

AB-ICI: Frozen by Oil Price Concerns

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Investment Summary

- The AB-ICI was flat last month as declining oil prices generated turbulence on the Russian financial markets.
- Keeping oil above an annual Urals average of \$50/bbl is crucial to assure stable growth in Russia.

The AB-ICI was flat due to oil price concerns

The AB-ICI was flat...

...as increasing capital outflows...

...were offset by a strong bond market

The Alfa Bank Investor Confidence Index (AB-ICI) was flat last month due to declining commodity prices:

- The Index's **economic confidence** component declined by 8%. Lower oil prices fuelled concerns regarding the future financial performance of the Russian financial market and the ruble, triggering capital outflows from the country.
- **Foreign confidence** was unchanged due to a lack of fresh statistical data.
- **Market confidence** was slightly damaged by volatility in oil prices; however, the Russian equity market correction was partially offset by strong bond market performance and an increasing share of SMEs in local fixed-income instruments.

Figure 1: The AB-ICI was flat last month due to oil price concerns.



Sources: Alfa Bank Research, New School of Economics

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The trade balance is vulnerable at \$35/bbl, as each 1\$/bbl drop costs \$3 bln in annual export revenues

The Russian budget is balanced at \$27/bbl

A \$1/bbl decline in oil price averages costs \$1 bln in Stabilization Fund growth

Russian monetary supply needs to increase by at least \$30 bln in 2007 to support GDP growth

The ideal scenario is for oil to be at \$50-60/bbl in coming years

Oil staying at \$50-60/bbl is the best case scenario

The recent decline in oil prices has raised questions regarding Russia's vulnerability to volatile commodity prices. The fuel sector's role in defining Russian financial flows is very significant. A whopping 65% of the country's total export revenues in 9M06 came from fuel exports, the highest level since 1991. Each \$1/bbl decline in annual oil prices costs Russia around \$3 bln in annual export revenues. Thus, given our expectations of a \$100 bln trade surplus for 2007 at \$70/bbl, a decline of oil prices to \$35/bbl could eliminate Russia's positive trade balance.

The Russian fiscal system has successfully reduced its vulnerability to oil prices. Despite upcoming parliamentary and presidential elections, the Russian federal budget is still balanced at \$27/bbl, the cut-off level of the Stabilization Fund. Given that 95% of revenues from the fuel sector are going to the federal budget, the enlarged budget will suffer from similar vulnerability to oil prices.

The Stabilization Fund will clearly bear the full burden of any adjustment to lower prices. Under the 2007 budget projection of \$61/bbl oil prices, the Stabilization Fund is expected to increase by \$50 bln, accumulating oil revenues collected in the range of \$27/bbl to \$61/bbl. Previous years indicate that a fall of \$1/bbl in the average oil price costs around \$1 bln to the Stabilization Fund.

However, despite these automatic fiscal adjustments, we believe that the current fiscal policy will be too rigid and, if not revised, will cause a lack of liquidity. To support 6% GDP growth in 2007, the CBR will have to increase the monetary supply by \$30 bln to keep the monetary base at a stable ratio to GDP. In our initial scenario of \$70/bbl, we expected CBR reserves to reach at least \$380 bln, *i.e.* a \$100 bln annual increase, of which \$60 bln would flow to the Stabilization Fund and \$40 bln would contribute to monetary supply growth. However, if oil drops from \$70/bbl to \$50/bbl, CBR reserves would increase by just \$40 bln, adjusted only for dropping export revenues, with a similar amount being sterilized by the Stabilization Fund. If oil drops to an annual average of \$50/bbl, the Russian economy will see no increases of monetary supply, and monetization will decline.

A liquidity squeeze could raise the likelihood of a banking sector crisis that would likely be used by state-owned banks to bolster their position on the market. As in summer 2004, state-owned banks could then see growth in their market shares for the deposit and lending markets. The ideal scenario for Russia would be oil prices remaining at \$50-60/bbl in coming years, which would guarantee continued banking market growth and a strong 6-7% annual increase in real GDP.

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