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Inflation as stimulus for investment in metals sector

Contributed to *Metal supply and sales* by Maxim Khudalov, Director of Corporate Ratings Group at ACRA

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Inflation and volatile exchange rate undermine economic agents' confidence and their motivation to take investment decisions. At the same time, availability of credit resources for investment projects may provoke acceleration of inflation due to speculative activities of economic agents on the market.

Responding to this challenge, the Bank of Russia has opted for a stiff policy of increasing the cost of borrowing in order to decelerate inflationary processes. As a result, inflation is indeed stabilizing. On the other hand, this policy leads to an increase in loan interest rates and, therefore, reduces the potential for borrowing-financed investments in the economy. Which one of the two evils is worse, high inflation or inexorable loan rates?

Now that's a good question, all the more so as inflation, through indexation of monopoly tariffs, raw material prices and wages, results in higher product prices and, consequently, to some extent acts as a stimulus to investments. This may be exemplified by the metals sector.

Steel industry's international track record shows that its product price growth, defined by both the current market environment (i.e. by deficit or surplus of a product on the global scale) and inflation (for simplicity, we assume that, with regard to exchange rates across the globe, this process may be considered a global trend, while inflation in Russia, based on the theory of purchasing power parity, is determined by the exchange rate dynamics, with the Bank of Russia being able to affect local inflation by lending restrictions imposed via a high key rate), is perceived as a sign of improving market situation by sector players, who in turn react to this by building up investment activity.

Historical data analysis reveals a rather high correlation between the estimated value of global steel sector investments and the steel price dynamics on international markets. Thus, Figure 1 shows that investments in the sector almost doubled in 2005–2008 peaking at USD 141 bln, but then started to decline and in 2015 amounted to USD 80–100 bln.

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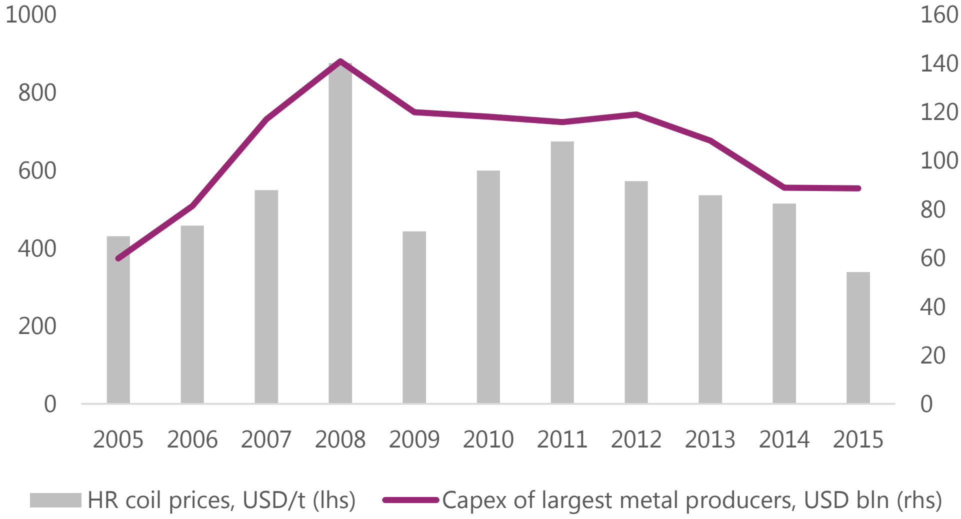
Figure 1. Correlation between steel prices and steel sector investments across the globe



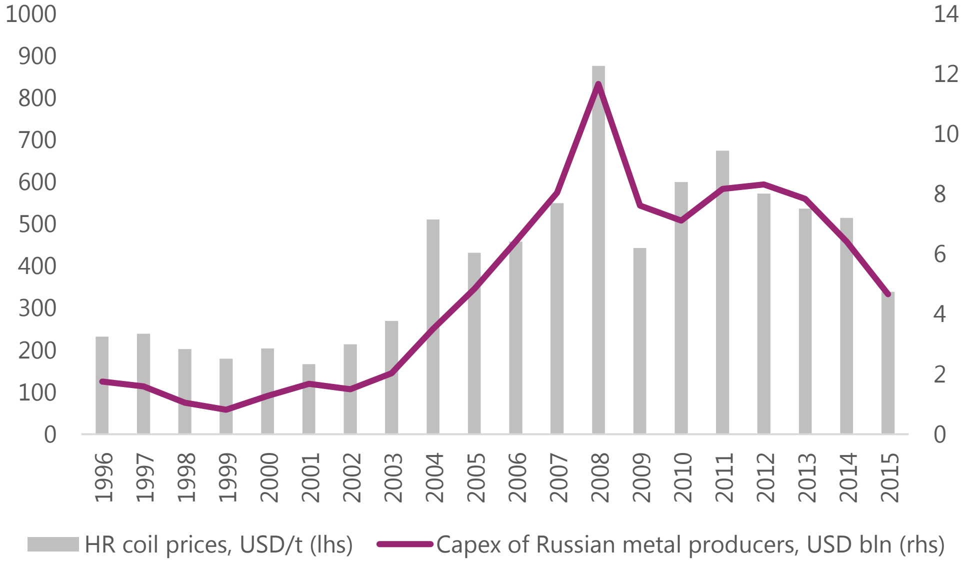
Source: Bloomberg

We note that correlation between steel prices and investments in the sector ran into 73% over the period. That is to say, both indicators were moving in the same direction, which does not contradict the hypothesis presuming the existence of a relationship between them.

