

Alfa Bank Investor Confidence Index

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A new leading indicator of portfolio and strategic investment sentiment towards Russia

Alfa Bank has commissioned the creation of a new monthly Index intended to be a leading indicator of investor sentiment towards Russia. The "Alfa Bank Investor Confidence Index (AB-ICI)", which has been developed as a joint project between Alfa Bank and the New Economic School (NES) in Moscow, brings together a number of data series that track both portfolio and strategic investor sentiment and offer a strong guide to future investment intentions in terms of FDI, RDI and capital market flows. The methodology used (see separate report inside) allows for the smoothing of "one-off" extreme observations so that the resulting Index is more even, reflecting long-term and medium-term fundamentals, and less prone to short-term changes in the underlying variables.

This is the first "Leading Indicator" of trends covering Russia

A number of existing surveys track confidence levels and the future intentions of business managers in Russia, which in turn are driven partly by historic data published by various government organizations and partly from the perceptions of business managers regarding the future investment climate. This new "AB-ICI" will remove the guesswork from those perceptions and provide business managers, economic planners, investors, analysts and media commentators with a solid leading indicator of the changing investment climate in Russia by tracking what investors are actually doing.

Updated and published, with commentary, each month

Monthly

The "AB-ICI" will be calculated at the start of each month, using the methodology described below, and the updated series will be published with a commentary by Alfa Bank's economic team. The commentary will reflect some of the most recent data and interpret any directional change or reconfirmation of an existing trend.

The continuation of a positive directional trend will suggest a likely increase in portfolio and strategic investment flows over the short to medium term, while a negative correction in the trend, if repeated for two or more consecutive months, could indicate a slowdown or reversal of investment liquidity inflows.

Data series have now developed enough to allow such a survey to give a reliable "indication"

Timely

We believe that now is a good time to introduce such a leading indicator, as although still relatively young in terms of overall development, Russia's economic and capital markets infrastructure is progressing very fast. The data underlying the calculation of the "AB-ICI" is now both reliable and supportive of the conclusions we require from such an indicator.



The story so far

The start date for the “AB-ICI” is March 31, 2000

The Index is calculated on a monthly basis with a starting date of March 31, 2000. Figure 1 shows the trend in the “AB-ICI” since then.

Figure 1. Alfa Bank Investment Confidence Index



Source: Alfa Bank estimates

Shows the initial “Putin” enthusiasm and how it waned as concerns about corporate governance and the deteriorating international environment grew

The AB-ICI reflects all of the key events that have affected investor sentiment since early 2000, i.e. from the installation of the present government and the start of economic reforms. Initial optimism after the March 2000 presidential election led to a substantial increase in the Index’s value, partly driven by improving economic fundamentals (high oil price and benefits of ruble devaluation in 1999) as well as optimism about the start of real changes. However, the equity market and debt market decline as a result of concerns about corporate governance abuses and a volatile international environment, both of which also contributed to a slowing of FDI flows, pushed the AB-ICI down over the second half of 2000. The “technical default” on Paris Club debt in January 2001 pushed the Index to a low point, but the ascending trend after that, particularly boosted by the September 2001 rapprochement between the U.S. and Russia, is a clear sign that investors expect the Russian economy to continue to benefit from both the internal reform process and the new global position the country has achieved over the past few years.

The AB-ICI has been a reliable leading indicator of the subsequent trend in the prices of both equities and debt

The trend in the Index has proven to be a good indicator of the subsequent trend in both the Russian equity and bond markets. We believe that it will also continue to provide a solidly reliable indicator of future strategic and portfolio investor flows into the Russian economy.

Alfa Bank Investor Confidence Index – Methodology

Our partner

Built in cooperation with the New Economic School

The Index was prepared with the support of the New Economic School (NES), an independent graduate school of economics in Moscow established in 1992. The NES was founded as a partnership between the Central Economic Mathematics Institute of the Russian Academy of Sciences (CEMI) and the Hebrew University in Jerusalem, along with a group of Western economic professors. The Research Center at the NES was created in 1995 to encourage modern economics research in Russia.

Methodology

Combines indicators that reflect confidence levels amongst portfolio and strategic investors, both Russian and foreign, as well as bank depositors

The AB-ICI was constructed using carefully selected variables that reflect the level of confidence among foreign and domestic investors in Russia's security markets as well as Russia's macroeconomic performance. The variables include characteristics of the ruble and foreign-currency corporate bond markets (including spread, duration and diversification), the performance of the stock market (normalized returns and the entry of new companies), the sovereign spread, capital outflows, GDP and sector-based growth, and the composition of retail banking deposits. The Index also takes into account foreign direct investment and the share of foreign banks in Russia's banking sector.

Uses the Stock and Watson approach as used by major international economic monitoring agencies

The methodology is based on the approach developed by James Stock and Mark Watson (1989) when constructing the coincident index of economic indicators used by the National Bureau of Economic Research (NBER) to evaluate the state of the U.S. economy. This methodology assumes that each of the above variables depends on a common factor (the "confidence") as well as an idiosyncratic component with a certain degree of independence. Both the common factor and the idiosyncratic component are characterized by inertia (in econometric terms, both follow certain auto-correlated processes). An estimate using the Kalman filter then determines the best statistical decomposition of the joint behavior of the selected variables as expressed by a common factor (the confidence index) and the idiosyncratic part.

It is designed to smooth out any 'one-off' or 'extreme' readings

While the methodology produces dynamics similar to those generated by the principal component method, there is an important distinction. The principal component does not take into account the inertial (i.e. auto-correlated) nature of the confidence index. Rather, it simply summarizes the auto-correlations of all the variables and does not allow one to single out the dynamic process of the confidence index per se. Our methodology does allow for the determination of such a process. Therefore, the resulting index reflects long-term and medium-term fundamentals, and is smoother and less prone to short-term changes in the underlying variables.

The Index is calculated based on three main components:

1. an indicator reflecting capital markets confidence (with a weight of 20%),
2. an indicator reflecting foreign confidence (37% weight), and;
3. an indicator of confidence in the economy (43% weight).



Trends in activity, pricing and risk in the capital markets

Capital markets

Incorporates the trend in equity prices, the number and size of IPO issues, the spread of a range of Russian corporate and sovereign bond issues over a peer group, the duration of corporate bond issues and the activity of smaller Russian enterprises in the bond markets.

FDI and banking sector asset growth

Foreign confidence

FDI per capita and the share of foreign banks in the overall assets of Russia's banking sector, both of which are designed to reflect the attractiveness of conducting business in Russia's financial sectors.

In the economy and currency

Confidence in the economy

Combining capital inflows in the balance of payments, the increase/decrease in retail deposits and the share of foreign currency in overall deposits, all of which should capture both Russian and foreign confidence in the economic trend, the currency and development of the banking system.

The AB-ICI will be published on a regular monthly basis starting from June 2003.

For further information and updates on the AB-ICI, please contact:

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