AB-ICI March: Focus on CBR Exchange Policy

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Investment Summary

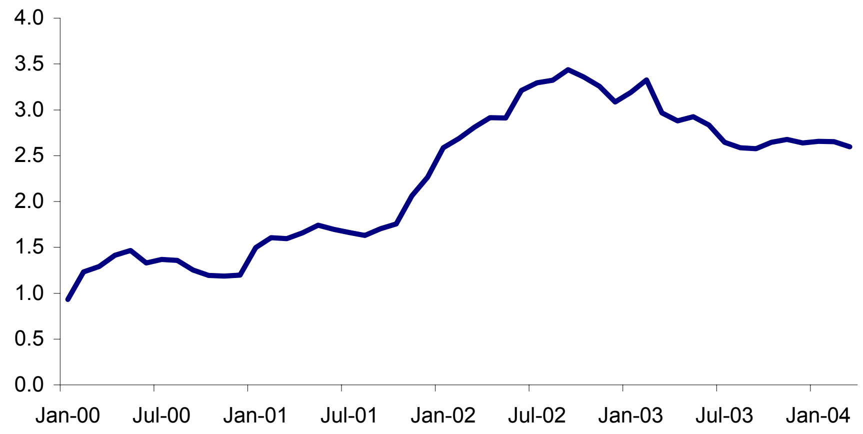
- **As we expected, capital flows show signs of reversal, but population is still switching to rubles**
- **Market fears that decline in CBR reserves will reduce liquidity, and thus price growth potential**
- **GDP slowdown favors weaker ruble; we believe the CBR may accumulate reserves in the future**

Reversal of capital flows pushed Index down 2%

Index declined 2% on weaker capital inflows and on profit-taking

The Alfa Bank Investor Confidence Index (AB-ICI) declined 2% in March on a reversal of capital flows and a lack of positive changes on the equity and bond markets. The previous sharp market growth triggered profit-taking, and thus the market component failed to positively contribute to the Index.

Figure 1. Alfa Bank Investor Confidence Index Down 2% in March



Sources: New School of Economics, Alfa Bank

With the switch from ruble liabilities into dollars, the markets will be concerned about a drop in ruble liquidity

As we mentioned in our most recent Index publication, the stagnation of CBR reserves was seen as a potential trigger for a reversal of capital flows, which were previously entering Russia agressively on expectations of ruble appreciation. In 1Q04 Russian banks began to reduce their exposure to the ruble, while devaluation expectations pushed companies to scale back their foreign borrowing. However, the population continues to switch from dollars into rubles and has sold $3.5 bln in 1Q04. We expect this behavior to change in April after the ruble begins weakening in nominal terms. This would place additional pressure on CBR reserves and send a negative signal to the markets.

Figure 2. Main Balance of Payments Items, 2004 vs. 2003 Quarterly, $ bln

	1Q03	2Q03	3Q03	4Q03	1Q04
Banking sector liabilities	0.6	2.7	1.9	6	1
Banking sector assets	0.2	0.6	-4.2	2.4	-2.8
Corporate sector liabilities	3.2	3	4.7	4.2	2.7
Corporate sector assets	-0.9	-1.5	-1.1	-1.1	-2.2
Foreign currency cash in assets	0.8	3.1	1.1	1.6	3.5

Note: "+" indicates decline in assets and increase in liabilities, "-" indicates increase in assets and decline in liabilities
Source: CBR

Stagnation of CBR reserves would be bad for the markets, as it would weigh on liquidity

Should CBR reserves stop growing, this would reduce the upside potential on domestic financial markets. Previously, around half of the fast growth in the monetary mass was not absorbed by the real sector and was instead channeled into financial assets, thereby supporting prices. The stagnation of CBR reserves has already triggered some profit-taking on the equity and bond markets on expectations of weaker demand in the coming months.

Slow growth pushes CBR to keep the ruble weak

0.7% q-o-q growth in 1Q04 calls for ruble depreciation

However, the dynamic of CBR reserves is not yet evident, and the CBR may still decide to depreciate the ruble at a faster rate by accumulating reserves. The recently announced 0.7% q-o-q growth in 1Q04 will require additional economic policy measures. As the decline in the tax burden will take effect only from January 2005, in the short term the CBR may feel pressure to support domestic producers.

As CPI does not reflect the true picture for all prices, targeting the ruble is preferable

Given a choice between keeping inflation under control and devaluing the ruble, the latter may be preferable, as CPI growth is not really a proxy for cost growth among Russian enterprises. This does not take into account the inflation of Russian assets, which has occurred at a much faster rate in previous years. Thus, control over inflation (i.e. consumer prices) does not please Russian industrialists, who are increasingly skeptical about CBR policy.

Policy of a weak ruble would allow the CBR to build reserves

Another way to manage the real exchange rate would be to allow the ruble to weaken, as would occur under reserves accumulation. We believe that the CBR may soon revisit the policy of previous years, when the ruble depreciated at a predictable rate of 6-9% per year, thereby compensating for domestic price growth.

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