That said, in 2005–2015, steel industry's development was fostered by investments made by China, whose demand significantly influenced the global steel price growth. Therefore, the steel sector data may be significantly biased due to the Chinese factor. A more correct view may be obtained by looking at investment dynamics in Russia, which saw no massive commissioning of new capacities over the specified period (except for two arc-furnace plants – NLMK Kaluga and Severstal Balakovo). Russian steelmakers were investing mainly in upstream acquisitions, modernization of existing capacities, and high value added products (rails, beams, wide sheet, and hot dip galvanized and color coated steel).

Russian metals investment statistics cover a longer period ranging from 1996 to 2015, but show a trend similar to the global one, i.e. growth during the period of high steel prices (Figure 2). Therefore, one can state that propensity to invest in the sector is to a large extent dependent on the market environment and inflationary factors.

Figure 2. Correlation between steel prices and steel sector investments in Russia



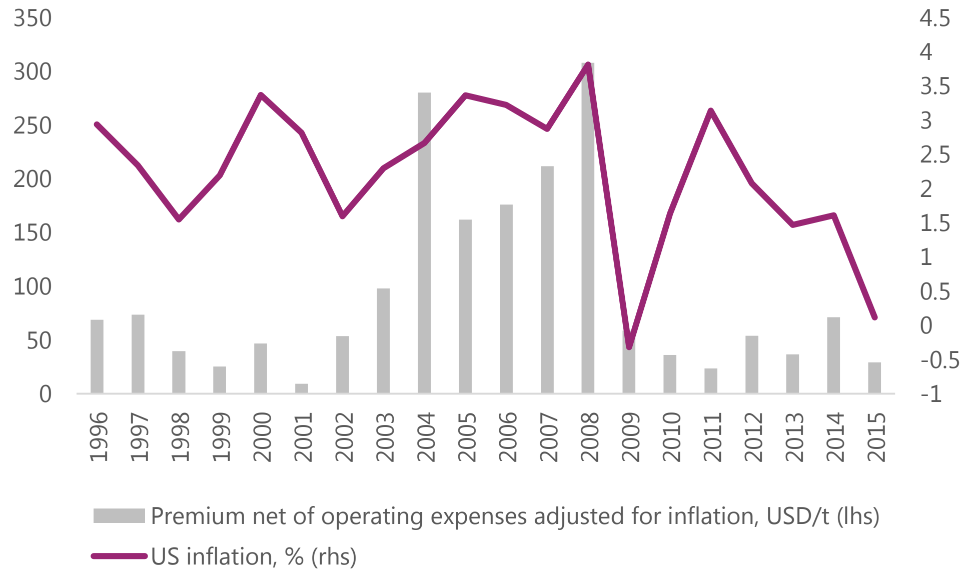
Source: Federal State Statistics Agency, Center for Economic Forecasting at Gazprombank

In general, sector's reaction to price growth is justified, since climbing prices reflect either an increased demand for products, or a production decline and product shortage, which in turn calls for investments.

The classical theory suggests that in a similar situation we would face a behavior pattern similar to that of a hypothetical farmer who sees surging wheat prices and takes out a bank loan to sow a twice as large area. As his neighbors do the same, they together create a glut on the market the following year, with prices falling and numerous farmers going bankrupt.

However, in reality the situation is somewhat different. As inflationary effects have different dynamics on different markets, companies are able to increase their efficiency (profitability) during periods of high inflation, while low inflation times usually see subdued profitability (Figure 3).

Figure 3. Inflation and margins in metals sector



Source: Center for Economic Forecasting at Gazprombank, ACRA estimates

Overall, the global steel industry does not confirm the argument that high inflation hampers investment growth, affecting only nominal values while having no real effect on production.

In Russia, local market trends are generally in line with global ones, although domestic prices also bear local inflationary effects associated with rising costs, including those related with transportation of raw materials, as well as other factors. In this regard, the Bank of Russia's policy of maintaining high interest rates in order to curb inflationary pressures hinders somewhat investments in the steel sector hampering the latter to build up profitability, for instance, in the stainless steel segment.

In no way does this article imply that inflation improves investment climate. Nevertheless, it does point out the necessity of a broader analysis of inflation as a phenomenon, suppressing which may result in slower lending growth.