Bank of Moscow

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Storm Warning in the Safe Haven

Center of Strategic Investigations

By almost all measures, world financial markets remain in turmoil. Most experts agree that it is still too early to assess the amount of losses suffered by major banks hit by the unfolding credit crisis, but their magnitude is apparent. Price gyrations on global financial markets are likely to trigger current year revisions of investment priorities and capital flow directions.

Most forecasts point to declining world economic growth, including of the US economy as a major player. Against the background of these projections, Russia's economic performance looks more than healthy. The latest economic growth projections for 2007 have been revised upwards: GDP to 8.1%, industrial production to 6.4%, and fixed capital investment to 21.5%. Such economic success has encouraged the Russian government to characterize Russia as a "safe haven" for international capital and a gateway for global investors.

However, we feel the government will need to solve quite a few problems before being truly able to call Russian a safe haven. First, over the past six months, Russia has been challenged by escalating inflation. Few expect this price growth to slow, and the government has been forced to regulate prices by administrative measures, thereby underscoring its inability to use market incentives to address the situation. A reduction of the monetary component of inflation (i.e. a decrease in money supply growth rates) is included only as a complementary factor in the state's package of anti-inflationary measures. In this context, it is notable that in the first six months of 2007, foreign investment in Russia totaled only $70 bln, which quickly raised the issues of money supply and regulation of the ruble exchange rate, while most interest rates fell below the level of inflation.

Second, the banking system remains unable to shrug off the liquidity problem. The asset structure of the Russian banking system formally excludes this issue, but interest rate fluctuations on the interbank market indicate substantial structural challenges – state-owned banks and foreign "daughters" are the only ones shielded from the liquidity crunch, while the private sector has experienced a higher cost of financing. Here, solving the liquidity problem and expanding refinancing runs into serious conflict with the struggle against inflation, but is stimulated by growing risks and an effort to support economic growth.

Third, support of the current economic growth model is based on broadening domestic demand (including investment demand). In recent years, this expansion was buoyed by two factors – the trade surplus and foreign capital flows, which helped spur bank lending volumes. Preserving the status quo depends on both the external environment and steps taken by the government and the CBR (relating to tax policy, the exchange rate and refinancing). If foreign capital inflows drop, then, other things being equal, growth in bank lending, as well as economic growth, will slow down.

The Russian economy, including the banking system and financial markets, is growing steadily. But in a growing economy, shocks are especially dangerous for national finances. Growth acceleration driven only by external capital will inevitably generate a backlash in the form of structural disproportions, spiraling prices and mounting risks. A growing economy requires adequate administrative steps from the monetary authorities targeted at sustaining stability, balancing growth and mitigating risks.

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Economic growth outlook

Official data indicating high real GDP growth (8.1%) published in late January triggered (apart from skepticism among economists) a cardinal revision of medium-term projections. First of all, the medium term forecast for Russia's economic development devised by the Ministry of Economic Development and Trade (MEDT) should be revisited. Concurrently, the three-year budget plan (Finance Ministry) and the monetary program (CBR) should be radically revised. Meanwhile, market participants and the analytical community have to rely on qualitative assessments and "letters of intent" offered by the government and CBR officials. Qualitative assessments refer to inflationary factors and responsibility for their acceleration, expected economic growth rates and how they fit in with the structural balance, etc. Various measures have been proposed – from tightening monetary policy and using maximum administrative resources to control price growth, to preserving banking system stability and resolving the liquidity crisis at any price, mainly by providing the banking system with state financing. The tasks seem contradictory, but the path taken to address them may dramatically alter the trajectory of economic growth.

However, despite the "somewhat unexpectedly high" economic growth numbers for 2007, the growth structure of the Russian economy in recent years and for the medium term remains the same.

In 2008, the uptrend in the Russian economy will continue – in real terms GDP may grow 7.0% and its nominal volume reach about R40 trillion. Such growth will be underpinned by world prices for raw materials sustained at a high level and providing the required "safety cushion" – a foreign trade surplus, a stable national currency and, potentially, a positive net flow of foreign capital. Meantime, Russia's positive trade balance with the rest of the world will generate growth in state budget revenues, household income and corporate earnings.

Growth, % y-o-y

	2001	2002	2003	2004	2005	2006	2007	2008 (forecast)
GDP growth	**5.1**	**4.7**	**7.3**	**7.2**	**6.4**	**7.4**	**8.1**	**7.0**
Growth in output of goods and services produced for domestic market	3.2	0.9	2.9	3.1	4.2	4.8	5.6	4.9
Growth in output of goods and services produced for export	1.9	3.8	4.4	4.1	2.2	2.6	2.5	2.1
Growth in domestic demand	**9.7**	**5.1**	**8.1**	**9.7**	**8.9**	**11.0**	**13.8**	**10.8**
factors:								
Household final consumption expenditure	5.4	4.7	4.3	6.8	6.7	6.5	7.3	5.3
Gross fixed capital formation	2.2	0.6	2.6	2.6	2.2	3.6	4.4	3.5
supply by:								
Growth in output of goods and services produced for domestic market	4.1	1.0	3.2	3.4	4.7	5.6	6.4	5.3
Growth in imports of goods and services	5.6	4.0	4.8	6.3	4.2	5.4	7.4	5.5

Source: Russian Statistics Service, CSI Bank of Moscow.

The fundamental question is whether it will be possible to preserve the existing economic growth model and, more importantly, change its quality based on investment growth. A recently published World Bank PPP survey showed that the share of gross fixed capital formation in Russian GDP in PPP dollars does not exceed 12%, whereas in the US it accounts for 20%, in Japan for 22%, and in China for 40% of GDP, respectively. Obviously, transiting to a new quality of growth in Russia requires a change in the quantitative and qualitative parameters of investment activity.

Nevertheless, the contribution of households to growth in gross domestic demand (calculated as the sum of economic sectors' expenditure on final consumption and gross fixed capital formation) *will be dominating*. Expansion of domestic demand continues to outperform GDP growth, but unlike in the past two years, rapidly surging imports in 2007 brought about structural shifts in real growth of domestic demand for goods and services: growth of imports accounted for the major portion (54%). In the current year, we do not expect any qualitative change in this ratio.

