermediaries, now it is concentrated directly in production divisions of holdings and other trading and industrial groups, which is a good omen for the prospects of Russian industry.

Russian Economy Profit Structure in January-July, 2006–2007, %



Note: * Net of profits of enterprises engaged in "other" economic activities.
Source: Russian Statistics Service, CSI Bank of Moscow.

Banking System

The banking system in Russia is gradually switching to a moderate growth phase. In August, banking assets increased by 2.8%, which barely changed from the growth registered a year ago. However, corporate loans are still growing at a fast pace, posting a 4.3% increase in August. Retail lending, which demonstrated slow growth in previous months, peaked in August and staged a 5.0% upturn – the highest level since the start of the year. Therefore, the slowdown in growth of banking assets was triggered by dwindling liquidity and investment in securities. It is important to note that the shrinkage in market instruments leads to proportional growth in banking system risks.

Major Banking Assets, % of total

	01.05	01.06	01.07	04.07	05.07	06.07	07.07	08.07	09.07
Assets, R bln	**7138**	**9751**	**14047**	**15600**	**15904**	**17032**	**17204**	**17477**	**17959**
Cash and precious metals	2.8	2.7	2.6	1.8	1.9	1.7	1.8	1.8	1.8
Accounts with CBR	9.8	7.3	7.5	8.0	9.5	13.1	10.9	9.1	7.5
Interbank transactions	6.2	6.3	5.8	5.4	5.2	4.6	5.3	5.3	5.3
Foreign assets	7.8	9.1	9.9	11.5	9.3	8.3	8.4	8.0	8.7
Households	8.7	12.1	14.7	14.4	14.7	14.3	14.9	15.3	15.7
Corporate sector	49.8	47.0	45.3	44.8	45.0	43.6	45.0	46.0	46.6
Government	8.0	6.6	5.2	5.0	4.9	4.8	4.7	4.8	4.6
Property	2.6	2.4	2.4	2.4	2.4	2.2	2.3	2.3	2.3

Source: CBR, CSI Bank of Moscow.

Volatility on global markets made all financial resources more expensive for the Russian banking system and narrowed the sources of funding. In August, foreign borrowing, the key source of financing for banks, switched into slower gear. In spring and June-July, the growth in foreign liabilities averaged 5.1%, whereas in August it sank to 3.8%. Starting from mid-July, no Russian bank held a eurobond placement, which meant that the market channel for raising funds from non-residents was effectively shut.

Major Banking Liabilities, % of total

	01.05	01.06	01.07	04.07	05.07	06.07	07.07	08.07	09.07
Liabilities, R bln	**7138**	**9751**	**14047**	**15600**	**15904**	**17032**	**17204**	**17477**	**17959**
Capital	17.1	16.3	15.2	15.9	15.8	16.1	16.2	16.4	16.4
CBR loans	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Interbank transactions	4.2	4.0	3.4	3.3	3.3	2.8	3.1	3.2	3.2
Foreign liabilities	9.9	12.8	16.1	15.3	15.4	15.3	16.1	16.5	16.7
Household deposits	28.4	28.9	27.6	26.3	26.6	25.3	25.9	26.0	29.9
Corporate deposits	23.7	24.0	24.0	24.9	24.7	26.6	25.1	24.0	24
Accounts and deposits of federal state authorities and local governments	2.9	2.0	2.2	2.6	2.6	2.7	2.4	2.7	2.9
Issued securities	9.0	7.6	7.2	6.4	6.0	5.7	5.8	5.7	5.5

Source: CBR, CSI Bank of Moscow.

In August, liquidity in the banking system dried up rapidly. In many respects, this contraction (as in the previous two months) was associated with transactions by major state-owned banks. However, the liquidity of other banks also bottomed out in August. The ratio of liquid assets to customer accounts and deposits in this segment of the banking system slid to 15.5% by September 1. Only in late October 2006 and February 2007 was the decline in liquidity comparable to this level.

The liquidity squeeze became worse in August, not only due to the outflow of external resources, but also to fast growing investment in foreign assets. For example, Gazprombank's assets held with non-resident institutions (primarily moved into short-term interbank loans) rocketed by $4.5 bln. Overall, foreign assets of the banking system soared by $6.7 bln over the month. Underlying this rally were growing interest rates on global financial markets and lowered risks. In late August-early September, LIBOR on intraday dollar-denominated loans stood at record-high levels exceeding 5.5%.

