

# AB-ICI: Further Growth Requires Transparency

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## Investment Summary

- Alfa Bank Investor Confidence Index was unchanged in January on the lack of news flow
- Equity market will boost the Index in February, but German Gref calls market growth a “bubble”
- Fundamental support for Index could come only with better transparency, as mentioned by WB

### AB-ICI flat in January on the lack of news flow

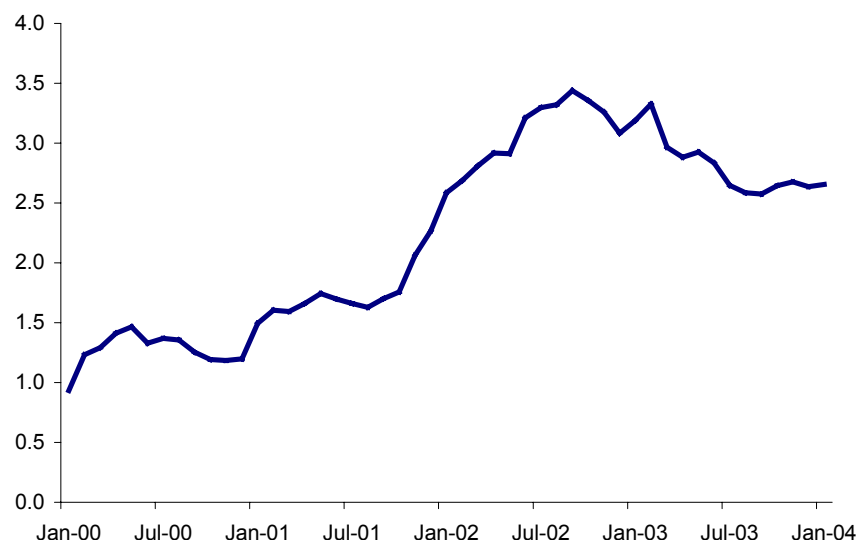
*We expect the AB-ICI to show growth from February, but fundamental support is still needed*

*Foreign participation in Russia's real sector is weak; FDI inflow is a response to stagnation in Europe*

A number of positive economic figures were released in January, such as the 7.3% GDP growth and \$6.8 bln FDI inflow in 2003. However, the Alfa Bank Investor Confidence Index (AB-ICI) remained flat, reflecting the lack of driving forces. Modest growth in CBR reserves, minor fluctuations on financial markets and the relative lack of news flow contributed to the stability of the Index. We expect growth to resume in February due to the faster increase in reserves, but the question of whether it reflects a speculative inflow of capital or fundamental change will remain.

Despite the fact that the FDI inflow set a record high in 2003, the participation of foreign investors in the Russian economy remains weak. Foreign banks account for only 5% of total banking assets, and their share in the insurance sector is even weaker. The main positive trend was the significant increase in the number of foreign managers in Russia, but this is more likely due to stagnation in European economies.

**Figure 1. Alfa Bank Investor Confidence Index Flat in January**



Sources: New School of Economics, Alfa Bank

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**Further Index growth requires transparency**

***Gref sees a “bubble” on the financial market, argues that reform should continue***

As for market confidence, the continuing increase in CBR reserves and on equity markets seems due to the liquidity inflow, which does not directly reflect fundamental improvement. High domestic interest rates and strong growth on the equity market have been enough to attract more capital from abroad. Even Economy Minister German Gref recently expressed concern about what he sees as a ‘bubble’ developing on financial markets, as the lack of long-term projects is preventing money from flowing to the real sector. The slowdown in fundamental change pushed the AB-ICI down 14% in 2003, but we believe pressure on the Cabinet to proceed with reform is now mounting.

***Recent World Bank report calls for change in GDP structure by promoting growth in services...***

The World Bank’s recent economic report on Russia strongly argues in favor of continuing with economic reform. First, the study argues that the Russian economy has not undergone substantial change since the beginning of 1990. The share of industry is still 55%, a level very similar to that seen more than ten years ago. At 40% the share of the services sector is far below the level in developed countries, where services contribute 60-70% of GDP.

***...and better transparency of private and state company operations,...***

Second, the study calls for greater transparency in corporate accounting. The fact that 16% of GDP created by oil & gas companies is reflected in the trade sector because of transfer pricing does not indicate a problem with Goskomstat’s methods or data, but rather the unwillingness of companies to declare all their operations to the tax authorities. The state must therefore create conditions that encourage private as well as state companies to switch to more transparent accounting.

***...which will be key in supporting confidence and driving the AB-ICI to new highs***

We expect the new Cabinet to adopt appropriate measures to proceed with reform after its formation in April-June. Only efforts to promote greater transparency can reduce the potential negative implications of a bubble developing on financial markets while driving confidence and the AB-ICI to new highs.

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