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How the BRICs Stack Up: Part 3 Russia: One Step Forward, Two Steps Back

Back in the 1990's, Russia's access to cheap natural resources enabled their economy to boom. As other world economies began to expand, Russia was a beneficiary of spiking global demand for their resources. As other global suppliers began to produce commodities, Russia's market share eroded and their relative cost advantage was lost. However, governmental corruption and the treachery further complicated foreign investing because of the difficulty of gauging risk. In the end, commodities topped out and foreign capital fled.

When will it be safe for foreign capital to return to Russia? The political realm in Russia is rife with self-dealing and corruption. It is impossible for business to be transacted in this environment. Even as recently as 2005, the Russian government showed its dark side when it committed fraud and human rights abuses in what has come to be known as the Magnitsky story.

The Magnitsky Act. Sergei Magnitsky was an attorney for the biggest portfolio investor in Russia, Hermitage Capital Management (HCM). William Browder was his boss as well as a big supporter of Putin. HCM made a name for themselves and money from their investments by putting pressure on Russian corporations to clean up their corporate structures. However, sometime in 2005, Hermitage campaign irked some powerful politicians, resulting in Hermitage being kicked out of Russia. Notice that Russian decision-makers were willing to hurt their own economy, kicking out investors and foreign capital for their corporations, in order to protect the elite.

To further prove a point, Russian officials, police officers, and courts conspired to seize, from the wreckage of the firm, a tax refund of \$230 million. Magnitsky called this claim a fraud and he was thrown into jail in 2009 where he died of neglect and abuse.¹

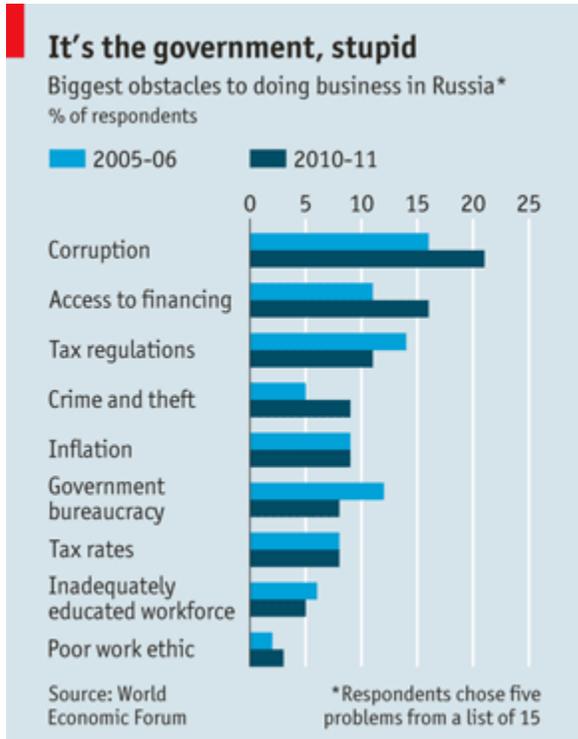
Why is there such a fixation in America about the Sergei Magnitsky story? Haven't there been many equally tragic human rights abuses in Russia? Yes, indeed, many whistle-blower citizens have dared to challenge the "establishment" that is the Russian government and their cronies. This case was especially tragic, as Russia demonstrated their disregard for the interests of their people by rigging the system for the benefit of the ruling clique.

In response, the U.S. passed the Magnitsky Act, which bans visas and freezes assets of anyone implicated in the lawyer's mistreatment. Russia then decided to halt all adoptions of Russian orphans by American families. This again hurt their own country more than anyone else. Secondly, Putin submitted a bill that bans officials and lawmakers from having foreign bank accounts or investing in foreign sovereign bonds. Additionally, they must declare all property owned abroad. This has created some angst and displacement among Russia's elite, even causing the head of the Russian ethics committee to resign.²

As you can see, this story seems to illustrate a bleak picture of a land that is still ruled by a few elitists.

¹ Economist. "Sergei Magnitsky. The enemy within" March 9, 2013.

² Economist. "Putin's Purges" March 2, 2013



On a more positive note, Russia is endeavoring to build its own version of “Silicon Valley” in an area that is called Skolkovo. Located near Moscow, it will be home to a research university with 1,800 students, 40 corporate R&D centers and 1,000 technology start-ups. It is being created to be its own economic zone (like Shenzhen in China), with tax breaks and special treatment of visas and imports. It aims to bring researchers, entrepreneurs, and investors together to help Russia modernize more quickly. The five areas of emphasis will be biomedical, energy-efficiency, space technology, nuclear technology, and information technology.³

What will be the biggest impediment to this Skolkovo project? The funding. Local capital is limited and foreign capital is not pouring in, because Western investors still see Russia as risky. Foreign investors will likely choose to funnel investments through offshore companies. Massachusetts Institute of

Technology (MIT) will be helping to set up the research university. Several large multi-national companies, including Cisco, IBM, and SAP will open up research laboratories to collaborate with SkTech. These companies are incentivized to do this because the Russian government is a large customer of theirs.³ However, the tale of Hermitage Capital Management and the ultimate demise of Magnitsky serves as a warning to potential business owners, local and foreign. Oleg Deripaska, the current head of the Gorky Automobile Plant (GAZ) and a famous oligarch who made his wealth in the Aluminum boom of the 1990’s, states, “You can’t do capitalism without capital.”⁴

The pervasive culture of corruption throughout the economy, from the smallest businesses to the highest ranking officials, makes Russia a risky investment. This culture has become a way of life and until the government is willing to protect foreign investors, Russia will struggle to attract the capital it needs to improve its economy.

- Rachel Wakefield, CFA

³ Economist. “Innovation in Russia. Can Russia create a new Silicon Valley?” July 14, 2012

⁴ Economist. “Lurching into the Fast Lane” July 12, 2012