GDP growth in 2008 will gravitate towards domestic consumption. Such a proportion has been maintained for the past three years: Output of goods and services for consumption on the domestic market is growing faster than export volumes. In these circumstances, it is important to note that since 2005, growth in mining and quarrying output has plunged sharply, particularly in oil production. Even though the average Urals oil price in 2008 has increased to $74 per barrel, this only highlights the persistently high prices for raw materials, but *not to their growth*. Therefore, a high pace of economic growth may be sustained by further expansion of demand, which may be hindered by receding foreign capital inflows, as well as trimmed growth in bank lending. Moreover, climbing imports will play a significant role in pushing up domestic demand, whereas “the leftovers” will shape demand for locally made goods.

Money supply

Today the CBR faces a dilemma on how to proceed with future monetary policy. On the one hand, spiraling inflation, apart from the development of countermeasures, also provokes the classic discussion: Who is to blame, and what to do? Some prominent government officials lay the blame at the door of the CBR authorities: In 2007 price growth exceeded the forecast by 50%, and producer prices soared an inconceivable 25.1%. Almost all economic agencies agree that the monetary component accounted for 54–58% of price growth, which was seen as both a reproach to the CBR for failing to control the money supply and a command to reduce it. The specific targets for 2008 were suggested at 23–25% (according to the MEDT, this will contribute 5% to overall price growth).

On the other hand, the banking system is still suffering from squeezed liquidity. CBR authorities admit the problem (as well as structural disproportions in liquidity supply among various bank groups), are acknowledging the associated risks, and are reassuring Russian bankers at unofficial meetings that the problems will be resolved. And that's precisely where all of the action ends….

Politically, combating inflation is a much higher priority than addressing the liquidity squeeze being experienced by some private banks. In fact, monetary policy has already been tightened slightly, by virtue of it having become passive. In this sense, passive monetary policy means that interest rates have already grown and refinancing rates will have only a minor effect, whereas growth in required reserves will only exacerbate the liquidity problem in certain banking segments.

Analysis of the money emission structure and channels is important for evaluating the means of containing growth in the money supply and the *effect* of such measures on finances and the economy in general. In recent years (since 2000), money supply growth was driven by expanding net foreign assets of the CBR. Other sources helped absorb the excessive money supply (net internal lending). This pattern was shaped by *objective* (BOP current account surplus) and *subjective* factors (non-existent refinancing of the banking system and expansion of internal lending) and reveals a key problem – weak protection of the Russian financial system from fluctuations in prices for raw materials and capital flows. The clearest illustration occurred in the first half of 2007, when the functioning sterilization mechanism shielded the country's finances from petro-dollar injections but could not provide protection from foreign capital flows. As a result, the

money supply ballooned, forming a springboard for the surge in inflation.
In the current year, the money supply will likely continue to be nurtured by net foreign assets (international reserves). On the one hand, this model is suitable for the monetary authorities thanks to its simplicity – there is no need to manage interest rates on a daily basis, and excessive export earnings in foreign currency are sterilized by tax measures. On the other hand, this model may be quite dangerous, as capital inflows are actually not regulated. A problem of adequate money supply may arise if growth in international reserves turns out to be insufficient, while all other instruments remain ill-developed.

Alternative money supply sources – growth in domestic credit creation and the refinancing of banks – cannot support the required growth rates of the monetary base. To ensure “inflation-safe” growth in the money supply (25–28%, according to MEDT estimates), the monetary base must increase by at least 22–24%, or R1.2–1.3 trillion. A slower pace of monetary base growth will not only painfully slash banking liquidity, but may also affect economic development throughout the country in general.

Money emission and its components

					2008			
	2004	2005	2006	2007	Variant I	Variant II	Variant III	Variant IV
Increase in monetary base, R bn	**466.0**	**533.9**	**1208.2**	**1390.3**	**1237.0**	**755.0**	**1214.0**	**1237.0**
Monetary base growth	24.3	22.4	41.5	33.7	22.4	13.7	22.0	22.4
Money emission factors, R bn:								
Changes in international reserves	1303.4	1738.5	2921.5	3808.4	2651.0	2169.0	2169.0	1687.0
Changes in gross lending to banks	9.5	2.3	15.3	7.2	0	0	100	300
Changes in gross lending to government	-81.1	-303.1	-29.1	106.3	0	0	100	150
Changes in budget account balances and public corporations’ account balances with CBR, other factors	-765.8	-903.7	-1699.6	-2531.6	-1414	-1414	-1155	-900
Dollar to Ruble exchange rate	**28.8**	**28.3**	**27.2**	**25.6**	**24.1**	**24.1**	**24.1**	**24.1**
Key BOP components, $ bn								
Current account balance	59.5	84.4	94.3	76.6	45	45	45	45
Capital inflow to private sector	-9.0	1.9	42.1	82.1	70	50	50	30
Capital transactions of public sector	-5.3	-24.9	-28.9	-9.8	-5	-5	-5	-5
Increase in international reserves	45.2	61.5	107.5	148.9	110	90	90	70

Source: CBR, Russian MOF, CSI Bank of Moscow.

Therefore, implementation of money emission targets will now depend on BOP indicators. These targets do not seem too difficult to achieve from the standpoint of battling inflation, but there may be some obstacles to their implementation. For example, in order to meet the above targets, international reserves must increase in the current year by at least $110 bln. In our opinion, such a volume of foreign currency proceeds in 2008 will set very stringent requirements for the level of net inflows to the private sector.

In the context of the $20 bln decline in the trade balance (according to MEDT data), growing payments of investment income and a $10 bln reduction in net flows from other current transactions (according to CSI Bank of Moscow), the net capital inflow to Russia in the current year is expected to settle at $70 bln (compared to $82 bln in 2007).

