

Inflation – Makes Russia a Good Bet

There are three factors that really make Russia an attractive object for investment. These are inflation, corruption and bureaucracy. – Sounds weird, I must admit, but when you make an investment you look for value, for hidden value. You want to identify what nobody yet has realized and invest ahead of the horde. This because you look to capture the value that will be evident for all the rest only after you are already invested. This should explain my seemingly odd assertion. What I mean is that the prospect of taming these ills makes Russia attractive.

Putin recently called inflation the Achilles heel of Russian economy. But corruption and bureaucracy equally affect the social body. Continuing with the somatic metaphors we could call corruption the stranglehold on society and bureaucracy the social cancer. And these all form part of the same syndrome, inflation rate just showing how sick the economy is.

The good news is that inflation has now finally been recognized as the problem it is. And any cure starts from admitting the problem. Fight against corruption is also becoming real, and some big heads have started to roll. The problem is just so endemic that it will take a time before any effect will be evident. Unfortunately, though, on taming the bureaucracy there is not much progress, and indeed the leadership has not realized the essence of the problem. A striking example of this represents the amendments to the Competition Law which now gives the competition authority the right to reject an application if it regards that all the necessary information was not included in it – and we know that there is no limit to what may constitute the “necessary information.” Earlier the authorities could not reject an application but were required to request additional information, which is the common practice in countries with a developed administrative culture. One may assume that the clerks at the competition authority have complained of their workload and managed to get this “improvement.” Just think what an opportunity this creates for negotiating what is to be considered “necessary.” Cutting bureaucracy while not costing anything would mean a huge stimulus for the economy. Bureaucracy has turned Russia in to a vast playground for adults where you practice churning out document after document, stamping them now with the square stamp, now with the royal round, standing in all kind of queues, jumping over hurdles, and creeping through pipelines. All this resulting in substantially increasing the cost of doing business, delays in realizing projects, inferior labor productivity – and of course, serving as the main source for corruption – all summed up in inflation.

Of course, inflation is also about monetary policies. There has been a substantial improvement in how the Russian leadership thinks about those, but some of the reoccurring policy statements are bewildering. One of the big things about inflation fighting is about getting interest rates down. In the long run – in a market economy - interest rates cannot be below the inflation rate. Therefore you have to set the steering rates in relation to the inflation figure. But here is where the central bankers and cabinet ministers go wrong. They constantly refer to their predictions about how much they expect the inflation to be at the end of the calendar year. But interest rates affect the future, and the inflation in the calendar year is about history. What sense is there today, in October, to match the interest rates to the predictions about calendar year inflation! This predilection means that the Central Bank is always late in fixing its benchmark rates. Now instead they should set the rates in comparison with the anticipated inflation, which is based on inflation trends and the knowledge on what has changed in the economy that could affect the

trend. This anticipated inflation rate – which is the only correct measure – is never used, instead they refer to another historical figure of little value, namely the rolling cumulative rate of the past 12 months. This latter figure is given out as the “official inflation rate.” – The CB needs to be braver in looking into the future and stop steering the Russian economy being hooked on to the rear mirror.

Nevertheless, there is a real chance that the refinancing rates would be cut in the near future to 8 – 8,5%. This would make all the difference for the economy enabling lending rates in the range of 10 – 14%, and the chance for a real financing sector to develop. The goal should be to reach lending rates of 8 to 12%. But inflation in an emerging economy like Russia does not have to be totally quenched; inflation below 5 or 6% would be more harmful than beneficial in suffocating the necessary flexibility.