



AB-ICI May: Index up 10% on Foreign Activity

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Investment Summary

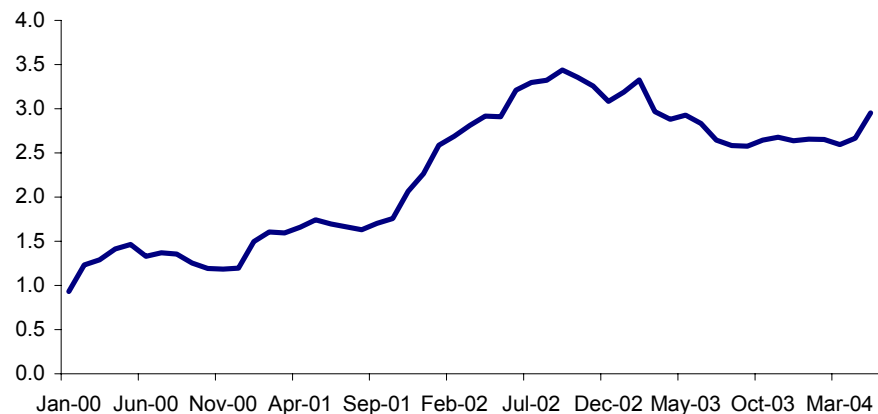
- AB-ICI rose an unprecedented 10% in May on FDI flows and an increase in foreign banks' assets
- Although capital outflow slowed in May, liquidity squeeze led to a drop in interbank confidence
- Increase in deposit rate is a key catalyst to watch in terms of banking sector recovery

AB-ICI shows unprecedented 10% m-o-m growth

Rapid penetration by foreign banks and healthy FDI boosted the Index 10%

The Alfa Bank Investor Confidence Index (AB-ICI) increased an unprecedented 10% in May, reflecting greater activity among foreign businesses in Russia. The share of foreign assets in total banking assets, which measures the penetration of foreign banks, rose from 5.3% to 5.9% during the first quarter of 2004. During this same period Goskomstat also reported increased FDI, up 43% y-o-y to a level of \$1.5 bln. This amount is equivalent to more than one-fifth of the total FDI inflow of \$6.8 bln in 2003. Such positive indications of increased foreign activity in Russia were the main factors supporting the rise of the Index in May.

Figure 1. Alfa Bank Investor Confidence Index jumped 10% in May



Sources: New School of Economics, Alfa Bank

Financial market suffered as a result of the liquidity squeeze

However, signals from domestic sectors of the economy were mixed in May. The financial market has suffered recently due to uncertainty surrounding Yukos and in response to the general decline in liquidity. Small and mid-sized banks, which, as a result of the crisis of confidence in the banking system, were unable to borrow resources on the interbank market, were forced to sell from their fixed-income and equity portfolios. While rates on the interbank market settled down after the CBR's decision to cut the rate of the Fund of Obligatory Reserves (FOR) and inject \$1.5 bln in liquidity into the banking system, rates remain largely indicative and interbank volumes squeezed.

Additional growth of Index expected on cautious recovery in domestic confidence

To summarize, the dynamic of the AB-ICI in May shows increased foreign confidence, which more than fully compensated for problems related to domestic confidence. We anticipate a further increase of the Index in the coming months as domestic confidence gradually begins to revive.



Recovery of confidence to drive Index higher

AB-ICI should rise...

...as the CBR targets a \$24 bln increase in reserves from current levels,...

...capital outflow will decline...

...higher liquidity will allow asset prices to recover...

...and inevitable culling of the banking sector will boost the share of foreign participants

Behavior of retail deposits will be crucial for the banking sector's future as well as for the AB-ICI

We see several factors that should allow the AB-ICI to show additional growth:

- A CBR representative declared a reserves target of \$100 bln by year's end, which means that the CBR intends to inject liquidity into the banking sector by printing money, i.e. accelerating the rate of reserves accumulation.
- The capital outflow declined in May on a monthly basis and is likely to be modest in June-July, simply because speculative capital has already exited the market.
- The prices of Russian assets have suffered in recent months because of a liquidity squeeze, and they will gradually recovery in the upcoming period. Should the CBR implement weaker than expected control over capital inflows to the Russian market (the deposit rates of the new currency law are expected to be published by August 1), this would have a positive impact on the inflow of foreign capital.
- We reiterate our view that the banking sector is now entering a period that will witness the bankruptcy of small and mid-sized banks due to introduction of the deposit insurance system. The decline in the number of Russian banks and the elimination of grey schemes will boost the comparative share of foreign banks, which in turn will favor growth in the AB-ICI.

In general, we are not worried about restructuring in the banking sector, and we see the bankruptcy process as an inevitable stage in its maturation. An important catalyst to watch, however, is the behavior and interpretation of this process by banking clients. As of now, the savings rate is rising, and the share of dollar deposits is declining. Any changes in the trend of these two indicators could reduce the level of wealth in the banking sector and, by extension, weigh on our Index.

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