AB-ICI August: Respite Ahead of Growth

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Investment Summary

- **AB-ICI flat in August due to mixed trend in the market, foreign and economic components**
- **Next year's budget approved easily as Duma expects to redistribute additional revenues**
- **Elasticity of deposits to interest rates up on deposit insurance; supervision must strengthen**

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The Alfa Bank Investor Confidence Index (AB-ICI) stayed virtually flat in August, as all of its three components (economic, foreign and market indices) exhibited mixed trends:

Capital inflow was hampered by dollar/euro volatility,…

- The Index's **economic confidence** indicators increased, driven by the decline of foreign currency deposits and a stable savings rate. However, the volatility of the dollar/euro rate did not favor a substantial capital inflow, while liquidity in the banking system remained flat. Hence, the increase of the economic index was rather modest.

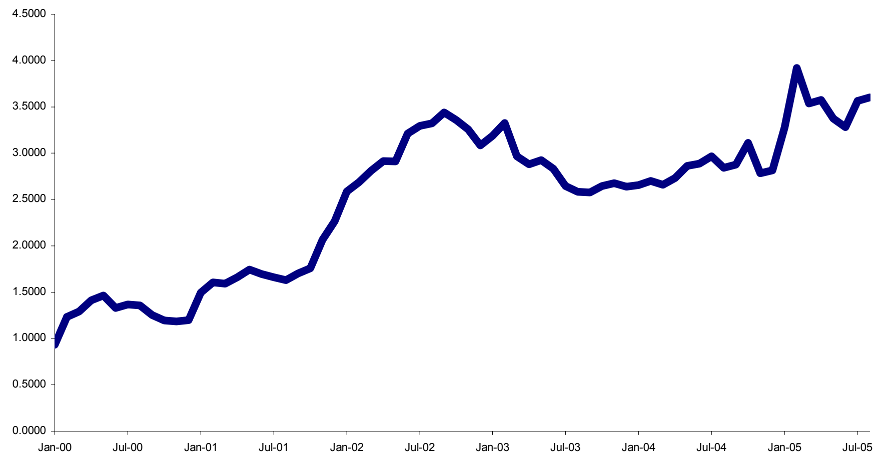
FDI as a share of GDP declined to 1.4% in 1H05 from 1.6% in 2004…

- **Foreign confidence** indicators showed improvement in terms of FDI flows (up 30% y-o-y in 1H05), while the share of foreign banks in total banking assets rose to 6.6%. However, none of these changes was significant. For example, despite nominal growth, the FDI inflow to Russia as a share of GDP reached only 1.4% in 1H05 vs. 1.6% of GDP in 2004.

…and there were no IPOs

- The **market confidence** component was driven by the rally of the RTS Index. However, the fixed income and equity segments did not undergo any structural improvements, as there were no IPOs and the bond market remains very concentrated on big companies.

Figure 1. AB-ICI flat in August on mixed trends



Sources: New School of Economics, Alfa Bank

Social spending will exceed budget targets

Macro assumptions of the 2006 budget are too conservative, but were nonetheless approved by the Duma

The Duma approved the 2006 draft budget in first reading on September 22 without any objections, which is particularly surprising given the conservative macro assumptions used in its projections. With a $40 p/bbl average Urals price forecast and a 7.0-8.5% inflation target, next year's budget revenues are likely to exceed the planned level of 20.7% of GDP. In our view, the Duma's rapid approval of the budget is due not only to United Russia's domination of the voting process, but also to the Cabinet's intention to increase social spending from additional fiscal revenues this and next year.

Figure 2. 2004-2006 Budget Parameters

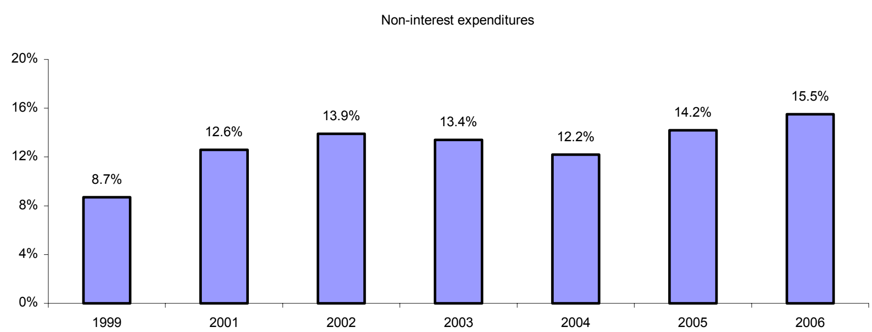
	2004	2005	2006
Total revenues	20.4%	23.7%	20.7%
Local tax collection	13.7%	14.5%	13.0%
Export duties	5.3%	7.6%	6.7%
Total expenditures	16.1%	16.6%	17.5%
Non-interest expenditures	14.8%	15.5%	16.7%
Fiscal surplus	4.3%	7.0%	3.2%
Stabilization Fund, $ bln	26.0	50.0	80.0
Stabilization Fund, % of GDP	4.4%	6.8%	9.2%
Foreign debt, % of GDP	18.9%	11.6%	9.3%
Domestic debt, % of GDP	4.6%	4.5%	4.7%

