# 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…**

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

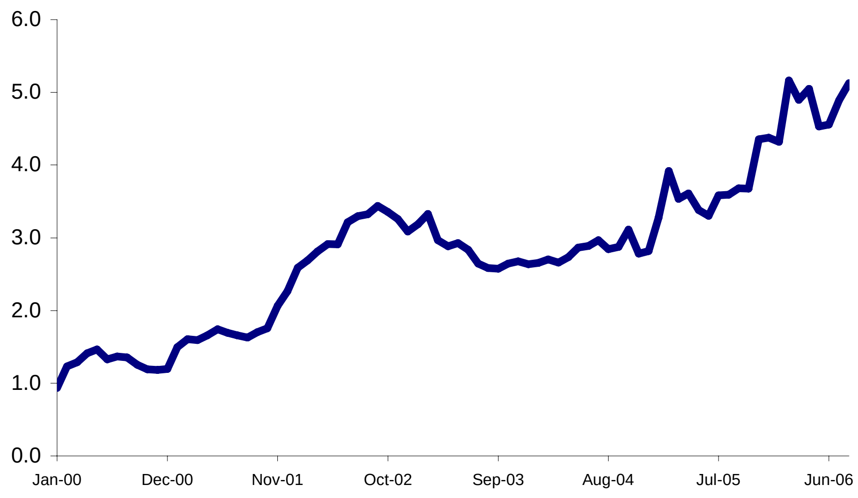
**…as increasing capital outflows…**

- 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.

**…were offset by a strong bond market**

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

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

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 budget is balanced at $27/bbl**

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.

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

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.

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

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.

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

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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