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Banking

AB-ICI: Additional Growth to Come from FDI

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Investment Summary

- AB-ICI was up 3% in April driven by accumulation of CBR reserves to $226 bln
- 100% y-o-y increase of FDI in 1Q06 was not incorporated in Index calculation, provides more upside
- FDI concentration in fuel sector increased to 61%, suggests even greater dependence on oil

AB-ICI is up by 3% on capital inflow

AB-ICI is up 3%…

The Alfa Bank Investor Confidence Index (AB-ICI) was up by 3% last month reflecting increasing capital inflows based on a weakening dollar and expectations of ruble convertibility:

…reflecting the capital inflow to Russian financial markets,…

- The Index's **economic confidence** increased, reflecting the strong increase of CBR reserves. As of the beginning of May CBR reserves reached $226 bln and were the world's fourth largest after China ($875 bln), Japan ($852 bln) and Taiwan ($257 bln). The CBR was accumulating reserves following a substantial increase of capital inflows to ruble assets, driven by the weakening dollar and a play on ruble convertibility.

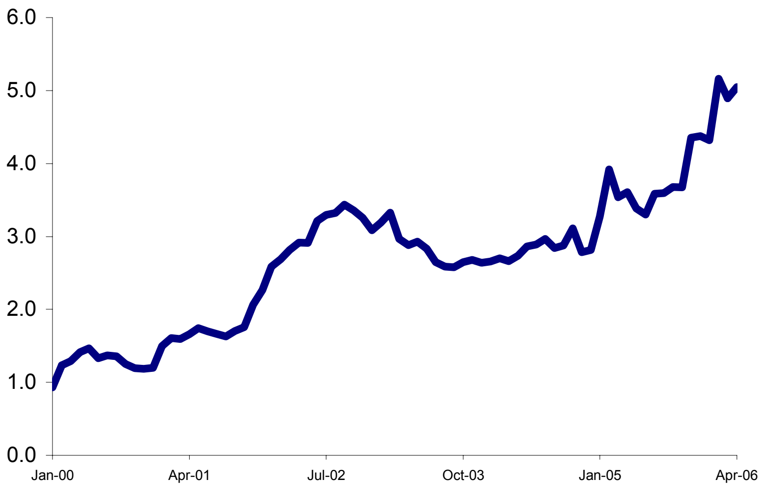
…strong FDI inflows to Russia…

- **Foreign confidence** indicators were unchanged, but recently published FDI data suggest strong upside potential for Index growth.

…and the increasing number of IPOs

- **Market confidence** showed a positive trend driven by an increased number of IPOs. Magnit and Cherkizovo together attracted $620 mln from the equity market in May.

Figure 1. AB-ICI up by 3% on capital inflows and growth of CBR reserves



Sources: New School of Economics, Alfa Bank

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Ruble convertibility affect market sentiment

Expectations of faster ruble appreciation triggered the increase of capital inflows to Russia in May. While the high oil price and weak dollar are clearly playing in favor of a strong ruble, we believe that ruble convertibility is largely a sentiment issue.

New currency regulation implies elimination of obligatory export sales and reserve requirements

The goal of ruble convertibility that President Putin outlined in his address to the Federation Council has boosted market sentiment but is not expected to generate significant capital inflows anytime soon. According to the President's proposal, ruble convertibility will be launched on July 1, 2006, with full liberalization of current and capital accounts including:

- elimination of obligatory export revenue sales (already cut to zero as of May 7); and
- elimination of reserve requirements on capital inflows.

These instruments of currency control will be fully eliminated, and any reintroduction in the future would require amendments to the currency law, thus making it highly unlikely.

Special accounts will be abolished starting in 2007

The CBR is also considering the elimination of special accounts for transactions by non-residents, which would be in line with Putin's call for full ruble convertibility. However, it is plausible that special accounts will not be fully abolished until the beginning of 2007.

Despite the elimination of currency controls, country risk and poorly developed infrastructure will constrain capital inflows

It seems that this legislation alone would be far from sufficient to stimulate capital inflows. First, the previous requirement did not hamper inflows – non-residents were always more concerned with the high level of local risk than currency controls. These local risks include a still-significant country risk, the risk of specific banks acting as intermediaries for non-residents, and poorly developed clearing and depositary systems.

The same consideration should be given to the Russian legal system: as long as it functions poorly, offshore operations will be preferable to onshore ones.

FDI in Russia doubled y-o-y in 1Q06

FDI inflow has yet be incorporated to Index calculation

The good news yet to be incorporated in calculation of the Index is the significant acceleration of FDI inflows to Russia in 1Q06. Such inflows totaled \$3.8 bln – double the amount in the same period last year and 1.5% of total GDP vs. 0.9% in 1Q05 and 1.7% in FY05.

ONGC's investment in Sakhalin explains 37% of 1Q06 FDI

Comparing the sector composition of FDI in 1Q06 to that of a year ago, we see that commodity extraction absorbed around 61% of the total FDI inflow, up from 48% in 1Q05. A major surprise is that India accounted for \$1.4 bln of the \$2.4 bln invested in the Russian fuel sector; India had never previously accounted for a substantial amount of FDI in Russia. We believe this figure reflects a one-off effect (ONGC's investment in Sakhalin projects), and believe that the total FDI inflow to Russia in 2006 will be around \$15 bln.

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Figure 2. Composition of FDI Flows, 1Q05 and 1Q06, $ mln

	1Q05	Structure, %	1Q06	Structure, %
Total FDI	**1,919**	**100%**	**3,845**	**100%**
Commodity extraction	916	48%	2,354	61%
Manufacturing	528	28%	577	15%
Financial	107	6%	370	10%
Real estate	222	12%	223	6%
Other	146	8%	321	8%

Source: Rosstat

The Netherlands, now the largest foreign investor in Russia, continues to invest in Sakhalin

As far as the composition of FDI by country is concerned, it is interesting that the Netherlands has invested twice as much in Russia as Cyprus in the past 12 months and has replaced the latter on the top of Russia's list of largest foreign direct investors. These two countries together now account for 61% of accumulated FDI in Russia, whereas at the end of 1Q05 their share was around 57%. As the Netherlands' FDI is focused on Sakhalin projects, the general FDI trend clearly favors the fuel sector, but has limited implications for the rest of the economy.

Figure 3. Structure of Accumulated Investment by Country, $ bln

	1Q05	1Q06
Total FDI	**37.8**	**53.9**
Cyprus	11.9	15.7
Netherlands	9.8	17.4
Luxembourg	0.3	0.6
Germany	2.1	2.7
UK	1.4	2.3
USA	4.2	4.7
France	0.4	0.5

Source: Rosstat

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