AB-ICI 2008: Steady decline

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February 2, 2008 **www.alfabank.com** **Moscow**

Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) declined 14% y-o-y in 2008; the RTS has lost close to three-quarters of its value.
- Significant outflow of foreign capital on the back of gradual ruble deprecation depleted Russia's foreign reserves; continuing capital outflow poses a significant risk in 2009

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Economic confidence worsened significantly as $130bln of foreign capital poured out of Russia

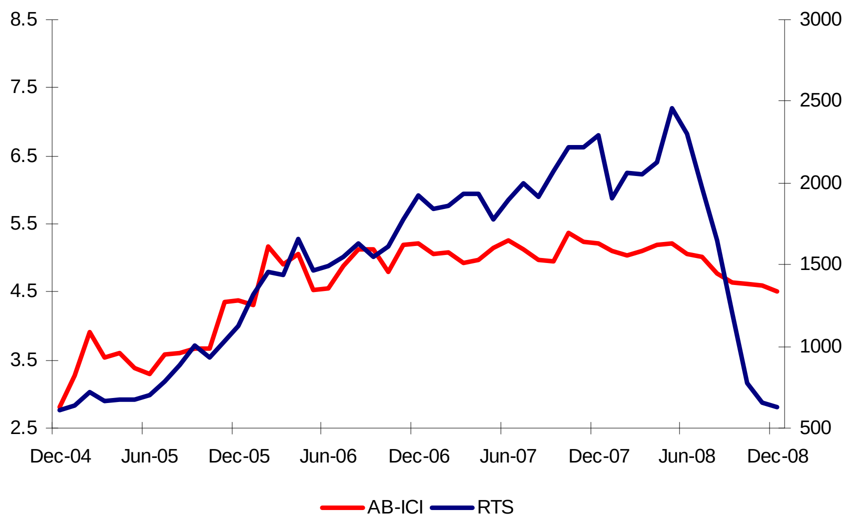
Foreign confidence declined as well as inflows of new investment capital dropped

Market confidence declined 14% y-o-y

The AB-ICI managed to record only a gradual decline despite the catastrophic drop in the RTS in 2008.

- The index's **economic confidence** dropped by 73% in 2008, a very poor performance. This reflects the outflow of capital as well as the higher share of foreign currency denominated deposits in the total bank currency deposits. Furthermore, the government budget surplus at 4% of GDP for 2008 is set to turn into 7% of GDP deficit in 2009;
- **Foreign confidence** was the key driving force behind the index's growth in 2007; this was far from the truth last year. The foreign confidence index declined by 6% y-o-y, reflecting the halt in FDI inflows into the economy;
- **The market confidence** indicator declined 14% y-o-y. A decline in the share of small businesses in the economy reflected the government's focus on the bigger fish in the pond. The steady decline in the RTS dragged down the market confidence index and had a negative impact on the AB-ICI as a whole.

Figure 1: The AB-ICI demonstrated a downward trajectory in 2008, but the decline was relatively insignificant when juxtaposed with that of the RTS



Source: Alfa Bank Research, New School of Economics

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Alfa-Bank

A new global reality has disabused investors of the previously popular notion of "decoupling" – Russia is feeling the effects of global liquidity constraints

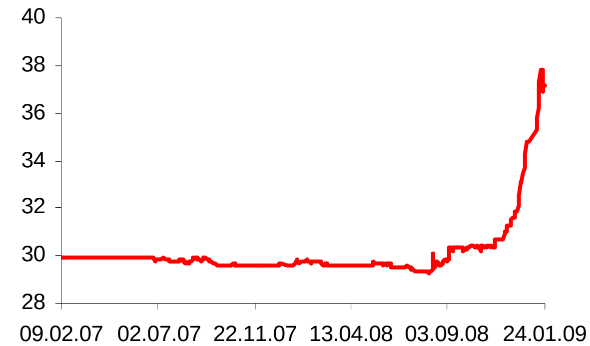
The AB-ICI, which is a reflection of the fundamental value of the Russian economy, was stagnant for the two years preceding the global financial crisis, despite the strong growth in equity market. However, the dawn of a new reality in the global economy is having a considerable impact in Russia, reflected in the 14% decline of the AB-ICI over the course of 2008. The ruble depreciation, undertaken by the government in the last two months of the year, has been fueling speculation and leading the CBR to spend significant reserves in order to defend the currency, which was reflected in the dramatic decline of the AB-ICI economic component.

