Economic Development Scenarios for Russia in the New Environment

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The last ten years have proved that the Russian economy *can grow steadily*. During the decade (1998–2008) real GDP grew by 94%, investments zoomed by over 200% and real disposable household incomes rose by 137%. Despite high inflation and negative real interest rates, ruble-denominated bank savings of households grew 21 times in the period from 2000 to 2009. The ruble's exchange rate has hardly changed relative to the major world currencies.

Economic growth in the post-Soviet Russia was resumed after the system-wide financial crisis of 1998. The upturn in the world prices for oil and other raw materials helped to balance the budget and strengthened the government's role in the national economy. The setup of the Stabilization Fund was instrumental not only in sterilizing the influx of petro-dollars but also in creating a certain "safety margin". At the peak of the crisis in late 2008 – 2009 the resources accumulated during the "fat years" allowed the Russian government to support the banking system and the budget. However, the cycle of high raw material prices was not used to implement a large-scale retooling of the Russian economy or infrastructure projects. The chance to strengthen the competitive edge of the national economy was lost.

The accelerated growth from 2006 to the first half of 2008 was underpinned by expanding consumption supported by both, incomes and the banking system – bank loans accounted for one third of domestic demand growth, while the share of bank loans in financing capital investments was a modest 9%. Economic growth driven by expanding consumption financed by petro-dollars and external borrowings proved unstable. In the context of the global crisis industrial production was thrown back to the 2005 level in a few months and the foreign private debt already exceeds Russia's international reserves.

In the conditions of the world financial (and economic) crisis Russia failed to become *"a safety haven".* Despite accumulated international reserves (Russia's international reserves are the 3rd largest in the world), the national banking system and financial markets were unable to cushion the negative external impact. *Systemic and structural problems* accumulated during the period of the accelerated growth exacerbated the crisis manifestations:

- The deficit of funds in the non-financial sector – the gap between loans and deposits of the corporate sector and households exceeded all banking equity in the middle of 2008;

- High inflation – the ill-developed competitive environment makes monetary methods of combating inflation less effective;
- The unproportionally high dependence of the economy and financial sector on the ruble's exchange rate;
- Substantial segmentation of the banking system evidenced by different requirements for liquidity and capitalization, access to domestic and foreign financing and, eventually, for risk levels;
- Ineffective use of external loans – only 20-25% of them were channeled to finance the non-financial sector.

Key problem is the deficit of financing

Fast growth in the Russian banking system (the banking system assets grew by 44% in 2006 - 2007 versus nominal GDP growth of 24.3 and 22.7%, accordingly) and loans to the non-financial sector was accompanied by the mounting deficit of domestic funding sources, i.e., the debt of the non-financial sector (obtained loans and issued securities) was persistently overshooting corporate and household deposits. For the first time after the 1998 crisis the deficit of domestic funding sources needed to spur up lending to the non-financial sector emerged in 2004. Until then domestic savings were excessive and the excess was absorbed by capital outflows from Russia and growing deposits with the CBR.

Table. Shortage («-» oversupply) of domestic financial resources and sources of its coverage (neutralization), ***R bn (net of foreign contributions to the share capital)***

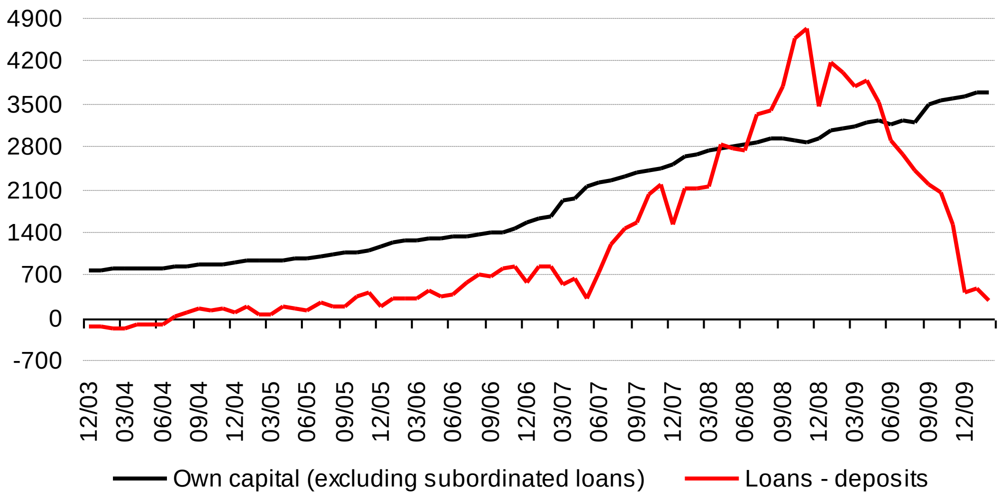
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Deficit of domestic financial resources	-101.9	-79.9	109.3	-26.6	134.1	308.1	205.3	594.5	984.9	1702.8
Sources of funding («-» – absorption):										
Rest of world	-101.7	-69.2	34.4	35.8	229.0	88.2	157.1	540.0	611.1	-1100.7
Federal Government	1.8	-90.1	-12.7	-62.1	-51.3	1.8	-51.3	-55.6	-49.5	335.8
CBR	-37.7	-83.9	23.6	-123.6	-208.1	-215.2	4.3	-313.3	-460.9	3083.8

Source: CBR, AL Vedi estimates

The deficit of domestic resources became apparent in 2004 and was triggered by fast growing loans to the non-financial sector (that year was marked by the outburst in consumer lending). The gap was rapidly widening – the ratio of loans to the non-financial sector to domestic deposits rose from 95% in early 2004 to 120% in early 2008.

The gap between the loans and deposits of the non-financial sector exceeded the banking system equity in the middle of 2008. From that time the situation went out of control and entirely depended on other than banking system sources – either on foreign capital inflows or “injections” from the monetary authorities.

