AB-ICI: Under Inflationary Pressure

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Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) was flat last month, kept down by inflation
- Despite increased reserve requirements in January and February, the CBR failed to curb inflation

The AB-ICI was flat last month

AB-ICI flat

The AB-ICI index was flat last month, reflecting the CBR's inability to deal with strong inflationary pressure.

Economic index was down

- **The index's economic confidence indicator** was down, reflecting a deteriorating perception of the government's ability to control price growth;

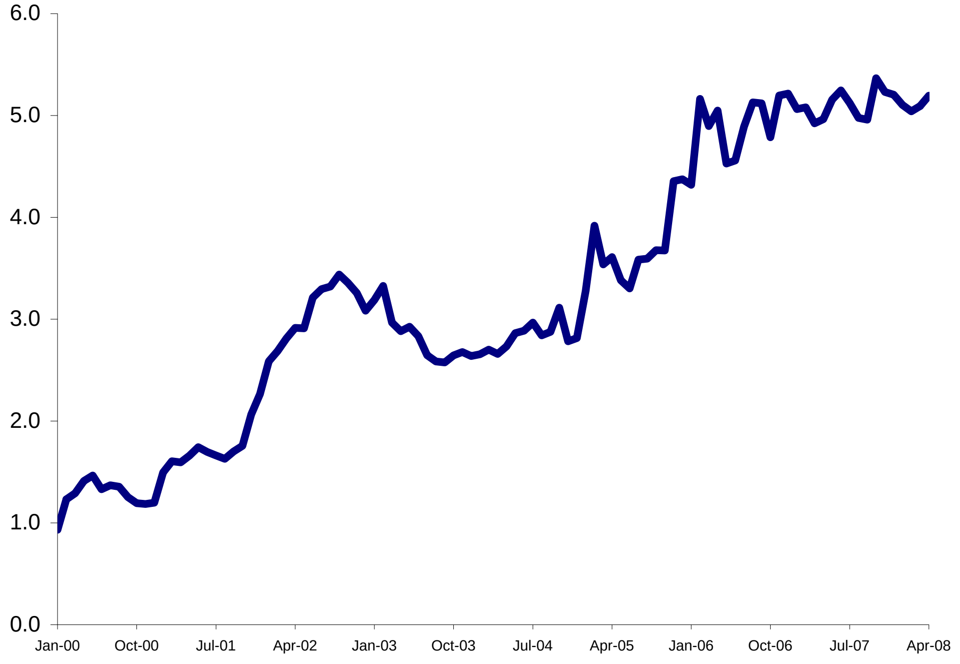
Foreign confidence flat

- **Foreign confidence** was unchanged owing to a lack of new statistics, but the general perception is that global markets' volatility is clearly preventing penetration by foreign banks and foreign investment in the Russian economy;

Market confidence weak

- **Market confidence** is still under pressure because of the poor growth of global markets and increasing uncertainty around the globe.

Figure 1: AB-ICI flat last month



Source: Alfa Research, New School of Economics

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Monetary tightening: myth or reality?

The CBR's promise to tighten monetary conditions damaged banking stocks but failed to slow the sector and curb inflation

The CBR's continued indications that it will address mounting inflationary pressure explain the poor performance of Russian banking stocks over the past five months. However, despite an increase in the Fund of Obligatory Reserves in January and February this year, the banking sector has not shown any signs of slowing down, maintaining 68% y-o-y growth in corporate loans in 4M08. The CPI was also not affected by monetary tightening, and May's inflation rose to 15.1% y-o-y.

CBR took $5.6 bln from banks via FOR, but deposits with the CBR and banks' bond portfolio declined

To explain this paradox, we need to look at the structure of the monetary base. While the FOR increased from $9.0 bln in January to $14.6 bln in April this year, that increase coincided with a decline in deposits with the CBR and banks' portfolio of CBR bonds. As a result, total sterilization by the CBR declined from $24.6 bln in January to $18.4 bln in April. These statistics clearly confirm the CBR's preference for supporting banking sector liquidity during the tax payment period in April. The fact that the FOR increase did not result in higher sterilization of liquidity explains why banking sector growth did not slow and inflation did not decline.

Figure 2: Liquidity sterilization by the CBR, $ bln

	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08
FOR	9.0	9.6	13.1	14.4	14.6	14.8
Deposits with the CBR	11.0	11.7	5.2	5.2	3.0	9.9
CBR bonds	4.1	4.1	5.4	0.8	0.8	0.8
Total	24.1	25.4	23.7	20.4	18.4	25.5

Source: CBR, Alfa Research

State banks are likely to increase their market share in 2Q08

Because CBR bonds and deposits with the CBR are mainly held by state banks, the FOR increase widened the gap between state and private market players. State banks are likely to maintain growth, while the rest of the sector has been under liquidity pressure. We therefore believe that 2Q08 will see a further strengthening of state banks' presence on the Russian banking market.

State banks attracted 70% of the $11 bln borrowed from abroad as of the end of May

In addition, the disparity between state banks and private banks will be further increased by the recent growth in foreign borrowing. Since the end of May, when the global market opened up for Eurobond placements, Russian banks have attracted some $11 bln in bonds and syndicated loans. Of this, $5 bln was borrowed by VTB, $1.8 bln by RosAgrobank, $0.5 bln by Gazprombank and $0.5 bln by Sberbank, followed by Alfa Bank and Home Credit with $0.7 mln and $0.5 mln, respectively. In total, state banks attracted 70% of the sector's total borrowing for this period. This large volume of borrowing by state banks explains the increase in banks' deposits with the CBR from $3.0 bln in April to $9.9 bln in May, a rise of $6.9 bln in a month.

A FOR increase, even if it is still needed in the event that June inflation is high, will only offset foreign debt inflow

We believe the abovementioned figures will have the following implications: First, we reiterate our view that if June inflation is above 1.0%, additional monetary tightening (a FOR increase) will be needed. The previous FOR increase did not result in high sterilization, providing a strong argument for continuing monetary tightening. However, given the recent increase in foreign borrowing, an additional FOR increase is likely only to offset the negative inflationary implications of the capital inflows.

The overly strong presence of state banks lowers the effectiveness of monetary policy: bad news for inflation

Second, given the huge gap between state banks' and private banks' liquidity, the CBR will not be able to increase the FOR high enough to make it an effective tool in its anti-inflationary package. In a nutshell, the overly strong position of state banks in the sector substantially reduces the CBR's ability to conduct monetary policy. We therefore reiterate our negative view on Russia's inflationary outlook and maintain our 2008 CPI forecast of 13%.

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