How low will it go? Ruble depreceation and capital outflow

Foreign capital outflow in 2H08 was modest at $30 bln; main pressure on ruble came from local flight

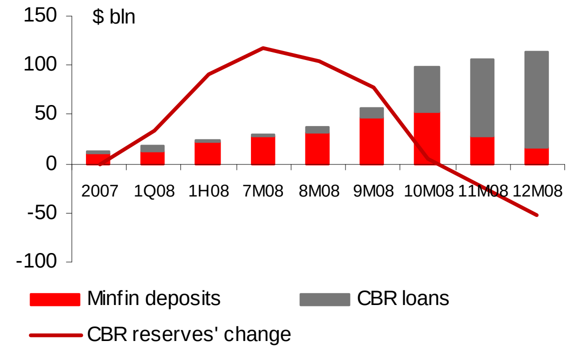
There appears to be considerable confusion in the market regarding the logic of ruble depreciation and its ultimate end goal. The paradox is that while the market tends to think the pressure on the ruble comes from the decline in oil prices, we believe the drop in the ruble rate is mainly the result of capital outflow, observed through the second half of 2008. We estimate that foreign capital outflow in 2H08 was a modest $30 bln; the majority of the outflow came from local players. This outflow was so large because the Central Bank injected a huge amount of liquidity to deal with the liquidity squeeze in October-November. In sum, we assess that around $60-70 bln were transferred from rubles to dollars by local companies, banks and households.

Figure 2: Ruble exchange rate to the basket



Source: CBR, Alfa Research

Figure 3: State liquidity and capital outflow



Source: CBR, Alfa Research

We do not believe the weaker exchange rate will help economic growth

Another myth is that the market consensus seems to reflect the expectations that the weaker ruble exchange rate will help to restore economic growth in 2009. This belief is based on Russia's experience in 1998, but we think this assumption is inaccurate in the current environment; the likelier scenario is the deeper the fall in the ruble, the sharper the subsequent economic slowdown in Russia.

Capacity utilization of 80% makes 2008 different from 1998

The key argument against the 1998 scenario is in the capacity utilization ratio, which was 55% in 1998 and is currently staying around 80%. This means that in 1998 ruble depreciation prompted a switch in local demand from import goods to the local market; essentially, domestic firms were able to increase output without investing. This year, the situation is completely different – under the current capacity utilization ratio, Russian companies cannot increase production without material investments, which can not be financed because of credit constrains.

Today in Russia, salaries and savings are denominated in rubles

The second point is that while in 1998 some households were paid in dollars and savings were largely kept "under the mattress," today salaries and savings are ruble-denominated. Thus, a weaker ruble today is sure to have an adverse impact on consumption, considerably more so than in 1998.

Russia's large foreign debt offsets the advantages of ruble depreciation

It is important to note that it makes sense for a country to devalue its currency when the size of its local debt is large and the foreign debt is modest. Russia, with $540 bln in foreign debt and a local bond market of just $50-60 bln, represents the opposite case; Russia's large foreign debt offsets the potential advantages of ruble depreciation.

Today, foreign demand is weak and will not be stimulated by a weaker ruble

Last, but not least, in 1998 ruble depreciation allowed some companies to become more competitive on international markets. Today, foreign demand is weak and will not be stimulated by a weaker ruble. The bottom line is that Russia needs to generate savings, not devalue the purchasing power of its households.

Ruble depreciation will result in weaker economic growth, which will be reflected in the performance of the AB-ICI in 2009

We believe that ruble depreciation will result in weaker economic growth and higher inflation, all things being equal. This will likely be reflected in the poor performance of the AB-ICI in 2009. In recent years the AB-ICI lagged behind the RTS index, which was a reflection of the overheating of the Russian financial markets. Now the opposite seems to be true; the sudden drop in the RTS better reflects the trends for 2009.

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