Furthermore, it is estimated that in 2008, banks and enterprises will have to repay up to $80 bln in foreign debt. This implies that gross borrowings of the private sector will total at least $150 bln. Taking into account the current situation on world financial markets, it will be far more difficult to generate the desired capital inflow than a year ago. Moreover, the mounting cost of borrowing increases the amount of future investment income payments, thereby narrowing the potential volume of foreign currency funds available for shaping money supply in the medium term. Hence in 2008, such a stable channel of money emission as growth in international reserves may not only lose its inflationary potential, but also appear insufficient to adequately increase the money supply.

Growth in domestic public debt, according to the 2008 budget, is expected to total R370 bln. A substantial portion of government securities will be acquired by the Pension Fund and commercial banks (to expand the collateral base for refinancing). CBR transactions related to the money supply are estimated at R100–150 bln.

The potential volume of refinancing of banks is considerably larger. However, the CBR, reiterating its readiness (by words and action) to provide banks with short-term support, also emphasized that its function was not to provide banks with long-term financing. Although the potential level of short-term refinancing is estimated by the CBR at R1.4 trillion, this source of money supply cannot be considered viable in the long term.

Therefore, the monetary program will be implemented by the CBR as follows. The desired result (monetary base growth of 22–24%) will be achieved through a decrease in the current account balance to $45 bln (vs. $76.6 bln in 2007) and net capital inflow to the private sector of $70 bln (vs. $82.1 bln in 2007). If the actual indicators overshoot the projected targets (owing to a stronger foreign capital inflow), the monetary authorities may face problems similar to those in the first half of 2007. In case of underperformance (which seems probable due to turbulent world markets and raw materials prices), the CBR may decide to broaden gross lending to the banking sector and/or increase its government securities portfolio, while the government may move part of budget balances into deposits with commercial banks. In our opinion, the major issues the CBR will face are shaping a well-balanced banking system and assuring reasonable refinancing, rather than withstanding foreign capital inflows.

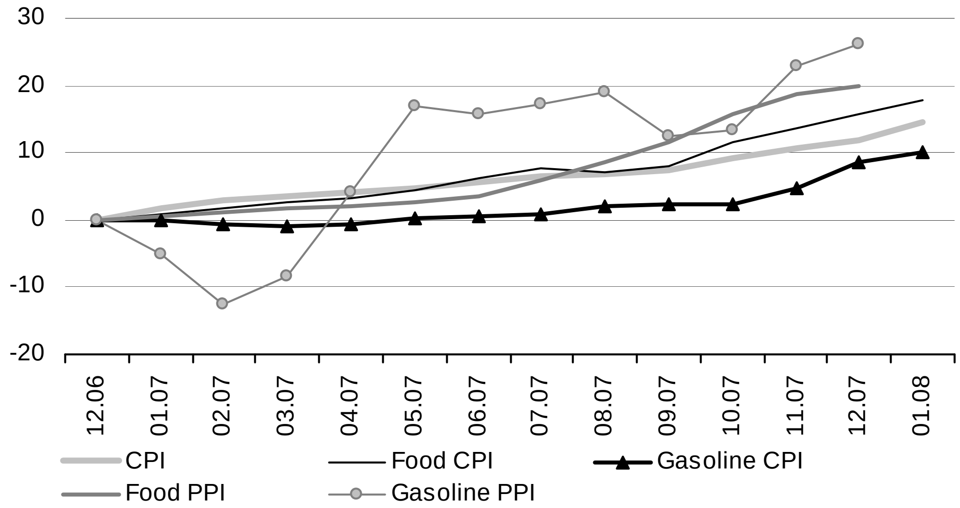
Inflation

Over the past six months the Russian economy and government officials have been confronted by accelerating inflation posing a real threat to financial and political stability amidst steady development of the economy in general. The fact that the official inflation target for 2007 was surpassed by 50% and consumer prices surged by 11.9% – exceeding the psychologically important double-digit level – is only half the problem. More worrying is that price growth is accelerating and is now virtually outside the control of the monetary authorities.

Furthermore, this price growth enveloped not only durable goods (automobiles, housing, etc), but also staple food products. First, price hikes in staple products dealt a blow to low-income households. Second, inflationary expectations soared in almost every segment, from expected growth in prices for similar and related goods to interest rates (on both loans and deposits). Finally, and most importantly, there is a growing awareness among households and enterprises that these processes are beyond the government's control. Essentially, this implies that all advantages (to wholesale and retail traders) and disadvantages (to final consumers) must be balanced by market participants themselves in the form of price hikes, consumption growth and a declining level of savings.

Inflation is indeed accelerating – in January 2008 consumer prices rose 2.3% compared to 1.7% a year ago. Moreover, according to a poll of traders (data presented in the MEDT report), prices are expected to surge in the first quarter. The government has already taken some measures, both reasonable and controversial. Reasonable steps were taken to cut import duties for a number of food products, while controversy surrounded the state's campaign to implement price freezes among retail chains. As it turns out, the reasonable measures (recommended in any macroeconomic textbook) have proven futile, while the controversial administrative measures, in our view, have only deferred the inevitable negative effects.

Growth in Consumer and Producer Prices, % to December 2006



Source: Russian Statistics Service, CSI Bank of Moscow.

The key threats from the current bout of price growth can be summarized as follows:

- Growth in prices for staple products constituting a direct threat to socio-political stability and adequacy of budget policy in the form of a persistent increase in budget expenditures;
- Deferred inflation: The end of administrative control should lead to a renewed surge in prices;
- Accumulating inflation potential buoyed by rising producer prices: The fact that growth in producer prices is twice the level in the consumer segment results in a trade-off between profit reduction and price growth. In conditions of mounting demand, the choice in favor of inflation is obvious;
- Continuing inflationary expectations stemming from possible weakening of savings activity and credit availability will at least dent demand and heighten banking sector risks in the medium term;
- Inadequate and risky government steps aimed at straight-jacketing inflation, for example investigating cartel agreements while failing to create a competitive environment, tightening monetary policy while failing to resolve structural problems in the banking system, passive regulation of foreign capital inflows, and feeble management of tax incentives and constraints.

