



### AB-ICI September: Recovering with the Markets

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#### Investment Summary

- AB-ICI increased 2% in September on higher confidence in the ruble alongside market growth
- Capital inflows to be supported by FSFM efforts and corporate borrowing, but concerns linger

#### AB-ICI up by 2% as all economic trends improve

*AB-ICI increased in September,...*

*...reflecting higher confidence in the ruble*

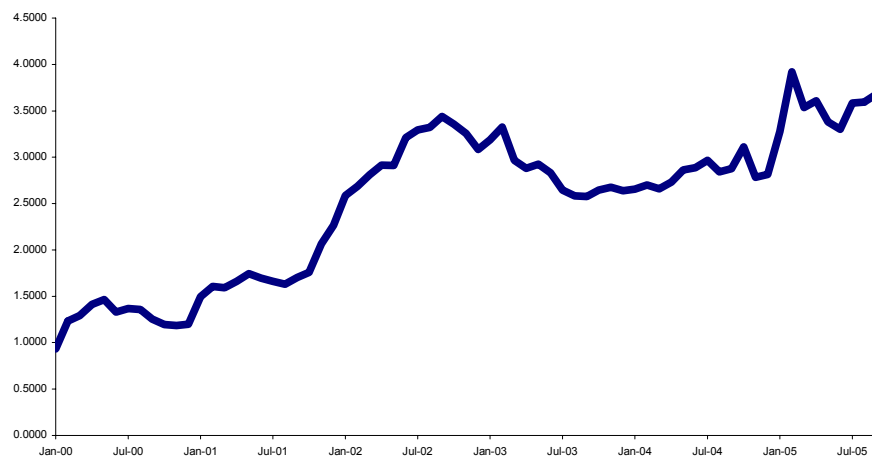
*The foreign component of the Index was flat,...*

*...while the market confidence component improved*

The Alfa Bank Investor Confidence Index (AB-ICI) rose by 2% in September, reflecting improvement in its economic and market components:

- The Index's **economic confidence** indicators increased significantly, reflecting higher capital inflows and the declining share of foreign currency in total savings. We generally link this positive result to greater confidence in the ruble.
- **Foreign confidence** indicators were flat, as no new information was published recently. The CBR's figures on FDI flows underscore the still significant interest on the part of foreign companies in the Russian market.
- The **market confidence** component continued to be driven by the RTS and the rise in bond prices.

Figure 1. AB-ICI up 2% in September



Sources: New School of Economics, Alfa Bank

*Capital inflow to Russia is a key factor for Index growth; trend uncertain for 2006*

All in all, capital inflows to Russia remain the key driving force for the AB-ICI, as reflected in higher capital flows *per se* alongside higher market valuations. Nevertheless, the trend for 2006 seems uncertain, as conflicting factors could affect short-term capital flows.

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## Capital inflows in 2006: Pros and cons

**On the positive side, Russian companies will continue to increase foreign borrowing**

The key factor supporting the expectation of a higher capital inflow is the corporate appetite for foreign borrowing. While the state is cutting its exposure to international markets while the size of sovereign foreign debt (9% of GDP) will be fully covered by the Stabilization Fund by 2007, the corporate segment is still under-leveraged. Total corporate debt represents just 35% of GDP and could potentially double to reach the average level of other emerging markets.

**Figure 2. Russia's Corporate Debt, \$ bln and % of GDP**

	1998	1999	2000	2001	2002	2003	2004	2005F
Foreign debt, \$ bln	19.6	21.1	21.8	24	33.6	55.1	77	115
Domestic debt, \$ bln	15.6	16.5	28.1	42.5	54.6	91.8	129	150
Share of GDP	12.9%	20.7%	19.8%	22.0%	26.1%	33.9%	35.3%	35.8%

Sources: CBR, Alfa Bank estimates

**FSFM intends to increase domestic market volumes**

Another positive factor is that the Federal Service for Financial Markets (FSFM) continues to implement measures to encourage Russian companies to launch IPOs domestically. In 2005 ten Russian companies have already attracted \$8 bln from the markets, and 60% of trading volumes this year have been registered locally vs. just 20-30% in 2004.

**However, back tax claims will continue to appear,...**

Meantime, capital inflows are likely to be constrained by the authorities' intention to continue collecting back taxes. In 2004 the additional amount collected from back tax claims represented 2% of GDP, and in 2005 it is likely to stay around 1.0-1.5% of GDP.

**...while the CBR prefers a weak ruble**

The CBR's exchange rate policy is also unlikely to favor strong capital inflows. Despite all official discussion regarding the need to control inflation, the weak ruble is a clear priority for the Cabinet. First, it is hard to imagine that the CBR will allow the ruble to appreciate in order to affect the imports component of price growth. Since the creation of the Stabilization Fund, growth in the monetary mass has been merely in line with the increase of GDP. While the ratio of M2 to GDP jumped from 19% in 2003 to 22% in 2004, this year it remains slightly below 23%. Another alarming signal for the CBR is that banking indicators, including the ratio of assets, loans and deposits to GDP, have remained flat this year, marking the first time this has occurred since the 1998 crisis.

Thus, capital inflows will remain significant in the coming months and into next year but still below their potential size pending further efforts to make the domestic investment climate more attractive.

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