

AB-ICI: Following Financial Markets

Natalia Orlova

(7 495) 795-3677

NOrlova@alfabank.ru

August 18, 2006

www.alfabank.com

Moscow

Investment Summary

- AB-ICI increased by 7.3% last month, following the recovery on Russia's financial markets
- De-dollarization supports index; share of foreign currency deposits dropped to a new low of 20.6%
- No indication yet of foreign banks' stronger presence, in line with Russia's WTO position

AB-ICI rose 7.3% on higher market confidence

The Alfa Bank Investor Confidence Index (AB-ICI) increased by 7.3% in July, mainly driven by economic and market confidence:

AB-ICI was up...

...on capital inflows driven by ruble appreciation...

- The Index's **economic confidence** component was up 7% thanks to increasing capital inflows to Russia. In our view, the pause in the Fed's rate hike campaign is making Russia vulnerable to speculative capital inflows, which are being attracted by the expectation of upcoming ruble appreciation.

...despite decline in share of foreign banks...

- **Foreign confidence** declined slightly due to the declining share of foreign banks in total banking assets to a level of 7.8%;

...and supported by positive market dynamic

- The **market confidence** indicator showed a positive trend driven by the Rosneft IPO and market recovery following the improving dynamic in emerging markets.

Figure 1. AB-ICI was up 7.3% last month driven by economic and market factors



Sources: Alfa Bank, New School of Economics

RESEARCH DEPARTMENT research@alfabank.ru

Alfa Bank Group and/or its affiliates does and seeks to do business with the issuers covered in this research report. As a result, investors should be aware that Alfa Bank Group and/or its affiliates may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. For important disclosure information relating to Alfa Bank Group and/or its affiliates' investment banking relationships, if any, with the issuers mentioned in this report and regarding Alfa Bank Group and/or its affiliates' rating system, valuation methods, analyst certification and potential conflicts of interest, please refer to the Disclosure Section at the end of this report.

Ruble appreciation under debate

Stronger ruble pushed the share of currency deposits down from 40% to 20.6%

The AB-ICI dynamic is largely supported by the economic impact of ruble appreciation. The first positive implication is that the ruble's nominal appreciation has been significantly reducing the dollarization of Russia's economy. While a couple of years ago the share of currency denominated deposits represented around 40% of total deposits, as of last month currency deposits dropped to 20.6% of total deposits.

Ruble appreciation is attracting capital inflows

The second result is that the ruble's appreciation is attracting speculative capital inflows. In the short term this is positive, as it leads to stronger CBR reserves growth, but in the longer term capital inflows could lead to high exchange rate volatility. The CBR's currency reserves are up \$11 bln since the beginning of August as a result of strong capital inflows to Russia. We believe this capital inflow trend will soon raise questions about the CBR's future exchange rate policy.

Figure 2. Government exchange rate forecasts for 2007-2009, R/\$ year end

	2007	2008	2009
Oil prices flat	26.5	26.5	26.9
Oil prices growth	26.2	25.5	25.3

Source: Ministry of Economic Development and Trade

Elimination of currency controls could reduce the pace of ruble appreciation

The issue of Russia's vulnerability to high capital inflows has become particularly important following the recent liberalization of currency controls. As a consequence of the new regulations, the CBR now lacks an administrative instrument with which to regulate balance of payment flows, leaving market intervention the only available option. We therefore believe that while previously the CBR was not concerned about speculative capital inflows, this attitude could change in the future. In all, we see more arguments emerging in favor of pegging the ruble to the dollar than to a currency basket, which in reality would not prevent the emergence of excessively strong capital inflows.

Low presence of foreign banks is due to protected market

Share of foreign banks is below 10% in any of Russian banking markets

The foreign component of the Index depressed its general growth because of the declining share of foreign banks in total assets in 2Q06. While this indicator dropped to 7.8%, data from 2002-2005 indicate very modest penetration of foreign entities to Russia's banking market. In all key banking markets, the presence of foreign banks remains below 10%.

Figure 3. Share of Foreign Banks on Different Market Areas

	2002	2005
Retail loans	3.1%	8.7%
Corporate loans	1.8%	6.9%
Retail deposits	1.5%	3.3%
Capital	4.7%	8.5%
Total assets	5.9%	8.6%

Source: Interfax

Situation unlikely to change as Russia intends to keep banking market protected

We believe that the poor penetration of foreign banks to the Russian market, which remains relatively closed and controlled by state banks, is in line with Russia's WTO negotiating position. The large share of state banks (close to 40% of total assets) stems from the slow pace of structural reforms and is not expected to decline anytime soon. We therefore believe that penetration by foreign banks will continue to be modest.

Contact Information

Alfa Bank (Moscow)

Head of Equities Dominic Gualtieri
Telephone (7 495) 795-3649
Facsimile (7 495) 745-7897

Research Department

Telephone (7 495) 795-3676
Facsimile (7 495) 745-7897
Head of Research Ronald P. Smith
Strategy Chris Weafer, Erik DePoy
Oil & Gas Nadia Kazakova CFA, Konstantin Batunin
Macroeconomics, Banking Natalya Orlova
Telecoms, Technology, Internet Barry Schumaker, Anna Kurbatova
Utilities Alexander Kornilov
Metals & Mining Vladimir Zhukov Ph. D, Natalya Sheveleva, Valentina Bogomolova
Consumer Goods, Retail, Media Brady Martin, Elina Kulieva
Russian Product Angelika Henkel, Ph.D, Vladimir Dorigov, Vladimir Kravchuk, Ph.D
Fixed Income Ekaterina Leonova, Marina Vlasenko
Technical Analysis Vladimir Kravchuk, Ph.D
Editorial Michael McAtavey, Cole Akeson
Translation Rinat Gainoulline
Production Elina Kulieva

