

AB-ICI: Ruble Volatility Hit Growth

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Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) dropped 3.1% last month on ruble volatility
- Refinancing-rate cut, budget execution and liquidity overhang are bad news for the ruble and thus the AB-ICI

The AB-ICI declined 3.1% last month

AB-ICI dropped 3.1% last month on ruble instability

Economic confidence was under pressure because of drop in CBR reserves

Strong growth of financial markets came to an end

In July, the AB-ICI declined 3.1% from the previous month as the ruble declined in response to falling oil prices, which tested \$60/bbl. Even though oil has since recovered, July's volatility proves that confidence in the ruble remains low.

- The **economic confidence indicator** was down as, after a couple of months of capital inflow and reserves growth, CBR reserves declined by \$10.7 bln in July;
- **Foreign confidence** was flat last month, as no new information was released;
- **Market confidence** declined slightly, as rapid growth of the equity market came to an end and the spread between Russian and other emerging-market Eurobonds widened.

Figure 1: AB-ICI dropped 3.1% last month



Source: New School of Economics, Alfa Research

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Ruble appreciation appears fragile

Ruble fragility will damage AB-ICI

Ruble appreciation was one of the main contributors to financial markets' strong performance, which helped push up the AB-ICI in 1H09. However, in July the ruble exchange rate experienced a round of volatility caused by a sharp correction in oil prices. While commodity markets around the world have now started rising again, we believe a number of internal factors will keep the ruble unstable in the short term.

In August, the ruble decoupled from oil and the dollar

Since the beginning of August, the ruble has decoupled from the dollar/euro basket and the oil market. The Russian currency has depreciated by 2-2.5% against the basket since the beginning of the month, while the ruble/dollar rate has remained virtually flat despite the dollar's depreciation against most other currencies. The market sees this as preparation by the CBR for a sharper ruble drop in the coming months.

Continuing rate cuts is one reason why ruble is under pressure

An important factor behind this view is the continuing cut in the CBR rate. From the beginning of this year until August, the CBR made four 0.5 ppt reductions in the refinancing rate, bringing it from 13% to 11%. On August 10, it cut the rate by another 0.25 ppts despite high price growth in July. Thus, it appears that boosting lending activity is the priority of the government's monetary policy.

7M09 budget deficit was only 4.3%

Another factor is budget execution. The federal government continues to exercise tight control over spending. Monthly expenditures rose by only RUB55 bln from June to July while revenues were up RUB98 bln. The budget deficit thus came in at RUB924 bln, only 4.3% of GDP for 7M09, well below the official forecast.

RUB1.7 bln will be withdrawn from the Reserve Fund before year-end

While in 1H09, the Finance Ministry spent RUB924 bln to finance the budget deficit, it also increased its deposits with banks by RUB350 bln. Thus, for the deficit to reach the official forecast, another RUB1.7 trln must be withdrawn from the Reserve Fund before year-end. This amount is large enough to keep volatility high on the exchange rate market. Given a budget deficit of 10% of GDP and an oil price of \$55/bbl, we would expect a RUB/\$ exchange rate of 36.6 by year-end.

Banks are keeping a large liquidity overhang on their balance sheets

The third point is that banks are keeping a large liquidity overhang on their balance sheets. Despite June's 4.2% growth in corporate accounts and 2.8% growth in retail accounts, Russian banks cut their lending portfolio by 1% in the same month. The combination of lower lending activity and increased deposits suggests that banks are continuing to accumulate a liquidity overhang. The banking system has accumulated around RUB385 bln in deposits with the CBR, and this amount could easily flow to the exchange rate market.

All of the above factors are likely to contribute to a weaker ruble, which could put pressure on the AB-ICI in the next few months.

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