AB-ICI July: Reflecting Fundamental Improvement

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Investment Summary

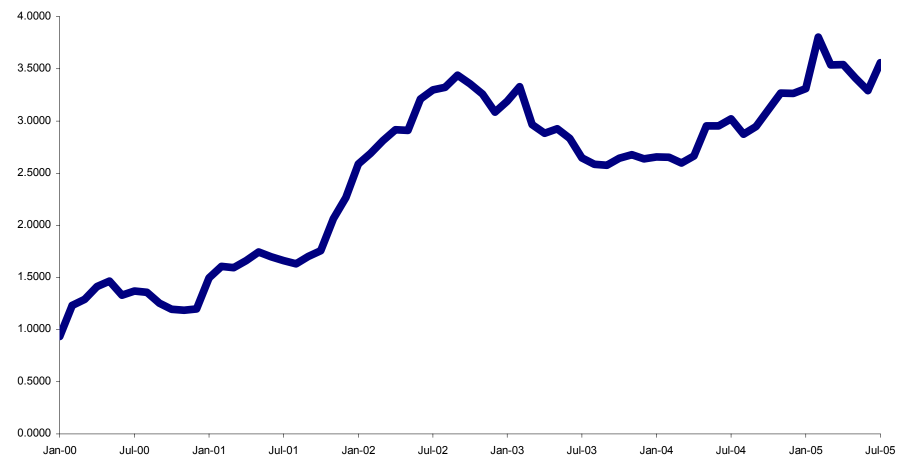
- **AB-ICI up 8% in July, reflecting liquidity inflow to Russian financial markets**
- **Stabilization Fund seen at $50 bln by 2006, implying greater spending and higher liquidity**
- **Despite high oil price, ruble unlikely to appreciate due to stronger dollar; good for economy**

AB-ICI increased 8% driven by liquidity

AB-ICI up 8%; liquidity inflow is backed by fundamental changes

The AB-ICI rose 8% in July, reflecting general growth of foreign investment and financial markets in Russia. The rise was mainly driven by high domestic liquidity boosting the value of domestic assets, though there were also some fundamental changes. Higher oil prices have allowed greater fiscal expenditures, which will help stimulate consumption and fuel economic growth. Meantime, as some countries (e.g. Indonesia) are already suffering from higher oil prices, flight to the dollar will strengthen the US currency and potentially weaken the ruble, which is also positive for Russian growth.

Figure 1. AB-ICI up 8% in July June driven by market growth



Sources: New School of Economics, Alfa Bank

Liquidity is pushing up asset prices

Last month's increase in the AB-ICI was clearly driven by high liquidity, which persists on domestic markets. During July-August the RTS Index rose by 17% while the spreads of Russian bonds to US Treasuries and Latin American bonds narrowed. Liquidity on banking accounts as of the beginning of August remained at $19 bln, which is virtually unchanged compared to a few months ago. The stable level of liquidity on banking accounts seems to reflect active participation of banks in financial market growth and implies that the level of $18-20 bln is fair relative to the current size of the economy. As we mentioned in our previous Index notes, the volatility of interbank rates, which regularly jump to 4-6% during periods of tax payments compared to the usual level of 1%, is explained not by poor liquidity in the banking sector, but rather by the excessive concentration of this liquidity among state-owned banks.

Figure 2. Monetary Base by Component, $ bln

	Dec-03	Sep-04	Nov-04	Dec-04	May-05	Jun-05	Jul-05
Cash in circulation	41.6	47.0	50.2	60.2	59.8	61.3	63.6
Correspondent accounts	10.4	7.8	9.9	17.5	9.7	9.9	9.5
Obligatory reserves	9.1	4.0	4.2	4.4	4.8	4.8	5.0
Deposits at the CBR+CBR bonds	3.0	1.6	7.8	3.6	5.9	4.5	4.1
Reverse repo	1.0	2.4	1.4	0.1	0.1	0.0	0.0
Reserves on foreign operations	0.0	0.0	0.3	0.2	0.3	0.2	0.3
Total in banks	**23.4**	**15.8**	**23.6**	**25.8**	**20.7**	**19.3**	**18.8**

Source: CBR, Alfa Bank estimates

$100 bln in Stabilization Fund by 2007 will fully cover foreign debt; Cabinet is ready to increase expenditures

The increase in asset value now seems to be backed by positive fundamental changes linked to the increase in oil prices. First, after aggressively building up the Stabilization Fund, the Cabinet is now considering ways to spend some of the money. The fiscal reserves expected to total $50 bln by the end of this year and $100 bln by the end of 2006 are too large to be kept unused. We expect the budget to increase social expenditures by at least $4 bln in 2006, and the R70 bln ($2 bln) Investment Fund may also be increased. Both mechanisms for spending money will help support the GDP growth rate, which we currently forecast at 5.5% for next year but are likely to upgrade. We are now less concerned about the inflationary implications of such a decision, as the monetary inflation impulse will be weak compared to the impact from rising gasoline prices.

Oil prices are not harming Russia's currency, as the ruble remains weak thanks to a stronger dollar

Second, while a number of countries are entering a period of economic instability due to high oil prices, Russia is being seen as a safe haven. Moreover, as concerns about fiscal vulnerability to an oil shock may hit European currencies, the dollar is likely to strengthen in the near future. This means that the ruble will be affected by opposite forces – the high oil prices will favor appreciation, while the stronger dollar will force depreciation. The latter trend is expected to be more pronounced, thereby offering competitive advantages to non-oil sectors. In other words, the good thing about the recent increase in oil prices is that Russia is avoiding sharp currency appreciation and thus extracting only the benefits from the current international environment

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