



AB-ICI January: Rising Despite Capital Outflow

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Investment Summary

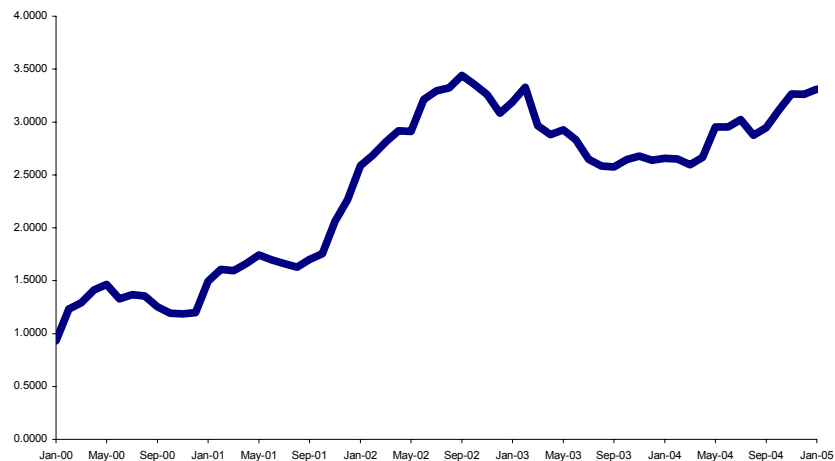
- Modest 1.4% rise in AB-ICI in January highlights weakening of sentiment among investors
- Conflict between economic and political decision-making belies optimistic macro performance
- Despite less chance of WTO entry in 2005 and problems with G-8, Russian assets still attractive

Modest 1.4% in AB-ICI in January due to liquidity

Modest increase in AB-ICI reflects increased liquidity coming from the budget

The Alfa Bank Investor Confidence Index (AB-ICI) rose 1.4% in January, mainly reflecting the liquidity trend. The easing of fiscal policy due to the monetization of social benefits is adding liquidity to the banking system and helping to prevent significant selling on domestic financial markets. The increase in liquidity even compensated for the greater net capital outflow, which in January reached the level of August 2004.

Figure 1. AB-ICI: Up 1.4% despite the increase in capital outflow



Sources: New School of Economics, Alfa Bank

AB-ICI performance is constrained by negative investment sentiment

Growth in the AB-ICI remains constrained by the gap between perception and actual economic trends observed in the second half of 2004, as described in our previous issue. The increase in liquidity is still positive for Index growth, (i.e. investors are still holding their positions in Russian assets), but the overall mood is clearly negative. We expect to see further divergence with regard to achieving political and economic goals, which in turn should affect investment sentiment this year.

Proposals to reduce the powers of the tax police are most welcome

The good news is that discussion of the economy within the Cabinet appears to have intensified last month. The liberal faction within the government seems unwilling to take responsibility for economic policy implemented in an environment characterized by disorderly tax inspections. Hence, we believe the recent proposals to reduce the power of the tax authorities would

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undoubtedly be welcomed by the business community. Having said that, we attach greater importance to the ultimate goals of economic policy and development strategy in the coming years than to the tactical powers of the tax authorities.

Lower chances for WTO membership this year due to tension with G-8

The second trend to emerge in recent months is the deterioration of Russia's relationship with the West, in particular the country's status within the G-8 and increasing difficulties during WTO negotiations. Whereas WTO entry was once a foregone conclusion based on political expediency, this optimistic outlook now seems a bit outdated, and entry this year is no longer a given.

Nevertheless, we expect investors to stay in Russian assets

The divergence between perception and actual economic results is likely to play a key role in 2005 for yet another reason. Economic growth is now largely being supported by higher fiscal spending. Thus, while the economic figures *per se* are rather good, the overall economic model Russia seems headed towards is now increasingly being questioned.

The initial goal of the AB-ICI when it was constructed was to separate perception (i.e. what people think and tell us about Russia) from business behavior (i.e. what they actually decided to do). Thus, while noting the evident deterioration in perception of the country's economic and political climate, we expect most investors to stay in Russian assets.

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