

AB-ICI October: Banking Crisis Overcome

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Investment Summary

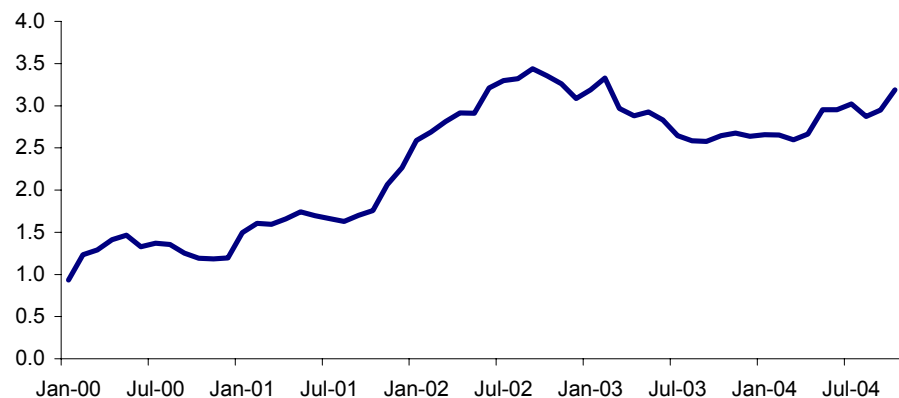
- AB-ICI showed a rapid 8% increase in October as liquidity grew, banking crisis fears evaporated
- Fitch's rating upgrade increases chances for S&P upgrade; we foresee asset price growth
- Coming months will be rich in good news; foreign bank deals seen alongside rising FDI

AB-ICI is back to its level of January-February 2003, but the role of FDI is now more important for Index growth

AB-ICI up 8% on easing fears after banking crisis

Alfa Bank's Investor Confidence Index (AB-ICI) showed a substantial 8% rise in October. The Index is now back to its level of January-February 2003, when its last peak was achieved. However, as mentioned in our previous publication, the mix of variables driving the AB-ICI is now different: while in 2002-2003 the increase in domestic confidence was a leading indicator of improving general confidence, now the role of foreign investment is much more significant. Having said that, we nevertheless stress that October's jump was mainly based on easing fears of another banking crisis and an improved situation with regard to liquidity.

Figure 1. AB-ICI: Up 8% as fears after banking crisis have been overcome



Sources: New School of Economics, Alfa Bank

AB-ICI reflected better liquidity though the capital inflow and growth in financial markets

The increase in banking liquidity has been affecting our Index in two ways. First, it has translated into a greater inflow of capital; Russian banks and companies attracted \$1.5 bln from international markets in October in addition to \$5 bln attracted in September. Second, better banking sector liquidity (see Figure 2 below) has boosted all of Russia's financial markets.

Figure 2. Monetary Base by Component

	Dec-01	Dec-02	Dec-03	Aug-04	Sep-04	Oct-04
Cash in circulation	20.7	25.6	41.6	47.0	47.0	48.4
Correspondent accounts	4.8	5.3	10.4	7.3	7.8	8.3
Obligatory reserves	5.2	6.3	9.1	3.9	4.0	4.1
Deposits at the CBR+CBR bonds	0.1	1.5	3.0	1.1	1.6	3.8
Reverse repo	0.0	0.0	1.0	3.0	2.4	2.4
Reserves on foreign operations	0.0	0.0	0.0	0.1	0.0	0.1
Total in banks	10.1	13.2	23.4	15.5	15.8	18.7

Source: CBR, Alfa Bank estimates

**More good news in the pipeline**

We anticipate much positive news that should help support the AB-ICI in the coming months.

Fitch upgrade means that S&P is likely to grant investment grade soon

First of all, after Fitch upped Russia's sovereign rating to investment grade, a similar move from S&P is now increasingly likely. An agreement with the Paris Club regarding early redemption of Russian bilateral debt could be a catalyst for such a move. This would have a positive effect on the spread of Russian debt to U.S. Treasuries as well as the performance of Russia's equity market.

Fiscal easing from 2005 will support liquidity growth in the banking system

Secondly, we expect liquidity in the banking sector to continue to improve. Next year's draft budget indicates an easing of fiscal policy, and thus sterilization via the stabilization fund will not harm economic growth. The tax burden will decline by around 2.2% of GDP, and the increase in non-interest expenditures will total around 1.3% of GDP.

FDI will reach \$8-10 bln for 2004; sale of 10% of VTB is a catalyst

Finally, we expect more foreign companies to enter Russia in the near future. The 9M04 FDI figure indicated a \$5.9 bln inflow of foreign capital to Russia's real sector, and the annual figure is likely to be around \$8-10 bln. In terms of concrete deals Vneshtorgbank, Russia's second-largest state-owned bank, is now in negotiations with several foreign banks regarding the sale of a 10% stake. A deal could potentially be announced before year's end.

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