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AB-ICI: Recovering With Capital Inflows

Natalia Orlova (7 495) 795-3677 NOrlova@alfabank.ru

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Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) rose by 1%, driven by improved capital account
- Capital inflows helped fend off a liquidity squeeze in April, demand for Finance Ministry money was modest

The AB-ICI recovered 1% last month

AB-ICI up 1%, expected to be supported

The AB-ICI index recovered 1% last month on an improved capital account position, and is expected to be well supported in the next two months because capital inflows are increasing and the RTS index seems to have hit bottom.

Economic confidence better

- **The index's economic confidence indicator** was up, backed by a slower capital outflow in March and an increase in individual deposits. We expect April's capital inflow to provide additional support to our index in the coming months;

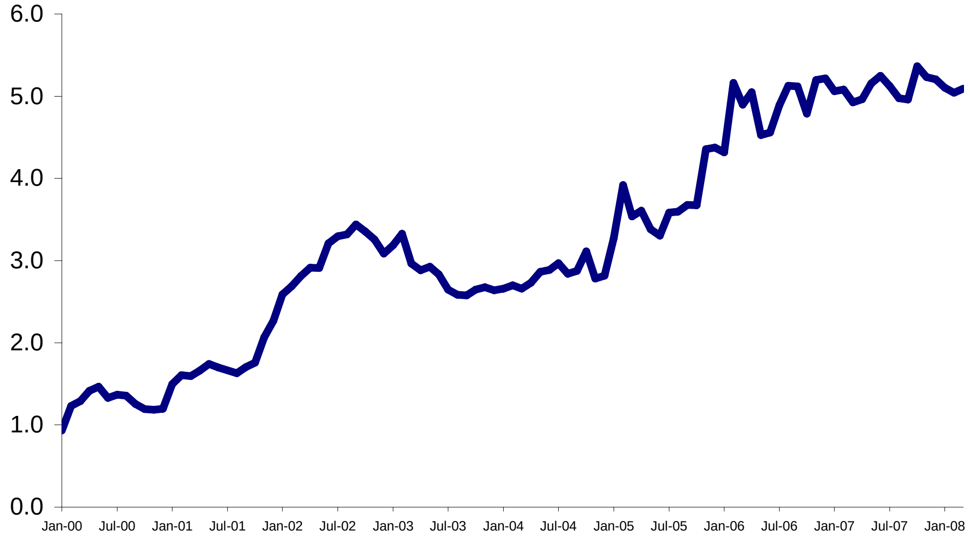
Foreign confidence flat and unlikely to change

- **Foreign confidence** changed only slightly, and we do not believe this index will substantially affect the AB-ICI in the coming months, as FDI inflows into Russia are modest;

Market confidence mixed

- **Market confidence** was mixed as the RTS index stopped declining. However, the structure of capital markets remains concentrated on big companies, and the large presence of local investors, as opposed to foreign funds, is making the market's performance less predictable and less correlated with fundamentals.

Figure 1: The AB-ICI up 1% last month



Source: Alfa Bank Research, New School of Economics

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Liquidity problem successfully avoided

April liquidity pressure successfully held at bay

Even though April had been expected to be a difficult month for the Russian banking system because of large tax payments, liquidity pressure was successfully held at bay. On April 21, Russian banks and companies paid around R400 bln in VAT, roughly 20% below our expectations, but still a very significant amount in relation to the size of Russian banks. However, the banking sector liquidity indicator was not affected, and was approximately R600 bln at the end of April, virtually unchanged from a month ago.

After capital outflow of $22.8 bln in 1Q08, CBR reserves have increased $12 bln since the beginning of April

The resumption of capital inflows looks to be the most likely reason behind this surprisingly positive outcome. In 1Q08, Russia saw a $22.8 bln net capital outflow, and the CBR's reserves were driven up solely by the current account surplus. In April, however, reserves growth accelerated. As of April 18, the CBR had accumulated $519 bln, a $12 bln increase since the beginning of April. We believe that the capital inflow was the main reason why there was no liquidity squeeze on the domestic market.

The Finance Ministry was ready to inject up to R300 bln, but Russian banks took only R23.6 bln and R17.7 bln at two Treasury auctions

The capital inflow appeared to be driven by Russian banks and companies, rather than foreign portfolio investors, explaining the low demand for repo operations and Treasury accounts. To head off a potential liquidity squeeze, the Russian Finance Ministry held auctions on April 17 and April 24 to inject up to R300 bln into the banking system. Banks took R23.6 bln at the first auction and only R17.7 bln at the second

Repo was modest, interbank rates stayed below 5%

The demand for repo was equally modest, increasing to R10-12 bln a day. Interbank rates went up slightly in the second half of April, but remained below 5%. This suggests that banks have successfully made it through the tax payment period.