The most obvious steps the Russian government can take in the current circumstances would be to strengthen control over the competitive environment and intervene in commodities markets. Such measures would at least help restrain growth in prices for staple goods. At the same time, more stringent monetary policy may be dangerous (if economic growth rates are sustained at the level of the past two years) in light of the existing growth model, problems on global financial markets, and potential instability in the country's banking system.

Real sector

2007: Industrial production accelerated against the background of more disproportional growth

In 2007, Russian industry boosted its output by 6.3%. Industrial production accelerated (vs. 3.9% in 2006) on a wave of mounting investment demand. In 2006–2007, final demand sectors demonstrated steady growth averaging 6% per year. At the same time, growth in the mining and quarrying, electricity, gas and water supply, and manufacturing sectors producing for intermediate demand switched into slower gear.

Industrial Production Output Growth, % y-o-y

	2006	2007	Growth acceleration	Contribution to growth acceleration, percentage points
Industrial production	**3.9**	**6.3**	**2.4**	**2.4**
Mining and quarrying	2.3	1.9	-0.4	-0.1
Manufacturing	4.4	9.3	4.9	3.2
Investment demand sectors	*2.1*	*16.1*	*14.0*	*3.9*
Including:				
Manufacture of machinery and equipment	1.1	16.2	15.0	3.9
Manufacture of other non-metallic mineral products	10.8	10.8	0.0	0.0
Intermediate demand sectors	*6.1*	*4.7*	*-1.5*	*-0.7*
Including:				
Manufacture of coke, refined petroleum products	6.1	2.7	-3.4	-0.1
Manufacture of basic metals and fabricated metal products	8.8	2.0	-6.8	-1.2
Other sectors (woodworking, manufacture of chemicals, manufacture of rubber and plastic products)	3.4	9.0	5.6	0.6
Final demand sectors	*6.0*	*5.9*	*-0.1*	*0.0*
Including:				
Manufacture of food products	5.4	6.1	0.7	0.1
Manufacture of textiles and textile products, leather, leather products, shoes	8.7	-0.3	-9.0	-0.2
Manufacture of pulp, paper and paper products; publishing and printing	6.4	9.0	2.6	0.1
Other sectors	7.2	5.1	-2.1	-0.1
Electricity, gas and water supply	**4.2**	**-0.2**	**-4.4**	**-0.7**

Note. 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, and 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, CSI Bank of Moscow.

The following growth drivers were responsible for 2.4 ppts of growth in industry (to 6.3% in 2007):

- a robust 16.2% upturn in the machinery and equipment sector, which spurred industry growth by 3.9%;
- manufacturers of food products, which contributed 0.1 ppt;

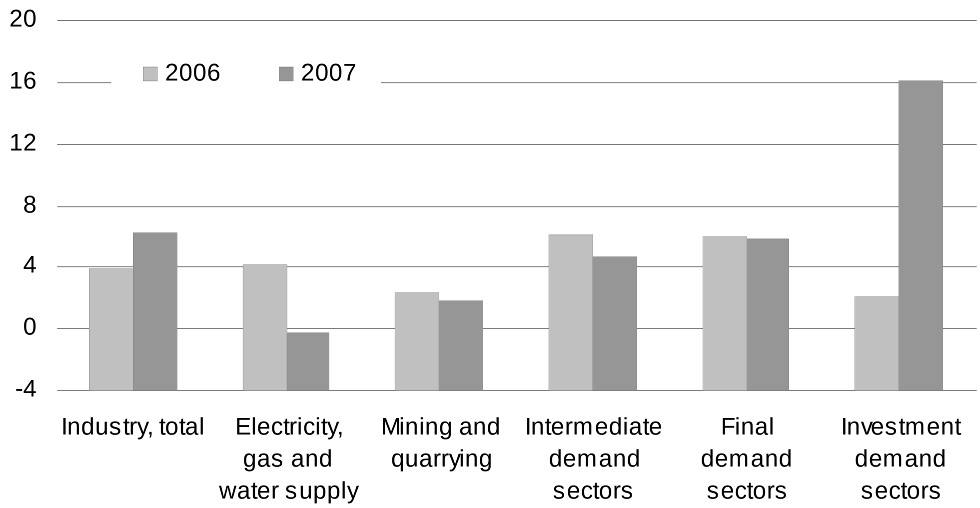
- manufacturers of pulp, paper and paper products, publishing and printing, which added 0.1 ppt;
- intermediate demand sectors (woodworking, manufacture of chemicals, manufacture of rubber and plastic products), which contributed 0.6 ppts.

If in 2007 the growth rates in other sectors had been sustained at the 2006 level, overall industrial growth would have accelerated by 4.7 ppts to 8.6%.

One of the reasons for this relatively slower industrial expansion was the downtrend of growth in core industries – mining and quarrying, manufacturing of coke and refined petroleum products, manufacturing of basic metals and fabricated metal products, and electricity, gas and water supply. In 2007, major producers in these segments registered only moderate growth rates (1.9–2.7% in mining and quarrying, manufacturing of basic metals and fabricated metal products and manufacturing of coke and refined petroleum products) or were actually stagnant (electricity, gas and water supply).

One negative feature of accelerating industrial growth in 2007 was the *clearly widening disproportion* within Russian industry. In 2006, growth in key industries (mining and quarrying, manufacturing industries serving final, intermediate and investment demand, and electricity, gas and water supply) ranged from 2.1% to 6.1%, but in 2007 the growth structure changed substantially. The two clear laggards were mining and quarrying, and electricity, gas and water supply, both of which teetered on the verge of stagnation. As it turned out, Russian industry owed its successful performance in 2007 to investment demand sectors, growth in which surged several-fold versus the average industry growth rates (see chart on following page).

Industrial Production Output Growth, % y-o-y



Note. 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 and 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, CSI Bank of Moscow.

