

AB-ICI: Under Pressure from Capital Outflows

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Investment Summary

- The AB-ICI was down 3% in January 2007 following strong capital outflows and flat market indicators.
- The CBR's decision to appreciate the ruble should support capital inflows, which should push the AB-ICI up in coming months.

The AB-ICI declined by 3% in January

The AB-ICI was down 3%...

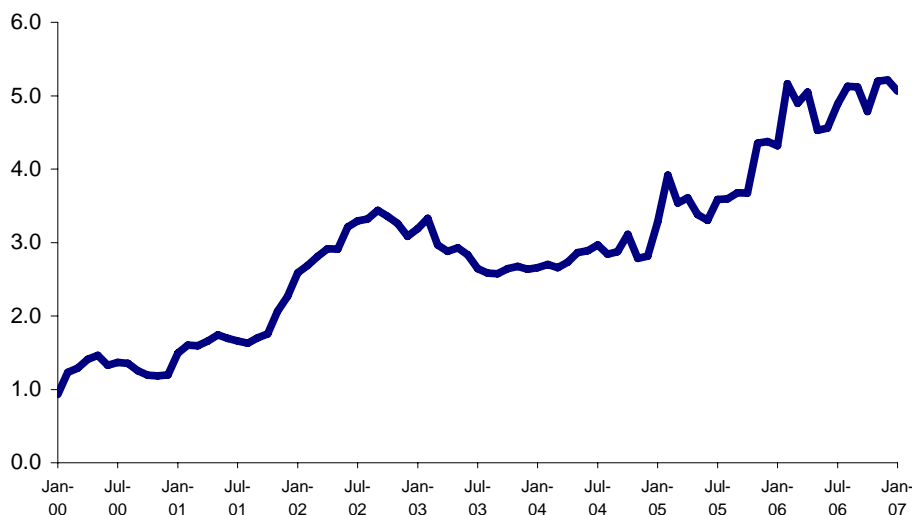
... as capital outflows materialize and dedollarization halted...

...and the equity market saw poor performance in January

The Alfa Bank Investor Confidence Index (AB-ICI) declined 3% in January 2007.

- The index's **economic confidence** declined substantially. Russia saw strong capital outflows in January, triggered by expectations of lower oil prices. As a result, the CBR's reserves were virtually unchanged in January, after delivering \$10 bln in average monthly growth in 2006. Additionally, the share of currency deposits stagnated at 18% of total, suggesting that dedollarization has ceased.
- **Foreign confidence** was slightly up as foreign banks' share of total assets increased.
- **Market confidence** stayed flat as the RTS delivered poor results in January.

Figure 1: The AB-ICI was down 3% in January due to capital outflows and flat trading on the RTS



Source: Alfa Bank Research, New School of Economics

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Ruble appreciation is used to stimulate capital inflows

The CBR raised the ruble and changed the structure of the currency basket

Capital outflow in January offers a good explanation for the CBR's decision to raise the ruble exchange rate in February.

The CBR raised the ruble against the dollar/euro basket on February 8 and also changed the structure of the currency basket. While before the share of the dollar accounted for 60% and the Euro for 40%, their weighting has been changed to 55% and 45%, respectively. According to the CBR, this basket structure reflects changes in the Russian trade balance and currency reserves.

Ruble appreciation will help to accelerate capital inflows and supports reserve growth

The decision to appreciate the ruble was a surprise for the market. The reported 1.7% inflation figure for January calmed rumors about ruble appreciation. However, considering the balance of payment figures, the CBR decision appears to have been correct. Slow reserves growth could result in slower monetary mass expansion and, as a result, hamper GDP growth in 2007. Thus, to finance economic activity, the CBR has to stimulate capital inflows. This is expected to affect the AB-ICI positively in coming months.

Short-term capital inflows could easily turn into capital outflows

However, one should be cautious instituting such a policy. High capital inflows help to offset the weakness of the trade balance and to maintain reserve growth in the near future. However, these capital flows are primarily driven by the rapid growth in asset prices, and thus could easily turn into outflows. Without increasing FDI, we believe that using ruble appreciation as a tool for improving capital flows is rather dangerous for the long-term stability of the exchange rate.

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