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Khodorkovsky Pardon Bodes Well for Economy

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By **Chris Weafer**

A great deal has been written recently about the early release from prison of former Yukos CEO Mikhail Khodorkovsky. Many commentators have concluded that the timing of his release was linked to the upcoming Sochi Olympics, now less than 50 days away, and that the move was possibly an effort to deflect media attention away from the Ukraine situation. Undoubtedly, there is some element of truth in both of these assumptions. But let us also place this news in the broader context of President Vladimir Putin's recent comments about the country's poor economic performance and the now urgent need for accelerated efforts to boost confidence and investment flows. Finally drawing a line under what has been one of the most egregious incidents in Russia's modern history can also be viewed much more positively — or perhaps hopefully — as part of that new reform focus.

The year 2013 was terrible in terms of economic growth. From 3.4 percent in 2012 and early expectations of a repeat performance this year, the economy is much more likely to report growth of only 1.3 percent. In global terms, that is still a good number, but it is certainly a long way from the 4 to 5 percent growth promised by Putin when he was re-elected in 2012. A second consecutive year of poor growth will create a sense of stagnation and a more negative backdrop coming into the next election cycle.

The good news is that the president is finally starting to pay attention. In his mid-December address to the Federal Assembly, there was a very important shift in his rhetoric about the economy. The president's diagnosis of the reasons for poor growth and his view of what needs to be done about it also changed markedly in that address. This is not a case of "we have heard this all before," as Putin has previously been very consistent with the view that Russia's economic problems are a consequence of global contagion and, therefore, the domestic policy priority should be to maintain fiscal and monetary stability while waiting for the rest of the world to sort itself out.

This change in attitude meant that the debate about the need for stimulus that was so prevalent in the spring this year was totally abandoned in favor of another "battening down of the hatches" immediately after U.S. Federal Reserve Chairman Ben Bernanke's tapering comments in May led to a sharp rise in currency volatility in emerging markets. Moving to Russia, stimulus and cutting rates was then deemed too dangerous. But while the decision led to greater ruble stability, the pace of growth in such areas as retail spending and capital investment continued to slide. These have been the two biggest factors behind the poor performance of the economy this past year.

In his mid-December address, however, Putin acknowledged that the slump had actually been caused by domestic policy failures. Still, even though the urgency is now better acknowledged, it is not expected that the debate over what specific policy changes to make will gain momentum until the spring. For the next two months, one policy priority will eclipse all others: delivering a controversy-free and efficiently managed Winter Olympics.

By then the sense of urgency will very likely have increased. The first quarter indicators are expected to be bad, especially on a yearly comparison with what was a strong first quarter this year. And that is a good thing. Russia has a bad habit of ignoring forewarnings of impending crises, taking remedial action only when already suffering the consequences of the problem. One only has to recall the persistent warnings of former Finance Minister Alexei Kudrin about the probability of a growth collapse. It is also very encouraging to see that he has been brought back into a formal economic advisory role as a member of the presidium of the presidential Economic Council.

Realizing the goal of returning growth back toward the 3 percent level in 2014, i.e. as an interim step toward the main goal of sustaining annualized growth at 4 to 5 percent, will require fiscal and monetary policy changes and faster progress with the reform agenda. With that in mind, investors' wish list for 2014 includes some clear actions from the government, including;

• greater efficiency in budget spending to shift resources toward growth boosting projects and away from non-productive areas such as defense spending

• the start of cuts to the Central Bank's benchmark interest rate and a big cut in the commercial bank's average lending rate to small businesses

• an increase in infrastructure spending

• greater determination to meet OECD conditions, which means improving investors' perception of Russia's risk and its business environment

• an improvement in corporate governance, especially in the state sector

The battle for lower interest rates will certainly be one of the tough issues. The Central Bank is opposed to any cuts in its benchmark rate so long as inflation is even close to 6 percent. Inflation has again been recently rising and is expected to end the year close to 6.5 percent. Putin's economic adviser recently demanded a rate cut as part of a growth stimulus package. That looks like it will be a key battle in the spring.

Ultimately it is recognized by all sides that the economy needs a new growth driver based on higher investment spending, and the only way to generate that is to create the conditions which lead to higher inward investment flows and lower capital flight. Although the decision to grant a presidential pardon to Khodorkovsky drew a line under one of the most nefarious episodes in Russia's modern history, on it's own, this surprise move is not a magic wand and will not lead to a boost in capital flows. Since Khodorkovsky's incarceration, the Yukos case as a poster child of Russia's business risk has been edged out by the Sergei Magnitsky case.

Today, investors are much more focused on what is actually being done to reduce the incidence of corruption, to improve the rule of law and to reduce bureaucratic hurdles. Progress remains slow. Despite the dismissive comments of Kremlin critics, however, there has been measurable progress in 2013. The number of former officials dismissed and now under formal investigation for corruption has increased. Russia moved up 20 places in the World Bank's Ease of Doing Business survey as the number of bureaucratic procedures and business costs are cut.

Of course, much more needs to be done across all areas of the reform program. One of the biggest obstacles in the past has been the intransigence of bureaucrats. Prime Minister Dmitry Medvedev directly blamed vested interest groups within the state bureaucracy for the big cut in the state's privatization program last spring. It must be said that attitudes among this powerful group will not be changed with a presidential signature.

That said, Khodorkovsky's release, along with the president's acknowledgement of the root cause of the current slowdown, plus his change of stance on the urgency for policy and spending reforms, at least offer greater optimism that 2014 will be the transition year we have been hoping for. The old model is broken. It needs to be replaced.

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