In our opinion, these qualitative changes (broadening disproportions) in 2007 *were no less important* than the formal quantitative acceleration. Primarily, it was structural change that helped shape the vector and quality of future industrial growth. We also believe that official output growth figures for 2007 were slightly overstated for the following reasons.

First, the *climatic factor* acted as a quasi-catalyst for industrial growth, adding several bonus points to the overall growth index.

The second half of January and first two weeks of February 2006 were exceedingly cold, leading to a significant curtailment of operations among many enterprises due to electric power limits. This led to a sharp contraction of industrial output in January-February 2006, which then formed an extremely low base for comparing the industrial production results of January–February 2007. Therefore, the final 2007 indicators reflect not only industry growth in the context of a normal economic environment, but also comprise "bonus" growth points stemming from a sharp localized industrial upswing at the start of the year (for example, in January–February, industrial growth settled at 8.6%, whereas the upturn in manufacturing sectors reached 15.7% y-o-y).

We estimate that in 2007, this "bonus" growth in industry averaged 0.2 ppts. At the same time, for a number of industries, the effect of the climatic factor turned out to be rather telling, and adjustment for this factor considerably impacts their growth trend analysis. Adjusted for the low base effect (January–February 2006), the output of final demand industries in 2007 grew much slower – at a rate of 5.3% per annum (vs. the official reading of 5.9%).

Therefore, net of the climatic factor effect, industrial growth in 2007 looked as follows:

- Total industrial output rose 6.1%, accelerating from 2006 by 2.0 ppts (vs. the official readings of 6.3% and 2.4 ppts, respectively);
- The electricity, gas and water supply sector and mining and quarrying demonstrated the weakest growth of 1.1–1.7%, which is below the moderate rate of 2.5–2.9% a year ago;
- Growth in intermediate demand sectors slowed to 4.5%, or by 1.5 times from 2006;
- In 2007, growth in final demand sectors faltered to 5.3% (vs. 6.6% in 2006), highlighting the dramatic variance between official data and numbers adjusted for the climatic factor;
- Investment demand sectors soared five-fold versus 2006 to 15.1%.

Therefore, accelerated growth in Russian industry in 2007 was triggered only *by investment demand sectors* against the background of sizably lagging *intermediate demand* sectors, and *near stagnation in the mining and quarrying and electricity, gas and water supply sectors.*

Although this industrial growth model helped sustain annual growth rates at more than 6% per annum in 2007, it also poses a serious threat to future growth. Among the risk factors are deepening structural disproportions, lopsided growth generated solely by investment flows, and weaker consumer demand growth stimulating local production. Therefore, in the 2007 growth pattern, the rise in industrial production was accompanied by mounting risks to its further growth.

Industrial producer prices: Back to the future

In 2007, industrial producer prices grew by 25.1%. This, following two years of decelerated growth in producer prices (13.4% in 2005 and 10.4% in 2006), has engendered a distinct feeling of déjà vu.

The producer price upswing in 2007 was comparable to the 2004 surge (28.8%) – similar in structure and equally unexpected. In fact, the price spurt in 2007 (to 25.1% after 10.4% in 2006) resembled more closely the record spike seen in 2004 (28.8% vs. 12.5% in 2003).

Mining and quarrying set the tone for the scale of producer price growth. Escalating contract prices for energy-producing materials – December prices for Russian oil exceeded last year's respective indicators by more than half – shaped a general price uptrend in mining and quarrying. As a result, prices in 2007 shot up 52.3% (vs. 1.6% a year ago). However, the price rebound in mining and quarrying in 2007 was still less impressive than in 2004, when prices zoomed 64.7% (vs. 1.8% in 2003).

Manufacturing industries continue to prepare the ground for price growth. Price growth trends for products in these sectors significantly impact the general producer price growth trend. In 2007, producer prices in the manufacturing sectors picked up considerably (to 17.9% vs. 13.3% a year ago), following the 2004 pattern (21.5% vs. 15.8% in 2003).

Finally, *prices for electricity, gas and water supply* continue to grow slowly at regulated rates (about 12–13% per annum).

The list of comparisons in 2004–2007 would not be complete without mentioning similar growth rates of consumer prices (11.7 and 11.9%, respectively).

Industrial Producer Price Growth (December to December), %

	2004	2005	2006	2007
Industry, total	**28.8**	**13.4**	**10.4**	**25.1**
Mining and quarrying	64.7	31.0	1.6	52.3
Mining and quarrying of energy producing materials	69.7	35.3	-3.6	58.1
Manufacturing	21.5	8.1	13.3	17.9
Investment demand sectors	*16.4*	*9.8*	*12.5*	*14.7*
Including:				
Manufacture of machinery and equipment	16.5	8.4	10.9	10.3
Manufacture of other non-metallic mineral products	15.8	16.7	19.0	31.1
Intermediate demand sectors	*36.8*	*11.8*	*17.0*	*14.1*
Including:				
Manufacture of coke, refined petroleum products	53.7	24.0	2.0	43.4
Manufacture of basic metals and fabricated metal products	37.4	5.4	24.8	5.0
Other sectors (woodworking, manufacture of chemicals, manufacture of rubber and plastic products)	19.5	10.5	12.4	12.2
Final demand sectors	*10.2*	*5.0*	*8.8*	*16.9*
Including:				
Manufacture of food products	11.1	4.0	8.3	20.0
Manufacture of textiles and textile products, Manufacture of leather, leather products, shoes	8.6	4.4	4.5	9.4
Manufacture of pulp, paper and paper products; publishing and printing	6.4	9.4	7.8	12.1
Other sectors	10.0	5.4	12.3	11.6
Electricity, gas and water supply	**12.5**	**12.6**	**10.3**	**13.3**
Consumer prices	**11.7**	**10.9**	**9.0**	**11.9**
Urals, $/bbl	27.8	49.9	8.4	51.8

Note. 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 and 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, CSI Bank of Moscow.