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



Source: CBR, CSI Bank of Moscow

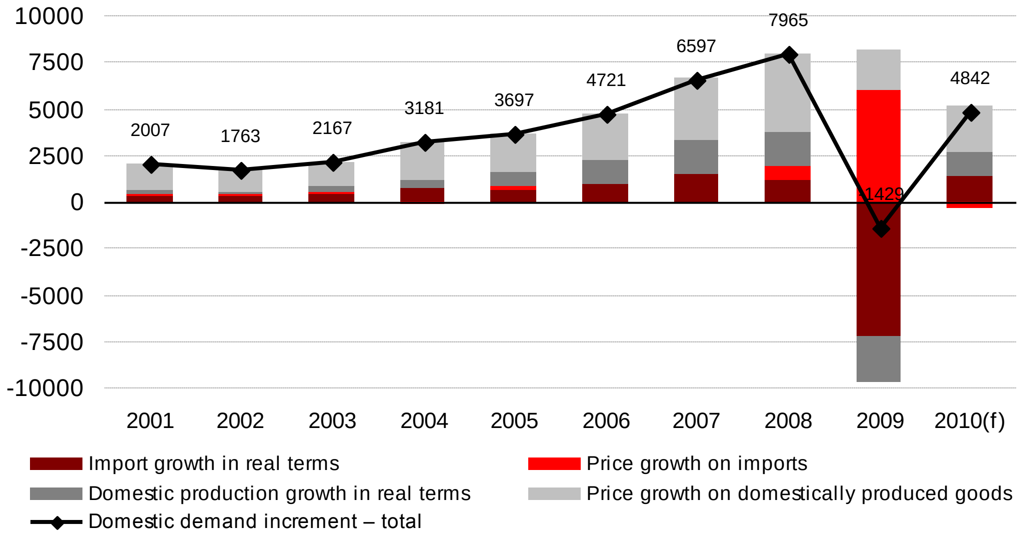
In 2008, the gap between loans and deposits totaled R 3.5 trillion. The equity capital of the banking system net of subordinated loans totaled R 2.9 trillion and in 2008 the deficit of domestic financial resources rose by R 1.9 trillion. In 2009 the gap between the loans and deposits was almost bridged due to growing household savings and stagnating corporate lending.

Russian inflation as a growth depressant

Spiraling inflation has been an invariable attribute of market development and reform in Russia since 1992. In the last ten years substantial price hikes co-existed with economic growth: they did not prevent it but noticeably affected its nature. The impact of inflation was observed in the prevailing consumption (covered by imports), the low savings rate and a distorted structure of sources of fixed capital investments.

Inflation combating depends more on *regulation of the market environment* rather than money supply control. During the global financial crisis only several countries (mostly the FSU members) were challenged with high inflation, while most countries of the world faced deflation against the background of the crisis and dropping demand. The eased monetary policy aimed at expanding domestic demand give rise to significant institutional constraints. In the last ten years each 100 rubles of growth in domestic demand were contributed by 53-55 rubles in price growth, 22-25 rubles of imports growth and only by 20-25 rubles of growth in domestic production. The vulnerability of this model was also borne out by the crisis - in the G20 list Russia posted the hardest production slump and the highest inflation (despite a historic record of Russia's post-Soviet time). Producers were more inclined to curtail production rather than prices. In case of a steady trend, the underdeveloped competitive environment in the Russian economy leads to a situation when the producers' response to expanding domestic demand *is to hike prices rather than increase the output.*

Graph. Domestic Demand Growth and Sources of Growth, R bn.



Source: CSI Bank of Moscow

Expected appreciation of the real ruble exchange rate in 2010 suggests that the imports' contribution to domestic demand growth may be somewhat higher than that of domestic production. And growing prices for domestic commodities and services may again generate over one half of the total growth in nominal domestic demand. Evidently, the monetary policy targeted at stimulating domestic demand growth will contribute only about 20-25% to the economic growth and by 75% will exacerbate the problems associated with the spiraling inflation and the worsening BOP structure.

It seems that the key problem is creation of a competitive environment on all segments of the domestic market fostering the adequate response of producers to market signals – to expand production and inventories, to increase or cut down prices. Only with this in place the monetary factors can have a regulating effect on inflation. This conclusion is of principal importance in the context of the currently discussed plans to implement the inflation targeting policy– the negative implications of this policy may appear not due to the wrong approach but because inflation will be impacted by other (non-monetary) reasons.

Disproportional dependence on the ruble's exchange rate

The Russian economy remains rather closed as regards the rest-of-world trade. Exports account for 18% of overall domestic output and the share of imports in gross consumption is even lower, being 10–12%. However, the imports structure with roughly equal shares of final, intermediate and investment demand products has a telling effect on production. Low elasticity of import substitution is also important – domestic producers do not manufacture similar goods and Russian consumers are not ready to replace imported goods with domestic produce.

The same situation is observed in the financial sector. The level of conversion of household savings into foreign currency is dwindling – household savings in foreign currency in stable periods fall to 12% of the total volume. In unstable periods they move up quickly to 30%–35%. With the signs of crisis in the banking sector, demand for foreign currency cash rockets.

Today the exchange rate of the Russian ruble acts as the inflation anchor and the contribution of the stable ruble to curbing inflation is fairly substantial. Considering the significant effect of the ruble's exchange rate on imports of manufactured and investment products and the price movements, *stability and predictability of the exchange rate is crucial for the recovering growth*. However, this requirement conflicts with the BOP stability in respect of the capital transactions account. High interest rates and the stable ruble generate sizeable inflows of short-term foreign capital stoking accelerated growth of the financial markets and fostering conditions for new "bubbles", which, if punctured, may trigger off a new wave of the crisis.

Ineffective foreign borrowings – clash between foreign debt and economic growth

Since 2004 the banking system has experienced a dearth of domestic financial resources needed to expand lending to the non-financial sector and covered this deficit through increased external borrowings. As at 1 January 2004 the private foreign debt totaled $ 80 bn, whereas as at 1 January 2008 it swelled to $ 417 bn (a more than fivefold growth). The problem is that Russian banks *indulged in foreign borrowings* to patch up the deficit of domestic funds traditionally reflected in the concurrent growth in capital outflows and unrestricted cash on the CBR accounts. The assumption that growth in gross capital outflow is proportionate to growth in gross capital outflows is not supported statistically (if it were true, we could expect gradual utilization of foreign investment). In fact we see the "grim reality" reflecting the risks and structural problems of the banking sector. For example, only 25% of total foreign investments in 2007 were channeled into loans to the non-financial sector, and the remaining balance was "sterilized" through capital outflows and climbing bank accounts with the CBR (20% in 2006).

