AB-ICI: Focus on Fiscal Risks

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Investment Summary

- In March, the AB-ICI continued to decline on the uneven performance of debt markets
- The Russian government is guiding for an increase in the 2011 budget deficit on higher social expenditures and lower-than-expected non-oil tax collection
- Poor consumption trends are hampering economic growth, underlining the debt risks Russia faces long-term

AB-ICI was down another 2.4% on growth concerns

2.4% m-o-m decline in AB-ICI reflects only modest improvement in Russia's balance of payments…

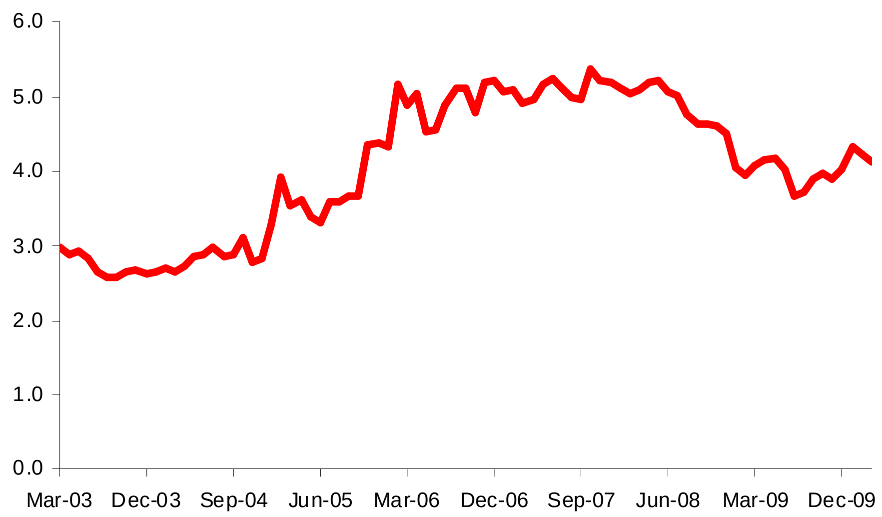
The AB-ICI continued to decline in March, as the improvement in economic confidence was outweighed by the market's heightened concern over Russia's growth outlook.

- **The economic confidence** indicator was up, reflecting continued de-dollarization backed by the ruble's strengthening vs. the basket and US dollar. However, capital inflows to Russia remain unstable and CBR reserves are up only $16 bln YTD, or $4 bln a month, even though the oil price reached $85/bbl, well above expectations;
- **The foreign confidence** indicator was flat, as no relevant FDI data were released over the period;

…and pressure on Russian financial markets

- **The market confidence** indicator fell as a result of the increased spreads of Russian sovereign bond yields over EM peers and a sharp decline in the presence of small borrowers on the local bond market. International investors are increasingly concerned about the outlook for Russian economic growth, as it is becoming more and more dependent on commodities.

Figure 1: AB-ICI was down 2.4% last month



Source: New School of Economics, Alfa Research

Eurobond placement puts focus on budget discipline

We expect the AB-ICI to continue to decline in the coming months owing to market instability on the back of European sovereign debt problems and pressure from Russia's weak balance of payments. This decline will come in spite of Russia's Eurobond placement, which would normally ensure an inflow of capital to the country. Russia's return to the bond market also means investors will focus on budget execution, which gives few reasons for optimism.

Revised macro forecast did not impress

First, the government's revised macro forecast for 2010 failed to impress the market. The GDP growth outlook was upgraded to just 4.0%, while expected investment growth remained unchanged at 2.9%, signaling that the government does not see any possibility of shifting from a consumption- to an investment-driven recovery.

Despite next year's planned increase in the payroll tax, the budget deficit may total RUB 2.4 trln

Second, debate over the 2011 draft budget is becoming more intense, suggesting the government is finding it difficult to limit growth in social obligations. As a result, next year's budget deficit may come in at RUB2.4 trln, more than the RUB2.2 trln we expect for this year. This is despite the planned increase in the payroll tax from 26% to 34%, which is equal to a 5-6% increase in total wages. Thus, instead of boosting investment, the Russian government is focusing on social spending at the expense of the private sector, which will have to cope with a higher tax burden.

State debt may increase by $60-70 bln in 2011-2012

Slow economic growth and mounting social obligations will necessitate more borrowing. Russia has just attracted $5.5 bln from international markets to finance this year's budget deficit. However, the accumulated budget deficit over the next two years will amount to around $150 bln, of which only $90 bln can be covered by the National Welfare Fund, while the remaining $60-70 bln will require increased government borrowing.

State borrowing to keep loan growth modest

The likely increase in government debt will increase competition between the Finance Ministry and corporate clients for borrowed funds. The recovery in corporate lending is currently very weak. In March, it was flat overall, with privately-owned banks posting growth but Sberbank reporting a significant 2.7% m-o-m decline. We expect the state's increased appetite for borrowing to keep lending growth modest this year.

Figure 2: Banking statistics

	Oct-09	Nov-09	Dec-09	Jan-10	Feb-10	Mar-10
Growth rates, m-o-m						
Retail loans	-0.7%	-0.2%	-0.3%	-0.8%	-0.6%	0.3%
Corporate loans	-0.5%	0.3%	-1.2%	-0.3%	-0.7%	0.0%
Retail accounts	1.4%	2.9%	6.9%	0.2%	2.3%	1.6%
Corporate accounts	-2.2%	2.6%	2.0%	-1.4%	-0.9%	2.7%
Quality of loans, % of loan book						
Corporate NPLs	5.9%	6.2%	6.1%	6.1%	6.2%	6.2%
Retail NPLs	6.6%	6.8%	6.8%	7.1%	7.3%	7.4%

Source: CBR

Government social spending will lead to import growth and put pressure on the ruble, undermining its long-term stability

The reallocation of state spending towards pension indexation and social payments creates a negative environment for the balance of payments, as increased consumption is likely to boost imports. This would reduce the current account to a very low $10-20 bln in 2012. The resulting decline in the capital account would put pressure on the ruble exchange rate. We therefore believe that the government's budget policy will be a key factor affecting the AB-ICI's long-term performance.

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