Price trend and industrial growth comparisons are attributes of the near-term inertia-based scenario for industrial production development, which is manifest in decelerated industrial output to 4%, producer price growth to 10–12%, and slow deceleration of inflation to 9–11%. In our opinion, even such a modest scenario (in the context of industrial growth of 2007) may look optimistic.

In the near term, the strongest growth driver for industrial output remains the high level of consumer demand. Meantime, continued growth of investment demand may be challenged by the capacity limitations of respective industries whose output leaped sharply in 2007. Furthermore, the price growth projection in this scenario may also be revised upwards.

In our view, analysis of price trends in 2007 suggests two discouraging conclusions: either consumer price growth in 2007 was significantly under-measured, or an enormous price overhang has formed in industry which will be practically impossible to rein in. Producer prices in final demand sectors grew 16.9% in 2007 (vs. 8.8% a year earlier), and substantial price acceleration was seen in almost all sectors of this group. Prices for statistically important goods – food products – surged 20% over the year (vs. 8.3% in 2006), and for clothes and footwear – by 9.4% (vs. 4.5% a year earlier). Furthermore, price increases in the manufacturing of coke and refined petroleum products exceeded 43%.

In this context, the increase in consumer prices by a mere 11.9% may be either a “statistical trick” or reflect the results of collusion between the government and major food and oil producers to fix retail prices for certain food products and gasoline. In any case, the behavior of producer and consumer prices in 2007 does not give any solid reason to expect inflation to slow down.

Analysis of growth in output and prices of Russian producers can be summarized as follows:

The development vector of Russian industry in 2007 was not aimed at achieving balanced growth. Of the industrial growth engines – increasing prices for exported energy-producing materials, and expansion of consumer and investment demand – the former has been switched off by the government and the latter is gradually running out of steam in the effort to bolster output. Moreover, anti-inflationary measures to regulate consumer food prices rob manufacturers operating in this segment of timely market signals regarding their competitiveness and actual demand for their products, leaving no incentives for modernization or output growth. Instead, industrial growth is being increasingly concentrated in investment demand sectors.

In light of the widened structural misbalance, accumulating price overhang in industry and high inflation on the one hand, and the government’s assertions on achieving stable economic growth rates on the other, we should clarify what is meant by stability.

If stability of economic growth is determined by its elasticity in terms of state administration and manageability, it has indeed become more stable compared to last year. However, if stability is understood as balanced growth reasonably responding to administrative signals, the Russian economy in 2007 stepped away from this path.

This terminological discordance is hazardous, as growing conceptual misinterpretations are arising at a time when the government is stepping up its activities as owner and investor participating in large-scale investment projects. Ignoring the threats revealed by misbalanced growth and taking unreasonably high responsibility for the country’s economic course aggravate the risks of failure to achieve the main long-term goal – sustainable growth via innovative development.

Banking system

2007 performance: Capitalization growth accompanied by widening structural disproportions

In 2007, banking sector assets grew at an annual rate of 44.1%, and in early 2008, total banking assets accounted for 61% of GDP. Last year preserved practically all of the main trends that transpired in 2006. In many respects, external factors laid the groundwork for radical change in the structure of transactions and development strategies of Russian banks.

Capitalization of the Russian banking system grew rapidly. As a result of share placements by state-owned banks, banking equity skyrocketed 61% y-o-y (R955 bln) and the share of additional paid-in capital jumped by 75% (R667 bln). The share of equity in total equity and liabilities increased considerably, from 14% in 2006 to 15% in 2007, while the capital adequacy ratio grew from 14.9% to 15.6%.

The downtrend in the share of household deposits in the banking sector's resource base continued. Growth in household deposits (35.6%) still lags growth in the Russian banking system. Accelerating growth in consumer prices brought about shifts in the household savings model. Most bank deposits remain unprofitable owing to escalating prices, thereby forcing the population to seek alternative savings instruments, which also boosts consumer activity.

External financing is broadening. Financing raised by banks from non-residents in 2007 leaped by $55 bln to $140 bln. The share of foreign loans reached 17.8% of total liabilities despite dwindling inflows of loans and borrowings in the second half of the year as a result of volatile world financial markets. In August to September, there was not a single eurobond placement by banks, while in the second half of 2007 this channel narrowed by more than half, dropping to $5.5 bln vs. $13.8 bln in the first half of the year.

The role of the government weakened significantly both in forming the resource base and in asset-based bank operations. The share of accounts and deposits of federal state authorities and local governments shrank by 0.6 ppts (from 2.2% to 1.5%), while the share of loans to government authorities and funds moved into government securities sank by 1.1 ppts in assets. This downtrend was caused by the strengthening of state development institutions – available budget funds were moved into the charter capital of the Russian Development Bank and the Russian Nanotechnology Corporation.

Major Banking Liabilities, (as of the first day of the month) % of total

	01.05	01.06	01.07	04.07	07.07	10.07	11.07	12.07	01.08
Liabilities (R bln)	**7138**	**9751**	**14047**	**15600**	**17204**	**18231**	**18248**	**18947**	**20270**
Capital	16.2	15.4	14.3	15.5	15.9	16.1	16.3	16.0	15.3
CBR loans	0.3	0.2	0.1	0.1	0.1	0.0	0.1	0.2	0.2
Interbank transactions	4.2	4.0	3.4	3.3	3.1	2.9	2.9	3.2	4.1
Foreign liabilities	10.9	13.7	17.1	16.3	17.0	17.6	17.9	17.6	17.8
Household deposits	28.4	28.9	27.6	26.3	25.9	26.0	26.2	26.0	26.0
Corporate deposits	23.7	24.0	24.0	24.9	25.1	24.5	23.6	23.9	25.3
Accounts and deposits of federal state authorities and local governments	2.9	2.0	2.2	2.6	2.4	2.6	2.6	2.3	1.5
Issued securities	9.0	7.6	7.2	6.4	5.8	5.3	5.4	5.7	5.8

Source: CBR, CSI Bank of Moscow.