The next few months will also be marked by a liquidity deficit and shortage of financing sources. The edge from the liquidity squeeze will be taken off by the CBR's decision to temporarily reduce (from October 11, 2007 to January 14, 2008) the standard requirements for mandatory reserves. Mandatory reserves were decreased by 1 percentage point to 3.0% in respect of ruble-denominated household accounts and to 3.5% in respect of other liabilities. This step will allow banks to release up to R90 bln, which is three times less than the maximum volumes of direct REPO transactions posted in late August but more than the volume of current transactions. In the first ten days of October, the daily volumes of direct REPO transactions ranged between R50 bln and R75 bln.

Any hope for cheap borrowings can be put aside indefinitely. Most top-ranking banks have already nudged up interest rates on household deposits by 0.5–1.0 percentage points to bolster household savings. The placement of bank bonds on the domestic market has become more expensive by 2–4 percentage points.

In general, we expect deceleration in the banking system, at least by the end of the current year. Annual growth in banking assets is estimated at 40%.

Forecast of Key Macroeconomic Indicators for 2007–2010

	Actual			Forecast			
	2004	2005	2006	2007	2008	2009	2010
National Accounts							
Nominal GDP:							
R bn	17 046	21 620	26 781	31 180	35 659	40 539	45 929
by market exchange rate, $ bn	592	764	987	1 210	1 394	1 566	1 721
Real GDP, % y/y	7.2	6.43	6.7	7.3	6.8	6.8	5.9
Industrial Production, %, y/y	8.3	4.0	4.4	5.2	5.0	5.2	5.2
Retail Turnover, real, %, y/y	13.3	12.8	13.9	14.0	12.3	10.6	8.2
Gross Fixed Investments, real, %, y/y	10.8	10.9	13.7	16.9	14.5	9.1	12.5
Exports real, % y/y	11.8	6.4	5.8	4.8	4.8	4.0	3.1
Imports real, % y/y	23.3	17.0	19.7	25.6	23.1	11.3	16.5
Monetary Aggregates							
M0, year end, % y/y	33.8	30.9	38.6	29.0	25.7	20.9	20.7
M2, year end, % y/y	35.8	38.6	48.8	37.3	27.5	21.9	19.5
M2X, year end, % y/y	33.7	37.4	40.5	30.2	20.7	19.6	21.3
Total Banking Assets, year end, % GDP	41.9	45.1	52.8	59.5	68.2	74.8	82.7
Inflation							
CPI, year end, %	11.7	10.9	9.0	10.0	7.8	7.2	6.8
CPI, year average, %	11.0	12.5	9.8	8.8	8.8	7.5	7.0
Core CPI, year end, %	10.6	8.3	7.8	9.0	6.6	6.4	6.1
Budget							
Federal Budget Revenues, % GDP	20.1	23.7	23	23.7	21.8	21.4	21.0
Interest Payments, % GDP	1.2	1.0	0.6	0.5	0.4	0.3	0.3
Non-Interest Expenditures, % GDP	14.6	15.3	15.5	17.4	17.9	17.9	17.9
Federal Budget Balance, % GDP[1]	-4.3	-7.5	-7.4	-5.8	-3.5	-3.1	-2.8
Reserve Fund, year end, $ bln	18.8	43.0	89.1	163.0	138	156	168
Future Generations Fund, year end, $ bln					64.1	82.3	88.5
Investment Fund, year end, $ bln			2.6	7.0	11.0	14.5	18.2
Consolidated Budget Balance, % GDP[2]	-4.5	-7.7	-7.7	-6.0	-3.7	-3.3	-3.0
Balance of Payments							
Exports, $ bn	184	244	304	338	354	354	358
Imports, $ bn	96	125	165	230	271	304	359
Current Account, % GDP	10.0	10.9	9.7	5.5	2.1	0.2	-2.9
Net Capital Inflow/Outflow, $ bn [3]	-8.4	0.7	41.7	50.0	52.1	48.9	55.0
International Reserves, year end, $ bn [5]	125	182	304	430	534	601	608
External Debt							
Foreign Public Debt, year end, % GDP	18.6	10.6	5.1	3.7	2.9	2.3	2.0
Foreign Private Debt, year end, % GDP[6]	4.4	3.9	3.8	3.2	2.7	1.9	0.8
Exchange Rate							
R/$:							
end of period	27.8	28.8	26.3	25.4	25.8	26.0	27.4
year average	28.8	28.3	27.1	25.8	25.6	25.9	26.7
Exogenous Parameters							
Urals, $ p/bbl	34.6	50.4	60.9	60	56	53	53
$/€	1.24	1.25	1.26	1.35	1.35	1.33	1.30

Source: Russian Statistics Service, CBR, Development Center, CSI Bank of Moscow forecast.