Table. Foreign capital flows into the Russian banking system, *R bn*

	2001	2002	2003	2004	2005	2006	2007
Gross inflow of foreign borrowings	56	106	256	205	531	1070	1212
Gross capital outflow	32	55	-6	85	337	512	587
Gross capital outflow as % of gross capital inflow	56	52	-	42	63	48	48
Growth in bank deposits with CBR	-3	154	248	13	25	344	321
Difference between the capital inflow, capital outflow and growth in bank deposits with CBR (received by the domestic market)	28	-103	14	107	169	214	304
Reference data:							
Funds received by the domestic market, as % of gross inflow	49	-	5	52	32	20	25

Source: CBR, AL Vedi estimates

The data in the table indicates that efficiency of utilization of external borrowings *has plenty of room for growth*. Expansion of refinancing opportunities could trim voluntary bank deposits with the CBR and the financial stability together with the improved investment climate could pare off the gross capital outflow.

Segmentation of the banking system – growing differences between the banks.

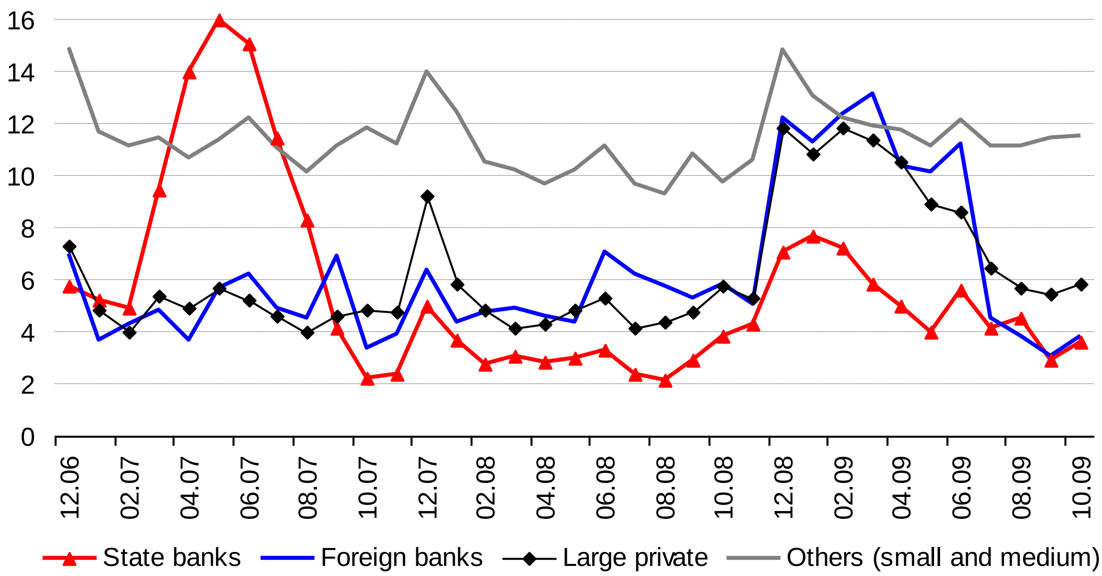
Segmentation of the Russian banking system is proved by the following facts:

- differing requirements to liquidity level (to ensure stable functioning of credit institutions);
- different access (in terms of cost and volumes) to foreign and domestic financing;
- the value of the liabilities on the domestic market;
- different policies of asset and risk management.

Segmentation of the banking system undermines the efficiency of the monetary policy during the crisis. We can single out at least 4 groups out of a thousand Russian commercial banks: banks with state ownership, banks with foreign capital, major private banks and the rest. The value of liabilities, access to borrowings, required liquidity levels and other parameters are different for each of these groups.

As at 1 January 2010, the banks outside the top hundred accounted for 10% of total banking assets and for almost 20% of liquid assets. The share of liquid assets required for normal operations in medium-sized and small banks is substantially higher than in large banks (3.2% in the top hundred, 6.9% outside the top hundred and 15.5% for the 300 smallest banks). The 300 smallest banks account only for 0.4% of total banking assets and the value of their total assets (about R 100 bn) is below that of any bank ranking among the top 30 banks.

Graph. Liquid Banking Assets, *% of total assets*



Note: the growth in liquidity in April-June 2007 was caused by SPO launched by the Savings Bank of the Russian Federation (Sberbank) and IPO conducted by VTB, as well as by capital inflows largely resulting from the auctions selling Yukos property.

Source: CBR, CSI Bank of Moscow

Obviously, in the period of economic turmoil the banking system cannot be managed as a *single whole*. In the context of the worsening external environment and fluctuations in liquidity, exchange rate of the ruble and money supply, financial parameters of each of the above groups will differ in their own way and may approach critical or even default levels.

Today the priorities of the Russian financial sector may be formulated as three groups of tasks:

- first, assessing *anti-crisis steps* for their relevance to the current conditions, determining the need of their revision and possible implications;

- second, removing *structural disproportions* piled up in the period of the accelerated growth;
- third, *fostering new conditions and configuration* transforming the financial system from economic growth depressant into a growth driver.

The first group of the tasks aims to remove *a threat to the normal functioning of the banking system* stemming from the failures in financial transactions, panicking bank depositors, defaults, etc. In autumn 2008 the situation forced the CBR to provide the banks with liquidity and its steps did not provoke any serious criticisms.

