AB-ICI May: Following the GDP trend

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Investment Summary

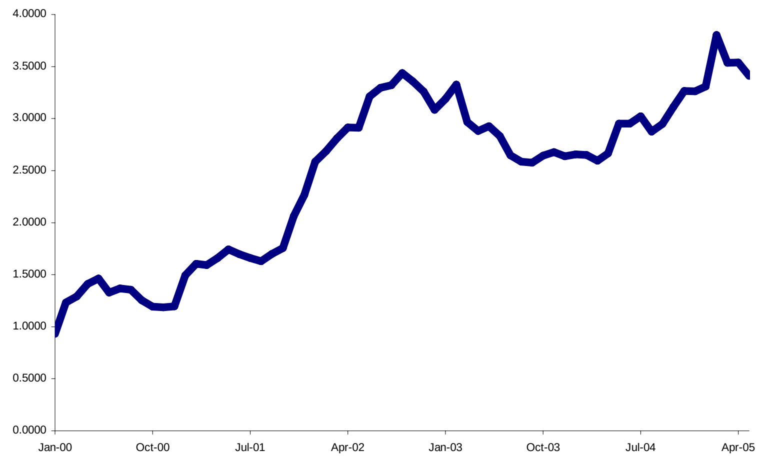
- **AB-ICI shows a modest 3.7% decline in May, supported only by the penetration of foreign banks into Russia**
- **The economic growth trend is now in focus, with May's growth of 1.4% damaging annual forecasts**
- **Banking liquidity remains stable, but potential capital outflow raise pressures.**

AB-ICI falls in sympathy with economic indicators

AB-ICI shows modest decline in May; supported only by foreign banks' penetration

The Alfa Bank Investor Confidence Index (AB-ICI) demonstrated a modest 3.7% decline in May, supported only by higher activity among foreign banks. The total $1.9 bln FDI inflow to Russia in 1Q05 was half absorbed by the oil sector, reflecting the poor allocation of attracted capital. The only good news is that foreign banks remain interested in Russia's banking assets. In 1Q05, the retail-oriented KMB-Bank was purchased by Italy's Intesa, and foreign banks' share of total banking assets increased.

Figure 1. AB-ICI up 3.7% in May driven by foreign investments



Sources: New School of Economics, Alfa Bank

Cabinet inability to produce new economic strategy to offset weak 1.4% y-o-y growth damages investor confidence

Unsurprisingly, the "Russian" component of the confidence index performed with mixed directions. Recent macroeconomic figures unveiled by Russian officials indicate significant risks for the growth rate in 2005 and 2006. In the oil sector, property restructuring, licensing problems, and unresolved pipeline constraints have already led to stagnation in daily production volumes and hurt the sector's ability to recover. Due to slower demand from oil companies and rapid ruble appreciation, Russian manufacturers have reduced their output. While the manufacturing sector posted a 7.8% y-o-y increase in April, its growth rate dropped to only 1.4% in May. After cutting its projection for the 2005 growth rate to 5.8% one month ago, the Cabinet is now discussing a further cut to 5.5%. Its inability to produce a new economic policy continues to damage investor confidence.

Banking liquidity has returned to normal levels after inordinate surge in December due to Yuganskneftegaz auction

One factor that is clearly supporting the index is the level of banking liquidity, which remains at an appropriate level. At the beginning of June, total liquid assets in banks amounted to around $20 bln, the same level of the past month. In our view, the decline in liquidity from December 2004 to current levels is not a concern; rather, it should be interpreted as a return to normal levels after an inordinate surge due to the auction of Yuganskneftegaz in December. The dynamic of capital flows is now crucial. We also believe that the return of the dollar-euro rate to the level of $1.23-1.25/€ will help to limit capital outflow. However, we note that clients' preference for non-ruble assets will remain a key risk factor for Russian banks in 2H05.

Figure 2. Cash in circulation and liquidity in banks, $ bln

	Dec-03	Sep-04	Nov-04	Dec-04	Mar-05	May-05
Cash in circulation	41.6	47.0	50.2	60.2	56.7	59.8
Correspondent accounts	10.4	7.8	9.9	17.5	11.7	9.6
Obligatory reserves	9.1	4.0	4.2	4.4	4.8	4.8
Deposits at the CBR+CBR bonds	3.0	1.6	7.8	3.6	6.3	5.9
Reverse repo	1.0	2.4	1.4	0.1	0.1	0.1
Reserves on foreign operations	0.0	0.0	0.3	0.2	0.2	0.3
Total in banks	**23.4**	**15.8**	**23.6**	**25.8**	**23.1**	**20.7**

Source: CBR, Alfa Bank

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