

AB-ICI March: Uncertainty Triggers Higher Volatility

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Investment Summary

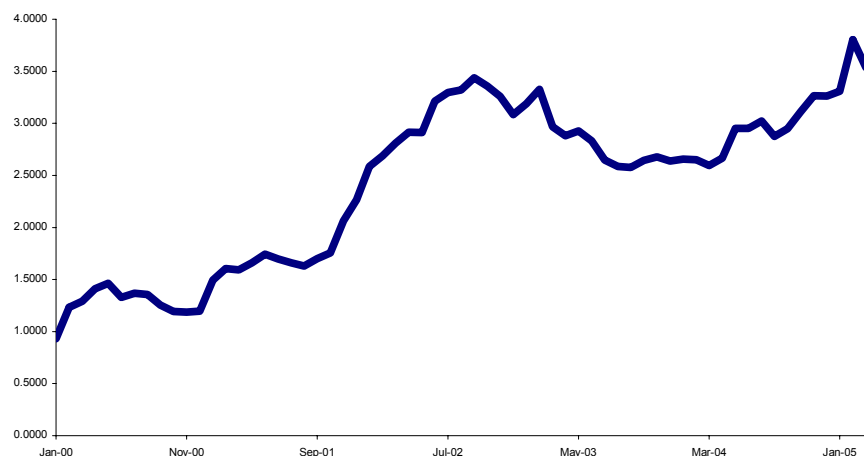
- AB-ICI dropped 8% in March; greater uncertainty suggests stronger Index volatility
- Faster inflation hit savings but stimulated consumption and is positive for short-term growth
- Currency volatility led to instability in capital flows, but Russia's dollarization remains strong

High uncertainty triggered 8% decline in AB-ICI

Greater uncertainty regarding international markets and Russia have increased Index volatility

After the unprecedented 20% increase in February, the Alfa Bank Investor Confidence Index (AB-ICI) fell 8% in March, back down to the longer-term trend line. The good news underpinning the previous month's increase was a one-off effect, and other factors are now gaining importance. We believe that the previous jump and current decline are both reflective of the larger, more volatile dynamic of the Index this year, due to the generally greater level of uncertainty surrounding international markets and the Russian economy. Meantime, the Index trend is still upward, as investment opportunities remain attractive.

Figure 1. AB-ICI declined 8% in March, back down to the longer-term trend



Sources: New School of Economics, Alfa Bank

Capital flows are following international dollar trends; stronger dollar threatens capital outflow from Russia

One area of uncertainty is clearly the euro-dollar dynamic and the ruble's appreciation, which is largely due to the weakening dollar rather than high oil prices. As a result, the net capital inflow posted in February turned rapidly into a net capital outflow in March as soon as the dollar began to strengthen on international currency markets.

Share of euro in Russia's savings did not grow at expense of dollar; its share remains only 5% of total deposits

At the same time, while financial markets are very much focused on currency volatility, the weak dollar did not help expand the euro's share in Russia's economy. Polls of the top Russian banks suggest that the euro still represents only around 5% of total deposits of state banks and that retail loans are mainly ruble-denominated. Thus, the population prefers to borrow in the currency in

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which it receives revenues, and demand for the euro seems to stem solely from tourism. Around 10 mln Russians travel abroad annually, and this figure is growing by 10% per year, which may explain additional demand for the euro.

Figure 2. Role of the Euro for Russian Banks

	Share of euro in currency deposits	Share of euro in total deposits	Information about lending in euros
State banks	Around 15% of currency deposits, increased in 2004	Around 5% of total deposits	Less than 1% of currency loans
Private banks	Decreased from 7% to 5% in 2004	-	Less than 0.5% of currency loans
Foreign banks	-	Increased from 16% to 21%	No demand

Source: Banking polls

Decline in savings is due to higher inflation; good for short-term growth but reflects problem with confidence

Another area of uncertainty is the public savings rate, which is a component of our Index. In our view, higher inflation will stimulate consumption and thus reduce the savings rate. Revenue allocation from 2001-2004 suggests that the inflationary environment last year boosted the share of consumption, which is positive for growth while reducing the rate of savings. This directly highlights one particular problem with Russia's current economic model: while there has been greater consumption growth (12% increase in consumption in 2004 versus 8% increase in real disposable income) and thus faster economic growth, in reality this is due to weak confidence in the ruble as a store of savings. Hence, ruble appreciation and inflation are exerting double pressure: the public has been pushed to save in rubles, which in turn are vulnerable to inflation, which finally led to a slower savings rate (see Figure 3 below).

Figure 3. Revenues Allocation in Consumption and Savings

	2001	2002	2003	2004
Disposable income	100	100	100	100
Consumption	87.3	85.2	83.2	84.6
Savings	12.7	14.8	16.8	15.4
ruble deposits	2.8	3.1	5.3	4.1
currency deposits	1.7	2.2	1.3	0.5
real estate	1.5	1.9	2.3	2.4
currency cash	1.6	2.1	1.7	3.3
cash rubles	2.1	1.9	3.1	1.6
other financial assets	3.1	3.6	3.1	3.5

Source: Rosstat

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