

AB-ICI October: No News is Bad News

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Investment Summary

- AB-ICI flat in October as bank liquidity dropped to \$21.4 bln; fears of liquidity squeeze persist
- Despite Amtel's IPO, the Index may remain weak next month, reflecting slow growth in FDI

AB-ICI flat in October on poor banking liquidity

AB-ICI was flat in October,...

...reflecting weaker local liquidity,...

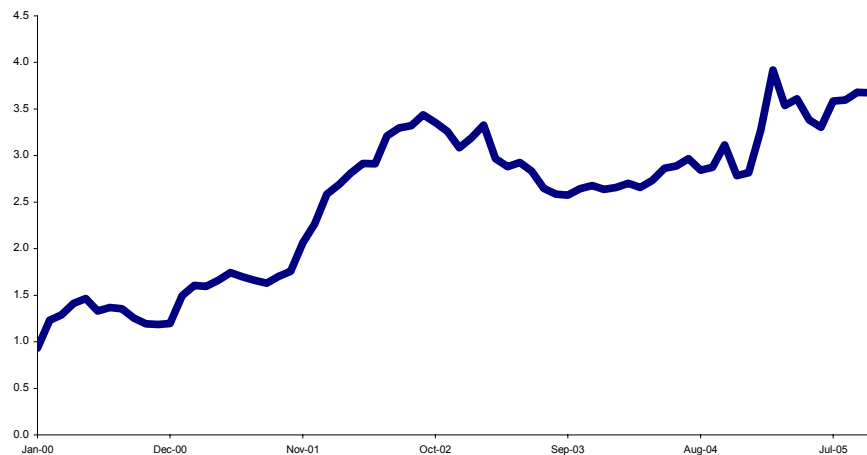
expected slowing of FDI inflows...

...and the correction of the RTS Index

The Alfa Bank Investor Confidence Index (AB-ICI) was flat in October, indicating little change in its economic and market components.

- The Index's **economic confidence** indicators declined, reflecting the slower increase in CBR reserves (just \$5.4 bln in October versus \$9.8 bln in September) and expectations of ruble depreciation. Banking liquidity also declined in October by some \$3 bln.
- **Foreign confidence** indicators were flat. However, the recently published FDI figures for 9M05, which will be accounted for in our next Index publication, suggest a slowing of FDI inflows from 30% y-o-y in 1H05 to 18% y-o-y in 9M05.
- The **market confidence** component changed only slightly, reflecting last month's correction of the RTS Index.

Figure 1. AB-ICI was flat in October



Sources: New School of Economics, Alfa Bank

Banking liquidity totaled only around \$21 bln in October, below the level at YE2004

In our view, the liquidity factor will be important in terms of the behavior of market participants next year. Current indicators of banking liquidity show no improvement with regard to the money available to facilitate economic activity. Whereas at the end of 2004 liquid banking accounts contained some \$25.8 bln (at least 20% of which comprised money accumulated for the Yuganskneftegaz action), as of the end of October banking liquidity totaled around \$21.4 bln. This year, however, the nominal value of GDP should

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increase by 27%, up from \$583 bln in 2004 to an expected \$740 bln, implying that banking liquidity should amount to at least \$25 bln. These poor figures reflect significant sterilization of liquidity by the budget, which has not helped control inflation but has prevented expansion of the banking sector and led to lower interest rates. It is thus unsurprising that the ratio of banking assets to GDP will stay flat at 44% of GDP this year, showing no growth for the first time since 1999.

Figure 2. Components of the Monetary Base, \$ bln

	Dec-03	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05	Oct-05
Cash in circulation	41.6	47.0	60.2	56.7	61.3	65.1	66.0
Correspondent accounts	10.4	7.8	17.5	11.7	9.9	13.3	10.6
Obligatory reserves	9.1	4.0	4.4	4.8	4.8	5.3	5.4
Deposits at the CBR+CBR bonds	3.0	1.6	3.6	6.3	4.5	5.3	5.1
Reverse repo	1.0	2.4	0.1	0.1	0.0	0.0	0.0
Reserves on foreign operations	0.0	0.0	0.2	0.2	0.2	0.3	0.3
Total in banks	23.4	15.8	25.8	23.1	19.3	24.2	21.4

Source: CBR, Alfa Bank estimates

Market is anticipating a liquidity squeeze, which in our view is unrealistic

Another important factor is that rumors are now circulating about a possible liquidity squeeze by year's end. According to the budget code, Russian banks will be prohibited from servicing accounts of regional authorities and state institutions starting in January 2006, with the potential decline in banking liquidity assessed at \$4-6 bln. However, we believe that local administrations may find a way to circumvent this requirement, thereby forcing local Treasuries to transfer state accounts to municipal banks.

Fiscal easing will support interest in IPOs; bank placements expected by 2007

As we mentioned in our previous Index publication, good news is on the horizon. The raising of the oil price floor for inflows to the Stabilization Fund (to \$27 p/bbl starting in 2006) and the increase of non-interest expenditures will help improve banking, and thus market, liquidity. In turn, this will boost corporate interest in holding IPOs, which should remain a potentially huge market in 2006-2007. Starting from 2007 we expect to see more IPO activity from Russian banks, which are currently constrained from using public placements because of CBR restrictions on foreign participation in banking capital.

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