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The Smart Money

By Konstantin Sonin

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Two years ago, I had the opportunity to speak with the deputy chairman of China's Central Bank. I had been warned in advance that the officials in charge of Chinese fiscal policy would never officially admit to a policy of trying to hold down the value of the yuan. Indeed, the closest the deputy chairman came to such an admission was when he stated Beijing could not allow the yuan to rise in value.

I came away puzzled not by the Chinese government's reluctance to discuss this policy openly, but by the economic logic. As one Chinese economist explained it, the government encourages Chinese businessmen to invest abroad because this helps hold down the value of the yuan.

Encouraging Chinese investment abroad to weaken the yuan makes no sense, however. Governments normally suppress the value of their own currencies to encourage investment at home. But not all forms of investment are alike. The Chinese authorities are interested in attracting foreign investment because it injects "smart money" into the economy. For one thing, foreign investors are much better than their local counterparts -- and far better than the state -- at identifying promising companies. Strategic foreign investors also back their money with technology inputs, which are indispensable for countries such as China and Russia that are playing catch-up with the developed world.

Unlike China, Russia seems to have little interest in attracting "smart money" from abroad. The Kremlin, awash in petrodollars, is doing everything possible to create the impression that Russia can take care of its own financing needs. The government does not seem concerned that Russian investors tend to back companies based on political calculation rather than profitability.

Take the case of Bill Browder, for example. For years, the CEO of Hermitage Capital Management -- the largest portfolio investor in the Russian stock market -- acted as an investment catalyst. Hermitage would buy shares in a company and then begin to push for improved corporate governance and efficiency, thereby driving up the value of its shares. Browder's clients were not the only ones to benefit from his efforts to increase transparency and profits in major companies such as Sberbank, Unified Energy Systems, Gazprom and Surgutneftegaz, in each of which Hermitage held a minority stake. Given that the majority owner at each of these companies is the state, the entire country ended up reaping the rewards of Browder's crusade.

A tiny minority of Russians suffered from Browder's activities: the heads of companies that thrive in a nontransparent business environment. This minority has friends in high places and all the right political slogans to justify its position. As a reward for all his hard work Browder has been barred from entering Russia -since last November. All that money he helped to invest in the Russian economy was just too "smart" for its own good.

Speaking at the St. Petersburg International Economic Forum last week, Economic Development and Trade Minister German Gref provided a more abstract example of the same trend. Gref confirmed a new law would limit foreign ownership in 39 so-called strategic sectors of the economy, up from an initially planned 17. Asked if telecoms would be declared a strategic sector, Gref replied with a chilling joke: "As soon as we call it strategic, that will be the end of it, and we'll all be left without mobile phones."

None of this should come as a surprise because for many Russian executives the influx of "smart money" is tremendously inconvenient. If you don't believe me, ask Browder or Gref.

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