The second task is focused on systematization of structural disproportions, analysis of reasons behind them and methods of their removal. The latest financial crisis has exacerbated their negative effect on the banking system, financial markets and the real sector. There is every reason to expect that the package of the government's anti-crisis measures can only temporarily mitigate their adverse effect today and will actually put off the solution till tomorrow which will be much more difficult and costly then. So, the major structural characteristics of the financial system and the quality of its regulative environment may become a serious barrier to sustainable development of the Russian economy.

It is obvious that after the first signs of stabilization a question will arise on the future direction of the Russian economy. The most rational will be the model combining the advantages of fast growth with its stability and resistance to external upheavals. Economic growth should be accompanied by the improving structure of institutional financial flows that can be attained through the growing contribution of the national financial sector to the general resilience to external turmoil, development and consolidation of Russia's competitive position in the global economy.

Major scenarios of the financial system development in the post-crisis period until 2013 and 2020

In the last ten years the key projections of Russia's economic development were traditionally based on the two fairly stable groups of factors. The first group comprises *external variables* (exogenous) which change *regardless of* the actions and intentions of the Russian government and major national giants. This group includes:

- prices for oil and other energy producing materials;
- growth rates of the world economy;
- foreign capital inflows.

External factors generate potential external demand for Russian exports, determine their cost and the inflow of foreign borrowings and investments. Therefore, external factors account for 15-17% of the domestic output, up to 30% of budget revenues and 15-18% of the banking system's financial resources. In the conditions of the balanced economic growth, the impact of external factors *should not be critical* for the Russian economy. The beneficial pricing environment creates a "safety cushion" and when the situation worsens the earlier accumulated reserves are used. However, the events of the last few years signal quite the opposite thing – the Russian economy is heavily dependent on demand for raw materials, their prices and foreign capital inflows.

The second group of factors represents *parameters of the Russian economic policy*, consisting of a *limited* range of factors, including:

- rates of growth in tariffs of natural monopolies;
- the size of federal budget expenditures.

The scarcity of factors characterizing the economic policy parameters conditions *the passive nature* of the Russian economic development scenarios in the medium-term. For this reason the scenarios are called pessimistic, inertia-based and optimistic.

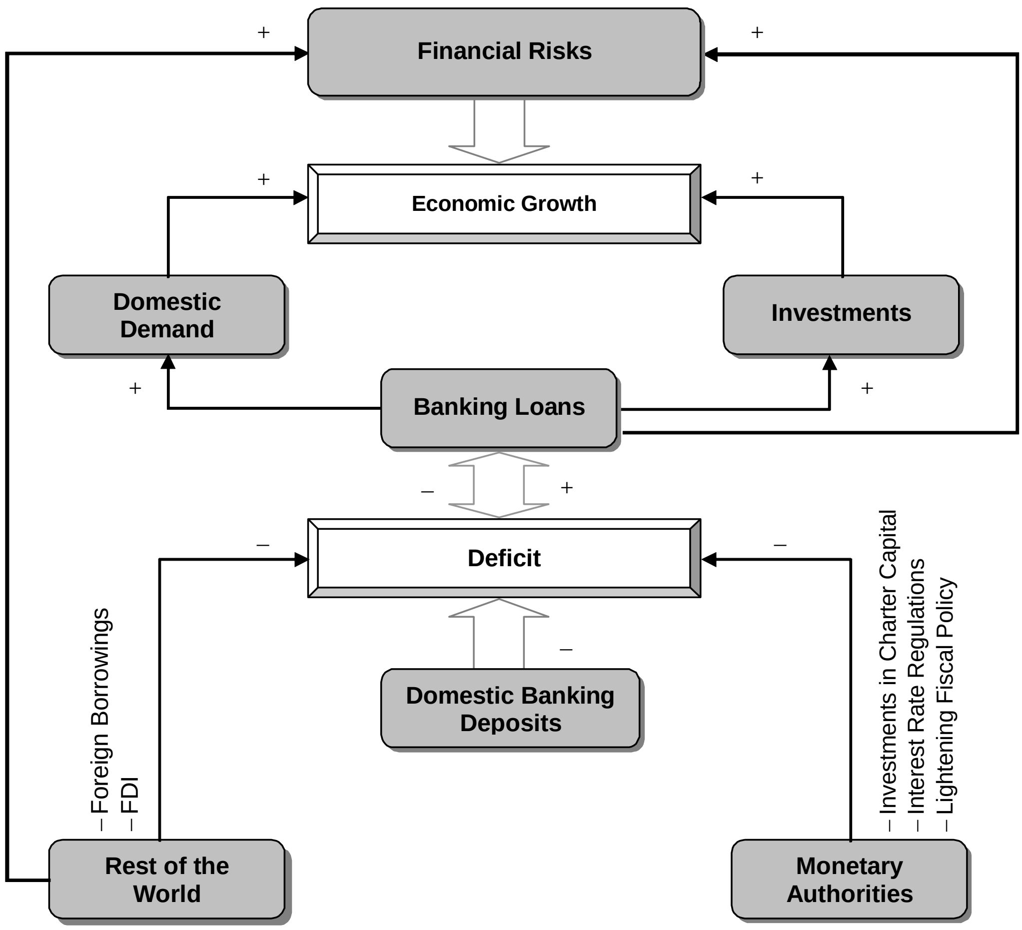
It seems that the medium-term projection should provide for measures aimed at resolving the following tasks in the financial sector:

- curtailing inflation and abating inflationary and devaluation expectations;
- sustaining the steadily functioning banking system and financial markets regardless of the changes in external environment;
- focus on removal of structural misbalances in the financial sector, possibly at the expense of the recession or growth rates in the economy and banking system;
- boosting household and corporate savings.

Successful resolution of the above tasks depends on various parameters of the financial policy under each scenario. Today there are no such monetary policy parameters in the medium-term forecast. Their inclusion in the forecast will allow to assess the efficiency of the monetary policy instruments and their effect on the national economy as a whole.