Source: Russian government, meeting of August 18, 2005

Half of $15 bln in additional fiscal revenues for 2005 will be used to finance social expenditures

Additional oil export duties and production taxes are accumulated in the Stabilization Fund, but these do not represent all additional revenues received by the budget. Of the $15 bln in additional fiscal revenues to be received this year, some $7 bln reflects additional tax collection from non-commodity sectors stemming from faster inflation, production growth and back tax claims. For example, in 2004 the budget collected 2% of GDP, or half of its annual 4.3% of GDP fiscal surplus, from tax claims on previous periods. Most likely, 1.0-1.5% of GDP will be collected from the same areas this year. On October 3 the Cabinet will present its expected use of additional fiscal revenues, which are likely to be used for the indexation of state salaries promised by President Putin at the beginning of September.

Figure 3. Non-interest expenditures of the Federal Budget, excl. Payrolls, % GDP



Fiscal easing is inevitable, but interest rates are unlikely to decline

This easing of fiscal policy, which is partly reflected in the highest level of budgeted non-interest expenditures since the 1998 crisis and partly from greater spending following the redistribution of additional revenues, means that asset prices will continue to grow driven by high liquidity. Meantime, this trend is unlikely to result in a continuing decline of interest rates because of the deposit insurance system.

Deposit insurance system favors rate increase

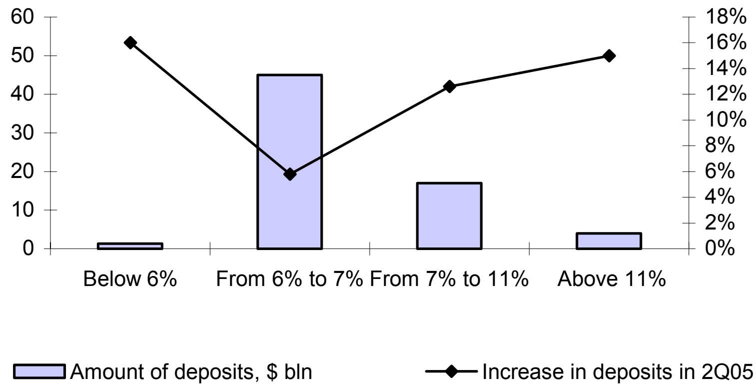
After the introduction of deposit insurance, foreign banks still received huge inflows of clients

The first results of the deposit insurance system suggest two implications for the banking system. First, as the population was generally poorly informed about the new system, depositors continued to show a clear preference for foreign and state-owned banks, driven by a desire to minimize risks. Second, for private Russian banks, the launch of the system led to increasing elasticity of deposit growth to interest rates. This means that stronger CBR monitoring will be crucial in guaranteeing sustainable functioning of the system.

The higher the interest rates of Russian private banks, the faster the deposit inflow

The results from 2Q05 indicate that foreign banks posted a faster (15%+) rate of deposit growth even though they offered very low rates of return. When analyzing private Russian banks, those offering more than an 11% rate reported 15% growth in deposits, while those paying 6-7% on deposits increased their retail deposits by only 6%. The obvious conclusion is that the 927 bank participants now run similar risks from the standpoint of retail depositors.

Figure 4. Deposit Growth by Category of Banks in 2Q05



Should the CBR implement strong oversight, deposit insurance will mobilize savings at a faster rate

The deposit insurance scheme is thus preventing banks from cutting rates and may even trigger some modest increase in deposit remuneration. Together with guarantees, higher interest rates will boost the savings ratio and thus positively affect the Index's performance. However, the CBR must make sure that adverse selection (i.e. client flows to banks offering higher rates because of a riskier lending strategy) does not result in greater systemic risk for the banking sector or instability on financial markets. Implementation of prudential regulation will thus be key in increasing the efficiency of deposit insurance, and we were positively surprised by the CBR's decision to reject applications from nearly 300 banks to participate in the system.

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