Having fended off a liquidity squeeze, the CBR will concentrate on anti-inflationary measures

With the end of the tax payment period, focus has shifted onto two areas: taming inflation and banking sector growth. We believe that since banking sector stability is no longer a concern, the CBR is likely to introduce anti-inflationary measures, *i.e.* an increase in the FOR or in the repo rate. However, we do not expect monetary policy to be significantly tightened, as a substantial increase in the local interest rate would boost demand for Finance Ministry funding.

The banking sector will likely grow 25-35% in 2008

Having made it through the period of high tax payments unscathed, the banking sector may see higher-than-expected growth. This is especially likely given that the liquidity problems were overcome with the help of capital inflows and not with the support of short-term liquidity. We had previously forecast 25-35% banking sector growth based on the capital inflow to the country. However, corporate lending grew 68% y-o-y in 2M08 vs. 63% y-o-y in FY2007. Stronger banking sector growth will positively affect the AB-ICI's performance in the coming months.

Contact Information

Alfa Bank (Moscow)

Head of Equities	Dominic Gualtieri
Telephone	(+7 495) 795-3649
Facsimile	(+7 495) 745-7897
Research Department	
Telephone	(+7 495) 795-3676
Facsimile	(+7 495) 745-7897
Head of Research	Ronald P. Smith
Strategy	Ronald P. Smith, Erik DePoy
Oil & Gas	Chirvani Abdoullaev, CFA, Konstantin Batunin
Macroeconomics, Banking	Natalia Orlova, Olga Naydenova
Telecoms, Technology, Internet, Media	Ivan Shuvalov, Konstantin Beletskiy
Utilities	Alexander Kornilov, Elina Kulieva
Metals & Mining	Maxim Semenovykh
Consumer Goods, Retail	Brady Martin, Vitaly Kupeev
Real Estate	Brady Martin, Alexey Kryuchkov
Transportation, Fertilizers, Machine-Building	Roydel Stewart, Andrei Fedorov
Kazakh Product	Rinat Gainoulline
Fixed Income	Ekaterina Leonova, Pavel Simonenko
Technical Analysis	Vladimir Kravchuk, Ph.D.
Russian Product	Angelika Henkel, Ph.D., Vladimir Dorogov, Vladimir Kravchuk, Ph.D.
Editorial	David Spencer, Heather Dean
Translation	Anna Sholomitskaya, Dmitry Dolgin
Production	Aleksei Balashov
Equity Sales & Trading	
Telephone	(+7 495) 795-3672, 795-3662
Facsimile	(+7 495) 745-7897
International Sales	Kirill Surikov, Mikhail Shipitsin, David Johnson, Michael McAtavey
Domestic Sales	Alexey Primak, Alexander Nasonov, Konstantin Shapsharov, Vsevolod Topolyansky, Diana Nuriakhmetova
Address	12 Akad. Sakharov Prospect, Moscow, Russia 107078

Alfa Capital (Kiev)

Research Department	
Telephone	(+380 44) 490-1600
Strategy, Macroeconomics, Fixed Income	Sergiy Kulpinsky, Ph.D.
Metals & Mining	Oleh Yuzefovych
Engineering, Chemicals	Denis Shauruk
Utilities	Maksym Nikulyak, Kateryna Ruskykh
Consumer Goods	Tetyana Orlova
Banking	Andrey Zaripov
Real Estate, Small-Cap Strategy	Andriy Gubachov
Editorial	Danylo Spolsky
Equity Sales	
Sales	Sergey Grigorian, Ivan Shehavtsov, Anfisa Anikushina
Telephone	(+380 44) 490-1600

Alfa Capital Markets (London)

Telephone	(+44 20) 7588-8500
Facsimile	(+44 20) 7382-4170
Sales	Maxim Shashenkov, Mark Cowley, Taissia Chinina
Sales Trading	Douglas Babic
Address	City Tower, 40 Basinghall Street, London, EC2V 5DE

Alfa Capital Markets (New York)

Telephones	(+1 212) 421-8563 / (+1 212) 421-7500
Facsimile	(+1 212) 421-8633
Sales	Robert Kaplan, Roman Kogan
Sales Trading	Roman Kogan
Address	540 Madison Avenue, 30th Floor, New York, NY 10022