The external environment is the essential factor for resumption of economic growth. However, the viability and quality of this growth will depend on elimination of the structural problems in the domestic financial sector. It is apparent that economic growth, and especially the investment-driven growth, needs substantial financial infusions, including bank loans. Domestic savings will not be sufficient for sustaining fast economic growth in the coming ten years (the annual average of 6-7%). Therefore, the course of the economic should be selected – either to support *this deficit to sustain high growth rates* or *reduce the deficit targeting financial stability.*

Graph. Base Scenarios for Development of Russia's Banking System



Source: AL Vedi

Selection of high growth in domestic demand to support economic growth will require sustainable and high growth in the bank lending volumes, other variables being equal. We will call this scenario *the accelerated growth scenario*. Obviously, it implies the continuing gap between domestic savings and bank lending growth. Under this scenario, the issue of sources for financing this deficit will remain at least in the medium term – up to 2012. There are two sources – foreign capital inflow (as it was in 2006–2008) or state finance. State funding may include government savings (National Wellbeing Fund) and money issued as loans of Central Bank to the banking system. Therefore, we may single out two options under the accelerated growth scenario (fixing support of high growth in lending as a monetary policy direction). They have the same growth rates for bank loans (and deposits of the non-financial sector), the only difference being the sources of financing. The first option is based on *preserving external financing*, and the second projects *substitution of foreign borrowings with domestic (state) financial resources*.

The positive aspect of this scenario is a possibility to achieve high economic growth rates. But the reverse side of this scenario will be high risks to financial stability directly leading to the banking, currency or debt crisis. We can reasonably assume that the price of overcoming this crisis will be increase and correlate with the extent of the financial sector's growing impact on the real sector's performance.

The probability of comeback to the accelerated growth policy (the 2006-2008 pattern) is rather high. The scenario of the accelerated growth of the financial system is actually reflected in the long-term program of the Russian government. Pursuing the anti-crisis policy, the Russian government proved the invariability of the major provisions in the Concept of long-term social and economic development up to 2020 (Concept). The financial sector in the Concept is expected to foster the necessary conditions for sustaining high economic growth (the annual average of 6–7% real GDP up to 2020). The tasks of the monetary policy for the period to 2020 are to bring inflation down to 3%, increase the monetization level of the economy (M2 to GDP ratio) to 70–75% and raise the volumes of bank lending to the non-financial sector to 80–85%. It seems that achievement of these high targets may *aggravate a threat to the financial stability* and add *additional structural disproportions* to the financial sector.

Risks and adverse effects of the accelerated economic growth scenario may be summed up as follows:

- Persisting high inflation. If high growth in banking lending is sustained, expanding domestic demand will be accompanied by structural misbalances fuelling inflation.
- Growing foreign debt. The accelerated economic growth scenario provides for maximum attraction of foreign investment. Among the threats will be the servicing of private foreign debt and the associated risks and likelihood of defaults.
- The worsening BOP structure. The inflow of foreign loans brings ruble appreciation, which, in its turn, accelerates growth in imports. All in all, together with rising interest payments on foreign debt, the current account balance of the BOP will decline and may slide to the negative territory.
- Sluggish growth in financial markets. Financial markets are developing more slowly due to the dwindling need to issue instruments (considering additional costs for their preparation and issue as compared to loans) and the diminishing investor demand for them.
- Growing credit risks. High growth in bank loans (especially consumer loans) inevitably hampers the quality of borrower assessment and heightens the risk of overdue debts.

Table. Key Monetary Targets in the Governmental Concept for Russia's long-term development up to the year 2020 (accelerated economic growth scenario), ***% of GDP***

	2005	2008	2009	2010	2015	2020
Cash rubles outside the CBR	10.2	10.5	11.6	11.5	11.5	11.5
M0	9.3	9.1	10.1	10.0	10.0	10.0
Broad monetary base	13.5	13.4	15.1	16.0	22.7	24.2
Banks' reserve assets	4.2	4.3	5.0	6.0	12.7	14.2
Ruble accounts	18.7	23.3	26.5	30.0	52.5	62.5
M2	28.0	32.4	36.6	40.0	62.5	72.5
Foreign currency accounts	5.4	7.9	10.1	8.9	5.1	3.0
Broad money	33.4	40.3	46.6	48.9	67.6	75.5
The share of cash in M2	33.2	28.1	27.6	25.0	16.0	13.8

Source: Russian MED, CSI Bank of Moscow

One of the targets in the government's program of the national economy development till 2020 is fast growth in GDP monetization to 70-75% by 2020. Achievement of this target in the coming ten years may give rise to large-scale misbalances in the financial sector. By their extent, these misbalances *will exceed* those that were behind the Russian crisis in 2008-2009:

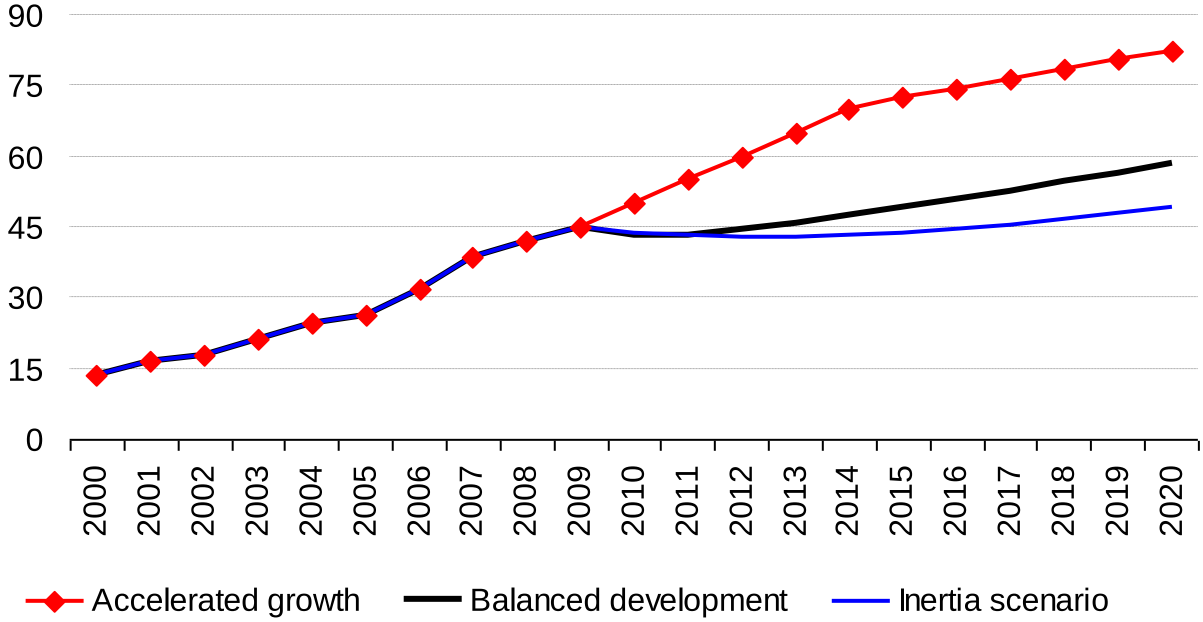
- Growth in the ruble money supply should steadily outperform the output growth in physical term by 1.5-2 times. Under the officially projected growth in nominal GDP at 12-15% in 2010-2015 and 10-12% in 2016-2020, growth in money supply should not be below 25% in 2010-2015 and 15% in 2016-2020. Monetization of GDP will be *no less inflationary, than in 2001–2007*, when the monetary authorities failed to rein in the double-digit inflation in Russia.
- De-dollarization of savings will not be instrumental in this model (or its effect will be considerably lower).