The share of loans to the economy broadened significantly in overall banking assets. The share of corporate loans increased by 1.7 ppts and of consumer loans – by 1.3 ppts. In total, the share of loans to non-banks in banking assets reached 59.1% (vs. 56.1% a year ago). The share of funds raised on the domestic market (customer accounts and deposits and issued securities, except equity shares) declined from 59.1% to 57.4%. As a result, the loans/deposits ratio rose to 103% (vs. 95% a year ago).

Major Banking Assets (as of the first day of the month) % of total

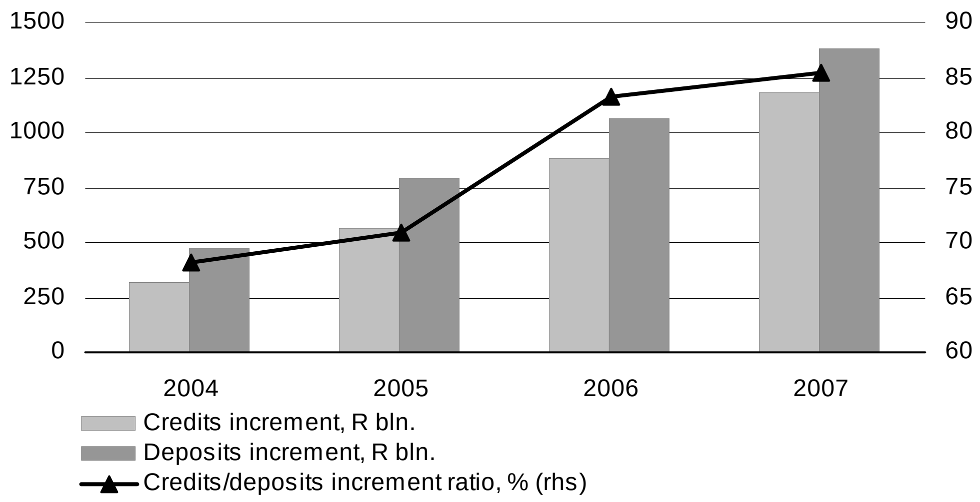
	01.05	01.06	01.07	04.07	07.07	10.07	11.07	12.07	01.08
Assets (R bln)	**7138**	**9751**	**14047**	**15600**	**17204**	**18231**	**18278**	**18947**	**20270**
Cash and precious metals	2.8	2.7	2.6	1.8	1.8	1.9	1.9	1.9	2.5
Accounts with CBR	9.8	7.3	7.5	8.0	10.9	6.1	4.9	5.3	6.9
Interbank transactions	6.2	6.3	5.8	5.4	5.3	4.7	4.6	4.8	5.4
Foreign assets	7.8	9.1	9.9	11.5	8.4	10.0	10.3	10.0	9.8
Households	8.7	12.1	14.7	14.4	14.9	16.0	16.5	16.6	16.0
Corporate sector	49.8	47.0	45.3	44.8	45.0	47.2	48.9	49.3	46.8
Government	8.0	6.6	5.2	5.0	4.7	4.1	3.7	3.6	4.1
Property	2.6	2.4	2.4	2.4	2.3	2.2	2.3	2.2	2.1

Source: CBR, CSI Bank of Moscow.

The imbalance in banks' operations with households is mounting. Growth in household savings hardly covers the level of consumer loans to the population. For example, the ratio of growth in consumer lending to growth in household deposits grew from 70% in 2005 to 85% in 2007. International comparisons of consumer credit versus household deposits range from 30–50%. In the Russian market, this ratio rose to more than 60% in 2007.

Concurrently, the quality of the consumer loan portfolio is worsening. The volume of *overdue consumer loans* rose by 86% y-o-y to more than R100 bln. The relatively low share of overdue loans (rising from 2.6% to 3.1%) can be viewed as a mitigating factor, but it does not reflect the level of bad debts written off and sold to collection agencies. In addition, fast growth in the total loan portfolio was the main factor concealing the rising volume of problem loans.

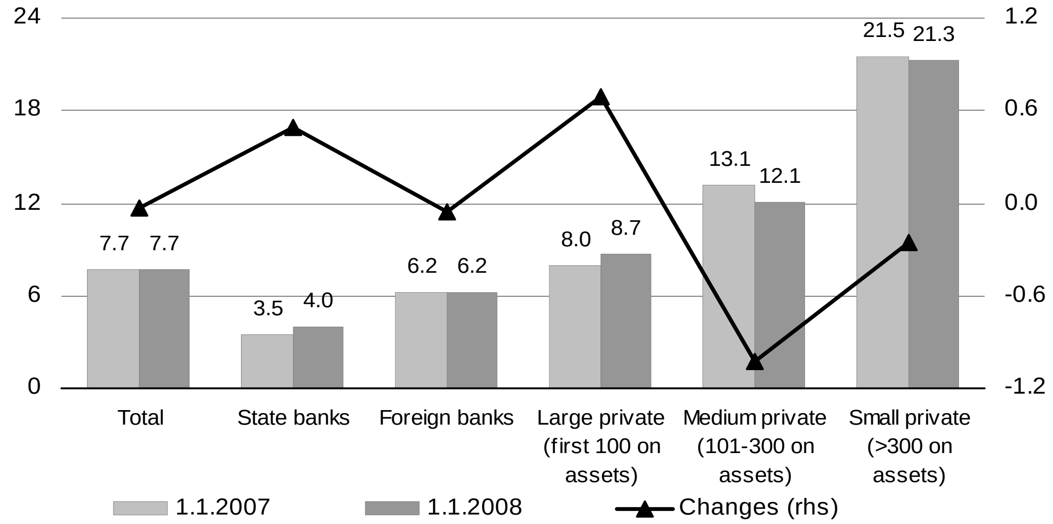
Banking Transactions with Households



Source: CBR, CSI Bank of Moscow.

Along with the share of the loan portfolio in banks' assets, a portion of banking assets was placed in *securities* (government and corporate). The shrinking share of market instruments in banking assets has exacerbated liquidity problems. The time-tested method of refinancing in the Russian banking sector (direct REPO transactions) is limited by the level of investment in securities from the Lombard list. The declining share of total investment in securities was accompanied by growth in the share of Russian issuers, being the most risky component.