Equity Sales & Trading

Telephone (7 495) 795-3712
Facsimile (7 495) 745-7897
International Sales Kirill Surikov, Mikhail Shipitsin, Shani Kogan, Bryce Meeker
Domestic Sales Oleg Martynenko; Alexander Nasonov;
Konstantin Shapsharov; Dmitri Sadoviy; Sergey Suvorov
Address 12 Akad. Sakharov Prospect, Moscow, Russia 107078

Alfa Capital (Kiev)

Research Department

Telephone (380 44) 490-1600
Head of Research, Strategy, Macro Volodymyr Dinul
Power Utilities, Oil & Gas Victoria Gorbenko
Metallurgy Oleg Yuzefovych
Machine Building, Chemicals Kateryna Polyakova

Equity Sales

Head of Sales Sergei Grigorian
Telephone (380 44) 490-1600

Alfa Capital Markets (London)

Telephone (44 20) 7588-8500
Facsimile (44 20) 7382-4170
Sales Maxim Shashenkov, Mark Cowley
Sales Trading Ross Hassett
Address City Tower, 40 Basinghall Street, London, EC2V 5DE

Alfa Capital Markets (New York)

Telephones (212) 421-8563 / (1 212) 421-7500
Facsimile (212) 421-8633
Sales Sabrina Ricci, Roman Kogan, Scott Licamele
Sales Trading Harold Warren, Alexander Pitalev
Address 540 Madison Avenue, 30th Floor, New York, NY 10022

Copyright Alfa Bank, 2006 All rights reserved

This report and the information contained herein are the exclusive property of Alfa Bank. Unauthorised duplication, replication and dissemination of this report, in whole or in part, without the express written consent of Alfa Bank is strictly prohibited. This report was prepared by Ronald P. Smith, Chris Weafer, Erik DePoy, Nadia Kazakova, Natalya Orlova, Konstantin Batunin, Brady Martin, Barry Schumaker, Natalya Sheveleva, Ekaterina Leonova, Elina Kulieva, Vladimir Kravchuk, Marina Vlasenko, Anna Kurbatova, Vladimir Zhukov, Valentina Bogomolova and Alexander Kornilov. Alfa Bank operates a policy to ensure the independence of its research. A copy of this policy is available on request from any of the Alfa Group firms that distribute this research. Under this policy the views expressed by the authors in this report accurately reflect their own personal views about the securities and issuers covered in the report. No part of their compensation was, is or will be related to the specific recommendations in this report either directly or indirectly. The authors do not report to Alfa Bank staff who have investment banking relationships with any of the issuers mentioned in the report. Where Alfa Bank or its affiliates have a relationship with any of the issuers covered in this report, the research in this report is produced separately from that relationship. Alfa Bank operates a system of "Chinese Walls" – information barriers to ensure that such relationships are excluded from published research. This publication has been approved for distribution in the United Kingdom by Alfa Capital Markets ("ACM"). ACM is regulated by the Financial Services Authority ("FSA") for the conduct of UK investment business and is the trading name of the UK branch of Alfa Capital Holdings (Cyprus) Limited ("ACC") which is authorised by the Cyprus Securities and Exchange Commission. This document has not been approved for distribution to private customers as defined by FSA Rules and may not be communicated to such persons. Although the information in this report has been obtained from, and is based on, sources the Alfa Bank believes to be reliable, no representation or warranty, express or implied, is made by Alfa Bank, ACM or the authors. ACM and its officers and employees do not accept any responsibility as to the accurateness or completeness of any information herein or as to whether any material facts have been omitted. All information and opinions stated herein are subject to change without notice. ACM makes no warranty or representation that the securities and/or opinions referred to herein are suitable for all recipients. This publication and its content are for information only and are not intended as an invitation, inducement, offer or solicitation to buy or sell securities or other financial instruments, or to engage in investment activity. Alfa Bank, ACC and their associated companies, officers and directors, from time to time, may deal in, hold or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to the securities, financial instruments and companies mentioned in this report, or may have been, or may be represented on the board of such companies. Alfa Bank has financial interests in Vimpel Communications and Golden Telecom. Vimpel Communications is a NYSE listed company. Alfa Bank and its affiliates will only accept unsolicited orders for this security. Some investments may not be readily realisable as the market in such securities may be illiquid and therefore valuing the investment and quantifying the risk to which customers are exposed may be difficult. Some investments may be subject to sudden and large falls in value and on realisation customers may receive less than originally invested or, in some cases, be required to pay more. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of the investment, or the income derived from it. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk. Investing in Russia and Russian securities involves a high degree of risk and investors should perform their own investigations and due diligence before investing. Investors should consult with their professional advisors as to the risks involved in making such a purchase. Alfa Bank, ACM, ACC and their associated companies may issue this publication in other countries. The distribution of this publication in such other jurisdictions may be restricted by law, and persons coming into possession of this document should inform themselves about, and observe, any such restrictions. Any failure to comply with these restrictions might result in a violation of the securities laws of such jurisdictions. **Additional note concerning United States securities laws:** This publication is distributed in the United States by Alfa Capital Markets (USA) Inc ("Alfa Capital"), a subsidiary of Alfa Bank Group, to certain US persons to the extent permitted by US securities laws and other applicable laws and regulations. In connection therewith, Alfa Capital has accepted responsibility for the content of this research. US persons receiving this document and wishing to effect a transaction in any security or financial instrument discussed herein should only do so by contacting a member of Alfa Capital in the US. Any failure to comply with these restrictions may constitute a violation of US securities laws.