The financial sector development model focused on achieving these targets will be highly unstable and exposed to the impact of external and domestic instability factors. *The economic growth will be more loan- dependent***.** The contribution of the loans' growth to expansion of aggregate demand should be at least 50-60% by 2020. In the pre-crisis period the highest indicator was 35% (2007).

2. *The Concept's targets providing for growth in lending to the economy overshoot the expected money supply volumes (M2) by 10% of GDP*. The deficit of domestic financial resources to finance loans to the economy is estimated at 16-18% of GDP by 2020. That means that growth in loans projected in the Concept cannot be attained without a strong influx of foreign capital and the credit expansion model should in many respects repeat the growth model of 2006-2008.

3. *The projected fast growth in the economy's demand for loans can hardly likely be combined with acceptable risks levels:* accelerated growth of consumer loans in 2004-2008 spurred growth in household debts on bank loans to 80% of domestic household deposits.

Enterprises used bank loans to fund the working capital, whereas the share of bank lending in capital investments did not exceed 10%. The chronic gap between the enterprises' profitability and the interest rates on bank loans is the main constraint of the real sector's expanding demand for loans.**Graph. Projected Movements in Bank Lending to the Economy, *% of GDP***



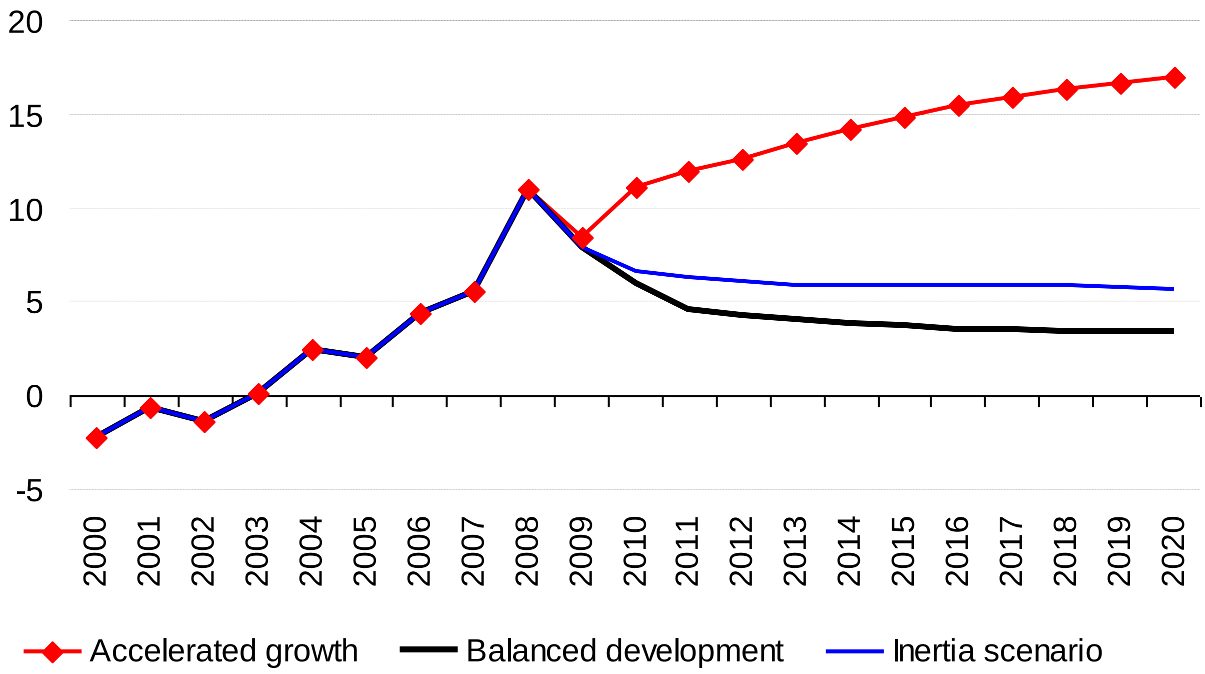
Source: CSI Bank of Moscow

The most reasonable development option in the next few years will be to sacrifice, to a certain extent, the economic growth rates to attain more *balance and viability* through:

- Matching the *economy's need for loans* with *the banking systems' lending possibilities* (including state support and foreign capital market);
- *consecutive development* of production factors – objective time lags between the capital investments and expanding capacities, as well as growing labor productivity, imply moderate demand expansion;
- *removal of current risks and misbalances* on the credit and interbank market, in utilization of external funds, reduction of overdue debts and resolving of the bad debt problem;
- reduced dependence of the Russian financial sector on the external environment, *consistent preparation for new monetary policy realities*, implying changes in money supply channels and gradual transition to the modified policy of inflation targeting;
- growth in *capitalization* of the national banking system;

- *development of financial markets* that will be an additional tool of the banking system in raising resources of the non-financial sector, helping resolve effectively the banking liquidity problems, accumulate domestic savings and facilitate growth in foreign capital inflows;
- *reducing non-tradable goods "bubbles"*. This popular term reflects fairly accurately the repercussions of the influx of the petrol-dollar revenues to Russia, explicit in the unjustified rally in prices for goods that do not compete with imports.