Ratio of Liquid Assets to Total Assets by Banking Sector Segment, %



Source: CBR, bank's corporate reports, CSI Bank of Moscow.

Most of the problems that sprung up last year are set to worsen in 2008:

- High inflationary expectations will impact the proportion of household savings and consumption and affect interest rates. Banks will have to raise interest rates on deposits to preserve their resource base. Accordingly, interest rates on credit transactions will be skewed upward, pushed higher by the reassessment of credit risks and credit demand regulation. The CBR's recent decision to raise all basic interest rates and required reserve levels has made money more expensive as well.
- The misbalance involving the banking system's internal resources and domestic demand for credit will be aggravated by shrinking access to external financing. Another challenge is posed by the refinancing of existing loans. In 2008, banks must redeem $8 bln in eurobonds, which is twice the level of 2007. Expected repayments of syndicated loans received by banks from foreign counterparties exceed $10 bln. Overall in 2008, banks must repay $28 bln in foreign loans and borrowing.

In 2008, the ongoing liquidity crunch will continue to be the main threat to the Russian banking sector. In general, liquid assets are still available in sufficient quantities, but rigid segmentation of the banking sector and the difficulties experienced by second- and third-tier banks in gaining access to international finance and budgetary funding may lead to a situation similar to that which occurred in late summer and autumn 2007 (i.e. a steep rise in interest rates on the interbank market and a need for refinancing). In 2007, the level of liquid assets declined in all segments of private banks outside the top 100 in terms of assets, although in the banking sector as a whole liquidity showed some signs of growth.

In 2008, we expect substantial deceleration in banking sector development (no more than 25–30%). The rate of fund inflows to the banking system will slow from almost all channels. The most stable source – the population – has for several years been sustaining growth in bank deposits at a rate of 35–37%, which in any event underperformed growth in banking assets for the past two years. Growth in the resource base of the corporate sector will also be constrained due to tighter access to external financing and the need to repay accumulated debts.

State corporations may become a new resource channel capable, to some extent, of patching up the shortfall, should a decision be made to hold their temporarily available funds with commercial banks. It would be unsurprising to see these entire volumes trickle to major state-owned banks. Other segments of the banking sector will have to contend with limited access to interbank lending.

Therefore, Russian banks will have to adapt their strategies to the new operating environment in an effort to maintain balanced operations against the background of receding growth in the resource base.

Forecast of Key Macroeconomic Indicators for 2007–2010

	Actual			Forecast			
	2004	2005	2006	2007	2008	2009	2010
National Accounts							
Nominal GDP:							
R trln.	17.0	21.6	26.9	33.0	40.0	47.5	55.5
$ bln	592	764	992	1 289	1 619	1 877	2 110
Real GDP, % y/y	7.2	6.4	7.4	8.1	7.0	6.8	6.5
Industrial Production, %, y/y	8.3	4.0	3.9	6.3	4.5	4.8	5.0
Retail Turnover, real, %, y/y	13.3	12.8	13.9	15.2	13.0	11.5	10.0
Gross Fixed Investments, real, %, y/y	13.7	10.9	13.7	21.1	18.0	15.0	13.0
Exports real, % y/y	11.8	6.5	7.3	7.4	4.8	4.0	3.1
Imports real, % y/y	23.3	16.6	21.6	30.4	23.1	11.3	10.0
Monetary Aggregates							
M0 (year end), % y/y	33.8	30.9	38.6	32.9	27.5	23.0	21.0
M2 (year end), % y/y	35.8	38.6	48.8	47.5	29.0	26.0	24.0
M2X (year end), % y/y	33.7	37.4	40.5	44.2	26.0	25.0	24.0
Total Banking Assets (year end), % GDP	41.9	45.1	52.4	61.4	65.8	69.1	73.7
Inflation							
CPI, year end, %	11.7	10.9	9.0	11.9	10.0	9.0	8.0
CPI, year average, %	11.0	12.5	9.8	9.1	11.9	9.3	8.5
Core CPI, year end, %	10.6	8.3	7.8	11.0	8.5	7.0	6.0
Budget							
Federal Budget Revenues, % GDP	20.1	23.7	23.4	23.6	20.1	18.3	17.0
Interest Payments, % GDP	15.8	16.3	15.9	18.1	17.3	17.4	16.3
Non-Interest Expenditures, % GDP	4.3	7.5	7.4	5.4	2.9	0.9	0.7
Federal Budget Balance, % GDP1	4.5	8.1	8.4	6.1	3.2	1.0	0.8
Reserve Fund, year end, $ bln	18.8	43.0	89.2	156.5	143.1	167.0	184.0
Future Generations Fund, year end, $ bln					68.3	67.4	64.9
Investment Fund, year end, $ bln			2.6	7.0	11	14.5	18.2
Balance of Payments							
Exports, $ bln	184	244	304	354	410	405	400
Imports, $ bln	96	125	165	225	290	330	370
Current Account, % GDP	10	11.1	9.5	5.9	3.4	0.0	-2.6
Net Capital Inflow/Outflow, $ bln	-8.4	0.7	41.7	82.1	50	45	40
International Reserves, syear end, $ bln	125	182	304	476	576	616	596
External Debt							
Foreign Public Debt, year end, % GDP	19.3	9.8	5.2	3.6	2.6	2.1	1.7
Foreign Private Debt, year end, % GDP6	4.4	3.9	3.8	3.8	4.0	4.2	4.6
Exchange Rate							
R/$:							
end of period	27.8	28.8	26.3	24.6	24.9	25.8	26.8
year average	28.8	28.3	27.1	25.6	24.7	25.3	26.3
Exogenous Parameters							
Urals, $ p/bbl	34.6	50.4	60.9	69.6	80	75	70
$/€	1.24	1.25	1.26	1.37	1.42	1.38	1.35

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

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