



AB-ICI October: \$2.1 bln FDI Offsets Drop on RTS

Natalya Orlova

(7 095) 795-3677

NOrlova@alfa-bank.com

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www.alfabank.com

Moscow

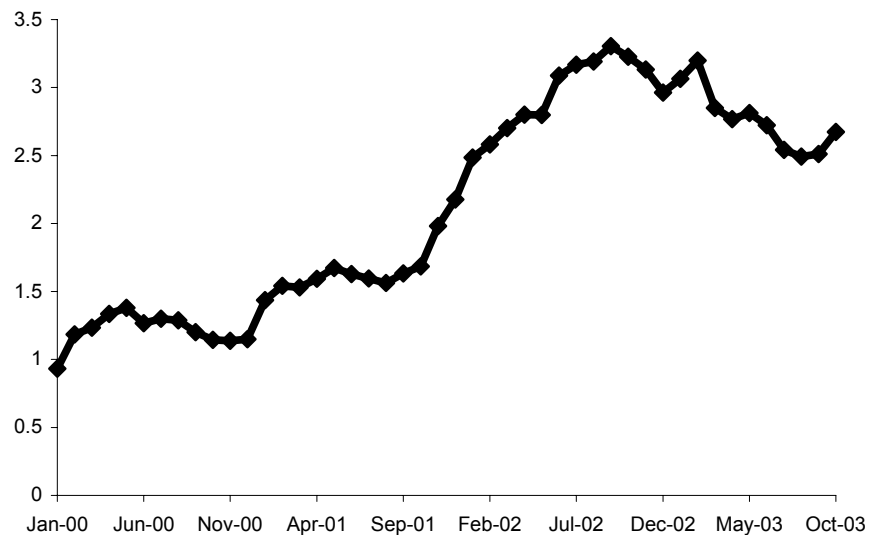
Investment Summary

- \$2.1 bln FDI inflow in 3Q03 was in line with our expectations, key for 6% increase in AB-ICI
- While the RTS Index continues to suffer from Yukos/Menatep uncertainty, FDI is unlikely to react
- The key question for the AB-ICI Index in 1Q04 is whether capital flight will resume

Latest AB-ICI did not reflect 11% RTS drop in October, as good news compensated

Expectations that uncertainty stemming from the Yukos/Menatep investigations would deal a blow to the AB-ICI Index in October did not materialize. Granted, the 11% drop in the RTS Index last month affected the market confidence component of the Index, but this was offset by good news in the form of improving fundamentals in the Russian economy.

Figure 1. AB-ICI showed a 6% m-o-m increase in October



FDI in 3Q03 was \$2.1 bln, up from \$1.5 bln in 2Q03

Goskomstat recently released FDI figures for 3Q03 showing a substantial increase in FDI flows, to \$2.1 bln from \$1.5 bln in 2Q03. Thus, based on the 9M03 FDI inflow of \$4.6 bln, we expect annual FDI to reach \$6 bln, the highest level in the transition era. Industry attracted a total of \$2.2 bln in FDI in 9M03, more than half of which stemmed from oil projects financed by Japan (\$0.5 bln, probably involving projects in Sakhalin) and the Netherlands (\$0.4 bln). Germany also made a substantial investment in market infrastructure in 9M03 of \$0.2 bln.

\$1 bln in FDI came from Cyprus in July-September, unaffected by recent volatility

Another important indicator was FDI from Cyprus. Despite speculation of an increase in capital flight since July, in 3Q03 FDI from Cyprus to Russia amounted to \$1 bln vs. \$7.6 bln accumulated to date in the transition era. This raises the question of whether FDI flows will continue to remain unaffected by the Yukos/Menatep affair or if they will react only with a substantial lag.



Figure 2. Foreign Investment in 9M03 vs. 1H03, \$ mln

	1H03	9M03	% change
Foreign investment, of which:	12,660	20,899	65.1
FDI	2,530	4,665	84.4
portfolio	38	81	113.2
other	10,092	16,153	60.1

Source: Goskomstat

\$3 bln greater capital inflow in October despite expectations of capital flight

In October Russia also saw substantial improvement in terms of capital flows. After experiencing a decrease in official reserves in August and September, in October the CBR boosted reserves by almost \$3 bln. This shows not only that FDI flows not did react to the Yukos/Menatop investigations, but also that capital flight has not resumed.

Capital flight may resume after the election season,...

However, such unexpectedly good performance last month should not prevent us from looking forward. The capital inflow to Russia in recent months can be explained by the upcoming parliamentary elections, which are requiring significant financing. Thus, if capital flight resumes, it would probably not occur before January-March 2004, and even then only given the emergence of some negative trigger, such as a decline in oil prices.

...but could be modest if the ruble continues to appreciate

Lastly, we note the possibility of a pleasant surprise. By itself, appreciation of the ruble is not merely a product of trade and capital flows, but is also an important variable affecting business decisions. Should the ruble remain strong (or rather, should the dollar remain weak) at the beginning of 2004, an increasing number of companies will prefer to keep their accounts denominated in rubles rather than in dollars abroad.

Contact Information

Alfa Bank (Moscow)

Head of Equities	Dominic Gualtieri
Telephone	(7 095) 795-3649
Facsimile	(7 095) 745-7897

Research Department

Telephone	(7 095) 795-3676
Facsimile	(7 095) 745-7897
Co-head of Research, Telecoms	Andrei Bogdanov
Co-head of Research, Chief Strategist	Chris Weafer
Oil & Gas Team	Matthew Thomas, Konstantin Reznikov, Anna Boutenko
Macroeconomics, Banking	Natalya Orlova
Utilities	Vitaliy Zarkhin, Natalya Devetyarova
Telecoms/Internet	Andrei Bogdanov, Elena Rogovina
Metals & Engineering	Maxim Matveev CFA, Natalya Sheveleva, Pavel Sokolov
Consumer Goods	Alexander Svinov
Russian Client Support	Angelika Henkel
Fixed Income	Valentina Krylova, Ekaterina Leonova, Oksana Klypina
Technical Analysis	Vladimir Kravchuk
Editor	Erik DePoy
Translation Team	Rinat Gainouline
Production Team	Pavel Sokolov, Robert Broadie, Natalya Sheveleva

Equity Sales & Trading

Telephone	(7 095) 795-3712
Facsimile	(7 095) 745-7897
International Sales	Kirill Surikov, Alexander Zakharov
Domestic Sales	Oleg Martynenko, Alexander Nasonov, Konstantin Shapsharov
Capital Markets, Structured Products	Armen Petergov, Alexei Gourianov, Tamara Zarechneva
Address	12 Akad. Sakharov Prospect, Moscow, Russia 107078

Alfa Securities (London)

Telephone	(44 20) 7588-8500
Facsimile	(44 20) 7382-4170
Head of Equities	Guyen Giray
Equity Sales	Maxim Shashenkov, Steve Downer
Address	City Tower, 40 Basinghall Street, London, EC2V 5DE

Alfa Capital Markets (New York)

Telephones	(212) 421-8564 / 1-866-999-ALFA
Facsimile	(212) 421-8633
Sales Trading	Nicholas Beech
Research Sales	Michael Kaplan
Address	540 Madison Avenue, 30 th Floor, New York, NY 10022

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