Graph. Movements in Deficit of Financial Resources (Loans minus Deposits), *% of GDP*



Source: CSI Bank of Moscow

The structural reforms should not be limited to the financial sector. Growth in value added production in the industry through cost reduction, equipment retooling and labor productivity growth is very important. Optimal combination of the real and financial sectors restructuring can be also helped by the strengthening competition and finalization of the structural reforms in the natural monopolies' sectors.

The balanced development scenario is based on the following assumptions.

1. Relations with the rest-of-world

1.1. Surplus of balance of trade of goods and services will be 5% of GDP on average annually (in the period from 2001 to 2005 - 12.5% of GDP and in 2007 – 8.6%);

1.2. Net foreign capital inflow to the private sector of the economy will not exceed on average 2% of GDP on an annual basis (the peak inflow in 2007- 6.4% of GDP);

1.3. Growth in CBR's international reserves is estimated at 3-4% of GDP (in the period from 2001 to 2005 – 6.3% and in 2007 – 11.5% of GDP).

2. Monetary sector

2.1. Purchase of foreign currency by the CBR will remain the key source of money supply. Moreover, their volumes will remain excessive versus the economy's demand for monetary balances and the banks' needs to underpin the ruble liquidity.

2.2. The share of cash in money supply (M0 to M2 ratio) will be gradually declining to settle at 15-17%.

2.3. Active de-dollarization of savings is expected. The share of foreign accounts in total non-cash funds is expected to contract to 5-7% by 2020 (from 36% in 2000 and 25% in 2008).

Under the balanced development scenario M2 is estimated at 65% of GDP by 2020:

- household deposits will stay within 30% of GDP in 2020 (16% in 2007). The average annual growth in bank deposits will hover at 4% of GDP (4.3% in 2007);
- corporate deposits in the Russian banking system are estimated at 25% of GDP by 2020. Annual growth in corporate accounts with banks is estimated at about 3% of GDP (this indicator ranged from 1.7% in 2002 to 6.6% of GDP in 2007 to drop to 1.5% in 2009).

Under this scenario the loan market will be largely driven by domestic resources. The size of the LTD will narrow from 11% of GDP in 2008 to 3-5% of GDP in 2020.

Table. Balanced Development Scenario – Key Monetary Indicators, *% of GDP*

	2005	2008	2009	2010	2015	2020
Cash rubles	10.2	10.5	11.6	11.5	11.5	11.5
M0	9.3	9.1	10.1	10.0	10.0	10.0
Broad monetary base	13.5	13.4	15.3	15.4	18.4	20.7
Banks' reserve assets	4.2	4.3	5.2	5.4	8.4	10.7
Ruble accounts	18.7	23.3	26.8	28.5	40.6	52.0

M2	28.0	32.4	36.9	38.5	50.6	62.0
Foreign currency accounts	5.4	7.9	10.1	8.9	5.1	3.0
Broad money (M2X)	33.4	40.3	47.0	47.4	55.7	65.0
Non-cash funds	24.1	31.2	36.9	37.4	45.7	55.0
Corporate sector	11.1	16.7	19.0	18.7	21.7	25.2
Households	13.0	14.4	17.9	18.7	24.0	29.8
Banking foreign liabilities	6.9	12.0	11.3	12.1	16.1	19.7
Loans to the private sector	26.2	42.2	44.9	43.4	49.4	58.4
Corporate loans, including non-bank financial institutions	20.7	31.8	35.3	34.0	37.0	42.6
Consumer loans	5.4	10.4	9.6	9.4	12.4	15.8
Loans to state bodies	4.4	3.0	3.9	3.5	2.2	1.6
Banking foreign assets	5.1	11.2	12.6	12.8	12.7	13.6
Money multiplier (M2/broad monetary base)	2.1	2.4	2.4	2.5	2.8	3.0
The share of M0 in M2	33.2	28.1	27.3	25.9	19.8	16.1

Source: CSI Bank of Moscow, CBR

Total bank loans in the economy in 2020 will average 60% of GDP. The above conditions will constrain the annual average growth in the banking loan portfolio to 14-16%. Annual growth in loans with respect to GDP will be comparable with the levels registered in 2003–2005, the period preceding the credit expansion of the years 2006-2008 (6-7% of GDP).

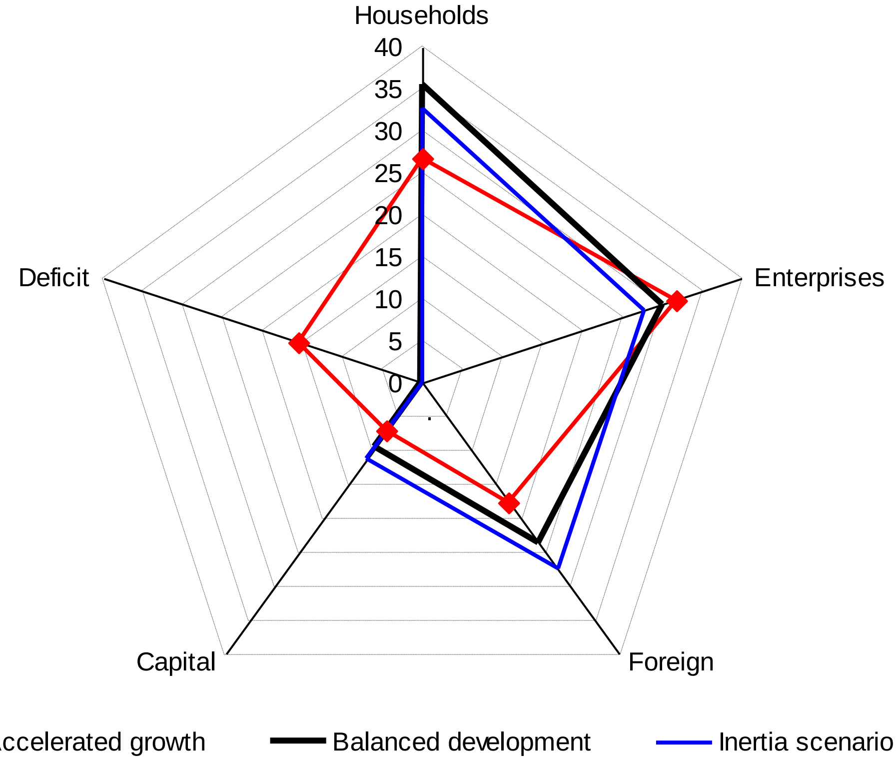
The balanced development scenario will foster the environment conducive for accelerated and more qualitative development of the financial sector:

