ALFA·BANK **Macroeconomic Analysis**

AB-ICI June: Relaxing after 10% Jump

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Investment Summary

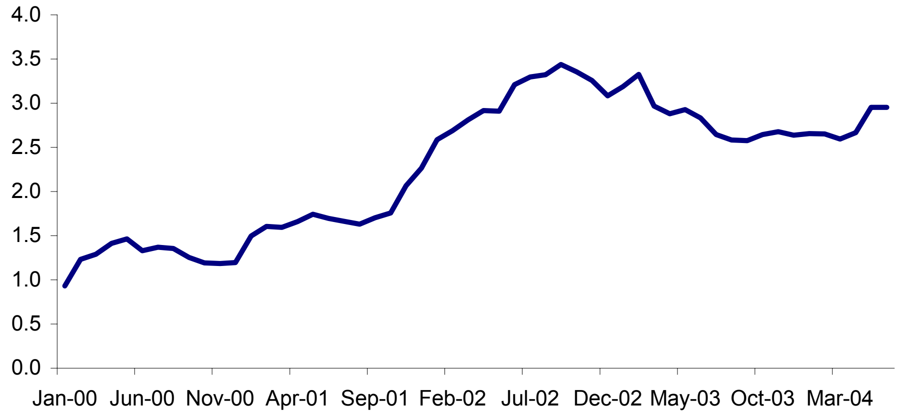
- **Movement slows down after sharp 10% Index increase in May; market awaits crisis aftermath**
- **We expect the $2 bln deposit withdrawals in June to hit the AB-ICI in the upcoming months**
- **Recovery in lending is key indicator defining future economic activity**

AB-ICI lying flat after 10% jump in May

June's AB ICI is flat due to weak financial markets and an overall drop in liquidity

Alfa Bank's Investor Confidence Index (AB-ICI) remained unchanged in June after an unprecedented 10% jump in May. Some improvements in the amount of the capital inflow and a continuing increase in savings rates were completely offset by the drop in financial market activity. The recovery in AB-ICI in May, which reflected greater activity among foreign businesses in Russia, has basically been hit by the liquidity squeeze and general instability in the banking sector.

Figure 1. Alfa Bank Investor Confidence Index: flat in June due to weak liquidity



Sources: New School of Economics, Alfa Bank

Despite some slowing down, capital outflow remains substantial and could reach $10 bln/year

The only positive change is a slight improvement in capital inflow, backed by a less aggressive trend in US rate increases and weaker R/$ dynamics. However, this seems to be a short-term effect. In 1H04, the net capital outflow reached $5.5 bln, versus $2.3 bln for the whole of 2003, as domestic interest rates are far less attractive then they were a year ago. While the CBR is now rushing to accumulate reserves to inject liquidity in the system, we believe that Russia will show around $8-10 bln in net capital outflow for the whole of 2004.

AB-ICI hit by Germany's decision to securitize Russian debt and weak RTS

June's AB-ICI was deeply affected by the liquidity squeeze in the economy and reflected the decline among Russian financial markets. The RTS market in June was around 6% below May's level on average; Russian bonds were underperforming compared to its Latin America peers due to Germany's decision to securitize part of Russia's debt to Germany under a Paris Club agreement. These market factors played an important role in explaining weakness in the AB-ICI.

Lending activity dynamics now crucial

In May client lending was up just 0.8% versus previous 3% average monthly growth

In the months to come, the economic focus will be interconnected with lending activity in the banking sector. Right now, the aggregated statistics for the CBR's list of top-30 banks suggest that lending to corporate clients was up by just 0.8% in May, compared to a 3% average monthly growth from the beginning of this year. However, money attracted from the interbank market dropped by $1.2 bln in May alone, reflecting liquidity problems in small and mid-sized banks.

Figure 2. Key banking sector figures, December 2003 - May 2004, $ bln

	Dec	Jan	Feb	March	April	May
Cash	2.4	2.3	2.0	2.0	2.2	2.1
Deposits in CBR	12.4	15.1	14.5	12.0	9.5	9.1
Securities purchased	23.6	25.1	27.2	26.1	28.0	27.6
Loans to customers	57.1	58.3	58.9	61.5	63.5	64.0
Customers accounts	69.7	73.6	75.8	77.9	81.4	81.7
Retail deposits	42.6	45.0	46.4	47.9	48.6	49.3
Bonds issued	13.3	13.5	13.4	13.8	13.5	12.1

Sources: CBR, Alfa Bank estimates

State-owned banks are responsible for replenishing liquidity in the economy

Some steps have been taken to resolve this situation. In particular, as things are likely to become worse in June-July, the CBR is forcing the two largest state-owned banks to help support the banking sector. Sberbank, the largest bank with assets totalling $54 bln, is now obliged to share the wealth with the interbank market. VTB is the second largest bank, with more then $9 bln in assets; it spent $200 mln on purchasing private bank lending portfolios and is likely to put in another $400 mln for similar transactions. As CBR is not showing a willingness to a direct disbursement of stabilization loans to banks in trouble, some money is likely to flow out of the banking sector and back under mattresses.

CBR must support depositor confidence

We believe that future AB-ICI dynamics will completely depend on the banks' ability to restore lending operations and support the economy with liquidity. Otherwise, if the banks are incapable of making enough money to quell solvency concerns, a gradual run of withdrawals will persist and confidence will sink even lower. This could still be avoided with more direct CBR intervention, but if it's not happening, we'll see a long-term impact on the entire economy.

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