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Khodorkovsky Release Is Nice, But Not Enough

By James Beadle

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It does not matter what real crimes former Yukos CEO Mikhail Khodorkovsky may have committed as he rose to become the richest man in Russia at the end of the 1990s. The highly selective case against him remained an open wound in the country's investment reputation for an entire decade. Now that he has finally been released, can Russia expect a sharp change in global investor sentiment?

Unfortunately, for the country's business community, the short answer is no. Khodorkovksy's release is great news. It lifts a huge dark cloud from Russia's financial reputation. But in the end, his imprisonment was only a symptom of a much larger and pervasive economic disease. Russia has spent the last 10 years marching down an economically debilitating path, at odds with the values and ideals of the 21st century globalized environment. Although his release was positive news, it does not reverse the destructive path that it symbolized.

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Not all is bad, though.

While President Vladimir Putin's announcement ending 10 years of personal acrimony was a complete surprise, it appears to mark a change toward realpolitik. The signs are increasingly hopeful that Russia is moving back toward a more pro-market phase. It has been clear for several years already that Russia's pre-crisis growth model is broken and that the missing component of gross domestic product growth is investment. Sure enough, the government, led largely by Prime Minister Dmitry Medvedev, has made improving the investment climate a top priority.

The catch is that what investors despise more than anything else is being duped. Many agree that the government is today committed — at least for now — to its efforts to begin a new era, but investors will take a long time to forgive, forget and trust once more. Fresh in their memories are repeated instances of state-owned enterprises abusing their privileged positions to seize assets and market share, the rewriting of rules that define investment returns for long-term projects and arbitrary application of regulations and taxes — all of which are underwritten by a pervasive environment of systemic corruption.

The hidden costs of operating in Russia were one thing when the economy was booming and revenue growth more than compensated. But growth has slowed now, and those hidden costs have only increased. No wonder that even Russia's wealthiest citizens are scaling back investment, keeping their offshore money right where they legitimately parked it.

Thus, the backdrop is bleak, but Russia is changing because it has no other choice. Without investment, there will be no growth. And without growth, the political elite will struggle to retain the popularity it needs to secure its own future. Yet, bankers cracking the champagne and dusting off their initial public offering books might want to pause for thought. There are three key threats that lie in Russia's path over the next 12 months:

1. Time. There are certainly members of the Medvedev Cabinet who understand the extent of the damage inflicted on Russia's investment reputation over the past 10 years. These politicians are leading reform efforts and understand that there is a long road to exoneration. If, however, their superiors get impatient or fail to grasp how long the journey back to the beginning will take, then there will be a risk of policy reversal, unleashing new rounds of anti-business activity with a populist bent.

2. Oil price. As much as there is a long road to reputation repair, there is also a long road to economic reform. Today, everyone understands that Russia needs to reduce its overdependence on natural resources. This process has started, but it will take many years to deliver substantial results. Meanwhile, Russia's economic outlook and political path remain

dependent on stable oil prices. As U.S. shale extraction continues to boom, Iran flirts with returning to the global marketplace and developed economies continue to improve their energy efficiency, the stability of oil prices remains a key concern.

3. Russia's failure to institute reforms. During his first news conference since being released, the former oil tycoon made clear that one of his primary goals will now be campaigning for those political prisoners still incarcerated. In other words, Khodorkovsky will dedicate himself to reminding the world how far Russia travelled from its relatively healthy, but painful, path of the late 1990s and early 2000s. Investors would do well to welcome such behavior. If the crowd gets a sense that Russia is really reforming, it will rush in, bidding up prices to discount future political change. Investors and the government itself need independent analysts to track real-time developments, notwithstanding that such activity superficially appears to hamper the extent to which achieved reforms are recognized and rewarded.

There is plenty that can go wrong then. But for now, there is also a growing sense that Russia is on the long path to rehabilitate itself with the global investment community. If the political elite can remain focused and sufficiently manage expectations, there is every chance they can deliver real improvement.

If so, Russian money will come back first, closely followed by foreigners, who are as eager for a genuine opportunity as they are cautious about being deceived again. The catch is that it will take time to get there. Russia's equity market differs from many of its peers because investors are no longer willing to give it the benefit of the doubt. Given the depth of the problems and the readiness of people like Khodorkovsky to counter irrational exuberance, it will be a long time before equities will function as a reliable discounting mechanism.

Global macro and domestic drivers point to a healthy year for both Russia's economy and its financial market — more so than depressed consensus economic forecasts imply. But at best, this is likely to be a year of stabilization, restoring Russia's reputation and laying the foundations for healthy gains in the years ahead.

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