- contracting share of M0 in total money supply from 28-36% of M2 in 2001-2009 to 16% of M2 in 2020;
- supporting de-dollarization of savings of the non-financial sector;
- maintaining current and capital account surpluses in the Russian BOP;
- sustainable growth in corporate deposits encouraged by the beneficial world price trends and increasing bank loans.

The estimates show that the balanced development scenario relying on domestic financial resources allows to achieve quite acceptable results. Additional opportunities for increasing the level of monetization in the economy will be:

- contraction of M0 in total money supply to 10-15% by 2020 – additional resources to the banking sector up to 10% of GDP;
- consolidation of the banking sector to 150-200 major banks will add 1% of GPD to money supply growth.

Graph. Forecast of the Banking Sector Liabilities Structure in 2020, *% of total liabilities*



Note: under the accelerated growth scenario the deficit of financial resources by 2020 will account for 20% of liabilities and will be covered either with foreign capital (with the existing foreign liabilities making up 18% of liabilities the total share will be 38%) or with state finance.

Source: CSI Bank of Moscow

The advantages of the balanced development scenario are evident. In the context of the steadily declining deficit of resources, bank lending will demonstrate substantial growth. Implementation of this scenario requires a lot of effort from the Russian monetary authorities to resolve the structural problems and regulate the development of the financial sector. The regulation should be aimed at preventing the overheating of the loan and other markets and mitigating the gyrations in capital inflow/outflow. The money supply should be changed and the banking system should be consolidated. The balanced development scenario should be a conscious choice and its implementation should be coordinated between all levels of the monetary authorities.

Conclusions

Economic growth in Russian led by expanding consumption and foreign loans proved unsustainable. The several months of the global crisis threw the country's industrial production back to the 2005 level.

The new financial policy should take into account the important lesson of the Russian economy accelerated growth in the period from 2006 to 1H 2008 – the statements «growth in gross economic indicators" and "qualitative economic growth" (shockproof and underpinned by growing competitiveness) may signify different things. There is a threat that the priority of innovative investment-driven growth and high competitiveness may have a purely declarative nature not only now but also when the crisis is over.

High on the post-crisis agenda should be the development of the strategy to achieve sustainable economic growth of a cardinally different quality. The financial sector should play the leading role – alongside the state task to foster the beneficial investments and business climate. The task of structural modernization of the financial sector is a priority and the global crisis has simply exacerbated the issue. Today, the most crucial for the financial sector are the following three groups of tasks:

1. assessing the adequacy of the ant-crisis measures to the current situation and their effectiveness, determining the necessity of their revision and expected outcome;
2. removing structural disproportions accumulated in the period of the accelerated growth;
3. creating new conditions and configuration allowing the financial system to be an economic growth driver instead of depressant.

The first signs of stabilization raise the question of further direction of the Russian economy. The most reasonable step will be to select the model combining the advantages of relatively fast growth with stability of the financial system and its resilience to external upheavals. If fast growing domestic demand is selected to shore up economic growth, high growth in bank lending will have to be sustained, other variables remaining constant. We will call this *the accelerated growth scenario*. The positive side of this scenario is a possibility to achieve high economic growth rates. But the side-effects will be a high threat to financial stability giving rise to the bank, currency and debt crisis. We can reasonably expect that the price of overcoming the crisis will be growing in step with the increasing impact of the financial sector on the real sector's performance.

The most reasonable scenario in the next few years will be to sacrifice, to a certain extent, the economic growth rates to attain more *balance and viability* through:

- Matching the *economy's need for loans* with *the banking systems' lending possibilities* (including state support and foreign capital market);

- *consecutive development* of production factors – objective time lags between the capital investments and expanding capacities, as well as growing labor productivity, imply moderate demand expansion;
- *removal of current risks and misbalances* on the credit and interbank market, in utilization of external funds, reduction of overdue debts and resolving of the bad debt problem;
- reduced dependence of the Russian financial sector on the external environment, *consistent preparation for new monetary policy realities,* implying changes in money supply channels and gradual transition to the modified policy of inflation targeting;
- growth in *capitalization* of the national banking system;
- *development of financial markets* that will be an additional tool of the banking system in raising resources of the non-financial sector, helping resolve effectively the banking liquidity problems, accumulate domestic savings and facilitate growth in foreign capital inflows;

The advantages of the *balanced development scenario* are evident. In the context of the steadily declining deficit of resources, bank lending will demonstrate substantial growth. Implementation of this scenario requires a lot of effort from the Russian monetary authorities to resolve the structural problems and regulate the development of the financial sector. The regulation should be aimed at preventing the overheating of the loan and other markets and mitigating the gyrations in capital inflow/outflow. The money supply should be changed and the banking system should be consolidated. The balanced growth scenario should be a conscious choice and its implementation should be coordinated between all levels of the monetary authorities.

Implementation of other ambitious projects – promotion of the ruble as a regional reserve currency or creation of an international financial center – call for substantial financial injections. The principal condition for successful implementation of such projects should become clearly formulated objectives and assessment of strategic advantages for the national economy.