

# AB-ICI: Domestic factors drag the index down

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## Investment Summary

- The AB-ICI fell significantly on faster net capital outflow and weak market performance
- Government proposal to freeze tariffs is negative for investments, credibility of inflation targeting still low
- Proposal to cancel 6% defined contribution for silent pension savers may trigger more capital outflow

**AB-ICI slumped by 2.2% in August on poor economic and market confidence**

**Confidence deteriorates as net capital outflow picks up**

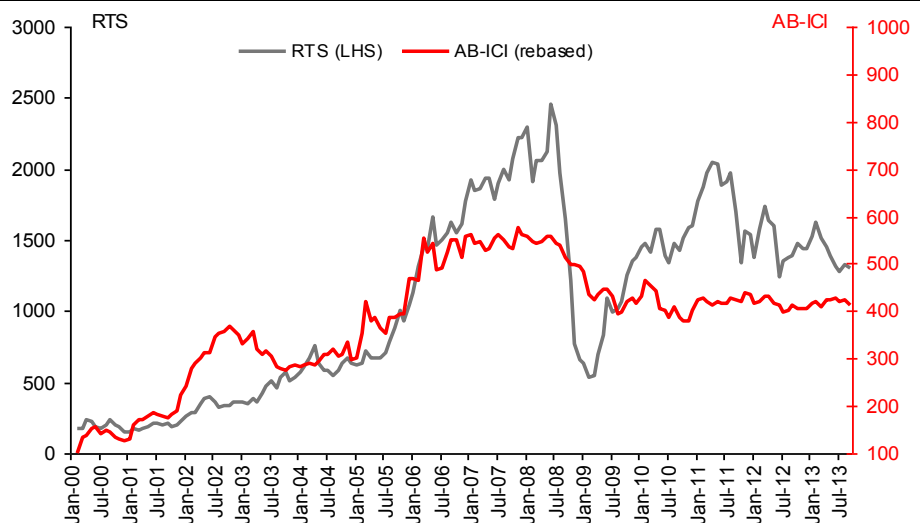
**Russian market is under pressure because of slow growth and decline in CBR reserves**

### AB-ICI declined considerably in August

The AB-ICI declined significantly in August, confirming our view that July's increase was a one-off. The 2.2% m/m fall was the sharpest since September 2012. The decrease was mainly due to internal factors: the capital account deteriorated further and confidence in the local currency ebbed. While global jitters over Fed tapering have subsided, markets remain uncertain about the future and are now focusing on US budget challenges.

- **Economic confidence** dropped sharply, reflecting capital outflow acceleration in August. According to preliminary estimates, net capital outflow accelerated to \$10bn in August from \$6-7bn in July. This has compelled the CBR to sell \$1.2bn a week over the last two months to protect the ruble exchange rate. Dollarization of retail deposits reached a 10-month high, highlighting the lack of confidence in the local currency.
- **Foreign confidence** was stable in August, as no new relevant data were released. Domestic factors suggest this indicator will deteriorate in future.
- **Market confidence** was down in August despite the decline in global volatility, as the Fed's decision to hold off on tapering positively surprised the market. The markets have been watching Russia closely as its economic slowdown has continued and CBR reserves have approached \$500bn, seen as a crucial benchmark. With 3Q13 current account data to be released soon, we expect confidence to be under pressure in the near term.

**Figure 1: AB-ICI slumped by 2.2% in August**



Source: New School of Economics, RTS, Alfa Research

## **Inconsistent policy is a challenge to AB-ICI**

**AB-ICI suffers from low policy credibility: tariff freeze and pension reform are the two most recent examples**

Though current pressure on the AB-ICI is partly due to increased volatility on global markets, we believe Russia's macroeconomic policy is not helping to improve the government's credibility. The two main topics last month were the tariff freeze, meant to assist with the inflation-targeting approach, and the new proposal for pension reform, which aims to improve budget stability.

**Decision to freeze tariffs in 2014 was revised immediately after it was announced**

The government's decision to freeze natural monopolies' tariffs next year came as a big surprise. Given that the direct contribution alone of tariff growth to Russia's CPI basket is 20%, market watchers initially saw this move as a strong sign the government wanted to knock 1-2pp off of next year's inflation from the current level of 6.5% y/y. However, this drastic change in the rules of the game was seen as very negative for investment growth, and the decision to freeze tariffs for only a year largely neutralized the potential positive impact of this initiative. In addition, the decision met with strong opposition from natural monopolies, which led the government to agree to increase tariffs for the general public and some industrial clients. As a result, though the initial proposal looked very positive for inflation targeting, the amendments that followed called into question the government's commitment to controlling inflation.

**CBR has to improve communication with the market**

The inconsistency of government policy complicates the CBR's position, which suffers from a lack of transparency. In the middle of the month, the monetary authorities sought to improve inflationary expectations through better communication with the market, i.e. by simplifying the policy rate corridor and announcing a 4.5% CPI target for next year. Following the tariff discussion, however, the CBR had to acknowledge that monetary measures had little impact on CPI and raised the target to 5.0%. As a result, we believe the CBR has yet to establish its credibility on the market and is unlikely to be able to influence inflationary expectations, at least in the near term.

**Cancellation of defined contributions for silent participants gives budget additional revenues**

Another blow to Russia's investment case was the discussion of pension system reform, which calls into question the development of the private pension savings market. Poor revenue growth is pushing the government to search for new sources of funds, one of which is the conversion of the defined contribution back into the pay-as-you-go system. The first negative surprise was the government's decision to completely cancel the 6% defined contribution for silent participants starting in 2014 and instead transfer it to current Pension Fund payments, while the initial plan was to keep a 2% contribution. As a result, only active participants in the defined contribution system, with savings managed privately, will be eligible for continued participation. As this group represents only 26m people out of Russia's labor force of 76m, growth in the defined contribution pension market is likely to slow significantly. This should give the budget around RUB100bn of additional revenues in 2014.

**State may freeze defined contribution growth in 2014**

Secondly, in order to launch auditing of the private pension industry, the social ministries proposed completely freezing the accumulation of defined contributions next year, even for active participants, and using the additional RUB240bn in new savings to cover current spending by the State Pension Fund. Regardless of whether this proposal is approved, we take it as a very negative sign that the government does not consider defined contributions as private savings, which will likely discourage participation in the defined contribution market and constitutes a de facto reversal of pension reform. On top of that, it does considerable damage to Russia's investment climate and may intensify the net capital outflow. All in all, we believe the lack of clarity on key economic policy issues will be a major drag on the AB-ICI going forward.

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