

AB-ICI: Expecting Reserves Growth

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July 27, 2006

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Investment Summary

- After declining 10% a month ago, the AB-ICI remains at a low level despite the Rosneft IPO
- We expect the Bank of Russia's (CBR's) reserves will reach \$300 bln by year end, the third-largest in the world after Japan and China

AB-ICI up by less than 1%

AB-ICI is flat...

...due to huge capital outflows,

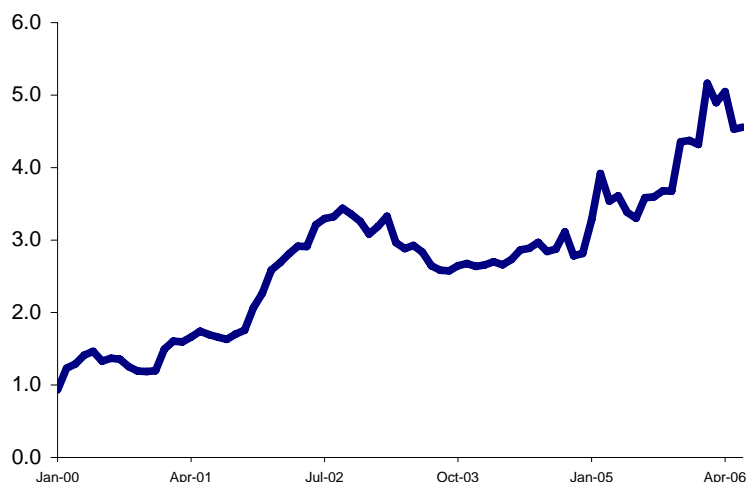
flat foreign confidence,

and declining liquidity and wide spreads on Russian financial markets

The Alfa Bank Investor Confidence Index (AB-ICI) remained virtually flat last month, reflecting the uncertainty on global markets and investors' worries:

- The Index's **economic confidence** dropped by 11%, reflecting capital outflows from Russia. In our view, global uncertainty with regards to interest rates pushed speculative investors to quit the Russian market, while Russia's payments on its foreign debt also contributed to slow CBR reserves growth;
- **Foreign confidence** remained unchanged as foreign banks' statistics and new FDI figures are being published only on a quarterly basis;
- **The market confidence** indicator was mixed as the Rosneft IPO, seen as positive news, was unfortunately offset by the still wide spread between Russian and international bonds and by the declining liquidity of second-tier instruments.

Figure 1. AB-ICI remains flat after declining 10% last month



Sources: New School of Economics, Alfa Bank

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CBR reserves to be third-largest in the world by 2007

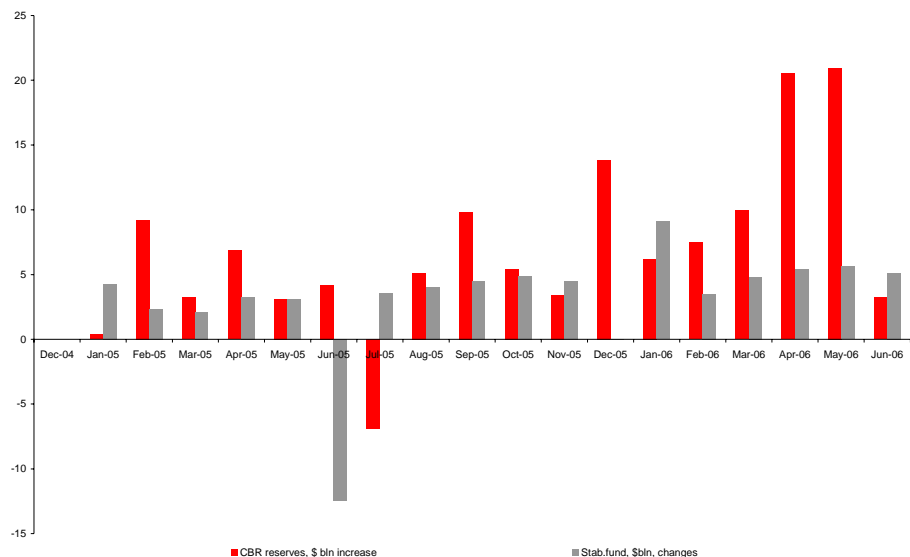
CBR reserves growth were just \$3 bln in June because of foreign debt redemption by Russian companies

We expect CBR reserves to reach \$300 bln by year end, good news for the AB-ICI

The dominant factor that prevented the AB-ICI from recovering was the very weak growth of CBR reserves in June due to a number of factors. First and foremost in our view was the redemption of debt obligation. While Russia paid around \$2 bln to redeem its debt obligations, we suspect that Russian companies were making huge redemptions (including a possible repayment of loans used for the Yuganskneftegaz purchase). In addition to this, the capital outflow driven by expectations of an US interest rates hike also seems to have damaged reserves growth. As a result, CBR reserves were up just \$3 bln in June vs. a \$21 bln increase in May and similarly strong growth in April.

While reserves growth resumed in July and reached \$12 bln for the first 20 days of this month, we expect the upcoming Paris club redemption will damage reserves growth in August. However, President Putin's recent indication that overly strong currency appreciation is damaging local producers should be seen as a sign that the CBR will produce aggressive growth in 2H06. CBR reserves will most likely reach \$300 bln by year end, putting Russia in third place in the world after Japan and China by size of reserves accumulated. In April-May the CBR was increasing reserves at a monthly volume of \$21 bln, quite close to the monthly increase of export revenues (\$26 bln), signaling strong capital inflow to the country. The good news is that increasing demand for money, based on faster GDP growth, now helps to avoid the inflationary outcome of money printing and will free the CBR's hands by the end of this year if not earlier.

Figure 2. CBR reserves growth and increase in stabilization fund, \$ bln a month



Source: Minfin

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